

The Effectiveness of Fiscal Stimulus Packages in Times of Crisis

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This paper provides theoretical and empirical evidence on the effectiveness of discretionary fiscal policy in times of crisis. In “normal” times, a whole range of arguments speaks against the use of discretionary fiscal policy for stabilization purposes – yet amid the current sharp economic downturn, many of those arguments (such as implementation lags or low fiscal multipliers) have comparatively little weight.

The OeNB estimates that the measures the Austrian government has adopted so far – an inflation package, two economic stimulus packages, personal income tax reform brought forward – will increase GDP by roughly ¾% and will provide for 12,000 additional jobs in 2009. The effects of those measures are expected to continue into 2010. However, as Austria’s debt ratio stands to increase substantially at the same time, the government would be well-advised to commit itself to cutting the deficit and debt ratios when the crisis is over.

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The prevailing global financial crisis finally spilled over to the Austrian economy at the end of 2008. Following comparatively robust output growth in the first half of 2008, economic activity weakened considerably in the third quarter and entered a phase of contraction in the fourth quarter, which became even more pronounced at the beginning of 2009. As a result, annual growth is likely to be negative in 2009 as a whole. Alongside Austria, countries across Europe and beyond are suffering growth setbacks or even recessions and are feeling the sting of sharply rising unemployment.

The current economic crisis is a daunting challenge for economic policymakers – be it because of its global reach, the speed with which it is cascading through the economy, or its proportions, which exceed those of all crises since the end of World War II. The strong tensions in financial markets have, moreover, jammed the usual channels of monetary policy transmission, weakening the stabilizing effect of monetary policy on the real economy.

Should a credit crunch occur, which cannot be ruled out at present, it would seriously affect economic developments by imposing supply-side financial constraints on businesses. At the same time, substantial asset price losses for households as well as fears of rising unemployment have forced consumers to retrench. Last but not least, the global dimension of the economic slowdown has also caused export demand to plunge and may continue to do so for a protracted period, as the world’s major economies are expected to unwind their economic imbalances.

In view of the impaired stabilizing function of monetary policy, we must ask how much fiscal policy can and should contribute in such exceptional situations – without running the risk of undermining the long-term sustainability of public finances in Europe and worldwide.

At the European level, the EU’s fiscal policy framework adds further substance to the goal of fiscal sustainability. As fiscal policy as such has remained a national responsibility within the EU,

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fiscal stabilization measures are taken at the national level, but they must be in line with the Stability and Growth Pact (SGP) and the Treaty of Maastricht. According to the Treaty, the budget deficit should rise no higher than 3% of GDP in normal downturns, and the debt ratio should not exceed 60% of GDP (unless the ratio has declined substantially and continuously and reached a level that comes close to 60%). At the same time, the European fiscal framework allows EU members to temporarily deviate from the deficit objective in times of severe economic downturns. Episodes of severe economic downturns have been defined as periods of negative GDP growth or as protracted periods of very low growth relative to potential. Under such exceptional circumstances, deficits may temporarily deviate from the 3% of GDP reference value, provided they remain “close” to it – then deficits will not be deemed excessive. EU policymakers presumably considered a sharp and global economic contraction such as that we have witnessed in the past few months to be most unrealistic when they reformed the SGP in 2005 – after all, they even considered the negative growth rate of 2% of the original SGP to be unrealistic at the time. For the situation at hand, this gives rise to two conclusions: First, the degree of the current contraction would imply that deviations from the 3% threshold may be handled more flexibly. Second, the phrase “temporary deviations” from the 3% reference value will have to be interpreted more broadly, as the rapidly widening negative output gaps are unlikely to be closed in the near term. At the same time, given marked deviations from the 3% threshold and the increased sensitivity of financial markets, governments will have to increase their efforts to consolidate the budget in the years

ahead in order to contain negative debt-interest rate spirals and preserve the credibility of sustainable economic policies.

The European fiscal framework is designed to ensure that in normal cyclical downturns the automatic stabilizers – which smooth fluctuations in real GDP growth without explicit policy action – may operate freely without endangering compliance with the 3% deficit ceiling. Yet given insufficient room for maneuver, budget policy has often reacted procyclically in economic downturns in the past decades, thus even neutralizing the effect of the automatic stabilizers. At the same time, there is widespread consensus among institutional policymakers and economists that discretionary fiscal measures are a meaningful response to economic downturns only under exceptional circumstances. This rather skeptical take on active fiscal policy action aimed at stabilization also reflects the desire to offset the inherent deficit bias of fiscal policymaking and to safeguard the long-term sustainability of public finances. In contrast, the purpose of the automatic stabilizers is to reduce the deviations of actual from potential growth and thereby produce welfare-enhancing effects.

Section 1 below discusses fundamental problems of discretionary policy. In section 2, we argue that many of the objections raised in section 1 are in fact of secondary importance in the current situation. Section 2, moreover, discusses the requirements that economic policy measures should meet in view of the sharp and pronounced contraction we are witnessing. Section 3 analyzes the intended effects of the economic stimulus packages recently adopted by the Austrian government, and their likely impact on growth and employment. Section 4 concludes.

1 Effects and Problems of Discretionary Fiscal Policy

Following Musgrave (1959), government essentially performs three functions for society: it allocates resources; it redistributes income; it stabilizes economic performance. This being so, the question arises as to the relative importance of each of these three functions.

With regard to resource allocation, there is a consensus in the literature and a social consensus about the function as such, but less so about the degree of intervention (which is invariably a tradeoff between market failure and government failure). Likewise, there is a basic consensus about income redistribution, albeit a broad range of opinions about the adequate design of the system and about the degree of redistribution that is best for society. In contrast, there is a fundamental lack of consensus among both academics and policymakers about the stabilizing function of fiscal policy, i.e. about the role fiscal policy can and should play in smoothing out the cyclical nature of economic development by stimulating the economy during slumps and deflating the economy during booms.

The importance of employing fiscal measures to stabilize the economy was driven home forcefully by the lessons learned from the Great Depression in the 1930s and substantiated theoretically in the works of John Maynard Keynes. Discretionary fiscal policy was the stabilizing tool of choice in the decades following World War II, whereas monetary policy was relegated to the back seat, not least because of the fixed exchanged rate regimes prevailing under the Bretton Woods system. Yet since the mid-1970s, the use of fiscal policy as a stabilization instrument has been largely abandoned; since then, the key rationale of fiscal policy has been

seen in smoothing out short-term deviations of actual from potential output through the operation of automatic stabilizers. Instead, the task of adjusting economic performance has been essentially transferred to monetary policy-making (Taylor, 2000).

1.1 Does the Size of Multipliers Justify Discretionary Fiscal Policy at All?

1.1.1 Economic Theory Divided about the Size of Fiscal Policy Multipliers

The traditional Keynesian view is that fiscal policy has a comparatively high multiplier effect, in any case exceeding 1.

