

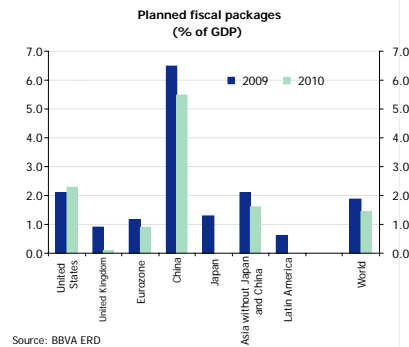
## The Fiscal Policy in the Current Crisis

Reflections on the Economic Crisis

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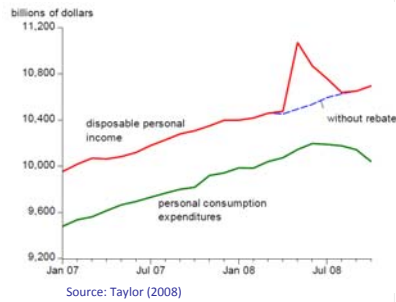
- From the point of view of economic policy, the current crisis is characterized by **heavy-handed use of monetary and fiscal policies** for stabilization purposes.
- Central banks have cut their **nominal interest rates** to all-time lows (*zero bound*) and have undertaken **unconventional monetary policies** (*quantitative easing*)
- A **different crisis** in which the monetary policy might not have been enough.
- The tax authorities have undertaken **discretionary expansive policies to increase government spending and cut taxes**, and so the fiscal policy has gone way beyond automatic stabilizers.
- **Goals:**
  - To present empirical evidence on fiscal policies in the current crisis.
  - To analyze the debate on the effectiveness of discretionary fiscal policy.
  - To evaluate the challenge of future tax consolidation.

- Until the onset of the economic crisis, the general consensus about fiscal policy for stabilization was to leave **the automatic stabilizers to operate** and not undertake discretionary fiscal policies to increase government spending or cut taxes.
- However, the current crisis has aroused a sudden interest in **discretionary policies**, such that most Western economies have launched **major fiscal stimulus packages**.



- The US has been one of the economies that has used **discretionary fiscal policies most heavily**:
  - 2008: check for \$80bn.
  - 2009-10: \$584bn (19% expenditure, 33.4% transfers to states and 47.6 tax cuts).
  - 2011-2017: \$203bn.
- **Untimeliness cannot be alleged** (*timely*).
- Transitory and targeted?
- How effective **have these** measures been?

- Taylor (2009) and Feldstein (2009) think that **the 2008 fiscal payout (tax rebate) has had limited effectiveness.**
- Private **consumption** is not responding positively to the increase in personal income available as the result of the tax rebate.
- The **regression analysis confirms these results:** the fiscal payout is not statistically significant, even when controlled for by oil prices.
- Almost all of the 2008 fiscal payout seems to have gone on **savings.**



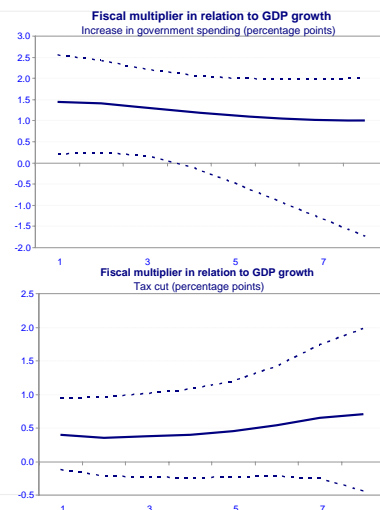
- Nevertheless, these **results are aggregate** and do not consider **individual cash flow** restraints.
- It is possible that the increase in consumption among people with cash flow restraints has been offset by the drop in consumption among people without these restraints, due to the increase in saving for precautionary reasons. Broda and Parker (2008) find that, in a broad survey, consumers **spent a significant part of the fiscal payout.**
- These results are also partly in contrast **with previous results** in the literature on the effectiveness of fiscal policies.
- **Theoretical results:**
  - **Keynesian models:** traditional view of partial equilibrium. High multipliers (more than one unit), due to the stimulus in private spending.
  - **General equilibrium models.** The results are depending upon assumptions (cash flow restrictions, public capital, wealth as collateral).

- The lack of observable effects of the fiscal payout at an aggregate level are in contrast with the **multipliers** that are usually found in empirical literature.
- Interpreting multipliers: Barro (2009, WSJ)
- In the case of transitory policies, the effects on GDP are usually greater for **increased spending** than for **tax cuts**.
- If tax cuts are permanent, the distortionary effects of taxes are also brought under consideration, thus their **long term impact is greater**.

