DG ECFIN workshop

Fiscal Rules in Europe:
Design and Enforcement

Debt Rule Design in Theory and Practice – The SGP's Debt Benchmark

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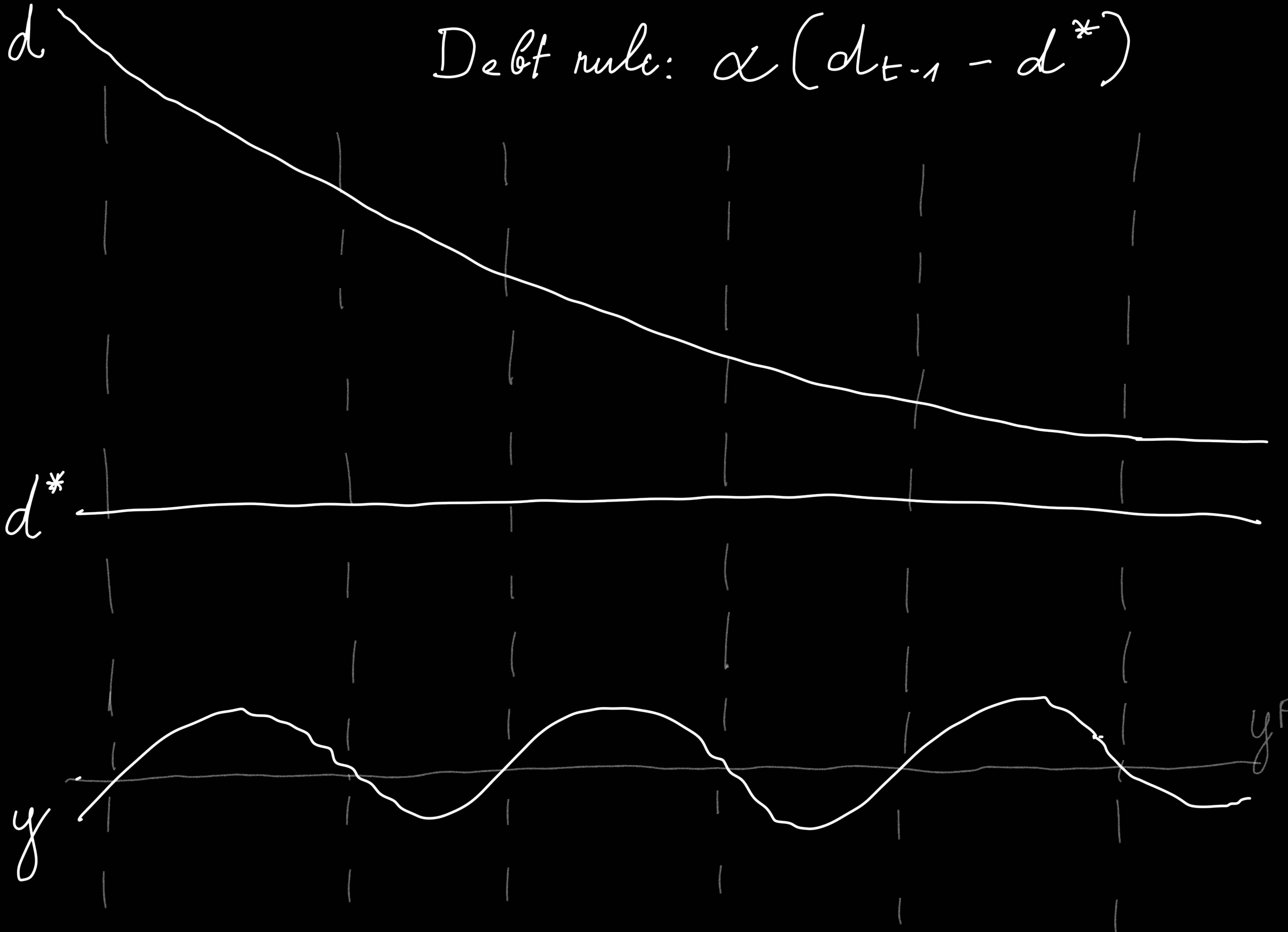
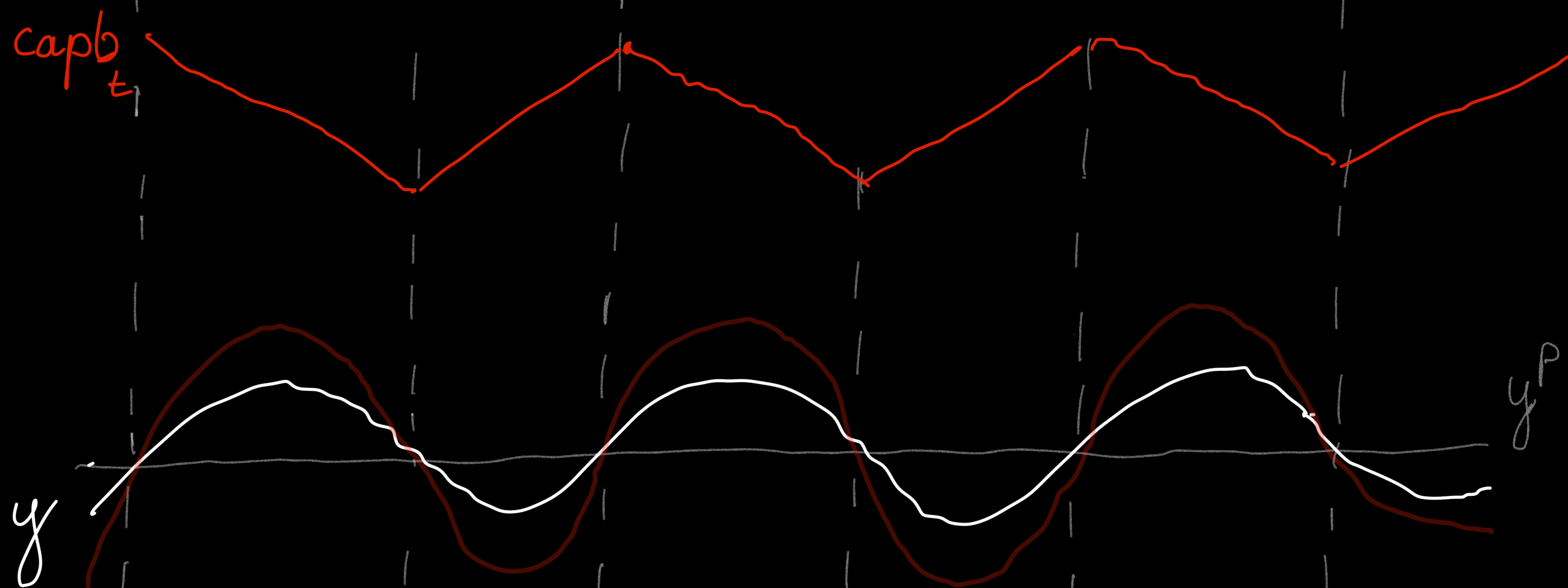
Brussels, 28 January 2020