According to the Keynesian conceptual framework, additional government spending stimulates macroeconomic demand either directly (by increasing public consumption and/or public investment) or indirectly (by bolstering private income through higher transfers). The ensuing increase in the disposable income of households will, in turn, boost consumer demand, which will raise private disposable income further. The size of the fiscal multiplier, i.e. the accumulated effects of fiscal policy on output, depends on households' marginal propensity to consume (positively correlated) as well as on the degree of capacity utilization and the propensity to import (both negatively correlated). As a rule, the positive impact of higher deficit spending on real GDP growth will be higher than the original fiscal stimulus.

Thus, deficit-financed increases in spending and tax cuts open up an avenue for jumpstarting consumer demand and business investment during episodes of recession, for diminishing the deviation of current real GDP growth from the underlying long-term growth trend, and for stabilizing income and employment without stoking inflation.

“The idea of using fiscal policy to reduce the magnitude of economic fluctuations dates back at least to the Great Depression of the 1930s, and it was the centerpiece in discussions of short-term economic policy for a number of decades thereafter” (Elmendorf and Furman, 2008, p. 6). The emergence of stagflation amid the first oil crisis in the early 1970s undermined Keynesian theory (and the closely related neoclassical synthesis model) and cast doubts on the effectiveness of fiscal policy in stabilizing output and employment fluctuations in the short term, especially in the case of supply shocks.² Above all, new classical economics – including the Ricardian equivalence theorem, which postulates the ineffectiveness of deficit-financed tax cuts – was highly critical about the stabilizing function of fiscal policy. In line with

new classical economics, new-Keynesian theories emerging above all in the 1980s argued that households and businesses were not as myopic as Keynes had claimed. The new-Keynesian theories, moreover, postulated that households more or less expect deficit-financed tax cuts or spending increases to drive up the tax burden at some point in the future. In other words, even if the validity of strict Ricardian equivalence is drawn into doubt, the mere assumption of forward-looking or intertemporally optimizing households implies lower fiscal multipliers. See the box entitled “Effects of Fiscal Policy according to Different Macroeconomic Schools” for a more detailed overview of the effects various strands of economic thinking expect fiscal policy to have on the size of economic output.

Effects of Fiscal Policy according to Different Macroeconomic Schools

This overview focuses on current mainstream macroeconomic theories and on short-term (and medium-term) impacts; it disregards the effect of measures on technological progress and on the underlying growth trend (as in endogenous growth theory) and schools outside the mainstream (such as post-Keynesian theory).

Neoclassical Synthesis¹

Models of neoclassical synthesis combine Keynesian aspects (demand-side constraints: the volume of GDP depends on effective demand) in the short run with neoclassical elements (supply-side constraints: the volume of GDP depends on the supply of labor and capital) in the medium and long term. Examples include the IS-LM/AS-AD model and the Phillips curve. Neoclassical synthesis dominated economic thinking after World War II and is still the standard in introductory macroeconomic textbooks (e.g. Blanchard, 2008). Moreover, it is still the theoretical basis for the current generation of central banking projection models (e.g. for the OeNB’s Austrian Quarterly Model, AQM; see Schneider and Leibrecht, 2006). One of the key representatives of this school of thought was Paul Samuelson.

According to neoclassical synthesis, expansionary fiscal policies will boost consumption and output in the short run by raising effective demand. In this respect, raising government spending will have a higher impact than lowering taxes, as consumers will put aside, rather than spend, part of their tax savings (the Keynesian part). In the medium term, supply-side constraints will push up the level of prices and drive GDP back to its initial level (neoclassical part).

¹ For instance, Snowdon and Vane (2005, chapters 2 and 3).

² In the case of negative supply shocks, expansionary fiscal policies contribute to stabilizing output but stoke inflation at the same time.

New Classical Economics²

Unlike neoclassical synthesis, new classical models assume complete market clearing – which means that, much like in the neoclassical view, supply-side constraints operate even in the short term. Moreover, new classical economics argues that Keynesian economics and neoclassical synthesis insufficiently reflect the role of expectations and microlevel influences. In new classical models, households optimize their consumption choices in a forward-looking manner and have rational expectations, i.e. make knowledgeable and informed predictions of actual outcomes.³ Key advocates of new classicism include Robert Lucas and Edward Prescott (cofounder of the real business cycle school), as well as Robert Barro.

The latter is known, among other things, for the model he developed in 1974 and further elaborated into the Barro-Ricardo equivalence proposition, also known as Ricardian equivalence. The basic idea behind Ricardian equivalence is that, given a fixed path of government spending, the levels of welfare, consumption and GDP will remain unchanged irrespective of whether government spending is financed through debt or through taxes. The effect of debt-financed tax cuts would be nil, because the reduction in public saving would be offset by an equivalent increase in private saving by consumers anticipating future tax increases that government will have to resort eventually to pay back its debt, given a fixed path of government spending. Households would not act on the basis of their current income alone, but on the broader basis of their lifetime income. Therefore, the impact of deficit-financed cyclical policies on the real economy is comparatively limited (in the case of credit-financed increases of government spending) or nil (in the case of credit-financed tax cuts).

In order for this theorem to work, it takes rational individuals and perfect credit markets (which are both standard assumptions of new classical economics) as well as the following additional restrictive assumptions: All taxes are of the lump-sum variety; individuals act as if they had infinite lives; and all taxpayers have intergenerational links (Elmendorf and Mankiw, 1998). For those very restrictive assumptions, the Ricardian equivalence theorem has come under criticism and is rather controversial.⁴ Blinder (2004) cites evidence from quasi-experiments made in the U.S.A., which suggests that credit constraints do indeed matter for households. Moreover, he argues that the proposition of lump-sum taxes is flawed. For instance, a (debt-financed) temporary reduction in consumption taxes changes the relative prices of current and later consumption and will motivate forward-looking optimizing households to consume more now. Likewise, changes in income tax rates do not have a directly stimulating effect on demand in such a setting; they only have an indirect effect on GDP through changes in the supply of labor and/or through changes in capital accumulation (e.g. Trabandt and Uhlig, 2006).

Furthermore, the **Barro-Ricardo equivalence proposition** does not say anything about the effect of raising or lowering government expenditure, as public consumption and public investment essentially constitute an alternative use of resources by the state rather than by the private sector. When hours worked are assumed to be endogenous, a permanent (temporary) rise in public consumption will have a permanent (temporary) positive effect on GDP. However, this effect is smaller than in the Keynesian view, and the way public measures are transmitted to the real economy is also very different: A rise in public consumption is financed by raising taxes now or later, which causes expected lifetime income to shrink. As a result, both consumption and spare time drop, since they are both normal goods for which demand rises as income rises. The ensuing implied increase in hours worked causes the level of GDP to rise; yet as consumption declines, so does the level of welfare (for a more detailed explanation of this relationship, see e.g. chapter 15 in Heijdra and van der Ploeg, 2002).

