



# 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

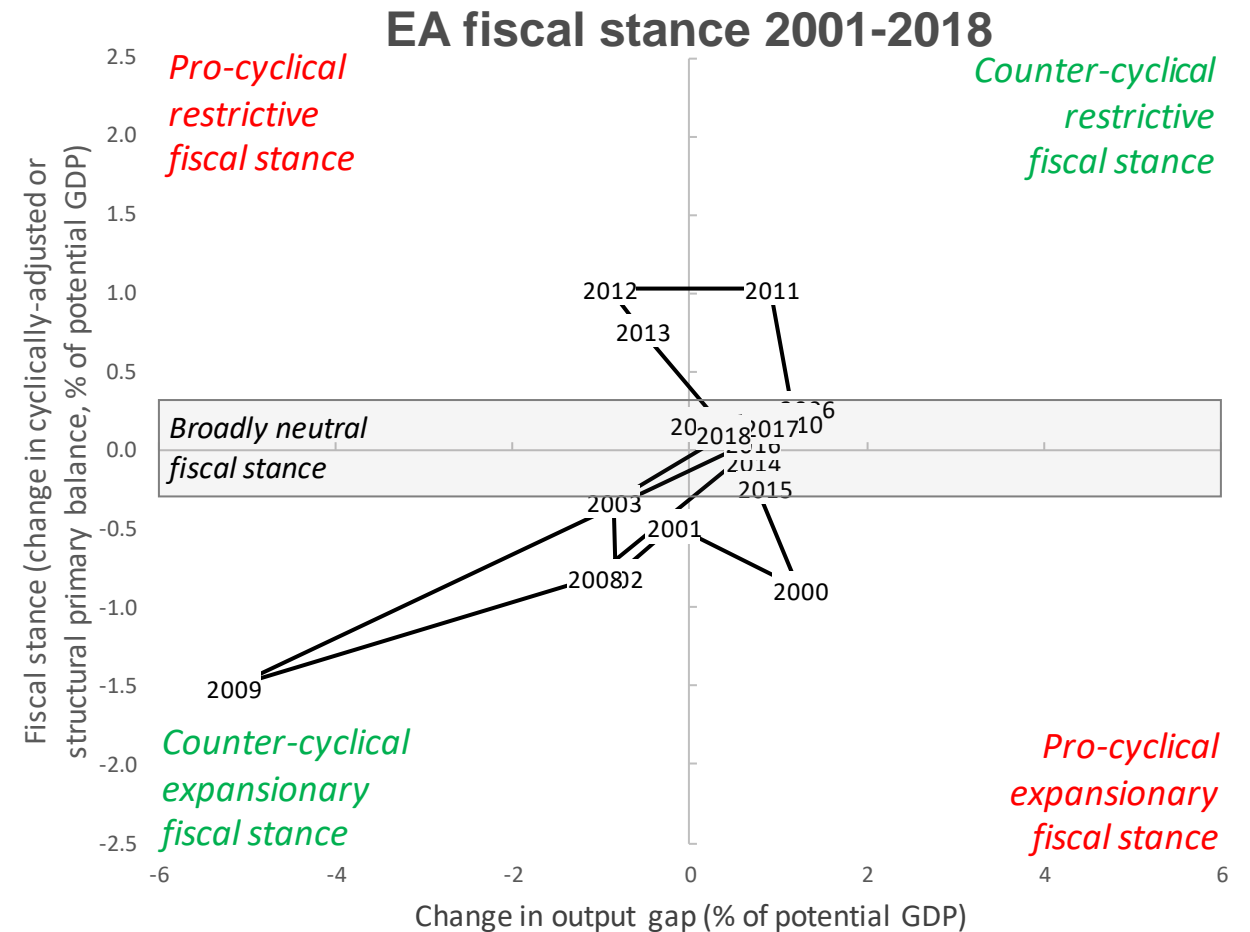
# Introduction

# Theory and practice

## Theory

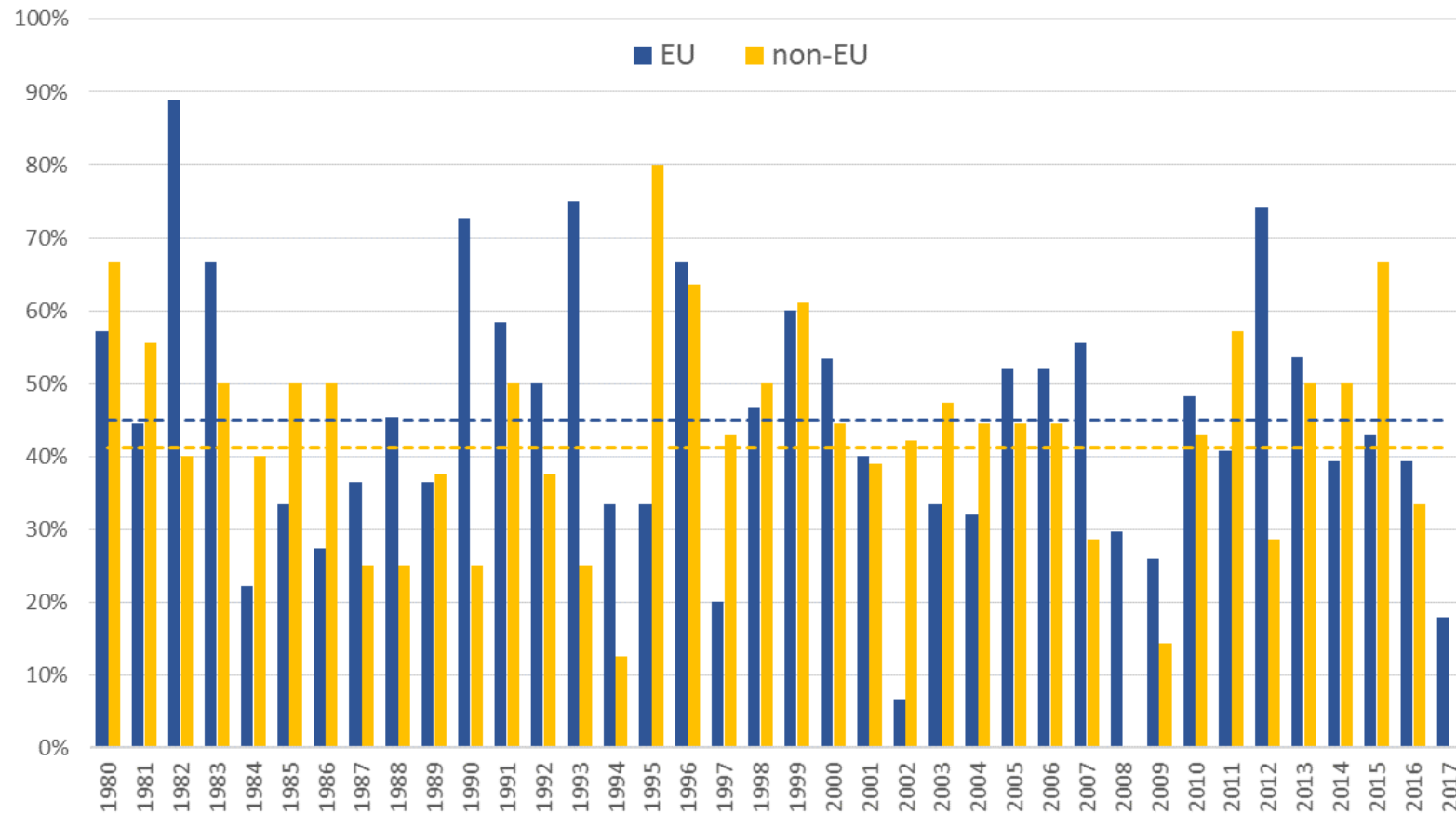
Recessions produce economic and social waste, which macroeconomic