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Fiscal policy and the global financial crisis

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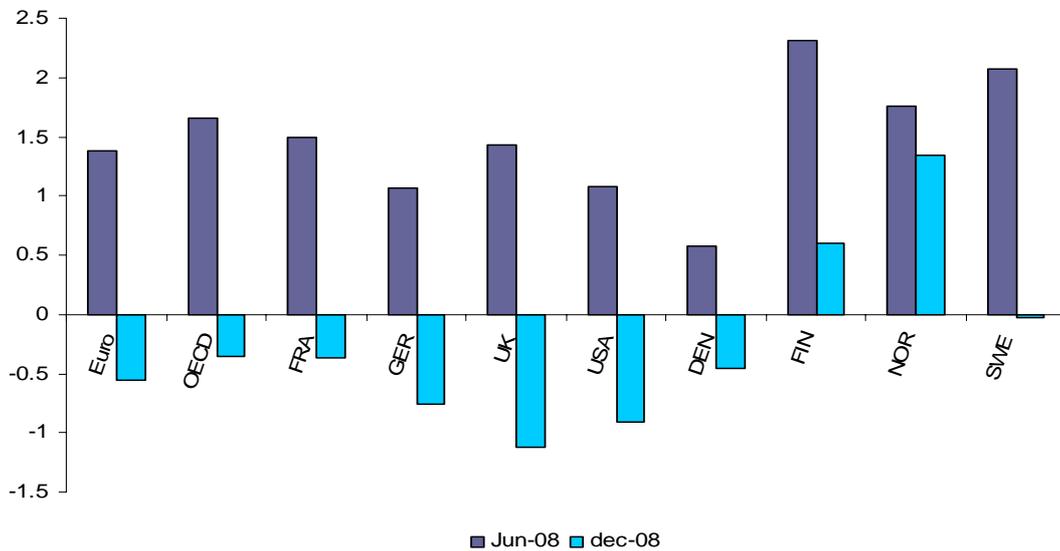
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1. Introduction

The global financial crisis is now turning into a world-wide economic crisis. Business cycle forecasts are continuously being revised downwards¹, and negative growth rates are expected for many OECD countries for 2009, cf figure 1. Growth rates are expected to recover only sluggishly, and as a consequence, unemployment rates are soaring in all OECD countries.

Figure 1: Forecast adjustments: OECD growth forecasts for 2009 – June and December 2008



Note: Forecast for real GDP growth in Economic Outlook 83 (June 2008) and Economic Outlook 84 (November 2008).

Source: <http://stats.oecd.org>

Against this background, increasing political interest is turning to fiscal policy as a possible remedy. While fiscal policy for some years has been downplayed, it now faces a renaissance with high expectations as to what fiscal policy can accomplish. In many countries, there is a vivid debate on the need for a fiscal stimulus, its magnitude, and its composition, and some countries have undertaken fiscal stimulus packages. Calls for a coordinated fiscal stimulus have been issued by many, including the G20 summit and by the EU Commission.

¹ In January, IMF (2009) revised the projected world growth rate for 2009 down to ½ %, in November 2008 it was forecasted to be 2 ¼ %, and in July 2008 3.9 %. The EU Commission (2009) has adjusted the projected growth rate for 2009 down by 2% to -0.2% between the autumn 2008 and January 2009.

The revival of fiscal policy begs the questions what role fiscal policy can play in the current situation, and what the lessons are on fiscal policy from past experiences. The views on fiscal policy prevailing before the onset of the crisis have been much influenced by events triggered by the so-called oil-crisis, where there were widespread attempts with demand management policies. Policies during that period were not particularly successful, and this can largely be attributed to the misperception that the crisis was temporary and a neglect of structural aspects². Another important lesson is the trade-off between short and long-run objectives. High debt levels accumulated during the 1970s and 1980s have turned out to be a significant burden and constraint on policy options for a number of countries for prolonged periods of time. For some countries, these problems had not even been fully solved before the onset of this crisis, and at the same time approaching demographic shifts are challenging public finances further.

The mainstream consensus view on macroeconomic policy can be summarized as follows³. Stabilization policy should be left to monetary policy pursuing credible policy rules with a focus on inflation. Fiscal policy should rely on the automatic stabilizers (the rule based part of fiscal policy) leaving only discretionary fiscal policy to very special circumstances with a clear need for policy intervention (escape clause). Hence, there should be no fiscal fine-tuning due to well-known lag-problems, but “coarse-tuning” is called for in special situations. The conditions for the latter clearly seem to be fulfilled in the current situation.

The recent wave of globalization is a reason why the current situation raises new questions. The cause of the crisis, and in particular its propagation, has a very strong global element driven by both closer financial and trade links. At the same time, this also significantly influences the effects of fiscal policy since increased demand leakages via trade and specialization of production may make fiscal instruments less effective. If either of these factors is important, it may, however, point to larger gains from policy coordination than in the past. Though, it is not clear that the political barriers and obstacles to enter coordinated stabilization endeavours have become

² See eg Andersen (1990) for an account and discussion of policy strategies in the Nordic countries.

³ This is clear in the so-called Maastricht assignment for the European Monetary Union leaving centralized monetary policy to stabilize inflation, and decentralized fiscal authorities to stabilize national output by primarily relying on the automatic stabilizers.

smaller. This may cause a “stabilization” deficit tending to worsen the depth and duration of the crisis.

The aim of this paper is to discuss the need and scope for fiscal policy against the background of the global financial crisis. It is not the aim here to give a general account of fiscal policy, but rather to focus on issues particularly relevant in the current situation. First, a few general remarks on the nature of the crisis and the role of fiscal policy are highlighted in section 2. Next, the role of automatic stabilizers and their strength are discussed in section 3. Some crucial aspects in relation to the effectiveness of fiscal policy are discussed in section 4, while section 5 considers specific aspects in relation to fiscal policy design in the current situation. The possible tension between short and long-run objectives is discussed in section 6, and section 7 considers coordination issues. Finally, section 8 offers some concluding remarks.

2. Economic implications of the crisis and fiscal policy

The need and scope for discretionary fiscal policy depend on the nature of the shock and on the value added it may contribute to monetary policy responses and automatic budget reactions. In the following, these issues are briefly considered.

While the origin of the crisis is attributed to the financial sectors, there are also some real counterparts. Most notably, the fact that the housing markets in a number of countries have been overheated is reflected both in excessive house price increases⁴ and a booming activity level in the sector. The specific problems in the financial sector (liquidity and solvency issues) are not to be discussed here, but the financial sector itself has also been overheated. Moreover, the implied effects for credit policy (eventually a credit crunch) are important since they make borrowing constraints more binding. This, in turn, has implications for both investments and consumption.

Maintaining status quo is thus neither a feasible nor desirable policy option. Some structural adjustments are inevitable, and it is important that policy discussions take this into account. If not, policy will be based on non-attainable objectives and lead to large waste as it attempts to counter-act inevitable structural adjustments.

⁴ IMF (2008) shows that price increases in a number of countries significantly exceed what can be explained by market fundamentals, leaving house price gaps in the order of 10-30 %.

However, the downturn is more than mere structural readjustments after “bubble” phenomena in the housing market and financial sectors. These effects are exacerbated by sharp declines in aggregate demand. This will apply to all three main components of private demand: private consumption, investments and net-exports. Private consumption growth declines due to several factors. Wealth losses induce a higher savings rate. Lack of confidence in the future and more dismal expectations as well as an increased perception of risk strengthen savings incentives further. In addition, tighter credit policies make liquidity constraints more binding for some households. Likewise, private investments are depressed by more tight credit policies (credit rationing, interest rates) as well as declining expectations and increased risk perceptions. Finally, net-exports are falling due to similar effects taking place in many countries. This may be called a global multiplier effect released by the fact that the crisis is global, and it has been strengthened due to globalization of financial and goods markets. The net-export changes may differ across countries depending on exchange rate regimes, as seen from the fact that effective exchange rates have appreciated in some countries and depreciated for others (eg Norway and Sweden)⁵.

