"Output Gap Nonsense" and the EU's Fiscal Rules

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> *This column deals with recent debates concerning the technical foundations underlying the EU's fiscal rules, which are of great political relevance. Leading economists of the European Commission have responded to criticism concerning the European Commission's model framework for estimating potential output and output gaps, which are relevant for assessing fiscal policies in EU member states. Our analysis sheds new light on why and how the Commission's experts defend the underlying model's authority against critique.*

An evaluation of the EU's fiscal rules and debates about reform options are underway as the new European Commissioner for Economic and Financial Affairs, Paolo Gentiloni, has taken up his office. In any case, these debates should be based on a sound analysis of the merits and problems of the status quo of the EU's fiscal rules; and they ideally should reach beyond the narrowly confined circle of established fiscal experts. However, this is easier said than done as the EU's fiscal rules are highly complex: the current document, by means of which the Commission explains the application of the existing fiscal rules, is about 100 pages long.

This column contributes to the clarification of the technical foundations of the EU's fiscal rules, which are of great political importance. To this end, we draw on our study "The power of economic models: The case of the EU's fiscal regulation framework", which has recently been published in the journal "Socio-Economic Review" as an outcome of the INET project "Economic policy and the performativity of economic models". We use our study to shed new light on the recent debate around the "campaign against nonsense output gaps", to which leading economists of the European Commission have responded by clarifying and defending their modelling approach to estimating these output gaps.

Criticism of the technical foundations of the EU's fiscal rules

The central criticism of the "campaign against output gap nonsense", which is run primarily via online articles and Twitter, is that "a false exactitude in economics has led to a terrible politics in the EU". This criticism addresses controversial model-based assessments ("false exactitude in economics") that refer to the concept of the output gap. The basic idea behind the output gap is to determine how far the real gross domestic product (GDP) of a certain country is above or below the potential output that would be attainable if all production factors were used at "normal" capacity utilization, implying no up- or downward pressure on inflation. The output gap supposedly provides information on where an economy is in the business cycle.

The EU's fiscal framework crucially depends on the estimation of the non-observable output gap. If the output gap is estimated to be small even in an economic downswing, the implication is that the production factors are almost fully utilised. Consequently, the fiscal policy space of the concerned government is reduced, because the country's achievement of its relevant medium-term fiscal targets is assessed more pessimistically. The EU's fiscal rules give countries with unfavourable output gap estimates only limited scope for higher budget deficits to stimulate the economy. This is the classic criticism of the "campaign against output gap nonsense", which has also been backed up by various academic studies.

In principle, the output gap can be estimated in various ways, but in the EU the model of the European Commission is especially relevant as it occupies the dominant role in the EU's fiscal regulation framework. Our recent study shows that the increasing impact of the European Commission's model estimates for assessing fiscal policy is a result of the reforms of the EU's fiscal rules since the financial and economic crisis. We also examine the basic assumptions and some of the technical developments of the model that is used to estimate the output gap. The model is based on a neoclassical production function, and at the level of modelling the contribution of the production factors further basic assumptions from neoclassical theory come into play. The model has been adapted in several steps over recent years. The Commission models the economy exclusively from the supply-side; the model is consistent with a paradigm that addresses macroeconomic problems by looking at the supply side of an economy instead of focusing on aggregate demand.

These model adjustments were largely due to the initiative of individual EU Member States. In the course of the crisis, Spain, for example, criticised that the Commission's estimates of the "structural" unemployment rate (proxied by estimating the non-accelerating wage inflation rate of unemployment, in short: NAWRU), which is relevant when calculating the contribution of the production factor labour in the Commission's model, were implausibly high. According to the Commission's real-time model estimates, Spain's "structural" unemployment rate stood at around 20% in 2012 and 2013 – almost as high as the actual unemployment rate. As a consequence, the output gap was estimated to be small, which put additional fiscal consolidation pressure on the Spanish government when applying the EU's fiscal rules, because a large part of the actual fiscal deficit was considered to be "structural". The Spanish government, with the support of other countries, worked toward implementing changes in the underlying model for estimating the NAWRU. After major political conflicts in the background, a compromise on adapting the NAWRU model was finally reached in 2014, which slightly reduced the fiscal consolidation pressure on Spain and some other countries.

This anecdote indicates that fiscal policy decisions in the EU in recent years have often been coined by technical details and, as a consequence, seemingly innocent technical assumptions have become objects of political demands. However, until the "campaign against nonsense output gaps" began to publicly address these issues a few months ago, which also inspired leading newspapers such as the *Financial Times* or *Handelsblatt* to take up the issue, these debates were largely hidden from the general public.

