

Proposal to revive the European fiscal framework

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Motivation

- **Pro-cyclical fiscal tightening in the EU in recent years may have been a reason behind the anaemic economic recovery**
- **Question: can the EU's fiscal framework effectively achieve its two main objectives: public debt sustainability and fiscal stabilisation?**

Outline

- 1. Introduction** (1 slide)
- 2. Sketch of the European fiscal framework** (3 slides)
- 3. Assessment of the European fiscal framework** (3 slides + 3 charts)
- 4. How to reform the European fiscal framework?** (5 slides + 2 charts)

1. Introduction

- **Assessments of the current EU rules vary widely:**
 - Marzinotto and Sapir (2013) and Micossi and Peirce (2014): *"the current rules represent a sophisticated system of surveillance and ex-post control that provides sufficient room for manoeuvre under exceptional circumstances"*
 - Manesse (2014) and Ódor and Kiss (2015): propose a fundamentally new fiscal framework
 - IMF (Andrle et al, 2015): various options for simplifying and making the EU fiscal governance framework more effective, of which the most ambitious would profoundly change the current rules
- **Revision of the EU's fiscal rules is off the table in the short term**
- **Should the framework be changed?**

2.1 The current fiscal framework of the EU

Basic numerical fiscal rules are simple ...

- **Basic numerical rules are simple:**
 1. The budget deficit must be below 3 percent of GDP;
 2. Gross public debt must be below 60 percent of GDP,
 - *If it is higher, it must decline annually by at least 1/20th of the gap between the actual debt level and the 60 percent reference value;*
 3. The structural budget balance must be higher than the country-specific medium-term objective (MTO)
 - *If the structural balance is lower than the MTO, it must increase by 0.5 percent of GDP per year as a baseline;*
 4. A measure of government expenditures cannot grow faster than the 10-year average rate of potential economic growth if the country's structural balance is at its MTO or higher;
 - *If the structural balance has not yet reached its MTO, expenditure growth must be lower than potential growth.*

2.2 The current fiscal framework of the EU

... but the framework is lost in flexibility and discretion

- **Flexibility options:**
 - Unusual or unexpected adverse economic event,
 - Severe economic downturn in the member state,
 - Severe economic downturn for the euro area or the Union as a whole,
 - Pension reforms,
 - Implemented or planned structural reforms,
 - Contribution to EU-funded investments,
 - “Relevant factors”,
 - Deviation from 3% deficit rule is small and temporary,
 - Deviation from the 1/20th debt when the country is assessed to do enough fiscal consolidation.
- **Opaque web of flexibility options leads to disputes**

2.3 The current fiscal framework of the EU

Budgetary procedures and institutions

- **In addition to numerical fiscal rules, the fiscal framework includes:**
 - Requirements for multi-annual budgeting
 - High-quality forecasting
 - Independent audit
 - Independent assessment of meeting fiscal rules (fiscal council)
 - Stability (euro area members) or a Convergence (non-euro area members) Programme in April
 - Draft Budget Plan (euro area members) in October

3.1 Assessment of the EU fiscal framework

Long-term sustainability of public debt

- **If European fiscal rules are fully adhered to, the public debt ratio declines to low levels**
 - E.g. MTO of -1.0% of GDP and 3% nominal growth AND no shocks → public debt converges to 34% of GDP
 - When there are shocks and exemptions from the rules, the expected long-term debt ratio is higher
 - European Commission (2016): high medium-term sustainability risk for about dozen EU countries
- **The conduct of counter-cyclical fiscal policy has an impact on debt sustainability**
 - Pro-cyclicality in good times: higher debt level and inability to act in bad times
 - Pro-cyclicality in bad times: amplifies recession, reduces potential growth if hysteresis effects present

