EU fiscal framework

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Contents

"Central banks are often accused of being obsessed with inflation. This is untrue. If they are obsessed with anything, it is with fiscal policy."

Discussions of fiscal policy often originate with central banks (…) the Bank of England was created to help the British government finance its deficit; and it was in the Federal Reserve Bank of Minneapolis' *Quarterly Review* that in 1981, Tom Sargent and Neil Wallace published their well-known article "Some Unpleasant Monetarist Arithmetic." Their basic proposition was that if the fiscal authority sets its budgets independently of the monetary authority, then the latter might be forced to tolerate a higher inflation rate than it would prefer in order to generate sufficient revenue from seigniorage to satisfy the government budget constraint.

Mervyn King (1995)

1957 Treaty of Rome (EEC: customs union; BE, NL, LU, DE, FR, IT)

1970 Werner Plan (end phase of Bretton Woods; three stages to monetary union by 1980; break up of Bretton Woods; oil crisis)

1979 EMS and ERM (stable exchange rates ±2.25% around central rate; change only by mutual agreement; bands widened 1992-93; IT and UK leave ERM)

1989 Delors Plan (three stages to monetary union by 1999)

1990 1 July, 1st stage of the EMU.

1991 Treaty on the EU approved (Maastricht Treaty; convergence criteria)

1994 1 January, setting up of the European Monetary Institute (EMI), 2nd stage of the EMU.

1997 Approval of Stability and Growth Pact (enter into force 1998 and 1999)

1998 Decision on EMU membership

1999 1 January, launching of the euro. Beginning of the 3rd stage of the EMU (11 countries; GR 01; SI 07; CY, MT 08; SK 09; notes and coins 2002)

EMU: division of labour

Monetary Policy

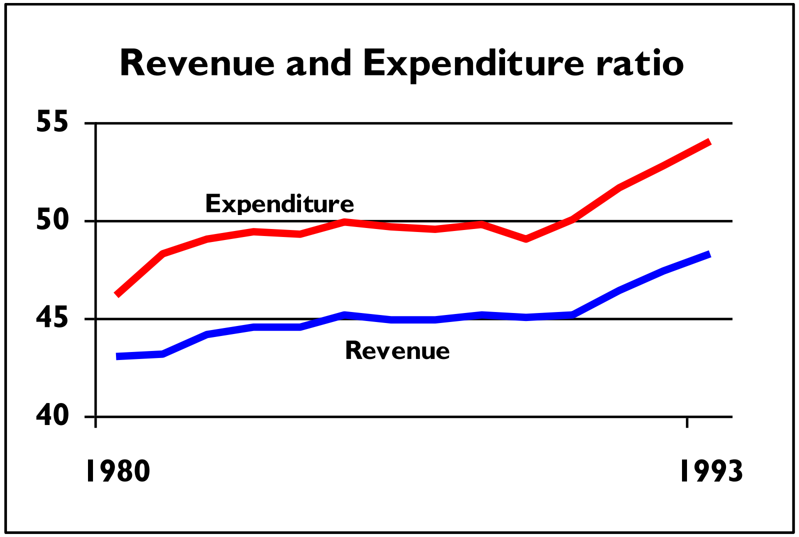
- Single monetary policy and independent central bank
- The primary objective is maintaining price stability
- Without prejudice to this, support the policies in the Community

Fiscal Policies

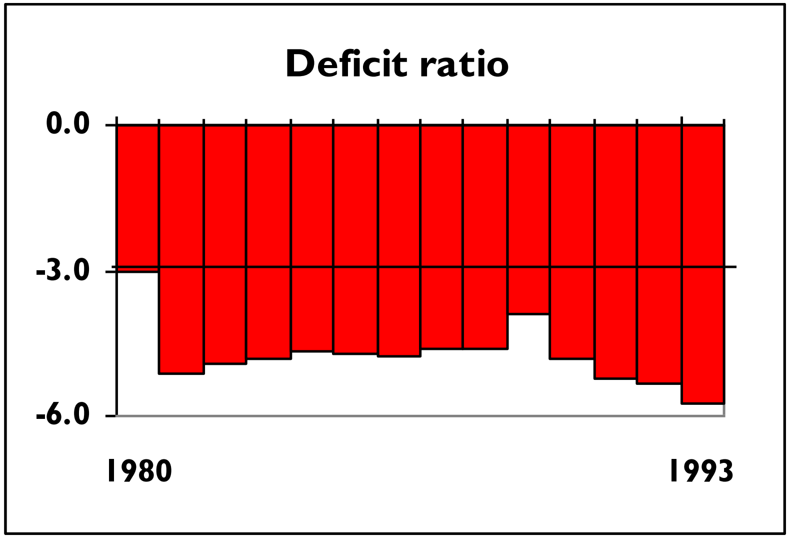
- Exclusive competence of Member States
- Budgetary autonomy is, in formal terms, absolute
- But fiscal policies are subject to rules of budgetary discipline

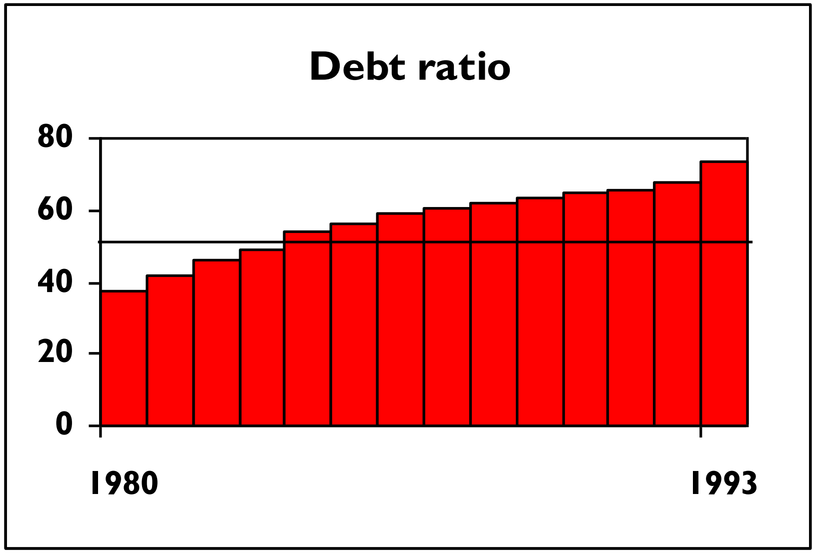
Fiscal developments: pre-Maastricht

High and rising expenditures



Large deficits





Increasing debt burden

Source: AMECO.