Debt rule: $\alpha(d_{t-1} - d^*)$



$$d_{t-1} - d_t = pb_t - \frac{i_t - y_t}{1+y_t} d_{t-1}$$

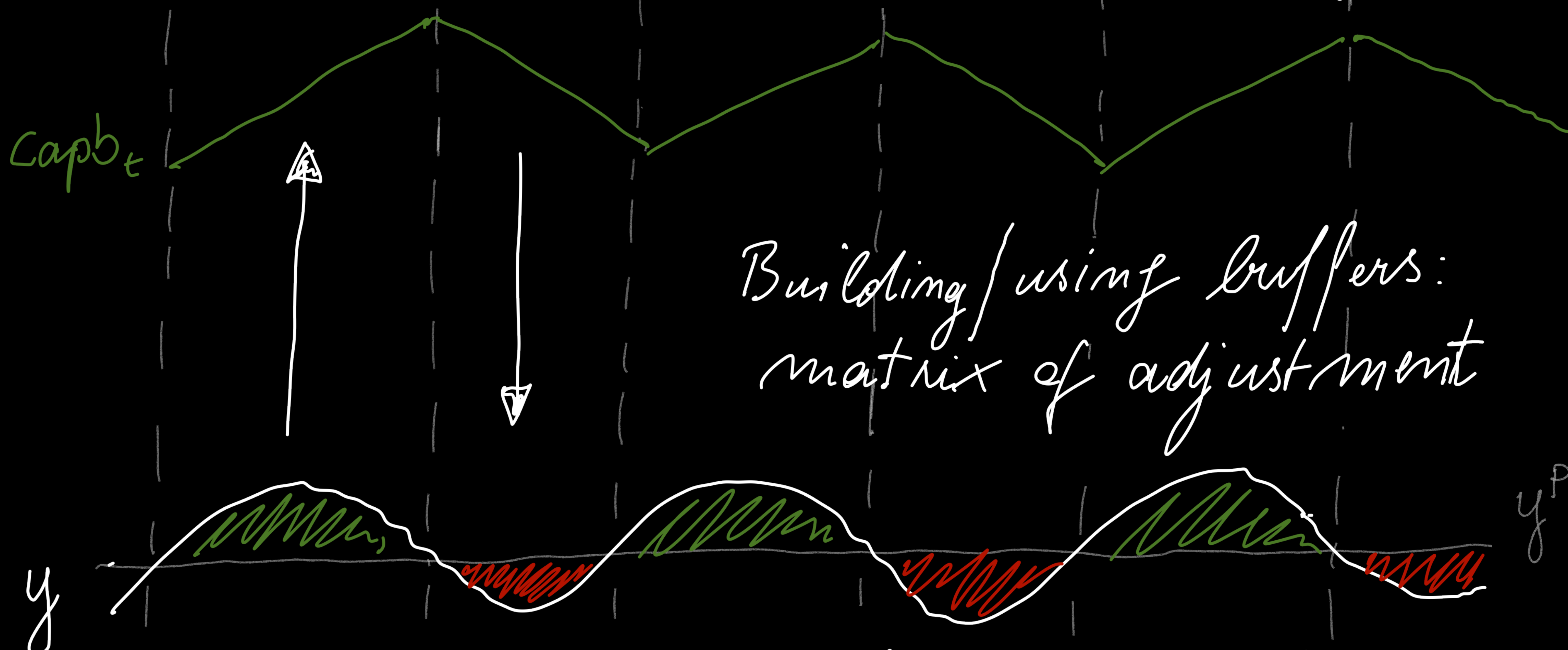
$$\alpha(d_{t-1} - d^*) = \overbrace{\Delta capb_t + capb_{t-1} + \mu\, og_t}^{pb_t} - \frac{i_t - y_t}{1+y_t} d_{t-1}$$



<u>Pro-cyclical:</u> smoothing debt path not Y

Benchmark ≠ target

$$\alpha(d_{t-1}-d^*) \lesseqgtr \Delta capb_t + capb_{t-1} + \mu og_t - \frac{i_t - y_t}{1+y_t} d_{t-1}$$



