Discussion of "Saving Europe? Some Unpleasant Supply-Side Arithmetics of the Fiscal Austerity" by Enrique Mendoza, Linda Tesar, and Jing Zhang

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- How do we fix public finances after the crisis?
- Most countries will need some form of fiscal consolidation
- In particular GIIPS countries
- What are the best instruments?
- Should take the cross-country spillovers into account
- The need for more fiscal revenue may clash with tax competition
- Cannot consider individual countries separately

Paper's contribution

- The paper makes the important point that tax competition should be taken into account in considering fiscal adjustment
- Typically not incorporated in the recent literature
- They present a benchmark model to take spillovers into account
- This will definitely be followed by a large literature

Basic framework

- Consider the two-country neo-classical model of Mendoza-Tesar (JME, 2005)
- One trade asset: bond
- No labor and physical capital mobility
- Study the impact of three taxes: consumption, labor and capital
- The two countries represent the GIIPS and the other Eurozone countries (EU10)
- Carefully calibrate to derive the effective taxation
- Consider the impact of offsetting the increase in public debt
- Larger adjustment needed in the GIIPS countries

Main comments

- Incomplete paper, I have no useful comment on the results
- Model has nothing new, but the numerical exercise appears very useful
- First, it gives a quantitative estimate of the required tax changes
- It compares the implications of alternative taxes
- Second it gives a benchmark analysis other researchers can start from

- But currently the role of externalities is not clear
- The text confuses openness with externalities
- The Nash solution for capital taxes coincides with the cooperative solution: no externality?

Beyond the benchmark

- What should be modified from the benchmark? How are the quantitative results affected?
- The main question is to analyze spillovers
- What is the spillover in the benchmark model?
- The world interest rate (only in transition periods)
- E.g. when the GIIPS increase their capital tax rate this reduces the demand for capital and lowers the global interest rate
- The other countries benefit from a low interest rate, but this is not taken into account by the GIIPS
- The capital tax rate may be inefficiently low

Spillovers

- How relevant is the benchmark spillover?
- Probably one of the least relevant we can think of
- Increase in GIIPS tax rate should decrease the world interest rate
- Is there any empirical evidence that this could happen?
- The GIIPS are not large and there are many countries outside of the Eurozone
- Moreover, we are at a zero lower bound: no room for a decrease in interest rate

More relevant spillovers

- The model has nothing specific about the Eurozone
  - Same model could be applied for US vs Japan
- The model does not consider the current context of a recession and sovereign debt crisis
- Many issues related to tax evasion
- Role of non EZ countries

Demand spillover

- In current context a fiscal contraction has a clear *negative* spillover
- Taxes could be too high
- May be quantitatively significant as fiscal multipliers are high
- Moreover, EZ has fixed exchange rate, which makes the impact higher

- Incentive for devaluation
- Can be implemented with the right tax combination
  - "Fiscal devaluation," Fahri, Gopinath, and Itskhoki (2012)

Sovereign debt crisis

- Debt is increasing faster in GIIPS countries due to high sovereign debt spreads
- What are the implications of these spreads for the magnitude of fiscal consolidation?
- Changes in these spreads will be huge compared to a potential change in the world interest rate
- How does the presence of these spreads affect externalities?

Tax evasion and factor mobility

- The tax competition literature typically considers these factors
- E.g. rich individuals or firms migrate due to high tax rates
- Or individuals evade taxes and send their money to Switzerland
- The residence principle no longer applies
- Countries need to compete both in tax rates and in tax bases
- E.g. Bacchetta and Espinosa (JIE, 1995). Two-stage game determining tax rates and information sharing among tax authorities

Role of non EZ countries

- What about spillovers to other countries?
- E.g. Switzerland would be very much affected by the considered tax changes
- Additional capital flows would have a negative effect, creating further exchange rate pressure
- But maybe the decline in sovereign spreads would lead to reduced capital flows for Switzerland

- Required adjustments in non-EZ countries may be substantial
    - e.g. US fiscal cliff

Conclusions

- MTZ provide a very useful numerical exercise
- Benchmark for future research
- But the paper cannot tell us how to "save Europe" since it does not incorporate the most relevant European features
- There is an exciting future research agenda