EFB proposals to reform the EU fiscal framework

Xavier Debrun
European Fiscal Board

Basic priors

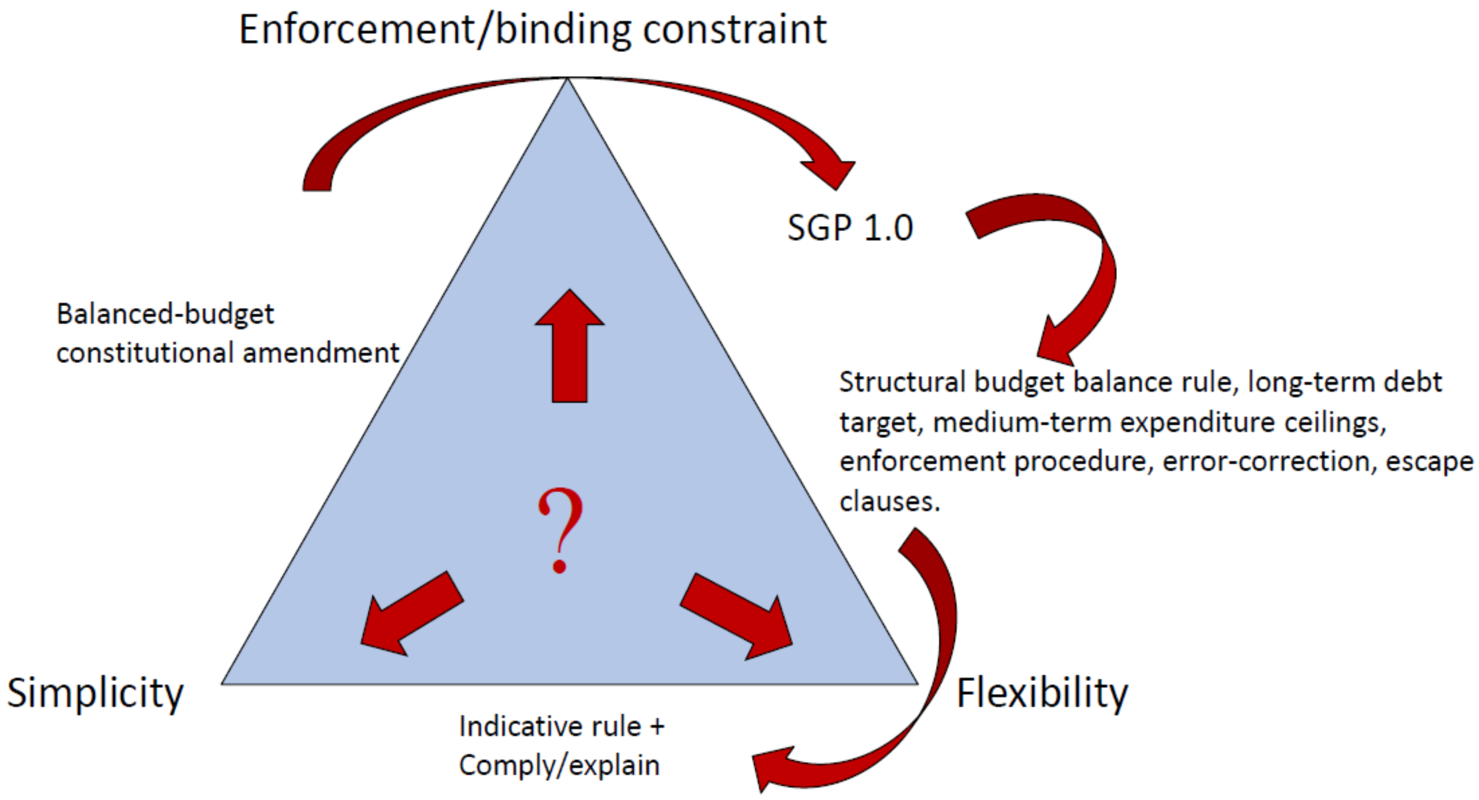
- Fiscal discretion must be constrained → many motives why well-intended policymakers systematically deviate from the social optimum. The **‘worst’ among such motives: fiscal illusion (little ownership tp be hoped for).**
- Issue of fiscal heterogeneity in a **monetary union**: existential crisis if weak links.
- Any system seeking to constrain policy discretion rests on two pillars with unequal weights depending on the policy area:
  - Rules (red-lines setting a perimeter for discretion; not your typical model-based ‘’rule.’’
  - Independent institutions.
- State-contingent fiscal rules work only in models. In practice, any contingency is a gateway for political intervention (e.g. we managed to politicize the output gap!).
  - **Independent fiscal institutions can expand the universe of feasible contingent rules → but effectiveness and survival depends on political context.**

