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How can reforms of spending and tax structure boost growth and enhance equality?

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Evaluating the impact of public finance structure: Main lessons

- Government size weighs on output except where the public deems government to be very effective.
- Reforming government spending or the revenue structure without changing its size offers potential to **boost output and**:

Reduce disposable income disparities	• Ease effective marginal tax rates on low-income earners • Hike inheritance taxes
Leave disposable income disparities broadly unchanged and improve absolute income levels for all	• Increase public investment • Raise recurring property taxes • Lower effective corporate income tax rates
Widen income disparities, but leave no group worse off in terms of absolute income	• Reduce subsidies, • Lower wealth taxes • Lighten the tax burden on above-average labour earnings

- Even when reallocating the tax burden from more to less distortive taxes, there are limits to increasing tax rates.

Evaluating the impact of the public finance structure: Outline of the presentation

Public sectors are often large, changing and diverse

Changes in public sectors have measurable effects on output per capita and its distribution

Countries have scope to improve the structure of their public finances

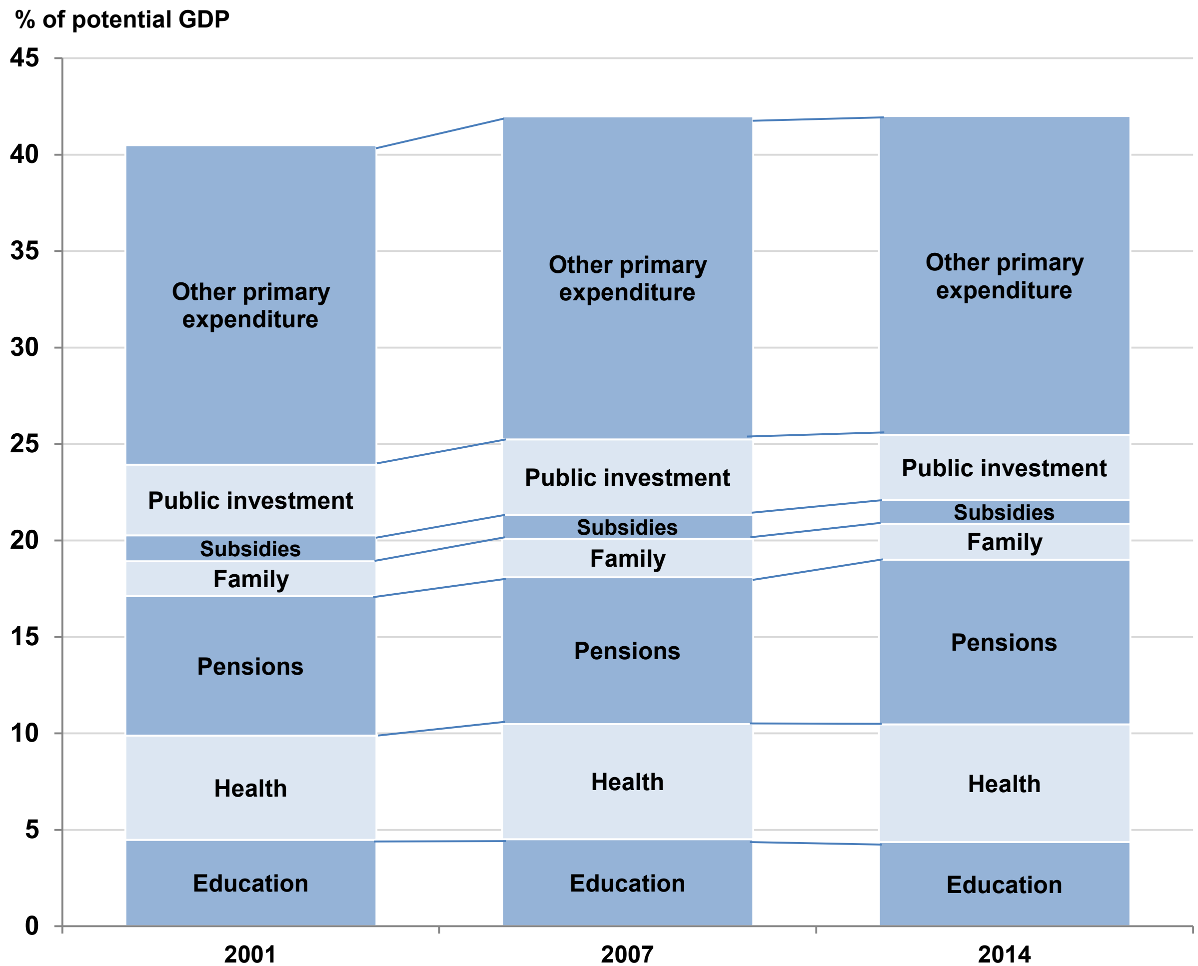
Public sectors are large, changing and diverse

Changes in public sectors have measurable effects on output per capita and its distribution

Countries have scope to improve the structure of their public finances

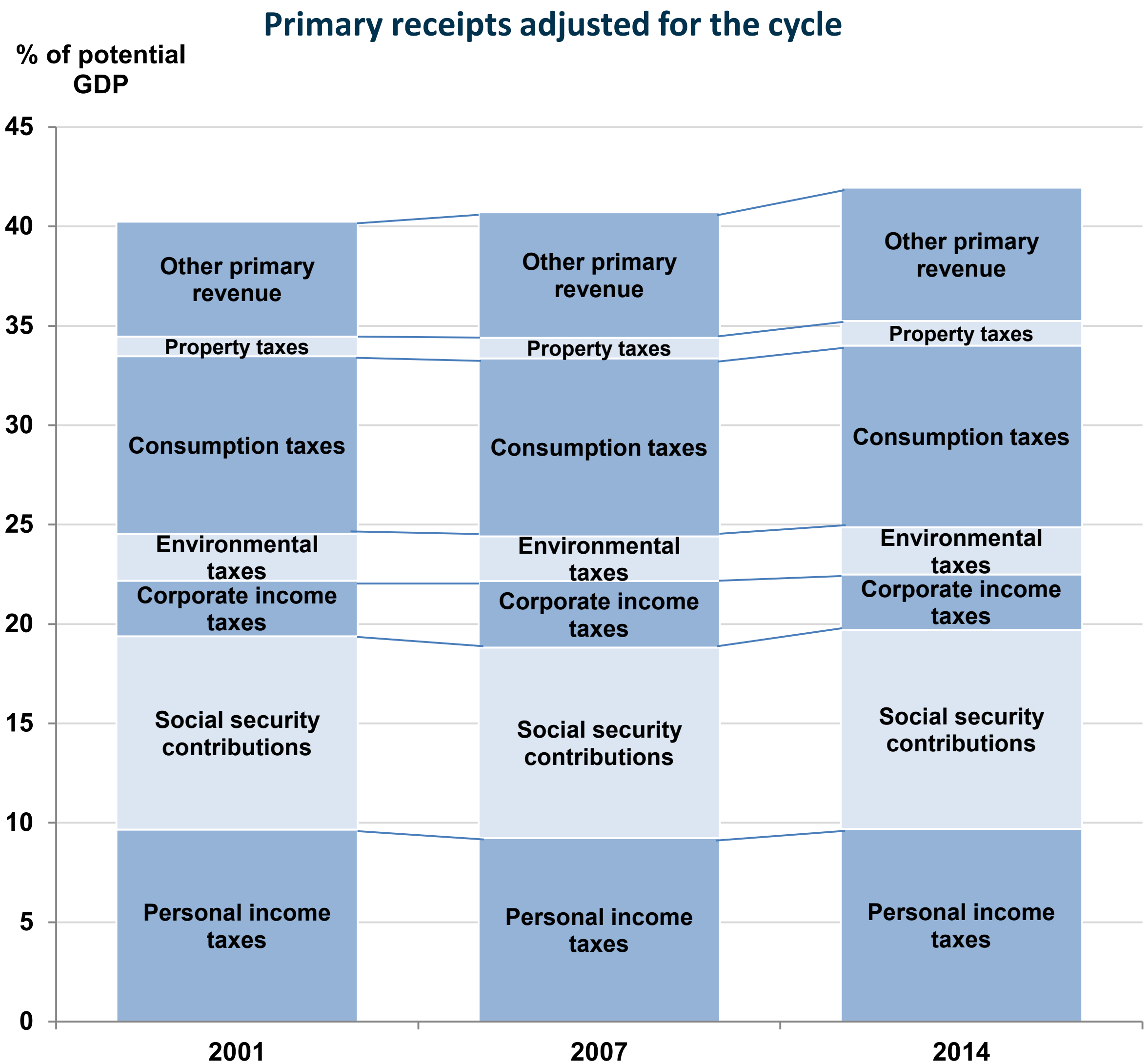
Public spending is large and its structure has been evolving

Expenditure excluding interest (i.e. primary) and adjusted for the cycle



Source: OECD Public Finance Dataset (Bloch et al., 2016), 2018 update.

