Fiscal rules in Europe – updates of design and implementation for fiscal rules after the global financial crisis

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1. The EU fiscal framework: origins and recent updates

2. Stock-taking

3. Which future? Searching for the right balance
Fiscal policy in the EU context

- EMU as unique model of economic integration
  - Common monetary policy & decentralised fiscal policies

- Common monetary policy
  - Price stability
  - Macroeconomic stabilisation: dealing with *common* shocks

- Fiscal policy at national level
  - Sustainability: avoiding deficit bias
  - Macroeconomic stabilisation: dealing with *idiosyncratic* shocks

- Common fiscal rules: Stability and Growth Pact
  - Avoiding fiscal dominance
  - Overcoming disincentives created by monetary union

⇒ Fiscal policy remains sovereign but must be compatible with SGP
Timeline of changes and reforms

- **Maastricht Treaty** signed (1992)
- **Preventive arm enters into force** (1997)
- **Stability and Growth Pact agreed** (1997)
- **Corrective arm enters into force** (1998)
- **Structural Balance takes central stage** (1999)
- **Six-pack enters into force** (2005)
- **First European Semester**
- **Global Financial Crisis**
- **'Fiscal compact' agreed** (2010)
- **Two-pack enters into force** (2011)
- **Communication Flexibility within existing rules** (2012)
- **Communication Flexibility within existing rules** (2013)
- **Communication Flexibility within existing rules** (2015)
# The Stability and Growth Pact

<table>
<thead>
<tr>
<th>Aim</th>
<th>Preventive arm: Member States run prudent fiscal policies over the medium run</th>
<th>Corrective arm: Member States correct 'gross' policy errors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal basis</td>
<td>Art. 121 TFEU, Regulation 1466/97</td>
<td>Art. 126 TFEU, Regulation 1467/97</td>
</tr>
</tbody>
</table>
| Objective | Close to balance or in surplus | • Deficit: 3% of GDP  
• Debt: 60% of GDP or sufficiently diminishing |
| Requirement | At the medium-term budgetary objective or on the path towards it | On the adjustment path towards correcting the excessive deficit |
| Assessment | Structural balance + expenditure growth | • Headline balance  
• Structural balance + expenditure growth |
| Process | European Semester, Stability and Convergence Programmes | Excessive Deficit Procedure: Opening – Monitoring – Abrogation |
| Enforcement | Significant Deviation Procedure | Sanctions (quasi automatic) |
Outline

1. The EU fiscal framework: origins and recent updates
2. Stock-taking
3. Which future? Searching for the right balance
Have the rules ensured sound fiscal positions in the EU?
The deficit criterion: some clustering around the 3% threshold
Debt developments are less benign...
... and a clear fiscal divide has emerged in the euro area...
... while pro-cyclicality has not been avoided

Aggregate euro area fiscal effort versus requirements and output gaps (% of potential GDP)

Source: European Commission autumn forecast 2017
Outline

1. The EU fiscal framework: origins and recent updates

2. Stock-taking

3. Which future? Searching for the right balance
Would an 'encompassing rule' be possible?

Debt anchor

Calibration of the intermediate objective reflects the choice of the debt anchor

Intermediate objective
Headline balance OR structural balance

• Starting position < Intermediate Objective
  → Requirement to adjust towards objective
• Starting position ≥ Intermediate Objective
  → Requirement to avoid deviation from objective

Operational instrument (annual compliance)
Expenditure growth (net of revenue measures)

• Default option: Gross debt ratio, 60% debt goal and 5% pace of reduction
• More freedom of choice (for the 5%)?

• Frequency of updates: annual or multi-annual?

• If multi-annual update of objective: annual or multi-annual update of instrument?
• Target or ceiling?
What would an encompassing rule imply for the EU fiscal architecture?

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<td>Assessment</td>
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<td>• Headline balance [?] • Expenditure growth</td>
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The **preventive arm** would be a natural vehicle for developing an encompassing rule (the current medium-term objective already incorporates a debt-anchor element).
What would an encompassing rule imply for the EU fiscal architecture?

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| Enforcement | Sanctions (quasi automatic) |

What to do with the Excessive Deficit Procedure, the only fiscal rule directly derived from the Treaty and arguably the only fiscal rule effective in practice?
Conclusion

- The unprecedented coexistence of **centralised monetary policy** and **decentralised fiscal policies** has led to the creation of common fiscal rules to avoid the risk of fiscal dominance.

