Columbia Business School

EU Governance: Insights from Theory

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References: My Work on Fiscal Rules (Mostly with Marina Halac)

“Fiscal Rules and Discretion under Persistent Shocks,” 2014, *Econometrica*

“Fiscal Rules and Discretion in a World Economy,” 2018, *American Economic Review*

“Commitment vs. Flexibility with Costly Verification,” 2020, *Journal of Political Economy*

“Fiscal Rules and Discretion under Limited Enforcement,” 2022, *Econometrica*

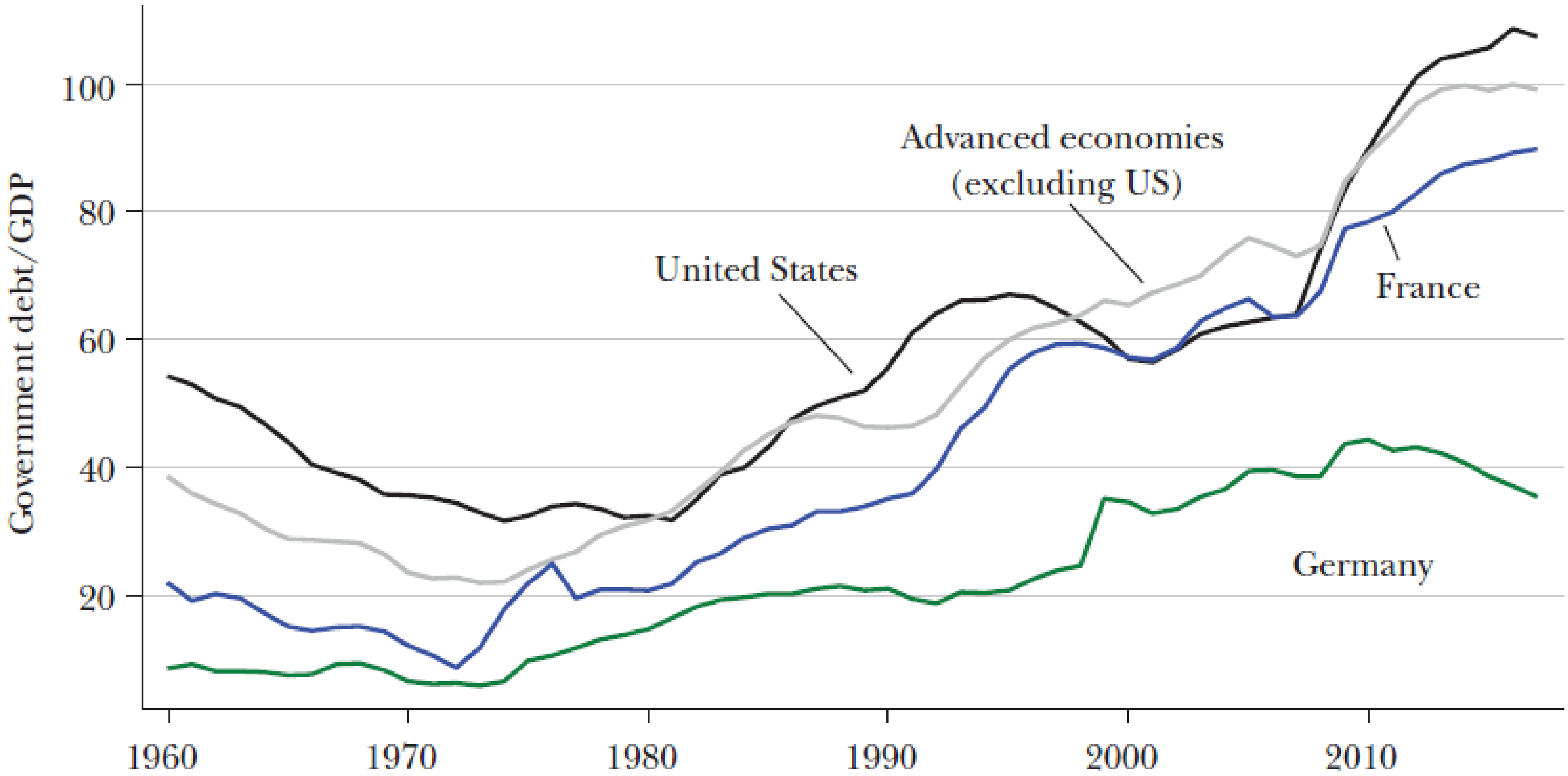
“Instrument-Based vs. Target-Based Rules,” 2022, *Review of Economic Studies*

