An assessment of the EU fiscal framework

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Outline

1. Stock-taking of the current EU fiscal framework

- Clarity
- Adequacy
- Efficacy

2. Which future? searching for the right balance

- Sustainability versus stabilization
- How to enforce fiscal rules:
  - Sanctions versus market discipline
  - EU versus national rules

3. Conclusion

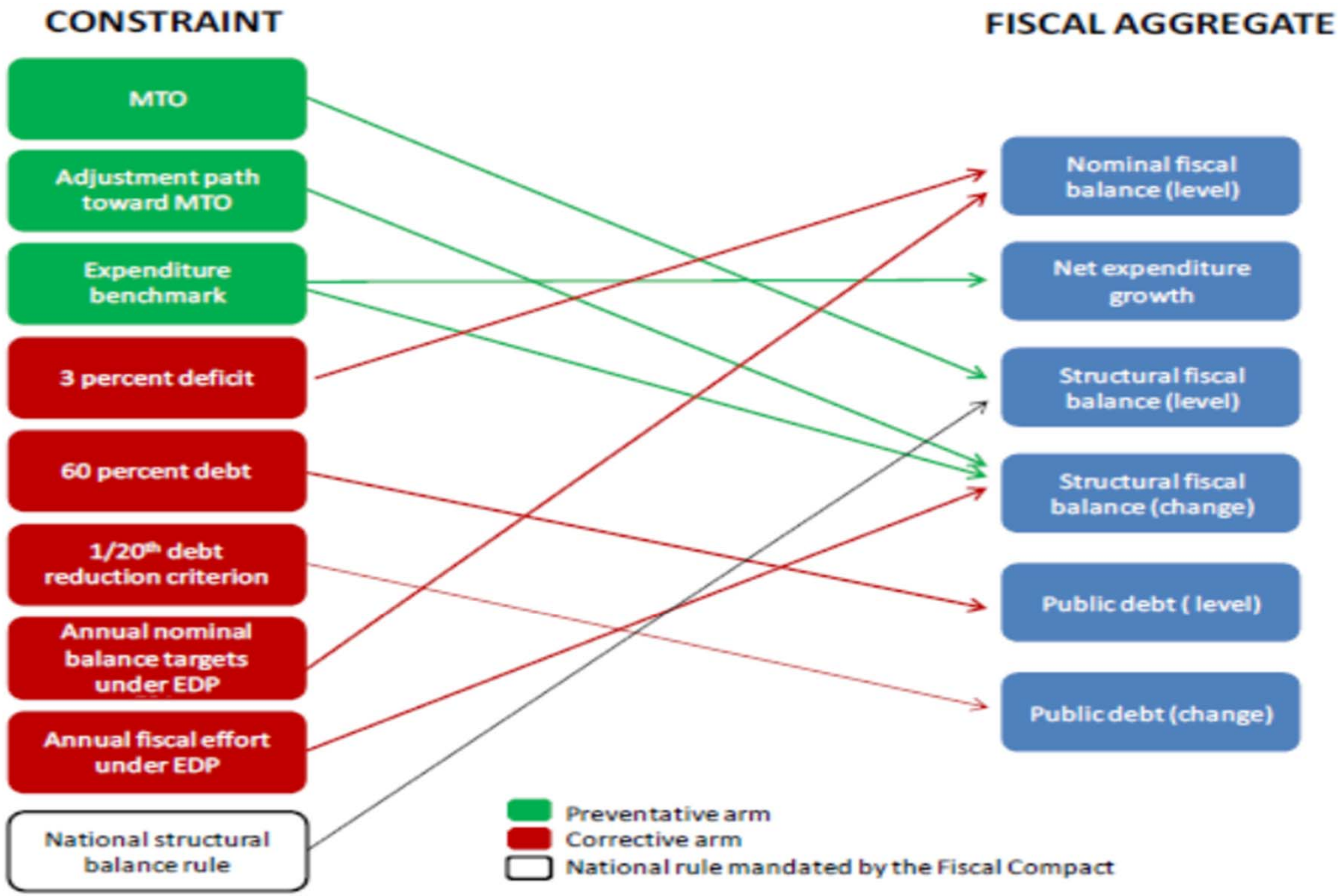
Stock-taking of the current EU fiscal framework

The strengths and weaknesses of a fiscal framework can be assessed by using a reformulation of the Kopits and Symansky (1998) criteria:

1. **Clarity**: Well-defined, transparent, and simple
   - Are the rules clearly defined and consistent?
   - Are they too numerous, elaborate or complex?
   - Are they transparent and predictable?
2. **Adequacy**: Adequate, consistent, flexible and efficient
   - Do the rules aim at the right objectives?
   - Do the rules stress the right balance between sustainability and stabilisation?
   - Should cyclical stabilisation take the backseat to securing a structurally balanced budget in all but exceptional circumstances?
3. **Efficacy**: Enforceable
   - Are the procedural steps of enforcement effective?
   - Are sanctions an effective deterrent?
   - Do the rules provide the right incentives to follow the rules?

Clarity of the EU fiscal framework

A multiplicity of indicators…



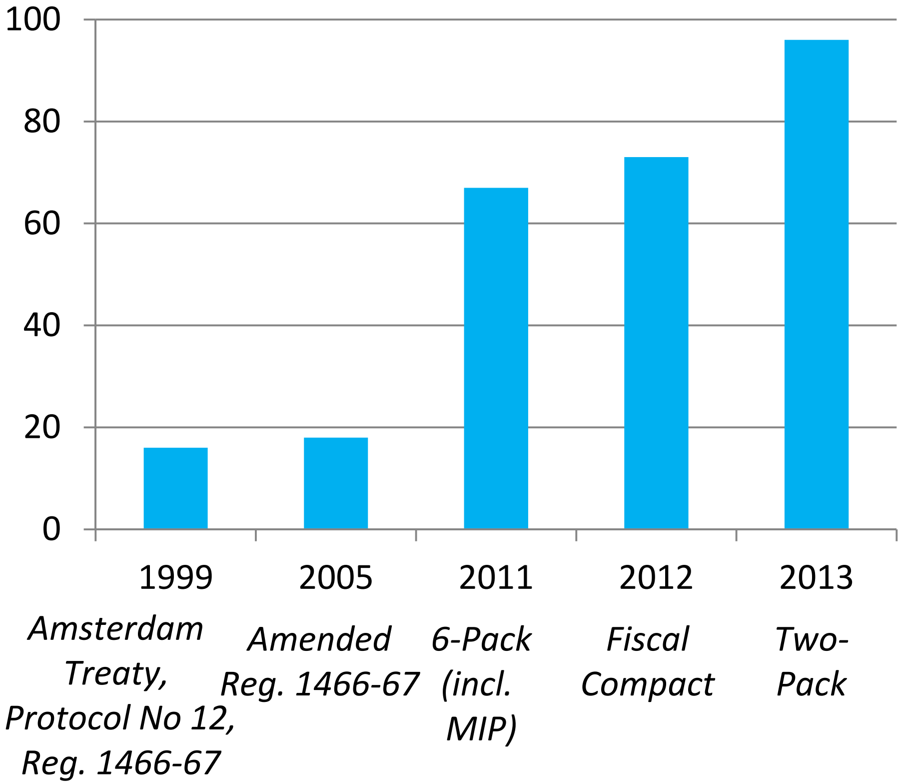
Source: Eyraud and Wu, "Playing by the Rules: Reforming Fiscal Governance in Europe", IMF Working Paper 15/67, 2015.

Clarity of the EU fiscal framework

… and a complex fiscal architecture…

Fiscal governance system became more complex

(pages of the entire framework in primary/secondary legislation by year, key innovation shown below in italics)

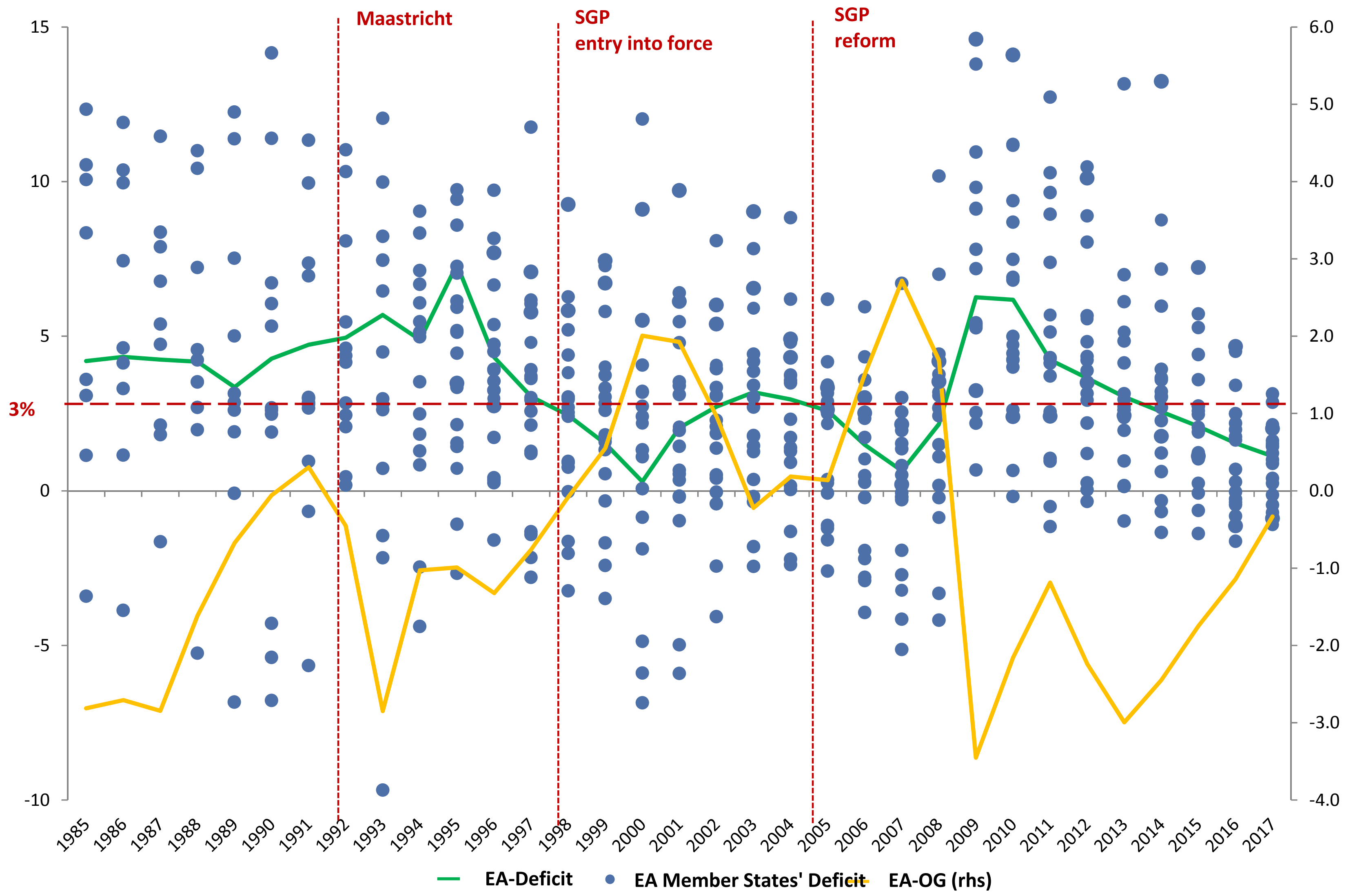


Main reasons for higher complexity

- **Path dependency**
  - New rules or bodies were established over time, often in response to emergencies
  - Sui-generis character of the EU system resulted in multiple and complex "checks and balances"
  - Evolving view on the role of fiscal policy in EMU
- **Lack of trust**
  - Missing trust across Member States and between Commission and Member States
  - Elusive quest for the 'complete contract'

