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European Fiscal Rules Require a Major Overhaul

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Fiscal Rules in Europe: Design and Enforcement

Technical contributions by Cepremap and OFCE

Some agreement among economists

- Follow-up work of 7 + 7 group on Eurozone reforms
- Joint statement of the French and German Economic Councils (Sept. 2018) + proposal by GCEE: not identical, but:
  - The two contributions converge on the need to markedly simplify the fiscal framework
  - Redesign fiscal rules with a focus on a public expenditure rule

"We recommend that the fiscal framework should be at the core of the agenda of reforms for the Eurozone"

The rationale for specific Eurozone fiscal rules

- We do not borrow in our “own” currency but shared one
- Lack of credibility of the “no bail-out” rule
  - Bail-out of fiscally fragile countries in case of crisis: less costly than messy default and of a potential exit from the currency union (contagion + collateral damage)
  - ECB may be pressured to use debt monetization
  - Reduction of market discipline
  - Surveillance of debt sustainability necessary

The role of fiscal rules

What a fiscal rule cannot be

- An optimal rule ✗
- A substitute for fiscal policy and political 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 ✓

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.

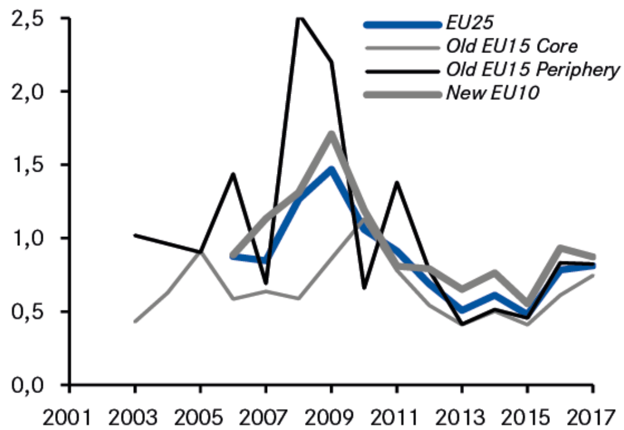
"The present rules-based system of the Stability and Growth Pact (SGP) has become nearly unmanageable due to its complexity, and the constant addition of exceptions, escape clauses, and other factors"

Thomas Wieser (2018)

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)

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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

Reforming the European fiscal framework (1/6)

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- **Target debt to GDP ratio**
- **Use public expenditure growth rate**

Proposal for a new public expenditure rule

Target the growth rate of nominal public expenditures: constrained by potential GDP growth rate, expected inflation rate and 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.

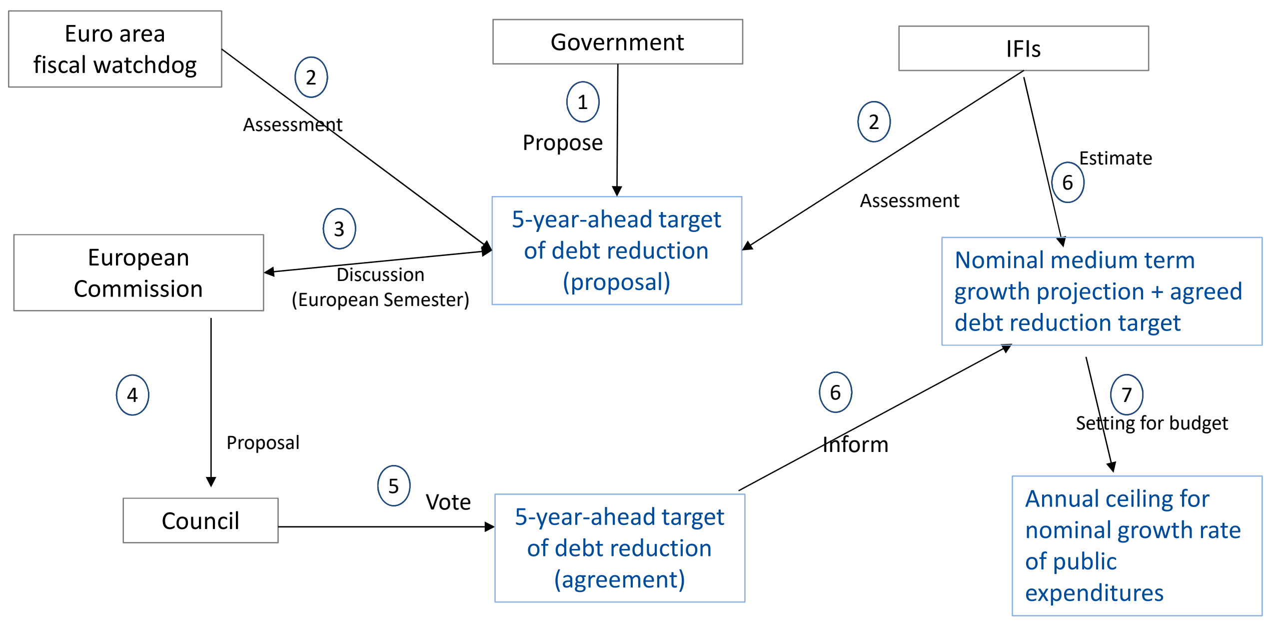
Reforming the European fiscal framework (2/6)

