



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

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Outline

1. Introduction
 - a. Theory and practice of fiscal stabilisation
 - b. EU fiscal rules and fiscal stabilisation
2. Analysis: is fiscal policy pro-cyclical and why?
 - a. Conventional fiscal reaction functions (extended)
 - b. Linear probability models
3. Conclusions

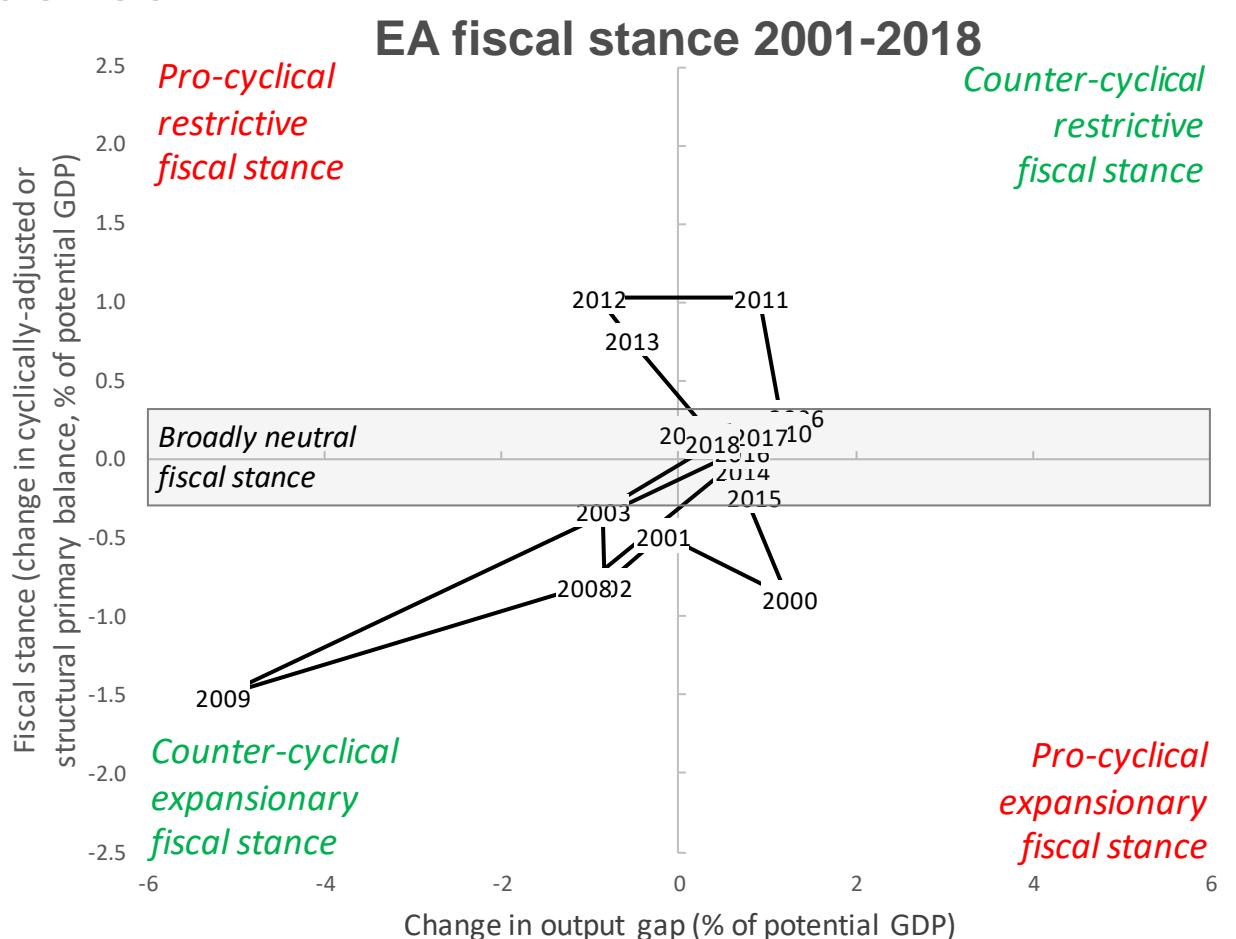
Introduction

Theory and practice

Theory

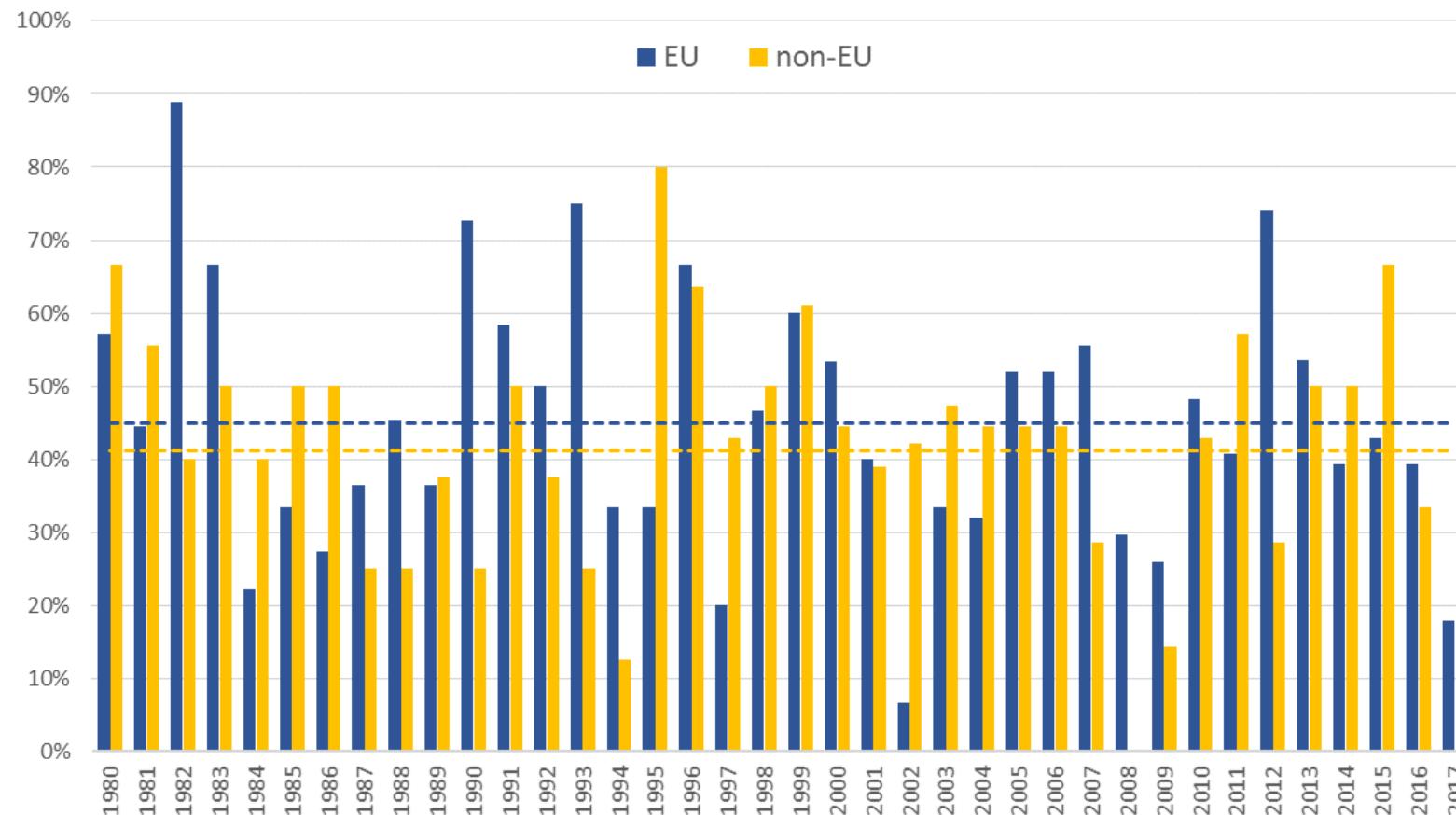
Recessions produce economic and social waste, which macroeconomic stabilisation, including fiscal policy, can help avert