3.2 Assessment of the EU fiscal framework

Counter-cyclical stabilisation: good in theory in a downturn

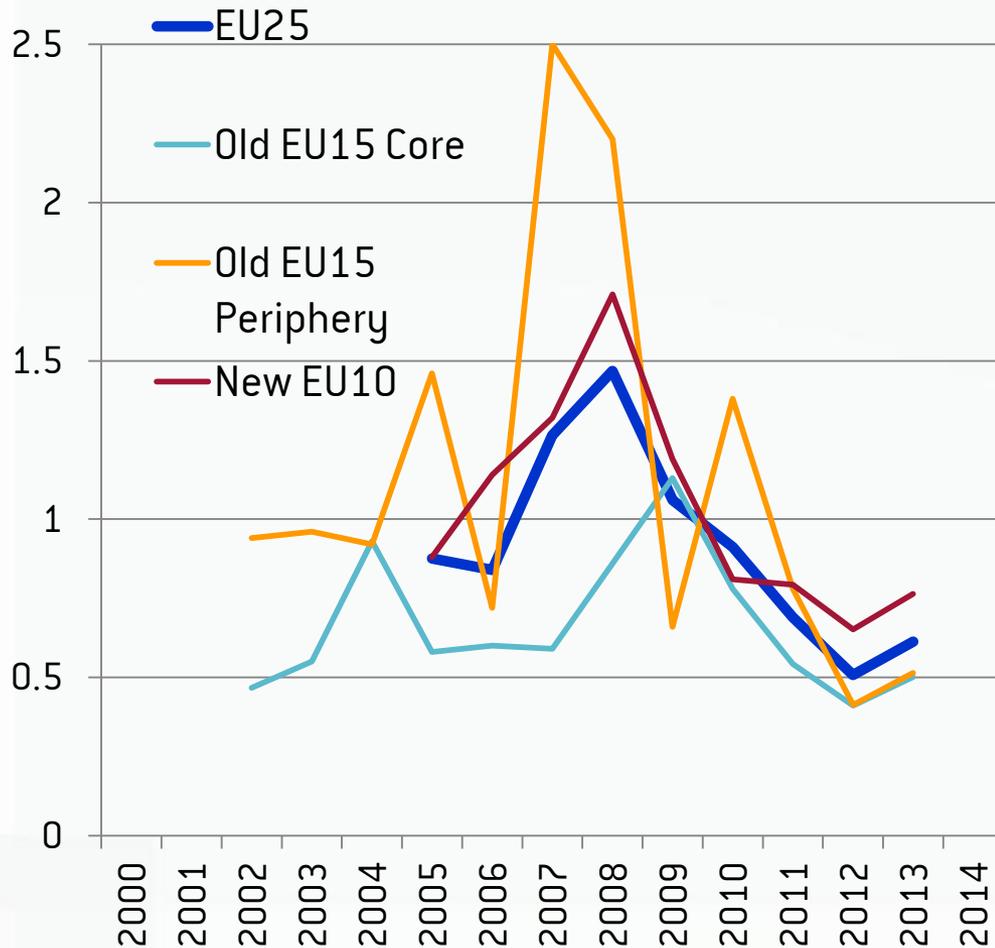
- **In theory, the respect of the 3% deficit criterion and the structural deficit rule allow automatic stabilizers to operate even in reasonably deep recessions**
 - E.g. standard parameters and 1965-2016 data suggest that the 10 core EU15 countries would breach the 3% deficit criterion in every 22nd year, while the 5 periphery EU15 countries would breach in every 6th year
- **Countries may do more fiscal stabilisation than what is allowed by the 3% deficit rule and enter an excessive deficit procedure**
 - In 2009 Commission called for an EU-wide stimulus of 1.5% GDP
 - Many EU countries increased their structural deficits to very high levels in 2009-10
 - Later years: rule exemptions, deadline extensions, no sanction

3.3 Assessment of the EU fiscal framework

Counter-cyclical policy: why it became pro-cyclical after 2010?

