Study on fiscal policy advocates for making hay while the sun shines

June 23 2021

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A study published in *Economic Inquiry* that examined data from 133 countries from 1950-2014 found that a reduction in fiscal space—with fiscal space being the ability of governments to provide resources without undermining fiscal sustainability—in high income countries

following the global financial crisis in 2007-2009 prevented these economies from adopting countercyclical fiscal policies. A countercyclical fiscal policy stance aims to smooth out business cycle fluctuations, through greater spending during recessions and lower spending during booms.

The study finds that a reduction of fiscal space led to an opposite—or procyclical—policy action, cutting spending further during the downturn, with serious negative consequences for the overall state of the economy.

In the context of the COVID-19 crisis, the findings point to the importance of building fiscal space in "better" financial times to allow for the capacity to adopt countercyclical policies during downturns.

"Our study points to a reversal of fortune in the conduct of fiscal policy. Whereas low and middle income countries were seen to conduct procyclical policy in the past, tables have turned in the aftermath of the global financial crisis with high income countries being associated with policies that have aggravated business cycle fluctuations, prolonging periods of economic downturn," said corresponding author Gulcin Ozkan, Ph.D., of King's College London. "Importantly, we highlight that it is a lack of fiscal space which drives these results, and that better policies in good times will allow for more responsive policies during crisis periods."

More information: Asif Ahmad et al, Fiscal space and the procyclicality of fiscal policy: The case for making hay while the sun shines, *Economic Inquiry* (2021). DOI: 10.1111/ecin.13008

Provided by Wiley