Debt sustainability and economic convergence of euro-area Member States: Challenges and Solutions

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Provided at the request of the Economic and Monetary Affairs Committee

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Abstract

Several member countries of the Eurozone are plagued by increasing government debt and weak economic growth, raising concerns about fiscal sustainability. This paper discusses policy options to improve fiscal sustainability, focusing on two proposals: more public investment and growth oriented tax reforms. In recent years, a significant part of fiscal adjustment has been achieved by cutting public investment, rather than consumption spending. This suggests that there is potential for viable investment projects, but additional investment should be financed by a restructuring of public expenditure, not by additional public debt. Proposals to revise the Stability and Growth Pact towards extending the room for debt financing of investment or to interpret the existing rules more ‘flexibly’ would undermine the credibility of the pact and question the commitment to fiscal sustainability. Tax policy can contribute to more growth by reducing taxes on corporate income and labour income, financed through higher taxes on consumption and higher recurrent taxes on immovable property. There are various options for temporary tax changes which would stimulate private consumption and investment spending in the short term.
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LIST OF ABBREVIATIONS

GDP  Gross Domestic Product
SGP  Stability and Growth Pact
EFSI  European Fund for Strategic Investment

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EXECUTIVE SUMMARY

The combination of growing government debt and weak economic growth in several Member States of the Eurozone raises concerns about the sustainability of fiscal policy finances. While most observers agree that more should be done to consolidate public finances and to boost economic growth, there is less agreement about what needs to be done.

This paper explores policy measures to improve debt sustainability, either by bringing down public debt or by boosting economic growth, or both, against the backdrop of the institutional framework for fiscal policy governance in the Eurozone, in particular the Stability and Growth Pact (SGP). The extent of further fiscal adjustment that would be needed to stabilise and eventually bring down debt to GDP ratios, given the currently predicted rates of economic growth, differs across countries and depends on a variety of factors, in particular on the future level of interest rates and the level of future nominal growth rates. Although current levels of interest rates are unusually low, several countries need to undertake considerable efforts to reverse the trend in their debt ratios.

It is unlikely that fiscal consolidation measures alone will be sufficient to reverse the trend towards increasing government debt. Achieving more economic growth is of prime importance. Here a wide range of policy areas is relevant. For instance, raising economic growth requires action in many fields including the labour market, education, sectoral regulations, taxes and others. The present paper focuses on two policy options, which are more closely related to fiscal policy:

1. More public investment and
2. Growth oriented tax reforms.

Our analysis leads to the following conclusions and policy recommendations:

1. A significant part of the fiscal consolidation measures taken since the outbreak of the European debt crisis have been cuts in public investment. This means that the contribution of this fiscal adjustment to debt sustainability is more limited than what an adjustment with a greater emphasis on consumption expenditures would have delivered.

2. For the same reason it is likely that viable projects are available in countries which have neglected public investment in recent years.

3. It should not be taken as given that additional public investment spending is financed by debt. Priority should be given to financing public investment by reducing public consumption spending.

4. Financing additional investment by additional public debt cannot be justified by the so-called ‘golden rule’ of fiscal policy. The golden rule states that debt financing should be restricted to net public investment, not gross investment. Net public investment is negative in many Eurozone countries.

5. Calls to reform the SGP to create additional room for debt financed public investment are misguided. The existing flexibility is significant and may give rise to conflicts with the main objective of the SGP, which is to preserve fiscal sustainability. A reform of the SGP towards allowing even more debt financing would damage the credibility of the pact and might lead to higher risk premia in government bond markets.

6. The member countries of the Eurozone should review their tax systems with the objective of moving towards more growth friendly tax structures. This would involve a reduction of corporate income taxes and direct taxes including taxes on labour. These tax cuts should be financed by higher taxes on consumption and higher recurrent taxes on immovable property.