As a response to the financial crisis, monetary policy has been radically eased, including both provisions of liquidity and significant interest rate reductions. Interest rates have been reduced to rather low levels, implying that the room for further interest rate reductions is small (related to the general discussion about the liquidity trap). Moreover, it is possible that monetary policy may have asymmetric effects or degrees of effectiveness in the sense that monetary policy is more effective in contracting a boom than in inducing a boom (you can pull a string, but not push it). Accordingly, it is a widespread perception that monetary policy cannot deliver sufficient stabilization in the present situation.

Attention is therefore turning to fiscal policy, and the first question is whether the conditions for use of discretionary fiscal policy are fulfilled. There is no general rule as to when a discretionary policy is called for, but output gaps below 1-2 % seem to be revealing severe problems justifying discretionary measures⁶. Clearly, the need and scope for policy intervention should be seen relative to other indicators including the

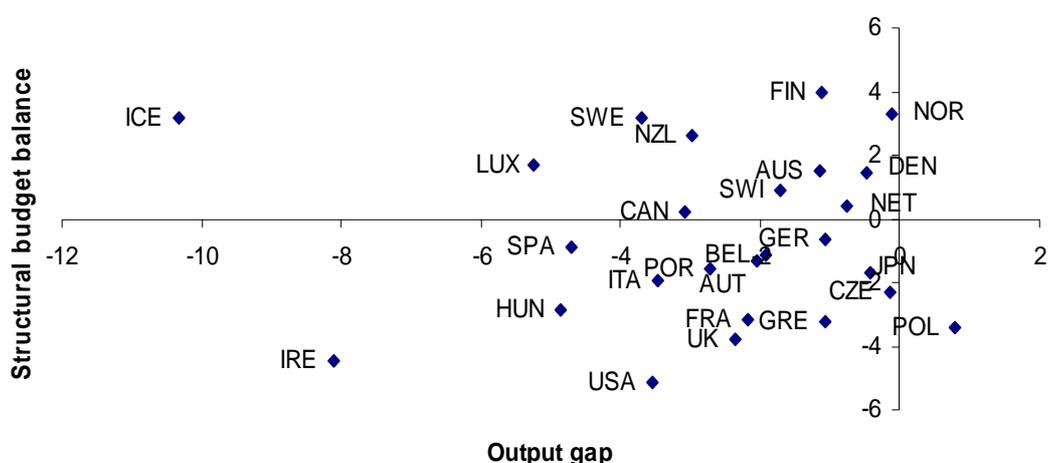
⁵ Eg Denmark has experienced tightened monetary conditions. The currency is pegged to the EURO, but the interest rate spread has increased due to turmoil in international financial markets.

⁶ There is no conventionally agreed cut-off point. In the STEMU report, an output gap of – 2% was proposed as a critical level (SOU(2002)).

unemployment rate. In determining the scope for fiscal policy intervention, it is important to take medium to long-run effects into account. Expansionary fiscal policy in combination with budget deteriorations implied by automatic budget reactions will drive up public debt, which, in turn, may create future adjustment problems (see also section 6). The more so, the less fiscal sustainability questions have been addressed in the past.

Figure 2: Need and scope for fiscal policy

Output gaps and structural budget balance, OECD countries



Note: Output gap for 2009 and structural budget balance relative to GDP for 2008

Source: Data from OECD Economic Outlook 84, December 2008

Figure 2 sheds some light on the need and scope for fiscal policy action. It shows both the output gap and the structural budget balance for OECD countries for 2009. For the sake of argument, take an output gap below -1 % as indicating a need for an expansionary policy, and a positive structural budget balance as an indicator for the presence of short-run room for manoeuvre without jeopardizing long-run objectives. This leaves four different possibilities in the need/no need and room/no room for expansionary fiscal policy, and the heterogeneity across countries stands out as an important factor. Where Sweden is in the “need and room” category, we have in the “need but no room” category a large number of countries including eg USA, France, and Italy. Clearly, the position of public finances may not constrain policy actions, but it points to the long-run consequences of such actions.

In summary, fiscal policy is called upon to provide additional stabilization. The conditions triggering the escape clause are fulfilled; the crisis is severe, and monetary policy combined with automatic stabilizers can not provide sufficient stabilization.

3. Automatic stabilizers

Automatic stabilizers are widely appreciated, and as noted the consensus view is that fiscal policy in “normal times” should be left to the automatic stabilizers. They have the advantage that they do not suffer from the usual information, decision, and implementation lags, and empirical evidence have shown that they contribute to stabilization (see eg van der Noord (2000) and Debrun et al (2008)). However, one key issue is whether automatic stabilizers are strong enough. The design of automatic stabilizers is more by chance than design in the sense that it captures the net effect of policy decisions in a number of policy areas⁷. Aiming at a specific level for the automatic stabilizer is usually not a policy target.

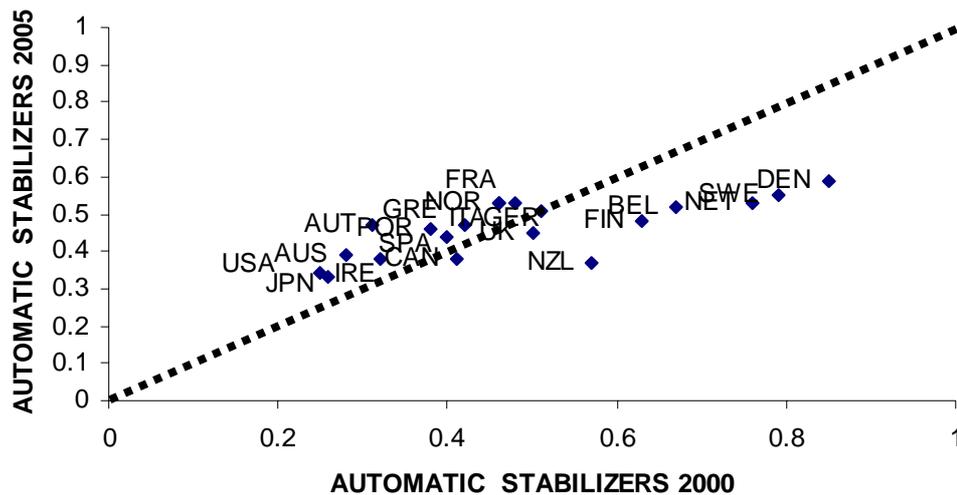
3.1. What has happened to automatic stabilizers?

One particular concern is whether automatic stabilizers have been weakened in recent years due to structural reforms focusing on incentive effects of both tax and labour market policy (see eg Knieser and Ziliak (2003)). Figure 3 shows estimates of the size of automatic stabilizers reported by OECD in 2000 and 2005, respectively. On average, there is no tendency that automatic stabilizers have become weaker (the average in 2000 was 0.49 and in 2005 0.46). Yet, there seems to be a systematic pattern since those countries with initial weak automatic stabilizers have tended to get stronger automatic stabilizers, whereas they have been muted for countries with initial strong automatic stabilizers. According to these estimates, there has been a levelling of the strength of automatic stabilizers. Note that it can not be concluded that this is due to reforms since different estimation methods and data have been applied. Moreover, active labour market policies are not included in the 2005 measure, and this is important for eg Denmark and Sweden. Including active labour market policies implies that automatic stabilizers have not been weakened in those countries.

⁷ It is empirically well established that economies with large public sectors tend to have large automatic stabilizers and vice versa.

It is thus not possible in general to conclude that automatic stabilizers have been weakened. However, for the countries for which they have been weakened, the question is, of course, whether that is a conscious policy choice, or whether it is an undesirable side effect of reforms in other policy areas.

Figure 3: Automatic stabilizers: 2000 vs 2005



Note: Automatic stabilizers are measured by the semi-elasticity of the budget balance wrt to GDP; that is, the change in the budget balance relative to GDP induced by a 1 % change in GDP. For Norway is mainland Norway

Source: van der Noord (2000) and Girouard and André (2005)

The overall fiscal response is the sum of the effects of automatic stabilizers and discretionary changes, and hence one might expect large discretionary changes in countries with weak automatic stabilizers. Historically, the Nordic countries stand out by having both large automatic stabilizers but also by having used discretionary fiscal policy more actively (Ahrend et al (2007)). By revealed preferences, it follows that the political value of stabilization is large.