Main advantages of such a rule

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

Reforming the European fiscal framework (3/6)

The new rule in practice



Reforming the European fiscal framework (4/6)

What should be the consequences of such an expenditure rule?

→ Simulations of the expenditure rule (structural model)

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

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

Real potential growth

Expected inflation

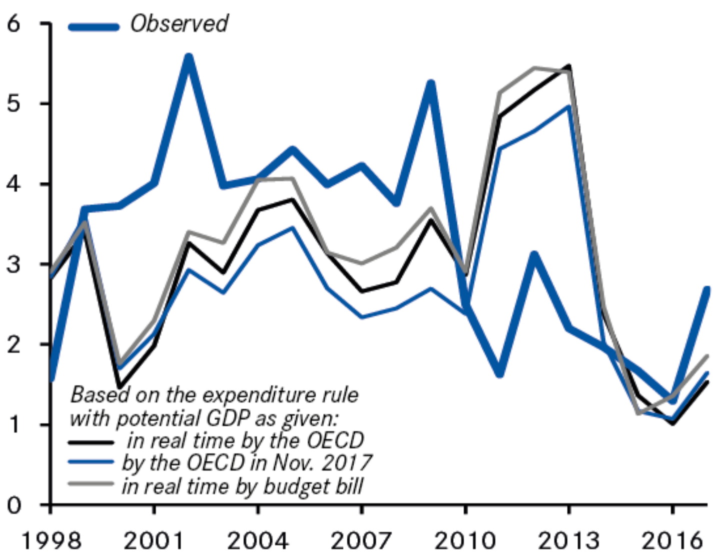
Debt brake term which takes into account the difference between the observed ratio of debt to GDP $d_{i,t}$ and the long term target d^* which we take to be 60%

– The parameter $\gamma_{i,t}$ 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)

Counterfactuals

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

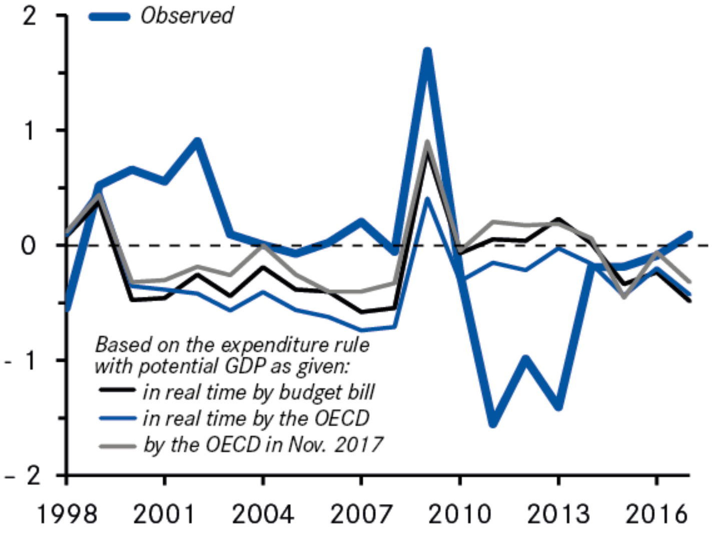


Sources: INSEE, OECD, Budget Bill, OFCE's calculations

Reforming the European fiscal framework (6/6)