Revenue structure has not dramatically changed

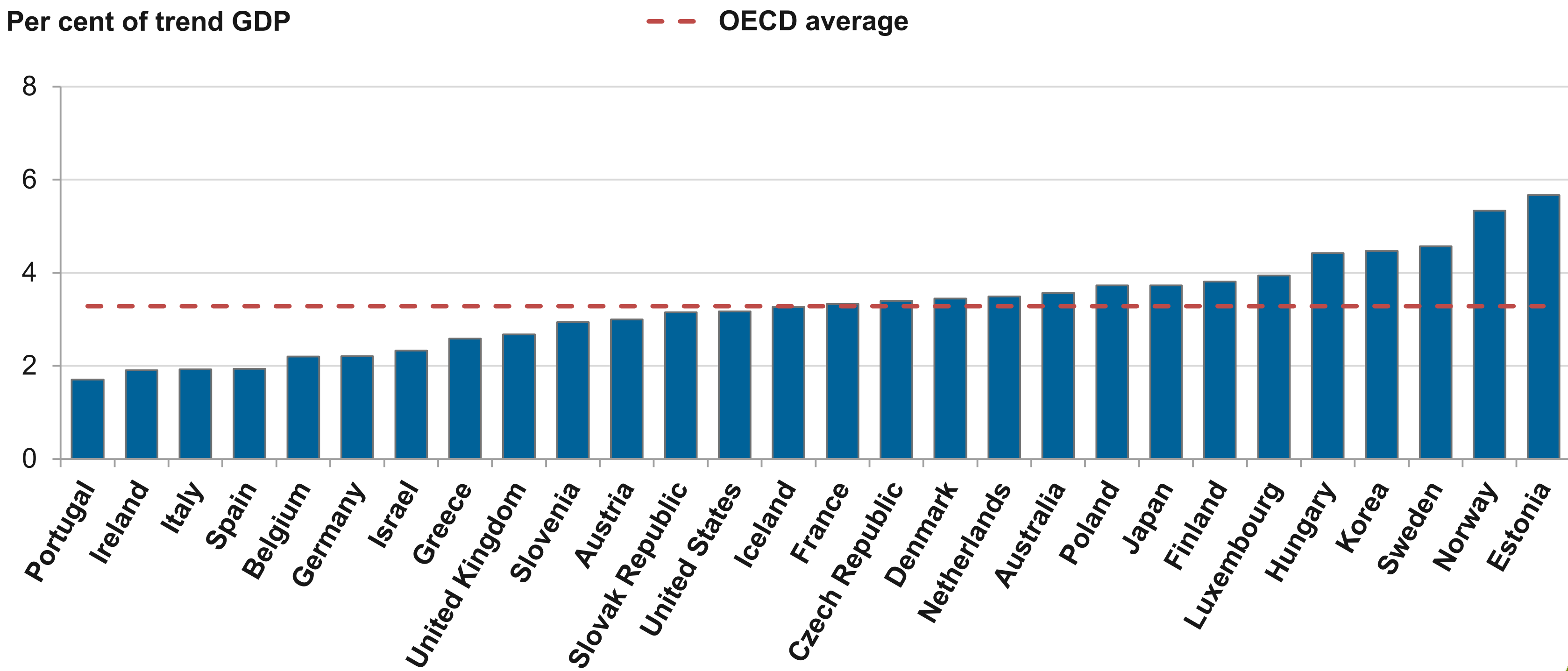


Source: OECD Public Finance Dataset (Bloch et al., 2016), 2018 update.

Large differences in public finance structure separate countries

One example: public investment by all government levels

Adjusted for the cycle, 2017

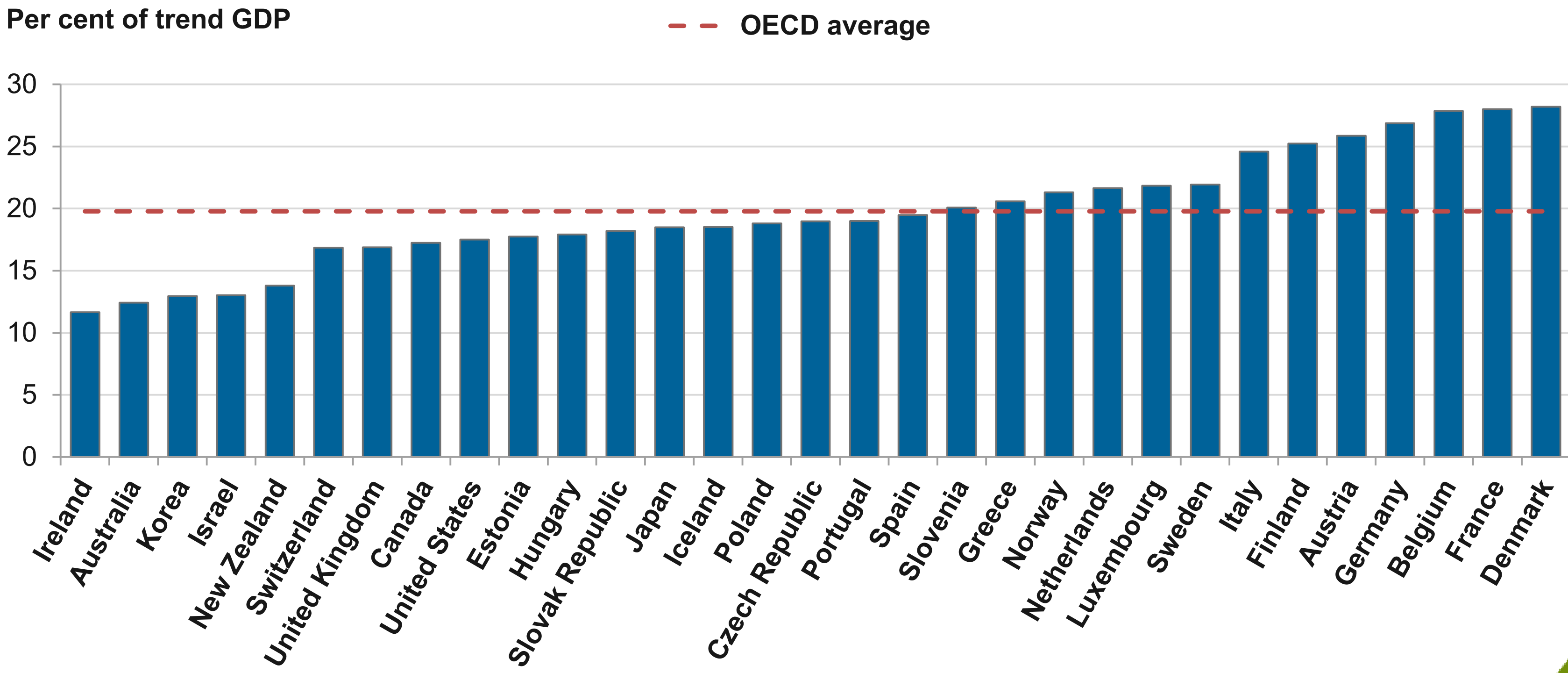


Source: OECD Public Finance Dataset (Bloch et al., 2016), 2018 update.

Large differences in public finance structure separate countries

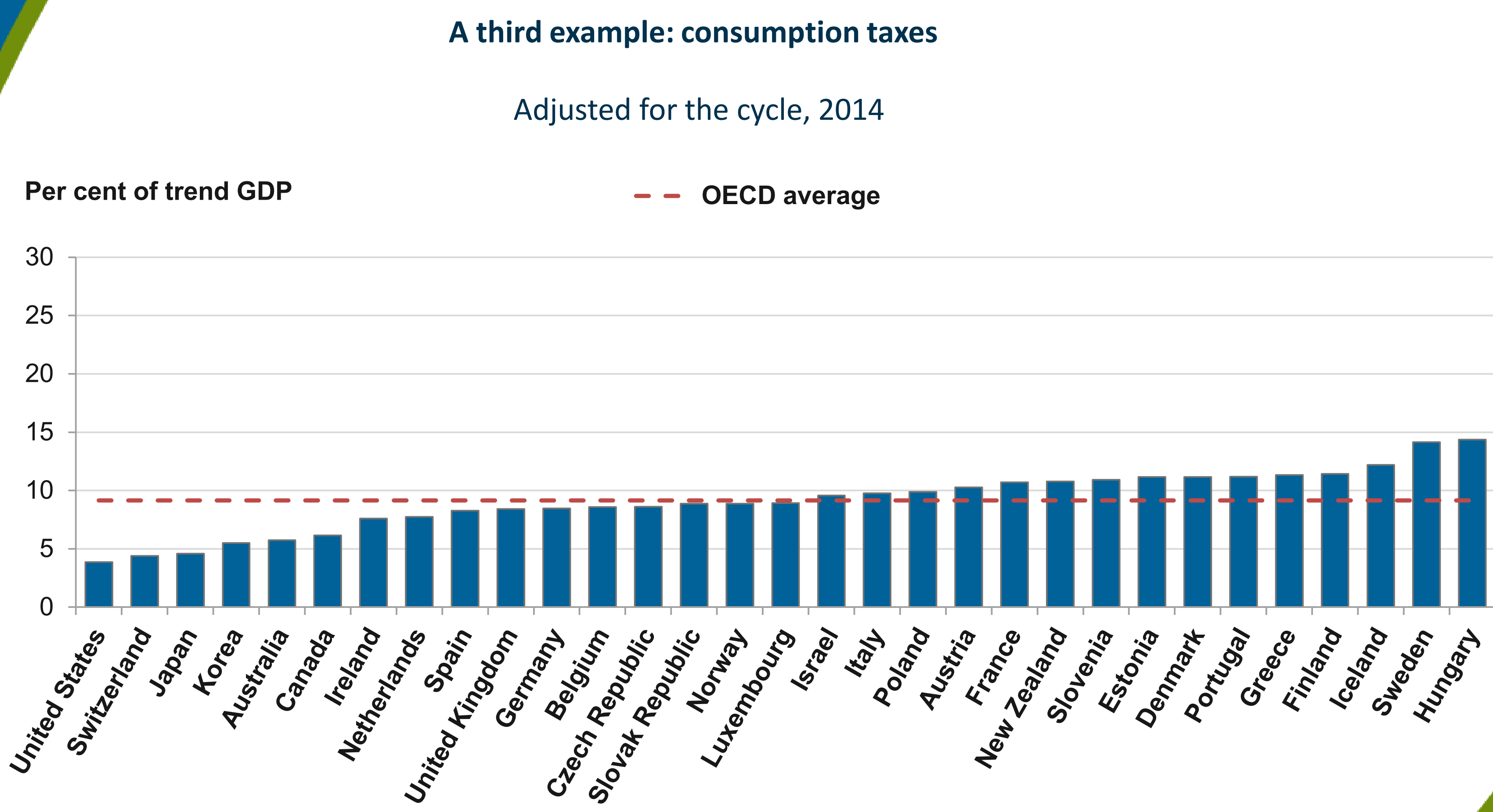
Another example: personal income taxes and social security contributions

