

FISCAL POLICY IN EURO COUNTRIES

The current discussion on a possible revision of the Stability and Growth Pact, signed by the member countries of the euro area, centres on the question of whether the main fiscal rules of the pact – the budget should be nearly at zero balance or even exhibit a surplus; a budget deficit should not exceed 3% of GDP unless in exceptional circumstances – are too inflexible, i.e. do not provide enough leeway for discretionary (stimulating) fiscal policy in specific situations, or whether the occurring violations of the rules are more due to an inappropriate fiscal policy. A recent OECD publication (Buti and van den Noord, 2004) tries to shed some new light on that question.

The authors construct an indicator which characterises the discretionary property of fiscal policy (see Table). They start from the concept of a neutral primary fiscal stance (part 1 of the Table) which is met when primary expenditure develops as does trend real GDP plus the inflation target of the ECB (taken as 1.5%) and when the growth of revenue is in line with actual nominal GDP (i.e. undisturbed by tax rate changes). That neutral fiscal stance is then compared with the actual primary fiscal balance (part 2). The discretionary policy effect (part 3) is the difference between the neutral and the actual budget position.

However, the discretionary policy effect, so far, entails two non-discretionary elements, namely a “growth dividend” and an “inflation dividend” (part 4 and 5, respectively). The former occurs when the expected GDP growth is larger than the trend growth; the latter when the expected inflation rate is larger than the ECB target rate of inflation. Both types of dividends permit a non-debt financing of deficits and are subtracted from the (simple) discretionary policy effect. What results is called the “genuine” discretionary fiscal policy effect (part 6).

In the Table, negative figures for simple and genuine effects indicate a tightening, and positive figures a loosening fiscal effect. What can be observed is that in 1999, the

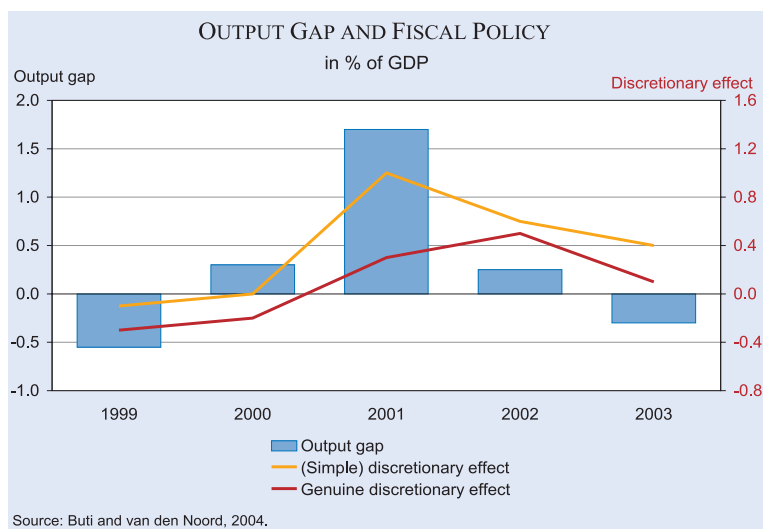
first year of the euro, the majority of countries still pursued a restrictive fiscal policy course. In the following years, however, fiscal policy became more and more expansionary, with a reversal of this trend in 2003.

The obvious question is now whether the (discretionary) fiscal effects are reasonable or not, i.e. whether they have contributed to mitigating or stimulating the cyclically development of real GDP. The answer is given in Figure 1, which contains the two lines for the simple and the genuine discretionary effects and bars for the output gap (actual GDP – potential GDP, one year before). When there were recessionary tendencies, fiscal policy was tightening, while it was stimulating in years of higher economic growth. Hence, fiscal policy behaved, more or less, pro-cyclically.

The great difficulty of always exerting the appropriate fiscal effect is textbook knowledge. But apart from an inability there might also be bad intentions on the side of the governments. This has been discussed in the literature under the heading of “electoral cycles”. The authors add to this discussion by relating the number of elections in the euro area to the discretionary fiscal effects. The result is presented in Figure 2. The bars indicate the number of countries that were in an election or pre-election year; the lines are again the discretionary effects. What we see is an astonishingly neat correlation between the discretionary effects and the number of countries in election years, specifically when one leaves out the year 1999.

It can be reasonably argued that the budget rules of the Stability and Growth Pact are, in a sense, “stupid”.

