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European Fiscal Rules Require a Major Overhaul

Zsolt Dravas (Bruegel), **Philippe Martin** (CAE) and **Xavier Ragot** (OFCE)

April 2019

Technical contributions: CEPREMAP & OFCE

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The general rationale for fiscal rules

The political cycle of public finances (pro-deficit bias)

- Incentive for deficits today followed by future austerity

More specificities within the euro area

- Risk of contagion and collateral damage in case of sovereign default
- Lack of credibility of the "no bail-out" rule
  - ➢ ECB may be pressured to use debt monetization
  - ➢ Reduction of market discipline

The role of fiscal rules

What a fiscal rule cannot be

- A silver bullet ✗
- A constraint on democratic choices ✗
- A substitute for fiscal coordination between the countries of the Euro area ✗

What a fiscal rule should be

- Simple, flexible and based on a clear and transparent institutional framework ✓
- Coherent and stabilizing from a macro-economic point of view ✓
- An effective way to ensure long-term sustainability of public debt ✓

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The actual SGP: 4 numerical fiscal rules

1. The budget deficit must be below 3% of GDP
2. Gross public debt must be below 60% of GDP
   - If it is higher, it must decline annually by at least 1/20th of the gap between the actual debt level and the 60% reference value
3. The structural budget balance must be higher than the country-specific medium-term objective (MTO)
   - In the case of EMU countries, MTO has to be chosen at or above – 0.5% of GDP, or – 1% for countries with a debt-to-GDP ratio below 60%
   - If the structural balance is lower than the MTO, is must increase by 0.5% of GDP per year as a baseline
4. An adjusted measure of real government expenditures (deflated by the GDP deflator forecast) cannot grow faster than the medium-term potential economic growth if the country's structural balance is at its MTO or higher
   - If the structural balance has not yet reached its MTO, expenditure growth must be lower than potential growth, in order to ensure an appropriate adjustment towards the MTO

Why we need to change? (1/3)

Complexity

Observation 1. European fiscal rules have become overly complex, which hinders their internalization by policy makers and their acceptance by the wider public.

"The present rules-based system of the Stability and Growth Pact (SGP) has become nearly unmanageable due to its complexity, and the constant addition of exceptions, escape clauses, and other factors"

Thomas Wieser (2018)

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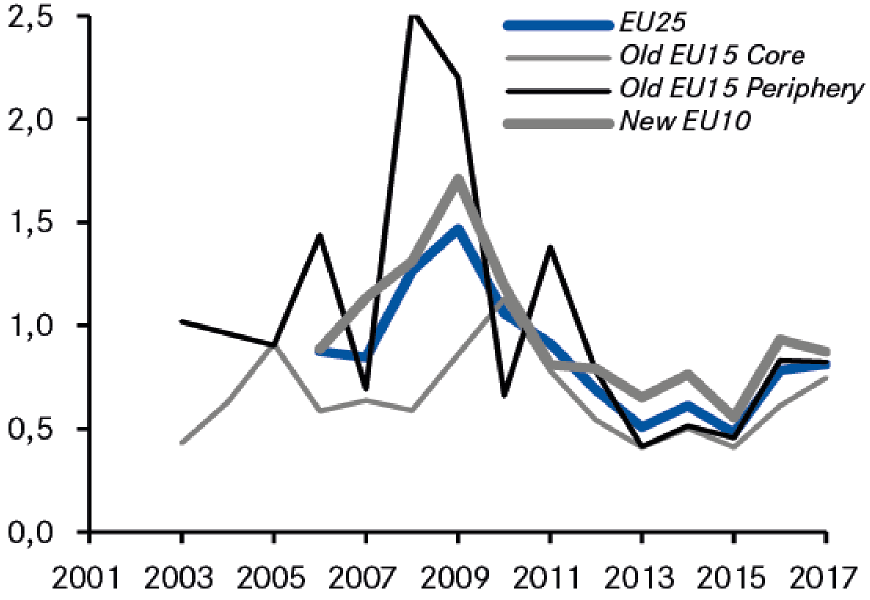
Why we need to change? (2/3)

Measurement issues

Average absolute revision of the change in structural budget balance from last year to current year one year later (% GDP)



Observation 2. Potential output, the output gap and the structural balance are badly estimated, misleading real time fiscal policy decision-making.

