Fiscal outcomes in the EU in a rules-based framework

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Outline

I. Fiscal surveillance at EU level

II. Fiscal outcomes in the EU in a rules-based framework
Part I
Fiscal surveillance at EU level
I. Fiscal surveillance at EU level

1. Fiscal and economic policies coordinated
   - Need for coordination at EU level
   - Greater interactions within the euro area
     - Common monetary policy, fixed exchange rate
     - Asymmetric shocks, not fully taken into account by the ECB
     - Euro area not an Optimal Currency Area (missing adjustment & risk sharing)
     - The more the area is heterogeneous, the more coordination is needed

2. The hybrid mandate of the EU
   - Not a « supra-State » (in many key aspects)
   - Not an international organisation « soft law »
I. Fiscal surveillance: the current state

The Stability and Growth Pact

- Framework within which Member States make their budgetary decisions
  - Member States are responsible for fiscal policy
  - But must be compatible with common fiscal rules

- Two arms
  - **Corrective Arm** (a.k.a. Excessive deficit procedure (EDP)) corrects gross policy errors, *in nominal terms*
  - **Preventive Arm** aims to ensure strong underlying public finances, *in structural terms (structural balance, expenditure benchmark)*
I. How has fiscal surveillance evolved over time?

1997
- Stability and Growth Pact

1998
- Preventive arm enters into force

1999
- €

2005
- EDP is clarified
- Structural Balance takes central stage

RECESSION BEGINS

2011
- 'Fiscal compact' agreed

2012

2013
- 'Flexibility Communication' and 5Ps report

2015
- Two-pack adopted and enters into force

2008
- Six-pack adopted and enters into force
I. Key changes of fiscal governance framework since 2011

<table>
<thead>
<tr>
<th>Main objective</th>
<th>Key measures to achieve the objective</th>
</tr>
</thead>
</table>
| Strengthen sustainability           | • Introduction of expenditure rule, debt benchmark (6P)  
• Possibility of imposing earlier/ more gradual sanctions (6P)  
• Surveillance of Draft Budgetary Plans (2P) |
| Foster stabilisation                | • Introduction of “general escape clause” (6P)  
• Stronger focus on euro area fiscal policy stance (2P)  
• Introduction of flexibility for cyclical conditions (*) |
| Promote national ownership          | • Mandatory min. requirements for national fiscal frameworks (6P)  
• Introduction of balanced budget rule at the national level (FC)  
• Monitoring of all national numerical fiscal rules by IFIs (2P) |


Note: Key institutional reform steps are shown in italics in brackets, namely six-pack (6P), Fiscal Compact (FC) as part of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, the two-pack (2P) and commonly agreed position on flexibility in the Stability and Growth Pact, see Council of the European Union (2015) and European Commission (2015) (*).
Part II
Fiscal outcomes in the EU in a rules-based framework
II. Fiscal outcomes in the EU in a rules-based framework

Have fiscal rules in the EU...

1. Contributed to sustainability of public finances?

2. Mitigated procyclicality?

→ Evidence-based, backward-looking analysis, long-term perspective
Public debt ratios increased much less in the EU than in the US and Japan

Public debt developments in EU, US and Japan since 1985 (% GDP)

Key contributions to change in debt (1998-2017, in pps. of GDP)

Significant improvements in fiscal positions; 3% deficit became a target for some MS

Headline balances in EU Member States (% GDP)

Distance between the structural balance and the MTO (in pps.)

Expenditure dynamics under better control since Great Recession

Pre-Great Recession

Post-Great Recession

Still, public debt ratios remain close to peaks and fiscal buffers are limited

Public debt-to-GDP ratios since 2008 (% GDP)

Debt ratios and structural balances, weighted by country size

II. Fiscal outcomes in the EU in a rules-based framework

Have fiscal rules in the EU ...

1. Contributed to sustainability of public finances?

2. Mitigated procyclicality?

→ Evidence-based, backward-looking analysis, long-term perspective
How to assess the cyclicality of the fiscal effort?

- Measures of economic cycle
- Measures of fiscal effort
- Large number of robustness tests
### Fiscal effort appears procyclical

