

## Is Fiscal Policy the Answer?

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## Is Fiscal Policy Effective?

- Maybe...the textbook “Keynesian multiplier” but not much supporting evidence
- Three types of fiscal policy:
  1. Automatic Stabilizers
  2. “Stimulus Packages”
  3. Politically-motivated changes

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## Fiscal Policy is Back

- A global recession, a renewed interest in the role of governments and the exhaustion of monetary policy actions have led to increased interest in the role of fiscal policy.
- Is fiscal policy the right tool? What are the risks? What are the rights institutional settings that can improve the effectiveness of fiscal policy?

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## Do Automatic Stabilizers Work?

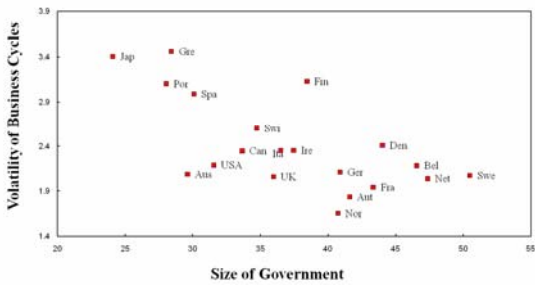
- In many cases they are the side-effect of other goals (e.g. progressive taxation)
- Very difficult to estimate their impact (impossible to build counterfactuals)
- Two approaches
  - a) Use large scale models of the economy
  - b) Look for cross-country evidence

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## Do Automatic Stabilizers Work?

Cross Country Evidence on the Effectiveness of Automatic Stabilizers



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## Bad News about Fiscal Policy Discretion

- Even if fiscal policy is effective, governments do not always get the timing right
- Strong evidence of acyclical or even procyclical fiscal policy (more so in emerging markets). The US is an exception where fiscal policy has been clearly countercyclically, especially in the last two recessions.

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## Do “Stimulus Packages” Work?

- Evidence is mixed.
- Recent evidence suggest that the Keynesian multiplier works but it is small (more so in emerging markets) and might be decreasing (in the US)
- And there are still many who believe (and provide evidence) that fiscal policy expansions lead to contractions in private consumption

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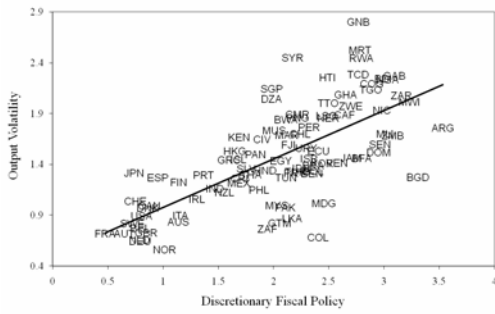
## (Even More) Bad News about Fiscal Policy Discretion

- Not only the timing of fiscal policy actions can be wrong, discretion in itself can generate additional volatility and harm macroeconomic performance
- Politically-motivated changes in fiscal policy add volatility to the business cycle and can reduce long-term growth

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## Discretion in Fiscal Policy generates more Volatility in output



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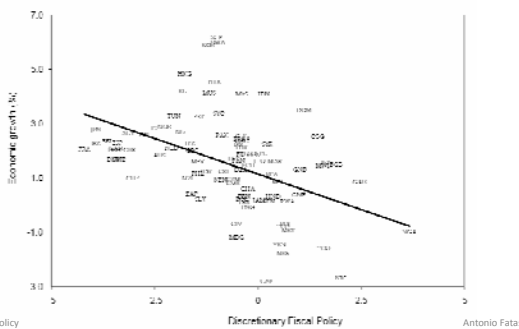
## (One final piece of) Bad News about Fiscal Policy Discretion

- Governments are good at generating deficits but not so good at finding the necessary surpluses to balance their accounts. Many countries have seen large increases in government debt over the last decades and it looks as if it will get worse over the coming years (or decades)

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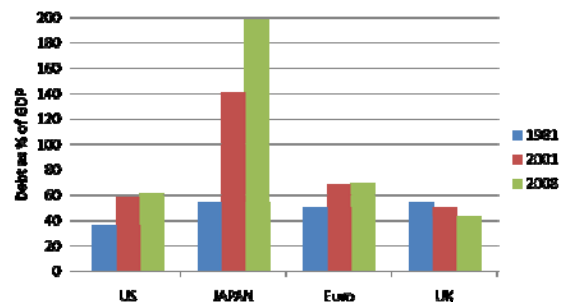
## Discretion in Fiscal Policy generates lower growth



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## Government (Gross) Debt



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## Summary so far

- Fiscal policy can be a tool to smooth out business cycles but...
- If we leave governments too much discretion there can be some undesired consequences
- What to do? We need to come up with policy rules (i.e. what governments should do) and an institutional framework that ensures that governments stick to these rules

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## The EMU Experience

- Maastricht Treaty: limit to deficits (3%) and debt (60%). Sustainability was the main (only) goal.
- Very early discussions on the need for exceptions (a deep recession, structural reforms).
- Debate led to political outcomes, distraction from real issues. No mechanisms to punish sinners.
- Result: it only worked before EMU (because of the threat of not joining the Euro). Limited discipline, procyclical.

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## Fiscal Policy Rules

- Balanced budgets avoid politically-motivated changes in fiscal policy but they constrain governments too much
- Slightly more sophisticated rules (Stability and Growth Pact (EMU); Golden Rule (UK), Chile) have not done well because of the tension between simple rules and credible and enforceable rules.
- Can we really define a rule?

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## Lessons from EMU experience

- (Soft) Rules & exceptions do not work
- Option 1: Strict rules approach (e.g. balanced budget, golden rule,...) but this is very costly
- Option 2: We create the right budget processes and a set of (independent) institutions with a clear goal and a strong enforcement mechanism. The case for "Independent" Fiscal Policy.

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## A parallel with monetary policy

- Strong academic debate in the 70s about whether monetary policy works (by the way, still no consensus among academics)
- A realization that monetary policy works in both ways (it can help but it can also hurt if misused)
- Constrained governments seems to deliver a better monetary policy. Move towards independent central banks (no strict rule, but good institutions, processes and judgment)

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## Less Extreme Proposals

- Fiscal Policy Councils (already in place in some countries).
- Need clear goals (Sustainability? Dealing with business cycles?)
- The difficulty is in making their advise heard, operational and enforceable.

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## Independent Fiscal Policy?

- Q: Can we do the same thing for fiscal policy?
- A: No!!!! Fiscal Policy affects political decisions (e.g. income redistribution).
  - Yes, but so does monetary policy (more so today)
- A: No!!! Politicians will never give up their power
  - They did with monetary policy and they have not asked for it back (yet)

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