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How should the crisis affect our views of fiscal policy?

Background Note for Session II – Monetary Policy
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The issues involving fiscal policy that are raised by the crisis fall largely into two categories. One set of issues concerns the use of fiscal policy for short-run stabilization. The other involves the long run. Of course, many issues involve interactions between short-run and long considerations.

I. Fiscal policy as a tool of stabilization policy

Before the crisis, there was broad consensus that monetary policy should be the primary tool of stabilization policy and that fiscal policy should play little role beyond allowing automatic stabilizers to operate. But almost all major countries used discretionary fiscal policy during the crisis. This raises a host of issues:

1. Was it appropriate to use discretionary fiscal policy during the crisis? If so, is this because there were exceptional circumstances that made this appropriate, or should discretionary fiscal policy become a regular part of the stabilization toolkit?

2. Should automatic stabilizers be strengthened, and if so, how? Should there be institutional changes to make discretionary fiscal policy more flexible, and if so, what should they be?

3. How dependent are the effects of fiscal policy on the circumstances under which it is used? For example, the effects might depend on whether monetary policy is constrained by the zero lower bound; on whether the financial system is functioning well; on whether the government's long-run fiscal situation is sound; and on whether the economy is weak or strong. Are there circumstances when stimulus can "jump start" a weak economy? That is, can it move the economy to a path of robust growth, or is it better to think of stimulus as merely filling in gaps left by private demand?

4. How large are the effects of various kinds of fiscal stimulus? Has the crisis provided significant new evidence about those effects? Should discretionary fiscal stimulus rely more on measures that affect intertemporal incentives (temporary sales tax holidays and investment incentives, phased-in increases in value-added taxes, and so on), and rely less on broad tax cuts and increases in transfers and government purchases?

5. What have we learned about the political economy of fiscal stabilization? Does the political backlash mean that it is important to use "overwhelming force" in designing stimulus?

6. Should there be mechanisms in place to promote international cooperation in discretionary fiscal policy and to ensure that the international spillovers are considered in designing fiscal stimulus?

7. How large are the budgetary costs of fiscal stimulus in a weak economy? What about the argument that, if and when hysteresis is present, a fiscal stimulus can actually pay for itself?

8. With many economies still facing both extended periods of weakness and looming long-run fiscal problems, what is the right timing of the switch from expansionary fiscal policy to combat the crisis to fiscal consolidation to address the long-run fiscal challenges? What should determine the timing and speed of the switch?

II. The unsustainable long-run fiscal trajectory

Before the crisis, fiscal policy in many countries was already on a trajectory that was not sustainable. The loss of revenues from the crisis and (to a smaller extent) the discretionary fiscal response have in effect brought that "long run" considerably closer. Again, this raises numerous issues:

1. To what extent did the dismal long-run fiscal outlooks constrain the short-run responses to the crisis?

2. How should the crisis change our views about what debt-to-GDP ratio countries should aim for in the long run? On the one hand, the events of the past few years show the value of having "fiscal space" to respond to a crisis. On the other, the deterioration of fiscal positions because of the crisis makes it harder to achieve a given debt-to-GDP ratio.

3. Can immediate fiscal consolidation be expansionary in the short run? At one extreme is the view that permanent consolation is often expansionary, particularly if it is done on the spending side. At the other extreme is the view that it is expansionary only when there is imminent danger of a sovereign debt crisis. Similarly, how large are the potential expansionary effects of back-loaded fiscal consolidation, such as announcements of future increases in the retirement age (which one would expect to reduce life-cycle saving) and announcements of phased-in increases in value-added taxes (which create incentives for consuming sooner rather than later)?

4. How soon do various countries need to take steps to address their long-run fiscal challenges? What fiscal rules, if any, have proven useful in the past in actually reducing deficits and return debt to a sustainable path?

5. How should countries and international institutions (such as the IMF and the ECB) respond to stresses placed on countries by high interest rates on their sovereign debt? How should they respond to full-blown sovereign debt crises?

6. There is a wide range of possible ways of dealing with long-run budget challenges, including broad-based increases in income or consumption taxes, broadening the tax base, caps on

discretionary spending, raising the retirement age, and various types of reforms to pension and health-care systems. What general principles should guide countries in their decisions about what mixes of these various options to use?

7. Is there a need for fundamental institutional reform in fiscal policy? How should we think of fiscal rules in the context of a common currency area, such as the Euro zone? What about such proposals as E-bonds, allowing Euro countries access to multilateral financing conditional on strong fiscal policy?