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European Fiscal Rules Require a Major Overhaul

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Technical contributions by Cepremap and OFCE

The rationale for fiscal rules

The political cycle of public finances (pro-deficit bias)

- Incentive for deficits today followed by future austerity

More specificities within the euro area

- Risk of contagion and collateral damage in case of sovereign default
- Lack of credibility of the "no bail-out" rule
  - ECB may be pressured to use debt monetization
  - Reduction of market discipline

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What a fiscal rule should be

1. Simple and transparent
2. Stabilizing/countercyclical fiscal stance
3. An effective way to ensure long-term sustainability of public debt

Why we need to change? (1/3)

Complexity

Observation 1. European fiscal rules have become overly complex, which hinders their internalization by policy makers and their acceptance by the wider public.

"The present rules-based system of the Stability and Growth Pact (SGP) has become nearly unmanageable due to its complexity, and the constant addition of exceptions, escape clauses, and other factors"

Thomas Wieser (2018)

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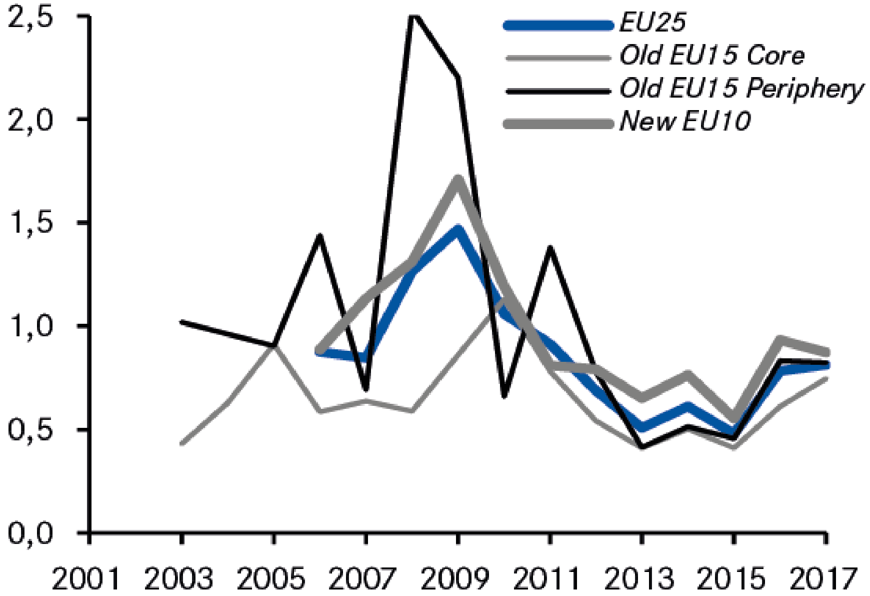
Why we need to change? (2/3)

Measurement issues

Average absolute revision of the change in structural budget balance from last year to current year one year later (% GDP)



Observation 2. Potential output, the output gap and the structural balance are badly estimated, misleading real time fiscal policy decision-making.

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Why we need to change? (3/3)

Pro-cyclicality and non-compliance

- Pro-cyclical fiscal expansive policies before the 2008 global financial crises then pro-cyclical fiscal tightening starting in 2010
- Weak compliance with the rules: while 24 EU countries were placed in an EDP after 2008, the complex web of flexibility has been used to the extreme to avoid sanctions.

Reforming the European fiscal framework (1/6)

Proposal for a new public expenditure rule

Nominal expenditures should not grow faster than long term nominal income, and they should grow at a slower pace in countries with excessive levels of debt

Main advantages of such a rule

- Simplicity
- Less measurement issues
  - Not based on output gap
  - Unlike the cyclically adjusted deficit, public expenditures are observable in real time and are directly controlled by the government
- Less pro-cyclicality
  - Stabilization of expenditures over the cycle
  - Unexpected shock on inflation → opposite effect in real expenditure
  - Exclude cyclical unemployment spendings

Reforming the European fiscal framework (4/6)

What should be the consequences of such an expenditure rule?