- **After 2010, fiscal policies became pro-cyclical**
- **Why?**
 - Germany – domestic political choice:
 - *small stimulus in 2009-10,*
 - *excessive deficit correction two years earlier than requested by Council,*
 - *more fiscal consolidation than what was planned in stability programme.*
 - Financial assistance programmes and market pressure in some countries
 - Incorrect forecasts by Commission: 2012 fiscal consolidation recommendations were based on optimistic forecasts that proved incorrect
 - Structural balance estimates gave misguided policy recommendations

3.4 Average one-year revision in the Commission's real-time estimate of the change in structural budget balance (% GDP)



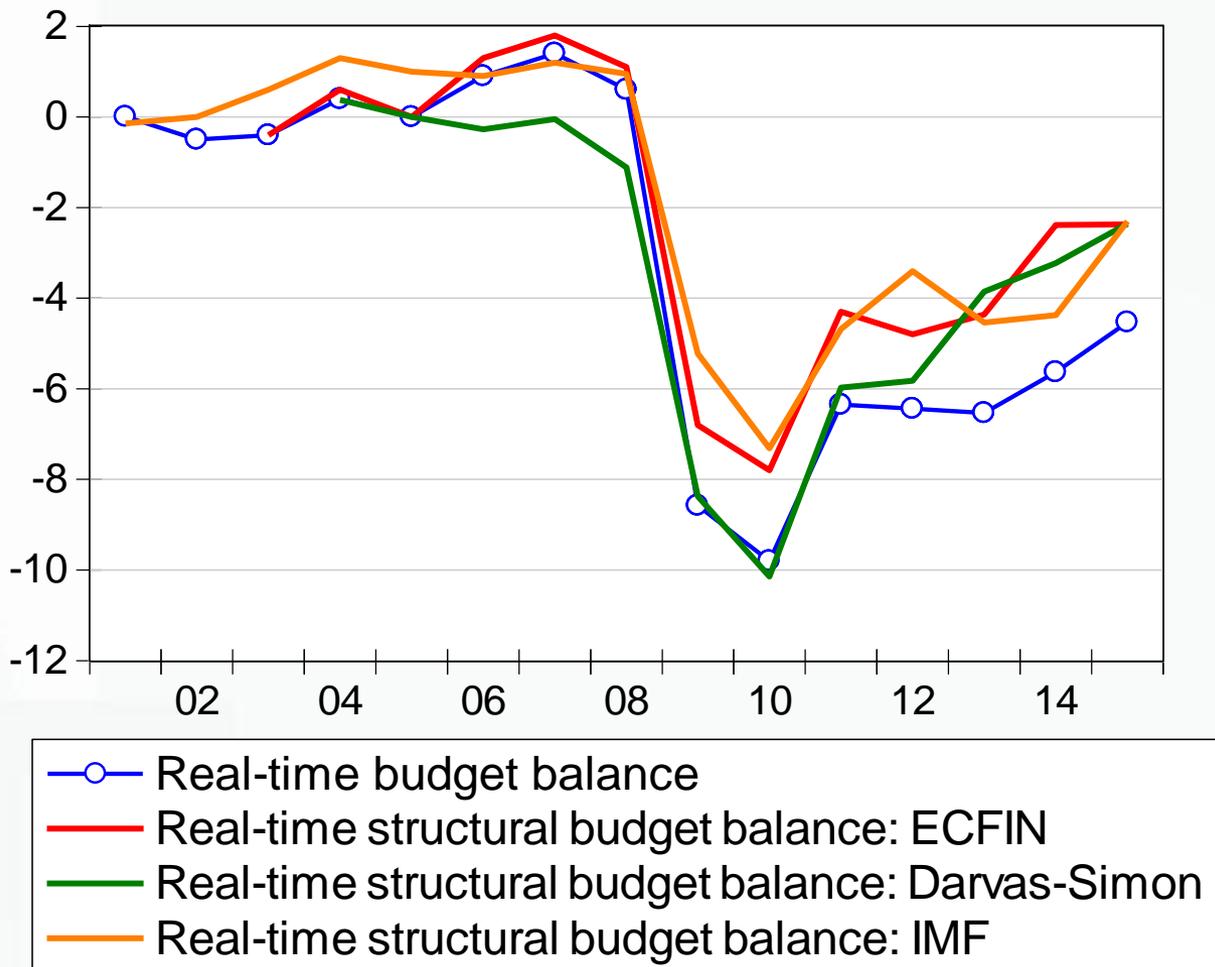
- The typical one-year revision is larger than the required benchmark policy action (0.5% GDP)

