European Fiscal Board

The European Fiscal Board's 2017 Annual Report

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Outline

- The EFB: origin and economic rationale
- EFB mandate and structure of the annual report
- Main findings of the report

Origin of EFB

June 2015: Five President's Report mapped lessons of crises into reform proposals

- Aggregation of national fiscal policies does not add up to appropriate fiscal stance in wake of very large shocks
  - ➔ Euro area dimension of fiscal policy making needs a "voice"
- Trust in EU fiscal rules suffered due to increased complexity, lack of predictability in implementation, and enforcement
  - ➔ Independent and public assessment of rules

October 2015: Establishment

- Commission Decision (2015/1937) establishing an independent advisory EFB

October 2016: Appointment

- Formal appointment of Board members by the Commission

Economic rationale

Political economy of fiscal policy making in general

- Fiscal policymakers not selfless decision makers maximising social welfare; applies to all levels of politics
  - ➔ Fiscal policy will not necessarily follow predictions of welfare economics

Economic governance of euro area

- Centralised monetary policy + decentralised fiscal policy subject to agreed rules
  - ➔ Tensions bound to arise especially in wake of large shocks
- Rules applied by sovereigns on sovereigns
  - ➔ Enforcement difficult, politics trumps macroeconomic considerations

➔ **Independent assessment**

- ✓ enhances **transparency**,
- ✓ supports **informed public debate** and, more generally,
- ✓ strengthens **accountability of decision makers**

EFB reports mirror EFB mandate

Main tasks of the EFB

Evaluation of the implementation of the Union fiscal framework

Cooperate with the **national fiscal councils**; in particular aim at exchanging **best practices**

Advise COM on fiscal stance:
- retrospective
- prospective

Advance suggestions for the **future evolution of the Union fiscal framework**

Annual Report November 2017

Section 2: SGP implementation in 2016

Section 3: Independent fiscal institutions

Section 4: Fiscal stance in 2016

Section 5: Future evolution of the fiscal framework

June 2017

Assessment of the fiscal stance appropriate for 2018

Annual Report 2017: Main findings

Looking back: Recent past (2016) challenging for fiscal policy makers in the euro area:

- o Major relaxation of the rules?
  → undermine the **sustainability of public finances** and the **credibility of rules**
- o Rigid application of the rules?
  → undermine the **fragile recovery**

Conclusions:

- SGP applied with extensive **flexibility** and **discretion**
- Led to a fiscal stance broadly **appropriate at euro area level** but **not at country level**
- Rules and procedures **very complex: discretion and judgement very prominent**, at the expense of transparency and predictability

Looking forward: there is **scope for improving** the EU's fiscal framework, **both within the boundaries of the current framework and beyond**

Section 2 – SGP implementation

Focus on **2016**, the last complete **surveillance cycle**

Assessment in autumn 2015: **Budgetary plans for 2016 presented sizeable risks** of non-compliance in several countries

Outturn in spring 2017: **Compliance largely observed**

- Not thanks to stronger economic growth: growth broadly in line with forecasts
- Risk of non-compliance addressed with **extensive recourse to discretion** and **greater flexibility** (including for high-debt, low-growth countries)
- Non-compliant countries were granted **additional time** and **sanctions cancelled** (Spain, Portugal)

➔ **Implementation of SGP imperfect but no gross errors:** Imperfectly implemented rules (see next slide) still preferable to a major relaxation or a very rigid interpretation of SGP

Cases of imperfect implementation in 2016

- **Two indicators to assess compliance (dSB and EB)** require judgement. Explanations for choosing one indicator over the other **not always consistent** across time and countries
- **Flexibility clauses for Italy:** Eligibility **conditional on actual implementation of structural reforms.** Ex-post assessment not conclusive; Commission Country Report raised questions
- **Excessive deficit procedures for Spain and Portugal:** In May 2016 COM **delayed conclusion on non-effective action** and recommended **extension of deadlines in conflict with existing Council recommendations**
- **Debt reduction insufficient** in Belgium, Italy and Finland, **but no procedure launched** due to broad interpretation of '**relevant factors**', although flexibility meant drifting away from the MTO
- **Draft budgetary plans:** Time frame and role of caretaker governments had to be **clarified** after **early (Spain) and late (Portugal) submissions** had created problems

