

**Strengthened EU fiscal framework: fiscal discipline
versus economic stabilization**

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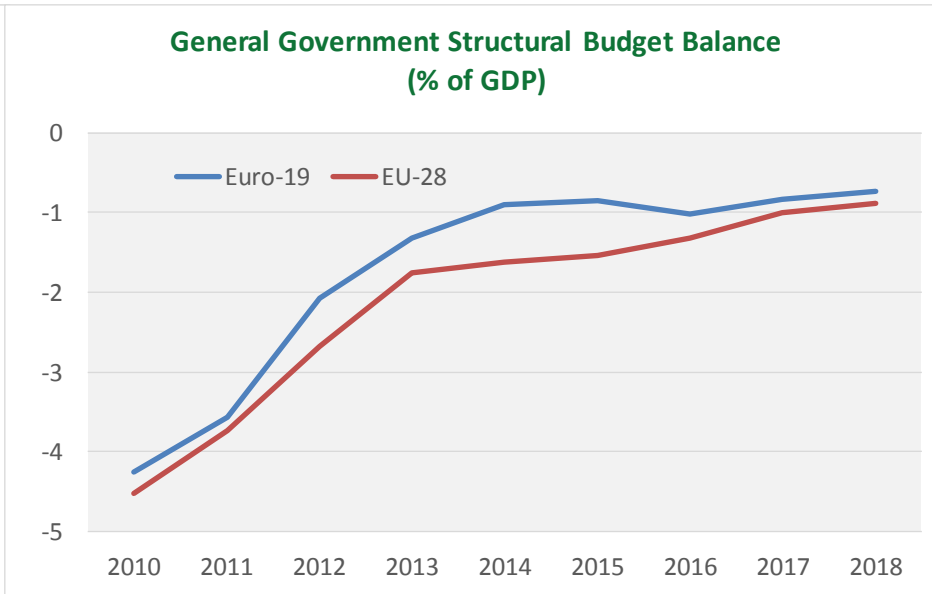
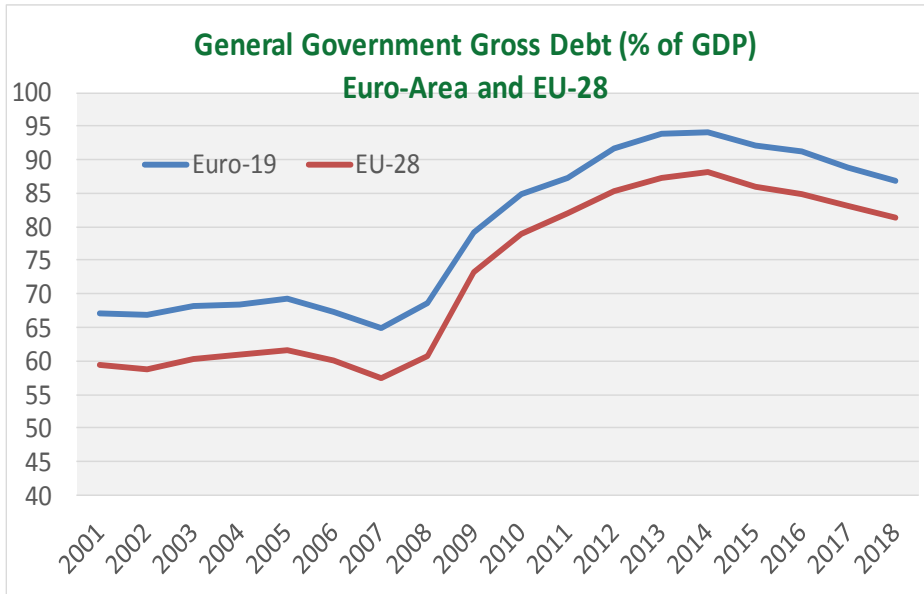
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Outline

- ❑ Strengthened fiscal framework...
 - Role of independent institutions
 - Role of fiscal rules
- ❑ ... increased fiscal discipline?
- ❑ Space for macroeconomic stabilization and shock absorption instruments
 - National/international
 - Public/private
 - Extension of EU shock absorber?
- ❑ Conclusions

Development of main fiscal indicators in EU-28 and EA-19



➔ Improvement due to stricter fiscal framework?

