

Do EU fiscal rules support or hinder counter-cyclical fiscal policies?

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Rethinking the European Fiscal Framework

Conference organised by the European Fiscal Board in collaboration with CEPR and ACES

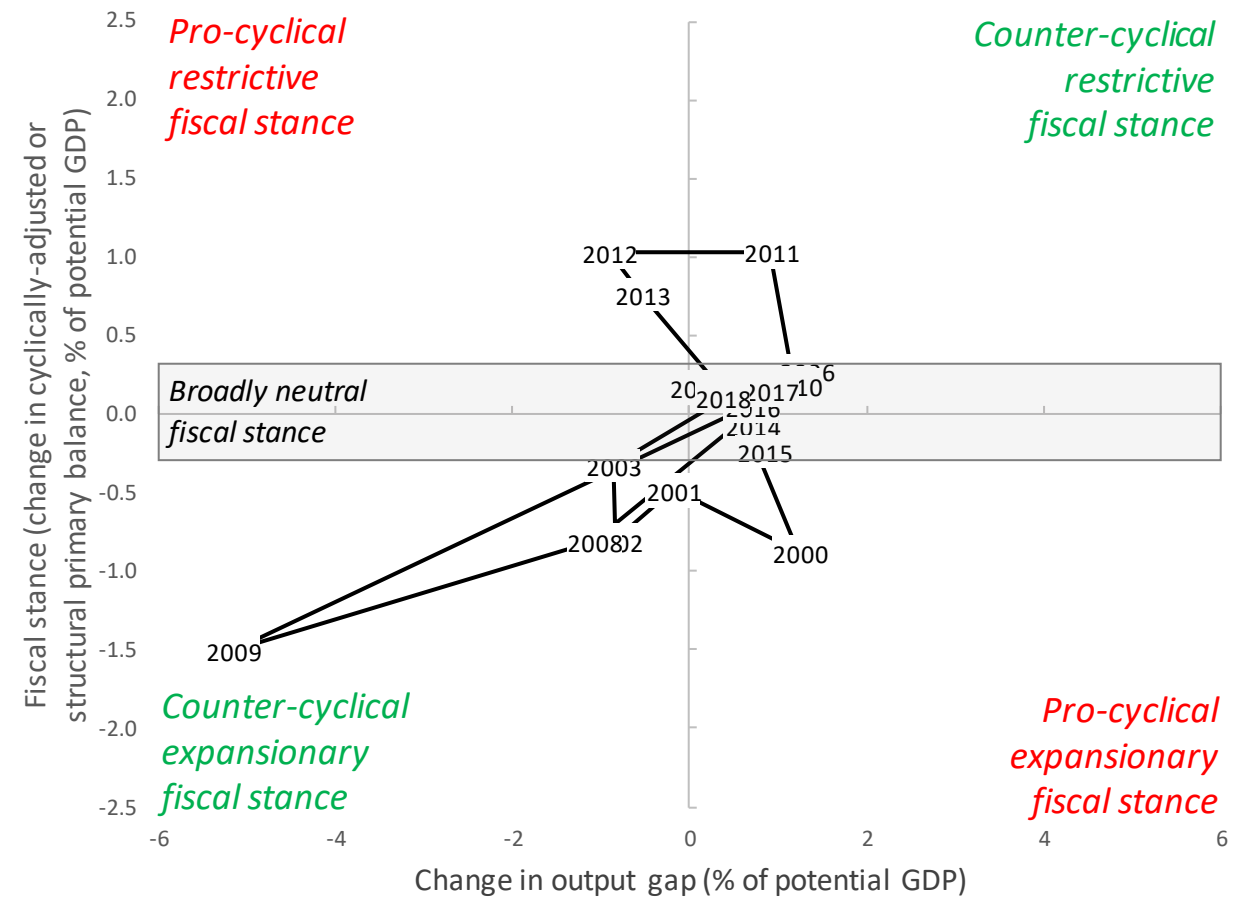
Brussels, 28 February 2020

- **Theory and practice of fiscal stabilisation**
- **EU fiscal rules and fiscal stabilisation**
- **A fresh look at the data: is fiscal policy pro-cyclical and why?**
 - **Conventional fiscal reaction functions**
 - **Binary logistic models**
- **Conclusions**

