

COMMENTS ON SESSION 3 TAXATION, REGULATIONS AND PUBLIC SERVICES

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The papers presented in this session provide interesting insights in the current debate on taxation. The two papers I will comment on are related to each other as they both analyses aspects of how of tax systems affect employment and economic growth. While the paper by Peter Benczur, Gabor Katay, Aron Kiss and Oliver Racs concentrates on the tax system and its interaction with transfers in one country, in this case Hungary, the paper by Bert Saveyn, Jonathan Pycroft and Salvador Barrios highlights the importance to take into account cross-country spillovers when analysing effects of tax changes in single countries.

1 Income taxation, transfers and labour supply at the extensive margin

The paper by Benczur, Katay, Kiss and Racs delves into a very relevant issue: The effects of reforms in taxes and transfers on labour market participation. This issue is highly topical in many countries. Related to the economic and fiscal crises in the Euro Area, structural reforms that have significant positive impact on employment and growth are search for high and low. Reforms that improve labour supply are obvious examples of growth-friendly policies, at least in the longer term. And more generally, reshuffling tax systems to make them more economically efficient is a good example of reforms that could be used in the current situation to boost growth.¹

This issue is not least relevant for Hungary, a country with one of the lowest labour market participation rates in the European Union. As the authors point out this has been an obstacle for convergence to higher income-levels after Hungary joined the EU in 2004. Some types of individuals have particularly low rates: women in child bearing ages, elderly and low skilled.

In my own country, Sweden, there has in recent years been a strong focus on the joint effects on participation in the labour market from a substantially increased Earned Income Tax Credit (EITC), together with reforms of the unemployment and sick leave insurances. An assessment is that these reforms will have a significant positive long-run effect on employment even if there are uncertainties around how large they will be in a longer perspective.²

In the Hungarian paper, effects on labour market participation of changes in taxes and transfers are estimated for different types of households and individuals. Related to this, it would be informative to get a bit more details about the Hungarian reforms in this area under the relevant time period and also how these reforms affect the calculated disposable income variable. The introduction of the flat tax in Hungary is mention, but not much more. For instance, reforms in unemployment benefit systems have been important in some countries. Is this also the case in Hungary? And, if this is the case, are these reforms included in the dataset?

Generally, the results in the paper for the different types and households and individuals seem reasonable. Weak groups in the labour market are more sensitive to changes in taxes and transfers for their decision to participate in the labour market. The only results that are a bit surprising are those related to the education level. Elementary, secondary and tertiary school backgrounds are related to weak effects of tax and transfer changes, while a vocational training background is related to stronger effects. Is there a rational for this difference?

* Finance Ministry, Stockholm.

¹ See, for instance, Å. Johansson, C. Heady, J. Arnold, B. Brys and L. Varia (2009), *Taxation and Economic Growth*, OECD.

² Swedish Fiscal Policy Council (2011), *Swedish Fiscal Policy*, pp. 222-23, Stockholm.

The features of the disposable income variable I mentioned earlier have also implications for the estimation of elasticities. In a recent Swedish study³ the authors look into the effects on labour supply of the recent Earned Income Tax Benefit (EITB) reform in Sweden. From this study it is concluded that the effects are significantly positive. However, the results are found uncertain because there is too little variation in treatment between different individuals and that there are underlying trends in participation/employment that co-varies with the tax credit in ways that are hard to control. A question is if such estimation problems also could be relevant in the Hungarian study?

A last issue is that reforms in tax, transfer and benefit systems could have effects on the equilibrium wage level and consequently on labour demand. It seems that the effects of these types of reforms on participation and employment could go through both supply and demand channels.

In the end of the paper the elasticities found at the micro level are used to calculate the aggregated effect of recent Hungarian reforms. The result is unfortunately not encouraging. In its latest Economic Survey of Hungary by the OECD,⁴ the Organisation also warns that the recent reforms in Hungary potentially can have negative effects on the participation rate, especially for low-income earners. This really shows how highly policy-relevant the work by Benczur, Katay, Kiss and Racz is.

2 The cost of tax increases in the EU

Not least in the wake of the global economic and financial crises governments need to implement tax systems that are growth-friendly. This is a complex issue in the European Union where economies are deeply interdependent. Bert Saveyn, Jonathan Pycroft and Salvador Barrios have in their paper chosen to gauge the size of potential cross-country spillover effects from tax changes by calculating the marginal cost of increases in labour taxes and energy taxes. The authors also analyses the role of labour market rigidities for the sizes of tax distortions.

The first question put by the authors is which types of tax reforms will promote growth in European countries. A second question is which types of taxes should or should not be coordinated at the European level.

The authors main contribution is that they take into account “spillover” effects when analyzing tax distortions, which they also claim has been ignored in earlier literature. Labour and energy taxes are in the focus of the analyses and this choice is well motivated in the paper. However, in the tax literature property taxes and broad based taxes on consumption are often seen as taxes which are least distortive, *i.e.*, most growth-friendly.⁵

A few questions on the analytical framework:

- is there empirical evidence that R&D expenditure is a good proxy for technological progress? There has been some criticism that this “input measure” is a rather blunt approximation;
- cross-border shopping is not included in the analysis. Could that potentially be of importance? What do we know empirically?
- the possibility to vary labour market imperfections are built into the model used by the authors through a parameter, *e.g.*, in equation 2.8 in Appendix 2. A question is if this parameter has an economic interpretation. Would it be possible to, as an alternative, use an index reflecting degrees of imperfections in the labour market in different countries?

³ K. Edman, C.Y. Liang, E. Mörk and H. Selin (2012). “Evaluation of the Swedish Earned Income Tax Credit”, IFAU, Uppsala.

⁴ OECD (2012), *Economic Survey – Hungary*, March.

⁵ See, for instance, Å. Johansson, C. Heady, J. Arnold, B. Brys and L. Varia (2009), *Taxation and Economic Growth*, OECD.

I also believe it would be fine, as a reader, to get more explicit descriptions about channels and mechanisms in the model leading to the spillover effects.

Most empirical results in the study seem plausible. First, distortions of income tax increases are higher in high tax countries compared in low tax countries. Second, “spillover” effects of income taxes are small, but larger in small open economies; third, it is really plausible that large countries have important roles in inducing “spillover” effects. Fourth, energy taxes has small direct effects, but relatively large “spillover” effects and last, distortions increases with labour market rigidities.

However, a less intuitive result is described by the statement: “A low degree of flexibility would result in lower welfare losses as wages adjust less to lower labour demand”. This result is probably true in the short term, but in the longer run there would be negative effects on employment (hysteresis effects) and on production resulting over time in lower welfare. This puts a question mark on the time horizon of the used model.

My concluding remarks are, first, that analyses of effects of tax changes in a coordinated European perspective, taking into account spillover effects, really is interesting and a promising strand of research. Second, a more detailed description of spillover channels and mechanisms given by the used model would be welcomed. And last, it would be interesting to see analyses of a broader set of taxes and their effects by the use of the presented analytical framework.