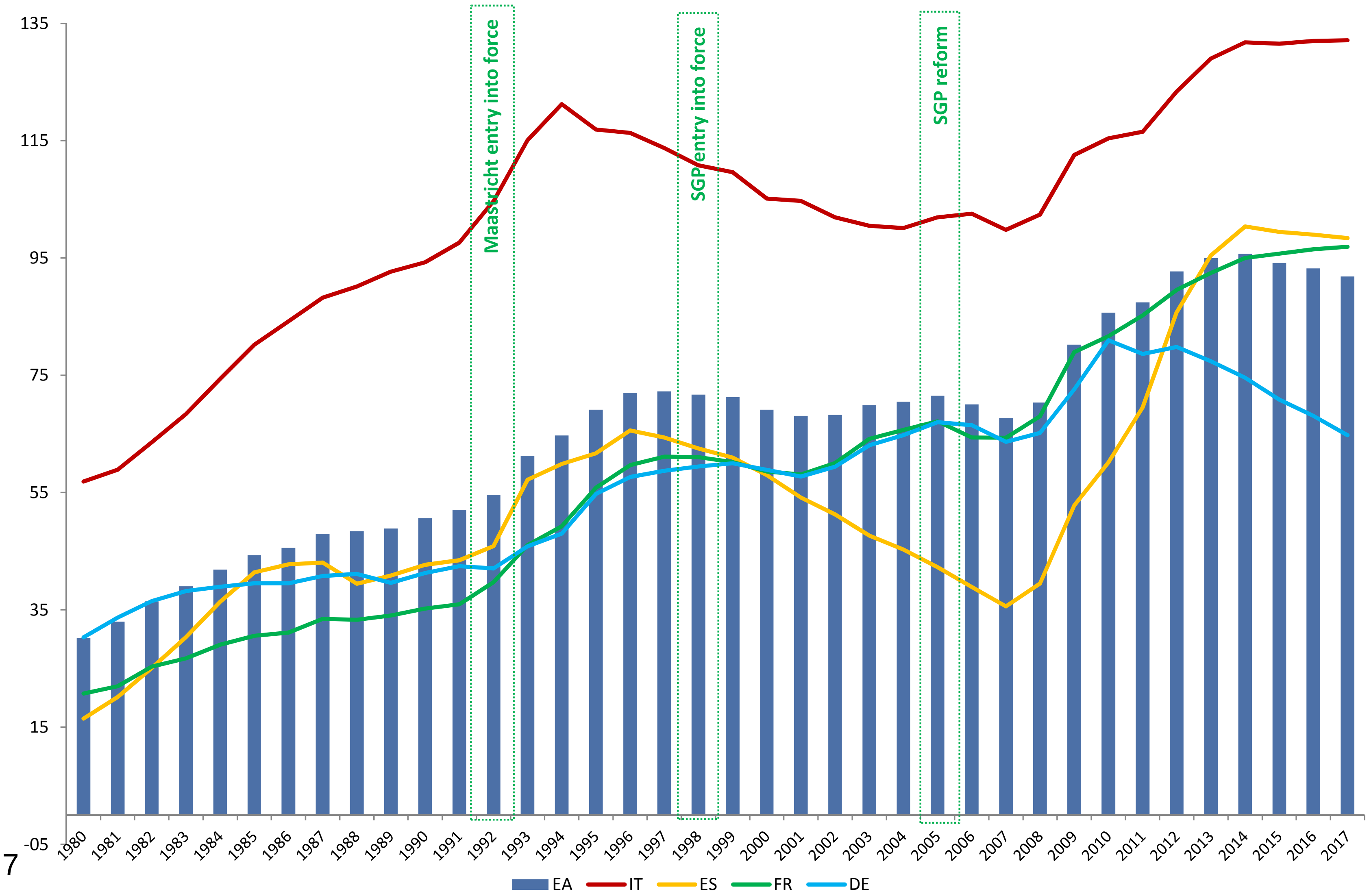
Adequacy of the EU fiscal framework

The deficit criterion: some clustering around the 3% threshold



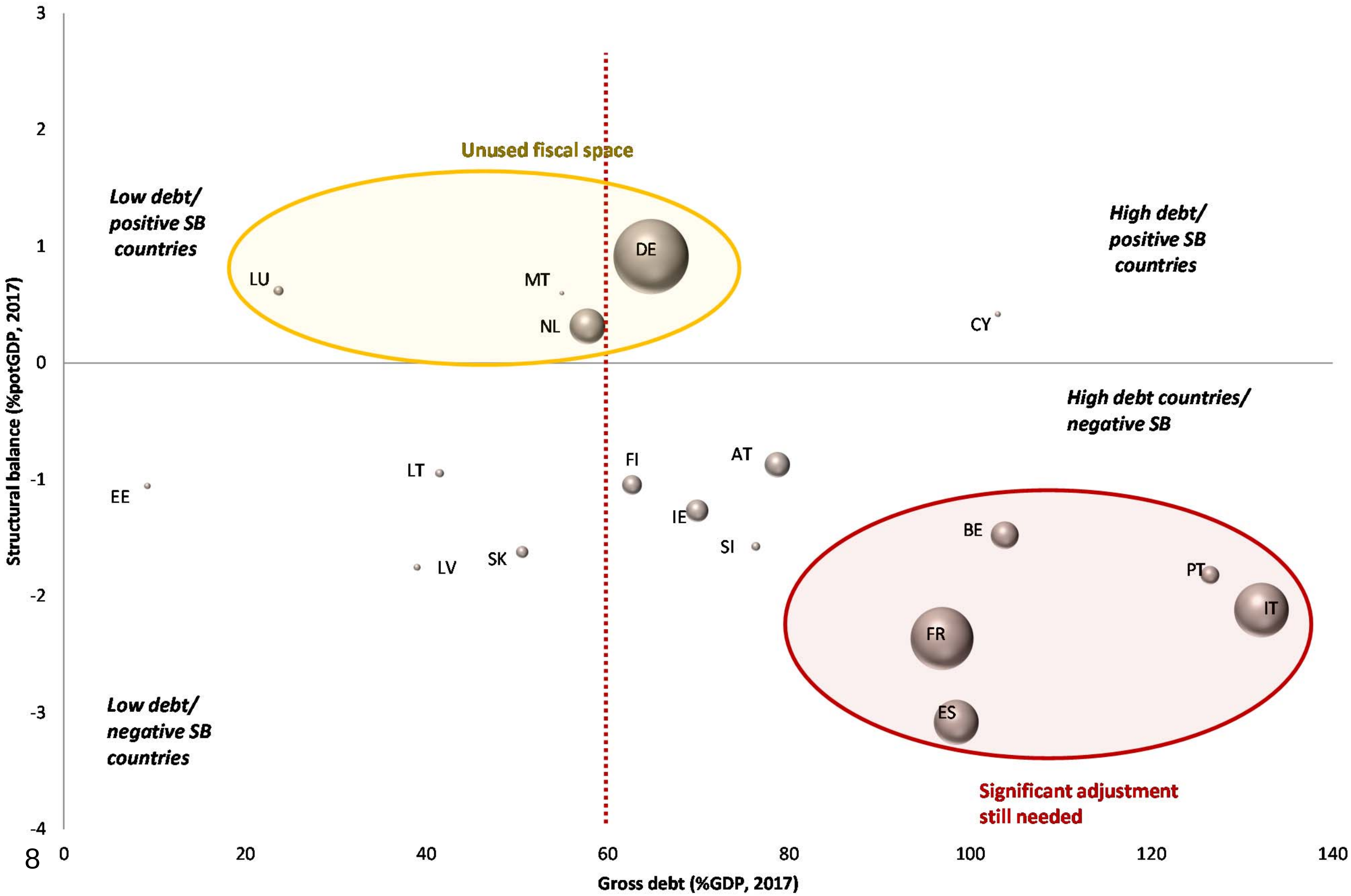
Adequacy of the EU fiscal framework

Debt developments are less benign…



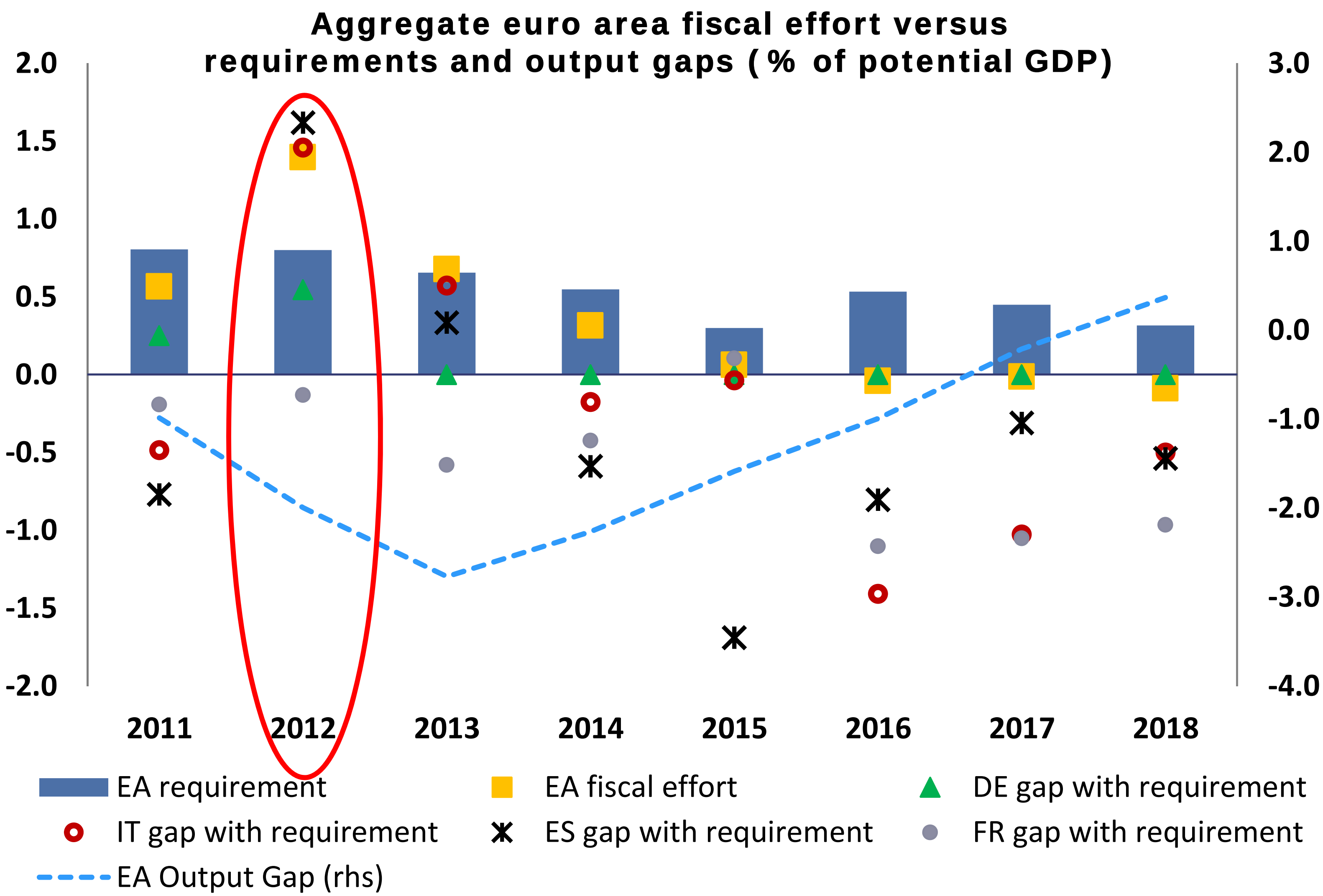
Adequacy of the EU fiscal framework

… and a clear dichotomy emerged in the euro area



Adequacy of the EU fiscal framework

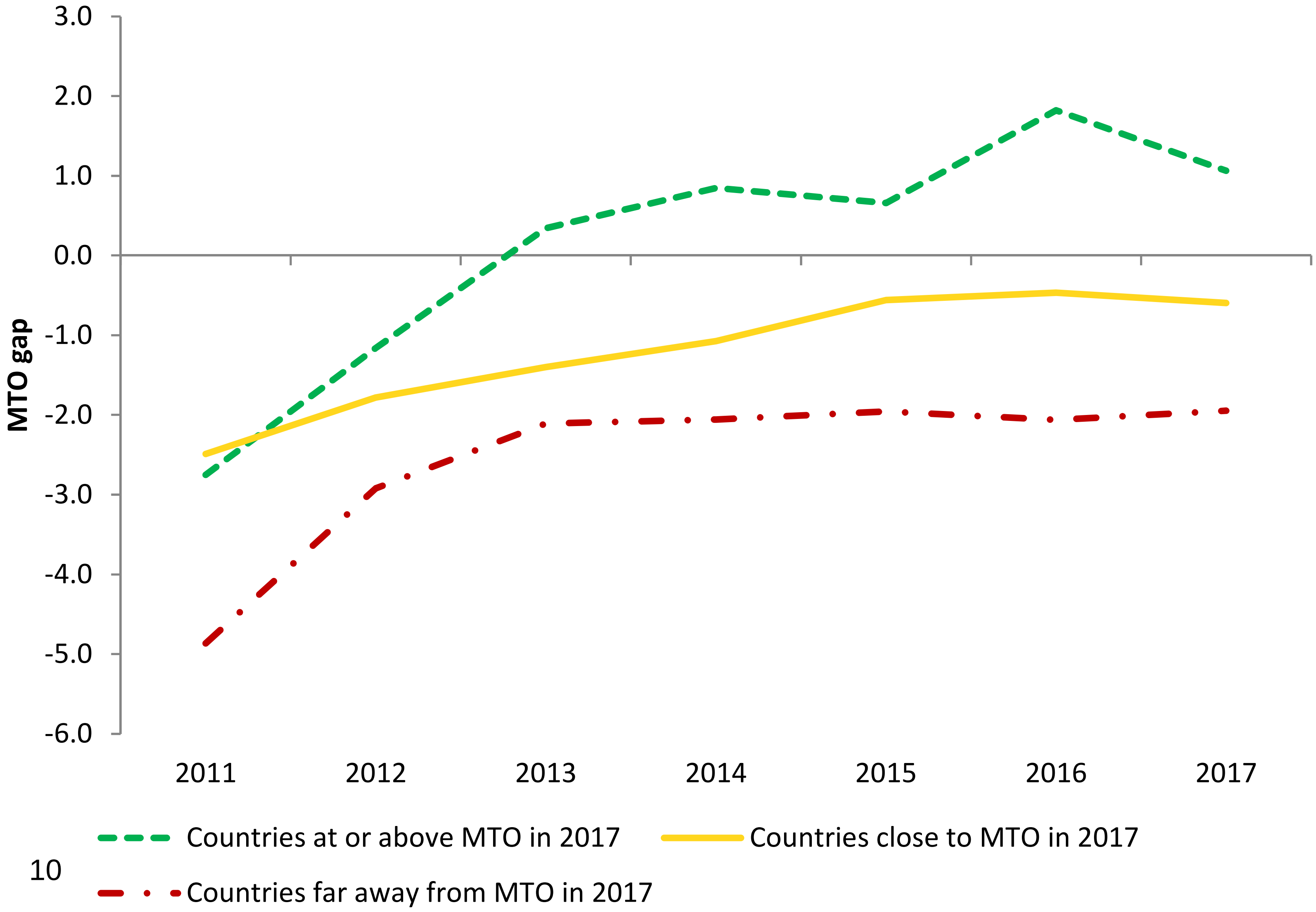
… while pro-cyclicality has not been avoided