3.2. Can automatic stabilizers be strengthened?

The crisis has raised concerns that automatic stabilizers are too weak, and proposals have been made to strengthen them. Most explicit is a recent position paper from the IMF (see Spilimbergo (2008)) where it is proposed that automatic stabilizers should be

strengthened by changing eg unemployment insurance schemes (benefit levels, duration and eligibility conditions)⁸.

Conditioning unemployment insurance schemes more explicitly on the business cycle situation is a possible way to strengthen automatic stabilizers. This will accomplish more insurance when it is needed most (when unemployment is high) and less when it is not much needed (when unemployment is low). The idea of introducing business cycle conditions explicitly into the unemployment insurance scheme is known in both Canada (benefit level, duration and eligibility conditions)⁹ and in the US (extending benefit periods), see eg Andersen and Svarer (2009) for details. Sweden is also known for using labour market policy as a semi-automatic stabilizer by varying in particular active labour market policies with the state of the labour market.

Making one or several dimensions of unemployment insurance more (less) generous in bad (good) times clearly strengthens insurance and automatic stabilizers. But such contingencies may have detrimental structural effects. One is that it may make wage setting less responsive to the labour market situation since the effects of changes in unemployment are countered by changes in benefits. Another important issue is how job search incentives are affected, and it turns out that it is not at all obvious that labour market structures are impaired. This depends on how the distortionary (incentive) effects of unemployment insurance are affected by the business cycle situation. If benefit generosity is more distortionary in good than in bad times, it follows that such a contingency will reduce benefits when they are most distortionary and increase them when they are least distortionary. That is, in this way the average distortionary effects can be lowered. This is interesting since it shows that it is possible to strengthen insurance and automatic stabilizers without necessarily increasing the structural unemployment rate. The strength of this mechanism can be debated, but it points out that the structural costs of the improved insurance coverage and strengthened automatic stabilizers need not be large (and they may be negative). However, a supply side consequence is that this contributes to make unemployment display more variability over the business cycle (see Andersen and Svarer (2009)).

⁸ Similarly, it is argued in the European Economic Recovery Plan (see European Commission (2008)) that unemployment benefits or their duration may be increased.

⁹ As an example benefits in Canada depend in a step-wise fashion on the regional unemployment rate, and the potential benefit level is about 50% higher if regional unemployment is high (above 13%) than if it is low (below 6%)

Changing elements of the unemployment insurance scheme with the business cycle entails a political risk since it may be easier to agree on a more generous scheme in bad times than to make the opposite adjustment in good times. The latter is of course an example of a general problem in relation to discretionary fiscal policy and whether it has a pro-cyclical bias. However, if changes to unemployment benefit schemes in the current situation are made explicitly business cycle dependent, this is a way to introduce a rules based policy, and therefore increasing the political costs of opportunism.

4. Effectiveness of discretionary fiscal policy

The current debate on fiscal policy raises a number of questions concerning the effectiveness of fiscal policy. This section considers some principal arguments, while the subsequent section turns to more specific issues on how to compose a fiscal policy package.

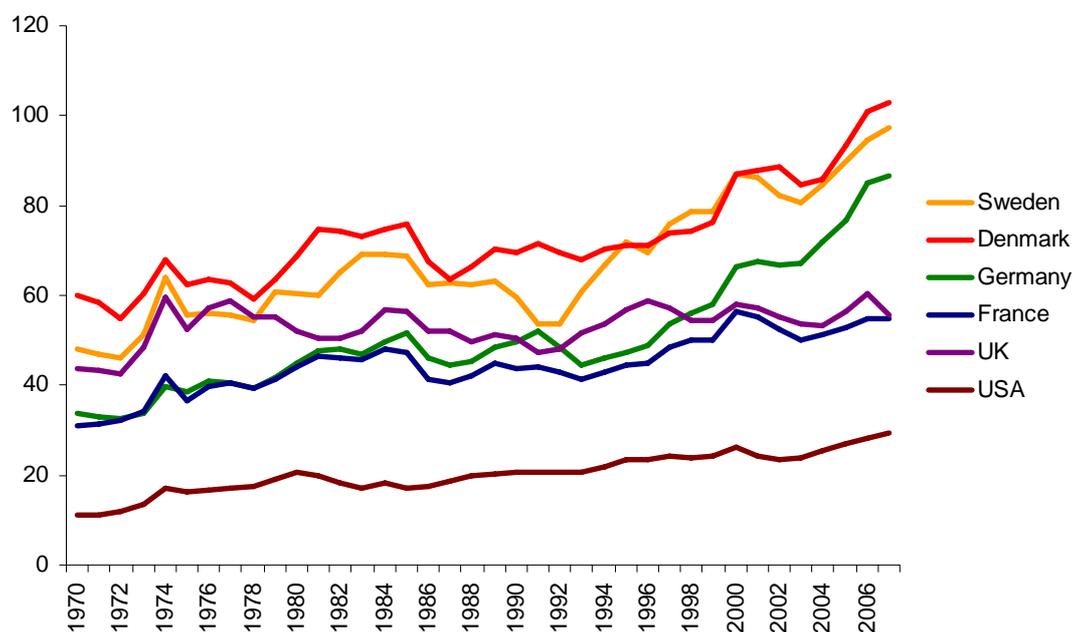
4.1. Demand leakages

Trade shares have been on an upward trend for some years, cf figure 4, and this is a visible consequence of tighter economic integration associated with the globalization process. It is a standard textbook result that fiscal multipliers are smaller, the larger the import leakage¹⁰. The reason is that a larger share of domestic demand turns to foreign production. Hence, via stronger trade links globalization tends to reduce the effectiveness of fiscal policy (see further below on fiscal policy coordination).

This point should be qualified by the fact that there may be a significant difference between private and public demand wrt the demand leakage. The reason is that the import content in private consumption is larger than in public consumption. Hence, the leakage problem relates in particular to measures aiming at increasing private demand, and less to public demand. By changing the composition of the fiscal policy package, it is possible to minimize the leakage effect (see section 7).

¹⁰ Borell et al (2009) show that the size of country-specific fiscal multipliers is inversely related to the openness of the country.

Figure 4: Openness measures – selected countries



Note: Openness measured by the sum of export and imports to GDP

Source: www.sourceoecd.com

4.2. Structural aspects

Traditional macro analyses take a very aggregate approach to the labour market, essentially assuming homogenous labour which easily/costless can be reallocated across sectors. It is an implication that only the aggregate level of demand matters, and a reduction in one component (say net-export) can be compensated by an increase in another component (say public demand) so as to leave aggregate activity and employment unchanged. This may also be phrased in the way that different components of aggregate demand are perfect substitutes as concerns employment.

Globalization is a particular reason why this homogeneity assumption may be called in question. It is an essential consequence of globalization that it leads to more specialization. In models of inter-industrial trade and outsourcing, globalization tends to strengthen skill bias in labour demand, ie increasing demand for skilled and decreasing demand for unskilled¹¹. Exploitation of comparative advantages is a key

¹¹ There has been a heated controversy whether skill-bias is primarily due to technological shifts or globalization. For the policy discussions discussed here, it is, however, of no consequence what the underlying cause is. See OECD (2007) for a recent discussion of how globalization affects labour markets.

driver, and further integration leads to expansions of sectors/types of production with high comparative advantages and vice versa. Since comparative advantages are closely related to specialization, and hence sector specific knowledge (human capital), it follows that the structural composition of the economy matters.

If labour for these – and other - reasons to an increasing degree is non-homogeneous across types of production, it follows that the composition of aggregate demand matters. When labour embodies sector specific knowledge, it is not plausible that labour can be reallocated across uses/sectors at no costs. The costs arise due to training costs (explicit or via on-the-job training) and due to the sluggishness by which workers may adapt their reservation demands to changes in the labour market prospects (in particular if it is associated with a different type of job, lower wage etc.). Of course the speed and willingness involved depend on wage formation and the social safety net, and the options it offers for “postponing” adjustment.

Such adjustment effects have several important implications for fiscal policy¹². First, even if falling private demands are counter-acted by a fiscal stimulus, there will be a transitional phase with excessive unemployment due to falling demand in contracting sectors and the sluggish process by which labour is reallocated (increasing mismatch problems). It is far from self-evident that a general expansion will “lift all boats” in the labour market. Those becoming unemployed may possess other skills than those being demanded as a consequence of a more expansionary fiscal policy. It is an implication that shocks may have more persistent effects (including more wage/unemployment dispersion), and fiscal policy may have a weaker short-run impact due to these supply factors.

