

ECONOMIC SURVEY OF THE EURO AREA 2007:

FISCAL SURGERY WITHOUT KILLING THE PATIENT

*This is an excerpt of the OECD Economic Survey of the Euro Area, 2007,
from the section on ways to restore fiscal sustainability in chapter 3.*

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From an accounting point of view, it makes little difference whether the fiscal situation is improved by raising taxes or cutting spending. In the real world, tax hikes and spending cuts alter the incentives facing economic agents in different ways and can result in contrasting outcomes. A general-equilibrium model has been developed to assess the impact of different ways of achieving fiscal consolidation while taking into account a number of feedbacks from taxation on economic activity. Because public finances will have to be consolidated during a period of significant demographic change, the model is based on overlapping generations rather than a single infinitely lived representative agent. At the heart of the model are households that decide how much they work, save and consume in order to maximise their lifetime welfare. Because taxes and social transfers, including pensions, affect their level of income and the returns from working, changes in tax rates and income transfer programmes will affect the behaviour of households. Cournède and Gonand (2006) describe the structure of the model and the methods used to solve it analytically and numerically.

Four scenarios of fiscal consolidation have been modelled. In all scenarios, fiscal consolidation means paying off debt by 2025 so as to bring the fiscal accounts into shape just before the ageing pressures hit with a vengeance.¹ Table 3.6 describes the scenarios to achieve and sustain fiscal consolidation. For the sake of realism, one common assumption has been made in all four scenarios: increases in public health care spending (which the model projects endogenously) are financed by raising labour taxes.

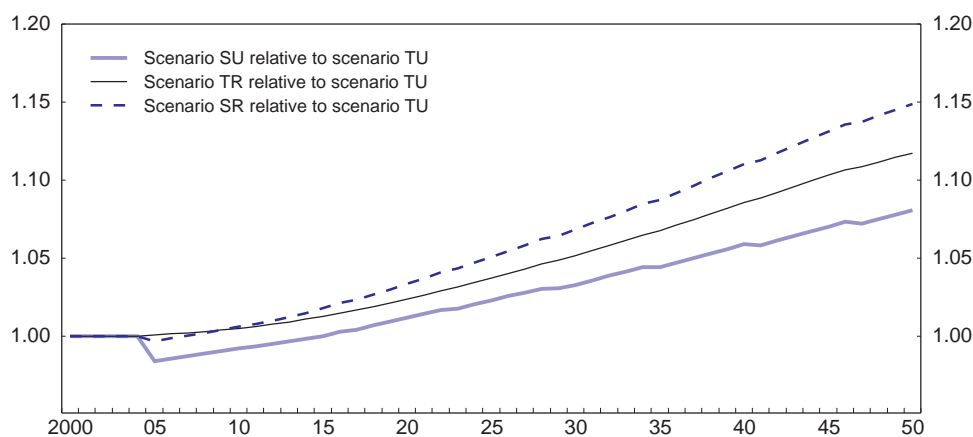
Table 3.6. The four scenarios

| | Unchanged retirement age | Rising retirement age |
|---------------------------|--|---|
| Tax hikes | TU: Tax hikes and unchanged retirement age | TR: Tax hikes and rising retirement age |
| Spending restraint | SU: Spending restraint and unchanged retirement age | SR: Spending restraint and rising retirement age |

The model results confirm that tax increases have costly economic consequences. This is not surprising since the general-equilibrium nature of the model implies that taxes and government transfers reduce incentives to work and save while no *ad hoc* offsetting positive feedback of public spending on growth has

been assumed. What is more interesting is that these costs are particularly large. Tax increases are a much more costly way to achieve fiscal sustainability when compared with spending restraint (Figure 3.8). At the end of the simulation period, spending restraint (scenario SU) brings consumption per head 8% above the level reached by a purely tax-based fiscal consolidation strategy (scenario TU).² Detailed results presented in Cournède and Gonand (2006) attribute the difference primarily to the way in which tax-based strategies depress savings, capital accumulation, the capital-labour ratio and ultimately real wages. Tax-based strategies also exacerbate tax-induced distortions in labour supply but this channel is relatively weak in net terms because income and substitution effects largely cancel out. These results also imply that mechanical or accounting-based exercises of long-term fiscal sustainability (see for instance EU Economic Policy Committee, 2006) may be unrealistically optimistic as they project future sharp increases in public expenditure without taking into account the impact that financing that expenditure will have on the growth rate.

Consumption per capita under different scenarios



Source: OECD calculations.

There is a benefit in combining expenditure restraint with appropriate structural reform (here in the form of increases in the retirement age). If expenditure restraint includes gradual increases in the retirement age in line with longevity (scenario SR), consumption per capita is 16% higher than in the purely tax-based scenario TU, and 8% higher than in scenario SU, where spending is curbed without adjusting the retirement age. The simulations are consistent with intuition and empirical evidence that fiscal consolidation and structural reform are to a large extent mutually reinforcing (see also Box 3.3).

An important caveat is that the different estimates have been obtained under conservative assumptions, most of which tend to under-estimate the distortions caused by taxation. All taxes in the model are proportional whereas they are progressive in euro area countries implying that they will be more distortionary. Furthermore, because multi-factor productivity (MFP) is assumed to be exogenous, there is no feedback of higher tax rates on investment in human capital and research and development, which most studies find to be negative and strong (Feldstein, 2006). On the other hand, the assumption that MFP is exogenous is valid only insofar as any cuts in expenditure fall on low-priority items and those that have no or little effect on MFP. Early retirement schemes are a good example whereas high-return infrastructure projects and efficient education programmes are two examples of areas that expenditure-based fiscal consolidation strategies should largely preserve. In other words, the model implicitly assumes that € 1 of public expenditure is “worth” € 1 of income to households in the form of public services received, but it takes more than € 1 of taxes to fund this because taxes have distortionary effects. In reality, there clearly are welfare benefits from funding a number of social programmes collectively – indeed, this is the *raison*

d'être for public expenditure in the first place. The problem is that the costs of taxation rise sharply with the tax rate whereas the marginal benefits of public expenditure programmes fall (the best programmes are implemented first). Thus, the appropriate conclusion from the model is not that public spending is bad *per se*, but that cuts to lower-priority spending items can deliver surprisingly large income gains compared with the alternative of raising taxes.

1. There is a strong case based on political economy and inter-generational equity grounds for going further and building a net asset position so as to pre-fund spending pressures associated with the demographic transition but given the difficulty of quantifying the desirable net asset position, aiming at zero debt is a reasonable if conservative assumption.

2. Spending restraint does not mean deep cuts: the expenditure to GDP ratio rises by 8 percentage points in scenario SU.

BIBLIOGRAPHY

Cournède B. and F. Gonand (2006), "Restoring Fiscal Sustainability in the Euro Area: Raise Taxes or Curb Spending?", *OECD Economics Department Working Papers*, No. 520, Paris.

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