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Fiscal Policy in the Aftermath of the Financial Crisis

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The financial crisis that erupted in 2007 triggered the deepest global recession since the 1930s. In many advanced economies, governments attempted to counter the recession by sizable fiscal stimulus measure. Those measures, and the fall in tax revenues due to the recession, frequently lead to sharp increases in public debt that threaten fiscal sustainability. A key fiscal policy challenge for major advanced economies will be to reduce public deficits and debt over the coming years, without harming real activity. This special issue of the Journal of Economic Dynamics and Control consists of six papers that offer novel empirical and theoretical perspectives on fiscal policy since the outbreak of the financial crisis. All papers were presented at a conference held at the European Commission in Brussels on March 2-3, 2012.

The first two papers provide empirical evidence on the effects of Euro Area fiscal stimulus during the crisis, based on estimated New Keynesian models with a detailed fiscal sector. The paper by Coenen, Straub and Trabandt, focuses on the European Economic Recovery Plan (EERP) of 2009-2010. Based on a set-up that allows for complementarities between private and government consumption, and between private and public capital, the authors argue that the EERP had a sizable, but short-lived, positive impact on Euro Area GDP.

Kollmann, Ratto, Roeger and in’t Veld point out that massive government support for banks

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was a key dimension of Euro Area fiscal policy during the crisis—that dimension has so far received little attention in the macro literature. Using a model with a banking sector, the authors argue that support for banks had a stabilizing effect on Euro Area real activity. Support for banks raised private sector investment, while higher government purchases crowded out investment.

The next two papers study fiscal consolidation strategies. Using calibrated simulation models of the US economy, Cogan, Taylor, Wieland and Wolters propose a consolidation plan that would raise output, in the short- and long-run. Its key ingredient is a substantial reduction in government transfers that is used to fund a reduction in labor taxes and in public debt. Erceg and Lindé study fiscal consolidations in a currency union. The loss of monetary policy autonomy in a currency union affects the efficacy of fiscal policy. Using a two-country simulation model, the authors show that a tax-based fiscal consolidation has a smaller adverse output effect than a spending-based consolidation; a consolidation that combines a sharp but temporary rise in taxes with gradual spending cuts is shown to be most desirable.

The role of the exchange rate regime for fiscal policy is also studied in the paper by Born, Juessen and Müller. Using time series models, the authors show that, empirically, government spending multipliers are larger under fixed exchange rates than under exchange rate floats, which is consistent with traditional Mundell-Fleming theory. However, there is little empirical evidence for the specific transmission channels of fiscal spending highlighted by the Mundell-Fleming model. By contrast, a modern New Keynesian model can account for the empirical transmission channels.

The financial crisis has led to frequent calls for the taxation of financial transactions. In the final paper of the special issue, Lendvai, Raciborski and Vogel, analyze the
macroeconomic effects of an equity transaction tax, using a general equilibrium model. The authors argue that, in the long run, such a tax is as distortive as a corporate income tax. The transaction tax lowers financial market volatility, but its effect on the volatility of real activity is limited.