



THE TRANSFORMATION OF FISCAL POLICY

Living la vida loca?

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CONTENT ***Chapters***

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01

FISCAL POLICY RESEARCH QUESTIONS

In this chapter, we briefly discuss
fiscal policy and the research
questions of the paper



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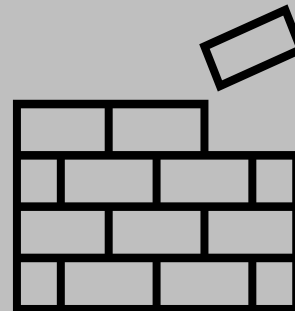
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02

DEVELOPMENT OF FISCAL POLICY FISCAL RULES

This chapter discusses the historical development of fiscal policy and fiscal rules as a new feature in the modern conduct of fiscal policy

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EMPIRICAL RESEARCH

This chapter discusses the empirical research and the results obtained



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CONCLUSION

Concluding remarks



INTRODUCTION

Fiscal policy

- **One of the fundamental instruments of a state's economic policy**, through which the state manages public revenues, expenditures and public debt in order to achieve macroeconomic stability, sustainable economic growth, high employment and a fairer distribution of income
- **Its importance** is particularly evident in periods of economic crises and financial instability
- **Functions:**
 - Developed countries: stabilize economic trends and maintain high employment,
 - Developing countries: stimulating economic growth and development processes

01

Research questions

1. How has fiscal policy evolved across successive macroeconomic paradigms?
2. Which factors have driven the resurgence of fiscal activism in the 21st century?
3. To what extent have supranational fiscal rules at the European Union level influenced the fiscal positions of the Member States?

Addition: Empirical analysis of the impact of supranational fiscal rules at the EU level on the fiscal positions of the Member States

INTRODUCTION

01

?

Are governments managing the economy responsibly, or are they living the fiscal equivalent of a reckless lifestyle — spending today and leaving the bill for tomorrow?

¿Sabes qué? ¡Estáis locos!

02

DEVELOPMENT OF FISCAL POLICY

*From balancing budgets to
managing the economy*



Late 19th - early 20th century

Classical economic liberalism

- *Laissez-faire* principle
- Fiscal policy played a predominantly passive role; its role was based on the doctrine of “sound finances”, that is, a balanced budget, limited public spending and avoiding excessive public debt
- Classical economic liberalism was based on the belief that the market has self-regulating mechanisms that ensure long-term equilibrium
 - Problem: periods of major economic shocks
 - In fiscal terms, such an approach implied a low level of public spending and a minimum tax burden, in order to minimize disruption to private initiative and entrepreneurial activity



'30s

Great Depression and the Keynesian Revolution

- The modern concept of fiscal policy began to take shape during the Great Depression in the 1930s, one of the deepest economic crises in modern economic history
 - it exposed the limitations of classical economic theory, since market mechanisms failed to ensure a quick recovery of the economy or a return to full employment
- John Maynard Keynes, *The General Theory of Employment, Interest and Money* (1936 [1987])
 - Advocated increasing public spending, including deficit financing during periods of recession, to stimulate aggregate demand, production and employment (public work)
- Fiscal policy was a key instrument for stabilizing economic cycles and maintaining a high level of economic activity
- After World War II, the Keynesian economics became the dominant paradigm in shaping fiscal policy in developed Western economies



'70s - '80s

Monetarism

- The changing economic environment characterized by:
 - decelerating growth and rising inflationary pressures; stagflation
 - oil crises of 1973 and 1979
- Milton Friedman
 - Considered inflation primarily a monetary phenomenon and advocated a stable and predictable monetary policy as a more effective stabilization instrument than discretionary fiscal policy
 - Monetarists advocated controlling the money stock and considered fiscal policy to be a less effective stabilization instrument due to the time lag
 - The neoliberal shift - reducing the state's direct role in the economy
- Fiscal policy gradually lost its central place in macroeconomic stabilization, while monetary policy became the dominant instrument of economic governance

End of the 20th - beginning of the 21st century

The Times They Are A-Changin'