² For instance, Snowdon and Vane (2005, chapters 5 and 6).

³ Rigorously applied, this means that households' expectations are fully in line with model forecasts (Snowdon and Vane, p. 225f). This excludes systematic deviations of expectations from actual outcomes.

⁴ For an in-depth discussion, see Seater (1993). Criticism has zeroed in above all on the assumptions, as it is difficult to test the implications of the theory in an empirical setting (Elmendorf and Mankiw, 1998).

New-Keynesian Economics⁵

New-Keynesian theory starts from assumptions on the behavior of households similar to those of new classical economics (forward-looking optimization, rational expectations). At the same time, new-Keynesian economics stresses the existence of nominal and real rigidities (nominal: rigid prices and nominal wages; real: e.g. imperfect competition) and thus does not postulate market clearing as a rule. This means that the demand side plays a comparatively bigger role and that, unlike in new classical economics, there is a role for public stabilization policy. Key advocates include Gregory Mankiw and Olivier Blanchard.

New-Keynesian dynamic-stochastic general equilibrium (DSGE) models such as the ECB's New Area Wide Model (Christoffel et al., 2008) or the European Commission's QUEST III model (Ratto et al., 2009) constitute the state of the art on analyzing the impact of different scenarios on macro variables. The bottom line is that new-Keynesian models produce very much the same qualitative results as the new classical models in determining the effects of changes in government consumption or tax cuts. The results of short-term effects, however, differ, owing to the respective assumed rigidities. As a case in point, Ratto et al. (2009) as well as Coenen et al. (2008) assume a certain share of households to be credit-constrained, as a result of which a rise in public transfers to households does have an impact on consumption in the short run.

Yet unlike original Keynesian economics, new-Keynesian economics essentially focuses on analyzing the impact of monetary policy and it is characterized by a very high degree of heterogeneity. Moreover, the concept of the hysteresis is also based on new-Keynesian thinking.

⁵ For instance Snowdon and Vane (chapter 7).

1.1.2 Growing External Trade and Market Liberalization Have Made Fiscal Stimulus Measures Less Effective

The rapid pace of integration within Europe (EU, EMU) and globalization trends as well as the spreading international division of labor have reduced the impact that national economic stimulus measures may have on national output and employment. The rising import propensity of individual economies resulting from intensified external trade implies a weakening of multiplier effects on domestic GDP, which means that built-in stabilizers also lose in effectiveness. Deregulating financial markets and easing access to credit markets may also have contributed to a decrease in the number of credit-constrained households, which will also have reduced multiplier effects.

1.1.3 Empirical Evidence on the Impact of Expansionary Fiscal Policy is Mixed

According to the European Commission (2001, p. 62), both empirical estimates and simulations of state-of-the-art macro models point to the existence of positive multipliers but at the same time indicate that those multipliers are relatively small compared with the traditional Keynesian view.³

A seminal work by Blanchard and Perotti (2002) finds positive expenditure and tax multipliers (around 1) for the U.S.A. and a strong crowding out of private investment following expenditure shocks. In a similar study for five OECD countries (U.S.A., United Kingdom, Canada, Australia and Germany), Perotti (2005) establishes low multipliers (and often negative multipliers for the post-1980 subsample) also for countries other than the U.S.A.

³ In recent years, fiscal multipliers have typically been calculated with structural vector auto-regressions (SVARs). Yet such tools allow for a certain degree of arbitrariness in identifying fiscal shocks (unexpected changes in fiscal policy). Furthermore, such studies are based on quarterly data, which are often not available for countries or are often fraught with quality problems. Apparently, this is the reason why the number of studies on the effectiveness of fiscal policies is so low for countries other than the U.S.A. (Afonso and Sousa, 2009).

Moreover, he finds evidence for a decline in multipliers over time. In a later analysis of four OECD countries (U.S.A., United Kingdom, Canada and Australia), Perotti (2007) shows the response of consumption and GDP to positive government spending shocks to be positive as a rule, but statistically not significantly different from zero in some instances; and to be generally higher in the U.S.A. than in the other three countries.

The IMF (2008a) finds mostly positive but very small multipliers for industrialized countries, whether the growth effects are higher for spending cuts or for tax increases depends on the method of calculation. The impact of discretionary fiscal policy measures on the real economy crucially depends on the long-term sustainability of public finances: The evidence shows the fiscal stimulus effects to be higher when the original debt ratios are low.

Moreover, a number of studies point to possible nonlinear effects of fiscal policies: Given certain conditions, such as excessive debt ratios, fiscal policies will not only be ineffective (multiplier of zero) but even contribute to destabilization (negative multiplier).⁴ The more recent literature thus even offers a further channel (in addition to the timing problem mentioned above) as an explanation why discretionary fiscal policies may have unintended destabilizing effects.

1.2 Economic Policy and Institutional Arguments Speak against Discretionary Stabilization Measures

Since the 1970s, the debate on the stabilizing function of fiscal policy has basi-

cally revolved around two issues: (1) Have discretionary policies indeed had a stabilizing effect in the past; and (2) how effective are the built-in automatic stabilizers when compared with discretionary policies? Both of those questions are closely related to institutional or political economy issues. The underlying questions are the relative lags with which fiscal and monetary policy measures become operative and effective, whether those measures are subject to political constraints (such as irreversibility) as well as the extent to which those measures may be biased by a “hidden agenda” of politicians seeking reelection (political election cycles) and by short-term orientation (time-inconsistency problems).

1.2.1 Implementation and Effectiveness Lags May Make Countercyclical Measures Procyclical

Fiscal measures have, as a rule, a more immediate effect on demand than key interest rate changes; in other words, fiscal policy has a shorter effectiveness lag than monetary policy. However, this only holds for projects that have been developed and adopted and simply need to be pulled out of the drawer, so to speak, as the design and decision-making or implementation lag is, in fact, longer for fiscal policy than for monetary policy. Yet more recent studies have established potentially long effectiveness lags also for fiscal policies (Blanchard and Perotti, 2002). The comparatively long implementation lag of fiscal policies alone would already imply that monetary policy is potentially “superior” to fiscal policy. Unlike monetary policy decisions, which are taken by the central bank, economic stimulus packages are

⁴ See Prammer (2004) for an overview of non-Keynesian effects, a description of the conceptual frameworks and an assessment of their empirical relevance.

adopted by parliament – a much slower process.⁵ This involves the inherent risk that fiscal measures taken in the course of “normal” economic downturns may not become effective until after the economy has started to rebound – causing countercyclical measures to be in fact procyclical as a result of decision-making and implementation lags. Consequently, in order to indeed have countercyclical effects, fiscal measures need to be implemented quickly and start operating right away. Above all, specific public investment projects, which may principally stimulate growth in the short run and enhance the long-term growth potential, may thus be unsuitable for short-term stimulation because of those lags. Given the long preparatory periods (planning, approval procedures, etc.) it does not come as a surprise that empirical studies often conclude that public investment projects have procyclical effects (Hallerberg and Strauch, 2002; Alberola, 2003). Yet the procyclicality of this spending category may also reflect the fact that such projects can be cut short without high political costs when governments needed to retrench.