■ Deficit bias - a trigger for a strengthened fiscal framework

Deficit-bias of fiscal policy due to/manifested by:

- Political business cycles
- Short-sightedness, pro-cyclicality in good times
- Moral hazard and free riders
- Informational asymmetry, lack of transparency, fiscal illusion
- Biased official forecasts

Possible ways forward:

- Improving policymakers' incentives by raising reputational and electoral costs of unsound policies
- Raising public awareness to address fiscal illusion and contribute to a stability culture
- Independent forecasts, assessments
- Closing „technical loopholes“ through independent expertise
- Fiscal rules and independent fiscal institutions

■ Alexandre Lamfalussy (contribution to the Delors' Report, 1989):

- Recognition of **fundamental imperfections** in the functioning of market discipline:

“the constraints imposed by market forces might either be too slow and weak or too sudden and disruptive”

- ➔ Main rationale for the **inclusion of fiscal rules** and the **“no bailout” clause** in the Maastricht Treaty

FISK ■ Crisis quickened economic governance process of EU

Fiscal policy:

- **Surveillance** (Analysis, forecasts, reports, rules)
- **Prevention** (goals, programs, assessments, recommendations)
- **Correction** (procedures)

Structural policies:

- Europe 2020 strategy
- Macroeconomic imbalance procedure (MIP)

Crisis resolution:

- Financial assistance (ESM etc.)
- ECB's non-standard measures
- Banking&capital markets union



■ Role of independent fiscal institutions (IFIs) in the EU

- IFIs as **compulsory part** of the **economic governance process** (Twopack, Fiscal compact)
 - Involvement in the „European Semester“ (macro and fiscal forecasts, recommendations)
- IFIs as **link** between **member states and EU**
- IFIs as „competence center“ relating to **national fiscal policy**, but international examples show varying
 - range of tasks
 - setting of resources

Conditions for effectiveness of IFIs

□ OECD Principles for IFIs:

- Local ownership, broad-based political support
- Non-partisan opinion
- Technical expertise (no “black box”)
- Anticipation of need for adjustment
- Consistent communication, outreach

□ FISK’s lessons learned:

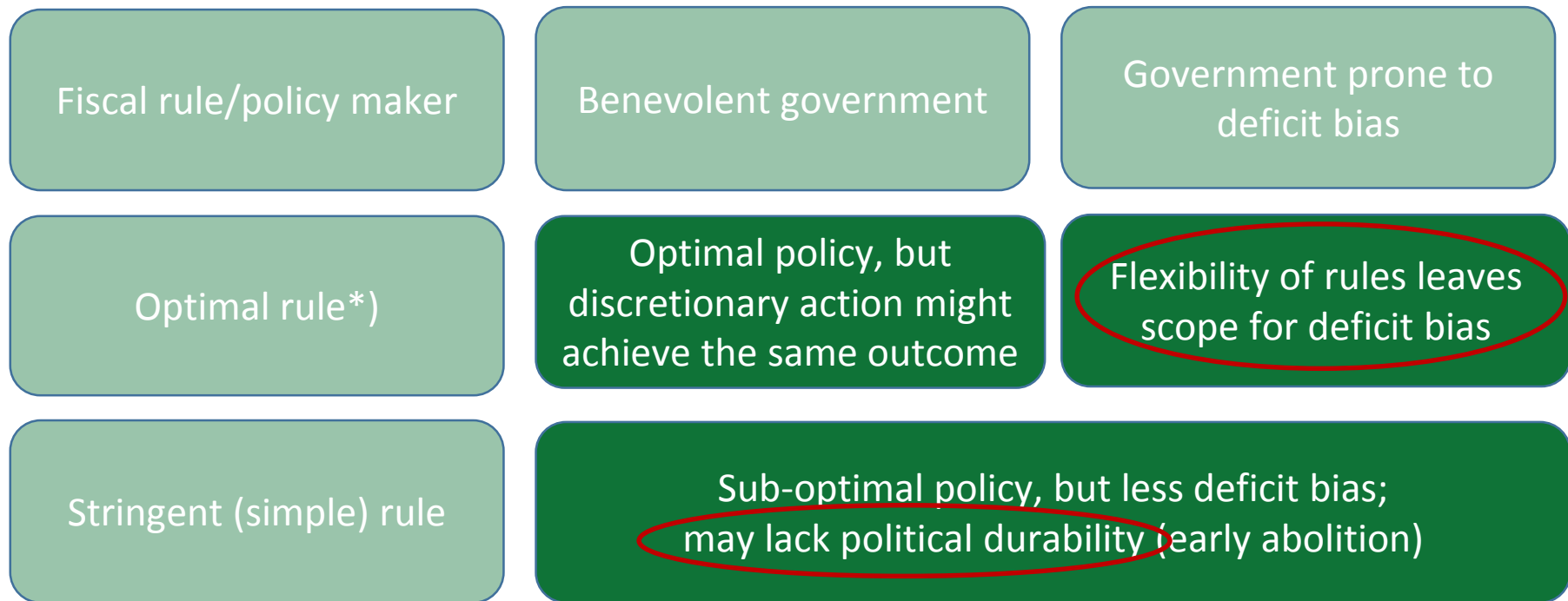
- FISK supports quality of official information
- Own disaggregated fiscal forecasts ensure
 - identification of potential fiscal gaps and
 - early warning for government’s counteracting measures
- High transparency and quality standards essential for the credibility and effectiveness
- Informal contacts and well founded data knowledge essential for evaluating the fiscal position
- Access to information is crucial
- Good media contacts are useful
- “Comply or explain” principle should be mandatory

IFIs impact on fiscal discipline: some evidence?

