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RE-EVALUATING THE STABILIZATION FUNCTION OF THE FISCAL POLICY

The fiscal–monetary policy mix has been used as anticyclical tools in the stabilization policy. In the last 10-15 years, the monetary policy became neutral and the fiscal policy transformed into pro-cyclical. As a result, large budget deficit emerged during the economic boom, which required debt financing and led to accumulation of significant government debt. Many countries have entered into debt fiscal crises. For going out of the vicious circle: permanent budget deficit, debt funding and growing public debt, changes are proposed in the model of conducting fiscal policy: creation of the fiscal reserves during economic upsurge, which has to be used for stimulating aggregate demand during crisis, instead debt financing; accepting the fiscal rules in order to discipline politicians in their fiscal decisions; accepting the low level of budget deficit in time of crisis, which has to be reached by budget expenditure cuts, instead tax rate increase. There are sufficient fiscal consolidation programmes, which testified the correctness of these changes, launched as optimal fiscal policy.

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During the last 10-15 years, the fiscal policy of many countries has been transformed into pro-cyclical. An indicator for that are the chronic budget deficits and the increased public debt in times of economic growth. As a result, the high debt payments diminished the stimulating effect of the expansionary fiscal policy during the 2008-2011`s crisis. A series of analyses revealed the weaknesses of the pro-cyclical fiscal policy and had advocated for a new model with anti-cyclical profile. A. Alesina defines it as “socially optimal fiscal policy”, suggesting that:

In the first place, in times of crisis, the right medicine is reducing the taxes and the budget expenditures, which according to the empirical studies creates trust amongst the economic agents and stimulates their consumption and investments.

Secondly, during the economic growth, the increased tax revenues should be collected in a stabilization fund (fiscal reserve) that in times of crisis will serve as a source of deficit financing the budget spending and encourage the aggregate demand. Under this condition, the stability in the economic development will be maintained and the need for debt financing - minimized, which in turn will reduce the public debt.

Thirdly, the introduction of rules to eliminate the fiscal discretion of the policy-makers and limit the fiscal decision-making process that can deteriorate the fiscal balances.

The above-mentioned recommendations are based on empirical research. The countries that followed them have improved their fiscal stability. In the long run, the socially optimal fiscal policy decreases the fiscal imbalances and creates more distinct anti-cyclical effect on the economic development.

From a legal point of view, the Keynesian stabilization policy model was developed and implemented in the period of the 60s and 70s. Originally, this model had an anti-crisis nature and only later took an anti-cyclical course. In times of economic crises, the aggregate demand was encouraged through deficit financing of the budget and increased money supply. After the revival of the economic activity and its overheating, restrictive fiscal and monetary measures were put into place. Within the framework of short-term stabilization of the economic activity, encouraging conditions for investments were introduced in order to increase the potential volume of the production.

The analyses of many economists reveal the negative economic and social consequences of the permanently expansionary and deficit budget policy. The public debt of many countries reached proportions that led to national and global fiscal crises that eroded the stimulating effects of budgetary spending to maintain economic growth. In a series of scientific studies (mainly from economists coming from the circles of the World Bank and IMF) an alternative to the current permanently expansionary fiscal policy was developed, which was defined as "optimal". It proposes a new algorithm to manage, which preventively restricts the deepening of the fiscal imbalances within the economic cycle and, in the long run, claims to optimize the fiscal balances.

In this article, the analysis is limited to the stabilization role of the fiscal policy and the development of a medium term model of fiscal optimization. The fiscal practice in Bulgaria is not analyzed since it requires a more in-depth analysis.[1] After the introduction of the currency board however, Bulgaria, to a great extent, has been following the new solutions for fiscal stabilization and optimization of the public finances. In this sense, even if implicitly, the analysis and the arguments in this study are relevant to the fiscal development of the country in the last decade.

The discretionary anti-cyclical fiscal policy

The Keynesian understanding of the deficit budget financing as a tool to encourage the aggregate demand in times of crises determined the stabilizing role of the fiscal policy. The monetary policy was included to support it. The combination of fiscal and monetary measures stimulated the aggregate demand and contributed to the growth in the 60's and 70's of the last century. The increased demand, however, provoked inflationary processes and formed negative expectations for the private investors. Monetarists and representatives of the theory of rational expectations disputed the Keynesian regulation, based on the Phillips` curve dilemma: the inflation stimulates economic activity and employment, but over time, it causes stagnation and rising unemployment. During the 80s, this reality changed the understanding of the role of the monetary policy: in the short term, it is

[1] See *Manliev, G*. Government Intervention and Fiscal Redistribution: Conceptual Analyses, Empirical Results, Fiscal Optimization and Fiscal Decisions in Bulgaria. "King", 2012, p. 183-200.

assumed that it encourages the aggregate demand, but it provokes an increasing inflation and undermines the stable growth in the coming years. For this reason, the Central Bank focuses on maintaining low inflation as a precondition for healthy growth.

The change in the role of the monetary policy and the increase in the independence of the Central Bank reflected also on the way of conducting fiscal policy.[2] The politicians were able to influence the course of the economic activity only through changes in the fiscal instruments: taxation, budgetary spending and budget deficit. The policy makers lost the support of the Central Bank and more fundamentally, the change in the interest rates as a powerful instrument to influence the level of investments. This evaluation however, is exaggerated because also in the modern situation the Central Banks in many countries change the interest rate (although gradually and in small steps), in order to support the effect of the fiscal measures, i.e. the coordination of the two policies continued, although in a more concealed manner.

In the period of the 60s and 70s, two automatically functioning stabilizers of the aggregate demand were built: progressive taxation and public spending on social transfers. During the crisis, the unemployed received compensation, which to a great extent retained the reduction in the personal consumption. In the revival phase, the income has increased and the individuals entered higher tax rate groups, which held their consumption and investment spending. The automatic action of these instruments stabilized the aggregate consumption and demand. Without them, the fluctuations in the raise and falls of the economic activity would be significantly larger and therefore less favorable for the society. Both Keynesians and neo-classics recognize this role, and therefore the automatic built-in stabilizers are a consensual element in the management of the fiscal policy. The politicians also accept them without discussion as their voters support them.

The automatic stabilizers however, only partially correct the aggregate consumption, which is why they are not sufficiently strong instrument for anti-cyclical impact. Furthermore, the effect of their action depends on the size of the economy, the level of development of the social transfers and the progressive nature of the taxation. These features require changes in the taxation and public expenditures as important anti-cyclical instruments. The solutions in times of crisis are well known: tax rates reductions and increases in the public spending, which as a rule requires budget deficit financing. The latter has become the primary vehicle to encourage the aggregate demand in times of crisis, while the tax cuts and the increase in the public investments – its concrete instruments.[3] In this period, the view of annual budget balancing was assumed to be a classical anachronism.

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[2] *Arestis, Ph., M. Sawyer*. Re-examing Monetary and Fiscal Policy in 21st Century. Edward Elgar, 2004, p. 1-9.

[3] *Perry, G.* (ed.). Fiscal Policy Stabilization and Growth. Prudence or Abstinence. The World Bank, 2008, p. 11.