The effectiveness of discretionary, stability-oriented fiscal policy depends above all on the precision with which the cyclical path can be assessed. Forecasting cyclical turning points is the most difficult task of cyclical analysis (Dynan and Elmendorf, 2001). In this respect, monetary policymakers are generally expected to be able to identify turning points more objectively, given central bank independence (e.g. Solow, 2005).

1.2.2 Deadweight Loss Effects of Fiscal Impulses

Every euro spent under discretionary fiscal measures needs to be well spent, i.e. should generate a strong (additional) impact on GDP, and should benefit above all those whom the economic slowdown or an economic crisis hits hardest. In other words, the measures need to be targeted. While expenditure measures are fraught with crowding-out problems and lead to implementation delays, incentive-based measures (such as investment subsidies) may be subject to large and unavoidable deadweight loss effects. Notwithstanding the aim of discretionary measures to create additional consumer and business demand, it is impossible to rule out that money will go into projects that would have been implemented even without stimulus measures. The special investment growth tax credit (“Investitionszuwachsprämie”) introduced temporarily under Austria’s economic stimulus and growth packages of 2002 is a case in point. Anecdotal evidence shows that firms were very resourceful in presenting their investment projects in such a way that they qualified for this special tax credit. Apart from that, more attention should be paid to the incentive effects underlying such measures, which – in the case of the above-mentioned special investment tax credit – might dampen investment demand in normal times in case firms expect policymakers to reintroduce such measures in times of future downturns.⁶

⁵ In this context, Solow (2005) has noted that some of those economic policy problems are more acute in the U.S.A. than in Europe, as party discipline is very low in U.S. Congress.

⁶ Moreover, such measures put at a disadvantage companies whose investment demand was high before economic activity shrank.

1.2.3 Irreversibility of Measures and Deficit Bias Threaten Long-Term Fiscal Stability

Another problem of anticyclical measures introduced in times of economic downturns is their irreversibility, even though they should be restricted to a limited period. However, expenditure measures (such as increasing the public service headcount or raising social transfers) that are not unwound or tax cuts that are not reversed when the economy recovers may create budget problems in the medium to long term, however effective they may have been in the short term. The negative effect on the sustainability of public finances will be weakened only if such short-term measures clearly raise potential long-term growth (as targeted investment in infrastructure, education or research does, or as is the case with tax reforms that stimulate capital accumulation as well as labor supply and demand). This negative effect evolves because budget deficits curb private investment demand as interest rates rise, which in turn causes the capital stock to shrink. At the same time, an increasing debt burden accompanied by growing long-term interest rates on government debt securities (especially when investors have sustainability concerns) reduces the leeway of fiscal policy. If fiscal policy does not succeed in keeping up investor confidence in the long-term sustainability of public finances, it ruins the chance of stimulating the economy during downturn periods.

The problem of the irreversibility of stability-oriented discretionary measures is closely linked with the problem of the asymmetric fiscal stance and the inherent deficit bias of fiscal policy⁷ –

i.e. the fact that fiscal policy tends to be expansionary during economic downturns but fails to be contractionary in recovery or boom periods.⁸

1.2.4 Numerous Tax Rate and Expenditure Changes Destabilize Expectations of Households and Businesses

While stability-oriented measures should be temporary as a rule, so as not to jeopardize the sustainability of public finances, raising and lowering spending levels or tax rates with a view to reinforcing stability too often in a row may in fact render those measures ineffective, as this will undermine the planning security for businesses and households and affect the process under which they form expectations.

Furthermore, if temporary adjustments in tax rates do not change the permanent income of households, only liquidity-constrained households will spend what they have temporarily gained in disposable income, which is one more reason why automatic stabilization was generally given priority.

1.2.5 Stability Measures Invariably Involve Distribution and Allocation Choices

Finally, stability measures are also controversial because of the distributive and allocation effects with which they ultimately come. “If choice is left to the democratic process, stabilization issues will tend to be fought out in terms of distribution and allocation, and the stabilization results will surely be delayed and may sometimes be perverse” (Solow, 2005, S. 512).

⁷ See Calmfors (2005) for different explanations for deficit bias.

⁸ Against this backdrop, it does not come as a surprise that the European Commission (2001, p. 63) concluded that “... empirical evidence indicates that countries in the last three decades have tended to behave pro-cyclically.”

2 The Effect of and Need for Discretionary Fiscal Policy in Times of Crisis

2.1 In Times of Crisis, Automatic Stabilizers Alone Will Not Do ...

For the economic and institutional reasons outlined above, discretionary fiscal policy as an instrument of stabilization has lost much of its luster in the past decade. The European fiscal framework has left little room for discretionary fiscal policy, even though this policy is considered to be a valuable tool – alongside income policy – for countering asymmetric shocks and permanent imbalances in a monetary union under the optimum currency area theory. In the case of symmetric demand shocks, monetary policy is considered the instrument of choice, provided it does not run counter to price stability considerations.

However, the advantages of (passive) stabilization through progressive tax systems and comprehensive unemployment insurance systems have been widely recognized.⁹ The same holds true for the size of government – subject to concerns that high expenditure/revenue ratios may have dampening effects on the long-term growth potential of economies.¹⁰ In the EU, the tax reforms of the past decades, which generally aimed at reducing marginal tax rates and softening tax progressivity, as well reforms of unemployment (and other transfer) systems have tended to reduce the effectiveness of automatic stabilizers.

The effectiveness of the automatic stabilizers generally depends on how sensitively the budget balance reacts to cyclical fluctuations. If such sensitivity

is high, i.e. if an economic contraction will strongly influence the budgetary situation given sharp increases in transfer expenditure or sharp declines in progressive income tax revenues, automatic stabilizers are likely to have a higher impact on the real economy. Grossmann and Prammer (2005) have found Austria to have an average budget sensitivity of 0.38. In other words, a 1% decline in GDP will cause the budget balance to decline by 0.38% of GDP on average; the actual effect will, however, also depend on the type of economic shock.

2.2 ... and (Discretionary) Fiscal Policy May Have Larger Effects in Times of Crisis than in “Normal” Times

In a period of economic contraction, as is currently emerging worldwide, the effectiveness of the automatic stabilizers appears to be low. Therefore, the European Commission (2008) has urged governments in its *European Economic Recovery Plan* to widely use discretionary fiscal measures. In addition, the weakening of the transmission mechanism as a result of the financial crisis and above all the possible emergence of supply-side credit constraints for businesses also justify the temporary use of discretionary fiscal measures. Moreover, concerns that private expenditure might be crowded out by higher government expenditure are currently unfounded – at least as long as there are no doubts about the sustainability of public finances. Rising unemployment and the sharpened risk perception of financial market participants has swelled the ranks of liquidity-

⁹ Conversely, letting the automatic stabilizers work has been questioned in the case of supply shocks.

