Available online at www.sciencedirect.com

SciVerse ScienceDirect

Journal of Policy Modeling 34 (2012) 735–754

Journal of Policy Modeling

www.elsevier.com/locate/jpm

Boom–bust cycles and procyclical fiscal policy in a small open economy☆

Alessandro Maravalle [a,1], Peter Claeys [b,*,2]

[a] *University of the Basque Country, Departamento de Fundamentos del Análisis Económico II, Avenida Lehendakari Aguirre, 83, E-48015 Bilbao, Spain*

[b] *Universitat de Barcelona, Facultat de Econòmia i Empresa, Grup AQR IREA, Avinguda Diagonal, 690, E-08034 Barcelona, Spain*

Received 1 September 2011; received in revised form 1 October 2011; accepted 1 January 2012
Available online 1 March 2012

Abstract

The PIGS countries have suffered economic instability and fiscal havoc in the aftermath of the Financial Crisis. We argue this is the consequence of pursuing procyclical fiscal policies. We add a fiscal rule, which varies public spending with the cycle, to an otherwise standard RBC model of a small open economy. This procyclical reaction of fiscal policy to output distorts intertemporal allocation decisions. Procyclical spending generates very volatile cycles in investment and the current account. Our model is able to replicate the relationship between the degree of cyclicality of fiscal policy and the volatility of consumption, investment and the current account we observe in OECD countries. A policy that let automatic stabilisers work can effectively smooth economic fluctuations, especially after structural reforms that raise the responsiveness of the economy.
© 2012 Society for Policy Modeling. Published by Elsevier Inc. All rights reserved.

JEL classification: E32; E62; F41; H62

Keywords: RBC; Current account; Small open economy; Fiscal rule; Spending

☆ We thank Antonio Afonso, Andrea Barone, Stefanie Haller, Werner Roeger, Athanasios Tagkalakis and participants at the EC Workshop on ‘External imbalances and public finances in the EU’, a seminar at Universidad del Pais Vasco and four anonymous referees for their comments.

* Corresponding author. Tel.: +34 93 4021010.
E-mail addresses: alessandro.maravalle@ehu.es (A. Maravalle), peter.claeys@ub.edu (P. Claeys).

[1] The author acknowledges financial support from the Departamento de Educación Universidades e Investigación del Gobierno Vasco (IT-313-07).

[2] The author acknowledges financial support from the Ministerio de Ciencia e Innovacion, under grant ECO2010-16006.

0161-8938/$ – see front matter © 2012 Society for Policy Modeling. Published by Elsevier Inc. All rights reserved.
doi:10.1016/j.jpolmod.2012.01.011

1. Introduction

Textbook macroeconomics tells us that for a given level of public spending, taxes should be smoothed along the cycle in order not to exacerbate the distortionary effect of taxation, or the government should let taxes and spending adjust in a countercyclical fashion to stabilise income. Automatic stabilisers fulfil these functions. Discretionary intervention might strengthen the countercyclical response under some specific circumstances. However, in practice governments do not reinforce the working of automatic stabilisers, but usually overturn them. Instead of dampening cyclical swings in output, governments give an additional boost to the economic cycle in a boom with spending hikes or tax cuts. They also often raise taxes – but omit reducing spending – in an economic crisis. Evidence for OECD countries shows that procyclical fiscal policies are mostly driven by government expenditure (Hauptmeier, Sanchez-Fuentes, & Schuknecht, 2011; Hercowitz & Strawczynski, 2004; Lane, 2003). Lavish spending is possible as the economic boom provides the treasury with plenty of additional tax revenues. In particular, in countries like Portugal, Ireland, Greece or Spain, public spending has often continued to grow during the economic boom as it was fuelled by buoyant tax receipts flowing to the treasury.[3] The surge in tax revenues often triggered tax cuts, with apparently little effect on total revenues. This fiscal relaxation has given an excessively strong boost to internal and external demand. Unwinding these fiscal imbalances in the Financial Crisis is much harder for the PIGS countries. Shrinking tax bases makes tax revenues dwindle, and forces cuts in spending at a time fiscal support would probably be needed most. Efforts to keep deficits in check set off the reverse procyclical mechanism and further aggravate the bust.

In this paper, we develop a simple RBC model to analyse the effect of procyclical fiscal policies in a small open economy. We model fiscal policy with a simple reaction function in which the government changes spending in response to the economic cycle.[4] The cyclical response of public spending distorts economic decisions. A boost to spending during a boom further inflates the economic outlook and spurs consumption and investment. The additional need for external financing of this domestic boom deepens the current account deficit. Unsurprisingly then, such policies contribute to economic imbalances and create a boom–bust cycle. A calibration of the model on Ireland shows that consumption is about a quarter more volatile than if the government would simply let the automatic stabilisers do their work. Our model is able to replicate the positive relationship between the degree of cyclicality of fiscal policy, and the volatility of consumption, investment and the current account observed in OECD countries. There is substantial evidence that large governments display less volatile economies (Fatas & Mihov, 2001; Galí, 1994). As in Andrès, Domenech, and Fatas (2008), a shift in the composition of total output towards public spending reduces economic volatility. But in addition to this composition effect, we find that the procyclical use of fiscal policy may offset this effect of government size.

Procyclical policy also has long-term consequences. As procyclical policy result in less economic stabilisation, it also discourages capital accumulation. Our model therefore establishes a link between two empirical regularities: (a) bad macroeconomic policies induce higher

[3] See Afonso, Claeys, and Sousa (2011) for evidence on Portugal, Lane (1998) on Ireland, Alesina, Campante, and Tabellini (2008) on Greece or Woo (2009) on Spain.

[4] A fiscal rule has become common to analyse determinacy of the economy in a monetary model (Aloi, Lloyd-Braga, & Whitta, 2003; Christiano & Harrison, 1999; Guo & Lansing, 1998; Schmitt-Grohe & Uribe, 2000), or to look at the response of the economy to changes in government behaviour (Forni, Monteforte, & Sessa, 2009) or to technology shocks (Malley, Philippopoulos, & Woitek, 2009).

Download English Version:

https://daneshyari.com/en/article/968355

Download Persian Version:

https://daneshyari.com/article/968355

Daneshyari.com