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How to make discretionary fiscal policy counter-cyclical

WP 02/2012/DE/UECE

WORKING PAPERS

ISSN N° 0874-4548



How to make discretionary fiscal policy counter-cyclical

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Abstract:

In most countries, *discretionary* fiscal policy has often been pro-cyclical: instead of dampening the business cycle, actual discretionary policy has mostly magnified it.

This paper proposes a mechanism that allows discretionary fiscal policy to be counter-cyclical. This involves the creation of a Budget Agency which carries out expenditures that, in addition to increasing its debt, also raise its *saleable* assets - and, therefore, do not reduce the net value of its balance-sheet. One example is the construction, during a downswing, of housing and office buildings that will be *sold* in the subsequent upswing. Besides real estate investment, the Budget Agency may also undertake “balance-sheet neutral” expenditures in two other sectors responsible for the bulk of business cycle fluctuations: business investment and durable consumption.

JEL: E32, E62, E63

Key words: stabilization, discretionary fiscal policy, business cycle

1. Introduction

Almost all economic research is focused on either theoretical or applied economic *analysis*. This paper has a different aim: to propose the *creation of a new institution* that may improve the way market economies work – in the same way as other relatively recent institutions (like the Central Bank, automatic stabilizers and, arguably, the *independent* Central Bank) have done.

In most OECD countries, and in almost all EU15 countries, *discretionary* fiscal policy has been pro-cyclical (Fatas and Mihov, 2009; IMF, 2004; Hallerberg and Strauch, 2002): instead of dampening the business cycle, actual discretionary policy has mostly magnified it. A noteworthy exception was the United States in 1999-2007, when discretionary fiscal policy was counter-cyclical (Fatas and Mihov, 2009).

This stylized fact can be explained as follows. The declines in output during recessions trigger automatic reductions in fiscal revenues and automatic increases in public spending, which raise budget deficits and public debts. As a result, financial investors become apprehensive about the ability of governments to pay their debts, and demand higher risk premiums and interest rates on those debts. By raising the burden of government interest payments, this in turn leads to further increases in budget deficits and public debts, generating a vicious circle of rising public debts and interest rates. Faced with this vicious cycle, governments are then forced to pursue discretionary restrictive policies – at a time when the exact opposite policies would be needed. The result is an aggravation of the declines in aggregate demand and a deepening of the recessions.¹

¹ Even governments that do not face higher interest rates as a result of recessions-induced large budget deficits tend to embark on restrictive discretionary policies (eg, the UK government since the end of 2010; see Sawyer, 2011). The previous narrative summarizes the typical responses of European

By contrast, during economic expansions governments have some leeway to cut tax rates and to increase discretionary spending. As a result, the debt-GDP ratio does not decline as much as it would be possible.

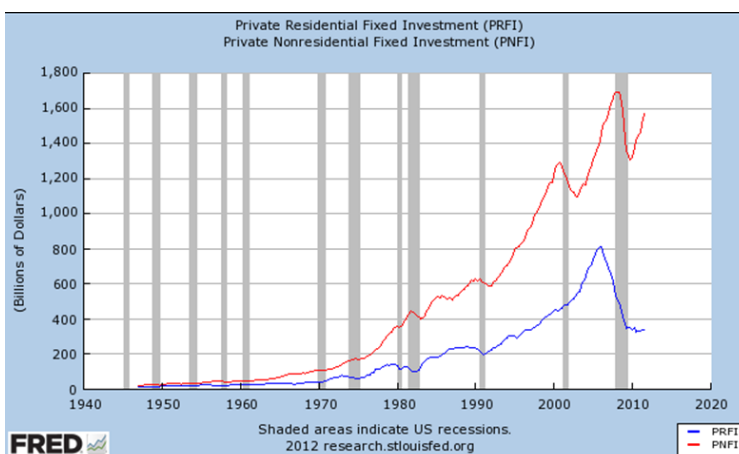
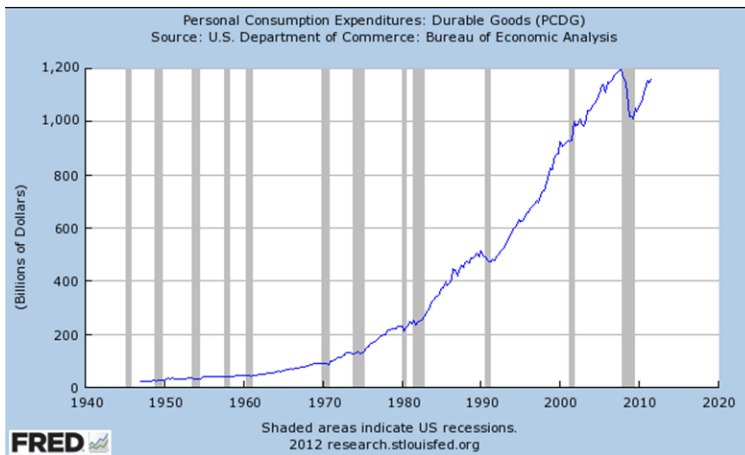
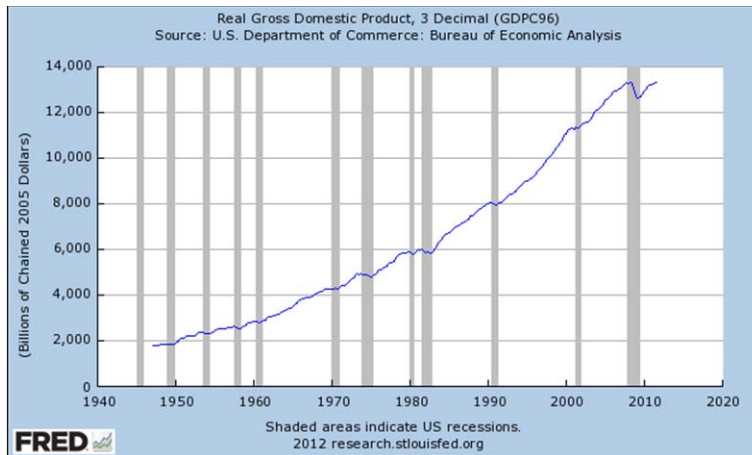
The purpose of this paper is to propose a device – involving the creation of an independent Budget Agency - that can not only prevent the pro-cyclical bias of discretionary fiscal policy, but also make it counter-cyclical.