Why we need to change? (3/3)

Pro-cyclicality and non-compliance

- Pro-cyclical fiscal expansive policies before the 2008 global financial crises then pro-cyclical fiscal tightening starting in 2010
- Weak compliance with the rules: while 24 EU countries were placed in an EDP after 2008, the complex web of flexibility has been used to the extreme to avoid sanctions.

Observation 3. European fiscal policy suffers from pro-cyclicality, while non-compliance with the rules has become the norm. EU fiscal rules lack proper enforcement mechanism and credibility.

Reforming the European fiscal framework (1/6)

Proposal for a new public expenditure rule

Nominal expenditures should not grow faster than long term nominal income, and they should grow at a slower pace in countries with excessive levels of debt

Main advantages of such a rule

- Simplicity
- Less measurement issues
  - Not based on output gap
  - Unlike the cyclically adjusted deficit, public expenditures are observable in real time and are directly controlled by the government
- Less pro-cyclicality
  - Stabilization of expenditures over the cycle
  - Unexpected shock on inflation → opposite effect in real expenditure
  - Exclude cyclical unemployment spendings

Reforming the European fiscal framework (2/6)

Proposal for a new public expenditure rule

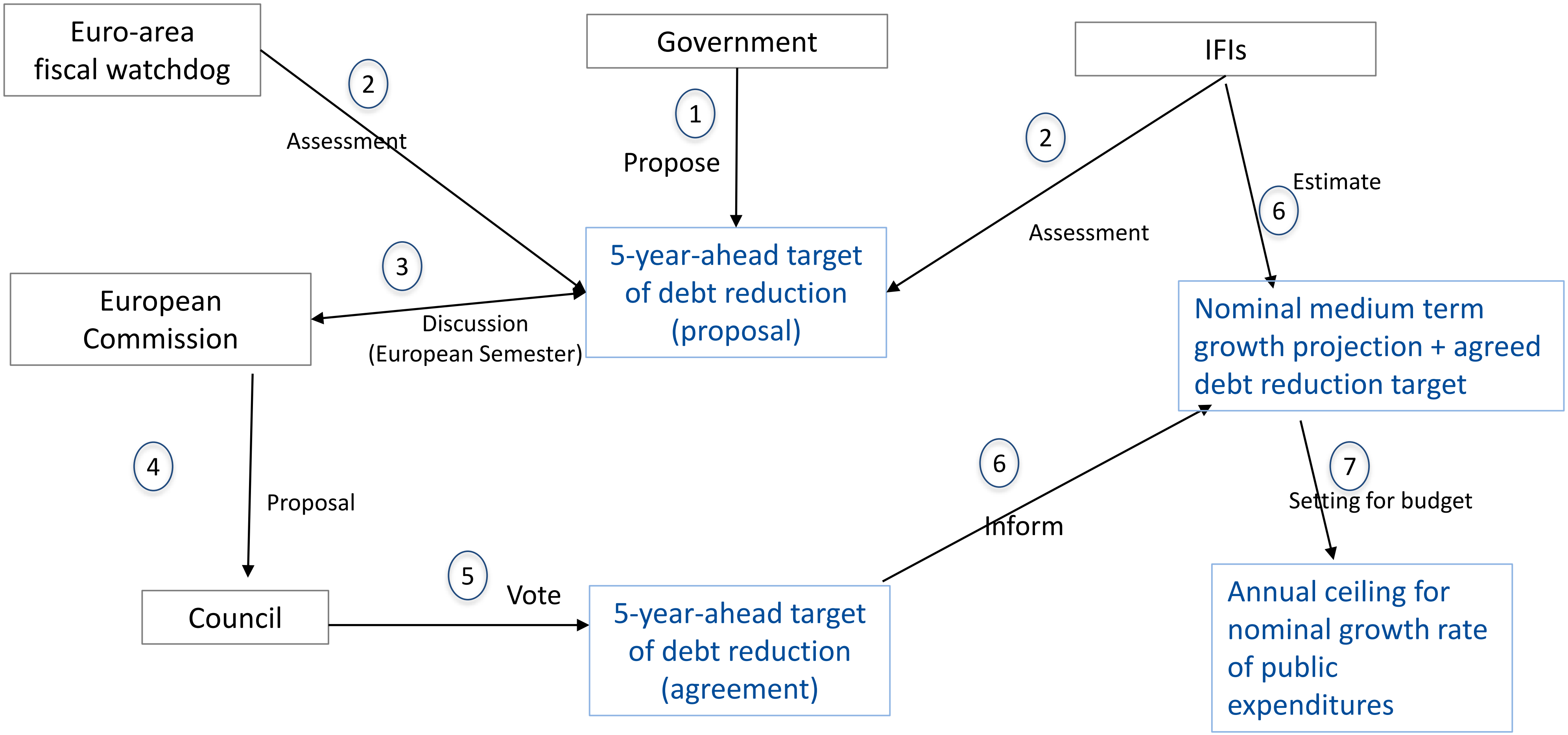
Implementation through a two-pillar approach consisting of:

- A long-term target debt level, such as 60% of GDP
- An expenditure-based operational rule to achieve the anchor

Recommendation 1. Adopt a new fiscal rule targeting the growth rate of nominal public expenditures. The growth rate should be constrained by the potential GDP growth rate, the expected inflation rate as well as a debt reduction objective specific to each country. The public spending trajectory must be consistent with the rolling medium-term (e. g. five-year-ahead) target of reduction on the debt to GDP ratio which European countries agree upon.

Reforming the European fiscal framework (3/6)

The new rule in practice



Reforming the European fiscal framework (4/6)

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What should be the consequences of such an expenditure rule?

→ Simulations of the expenditure rule (structural model based on the iAGS project) by OFCE

$$\hat{g}_{i,t} = \hat{y}_{i,t} + E_{t-1}\pi_{i,t} - \boldsymbol{\gamma_{i,t}}(d_{i,t} - d^*)$$

Growth rate of nominal public spending (net of interest payments and of unemployment spending)

Real potential growth

Expected inflation

debt brake term which takes into account the difference between the observed ratio of debt to GDP $d_{i,t}$ and the long term target d^* which we take to be 60%

- The parameter $\boldsymbol{\gamma_{i,t}}$ drives the speed at which the country converges to its long-term debt target
- It should be computed to be consistent with the debt reduction objective at a five-year horizon and should therefore be different among countries

Reforming the European fiscal framework (5/6)

