FISCAL POLICY AFTER THE GREAT RECESSION

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What do we agree upon

- Tax smoothing principle
- Automatic stabilizers have to do their work
- That would imply that balanced budge rules are a bad idea.
- But…political distortions?
- There are huge issues on the politics of fiscal policy

What we don’t agree about

- Discretionary counter cyclical policies when should we use them?
- Taxes or spending: size of multipliers

The old identification problem…

- Co-movements of G T and GDP. What causes what?
- There are always third factors moving around, so?
- Is G and T a response to movements in Y or vice versa?

…and what do people do to solve it

- Dynamic general equilibrium models
- Vector auto regression analysis (Blanchard Perotti)
- Isolate episodes of exogenous changes in tax rates (Romer and Romer)
- Isolate exogenous and unexpected changes in spending, military spending (Barro Ramey)
- Case studies

The size of multipliers:
Basic Keynesian Ec 101 model

- Spending multiplier (much) bigger than one.
- Spending multiplier bigger than tax multiplier

How does it come out

- Not too well
- Range of spending multiplier estimated from 0.4 to 1.5
- Tax multipliers seem bigger (Romer and Romer up to 3!)

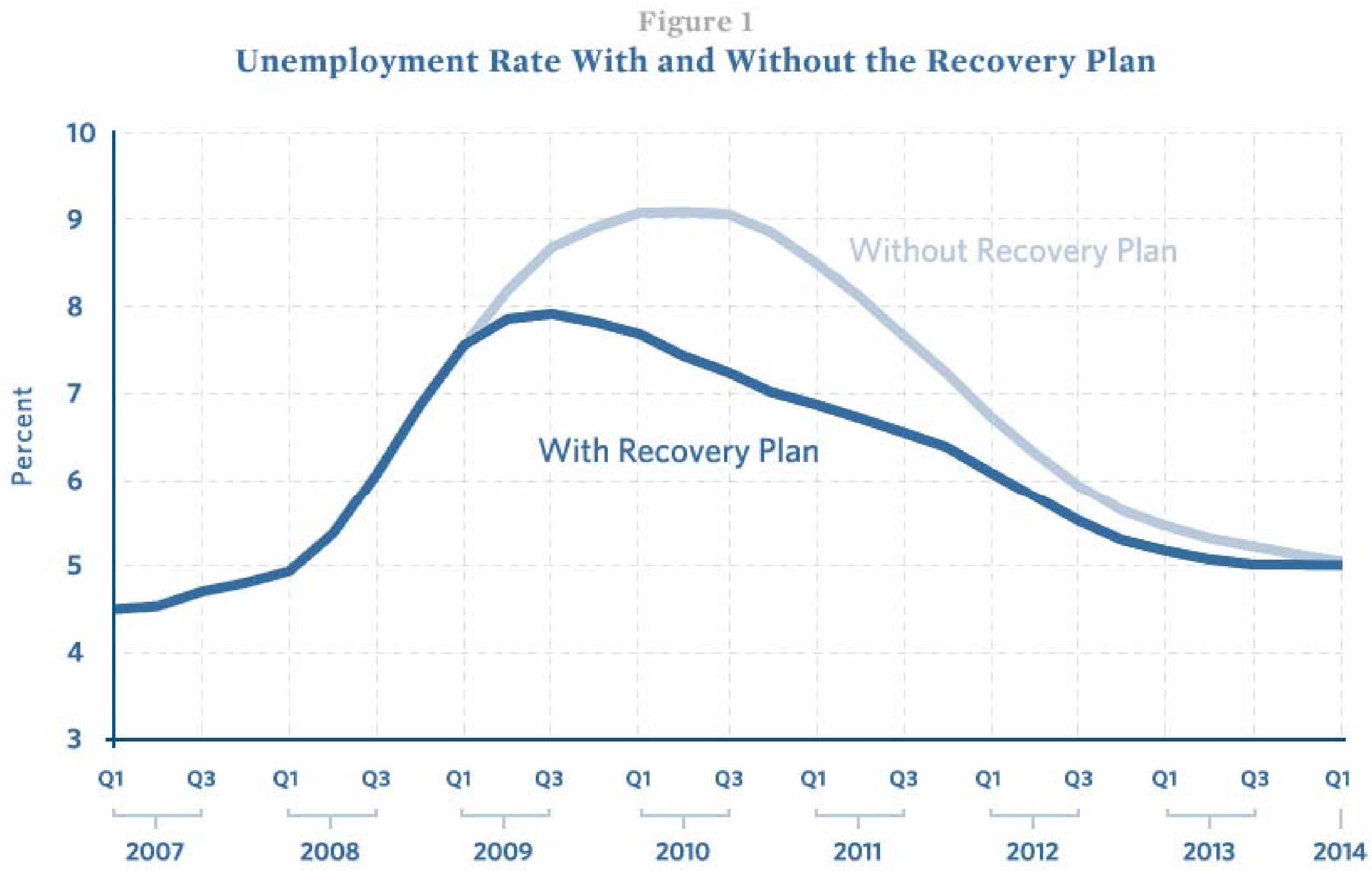
Contentious issues: Spending

- Hansen and Sargent, Ramey and Barro argue that the VAR analysis of Blanchard and Perotti tend to overestimate spending multipliers
- This is because the methodology does not distinguish between expected and unexpected changes in spending and fails in identification

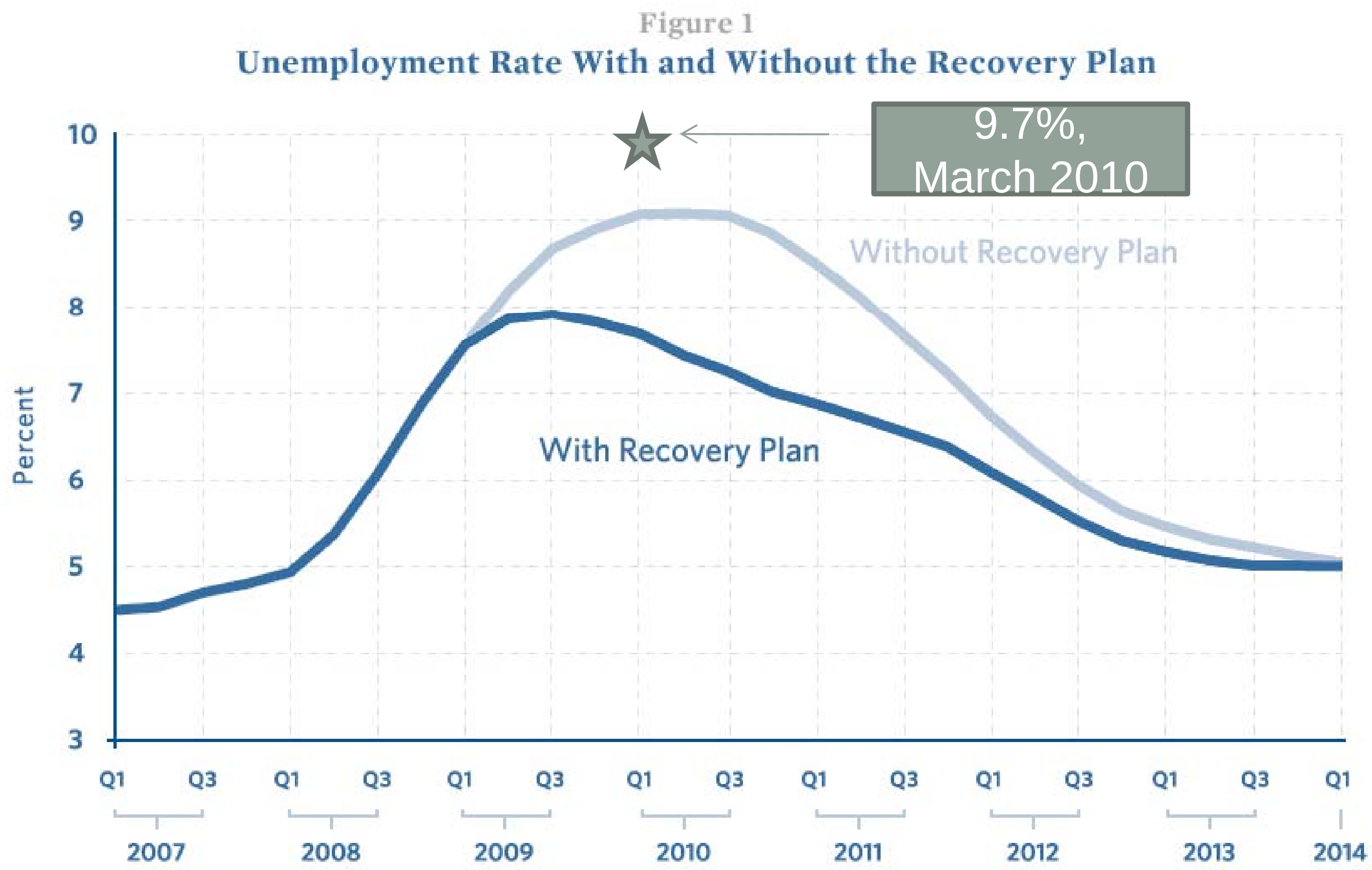
Contentious issues: spending

- Barro, Ramey et all uses military spending as source of exogenous episodes.
- Either a “narrative” approach or actual military spending
- Criticism: is there something special about war periods?
- During wars: constraints on consumers’ purchases of durables (this goes against finding large multipliers)
- During wars: patriotism forced labor (this goes in favor of finding large multipliers)

