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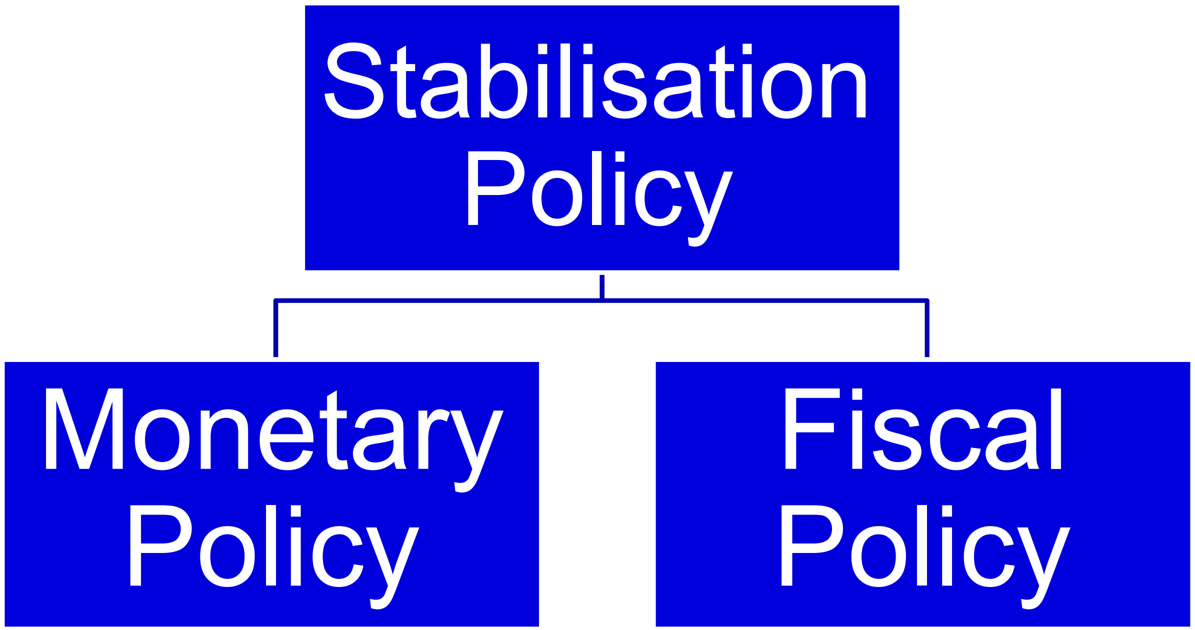
Fiscal Policy

III.

Stabilisation Policy

– Aim: to maintain a healthy level of economic growth and minimal price changes; to **smooth** the **economic cycle**



Three key facts about economic fluctuations

- Fact 1: Economic fluctuations are irregular and unpredictable

- Fact 2: Most macroeconomic quantities fluctuate together
  - e.g., investment, unemployment, consumption

- Fact 3: As output falls, unemployment rises

Fiscal policy - concepts and measurements

Fiscal policy (FP) = set of decisions and rules regarding taxes and public expenditures for purposes of smoothing the fluctuations of economic cycle in order to keep unemployment close to its equilibrium value and avoid the build-up of deflationary and inflationary pressures (Samuelson, 1948)

Theoretically inspired by J.M. Keynes.

In the end of 20th century theoretical and empirical doubts surfaced about the effectiveness of FP.

Now in many countries the key point of FP is public debt sustainability.

Keynesian view: AS – AD model

- A macroeconomic model that explains price level and output through the relationship between AD and AS

- Aggregate demand (AD)
  = Total amount of demand for goods and services produced in the economy
  - Combinations of price level and level of output (GDP)
  - AD slopes downward:
    a) The Wealth Effect (when prices fall, consumers are wealthier which encourages to spend more)

    b) The Interest-Rate Effect (lower price level reduces the interest rate which encourages greater spending on investment goods)

    c) The Exchange-Rate Effect (lower interest-rate depreciate the real exchange rate which stimulates exports)

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Keynesian view: AS – AD model

– Long-run aggregate supply (LRAS) - Determines the quantity of goods and services supplied in the long run. In the long run it depends on labour, capital, natural resources and technology.

– Short-run aggregate supply (SRAS) = A combination of price level and level of goods and services supplied in the short run.

  – SRAS slopes upward:
    a) The Sticky-Wage Theory (nominal wages are slow to adjust, or are „rigid“ in the short run).
    b) The Sticky-Price Theory (prices of some goods and services are slow to adjust in the short run).
    c) The Misperceptions Theory (lower price level causes misperceptions about relative prices; these misperceptions induce suppliers to respond to the lower price level by decreasing the quantity of goods and services supplied).

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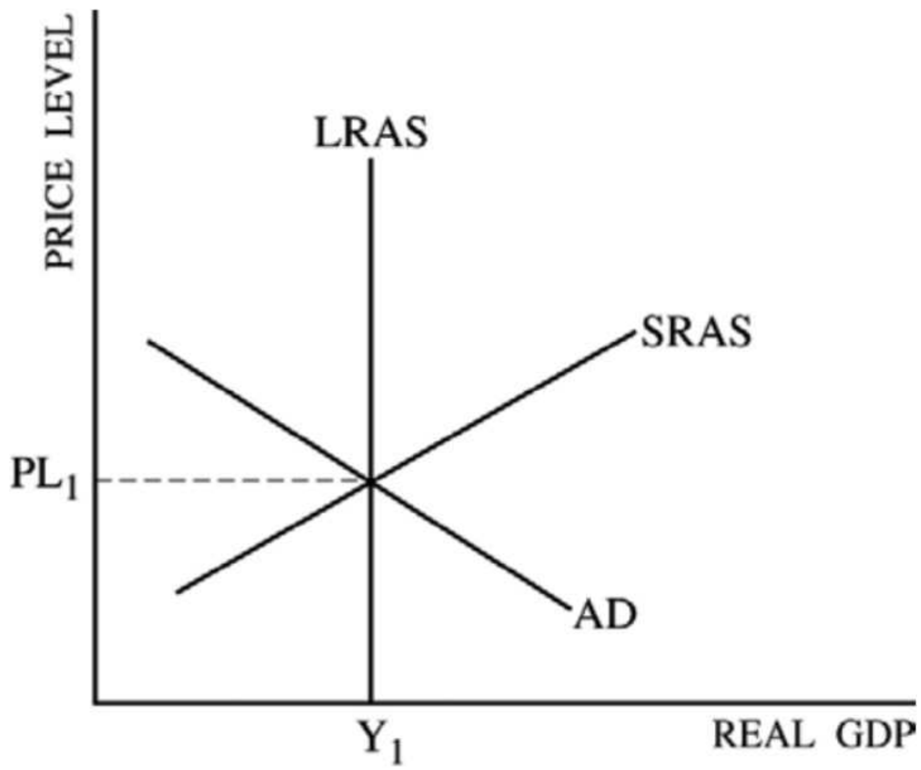
Keynesian view: AS – AD model



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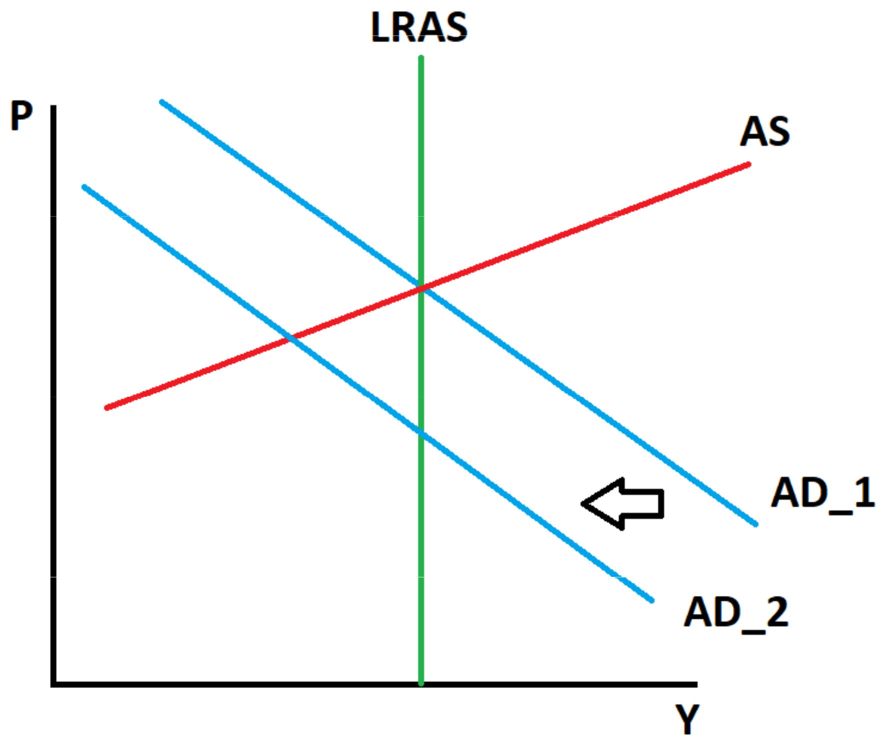
Economic Fluctuations in AS – AD model

