COMMENTS ON SESSION 1
AUTOMATIC STABILISERS AND DISCRETIONARY FISCAL POLICY

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Let me start by thanking the organisers for inviting me and giving me the opportunity to discuss two excellent papers, the one by Ludger Schuknecht on "Fiscal Activism in Booms, Busts and Beyond" and the one by Britta Hamburg *et al.* comparing the fiscal policy reaction to the recession in Germany and Italy. The tone and the messages of both papers are quite different. Ludger is essentially telling us that policy mistakes have been made both in the run-up to and during the crisis while the second paper argues that the Italian and German government have all in all done a good job as they have successfully limited the drop in output in a relatively similar and efficient manner. So, clearly there is a difference in views there. What both papers agree upon, though, is that the time has now come to face the challenge of designing and implementing a coherent fiscal exit strategy, although I also sensed a greater urgency in Ludger's paper and presentation than in the paper by the colleagues of the Deutsche Bundesbank and the Banca d'Italia.

Let me treat both papers in chronological order and start with the one by Ludger Schuknecht. In my view, this paper offers an excellent descriptive analysis of the policies before and during the Great 2008-09 Recession. Fiscal – but also other – policies were overly imprudent in good times. This was partially obscured by the problems in measuring output gaps and structural fiscal positions in real time (and, more in particular, an overestimation of the growth outlook) and compounded by unsustainable private-sector developments leading to macroeconomic imbalances. Then, when the recession hit, there was a panic reaction and governments all over the world rediscovered the alleged virtues of "old skool" Keynesiansm, which substantially aggravated already existing fiscal sustainability problems. Now the issue is to implement fiscal consolidation strategies in a timely manner with a view to bringing public finances closer to a sustainable path and expenditure retrenchment should – for a number of reasons – be a key ingredient of those strategies.

I reckon that, if economic historians look back upon the current episode in fifty years' time or so, this is more or less the story that they will come up with. Of course, Ludger's great merit is that he writes this today, rather than 50 years from now, when the dust has far from settled and opinions on what governments should and should not do still diverge quite a lot (including, e.g., calls from leading policy analysts to address government debt problems by creating more inflation).

I would argue that this paper is vintage Schuknecht: it presents a logical sequence of arguments, specifically highlighting where policy mistakes have been made and, obviously, it ends with a call to substantially reduce government expenditure ratios! The thing is, it is really hard to find fault with the reasoning and, to be honest, I am not going to try very hard. I realise that I am not doing my job as discussant very well but what I would like to do instead is to offer some general comments that will mostly corroborate or add to the story.

Let me start with the measurement issue. The paper reminds us again about the difficulties involved in gauging the structural component of the budget balances, especially in times of strong cyclical fluctuations. In this connection, there are three possible reactions. First, one can stop using these indicators altogether. However, it is obviously highly doubtful whether nominal budget balances will prove to be a more reliable compass for fiscal analysis. Second, one can try to further

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improve the methods used for the cyclical adjustment of budget balances (by, e.g., explicitly accounting for asset price cycles) but there is a clear risk of "overburdening" the indicator. Finally, one may interpret structural balance estimates with (greater) caution. In this connection, it may be worthwhile to focus more on methods that help to *explain*, rather than just gauge movements in structural balances as they can point to windfalls or shortfalls that can not be traced back to policy actions or structural elements. However, as long as one accepts that the current assessment of the cyclical position to some extent depends on projected future developments – and, to my mind, this is the only viable approach from an intellectual point of view –, estimates of structural balances will continue to come with at least some degree of uncertainty. In addition, one should not forget that a more serious problem, that is not explicitly addressed in the paper, is the apparent general unreliability of the actual government accounts for certain countries. To my mind, structural reforms are also warranted in the area of government finance statistics both at the national level in certain countries, but most likely also at the level of Eurostat. In the recent past and in part due to limitations in terms of its mandate, the latter institution has not always been the "rapid statistical reaction force" that fiscal analysts would want.

My second general comment pertains to the fact that quite a few of the elements in the cocktail that according to Ludger led up to the recent recession and the very worrisome public finance situation were actually well-known: fiscal analysts have repeatedly warned that buoyant expenditure trends and, more generally, a post-Maastricht "fiscal fatigue" were weakening the budgetary fundamentals and making government budgets more vulnerable to adverse shocks. The fact that substantial revenue windfalls are not always captured by traditional cyclical adjustment methods and, hence, estimates of structural budget balances may offer a false sense of comfort, has been documented many times, not least by Ludger himself. It seems fair to say that there was no shortage of warnings against unsustainable fiscal – but also macroeconomic – developments. Actually, in some ways, the current episode even looks like a more spectacular remake – with, granted, a starring role for a new villain, the financial sector – of the fiscal crisis at the beginning of the decade when the euro area and the EU fiscal framework were hit by the first wave of excessive deficits. It would appear that, while the writing may have been on the wall, the font was apparently not clear or big enough for governments to start following the path of activist prudence recommend by Ludger. Against this background, a solid case can in my view be made for strengthening the (supra-national) regulatory and institutional framework for public finances.

