



The fiscal stance in the euro area

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Introduction

- **Maastricht assignment**

- Monetary policy centralised
- Fiscal policy decentralised, subject to Stability and Growth Pact (SGP)

- **Delors Report (1989) stressed the importance of the fiscal stance in the euro area**

*"(...) the task of **setting a Community-wide fiscal policy stance** will have to be performed through the coordination of national budgetary policies."*

=> Does the current degree of coordination guarantee appropriate fiscal stance in the euro area and the member states?

Outline

- 1. Rationale:** *Why is it useful?*
- 2. Concept:** *How to define it?*
- 3. Fiscal stance in practice:** *How appropriate?*
- 4. Policy:** *What are the implications?*
- 5. Alternative avenues:** *What more can be done?*
- 6. Conclusions**

Economic underpinning

■ Normal times

- Monetary policy *cum sound fiscal policy + automatic stabilisers in general successful tools for stabilisation*

■ Severe crisis/protracted stagnation

- Significant economic slack and persistently low inflation
- Monetary policy overburdened: reaching its limits, diminishing effectiveness, adverse side-effects
- At ZLB, fiscal multipliers likely to be higher than in normal times

=> *Additional discretionary action needed for stabilisation and to support reaching inflation objective*

Legal basis

- **Article 121 of the Treaty:** *"Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council"*
 - => **recommendations for countries and for euro area as a whole, including on euro area fiscal stance**
- **Article 7(4) of the Two Pack (Regulation (EU) 473/2013)** requires the Commission to "make an overall assessment of the budgetary situation and prospects in the euro area as a whole", based on "the national budgetary prospects and their interaction across the area" and the Commission shall also, "as appropriate, outline measures to **reinforce** the coordination of budgetary (...) policy at the euro-area level".

Political support

- **Long tradition of Commission assessments of euro area national fiscal policies and implications for the euro area**
 - E.g. annual mid-year review of budgetary policies for the Eurogroup
 - E.g. assessments of draft budgetary plans
- **More recently, work following mandate of two-pack on euro area fiscal stance (*) => evolving mood:**
 - Many Member States supportive, along with the ECB
 - Exercise considered useful in committees

(*) See e.g. European Commission, "The 2016 Stability and Convergence Programmes: An Overview and Implications for the Euro Area Fiscal Stance", Institutional Paper 34, September 2016.

What is the appropriate fiscal stance?

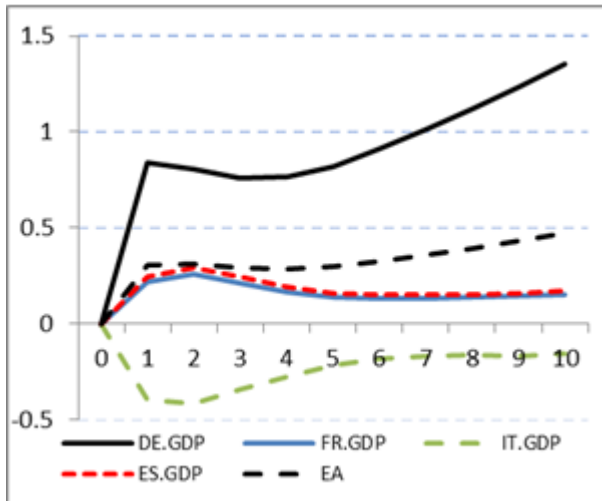
- **No universally accepted definition**
- **Stabilisation *versus* sustainability objectives**
 - Stabilisation: Δ structural (primary) balance; discretionary fiscal effort (DFE)
 - Sustainability: S1 indicator, distance to MTO
- **Measurement issues and uncertainty**
 - Output gap: (i) measurement in real time; (ii) length and depth of the cycle; (iii) pace of closing output gap
 - Stabilisation impact: (i) fiscal multipliers; (ii) time lags; (iii) spillovers
 - Aggregation: (i) sensitivity to method used; (ii) consistency

How do we do it in practice?

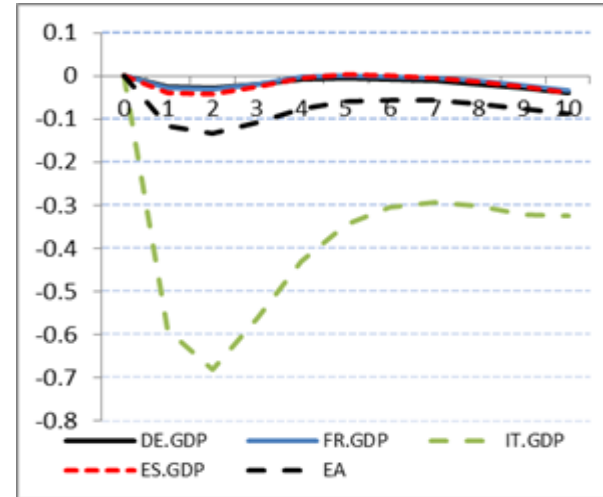
- **Ranges for working towards stabilisation**
 - The change in the output gap projected in the Commission's forecast (but corrected for the expected impact of fiscal policy) measures the spontaneous closure of the output gap that would result from a neutral fiscal stance (all other assumptions unchanged compared to baseline).
 - Range: the structural primary balance in 2017 adjusts to close the output gap compared to its 2016 level by **either 25% or 50%**.
- **Ranges for working towards sustainability**
 - The S1 indicator measures the cumulative adjustment of the structural primary balance over the next 5 years needed to reduce debt to 60% of GDP by 2030 (taking into account ageing costs).
 - Range: the structural primary balance in 2017 adjusts by **either 25% or 50%** of this cumulative adjustment (i.e. frontloading).