- ❑ **General potential impact of IFIs:**
 - **Beetsma and Debrun (2016):** IFIs can increase the likelihood of electing competent governments and discourage excessive deficits
- ❑ **IFIs impact on fiscal performance:**
 - **Debrun and Kinda (2014):** IFIs can promote stronger fiscal discipline as long as they are well-designed (certain characteristics of IFIs are associated with stronger fiscal performance, but the mere existence of a council is not)
 - **Coletta, Graziano and Infantino (2015):** empirical support for the hypothesis of a positive impact of IFIs on fiscal performance, notably depending on legal status (ensuring institutional and financial independence and access to inside information)
 - **Beetsma et al. (2018):** Tentative econometric evidence for more accurate/less optimistic fiscal forecasts and greater compliance with fiscal rules due to presence of IFIs

 **Potential causality issues?!**

Trade-off between simplicity and effectiveness of fiscal rules



Portes, J. and S. Wren-Lewis, 2014.

*) Rules that ensure tax smoothing as defined by Barro and anti-cyclical fiscal policy as defined by Keynes.

Effective fiscal rules ensure the achievement of their main goals:

- Keep/reduce debt-to-GDP ratio at/to a sustainable level
- Generating budgetary room of manoeuvre to absorb shocks

Conditions for effectiveness of fiscal rules

- ❑ **Design:** Kopits-Symanski criteria (1998) of good practice
 - Well defined
 - Transparent
 - Simple
 - Sufficiently flexible
 - Adequate to the final goal
 - Enforceable
 - Consistent and underpinned by structural reforms
- ❑ **Local ownership, political will** (regardless of statutory basis)
- ❑ **Monitoring** by IFI (FR and IFI are complementary)
- ❑ **No-bailout clause**, letting markets exert pressure

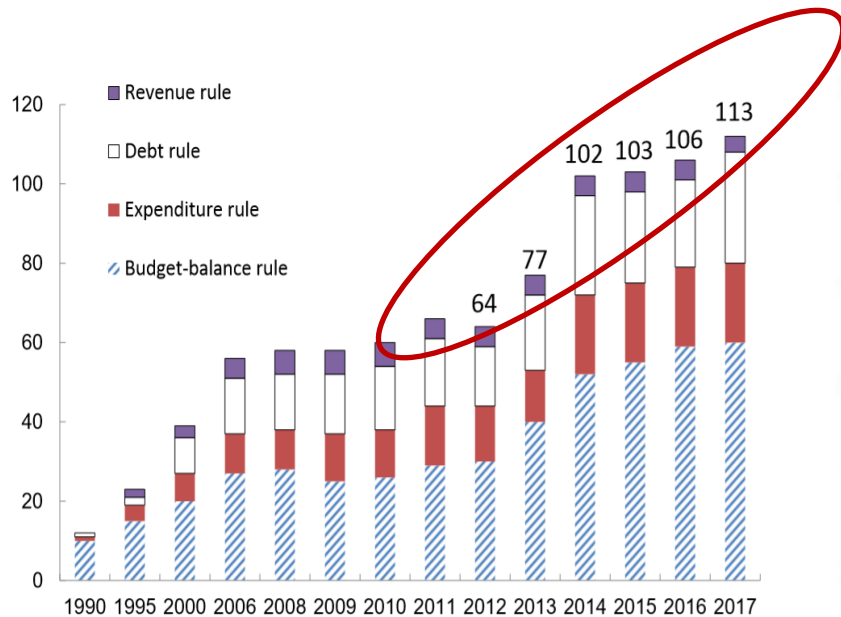
➔ ... but different economic policy models and traditions

Some evidence: do rules work?

- Increasing number of fiscal rules ...

