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Reforming the public sector

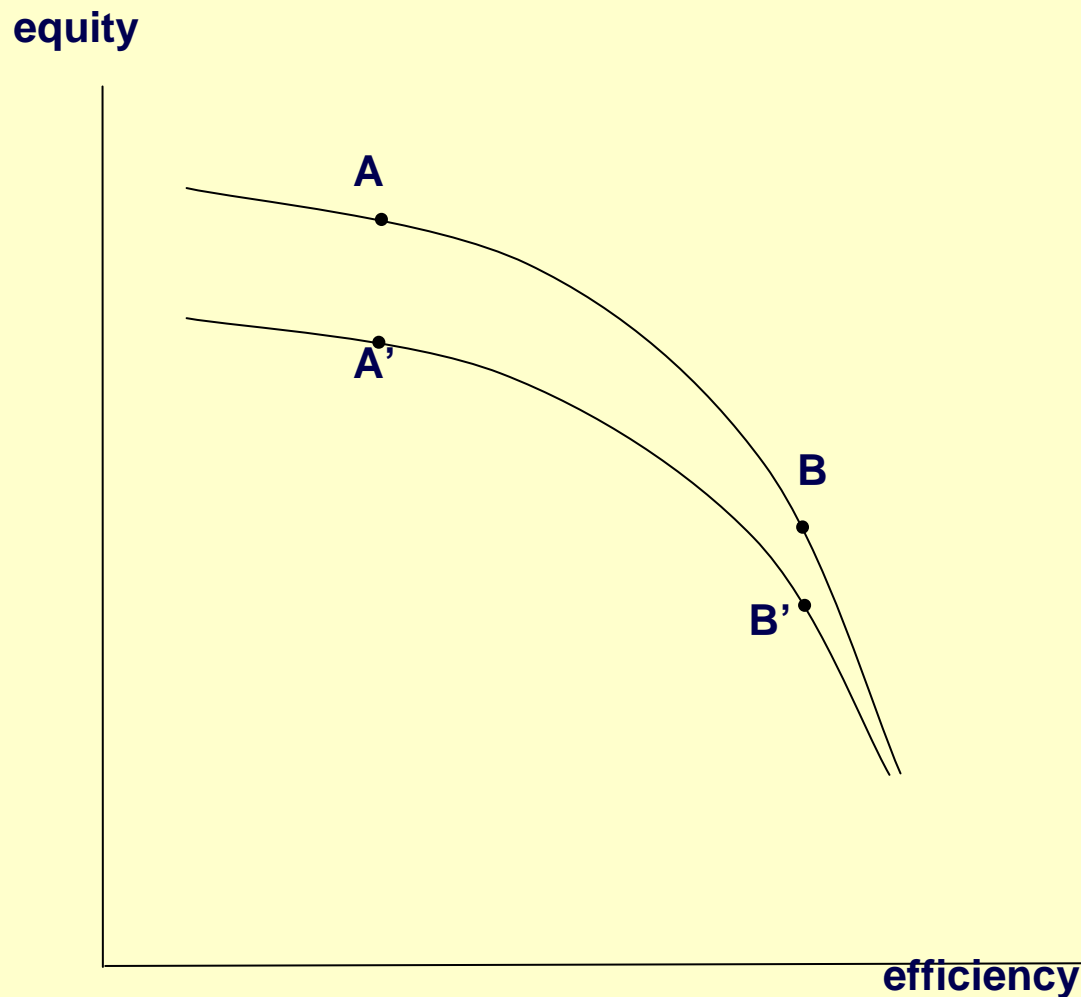
Workshop
Fiscal Surveillance
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Reforming the Public Sector in Europe: Reconciling Equity and Efficiency

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The equity-efficiency trade-off



A moving trade-off in the EU

- Ageing moves trade-off inwards (AB to A'B')
 - ▶ worse combinations of equity and efficiency

- Lisbon ambition = move trade-off outwards
 - ▶ better combinations of equity and efficiency

- 1. Increase productivity - innovation / integration
 - Problem: worse position low skilled (skill bias)

- 2. Increase participation - hours worked
 - Problem: calls for less redistribution (equity)

Ageing = growing need for public funds

- Option 1: Reduce intergenerational transfers
 - ▶ Lower pension levels (e.g. no indexation)
 - ▶ Higher retirement age
 - ▶ Fiscal surplus

- Option 2: Raise taxes on working generations
 - ▶ To be discussed

- Option 3: Reduce expenditures elsewhere
 - ▶ To be discussed

Option 2: Raise taxes

- Increasing welfare cost of corporate tax
 - ▶ Mobility of capital
 - ▶ Mobility of multinational profits