Design of fiscal rules for EMU

Policy setting

- No 'political union': national fiscal sovereignty
- EMU relies on rules-based, intergovernmental framework

Requirements for rules

- Need for right incentives for policy makers
- Aim for discipline and efficiency
- Effective policy rules are
  - clear and simple
  - implementable and enforceable
  - credible and durable

The EU Treaty

Building blocks of EMU fiscal policy framework in the Treaty

- **Article 126: Excessive Deficit Procedure (EDP)**
- Protocol on the EDP: 3% and 60% reference values
- Article 121: Co-ordination of economic policies
- Further relevant provisions
  - Article 122: Union financial assistance in exceptional circumstances
  - Article 123: no monetary ECB financing of governments
  - Article 124: no privileged government access to financial institutions
  - Article 125: no bail out clause

But Treaty needs to be made operational

The Stability and Growth Pact

Council regulations (1466/97; 1055/2005 and 1467/97; 1056/2005)

Preventive arm: monitoring and surveillance

- Annual stability and convergence programmes
- Medium-term budgetary objectives

Corrective arm: the excessive deficit procedure

- Identification of excessive deficits
- Commitment to correct excessive deficits (deadlines, speed of adjustment)

Preventive arm

Stability and convergence programmes

- Annual programs submitted by Member States;
- Outline macroeconomic projections and fiscal policy plans for the next and the following 2 years;
- Peer review process, discussed by all Member States in Brussels;
- ECOFIN Council conclusions.

MTO: medium-term objective (by country)

- MTOs defined in terms of structural balance (cyclically adjusted, net of one-off and temporary measures)
  - minimum benchmarks: need to stay away from 3% limit (dependent on GDP growth volatility and budgetary elasticities);
  - make progress toward fiscal sustainability (reduction of high debt ratios);
  - leave room for manoeuvre;
- Adjustment path to MTO: 0.5% of GDP structural adjustment.

MATRIX FOR SPECIFYING THE ANNUAL FISCAL ADJUSTMENT TOWARDS THE MEDIUM-TERM OBJECTIVE (MTO) UNDER THE PREVENTIVE ARM

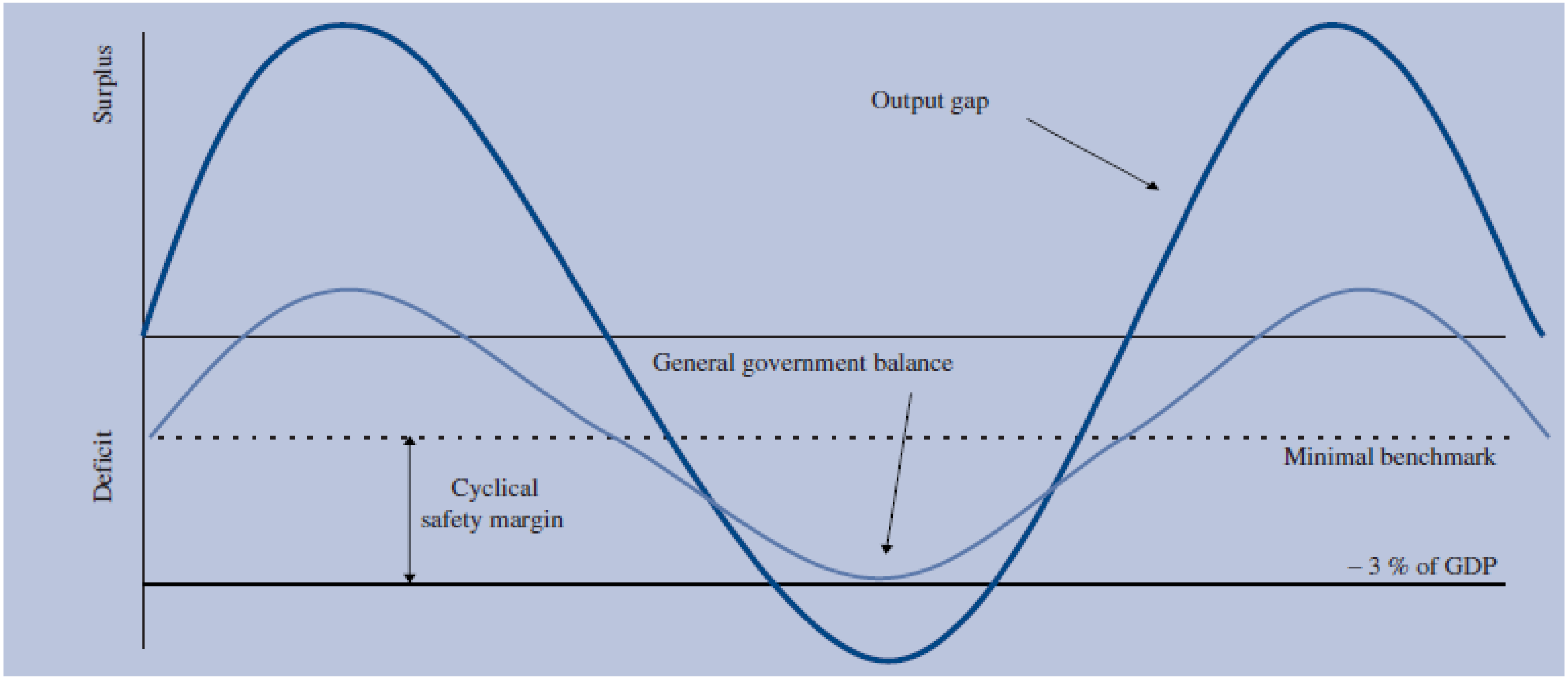
		Required annual fiscal adjustment*	
	Condition	Debt below 60 % and no sustainability risk	Debt above 60 % or sustainability risk
Exceptionally bad times	Real growth <0 or output gap <-4	No adjustment needed	
Very bad times	-4 ≤ output gap <-3	0	0.25
Bad times	-3 ≤ output gap < -1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1.5 ≤ output gap < 1.5	0.5	> 0.5
Good times	output gap ≥ 1.5 %	> 0.5 if growth below potential, ≥ 0.75 if growth above potential	≥ 0.75 if growth below potential, ≥ 1 if growth above potential

* all figures are in percentage points of GDP

Source: EC (2015).

MTO: sound fiscal positions provide flexibility

Objective of sound fiscal positions: when the deficit is safely below the reference value (at MTO), automatic fiscal stabilisers can operate freely.



Source: EC (2006).

Corrective arm: excessive deficit procedure
(deficit above 3% of GDP**)**

- European Commission initiates excessive deficit procedure (mostly ex post, ex ante less frequent);
- Ecofin Council decides on i) existence of excessive deficit; ii) recommendation to correct the excessive deficit situation
  - deadline for correction (usually 1 year after identification);
  - correction path (annual adjustment of 0.5% in structural terms);
  - implement corrective measures;
  - regular monitoring.
- If excessive deficit is corrected: abrogation.
- If it is not corrected:
  - new recommendation with new deadline (e.g. if macroeconomic environment more difficult than originally expected);
  - tightening of the procedure: give notice; impose sanctions (non-interest bearing deposit; ultimately fine).

