

Panel discussion

Fiscal rules and independent fiscal councils

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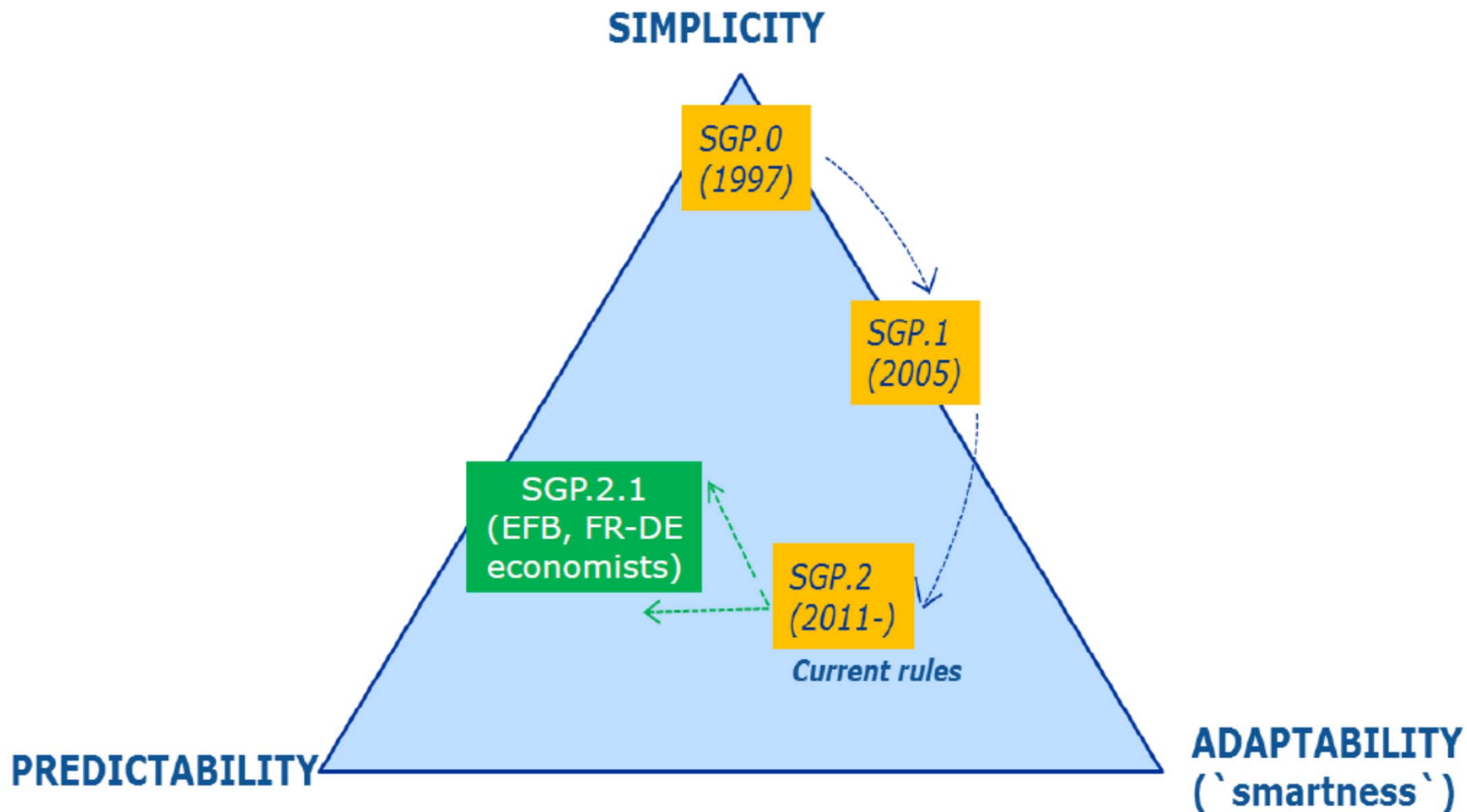
Overview

- Functioning and (re)design of European fiscal framework
- EU-level fiscal watchdog
- Fiscal rules and fiscal councils at the national level – empirical evidence

European fiscal framework

Evolution SGP (Source: Buti)

