# THE DISCRETIONARY FISCAL POLICY IN THE EUROPEAN ECONOMIC AND MONETARY UNION

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***Abstract***

*This paper reviews the macroeconomic use of national fiscal policy within the European Econ omic and Monetary Union and the effect the discretionary fiscal policy has on the economic activity. It also considers the difference between policy intentions, as formulated or perceived in real time, and actual outturns, and possible reasons for the gap between the two. The analysis of the stance of national fiscal policies finds evidence that the quality of fiscal policies has improved in two ways: they are more clearly countercyclical – or less procyclical – and they are more readily used to restore competitiveness than to attempt to boost demand when competitiveness is eroded. In Sections IV and V there are presented two successful cases of discretionary fiscal stabilisation, respectively the lessons to be drawn.*

**Key words**: Fiscal policy, fiscal stabilization, Stability and Growth Pact, monetary union, euro, EMU.

**JEL classification**: E61, E62, E63

## 1. INTRODUCTION

The Euro area will likely remain for a long time a one-of-its kind arrangement with a centralized monetary policy and decentralized fiscal policies. This is, after all, the same arrangement as in most federal states, with two key differences. First, in Europe, the "federal" budget is very small and largely automatic. Second, in contrast with many federations where decentralized budgets are subject to strict imbalance limits while the centre carries out fiscal policy, Europe's centralized budget must be balanced while sub-central budgets are in charge of fiscal policies.

That fiscal policy can be used as a macroeconomic policy tool does not mean that governments do so in an appropriate way. A long tradition has identified a number of lags – recognition, decision, implementation – which could result in badly timed effects. An equally long tradition has pointed out that governments may be more motivated by political gains rather than by economic management concerns. If fiscal policy actions are not driven by a macroeconomic stabilization motive, it may not be systematically countercyclical. The question, then, is whether euro area membership affect policymakers' incentives and, if so, how. A first place to look at is the Stability and Growth Pact (SGP). On one hand, it can help governments to resist pressure from interest groups and therefore improve the quality of fiscal policy. On the other hand, it reduces the room for manoeuvre and lead to pro-cyclical policies.

Another consideration is the fact that the exchange rate is no longer available to boost external competitiveness, with two opposite potential effects on the conduct of fiscal policy. First, governments may be tempted to use fiscal policy instead of monetary policy to counteract a temporary competitiveness loss when a euro appreciation reduces domestic demand. A different case concerns a loss of external competitiveness due to domestic inflation or to a relative productivity decline. In a monetary union, external competitiveness can only be restored the hard way, through sustained cost and price moderation or enhanced productivity gains. Fiscal policy is no longer a substitute to monetary policy (1). Its only possible macroeconomic contribution is to encourage cost and price moderation, possibly by restricting demand in goods and labour markets. This would make fiscal policy countercyclical during upswings and a-cyclical during downswings as long as the exchange rate is overvalued.

All in all, the impact of the adoption of the euro on the macroeconomic use of fiscal policy is ambiguous. We expect more countercyclical action as fiscal policy substitutes for the lost monetary policy instrument, less use of this instrument in downswings as a result of the SGP, especially in countries where the budget deficit is not far enough from its 3% ceiling and an asymmetric use for countries with an external competitiveness shortfall.

## 2. THE EFFECT OF DISCRETIONARY FISCAL POLICY ON ECONOMIC ACTIVITY

The question of the usefulness of fiscal policy as a macroeconomic tool is highly controversial. At the theoretical level, the debate pits (neo)classical against (neo)Keynesian macroeconomists. The former asserts that, one way or another, consumers and firms view public debts as their own liability; accordingly, they reduce their expenditures whenever the debt increases or diminishes less than previously expected. The latter relies on price stickiness, borrowing constraints and/or other market imperfections to find that fiscal policy can affect output. In view of such conflicting theoretical results, the verdict should come from empirical studies.

Empirically, too, the issue is controversial. Some authors find that fiscal policy affects the output, even though the multipliers are small and have possibly declined in recent years. Others find that consumption moves in an offsetting direction, although the offset effect is partial, which leaves a small output effect. The reason why different authors reach different results is that, even if all of them use variables estimates to pinpoint the relationship between output and fiscal policy, and the cyclically adjusted balance as a measure of the fiscal policy stance (2), they differ in the way they identify the variables. Those who find a positive effect of fiscal shocks on consumption, and therefore output, typically use quarterly variables and make the assumption that there is no contemporaneous effect from cyclical conditions to policy discretionary actions.

