Box 8

DISCRETIONARY FISCAL POLICIES, AUTOMATIC STABILISATION AND ECONOMIC UNCERTAINTY

This box takes a look at the role of fiscal activism and automatic stabilisation in uncertain economic times. In view of recent calls for fiscal stimulus, this box highlights some of the dangers of a discretionary fiscal loosening, in particular the potential to increase cyclical economic fluctuations as well as the downside risks to medium-term growth and the upside risks to inflation. In addition, an activist fiscal stimulus could entail serious negative risks to fiscal outcomes, especially as a breach of the 3% of GDP reference value for the government deficit cannot be excluded for some euro area countries. These risks to fiscal soundness can be compounded by real GDP growth falling short of expectations and by a reversal of windfall revenues collected over the past years.

Assessing current calls for a discretionary fiscal stimulus

A discretionary fiscal policy attempting to fine tune the economy can have stabilising effects, but the size of the effect tends to vary depending on several factors and is generally assessed to be small.[1] What is not small, however, is the risk associated with such activist fiscal policies. Experience suggests that unless a discretionary fiscal stimulus is timely, targeted and temporary, it actually risks being harmful.

The reasons why fiscal policies frequently fail to meet the above-mentioned criteria and risk making matters worse are well documented.[2] As regards the first criterion of timeliness, fiscal policy is characterised by long lags regarding the design, decision and implementation of measures.[3] In the current uncertain economic environment, there is thus a risk that by the time the prospective fiscal impulse finally reaches the economy, the measures taken are no longer timely, but could indeed turn out to be pro-cyclical. There is some historical evidence of such pro-cyclicality, notably in euro area countries.[4]

A similar argument applies to the second criterion of fiscal measures being well targeted. Political calls for activism frequently point to the need to support particular groups in society. But in the political process of finding majority support, the group of beneficiaries risks being expanded beyond credit-constrained consumers to also include those who may be more inclined to hold on to the money rather than spend it. This reduces the effectiveness of fiscal activism.

Finally, there is a clear risk that tax cuts or spending increases that are intended to be temporary will, in practice, become permanent, as governments – for example those close to elections – tend to refrain from reversing new benefit programmes. This raises the risk of government debt accumulation and long-term fiscal sustainability issues. The build-up of debt that has plagued many countries is a reflection of the difficulties associated with fiscal activism. A more permanent fiscal expansion that increases the budget deficit may also imply higher domestic interest rates, generating unwarranted effects on private investment, which may then negatively impinge on growth.[5] Moreover, the rising budgetary costs from an ageing population underline the need to take the risks of an unintended permanent rise in deficits and debt seriously.

Beyond the risks that discretionary fiscal policy measures will not comply with the three criteria outlined above, there are additional caveats. First, high and volatile government spending and revenues may be harmful to growth as economic agents may postpone – or even refrain from – investment or consumption decisions.[6] Second, there is a risk that resorting to short-term activism will detract euro area countries from implementing growth-enhancing structural reforms. Empirical evidence suggests that countries that were early in pursuing fiscal consolidation benefited more

1 See, for example, "When does fiscal stimulus work?" Box 2.1. in IMF World Economic Outlook, pp. 70-75, April 2008, and R. Hemming, M. Kell and S. Mahfouz, "The effectiveness of fiscal policy in stimulating economic activity – a review of the literature", IMF WP/02/208, 2002.

2 See, for example, A. Fatás and I. Mihov, "The case for restricting fiscal policy discretion", Quarterly Journal of Economics, 118 (4), pp. 1419-1447, 2003.

3 The time-lag aspect regarding fiscal policies is highlighted by A. Blinder, "The case against the case against discretionary fiscal policy", CEPS Working Paper 100, June, 2004.

4 See OECD Economic Outlook, "Fiscal policy and institutions", 74, pp. 125-137, December 2003 and A. Turrini, "Fiscal policy and the cycle in the euro area: The role of government revenue and expenditure", European Commission Economic Papers, No. 323, 2008.

5 See, for instance, A. Afonso and M. St. Aubyn, "Macroeconomic Rates of Return of Public and Private Investment: Crowding-in and Crowding-out Effects", ECB Working Paper Series, No. 864, 2008.