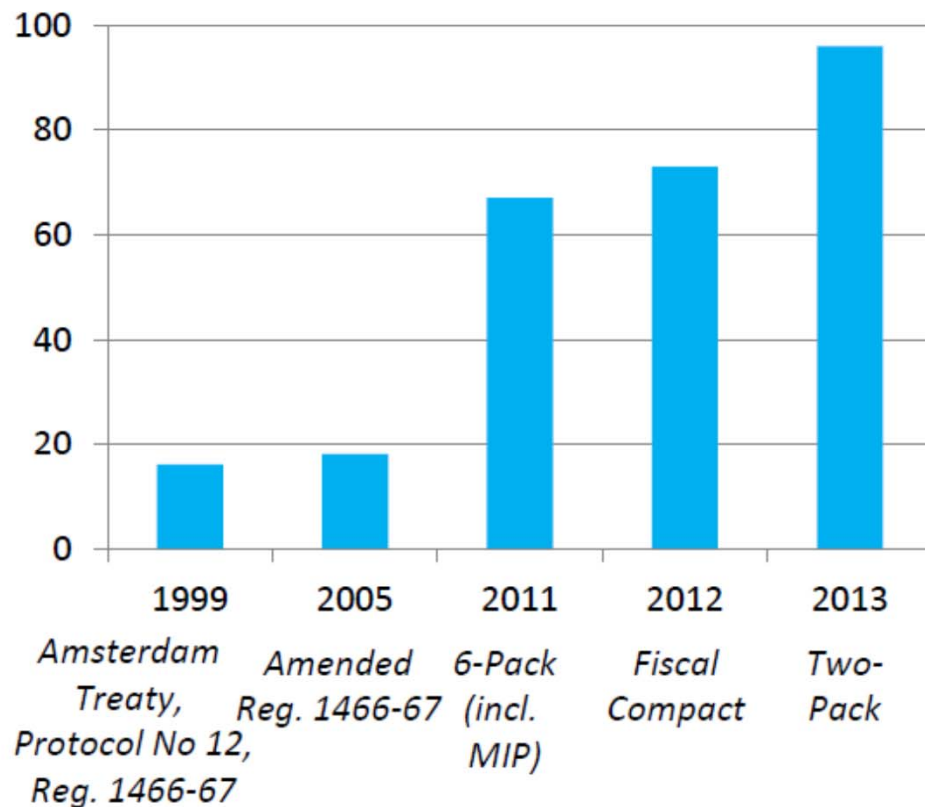
Inherent trade-offs in design of a fiscal framework



Increasing complexity (Source: Buti)

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

- ***Sui-generis character of the EU system*** resulted in a in multiple and complex "checks and balances"
- ***Missing trust*** across Member States and between Commission and Member States
- ***Increased competencies at EU level*** (e.g. DBP review)
- ***Learning*** (evolving view on the role of fiscal policy in EMU)

EFB Annual Report 2017: Main findings

Looking back: Recent past, including 2016, very challenging for fiscal policy makers. Room of manoeuvre demarcated by two adverse alternatives:

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

Observations:

- 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 judgment 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**

EFB Annual Report 2017: Main findings

Overall: Europe's fiscal framework has had an **impact**, but the rules have been **applied imperfectly**

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

Proposals for improving the SGP

More symmetric rules: [\[pro-cyclicality\]](#) [\[more\]](#)

- Compensating [deviations](#) from the adjustment path towards MTO, as do debt brakes in Switzerland and Germany
- Updating EDP recommendations following positive economic surprises [\[more\]](#)

Strengthening enforcement: [\[more\]](#)

- Broadening conditionality in the EU budget. Conditionality not a sanction, but an instrument to safeguard efficiency of EU funds

Enhancing economic resilience: [\[more\]](#)

- Linking the SGP with the Macroeconomic Imbalance Procedure

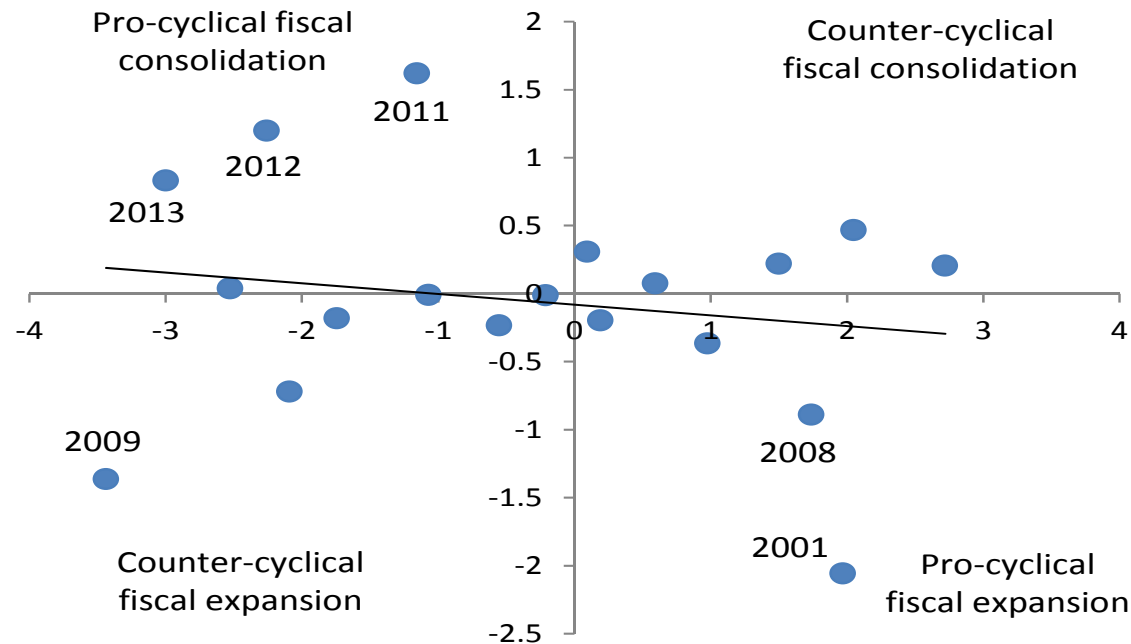
Radical simplification of the rules: [\[more\]](#)

