Constricted, lame and pro-cyclical?
Fiscal policy in the euro area revisited

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It is often argued that fiscal stabilisation in the euro area compares unfavourably with the US, not least because of the perceived limitations that the 3% deficit threshold of the Stability and Growth Pact imposes. This paper takes issue with this perception by taking a closer look at fiscal policy making in the euro area and the US since the mid-1990s. It examines a number of elements which are generally overlooked or not considered in the analysis of fiscal stabilisation.

In particular, on top of discretionary fiscal policy, which generally is at the core of existing studies, the paper also takes into account the size of so-called automatic stabilisers. These are budgetary arrangements which produce a stabilising effect on the economy over the cycle without requiring discretionary interventions by fiscal authorities. The two elements most frequently stressed to exert this effect are progressive tax systems and unemployment benefits. Tax revenues increase more than proportionally when GDP rises and similarly expenditure for unemployment benefits drop in economic good times, which improves the fiscal position and produces a countercyclical effect. However, the bulk of automatic stabilisation originates not from those two factors but rather from the size of government. In particular, it is the inertia in adjusting the level of non-cyclical expenditure – the majority of public spending – that produces the largest stabilising effect: governments generally do not close schools, fire doctors or leave infrastructure projects unfinished during a downturn. In other words, the implementation of discretionary expenditure levels in line with plans leans against the decline or increase in aggregate output. Because of the significantly larger government sector in the euro area, automatic stabilisers have played a more important role than in the US. Taking this into account, the track record of fiscal stabilisation in the euro area looks less dire.

The paper also considers the difference between fiscal policy intentions, as formulated or perceived in real time, and actual outcomes. Some episodes in the euro area which in hindsight are assessed to be clear examples of pro-cyclical discretionary policy were in fact not in the budget plans. But eventually policies contributed to the cycle, rather than smoothing it, because expenditure plans were not adjusted as sometimes rosy medium-term economic growth projections did not materialise. The years 2000 and 2001, when the dot.com bubble burst, are prime examples. The US, on the other hand, made smaller forecast errors which meant that the planned fiscal stance was more closely in line with the actual. Another factor that contributed to the worse track record in the euro area than the US was the spending of windfall revenues in economic good times and the re-adjustment of spending during subsequent downturns.

To tackle these shortcomings in the euro area, the paper provides some policy considerations. They include foremost strengthening fiscal governance. Strong national budgetary
institutions, such a numerical fiscal rules, could contribute to greater fiscal discipline. Moreover, better fiscal governance could also help remedy the overoptimistic macroeconomic forecasts by involving independent institutions in preparing the macroeconomic assumptions for the budget. And finally, implementing structural policies, in line with the Lisbon Strategy for Growth and Jobs, would make Europe's economies more resilient to shocks.

In addition to this longer-term perspective, the paper also puts the analysis into the current context of the financial crises and global recession. While the US have quickly opted for a fiscal stimulus package, the euro area started to seriously consider a co-ordinated response only late in 2008 under the initiative of the Commission's European Economic Recovery Plan launched on 26 November 2008. This seemingly lagged or slow reaction on this side of the Atlantic should, however, not be read as a sign of political failure or indifference. Rather, there are good arguments that explain more caution and country-differentiated responses in fiscal stimulus measures in the euro area. This includes first the larger role of automatic stabilisers compared to the US. Second, in a number of euro-area countries the current crises reflects a supply shock that requires some adjustment of the economy (e.g. the oversized construction sectors in Ireland and Spain) which cannot be cured with fiscal stabilisation. And third, in spite of the impressive progress made over the past several years, the underlying fiscal situation in a number of euro-area countries does still not ensure sustainability especially in the light of the imminent budgetary impact of ageing populations. The financial crisis and the contingent liabilities taken on board by governments have further endangered sustainability. However, the belated discussions in the euro area on the need for fiscal stimulus measures may again also reflect the overoptimistic assessment of the growth outlook in contrast to the quicker downward adjustments in the US projections.