Uniting European Fiscal Rules: How to Strengthen the Fiscal Framework

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Mostly agreement on problems of the status quo

- Fiscal framework is too complex and not transparent
- Constrained variables are not under direct control of government
- Forecasts of compliance and central variables are not very reliable
- Revisions of constrained variables can be very large relative to real time estimates
- Especially old rules of the SGP lead to procyclical fiscal policy
- Ex-ante and ex-post compliance with rules often do not match
- Inflation of exemptions, escape and flexibility clauses
- Sanctions are not enforced and compliance is low
Fiscal rules should...

...target fiscal aggregates which
  – are under direct control of governments,
  – can be forecast reliably, and
  – are prone to only minor revisions

... not limit automatic stabilisers, i.e., prevent pro-cyclicality in fiscal policy

... ensure reduction of debt to GDP ratios over a reasonable time horizon

... be associated with high political costs for non-compliance, through
  – transparency vis-à-vis the public and media
  – quasi-automatic and noticeable sanctions
Plus: Macroeconomic stabilization


  - Confirm findings of literature, but only for:
    - Budget Balance Rules set in structural or cyclically adjusted terms
    - Exp. Rules with limit rel. to potential not current GDP
  - Effect increases with strength of fiscal rules and frameworks
  - Stabilizing effect not associated with year-to-year compliance: Rules act as anchor for policy makers

Budget Balance Rules in the EU28, 1996-2015
Framework of the GCEE proposal

Goal: fiscal sustainability with national sovereignty in fiscal policy

- Reduction and retention of public debt below threshold
  - debt limit (long-term)
- Budget close to balance over the business cycle
  - limit to structural deficit (medium-term)
- No excessive expenditure growth
  - growth ceiling for adjusted nominal expenditure (annual)

Independent monitoring
Automatic sanctions
Transparency

Debt correction

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Operationalised by an annual expenditure rule

Nominal expenditure growth \( \leq \) Benchmark \( + \) Multi-purpose adjustment account \( + \) Debt correction

- excluding: interest expenditures, cyclical unemployment expenditures, discretionary revenue measures
- based on: potential GDP growth, inflation, calibrated constant
- capturing: deviations from structural balance rule, estimation errors of discretionary revenue measures, small deviations in budgetary process

relative to distance between debt limit and current debt level

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Constraining growth of expenditures depending on debt level

- Nominal government expenditure growth, excluding:
  i) cyclical unemployment expenditures,
  ii) interest expenditures,
  iii) discretionary revenue measures
  - Directly influenced by governments
  - Largely independent from the business cycle
  - Forecast errors are substantially smaller
  - Largely acyclical, i.e., automatic stabilisers are free to work

- Debt correction: Rule determines markdown relative to difference between present debt to GDP ratio and long-term limit
  - Based on rule because fiscal councils are very heterogenous (mandate, endowment with executive rights and factual independence) and to ensure democratic accountability
Multi-purpose adjustment account

- Four components
  - Deviations from structural balance rule
  - Revisions of structural balance
  - Estimation errors of discretionary revenues
  - Short-term deviations between actual and budgeted expenditures

- Net inflows of one year reduced proportionally in each of the subsequent years
  - Revisions after t+1 substantially smaller
  - Addresses problem of real-time estimation

Sources: European Commission, Project FIRSTRUN, own calculations
Why keep the structural balance rule?

- Structural balance rule has clear theoretical rationale
  - Main problem: Real time estimation errors – thus compliance only in medium-term
- In theory approximately equal to the expenditure rule:
  \[
  \alpha \geq G^{struct} - R^{struct} = [G - G^{cyc}(Y)] - [R - R^{cyc}(Y)] \approx [G - G^{unemp}(Y)] - [\gamma Y^{Pot}]
  \]
  \[
  \Delta Y^{Pot} \geq \Delta G^{struct} = \Delta[G - G^{unemp}(Y)]
  \]
- In practice:
  - Link between potential output and revenues might not be time-invariant
  - Revenues and expenditures might diverge in the medium-term
  - Estimates of discretionary revenue measures prone to errors
  - Governments might be “creative“ w.r.t. excluded unemployment expenditures
- Advantage for implementation: In line with existing national & supranational rules
Compliance with fiscal rules

- Average compliance over all rules and countries is only around 50% 
  - „Statistical“, not „de jure“ compliance
- However, rules act as an anchor: There is a “magnet effect” that tilts fiscal policy towards numerical limit
  - Especially in times of non-compliance
- Governments seem to use rules as targets not ceilings
  - Needs to be taken into account when calibrating the rule

Source: Reuter (2017)  
Source: Lledo and Reuter (2018)
Share of rules in compliance over time
Exemptions at the EU level

Frequency of exemptions granted in the SGP

- Pension reform
- Structural reform
- Investment
- Adverse economic conditions
- Small deviation
- Refugees
- Security-related measures
- Natural disasters

Sources: European Commission, own calculations

Average size of the exemptions granted in the SGP

- Pension reform
- Structural reform
- Investment
- Refugees
- Security-related measures
- Natural disasters

- Mean
- Median

Sources: European Commission, own calculations
Why do countries comply with their rules and why not?

  - EC and IMF datasets, legal documents, 1995-2014, 20 countries of EU28
  - Budget balance rules (49%), Debt rules (22%), Expenditure rules (29%)

- Probability of compliance related to
  - Stronger independent monitoring and enforcement bodies (issuing real-time alerts)
  - Reasons for deficit bias: Government fragmentation, decentralization, election years

- Compliance probability is not systematically associated with
  - (Socio-)Economic, Business Cycle variables
  - History of rules
  - Combinations of rules
  - Forecast errors
Sanctions & escape clauses

- Sanctions of SGP not applied so far
- Low level of transparency results in low peer-pressure
- Application of escape clauses non-transparent
- Goal: increase political costs of rule violations
  - Simplification by targeting directly observable aggregates
  - Increasing transparency and independent surveillance: Strengthening of national and European fiscal councils
  - No exemptions and only two escape clauses: Natural disasters & exceptionally severe economic crises (decision based on set of economic indicators)
  - Increasing credibility of sanctions, e.g., through less discretion in imposition of sanctions, more automaticity
Implementation

- Keeping structural balance rule is in line with rules in national (Fiscal compact) and EU regulation
- Builds on elements that already exist today
  - Would unite supranational and national rules, as well as different supranational rules
- Procedures and specifications causing complexity not enshrined in treaties
  - Regulations and guidelines by European Commission or Council of the EU can be changed more easily