The fiscal governance in the EU: the role of structural budget balances

Seminar organised by Norwegian MoF's Advisory Panel on Macroeconomic Model and Methods
"Use of indicators for resource utilisation and potential output in economic policy design"
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Outline

1. The use of structural budget balance (SBB) rules in EU fiscal surveillance

2. Implementation of SBB more difficult than it first seems

- measuring Output Gap in real time accurately
- large short fluctuation of standard elasticities
- removing one-off measures
- windfall/shortfall caused by fluctuations in asset markets

3. Making it work: how to solve measurement issues?

4. Conclusion

I. Structural Budget Balance (SBB) in EU setting

Enhanced economic governance in the EU in three steps

The 1st step: the Six-Pack

A major reform for economic governance in the EU

The 2nd step: the Two-Pack (under adoption)

A more stringent budgetary framework for the euro area

The 3rd step: the Fiscal Compact in a new International Treaty (under ratification). The Treaty on Stability Coordination and Governance TSCG in the EMU was signed in March 2012.

Mirroring EU rules at the national level

I. Structural Budget Balance (SBB) in EU setting

The original Stability and Growth Pact

The Stability and Growth Pact in 1997 → operationalize the thresholds of 3% deficit and 60% of debt

Preventive arm:

- ***Balance Budget Rule***

Corrective arm:

- *Deals with gross errors in policy (3% deficit and 60% debt thresholds)*
- *Specifies the steps of the excessive deficit procedure(EDP)*
- *Sets up a timetable for the correction of excessive deficits*
- *Sanctions at the very end of the procedure*

I. SBB in EU setting

The 2005 Reform

Reformed in 2005: more economic rational
→ Focus on the notion of structural effort

Preventive arm:

- ***Specify Balanced Budget Rule = SBB reaching the country- specifc medium-term budgetary objectives (MTOs)***
- ***Adjustment of SBB towards the MTO: 0.5% per year, more in good times, less in bad times***
- *List possibility of deviations from the adjustment (pension reforms)*

Corrective arm:

- *Conditional compliance with the EDP recommendations: "effective action" focusing on structural effort*
- *Flexibilise the exceptional circumstances*

I. SBB and EU setting

The 2011 Reform: "six pack"

2011 Reform: no additional rule but better specification + enforcement mechanisms

Preventive arm:

- ***Complement the structural adjustment of 0.5% per year by an expenditure benchmark to be respected***
- ***Quantify deviation from the MTO or its adjustment path towards it***
- ***Possible sanctions in case of significant deviations***
- *Complement the exceptional circumstances (severe recession for the whole area)*

Corrective arm:

- *Operationalize the debt criterion (reduction of the gap to 60% by 5% on average over 3 years)*
- *Set-up a system of early and gradual sanctions*
- *Complement the exceptional circumstances (severe recession for the whole area)*

National layer → *Directive on national budgetary frameworks (Accounting and statistical reporting, forecasts for budgetary planning, country-specific numerical fiscal rules, budgetary procedures, medium-term budgetary frameworks, independent monitoring and analysis, fiscal relationships across sub-sectors of general government)*

I. SBB in EU setting

Before the 2011 Reform: MTO and SBB

- ✓ Central concept of the Stability and Growth Pact is the medium-term budgetary objective (MTO) = a numerical value for the structural deficit which ensures:

$$MTO^{ILD} = \underbrace{Balance_{debt-stabilizing\,(60\%\,of\,GDP)}}_{(i)} + \underbrace{\alpha * AgeingCosts_{\text{infinite horizon}}}_{(ii)} + \underbrace{Effort_{debt-reduction}}_{(iii)}$$

(i) a safety margin against breaching 3% of GDP;
(ii) sustainable public finances or rapid progress towards sustainability (ageing cost)
(iii) room for stabilisation over the cycle

- ✓ Adjustment path towards MTO = 0.5% of GDP; more in good, less in bad times.
- ✓ Enforcement through peer pressure (Council recommendations).

