Report, MS#1230

“Systematic .fiscal policy and macroeconomic performance: A critical overview of the literature”, by Claire Reicher

The paper offers a literature review on the fast growing branch of issues related to systematic fiscal policy over the business cycle. I like the paper as the topic is highly relevant. Nevertheless, in my view parts of the paper need to be rewritten.

Main Comments

1. The way households form their consumption is key to understand the effectiveness of fiscal policy to stimulate output. Keynes (1936) forwarded the idea that households condition their current consumption on current income. As it is well known, this makes fiscal policy highly effective. Recently this idea has been revitalized under the header “financial frictions”. Financial frictions are key to understand the effectiveness of fiscal policy, may it be systematic or discretionary policy. In my view the review offered by the author is much too narrow in the coverage of this aspect of recent literature. There are at least three established ways to introduce financial frictions that are relevant for fiscal policy. The first is Rule-of-thumb consumers. This aspect is somewhat covered in the paper. The second aspect are collateral-constraint consumers which is not sufficiently covered and the third aspect is limited asset-market participation by liquidity-constraint consumers that exhaust their precautionary savings. Let me say some words on each of the frictions. Rule-of-thumb consumer’s directly follow the old Keynesian idea that consumption depends on current income. This may be for two reasons. First, people are not so sophisticated to form optimal intertemporal consumption plans. Second, people do not have sufficient access to financial markets. Note that many colleagues in the macroeconomic profession dislike the idea that economic agents do not optimize. So in my view, the review offers a far too sympathetic perception of the Rule-of-thumb hypothesis. A more sophisticated way to model excess dependency on current income is to model collateral constraint consumers, which makes the friction endogenous to the model. In so far, as fiscal policy affects the business cycle and thus collateral values fiscal authorities will boost/ depress the consumption behavior of collateral constraint households. A third sophisticated approach to model endogenous constraints is precautionary savings. If agents are credit constraint public debt offers a stock of financial assets that agents can use to save in. As shown in Challe and Ragot (2011) this also enhances the effectiveness of fiscal policy. In a nutshell, the author

should give a broader overview on financial frictions and their relevance for the transmission of fiscal policy.

2. I would like to have some more information on the interaction of government size and macroeconomic stability. I do not find, in my view, sufficient coverage on the interaction of systematic institutional feature such as progressive tax systems, degree of redistribution in the society and macroeconomic stability.
3. In my view, it would be nice for the reader if the author would collect results and provide some tables with key facts. For instance, it may be an idea to provide a table that collects estimates on the sensitivity of revenues to the cycle, inside and outside the US.
4. I understand that the paper is focused on systematic fiscal policy. But by that strategy many highly relevant topics are not covered. In particular, the author does not systematically review issues of fiscal consolidation in the euro area and the effects on the business cycle. Additionally issues like the effectiveness of fiscal policy may it be systematic or unsystematic in the zero lower bound of nominal interest rates is not covered sufficiently. Also issues of fiscal austerity and the question if fiscal austerity may be expansionary if credibility is regained on financial markets is not covered. The author may rethink if these issues can be covered in an additional section.

Literature (only those not cited…)

Challe, Edouard and Xavier Ragot, 2011. "Fiscal Policy in a Tractable Liquidity-Constrained Economy," Economic Journal, Royal Economic Society, vol. 121(551), pages 273-317, March.

Keynes, John Maynard. 1936. General Theory of Employment, Interest and Money. Cambridge University Press.