

## COMMENTS ON SESSION 1 AUTOMATIC STABILISERS AND DISCRETIONARY FISCAL POLICY

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### 1 Key analytical issues for policy choice and design

A basic question facing policy makers at the outset of a crisis is to accurately portray the economy's position at the crisis outset. Such a characterization is essential to avoid overreaction and to calculate the costs of the intervention in light of the country's medium and long-term needs and risks. Two key components of such analysis are the evaluation of the output gap and of the economy's "trend" growth. It is quite possible, and in the case of the current crisis very likely, that many economies operated above capacity in the years preceding the crisis, and that estimates of trend growth based on performance during these years are exaggerated. If this is the case, policies should not aim at reaching the same trend growth in the years to come, nor should they count on a return to the level of tax revenues that was associated with this output level. Moreover, tax revenues in many countries also included a substantial component that was associated with the unsustainable developments in the capital and real-estate markets, and such excesses should not be part of the expected long-term revenues.

Once the economy's position at the outset is understood, another challenging task is to properly characterize the source of the shock – demand or supply. This stage is critical in forming the appropriate policy response. It is also essential to identify whether the shock is cyclical or permanent and how it is understood by the markets. It is likely that the effectiveness of an expansionary fiscal policy will be affected by the markets' evaluation of the policy's sustainability, which depends on whether the shock is perceived to be permanent or temporary. While in the first case offsetting Ricardian considerations may show up as well as an increase in the country's risk premium, in the latter case these effects are less likely to constrain the fiscal strategy.

Once the economic environment and the shock have been characterized, policy-makers are faced with the task of identifying and choosing the required policy measures. This choice depends on several considerations, not all of which will necessarily lead to the same composition of measures:

- **Intervene beyond the automatic stabilizers?** In most countries the operation of the automatic stabilizers moderated the decline of economic activity at times of crisis, but at a cost of increasing the public debt. An important decision for the government is whether to settle for this effect or add discretionary measures to further support economic activity.
- **When to act?** If a government considers discretionary intervention, a key question is when to intervene. An early intervention has the advantage of tackling the recession soon and possibly preventing deterioration. In contrast, a delayed response provides scope to avoid unnecessary interventions, and their associated costs and distortions, in short recessions where the economy – helped by the automatic stabilizers – may recover on its own.
- **What is effective?** Some policy measures that work well in one country in one period may not lead to the desired results in other circumstances. For example, construction projects may work well where planning procedures are quick, land is available and employment in this sector is predominantly by locals. In contrast, it may not work where foreign workers fill most of the jobs in this sector.

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- **What causes the smallest long-run damage?** Interventions during a crisis may have significant negative long-run effects. These may be due to public debt accumulation, distorted incentives in the case of transfer payments, or moral hazard where business support and rescue operations are activated.
- **Market information:** One important feature that governments have to consider when operating during a crisis is that information derived from the markets may be less indicative than in normal times. The recent crisis and the preceding period were characterized by the departure of asset prices, project evaluations and risk assessments from “sensible” values. While these market perceptions are still relevant in certain aspects (e.g., whether “correct” or not, they influence the cost of government borrowing), governments may need the “courage” to decide that the markets are “wrong” and intervene based on their own (preferably well justified) assessments.

## 2 What have we learned in the current crisis?

While there are many analytical considerations in implementing fiscal policy during a crisis, the development of the current crisis has demonstrated that, in practice, policy decisions have to be taken in “real-time” with a high degree of uncertainty. Policy makers in the height of a crisis do not usually pose the required information and analysis, so decisions need to be based on a “balance of risks”, not on “solid” data. In the current crisis it was particularly evident that the existing analytical tools were inaccurate, as emphasized by Fischer and Justo above: *“in this juncture the estimates of the cyclical budget component are possibly more uncertain than ever, given the difficulty in knowing what are really the representative output gap as well as budgetary sensitivity to the cycle”*.

An important lesson that should be drawn from this realization is that given the sharp changes of what we thought we knew about 2009, it would be hasty to base decisions on what we think we know about 2060, the current target year for long-term fiscal frameworks (which changed a lot too). Another lesson that can be drawn from the developments that led to the crisis is that – just like in the financial markets – there is always a new “story” for good old fiscal expansions. To contain this risk, fiscal economists should keep models simple and based on long-run **past** developments. We should remind ourselves constantly that the fundamentals of the economy change less frequently than might be suggested by analyses based on the “last observation”. The principle of keeping our models simple and transparent should be especially adhered to in setting fiscal rules.