– Suppose a wave of pessimism in the economy = people lose confidence in the future:
  - Households cut back on their spending
  - Firms put off buying new equipment

– Fall in AD
  - A decrease of output
  - A decrease in prices

Economic Fluctuations in AS – AD model



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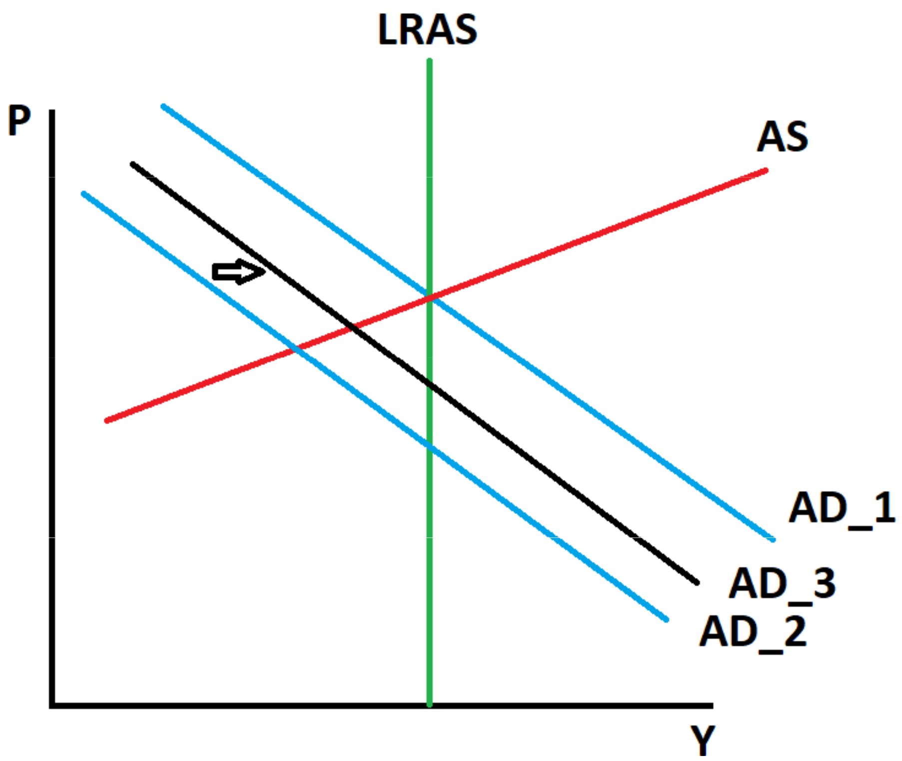
The role of government in AS – AD model



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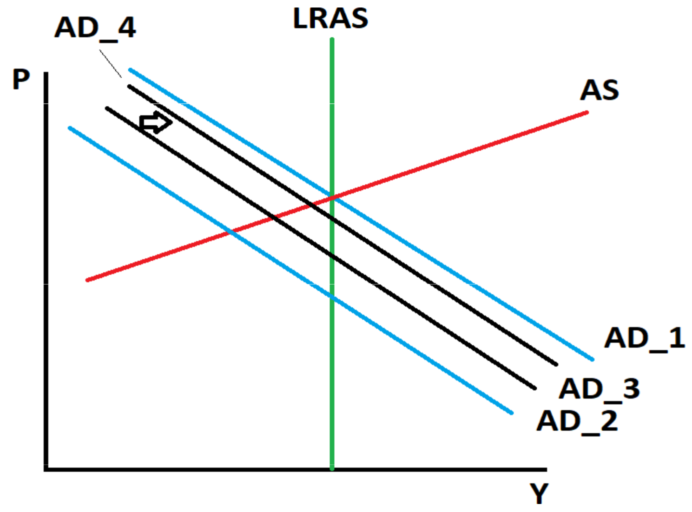
a) Multiplier



- The US government buys $20 billion of goods from Boeing ➡ an increase in employment and profits of Boeing.

- Workers and firm owners see higher profits, they respond to this increase in income by raising their own spending.

- Increase in government spending ➡ an increase the demand for the products of many firms in the economy.

- **Multiplier** = the additional **shifts** in AD that result when expansionary fiscal policy increases consumer spending.

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b) Crowding-out effect

– An increase in government spending → an increase in government deficit → an increase in interest rate → a decrease in private investment.

– **The crowding-out effect** = the **offset** in **aggregate demand** that results when expansionary fiscal policy raises the interest rate and thereby reduces investment spending.

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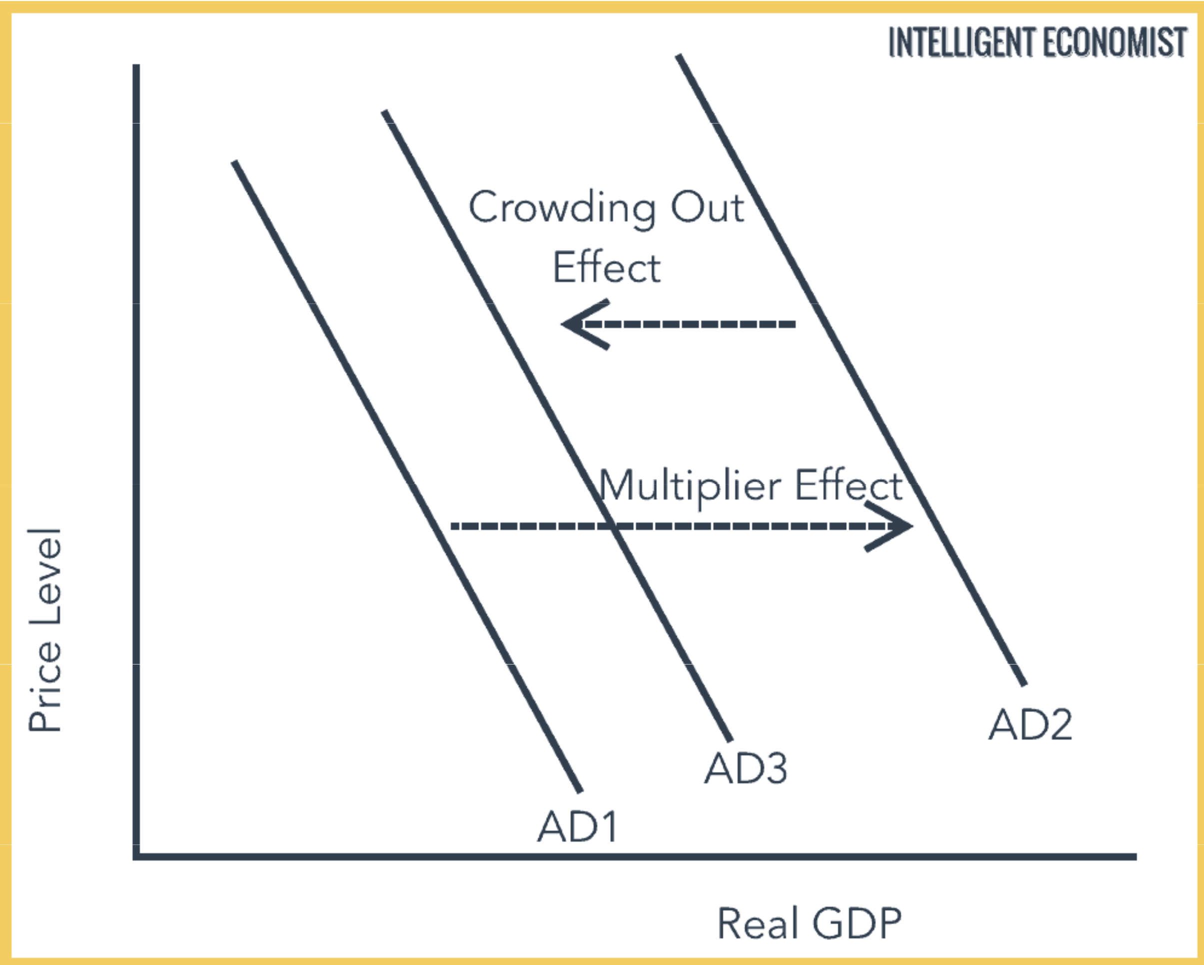
Crowding-out effect