Reflections on the defence against criticism from the European Commission's economists

Leading economists working for the European Commission, including the (former) Director-General for Economic and Financial Affairs, Marco Buti, have publicly defended the model that is used to calculate the output gap and the fiscal control indicator derived from it (the "structural" fiscal balance) against criticism from the "campaign against output gap nonsense". Since it is rather unusual to see top officials of the EU Commission and their team of experts publicly defending their economic expertise and the associated policy recommendations, it is all the more worthwhile to take a closer look at the line of argumentation of the Commission's economists.

First of all, one may want to ask why Buti et al. (2019) even bother about defending the European Commission's model against criticism. Why don't they simply let the critics of the "campaign against nonsense output gaps" voice their concerns? Our study provides an answer to this question: we argue that the Commission's economists are forced to defend the authority of the model to sustain political legitimacy of the current fiscal governance regime, which hinges on the economic expertise underlying the model. The recent fiscal dispute between the Commission and Italy's authorities shows that representatives of individual member states constantly challenge the actors of the European Commission. This is not surprising, since the legally anchored model estimates of "output gaps" and "structural deficits" have a direct influence on the fiscal policy space of the governments concerned. With their public defence of their model-based economic expertise, Buti et al. (2019) try to consolidate their authority in the political process of negotiating with representatives of EU member states.

An important argument put forward by the Commission's economists in this context is the reference to the "commonly owned methodology", which has been jointly agreed upon by all EU countries. Although the reference to the "commonly owned methodology" is formally correct, it should be put into perspective: it is the Commission's economic experts that develop the PO model's foundations and necessary software applications. In doing so, the Commission sets technical standards for achieving fiscal policy coordination. Once approved, these standards are effectively conserved by the unanimity regime in the relevant technical working group (Output Gaps Working Group), since proposals challenging established practices have to be accepted by every EU Member State. In other words, while the initial decision in the late 1990s to adopt a neoclassical approach of modelling an economy's output (from a supply-side perspective) can be understood against the background of the dominance of neoclassical ideas in macroeconomics, the political unanimity requirement for choosing a different modelling approach has effectively triggered a path-dependent process in which established theoretical priors are difficult to challenge – and relatively marginal technical model adaptions are the most realistic way to achieving model estimates that 'work for your country', as one of the experts we interviewed for our study puts it. An example of this are the already mentioned demands by the Spanish government, which effectively amounted to adapting some model parameters to arrive at more flexible estimates for the "structural" unemployment rate (proxied by the NAWRU), which slightly eased the fiscal constraints imposed by the model for Spain and some other countries.

Buti et al. (2019) emphasise the "commonly agreed methodology" for calculating "output gaps" and "structural deficits". This may be useful when it comes to immunising the Commission's technical experts against criticism, but ignores the fact that the degree to which an EU Member State actually perceives the underlying methodology as being "commonly owned" can be expected to vary and correlate with the interests of EU Member States. At the beginning of 2016, for example, the finance ministers of eight EU countries (Italy, Spain, Latvia, Lithuania, Luxembourg, Portugal, Slovenia and Slovakia) expressed their concerns about the "commonly agreed methodology" in a joint letter to the European Commission and called for further technical work. This focus on a "commonly agreed methodology" illustrates our claim that concerns for political legitimacy play a key role in this context, as the phrase is intended to provide a specific framing rather than to describe current political realities.

Buti et al (2019) also argue that the underlying model of the European Commission is much more reliable than many critics claim. However, they do not even address the central criticism of those studies to which the "campaign against output gap nonsense" refers: they ignore that the estimates of potential output (and the output gap) are regularly adjusted downwards with actual economic growth due to methodological problems. In the meantime, it is well documented that this bias has promoted overly restrictive fiscal policies during the economic downturn and in some cases also excessively expansionary fiscal policies during the upswing that preceded the financial crisis.