Administration estimates, Jan 2009

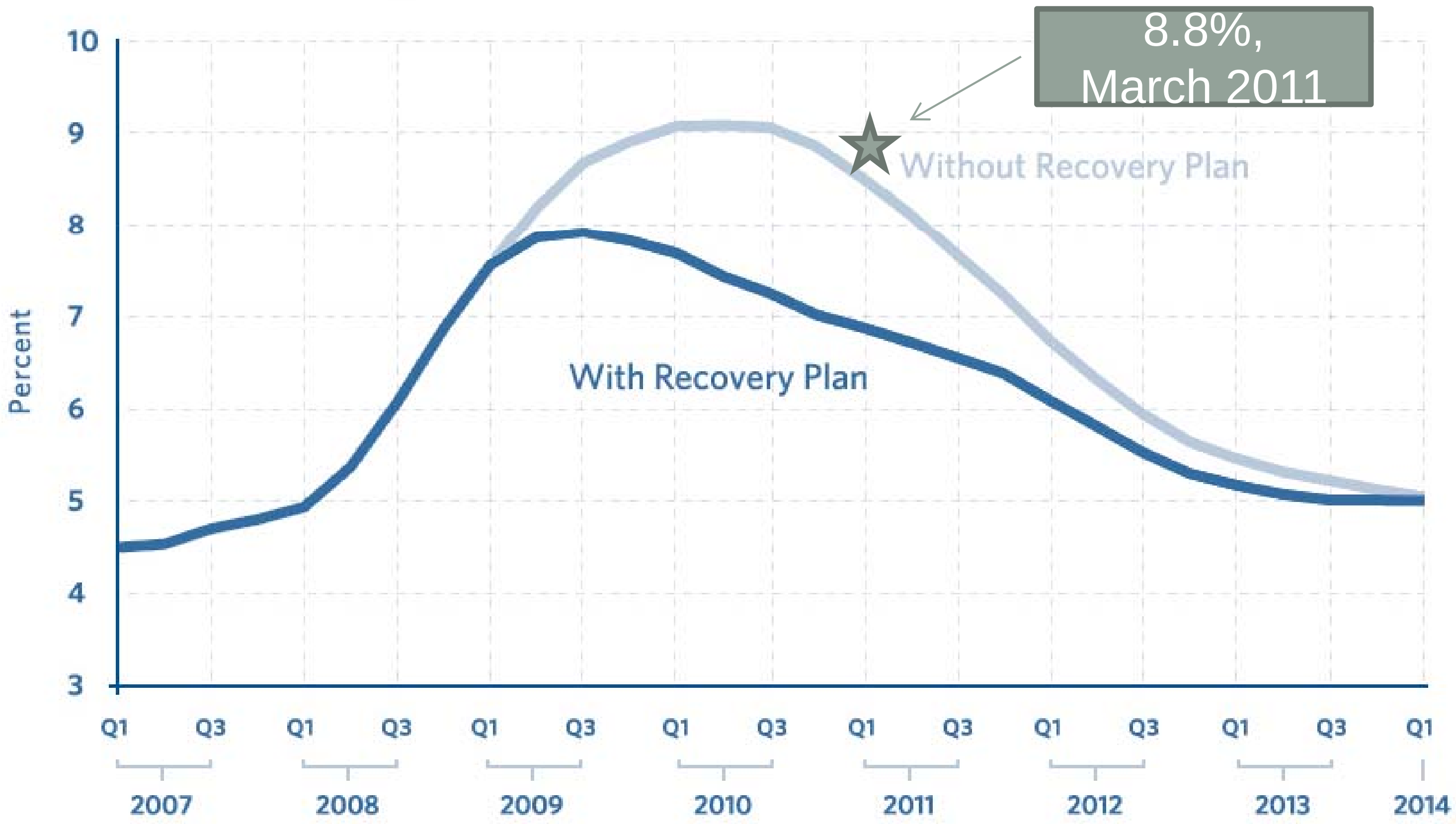


How has it worked out?