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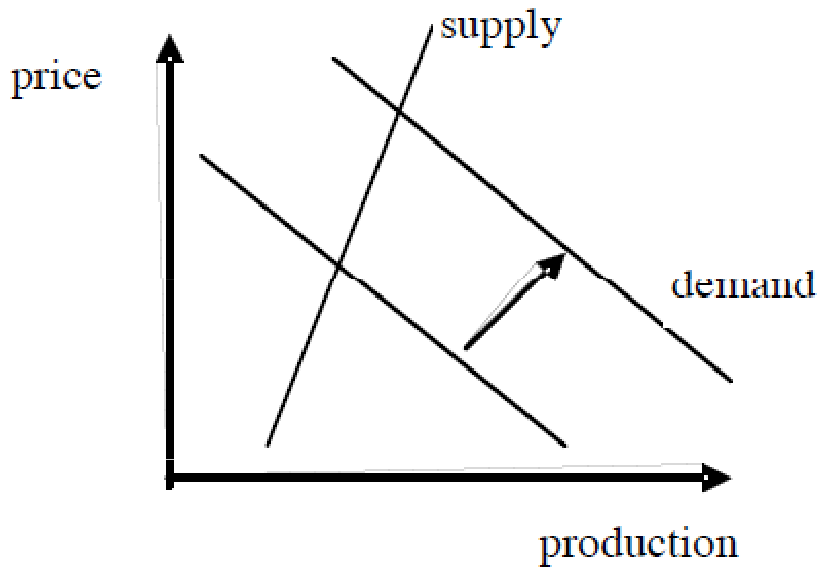
The neoclassical critique

- Critique of the multiplier
  - Full financial crowding-out
  - Supply rigidity
- Fiscal expansion
  - Rise in the interest rate penalises private investment
  - Fiscal policy effectiveness is limited in time (data shows that multiplier is close to zero after one year)

Effect of an expansionary fiscal policy



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Public budget

- Public budget = a document that specifies the origin and volume of both income ("receipts") and intended spending over a certain horizon (usually a year)

  Public budget
  - Budget of central government
  - Budgets of local governments

- Functions: allocation, redistribution and **stabilisation**

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Public budget

- **Revenue**: e.g. an income from direct and indirect taxation, social contributions, income from public assets, income from provision of public services and, possibly, income from disposal of public assets

- **Spending**: e.g. defence, police, justice, education, research, support to the economy, social policy, health, foreign policy, development assistance, etc.

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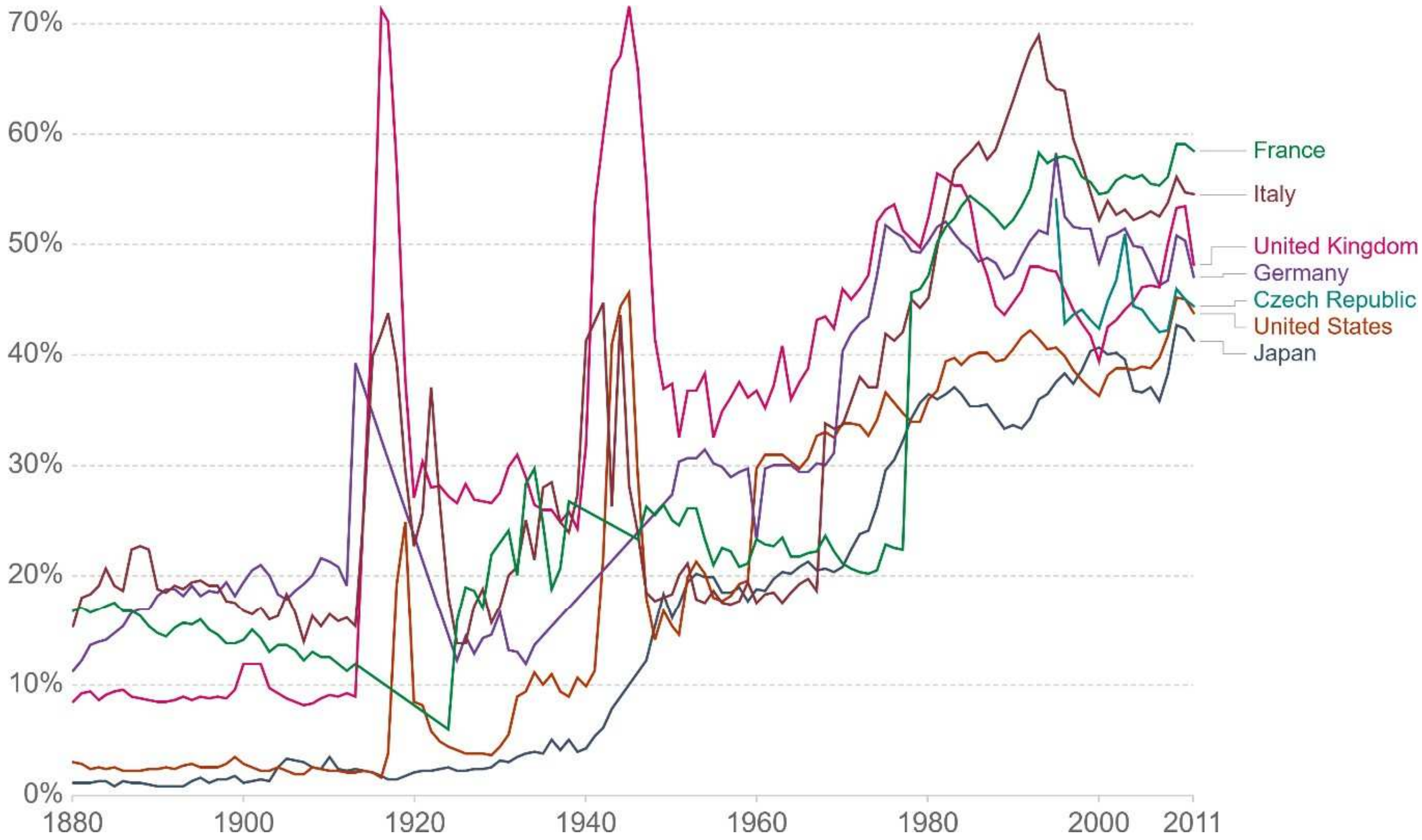
Government spending



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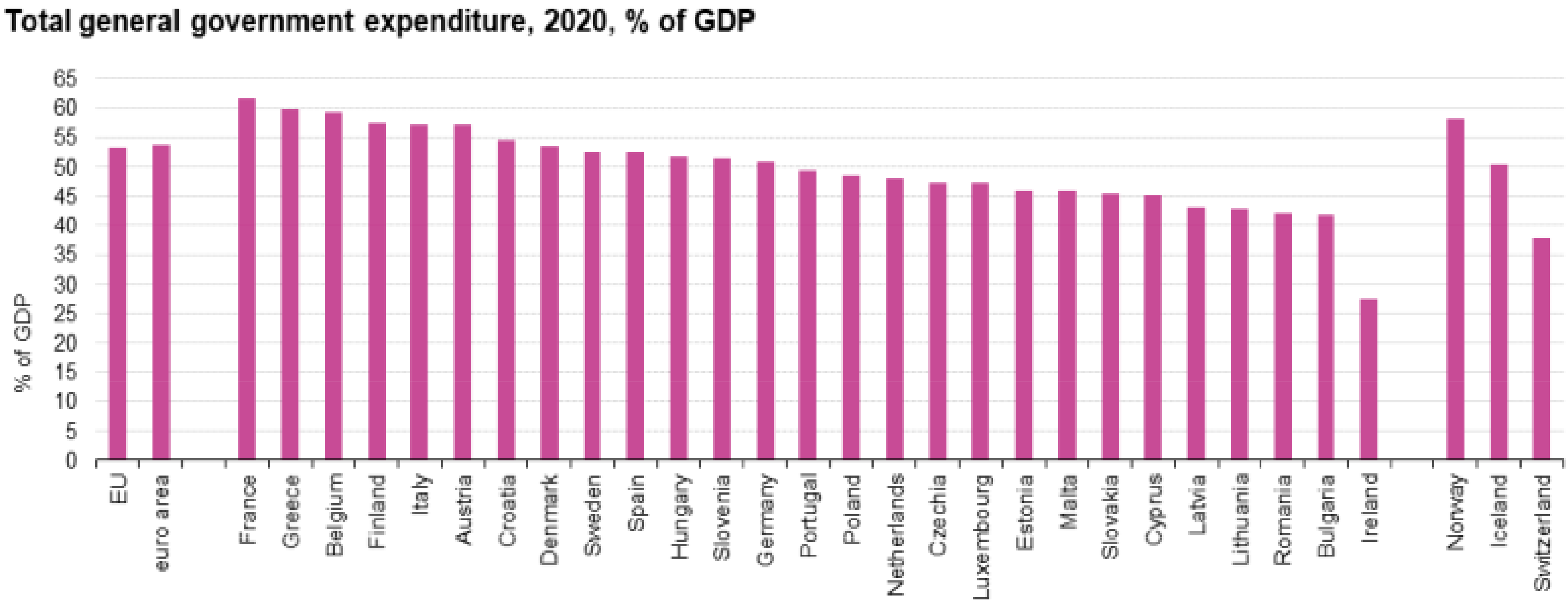
Government spending (EU countries)



