# The Future Fiscal Policy Framework in the EU:

# What Can the Stability Pact Achieve and What Must National Fiscal Institutions Do?

# Why is the EU fiscal policy framework important?

- General tendency to excessive accumulation of government debt: the establishment of the EMU offered a unique opportunity to deal with a difficult national problem at the European level
- This tendency is likely to be reinforced in the EMU
- But: we do not know what an excessive level of government debt is
- Nor do we know what is an optimal level of government debt

# What is the problem?

1. Rules or discretionary decision
2. The contents of rules (numerical targets)
3. Ex-ante incentives to avoid excessive deficits
4. Ex-post incentives to avoid excessive deficits (enforcement mechanisms)
5. EU and/or national fiscal policy institutions

# The enforcement issue is the most acute problem

- Most reform proposals focus on the secondary problem of improving the rules
  - this holds also for recent Commission proposals
- Unless the credibility of present rules is restored, revised rules are not credible either
- The present situation is unusually unsuitable for revisions of the rules
  - short-term consideration will weigh too heavily
  - new rules should be negotiated behind a ”veil of ignorance”

# What should be done now?

- Resume excessive deficit procedure against France and Germany
- Small countries should take a tough line

# The fundamental problem

- Political decision-making
  - strategic considerations
  - fear of political conflicts
- First-best solution: move EDP decisions to a third party
  - The judicial level of the European Court of Justice
  - Commission
  - Independent committee of economists

# Alternative possibilities

- Abandon legalistic approach
  - ”taxes” instead of ”corrective actions, ”sanctions”, and ”fines”
  - measures to increase costs of undesirable behaviour and not legal punishments
  - more scope for ”flexibility”
- Payments of ”fines” in the next boom instead of in recessions
  - ”fines” conditional on behaviour in the next boom?
- Other sanctions than pecuniary costs
  - loss of votes?
  - loss of the right to vote in the EDP regarding other countries

# Ex-ante incentives to avoid excessive deficits

- Ex-ante incentives will always have less clout than credible ex-post incentives
- Early warnings from the Commission only
- Better integration of stability programmes and the BEPGs with national budget processes
- Improved forecasting capacity at the Commission
- Reaffirmed commitments to runt symmetric fiscal policy over the cycle and stronger ex-ante peer pressure – what does it mean?
- Enhanced role of EU judgements in the national political debate

  - physical deliverance of EU reports in the country concerned
  - obligation for governments to testify before parliaments regarding Commission reports and Council opinions

# Contents of rules: numerical targets and constraints

- Exceptional circumstances clause
- More focus on debt
- Golden rule and real capital formation
- Differences in nominal GDP growth

# Exceptional circumstances clause

- Extension to protracted slowdowns with sluggish growth
- Reasonable to take cumulative output gaps into account
- But: judgements of output gaps are notoriously uncertain
  - sanctions based on uncertain measures cannot obtain political legitimacy
  - slower long-run potential growth causes a higher steady-state debt ratio

# More focus on debt levels

- If sustainability, intergenerational transfers or the risk of bail-outs are the problem, the focus should be on debt
- But:
  - demand spillovers are associated with deficits
  - so are transfers of time-inconsistency problems from monetary to fiscal policy
  - current deficits are a better predictor of future debt developments than past debt levels

# Alternative proposals

- Commission: condition deadlines for correcting an excessive deficit on the amount of debt
- EEAG: Relate the deficit ceiling explicitly to the debt situation
- EEAG proposal is better

  - clear ”prize” for governments that reduce debt levels in booms

  - movement to more prestigious categories

## A possible way of letting the deficit ceiling depend on the debt ratio

| Debt ratio (% of GDP) | Deficit ceiling (% of GDP) | Countries in the range (debt ratio in parenthesis) |
|---|---|---|
| <25 | 5.0 | Luxembourg (4.5), **Estonia (5.4)**, **Latvia (16.0)**, **Lithuania (22.8)** |
| 25-35 | 4.5 | **Slovenia (28.3),** Ireland (32.4) |
| 35-45 | 4.0 | Denmark (40.0), UK (40.6), **Czech Republic (40.6),** Finland (44.5) |
| 45-55 | 3.5 | **Slovakia (45.1),** Spain (48.0), **Poland (49.1),** Sweden (51.8), Netherlands (56.3) |
| >55 | 3.0 | **Hungary (58.7),** Portugal (60.7), France (64.6), Austria (65.5), Germany (65.5), **Malta (73.9)**, **Cyprus (74.6),** Belgium (97.4), Greece (102.8), Italy (106.0) |

*Note*: New EU states in italics. All data are are Commission forecasts for 2004.

