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The composition of fiscal adjustments: some principles

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Introduction

Large and differentiated fiscal adjustments are underway across EU countries. These require credible strategies restoring the sustainability of public finances while creating the basis for lasting growth. Fiscal policy recommendations under the EU framework aim at promoting a growth-friendly approach to consolidation design.

This brief aims at capturing in a summary fashion the main underlying principles for fiscal adjustments of high quality. It builds on the common wisdom from the existing literature[1]. The complexity of this debate is acknowledged. Fiscal measures involve macroeconomic and microeconomic dimensions. Country-specific features hamper universal conclusions. And there is a strong aspect of political choice in designing consolidation packages.

The main conclusions are as follows:

• Some focus on expenditure restraint is generally part of a well-designed consolidation strategy, especially where government sectors are comparatively large, implying a higher marginal cost of distortionary taxation. Spending based adjustments also appear less likely to be reversed at a later stage.

• However relying on both tax and spending measures is almost unavoidable when consolidation gaps are sizable, as in many countries today. Besides, tax consolidation measures generally can feed in more rapidly and usually have lower short-run multipliers. One should thus go beyond the broad categories of aggregate spending and taxation and pick-up growth-friendly consolidation measures in a comprehensive and fair approach relying on multiple instruments.

Summary

Large and differentiated fiscal adjustments underway in EU countries require credible strategies, including a growth-friendly approach to consolidation design. This brief captures in a summary fashion the main underlying principles for fiscal adjustments of high quality. While setting some general markers, it acknowledges the complexity of this debate, which blends macroeconomic and microeconomic considerations, country-specific features, and a dimension of political choice in consolidation strategies. The brief concludes that while some emphasis on expenditure restraint is generally part of well-designed consolidations, one should pick-up growth-friendly measures in a comprehensive approach on both the spending and revenues sides. Fiscal adjustment offers an opportunity to improve the quality of public spending as well as the structure of the tax system.

[1] Overviews of approaches to designing fiscal adjustments can be found in IMF (2010) and OECD (2012).

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Economic and Financial Affairs

• On the spending side, there is a theoretical case for preserving public investment and other expenditure with strong positive spillovers, although equal emphasis should be given to realistic and transparent cost-benefit analyses. Curbing the public wage bill is often important, preferably backed by performance reviews rather than blanket cuts. Welfare state reforms are generally essential. While the precise picture differs across countries, reforms in pension systems, health care or the tax and benefit system, typically provide budgetary savings while raising the economy's potential.

• On the revenue side, fiscal consolidation offers an opportunity to improve the structure of the tax system. Certain relatively inelastic tax bases, such as property, as well as so called Pigovian taxes, such as green or behavioural taxes, should be given preference. Broadening tax bases, in particular by cutting tax expenditures, quite often present a comparatively favourable trade-off with growth. Improving tax governance is paramount in some countries, although one should not expect too high short term yields. Finally, outright increases in tax rates can be considered as a last-resort option only, in particular when increasing the labour tax wedge or the cost of capital.

The brief examines in turn: the aggregate balance between spending-based and tax-based consolidation (section 2); the more specific guidance within expenditure and revenue items (section 3); some general considerations on sequencing, governance and credibility (section 4).

2. The aggregate balance between spending and taxation

Economists often advocate putting emphasis on expenditure restraint as part of a well-designed consolidation strategy. This reflects the broad view that both spending and taxation levels have reached relatively high levels in advanced economies. There is no optimal government size, but the common presumption is that both potential efficiency gains in spending and the opportunity cost of incremental taxation increase more than proportionately with the size of the public sector. Focusing on expenditure reduction would be especially advisable where levels of taxation and spending are already elevated.

This conclusion is however qualified by several economic and more pragmatic considerations. Parts of government spending can be highly efficient, including by increasing physical and human capital, or raising the productivity of the private sector. Redistribution is a key objective of governments, and this can conflict with spending-based adjustments, though not always. Importantly, consolidation needs are large in many countries today, making almost unavoidable the reliance on a mix of tax and spending measures[2]. Finally, 'fiscal rigidities' imply that curbing spending can often (though again, not always) be implemented only over time, whereas revenue increases can typically kick in speedily.

