

# Economic Policy #03

## Fiscal Policy I

(Concepts, Measurements and  
Theories)

# Concepts

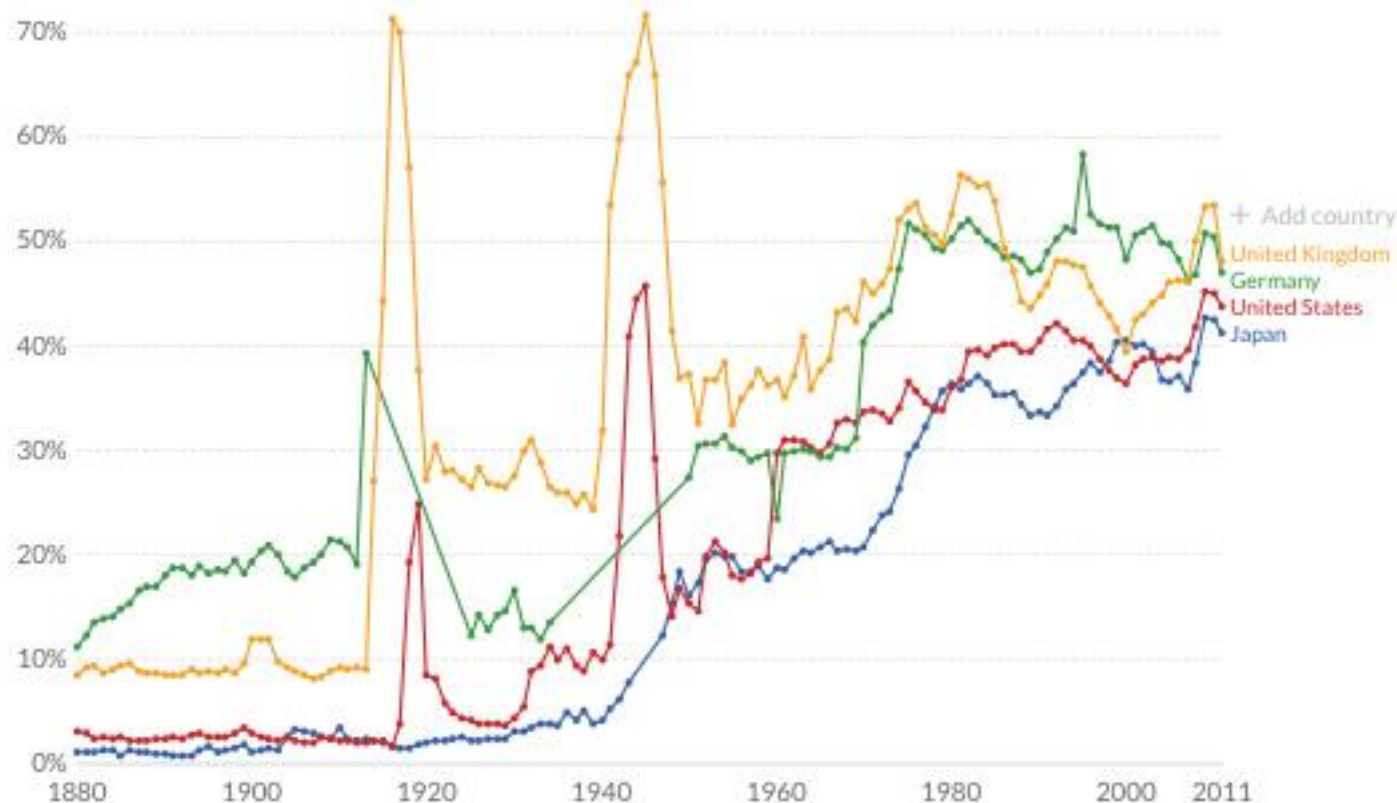
Fiscal policy (FP) contains decisions regarding taxes and public spending.

The notion of FP usually refers to its *stabilization function* – changes in taxes and public expenditures for purposes of dampening the fluctuations of the economic cycle – theoretically inspired by J.M. Keynes.

