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# **FISCAL POLICY REACTION FUNCTION AND SUSTAINABILITY OF FISCAL POLICY IN UKRAINE**

**Artem Vdovychenko**

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## **Policy Brief**

### **Fiscal Policy Reaction Function and Sustainability of Fiscal Policy in Ukraine**

#### **Exposition of the policy problem(s) under investigation**

The issue of determination fiscal policy regimes is not only of academic interest, but it also has policy context. The last eight years Ukraine is experiencing a period of rapid public debt growth, so the issue of debt stabilization is important for fiscal policy. The study of fiscal policy regimes evolution allows to shed light on the reasons for the exponential growth of the public debt of recent years and to generate recommendations for its stabilization.

#### **Critical review of existing policies and/or legislation**

The general conclusion is that fiscal policy in Ukraine is procyclical and sustainable (passive). Fiscal policy switched in passive regime not during the rapid growth of debt, but during the strong economic growth. At the time dimension regime switching took place in the 3<sup>rd</sup> quarter of 2006, when the rapid growth of the global and Ukrainian economy began. During this period, fiscal policy of Ukraine switched from the regime close to the active-sustainable in passive, and still in it. This switch was caused by the government's decision to increase the budget deficit while economic growth. The access to foreign markets in conditions of economic boom contributed to the accumulation of external debt. After the global financial crisis and the collapse of the hryvnia this has led to the rapid growth of debt and conservation of passive fiscal policy in Ukraine. The main problem of Ukraine's fiscal policy that does not allow reducing the level of public debt and switching of fiscal regimes according to the macroeconomic environment is asymmetry in response to the phase of the business cycle. In periods of economic growth, fiscal policy in Ukraine is procyclical, during the recessions - neutral. Procyclicality in periods of economic growth does not allow creating sufficient fiscal space to maintain active fiscal policy. On the other hand, this incomplete asymmetry can help to reduce debt, because in times of economic downturn government does not increase the budget deficit. But it also can increase the level of debt because the lack of countercyclical policy extends the time of being the economy in a phase of depression that affects the state of public finances.

#### **Overview of alternative policy changes**

Symmetry in the fiscal response between good and bad times is important for three main reasons: rebuilding buffers ahead of the next cyclical downturn; reducing the risk of overheating; and avoiding a ratcheting up of public debt over successive cycles. That implies that the asymmetric

response of fiscal policy at different phases of the economic cycle bears threats for debt sustainability. IMF (April, 2015) demonstrates that systematic asymmetric response is associated with a non negligible upward drift in the debt-to-GDP ratio. Under fairly benign macroeconomic assumptions, asymmetric stabilization could, after 20 years, lead to a debt-to-GDP ratio much higher than with symmetric stabilization.

### **Policy recommendations arising from the research**

Our analysis shows the need to address the issue of the asymmetry in the response of fiscal policy on the different phases of the economic cycle. Procyclical fiscal policy in periods of a positive GDP gap does not allow reducing debt level and constantly threaten fiscal sustainability. Under such asymmetry government on the one hand tries to ensure fiscal sustainability through a strong reaction of budget on debt changes, and on the other hand it creates prerequisites for further increasing of debt. Being constantly in the regime of passive fiscal policy the government can't use fiscal instruments for countercyclical regulation of the economy. Thus, Ukraine found itself in a situation when monetary policy has been deactivated for a long time because of maintaining the regime of fixed exchange rate, and fiscal policy is focused on debt dynamics. The way out of this situation is to consolidate the budget to reduce and stabilize the level of debt and the development of fiscal rules that have to limit the ability of conducting procyclical fiscal policy in phases of positive GDP gap.

### **Directions for further policy analysis**

The promising direction of further policy analysis is the estimation of impact which would make the symmetrical fiscal response on GDP gap on the level of public debt in Ukraine.