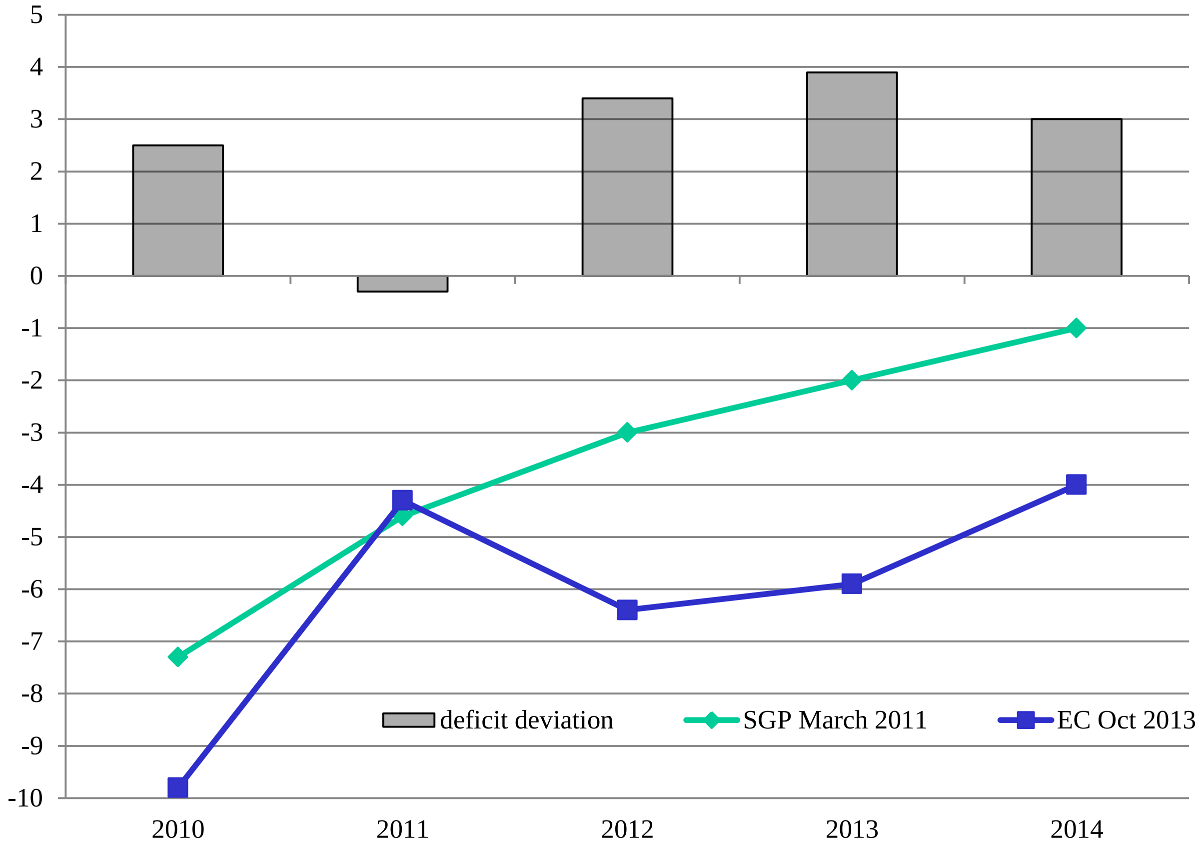
Corrective arm: excessive deficit procedure

104(7) recommendations formulated in the past for EU-15 Member States

		Indentification (= year t)	Deadline for the correction	Effort in t	Effort in t+1	Effort in t+2	Effort in t+3	Yearly average
104(7) rec. under the original SGP to EU-15 Member States	DE	2003	2004 (t+1)	1.0 % of GDP of structural measures		—	—	0.5 % of GDP
	FR	2003	2004 (t+1)	> 0 % of GDP	at least 0.5 % of GDP	—	—	0.3 % of GDP
	NL	2004	2005 (t+1)	0.6 % of GDP	at least 0.5 % of GDP	—	—	0.5 % of GDP
	GR	2004	2005 (t+1)	Structural measures of at least 1 % of GDP over the 2 years		—		0.5 % of GDP
104(7) rec. under the revised SGP	IT	2005	2007 (t+2)	> 0 % of GDP	Change in the structural balance of at least 1.6 % of GDP cumulated		—	0.6 % of GDP
	PT-II	2005	2008 (t+3)	Package of 0.6 % of GDP	1.5 % structural	0.75 % structural	0.75 % structural	0.9 % of GDP
	UK	2006 (fiscal year)	2006 (t)	0.5 % structural	—	—	—	0.5 % of GDP

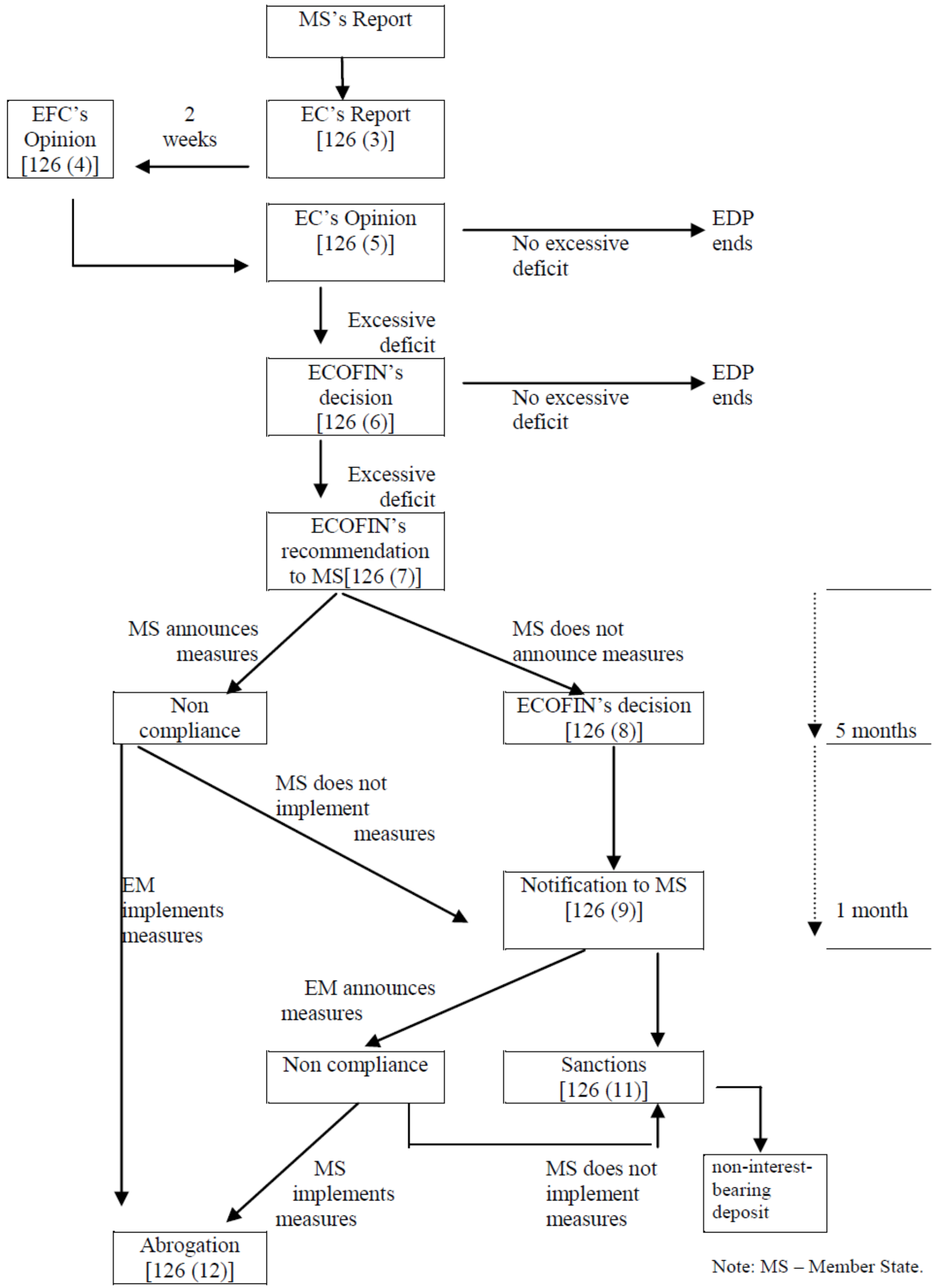
Source: EC (2006).

