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**Article**

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## **What do we know about the government interventions in the economy?**

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**Abstract:** In the context of the increasing budget deficit and public debt, on one hand, and the need to restore economic growth without compromising financial stability and fiscal sustainability on long term, on the other hand, governments must undertake severe measures concentrated especially on expenditure and secondly on revenue. The paper aim is to present what it is already know regarding the government interventions in the economy and its effects based on an investigation of the main findings from the literature review. This gives useful

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information on the adequate mix of policies and instruments to correct the economic distortions.

**Keywords:** fiscal policy, budgetary policy, economy, crisis, sustainability

**JEL Classification:** E62, H62, H63

## **1. Introduction**

Fiscal and budgetary policies have reached a point where they are considered as the main pillars that can correct the economic problems even more as the behavior of governments had an important contribution to the weakening of the fiscal position and to build a huge stock of public debt. It is also know the fact that government policies have a continuous increasing role as its must ensure welfare increase, efficient and equitable redistribution of income in the economy, and provide social protection to correct imbalances in the current crisis. Al these pose enormous pressures on national and international policies as a result of the accumulated budget deficits and public debt even in periods of economic boom (György, 2010). The deterioration of fiscal and budgetary position is exacerbated by the crisis. But, it must be taken into consideration that all these will expose economies to great risks (illiquidity, or even insolvability) that are overlapping with the risks caused by ageing population. Therefore, government interventions are needed both by improving the legal and institutional framework and

concrete fiscal policy measures that will allow the reduction of the budget deficit and public debt in order to ensure economic recovery and macroeconomic stabilization without neglecting the public finances sustainability on long term.

Government interventions on the economy are represented by changes in the revenue and/or expenditure. These have different effects depending on the macroeconomic context, the time horizon, the multipliers, the confidence in the ability and willingness of governments to adopt such measures, the composition of revenues and expenditures. In the current context, the most important factor is the confidence in the government policies and financial system.

The aim of this paper is to present what it is already known regarding the government interventions in the economy and its effects based on an investigation of the main findings from the literature review. Therefore, the paper is structured in two parts in order to present the government interventions in the economy and then to highlight some of the effects of fiscal and budgetary policies on the economy.

## **2. Short presentation of the government interventions in the economy**

To achieve the objectives set at the national and international level are needed intervention in the economy both by improving the legal and institutional framework and by applying specific measures of fiscal and budgetary policy and monetary policy. The governments must face the dilemma regarding the adequate policy mix considering the economy state. Each government applies interventions using the instruments of fiscal and budgetary policies. The mix of fiscal and budgetary measures should also lead to the improvement of fiscal and budgetary position that is shown by decreasing the budget deficit, recording primary surpluses and reducing public debt stock.

However, specialized paper in the field of fiscal and budgetary policies have shown that government intervention in the economy have different effects depending on the context of macro economy, fiscal and budgetary position (Kitao, 2010), the level of fiscal and budgetary multipliers (Barro, 2009; Christiano, Eichenbaum and Rebelo, 2009; Cogan, Cwik, Taylor

and Wieland, 2009; Leeper, Walker and Yang, 2009), trust in the ability and willingness of governments to implement effective proactive measures to stimulate economic growth (Auerbach and Gale, 2009; Romer, 2010; Popescu and Prodan, 2010) and ensure fiscal sustainability in the long term budget (Daniel, Davis, Fouad and Van Rijckeghem, 2006; European Commission, 2009). In addition, the composition of revenues and expenditures of the specific measures of state intervention is also important. Intervention effects differ depending on the relevant time horizon (short term to medium term).

Specifically, the government interventions in the economy based on increasing and/or reductions in revenues and expenditures and on changes in income and expenditure components generate different effects on growth, consumption, investment, macroeconomic stabilization and external imbalance.

Focus of the government intervention is represented, firstly, by the way in which expansionary or restrictive fiscal and budgetary policies affect GDP. Expansionist policies lead to budget deficit and, consequently, to the accumulation of public debt in order

to finance this imbalance between revenues and spending. The deterioration of fiscal and budgetary position is the result of reducing tax revenues, at the fiscal policy level, and/or increase spending, at the budgetary policy level. Restrictive state policies contribute to budget deficit and public debt reduction as a result of the tax revenues increasing and/or spending cuts.

Taking into consideration these restrictive or expansionary government measures, it is also useful and relevant the investigation of the fiscal and budgetary policies' effects on the economy.