Note: Average absolute revision of the real-time estimate made in spring of a year one year later. For example, the last observation shows the difference between the May 2015 and May 2014 estimates for the 2013-14 change in the structural balance (absolute values of the differences averaged for the country-group indicated in the legend).

3.5 Assessment of the EU fiscal framework

Counter-cyclical stabilisation: not good in a boom

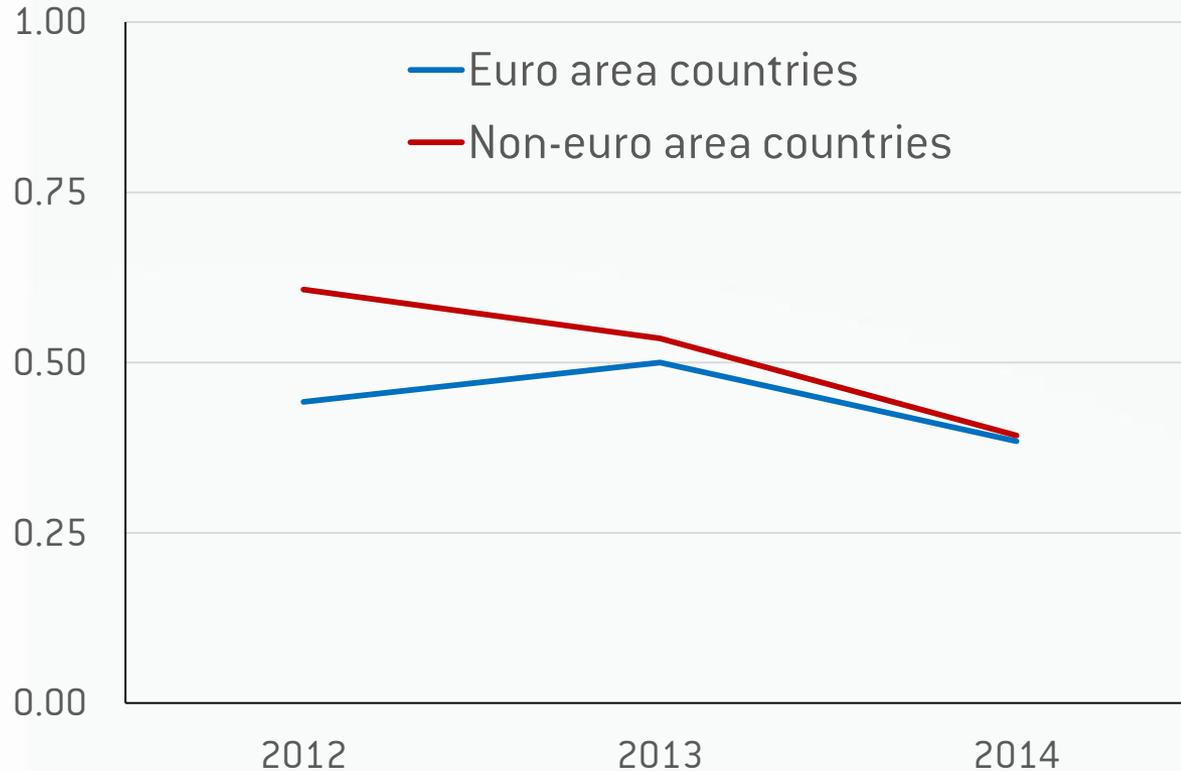
Spain: real-time estimates of the actual budget balance and structural budget balance made in spring each year