Section 3 – Independent fiscal institutions

IFIs an integral part of the domestic institutional setup in most EU Member States

- Preparing or endorsing economic forecasts
- Monitoring compliance with fiscal rules

IFIs are not policy-makers but can influence governments' decisions, through independent analysis

- This puts pressure on government to comply

Portrait of two IFIs

- Ireland: recent, small, home-grown, targeted
- The Netherlands: longstanding, credibility built over time, scope gradually broadened

Horizontal topic

- Comply-or-explain principle: a relatively new tool with some positive outcomes, but needs stronger anchoring to bolster effectiveness of IFIs

Section 4 – Fiscal stance in 2016

Guidance given in 2015 by Commission and Council:

A **broadly neutral aggregate fiscal stance** in 2016, but **differentiated at national level,** in a context of:

- **Fragile recovery** after a long crisis, but still **high debt ratios**
- **Constrained monetary policy**, likely larger fiscal multipliers

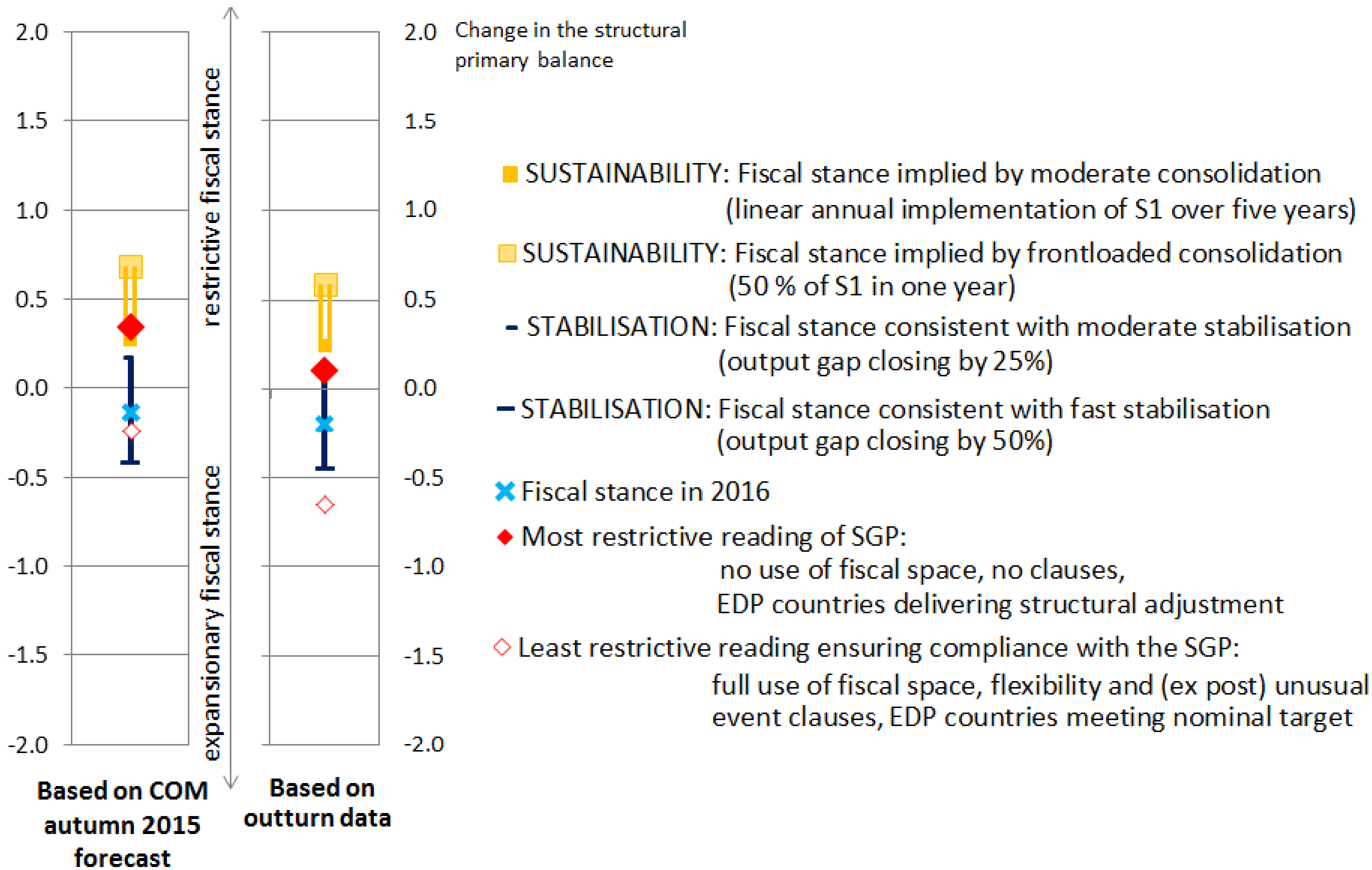
With hindsight: slightly expansionary fiscal stance observed