Source: Eurostat (gov_10a_main)

eurostat

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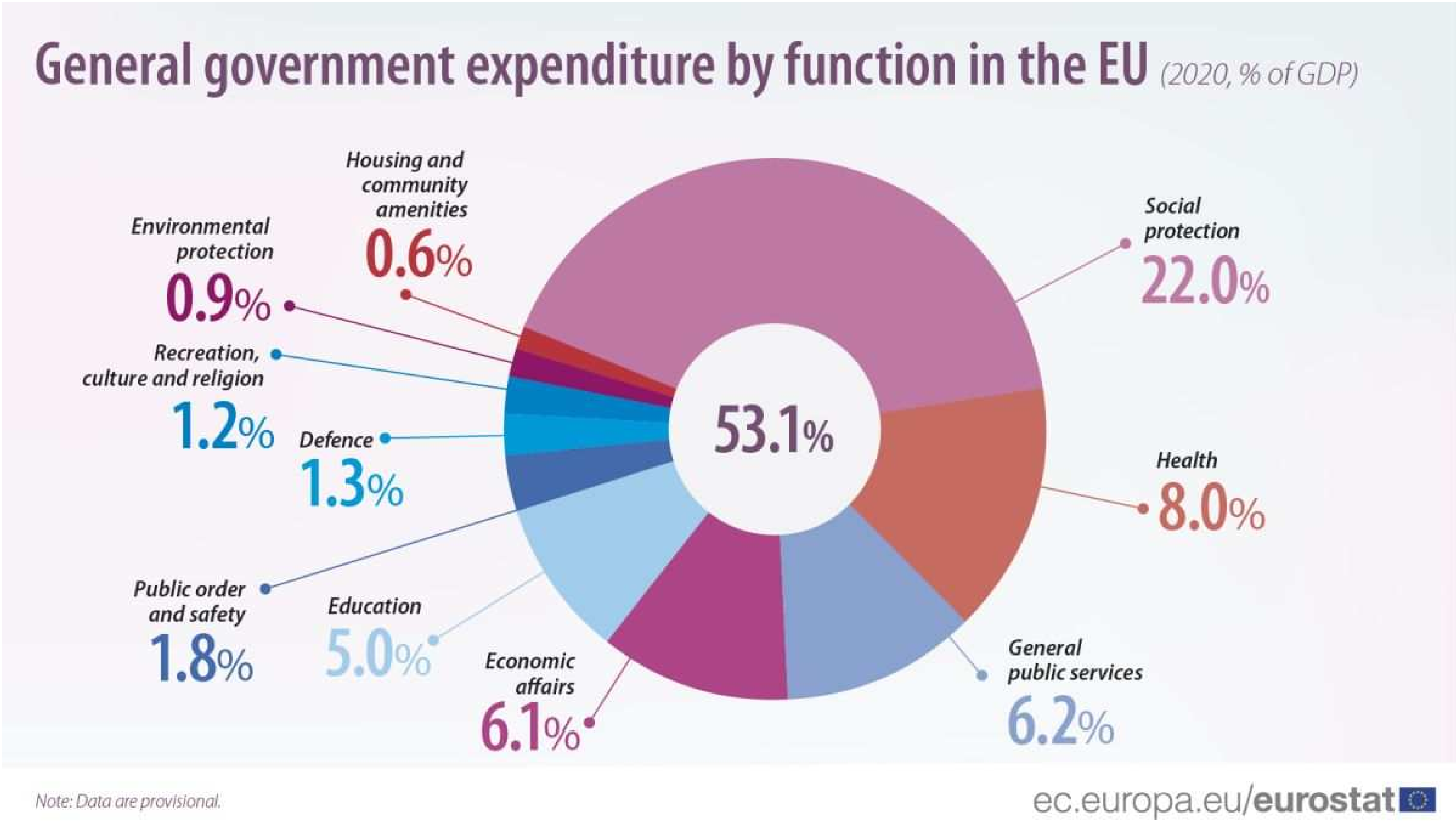
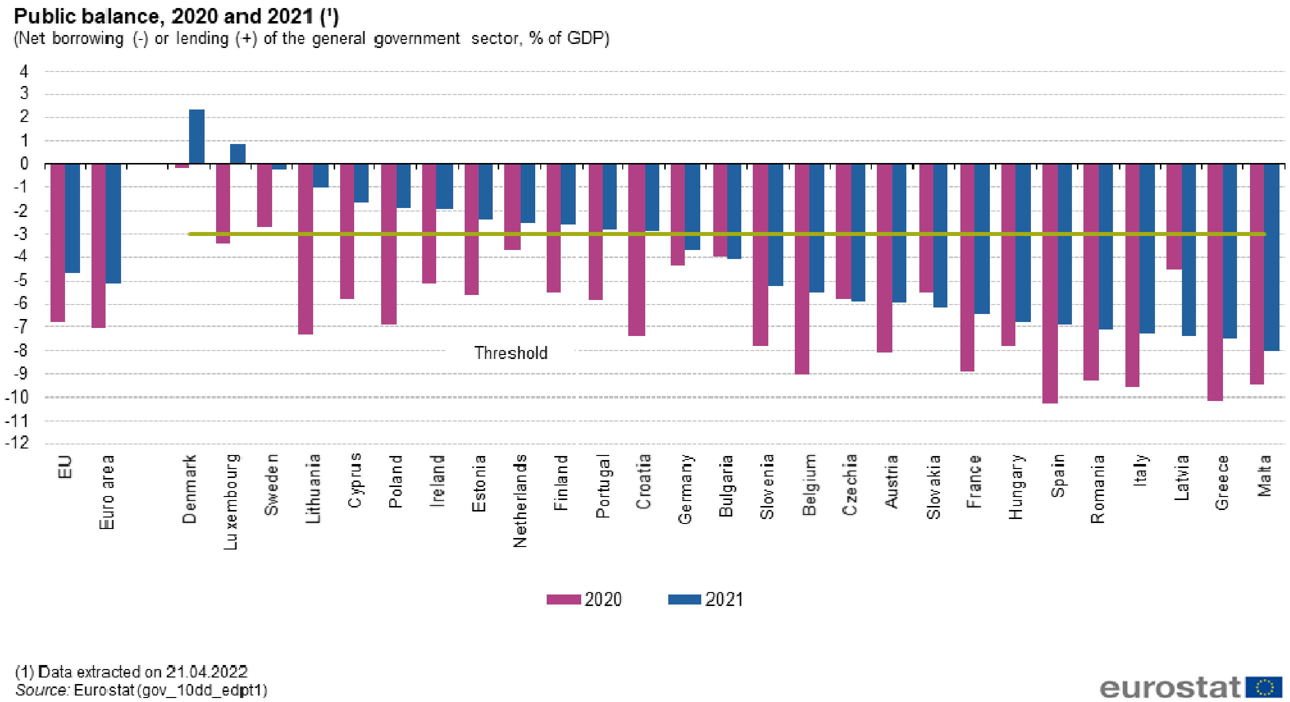

