Economic resilience: The role of fiscal policy

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On top of the ST Keynesian effect, fiscal policy has long-term effects

- Short-term: trade-off between reducing recession risk and reducing public debt risk.
- Long-term: spending mix/government effectiveness has an effect on potential output.
- Decreasing marginal return to public investment.

In practice, fiscal policy is poorly used during crisis

- Quality of public finance tends to go down during the GFC: makes shock losses more persistent.
- Deterioration of the spending mix during recessions, especially large ones.

Fiscal initiative to exit the low-growth trap

- Low interest rates provide a window of opportunity.
- ½ percentage point of GDP fiscal initiative.
  - More productive spending funded with deficits for three to four years on average.
  - Re-prioritising spending in later years.
- GDP gains help preserving long-term fiscal sustainability.
On top of the ST Keynesian effect, fiscal policy has long-term effects
The trade-off between counter-cyclical policy and hitting the debt target

- Strict primary balance rule: target is constant
- Rule allowing automatic stabilisers to operate

Note: The long-term recession risk is the probability of GDP per capita growth to become negative. The uncertainty surrounding the debt trajectory is assessed by the interquartile range of the debt level in 2040.
Key issue: Raising long-term growth while addressing inequality

Empirical setup:

- **Potential growth**: Neoclassical convergence model
- **Inequality**: Estimation of the impact of the mix of spending along the distribution of household income
- The overall effect of public finance on the distribution of disposable income is the sum of the direct effect on disposable income and the indirect growth effect.

Illustrative long-term growth effects of an increase in the education level

Note: In countries where the mean PISA score or average years of schooling are below the average level of countries in the top half of the sample, educational attainment is assumed to gradually converge to this level. The figure reports the effect after 45 years of a reform phased in over 45 years.

The effect of public investment on potential GDP decreases with the level of capital stock

The analysis suggests that all OECD countries, except Japan, have room for additional public investment.

Note: Public investment is scaled by underlying primary public spending. The dashed line indicates the 95% confidence interval. Light shading indicates a positive not significant investment effect and darker shading indicates a negative not significant investment effect.

The adverse effect of government size on potential GDP decreases with government effectiveness.

Note: The dashed lines indicate the 95% confidence interval. Light shading indicates a negative not significant size effect and darker shading indicates a positive not significant size effect.

# Impact of different instruments on growth and equity

<table>
<thead>
<tr>
<th>Policy</th>
<th>Growth</th>
<th>Equity</th>
<th>Income of the poor</th>
<th>Countries with the most room for growth gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decreasing the size of government</td>
<td></td>
<td></td>
<td></td>
<td>BEL, CZE, FRA, GRC, HUN, ITA, POL, PRT, SVN</td>
</tr>
<tr>
<td>Low to moderate government effectiveness</td>
<td>+</td>
<td>-</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>High government effectiveness</td>
<td>n.s.</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Increasing government effectiveness</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>FRA, GRC, HUN, ITA, SVN</td>
</tr>
<tr>
<td>Increasing education outcomes</td>
<td>+</td>
<td>0/+</td>
<td>+</td>
<td>CHL, GRC, MEX, PRT, TUR</td>
</tr>
<tr>
<td>Increasing public investment (including R&amp;D)</td>
<td>+</td>
<td>n.s.</td>
<td>+</td>
<td>BEL, DEU, GBR, IRL, ISR, ITA, MEX, TUR</td>
</tr>
<tr>
<td>Pension reform</td>
<td>+</td>
<td>n.s.</td>
<td>+</td>
<td>AUT, DEU, FIN, FRA, GRC, ITA, JPN, POL, PRT, SVN</td>
</tr>
<tr>
<td>Increasing family benefits</td>
<td>n.s.</td>
<td>+</td>
<td>+</td>
<td>CHE, ESP, GRC, PRT</td>
</tr>
<tr>
<td>Decreasing public subsidies</td>
<td>+</td>
<td>-</td>
<td>n.s.</td>
<td>BEL, CHE</td>
</tr>
</tbody>
</table>

Note: + stands for a positively significant, – for a negatively significant and n.s. for non-significant effect.

In practice, fiscal policy has been poorly used during crisis
An indicator of the quality of public finance

- Each characteristic is multiplied with an estimated coefficient from growth and inequality equations.
- Both a growth and an income distribution component.
Global Financial Crisis: quality of public spending has deteriorated in most countries

Productive spending drops more during deep crises

Note: The link between cyclical shocks and the growth component of the spending mix is measured by the correlation between the country-specific change in the output gap estimated by the OECD and the change in the indicator component over time. The size and persistence of crises is measured by the standard deviation of the country-specific output gap.
Fiscal initiative to exit the low-growth trap
Low interest rates provide fiscal space

Contributions to changes in fiscal space between 2014 and 2016

% of GDP

-50 -25 0 25 50 75 100

FIN HUN KOR ISR FRA POL USA CZE GBR ITA AUS CAN NZL AUT DNK NLD DEU NOR SWE BEL

Contribution of potential growth
Contribution of real interest rate
Contribution of gross debt

Source: OECD calculations based on Fournier and Fall (2015) and OECD Economic Outlook database.
What is a fiscal initiative?

Using fiscal space: Types of fiscal initiatives

• Increase soft or hard infrastructure
• Increase spending on education/childcare
• Lower harmful taxes

Budget neutral reforms

• Change the tax and spending mix to make it more supportive of growth and inclusiveness

Scenarios: ½ percent of GDP fiscal initiative

• Individually, or as collective action
• With structural reforms to reduce long-term unemployment
• Combination with green growth strategy
Growth-enhancing fiscal stimulus can repay itself

- Debt-financed public investment has two long-term effects on the debt-to-GDP ratio:
  - Increase in the debt level as the government borrows
  - Increase in the denominator as potential GDP is boosted
- The simulation assumes public investment is effective.

Multi-year scope for fiscal initiative

Number of years during which a fiscal initiative can be financed through temporary deficits

Note: It is assumed that the fiscal initiative consists of an 0.5% of GDP increase in public investment.
Source: OECD calculations based on Mourougane et al. (2016).


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Additional slides
Illustrative long-term GDP gains from decreasing pension spending

Note: In countries where spending to the potential GDP ratio on pensions is above the average level of countries in the bottom half of the sample, spending will gradually decline to this level. The figure reports the simulated effect after 45 years of a reform phased in over 10 years.

Illustrative long-term GDP gains from decreasing public subsidies

Note: In countries where subsidies to potential GDP are above the average ratio of that of countries in the bottom half of the sample, subsidies will gradually decline to this ratio. The figure reports the simulated effect after 45 years of a reform phased in over 10 years.

Illustrative gains from raising family and child benefits on disposable income

Note: In countries where family benefits to potential GDP is below the average ratio of that of countries in the top half of the sample, family benefits will gradually converge to this average ratio. The figure reports the simulated effect after 45 years of a reform phased in over 10 years.