Adjusted for the cycle, 2016



Source: OECD Public Finance Dataset (Bloch et al., 2016), 2018 update.

Large differences in public finance structure separate countries



Source: OECD Public Finance Dataset (Bloch et al., 2016), 2018 update.

Public sectors are large, changing and diverse

Changes in public sectors have measurable effects on output per capita and its distribution

Countries have scope to improve the structure of their public finances

Estimates measure the impact of changes in public finance structure

Estimate long-term effects of policy reforms on

- Output per capita
- Household disposable income by decile allowing to gauge
  - Moves relative to other deciles
  - Changes in absolute income levels by decile

With econometric regressions

- Production function framework for output
- Estimation by decile
- Long-term effects (after cyclical impacts have played out)

On an internationally comparable dataset

- Covers 35 countries over 1985-2014
- Adjusts for cyclical effects

There are reforms that can both boost output and reduce income differentials

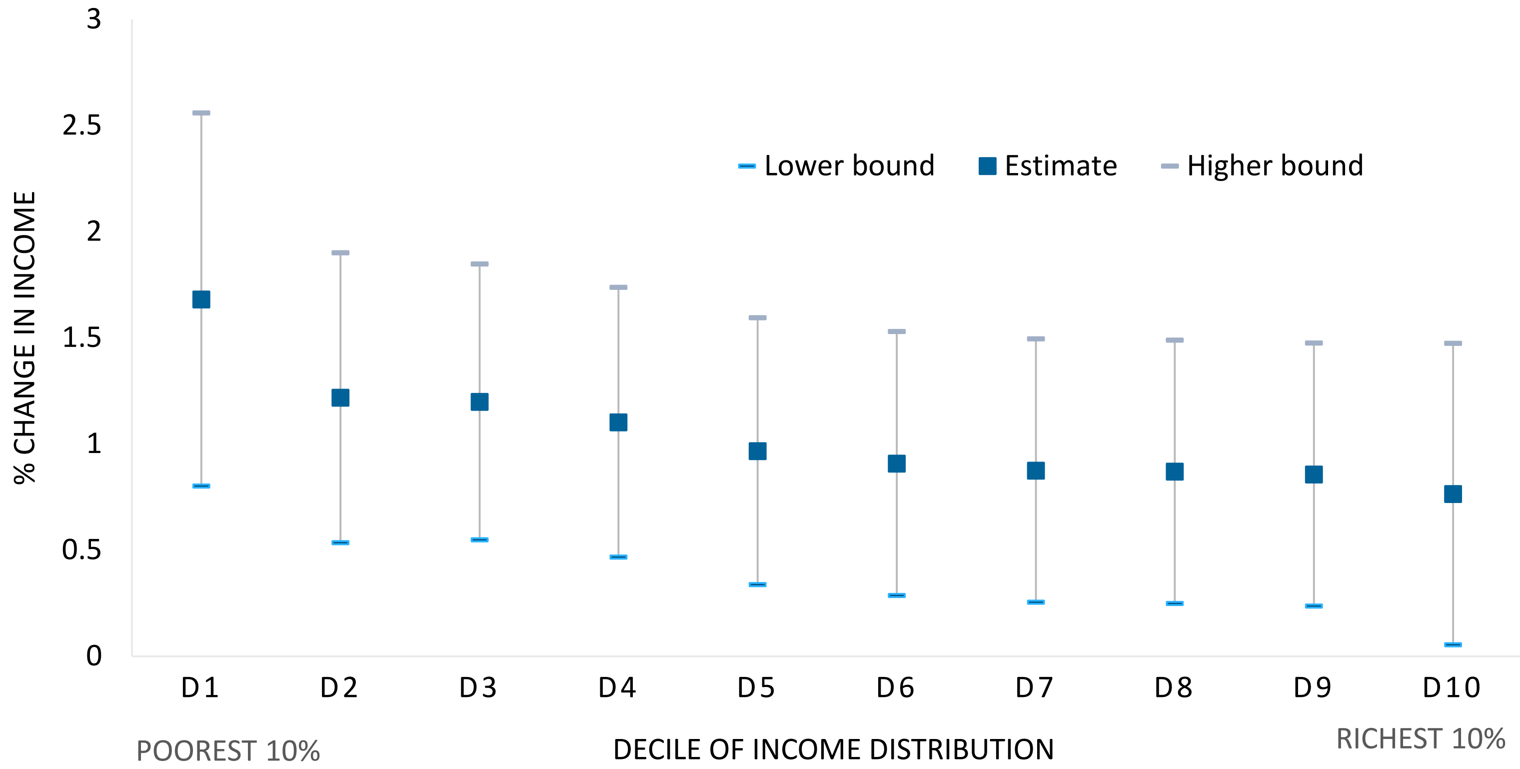
Lower all-in effective tax rates on low-income earners

Raise inheritance and gift taxes

As part of revenue-neutral reforms

Moving the tax burden away from low-wage earners improves incomes for all

Estimated long-term effect on disposable income of reducing the labour tax wedge applicable at 67% of average income by one percentage point while increasing other taxes to compensate the revenue loss

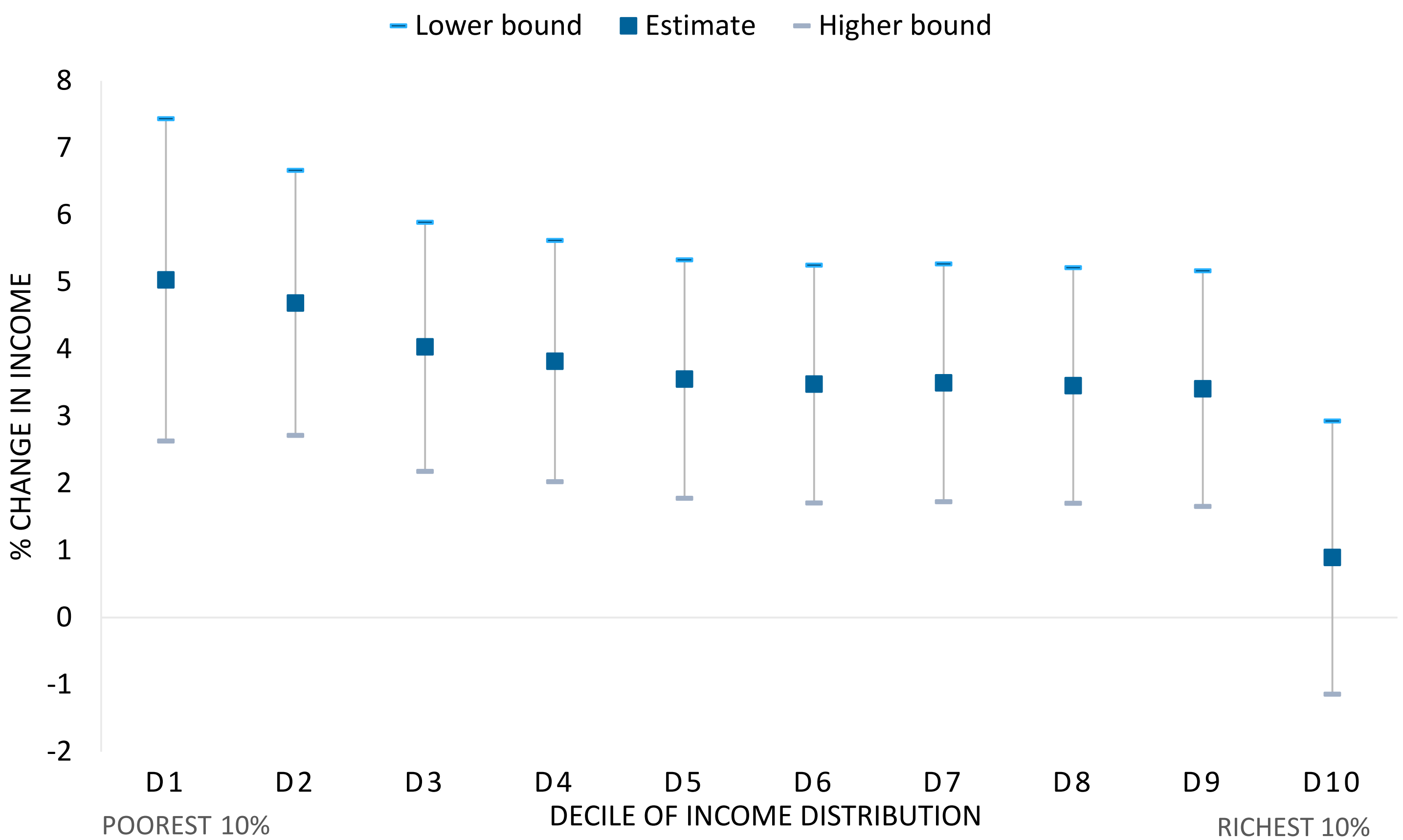


Note: the bounds delineate 90% confidence intervals.

