NERO Meeting
21 June 2013

THE CHOICE OF CONSOLIDATION INSTRUMENTS IN THE FACE OF CONFLICTING OBJECTIVES

Boris Cournède
OECD Economics Department

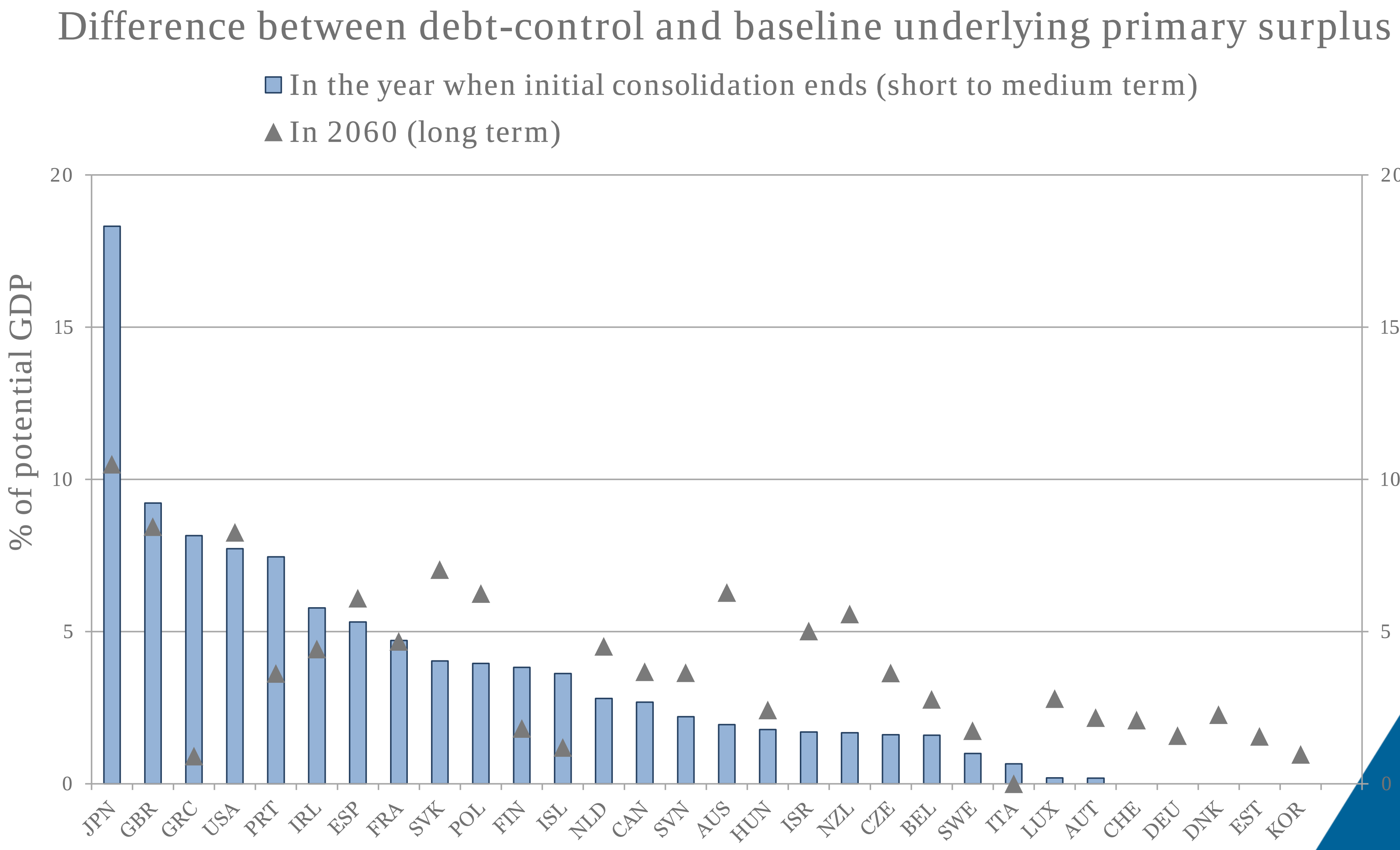
OECD
BETTER POLICIES FOR BETTER LIVES

The objectives:

- Propose a structured way of looking at the selection of consolidation instruments in the light of their effects on:
  - growth (short and long term)
  - income inequality (short and long term)
  - global rebalancing
- Illustrate this approach with numerical examples
- Highlight the role of structural reforms

To be published as an OECD Policy Paper accompanied by OECD working papers.

