Income redistribution through taxes and transfers across OECD countries

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Many OECD countries have been facing a prolonged period of low growth and stagnating income of the poorest. This challenges governments' fiscal redistribution, all the more so in a context where new forms of work are calling into question the effectiveness of traditional social safety nets and population ageing is putting pressure on public finances. Yet, the system of taxes and transfers that underpins social protection is a fundamental pillar of an inclusive growth policy agenda that aims at sharing the benefits of growth more equally. A new OECD report by Causa and Hermansen (2017) ("Income redistribution through taxes and transfers across OECD countries") takes stock of the extent to which tax and transfer systems mitigate market income inequality today, and how this has changed over a period of rising globalisation and rapid technological change.

Redistribution through taxes and transfers has tended to decline across OECD countries since the mid-1990s

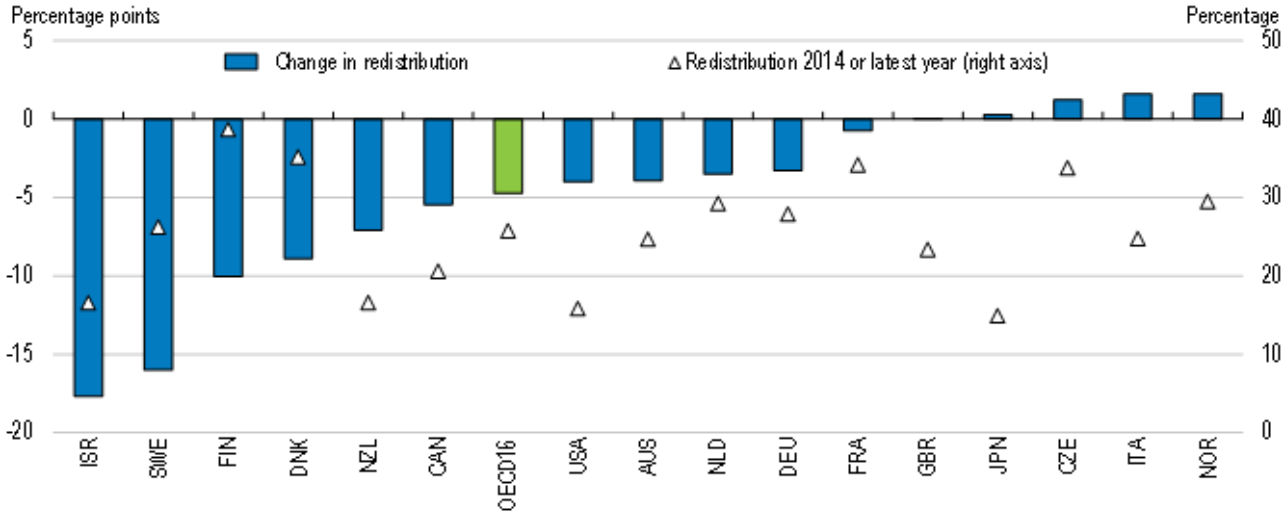
Since the mid-1990s, the redistributive effect of taxes and transfers has declined in the majority of OECD countries for which data are available (Figure 1, Panel A). The trend towards less redistribution was most pronounced over the pre-crisis period, and was temporarily reversed during the first phase of the crisis, reflecting the cushioning impact of automatic stabilisers and fiscal discretionary measures. The

decline in redistribution was particularly pronounced in some Nordic countries, which are among the most egalitarian OECD countries. Admittedly, the extent of the decline observed in these countries was amplified by high levels of redistribution prevailing in the mid-1990s due to high unemployment. The steadily improving labour market outlook during the subsequent decade reduced the need for redistribution. The inequality-reducing effect of redistribution also declined among the least egalitarian of OECD countries, especially Israel, but also Australia and Canada. Trends in redistribution were more heterogeneous over the most recent decade, with increases in around half of OECD countries, in particular those hardest hit by the crisis (Figure 1, Panel B).

