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A New Paradigm for Fiscal Policy?

Fiscal policy is about the role of the state in the economy. It can change the tax structure, amend public spending to increase growth and welfare, and reduce inefficient fluctuations or destabilising crises in the short term. The 2008 financial crisis in the US and the subsequent European sovereign debt crisis have changed views about fiscal policy's ability to stabilise market economies. The debate about fiscal policy is mainly evolving along two lines. The first focuses on inequality dynamics and the role of capital taxes on the evolution of inequality, mostly in the US. This obviously draws from the work of Thomas Piketty and Emmanuel Saez.¹ The second line of debate is about the use of public debt as a macroeconomic stabilisation tool. The sharp increase in public debt around the world to previously unknown levels has induced a new debate about a possible trade-off between the stabilisation and sustainability of public debt.

¹ See, T. Piketty: *Capital in the Twenty-First Century*, Cambridge 2014, Harvard University Press; or E. Saez: *Income and wealth inequality: Evidence and policy implications*, in: *Contemporary Economic Policy*, Vol. 35, No. 1, 2017, pp. 7-25 for a recent discussion.

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In this paper, I consider the macroeconomic view of fiscal policy and lessons learned from the European crisis. I first try to define an old paradigm for fiscal policy, examining it within the framework of the recent financial crisis. Although it is hard to identify a specific paradigm in economic literature, one can nevertheless be identified within the institutions in Europe and the US stipulating the importance of rules, low fiscal multipliers and the overall stability of the market economy. In the second part, I discuss what went wrong with the old paradigm, focussing mainly on the role of fiscal policy in the business cycle. In the final section, I look at elements of a new paradigm and propose some concrete changes, such as a European unemployment reinsurance scheme.

Description of old paradigms

The management of the aftermath of the 2008 subprime crisis or the euro crisis after 2009 revealed distinct reactions and a divergent deployment of fiscal policy. These reactions were derived from worldviews either embedded in institutions or more generally derived from common frameworks on the role of fiscal policy. As a result, the notion of a paradigm is a useful policymaking tool, although it is important that the identification of the paradigm stems from actual policymaking.

Different fiscal policy paradigms developed in Europe and the US during the crisis. The US was much more Keynes-

Box 1

Macroeconomic analysis of fiscal policy

Surveying the body of academic literature on the subject, one finds that the very notion of a fiscal policy paradigm is blurry due to the diversity of models and empirical studies. Fiscal policy is studied in literature with regard to many types of “frictions” such as sticky prices, bounded rationality, financial frictions and involuntary unemployment. I present selected macroeconomic models analysing the role of fiscal policy in the stabilisation of business cycles as an example of the diversity of the various models.

1. In the neo-classical model of fiscal policy by Baxter and King,¹ a change in public expenditure can be expansionary, but it results in a decrease in private consumption as households anticipate higher taxes and thus experience a negative wealth effect. In other words, public consumption crowds out private consumption.
2. The neo-Keynesian model of Gali, Lopez-Salodi and Valles uses empirical data to show that private consumption *increases* after government spending. They reproduce this with sticky-price and bounded-rational households.²
3. Le Grand and Ragot study fiscal policy in a heterogeneous agent model,³ à la Bewley-Aiyagari-Huggett with aggregate shocks. They find that public debt slowly reverts back to the mean after an economic shock.
4. Alternatively, some models have agents that are presumed to follow simple rules with limited rationality. Dosi et al. find that fiscal policy can stabilise the economy and reduce the probability of crises.⁴
5. Woodford shows that when prices adjust slowly (in a neo-Keynesian framework),⁵ government expenditure can be very effective depending on monetary policy. When monetary policy is at the zero lower bound (or does not react), government spending is a powerful tool to stabilise the economy.

1 M. Baxter, R. King: Fiscal Policy in General Equilibrium, in: American Economic Review, Vol. 83, No. 3, 1993, pp. 315-334.

2 J. Gali, D. Lopez-Salido, J. Valles: Understanding the effects of government spending on consumption, in: Journal of the European Economic Association, Vol. 5, No. 1, pp. 227-270.