Theory

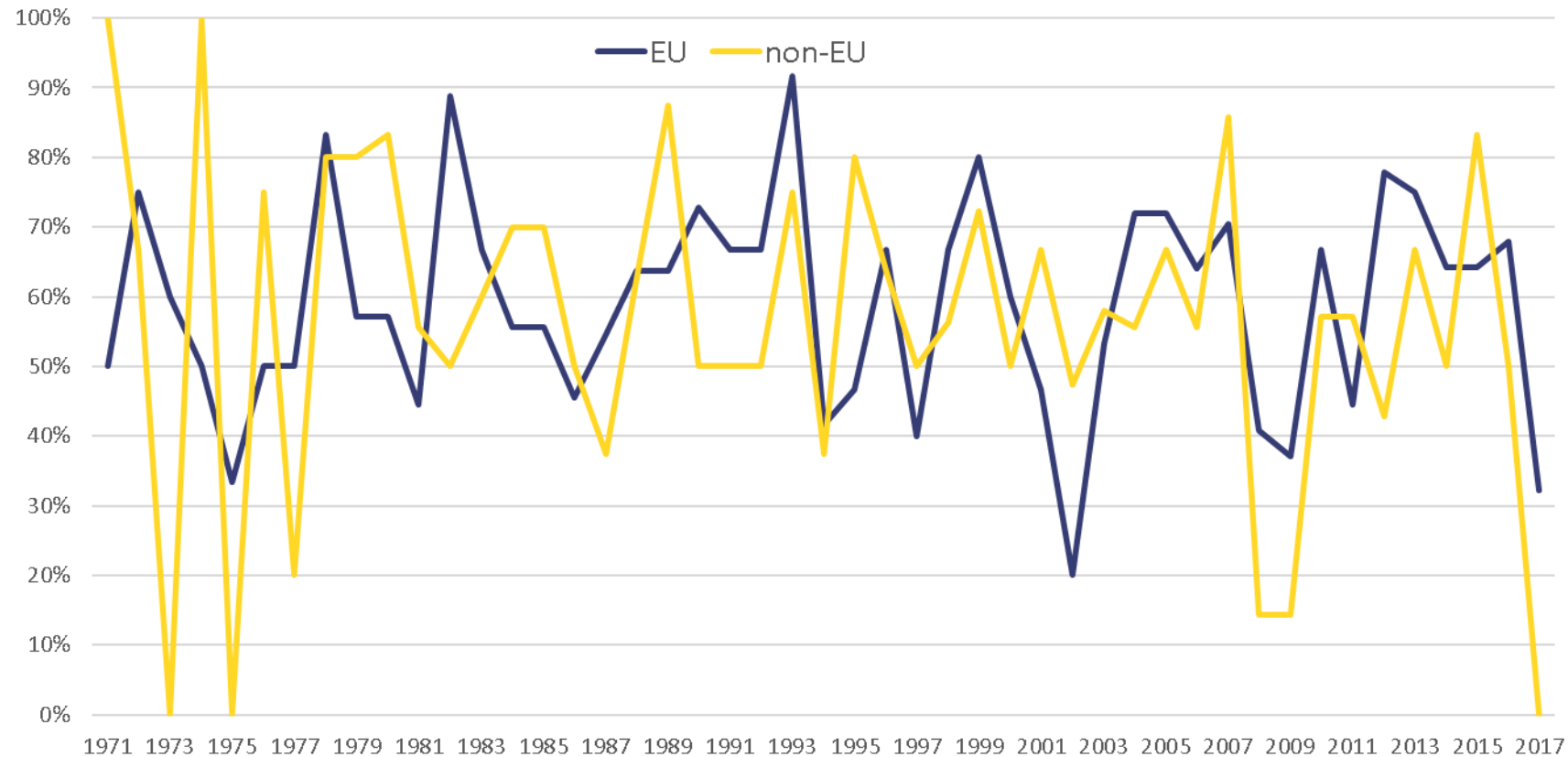
Recessions produce economic and social waste, which macroeconomic stabilisation, including fiscal policy, can help avert.

