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

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

Main findings

- In most OECD countries, further fiscal consolidation is needed in the coming years to put public debt on a declining path and keep it stable in the very long term.
- This study proposes a structured approach to look at how the choice of consolidation instruments can minimise the adverse side-effects of fiscal adjustment on other policy objectives.
- Fiscal consolidation instruments (increases in particular taxes and cuts in specific spending areas) have been assessed for the likely severity of their side effects on short- and long-term growth, income distribution and current accounts.
- These impact assessments have been used to rank consolidation instruments from least to most harmful. The rankings are differentiated by country group to take into account the relevance of objectives depending on country circumstances.
- Based on this assessment, fiscal consolidation packages have been simulated by using the instruments sequentially from least to most harmful until consolidation needs are fully met while maintaining the tax and spending structure well within ranges commonly observed among OECD countries.
- The results suggest that half of OECD countries can fulfill their short-to-medium term consolidation needs with relatively limited adverse side effects. Still, with the constraints imposed by the simulation design on the room for manoeuvre available to each instrument, eight OECD countries need to rely to some extent on instruments that have more damaging effects on other policy goals. For three countries (Japan, United Kingdom and the United States), those instruments account for more than 50% of the simulated short-term adjustment.
- The results also indicate that a vast majority of OECD countries have scope to keep debt durably stable at 60% of GDP in the long run with an instrument mix that is not too damaging to other policy goals. However, a few countries have to rely more heavily on less growth- and equity-friendly instruments to fulfill the same requirements while complying with the constraints on instrument use imposed in the simulations.
- On average across countries, spending reductions would account for 41% of short-term and 65% of long-term simulated consolidation packages, the rest being achieved through tax hikes.
- In the cases where countries have to use fiscal instruments that are detrimental for growth or equity on their own, they can ease the potential trade-off between consolidation and other policy objectives by implementing structural reforms.

Estimating fiscal consolidation needs

1. Many OECD countries have to improve their fiscal position substantially to remain durably solvent. This need results from high current debt levels, strong long-term pressures toward greater public spending on health and pensions, or large current deficits, or a combination of these factors.

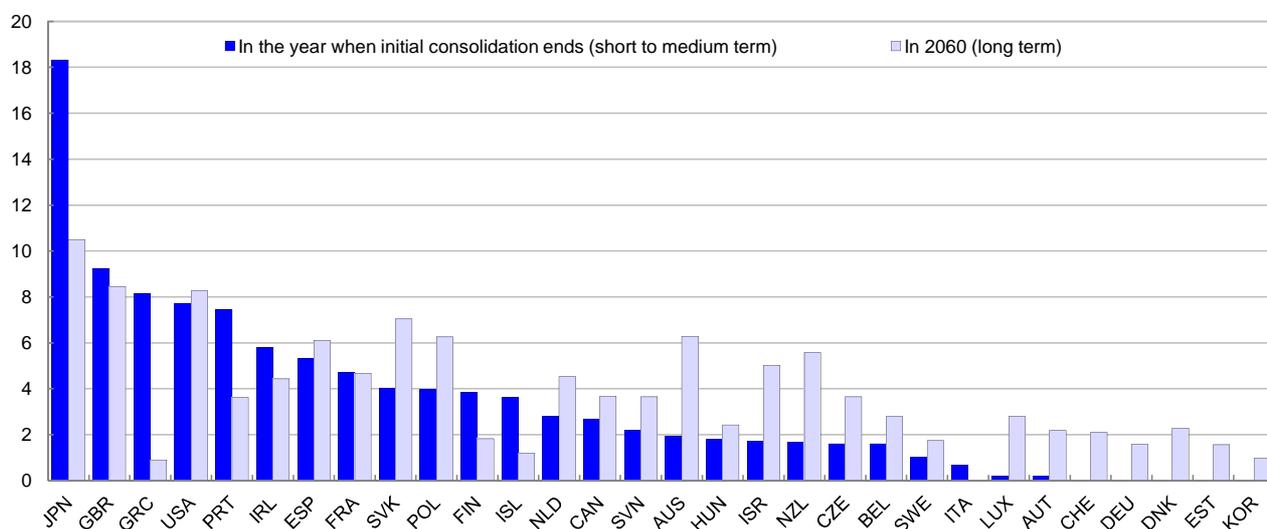
2. While inevitably somewhat arbitrary, one way of gauging the size of the consolidation need is to choose a specific definition of fiscal sustainability and compare the associated path for fiscal balances with a no-consolidation baseline. Here, sustainability is defined as stabilising gross public debt at 60% of GDP by 2060. This number is chosen for ease of comparability even though debt objectives may deviate across countries for many reasons. Among the many possible ways of achieving this objective, fiscal balances are assumed to improve each year by one per cent of GDP until public debt is put on a track that brings it to 60% by 2060. Fiscal balances are subsequently assumed to evolve very gradually until 2060 consistent with keeping public debt stable at 60%. This approach allows looking at consolidation at two points in time (the maximum effort in the short to medium term and the very long-term adjustment) and complements the average medium-term requirements to 2030 published in the *May 2013 OECD Economic Outlook*.