- One main rule (debt or deficit), one indicator of compliance, well defined escape clauses, triggered with help of independent advice

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

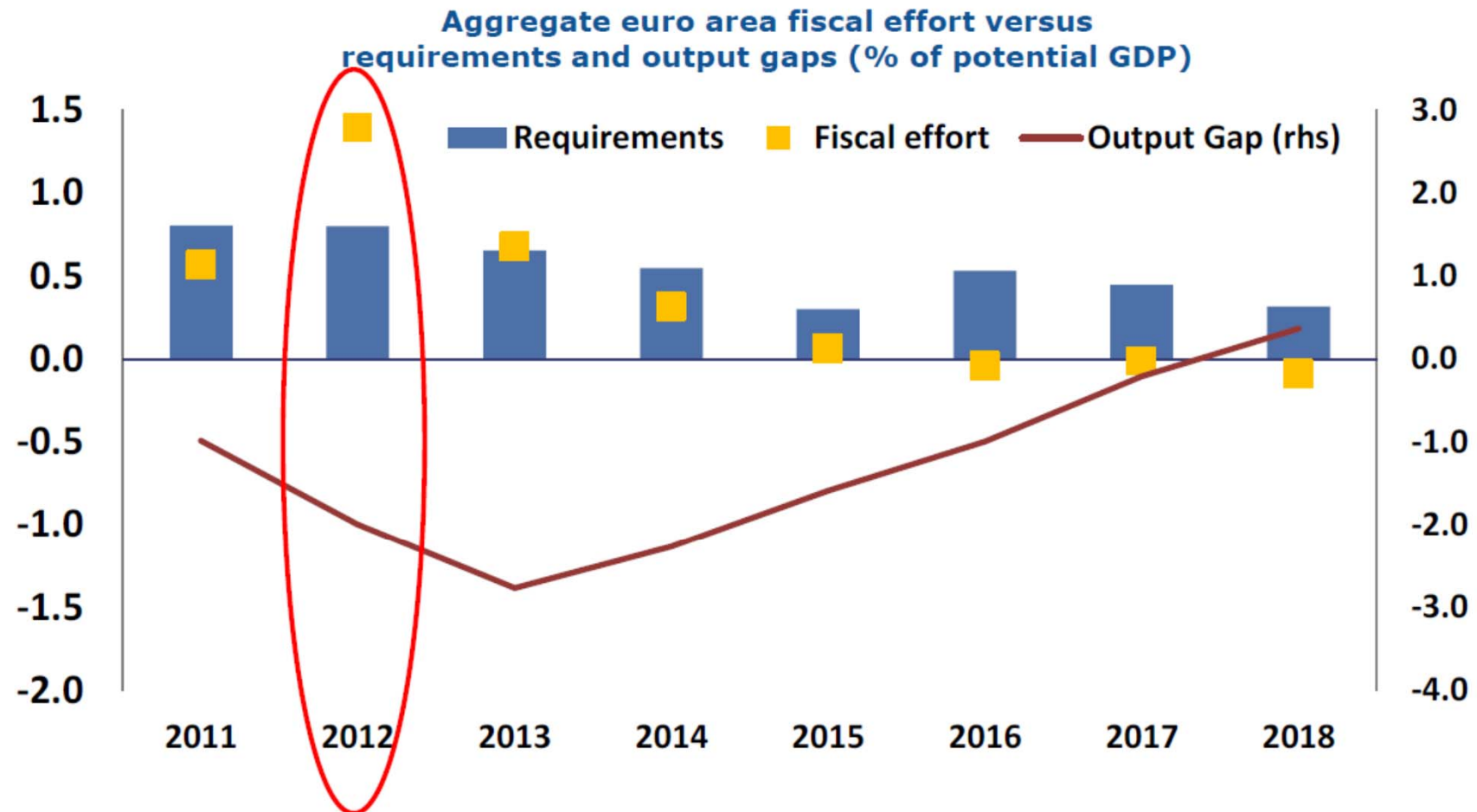


Source: European Commission.

