European Fiscal Board

Annual Report 2018

Roel Beetsma, Member of the European Fiscal Board

CEPR – Paris, 15 April 2019

Annual Report reflects EFB mandate

Main tasks of the EFB

Evaluation of the implementation of the Union fiscal framework

Cooperate with the **national fiscal councils**; exchange **best practices**

Assessment of fiscal stance

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

Annual Report

Chapter 2: SGP implementation in 2017

Chapter 3: Independent fiscal institutions

Chapter 4: Fiscal stance in 2017

Chapter 5: Flexibility clauses 2015-2017

Chapter 6: Future evolution of SGP

Recent initiatives to improve the SGP

SIMPLIFICATIONS
CLARIFICATIONS

MOVED IN OPPOSITE DIRECTIONS

MORE ECONOMIC JUDGEMENT
MARGIN OF DISCRECTION

- More prominence to expenditure benchmark in preventive arm of SGP
- Use of expenditure benchmark in corrective arm of SGP
- Attempt to clarify reading of the two indicators in assessing compliance with SGP

- Plausibility tool for output gap estimates
- Country-specific changes to commonly agreed methodology for output gap estimates
- Introduction of 'margin of discretion' on top of existing flexibility

In sum, recent innovations have increased complexity; they have been added to, not simplified, existing provisions

Implementation of the EU fiscal framework in 2017

MACROECONOMIC SITUATION: SOLID AND BETTER THAN EXPECTED

EU: outcomes vs. forecasts

• GDP growth	+2.4%	(+1.9%)
• Pot. GDP growth	+1.7%	(+1.4%)
• Output gap	- 0.1%	(-0.2%)

FISCAL POSITION IMPROVED

	2016	2017
• Deficit	-1.6%	-1.0%
• Structural bal.	-1.2%	-0.8%
• Debt	84.8%	83.1%
• In EDP	5	2
• At MTO	6	13

SGP IMPLEMENTATION: MUCH FORBEARANCE

Lack of symmetry: rules and discretion softened adjustment requirements while economy performed better than expected

Windfalls only partially used for consolidation

Euro area: 1/3 of higher revenue used to raise expenditure compared to plans

Lopsided use of windfalls:

- **Less fiscal adjustment by high-debt and EDP countries**
- **More by those already enjoying a healthier fiscal position**

2017: a missed opportunity

to secure a faster reduction of high debt and build fiscal buffers where needed

Objectives of the reform

1. **SIMPLIFYING THE RULES**
   - A single fiscal anchor, a single requirement, a single indicator of compliance and a general escape clause.

2. **STRENGHTENING PREDICTABILITY**
   - Fiscal requirements set for a three-year period.
   - No revision of requirements.

3. **STRONGER ENFORCEMENT**
   - Deviations from requirements must be compensated.
   - Sanctions (in the form of EU funds conditionality) already kick-in under the preventive arm.

4. **A MORE TRANSPARENT GOVERNANCE**
   - Economic analysis demarcated from policy decisions.
   - Escape clause triggered based on independent assessment, with “comply-or-explain” principle.

Proposal for a new fiscal framework

CURRENT SGP

TWO FISCAL ANCHORS:
- → Maintain balanced budget over the cycle, with deficit ceiling at 3%
- → Reduce debt to 60%

FOUR FISCAL REQUIREMENTS:
- → Structural budget balance
- → Nominal budget balance
- → Net expenditure growth
- → Short-term debt dynamics

MANY FLEXIBILITY PROVISIONS:
- → Fiscal adjustment modulated over the cycle
- → Flexibility clauses: investment, structural reforms
- → Several escape clauses covering different contingencies: economic downturn, unusual events

SURVEILLANCE:
- → Annual surveillance cycle

GOVERNANCE:
- → Commission and Council

NEW FISCAL RULES

ONE FISCAL ANCHOR:
- → Reduce debt to 60%

ONE FISCAL REQUIREMENT:
- → Net expenditure growth

ONE ESCAPE CLAUSE :
- → Covering different contingencies (economic downturn, unusual events)

LESS INVASIVE SURVEILLANCE:
- → 3-year surveillance cycle

UPGRADED GOVERNANCE:
- → Commission and Council
- → Independent bodies to produce economic assessment including for escape clause

Proposal for a new fiscal framework

OBJECTIVE

Debt below 60% of GDP

FISCAL REQUIREMENT

(Net) primary expenditure growth capped at level ensuring decline of debt ratio

MONITORING COMPLIANCE

Expenditure growth exceeds cap by more than 1% of GDP?

NO

Compensate deviation over time

YES

Exceptional circumstances?

(Involvement of independent body)

NO

Sanctions

YES

Escape clause

Can analysis be more clearly demarcated from political decision-making?