Estimated consolidation needs



The instruments of consolidation: spending side

- Education (public consumption)
- Health (public consumption)
- Other public consumption except family policy
- Pensions (cash transfers)
- Unemployment (cash transfers)
- Sickness and disability (cash transfers)
- Family policy (public consumption and cash transfers)
- Subsidies
- Public investment

The instruments of consolidation: revenue side

- Personal income taxes
- Social security contributions
- Corporate income taxes
- Environmental taxes
- Consumption taxes (non-environmental)
- Recurrent taxes on immovable property
- Other property taxes
- Sales of goods and services

Assessing the instruments
one example

	Growth		Equity		Current account[a]
	ST	LT	ST	LT	ST
Spending cuts					
Education	--	--	-	--	+
Health services provided in kind	--	-	-	-	++
Other government consumption	--	+	-		+
Pensions		++			++
Sickness and disability payments	-	+	--	-	++
Unemployment insurance	-	+	-		++
Family	-	-	--	--	+
Subsidies	-	++	+	+	+
Public investment	--	--			++
Revenue increases					
Personal income taxes	**-**	**--**	**+**	**+**	**+**
Social security contributions	-	--	-	-	
Corporate income taxes	-	--	+	+	++
Environmental taxes	-	+[b]	-		+
Consumption taxes	-	-	-		++
Recurrent taxes on immovable property	-				+
Other property taxes	-		++	+	+
Sales of goods and services	-	+	-	-	+

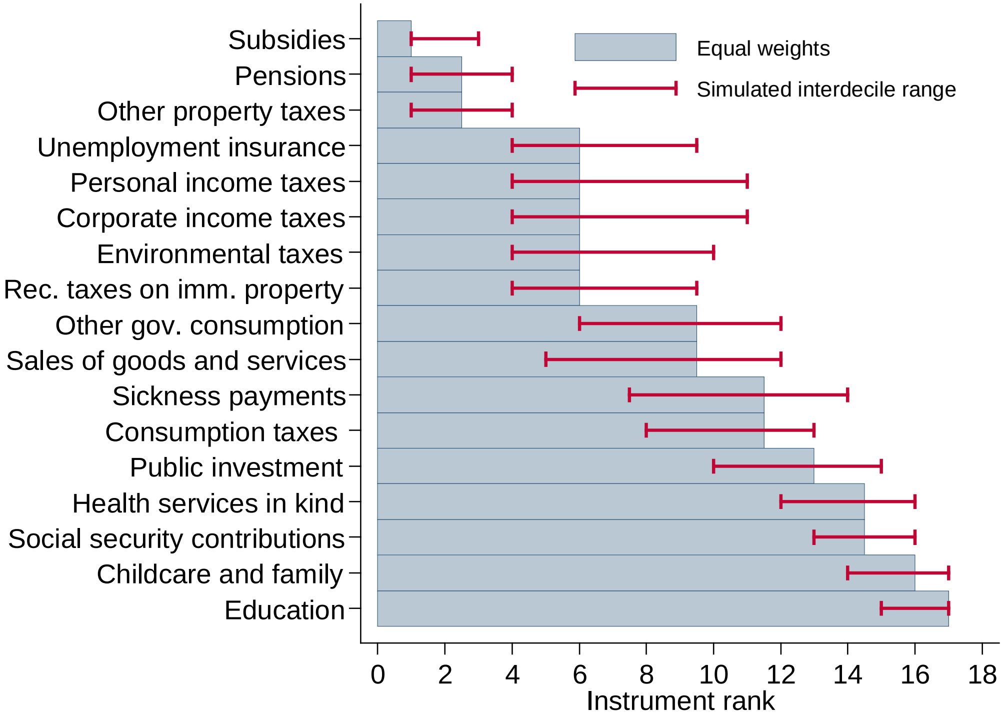
Notes: (a) current account effects refer to a deficit country and would switch signs for a surplus country
(b) this + sign relates to welfare effects as the GDP impact may be ambiguous.