Toward the end of the 20<sup>th</sup> century theoretical and empirical doubts about the effectiveness of FP strengthened.

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

## BOX. Total government spending as a share of GDP



Source: IMF Fiscal Affairs Departmental Data, based on Mauro et al. (2015)

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=> Governments have been transformed from irrelevant economic players into major contributors to aggregate demand.

## BOX. The role of government transfers

 **Table 17.2 Government Transfers, Various Countries, 1960 and 2010**

	% of GDP		% of government outlays	
	1960	2010	1960	2010
Austria	14.8	31.0	51.8	59.1
Belgium	12.7	32.7	44.8	61.7
Denmark	7.6	38.2	35.1	65.4
Finland	9.0	34.3	41.6	62.3
France	16.3	35.7	53.5	63.0
Germany	14.1	29.9	50.2	62.6
Greece	5.3	28.1	30.6	56.0
Ireland	9.6	28.7	38.7	43.0
Italy	11.2	31.6	45.4	62.9
Japan	4.5	24.8	34.5	60.5
Netherlands	8.6	28.8	n.a.	56.3
Portugal	3.7	29.2	24.5	56.8
Spain	2.9	27.8	23.1	60.8
Sweden	8.6	34.9	32.2	65.9
UK	9.0	29.7	30.7	58.7
USA	6.0	30.9	24.4	52.2

Sources: European Economy; OECD, *Economic Outlook*.

## BOX. Public expenditures in various countries

Public expenditures / GDP	2006	2007	2008	2009	2010	2011	2012	2013	2014
EU28	45,6	44,9	46,5	50,3	50,0	48,5	49,0	48,6	48,1
EA	46,0	45,3	46,5	50,6	50,5	49,0	49,6	49,5	49,1
Czech Republic	40,8	40,0	40,2	43,6	43,0	42,4	43,8	41,9	42,0
Germany	44,6	42,7	43,5	47,4	47,2	44,6	44,2	44,3	43,9
Hungary	51,9	50,2	48,9	50,8	49,8	49,9	48,7	49,8	50,1
Poland	44,7	43,1	44,4	45,2	45,9	43,9	42,9	42,2	41,8
Slovakia	38,5	36,1	36,7	43,8	42,0	40,6	40,2	41,0	41,8

*Note: ESA methodology. Data source: Eurostat.*

# Measurements

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

- **Receipts:** income from direct and indirect taxation, social contributions, income from public assets or from provision of public services and, possibly, disposal of public assets.
- **Spending:** on core sovereign activities (defense, police, justice, foreign policy), the provision of public services (education, health care), indirect or direct support to the economy (research, infrastructure).
  - familiar budget categories include *capital expenditures* and *current expenditures*
- Budgets are established autonomously for different **levels** of government, cities to central government.

# Problems in measurements: inflation

- Suppose the real debt is constant, which implies a zero real deficit.
- In this case, the nominal debt  $D$  grows at the rate of inflation:  
$$\Delta D/D = \pi \quad \text{or} \quad \Delta D = \pi D$$
- The reported deficit (nominal) is  $\pi D$  even though the real deficit is zero.
- Hence, should subtract  $\pi D$  from the reported deficit to correct for inflation.
- Correcting the deficit for inflation can make a huge difference, especially when inflation is high.

# Problems in measurements: capital assets

- Currently, deficit = change in debt
- Better, **capital budgeting**:  
deficit = (change in debt) – (change in assets)
- Example: Suppose governmentt sells an office building and uses the proceeds to pay down the debt.
  - under current system, deficit would fall
  - under capital budgeting, deficit unchanged, because fall in debt is offset by a fall in assets.
- Problem: determining which government expenditures count as capital expenditures.



# Problems in measurements: uncounted liabilities

- Current measure of deficit omits important liabilities of the government:
  - future pension payments
  - future social security payments
  - contingent liabilities, *e.g.*, covering federally insured deposits when banks fail  
(Hard to attach a dollar value to contingent liabilities, due to inherent uncertainty.)

