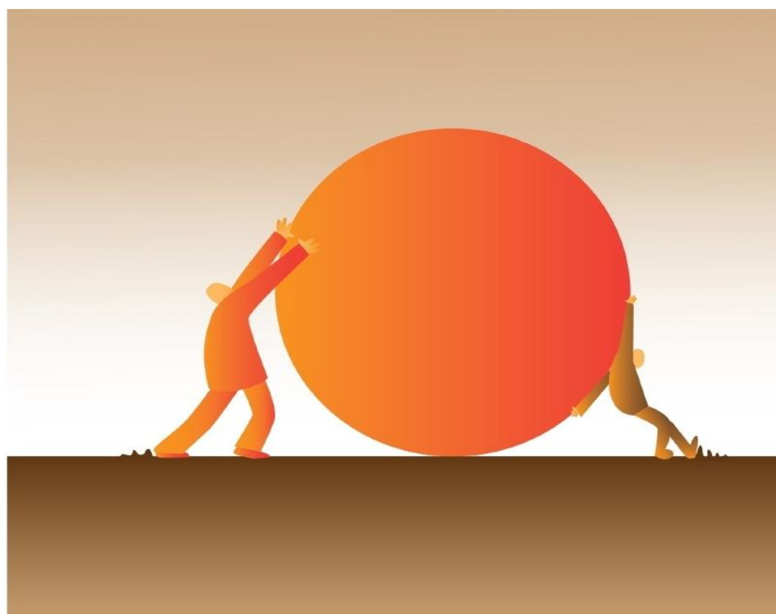
Please cite this paper as:

OECD (2012), "What are the Best Policy Instruments for Fiscal Consolidation?", *OECD Economics Department Policy Notes,* No. 12, April.

ECONOMICS DEPARTMENT POLICY NOTE No. 12

WHAT ARE THE BEST POLICY INSTRUMENTS FOR FISCAL CONSOLIDATION?



Economics Department
Organisation for Economic Co-operation and Development

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WHAT ARE THE BEST POLICY INSTRUMENTS FOR FISCAL CONSOLIDATION?

- Countries can reap sizeable budgetary benefits by adopting "best practices" in many spending areas, notably health and education and *via* pension reforms.
- Against a backdrop of often poorly targeted and sometimes quite generous benefits, some governments may benefit from reforming transfer programmes to rein in spending and to sharpen incentives to work and save.
- Revenue measures should initially concentrate on limiting tax-induced distortions that are detrimental to growth by broadening tax bases. Governments should also favour less harmful taxes, such as those on immobile property and corrective taxes such as pollution charges.
- Should the less fortunate members of society face additional hardship due to consolidation, flanking measures could cushion the blow.
- Country-specific estimates of budgetary gains from a wide range of spending and revenue measures, which have little adverse or even a positive effect on growth, at least over the medium term, have been assembled. On average across all countries, consolidation of 7% of GDP could be achieved by such measures.

Fiscal consolidation will require discretionary measures

1. Large fiscal challenges will pre-occupy OECD governments for some time to come. The economic crisis that began in 2008 caused deficits to surge, and fiscal imbalances were swollen further by stimulus measures and bank rescue operations. Together, these forces led to ballooning public indebtedness, the general government public debt-GDP ratio rising from under 80% of GDP in 2008 to almost 100% of GDP in 2010. Arresting the rise in debt and returning debt stocks to sustainable levels will require large and durable improvements in budget balances. In countries with a high debt-GDP ratio, the required adjustment is very large, exceeding 5% of GDP (See Policy Note No. 11, "Fiscal Consolidation: How Much is Needed to Get to a Prudent Debt Level?"). Fiscal consolidation will require both spending cuts and revenue measures. But these have to be chosen carefully, balancing trade-offs between occasionally conflicting policy objectives. For instance, fiscal consolidation should minimise negative near-term weakening of domestic demand, and should include remedial actions in anticipation of unacceptable adverse distributional consequences. In the short term the choice of instrument could favour initially policies with comparatively low multipliers or reforms that underpin credibility, but have little negative effect on demand in the short run.

