How can public finance reforms boost economic growth and enhance income equality?

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Most OECD countries have very large government sectors: public expenditure amounts to 43% of economic activity, measured by GDP, on average across OECD countries. This proportion exceeds 50% in four OECD countries. The programmes on which governments spend have thus deep implications for people'swell-being and a country's economic fortunes. Similarly, the choice and design of taxes that fund expenditure will also shape economic decisions and influence people's choices to work, invest and consume.

New OECD empirical work has identified lessons provided by the experience of OECD countries over the past three decades. These empirical investigations shed light on the effects of public finance on economic activity as well as on the distribution of income across households.

First, large governments can be compatible with high levels of economic activity: the condition is that governments provide their services very efficiently. The Nordic countries display the levels of government effectiveness at which governments can be large without weighing on growth. Where governments are less effective, reducing their size can be expected to lead to higher growth; however, reducing the size of government typically entails arise in income inequality, because public expenditure, and especially transfers, are a powerful equaliser of incomes.

Second, leaving aside questions about government size, many public finance reforms that change the composition of spending or the mix of taxes offer the potential to boost economic activity and household incomes:

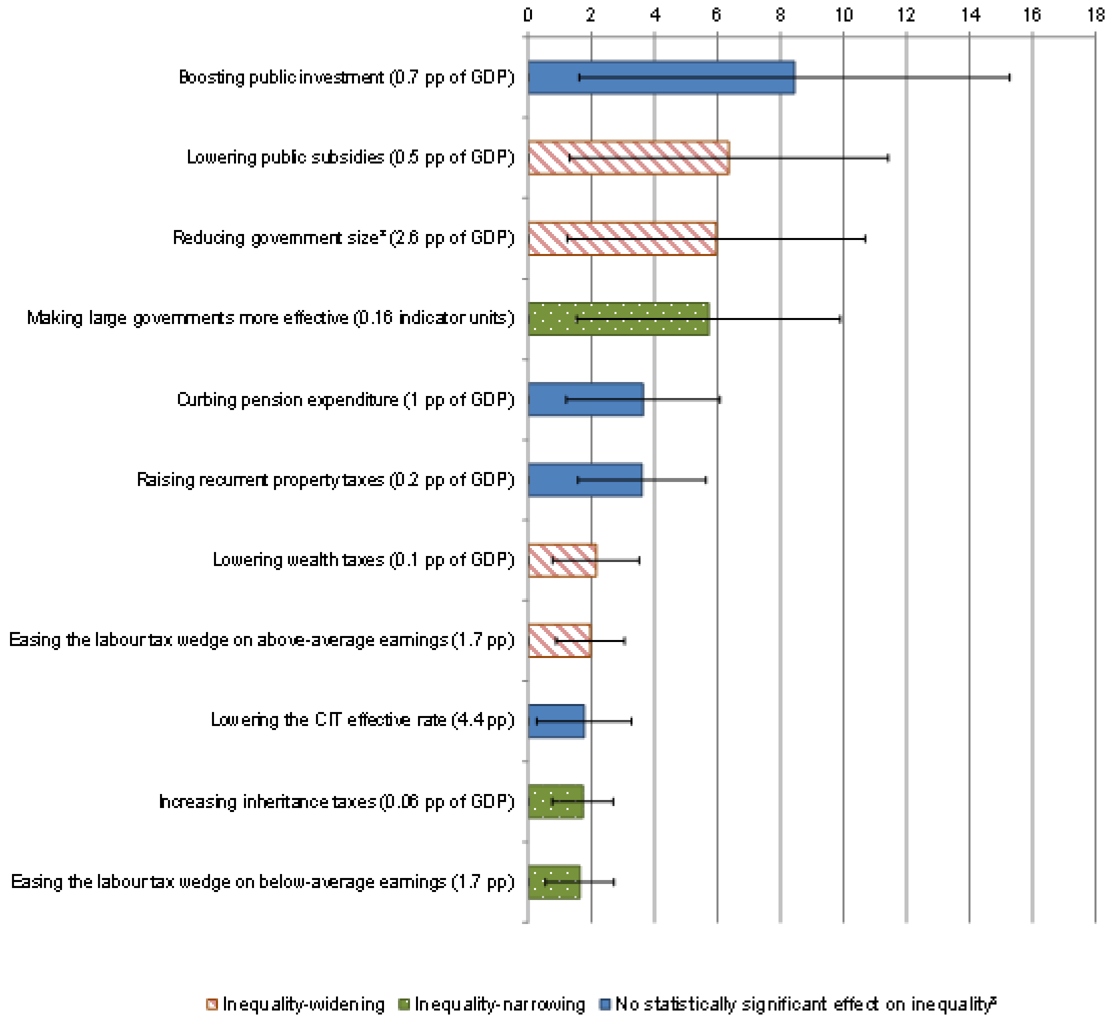
- Some reforms can boost overall economic activity while reducing income gaps:
    - One important reform of this nature is to reduce the effective tax that low-income workers face (taking into account the withdrawal of benefits) and funding this change through proportional increases in other taxes.
    - Another reform that belongs in this win-win category for higher activity and less inequality is to increase inheritance taxes and use the proceeds to reduce other taxes proportionally.
- A number of public finance reforms can increase activity without altering income differentials, thereby “lifting all boats”roughly equally. They include:
    - Higher public investment, while reducing other spending programmes by the same amount;
    - Higher recurrent property taxes, while lowering other taxes by as much;
    - Lower effective rates of corporate income tax,while increasing other taxes.
- One public finance change that benefits the poor with no substantial effect on overall activity is to expand spending on family policy while reducing other spending programmes by the same amount.
- Finally, a number of changes to the structure of public finance can be expected to boost economic activity but widen relative income gaps yet leave no income group worse of in absolute terms. Such reforms include:
    - Lowering public subsidies, while increasing other expenditure categories by as much, giving priority to the most favourable for growth such as investment and education;
    - Lowering net wealth taxes while raising other taxes by the same amount;

