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HOW MUCH SCOPE FOR GROWTH- AND EQUITY-FRIENDLY CONSOLIDATION?

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BETTER POLICIES FOR BETTER LIVES

Remarks

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The objectives:

- Propose a structured way of looking at the selection of consolidation instruments in the light of their effects on:
  - growth (short and long term)
  - income inequality (short and long term)
  - global rebalancing
- Illustrate this approach with quantitative simulations
- Highlight the role of structural reforms

Consolidation and other objectives

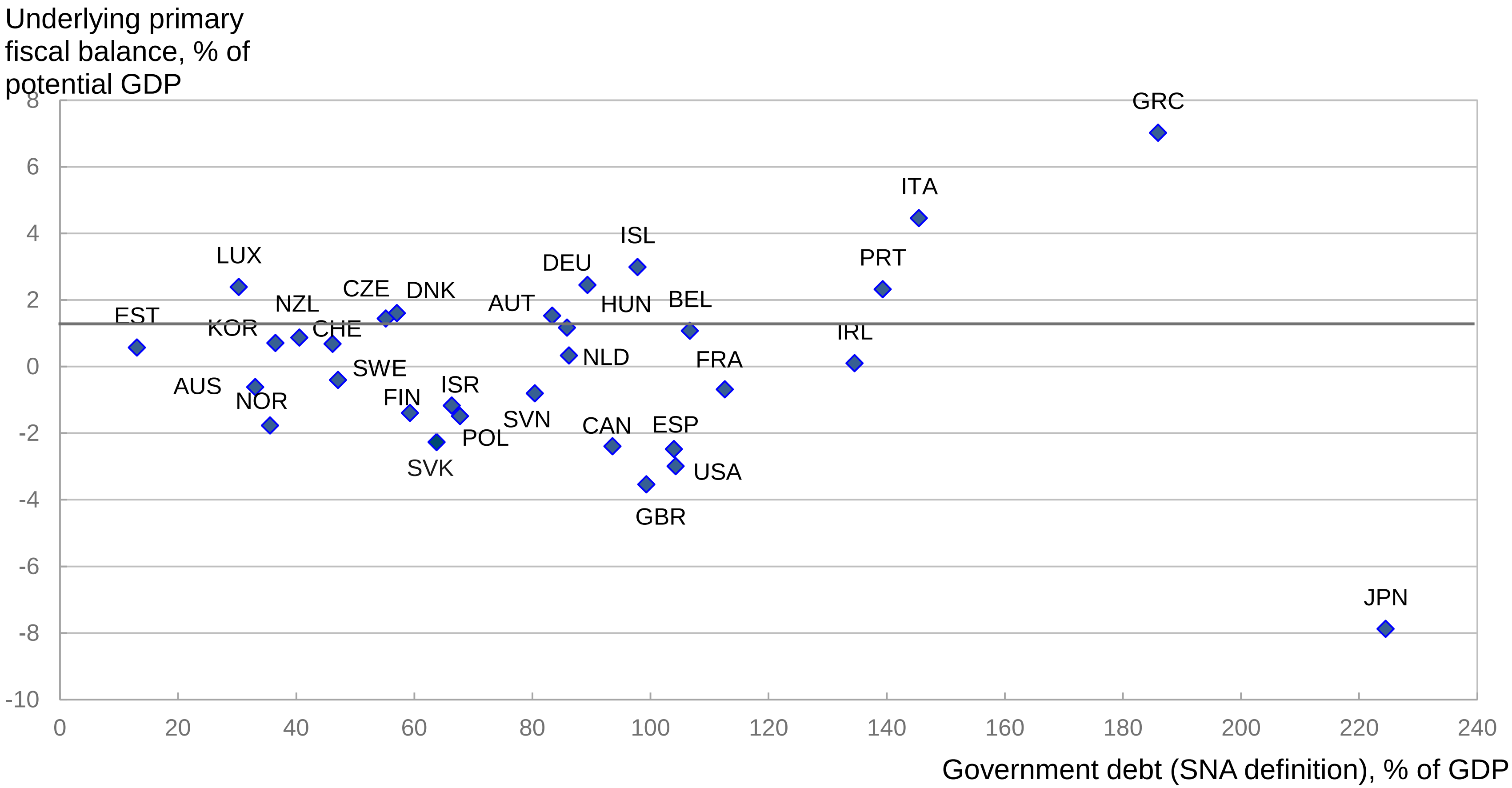
- Bring gross debt to 60% of GDP <u>and</u> keep it stable.

→ Defines consolidation needs: short <u>and</u> long term

- Other objectives
  - Output: long-term but also short-term
  - Equity
  - Global rebalancing

→ Guides the choice of instruments

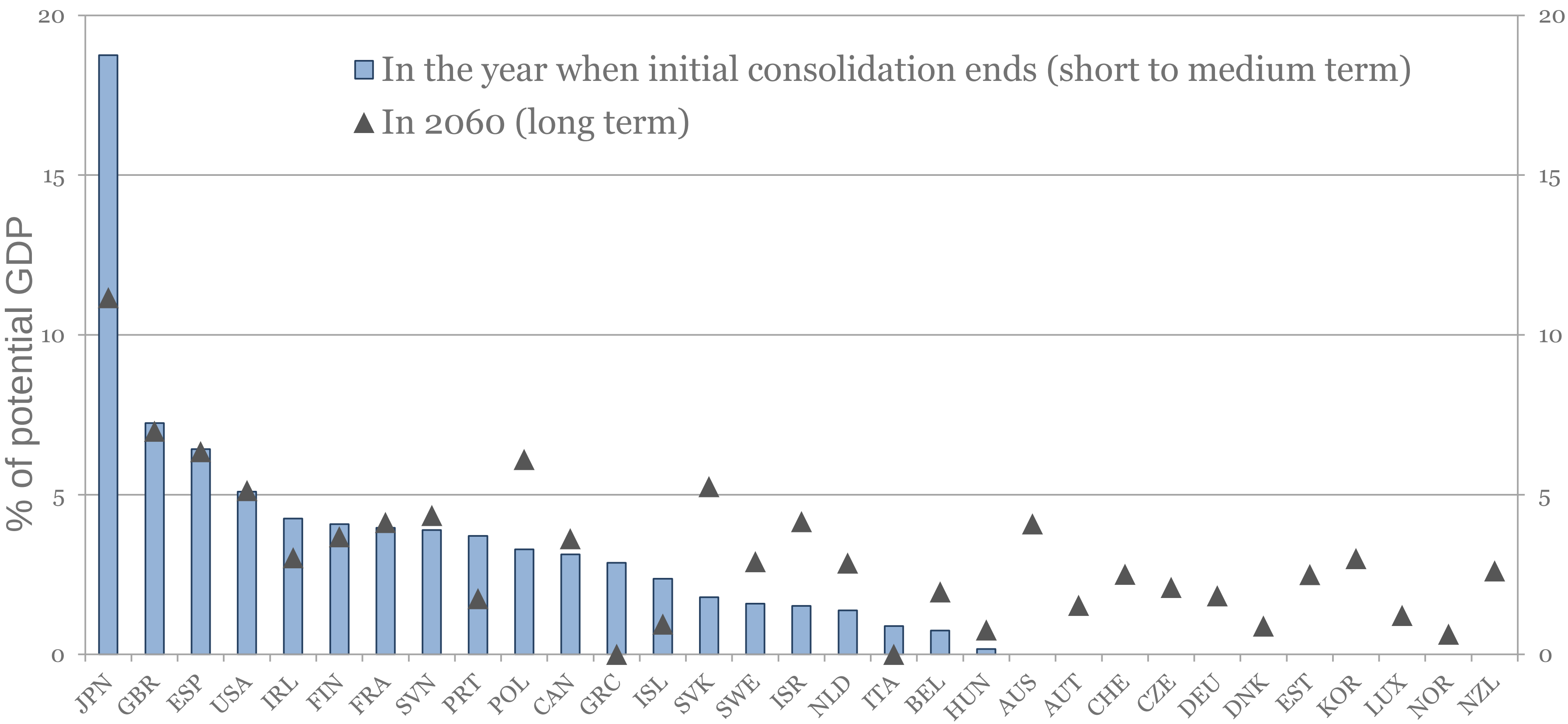
Government debt and deficit as of end-2013



Source: OECD Economic Outlook of May 2014 database.

Further consolidation is needed over the outcomes achieved as of end-2013

Difference between debt-control and baseline underlying primary surplus



Source: Update of the estimates presented in Cournède, Goujard Pina (2014) using OECD Economic Outlook of May 2014 database.

