



Strategies to foster fiscal discipline and
economic growth
Vienna, 29 September 2015

FISCAL POLICY IN A DEPRESSED ECONOMY

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Outline

1. The context:

- Growth prospects have been dismal since the crisis
- Reduced scope for economic stimulus
- Structural policy in a context of weak demand

2. The composition of fiscal packages

- Less consolidation is planned and change in the composition
- Choice of instruments
- Reforms to enhance the efficiency of spending

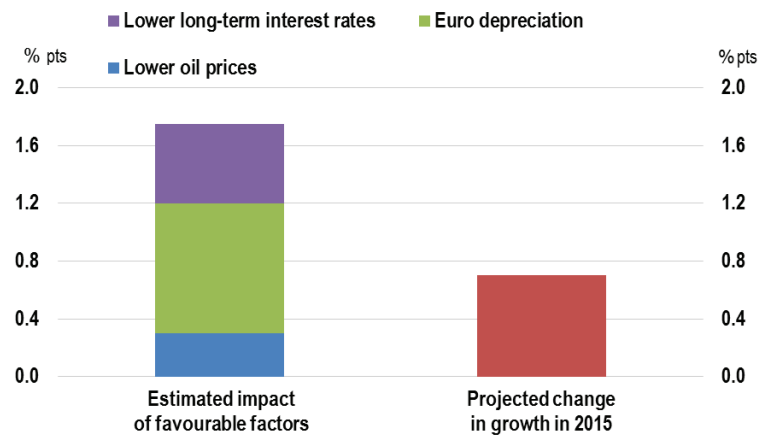
3. How does the trade-off change in a low growth-low inflation environment

4. The conditions to have a self-financing fiscal expansion



Growth in the euro area is improving, but not as fast as might be expected

Projected change in GDP growth rate in 2015 compared to estimated impact of favourable factors



Note: Estimated impact of favourable factors calculated using the NiGEM model.
Source: OECD National Accounts Database; OECD calculations

Context

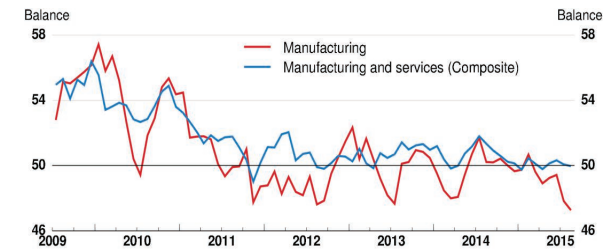
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The main puzzle concerning global growth centres on China

Recorded GDP growth has held up well, but some indicators point to a marked slowdown

Purchasing Managers Index (PMI)



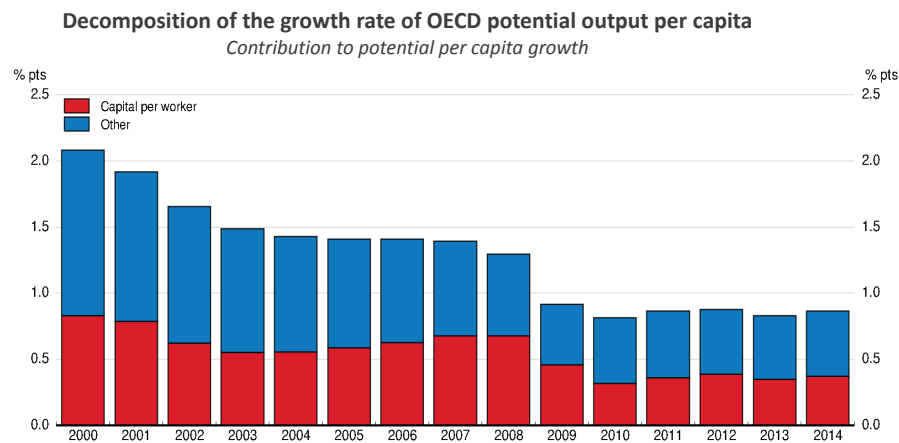
Source: Markit

Context

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The potential growth slowdown in advanced countries is an ongoing concern