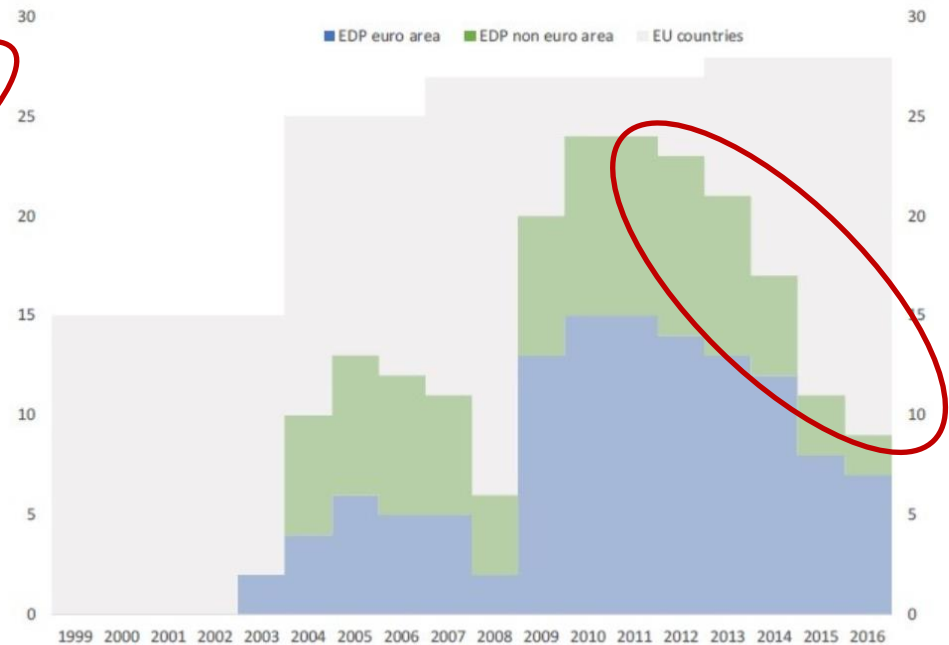
- ... but non-compliance?
 - Weak enforcement?
 - Just result of exogenous crisis?
 - Negative correlation 2012-2016

Number of numerical fiscal rules in force in the EU Member States by type



Source: European Commission, Fiscal rules database (2019)

Number of EU-countries under the EDP



Source: Diaz Kalan, Popescu and Reynaud (2018).

■ Fiscal rules' impact on fiscal discipline: some evidence?

- **Debrun et al., 2018:** unconstrained discretion might lead to neglect public sector solvency
- **Heinemann et al., 2017:** meta-regression analysis shows constraining effect of rules on fiscal aggregates, but endogeneity problem and publication bias
- **Bergman et al., 2016:** rules effective in reducing structural primary deficits; effect is smaller as government efficiency increases (institutional substitutes)
- **Reuter, 2015:** compliance with rules only in about 50% of the years; but link between introduction of rules and change of fiscal policy's behaviour
- **Badinger and Reuter, 2014:** positive effect of rules (new created indices based on POSET) on fiscal balance
- **Caselli and Reynaud, 2018:** no statistically significant impact of rules on fiscal balance on average, once endogeneity is adequately controlled for

➔ Optimal design of fiscal rules for achieving the desired outcomes...?

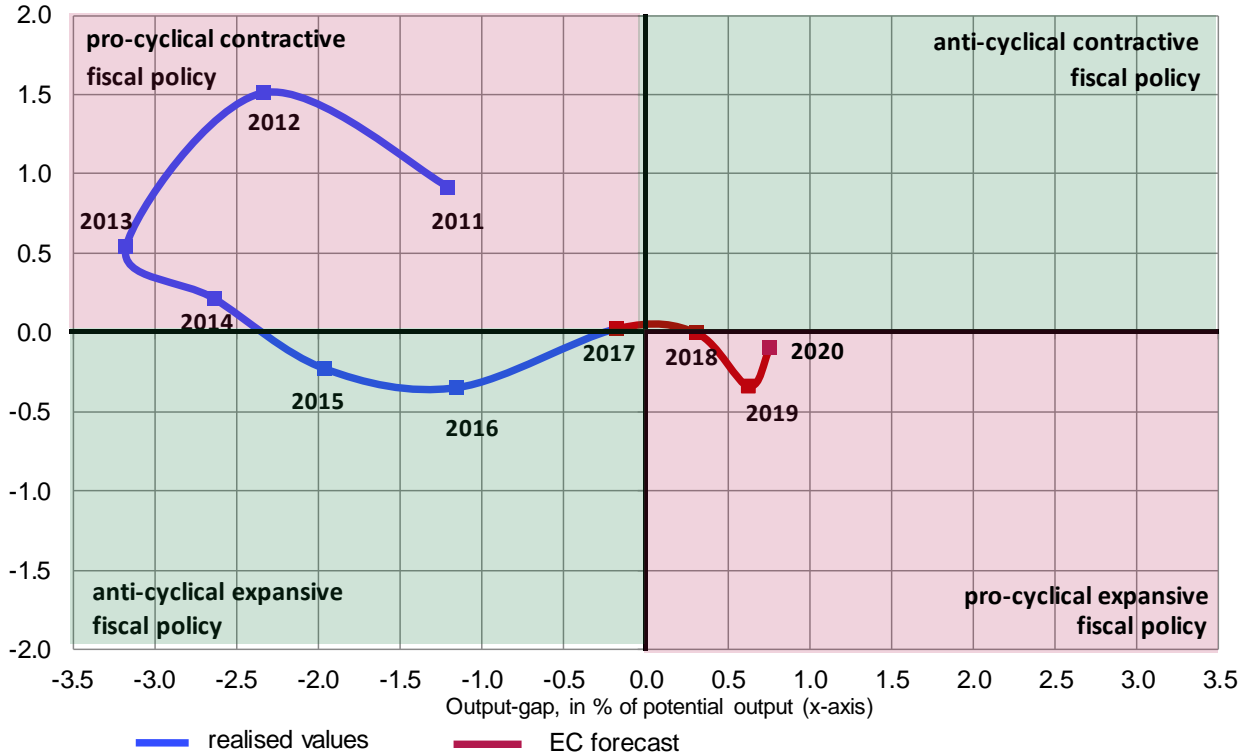
Need to improve fiscal (rules) framework...?

