Can Fiscal Budget-Balanced Reforms Stimulate Growth? Model Based Evidence

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Abstract

The paper focuses on growth enhancing budget-neutral fiscal reforms, i.e. changes in the composition of government revenues and spending that stimulate GDP growth while keeping the ratio of the fiscal budget to GDP balanced. To this aim, we present simulation results using a three-country DSGE model with three large economic regions, the US, the euro area and the rest of the world. The model features a detailed government sector and its multi-country nature allows investigating cross-country spillovers. The paper focuses on the most growth-friendly budget-neutral fiscal measures: (i) a fiscal devaluation (ii) a rise in government investment compensated by a fall in government consumption and (iii) a rise in government investment compensated by a rise in consumption taxes, labor taxes and lump-sum taxes. Dampening or amplifying effects due to coordination across policy (monetary and fiscal) and across economic regions are also considered. The main result is that an increase in government investment financed by rising less distortionary taxes appears to be an optimal growth-friendly budget neutral reform in the sense that it generates GDP growth and improves fiscal sustainability. In addition, we find that budget-neutral reforms, even if coordinated across countries, do not have large cross-border spillovers.

Keywords: theory