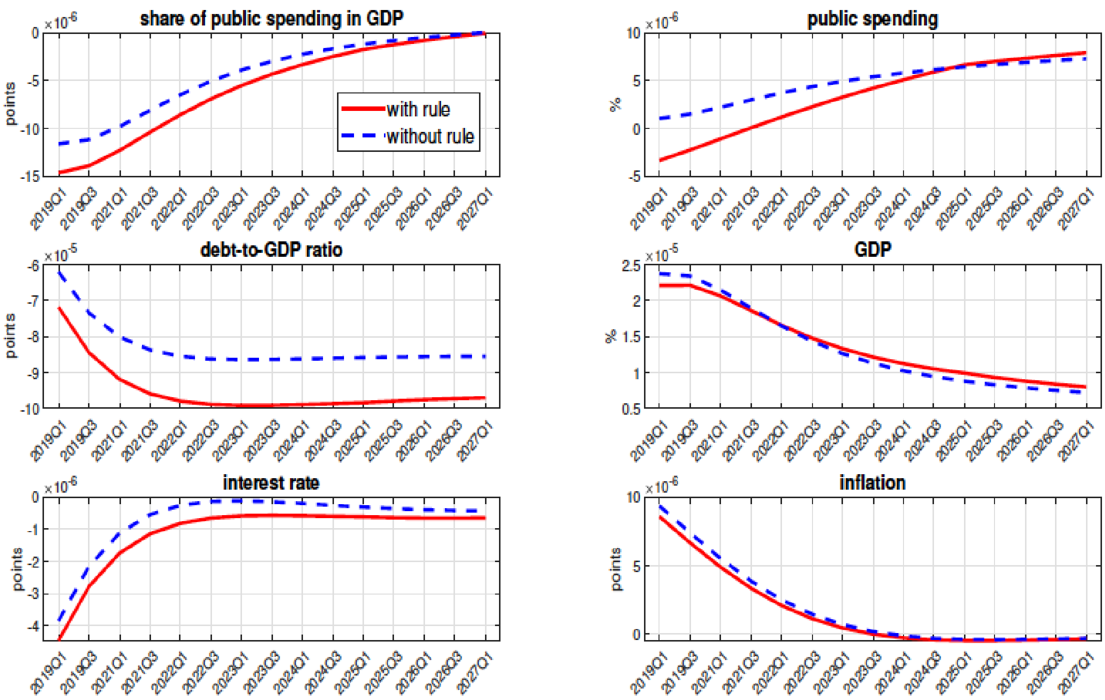
Counterfactuals

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



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

DSGE simulation (Brand and Langot, 2018) of positive demand shock



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Other questions (1/2): Can the fiscal rule react to persistent slowdown of growth ?

- Need more economic discussions on nature of shocks when deciding debt reduction targets
- Are automatic stabilizers enough? What about discretionary fiscal stimulus?
- What link with Eurozone budget? Should constraints on national fiscal policy be balanced by EZ budget with stabilization
- What is the nature of the slowdown ? (short-term or persistent)
- What about issues of secular stagnation?

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Other questions (2/2): We need to have a discussion of fiscal policy rules in low interest rate environment

- This is not exclusively due to ECB (Persistent but not permanent)
  - Since 1990s
  - Determinants are structural: supply (increased saving) and demand (decreased investment)
- Rules are silent on interest rates
- If persistent should lead to revised targets
  - With $r < g$ higher sustainable levels of debt (stabilization of debt/GDP): revised debt target?
- How do we take into account climate change investments?