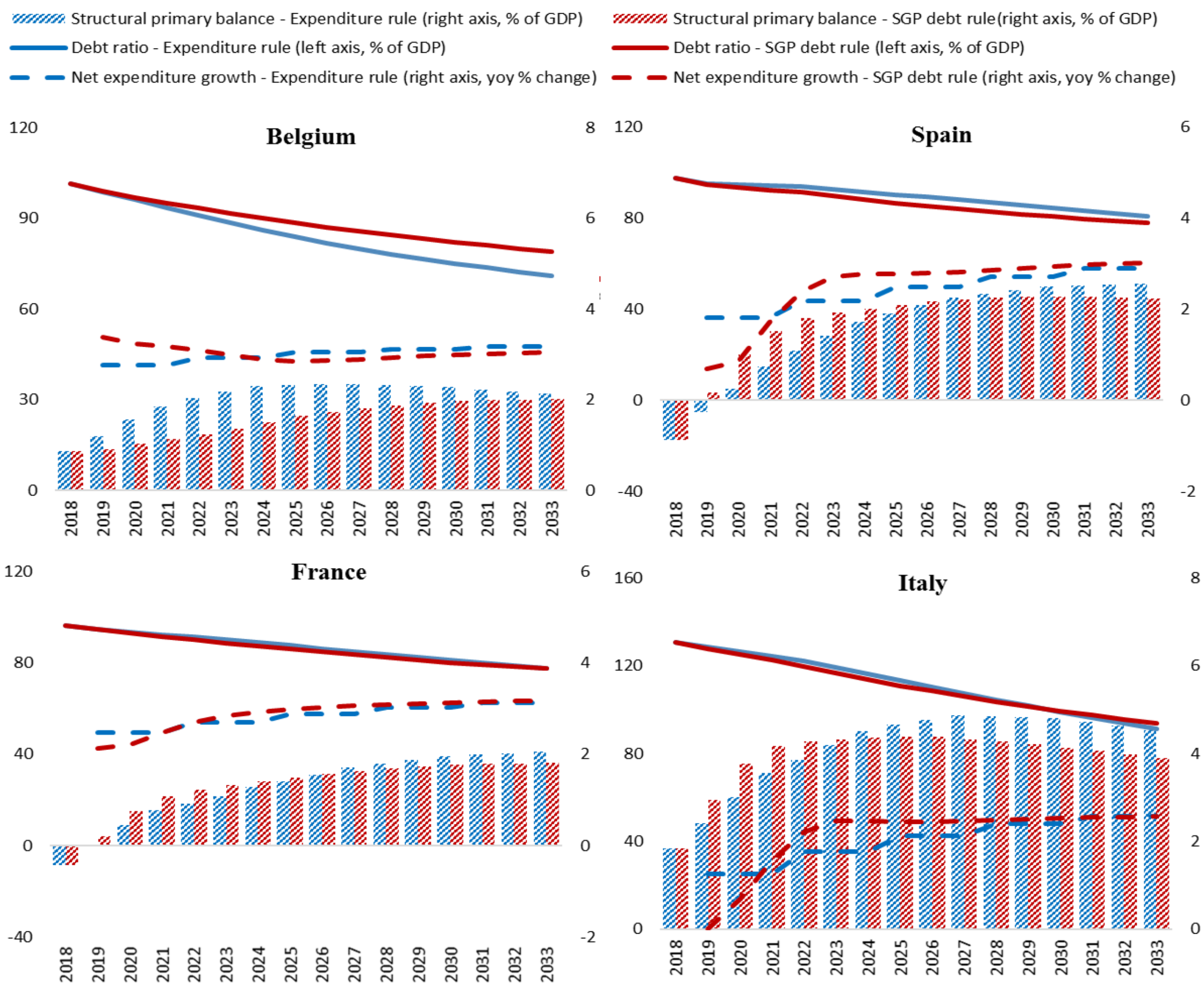
Functions in country surveillance	Description	Institution in charge in the post-crisis EU
(1) Advisory function	Provide analysis/advice to national governments	Commission: central role
(2) Rating agency function	Supply information to the public (and financial markets) about country performance and prospective compliance with rules	Commission: increasing role
(3) Creditor/lender function	Provide the basis for decisions on conditional lending to countries	ESM to have a larger role as the representative of future creditors

Demarcation between analysis and decision-making is important for (2) – and for the survival of a rules-based system

Political evaluations are an unavoidable part of recommendations in challenging cases – but **only after an independent analysis** is provided by a non-political Commission staff (DG ECFIN) or by an outside agency and a "comply-or-explain" process when required

