

**COMMENTS ON SESSION 2:
EVALUATING THE EFFICIENCY AND EFFECTS OF PUBLIC SPENDING**

*Doris Prammer**

This contribution discusses the papers by Marie-Anne Deussing and Jagadeesh Gokhale, which give insights into the distributional effects of (net) transfers in Canada and the USA respectively. Even though both papers deal with the distribution of transfers, they approach the issue from different angles and focus on very different distributional effects. While Deussing concentrates on the provincial distribution of federal net transfers across family income groups and across provinces, Gokhale analyses the impact of general government non-retirement spending on working and earning.

**“Federal Taxes and Transfers Across Canada: Impact on Families” by
Marie-Anne Deussing**

In contrast to many studies focusing on direct federal taxes and direct transfers to income groups, Deussing’s paper provides a fuller picture. In addition to analysing the impact of direct federal taxes (such as personal income tax and employment insurance contributions) and the effect of indirect taxes on post-tax, post-transfer income, Deussing – in line with an earlier study by Finn Poschmann – also accounts for direct and indirect federal transfers. However, while the findings of Poschmann are based on shares in historical indirect transfer programmes, Deussing allocates indirect transfers stemming from the Canada Health and Social Transfer (CHST) to provinces and income groups according to the actual provincial spending pattern. Furthermore, this paper also takes a different approach with regard to the allocation of equalization entitlements. Here, equalization is treated as a block transfer instead of a tax point transfer.

The interesting key results on the distributional effects are that:

- the total federal tax is progressive for all provinces,
- the impact of direct federal transfers is progressive as well, with greater variation across provinces and across income groups than observed for federal taxes.

These two results are well in line with the 1998 study by Poschmann. However, his third main conclusion, namely that “*the federal government collects taxes from low-income Canadians in high-income provinces in part to fund transfers to higher-income residents of poorer provinces*” (Poschmann, p. 3), cannot be supported by the current study. The diverging conclusions basically reflect the different treatment of indirect transfers, which exert a considerable influence on the distribution of the overall net tax burden on income groups across provinces.

* National Bank of Austria.

Comments

Regarding the theoretical approach, I find Deussing's way of analysing the distributional effects of federal net transfers very attractive. Yet a short introduction into the Canadian public finance system – for example in an appendix – would have been helpful for readers who are not that familiar with the Canadian public finance system.

Furthermore, although the effective net transfer rates across income groups and across provinces provide a clear picture of the progressivity of the Canadian federal tax system, this is not the end of the story. The distributional power of a tax system is not only given by effective tax rates, but also by the number of people paying these tax rates. Consequently, some information on the distribution of income would be welcome. Hence, it would be interesting to see similar results calculated using family income percentiles.

As this study is closely related to Finn Poschmann's study – at least the part on direct taxes and direct transfer payments – the two papers could provide interesting comparative information. Comparing Poschmann's and Deussing's table on federal direct transfers as a percentage of post-tax, post-transfer income across income groups, I realised that while overall federal direct transfers decreased from 12.2 to 9.1 per cent of post-tax, post-transfer income, federal direct transfers to the lowest income group increased from 36.9 to 39.6 per cent. This gives rise to the question as to whether this change is the mere result of methodological differences – or is there any economic explanation to it? Have federal direct transfers been redesigned to decrease income inequality, or are the higher transfer payments just the result of an even more unequal primary income distribution?

In general, has the progressivity in the Canadian federal net transfer system been increasing or decreasing?

“The Cross-Cohort Distribution of Government Non-retirement Transfers and Its Impact on Working and Earning” by Jagadeesh Gokhale

Rather than analysing where government transfer spending goes like Deussing, Gokhale puts the focus on how these transfers affect the economy.

Gokhale classifies government non-retirement transfers according to their basic effects on recipients into *defensive* and *offensive* spending. While defensive transfers are intended to prevent the bad consequences of market failure (*i.e.* provide just the needy with welfare payments) offensive spending provides services that enhance worker productivity, thereby improving the overall economic and social environment.

Gokhale then investigates the direct impact of four types of federal transfers, namely unemployment insurance transfers, child care transfers, education subsidies and other government non-retirement transfers on labour market outcomes.