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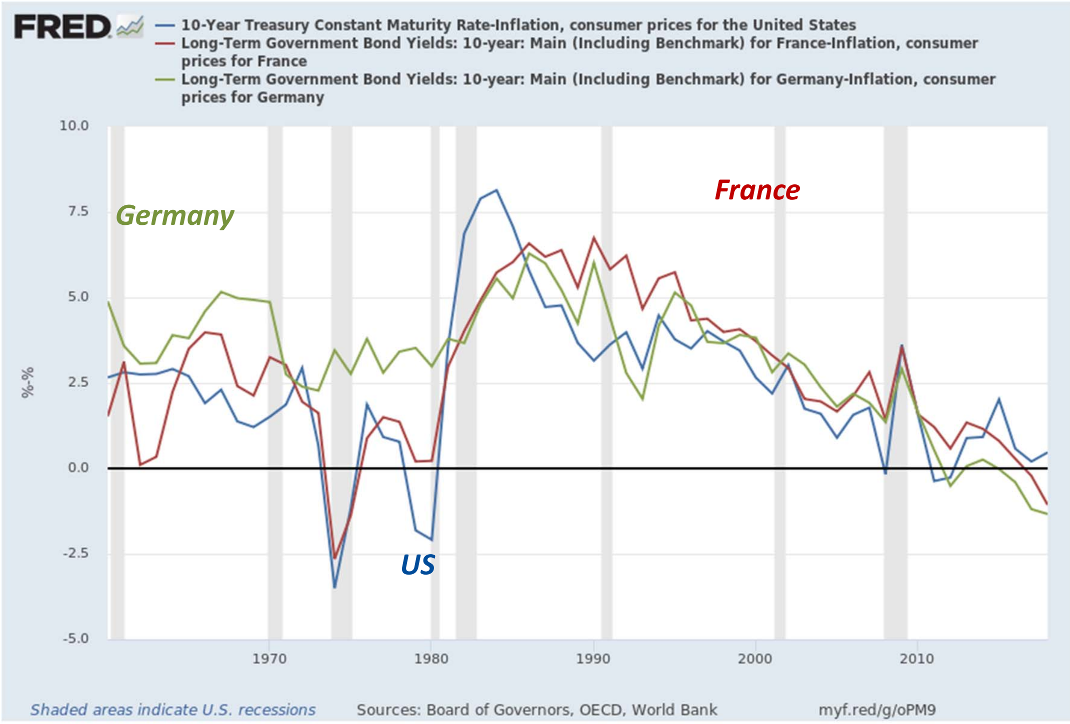
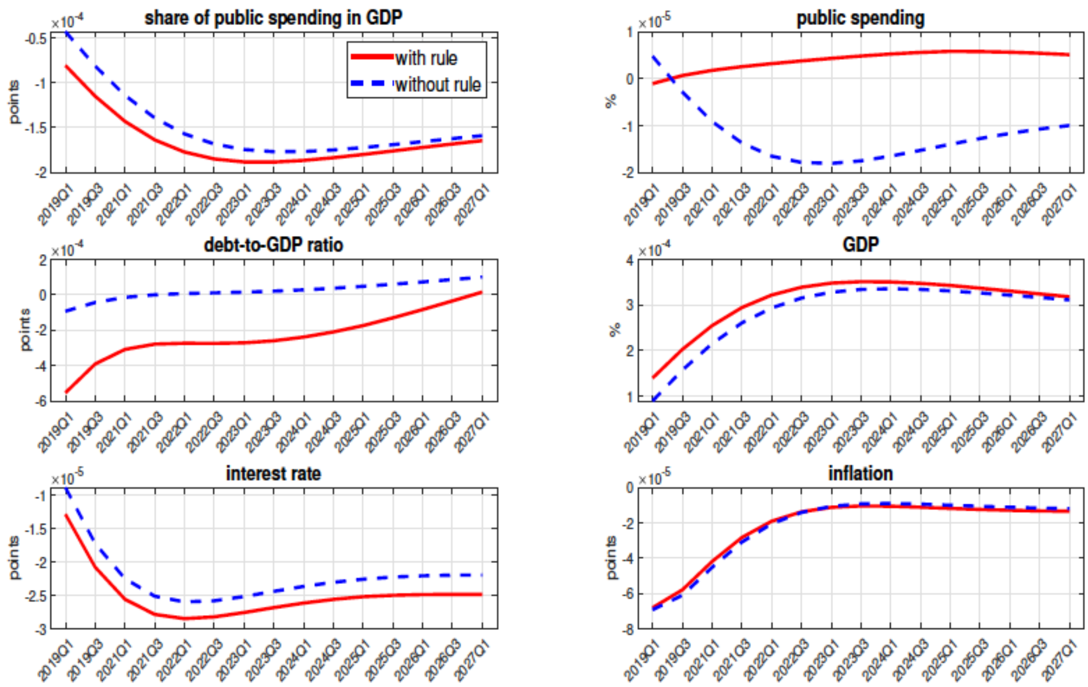
Real 10 year interest rates



Impact of a supply shock: increase in the efficiency of technology



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)

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