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REVENUE BUOYANCY AND ITS FISCAL POLICY IMPLICATIONS

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By

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ABSTRACT/RÉSUMÉ

Revenue buoyancy and its fiscal policy implications

Tax receipts surged between 2005 and 2007 in many OECD countries, resulting in significant improvements in headline fiscal positions. As a consequence, pressures for tax cuts and for public spending increases have emerged. In the past, responding to such demands has permanently weakened budget positions as revenue windfalls ultimately proved to be temporary. Hence, the opportunity to address structural deficit problems and prepare for future demographic trends has been lost, and the ability to respond to subsequent cyclical downturns has been weakened. This paper provides an analysis of the factors behind recent revenue buoyancy and examines past responses to unexpected revenue gains. It also discusses whether improved information on fiscal positions and future fiscal challenges, combined with relevant fiscal rules, might help in avoiding a repetition of past errors in fiscal policy.

JEL classification: H2, H3, H6, H62

Keywords: Fiscal policy; windfall tax revenues; fiscal rules

Dynamisme des recettes fiscales et implications de politique budgétaire

Les recettes budgétaires ont fortement progressé entre 2005 et 2007 dans de nombreux pays de l'OCDE, provoquant une nette amélioration des soldes budgétaires. Cela a généré de nouvelles demandes de réductions d'impôts ou d'accroissement des dépenses publiques. Dans le passé, les gouvernements ont fréquemment cédé à ces demandes alors que les embellies de ressources n'étaient que temporaires, entraînant une détérioration durable des soldes budgétaires. En conséquence, des opportunités de réduire les déficits structurels et de préparer les sociétés aux évolutions démographiques ont été manquées. La capacité à répondre à un retournement ultérieur de la conjoncture s'en est aussi trouvée amoindrie. Ce document fournit une analyse des facteurs sous-tendant le dynamisme récent des recettes fiscales et examine comment les gouvernements y ont répondu dans le passé. Il discute également des moyens d'éviter la répétition des erreurs de politique budgétaire passées, et notamment du rôle de règles budgétaires appropriées ainsi que d'une meilleure information sur les situations budgétaires et les défis à venir.

Classification JEL : H2, H3, H6, H62

Mots clefs : Politique budgétaire ; recettes fiscales exceptionnelles ; règles budgétaires

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REVENUE BUOYANCY AND ITS FISCAL POLICY IMPLICATIONS

by

Isabelle Joumard and Christophe André¹

1. Introduction

1. Tax receipts surged between 2005 and 2007, resulting in significant improvements in headline fiscal positions. In consequence, pressures to cut tax rates or raise spending have increased in many OECD countries. While in some circumstances such a response may have an economic rationale -- to offset biases in the tax system or to facilitate the process of structural reform, for example -- it implies that the opportunity is perhaps being lost to address the structural deficit problems and thereby prepare for future demographic trends. It also risks repeating past experiences, when revenue windfalls, which ultimately proved to be temporary, prompted policy measures that permanently weakened budget positions, restricting the ability to respond to subsequent cyclical downturns. This paper provides an analysis of the factors behind recent revenue buoyancy and examines past responses to unexpected revenue gains. It also discusses whether improved information on fiscal positions and future fiscal challenges, combined with relevant fiscal rules might help in avoiding a repetition of past errors in fiscal policy.