Balancing spending cuts and revenue increases

2. Successful fiscal consolidations in the past have been largely driven by spending cuts due to political economy considerations and their positive impacts on efficiency and, when concentrated on transfers and other current spending, their perceived durability. Already reaching around 35% of GDP on average across the OECD (and up to around 50% of GDP in some countries), many tax regimes reduce GDP by blunting incentives to work, save and invest. Public spending is elevated in most high-debt OECD countries. Faced with imminent spending pressures from population ageing, the most promising path to fiscal sustainability is through spending reforms that reduce outlays to improve allocative efficiency

(*i.e.*, better overall use of resources) or productive efficiency (*i.e.*, lower resource cost per unit of service delivery). At the same time, the more vulnerable members of society need to be protected from cuts, including through targeted offsets if necessary.

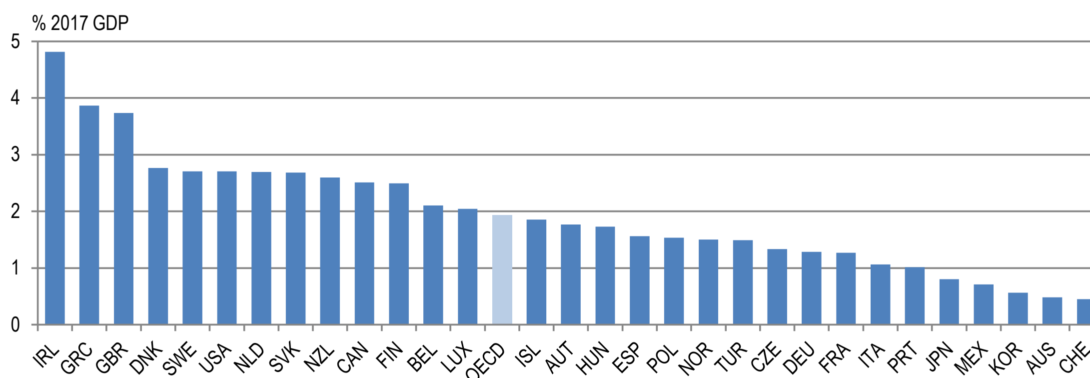
3. Where further cutbacks in spending are either undesirable or politically unfeasible, however, fiscal consolidation will require revenue increases. Raising additional revenue by minimising their adverse effects on efficiency and welfare would help reduce the long-term costs of consolidation. For example, revenue raising efforts, at least initially, should concentrate on measures that reduce the distortions that are most harmful to growth, and tilt revenue structures toward taxes and charges that are the least inefficient or that correct externalities (*e.g.*, due to pollution).

Cutting spending without harming outcomes

Achieving savings through efficiency gains

- Public health care spending absorbs 6½% of GDP and could rise by a further 3 to 6% of GDP by 2050. Throughout the OECD, there exists a variety of institutional arrangements for financing and delivering health care services and no health care system has been shown to be superior to others. Nonetheless, lessons learned from this wide-ranging experience suggest that strengthening the role of market mechanisms, changing reimbursement schemes, improving public management and control and imposing budget caps should form part of a cost containment strategy. Work by the OECD suggests that adopting "best practices" can save on average 2% of GDP, while achieving the same health outcomes (Figure 1).

Figure 1**. Potential savings from greater efficiency in public health care spending**