7. If countries see the need for a temporary to boost consumption and investment spending, several tax instruments could be employed: A temporary reduction in standard VAT rates or the announcement of a VAT rate increase in the future, a temporary reduction in real estate transactions taxes or a temporary increase in tax allowance for investment in equipment. Various options to maintain revenue neutrality are proposed.
1. INTRODUCTION

The combination of growing public debt and weak economic growth in the Eurozone is a matter of rising concern. While both policy makers and independent experts broadly agree that the current economic development of the Eurozone may not be sustainable, views about what needs to be done differ widely.

One view is that fiscal consolidation (or fiscal austerity) went too far and should be blamed for causing the recent decline in growth rates. From this perspective, more expansionary fiscal and monetary policies are needed. This approach implies that fiscal consolidation should be addressed later, in a more solid economic environment. Proponents of this view argue that countries with ‘fiscal space’, in particular Germany, should increase public spending or cut taxes to boost demand.

The opposing view argues that expansionary fiscal policy would provide only temporary relief at the price of ever increasing public debt, delay unavoidable adjustments and divert attention from unpopular but necessary ‘structural reforms’, in particular labor market reforms and reforms of the tax system. This view also emphasizes the need for price adjustments to boost competitiveness.

Yet another view is that the current economic woes of the Eurozone reflect the detrimental impact of debt overhang in the private and the public sector. Highly indebted households and private companies cut down their spending to reduce the debt burden and they will find it hard to raise funding even if they have attractive investment opportunities. Highly indebted countries will find it difficult to attract investors because investors fear that the country will increase taxes or cut public services in the future to finance the debt. Highly indebted countries may also be vulnerable to runs and their ability to absorb future economic shocks is more limited than that of countries with lower debt levels. Therefore high levels of debt can be seen as a ‘tax on economic growth’. Yet addressing the debt overhang issue is difficult. ‘Normal’ deleveraging may be a long and painful process. Debt restructuring is an important way of dealing with excessive debt. But the magnitude of the debt problem is such that debt restructuring may easily undermine financial stability, in particular when it comes to the restructuring of public debt.

This paper discusses policy measures which may help to improve debt sustainability, either by bringing down public debt or by boosting economic growth, or both, against the backdrop of the institutional framework for fiscal policy governance in the Eurozone, in particular the SGP. We focus on two policy options: More public investment and growth oriented tax reforms. The setup of the paper is as follows. Section 2 analyses how much fiscal adjustment is needed. Section 3 discusses policy options to improve fiscal sustainability, focusing on public investment and tax reforms. Section 4 concludes.

2. FISCAL SUSTAINABILITY IN THE EUROZONE: HOW MUCH ADJUSTMENT IS NEEDED?

Fiscal sustainability has different aspects and can be measured in different ways. A simple and widely used indicator of fiscal sustainability is the debt to GDP ratio. Although public finance theory has little to say about the optimal level of the debt to GDP ratio, current debt levels and current debt dynamics in many Eurozone countries are a reason for concern. This is not just because a high debt ratio implies high interest payments, higher taxes and fewer resources for the provision of public services in the future. High public debt levels are problematic because they make countries vulnerable to future crises which require fiscal space to absorb economic shocks. Moreover they make countries vulnerable to investor panics and a breakdown of funding, in particular in cases where the maturity structure of debt is unfavorable.

After the outbreak of the financial crisis in 2008 debt to GDP ratios have soared in all Eurozone countries, as graph 2.1. illustrates.
Recently some countries managed to stabilize their debt ratios. But in other countries, in particular the periphery countries most affected by the Eurozone debt crisis, they continue to rise.

What is necessary to stop the trend towards increasing public debt levels? The change in the debt to GDP ratio over time can be expressed by the following formula (for the derivation see the appendix):

$$\Delta d_t = \frac{(r_t - g_t)}{(1 + g_t)d_{t-1} - p_t}$$

(1)

The change in the debt ratio in year $t$ depends on the interest rate on government debt ($r_t$), the nominal growth rate of GDP ($g_t$), the debt ratio the year before ($d_{t-1}$) and the difference between government revenue and expenditures excluding interest payments, in per cent of GDP (the primary surplus ratio, $p_t$). If the interest rate exceeds nominal GDP growth, stabilizing or even reducing the debt to GDP ratio requires a primary surplus. The required primary surplus is higher the higher the initial debt level.