Tax cut multipliers		
	1st year	2nd year
Blanchard and Perotti (2002)	1.07	1.32
Mountfor and Uhlig (2009)	0.80	1.76
Romer and Romer (2008)	1.10	1.30
Average in empirical literature	0.66	0.99
BBVA (2009)	0.50	0.80

Spending increase multipliers		
	1st year	2nd year
Blanchard and Perotti (2002)	0.73	0.60
Mountfor and Uhlig (2009)	0.35	0.33
Romer and Romer (2008)		
Average in empirical literature	1.44	1.57
BBVA (2009)	1.30	1.20

- There is a lot of **uncertainty** about the impact of fiscal policy.
- Confidence **intervals** are relatively broad.
- Governments seem to have used the estimates in the **higher range** of intervals.
- In light of the large decrease in **wealth**, greater **lending restrictions** and increased **uncertainty**, in this crisis economic actors can react to increased spending and tax cuts in a **very different** way than in the past.



- In Spain the fiscal stimulus package has been as important between 2008 (2% of the GDP) and 2009 (2.8%) as the one that is going to be undertaken in the US in the 2009-10 period.

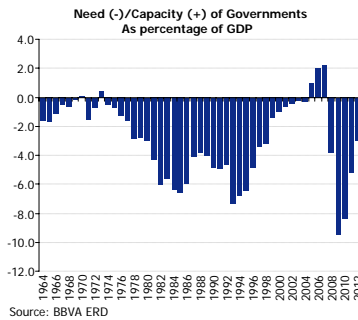
**Fiscal stimulus packages applied in the PlanE**

Millions of euros	2008	2009	2010
<b>Revenue</b>	<b>-19.825</b>	<b>-15.128</b>	<b>-83</b>
Reform of Income Tax and update of minimum exemptions	-2.400		
Tax benefit for birth or adoption of children	-1.234	-1.250	
Last phase of corporate income tax cut	-5.300		
New special VAT group system	-3.000		
400 euro reduction in Income Tax	-4.891	-6.000	
Lifting of wealth tax		-1.800	
Extension of term for property saving accounts		-15	
Application of mortgage periods		-2.080	
Anticipated deduction on habitual residence		-1.700	
Monthly VAT rebate	-3.000	-6.000	
New payments in installment for Corporate Income Tax		3.000	
Discount in social security contribution due to recruitment of unemployed people		-83	-83
Promotion of part-time contracts		-1.200	
Updating Special taxes		2.000	

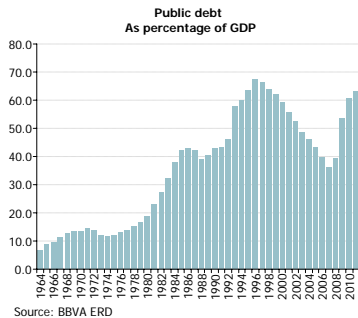
Expenditure	2008	2009	2010
<b>Permanent impact</b>	<b>281</b>	<b>12.875</b>	<b>-285</b>
Renta básica de emancipación grant	100	331	
Cut in government spending budget	-20	-2.500	
Reduction in public job offer			-300
Law of dependence		1.599	
Special plan measures: guidance, vocational training, etc	201		
Public tender offer for land		430	
<b>Temporary impact</b>			
Local Investment Fund		8.000	
Economy and Employment Stimulus Fund		3.000	
Comprehensive automotive plan (includes VIVE Plan)		2.000	
Plan 200E to update motor vehicles			
Training unemployed university graduates		55	15
<b>Total impact</b>	<b>-20.106</b>	<b>-28.003</b>	<b>203</b>

Source: MoE and Bank of Spain (29/06/09)

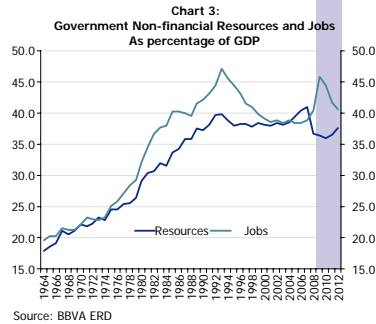
- The consequences are a significant reduction in the public deficit.
- For 2009 the Government expects a **deficit of 9.5%**. The budgetary deterioration is due to the combination of a **sharp increase in public spending**, especially in 2009 and 2010, and a **considerable fall in public revenue**, mainly in 2008, which has gone **much further than automatic stabilizers can explain**.
- The **deficit target of 3% in 2012** would mean correcting the high structural deficit in 2009 (probably by 8%), until it is reduced to 1% of GDP, similar to before the crisis.



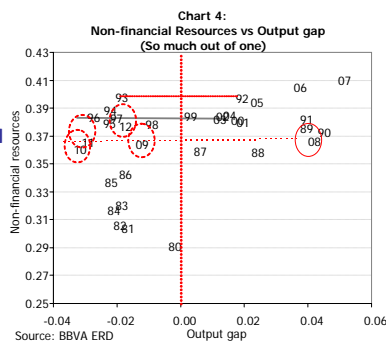
- In spite of the significant fiscal consolidation that the Government envisages, these forecasts put **public debt above 60% of GDP** (36.2 in 2007).
- The increase in debt will have a major impact on **interest charges**. Interest payments in 2008 represented 1.6% of GDP (5.2% in 1996).
- Laubach (2009) finds that each debt point of GDP represents an increase of 12 to 16 basic points in the **interest rate**.