The proposed expenditure rule in practice

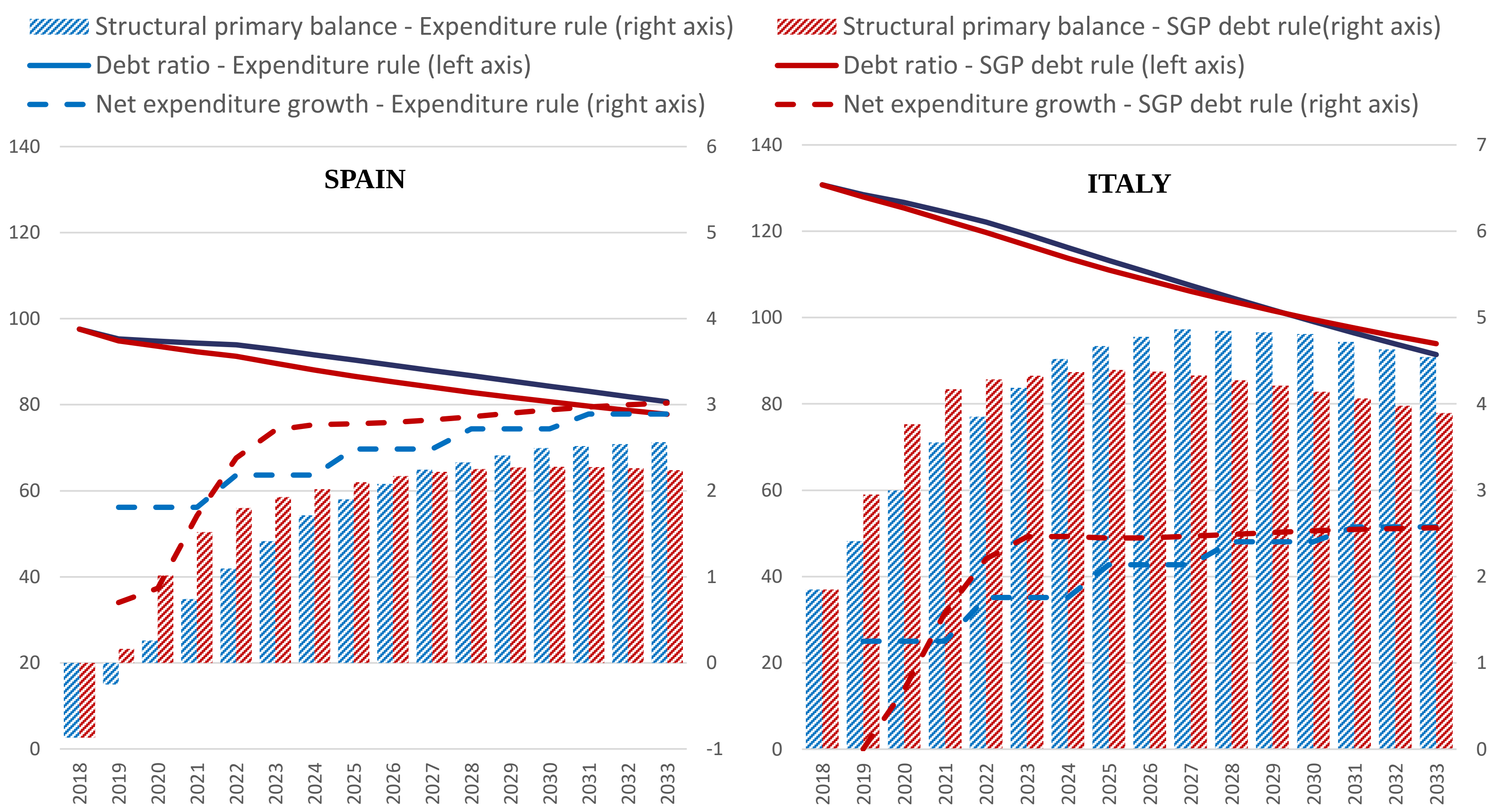
For high-debt countries, the expenditure rule (blue) achieves comparable rates of debt reduction than the current debt rule in the SGP (red), but is less pro-cyclical.



Note: The adjustment path under the expenditure rule is computed assuming that the economy is growing at its potential rate and that inflation is at 2%. Implicit interest rates are computed assuming that long-term nominal rates converge to 5% over ten years, and interest expenditures increase in line with the expected roll-over schedule of debt.

Background: Ch. 6 – Simulations of proposed rule vs existing debt rule

Medium term: proposed rule achieves same debt reduction as current debt rule
Short term: proposed rule allows for greater economic stabilisation



***Note**:* The adjustment path under the expenditure rule is computed assuming that the economy is growing at its potential rate and that inflation is at 2%. The adjustment path under the debt rule is computed based on actual projections for GDP and inflation. Implicit interest rates are computed assuming that long-term nominal rates converge to 5% over ten years, and interest expenditures increase in line with the expected roll-over schedule of debt.
'Net expenditure growth' refers to the growth rate of primary expenditures at current prices, net of discretionary revenue measures and cyclical

Thank you for your attention

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

Background slides

Main messages of annual report 2018

- Macro-economy of euro area and EU markedly better than expected in terms of real GDP growth; inflation also slightly higher
- SGP not adjusted to better economic conditions due to
  (i) asymmetry of rules and
  (ii) discretion applied to soften requirements
- Use of windfalls lopsided:
  (i) countries with favourable public finances took advantage;
  (ii) high-debt countries spent important part of higher revenues
- Some national IFIs successful in strengthening public scrutiny
- Recent attempts to simplify SGP not effective or not followed through with consistently. Overhaul of SGP needed: EFB proposes simplification of the framework coupled with review of governance

Notable cases of forbearance in 2017 fiscal surveillance cycle

- **SI:** Required **fiscal adjustment weaker than implied by matrix** of requirements in spring 2016
- **SI and PT:** Final assessment: **ad hoc correction to the expenditure benchmark** by COM, adjusting the medium-term reference rate
- **IT:** Final assessment benefited from:
  (i) **generous reading** of structural balance indicator;
  (ii) carryforward of flexibility from previous years, **although safety margin not observed**;
  (iii) **quantification** of refugee-related costs not in line with past practice
- **BE:** COM concluded on **no sufficient evidence to establish a significant deviation**, although evidence from 2018 spring forecast and ample use of **margin of broad compliance**
- **BE and IT: Insufficient debt reduction** but no procedure launched due to broad interpretation of **'relevant factors'**
- **FR and ES:** Continued to follow a **'nominal strategy' under the EDP**, i.e. replaced adjustment with windfalls

Independent fiscal institutions

Role in 2017 fiscal surveillance cycle

- Some IFIs helped with the implementation of rules: Italy, Romania
- Others remained silent
- Different reactions reflect different mandates and constraints:
  - Role in preparing forecasts
  - Timing and coverage of assessment
  - Availability of information
- Information issue: IFIs do not have the same real-time information as the Commission
- Coordination issue: IFIs not involved in discussions between Commission and governments