- **V. Gaspar and D. Amaglobeli (IMF, 2019)** ask for a fundamental reform of the EU fiscal rules - more urgent than ever:
 - High debt levels and the record of weak compliance and lax enforcement
 - Simpler and more transparent rules, better aligning political incentives with rule compliance
- **D. Gros (2014)** argues *“What the eurozone really needs is not a system that offsets all shocks by some small fraction, but a system that protects against shocks that are rare, but potentially catastrophic.”*
 - Minor cyclical shocks that do not impair the functioning of financial markets can be dealt with via borrowing at the national level
 - Full coverage by a common shock absorber only above certain threshold (“reinsurance” for national unemployment insurance systems)

Fiscal stance of EA-19

Structural primary balance of gen. govnt. and output gap 2011 to 2020

Change of structural primary balance in % of GDP (y-axis)



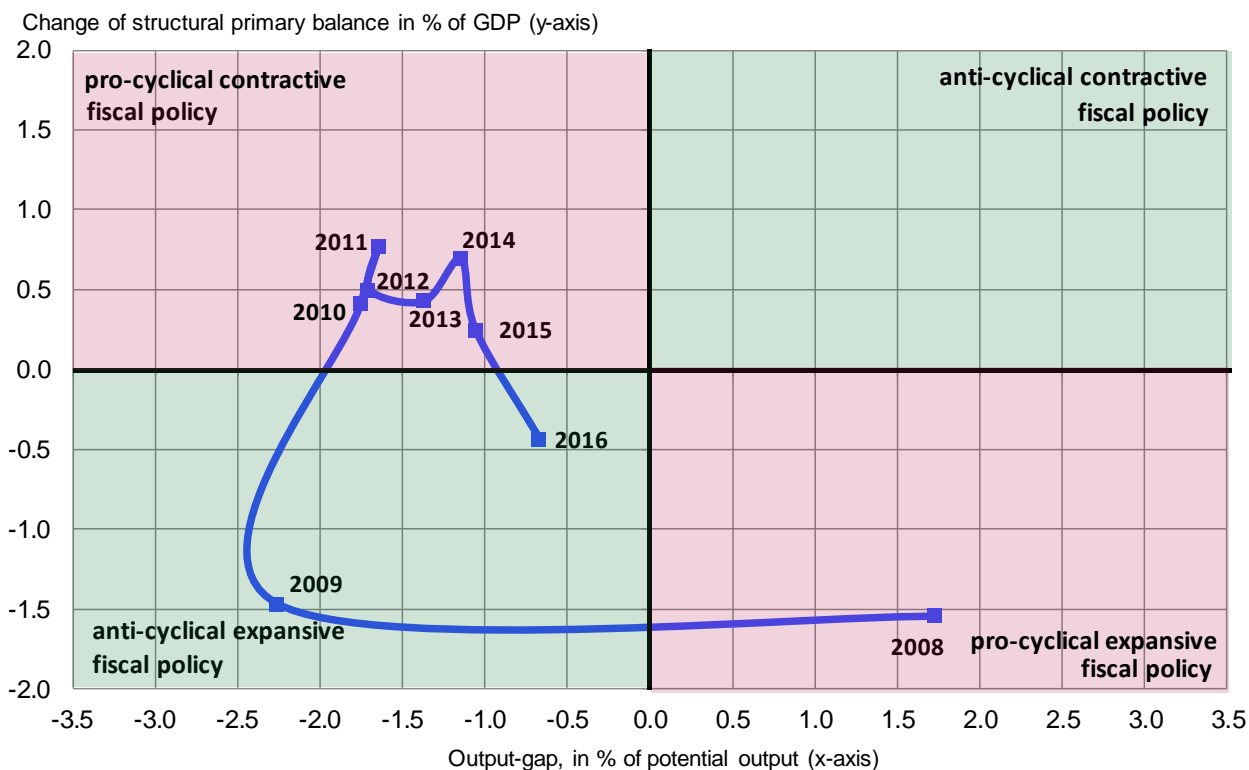
Source: EC fall 2018 forecast (2018 to 2020).

