


Discussion of Pierre Yared's
Fiscal Rules and Discretion


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DG ECFIN Workshop: „Fiscal Rules in Europe“

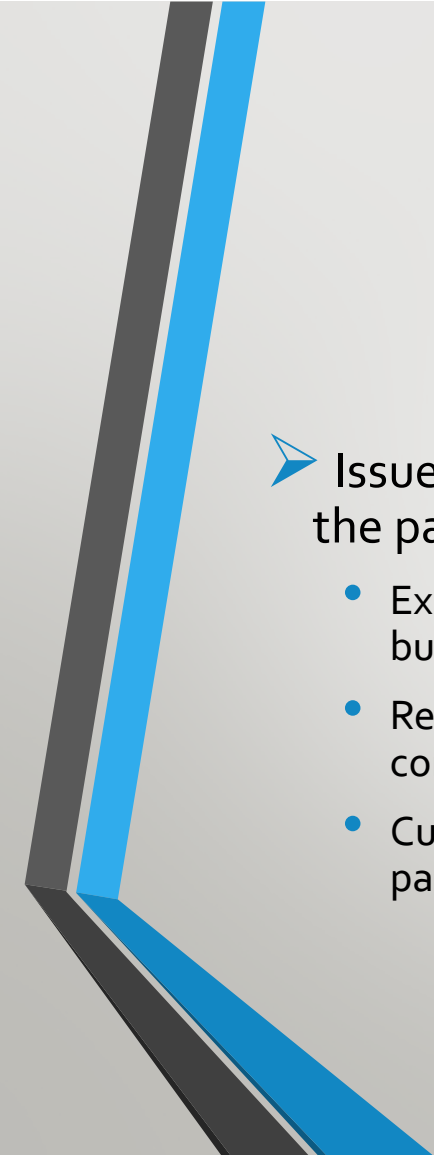
January 28, 2020

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- Analysis of fiscal rules based on deep theoretical modeling
 - Trade off between flexibility and commitment due to present bias and private information of government
 - Focus on political economy aspects
 - Welfare maximizing policies cannot explain rising government debt-to-GDP ratios
 - Rich analysis with novel insights, e.g.
 - Link between fundamentals and optimal deficit level
 - Interplay of national and supranational rules

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- **Conditioning Fiscal Rule on Public Information**
 - Enforcement
 - Supranational rules
 - Target vs. Instrument-based rules


Conditioning Fiscal Rule on *Public* Information

- Need to determine average optimal primary deficit
- Issue 1: Optimal primary deficit may be a moving target
 - deficit can be conditioned on economic variables; however, unforeseen fundamental economic changes (e.g., low interest rates) may require new optimal primary deficit
 - How to identify such a change? Hard to distinguish from attempts to soften the rule for political reasons




➤ Issue 2: How to provide dynamic incentives? Conditioning on compliance in the past

- Example: „Control account“ as part of German debt brake (aim: compliance not only in budgetary planning but also in realized budget)
- Records part of realized new borrowing not due to error in estimate of cyclical component (e.g., bad estimate of tax reform effects)
- Cumulated control account balance carried forward, triggers policy adjustment when passing a threshold

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Enforcement

- Violation of rules common because i) difficult to establish violation, ii) sanctions often not credible, and iii) financial markets often weak
- Search for alternative mechanisms
 - Mechanism 1: politicians comply today to avoid setting precedent for violation by future politicians (attractive for left-leaning politicians?)
 - Mechanism 2: perceived reputational/electoral punishment by voters; German Minister of Finance, Olaf Scholz (Social Democrat), complies with predecessor Schäuble's (Christian Democrat) „black zero“ - policy (=balanced headline budget)

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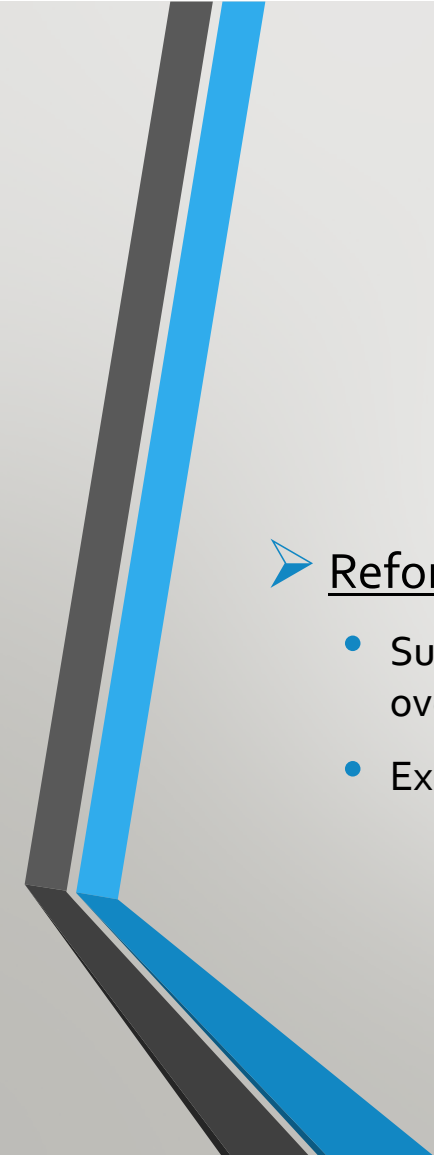
Supranational rules

- Distinction between supranational and national rules fuzzy in Europe
 - Fiscal Compact [Art. 3(2)] requires signatory states to implement structural balance rule at national level, preferably in constitution
 - monitoring of translation of rule into national law at European level
 - monitoring of rule compliance by independent fiscal council at national level
- Reflects lessons from lack of compliance with Stability and Growth Pact
=> need national stake in rule compliance game

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Target vs. Instrument-based rules

- Target-based rule better when i) govt has superior information, ii) debt bias is small, and iii) penalties for violation are severe
- Debate about translating Fiscal Compact into EU law
 - EU Commission proposal (2017): shift to expenditure rule net of discretionary revenue measures; taking account of structural reforms; compliance with MTO in multi-annual framework
 - Position of EUIFIs (2018): *"the experience of MTOs as operational fiscal policy instrument has been mixed across countries. Real-time point estimates of the structural balance level have sometimes been imprecise in the case of more volatile economies, resulting in inadequate policy prescriptions. National fiscal frameworks would thus benefit from operationalising the rules ... through more observable variables."*

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- Reform proposal of European Fiscal Board (2019) for EU fiscal framework
 - Sustainable debt level as target, to be reached via control of net expenditure growth over the business cycle
 - Existing framework too complex, opaque, and with too much political interference