Also, it must be highlighted the fact that governments apply measures at both national and local level (Boboc, 2011). The sub-national authorities undertake measures in order to achieve their objectives and to assure a sustainable position of their financial obligations. In order to do so, the sub-national governments receive resources from local taxes and subsidies from the central budget. Despite of the decentralization process the local authorities have an important dependency degree from the central budget as a result of a relative low local financial autonomy.



### **3. Effects of government interventions in the economy**

Regarding the effects on economic growth, it must be achieved such distinction between the neo-classical, Keynesian, and neo-Keynesian effects. In these approaches it can be distinguished the effects of the restriction ("crowding out") or the stimulation of the economic activities ("crowding in"). First, the neoclassical paradigm argues that government intervention in the economy may constrain private sector economic activities (Buiter, 1977). As a result, governments should limit their interventions. Secondly, the Keynesian approach stresses the active role of governments due to the multiplier effects of its interventions by the fiscal and budgetary policies (Fazzari, 1994). Finally, the Ricardian equivalence demonstrates the neutrality of the fiscal and budgetary policies (Barro, 1989).

In the Keynesian approach, the government intervention can have positive effects on both short and

long term. Expansionary policy has a multiplier effect over one, while restrictive policy will lead to decreasing GDP. Spending multiplier is one ahead of budget revenues. These budget and fiscal multipliers vary between 0.8 and 1.3 for European countries (Dalsgaard, André and Richardson, 2001; Roeger and Veld, 2002, Hunt and Laxton, 2003), and between 0.6 and 0.8 for OECD countries and not only when it is taken into consideration the financial crisis (Afonso, Grüner and Kolerus, 2010). Therefore, expansionary policy based on increased spending induces an effect of GDP reduction ("crowding out") while consumption and interest rates increase and thus, investment decrease. The opposite effect ("crowding in") is observed for restrictive policy. Reducing the budget expenditure has as affect the decrease of the interest rates and thus the investment growth will attenuate the negative effect induced by revenues increased.

In neo-Keynesian models, fiscal and budgetary policy measures aimed at reducing the budget deficit leads to lower prices and interest rates with positive impacts on investment while the national currencies depreciate.

At the opposite pole are the neo-Keynesian effects that are based on rational expectations, Ricardian equivalence and credibility of government measures to reduce the budget deficit and public debt through fiscal adjustment (increase revenues and/or reduce expenditures, especially current consumption spending).

However, the effects of fiscal and budgetary policies on the economy may be different depending on the degree of economic development of each country (Bose, Haque and Osborn, 2007).

In carrying out tests to investigate the effects of fiscal and budgetary policies, the authors use data sets, methods and different groups of countries which conduct to different results.

Blanchard and Perotti (2002), investigating the USA case based on quarterly data since '50, have shown that fiscal policy and budgetary decisions affect the economy in the medium-term since the decision implementation takes time. As a result, short-term governmental decisions affect the real economy even if financial markets react immediately. The positive dynamics of expenditures raise the GDP growth and

consumption in U.S.A., while increasing revenues from taxes and contributions results in a contraction of GDP. However, the authors have obtained a neoclassical effect because the budget expenditure growth restricts private investment. The study is continued by Claeys (2008) based on Sweden's case, during 1970-2006, that and obtained that the increase of the government spending for consumption have a negative impact on economic growth and this effect is manifested in at least one year after the initial shock.

Ramos and Roca Sagales (2007), using vector autoregressive model for annual data during 1970-2005, obtained that in the United Kingdom the effects of fiscal and budgetary policies are consistent with the economy in the Keynesian Paradigm for the action of budgetary revenues and not for the expenditure. As a result, according to the authors, the tax reduction will contribute to economic growth while spending increase affect negatively the economy. In the long run, however, the impact of these measures is negative, especially when current spending increase.

Afonso and Claeys (2007) investigated the relationship between the cyclical component fiscal

variables and macroeconomic variables for France, Germany, Portugal and Spain using a structural vector autoregressive. Following the historical data, the authors showed that government interventions in the economy were based mostly on revenue without being supported and sustained with spending cut actions. Budget deficits and debt have increased which generates negative effects on the economy on long term. Thus, fiscal and budgetary policies have induced other economic fluctuations than those generated by the development of economic activities, leading to macroeconomic instability. As a result, governments prefer measures that bring immediate effects even if important long-term costs correspond to these short-term benefits (Kitao, 2010). The opposite is the study of Coenen, Mohr and Straub (2008) that examine the fiscal consolidation measures in order to generate long-term positive effects despite the adverse conditions in the short term. In this sense, the authors used for the euro area, new models of the European Central Bank for open economy. Increases in tax revenues and reductions in government spending affect the economy negatively in the short term while improving fiscal position and budget will stimulate

the economy long term. In addition, the authors show that the measures composition of state intervention is also important especially for the effects distribution of fiscal and budgetary policies on the economy.