Turning this assessment into a possible generic ranking

1. Each plus sign is valued as +1 and each minus sign as -1
2. Equal weights are given to each column: 0.25 each for short- and long-term growth and equity. *N.B.: later, weights are differentiated and the current account is incorporated when defining specific hierarchies for country groups.*
3. As a result each instrument gets a score and is ranked accordingly from highest to lowest.

A possible generic hierarchy of consolidation instruments

Ranking from most (highest score) to least (lowest score) desirable instrument of consolidation



Note: The rankings are based on the assessment in Table 2. Scores of +1 and -1 are given to each + and- signs respectively, each objective is given a weight, and the resulting indicator is used to rank instruments. Each individual instrument score based on the assessment in Table 2 is kept with a probability of ¾ or increased by +1 with a probability of 1/8 or reduced by -1 with a probability of 1/8. Weights ranging each from 0.15 to 0.55 and summing to unity have been given to each objective. Weights have been restricted to no smaller than 0.15 because each objective is considered important. A total of 40,000 random draws have been made.

Adapting the hierarchy to country circumstances

- Short-term growth: degree of cyclical weakness (output gap and 2007-12 increase in long-term unemployment).
- Equity: income distribution and poverty.
- Current account: relative to country and OECD GDP.
    - Five country clusters
    - A specific hierarchy for each cluster

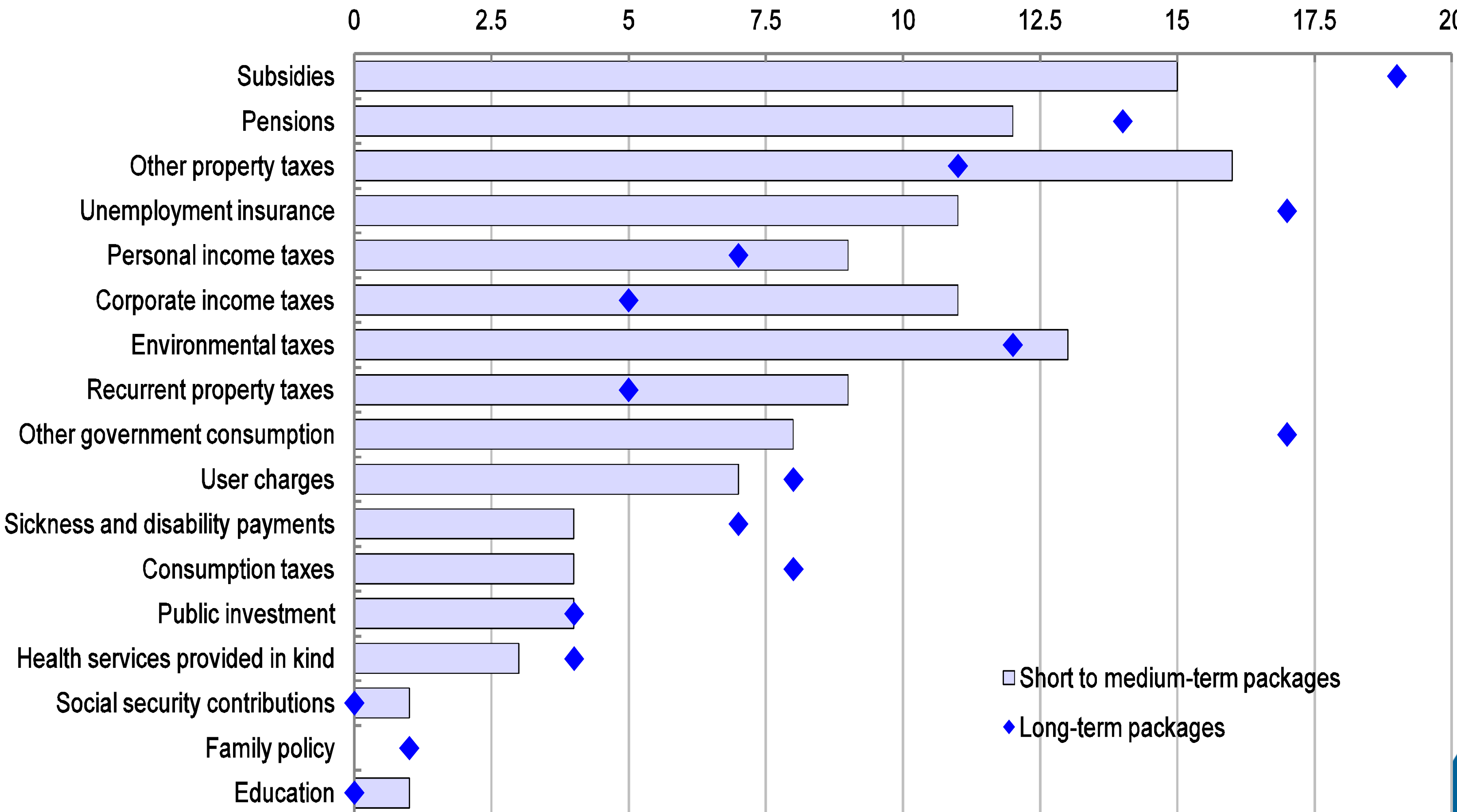
The simulated illustrative optimal use of instruments depends on:

