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Do Spanish fiscal regimes follow the euro-area trends? Evidence from Markov-Switching fiscal rules

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ABSTRACT

As has been the case for Spain, the Great Recession has exposed the destabilizing potential of national fiscal decisions which do not adhere to the European rules for the euro area. In this context, we characterize the discretionary behavior of Spanish fiscal policymakers in comparison with the euro-area one. For this purpose, we estimate cyclically-adjusted fiscal policy rules for the period 1986–2012 within a Markov-Switching framework. Our results show that the discretionary fiscal behavior of Spanish and euro-area governments has manifested switching properties throughout the last thirty years, uncovering the existence of two fiscal regimes which shift in accordance with the extent of deficit persistence and the intensity of debt-stabilizing and output-countercyclical measures. Irrespective of fiscal regime, the Spanish authorities have committed to meeting the Maastricht criteria and the SGP rules by centering on the public deficit-debt association, whereas the euro-area administrations have engaged in stimulating the economic activity by focusing on the deficit-output gap relation. Our conclusions are robust to the impact of house price changes on fiscal policy variables for the Spanish case.
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1. Introduction: fiscal stance in context

The Great Recession has shaken the foundations of the global economy and has generated serious doubts about the decisions of fiscal policymakers. Contrary to what it might seem, the fiscal performance of the euro area has been slightly better than that of some advanced economies as the United States (USA) or Japan since the beginning of the current international financial and economic crisis. According to the IMF (2016), the euro area experienced lower annual deficit-to-GDP ratios and annual debt-to-GDP ratios than the USA and Japan on a year-by-year basis and also lower debt-to-GDP ratio growth rates than the USA between 2008 and 2014 (see Table 1).

Whereas the USA and Japan are sovereign individual countries that have a single fiscal policy, the euro area is an ad-hoc group of 19 Member States of the European Union (EU), including Spain, which have adopted the euro as their single currency and share a single monetary policy, but preserve fiscal sovereignty. Euro-area countries have agreed on introducing some kind of fiscal policy coordination for achieving the common objectives of stability, growth and jobs. Coordination of fiscal policies has adopted several forms at the euro-area level, but one of the most important is fiscal rules.

In general terms, a fiscal rule is a tool that matches an objective with some instruments in order to guide the action of fiscal policymakers. In the economic literature, fiscal rules are powerful instruments to disentangle the factors determining fiscal policymaking. In the real world, fiscal rules are nevertheless neither a necessary nor a sufficient condition for fiscal policy to pursue both the sustainability of public finances and macroeconomic stability in the medium to long term simultaneously (Castañeda, 2009), as the recent euro-area fiscal developments have proven.

The most widely-known euro-area fiscal rules are enshrined in the Stability and Growth Pact (SGP), approved in 1997 and revised later. The SGP is applied not only to euro-area countries, but to all EU Member States, even though the former are subject to sanctions in case of non-compliance. Under the provisions of the SGP, Member States must respect two basic criteria: a deficit-to-GDP ratio should be lower than 3% and a debt-to-GDP ratio should not exceed 60%. Moreover, Member States must register structural budgetary improvements that ensure a steady and lasting convergence towards their medium-term budgetary objectives (MTOs).[1]

Although all EU Member States have to comply with those regulations, the fiscal performance of the aggregate outlined above can hide the different behaviors of its parts as the European integration process is far from concluded. Moreover, no sanctions have been adopted so

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[1] Šehović (2015) offers a recent analysis of fiscal rules in the Economic and Monetary Union (EMU).

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Table 1
Fiscal performance in the euro area, Japan and the United States.
Source: International Monetary Fund, World Economic Outlook Database, April 2016.

Country	2008	2009	2010	2011	2012	2013	2014
General government structural balance (Percent of potential GDP)							
Euro area	−3.3	−4.6	−4.5	−3.7	−2.0	−1.2	−1.0
Japan	−3.6	−7.5	−7.9	−8.5	−7.9	−8.2	−5.8
United States	−5.9	−7.6	−9.4	−8.1	−6.1	−4.0	−3.5
General government gross debt (Percent of GDP)							
Euro area	68.5	78.3	84.0	86.6	91.3	93.4	94.5
Japan	191.8	210.2	215.8	231.6	238.0	244.5	249.1
United States	72.8	86.0	94.7	99.0	102.5	104.8	105.0

far, despite the excessive deficits registered by a number of euro-area countries. Accordingly, in the height of the current financial and economic crisis, fears about the fiscal weaknesses of the euro area were revealed to governments and investors alike and markets brought back the spotlight to the PIIGS (i.e. Portugal, Ireland, Italy, Greece and Spain), a group of euro-area's peripheral economies which have faced deficit and debt issues and have experienced slow growth.

Since the PIIGS account for almost 30% of euro-area GDP (IMF, 2016), concerns on the sustainability of their public finances can spread across Member States and can undermine the whole euro area. For restoring credibility in the European project, several extraordinary policy responses have been implemented, e.g. numerous austerity measures, which help to contain the deficit as data presented in Fig. 1 corroborate, have been enforced. Alesina et al. (2015) describe in detail the size and composition of the fiscal plans executed by a selection of EU countries over 2009–13 and their effects on output growth, whereas Baldwin et al. (2015) formulate a consensus narrative on the causes of the euro-area crisis.