- Easing the tax burden on workers earning above-average wages while increasing other taxes to make up for the revenue shortfall.

The empirical work shows that reforms of sizes that correspond to changes that have been observed in OECD countries in the past three decades can have substantial effects on economic activity (Figure). This work can help select reform priorities in the light of their expected overall economic benefits and their distributional consequences, which will determine how inclusive, and therefore acceptable in political terms, they are likely to be. Importantly, the exact choice and design of the reforms will also have to reflect country specificities in terms of institutions and preferences.

Figure 1. A number of public finance shifts can boost average output with no adverse consequences for income inequality while some involve trade-offs

Permanent percentage effect on output per capita of a typically observed long-term change in a public finance instrument while keeping overall government size constant[1]



Notes: 1. The bars show the point estimates while bracketed solid lines depict the 10% confidence intervals. Estimates come from panel regressions covering 34 OECD countries over 1981-2014 or fewer observations depending on data availability. A typically observed long-term change in a public finance instrument is defined as the average across countries of the standard deviation in the tax or spending instrument over time. The standard deviation is calculated only within-country changes, implying that it reflects changes that have occurred within countries rather than long-standing differences across countries. They are equal to percentage point changes in the ratios to GDP, denoted as "pp of GDP", for instruments measured as ratios to GDP. They are simple percentage point changes for tax rates or wedges. For education quality, the standard deviation is a 1.3% increase in the average PISA score. For government effectiveness, the standard deviation is calculated in units of the indicator published by the World Bank.

2. By exception, government size is not kept constant for this change.

3. Inequality relates to disposable income inequality within the working-age population.

Source: Cournède, B., J.-M. Fournier and P. Hoeller (2018), "Public Finance Structure and Inclusive Growth ", OECD *Economic Policy Paper*, No. 25

Read more:

- Cournède, B., J.-M. Fournier and P. Hoeller (2018), "Public Finance Structure and Inclusive Growth, " *OECD Economic Policy Paper*, No. 25. https://www.oecd-ilibrary.org/economics/public-finance-structure-and-inclusive-growth_e99683b5-en
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