Press points for Chapter 5: ***Fiscal Policy as a Countercyclical Tool***

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Key points

- **Empirical work in this chapter finds that discretionary fiscal policy can have effects on economic activity, but these are typically modest and can even go in the wrong direction. In practice, it has proven difficult to ensure that reactions are timely, well targeted and temporary. Concerns about debt sustainability may play a key role in limiting the effectiveness of fiscal stimulus packages, especially in emerging economies. To create room for successful fiscal stimulus, governments need to improve fiscal positions during good times, which has proved challenging.**

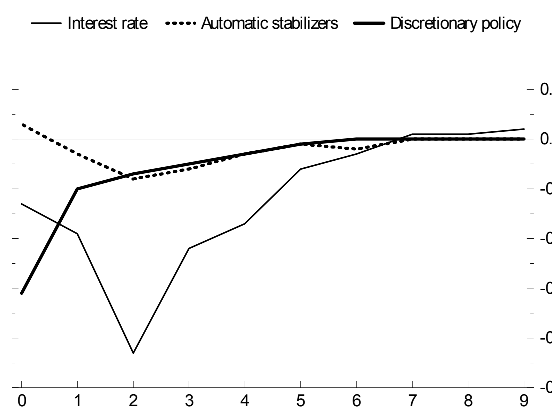
- **The countercyclical effects of fiscal policy could be raised by enhancing the scope of automatic stabilizers or strengthening fiscal governance, to reduce the "debt bias" problem.**

The chapter investigates the role of fiscal policy in combating business cycle fluctuations, asking whether discretionary fiscal policy can successfully stimulate output, or whether it does more harm than good.

It finds that discretionary fiscal policy has been used less frequently than monetary policy during downturns, and has taken longer to arrive ─ often after it is needed. Moreover, discretionary policy typically shows an easing bias—there is more stimulus during downturns than tightening during upturns—which means that public debt typically creeps upward.

How Strong Was the Fiscal Policy Response in G7 Economies?
(Percentage point deviation; quarters on x-axis; shock occurs in period zero; sample over 1992:Q1–2007:Q4)

After a fall in demand, monetary policy reacts by cutting interest rates immediately, with the policy response strongest after two quarters. The response of automatic stabilizers is an immediate fall in fiscal balances. The initial discretionary response of fiscal balances is close to zero, and remains small compared with automatic stabilizers.



Source: IMF staff calculations.

By contrast, automatic stabilizers respond symmetrically. In advanced economies, discretionary fiscal policy has typically been countercyclical, but in emerging economies, it has been *procyclical*—stimulus has been added during good times and removed during downturns.

The chapter also finds that discretionary fiscal policy can have moderately countercyclical effects—but there are important caveats. New evidence presented in the chapter shows important differences between advanced and emerging economies. On average, a 1 percentage discretionary stimulus package is associated with GDP increases of about 0.1 to 0.2 percent on impact. But whereas the longer-term effects are also positive and even possibly higher in advanced economies, the effects turn negative in emerging economies. Debt sustainability concerns may play a key role—domestic households and firms may anticipate higher taxes or inflation in the future, and international capital markets may impose higher interest rates to insure against these risks.

For discretionary fiscal policy to be successful, governments need to ensure that they improve fiscal positions during good times and credibly commit that stimulus packages are temporary. The composition of stimulus also matters: revenue-based policy changes appear to be more successful at stimulating growth than expenditure-based changes, possibly reflecting that spending increases are difficult to reverse.

Fiscal policy could be made a more effective counter-cyclical tool by enhancing the scope and effectiveness of automatic stabilizers or strengthening fiscal governance. One possibility for governments would be to increase the response of automatic stabilizers, say by linking tax, transfer or spending programs to the state of the economy. The advantage of boosting automatic stabilizers is that work symmetrically over the business cycle, hence avoiding debt bias, can have immediate effects during downturns, and are less subject to political bias. Another possibility is to bolster the credibility of discretionary measures, to reduce debt bias, by strengthening fiscal governance, such as by increased emphasis on transparent evaluations of the state of the economy and longer-term implications of fiscal measures.