Global Economy

A pro-cyclical fiscal policy

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One of the most important public services provided by the State is to insure against risks. Access to education, health care or unemployment benefits means that, during a recession, the most vulnerable households do not reduce their consumption as much. In addition to giving people stability, fiscal policy also allows smoothing of the economic cycle by offsetting temporary falls in private demand with higher public spending. This is what is called a “counter-cyclical” fiscal policy. On the other hand, when the measures taken by the government serve to intensify the volatility of the economy, exacerbating the ups and downs, we speak of a “pro-cyclical” fiscal policy. Now that a new deficit path for the Public Administrations has been announced, a key question is to determine what the tone of fiscal policy will be if the established goals are met and whether this will help to stabilise the economy.

In order to answer, the first thing would be to define whether we are in a positive or negative moment in the economic cycle and the second to determine the sign of the fiscal impulse. Regarding the first question, what we want is, for example, to infer how much of the improvement in public revenues is transitory and how much is structural. In this respect, an increase in GDP of around 3% as recently observed seems more like a ceiling than a floor. Thus, it is difficult to conceive of tail winds as favourable as those we have had in recent years, with strong global growth, low oil prices, an expansive monetary policy, etc. In fact, the IMF points out that the potential GDP growth in Spain would be around 1.5%. It seems reasonable then to think that we are in a period where the economy is creating jobs faster than the rate at which it will do so over the next 10 years. Additionally, the problems of a lack of private demand and excess idle capacity observed during the crisis seem to have been left behind: although unemployment remains high, its current level is similar to the average of the last 30 years, so the unemployment problem appears more structural than cyclical.

Regarding the tone of fiscal policy, it is worth analysing what happened in 2017. Last year, the public deficit was reduced by 1 percentage point (pp) of GDP. Does this mean that there has been a contractionary policy? Not necessarily. In fact, given that it is difficult to detect discretionary measures that may have significantly increased the tax burden or, failing that, structurally reduced spending, it is very likely that the entire fall in the deficit was a consequence of the good behaviour associated with the economic recovery. Therefore, we could deduce that in an environment where fiscal policy has been neutral (neither pro-cyclical nor counter-cyclical), a growth of around 3%, like the one observed during the past year, has allowed a drop of 1 pp of GDP in the imbalance in public accounts. Moving this towards 2018, and seeing that the forecasts on the advance of GDP remain slightly below those of last year, we would expect to see a cyclical improvement in the deficit similar to that of 2017. However, the new path that has been announced during these last few days points to a decrease of just 0.4 pp of GDP. This would suggest that fiscal policy will be expansionary this year, including measures that would reach around 0.5 pp of GDP.

In summary, in a period of above-normal expansion, the Public Administrations will contribute positively to the growth of demand. That is, there will be a pro-cyclical fiscal policy. In fact, this would have been the case in 3 of the last 4 years. In a country like Spain, where monetary policy is managed according to the needs of the euro zone as a whole, it is essential that during these years of growth, the necessary fiscal space can be generated to offset any possible idiosyncratic shocks. In the absence of these savings, the Government will have less room in the future to fulfil its stabilising function, and the households that are most affected will be precisely those that depend to a greater extent on the State to guarantee certain levels of consumption.

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