Conférence

Modèles économiques et politiques budgétaires. *L'output gap* en débat

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Criticisms and proposals of Dr. Heimberger relating to the "output gap" model

Dr. Heimberger's criticisms aim at certain problems with European economic governance and particularly the fiscal models that underpin it.

The restrictive bias of EU fiscal governance

EU economic governance has been accompanied by an overly restrictive fiscal policy, which amplifies economic crises instead of reducing them. The textbook case is the "double-dip" recession of 2011-2013, when a discretionary fiscal consolidation policy caused a second recession after the one induced by the financial shock of 2008-2009[1].

The link with the output gap model

Dr. Heimberger shows that the European Commission's output gap model (the one also used by Member states) bears a heavy responsibility for these fiscal policy errors. This model is used to estimate the output gap (i.e. the position in the business cycle) and the structural budget balance (i.e. the budgetary efforts required to return to balance). Several criticisms have been made:

-During the Eurozone crisis, periodic downward revisions of potential GDP induced by the model sent the wrong signal to the public authorities (reduce the "excessive" structural deficit, conduct a pro-cyclical policy).

-Some econometric features of the model (Kalman filter…) reinforce the tendency to underestimate potential GDP and to pursue a pro-cyclical policy.

-These estimation errors can have long-lasting negative economic effects (hysteresis) with the paradoxical result of increasing the debt/GDP ratio.

-Despite recent technical adjustments to the model by the Commission, the model continues to underestimate the output gap and overestimate the structural deficit, as apparent in the Commission's structural deficit estimates for 2022-2023.

-In the course of his research, Dr. Heimberger and his colleagues interviewed economists from European institutions (Commission, Economic Policy Committee, Output Gap Working Group), some of whom are highly critical of the current model[2].

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[1] Ph. Heimberger (2017), "Did fiscal consolidation cause the double-dip recession in the euro area?", *Review of Keynesian Economics*.

[2] Cf. Heimberger_Belgium_debate_November_2021 (ccecrb-debat.com). One of them declares : *"For economists, the structural deficit is understandable. In their models, it's defined. But in the real world it is not only unmeasurable but also undefined. We are not sure what we mean by the concept"*.

A problem of democratic accountability

The NAWRU, the potential GDP, the output gap and the structural deficit are unobservable and ill-defined variables, as one of the economists interviewed by Dr. Heimberger noted. From a political point of view, there are two main criticisms against the current model:

> -It is not ideologically neutral, although this lack of neutrality is masked by the opaque technical details of the output gap model;
>
> -it gives a lot of power to experts who determine beyond closed doors the level of the structural deficit and other variables that determine the budgetary decisions of governments. This point is recognized by a member of the OGWG interviewed by Dr. Heimberger: *"The fiscal framework assigns a lot of power to the people that estimate potential output"*[3].

Dr. Heimberger asks: *"Should democratic economic policy-making depend heavily on such highly revision-prone, opaque model estimates?"* [4].

Proposals to improve fiscal policy

Dr. Heimberger proposes a pragmatic strategy for improving the estimates, should the political constraints impede the development of a new fiscal framework at European level:

1. Promote a more open debate on these models in society and parliaments.

2. Modify the current output gap model. Dr. Heimberger argues that pragmatically substantial improvements could be achieved even in maintaining the current approach based on the estimation of potential GDP: by introducing technical adjustments that could reduce the estimated size of the structural deficit, thereby providing more fiscal space to governments. For example, a recent proposal by the German think-tank *Dezernat Zukunft* argues in favor of a modification of the method of estimating potential GDP by replacing the NAWRU with a full employment rate and correcting other sub-components of the model for involuntary underemployment.[5]

3. Combine it with other reforms (modification of the investment clause, replacement of the 1/20th rule for the reduction of the debt/GDP ratio...).

[3] Ph. Heimberger, J. Huber et J. Kapeller (2019), "The power of economic models: the case of the EU's fiscal regulation framework", *Socio-Economic Review*.

[4] Exposé au CCE-CRB, *op. cit*.

[5] Schuster, F., Krahe, M., Sigl-Glöckner, P., Leusder, D. (2021), "The cyclical component of the debt brake: analysis and a reform proposal", *Dezernat Zukunft Policy Brief*, https://www.dezernatzukunft.org/the-cyclical-component-of-the-debt-brake-analysis-and-a-reform-proposal/