SWEDISH ECONOMIC POLICY REVIEW 3 (1996) 171–174

Comment on Assaf Razin and Efraim Sadka: Fiscal Balance During Inflation, Disinflation, and Immigration: Policy Lessons

Nils Gottfries*

From their interesting review of fiscal developments in Israel, Assaf Razin and Efraim Sadka draw some policy conclusions which may have more general validity. Let me discuss some of them.

1. Deficits and inflation

Do deficits lead to inflation? The data for Israel certainly suggest a close relation between deficits and inflation. Large deficits continued from the late 1960s until 1985, and during this period there was a strong upward trend in inflation. After the deficit was eliminated in 1985, inflation dropped down to about 20 percent.

Was inflation a necessary consequence of the deficit? With deficits of the magnitude and persistence experienced in Israel, the answer is surely yes. What is less clear, however, is the extent to which we can extrapolate this relation to lower levels of debt. In the mid 1970s, for example, public debt was about equal to GDP, a level that other countries have been able to maintain without high inflation. Was the deficit causing inflation at this stage?

A striking characteristic of Israel in the 1970s was that the debt/income ratio was rising very rapidly: fiscal policy was clearly unsustainable. This may have caused inflation since the anticipation that the government will have to resort to money financing in the future may lead to inflation even if there is no money creation today. The reason is that inflation is a tax on money, so when inflation is expected in the future, money

* *The discussant is Professor of Economics at Uppsala University.*

demand falls, and inflation increases today. This appears to be part of the story, but some of the rise in inflation in the mid 1970s was due to simultaneous money creation.[1] Why was inflation not counteracted by the central bank? Other factors, particularly exchange rate policy, may have been equally important.

An interesting issue is to what extent unsustainable fiscal policy makes the policy dilemma of the central bank more difficult. The authors' view is that the large deficit made anti-inflation policy "politically infeasible", but the exact mechanism is not spelled out. Recent Swedish experience suggests one mechanism: unsustainable fiscal policy creates a risk of future inflation which raises medium and long term interest rates. This causes financial fragility in some sectors of the economy, and pressure on the central bank to alleviate the problem by accepting inflation.[2]

2. Stabilization and recession

The authors note that private saving as a fraction of GDP is almost a mirror image of public saving. It is tempting to take this as an indication of Ricardian equivalence, but this would be a mistake since causality often goes the other way: a shock to private saving reduces public saving because of automatic stabilizers. This two-way causality makes it very hard to test the Ricardian proposition in normal times, and therefore large identifiable shocks like the 1985 stabilization are particularly interesting to examine.[3]

The stabilization program in 1985 was a remarkable sucess. What happened was very different from the usual Keynesian story, where monetary and fiscal contraction brings about a reduction in aggregate demand, falling production and employment, and a gradual reduction of the inflation rate. The deficit was eliminated by cuts in net transfers, etc. and there was a temporary reduction in the real wage, partly due to wage controls. Yet, private consumption remained unchanged in 1985 and in-

[1] Between 1973 and 1977 yearly growth rates were as follows: consumer prices: 39, 39, 31, 35; reserve money: 5, 14, 36, 43; quasi-money: 71, 37, 52, 98 percent. (*Source:* International Financial Statistics.)

[2] In fact, Israel in the mid-1970s should be a good case for testing the Giavazzi–Pagano hypothesis that extreme fiscal expansion may be contractionary. See Giavazzi and Pagano (1996).

[3] At the same time, the extreme situation means that the lessons learned may not apply to more normal situations.

creased by about 10 percent in 1986. Investments decreased, but exports increased and the net effect on production and employment was small.

The data certainly suggest that consumers "internalized" the fiscal changes to a large extent – realizing that they had not become poorer because the government cut transfers which were financed by printing money and bonds. Apparently, the fiscal stabilization did not have large contractionary effects. Whether it was actually expansionary is less clear. Like many other stabilization programs, this program involved a sharp depreciation of the currency, leading to high export growth in 1985-1987, and this appears to be an important reason for the expansion in the two years following the stabilization. In any case, the experience from Israel suggests that in a situation with very large and rising public debt, we should not worry too much about the contractionary effects of fiscal stabilization.

3. Post-stabilisation recession, immigration, and job growth

If one looks at a somewhat longer period after the sucessful stabilization in 1985, the picture is less rosy. After an initial decrease in unemployment, there was a period with low investment, low growth, and a rise in unemployment from 6 to 11 percent. The authors argue that increased effective taxation of capital (see below) had a negative effect on investment and growth, but there also appears to have been a problem with respect to wage and price formation. The exchange rate was used as a nominal anchor, but wages and prices increased and produced a drastic loss of competitiveness. It is tempting to interpret this as a period when the low-inflation policy had not yet acquired complete credibility, but the authors have informed me that inflationary expectations were essentially correct, which contradicts this interpretation. Was inflation still built into the system? Were there factors in the labor market that created a rising equilibrium rate of unemployment?

The trend was reversed, however. After the great immigration wave in 1990-91, real wages in the manufacturing sector decreased considerably, employment surged and, surprisingly, unemployment *decreased* in spite of the large immigration. The labor market in Israel seems to have undergone dramatic changes in recent years, and it has demonstrated enormous flexibility and ability to create jobs. This looks like an area where Sweden, and Europe, may have something to learn from Israel.

4. Tax burdens and inflation

The authors argue that an important effect of inflation was to shift the tax burden from capital to labor because i) the tax system is not neutral with respect to inflation (with non-neutralities going in different directions), ii) taxpayers, particularly businesses, take actions to exploit these non-neutralities, and iii) those who are are unfairly taxed due to inflation will push for changes in tax legislation while those who benefit from non-neutralities remain silent. The end result was that the effective tax on capital was reduced by inflation. Workers, on the other hand, had few opportunities to exploit non-neutralities in the tax system, and had to bear a larger fraction of the tax burden.

I have not tried to make similar calculations for Sweden, but in one area there is a striking parallel. Since homeowners were allowed to deduct nominal interest rates from taxable income and effective taxation of capital gains was relatively low, the increase in inflation in the mid-1970s implied a large real subsidy to investments in private homes.[4] This was pointed out by some Swedish economists, but strong groups resisted changes and it took more than ten years before the deductability of interest rates was reduced (in 1985). It was not until the tax reform in 1991 that approximate neutrality was achieved.

In stylized theoretical models, the non-neutralities of the tax system may be simple to understand and easy to correct, but implementing such changes in actual tax systems is complicated, and explaining these matters to the general public is difficult. Money remains the basic unit of account even if there is inflation. Hence non-neutralities of the tax system with respect to inflation will always exist and be exploited by those who have such opportunities. This is a good reason for hating inflation.

Reference

Giavazzi, F. and M. Pagano (1996), Non-Keynesian Effects of Fiscal Policy Changes: International Evidence and the Swedish Experience, Swedish Economic Policy Review, this issue.

[4] In the boom year 1990 deficit deductions of individuals, mainly consisting of interest rate deductions, reduced taxable income by SEK 74 billion (6.2 percent of GDP at factor prices), while individuals' taxable income from capital, real estate, capital gains, agricultural estates and business income amounted to 78 billion.