



Fiscal adjustments and asset price changes

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ABSTRACT

This paper examines the links between asset price movements and fiscal adjustments. Our findings suggest that higher asset prices improve fiscal balances and contribute to sustained consolidation. This refers in particular to real equity and real residential property prices. We find evidence that revenue windfalls due to higher residential, commercial property and equity prices can be sustained, thus, improving revenue and primary balances. There is evidence of a positive association of some asset prices changes with expenditure adjustments. Fiscal adjustments and in particular sharp spending cuts are more likely to be successful if undertaken in periods of dire budgetary and economic conditions.

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1. Introduction

In the context of the current macroeconomic and financial market turmoil and in the presence of asset price swings expansionary fiscal policy has been at the forefront. This has led to huge fiscal imbalances as fallout of the crisis, impairing the sustainability of fiscal balances. Consequently, it is of utmost importance that governments around the globe start withdrawing some of the fiscal stimulus and initiating fiscal consolidation in order to ensure sustainable fiscal positions. These consolidation efforts will be affected by asset price movements as the economy picks up.

For example, in view of the forthcoming gradual economic recovery asset prices (e.g. stock market indices) have started to improve (see BIS, 2009; IMF, 2010), which provides a boost to public finances, through the revenue channel. However, given that uncertainty remains high and that the recovery might be more gradual than expected this could have significant effects (IMF, 2010; World Economic Forum, 2010), in terms of volatility, on asset markets and asset prices, which have a negative feedback effect on fiscal balances and the fiscal consolidation effort.¹ Therefore, it is important to better understand the linkages between government finances and asset prices (as well as the bigger picture of asset price cycles, economic cycles and government responses). The relevance of asset price movements for fiscal outcomes was manifested by the recent experiences of

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¹ According to the 2010 Global Risk report of the World Economic Forum “the risk of an asset price collapse remains the strongest risk” which “illustrates the continuing uncertainty about the resilience of the global economy and the effectiveness of fiscal and monetary responses, governance and regulation”.

several countries which faced a rapid deterioration of tax revenues following the collapse of residential activity and prices (e.g. Ireland, Spain).²

As has been discussed by Eschenbanch and Schuknecht (2002), Schuknecht and Eschenbanch (2004), and Jaeger and Schuknecht (2004), asset prices can affect the budget via a series of channels.^{3,4} Directly, asset prices affect the budget via certain revenue categories, e.g., capital gains/losses related taxes. Indirectly, higher asset prices raise consumer confidence and consumption, via the wealth effect, and increase the collection of indirect taxes. Tujula and Wolswijk (2004) investigating what determines overall, non-cyclically adjusted, fiscal balances in 22 OECD countries find significant evidence that asset prices (housing and equity prices) affect budgetary outcomes, but their effect is limited in normal times. Finally, in case of asset price busts and ailing financial institutions, the state might be asked to intervene bearing some of the costs.^{5,6}

The determinants of successful fiscal adjustments have been discussed extensively in the literature. The composition of the stabilization effort was found to be very important, with fiscal consolidations based on expenditure cuts having more chances to succeed rather than those based on tax hikes (Alesina and Perotti, 1995, 1997; Alesina and Ardagna, 1998). The size and persistence of fiscal consolidation were identified as quite significant determinants of adjustment efforts (Giavazzi and Pagano, 1990, 1996; Ardagna, 2004; Alesina and Ardagna, 1998). In addition, fiscal adjustments have been linked to the underlying budgetary, economic (e.g., von Hagen and Strauch, 2001; Ardagna, 2004),⁷ and monetary and exchange rate conditions; with a monetary easing and depreciation increasing the chances of a success (e.g., Lambertini and Tavares, 2005; Ahrend et al., 2006).

Tagkalakis (2009) finds that labor and product market institutions can affect the likelihood of initiating and successfully concluding fiscal adjustment. The OECD (2007) and the European Commission (2007a) have shown that fiscal rules and budgetary procedures contribute significantly to the success of fiscal adjustment. Alesina et al. (2006) have shown that the likelihood of successfully concluding a fiscal consolidation increases in the case of newly elected governments and in presidential systems where the government in office has a large margin of majority. Tavares (2004) finds that spending cuts by the left and tax increases by the right are associated with persistent adjustments, because these actions signal commitment to undertake the adjustment in ways that are not favored by their constituencies. Alesina and Perotti (1995) have shown that single party governments are more likely to succeed in a fiscal consolidation program compared to coalition governments.

