FISCAL POLICY CONTROVERSIES

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- What are the effects of fiscal stimulus or consolidation?

- Recent foolishness in the United States

EFFECTS OF CONSOLIDATION:

Traditional view:

(a) Consolidation is necessary for long-run fiscal sustainability.... but

(b) Consolidation is contractionary in short run.

In recent years, some economists and policymakers dispute point (b)

-- Alesina and Ardagna (2010)

-- David Cameron (2011): "Those who argue that dealing with our deficit and promoting growth are somehow alternatives are wrong. You cannot put off the first in order to promote the second.

In my view, recent research supports (b)... the questionable part of the mainstream view is (a).

Overview:

- Key research by IMF on short-run effects of consolidation.

- Evidence for hysteresis -> contractionary effects of consolidation are persistent

- With hysteresis, fiscal expansions can be self-financing and consolidation can be self-defeating (DeLong and Summers, 2012).

KEY RESEARCH ON CONSOLIDATION:

(1) IMF, World Economic Outlook, 2010

- Historical approach to identifying fiscal consolidations: Examine 15 advanced countries over 1980-2009, find 173 years with budgetary measures aimed at fiscal consolidation.

- This approach avoids endogeneity problems when fiscal policy is measured with budget deficits.

- Estimate of fiscal multiplier is 0.5 on average (a consolidation of one percent of GDP reduces GDP by 0.5 percent.

(2) Blanchard and Leigh, IMF Working Paper, 2012:

- For consolidations since 2009, multiplier is 1.5 on average.

- Multiplier is higher than usual because no offsetting effect from lower interest rates or depreciation.

- IMF output forecasts were over-optimistic for countries with large consolidations, because the forecasts assumed small multipliers.

- For U.S., a one percent decrease in output raises unemployment by half a percentage point (Okun’s Law; Ball, Leigh, and Loungani 2013). So consolidation of one percent of GDP raises unemployment by 0.75 percentage points.

The most promiment study finding that consolidations are expansionary is Alesina and Ardagna (2010).

A-A define a consolidation as a large decrease in the cyclically-adjusted budget deficit. This variable is a poor measure of the stance of fiscal policy.

The IMF examines episodes when there is a large consolidation by their measure but not by A-A's, or vice versa... for example,

- Germany 1996: A-A find spurious consolidation because of accounting change in 1995.
- Ireland 1982: Historical record shows large consolidation: an increase in VAT. A-A measure fails to capture this policy because of unusual behavior of consumption.

- HYSTERESIS (long-run effects of demand shifts on unemployment and output)

  - In IMF results, little evidence that effects of consolidation are dying out after five years.

  - More generally, much evidence that shifts in aggregate demand have highly persistent effects on output and unemployment, unless monetary policy is strongly countercyclical. For example...

    -- European disinflations of 1980s (Ball 1999, 2009)

    -- Episodes of capital flight with hard exchange-rate pegs (Ball 2010, 2011)

    -- Current U.S. recession

  - DeLong and Summers (2012): Output losses over 2008-2012 lead CBO to reduce long-run forecasts of output.

ARE FISCAL EXPANSIONS SELF-FINANCING?

DeLong and Summers (2012): Yes, for the United States, if interest rates are near zero and there is a small amount of hysteresis.

Their argument:

- -- Let the multiplier for fiscal expansion be μ.
- -- A unit of fiscal expansion raises tax revenue by $\mu\tau$, where τ is the marginal tax rate. Therefore, net cost of expansion is $1-\mu\tau$.

-- To maintain a constant debt-income ratio, need a permanent increase in annual revenue of $(r-g)(1-\mu\tau)$, where r is interest rate on government debt and g is growth rate of output.

-- Suppose a unit increase in current output raises output permanently by η. This parameter is the "degree of hysteresis." A unit of fiscal expansion raises output permanently by $\mu\eta$, and raises tax revenue permanently by $\mu\eta\tau$.

-- Fiscal expansion is self-financing, and consolidation is self-defeating, if

$$\mu\eta\tau > (r-g)(1-\mu\tau)$$

$$r < g + \mu\eta\tau/(1-\mu\tau)$$

-- Suppose $\mu=1.0$, $g=2.5\%$, $\tau=0.33$, and $\eta=0.1$. Then the condition holds for $r<7.5\%$.

CONCLUSIONS FOR OPTIMAL FISCAL POLICY

- In both Europe and U.S., long-term reforms are needed to make fiscal policy sustainable (in U.S., key is reform of Social Security and Medicare).

- However, rapid consolidation raises unemployment and may be counterproductive for controlling debt. Optimal policy is a combination of long-term reforms and short-run stimulus.

U.S. POLICY: THE FISCAL CLIFF

- Various tax increases and spending cuts were scheduled to take effect on January 1. A coincidence resulting from legislation in early 2000s and 2010. Consolidation of 3.5% of GDP.

- Last-minute agreement cancelled some of the changes, but we still have consolidation of 1.5% of GDP (?). Main parts are increased taxes on high incomes and expiration of payroll tax holiday.

- Multiplier of 1.5 implies that GDP is reduced by 2.25%, so growth likely near zero in 2013. Effect on unemployment rate is about 1 percentage point, so unemployment is likely to rise from current level of 7.8%.

- Could be worse if new crisis in Europe or new fiscal crisis in U.S....

U.S. POLICY: THE DEBT CEILING

- U.S. law sets arbitrary limit on government debt, which needs to be raised periodically. In recent years, Republicans demand policy changes to approve increases in ceiling.

- If debt ceiling is not raised when needed, U.S. could default on Treasury securities! What would that do to confidence in U.S. economy and financial markets??

- Default narrowly averted in 2010.

- Ceiling needs to be raised again by March 2013. Once again, we are heading toward default unless there is a new deal. A dangerous game.

- Growing interest in the "platinum coin" option. Essentially an accounting trick to reduce the measured level of debt.