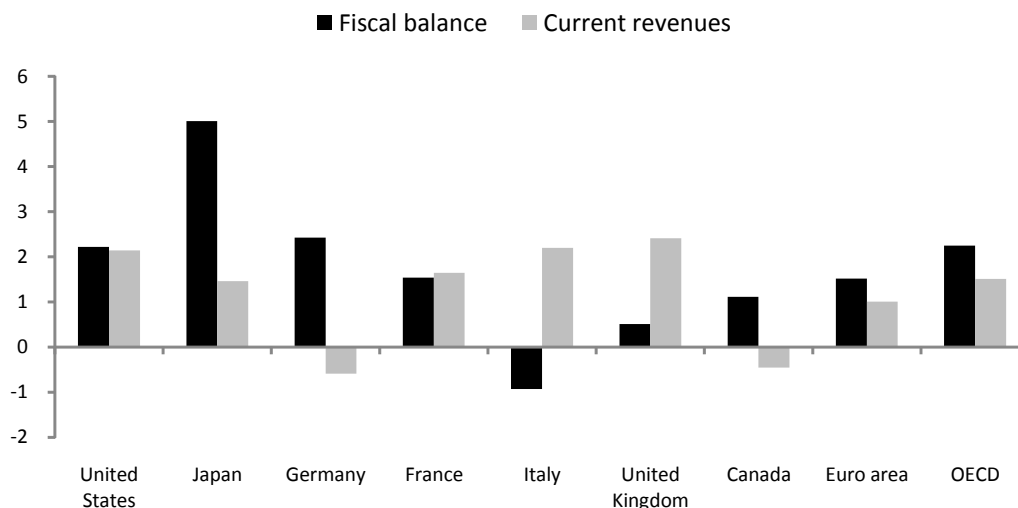
2. Tax revenues grew much faster than the economy in the mid-2000s

2. Headline fiscal positions improved rapidly in the vast majority of OECD countries after the trough of early 2000s economic cycle. Between 2003 and 2006, the general government deficit in the OECD area was reduced by 2.2% of GDP (Figure 1). Only a minor part of this increase can be ascribed to a traditional cyclical influence, but this does not imply that the remainder is permanent or structural (see below). The improvement in public finances has been largely the result of increased government revenues -- by 1.6% of GDP in the OECD area. On the spending side, the rise in GDP has generally resulted in a small decline in the spending ratio, though some countries have succeeded in reducing their spending to GDP ratio more substantially, among them the Czech Republic, Denmark, Germany and Iceland.

1. The authors are members of the Monetary and Fiscal Policy Division of the Economics Department. They wish to thank Jørgen Elmeskov, Christopher Heady, Vincent Koen, Robert Price, Jean-Luc Schneider and Economics Department country desks experts for helpful comments and suggestions, Chantal Nicq for excellent statistical assistance, Véronica Humi and Sandra Raymond for excellent secretarial assistance. The views expressed in this paper are those of the authors and do not necessarily reflect those of the OECD.

Figure 1. Fiscal balances improved between 2003 and 2006

Changes in the ratio to GDP

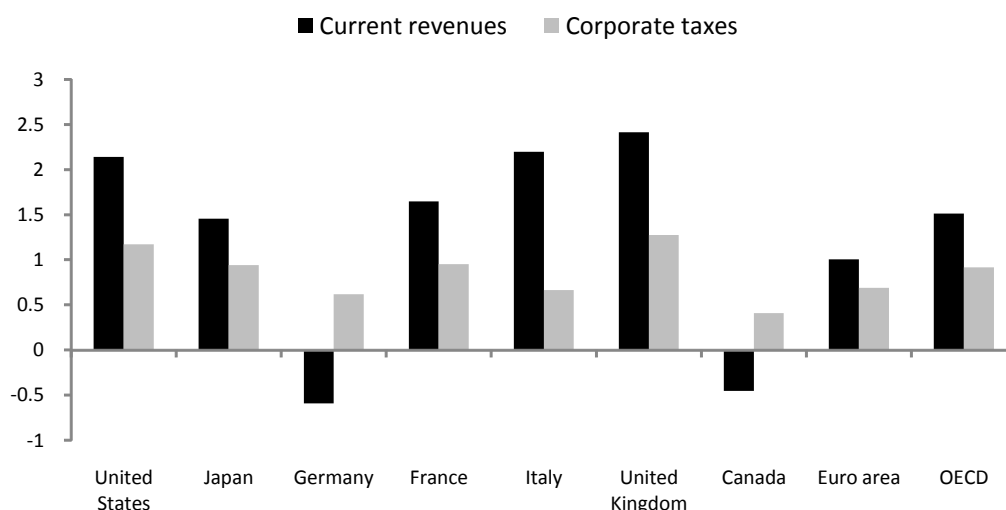


Source: OECD Economic Outlook 82 database.