Source: Cournède, Fournier and Hoeller (2018).

Shifting the tax mix towards inheritance taxes boosts output and results in narrower income gaps

Estimated long-term effect on disposable income of raising 0.1 per cent of GDP in receipts from inheritance tax and reducing other taxes by the same amount



Note: the bounds delineate 90% confidence intervals.

Source: Cournède, Fournier and Hoeller (2018).

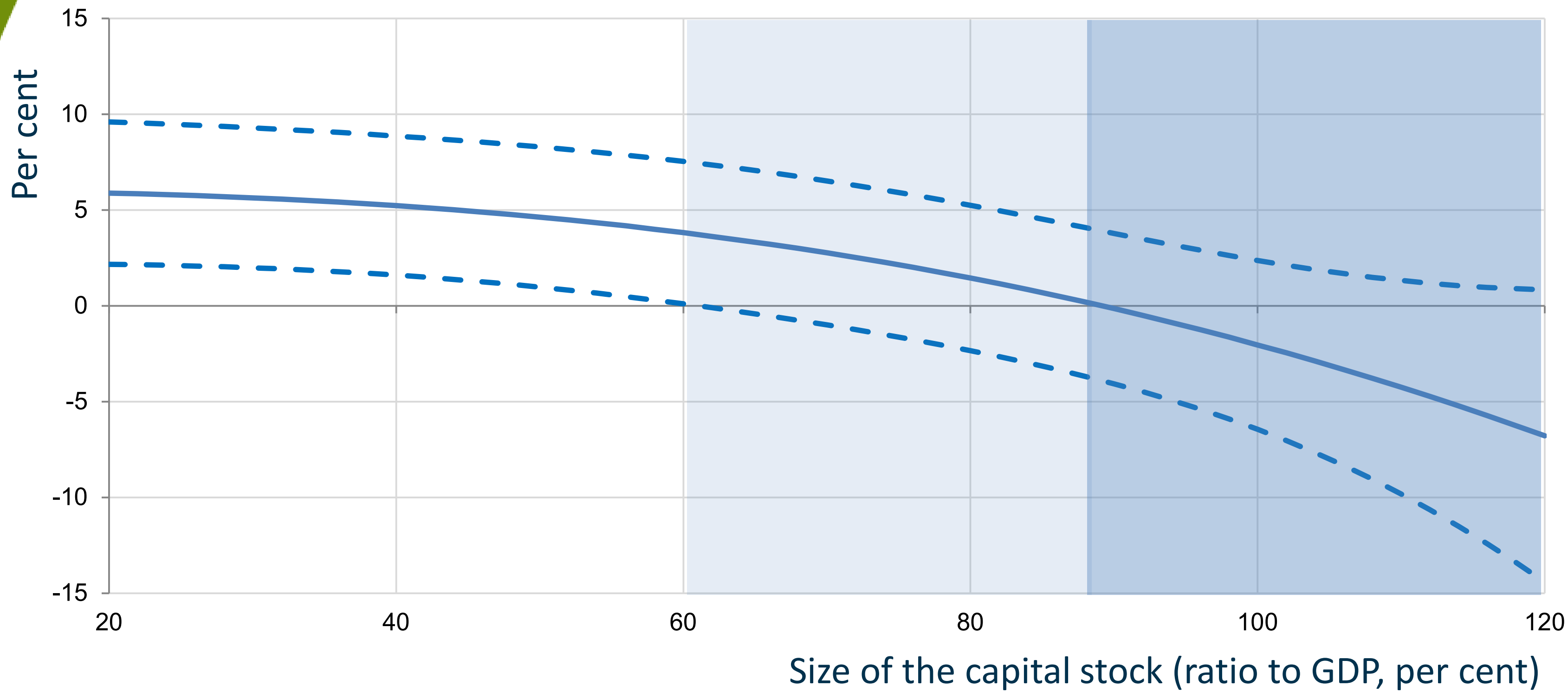
Some reforms boost output without substantially altering the distribution of income

- Boosting public investment
- Keeping pension spending in check
- Raising recurrent property taxes
- Lowering effective corporate income tax rates

As part of revenue and size-neutral reforms

The benefits of public investment diminish with the size of the public capital stock

Long-term output effect of a 1pp increase in the public investment to GDP ratio



Note: the dotted lines delineate the 95% confidence interval.

Source: Fournier (2016).

Other reforms boost output and widen income gaps but leave no income group worse off

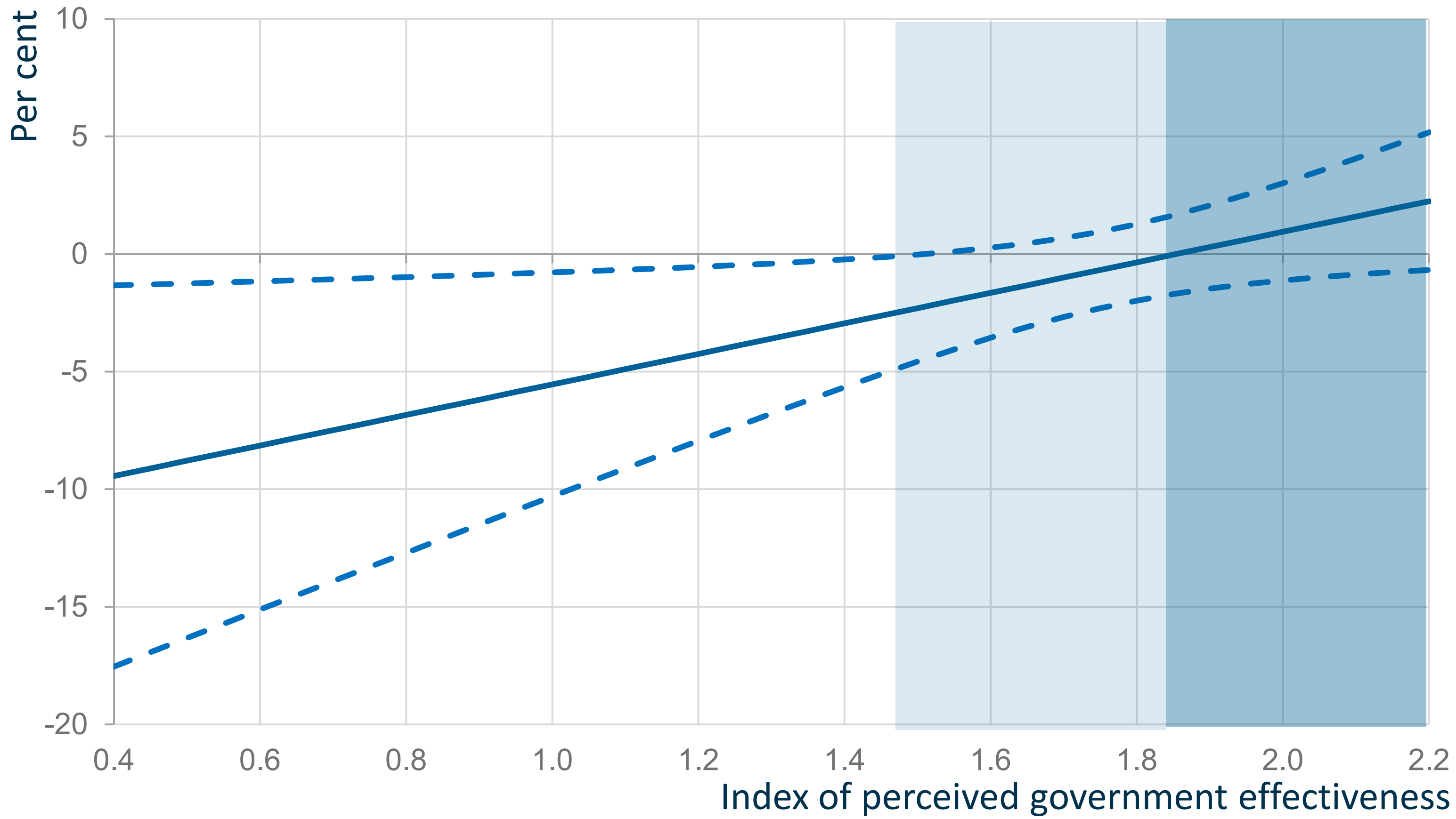
Reducing spending in countries with low or average government effectiveness

