Atl Econ J (2012) 40:429–435
DOI 10.1007/s11293-012-9337-z

Fiscal Policy after the Great Recession

Alberto Alesina

Published online: 12 September 2012

Abstract The Great Recession has severely hit the economies of most of the countries. Given that, fiscal policies have gained back a central role in the debate as a tool to recover from this situation. This paper provides an overview about the main controversial issues related to the fiscal policy. In particular, we analyze the role and the different effects played by discretionary counter-cyclical policies – say, for instance, tax cuts or increased government spending. Disagreement on this topic follows from the fact that it is extremely difficult to isolate the exogenous effect of these policies on GDP. We review several ways in which economists have tried to deal with this problem of estimation. Finally, we discuss why spending-based adjustments are preferable and less likely to be costly than tax-based ones and why large fiscal consolidation accompanied by appropriate policies can be much less costly than what we think.

Keywords Fiscal policy · Fiscal multipliers · Reverse causation · Counter-cyclical policies

There are many things that we as economists know and many things we do not know about fiscal policy. There are many things that we agree upon, but even more things we do not agree upon. I am going to begin by discussing what we agree upon with fiscal policy. For a much more extensive discussion of these issues, see Alesina and Giavazzi (2013).

The tax smoothing principle is one example of what we agree upon. It is the idea that it is good to allow deficit to increase during recessions as long as they are

Presented at the 73rd International Atlantic Economic Conference
March 30, 2012 in Istanbul, Turkey

Transcribed by Sara Hensel
April 26, 2012

A. Alesina (✉)
Harvard University, Cambridge, MA, USA
e-mail: aalesina@harvard.edu

compensated by a surplus during booms. The goal is to keep tax rates stable and allow the deficit to fluctuate over the cycle. It would be a bad idea to raise taxes during a recession and to cut taxes during a boom. On the spending side, automatic stabilizers have to do their work. It is perfectly fine to allow, for example, unemployment compensations to go up during a recession. If this causes a deficit, so be it, as long as they are compensated for by surpluses when the recession ends. This implies that balanced budget rules are a bad idea. That is, it is a bad idea to balance the budget every period, because it goes against the basic economic principle of tax smoothing.

However, this basic principle of tax smoothing is unfortunately not often followed by policy makers. They are content to let deficits grow during recessions and are less comfortable to reduce them during surpluses. As a result, a balanced budget may be a second best against this political distortion.

There are also things that economists do not agree upon. There are two critical issues that are really at the forefront of the political debate. First, in addition to the automatic stabilizers, when should discretionary counter-cyclical policies be used? Namely, during a recession should we actively cut taxes or increase discretionary spending in a Keynesian fashion?

The second thing we do not agree upon is: what is the effect of a tax or spend policy? What is the size of a tax multiplier from government spending? That is, if a government increases spending by $1.00, what is the effect on the economy? Does increased government spending cause a decrease in private sector spending? The answer to the question about the size of the multiplier is crucial in deciding whether or not this discretionary policy is a good idea on the expansionary side and whether or not budget cuts are particularly costly.

There are two reasons why we disagree upon this issue. One reason is that these are very highly politically charged issues about the role of the state. Governments' involvement in private sector activities creates a very big ideological divide. Leaving that aside, there are a lot of economic reasons why the problem is difficult, which has to do with the fact that it is essentially very difficult to disentangle what the effects are of government spending (G) and taxes (T) on Gross Domestic Product (GDP) because it is difficult to measure the co-movement of these three variables. For example, if G goes up during a recession and tax revenues go down, the ratio of the deficit over GDP goes up during a recession, but that does not mean deficits cause the recession. It simply means that the denominator goes up, and vice versa during a boom. More generally, spending, taxes, and GDP are highly inter-correlated and it is very difficult to isolate the exogenous effects and changes of government spending on GDP.

The second reason why we disagree is that when we examine the cost of fiscal adjustments, it is very difficult to figure out the exact cost of budget cuts because there are many things which occur at the same time. For instance, what is happening to monetary policy, what is happening with the exchange rate, what is happening to the price of oil or to wage setting agreements all matters. It is very difficult to isolate the effects of fiscal policy. Therefore, the problem is inherently difficult. As economists, we should be more ready than we actually are in admitting that there are a lot of things that we do not know and be careful not to claim more than we actually know.

So, how do people deal with addressing these complicated issues of reverse causation when many things are going on at the same time? There are essentially four ways of doing it.