There are empirical indications that spending-based consolidations are more durable. Many factors affect the likelihood of success of fiscal adjustments, including the overall economic, monetary and financial environment. This complicates the empirical analysis of the determinants of successful consolidations. The evidence nevertheless suggests that adjustments putting emphasis on the expenditure side are more likely to be sustained, rather than reversed at a later stage[3].

Some authors insist that expenditure-based adjustments are also less contractionary (or possibly even expansionary)[4]. The available evidence appears fragile however. For example, the use of cyclically-adjusted data to identify fiscal adjustments is exposed to endogeneity biases bearing on both the success rate of consolidations and the measurement of its composition[5]. This could lead to overstating the positive growth effects of consolidations and biasing the identification of the determinants of success.

[2] Moreover, the frontier between spending and revenues can itself be moot: reducing 'tax expenditures' will be accounted as revenue-based consolidation, although tax expenditures have sometimes been created to circumvent obstacles to additional spending.

[3] This conclusion is found in particular in European Commission (2007). However, it is found to apply more weakly to recent episodes of consolidation (in the 1990s and early 2000s) than to earlier episodes (in the 1970s and 1980s).

[4] See in particular Alesina and Ardagna (2010, 2012), and previous papers of these authors.

[5] Guajardo *et alii* (2011) spots two issues: first, changes in cyclically-adjusted primary deficits include nonpolicy factors correlated with other developments affecting growth. Second, fiscal adjustments may reflect deliberate responses to the economic outlook, e.g. with a view to cool the economy, inducing a reverse causality problem.

Model-based analysis suggests differing short-run and long-run relative responses of the economy to tax hikes and spending cuts (Roeger and in't Veld, 2010):

- Macroeconomic models such as QUEST tend to confirm that expenditure-based adjustments are more growth-friendly in the long-term, with possible exceptions such as investment or innovation-related expenditures. Cuts in inefficient spending imply a lower sustainable tax burden and positive supply-side effects.

- By contrast in the short-run the prevailing view is for generally lower tax multipliers, with not insignificant variations across tax and spending categories however. Indeed, the short-run growth effects of increased revenues are partly absorbed by fluctuations in private savings.

This seems to lead to a growth-optimal strategy combining higher revenues in the short-run gradually complemented[6] by spending measures over time (Batini *et alii*, 2012). It is important, however, that the future spending restraint be credible and doesn't run into time-consistency problems (see section 3).

The composition of fiscal adjustments has an important bearing on the private sector response to consolidation. A credible consolidation strategy would be expected to earn positive feedback from financial markets in terms of lower borrowing costs. For example, tackling the structural fiscal problems, through civil service modernisation, pension reforms or simplifying the tax code, helps convince of the durability of the adjustment. This may garner a stronger response from private spending, notably business investment. When consolidation measures boost potential output, they may also elicit a degree of monetary accommodation, to the extent that a significant underutilisation of resources creates negative risks to medium-term price stability. This can also induce stronger private sector crowding-in and reduce consolidation multipliers[7]. At the same time, ill-received reforms can also generate negative confidence effects or increased precautionary savings. Overall, the argument strengthens the case for focusing on quality measures rather than quick fixes, especially on the spending side.

3. Broad guidance over sub-categories of spending and taxation

3.1 Spending

Public investment features in theory among the most productivity-enhancing public expenditures. Models suggest that cutting investment programmes is more growth-detrimental than other adjustments, both in the short and long-run. This being said, significant scope can be found for improving the quality of investment projects, in particular through realistic cost-benefit analyses and increased transparency in selecting and managing projects. With this significant caveat in mind, there is a case for preserving investment programmes from budgetary cuts. This conclusion can be extended to other public expenditures with strong positive externalities such as R&D and education.

