Non-Technical Summary

Project no. RRC IX-50:

"Fiscal sustainability within the EU area. Empirical evidence for old members and newcomers"

Fiscal sustainability still represents a much debated issue, and considering the present international economic context, this topic is up to date. This research project had several aims: (i) theoretically speaking, the concept of fiscal sustainability is comprehensive but not well defined within literature mainstream. Therefore, it is accounted as being useful to review the most significant definitions on *fiscal sustainability.* In this sense, it is possible to define fiscal sustainability as *expressing one dominant feature of fiscal policy to be maintained at a certain stance using appropriate means and considering the future challenges for fiscal policy*. (ii) the mathematical model of fiscal sustainability based on intertemporal budget constraints has some caveats related to discount rate, time horizon and terminal value of public debt that make it difficult to apply it for assessing fiscal sustainability. Most of the studies investigating fiscal sustainability rely upon stationarity and cointegration tests, and evaluate fiscal sustainability based on historical data set. The main findings show that fiscal policy was sustainable/not sustainable over the period considered. The main question arising is how could it be recognized, in real time, when fiscal policy is not longer sustainable or is about to become unsustainable on long run? (iii) consequently, it was introduced the concept of *fiscal vulnerability*, that could be defined as representing current fiscal policy that could deteriorate fiscal indicators on short run (one year), exposing economy to different threats. If governments do not interfere to adjust current policy, then running the same vulnerable fiscal policy on medium term, will lead to a *non-sustainable* fiscal policy, meaning that fiscal policy will not longer be able to generate future primary surpluses to meet public debt servicing requirements, and have to default. (iv) an indicator that could signal the "vulnerability" of fiscal policy could be the marginal rate of public debt related to real growth rate, taking into account the general assumption that government should have not indebt itself more than the capacity and ability of economy to produce.

Following previous mentioned, it was applied the methodology for European countries, making some distinction between '*old members*' and '*new comers'*. The major findings of this research revealed that for 12 European countries *old members*, fiscal policy was vulnerable over the period considered The statistics shows that in 55% of the analyzed cases, public debt increased more then economy grew. The results for *fiscal impulse* showed that reaction is, mostly, delayed and sequential. An in depth analysis following *fiscal reaction function* pointed out the lag between government intervention to shocks on public debt. The reaction of primary balance is delayed by 1 to 3 years, which could be considered as appropriate, taking into consideration the occurring of some operational postponements. Moreover, according to VAR estimations and impulse-response function, only in the case of Belgium, France, Greece and Portugal, the government reaction to shocks on public debt runs for one and a half year, thereafter, it becomes insignificant and unstable. In rest of the cases, the reaction is not significant from the beginning. Consequently, the 12 European countries will confront difficulties on fiscal sustainability. The fiscal policy is vulnerable and affects its sustainability on long run. The government intervention aims only in restoring the primary surplus or in reducing the primary deficit on short and medium term. The adjustments could be efficient for the next years, but are not sufficient enough to assess fiscal sustainability.

In the case of 12 *new comers* of European Union, results are similar with those for the old members. Even if their public finance indicators correspond to the constraints imposed by Maastricht Treaty, their current fiscal policy is not sustainable on long run. Using fiscal reaction function model and a database consisted of quarterly data over 2000 and 2008, the results show that only in the case of Estonia, Hungary and Lithuania the reaction of primary balance to shocks on public debt is as expected in the sense that an increase of public debt goes to an increase of primary balance. In rest of the cases, the response of government is opposite, which indicates some vulnerability of fiscal policy. Moreover, VAR estimations and impulse response function show that the reaction is not stable, and it stands only to restore the primary balance. Consequently, the current fiscal policy for Central and European countries could be vulnerable and could confront difficulties in assessing sustainability on long run.