stabilisation, including fiscal policy, can help avert

## Practice



# Theory and practice

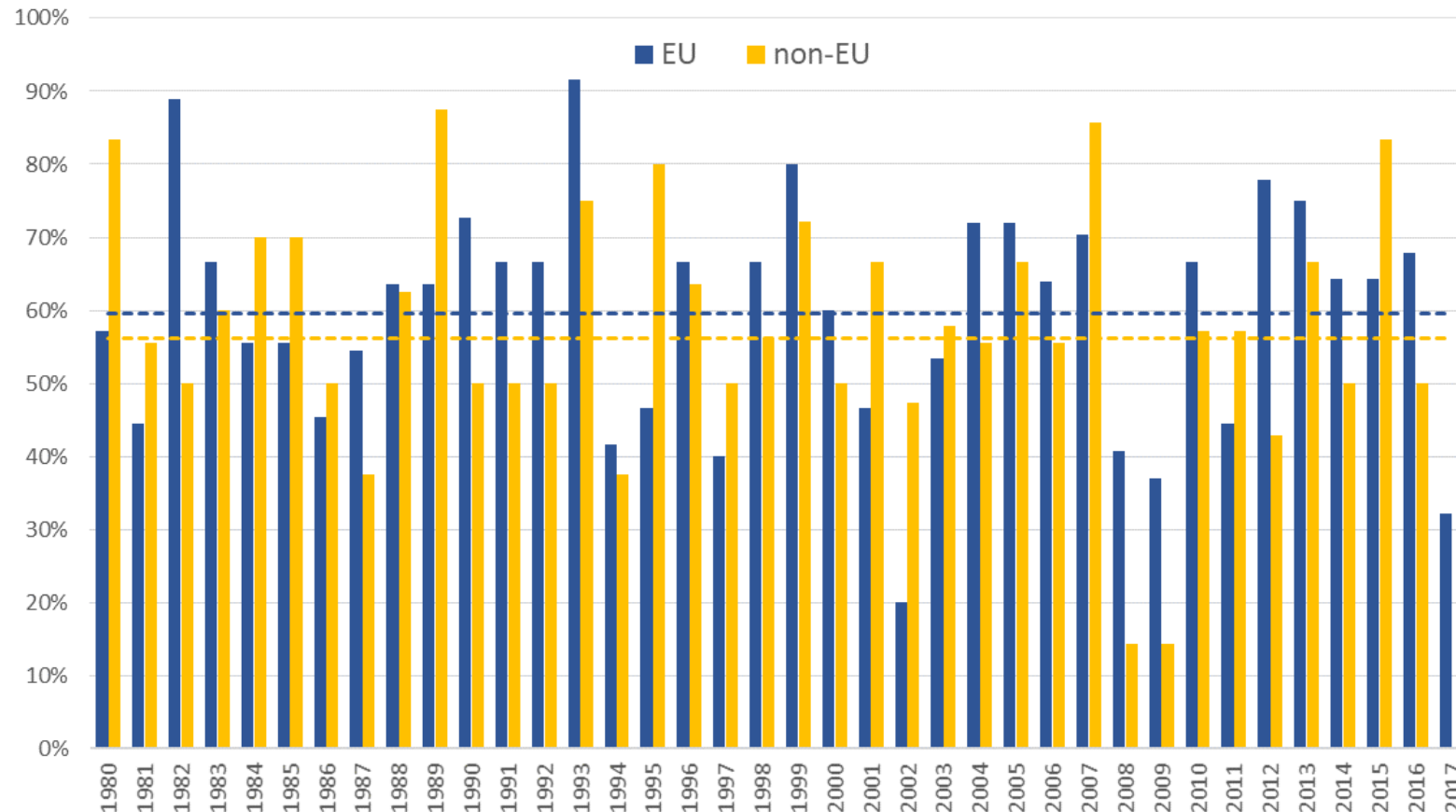
"Nobody uses fiscal policy as a macroeconomic policy tool, except macroeconomists in their models" (Eurointelligence 06-02-2020)