Afonso, Grüner and Kolerus (2010) analyzed the effects of government decisions on macroeconomic variables considering the financial crisis. The investigation covered 127 countries of which 98 countries faced financial crises over the period 1981-2007. As a result, the analysis based on panel data showed that the government's expansionist policies applied in times of banking crises have a negative impact on growth.

Kuisman and Kämpfi (2009) identified that the budgetary and fiscal policy shocks had an effect on the Finnish economy in 1990-2007. An increase in government revenue has a positive effect on investment and hence GDP while private consumption has a mixed response with regard to the two different methods of investigation ("vector stochastic process with dummy variables – VSPD"). Spending increase limit private sector activities and this effect occurs more quickly than in the case of income shock.

In addition, Auerbach and Gale (2009), using structural vector autoregressive, have shown that reducing revenues and increasing spending on goods and services can foster growth in the U.S.A., however, these measures are difficult to apply in the current financial crisis. Dynamic stochastic general equilibrium models can be adapted to suit the current economic situation (Cogan, Cwik, Taylor and Wieland, 2009; Christiano, Eichenbaum and Rebelo, 2009; Hall, 2009).

Kitao (2010) quantified the short-term positive effects of fiscal policy (a temporary reduction of income tax) and budgetary policy (transfer increase). In this respect, based on dynamic general equilibrium approach, the analysis focused on the original situation before the implementation of the indicated measures, on the temporary unexpected changes in fiscal and budgetary policies, and on the final three years of policy implementation. However, on long-term, the accumulation of public debt will require tax revenues increase to meet debt service payments that will reduce investment, consumption and GDP, leading to deterioration of social and individual welfare.

Also, the main stream of literature reveals that systematic and sustained intervention, and fiscal and budgetary discipline and long term, governments can also ensure macroeconomic stabilization while reducing the external imbalances. In this sense, fiscal and budgetary policies can be used to achieve these economic objectives mentioned above. Thus, increases in budget deficits are followed also by the increases of the inflation rate. These effects vary depending on the development degree of each state. For example, Giavazzi, Jappelli and Pagano (2000) showed that in industrialized countries and developing non-linear effects of fiscal and budgetary policies on national saving tends to be associated with significant increases in the primary deficit.

Daniel, Davis, Fouad and Van Rijckeghem (2006), as well as Segura-Ubierno, Simone and Gupta (2006) highlights how fiscal and budgetary policies can influence inflation through the impact on the aggregate demand based on: i) spending on goods and services and transfers growth; ii) the reduction of tax revenue; iii) the financing method of the budget deficit. The authors



also explain the importance of the state interventions on reducing the external imbalance.

Starting from those indicated above, it is necessary to investigate the effects of fiscal and budgetary policies on the economy, for different countries, to determine their extent. In addition, by studying these effects on other European countries can obtain useful information on the adequate mix of fiscal and budgetary policies to ensure economic growth, stimulate consumption and investment, and reduce external imbalances and macroeconomic stabilization. Thus, the experiences of other countries can be integrated national healthy fiscal and budgetary policies. All these represent the subject for the next research in this area. Thus, the scientific approach will contribute to the development status of knowledge in the proposed theme.

#### **4. Conclusions**


Fiscal and budgetary policies have an increasing role especially in economic downturns. In addition, pressures on national fiscal and budgetary policies are even greater when the countries have accumulated budget deficits and public debt even in periods of economic boom. Therefore, state interventions are needed both by improving the legal and institutional framework and current fiscal policy measures that will allow the reduction of the budget deficit and public debt in order to ensure economic recovery and macroeconomic stabilization without neglecting the public finance's sustainability on long term.


Government interventions on the economy have different effects depending on the macroeconomic context, the time horizon, fiscal and budgetary position, the level of fiscal and budgetary multipliers, trust in the ability and willingness of governments to implement effective proactive measures to stimulate economic growth and ensure fiscal sustainability in the long term budget.


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