Public wages account for a sizable chunk of public expenditure, and a large consolidation is hard to achieve without efforts at restraining the wage bill. Wage bill cuts are found to be important ingredients in successful consolidations (Hernandez de Cos and Moral-Benito, 2012). Nevertheless, these also entail rather strong negative demand effects in the short-run. Besides, some labour-intensive public services may see their optimal size increase with income levels.

To inflect the wage bill, one can act on public employment and/or on compensation per employee:

- *Downsizing public employment* requires strong political commitment, and may help build credibility. Its efficiency is enhanced by an on-going review of public sector efficiency, as opposed to relying on blanket cuts.

- Curbs in *civil servants compensation* can reduce differentials with the private sector when those have excessively increased, although comparing public and private compensation package is mired with pitfalls. In addition, government pay restraint is instrumental in moderating private wages, thereby contributing to the broader rebalancing of the economy.

[6] In theory the tax hikes could ideally be 'replaced', rather than just 'complemented' over time, by spending cuts. In practice however, such approach can well seem unrealistic, given the size of the required consolidation, as well as possible concerns over redistributive objectives and the political sustainability of the adjustment.

[7] As noted by Erceg and Lindé (2012), this potential effect would be dampened in a monetary union where monetary policy focuses on average conditions. It would also be prevented when the zero-low-floor constraint is binding.

Welfare state reforms are another essential component of sizable fiscal adjustments, particularly in European economies where social expenditure is already high and is exposed to further ageing-related pressures. In the short-run, the multiplier associated with reducing social transfers is generally considered lower than that of government investment or spending on goods and services, but can be higher than tax multipliers if the cuts fall more on rule of thumbs consumers. In the longer-run, many welfare state reforms can raise the efficiency as well as the employment and growth potentials of the economy without endangering the indispensable role played by social insurance in risk sharing and maintaining social cohesion.

There are significant differences across countries in the composition of social spending, suggesting that the menu of priorities and desirable reforms varies with circumstances:

- *Pension reforms* typically entail a long-run double dividend by reducing budgetary costs and at the same time raising labour supply and growth. Moderate increases of retirement ages in line with increased longevity can dramatically improve dependency ratios[8]. Systemic approaches to pension reforms strengthening the contributory principle may also boost labour incentives.

- *Health-care reforms* entail high potential efficiency gains according to recent studies (Joumard *et alii*, 2010). These reforms often address the supply side of health care delivery (e.g. modifying the incentives of practitioners) but may also act on the demand side (e.g. co-payments, possibly exempting the most vulnerable), with the latter typically producing faster budgetary effects but the former being essential in a medium-run perspective.

- *Reviewing the tax and benefit system* can also generate non-negligible budgetary savings. Means-testing of social payments is a common avenue, although one should carefully examine design issues, notably to maintain a labour-friendly curve of effective marginal tax rates.

[8] One often noted limitation of pension reforms is that their budgetary effects take time to materialise. However, even gradual increases in effective retirement ages can make a notable contribution to budgetary consolidation over a span of 5-10 years, and thus be part of a credible medium-term plan.

3.2 Taxation

Achieving consolidation through higher revenues offers an opportunity to improve the structure of the tax system. An efficient tax system designs taxes minimising distortions and correcting market failures where possible. A number of principles, based on model simulations and empirical evidence, have been developed over years for improving the tax structure and selecting growth-friendly approaches to tax-based consolidations (see e.g. European Commission, 2012).

Certain relatively **inelastic tax bases** should be given preference when looking for new sources of revenues. In particular, *property taxation* is a lever to consider, as studies suggest it to be among the taxes least detrimental to growth, notably recurrent taxes on real estate (Johannesson Linden and Gayer, 2012). The reliance on property taxation varies considerably across countries, pointing to significant scope for further revenues in many of them.

So called **Pigovian taxes** are also important. *Green taxation*, spanning the elimination of harmful environmental tax subsidies to carbon taxation, would serve both fiscal and environmental purposes. Other *behavioural taxes* with a priori limited adverse growth-effects are 'sin taxes' and congestion taxes. Taxation of the financial sector also removes the implicit subsidy of 'too big to fail' entities and thereby favours sustainable growth.