Applying regression analysis the author finds that unemployment benefits reduce earnings growth and accelerate the rate of non-work by males. Faster growth in educational spending seems to positively affect male earnings growth, while it appears to dampen female earnings growth. In contrast, child care transfers are associated with higher earnings growth and higher full-time job rates for women only.

Hence, overall these regressions provide only “*little support to the idea that non-retirement transfers improve the functioning of labor markets and the economy*” (Gokhale, p. 478).

Comments

Oversimplifying, one could draw the following policy conclusions from Gokhale’s results: “*to improve the economy by subsidizing the acquisition of skills and provide services that increase workers’ labor force participation*” (Gokhale, p. 459), the transfer spending of the federal government should be redirected. Unemployment benefits should be cut or eliminated altogether, as they negatively affect male earnings growth and accelerate the rate of non-work by males, while they do not exert any significant impact on female labour market variables. Furthermore, educational spending for women should be cut and invested either in educational spending for men or child care transfers for women. Both measures should enhance worker productivity according to Gokhale’s results.

However, I would not dare to give such policy advice, since I am not ready to defend Gokhale’s results on an economic ground.

First, reduced earnings growth need not necessarily reflect the level/rate of unemployment benefits; both variables might just as well indicate reactions to cyclical conditions – such as the overall level of unemployment. By decreasing trade union negotiation powers, both high levels of unemployment and long periods of unemployment – via decreasing human capital – would decrease earnings growth while unemployment benefits increase at the same time.

Second, I do not have any economic interpretation for the result that, while boosting male earnings, educational spending growth should negatively affect female earnings growth.

Also, the third result, namely that child care transfers are associated with higher earnings growth and higher full-time job rates for women, is not evident to me. In Austria, the newly-introduced lump-sum child care benefit has reduced the labour force (full-time) re-entry rate of women with children below the age of 2½. According to a WIFO paper, the percentage of woman returning to the labour market before their children reach the age of 2½ has dropped from 54 to 35 per cent. Obviously, the incentive effects of child care benefits do not only depend on the monetary transfer alone, but also on the “*accompanying institutional setting*” such as the possibility of maternal leave and its length or dismissal protection during parental leave. Hence, it would be interesting to learn to what extent Gokhale’s

result would be altered with respect to the European child care benefit system in general and the Austrian in particular.

Even though the author himself admits that the dividing line between transfers serving defensive versus offensive objectives is not sharp (for example child care support may enable household adults to spend more time at work), I would refrain from such a classification on the basis of effects on the economy. Even the most defensive transfer might exert externalities that improve the overall economic and social environment as well as the functioning of the markets. In general, while findings are ambiguous on the size of the effect, there is evidence that *“redistributive policies that result in less income inequality could well promote growth”* (Tanzi and Zee, 1997, p. 198) (for a more recent literature survey, see Harris, 2002). Hence, to my mind, this classification is even more questionable than the separation into productive and unproductive general government expenditure made in other contributions to this book.

After these very general remarks, I have some more specific comments concerning the econometric part of the paper. First, the author is not very clear on the econometric model. Judging from the limited explanation available, I assume that the author used pooled panel regression. This specification foregoes the opportunity to control for unobserved time-fixed cohort specific effects. This is important, as cohort specific effects in the form of different preferences with regard to leisure or participation in child care might be prevalent, given that the difference between the youngest and the oldest cohort is as much as 20 years. Furthermore, as these preferences may be correlated with the variables of part-time work and unemployment they will lead to biased estimates of other parameters in the model. Hence, the fixed-effects panel data estimator may be more appropriate for this data set than the pooled OLS estimator.

Gokhale himself suspects that the regression results might be driven by changes in unobserved variables including macroeconomic shocks. Moreover, as both unemployment benefits and the level of employment (especially female labour force participation) are very susceptible to the cycle, I wonder if one can actually infer the causality that unemployment benefits cause lower earnings growth. Instead, I suggest controlling for the business cycle explicitly, by including some output gap variable.

Finally, the estimation of the effects of government non-retirement transfers on labour market outcomes does not take into account the life cycle position of the respective cohort. While I assume that child care transfers have a significant effect for women in their late 20s and early 30s, they will possibly not affect labour market decisions of older women. Interacting the child care benefit variable with an age dummy could control for this and separate the overall effect into distinct effects. This could provide additional insights into the effects of transfer payments on the labour market and earnings, thereby strengthening the assumption that transfer payment might be directly “offensive” for particular age groups.

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