Corporate taxes surged, largely driven by temporary factors ...

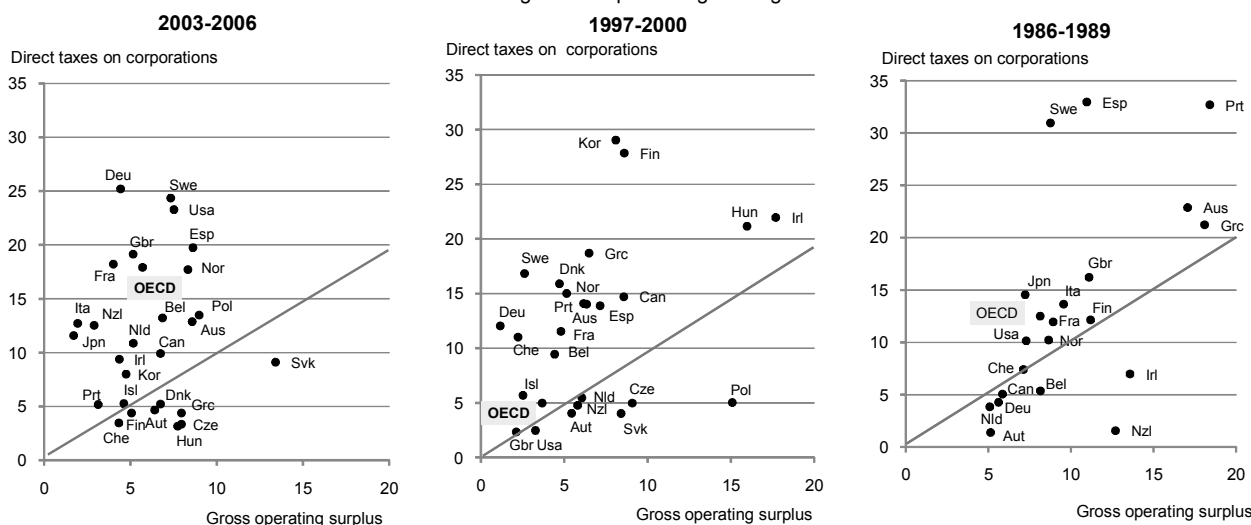
3. A breakdown of government revenues suggests that a large part of the recent surge in government receipts, over and above that resulting from business cycle developments, is related to unusually high company profits and large capital gains. More than half of the revenue gain over the period 2003-06 came from corporate taxes -- the increase in corporate tax revenues amounted to almost 1% of GDP on average across OECD countries (Figure 2). The increase in corporate tax revenues owed much to strong performances in the financial, energy and housing-related sectors. But, in addition, corporate taxes have responded much more strongly to higher profits than in past cyclical upswings, particularly in large OECD countries: between 2003 and 2006, corporate tax receipts rose at an average annual rate of almost 20%, while the gross operating surplus increased by just under 6% (Figure 3). This tax buoyancy probably reflects the progressive exhaustion of carry-forward provisions for past losses, as well as greater limits on tax sheltering activities (André *et al.*, 2007) and expanding income from capital gains on financial investments. Overall, the heightened buoyancy of corporate taxes will likely prove transitory, the more so as the economy started to slow down in 2007 and with the risk that the financial turmoil triggered by the subprime crisis turns out to have persistent effects on corporate financing costs. Moreover, on-going adjustment in financial and construction sectors is likely to reduce what has been a source of high corporate profits in recent years. Evidence is already accumulating that in several OECD countries tax revenues were decelerating in the second half of 2007, often growing at a pace significantly below official projections.

Figure 2. Most of the improvement in current revenues came from corporate taxes
Changes in the ratio to GDP between 2003 and 2006



Source: OECD Economic Outlook 82 database.