3. The baseline with which to compare the chosen debt-stabilising path starts from the fiscal balance in 2012 (evaluated in an underlying primary sense, that is to say net of interest payments, cyclical influences and one-off factors). Starting from this point, the fiscal balance drifts under the impact of gradual increases in government spending on health and long-term care. This baseline incorporates two strong policy assumptions. Firstly, the moderate pace of increases in government spending on health and long-term care reflects the assumption that policy measures are put in place to keep costs contained in this sector. Secondly, public pension spending is assumed to remain constant as a share of GDP, meaning that the baseline incorporates the hypothesis that effective pension reforms are implemented in countries where unchanged policies would imply a trend increase in government expenditure on pensions.

4. With this approach, Greece, Ireland, Japan, Portugal, Spain, United Kingdom and the United States are reckoned to have to improve their underlying fiscal positions in the short to medium term by more than 5% of GDP to reduce debt to 60% of GDP by 2060 (Figure 1). This is the result of currently high debt levels (Greece, Ireland, Portugal, Spain) or their combination with large underlying primary deficits (Japan, United Kingdom, United States). To bring debt to the same level, another group needs to consolidate by more than 3% of GDP — though less than 5% — because of high debt levels (France, Iceland) or a significant underlying primary deficit (Finland, Poland, Slovak Republic). Other countries face more limited or no short- to medium-term consolidation needs. In the majority of cases where significant consolidation is required, the peak in tightening is reached in the simulations in four years or less. For many countries, this profile is consistent with their announced consolidation plans, even if such consistency is not imposed by the approach.

Figure 1. Consolidation needs estimated at the end of 2012 are substantial

Difference between debt-control and baseline underlying primary surplus, per cent of potential GDP



Note: these estimated consolidation needs differ in purpose and quantitatively from the fiscal gaps presented in Chapter 4 of the *OECD Economic Outlook* of May 2013. See the reference quoted below for more details.

Source: Cournède, Goujard and Pina (2013).

5. Estimated consolidation needs are larger in the long than the short term for the majority of countries (Figure 1) reflecting the large expected increases in government spending on health and long-term care. Since the latter increases are fairly homogenous across countries, they only explain to a limited extent the cross-country variations in estimated long-term consolidation needs. The latter are primarily due to the starting-point fiscal position in 2012.

Assessing the effects of consolidation instruments on other policy objectives

6. While the point of fiscal consolidation is to reduce debt, it cannot ignore other policy objectives. The present study looks at the extent to which fiscal consolidation can proceed while minimising adverse effects on short-term growth, preserving long-term prosperity, cushioning equity in the short and long term and contributing to global rebalancing. A crucial aspect of this balancing act is the choice of policy instruments for consolidation. The instruments considered are specific categories of spending, transfers and taxation that permanently affect government underlying primary spending and revenues. One *caveat* is that cutting tax expenditures (*i.e.* targeted tax exemptions or application of reduced rates), a potentially large and attractive source of revenue, is not included as an autonomous instrument. The reason is that tax expenditures are not recorded as government spending but amount to “foregone revenues” and are not estimated in ways that are sufficiently reliable and internationally comparable.

7. A qualitative assessment of the effects of revenue increases and expenditure cuts on growth, equity and global rebalancing objectives is proposed in Table 1, based on new and earlier studies from the OECD and other institutions (Table 1). The effects of instruments on the current account are also evaluated because consolidation strategies should take into account coordinated efforts in multilateral settings such as the G20 to achieve balanced growth at the global level. For the purpose of this exercise, the instruments are assessed on their own, on a pure fiscal basis, assuming proportional changes to the existing expenditures or revenues. At this stage of the analysis, no consideration is given to smarter instrument design or accompanying structural reforms and redistributive policies that could minimise adverse side-effects,

although these are highly desirable in most cases. While the impact assessments summarised in Table 1 have been found to hold in general, they might not apply in some cases because of specific country circumstances.

Table 1. Summary assessment of the effects of budgetary tightening through specific instruments

	Growth		Equity		Current account balance ^(a)
	Short-term	Long-term	Short-term	Long-term	Short- to medium-term
Reducing spending in:					
Education	--	--	-	--	+
Health services provided in kind	--	-	-	-	++
Other government consumption (excluding family policy)	--	+	-		+
Pensions		++			++
Sickness and disability payments	-	+	--	-	++
Unemployment insurance	-	+	-		++
Family	-	-	--	--	+
Subsidies	-	++	+	+	+
Public investment	--	--			++
Raising revenues from:					
Personal income taxes	-	--	+	+	+
Social security contributions	-	--	-	-	
Corporate income taxes	-	--	+	+	++
Environmental taxes	-	+(b)	-		+
Consumption taxes (other than environmental)	-	-	-		++
Recurrent taxes on immovable property	-				+
Other property taxes	-		++	+	+
Sales of goods and services	-	+	-	-	+

Note: (a) By raising public-sector savings, and hence national savings, fiscal consolidation contributes to strengthen the current account position, regardless of the instrument used. Only the magnitude varies depending on the indirect effect on private saving.

