

NEW EVIDENCE ON THE EFFECTIVENESS OF EUROPE'S FISCAL RESTRICTIONS

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NON-TECHNICAL SUMMARY

The Maastricht Treaty (MT) has now been in existence for more than fifteen years. Its creation marked a new era for European fiscal policy with the introduction of strict fiscal rules and restrictions that were later reinforced with the introduction of the Stability and Growth Pact (SGP). Nevertheless, their usefulness has been hardly challenged in the literature.

This paper investigates how effective these rules have been in disciplining fiscal policy in the Euro zone. These days, such issue is even more compelling given the budgetary implications of the current financial crisis. In particular, an empirical assessment of the past effectiveness of Europe's fiscal restrictions can shed some light on how to enhance them in order to conciliate the European bail-out and fiscal stimulus plans with sustainable fiscal policy over the medium term.

In accordance with Fatás and Mihov (2003) and Fatás (2005), we concentrate on two types of biases that are the result of poor fiscal policy management and assess how the EU fiscal framework has affected them.

The first type of bias is the possibility of excessive deficits that arise either when governments do not internalize the cost of additional debt or when they postpone fiscal adjustment after a cyclical downturn. The second bias is the possibility of fiscal policy being procyclical, for instance due to the misinterpretation by politicians of cyclical increases in revenues as being structural.

Our methodology follows closely that of Galí and Perotti (2003). However, different from those authors, we separate the MT period (1992-1998) and the SGP period (1999-2007), disentangling the effects of each set of restrictions and isolating the fiscal impacts stemming from the efforts of European countries to enter the Euro zone. The failure of several countries to comply with the deficit target imposed by the pact adds concerns about whether the SGP is indeed an effective instrument in reducing fiscal profligacy.

As main novelty, we examine how the cyclically-adjusted primary deficit (our measure of fiscal stance) reacted when the reference deficit level of the Treaty (or Pact) were exceeded, after controlling for relevant economic and political variables. Moreover, we investigate whether (i) the average level of this measure of stance and (ii) its response to the output gap have changed during the MT- and SGP periods.

These reactions are estimated using pooling and instrumental variables techniques. They are compared with responses of other "industrialized" OECD countries, putting the European experience with the MT and the SGP into a broader perspective. Further, the more recent period after the reform of the SGP is also scrutinized.

Our main finding is that in contrast with the MT, the SGP has been ineffective in reducing fiscal profligacy in the Euro zone when the deficit limit was exceeded, i.e. it has failed to induce a contraction of the cyclically-adjusted primary deficit in response to excessive deficits. Moreover, the SGP has not prompted fiscal authorities in the region to behave countercyclically. Such results survive extensive robustness testing, and therefore, evidence the need for improvements in the current fiscal framework, in particular to enforce countercyclical fiscal policy in the Euro zone.

We, then, discuss some proposals made in this direction. One involves establishing independent and nonpartisan government fiscal agencies (see Jonung and Larch, 2006; and Debrun et al., 2009). Other suggestions, which could be easily combined with independent agencies, consist in: (i) strengthening the role of the debt level in the SGP rules; and (ii) creating rainy day funds that would allow Member states to fall into excess deficits when necessary, provided they have previously accumulated surpluses. Those proposals could give more room for counter-cyclical policies while helping countries to comply with the Pact.

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