By setting $\Delta d_t = 0$ equation (1) allows to calculate the primary surplus required to stabilize the debt to GDP ratio. Figure 1 shows the results of calculations for the primary surplus required to stabilize the debt to GDP ratio at its 2013 level in France, Germany and the periphery countries most affected by the debt crisis. The results are compared to the actual primary surplus realized in 2013. The calculations suggest that many countries, in particular Ireland and Spain, need to make considerable additional consolidation efforts to stabilize their debt ratios.

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1 This is a widely used approach for analyzing fiscal sustainability and required adjustments, for similar calculations with slightly different assumptions and underlying data see e.g. EEAG (2014).

2 The result that Greece may run a primary deficit and still stabilize its debt ratio is due to the fact that interest payments are currently very low, due to special conditions granted by the creditors of Greece, while forecasts for nominal economic growth underlying our calculations are relatively high.
Clearly, for some countries including not only Greece but at least also Italy, Portugal and Ireland, stabilizing the debt ratio is not enough. The rules of the SGP imply that countries with high debt ratios should reduce their debt towards the 60% debt to GDP reference value, reducing the gap by 1/20 each year. Table A1 in the appendix shows the primary surpluses that would be required to achieve this more ambitious target. Unsurprisingly, they are significantly higher than those required to stabilise the debt ratios.

One should note that the results for the required primary surpluses need to be interpreted taking into account the limitations of the underlying approach. First, the results depend strongly on the assumptions made about the difference between the interest rate on government debt and the nominal growth rate of GDP. This is illustrated by table A2 in the appendix, which reports results of the same calculations where we have assumed that the difference between the interest rate and the nominal growth rate of GDP is one percent larger than assumed here.

Second, the calculations presented here do not take into account effects of changes in the primary balance on GDP growth. Cutting public expenditure or raising taxes will affect growth at least in the short term. The impact will depend on the size of fiscal multipliers and the persistence of the effects (Eyraud and Weber, 2013).

Third, these calculations do not take into account implicit debt. Some Eurozone member face considerable fiscal sustainability challenges caused by future expenditures related to population ageing. This implicit debt differs in various respects from explicit debt, in particular in that it can be reduced through reforms of the social security system, for instance. For a complete assessment of fiscal sustainability, implicit debt should nevertheless be taken into account.

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3 The assumptions made in the calculations which generate the results reported in table 1 are given in the appendix.

4 Graph A3 in the appendix provides an overview over implicit debt in the Eurozone countries.
2. POLICY MEASURES TO IMPROVE FISCAL SUSTAINABILITY

The contribution a policy measure can make to improve fiscal sustainability depends on how it affects the three factors that drive the debt to GDP ratio (as described by equation 1),

i.) the primary balance,
ii.) the interest rate and
iii.) the GDP growth rate.

Many policy measures aim primarily at one of these factors but have side effects on others. For instance, expenditure cuts and tax increases aim at improving the primary budget balance but they reduce demand, at least in the short term, and may therefore reduce economic growth. A debt financed expansion of public investment would boost economic activity but this would come at the cost of a higher primary deficit and possibly also higher interest rates.

Which policy measures should be taken to improve debt sustainability? It is unlikely that fiscal consolidation measures alone will be sufficient to reverse the trend towards increasing government debt. Achieving more economic growth is of prime importance. Here a wide range of policy areas is relevant. For instance, raising economic growth requires action in many fields including the labour market, education, sectoral regulations, taxes and others. In the following we will focus on two policy options more closely related to fiscal policy:

1. More public investment and
2. Growth oriented tax reforms.

Clearly, this does not mean that other economic policy areas are less important.