General government expenditure by function in the EU (2020, % of GDP)
Housing and community amenities
0.6%
Environmental protection
0.9%
Recreation, culture and religion
1.2%
Defence
1.3%
Public order and safety
1.8%
Education
5.0%
Economic affairs
6.1%
53.1%
Social protection
22.0%
Health
8.0%
General public services
6.2%
Note: Data are provisional.
ec.europa.eu/eurostat

Public budget balance

– The fiscal (budgetary) balance = a difference between income and expenditure



Fiscal (budget) surplus
- Can be used to pay down public debt or invested

Fiscal (budget) deficit

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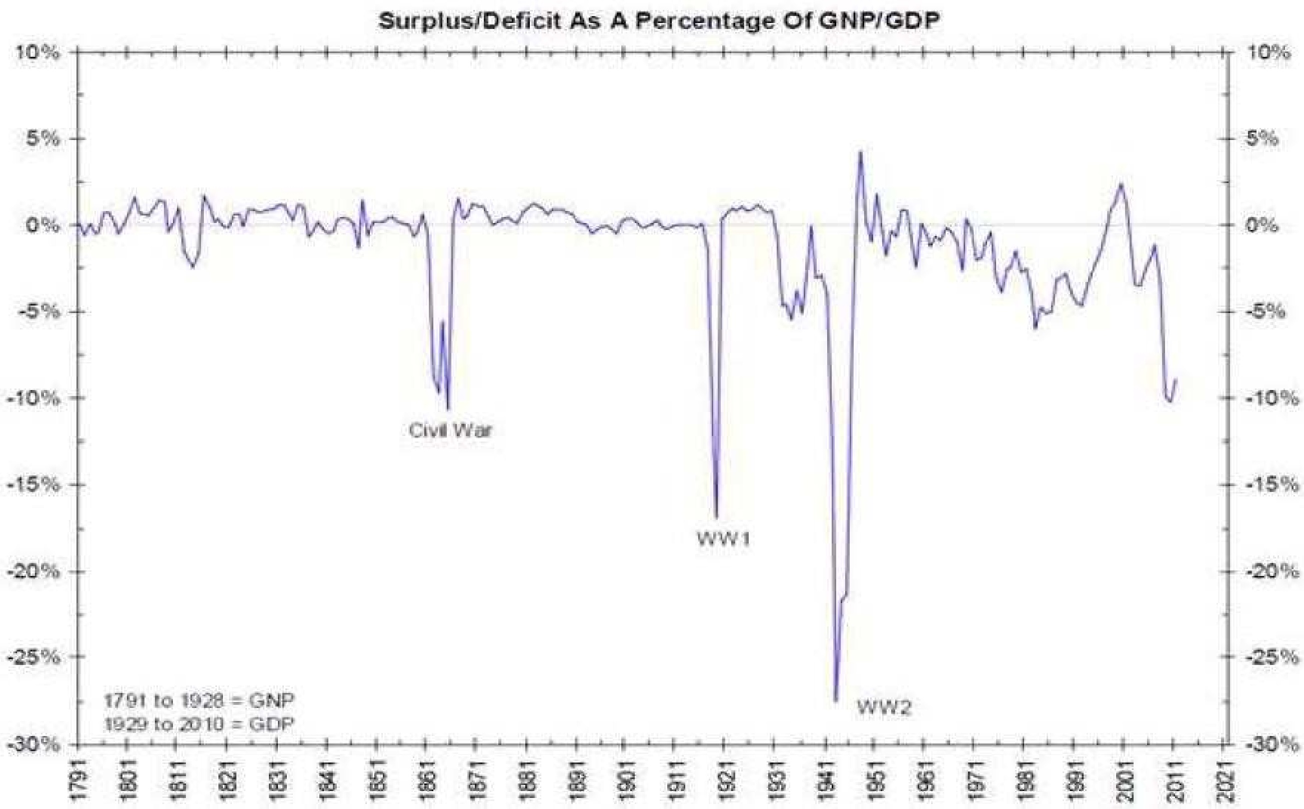
Large deficits were mostly the results of wars (e.g., USA)



Budget imbalance

- Budget balance = income – expenditures: surplus (+) or deficit (-)
  - **Central** or **general government** balance
  - **Financial** (overall) balance (= net lending); includes net interest payment
  - **Primary balance**: excluding net interest payments
  - **Cyclically-adjusted (structural) balance:** excluding cyclical balance = FP stance

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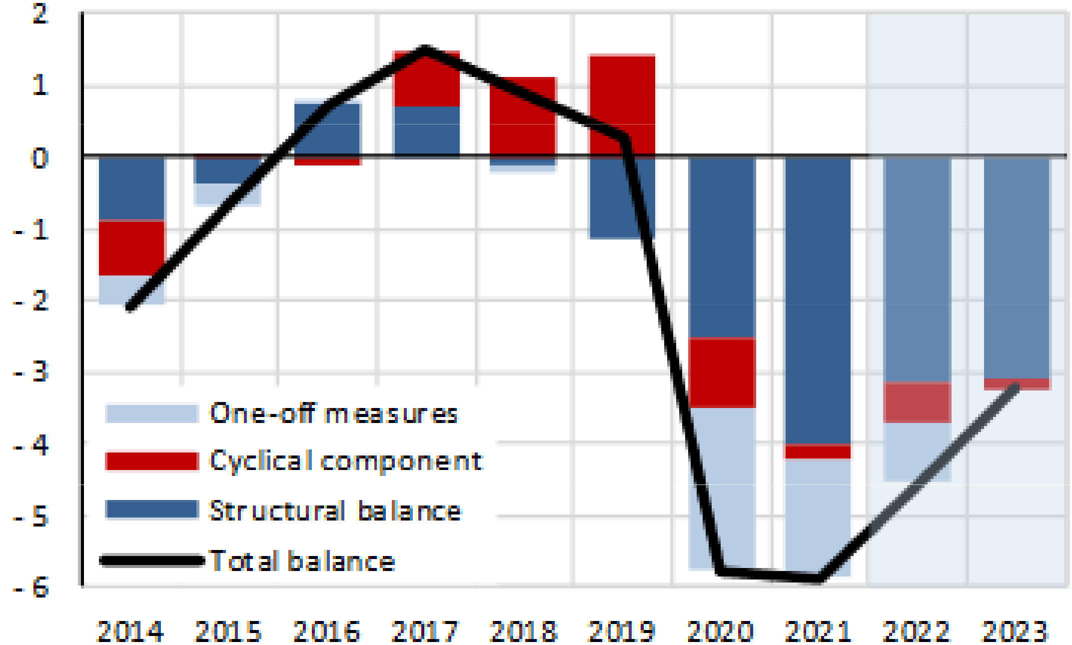
Cyclical and structural components

Graph 1.1: General Government Balance

in % of GDP



Source: CZSO (2022a, 2022b). MF CR forecast and calculations.

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Table 17.3 Government Budget Balances, Various Countries, 1975 – 2010 (% of GDP)

	1975	1980	1985	1990	1995	2000	2005	2010	Average 1970–2010
Austria	−2.4	−2.0	−3.0	−2.5	−5.9	−1.9	−1.8	−4.6	−3.0
Belgium	−6.4	−10.2	−9.9	−6.7	−4.5	−0.1	−2.8	−4.2	−5.6
Denmark	−2.4	−3.5	−2.1	−1.3	−2.9	2.2	5.0	−2.9	−1.0
Finland	5.1	3.8	3.5	5.4	−6.2	6.8	2.5	−2.8	2.3
France	−1.9	−0.1	−3.0	−2.4	−5.5	−1.5	−3.0	−7.0	−3.0
Germany	−5.6	−2.9	−1.1	−1.9	−9.7	1.3	−3.3	−3.3	−3.3
Greece	−2.6	−2.3	−10.4	−14.0	−9.1	−3.7	−5.3	−10.4	−7.2
Ireland	−11.2	−11.2	−10.8	−2.8	−2.1	4.8	1.6	−32.4	−8.0
Italy	−10.3	−7.0	−12.4	−11.4	−7.4	−0.9	−4.4	−4.5	−7.3
Japan	−2.0	−3.2	−0.6	2.1	−4.7	−7.6	−6.7	−8.1	−3.9
Netherlands	−3.4	−4.2	−3.7	−5.3	−9.2	2.0	−0.3	−5.3	−3.7
Norway	3.0	5.4	9.7	2.2	3.2	15.4	15.1	10.5	8.1
Spain	−0.2	−3.0	−7.3	−4.1	−6.5	−1.0	1.0	−9.2	−3.8
Sweden	5.1	−5.8	−3.7	3.4	−7.3	3.6	1.9	−0.3	−0.4
UK	−5.2	−3.7	−3.3	−1.8	−5.8	3.7	−3.3	−10.3	−3.7
USA	−5.2	−2.6	−5.0	−4.2	−3.3	1.5	−3.3	−10.6	−4.1

Source: OECD, *Economic Outlook*.