Practice



"Nobody uses fiscal policy as a macroeconomic policy tool, except macroeconomists in their models " (Eurointelligence 6/2/2020)

Share of pro-cyclical episodes per year



Prevailing paradigm when SGP entered into force:

Keep clear of discretionary fiscal stabilisation! Follow rules.*

- Main focus of SGP was deficit bias and sustainability.
- But the original version included some traces of fiscal stabilisation.

**Taylor (2000) 'Reassessing discretionary fiscal policy', JEP.*

Fatas and Mihov (2003) 'The Case for restricting fiscal policy discretion', QJE.

Original version of Reg. 1467/97 – Preventive arm of the SGP

Recitals

- ... *adherence to the medium-term objective of budgetary positions close to balance or in surplus will allow Member States to deal with normal cyclical fluctuations* while keeping the government deficit within the 3 % of GDP reference value ;
- ... when examining and monitoring the stability programmes ... , **should take into account the relevant cyclical and structural characteristics of the economy of each Member State;**

Legally binding part

- ... *examine whether the medium-term budget objective in the stability programme provides for a safety margin to ensure the avoidance of an excessive deficit ...*

Successive reforms (legal or not) extended the idea of modulating fiscal adjustment over the cycle. **But as an objective, stabilisation is mentioned nowhere in the SGP legislation.**

Only the 2018 Vade Mecum of the SGP (COM staff document) explicitly refers to “**assessment of sustainability and stabilisation challenges**” in the implementation of the Pact (margin of discretion).

Trade-off between stabilisation and sustainability?

$$\Delta capb_t = \alpha + \beta og_t + \gamma d_{t-1} + \delta X_t + e_t$$

Standard fiscal reaction functions: 47 OECD countries including 28 EU Member States, 1970+

What drives discretionary
fiscal policy?

Is discretionary fiscal
policy pro-cyclical?

Findings:

- Discretionary fiscal policy is pro-cyclical
- Higher debt leads to discretionary correction
- Political economy factors weigh on structural budget balance: elections, change in government, vested interests.
- Financial assistance programmes improve public finances

Determinants of pro-cyclical fiscal policy: **uncertainty**

Do lawmakers really target a fickle and unobserved variable such as the output gap?

What about less uncertain and politically more meaningful variables?

Findings:

Fiscal policy remains pro-cyclical when change in output gap is replaced by:

- change in rate of unemployment
- change in economic confidence (OECD composite leading indicator)

Determinants of pro-cyclical fiscal policy: **non-linearities**

Are there any economic or institutional factors that make discretionary fiscal policy more or less pro-cyclical?

Findings:

Factors amplifying pro-cyclical stance

- High government debt ($> 90\%$ of GDP)
- Improvements of cycle
- Quality of fiscal rules (?)

Factors dampening pro-cyclical stance

- Medium-term spending rules
- Compliance with EU fiscal rules (?)

