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Some Insights on the Link between the Public Sector and Economic Growth and International Trade and Economic Growth

Panel Discussion

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In the workshop the link between the public sector and economic growth was covered to some extent but not in depth. This comment will focus on some public sector issues such as fiscal federal relations, budgeting procedures and taxes affecting the supply side. The link between trade and growth has not been mentioned at all. This link will be discussed shortly which will provide the basis for the identification of further necessary applied research in this field.

1. The Public Sector and Economic Growth

1.1 Which Fiscal Federal Relations? Will Better Fiscal Federal Relations Help Growth?

The Organisation for Economic Co-operation and Development (OECD) recommendations by Wörgötter dedicate much room to the improvement of fiscal relations in Austria. Since the first Finanzausgleichsgesetz (Fiscal Equalisation Law) (Federal Law Gazette – BGBl. 45/1948) was stipulated in 1948 – this law regulates the redistribution of tax revenue shares across sub-national governments – it has undergone only minor changes in a period of more than 50 years. A large body of literature has already extensively covered the demand for reform and has reached similar conclusions: allocative efficiency has to be raised, expenditures and revenues should be linked at the same government level, co-financing should be reduced, and last but not least the revenue distribution mechanism should be simplified and made more transparent (compare inter-field Beirat, 1992, Staatsschuldenausschuss, 2005).

It could be expected that the OECD would formulate policy recommendations that are largely similar to the ones of the existing literature. On 30 June 2003, the Austrian Convention started with working out proposals for reforming the Austrian constitution. The resulting constitutional draft of January 2005 states in Article 279 that the sub-levels of government should strive for linking accountability, revenues and expenditures at the same government level. Political action for any kind of reform has not yet been taken. As is shown by this example: The central question for Austria is not which design of reform to choose but how to introduce the necessary reform.

A controversial issue in the literature as well as in the public discussion is whether and to what extent tax-setting powers of sub national governments should be strengthened. The OECD recommendation of allowing for a surcharge on personal income tax has to be viewed critically. First of all, it is not a contribution to the simplification of the tax system as the OECD simultaneously demands (compare Kronberger, 2006a). Second, labour supply in Austria is relatively expensive as a result of high non-wage labour costs. It could be counterproductive for a state to raise (the surcharge on) income taxes if unemployment is already at a high level. Therefore, the power of setting and collecting of property tax or motor vehicle tax should be transferred to lower levels of government.

The chosen topic for the workshop was “Strategies for Employment and Growth in Austria”. Nonetheless, the link between fiscal federal relations and economic growth was not discussed. This is more important since theory and empirical evidence on this link yield ambiguous results. Theoretical arguments pointing to a positive link are: (1) Fiscal decentralization enhances Pareto efficiency provided that differentiated spending of local governments is needed to meet local demands. (2) Governments possibly behave as revenue-maximizers. In this case vertical and horizontal competition among different levels of governments may put a restraint on the size of the public sector, e.g. preventing an oversupply of goods. (3) Increased accountability for local governments may provide an incentive for them to innovate on the production of public services and public goods. (4) Fiscal decentralization brings about less concentration of power which in turn holds back vested interests on public policy; therefore, fostering democracy and long-term economic growth. The same number of arguments point to a negative link between fiscal decentralization and economic growth: (1) A high degree of fiscal decentralization possibly reinforces regional inequalities as was the case in Switzerland. (2) The smaller the government units are the fewer career opportunities are available and the more corruption is present. (3) The smaller government units are, the higher is the share of fixed costs. (4) Long-run economic growth may be hampered since cyclical stabilization as well as structural adjustment becomes more difficult. In conclusion, these theoretical arguments could not be tested satisfactorily, in the field, due to the difficulty of measuring fiscal decentralization. Thießen (2005) estimated the relationship between fiscal decentralization and per-capita growth. He found a bell-shaped relationship. Accordingly, maximum economic growth can be attained by an intermediate degree of fiscal decentralization. Nevertheless, the author stresses the weakness of his results due to the sample size and deficient operators for fiscal decentralization. Thus, rather the design of fiscal federal relations and the redistribution mechanism for revenues should be improved within a determined scope than augmenting the degree of fiscal decentralization in Austria.

1.2 Will the New Multi-Annual Budgeting Framework Help Smooth the Cycle?

Wörgötter recommends in his OECD paper the implementation of a medium-term budgeting framework. Since February 2006, the draft for amendments of the budget law and corresponding amendments in the financial constitution is ready to enter the parliamentary process. They stipulate, inter-field, a medium-term expenditure framework which determines a general expenditure ceiling over four years with an annual rolling basis. Five broad categories are defined, each with separate binding ceilings (Steger, 2006). The draft contains a relatively weak form of a debt brake since the expenditure ceiling exclusively applies to the federal budget (Kronberger, 2006b). Sub-levels of government are exempt from the debt brake. The expenditure ceiling (of the framework not of the current budget) can be altered by a single majority in parliament. It is still to be seen whether this represents a strong enough binding. The draft does not indicate which level of expenditure path should be achieved nor does it contain any economic reasoning. Therefore, the expenditure path can easily be set too high, thereby forcing taxes to be raised which consequently can dampen the economic cycle. The original objective of a debt brake to avoid a strain on fiscal policy through budget consolidation would be circumvented as a consequence.

