Division of Economics, EGC
School of Humanities and Social Sciences
Nanyang Technological University
14 Nanyang Drive
Singapore 637332

Fiscal Policy and Equity in Advanced Economies: Lessons for Asia

Gemma ESTRADA, James ANGRESANO, Jo Thori LIND, Niku MÄÄTTÄNEN, William MCBRIDE, Donghyun PARK, Motohiro SATO and Karin SVANBORG-SJÖVALL

26 November 2014

EGC Report No: 2014/14

HSS-04-88
Tel: +65 67905689
Email: D-EGC@ntu.edu.sg
http://egc.hss.ntu.edu.sg

Fiscal Policy and Equity in Advanced Economies: Lessons for Asia

Gemma ESTRADA*[*], James ANGRESANO*[†], Jo Thori LIND*[‡], Niku MÄÄTTÄNEN*[§], William MCBRIDE*[**], Donghyun PARK*[††], Motohiro SATO*[‡‡], and Karin SVANBORG-SJÖVALL*[§§]

26 November 2014
JEL-code: D31, H20, H50
Keywords: fiscal policy, inequality, inclusive growth, advanced countries, developing Asia

Abstract

Advanced economies have a longer history of leveraging fiscal policy to address inequality relative to developing Asia. We examine the country experiences of the Nordic countries, France, Japan, and the US, to draw lessons for developing Asia in its relatively new quest to use fiscal policy to promote inclusive growth. Those experiences suggest that fiscal policy can indeed be an effective tool for inclusive growth as long as it does not compromise fiscal sustainability or economic growth.

[*] Senior Economics Officer at the Economics and Research Department, Asian Development Bank, 6 ADB Avenue, Mandaluyong City, 1550 Metro Manila, Philippines; gestrada@adb.org

[†] Professor of Political Economy, College of Idaho, 2112 Cleveland Boulevard, Caldwell, ID 83605, United States; jangresano@collegeofidaho.edu

[‡] Associate Professor, Centre for the Study of Equality, Social Organization, and Performance (ESOP) and Department of Economics, University of Oslo, P.O. Box 1072 Blindern0316 Oslo, Norway; j.t.lind@econ.uio.no

[§] Research Supervisor at the Research Institute of the Finnish Economy, Lounrotinkatu 4B Helsinki 120, Finland; niku.maattanen@etla.fi

[**] Chief Economist at the Tax Foundation, National Press Building Leasing, 529 14th Street Northwest #420, Washington, DC 20045, United States; mcbride@taxfoundation.org

[††] Principal Economist, Economics and Research Department, Asian Development Bank, 6 ADB Avenue, Mandaluyong City, 1550 Metro Manila, Philippines; dpark@adb.org

[‡‡] Professor at the Graduate School of Economics,Applied Economics, School of International and Public Policy, Hitotsubashi University, 2-1 Naka, Kunitachi, Tokyo 186-8601, Japan; satom@econ.hit-u.ac.jp

[§§] Chief Executive Officer at Timbro, Box 3037, 103 61 Stockholm; karin.svanborg.sjovall@timbro.se

1 Introduction

While sustained rapid growth has sharply lifted developing Asia's general living standards and made a big dent in its poverty, the region now faces the problem of widening inequality. Asia's widening income gaps strengthens the case for governments around the region to play a more active and direct role in fostering equity. While advanced economies have a long history of actively using fiscal policy for redistribution, in developing Asia fiscal policy has put greater emphasis on facilitating growth rather than on promoting equity. In addition, much of developing Asia has a history of fiscal prudence, which gives the region some fiscal space to meet future fiscal demands. The critical issue facing the region is how to deploy fiscal policy to achieve a more equitable society, without undermining fiscal sustainability.

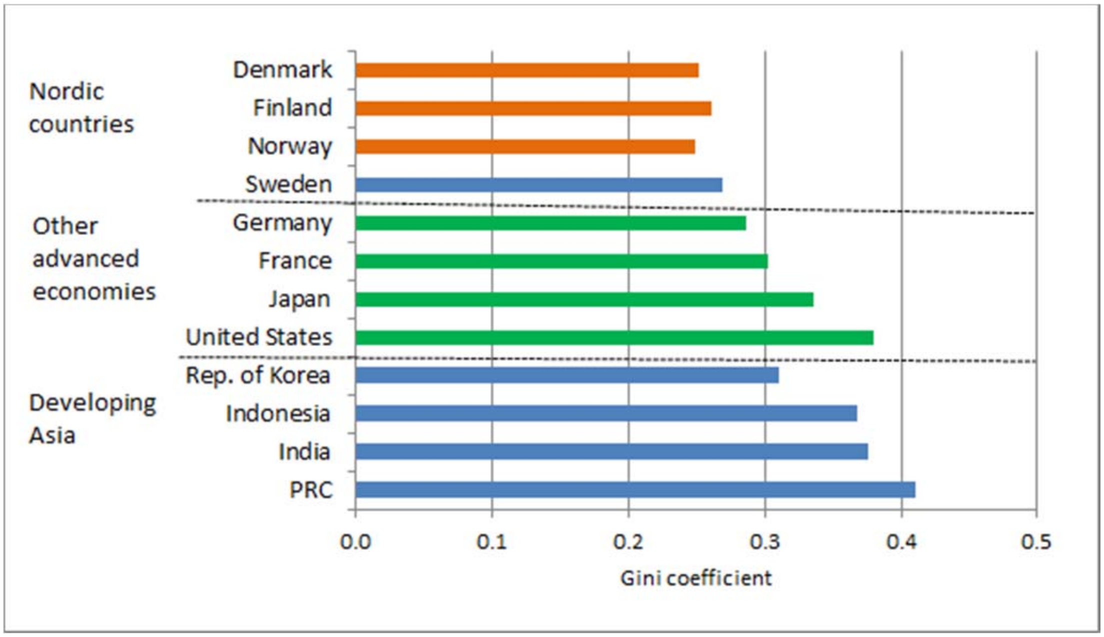
Asian developing countries have much to learn from the experience of advanced economies on how to make more active use fiscal policy to promote equity. After all, high-income countries have extensively used their fiscal policy to achieve a more equitable society (Heshmati et al. 2014). But at the same time, some advanced economies find it increasingly difficult to finance their huge social spending. Developing Asia can learn valuable lessons from the experiences of advanced economies. Some of those lessons will be positive – i.e. what to emulate – whereas others will be negative – i.e. what to avoid. This note briefly examines some of the key lessons.