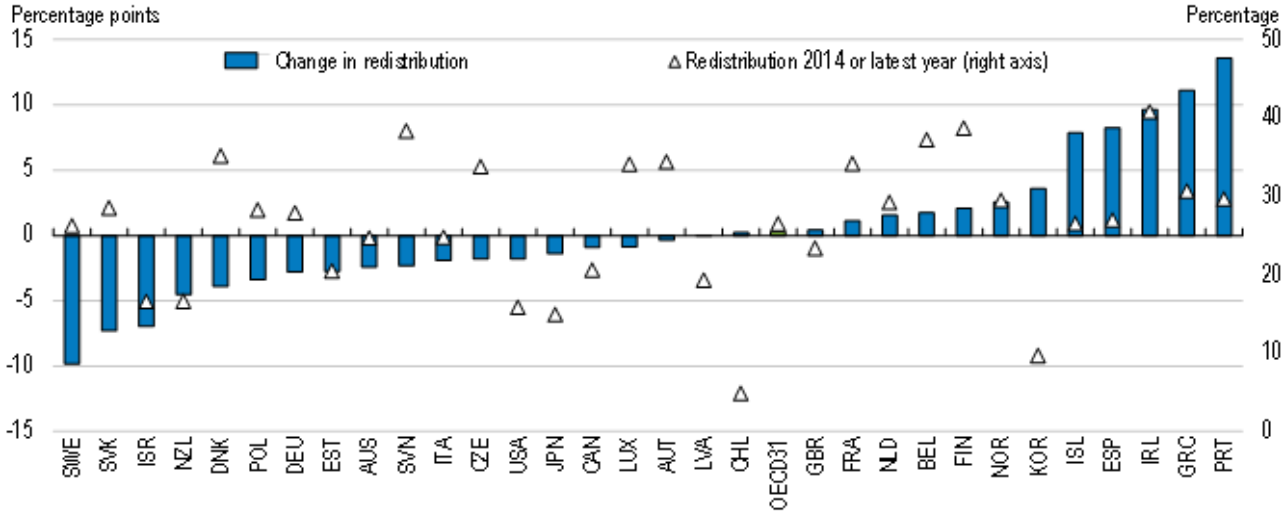
Figure 1. A widespread decline in redistribution across advanced OECD countries since the mid-1990s

Change in redistribution for the working-age population

A. Mid-1990s to 2014 or latest available year



B. Mid-2000s to 2014 or latest available year



Note: For Panel A data refer to 1994-2015 for the United Kingdom; 1995-2012 for Japan; 1995-2015 for Finland, Israel, the Netherlands and the United States; 1996-2014 for Czech Republic and France; and 1995-2014 for the rest. For Panel B data refer to 2003-2012 for Japan; 2003-2014 for New Zealand; 2004-2015 for Finland and the United Kingdom; 2005-2014 for Denmark, France and Poland; 2005-2015 for Israel, the Netherlands and the United States; 2006-2015 for Chile and Korea; and 2004-2014 for the rest. See note to Figure 1 for further details on redistribution measure and working-age population.

Source: OECD Income Distribution Database.

The decline in redistribution was largely driven by insurance transfers to working-age households

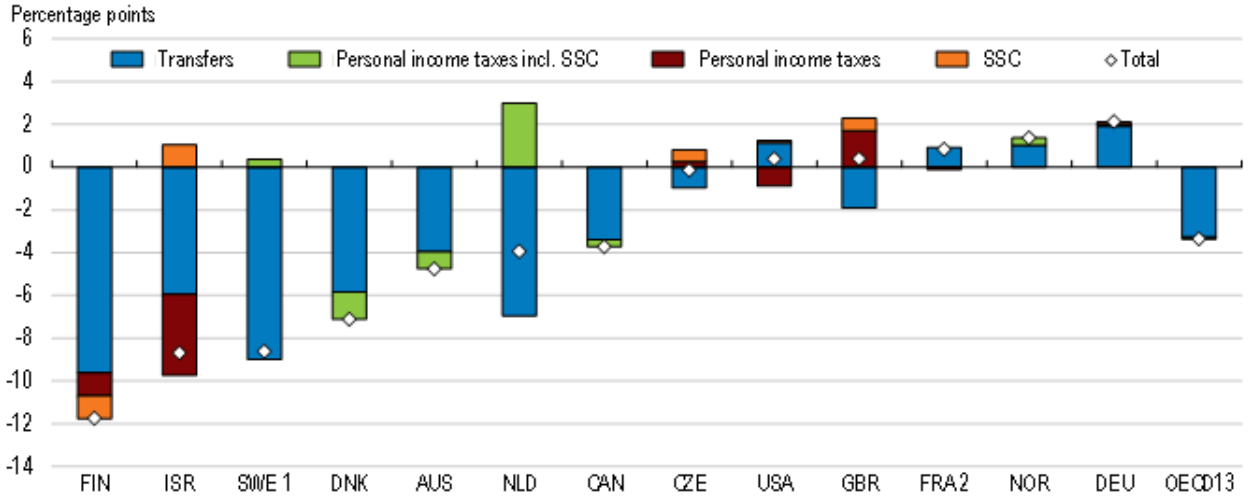
By and large, the decline in redistribution across OECD countries has been primarily driven by a decline in redistribution by cash transfers, which is not surprising insofar as cash transfers account for the bulk of

