POSSIBILITIES AND LIMITS OF THE USE OF COUNTER-CYCLICAL FISCAL POLICY IN EURO AREA COUNTRIES

Assoc. Prof. Marta Martincová, PhD.
University of Economics in Bratislava, Slovakia

ABSTRACT

If a country becomes part of a monetary union, it loses one of the key macroeconomic stabilization instruments, the monetary policy. Fiscal policy, therefore, appears to be an ideal tool in the event of asymmetric shocks and should fully replace monetary policy instruments. In general, fiscal policy should act counter-cyclically. This means that at a time of economic slowdown, when household incomes are low, corporate profits are declining and consumption is low, tax revenues are falling, and unemployment support spending and other social benefits are increasing. As a result, expenditures in the state budget are growing and fiscal policy is automatically expansive. The 2008 crisis has had a negative impact on euro area economies. The euro area governments' stimulus measures were to complement the role of automatic stabilizers, taking into account that they were in line with the Stability and Growth Pact and the Lisbon Strategy for Growth and Jobs. In the event of a cyclical downturn, automatic stabilizers provide an automatic bumper for private demand through state budget measures. They mainly reflect rising unemployment and other social security benefits on the expenditure side and a decline in tax revenue on the revenue side. On the contrary, they operate in the case of a cyclical recovery, when automatic budget measures hinder private demand. In our paper, we analyze the situation, if automatic stabilizers provide an automatic bumper for private demand through built-in state budget measures in the case of a cyclical downturn. From the methodological point of view, we used mainly the comparison method, on the basis of which we compare the use of countercyclical fiscal policy in individual selected euro area countries. A fiscal position is commonly used to measure the impact of discrete fiscal policies on government finances. Fiscal stimulus packages adopted by individual governments in response to the economic crisis are a subset of discrete fiscal policies. However, the fiscal position is also influenced by political factors that are beyond government control. Correct measurement of the fiscal position may be disrupted by incorrect estimation of the output gap in real time, which complicates the distinction between cyclical and politically related changes.

Keywords: *fiscal policy, counter-cyclical measures, fiscal position, fiscal stimulus*

INTRODUCTION

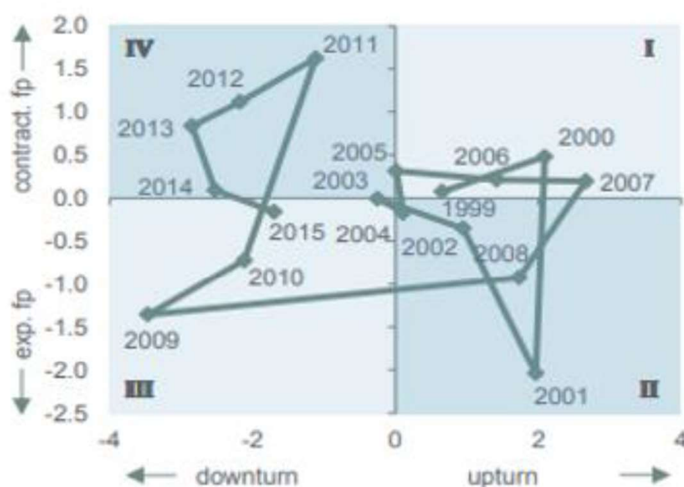
The issue of financial crises and fluctuations in economic performance has brought more attention to both economists and politicians, as well as to the general public in the context of the financial and economic crisis of 2008. After the emergence of economic and monetary union in Europe, with respect to the economic cycle and cyclical developments, fiscal policy is increasingly playing crucial role. Our contribution is focused on assessing the impact and effects of fiscal policy instruments on the economic cycle in the euro area.

PROTICYCLIC VERSUS PROCYCLIC FISCAL POLICY

There is a very large amount of fiscal policy literature, but it is difficult to characterize what type of fiscal policy would be most appropriate during the business cycle. In general, fiscal policy should be countercyclical. This means that at a time of economic slowdown, when

