COMMENTS ON SESSION 2
FISCAL CONSOLIDATION

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First, I would like to thank Daniele Franco and the Banca d'Italia for organising this excellent workshop. As usual, the organisation is first class and the atmosphere stimulating. I would also like to thank the organisers for giving me the opportunity to comment two of the papers presented in this session. I will deal them one by one.

1 Discussion on "Assessing Overall Fiscal Effort in ECA, 1995-2004" by Emilia Skrok and Aristomene Varoudakis

In their paper, Skrok and Varoudakis assess the ability – or willingness – of governments to collect taxes. They use two performance indicators. The first indicator is the index of tax effort calculated as a ratio of actual taxes collected to estimated reference taxes that could be collected. The second indicator is the productivity of tax collection calculated as the ratio of effective tax rate to administrative tax rate, where the effective tax rate is the ratio of tax revenue to GDP. The results indicate that tax effort varies substantially among European and Central Asian countries (ECA) and several countries have potential to increase tax revenue by increasing tax effort.

The approach raises many important questions on the forces driving the developments in the tax to GDP ratio and the issues that should be taken into account when comparing these developments in different countries. Together with the indicators of tax effort and the productivity of tax collection, information on the driving forces could be used in analysing whether tax increases or expenditure cuts are the suitable measures for fiscal consolidation.

First, are taxes determined by the need to finance expenditure or is expenditure determined by the ability to collect taxes? It seems that global tax competition has restricted the capabilities to automatically rely on additional taxes as an obvious solution to finance the increase in expenditure. Second, what economic, political and institutional factors determine tax effort and what is the role of public welfare benefit systems in the comparison of tax effort? Here again, expenditure side matters. In the sense of net benefits paid, countries can run effectively the same welfare benefit system with completely different actual taxes as percentage of GDP. This naturally affects the estimate on the relevant "reference" taxes as percentage of GDP and distorts the comparison of tax effort in different countries.

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Revenue from inflation tax as percentage of GDP could be used as a further indicator in the comparison of tax effort. Inflation tax, seigniorage or central bank monetary income is the way for institutionally less developed countries to collect taxes. Reliance on inflation tax indicates that there are administrative problems in tax collection, e.g. because of poor tax administration, weak institutions, tax evasion or large shadow economy. It might be useful to assess the relevance of inflation tax in ECA countries. Central banks' balance sheets and decisions on the distribution of central banks' profits should give information on the amount and relevance of inflation tax.

A further suggestion would be to apply the idea of efficient frontier to the estimation of tax effort, as in the case of the estimation of production function. This might shed some light on the phenomenon of over-taxation which was observed in some ECA countries.

Finally, in the paper, effective tax rates are calculated as a ratio of tax revenue to GDP and not to the actual tax base. This is the inevitable choice on the basis of the availability of reliable data but, unfortunately, it complicates the country comparison. In addition to the differences in the capabilities of effectively levying taxes on tax bases, e.g. private consumption, the differences in the country specific productivity indices depend on the differences in the ratio of tax bases to GDP. Lower ratios of tax base to GDP results in lower productivity indices, irrespective of the actual effectiveness of tax collection.

2 Discussion on "Expansionary Fiscal Consolidation in Europe: New Evidence" by António Afonso

In his paper, Afonso searches for evidence on expansionary fiscal consolidation. He proposes an indicator to identify fiscal episodes – contractions or expansions – and uses a fixed effect panel data specification of private consumption for EU 15 over 1970-2005 to empirically test his hypotheses.

Technically, the debate on expansionary fiscal consolidation concentrates on the sign and the size of the impact of fiscal policy measures on economic activity in the long and especially short run. According to the non-Keynesian view, fiscal consolidation can lead to strongly improved long-term income expectations and, other things being equal, trigger an immediate increase in current private-sector spending rather than a reduction, in contrast with the traditional conclusions of Keynesian theory. The literature[1] suggests that the occurrence of non-Keynesian

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[1] For surveys see, e.g., Briotti, M.G. (2005), "Economic Reactions to Public Finance Consolidation: A Survey of the Literature", European Central Bank, Occasional Paper, No. 38, or Prammer, D. (2004), "Expansionary Fiscal Consolidations? An Appraisal of the Literature on Non-Keynesian Effects of Fiscal

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effects of fiscal policy may depend on such factors as the composition of the fiscal program, the size and persistence of the fiscal adjustment, the initial state of public finances (e.g. the debt to GDP ratio), the international macroeconomic environment and the conduct of domestic monetary and exchange rate policies.

Afonso finds that long-run elasticity of private consumption with respect to public consumption is negative, with respect to tax revenue positive and with respect to public consumption net of taxes negative and even more so under contraction episodes. The long-run elasticity of private consumption with respect to social transfers is also negative but only for post-Maastricht period. These results hint to non-Keynesian behaviour of consumers in the long run. In addition, high initial debt-to-GDP ratio seems to strengthen the non-Keynesian behaviour to some extent.

However, the results by Afonso do not support the non-Keynesian view that fiscal consolidation has expansionary effects on economic activity in the short run. The simulation results are clear on this while the results by Afonso on the short-run elasticities are too vague to make any conclusions in any direction. On the whole, the conclusions made by Afonso are fair to the evidence presented: country-specific analysis is essential to be able to separate the role of fiscal consolidation from that of the numerous non-fiscal factors affecting economic activity.

The role of non-fiscal factors – such as changes in external macroeconomic environment, exchange rate and monetary policy stance, structural reforms in labour, capital and goods market and in social benefit systems as well as EU accession – in shaping the outcome of fiscal consolidation is emphasised e.g. by Barry (1991),[2] Eichengreen (1998)[3] and Blanchard (2000).[4] Regarding the often cited fiscal episodes in Denmark in 1983-84 and in Ireland 1988-89, they argue that, contrary to e.g. Giavazzi and Pagano (1990),[5] Bertola and Drazen (1993)[6] and Alesina and Perotti (1997),[7] no expansionary fiscal contraction was actually experienced, when the impact of non-fiscal factors is taken into account. The positive macroeconomic developments were mainly driven by non-fiscal factors in these countries.

Policy and a Case Study for Austria", *OeNB Monetary Policy & the Economy*, Q3/04, Oesterreichische Nationalbank.

2 Barry, F. (1991), "The Irish Recovery 1987-90: An Economic Miracle?", *Irish Banking Review*, Winter.

3 Eichengreen, B. (1998), "Comment on Alesina, A., R. Perotti and J. Tavares: 'The Political Economy of Fiscal Adjustments'", Brookings Papers on Economic Activity, Vol. 1998, No. 1.

4 Blanchard, O. (2000), *Macroeconomics*, 2nd Edition, Prentice-Hall International.

5 Giavazzi, F. and M. Pagano (1990), "Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries", *NBER Macroeconomics Annual*, Vol. 5, MIT Press.

6 Bertola, G. and A. Drazen (1993), "Trigger Points and Budget Cuts: Explaining the Effects of Fiscal Austerity", *American Economic Review*, Vol. 83, No. 1.

7 Alesina, A. and R. Perotti (1997), "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects", International Monetary Fund, Staff Papers, Vol. 44, No. 2.

The exercise by Afonso is a valuable addition to the empirical literature on the impact of fiscal consolidation on economic activity. However, the key question for a policy maker still remains. Even if evidence is found in favour of expansionary fiscal consolidation episodes in the past, can the necessary conditions for the success be recognised and fiscal policy actions designed on that basis *ex ante*? Whether we consider short or long-run, recognising sufficient conditions for expansionary fiscal consolidation is difficult because of the major role of the non-fiscal factors and their complex interactions.