The instruments of consolidation: spending side

- Education (public consumption)
- Health (public consumption)
- Other public consumption except family policy
- Pensions (cash transfers)
- Unemployment (cash transfers)
- Sickness and disability (cash transfers)
- Family policy (public consumption and cash transfers)
- Subsidies
- Public investment

The instruments of consolidation: revenue side

- Personal income taxes
- Social security contributions
- Corporate income taxes
- Environmental taxes
- Consumption taxes (non-environmental)
- Recurrent taxes on immovable property
- Other property taxes
- Sales of goods and services

Assessing the instruments: highlighting trade-offs and complementarities

- Rough assessment (from -- to ++) are given to the effects of each instrument on:
  - short- and long-term growth
  - short- and long-term equity
  - global rebalancing
- Based on wide body of work including
  - Study on the Sources of Growth
  - Going for Growth
  - Wider literature
  - New econometric estimates

Assessing the instruments

	Growth		Equity		Current account[a]
	ST	LT	ST	LT	ST
Spending cuts					
Education	--	--	-	--	+
Health services provided in kind	--	-	-	-	++
Other government consumption	--	+	-		+
Pensions		++			++
Sickness and disability payments	-	+	--	-	++
Unemployment insurance	-	+	-		++
Family	-	-	--	--	+
Subsidies	-	++	+	+	+
Public investment	--	--			++
Revenue increases					
Personal income taxes	-	--	+	+	+
Social security contributions	-	--	-	-	
Corporate income taxes	-	--	+	+	++
Environmental taxes	-	+[b]	-		+
Consumption taxes	-	-	-		++
Recurrent taxes on immovable property	-				+
Other property taxes	-		++	+	+
Sales of goods and services	-	+	-	-	+

Notes: (a) current account effects refer to a deficit country and would switch signs for a surplus country
(b) this + sign relates to welfare effects as the GDP impact may be ambiguous.

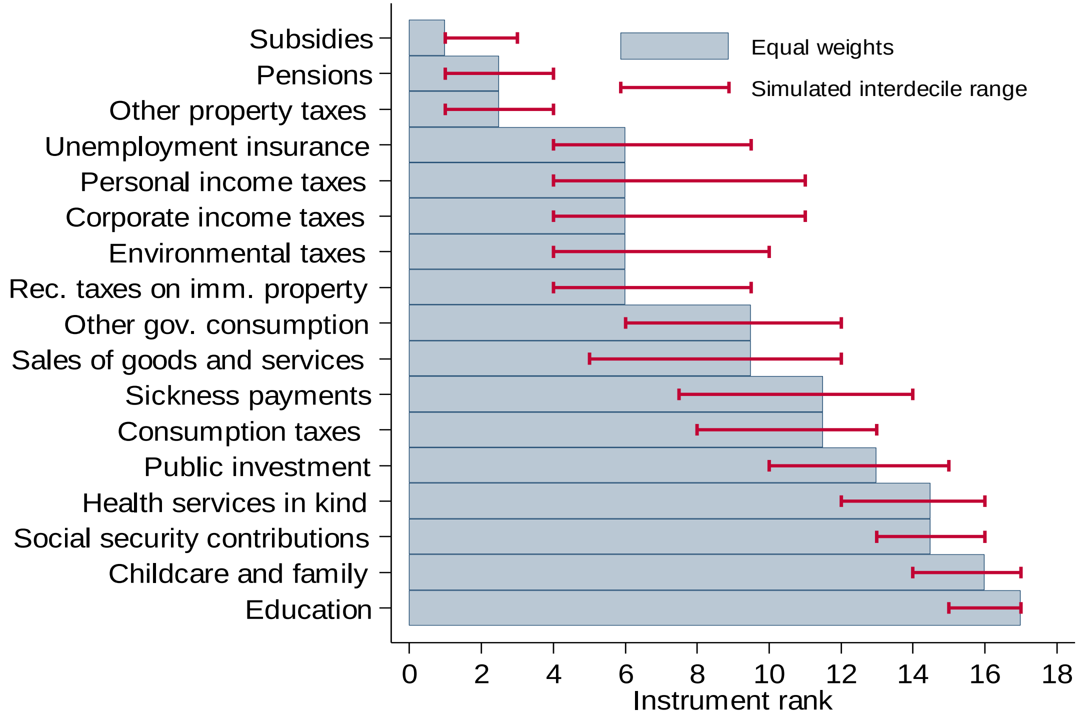
Source: Cournède, Goujard and Pina (2014).

Turning this assessment into a possible generic ranking

1. Each plus sign is valued as +1 and each minus sign as -1
2. Equal weights are given to each column: 0.25 each for short- and long-term growth and equity. [the current account is dealt with separately].
3. As a result each instrument gets a score and is ranked accordingly from highest to lowest.

A possible generic hierarchy of consolidation instruments

Ranking from most (highest score) to least (lowest score) desirable instrument of consolidation



Note: The rankings are based on the assessment in Table 2. Scores of +1 and -1 are given to each + and- signs respectively, each objective is given a weight, and the resulting indicator is used to rank instruments. Each individual instrument score based on the assessment in Table 2 is kept with a probability of ¾ or increased by +1 with a probability of 1/8 or reduced by -1 with a probability of 1/8. Weights ranging each from 0.15 to 0.55 and summing to unity have been given to each objective. Weights have been restricted to no smaller than 0.15 because each objective is considered important. A total of 40,000 random draws have been made.

Source: Cournède, Goujard and Pina (2014).

Adapting the hierarchy to country circumstances

- Short-term growth: cyclical weakness (output gap) and risk of hysteresis (2007-12 increase in long-term unemployment).
- Equity: income distribution and poverty.
- Current account: relative to country and OECD GDP.

  - Five country clusters
  - A specific hierarchy for each cluster

Adapting the hierarchy to the long-term perspective (2060)

- Long-term effects only:
  - growth
  - equity
- Current-account effects ignored

Spending reductions move up the list when looking at long-term consolidation.

Rankings are differentiated by country group in the short term

Instruments	Generic ST ranking	Cluster-specific short-term ranking					Long-term ranking
		1*	2*	3*	4*	5*	
Subsidies	1	1	1	2	2	1	1
Pensions	2-3	3	2	1	1	3	2
Other property taxes	2-3	2	3	3	3	2	3-6
Unemployment benefits	4-8	7	4	4	4	9	3-6
Personal income taxes	4-8	5	8	9	9-10	8	10-12
Corporate income taxes	4-8	4	5	7	9-10	12	10-12
Environmental taxes	4-8	8	6	5	4	4	3-6
Recurrent taxes on immovable property	4-8	6	7	6	6	5	7-9
Other government in kind consumption	9-10	9	9	11	11	6	3-6
Sales of goods and services	9-10	10	10	8	7	7	7-9
Sickness and disability payments	11-12	13	11	10	8	11	7-9
Consumption taxes (other than environmental)	11-12	11	12	12	12	13	10-12
Public investment	13	12	13	13	15	15	13-14
Health services provided in kind	14-15	14	14	14	16	16	13-14
Social security contributions	14-15	15	16	15	13	10	15-16
Family	16	16	15	16	14	14	15-16
Education	17	17	17	17	17	17	17

1*: AUS, CAN, EST, ISR, ITA, JPN, KOR, NZL, POL, PRT, GBR / 2*: USA
3*: GRC, IRL, ESP / 4*: AUT, BEL, CZE, DNK, FIN, FRA, HUN, ISL, NOR, SVK, SVN
5*: DEU, LUX, NLD, SWE, CHE.

Source: Cournède, Goujard and Pina (2014).