The first is with dynamic general equilibrium models. They are large models of the entire economy in which fiscal policy is one of the variables involved. As predictive tools, the results of these models very much depend on the assumptions that you make to begin with. If you assume large multipliers, then you will get out a certain effect of fiscal policy, and vice versa. They are very useful predictive models, but what they spit out is very much affected by what is put in as assumptions.

The second way is based upon a very influential paper by Blanchard and Perotti (2002), who used vector auto regression analysis to study the effect of fiscal policy. These are models in which government spending, taxation, and GDP are studied in a vector auto regression. The identification comes from assuming certain timing of the three variables.

On the tax side, an approach being proposed by Romer and Romer (2010) is to isolate episodes in which the tax rates have been changed for exogenous reasons. Rates may be changed for reasons that have nothing to do with the business cycle. For example, a new president decides that he wants to redistribute more income from the rich to the poor, so he raises the tax rate. They isolate seven episodes of up and down tax changes in the post-war U.S.

A similar idea on the spending side is by Barro and Redlick (2011) and Ramey (2011). They isolate exogenous and unexpected changes in government spending, especially with respect to wars. Wars are supposed to be exogenous to the economy, so more government spending can be considered exogenous to GDP. One can study the effect of increases and decreases in military spending on the economy. Finally, there is an active literature in case studies trying to look at various episodes of large fiscal adjustments, which I will review below.

The basic Keynesian model would say that the spending multiplier in a \$1.00 increase in government spending should be much bigger than one, and the spending multiplier should be bigger than the tax multiplier because in the basic Keynesian model the decrease in government spending will be saved and not affect aggregate demand. Thus, the spending multiplier is bigger than one and the tax multiplier is smaller than the spending multiplier.

How did this model come out? Not too well. The range of the spending multiplier estimated using these various approaches is from .4 to 1.5, with some estimates even lower than .4 and some estimates larger than 1.5. However, most fall in the .4 to 1.5 range. This is a huge range because it includes 1.0. Even though the issue about welfare is a little bit fuzzy and needs to be examined more, it is very hard to argue that it is a good policy to increase government spending if the multiplier is, for example, 0.5. That would mean that a \$1.00 increase in government spending would need to be covered by taxes in the future, since it leads to only a \$0.50 increase in aggregate demand because \$0.50 is compensated by a fall in private demand. Instead, if the multiplier is 1.5, then it would be reasonable to argue for a discretionary spending increase during a recession.

The second thing which departs from the basic Keynesian model is that tax multipliers seem to be much bigger than spending multipliers. Namely, tax increases have a multiplier up to 3.0, according to Romer and Romer (2010). This 3.0 is probably too high, and more recent papers have lowered the estimated tax multiplier. But still, they are found to be consistently higher than spending multipliers.

There are two issues on the spending side to be considered. First, Ramey (2011) argues that the VAR analysis of Blanchard and Perotti (2002) tends to overestimate spending multipliers, because they do not distinguish between expected and unexpected government spending. They treat all government spending as exogenous without taking into account that some of it is anticipated and some of it is not, which should have a different effect on aggregate demand. By not distinguishing between the two, the spending multiplier is overestimated. Thus, the Blanchard and Perotti (2002) spending multiplier of around 1.0 is too high because they overestimated it.

On the other hand, in a recent paper, Perotti (2012) argues that estimating the effect of government spending using military spending is not a good idea because it is driven by only a very few years with major wars, such as World War II, the Korean War, and the Vietnam War. If the analysis relies on military spending, it has too few observations. More importantly, during periods of war there are a lot of other things taking place, like price controls and nationalistic feelings, that cause people to work harder. The war period, they argue, is not a good or normal period to start measuring the effect of fiscal policy. Validation is difficult because during a war there are big changes in government spending.

Therefore, the debate is still going on. But again, if the spending multiplier is not much larger than 1.0, then how valuable is it to increase discretionary government spending during a recession? Obviously, one major application in the discussion has to do with the effect of the expansionary government spending program that recently occurred in the U.S. I think it will be close to impossible to give an answer about whether the expansionary fiscal policy in the U.S. has been valuable in reducing the size of the recession. First of all, we do not even agree on how large the amount of government spending was. For example, some of the spending on the federal level compensated for cuts in state level spending. Therefore, it is not clear how large the stimulus actually was. Second, we will never have a counterfactual, namely, what would have happened without it.