Source: European Commission autumn forecast 2017

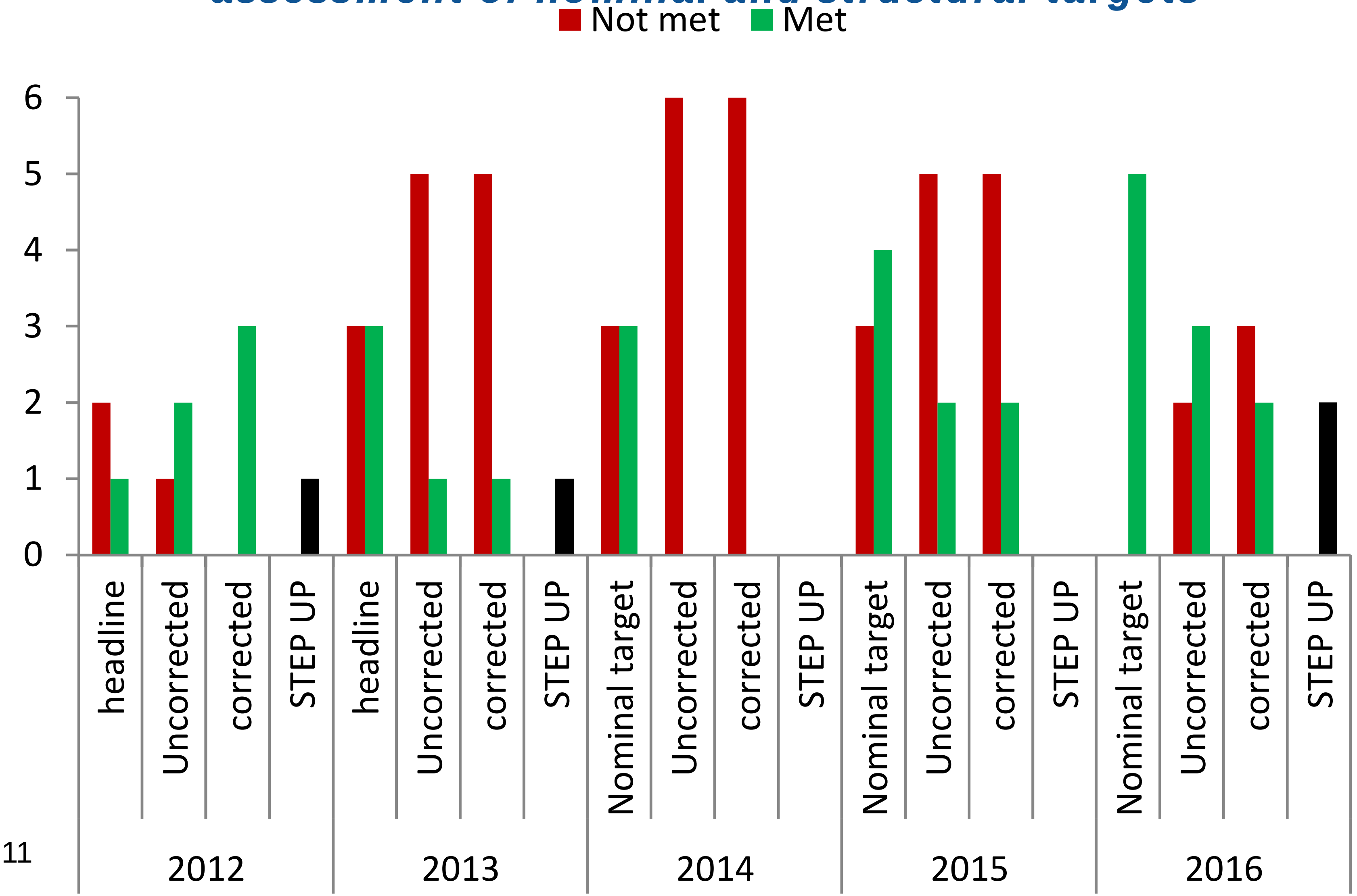
Efficacy of the EU fiscal framework

No convergence between euro area Member States



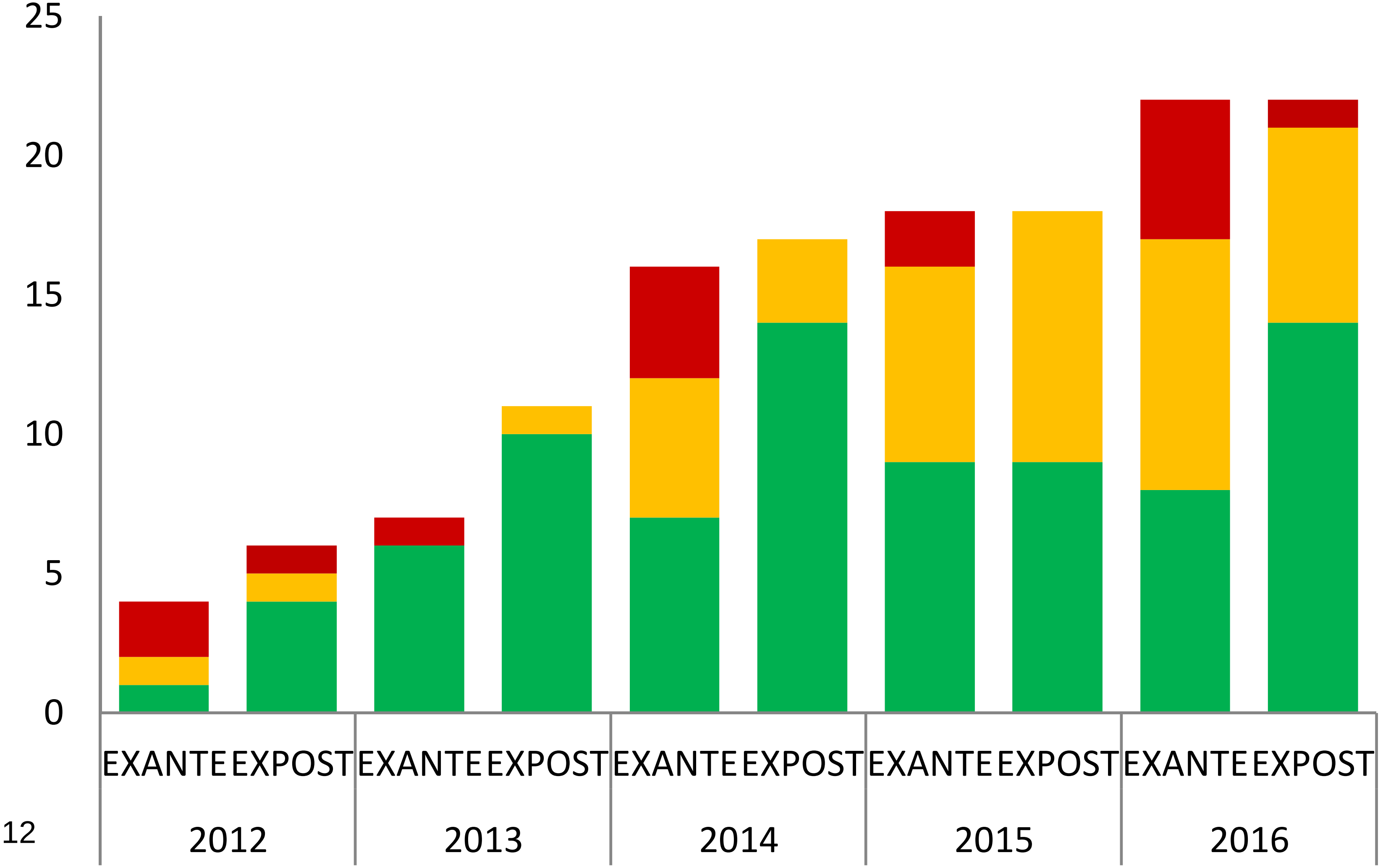
Efficacy of the EU fiscal framework

Compliance with the corrective arm: assessment of nominal and structural targets



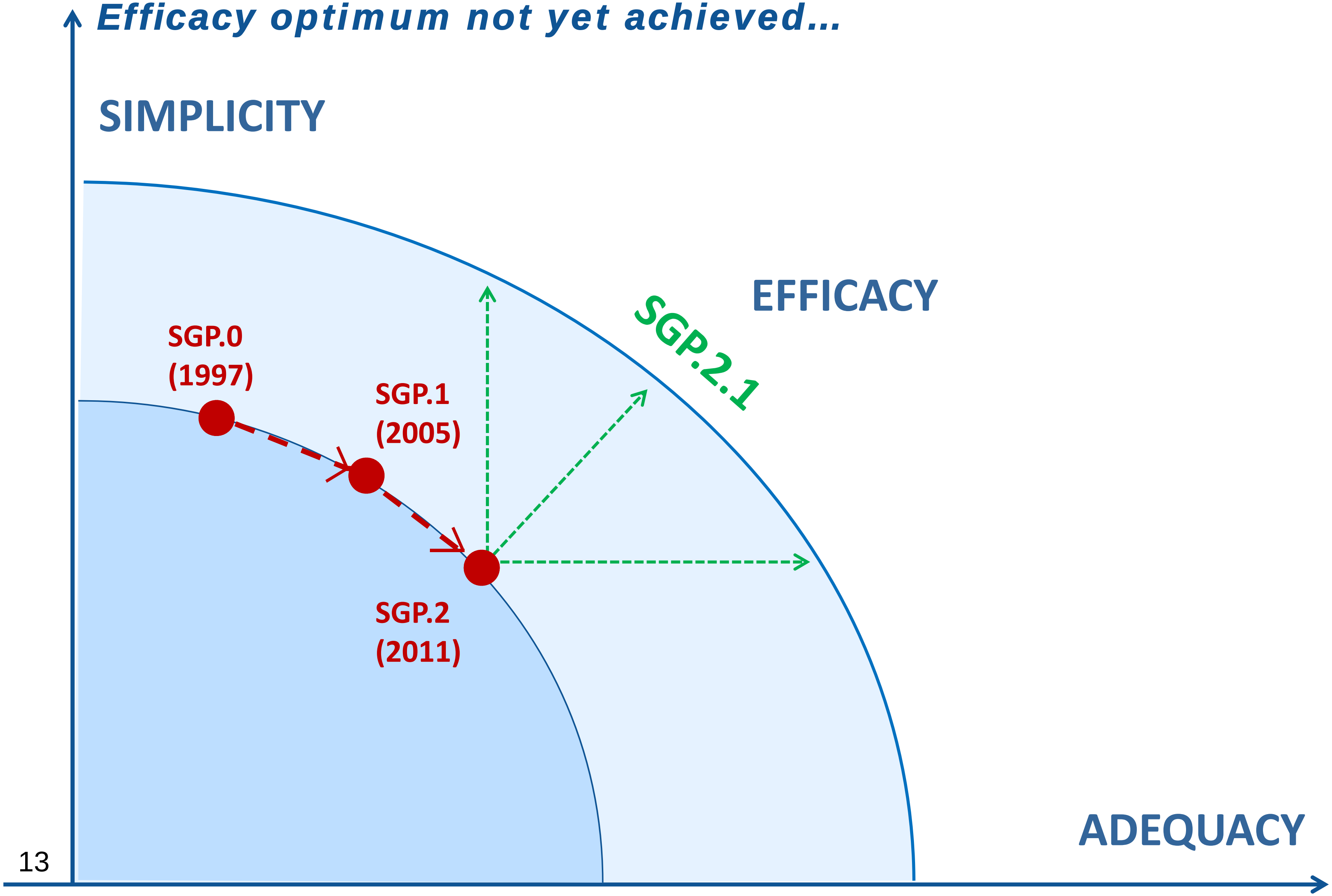
Efficacy of the EU fiscal framework

Compliance with the preventive arm: Conclusion of the overall assessment



Stock-taking of the current EU fiscal framework

Efficacy optimum not yet achieved…



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How to streamline the sustainability core of the Pact?

- **Diagnosis: current SGP stockpiles variables**
  - Headline balance, structural balance (level and change), debt, expenditure benchmark … but how to 'streamline'?

- **Idea n°1: Find the right place for each indicator:**
  - Debt: the better long-term objective
  - Annual compliance (action) indicators: change in structural balance or net expenditure growth
  - Compliance (action) indicator can't be directly linked to long-term objective → Need for intermediate objective: headline, structural balance?

