Economic Stimulus Plans against the Crisis
Off to the Road-worthiness Test

The financial and economic crisis has led to massive fiscal interventions worldwide. Economic stimulus plans are intended to bolster macroeconomic demand and thereby cushion a collapse in production. In this way employment is to be stabilized and unemployment avoided. Economic stimulus plans have been applied in Germany as well. What can they achieve and what effects on the labour market are to be expected? A test report.

The Federal Government reacted to the worldwide financial crisis in November 2008 by issuing a first economic stimulus package (see Box "Economic stimulus packages in detail" on page 91). According to the joint economic forecast of the leading German economic research institutes it covers a fiscal stimulus of almost 12 billion euro in total for the years 2009 and 2010. Economic stimulus package II followed in January 2009. The institutes estimated its stimulus to be roughly 47 billion euros for the years 2009 and 2010. Further quantitatively important impulses are to be expected from the reintroduction of the commuting allowance and from the changes in tax allowances for expenses of a provident nature. Both measures are consequences of verdicts of the Federal Constitutional Court and would have been implemented in any case even if the economic crisis had not taken place. Finally so-called "automatic stabilizers" increase macroeconomic demand. The term "automatic stabilizers" applies to taxes and transfers dependent upon the economic situation which lessen the effects of economic shocks on domestic demand without any further political decisions being necessary. This causes the current deficits of the Federal State itself and the individual Federal States to rise because, for instance, revenues from income tax fall and expenditures for unemployment support rise. The Organisation for Economic Cooperation and Development (OECD) estimates the total volume of fiscal expansion in Germany in the years 2009 and 2010 to be roughly 7.5 per cent of the gross domestic product.

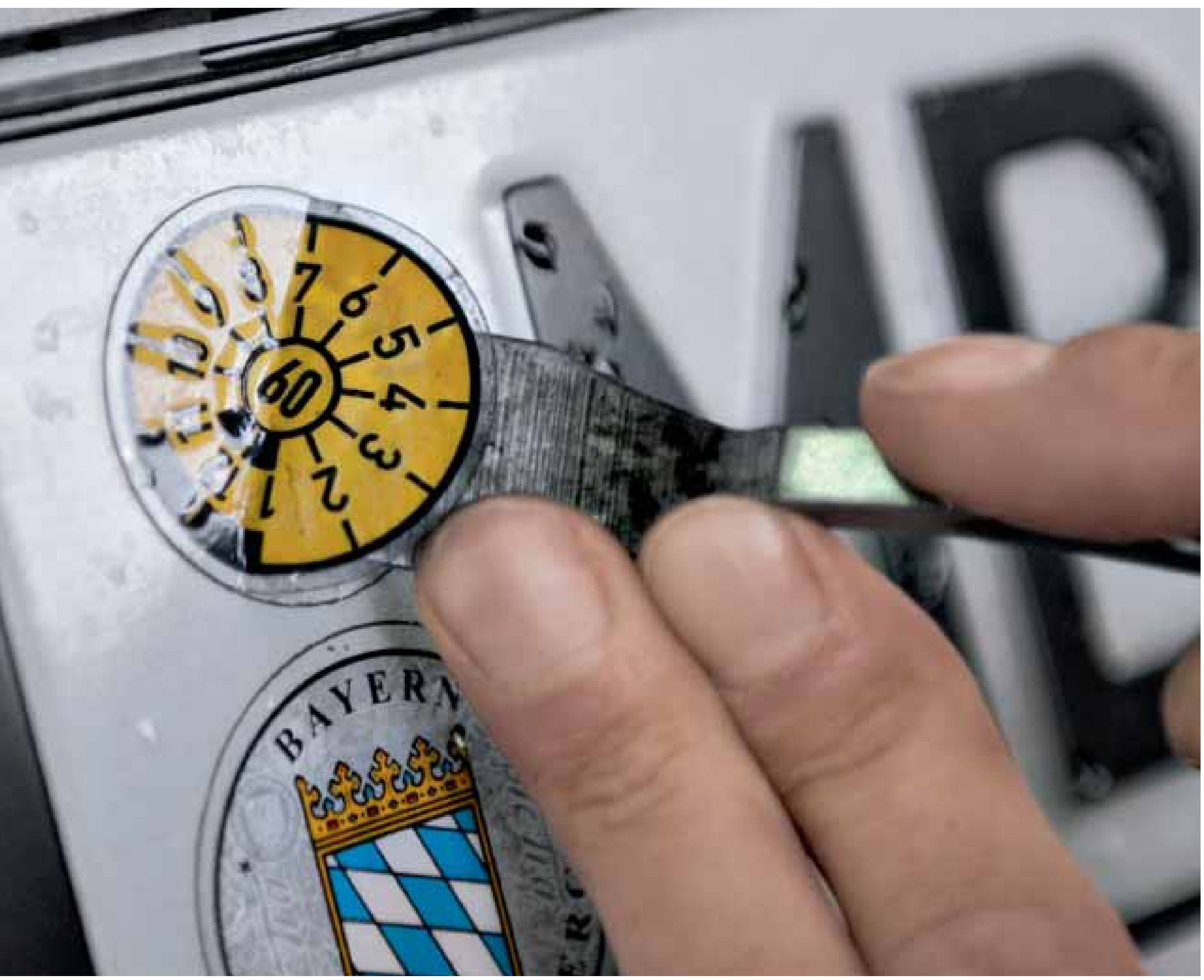
Although the German Council of Economic Experts predicted in its report of November 2008 that there would be a comparatively favourable economic development in 2009, it recommended, under the term "a business-