I. SBB and EU setting

2011 Reform: Complementing SBB

Lessons learned:

- Central concept is based on the structural balance, which is not observable → difficulties with estimates, time-lag, etc…
- No quantification of deviation, enforcement through peer pressure → lacks teeth

Innovation: a 2-pillar structure: an expenditure rule complementing the structural balance

= operational guidance for adjustment path towards MTO

<u>Def</u>: expenditure growth should not exceed a reference rate of potential GDP growth

✓ If significant deviations from the rule (= 0.5% of GDP in one or 0.25% of GDP on average in two consecutive years) → recommendation to correct + interest-bearing deposit for euro area MS

✓ Safeguard clauses: can deviate from the rule if unusual event or severe economic downturn for the euro area or the EU as a whole

I. SBB and EU setting

The 2011 Reform: enforcement

Step of the procedure	Sanction
Adjustment towards the MTO/expenditure rule not respected	**Interest-bearing deposit 0.2% of GDP**
Opening of the EDP	Non-interest-bearing deposit 0.2% of GDP
Failure to take effective action to correct the excessive deficit	Fine 0.2% of GDP
Repeated failure to take effective action to correct the excessive deficit	Fine 0.2% of GDP + variable component

I. SBB and EU setting

Work in progress: the "two-pack"

Rationale / Lessons learned	Innovations
	Common Budgetary Rules
Enshrining core principles of European framework in national framework to increase ownership	- Numerical fiscal rules on budget balance implementing MTOs in national budgetary processes - Independent fiscal council - Independent macroeconomic forecast
Better synchronizing key steps in preparation of national budgets	**A Common Budgetary Timeline**

15 April
- Medium-Term fiscal plans made public.

15 October
- Draft Budget Laws for the general government made public with the independent macroeconomic forecast on which they are based.

31 December
- Budget Laws for the general government adopted and made public.

I. SBB and EU setting

Work in progress: the "two-pack"

Two-Pack: A more stringent framework for the euro area

Autumn

Presentation of draft budgetary plan for following year

➔ Possible Opinion/Request for change by the COM

➔ Discussion at the eurogroup

End of Year

Budget Law

European Semester – Spring

➔ Assessment of compliance with preventive arm of SGP (structural balance + expenditure benchmark)
- *Ex ante* for in-year and following years
- *Ex post* for previous year

➔ Macroeconomic surveillance

➔ Policy guidance and recommendation

I. SBB and EU setting

Under ratification: the Fiscal Compact

→ Mirroring EU rules at national level

General government budget shall be balanced or in surplus

- Implementation of the EU medium-term objectives (MTOs) at national level
- Automatic correction mechanism triggered when 'significant deviations' from the objective (as in the SGP)
- ... but deviation allowed in case of "exceptional circumstances" (as in the SGP)

Reinforcement of the correction of fiscal imbalances

- Change in the voting rule
- Economic partnership programme

Enforcement

- Rules in national law through provisions of "binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes. "
- If MS fails to transpose properly, the matter will be brought to EU Court of Justice (possibility of financial sanction of up to 0.1% of GDP)
- Compliance with the national rule monitored at the national level by independent institutions

I. SBB and EU setting: Wrap-up

1. Stability and growth pact (SGP)

- SGP Mark 1 before 2005: nominal deficit rules <3% (EU treaty) + close to balance or in surplus in medium run
- SGP Mark 2: 3% rule + Structural Budget Balance

2. The role of SBB in SGP

- SBB: fiscal requirement expressed and assessed net of cyclical conditions and one-off measures
- SBB should be at or converge to the country-specific Medium Term Budgetary Objective (MTO), generally close to balance …
- with an annual improvement of SBB of 0.5% of GDP required to meet MTO …
- … so as to ensure sustainable public finance in the long run

3. The role of SBB confirmed in

- **"Six Packs" regulations** amending the SCP and adopted in 2011
- **"Two Packs" regulations** further strengthening the fiscal monitoring and surveillance mechanisms in the euro area (under adoption)
- **The fiscal compact**, signed by Heads of State and Government in Dec 2011 as political commitment to fiscal discipline

II. Difficult implementation

CAB $_t$ ***= Nominal Budget Balance*** $_t$ ***–*** ε ***.*** $\boxed{\textbf{OG}_t}$ ***– one-offs***

= Structural balance

(legal definition excl.one-offs)

Cyclical correction

1. Measuring the output gap in real time (OG $_t$)

- Important revisions over time due to i) updates in GDP within 3 year spell but, above all, ii) changes in forecast
- which are particularly large in times of cyclical turnaround and uncertainty

$$y^P_{T+i|T+i} - y^P_{T+i|T} = b_0 + \sum_{j=1}^{\infty} b_j (y_{T+i+j} - Ey_{T+i+j|T})$$