Practice



Theory and practice

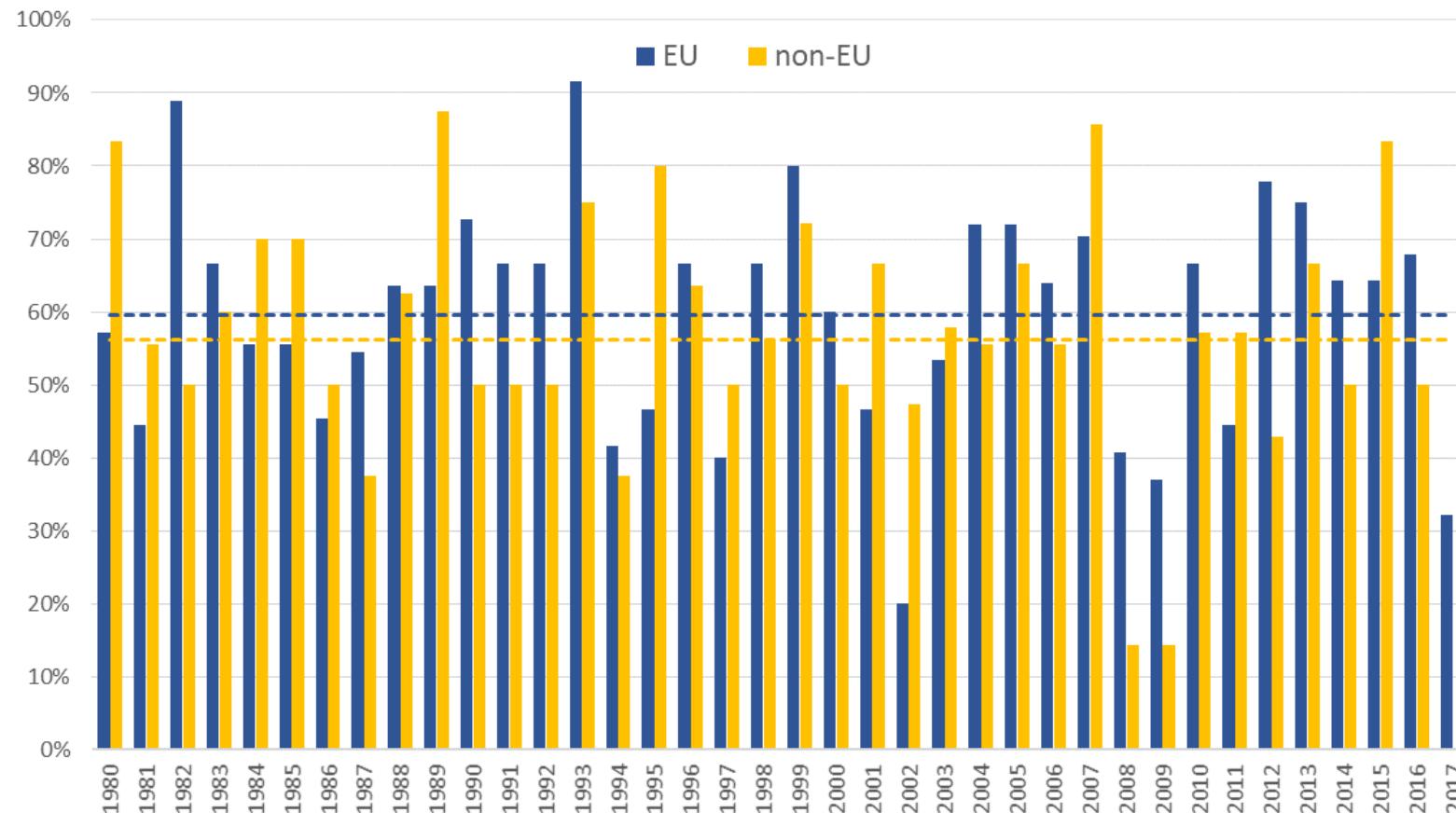
"Nobody uses fiscal policy as a macroeconomic policy tool, except macroeconomists in their models" (Eurointelligence 06-02-2020)