- **Idea n°2: Connect the 'ideas around'**
  - Cf. IMF, others: Single debt anchor *cum* single operational instrument
  - Find agreed reference for deficits:
    - 3%: problem when understood as target
    - MTO too tight? (more controversial)

    → Something in-between?

How to streamline the sustainability core of the Pact?

Debt anchor

- *Default option: Gross debt ratio, 60% and 5%*
- *Other choices?*

Calibration of the intermediate objective reflects the choice of the debt anchor

Intermediate objective

Headline balance OR structural balance

- *Uniform or country-differentiated?*
- *Frequency of updates?*

If objective meant to be pluriannual:

- *Update (or not) path towards it?*
- *Update (or not) compliance indicator?*

- *Actual position < Intermediate Objective → Requirement for a positive adjustment*
- *Actual position > Intermediate Objective → Requirement to stay there*

Operational instrument (annual compliance)

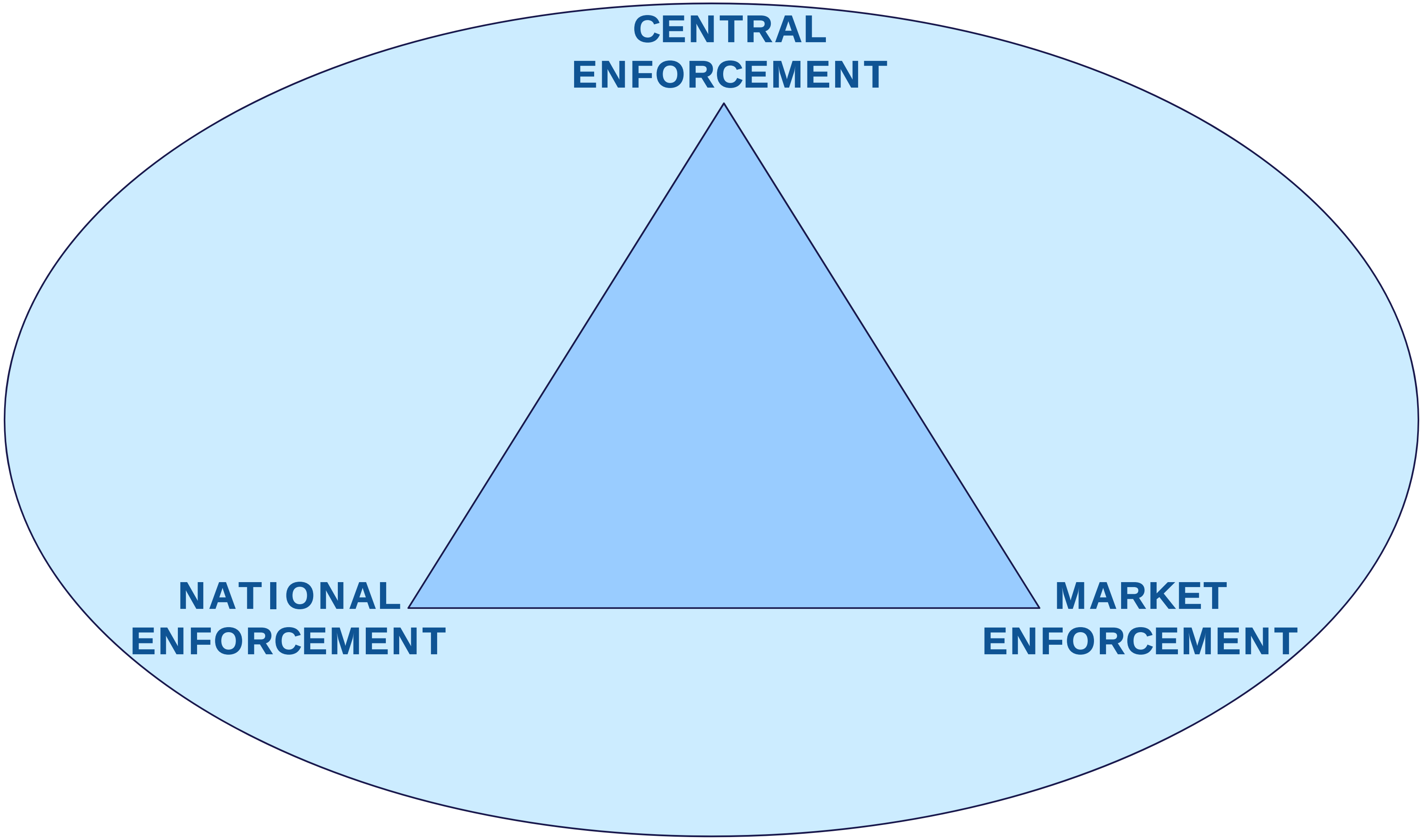
(Change in) structural balance OR expenditure growth (net of revenue measures)

- *Pros/cons of each*

Quid stabilisation dimension?