Fiscal stance in the euro area: marginally restrictive

July 2016 Commission and Council guidance: **broadly neutral fiscal stance**

Nov 2016 Commission guidance: **fiscal expansion of up to 0.5% of GDP**

- No major change in economic outlook
- Not feasible without at least some countries breaching the SGP
- Coming at an advanced stage of the recovery
- Not backed by the Council

Outturn as estimated in spring 2018: **marginally restrictive fiscal stance**

- Fine on aggregate, structural primary balance improving by 0.1 % of GDP
- Generally improved country composition
- But notable exceptions:
    - Italy and EDP countries (France, Spain): no/insufficient consolidation
    - Germany: consolidated even further
    - Some countries did not use the higher-than-expected revenue to reduce their high debt but to increase expenditure

Review of flexibility in 2015-2017

- **January 2015: COM Communication on 'Making the best use of the flexibility** within the existing rules of the SGP'
- **Early 2016: Commonly agreed position** reached with the Council

Our main findings:

- **Flexibility for cyclical conditions: marginal modulation** of fiscal efforts compared to benchmark of 0.5% adjustment per year
- **Element of asymmetry:** more modulation for bad economic times coupled with tendency to underestimate good times when they occur
- **Not much of an incentive to invest or reform:** the two countries that applied for the investment clause **did not actually increase investment**; only few countries used the reform clause, and **assessment** of implementation was **not always conclusive**
- **No visible impact on compliance:** Member States failed to meet even much reduced adjustment requirements
- **Unusual event clause:** applied quite frequently, with considerable degree of **discretion**

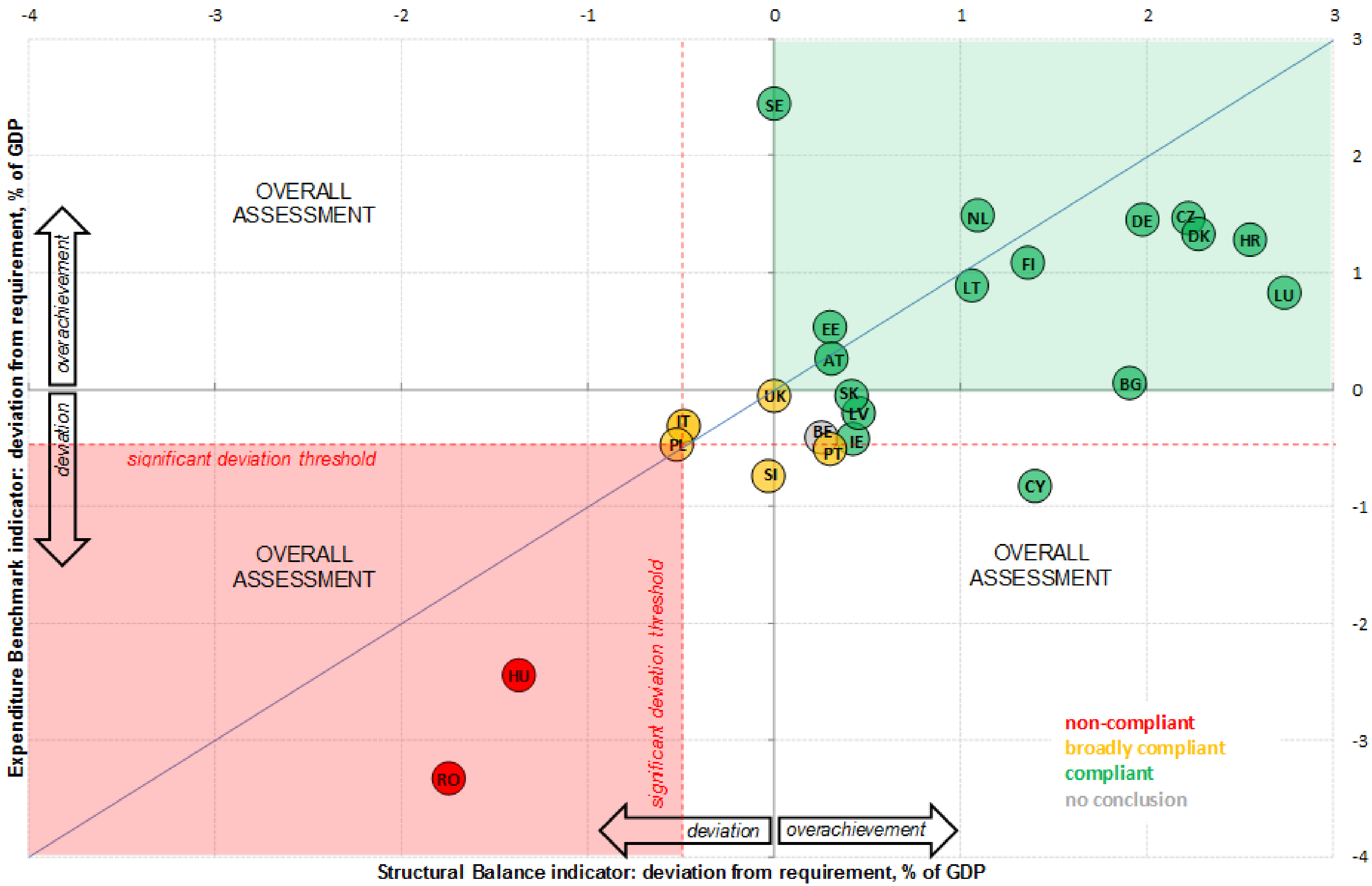
Background: Ch. 2 – Forecasts and outturns in 2017 (euro area)