household incomes are low, corporate profits are declining and consumption is low, tax revenues are falling and expenditures on unemployment support as well as on other social benefits are rising, the fiscal policy should be executed in the direction of boosting economic growth and employment. As a result, budget spending is growing and fiscal policy is automatically expansive. However, in many cases, fiscal policy is actually pro-cyclical, aggravating the economic cycle and making monetary policy more difficult. In analyzing the cyclical behaviour of fiscal policy, we must understand that the resulting fiscal policy is the result of a combination of automatic stabilizers and discretionary policy. Discretionary fiscal policies are generally seen as a weak instrument of macroeconomic stabilization during normal economic cycles. Firstly, fiscal measures, in particular new programs, need to be adopted and implemented. Secondly, fiscal measures to support the economy are usually difficult to reverse. After they had been implemented, their cancellation faces disagreement from the group of people that have had previously supported these fiscal measures. Thirdly, it is difficult to estimate the size and timing of fiscal stimuli. There is therefore a risk that the economic impact of discrete fiscal stimulus will begin to manifest itself as the economy is already in the growth phase, causing the instrument to be pro-cyclical instead of countercyclical. In exceptional circumstances, automatic stabilizers themselves may also be considered insufficient to mitigate the very harmful and long-lasting impact of deep cycling fluctuations. Deviations from optimum fiscal policy performance are manifested by leading to an excessive deficit and a tendency for fiscal policy to be pro-cyclical. Fiscal policy could in principle be pro-cyclical without leading to a deficit, but it is largely the result of an inability to control spending increases and tax cuts in "good times" and are therefore it is closely linked with budget deficit. Figure 1 shows the euro area fiscal position and hence the impact of fiscal policy on its economy between 1999 and 2014. Quadrants I and IV show years of fiscal consolidation, while quadrants II and III years show expansionary fiscal policy. The fiscal position is compared with the economic situation measured by the output gap. Quadrants I and III identify years of countercyclical fiscal policy. In these cases, the economic upturn coincided with fiscal consolidation (quadrant I) and declined with fiscal expansion (quadrant III). A coordinated fiscal response would probably alleviate the difficulties of the recession in countries affected by the crisis, but fiscal consolidation in all countries, including those that did not, has aggravated the situation. Figure 1 shows how fiscal policy was strongly pro-cyclical in 2011-2013, worsening the general recession in the euro area. Veld and Rennarberg estimate that fiscal consolidation in 2011-2013 has caused euro area GDP loss of between 8% to 20%, depending on the countries under review [4].

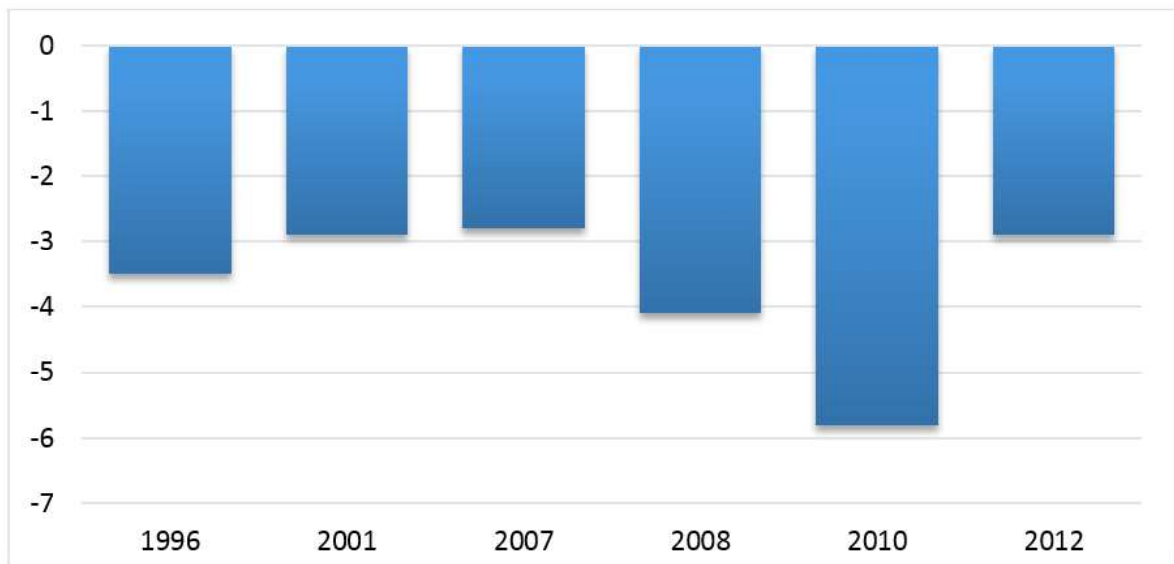
Figure 1: Procyclical fiscal policy in times of debt crisis



X-axis - output gap of the euro area,% of potential GDP,

Y-axis: change in the cyclically-adjusted euro area surplus, p. b. year on year. Source: EHMER, P. 2016. Fiscal policy in the euro area – greater focus on the economic cycle and closer coordination between member states. In KFW. 2016, research no. 139. [3]

Figure 2: Cyclically-adjusted euro area budget balance in previous expansion and contraction



Source: European Central Bank [5]

A period of prolonged expansion persisted in the euro area between 1996 and 2007. The slight pro-cyclicality or neutral attitude that prevailed during the expansionary phase before the financial crisis did not lead to the creation of the necessary buffers for the future recession. During the whole period of expansion that preceded the economic crisis, insufficient fiscal reserves were created. In Figure 2, we see that the euro area has entered into a crisis with a cyclically adjusted balance - 2.8%, which deteriorated even further in 2008-2010 by almost 3% of GDP points. It reached -5.8% in 2010 and the debt-to-GDP ratio increased by almost 20 percentage points of GDP.