cycle-conformable growth policy" an expansion of public investments in general as well as special higher expenditures for education and support in early childhood. According to the German Council of Economic Experts, the funds necessary for this were to be provided by additional public borrowing. Such a credit-financed economic stimulus plan received further support in autumn of 2009 from a row of well-known economists as well as the Academic Advisory Council of the Federal Ministry of Finance.

Fiscal policy and its effectiveness

Can fiscal policy stimulate macroeconomic demand? Macroeconomic research sees the possibilities of such stabilization more critically today than in the 1970s. Having said that, current empirical research assumes that additional expenditures on the part of the state or reductions in unemployment contributions will trigger additional demand in the short term. As a rule, however, expansive fiscal policy is faced with massive problems of implementation. A quick implementation of expenditures programmes is especially difficult in practice.

If most economists were against economic stimulus plans in the past, this was also because they could not see any serious problems in demand. In the wake of the strongest post-war collapse in demand however, the discipline is today in general united in believing that economic stimulus programmes are right in this situation. Apart from fiscal policy, monetary policy can also be used to stimulate demand. At the moment however a further loosening of monetary policy is ruled out as no more leeway exists where a further lowering of interest rates are concerned. Moreover it is likely that consumers and companies are so uncertain about the further economic development that the effect of monetary policy



measures is slight whereas fiscal policy measures can directly stimulate demand.

In order to assess economic stimulus plans correctly, one has to differentiate between whether the impulse has been triggered by credit-financed tax cuts and where by credit-financed state expenditure. Tax cuts are usually attributed with having a smaller effect, as private households tend to save a portion of the additional money and thus stifle some of the fiscal stimulus. In contrast, additional expenditures by the state are in total effective where demand is concerned. On the other hand, tax cuts are the quicker form of expansive fiscal policy as public expenditures as a rule require a relatively long run-up time. A further advantage of tax cuts is that they lead to additional demand that is more broadly spread, while additional public spending is almost always concentrated on a few branches, above all the construction industry. Because of this, the danger of overheating and price increases becomes greater, and this weakens the economic development in the short to mid-term.

Under certain circumstances, economic stimulus plans can repress private demand, but they can also stimulate additional private demand and thus multiply the fiscal stimulus. The discussion among economists on the effect of stimulus plans thus revolves around the so-called fiscal multiplicators. If the multiplicator lies above the number one, the fiscal impulse triggers additional private spending. Correspondingly, multiplicators below one signalise that private spending is being crowded out. A wide spectrum of figures can be found in the empirical literature on fiscal multiplicators. However most economists are of the opinion that the multiplicators are more likely to be small: the government spending multiplicators are around 1.2 at best; the effects of lowered tax revenue lie clearly below 1.