1. Consolidation needs
2. Hierarchy of instruments: instruments are used one by one until consolidation needs are met
3. Room for manoeuvre in each instrument:
   - Move until reaching the group of the ten OECD countries with lowest spending or highest taxation in the area under consideration
   - No more than one standard deviation (national preferences)
   - Other technical assumptions:
     - Reduced margins for pensions (especially in the short term)
     - Adjustments for pensions and education (demography) and for unemployment benefits (structural unemployment level)
     - Leeway in personal income tax and social security contributions assessed on the basis of their sum

Two sets of simulations for each country

- Short to medium term simulations:
  - short- to medium-term consolidation needs
  - hierarchies that are differentiated by country cluster
- Long-term simulations:
  - long-term consolidation needs
  - same hierarchy for all countries (considering only long-term growth and equity effects)

Number of countries using instruments in simulations



How far down the hierarchy of instruments do countries need to go?

Simulated short- to medium-term consolidation packages:

- Top-half instruments only in fourteen countries (e.g. Australia, Netherlands, New Zealand).
- Top-half instruments mainly in 8 countries (e.g. France, Greece).
- Bottom-half instruments mainly: Japan, the United Kingdom and the United States.

How far down the hierarchy of instruments do countries need to go?

Simulated long-term consolidation packages:

- Top-half instruments only in 20 countries.
- Top-half instruments mainly in 6 countries.
- Bottom-half instruments mainly in three countries: Australia, New Zealand and the United States.