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Improving the SGP: more symmetric rules (source: Buti)

How can fiscal rules mitigate pro-cyclicality?



Source: European Commission autumn forecast 2017

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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: independent judgment

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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Improving the SGP: independent judgment

Some flexibility may effectively be preserved

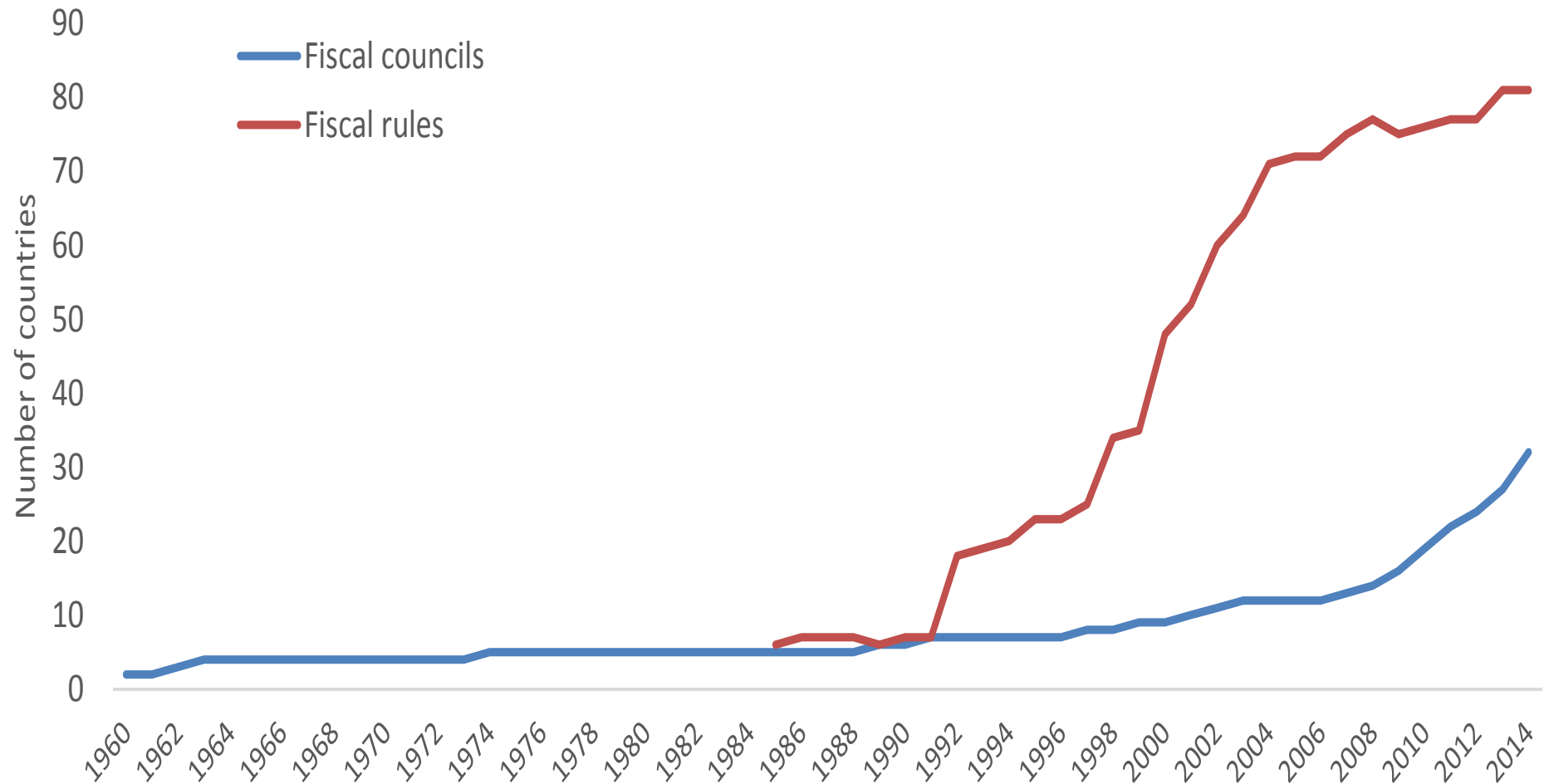
- Flexibility is there for a reason, if only for political pressures
- However, flexibility sometimes applied in ad hoc / opportunistic way
- Trade-off between credibility/enforceability and flexibility can be mitigated by judgment independent institution: under normal circumstances, simple criterion more tightly enforced, under special circumstances escape may be possible, upon recommendation independent institution

Solution: design of independent institution crucial – draw on national experiences