- ***In part linked to previous choices***
  - Not the same if headline or structural is intermediate objective
  - Not the same if operational instrument is structural balance or expenditure
- **'Matrix' or not? Pros and cons, link with escape clauses**
- ***EDPs***
  - Duality headline/structural a problem (currently, 'weakest applied')
  - Can one 'relativise' role of headline targets?
    - Returning to 3% on time neither necessary nor sufficient for compliance
    - Compliance based exclusively on structural metric (structural bal. or exp.)
- *Stabilisation function for large shocks*
  - Would it affect above choices?

How to enforce fiscal rules?



Summary

- **Stock-taking of the current framework:**
  - **Clarity**: attempt to make the rules more 'adaptable' resulting in increased complexity, also owing to path dependency and lack of trust.
  - **Adequacy**: mixed results, with diverging national preferences on the appropriate level of deficit and debt, and persistent pro-cyclical pattern of fiscal policy.
  - **Efficacy**: rules not enforced as intended, reflecting post-crisis fiscal fatigue but also deeper lack of consensus.

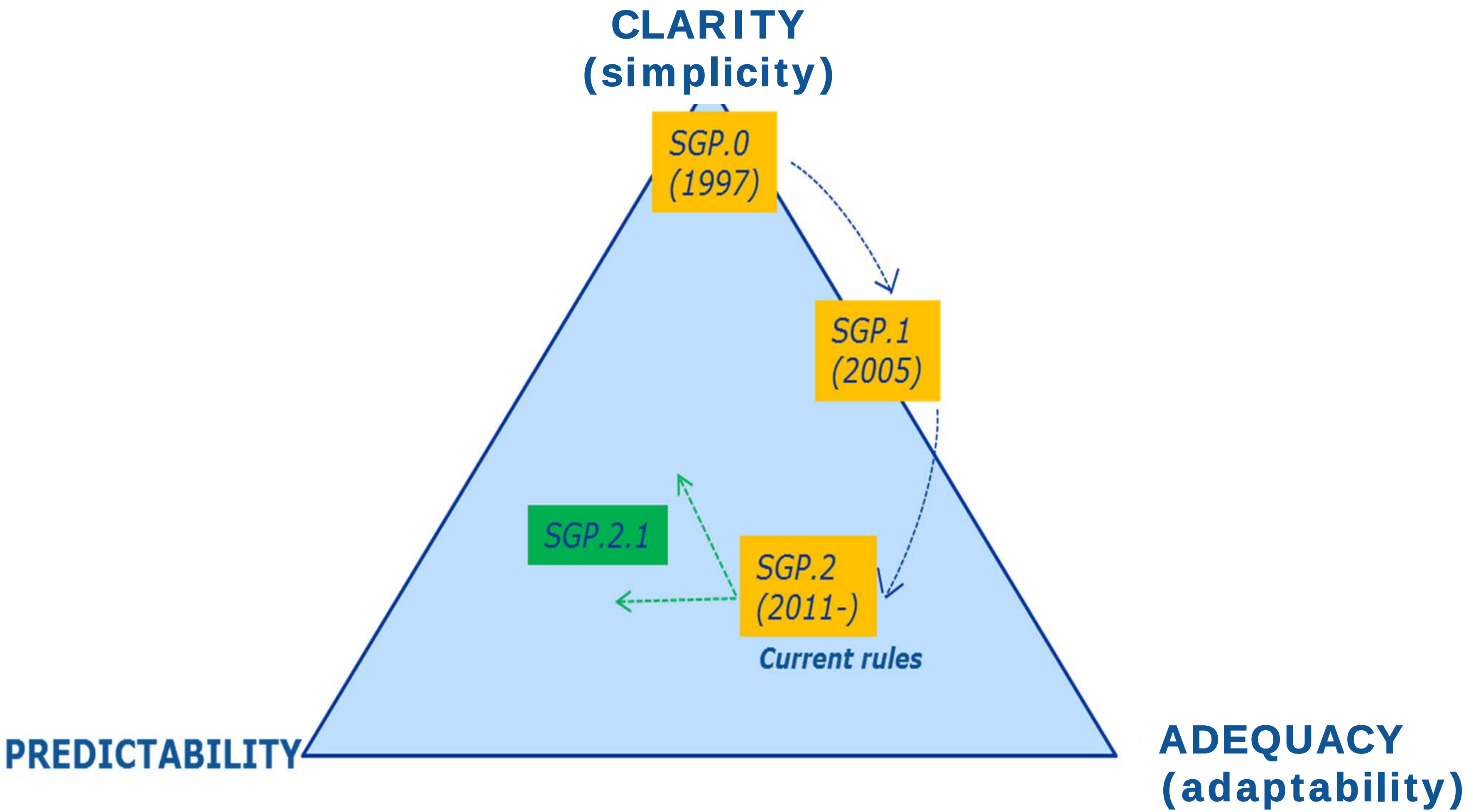
- **But diverging views on how to change the SGP:**
  - **Clarity**: flexibility (implying discretion by institutions) versus predictability (implying strict and numerous rules)?
  - **Adequacy**: how to streamline the sustainability core, and how to deal with the stabilisation dimension?
  - **Efficacy**: central enforcement versus national enforcement? Sanctions versus market enforcement? Or should one rely only on peer pressure/ reputation costs?

Thank you

Additional slides

Clarity of the EU fiscal framework

Increased adaptability at the expense of simplicity…



Adequacy of the EU fiscal framework

Pro-cyclicality: regression results

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Dependent variable:	Δ SB	Δ SB	DFE	DFE	Δ SB	Δ SB	Δ SB	Δ SB
Dummy:					EDP	IMF programme	EDP if Δ OG > 0	Publ. exp. < potential gr
Data:	ex post	real time	ex post	ex post	real time	real time	real time	real time
Measure for econ. cycle:	Δ OG	Δ OG	Δ OG	level OG	Δ OG	Δ OG	Δ OG	Δ OG
Econ. cycle (t-1)	-0.34***	-0.27***	-0.39***	0.09	-0.18**	-0.28***	-0.23*	-0.31***
	(-5.50)	(-3.64)	(-3.39)	(0.73)	(-2.33)	(-2.99)	(-1.86)	(-3.84)
Debt (t-1)	0.03***	0.04***	0.01***	0.030***	0.04***	0.04***	0.02**	0.04***
	(4.87)	(4.92)	(2.94)	(3.57)	(5.10)	(4.41)	(2.03)	(5.03)
Econ. cycle x dummy (t-1)					-0.36***	-0.25**	-0.12	0.09
					(-3.35)	(2.13)	(-0.66)	(0.85)
Dummy (t-1)					0.16	-0.33	0.13	-0.11
					(0.80)	(-0.68)	(0.44)	(-0.53)
Obs.	473	367	168	168	367	367	191	367
# countries	28	28	28	28	28	28	28	28
R-squared	0.31	0.39	0.39	0.52	0.41	0.39	0.25	0.39
Econ. cycle|dummy = 1					-0.54***	-0.53***	-0.34**	-0.22***

