FIRSTRUN – Fiscal Rules and Strategies under Externalities and Uncertainties.
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Summary report of the FIRSTRUN project

Executive summary

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FIRSTRUN, or Fiscal Rules and Strategies under Externalities and Uncertainties, is a Horizon 2020 project that has investigated fiscal policy coordination in the EU. This report provides a brief overview of the project and its key findings relevant to several policy areas.

Do fiscal and other economic spillovers matter and, if so, why or to what extent?

There have been conflicting results from past analyses of whether economic policies in one EU country have a pronounced effect in others. FIRSTRUN findings shed new light on this issue. In addition to spillovers from changes in the level of government spending or taxation, which influence aggregate demand, the project has studied spillovers from "structural fiscal policies", such as pension reforms, which influence the supply side of the economy.

Both the empirical and model-based results are in line with the view that during "normal times", fiscal spillovers from changes in the level of government spending or taxation are relatively small. However, spillovers may be much larger during "crisis times", when the borrowing of many households is constrained, or when monetary policy has effectively reached the limits of what it can do when interest rates fall close to zero. Even if unconventional measures are adopted, the (effective) "zero lower bound" in monetary policy means other policy responses may be required, especially if panic in financial markets can spread over countries' borders. Spillovers also increase when national fiscal policies are coordinated. These results underline the importance of fiscal coordination at least under special circumstances. Fiscal coordination may also be needed to make sure that national fiscal policies have room for stimulus when needed.

Certain structural reforms also have non-trivial spillover effects via international capital markets. These spillovers do not necessarily require policy coordination from the efficiency point of view, but they do have redistributive implications.

Policy coordination and risk sharing

An unresolved policy issue that has elicited conflicting opinions since the early days of monetary union is how fiscal policies should be coordinated under EMU to stabilise output growth and maximise average welfare. A FIRSTRUN analysis using an appropriate economic modelling technique suggests that fiscal policies should be used to reduce excessive deficits and surpluses in the current account of the balances of payments of member states. This result stems from country-specific nominal price rigidities, which imply destabilising fluctuations in the terms of trade over the business cycle.

Another stabilization mechanism relates to cross-country risk-sharing. The FIRSTRUN project has considered private and public risk-sharing mechanisms and compared cross-country risk-sharing in the Economic and Monetary Union (EMU) to risk-sharing across states in the United States. The results show that there is still relatively little cross-country risk-sharing via private capital markets in the EMU. One reason for this is that the cross-border ownership of productive assets remains very limited.

How effective is the EU fiscal governance framework?

A large part of the FIRSTRUN research was dedicated to evaluating the new, enhanced framework of EU fiscal governance. One strand of work was to look, retrospectively, at how the new fiscal rules would have constrained fiscal policies during past economic booms and busts. This requires a clear and comprehensive view of the information that was available at the time the rules would have been applied, bearing in mind that subsequent data revisions are often substantial. To allow for this we collected and examined the data from the European Commission AMECO database, as published at the time, from 2002 onwards.[1]

One result in this regard is that the use of the structural deficit – a constructed variable which seeks to adjust the actual deficit to reflect the phase in the economic cycle - for steering fiscal policy can paint a misleading picture. If the adjustment is based on incorrect data it may deter policy-makers from choosing the required counter-cyclical or even neutral fiscal policy. Essentially, this is because it is very difficult to estimate the deviation of the economy from a sustainable position – known as the output gap – in real time. In other words, the structurally adjusted indicators, on which the fiscal framework large relies, are relatively unreliable. More generally, "real-time uncertainty", i.e. uncertainty about the current state of the economy appears to be very relevant for fiscal policy. This is because it is particularly difficult to distinguish between cyclical and structural components in economic growth sufficiently rapidly to be confident that the underlying data are stable.

Because of the problems associated with the output gap method, the project has considered alternative measures for estimating the structural balance. These include the expenditure rule – which stipulates a target for the increase in government spending – used in the preventive arm of the Stability and Growth Pact (SGP) and the corresponding bottom-up method in the corrective arm. They rely on the micro-level assessment of discretionary fiscal policy measures. The results show that at least in the past, these methods would have been more conducive than the output gap method to fiscal policy choices that helped to diminish cyclical fluctuations in the economy. It is therefore likely that the bottom-up measures would serve as a better guide for fiscal policy than the current measures based on the output gap method.

It is not just about fiscal policy…

In a similar vein, FIRSTRUN researchers have analysed whether the Macroeconomic Imbalance Procedure (MIP) would have been able to detect increasing macroeconomic risks prior to the 2008 financial crisis and the subsequent recession. The results show that the MIP would have provided moderately useful alerts in terms of crisis prediction before 2009. However, many of the indicators, especially those related to the financial markets, would have been uninformative. It is also difficult to see how some of the indicators used relate to macroeconomic imbalances. This suggests that the MIP Scoreboard could be simplified.

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[1] The dataset is available on the FIRSTRUN web page http://www.firstrun.eu/research/data/

Political economy considerations

The project also dealt with political and institutional aspects of EU fiscal governance. It raised concerns regarding the erosion of democratic legitimation in EU fiscal governance. Given that fiscal policy has more direct distributive consequences than other areas of policy which have become more technocratic, this may undermine the implicit contract between voters and national governments. Public trust in government declined during the years of crisis in many countries, particularly those in which the EU level is viewed as having imposed harsh policies with little opportunity for citizens to influence them. Although the concern is often about allowing voters a say in significant policy decisions, the concept of "throughput legitimacy" offers a broader approach to the challenges of more technocratic governance by asking how the institutions which set, monitor and enforce rule-based approaches to governance arrive at their policy models. Why, for example, is one interpretation of fiscal sustainability or a means of estimating the output gap preferred to another and who determines the choice?

Innovation in research methods and provision of data

Finally, the project has produced new tools in the form of quantitative economic models for designing fiscal policies and developing fiscal coordination mechanisms in the EU. In addition, a dataset of "real-time" macroeconomic variables has been made available.