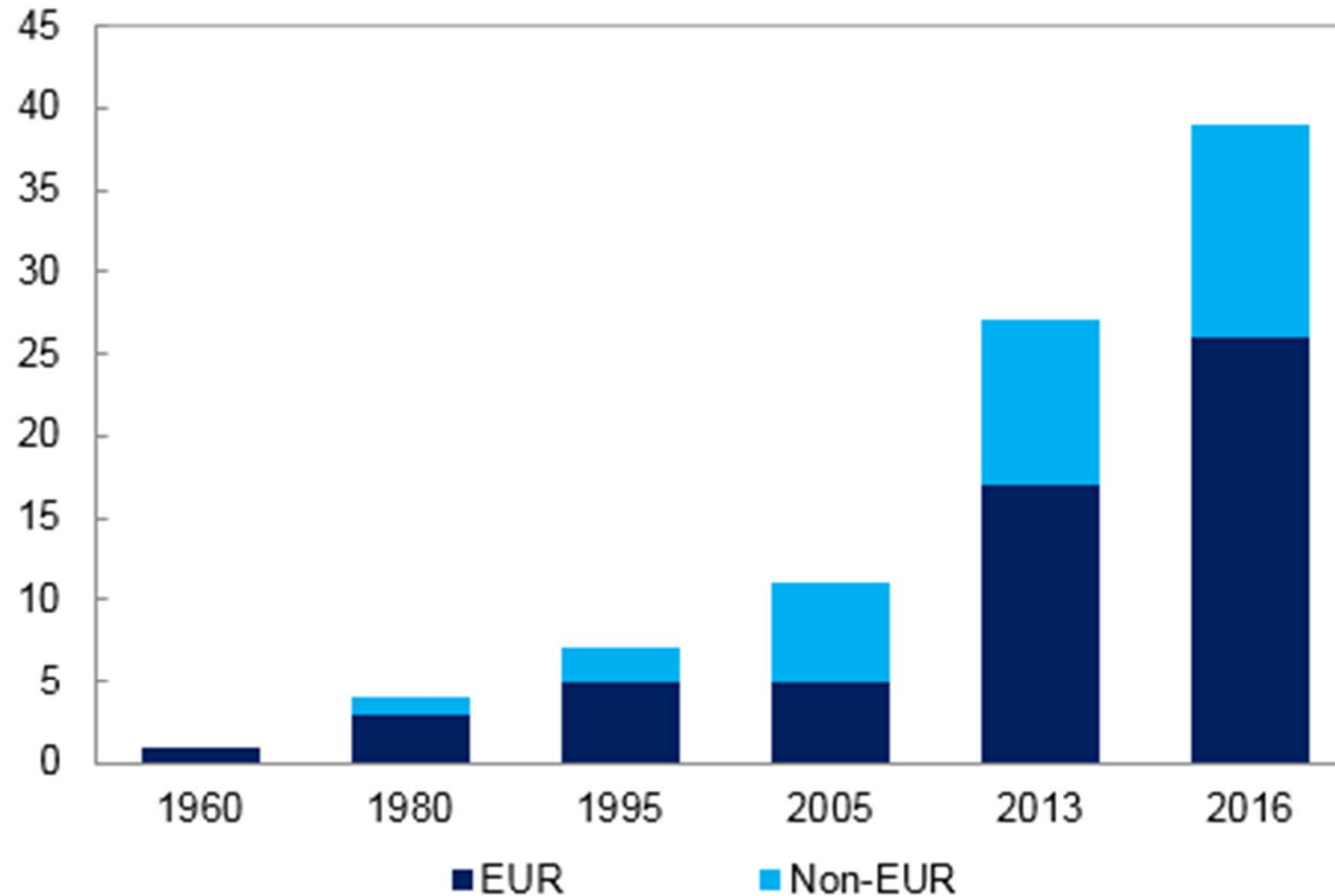
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National arrangements