¹⁰ Growing public sectors tend to have higher spending and revenue ratios. However, high labor taxation may dampen labor supply and demand. Moreover, capital taxation is likely to distort the saving and investment decisions of households and businesses.

constrained households.¹¹ All this would speak for the temporary use of discretionary fiscal measures.

Furthermore, medium- and long-term considerations also support the use of discretionary fiscal measures under the current circumstances. After all, the latest economic forecasts (e.g. the Interim Forecast of the European Commission, 2009) point to a sharp increase in unemployment. Unless countermeasures are taken, potential economic growth will be seriously dampened. The non-accelerating inflation rate of unemployment (NAIRU) might rise significantly given the loss of human capital as a result of protracted unemployment, insider-outsider effects (the possibility that wage negotiators neglect the marginalized jobless) and the loss of firm-specific know-how following business failures.^{12,13}

2.3 Reinforced Impact through (at Least) EU-Wide Coordination of Economic Policies in Line with the Lisbon Strategy

Given the potential pitfalls of discretionary fiscal stabilization measures outlined above, it is important to consider a number of aspects to ensure that such measures are effective. First, even under the current exceptional economic developments, policymakers should refrain from going it alone nationally in response to the economic

crisis, as the strong integration of individual economies reduces national multiplier effects given the high import propensity of consumers. Coordinated action within EU boundaries should both improve the effectiveness of national measures and prevent free-riding behavior (relying on trading partners taking fiscal measures and waiting for positive spillover effects to the national economy).

The fiscal stimulus resulting from the discretionary national reform measures announced by individual EU countries in the fall and winter of 2008 amounts to roughly 1% of GDP in 2009 and to 0.5% in 2010 (European Commission, 2009, p. 16). At the same time, automatic stabilizers are expected to drive up the EU-wide deficit by another 2½% of GDP. In the QUEST III model underlying the analysis of the European Commission, EU-wide fiscal multipliers are lower than 1 on average;¹⁴ overall, the European Commission expects the positive EU-wide growth impact of the fiscal measures to be 0.8 percentage points in 2009 and 0.3 percentage points in 2010.

In addition to being collective, the optimal fiscal package should be timely, large, lasting, diversified, contingent and sustainable, according to the IMF (2008b). A fiscal stimulus should be *timely* because there is an urgent need for action given the drastic pace of the

¹¹ In this context, an empirical study by Tagkalakis (2008) shows that unexpected changes in government spending and revenues have a stronger impact during cyclical downturns than during upswings. The author explains this phenomenon above all with the rise in the number of liquidity-constrained households in times of crisis.

¹² For a more detailed discussion of the concepts of NAIRU and of hysteresis, see chapter 7.9 in Snowdon and Vane (2005).

¹³ Models such as the New Area-Wide Model of the ECB (or the model of Barro, 1974) start from the assumption of a situation of almost full employment (or of an unemployment rate that is close to its "natural" level) and presume that, following negative shocks, market mechanisms or monetary policy will cause unemployment rates to bounce back to the old equilibrium after a certain period. The aforementioned hysteresis effects, however, prevent a reversion to the "old" market equilibrium.

¹⁴ Fiscal multipliers for transitory shocks range from 0.6 for tax reductions and transfer shocks to 1 for government consumption and slightly larger than 1 for government investment shocks (assuming a large degree of monetary accommodation and no implementation lags).

contraction and the need to offset negative confidence effects among consumers. As outlined in section 1, a timely implementation of measures is essential to ensure the intended anticyclical impact. At the present juncture there is, however, little risk that the measures might become effective too late, i.e. have a procyclical effect as a result of decision-making and implementation lags, as history shows that economic crises involving banking crises tend to last longer than “normal” recessions. Moreover, in view of the global dimension and the depth of the crisis and of the fact that all demand aggregates have been hit by the crisis, stimulus packages need to be sufficiently large to make a significant dent.

Another challenge is the need not to lose sight of the *sustainability* goal of fiscal policy in view of the need for large and timely action. In line with the objectives of the Stability and Growth Pact, national fiscal policies need to set corresponding consolidation measures when the economy bottoms out or begins to recover, especially given the budgetary implications of ageing. Therefore, stimulus packages need to come with a credible exit strategy to prevent concerns about the sustainability of public finances, which would lead to confidence losses among investors. Failure to do that would result in rising financing costs destroying the positive effects such measures may have had earlier. Dwindling public confidence would, in turn, make transfer increases

and tax cuts less effective – which makes the case for a strong emphasis on one-off measures (such as infrastructure projects) or measures that may be reversed easily.

Of course, *sustainability* also means that measures that have positive effects in the short run should not have adverse effects in the long run. While efficiency-increasing measures may not have top priority given the low degree of capacity utilization at the current juncture, it is essential to consider the implied long-term effects of measures aimed at producing short-run effects.¹⁵

Any protracted crisis principally conflicts with the requirement to take *temporary* action, i.e. to rapidly unwind those measures when no longer needed. Unwinding transitory measures – above all in case the negative output gap widens – would after all prolong the crisis. Given the dramatic dimension the crisis has reached, economic policymakers would thus be well advised to signal that they stand ready to take further action, *contingent* on a further deterioration of the crisis.

Finally, the fact that the demand setback affects all demand aggregates would call for implementing strongly *diversified* packages to boost consumer and business confidence through the fiscal stimulus measures. What also supports a diversified approach is that different measures come with different lags of effectiveness, and with different multiplier effects (the size of which is subject to uncertainty at present).

¹⁵ In its European Economic Recovery Plan, the European Commission therefore sorted its proposals for action in line with the priority areas of the Lisbon strategy: In the labor market context, the European Commission recommended, among other things, to permanently reduce VAT rates for labor-intensive services, and to increase unemployment entitlement periods and amounts. The latter would also contribute to reinforced passive stabilization. Moreover, the European Commission recommends enhancing access to financing for SMEs, stepping up investment in infrastructure (such as broadband infrastructure projects and trans-European transport projects) and energy efficiency measures, and increasing investment in research and innovation. These recommendations are broadly in line with the short- and medium-term objectives for fiscal measures outlined by the IMF (2008b).

