Economic Policy #03

Fiscal Policy

Fiscal Policy

- Concepts and measurements
- Theories: keynesian vs. neo-classical view
- FP during crisis
- Public debt
  - measurement
  - debt and deficit dynamics
  - how to reduce the debt burden
- Fiscal rules

Concepts and measurements #1

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 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.

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*.

CS. 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.

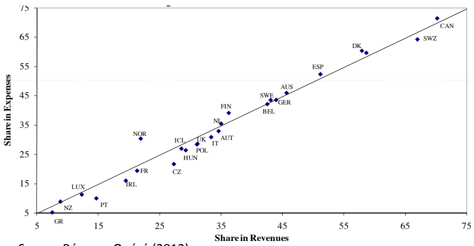
Concepts and measurements #2

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***: defense, police, justice, education, research, support to the economy, social policy, health, foreign policy, development assistance, etc.
- Budgets for different ***levels*** of government, cities to central government.

Various degrees of centralization

Fig. Ratio of local to general government expenses and revenues



Source: Bénassy-Quéré (2012)

Table 17.5 Expected and Realized Government Budgets in 2010 (% of GDP)

Forecast time	Dec 2008	June 2009	Dec 2009	Dec 2010	Actual
France	−3.9	−7.9	−8.6	−7.4	−7.0
Germany	−1.0	−6.2	−5.3	−4.0	−3.3
Italy	−3.1	−5.8	−5.4	−5.0	−4.5
The Netherlands	−0.9	−7.0	−5.9	−5.8	−5.3
Spain	−3.8	−9.6	−8.5	−9.2	−9.2

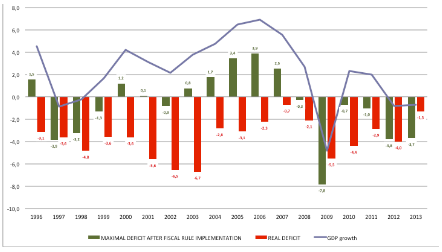
Source: OECD, *Economic Outlook*.

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
- ***Underlying (structural) fiscal balance***: cyclically adjusted fiscal deficits adjusted for one-off operations

CS. Public deficits and GDP growth in the Czech Republic



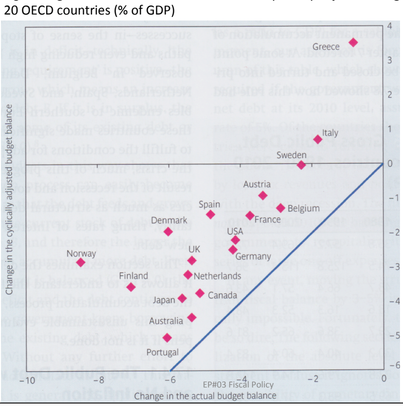
Data source: Ministry of Finance and the Czech Statistical Office, Czech Republic.

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.*

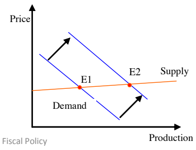
Fig. Changes from 2008 to 2010 in actual and cyclically adjusted budget balances, 20 OECD countries (% of GDP)



Keynesian view

- ***Keynesian multiplier***
- Limitations:
  - slope of supply curve
  - crowding-out (interest rate, exchange rate)
  - Ricardian equivalence

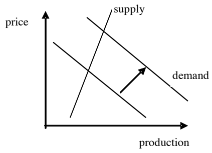
Effect of an expansionary fiscal policy



Neo-classical view

- complete *crowding out* or ricardian equivalence
- supply rigidity: price flexibility, rational expectations

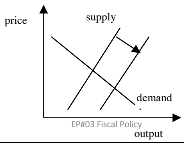
Effect of an expansionary fiscal policy



Supply-side effects of FP

- Directs: positive for (most) tax cuts, negative for (some) spending cuts
- Permanent spending cuts also signal lower taxes in the future, thereby they have supply-side effects
- Composition of fiscal adjustments matters

Supply-side effects of a tax cut



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.

FP during the 2008-09 crisis

- Arguments in favor of 2009 stimulus:
  - risk of depression
  - ineffectiveness of monetary policy (transmission through financial system clogged, in addition to zero bound)
- 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

to be continued…