Fiscal Sustainability in Europe

Reporting

Project Information

FISCSUST

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Final Report Summary - FISCSUST (Fiscal Sustainability in Europe)

The primary objective of FISCSUST project is to develop a theoretical framework to help researchers and policy makers understanding and assessing the notion of fiscal sustainability and use this framework to address the recent debt sustainability problems in the world economy with a particular emphasis to the European experience. In order to do so, we have developed a framework that helps to analyze, understand and provide insights to answer the question "What is sustainable fiscal policy?" from a different perspective than that already exist in literature.

The main aim of work planned for the first half of the project was to review the current knowledge base on the topic and establish a set of results that would further motivate and guide us in formation of the alternative framework the project aims to establish. This included a thorough analysis of fiscal policy conduct in with respect to macroeconomic aggregates in European countries and fiscal sustainability tests of these countries using existing methodologies. In light of these objectives, we have completed a comprehensive survey on widely used tests of fiscal sustainability measures, completed a detailed

descriptive analysis of the macroeconomic fiscal policy conduct and performed fiscal sustainability tests on subject countries. As a result of the work completed, we have investigated and documented the similarities and differences of the countries that were affected the most from the fiscal crises such as Greece, Portugal, Ireland, Spain, Italy and Belgium.
We found that public debt levels and standard public budget balances by themselves are not sufficient to explain the differences in cross country experiences. Almost as important, and in some cases more, were the external imbalances of the country vis-a-vis the rest of the world, private sector imbalances and political constraints. We showed that countries with similar debt levels and deficit performances in the beginning of the global recession, ended up at very different ends of the spectrum with respect to fiscal fragility later. This supported our argument for a holistic analysis of fiscal sustainability that allows for public sector interaction with the rest of the economy and contingencies that do not explicitly show up in official fiscal accounts. In light of these findings, our argument is that the concept of 'fiscally sustainability' as an absolute notion based only on official fiscal imbalances is not very useful in many cases, i.e. regardless of how sustainable the official fiscal accounts look, private sector imbalances and unforeseen contingencies that is not on fiscal balance sheet of a sovereign might has to be closely monitored. Based on our findings, a more appropriate approach we argue then is 'fiscal vulnerability' that takes into account these neglected dimensions.
During the second part of the project, our main task was to develop the framework that could potentially incorporate the aforementioned neglected dimensions of fiscal sustainability in existing literature. We have accomplished this task by building a dynamic stochastic general equilibrium model that endogenizes optimal fiscal policy making, where potential default is an option, in an environment that inherits some of the missing parts of standard sustainability analysis, pointed out by the results that came out from the first part of our work. The novelty of the framework comes from the fact that it allows to investigate the dynamic interaction of fiscal policy with private sector actions and allows for investigating behavior of fiscal policy and debt sustainability in response to different types of shocks and potential policy options. This framework by construction allowed us to do fiscal sustainability analysis that is 'state and model dependent' i.e. we were able to update and observe changes in fiscal vulnerability in response to changing state and model structure. This setup allowed us to investigate the response of optimally behaving fiscal decision maker to alternative scenarios to do counter-factual policy experimentation with respect to important policy parameters. To be more precise, we were able to find endogenous sustainability thresholds under different scenarios, i.e. we were able to define 'fiscal sustainability' in our framework as a multidimensional notion, which can potentially and explicitly depend on all relevant variables and constraints in the environment fiscal policy is conducted. Preliminary findings of our research suggests that for reasonable of parametrization of the benchmark model typical 'fiscal rules' as a way of improving fiscal sustainability are not welfare enhancing. It is important to note that, this result should be taken with caution as the benchmark model takes all sovereign debt as external, hence cost of default for the lenders is not a part of welfare calculations. The discretionary 'optimal' policy, even though generating more defaults in equilibrium, improves welfare by mimicking a more complete market, i.e. defaultable debt having a partial state contingent character.

The empirical analysis and the theoretical framework built has provided us with valuable insights that will be translated into policy sphere and generate testable hypothesis against the data. We also believe this framework can be operationalized to generate a practical multidimensional fiscal vulnerability index that is sensitive to changes in general macroeconomic environment, rather than just fiscal accounts of the sovereign. Our framework utilizing the notion of 'sustainability' with respect to fiscal policy from the sovereign. Our framework utilizing the notion of "sustainability" with respect to fiscal policy from the perspective of both willingness and ability to pay will hopefully will be accepted as a useful complement to the existing methods, will generate scholarly discussion around this notion and attract attention from policy spheres.

You can find more detailed information about our findings and access to up to date project documents at our project website: http://www.fiscsust.org/

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