2 Fostering Equity and Economic Dynamism: The Nordic Model

Recent financial crises have prompted an increasing interest in what is known as the Nordic Welfare Model. While large parts of Europe struggle with enormous deficits and galloping unemployment, the Nordic countries have by and large enjoyed favourable economic growth coupled with social gaps that continue to be slight. Reflecting the experience of Finland, Denmark, Norway, and Sweden, the Nordic model provides an example of how fiscal policy can be more actively used to achieve equity. The experience of this group of countries shows that it is possible to achieve a strong economy while relying upon a large public sector to achieve a more equitable society through high taxes that fund extensive social insurance and welfare programs.

Nordic countries are among those with the lowest income inequality (Figure 1). The small income disparities in the Nordic countries are partly due to a redistribution of income via public tax-and-transfer schemes such as progressive income taxation, comprehensive unemployment insurance, and public pensions. Free access to education and health care services has also significantly contributed in equalizing economic opportunities. Naturally, these policies require a large public sector. In the Nordic countries, total tax revenue amounts to about 45% of GDP (Table 1).

Figure 1 Income Inequality in Selected Economies



Note: Inequality data range between 2006 and 2009.
Source: Organization for Economic Co-operation and Development Data. http://www.oecd.org/statistics/ (accessed 11 July 2014).

Table 1 Selected Indicators, Nordic Economies vs. Others

	GDP per capita (PPP) relative to US, %	Tax revenue relative to GDP, %	Labour productivity in manufacturing (ex. ICT) relative to US, %
enmark	81.6	47.6	62.0
Finland	74.1	42.5	113.0
Norway	123.9	43.2	n.a.
Sweden	83.2	45.5	93.0
USA	100.0	24.8	100.0
EU-15 average	79.1	38.4	n.a.
OECD average	70.7	33.8	n.a.
Year	2012	2010	2007
Source	OECD	OECD	Maliranta et al. (2012)

n.a. = data not available; PPP = purchasing power parity.
Note: * EU-15 excluding Luxembourg. Tax revenue data for EU-15 and OECD averages are for 2010, while the rest are for 2012.
Sources: International Monetary Fund, Fiscal Monitor (April 2013)

and World Economic Outlook Database (October 2014); Maliranta, et al. (2012).

Despite a very high tax burden, the Nordic countries are also quite rich. In 2012, GDP per capita in Denmark, Sweden, and Finland was around 80% of the US figure, while that of Norway was more than that of the US (Table 1). Arguably, an even better comparative measure of economic well-being is labor productivity (value-added/hours). Measurement of labor productivity is most reliable in manufacturing industries. Except for Denmark (that has a strong service sector), labour productivity in manufacturing appears to be at the same level, or even higher in the Nordic countries than in the US. In other words, the Nordic countries have been able to combine economic efficiency and low income inequality remarkably well. Since the Nordic countries also share many similarities in terms of institutions and policies, it has become commonplace to refer to a “Nordic model”.

One important factor driving Nordic countries’ egalitarian distribution of income is its strong labor movement and large degree of centralized wage bargaining. Centralized and coordinated wage bargaining tends to increase the lower wages more than the higher ones, leading to a compression of wages. In economic terms, low productivity workers are paid more than their marginal product whereas high productivity workers are paid below theirs. This leads to less productive workers being expensive whereas highly productive workers are cheap compared to trading partners. For this reason, low productivity firms, that would usually employ the former, struggle to stay in business. Driving out low productivity firms and strengthening high productivity firms enhances the process of creative destruction, enhancing the growth of productivity.

Many of the policies and institutions in Nordic countries reflect a common cultural and historical background. It is probably not possible nor desirable to try and bring the Nordic model as such into culturally very different societies, such as Asian countries. Moreover, the Nordic model has its problems. In particular, population ageing has raised concerns about the sustainability of the generous public pension and health insurance systems. Yet the development of social policies in the Nordic countries has followed, albeit imperfectly, certain quite sensible principles that at least help explain why the Nordic model has worked so well. (For an extensive discussion about the Nordic model, with a focus on its current challenges, see Andersen et al., 2007.)