3 F. Le Grand, X. Ragot: Optimal fiscal policy with heterogeneous agents and aggregate shocks, Working Paper, 2017.

4 G. Dosi, G. Fagiolo, M. Napoletano, A. Roventini: Income distribution, credit and fiscal policies in an agent-based model, in: Journal of Economic Dynamics and Control, Vol. 37, No. 8, 2013, pp. 1598-1625.

5 M. Woodford: Simple Analytics of the Government Expenditure Multiplier, in: American Economic Journal: Macroeconomics, Vol. 3, No. 1, 2011, pp. 1-35.

ian – both in fiscal and monetary policy – in the way it managed the crisis than Europe. The US implemented a fiscal system with much less redistribution compared to Europe. Without minimising these differences, one can broadly define an old paradigm in fiscal policy by the following properties:

1. Distrust in fiscal policy that is not based on rules and a belief that discretionary fiscal policy is destabilising;
2. A belief that the costs of fiscal consolidation are small;
3. A strong confidence in the stability of the market economy that rules out the possibility of large-scale crises, justifying a rule-based approach.

The first characteristic justifies those that follow, as we see in a case study of the recent subprime crisis.

Fiscal policy during the crisis

The analysis of the crisis in the European Economic and Monetary Union (EMU) is quite straightforward, as the fiscal rules are described in treaties at the European level. These rules are incredibly complex and still evolving. Indeed, the emerging paradigm change at the European level since 2014 has translated into subtlety and flexibility in the application of rules. We thus have the Stability and Growth Pact (SGP), the Fiscal Compact, the two-pack and six-pack, the macroeconomic imbalance procedure, and the excess deficit procedure, all of which are embedded in the European Semester.²

2 A. Bénassy-Quéré, X. Ragot: A Policy mix for the Euro Area, CAE note No. 21, 2015, French Council of Economic Analysis.

It is essential to start from the SGP, which, I will argue, led to a policy mistake in the management of the crisis around 2010. The fiscal rules are based on a limit of public deficit equal to three per cent of GDP and a maximum public debt equal to 60% of GDP, with some flexibility in case of big recessions. For good reasons, which illustrate the failure of the previous paradigm, many countries gave up trying to comply with the SGP after 2008.

The logic behind the SGP's rules rested on the following assumptions:

1. Coordination of fiscal policy is not needed. It is a national tool in the euro area.
2. The economic and social costs of reducing public deficits are small.
3. National governments are not able to design consistent fiscal policies, and rules are required to avoid spillovers, which are mainly seen in the member states' diverging risks of requiring a bailout.

Let us consider each of these claims individually. First, coordination of fiscal policy was not supposed to be necessary. Fiscal policy was to accommodate asymmetric shocks (see Box 1), and monetary policy was supposed to deal with symmetric shocks. As a consequence, there was no fiscal coordination and the crisis appeared to prove the dichotomy wrong. Once the nominal interest rate hit the zero lower bound and quantitative easing proved partially ineffective, the very possibility of using monetary policy disappeared. Quantitative research concludes that the coordination of aggregate demand management in Europe is not necessary in response to small shocks which can be dealt with using monetary policy.³ However, this is not the case for large financial crises.

Second, in the case of very high public deficits, as in 2009, the European Commission asked countries to rapidly reach the three per cent threshold for public deficits by applying the forceful tax adjustments implied by the SGP. This generated a contraction of economic activity and an increase in unemployment which was greater than anticipated. In other words, the fiscal multiplier was larger than expected (see Box 2).

Third, and importantly, the management of economic policy prior to the crisis tended to rely on rules to avoid discretion in policymaking. The basic intuition for this ten-

3 O. Blanchard, C.J. Erceg, J. Linde: Jump-Starting the Euro Area Recovery: Would a Rise in Core Fiscal Spending Help the Periphery?, mimeo, 30 June 2014.

Box 2

The value of fiscal multipliers

Fiscal multipliers measure the short-term impact of discretionary fiscal policy on output. The value of these multipliers is usually used to distinguish between neo-classical analysis, for which these multipliers are low or even negative, and Keynesian economics, for which these multipliers are high – which means that the state can efficiently stabilise the economy. As a direct consequence, the measure of fiscal multipliers has generated a huge empirical literature with various identification strategies.