3.1. More public investment?

Increasing public investment to boost growth is probably the most widely debated economic policy measure in the Eurozone. Although public investment is primarily a responsibility of the Member States, the European Commission which came into office in 2014 has made investment, not just public but also private investment, one of its top policy priorities. This is reflected in the Commission’s ‘Investment Plan for Europe’.\(^5\) A key element of this plan is the newly created ‘European Fund for Strategic Investment’ (EFSI). The fund will be endowed with a guarantee of 16 billion Euros and a contribution by the EIB of 5 billion Euros. These funds will be combined with private capital. The EFSI aims at raising at least 315 billion Euros for additional investment in Europe.

Is there empirical evidence that public investment generally encourages growth? Measuring the impact of public investment on economic growth poses a number of statistical challenges. Most importantly, causality may run from economic growth to investment, as well as vice versa, so that the growth effects of public investment are difficult to identify.\(^6\) But existing studies of the growth effects of public investment do support the view that public investment has a positive impact on growth. The rates of return measured by existing studies vary widely but are generally positive. However, careful planning and effective governance of public investment projects is of key importance.\(^7\)

\(^6\) The recent economic crisis in the Eurozone is a good example. It is clear that the economic downturn and the need for fiscal adjustment have caused the decline in public investment. At the same time the reduction in investment has certainly contributed to the collapse of demand, deepening the downturn. Given this interaction it is difficult to disentangle the causal effect of public investment on growth and the impact of the general economic situation on public investment expenditure. In addition, public investment is likely to affect economic growth in the medium to long term, which makes the identification of the effects even more difficult.
\(^7\) For a recent survey of the empirical literature see Pereira and Andraz (2013).
3.1.1. The case for more public investment in the Eurozone

There are three key arguments in favor of increasing public investment in the Eurozone. Firstly, a lack of public investment may undermine the sustainability of public finances as much as excessive debt because neglecting investment today increases the need for investment expenditures in the future. This suggests that, as an instrument to stabilize demand in the short term, more investment spending is easier to reconcile with sustainable public finances than more public consumption.

Secondly, public investment can boost economic growth by raising the productivity of labor and private investment. Thirdly, a large part of the cuts in public spending that have been made in the highly indebted countries of the Eurozone since the outbreak of the crisis have focused on public investment. Graph 3.1. illustrates the development of public investment for selected Eurozone member countries between 2008 and 2013.

Graph 3.1.: Change in gross public investment relative to the preceding year (% of GDP)

Ireland, Greece, Spain and Portugal have reduced their public investment spending massively during their fiscal adjustment. The focus on cutting public investment has two implications. Firstly, the fiscal adjustment has done less for improving fiscal sustainability than a more balanced fiscal consolidation program with more emphasis on cutting public consumption could have achieved. Secondly, the neglect of public investment does suggest that productive investment opportunities may now be available in some countries, even if one takes into account that overinvestment may have taken place in the years before 2008.

3.1.2. The financing of public investment and the ‘golden rule’

Proposals to increase public investment often take it for granted that the additional investment should be financed by more public debt. This is highly problematic. The key argument in favor of debt financing is that more investment increases productivity and tax revenues in the future, so that the additional tax revenue can be used to service the debt. Public consumption, in contrast, does not increase future growth and should therefore be financed by current tax revenue. The fact that public investment creates assets which generate future payoffs is the basis of the so-called ‘golden rule’ of fiscal policy, which links...
public debt to public investment. The golden rule states that fiscal policy is sustainable if net public debt, that is gross public debt minus public sector assets, remains constant over time.

The golden rule is helpful as a guideline for fiscal policy but it is important to bear in mind that the golden rule can only justify the debt financing of net public investment, not gross public investment. Investment needed to preserve the existing stock of public capital should be financed out of current revenues. If gross public investment is financed entirely by debt the level of net public debt will grow and debt sustainability is undermined.\(^8\) Graph 3.2. compares current structural budget balances to net public investment levels in selected Eurozone countries.