Source: OECD National Accounts Database; OECD calculations

Context



Interim Outlook: global growth still sub-par

Real GDP¹
Percentage change

	2014	2015		2016	
		September 2015 Interim Projections	difference from June Economic Outlook (percentage points)	September 2015 Interim Projections	difference from June Economic Outlook (percentage points)
United States	2.4	2.4	0.4	2.6	-0.2
Euro area	0.9	1.6	0.1	1.9	-0.2
Japan	-0.1	0.6	-0.1	1.2	-0.2
Germany	1.6	1.6	0.0	2.0	-0.4
France	0.2	1.0	-0.1	1.4	-0.3
Italy	-0.4	0.7	0.1	1.3	-0.2
United Kingdom	3.0	2.4	0.0	2.3	0.0
Canada	2.4	1.1	-0.4	2.1	-0.2
China	7.4	6.7	-0.1	6.5	-0.2
India ²	7.2	7.2	-0.1	7.3	-0.1
Brazil	0.2	-2.8	-2.0	-0.7	-1.8
Rest of the world ³	2.8	2.3	-0.2	3.3	-0.3
World	3.3	3.0	-0.1	3.6	-0.2

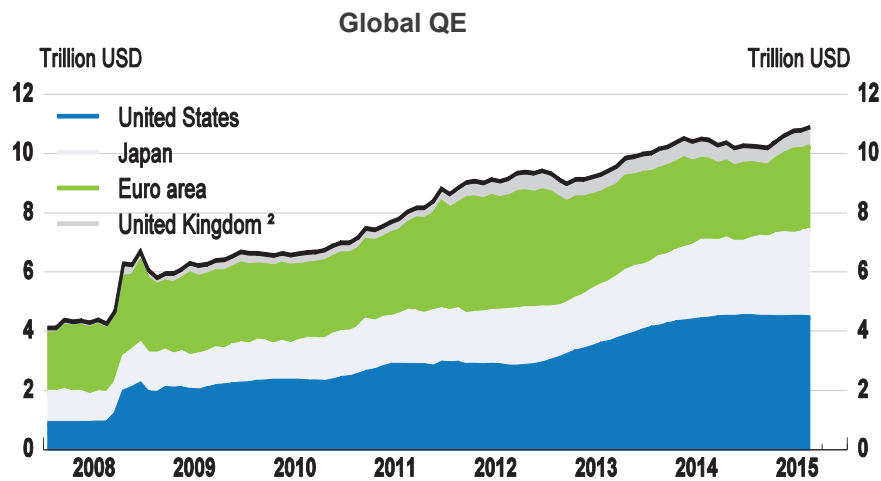
1. GDP at market prices adjusted for working days. In the case of Germany, this differs from the "headline" measure, which does not include the working day adjustment. The unadjusted number for Germany would be higher by 0.2 percentage points in 2015 and no different in 2016.

2. Data refer to fiscal years starting in April.

3. Estimated based on revisions to the June 2015 Economic Outlook projections on the basis of changes to external forecasts.

Context

Scope for further monetary stimuli are limited



*The sum of total assets of the four central banks, using actual exchange rates.
 *The Bank of England's consolidated balance sheet is not available before May 2006. Following changes to the Bank of England's weekly reporting regime, the total assets since September 2014 refer to the sum of balance sheet items that are released immediately.
 Source: Board of Governors of the Federal Reserve System, European Central Bank, Bank of Japan, and Bank of England; and OECD calculations.

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Reforms to be promoted in a context of weak demand

Shift in the composition of public spending towards investment

- Public infrastructure investment with high growth impact (broadband network)
- Regulatory harmonisation

Product market reforms in specific service sectors

- Removing restrictions on the entry of new suppliers in services characterised by low entry costs – and in some cases – latent demand (professions, taxis, etc).