Share of pro-cyclical
episodes per year (excl.
'broadly neutral' band)

Theory and practice

"Nobody uses fiscal policy as a macroeconomic policy tool, except macroeconomists in their models" (Eurointelligence 06-02-2020)



Difference in average incidence not significant

Share of pro-cyclical episodes per year (incl. 'broadly neutral' band)

EU rules and stabilisation

Stability and Growth Pact (SGP)

- Prevailing paradigm: Keep clear of discretionary fiscal stabilisation! Follow rules.
 - *Taylor (2000, JEP) 'Reassessing discretionary fiscal policy'*
 - *Fatas and Mihov (2003, QJE) 'The Case for restricting fiscal policy discretion'*
- Main focus of SGP was deficit bias and sustainability.
- But the original version included some traces of fiscal stabilisation, too.

EU rules and stabilisation

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 ... and in particular their medium-term budgetary objective or the targeted adjustment path towards this objective, 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 ...

EU rules and stabilisation

- **Successive reforms:**

extended the idea of modulating fiscal adjustment over the cycle. But as an objective, stabilisation is mentioned nowhere in the SGP legislation.

- **2018 Vade Mecum of the SGP:**

explicitly refers to “assessment of sustainability and stabilisation challenges” in the implementation of the Pact (margin of discretion).

→ **Trade-off between stabilisation and sustainability?**

Analysis

A fresh look at the data

Panel:

- Around 40 middle to high-income countries
- Unbalanced, 1971-2017
- Sample is exogenous to the questions addressed
- Incl. EFB compliance database (Larch & Santacroce, 2020)

Confirm established results:

- 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-cyclicality: uncertainty

- Do lawmakers really target a fickle and unobserved variable such as the output gap?
- What about less uncertain and politically more meaningful variables?
- **Finding:** fiscal policy remains pro-cyclical when change in output gap is replaced by the change in
 - the unemployment rate
 - the industrial production index
 - the OECD's Composite Leading Indicator