→ Simulations of the expenditure rule (structural model)

$$\hat{g}_{i,t} = \hat{y}_{i,t} + E_{t-1}\pi_{i,t} - \boldsymbol{\gamma_{i,t}}(d_{i,t} - d^*)$$

Growth rate of nominal public spending (net of interest payments and of unemployment spending)

Real potential growth

Expected inflation

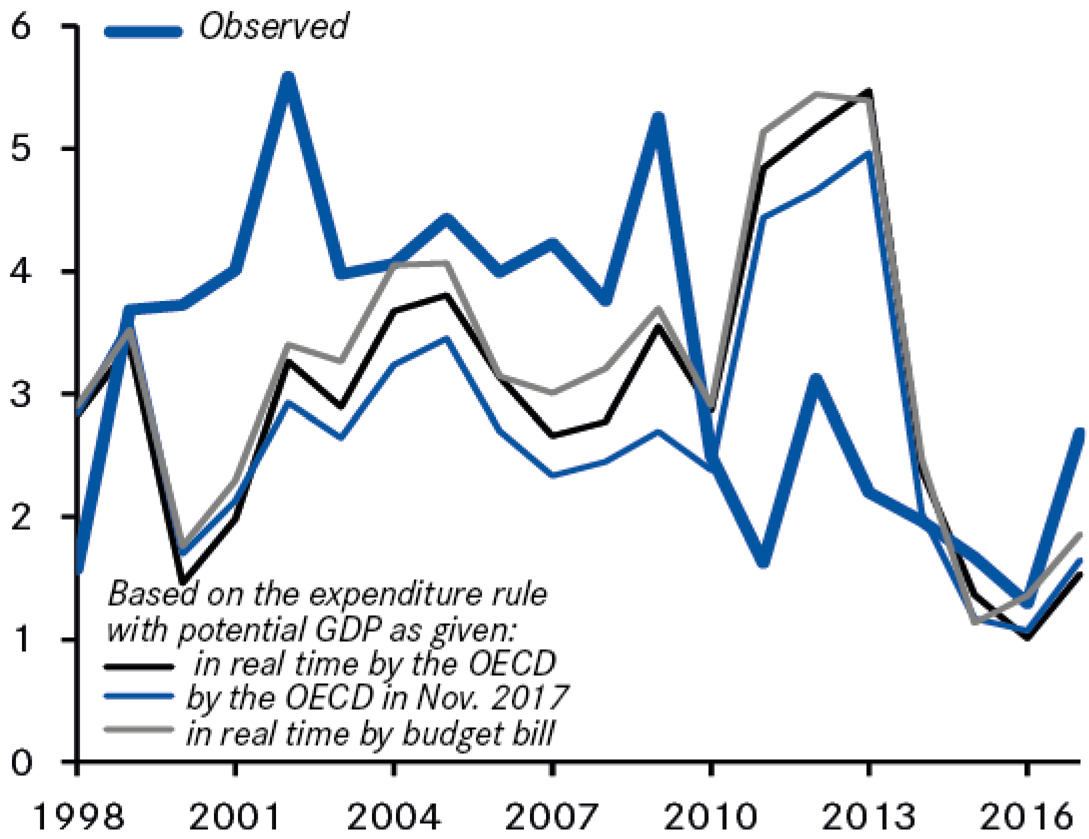
debt brake term which takes into account the difference between the observed ratio of debt to GDP $d_{i,t}$ and the long term target d^* which we take to be 60%

- The parameter $\boldsymbol{\gamma_{i,t}}$ drives the speed at which the country converges to its long-term debt target
- It should be computed to be consistent with the debt reduction objective at a five-year horizon and should therefore be different among countries

Reforming the European fiscal framework (5/6)

Counterfactuals

Nominal growth rate of primary public spending in France for the period 1998-2017 (in %, current euro)