Reforms of benefit entitlements in the areas of pensions and/or health

- Improve sustainability of public finances and create space for fiscal stimulus
- Effective/credible back-loaded consolidation

Reforms easing frictions in the reallocation of resources

- Reducing barriers to geographical or jobs mobility
- Housing market policies and job-search assistance

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Reforms least likely to succeed in a context of weak demand

Reforms that initially put downward pressures on wages or mark-ups

- Employment protection legislation, minimum wages or product market regulation (network industries)

Factors mitigating the impacts of such reforms

- *Packaging*: Simultaneous reforms of labour and product markets reduce risks or extent of contractionary effects.
- *Synchronisation*: In euro area, help to reduce transition costs by giving greater scope to monetary policy
- *Boldness*: Once and for all price level adjustment vs lower inflation expectations

Measures to shift the relative strength of channels

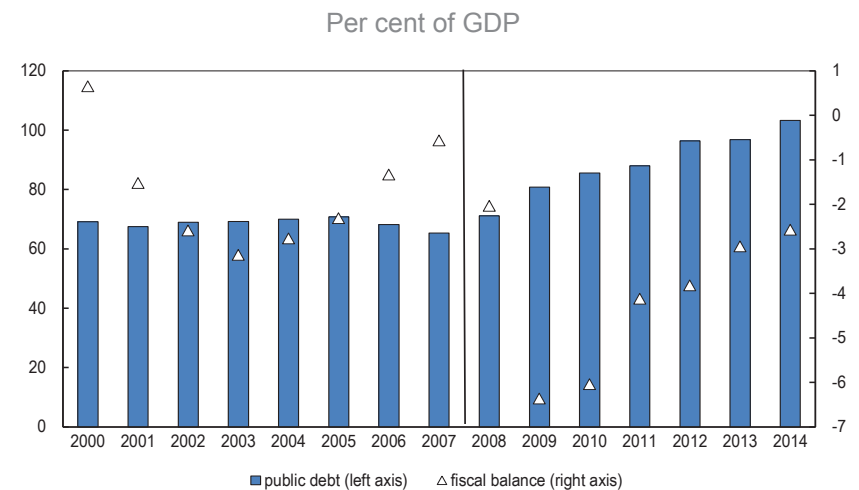
- Addressing financial sector dysfunctions to improve credit flow
- Reducing policy uncertainty to boost the positive confidence channel

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Budget deficit and public debt in the euro area

Fiscal package



Source: OECD Economic Outlook.

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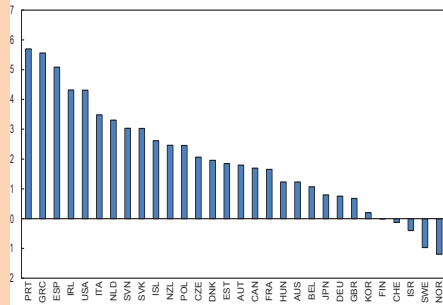


Recent and planned consolidation

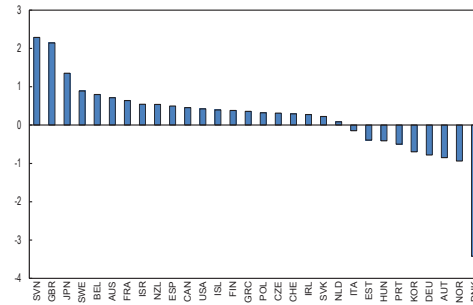
Fiscal package

Change in the underlying primary balance

2011 - 2014



2014 - 2016



Source: OECD Economic Outlook.

