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A welfare perspective on the fiscal–monetary policy mix: The role of alternative fiscal instruments[☆]

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Abstract

The need of fiscal consolidation is likely to dominate the policy agenda in the next decade; starting from statistical evidence on the conduct of fiscal policy in the EMU area over the last decade, this paper addresses the optimality of alternative fiscal consolidation strategies. In this paper, we explore the welfare properties of debt-targeting fiscal policy implemented through, alternatively, distortionary taxation on consumption, labour and capital income or productive and wasteful government expenditure. We build a general equilibrium model with various distortions in order to evaluate the welfare ranking of alternative fiscal policy configurations under different monetary policy regimes. Our results show the welfare superiority of fiscal adjustments based on productive government expenditure, whereas the use of a capital income tax rate as fiscal instruments yields the highest welfare loss.

JEL classification: E62; E63

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☆ The views expressed herein are those of the authors only and should not be attributed to the members of the Executive Board of Sveriges Riksbank.

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1. Introduction

The process of cutting-back the massive stock of public debt accumulated after the 2008-2009 recession is likely to dominate the policy debate over the next decade. Table 1 shows the change in levels of the debt/GDP ratio in major industrialized countries from 2007 to 2010.

These figures suggest that the question is not so much whether to implement a fiscal consolidation, but rather how to do it. Specifically, whether it would be preferable to carry it out by cutting public expenditure or by increasing average tax rates on factor incomes and consumption.

The issue of whether fiscal adjustments should rely on the expenditure rather than the revenue side is hardly a new topic in the policy debate. Its importance was already emphasized by the January 2004 ECB Monthly Bulletin (p.46)

> "The composition of the budgetary adjustment is particularly relevant, there being evidence that an expenditure-based adjustment tends to be more growth-friendly and long-lived than a tax-based adjustment without expenditure retrenchment."

Looking at the case-studies of Ireland and Denmark in the Eighties, Giavazzi and Pagano (1990) were the first ones to suggest that fiscal adjustments implemented on the government spending side could be expansionary. This view is confirmed by Alesina and Perotti (1997), who examine a full sample of OECD countries and find that adjustments relying on government expenditure cuts had a better chance of being successful and expansionary; on the other hand, if they are based on tax increases and cuts in public investments, tend not to be non-persistent and contractionary. This result is strengthened by Alesina and Ardagna (2009) who extend the analysis up to 2007. Using a panel OECD from 1970 to 2007, they define fiscal adjustments (stimuli) as episodes where the cyclically adjusted primary balance improves (deteriorates) by at least 1.5 per cent of GDP. Subsequently they investigate whether such episodes – that differ in size and composition – are associated with booms or recessions and with success in debt stabilization. Their conclusion is that most successful fiscal adjustments are those in which a larger share of the reduction of primary deficit is due to cuts in current spending (wage and non-wage component) and to subsidies.

Based on these considerations, in this paper we introduce a new dimension to assess the desiderability of alternative debt-stabilizing plans: what are the welfare effects (and not simply

Table 1
Evolution of Debt/GDP ratio, major industrialized countries.

Country	Debt/GDP 2007	Debt/GDP 2010
Ireland	24.80	79.70
Luxembourg	7	14.50
Spain	36.20	62.30
United Kingdom	44.15	71
United States	63.05%	91.57
Netherlands	45.70	63.10
Finland	35.10	45.70
Portugal	63.60	81.50
Denmark	26.84	33.66
Germany	65.10	78.70
Belgium	83.90	100.90
Japan	167.10	193.97
Italy	104.10	116.10