Blanchard and Leigh, the IMF Fiscal Monitor and the iAGS report are examples of surveys with descriptions of the various estimation strategies.¹ Although the debate is still intense, a fair assessment of the literature is that the multiplier during the crisis was higher than previously estimated. It is now estimated to be between 1 and 1.5. In other words, the cost of fiscal consolidation (raising taxes to reduce public debt) was underestimated.²

1 See O. Blanchard, D. Leigh: Growth Forecast Errors and Fiscal Multipliers, IMF Working Paper No. 13/1, 2013, International Monetary Fund; IMF: Fiscal Monitor. Taxing Times, October 2013; and The independent Annual Growth Survey: iAGS 2017: The Elusive Recovery, 2016.

2 See also G. Coenen et al.: Effects of Fiscal Stimulus in Structural Models, in: American Economic Journal, Vol. 4, No. 1, 2012, pp. 22-68.

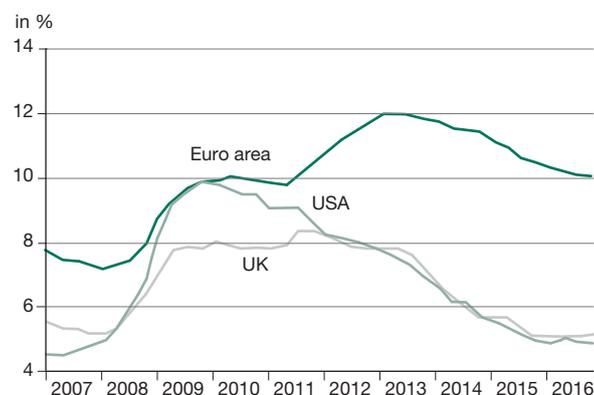
dency was the general focus of the time-inconsistency of monetary policy, rooted in the contribution of Kydland and Prescott, who argued that central banks ought to follow an explicit mandate to target inflation and should have operational independence.⁴ Therefore, fiscal policy should be used to design automatic fiscal multipliers and to reduce political uncertainty.⁵ This logic was based on a presumably normal and predictable business cycle. Of course, the same rules do not always apply to all cases and vary by situation; thus, discretion is necessary to complement existing rules.

An additional implicit assumption is that these rules should be the same for all European countries and that the national debate should not be able to determine the relevant policies. However, there is no clear economic reason to follow

4 F. Kydland, E.C. Prescott: Rules Rather than Discretion: The Inconsistency of Optimal Plans, in: Journal of Political Economy, Vol. 85, No. 3, 1977, pp. 473-491.

5 D. Carroll: Time-Consistent Rules in Monetary and Fiscal Policy, Economic Commentary No. 2012-19, 2012, Federal Reserve Bank of Cleveland.

Figure 1
Unemployment rates in the euro area, UK and US,
2007-16



Source: The independent Annual Growth Survey: iAGS 2017: The Elusive Recovery, 2016.

EMU-wide rules and to prevent countries from borrowing as much as they want. The only reason to do so was to prevent countries from borrowing excessively in anticipation of being bailed out by other member states in case they were excluded from participating in financial markets. As a consequence, a ceiling for public debt was thought to be a substitute for sovereign default. Eventually, the crisis revealed that the ceiling was not credible and that default was possible, as demonstrated by the case of Greece, where public debt was reduced by 50% of GDP in Net Present Value according to the European Stability Mechanism.

The management of the crisis was very different in the US. Congress voted very rapidly for a fiscal policy that sustained aggregate demand – on a *discretionary* basis.⁶ As a result, public debt increased by 42% in the US between 2007 and 2017, whereas the increase was around 30% in the biggest euro area countries.

Figure 1 plots the unemployment rate for the euro area, the UK and the US. The euro area policy mistake in 2011 is remarkable.