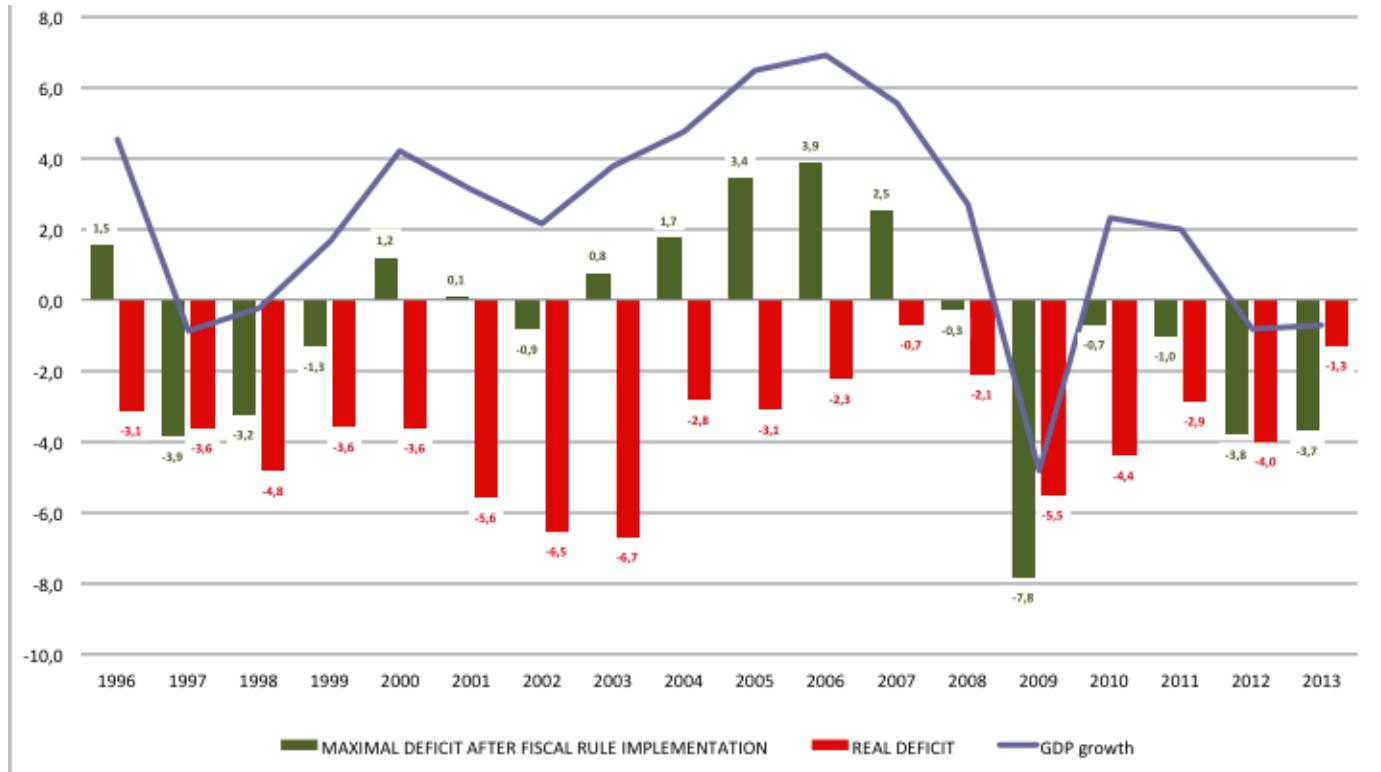
# Budget imbalance

Budget balance = income – expenditures: surplus (+) or deficit (-)

- **Financial** (overall) balance (= net lending): including net interest payments
- **Primary balance**: excluding net interest payments
- **Cyclically-adjusted (structural) balance**: excluding cyclical balance => FP stance

*Note: In EU fiscal framework: structural balance = cyclical adjusted balance – one-off net receipts*

## BOX. Public deficits and GDP growth in the Czech Rep.



*Data source: Ministry of Finance and the Czech Statistical Office, Czech Republic.*

=> Because of cyclical part, the overall deficit is procyclical..