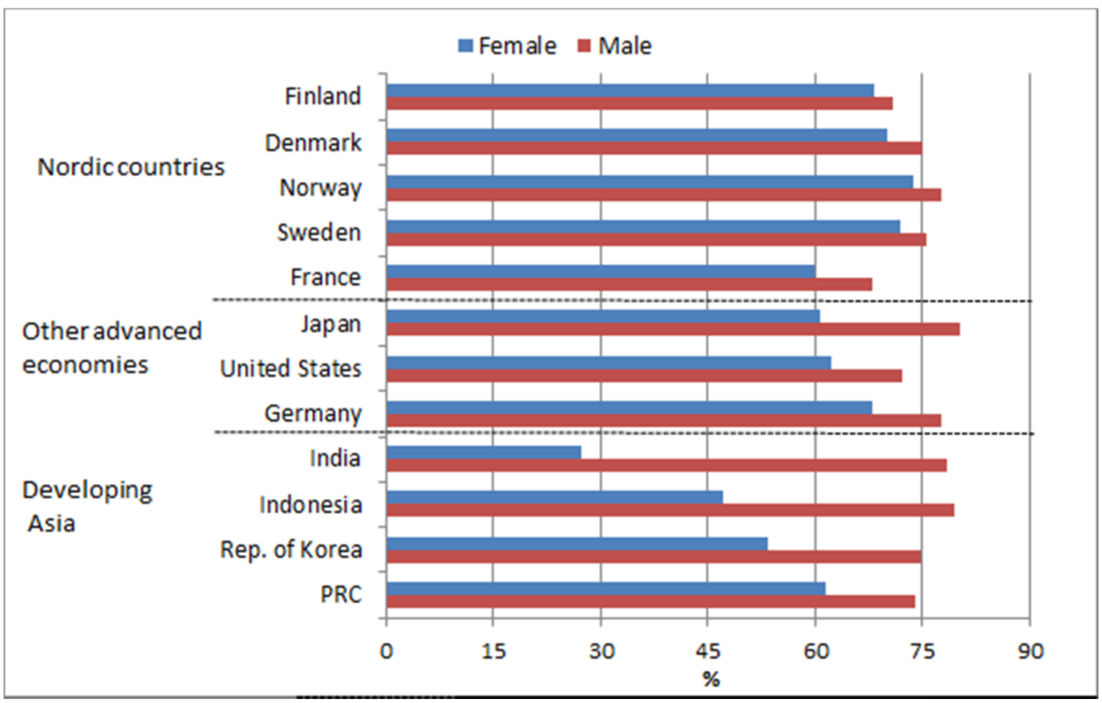
A common feature among Nordic countries is that the state guarantees a generally acceptable standard of living, a perspective related to the relationship between the individual and the public sector that has come to be called state individualism. This assumes a strong state that relieves the family of most of its responsibility to provide for the household through high taxation and a well-developed public sector. The welfare state reallocates resources and strives to even out chances in life through extensive national transfer and social insurance systems.

A social innovation adopted in Nordic countries is the opportunity for private companies to deliver state-funded welfare services. On the one hand, this is a potentially important new export market. On the other hand, the opportunity to do business gives people, women in particular, a chance to develop new business and welfare services – services they previously provided without pay and more recently, solely within the framework of the low-income public sector. Above all, however, the idea of completely or partially state-funded freedom of choice in terms of education offers the chance to combine the capacity of private enterprises to be innovative and effectively manage resources with an equal-opportunity approach that gives also students and parents with limited resources the chance to place demands on the education system.

The Nordic model illustrates how fiscal policies can be desirable for both equity and efficiency reasons. An example from the Nordic countries is the equal opportunity education system: it reduces economic inequality by increasing social mobility and improves economic efficiency by helping to harvest talents for gainful economic activity. Another example is subsidized day care and other policies that make it easier to combine work and family life. The Nordic model relies on the two-income family, placing high demands on extensive childcare and elderly care services. Hence, female employment rates are quite high in all Nordic countries and are very close to male employment rates (Figure 2). This helps to sustain the public sector via high tax revenues. In a way, the high female employment rate was also a prerequisite for expanding the public sector.

The parental insurance system is uniquely generous, and designed to encourage fathers to take time off from work to spend with their children. None of the Nordic countries have joint taxation in families any longer since this is considered to stifle women's participation in the labour market. This means that women have unique opportunities for social participation on terms comparable to those for men.