Broadening tax bases, in particular through cutting **tax expenditure** is a prime candidate for contributing to fiscal consolidation in a growth-friendly manner. Not all tax expenditure is unwarranted or inefficient. Still, broadening tax bases quite often present a comparatively favourable trade-off with growth in both the short- and long-run. In many cases (e.g. loopholes in direct taxation or pension tax breaks), cutting tax expenditures also contributes to raising transparency and fairness while reducing distortions. More specifically, tax expenditure may also generate a bias in favour of debt finance, the correction of which can generate budgetary gains while improving the stability of the economy.

The spectrum of tax expenditures is very large, and a thorough public evaluation of the costs/benefits of each scheme is a useful step in achieving widespread reforms and improving their design. For example, loopholes in savings taxation typically change the composition of savings without much affecting its overall level, though it is sometimes claimed that tax incentives should favour 'long-term' saving. Similarly, reducing loopholes in indirect taxation is sometimes hampered by redistributive considerations, and might more easily be done as part of a broader package also affecting affluent households.

Improving **tax governance** can be paramount is some countries, and bring a notable contribution to fiscal adjustments in others (Jensen and Woehlbier, 2012). Tackling non-compliance reduces inefficiencies and is key to sustaining fairness, with positive effects on long-term growth. However, often the improvement in tax compliance can only materialise in the long-term and one should not use over-optimistic evaluations of short-term gains.

Despite a relatively rich menu of alternative options, policy makers often find it hard to avoid **outright increases in tax rates** when faced with pressing consolidation needs. Unless these are low to start with, this appears a last-resort option from an economic viewpoint, in particular when it involves directly increasing the tax wedge on labour, especially for low-income workers and vulnerable groups, or across-the-board rise in the cost of capital. Value-added taxation nevertheless appears less detrimental. Indeed, tax shifts from labour taxation to other tax bases, including VAT, engineer an internal devaluation that can be helpful in restoring cost-competitiveness. In addition, one can see a case for raising top income tax rates as part of a broader strategy for pursuing redistributive objectives and garnering broad-based political support in favour of budgetary consolidation.

4. Sequencing, credibility and governance

The above considerations make clear that large fiscal adjustments have to rely on multiple instruments to be successful. Some emphasis on expenditure is usually important, but one should go beyond the broad categories of aggregate spending and taxation and pick up growth-friendly measures in an encompassing manner. A comprehensive approach spreads the costs across the population, rather than targeting some groups, and this helps generate a sense that everyone pays its fair share (Steger, 2012).

Some measures can feed in rapidly, while others only take effect over time, or simply will be undertaken later. Measures that tackle the underlying structural fiscal issues (such as entitlement reforms) typically need time to produce effects. Measures of a more budgetary nature (such as tax hikes or spending freezes) can be implemented and yield budgetary gains rapidly. Both kinds of measures are likely needed for sizable adjustments, but there is a risk of policymakers focusing on the latter while leaving the former for later. This can lead to time-consistency problems and lack of credibility.

A credible medium-term plan, particularly on the expenditure side, helps lock-in credibility. In particular, a medium-term framework of binding expenditure ceilings fosters reliable planning and provides an operational basis for the forthcoming annual budgets. The credibility of the ceilings is essential. A path of binding floors for discretionary tax measures is a natural complement. Launching spending reviews, performance budgeting and a comprehensive evaluation of tax expenditures are useful or even decisive parallel steps. They help ensure, and demonstrate, that the fiscal effort is above all about delivering better results for the citizens. Moreover, building credibility requires "showing some flesh" early in the adjustment, in the form of addressing some politically-sensitive items rather than just initially relying on quick fixes.

Finally, fiscal adjustments should be complemented by reforms of labour and product markets. By raising work-force participation, reducing rents and increasing the resilience to shocks, these considerably enhance the likelihood of successful consolidations.

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