Spill-overs: coordination *versus* no coordination

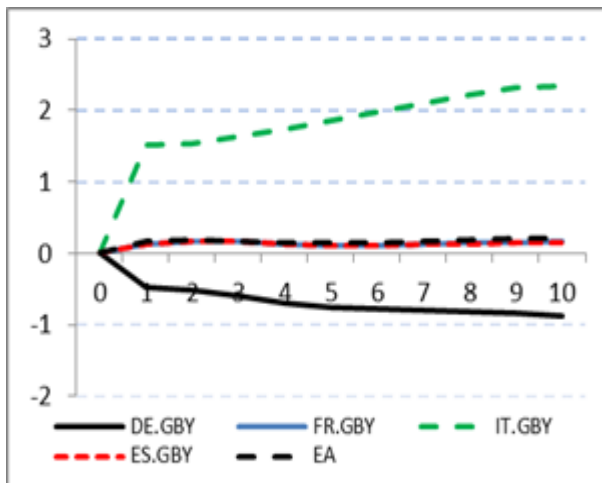
GDP



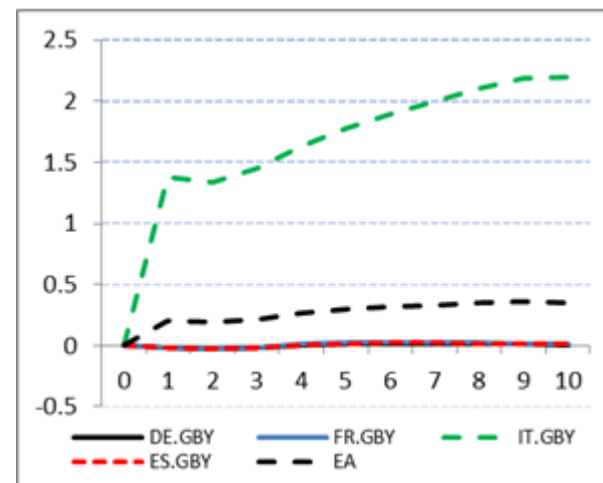
GDP



Gov't
Balance
(% GDP)

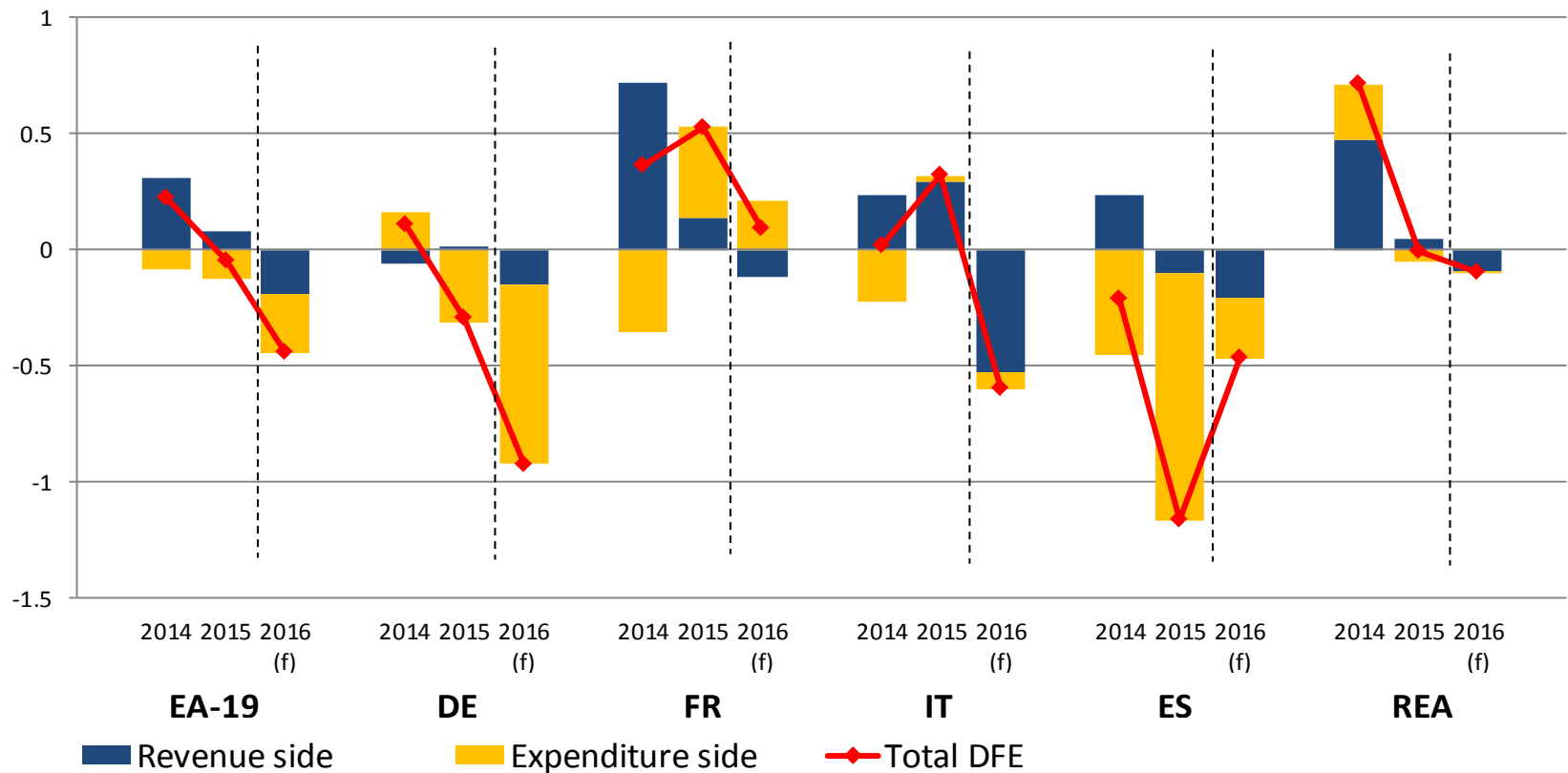


Gov't
Balance
(% GDP)