Designing fiscal rules is hard

- Core Kopits-Symansky (1998) **criteria for a good rule:**
  - **Enforceable**: speed limit view (see also Buiter's [2004] Ten Commandments).
  - **Flexible**: contingent enough not to conflict with other policy objectives.
  - **Simple**: credibility requires clear guidance about future fiscal policy (=shape expectations).
- This is a **trilemma**: only two of three properties can be met simultaneously:
  - **Enforceable and simple**: Constitutional balanced-budget amendment.
  - **Enforceable and flexible**: The quest of the SGP in Europe.
  - **Simple and flexible:** indicative rules → Fiscal Taylor rules (Taylor [2000]).

Designing fiscal rules is hard

- Frustrating **struggle** with trilemma.
- Sedimentation process (**partial** reforms).
- Alchemy (Leeper, 2010) used to characterize exercise of fiscal discretion, now it describes the rules supposed to constrain it.
- Lesson from past experience: cannot get the rule right AND enforce it.
- Lessons for the future:
    - Try harder: internalize trade-offs better (IMF, 2018; EFB, 2018-20).
    - Consider uncharted territory if politics allow → FTR + IFI.



Source: Debrun and Jonung (2019), *European Journal of Political Economy*

The EFB reporting cycle

June report

- Mainly guidance for euro area fiscal stance in t+1
- Ad hoc additions:
  - Analytical boxes
  - Focus on one specific topical aspect of the fiscal framework (CFC, golden rule...)

Annual report (in October)

- Assessment of fiscal policy in t-1
  - Implementation of SGP
  - Role of national IFIs
  - Euro area fiscal stance
- Chapter 5: Future evolution of fiscal framework

Main EFB proposal – 2018 Annual report

Current fiscal framework not optimal: **poor compliance, relies on non-observables, highly complex, not preventing pro-cyclical policies**…

Proposed overhaul (based on principles first laid out in Debrun, Epstein, Symansky, 2008):

One debt anchor

(≤ 60% of GDP)

Focus on sustainability

One operational rule

(net expenditure growth)