- **Broadly in line with guidance** and **appropriate at aggregate level**
- But **composition across countries not optimal:**
  - Some countries with high sustainability risks **did not fully comply** with requirements or were **given less demanding requirements** in 2016/spring 2017
  - Fiscal policy could have been more supportive if countries with fiscal space had used it more fully, but:
    - SGP requires consolidation, but **cannot oblige countries to expand**
    - **Fiscal space can only be used once**: when is the best time to use it?
  - Such tensions are bound to arise with decentralised fiscal policies

[more on relevance]

[more on the EFB's approach]

Fiscal stance in 2016: autumn 2015 vs. outturn



Section 5 – Proposals for improving the SGP

Insufficient use of good times → Making rules more symmetric:

- Compensate past **deviations from the fiscal targets** by stronger subsequent fiscal effort (debt brake in Switzerland and Germany) **[more]**
- Make recommendations more stringent, if the economic outlook becomes more favourable **[more]**

Sanctions not effective → Enforcement more incentive-compatible:

- Broaden conditionality in the EU budget. Objective is not to sanction, but to safeguard efficiency of EU funds **[more]**

Structural weaknesses make public finances vulnerable
→ Enhancing economic resilience:

- Link the SGP with the Macroeconomic Imbalance Procedure **[more]**

Complexity hampers transparency and predictability
→ Radically simplifying the rules: [more]

- One operational rule (debt or deficit), one indicator of compliance
- Simplification and flexibility not necessarily in conflict: can be reconciled with escape clauses triggered with independent advice

Proposals for the future evolution of EMU

A euro area stabilisation function

- Governance framework of euro area incomplete
- A central fiscal capacity would make the euro area more resilient to large shocks, symmetric as asymmetric
- Focus on crisis prevention, no fine-tuning of fiscal policy
- Access to central capacity conditional on compliance with national fiscal rules
- A case for an investment protection scheme, building on the "Juncker Plan‟, but work should continue on alternatives

Conclusions

- **Policy dilemma** in 2016:
  - Sustainability concerns in some countries vs. risk of undermining the recovery in the euro area
  - Use of discretion vs. risk of undermining the SGP
- **Middle ground was reached:** implementation of SGP was not perfect but provided some support to the recovery in the euro area, although country-by-country composition of fiscal stance suboptimal
- Now that the economic situation has improved significantly, SGP faces new challenges: **Take advantage of the good times to build buffers for next downturn**. Flexibility of rules should imply **more effort during the current and future upturns**
- Long-term viability of EMU would be strengthened with a **centralised fiscal capacity**. An investment protection scheme currently appears to have advantages over alternative designs

Thank you for your attention!

https://ec.europa.eu/european-fiscal-board

Background slides

Implementation of the SGP

Analysis does not cover the whole history of the SGP. **Focus on the last complete surveillance cycle: 2016**

Spring year T

- Member States submit stability and convergence programmes covering years T-1 toT+3
- Commission publishes spring forecast in early May
- Commission assesses compliance with the SGP
  - ex-post for year T-1
  - in-year and ex-ante for years T and beyond
- Commission issues policy guidance for year T+1 in the form of fiscal CSRs and, where relevant, launches new steps under the SGP
- Council adopts CSRs in July