Fiscal policy on the test stand

Economic stimulus plans can only be effective if one first removes the cause of the collapse in demand – in this case, if one puts the financial sector in order again. That is a lesson that can be learned from the financial crises in Japan and South Korea. South Korea reacted quickly after the financial crisis of 1998; 5 out of 33 banks were shut. The other banks were given support by means of government guarantees or by the buying up bad credits. In this way the financial sector was stabilized. In comparison, fiscal policy measures aimed at raising demand were of a relatively small dimension but had a large effect. By contrast, the Japanese government at that time approached the stabilization of the financial sector in a slower, less energetic way, although it applied a considerably larger economic stimulus plan, but this was not able to lead the Japanese economy out of the crisis.

Further experiences with fiscal policy in financial crises have been gathered in the past. The International Monetary Fund has summarized these in a new report and this may be used to evaluate the German stimulus packages. According to this study, economic stimulus plans in financial crises should have the following characteristics: they should be timely, large and lasting, diversified, coordinated, and sustainable.

- Timely, because the collapse in demand itself comes very quickly; hence quick stimulation is also necessary. To this extent, the timing of the German economic stimulus plan is problematical: the economic collapse was particularly strong at the turn of the year, while many of the measures will only have an effect in the course of this year and next.
- Large and sufficiently lasting, because the collapse in demand during the current crisis is also strong and ongoing. Relative to the drop in gross domestic product expected in 2009, both economic stimulus packages appear small. But, in the face of the implementation problems linked to additional public spending, the packages can still be seen as sensibly dimensioned. On account of German‘s relatively large amount of public debt, a larger scale might even have been contraproductive.
- Diversified, because there is great uncertainty as to which measures have a strong and which a less strong

effect. A bundle of measures that is applied to several adjusting screws therefore has greater chances of success. From this perspective, the compilation of a German economic stimulus package consisting of a great variety of elements is of an advantage.

- Coordinated with other countries, because a part of the stimulus for demand leaks abroad. As the current crisis is affecting the whole world, most industrial countries have issued stimulus plans. In part, the effects of leaking abroad are therefore likely to be compensated for mutually.
- Sustainable from a politico-financial perspective, because the signal is to be sent to the financial markets that despite additional accumulation of debt a solid financial policy should be adhered to in the mid-term. Hence the combination of an economic stimulus plan with a debt brake anchored in the Basic Law of the German Constitution that is effective in the mid-term is very much to be welcomed.

Effects on gross domestic product

The effects that the economic stimulus packages will unfurl on the gross domestic product in Germany have been estimated by the Halle Institute of Economic Research Halle (IWH) and the Rhine-Westphalian Institute (Rheinisch-Westfälische Institut, RWI) by way of simulation calculations. The calculations of the institutes differ as regards the level of the total stimulus as well as its distribution over time. Nonetheless, both studies reach similar conclusions: for 2009, the IWH reckons with an additional growth in gross domestic product of 0.6 percentage points; the RWI of 0.5 percentage points. The cumulative additional growth in 2009 and 2010 is expected to amount to 0.9 (IWH) and 0.8 percentage points (RWI).

The simulation studies confirm the unfavourable timing of the economic stimulus packages mentioned above. With these planned measures, roughly 40 per cent of the stimulus will be effective in this year, 60 per cent in 2010. Where infrastructural measures are concerned,

Economic stimulus packages in detail

The German Government reacted to the outbreak of the economic crisis in Autumn 2008 with two packages of measures: Economic Stimulus Package I in November 2008 and Economic Stimulus Package II in January 2009. It was intended that these packages support the macroeconomic demand for goods and services – and thus safeguard jobs – through higher government spending and the raising of private net incomes. In all, the economic stimulus packages consist of a variety of individual measures (see Table).

In the field of economics, economic stimulus packages are termed discretional fiscal policy. It is a reaction to an economic downturn that is not induced by existing rules and regulations, but by deliberate government action. Through the forgoing of simultaneous cuts in public expenditures or the raising of revenues, the state budget deficit rises. This is the reason why one also speaks here of "expansive fiscal policy".