amplifies pro-cyclicality

reduces pro-cyclicality

pro-cyclical if < 0

additional impact if dummy is 1

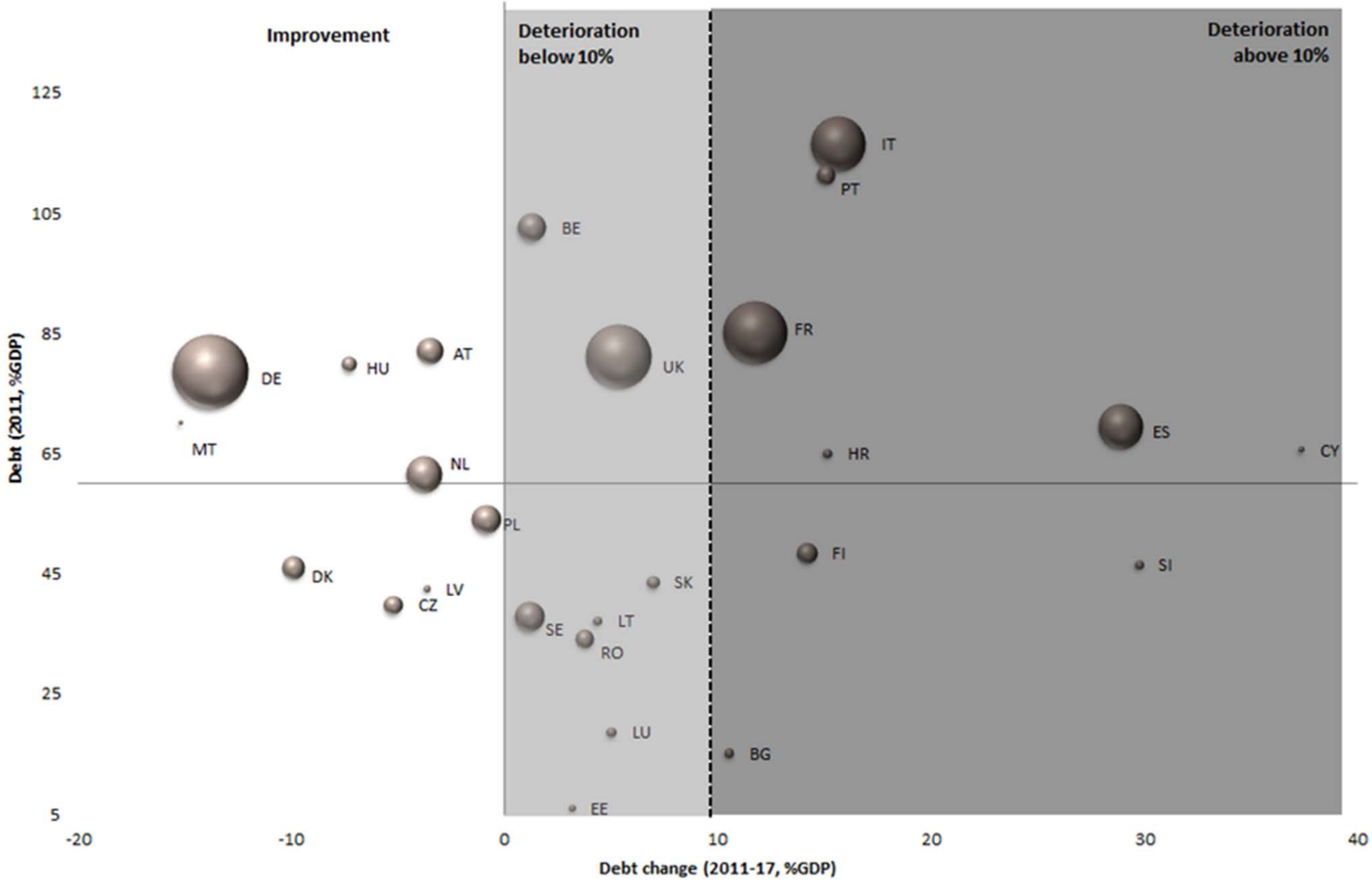
marginal impact if dummy is 1

***Source*: Commission calculations.**

***Note:* The table shows panel regression results replicating and extending the estimations shown in the IMF paper using the following specification: $\Delta SB_{i,t} = \beta_1\, \Delta output\ gap_{i,t} + \beta_2 debt_{i,t-1} + \beta_3 dummy_{i,t-1} \cdot \Delta output\ gap_{i,t} + \beta_4 dummy_{i,t-1} + \theta_t + \vartheta_i + u_{i,t}$. The sample includes 28 EU countries (IMF 19 EA) covering the period 2000-16 (IMF 1999-15). Data for regressions using "ex post" data come from the Commission autumn forecast 2016 (IMF spring 2015). "Real time" indicates outturns in period t reported in period t+1 in line with the second IMF scenario (see Table 1). All estimations include time and country dummies and a constant, which are not shown due to space constraints. Estimation approach: least square dummy variable estimator (LSDV) using heteroskedasticity-robust Huber-White standard errors. t-statistics in parentheses. ***, ** and * denote respectively statistical significance at 1, 5 and 10%.**