The state could use two instruments to finance the deficit budget: to increase the money supply and to attract credit from the capital market.[4] The first solution has a zero cost to the state and thus became the preferred influence instrument. It generates a certain degree of inflation that maximizes the benefits and promotes the expansion of the economic activity. After all, the unemployment has been reduced, which is always the goal of the macroeconomic policy. However, since the Phillips` curve (the alternative to inflation-unemployment) no longer gave results - only one alternative to the budget deficit remained: the borrowing debt. It led to an increase in the public debt, which created problems for its repayment in the coming years. The rational proposal for solution was the concept of cyclically balanced budget. According to it, the debt financing of the budget is justifiable in times of crisis to encourage the aggregate demand but in times of economic growth, a budget surplus is necessary to be formed in order to pay for the principal and the interest on borrowings. The normative solution is: if for example, for 3 years a deficit of 8% of GDP has been generated, it is necessary to accumulate budget surplus of 9% in three consecutive years of economic growth. It will cover the maturities on the principal and the interests on state loans. In fact, the fiscal policy in the medium term is balanced, and in the meanwhile, the annual deficits and surpluses bring about flexibility in the implementation of its stabilization role. After the restoration of the fiscal balance, the government has a space to make a new fiscal influence through deficit financing of the budget. In other words, the concept of cyclically balanced budget is a variation of the Keynesian anti-cyclical policy, which held the public debt within a range that does not threaten the fiscal stability in the country in the course of time. The first solution has a zero cost to the state and thus became the preferred influence instrument. It generates a certain degree of inflation that maximizes the benefits and promotes the expansion of the economic activity. After all, the unemployment has been reduced, which is always the goal of the macroeconomic policy. However, since the Phillips` curve (the alternative to inflation-unemployment) no longer gave results - only one alternative to the budget deficit remained: the borrowing debt. It led to an increase in the public debt, which created problems for its repayment in the coming years. The rational proposal for solution was the concept of cyclically balanced budget. According to it, the debt financing of the budget is justifiable in times of crisis to encourage the aggregate demand but in times of economic growth, a budget surplus is necessary to be formed in order to pay for the principal and the interest on borrowings. The normative solution is: if for example, for 3 years a deficit of 8% of GDP has been generated, it is necessary to accumulate budget surplus of 9% in three consecutive years of economic growth. It will cover the maturities on the principal and the interests on state loans. In fact, the fiscal policy in the medium term is balanced, and in the meanwhile, the annual deficits and surpluses bring about flexibility in the implementation of its stabilization role. After the restoration

[4] *Acocela, N.* The Foundations of Economic Policy. Cambridge Univ. Press, 1994, p. 335 – 343.

of the fiscal balance, the government has a space to make a new fiscal influence through deficit financing of the budget. In other words, the concept of cyclically balanced budget is a variation of the Keynesian anti-cyclical policy, which held the public debt within a range that does not threaten the fiscal stability in the country in the course of time.

The fiscal policy, regardless of whether it is with an anti-cyclical or a balanced orientation within the business cycle, requires discretionary actions by the government, i.e. when to put in place the fiscal measures so as to guide the course of the economic activity in the desired direction. In order to be timely, and accurate, the discretionary fiscal decisions should be based on:[5]

●Macroeconomic analyses and assessment of the evolution of the business cycle;

●Knowledge of the tax and budget multiplier parameters and the time lag of the effects of the fiscal measures;

●Estimates of the influence of the automatic built-in stabilizers and the public investments on the level of the aggregate demand, in order to determine the need for debt financing;

●Understanding of the development of the anti-crisis programs with measures to stimulate the aggregate demand and the programs that make part of the larger budget revenues in times of economic growth in the form of a budget surplus and its storage in reserve funds, as well as finding the right time within the cycle to switch from one to another program;

●Multi-annual budgeting to optimize the level of budget deficit and surplus and obtain a zero budget balance at the end of the cycle;

Risk assessment of the fiscal decisions on major public projects and programs (especially the social);

●A system of permanent control over the amount of the public expenditures.

The preparation of the above analyses and estimates concerning the fiscal policy requires the formation of a professional institutional capacity, which to offer adequate solutions for fiscal adaptation, stabilization and equilibrium over time. Herein arises the first big risk in the discretionary fiscal policy: there is no guarantee that the professional analyses and estimates are precise enough to implement effectively the regulatory model of cyclically balanced budget. In practice, many analyses of the IMF, the World Bank, OECD and other researchers reveal these quite a few differences in the preliminary estimates and the subsequent results of the discretionary fiscal policy decisions of the governments. There is however, a second, even bigger risk, related to the political decisions concerning the fiscal measures of the government. Within the scope of their mandate, the politicians pursue and maintain the economic activity together with winning voters. Their decisions are short-term oriented and because the economic recovery before

[5] *Arestis, Ph., M. Sawyer.* Re-examing Monetary and Fiscal Policy in 21st Centuries, Edward Elgar, 2004, p. 125.

the elections is important, and not so much what would be the consequences of the encouraging or discouraging fiscal measures in a few years.

The conclusion of the numerous empirical analyses of the results from the discretionary policy is that despite the successful examples of fiscal adjustments, it does not lead to a balanced budget and fiscal equilibrium within the cycle. Particularly disappointing are the fiscal decisions in times of economic growth. The usual scenario is when the budget deficit and the debt loans, which increase the level of public debt and worsen the fiscal imbalances. As a result, the fiscal policy in many countries has acquired a pro-cyclical character: the public expenditures increased during the growth, which further stimulated the growth. During the crisis, however, they have been cut down (if there was no room for debt loans), which deepened the economic slowdown. The pro-cyclical character of the fiscal policy significantly reduces the state`s fiscal space to respond in times of economic crises.

The empirical analyses present a number of recommendations for increasing the effectiveness of the fiscal policy, three of which are about to change the model of its implementation:[6]

First, it is necessary that the pro-cyclical policy (the one that increases the public spending during economic growth and limits them in times of crisis) should be transformed into an anti-cyclical.

Second, new approaches are indispensable for making fiscal decisions, which to guarantee the fiscal discipline and responsibility of the politicians, i.e. serious deficits should be prevented, and the increase of the public debt should be limited to a size that would not impair the countries` socio-economic stability. The introduction of legal rules, which to define the framework and the procedures for making fiscal decisions, alters the model of development and implementation of the modern fiscal policy.

Third, in times of crises, the governments face the dilemma: raising the taxes or cutting the spending, in order to reduce the negative impact of the budget deficit and the debt financing. Which of the two instruments creates a more effective fiscal adaptation, i.e. exit from the crisis with better opportunities for consequent growth?

Rules vs discretion in the conduct of fiscal policy

The conventional macroeconomic understanding is that fiscal policy should have an anti-cyclical character: in times of crisis, it should be expansionary, and in times of growth – restricting. The empirical analysis on the impact of the fiscal

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[6] These questions are examined in the articles: *Spilimbergo, A., St. Symanski, O. Blanchard.* Fiscal Policy for the Crisis. IMF, Dec. 29, 2008; *Alesina, A., S. Ardagna*. Large Changes in Fiscal Policy: Taxes versus Spending. NBER Working Paper 15438, www.nber.org /papers/w15438; *Alesina, A., F. Campante, G. Tabellini.* Why is Fiscal Policy Often Procyclical? - Journal of European Economic Association, Sept. 2008, 6(5), p. 1006-1036; *Persson, T., G. Tabellini*. Constitutional Rules and Fiscal Policy. - The American Economic Review, Vol. 94, 1, 2004, p. 25-45; *Alesina, A*. Fiscal Adjustments: What do we know? What we are doing? GMU, Mercatus Center, Sept. 2010, WP 10-61.

policy in the 80s and 90s, however, revealed that in many countries it is pro-cyclical: instead of increasing the budget spending during the crisis, they are cut down and vice versa in times of economic growth: the expenses are increasing, in order to compensate for the deprivations during the crisis years. One of the reasons for the pro-cyclical character of the fiscal policy (together with the money supply, the changes in the financial market, the international prices and the movement of capital) is the discretionary actions of the politicians (according to their own analysis and evaluations).[7]

The pro-cyclical action of the fiscal policy exacerbates the macroeconomic fluctuations in the economic activity, i.e. the crises become more and more deep, and the growth more dynamic. This change significantly deteriorates the ability of the fiscal policy to stabilize the economic activity within the business cycle. The economy enters the crisis with a budget deficit and public debt, which are limiting the "fiscal freedom" of the government, i.e. its ability to use the budget deficit and the debt financing as anti-cyclical instruments.