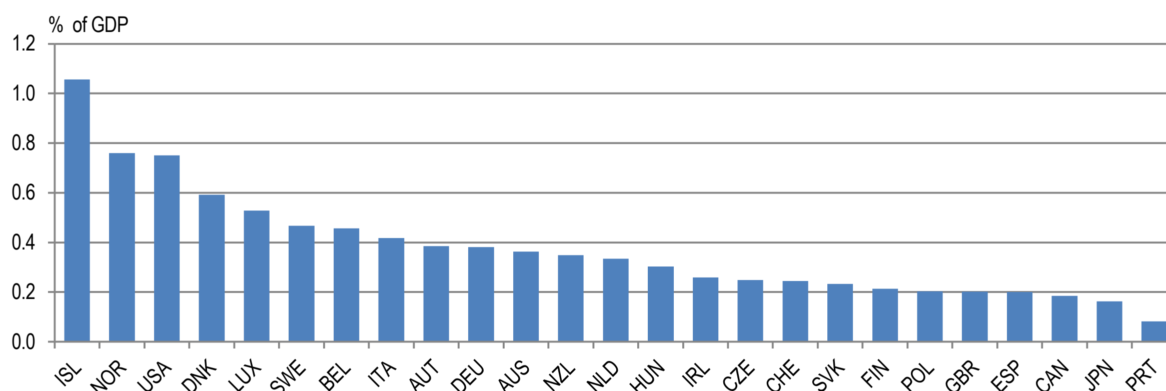
Note: Potential savings represent the difference between a no-reform scenario and a scenario where countries would exploit efficiency gains. The no-reform scenario assumes that between 2007 and 2017 life expectancy and spending increase at the same pace as over the previous 10 years and that the mix between public and private spending remains constant over time.

Source: Joumard, I., P. Hoeller, C. André and C. Nicq (2010), *Health Care Systems: Efficiency and Policy Settings*, OECD Publishing.

- Reforms to public education can reduce outlays, improve educational outcomes, and impart more fairness. OECD governments devote large amounts of resources to public education, reaching on average 5.7% of GDP. And yet, research does not find that higher spending *per se* delivers systematically higher educational attainment. At primary and secondary levels, effective reforms include making budgets more responsive to the educational needs of students (*e.g.*, through more decentralised budgets), allowing more autonomous budget management balanced by greater accountability (*e.g.*, at the school level), and introducing more competition. OECD-wide savings up to 1% of GDP could be achieved through efficiency-enhancing reforms to primary and

secondary schooling (Figure 2). At the tertiary level, some countries apply high tuition fees, whereas others apply no or a low tuition fee. In this context, introducing or raising low tuition fees would reduce budgetary pressures, while simultaneously improving outcomes. Fees induce greater responsiveness to students' preferences, and tighten the link between the choice of discipline and occupation.

Figure 2. **Potential savings from greater efficiency in primary and secondary education spending**



Source: Based on Sutherland, D., R. Price, I. Joumard and C. Nicq (2007), "Performance and Indicators for Public Spending Efficiency in Primary and Secondary Education", *OECD Economics Department Working Papers*, No. 546, OECD Publishing.

- Improving the efficiency of public services more generally can yield significant savings. A host of management, governance, and pay reforms can help achieve the same public service outcomes at lower resource cost. With the general government wage bill accounting for roughly one quarter of overall spending, which to varying extents across countries will include health and education, reducing public employee compensation costs is an obvious area to examine whether savings can be made. At the same time, wage bill savings must avoid harming the quality and productivity of the public sector work force through arbitrary and automatic across-the-board cuts. This does not rule out, however, cuts that are warranted to restore private-public pay relativities, such as recent reforms in Hungary and Ireland aimed to do.

Rationalising transfers can reduce outlays and boost long-run growth

- Reforming social transfers, which OECD-wide account for 14% of GDP, presents one of the most promising avenues for fiscal consolidation in many countries. Family and housing benefits, unemployment insurance, and disability payments play important roles in modern economies. But in many countries, transfers have become less focused on their original objectives and have become replete with disincentives to work (*e.g.,* lengthy and unconditional unemployment benefits). Reforms that restore the original focus of the transfers and reconsider the level of generosity could yield considerable savings which together with improving job search and work incentives can boost growth, with positive knock-on impacts on revenues over time.

- Public pension programmes continue to threaten fiscal sustainability. Pay-as-you-go (PAYG) pension schemes are a particular threat to the long-run fiscal outlook as the ratio of pensioners to contributors will rise rapidly over the coming decades. Indeed, pension pressures increase the long-term fiscal gap in most countries, and substantially in some. Several reforms hold particular promise of improving the sustainability of public pension schemes and contributing to fiscal consolidation, including lengthening the contribution period required for a full pension,

increasing incentives to postpone retirement and remain employed, and linking the pensionable age to life expectancy. The contribution of delayed pension take-up to long-run consolidation can be substantial, amounting to several percentage points of GDP in some countries.

