COMMENTS ON SESSION II:
TAXATION AND FISCAL POLICY

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In face of a more prolonged than expected cyclical downturn in nearly the whole of the world, we see very diverging approaches in tax policies at present. On the one hand, some countries, *i.e.* the US, F, D, I, in addition to buoyant growth of public consumption spending, have implemented pro-active counter-cyclical measures, with the primary goal to back up short-term growth by boosting consumption/investment through higher real disposable income and enhanced economic confidence (albeit the fiscal multiplier is lower than in the case of expenditure). On the other hand, some governments have put their focus on changes in the structure of taxes with the aim to strengthen the longer-term growth potential of the economy or on pure automatic fiscal stabilisation.

While discretionary, short-term oriented tax policies have been applied widely across industrialised countries in this recent period of weak economic growth, the papers of session 2 do not draw much attention to this evidence. In fact, with regard to this discretionary uncompensated tax relief, we have observed fairly mixed experience in recent years, very often even very poor positive impacts on growth and employment. Nagaosa, for instance, demonstrates plainly that the discretionary tax measures in the order of 1.3 per cent of GDP to stimulate the economy, implemented in Japan since 1999 in a period of prolonged extremely subdued growth and deflation, have brought about very disappointing effects. In this respect, both the Australian and Japanese policy papers state unambiguously that in the future active measures will play an only negligible role in policy shaping in their countries.

Moreover, strikingly, while the theoretical papers concentrate on issues concerning automatic short-term stabilisation in this session 2, the more policy-oriented papers, in particular, emphasise structural, longer-term aspects of tax reforms and their short-term positive impacts on economic confidence.

1. Short-term stabilisation via automatic tax stabilisers

Automatic stabilisers in the tax system contribute significantly to short-term stabilisation, generally much more than the expenditure side. Buti and van den Noord stress in their paper in particular the government size in form of the overall tax burden. They claim that reforms in tax and benefit systems will not only increase economic efficiency, but, depending on the nature of shocks, especially when referring to the supply side, would also improve stabilisation properties when the tax

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burden would be lowered below critical levels (estimated values between 40 and 42 per cent of GDP in case of EU Member States).

However, the cyclical elasticity of automatic tax stabilisers is also determined via various other channels. The progressivity of the tax system, impact lags and the cyclical sensitivity of the tax base may influence the total tax elasticity as well. Austria, as an example, with a fairly high overall tax burden of around 44.5 per cent of GDP by international comparison, proved to have quite a low cyclical elasticity of taxes of less than 0.3. With relatively small output fluctuations, this results in an approximately average impact of automatic stabilisers on growth and employment.

Furthermore, Marino, Monacelli and Siviero show in their paper as one of the core results that the tax elasticity in personal income tax has, on average, become markedly more volatile in recent years. And due to higher marginal propensity to consume, tax elasticities for low incomes turn out to be higher than for high incomes. Therefore, as tax reforms impact both the progressivity and the size of automatic stabilisation and as cyclical swings show a varying composition of aggregate demand, tax elasticities in relation to GDP will be not stable. Thus, as the tax system is typically amended by every (annual) budget act, the economic impact of automatic stabilisation is fairly difficult to be accounted for by policy-making.

2. Medium and long-term (efficiency) considerations of tax reforms

The European Union set itself via the Lisbon agenda fairly ambitious medium and long-term goals to raise the growth potential. Tax policies, embedded into an overall framework of public finances, may contribute to increase growth and employment. More or less in the same vein as the Lisbon strategy of the European Union, the policy papers by Smith and Nagaosa also emphasise the longer-term growth strategy of tax policies in their countries.

Smith, in presenting the main objectives of the Australian tax policies, especially emphasises longer-term effects of tax reforms. Budgetary discipline and long-term financial sustainability should safeguard an appropriate national savings-investment balance which makes the economy more resilient to shocks in the medium-term and contributes to smooth growth and employment developments. In the long run, in particular in view of ageing populations, the tax system should be reoriented towards providing the right incentives to raise labour participation and productivity.

The paper by Nagaosa presents the shift in the policy focus of the Japanese government towards structural reform in consequence of the poor economic performance of active, counter-cyclical tax measures. Thereby, tax reform represents one of the four pillars of structural reform in restoring confidence into the Japanese economy and growth in the medium term. The tax system will be overhauled with the primary policy objectives of better intergenerational fairness, higher efficiency, less volatility in the system and markedly improved competitiveness.

While the latest EU and OECD reports on forecasting age-related public expenditure showed very clearly that demographic changes will exert significant pressures on public expenditure in almost all industrialised countries, in particular on pensions and health care, the impact of ageing on the overall tax burden does not appear to be that clear from the economic literature. Here, the Australian paper assumes a constant tax share in GDP within the context that the bulk of pension provision is based on privately funded pension schemes. In contrast, for instance, the Danish and Dutch governments argue in their stability and convergence programmes that in the long run they will receive higher tax revenues from their funded second and third pension provision pillars. This will be in the order of 2-4 percentage points of GDP, in particular from higher VAT and income tax revenues, in line with the rising volume of taxable pension income. The economic model used here is based on pension benefits, which are taxed when they are paid, while the contributions are exempt from income taxation. This implies significant tax subsidies in favour of such schemes and, thus, for retirement savings. The tax subsidies occur because firstly, tax payments are deferred into the future, secondly, in a progressive tax system a lower tax rate will, in general, be levied on pension benefits compared to the income from which the contribution was subtracted, and thirdly, when returns on capital invested are not taxed, investment in these funds are treated more favourable than other forms of investment.