As opposed to Portugal, Ireland and Greece, smaller economies which have been bailed out, the case for Spain should be highlighted, because of two converging reasons: the larger size of the Spanish economy and the need for European financial assistance have inflamed the controversy about the convenience of euro-area fiscal rules. Spain's significant fiscal efforts made so far following the European guidelines have been recognized by both investors and economists and have also begun to bear fruit (see Martí and Pérez, 2015, for a discussion on the evolution of Spanish public finances through the financial and economic crisis). Under these circumstances, it would be particularly interesting to examine whether those factors that characterize the behavior of Spanish fiscal policymakers are similar to or different from the euro-area ones.

In this paper, first we analyze the discretionary fiscal behavior of the Spanish economy by estimating cyclically-adjusted fiscal policy rules in which the government reacts to public debt and business cycles, and

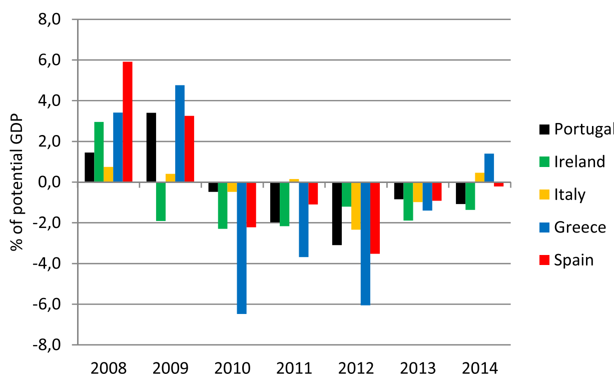

Fig. 1. Change in general government structural deficit (fiscal stance) for Portugal, Ireland, Italy, Greece and Spain, 2008–2014. *Note*: The actual balance is adjusted for the cyclical component and one-time and other factors.
Source: Own calculations based on IMF (2016) database.

then we compare the results obtained for Spain with those for the euro area as a whole. We apply Markov-Switching techniques to allow for a shift in the parameters of the fiscal policy rules in order to account for the non-linearity of fiscal policy and its relation to different political preferences. For this purpose, we use two new quarterly fiscal databases fit for economic analysis (see De Castro et al., 2014, for Spain; and Paredes et al., 2014, for the euro area) compiled by means of similar statistical techniques to guarantee the comparability of our results.

The rest of the paper is structured as follows. In Section 2, we briefly review the recent literature on fiscal rules that focuses on European countries. Section 3 explains the methodology used in this paper, concentrating on the specification of our fiscal rules. In Section 4, we describe the main characteristics of the two new quarterly fiscal datasets employed in our paper. In Section 5, we present the results for the different Spanish and euro-area fiscal regimes and discuss the economic policy implications of our results. Finally, Section 6 summarizes our findings and concludes.

2. A brief literature review about fiscal policy rules

Since the publication of the famous article "Discretionary versus Policy Rules in Practice" by Taylor (1993), where he proposed a simple monetary policy rule according to which interest rates are set as a function of inflation and output deviations, much has been said about the use of rules in policymaking, especially on the monetary side. Among the advantages of policy rules are their simple specification, their potential to differentiate between discretionary and rule-based policy behavior and their use as a benchmark for policy evaluation (Thams, 2007). Nevertheless, their main disadvantage follows from one of their benefits: their simplicity may not be adequate to deal with complex situations like the current international economic crisis. All in all, policy rules are tools that can guide the action of economic policymakers, as they explicitly link the instruments to the objectives. However, the instruments, the objectives and the links between them can change over time.

On the fiscal side, many advanced countries introduced fiscal rules over the last 25 years, in the form of golden rules, balanced budget rules or deficit and debts targets; the EU's Maastricht criteria and the SGP are usually put as examples. Following Badinger (2009), two basic reasons support the introduction of fiscal rules: the need to ensure sustainability of fiscal policy by avoiding excessive deficits and unsound policies and the need to achieve macroeconomic stability by limiting the room for discretionary fiscal policy. Both academics and policymakers acknowledge that the Maastricht criteria together with the SGP led to fiscal consolidations in many EU countries in the nineties, and thus served as a discipline device for fiscal authorities.

This move towards "rules rather than authorities" (in the terminology of Friedman, 1948) reflects a fundamental shift in the paradigm of fiscal policy. According to the behavior of fiscal authorities, we can distinguish between "active" (non-Ricardian) fiscal policies and "passive" (Ricardian) fiscal policies (Leeper, 1991). Fiscal policy is said to be "active" when is does not stabilize public debt, and "passive" when it does stabilize government debt. In this latter case, primary budget balances react to changes in public debt to safeguard fiscal solvency in a way that future fiscal receipts cover the cost of current outstanding government liabilities.

Following the seminal papers of Bohn (1998, 2005), in which he examines the behavior of US public debt and deficits, and Favero and Monacelli (2005) and Davig and Leeper (2007, 2011), in which they estimate Markov-Switching policy rules for the USA, the applied study of fiscal rules for European countries has been methodologically developed from two different perspectives: panel analysis and Markov-Switching regressions. Those papers present and test some kind of fiscal policy reaction functions where the primary budget balance reacts not only to the public debt, in order to ensure fiscal sustainability, but also to the output gap, in order to smooth business cycle fluctuations.

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