Reducing public subsidies making room for other spending

Lowering taxes on net wealth and increasing other taxes by the same amount

The adverse effect of government size on long-term output decreases with government effectiveness

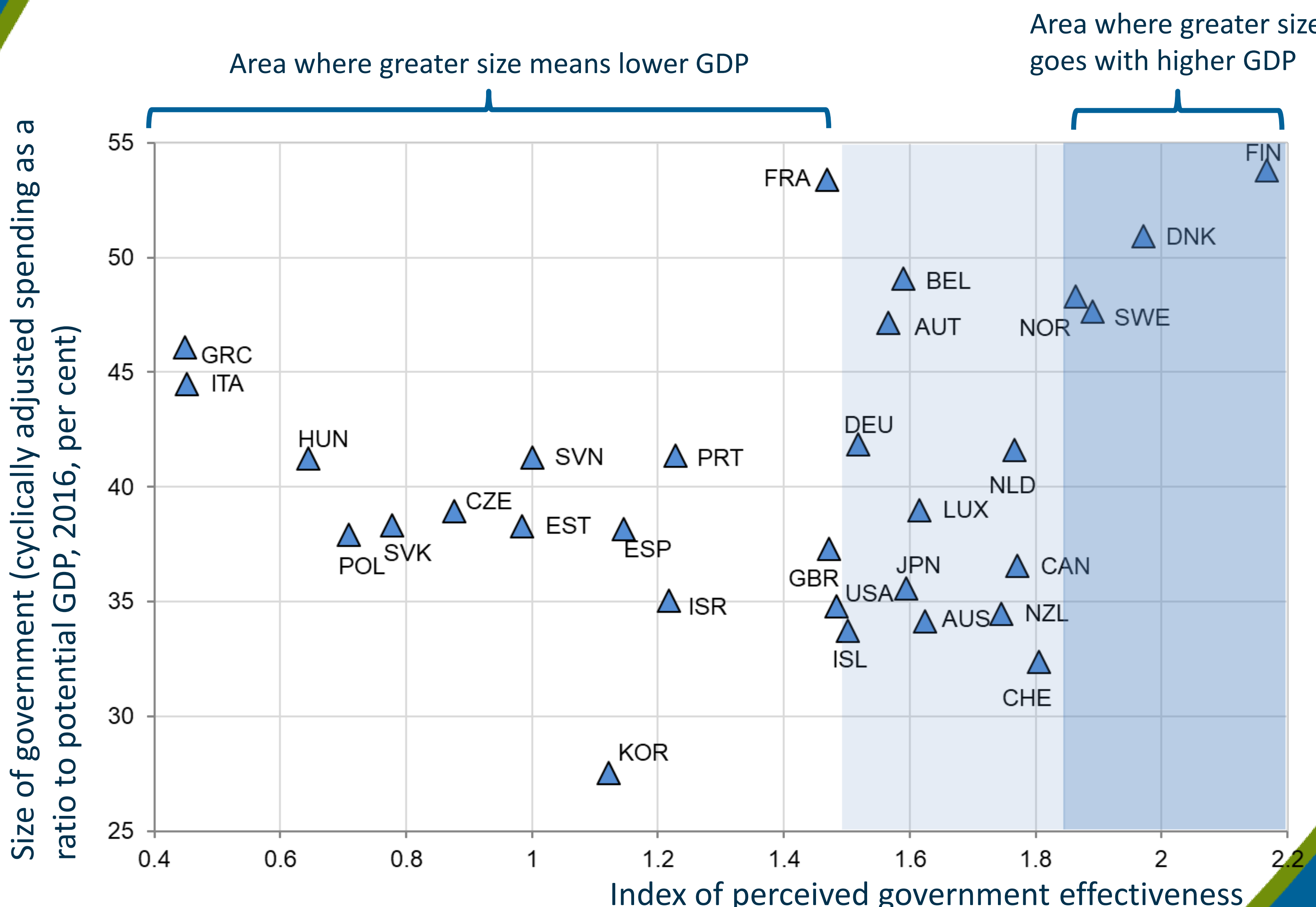
Effect on output per capita of a 1pp increase in the government spending to GDP ratio



Note: the dotted lines delineate the 95% confidence interval

Source: Fournier and Johansson (2016).

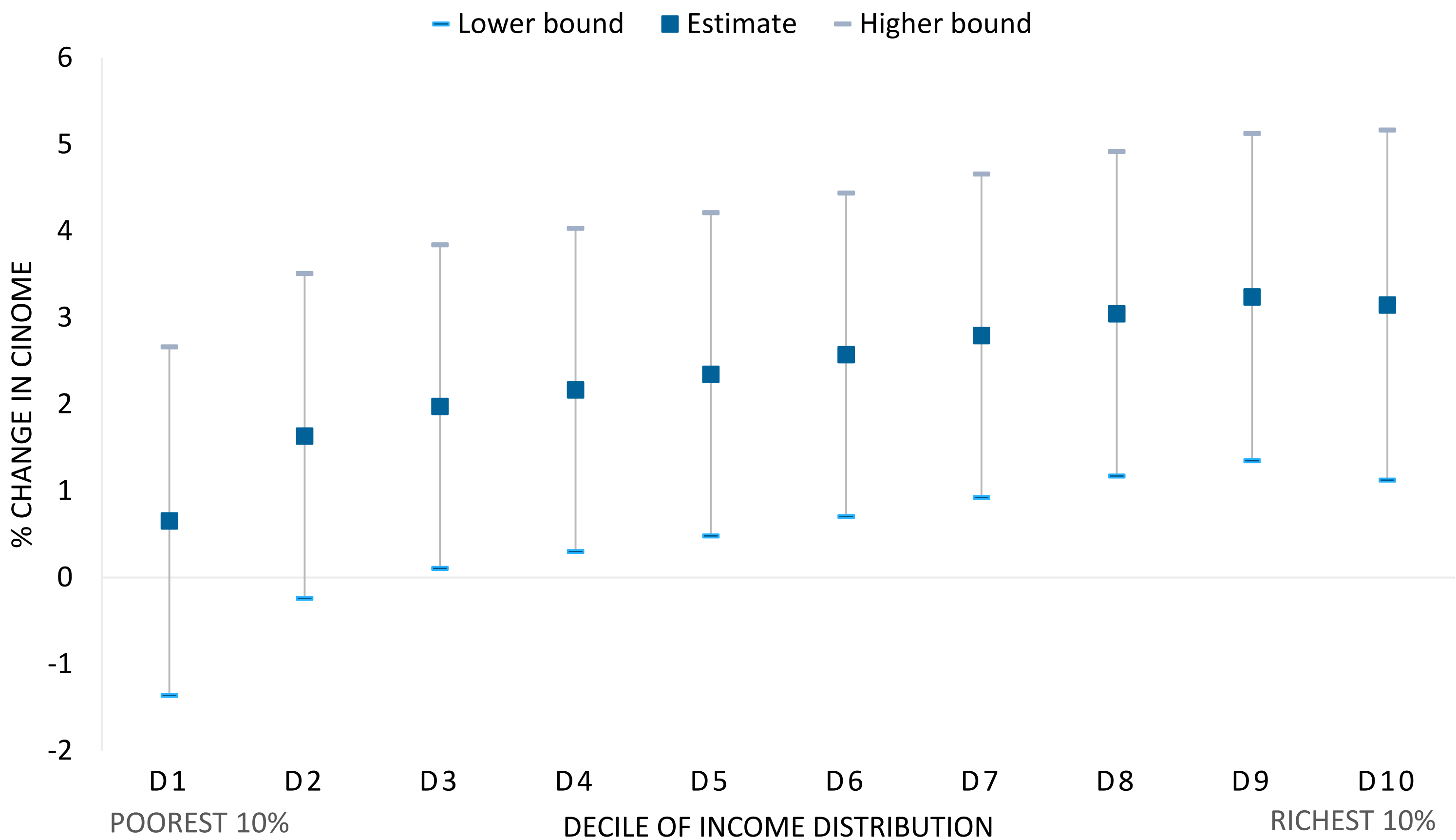
OECD governments exhibit varied sizes and levels of perceived effectiveness



Source: Fournier and Johansson (2016) and 2018 update of Bloch et al.'s (2016) database.