Despite the conventional macroeconomic thinking that fiscal policy can and should contribute to smoothing temporary swings in aggregate economic activity, pro-cyclicality of fiscal policy remains a widespread phenomenon around the world. Studies find that in developing and middle income countries fiscal policy has frequently moved with the cycle. For developed economies the findings are more nuanced and depend on the time period and countries considered. When fiscal policy has been pro-cyclical in industrial countries, it has mostly been so in good economic times (Manasse, 2006 and Alesina and Tabellini, 2005). The deficit bias in good times has largely been attributed to political economic motives as policy makers may attach more weight to objectives other than the stabilisation of output. In particular, when competing for public resources ministers neglect the repercussions of their decisions on overall public finances. This 'common pool problem' gets worse in good economic times as more overall resources are available.

The pro-cyclicality of fiscal policy has also emerged as a characteristic of the euro area (Langedijk, 2004). Since the early 1990s, when EU Member States agreed to establish an economic and monetary union and started preparing for the single European currency - which was effectively introduced in 1999 - repeated episodes of pro-cyclical fiscal policy have been observed. On the face of it, these episodes seem to have vindicated critics who have argued that the SGP would seriously hamper the stabilisation function of fiscal policy. Such judgement was passed well before the SGP came into force - for instance by Buiter et al. (1993) - and was reiterated more forcefully - for instance by Canzoneri and Diba (2001) and Calmfors (2003) – a few years after its inception.

However, available econometric evidence on how the EU fiscal framework may have affected fiscal stabilisation in the countries adopting the single European currency is not necessarily discouraging. The introduction of the euro does not seem to have weakened the ability of fiscal policy to stabilise cyclical swings in general. Gali and Perotti (2003) were among the first to conclude that the SGP has not impaired the stabilisation role of fiscal policy. They actually find that a clear pro-cyclical pattern in the pre-Maastricht period has given way to a more counter- or a-cyclical trend after 1991. Similarly, Fatas and Mihov (2003) document that the SGP constraints seem to have mitigated the various influences that are believed to distort the use of the fiscal policy instrument. But these findings need to be qualified on at least three accounts.

First, the estimated improvement in the stabilisation property of fiscal policy in the euro area after 1991 masks a significant change in the behaviour across the different phases of the economic cycle. In the period preceding Maastricht (1980-1991), there is a clear pro-cyclical stance in both stages of the cycle: the fiscal stance is on average expansionary in good times and contractionary in bad times. The pattern changed in the second sub-period (1992-1998) when the countries, in an effort to fulfil the Maastricht criteria for adopting the euro, ran on average tight fiscal policies irrespective of the cyclical position (3). After the introduction of the SGP and the single currency in 1999, the pattern has shifted back to what it was in pre-Maastricht times with pro-cyclicality in good times being particularly pronounced.

A second important *provisio* to keep in mind when considering the findings of Gali and Perotti (2003) is that the panel estimates may not necessarily capture the correct policy implications. While ensuring statistical rigour, panel estimates attach the same weight to each country independently of its relative size in the euro area. Consequently, emerging statistical regularities may not reflect the factors that actually shape the policy stance and, in turn, the policy mix in the monetary union as whole. In particular, they do not appropriately highlight the role played by the fiscal performance in large euro-area countries, whose behaviour ran afoul with the provisions of the SGP and eventually led to the crisis of the Pact in 2003 (Buti and Pench, 2004). Even if all euro-area countries run a counter-or a-cyclical fiscal policy, except Germany, France and Italy (as was for instance the case in the early 2000s) the overall policy stance of the euro area would still be pro-cyclical.

And third, Gali and Perotti's study accounts only for the period up to 2002 and therefore does not capture the pro-cyclical episodes since. Across the EU-11 nearly half the years since 2002 were characterised by a pro-cyclical stance. Since this included the largest members of the monetary union this has translated into pro-cyclicality for the euro area as a whole.