- EU fiscal rules have evolved in the sense of greater complexity, in part reflecting the perceived need of **balancing** the primary original objective of strongly safeguarding **fiscal sustainability** against the secondary objective of allowing for **stabilisation**.

- Evidence of **success of EU rules in curbing public deficits**, in contrast with **failure to avoid pro-cyclicality**.

- Emerging consensus on ideal design of an 'encompassing fiscal rule' but persisting '**doubts' on the effectiveness of 'encompassing' vs 'narrow' fiscal rule in a supranational context**.
Thank you
Additional slides
Fiscal policy in EMU: an evolving view

Conventional view on fiscal policies in EMU – pre crisis

"Put own house in order..."

- Rules to tame deficit bias in absence of national exchange rate policy
- Automatic stabilisers: let them play
- Risk of debt monetisation dominates monetary-fiscal relations
- Low spillovers because of offsetting monetary policy reaction
- Threat of financial sanctions helps discipline governments
- Negative coordination suffices

Revising the role of fiscal policy in EMU – post crisis

"...and strengthen the joint foundation"

- Discretionary fiscal policy needed in case of large shocks
- High multipliers and spillovers when monetary policy is constrained
- Aggregate fiscal stance and differentiated fiscal space matter
- Sovereign-banks nexus
- Institutions / rules / markets
- Links fiscal policies/ structural reforms
- Difficult to sanction sovereign states
**Institutional changes in EMU since 2011**

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Measure taken</th>
<th>Measure in greater detail</th>
<th>Application</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conventional view on fiscal policies in EMU (pre-crisis)</td>
<td>Stronger SGP</td>
<td>• Introduction of expenditure rule, debt benchmark (6-P) and balanced budget rule (TSCG) • Possibility of imposing earlier/more gradual sanctions (6-P) • Surveillance of DBPs (2-P)</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>National fiscal frameworks</td>
<td>• Mandatory min. requirements at the national level) (6-P)</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Macro surveillance</td>
<td>• Prevention/correction of macroeconomic imbalances via the introduction of the new Macroeconomic Imbalance Procedure (MIP) (6-P)</td>
<td>being implemented</td>
</tr>
<tr>
<td>Revising the role of fiscal policy in EMU (post-crisis)</td>
<td>Crisis resolution mechanism</td>
<td>• European Stability Mechanism (ESM)</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Better articulation of fiscal rules</td>
<td>• More flexibility in applying the rules • Euro area fiscal stance</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Breaking sovereign/banks nexus</td>
<td>• Banking Union • Capital Markets Union</td>
<td>to be completed</td>
</tr>
</tbody>
</table>

*Note: Key reforms steps taken in the area of fiscal and macroeconomic policies are shown in italics in brackets, namely 6-Pack (6-P), Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), 2-Pack (2-P).*
Remaining vulnerabilities

**Have the financial sovereign doom loops been sufficiently severed?**
- Banking union not completed yet

**Are large public debts being reduced sufficiently?**
- Difficult to enforce rules in good times

**Does EMU have the capacity to withstand the next large shock?**
- ESM remains entirely dependent on national Treasuries and slow decision-making
- No tool for smoothing large shocks

**Is the appropriate fiscal stance at the EA level being achieved?**
- Bottom-up coordination to achieve appropriate EA fiscal stance does not work

→ Sustaining euro area falls too much on the ECB shoulders

→ Missing piece: minimum fiscal capacity to secure macroeconomic and financial stability
Zoom: Cyclical conditions

Modulation of the fiscal effort according to the economic cycle
Flexibility and unusual events (without changing the rules)

Communication on flexibility

2015-2017 Unusual event clause

Cyclical conditions

Structural reform clause

Investment clause

Refugee

Security
Stock-taking of the current framework

The strengths and weaknesses of a fiscal framework can be assessed by using a reformulation of the Kopits and Symansky (1998) criteria:

**Clarity**: Well-defined, transparent and simple
- Are the rules clearly defined and consistent?
- Are they too numerous, elaborate or complex?
- Are they transparent and predictable?

**Adequacy**: Adequate, consistent, flexible and efficient
- Do the rules aim at the right objectives?
- Do the rules stress the right balance between sustainability and stabilisation?
- Should cyclical stabilisation take the backseat to securing a structurally balanced budget in all but exceptional circumstances?

**Efficacy**: Enforceable
- Are the procedural steps of enforcement effective?
- Are sanctions an effective deterrent?
- Do the rules provide the right incentives to follow the rules?
Clarity of the framework

A multiplicity of indicators...