Leaving that aside, one can look at the unemployment rates that the administration predicted in 2008 without the recovery plan and the lower unemployment rate it predicted with the stimulus package. In March 2010, the unemployment rate was 9.7 %, which was way above what the administration had predicted it would be without the recovery plan. So, the recovery plan seemed to have no effect. In March 2011, the unemployment rate was 8.8 %, which is exactly what it was predicted to be without the recovery plan. There are several reasons why the administration's predictions about the unemployment levels with the stimulus plan failed. First, the projections might have been wrong. Second, perhaps the unemployment rate during the recession went up more than one could have predicted relative to the reduction in GDP growth. The unemployment rate went up and stayed up longer than one would have anticipated. This does not mean that the recovery plan did nothing, but it simply means that the prediction was wrong. Nevertheless, there was a stimulus package, and the unemployment rate was high and stayed high.

There is a similar debate going on about taxes. Romer and Romer (2010) find that tax multipliers are very large. However, recent research shows that they are probably actually much lower. Another issue is that tax, spending and multipliers can be quite different depending on the level of debt of the country, and depending on whether or not the country is in a deep recession. There is a view that when you are in a deep recession, like we were a few years ago, then spending multipliers are larger than they are in normal times. Even though one may think that, in general, discretionary counter-cyclical fiscal policy is not a good idea, there is still room for some of it during particularly deep recessions.

Now that the great recession is over, there has been a very active revival in the literature about the costs of large fiscal adjustments. The particularly big debate is about whether the cost of fiscal adjustments is very large or whether an appropriate combination of policies can actually make the cost of fiscal adjustments small or even zero.

There are two important issues about fiscal adjustment. First, should it be done on the spending side or on the tax side? I am referring here to Organisation for Economic Cooperation and Development (OECD) countries where the size of the government is in the order of 40–50 %. I am not talking about developing countries where the issues may be different. The question is, are spending-based adjustments less contractionary than tax-based adjustment? I think the answer is that spending-based adjustments are less contractionary.

The second issue is that some fiscal adjustments have been expansionary, even on impact. They were not accompanied by recession but by expansion. The question is, how common is this, and what is the channel through which this might happen?

There has been some heated debate regarding fiscal adjustments that has reached even the popular press. I think that when things reach the popular press, the details often get exaggerated. My view about how to summarize this debate about the status of large fiscal adjustments is the following and, even though I am part of the debate, I think it is a fairly objective summary:

First, spending-based adjustments in OECD economies with close to 50 % of G/Y are preferable and less likely to be very costly than tax-based ones. So, if you want to do a fiscal adjustment, you need to do it on the spending side.

Second, even a large fiscal consolidation that is accompanied by appropriate policies, like agreement with the union for wage moderation, a friendly monetary policy, public sector wages which are kept in check, and stabilizing the expectation of inflation, can be much less costly than we normally think. Sometimes, it might be not costly at all. Even in the short term, fiscal adjustments of this type can be seen as an expansion rather than a contraction. Whether or not this appropriate mix of policies is applicable today is a different question that remains to be seen.

How is it possible that fiscal adjustments on the spending side may not be so recessionary as we think, if we have in mind the Keynesian model? One channel is a rapid reduction of interest rates. People get less worried about the future and apply a lower risk premium to the government debt of the country. Therefore, the fiscal adjustment may have a big effect on interest rates. Interest rates are low for some countries today, but for some other countries they actually rose because of the risk of defaults. If you keep public sector wages down, it may have a causative effect on wage agreement overall in the private sector of the economy, which creates competiveness. If you cut government spending, you are going to signal that in the future taxes will be lower, or at least not higher. This has a positive effect on consumption and investment, because people expect lower taxes in the future. There is a distortionary cost of taxation, because higher taxes will discourage investment and labor supply. So, this will be the channel that makes fiscal adjustment on the spending side less costly than it is on the tax side, and in some cases, not costly at all.

A devaluation may help. If you do a fiscal adjustment and you devalue at the same time, that may help your competitiveness. It does happen sometimes. For example, one of the most famous fiscal adjustments was done in the 1980s by Ireland, and that was helped by devaluation. Some argue that devaluation of the euro would help and devaluation of the pound would help England. One paper I have been working on suggests that often there is a big effect on confidence when a country announces a credible fiscal adjustment. Confidence of the investor increases, because this helps reduce the effect of the adjustment on the recession. It is particularly important in the U.S. today. Firms are profitable, but they are worried about investing, because they are uncertain about the fiscal stance and the regulatory stance of the government. A little bit more rigor or a little less uncertainty about the future course of fiscal policy in the U.S. may have a positive effect on investment.