Recent fiscal stance: slightly expansionary

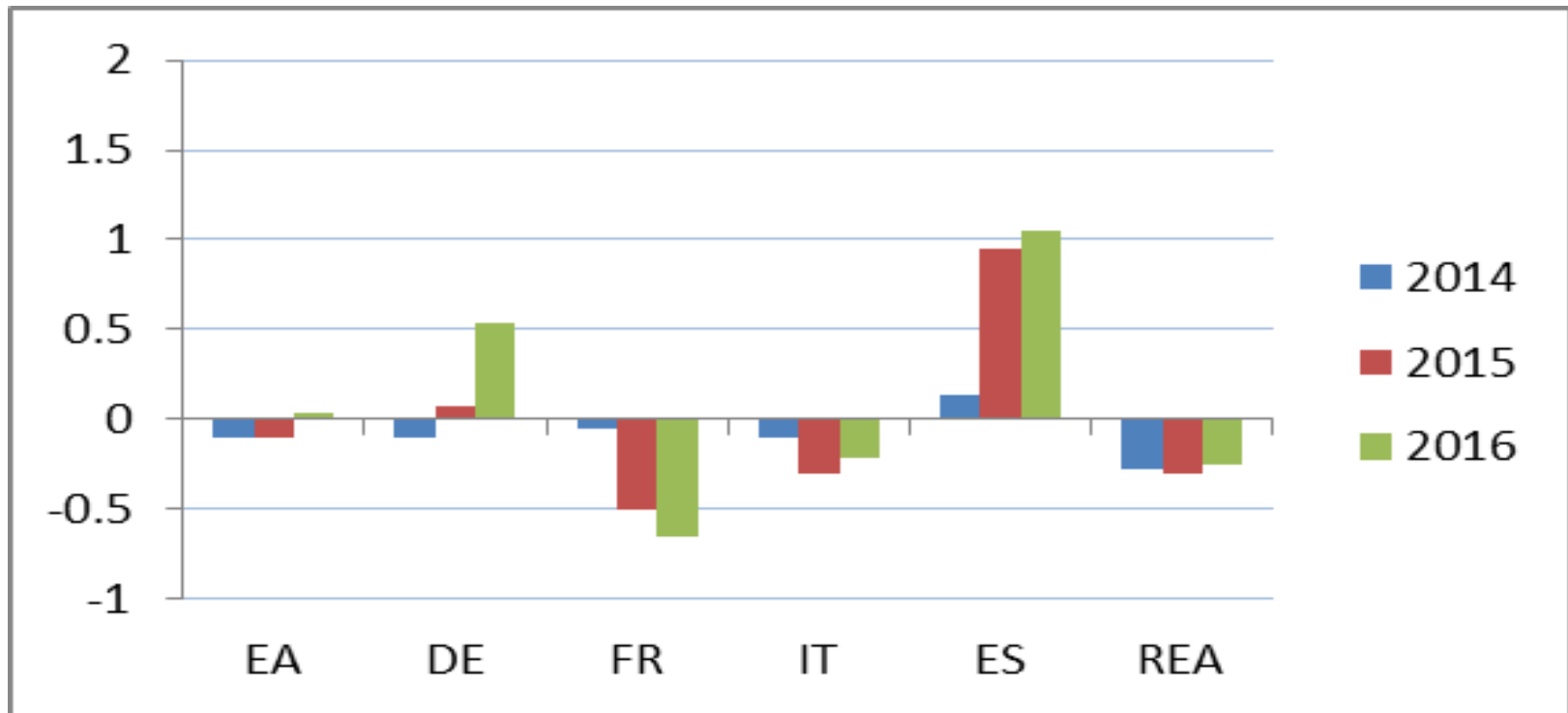
Discretionary fiscal effort in 2014-16 (% of GDP)



Note: (f) indicates forecasts. *Source:* DG ECFIN.

Limited overall GDP effects

Impact of discretionary fiscal policy on GDP in 2014-16 (% of GDP)

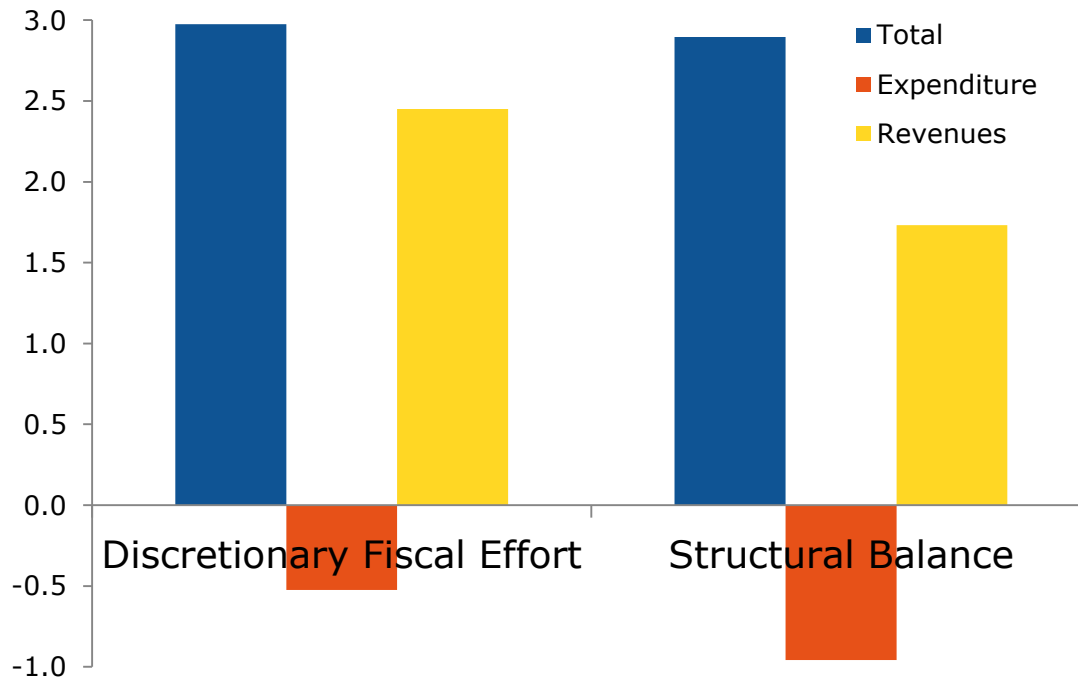


Note: Cumulative difference in the real GDP level between actual developments and a counterfactual where the fiscal stance would have been neutral from 2014 onwards. The simulations focus on short-run macroeconomic effects and assume that there are no sustainability risks.

Source: DG ECFIN, QUEST simulations.