Second, it is of utmost importance whether the changes are transitory or permanent. In the case of transitory changes, reallocation of labour may entail inefficiently large adjustment costs due to excessive labour turnover. In the case of permanent changes, the issue is more complicated. On the one hand, it is important that policy does not constrain the necessary structural adjustment process. On the other hand, if idle

¹² The effects and design of fiscal policy in the presence of sectoral adjustment costs have not been much researched. One exception is Steigum and Thøgersen (2003). In a full employment model, they allow for costs of transferring labour from the non-tradeable sector to the tradeable sector. An implication of negative private wealth shocks is that fiscal policy both redistributes from future to current generations by running deficits (consumers are non-Ricardian) and that demand for non-tradeables is supported in the transition.

resources are only sluggishly absorbed in other sectors, there may be an argument for some temporary support even to declining sectors. Dealing with this issue is not an easy task since it requires an identification of the sectors facing particular problems, and policies targeted to the problems of these sectors. General measures like tax cuts may be too imprecisely targeted, and sector specific measures may amount to sector subsidies which raise questions both in relation to EU rule and moral hazard problems arising if sectors are bailed out.

4.3. Expectations

Expectations may play a critical role for the effects of fiscal policy. Arguments are often made that fiscal policies could be very influential because it may induce more optimistic expectations fuelling domestic demand. Likewise arguments are often made that expectations can make fiscal policy ineffective if expansionary policies lead to unsustainable debt levels. Let us consider these two arguments in some detail.

In a recessionary period, it is often suggested that a fiscal stimulus can be used to jump- or kick-start the economy. The idea is that a fiscal stimulus can induce a shift in expectations in a more optimistic direction, which, in turn, via private demand and investments can give momentum to an up-turn. This is essentially an argument that a properly timed fiscal stimulus package may have a larger multiplier effect if it can trigger an expectation effect¹³. This idea has not been much studied, but discussions of some policy episodes may shed some light on the idea. One case example which is often highlighted as a “kick start” is a fiscal stimulus package in Denmark in 1993/94 leading to a significant change in the business cycle situation with strong growth in domestic demand. It is, however, difficult to assess whether this was driven by an expectations effect or other factors.¹⁴ There is, however, a prominent case pointing to the possibility that expectation shifts may have muted fiscal multipliers. During the crisis in Japan in the 1990s, economic insecurity fuelled more pessimistic expectations causing tax decrease to go into more (precautionary) saving rather than consumption, and thereby lowering the effects of fiscal stimulus packages¹⁵.

¹³ Yellen (2009) argues that a fiscal expansion is essential in the current situation since it is expected by the private sector. Disappointing these expectations will worsen the crisis.

¹⁴ Previous to the policy change, there was a prolonged recession, and the increase in demand seems in part to reflect a “ketchup” effect in the demand for durables.

¹⁵ Doi (2004) finds that employment risk had a significant effect on precautionary savings in Japan. However, it is disputed to what extent fiscal policy was expansionary in the period. An alternative explanation is that the savings increase reflects a Ricardian response to increasing levels of public debt.

Another expectations argument stresses entirely different factors. The idea is that a fiscal expansion may trigger expectations of a tightening of fiscal policy if the expansionary policy is not tenable. The point is that expectations of future fiscal policy may depend critically on the present fiscal stance, eg the current expenditure level or the current debt level. This is so since these levels may signal something about future fiscal policy, and thereby influence expectations formation. This may cause non-linearities or state dependencies in the effects of fiscal policy; that is, the effects of fiscal policy intervention may depend critically on the initial policy situation. A fiscal expansion causing increasing deficits may thus induce expectations of a policy change in the opposite direction in the future if the policy change brings fiscal sustainability in question¹⁶. In this situation, the private sector response to the announcement of a fiscal expansion may be a contraction in demand. This tends to counteract the expansionary effects of the fiscal stimulus package. If a moderate policy change makes a large future policy adjustment likely, it is even possible that a fiscal expansion can be contractionary.^{17 18}.

To sum up, expectations effects may cause fiscal policy multipliers to increase or decrease (or even change signs), and hence it is not possible to make unambiguous conclusions on how expectation formation influences fiscal policy. One lesson is that expectations matter, and credibility problems make it is easier to have them working against you than for you.

5. Designing fiscal policy packages

Appropriate fiscal interventions depend both on the nature of shocks, the capability of monetary policy and the strength of automatic stabilizers. Requirements to a discretionary fiscal policy are that it should be *well-timed* to the business cycle

¹⁶ Consider the effects of a tax reduction causing a budget deficit and rising debt. If the initial debt level is low, the deficit would have only a small effect on expected future taxes, and therefore private consumption would increase. However, at a high debt level a further deficit would make the point of consolidation and thus tax increases approaching, and therefore private consumption may fall. Both the size and sign of how taxes affect private consumption are thus dependent on the level of debt.

¹⁷ This holds both with Ricardian Equivalence (see Bertola and Drazen (1993)) and with non-Ricardian Equivalence (see Sutherland (1997))

¹⁸ There has been an extensive debate on the possibility of encountering expansionary fiscal contractions, various case studies have been undertaken, and econometric studies of the issue have been performed (see eg Giudice et al 2003).

situation, which includes that it should be adapted to the nature of the shocks, it should be *temporary*, the specific instruments applied should be *effective* towards the policy goals, and medium-to *long-run constraints* should be taken into account.

A business cycle event (its impulse response) can be characterized by its impact effect and its persistence. Most policy discussions are focussed on muting the impact effect of the crisis based on the perception that this will lower both the immediate cost and the duration of the crisis (cf discussion above on “kick starts”). However, the issue of how policy can affect the persistence is equally important. Whereas addressing the impact effect mainly involves aggregate demand management, the issue of persistence mainly involves structural issues, not least labour market policies.

5.1 Targeting public or private demand?

To mute or mitigate the effects of the financial crisis, the primary focus is on the extent to which falling private aggregate demand, and thus employment, can be countered by an expansionary fiscal policy.

An important choice is whether to target private or public demand. Targeting private demand mainly involves tax instruments to increase disposable income (eg temporary reductions in direct taxes) or induce intertemporal substitution in demand (eg temporary vat reduction). Public demand involves all expenditure items composing public consumption and public investments.

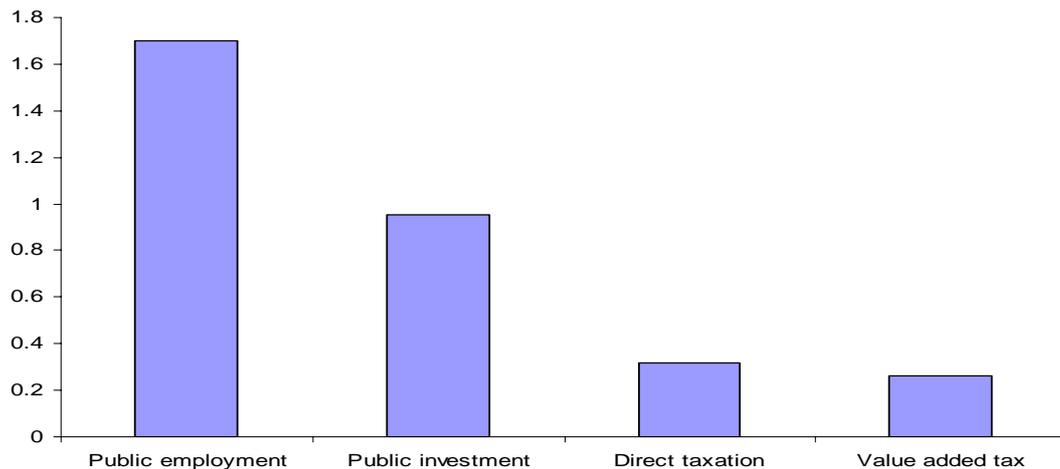
There is a large empirical literature supporting that expenditure instruments have larger short-run multipliers¹⁹ than tax instruments. As an illustration, figure 5 shows employment multipliers for four main types of fiscal instruments²⁰. In a survey of a number of applied policy models, Hemming et al (2002) conclude that although the range of short-run multipliers is wide, the expenditure multipliers tend to be in the range 0.6 to 1.4 (a one percentage increase in government consumption will increase

¹⁹ Stabilization policy is a question of temporary policy changes, and hence short-run multipliers are relevant. Many theoretical discussions have focused on the long-run multipliers, and the extent to which these may be negative due to various crowding out mechanisms. However, short-run multipliers are generally conventionally signed even though the long-run multipliers are smaller or even oppositely signed, see eg Andersen (2005).