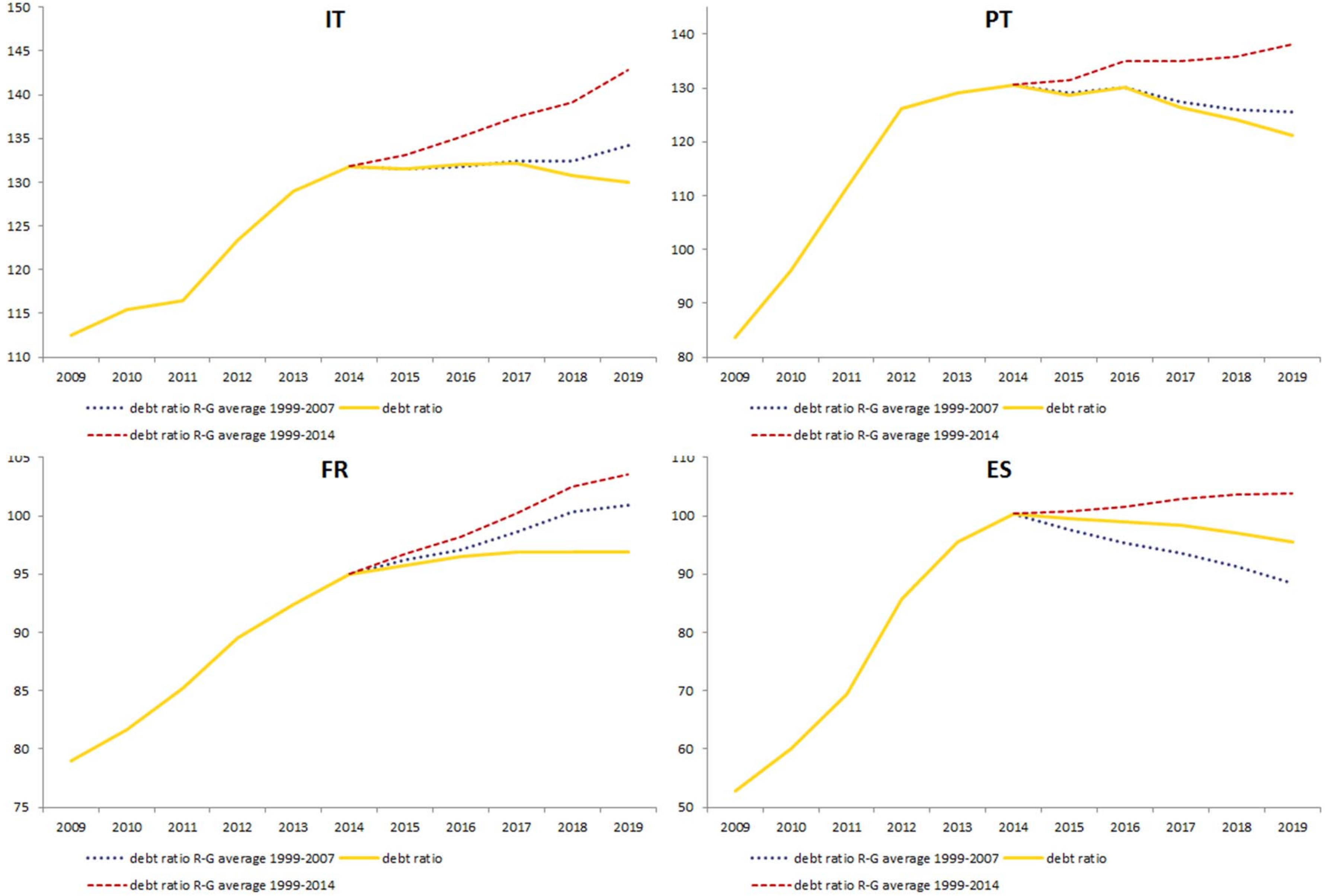
Adequacy of the EU fiscal framework

Divergent debt developments



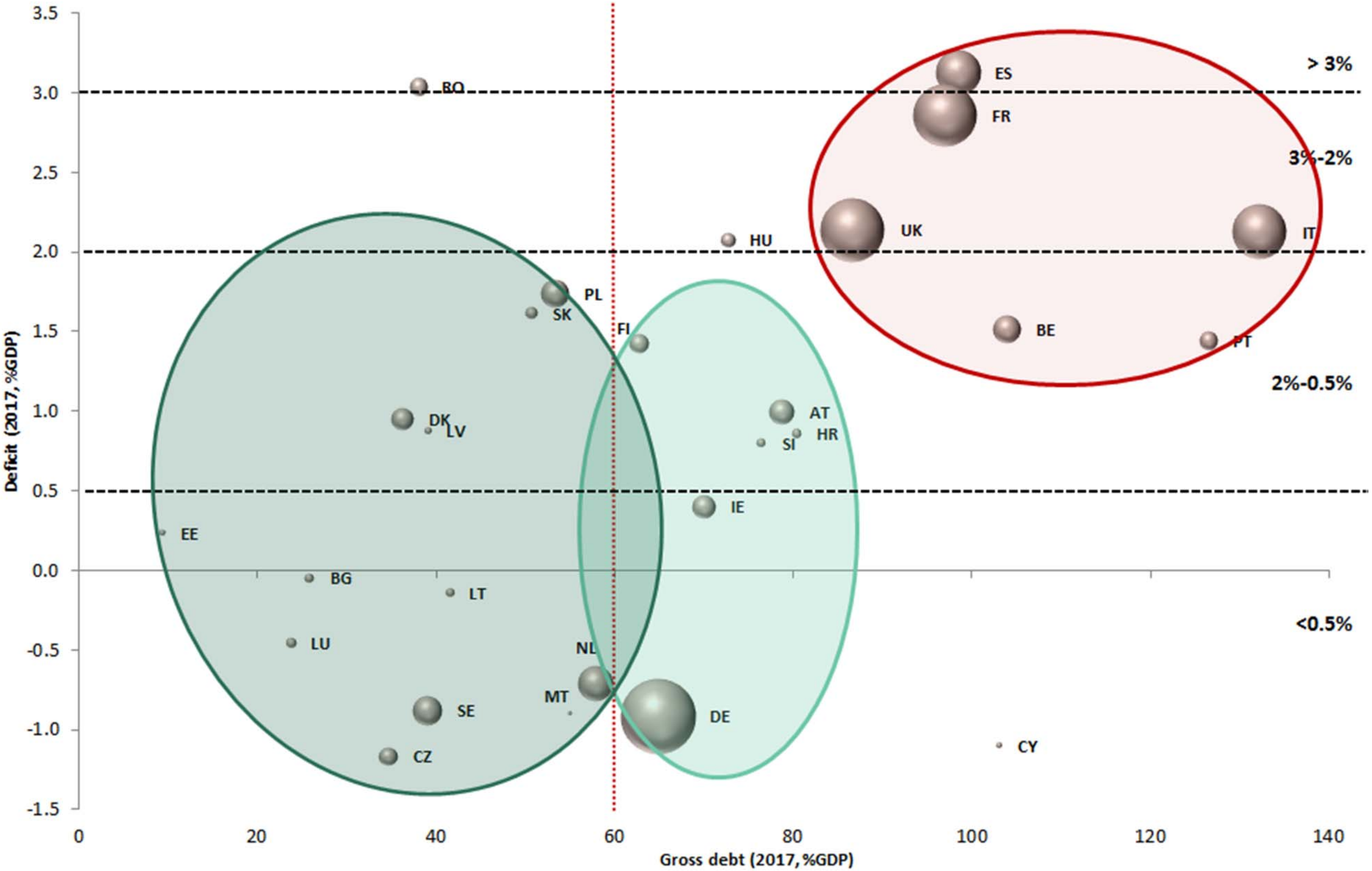
Adequacy of the EU fiscal framework

Favourable snowball effect since 2014 helped curb debt



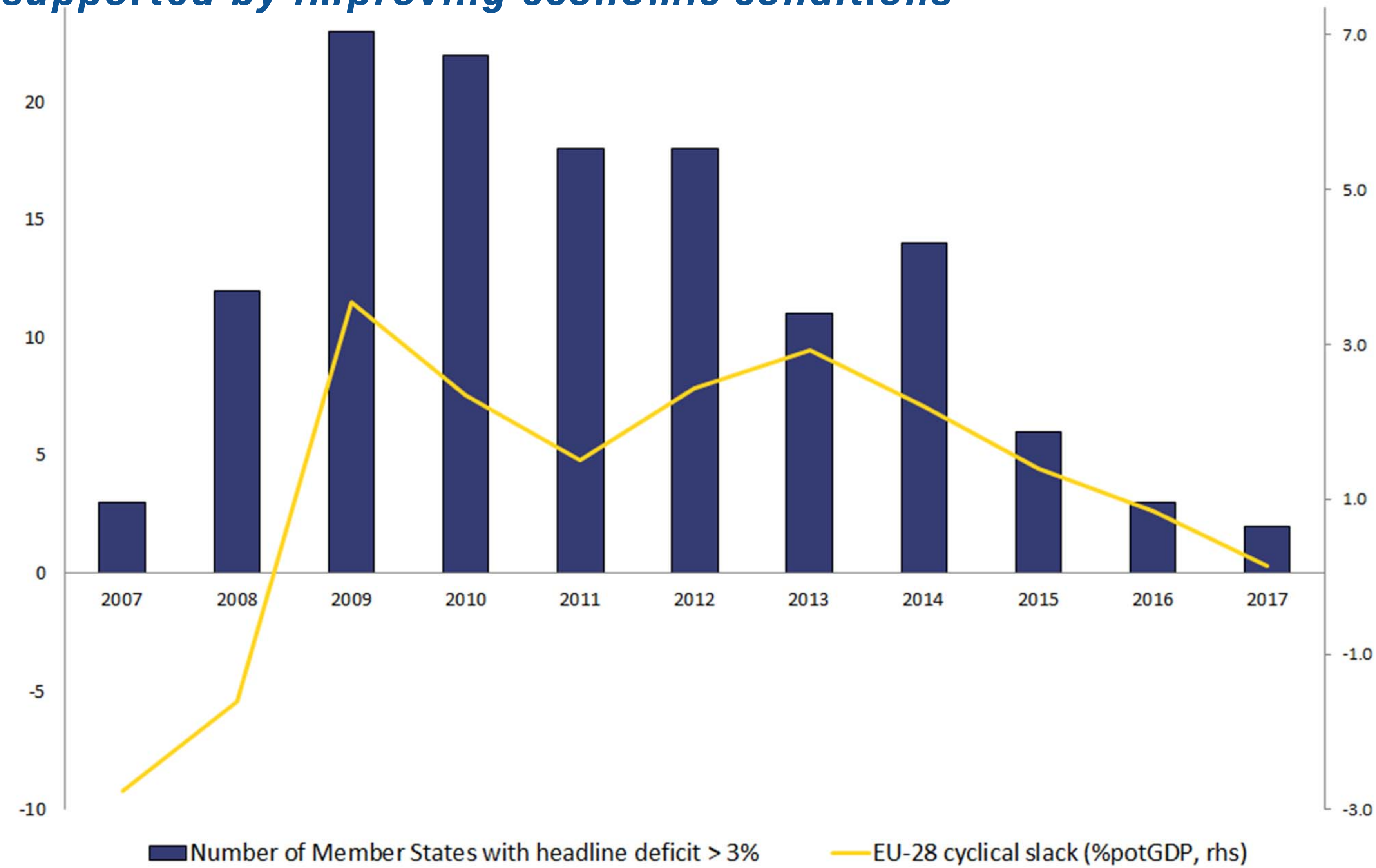
Efficacy of the EU fiscal framework

Mixed picture with regard to Treaty criteria…



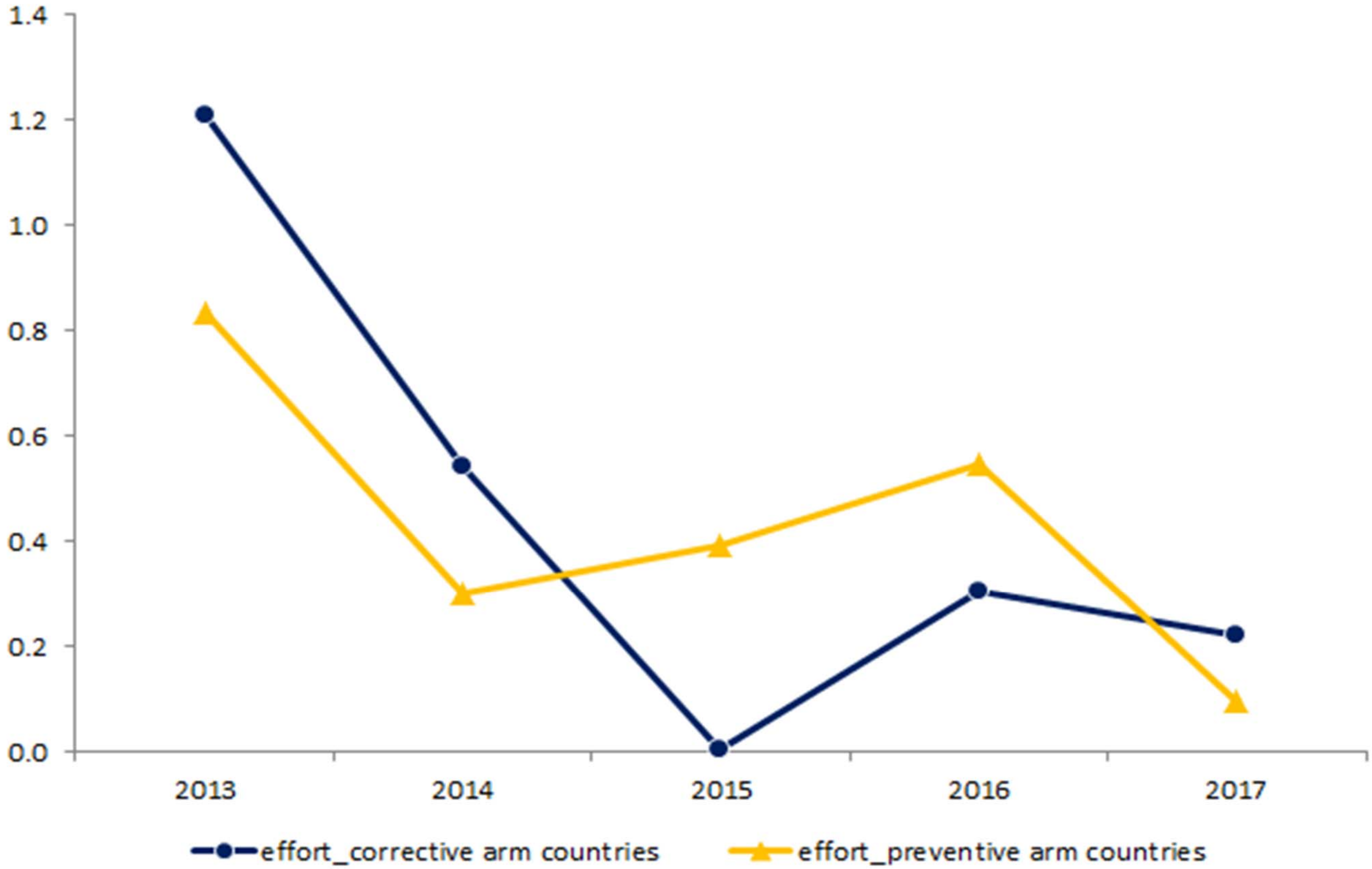
Efficacy of the EU fiscal framework

Reduced number of Member States with excessive deficits, supported by improving economic conditions