In this connection, the current crisis provides an ideal opportunity to rethink the design but especially the implementation of the EU fiscal rules. If the latter are to contribute to preventing the emergence of huge fiscal imbalances, then, clearly, more attention should be paid to sound fiscal positions in the medium and the longer term. This implies in my view that the so-called preventive procedures of the Stability and Growth Pact, that are anchored to the achievement of sound medium-term objectives for public finances, should become truly binding. In addition, one should carefully consider whether the new approach to defining these medium-term objectives will be sufficiently prudent, especially when taking into account the longer-term fiscal challenges related to population ageing. As regards the corrective procedures of the Pact, it may be appropriate to turn back some of the "flexibility" that was introduced in EU fiscal rules when the Pact was reformed in 2005. Turning to the national fiscal frameworks, it seems obvious that national rules can be a useful complement to the Stability and Growth Pact. However, certain countries may also explore the scope for (further) delegating specific aspects of budgetary policy to independent fiscal councils. In this respect, the elaboration of prudent macroeconomic and government revenue assumptions for the budget is an example that comes to mind. More generally, the crisis has also clearly shown that a much broader assessment of fiscal risks is warranted: rather than just focusing on budget balances, one should pay greater attention to public debt developments, implicit liabilities and macroeconomic imbalances. I would argue that the Stability and Growth Pact was the main victim

of the fiscal slippage as of 2001. It would be somewhat ironic, but certainly very welcome, if the more dramatic fiscal problems that we experience today would lead to tougher EU fiscal rules...

Finally, as any story about the Great Recession 2008-09, also Ludger's paper contains a chapter about the financial institutions and the government support measures to keep some important ones afloat. What always strikes me, is that fiscal analysts, including the ones that tend to be rather critical of interventionist policies, are typically more hesitant to criticise the measures taken to support ailing financial institutions. Even Ludger, whom nobody will accuse of having the habit of turning a blind eye on policy mistakes, indicates that these measures "can probably be called rather successful". This generally more lenient attitude is probably related to the fact that the absence of any intervention could have triggered a financial meltdown and a much deeper or longer recession. Still, in retrospect one can ask whether tax money has been used wisely in all bank rescue operations, in particular as a perceived "fiscal largesse" for the banking sector at least represents a communication challenge in times when draconian consolidation measures appear necessary for many countries. In my view a number of parallels can be drawn with the story about the real economy that go beyond the obvious lack of prudence in good times. First, I could think of a number of cases where panic-driven government actions have clearly led to second-best solutions. Second, as with the Keynesian demand management, it does not seem outrageous to think that also the fiscal support measures for the banking sector have sometimes been captured by special interests.

I turn now to the second paper that I will discuss, the excellent empirical assessment of the fiscal reaction in Italy and Germany that was presented by Sandro Momigliano. The paper makes a couple of very interesting points. First, appearances can be deceiving: the authors argue that, all in all, fiscal policy was loosened to a roughly similar extent in both countries despite the alleged different size of the "stimulus measures". Second, their simulations suggest that this fiscal reaction salvaged some 1 percent of 2009 GDP in Italy and some 2 per cent of 2009 GDP in Germany. The different impact is attributed to country differences in fiscal multipliers; in this connection, the growth contribution of Italian automatic stabilisers is surprisingly low to my mind. Finally, they also present a "neutral" benchmark simulation showing what would have been the outcome in the absence of any policy reaction and an earlier version of the paper that I read, suggested that a comparison with this benchmark showed that the policy reaction may have been relatively efficient. My comments will generally focus on how to assess – the efficiency and, more generally, the appropriateness of – a government's fiscal reaction.

The first issue in this respect is the correct measurement of this fiscal reaction. One of the things that I like very much about the Hamburg et al. paper is the fact that it clearly shows that there is a significant gap between the "bottom-up" and the "top-down" approach, *i.e.* between a measurement based on the adding up of individual stimulus measures and one anchored to the change in structural (primary) budget balances. As indicated in the paper, the bottom-up approach is biased by differences in budgetary (*i.e.* mostly expenditure) trends as well as political economy issues: governments may have reasons to misrepresent actual stimulus efforts. While the top-down approach, on the other hand, may be affected by the measurement problems related to the real-time assessment of the cyclical situation and referred to in Ludger Schuknecht's paper, it would still seem to be a more reliable yardstick to gauge policy intervention in my view. However, it is crucially important to try to identify the sources of the gap between these two approaches to get a deeper understanding of the orientation of fiscal policy. At any rate, the paper also clearly shows the need to look at explicit policy action and automatic stabilisers together.