Enforceability

One escape clause

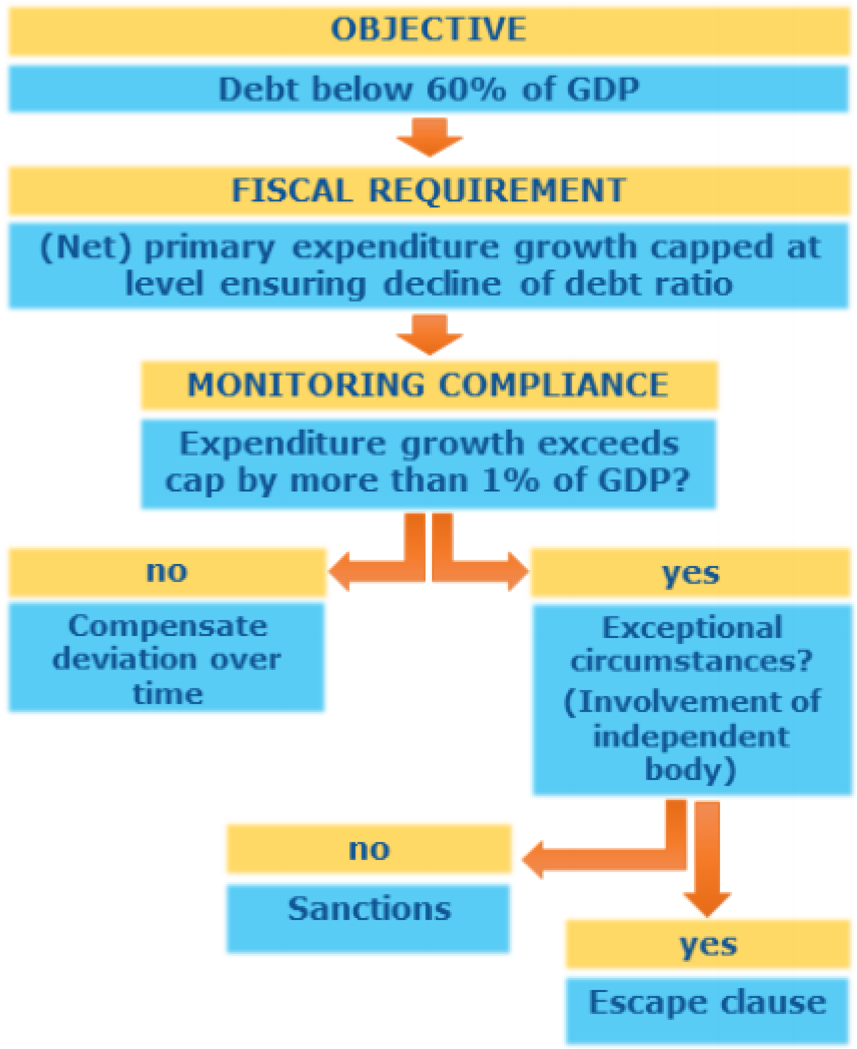
(exceptional circumstances + pension reform)

Flexibility

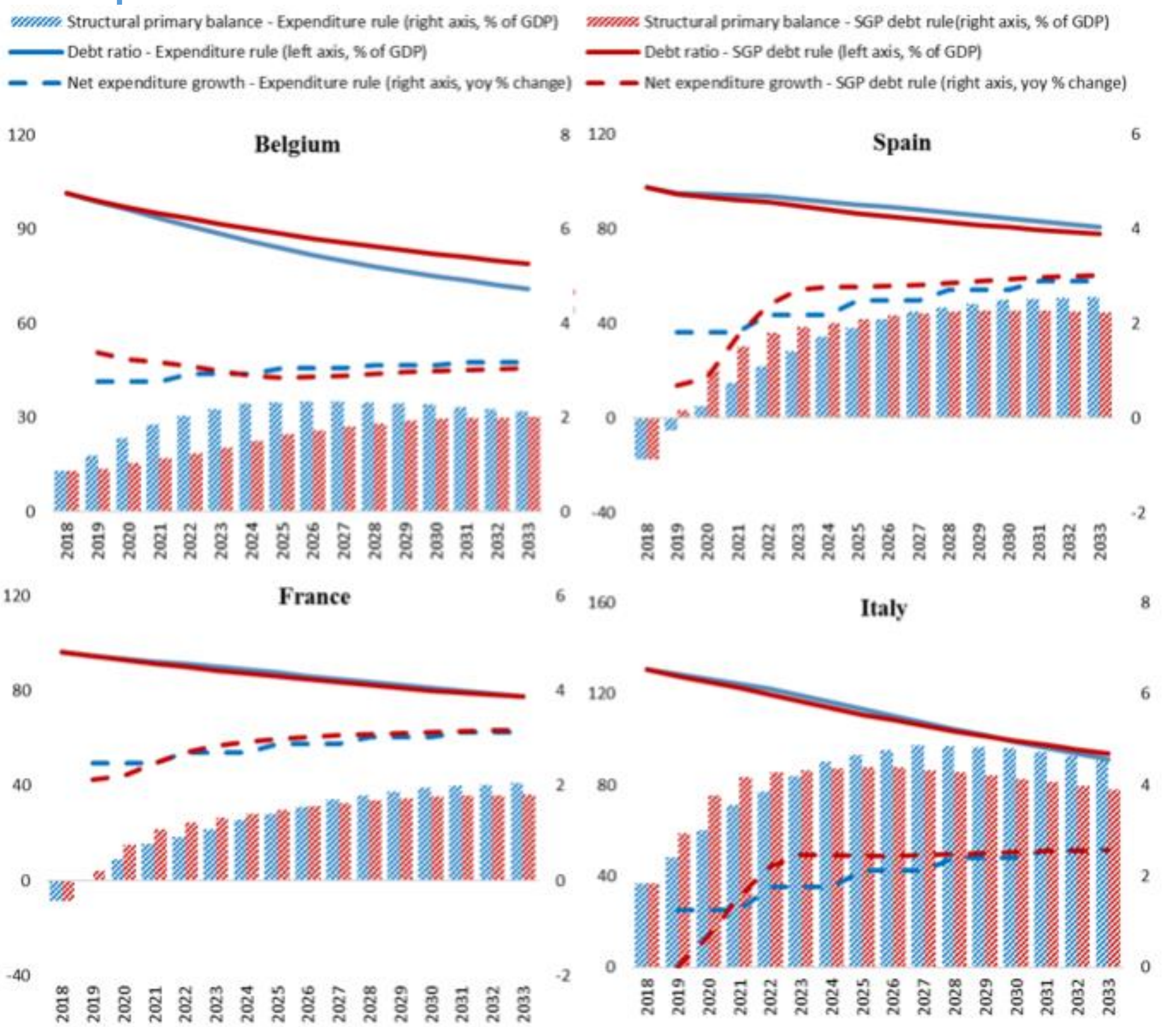
Not only an EFB idea – also IMF, OECD, ECB, think tanks, academics...
Growing consensus, especially since Eyraud et al. (2018).