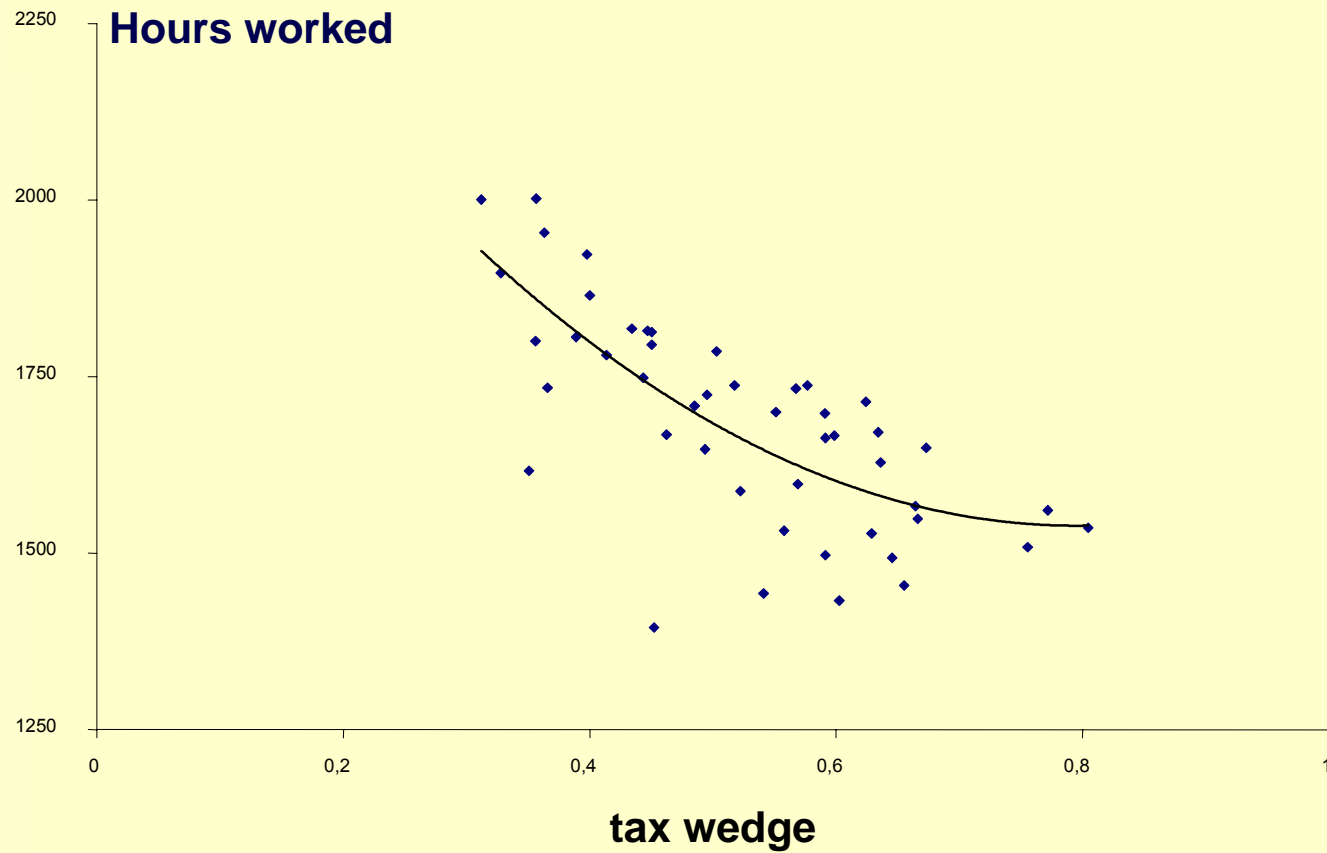
- Increasing welfare cost of income tax
 - ▶ Mobility of skilled labour
 - ▶ Increasing importance of human capital
 - ▶ Flexibility in hours worked

Taxes do not escape the trade-off

- Panel regressions
- Performance indicator = f [institutions]
- Data
 - ▶ 18 OECD countries
 - ▶ 7 five-year periods (1960 - 1995)

	participation	unemployment	Inequality
Tax wedge	- **	+ **	- **

Taxes also affect hours worked



Policy options in taxation

- Lower marginal tax rates required
 - ▶ Internationalization
 - ▶ Flexibility
 - ▶ Knowledge-based economy

- Options for broadening the tax base
 - ▶ Alleviate tax deductions (savings, housing)
 - ▶ Tax scarcity rents (road pricing, tradable permits)
 - ▶ Better application of benefit principle

- ☹ Redistribution via benefits in kind

Option 3: Reduce expenditures (1)

- Lower expenditures on education?
 - ▶ May worsen trade-off between equity and efficiency
 - ▶ Especially important in light of increasing skill bias

	Participation	Unemployment	Inequality
Lower secondary		- ***	
Upper secondary	+ ***	- ***	- ***

Option 3: Reduce expenditures (2)

- Lower social expenditures?
 - ▶ Social insurance has an efficiency aspect as well
 - ▶ May even escape the trade-off (ALMP)

	Participation	Unemployment	Inequality
Benefit level		+*	- ^{***}
Benefit duration	- ^{**}	+*	- ^{***}
Active labour market policy	+ ^{***}	- ^{**}	- ^{***}

Policy options in expenditures

- Blunt expenditure cuts are counterproductive
 - ▶ Education expenditures
 - ▶ Active labour market policies

- Better targeting income support (= information)
 - ▶ Individual saving accounts for unemployment risk
 - ▶ Equity participation in higher education
 - ▶ Workfare in exchange for income guarantee

☹ Poverty trap

Summing up

- Challenge:
 - ▶ Ageing in Europe jeopardizes equity and efficiency
 - ▶ We aim to maintain intergenerational redistribution
 - ▶ Lisbon ambition is to improve the trade-off

- Tax increases?
 - ▶ We need lower marginal tax rates in light of trends
 - ▶ We can broaden the tax base

- Expenditure cuts?
 - ▶ Some expenditures escape the trade-off
 - ▶ We can better target income support