(b) This + sign reflects positive welfare effects as the long-term impact on output narrowly defined as GDP may be ambiguous.

Source: Cournède, Goujard and Pina (2013).

8. The logic underlying the assessments summarised in Table 1 can be summarised as follows:

- *Short-term growth effects:* most fiscal consolidation instruments are harmful growth in the short run (through the so-called multiplier effect), but there are differences among them. Despite a lack of consensus, international experience suggests by and large that the demand effects of fiscal changes are highest for public investment and government consumption and smaller for transfers and taxes.
- *Long-term growth effects:* Even though there may be no such thing as an “optimal” size of the public sector, cuts in various areas of public spending can increase the long-term level of output, especially where such expenditures have reached high amounts relative to GDP. This effect is likely to be greatest in areas where public spending can distort resource allocation (such as

subsidies) or reduce incentives to work. In contrast, cutting the provision of public health services or education would have adverse effects on long-term growth. Many revenue-raising instruments can restrain the productive potential of economies, the prime example being taxes on labour and capital inputs, but taxes aimed at encouraging pollution abatement and a more efficient use of natural resources may have a favourable impact on output in the long term.

- *Equity*: many consolidation instruments work in the direction of increasing income inequality. Transfers in particular have strong redistributive power so that cuts in benefits are generally regressive, perhaps with the exception of public pensions where the equity effect is unclear especially when considered also from an intergenerational point of view. Some fiscal consolidation instruments, on the other hand, can reduce income or wealth inequality. Such is particularly the case of hikes in inheritance and capital gains taxes, which the present study includes among “other property taxes”.
- *Current account*: while at a broad level fiscal consolidation works to push the current account towards a surplus over the short to medium term through higher public-sector saving, different instruments can have different effects depending on how they shape private saving and investment decisions. For instance, reductions in health care spending and in unemployment or disability benefits are likely to further strengthen the current account through increased precautionary saving. Higher consumption taxes tend to penalise imports relative to exports, and thus may temporarily strengthen the current account, while increases in social security contributions will have the opposite impact on net exports and thus mitigate the favourable effect of consolidation on the current account.

Ranking consolidation instruments

9. Based on the estimated impacts reported above, a generic hierarchy of consolidation instruments can be established (Table 2, first column). This is done simply by putting the same weight on each objective, adding the pluses and minuses after converting them to numeric values, and using the resulting scores to rank the instruments. A long-term variant of the generic hierarchy can also be established for the purposes of looking solely at very long-term consolidation strategies by including only long-term growth and equity effects (Table 2, last column). The generic hierarchy (as well as its long-term variant) puts no weight on the current-account because this objective affects policy choice in opposite ways depending on the sign of the imbalance and not at all in countries that have broadly balanced positions.

10. The rankings have been thoroughly checked for their robustness to uncertainty about the individual assessments and the weighting of objectives. Reductions in subsidies and in pension spending as well as increases in other property taxes come out robustly as preferred consolidation instruments as they involve limited adverse side-effects. At the lower end, spending cuts in the areas of education, health care and family policy, as well as hikes in social security contributions, appear as particularly unfavourable in terms of generating adverse side effects for growth and equity. In contrast, the middle part of the ranking is more fluid. Hikes in corporate and personal income taxes can take different places in the ranking depending on the weights given to objectives, reflecting that they raise severe trade-offs between output and equity considerations.

Table 2. Possible hierarchies of consolidation instruments for groups of countries

Instruments	Generic ranking	Cluster-specific 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 insurance	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

Note: The rankings are based on the assessments in Table 1 with scores of +1 and -1 given to each + and – signs, respectively, and weights from clustering analysis (see papers quoted in reference). The current account scores of Table 1 switch sign for surplus clusters. The final column gives the long-term ranking where only long-term effects on growth and equity are considered, with equal weight. The composition of clusters is as follows: Cluster 1 groups Australia, Canada, Estonia, Israel, Italy, Japan, Korea, New Zealand, Poland, Portugal, United Kingdom; Cluster 2 comprises only the United States; Cluster 3 groups Greece, Ireland and Spain; Cluster 4 groups Austria, Belgium, Czech Republic, Denmark, Finland, France, Hungary, Iceland, Norway, Slovak Republic, Slovenia, Cluster 5 groups Germany, Luxembourg, Netherlands, Sweden, Switzerland.