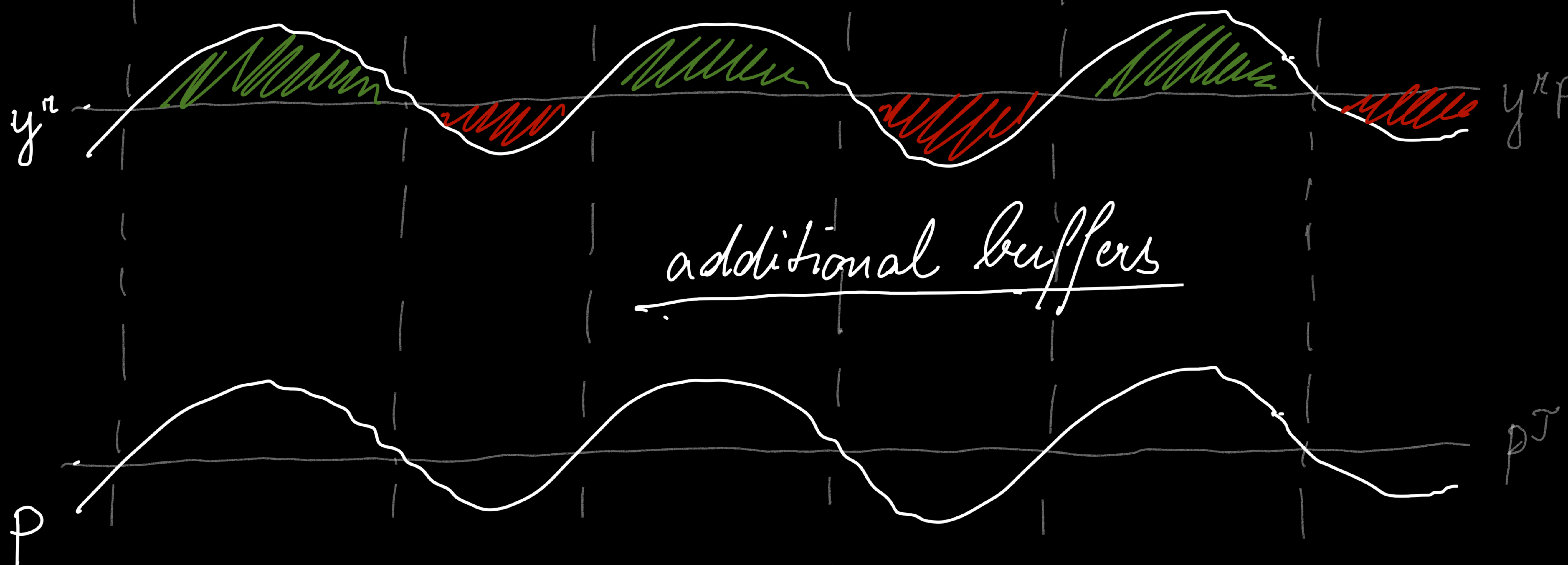
Building/using buffers: matrix of adjustment

Counter-cyclical: smoothing Y not debt path

$$\alpha(d_{t-1} - d^*) = \Delta capb_t + capb_{t-1} + \mu\, og_t - \frac{i_t - y_t}{1 + y_t} d_{t-1}$$