- Globalization, liberalization of trade and capital flows, integration of international financial markets, strengthening of supranational institutional frameworks and accelerated development of information and communication technologies
- Global crises - 2008 and the COVID-19 pandemic of 2020
 - The 2008 crisis exposed weaknesses in the deregulated financial system and encouraged extensive state interventions
 - Renewed interest in the Keynesian approach to active fiscal policy, while at the same time questioning the assumption of rapid self-regulation of the market after economic shocks and disruptions
 - The response to rising indebtedness was the implementation of post-crisis fiscal consolidation (austerity) programmes, which, although aimed at restoring fiscal sustainability, associated with a slower recovery (EU)

'90s - early '00s

Fiscal rules

- The contemporary wave of introducing fiscal rules began with the adoption of the New Zealand Fiscal Responsibility Act in 1994, shortly after the country pioneered inflation targeting regime in that country
- The emergence of fiscal rules marked a new chapter in shaping and implementing fiscal policy
 - Their primary purpose is to limit the growth of public debt and budgetary imbalances, and to contribute to increasing the credibility of fiscal policy

EUROPEAN UNION

- Maastricht Treaty – significantly shaped EU fiscal policy (development of fiscal rules at the EU level)
 - The establishing of common rules limits the Member States' fiscal autonomy and reduces space for discretionary fiscal policy
 - The new fiscal consensus was further shaped by the establishment of the Stability and Growth Pact in 1997, which required Member States to balance their budgets over the economic cycle

'90s - early '00s

Fiscal rules

POSITIVE EFFECTS

- Reduction in budget deficits, public spending and borrowing costs
- Higher GDP growth rates

NEGATIVE EFFECTS

- Inadequately designed fiscal rules can limit the possibility of implementing countercyclical fiscal policies (recession, economic shocks)

A NEED FOR

- Designed to have a certain degree of flexibility in crises, while encouraging the build-up of fiscal buffers in good times
- Independent fiscal bodies

21st century

Contemporary challenges

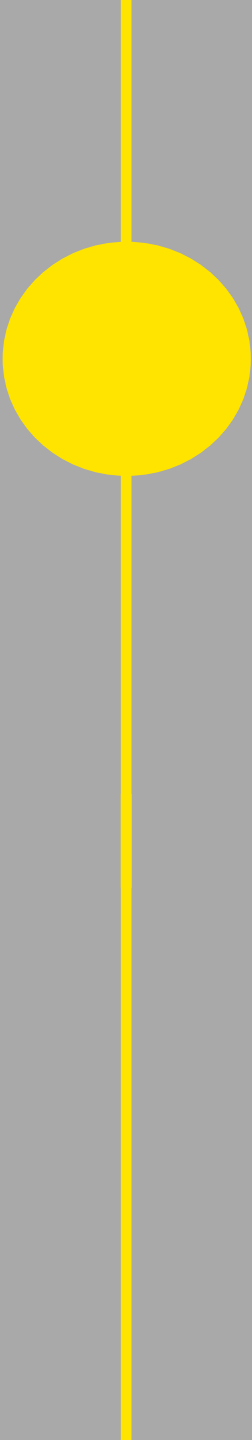
'The turning point(s)'

- Turning points:
 - 2008 financial crisis: stimulus and financial-sector support became central to economic recovery.
 - COVID-19 pandemic: governments financed emergency healthcare, wage support, and business assistance.
 - Energy-price shocks: subsidies and temporary relief measures protected households and firms.
 - Today's pressures: ageing populations, defence spending, climate change, and higher debt-servicing costs compete for limited public resources.
- Fiscal policy has once again taken a prominent place in discussions about the role of the state in the economy
- One of the key issues of modern fiscal policy is finding the right balance between fiscal discipline and stimulating economic growth
 - 'Smart fiscal consolidation' links responsible public finance management with investment in infrastructure, education and innovation as the foundation of long-term development

El problema de la vida loca
deficits, debt, and political choices

03

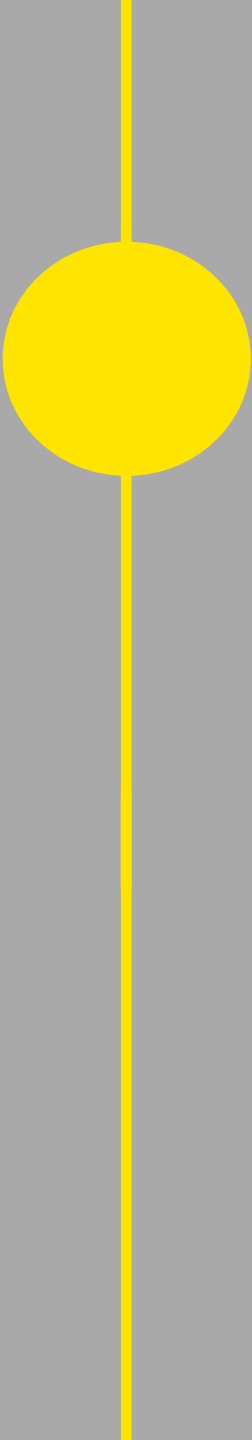
METHODOLOGY AND EMPIRICAL RESULTS OF THE RESEARCH