redistribution. Personal income taxes also contributed but played a less important and more heterogeneous role across countries (Figure 2, Panel A). In turn, the decline in transfer redistribution was largely driven by insurance transfers (e.g. unemployment insurance, work-related sickness and disability benefits). This was partly mitigated by more redistributive assistance transfers (e.g. minimum income transfers, means- or income-tested social safety net) in some countries such as Germany and the United Kingdom (Figure 2, Panel B). Assistance transfers are in many OECD countries less redistributive than insurance transfers, for instance due to low take-up but also due to relatively low benefit amounts, so that their size is generally smaller than insurance transfers.

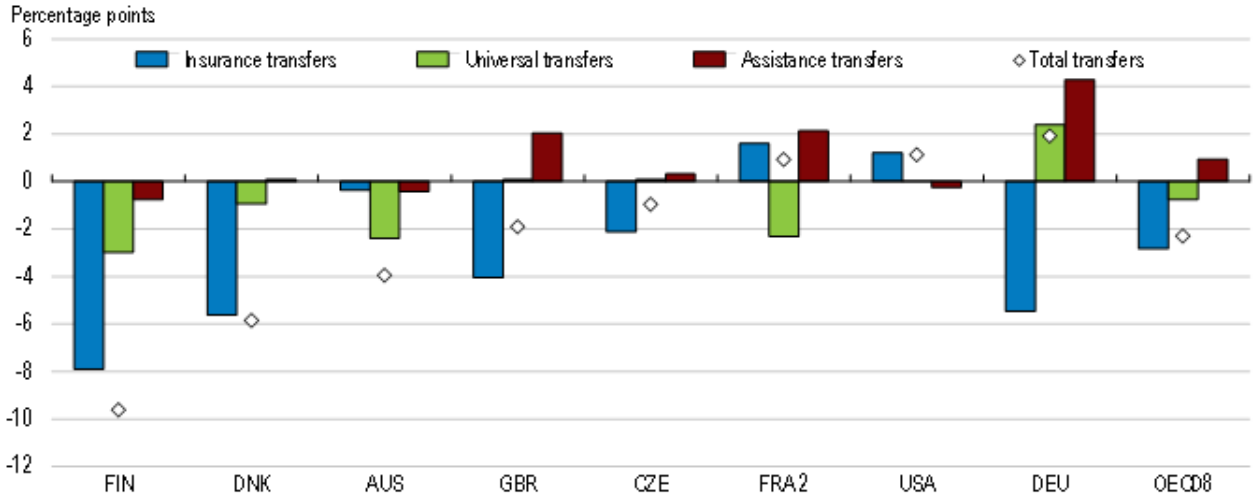
Figure 2. The redistributive effect of transfers has declined markedly across OECD countries

Change in redistribution for the working-age population, mid-1990s to 2013 or latest available year

A. Total redistribution by instrument



B. Transfer redistribution by type of transfer



1. Sweden only available for 1995-2005.
2. Social security contributions not available for France.

Note: See Box 4 for the approach to assess the redistributive impact of individual parts of the tax and transfer systems. Data refer to 1993-2013 for the Netherlands; 1994-2010 for Canada and France; 1994-2012 for Hungary; 1994-2013 for Germany, the United Kingdom and the United States; 1995-2000 for Belgium; 1995-2005 for Sweden; 1995-2010 for Australia; 1995-2013 for Denmark, Finland and Norway; 1996-2012 for Mexico; 1996-2013 for Czech Republic; 1997-2012 for Israel and Slovenia.

