Fiscal stabilization policy

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Financial crisis

• What is the scope for fiscal stabilization policy?

• The role of fiscal space

• Fiscal rules – are they too tight?
Stabilization policy

- Financial crisis caused by fundamental unbalances
- Can the consequences be muted by stabilization policy?
- Structural (re)adjustments required
- Many proposals resemble policies from th 1970s and 1980s – the track record is not that good!
- Too much focus on discretionary policies – don’t forget the automatic stabilizers!
Fiscal policy – automatic stabilizers and discretionary policy

OECD Countries 2009-13

Expansion

Automatic stabilizers

Contraction

Discretionary

Expansion

-16 -14 -12 -10 -8 -6 -4 -2 0 2 4 6 8 10

Automatic stabilizers

Expansion
Automatic stabilizers - properties

- Cushion individual disposable income = insurance to risk-averse agents.
- Contribute to stabilization of disposable income and hence private consumption and aggregate demand
- Mute the consequences of economic crises on income inequality
- Rule-based policy response – low information requirements, not dependent on discretionary policy choices
Fiscal space

• Room for stabilization policy (automatic stabilizers + discretionary policy) requires fiscal space

• Asymmetry in public finances:
  – Deficits and increasing debt in bad times
  – No consolidation in good times

• Unresolved problems of fiscal sustainability
Systematic deficit bias – failure to consolidate public finances prior to crisis

Public debt, % of GDP, OECD

% of GDP

Needed fiscal tightening
Permanent improvement in primary balance

Ensuring that public debt is no larger than 60% of GDP in 2030
Lack of fiscal space = welfare state retrenchment

Planned fiscal tightening 2011-2013 – EU countries

- Tax increases
- Expenditure cuts

% of BNP

Countries: PRT, GRC, ITA, HUN, IRL, POL, ESP, FRA, ISL, SVN, AUS, GBR, BEL, CAN, USA, CZE, NLD, NZL, FIN, KOR, SWE, ISR, AUT, DEU, EST, DNK, JPN, CHE, LUX, NOR.
Fiscal rules

• Needed to create discipline

• Do not hamper stabilization policy – create the room for them to operate

• EU – rules were in place, but not followed!

• New rules are too inflexible
  – Risk of enforcing counter-cyclical policies
  – Fine-tuning is difficult
Fiscal rules

- The excessive deficit procedure (Maastricht Treaty)
  - Deficit and debt limits (3% and 60%)
  - Monitoring and sanctions

  - "Close to balance or above"/cyclically adjusted budget balance
  - Stronger surveillance (convergence/stability reports)

- Stability and Growth Pact Reform (2005)
  - More flexible – differentiating budget objectives
  - Fiscal sustainability

- Fiscal Compact (2012)
  - Structural deficit not to exceed 0.5% of GDP
  - Correction mechanism
  - Budget laws
• The scope for fiscal policy is often overrated

• Fiscal policy matters – but it is difficult and requires fiscal space

• Fiscal rules are important – but should take the overall fiscal stance into account