- ❑ Fiscal stance 2017 marginally restrictive
- ❑ Appropriate in light of significantly better-than-expected economic growth (EFB, 2018)

- ➔ Macroeconomic stabilization needs anti-cyclical fiscal policy
- ➔ Necessary achievement of MTOs might cause pro-cyclicality

Fiscal stance of OECD (without EU-countries)

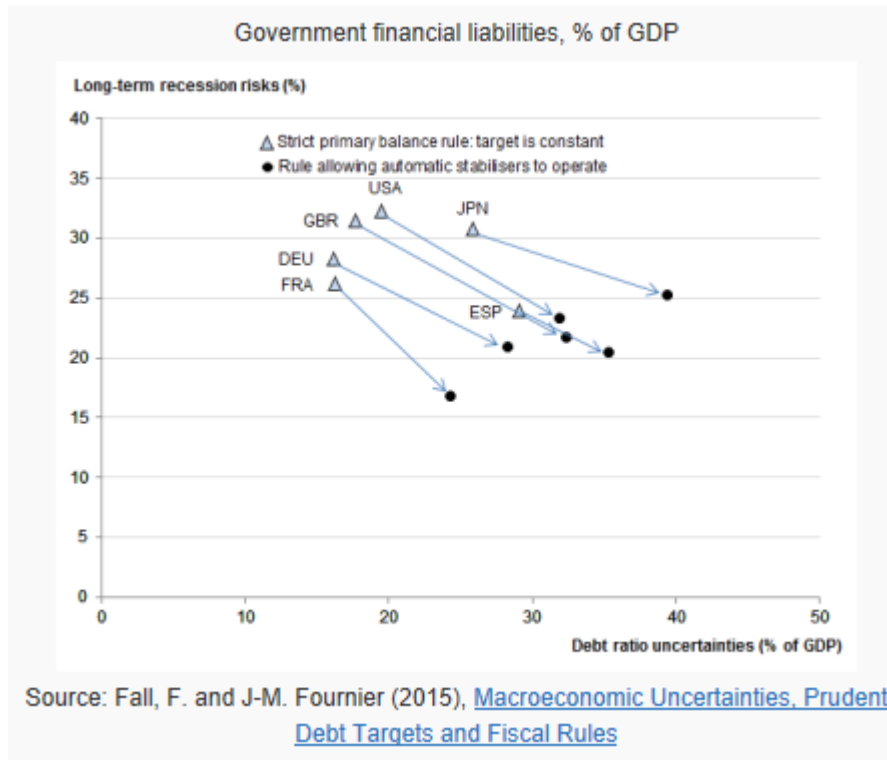
Structural primary balance of gen. govnt. and output gap 2008 to 2016



Source: OECD and own calculations.

➔ ... but feasible pro-cyclicality might be no single matter of fiscal rules

Trade-off: promoting fiscal discipline and permitting macroeconomic stabilization



- But...**
- structural balance rules:**
- ➔ Let automatic stabilizers work and ensure sustainable debt levels
 - ➔ Reduce excessive discretionary expenditure and thus output volatility
 - ➔ Flexibility of SGP (clauses, relevant factors ...) ensures additional room of manoeuvre

Note : The long-term recession risk is the probability of GDP per capita growth to become negative. The uncertainty surrounding the debt trajectory is assessed by the interquartile range of the debt level in 2040. The “Constant primary balance” simulation is a stylised scenario in which the actual primary balance is kept constant such that the prudent debt target is reached, with no automatic stabilisers. In the scenario labelled “Automatic stabilisers”, a one percentage point negative surprise in the output gap is associated with a 0.4% of GDP stimulus.