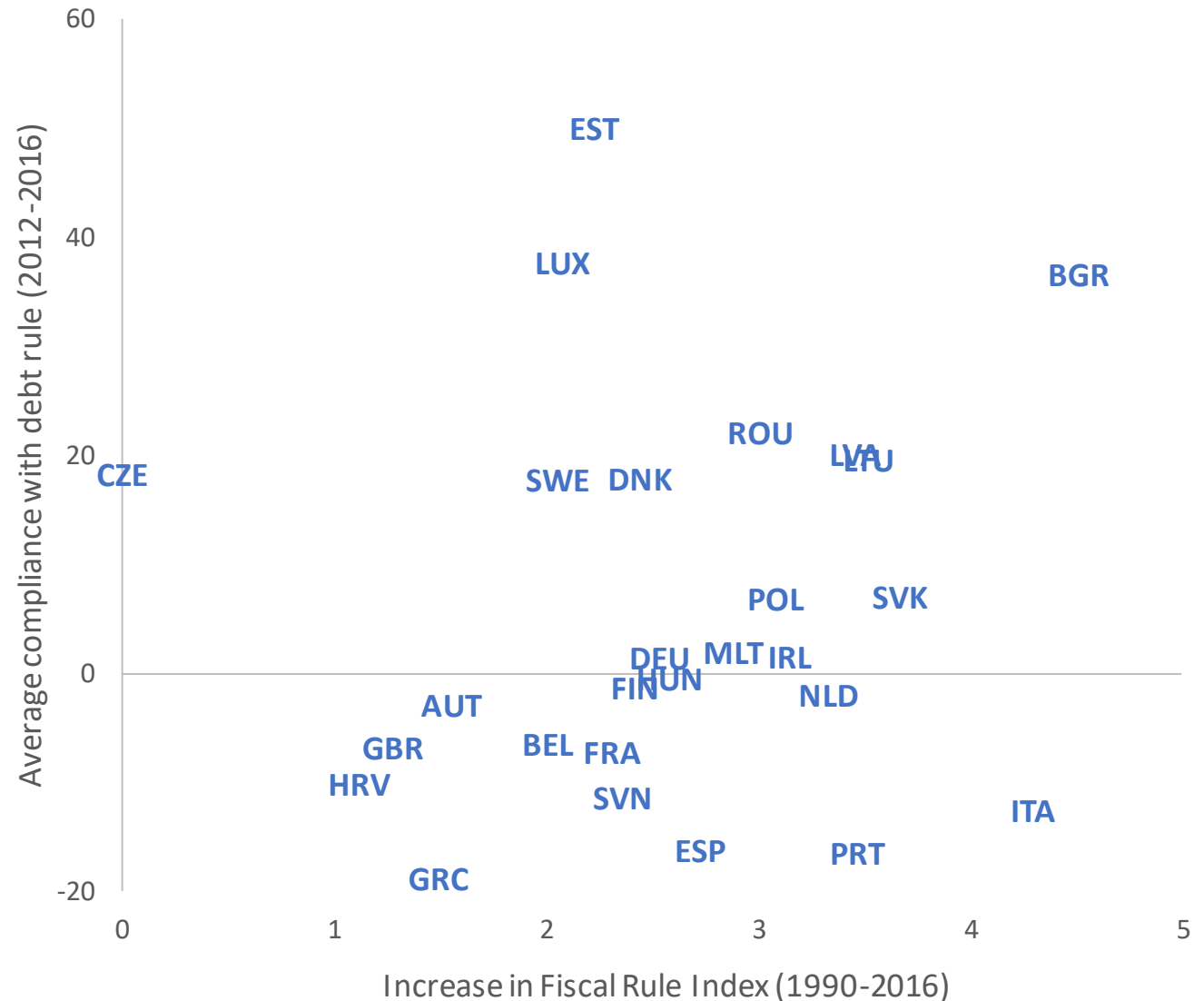
A fresh look at the data

Improvements in **quality of rules** do not result in improvements in **stabilisation**.

The missing link: **compliance**

Most rules are meant to ensure sustainable public finances by building buffers in good times for bad ones.

If rules are not followed, there is no room for stabilisation.



