COMMENTS ON SESSION 4
POLICIES TO PROMOTE SUSTAINABLE GROWTH

DOES FISCAL POLICY MATTER?

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In the context of the current EMU debate on austerity and stimulus, the papers by Bouthevillain and Dufrénot and Gavilán *et al.* address important questions. As fiscal policy is the only policy area which instruments affect growth very differently the question on how heterogeneous growth patterns in the euro area can be shaped by fiscal policy measures compared to structural reforms is topical.[1] Coming from a finance ministry, our perspective is necessarily more practical than academic. Hence, we focus on the question: Does fiscal policy matter? That includes a discussion of the possible use of the results of these papers for the discussion on shaping the institutional context of the EU and the euro area.

1 Common motivation: need for disaggregation

When addressing the "fiscal policy and growth" issue,[2] historical experience with fiscal policy measures shows that a "one-size-fits-all" approach does not work well, particularly in a common currency area. Although aggregate models undisputedly have their merits, concerning these policy issues it is wise to disaggregate and to be more country-specific in order to derive practical policy conclusions. Therefore, both papers follow a quite sensible approach of explicitly taking heterogeneity into account: Bouthevillain and Dufrénot do so by disaggregating public expenditures and revenues and by selecting different growth periods, Gavilán *et al.* by following a country-specific long-term approach including open economy and external imbalances variables. The first paper concentrates on fiscal policy and growth while the second one focuses on structural policies with a specific view on macroeconomic imbalances and growth.

2 Models and main findings

Bouthevillain and Dufrénot raise the following question: does a common fiscal policy (taxation and expenditure measures) become growth enhancing or reducing in a similar way across countries? They run a double quantile fixed effects regression on the effects of fiscal variables on growth. Using the period between 2000 and 2010, they look at real and per capita GDP as that allows differentiating between fiscal policies' effects that are different by country and time. For the analysis of growth effects of social expenditure vs. "economic" spending, taxation vs. social security contributions and direct vs. indirect taxation, they make use of COFOG data. Concerning practical economic policy, their basic assumption is that the "recipes" for generating growth by

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The views expressed here represent their personal opinion, and not necessarily the view of the Ministry.

[1] One could refer to the recent research on growth in the EMU by the EU COM.

[2] Refer to the work by the EU COM (Pench *et al.*), the EU Economic Policy Committee with its Working Group on the Quality of Public Finances, the OECD (Heady on tax issues) and also by the ECB (Afonso and his team on efficiency and effectiveness of public spending). We are delighted that new literature on this topic is being provided at this conference in Perugia (e.g., by WIFO Austria, Afonso).

fiscal policies are very different in high and low growth countries. In their specific model they come to mixed and partly counterintuitive results:

1) welfare expenditure can foster growth in general while human capital expenditure can foster growth only in low-growth countries and can be even harmful for growth in high-growth countries;
2) the effect of a social VAT (replacing social security contributions) on growth is mixed, in low-growth countries positive, in high-growth countries neutral;
3) replacing direct by indirect taxation has a significant impact in high growth countries, not so in low-growth countries.

Gavilán *et al.* use an overlapping generations model of a small open economy characterized by imperfect competition. They focus on three periods, one between the mid-late nineties until the beginning of the crisis in Europe in 2008, the crisis years and a simulated post-crisis period. The basic question they try to answer is: How did external imbalances (in Spain and the euro area) evolve? As the main drivers of the performance of growth and external imbalances they identify demography and immigration causing changes in the work age population and the interest rate channel (permanent nominal convergence). The counterfactual question is what potential role fiscal policy could play to avoid imbalances and to foster growth. They conclude that a continuous tight fiscal policy does not reduce imbalances because of the forward looking behavior of households. Even structural reforms via reducing markups are not considered to help reducing imbalances. However, beyond the crisis the scenario changes as negative wealth shocks on consumption materialize, external imbalances decrease while public deficits increase. During the scenario, GDP falls first and recovers gradually. In that scenario structural reforms and frontloading of fiscal consolidation help mitigating the short-term drop of output and avoiding the medium-term output loss.