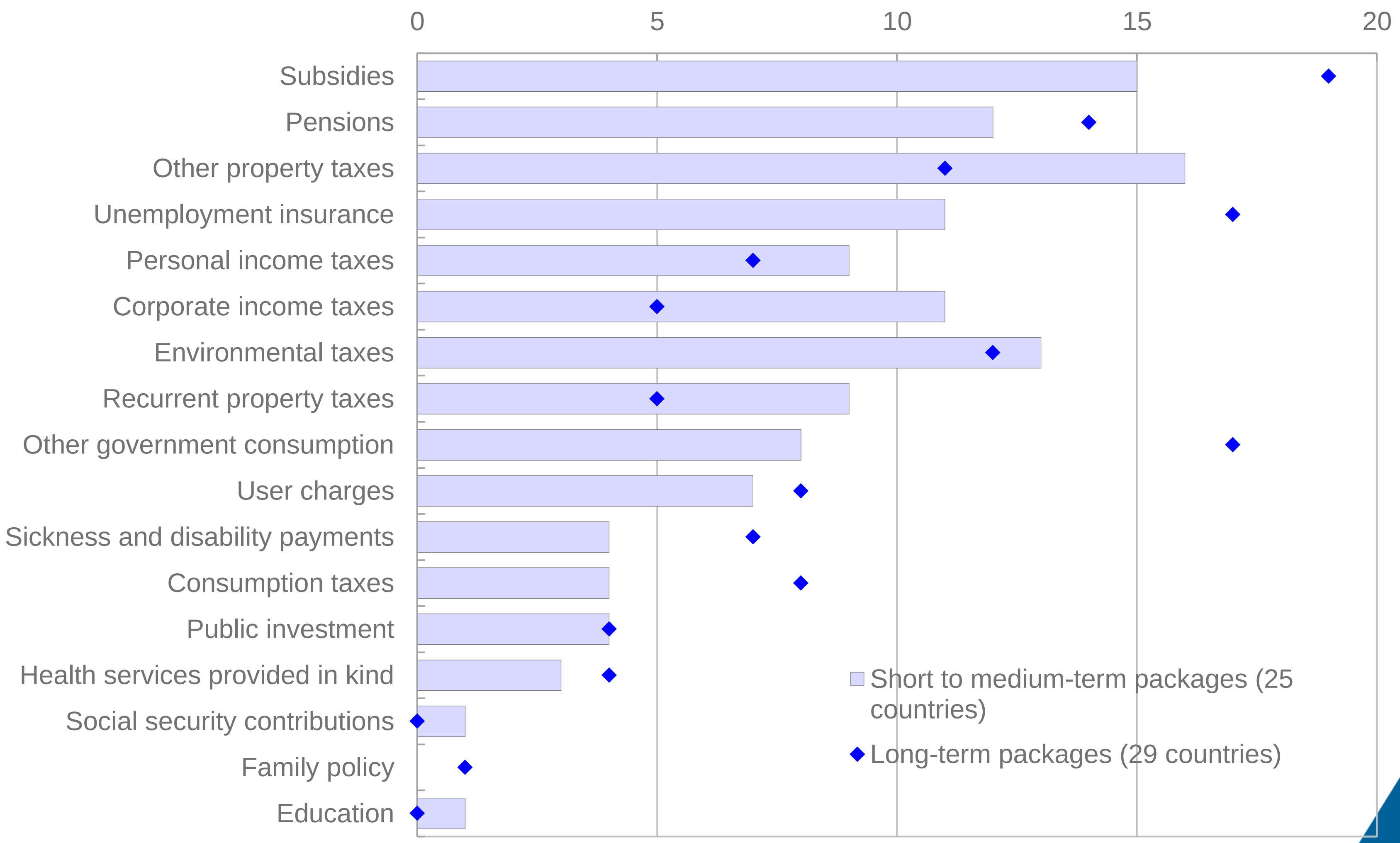
The optimal use of instruments depends on:

1. Consolidation needs <u>as of end-2012</u>
2. Hierarchy of instruments: instruments are used one by one until consolidation needs are met.
3. Room for manoeuvre in each instrument:
   - Move until reaching the group of the ten OECD countries with lowest spending or highest taxation for the instrument under consideration (avoid extreme policy settings)
   - No move larger than one standard deviation (respect national preferences as revealed by existing spending/tax structures)
   - Specific technical adjustments:
     - Reduced margins for pensions (especially in the short term)
     - Adjustments for pensions and education (demography) and for unemployment benefits (structural unemployment level)
     - Leeway evaluated jointly for personal income tax and social contributions

Two sets of simulations for each country

- Short to medium term simulations:
  - short- to medium-term consolidation needs
  - Instrument hierarchies are differentiated by country cluster depending on circumstances (cyclical position, inequality level, current-account position)
- Long-term simulations:
  - long-term consolidation needs
  - Uniform instrument hierarchy (considering only long-term growth and equity effects)

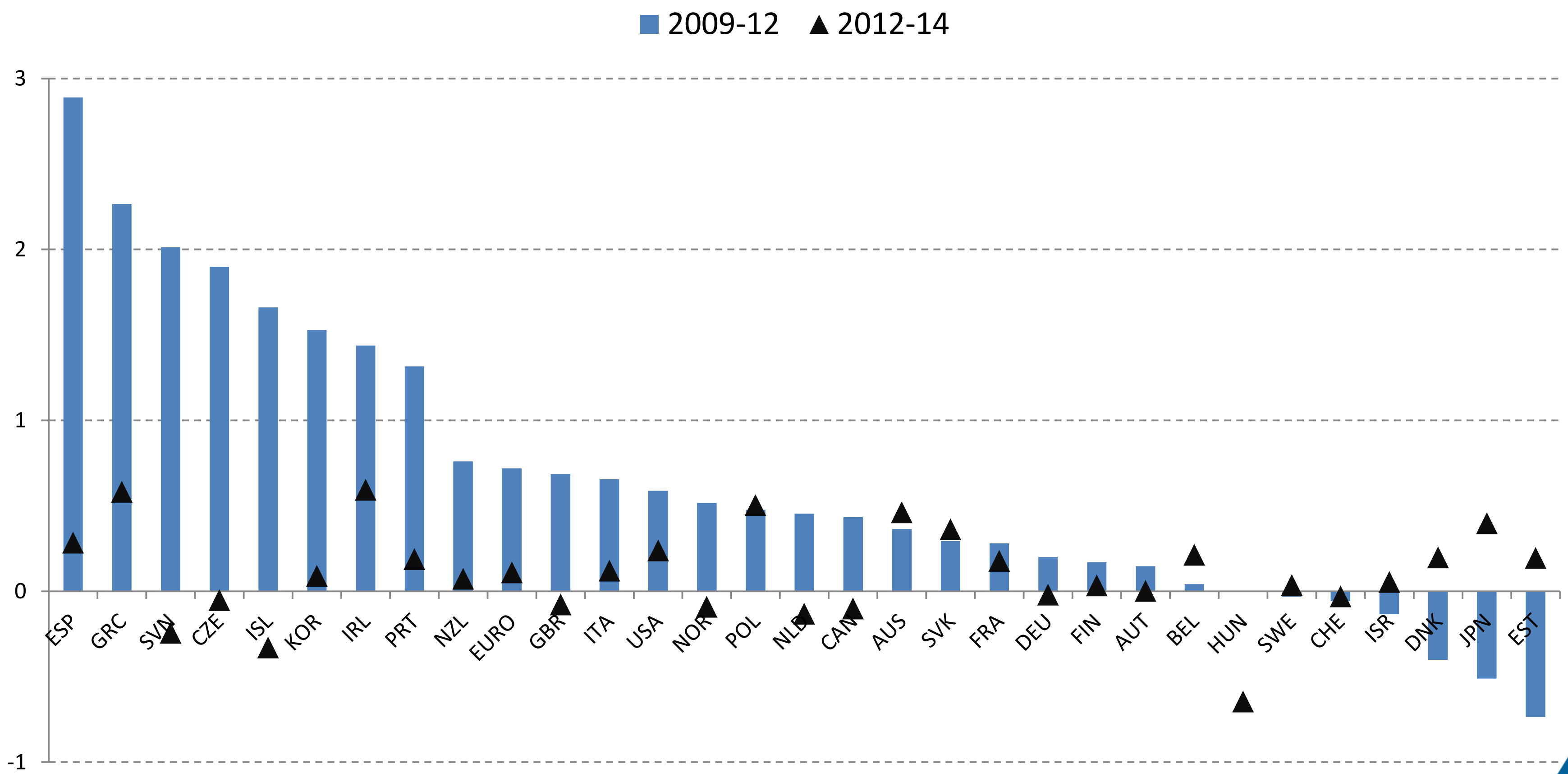
Number of countries using instruments in simulations



Source: Cournède, Goujard and Pina (2014).

Fiscal consolidation in practice: the role of public investment cutbacks

Consolidation achieved through cuts in net public investment, % of potential GDP



Source: OECD Economic Outlook No. 93.

How far down the hierarchy of instruments do countries need to go?

Simulated short- to medium-term consolidation packages:

- Top-half instruments only in sixteen countries (e.g. Australia, Canada, Netherlands).
- Top-half instruments mainly in 6 countries (e.g. Finland, France).
- Bottom-half instruments account for most of consolidation in Japan, the United Kingdom and the United States.

How far down the hierarchy of instruments do countries need to go?

Simulated long-term consolidation packages:

- Top-half instruments only in 20 countries.
- Top-half instruments mainly in 6 countries.
- Bottom-half instruments account for most of consolidation in three countries: Australia, New Zealand and the United States.