Example of deficit forecast deviations (Portugal, % of GDP)



Source: SGP, March 2011, EC, October 2013.

Excessive Deficit Procedure



Note: MS – Member State.

Financing programmes in the EU

Greece

- 1st programme: May 2010 - Dec. 2013;
- EUR 110 bn; 47% of Greek GDP;
- 2nd programme (until 2014);

  EUR 109 bn official financing (of which EUR 34 bn refinancing), EUR 54 bn (gross) private sector involvement.

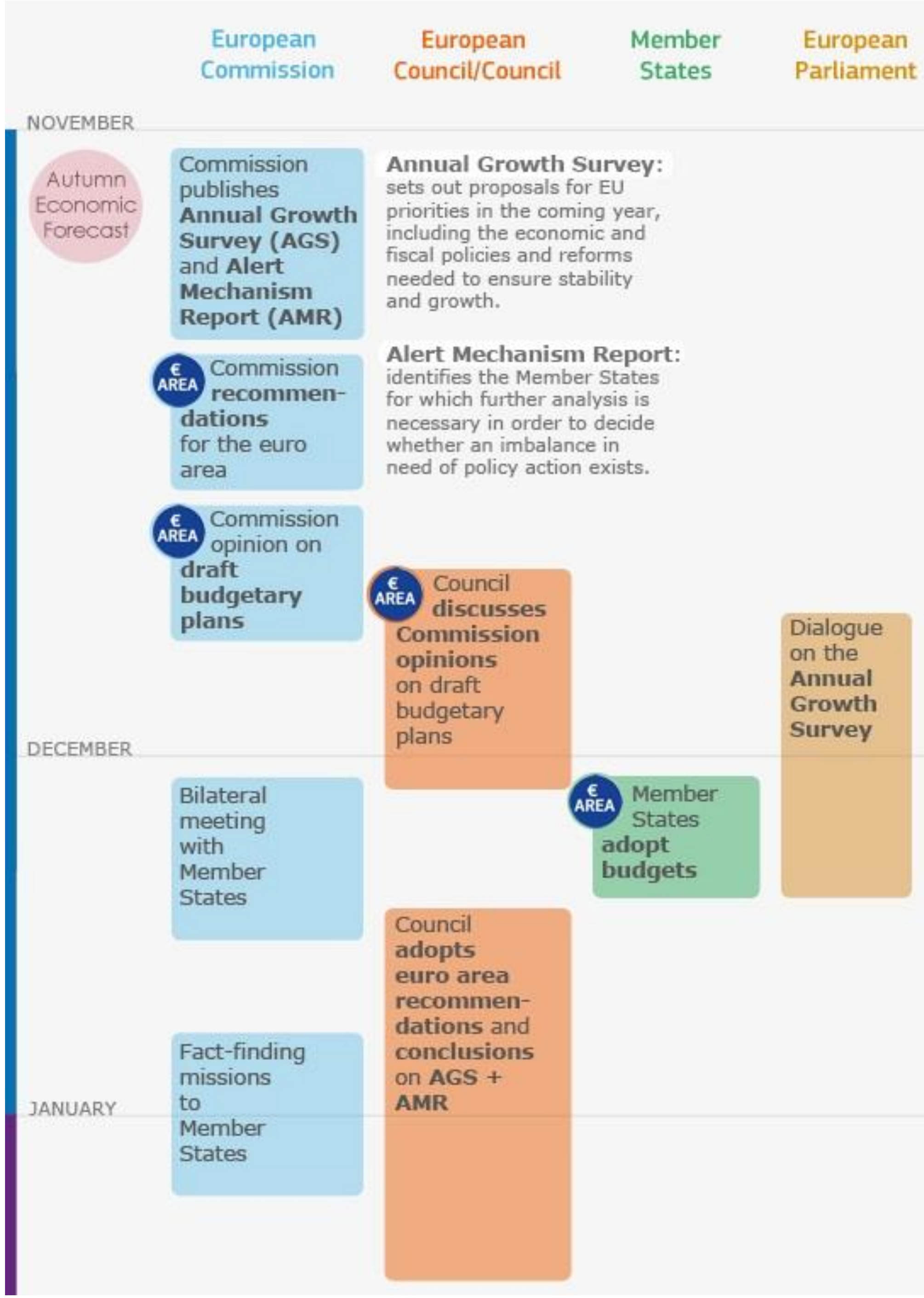
Ireland

- Dec. 2010 - Dec. 2013;
- EUR 67.5 bn; 44% of Irish GDP.