The recent evolution in Europe

The European approach to fiscal policy changed after 2014. The fiscal consolidation slowed down, sustaining aggregate demand. One could say austerity ended in 2015. New institutions have been introduced such as the European Fiscal Board, which analyses the aggregate fiscal stance at the European level. In addition, the Council

6 See G. Kaplan, G.L. Violante: A Model of the Consumption Response to Fiscal Stimulus Payments, in: *Econometrica*, Vol. 82, No. 4, 2014, pp. 1199-1239, among others.

of the European Union provided a useful clarification on “Flexibility within the Stability and Growth Pact” in November 2015. However, this change in the European vision of fiscal policy is more a loosening of the previous paradigm rather than an alternative set of rules defining a new one.

What went wrong?

We will now examine six main issues facing fiscal policy after the crisis. The goal is not to be exhaustive, but to highlight the complexity of the new environment for which a new paradigm must be defined.

Poor aggregate demand management in the euro area

As we have seen, the rule-based view of fiscal policy in the euro area, designed to prevent permanent fiscal transfers across countries, has generated a fiscal contraction. It has raised unemployment and induced deflationary pressures without preventing an increase in public debt in all EMU countries. The root of this policy mistake is the underestimation of fiscal multipliers when monetary policy sets interest rates at zero.

Inequalities in the US

Another notable area of evolution in fiscal policy is with regard to inequality. Piketty’s rise to prominence is an indication of the increasing awareness of rising inequality in the US.⁷ In Europe, post-crisis inequality did not increase by the same amount, but this brings us to the core of the subject: the utilisation of taxes to reduce inequality in Europe. To give an example, public spending in terms of GDP in 2015 was 37.6% in the US, 43.8% in Germany and 56.6% in France. In short, the key finding that Piketty identifies to explain the amazing trends in the data about inequality is that the returns on capital income are higher than the returns on labour income ($r < g$). The main reason for this difference is the lower taxation of capital income.

The mainstream approach to optimal capital taxation actually goes even further, concluding that capital taxes should equal zero in the long run. This is the traditional Chamley-Judd result,⁸ although recent contributions focusing on inequality conclude that the results are not applicable and that positive capital taxes effectively reduce distortions generated by financial market imperfections.⁹

7 T. Piketty, op. cit.

8 See V.V. Chari, P. Kehoe: Optimal Fiscal and Monetary Policy, Federal Reserve Bank of Minneapolis Research Department Staff Report No. 251, July 1998.

9 F. Le Grand, X. Ragot: Optimal fiscal policy with heterogeneous agents and aggregate shocks, Working Paper, 2017.

Recent quantitative investigations conclude that the evolution of the tax system is indeed the main driver of the increase in inequality in the US.¹⁰

High public debt

The crisis led to a huge increase in public debt, which was necessary to stabilise economic activity. Global public debt has recently risen to historically high levels. High public debt obviously generates new challenges for fiscal policy.

First, one must recognise that there is no good theory of the optimal level of public debt. The standard theory suggests that public debt should be used for tax smoothing. We should not make hasty changes to the tax system to achieve a specific level of public debt, as the main issue is the distorting tax system, not the level of public debt itself. As a consequence, public debt increases in bad times, decreases in good times and fluctuates according to economic activity.¹¹

Although the cost of high public debt (around 100% of GDP) is hard to quantify, we have learned through the recent recession that it is wise to significantly reduce public debt for the sake of “crisis management”. A large macroeconomic crisis generates an increase in public debt of at least 30% of GDP. Since we cannot be sure that such a crisis will not occur again in the next ten years, governments should have the flexibility to prepare fiscal remedies in the coming years. Reducing public debt generates a need for additional fiscal revenue. We are entering “Taxing Times”, to quote the title of the IMF Fiscal Monitor 2013, which raises two main challenges related to the above discussion.¹² First, a reduction in public debt should not reduce aggregate demand inefficiently. Second, an increase in inequality should be avoided.

Labour market turmoil

The labour market, and working conditions more generally, was disrupted by two major transformations whose

consequences have been underestimated. The first is the opening to international trade, which generated an abrupt decline in the demand for certain qualifications. When studying the US labour market, Autor, Dorn and Hanson label this as the China Shock.¹³ In this vast literature, it is found that economics may have underestimated the cost of labour mobility across sectors.

