Summary for non-specialists
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Discretionary measures and tax revenues in the run-up to the financial crisis

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The run-up to the global financial crisis was characterised in some EU countries by buoyant tax revenues especially in those countries where asset prices and domestic demand had experienced sustained increases. Favourable tax revenues developments often fostered increases in public expenditure which, with hindsight, proved to be unsustainable. Part of these evolutions might be attributed to business cycle fluctuations and the exceptional credit expansion that has characterised the period preceding the global financial meltdown. Anecdotal evidence suggests however, that EU governments have also sometimes directly fuelled such expansionary cycle by granting (or maintaining) generous tax breaks, for instance in the case of corporate taxation and property acquisition. The large swings in tax revenues during the period preceding and immediately following the global financial crisis has bluntly revealed how unstable tax revenues could sometimes be and could also seriously hamper the role of fiscal policy as macroeconomic stabilisation device. Still little is known about the underlying causes of errors affecting medium-term tax revenues projections as well as on the influence of tax policy changes on tax revenues and the fiscal stance. This paper sets out to investigate these issues by making use of novel data on the impact of discretionary measures on tax revenues recently collected by the European Commission in the context of the Output Gap working Group of the Economic Policy Committee and covering the period immediately preceding the global financial crisis.

The use of this data allows us to shed new light on the incidence of tax policy changes in the EU and on their link with the business cycle. The question of whether fiscal policy tends to exacerbate or, on the contrary, to moderate business cycle evolutions is an old one which has gained renewed interest in the current context. Existing studies on this topic have often resorted to rather rough proxies of the structural nature of fiscal policy changes either using filtering techniques or netting out fiscal variables for the effect of the business cycle using estimated tax elasticities. One limitation of these approaches, however, is that it is notoriously difficult to assess business cycle positions in real-time and therefore to distinguish wrong policy behaviour from genuine mistakes in business cycle assessments. From a policy perspective an additional factor of confusion stems from the lack of transparency of the no-policy change scenario used by governments when discretionary fiscal policy decisions are taken and tax revenue projections are made to determine their effect. These issues have direct consequences for the measurement of cyclically adjusted fiscal positions given that discretionary measures are likely to influence apparent tax elasticities (i.e. the relation between tax yields and the business cycle) which may, as a result, depart from their benchmark values used in EU fiscal surveillance. The availability of detailed governments' tax revenue projections resulting from the implementation of discretionary measures as well as information regarding the method and hypothesis used to build such estimates would thus help addressing (at least partly) these drawbacks by providing complementary information on the causes of potential discrepancies between medium-term fiscal plans and outcomes.

The results of our analysis reveals that, while estimates of the impact of discretionary measures affecting tax yields is made systematically in most EU countries, current practices and methods used to compile this type of data vary greatly across EU Member States, in part reflecting country-specific institutional settings. In addition, the "no policy change scenario" definition used is often fairly general being defined in most cases as if no changes were undertaken in the tax system while sometimes including references to price indexation mechanisms. Our analysis further shows that while discretionary measures have limited impact on tax yields they can also significantly affect the value of apparent tax elasticities and thereby alter the relationship between tax revenues and the business cycle which plays a key role in the EU fiscal surveillance framework. We provide evidence on the pro-cyclical nature of discretionary measures affecting tax revenues whereby governments tend to implement tax cuts during expansionary phases while resorting to tax increases during periods of slowdown. Such pro-cyclical nature of tax policy changes is particularly salient in the case of direct taxes which are more often used by policy makers (either explicitly or implicitly) to introduce changes in the tax system in reaction to business cycle evolutions. By contrast, other tax categories such as indirect taxes and social security contributions, do not seem to display any specific pattern in relation to the business cycle. Given that the time span covered by this database is in most cases relatively short (covering on average 7 to 8 years) future updates of the data should allow to further dig into the issue of the influence of discretionary measures on tax revenues and elasticities as well as to provide elements for a backward assessment of budgetary slippages.

It is important to note that the data used in this paper suffer from a number of limitations which should be addressed in future updates. In particular, differences in the accounting rules followed (i.e., data expressed in either accrual or cash) or in the definition of what constitutes a discretionary measure (i.e., differences in the “no- policy change assumption”), represent important limitations for cross-country comparison. Furthermore, as our paper shows, these tax revenue projections are made ex-ante and usually not revised ex-post such that their real value remains limited regarding an analysis of the permanent effect of discretionary measures on tax yields. Last but not least, governments' projections on the impact of discretionary measures on tax revenues might be biased for political reasons.

There are a number of positive elements attached to this data which make it a valuable tool for fiscal policy analysis and should thus promote future update of the database on discretionary measures affecting tax revenues, however. First the political bias mentioned above can be made a virtue to the extent that in order to make tax revenue projections governments need to make explicit the no-policy change assumptions specific to each tax category. This detailed information can in turn help re-construct the source of errors made for the total tax revenue projections which have been substantial in some EU countries in the run-up to the financial crisis. Using data on the impact of discretionary measures for each specific tax category also enables an assessment of budgetary slippages that is not influenced by composition effects linked to the difference in growth rates between each specific tax basis and the overall GDP. The latter could for instance allow for a better understanding of the role played by non-policy factors such as, for instance, asset or oil prices in driving short-run variations in tax revenues. The availability of data on discretionary measure also permits a more precise analysis of the relationship between fiscal policy and the business cycle by netting out tax series for the influence of discretionary measures given that tax revenues developments stemming from policy and/or legislative changes (or other indirect policy-induced measures affecting tax yields) can sometimes hardly be distinguished from the endogenous behaviour of taxation systems.