Spending vs. taxes in simulated packages

On average across countries, spending reductions account for:

- 41% of short- to medium-term simulated packages
- 65% of long-term simulated packages

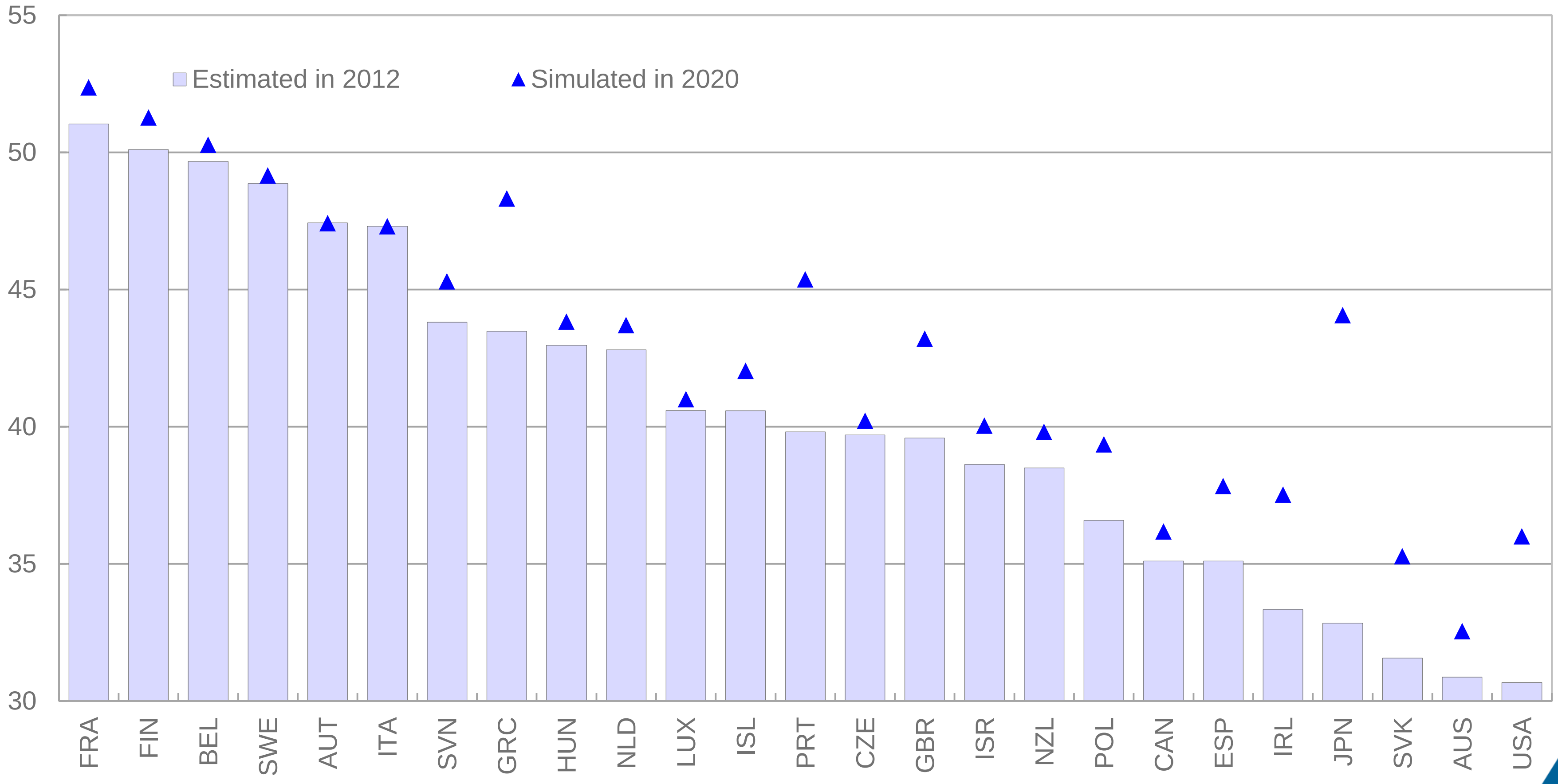
with considerable variation across countries.

Some examples:

- In Japan and the United States, the simulations give a large role to tax increases (70% of consolidation over the medium term).
- France has a very strong potential for spending cuts which make up 73% of the simulated medium-term package.

A medium-term increase in the tax share

Cyclically-adjusted primary government revenue, % of potential GDP



The proposed consolidation packages respect the diversity of tax and spending structures

Standard deviations of spending and tax items as a percentage of potential GDP assuming that the simulated long-term consolidation packages are implemented in full

Spending	2012	2060	Receipts	2012	2060
Unemployment insurance	0.9	0.5	Other property taxes	0.6	0.5
Subsidies	0.7	0.6	Recurrent property taxes	1.0	1.0
Sickness and disability ben.	0.6	0.5	Environmental taxes	0.7	0.5
Family benefits	1.1	1.1	Sales of goods and services	1.1	0.9
Education	1.1	1.1	Corporate income taxes	0.9	0.9
Health services	1.4	1.2	Personal income taxes	3.3	3.1
Other gov. consumption	2.3	1.9	Consumption taxes	2.4	2.0
Pensions	3.6	2.8	Social security contributions	5.3	5.3

Source: Cournède, Goujard and Pina (2014).

Instrument use in illustrative simulations: Slovak Republic

Medium-term consolidation

Instrument	% of GDP
Subsidies	0.5
Other property taxes	0.7
Environmental taxes	0.6

Long-term consolidation

Instrument	% of GDP
Subsidies	0.5
Other property taxes	0.7
Environmental taxes	0.7
Recurrent real-estate taxes	1.0
Personal income taxes	1.8
Corporate income tax	0.2
Consumption taxes	0.3

Source: Cournède, Goujard and Pina (2014) and updated estimates of consolidation needs.

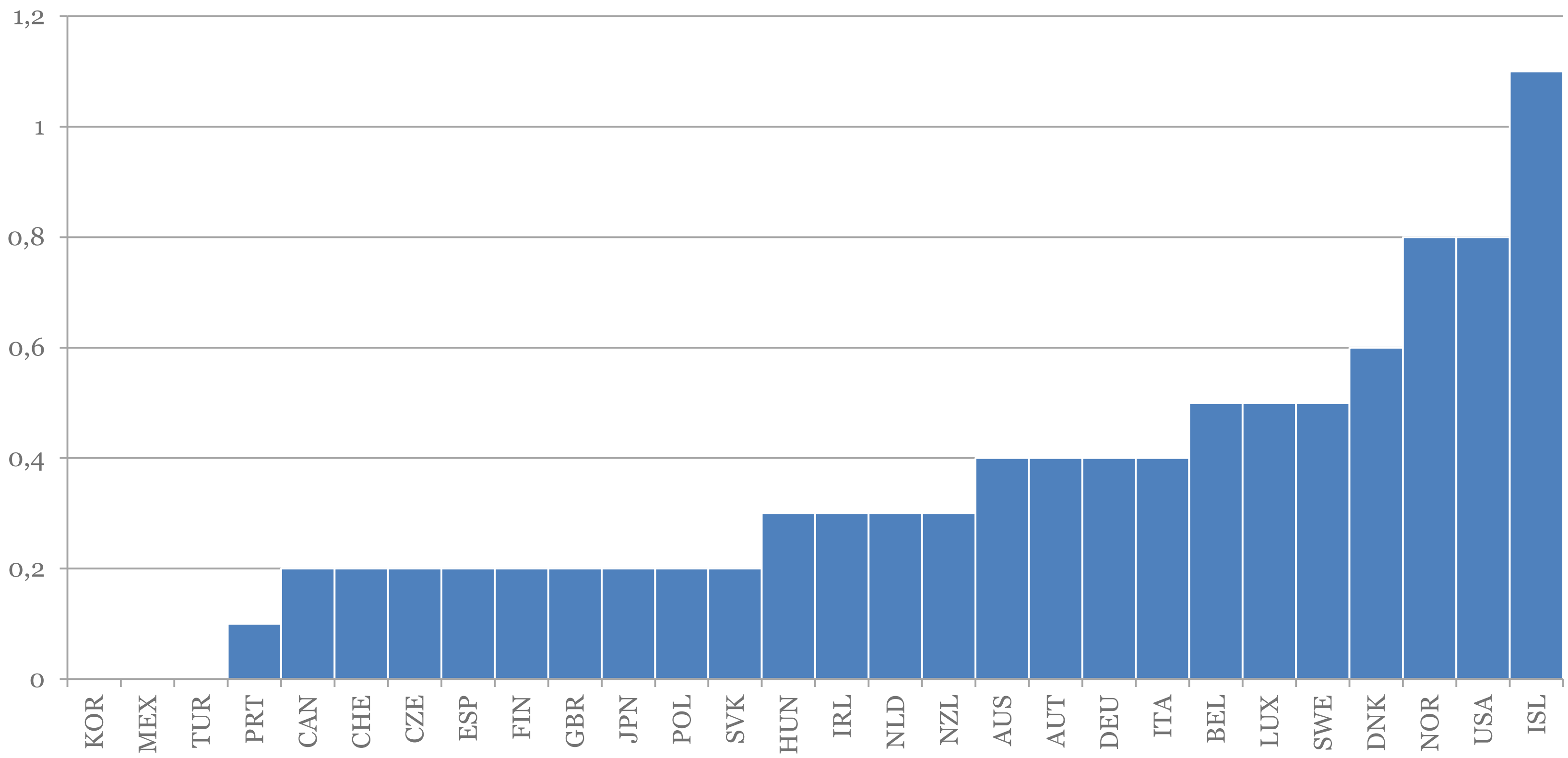
Structural policy has a key role to play