The current crisis poses even more difficulties to policy makers than a normal recession during the business cycle. First, this crisis is global, meaning that it is more difficult to “push” the problem away to other countries. Policies that usually work by enhancing competitiveness and raising net exports were less likely to work when trading partners are hit simultaneously. Second, the risk of financial collapse demanded – in some countries – significant fiscal resources that gave rise to potential Ricardian considerations with little impact on real activity (compared to normal periods, not to the counterfactual of not saving the financial institutions). Finally, the size of the shock and of the required intervention to make an impact were simply too big to ignore “fairness” issues; implying a larger cost of the intervention in order to spread the help beyond the segments of society that were directly affected by the crisis.

In such a crisis the balance of risks tilts clearly in favor of fiscal intervention to avoid the “liquidity trap” and significant hysteresis effects, even at the cost of future adjustments. The two papers I discuss below deal with the question of “how to intervene”, rather than “whether to intervene”, which, in the current crisis, is the more relevant and useful analysis. Specifically,

Bouthevillain and Dufrenot compare the size of multipliers in recessions and “normal” times and point out which measures are more effective in each, and Fischer and Justo provide detailed data on the measures that European governments implemented during the current crisis and classify them according to various criteria.

### 3 Comments on “Are the Effects of Fiscal Changes Different in Times of Crisis and Non-crisis? – The French Case” by Carine Bouthevillain and Gilles Dufrenot

The paper examines the differences in the effectiveness of policy measures in recessions, compared to “normal” times. While this is an interesting question in general, it is less relevant to the current crisis which is not a “regular” recession. Accordingly, the relevant question is non-linearity in the effectiveness of various measures during recessions, not differences between recessions and “normal” times. While the authors do allow the data to decide where the breaking points are, with the potential that these breaking points will separate large crises from all other periods, the sample does not contain enough data points with “serious” recessions, as evident from the average growth rates in the periods classified by the model as “recession”; such an analysis would probably require a panel of quite a few countries. Moreover, limiting the number of “regimes” to 2, significantly reduces the probability that the periods identifies as “recession regime” will provide a relevant parameterization for the effectiveness of policy measures in a crisis like the current one.<sup>1</sup>

A second important caveat of the paper is the selection of the variables: there is too much “data mining” instead of analytical reasoning in the choice of the RHS variables. As discussed above, this type of modeling may lead eventually to results that place too much weight on “what works”, rather than on “what makes sense”, precisely the type of modeling associated with the policy misconceptions preceding the crisis. This process of choosing the variables is reflected, *inter alia*, in the non-intuitive lag structure in some equations – even if AIC supports them. Additionally, the regime-switching methodology should also control for changes in the political arena that may affect fiscal policies. While the analysis is definitely in the domain of legitimate academic and analytical analysis, jumping from it to policy prescriptions should be done with extreme caution.

In terms of Model Specification, the chosen explanatory variables: change in openness, short-term interest rates, the shares of public expenditure and revenues in GDP, do not seem to be the best candidates to explain changes in growth. More appropriate variables would be, for example, the change in world trade, Investment in the previous period, the growth rate of the population at ages 25-64, and changes in tax rates. Moreover, in dealing with issues of Ricardian effects, the key relevant variables are those that reflect long-term perceptions – which indicate future taxation – and not cyclical increases in public debt. In order to account for those, the model needs to use variables such as a persistent rise of debt, cyclically adjusted fiscal variables and debt levels. Again, using such variables would probably be easier in a multi-country panel, which seems to be the more appropriate empirical setting for the studied question. This is particularly relevant because **the available fiscal data are not really quarterly** – the quarterly fiscal figures are interpolated from annual data – a key problem in identifying the true fiscal response in quarterly estimation.

Another issue related to model specification is that when the output gap is small or negative, fiscal expansions lead to inflation – not to growth. This may bias the results towards not finding an effect of fiscal expansion on real GDP growth in such periods. Accordingly, there is a need to

<sup>1</sup> A disturbing feature of the methodology is that periods are classified differently in each equation.

control in some form for the output gap or, more specifically, for the interaction of the output gap with fiscal policy. This bias is particularly important in the current setting of the estimation which allows only two “states of the world” and “forces” a single coefficient for all the periods that are not a “recession”.

