COMMENTS ON SESSION II: FISCAL STABILISATION

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I am pleased to be in Perugia once again at a conference which deals with important issues from a policy-maker's perspective. It is rare to have the opportunity to compare notes on fiscal problems in such a broad international context. We have just heard six very good papers, each one rich with relevant and useful insights and based on thorough research. I congratulate the authors on their achievements.

In the UK policy context there is now greater emphasis on the need for evidence-based policy-making, with the idea that policy-makers should carefully examine the evidence before making – possibly otherwise faulty – judgements. The history of fiscal policy around the world is littered with rash and hasty judgements, so it is particularly important that the valuable work we have been listening to this afternoon (and this morning) percolates into policy-thinking.

All too often the role of the discussant, not just in academic circles, is to find fault with the papers discussed. That is <u>not</u> my intention. The papers do not in any way seem flawed. They offer important, but different, perspectives on our theme this afternoon: <u>fiscal stabilisation</u>. Two of the papers (Barrell *et al.* and Meyermans) use full model simulations to look at, among other things, automatic stabilisers; two others (Comley and Steindel) touch on Ricardian Equivalence issues to assess whether and how far fiscal effects are long-lasting and effective; another paper (Hemming *et al.*) focuses on recession experience and whether fiscal policy can help; and a further paper (Fischer and Eckefeldt) goes beyond the issue of stabilisation to look at the wider role of Government and EU Member States' preferences for the manner of that stabilisation – whether through automatic stabilisers, discretionary policy or big Government or regulation. Let me start by making some broad observations on fiscal policy.

First, <u>the general context</u>. Reappraising the impact of fiscal policy seems particularly relevant today. The recovery from recession in the US

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and the potential impact of the recent tax stimulus package is of particular interest.

In the UK the Government has embarked on an expansionary spending programme, traditionally thought to have strong demand effects, though so far taxes and growth have been adequate to maintain the good fiscal position. In Japan, where fiscal policy is one of the few remaining policy instruments, given zero interest rates, successive fiscal stimuli have been applied, seemingly without the desired results. And in Europe, the constraints of the Stability and Growth Pact (SGP) have begun to bite, raising questions both about stabilisation but also longer-term growth.

A further general observation on the role of Governments is worth considering – while output in the euro area has been somewhat more stable than in the US, euro area growth has on average been much slower. Do EU Member States prefer a quieter, more stable but less productive life than their US counterparts or, as Jonas Fischer asks us, are big Governments and, specifically, policy-makers to blame for this relative lack of performance?

Second, the EMU context. Member States in the euro area now have only an indirect influence on the monetary policy that is relevant for their individual circumstances. The interest rate is set by the European Central Bank to ensure euro area price stability and exchange rates are fixed, other than the euro rate. For fiscal authorities, however, this should be advantageous. Not only do they have more individual responsibility, they also have an instrument, i.e. fiscal policy, which should be more powerful than before, at least in theory. In this context, empirical results for individual Member States based on data from earlier policy regimes may be biased when looking forward. Moreover, although fiscal authorities may wish to act to counter idiosyncratic shocks they are constrained in what they may do by the Stability and Growth Pact. If fiscal policy turns out to be powerless in affecting the economy it would not matter. But if it does have some impact then this is an important issue, as Ray Barrell notes.

Third, the wider policy context. In many countries there is a formal separation of the roles of fiscal and monetary policy. Nonetheless, the authorities respond to the same information and may not have completely separate goals *vis-à-vis* demand management and stabilisation. A demand shock may thus prompt both a monetary and fiscal (discretionary and non-discretionary) response. For example, exchange rate and financial market changes affect wealth, incomes and thus taxes and budget balances as well as inflation prospects. Often fiscal and monetary policy responses go together, but not always in a co-ordinated way, with fiscal and monetary responses sometimes competing against one another. Disentangling the pure fiscal impact from other influences, particularly monetary policy responses (and of course the general problem of lagged effects) is not easy. Macro models have the upper hand in this context, though against that the richness of detail in relation to specific policy impacts can be lost. The implication is that we should always be asking "what else is going on" beyond the immediate change in the budget deficit and I am encouraged that the papers generally do this.