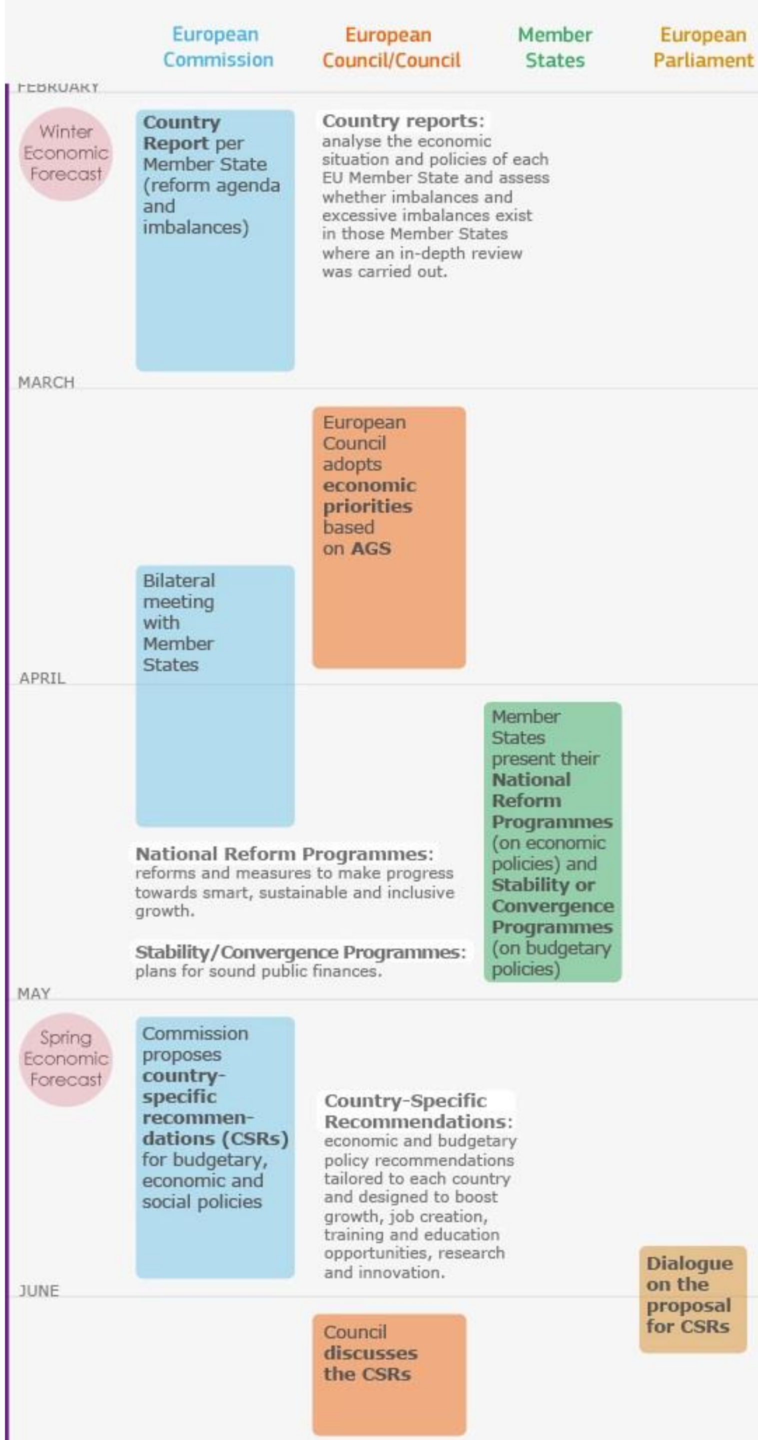
Portugal

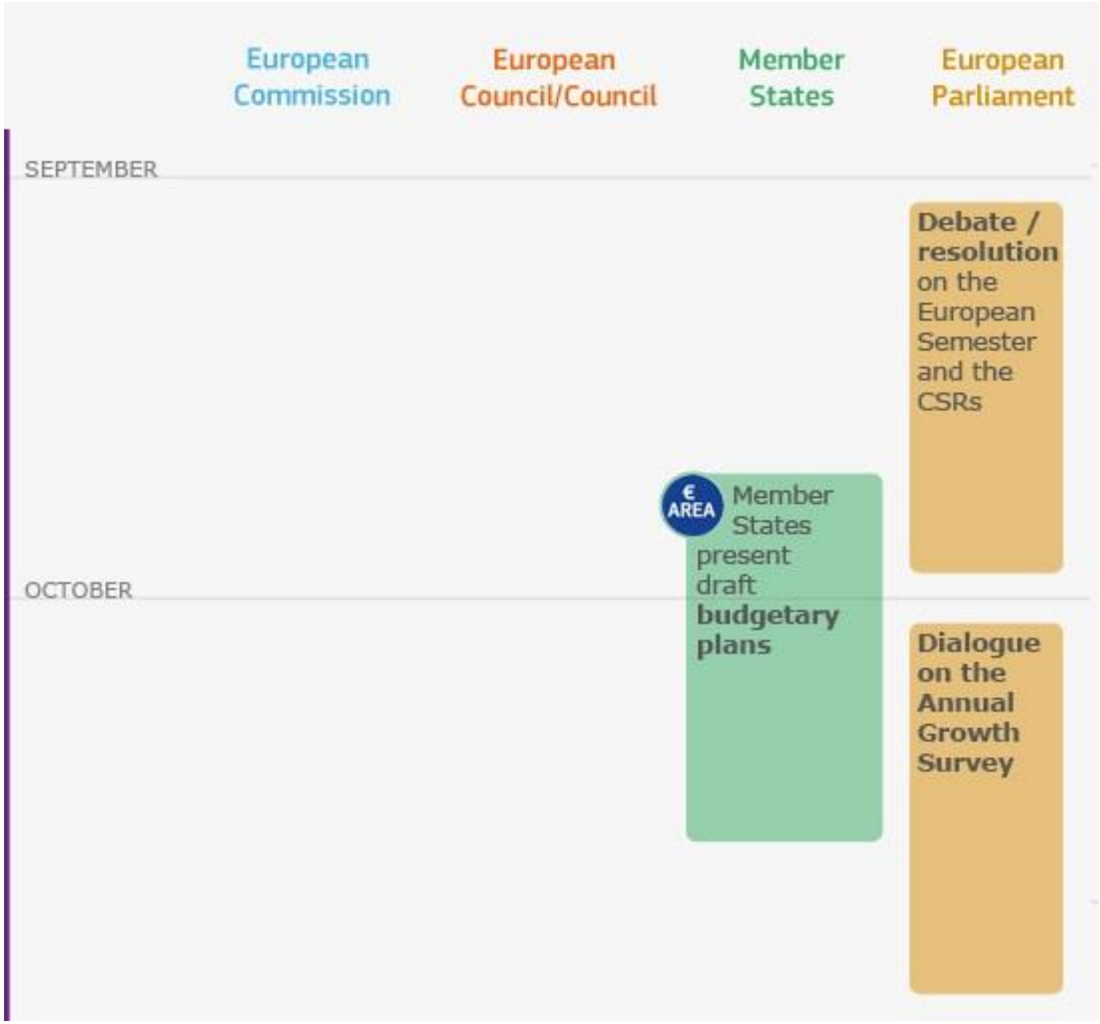
- May 2011- May 2014;
- EUR 78 bn; 46% of Portuguese GDP.