Ease trade-offs between consolidation and other objectives

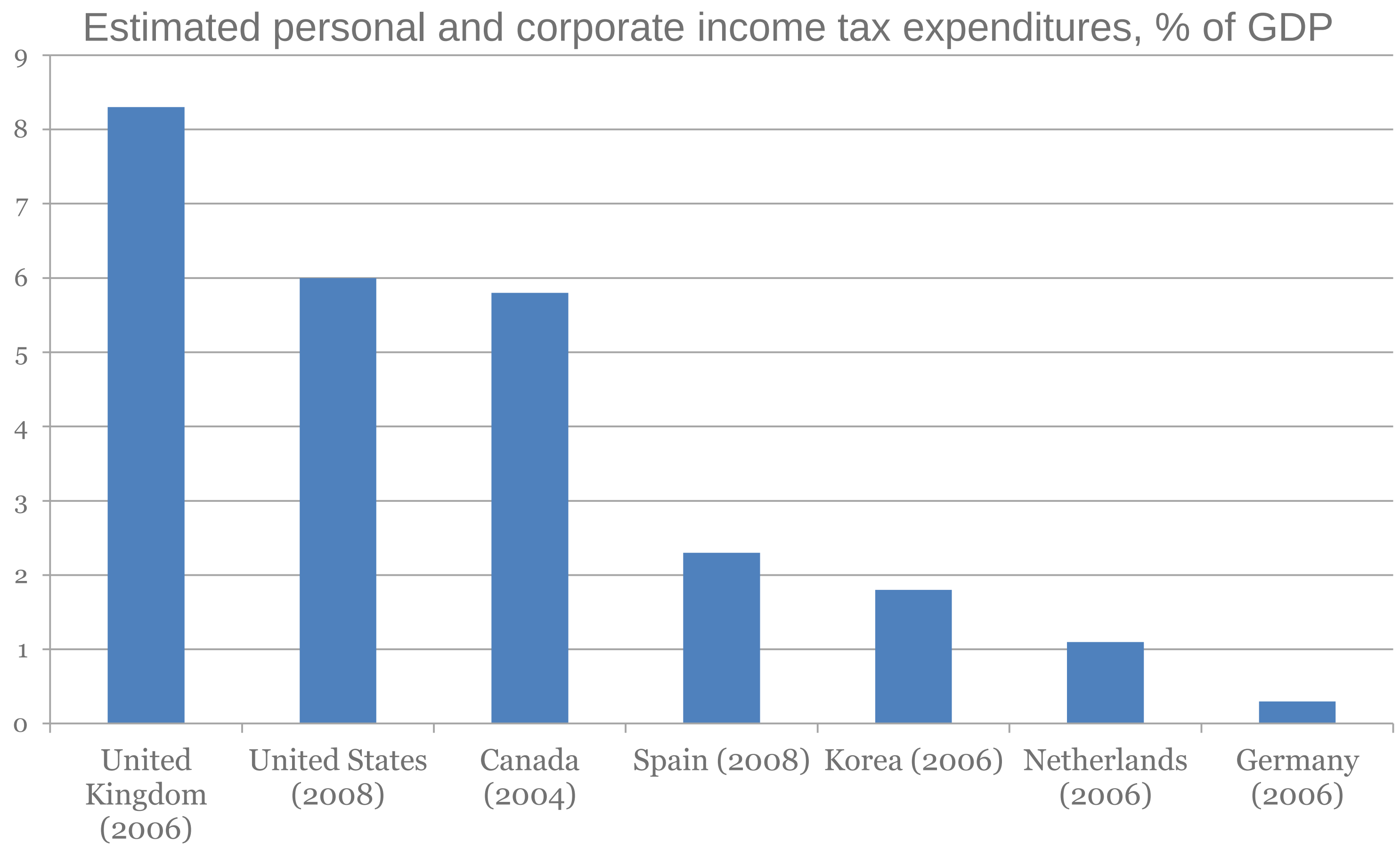
- Spending reductions: *e.g.* efficiency gains.
- Revenue increases: *e.g.* base broadening, reducing tax expenditures.

Potential efficiency gains in primary and secondary education

Per cent of GDP, 2007

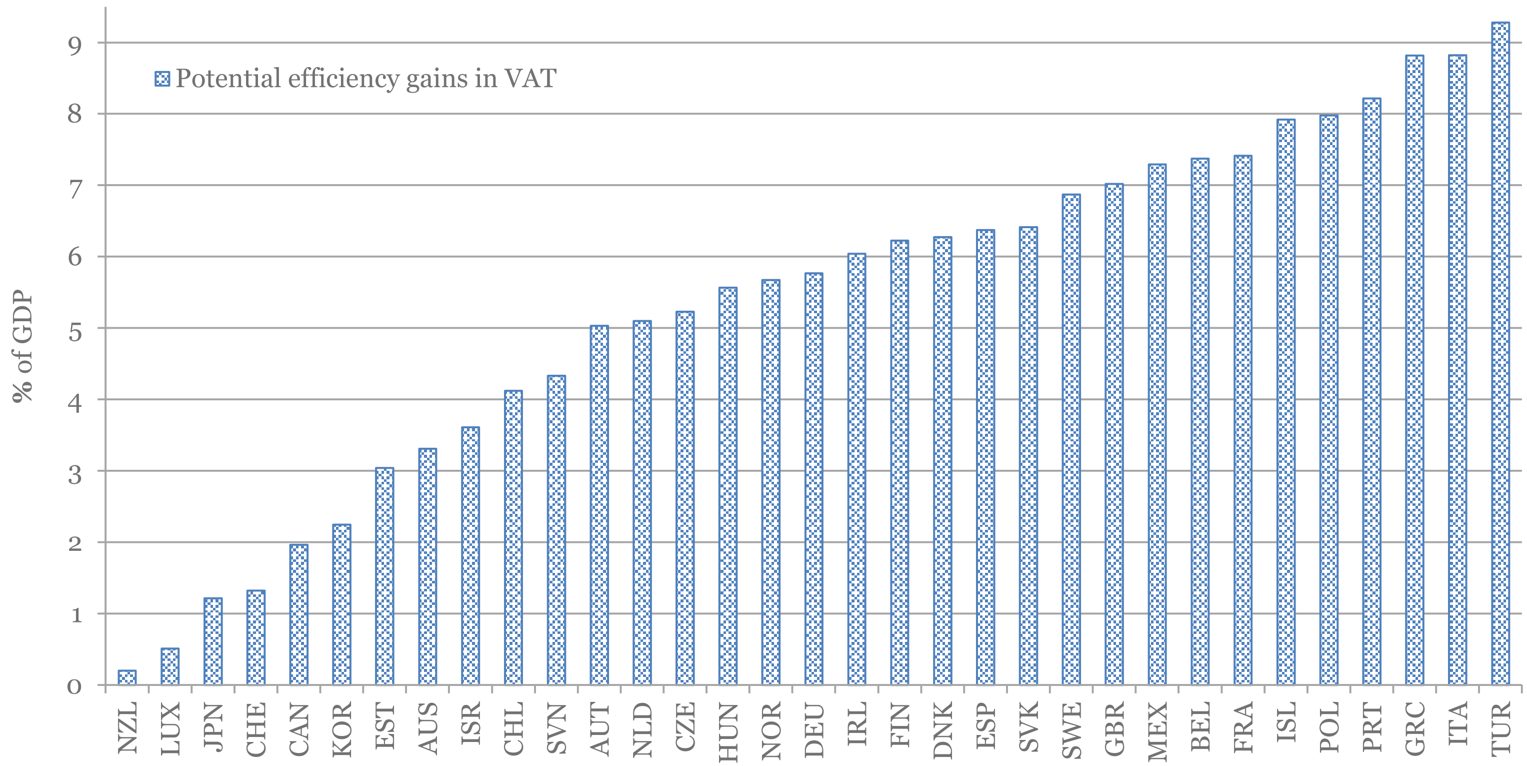


Tax expenditures in personal and corporate income taxes are difficult to estimate but large



Source: OECD (2010), *Tax Expenditures in OECD Countries*.