²⁰ In Prop. 2008/09:97 it is shown in table 1.2 that the net-costs of creating a job via fiscal policy is in the order of magnitude of 1.7 mill. SEK if the fiscal multiplier is 0.5., and 0.6 mill. SEK if the multiplier is 1.

GDP by 0.6 to 1.4 percent), while tax multipliers are in the range 0.3 to 0.8. As expected, long-run multipliers are significantly smaller than short-run multipliers. Similar findings are reported in eg Spilimbergo et al (2008).

Figure 4: Fiscal employment multipliers – change in employment for a 1 percentage point change in the budget balance relative to GDP



Note: Gives the % increase in total employment from a change in the instrument causing a 1 % change in the budget balance relative to GDP. The effect is the first year effect, and the policy change is assumed to be permanent. This may in particular lower the effect of a VAT change compared to a credible temporary change.

Source: Calculated on the basis of multipliers reported in Grinderslev and Smith (2007)

Effectiveness in terms of achieving the largest employment effect for a given change in public finances points to the use of expenditure instruments. However, the ease by which the instruments can be changed tends to be inversely related to the size of the multipliers. A change in the VAT or the income tax system can relatively quickly be implemented, and although there are administrative aspects, it is mainly a question of changing parameters in given systems. Public investments in general have very long planning lags, and only if a stock of already approved projects exists (shovel ready), is it possible to have an effect with a reasonable short lag. If so, public investments fulfil both the criteria of being temporary and effective with short notice. It exploits existing capacity in eg the building and construction sector, and thereby public activities are placed in time where their opportunity costs are lowest. Public consumption and

employment are somewhat trickier. Core basic public sector activities (administration, legal system etc.) and welfare services (care, health, and education) are not ideal for temporary variations. A question is whether there is capacity to absorb more staff in the short run (existence of work-places etc.), and it may moreover be politically difficult to implement a temporary hike without creating anticipations of new higher service levels. A particular problem may arise if municipalities or regions operate under balanced budget requirements since this may enforce pro-cyclical policies. If so, there is a need to resurrect this situation.

The effect of various fiscal policy instruments is generally shock dependent. Therefore one can not critically rely on historical assessments of fiscal policy, and there is reason to ask whether the present situation makes fiscal policy more or less effective²¹. At a general level, it may be argued that the severeness of the crisis makes the usual crowding-out mechanisms weak. In the short term, an expansionary fiscal policy is not likely to induce interest rate increases via an increase in inflation. Actually, if deflation is a risk, an expansionary fiscal policy may prevent that monetary policy effectively becomes contractionary. The effect on wage formation is not to induce higher wage growth, but rather to counteract wage (growth) moderation due to higher unemployment. Since wage formation is downward rigid, this effect may be small. Hence, basing discussions of fiscal policies on “normal” measures of fiscal multipliers may lead to an underestimation of their effects in the current business cycle situation.

There are specific arguments why tax instruments may be either more or less effective in the present situation²². The transmission mechanism of a tax reduction runs via disposable income to private consumption. If households are very pessimistic and perceive an increasing risk concerning future economic possibilities, they may want to expand their savings, and therefore tax increases end up supporting savings rather than consumption. Though, the policy is not in vain since it implies that households sooner reach their savings target²³, and therefore it aids in supporting demand at a

²¹ However, large policy changes call into question whether available empirical evidence (econometric and model based) is a reliable guide since the maintained assumption for such analyses is that the policy changes are small.

²² In the US, there has been much debate about the effects of the tax reduction in 2001. Macroevidence does not point to an effect (see eg Taylor (2009) but microevidence does (see e.g. Johnson et al (2006))

²³ This may be interpreted as “buffer stock” saving behaviour, cf Carroll (2001) in the sense that agents will target a given level of “cash-on-hand” (relative to permanent income) given by financial wealth

later date (but still an imprecise instrument). To this it may be argued that it is a question of targeting the tax decrease. By targeting towards liquidity constrained consumers (and the crisis may have increased the fraction of liquidity constrained households), the expansionary effect is larger since these groups have a marginal propensity to consume of one. It has been argued that such a targeting can be achieved by increasing unemployment benefits since they mainly go to liquidity constrained households. However, this demand effect has to be weighted against the possible supply side effect arising via a change in the incentive structure (see section 3).

A reduction of consumption taxes (eg temporary reduction of VAT) does not to the same extent suffer from an uncertain transmission mechanism since it is targeted at consumption. However, the problem with this instrument is that it needs to be well timed relative to the duration of the crisis. This instrument works by inducing consumers to shift demand forward in time. The flip-side of this is that consumption will fall when the tax is re-set at its pre-crisis level. When the duration of the crisis is uncertain, it is difficult to time this instrument and it may destabilize the situation. Moreover, the possibility of inducing intertemporal substitution relates only to non-liquidity constrained households. Since the fraction of liquidity constrained households has increased due to the crisis, this works to make this instrument less effective.

Included in tax instruments are also social security reductions to boost labour demand. The design of such schemes raises a standard problem of targeting to minimize the deadweight losses. Such targeting is difficult since it is very hard to tie subsidies to new job-creation or to jobs at a marginal risk of destruction.²⁴ While this instrument may be an effective instrument if it can be targeted to a specific sector, this is in practice difficult or may violate free trade arrangements.

For the reasons noted above, both measures directed towards private and public demand suffer from problems in relation to timing and effect lags. Pragmatically, it may thus be argued that a fiscal stimulus package should include a portfolio of

and current income. If “cash-on-hand” is below target, agents will try to rebuild the stock, and if it is above, it can be depleted.

²⁴ The empirical evidence in general supports that wage subsidies boost employment of the affected groups, see eg Kluve (2006)). Only few studies consider the substitution effects, but a recent analysis on Finnish data shows that firms who hire subsidized labour experience a real increase in total employment, and firms in the same industry do not seem to be disadvantaged (Kangasharju (2007)).

instruments. This is also the case for most of the fiscal stimulus packages undertaken due to the financial crisis. Table 1 gives a brief overview of fiscal stimulus packages for some key countries.

5.2. Labour market policies

Discussions of stabilization policy tend to focus on aggregate demand management, but there is reason also to consider labour market policies in general and active labour market policies in particular. Down-turns tend to produce persistent reductions in employment rates. Figure 6 illustrates this by considering the path for the overall employment rates²⁵ during crisis years in the 1980s for the four large Nordic countries. It is seen that the recovery of the employment rate has been very sluggish. Time spans of 10 years or more elapsed for the employment rate to return to its previous peak level²⁶. Since public finances are very sensitive to the employment rate (see eg Finanspolitiska Rådet (2008)), the pattern depicted is a key reason for significant and persistent public deficit problems²⁷. Hence, persistence is important both for the social consequences and for their fiscal implications²⁸.

²⁵ Note this measure is better than unemployment since the latter may be affected by schemes allowing unemployed to opt out of the labour force.

²⁶ If marginalization problems are not solved, the effects become persistent due to the overlapping generations mechanism arising since these cohorts will have to reach normal retirement age and new cohorts will have to enter the labour market for the average employment rate to resume its “normal” level.

²⁷ Van den Noord et al (2006) argue that countries with more generous social safety nets tend to display more persistent responses to adverse shocks.

²⁸ Ljungqvist and Sargent (1995) argue that a system relying on active labour market policies may display multiple equilibria, a low unemployment equilibrium with effective active labour market policy and small expenditures on the policy, and a high unemployment equilibrium where policy becomes less effective but more expensive. The Nordic experience seems to indicate that there is very strong persistence, but also that policies have been adapted to prevent high and persistent non-employment.

