



On graduation from fiscal procyclicality[☆]

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ABSTRACT

In the past, industrial countries have tended to pursue countercyclical or, at worst, acyclical fiscal policy. In sharp contrast, emerging and developing countries have followed procyclical fiscal policy, thus exacerbating the underlying business cycle. We show that, over the last decade, about a third of the developing world has been able to escape the procyclicality trap and actually become countercyclical. We then focus on the role played by the quality of institutions, which appears to be a key determinant of a country's ability to graduate. We show that, even after controlling for the endogeneity of institutions and other determinants of fiscal procyclicality, there is a causal link running from stronger institutions to less procyclical or more countercyclical fiscal policy.

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1. Introduction

The cyclical behavior of fiscal policy differs across countries by income group. In the past, while industrial countries have tended to pursue fiscal policy that is countercyclical or at worst acyclical, developing countries have tended to follow procyclical fiscal policy: they have increased spending (or cut taxes) during periods of expansion and cut spending (or raised taxes) during periods of recession. Many authors have documented that fiscal policy has tended to be more procyclical in developing countries than industrialized countries.¹ Most studies look at the procyclicality of government spending because tax receipts are endogenous with respect to the business cycle. Indeed, an important reason for

procyclical spending is precisely that government receipts from taxes or mineral royalties rise in booms, and the government cannot resist the temptation or political pressures to increase spending proportionately, or even more than proportionately. A similar procyclical pattern can be found on the tax side by focusing on tax rates rather than revenues, though cross-country evidence is harder to come by. Vegh and Vuletin (2012) find that tax rate policy has been mostly procyclical in developing countries and acyclical in industrialized countries.

In terms of government spending, the contrast between the two groups of countries can be clearly seen in Fig. 1, which updates evidence presented in Kaminsky et al. (2004). The figure depicts the correlation between (the cyclical components of) government spending and GDP for 94 countries (21 developed and 73 developing countries) for the period 1960–2009. Black bars represent industrial countries while light bars represent developing countries. A positive (negative) correlation indicates procyclical (countercyclical) government spending.² The visual image tells the whole story: light bars lie overwhelmingly on the right hand side (positive correlations) while black bars dominate the left

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¹ See Gavin and Perotti (1997), Tornell and Lane (1999), Kaminsky et al. (2004), Talvi and Vegh (2005), Mendoza and Oviedo (2006), Alesina et al. (2008), and Ilzetzki and Vegh (2008).

² Needless to say, correlations do not tell us anything about causality which, in principle, could go in either direction. Ilzetzki and Vegh (2008), however, show that, even when properly instrumented, output does cause government spending, as emphasized by the fiscal procyclicality literature.