The European Semester (1/3)

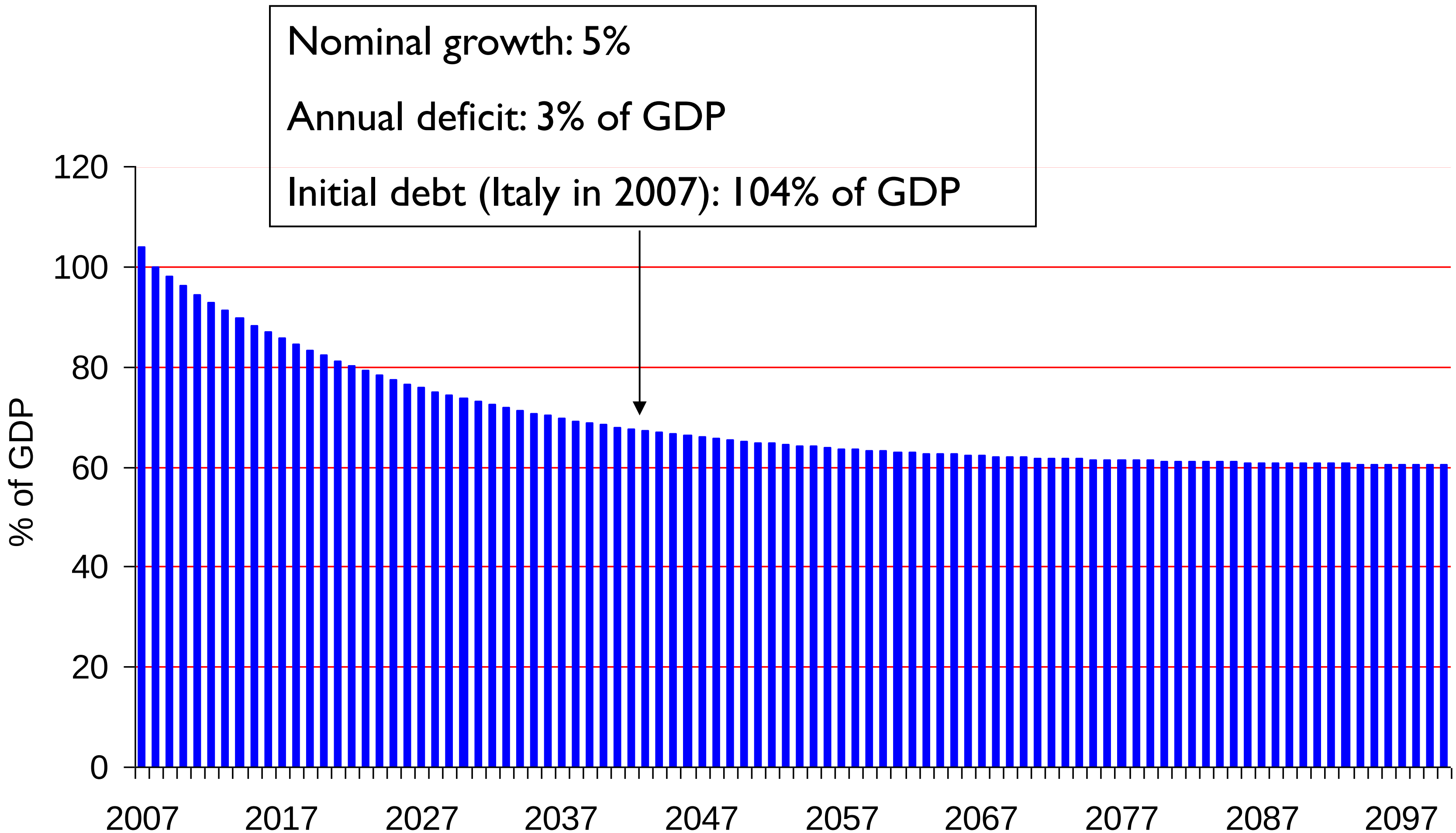


The European Semester (2/3)

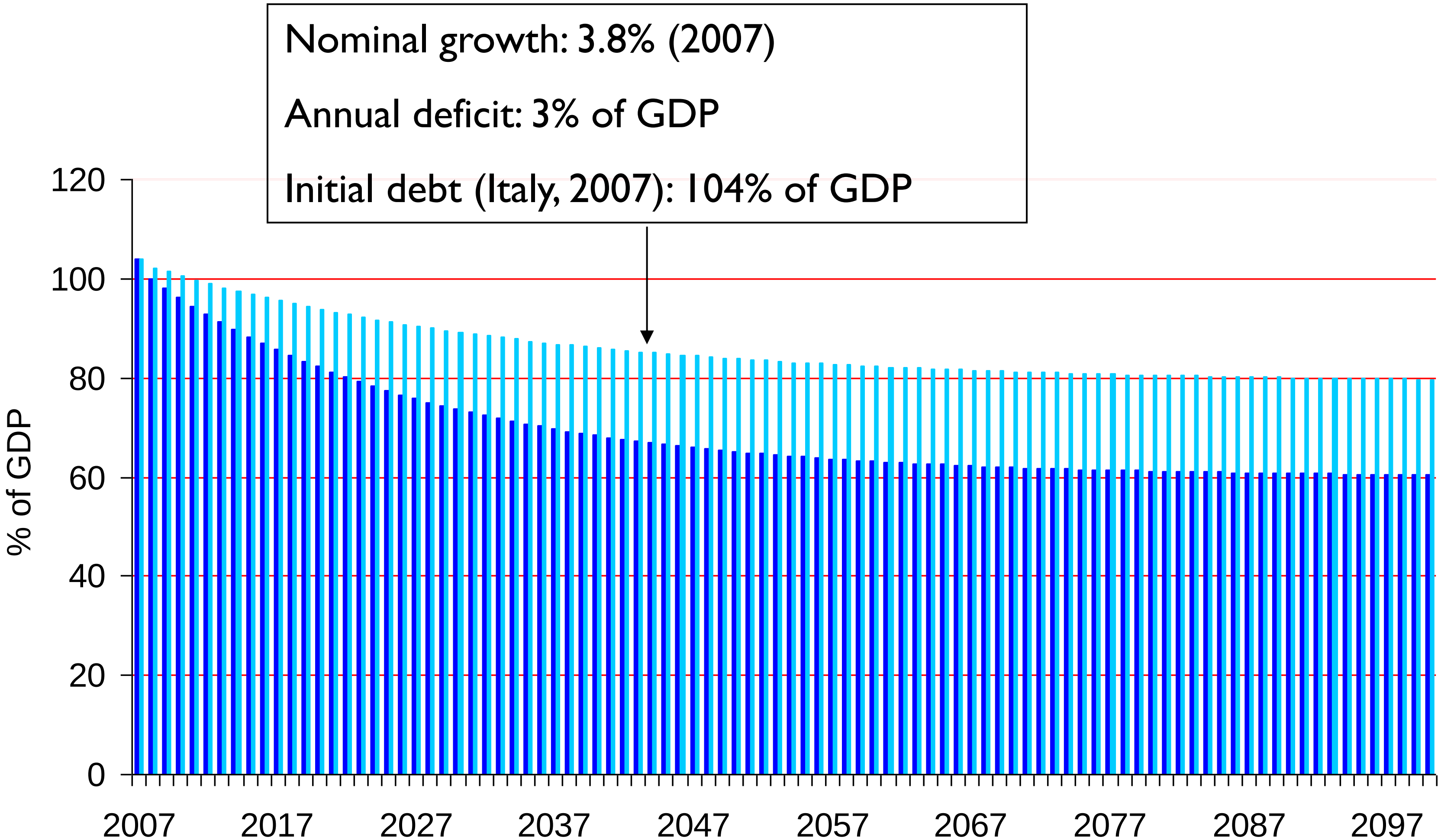



European Commission
European Council/Council
Member States
European Parliament
SEPTEMBER
Debate / resolution on the European Semester and the CSRs
€ AREA
Member States present draft budgetary plans
OCTOBER
Dialogue on the Annual Growth Survey

