EXPENDITURE MANAGEMENT DURING ECONOMIC DOWNTURNS

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The Global Financial Crisis Has Challenged Economic Doctrine

- Although it was not global, the financial crisis, which was centered in advanced economies, has impacted stabilization policy in emerging and developing countries
- For decades, it was settled doctrine that automatic stabilizers promote economic recovery, even though they enlarge fiscal deficits
- Automatic stabilizers work principally through changes in revenues, with smaller adjustments in expenditures
- A key advantage of automatic stabilizers is that they fade away when the economy recovers, thereby doing little (or no) damage to the country's long-term fiscal position
- To stimulate demand during downturns, governments often supplemented built-in stabilizers with discretionary actions that enlarged deficits and debt
- In effect national governments strove to balance the economy by unbalancing the budget
- The emphasis on austerity during the recent downturn in many advanced countries indicates lack of confidence in automatic and discretionary stabilizers

Lessons From Affluent Countries: Fiscal Rules Versus Economic Stabilizers

- During the Post World War II period, automatic stabilizers made fiscal outturns hostage to performance of the economy
- Fiscal aggregates set in the budget were elastic: they automatically adjusted to variances between projected and actual macroeconomic conditions
- There were no (or weak) preset limits on aggregate expenditures, deficits or public debt
- During downturns deficits in excess of budgeted levels were welcome as indicators of stabilization policy at work
- However, the rapid spread of fixed fiscal rules late in the 20th century signaled a fundamental shift in stabilization policy
- These rules generally disregarded economic cycles, and could be effective only if they constrain or disable automatic stabilizers
- Demobilization of automatic stabilizers was implied rather than stated, and the absence of effective enforcement mechanisms and their procyclical bias doomed the rules
- Violations were common, though they did have a constraining impact in quite a few developed countries

Lessons From Affluent Countries: Perceived Deficiencies in Stabilization Policies

- Postwar stabilization policies were considered successful, but only as long as downturns were short and shallow, and were followed by robust growth
- The slowdown of growth late in the 20th century impelled many affluent countries to reconsider these policies
- Stabilization left a legacy of rising public expenditures at the end of the century. Across the OECD community, expenditures were approximately 20 percentage points higher as a share of GDP than they were in 1960
- High public expenditures were partly financed by rising tax burdens, but it became increasingly difficult to raise taxes further: in fact, many OECD countries sought to reduce tax rates
- Public debt escalated, spurring concern as to the long-term sustainability of public finances
- These concerns were whetted by aging populations and long-term pension and health-care obligations
- Stabilization had a built in bias: governments spent more during downturns to boost the economy, and spent more during good times because they had more to spend
- Sticky expenditures (on entitlements) accounted for a rising share of national budgets, and weakened the capacity of political leaders to manage spending levels

Lessons from Developed Countries
Deficiencies In First Generation Rules

- Most rules cover a single fiscal year, not the medium-term or an economic cycle
- Many counties established Medium-Term Expenditure Frameworks, but these were to have been weak constraints on future spending
- Procyclical fiscal rules have the potential to deepen social misery and to retard economic recovery
- Fiscal rules have been undermined in some countries by unduly buoyant economic forecasts
- Fiscal rules are not self-enforcing: They require political commitment to curtail spending demands and pressure for tax relief
- During good times, fiscal limits are used to justify additional spending
- Fiscal rules invite ploys that hide contingent liabilities and other risks, shift expenditures to future fiscal periods, capture one-off income from sale of public assets, and raid the cash balances of state enterprises
- Fiscal responsibility procedures that empower political leaders to set annual or medium-term targets have been more effective than preset constraints

Why Fiscal Rules?
Why Austerity?

- If fiscal rules have been ineffective, why seek next generation rules to constrain public finance?
- Part of the answer is that even when they fail, fiscal rules often leave a legacy of austerity
- In the aftermath of crisis, numerous OECD countries have adopted austere policies despite very high unemployment. These include countries that voluntarily adopted austerity (The United Kingdom and the United States) and countries that have been compelled to adopt austerity (Ireland, Spain, Portugal, Greece)
- However, pressure is rising in some countries to ease the grip of austerity on national budgets and to return to stimulus
- To comprehend these pressures in policy, it is useful to shift attention from developed countries to the developing world

Lessons From Low-Income Countries: Austerity During Economic Adversity

- Austerity has long been the fiscal fate of many developing countries
- Many of these countries have feeble built-in stabilizers because of low revenue mobilization and small income supports
- During downturns discretionary policy often favors expenditure cuts, especially when terms of trade have deteriorated, interest rates are high, and the country runs chronic current account deficits
- Even while affluent countries enlarge budget deficits during downturns, low-income countries are pressured to curtail deficits by shrinking public expenditures
- This double standard has been due more to capital markets than to International Finance Institutions' conditionalities, though populist media often blame the IFIs
- Capital often migrates to high-income countries that have fiscal deficits, but flees from low-income countries when economic prospects become unfavorable
- It appears that some developed countries now are getting the bitter fiscal medicine that once was the fate of less fortunate countries
- In considering next generation rules, it is appropriate to inquire whether other treatments, such as stabilization policies would be more benign developed and developing countries

The Return of Stabilizers (Perhaps They Never Left): Affluent Countries

- High unemployment, low (or no) growth, low interest rates, and the risk of deflation speak to the legitimacy of and need for stimulative policies
- Stimulus may entail both automatic and discretionary responses to economic weakness
- Because of elevated debt levels and long-term sustainability concerns, care must be taken to assure that the fiscal effects of stimulus fade away as growth resumes
- In other words, stabilization must be truly countercyclical, constraining national budgets when the economy is strong
- Achieving this will require next generation rules that enforce fiscal discipline during good economic times
- It is too early to assess whether next generation rules, such as EU's Fiscal Compact, will work, but early signs have not been favorable

Strengthening Stabilizers: Emerging Market Countries

- As a country develops, public expenditure usually rises as a share of GDP
- Governments expand income supports and enlarge their capacity to stabilize economic conditions through automatic and discretionary policies
- BRICs countries that have large public sectors may have little room for growth in relative expenditures as their economies expend
- Countries that have high growth and high deficits (for example, 6% growth and 6% deficits) have little margin for stabilization during downturns
- Countries dependent on natural resources would do well to promote stabilization through reserve funds, such as Chile's copper fund and Norway's sovereign fund
- Stabilization policy would be facilitated through politically-difficult expenditure policies, such as curtailing subsidies, reducing the public service head count, and better targeting of transfers
- Fiscal responsibility frameworks are a better fit for emerging countries than fixed fiscal rules