Source: OECD staff calculations based on the Luxembourg Income Study.

Policy implications

One finding highlighted in Causa and Hermansen (2017) is a fairly widespread shift in transfer policy from out-of-work to in-work support, at least partly driven by reforms to make work pay, especially for workers with weak labour market attachment. While this is likely to have mitigated market income inequalities by spurring employment growth, it could

have contributed to the decline in redistribution. This should not lead to the conclusion that countries have no choice but to trade more efficiency for less equity. The reason is that redistribution policies should be considered as part of broader policy packages to make growth more inclusive. For example, well-designed inclusive growth packages should combine tax and transfer policies to make work pay and boost jobs with policies to improve employability, skill adaptability and wage prospects. To the extent that such packages have not been broadly deployed by OECD countries, potentially reflecting budgetary constraints, reductions in market income inequality induced by such reforms have not been sufficient to prevent disposable income inequality from rising.

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Economic research on international capital flows: where do we stand 10 years after the Global Financial Crisis started?

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Stéphanie Guichard, our guest author, is a former Economic Counsellor to Catherine L. Mann, OECD Chief Economist.

Financial globalisation has given international capital flows a central role in the functioning of the global economy, leading to considerable economic research over the past 30 years. Making the most of these capital flows has always been a challenge, as they can bring both good and bad. On the one hand, they can support long-term growth through a better international allocation of saving and investment, through technology and management improvements associated with FDI inflows or through enhanced transparency and corporate governance due to the exposure of flow recipients to international investors. On the other hand, they complicate macroeconomic management of recipient countries, increase financial vulnerabilities and amplify domestic distortions, and can lead to financial crises and sudden stops with negative implications for economic growth.

This challenge has become even more acute after the Global Financial Crisis financial revealed the complexity of global financial relations and their role in shock transmission. The crisis also questioned the ability of fundamentals to protect countries from financial instability and the global financial cycle. Overall it showed that global financial integration has not only led to an increase in the size of capital flows (annual gross cross-border capital flows increased from about 5% of world GDP in the mid-1990s to around 20% in 2007) but has also affected the drivers of these flows as well as the transmission and contagion mechanisms. For instance, there has been a growing decoupling between gross and net flows since the late 90s which means that surplus countries do not necessarily “finance” deficit countries, and economies with a balanced current account may still get important financing from abroad and be vulnerable to sudden stops. These changes have implications for a wide range of policies from surveillance, to how to best deal with inflows and outflows in

order to reap their benefits while reducing associated risks. Moreover, over the past few years, while financial globalisation has marked a pause, the nature of capital flows has continued to evolve and new concerns have emerged.

The new OECD working paper *Findings of the Recent Literature on International Capital Flows: Implications and Suggestions for Further Research* takes stock of recent empirical and theoretical research. It assesses how this literature helps assess the current situation, associated risks and policy needs. The main findings are as follows.

- **Foreign debt accumulation by EMEs non-financial corporation has become a potential source of instability.** Foreign debt accumulated by EMEs non-financial corporation (NFC) has increased substantially since 2010. There is also evidence suggesting a significant part of this debt has been financing financial assets acquisitions or deposited in local banks rather than investment in fixed assets, supported by the favourable carry trade opportunities resulting from the low dollar interest rates. A USD appreciation and an increase in dollar interest rates could hence lead to a fast unwinding on some of these positions.
- **The protecting role of good fundamentals is being questioned.** The capital inflow surge to EMEs that followed the implementation of QE in advanced economies, the "taper tantrum" episode, the vulnerabilities associated with EME corporate borrowing have all revived the debate on EMEs vulnerabilities to global financial shocks, especially the monetary policy stance in advanced economies. The analysis of push (global) and pull (local) factors has focused on the mechanisms by which push factors affect EMEs and whether some fundamentals affect the sensitivity of countries to these factors. and mitigate the impact of the global financial cycle. However, findings have been mixed,

potentially questioning the traditional view that good fundamentals necessarily protect countries from financial turbulences.