- **Sizeable GDP growth surprise!**
- **Similar revision of real and potential GDP level**
- **Fiscal position improved**
- **But windfalls only partially used for consolidation**

		Spring 2016		Spring 2018	Revisions	
		Commission forecasts (SF16)	Stability and convergence programmes (SCPs)	Outturn	**Outturn vs SF16**	**Outturn vs SCPs**
Euro area - 18[1]		**year-on-year % change**			**percentage points**	
	Real GDP	1.7	1.7	2.3	0.6	0.6
	Nominal GDP	3.1	3.1	3.5	0.4	0.4
	Potential GDP	1.1	1.3	1.5	0.4	0.2
	Total revenue	2.8	2.9	3.7	0.9	0.8
	Total expenditure	2.2	1.8	2.4	0.2	0.5
	Primary expenditure	2.4	2.1	2.7	0.3	0.6
		billion euro			**percent**	
	Real GDP	9973	9983	10152	1.8%	1.7%
	Nominal GDP	10858	10874	10991	1.2%	1.1%
	Potential GDP	10015	N/A	10187	1.7%	
	Total revenue	4995	4996	5071	1.5%	1.5%
	Total expenditure	5170	5147	5172	0.0%	0.5%
	Primary expenditure	4939	4919	4958	0.4%	0.8%
		% of GDP			**% of GDP**	
	Output gap, % of potential GDP	-0.4	-0.6	-0.4	0.0	0.3
	Budget balance	-1.6	-1.4	-0.9	0.7	0.5
	Primary balance	0.5	0.7	1.0	0.5	0.3
	Structural primary balance	0.7	1.0	1.3	0.6	0.3

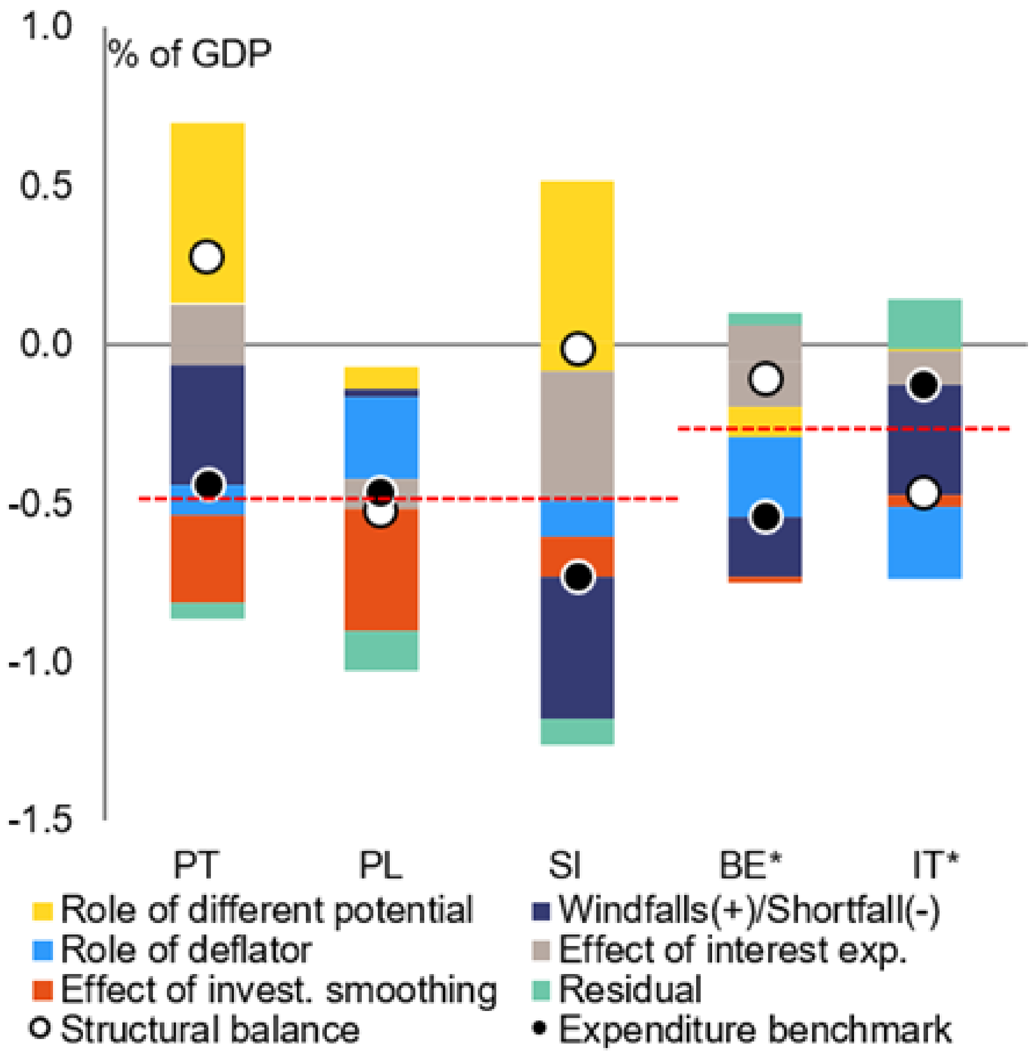
Background: Ch. 2 – Preventive arm of the SGP (final assessment)

- **In good times, expenditure benchmark more stringent than structural balance indicator**
- **Few but relevant borderline cases**



