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The dynamic behaviour of budget components and output ☆

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Abstract

The main focus of this paper is the relation between the cyclical components of total revenues and expenditures and the budget balance in France, Germany, Portugal, and Spain. We try to uncover past trends behind the development of public finances that contribute to explaining the current stance of fiscal policy. The disaggregate analysis of fiscal policy in an SVAR that mixes long and short-term constraints allows us to look into the transmission channels of fiscal policy and to derive a model-based indicator of structural balance. The main conclusions are that fiscal slippages are mainly due to reversals in tax policies, which are unmatched by expenditure adjustments. As a consequence, deficits rise when economic conditions worsen but cause a 'ratcheting up' in the size of government in economic booms. The Stability and Growth Pact has not eradicated these procyclical policies. Bad policies in good times also contribute to aggregate macroeconomic instability.

JEL classification: E62; E65; E66; H61; H62

Keywords: Fiscal indicator; Structural balance; Output gap; SGP; EMU; SVAR; Short and long-term restrictions

1. Introduction

In recent years, we have witnessed a worldwide swing towards fiscal profligacy. In the European Union, this has come somewhat as a surprise as the Maastricht Treaty and afterwards the Stability and Growth Pact seemed to have put in place a set of fiscal rules that guarantee the sustainability of public finances. After the initial nuisance in applying the Pact to Portugal, France or Germany, there was a breach of the 3% deficit limit in several other EU countries. A revised

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version of the Pact was negotiated in March 2005. The new budget rules offer a more flexible approach for curbing excessive deficits over a longer period of time, and put the emphasis on the sustainability of public finances. As part of the Lisbon Strategy, considerably more attention is given to the composition of budget adjustments with a view to promote economic growth.

A variety of political and economic factors probably underlie the observed rise in public deficit and debt ratios. We try to uncover underlying past trends behind the development of public finances that may contribute to explain the recent budgetary outlook in France, Germany, Portugal, and Spain. While the first three countries were subject to several steps of the Excessive Deficit Procedure, Spain on the other hand can be seen as an example of more vigorous fiscal management. We are particularly interested in the underlying causes of the breach of the Pact's rules by looking into adjustments in various budget components. At the same time, we look into how these adjustments contribute to the long-term growth prospects and outlook for the sustainability of public finances.

To that end, we construct a model-based indicator of structural balance by combining insights from the growing empirical literature on the effects of fiscal policy – modelled with structural VARs – with statistical methods for cyclically adjusting fiscal balances. Our approach innovates on extant evidence in using a mixture of short and long-term restrictions to identify economic and fiscal shocks in a small-scale empirical model in economic growth and fiscal variables. This allows for permanent shocks to determine trending behaviour of output and fiscal variables à la Blanchard and Quah (1989). Discretionary fiscal adjustments are captured by filtering out the fiscal balance for cyclical reactions of budget items, following Blanchard and Perotti (2002). As a first step, we examine total spending and revenues. More elaborate models might incorporate refinements of the composition of budget balance.

The quantitative indicator that we obtain is best seen in the light of the growing theoretical literature on the effects of fiscal policy. Dynamic stochastic general equilibrium models with nominal rigidities offer a rationale for fiscal stabilisation policies. But these New Keynesian models attribute a major role to the supply side effects of fiscal policy adjustments. Our indicator is consistent with such a distinction. In contrast to statistical models for adjusting fiscal balance, our economic indicator of structural balance has some attractive practical properties. Uncertainty is explicitly quantified; theoretical assumptions can be explicitly tested. Also, the end-of-sample problem is reduced. The model is not necessarily more demanding in terms of data availability.

The main result of our study is that both the fiscal consolidations undertaken after Maastricht and the mounting deficits since the start of the EMU are due to adjustments in revenues. Governments cut tax rates during economic boom, but do not curtail spending equally. As a consequence, deficits surface again when economic boom turns into bust. Governments then reverse previous tax cuts to avoid large deficits. This leads to a 'ratcheting up' of spending over the economic cycle. This procyclical bias in fiscal policies has not been eliminated with the Stability and Growth Pact. Governments still implement bad policies in good times. This unnecessarily induces macroeconomic fluctuations. We indeed find that fiscal policy has minor supply but rather large demand effects.

The remainder of the paper is organised as follows. In Section 2, we briefly review recent fiscal developments in the EU, notably for the cases of France, Germany, Portugal, and Spain. Our structural VAR approach towards disentangling these developments, and the derivation of the fiscal indicator, is discussed in Section 3. Section 4 reports our empirical results, and Section 5 concludes the paper.

2. The recent fiscal imbalances in the EU

The fiscal framework of EMU has been considered a means for implementing fiscal consolidation. However, recent developments in several Euro Area countries raise the question as to whether fiscal sustainability is endangered, in view of rising deficits and debts at a moment when the effects of ageing populations will have a further burdening effect. In 2005, Excessive Deficit Procedures (EDP) have been carried out for both France and Germany, while yet another EDP was launched for Portugal. There are also ongoing procedures for Greece and Italy, while several other EU Member States face a situation of excessive deficit. Recent developments cannot be seen without taking into account past actions and trends in public finances. We focus attention on the evolution of public finances since 1970 in the countries that initially 'sinned' to the Pact (France, Germany and Portugal). For comparison, we consider Spain as an example of a more prudent fiscal management.

We report in Fig. 1 the general government balance, and its breakdown in revenue and expenditure ratios. Visual inspection shows that expenditure and revenue ratios have been following an increasing trend since the early seventies, notably in France, Portugal and Spain. But the increases in spending have outdone the growth in revenues by far.