COMMENTS ON SESSION 2: DISCRETIONARY POLICY AND FISCAL IMPACT

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First of all I would like to thank the organisers of the workshop for the invitation and the opportunity to comment on three excellent papers from the session on Discretionary Policy and Fiscal Impact. The main theme of all three is essentially the impact of fiscal policy, but the detailed issues discussed and the approaches followed by their authors are quite different, and in my view in each case innovative.

The paper by Kąsek, Laursen and Skrok consists of an overview of theory and previous empirical work and three separate studies investigating different aspects of the impact of fiscal policy in the eight new EU Member States from Central and Eastern Europe (EU8). The first study, which is the most comprehensive and in my view the most significant of the three, deals with the impact of taxation and public expenditure on economic growth. The authors' specification is based on growth literature, and follows a framework of dividing taxation into distortionary and non-distortionary and public expenditure into productive and non-productive, as proposed . The other two studies focus on labour market distortions caused by the tax wedge and on the role of corporate income taxes in determining FDI flows, in the context of the "tax competition" debate related to Central and Eastern European countries.

The paper by Botman and Kumar presents the Global Fiscal Model, developed at the IMF. The GFM is a multi-country dynamic general equilibrium model with an extensive fiscal block, offering a unique, state-of-the-art tool for analysing fiscal policy in an international context.

The third paper, by Creel, Monperrus-Veroni and Saraceno, also proposes a very innovative framework in the form of an SVAR model with long-term public debt dynamics derived from the Fiscal Theory of the Price Level. This framework is employed to study the impact of public investment on long-term growth, using data for the UK, particularly in the context of the golden rule embodied in the Code for Fiscal Stability, introduced there in 1997.

Let me now briefly go over some of the main lessons to be drawn from economic theory and previous research as regards the impact of fiscal policy and relating to them the findings of the three papers.

I will start with a basic, stylised, government consumption shock. Empirical literature tells us, in line with Keynesian theories, that its effect on private consumption, at least in the short run, is likely to be positive, especially because of

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liquidity constrained and myopic consumers. The multiplier is likely to be less than unity, because of forward looking consumers anticipating the higher future tax burden and increasing their saving rate in response to the government consumption shock. A study by de Mello, Kongsrud and Price[1] of the OECD found that in the short-run, the private saving offset of public dissaving is likely to amount to ½, while in the longer run, it increases to ¾. However, this effect may depend on the initial state of public finances, notably the level of public debt. Based on a study of 19 OECD countries,[2] Perotti finds that in "normal" (low debt) times, the impact of an increase in government purchases of goods and services on private consumption is indeed positive. It turns negative in "difficult" (high debt) times, when consumers associate an increase in government consumption with an imminent tax increase.

Meanwhile, private investment is likely to decline in response to a government consumption shock, through the effect of "crowding out" of private savings in response to government dissaving. Moreover, the negative response of private investment may occur through another channel, namely the labour market. Alesina *et al.*[3] find that a government spending shock leads to an economy-wide increase in real wages, exerting a negative effect on profits and investment.

Most of these effects are very well reflected in the Global Fiscal Model, presented by Botman and Kumar. The model features myopic, liquidity constrained and forward looking consumers, allowing for the effects of public spending shocks on private consumption to mimic those reported in empirical studies. The paper clearly illustrates the difference between the impact of partly or fully reversed spending shocks, which is a close approximation of the actual behaviour of consumers, although an imperfect one, given that their reaction will not depend on the true nature of the shock, but their initial perception thereof. The model also features crowding out effects of government consumption, illustrating how they differ for large and small economies.