However, following another stream of economic arguments, when ageing will raise age-related expenditure and, consequently, contribution rates in particular in PAYG schemes, gross wages (defined here as and wages gross of taxes, but net of social contributions) as a share of GDP may decline. Thus, tax revenues from wages as a proportion of GDP may even fall, given unchanged tax rates. As a result, the ultimate sign of future tax revenue developments depends on whether higher tax revenues from mounting and taxed pension benefits will offset the tax losses due to the decline of the wage sum. If wage sum reductions equal pension expenditure rises, total tax revenues will decline definitely, as on average a lower tax rate is imposed on pension benefits than on wages.

In addition, Japan faces a clear trade-off between reversing the deficit-debt spiral and revenue-neutral structural tax reform. Firstly, from a policy perspective, curbing high and unsustainable deficits of about 7 per cent of GDP only through expenditure cuts, appear to be fairly ambitious without any tax increases. Interest group pressures and social costs (*i.e.* in form of strikes) may get too high when the burden will not be borne by the general public. Secondly, also revenue-neutral oriented tax reforms may face lags in being fully financed, which will then contribute to a further widening of the deficit in the short-term. Expenditure reforms in certain fields, such as pensions and public administration, typically take time to fully work their effects through. And thirdly, the economic impact of a greying population is already more advanced than in most other industrialised countries. In this respect, tax revenues may already be affected negatively today.

Austrian tax reform 2004-05

Very much in line with the Australian and Japanese goals, the Austrian government set as its primary policy objective for the tax reform 2004-05 to enhance the growth and employment potential. In this reform, the Austrian government obviously stresses efficiency gains, gives some considerations on income distribution and draws only limited attention to short-term stabilisation. This tax reform will be implemented in two separate steps in the years 2004 and 2005, especially by lowering business and labour taxes and strengthening ecological taxation. This reform is presumed to reduce the net tax burden by 1.3 per cent of GDP in 2004/2005. Hence, this will amount to the largest reform since 1945. Despite this large volume, the public deficit will rise only to 1.5 per cent of GDP in 2005, before approaching again the common EU objective of "close to balance or in surplus". This reform will continue the line taken in two "stimulus" packages of the year 2002, which intended to strengthen the supply-side in particular by improving tax incentives on R&D investment and education in particular.

For the large tax reforms of the years 1989 and 1994 (which had, indeed, somewhat smaller supply side effects) model calculations showed an increase in GDP in the course of four years of approximately the size of the tax relief. This implied that the tax reforms were partly self-financed (by about one fifth). The growth effects, as focused on the supply-side, are estimated to be higher for this reform than for the previous ones. It is thus essential that government expenditures decline substantially in order to ensure financial sustainability. Additionally, labour supply will markedly increase due to a reform of the pension system. Since overall supply and demand are increased simultaneously, the rate of growth is expected to rise at least temporarily, especially by employment growth.

3. Timing of tax reforms

The main conclusion of the paper on tax policy analysis by Hort and Ohlsson is that, despite EU tax coordination and international economic integration, the lack of convergence in the tax systems will still hint at the existence of some national room for manoeuvre for EU Member States. Moreover, the paper points out rightly that major constraints represent tax competition, tax avoidance/evasion, interest groups and collection costs.

In addition to Hort and Ohlsson, in designing tax reforms, policy-makers may face the principal challenge: when is the right time to enact the reform, and when does a respective budgetary room for manoeuvre exist? They are confronted (at least) with four policy constraints:

a) Should they enact reforms in good or bad cyclical times: one may find the Irish case that tax relief has been perceived as expansionary (and led to an Art. 99(4) recommendation by the ECOFIN Council in 2001), contributing to inflationary tensions in an already overheating economic environment. Or one may create budgetary imbalances as it was demonstrated by initiating the Excessive Deficit

Procedure according to Art. 104 in the case of Germany and France in the years 2002 and 2003.

b) Should you implement the tax reform in one immediate or more gradual steps? As to the former, you are in danger to create a vicious circle of stop-and-go policies, with initiating high deficits, followed by consolidation. In the latter, one may face difficulties to adhere to the proposed time-schedule, which then may drag severely on economic confidence.

c) The timing is also closely linked with the issue of financing the tax reform. There may be some lags in structural expenditure restraint (*i.e.* pensions, administration), which in the short-term may lead then only to cuts in capital formation expenditure or shifts in taxation. This, however, will generate new economic distortions or will significantly hamper the growth potential.

d) In line with the Hort and Ohlsson paper, lags in decision, implementation and in effectiveness may negatively influence the outcome of the tax reform, *i.e.* through pro-cyclical effects, due to inappropriate timing. The Australian paper states that this tax reform should, in particular, improve timeliness.