Background: Ch. 2 – Overall assessment for borderline cases

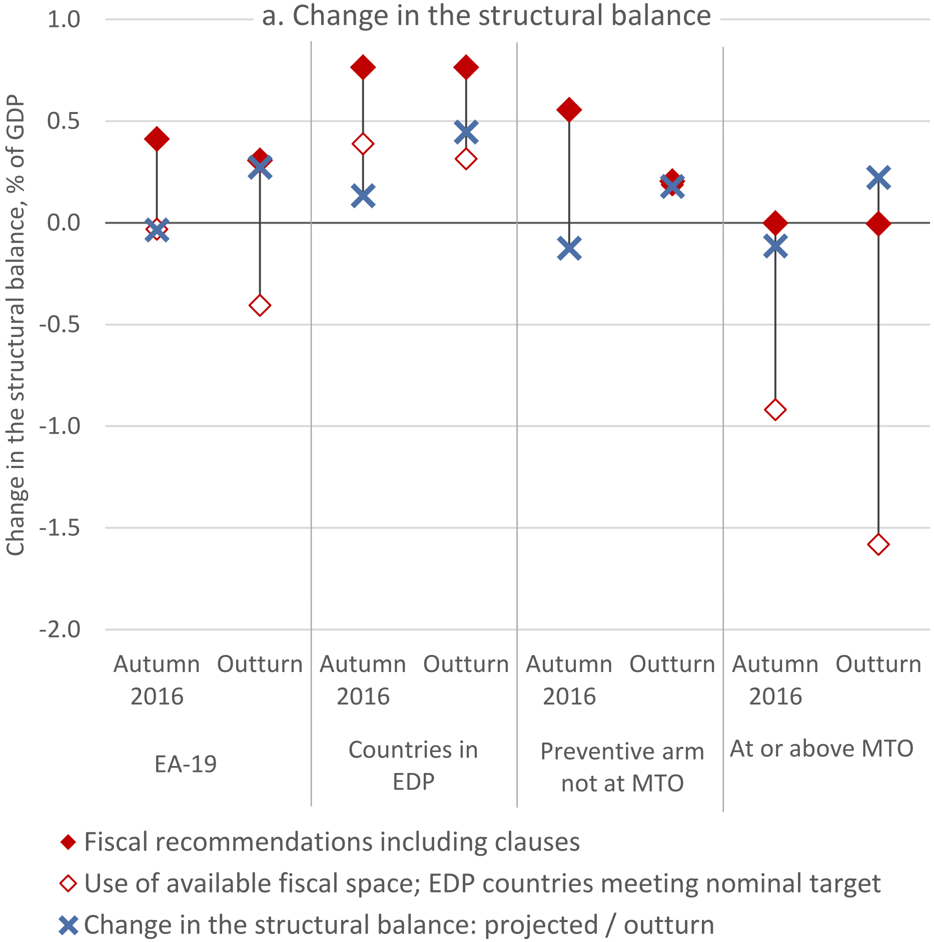
- **Discrepancies between indicators interpreted in favour of the structural balance**
- **Assessment highly judgemental often lacking of convincing explanation (forbearance?)**
- **Replicability by independent assessor remains a challenge**



Background: Ch. 4 - Fiscal stance in the euro area

Aggregate fine and generally improved composition, but notable exceptions:

- Italy and EDP countries (France, Spain): no/insufficient consolidation
- Germany: consolidated even further



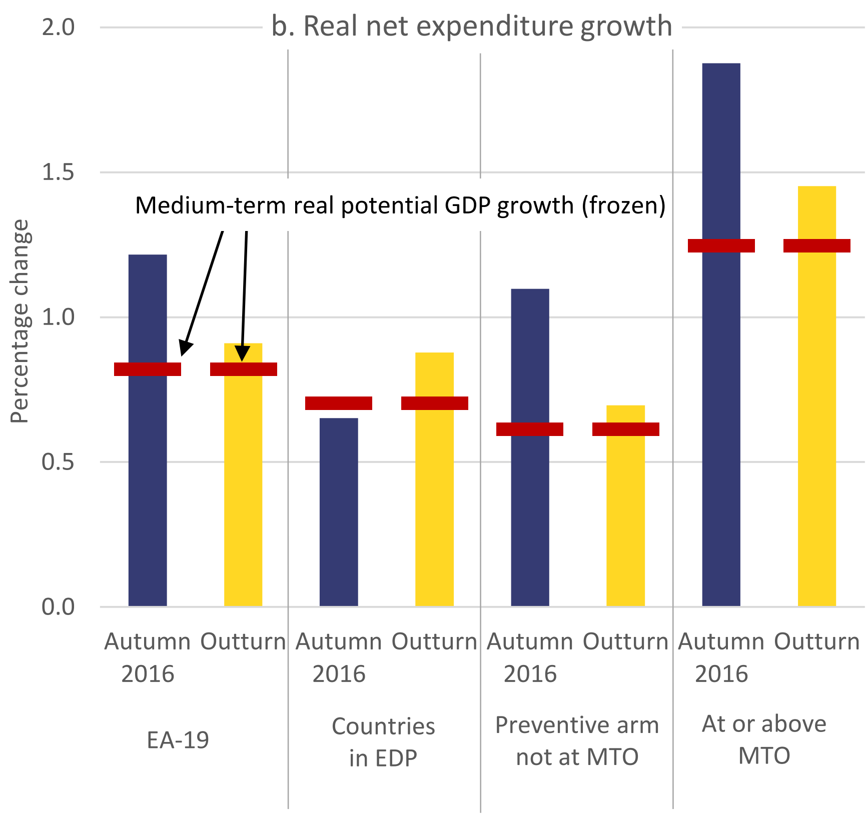
Structural adjustment, euro area:

- **Autumn 2016:** no consolidation
- **Outturn:** compliance.