Autumn year T

- Euro area Member States submit draft budgetary plans for year T+1 by 15 October
- Commission publishes autumn forecast in early November
- Commission assesses
  - compliance with SGP for individual Member States, and issues Opinions on DBPs
  - prospects for the euro area as a whole, including the fiscal stance in year T+1, and issues a proposal for a recommendation on the economic policy of the euro area

End year T / beginning year T+1

- Member States adopt national budgets for year T+1 by end December of year T
- Commission publishes winter forecast in early February T+1
- Council adopts recommendation on the economic policy of the euro area in March T+1

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SGP implementation in 2016: two compliance indicators

- The Commission uses **two indicators** to assess whether a government has taken sufficient measures to progress towards the MTO:
  - Is the public deficit reduced beyond the automatic impact of higher or lower economic growth? → ***change in the structural balance***
  - Is public expenditure under control compared to how the economy is growing over the medium term? → ***'expenditure benchmark'***
- Both indicators have the **same goal** but are **technically different**. As a result, they may send conflicting signals. **Judgement** is necessary to decide which indicator is more relevant
- When assessing compliance, the explanations provided by the Commission have **changed over time**. For instance, in 2015 the structural balance was often presented as more relevant to discuss fiscal developments in 2016, while in the spring of 2017 the expenditure benchmark was considered to be more reliable in that respect
- In some cases the choices and explanations have also **differed across countries**, e.g.:
  - Profile of investment more accurate with or without smoothing?
  - More prudent to use potential growth estimates over 1 or 10 years?

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SGP implementation in 2016: Flexibility clauses for Italy

- For 2016, the Italian government requested to benefit from the **flexibility available within the SGP** to reduce the amount of fiscal adjustment it was expected to deliver
- The largest factor it invoked was **major structural reforms** that were expected to make the Italian economy and public finances stronger in the future
- The Commission and the Council agreed that this was a valid reason to **reduce the fiscal requirements for Italy by 0.5% of GDP** in 2016

  In total the adjustment requirements for Italy were reduced 0.83 % of GDP in 2016 on account of additional factors, including public expenditure on investment, costs related to the inflow of asylum seekers and security measures against terrorist threats

- However, this reduction was allowed only **to the extent that structural reforms were actually implemented.** This was supposed to be checked in early 2017
- In its assessment of spring 2017, the Commission referred to this condition but it **did not explicitly discuss whether reforms had effectively been implemented**

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SGP implementation in 2016: Relevant factors

- Whenever a breach in the debt criterion is observed, the Commission prepares a report under Art. 126(3) TFEU to assess the case for opening an EDP
- Art. 2(3) of Regulation (EC) 1467/97 – *"The report shall reflect, as appropriate:*
  - *a) The developments in the **medium-term economic position**, in particular **potential** growth, …, **cyclical** developments …;*
  - *b) The developments in the medium-term budgetary positions, including, in particular, the record of **adjustment towards the [MTO]** … ;*
  - *c) the developments in the medium-term government debt position …;*

  … any other factors which, in the opinion of the Member State concerned, are relevant. … [P]articular consideration shall be given to financial contributions to fostering international solidarity and achieving the policy goals of the Union"
- The Commission considers at least the three following main aspects:
  1. Adherence to the MTO or the adjustment path towards it, **including flexibility**
  2. Structural reforms, already implemented **or detailed in a structural reform plan**, which are expected to enhance sustainability through their impact on growth
  3. Unfavourable macroeconomic conditions and, in particular, low inflation

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SGP implementation in 2016: Draft budgetary plans