Turning to the measurement of the fiscal impact, this paper uses the macroeconometric models of the Banca d'Italia and the Deutsche Bundesbank. I am certainly not in position to quarrel with the modelers of these two institutions but such models obviously tend to reflect *average* behaviour. In this connection, it should be stressed that appendix A suggests that both models are

basically of the Keynesian type in the short run. Hence, we should probably not expect the empirical results to point to negative, or even small, fiscal multipliers. However, several studies show that fiscal multipliers may be regime-dependent. This is the case for the paper by Bouthevillain and Dufrénot that was presented here in the same session but, e.g., also for Tagkalakis (2008) and Nickel and Vansteenkiste (2008). Against this background, the million-dollar question is to what extent the current exceptional circumstances change the "normal" fiscal multipliers. What is the impact, in particular, of the higher incidence of liquidity constraints (that could be expected to increase multipliers) and of the increased fiscal stress (that could be expected to lower multipliers)?

At any rate, an appraisal of the efficiency of the fiscal intervention generally relates the fiscal reaction to its impact. In this connection, one can compare efficiency across countries but also try to relate the fiscal reaction to some benchmark (e.g., a no-policy-change scenario). The version of the paper that was presented by Sandro mainly focuses on the cross-country dimension and compares the fiscal reactions in Germany and Italy.

The paper specifically gauges the impact of the fiscal stimulus (measured in the "bottom-up" way) and the automatic stabilisers. With respect to the former, Italy is shown to be more "efficient" as a marginal budgetary worsening is accompanied by a boost to GDP of more than half a percentage point, while the increase to German GDP of somewhat less than 1 percentage point seems to require a significant worsening of the budget balance by 0.9 per cent of GDP. This may be due to the higher share, in Italy, of stimulus measures that, according to the literature, have a higher multiplier, such as the car scrapping schemes, as well as the increased incentives for investment in machinery. However, it should be stressed that the net budgetary impact of the Italian stimulus measures is lowered by the exceptional capital taxes, that were introduced to (partly) finance these measures. While these taxes are assumed to have only a negligible, if any, impact on current activity growth, the authors indicate that they may have important negative effects on government revenue in the coming years. In this sense, the measured "efficiency" of the Italian stimulus package in 2009 may come at a significant cost. As regards the automatic stabilisers, the picture is quite different, as, in this case, the German government seems to be much more efficient – when comparing the budgetary impact to the boost in GDP – in cushioning the impact of the recession. I was a personally a bit puzzled by the relatively low impact of the automatic stabilisers in Italy (a worsening in the budget balance by 1.2 per cent of GDP would only boost GDP growth by 0.3 percentage points). The authors attribute the striking difference with the results for Germany to differences in the importance of unemployment benefits between both countries and, more generally, to higher multipliers in the model for the German economy. However, to my mind the paper could benefit from a deeper discussion of this issue (e.g., could it be that social expenditure is more targeted in Germany and that multipliers are generally lower in Italy due to Ricardian effects stemming from the higher level of government debt?).

By focusing on the stimulus measures and the automatic stabilisers the authors neglect the differences in budgetary trends, even though they indicated before that these may be important and the "bottom-up" measurement of fiscal stimulus that is used here may give a misleading picture of the actual fiscal policy loosening. Against that background, it may be worthwhile to develop more the other dimension in the paper, *i.e.* the comparison of government actions in each country with a neutral benchmark. Obviously, it is not easy to define such a neutral benchmark. The authors' approach is to hold all budget items constant with respect to trend GDP. While that corresponds to my understanding of a neutral policy stance on the expenditure side, one could also define a neutral stance on the revenue side as a situation in which all revenue items grow (or, in this case, fall) in line with *actual* GDP. By comparing the results of this alternative simulation of a neutral policy stance with the actual developments, one may get an impression of the overall impact of policy action (irrespective of whether it comes with the "stimulus" label) in both countries.

Finally, apart from the quantification of the macroeconomic impact of the fiscal stimulus, which is the main focus of this paper, there are also a number of more qualitative considerations. To my mind, these primarily pertain to the third T of the 3T mantra: were the measures appropriately "targeted", or to put it more bluntly: did the money end up where it was most needed? At least one observer – Ludger Schuknecht – is rather pessimistic on this issue as in his paper he argues that "targeting was poor", "stimuli were also captured by special interests" and there was "little focus on facilitating economic restructuring". Let's take the example of the car scrapping schemes that were a key element of the stimulus packages in both countries considered here. On the one hand, one could argue that these subsidies target industries in need. On the other hand, one could also point to the important lobbying power of the car manufacturing industry: jobs were also threatened in, say, the local grocery stores but it may be more difficult to elicit government support measures in this case, even though such measures may have been equally appropriate, or inappropriate, as those in favour of the car producers. In addition, it is questionable whether support for the car manufacturing industry is the best example of stimulus measures that facilitate economic restructuring. More generally, I would like to stress that the "old" arguments against active demand management are still very relevant in my view: this applies to the political economy considerations related to "appropriate" targeting but also to the timeliness and the reversibility of the stimulus measures. In this latter connection, governments should now prove that they are capable of taking away the stimulus when it can no longer be justified in the context of the substantial consolidation programmes that are now required in most OECD countries.

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