Raising revenue should reduce harmful distortions

4. In searching for additional revenue, governments should examine the scope for broadening tax bases in order to keep rates low, and focus on mobilising revenue from the least harmful taxes.

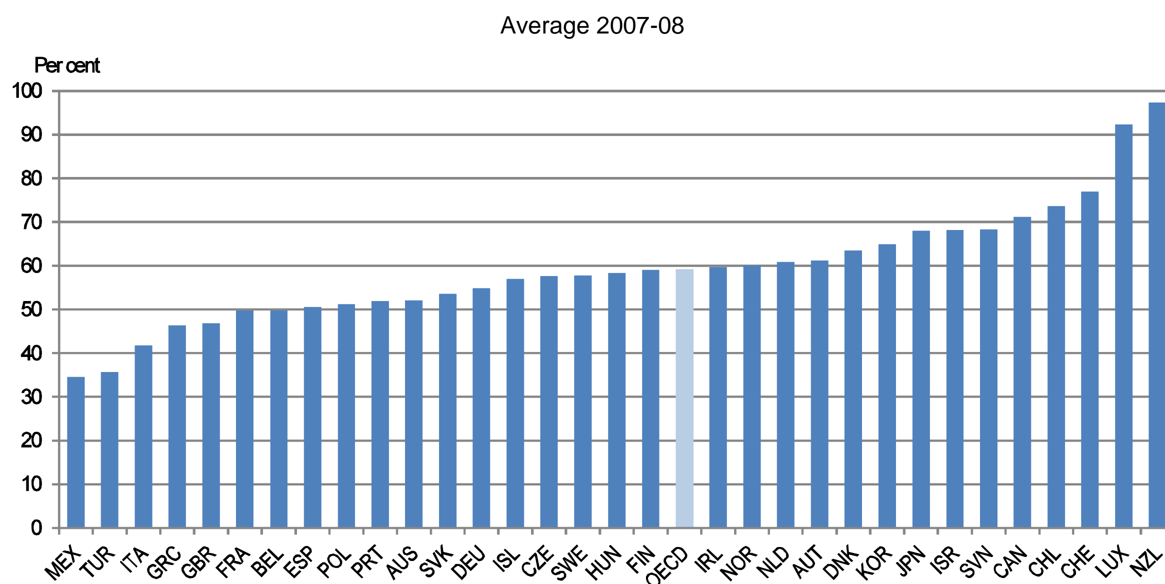
Scaling back tax expenditures is long overdue in most countries

5. To promote a range of objectives, governments use tax expenditures in the form of exclusions from income, tax deductions and credits for selected items and, in the case of consumption taxes, lower tax rates for some items or outright exemption. While their scope varies across countries, tax expenditures often account for substantial revenue leakages. While some tax expenditures, such as earned income tax credits, raise employment and thereby economic activity, many are distorting, poorly targeted and reduce transparency. And by narrowing the tax base, distortionary tax expenditures cause statutory rates to be higher than otherwise, further damaging overall efficiency.

- The VAT is widely recognised as an efficient and buoyant source of revenue, but its revenue potential is not fully used. With the exception of New Zealand, most countries forego significant amounts of revenue due to a combination of reduced rates for selected items, a narrowed base, and low compliance (Figure 3). Broadening the base and reducing the number of rates would both lessen complexity and improve compliance, boosting revenue and countering political pressures for additional low rates. Admittedly, increased rates could have an adverse impact on low-income households, but these could be compensated through targeted cash transfers.

Figure 3. **Value added tax performance: the VAT revenue ratio**

Average 2007-08



Note: The VAT revenue ratio measures the difference between the VAT revenue actually collected and what would theoretically be raised if VAT was applied at the standard rate to the entire potential tax base in a "pure" VAT regime and all revenue was collected: The VAT revenue ratio equals VAT Revenue/(Consumption * Standard VAT rate)*100.

Source: OECD (2011), *Consumption Tax Trends 2010: VAT/GST and Excise Rates, Trends and Administration Issues,* OECD Publishing.