Composition of adjustment has been sub-optimal

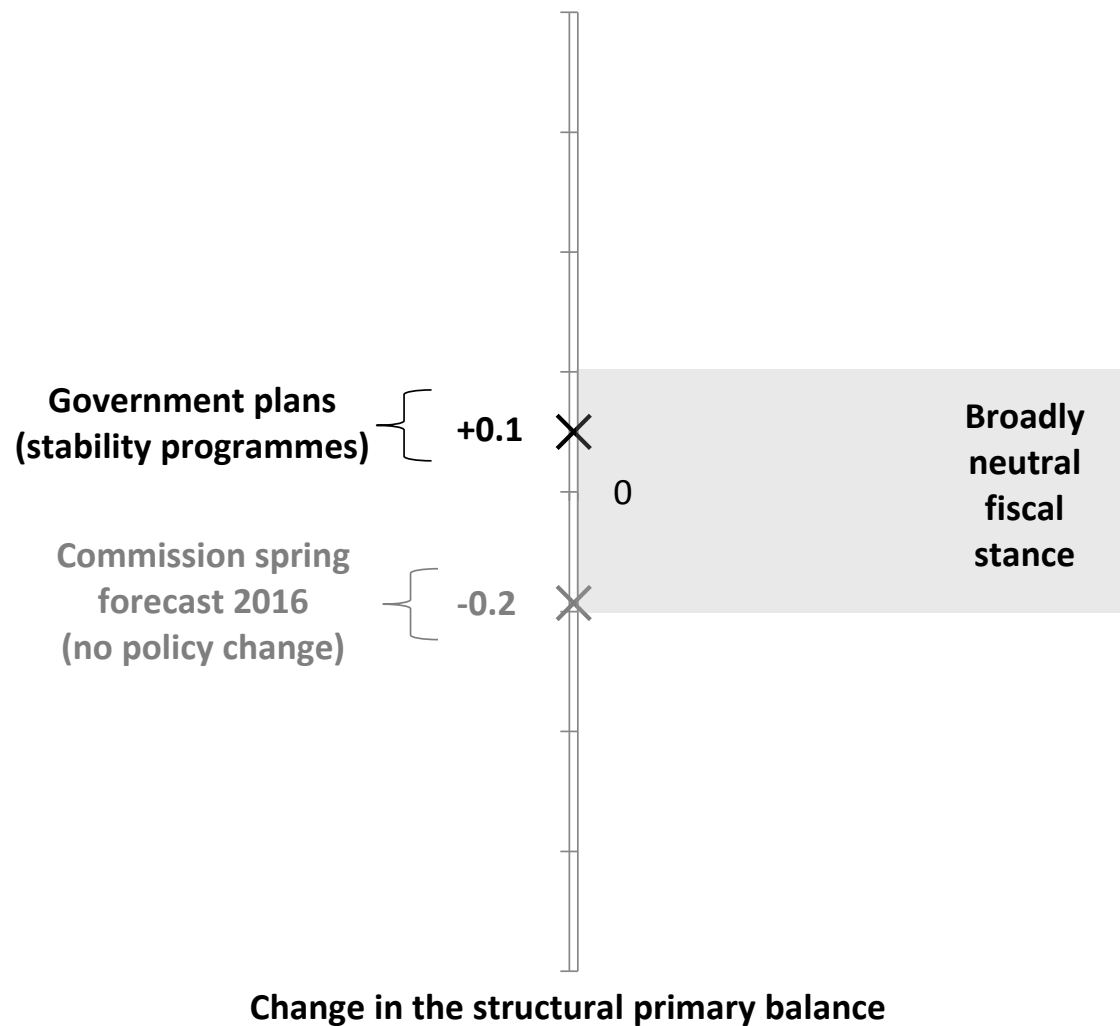
Euro area, 2011-2016 (% GDP)



Mainly tax-based with standard methodology (SB), and even more so with refined methodology (DFE) + Expenditure cuts often **at the expense of investment**

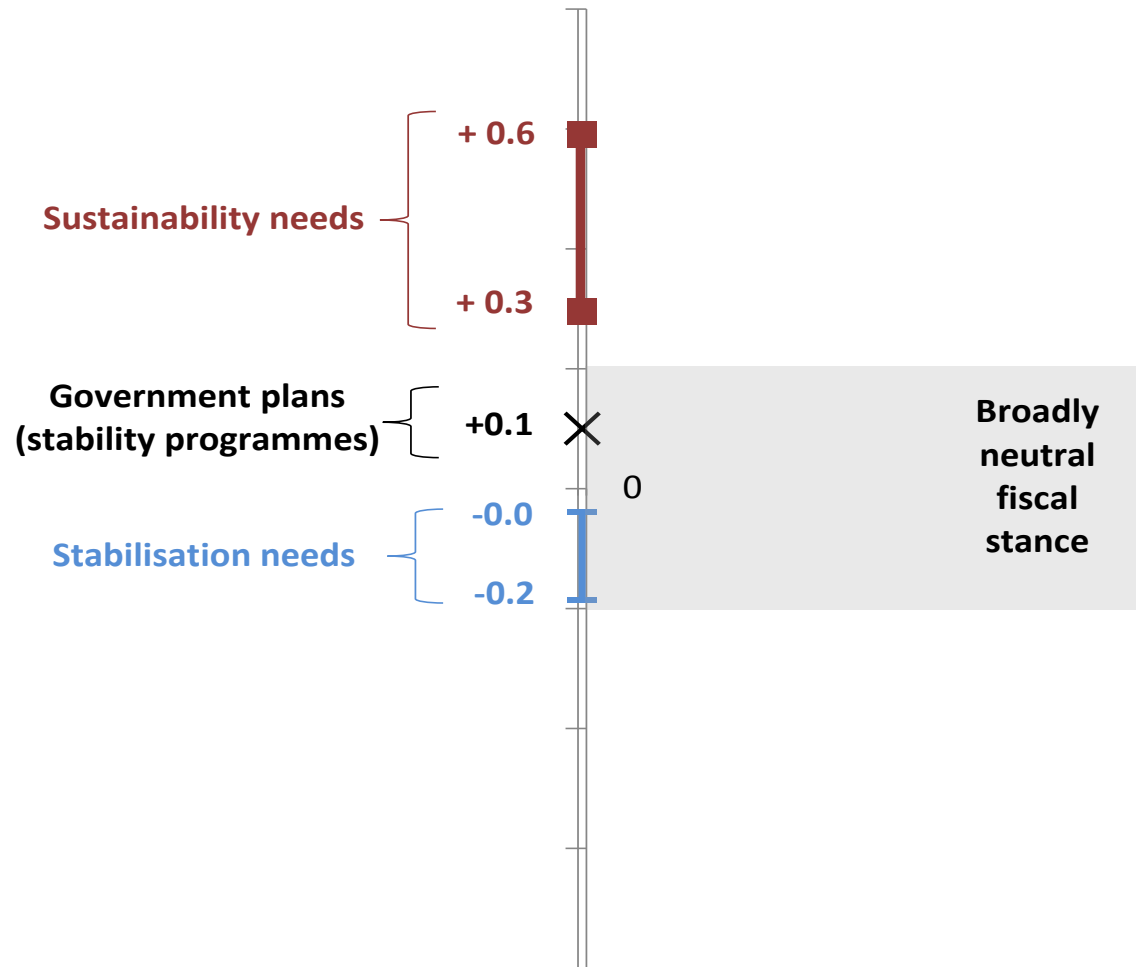
Source: DG ECFIN.

Aggregated government plans



Note: % of GDP. *Source:* DG ECFIN.