By group of countries:

- **EDP countries:** again nominal strategy
- **Countries in preventive arm:** consolidation beyond requirements in some countries, offset by deviation in Italy
- **Countries at/above MTO:** Germany consolidated further, other countries used some of their fiscal space.

Background: Ch. 4 - Fiscal stance in the euro area (2)



Net expenditure growth, euro area:

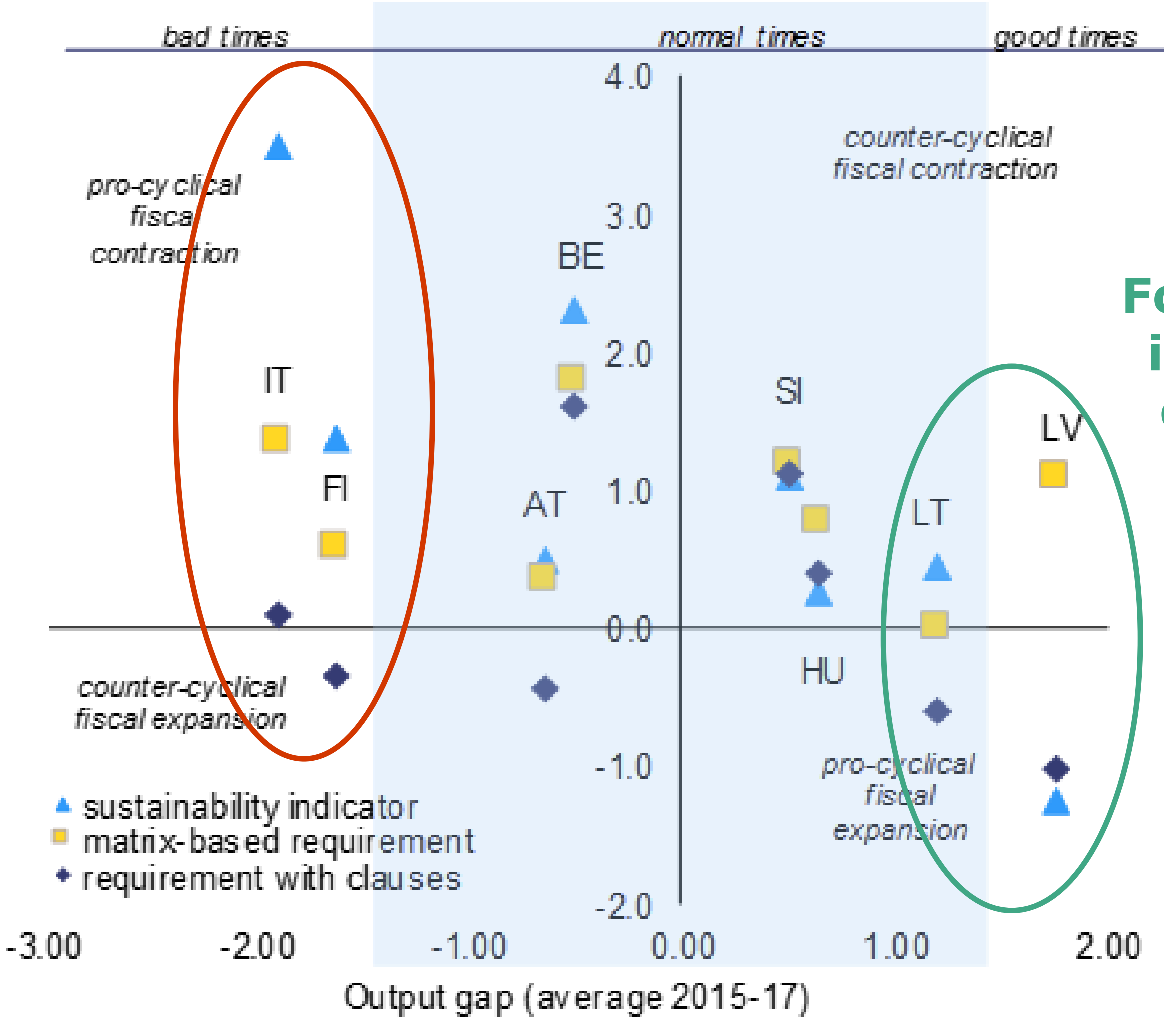
- Lower than expected
- Still slightly above medium-term potential growth

By group of countries:

- **Countries in preventive arm:** reduced expenditure growth compared to plans
- **EDP countries:** faster net expenditure growth than planned, above medium-term growth

Flexibility did not necessarily improve the balance between stabilisation and sustainability

For countries in bad times: averted pro-cyclical contraction but implied major departure from sustainability needs