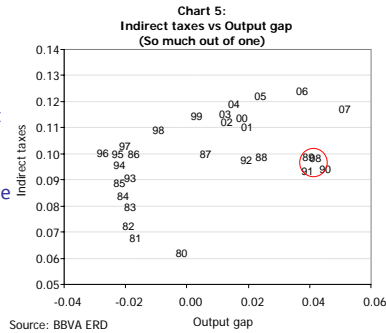
- The budgetary deterioration is due to the combination of a **fall in public revenue** and a dramatic **increase in spending**, especially in 2009 and 2010.
- The ambitious **fiscal stimulus** package and the rise in **welfare benefit payments** will push government spending to over 45% of GDP in 2010, levels that have not been seen since the 1990s.
- The drop in revenue is due to **discretionary policies** by the fiscal authorities, **automatic stabilizers** and cuts in certain **tax bases**.



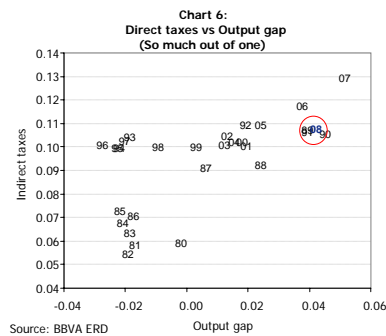
- **Automatic stabilizers:** throughout the economic cycle. When economic activity slows, so do available tax bases, and tax collection falls as a result.
- Overall, public revenue is practically **proportional** to GDP. The progressivity of some taxes, such as income tax, is offset by the countercyclical behavior of contributions/GDP.
- Reduction in public revenue between 2007 and 2008 of **4.4 percentage points of GDP**, a part of which is exceptional.



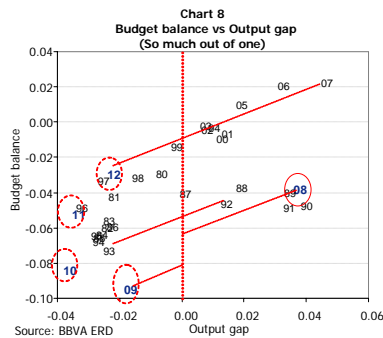
- For instance, **investment in residential property**, which recorded a 10% fall in 2008, or **household consumption**, which in real terms remained practically stable, explain the one percentage point fall in VAT collections of GDP.
- The plunge in **imports** recorded in 2008 explains the one percentage point fall in taxes on output and imports (excluding VAT).



- The fall was even more dramatic in the case of **Corporate Income Tax** in relation to GDP, equivalent to almost 2 percentage points, due to the reduction in **the tax rate**, and in the tax base in relation to GDP, due to **the fall in benefits and capital gains**.
- Most of the fall in revenue is not caused by the normal operation of automatic stabilizers and is therefore **structural**, due to special revenue between 2004 and 2007 that is **not recoverable** in the coming years, insofar as it is linked to imbalances.



- Automatic stabilizers mean that for **every falling point** in the *output gap* the budget balance in relation to GDP drops by **almost one point**.
- Using this ratio between output gap and budget balance, the structural budget for each year can be calculated easily: we only need to apply the straight line of that gradient to that year and check the budget balance level at which the vertical intersects it for the **output gap to be equal to zero**.
- If this is applied to **2009** we can see that the structural budget deficit was **8% of GDP**, approximately (1% in 2007).



- To reduce the budget deficit from 9.5% in 2009 to 3% of GDP in 2012, bearing in mind that without tax rises public revenue in relation to output would probably increase by 1.5 percentage points, **spending would need to be cut by more than 5 percentage points** of GDP, to take it back to 41%.
- An alternative to cutting government spending could be a **tax rise**, but the **results in the economic literature** are quite clear.
- Alesina and Perotti (1997), McDermott and Wescott (1996), Perotti, Strauch and von Hagen (1998) and von Hagen, Hughes-Hallett and Strauch (2001) find that almost every tax consolidation that has **failed** in the past has been based almost exclusively (up to 88 percent) on **tax rises**, while those that have been successful have placed an emphasis on cutting back non-productive government spending.
- Alongside political and economic arguments, these results are also partly explained by **the distortionary effects of taxes** (see Boscá, Doménech and Ferri, 2009, and Coenen, McAdam and Straub, 2008).

- **Discretionary expansive policies to increase government spending and lower taxes**, beyond automatic stabilizers.
- These **fiscal policies** were **necessary** to check the freefall of Western economies at the end of 2008 and start of 2009. These policies **have short-term benefits but long-term costs**.
- Given the importance of the fiscal packages approved in different countries, more importance should have been attached to **the design of the implemented policies**. The importance of conducting a **cost-benefit analysis**. Not all measures are the same.
- There is a risk that the increased **uncertainty regarding the effects** of fiscal policies could make the **economic cycle more volatile**.
- Developed economies, especially Spain, need to tackle a major tax **consolidation in the future**. Discretionary fiscal stimulus policies need to be offset by consolidation policies as soon as **the recovery begins**.
- **Preferred strategy**: tax consolidation prior to toughening of monetary policy. The **rise in interest rates** makes tax consolidation difficult.

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