Determinants of pro-cyclicality: non-linearities

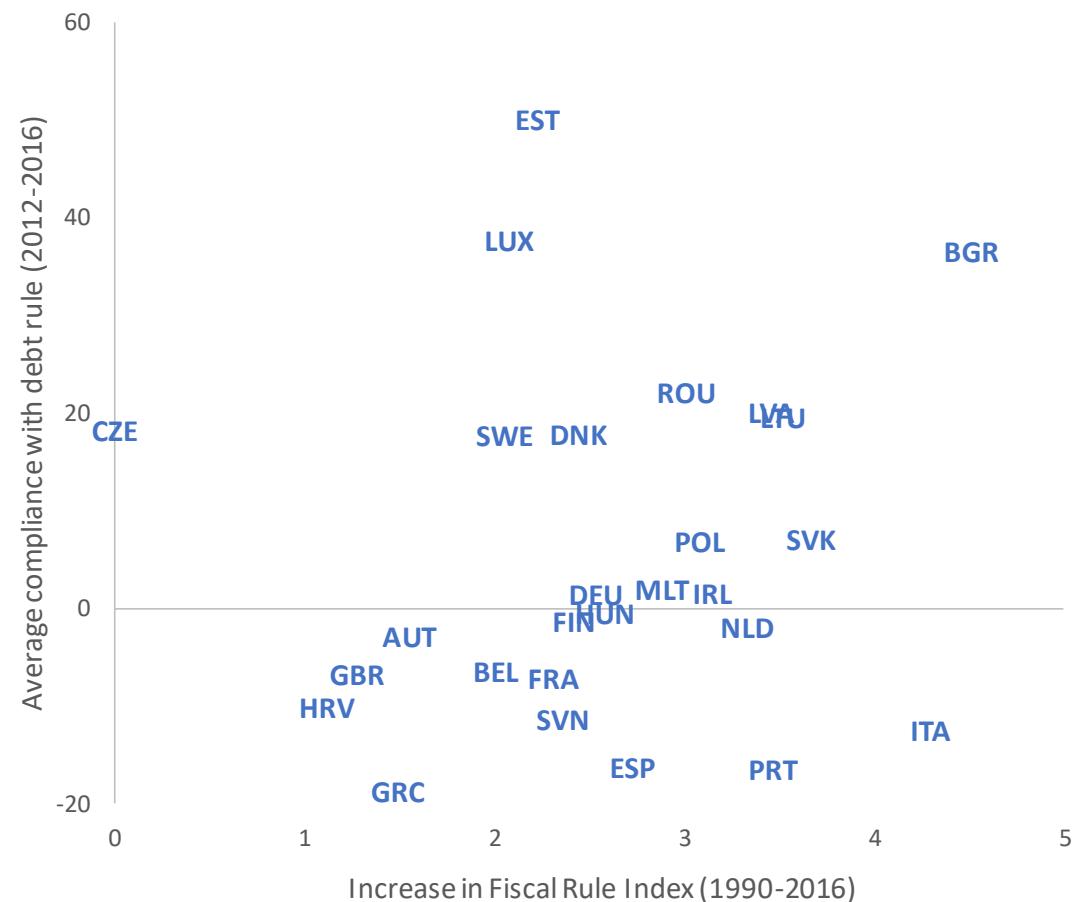
- Are there any economic or institutional factors that make discretionary fiscal policy more or less pro-cyclical?
- **Finding:** factors amplifying (-) / dampening (+) pro-cyclical stance
 - High government debt (> 90% of GDP)
 - Improvements of cycle
 - + Medium-term spending rules
 - + Compliance with EU fiscal rules



Gootjes and de Haan (2020, JIMF) corroborate role of fiscal rules, using same extension of fiscal reaction function approach

Determinants of pro-cyclicality: non-linearities

- Improvements in design and quality of fiscal rules do not necessarily result in improvements in stabilisation?
- **Finding: compliance = missing link**
 - Rules are meant to ensure sustainable public finances by building buffers in good times for bad ones
 - If rules are not followed, there is less room for stabilisation



Determinants of pro-cyclicality: logit models

- Are there any economic or institutional factors that make discretionary fiscal policy more or less likely?
- **Finding (1/2):** fiscal policy *more* likely to be pro-cyclical when:
 - Debt-to-GDP is high
 - GDP growth is high and volatile
 - Elections take place
 - Interest rates are low

Determinants of pro-cyclicality: logit models

- Are there any economic or institutional factors that make discretionary fiscal policy more or less likely?
- **Finding (2/2):** fiscal policy *less* likely to be pro-cyclical when:
 - + Higher compliance with **EU fiscal rules**
Especially for the debt target, but also for the spending benchmark and structural balance

Robustness checks

Fiscal reaction functions:

- LSDVC, 2SLS and system GMM estimates
- Effect sizes: 1,023 permutations (cf. Brodeur et al., 2020)

Logit models:

- Classification of fiscal episodes
- Panel multinomial logit models (using generalized SEM)
- Discrete choice models with instrumental variables (Lewbel, 2000)

Conclusions

Main findings

- New evidence that **pro-cyclicality** is not 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 too important, they trump the stabilisation objective
- The design of **fiscal rules** matters, but not as much as compliance with them
- **Fiscal sustainability** is a precondition for fiscal stabilisation

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Thank you



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