Clarity of the framework

... and a complex fiscal architecture...

**Fiscal governance system became more complex**
(pages of the entire framework in primary/secondary legislation by year, key innovation shown below in italics)

**Main reasons for higher complexity**

- Path dependency
- New rules or bodies were established over time, often in response to emergencies
- Sui-generis character of the EU system resulted in multiple and complex 'checks and balances'
- Evolving view on the role of fiscal policy in EMU
- Lack of trust
- Missing trust across Member States and between Commission and Member States
- Elusive quest for the 'complete contract'
Adequacy of the EU fiscal framework  
_Pro-cyclicality: regression results_

<table>
<thead>
<tr>
<th>Source: Commission calculations.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note: The table shows panel regression results replicating and extending the estimations shown in the IMF paper using the following specification: $\Delta S_B_{t,t} = \beta_1 \Delta \text{output gap}<em>{i,t} + \beta_2 \text{debt}</em>{i,t-1} + \beta_3 \text{dummy}<em>{i,t-1} \cdot \Delta \text{output gap}</em>{i,t} + \beta_4 \text{dummy}<em>{i,t-1} \cdot \theta + \theta_t + \eta</em>{i,t}$. The sample includes 28 EU countries (IMF 19 EA) covering the period 2000-16 (IMF 1999-15). Data for regressions using &quot;ex post&quot; data come from the Commission autumn forecast 2016 (IMF spring 2015). &quot;Real time&quot; indicates outturns in period t reported in period t+1 in line with the second IMF scenario (see Table 1). All estimations include time and country dummies and a constant, which are not shown due to space constraints. Estimation approach: least square dummy variable estimator (LSDV) using heteroskedasticity-robust Huber-White standard errors. *-statistics in parentheses. ***, ** and * denote respectively statistical significance at 1, 5 and 10%.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Dependent variable:</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
<th>(7)</th>
<th>(8)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\Delta S_B$</td>
<td>$\Delta S_B$</td>
<td>$DFE$</td>
<td>$DFE$</td>
<td>$\Delta S_B$</td>
<td>$\Delta S_B$</td>
<td>$\Delta S_B$</td>
<td>$\Delta S_B$</td>
<td></td>
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<tr>
<td>Dummy:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>EDP</td>
<td>IMF programme</td>
</tr>
<tr>
<td>Data:</td>
<td></td>
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<td></td>
<td></td>
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<td>Publ. exp. &lt; potential gr</td>
</tr>
<tr>
<td>Measure for econ. cycle:</td>
<td>ex post</td>
<td>real time</td>
<td>ex post</td>
<td>ex post</td>
<td>real time</td>
<td>real time</td>
<td>real time</td>
<td>real time</td>
</tr>
<tr>
<td>Econ. cycle (t-1)</td>
<td>-0.34***</td>
<td>-0.27***</td>
<td>-0.39***</td>
<td>0.09</td>
<td>-0.18**</td>
<td>-0.28***</td>
<td>-0.23*</td>
<td>-0.31***</td>
</tr>
<tr>
<td>Debt (t-1)</td>
<td>0.03***</td>
<td>0.04***</td>
<td>0.01***</td>
<td>0.030**</td>
<td>0.04***</td>
<td>0.04***</td>
<td>0.02**</td>
<td>0.04***</td>
</tr>
<tr>
<td>Econ. cycle x dummy (t-1)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>-0.36***</td>
<td>-0.25**</td>
</tr>
<tr>
<td>Dummy (t-1)</td>
<td>0.03***</td>
<td>0.04***</td>
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<tr>
<td>Obs.</td>
<td>473</td>
<td>367</td>
<td>168</td>
<td>168</td>
<td>367</td>
<td>367</td>
<td>191</td>
<td>367</td>
</tr>
<tr>
<td># countries</td>
<td>28</td>
<td>28</td>
<td>28</td>
<td>28</td>
<td>28</td>
<td>28</td>
<td>28</td>
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</tr>
<tr>
<td>R-squared</td>
<td>0.31</td>
<td>0.39</td>
<td>0.39</td>
<td>0.52</td>
<td>0.41</td>
<td>0.39</td>
<td>0.25</td>
<td>0.39</td>
</tr>
<tr>
<td>Econ. cycle</td>
<td>dummy = 1</td>
<td>-0.54***</td>
<td>-0.53***</td>
<td>-0.34**</td>
<td>-0.22***</td>
<td></td>
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_reduces pro-cyclicality_  
_amplifies pro-cyclicality_  
_pro-cyclical if < 0_  
_additional impact if dummy is 1_  
_marginal impact if dummy is 1_
Efficacy of the EU fiscal framework