- **The ability of exchange flexibility in mitigating the risks associated with capital inflows is also questioned.** The existence of a global financial cycle that affects countries independently of their exchange rate regime has questioned the ability of the move towards more exchange rate flexibility by many EMEs over the past two decades to shield them better from financial turbulences than the less flexible regimes of the 90s. This is especially the case as exchange rate fluctuations may amplify the impact of financial shocks via balance sheets effects. While this point is largely shared by recent analyses, the further implications for policy making including monetary policy and capital controls is under debate. While some argue that under full capital mobility, countries outside the US lose monetary autonomy, even with flexible exchange rate, and call for a greater use of prudential and capital flow management tools, (e.g. Rey 2016), others reject this view and rather stress that central bankers have to deal with worse trade-offs related to financial stability issues (e.g. Banerjee et al. (2015) and Obstfeld (2015)).
- **While capital controls have been increasingly considered as a complementary policy tool to deal with international capital flows, evidence on their impact remains inconclusive**. The reliance on capital controls or more generally capital flow management measures remains an important, and yet unsettled, policy debate regarding international capital flows. As the risks associated with international capital flows have become more obvious, there has been a slow shift in the post-Bretton woods consensus view that capital should be allowed to move freely across countries and that the use of capital control, even in face of large inflows or

sudden stops, was unwarranted. However, most of the issues regarding the use, effectiveness and spillover effects of capital control remain largely open, as empirical results point to different directions, partly because of the diversity of the measures of capital controls that have been used, the different time horizon and countries under review.

- **International policy coordination is essential**. Deeper global financial integration means that monetary and financial shocks are transmitted through the financial system across countries and that imbalances or credit booms abroad can affect the domestic economy and its stability, as seen during the financial crisis. Domestic policies, especially monetary and financial policies, may spill over to other countries and even have spillback effects on the domestic economy. Hence international cooperation and coordination of policies have been put forward to deal with international capital flows in three main areas: monetary policy; capital control management and more broadly financial policies; the global safety nets.

The paper points to many areas where further investigation is needed to guide policy making. They include the role of fundamentals in protecting countries against the risks associated with capital account openness, the impact of exchange rate fluctuations taking into account the balance sheet transmissions channels, the costs and benefits of capital controls, financial policy spillovers, the costs and benefits of the global financial safety net, the drivers of capital outflows – especially as China is further liberalising its capital account–, how the characteristics of the sectors receiving/exporting inflows affect the drivers of the flows and their impact on the economy.

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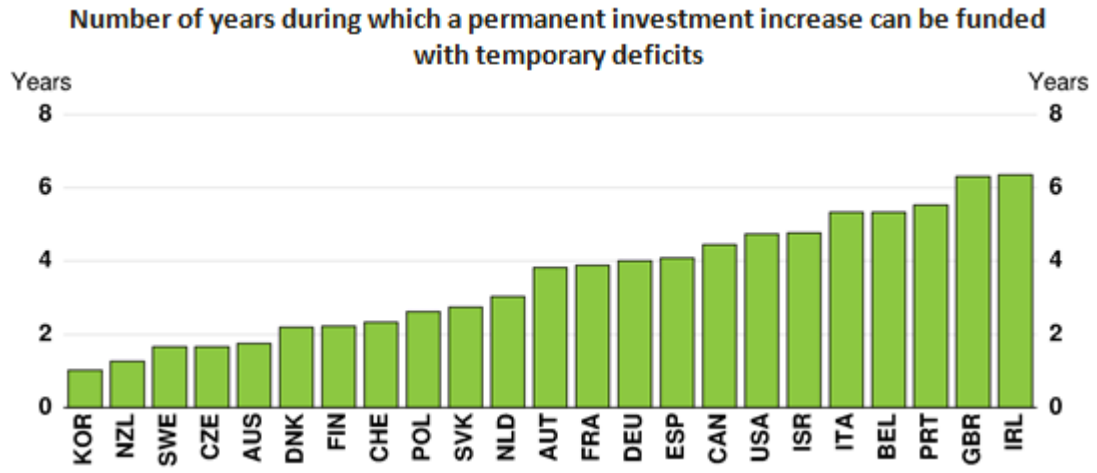
Time to deploy the fiscal levers actively and wisely

Category: fiscal policy,Public finance,Uncategorized
written by oecdecoscope | February 1, 2018
by Catherine L. Mann, OECD Chief Economist, OECD Economics Department