Figure 2. Employment-to-Population Ratios in Selected Economies in 2012, by Gender

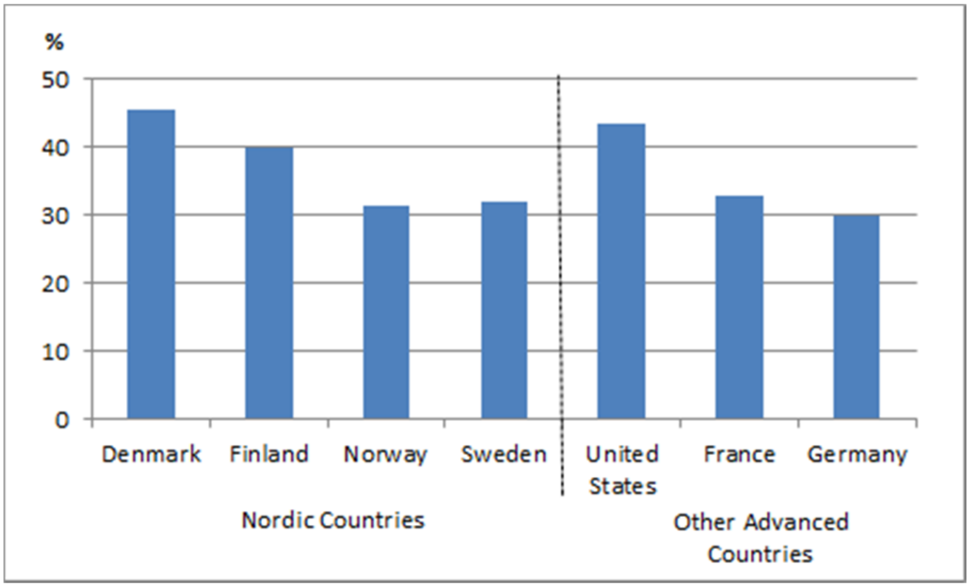


PRC = People's Republic of China.
Sources: International Labour Organization, Key Indicators of the Labor Market, 8th Edition; OECD iLibrary. http://www.oecd-ilibrary.org/employment/employment-rate_20752342-table4 (accessed 31 July 2014).

Supporting Nordic countries' large public sector is their vibrant economy. Nordic economies are quite dynamic, as seen in the intensity of job creation and job destruction (Bassanini and

Garnero 2012). The process of “creative destruction” helps in sustaining high productivity growth in the private sector. In terms of job creation and job destruction, Denmark and Finland are about as dynamic as the United States (US) (Figure 3). Social policies in the Nordic countries have helped to generate political support for free markets and international trade and made it easier for workers to accept growth-enhancing structural changes. For instance, unemployment insurance and other elements of social security can be seen as mechanisms through which the winners from technological change and globalization compensate the losers.

Figure 3. Worker Reallocation in Selected Economies, 2000-2007



Note: Worker reallocation is defined as the sum of hiring rate and separation rate.
Source: Bassanini and Garnero 2012.

3 Meeting the Preconditions for a Generous Social Welfare System: The Contrast between France versus Sweden

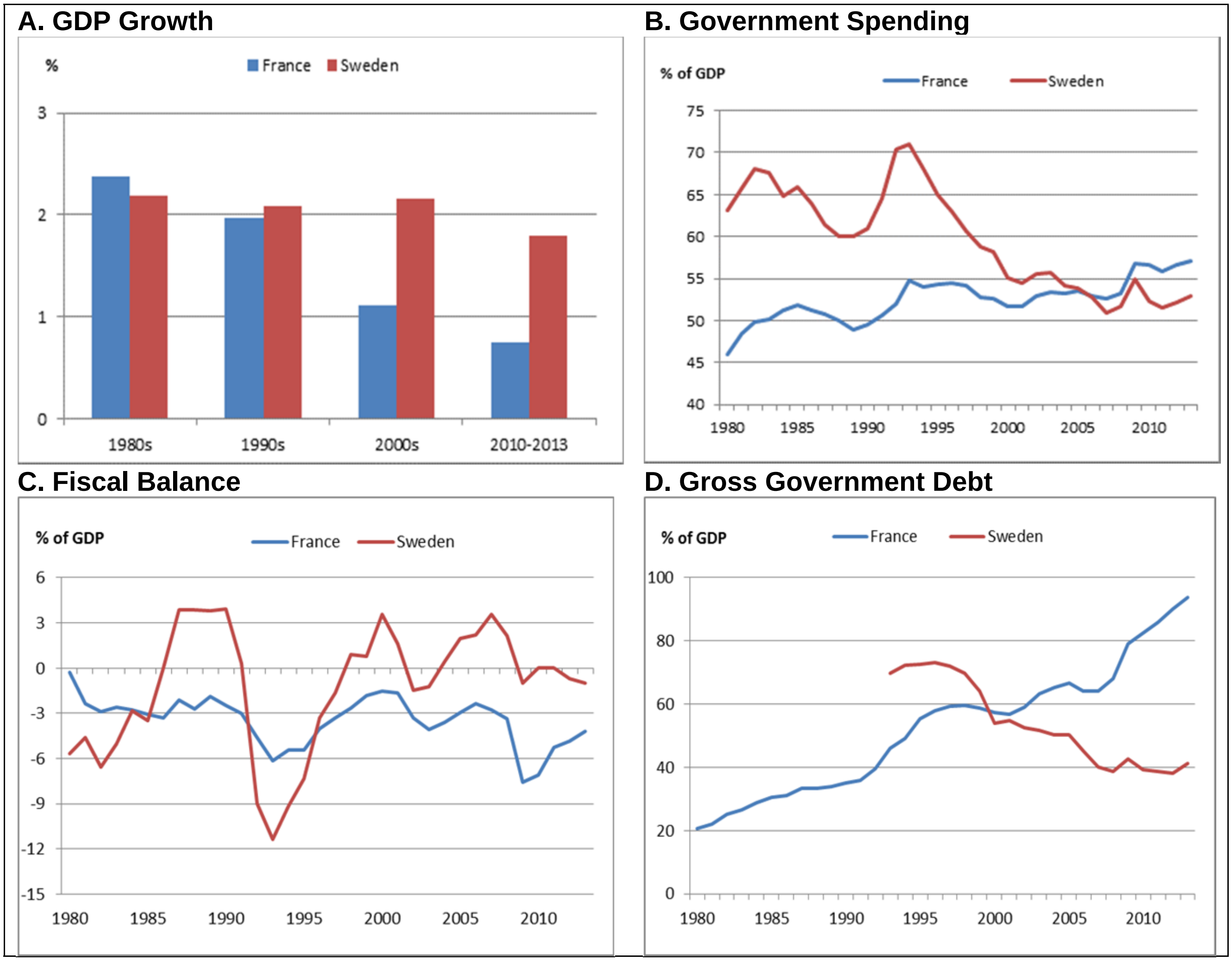
A generous social welfare system is based on a premise that an economy exhibits sufficient growth to generate adequate tax revenue. Raising social insurance and welfare spending too far so that the preconditions for achieving favorable growth rates and fiscal stability are violated will cause the economy to go in reverse. When necessary, it is important to introduce pragmatic reforms to satisfy the preconditions for achieving favorable growth and fiscal sustainability.