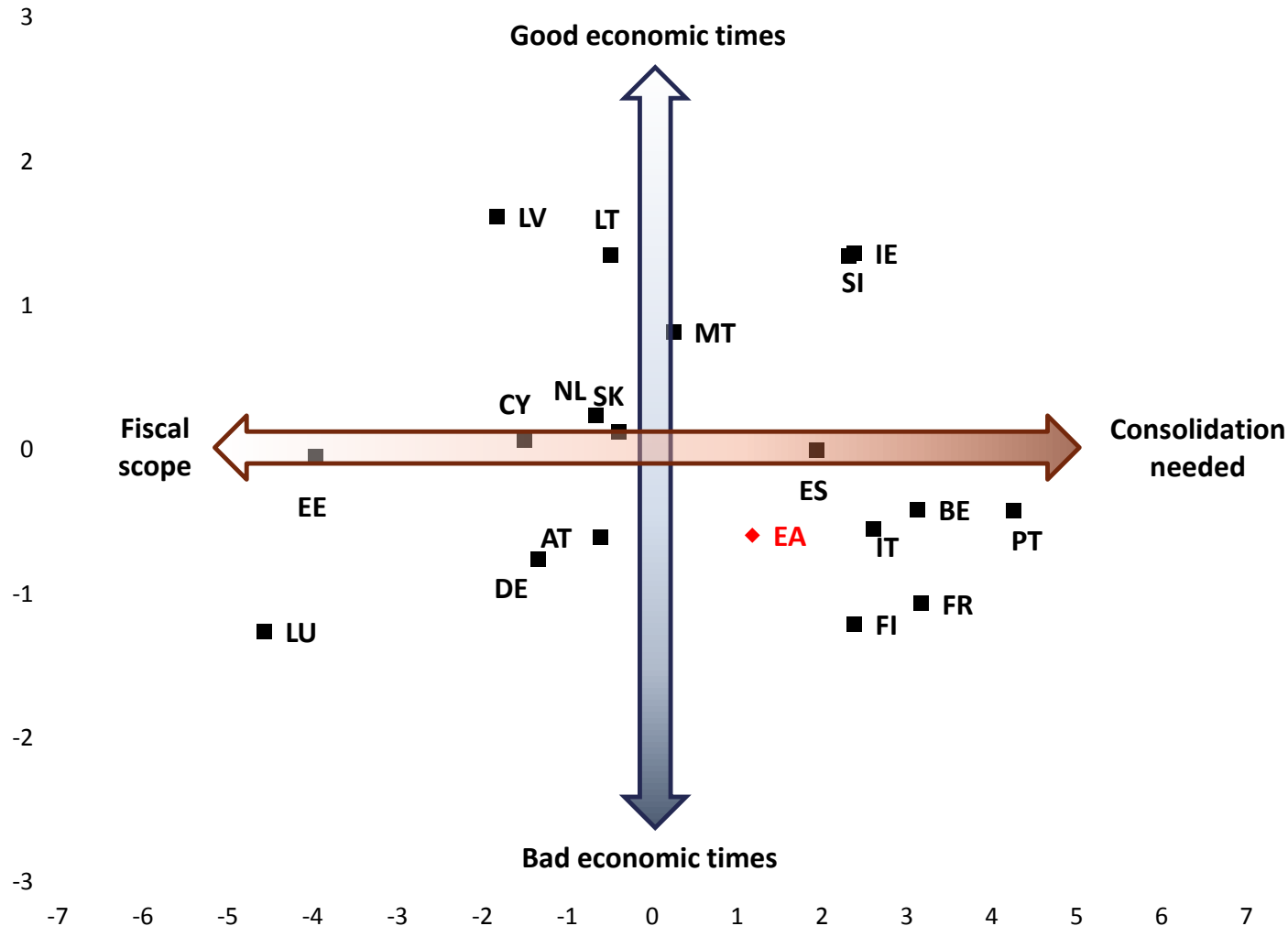
Plans vs. sustainability and stabilisation needs



Change in the structural primary balance

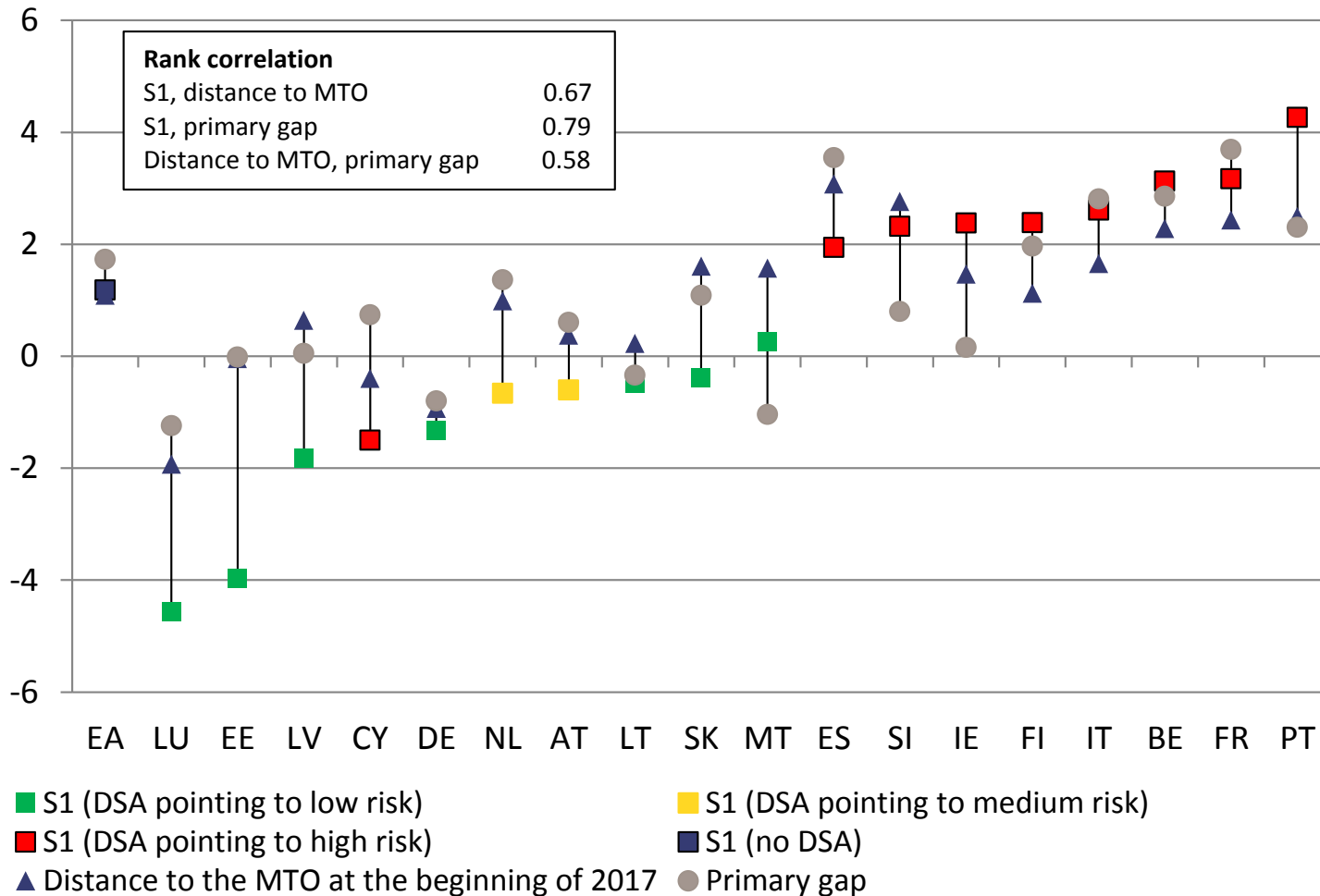
Note: % of GDP. Source: DG ECFIN.