“Rising Government Debt: Causes and Solutions for a Decades-Old Trend,” 2019, *Journal of Economic Perspectives*

Outline

- Why adopt fiscal rules?
- Cross-country coordination in an economic union
- Other issues: Enforcement, escape clauses, criteria

Rising Government Debt Across Advanced Economies



Rising Government Debt Across Advanced Economies

Table 1.2. General Government Debt, 2017–27
(Percent of GDP)

	2017	2018	2019	2020	2021	Projections 2022	2023	2024	2025	2026	2027
Gross Debt											
World	**82.0**	**82.2**	**83.6**	**99.2**	**97.0**	**94.4**	**94.1**	**94.5**	**95.0**	**95.4**	**95.5**
Advanced Economies	**103.2**	**102.7**	**103.8**	**123.2**	**119.8**	**115.5**	**113.7**	**113.1**	**113.0**	**112.9**	**112.7**
Canada[1]	88.9	88.9	87.2	117.8	112.1	101.8	98.5	96.2	93.4	90.5	87.7
Euro Area	87.5	85.5	83.5	97.3	96.0	95.2	93.4	92.1	91.0	90.0	88.9
France	98.1	97.8	97.4	115.2	112.3	112.6	112.9	113.1	113.3	113.6	114.0
Germany	64.7	61.3	58.9	68.7	70.2	70.9	67.7	65.5	63.2	60.9	58.7
Italy	134.2	134.4	134.1	155.3	150.9	150.6	148.7	147.2	145.7	144.3	142.9
Spain	98.6	97.5	95.5	120.0	118.7	116.4	115.9	114.7	114.5	114.5	114.6
Japan	231.4	232.5	236.1	259.0	263.1	262.5	258.3	258.7	259.4	260.5	261.8
United Kingdom	85.1	84.5	83.9	102.6	95.3	87.8	82.7	79.6	76.3	73.4	70.7
United States[1]	106.2	107.5	108.8	134.2	132.6	125.6	123.7	124.0	125.1	126.2	127.4