- Since 2013, euro area countries are expected to present to the Commission and the Eurogroup their **draft budgetary plans for the following year in autumn**. The Commission assesses whether the plans meet the SGP requirements and discusses the aggregate picture at euro area level
- The deadline for governments to send their plans is **October 15**
- In 2015, **Spain sent its plans well ahead of the deadline**, on 11 September. While not illegal, this was considered problematic because it put the Commission in the position of assessing plans submitted by an outgoing government ahead of general elections
- By contrast, **Portugal did not submit its plans by the deadline** due to general elections on 5 October. The new government sent plans on 22 January 2016
- These cases of early and late submissions gave rise to discussions among euro area governments. In September 2016, they agreed that:
  - ❑ plans could not be submitted earlier than 1 October
  - ❑ caretaker governments should send plans by 15 October with neutral assumptions
  - ❑ the new government should send updated plans once in office

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Fiscal stance of the euro area: relevance

Risk of suboptimal decisions if spillover effects not internalised

- Governments do not usually consider how national fiscal policy measures combine with measures in other countries
- Still, fiscal policy can have non-negligible spillover effects on other countries. In particular, if several countries consolidate (or expand) at the same time, the impact in each country tends to be larger than if each country acted on its own

Crisis showed that simple aggregation of national fiscal policies not necessarily optimal for euro area as a whole

- Sizeable joint consolidation in 2012 not optimal with hindsight; did not sufficiently take into account euro-area-wide implications

Use quieter economic times to prepare for future downturns

- Think of whether, when and how to use the fiscal stance as a policy instrument, in order to be better prepared to design appropriate policies when next crisis hits
- Discussing the fiscal stance does not necessarily imply making use of it. In normal times, automatic fiscal stabilisers can be expected to be sufficient
- No fine tuning, but e.g. support aggregate demand in exceptional situations when monetary policy overburdened; requires identifying such situations

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Fiscal stance of the euro area: the EFB's approach

- Considering **the euro area as a single entity**
  - Also analysis at country level, especially for **sustainability**

- **Cyclical conditions** assessed based on:
  - Latest growth forecasts from European and international institutions: Commission, ECB, IMF, OECD, plus others
  - A broad set of additional indicators of slack / overheating

- Role of **monetary policy** taken into account, with implications for fiscal multipliers

- **No fiscal fine-tuning**:
  - No quantified target but qualitative guidance
  - No need for discretionary fiscal stabilisation if automatic fiscal stabilisers and monetary policy are sufficient

- Within the SGP: checked against **boundaries of EU fiscal rules**

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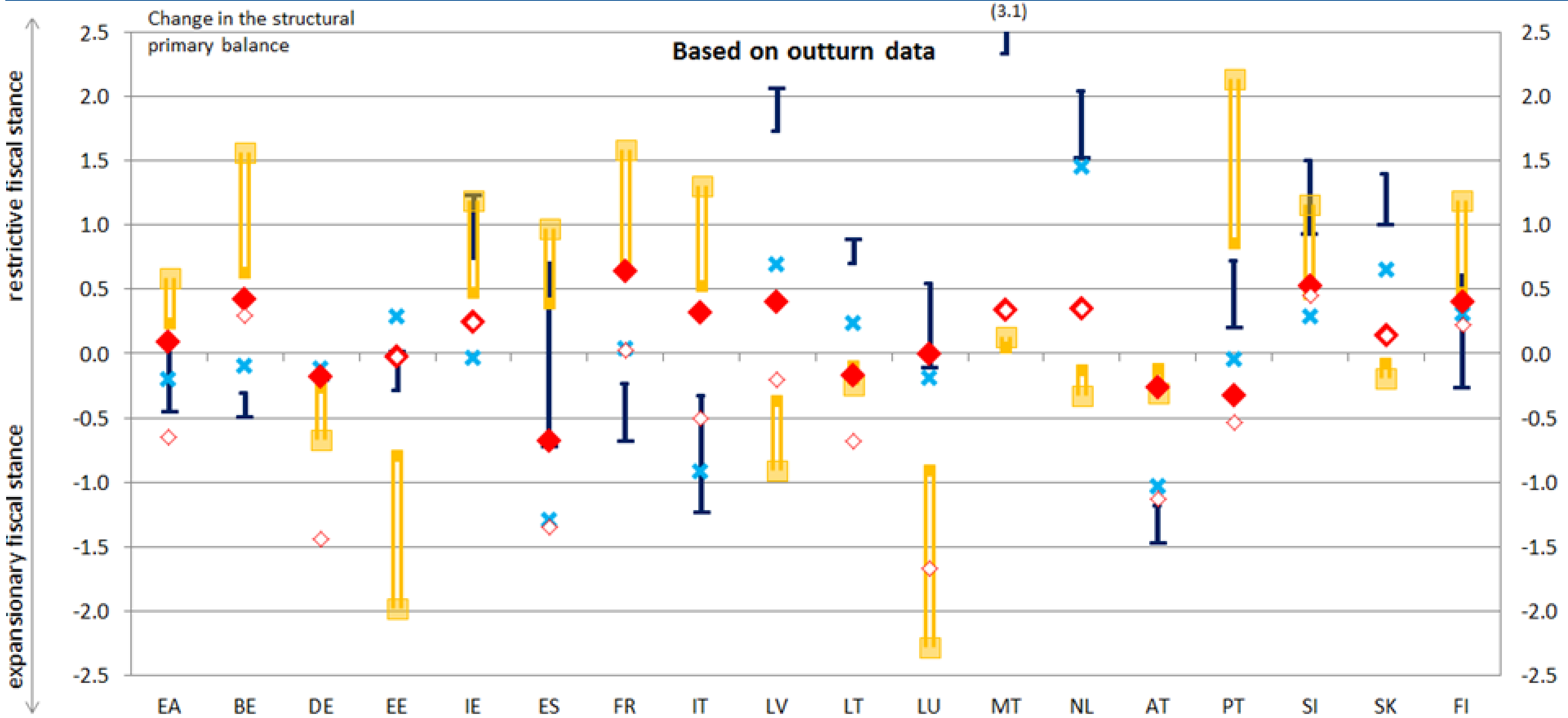
Fiscal stance in 2016