The cause of the pro-cyclical action of the fiscal policy is the lag of time to take and implement the fiscal decisions. They are prepared over months by the experts, then they go through a parliamentary debate, then they are accepted as a law, and only then, they take action, and hence the expected effect of them comes after a few months. In practice, more than one year passes from launching the idea for fiscal stabilization measures until the first results. During this period, it is possible that the economy has entered a phase of recovery, and the encouraging fiscal measures, instead of having an anti-cyclical effect, have a pro-cyclical action: they enhance the effect the increased demand, resulting from the recovery of the private consumption and investments. Likewise, the fiscal measures to limit the aggregate demand in times of economic growth when the economy is already on the verge of a crisis, actually stimulate the rapid contraction of the economic activity. In other words, the pro-cyclical action of the discretionary measures exacerbates the fluctuations on the economic activity.[8]

The discretionary fiscal policy creates a tendency to form and increase budget deficits. It stems from the inconsistency of the fiscal decisions over time. The politicians deviate from their intentions of fiscal discipline in the expenditures under the influence of some social pressure groups or due to entering election year. At that time, the control over the costs is reduced and channels are quickly created to increase the budget deficit. For example, it is difficult for the politicians to increase the tax rates and to reduce the public expenditures during the economic boom. At that time, they do not form the normatively recommended budget surplus and reduction in the public debt in order to overcome the fiscal imbalances and to ensure a space for fiscal support in times of crisis. The voters

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[7] *Perry, G.* (ed.). Fiscal Policy Stabilization and Growth, Prudence or Abstinence. The World Bank, 2008 p. 163.

[8] *Kopits, G.* (ed.). Rules-Based Fiscal Policy in Emerging Markets. Palgrave, 2004, p. 56-58.

themselves demonstrate a myopia and fiscal illusion in their behavior. They pursue the recipient of immediate benefits while ignoring the question who is going to pay the bill for the higher expenses, they are even willing to pass the bill to the future generation, which is the case with the debt financing. In the end, there are quite a few cases described where the politicians from the ruling party take fiscal decisions to increase the expenses, which to bring them political dividends within their mandate. However, they shift the burden of the implementation on the next generation. This is a political game, which pursues the formation of impediments for the next government with the idea to discredit it in front of the electorate.[9]

The pro-cyclical fiscal policy also creates a tendency to reduce the public investments. For the EU countries, John Perry has found out that in times of crises, in contradiction to the conventional anti-crisis logic, the public investments decrease.[10] This relationship is typical for many other countries. What are the reasons for its explanation? During the crises, the politicians prefer to keep the jobs in the public sector or the level of the social expenditures, thus shrinking the public expenditures by cutting public investments. As a rule, the short-term indicators (within a year) are fixed in the fiscal adjustment programs considering the budget deficit and the public debt level. In view of their achievement, the expenses for public investments, which could be postponed over time, are reduced. In this case, the short-term multiplier effect of the public investments on the growth, as well as the long-term benefits have been ignored because none of them (bridges, tunnels, water treatment plants) can guarantee significant future income taxes. In the end, the reduction of the public investments in times of crisis reduced their overall level and worsened the long-term stability in the countries` economic development.[11]

The proposal to impose fiscal rules is in response to the discretionary fiscal actions of the politicians, who always find arguments for increasing the public expenditures. The rules impose restrictions on the conduct of fiscal policy regarding key fiscal balances. For example, the adoption of a legal rule that 2% deficit during the economic crisis limits the politicians in the process of making fiscal decisions. On this occasion, George Kopits noted that "the fiscal rules are an instrument to avoid the myopic (short-term oriented) fiscal policies, which stem from the political inconsistency and irrational fiscal decisions".[12]

The introduction of rules to conduct fiscal policy received a rapid dissemination, especially in the countries experiencing serious political influence on the fiscal decisions. As a result, in the last ten years there has been a transition to a fiscal policy, based on rules rather than discretionary actions of the politicians.

[9] *Kopits, G.* (ed.). Rules-Based Fiscal Policy in Emerging Markets…, p. 16-18.
[10] *Perry, G.* (ed.). Fiscal Policy Stabilization and Growth…, p. 21.
[11] Ibid., p. 172-173.
[12] *Kopits, G.* (ed.). Rules-Based Fiscal Policy in Emerging Markets…, p. 2.

Depending on the concrete circumstances, the states introduce rules, which are directed predominantly towards the expenditure side of the budget.

A second major issue for the efficient enforcement of the rules is the guarantees for their compliance. The declaration of intent of the government and their consistent pursuit is an important but not sufficient condition. Without legislative changes, the politicians can hardly be disciplined. In this connection, softer and harder fiscal rules are introduced. It is possible that the government declares that it will maintain a balanced budget during its mandate and to consistently follow its intention. The succeeding government however, is not obliged to comply with the fiscal rule, which is why it has a medium-term character. Most often however, the governments accept the fiscal rules with a law, which is integrated into the general budget law or a special law, such as for instance the size of the budget deficit. The rule is the most solid and long-term oriented when incorporated in the Constitution of the country.[13]

In the fiscal practice of the countries application have found rules that can be grouped as follows:

a) rules, limiting the public expenditures to a certain degree of the GDP or to specific categories of public expenditures;

b) rules, pursuing balance of the running costs. They cut the spending to the level of the incomes for a certain period of time (most often years), or prohibit the use of loans to finance the current expenses of the country;

c) rule of balanced budget, requiring the budget balance or allowing a certain percentage of budget surplus;

d) rules of debt financing, which prohibit borrowing from certain sources (the Central Bank) or limiting the amount of debt to a certain amount of nominal values or percentage of GDP.

The rule for restricting the public expenditures puts limits on their increase. A ceiling on the amount of the total expenses or of a concrete group of expenses, for example for education, defense and others to the GDP is fixed. Although the indicators of these costs are a subject to a continuous analysis and fiscal debates, the governments refrain from adopting a rule to put a cap on the public expenditures. Japan has introduced in the Constitution a rule of 38% fiscal redistribution of the GDP. Merely a few countries have followed the Japanese example.

The politicians have raised the argument that the rule of public expenditure ceiling will limit the flexibility of the government to combat the exogenous shocks and other phenomena. Indeed, they are a reality, but the problem is surmountable because in the rule they can be incorporated elements for more flexible fiscal procedure. However, some countries, such as Canada, Switzerland, the Netherlands and others, that have reached a high level of public spending, take a decision to

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[13] See more *Persson, T., G.Tabellini*. Constitutional Rules and Fiscal Policy. - The American Economic Review, 2004, Vol. 94, 1, p. 25-45.

reduce them to a certain amount of the GDP for a given period of time. Their fiscal decisions however, are not based on a generally accepted rule, but represent mid-term programs for fiscal optimization of the expenses.