11. As the example of the current account makes clear, there is a case for adapting the hierarchy to country circumstances. This is done by adjusting the weights put on growth, equity and global rebalancing objectives with countries grouped based on similarities in their economic situations. Long-term growth is not considered a differentiating factor because it is seen as equally important everywhere. The country groups are based on the following:

- *Short-term growth*: The weight attached to the short-run growth impacts of fiscal retrenchment depends on the degree of cyclical slack faced by countries and the risk that temporary weakness, especially high unemployment, may become entrenched.
- *Income distribution*: The assumption is that more unequal countries will put a higher weight on reducing inequality. The overall degree of inequality and the incidence of relative poverty are considered.
- *Current account*: Imbalances carry risks for the individual countries concerned when they are large relative to the economic size of a country and for the global economy when they are large in absolute terms. Both the absolute and relative sizes of imbalances are therefore taken into account.

12. Based on the indicators of country situations discussed above, five country groups have been identified:

- The first grouping or cluster is formed by eleven geographically dispersed countries (Australia, Canada, Estonia, Israel, Italy, Japan, Korea, New Zealand, Poland, Portugal and the United Kingdom), which mainly have in common above-average levels of inequality.
- The United States finds itself alone in the second cluster, as the sheer absolute size of its current account deficit puts it at a considerable distance even from other deficit countries. Inequality is high and cyclical developments carry important hysteresis risks although the materialisation of these risks would run counter to historical experience.
- The third cluster comprises three peripheral euro area members (Greece, Ireland and Spain) sharing very high cyclical slack and hysteresis risks. Greece and Spain (but not Ireland) also display above-average inequality and large external deficits.
- A fourth cluster is formed by eleven European countries: Austria, Belgium, the Czech Republic, Denmark, Finland, France, Hungary, Iceland, Norway, Slovakia and Slovenia. It is the most egalitarian cluster. Hysteresis risks from persistently weak demand are relatively moderate.
- The fifth and final cluster comprises five countries, Germany, Luxembourg, the Netherlands, Sweden and Switzerland, all with large current account surpluses. Inequality levels are below-average and hysteresis risks are among the lowest in the OECD.

13. Table 2, on its five central columns, displays the ensuing cluster-specific instrument rankings. Rank variation across country groups is smallest for those instruments that are either favourable or unfavourable across most objectives, such as education, subsidies or property taxes, and widest for instruments with the sharpest trade-offs between growth, equity and the current account. For instance, personal and corporate income taxes come out as good candidate instruments for cluster 1, where equity objectives carry a high weight, but much less so for more egalitarian groups of countries such as those forming clusters 4 and 5. The clustering exercise and the associated weights implicitly assume that cross-country differences in the indicators considered do not simply reflect national preferences.

Simulating illustrative short- to medium-term and long-term consolidation packages

14. Illustrative simulations have been performed to investigate how far down instrument rankings OECD countries will need to go in order to meet their consolidation needs. Countries are assumed to implement budget tightening according to the relevant instrument ranking, *i.e.* to start by adjusting the most beneficial (or least detrimental) instrument and only proceed down the list after exhausting the estimated room for manoeuvre available in the preceding instrument. For the short- to medium-term consolidation packages, the rankings used are the cluster-specific ones reported in the middle of Table 2. The ranking shown in the last column of Table 2 is used for long-term packages.

15. But it is clear that limits exist: determining the room for manoeuvre on each instrument necessarily involves judgement. Criteria are set to limit the scope that countries have for using the more desirable instruments. More specifically, for each consolidation measure, say a spending cut, it is assumed that it can proceed as long as the cut does not take the country under consideration into the group of ten OECD countries (among the 31 covered) which spend least in this area as a share of potential GDP. In addition, the simulations impose the constraint that the cut cannot be excessively large. Similar criteria are used to define the leeway on the revenue side. Additional assumptions have been made, in particular to take into account pension reforms that have already been implemented.

16. Three groups of countries can be identified in the illustrative short- to medium-term simulations:

- Sixteen countries (Australia, Austria, Belgium, Canada, Czech Republic, Hungary, Israel, Italy, Luxembourg, Netherlands, Poland, Portugal, Slovak Republic, Slovenia, Spain and Sweden) only need to use instruments featuring in the top half (first nine places) of their respective cluster-specific rankings. All these countries have short- and medium-term consolidation needs which do not exceed 3 percentage points of potential GDP. Though the simulated adjustment is not without costs, these will be mainly of a Keynesian nature, while negative impacts on equity or on long-term growth will be absent or, at worst, limited.
- Six countries (Finland, France, Greece, Iceland, Ireland and New Zealand) need to make some use of instruments placed in the lower half of the respective cluster-specific hierarchies but more than 50% of their consolidation comes from instruments in the upper half. While the use of the more detrimental instruments remains moderate, fiscal tightening will entail costs which go beyond short-run aggregate demand, raising concerns about impacts on equity and long-term growth.
- Three countries (Japan, United Kingdom and the United States) have to resort to instruments at the bottom of the relevant rankings with more than 50% of simulated consolidation stemming from instruments in the lower half of rankings. Short- and medium-term consolidation therefore presents significant challenges for these countries as it appears difficult to avoid potentially strong detrimental effects on both growth and equity.