- Several tax expenditures under the personal income tax are costly yet ineffective. Tax incentives for retirement saving generally result in a reallocation of saving from non-tax preferred to tax-preferred vehicles, without much impact on private, let alone national saving. Phasing out such incentives could yield around 1.7% of GDP in additional revenue. At the same time, promoting retirement saving through mandatory schemes can be effective (*e.g.,* in New Zealand, the United Kingdom), and low-income savers can be helped through matching contributions by the government, as in Australia.

- Owner-occupied housing is one of the costliest tax preferences in many OECD countries. The principal housing-related revenue leakage arises from excluding from taxation the implicit rental income that accrues to the owner-occupant, while nevertheless allowing a deduction for mortgage interest costs. In addition, long-term capital gains from the sale of owner-occupied housing are often untaxed, or taxed at a lower rate. As tax preferences are likely to raise home prices, they are unlikely to make home-ownership more accessible. Moreover, the investment bias favouring residential housing leads to a less productive capital stock, reducing income over the long term.

- Scaling back other tax preferences would provide additional opportunities for fiscal consolidation. Notwithstanding the original merits that underpinned the introduction of each tax preference, the fiscal policy challenges faced by many countries argue for their reassessment. Given the political challenges governments face in reducing or eliminating selected tax preferences, however, a possible interim approach can be to cap the amount of tax savings.

Less distortive and corrective taxes should be given priority

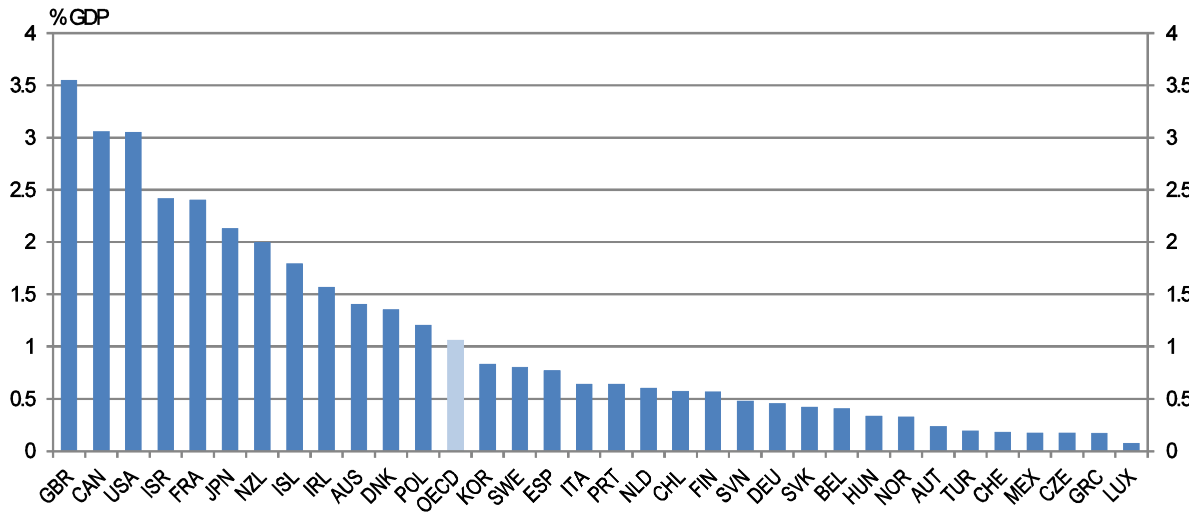
6. Additional revenue can be raised from sources that are either less distortive or can improve welfare by taxing harmful behaviour.

- Because of its fixity of the housing stock in the short run, the real estate tax base is less responsive to changes in the effective tax rate than many other tax bases. Increasing taxation on property is thus less harmful to growth than increasing the burden on more elastic tax bases such as labour or footloose physical or financial capital. Among countries with relatively low yields from taxes on immobile property, additional revenue of over ½ per cent of GDP could be gained, if the tax take were to be lifted to the OECD average (Figure 4). However, such a reform is not without costs and may need flanking measures to compensate adverse impacts on low-income households, or on elderly, which are sometime housing rich, but income poor.

