

## FISCAL POLICY AS AN STABILIZER OF BUSINESS CYCLE FLUCTUATIONS IN THE EURO-AREA

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Fiscal policy can be used as a stabilizing tool of economic activity either through the work of the built in “automatic stabilizers”, through discretionary tax or expenditure measures or through both.

The empirical research done about the efficiency of fiscal policy as a stabilizer of business cycles shows some interesting results. Fatás and Mihov (2000), using a sample of 20 OCDE countries, that include most of the Euro-Area members, achieve the following conclusions: First, taking the size of the government as a simple proxy for the automatic stabilizers, find that the size of governments is clearly inversely related to the volatility of GDP. The same effects are found when using alternative measures of the size of governments such as expenditures, taxes or transfers or even taking into account the endogeneity of government size to economic conditions. Second, the size of government also reduces the volatility of the private GDP and the coefficient of correlation is equally high. Third, the reduction of volatility tends to be smaller when disposable income or consumption are used instead of GDP. That is, automatic stabilizers tend to justify their name. Fourth, the response of economic activity to discretionary fiscal policy is also found to be strong, positive and persistent.

Nevertheless, there are some critiques that can be done to the use of fiscal discretionary policy. The first is that fiscal policy operates with variable lags. It takes time for governments to recognize an economic downturn. The best example of this problem is the policy mistake of European governments, during the course of most part of 2001, believing that the Euro-Area was not going to be much affected by the strong slow down of the U.S. economy. It takes time, as well, to pass the fiscal measures through the national Parliaments and it takes time for the economy to respond (Buti 2001) As a result, once decided, the fiscal policy measures can rarely be adjusted to the changing economic circumstances. The second is that there are always some political constraints: it tends to be much easier for governments to ease fiscal policy than to tighten and once the measure is taken it tends to become irreversible. Finally, the effects of fiscal policy can be neutralized by an offsetting behaviour of the private sector. A fiscal expansion can exert upward pressure on long term interest rates and crowd out private investment or it may induce private households to save more if fiscal expansion raises fears of higher taxes in the future. This “Ricardian equivalence” behaviour is very common in countries with high levels of government debt and deficits. The case in point is Japan today, but the IMF, in its World Economic Outlook of May 2001, points out that this “non Keynesian effects” are also important in the countries of The Euro-Area. Similar empirical results for the U.S. economy were found by David and Christina Romer (1994), two important post-keynesians, who show that monetary policy alone is a sufficiently powerful and flexible tool to end recessions while, in contrast, discretionary fiscal policy does not appear to have had an important role in generating recoveries given that fiscal responses to economic downturns have, generally, not occurred until real activity was approximately at its trough. Therefore, it seems quite clear that the best fiscal response to a strong slowdown in the economy is to let the automatic stabilizers play their role and avoid discretionary policy measures, which, because of political constraints, tend to be irreversible, leading to ratcheting up public spending.

In the present economic context of the Euro-Area, the success of the Stability Pact is going to make possible, for the first time in many years, that the automatic stabilizers

play their role, efficiently, in the actual downturn. The experience of most member countries of the Euro-Area in the past shows that fiscal policy, given the strong constraints of the high levels of debt and deficits, had always to be pro-cyclical. Not only the Stability Pact is a necessary condition for the ECB proper functioning and credibility, but also it tends to avoid pro-cyclical behaviour and, in the medium term, some structural fiscal rigidities, such as a high level of taxes and excessive volatility of tax rates, which reduce competitiveness.

Buti, Franco and Ongena (1997) have made a very interesting exercise consisting in a retrospective application of the Stability Pact to the post-war period. Their historical analysis, without Stability Pact, shows: first of all, that most EU members either carried out a fiscal retrenchment policy during the periods of economic slowdown or they were not able to smooth out the cycle through fiscal policies. On no occasion was fiscal policy expansionary when growth was below trend. Secondly, that the sensitivity of the budget balances of the E.U as a whole to the cycle lies around 0.5. This means that each deterioration of a negative output gap by 1% of trend GDP increases the actual government deficit by 0.5 points of GDP. Thirdly, that the cyclical fluctuations in revenue are usually much larger than those of expenditure. The decrease of government revenue during recessions, accounts, on average, for four fifths of the cyclical deterioration of the government deficit, while the increase in expenditure only accounts for one fifth. Fourthly, that the cyclical impact on government budgets is both higher and more volatile in the smaller member countries than in the larger ones and finally, that the cyclical component varies, on average, by around 1 percentage point of GDP in either direction around its mean and that for all but two countries (Finland and Sweden) never surpassed the 3% of GDP value on either side.

The retrospective application of the Stability Pact shows, first, that an initially balance budget would have prevented all one year recessions from leading to a budget deficit above 3% of GDP in the year following the recession. Second, that the risk of incurring an excessive deficit, in case of protracted or severe recessions with negative growth of 2% or more, would be high, even if the starting point is a sound budgetary position and third, that when members countries start off with a balance budget, then, even in the event of breaching the 3% ceiling during the recession year, a fast budgetary adjustment to fend off the threat of sanctions is feasible.

Will the Stability Pact hold in 2002, when the trough of the present slow down will be reached or in 2003, when part of the trough will be reflected in the budgets? There are two countries, Germany and France, which could be very close to the limit budgetary balance of - 3% of GDP in 2002. The present consensus, among market analysts, is that Germany could reach -2.9% and France -2.6%. The ensemble of the Euro-Area could reach 2%. The main reason for this unpleasant surprise is that the official estimates of trend GDP have been, until now, too optimistic. The problem for both countries is that, as they are close to elections, they have introduced some discretionary expansionary measures.

In this context, the main and optimal collective objective should be to let the automatic stabilizers do their full compensatory work, and, at the same time, try to maintain intact the so-called "Brussels-Frankfurt consensus". That is, fiscal policy under the Stability Pact may accept cyclically induced increases in budget deficits, provided a balanced budget is reached over the medium term, and those which have not been able to reach it in 2000 or 2001, should fully refrain from any discretionary measure. It is much more important the speed of return to the balance budget than a temporary breach of the deficit barrier, especially if it is by a tiny percentage. Therefore, the medium term objectives of reaching budgetary balance by 2004 should not be subject to any kind of compromise or delay. If these basic consensus is

maintained a rise of the budget deficit of the Euro-Area to 2% of GDP should not pose any problem to the ECB softer monetary policy.

Finally, about the need to coordinate fiscal policy in the Euro-Area, it is important to remind policy makers that, according to the Mundell-Fleming framework, budgetary policy will, in principle, become more effective in dampening the size of cyclical fluctuations under the new policy environment of EMU, with centralized monetary policy and a single currency. However, as EMU increases the process of economic integration, leakages of budgetary policies will gradually increase, thereby reducing the domestic effectiveness of national budgetary policies. Therefore, unless national fiscal policies are coordinated, the changes in the budget deficits required in order to achieve the same degree of stabilization reached in the past will need to be much larger, making it necessary to change and soften the Stability Pact.

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