Another aspect of the impact of fiscal policy, also addressed in the papers presented, are tax distortions, particularly on labour income. The negative impact of the tax wedge on labour demand and supply is well established in theoretical and empirical literature and confirmed for Central and Eastern European countries in the Kąsek, Laursen and Skrok paper. The authors find that a 1 percentage point increase in the tax wedge is associated with a 0.5-0.8 percentage points decline in employment growth, which is a fairly strong effect compared to other studies. Considering that their study covers a distinct group of countries over a relatively short period of time, in which they had been undergoing their transformation to fully-fledged market economies, one could consider whether the estimation is not

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1 De Mello, L., P.M. Kongsrud and R.W.R. Price (2004), "Saving Behaviour and the Effectiveness of Fiscal Policy", OECD, Economics Department, Working Paper.

2 Perotti, R. (1999), "Fiscal Policy in Good Times and Bad", *The Quarterly Journal of Economic*s, Vol. 114, No. 4.

3 Alesina, A., S. Ardagna, R. Perotti, F. Schiantarelli (1999), "Fiscal Policy, Profits and Investment", NBER, Working Paper, No. 7207.

affected by some extraordinary factors. One factor, which comes to mind, is the excessive employment these countries had experienced before their economic transition. This was shed over the transition period, partly at the beginning of the 1990s, but partly also during the analysed period. This is demonstrated by a back-of-the-envelope calculation showing a striking difference between employment growth in the EU15 and EU8 over the 1996-2004 period, on which the estimation is based. Employment in EU15 grew by 10.5% over that period, whereas in the EU8, it declined by 1.3 per cent.[4]

When discussing the effects of the tax wedge on the labour market, the impact of the opposite side of public finances comes to mind – namely disincentive effects associated with some categories of public spending. Firstly, social safety nets may exacerbate the high marginal effective tax rates faced by low income households in their work-leisure trade-off. Secondly, generous access to early retirement and disability pensions may cause many workers, particularly those close to retirement age, to leave the labour market, while still able to work. These effects did play a role in EU8 countries, notably the latter one is an important factor contributing to Poland's record-low labour activity rate. Unfortunately they are not included in the tax wedge and employment regression of the Kąsek, Laursen and Skrok paper, though admittedly, obtaining relevant data for the eight countries in a form which would allow for their use in the estimation would be a impossible task. The same can be said of the Global Fiscal Model presented by Botman and Kumar – it features distortions caused by the tax wedge, but not those arising from progressivity of tax and benefit schemes, which would require very detailed, country specific information.

The Kąsek, Laursen and Skrok paper also addresses another channel through which tax policy affects the economy, namely the role of corporate taxes in attracting foreign direct investment and the possible ensuing tax competition between countries. There is no clear empirical evidence that corporate taxes play a major role in attracting foreign direct investment. Nevertheless, it appears that in a group of countries among which there are no great differences in terms of other key determinants of FDI inflows, such as political and legal stability, openness of the economy, labour costs, education of the workforce, transport infrastructure, etc., corporate tax rates may play a role. This could be the case for countries of Central and Eastern Europe, a hypothesis further supported by the downward movement in corporate tax rates observed there in recent years. The estimation of Kąsek, Laursen and Skrok confirms previous empirical findings, as the corporate tax rate is found to be a statistically significant determinant of FDI flows, but less important than other factors.

A vital issue in the context of the impact of fiscal policy, addressed in many empirical studies, but with no unanimity in findings, is that of the structure of public expenditure, its effectiveness and the impact of different components of spending on growth. Kąsek, Laursen and Skrok estimate the impact of fiscal policy on economic

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[4] Calculations made using data from the AMECO database. Unweighted average for EU8 countries.

growth in the framework of "productive" vs "unproductive" expenditure and "distortionary" vs "non-distortionary" taxation. Their findings for EU8 countries are similar to those of Kneller et al. for OECD countries – "productive" spending has a positive impact of growth. The division of various categories of public expenditure into productive and non-productive is clearly a controversial issue with implications for results. Kąsek, Laursen and Skrok include in the productive group general public services, educational, health and housing expenditure. Due to data limitations they could not include spending on transport infrastructure in this group, although normally this category would be a strong candidate for inclusion. In addition, the estimation spans a relatively short period of 10 years, which raises the issue of lags with which educational and health care expenditure could be expected to impact growth. The discussion of "productivity" of different public expenditure categories has important policy implications, which is one of the reasons for creation of the Working Group on the Quality of Public Finances under the Economic Policy Committee.