- **The current structural balance rule would have not constrained Spain in 2001-07**

*Note: For each year, the real-time estimate for the given year made in the spring of that year is indicated. E.g. for 2010 the spring 2010 estimate for 2010 is included, for 2011 the spring 2011 estimate for 2011 is included, etc.*¹²

3.6 Implementation rates of the Stability and Growth Pact



- **European fiscal rules are hardly implemented**

Note: We consider recommendations related to the SGP made in the context of the European Semester and the European Commission's assessments regarding the progress with the implementation of the recommendations, which is graded on a 5-scale. We gave a score of 1 to 'full implementation', a score of 0.75 to 'substantial progress', a score of 0.5 to 'some progress', a score of 0.25 to 'limited progress' and a score of zero to 'no progress': we report an unweighted average of those countries for which data is available for all years. The horizontal axis indicates the date of the European Semester recommendations.

4.1 Should the fiscal framework be changed?

YES!

- **Three options for the EU fiscal framework:**
 - ‘No change’ vision of the Five Presidents’ report: suboptimal, would preserve an inefficient system
 - 1st best in our view: complete overhaul of the framework to have: (a) credible no-bail-out policy, (b) large degree of fiscal independence of member states, (c) European cyclical stabilisation mechanism ← UNREALISTIC TODAY, NOT DEVELOPED IN THIS PAPER
 - 2nd best: revise Stability and Growth Pack (SGP) for a better fiscal rule and surveillance ← SCOPE OF THIS PAPER
- **Do we need a fiscal framework at the European level?**
 - Yes, due to cross-border externalities

4.2 The proposed new fiscal rule:

New expenditure rule with a debt-feedback mechanism

- Comparison with the current EU expenditure rule:

	Current EU rule	Our proposed rule
Expenditure aggregate	Real	Nominal
Items excluded from the expenditure aggregate	Interest, non-discretionary changes in unemployment benefit expenditure, EU-funded programmes	Interest, all unemployment benefit expenditure, one-offs
Expenditure growth benchmark	Real medium-term potential GDP growth	Real medium-term potential GDP growth + 2% for inflation target
Revenue correction	Yes	Yes
Debt correction	No	Yes
Expenditure-overrun correction	No	Yes

4.3 The proposed new fiscal rule:

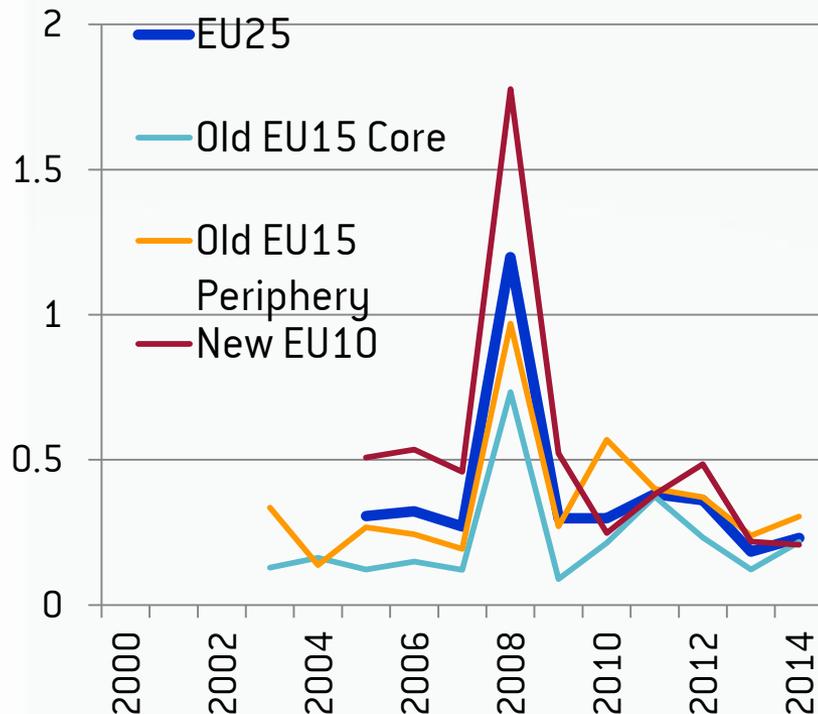
New expenditure rule with a debt-feedback mechanism