There is an alarming increase in the public debt and the transfer of its interest rate burden on the next generation, which compels some governments to adopt a rule to put a limit (ceiling) for its growth. It is modeled as an annual expansion limit, which in the next year may change or a fixed amount to be set that the governments cannot exceed. The United States adopt every year a ceiling on the increase of the public debt with their budget law. Providing that the budget revenues are insufficient, the Congress may decide to increase the debt ceiling, i.e. the government is not free to increase the expenses according to their views, but this requires a political consensus. The Great Britain has adopted with a law a limit on the size of its public debt, while Poland has incorporated in the constitution of 1999 the rule of a 60% ceiling on its amount to the GDP.[14]

Undoubtedly, despite some deviations, the rule of the debt ceiling on the public debt constrains the debt financing of the budget deficit and allows the adoption of a budget with higher costs. In this sense, it acts as a direct restriction on the budget deficit and the public spending in the country. Supposing that the countries agree on the public debt ceiling at a lower level, they could have controlled the amount of the budget deficit and the overall increase in the public expenses. For example, if Greece and Portugal had introduced limits on the growth of the public debt in the period after 2004-2005, they would not have permitted such large deficits and would have prevented the entry into the debt crisis of 2010-2012.

The neoclassical recommendation for a balanced budget is a very tight fiscal requirement that restricts the freedom of the governments for fiscal reaction against the critical declines and shocks of another nature. That is why the governments are reluctant to adopt a rule with such an effect. A serious argument in this direction is the unsuccessful experiment in the United States with the 1985 Act to reduce the deficit, known as the law of the Gramm-Rudman-Hollings. According to this law, the government was obliged for five years to reduce the deficit to zero. The implementation of this rule is impossible for the government, and the Congress passed a new law, which defined far less ambitious goals in the reduction of the budget deficit.[15]

The serious limitations, which impose the rule of the balanced budget led to the development of the so-called “golden fiscal rule”. It was introduced in the fiscal practices of the UK and other countries. The golden rule requires that only the current budget expenses and revenues should be balanced, i.e. those, consumed with no further benefit to the society over time. No deficit is allowed for them and therefore no debt financing. An exception to the rule is allowed for capital

[14] *Kopits, G.* (ed.). Rules-Based Fiscal Policy in Emerging Markets…, p. 242-243.
[15] Ibid., p. 21-21.

expenditures, which increase the net wealth of the country and contribute to the economic growth.

In order to increase the public debt however, the golden rule is completed with the rule for a limit on the amount of the debt to the GDP. In the case of the UK, it is fixed to 40% of the GDP.[16] Within the year, however, the debt is decreasing with a certain amount (due to the payment of principals and interests on loans), which allows the government to take a new loan in the same amount. However, they can only be used for financing capital projects, i.e. those that restore or increase the capital assets of the state. Investments in the field of education and healthcare are given priority, since they improve the quality of the human capital and create long-term conditions for economic growth. The golden rule is derived from the US practice, where the budget is divided into current and capital. This approach guarantees to some extend that the capital expenses will not be sacrificed in favor of the chronic deficits of the state`s current expenditures.

The application of the golden rule, however, can cause low efficiency of the fiscal decisions. Its critics point out to the existence of a moral hazard in the actions of some governments: they discount with a lower percentage the benefits from the public projects, in order to justify the substantial capital expenses and their possible deficit financing.[17] As a result, there are many public projects with a low efficiency or investments with lower priority. In such cases, the golden rule for debt financing of the public investments has contributed to the hidden rise in the public debt.

As an alternative to overcome the distortions, which the golden rule trigger, the rule for a permanently balanced budget (permanent balance rule) has been promoted.[18] According to this rule, the amount of the tax revenues is fixed to the GDP, which is sufficient to finance the current and the future expense of the government. When the tax revenues are lower as a result from cyclical factors or the investment opportunities are good (low prices of capital goods), the government issues loans to finance the capital projects. In the following year, with the tax revenues above the determined amount of GDP, the loans are paid off. The advantage of the balanced budget rule in comparison with golden rule is that it has a markedly anti-crisis action. Its disadvantage is the there are no guarantees for more tax revenues in the coming years than the normatively determined percentage, which is used to repay the capital loans. The most serious problem for the application of the rule for permanently balanced budget, however, is the legally determined amount of the tax revenues to the GDP, which has to be fixed for a longer period of time.

In the search of a compromise between the two rules for maintaining the public investments, John Mints and M. Smart propose a modified golden rule: the

[16] *Perry, G.* (ed.). Fiscal Policy Stabilization and Growth…, p. 244-245.
[17] Ibid., p. 250-251.
[18] Ibid., p. 252-253.

debt financing is acceptable for public projects guarantying future revenues from the state in the form of taxes and consumer charges (toll charges, local taxes, port charges etc.). With them, the government can repay the loans and the interests on them. This option excludes the deficit financing of capital expenses for social projects because they do not have a moneymaking character. Their funding remains at the expense of the revenues from the general taxation.[19]

The English version of the golden rule is a good fiscal decision because it maintains the amount of the public investments and builds in another automatic stabilizer of the economic activity (after those with a social nature: the progressive taxation and the unemployment compensations). Meanwhile, it becomes an impediment for the increase of the public debt, which creates another positive fiscal impact: the country`s reputation for maintaining a consistent and responsible fiscal policy. The modified version of the rule brings it closer to the model of private equity financing of projects. It furthermore ensures that the loans will not be repaid at the expense of the revenues from the general taxation. This is why the “golden rule” contributes to the maintenance and increase of the public investments, which generate stabilizing effects on the economic activity and the private investments, and therefore, the long-term economic growth.

The rule of limiting the budget deficit or surplus fixes their volume within the business cycle. In practice, it pursues to change the nature of the fiscal policy from pro-cyclical to anti-cyclical. During the economic boom, the rule requires the budget to be adopted with a surplus, which is put aside in a specialized fund (fiscal reserve). Sources of revenue in the fund are the revenues from the general taxation, which are increased in the circumstances of raised incomes and consumption. During the crisis, the budget could be adopted with a deficit within a certain range and its financing is from a specialized fund. Thus, the debt financing is evaded and equilibrium in the budget is achieved within the economic cycle.

The rule of forming a stabilization fund from revenues derived from the export of goods (using un-renewable sources) is introduced in some countries (Chili, Venezuela, Russia, Botswana, etc.), which are major exporters of cooper, oil, diamonds and other precious raw materials. Their prices fluctuate on the international market and bring significant revenues to the state`s treasury. When the prices are high, the incomes are higher and the states can afford higher expenses. The problem arises, however, when the prices are falling. Then the expenses need to be cut with all the negative economic and social impacts on the society.

The stabilization fund is a new and important instrument for a fiscal stabilization policy. It is something like “save money for a rainy day”. After the adoption of a bottom base price of the resources (covering the production costs and yielding a normal profit), additional revenues from their growth accumulate in the stabilization fund. In the years when the prices of the export goods are low and

[19] *Perry, G.* (ed.). Fiscal Policy Stabilization and Growth…, p. 28.

the budget revenues respectively, the resources from the fund are used to finance public programs that reduce their unwanted contraction. The stabilization fund is a good source of financing the public investments. It performs another important function: reducing the need of debt financing of the budget deficit, which keeps the increase of the public debt.