To underscore the alleged shortcomings of the EU fiscal framework, critics often called attention to the US experience since the mid-1990s where, *prima facie*, fiscal stabilisation appears to have been more successful. Based on the traditional analysis which looks only at the role of discretionary fiscal policy, fiscal policy in the euro area emerges as having been more pro-cyclical than that of the US. The euro-area fiscal policy was characterised by strong pro-cyclical fiscal tightening in the run-up to EMU, followed by an adjustment fatigue that created a pro-cyclical fiscal loosening despite sustained economic growth (2000-2001). When economic conditions deteriorated from 2002, fiscal policy tightened again and then moved towards a neutral stance during the upswing in 2005-2007. This pattern seems to be in contrast with the experience recorded in the US where discretionary fiscal stance has largely helped to stabilise the economy even though this was not the explicit and prime objective of fiscal policy in every year. In particular, the sharp turnaround from a cyclically-adjusted primary surplus in 2000 to a deficit of more than 3% of GDP in 2002 was not only a response to the economic slowdown following the bursting of the information society and technology (ICT) bubble in 2001. Rather, it largely reflected (i) the increase in defence spending linked to the war in Iraq and (ii) tax cuts with an electoral motive.

## 3. THE STANCE OF FISCAL POLICIES

Assessing the stance of fiscal policies is complicated since the cyclical position of the economy is not always clear. From the point of view of fiscal policy the most common measure of the cyclical position of the economy has traditionally been the output gap. The first ten years of EMU then roughly coincides with a full cycle, consisting of three phases, dubbed “boom” (or "good times"), “downturn” and “recovery”. A boom is defined here as an episode in which the gap is positive and increasing. A downturn is called if the gap is falling and turning negative and a recovery is called when the negative gap is closing (4).

There is a strong resemblance with the previous cycle, which according to the same criteria also spanned ten years (1989-1998) and portrayed a similar time profile for the output gap. For the assessment of the stance of fiscal policy it is important to consider that governments may have been led by quite different perceptions of the cyclical position of the economy than suggested by the output gaps as estimated ex post. Comparing the actual (ex post) evolution of the output gap in the euro area with that observed in real time, it can be observed a much smaller variation of the level and changes of the output gap ex ante than ex post, a phenomenon that is common to virtually all participating countries. Apparently, most countries did not perceive the relatively hefty cyclical swings going on at the time. More specifically, many countries did not recognise the positive values and saw much smaller increases of the output gap in 1999-2000. They were also largely unaware of the extent of the 2001-2003 downturn. The record of Euro area countries with respect to the errors in assessing the cyclical position of the economy over this period compares unfavourably with that of the United States where revisions of the output gap have been relatively small since 2000 (5).

Political economy factors play a role in explaining why official macroeconomic forecasts in EMU display systematic optimism about medium-term economic growth and – by extension – of potential output during upswings. While most forecasters had a tendency to overstate growth prospects in the early 2000s, in a number of large euro-area countries, the macroeconomic scenarios underpinning budget plans exhibited a rather persistent upward bias (Jonung and Larch 2006). These optimistic growth projections biased the estimated trend growth upward and as a result potential output was overestimated and the real time output gap accordingly underestimated. This bias may be partly the result of the incentives generated by the SGP itself. Indeed, an overestimation of potential output is "convenient" in the sense that it puts a favourable gloss on the annual stability programmes by easing the move towards the close to balance or surplus requirement over the medium term (since a bigger share of fiscal deficits will be labelled "cyclical"). Ex post, however, it causes budgetary slippages as expenditure levels are typically not immediately adjusted in the face of lower than projected economic growth and the associated lower than projected revenues.