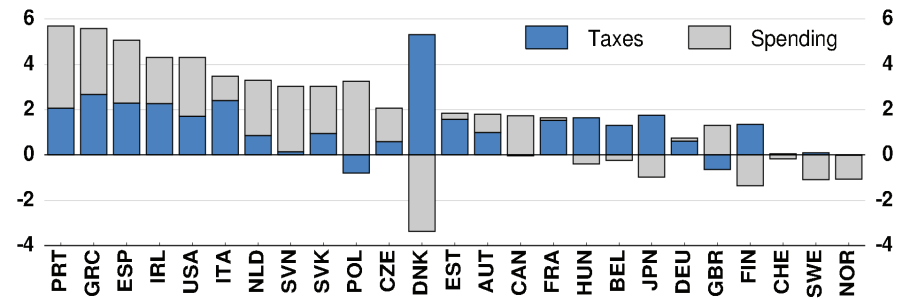


Consolidation relied to a large extent on tax increases up to 2014

Fiscal package

Change in key components of the primary balance

2011-14, in per cent of potential GDP



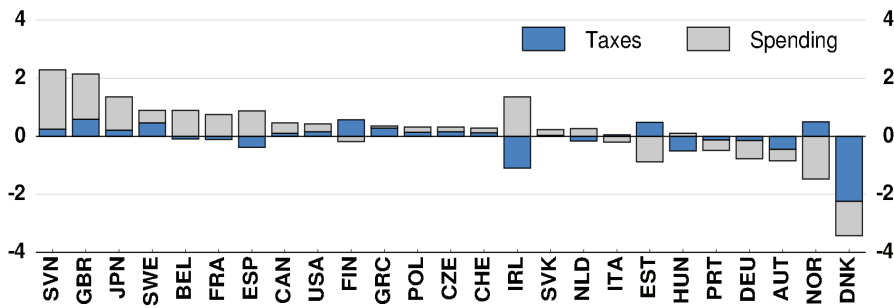
Source: OECD Economic Outlook.



In the coming years, the focus is going to be expenditure restraints

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Change in key components of the primary balance
2014-16, in per cent of potential GDP



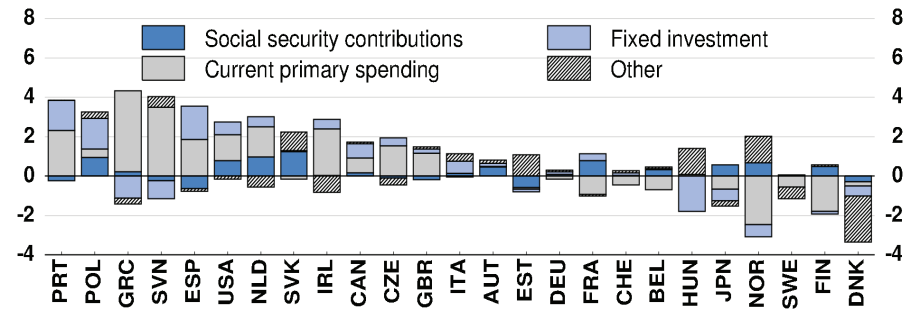
Source: OECD Economic Outlook.



In the past, some countries have adjusted public investment

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Change in key components of the primary balance
2011-14, in per cent of potential GDP



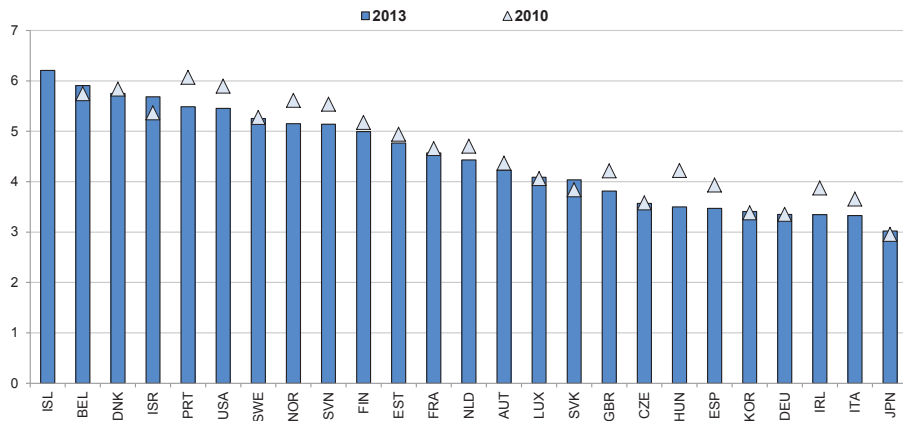
Source: OECD Economic Outlook.