Fiscal rules with regard to fiscal discipline and room for macroeconomic stabilization

Objective: long-term sustainability of public finances

Operative rules	Strengthening of fiscal discipline	Support to macro-economic stabilization	Risks and implications
Nominal budget balance rule	<ul style="list-style-type: none"> Boosts fiscal discipline 	<ul style="list-style-type: none"> No flexibility for economic stabilization Tends to procyclical fiscal policy 	<ul style="list-style-type: none"> Consolidation might worsen quality of public finances
Structural budget balance rule	<ul style="list-style-type: none"> Boosts fiscal discipline Defines room for discretion 	<ul style="list-style-type: none"> Let automatic stabilizers work 	<ul style="list-style-type: none"> Uncertainty of potential output/output gap measures impede planning and monitoring
Expenditure rule	<ul style="list-style-type: none"> Boosts fiscal discipline Possible integration into budgetary process Directly influenceable 	<ul style="list-style-type: none"> Limited development of automatic stabilizers on the expenditure side 	<ul style="list-style-type: none"> Does not ensure balanced budget Possible evasions
Debt rule	<ul style="list-style-type: none"> Boosts fiscal discipline Usually no operative rule but anchor 	<ul style="list-style-type: none"> Tends to procyclical fiscal policy 	<ul style="list-style-type: none"> Often distorted by special items Possible evasions

➔ More than 96 countries make use of fiscal rules (resp. budget balance and debt rules; average number = 2,0; Source: IMF, 2017).

National fiscal shock absorber

- ❑ **Fiscal measures** to ensure economic smoothing
 - Automatic stabilizers
 - Discretionary fiscal policy
 - ❑ Higher **fiscal multipliers** in recessions (e. g. Woodford, 2011)
 - ❑ **Fiscal space** - scope for budgetary manoeuvre while preserving overall fiscal soundness (ECB, 2017) – e. g. determined by:
 - Fiscal frameworks (e. g. distance of structural balance to MTO, flexibility instruments depending on cyclical and other „relevant“ factors)
 - Comprehensive debt sustainability analysis
 - Debt limits (i. e. distance of current debt-to-GDP ratio to sustainable levels)
- ➡ Growth-friendly structural reforms to generate fiscal space
- ➡ Use existing fiscal space to support structural reforms and to boost long-term growth potential

■ **Monetary policy's contribution to gain fiscal space via lower interest payments - case of AT**

	Bundesbank	FISK	OeNB	OeBFA
Interest savings	35 bn	9.3 bn	3.5 bn	17 bn
Considered entities	General gov (ESA) (no correction for reclassifications)	Federal gov excl. off-budgetary entities	General gov (ESA) (corrected for reclassifications)	Federal gov excl. off-budgetary entities
Considered time horizon	2008-2016	2009-2016	2012-2016	2009-2016
Counter-factual	Implicit interest of 2007 (4.9%)	Implicit interest of 2008 (4.31%)	Re-financing based on forecast assumptions (06/2012)	Re-financing rel. to average interests 1999-2008 (4.17%)

➔ Monetary policy contributed to fiscal space in the past...

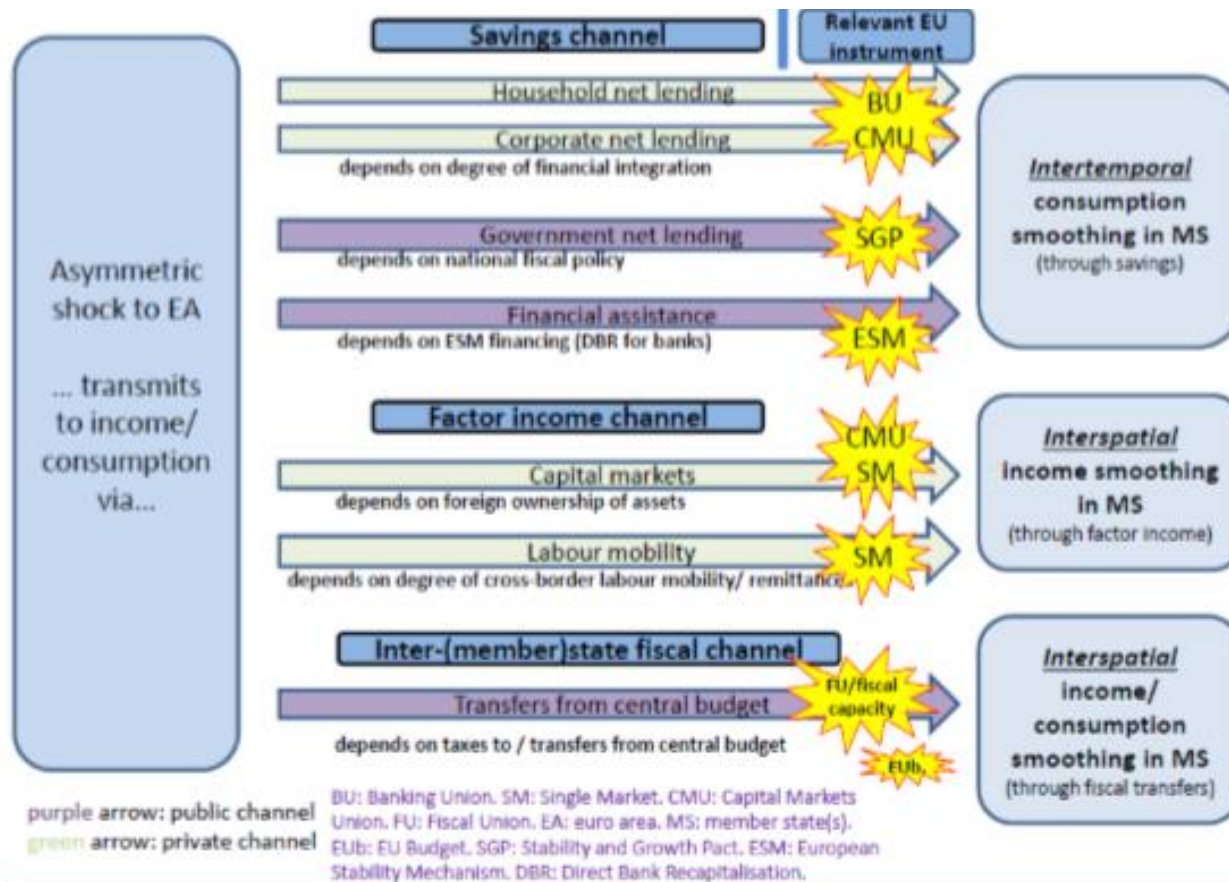
➔ ... but increasing fiscal risks due to expected interest changes