Shrinking governments typically involves a growth-equality trade-off but still leaves most better off

Estimated change in disposable income after permanently reducing government size by one percent of GDP in countries with median perceived government effectiveness

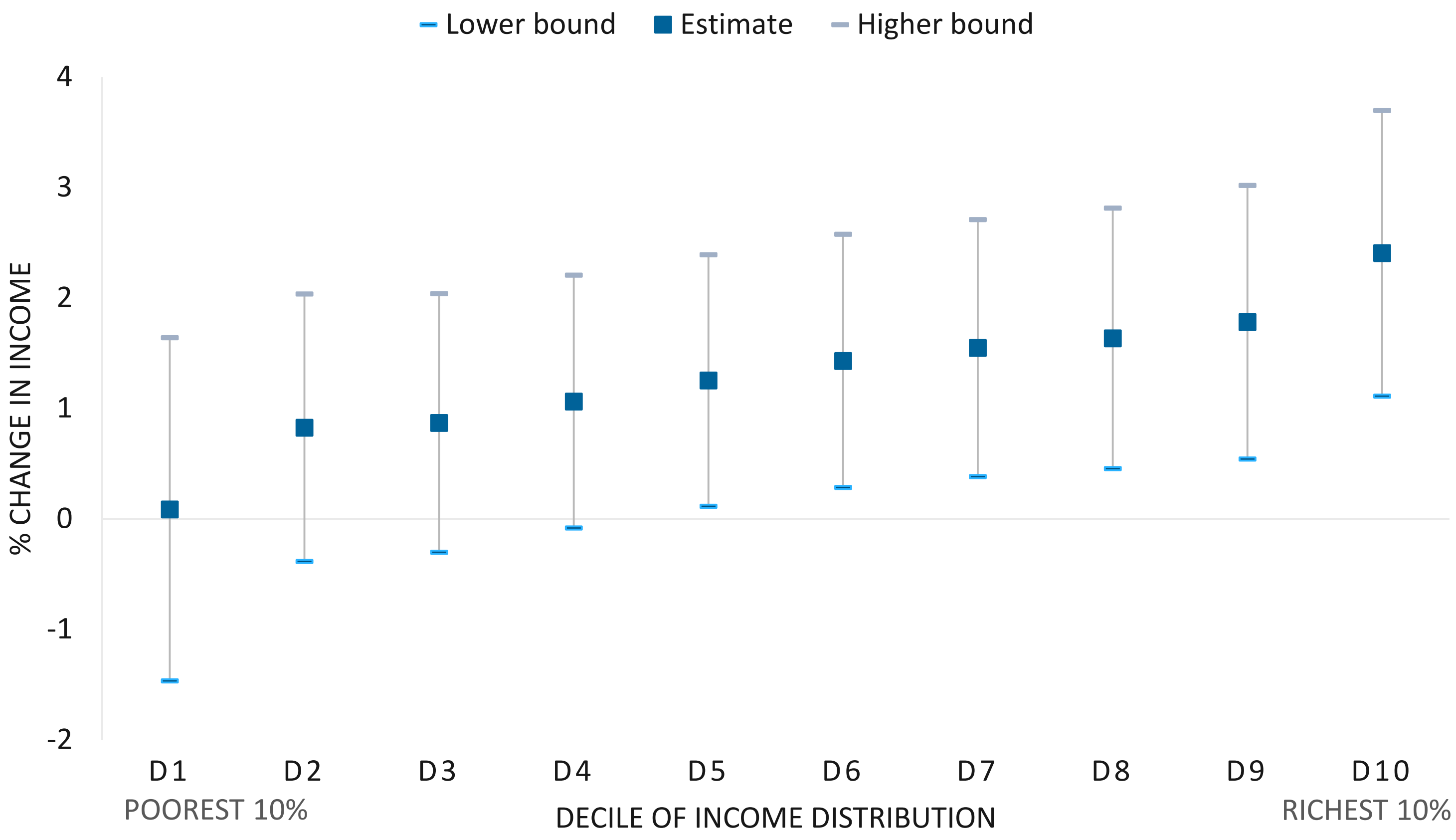


Note: the bounds delineate 90% confidence intervals.

Source: Cournède, Fournier and Hoeller (2018).

Shifting spending away from subsidies boosts output but only raises above-average incomes

Estimated long-term change in disposable income after permanently reducing subsidies by 0.1% of GDP while increasing other spending items

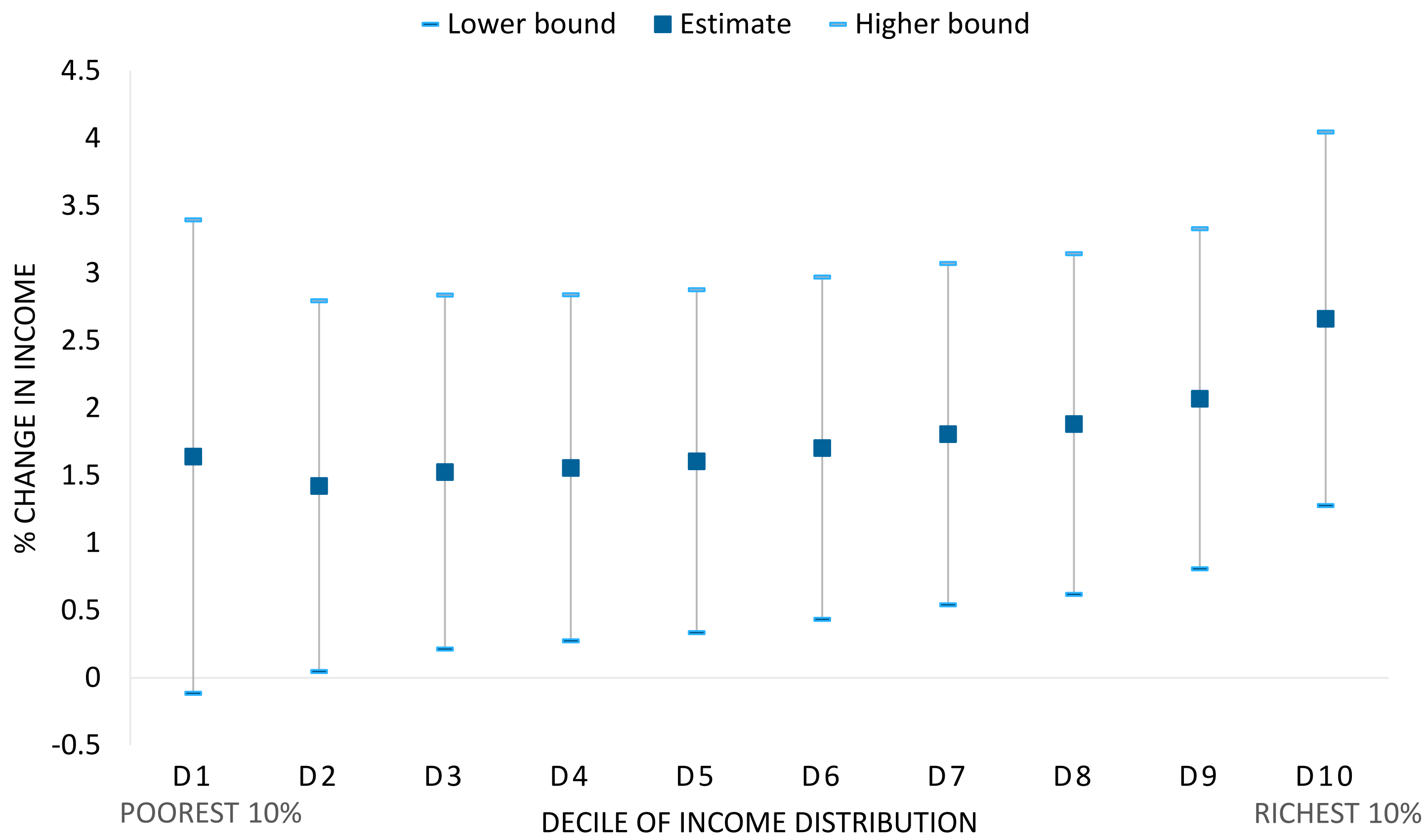


Note: the bounds delineate 90% confidence intervals.

Source: Cournède, Fournier and Hoeller (2018).

Reducing net wealth taxes predominantly benefits the rich but raises nearly everybody's income

Estimated long-term change in disposable income after permanently reducing net wealth tax receipts by 0.1% of GDP while increasing other taxes