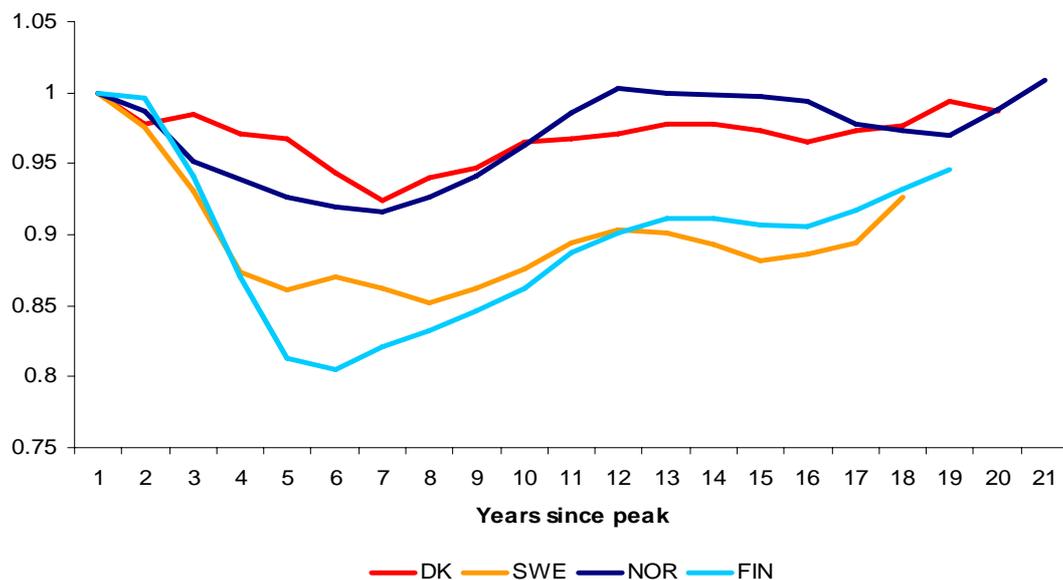
Table 1: Fiscal stimulus packages for 2009-10

	Budget Effect (% of GDP)	Measures	Share of package	Remarks
USA	5.5 %	Tax relief State and local relief Health care, energy and education	40 % : public consumption 40% taxes, transfers 15 % : infrastructure	
UK	1.1 %	Temporary lower VAT reduction from 17.5 % to 15 % Public investment project brought forward in time	30 % : public investments 70 % : taxes	Some transfers and basic allowances have also been changed The temporary nature of the measures is stressed: future tax and social security increases have been announced
Germany	3.2 %	Tax and social security contribution reductions Labour market policy (job rotation, training) Infrastructure	Taxes: 60 % Expenditures: 20% Infrastructure: 20 %	Proposes limits for public borrowing to safeguard long-run fiscal sustainability
France	1.3 %	Public expenditures/infrastructure Tax cuts for firms Support to sectors particularly affected by the crisis Employment measures and support to small firms	45 % public expenditures/investments 40 % tax rebates 8 % sector support Other:8%	
Sweden	2.4 %	Income tax and social security contribution reductions Subsidies for house repairs/rebuilding Strengthening active labour market policies	60 % = tax 40 % = public consumption	Expansionary policy was planned in budget before financial crisis was fully perceived, additional measures (mostly labour market policies) some of which have supply-side effects

Note: The table includes measures planned/approved before February 2009. For Sweden, the numbers include both already planned expansionary measures in the budget for 2009 and specific additional discretionary measures taken subsequently.

Source: USA: American Recovery and Reinvestment Act. UK: Pre-Budget report 2008, US: Germany: Bundesregierung: Emerging from the crisis ready for the next upswing, 13/1-09, France: Mission Plan de Relance de l'économie, December 2008, Sweden: Regeringens proposition, Åtgärder för job och omställning, 2008/09:97

Figure 5: Previous crises in Nordic countries – persistent reductions in employment rates



Note: The figure shows the employment rate in subsequent years relative to its peak level in the 1980s. The peak year is 1988 for Denmark, 1990 for Sweden, 1987 Norway and 1989 Finland. The employment rate is for the age group 15-64.

Source: Computations based on data from www.source.oecd.org

Labour market policies are intertwined in fiscal policy. This is obvious for measures aiming at job creation like lower social security contributions or public employment programmes. But equally important are other elements of active labour market policies since they are of importance in maintaining a high employment rate to ensure the financial viability of a large public sector. Increasing unemployment leads to increasing expenditures on active labour market policies at the same time as there is a risk that these policies become less effective.

Recessions are generally associated with increasing inflows into unemployment as well as decreasing outflows from unemployment, i.e. longer unemployment spells (long-term unemployment), see eg Elsby et al (2008). This causes inflows into labour market programmes to increase, but the composition of the unemployed also changes also since more core workers experience unemployment. The latter seems a particular relevant aspect in the current crisis since unemployment is rising for groups with long work experience and labour market relevant qualifications. In recent years, labour market policies in Denmark and Sweden have to an increasing degree been focussing

on long-term unemployed and marginalized. While this is both important and natural in a situation where unemployment has been falling, the present situation calls for a reconsideration of active labour market policies.

The issue is how to adopt active labour market policies to these changes. Intensive and costly programmes early in unemployment spells may have large deadweight losses since most of the newly unemployed have a strong work record, and thus labour market relevant qualifications. However, it is important to prevent an inflow into long-term unemployment. This calls for measures to allow unemployed to maintain contact with the labour market, including both incentives for temporary jobs and job rotation as well as short-term activation programmes intended to keep the participants in close contact with the labour market. To prevent inflow into long-term unemployment, there is a need to focus on significant programme activities after some duration of an unemployment spell (say 9-12 months).

Educational and re-training programmes are often highlighted as being a remedy during a downturn. The basic argument is that the opportunity costs of programme participation are lower, and that the potential detrimental effects on job-search (the locking-in effect) are smaller in a downturn. However, such programmes also have their pitfalls. They are generally rather costly and they may be difficult to target. The targeting problem is two-sided since it requires programmes targeted to individuals with specific qualification barriers to employment, and that the content/type is directed towards areas where there will be demand for labour in the future. Evaluation studies of re-training programmes are not very positive, which stresses the problems of designing effective retraining programmes (see eg Kluve (2007)). For Sweden, this issue is particularly important. The empirical findings indicate that educational programmes have been more effective in the 1980s with low unemployment than in the 1990s with high unemployment (Calmfors et al (2004)). More recent studies for 2002-04 with low unemployment find more positive effects (see de Luna et al (2008)). This may be explained by better empirical identification of the effects and better targeting of policy. Moreover, this may suggest that these policies have been less effective during high unemployment periods, perhaps because they mainly have had a passive orientation. One lesson from this is that it is important to maintain an active focus on job prospects and job search in labour market policies.

One important lesson from earlier crisis is that measures making it easier for unemployed to opt out of the labour force (eg earlier retirement) are very costly since they cause a persistent decline in employment. Moreover, even though high unemployment rates tend to create pessimism wrt job creation, experience has repeatedly proven this pessimism wrong (see figure 6).

6. Conflict between short-term and medium-term objectives

– fiscal sustainability

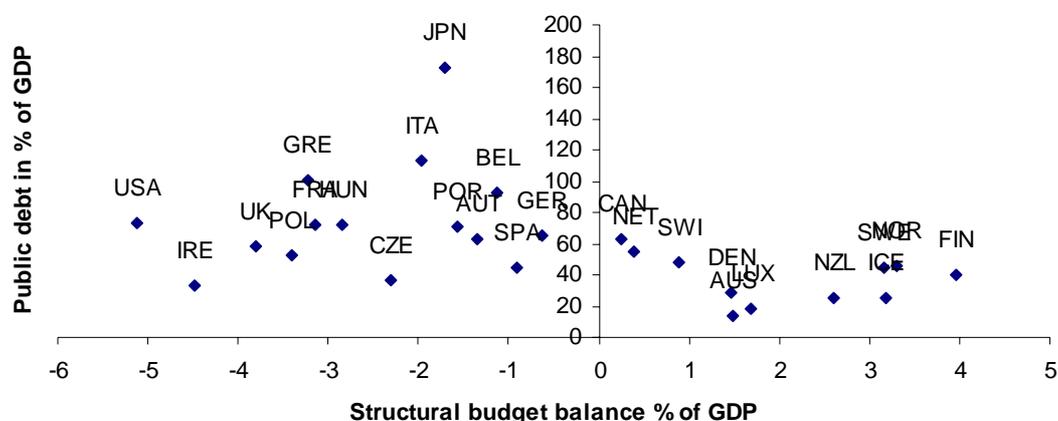
Another important lesson from the past is that short-run policies can have large long-run costs. After the prolonged downturn in the 1970s and 1980s, many countries faced public debt problems, and consolidation has since been pursued although with varying success. In addition, approaching demographic changes will strain public finances, and therefore the issue of fiscal sustainability is at the fore in fiscal policy discussions.