Illustrative potential efficiency gains in value-added taxation



Note: these highly hypothetical estimates show how much additional revenue could be raised if VAT receipts rose from their current level to become equal to the VAT standard rate times the amount of final consumption expenditure. This is subject to considerable caveats.

Source: Cournède, Goujard and Pina (2014).

A need for integrated policy strategies

- Successful structural reform does not necessarily ensue from fiscal consolidation
- Joint efforts to consolidate and reform can
  - make consolidation more durable, and
  - avoid “quick fixes” to the budget with harmful side-effects.

The full results are available in:

- OECD Economic Policy Papers No. 07, “Choosing Fiscal Consolidation Instruments Compatible With Growth and Equity”, A Going for Growth Report, July 2013.
- Cournède, B., A. Pina and A. Goujard (2014), “Reconciling fiscal consolidation with growth and equity”, *OECD Journal: Economic Studies,* Vol. 2013 Issue 1.
- Barbiero, O. and Cournède (2013), “New Econometric Estimates of Long-Term Growth Effects of Different Areas of Public Spending”, *OECD Economics Department Working Papers*, forthcoming.
- Goujard, A. (2013), “Cross-Country Spillovers from Fiscal Consolidation”, *OECD Economics Department Working Papers*, forthcoming.

BACKGROUND SLIDES

Background slides (not for presentation)

- Metholodogical details
- Further detail on results
- Information on the central-subnational split of best and lowest ranked instruments.

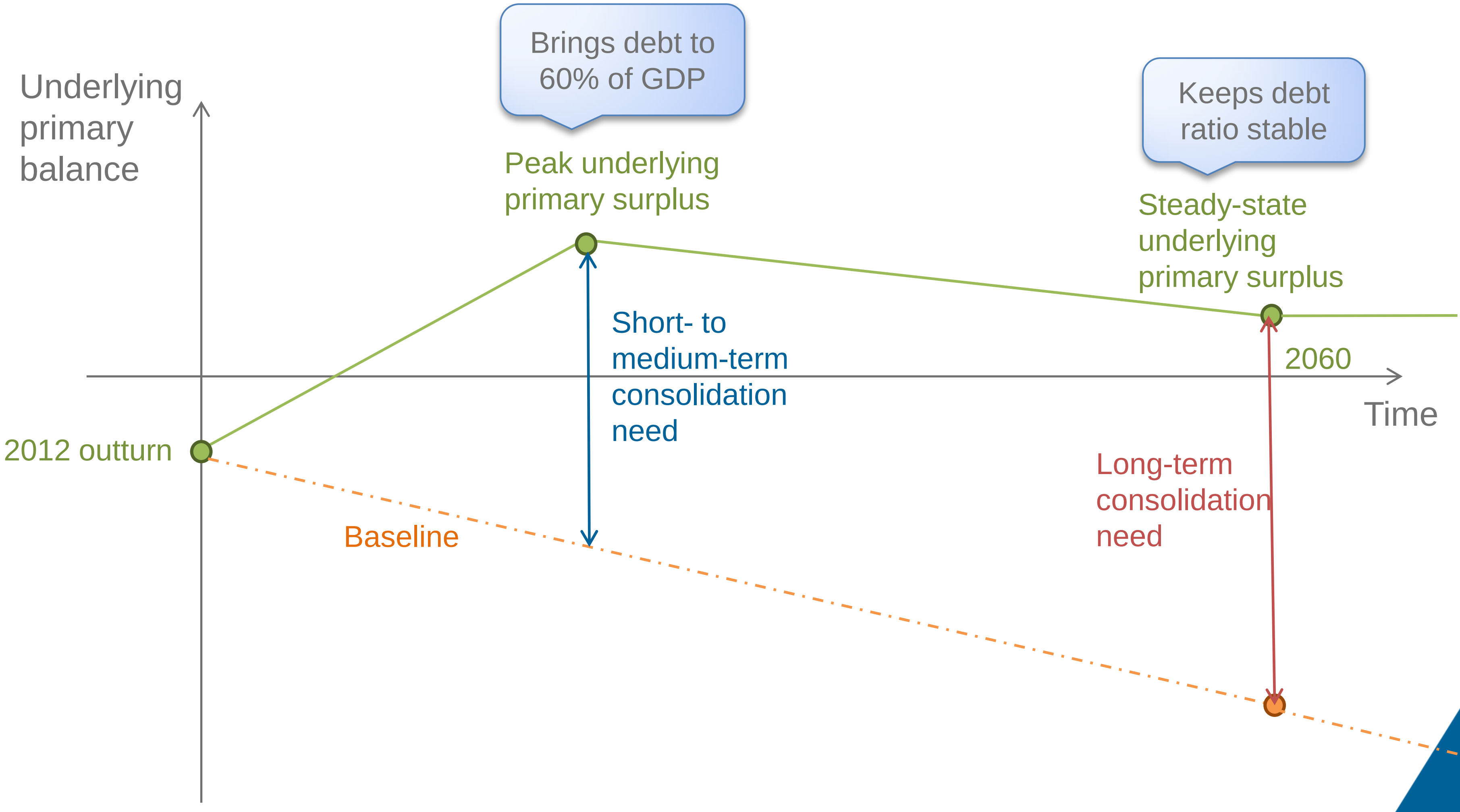
The baseline

- Starts from the underlying primary balance in 2012
- Unchanged fiscal policy except:
  - measures to keep public pension spending constant as a share of potential GDP
  - measures to contain the increase in government expenditure on health and long-term care as in de la Maissonneuve and Oliveira-Martins (2013)

Main features of the simulated consolidation profiles

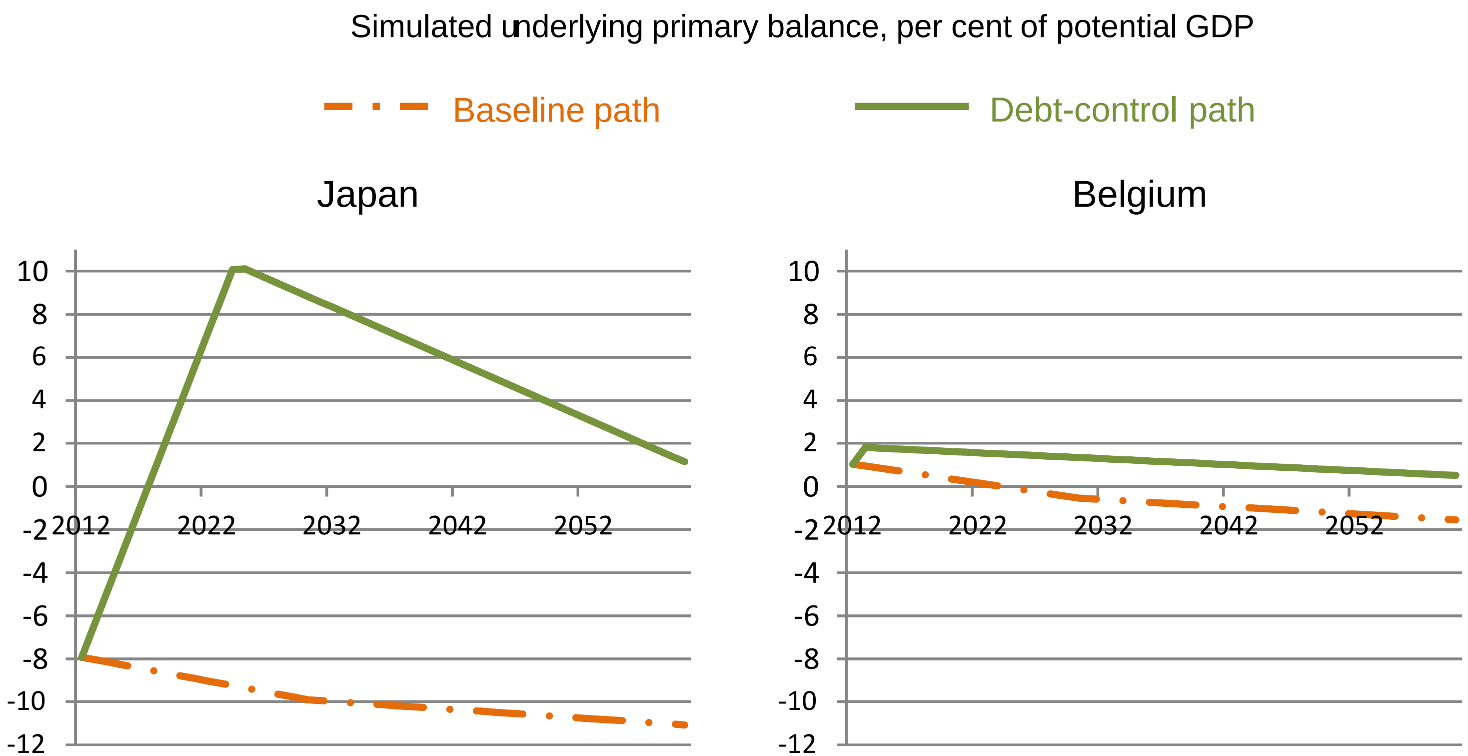
- The underlying primary surplus increases by 1% of potential GDP each year until enough is done to put the debt-GDP ratio on a trajectory bringing it to 60% by 2060.
- Afterwards, the underlying primary surplus evolves gradually toward the value that keeps the debt ratio stable .