The issue then becomes how fiscal policy, as gauged by the change in the cyclically-adjusted primary balance as a share of GDP, behaved during the cycle, both in real time and ex post. Differences between the two largely reflect the assessment of the output gaps as revisions in the nominal budget numbers themselves have been comparatively minor (6). Looking at the record in more detail, the following can be inferred:

- In an *ex post* sense, although pro-cyclicality has not been widespread in the 1999-2000 boom, on aggregate the stance was slightly stimulatory. This does not compare unfavourably with the boom of 1989-1990, when fiscal policy was clearly eased in a pro-cyclical manner in the vast majority of countries – with the notable exceptions of Italy and Belgium where high debt levels and an associated surge in debt servicing forced fiscal consolidation upon them. However, the ex post observed neutrality was not in the plans in most countries *ex ante*, with the real time measure suggesting that, on average, the fiscal stance was tightening – *i.e.* counter-cyclical. This reflects the underestimation of the extent of the boom and hence the cyclical component of fiscal gains.
- In the 2001-2003 downturn the fiscal stance was stimulatory in most countries (except for Spain, Portugal and Austria) in an *ex post* sense – *i.e.* counter-cyclical. This may have been motivated by stabilisation considerations, but it is more likely to have been driven by the mechanism described above: governments were responding as if there had been a structural improvement in the fiscal position. This tendency may have been reinforced by the unusually busy electoral calendar at the time – notably in the larger countries (Buti and van den Noord, 2004). The *ex ante* stance also suggests counter-cyclical fiscal stimulus in this episode, but again this was probably accidental. It is in contrast with the 1991-1993 downturns when many countries tightened their budgets, possibly in response to sustainability concerns and financial market turbulence.
- In the 2004-2008 recovery governments were forced to correct the past excesses, with several countries facing Excessive Deficit Procedures. The fiscal tightening eventually leaned against the wind of the recovery, but this was prompted more by the fiscal consolidation needs imposed by the SGP than by a desire to choke off the upswing. This drive to consolidate budgets is confirmed by the real time measure, which also indicates a tightening stance of fiscal policy. This behaviour is quite similar to the previous cycle, when

fiscal policy was tightened in the recovery phase in a vast majority of countries (France is a notable exception). This reflected the measures taken to qualify for eu ro adoption subsequent to the Maastricht Treaty. Electoral considerations may have played a role as well: qualifying for the single currency was seen to raise the odds of re -election unlike in normal times when governments tend to ease fiscal policy during the election campaign (Von Hagen 2002).

Building on the past experience, the macroeconomic projections underpinning budgetary plans seem to have become more cautious in recent years. However, at this stage there is still considerably uncertainty around the size of the output gap. There have recently been downward revisions of the macroeconomic projections and this may be reflected again in lower potential output, in which case the output gaps may well turn out higher (and the structural fiscal positions worse) than initially thought. In addition, the structural fiscal positions may be biased upward due to the (now maturing) housing booms in many countries. The experience of the end of the 1990s has shown that upswings in asset prices go along with buoyant inflows of tax revenues going well beyond the expansion of aggregate economic activity, which lead to a temporary increase in implicit tax elasticity with respect to the output gap (7).

In several countries the convergence towards the euro unleashed a set of events that is likely to have led to higher than normal government revenues, which in turn may mislead fiscal policy makers to believe in a structural increase in available resources. This risk is further heightened by the fact that during the upswing the composition of output itself is comparatively tax -rich, with home pressure of demand and competitiveness effects squeezing VAT -exempt exports and boosting VAT-liable imports. During the 1999-2000 boom these types of mechanisms led to the conclusion that the high tax content of growth was likely to be permanent, and the policy response was to reduce taxes or to increase expenditure plans at a time when the economy was *de facto* operating above potential. The same type of errors may well turn out to have b een repeated at the current juncture.

## 4. SUCCESSFUL CASES OF DISCRETIONARY FISCAL STABILISATION

In spite of the generally negative findings of econometric studies, one may still raise the question whether there are any *specific* and *significant* cases of successful discretionary fiscal stabilisation in the recent history of the EU and, if yes, what lessons can be drawn from them.
Two episodes are of particular interest, which are however very a -typical as deficits were also run in order to bail out financi al institutions: Sweden and Finland in the early 1990s. At the time, the two countries went through a very steep recession, in the aftermath of the collapse of the Soviet Union coupled with a domestic crisis of the banking sector, and against the backdrop of an overvalued exchange rate and tight monetary policy. Both economies recorded negative growth over the three consecutive years 1991-1993, amounting to a cumulated loss of output of 4.3% of GDP in Sweden, and 10.8% in Finland. In both countries, the cri sis triggered a significant fiscal expansion, largely focused on the expenditure side. Starting from surpluses, the headline balance of the general government accounts moved deeply into negative territory posting in 1991 a deficit of 11.4% of GDP in Sweden and of 7.8% of GDP in Finland. Over the whole episode (1991 -1993) the cyclically-adjusted primary budget balance (CAPB) deteriorated by 9.9% in Sweden, while in Finland it deteriorated by 'only' 3.4%. However, the latter fact could also be interpreted as a successful switching strategy, with tightening taking place once the economy had been 'kick -started' again. Indeed, by then the Finnish authorities already increased taxation considerably and only reversed that policy stance from the mid-1990s onwards. The Swedes took longer to reverse their fiscal policy stance.