A closely related matter concerns financial deregulation and wealth effects. The last twenty years have seen dramatic changes in financial markets and increases in household wealth. In looking at, say, consumer behaviour following a fiscal policy change it is also necessary to look at the behaviour of wealth. Blair Comley's paper for example looks at this aspect of wealth's impact on savers. A small tax cut, say, may dominate subsequent consumer behaviour via housing and equity market impacts, as compared with a small spending increase of equivalent size not favoured by markets or noticed by the public. The enhanced opportunity for forward-looking behaviour by consumers in deregulated financial markets impinges on the effectiveness of tax and spending policies. A key question is the role of markets as a stabilising force. I was struck by Jonas Fischer's result that with big Government, output tends to be more stable. But I suspect that countries which are particularly market-oriented, flexible or with rich financial markets can also be stable. I think Jonas Fischer's view might be that countries can get there by this route if they pursue suitable economic reforms.

Fourth – but slightly tongue-in-cheek – what do we see fiscal policy encompassing? For those politicians who actually operate fiscal policy, it is much more than stabilisation. Indeed, it is increasingly seen as part of a wider efficiency and growth agenda as Jonas Fischer's paper indicated. The quality of public finances, i.e. the way taxes are raised or the type of public spending that is conducted is as important as the balance between the two aggregates. Here Ray Barrell's remarks about public investment are important and the connected question of what is an appropriate medium-term fiscal objective, once sustainability is no longer a pressing issue.

Another dimension raised in these papers is more practical. How do we measure fiscal policy and calibrate its impact? It was very useful that a number of authors looked at several options here. For example, Richard Hemming considers actual balances, primary balances and structural versions of both. Which we choose colours whether we think the context is a fiscal expansion or a contraction; for example, 33 expansion v 6 contraction episodes on an overall balance basis, but 16 expansion v 23 contraction episodes on a primary structural balance basis. And the primary balance results compared with overall balance are intriguingly more Keynesian in nature, so the choice of measure is important.

A structural measure of the movement in fiscal balance is certainly a good first approximation in identifying fiscal change. But it is also clear that composition counts (ref. Banca d'Italia paper). It is also important to consider what is already in the pipeline from earlier discretionary policies but which has taken time to come through into the fiscal numbers; and how the fiscal path is evolving relative to what was previously anticipated. And a fiscal adjustment – say, a move into deficit – that has been long advertised may have less impact than one that comes out of the blue or in a crisis.

This brings me to Charles Steindel's paper which I found fascinating in its charting of household responses to specific tax events in the US. The issue of what is taken to be temporary and what is seen as permanent is clearly vital in the fiscal policy context. It is encouraging to hear that US consumers' reaction to temporary changes is smaller than permanent ones. And interesting to see that, despite pre-announcements, they wait for the cash before making their decisions – cash truly is king! The latter partly reflects liquidity-constrained households and I wondered whether this effect might have moderated over the period as financial markets have become deregulated and wealth has accumulated. The result seems likely to translate to the UK context and perhaps other EU Member States.

I did wonder where the media and all those sophisticated pundits fitted into Charles Steindel's story. In the UK, for example, tabloid newspapers have pages of "what the Budget means for you" and related tax tables to read off how many pounds per week better or worse off individuals are following major fiscal events. But I very much agree with this point that the complexity of the US tax system and its process hampers even an intelligent guess as to what the implications of tax changes might be. And the Budget process in the US leaves some uncertainty as to whether a stimulus package will or will not run, quite apart from whether it will stimulate anything!

Let me return to the main themes of this session on fiscal stabilisation and the issues that have been raised:

- what is the Government's role in stabilisation?
- how far should it go?
- will it work?

In short, the answers seem to be:

- Governments do have a role, mostly through automatic stabilisers and in keeping to a steady fiscal path;
- but they should use their influence wisely and only occasionally, and certainly not at every opportunity;
- fiscal stabilisation can work and is worth trying, but don't expect too much and perhaps it is as important to focus on getting quality right as much as quantity.