- STABILISATION: Fiscal stance consistent with moderate stabilisation (output gap closing by 25%)
- STABILISATION: Fiscal stance consistent with fast stabilisation (output gap closing by 50%)
- SUSTAINABILITY: Fiscal stance implied by moderate consolidation (linear annual implementation of S1 over five years)
- SUSTAINABILITY: Fiscal stance implied by frontloaded consolidation (50 % of S1 in one year)
- Fiscal stance in 2016 (outturn)
- Most restrictive reading of SGP: no use of fiscal space, no clauses, EDP countries delivering structural adjustment
- Least restrictive reading ensuring compliance with the SGP: full use of fiscal space, flexibility and (ex post) unusual event clauses, EDP countries meeting nominal target

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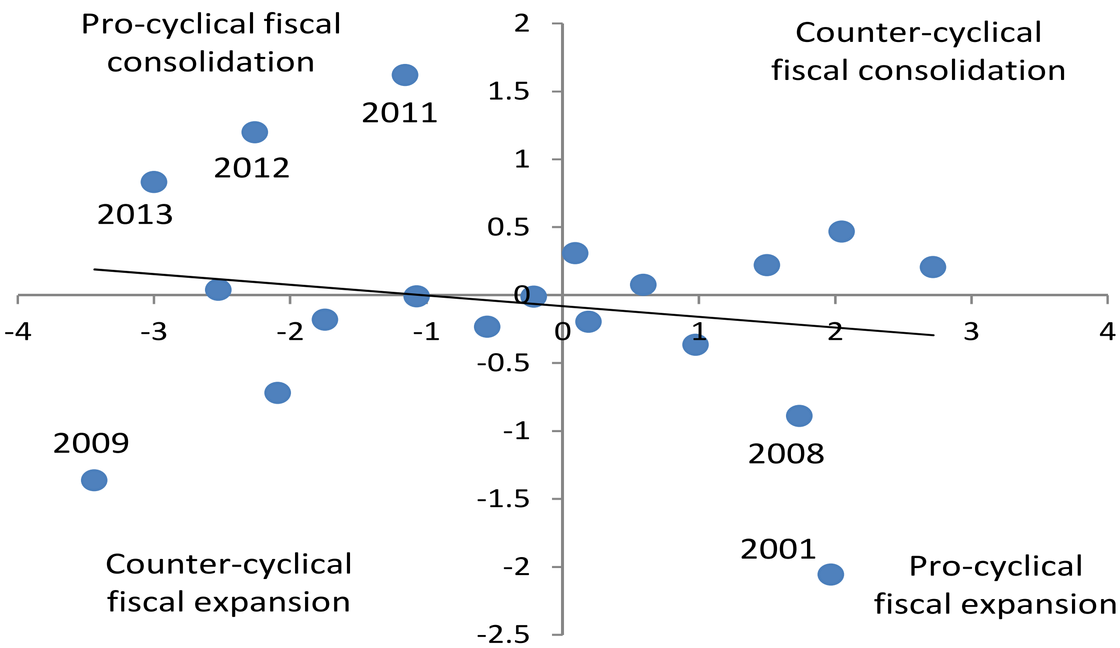
Improving the SGP: more symmetric rules