- Comparison with the structural balance rule:

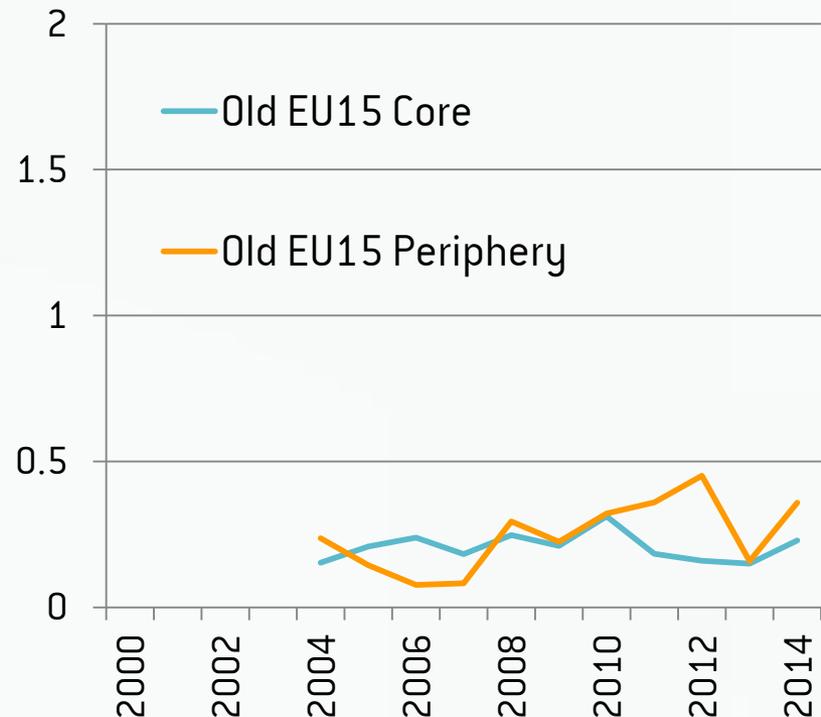
	Structural balance rule	Our proposed rule
Operational target	Structural balance (not under government control)	Adjusted nominal expenditure (under government control)
Role of forecasts	GDP and inflation forecasts matter a lot	Forecasts do not matter much
Estimation error	Large (output gap in a given year, elasticity of budget balance to output gap)	Small (multi-year average of potential growth; see next slide)
Quantification of one-offs	Yes	Yes
Counter-cyclicality	Good in theory, bad in practice	Good in theory, good prospect for practice
Debt sustainability	Good in theory, dubious in practice	Good in theory, good prospect for practice