The issue on which it is probably easiest to find consensus, looking through the papers and hearing the presentations, is automatic stabilisers. One of their great advantages is precisely that they are automatic, i.e. fast and pretty much out of Government hands. But, as Eric Meyermans' paper shows, for example, automatic stabilisers are not without downsides. They are very useful for demand shocks but not so helpful when faced with supply shocks. That raises two questions:

(i) should we try to identify the nature of shocks more precisely and react differently? Or is that more trouble than it's worth? My sense is that it is too much trouble on the whole.

(ii) Governments can alter the strength of automatic stabilisers, or create fiscal instruments to do so. EMU implies fiscal policy is both more necessary and more powerful. And there is no cross-border transfer system. Should this power be used and strengthened? It was noticeable that Eric Meyermans' results suggested a weaker stabilisation effect for the euro area (11½%) relative to the US (22%). This may be worth considering further. But there is a trade-off: stronger stabilisers may mean smoother output but it means more volatility in the budget balance. This could alter the currently fairly reassuring probabilities of breaching the 3% limit of SGP set out in Ray Barrell's paper. But on automatic stabilisers at least, Ray Barrell and Eric Meyermans offer some reassurance that they are helpful.

Turning to discretionary policy life becomes more difficult. Jonas Fischer's first chart on pro-cyclicality suggests history is against successful discretionary policy. There are certain situations where we know discretionary action will not be appropriate. For example, loosening policy when:

- debt ratios are high or unstable; or where
- the population is ageing and surpluses perhaps need to be built up;
- at a peak of a boom (obvious in theory but often trend growth gets raised blurring the structural position);
- where a Government lacks credibility;
- where the fiscal path is already off track;
- where the nature of the loosening involves poor value-for-money spending, and so on.

In these circumstances a discretionary tightening, however, might be appropriate even if only a portion works through because of Ricardian effects. But this does not mean loosening should always be ruled out. For example, where the debt ratio is low and the fiscal position is sustainable and in:

- a severe but temporary downturn; or perhaps when
- policy can be well targeted and the effects on incentives or capital can be reasonably certain. Note, too, Ray Barrell's suggestion that higher public investment could be welfare enhancing.

But will it work? Here the papers clearly give us pause for thought:

- for most fiscal policy-makers administrative, legal, parliamentary, and regional constraints are very real and imply long and variable lags. Charles Steindel's paper rightly adds another to the list – tax complexities. It is not clear we even start at the first tee with the right club;
- circumstances count. Richard Hemming's paper usefully catalogues the key features here and investigates the practical implications of when fiscal policy might be Keynesian in nature;
- excess capacity helps;
- so too does a more closed economy or fixed exchange rate;
- liquidity-constrained households increase the chances of success;
- monetary and other policies matter too;

- and myopia may help.

The evidence broadly supports the theoretical points, which I regard as an encouraging start. I was interested to know whether the results extend beyond the advanced countries in Richard Hemming's paper to a wider group where the variations of experience may be richer.

But even in the best of circumstances:

- Will fiscal changes be seen as temporary or permanent and what will households actually do? Blair Comley's paper shows some significant offsets to fiscal changes, particularly when the structural side is looked at. This is bad news for Finance Ministers. I think few of them realise this is a possibility, let alone perhaps a reality. Charles Steindel's paper at a more micro level makes clear that households do indeed look carefully to try to discern the permanent effects of fiscal changes.
- And what about other offsets, such as interest rates or exchange rates? Blair Comley's result for Australia showing a noticeable (32 basis point) impact of structural fiscal policy on interest rates, and Ray Barrell's simulations, make clear this is an important consideration to factor into fiscal policy decision-making.

To sum up

None of these results is wholly inconsistent with some impact of fiscal policy in a Keynesian sense. They do especially lend support to the view that automatic stabilisers have a moderate and useful effect, at least for demand shocks. More work needs to be done, but these six papers have provided a very good basis on which to move forward.