# Golden rule

- Well-known arguments
  - risk of too low government investment with current rules (if credible)
  - golden rule implies risks of creative accounting and distortion of trade-off between real and human capital formation
- Larger diversity after enlargement
  - higher returns on government investment
  - golden-rule exception for new member states?
  - all countries with GDP per capita below 80 % of EU average: higher deficit ceiling if government investment above threshold

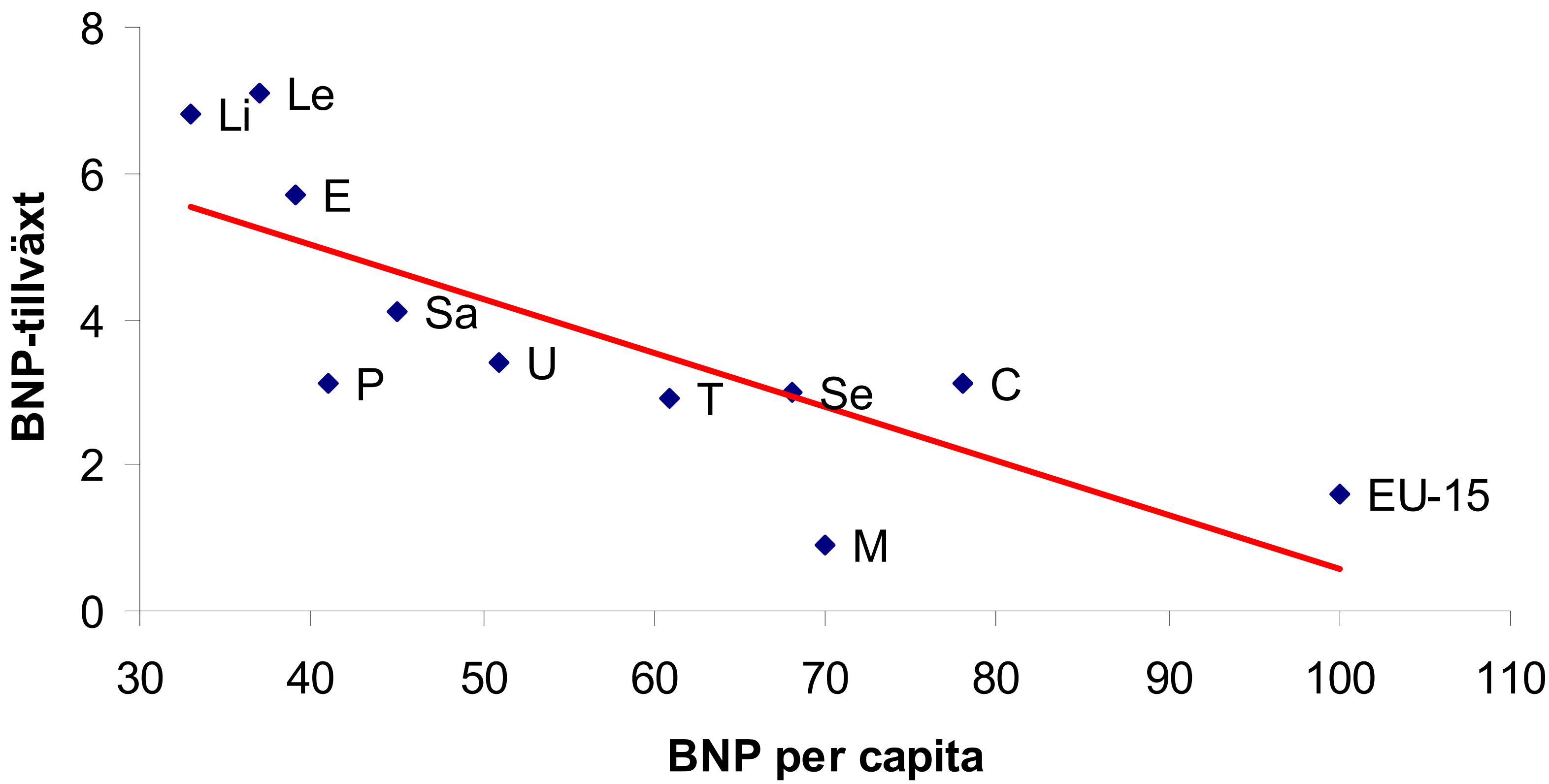
**Public finances of the new EU states (2004)**