Defining consolidation needs



Source: Cournède, Goujard and Pina (2014).

Illustration of the budget consolidation profile and baseline in two countries



Source: Cournède, Goujard and Pina (2014).

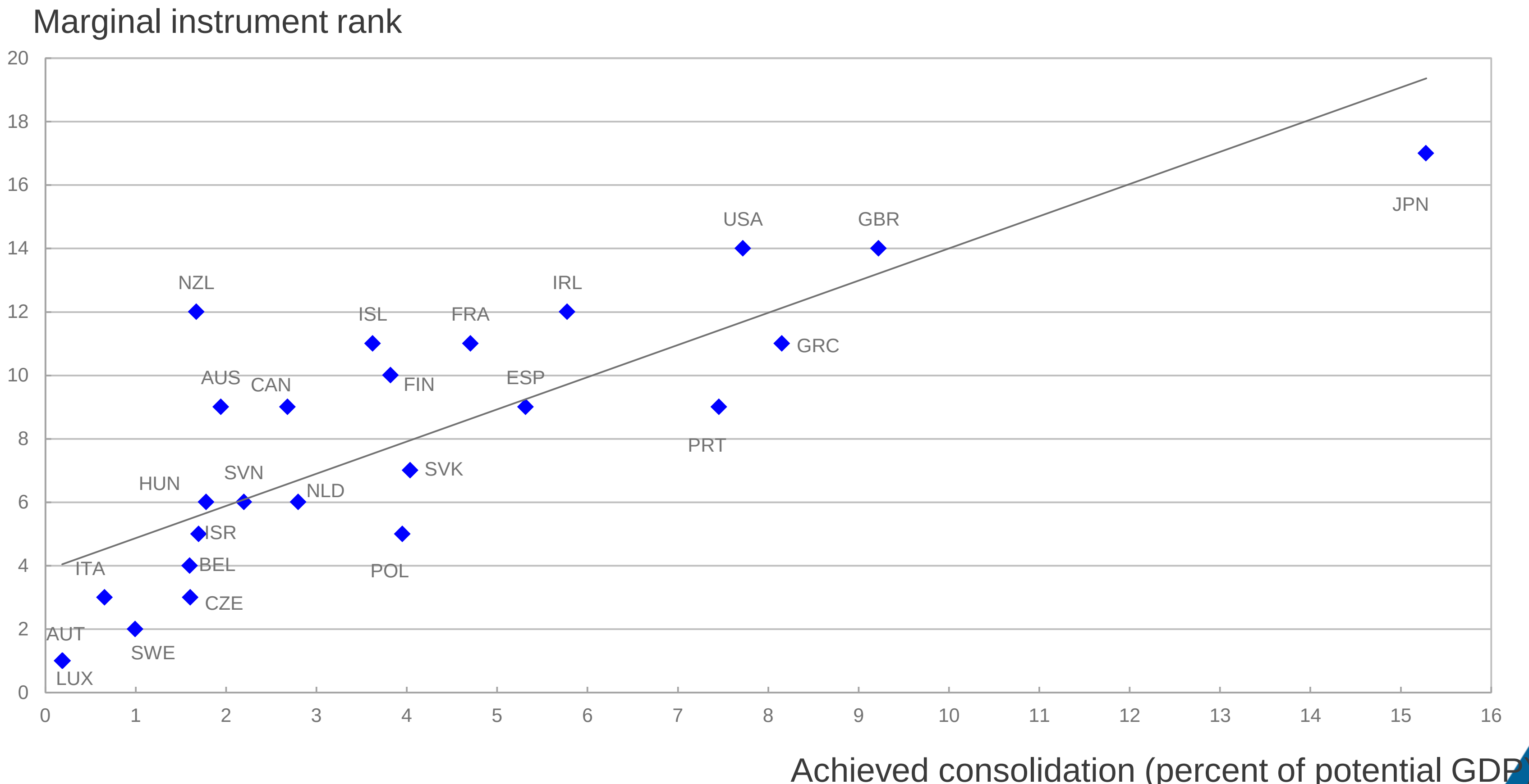
Adapting the hierarchy to the long-term perspective (2060)

- Long-term effects only:
  - growth
  - equity
- Current-account effects ignored

➡ Spending reductions move up the list

Results from short- to medium-term simulations

Consolidating more in general implies using more unfavourable marginal instruments (but there are exceptions)



Source: Cournède, Goujard and Pina (2014).