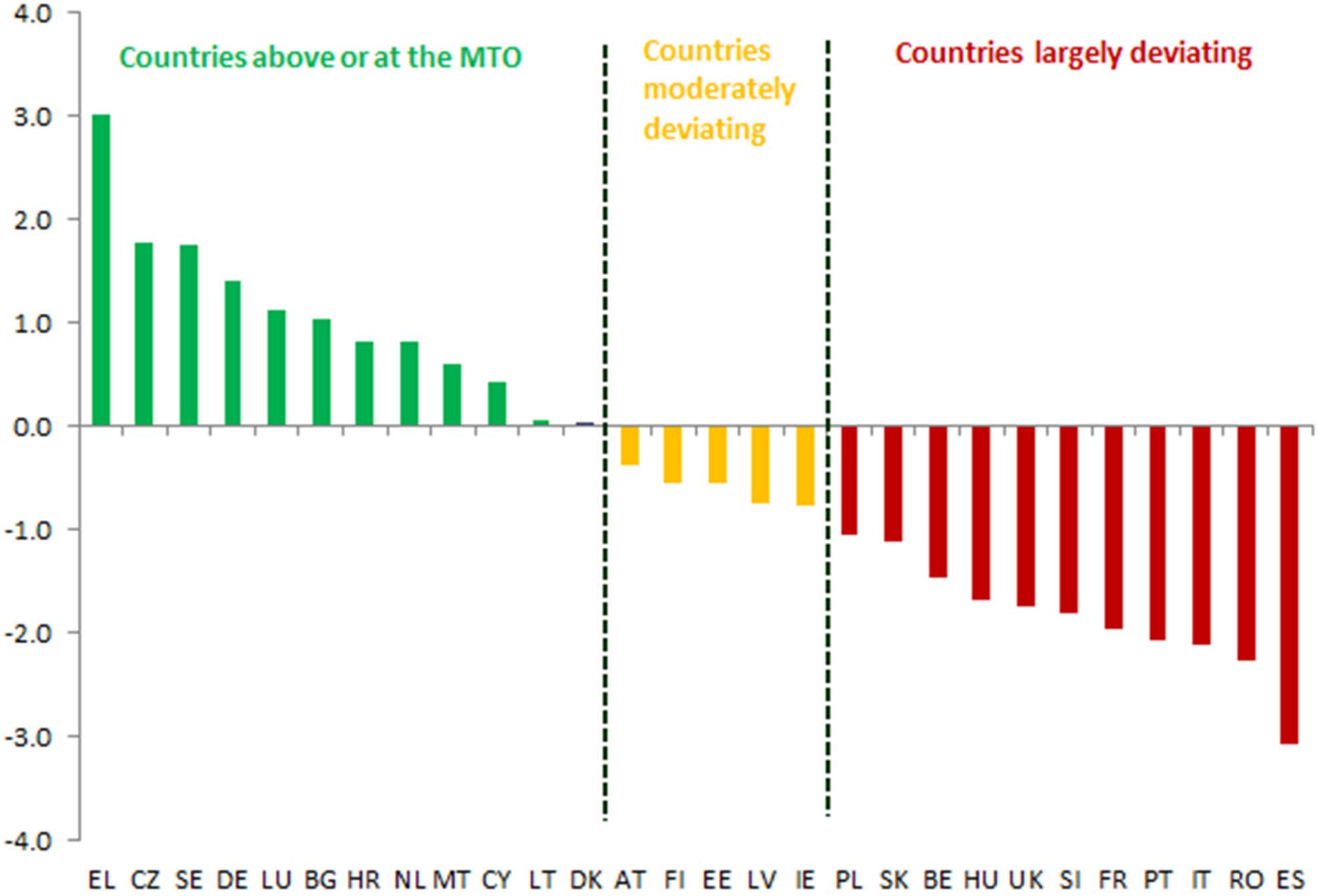
Efficacy of the EU fiscal framework

Slowdown in fiscal adjustment, especially in the corrective arm

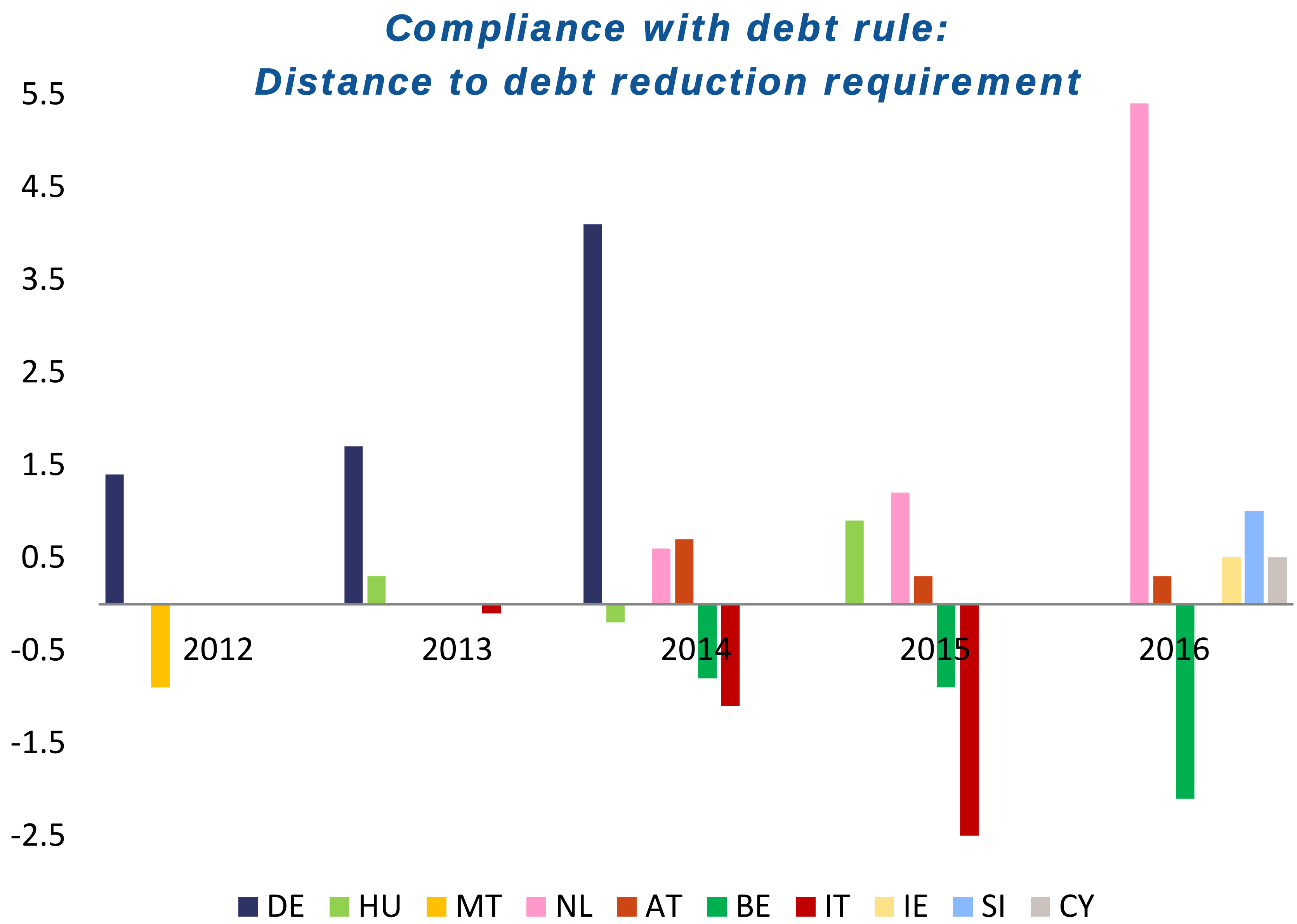


Efficacy of the EU fiscal framework

Divergent positions vis-à-vis Medium Term Objectives…

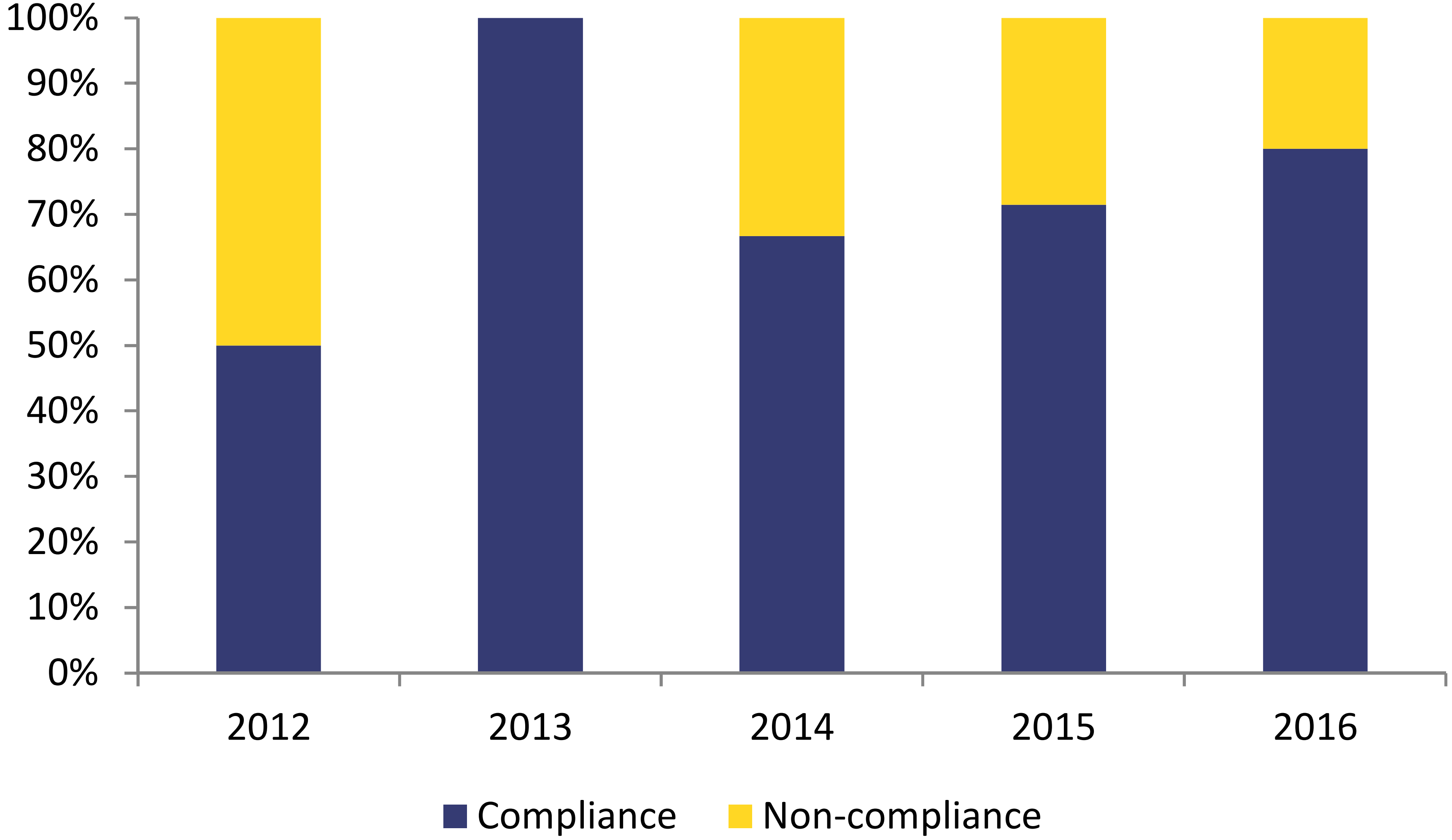


Efficacy of the EU fiscal framework



Efficacy of the EU fiscal framework

(Prima facie) compliance with debt rule:



Sustainability versus stabilization

Schematic presentation of possible simplified framework

Debt Anchor

Based on current paramaterisation of a convergence towards 60% threshold at a pace of 5% a year or variations of the latter

↓

Intermediate Objective (either headline or structural)

The intermediate objective would be calibrated to deliver the debt anchor, with the option of a single uniform norm for all MS or country-specific norms

↓

Operational Instrument

The assessment of compliance is based on an operational instrument which also puts into effect the adjustment path to the deficit norm - the two main options are the structural balance and a net expenditure rule

How to enforce fiscal rules?

Sanctions versus market discipline

Experience so far:

- **Sanctions** difficult to apply strictly in practice
- Limitations to **peer pressure** among Member States
- Insufficiency of **market pressure** in bad times, complacency in good times

Different ways forward:

- Focus on **peer pressure** and political dialogue instead of sanctions
- Recover the **enforcement mechanism** envisaged in the 6-pack
- Introduce **carrots** instead of sticks (e.g. eligibility condition to central stabilization mechanism)
- Rely on **market enforcement** by promoting a proper risk sharing (Banking Union, Capital Market Union)

How to enforce fiscal rules?

Sanctions versus market discipline: Similar magnitude but very different acceptability

Budgetary costs of rules- versus market-based 'sanctions

Sanction type	Stability and Growth Pact: deposit / fine [(1)]	Interest rate spreads (30 to 200 basis points) [(2)]
Budgetary impact	0.005% of GDP / 0.205 – 0.5125% of GDP	0.06 – 0.39% of GDP

(1) *Non-interest bearing deposit following a 126(6) Council decision. Interest rate assumption: 2.5% based on IT and PT long-term rates in 2017 (2.1% and 3.1%, respectively). Fine following a 126(8) Council decision is 0.205% of GDP. 'Initial' fine under Article 126(11) ranges from 0.205-0.5125% of GDP. 'Additional' fine under 126(11) is up to 0.5125% of GDP.*

(2) *Calculations based on the current debt ratios of IT and PT (132% of GDP and 126% of GDP, respectively) and an average debt maturity of around 6½ years. This corresponds to an annual refinancing of around 20% of GDP. A 1 pp. higher interest rate then would translate into a 0.2% of GDP higher interest bill.*

How to enforce fiscal rules?

Centralization versus decentralization:

Elements of centralisation	Elements of decentralisation
Simplified fiscal rules	Operational national rules with links to the EU framework
A common fiscal capacity	More binding nature of medium-term fiscal planning at MS level
Last resort backstop to the banking union	Empowered independent national fiscal institutions
Reinforced ability to intervene in case of gross errors	Reinforced market discipline

Fiscal federalism by exception vs No bail out / market discipline

→ **Essential to conceive the different elements of the framework together**

How to enforce fiscal rules?

Centralization versus decentralization:

Integrating the Treaty on Stability, Coordination and Governance into the Union legal framework

- Proposed Council Directive for strengthening the medium-term budgetary orientation in the Member States and role of IFIs
- Focuses on substance of fiscal compact, namely the underlying objective : convergence to prudent levels of public debt, complementing and reinforcing the SGP
- Current SGP requirements prevail but Directive compatible with future modifications
- Main features:
  - o **(national) medium-term objective** in terms of structural balance, geared towards prudent gov't debt level + correction mechanism for significant deviations
  - o **medium-term expenditure path** (net of discretionary revenue measures) set for the entire legislature when new gov't takes office, **binding on annual budgets**
  - o key role for **national fiscal councils** in setting the above parameters and monitoring compliance with them (including 'comply-or-justify' principle)