FISCAL IMPULSE AND ITS COMPONENTS

The 2008 crisis has had a negative impact on economies around the world. The difficulties were in the financial sector as well as the growing mistrust of private consumption, investment and international trade. National governments have responded by increasing their activity, in two ways, through automatic stabilizers and fiscal stimuli through discrete spending or tax cuts. G20 leaders decided to use fiscal measures to stimulate domestic demand, given the expected economic downturn due to the financial crisis, at the Washington Summit on 15 November 2008. On 16 November 2008, the European Commission launched a European Economic Recovery Plan to ensure a coordinated short-term budgetary impulse for demand, while strengthening competitiveness and potential growth. The total package of measures was EUR 200 billion, representing 1.5% of the European Union's GDP. Member States were invited to contribute about € 170 billion, or 1.2% of GDP, while the European Union and the European Investment Bank amounted to some € 30 billion, 0.3% of GDP. Stimulation measures should complement the role of automatic stabilizers, taking into account that they were in line with the Stability and Growth Pact and the Lisbon strategy for growth and jobs. Budget support or a fiscal impulse that the government can realize in the economy reflects the initial dynamics of public support for the economy, which is largely reflected in the year-on-year change in the general government budget balance as a share of GDP. Fiscal impulse can be divided into three categories. The first is the operation of automatic fiscal stabilizers linked to the business cycle, which is equivalent to changing the cyclical component of the budget. The second category is a fictitious position

consisting of discretionary fiscal policy measures and more than political factors captured by changes in the cyclically-adjusted (or structural) primary balance. The last third category is interest payments, which represent the financial flow between the government and other sectors in the economy and can therefore be seen as part of a fictitious impulse. In the event of a cyclical downturn, automatic stabilizers provide an automatic bumper for private demand through state budget measures. They mainly reflect rising unemployment and other social security benefits on the expenditure side and a decline in tax revenue on the revenue side. On the contrary, they act in the case of a cyclical recovery, when automatic budget measures hinder private demand. A fiscal position is commonly used to measure the impact of discrete fiscal policies on government finances. Fiscal stimulus packages adopted by individual governments in response to the economic crisis are a subset of discretionary fiscal policies. However, the fiscal position is also influenced by political factors that are beyond government control. Correct measurement of the fiscal position may disrupt the estimation of the output gap in real time, which complicates the separation of cyclical and politically related changes. Details based on the estimated size of the fiscal impulse and its components for the euro area are presented in Table 1. The analysis of the components of the fiscal impulse at the bottom of the table is based on annual changes in the GDP ratio, with the deterioration of the relevant balance indicating a positive stimulus. The overall fiscal impulse for the euro area is projected to rise substantially by around 4.4 percentage points of GDP in 2009, as a result of the decline in the government budget balance, and by 0.5 percentage points more in 2010. The impact of automatic stabilizers from the overall fiscal impulse is about half, at 2.4 percentage points of GDP, while the other half is more relaxed.

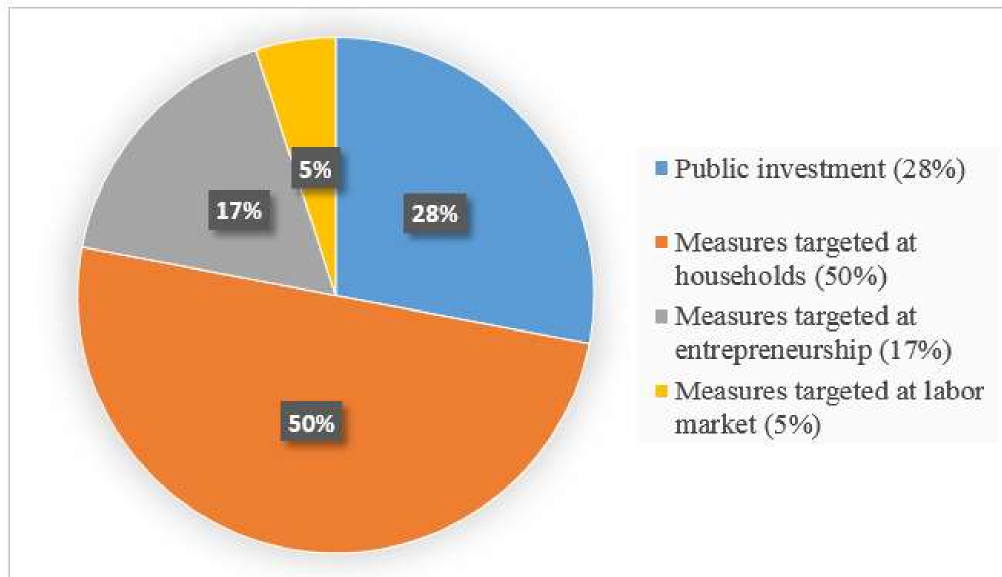
Table 1: Fiscal impulse and its components in the Euro area