Proliferation fiscal rules and fiscal councils

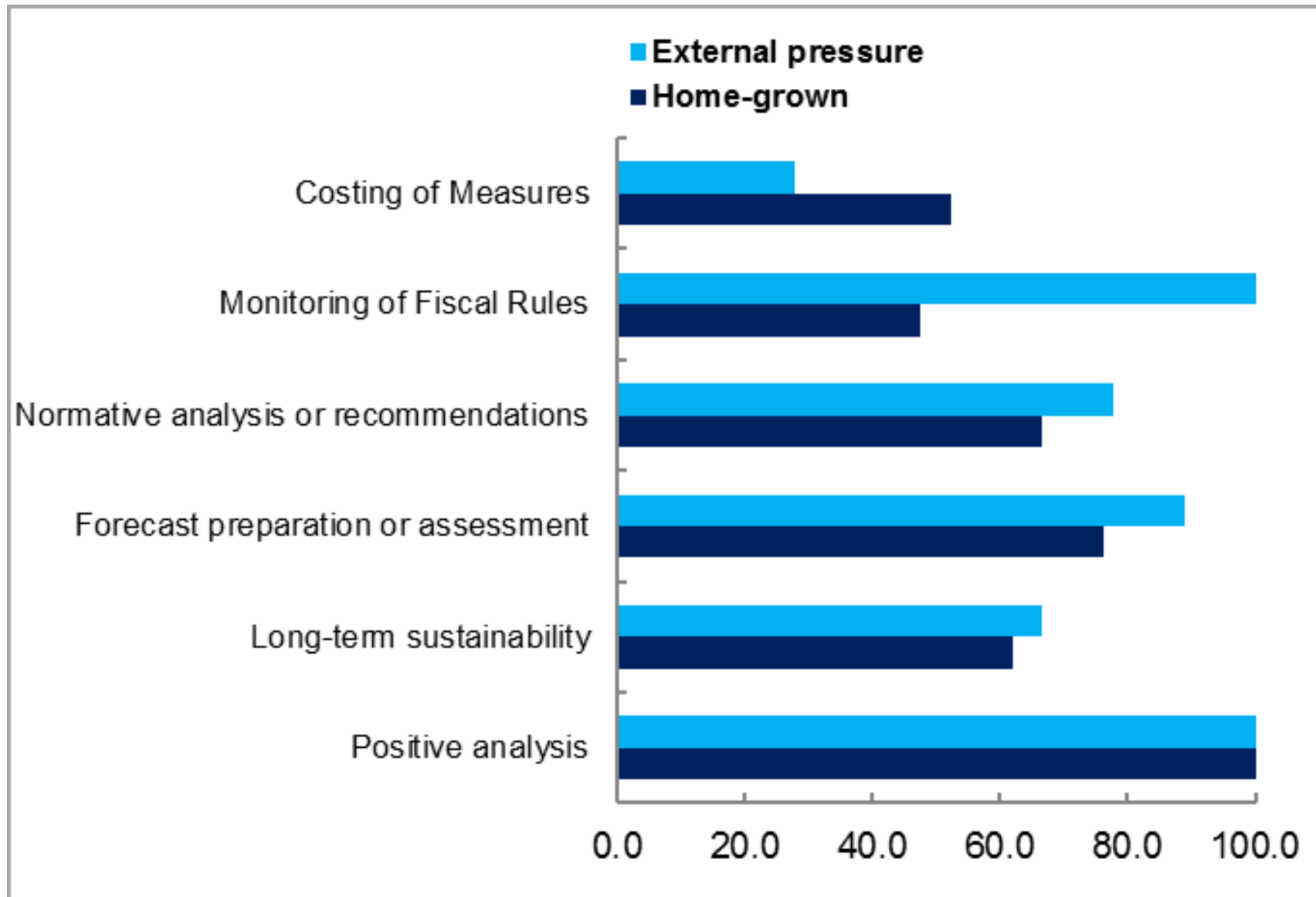


Proliferation of