Requirements for effective modeling of fiscal (instead existing) rules

The adoption of rules that limit the discretion in the fiscal decision-making is an important, but not sufficient condition for the effective conduct of the fiscal policy. The analysis of their application indicates several important recommendations for their effective implementation.[20] It is necessary that the rules should acquire a legal force in order to create some fiscal flexibility in the process of their application, to be applied consistently, without bias and attempts to circumvent, to cause high costs (losses) in exit case, to be included in the preventive monitoring system and to introduce penalties for their violation.

There are three lawful levels where the rules can be assembled as a legal norm with a coercive force of application. The rules of fiscal responsibility are specialized laws, governing the establishment of rules and procedures for compliance. This is the practice in countries, which are at the initial stage of changing their fiscal policy. If the rules become part of the Budget Law, then there is a higher degree of readiness for their implementation. It integrates in one the rules and procedures in making and implementing the budget, which increases the effectiveness of the fiscal policy. The rules have the strongest impact if they are enshrined in the Constitution of the country. Then, all the legal and sublegal acts, as well as all the state institutions adhere to the rules unconditionally. This creates a stronger protection against potential deviations. Moreover, every change or departure from the rule is a complicated procedure, because it requires time and a qualified majority in the parliament. This is why, the constitutional rules create in the highest degree a fiscal discipline and responsibility of the governments.

When modeling the rules, every country experiences a dilemma between their flexibility and their reliability.[21] The adoption of stricter and more solid rules can lead to a lack of flexibility in the implementation, which can discredit them. Consequently, sizable expenses are paid to introduce the rules, without achieving the desired fiscal result. This requires that in the operating procedures of the rule a certain degree of opportunities for flexibility in their application should be incorporated. The real situations require that there is a back-up plan, even if with restrictions on its operation.

In 1962, in the USA a ceiling on the state debt was legally adopted. According to this rule, the government can finance through loans the current budget deficit up to a certain amount. The ceiling is determined annually in the annual budget of the

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[20] *Kopits, G.* (ed.). Rules-Based Fiscal Policy in Emerging Markets…, p. 19-27.
[21] Ibid., p. 58-59.

country. It is possible however, that the demand for debt financing turns out to be higher than the initial expectations and estimations. In this case, the rule can block the activity of the government. For this reason, the condition was introduced that the Congress should decide whether to increase the debt ceiling, which creates guarantees for the financing of the public program, i.e. an element of flexibility is incorporated in the rule.

What is the practice? Does it prove the effectiveness of the rule? For a period of 40 years, the U.S. Congress adopted 74 amendments to increase the debt ceiling, which is an average of two times a year. This is an alarming fact, but the data show that the debt was under control. It was in the range of 32-36% of GDP in 2001-2006. After 2008, however, the public debt has steadily increased and is now nearly 90% of GDP.[22] Obviously, in the recent years the rule does not work well, which raises the dilemma: should there be budget limitations or quit the rule. The public attitudes in the country are in favor of a medium-term cut in the deficit and reduction in the public debt of the country, i.e. to keep the rule, because it is still a barrier for the government to spend more money.

The successful implementation of the rules in practice creates a fiscal discipline in the actions of the politicians, which prevents the worsening of the fiscal balances of the country (which is a common phenomenon in the discretionary policy). The politicians are not particularly excited about such a model of fiscal policy and tend to deviate, circumvent, or even breach the rule. Indisputably, the motive for such an action is the desire of the politicians to improve the welfare of their voters. If they, under such a pretext, manage to break the rule, the fiscal policy based on rules creates over time the same effect as the discretionary inconsistency of the fiscal decisions. In order to avoid such a scenario in the fiscal policy based on rules, it is necessary that the laws should include criminal provisions. They will preventively limit the attempts of the politicians to breach or circumvent the rules.

Importance for the reliability of the rule and its credibility has the question of the time framework and the possible exit strategy. The restrictions are sometimes so strong that the politicians are impatient when the time of the rule`s action is up or even to discredit the rule as inefficient in order to make the decision for its abandonment. For example, the U.S. Congress simply changed the target parameters of the law Gramm-Rudman-Hollings, which made it obsolete. For this reason, it is necessary that in the legal regulation of the fiscal rule, the condition that the exit from the rule can bring huge losses to the society should be clearly formulated. Then the politicians would be less likely to change the rules at their discretion.

Until this moment, it was a matter of fiscal policy rules. However, who develops and controls them? Now the experts who create the rules have importance. They derive the arguments for the introduction of the rules, including the proposal of

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[22] *Yandle, B*. Everyman Deficit, Spending Beyond our Means. Mercatus Center, July 2010, www.mercatus.org/publications; USA Today, 20.04.2011.

schemes for their flexile implementation. An institutional capacity is therefore necessary, i.e. knowledge and ability of the institutions to develop and implement flexible and effective rules.[23]

An important condition for the success of the fiscal policy based on rules is the control of its implementation. It can be assigned to an authorized unit in the Ministry of Finance or to the National Audit Office, to assess the effectiveness of the budget decisions. In case of deviation or violation of the rule, the law refers the offenders to the justice system.

The unsuccessful experience with the application of the fiscal rules in some countries is to a large extent due to neglecting the specified requirements for their development. The compliance with these weaknesses, and the study of the experience of the successful countries is a precondition for the efficient adoption of fiscal rules.

New suggestions for fiscal decisions in times of crisis

Inevitably, together with the beginning of the economic crisis in 2008, a demand for anti-crisis measures arises in order to detain the decrease of the economic activity. However, the governments of many countries were faced with one dilemma: whether to decrease or increase the public expenditures and stimulate the aggregate demand. The first decision allows the budget deficit to remain on a lower level and to activate the automatic stabilizers. However, they are insufficient to maintain the aggregate demand. That is why the fiscal policy of shortening the public expenditures has a pro-cyclic character. In this way the crisis goes deeper, which leads to higher unemployment rate and creates discontent among the people.

The second decision follows the anti-cyclical model: the government increases the public expenditures through a budget deficit. It is financed by means of debt creation and to a certain degree through increase in the money supply. The automatic stabilizers together with the increased public expenditures keep up the aggregate demand, which counteract to the economic slow-down and the increase of the unemployment rate. The fiscal decision in this case has its price: the increase in the public debt. If the latter is on a low level, than the government has some fiscal space for its augmentation and decrease the crisis drop in the economic activity. However, if the debt is already high, the fiscal impact on the aggregate demand has a weak effect because of getting into a debt spiral: new loans are taken in order to liquidate the capital and the interest rates of the old ones, which have a restrictive effect on the deficit financing of the budget.

Based on the numerous analyses of the effects of the anti-cyclical fiscal policy, most of the economists are in agreement with the normative recommendation that the

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[23] *Poterba, J., J. Hagen* (eds.). Fiscal Institutions and Fiscal Performance. Univ. of Chicago Press, 1999; *Wyplosz, M., M. Buti, J. von Hagen and C. Martinez-Mongay* (eds.). The Behavior of Fiscal Authorities – Stabilization, Growth and Institutions. Palgrave, 2002; Fiscal Policy, Institution versus Rules. CEPR Discussion paper, N-3228,2003; *Eishengreen, B.* Institutions for Fiscal Stability. CES info Economic Studies, 2004, N 50.

tax rates and the discretion public expenditures (those that are determined according to the politicians' estimates) as part of the GDP must stay unchanged during the business cycle.[24] Under this condition, the economic fluctuations create regular changes in the movement of the fiscal flows:

a) if the tax rates were stable and there was a certain degree of progressivity of taxation, the public revenues as a part of the GDP increase during the times of the growth and decrease during the crises, meaning that there is a cyclic recurrence of the tax revenues in the budget;

b) the aggregate public expenditures increase or decrease with a lower rate in comparison with their cyclical character during the growth and the crisis, as a result of the automatic stabilizers. They take away income from the economic subjects, lower the aggregate demand during the times of the growth, and act exactly the opposite way during the crises;

c) as a result of the former two relationships are possible: during the times of growth the budget surplus is growing, whereas during the crisis there is a budget deficit.