How has it worked out?

Figure 1
Unemployment Rate With and Without the Recovery Plan



Contentious issues: Taxes

- Are the Roemer and Romer multipliers “too large”?
- Most likely (recent work by Favero Giavazzi and Perotti)
- Probably smaller but they might be larger than spending multipliers. Why?
- Tax and spending multipliers can be very different in different countries and at different levels of debt (Giavazzi Favero)

Case studies of large fiscal adjustments

- Lively revival of a literature started by Giavazzi and Pagano and Alesina and Perotti in the early nineties about the possibility of expansionary fiscal adjustments.
- Recent papers by Weo, (2010) Alesina Ardagna,(2010) Perotti (2011), IMF volume (2011)

What are the issues?

- Are spending based adjustments less contractionary in the short run that tax based adjustments?
- Some fiscal adjustment have been expansionary even on impact. Why? What is the channel?

My take

- Spending based adjustments in OECD economies with close to 50 per cent of G/Y are preferable and very likely to be less costly than tax based ones (This may not hold for developing countries)
- A large fiscal consolidation accompanied by appropriate policies (wage moderation, friendly monetary policy, stabilizing inflationary expectations) can be much less costly than we normally think not only in the medium run but also in the short run

Channels

- Interest rates reductions when deficits down. Today they are low (for some countries) but they could go up so the benchmark against which to evaluate fiscal adjustment today is what would happen with raising rates
- Wage effects from public sector wages
- Expected future taxes down if G goes down
- Distortionary cost of taxation

Channels

- Devaluation helps (It does not work today for Euro countries, but will help England)
- Confidence effects on investment, may be important for the US

My take

- There is no alternative to tightening of fiscal policy in many (but not all) OECD countries
- But there is not enough emphasis on the quality and composition of the adjustment
- This does NOT mean that the entire world is tightening there is a developing world that can help world demand.

Fiscal deficits and elections

- There is not evidence that larger budget deficits increase changes of reelection.
- Brender and Drazen (AER 2008) find the opposite: larger deficits are (weakly) associated with less success at the polls.

Table 1 – 10 periods with largest cumulative fiscal adjustment (cyclically adjusted variables)

COUNTRY	YEARS	NUMBER OF YEARS	CHANGE IN CYCL. ADJ. DEFICIT (COCHDEF)	CHANGE IN CYCL. ADJ. EXPENDITURES (COCHEXP)	CHANGE IN CYCL. ADJ. REVENUES (COCHREV)	CUMULATIVE FISCAL ADJUSTMENT	FISCAL ADJUSTMENT PER YEAR	% OF FISCAL ADJ. DUE TO CUT IN EXPENDITURES	TERM	CHANGE IN IDEOLOGY
DENMARK	1983-86	4	-2.43	-0.85	1.58	-9.74	-2.43	35.03	2	0
GREECE	1990-94	5	-1.88	-0.50	1.38	-9.39	-1.88	26.38	2	1
SWEDEN	1994-2000	7	-1.20	-0.81	0.38	-8.38	-1.20	67.91	3	0
BELGIUM	1982-87	6	-1.26	-0.96	0.30	-7.57	-1.26	76.50	2	0
CANADA	1993-97	5	-1.36	-1.25	0.11	-6.80	-1.36	91.80	1	0
UNITED KINGDOM	1994-99	6	-1.12	-0.66	0.47	-6.72	-1.12	58.45	1	1
FINLAND	1993-98	6	-1.04	-0.81	0.23	-6.23	-1.04	78.13	2	1
PORTUGAL	1982-84	3	-1.89	-1.14	0.75	-5.67	-1.89	60.16	2	2
ITALY	1990-93	4	-1.24	0.13	1.36	-4.95	-1.24	-10.21	2	1
IRELAND	1986-89	4	-1.21	-1.54	-0.33	-4.82	-1.21	127.50	2	1

Source: Authors' calculations on OECD Economic Outlook Database no.84 and DPI 2009.

Reverse causality?

- Could it be that only those governments which know they are strong engage in fiscal adjustment?
- Thus government are reelected despite not because of fiscal adjustments.
- Difficult to test. How do you define “strong”?
- No obvious evidence of this effect.

Conclusion

- The crisis was a shock that lead us to rethink and work harder on many policy issues which we thought we had solved.
- For the moment we have more questions than answers
- ..but the macro seminars are again full of students!