A fresh look at the data

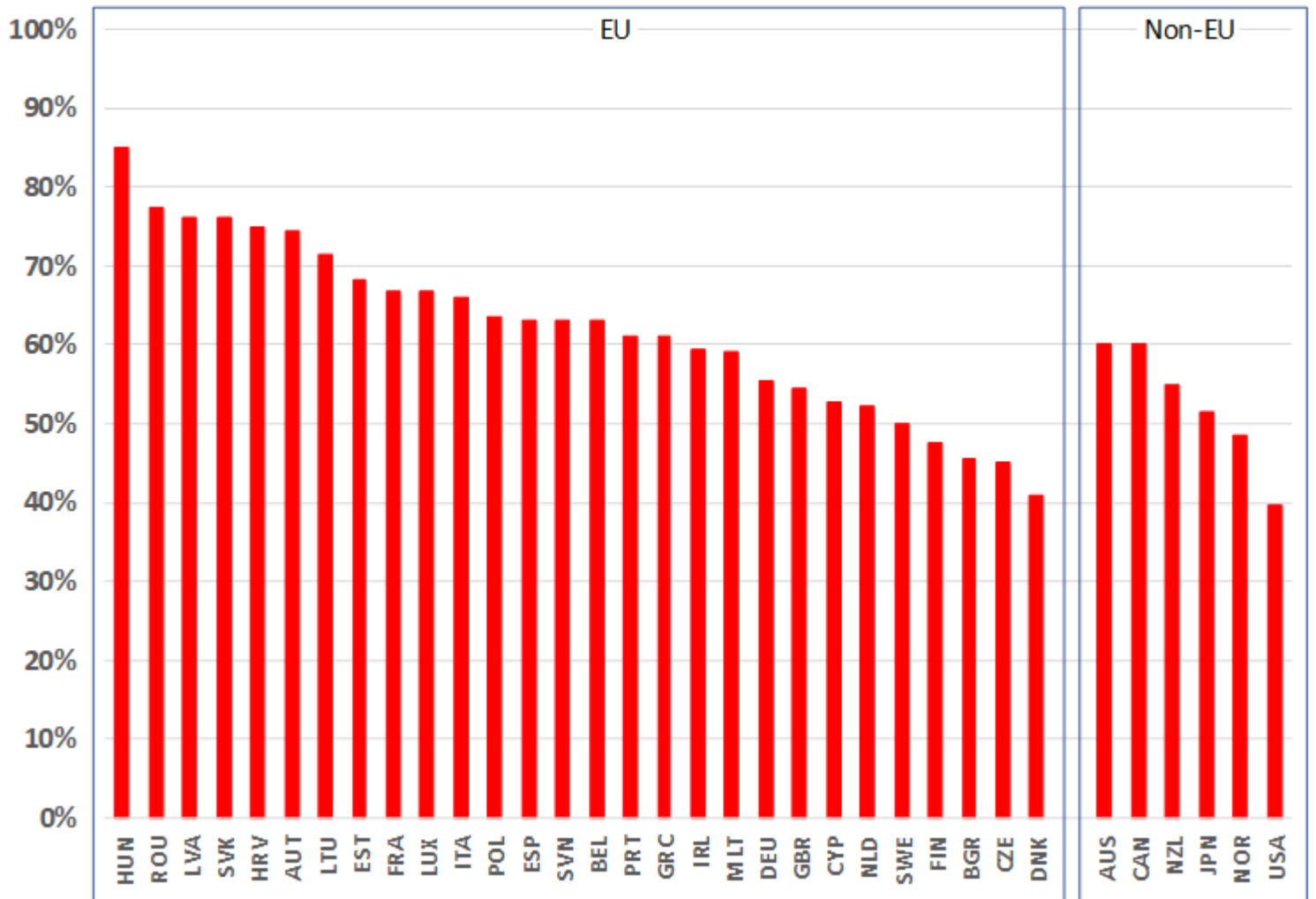
Discretionary fiscal policy
pro-cyclical if:

$\Delta OG > 0$ and $\Delta capb < 0.25$

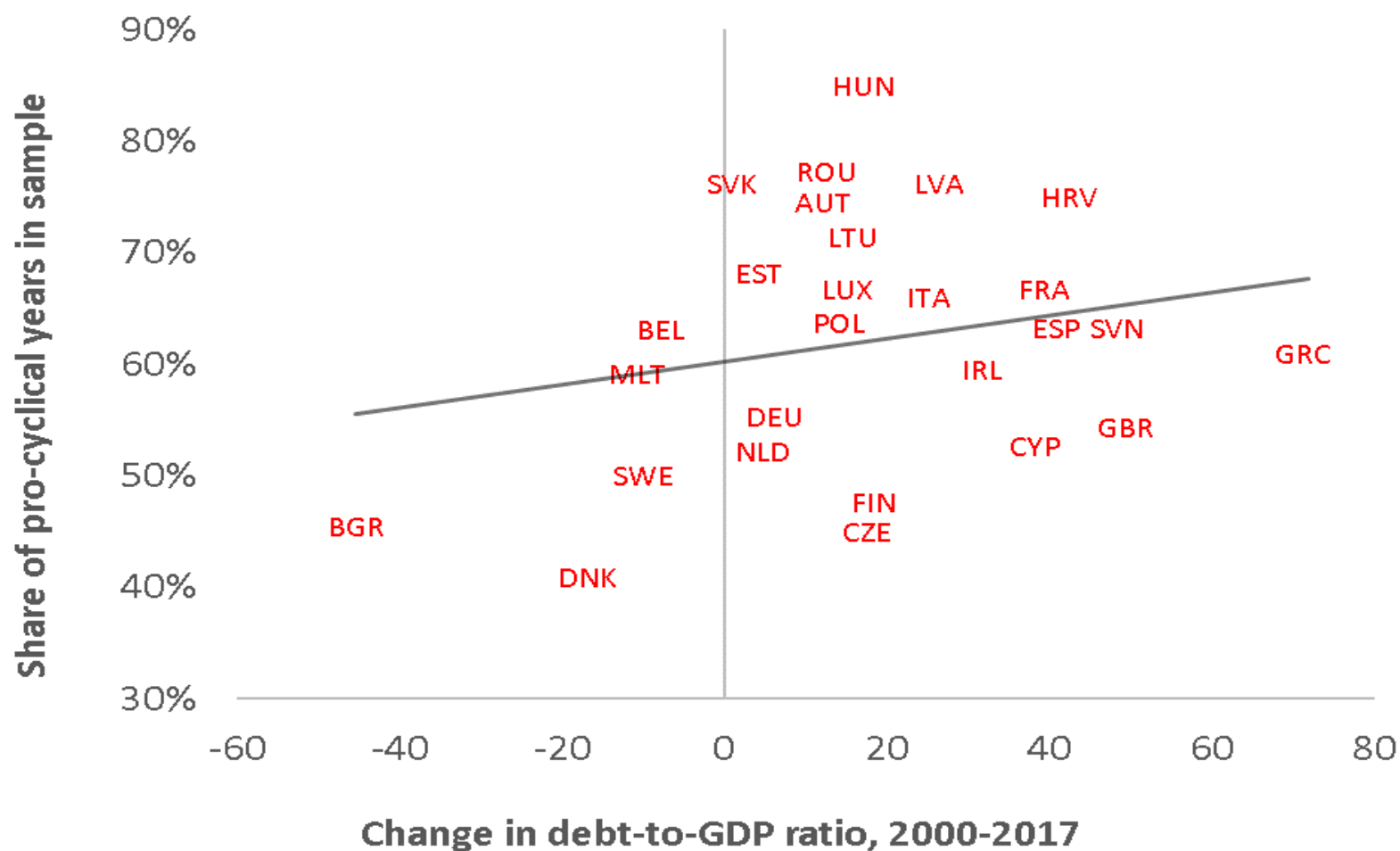
or

$\Delta OG < 0$ and $\Delta capb > -0.25$

Share of pro-cyclical years per country in sample



Debt and pro-cyclicality in the EU



Determinants of pro-cyclical fiscal policy: Logit regressions

What are the economic or institutional factors that make a pro-cyclical stance more or less likely?

Findings:

Fiscal policy more likely to be pro-cyclical when:

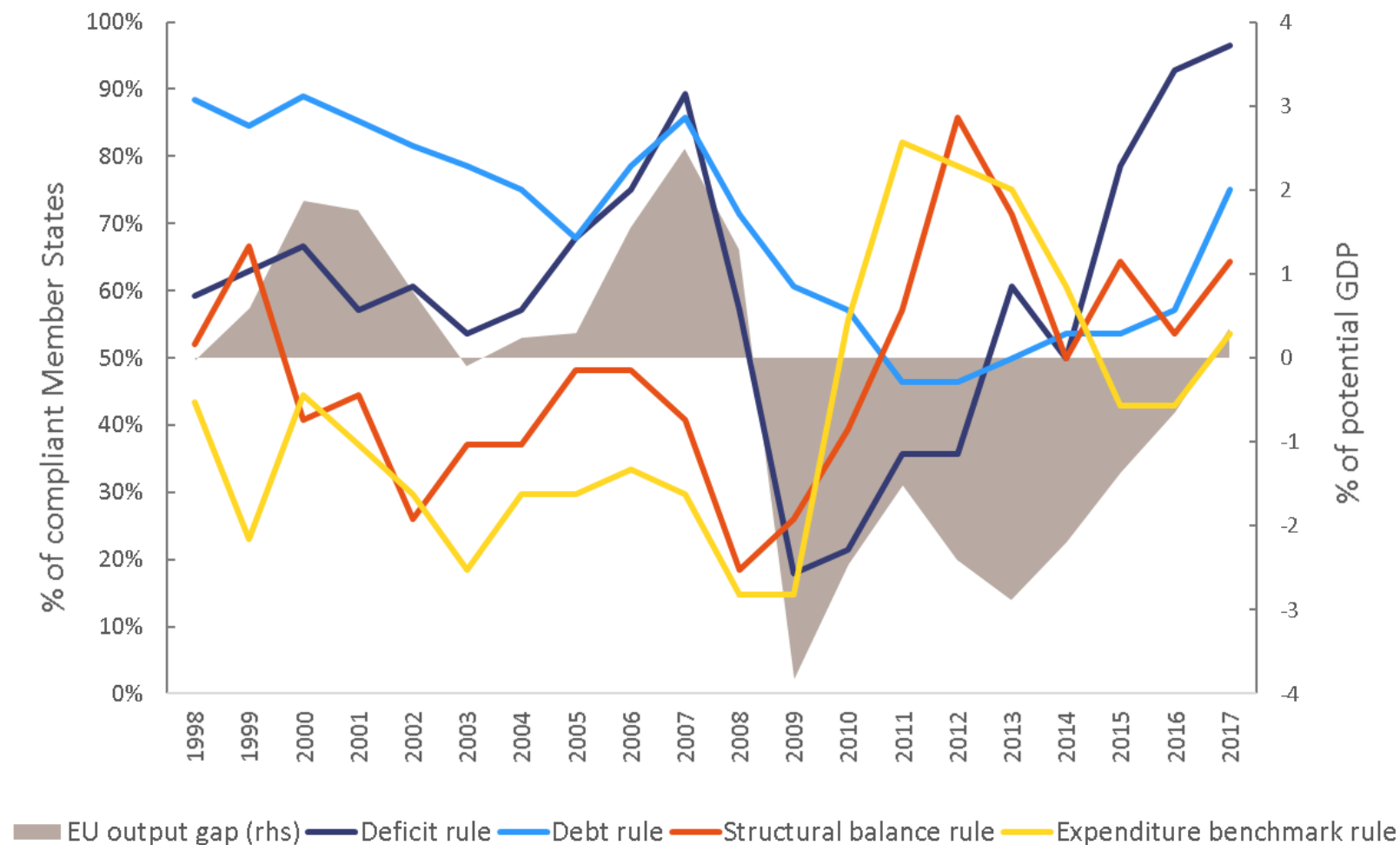
- debt is high (likelihood increases exponentially)
- GDP growth is high and volatile
- elections take place
- interest rates are low

Role of institutional factors:

- Run-up to the EU/euro: ↑ likelihood
- Compliance with EU fiscal rules: ↓ likelihood, especially for the SB and EB

Did EU fiscal rules support or hinder counter-cyclical fiscal policy?

Yes, if thresholds were used as targets. No, if adjustment to MTO was followed.



Main findings

- Additional evidence: pro-cyclicality is not only a matter of uncertainty around output gap estimates but above all a political economy problem
- Non-linear impact of the debt level: **when sustainability concerns become important, stabilisation no longer an option.**
- **Fiscal sustainability is a precondition for fiscal stabilisation** (Philip Lane, ECFIN workshop, Jan 2020)
- The design of fiscal rules matters, but not if rules are not followed: **compliance!**