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

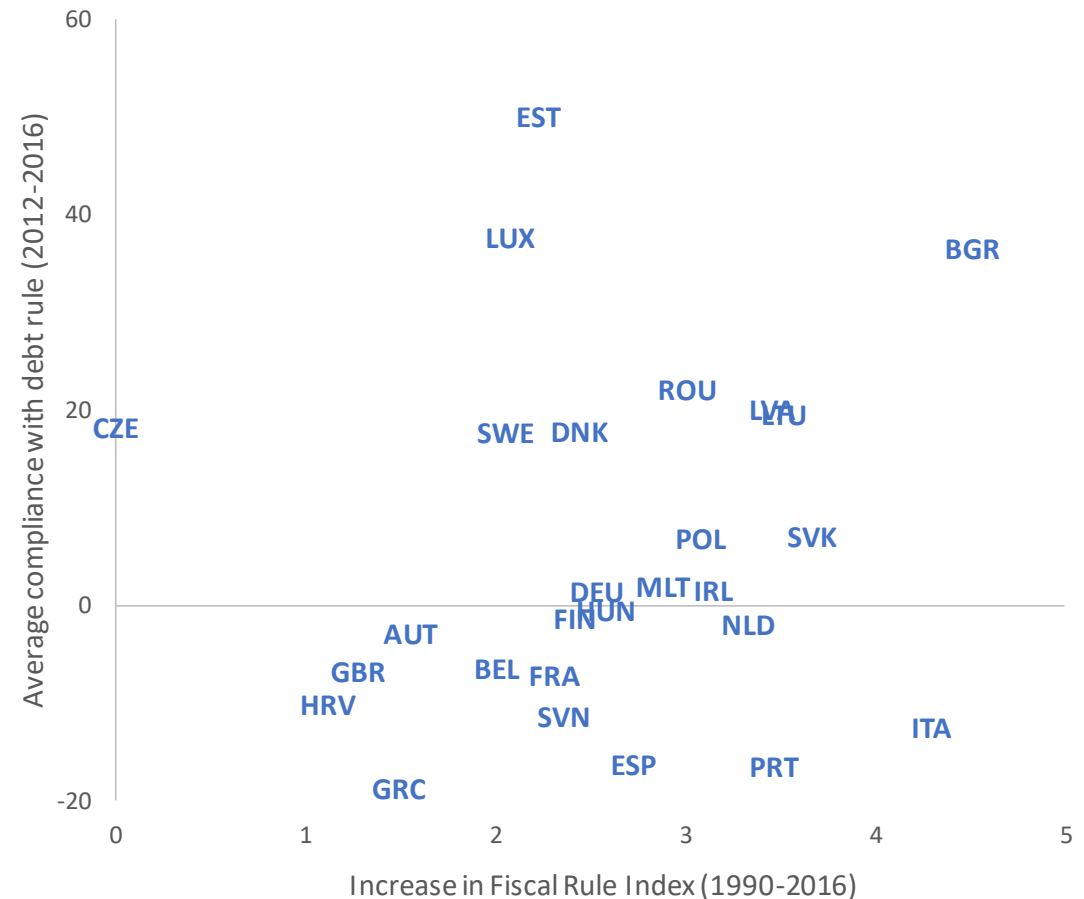
# Determinants of pro-cyclicality: non-linearities

- 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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