Main EFB proposal – 2018 Annual report

- Net expenditure growth capped so that debt is reduced to 60% of GDP in 15 years
- 3-year surveillance cycle with compensation account (preventive arm only)
- Path re-estimated and horizon extended by 3 years every 3 years
  → debt target reached asymptotically
- Governance: independent economic assessor (tbd), comply-or-explain principle
- Sanctions: compliance a precondition for EU disbursements and access to (future) CFC



Debt trajectory: illustrative simulations



SGP debt rule (forward-looking)

Proposed expenditure rule

Assumptions

SGP debt rule (forward-looking):

- dSB to reduce excess of debt over 60% by 1/20th in t+1
- Based on actual projections for GDP and inflation
- Recalculated every year

Proposed expenditure rule:

- Flat ceiling on net expenditure growth to reduce debt to 60% over 15 years
- GDP growing at medium-term potential rate, inflation: 2%
- Recalculated every 3 years

Outcome

SGP debt rule (forward-looking):

Nominal target implies procyclicality: needs more consolidation when outlook subdued (ES, IT), less effort if stronger outlook (BE)

Proposed expenditure rule:

- Frontloaded effort; reduces as debt approaches 60%
- Built-in counter-cyclicality

Strengths and weaknesses of 2018 proposal

- Simple(r)
- Largely observable
- Flexibility (built-in counter-cyclicality + compensation account + escape clause), medium-term perspective
- Transparent: separation independent economic analysis / political discretion
- Conditionality = positive incentive to comply

- Requires building large primary surpluses over an extended period in very high-debt countries
- Convergence to 60% of GDP only asymptotically (as with existing debt rule – and standard S1 – but what matters is trend and credibility)
- Only constraint if debt < 60% is to keep deficit below 3%

2019 Annual report: additional proposals (1)

1. Beyond uniform rules: country-specific debt targets

- Mutual agreement between Member States over 7 years
- High-debt countries would commit to reducing their debt
- Symmetrically, low-debt countries would commit to increasing growth-enhancing expenditure
- Would effectively implement a euro area aggregate fiscal stance