Figure 3. Increase in corporate tax receipts during cyclical upswings
Average annual percentage change



Source: OECD Economic Outlook 82 database.

Personal income taxes also played a role...

4. Direct taxes on households have also contributed significantly to growing tax revenues in a number of economies, notably in some English-speaking countries (Canada, New Zealand, United Kingdom and the United States). The rapid increase in personal income tax receipts relative to the growth of income and activity reflects several factors: higher capital gains as equity markets recovered and higher interest income as interest rates rose; a concentration of income growth at the upper end of the income distribution where taxes are higher; and “bracket creep”, whereby the growth of income causes a greater proportion of taxpayers’ income to be taxed in higher tax brackets. The United States provides an illustration with an increase in personal income tax amounting to more than one percentage point of GDP,

roughly as much as corporate taxes (Swiston *et al.*, 2007).² Looking forward, a slowdown of personal income taxes can be expected as capital gains and bonuses converge to their long-term level as a share of GDP.³

The boom in house prices gave rise to windfall revenues

5. The housing boom has also generated substantial revenues from taxes on transactions in some countries (including France, Ireland, Italy, the Netherlands and the United Kingdom). In Ireland, the increase in receipts from stamp duty was particularly high, amounting to 0.9% of GDP over the 2003-06 period. Inheritance taxes may also have risen where thresholds have not been adjusted for house price inflation, but the effect may be drawn out and they do not seem to have contributed as yet to the boom in revenues. These windfall tax effects will however likely vanish as house prices have been increasing more modestly in many OECD countries since 2007, or even declining in some.

3. Short-term fiscal gains have often given rise to long-term pain

Tax cuts and spending hikes have been common responses in the past ...

6. Economic upswings have often been followed by significant deteriorations in structural fiscal positions because governments find it difficult to resist demands for higher spending and/or tax cuts when revenues are piling up -- the “cagnotte” or “kitty” problem. Short-term fiscal gains then give rise to long-term pain, eventually forcing governments to tighten the fiscal stance during downturn episodes. Comparing previous upswing episodes, it appears that many governments failed to learn from earlier fiscal mistakes: after the late 1990s boom, a large majority of countries again experienced a deterioration of the structural fiscal balance as after the late 1980s boom. In most cases, the deterioration was more pronounced, with eleven countries experiencing a deterioration of more than 2 percentage points in their structural fiscal balance to GDP ratio (Figure 4). The nature of the fiscal loosening also differs between the two past upswing episodes. While after the late 1980s economic boom, many countries launched or expanded permanent spending programmes, revenue windfalls in the late 1990s mainly triggered tax cuts. Later, during downturns, these tax cuts and spending hikes required pro-cyclical retrenchment.