1.3 We Should Have Better Knowledge on the Link between the Supply Side of Taxes and Growth

In the workshop the discussion whether growth or employment is demand side or supply side driven was centered on the labor market. Little doubt remains regarding the question of whether lowering the non wage labor cost – this is reducing the cost of labor supply – will help employment, whereas the empirical knowledge of the effect of reducing corporate taxes in Austria is limited. The effects of the Austrian tax reform 2004/2005 have only been estimated with respect to the demand side (Breuss et al., 2004). The supply side effects have explicitly been left out, therefore, underestimating the growth effects resulting from the lower corporate income taxes. For coming tax reforms econometric models should be ready to mimic corporate tax changes in order to provide adequate economic policy advice.[1]

2. International Trade and Economic Growth

2.1 How Does Export Growth Contribute to Economic Growth in Austria?

Since Austria joined the EU in 1995 the export share has risen from 24.5% of GDP to 38.3% in 2005. The import share has seen a similar growth. Presumably, the exchange of goods has gained importance with respect to Austrian economic performance. Seen from the perspective of the business cycle, recent economic growth in Austria and the EMU Member States was largely induced by export growth (in EMU investment growth has been an important factor, too) as stated by forecasts of Austrian economic research institutes (Marterbauer and Steindl, 2006; Felderer et al., 2006).

2.2 What Does Economic Analysis Tell Us on the Link between International Trade and Growth?

According to the economic mainstream increased trade openness brings about faster economic growth. Surveys on theoretical and empirical literature show that the evidence is mixed. Wälde and Wood (2004) criticize the current literature as policy instruments are either insufficiently considered or left out completely. Mostly, the relationship between trade volumes and the economic performance is analyzed. But to prove the effect of trade policy on growth the effects of trade policy instruments on growth have to be provided. For example, first the effect of reduced tariffs or non-tariff barriers on imports and the effect of export subsidies on exports should be shown. Given that this link is established, the link between volumes of exports/imports and growth could be shown. Little research has been done in this field. Hallak and Levinson (2004) point out the variety of available trade instruments as tariffs, quotas, import licences, and subsidized credit to exporters will operate through many channels in a particular environment. The outcome as such can rarely be shown by the typical trade and growth regression. These authors and also Winters (2004) ask for an investigation into particular microeconomic models that will give answers to more specific questions, such as the impact of trade on plant productivity – since enterprises trade goods and services and not entire states, the effect of foreign ownership on plant productivity or the role of trade on market discipline. Winters labels this approach as indirect

[1] A supply side oriented growth model computing the effects of a tax reform for Switzerland has been developed by Keuschnigg (2004).

evidence and sees the positive link by a number of empirical studies confirmed. Whatever the critique, there is no systemic evidence that trade restrictions stimulate growth (Rodriguez and Rodrik, 2001).

2.3 Much More Emphasis Must Be Devoted to Empirical Trade Analysis and Monitoring International Trade Policy

The research on trade policy and its economic effects particularly focusing on the Austrian economy is of limited scope. One reason could be the institutional setting due to the accession of Austria to the European Union. The sovereignty on trade policy has been transferred to the institutions of the EU. Decision-making has become more complex and the direct influence of the national government has declined. In addition, many decisions on trade policy are taken at the WTO level, which increases the complexity still further. Another reason is the increased variety of trade policy instruments, which are difficult to grasp with economic analysis. The various service sectors, for example, are highly regulated with differing regulations. Last but not least trade statistics – aside the traded goods statistics – are poor (services trade) or even non existent (e.g. FATS statistics) (Kronberger and Wörz, 2004).

Trade policy always has to be considered jointly with other policy areas as, for example, investment policy, education and research, competition policy, institutional aspects, etc. as was pointed out by Aiginger (2006) in his presentation. As such trade policy and the continental concept of "Standortpolitik" are complements and dependent on each other. As was indicated earlier in general, this is also true for Austria. More focused research has to be done in the field of services trade on a sector by sector basis. The effects of outsourcing and off shoring also must be analysed carefully for the goods and the services sector, also on a sector by sector basis. Both phenomena are strongly linked with "Standortpolitik". Moreover, a small open economy that forms part of an integrated economic area with a common external trade policy should provide enough resources to actively monitor supranational and international trade agreements and also actively formulate policy recommendations for these institutions. The Common European Trade Policy as well as the WTO agreements may have differing effects on the various EU Member States due to their still differing economic and legal environment.

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