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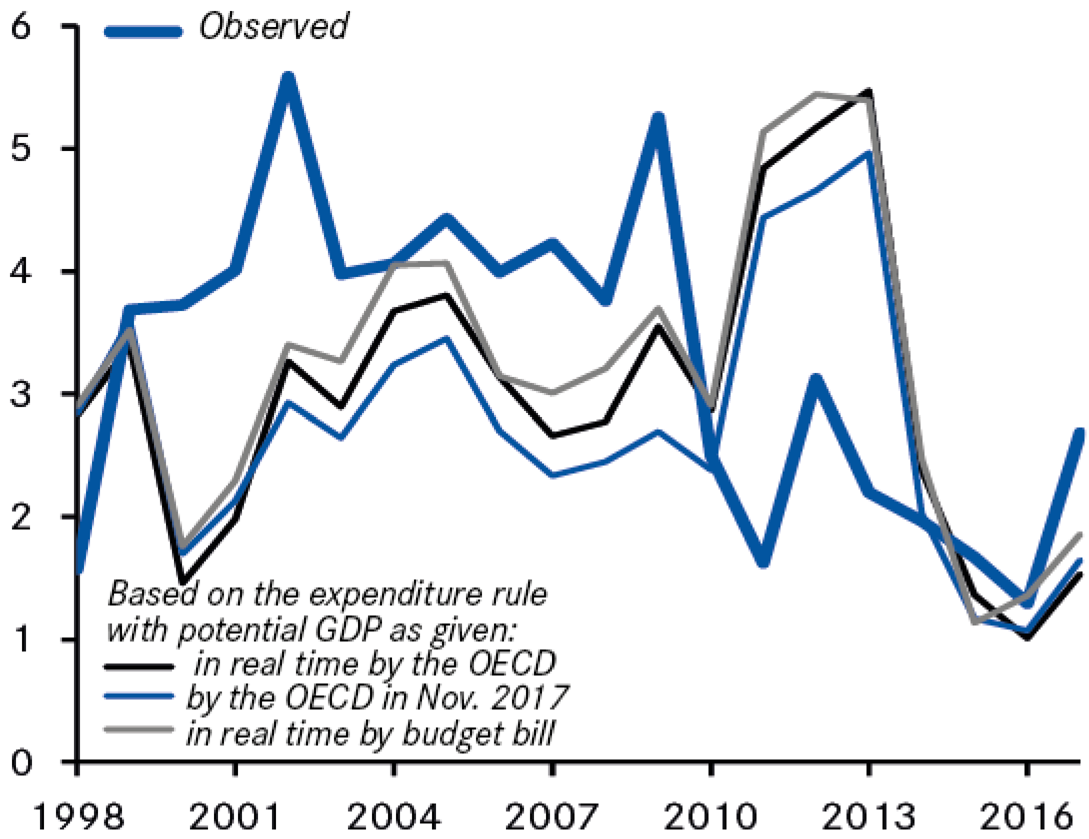
Counterfactuals

Nominal growth rate of primary public spending in France for the period 1998-2017 (in %, current euro)



Sources: INSEE, OECD, Budget Bill, OFCE's calculations

Reforming the European fiscal framework (6/6)

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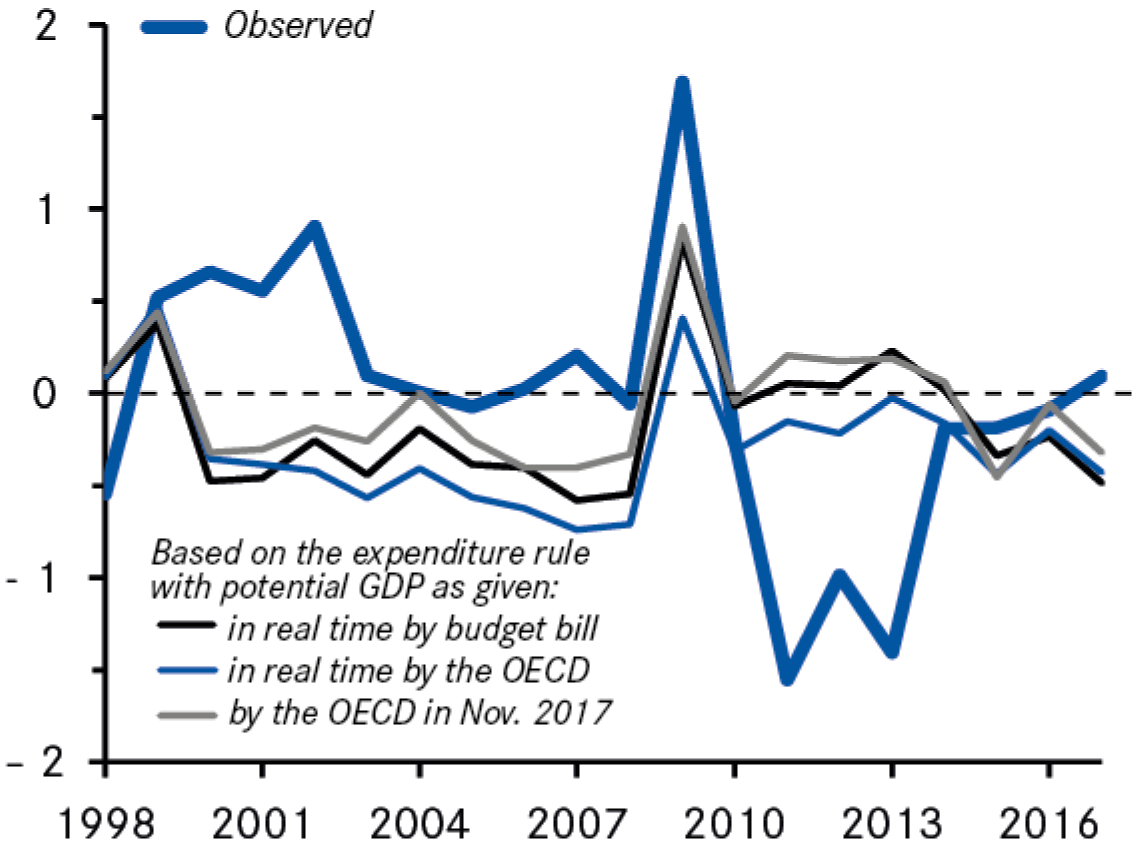
Counterfactuals