The analysis in the paper, especially with respect to potential Ricardian effects could benefit from separating endogenous developments from discrete measures. As mentioned above, Ricardian effects should result predominantly from permanent (discrete) measures, while cyclical developments should be associated with them to a much lesser extent. For example, if transfers rise (relative to GDP) during a growth period, this increase is likely to reflect legislation; in a recession it is probably an endogenous response. The opposite is probably true for taxes. Without, at least, such a basic analysis, the scope for useful analysis of Ricardian effects is fairly limited, and seems to be overdone in the paper. Without this analysis the interpretation of the coefficients in general is also hampered.

The policy implications derived from the results suggests that expansionary fiscal policy – either raising expenditure or cutting taxes – is effective in times of recession. Moreover, the authors also find that in non-recession periods cutting expenditures will moderate growth by a lesser degree (if at all, according to Table 1b) than the acceleration achieved during the recession,<sup>2</sup> and that raising taxes in non-recession periods does not affect growth. Hence, the results indicate a permanent gain in the level of GDP from countercyclical fiscal adjustments. I find this result to suggest, predominantly, that further work is needed to strengthen and examine the paper’s empirical findings.

The investment and employment equations provide more depth for the analysis, but essentially also carry the same basic problems as the growth equations. I would not repeat those. However, the fact that the methodology identifies different periods as a recession in each equation undermines the benefit from this expansion. As for the specific findings, it is worth noting that the results suggest that the effect of subsidies on investment is with a lag of 2 quarters, meaning that measures implemented during recessions – allowing for some lag between the recognition of the crisis and policy implementation – typically affect performance when the economy already begins to recover. Again, there is no offsetting effect when these subsidies are removed as the economy emerges out of the recession. As for the private employment equations, it should be better explained why lagged public investment has a negative effect on private employment (in regime 2), and the reversed sign of unit labor costs. Such findings are more indicative of endogeneity problems in the estimation rather than the behavior of the economy.

#### **4 Comments on “Government Fiscal and Real Economy Responses to the Crises: Automatic Stabilisers Versus Automatic Stabilisation” by Jonas Fischer and Isabelle Justo**

Fischer and Justo constructed a very useful dataset on the policy measures adopted by EU members in the current crisis. This dataset is useful and will probably serve many future studies and policy discussions. Moreover, given the uniqueness of the current crisis, the approach adopted in this paper – to examine the developments in a cross-section setting rather than in time-series – is indeed the more appropriate one. Nevertheless, as an independent study this paper is a miss, because it provides too little analysis. The key feature absent in their work is a greater focus on the cross-section variability rather than on averages for the sample. Since the authors do a thorough job in collecting and describing the data on the policy measures, I will focus my comments on

<sup>2</sup> The authors highlight this result, although they do not provide a test whether it is statistically significant.

suggestions for more ambitious analysis that could be implemented by the authors – sort of a “wish list”.

In terms of the descriptive data, the authors could compare the size of measures in various policy areas to the initial level of expenditure. In some fields the addition to public expenditure during the crisis was small in absolute terms but significant compared to the base. This may provide an indication for the potential capacity limitations facing policy-makers when they want to target certain activities or fields of activity.

To enhance the analytical value of the paper the authors could present a breakdown of the policy measures taken by the country’s fiscal position at the outset of the crisis and the required long-term fiscal adjustment, and according to the size of government relative to GDP. It would also be interesting to show a descriptive analysis of the relationship between the types of measures adopted and labor market conditions, the relation between the size of discrete policy measures and the need for financial sector support, and the effect of initial country risk on the intervention’s magnitude and the selection of instruments. Furthermore, it would be useful to examine if discretionary interventions tended to complement the automatic stabilizers to a given absolute size, or whether the two types of fiscal expansions are positively correlated.

As for more ambitious in-depth analysis, it would be valuable to study the effectiveness of automatic stabilizers and discretionary measures with long-term regressions, or simulate coefficients taken from other studies, and compare the projected elasticities with those in the current crisis. The key question that would be particularly interesting in the current study is whether the measures that were chosen in the recent crisis are those that were found to be effective in the past, and whether different past country experiences affected the recent composition of policy instruments. While these questions definitely go beyond the current scope of the paper, much of the relevant raw information is already presented in the paper, and the added examination would substantially upgrade the analysis.