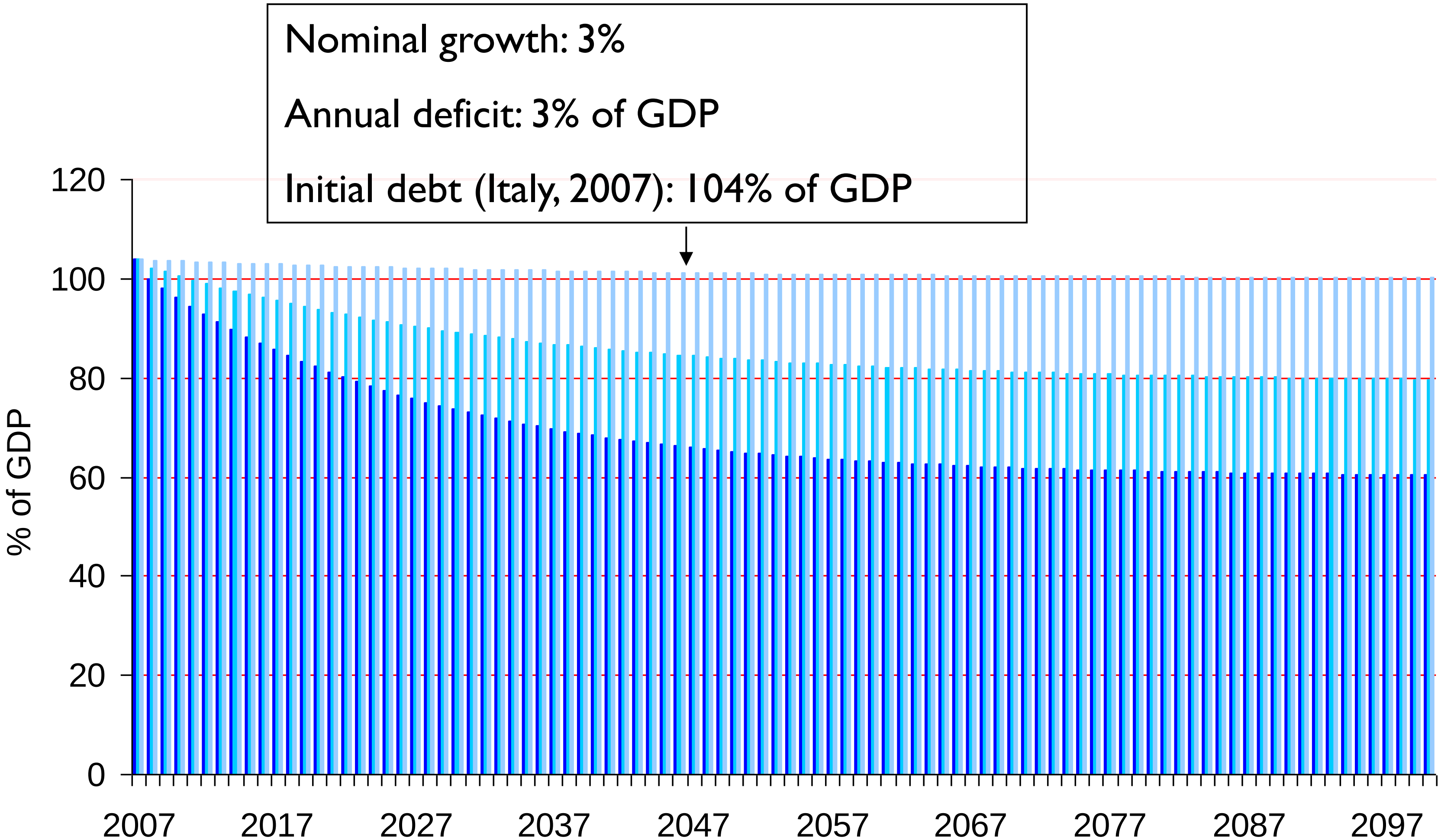
3% limit: implications for the evolution of public debt



3% limit: implications for the evolution of public debt



3% limit: implications for the evolution of public debt



Arguments about the EU fiscal rules

Most frequent criticisms	**Assessment**
Rules are too rigid (may force pro-cyclical consolidation in downturn)	Rules contain considerable flexibility
Rules lack economic rationale (numerical limits; focus on deficits rather than debt sustainability)	Need to trade off transparency, implementability with economic rationale
Rules are not country-specific	Preventive arm is country-specific; corrective arm set limits for all
Rules invite creative accounting	There is some evidence: need for good monitoring
Rules prevent implementation of costly structural reforms	Structural reforms and fiscal soundness are complements, not substitutes
Uneven enforcement of rules (small v. large countries)	Need for rigorous implementation

Why have fiscal rules?

Public spending and deficit biases

- Fiscal illusion and electoral cycles: myopic voters underestimate financing costs of deficits; governments have an incentive to raise expenditure before the election;
- “Common pool” problem: benefits of government spending for specific groups; costs are borne by all taxpayers;
- Self interested bureaucracies: incentive to maximise power via increasing budget allocations.

Rules to balance the deficit bias

Need for rules: impose constraints, raise incentives

Alternative fiscal rules

- Procedural rules
- Numerical rules
- Independent bodies or institutions

Procedural rules: budget stages

Stages in the budget process:

- Preparation: expenditure plans by line ministries;
- Decision: co-ordination in the cabinet (overall financing constraint), approval by parliament;
- Implementation: spending decisions by line ministries;
- Validation: e.g. identification of expenditure overruns.

Procedural rules' issues

Underlying procedural issues

- agenda setting;
- number of participants;
- power of line ministries v. finance minister;
- power of regional v. central authorities;
- accountability of spending agencies.

Budget system characteristics

- comprehensiveness (extra budgetary funds);
- transparency (including monitoring and auditing);
- reliability of underlying assumption.

Procedural rules: Empirical evidence

- Institutional set up of budget process matters
- Contract approach: negotiation and agreement on key fiscal variables by all ministers.
- Delegation approach: finance minister has control over budget envelope.
- Appropriate form of budget process depends on the degree of fragmentation in the government:
  - fragmented (coalition) governments: contract approach;
  - unified (singly party) government: delegation.

Numerical fiscal rules

Underlying issue: set binding constraints or orientation benchmarks for governments (deficit, expenditure, revenues, debt).

