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Do Economists Affect Fiscal Policy?

A Review of The Relevance of Public Finance for
Policy-making. Hans van de Kar and Barbara Wolfe, Eds.,
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by

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Conferences are a vital part of the professional's life. They bring together leaders in his field of interest who can provide a quick capsule of the state of knowledge. In the area of public finance the premier occasion for economists to meet is the Annual Congress of the International Institute of Public Finance. The proceedings of the 1985 congress, which are the subject of this review, provide an overview of issues of tax reform, deregulation, the funding of social security programmes, measures of the efficiency of government service and the usefulness of economic policy advice.

A tremendous amount of economic analysis has been done on fiscal problems, especially since the end of World War II. The work has been both academic and policy oriented. Tax reform missions have been sent to a long list of less developed countries, including India, Sri Lanka, Venezuela, Colombia, Bolivia, Indonesia, Jamaica, Chile, Egypt, Argentina, Panama, Peru and Liberia. Commissions of enquiry have produced reports for Canada, Australia, New Zealand, the UK and the United States.

It proves impossible to derive any generalizations from this work. There are too many issues and too great a variety of circumstance. Research has served to throw out the easy answers: it emerges that there are no transparent verities about public finance. There is a daunting amount of fundamental work still to be done. We have no effective methodology for simulating the full fiscal impact of combinations of taxes and spending. The gap between theory and policy recommendations is impossibly wide. Once economists have relaxed enough of their theoretical assumptions to get us into the real world, no useful conclusions remain valid. The work we have done so far should leave economists chastened. There is little that can be said with authority and it is very very difficult to get a hearing among policy makers even for that.

Nonetheless, economists have a vital role in improved fiscal management - management that may better serve to enhance material well-being. They are charged to set down for the public the total fiscal picture, explaining that there are no free lunches, that if there are gainers there will be losers and that rising aspirations can only be met if we secure more production for each unit of resource we use. Expenditure cannot be raised indiscriminately nor taxes lowered without limit even though government may increase its overdraft with central bank. Profligacy will eventually result in inflation or devaluation of the exchange rate.

More people may be employed and they may take home larger amounts of local currency, but the fiscal deficit will have driven up prices to such an extent that the increased pay will be of little value to them. Economists must also help to put together a fiscal programme that is internally consistent and that accords with government's goals. They must demonstrate clearly when programmes are over-ambitious and/or inconsistent and they should present alternatives which are reasonable. Economists should also provide measures, however crude, to assist in making the hard choices in the mix of taxation and spending.

The volume under review opens with a summary of the main issues by the editors. Among the objectives they suggest for fiscal analysis are to ensure that existing government policies (and the options that are available to government) provide services efficiently and that they are fair. Fairness has two aspects. People with the same endowment of resources, however that maybe defined, should bear equal burdens and there should be some agreed way of lessening the burden on the relatively disadvantaged. Economic analysis should observe the practical limitations on the implementation of policy and options which clearly cannot survive the political process should not not be taken on board. The analysis should help to anticipate what may happen in the future and should caution government against inconsistencies. Van De Kar and Wolfe reflect, rather ruefully, that

the conditions for the effectiveness of policy advice are beyond the control of advisers - for example, a commitment by policy makers that lasts over a sufficiently long horizon.

Kay reports on the conclusions of commissions of enquiry in several industrialised countries. He finds similarities in that they all recommend more vigorous taxation of fringe benefits and fewer bands of the income tax. They all agree that the household should be regarded as the unit for taxation though they disagree on the choice of base for the income tax. Kay believes that the commissions influenced the climate of opinion and cleared the way for the eventual implementation of some policies; however, they had limited immediate effect.

Aaron discusses social security programmes which are running out of money. The current systems are not designed (like private pension systems) for contributions to provide sufficient funding for pensions. The deficit has to be made up out of taxation. The proportion of retirees to the total working population is increasing as people live longer and the birth rate declines. Current workers have to be taxed more and more heavily to pay adequate pensions to retirees.

Aaron favours adding provision for voluntary contributions to the current schemes. Workers could arrange to top up their pensions by making voluntary contributions. It would

then not be necessary to index all pensions to the rate of inflation. Anyone who wanted to insure himself against the erosion in the real value of his pension would have the opportunity to do so through the voluntary scheme. In time, the burden on the tax payer would fall as the real value of unfunded pensions declines.