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Discretionary FP vs. automatic stabilisers

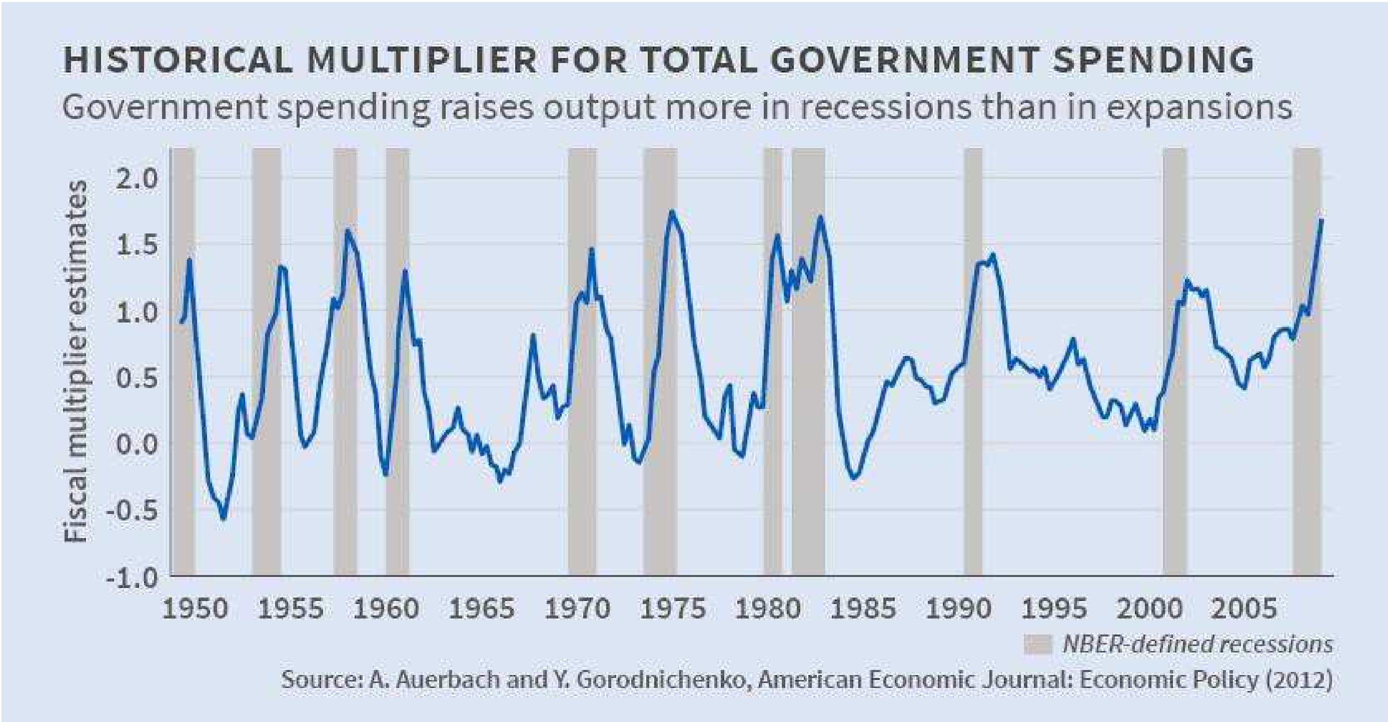
– **Discretionary FP** includes changes in government spending and taxation that need specific approval (usually requires legislative action) = a risk of time lags.

– **Automatic stabilizers** increase (decrease) budget deficits during times of recession (booms) without specific new legislation = no time lags: e.g., unemployment insurance program, progressive income taxes

Empirical assessment of fiscal multipliers

- Effectiveness of fiscal policy depends on the amount of fiscal multiplier

- Studies lead to wide range of estimates for fiscal multipliers from less than zero to more than four



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CS: FP during the 2008-2009 crisis

- **Arguments in favor of 2009 stimulus**:
  - Risk of depression (recession with a decline of GDP more than 10 %)
  - Ineffectiveness of monetary policy (transmission through financial system clogged, in addition to zero band)
- **Exceptional effectiveness of fiscal policy because of**:
  - General excess supply
  - Excess savings and flight to safety resulting in ultra-low bond rates
  - Focus of agents on short-term horizon, credit constraints
  - Symmetric character of shocks, therefore gains from coordinated action

Public debt

- Public debt = the total of all bonds and other debt owed by a government. Usually, cumulated deficits.

- Debt-to-GDP ratio

- Net public debt = gross public debt – value of public assets

- Problem of off-balance-sheet liabilities (ageing, too-big-to fail banks)

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Debt sustainability

— Solvency = borrower's ability to face its commitments.

— Sustainability = a policy course compatible with solvency at all times in the future.

— Sustainability = forward-looking by nature and relies on assumptions on future policy and on the ability of the government to collect/increase taxes.

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Debt sustainability

- *„Debt can almost always be serviced in some abstract sense, through additional taxation and through the diversion of yet more domestic production to exports to generate the revenue and foreign exchange needed to service the debt. But there is a political and social, and perhaps moral, threshold beyond which policies to force these results become unacceptable.“*

J. Boorman (2002)

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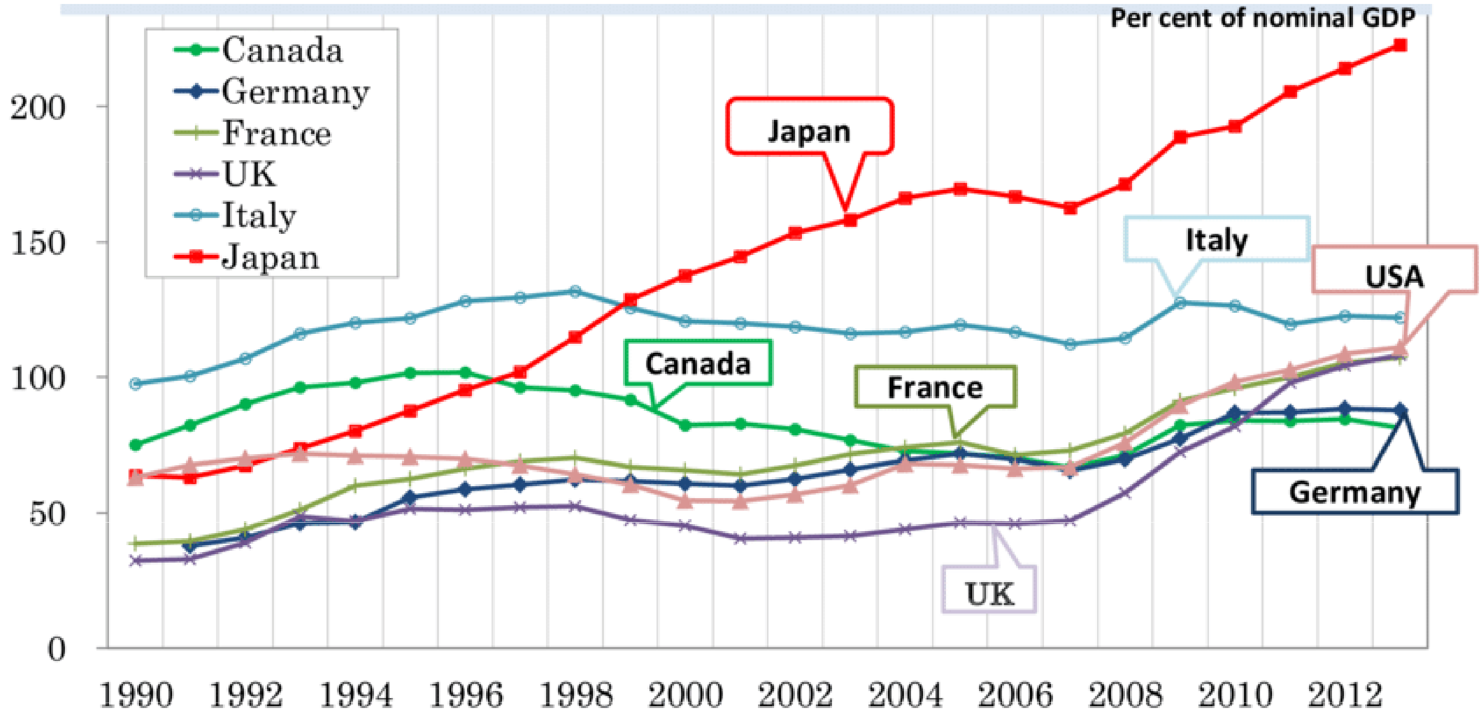
Public debt developments in selected European countries