- Introducing or increasing taxes on polluting behaviour provides potentially a win-win option. First, environmental taxes or auctioned tradable emission rights could yield substantial revenue. Second, they are effective market-based mechanisms for discouraging polluting behaviour and for spurring the development of alternative "clean" energy sources. Since many countries are committed to reducing greenhouse gases, the time is propitious for addressing fiscal consolidation and environmental protection jointly. While the yield from such taxes is already relatively high in some countries such as Denmark and the Netherlands (4% of GDP in 2009), it is relatively small in Canada, New Zealand and the United States (1% of GDP or less in 2009).

Figure 4. **Recurrent taxes on immovable property**

2009 or latest year available



Source: *OECD Revenue Tax Database.*

How much consolidation could be achieved?

7. Comparable estimates of the potential contribution of spending and revenue measures to fiscal consolidation are typically not available. Table 1 brings together a number of estimates to assess the potential scale of these. On average, reforms along the lines presented above could yield around 7% of GDP, slightly more than half coming from spending measures. A large share of savings would be achieved *via* efficiency gains and transfer reforms, although these will take time to materialise. On the revenue side, substantial opportunities exist for greater use of environmental levies, and broadening the income and indirect tax bases to avoid increasing tax rates.

Table 1. **Quantifying the contribution of various policy instruments to fiscal consolidation**

Per cent of GDP

	AUS	AUT	BEL	CAN	CHE	CZE	DEU	DNK	ESP	FRA	FIN	GBR	GRC	HUN	ISL
1. Social transfers															
A. Family benefits	0.5	0.7	0.6	-	-	0.1	-	1.4	-	1.1	0.9	1.3	-	1.4	1.0
B. Disability benefits	-	0.3	0.2	-	0.5	0.5	-	1.3	0.6	-	0.9	0.3	-	0.6	-
2. Pensions															
A. Eliminate tax breaks	2.7	0.1	0.1	2.0		0.1	0.8		0.2	0.0	0.1	1.2			1.0
3. Health care															
A. Increase efficiency	0.5	1.8	2.1	2.5	0.5	1.3	1.3	2.8	1.6	1.3	2.5	3.7	3.9	1.7	1.9
4. Education															
A. Increase efficiency in primary and secondary education	0.4	0.4	0.5	0.2	0.2	0.2	0.4	0.6	0.2		0.2	0.2		0.3	1.1
B. Introduce or raise tuition fees for tertiary education	-	0.4	0.4	-	0.4	0.3	0.4	0.4	0.2	0.3	0.4	-	0.4	0.4	0.3
5. Government wage bill															
A. Restore public-private sector pay relativities	-	0.3	0.6	-	-	0.4	0.2	2.0	1.0	-	0.5	1.8	-	-	-
6.. Reduce subsidies as share of GDP to OECD average	-	2.3	0.8	-	2.4	0.7	-	1.2	-	0.2	-	-	-	-	0.4
7. Broaden VAT base	0.6	-	1.4	-	-	-	0.4	-	1.4	1.4	0.1	1.8	2.0	0.1	0.8
8. Introduce or increase taxes on immovable property	-	0.8	0.6	-	0.9	0.8	0.6	-	0.3	-	0.5	-	0.8	0.7	-
9. Environmental taxes															
A. Cut GHG emissions to 20% below 1990 levels *via* an emission trading system with full permit auctioning	4.2	1.8	1.8	2.5	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	

Table 1. Quantifying the contribution of various policy instruments to fiscal consolidation (continued)