The cyclic recurrence in the movement of the fiscal flaws is in the basis of the anti-cyclic policy. During the crises, this cyclic recurrence increases the aggregate demand and decreases it during the growth. This type of regulation lowers up the fluctuations of the aggregate demand and brings up the wanted stabilization effect on the economic activity. During the last 10-15 years, however, it can be noticed that the public expenditures increase during the growth and decrease during the crisis, meaning that they do not act anti-cyclical but pro-cyclical! The budget balance follows this move: the deficit increases during the growth and decreases during the crisis. In other words, the changes in GDP, the tax revenues, the budget expenditures are moving in the same direction. In this way, the fiscal policy deepens up the macroeconomic instability and creates fiscal misbalances that intensify over the years.

During the crises, the countries with fiscal policy are forced to diminish the public expenditures in order to avoid uncontrolled deficit. As a result, the crisis deepens up and slows down the process of recovery. The public loans present one opportunity to increase the budget expenditures and the aggregate demand but it has quite limited scope if the countries already have chronic deficits and amassed high public debt or if the interest rates on the loans are too high. During the growth, the tax incomes increase and the attraction of public loans gets easier. Under these circumstances, Talvi and Veghfind have discovered the following regularity: the budget surplus creates a tendency of the government to spend more.[25]

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[24] *Alesina, A., F. Kampante, G.Tabelini.* Why Fiscal Policy is Often Procyclical? - Journal of European Economic Association, Sept 2008, 6 (5), p. 1006-1036.

[25] *Talvi, E., and C. Vegh.* Tax Base Variability and Procyclicality of Fiscal Policy. - Journal of Development Economics, 2005, 78, p. 156–190.

According to A. Alesina, the pro-cyclical character of the fiscal policy is due to the asymmetric information between the electorate and the politicians. The former observe and evaluate the private and public consumption, their income and the amount of the taxes they pay. However, they cannot evaluate the rents the government is paying and the consequences of the amassed public debt. "This pro-cyclical and myopic character of the fiscal policy (increase in the public expenditures and the unnecessary government borrowing during the growth) originates from the electorates` demand."[26] The latter wants extra public expenditures in order to increase their well-being. However, they are not informed about the consequences resulting from the pro-cyclical policy during the growth. The politicians, on the other hand, agree with the electorates' demands because that brings them political rents (economic activity and eventually, re-election). There is a "moral hazard" in the behavior of the politicians: they bring to the front their political interests and neglect the negative effects of the public debt and the increased public expenditures during the growth.

The countries with pro-cyclical fiscal policy do not benefit from the increasing revenues during the growth: they spend them instead of saving them and spend them during the crisis. The good public governance requires that the higher revenues during the growth are saved in a special fund which can be used to increase the public expenditures during the times of crisis without the need of debt borrowing. This rational fiscal behavior of the state creates fiscal policy, which A. Alesina defines as "socially optimal". This is a new conception that preserves the anti-cyclical purpose of the fiscal policy, but diminishes and eliminates the possibility for debt financing and worsening of the fiscal balances of the states over the time. The algorithm of leading this type of fiscal policy is the following:

●the operation of the automatic stabilizers, which has clearly pronounced anti-cyclical direction, is maintaining (the automatic stabilizers increase the public expenditures during the crisis and decrease them during the growth);

●part of the tax incomes which are increasing during the growth are amassed in special budget fund. Through its operation, the public expenditures decrease during the growth and the risk of "sharp downturn or recession" during the crisis is diminished;

●the special budget fund plays the role of a fiscal reserve. Under the condition of unchanging tax system, it is filling up during the growth and it is being spent during the crisis when the country is forced to increase the public expenditures;

●on the one hand, the special budget fund permits that a stability of the tax system can be achieved and on the other hand, it gives opportunity for its optimization if there is such a necessity;

●like a fiscal reserve, the special budget fund decreases the need of borrowing money which stops the increase in the government debt, the public debt burden decrease and the crowding out effect of the economy.

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[26] *Alesina, A., F. Kampante, G. Tabelini.* Op. cit.

In its operation, the optimal fiscal policy preventively would not allow the fiscal imbalances of the discretion policy, which caused the fiscal crises in some countries throughout the last decades. What is more, it permits that a fiscal balance can be achieved during the following couple of years.

Some elements of the optimal fiscal policy are lacking in the classical anti-cyclic fiscal policy. Those are mainly the decision for less tax changes, the formation of the special budget fund and the avoidance of the debt borrowing. The classical anti-cyclic policy did not achieve the rule for zero budget deficits in the frame of the business cycle, and did not lead to the retention or optimization of the public expenditures as part of the GDP. That is the reason why the fiscal imbalances occur, which leads to the development of special medium-term programs for fiscal consolidation. The pro-cyclic fiscal policy is moving even further away from the normative optimal fiscal policy. It deepens up the macroeconomic fluctuations during the economic cycle and the fiscal imbalances: serious deficits, high public debt, high interest rates.

The optimal fiscal policy is a normative concept that is derived from the good fiscal practice of some countries during the last 10-15 years. However, it can become a real policy under the conditions of economic growth and availability of political willingness for its implementation. During the period 2008-2011, the interest of politicians and economists was directed towards faster overcoming of the economic crisis. In many countries, this leads to the adoption of anti-cyclic packages with stimulating fiscal measures. However, their effectiveness was questioned because the debt financing of the budget deficits worsen off the fiscal condition of the countries and creates negative business expectations for their development. Therefore, many economists warned in advance about the absurdity of the expansionary fiscal policy based on borrowing debt.

Although there are some common threats, the economic crises occur and develop under certain conditions. During the crisis in 2008-2010, there is a decrease in the aggregate demand accompanied with huge structure misbalances: housing balloon and mortgage crisis, chronic budget deficits during the economic growth, high level of the government debt and high loan rates, serious deficits in the social funds. At the same time, the banks were in the position to obtain toxic or bad credits, which leads to banks going bankrupt with the potential danger of a chain reaction that reminds of the one from the Great Depression. The credit market was eroded because the lowering of the interest rate from the Central banks did not result in the credit expansion of the commercial banks. They were occupied with improving their banking liquidity, which is the reason why the monetary measures for stimulating the investments did not produce any result. These peculiarities in total create the specific nature of the crisis and accordingly, they demand a specific anti-crisis regulation in order to restore the economic activity. On that occasion, V. Tanzi wrote that: “the current crisis cannot be improved through governance of the aggregate demand and through injection of financial stimulus. This crisis is caused by huge structure misbalances in the current balances and some

sectors of the economy."[27] This requires that middle-term fiscal measures are adopted via which the fiscal balances can be restored and the consequent model for fiscal impact can be changed, meaning that a socially optimal fiscal policy is put into practice.

