Reforming the Public Sector in Europe: Reconciling Equity and Efficiency

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The equity-efficiency trade-off
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)

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<th>participation</th>
<th>unemployment</th>
<th>Inequality</th>
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<tr>
<td>Tax wedge</td>
<td>-**</td>
<td>+**</td>
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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

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<tr>
<td>Lower secondary</td>
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<tr>
<td>Upper secondary</td>
<td>+***</td>
<td>-***</td>
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Option 3: Reduce expenditures (2)

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

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<td>Benefit duration</td>
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<td>Active labour</td>
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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