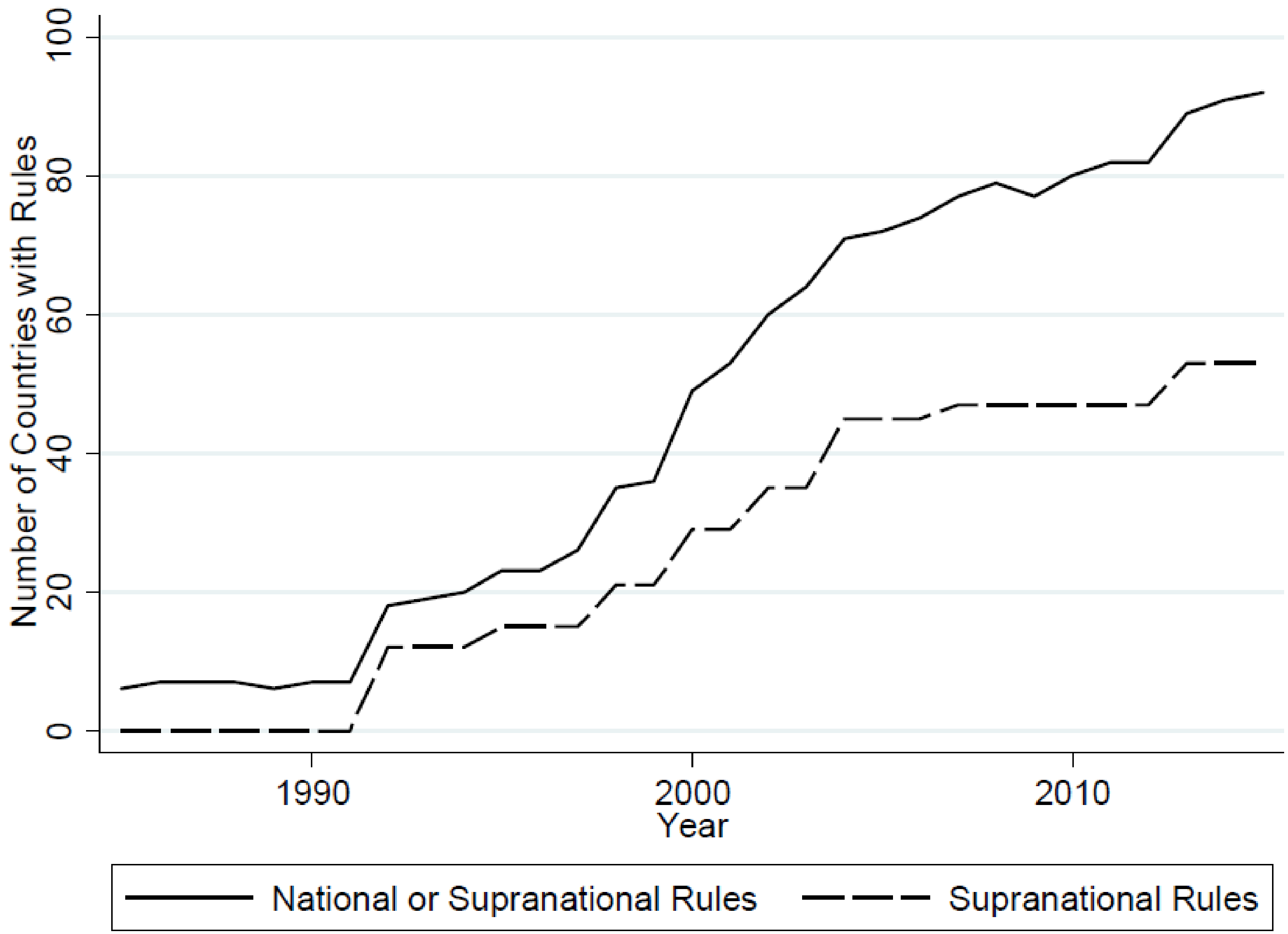
Fiscal Rules

- Political explanations for rising debt justify fiscal rules
  - Current governments want to be fiscally irresponsible
  - They want future governments to be fiscally responsible

- Governments across the world have adopted fiscal rules
  - Types: expenditure, revenue, deficit, debt
  - Level: subnational, national, supranational

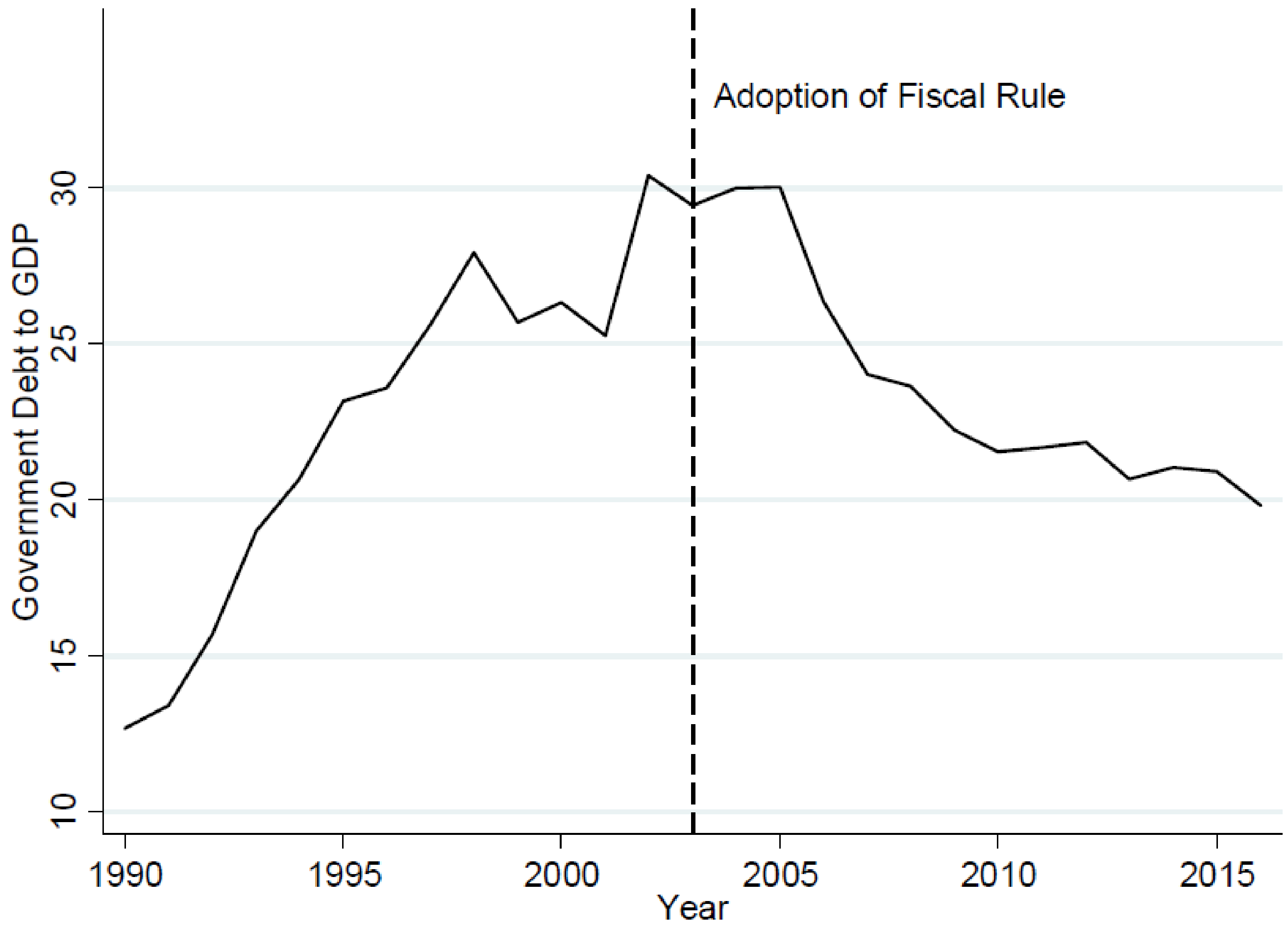
- Rules are an effective force against rising debt in some cases