Tabelle

Economic Stimulus Packages I and II

Data in billion euros

	2009	2010
Public expenditures		
Increase in investment in transport	1	1
Increase of KfW programmes	0.3	0.5
Publically funded "future investments"	3	12
Subsidization of mobility research	0.7	0.7
Raising of the standard benefit rate for children under Book II of the Social Code	0.2	0.3
Car scrappage premium	5	
Changes in short-time working allowances and additional placement staff at the Federal Employment Agency	2.9	3.2
Deficiency in tax revenues		
Improved amortisation conditions, suspension and new regulation of vehicle tax	2.7	5.9
Cuts in income tax, and child bonuses	4.9	5.6
Reduction in the rate of contributions to statutory health insurance	3	6
Total burden on public budgets	23.7	35.2

Source: Joint economic forecast of the leading German economic research institutes, Spring report 2009 ©IAB even a ratio of 25 per cent in 2009 to 75 per cent in 2010 is to be expected. The unfavourable timing is above all a result of the fact that it took time to implement the measures.

Additional state spending on education, transport, communal infrastructure and research will tendentially improve the mid-term chances of growth. Their contribution to compensating short-term drop in demand is relatively small. Adding to the time-delay is the absence of precise targeting: public spending will mainly lead to additional demand in branches that have been less affected by the economic crisis. Especially strongly affected branches – export-orientated companies from the manufacturing industry – will on the other hand hardly be reached.

Despite these limitations, the "investments in the future" that have been announced could make an important contribution to stabilizing demand. In a situation, in which private demanders delay decisions on consumption and investments because of uncertainty, it is possible that signals will be emitted from public spending announcements that create confidence in future economic development.

An economic stimulus plan in Germany of a similar size to that in the USA – the economic stimulus packages would have had to be roughly double as big – could have contributed to less of a fall in gross domestic product. But this would also have been linked to high risks. The degree of openness of the German economy would have made an "American-type" fiscal policy more difficult because with Germany a greater proportion of stimulus trickles away abroad. A more expansive policy would at the same time raise doubts about the mid-term consolidation course.