Divergent positions vis-à-vis Medium Term Objectives...
Efficacy of the framework

No convergence between euro area Member States

Countries at or above MTO in 2017
Countries close to MTO in 2017
Countries far away from MTO in 2017
How to enforce fiscal rules?
SGP sanctions versus market-based 'sanctions'

<table>
<thead>
<tr>
<th>Sanction type</th>
<th>Stability and Growth Pact: deposit / fine (1)</th>
<th>Interest rate spreads (30 to 200 basis points) (2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budgetary impact</td>
<td>0.005% of GDP / 0.205 – 0.5125% of GDP</td>
<td>0.06 – 0.39% of GDP</td>
</tr>
</tbody>
</table>

*Source: Ameco, authors' calculations (based on Manganelli and Wolswijk, 2007)*

(1) Non-interest bearing deposit following a 126(6) Council decision. Interest rate assumption: 2.5% based on IT and PT long-term rates in 2017 (2.1% and 3.1%, respectively). Fine following a 126(8) Council decision is 0.205% of GDP. ‘Initial’ fine under Article 126(11) ranges from 0.205-0.5125% of GDP. ‘Additional’ fine under 126(11) is up to 0.5125% of GDP.

(2) Calculations based on the current debt ratios of IT and PT (132% of GDP and 126% of GDP, respectively) and an average debt maturity of around 6½ years. This corresponds to an annual refinancing of around 20% of GDP. A 1 pp. higher interest rate then would translate into a 0.2% of GDP higher interest bill.
Stock-taking of the current framework

Efficacy optimum not yet achieved...

SIMPLICITY

Efficacy

ADEQUACY

SGP.0 (1997)

SGP.1 (2005)

SGP.2 (2011)
How to streamline the sustainability core of the SGP?

- **Diagnosis:** current SGP stockpiles variables
  - Headline balance, structural balance (level and change), debt, expenditure growth... but how to 'streamline'?

- **Idea n°1: Finding the right place for each indicator:**
  - Debt: the better long-term objective
  - Annual compliance (action) indicators: change in structural balance or net expenditure growth?
  - Compliance indicator can't be directly linked to LT objective ⇒ Need for intermediate target: headline, structural balance?

- **Idea n°2: Connecting the 'ideas around':**
  - Cf. IMF, others: Single debt anchor *cum* single operational target
  - Finding agreed reference for deficits:
    - 3%: problem when understood as target
    - MTO too tight? (more controversial)
    ⇒ Something in-between?
Quid stabilisation dimension?

- In part linked to previous choices
  - *Not the same if* headline or structural is intermediate objective
  - *Not the same if* operational instrument is structural balance or expenditure growth

- 'Matrix-based' or not? Pros and cons, link with escape clauses

- EDPs
  - Duality headline/structural an issue (currently, 'weakest applied')
  - Can one 'relativise' role of headline targets?
    - Returning to 3% on time neither necessary nor sufficient for compliance
    - Compliance based exclusively on structural metric (structural balance or expenditure growth)

- Stabilisation function for large shocks
  - Would it affect above choices?
Value added of a stabilisation function

**National mechanisms**
- National Fiscal Policy (SGP guides response)

**Common mechanisms**
- Common Monetary Policy

**Usual fluctuations**
- National Fiscal Policy may be constrained...
- ...and faces complex trade-off stabilisation-sustainability

**Deep downturn**
- Monetary Policy may be constrained
- Fiscal Policy coordination reaches its limits

Stabilisation Capacity: Tops up national fiscal stabilisers
A European stabilisation function in support of investment

Loans

Insurance mechanism

37
Sovereign bond market reaction

Ten year government bond yields

- Benign neglect to contagion
- Draghi "Whatever it takes"
- ECB letter to Berlusconi
- May 2010 package
- Anesthesia

Germany
Spain
Ireland
Italy
Portugal
Greece
Role of market discipline: right sequencing is key

Move forward with risk reduction and risk-sharing

- complete Banking Union and Capital Markets Union
- treatment of national sovereign exposures of the banking sector (RTSE)
- Euro safe asset

Simplification of EU fiscal rules + Fiscal stabilisation function

Better enforcement of national and EU rules