And some have adjusted education spending

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Current education spending as a per cent of potential output



Source: OECD.

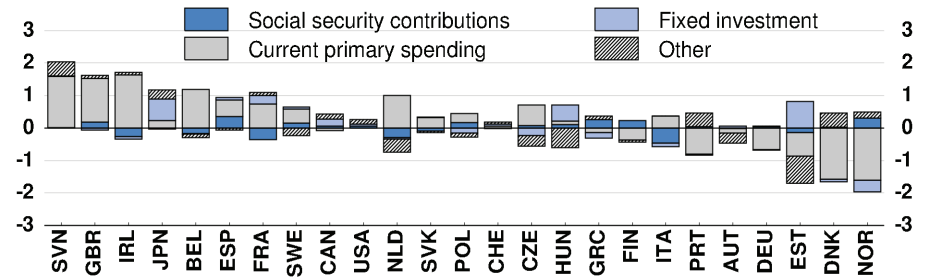


In the coming years, the plan is to rather slow current primary spending.

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Change in key components of the primary balance

2014-16, in per cent of potential GDP

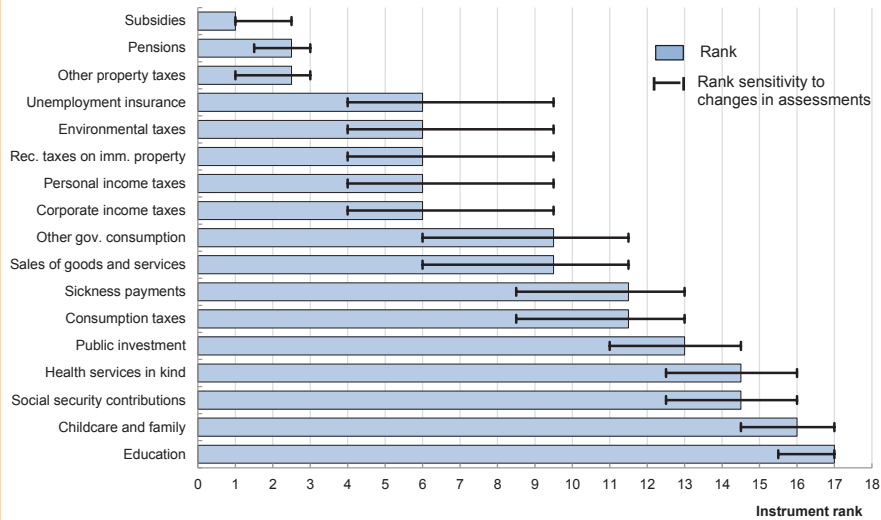


Source: OECD Economic Outlook.



Choice of instruments

Fiscal package



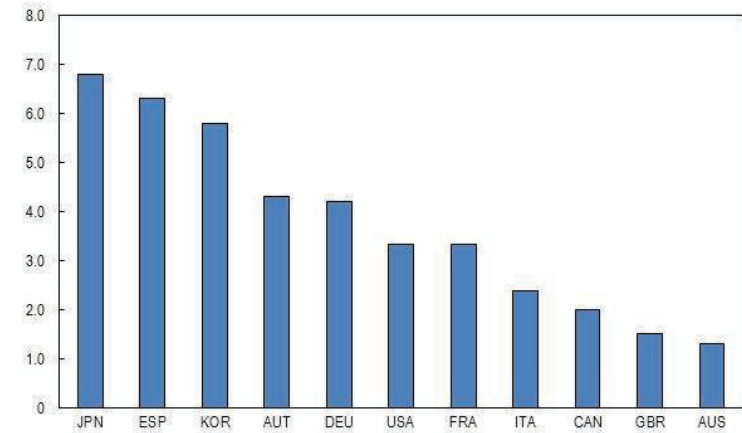
Source: Cournède, Goujard and Pina (2014).