Among the countries covered in this study, six do not need any short- and medium-term fiscal tightening (Denmark, Estonia, Germany, Korea, Norway and Switzerland) so that no packages have been simulated for them.

17. In the long-term simulations, as above, one can identify three groups of countries:

- Twenty countries (Austria, Belgium, Canada, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Korea, Luxembourg, Netherlands, Poland, Portugal, Slovenia, Sweden and Switzerland) with low or moderate consolidation needs enjoy the favourable position of only having to use instruments in the upper half of the long-run hierarchy, with the overall impact on long-run growth and equity likely to be mostly beneficial or fairly neutral.¹
- Six countries (Ireland, Israel, Japan, Slovak Republic, Spain and the United Kingdom) need resort to instruments in the lower half of the ranking, which have overall potential detrimental consequences for growth and equity objectives. However, these countries have consolidation packages where more than half (and in some cases virtually all) of the adjustment comes from better instruments (those in the upper half of the hierarchy).
- Three countries (Australia, New Zealand and the United States) face the unpleasant prospect of both employing low-quality marginal instruments and letting poor instruments (those in the lower half of the ranking) account for more than half of the total fiscal adjustment. Therefore this group

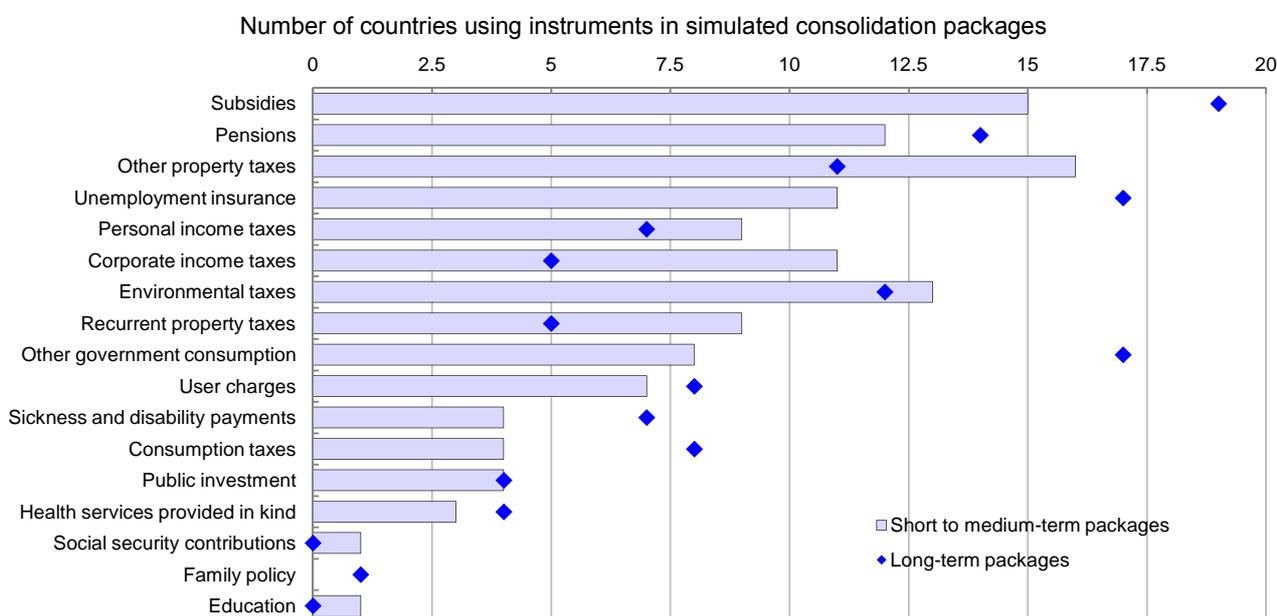
1. The top nine instruments have either (i) beneficial impacts on both long-term growth and long-term equity (Table 2), as is the case of subsidies, (ii) impacts which are beneficial on one objective and fairly neutral on the other, as it happens with lower other government consumption, or (iii) opposite impacts on long-term growth and long-term equity which can somehow be regarded as compensating each other, reduction in sickness and disability payments being an example. Implicit in this ‘compensation’ argument is the use of +1 and -1 scores for each + and – sign in Table 2, which is admittedly a simplifying assumption, rather than an attempt to calibrate a social welfare function.

faces a substantial risk of overall negative impacts of consolidation on growth and equity under the constraints on instrument use imposed in the simulations. This reflects substantial consolidation needs in the long term but also the fact that these countries' starting positions in terms of tax and spending structure leaves them with relatively little room for relying on the less harmful instruments in the simulations.