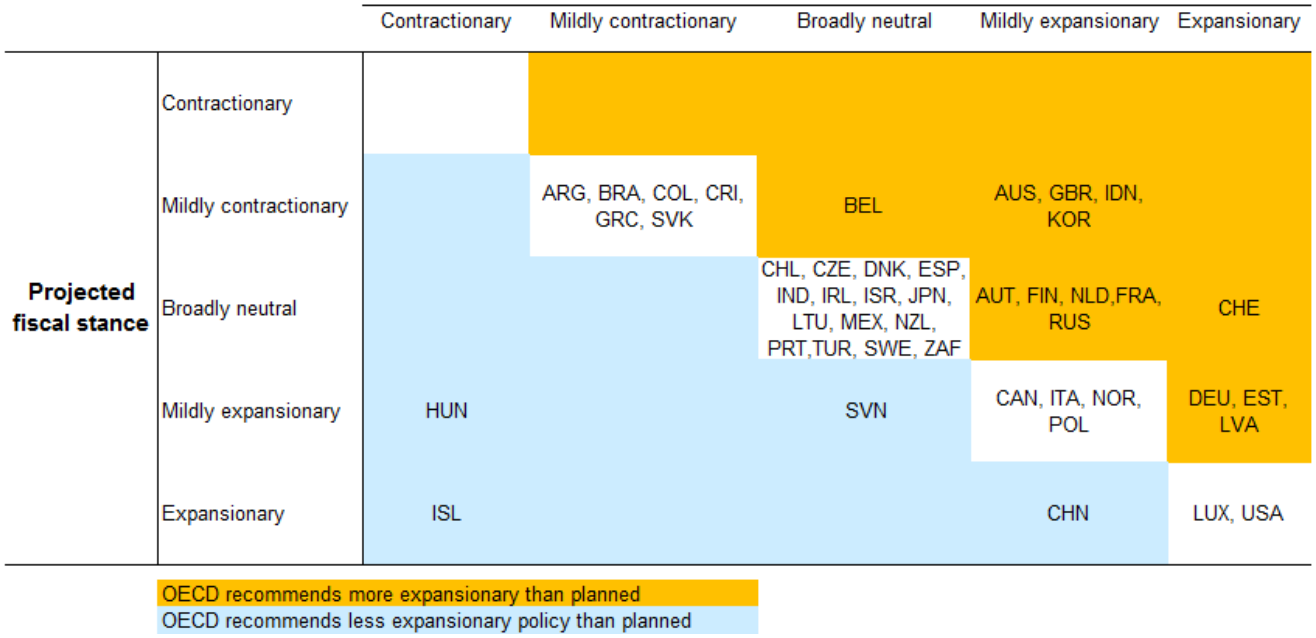
The role of fiscal policy has been at the heart of the policy debate since the financial crisis. With the global economy stuck in a low-growth trap and monetary policy overburdened, it is time to re-assess the use of fiscal policy levers.

Government interest payments have fallen sharply as interest

rates have declined to very low levels, freeing up cash. In addition, new OECD estimates show that “fiscal space” – the gap between current government debt and levels at which market access would be compromised – have widened since 2014, as lower interest rates have more than offset headwinds from lower potential growth. This creates a window of opportunity.



Most OECD governments have space to pursue a ½ percent of GDP deficit-financed “fiscal initiative” to support productivity-enhancing measures for 3-4 years without increasing public debt in the medium term. The withdrawal of deficit financing after the initial fiscal initiative and the outcome of higher growth from the initiative are enough to ensure that debt sustainability does not deteriorate, while the low interest rate environment means that stimulus is not crowded out. The benefits are greater if boosting short-term activity helps to avoid high and persistent unemployment, if countries reduce regulatory burdens, and if countries undertake these efforts collectively.



While it may be easy to relax the fiscal stance, the success of the fiscal initiative to promote growth, enhance long-run potential output, and improve debt sustainability depends on an effective strategy of additional spending or tax reductions to achieve more inclusive and higher growth.

Several major economies are now using the fiscal levers more *actively*, following the consolidation of the years following the crisis. But, some countries – notably in Europe – have yet to seize the opportunity.