	IRL	ITA	JPN	KOR	LUX	MEX	NLD	NZL	NOR	POL	PRT	SVK	SWE	TUR	USA
1. Social transfers															
A. Family benefits	0.7	-	-	-	1.2	-	0.1	1.1	0.9	-	-	-	1.4	-	-
B. Disability benefits	-	-	-	-	0.1	-	0.8	0.7	1.8	0.6	0.3	-	1.3	-	-
2. Pensions															
A. Eliminate tax breaks	1.2	0.0	0.7		0.5	0.2			0.6	0.2	0.1	0.2			0.8
3. Health care															
A. Increase efficiency	4.8	1.1	0.8	0.6	2.0	0.7	2.7	2.6	1.5	1.5	1.0	2.7	2.7	1.5	2.7
4. Education															
A. Increase efficiency in primary and secondary education	0.3	0.4	0.2	-	0.5	-	0.3	0.3	0.8	0.2	0.1	0.2	0.5	-	0.8
B. Introduce or raise tuition fees for tertiary education	0.3	0.2	-	-	0.4	0.1	0.2	-	0.4	0.1	0.1	-	0.4	0.4	-
5. Government wage bill															
A. Restore public-private sector pay relativities	0.9	1.1	0.6	-	0.8	-	0.3	0.9	-	2.2	-	0.8	0.7	-	0.5
6. Reduce subsidies as share of GDP to OECD average	-	-	-	-	0.2	-	0.1	-	0.7	-	-	0.2	0.1	-	-
7. Broaden VAT base	0.4	2.6	-	-	-	2..5	-	-	0.2	1.4	1.2	0.6	-	3.3	
8. Introduce or increase taxes on immovable property	0.2	0.4	-	0.0	0.9	0.8	0.4	-	0.7	-	0.3	0.6	0.2	0.9	-
9. Environmental															
A. Cut GHG emissions to 20% below 1990 levels *via* an ETS with full permit auctioning	1.8	1.8	1.2		1.8		1.8	4.2		1.8	1.8	1.8	1.8		2.2

Notes:
An empty cell indicates that no information was available. Cells with a dash indicate that no savings are available from this source.
Estimates for family benefits are based on reducing the figure for 2007 reported in the OECD SOCX Database to the unweighted OECD average as a per cent of GDP.
Estimates for disability benefits are based on reducing the figure for 2007 reported in the OECD SOCX Database to the unweighted OECD average as a per cent of GDP.
The elimination of tax breaks for retirement is based on data for 2007 from OECD (2011), *Pensions at a Glance 2011*.
Health care efficiency estimates are from Joumard *et al.* (2010).
Education efficiency estimates are based on Sutherland *et al.* (2007) updated to 2007 spending figures.
Tuition fees for tertiary education are based on raising direct household expenditure for tertiary education institutions to the unweighted average of those countries where households spend on this category.
Government wage relativities are based on returning the government to private sector wage ratio in the early 2000s.
Estimates for subsidies are based on reducing national account data for 2009 to the unweighted OECD average.
The figures for broadening VAT base assume the mechanical effect of collection efficiency rising to the unweighted OECD average in 2007-2008.
The figures for immovable property are based on the unweighted average for 2008 from the Revenue Statistics.
Revenues from greenhouse gas emissions are based on de Serres *et al.* (2010).

Source: Hagemann, R. (2012), “Fiscal Consolidation: Part 6. What are the Best Policy Instruments for Fiscal Consolidation?”, *OECD Economics Department Working Papers,* No. 937, OECD Publishing.

Suggested further reading

The main papers providing background to this note are:

Hagemann, R.P. (2012), "Fiscal Consolidation: Part 6. What Are the Best Instruments for Fiscal Consolidation?", *OECD Economics Department Working Papers*, No. 937, OECD Publishing.

OECD (2012), "How Much is Needed to get to a Prudent Debt Level", *OECD Economics Department Policy Notes*, No. 11.

Sutherland, D., P. Hoeller and R. Merola (2012), "Fiscal Consolidation: Part 1. How Much Is Needed and How to Reduce Debt to a Prudent Level?", *OECD Economics Department Working Papers,* No. 932, OECD Publishing.

Additional related papers include:

Antolin, P., A. de Serres and C. Maisonneuve (2004), "Long-Term Budgetary Implications of Tax-Favoured Retirement Plans", *OECD Economics Department Working Papers*, No. 393, OECD Publishing.

Joumard, I., P. Hoeller, C. André and C. Nicq (2010), *Health Care Systems: Efficiency and Policy Settings*, OECD Publishing.

Merola, R. and D. Sutherland (2012), "Fiscal Consolidation: Part 3. Long-run Projections and Fiscal Gap Calculations", *OECD Economics Department Working Papers,* No. 934, OECD Publishing.

OECD (2010*a*), *Tax Policy Reform and Economic Growth*, OECD Publishing.

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