A comparison of economies demonstrates the importance of good government policies that promote sustained growth and that mitigate poverty and income inequalities. Sweden’s social democratic policies are generally studied as a success story. France has also committed itself to social democratic policies, but with less success. Sweden had sound macroeconomic performance prior to 1980, and again after its early 1990 crisis. France, however, featured a similar favorable economy throughout several decades prior to the 1990s, but not thereafter. A comparison of French and Swedish development indicators in the data below suggests why France has been less successful. What appears to be the critical factor is the two countries’ response to their respective crises. This comparison may therefore offer useful lessons for Asian economic policy-makers.

The case of France illustrates the risks of delaying necessary reforms when necessary preconditions fail. Similar to Nordic countries, the philosophy underlying the French social democratic model is to establish a fair society, whereby the entire society shares the financial burden of universal, nondiscriminatory social services, and a safety net. Inequalities would be reduced through redistribution programs that seek to raise direct wages and social welfare payments for lower income groups. The State acts as the primary guarantor against social risks such as unemployment, ill-health, disability and old-age while providing essential services such as education, housing, and child care. To satisfy these goals, France relies on a range of measures, including public works and unemployment benefits; relatively early retirement age; universal health care and pensions; four to six weeks of guaranteed paid vacations; nationalization of many industries; extensive subsidies to support and regulate the private sector while maintaining employment security; and universal allowance for families with at least two children. For any government to fund these commitments and ensure financial stability, economy should have high rates of economic growth to generate sufficient tax revenue, the average life expectancy should only moderately exceed average retirement age, and state should manage well its public spending. France was able to satisfy the economic preconditions before the 1990s, after which a decline in economic performance has become evident (Figure 4). Government expenditure as percent of GDP rose to above 50% by the mid-1990s partly due to rising subsidies for declining industries and partly due to rapidly rising social insurance and welfare program spending. Taxes rose to levels among the highest in OECD, but not enough to prevent budget deficits that exceeded Maastricht requirements during the late 1990s and again since 2010. Gross government debt as a percentage of GDP has reached over 90% of GDP. Debt service now consumes about 14% of annual government spending. Private sector job creation remains low. Unemployment remains officially above 9%, while youth unemployment has exceeded 20% since the mid-1990s, (Figure 5). A looming issue is an unsustainable welfare state funding.