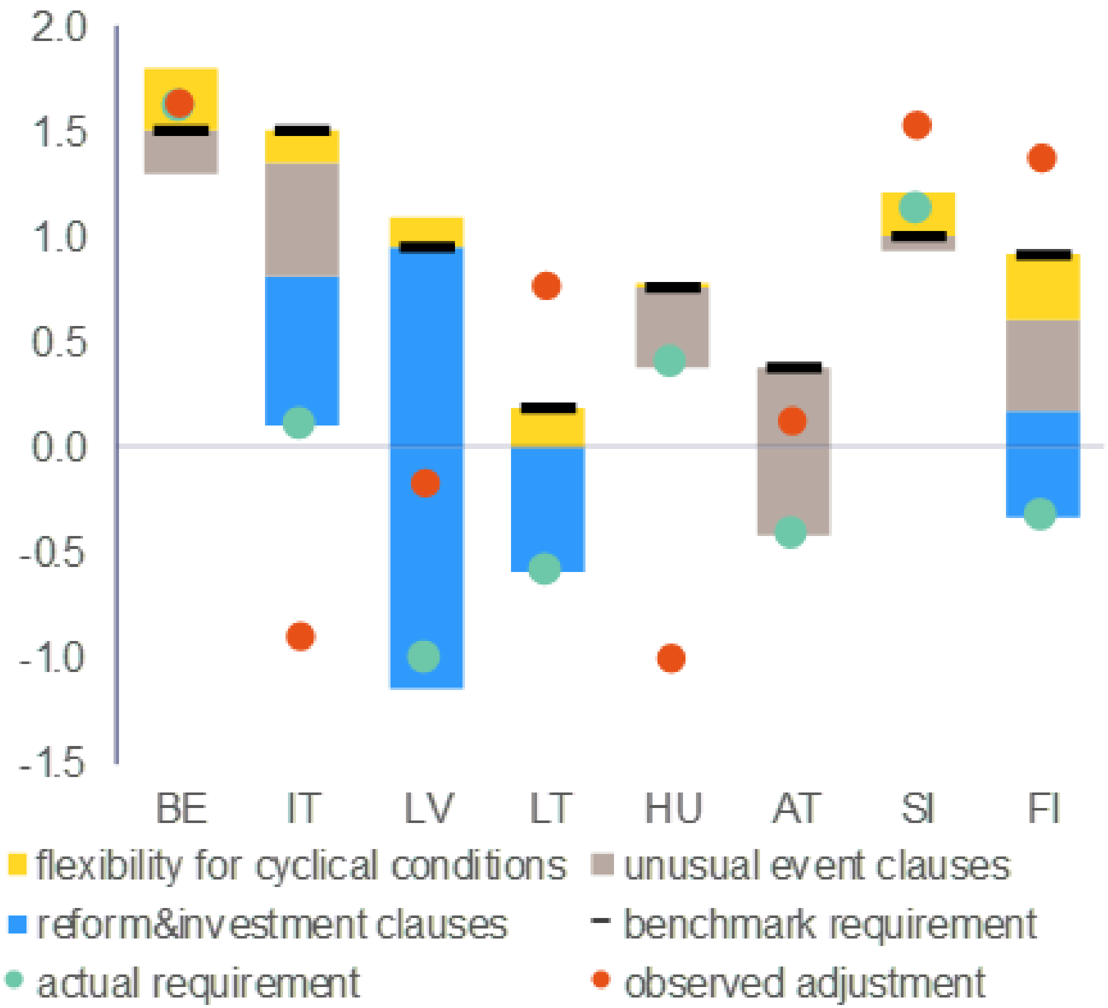


For countries in normal or good times: flexibility entailed a pro-cyclical fiscal expansion

Background: Ch. 5 – Fiscal requirements and observed adjustment

- **Some Member States failed to observe the more comfortable adjustment path**

- **Italy stands out: although flexibility and other clauses lowered the total requirement from 1.5% to 0.1% of GDP, the structural balance deteriorated by 0.9% of GDP in 2015-2017**



Background: Ch. 5 – Repeated failures to meet targets

- **Does the design of the flexibility framework offer adequate incentive and ownership to comply with EU fiscal rules?**
- **Italy is an example where the targeted structural budget balance (in level) has never been observed, while continuing to benefit from flexibility**

ITALY				
Structural budget balance	**2015**	**2016**	**2017**	**2018**
required no clauses	-0.9	-0.5	-0.8	-1.1
required with clauses	-0.9	-1.3	-1.2	-1.4
outturn	-1.0	-1.7	-1.7	?

- **However, the recurring failure to comply with fiscal targets did not lead to a formal breach of EU fiscal rules.**
- **This can be mostly explained by the possibility to cumulate the margin of broad compliance that comes on top of the different flexibility provisions**

Background: Ch. 5 – Assessment of structural reforms

- **Commission assessment of whether reforms have been fully implemented was sometimes not conclusive**

- **Most of the times, the assessment pointed to limited or some progress in the implementation of reforms. Is it enough?**

country	granted deviation	main area of intervention	Country Report ex-post assessment
Italy	2015 Stability Programme (SP) 0.4% in 2016	(i) public administration	limited progress (2017) some progress (2018)
		(ii) product and service markets	limited progress (2017) some progress (2018)
		(iii) labour market	some progress (2017) limited progress (2018)
		(iv) civil justice	some progress (2017) limited progress (2018)
		(v) education	-
		(vi) a tax shift	some progress (2017) limited progress (2018)
		(vii) spending review	substantial progress (2017)
	2016 SP 0.1% in 2016	(viii) bank insolvency procedure	some progress (2017) limited progress (2018)
Latvia	2017 SP 0.1% in 2017	(ii) healthcare reform	limited progress (2017) some progress (2018)
Lithuania	2017 SP 0.5% in 2017	(ii) labour market	some progress (2017; 2018)
		(iii) additional pension reforms	some progress (2018)
Finland	2017 SP 0.5% in 2017	(i) pension reform	-
		(ii) health and social services	some progress (2017) limited progress (2018)