**Graph 3.2.: Budget balances and net public investment 2013**

\[\% \text{ of GDP}\]

In most countries included here, net public investment is much lower than the current budget deficit. In Greece, Spain, Italy and Portugal net public investment is even negative. Fiscal policy guided by the golden rule would imply that an increase in public investment cannot be financed by additional debt because the deficit is already much too high. More public investment needs to be financed by increasing taxes or by cutting public consumption.\(^9\)

### 3.1.3. The role of private investors for public investment projects

Since it is difficult for highly indebted governments to finance additional public investment the mobilization of private capital for public investment, for instance in the form of public private partnerships (PPPs) is a widely discussed option. While PPPs may offer significant advantages, they also involve a number of risks.

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8 Buti et al (2003) put this as follows: ‘Indeed, it is only the net addition to public capital that should be financed via borrowing while the part that covers depreciation should remain tax-financed. While commonly agreed estimates of amortisation are not available, in developed countries in which infrastructures are partly developed by subjects not included in general government, the level of net investment seems limited and not necessarily inconsistent with the close-to-balance rule of the SGP.’, ibid, p. 17.

9 Experience with past fiscal adjustments suggests that a focus on expenditure cuts rather than tax increases may be preferable, see Alesina and Ardagna (2012). For an extensive discussion including a recent survey of the literature on this issue see European Commission (2014a)
It is plausible that the advantages can take the form of more efficient planning and a more effective operation of public investment projects. Disadvantages arise, however, if private investors provide funding requiring excessive rates of return or if the projects are arranged so that private investors bear no significant risks and therefore have little incentives to contribute to the efficient operation of the project. This should be borne in mind, for instance, in the design of investment programs co-financed by the EFSI.10

Another issue raised by the involvement of private capital in public investment is transparency. Public investment on the basis of contracts with private investors may be economically similar or even equivalent to the financing of public investments with standard government debt but it may be less visible in government debt statistics. There is a risk that the current pressures to comply with the rules of the SGP give rise to the creation of shadow budgets where public investment spending is financed via additional debt while public investment in the normal government budgets declines. The result would be that the additional debt effectively finances more public consumption so that fiscal sustainability is undermined.

3.1.4. Public investment and the Stability and Growth Pact

Whether the fiscal rules of the SGP should allow for higher deficits if a country increases its public investment has been debated since the introduction of the SGP.11 In a recent communication, the European Commission (2015) has pointed out that the existing rules offer various ways in which countries can increase their debt to finance public investment. The Commission distinguishes between contributions to the EFSI, which are typically one off measures, and national investment spending which may or may not co-finance EFSI investment. Regarding contributions to the EFSI the European Commission states:

‘National contributions to the EFSI will not be taken into account by the Commission when defining the fiscal adjustment under either the preventive or the corrective arm of the Pact. In case of an excess over the deficit reference value, the Commission will not launch an EDP if this excess is only due to the contribution and is small and expected to be temporary. When assessing an excess over the debt reference value, contributions to the EFSI will not be taken into account by the Commission.’(European Commission, 2015, p. 8)

This implies that there is additional room for countries to make contributions to the EFSI provided that the budget balance is not too far above the deficit reference value of 3% of GDP.

Regarding national co-financing of European public investment programs including EFSI investment the European Commission states:

‘Member States in the preventive arm of the Pact can deviate temporarily from their MTO or adjustment path towards it to accommodate investment, provided that: their GDP growth is negative or GDP remains well below its potential; the deviation does not lead to an excess over the 3 % deficit reference value and an appropriate safety margin is preserved; investment levels are effectively increased as a result; the deviation is compensated within the timeframe of the Member State’s Stability or Convergence Programme. Eligible investments are national expenditures on projects co-funded by the EU under the Structural and Cohesion policy, Trans-European Networks and the Connecting Europe Facility, as well