Spending vs. taxes in simulated packages

On average across countries, spending reductions account for

- 41% of short- to medium-term simulated packages
- 65% of long-term simulated packages

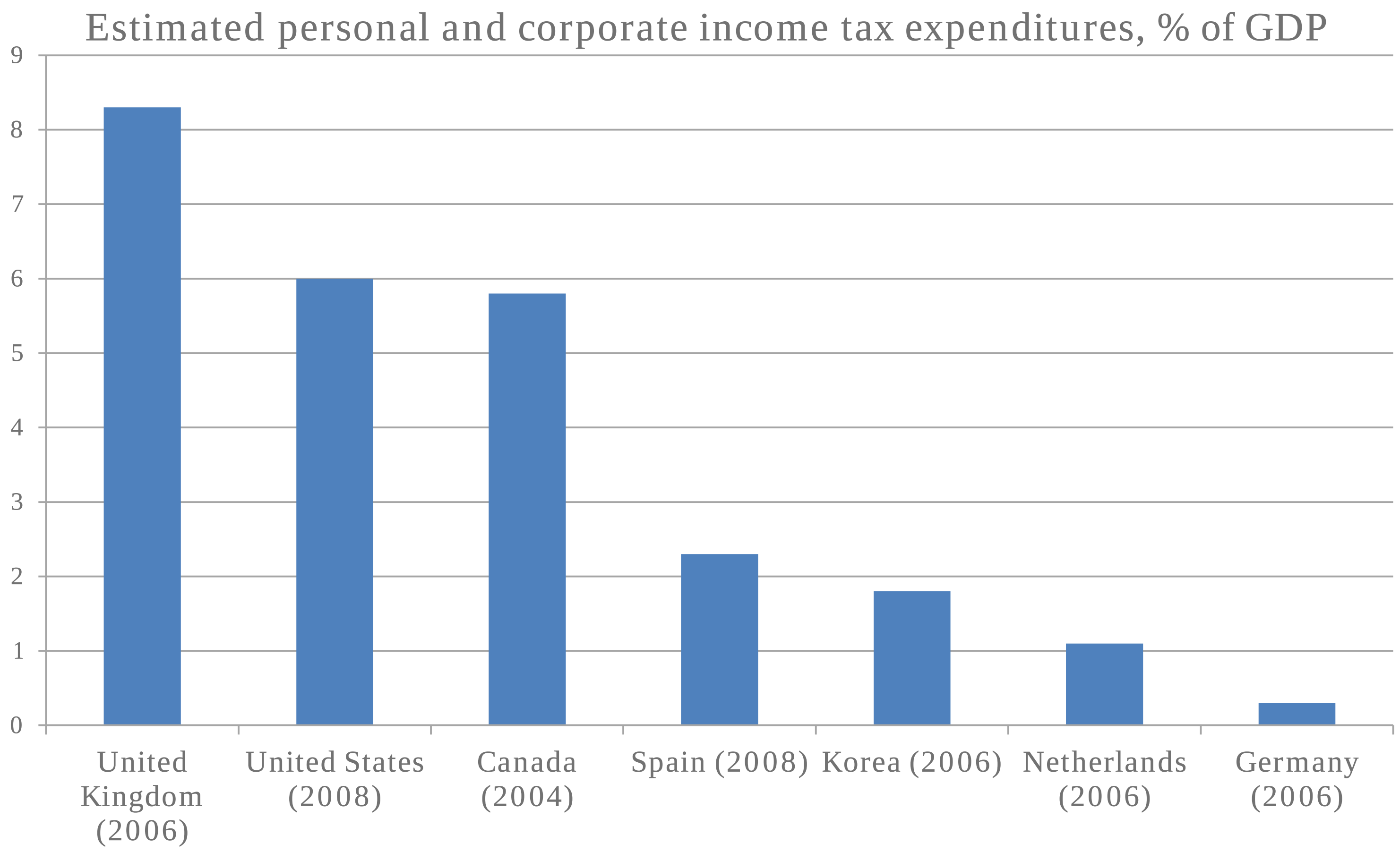
with considerable variation across countries.

Structural policy has a key role to play

Ease trade-offs between consolidation and other objectives

- Spending reductions: *e.g.* efficiency gains.
- Revenue increases: *e.g.* base broadening, reducing tax expenditures.