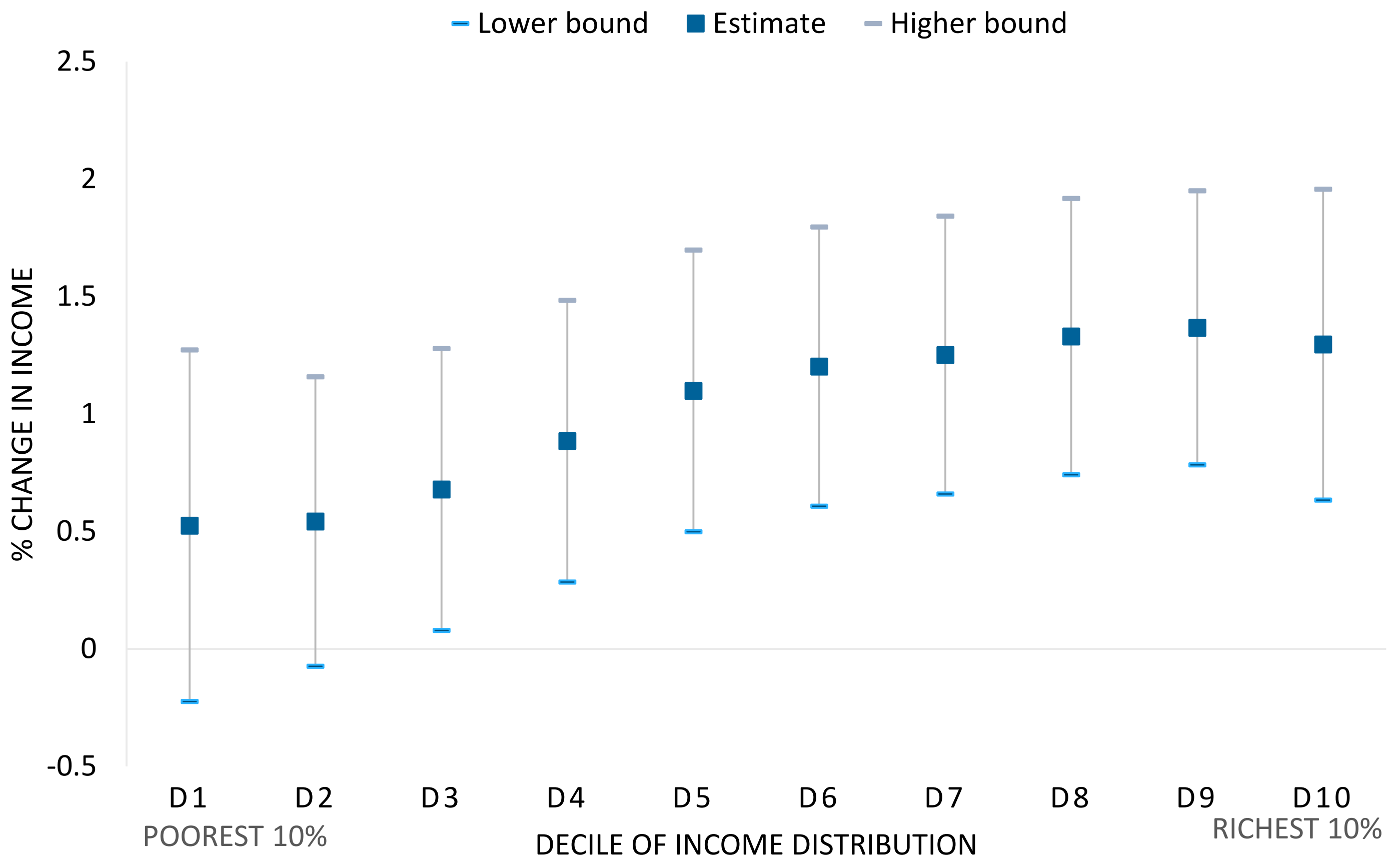


Note: the bounds delineate 90% confidence intervals.

Source: Cournède, Fournier and Hoeller (2018).

Easing the tax burden on above-average earners improves incomes for all but by more for them

Estimated long-term change in disposable income after a 1 percentage point cut in the labour tax wedge applicable to people earning 167% of the average wage while increasing other taxes

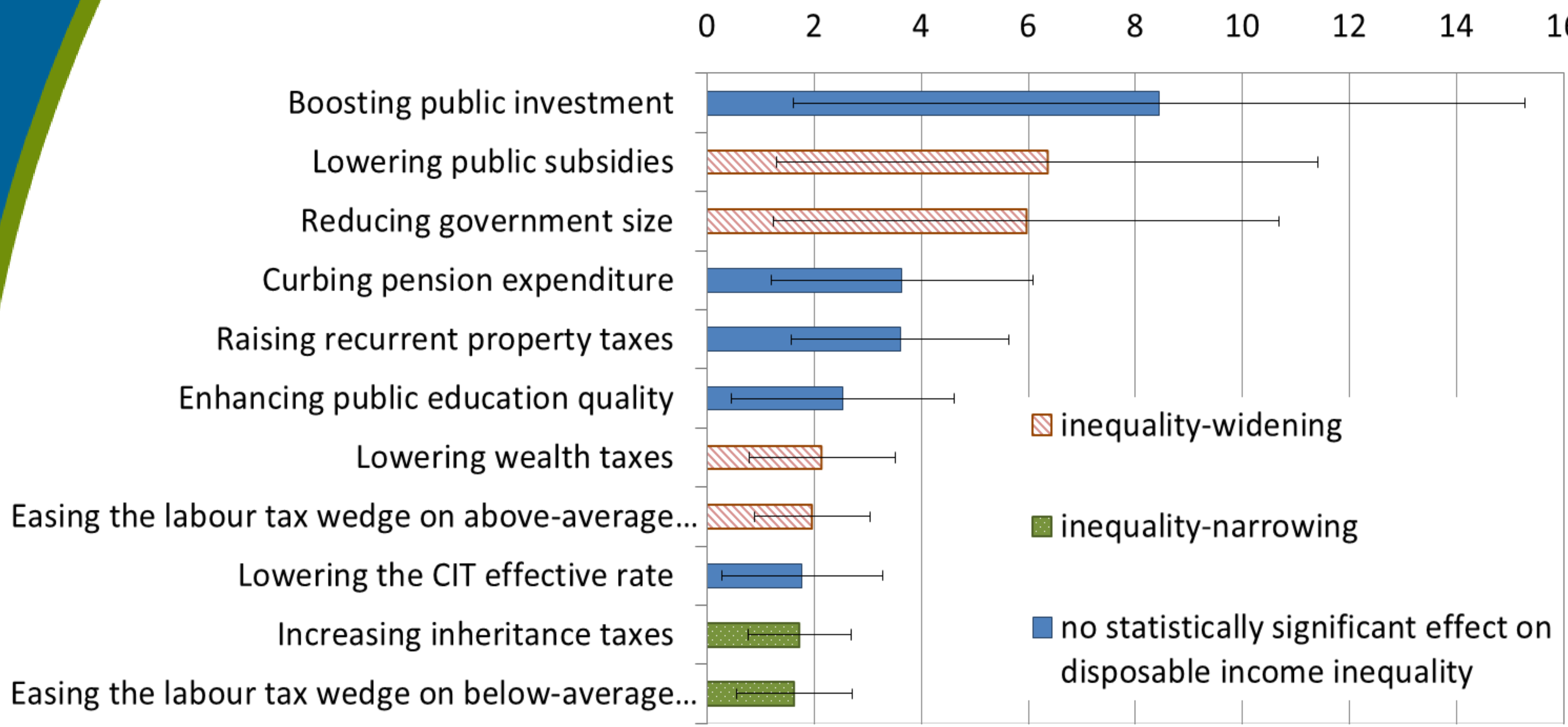


Note: the bounds delineate 90% confidence intervals.

Source: Cournède, Fournier and Hoeller (2018).

Illustrating the size of the estimated long-run effects following typical long-term changes

Permanent percentage effect on output per capita of a typically observed long-term change in a public finance instrument while keeping overall government spending and revenue constant



Note: A typically observed long-term change in a public finance instrument is defined as the average across countries of the within-country standard deviation in the tax or spending instrument over time. The brackets show 10% confidence intervals.

***Source**:* Cournède, Fournier and Hoeller (2018).

Public sectors are large, changing and diverse

Changes in public sectors have measurable effects on output per capita and its distribution

Countries have scope to improve the structure of their public finances

A number of areas offer scope to make public finances more growth-friendly in many countries

- The results allow quantifying how much potential a reform of each instrument can offer for each country

- The following areas are the four most frequent ones to arise among the two top candidate reform areas to boost output per capita:
  - Increasing recurring property taxes as part of a revenue-neutral reform: Austria, Czech Republic, Germany, Estonia, Finland, Ireland, Korea, Luxembourg, Netherlands, Slovenia.
  - Containing public pension expenditure to make room for other spending: Austria, Finland, France, Greece, Italy, Japan, Korea, Poland.
  - Expanding public investment as part of a spending shift: Germany, United Kingdom, Ireland, Israel, Netherlands, Portugal, Spain.
  - Reducing subsidies to make room for other spending: Austria, Belgium, Switzerland, Czech Republic, Denmark, Norway

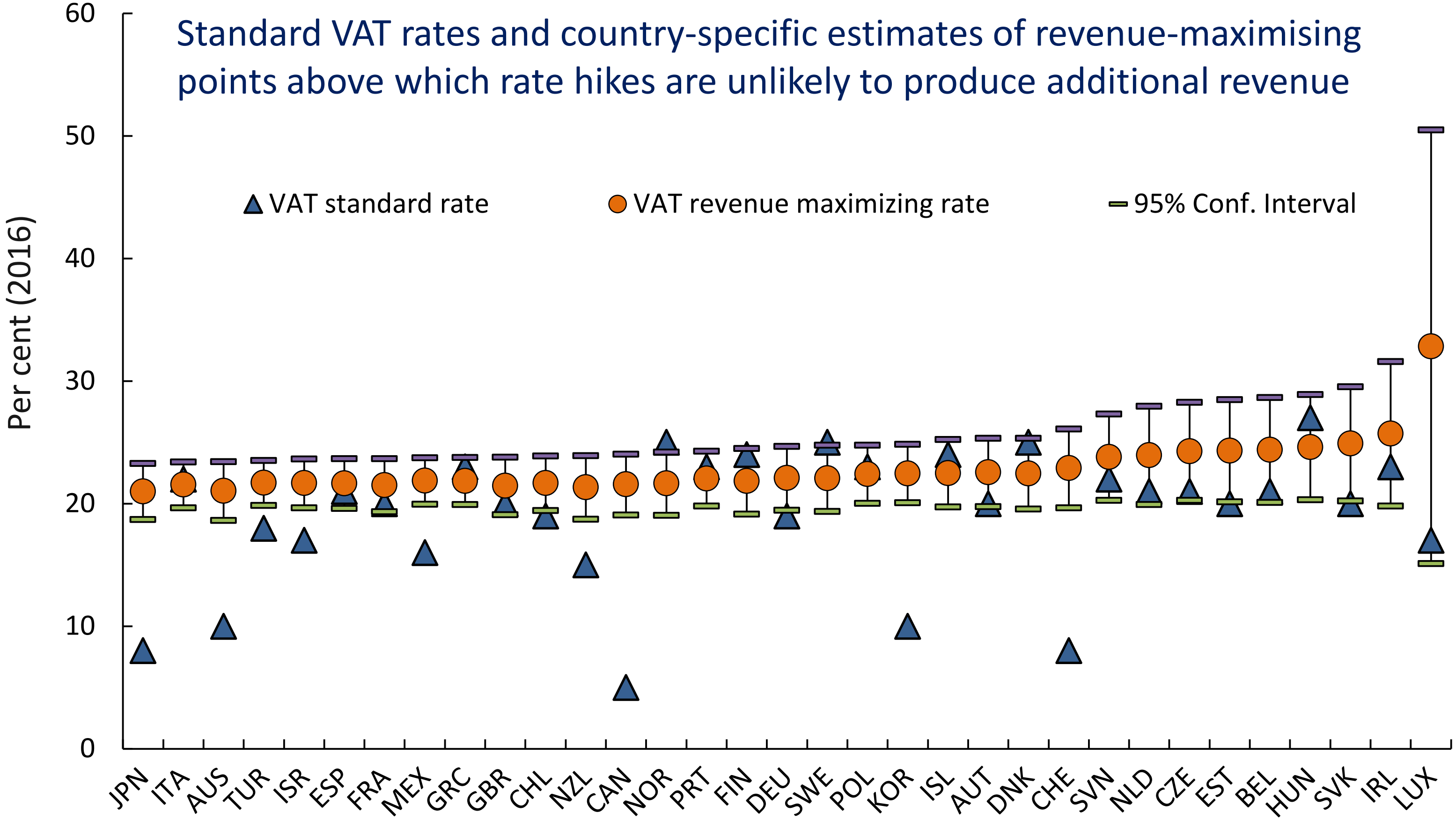
Slightly different areas offer scope to make public finances more supportive for low income groups