Discussion about fiscal tightening in the U.S., and especially in Europe, is focusing too much about quantity and not quality. In my view, which I think is supported by the historical evidence, a fiscal adjustment of, say, 3 % of GDP, which is done all on the tax side, could be much less successful and much more recessionary than a smaller adjustment on the spending side. If I were the European Union, I would prefer a country to reduce the deficit by less, but do it on the spending side, rather than have a bigger deficit cut all on the tax side. This discussion about the composition, quality, and how to achieve fiscal adjustment should be more at the center of attention. There is too much emphasis on how much and not enough on how, and that may lead some countries in Europe into a dangerous spiral of raising taxes, creating a recession, reducing tax revenue, and raising tax rates even more.

There is a conventional wisdom which goes as follows. Fiscal adjustments are politically costly. Therefore, politicians will be very reluctant in engaging in them, because they are very afraid of not being reelected. Therefore, one has to worry from the political side about how to do fiscal adjustments from the point of view of reelection. This is based on the conventional wisdom that if you do a large fiscal adjustment you are automatically thrown out of office. However, this idea is over emphasized. The evidence is not as clear cut as one might think. There is a very nice paper by Brender and Drazen (2008) that shows that larger fiscal deficits are weakly associated with less success at the polls. They do not find evidence that more deficit leads to reelection, but rather find some evidence that voters actually dislike deficit.

There is always a problem with reverse causality in economics. It could be that certain governments that are particularly strong and popular can engage in fiscal adjustments without a negative effect. Some governments are reelected despite having done a fiscal adjustment and not because they have done a fiscal adjustment.

This is very difficult to test. How does one define a strong government? Sometimes the weakness or strength of a government has to do with very intangible things, like the personality of the prime minister. When one tries to define a strong government based on objective measures, like the size of the majority in parliament, how many seats government parties hold in congress, and the size of the majority when they won the previous election, one does not find much to hold a view that only a strong government can have a fiscal adjustment and get away with it. It is not clear how to find strong evidence to prove this. There does seem to be a weak conclusion that some governments can engage in fiscal adjustments and be reelected.

A more aggressive interpretation would be that voters believe that a fiscal adjustment is needed, and, therefore, are willing to actually reward a government that engages in fiscal adjustment because they understand that it is needed. For example, the government in Canada was elected in 1994 on a platform of aggressively reducing the deficit. This was a clear case in which the voters understood that they wanted a fiscal adjustment.

To conclude, I think that the Great Recession has caused economists to reevaluate what they know about macroeconomic policy. The Great Recession has shown how much we as macroeconomists do not understand. It was a shock that has caused us to rethink and work harder on many policy issues which we thought we had solved. For now, we have more questions than answers. On the other hand, macroeconomics is becoming fun again. It now appears we know much less than we thought. Macroeconomics is becoming a very popular field again. As empirical evidence of this, in our department we had to move the macro seminars to a much bigger room, because we could not fit all the students after the Great Recession.

References

Alesina, A., & Giavazzi, F. (eds.) (2013) *Fiscal Policy after the Great Depression*. University of Chicago Press and NBER, forthcoming.

Barro, R., & Redlick C. J. (2011) Macroeconomic effects of government purchases and taxes. *The Quarterly Journal of Economics, 126*(1), 51–102.

Blanchard, O., & Perotti, R. (2002). An empirical characterization of the dynamic effects of changes in government spending and taxes on output. *The Quarterly Journal of Economics, 117*(4), 1329–68.

Brender, A., & Drazen, A. (2008). How do budget deficit and economic growth affect reelection prospects? Evidence from a large panel of countries. *American Economic Review, 98*(5), 2203–2220.

Perotti, R. (2012). Expectation and fiscal policy, an empirical investigation. Unpublished.

Ramey, V. (2011). Identifying government spending shocks: it is all in the timing. *The Quarterly Journal of Economics, 126*(1), 1–50.

Romer, C., & Romer, D. H. (2010). The macroeconomic effects of tax changes: estimates based on a new measure of fiscal shocks. *American Economic Review, 100*, 763–801.