Fiscal policies tend to be pro-cyclical

Change of the cyclically adjusted primary balance (vertical axis) vs. the output gap (horizontal axis), in percent of potential GDP



Source: European Commission

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Improving the SGP: more symmetric rules

Margins of uncertainty are being used systematically

Assessment of compliance of the draft budgetary plans with the preventive arm of the SGP

					Ex-ante cumulative deviation	
	2014	2015	2016	2017	SB	EB
BE					-0.4	-1.4
DE					-	-
EE					-	-
IE					0.3	-0.7
IT					-2.5	-2.2
CY					-1.0	-0.9
LV					0.1	-1.0
LT					-0.6	-2.0
LU					-	-
MT					-1.2	-3.2
NL					-	-
AT					-1.8	-0.8
PT					-0.6	-0.5
SI					-1.2	-1.6
SK					-1.3	-0.5
FI					-1.8	-1.6

Notes: (1) Green, yellow and red correspond respectively to an assessment of 'compliance', 'broad compliance' and 'risk of non-compliance'. (2) 'SB' refers to the structural balance; 'EB' to the expenditure benchmark. (3) The numbers of the planned cumulative deviation do not automatically map into the colour code of compliance reported on the left hand-side. The assessment of compliance is based on an 'overall assessment', which includes also deviations over two years and the possible role of expenditures under the 'unusual event clause'.

Source: European Commission

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Improving the SGP: more symmetric rules

Compensating deviations from the adjustment path towards the MTO

- Currently, the preventive arm of the SGP does not require compensating for past deviations from fiscal targets
- Potential incentive to target a 'non-significant' deviation of 0.25% every year
- Rules could be amended to include a 'compensation account', like in the Swiss and German debt brakes

Updating EDP recommendations following positive economic surprises

- Currently, a worsening of economic conditions may lead to more lenient fiscal targets
- Rules should allow also for more stringent fiscal targets when economic conditions improve

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Improving the SGP: strengthening enforcement

Current sanctions lack effectiveness

- Under the SGP, the Commission and the Council have the discretion to cancel fines for no effective action (e.g. Spain and Portugal in 2016)
- Conditionality on ESI funds may be pro-cyclical and does not affect countries which receive little funds

Solution: expand conditionality to the whole EU budget

- Would be a credible sanction mechanism for all Member States
- Could be aimed at non-productive expenditures

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Improving the SGP: encouraging resilience

Two-way link between fiscal and macro side:

- Macroeconomic imbalances may lead to fiscal crises (e.g. Spain and Ireland before the crisis)
- Fiscal policy may amplify macroeconomic imbalances (e.g. France, Germany and Italy)

Linking the SGP with the MIP

- Based on the type of imbalance, strengthen or loosen fiscal targets in the SGP

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Improving the SGP: simplifying the rules

Trade-off between simplicity and flexibility

- Simple rules do not account for economic circumstances and are inflexible → may force suboptimal policies
- Flexible rules require complex provisions to account for all possible circumstances → may be difficult to enforce

Solution: independent judgement

- Radical simplification of the SGP, introducing escape clauses for adverse economic circumstances
- Escape clauses are triggered on the basis of a recommendation from an independent institution

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