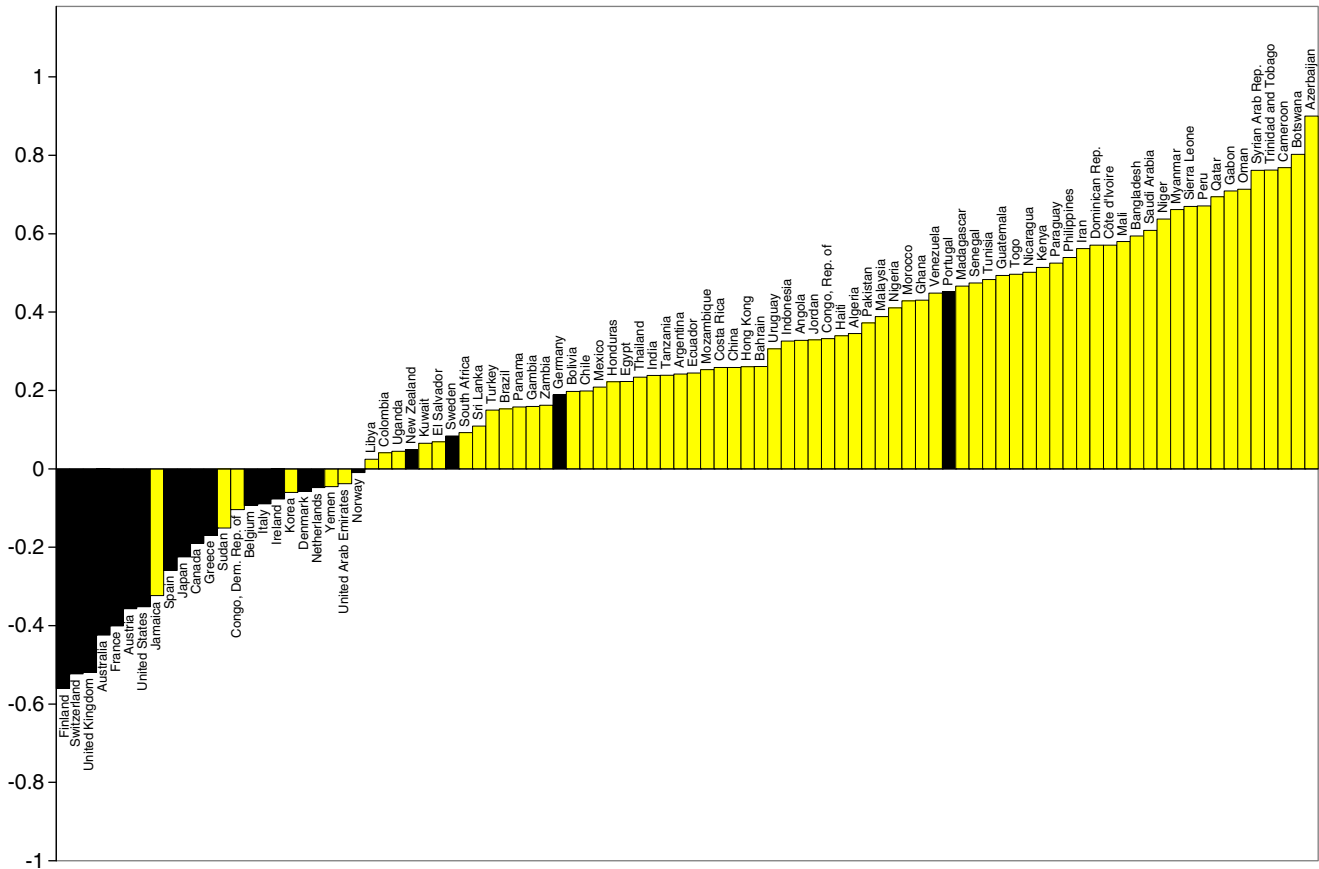


Fig. 1. Country correlations between the cyclical components of real government expenditure and real GDP, 1960–2009. Notes: Dark bars are industrial countries and light ones are developing countries. The cyclical components have been estimated using the Hodrick–Prescott Filter. A positive (negative) correlation indicates procyclical (countercyclical) fiscal policy. Real government expenditure is defined as central government expenditure and net lending deflated by the GDP deflator. See Appendix 2 for correlation values for each country. Source: World Economic Outlook and International Financial Statistics (IMF).

hand side (negative correlations). Indeed, more than 90% of developing countries (67 out of 73) show procyclical government spending, while around 80% of industrial countries (17 out of 21) show countercyclical government spending.

Why would policymakers pursue procyclical fiscal policy? After all, such policy cannot be optimal since it will tend to reinforce the business cycle, exacerbating booms and aggravating busts. The most convincing explanations in the literature fall in two, not necessarily inconsistent, camps: (i) imperfect access to international credit markets and lack of financial depth (Caballero and Krishnamurthy, 2004; Gavin and Perotti, 1997; Gavin et al., 1996; Riascos and Vegh, 2003) and (ii) political distortions (Talvi and Vegh, 2005; Tornell and Lane, 1999; Velasco, 1997).³ Lack of access to credit markets in bad times will naturally leave governments with no choice but to cut spending and raise taxes, whereas political pressures for additional spending in good times are hard to resist, particularly when there may exist a genuine need for more government spending in critical social areas. Improving access to credit in bad times (including official financial assistance from multilateral financial institutions such as the IMF) and designing rules and institutions that aim at ensuring that fiscal revenues are saved in good times so that they are available in bad times would go a long way to alleviate the scourge of procyclical fiscal policy.

In fact – and as we will argue in this paper – over the last decade several developing countries have been able to “graduate” in the sense of overcoming the problem of procyclicality and becoming

countercyclical.⁴ Theoretical work by Christiano et al. (2011) and Nakata (2011) clearly suggests that this shift in the cyclical properties of fiscal policy is welfare improving since the optimal fiscal policy in a stochastic model with sticky prices is countercyclical. In fact, both papers show that countercyclical fiscal policy is even more effective when monetary policy has become powerless because the policy interest rate has hit the zero bound. Intuitively, suppose the economy is hit systematically (in a stochastic sense) by, say, shocks to the discount factor. In bad times (when the preference shock induces household to save more), it becomes optimal for the government to increase spending (even to the point of making the zero bound marginally non-binding if it was binding to begin with).⁵

Chile is undoubtedly the poster child of this graduation movement. As discussed in Frankel (forthcoming), since 2001 Chile has followed a fiscal rule that has a structural (i.e., cyclically-adjusted) fiscal balance as its target.⁶ By construction, such a rule ensures that temporarily high fiscal revenues are saved rather than spent. But, as we will show below, Chile is not the only country that seems to have escaped the procyclicality trap.

⁴ Our work can be viewed as complementing, on the fiscal side, recent work by Reinhart et al. (2010) who study graduation from default, inflation, and banking crises, and Vegh and Vuletin (forthcoming) who study graduation from monetary procyclicality.

⁵ Christiano et al. (2011) derive this result taking monetary policy as given. Nakata (2011), however, shows that countercyclical fiscal policy is optimal even if monetary policy is chosen optimally.

⁶ The original target was a structural surplus of 1%, reflecting the need to repay Central Bank debt associated with the bailout of private banks in the 1980s. As this debt was paid off over time, the targeted structural balance was reduced to 0.5% in 2008 and 0% in 2009.

³ Calderón and Schmidt-Hebbel (2008) provide evidence for the empirical relevance of these two channels.

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