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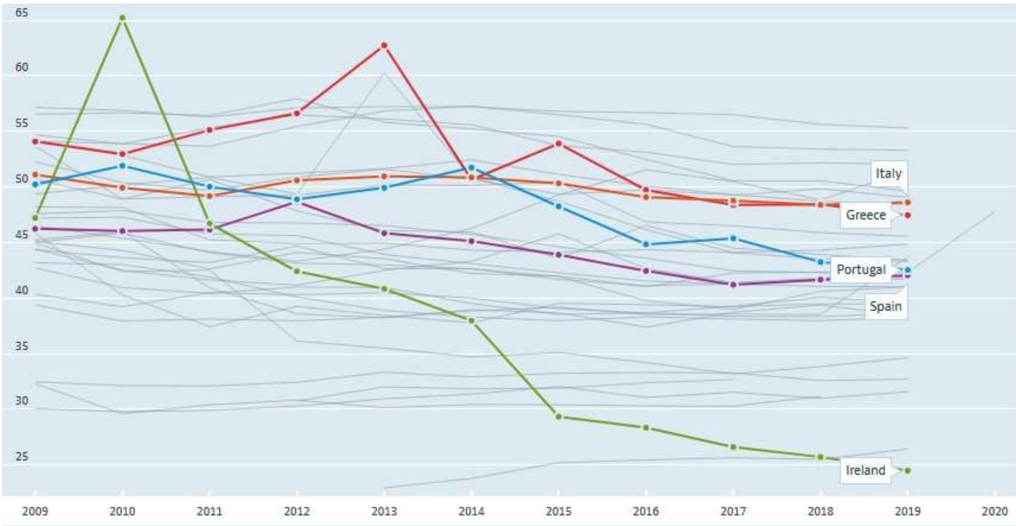
How to reduce the debt burden?

1. Fiscal adjustment: cut spending, raise taxes

— The most direct but also most difficult way

— As difficult as it is, deficit reduction had been successfully implemented in many European countries.



General government spending (% GDP)

How to reduce the debt burden?

2. Raising economic growth

— It is possible in medium to long-run

— Factors influencing the rate of growth will be spelt out later (Growth policy)

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How to reduce the debt burden?

3. Monetisation (inflation tax)

— Reducing the value of the money base (the central bank's liability) and of the public debt (the Treasury's liability) => tax on money and bondholders.

— Inflation must rise unexpectedly and quickly enough.

— A temporary solution: lenders will demand higher interest rates and will be less willing to agree to long-term loans.

— Risk of hyperinflation if the government will be forced to create more money to pay back maturing debt.

Monetisation

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How to reduce the debt burden?

—4. Default

—not rare in Europe before 20th century

—restructuring: rescheduling, write-downs, interest reductions...

—coordination: Paris club (public creditors); London club (private creditors); IMF, World Bank.

How to reduce the debt burden?

In practice:

- An assistance from financial institution
- Implementation of an adjustment program aimed at restoring debt sustainability
- Debt reduction

Political theory of debt

- The choice of who should pay for the reduction of a high debt is a problem of redistribution.
- Suppose that society can be divided into **three groups**: rentiers, entrepreneurs and workers.
- Each of these interest groups will seek to avoid the burden of adjustment and **shift onto someone** else:
  - Rentiers are opposed to default and inflation tax
  - Entrepreneurs are opposed to taxes on capital
  - Workers prefer taxes on wealth and capital and the repudiation of debt

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Rules and principles

- Fiscal policy is traditionally discretionary
- However, increasing reliance on rules to:
  - Improve predictability
  - Address political failures
  - Improve credibility
  - Enforce coordination
- European Stability and Growth Pact (1997)
- Current discussions in Europe:
  - Strengthening fiscal discipline
  - National fiscal rules and institutions

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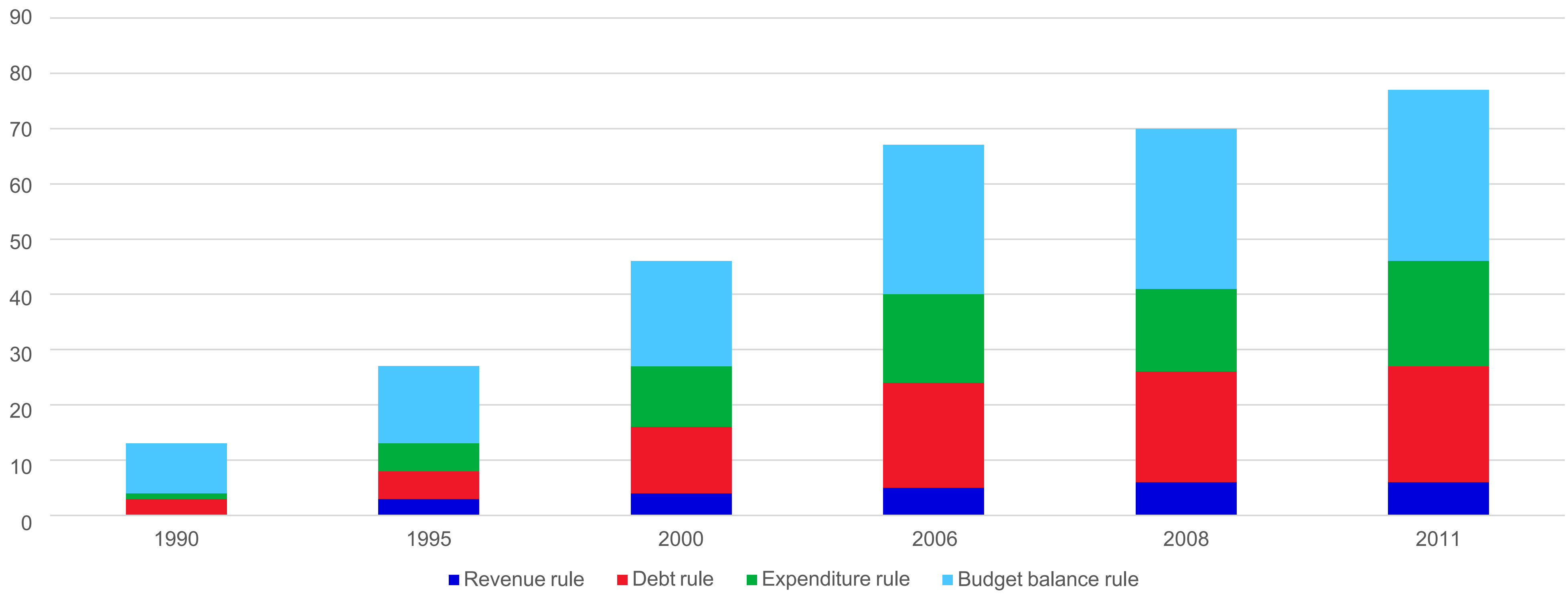
More and more rules in the EU



What is a good rule?

- The ‘good rule’ according to Kopits and Symansky (1998):
  - Clear definition,
  - Transparent public accounts,
  - Simplicity,
  - Flexibility – in particular regarding the capacity to react to exogenous shocks,
  - A rule with possibility of sanctioning non-observance,
  - Consistency with the other objectives and rules of public policies,
  - Accompanied by other effective policies.