independent fiscal councils

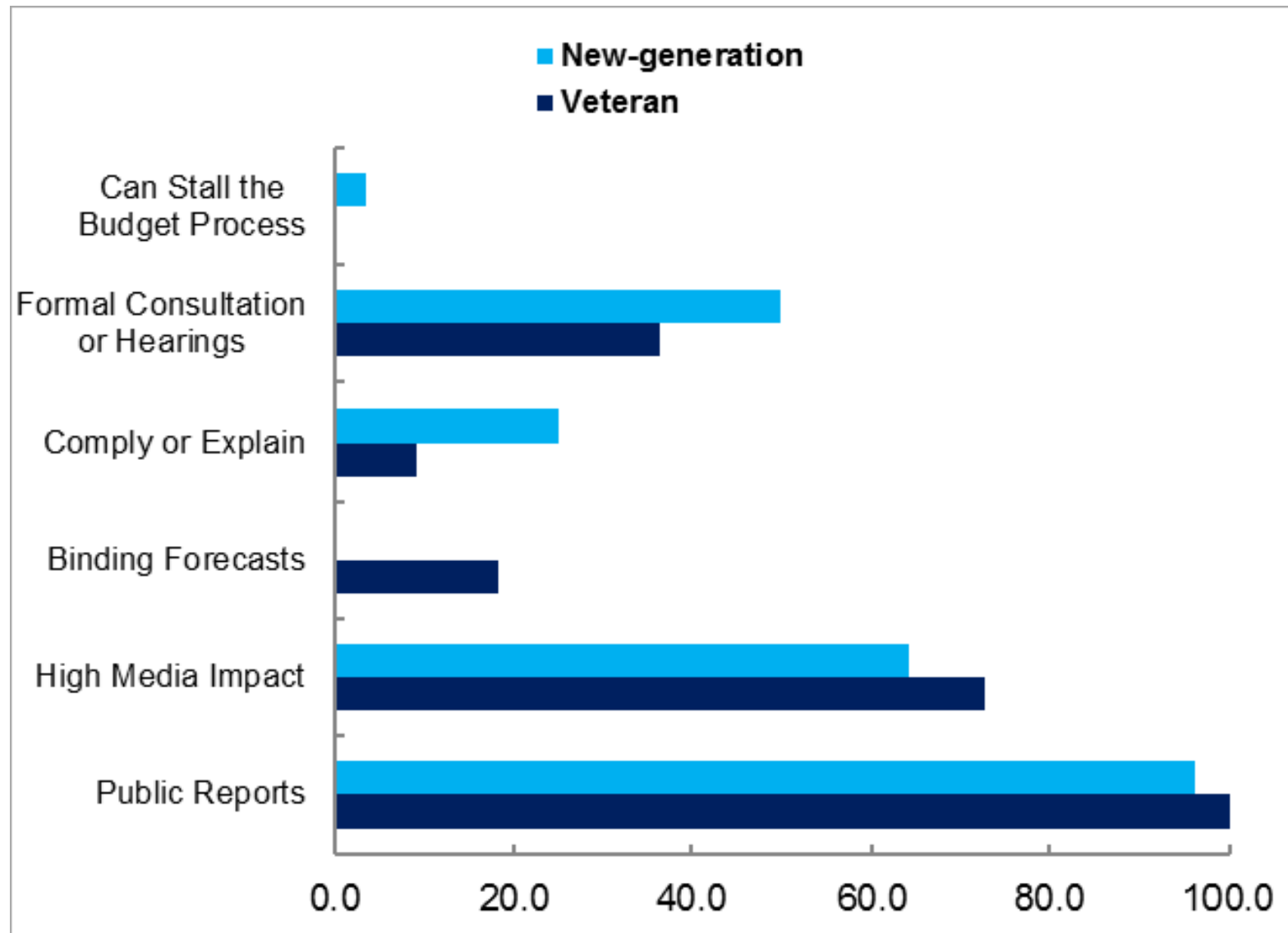


Source: IMF fiscal council dataset.