3 Possible extensions

Concerning Gavilán *et al.*, while the overlapping generations model nicely captures the effect of demography on external imbalances in principle it is indeed a surprising result that fiscal policy would have no correcting impact on imbalances in the "normal times" period before the (post) crisis scenario. Maybe more differentiation is needed and the impact on imbalances needs to be considered in more detail. In fact, we are confronted with the issue of reversed causality between demography and imbalances. There is an economic intuition that the built-up of the house price bubble triggered immigration, particularly of low-skilled labor. Extending the causal chain, one could expand the model by incorporating the other side of the coin, which is capital flows. And one could check where capital inflows came from. One hypothesis could be that capital flows have been starting after the German reunification (big open economy). Capital released due to the German consolidation process in the Nineties and the beginning of the 2000s complemented or may even have triggered the imbalances in south European countries. Recent OECD analyses support that hypothesis since they show a strong correlation between taxes on housing and the house price bubble in Spain possibly affecting the external current account balance. Therefore, somehow fiscal policy influenced imbalances also before the crisis and the question is if such an effect can be integrated in the model. The sound rational behavior assumption of private borrowing replacing public borrowing might be challenged by introducing myopic behavior of households as an alternative assumption. Bouthevillain and Dufrénot differentiate between high growth countries showing Keynesian behavior and low growth countries showing Ricardian behavior. This could be introduced in the model by Gavilán *et al.*, too.

Concerning the paper by Bouthevillain and Dufrénot, the model could differentiate further regarding the conflict between output and efficiency, basically asking: Do public expenditures, e.g. education, health, and R&D, improve efficiency? The authors indeed point to possible inefficiencies in high growth countries. Therefore, the question is if the analysed countries lie on the 'efficiency frontier' and if there is a systematic link between effectiveness of public spending and its impact on growth. That in principle is an invitation to combine the work by Gavilán *et al.* and also Afonso with country samples regarding their growth level. Nevertheless, it is very difficult to separate productive and unproductive expenditures (see Brender's intervention in this session).

Concerning the data used, we would encourage the authors to disaggregate the dataset further. The current dataset only differentiates between 10 categories displaying functions of government expenditures, whereas the Eurostat dataset knows around 70 subcategories which can be assigned to productive or unproductive spending (COFOG 2 digit structure). This data structure makes it possible to better assess those subcategories that gather growth enhancing policies and this could render the model's results more specific. With respect to the structure of public expenditures one could refer to a German case study by FiFo Köln which tries to assess the effects on growth of different types of expenditures in Germany using the disaggregated COFOG l/2 digit level. Additionally, one should differentiate between several growth indicators and what they should measure: either short-term growth (GDP or GDP per capita) or long-term sustainable growth. The latter one is difficult to assess. A well-known indicator to describe medium-term growth is the potential GDP. Nonetheless, there are more ways to describe sustainable growth as for example environmental accounting or accounting considering ageing and demography. Using "growth potential" could help to take supply side effects into account. These seem to be neglected in the presented models since they are incorporated only tentatively. This may cause the model's result that fiscal policy does not affect imbalances, and, hence, this result might be misleading. Furthermore, one could control for fiscal institutions and measure the effect of changes in debt rules for example. This would be especially interesting with regard to the current developments in the euro area regarding the enhanced Stability and Growth Pact (SGP) and the Fiscal Compact.

4 Lessons for the EU governance

From the point of view of a ministry, it is especially interesting to ask for the "practical" relevance of these papers. Do they provide useful information to improve policies? The reformed SGP 3.0 that now focuses on fiscal sustainability has a very limited view on growth. On the other hand, the new macroeconomic surveillance process (Macroeconomic Imbalance Procedure, MIP) focuses on internal and external imbalances and hence looks at growth, although only indirectly. Also, the strategy 'Europe 2020' as a follow-up to the Lisbon Strategy, referred to in the paper by Bouthevillain and Dufrénot (Guideline 3 of the Integrated Guidelines), is diluted and has a very imprecise focus on 'sustainable' growth. All three processes are quite isolated although the EU Commission tried to gather them under an integrated framework, the European Semester.

What can we learn from the papers for strengthening the governance in the euro area? The approach by Bouthevillain and Dufrénot calls for a renewed agenda on the quality of public finances which should be integrated in 'Europe 2020' and the SGP. The approach of Gavilán *et al.* could help to analyse the links between the MIP and fiscal policy observation under the SGP. While currently no "one-size-fits-all" approach for EU member states' fiscal policies is possible or desired, one could think of alternative measures:

- the medium-term objectives (MTO) could be country-specific differentiating with respect to the country's business cycle, growth rate or effectiveness of public finances;

- the SGP thresholds could be made country-specific, modified with respect to the country's sustainability of public finances and MIP variables;
- "Europe 2020" should be redefined with regard to structural policies enhancing potential growth and be linked to the Euro Plus Pact.

In general, the institutional link between different fiscal policy measures and growth is weak and the impact of structural reforms on fiscal sustainability is widely neglected in the current framework. Therefore, both papers are highly relevant for the current debate on the EU and euro area governance architecture. We encourage the EU COM and the member states to have a close look at these different channels of fiscal policies and to make use of the general ideas of the two papers.