4.4 Average one-year revision in real-time estimate of medium-term potential growth rate

(A) European Commission



(B) Darvas and Simon (2015) model



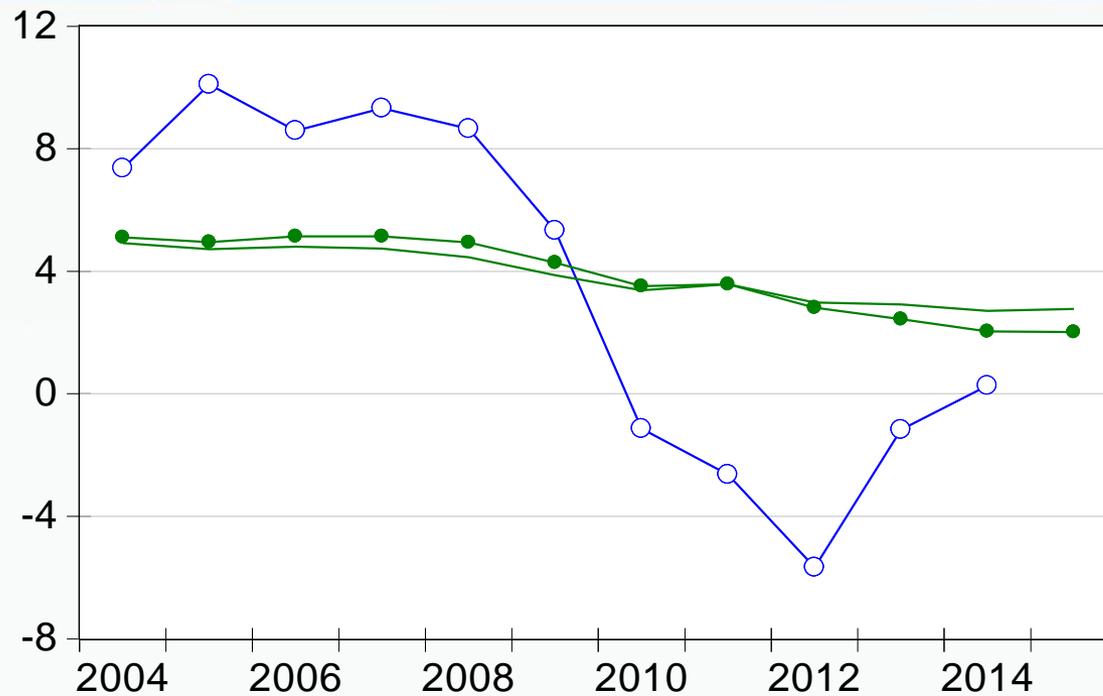
- Note: public expenditure is about half of GDP and thereby a 0.3% revision in potential growth has about 0.15% GDP impact on budget balance**

Note: Average absolute revision of the real-time estimate made in spring of a year one year later. For example, the last observation on the left panel shows the difference between the May 2015 and May 2014 estimates for the 2013-14 change in the structural balance, while the last observation on the right panel shows the difference between May 2015 and May 2014 estimates for the 2010-19 average potential growth rate (absolute values of the differences averaged for the country-group indicated in the legend).

4.5 Literature

- **The advantages of expenditure rules over structural balance rules are emphasised by several researchers from:**
 - ECFIN
 - ECB
 - IMF
 - OECD
 - Universities
- **Make it happen: scrap structural balance rules and the complex web of flexibility options and introduce a proper expenditure rule, which is**
 - Simple; transparent; easy to monitor; easy to explain; involves an indicator under the control of the government; conducive to both debt sustainability and counter-cyclical fiscal policy both in good times and bad times

4.6 Expenditure growth and real-time expenditure limit estimate for Spain



- **Our rule would have constrained Spain pre-crisis**

—○— Nominal expenditure growth (excl. interest, labour market and one-off exp.)
— Real-time medium-term potential growth estimate plus 2%
—●— Real-time expenditure limit estimate considering debt correction

Note: Nominal public expenditures excluding interest expenditures, labour-market related expenditures, and one-off expenditures, but no correction is made for revenues and public investment. The real-time estimate of potential output growth uses the Darvas and Simon (2015) model. The expenditure limit corrects the real-time potential growth estimate plus 2 percent inflation benchmark with the real-time data on public debt, but for simplicity we do not consider expenditure-overrun correction.

4.7 Surveillance

- **National**
 - Transpose into national law
 - Monitor implementation by national fiscal council
- **European**
 - Perception: Commission & Council not always unbiased, politics undermine rules
 - Establish a European Fiscal Council
 - Proper mandate, appointment procedure, accountability
 - ECB-style: executive board plus chairs of national fiscal councils
 - Oversee the system, exercise discretion
- **Eliminate financial sanctions**
 - Sanctions not credible today
 - Belief that rule is good should provide the incentive to comply

Thank you for your attention!