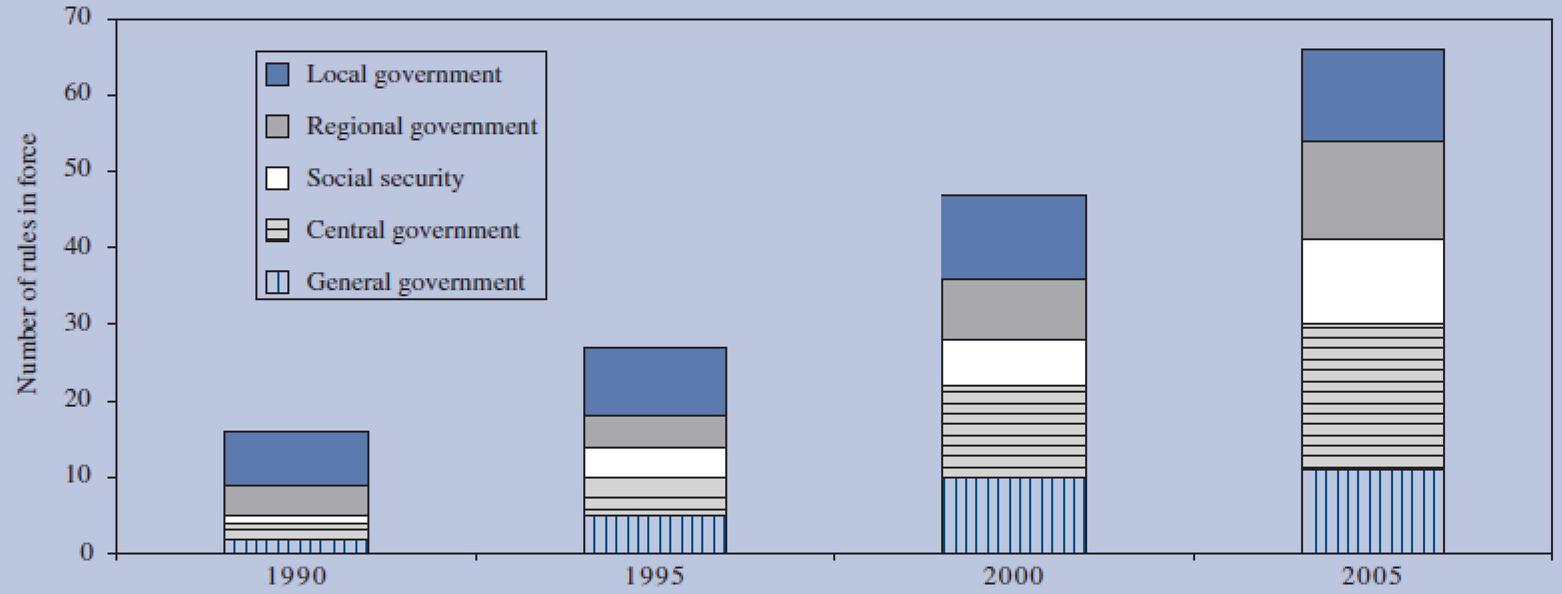
Issues to be addressed: enforcement; coverage (e.g. expenditure category, level of government); information problems (e.g. cycl adjusted balances).

Drawbacks:

- need for commitment, institutions;
- trade-off stability of the rule v. flexibility (to deal with shocks);
- need for rationale (economic, political).

Numerical fiscal rules: data

Graph III.3: **Number of numerical fiscal rules in force in the EU Member States**

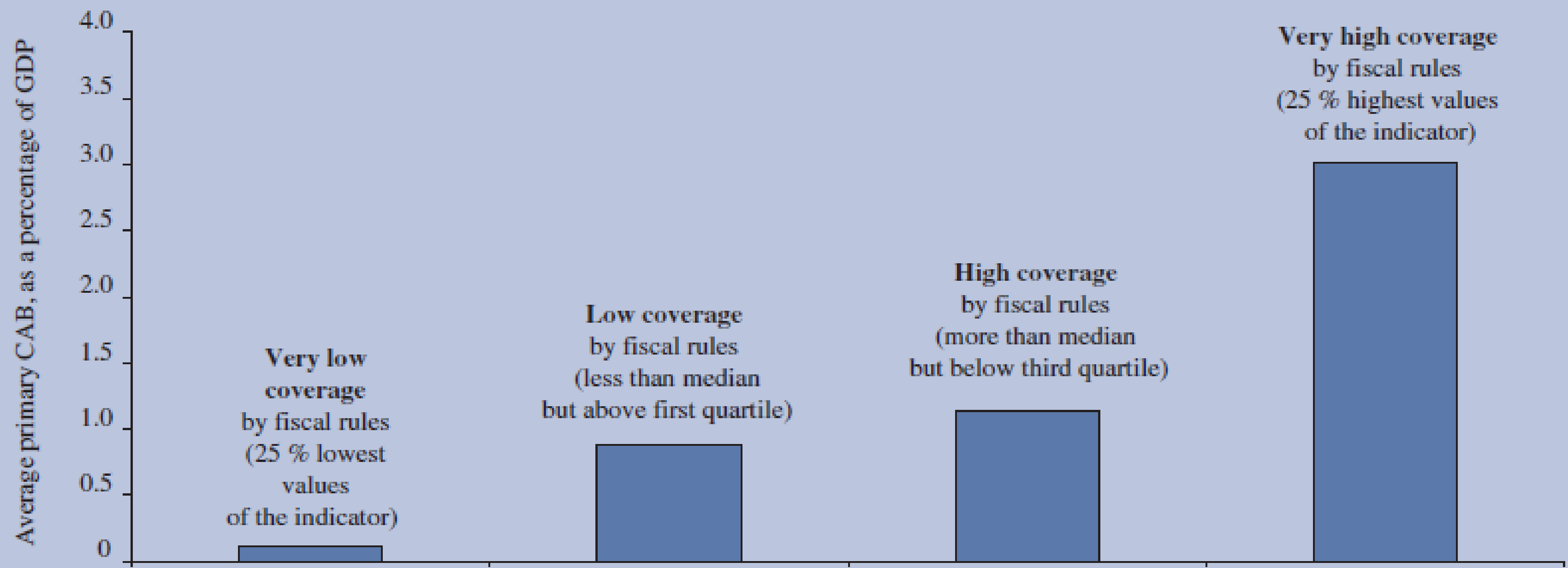


N.B.: Data for EU are the weighted average by all the old 15 Member States, data for BE are available since 1971, for DK since 1971, for NL since 1975 and for PT since 1973

Source: EC (2006).

Numerical fiscal rules: data

Graph III.10: **Fiscal rule coverage index and average primary CABs in the EU-25 countries**



Source: EC (2006).

Independent bodies or institutions

Underlying issue: time consistency problem: inability by policy makers to commit credibly to welfare optimising policies leads to suboptimal outcomes.

In central banking: independent central bank with clear mandate, tools and accountability.

In fiscal policies: delegate decision and monitoring of deficit developments to independent (non-political) authority (currently no practical example).

Difficulties:

- no consensus on "sound" fiscal policies;
- redistribution issues;
- impact on other policy areas (labour, product markets).

Less ambitious: independent fiscal council to monitor and assess fiscal policies; report to public (media) and parliament (Sweden)

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