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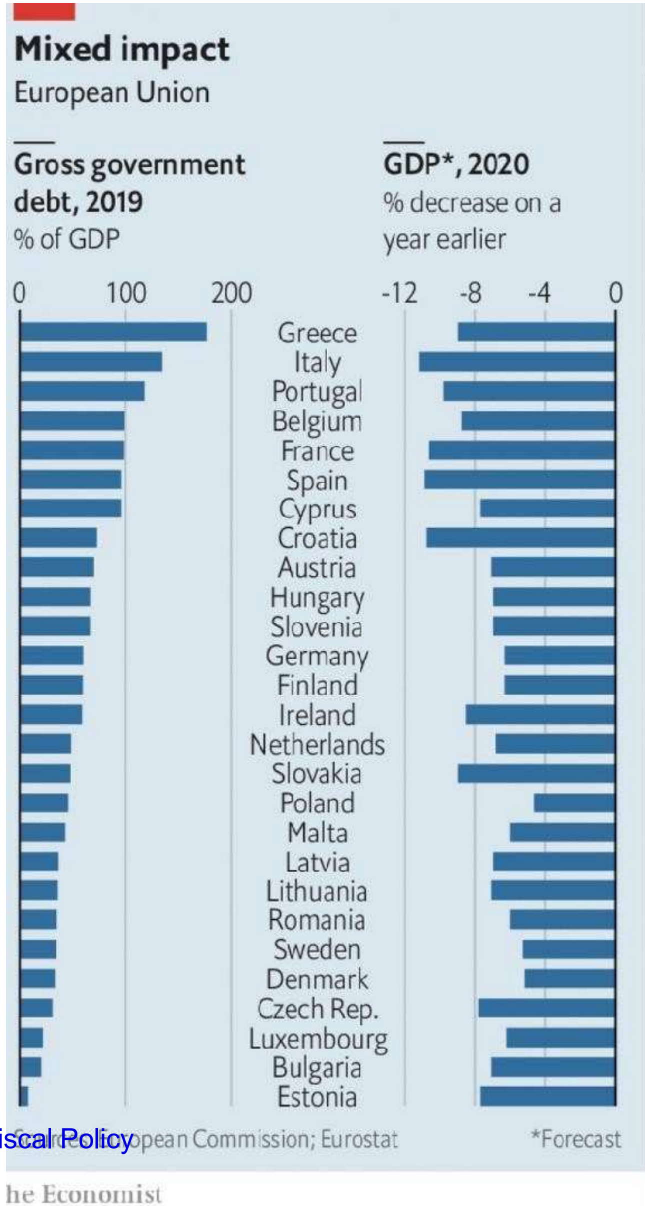
CS: The Stability and Growth Pact

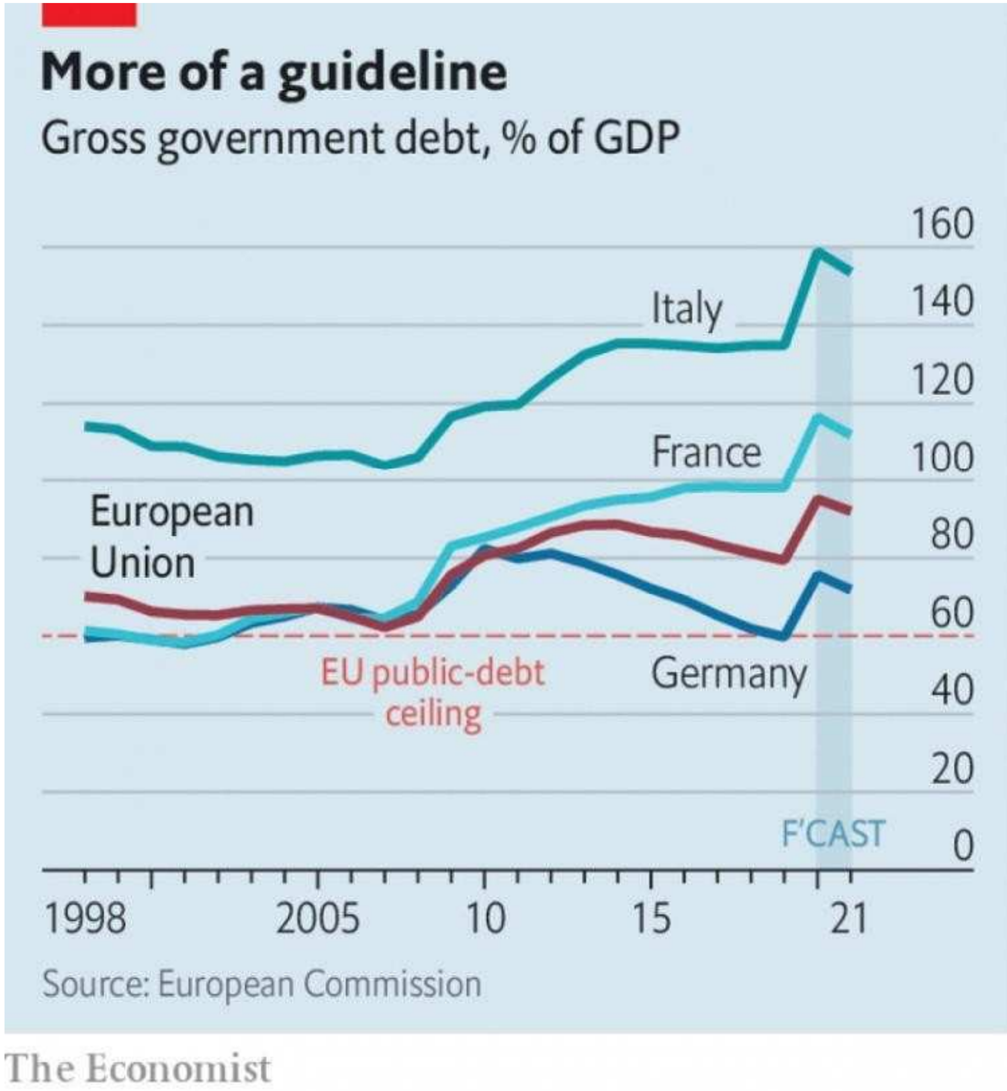
Two elements:

- The preventive arm
  - A medium term objective
  - ‘Stability’ (Eurozone) and ‘convergence’ (non-Eurozone) programs
- the corrective arm (‘Excessive Deficit Procedure’) allows for:
  - Advance warning
  - Recommendation to correct excessive deficit within given timeframe
  - Eventual sanctions

CS: The Stability and Growth Pact

- Recent reforms (six-pack, fiscal compact)
  - Earlier sanctions
  - Debt rule

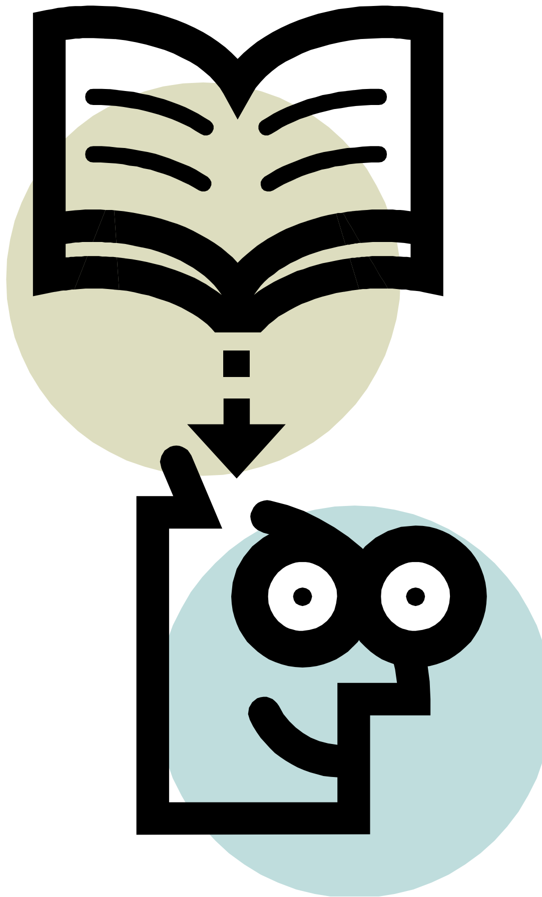

Mixed impact
European Union
Gross government debt, 2019
% of GDP
GDP*, 2020
% decrease on a year earlier
0
100
200
-12
-8
-4
0
Greece
Italy
Portugal
Belgium
France
Spain
Cyprus
Croatia
Austria
Hungary
Slovenia
Germany
Finland
Ireland
Netherlands
Slovakia
Poland
Malta
Latvia
Lithuania
Romania
Sweden
Denmark
Czech Rep.
Luxembourg
Bulgaria
Estonia
Commission; Eurostat
*Forecast


More of a guideline
Gross government debt, % of GDP
160
140
120
100
80
60
40
20
0
Italy
France
European Union
Germany
EU public-debt ceiling
F'CAST
1998
2005
10
15
21
Source: European Commission
The Economist

Reference textbook

– Benassy-Quéré, A. et al. *Economic Policy: Theory and practise*.

Oxford University Press, 2010. ***Chap. 3***



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