During the elaboration of the anti-crisis fiscal packages, most of the countries were faced with serious limitations. The first one of them, the reduction of the budget expenditures in order to lower down the public deficit and the debt financing, would deepen up the recession. Obviously, this option of the fiscal policy was not suitable. Secondly, according to the Keynesian anti-crisis scheme, the single tax cuts would ensure an increase in the available income and respectively in the private demand. The effect of this measure in the 2008-2010 economic crisis is insignificant because the households would direct the available incomes to paying off the mortgage and consumer loans instead of increasing their personal consumption. M. Feldstein shows that under normal conditions in the USA, the utmost propensity for consumption is 0.7, whereas the single tax cuts in the fiscal packages of the Obama government would give an effect of only 0.13 on the private consumption! [28] There were only two possible stimuli: tax credit on the investment for the private investments, which give effects, but lower up the incomes of the corporate tax. The second stimulus: the increase in the public expenditures leads to budget deficit and inevitably requires debt borrowing.

Many countries put into practice the deficit financing of the budget as a reliable remedy for overcoming the crisis. However, it increases the size of the public debt and the consecutive interest weights. In order to achieve higher effectiveness of the deficit financing of the budget, the governments set up priorities, which would result in the highest possible economic and social effect. For example, in the USA the investments in infrastructure, education, energy, health care and the support of the vulnerable groups in the society were defined as such. Indeed, in those fields, the budget multiplier has a higher magnitude and the stimulating effect is bigger. However, it is insufficient in order to increase the aggregate expenditures up to a level, where the economic activity can be encouraged. Considerable influence in this direction could have the increase in exports, but this is no more a question of fiscal policy, whereas it is a question of national competitiveness.

The conclusion from the numerous analyses is that the fiscal stimuli under the conditions of reduced quantity of the fiscal multiplication, budget deficit and high level of public debt (which are typical features for most of the developed countries during the examined period) would not increase the aggregate demand in sufficient degree in order to stimulate the economic activity.[29] J. Stiglitz recognizes

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[27] *Tanzi, V.* The Economic Role of the State Before and After Current Crisis, www.iipf.org/speeches/Tanzi_2009.pdf

[28] *Feldstein, M.* Rethinking the Role of Fiscal Policy. NBER Working Paper 14684, Jan. 2009.

[29] Ibid.

this fact and highlights that without monetary measures the fiscal stimuli are insufficient in order to lead the economy out of the crisis.[30] However, the problem is that the developing countries enter into the crisis with low interest rates and that is the reason why the scope of their further reduction is limited. This is the reason why M. Feldstein draws the conclusion for rethinking the role of the fiscal policy as anti-crisis instrument. He points out that "the fiscal stimuli have to be redirected from increasing the public expenditure towards substantial decrease in the private and corporate taxes. There should be changes in the expenditure policy that require the limitation of the public debt growth if this strategy is to be adopted."[31]

Each government will try to compensate the initially anticipated decrease of in the public incomes with increase in the debt financing of the budget deficit, which will worsen off the balance: public debt - GDP. That is the reason why, the introduction of a limit to the public debt growth mixes the fiscal policy: on the one hand, tax reduction is being made, that stimulate the private consumption and investments and on the other hand, the public expenditures increase, but within a limited extend. According to M. Feldstein, this model of leading the fiscal policy limits the opportunities for deterioration of the fiscal misbalances during the economic crises and at the same time creates encouraging impulses on the private consumption and investments. Obviously, the private expenditures stimulate the increase in the aggregate demand rather than the public expenditures. If the governments follow the proposed policy for getting out of the crisis, they can improve the situation of their fiscal balances during the times of the growth.

Largely, "rethinking the fiscal policy", proposed by M. Feldstein, is within the framework of the discretion type of anti-crisis fiscal policy: precise analyses on the depth of the crisis, according to the changes of the separate aggregates; exact estimates on the size of the fiscal multiplier according to the separate expenditures programs and the elaboration of the fiscal mix (tax reductions plus limited increase of the public expenditures), which creates stimulating effects on the aggregate demand with delaying effect on the increase in the budget deficit and the public debt.

The fiscal alternative: reduce the public spending and budget deficits during the crisis

The conventional type of fiscal policy, i.e. the Keynesian anti-crisis fiscal regulation is based on the following postulates:

●reducing the deficit in times of crisis deepens the recession.

●reducing the public spending or increasing the tax is met with an opposition by the voters.

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[30] *Stiglitz, J.* Financial Times, 17.10.2010 (Article also published in the newspaper "Dnevnik", 19.10.2010).

[31] *Feldstein, M.* Rethinking the Role of Fiscal Policy. NBER Working Paper 14684, Jan 2009.

●the governments are reluctant to accept the fiscal consolidation leading to the reduction of the budget deficit, because they fear that they will lose the next political elections.

As a result of the above mentioned regularities, A. Alesina emphasizes that "when the countries that postpone the bitter medicine of fiscal consolidation eventually implement the policy of fiscal contraction they may experience a recession together with mandatory political loses".[32] He developed an alternative to the conventional fiscal policy in times of crisis, which draws upon the analysis on the countries with successful fiscal consolidations. In support of his proposal, he tested the following three hypotheses:

1. Does the fiscal consolidation (mainly the significant reduction in the budget deficit) cause a recession, or contrary to the Keynesian belief, creates growth?

Reducing the budget deficit may be due to the stimulating effect of the supply and demand. The fiscal tightening creates expectations in the economic agents to avoid further fiscal contraction in the coming years. It maintains the consumption and the investments, hence contributing to the rapid exit from the crisis. The economic agents also monitor the changes in the interest rate. The lower fiscal consolidation creates confidence in them and avoids a potential bankruptcy due to inability to repay the debt obligations, the interest rate on the government bonds is much lower. This development is a positive signal to the private investors. Furthermore, the lower interest rate increases the value of the assets of the economic subjects, which creates new stimuli for their increase.

On the supply side, the encouraging effect of the shrinking budget deficit passes over the labor market and the individual labor supply, resulting from the increase in the taxes or the reduction of the expenses. If the income taxes are increasing, the workers increase their supply on the labor market, in order to preserve their wellbeing. At the same time, the retention or the reduction of the wages in the public sector decreases the pressure to increase the wages in the private sector, which creates additional incentives to expand the economic activity.

Based on an in-depth empirical analysis of 107 programs of fiscal consolidation over the past 20 years, Alesina and Ardagna revealed that for one year, the stimulating effect of this policy has amounted to 1.5% of GDP. For a period of three years of fiscal consolidation (which is the average lifetime of the programs in this field), the effect amounted to 4.5% GDP growth. In identifying the factors that have contributed to the positive result, Alesina points out that 70% are due to cuts in the spending to reduce the deficit. His evaluation is that "the fiscal consolidation can be accompanied without a possibility of recession and this is possibly happening when the consolidation occurs primarily through cuts in the spending".[33] In the end, Alesina reaches two conclusions that change the Keynesian understanding of the

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[32] *Alesina, A.* Op. cit.

[33] Ibid.

fiscal consolidation programs.[34] In the end, Alesina reaches two conclusions that change the Keynesian understanding of the fiscal consolidation programs:[35]

First, the reduction of the budget deficit (i.e. the fiscal consolidation) generates economic growth instead of the expected deepening of the recession.

Second, the reduction of the budget deficit by cutting the budget spending creates a stronger stimulating economic effect than the tax increases.