3 Discretionary Fiscal Stabilization Measures in Austria

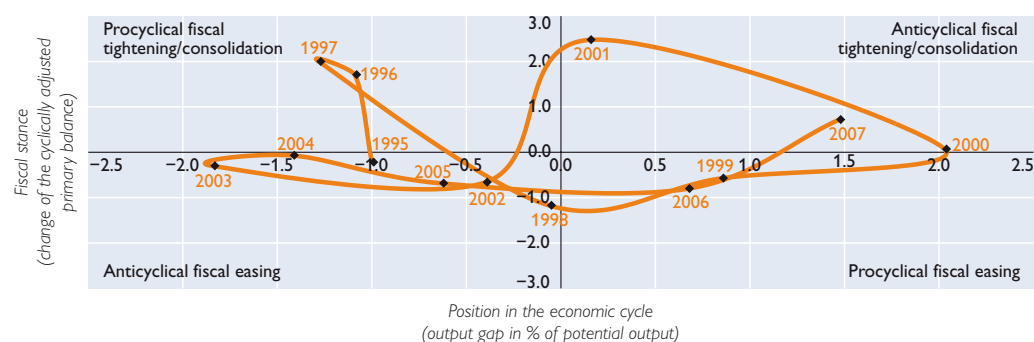
Judging from the fiscal stance, that is to say assessing the orientation of discretionary fiscal measures in conjunction with the development of the output gap, Austria's fiscal policy was procyclical throughout the 1990s, be it as a result of EU accession in 1995 or as a result of the consolidation required to meet the convergence criteria for introducing the euro (chart 1). The goal of meeting the fiscal convergence criteria laid down in the Maastricht Treaty by 1997 required extensive expenditure and revenue measures (Katterl and Köhler-Töglhofer, 2005). In the high-growth years following the introduction of the euro, fiscal consolidation was subsequently put on the back burner. In the current decade, however, policymakers have again resorted to fiscal stimulation and have already adopted a number of growth and employment packages,¹⁶ including incen-

tives for investment and research, labor market activation policies and infrastructure investment projects.¹⁷ As is evident from chart 1, discretionary fiscal measures have tended to be anticyclical in Austria since 2000.

The tax reforms of 2004 and 2005 have had positive growth effects, even though the reform of corporate taxation was basically aimed at enhancing medium- to long-term growth, while the reform of individual taxation was subject to some controversy, as it increased the degree of tax progressivity for middle-income earners. However, the tax reform was not primarily meant to stimulate the economy anticyclically but was motivated by medium- to long-term growth and structural policy objectives. Some reforms adopted earlier, in the late 1980s and in the 1990s, had been driven primarily by structural policy considerations and had happened to produce “economic stimulus wind-falls.”

Chart 1

Fiscal Stance in Austria from 1995 to 2007



Source: AMECO database, OeNB.

Note: The structural balance for 2004 has been adjusted for capital transfers made from the government to Austrian Railways (debt relief and capital injection).

¹⁶ For an overview of the string of reforms (stimulus packages of 2001 and 2002, growth and location package of 2004, tax reform of 2004/05), see Aiginger (2005), who also provides estimates of actual growth effects achieved. The year 2005 saw the adoption of additional stimulus measures, especially employment initiatives.

¹⁷ “Given the intention to consolidate the budget in the medium term and given the risk that the government measures might be nullified through imports or deadweight losses, the volume of measures was limited in the first place.” (translated from Aiginger, 2005, p. 14).

3.1 Composition of Current Fiscal Stabilization Measures

Given the comparatively strong increase in inflation starting in the fall of 2007 and continuing through the first half of 2008, compared with the level of the preceding years, the Austrian government adopted a number of measures aimed at softening the inflation effects on the disposable income of households. Those measures consisted above all in increasing transfer payments (such as pensions and family allowance) and in lowering unemployment insurance contributions for lower-income groups. As argued by Gnan (2009), many of the income-support measures originally intended to help curb inflation have turned out to be useful and adequate also in the entirely different environment of a sharp recession.

In response to the looming economic downturn, the government adopted a stimulus package designed to facilitate access to funding notably for Austrian businesses, and in particular for SMEs, through loans and guarantees. When it became clear that the downturn would turn into a pronounced contraction, the government followed suit with a second stimulus package and, moreover, brought forward the announced personal income tax reform. The two stimulus packages contain higher infrastructure spending by public companies classified to the private sector, such as ÖBB, the Austrian Railways and ASFINAG, the Austria's highway authority (first package) and BIG, the public facility management company (second package). To stimulate private investment demand, the second package also provides for the

transitory option to frontload depreciation (up to 30%; expires at the end of 2010) and transitory subsidies for energy efficiency renovation projects. In addition, the government has appropriated higher funds to research promotion and to regional job support initiatives (table 1); it has adopted a car subsidy as an incentive for car-owners to scrap old cars and buy new, fuel-efficient vehicles; and it has agreed to extend the short-term working rules.

The mix of measures is meant to stimulate both consumer expenditure and business investment, and it has been designed to balance short-term and medium-term goals. Stabilization measures invariably entail distribution and structural policy effects, as argued above. The measures to dampen inflation effects are cases in point as they also contain a major distributional component, resulting above all from the introduction of a 13th family allowance installment as well as increases in long-term care allowances, payment of a federal heating subsidy, and cuts in low-income workers' unemployment insurance contribution.¹⁸ In addition, the first stimulus package and parts of the second stimulus package reflect the intentions of the Lisbon strategy (investing more in infrastructure projects and facilitating research and job initiative projects) as well as the intention to make Austrian households less dependent on fuel so as to permanently reduce the pass-through of energy cost-driven inflation to the disposable income of households.

Below, readers will find a systematic assessment of the individual measures (see sections 3.1.1 through 3.1.4)

¹⁸ *The idea is to enhance the net wages of low-income workers and thereby generate a positive influence on the supply of labor.*

Table 1

Volume and Intention of Stimulus Measures Announced in 2008 and 2009

	Volume		Categorization
	2009	2010	
<i>EUR million</i>			
Measures to combat inflation			
Lower unemployment insurance contribution	300	300	strengthening consumption
Higher pensions ¹	300	110	strengthening consumption
Student tuition fee partly abolished	150	150	strengthening consumption
13 th family allowance installment	250	250	strengthening consumption
Lower VAT rate for medication ²	100	100	strengthening consumption
Higher long-term care allowance	120	120	strengthening consumption
Higher heating subsidy	30	0	strengthening consumption
Additional wage tax exemptions	150	150	strengthening consumption
First economic stimulus package			
Railway (ÖBB) and highway (ASFINAG) infrastructure projects ³	225	225	infrastructure investment ⁸
Higher credit line (EIB, KfW, ERP) ³	500	500	investment incentive
Higher guarantee line for AWS (Austria Wirtschaftsservice) funding ³	400	400	investment incentive
Higher government subsidy for savings plans with building and loan associations	20	20	investment incentive
SME fund for growth projects ³	40	40	investment incentive
Internationalization drive	25	25	export promotion
Broadband drive	10	0	investment incentive
Second economic stimulus package			
BIG public facility management projects ^{3,4}	355	520	infrastructure investment ⁸
Accelerated depreciation (temporary) ⁵	250	350	investment incentive
Energy-efficiency renovation	100	0	investment incentive
Research facilitation	50	50	investment incentive
Regional job support initiatives	75	75	saving jobs, strengthening consumption
Public funding for pre-school kindergarten year	30	70	strengthening consumption
Tax reform including family package⁶	2,910	3,210	strengthening consumption
Other measures			
Subsidies for short-term working	200	200	saving jobs, strengthening consumption
Government car subsidy	20		strengthening consumption
Total volume of measures	6,610	6,865	
of which having an impact on the deficit⁷	4,095	4,758	

Source: Austrian Ministry of Finance, OeNB.