With the assumptions outlined above, Italy and Norway have no estimated long-term consolidation needs and therefore no simulated packages at that horizon. The simulated long-term packages are not additional to the short-term ones but replace them, which may not always be feasible if some measures are irreversible.

18. In the short and medium term, subsidies and other property taxes are the most widely used instruments in the illustrative packages (Figure 2). Spending reductions on unemployment insurance and pensions as well as increases in environmental taxes, corporate and personal income taxes, and recurring property taxes come next in frequency of use. As a result of the frequent use of taxes in the illustrative short-term consolidation packages, the tax share increases noticeably in the simulations in most countries at a medium-term horizon (Figure 3). Cuts in the areas of health, education and family policy are very rare in simulated packages, as are increases in social security contributions, reflecting their negative side-effects across the growth and equity dimensions. Alternative simulations where a quarter of the impact assessments are changed randomly indicate that this finding is robust to uncertainty about the effects of instruments and their ranking. The frequency with which instruments are used is not perfectly linked to their ranking because each instrument is unavailable in one third of the countries.

Figure 2. Cuts in subsidies and increases in property and environmental taxes should be part of most consolidation packages

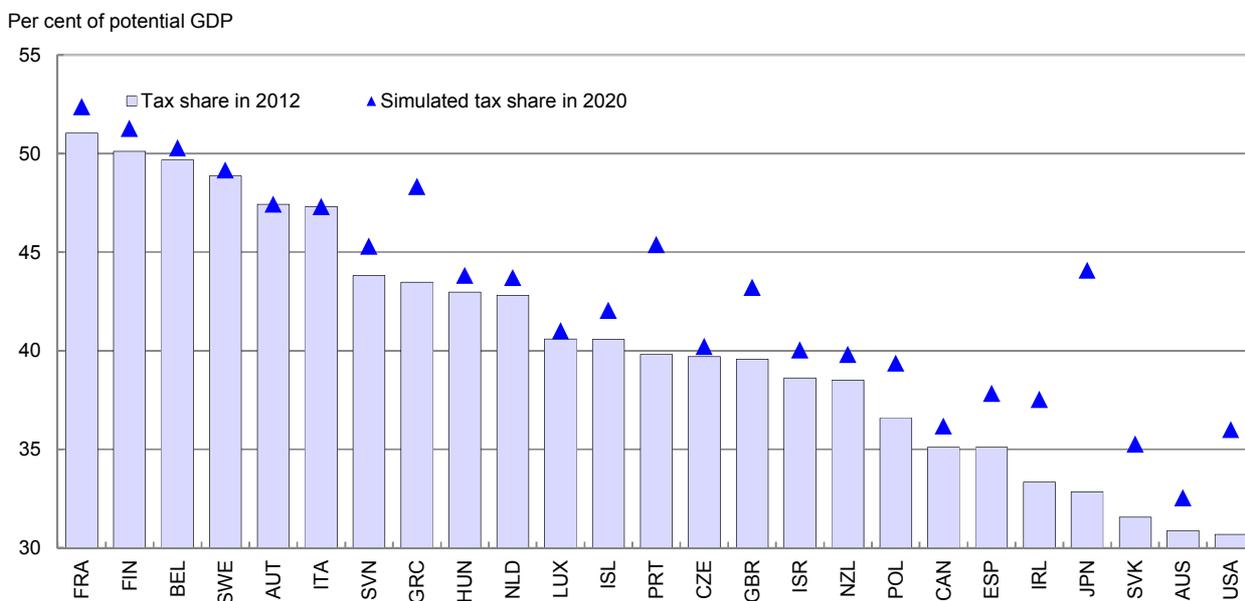


Note: Instruments are listed according to the generic illustrative ranking which takes into account short- and long-term effects on growth and equity so that least harmful instruments across these dimensions appear at the top and most harmful ones at the bottom. Each bar shows the number of countries in which the corresponding consolidation instrument is used in simulated short- to medium-term packages. Diamonds show the number of countries using the instrument in their simulated long-term packages.

19. In the long term, simulated consolidation packages give a greater role to spending reductions as their larger Keynesian demand effects are no longer taken into account. Spending reductions on pensions, other government consumption and subsidies contribute large amounts to simulated long-term packages

although consumption taxes still play a very significant role in the long term (Figure 4). If aggregating individual instruments into overall expenditure reductions and receipt increases, spending cuts make up 65% of simulated long-term packages, up from 41% in the short to medium term.

Figure 3. The simulated consolidation packages translate into a medium-term increase in the tax share



Note: the figure shows cyclically-adjusted primary government revenue (*i.e.* excluding property income received but including user charges) as a ratio to GDP in 2012 as estimated and in 2020 as it would result from the implementation of the simulated short- to medium-term consolidation packages.