$$y = y^r + p = y^{rp} + y^{rc} + p^J + p^c$$

$$y^P = y^{rp} + p^J$$

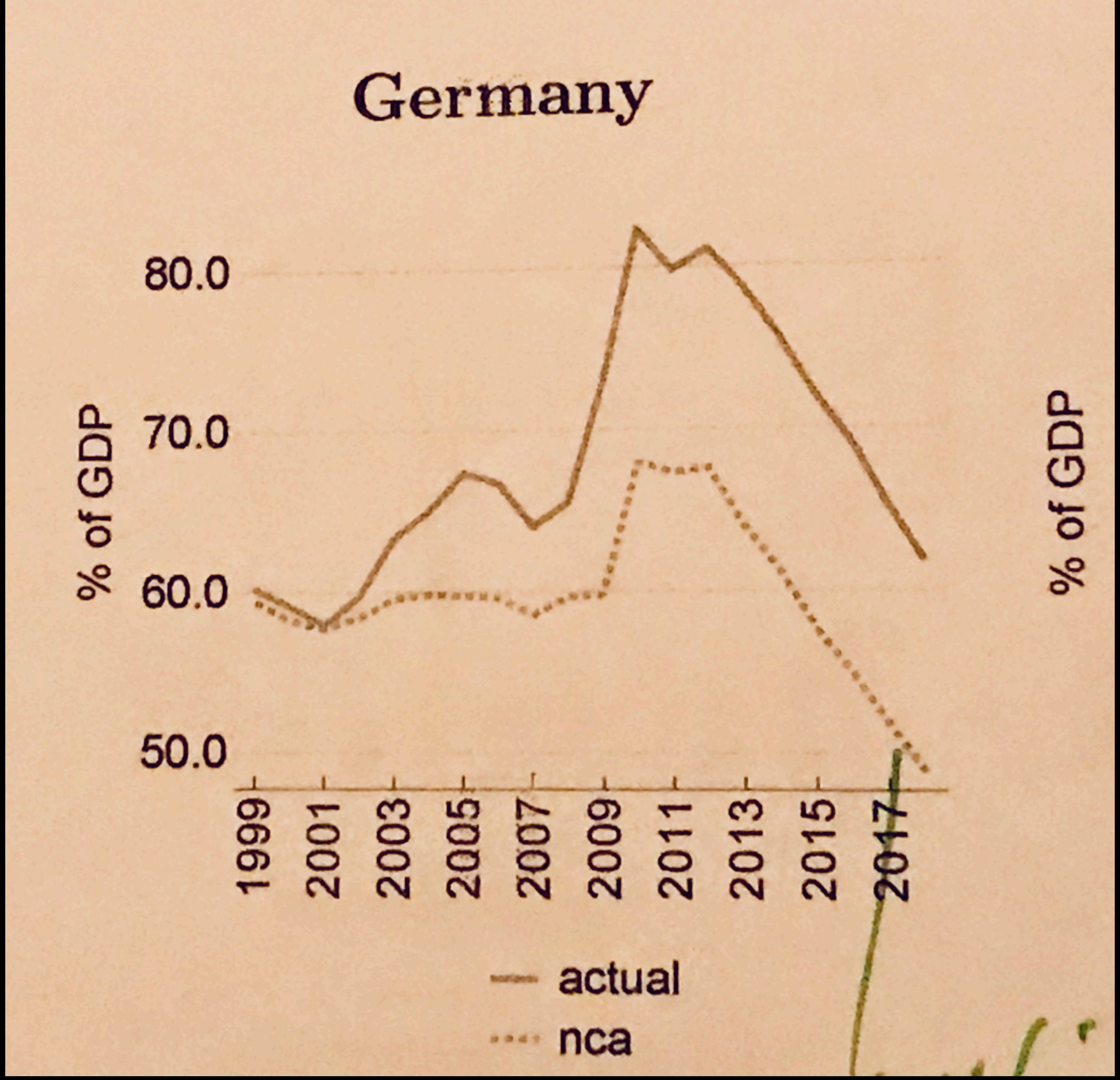


$$d_t^{\text{3-year-adj.}} = \frac{d_t Y_t + \sum_{j=0}^{2} C_{t-j}}{Y_{t-3} \prod_{h=0}^{2} \left(1 + y_{t-h}^{np}\right)\left(1 + \rho_{t-h}^{g} + \cancel{\rho_{t-h}^{c}}\right)}$$

$$d_t^{\text{3-year-adj.}} < d_t^{\text{3-year-adj.}} \quad \text{for } \rho_{t-h}^{c} < 0$$

$$\Rightarrow \quad \alpha\left(d_t^{\text{3-year-adj.}} - d^*\right) < \alpha\left(d_t^{\text{3-year-adj.}} - d^*\right)$$

Semantics : cyclical adjusment of persisting deviations?



Questions:

(i) Do you really need to adjust for persisting deviations of inflation from target?

(ii) Is lowering the speed of debt adjustment not enough?

(iii) Does "more feasible" mean better compliance?

Questions (cont'd)

(iv) Does symmetric treatment mean it is enforceable?

(v) Is it really a simplification?

Instead of complicating debt rule:

use debt as anchor: d^*

+ operational rule focusing on elements under direct control of government.

$$\alpha\left(d_{t-1} - d^*\right) = \Delta capb_t + capb_{t-1} + mog_t - \frac{i_t - y_t}{1+y_t} d_{t-1}$$

Expenditure rule

$$\Delta capb \simeq \underbrace{(r^s - y^p)}_{=\emptyset}\frac{R^s}{Y^p} - (g^s - y^p)\frac{G^s}{Y^p}$$

$$y^p = y^{rp} + p^J$$

$$\Delta capb \simeq -\left(g^s - (y^{rp} + p^J)\right)\frac{G^s}{Y^p}$$

Expenditure rule (cont'd)

$$g^* = \beta\left[y^{rp} + p^T\right] + r^d$$

speed limit of primary gov. exp.

→ β: function of d_{t-1}, d^*, $\frac{G^s}{Y}_p$, i

→ $\beta < 1$ for $d_{t-1} > d^*$

→ $\beta > 1$ for $d_{t-1} < d^*$

Thank you for your time!

https://ec.europa.eu/European-Fiscal-Board