Note: The volume of measures reflects the increase over the 2007 budget and has been prepared on an accrual basis.

¹ One-off payment in 2009, permanent increase above inflation rate by 0.2 percentage points; abolition of the one-year waiting period for pension adjustment entitlements.

² The main beneficiaries of the VAT reduction on medication are the cash-constrained social security funds.

³ Not relevant at all for the Maastricht-based deficit measure (or only to a minor extent).

⁴ In turn, BIG will receive an additional EUR 20 million per year in rental payments.

⁵ Delayed fiscal effect (tax collection lag).

⁶ Fiscal effect partly delayed (tax collection lag).

⁷ Adjusted for the tax collection lag.

⁸ Off-budget: not classified under the government sector under ESA 95 (and thus not relevant for the Maastricht deficit).

3.1.1 Boosting Consumption by Raising Disposable Personal Income

While the private saving ratio kept increasing, consumer demand was comparatively soft even in the last few (very good economic) years. Amid the pronounced contraction, which has been

accompanied by an exceptionally sharp decline in unemployment, consumer demand will at best stagnate in 2009 at the 2008 level (European Commission, 2009). Therefore, fiscal measures to raise household disposable income should thus help stabilize consumer de-

mand. This is the intention of most of the government's income tax reform measures, which have been brought forward by one year. Those measures include a reduction of tax rates (freeing up about EUR 2.3 billion¹⁹) and a family package (corresponding to about EUR 500 million, resulting among other things from higher child tax credits and the move to make child care partly tax deductible). Moreover, the government made donations to charity and aid organizations tax deductible (about EUR 100 million) and increased the tax deductibility cap for church tax payments. At the same time, the preferential tax treatment for stock options was abolished.²⁰ Moreover, the tax burden of self-employed persons will be reduced from 2010 by a broadening of the profit allowance (freeing up roughly EUR 300 million, already adjusted for the concomitant abolition of preferential treatment for profit carried forward).

In the short run, those parts of the reform that boost disposable income tend to increase consumer demand;²¹ in the medium term, the measures are expected to also have a slightly positive effect on labor supply and demand. Some parts of the tax reform of 2009 took up the thread of the tax rate changes implemented in 2004 and 2005 and the cuts in unemployment insurance contributions for lower income groups in 2008, which were specifically designed to boost smaller incomes. Those measures – such as the higher profit allowance applicable from

2010 – reflect distribution rather than growth intentions. Basically, this is also true for the rate reduction, from which the higher income groups tend to benefit more (in absolute figures). While this move is to be welcomed from a structural policy perspective (as it smooths out the bracket creep of recent years and provides incentives for accumulating human capital), it would have been more effective from a stability policy perspective to put a stronger focus on lowering the tax burden of low-income households, which have a comparatively larger marginal propensity to consume and/or are highly liquidity constrained.

On balance, some of the measures aimed at dampening the impact of inflation on disposable household income imply a sizeable increase in the disposable income of low-income groups, such as the (staggered) decrease of low-income groups' unemployment insurance contributions, the introduction of a 13th family allowance installment, the reduction of VAT on medication, the (partial) abolition of student tuition fees, the increase of long-term care allowances and the (frontloaded) increase of pensions above the inflation rate (plus a one-off payment). Thus, these measures can be expected to have a comparatively stronger stimulating effect on consumption in the short term, as lower-income households stand to benefit disproportionately more from those measures than from the tax reform. More or less the same holds true for parts of the family pack-

¹⁹ The figures listed here refer to the long-term effects of the respective measures, i.e. they include both measures that have an immediate effect on the budget (such as child tax credits, which are paid out), as well as lagged effects in the form of higher tax repayments following income tax assessments (reflecting for example the tax deductibility of donations).

²⁰ The – limited and offsetting – effects resulting from the higher deductibility cap for church tax payments and the abolition of preferential tax treatment for stock options are likely to cancel each other out.

²¹ However, given the current external macroeconomic developments, it cannot be ruled out that increased precautionary saving by households apprehensive about future developments may broadly nullify the stimulus effects.

age, above all for the increase of the child tax credit, which is not income-linked.

Another measure announced in the stimulus packages, namely government funding for the final preschool year, which will be compulsory, would appear to have a limited positive impact on the disposable income of households with small children, but will definitely increase public consumption given the need to hire more personnel.

Last but not least, the job support measures, such as short-term working rules and the regional job support initiatives, also have a consumption-boosting effect.

3.1.2 Measures to Fuel Business Investment Demand and Improve Corporate Financing Conditions

Business investment demand has been hit particularly hard by the current economic crisis. The successive tightening of financing conditions since the financial turmoil began in the fall of 2007, the sharply declining domestic and external order intake, dwindling export demand and the ensuing extremely bleak sales perspectives, together with a rapid drop in capacity utilization have caused corporate investment demand to contract sharply. As a result of the global crisis, companies will continue to retrench and cut back significantly on investment.

With a view to easing the ever tighter financing conditions ensuing from the financial crisis as well as to facilitate ongoing access to corporate loans, above all the first stimulus package provided support through a EUR 900 million expansion of credit lines (subsidized loans granted by the Kredit-

anstalt für Wiederaufbau (KfW) banking group, under the European Recovery Program (ERP) and by the European Investment Bank (EIB)) and of guarantee lines (provided by Austria Wirtschaftsservice (AWS)) for SMEs. In addition to those measures, a limited amount of funds was also appropriated for the establishment of an SME fund for growth projects and for continuing internationalization initiatives.