Stabilisation and sustainability

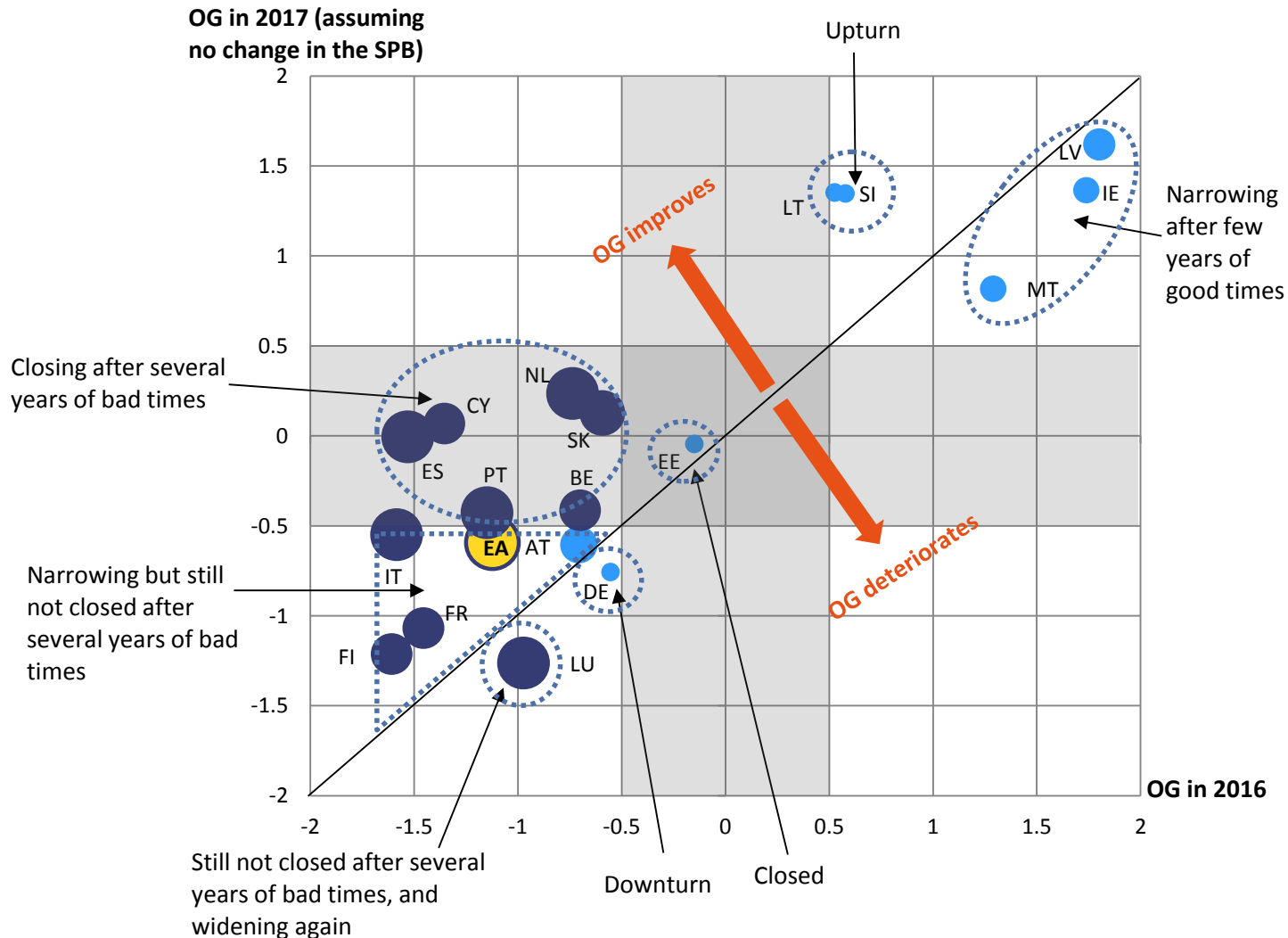


Note:
Horizontal axis: S1 indicator.
Vertical axis: output gap in 2017 assuming a neutral fiscal stance.