| | Government net lending (per cent of GDP) | Government debt ratio (per cent of GDP) | Government investment (per cent of GDP) |
|---|---|---|---|
| Cyprus | -4.6 | 74.6 | - |
| Czech Republic | -5.9 | 40.6 | 4.4 |
| Estonia | 0.7 | 5.4 | 4.5 |
| Hungary | -4.9 | 58.7 | 4.5 |
| Latvia | -2.2 | 16.0 | 2.3 |
| Lithuania | -2.8 | 22.8 | 3.2 |
| Malta | -5.9 | 73.9 | 5.1 |
| Poland | -6.0 | 49.1 | 3.5 |
| Slovakia | -4.1 | 45.1 | 2.7 |
| Slovenia | -1.7 | 28.3 | - |
| EU-10 | -5.7 | 44.4 | |
| EU-15 | -2.6 | 64.2 | 2.4 |

# Higher nominal GDP growth in new member states

- Real income convergence and Balassa-Samuelson
- Given the budget deficit: ”convergence” on lower debt ratio
- Or: given the ”steady-state” debt ratio, higher deficits are possible
- The golden-rule exception could address this problem as well

**Figur 3: Tillväxt och inkomstnivå**




Not: BNP per capita avser 2001 och BNP-tillväxt genomsnittet för åren 2001-2005

# Rules versus discretion

- The Commission's proposals

  - yearly assessments of debt developments should take country-specific growth conditions into account

  - potential economic growth, inflation, existing implicit liabilities, structural reforms, and needs for net investment should be considered

  - discretionary judgements regarding slow growth

  - country-specific adjustment paths and deadlines for correction of excessive deficits

# General knowledge

- Discretionary macroeconomic policy making in the absence of constraints lead to inflation and deficit biases
- Rules mitigate these problems but limit flexibility
- Delegation of discretionary monetary policy to independent central banks is a reasonable compromise between credibility and flexibility
- One cannot introduce more discretion into a political system of decision-making without undermining credibility further
- It is a mistake to believe that the current rules-based system can be reformed without Treaty (constitutional) changes
- More flexibility should be introduced through transparent rules
- Rules must ”by definition” be reasonably simple

# Proposals on national fiscal policy institutions

1. A more transparent fiscal policy framework
2. An obligation to base budget decisions on independent forecasts
3. An independent advisory *Fiscal Policy Council*
4. Delegation of actual decisions to an independent *Fiscal Policy Committee*

# A more transparent fiscal policy framework

- Well-defined medium- and long-term deficit or debt goals
- Well-defined stabilisation objectives
- Guidelines for use of automatic stabilisers and for discretionary action
- An obligation for the government to indicate which fiscal measures are temporary and the process for their reversal
- Ex-ante specification of fiscal policy instruments to be used for stabilisation
- Open-letter procedure of the UK type

# Independent forecasts

- Lars Jonung and Martin Larch
- Truly independent agency
- How much difference will it make?

# Advisory Fiscal Policy Council

- Recommendations on fiscal policy action
- How boost the council's political weight?
  - Recommendations could be formally addressed to the parliament
  - An obligation for the government to respond formally
  - Stipulation that the normal procedure for governments is to follow the recommendations: deviations only under exceptional circumstances and then need for formal explanation to the parliament
  - Reversed public hearings

# Delegation of actual fiscal policy decisions

- The Fiscal Policy Committee can vary specific tax rate
  - variations around a normal value within certain margins
  - clear objective of stabilising output fluctuations
  - constraint of neutral budget effects over the cycle
  - government undertaking not to use other instruments for cyclical stabilisation
- Only marginal income distribution effects
- Somewhat larger income distribution effects if freedom for committee to choose instrument in specific situations

Larger degree of democratic control and accountability than for monetary policy at present is possible

1. The objectives of the committee should be decided by parliament
2. Requirements on a high degree of transparency
3. Systematic ex-post evaluations
4. Dismissal possibilities
5. Escape clause enabling the parliament to override committee decisions (with qualified majority)

# Why is fiscal policy delegation so controversial?

1. No existing examples to use as blueprints
2. Opponents do not understand the proposals
3. The electorate accepts worse policies on average in exchange for larger possibilities of affecting policies in the short run
4. Considerations with respect to the *total* amount of delegation of macroeconomic policy
5. Could delegation of responsibility for clearly delineated stabilisation (”rainy-day”) fund be accepted?

# The role of national institutional reforms

- Complement to the numerical rules?
- Common EU standards on national institutions?
  - need for experimenting
  - EU is not the right agent to initiate technocratic solutions at the national level
- An alternative to an EU fiscal policy framework