Effects on employment

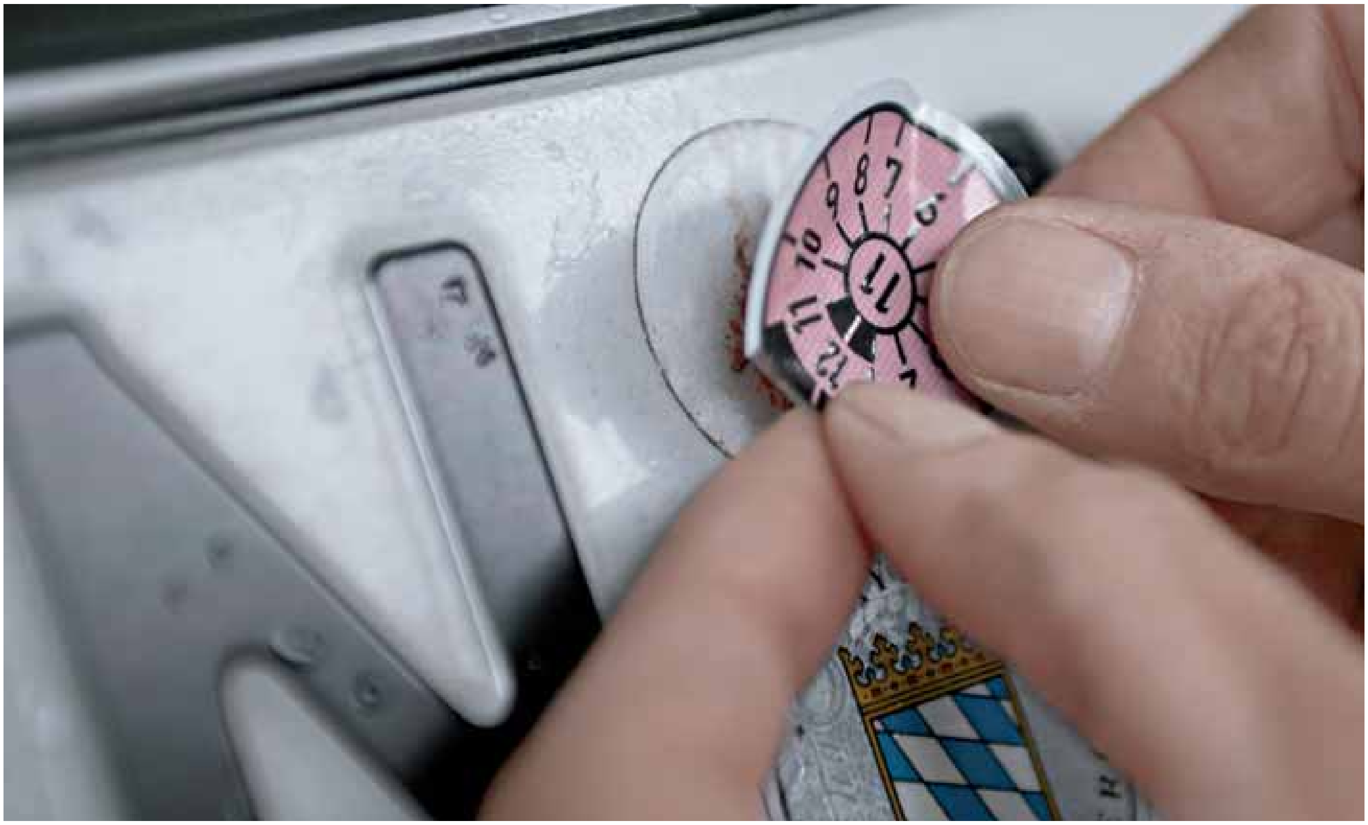
The effects on employment of the economic stimulus packages have been estimated to be relatively optimistic in the simulation calculations of RWI and IWH. Firstly, in both models employment appears to react strongly to changes in gross domestic product. For instance, in the RWI model the difference in growth of 0.8 percentage points in 2010 means that 260,000 less jobs will be lost. This so-called employment sensitivity is more than double as high as in the usual estimates and even exceeds the estimated figure for the USA. Secondly, productivity – measured in output per worker - is only increasing marginally. In view of working time accounts that have been driven down to nil or have even entered the minus area and strongly widespread short-time work, that seems unlikely.

The reason why we see the labour market effects of the simulation calculations as too optimistic can be explained with the help of a supposed employment sensitivity of growth which underlie recent IAB's forecasts: if there is additional growth in the gross domestic product via the economic stimulus package of about 0.5 percentage points in the current year, then the effect of additionally roughly 75,000 employees is to be expected. As, in contrast to 2009, the hourly output from work will rise in 2010, in the coming year an even smaller effect on employment from fiscal policy-induced growth is to be expected. According to the RWI, the induced growth in gross domestic product in 2010 will amount to 0.3 percent and will contribute, in our estimations, to bringing about the existence of 30,000 additional jobs. The employment effect of the cumulated growth impulses up to the year 2010 would thus amount to circa 105,000 jobs.

Conclusions

In the short term, the most important political instrument for the labour market is the short-time working allowance, the extension of which is part of the economic stimulus plan. Along with the direct effect that establishments retain their employees longer, the short-time working allowance also has a significant indirect impact: it stabilizes macroeconomic demand by unburdening companies that have become "numb" and lessens the fear experienced by consumers in the face of unemployment. At the same time, however, short-time work that has been made necessary by the economic situation conceals the danger of merely postponing unavoidable structural changes.

The impact of fiscal policy impulses on the labour market is thus limited. If the labour market manages to survive the crash with only a few bumps and cracks, this



will probably be due above all to the heavy use of short-time work. Along with flexibilization measures at the level of the establishment, taking recourse to short-time work enables a company to retain its labour force in employment for a further limited period of time. What must also not be forgotten is that the labour market is now better equipped to deal with the crisis than in earlier times because of the Hartz reforms.

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