Empirical studies of fiscal policy and unemployment

Comments on two reports to the Fiscal Policy Council by U. Michael Bergman

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Effects of fiscal policy

- Old-style Keynesian models:
  - Higher T means lower GDP through disposable income and aggregate demand
  - Lower G means lower GDP through aggregate demand
- General equlibrium and New-Keynesian models:
  - Higher T means lower GDP through supply
  - Lower G may lead to higher GDP through lower T (EFC)
- Which effects are ″normal″?
- Policy recommendations to Greece and others are (implicitly) based on GE and NK models

In order to understand the effects of fiscal policy…

… one has to:

- Distinguish between the effects of T and G
- Distinguish between permanent and temporary effects of T and G
- Impose restrictions ensuring that T and G move together in the long run

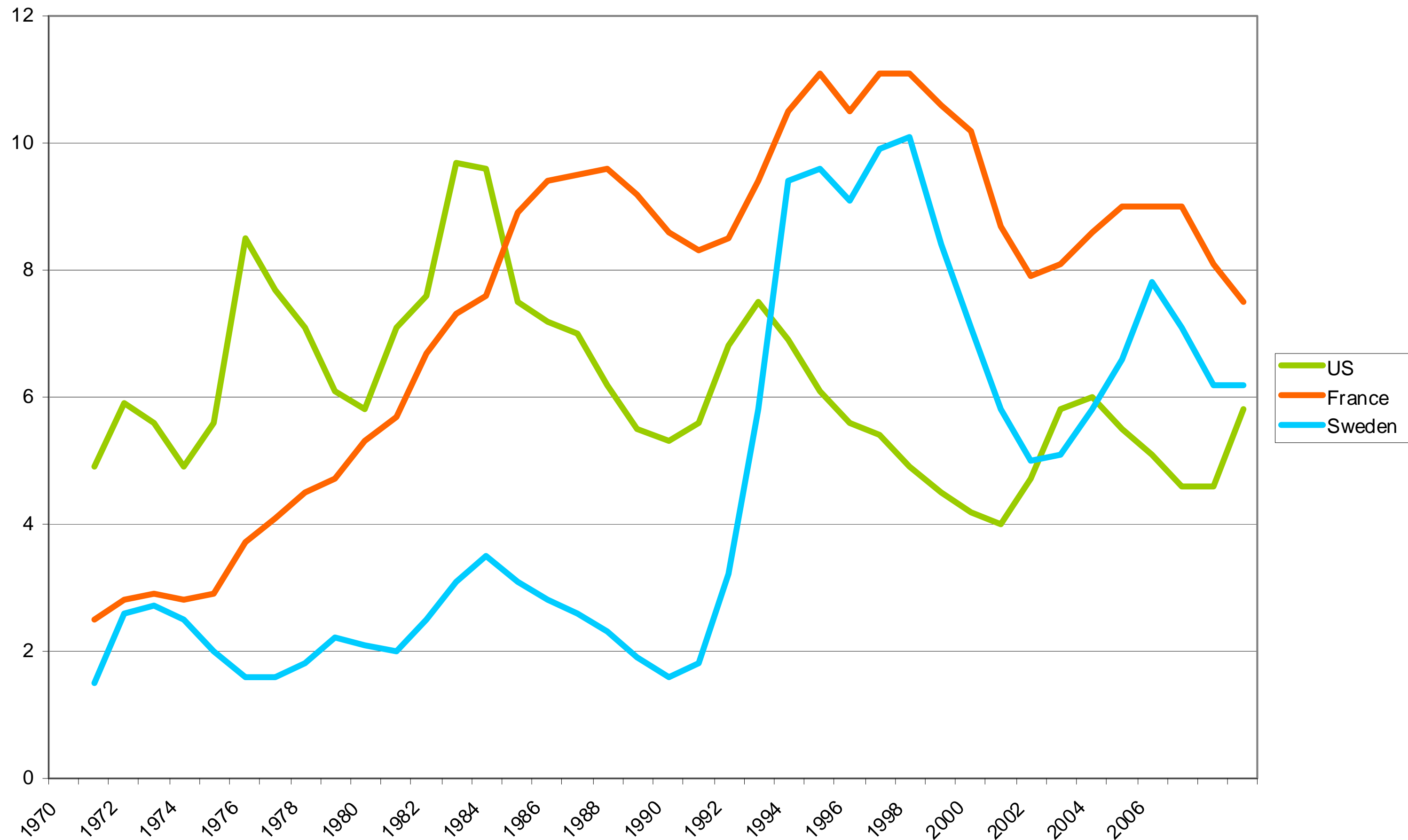
Bergman's conclusions

- The changes in fiscal policy 1994 – 1997 had the usual Keynesian effects
- There is no empirical evidence for ″reversed″ effects (EFC)

Properties of Bergman's model

- The regime change 1994 – 1997 is assumed to be only temporary (dummy variable)
- All other, "normal", shocks are assumed to be permanent
- A T-shock raises T and G *and* T-G in the long run
- A G-shock lowers G and T *and* T-G in the long run
- T-shocks have large effects, G-shocks small
- No other shocks are identified (economically interpreted)

”Unemployment will adjust back to its initial level. This adjustment however is very slow”



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Source: US Bureau of Labor Statistics

But what determines the ”initial” level?

- A constant trend?
- Persistent changes in policy or behavior?
- Other permanent shocks? (T and G shocks, for example, as in Bergman′s model of fiscal policy)

Properties of Bergman's unemployment model

- Includes no other variables than unemployment
- Different kinds of U-shocks are not identified
- Persistence a result of regime changes
- Transition probabilities are fixed
- One regime dominating until 1990, two others after 1990

Alternative approach

- One regime, but more variables and shocks (like Bergman's model of fiscal policy)
- Allow some shocks to have permanent effects on U, others temporary
- Jacobson, Vredin, Warne (1997):
  - The only common source of hysteresis in the Scandinavian labor markets is shocks to wage setting
  - Transitory labor demand shocks do not seem to be empirically important