Sustainability: Alternative indicators confirm high risks



Stabilisation: Output gap dynamics and length of cycle

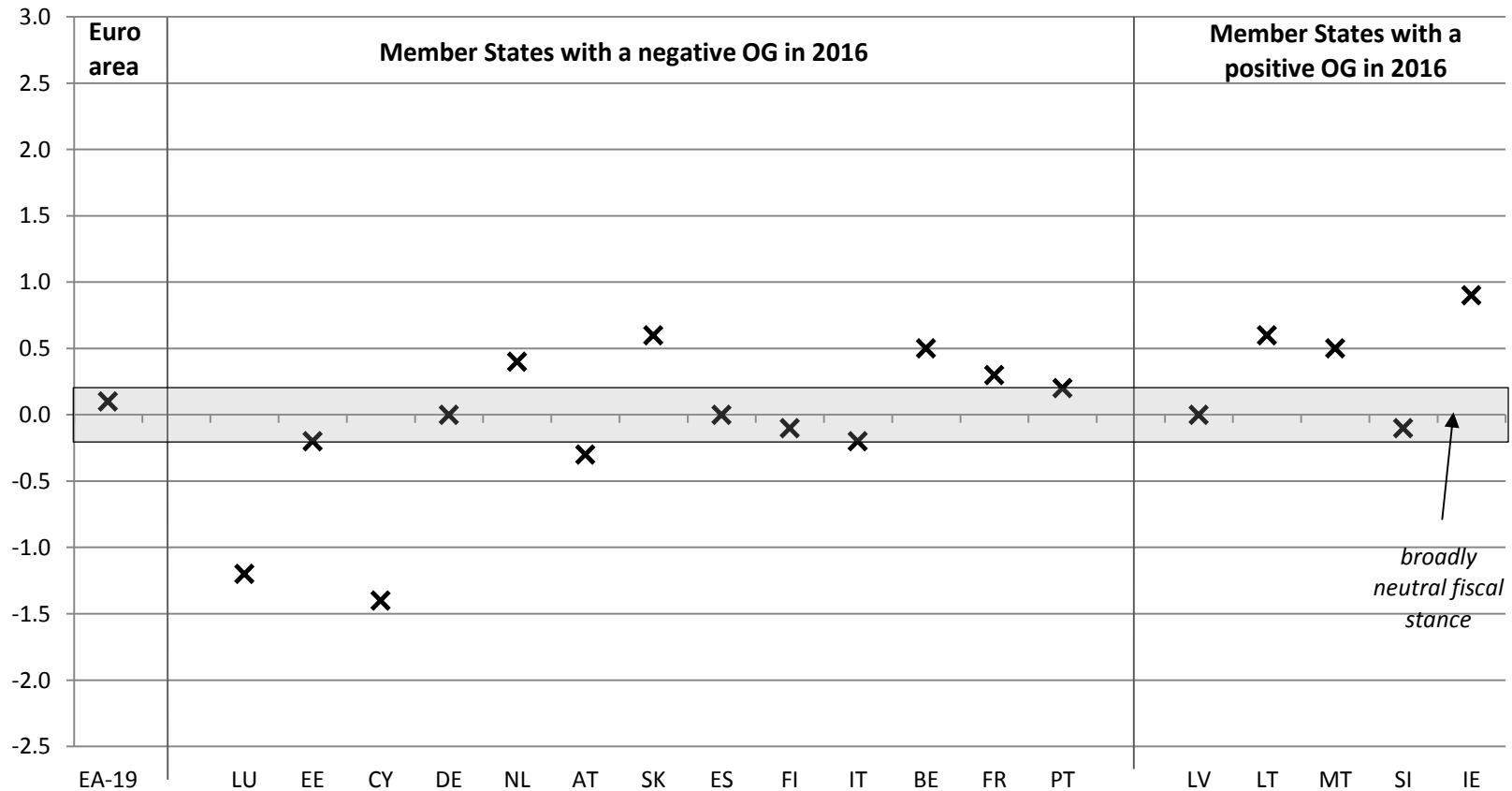


Note: **2017** assuming a neutral fiscal stance.
Shaded areas: levels at which the output gap is considered to be broadly closed.
Size of the bubbles: number of consecutive years with an output gap of the same sign, as measured in 2016 (**pale blue: 1-4 years, dark blue: 5-8 years**).

Source: DG ECFIN.

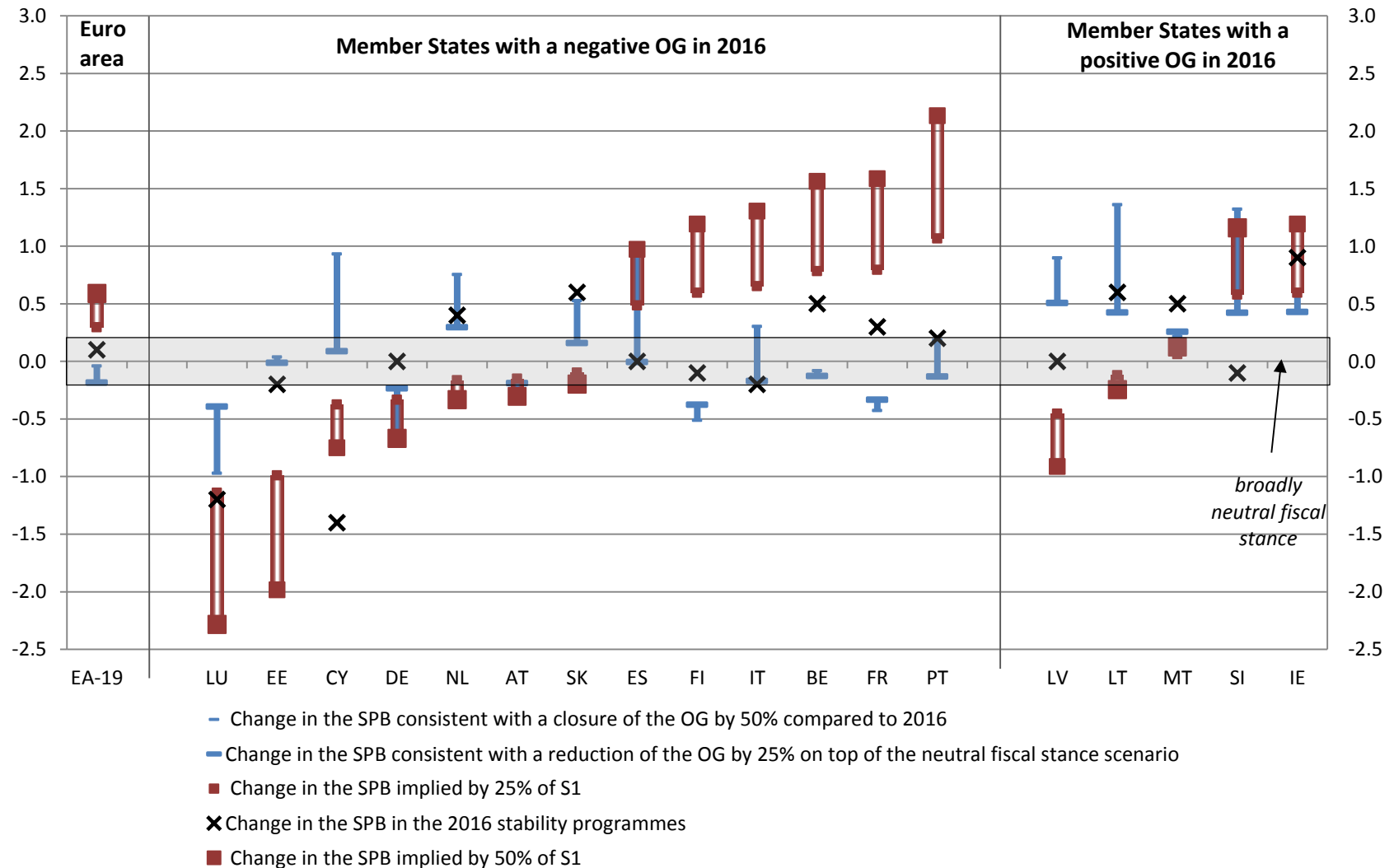


Government plans



× Change in the SPB in the 2016 stability programmes

Plans vs. sustainability and stabilisation needs



Policy implications

- **What aggregate fiscal stance is needed?**
 - Requires consensus on the objectives in terms of stabilisation and sustainability, and on their relative weights
- **How can, in theory, a given aggregate fiscal stance be broken down into national fiscal policies?**
 - Consistency with needs in individual Member States
 - Internalisation of spillovers and contagion risks
 - Efficiency and political economy considerations
- **How to deal with inadequate geographical composition?**

What more can be done?