McClure discusses the preparation which went into the recent US tax reform proposals. The first set of proposals had to be prepared in great secrecy so that interest groups would not interfere to prevent the publication of a consistent set of proposals. The final package was, inevitably, the result of compromises reflecting the economic power of interest groups. It also reflected the conviction and political acumen of the President and the persuasiveness and skills of the many other protagonists.

Musgrave deals with difficulties in trying to establish an equitable basis of public finance. It is virtually impossible to make equals equally liable to taxation, partly because of the difficulty of defining the tax base. For example someone who own his own home is better off than his colleague with the same income who is not a homeowner. To treat them equally, we should have to tax the homeowner at a higher rate, something which no tax administration has dared to do. There are many problems of a similar nature. Furthermore, differences in individual preferences would

make it impossible to know that one were imposing an equal burden on everyone even if one were able to tax equal incomes equally.

It is even more difficult to decide how much one should increase the burden on the relatively well-to-do to support the indigent and poor. One ought also to take account of the benefits that the taxpayer receives from the provision of public services in assessing whether he is made better off or worse off by a higher or lower tax rate. There are really no good economic answers to any of these questions.

Burtless and Haveman discuss how tax affects the supply of labour. Their conclusion is that "benefits attributable to government taxes and transfers - reduced uncertainty, reduced poverty and inequality, increases in human capital investment, increases in economic stability and the facilitation of economic change - exceed the probable losses, at least in the United States" (pg. 142).

Goode discusses obstacles to tax reform in developing countries. He argues that tax elasticities have to be relatively high to keep up with spending. If the tax does not keep up with spending governments will borrow and create money. Goode is skeptical of "revenue neutral tax reform". It offers nothing with which to bribe the losers into accepting the reform. Instead tax reform should capture a larger share of increases in income which can then allow for

a reduction in all tax rates. There will be no absolute losers though some may gain more than they would have without reform and others less.

Tanzi reviews major tax policy missions in developing countries. The list is long and teams have been organised by the Harvard International Tax Programme, the OAS-IDB Joint Tax Programme, the US Internal Revenue Service, the USAID and the United Nations.

Tanzi critiques the missions for a cavalier willingness to experiment. For example untried expenditure tax introduced in India and Sri Lanka eventually had to be abandoned. They also exhibited cultural bias, spending a disproportionate amount of time on the income tax (which yielded relatively little in LDCs) and little time on import duties which were the main source of revenue. The missions also tended to reflect current fads such as the present infatuation with VAT. Missions tended to insist on global changes that would affect the entire tax system thereby prejudicing the chances of any reform whatsoever. They paid insufficient attention to the administration of taxation.

Peacock offers some "gratuitous advice" to fiscal advisers. He cautions that real decision-making bears no resemblance to the behaviour of "economic man". "Economic man" has known objectives with trade-offs between them that can be

quantified. He maximises the objectives subject to constraints and he wishes to minimize the cost of implementation. None of these applies in real life. Administrators are likely to view economic experts with some skepticism. Most tax reform ideas have come to their attention before. Economists cannot escape the reality of conflicts of interests within government service and outside. Even if the policy advice is accepted, the champion of the policy may fail in his attempt to push through reforms.

Tarschys, reviewing OECD experience, argues that tensions inherent in the budgetary process are manageable so long as the economy is growing and expectations do not exceed fiscal capacity. When there is a slowdown and expectations are too high budget targets are exceeded. OECD Governments have tried to cope by "investing in building consensus, improving analysis and reinforcing the authority of the budget office". Results have so far been very "iffy".

Consensus building activities include public education to present the "treasury view" to a wider audience, special meetings to get Cabinet agreement on expenditure guidelines, forming alliances to contain free-spending ministries, explaining the reasons for austerity to civil servants who will have to implement the measures and involving opposition and interest groups in the debate. The budget ministries have often allowed the spending ministries more freedom in

their use of money allocated in return for a lower allocation.

Economic analysis has been improved by providing legislatures with an analytical capability as in the case of the US Congressional Budget Office. Some countries have required that all new programmes be presented along with long-term costings rigorously prepared. Public audit committees have been revived and charged with auditing for value for money. Task forces, consultancies and independent institutes have been established to analyse tax policy. Budget offices have themselves developed greater capability for analysis. The budget office has been given authority to demand more rigorous analysis from spending ministries and to insist on a disciplined budget cycle.

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