2. The proposed solution: the creation of a Budget Agency

Before proceeding to the explanation of how the proposed Budget Agency will work, it is important to make three remarks. First, the Budget Agency will be an institution with the same function of a Central Bank – to adjust aggregate demand to full-employment output. Its purpose is to replace the central bank in two cases: when countries, like the members of the Eurozone, do not have one; and when - like America and many European countries since 2008 and Japan since 1995 - the Central Bank interest rate has already been cut to zero but the economy still remains below full-employment. Second, like a Central Bank a Budget Agency should be independent from the political power. For two reasons: to be exempted from the temptation to increase spending during business expansions, and to be freed from the political cycle (that is, from the pressure to raise expenditure during election years). Finally, it should be borne in mind along the following exposition that the bulk of cyclical movements in output is associated with just three types of goods: dwellings, business investment goods

governments to the high budget deficits triggered by the Great Recession of 2008-9. To give one example, in Portugal the budget deficit was below 3% of GDP in both 2007 and 2008 and the public debt was slightly above 60% of GDP. However, because of the Great Recession fiscal revenue declined by 11.4% and government spending rose by 6.3% in 2009, leading to budget deficits close to 10% in 2009 and 2010 and to a public debt of 93% of GDP by the end of 2010. In the context of the Greek sovereign debt crisis, this then led to rising interest rates on the public debt, which forced increases in tax rates and expenditure cuts that led to a new recession in the beginning of 2011.

(machines, equipment and firm's buildings) and durable consumption goods. The following charts show this quite clearly for the US since the Second World War:



Given the previous remarks, I can now turn to the central idea of the paper: how the Budget Agency works. During a recession, it issues debt (eg, \$50 billion) to carry

out expenditures in *investment goods which are saleable*. The debt thus contracted is guaranteed with the value of the acquired investment goods (\$50 billion). Examples include the construction of residential and office buildings, which are *saleable*, but not of roads or bridges, which are not; the purchase and rehabilitation of decrepit urban buildings during recessions that can afterwards be *sold*; and the construction of hydroelectric dams, which are *saleable*.

The result: when the private construction sector is suffering from the usual deep contractions during an economic downturn, the laid-off workers and the unused capital stock of private firms are utilized in the construction projects promoted by the Budget Agency. Afterwards, when the subsequent economic expansion eventually arrives, the office and residential buildings constructed and rehabilitated during the recession are sold off. Finally, the revenue thus raised is used to pay the initial debt so that, at the beginning of the next recession the Budget Agency's debt is back to zero.²

In sum, the operation of the Budget Agency involves the following trick. When it promotes the construction of investment *saleable* goods during a downswing, the Budget Agency incurs in a deficit which raises its debt, but in the process - and unlike the government when it makes investment or consumption expenditures - *it acquires saleable assets of equal value*. As a result, the net value of the Budget Agency remains constant during a recession, and it can cut its debt back to zero in the following upswing.

Now, and as already noted, the bulk of business cycle fluctuations consist of wide movements in the output of two other types of goods besides construction goods: machines and equipment, and durable consumption goods (notably, autos). Could the

² The sales of buildings during business expansions bring an additional advantage: they mitigate the tendency for the excessive increase in both property prices and property construction during those periods.

Budget Agency help dampen the cycles observed in these two industries as well? One way would be to issue debt in order to grant *subsidies* to private expenditures in machines, equipment and durable consumption goods during recessions, with the condition that the debt would be *paid off with extra taxes* charged by the Budget Agency on those goods during the subsequent expansions.³

Finally, notice that the operation of a Budget Agency has an important advantage over that of a Central Bank. Monetary policy has an indiscriminate effect on all regions of one country - even though there are always some regions more severely hit by recessions than others. By contrast, a Budget Agency can concentrate the construction and the rehabilitation of buildings in the regions worse affected by recessions. In this sense, the effects of the actions of the Budget Agency are spatially more fine-tuned than the effects of monetary policy.

4. Conclusion

In most countries, *discretionary* fiscal policy has often been pro-cyclical: instead of checking the business cycle, actual discretionary policy has typically amplified it. This paper has proposed a mechanism that can not only prevent the pro-cyclical bias of discretionary fiscal policy, but also make it counter-cyclical. That mechanism involves the creation of an independent Budget Agency which undertakes expenditures that, in addition to augmenting its debt, also raise its *saleable* assets - and, therefore, do not reduce the net value of its balance-sheet. One example is the construction, during recessions, of housing and office buildings that will be *sold* in the subsequent expansions. Besides real estate investment, the Budget Agency can also carry out

³ In this way, the operation of the Budget Agency would be analogous to that of the Central bank when this cuts interest rates during economic downturns and raises them in the following upturns.

“balance-sheet neutral” expenditures in two other sectors responsible for the bulk of business cycle fluctuations: business investment, and durable consumption.

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