Abstract  We investigate the dynamic effects of discretionary fiscal policy in Austria over the period 1983:1 to 2002:4. A structural vector autoregressive (VAR) analysis, using the identification strategy suggested by Blanchard and Perotti (2002, Q J Econ 117(4):1329–1368), suggests that tax shocks have a negative effect on output, consumption, and investment. Spending shocks have a positive effect but are crowded out to a large extent after a few years. We then estimate ARCH models for output growth and inflation with the fiscal shocks included as explanatory variable in the variance equation. In line with recent cross-country studies there is evidence for a destabilizing role of discretionary fiscal policy.

Keywords  Fiscal shocks · Inflation volatility · Output volatility

JEL No  C22 · C32 · E60

1 Introduction

Over the last 35 years, while the profession “has collectively struggled with the task of separating the wheat from the chaff of Friedman’s (1968) Presidential Address” (Eichenbaum 1997, p. 236), fiscal policy issues have taken a back seat in the debate on economic and stabilization policy. Since the early 1990s, however, with the self-imposed requirement to adhere to particular fiscal rules by the EU Member States (Maastricht criteria, Stability and Growth Pact), fiscal policy has come back to the fore again. At the same time, a revival of the academic debate on fiscal policy can be observed, which is revolving mainly about three issues. The first is whether severe fiscal contractions may be expansionary even in the short run (Giavazzi and Pagano...
Second, recent results on the effects of fiscal shocks from structural vector autoregressions (VARs) (Blanchard and Perotti 2002) are at odds with both a Keynesian and neoclassical view. A third strand of research emphasizes the role of institutions in shaping fiscal policy (e.g. Person and Tabellini 2000), and that of fiscal policy for long-run economic growth. Fatas and Mihov (2003), for example, make a case for restricting fiscal policy discretion through a proper institutional design, based on their findings that aggressive use of discretionary fiscal policy lowers growth via higher output volatility.

Whether fiscal policy should be left discretionary or bound by rule (and how such an optimal rule would look like) are open questions. The widespread disagreement in the debate on the reform (abolishment) of the EU’s Stability and Growth pact, which is a vital example that touches upon all these issues, does not only reflect alternative ideological positions but also bears witness that the academic debate is far from settled. Thus more research is warranted, given the obvious relevance of the involved questions for framing an optimal design for fiscal rules and fiscal policy.

This paper provides an assessment of Austrian fiscal policy, using quarterly data over the period 1983 to 2002. Emphasis is on the short- and medium run effects of discretionary fiscal policy in two respects: First, we estimate impulse responses of GDP and its components to tax and spending shocks from a structural VAR, using the identification strategy suggested by Blanchard and Perotti (2002). In a second step, the structural tax and spending shocks (recovered from our VAR model) are used to investigate the effect of discretionary policy on output volatility as well as inflation volatility in an ARCH framework. Two major tax reforms in Austria in 1988 and 1994, together with the consolidation measures after Austria’s EU accession in 1995 offer a potentially valuable source for investigating the implications of discretionary fiscal policy.

The VAR analysis suggests that tax shocks have a negative effect on output, consumption and investment; spending shocks have a positive effect on each of them, but are crowded out to a large extent after a few years. The ARCH estimates point to a destabilizing role of spending shocks, which account for a considerable share of output and inflation volatility.

The remainder of the paper is organized as follows. Section 2 investigates the effects of fiscal shocks and GDP components using a just-identified VAR approach along the lines of Blanchard and Perotti (2002). Section 3 uses the structural tax and spending shocks to assess the impact of discretionary fiscal policy on output and inflation volatility. The final section 4 summarizes the results and concludes.

2 Fiscal shocks and their effects on output: a structural VAR analysis

2.1 Data description

The proper specification of the model to characterize the dynamics of output as a response to tax or spending shocks depends on the characteristics of our data set. Hence, before setting up our empirical model we summarize the time series properties of our variables. At this point the discussion focuses on taxes \( T \), government spending \( G \), and GDP \( Y \), all in real, per capita terms, the three variables which constitute the most parsimonious VAR model. Augmented Dickey–Fuller (ADF) unit root tests indicate that \( T, G, \) and \( Y \) are integrated of order one (see Appendix B).