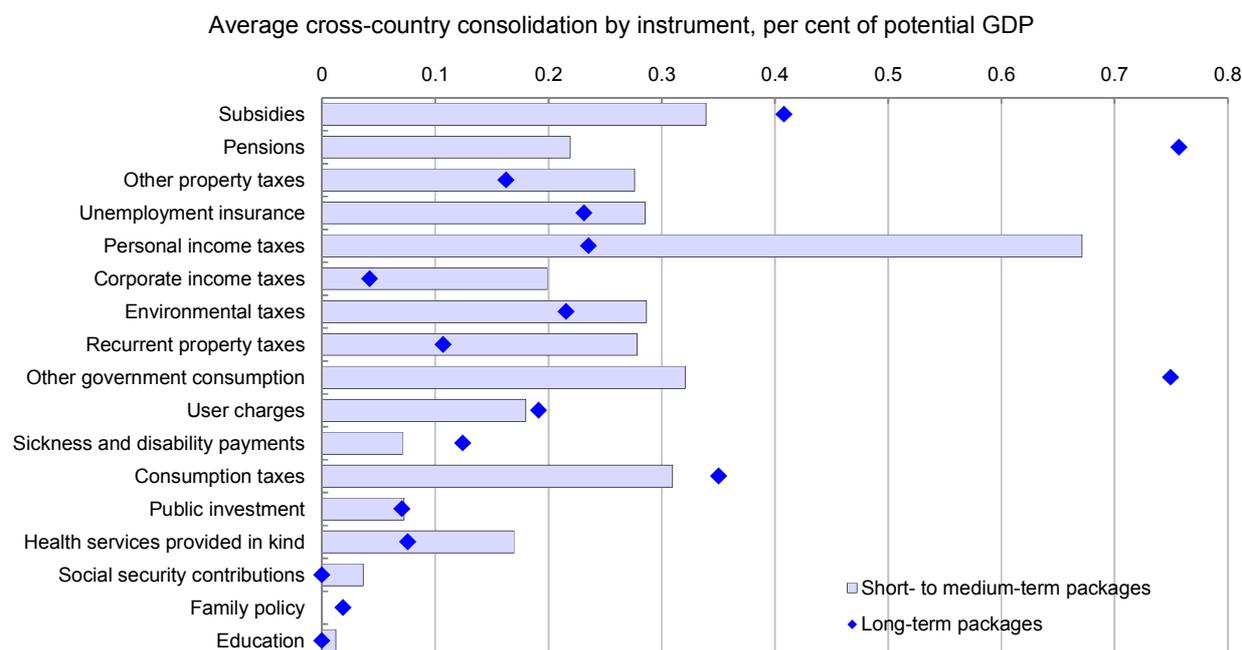
20. The simulated short- to medium-term consolidation packages can be summarised as follows in the countries where they are particularly large (*i.e.* in excess of 4% of potential GDP):

- In Japan, the simulated adjustment is achieved for the most part (70% of the total effort) through tax increases in particular on personal income and consumption (7.1% of GDP in total). There also appears to be scope for the government to charge more for the services it provides. On the spending side, the simulated package incorporates significant cutbacks in health spending and public investment (2.6% of GDP in total).
- In the United Kingdom, the simulated medium-term adjustment is broadly balanced between revenue increases and spending reductions. On the revenue side, the simulations give a large role to increases in consumption taxes and in user charges for government-provided services (2.1% of GDP in total). The simulated package relies on significant reductions in health expenditure (1.5 % of GDP) and other government consumption (2.2% of GDP) but safeguards education spending.
- In Greece, the simulations suggest that tax increases could contribute two thirds of the remaining adjustment, with the possibility of raising a further 4.4% of GDP in personal income and property taxes. On the spending side, the simulated medium-term package relies on a further 2.5% of GDP saving on pensions and government consumption in areas other than education and health. In education and health, exploiting the potential for efficiency gains can provide a way of further reducing expenditure without adverse side-effects on other policy objectives.