Finally, Buti et al. (2019) seek to downplay the importance of the relevant model estimates "with the practice of surveillance being much more flexible and less rigid than many commentators tend to suggest". In fact, so-called "flexibility clauses" were introduced in the EU's fiscal rules. This step was at least partly a response to the criticism voiced by several member states, which, for the reasons outlined above, considered the existing rules as too rigid. The "flexibility" guidelines now establish a direct link between the size of the output gap and the required fiscal adjustment effort. In the case of a larger output gap (i.e. when the model estimates suggest that there is a lot of economic slack), little or no fiscal adjustment is required. But in the case of a small output gap, the fiscal consolidation requirements increase. This step of introducing "flexibility" may have led to additional leeway in the political case-by-case assessment. Paradoxically, it has further increased the relevance of the underlying estimates with the European

Commission's model, and thus the importance of technical details. However, it is precisely this aspect, which focuses on the power of employing the underlying model when assessing fiscal policy, which the Commission's economists seek to downplay. In contrast, the Italian government has recently pointed out (in the context of its conflict with the European Commission over Italy's budget) that the Commission's output gap estimates are too small and that alternative estimates would have been much less constraining for Italy's government.

What questions should be discussed in the process of reforming the fiscal rules?

When it comes to promoting an open public debate on the relevance of the technical foundations of the EU's fiscal framework, the clarifications provided by Buti et al. (2019) are very welcome. However, the results of our recently published study shed new light on some of the arguments put forward by the European Commission's economists in defence against the "campaign against output gap nonsense". As the "gatekeepers" of the model, Buti et al (2019) seek to strengthen the authority of the model on which assessments of fiscal policy space are based in the EU's fiscal framework. Estimates of the "output gap" and the corresponding "structural deficit" are reported by the majority of journalists as "hard numbers" that do not require further interpretation or clarification. In fact, however, they do not only come with a high degree of estimation uncertainty, but also show several deficits from both a statistical and a political point of view. Against this background, it is clear that the technical details on which the respective estimates are based are of great political relevance: they shape the fiscal policy space of individual EU member states.

Now that the current debate on the technical and political foundations of the EU's fiscal rules has been analysed from a new perspective, it is also possible to take a look at the implications for upcoming reform discussions. If the goal of the reform is to improve fiscal policy coordination, the points of criticism raised by the "campaign against nonsense output gaps" must be weighed against the response of the Commission's economists. Is the existing regulation framework inherently pro-cyclical, as the critics argue, or do the Commission's experts have the more convincing arguments? It certainly makes sense to take another look at these arguments under the political leadership of the new European Commissioner for Economic and Financial Affairs, Paolo Gentiloni. If the critics' arguments are to find political support, the minimum requirement for reform is a fundamental evaluation, if not revision, of the methodology for estimating "output gaps" and corresponding "structural" budget balances.

Fiscal policy decisions affect key social institutions such as welfare programs, education, health and environmental safeguards. Debates about the institutional foundations of fiscal policy in the EU are, therefore, about much more than just the macroeconomic issues on which the "campaign against nonsense output gaps" has focused.

Finally, the fundamental problem remains that the complexity of the existing fiscal rules has increased in the wake of post-crisis reforms. In the interviews we conducted for our study, several interviewees familiar with the model noted that fiscal policy makers, especially at the national level, sometimes lack a basic understanding of how the legally binding estimates are calculated. In this context, one could discuss a statement by the former Austrian Finance Minister Hans-Jörg Schelling, who said in April 2016: “Anything simpler is a major step forward. One can no longer explain to anyone how the structural deficit is calculated”. Even if one may doubt whether “everything that is simpler” can really be considered progressive, demands for a reduction in the complexity of the EU’s fiscal rules remain valid.

The technicalities of the estimates underlying the EU’s fiscal regulation framework and the associated flexibility clauses are complex, but the basic assumptions of the model are actually not too difficult to grasp: they are firmly rooted in the neoclassical paradigm and supply-side economics, as we show in our study. However, there is currently little political space for an open discussion on the underlying assumptions and the political implications of the model estimates. With a push from the “campaign against nonsense output gap nonsense”, intermediated by the media and actors in society, the creation of such a space could be fostered.

Should Europe continue to have a set of fiscal rules whose technical foundations even some EU finance ministers (especially if they lack the appropriate technical economic training) can hardly understand comprehensively, let alone adequately explain to their voters when it comes to justifying their fiscal policy decisions? Should there be a set of fiscal rules in which technical expertise has a decisive influence on political processes, but which is difficult for a general public to understand, raising problems of democratic legitimacy? Where is it legitimate to decide about the fiscal policy of a country? Should a comprehensive understanding of the foundations of fiscal policy in the EU be reserved for a few specialized experts, or are fiscal policy decisions too important to accept this in a democratic context? In the months and years to come, these questions should also be duly discussed in the context of the debates on the EU’s fiscal rules.