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Hypotheses

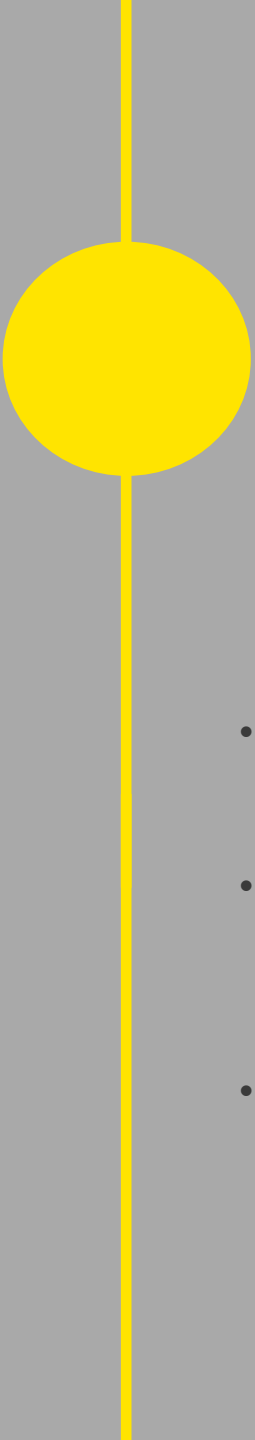
The empirical research tests the following hypotheses:

1. The Excessive Deficit Procedure (EDP) does not have a statistically significant impact on the cyclically adjusted primary balance of EU Member States.
2. There is no statistically significant difference in the effect of excessive deficit procedure (EDP) between large and small economies.

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Data and Variables

- The analysis was conducted on a panel of 27 EU Member States from 2003 to 2023 (subsample 2003-2019)
- The dependent variable is the cyclically adjusted primary balance (CAPB) expressed as a percentage of potential GDP
- Key explanatory variables:
 - EDP: fractional measure of exposure to the procedure
 - $EDP \times LARGE$: interaction term testing the asymmetry of institutional pressure on small and large economies
- Control variables:
 - Lagged public debt (DEBT, % of GDP),
 - Lagged output gap (OUTPUT, % of potential GDP)
 - NFR (*National Fiscal Rules*): indicates the presence of national fiscal rules more restrictive than those defined by the Stability and Growth Pact,
 - LARGE: dummy for large economies, defined as Member States whose share of EU GDP exceeds 2.5%
 - Linear trend (values 1-21 for the period 2003-2023)



Econometric specification and estimation methodology

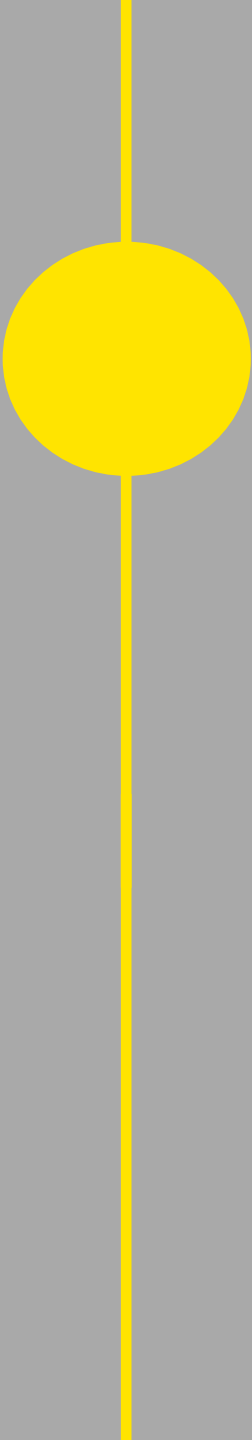
$$CAPB_{it} = \rho \cdot CAPB_{i,t-1} + \beta_1 \cdot EDP_{it} + \beta_2 \cdot NFR_{it} + \beta_3 \cdot OUTPUT_{i,t-1} + \beta_4 \cdot DEBT_{i,t-1} + \beta_5 \cdot LARGE_{it} + \beta_6 \cdot (EDP_{it} \times LARGE_{it}) + \beta_7 \cdot trend_t + \alpha_i + \varepsilon_{it}$$