... and several countries again followed the same route in the mid-2000s

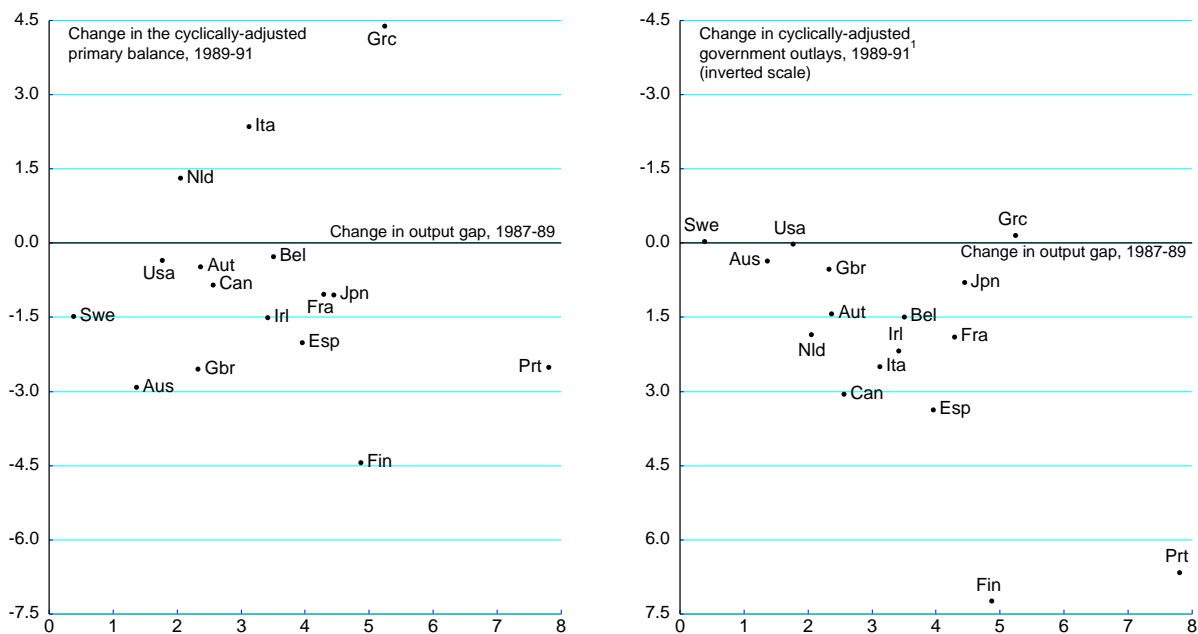
7. The 2005-06 tax bonanza may open the way to a structural deterioration in fiscal balances. Many OECD countries have implemented or announced cuts in tax rates in 2007, on companies in Czech Republic, Denmark, Germany, Italy, Netherlands, New Zealand, Spain, United Kingdom and the United States, and on households in Canada, Denmark, Spain and Sweden. Though some countries have improved the tax structure by simultaneously broadening the tax base (Germany and Spain), tax expenditures have also been increased (including in France and Italy for the housing sector). On the spending side, some governments have decided to increase expenditure on certain services, or are considering doing so, notably health and education (Denmark, United Kingdom and United States) and social programmes and transfers (Italy and Spain).

2. For 2005, realisations of capital gains grew by about 29% and taxable interest income by more than 20% according to the CBO (2007).

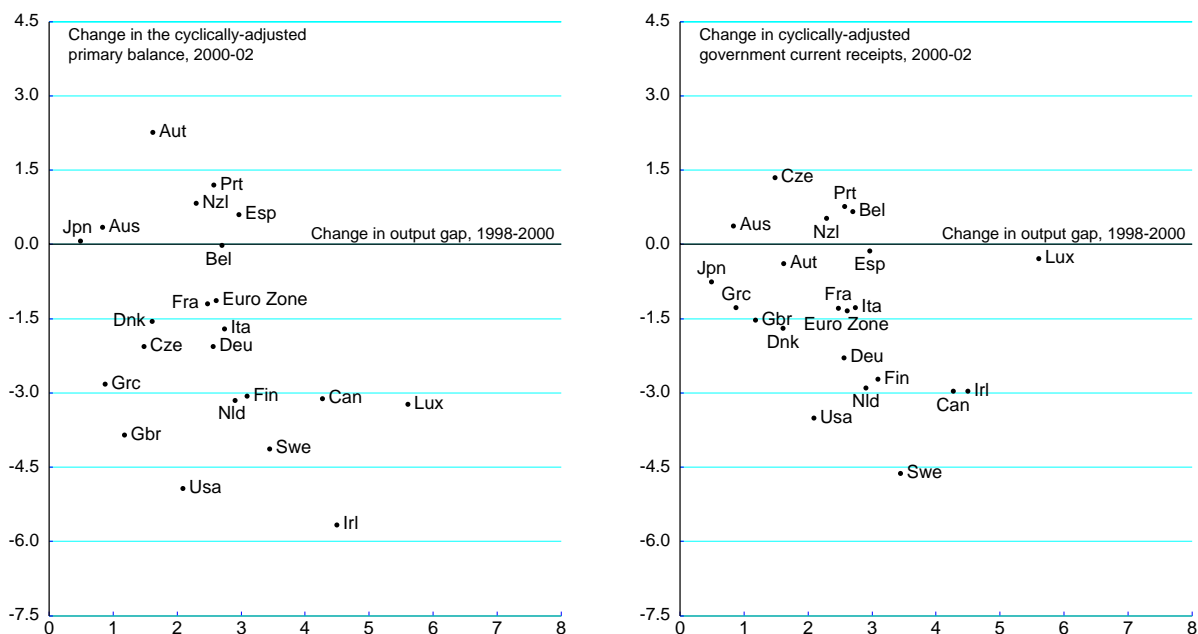
3. The CBO (2007) baseline assumes that realised capital gains will grow more slowly than GDP after 2006.