Fiscal effort appears procyclical if $\Delta OG < 0$

<table>
<thead>
<tr>
<th>Estimator</th>
<th>SYS-GMM (1)</th>
<th>SYS-GMM (2)</th>
<th>SYS-GMM (3)</th>
<th>SYS-GMM (4)</th>
<th>SYS-GMM (5)</th>
<th>SYS-GMM (6)</th>
<th>SYS-GMM (7)</th>
<th>SYS-GMM (8)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependant variable (t-1)</td>
<td>0.128* (1.758)</td>
<td>0.08 (1.226)</td>
<td>0.079 (1.158)</td>
<td>0.074 (1.135)</td>
<td>0.288** (1.978)</td>
<td>0.307** (2.357)</td>
<td>0.309** (2.355)</td>
<td>0.261* (1.890)</td>
</tr>
<tr>
<td>$\Delta$ Output gap (t)</td>
<td>-0.321*** (-3.756)</td>
<td>-0.370*** (-5.190)</td>
<td>-0.371*** (-5.093)</td>
<td>-0.369*** (-4.730)</td>
<td>0.754*** (2.765)</td>
<td>0.892*** (2.908)</td>
<td>0.869*** (2.847)</td>
<td>0.791** (2.166)</td>
</tr>
<tr>
<td>Public debt (t-1)</td>
<td>0.006*** (3.529)</td>
<td>0.011*** (3.804)</td>
<td>0.011*** (3.209)</td>
<td>0.011*** (2.897)</td>
<td>-0.019** (-2.485)</td>
<td>-0.036*** (-2.874)</td>
<td>-0.036*** (-2.754)</td>
<td>-0.045*** (-3.530)</td>
</tr>
<tr>
<td>Current account (t-1)</td>
<td>0.108*** (3.315)</td>
<td>0.114*** (3.508)</td>
<td>0.112*** (3.487)</td>
<td>-0.198 (-1.265)</td>
<td>-0.198 (-1.252)</td>
<td>-0.087* (-1.973)</td>
<td></td>
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<tr>
<td>Age dependency ratio (t-1)</td>
<td>-0.074*** (-3.332)</td>
<td>-0.076** (-2.440)</td>
<td>-0.103** (-2.584)</td>
<td>0.244* (1.664)</td>
<td>0.249* (1.702)</td>
<td>0.211** (2.139)</td>
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<tr>
<td>Election year (t-1)</td>
<td>-0.003* (-2.106)</td>
<td>-0.003* (-1.974)</td>
<td>0.011** (2.436)</td>
<td>0.014*** (3.388)</td>
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<tr>
<td>Crisis dummy 2008-09</td>
<td>-1.584** (-2.102)</td>
<td>1.396* (1.948)</td>
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<td># observations</td>
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<td>R-squared</td>
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<td></td>
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<tr>
<td>Wald test time/country dummies</td>
<td>0.00</td>
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<td>0.00</td>
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<tr>
<td>AR(1) (p-value)</td>
<td>0.00</td>
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<td>0.00</td>
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<tr>
<td>AR(2) (p-value)</td>
<td>0.31</td>
<td>0.22</td>
<td>0.28</td>
<td>0.29</td>
<td>0.84</td>
<td>0.84</td>
<td>0.83</td>
<td>0.90</td>
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<tr>
<td>Hansen (p-value)</td>
<td>0.29</td>
<td>0.83</td>
<td>0.78</td>
<td>0.77</td>
<td>0.52</td>
<td>0.58</td>
<td>0.57</td>
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<td># instruments</td>
<td>25</td>
<td>29</td>
<td>30</td>
<td>30</td>
<td>22</td>
<td>26</td>
<td>27</td>
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</tr>
</tbody>
</table>

“Complying with” fiscal rules mitigates procyclicality

The graph shows the size of the interaction coefficients, which are significant at the 10% level. The findings are based on the same sample and estimations techniques as described in the table above.

Note: Specification: $\text{effort}_{i,t} = \beta_1 \text{effort}_{i,t-1} + \beta_2 \text{cycle}_{i,t} + \beta_3 \text{debt}_{i,t-1} + \beta_4 X_{i,t-1} + \beta_5 \text{dummy}_{i,t} \cdot \text{cycle}_{i,t} + \beta_6 \text{dummy}_{i,t} + \theta_t + \delta_t + \epsilon_{i,t}$

# Main take-aways

<table>
<thead>
<tr>
<th>Main Objective</th>
<th>Key findings</th>
</tr>
</thead>
</table>
| Strengthen sustainability        | • Over the last 2/3 decades, public debt increased much less in the EU compared with most advanced economics (EU had on average a primary surplus)  
                                          • Significant improvements in Member States with most fragile fiscal positions  
                                          • But, debt is very high and fiscal buffers small in some Member States |
| Foster stabilisation            | • Fiscal adjustment effort appears procyclical in the EU  
                                          • Discretionary fiscal policy tends to be most procyclical in good times  
                                          • Respect of fiscal rules can mitigate procyclicality |
| Promote national ownership      | • National fiscal rules became more numerous and stronger  
                                          • Effective national / medium-term fiscal frameworks promote sound fiscal positions |

*Source: European Commission, 2018.*
Thanks!

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Well-established format:

- Covers fiscal surveillance-related and analytical topics; thereby addressing different audiences
- The analytical work is potentially useful for fiscal surveillance-related purposes, but also for maintaining a fruitful dialogue with the academic community

- **Available** here:
  