The Effects of Fiscal Policy on Employment: an Analysis of the Aggregate Evidence

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Abstract

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This study extends the literature on hysteresis followed from Blanchard and Summers (1986) seminal paper, investigating whether also a demand shock – that in this study is a change in fiscal policy – is able to affect the employment equilibrium level, triggering hysteresis independently form the GDP behavior. To this end, it presents new empirical evidence on how fiscal policy affect the labor market in the long-term.

The presence of hysteresis has remarkable consequences on the economy behavior, amplifying and prolonging the effects of recessions. The presence of hysteresis can keep the productive capacity of the economy persistently low. Consequently, the economy may converge to the steady state levels of output and employment in the very long-run, while in the medium term, those levels are substantially lower than without hysteresis: crises effects are larger and longer in presence of hysteresis.

Furthermore, if the employment behavior is affected by hysteresis, the analyses on its cyclical component suffer of estimation concerns, determining unreliable results. As a matter of facts, when a fraction of the cyclical employment becomes structural, the impact of fiscal shocks on labor market is underestimated considering only the unemployment cyclical component. Therefore, taking into account the equilibrium level of employment, researchers can better evaluate the persistency of the fiscal policy effects.

Following Guajardo, Leigh, and Pescatori (2014), this study employs a SVAR to estimate the relation between fiscal policy and employment trend. In the presented model, the possible information shortage to identify a true unexpected fiscal shock (Lutkephol 2012) is overcame employing information from a recent dataset of exogenous fiscal shock from the IMF (Devries et al. 2011) based on the narrative approach, which covers the period 1980-2010 for 17 OECD countries. The dataset retains the changes in tax level and public expenditure from fiscal consolidation, which are independent to current economic development.

My results suggest that a fiscal shock can modify the employment equilibrium level even without influencing potential output. Various extensions are presented, considering the effects of composition, monetary policy, and state-dependency. I found that spending cuts affect employment more than tax increases, while tax effects are larger on real per capita GDP. Such a result may be explained by different reactions of monetary policy respect spending cuts and tax growths. My evidence suggests that the multiplier is state-dependent, i.e. larger during recessions, and such effect is stronger on employment trend.

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