Figure 4. Short-term fiscal gains for long-term fiscal pains

Late 1980s episode: short-term fiscal gains gave rise to higher permanent spending



Late 1990s episode: short-term fiscal gains created momentum for tax cuts



Note: All data are expressed in percentage of potential GDP.
 1. Cyclically-adjusted government outlays are proxied by adding government investment to cyclically-adjusted total current government outlays.
 Source: OECD Economic Outlook 82 database.

4. Why are spending increases and tax cuts frequent during upswings?

Temporary increases in revenue may be mistakenly regarded as structural

8. While improvements in headline fiscal balances are common during upturns, it is always difficult to disentangle their permanent and transitory components. *First*, the cyclical position of the economy, traditionally measured by the output gap -- *i.e.* the difference between actual and potential real GDP -- is notoriously difficult to assess in real time. In particular, during expansions, there is a tendency to overestimate potential output. The flip-side of this is an underestimate of the extent to which output exceeds potential and hence of the cyclical component of fiscal gains. The corollary is an unwarranted optimism about structural fiscal positions. A recent study (Cimadomo, 2007) suggests that the intended fiscal stance, based on information available at the time budgetary decisions are made, is usually not procyclical, even if the *ex post* result often turns out to be. Misjudgement about the cyclical position of the economy frequently induces policy mistakes.

9. *Second*, some categories of tax revenues, such as taxes on capital gains, are related to developments in asset prices, which are only loosely related to the business cycle. Since asset cycles differ substantially both in magnitude and with respect to the categories of assets affected, it is very difficult to derive a systematic measure of their impact on fiscal revenues. However, capital gains tax receipts can be boosted substantially by a surge in asset prices (Figure 5), as can ordinary corporate tax liabilities.⁴ Hence, when a cyclical upswing coincides with an asset price cycle, the risk is high that the underlying health of public finances will be overestimated because the cyclical adjustment of budget balances will take into account only the output cycle. Morris and Schuknecht (2007) estimate that “taking into account the impact of asset price movements would give rise to an estimate of the euro area underlying fiscal position that is ½ per cent of GDP lower during the asset price upswing”.⁵