- β_1 captures the short-term effect of EDP exposure on CAPB in small countries, and β_6 the differential effect for large countries. The overall EDP effect for large Member States is given by $\beta_1 + \beta_6$
- Dynamic panel model approach using the Difference GMM estimator, which solves the problem of endogeneity of the lagged dependent variable by eliminating fixed effects through first-differencing, while using deeper lagged values as instruments
- The validity of the specification is verified using the Arellano-Bond's test for first- and second-order autocorrelation and the Hansen test of overidentifying restrictions

Empirical results

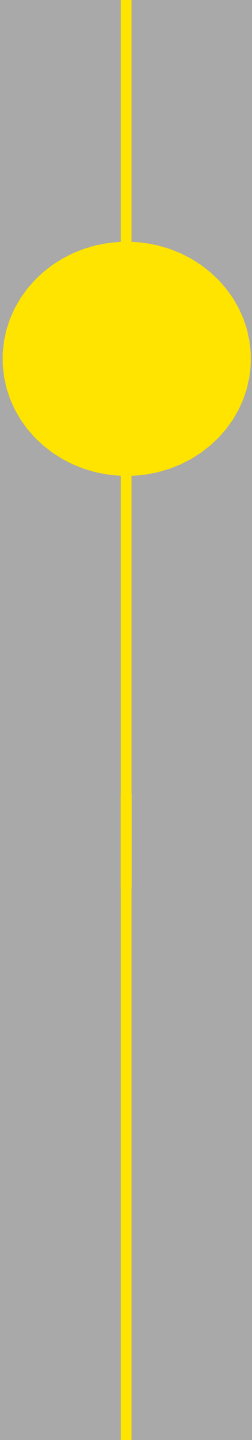
Variable	Full sample 2003-2023			Subsample 2003-2019		
	Frac.	≥3 Q	≥2 Q	Frac.	≥3 Q	≥2 Q
L.CAPB	0.510*** (0.005)	0.496*** (0.005)	0.494*** (0.004)	0.204 (0.252)	0.190 (0.246)	0.231 (0.140)
EDP	1.718* (0.067)	0.581 (0.233)	1.488** (0.012)	-0.194 (0.857)	-0.409 (0.444)	0.451 (0.493)
NFR	-1.606** (0.028)	-1.614** (0.024)	-1.680** (0.023)	-1.201 (0.130)	-1.223 (0.121)	-1.238 (0.108)
OUTPUT_1	0.382*** (0.001)	0.360*** (0.001)	0.367*** (0.001)	0.042 (0.765)	0.030 (0.813)	0.078 (0.514)
DEBT_1	0.115*** (0.001)	0.121*** (0.001)	0.118*** (0.001)	0.211*** (0.000)	0.213*** (0.000)	0.204*** (0.000)
LARGE	3.063*** (0.000)	2.457*** (0.004)	3.520*** (0.000)	3.009*** (0.000)	2.828*** (0.000)	3.018*** (0.000)
EDP_LARGE	-1.934** (0.036)	-0.439 (0.398)	-1.995** (0.010)	-0.975 (0.307)	-0.357 (0.527)	-1.133 (0.106)
trend	-0.124* (0.082)	-0.139** (0.038)	-0.125* (0.074)	-0.289*** (0.007)	-0.286*** (0.004)	-0.268*** (0.009)
AR(2) p	0.534	0.493	0.666	0.325	0.356	0.366
Hansen p	0.091	0.069	0.068	0.141	0.132	0.135
Instruments	9	9	9	9	9	9
Observations	498	498	498	390	390	390

Note: *** $p < 0.01$; ** $p < 0.05$; * $p < 0.10$; p -values in parentheses; Difference GMM, one-step, $\text{gmm}(\text{L.CAPB}, \text{lag}(3\ 4) \text{ collapse})$. Frac.: fractional EDP variable.
 $\geq 3/\geq 2$ Q: binary thresholds