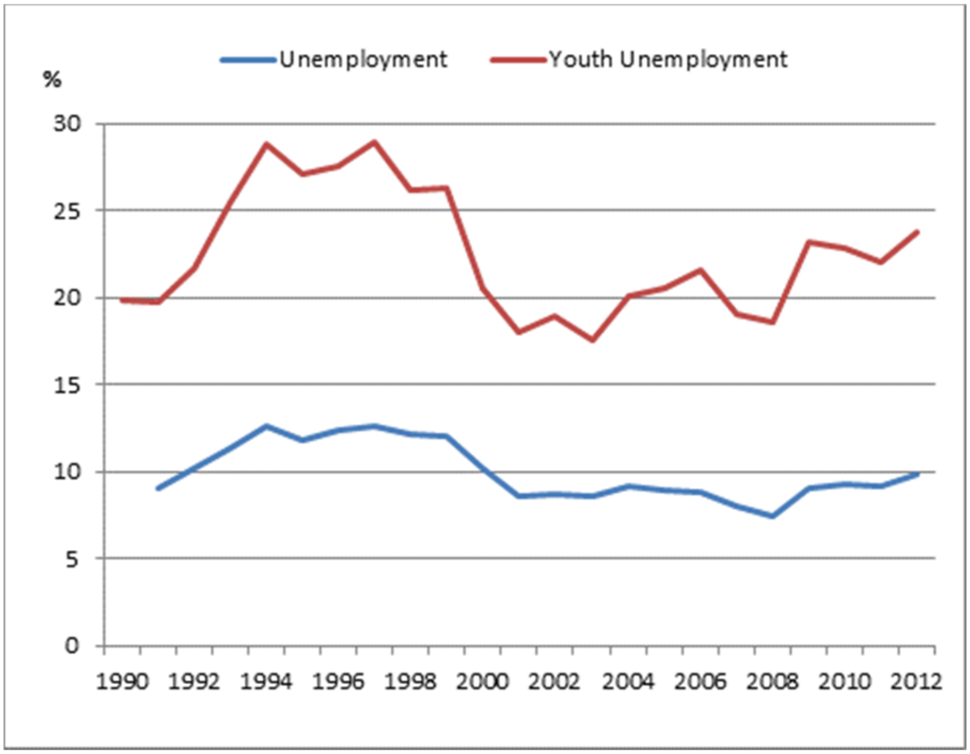
By contrast, the experience of Sweden shows how a pragmatic and firm response to an economic crisis can be important in staging a robust recovery. The country's economic performance was favorable until about the 1980s, but in the early 1990s the country sank into a serious macroeconomic and financial crisis. In contrast to France, Sweden introduced a series of macroeconomic, financial, labor market, and social insurance reforms, resulting to an economic recovery by 2000. While the country's budget deficit swelled to around 10% of GDP in the early to mid-1990s, this fell to just around 2% ten years later (Figure 4). Gross government debt fell from over 70% of GDP in the latter half of the 1990s to just around 40% by 2007, and has steadily fallen since then. The country's Human Development Index (HDI) ranking, which had been as high as 2nd in 1987 before falling to 10th in 1995, was 7th in 2012. Further, its 2010 Global Competitiveness Ranking rose to 2nd in 2010, and was 6th in 2013, as compared to its 13th place ranking in 2000. The lesson for developing Asia is, as Sweden demonstrates, that a social democracy that introduces pragmatic, substantive macroeconomic, labor market, and social insurance and welfare program reforms to satisfy necessary preconditions can still achieve highly favorable macroeconomic indicators, including financial stability and enviable HDI and Global Competitiveness rankings.

Figure 4. Selected Macroeconomic Indicators of France and Sweden



Sources: International Monetary Fund, World Economic Outlook, April 2014; World Bank, World Development Indicators online database (accessed 31 July 2014).

Figure 5. Unemployment Rates in France



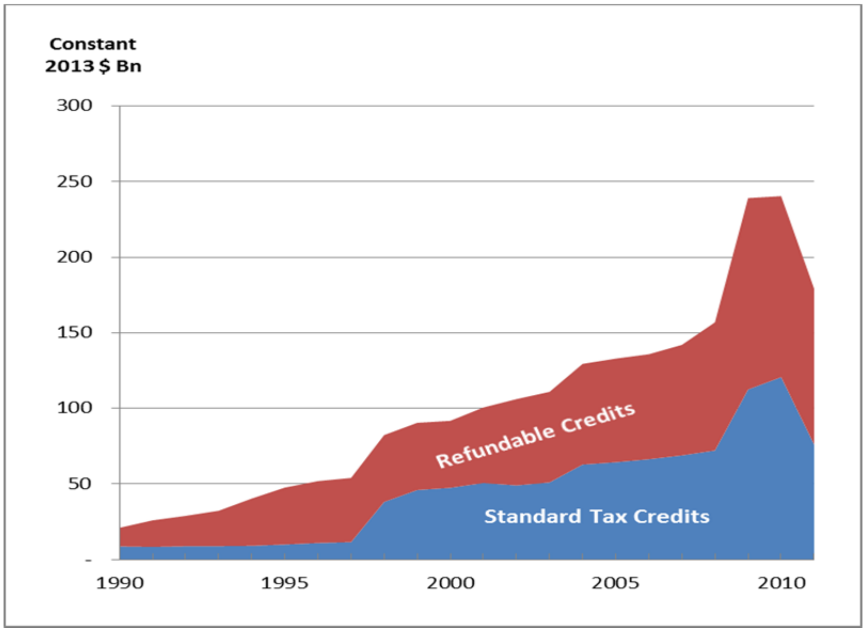
Source: International Labour Organization, Key Indicators of the Labour Market, 8th edition.

4 Separating Welfare Spending from Taxation: The US Experience

Integrating welfare support into the tax systems is a practice seen among some advanced countries. Income support is provided through tax credits, deductions, and other similar types. As seen in the experience of the US, the scheme, if not carefully implemented, can be more complicated and less transparent than direct welfare spending and can entail huge fiscal costs.

A significant part of the welfare spending in the US is through the tax code. For instance, the US does not tax employer-provided healthcare, resulting in over $250 billion in lost tax revenue (Horpedahl and Searles 2013). The US also provides about $60 billion in aid to working families in the form of the earned income tax credit and another $60 billion for low- and middle-income families with children (Carasso and Steuerle 2011). The child credit and earned income tax credit are the two largest so-called refundable tax credits, which means they are payable even beyond any tax liability (Cole 2014). Figure 6 shows the dramatic growth of refundable tax credits since 1990. Welfare spending in the tax code is also part of Obamacare, since the law's healthcare exchange subsidies are implemented as refundable tax credits, so the upward trend is expected to continue.