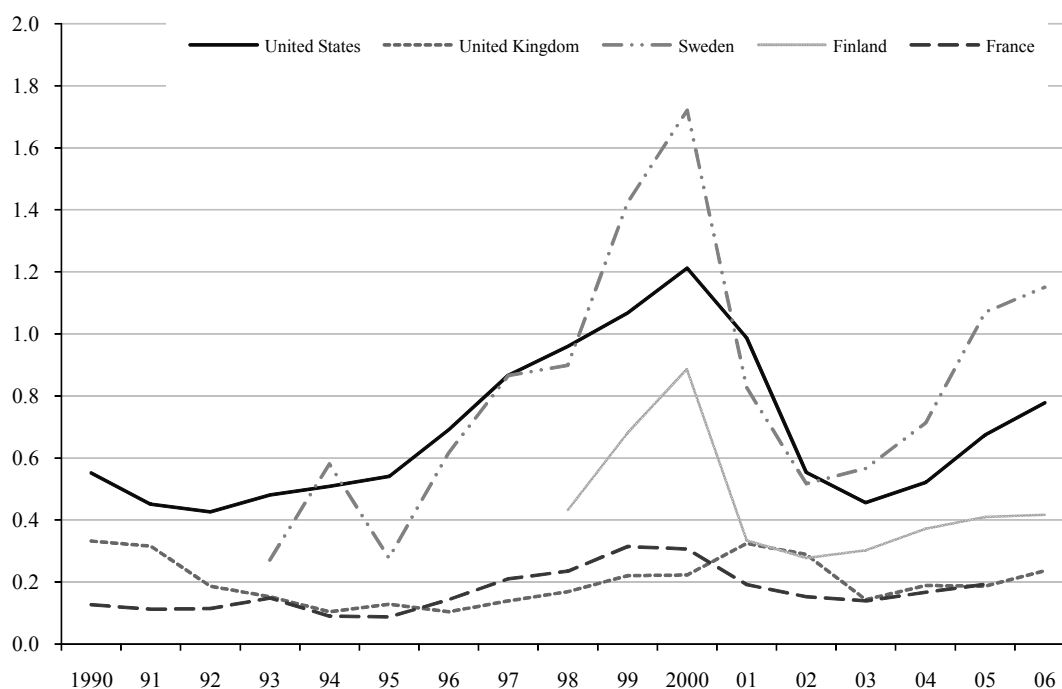
Political economy considerations make it difficult to consolidate in upturns

10. Political economy considerations may also explain why budgetary gains are difficult to hold on to. *First*, a benign argument is that exploiting the short-term potential for fiscal largesse can be justified insofar as this may ease structural reforms. Indeed, overcoming the resistance of groups opposed to such reforms may require the temporary payment of compensation or the “grandfathering” of existing policies, which may show up as fiscal easing. However, implementing necessary structural reforms aimed at boosting employment and productivity can yield long-term budgetary savings that dominate their short-term costs (van den Noord and Cournède, 2006). In the case of EU countries, the 2005 revision of the Stability and Growth Pact provides scope to overshoot the Maastricht deficit threshold to some extent in the case of structural reform, and therefore in principle allows fiscal policy to “grease the wheels” of such reform (OECD, 2007).

4. In Denmark for instance, tax revenues from pension funds’ capital gains rose from less than 0.1% of GDP in 2002 to 2.4% in 2004.

5. A detailed analysis of the impact of asset prices on fiscal positions in OECD countries can be found in Girouard and Price (2004).

Figure 5. Capital gains tax receipts
Per cent of GDP



Source: National authorities.

11. *Second*, political economy considerations may also lead to unsustainable fiscal behaviour. When budgets are in surplus or deficits are small, fiscal unsustainability is rarely perceived by the public as being a major risk and it is difficult to cut spending. Where the tax burden is perceived as too high, there can be pressure to take the opportunity to translate large receipts into tax cuts. Empirical evidence on whether the political cycle is a factor in such responses is mixed.⁶

5. Potential elements of a prudent fiscal policy

Strengthening fiscal rules and budget institutions

12. Strong budgetary rules may be helpful in a situation where political pressure for fiscal action is mounting, though there is no easy fix and “one-size-fits-all” fiscal rules do not exist. To prevent cyclical fluctuations leading to policy mistakes, some countries have implemented rules or institutions to deal with revenue surprises. Others have introduced cyclically adjusted fiscal balance rules (*e.g.* Switzerland). The Netherlands, together with Mexico and Norway (which experience highly volatile oil revenues) and several US states and Canadian Provinces have implemented “rainy day funds” or other mechanisms that set aside the surplus generated by booming revenues and falling expenditure. However, accounting for the business cycle, or other special factors, may come at the expense of desirable rule properties such as simplicity, transparency and communicability. Also, cyclically-adjusted fiscal rules are not easy to monitor in real

6. According to the political budget cycle theory, governments have incentives to boost output by loosening the fiscal stance, increase transfers to specific groups or lower taxes in pre-election years, but research does not confirm this for developed economies and deficits do not in fact help re-election (Brender and Drazen, 2005). On the other hand, in the initial years of the EMU (1999-2002), the fiscal stance appears to have been easier in pre-election and election years than otherwise (Buti and van den Noord, 2003).

time. The lack of a unique and undisputed approach to the estimation of cyclically-adjusted balances weakens transparency and may create a credibility gap. On its own, a cyclically-adjusted budget balance rule may thus not always provide a sufficient safeguard.