■ Macroeconomic stabilization and shock absorption instruments in the EU and the EA

■ Status quo ... (Katterl and Koehler-Toeglhofer, 2018):

- SGP including macroeconomic imbalance procedure (MIP)
 - ESM as a lender of last resort
 - EU-Budget
 - National fiscal or regulatory buffers (automatic stabilizers, institutional set up, market flexibilities etc.)
 - European financial union (banking union, capital markets union, macroprudential supervision)
 - Monetary policy measures (e. g. targeted longer-term refinancing operations – TLTRO; Asset Purchase Programme – APP)
- Fiscal policy
- Non-fiscal policy

Private and public shock absorption channels and EU/EA instruments



- ❑ 3 channels as **complements** based on recent research
- ❑ **Increased shock-absorption capacity in EA** (ECB, 2018):
 - Higher financial integration
 - E. g. activation of EFSF/ESM
- ❑ „**Calibration**“? (Daianu, 2018):
 - Risk reduction (by rules) vs sharing
 - Private vs public risk-sharing

■ Additional stabilization and shock absorption instruments necessary?

Common risk sharing mechanism against asymmetric shocks (Andritzky and Rocholl, 2018; EK, 2017), e. g.:

- ❑ **Rainy day funds** with pay-outs proportional to downturns
 - ❑ **Reinsurance** for national **unemployment** insurance systems (regular premia to a central euro area fund, pay-outs just for large shocks that exceed specific thresholds) or **investment** protection capacity
 - ❑ Strengthening market discipline ex ante by an **operational debt restructuring framework** (1st stage: maturity extension, 2nd stage: deeper debt restructuring)
 - ❑ **Common safe asset** (e. g. 'sovereign bond backed securities' (SBBS) issued by intermediaries that would purchase a diversified pool of euro area sovereign bonds)
 - ❑ **European Monetary Fund**
 - ❑ **Enhancing the ESM's** lending toolkit
 - ❑ **European finance minister** defending European interests
- ➡ **Now** – after the crisis and a strengthened fiscal framework – enough incentives to keep public indebtedness low to avoid getting into trouble, just by **market discipline**?
- ➡ **More risk-sharing** (through completing BU, CMU and a fiscal capacity) would notably **improve EA's shock absorption capacity** (SUERF PN 21/2017)

Conclusions

- ❑ **Fiscal stabilization matters**
 - Sound public finances define scope for (discretionary) fiscal stimulus
 - Automatic stabilizers play an important macroeconomic stabilization function
 - Design of fiscal rules is crucial
- ❑ Improving the **quality of public finance** is key to ease trade-offs between consolidation, equity and long-term growth objectives
- ❑ From a longer term perspective, fiscal policy should be framed by fiscal rules, complemented by a **well-designed institutional framework**, where fiscal councils play a key role
- ❑ **Central fiscal capacity** might counteract asymmetric shocks without violating fiscal rules

Contact and links

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