- The results allow quantifying how much potential each reform can offer in each country

- The following areas are the four most frequent ones to arise among the two top candidate reform areas to boost disposable income of the bottom 20%:
  - Increasing recurring property taxes as part of a revenue-neutral reform: Austria, Czech Republic, Estonia, Finland, Korea, Luxembourg, Netherlands, Switzerland.
  - Expanding family and childcare support: Czech Republic, Japan, Korea, Netherlands, Spain, United Kingdom, United States.
  - Easing the effective tax burden (and benefit withdrawal) for low income earners: Belgium, France, Germany, Hungary, Iceland, Norway, Sweden.
  - Expanding public investment as part of a spending shift: Belgium, Germany, United Kingdom, Ireland, Israel, Portugal, Spain.

Many countries have limited room to hike VAT rates as a way of funding cuts in more distortive taxes

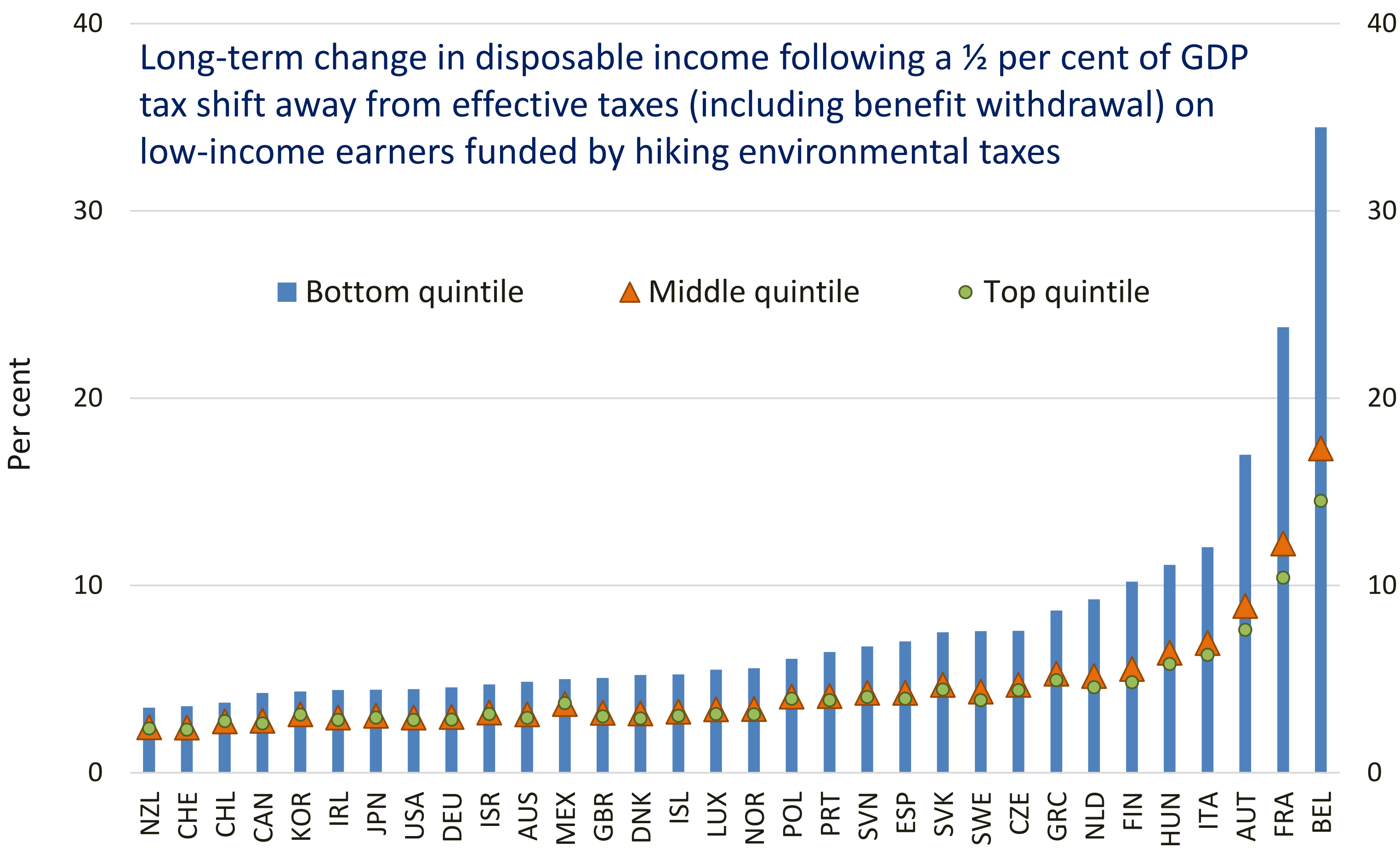
The empirical analysis finds that value-added tax rate hikes have no significant effect on output or income distribution, which makes them a candidate for adjustment in revenue-neutral reforms that cut more distortive taxes



Source: Akgun, Bartolini and Cournède (2017).

Shifting taxation away from low-paid labour towards pollution can generate large income gains

The empirical framework allows quantifying effects of reform packages by decile



Source: Cournède, Fournier and Hoeller (2018).

Shifting the tax burden from low income earners to pollution works through two channels

A concrete example: British Columbia's 2008 carbon tax

- CAD10 per tonne of CO_2 rising to CAD30 per tonne in 2012 on all fossil fuels
  → including but not limited to motor fuels
- 5 percentage point rate reduction for the first two personal income tax brackets
- Low-income tax credit
- 2 percentage point cut in the provincial rate of corporate income tax

Selected take-aways

- Many OECD countries have very **large public sectors** that are seen as not highly effective.
- Reshuffling public spending in favour of **investment** offers great potential to boost long-term output levels.
- Shifting the tax mix towards greater use of **annual property taxes** would boost average output and support bottom disposable incomes.
- Reducing the all-in tax burden on low-paid workers **boosts growth and enhances income equality**.
- Many countries have **limited room to hike VAT rates** as a way of funding cuts in more harmful taxes.
- **Reform packages**, such as coupling environmental tax hikes with cuts in effective taxes on low-income labour, offer ways to ensure outcomes that are efficient and inclusive.

These reports provide additional results and more detail on the analysis

- Cournède, B., J.-M. Fournier and P. Hoeller (2018), "Public Finance Structure and Inclusive Growth", OECD Economic Policy Paper, No. 24, OECD Publishing, Paris.
- Akgun, O., D. Bartolini and B. Cournède (2017), "The Capacity of Governments to Raise Taxes", OECD Economics Department Working Papers, No. 1407, OECD Publishing, Paris, http://dx.doi.org/10.1787/6bee2df9-en.
- Akgun, O., B. Cournède and J. Fournier (2017), "Effects of the Tax Mix on Inequality and Growth", OECD Economics Department Working Papers, No. 1447, OECD Publishing, Paris, http://dx.doi.org/10.1787/c57eaa14-en.
- Fournier, J. (2016), "The Positive Effect of Public Investment on Potential Growth", OECD Economics Department Working Papers, No. 1347, OECD Publishing, Paris, http://dx.doi.org/10.1787/15e400d4-en.
- Fournier, J. and Å. Johansson (2016), "The Effect of the Size and the Mix of Public Spending on Growth and Inequality", OECD Economics Department Working Papers, No. 1344, OECD Publishing, Paris, http://dx.doi.org/10.1787/f99f6b36-en.

Look up the dedicated website
http://oe.cd/pfig