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The importance of composition of fiscal policy: evidence from different exchange rate regimes

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Abstract

We study the macroeconomic effects of fiscal policies in an open economy. We emphasize two transmission mechanisms: the cost channel, by which wage government spending and labor taxes raise the real wage firms must pay, and the exchange rate channel, by which the nominal exchange rate shifts induced by fiscal policy have real effects if (some) prices and wages are sticky. The latter channel implies that changes in wage government spending or in labor taxation should have different effects under flexible than under fixed exchange rates. In a 1964–93 panel of OECD countries we find significant evidence for both channels. Moreover, we find that the real product wage and profitability are more responsive than quantities (employment and output) to fiscal policy innovations.
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Keywords: Fiscal policy; Transmission mechanisms; Open economy

1. Introduction

In this paper we study the short-run macroeconomic effects of shifts in fiscal policy in an open economy. We are especially interested in two questions. One is the importance of the composition of a given movement in fiscal policy. The other is whether the exchange rate regime makes a difference in the transmission of fiscal policy.

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Research on recent fiscal consolidations in the OECD has highlighted the importance of composition in the success and persistence of fiscal reforms. As argued by Giavazzi and Pagano (1990) and formalized by Bertola and Drazen (1993), the consolidations in Denmark and Ireland in the mid-1980s were associated with a macroeconomic boom, rather than a recession, because they were mainly based on expenditure cuts rather than tax increases. Alesina and Perotti (1995, 1997a) and Alesina and Ardagna (1998) show that, controlling for the size of the budget deficit reduction, those adjustments that were implemented by cutting government transfers and public wages have been much more persistent than those achieved by increasing taxes.

One reason the composition of a fiscal reform may be important is that it matters for the macroeconomic effects of a shift in fiscal policy. We start from the simple observation that, to different degrees, all industrialized countries are open economies: therefore, an understanding of how fiscal policy affects the tradable (here, manufacturing) sector is crucial for an understanding of the overall macroeconomic effects of fiscal policy. We consider four key indicators of the performance of the tradable sector: employment, output, the real product wage, and profitability.

Our focus on these variables is motivated by the observation that the labor market is a key channel by which fiscal policy movements affect the non-government sectors of the economy. Even if the tradable sector does not rely on the domestic economy as a source of final demand, it must compete with the non-traded sector (including the government sector) for non-traded factors such as labor. For instance, an increase in government employment or wages shifts out the aggregate demand for labor and causes upward pressure on economy-wide wages. Similarly, the workings of the labor market determine the extent to which increases in labor taxes are shifted onto firms in the form of higher pre-tax wages. In turn, higher labor costs induce firms to scale back the levels of employment and output and depress profitability. This *cost channel* is a primary mechanism by which fiscal policy affects the performance even of sectors that sell exclusively to foreign customers and hence are insulated from the level of aggregate demand in the domestic economy.

In the presence of sticky prices or wages, fiscal policy affects macroeconomic performance via a second channel, the *exchange rate channel*. For instance, an increase in government spending that generates nominal appreciation hurts the profitability of firms in the traded sector if they face exogenous foreign currency prices and domestic nominal wages are not fully flexible. We investigate this issue formally by conditioning responses to fiscal policy shifts on the exchange rate regime in place in each country in each time period.[1]

[1]At the level of casual empiricism, many economists and policy-makers have argued that devaluation was an essential ingredient in the success of the 1987 Irish fiscal consolidation (see e.g. Alogoskoufis, 1992, for an exposition of this view). Similarly, it is widely believed that the 1992 devaluations in the UK and Italy had a large positive impact on the international competitiveness of firms in those countries (see e.g. European Commission, 1994).

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