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10 The European Commission (2014b, p8) suggests that the public money contributed to the EFSI will be used as an ‘initial risk bearing capacity’. This may increase the volume of private funds that can be attracted to the fund, but at the same time the interest of private investors in the efficiency of the projects is undermined.
11 See the discussion in Buti et al. (2003).
as national co-financing of projects also co-financed by the European Fund for Strategic Investments.' (European Commission, 2015, p. 9)

This approach to applying the SGP rules in the preventive arm of the SGP provides significant additional room for the debt financing of investment expenditures related to European investment programs. In the corrective arm of the SGP there is slightly less flexibility. While contributions to the EFSI will not be taken into account when defining the necessary fiscal adjustment or when deciding about the launch of an excessive deficit procedure, no such exception is granted for national investment spending.

Overall, the room for debt financing of investment spending granted by the SGP is significant. As explained in section 3.1.2, more public investment is welcome but should primarily be financed by restructuring public expenditure, rather than increasing public debt, at least in the highly indebted countries which have neglected public investment in recent years. Moreover it is not quite clear why spending in European programs should be treated differently under the SGP than national public investment spending. A possible justification could be that this restriction facilitates the otherwise difficult distinction between public investment and public consumption.

At a more general level, ‘flexible’ interpretations of the SGP imply the risk of damaging the credibility of the SGP. If the commitment of the Eurozone to fiscal consolidation is reduced, investors are likely to demand higher risk premia. This would make fiscal consolidation more difficult.

3.2. Growth oriented tax reforms

Tax policy is an important and effective instrument for stimulating the economy. However, tax policy faces tradeoffs. Stimulating growth through tax cuts may be incompatible with the objective of containing or reducing budget deficits. In addition, tax policy has to strike a balance between, on the one hand, improving incentives, work, invest and consume and, on the other hand, achieving an equitable distribution of the tax burden.

Given this, proposals to use tax policy instruments to boost growth need to take into account revenue constraints and distributional implications, in particular implications of tax changes for people with low incomes.

3.2.1. Long term changes for more growth friendly tax structure

Economic research on the growth effects of tax structures and tax reforms has led to the view that countries can increase economic growth by adjusting their tax structure. An influential study of the relationship between tax structures and growth conducted by the OECD (Johansson et al (2008)) concludes:

‘The reviewed evidence and the empirical work suggests a “tax and growth ranking” with recurrent taxes on immovable property being the least distortive tax instrument in terms of reducing long-run GDP per capita, followed by consumption taxes (and other property taxes), personal income taxes and corporate income taxes.’

The empirical analysis underpinning this conclusion in the study by Johansson et al (2008) is the subject of an ongoing and controversial debate. Nevertheless the available empirical evidence, combined with and theoretical considerations, does suggest that changes in the tax structure may be an important element in a policy strategy which aims at increasing growth rates. This would be reforms towards higher taxes on

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13 See Xing (2012).
consumption as well as immovable property, which would allow reductions in direct taxes including taxes on labour income.\textsuperscript{14}

Eurozone countries should therefore consider tax reforms towards more growth friendly structures. For instance, recurrent taxes on immovable property vary widely across Eurozone countries. As graph 3.3. shows, the revenue from this type of tax varies between 2.4\% of GDP in France and zero in Malta. Countries with low levels of these taxes could increase them and reduce taxes on real estate transactions instead. Along the same lines, revenue from taxes on corporate income or labour income could be replaced by revenue raised through consumption taxes. Of course, to the extent that this increases the tax burden on low income households compensating reforms of the tax and transfer system are necessary.