The focus on fiscal sustainability is explicitly reflected in the set-up of fiscal policy frameworks in a number of countries. While the specific formulation and institutional design of such frameworks differ, the main motivation has been to ensure that short-run policy decisions are made without jeopardizing medium- to long-run objectives. The present crisis challenges these developments both because it is likely to produce systematic budget deficits and thus accumulating debt levels, and because it raises questions on how to reformulate targets in fiscal policy frameworks so as to set public finances back on track.

6.1. Public debt - a constraint on fiscal stabilization policy?

It is notable that that medium-/long-run aspects are much more in focus in fiscal policy discussions now than in the past. To take two prominent examples, both the G20 statement in November 2008 and the EU statement on a *European Economic Recovery Plan* stress that fiscal stimulus packages should be designed taking into account the current situation of public finances and the fiscal sustainability aspects.

Figure 8: Budget balance and debt level for OECD countries



Note: Gross financial liabilities and structural budget balances as a share of GDP

Source: OECD

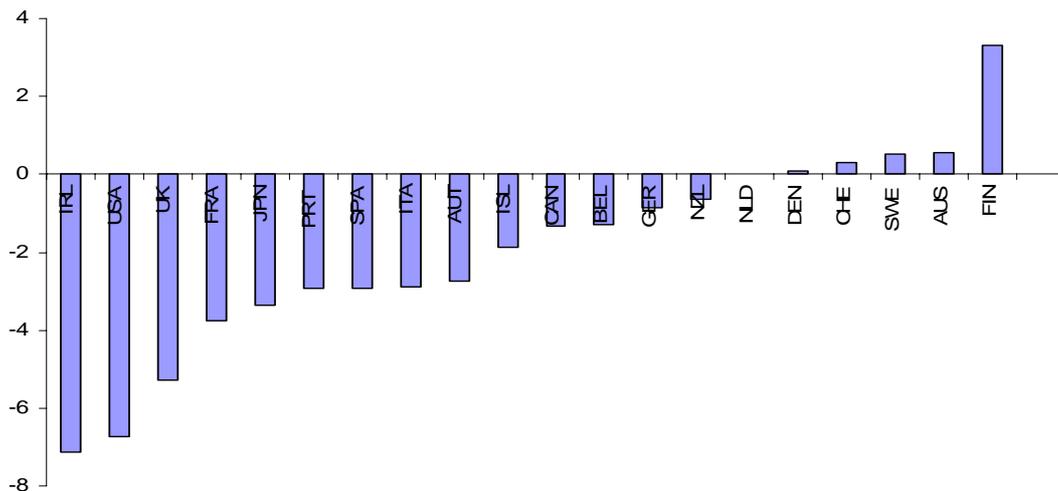
The importance of the public finance constraint for an active stabilization policy depends both on the initial situation and how public finances are affected by the crisis. The first issue can be assessed from figure 8 showing the current structural budget balance²⁹ and debt position for OECD countries. It is seen that already at the outset a significant number of countries have a structural public finance problem; that is, structural budget deficits and high debt levels. A deep and long recession will cause budget deteriorations adding to the debt problems, and combined with debt servicing this will increase debt levels. The budget effects of the crisis can be read of figure 9 showing the projected budget balance for 2009 for some selected countries according to OECD forecasts. For the whole OECD area, the average budget deficit in 2009 is projected to be -3.8 % of GDP, and for the euro-area -2.2% of GDP. It is seen from the figure that some countries face severe public finance problems, including Ireland, US, UK, France, and Japan. Hence, the crisis causes most countries to be on trajectories in the north-west direction in figure 8. This leaves one clear implication, namely that the current crisis will bring the problem of high public debt levels back at the policy scene. Only few countries have pursued a sufficiently strong consolidation policy to be in the low risk zone. Interestingly, both Denmark and Sweden are found

²⁹ Revisions of structural budget balances are to be expected both because some extraordinary income streams in the past may have been taken to be permanent and because structural unemployment rates are likely to be revised upwards.

here. Ireland is an example of failure to ensure sufficient consolidation and have recently taken resort to reductions in public spending despite a very deep crisis³⁰.

A particular problem which makes it difficult to assess public debt levels in the current situation is liabilities implied by various arrangements to provide loans and capital to private companies (primarily in the financial sector).

Figure 9: Projected budget balance for 2009, selected countries



Source: OECD Economic Outlook 84.

Public debt problems may contribute to higher interest rates. While government bonds currently are perceived as being low risk assets and therefore highly priced relative to private sector bonds, this situation may change alongside normalisation in financial markets and increasing debt levels. Some indication of this is already visible when considering interest rates on government bonds. There is wide dispersion in government bond rates, and for some countries (eg Greece, Spain and Italy) mounting public finance problems are already reflected in large interest rate premiums.

6.2. Adapting fiscal policy frameworks

Fiscal policy frameworks aim at ensuring that short-run policy decisions are consistent with medium- to long-run objectives. While the specific form differs, the core elements are intermediary targets (structural budget balance, debt levels etc.) set

³⁰The GNP growth rate for 2008 was -2.8 %, and for 2009 it is expected to be -4.5 %. Unemployment is projected to approach 10 % (Department of Finance Ireland (2009)). This development shows up in large budget deficits (2008: 6 ¼ % of GDP; 2009: 10 1/2 % of GDP), and even though public debt in 2007 only constituted 25 % of GDP, it is expected to reach 62 % in 2010. In the autumn, Ireland did launch a crisis package mainly containing tax reductions.

in accordance with long-term objectives, and with some room for variation in the short run to cope with business cycle fluctuations. The latter is often formulated in the sense that there is some requirement to balance the budget “on average over the business cycle”³¹. This reflects first and foremost that budget balances are very cyclically sensitive, and therefore variations due to the cycle are to be expected, but they pose no problem if the “average criterion” is met. Implicitly, this view takes business cycle fluctuations to be relatively short-lived and symmetric. However, the latter assumption may be called in question for the financial crisis. The crisis is likely to be deep and prolonged, and it is difficult to maintain that it is probable that an opposite strong and prolonged upturn can be expected in the near future such that the “average” criterion can be met.

Implemented fiscal policy frameworks are not designed to cope with large shocks. One problem is that they usually have not formulated “escape clauses” indicating when a situation is to be considered special and therefore justifies discretionary fiscal policy initiatives (see discussion in Swedish Fiscal Policy Council (2008)). Another problem is that large persistent shocks make it impossible to meet intermediary targets in the framework, and therefore necessitate that targets have to be reset. There is thus an eminent risk that some or all of the credibility gained by formulating fiscal policy frameworks is lost.

The tension between the current situation and the fiscal policy frameworks is exemplified by the UK, which has explicitly announced that the crisis implies that the fiscal framework is temporarily dispensed. In the words of the Chancellor of the exchequer:

...to apply these rules rigidly in today’s changed conditions would be perverse
(Darling (2008), p 1)

However, at the same time it is stipulated that dispensing the rules has a future consequence in getting back on track

³¹ This has been the explicit formulation in eg the Swedish Policy Framework.

...the government is setting a temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full (UK 2008 pre-budget report, p 13).