The second stimulus package facilitates accelerated depreciation (up to 2010), includes incentives for investing in energy-efficiency renovation and job-creation initiatives (subsidies for firms that create jobs, facilitation of regional job support programs) and provides additional funds for research and innovation (paying for state-of-the-art equipment at universities, etc.). Accelerated depreciation reduces the tax base initially, i.e. it makes a higher share of investment expenditure tax deductible in the year of investment while increasing the tax base in the following years.²² From a firm-level perspective, this measure is tantamount to an interest-free investment loan, subject to the limitation that firms need to achieve a profit in the first place to actually benefit from this measure. The underlying intention of this measure is to encourage companies to bring forward planned investment projects and thus help cushion the sharp drop in investment demand. From the government's point of view, this measure is comparatively cost-efficient, at least from an intertemporal perspective. From a firm-level perspective, the effect is broadly similar to the effect of government loans as well as guarantees, which lower the cost of (debt) financ-

²² Hence the loss in revenues expected by the finance ministry for the period from 2010 to 2012 is expected to be offset by revenue increases in the following years.

ing compared with private sector loans without state guarantees; however, the latter also benefit firms that do not achieve profits. Another alternative would be a special investment tax credit for new investment above previous-year levels, as offered by the Austrian government in the first half of the current decade, which is, however, somewhat controversial because of the resultant deadweight losses. What would make such tax credits attractive for companies, of course, is that they need not achieve a profit to actually benefit from this measure, because such tax credits are after all an investment subsidy.²³

Similar to the economic stimulus measures implemented in the first half of the current decade, some of the subsidies or funds have been appropriated for facilitating research, which means that those measures have been designed both to stimulate demand in the short term and to boost potential long-term growth. Yet those measures, too, are likely to come with nonnegligible deadweight losses. According to evidence compiled by Aiginger (2005, p. 20) for 2003, only 3% of manufacturing firms and 15% of service providers with R&D activities indicated to have tackled research projects they would not have implemented without the tax credit or investment subsidy. Furthermore, Austria features in the mid-ranks of international comparisons (Cincera et al., 2009) cross-tabulating public R&D expenditure and output indicators. Rather than implying the need to increase funding, those figures would

call for a more efficient use of public funds.

3.1.3 Stimulating the Economy by Reinforcing Public Investment Demand

In the current exceptional economic situation, it cannot be ruled out that the measures adopted so far to stimulate consumer and business demand may fail to create the expected positive demand effects – be it because of the precautionary saving bias of households mentioned above or because of the particularly pessimistic assessment of corporate sales perspectives. In this case, only demand impulses generated by the government will have stabilizing effects for the overall economy and for employment. Therefore, both stimulus packages also provide for higher “public” investment spending by state-owned companies that are classified to the private sector, such as the federal railways (ÖBB), the highway authority (ASFINAG) and the public facility management company (BIG). In the coming four years, ÖBB is going to invest an additional EUR 700 million, and ASFINAG another EUR 200 million, while BIG envisages increasing its investment spending by EUR 875 million in 2009 and 2010. As those companies statistically belong to the private sector, the higher investment spending does not have an impact on the Maastricht debt and deficit measures. At the same time, they do not qualify as public investment, but add to private sector investment.²⁴

²³ The fact that this measure was designed as a subsidy – plus nonnegligible deadweight losses – caused the impact on the budget balance to be much stronger than anticipated. Aiginger (2005) puts the loss in tax revenues at approximately EUR 1.7 billion.

²⁴ The statistical reclassification of public companies has increased the Austrian government’s cyclical policy leeway, above all since it has been committed to meet the Maastricht criteria and to comply with the Stability and Growth Pact. This is evident not only from the two latest economic stimulus packages, but has already been true for the earlier stimulation packages.

3.1.4 Stimulation of Exports

The current economic contraction reflects above all export setbacks. Given Austria's export structure, there is but limited room for public export stimulation, and it basically focuses on continuing export initiatives and expanding export guarantee schemes. In addition, short-term working rules contribute to retaining the specific know-how of export-oriented firms in the near future.

3.2 Quantitative Effects of Economic Stimulus Measures on Growth and Employment

On balance, the stabilization measures adopted in 2008 and discussed in this article, to the extent that they may be quantified, have been projected to push up GDP by more than $\frac{3}{4}\%$ of GDP in 2009, based on simulations with the OeNB's macro model. By 2010, GDP should have increased by about $1\frac{1}{3}\%$ compared to a baseline scenario without any such measures. At the same time, the measures are expected to translate into a sizeable positive effect

on employment, creating close to 25,000 jobs in more than two years (calculated cumulatively, not reflecting job support initiatives and not adjusted for short-term work schemes).

4 Summary

In "normal" times, a whole range of arguments would discount the use of discretionary fiscal policy for stabilization purposes. Yet amid the current contraction, supporting the automatic stabilizers by taking discretionary fiscal action would appear to be a useful countermeasure to soften the rapid setback in private demand and to dampen the sustained negative effects on the overall economy ensuing from a sharp increase in unemployment as well as the NAIRU.

That said, the adopted economic stimulus and tax reform measures will at best mitigate the contraction of the real economy triggered by the global financial crisis – but they must not be expected to prevent the recession from unfolding, even taking into account potential positive spillover effects from

Table 2

Estimated Growth and Employment Effects of Economic Stimulus and Tax Reform Measures

	Volume in EUR million		Employment ¹ in persons		GDP in % of baseline solution	
	2009	2010	2009	2010	2009	2010
Consumption-stimulating measures	4,360	4,460	9,312	17,840	0.57	0.89
excluding inflation-dampening measures	2,960	3,280	5,640	11,999	0.34	0.61
Investment incentives and export facilitation	1,395	1,385	590	1,079	0.05	0.07
Investment in infrastructure	580	745	2,698	6,299	0.16	0.33
Job support measures ¹	275	275	–	–	0.04	0.06
Measures adopted by the new cabinet (in office since December 2008)	5,210	5,685	8,927	19,378	0.59	1.08
Total (incl. inflation-dampening measures)	6,610	6,865	12,600	25,218	0.82	1.36

Source: Austrian Finance Ministry, OeNB.

¹ The job support effects of short-term working rules and of the job support initiatives cannot be quantified at present.

Note: Simulation with the OeNB's macro model (AQM). Volumes are annual totals (reflecting increases over the 2007 budget), effects on employment and GDP are cumulative. Underlying assumption: no tax reform anticipation effects.

stabilization measures undertaken by major trading partners and neighboring states.

Many of the adopted measures have been designed to improve long-term growth rather than stimulating short-term private demand. This is above all true for the tax reform, which is to be welcomed from a structural perspective, given the comparatively high tax burden on labor in Austria. Yet with a view to reinforcing stabilization effects, policymakers would have had to provide more support to low-income groups and to liquidity constrained households. At the same time, other measures boosting disposable income do reflect such intentions.

As in the other European countries, the measures adopted in Austria contribute to driving the general government deficit ratio beyond the 3% threshold – possibly by a sizeable margin. Together with the bank support

packages, these measures will push up the general government debt ratio as well as the ratio of interest expenditure to tax revenue, thus causing the government's fiscal policy leeway to shrink. Those effects would be even more pronounced should the individual governments, including Austria, fail to convince investors and financial agents that public households remain sustainable in the long run. What is thus essential is an explicit commitment to rapid consolidation when the economic crisis has ended, so as to preempt any loss of confidence on the part of potential investors. The latter would nullify any short-term economic stimulus, as the Austrian government would have to face much higher yield spreads and as the loss of confidence by the general public would become entrenched. Tax cuts and transfer increases would then be less effective.

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