Scope to use relatively favourable instruments differs across countries

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Availability of instruments appearing in the top half of the ranking, % of GDP



Countries with tax and spending structures well aligned with the ranking have smaller potential to improve growth and equity through fiscal shifts



Reforms can raise the effectiveness and efficiency of spending

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- Prioritisation of expenditure and spending reviews
- Performance-based budgeting
- Public administration reforms

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Reforms can enhance efficiency within instruments

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Trade-offs between instruments can be eased by improving their design

- Spending: e.g. efficiency gains in health care and education.
- Revenue : e.g. base broadening, reducing tax expenditures

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Typology of fiscal rules

Objectives of fiscal rules : (1) anchor fiscal policy expectations by targeting a prudent debt level and (2) allow for macroeconomic stabilisation.

	Budget balance	Structural balance	Expenditure rule	Revenue rule
Fiscal stabilisation	-	+	+	-
Fiscal discipline	++	+	+	-+
Side-effects and risks	-	--	-	-

Source: Fall et al. (2015)

The adoption of a budget balance rule complemented by an expenditure rule suits most countries well.

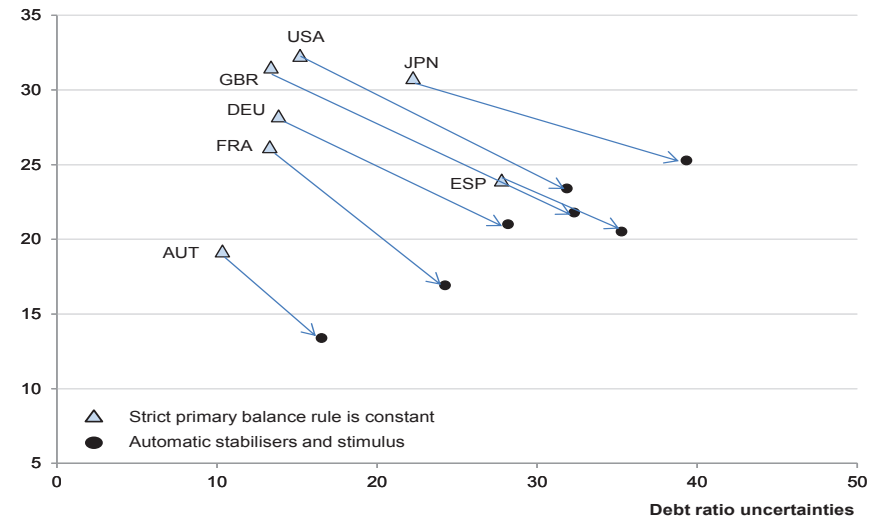
Trade-off

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The trade-off between fiscal discipline and stabilisation

Long-term recession risks



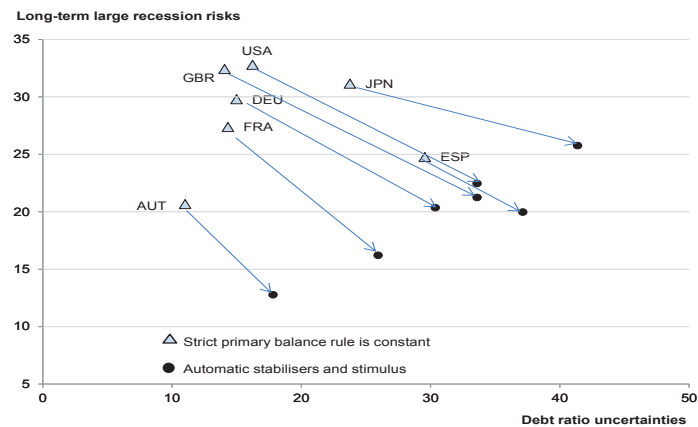
Source: Fall et al. (2015)

Trade-off

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In an environment of lower growth and lower interest rates, the recession risk is higher

Fiscal stimulus can nonetheless reduce large recession risks.