Figure 6. Tax Credits in the United States



Source: Cole 2014.

Welfare programs run through the tax code are in many ways more complicated and less transparent than those run through traditional spending agencies, resulting in high rates of fraud and error. For example, the Treasury Inspector General found that about 25% or over $10 billion per year, of earned income tax credit payments were made in error in 2003-2012 (Government of the United States, Treasury Inspector General for Tax Administration 2013). Welfare in the tax code also leads to excessive spending since tax provisions do not experience the same level of scrutiny and oversight as spending programs. Further, welfare spending in the tax code reaches the recipients just once a year, during tax filing season in Spring, making it less effective at providing income security.

The US experience shows that a welfare system implemented through the tax code can be complex, opaque, and poorly targeted. Further, it can be seriously held back by insufficient oversight. A main lesson for developing countries in Asia and elsewhere is to keep welfare spending out of the tax code.

5 Addressing the Challenge of Population Aging: The Case of Japan

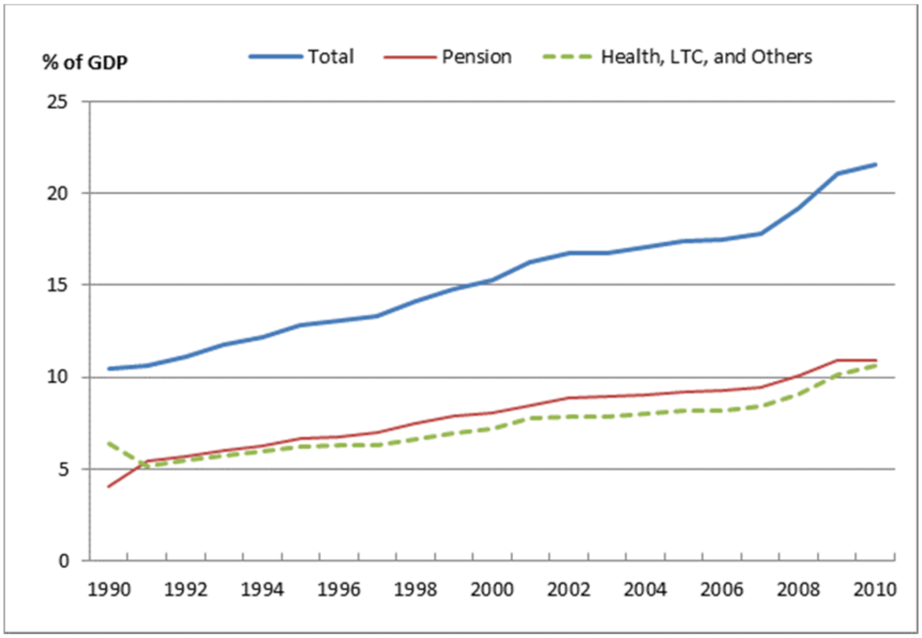
Demographic shifts due to rising life expectancy rates and falling fertility rates are a huge source of fiscal pressure among advanced economies. In general, advanced economies face the daunting challenge of a rapidly growing elderly population. The issue is particularly acute in Japan: the country's share of the elderly population or those aged 65 and above are expected to rise from about 25% in 2013 to 30% by 2030, and up to 40% by 2050 (United Nations 2013). Thus, providing income security for the elderly and the fiscal burden this entails have been increasingly serious concerns.

Japan was the first among the large East Asian economies to build a welfare state during the initial stages of its rapid economic growth. The country currently has a comprehensive social welfare system that includes pension, health, social assistance, and disability benefits. Pension schemes were initially established under the principle of reserve financing. As the social security system evolved, it came to a point that the reserves became insufficient to cover current payouts, thus requiring the government to shift to pay-as-you-go schemes, i.e., the current pension payments are financed from contributions of current workers (Ogawa et al. 2012). The scheme may work when an economy exhibits high growth; otherwise, the fiscal burden is passed on to the next generations. Further, the current weak link between benefit and payment makes social security contributions act like a de facto tax, that in turn raises labor cost and undermines employment. The country's current social welfare system is based on the presumption of high economic growth and a favorable demographic profile. Since low economic growth has persisted and the society is aging, there have been concerns on intergenerational equity and fiscal sustainability.

In 2010, Japan's health and long-term care spending has already reached about 10% of GDP and is expected to rise significantly in the coming years (Figure 7). The government views rising health and long-term care spending as an opportunity to promote sectors linked to health-care services. For instance, pharmacy and medical equipment have the potential to become leading industries. Medical tourism can also benefit from rising health-care needs. Home and institutional care for the elderly requires a large manpower, and thus can offer job opportunities. Robotics can also be developed to support long-term care. The government has identified the National Institute of Health as a center of medical technology research and development. Beyond supporting industries that cater to the health-care needs of the elderly, the government also needs to institute reforms to help ease various constraints in the health sector, such as stemming stringent regulations that protect vested interests and providing greater scope for market-oriented reforms.