Fiscal Rules Across the World



Data is from International Monetary Fund. A country is classified as having a fiscal rule if it is subject to an expenditure rule, a revenue rule, a budget balance rule, or a debt rule.

Adoption of Fiscal Rule in Switzerland



Government debt to GDP is gross central government debt as a percentage of GDP for Switzerland from World Bank. Date of adoption of fiscal rule is from International Monetary Fund.

Commitment vs. Flexibility

- Commitment vs. flexibility tradeoff
  - Commitment: Tighter rules limit present bias and debt accumulation
  - Flexibility: Tighter rules reduce flexibility to unexpected shocks
- Two modeling approaches to tradeoff
  - #1: Restricted rule structure → Determine optimal stringency
  - #2: Unrestricted rule structure → Determine optimal stringency and form
    - Distinguish between contractible and non-contractible fiscal info
    - Approach: Mechanism design with private government information
- Advantage of each approach
  - #1: Analysis feasible in rich political-economic framework
  - #2: Bird's eye view of optimal structure
    - Global vs. partial reform
    - Decompose factors behind different rule features

How to Condition on Information

- Measure **average** optimal primary deficit $d^{Forecast}$
  - Can condition on GDP, cycle, etc.

- When is $d^{Forecast}$ the optimal rule with deficit limit $d^* = d^{Forecast}$?
  - If deficit bias is severe and government borrows maximally
    - Government can choose any deficit below $d^{Forecast}$, but chooses not to

- Otherwise, optimal rule is more relaxed: $d^* > d^{Forecast}$
  - d^* is optimal <u>on average</u> whenever government chooses it
  - Example: Government wants to borrow 2 percent more than optimal
    - In equilibrium, d^* chosen whenever social needs exceed $d^* - 2$
    - Optimal d^* : Avg social needs conditional on exceeding $d^* - 2$ should be d^*
  - d^* higher if bias low or shocks volatile

Challenges

- How do we measure average optimal primary deficit $d^{Forecast}$?
  - Need appropriate normative model of social needs
  - Note: If goal is debt stabilization → $d^{Forecast}$ = -(avg interest expense)
  - Dependence on cycle poses challenges

- Could additional information help?
  - Optimal rule could depend on whether past policies agreed with targets
  - How to provide dynamic incentives challenging in practice
  - Perceptions of immediate and distant future can differ
    - Government wants to spend in immediate future
    - Does not want future governments to spend in distant future

- How do we measure the deficit bias?
  - Can compare historical deficit absent rule to normative benchmark
  - More sophisticated approach conditions bias on state of economy

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Supranational Rules

- More than half of fiscal rules are supranational
  - Many countries have national and supranational rules
- Rationale for supranational rules: Tragedy of the Commons
  - Individual borrowing decisions affect regional interest rates
  - High borrowing by one country risks future inflation in region
  - Future default by one country can have contagion effect on region
- Can frame as commitment vs. flexibility plus externality

Challenges

- Imposition of uniform threshold may be inappropriate
  - Countries differ on bias, fiscal needs, and benefit of flexibility
  - Conditioning on market signals (spreads) potentially more appropriate