2019 Annual report: additional proposals (2)

2. Strengthening governance: stronger separation between policy decisions and underlying economic assessment

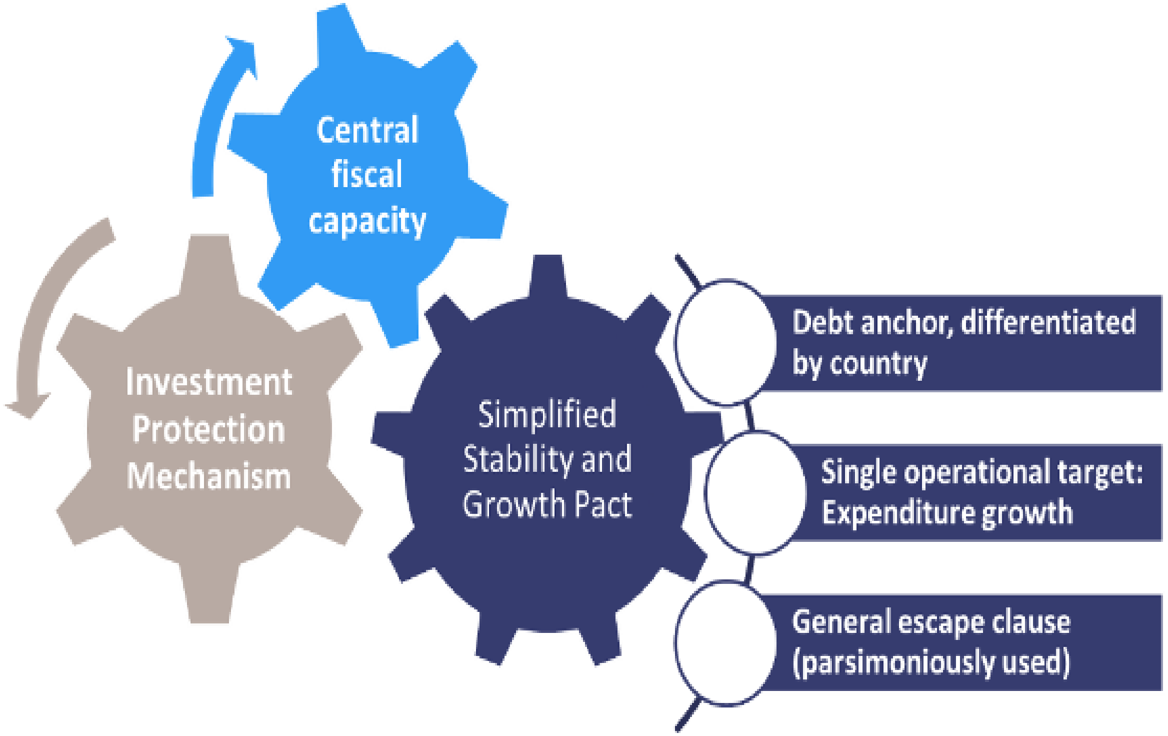
- DG ECFIN more independent
- Full-time Eurogroup president
- …

3. Targeted golden rule

- Aim: protect growth-enhancing expenditure
- Some investment protection
- Monitoring by national IFIs

2020 Annual report: new proposals in light of the crisis

- New context:
  - Uncertainty as to length and impact of crisis
  - Higher debt levels
  - NGEU
  - General escape clause
- Not developed in this presentation:
  - Need for a permanent CFC
  - Investment protection mechanism (addressed in 2020 June report)
- Focus on differentiation of debt anchors across countries: why, when, how?



2020 Annual report: differentiated debt paths

Why?

- Debt levels much higher as a result of COVID-crisis
- Existing debt rule would imply strong consolidation
- Neither realistic nor desirable

When?

- Use window before GEC deactivation, otherwise:
- Either compliance with old rules → ill-timed fiscal contraction
- Or non-compliance → weakens credibility of framework

How?