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Empirical results

- The basic model uses the EDP fractional method, defines large Member States a share of EU GDP above 2.5 % and observes the period from 2003 to 2023. To verify its robustness, two additional models were estimated with binary EDP coding ($\geq 3/\geq 2$ *quarters*) instead of the fractional measure
 - In addition, the verification of the results of the main and additional models was carried out on the subsample for the period from 2003 to 2019, which excludes the impact of the COVID-19 pandemic on economic trends
 - The sensitivity analysis of the model was carried out through changes in the definition of the LARGE variable, which determines the size of the economy, using threshold of 2% and 3% of total EU GDP, for both the full sample and the subsample
- The coefficient of the lagged dependent variable CAPB (0.510, $p < 0.01$) confirms that the process is stationary with moderate inertia of the fiscal position, the carry-over of the fiscal outcome from the previous year into the current one. The result is robust across the binary EDP specifications on the full sample
- The coefficient of the key independent variable of the EDP (1.718, $p < 0.1$) indicates that the EDP has a positive effect on CAPB improvement, especially in the case of small EU27 economies.
- interaction coefficient (EDP x LARGE) is -1.934 ($p < 0.05$). This implies a total EDP effect of -0.216 pp of GDP (= $1.718 + (-1.934)$) for large economies. The negative sign of the interaction variable shows that CAPB actually deteriorates in large economies during the periods they spend under EDP
- The LARGE variable (3.063, $p < 0.01$) is included as a control; the key result is the interaction term $EDP \times LARGE$

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Empirical results

- The NFR variable coefficient (-1.606, $p < 0.05$) reflects the endogenous nature of the adoption of national fiscal rules. Most studies on fiscal rules address the problem of endogeneity by using the generalised method of moments (GMM) or instrumental variable techniques involving variables of political economy (Badinger, Reter, 2015; Bergman, Hutchison, Hougaard, 2016; Caselli, Reynaud, 2020)
- The positive DEBT_1 coefficient (0.115, $p < 0.01$), robust through all specifications, consistent with Bohn's (1998) fiscal sustainability conditions, but its linear specification also assumes a uniform response across Member States to the debt level. This assumption could be tested in a non-linear model in future research.
- Although the positive coefficient of the lagged output gap (0.382, $p < 0.01$) on the full sample points to an, on average, countercyclical pattern in the EU27, the result should be interpreted bearing in mind that the linear model cannot capture potentially different behaviour at different levels of public debt
 - Combes, Minea and Sow (2017) empirically identified a threshold of 87% of GDP above which fiscal policy shifts from countercyclical to procyclical, as highly indebted countries lose fiscal space for a countercyclical response
 - Mamatzakis (2024) finds an endogenous public debt threshold of 75.6% for the EU27 and 78.7 % for the euro area
- These findings suggest that future research could apply a non-linear specification with a public debt threshold (for example the dynamic panel threshold model with Seo and Shin (2016)) to identify a potentially different reaction function for the EU27 Member States with levels of debt.

CONCLUSION

04

- Fiscal policy has undergone a profound theoretical and institutional transformation, evolving from a means of securing public revenue into one of the fundamental instruments of macroeconomic stability
- The 2008 global financial crisis and the COVID-19 pandemic have reaffirmed fiscal policy as an indispensable instrument for managing economic shocks
 - permanently higher public debt ratios, more intense coordination with monetary policy, and the extension of its goals to the climate transition, industrial policy and the long-term strengthening of economic resilience
- The empirical findings of the research carried out in this paper indicate that the EU institutional framework, despite the formally established corrective mechanisms, does not ensure an equal degree of fiscal discipline among Member States
 - Need for fiscal space to implement countercyclical fiscal policy because otherwise forced to act in a procyclical manner, thus further deepening the fiscal imbalance

When does responsible spending become fiscal *living la vida loca?*

- *Governments promise benefits and services without securing sustainable funding*
- *Persistent deficits increase public borrowing*
- *Higher interest costs leave less money for public services and investment*
- *Future governments may have less room to respond to recessions or emergencies*

04

Final *'wild thoughts'*

- *A deficit is not automatically bad. The problem is borrowing without a credible plan for long-term benefits and debt sustainability*
- *Fiscal policy is not about living la vida loca on taxpayers' money. It is about building a society that can afford a good life, today and for generations to come*

**THANK
YOU
FOR
YOUR
ATTENTION**

**THE
END**

