



Discussion of M. Bungert and V. Wieland

The role of tax policy for consolidation: Insights from macroeconomic modelling

**By Werner Roeger
DG ECFIN
October 2012**

This paper uses the ECBs New Area Wide model to analyse the impact of tax policy in the context of a fiscal consolidation strategy.

I will concentrate on the consolidation scenario .

This paper provides a contribution to the re-invigorated debate on the effects of fiscal consolidations on real economic activity, supporting a non Keynesian view.

In the early 90s Giavazzo and Pagano (1990) and Alesina and Perotti (1995) challenged the conventional wisdom.

Their empirical work suggested that expenditure cuts are more successful in reaping short term benefits compared to tax increases.

These observations are in principle consistent with (pre-crisis) macroeconomic thinking emphasising the absence of credit frictions which allows households to respond quickly to expectations of higher net income associated with lower tax burden.

However, these "non-Keynesian" effects have also been questioned. In particular it was argued that non-Keynesian effects are only possible if fiscal policy is accommodated by monetary policy.

For example:

Roberto Perotti, 2012. "The "Austerity Myth": Gain Without Pain?," NBER Chapters, in: Fiscal Policy after the Financial Crisis National Bureau of Economic Research, Inc.

"In all consolidations interest rate fell fast, and wage moderation played a key role in generating a gain in competitiveness and a decline in interest rates. These results cast doubt on at least some versions of the "expansionary fiscal consolidations" hypothesis."

The paper proposes a combination of tax and expenditure based consolidations.

In fact it does not propose a consolidation via a tax increase but a consolidation via a tax reduction, accompanied by a temporary increase of transfers to households.

It achieves a permanent reduction of debt with only a temporary reduction of transfers.

The strategy frontloads the tax reduction and does not rely on future tax reductions.

It addresses the problem that the non Keynesian proposition cannot work in the presence of liquidity constrained households which cannot borrow against future increases in net income.

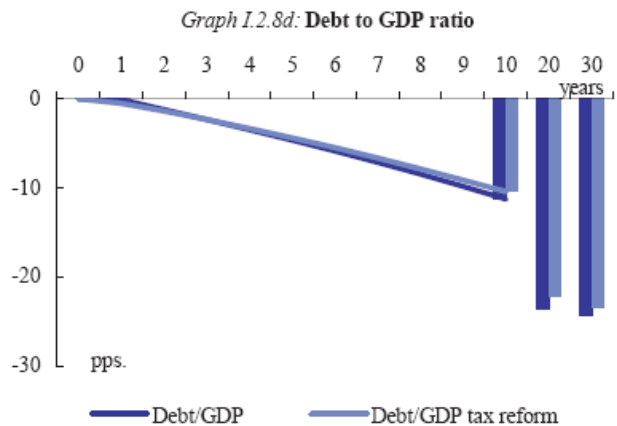
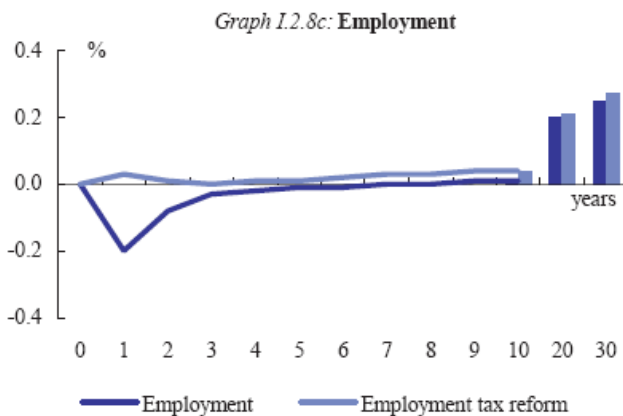
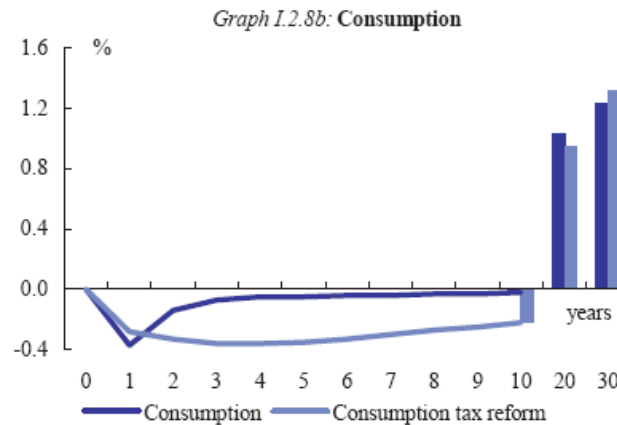
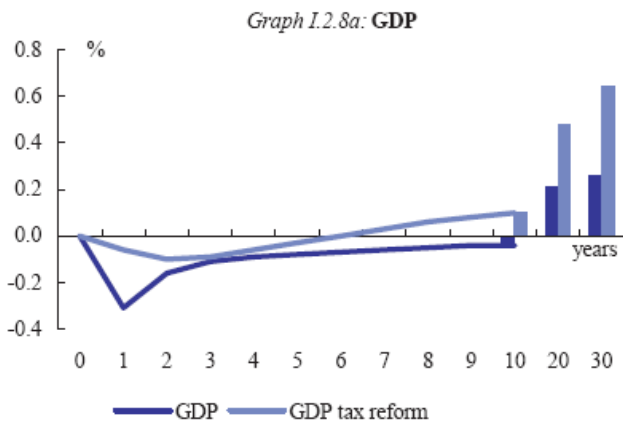
However, this policy must be offset by a temporary reduction in transfers (or an increase in lump sum taxes) which must exceed the loss in revenues from income taxes.