6 See A. Afonso and D. Furceri, "Government Size, Composition, Volatility and Economic Growth", ECB Working Paper Series, No. 849, 2008 and Fatás and Mihov, 2003.

afterwards in terms of output growth than countries that were either slower or altogether failed to implement reforms.[7] While the causality is often difficult to pin down, it may be the case that governments that opt for short-term activist fiscal policies may lose the focus and resolve required to pursue structural reforms that would be beneficial for potential growth in the medium term.

Automatic stabilisation and policy implications

The Stability and Growth Pact provides appropriate guidance for the conduct of fiscal policies in the euro area. In particular, it specifies the adjustment path for the structural budget balance towards a country-specific "close to balance or surplus" medium-term objective (MTO). These MTOs have been set at a level that ensures fiscal sustainability and provides sufficient leeway against breaching the 3% of GDP reference value for the government deficit under normal economic fluctuations. Indeed, those countries that have achieved their MTO are free to let automatic stabilisers operate and thus contribute to smooth economic fluctuations.[8] The more euro area countries are in such a position, the more scope there will be for the automatic stabilisers at the aggregate euro area level to operate freely, thereby contributing to a smooth functioning of EMU.

The advantages of being able to let the automatic stabilisers operate are well known. They are not subject to time-lags in decisions in contrast with discretionary measures. Moreover, they are not subject to political decision-making processes and their economic impact adjusts automatically to the cycle.[9] At the same time, hard earned experience from the last decades suggests caution. Recent evidence supports the advantage of automatic stabilisers, but indicates that government expenditure levels above 40% of GDP no longer bring any additional stabilisation benefits.[10] Moreover, the operation of automatic stabilisers on the expenditure side may be misused as an excuse to exceed public spending limits, a situation which could be difficult to reverse. Last but not least, there is also considerable uncertainty about the measurement of output gaps and thus about the extent to which automatic stabilisers are already impacting on the economy.[11]

To sum up, euro area countries with large government deficits and still high government debt ratios need to give priority to complying with the consolidation requirements of the Stability and Growth Pact with the aim of meeting their MTO. Attaining the MTO will give countries scope to let automatic stabilisers operate freely and fully, thereby contributing to smoothing the business cycle. They should thus resist the temptation of fiscal action to fine tune the economy in the short term, as they may end up harming long-term growth and fiscal sustainability. In this respect, euro area governments would be well advised to heed the lessons from the 1970s and ensure consistently sound and prudent fiscal policies. Finally, a discretionary fiscal stimulus also bears inflation risks. In the current environment, with inflation in the euro area standing at elevated levels, additional impulses from fiscal policy would further increase the risks to price stability. Even small fiscal impulses could potentially have lasting negative effects if they contribute to higher inflation expectations.

7 See S. Hauptmeier, M. Heipertz, and L. Schuknecht, "Expenditure reform in industrialised countries – A case study approach", Fiscal Studies, 28 (3), pp. 293-342, 2007.

8 Social payments, such as unemployment benefits, are expected to increase and tax revenues and social contributions are expected to decline automatically in downturns and vice versa in upturns.

9 On the size of automatic stabilisers, see for example, A. Fatás, and I. Mihov, "Government size and automatic stabilisers: international and intranational evidence," Journal of International Economics, 55 (1), pp. 3-28, 2001.

10 See X. Debrun, J. Pisani-Ferry and A. Sapir, "Government size and output volatility: should we forsake automatic stabilisation?", IMF WP/08/122, 2008.

11 Differences between real-time output gap and those after final GDP revisions are documented by A Orphanides and S. van Norden, "The Reliability of Inflation Forecasts Based on Output Gap Estimates in Real Time", Journal of Money, Credit and Banking, 37 (3), pp. 583-601, 2005, and in "The (un)reliability of output gap estimates in real time", ECB Monthly Bulletin box, February 2005, while automatic stabilisers are discussed in "The operation of automatic fiscal stabilisers in the euro area", ECB Monthly Bulletin article, April 2002.