- **Limited scope for an accommodative fiscal stance in the euro area**
 - Economically
 - Institutionally
 - Flexibility within SGP exhausted

- **Other avenues for fiscal policy to play its role in supporting the economy, in the short and medium term:**
 - Enhance automatic stabilisers
 - Make budget composition more growth-friendly
 - Central fiscal capacity?

- **The new European Fiscal Board**

Enhance automatic stabilisers

- **How?**
 - Acknowledge trade-off (risk of allocative distortion) and political economy risk of perpetuating temporary measures
 - Add safeguards to minimise these risks

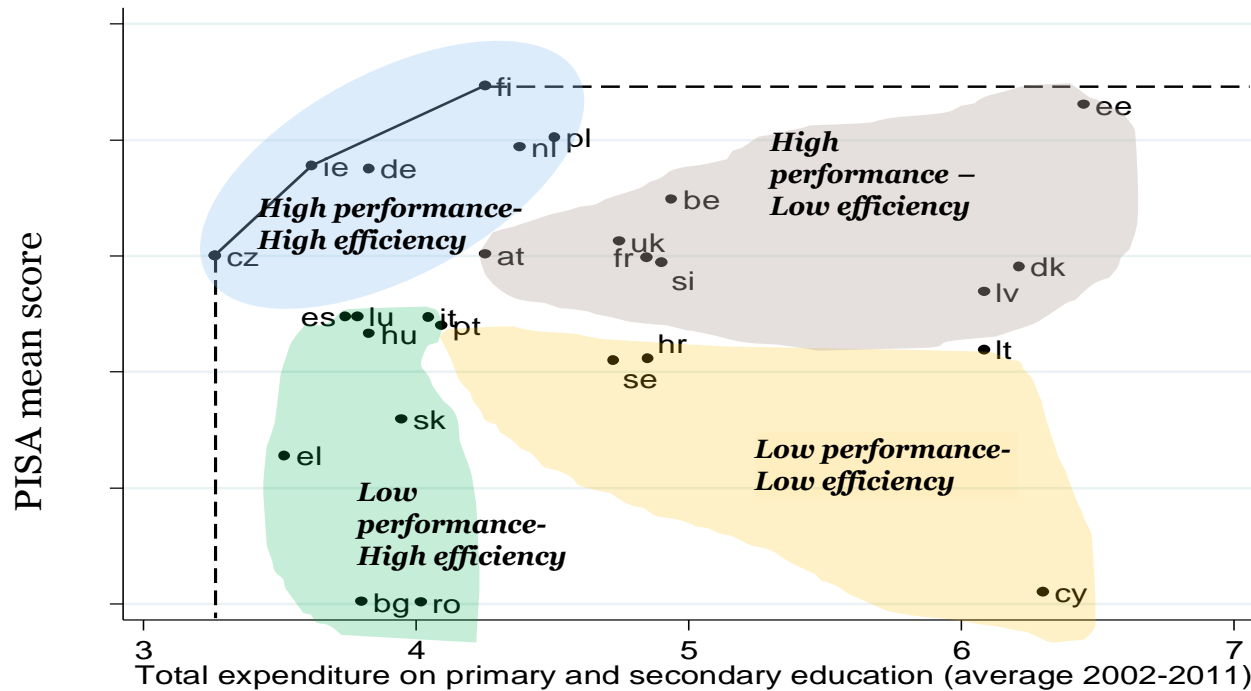
- **Example: time profile of unemployment benefits**
 - More generous in the first 6 months, with a rapid decrease thereafter => help stabilisation and reduce unemployment trap

- **Additional measures to mitigate adverse effects of automatic stabilisers**
 - E.g. cyclical investment tax credits or property taxation

Improve the composition of the budget

- **A more growth-friendly composition of budgets could help support growth in the short and long term**
 - Ex-ante budgetary neutral => no tensions with fiscal rules
 - Possibly ex-post expansionary impact
- **Expenditure**
 - Raise importance of productive spending, such as public investment, R&D, education, active labour market policies (by reviewing public wage bill, subsidies)
 - Increase efficiency / better targeting => better outcomes at an unchanged level of expenditure or lower expenditure for same outcome
- **Revenue**
 - Shift tax away from labour to consumption, property and environmental taxes
 - Broaden tax bases and eliminate inefficient tax expenditures

Improving the quality of public finances



The example of expenditure in education (Pisa score)

A central fiscal capacity?

- **Strengthen stabilisation via central capacity, whilst ensuring compliance with SGP at national level**
- **Different modalities**
 - Unemployment (re-)insurance mechanism
 - Macroeconomic stabilisation fund
 - Investment facility
- **Unresolved issues**
 - No permanent transfers
 - Avoid moral hazard
 - Degree of automaticity
 - Financing

The new European Fiscal Board

- **Mandate: advise the Commission in its fiscal surveillance tasks concerning the euro area, e.g.**
 - Evaluate horizontal consistency of fiscal surveillance decisions
 - Evaluate the appropriateness of the **actual** fiscal stance at euro area and national level
 - Advise on the appropriateness of the **prospective** fiscal stance for the euro area and possibly on the appropriate national fiscal stances consistent with it
- **Composition:**
 - Chair + 4 members (international experts, appointed for 3 years)
 - Independent and transparent (annual report)

Conclusions

- **Since the 2013 two-pack reforms**
 - More attention for the euro area fiscal stance
 - More political support
 - New player: European Fiscal Board
- **But not easy to implement in practice**
 - Different objectives (sustainability / stabilisation); weights?
 - Measurement issues and uncertainty
 - Consistency between appropriate fiscal stance for the euro area as a whole and the sum of the national fiscal stances?
- **What can fiscal policy do in the current circumstances of sub-par growth and limits to monetary policy?**
 - Asymmetry of SGP => only moral suasion, no obligation for countries with fiscal space to use it
 - Enhance automatic stabilisers
 - Improve composition of budgets
 - Central fiscal capacity?