Thus the plan rests on the idea that a permanent reduction of a distortionary tax has positive incentive effects which exceed the negative (income) effects of increasing a non-distortionary tax.

Alternative consolidation strategies: Expenditure based vs. Expenditure reduction plus change in tax composition



Graph I.2.8: Impact of 1% of GDP fiscal consolidation combined with tax reform



Expenditure: -1%, VAT+property tax: +0.5%, labour+capital tax -0.3%

Critical remarks:

The analysis is undertaken at the EA level assuming a normal functioning of monetary policy.

What happens without monetary accommodation (e. g. single country in EMU)?

I obtain the following results:

The absence of monetary policy accommodation is important for not getting short run positive effects.

While the GDP effects are not very negative (GDP multiplier is at around 0.2 (in the case of the adverse scenario)), the consumption multiplier is quite sizeable. (important adverse effect on transfer recipients (pensioners)).

Permanent labour tax reduction accompanied by temporary increase in HH-transfers

Table 1: Single Country in EMU (no real wage rigidity)

	2013A	2014A	2015A	2016A	2017A	2018A	2019A	2020A	2030A
GDP_PCER	-0.03	-0.04	0.00	0.04	0.07	0.10	0.12	0.14	0.23
EMPLOYMENT_PCER	0.00	0.05	0.11	0.16	0.19	0.21	0.22	0.23	0.23
CONSUMPTION_PCER	-0.11	-0.22	-0.25	-0.28	-0.29	-0.27	-0.23	-0.19	0.22
INVESTMENT_PCER	-0.27	-0.37	-0.26	-0.11	0.03	0.14	0.21	0.25	0.21
EXPORTS_PCER	0.02	0.08	0.15	0.23	0.29	0.34	0.37	0.39	0.22
IMPORTS_PCER	-0.04	-0.14	-0.24	-0.33	-0.39	-0.43	-0.44	-0.42	-0.06
REAL.WAGES_PCER	-0.09	-0.21	-0.29	-0.31	-0.29	-0.25	-0.22	-0.20	-0.08
GOV.TRANSFERS.HH.REAL.PC_PCER	-2.15	-5.02	-7.05	-8.32	-8.90	-8.94	-8.60	-8.03	-1.17
PRICE.LEVEL.GDP_PCER	-0.11	-0.28	-0.41	-0.50	-0.55	-0.57	-0.57	-0.55	-0.29
GOV.DEBT.GDP_ER	-0.05	-0.39	-1.05	-1.93	-3.00	-4.16	-5.36	-6.53	-13.64
CURRENT.ACC.GDP_ER	-0.01	0.00	0.03	0.06	0.09	0.11	0.13	0.14	0.08

Since the policy relies on labour taxes being transmitted into lower real wages, the degree of wage flexibility is obviously crucial for the success of this policy

Table 2: Single Country in EMU (real wage rigidity)

	2013A	2014A	2015A	2016A	2017A	2018A	2019A	2020A	2030A
GDP_PCER	-0.08	-0.15	-0.19	-0.21	-0.23	-0.23	-0.21	-0.19	0.04
EMPLOYMENT_PCER	-0.06	-0.12	-0.14	-0.16	-0.17	-0.16	-0.15	-0.14	0.05
CONSUMPTION_PCER	-0.16	-0.33	-0.43	-0.51	-0.56	-0.58	-0.56	-0.53	-0.00
INVESTMENT_PCER	-0.17	-0.27	-0.27	-0.22	-0.16	-0.11	-0.06	-0.02	0.11
EXPORTS_PCER	0.01	0.03	0.05	0.08	0.10	0.12	0.13	0.14	0.07
IMPORTS_PCER	-0.03	-0.09	-0.17	-0.24	-0.30	-0.33	-0.36	-0.36	-0.09
REAL.WAGES_PCER	-0.00	-0.02	-0.03	-0.03	-0.03	-0.03	-0.02	-0.02	-0.02
GOV.TRANSFERS.HH.REAL.PC_PCER	-2.17	-5.05	-7.19	-8.65	-9.45	-9.71	-9.57	-9.15	-2.01
PRICE.LEVEL.GDP_PCER	-0.04	-0.09	-0.14	-0.17	-0.19	-0.20	-0.21	-0.21	-0.10
GOV.DEBT.GDP_ER	-0.04	-0.37	-0.96	-1.77	-2.75	-3.85	-4.99	-6.14	-13.64
CURRENT.ACC.GDP_ER	0.00	0.02	0.04	0.06	0.09	0.10	0.12	0.13	0.07

Table 3 summarizes the differences of adjustment

Table 3: Model Comparison

Year	Bungert & Wieland			Small Economy in EMU		
	1 - 2	3 - 10	11+	1 - 2	3 - 10	11+
Y	+	+	+	-	+/-	+
C	+	+	+	-	+	+
I	+	+	+	-	+/-	+
L	+	+	+	0/-	+/-	+

Why the results could be more negative in the short run:

With financial market frictions a larger share of households could be credit constrained.

Transfer reductions are lump sum and equally distributed between constrained and unconstrained households. Actual transfer reductions could be directed more strongly to constrained households.

Since the proposed policy would mostly affect pensioners, the wealth effect on labour supply could be smaller (smaller wage response).

Conclusion

The paper has presented an interesting scenario on how to conduct a fiscal consolidation which could minimize the short run negative GDP effects.

It generates small negative or even positive GDP effects by improving competitiveness and therefore could also help in reducing current deficits.

However it is unlikely that it can achieve all three targets simultaneously in the short run: $DY > 0$, $DC > 0$ and $DCA > 0$, especially not for a country in a Monetary Union