The one category of public expenditure, which studies show is most likely to have a positive impact on growth, is public investment. Theoretical literature – endogenous growth theory – as well as empirical studies, are relatively undivided on the existence of a general growth-enhancing impact. This does not of course apply to all situations, there appears to be a threshold beyond which returns are diminishing and the composition of public investment also matters. In order to promote productive spending, as well as to shift some of the burden of financing investment to those generations who will actually benefit from it, a golden rule deficit limit has been proposed by many authors and in some countries also actually introduced. The golden rule does have its drawbacks, as exclusion of capital spending from the deficit limit may among other things lead to an uncontrollable increase in public debt, as well as reduce the pressure on public investment projects to be effective *vis-à-vis* current expenditure, which is under closer scrutiny as it has to fit within the deficit limit. Creel, Monperrus-Veroni and Saraceno look at the effects of public investment in case of one of the best-known golden rule arrangements, namely in the United Kingdom. They confirm the positive impact of public investment on long-term growth, and show that it is additionally strengthened by the presence of the formal golden rule as featured in the Code for Fiscal Stability. This is a bold conclusion, considering that it has been less than 10 years since the introduction of the golden rule there. Another point worth mentioning is the transparency of the UK golden rule and framework for appraisal of public investment projects, which may be hard to replicate in other countries, so the (potential) success of the Code for Fiscal Stability is not necessarily an example which all countries can and should follow.

Let me now conclude with some specific questions and comments to each of the papers.

On the Kąsek, Laursen and Skrok paper I would like to raise two methodological concerns. The first, which I realise they can do little about, given data availability, is that their studies are based on samples dating from 1995 to 2004

or shorter, which are fairly short and in addition in case of EU8 countries include a large shock in the form of the Russian crisis, impacting on the results of their estimations. The second issue, which in my view can be dealt with, is that the fiscal variables in the estimation of the impact of taxes and spending on growth appear not to have been cyclically adjusted. This could distort results significantly and in particular seems to undermine the authors' finding that "a strong fiscal position appeared to be supportive of growth".

While the entire Botman and Kumar paper is very enlightening, I found the simulations and findings concerning pension reforms of particular interest. Firstly, as one of the benefits of a shift to a mandatory public funded pension system, the paper mentions the public and political awareness effect of making future pension liabilities explicit. I think this is a very valid point, which is often overlooked in the discussion of pension reforms of this nature, which have been introduced in Central and Eastern Europe in recent years. Secondly, I have a question on the assumed pension formula in the Personal Retirement Accounts they discuss, as pensions paid out appear to be the same under the PRA scheme as in the previously existing, unfunded system. This may be the case for the reform proposed in the U.S., but in case of most European reforms, the move to funding also entailed a change of the pension formula, which was the main driver of the improvement in overall fiscal sustainability. Thirdly, the authors refer to a voluntary opt-out of PRAs as a "permanent tax cut", but one could argue that a more appropriate description would be an "abolishment of a part of a public social security scheme" with the ensuing consequences, including potentially insufficient social security provision and the need for increased social assistance from the state.

Finally, I have a few comments on the Creel, Monperrus-Veroni and Saraceno paper. The authors base their conclusion of the effectiveness of the golden rule framework on the impact on results of exclusion of the 1997-2004 period from their estimation sample, which appears to be a bit of a fragile basis. In addition, the estimation does not take into account other structural and policy changes, which took place around 1997 or in preceding years, most notably the change of the monetary policy framework. The authors refer to the Pandora box effect in which if public investment increases, policymakers are more eager to satisfy the claims for higher current expenditures as well. It is worth noting, that this effect appears to be stronger with the Code for Fiscal Stability years *in the sample*, which undermines somewhat their positive assessment of introduction of the Code.