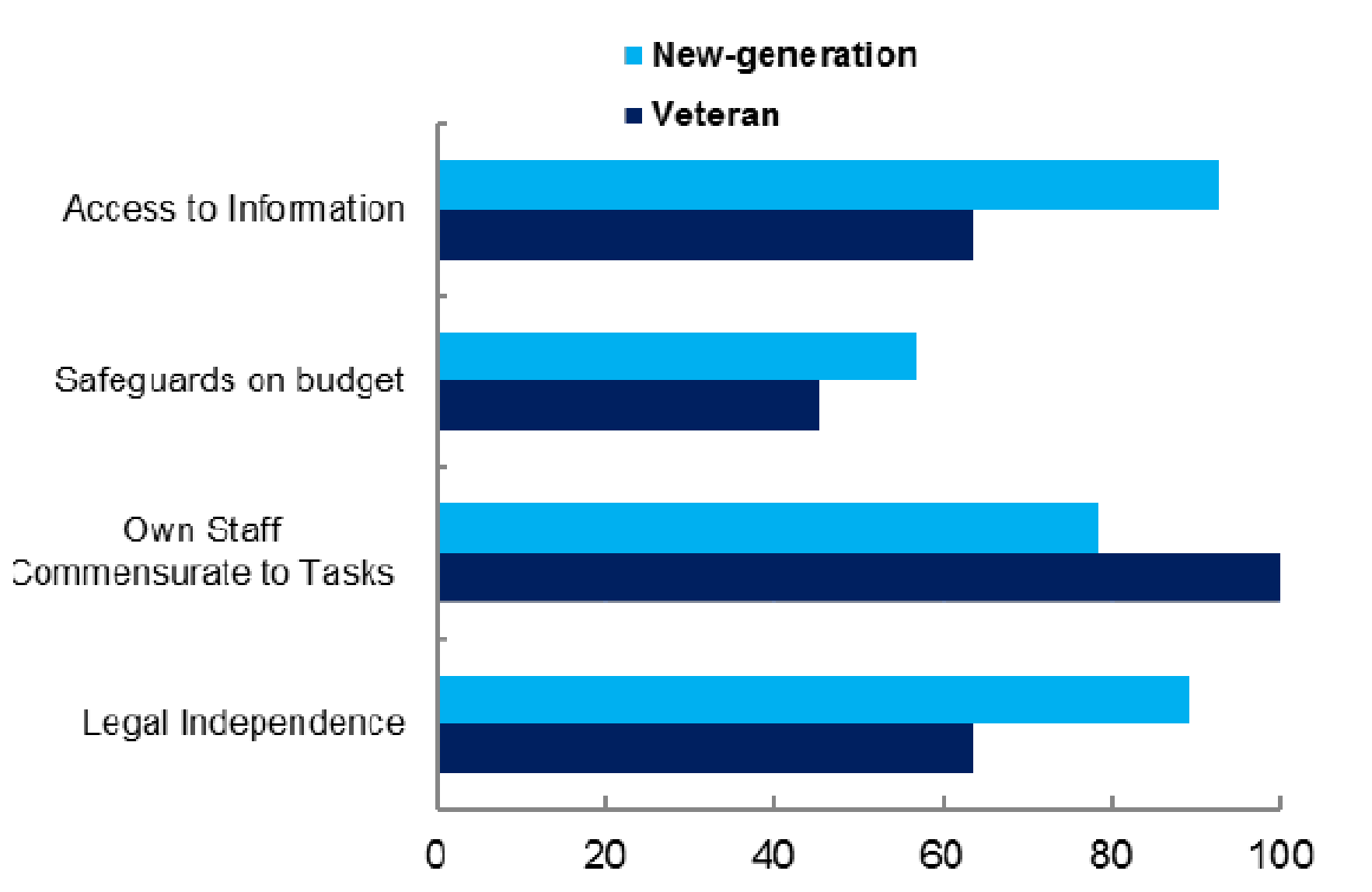
Channels of influence



Fiscal councils remit



Aspects of legal and operational influence



Forecasting errors (Beetsma et al., 2018)

$$ABS(FE_{it}) = \mu_i + \delta_t + \alpha FR_{i,t-1} + \beta FC_{i,t-1} + \sum_k \gamma_k X_{k,i,t-1} + \varepsilon_{i,t}$$

Table 5. Regressions for Absolute Forecasting Error in the Primary Balance

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Constant	1.680 (0.999)	1.934 (1.183)	2.086** (0.943)	1.732* (0.930)	3.235* (1.892)	1.988* (1.101)	1.703 (1.065)
Real-time output gap (lag)	-0.217 (0.128)	-0.219 (0.132)	-0.228 (0.147)	-0.0869 (0.0860)	-0.225* (0.124)	-0.219 (0.129)	-0.225 (0.135)
Debt to GDP ratio (lag)	-0.00891 (0.00986)	-0.0122 (0.0116)	-0.0106 (0.00987)	-0.00619 (0.0130)	-0.0120 (0.0110)	-0.00689 (0.00896)	-0.0114 (0.0109)
Fiscal rule index (lag)	0.174 (0.121)		0.175 (0.140)	0.122 (0.132)	0.144 (0.122)	0.0583 (0.196)	0.244* (0.121)
Fiscal council (lag)	-1.133* (0.601)		-1.260** (0.574)	-0.729* (0.368)	-1.077* (0.602)	-1.592 (1.001)	-1.104* (0.646)
Fiscal rule index (2nd lag)		0.0645 (0.102)					
Fiscal council (2nd lag)		-0.867* (0.460)					
Short-term interest rate (lag)			-0.185* (0.0975)				
10y bond yield (lag)				0.0352 (0.113)			
Government effectiveness (lag)					-0.985 (0.701)		
Fiscal rule and fiscal council interaction (lag)						0.233 (0.287)	
Absolute value of primary balance forecast error (lag)							-0.00941 (0.0508)

Compliance (Beetsma et al., 2018)

$$F^* - F_{it} = \mu_i + \delta_t + \alpha FR_{i,t-1} + \beta FC_{i,t-1} + \sum_k \gamma_k X_{k,i,t-1} + \varepsilon_{i,t}$$

VARIABLES

Constant	4.043** (1.764)	1.590* (0.785)
Real-time output gap (lag)	0.00584 (0.0637)	0.0300 (0.0645)
Debt-to-GDP ratio (lag)	-0.0740** (0.0337)	-0.0459*** (0.0156)
Fiscal rule index (lag)	-0.313 (0.345)	
Fiscal council (lag)	1.062* (0.552)	1.256** (0.484)

Summary empirical evidence

- Empirical evidence mildly favourable for independent fiscal councils
- However, amount of data limited – country fixed effects absorb most of variation
- Substantial heterogeneity in both fiscal rules and fiscal councils
- Design may be crucial – see EFB Annual Report 2017

Stronger 'comply-or-explain' principle

The 'comply-or-explain' principle is a strong instrument in the IFI's toolkit

- Implementation of this principle at the national level revealed some imperfections that need to be addressed

The effectiveness of the comply-or-explain principle can be strengthened through

- Anchoring the comply-or-explain provisions in national legislation
- Ensuring a more extensive and wide-ranging application of this principle
 - Specific details clarifying the nature, process and outcome of recommendations that fall under these provisions
 - Use of pre-defined deadlines for the government to react to IFIs' assessments in a detailed manner

Long-term evolution of this principle could be to allow IFIs to have the right of legislative initiative in cases of blatant disrespect of the fiscal rules by the government