Figure 1



Fiscal policy indicators, in percent of GDP

	Neutral primary fiscal stance					Actual primary fiscal stance					Discretionary policy effect				
	(1)					(2)					(3) = (1) - (2)				
	1999	2000	2001	2002	2003	1999	2000	2001	2002	2003	1999	2000	2001	2002	2003
Austria	0,1	0,3	-0,1	2,0	1,4	0,8	1,2	3,2	2,2	1,4	-0,8	-0,9	-3,2	-0,2	0,0
Belgium	7,0	6,8	6,1	6,2	5,7	6,2	6,6	6,4	5,7	5,2	0,9	0,2	-0,3	0,5	0,5
Finland	2,6	5,8	8,0	5,4	4,7	3,6	8,0	5,8	4,8	3,2	-1,0	-2,2	2,2	0,6	1,5
France	-0,2	0,9	0,7	0,4	-1,5	1,1	1,4	1,1	-0,5	-0,8	-1,3	-0,4	-0,4	0,9	-0,7
Germany	0,9	1,6	1,1	-0,4	-1,5	1,6	1,5	0,0	-0,8	-0,8	-0,7	0,1	1,1	0,4	-0,8
Greece	6,4	6,9	6,6	5,8	5,4	5,4	5,1	4,4	4,3	4,3	1,0	1,8	2,2	1,5	1,1
Ireland	5,2	4,2	5,4	2,0	-0,7	3,5	5,4	1,8	-0,2	-0,6	1,7	-1,2	3,6	2,3	-0,1
Italy	4,6	5,0	4,5	3,1	3,0	4,4	4,1	3,3	2,9	2,2	0,2	0,8	1,3	0,3	0,8
Netherlands	3,6	5,4	5,4	2,5	1,3	4,5	4,7	2,8	1,5	0,7	-0,9	0,6	2,6	1,0	0,6
Portugal	0,4	0,5	0,1	-1,1	0,1	0,4	0,0	-1,1	0,4	-0,1	0,1	0,5	1,2	-1,4	0,3
Spain	2,2	3,2	2,9	3,4	2,9	2,2	2,1	2,7	2,6	2,2	0,0	1,1	0,2	0,8	0,7
Unweighted avg.	3,0	3,7	3,7	2,7	1,9	3,1	3,6	2,8	2,1	1,5	-0,1	0,0	1,0	0,6	0,4
	Projected "growth dividend"					Projected "inflation dividend"					"Genuine" discretionary policy effect				
	(4)					(5)					(6) = (3) - (4) - (5)				
	1999	2000	2001	2002	2003	1999	2000	2001	2002	2003	1999	2000	2001	2002	2003
Austria	0,2	0,0	0,1	-0,5	-0,3	-0,2	-0,3	0,1	0,3	0,0	-0,8	-0,6	-3,4	0,0	0,2
Belgium	0,1	0,1	0,0	-0,3	0,0	0,0	-0,2	-0,1	0,3	0,0	0,8	0,3	-0,2	0,5	0,4
Finland	0,4	0,5	0,6	-0,5	0,1	0,2	0,0	-0,1	-0,2	-0,1	-1,6	-2,8	1,8	1,2	1,5
France	0,2	0,4	0,5	0,2	0,1	-0,1	0,0	-0,1	0,1	0,0	-1,4	-0,8	-0,7	0,6	-0,8
Germany	0,2	0,5	0,5	-0,3	0,0	-0,2	-0,2	0,0	0,0	0,0	-0,7	-0,2	0,6	0,6	-0,8
Greece	0,2	0,3	0,8	0,2	0,1	0,3	0,2	0,3	0,5	0,6	0,4	1,3	1,2	0,8	0,5
Ireland	-0,3	0,2	0,5	-0,6	-0,6	0,3	0,4	0,8	0,6	0,6	1,7	-1,8	2,4	2,2	-0,1
Italy	0,3	0,1	0,4	0,2	0,2	0,2	0,1	0,4	0,4	0,2	-0,3	0,7	0,5	-0,3	0,4
Netherlands	0,0	-0,2	0,5	-0,6	-0,6	0,3	0,4	0,9	0,7	0,9	-1,2	0,5	1,2	0,8	0,2
Portugal	0,1	0,0	0,1	-0,2	-0,1	0,3	0,3	0,8	0,7	0,7	-0,3	0,2	0,3	-2,0	-0,4
Spain	0,3	0,2	0,2	-0,1	0,1	0,1	0,2	0,3	0,4	0,4	-0,4	0,8	-0,2	0,5	0,2
Unweighted avg.	0,1	0,2	0,4	-0,2	-0,1	0,1	0,1	0,3	0,4	0,3	-0,3	-0,2	0,3	0,5	0,1

Example: Ireland in 2000: for neutrality, the primary budget should have been in surplus (4.2%). But the actual surplus was higher (5.4%). A tightening discretionary effect (-1.2%) resulted. Due to the growth and inflation dividend, the genuine discretionary (contractionary) effect was even larger (-1.8%).
Note: The figures do not always add up exactly.

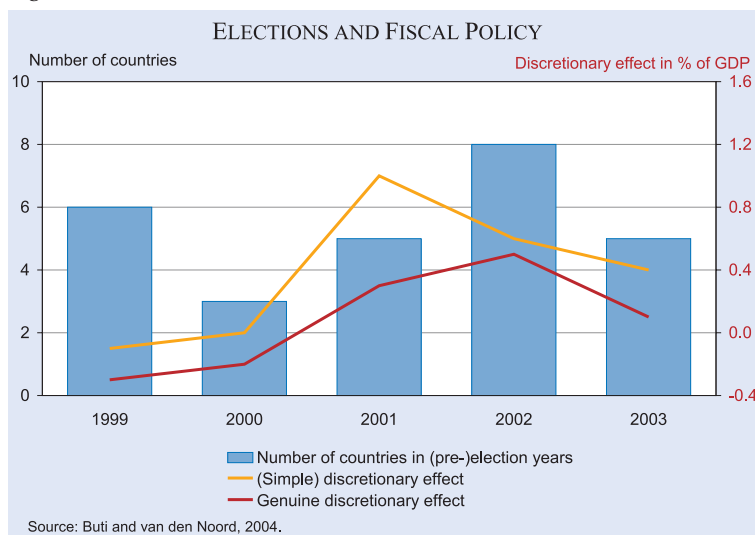
Source: Buti and van den Noord, 2004.

However, wiser and more flexible rules might work only in a world where neither inability nor bad inten-

tion occur. In the world as it is, a strict observance of the "stupid" rules must finally lead to an inactive (non-discretionary) fiscal policy which, instead, relies on automatic stabilisers. Given the large size of the public (tax and social benefit) sectors in Europe, those automatic stabilisers are generally estimated to have a considerable impact, at least one which is not pro-cyclical.

R.O.

Figure 2



Source: Buti and van den Noord, 2004.

References

Buti, M. and P. van den Noord (2004), "Fiscal Policy in EMU: Rules, discretion and political incentives", European Commission, *Economic Papers* no. 206.