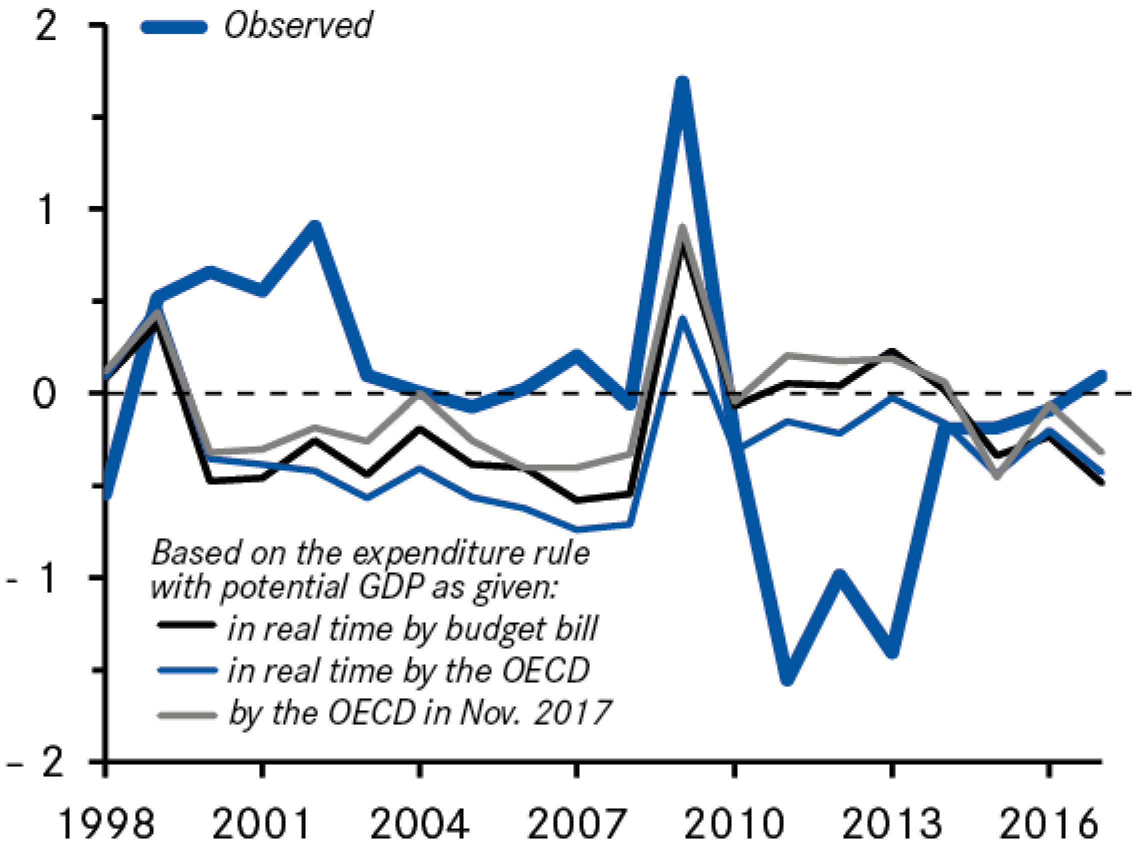


Sources: INSEE, OECD, Budget Bill, OFCE's calculations

Reforming the European fiscal framework (6/6)

Counterfactuals

Fiscal impulse in France for the period 1998-2017 (in % of potential GDP)



Sources: INSEE, OECD, Budget Bill, OFCE's calculations

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Adapting the institutions (1/2)

The necessity of national independent fiscal councils…

- The establishment of national independent fiscal institutions (IFIs) or fiscal councils is a prerequisite to the well-functioning of expenditure rule
- The ability of a fiscal council to identify biases of governments' fiscal and economic forecasts, and to provide competent macroeconomic analysis is essential to its effectiveness

… in Europe…

Recommendation 2. Expand the mandate of all independent fiscal institutions so they can make assessments of the medium term potential growth, inflation and the impact of tax changes on government revenues, and also run long term fiscal sustainability analysis.

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How to enforce the rule? (1/2)

Sticks and carrots

On top of the institutional surveillance described previously, the reform should focus in two main aspects: rewards and sanctions

> **Recommendation 4.** Transfer surveillance to well-equipped national fiscal councils, coordinated and overseen by a European fiscal council. Subject the access to a “flexible” ESM/EMF credit line and the participation in euro area-wide fiscal stabilization instrument to compliance with the fiscal rule.

How to enforce the rule? (2/2)

Comply or explain

A further "stick" would be to increase the political cost of deviating from the fiscal rule, in line with objective to renationalize the fiscal debates

Recommendation 5. In case of non-compliance with fiscal rules, as concluded by the national fiscal council introduce national "comply or explain" procedures for the Minister of Finance in front of the parliament and the press in member states, and in front of the European Parliament in the case of a major deviation as concluded by the European fiscal council.

Extra Slides

Legislative changes

Main issue: compatibility between the violations of the expenditure rule and the 3% deficit rule

Therefore, there are three possible cases of violations

1. The 3% deficit rule is violated but the expenditure rule is obeyed
2. Both the 3% deficit rule and the expenditure rule are violated
3. The 3% deficit rule is obeyed but the expenditure rule is violated, Such situations are different and require different interventions

In the first case (1), we recommend "**light**" EDP: the Commission carefully considers the opinion of the European Fiscal Council

When our proposed expenditure rule is violated (cases 2 and 3), the "**normal**" level of the EDP should be applied (as well as the positive and negative incentives discussed previously)

Reforming the European fiscal framework (3/6)

The new rule in practice