However, are countries using the fiscal levers more *wisely?* The evidence of recent years is that many countries have cut the share of spending on investment and education, while increasing the share of taxes that are most harmful to growth and equality. A shift toward a more effective mix is needed.

The OECD is today releasing new research on the mix, size and quality of public investment, including a new dataset on the composition of public spending. Soft investment, such as skills and R&D, together with well-governed public investment in infrastructure, can yield large growth gains. Good institutions enhance the effectiveness of government spending and tax policy.

The policy debate will continue, but now is the time to deploy the fiscal levers actively and wisely !

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Most countries have room to increase public investment

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by Jean Marc Fournier, Economist, Public Economics Division, OECD Economics Department

Public investment benefits current as well as future generations. My research shows that public investment is a game changer, when it comes to boosting long-term growth. Increasing the share of public investment in primary government spending by one percentage point (offset by a reduction in other spending) would increase the long-term GDP

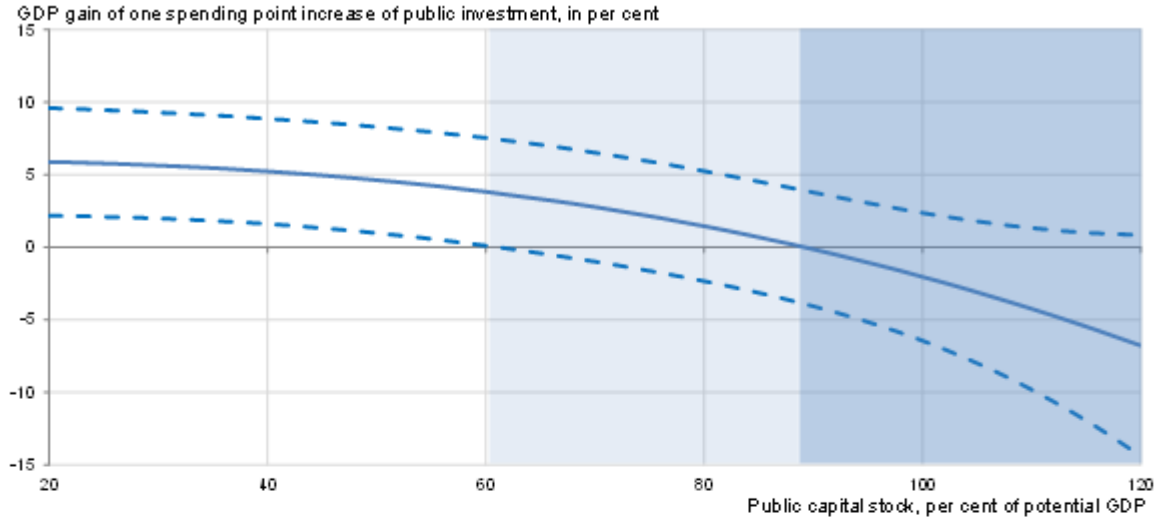
level by about 5%. For countries that are catching-up to the productivity frontier, there is also evidence that public investment can substantially speed up the pace of convergence.

Public investment is good for economic activity because it stimulates private investment. Indeed, a recipe that mixes public and private investment produces a bigger economic pie. For instance, roads and railways connect firms. This suggests that the most relevant investment projects are those with the largest spill-overs. For instance, investment in health (hospitals and their equipment) is found to have a large effect as healthier workers are more productive. Investment in research and development also can have a particularly large effect as public research can spur private innovation.