**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*.

## BOX. Changes in actual and cyclically adjusted budget balances from 2008-2010, 20 OECD countries (% of GDP)



# Discretionary FP vs. automatic stabilizers

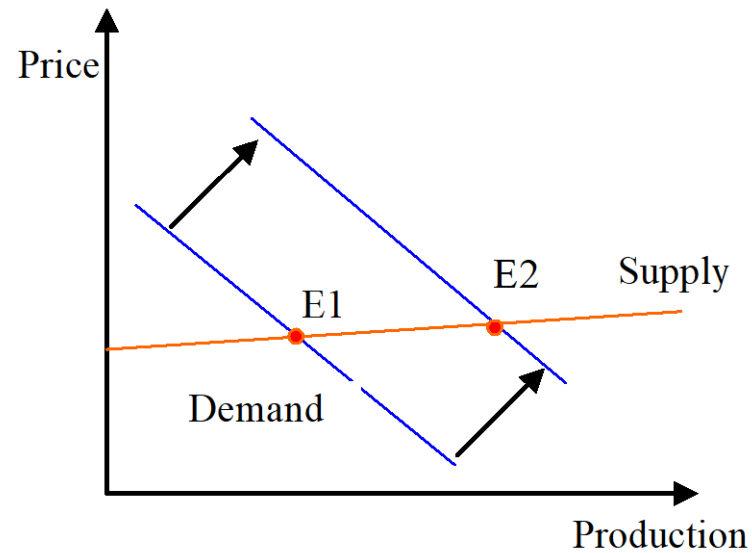
***Discretionary FP*** includes changes in government spending and taxation that need specific approval (usually requires legislative action) => risk of time lags.

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

# Keynesian view

- *Keynesian multiplier*

Effect of an expansionary fiscal policy



# Strenght of fiscal multiplier

How strong is multiplier?

It depends mainly on:

- characteristics of the economy, especially on trade openness (-), size of the economy (+), public debt (-) and exchange rate flexibility (-)
- monetary stance (degree of monetary support)
- overall economic conditions
- choice of the fiscal instrument



# Criticism

- Can expansionary fiscal policy actually work?

Some arguments have been put forward against the Keynesian approach:

- financial or investment crowding out
- Ricardian equivalence
- supply side rigidities

# The logic of Ricardian equivalence

- Consumers are forward-looking, know that a debt-financed tax cut today implies an increase in future taxes that is equal---in present value---to the tax cut.
- Thus, the tax cut does not make consumers better off, so they do not raise consumption.
- They save the full tax cut in order to repay the future tax liability.
- Result: Private saving rises by the amount public saving falls, leaving national saving unchanged

# The logic of Ricardian equivalence

## Criticism:

- Not all consumers think that far ahead, so they see the tax cut as a windfall.
- Future generations: If consumers expect that the burden of repaying a tax cut will fall on future generations, then a tax cut now makes them feel better off, so they increase spending.

# Time lags

A cautionary note: lags in fiscal policy

Active stabilization policy can end up making the economy less stable because:

- the government has to realize that recessionary gap exists
- the government has to develop a spending plan
- it takes time to spend money

# FP debate: stimulus or austerity?

Arguments in favor of 2009 stimulus:

- risk of depression
- ineffectiveness of monetary policy (transmission through financial system clogged, in addition to zero bound)
- potentially large multiplier effect
- symmetric character of shocks, therefore gains from coordinated action

# FP debate: stimulus or austerity?

Arguments against stimulus:

- Ricardian equivalence
- undermined investors' faith in the government's ability to repay its debts

=> theory of *expansionary austerity*

... to be continued..