COMMENTS ON SESSION I: INDICATORS OF FISCAL IMPACT

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Most of the papers in this session are concerned with the construction or assessment of indicators of fiscal policy in the short run. The indicators relate either to measuring the policy itself or to evaluating its effects on economic activity over the business cycle.

My comments are organized along three major themes, which I shall discuss in turn.

1. Level versus composition in the choice of policy instruments

An important point the papers raise is that when one examines fiscal policy over the business cycle, reference to levels (of expenditures, revenues, deficits) is not enough. One should also look at the composition, given any level.

In terms of composition two major distinctions arise from the papers:

1. The item – composition: the spending mix such as public consumption versus transfer payments; the composition of revenues, e.g., the distinction between direct and indirect taxes; the structure of the budget balance in terms of expenditures versus revenues.
2. The composition of fiscal policy over the business cycle regarding discretionary policy versus automatic stabilizers. That is, what part of the change in the budget balance comes from explicit government decisions as opposed to the effect of the business cycle given existing tax rates, unemployment benefits, etc.

I would like to emphasize several points as to why these distinctions are important and potentially fruitful for policy making:

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1. Countries are losing or giving up their ability to use the deficit level as a policy instrument. EU members have not only conceded monetary policy. To some extent they have also given up fiscal policy. Agreements such as the Maastricht Treaty and the Stability and Growth Pact limit members' ability to respond to the business cycle by large changes in their overall budget balance. Therefore they are largely left just with the ability to affect activity through the *composition* of the balance. Hence it is becoming more important in today's Europe to choose the optimal composition of the budget balance (in both dimensions that I have just mentioned), rather than its level. This is increasingly true also outside the EU as more countries unilaterally commit themselves to budget-balance targets.
2. While acknowledging the issue, the papers do not yet provide separate estimates of the effect on economic activity of automatic stabilizers compared to discretionary policy. Such estimates could help policy-makers decide on the optimal mix of automatic and discretionary measures. Moreover, the choice of this mix may have implications for the levels of the automatic stabilizers themselves.

An example may clarify this point. Are high marginal income tax rates, which induce an automatic stabilizer (but have other costs), preferable to discretionary changes in tax rates when the cycle changes? More specifically, Philip and Janssen mention in their paper that in New Zealand there is a general approach of relying almost solely on automatic stabilizers, rather than discretion, in responding to the business cycle. That, I think, could lead to a sub-optimal choice of tax rates.

2. The composition of policy objectives

Murchison and Robbins emphasize the important distinction, apparently often neglected in the literature, between the impact of fiscal policy on the economy (FiPS) and the budgetary position over the business cycle (CABB).

A potential application is that their estimation of both indicators allows an assessment of the trade-off between two conflicting objectives (high activity, low deficit). It could also help in deriving a deficit-target that reflects policy-makers' preferences regarding these objectives. The explicit consideration of both objectives may enhance the transparency of the decision making process and the credibility of the chosen target.

3. Issues that arise from comparing the papers

3.1 Are findings comparable?

One might think that three of the papers (Murchison and Robbins, Momigliano and Siviero, Philip and Janssen) examine roughly the same phenomenon in their respective countries: they all look at data over a certain time period to estimate the effect of fiscal policy. It is however important to note that the circumstances are quite different, hence comparing their results requires caution. In Italy and New Zealand there is a change of regime during the sample period – a shift to a more disciplined fiscal policy, which is probably not the case in Canada. As the authors acknowledge, and bearing in mind the Lucas critique, the effect of fiscal policy at a time of structural change could differ substantially from its effect during a normal business cycle, in which the regime is stable.

3.2 A word on methodology

The three papers just mentioned employ a time series framework, testing the effects of fiscal policy within a single country over time. In contrast, Denis and Quinet use pooled data for several countries over time. However, the value added relative to country-specific studies is not fully exploited. They present only fixed-effects estimation, which utilizes just the time variation within each country, but neglects the cross-country variation. Supplementing the results with random-effects (GLS) estimation, which makes use of both variations, could be instructive.

3.3 Openness

Denis and Quinet emphasize the potential significance of a country's openness for the effect of fiscal policy. This point might merit consideration in the single country studies, to the extent that these countries had gone through significant trade liberalizations or capital market reforms during the period in question.

3.4 Inequality

The papers offer a careful analysis of fiscal policy over the business cycle. Extending the analysis to additional aspects that are likely influenced by this policy could be useful. Inequality is a case in point. The composition of policy instruments discussed earlier may have a considerable effect on the cyclical behavior of inequality. Specifically, high income tax rates are potentially important automatic stabilizers and could also mitigate after-tax inequality over the cycle. The same may apply for the choice of different taxes or taxes versus subsidies.

3.5 Generational accounting

Vanne's paper shifts the discussion from the very short run to the very long run. Yet, generational accounting may alter the impact of fiscal policy even in the short run. For example, suppose a country realizes that its social security system is unsustainable and therefore decides to start accumulating budget surpluses. This could constitute a shift in the fiscal regime, thereby changing the manner in which fiscal policy is perceived by the public, hence the way it affects the economy even in the short run. In fact, such a change in regime designed to pre-fund the public pension system seems to have taken place in New Zealand (see Philip and Janssen's paper). To a lesser degree this may also be the case in the US, regarding the allocation of some budget surpluses to Social Security.