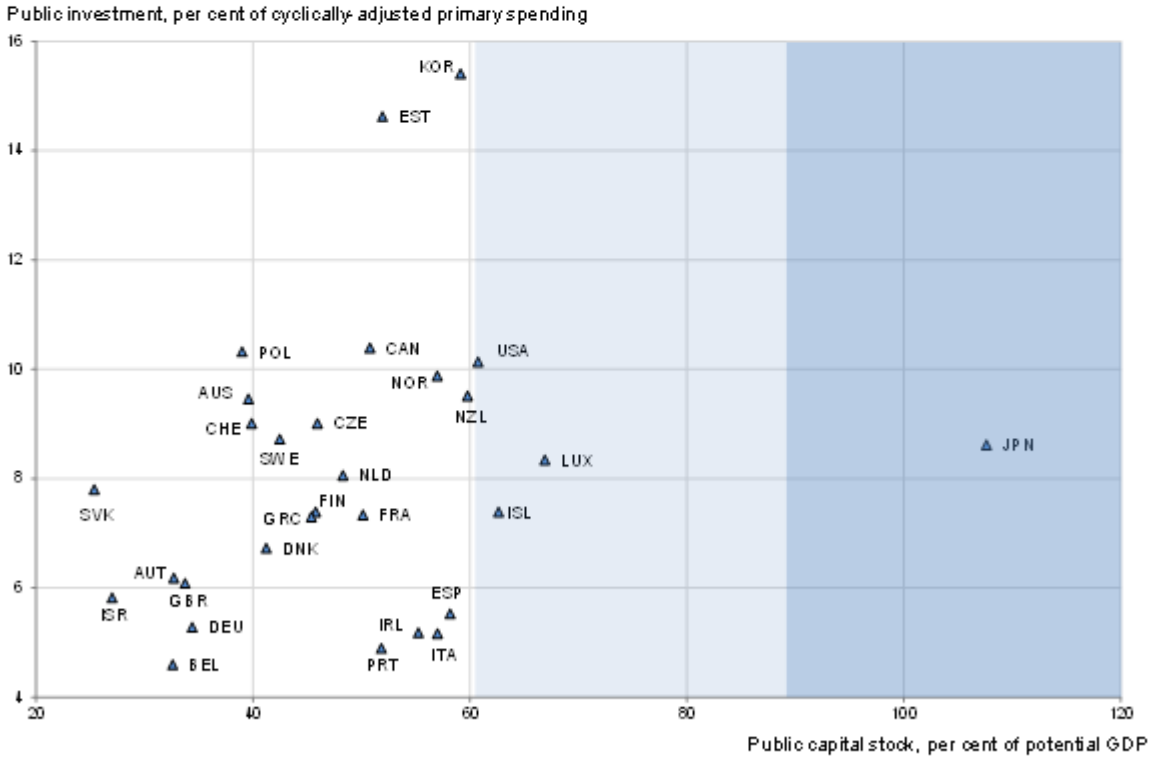
The long-term effect of public investment depends on the initial level of the public capital stock, which includes, for instance, roads, schools or patents. In countries where this initial level is relatively low compared with the size of the economy, there is more scope for high-yielding investment projects. The analysis shows that virtually all countries have room to expand the public capital stock, with the exception of Japan, where it is already very large (Figure).

Estimates of decreasing returns to public investment

Panel A. The effect of public investment on potential GDP decreases with the level of capital stock[1]



Panel B. Most countries have room to increase the stock of public capital (2013 data)



1. Public investment is scaled by underlying primary public spending. The dashed line indicates the 95% confidence interval. The measure of the capital stock depends on assumptions on the rate of depreciation of capital and on the level of disaggregation at which the calculation is made. The IMF data can thus differ from national sources. The data of the two sources are close for most countries. In a few cases, such as Austria, the difference can be considerable. The IMF database is used here because the capital stock is computed in all countries with the same methodology. Light shading indicates a positive not significant investment effect and darker shading indicates a negative not significant investment effect.

The evidence that the public capital stock is below its optimal level means that public investment should rise above the pre-crisis level. However, the opposite has happened. In most countries, public investment has declined substantially during the recent fiscal consolidation period. In 2015, net investment was even negative in Germany, Italy, Portugal and

Spain. This means that public investment does not suffice to compensate for the natural depreciation of the existing public capital stock in these countries. In the United States, net investment has reached an almost record low level of 0.5 per cent of GDP in 2015, so that the public capital stock grows much less than GDP.

Major challenges are to identify the right investment projects, and to implement them in an efficient way. For this, governments need sound public investment policies (provide the right incentives, carry out cost/benefit analysis underpinned by good data). Moreover, the focus should be on projects with high spill-overs.

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Source: Fournier, J.M. (2016), “The Positive Effect of Public Investment on Potential Growth”, *OECD Economics Department Working Paper*, No. 1347, OECD Publishing, Paris.

Related material see:

The effect of the size and mix of public spending on growth and inequality

Using the fiscal levers to escape the low-growth trap