The second shock is seen in the new technologies changing the production processes, such as robots or digital technologies. It is generally the case that the demand for routine tasks is falling and the demand for abstract or cognitive tasks is increasing. There is still a debate about the size of the quantitative effects, but the impact is real.

The social and economic costs of the adjustment of the labour market are a new challenge for public policy, and it will have implications for fiscal policy. Some authors call for a universal basic income as a general solution for the labour market and such costly frictional unemployment. This is a very inefficient way to generate redistribution and I would thus advise targeted social transfers. In any case, the design of a proper fiscal policy to ease labour market evolution is on the agenda.

European divergences

European divergences in terms of productivity or in terms of competitiveness are based on real trends, not on diverging fiscal policies. This being said, fiscal policy may be part of the solution to make Europe converge again.

As an example, the French government under François Hollande introduced a reform to reduce social contributions on wages and to raise other taxes in order to increase the competitiveness of France. The fiscal transfer was more than one per cent of GDP, and it reduced unit labour costs by more than four per cent for low-wage workers. In the economic literature, this change in fiscal policy is called a fiscal devaluation, and it is still on the agenda. Estimations of the remaining misalignment within the eurozone show that an additional correction of more than ten per cent is still necessary between France and Germany, for example.¹⁴

Climate change

Climate change is an old challenge still waiting for proper policy responses. Fiscal policy should be one compo-

10 J. Hubmer, P. Krusell, A.A. Smith Jr.: The Historical Evolution of the Wealth Distribution: A Quantitative-Theoretic Investigation, Working Paper, 2017.

11 This result is challenged by recent models introducing financial frictions, such as credit constraint and incomplete markets. See e.g. S.R. Aiyagari, E.R. McGrattan: The optimum quantity of debt, in: *Journal of Monetary Economics*, Vol. 42, No. 3, 1998, pp. 447-469; O. Acikgoz: Transitional Dynamics and Long-run Optimal Taxation Under Incomplete Markets, MPRA Paper No. 50160, 2013; and F. Le Grand, X. Ragot, op. cit. A common result of these models is that the optimal level of public debt is not robustly pinned down and big movements in public debt are not that costly.

12 International Monetary Fund: *Fiscal Monitor: Taxing Times*, October 2013.

13 D. Autor, D. David, G.H. Hanson: The China Shock: Learning from Labor-Market Adjustment to Large Changes in Trade, in: *Annual Review of Economics*, Vol. 8, 2016, pp. 205-40.

14 The independent Annual Growth Survey: *iAGS 2017: The Elusive Recovery*, 2016.

ment of a general framework, which should include market mechanisms, taxes and subsidies, and regulation. Recent literature suggests that the main issue is to get a consistent mix of these tools, although the proper composition of this mix remains hotly debated.¹⁵

Elements for a new paradigm emerging

In sum, we have moved from a world where fiscal policy was supposed to be implemented via rules, such as automatic stabilisers, to a world where fiscal policy has many different targets: inequality, demand and crisis management, climate change, and European convergence. This is not a problem in itself, as fiscal policy consists of a wide set of tools, such as taxes and subsidies. Nevertheless, a new paradigm is needed to coordinate expectations into a consistent set of policies.

Taking the past into consideration, the new paradigm should be able to coordinate fiscal policies in Europe when necessary. This requires analytical capacity. The European Fiscal Board is a first attempt at delivering these insights. Still, more quantitative work must be done. Secondly, it should provide a consistent path to reduce public debt in a smooth way to avoid sharp reductions in aggregate demand. The credible implementation of this path is a central issue. Finally, it should acknowledge that the emergence of economic shocks are not predictable, neither their size nor their origin (banking sector, financial markets, commodity prices). Discretion and escape clauses are therefore unavoidable.