Fiscal impulse in France for the period 1998-2017 (in % of potential GDP)



Sources: INSEE, OECD, Budget Bill, OFCE's calculations

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Adapting the institutions (1/2)

The necessity of national independent fiscal councils…

- The establishment of national independent fiscal institutions (IFIs) or fiscal councils is a prerequisite to the well-functioning of expenditure rule
- The ability of a fiscal council to identify biases of governments' fiscal and economic forecasts, and to provide competent macroeconomic analysis is essential to its effectiveness

… in Europe…

Recommendation 2. Expand the mandate of all independent fiscal institutions so they can make assessments of the medium term potential growth, inflation and the impact of tax changes on government revenues, and also run long term fiscal sustainability analysis.

Adapting the institutions (2/2)

… and in France!

Recommendation 3. Broaden and better integrate the mandate of the HCFP into the national budget process by including fiscal forecasts endorsement and debt sustainability analysis and by increasing its capacity to independently produce fiscal and macroeconomic forecasts.

Two practical options

- Creating a small economic team in charge of economic forecasts in the HCFP
  - Such a team would have the right interplay with the Treasury staff, and other administrations or independent institutions, in charge of public finance forecasts
- Moving the growth forecasting unit of the Treasury to the HCFP
  - It would still produce regular confidential forecasts for the Minister and Treasury. However, the Minister would not have anymore authority on the forecasting unit

How to enforce the rule? (1/2)

Sticks and carrots

On top of the institutional surveillance described previously, the reform should focus in two main aspects: rewards and sanctions

> **Recommendation 4.** Transfer surveillance to well-equipped national fiscal councils, coordinated and overseen by a European fiscal council. Subject the access to a "flexible" ESM/EMF credit line and the participation in euro area-wide fiscal stabilization instrument to compliance with the fiscal rule.

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How to enforce the rule? (2/2)

Comply or explain

A further "stick" would be to increase the political cost of deviating from the fiscal rule, in line with objective to renationalize the fiscal debates

Recommendation 5. In case of non-compliance with fiscal rules, as concluded by the national fiscal council introduce national "comply or explain" procedures for the Minister of Finance in front of the parliament and the press in member states, and in front of the European Parliament in the case of a major deviation as concluded by the European fiscal council.

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Legislative changes

Main issue: compatibility between the violations of the expenditure rule and the 3% deficit rule

Therefore, there are three possible cases of violations

1. The 3% deficit rule is violated but the expenditure rule is obeyed
2. Both the 3% deficit rule and the expenditure rule are violated
3. The 3% deficit rule is obeyed but the expenditure rule is violated, Such situations are different and require different interventions

In the first case (1), we recommend "**light**" EDP: the Commission carefully considers the opinion of the European Fiscal Council

When our proposed expenditure rule is violated (cases 2 and 3), the "**normal**" level of the EDP should be applied (as well as the positive and negative incentives discussed previously)