- Differentiate either debt target d^* over fixed time horizon or number of years n to reach 60%:

$$pb_t^* = \left(\frac{i_t - y_t}{1 + y_t}\right) d_{t-1} + \frac{1}{\boldsymbol{n}}(d_{t-1} - \boldsymbol{d}^*)$$

(EFB based on Hauptmeier and Kamps, 2020)

- In practice, both options can lead to similar paths; difference is whether it requires Treaty change

Two possibilities to differentiate debt paths

- The reference value for the debt ratio (60% of GDP) is set in Protocol No. 12 to the Treaty

→ An explicit differentiation of the debt target would require a change of the Treaty or of the relevant Protocol of the Treaty as a minimum

- The definition of when a debt ratio is 'sufficiently diminishing and approaching the reference value at a satisfactory pace' has been left to secondary legislation (Regulation (EC) 1467/97)

→ A differentiation of the adjustment speed can be introduced more easily in the EU framework, simply by amending secondary legislation

Two options to implement differentiation

Set adjustment speed over next 3 years *ex ante* e.g. with predefined matrix based on initial debt level and r-g:

interest rate-growth differential	$1/n$	initial debt level: $60<d_{t-1}<100$	initial debt level: $100<d_{t-1}<150$	initial debt level: $d_{t-1}>150$
	i-y<0	0.06	0.05	0.04
	0<i-y<1	0.05	0.03	0.03
	i-y>1	0.04	0.03	0.02

Set adjustment speed over next 3 years *on a case-by-case basis* based on comprehensive independent economic judgement, including:

- Initial debt level and composition
- Growth and inflation outlook
- Projected costs of ageing and environmental challenges
- Internal and external imbalances
- Realism of implied fiscal adjustment

What can we propose? Some paths for debate and future work

- Taking into account the impact of the new macro and institutional environment

– Uncertainty about r-g: how can we handle it?

– RRF changes the game. March 2021 COM communication: "Considering the total fiscal impulse (…) stemming from national budgets and the RRF (…) as it is not captured by the usual metrics" → need to develop EU accounting.

- Giving existing sustainability tools more visibility

– Sustainability indicators well established but not always well understood
– Strong interest in our DSA, see Blanchard et al. suggesting using standards + Commission DSA
– Side remark: reassessment every 3 years matches Ageing Report calendar, would need to reflect new LT projections too

- Complementing/rethinking sustainability tools

– Better link sustainability indicators with SGP
– Additional debt paths based on net expenditure trajectory rather than SPB, use of potential rather than actual GDP in short/medium term?

- **Governance: what role for whom?**

– **EU vs. national level:** need to keep central rules (external anchor/ magnet effect)
– IFIs (at national or EU level) vs Commission
  – Martin, Pisani-Ferry & Ragot (2021): enlarged and more independent EFB should be responsible for defining the methodology to assess sustainability; national IFIs to endorse debt target
– SGP sanctions vs. market discipline, debt brake.
– Credibility will be key for a smooth transition!

Additional slides

European Commission

Calculation of the net expenditure ceiling

- 'Net expenditure growth' refers to the growth rate of primary expenditure at current prices, net of discretionary revenue measures and cyclical unemployment benefit expenditure.
- The expenditure ceiling is computed to ensure that, if net expenditure grows consistently at this pace, the gross debt-to-GDP ratio reaches the 60% of GDP reference value after 15 years, provided the economy grows at its potential rate and inflation is at 2% (see Box 6.3 of the 2018 Annual Report).
- The net expenditure ceiling is recomputed every three years; at the same time, the 15-year horizon to bring the debt ratio to 60% is extended by three years. The target is therefore reached asymptotically.

European Commission

Interest rate assumptions

- 2018 Annual Report:

- Implicit interest rates are computed assuming that long-term nominal rates converge to 5% over 10 years
- Interest payments increase in line with the expected rollover schedule of debt.

- 2020 Annual Report:

- Implicit interest rates are computed assuming that long-term nominal rates converge to 3.1%, i.e. the observed 10-year average
- Interest payments increase in line with the expected rollover schedule of debt.

European Commission