13. Expenditure rules have become a popular way of ensuring fiscal discipline in many OECD countries, though again their effectiveness depends largely on their design and the way they are linked with other fiscal rules. Expenditure rules have several merits (Anderson and Minarik, 2006; Guichard *et al.*, 2007): they are more transparent and operationally targeted than cyclically-adjusted balances; they force governments to prioritise spending and avoid the risk of directing revenue windfalls into government spending programmes. As any other fiscal rule, however, spending limits will only be effective if they are backed by a strong political commitment, enshrined in a legislatively specified budget process. The US Budget Enforcement Act, which expired in 2002 and was instrumental in reducing the government deficit in the 1990s, consisted of both discretionary expenditure caps and pay-as-you-go rules that required all legislation involving new mandatory spending or tax cuts to be deficit neutral. The effectiveness of such limits will, even then, depend on their coverage and the extent to which due account is taken of tax expenditures. Spending rules do not prevent the risk of fiscal loosening stemming from tax cuts -- a route followed by many OECD countries in the late 1990s boom and which appears again recently to have tempted many. This might suggest that a combination of spending and cyclically-adjusted budget balance rules would be required. And even then, revenue buoyancy related to factors such as asset prices might still lead to unsustainable fiscal decisions.

Improving information on short-term fiscal developments and long-term fiscal needs

14. Improving information on both current fiscal positions and the longer-term fiscal outlook may serve to reduce political economy pressures on the budget and strengthen political commitment to prudent policies or adherence to rules. Some efforts have been made to better measure cyclical and structural fiscal positions, both at the country level and within international organisations (see for instance Girouard and André, 2005). While further work may improve measurement in this area, assessing the extent to which revenues are of a cyclical or other non-permanent nature during upswing episodes will probably remain surrounded by large uncertainties. In contrast, there is little doubt that the longer-term fiscal outlook is worrying: debt-to-GDP ratios are already very high in many OECD countries; off-balance-sheet liabilities (including those associated with public sector pensions, public entities and public-private partnerships) will probably add significantly to the burden in several countries;⁷ population ageing along with cost pressures in the health care sector will place further strain on public finances (OECD, 2006). Laying greater emphasis on these long-term fiscal challenges would help to reduce short-sighted pressures on the budget during upswings and may also increase support for necessary reform in some of the programmes associated with long-term spending pressures.

15. Consideration could further be given to establishing independent fiscal institutions so as to increase people's (voters') awareness of longer-term fiscal challenges and make the government more accountable. These institutions could, in particular:

- Provide the main elements of the economic scenario on which the government builds its budget proposals (Austria, Belgium, Canada and the Netherlands have already moved in this direction, and in the United States the task of drawing up macroeconomic assumptions is given to a

7. The 1993 System of National Accounts (SNA) only gives a partial picture of the pension obligations of government. If liabilities for unfunded defined-benefit schemes for government employees were recognised, the ratio of public debt to GDP could rise by up to 80 percentage points in OECD countries (Aspden, 2007). Some countries, including Australia, Canada and New Zealand, have already included these liabilities into their general government debt data.

committee that is to some degree autonomous from the Budget Office). This could serve to address possible optimistic biases in macroeconomic projections and avoid systematic growth surprises.

- Ensure prevailing rules are respected (Sweden established a Fiscal Council in 2007 with this role).
- Conduct and publicise forward-looking budget assessments, including on implicit liabilities.

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