This statement recognizes the costs of violating budget rules irrespective of the fact that a strict adherence would imply pro-cyclical policies which are hardly recommendable. At the same time, it is clear that the plan to bring the framework back on track is quite loosely formulated and open for interpretation and manipulation. The same may be said in relation the Stability and Growth Pact where it has been stressed that despite the crisis:

The Stability and Growth Pact will therefore be applied judiciously ensuring credible medium-term fiscal policy strategies (EU Commission (2008, p 10)).

Significant deteriorations of public finances in member states among which some already at the outset have difficulties with the fiscal norms make it unclear precisely how and whether the pact will be adhered to.

The UK case underlines the fragility of fiscal policy frameworks if they have not been properly specified or adhered to. The UK fiscal framework has been based on an upper target for public net debt (should not exceed 40 % of GDP). However, the actual debt levels have been very close to this upper bound. Hence, already prior to the crisis it was obvious that even a relatively modest change in the business cycle situation could lead to a violation of the target.

Such ad-hoc definitions or introductions of escape clauses to the fiscal policy framework may be seen as a deficiency of the framework in the sense of not creating enough room for counter-cyclical fiscal policy. However, more pragmatically it may be argued that it is impossible to make a complete blueprint of all possible contingencies relevant for fiscal policy, and therefore some ad-hoc approach is inevitable.

Even for Sweden, the issue of adaptation of the fiscal policy framework may arise. At the outset, the fiscal position is well within the targets set in the fiscal policy framework. However, a sequence of bad years can easily bring the seven year moving average indicator below the 1 % target, and the estimates of the structural budget balance may also be significantly revised both in light of an increase in unemployment as well as a reassessment of certain revenue sources.

Reformulating new intermediary targets is difficult as long as the depth and duration of the crisis are unknown. New targets will have to take into account the significant deterioration in public finances during the crisis. Since the crisis has been unanticipated, both tax smoothing and intergenerational risk sharing arguments can be given why the consequences should be smoothed across time and thus generations. One clear implication is that the need for reforms to ensure fiscal sustainability will be even more urgent in most countries.

7. Policy coordination

Designing fiscal policy raises coordination issues in relation to both the interaction between fiscal and monetary policy, and the international coordination of policy initiatives.

7.1. Monetary and fiscal policy

The mainstream view on stabilization policy stresses that monetary policy is in a leadership role, leaving fiscal policy to passively follow automatic stabilizers in normal times. In this way, coordination problems between monetary and fiscal policy are minimized. A prompt discretionary fiscal policy change to the crisis raises the question whether there are coordination problems with monetary policy, and whether an inadequate policy mix may arise.

However, these problems seem small in the initial phase of the crisis. The policy objective is reasonably clear and does not seem to involve traditional dilemmas between inflation and output. The crisis creates a need for policies to boost activity, and inflation is not a likely problem in the foreseeable future. As noted above, the interest rate spill-over from fiscal policy is weak in the current situation, and this reduces coordination problems.

A particular issue within the euro-area is the tensions or problems which can arise since the common monetary policy may not be equally well aligned to the business cycle situation in the separate euro-countries. However, in the current situation the need for a monetary policy ease is shared by all, and this tension is not present. However, the euro-countries may recover at different paces and face different structural problems (including public finance positions), and tensions may therefore develop within the euro-area in the future.

7.2. International coordination

Since the crisis is global and since its effects are propagated globally, it is natural to call for coordinated policy actions. This is even more relevant now because increasing trade shares have weakened the effectiveness of national fiscal policies directed at aggregate demand since the demand leakage is larger and due to structural reallocations (see discussion above). Calls for coordinated fiscal policy initiatives are numerous including statements from the G20 in November 2008 and the EU recovery plan:

.....the influence of intelligent coordination adds up to a potent force to arrest the trend towards a deeper recession. A Europe ready to take swift, bold, ambitious and well-targeted action will be a Europe able to put the brakes on the downturn and begin to turn the tide. We sink or swim together (preface by J. Barroso to European Economic Recovery Plan, European Commission 2008).

The calls for coordinated initiatives reflect both that the crisis is global and a concern that national planning of fiscal stabilization policy will create an undersupply of initiatives because non-cooperative national policy making will not take into account the effects on trading partners. Demand leakages may curtail the incentive to pursue expansionary policies since the beneficial effect in terms of improved export possibilities for trading partners is not valued in the political decision process³².

³² Barel et al(2009) show that fiscal policy is significantly more effective in the coordinated than in the non-coordinated case.

However, one can not necessarily conclude from this that there is a stabilization “deficit”. Governments acting non-cooperatively may change the composition of fiscal policy packages to achieve the largest impact effect on domestic demand and production (see discussion section 4 and 5). There are various ways of accomplishing this. At one end of the spectrum are preferential treatments of domestic firms, support conditional on use of domestic firms/products etc. as has been discussed recently in some countries, and which effectively is protectionism violating free trade. At the other end is a change in the composition of fiscal packages targeting public demand rather private demand. Public demand does to a larger extent target non-tradeable sectors (therefore the demand leakage is lower) and thereby this policy has a twist effect between domestic and foreign activities. It is a well-established and robust result³³ that this twist mechanism causes governments to overestimate the potential gains from such policies in the non-cooperative case since they perceive one of the benefits of this policy to be an improvement of the terms of trade. Consequently, there may be an upward bias in non-cooperative policies. In the present situation, the implication is that non-cooperative policy making twists fiscal policy too much towards public rather than private demand.

The scope for a coordinated effort is complicated by large cross-country variations both in the need (see figure 1) and the room for an expansionary fiscal policy which does not jeopardize medium-term objectives (see figure 8). Hence, the heterogeneity in the position on the need and scope for fiscal stimulus makes the likelihood of a larger coordinated fiscal stimulus rather bleak. The recovery plan from the EU is also an example of the tension involved since it stresses the need for coordinated actions and recognizes the difference in the initial position of the member countries, and it stresses the rules of the Stability and Growth pact. Fiscal policy initiatives will remain driven by national priorities, and despite the strong theoretical arguments that can be made in the present situation, it remains that the possibility of enacting a large coordinated fiscal stimulus remains very bleak.

8. Concluding remarks

³³ It holds under various market forms, with or without full employment, and in models with both an exogenous and endogenous trade structure, see eg Andersen and Sørensen (2008) for references and analysis of this mechanism.

The economic consequences of the financial crisis include a sharp fall in aggregate demand. It is therefore natural to discuss the scope for an aggregate demand management policy. Since monetary policy cannot be expected to provide sufficient stimulus, attention has turned towards fiscal policy instruments. Globalization has both been a factor in causing and propagating the crisis, but it is also a factor which may make fiscal policy less effective. Most important is the weakening of fiscal multipliers due to the demand leakages created by trade, and the specialization of production of labour which makes structural (re)adjustments more difficult and costly.

Fiscal policy instruments will be effective towards aggregate demand in current circumstances both because traditional crowding out mechanisms will be weak due to large excess capacity created by the sharp decrease in demand, and because problems in the financial market create liquidity constraints. However, important timing problems remain. This applies both in terms of the effects policy may have on expectations formation, and more generally in adapting policies to the nature of the shocks. The crisis necessitates structural adjustments, and fiscal policy has to take this into account.

A primary policy aim is to prevent long-term unemployment by ensuring that unemployed do not get marginalized and lose contact with the labour market. The specific measures needed to ensure this may include: i) targeted job market training and education programmes, ii) measures promoting job rotation and work sharing since empirical evidence shows that private job/job training is the most effective, and iii) stronger incentives to accept short-term positions by eg shortening the employment criterion to regain entitlement to unemployment benefits after an unemployment spell.

The crisis puts public finances under strain and comes on top of unsolved problems with fiscal sustainability in most countries. Steeply increasing public debt levels will arise in a number of countries. A huge question is how to reset fiscal policy targets post to the crisis to ensure that fiscal policy becomes sustainable.

There is substantial heterogeneity across countries with respect to both the initial position (business cycle, public finances) and the effect of the crisis (shocks, duration). Therefore, there are huge differences in both the need and scope for fiscal

policy activism. Hence, even though globalization may point to larger gains from policy coordination, it is unlikely that the conditions needed for a coordinated effort are in place. It is unrealistic to expect anything but “speeches”. The driver remains national interests, and the positions of various countries simply differ too much to make it likely that a reasonable common policy approach can be agreed upon.

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