\textbf{Graph 3.3.}: Revenue from recurrent property taxes 2012
\hspace{1cm} (% of GDP)

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{graph3.3}
\caption{Revenue from recurrent property taxes 2012 (% of GDP)}
\end{figure}

\hspace{2cm} Data: Eurostat

\subsection*{3.2.2. Tax policy measures for short term stimulus}

While the issues discussed in the preceding section are related to the medium to long term relationship between tax structures and growth, the Eurozone countries may also want to consider tax policy measures which may boost economic activity in the short term. Three instruments should be taken into consideration:

\textbf{i) A temporary reduction in the standard VAT rate}

It would be the objective of this measure to create incentives to increase current spending on all goods which are subject to VAT. This would affect, in particular, purchases of durable consumer goods or spending on housing improvements. The reform would include a temporary reduction in the standard rate of VAT, limited to one or two years, followed by a tax rate increase. The tax increase after the period of the reduced rates could even go beyond the original level to make sure that the entire reform is revenue neutral. It would even be possible to achieve a positive effect on current spending by announcing a VAT tax rate increase in the future, without prior reduction. However, this approach has its limitations because the standard VAT rates of most countries in the Euro Area are already quite high (see graph 3.4.).

\footnote{14 For a detailed analysis of this issue with respect to European countries see European Commission (2013), chapter 3.}
An alternative way of making the reform revenue neutral would be to combine it with a reform of the system of reduced rates. If this affects goods with a high weight in the consumption of low income households this should be compensated by adjusting transfers to these households.

**ii) A temporary cut in real estate transaction taxes**

Transactions in the real estate market are an important source of economic activity. More transactions imply more spending on the conversion and renovation of housing. Taxes on real estate transactions vary widely across Eurozone member states (see table 1). While these taxes are equal or close to zero in some countries they can reach levels above 10 per cent in others.

<table>
<thead>
<tr>
<th>Tax rate</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>≥10%</td>
<td>Belgium, Greece*, Italy*</td>
</tr>
<tr>
<td>5-8%</td>
<td>Germany**, France, Luxemburg, Spain, Cyprus,* Portugal*</td>
</tr>
<tr>
<td>&lt;5%</td>
<td>Austria, Ireland, Malta, Netherlands, Slovenia, Finland</td>
</tr>
<tr>
<td>None</td>
<td>Slovakia, Estonia</td>
</tr>
</tbody>
</table>

* Progressive or multiple rate structure, partly based on cadastal values
** Rate varies across states, partly below 5%

Source: European Commission

From a welfare perspective taxes on real estate transactions are widely seen as rather inefficient. They lead to significant economic distortions due to lock in effects, at the same time they may be rather volatile as a source of government revenue, in particular in cases where a real estate boom with high transaction volumes is followed by a bust.

While a case can thus be made for reducing real estate transaction taxes generally, a temporary reduction may provide a short term boost to economic activity. This reduction may be targeted to certain groups of buyers or certain price ranges. Recent experience with relief for first time buyers and houses in the lower
price range in the UK, which was introduced in 2010, with the objective to stimulate economic activity, suggests that this instrument can be effective in inducing more transactions.\textsuperscript{15}

iii) A temporary increase in tax allowances for investment in equipment

Business investment is a key driver of economic growth. At the same time it is very sensitive to uncertainty and aggregate investment is very volatile over the business cycle. In many Eurozone countries business investment has been low recently. A temporary increase in tax depreciation allowances for equipment investment would provide an incentive to bring forward investment spending which may have been planned but suspended or delayed.

Focusing on equipment investment would limit the tax revenue impact, both because other assets are excluded and because depreciation periods for equipment are generally shorter than those typically granted for structures (buildings). If full revenue neutrality is required this can be achieved by slightly increasing the corporate tax rate. Of course, a higher corporate tax rate has other disadvantages, in particular a high salience. But if the corporate tax increase is temporary that may be acceptable.

\textsuperscript{15} The UK stamp duty tax relief is evaluated in Bolster (2011).
3. CONCLUSIONS AND POLICY RECOMMENDATIONS

Policy measures to improve fiscal sustainability in the Eurozone face a number of challenges and tradeoffs. Despite considerable efforts to achieve fiscal consolidation several countries in the Eurozone are still running budget deficits which are incompatible with a stabilization of the debt to GDP ratios. At the same time economic growth is weak and unemployment remains high, especially in Southern Europe. There is a danger that the Eurozone gets stuck in a trap of economic stagnation, growing unemployment and increasing government debt. Therefore efforts have to be made to stimulate economic activity without giving up fiscal consolidation.