Note: The potential growth rate and the interest rates are assumed to be 1% lower. A large recession risk is the risk that annual GDP per capita growth falls under -1%.

Source: Fall et al. (2015)

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Condition for fiscal policy to be self-financing in a stylised model

$$r < g^* + \frac{\varphi\mu\tau}{1 - \mu\tau}$$

r : real government borrowing rate

g^* : potential output growth

τ : marginal tax and transfer rate

2 key parameters:

- Fiscal multipliers (μ): non linear in the multiplier
- Hysteresis (φ): the higher the amplitude of the hysteresis the easiest it is to fulfil the condition

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Size of the fiscal multiplier is uncertain

Multipliers depend:

- ✓ on whether policy focuses on spending or taxes
- ✓ on whether the change is temporary or permanent
- ✓ whether the stimulus is provided in good or bad times
- ✓ how many households are liquidity-constrained
- ✓ how monetary policy is going to react
- ✓ the credibility of government
- ✓ whether the Ricardian equivalence holds



The degree of hysteresis is hard to estimate

Paper	Degree of hysteresis	United States	Euro area
Delong and Summers (2012)	0-0.2	0.1	
Logeay and Tober (2006)			0.3
Kienzler and Schmid (2013)	0.2-0.3	0.3	
Rawdanowicz <i>et al.</i> (2014)	0.1-0.9	0.1	0.2-0.5



Critical value for the real interest rate for the expansion to be self-financing

Germany in 2015

	h=0	h=0.1	h=0.2
m=0.5	1.1	3.4	5.7
m=1	1.1	7.1	13.2
m=1.5	1.1	14.1	27.1
m=2	1.1	31.7	62.4

Self-financing policy



Critical value for the real interest rate for the expansion to be self-financing

United States in 2015

	h=0	h=0.1	h=0.2
m=0.5	1.9	3.5	5.2
m=1	1.9	5.9	9.9
m=1.5	1.9	9.4	16.9
m=2	1.9	15.3	28.7

Self-financing policy



Critical value for the real interest rate for the expansion to be self-financing

Austria in 2015

	h=0	h=0.1	h=0.2
m=0.5	1.2	3.8	6.4
m=1	1.2	8.3	15.3
m=1.5	1.2	17.6	33.9
m=2	1.2	48.9	96.6

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Fiscal policy in a slow growth environment with lesser scope for monetary stimulus

Conclusions

- Fiscal policy in the euro area is expected to be broadly neutral and there will be a significant change in the composition from tax increases to expenditure restraints, whose objective may be more challenging to achieve.
- Many OECD countries have significant scope to meet fiscal challenges with limited adverse side-effects on growth and equity if instruments are well-chosen (cutting subsidies and pension outlays, increasing inheritance, capital gains and other property taxes.)
- Improving the quality of public finance is key to ease the trade-offs between consolidation, equity and long-term growth objectives.
- From a longer term perspective, fiscal policy should be framed by fiscal rules, complemented by a well-designed institutional framework, where fiscal councils play a key role.

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Future areas of research

- It seems that fiscal policy can still reduce recession risks...
- ...but there are still a lot of information gaps in the functioning of fiscal policy in the current economic environment : size of the fiscal multipliers, degree of hysteresis.
- To contribute to a better understanding of these issues, the OECD Economics Department is planning to examine in more details the quality of public finances, and its relation with growth and inequality.



OECD references

- Cournède, B., A. Pina and A. Goujard (2014), “Reconciling fiscal consolidation with growth and equity”, *OECD Journal: Economic Studies*, Vol. 2013 Issue 1.
- Barbiero, O. and Cournède (2013), “New Econometric Estimates of Long-Term Growth Effects of Different Areas of Public Spending”, *OECD Economics Department Working Papers*.
- Fall F., D. Bloch, J-M Fournier and P. Hoeller (2015), “Government Debt and Fiscal Frameworks”, *OECD Economics Department Policy Papers*.



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THANK YOU