- In the United States, the simulations suggest that tax increases could play a significant role in the restoration of fiscal sustainability as they could contribute almost 70% of the total adjustment. Consumption, environmental and inheritance taxes, as well as personal income taxes, appear to offer considerable potential (reckoned at 4.9% of GDP in total). The simulations also highlight the scope for significant fiscal adjustment on the spending side in particular in entitlement programmes as government expenditure on health and pensions could be cut by 1.8% of GDP from its current level.
- In Portugal, the simulated medium-term package suggests achieving most (80%) of the remaining adjustment through tax increases, with in particular a strong rise in personal income taxes (4.1% of GDP compared with the 2012 outcome). Consolidation efforts underway in 2013 already involve a substantial increase in personal income tax.
- In Ireland, the simulations point to tax increases contributing more than 70% of the remaining medium-term consolidation, in particular through hikes in consumption, property taxes and corporate income taxes (for 3.2% of GDP in total). On the spending side, the simulated package suggests reducing expenditure on unemployment benefits by 1.1% of GDP.
- In Spain as well, the simulations give a large role to user charges and tax increases which make up 64% of the remaining need for medium-term consolidation. On the spending side, the simulated package incorporates a large reduction in expenditure on unemployment insurance (1.6% of GDP), which in practice is likely to be difficult to implement until the labour market shows signs of improvement.
- In France, in contrast, the illustrative medium-term consolidation package highlights a very strong potential for spending cuts, which make up almost three quarters of the simulated adjustment.

21. While the criteria used to guide the fiscal adjustment in individual countries could in principle lead to some convergence of the budget composition across countries, the simulated consolidation packages do not in practice result in a standardisation of tax and spending structures. Compared with the current situation, the variation across countries about how much is spent in each individual area and how much is levied with each tax would diminish only by a very small amount if the simulated packages to 2060 were implemented in full. In this regard, with the constraints it imposes on instrument use, the simulation exercise can be considered as respectful of countries' individual preferences over the structure of government.

Figure 4. Simulations suggest relying more on spending cuts for long- than short-term consolidation



Note: Instruments are ranked according to the generic illustrative ranking which takes into account short- and long-term effects on growth and equity so that least harmful instruments across these dimensions appear at the top and most harmful ones at the bottom.

The case for integrated policy strategies combining structural reforms and fiscal adjustment

22. For the purpose of the simulations reported above, no consideration was given to the scope for achieving efficiency gains when raising taxes or reducing spending. Structural reforms, while desirable in their own right, can also ease the trade-offs between consolidation, equity and long-term growth objectives. In the most favourable cases, structural reform can even eliminate trade-offs and bring fiscal improvements as well as progress along growth or equity goals. As a result, structural reforms also have the potential to make fiscal consolidation more likely to succeed.

23. At a general level, structural reforms that improve efficiency in the delivery of public services can reduce the adverse growth impact of spending cuts in productive areas of government spending. Similarly, the negative equity impact of spending cuts can be headed off by structural reforms that ensure a better targeting of public services and transfers and stimulate labour supply. On the tax side, the growth impact of hikes can be reduced through the closing of loopholes and base broadening (including by curbing fraud and evasion) rather than *via* rate increases. Hence, an important way of improving the trade-off between raising more revenue and preserving growth-friendly incentives is to cut back tax expenditures. However, the recommendation of structural tax reform to eliminate tax breaks cannot be made across the board as some measures work to preserve productive potential or to alleviate poverty or both. Such is the case of tax credits for low-income earners, which tackle poverty traps created by other parts of the tax and transfer system and help boost the employment of low-skill workers. Another important example are well-designed corporate income tax credits for research and development activities, which can provide remuneration for the growth-enhancing externalities from R&D.

24. Even though substantial consolidation often requires deep changes in parameters of taxation and spending, these changes do not in themselves amount to effective structural reform. International experience suggests that in fast-paced consolidation episodes the need for quick spending reductions or tax

increases means that the changes in tax and spending parameters introduced for consolidation purposes often tend to be at odds with efficiency objectives. In particular, when the main objective is to achieve fiscal results quickly, it appears very difficult to introduce effective structural reforms in areas such as pension and health care where long lead times are required. Furthermore, changes in tax and spending items that are presented to the public as needed essentially for fiscal adjustment can meet strong, sometimes successful, pressure to reverse them once consolidation is achieved. These lessons from experience indicate that effective structural reform does not necessarily ensue from fiscal consolidation efforts. Policy strategies that explicitly combine fiscal and structural efforts in a common framework are thus desirable to take full advantage of their complementarities.

25. Most countries have made consolidation plans that go a long way toward meeting their consolidation needs. The present study proposed one structured way of thinking about the detailed instruments with which these plans can be implemented to reduce adverse side effects on other policy objectives. With a number of assumptions, illustrative quantified packages have been simulated to give indications about the feasibility of such strategies and help assess to what extent focusing on more favourable instruments requires deviations from existing tax and spending structures. While they can provide some suggestions about ways to pursue growth- and equity-friendly consolidation, the simulated packages cannot substitute for country-by-country analysis of an appropriate mix of instruments. The actual design of fiscal consolidation has to take into account ways in which consolidation instruments interact with each other and with a country's particular characteristics.

Suggested further reading

The papers providing background to this note are:

OECD (2013), "Choosing Fiscal Consolidation Instruments Compatible with Growth and Equity", *OECD Economic Policy Papers*, No. 7, OECD, Paris.

Cournède, B., A. Pina and A. Goujard (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*, forthcoming.

Barbiero, O. and B. 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.

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