Policy measures and reforms to stimulate economic growth are required in many fields including the labour market, education, research and development and many more. In this short paper we have discussed two options for addressing the issue of fiscal sustainability. More public investment and growth oriented tax reforms. Our analysis leads to the following conclusions and policy recommendations:

1. A significant part of the fiscal consolidation measures taken since the outbreak of the European debt crisis have been cuts in public investment. This means that the contribution of this fiscal adjustment to fiscal sustainability is limited.
2. For the same reason it is likely that viable projects are available in countries which have neglected public investment in recent years.
3. It should not be taken as given that additional public investment spending is financed by debt. Priority should be given to financing public investment by reducing public consumption spending.
4. Financing additional investment by additional public debt cannot be justified by the so-called ‘golden rule’ of fiscal policy. The golden rule states that debt financing should be restricted to net public investment, not gross investment. Net public investment is negative in many Eurozone countries.
5. Calls to reform the SGP to create additional room for debt financed public investment are misguided. The existing flexibility is significant and may give rise to conflicts with the main objective of the SGP, which is to preserve fiscal sustainability. A reform of the SGP towards allowing even more debt financing would damage the credibility of the pact and might lead to higher risk premia in government bond markets.
6. The member countries of the Eurozone should review their tax systems with the objective of moving towards more growth friendly tax structures. This would involve a reduction of corporate income taxes and direct taxes including taxes on labour. These tax cuts should be financed by higher taxes on consumption and higher recurrent taxes on immovable property.
7. If countries see the need for a temporary to boost consumption and investment spending several tax instruments could be employed: A temporary reduction in standard VAT rates or the announcement of a VAT rate increase in the future, a temporary reduction in real estate transactions taxes or a temporary increase in tax allowance for investment in equipment. Various options to maintain revenue neutrality have been proposed.
REFERENCES


The development of the government debt to GDP ratio over time as described by equation (1) in the text can be derived as follows. Government debt at the end of period t \((D_t)\) is equal to debt in period t-1 plus interest payments minus the primary surplus of period t \((P_t)\):

\[
D_t = (1 + r_t)D_{t-1} - P_t
\]  
(A1)
Dividing both sides of (A1) by the GDP of period t \((Y_t)\), and using \((1 + g_t)Y_{t-1} = Y_t\), (A1) can be expressed as

\[
\frac{D_t}{Y_t} = \frac{(1 + r_t)D_{t-1} - P_t}{(1 + g_t)Y_{t-1}}
\]
Subtracting \(D_{t-1}/Y_{t-1}\) and making some rearrangements yields equation 1 in the text.

The calculations of the primary surpluses required to stabilise or reduce the debt to GDP ratios are based on the following assumptions and data. The nominal GDP growth rates are equal to the average nominal growth rates predicted by the IMF World Economic Outlook (October 2014) for the years 2013-2019. The interest rates are equal to the ratio of interest payments and gross government debt levels in 2013 reported by Eurostat. Initial debt ratios are gross government debt levels in 2013 reported by Eurostat.

**Graph A1:** Primary surplus required to reduce the debt ratio and actual primary surplus 2013
**Graph A2:** Primary surplus required to stabilise the debt ratio and actual primary surplus 2013 (increased interest rate growth diff.)

**Graph A3:** Implicit debt levels 2014 (% of GDP)

Source: Own calculations, Data: Eurostat, IMF

Source: Stiftung Marktwirtschaft (2014)
Implicit debt is defined as the present value of the difference between future public expenditure (excluding the servicing of existing, explicit debt) and future public revenue if current institutional rules, in particular social insurance systems, are unchanged. A negative value for implicit debt implies that the present value of future revenue exceeds the present value of future expenditures. For a detailed description of the methodology see Moog and Raffelhüschen (2014)