The economies soon returned to a relatively high growth path and the rate of unemployment declined. Fiscal policy remained tight in both countries after the counter -cyclical episode, with the result that within a few years they were both building up budgetary surpluses, Finland in particular some of the highest ones in the EU. So overall, and with the benefit of hindsight, both cases appear to have been a success. On the face of their apparent success, however, much of the fiscal expansions recorded ex post in Sweden and Finland in the beginning of the 1990s was simply the working of automatic stabilisers or occurred un-intentionally; i.e. was about not adjusting discretionary expenditure in the event of a sharp decline of revenues during the recession. In fact at the time already fiscal contractions were actually intended (Jonung, 2008), but did not materialise due notably to a mis-estimation of potential growth. Interestingly, in both countries the counter-cyclical fiscal stance of policy was accompanied by far reaching measures to scale back public consumption, which in Finland started earlier than in Sweden. A major decline of the size of the public sector took place after the end of the recession period. Indeed, counter-cyclicality in the two Member States went hand-in-hand with fundamental structural and institutional reforms.

## 5. LESSONS TO BE LEARNED FOR THE CURRENT SITUATION

Discretionary fiscal policy has the potential to smooth cyclical fluctuations. In practice, however, the potential effectiveness most of the time does not come to fruition. Available evidence shows that discretionary fiscal policy is at best a-cyclical largely because (i) policy makers do not have the necessarily information in real time to implement effective measures and (ii) stabilisation of output may not be the primary preoccupation of fiscal policy makers when implementing discretionary measures.

One of the key lessons to be drawn from this is that the stabilisation function of fiscal policy should mainly be taken care of by automatic stabilisers. According to existing work, automatic stabilisers are comparatively effective in the EU reducing the volatility of output by around 25% and more (van den Noord, 2000 and Barrel and Pina, 2000). The size of automatic stabilisers in Europe also compares favourably with the US. In the group of countries adopting the single European currency the budgetary sensitivity, the parameter that measures the automatic reaction of the government budget to cyclical swings in output, averages 0.5, twice the size of what is estimated for the US.

To the extent that it does not conflict with the requirements of the SGP, the recourse to significant discretionary fiscal stabilisation could be instrumental in the wake of sharp and protracted economic slowdowns after other policy instruments have not produced the desired effect. These conditions are clearly not met at the current juncture. The EU economy exhibits signs of recession, but is more resilient than the US. Automatic stabilisers and the common monetary policy should take their part first, before any other measures are to be considered.

## NOTES:

(1) *Tax changes, as enacted in Germany in 2007, may partly mimic a depreciation, but this is not a macroeconomic use and it does not require any change in the budget balance.*
(2) *A different literature looks at the automatic stabilizers. Some authors claim that a heavy tax burden may well reduce the effectiveness of the stabilizers.*
(3) *The on average counter-cyclical stance in good times in 1992-1998 must be interpreted with caution since the output gap was positive only in a single year (1992).*
(4) *The output gap showed another decline in 2005. However, this decline was comparatively small and in terms of changes in the output gap the trough had clearly been attained in 2003.*
(5) *On the other hand, there is a substantial difference between real-time and ex-post estimates for the US prior to 2000. This reflects that forecasters ex post attributed a bigger share of the expansion in the second half of the 1990s to stronger potential growth as opposed to the cycle (which led to smaller output gaps).*
(6) *This is with the exception of cases where accounting issues gave rise to major revisions*
(7) *The increase in the stock of wealth had a beneficial effect on government revenues through a number of channels: (i) via the wealth effect and high consumption on indirect taxes; (ii) via capital gains on taxes on income; (iii) via transactions on assets on turnover taxes.*

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