Results from long-term simulations

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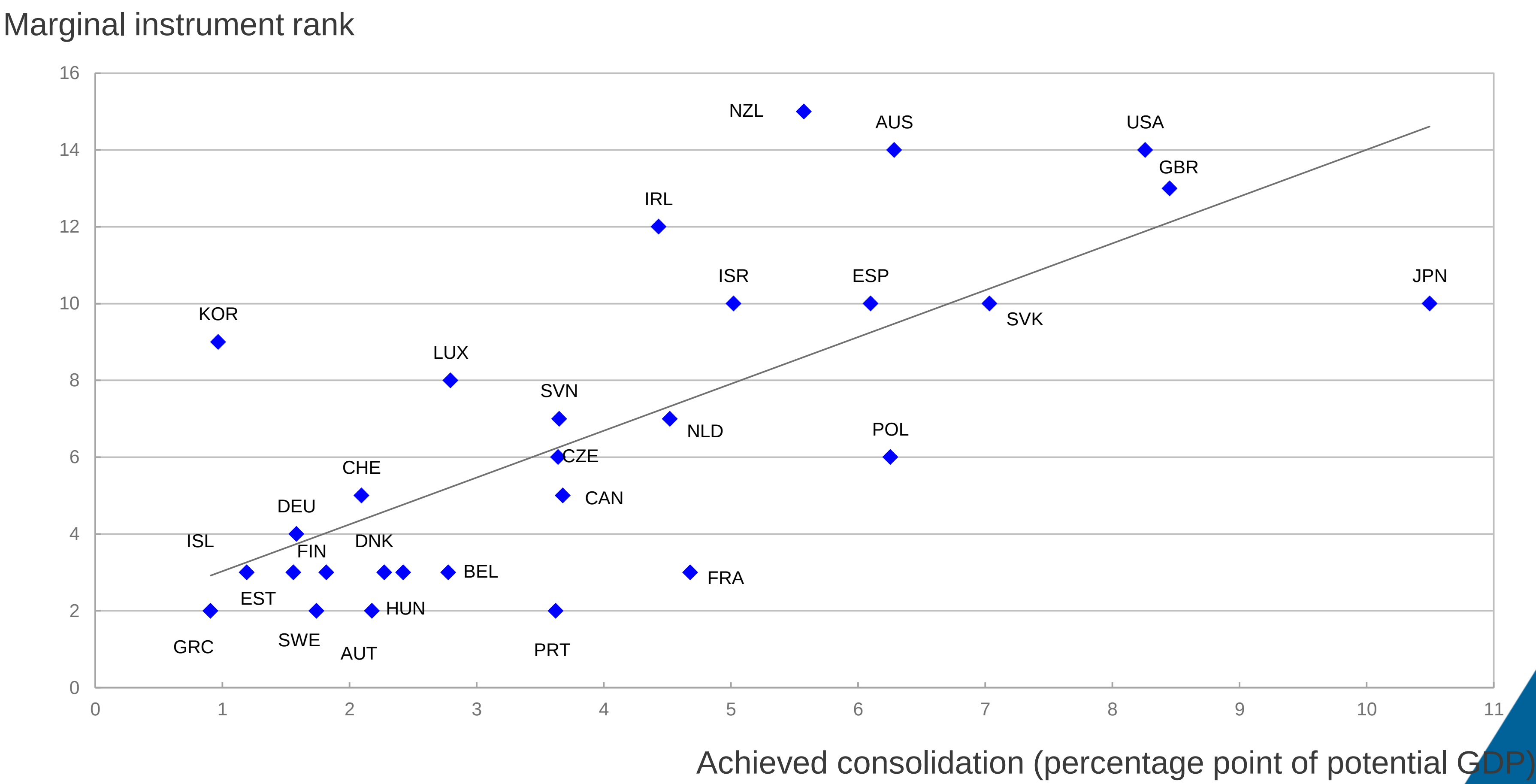
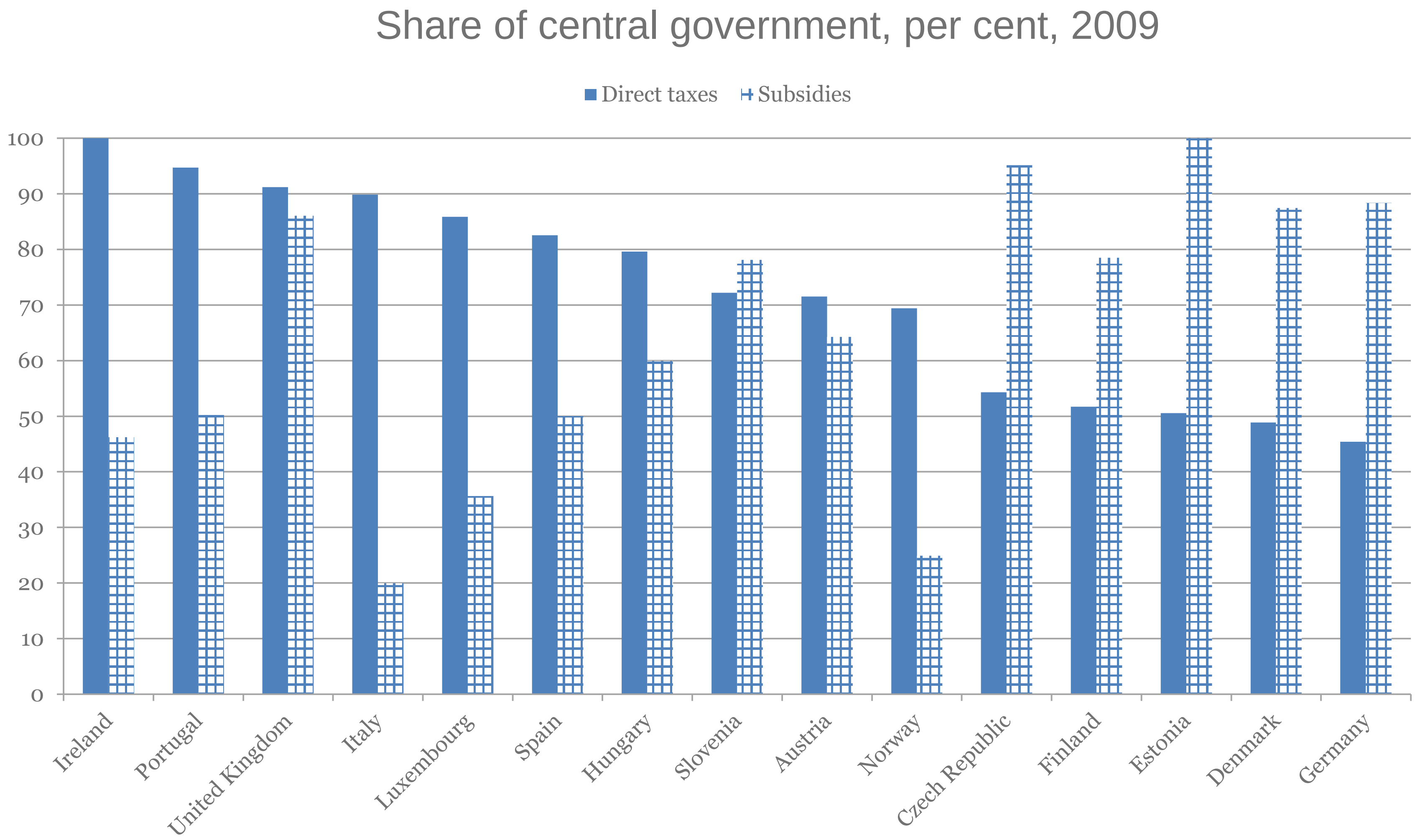


Source: Cournède, Goujard and Pina (2014).

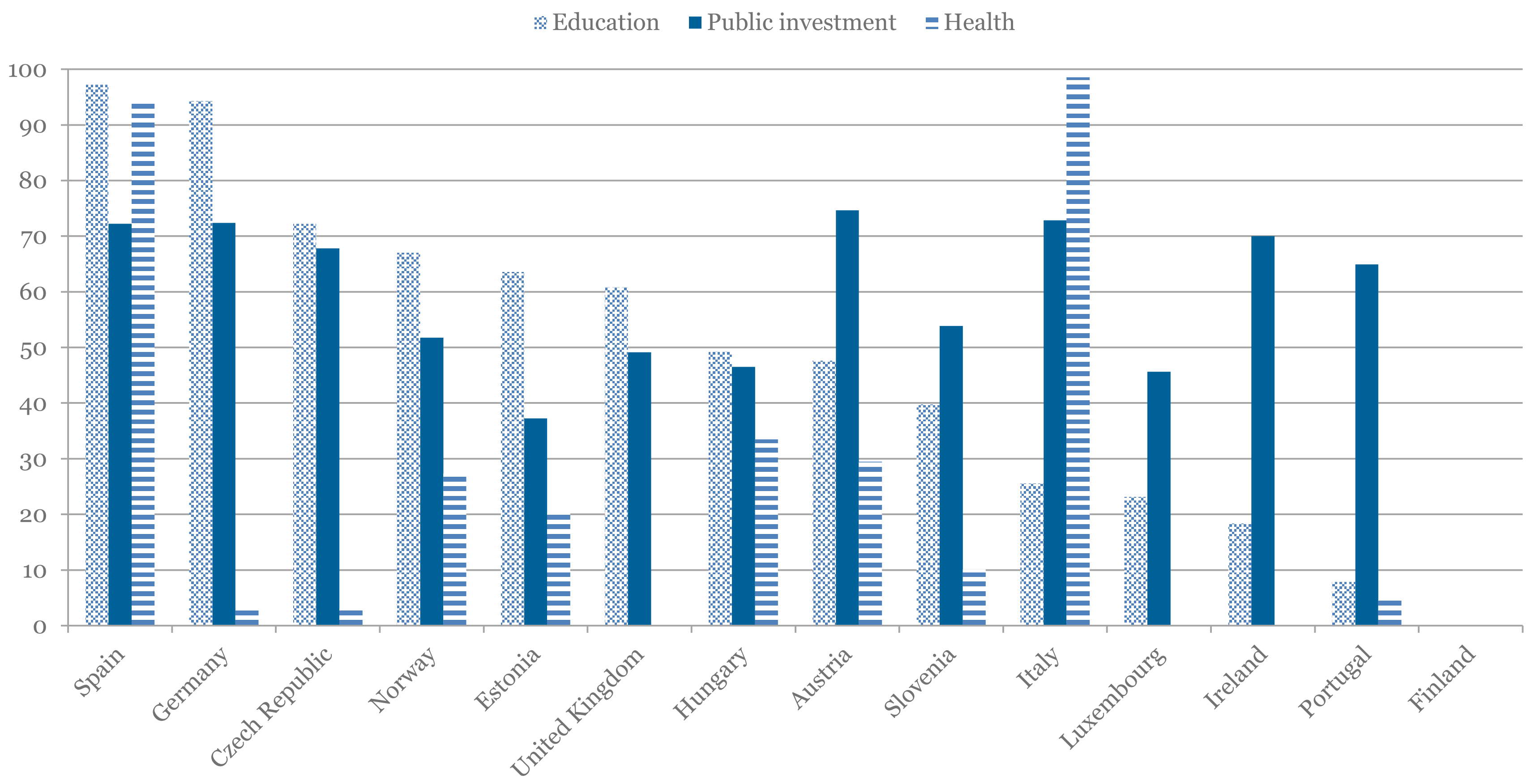
In many countries, well-ranked instruments are mainly central-level items



Source: Cournède, Goujard and Pina (2013).

In many countries, large low-ranked spending instruments are subnational.

Share of subnational government, per cent, 2009



Source: Cournède, Goujard and Pina (2013).

Reference for additional material:

Cournède, B., A. Goujard and Á. Pina (2013), "How to Achieve Growth- and Equity-Friendly Fiscal Consolidation? A Proposed Methodology for Instrument Choice with an Illustrative Application to OECD Countries", OECD Economics Department Working Papers, No. 1088.