The study by Ardagna (2009) comes closer to the analysis in this paper. She shows that stock market prices surge around times of substantial fiscal tightening and plunge in periods of very loose fiscal policy. Hence, financial markets appear to welcome fiscal consolidation efforts and punish governments that have a loose fiscal stance, i.e. they seem to react in anticipation of the future path of government debt-to-GDP ratio. In addition, Ardagna (2009) shows that fiscal adjustments that occur in country-years with high levels of government deficit, that are implemented by cutting government spending,

² Recent IMF work (IMF, 2009) discusses the links between tax policy issues, excessive leveraging and the development of asset price bubbles. It is shown that tax distortions can significantly affect financial markets and that tax measures can have significant effects on asset price dynamics (e.g., the favourable treatment of housing with mortgage interest relief encouraged heavy household leverage in several countries, etc.). The IMF (2009) concludes that “tax measures can have significant effects on asset price dynamics, but are unlikely to be the best way to deal with bubbles”. However, early alleviation of tax distortion could have contributed to reducing the impact of factors that have facilitated excessive leveraging and led to high debt levels, paving, thus, the way for the recent financial crisis (IMF, 2009). As is pointed out by Wolswijk (2010) fiscal instruments may be useful either for preventing or for correcting some housing market disequilibrium. Moreover, “structural fiscal measures such as reducing mortgage interest relief and increasing reliance on quick adjustments of tax bases to market price developments appear to be useful options for governments for limiting growth rates of mortgages and house prices”.

³ Eschenbanch and Schuknecht (2002) find that a 10% change in stock and real estate prices affects the fiscal balance by on average 0.4% of GDP in most industrialized OECD countries with values ranging from 0.1% to 0.8% of GDP depending on the country. Schuknecht and Eschenbanch (2004) investigate the effect that asset prices have on fiscal balances via expenditure and government financial activities by focusing on specific countries (UK and Sweden) that have experienced strong asset price fluctuations, financial instability and government bailouts. They report that Sweden and the UK experienced in the late 1980s–early 1990s a dramatic deterioration in fiscal balances by 9% and 16%, respectively, 40–50% of this deterioration was due to asset price and financial instability related effects on revenues and financial sector bail-out costs.

⁴ Jaeger and Schuknecht (2004) find that conventional estimates of tax elasticities are not accurate, leading to a biased assessment of the fiscal stance and the underlying fiscal position in boom-bust phases, and that boom-bust phases exacerbate existing pro-cyclical policy biases, and political economy biases toward higher spending and public debt ratios.

⁵ Honohan and Klingebiel (2003), Reinhart and Rogoff (2009) and European Commission (2009) discuss in detail the fiscal implications of past financial and banking crises. Reinhart and Rogoff (2009) find that “on a peak-to-trough basis, real housing price declines average 35% stretched out over six years, while equity price collapses average 55% over a downturn of about three and a half years.” The unemployment rate rises by about 7 percentage points over the 4 years of the down phase of the cycle and output falls by about 9%, but the duration of the downturn last only 2 years. In the aftermath of several financial crises the real value of government debt (not debt to GDP ratio) rose on average by 86% in a panel of developed and developing economies. Moreover, according to Reinhart and Rogoff (2009) “the big drivers of debt increases are the inevitable collapse in tax revenues that governments suffer in the wake of deep and prolonged output contractions, as well as often ambitious countercyclical fiscal policies aimed at mitigating the downturn”.

⁶ The performance of financial and real estate market movements can affect public pension reserve funds, which support social security systems, to the extent they have invested in these asset classes. This could affect the viability of social security systems, in case asset prices deteriorate sharply, which could impact on social security spending and related benefits (lowering pension related expenditures), as well as on the level of contributions paid by employers and employees (increasing the contributions paid to improve the viability of the system). According to OECD (2010) public pension reserve funds in some countries were hit badly by the financial crisis during 2008, however thanks to the rebound in equity prices that started in March 2009 they experience a strong recovery in performance in 2009, which largely made up for the losses suffered in the previous year.

⁷ See also Heylen and Everaert (2000), Alesina et al. (1998), Alesina and Ardagna (1998).

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