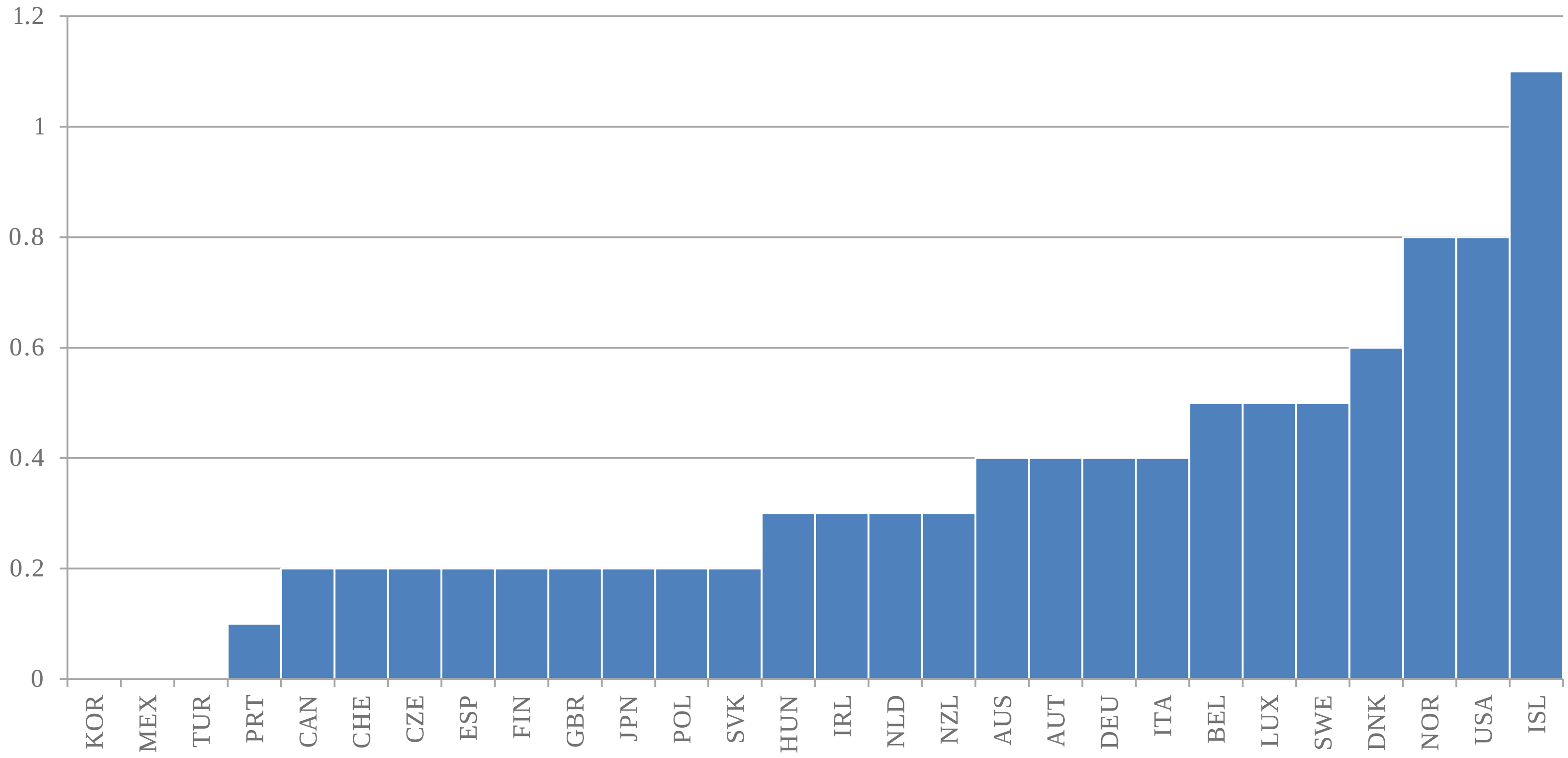
Tax expenditures in personal and corporate income taxes are difficult to estimate but large