The implementation of these objectives could be done in a few different manners. A first option is a reliance on rules. For example, a group of economists have proposed a new public spending rule in an attempt to redefine fiscal rules and make them less pro-cyclical.¹⁶ Institutions provide a second way to implement fiscal policy. An institution could be envisioned in which both Members of the European Parliament and governments are represented to minimise negative and maximise positive spillovers. The idea of a finance minister in the eurozone is clearly a first step in this direction. A third option is to rely on market discipline. This requires that European institutions are designed in such a way to allow for sovereign default (for

instance, by finalising the European Banking Union and European deposit insurance).

Of these three elements, I favour building institutions with established political rules for the following reason: The heterogeneity in Europe does not allow for a unique fiscal rule for all countries. The Italian debt-to-GDP ratio is twice as high as Germany's. We need consistent institutions to implement a realistic path for public debt in Italy and Portugal.

Market discipline is logically consistent, but it seems impossible to implement, and I think that some economists do not fully comprehend what a sovereign default in Europe would mean. To give an idea of the magnitude, the largest sovereign default in history was the reduction of Greek debt in 2012. Greece makes up around four per cent of European GDP, and thus the size of the debt reduction was actually quite small.

The key criticisms of institutions are twofold. First, the lack of political consensus makes this option very risky politically, as some countries would see such institutions as an infringement upon their sovereignty. Secondly, these institutions would need to be able to punish countries that do not comply with their commitments. The two critiques are related. I think they do not only concern institutions but also the ability to implement rules in general. The enforcing mechanism should be a reduction in some European transfers. As such, I consider the design of a European budget (with a consistent size) a disciplinary tool that would allow for the reduction of transfers to countries that do not fulfil their commitments.

Such institutions should be pragmatic. One must acknowledge a pervasive difference in national preferences, which can be summarised by the amount of national redistribution. In addition, as Europe is not a federation, high permanent transfers across countries do not appear to be a viable policy option. Finally, the amount of public debt inherited from the crisis creates additional difficulties in the transition process toward any new fiscal system.

A solution to these constraints could be the clear distinction between the regular business cycle and a crisis period. Fiscal policy in the coming years will have to deal with public debt reduction in all European countries. National tools must do this while avoiding contraction in aggregate demand and an increase in inequality. Relevant tools to achieving this end include correctly calibrated national automatic stabilisers and the public pension system.

¹⁵ See I.W.H. Parry, R. de Mooij, M. Keen: Fiscal Policy to Mitigate Climate Change: a guide for policy makers, International Monetary Fund, 2012.

¹⁶ A. Bénassy-Quéré, M.K. Brunnermeier, H. Enderlein, E. Farhi, M. Fratzscher, C. Fuest, P.-O. Gourinchas, P. Martin, J. Pisani-Ferry, H. Rey, I. Schnabel, N. Véron, B. Weder di Mauro, J. Zettelmeyer: How to reconcile risk sharing and market discipline in the euro area, VoxEU, 17 January 2018, available at <https://voxeu.org/article/how-reconcile-risk-sharing-and-market-discipline-euro-area>.

The main focus should be on crisis management. In addition to the institutional coordination of national fiscal policy, we need stabilising tools implementing risk-sharing among European member states and their citizens, notably to mitigate the unemployment risk. Of the many good ideas currently being discussed in Europe, the most interesting proposal is to let national unemployment schemes manage the regular business cycle, and to provide European financing to extend the duration of unemployment benefits during a crisis period. The crisis period is defined as a period with an abrupt fall in GDP and a sharp increase in unemployment. The financing would be provided by national contributions in good times and through a borrowing capacity in a crisis period. This system is in place in the US and is consistent with a diversified unemployment system at the state level.

Such a scheme would solve many issues facing fiscal policy in Europe: 1. It would help reduce inequality during a crisis period, easing unemployment. 2. It would prevent an abrupt fall in aggregate demand, sustaining households with a high propensity to consume. 3. It is consistent with a progressive reduction in public debt within countries, and it would ensure that the effort of citizens would not be wasted by an upsurge in public debt due to an unexpected crisis. 4. Permanent transfers across member states would be avoided through the proper design of national contributions. 5. It would help mitigate labour market turmoil during a crisis and contribute to European convergence. 6. Finally, because it is an automatic stabiliser in times of crisis, it would avoid the discretion dilemma at the European level.