2. The political consequences of the fiscal consolidation

What happens to the government engaged in fiscal consolidation programs? In search of the answer to this question Alesina, Carlos and Lecce analyze the political results of the fiscal consolidations in the OECD countries. They have found out that unlike the conventional Keynesian paradigm, the governments that have substantially reduced their budget deficit have neither lost popularity nor the next political elections. Moreover, the studies revealed that the governments that have accomplished successful consolidations by cutting the expenditures have increased their popularity. The explanation of this phenomenon is that the voters can see the positive effects of the increased GDP.[36] Other two authors, Brender and Drazen reveal that the governments that increase their budget deficit do not receive political premium during elections, i.e. reelection. The voters evaluate negatively the increase in the debt deficit of the public expenditures, which is accomplished by increasing the state debt, and punish the governments with their vote in the election.[37]

3. When do the governments adopt the fiscal consolidation programs and why they are often delayed?

Cutting the budget deficits and certain public expenses are the core of the programs of fiscal consolidation. Usually such programs are adopted when there are economic crises, a serious deterioration of fiscal balances and decisive governments with greater political support in the parliament. As a rule, the reforms start immediately after the elections. However, there are obstacles that delay the decision-making process about the fiscal consolidation and increase the public expenditures. The first obstacle is the counteraction of social groups that receive salaries, subsidies and pensions from the budget. To these could be added the lobbyists who seek rents from the public programs. These groups, in general demonstrate the Keynesian argument that the decline in public spending will further deepen the recession. Their powerful counteraction can block and delay the beginning of the fiscal consolidation programs.

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[34] *Alesina, A., S. Ardagna*. Large Changes in Fiscal Policy: Taxes Versus Spending. Tax Policy and the Economy, Issue 24, 2010.

[35] *Alesina, A*. Op. cit.

[36] Ibid.

[37] *Brender, A., A. Drazen*. How The Budget Deficits and Economic Growth Affect Reelection Prospects? Evidence from Large Panel of Countries. AER, 2008, 98(5), p. 2203-20.

The political decision-making process on the fiscal consolidation is identified as a second barrier. The opposition parties, as a rule, oppose the fiscal consolidation programs or offer soft alternatives for their realization. After the political disputes, follow parliamentary debates and eventually voting that may delay the consolidation at least with a few months. The budget cuts in the social expenses are pointed out as the third reason for delay. It is true that the fiscal consolidation programs are often related to reforms of the social security system. Alesina, however, reveals that many of those reforms are ineffective, which is why tightening the social expenditures will not seriously worsen the situation of the vulnerable groups. He makes an interesting comparison between the social program in the Nordic and Mediterranean countries. In the first group, the social programs are quite effective since the social transfers significantly reduce the poverty level. The second group of countries (Italy, Greece, Spain, and Portugal) has lower spending on social transfers, but also achieves a minimum reduction in the household poverty. For this reason, it is assumed that the reduction of some ineffective costs of the social programs will not lead to greater social losses.

After testing the above three hypotheses, A. Alesina synthesized the possible anti-crisis scenarios that the governments can implement in their fiscal policy or program of fiscal consolidation:[38]

a) increase in the public expenditures through increasing the deficit, i.e. the Keynesian recipe for exit from the crisis;

b) selective increase in the tax (especially on the income of the wealthy), in order to control the size of the deficit and increase the budget expenditures. The stimulating effect on the economic activity is expected in respect to the expenses. The reduced amount of the fiscal multiplier makes this option ineffective;

c) increase the taxes and cut the expenditures, in order to achieve the desired amount of the budget deficit. This is a conservative type of fiscal policy, that is improving the fiscal balances, but it does not create stimuli to the economic activity and slows down the recovery from the crisis;

d) maintain the taxes (even if reduced) to stimulate the economic activity and to reduce the expenditures, which is allowing to control the amount of the deficit and the debt borrowing. This option guarantees the effective exit from the economic crisis. It is an alternative to the Keynesian anti-crisis fiscal policy, because it detains the budget deficit and limits the debt borrowing. At the same time, the fiscal responsibility of the government for the deficit and the debt create trust and positive expectations in the economic subjects, which stimulates the private consumption and investments.

A new model of conducting an anti-cyclical fiscal policy is emerging from the latest analysis. With the advent of the crisis, the tax revenues fall, the rule of a balance budget or 2% budget deficit does not allow a significant increase in the public expenditures and debt financing. There is no guarantee for a monetary

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[38] *Alesina, A.* Op. cit.

support because the Central Bank pursues to keep the inflation at a low level. Then the following possibilities remain to maintain the aggregate demand:

●First, the action of the automatic stabilizers;

●Second, rising the public investments, which can be achieved by debt financing (for instance, the golden rule in the UK) or by means of the stabilization fund, which the governments should create. Provisions in the fund are made from the larger tax revenues during the upswing, the rising prices of export goods or with revenues from the privatization of state enterprises;

●Third, increasing the private investments and the private consumption, this is what the Central Bank is trying to achieve by gradually reducing the interest rates. Corporate investment decisions or citizens` decisions to obtain long-term capital assets (houses, cars, financial assets, shares, etc.), however, depend not only on the interest rate, but also on the stable long-term growth horizon. If the companies assess the consumer or investment demand for stable over the next couple of years, they would invest in times of crisis. Then the cost of capital increase and acquisition of new assets is lower. If the citizens were secure in their jobs and incomes in the next few years, they would take mortgages to buy house and leasing loans for durable goods. If the foreign investors believe that, the government conducts a credible and transparent fiscal policy and that they will not increase the taxes in the next years (to repay the interests on loans), they would put their investments in those countries.

The new model of fiscal consolidation in times of crisis is part of leading an optimal fiscal policy. It allows the economy to enter in the recovery phase with limited fiscal imbalances, which allows part of the growing revenues in time of economic boom to accumulate in the special stabilization fund. It is this fund and not the debt financing that becomes a source of financing the budget deficit in the next crisis, which creates conditions for a permanent decrease in the amount of the public debt and its fiscal burdens. Thus, the normative model of optimal fiscal policy within the business cycle would be realized.

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The empirical analysis and evidences are always an argument for the accuracy of one or another model of fiscal policy. In the period of 2010-2011, when the debt problems in the Eurozone slowed down the recovery of the European economies, there were quite a few comments and suggestions for a faster exit from the crisis. John Stiglitz, wrote that "only cutting spending will not solve the problems of the European countries. It is more likely that cutting the spending will only accelerate the economic downturn."[39] This thesis is supported by the Keynesian oriented economists, for whom the solution to exit the crisis are the measures of common fiscal and monetary expansion. In the EU they are even

[39] www.investor.bg, 16.01.2012

debating that after the Fiscal Stability Pact it is necessary to adopt a growth pact, i.e. a combination of fiscal austerity with measures to achieve economic growth. How to achieve this magical combination? The propositions are: pouring liquidity into the banks, the reduction of the interest rate and the increase in public spending! The first two measures were implemented in the US and Europe, but the expenditure increase is associated with the increase in the tax rates and the debt financing of the budgets. In other words, the fiscal incentive measures are not appropriate because they increase the debt burden and inflation. This gives rise to the argument that in a short period of time, the monetary measures are not enough to ensure a prompt exit from the crisis. Obviously, the Keynesian-oriented economists and politicians have to accept the fact that after many years of debt “intoxication”, a period of detoxification and overcoming of the fiscal imbalances is inevitable. Every attempt to exit quickly the recession by emitting a new debt only postpones the surgical intervention to remove the tumor “live and well-being in a condition of indebtedness” created by Keynes, elaborated by the politicians and supported by the myopia of the electorate. This is why, the perception of “optimal fiscal policy”, although not giving rapid effects as the Keynesian policies to encourage the aggregate demand, traces the slow, but sure path to sustainable and stable development of the economy and growing social welfare.

10.V.2012