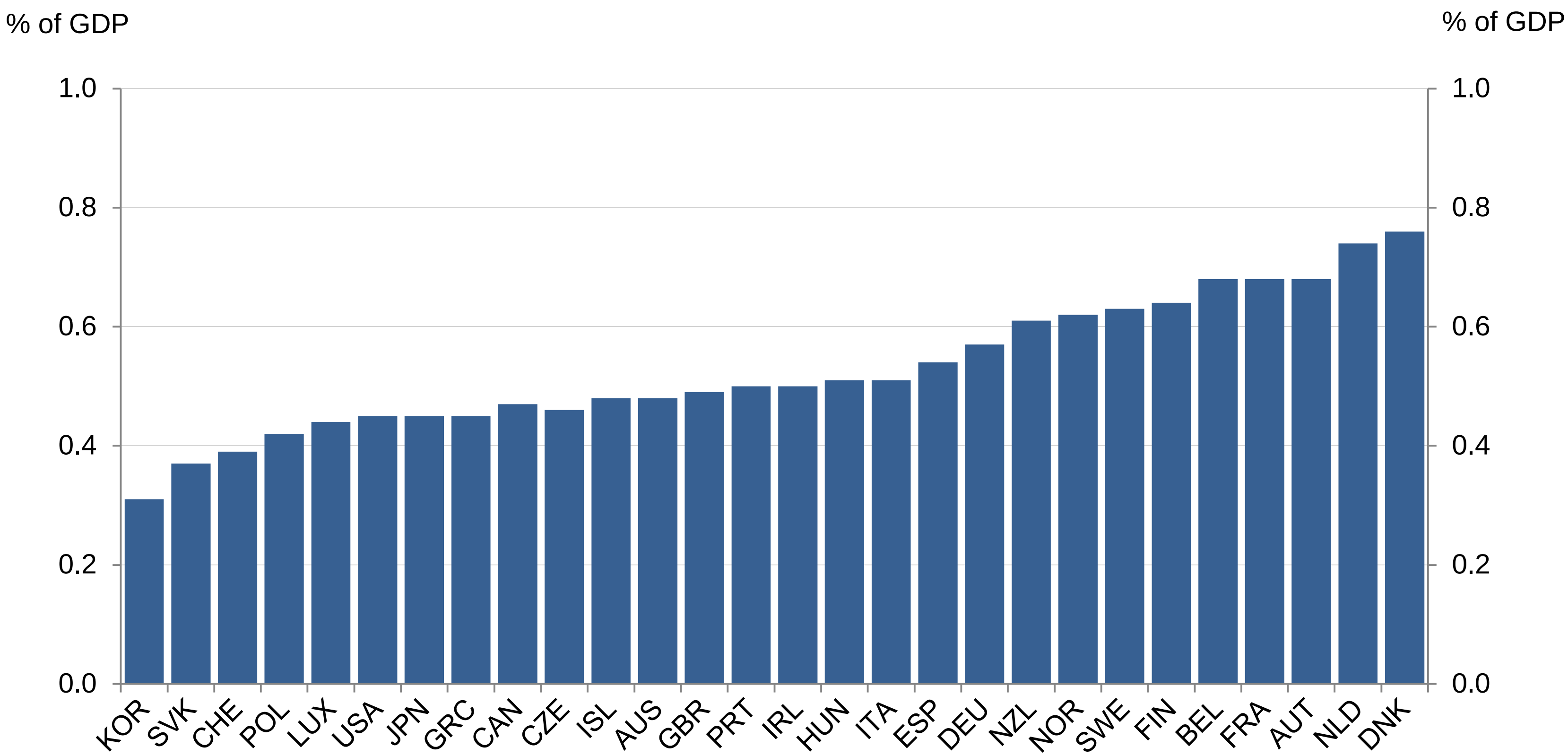
Source: OECD (2010), *Tax Expenditures in OECD Countries*.

Potential efficiency gains in primary and secondary education

Per cent of GDP, 2007



Effect of 1% higher potential employment on the primary balance



***Source*:** Economic Outlook 88.