In general, countries at the advanced stage of demographic transition including those in developing Asia may well benefit from implementing structural reforms. Now is the opportunity to raise the urgency of carrying-out needed reforms. These include developing the finance sector to promote saving and productive investment; enabling the education sector to foster life-long learning that provides more work opportunities for the elderly; and implementing labor market reforms to help raise productivity and alleviate labor shortages. Moreover, countries should strengthen their pension, health care, and overall social security systems for their large and rising elderly populations.

Figure 7. Social Spending in Japan



LTC = Long-term care.
Source: Sato 2014.

6 Policy Implications for Developing Asia

Widening income inequality in developing Asia strengthens the case for governments around the region to play a deeper role in fostering equity. The experience of advanced countries has shown that fiscal policy can help drive down inequality. For example, public spending for education and health care can help equalize economic opportunities. In developing Asia, public spending on education amounts to only about 2.9% of GDP, compared to 5.3% for advanced economies. The region trails even far behind public spending for health care, at 2.4% of GDP, compared to 8.1% for advanced economies. Clearly, there is a large scope for the region to increase spending in both education and health care. In addition to such spending that promotes both growth and equity, there is a case for expanding the social safety net of public transfers and subsidies, as long as the transfers and subsidies are selective and targeted to the most needy and vulnerable groups.

Boosting equity-promoting spending will be critical for the region, but so is guarding government finances so as not to undermine growth and stability. Developing Asia should learn from the experience of advanced countries that have suffered from the consequences of having unsustainable levels of government spending. Broader public spending will require strengthening fiscal mobilization efforts and exploring other sources of revenues. Sustainable inclusive fiscal policy requires sustainable public finances. The experience of the Nordic countries suggests that it is possible to have the best of both worlds – comprehensive social protection and economic dynamism. While those countries are much richer than developing Asia, their experience implies that more inclusive fiscal policy need not come at the expense of growth. For Asia, an especially significant and relevant component of the Nordic model is equal opportunity for all in education. Indeed a cornerstone of the model is universal access to high-quality education. Another distinctive feature of the Nordic model which holds valuable lessons for developing Asia is the role of innovative policies. A good example is provision of state-funded social welfare services by private companies. Such innovation contributes to better and more efficient delivery of basic public services, and delivers a bigger bang for each fiscal buck.

Rapid population aging poses significant medium term fiscal challenges for developing Asia. It also creates a serious risk of widespread old-age poverty since the region's pension systems are under-developed and family-based old-age support systems are weakening. The realization of the risk will adversely affect equity by widening the gap between the working-age population and the elderly. Therefore, significant reforms are needed to strengthen pension, healthcare, and social insurance systems. To support growth, it is also important that countries with young demographic profiles take advantage of demographic dividends while they last, by placing high investments on physical and human capital and by promoting social, economic, and political institutions that facilitate growth (ADB 2011). Sustaining rapid economic growth will be important in generating sufficient revenues.

References

Andersen, T., B. Holmström, S. Honkapohja, S. Korkman, H.T. Södeström, J. Vartiainen. 2007. The Nordic Model – Embracing globalization and sharing risks. ETLA B232, Taloustieto Oy.

Asian Development Bank. 2011. Asian *Development Outlook: Preparing for Demographic Transition*. Manila.

Bassanini, A. and A. Garnero. 2012. Dismissal Protection and Worker Flows in OECD Countries: Evidence from Cross-Country/Cross-Industry Data. Discussion Paper Series Institute for the Study of Labor, Bonn.

Carasso, A. and C. E. Steuerle. 2011. The Tax Policy Briefing Book: A Citizen's Guide for the 2008 Election and Beyond. Tax Policy Center, Urban Institute and Brookings Institution, Washington, D.C.

Cole, A. 2014. Changes in Refundable Tax Credits. Fiscal Fact No. 419, Tax Foundation, Washington, D.C. http://taxfoundation.org/article/changes-refundable-tax-credits (accessed 1 Aug. 2014).

Government of the United States, Treasury Inspector General for Tax Administration. 2013. The Internal Revenue Services is Not in Compliance with Executive Order 13520 to Reduce Improper Payments. Reference Number 2013-40-084, Washington D.C.

Heshmati, A., J. Kim, and D. Park. 2014. Fiscal Policy and Inclusive Growth in Advanced Countries: Their Experience and Implications for Asia. ADB Economics Working Paper Series No. 422. Manila: Asian Development Bank.

Horpedahl, J. and H. Searles. 2013. The Tax Exemption of Employer-Provided Health Insurane. Mercatus on Policy. Mercatus Center at George Mason University, Arlington, Virginia.

Maliranta, M., N. Määttänen and V. Vihriälä. 2012. Are the Nordic Countries Really Less Innovative than the US? VoxEU.Org, 19.12.2012.

Ogawa, N., S- H Lee, R. Matsukura, A- C Tung, and M. S. Lai. 2012. Population Aging, Economic growth, and Intergenerational Transfers in Japan: How Dire are the Prospects? In Park, D. S-H Lee, and A. Mason, eds. *Aging, Economic Growth, and Old-Age Security in Asia*. Cheltenham and Northampton: Asian Development and Edward Elgar.

Sato, M. 2014. Japanese Social Welfare and Growth. Unpublished mimeo.

United Nations, Department of Economic and Social Affairs, Population Division. 2013. World Population Prospects: The 2012 Revision, DVD Edition.