	2008	2009	2010
FISCAL POSITION (% of GDP)			
State budget balance	-2	-6.4	-6.9
The cyclical component of the state budget	0.9	-1.4	-1.4
Cyclically adjusted state budget	-2.9	-5	-5.4
Interest expenditure	3	3	3.2
Cyclically adjusted primary balance	0.1	-2	-2.2
Fiscal stimulus packages		1.1	0.8
FISCAL IMPULSE (ANNUAL CHANGE OF P.P. GDP)			
Change in the state budget balance	-1.4	-4.4	-1.5
Fiscal impulse	1.4	4.4	1.5
cyclic component - automatic stabilizers	0.3	2.4	0
cyclically adjusted primary balance	1	2.1	0.2
interest expenditure	0.1	0	0.2
Change in fiscal stimulus packages		1.1	-0.3

Source: European Central Bank [6]

A detailed composition of the fiscal stimulus packages for the euro area is shown in Figure 3.

Figure 3: Fiscal stimulus measures 2009-2010



Source: European Central Bank [6]

The graph shows the composition of fiscal stimulus measures in 2009-2010 in terms of budgetary impact. In these years, four categories of euro area countries were supported. Most governments have taken measures to support household purchasing power, notably through the reduction of direct taxes, social security contributions and VAT, as well as through direct aid, such as income support for households.

CONCLUSION

Eurozone countries have used different combinations of government spending and tax cuts to boost economic growth in response to the 2008 crisis. In our opinion, national fiscal policy measures produce effects that have an international impact, especially in the area of the common currency, such as the euro area. Thus, cross-border tax penetrations linked to trade ties, a high degree of financial market integration and consistent monetary policy response are also important factors to be considered in the euro area. There is also very limited harmonization of spending and tax policies. Through these channels, a Member State's fiscal imbalance can affect the fiscal position of other Member States. These side effects can act in two ways. They either result in an improvement or deterioration in the fiscal position of neighboring countries. Negative side effects have been addressed by several authors, such as Caporale and Girardi [2]. They point out that the governmental yields of individual euro area countries are very closely linked and that the deterioration of one country's fiscal position can be passed on to borrowing costs of other Member States. But fiscal impacts can also be positive. Fiscal prosperity in one country can benefit its business partners by increasing demand for goods and services exports. This view is based on several empirical documents such as Giulidori and Beetsma [1] and others. In my opinion, the problem with national fiscal policy is that only the impact on the economy is usually taken into account and the wider effects are being neglected. The result is a great divergence in the fiscal policy stance of the various economies. This results in less effective fiscal policy in the euro area as a whole.

ACKNOWLEDGEMENTS

This paper was prepared within the frame of research project VEGA No. 1/0246/16 entitled "Efficiency of fiscal and monetary policy during the economic cycle".

REFERENCES

[1] Beetsma, R. – Giuliodori, M. – Wierts, P. 2009. Planning to cheat: EU fiscal policy in real time. In Economic Policy. 2009, Vol. 24, No. 60 (Oct., 2009), pp. 753-804. Available at: https://www.jstor.org/stable/40272536

[2] Caporale, G. M. – Girardi, A. 2011. Fiscal spillovers in the euro area. In DIW Berlin. 2011, DIW Discussion Papers, No. 1164. Available at: https://www.econstor.eu/bitstream/10419/61323/1/72222138X.pdf

[3] Ehmer, P. 2016. Fiscal policy in the euro area – greater focus on the economic cycle and closer coordination between member states. In *KFW*. 2016, research no. 139. Available at: https://www.kfw.de/PDF/Download-Center/Konzernthemen/Research/PDF-Dokumente-Fokus-Volkswirtschaft/Fokus-englische-Dateien/Focus-No.-139-August-2016-Fiscal-policy-in-the-euro-area.pdf

[4] Rannenberg, A. – Schoder, C. – Strásky, J. 2015. The macroeconomic effects of the Euro Area's fiscal consolidation 2011-2013: A simulation-based approach. In IMF Working Paper [online]. 2015, no. 156

[5] European Central BankCB, available at : https://www.ecb.europa.eu/pub/pdf/other/ebbox201802_07.en.pdf?f54f555123c91bba3f3691bbf9c1075b

[6] Europen Central Bank, available at: https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp109.pdf?fbclid=IwAR3mhJgyy7fP52_l9GYQ5Zz7ET0vMW0byWQibtUiQVIupJzcOkXdavU20Ek