- Direction and magnitude of externality is ambiguous
  - Tight rules can reduce regional interest rates, promote irresponsibility
  - Countries with more stringent national rules impose externality on others
    - This force pushes for even tighter supranational rules

- Issues with enforcement
  - Collective action problem and disagreement
  - External authority ideally less subject to political pressure

Central Fiscal Capacity

- Considerations for unleashing central fiscal capacity
  - Benefits: Larger capacity. Center internalizes externality from borrowing
  - Costs:
    - Tailoring to local economic condition more politically challenging
    - Center also suffers from deficit bias

- Center should be less restrained if country shocks correlated
  - Tailoring to local conditions less important and it internalizes externality
  - In this case, countries should be highly restrained
  - This is the US model

- Center should be highly restrained if country shocks uncorrelated
  - Center borrowing exacerbates deficit bias (no tailoring)
  - In this case, countries should be much less restrained

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How to Address Lack of Enforcement

- Governments comply with rules 50 percent of the time
  - Formal enforcement: Excessive Deficit Procedure in EU
  - Informal enforcement: Market punishment, bad precedent for future

- Under lack of enforcement, d* should be more relaxed
  - Also, if extreme shocks unlikely, sanctions weak → Occasional breach
  - Inefficient to impose a rule lax enough that it can always be respected
  - Optimal breach likelihood rises the weaker enforcement mechanisms

- How to calibrate d*
  - If rule never breached, corresponds to tightest enforceable rule
  - Under probabilistic breach, d* weighs costs and benefits
    - Benefit of tightening d*: More discipline
    - Cost of tightening d*: More likely breach and sanctions
    - d* is above average social needs conditional on binding limit
      - Additional benefit of relaxing limit is fewer costly sanctions

Challenges

- Determining whether rules have been broken is difficult
  - Off-balance sheet liabilities can grow
  - Need for independent fiscal councils

- Credibility of penalty mechanism is critical
  - Punishment through austerity measures hard to enforce
  - Credible punishments require a constituency that gains under penalty
    - Rule abandonment for the next administration more credible

- Private sector response to rule breach should be considered
  - Higher interest spreads in response to rule breach is a market penalty

Escape Clause

- Costly review process to break rule
  - Decision by independent fiscal council, legislature, or referendum
  - Example of reasons: natural disaster, financial crisis, accounting change

- Comparison to enforcement
  - Like enforcement, costly to trigger, deters government from spending
  - Unlike enforcement, costs directly related to evaluation
  - Useful even in absence of enforcement issues

- With escape clause, deficit limit d^* can be tighter
  - Allows more flexibility in response to extreme conditions
  - Optimal if review is cheap, shocks volatile, deficit bias severe
  - d^* above average social needs conditional on binding limit
    - Additional benefit of relaxing limit is fewer costly reviews on margin
  - Main challenge: Interpretation of events subjective, costly delays

Instrument-Based Rules

- Rules can constrain different instruments of policy
  - Example: tax rate/spending rules, “golden rules” on capital spending

- Rationale for different thresholds
  - Slacker rules for tools associated with volatile needs (e.g., military)
  - Slacker rules for tools associated with less bias (e.g., capital)

- Multiple layers optimal if complementarities in instruments
  - e.g., forecasted deficit rule on top of tax rate/spending rule
  - Optimal if temptation to spend rises if tax rates low

Instrument-Based vs. Target-Based Rules

- Target-based rule focus on outcome of policy
  - Example: deficit to GDP ratio, tax revenue

- Comparison to instrument-based rule
  - Directly ties incentives to economic goals
  - More instrument discretion to respond to macro conditions
  - Macro surprise risk: Penalties for rule breach despite best efforts
  - Optimal rule balances this risk against benefit of reining in bias
    - Rule admits threshold outcome beyond which penalties ensue
    - Target (average) outcome below threshold

- When are target-based rules better?
  - If government has sufficiently superior information about macro risks
  - If government bias not very severe
  - If penalties for rule breach are very severe, impose lots of discipline
  - Hybrid rules dominates either (e.g., Switzerland)
    - Instrument rule threshold, switches to target when violated

Summary

- Fiscal rules counteract rise in debt driven by political factors

- Challenges of adoption in an economic union
  - Uniformity
  - Externalities
  - Enforcement
  - Appropriate use of central fiscal capacity

- Commitment vs. flexibility tradeoff with many considerations
  - Enforcement
  - Escape clauses
  - Instrument vs. target criteria