Compounded forecasting errors

2. Fluctuation in tax elasticities ε in the short term

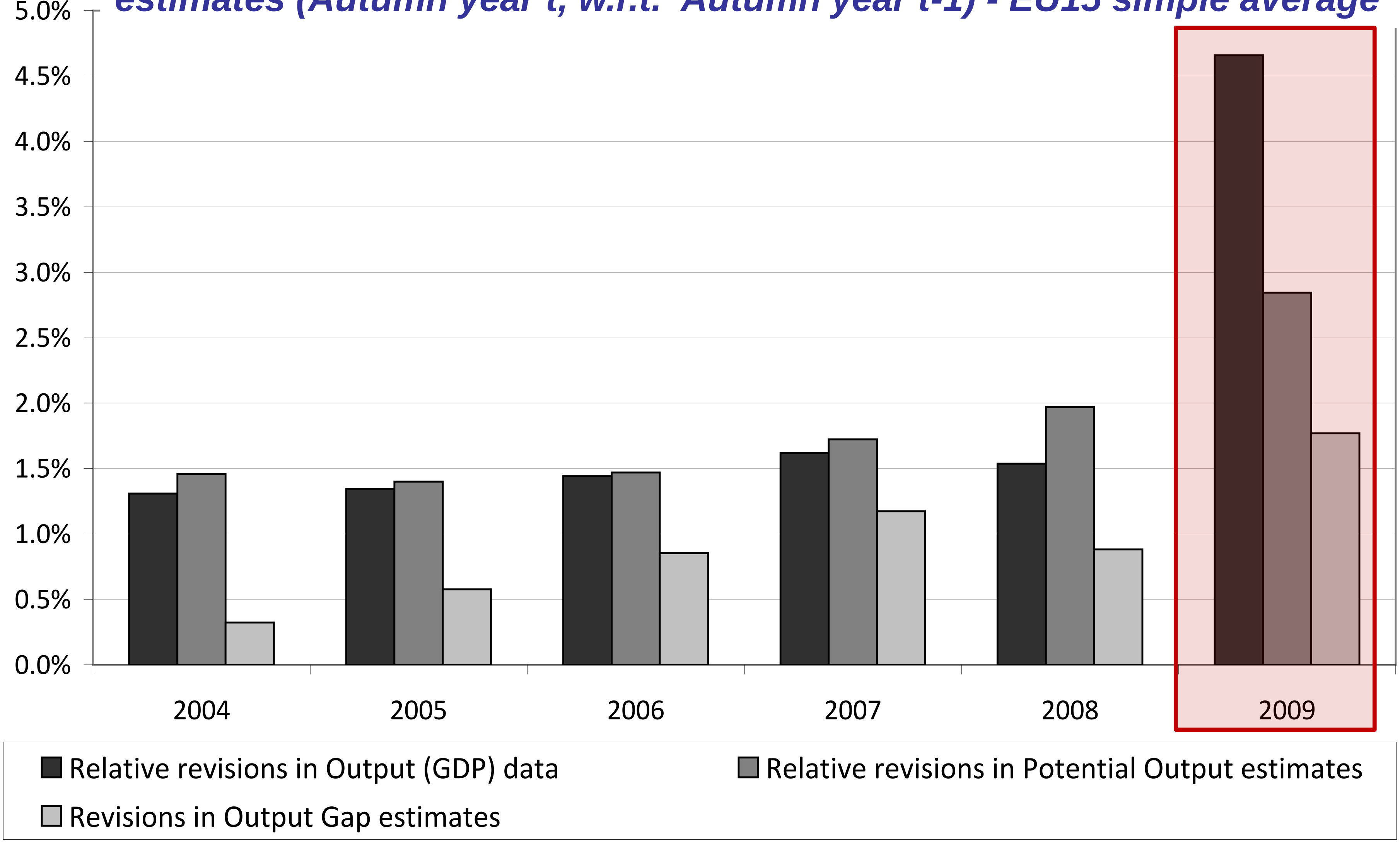
3. Identifying and removing one-offs

4. Correcting for windfalls/short-falls (from asset markets)

II. Difficult implementation

1. Measuring the output gap in real time

Comparison of Revisions in Output, Potential Output and Output Gap estimates (Autumn year t, w.r.t. Autumn year t-1) - EU15 simple average

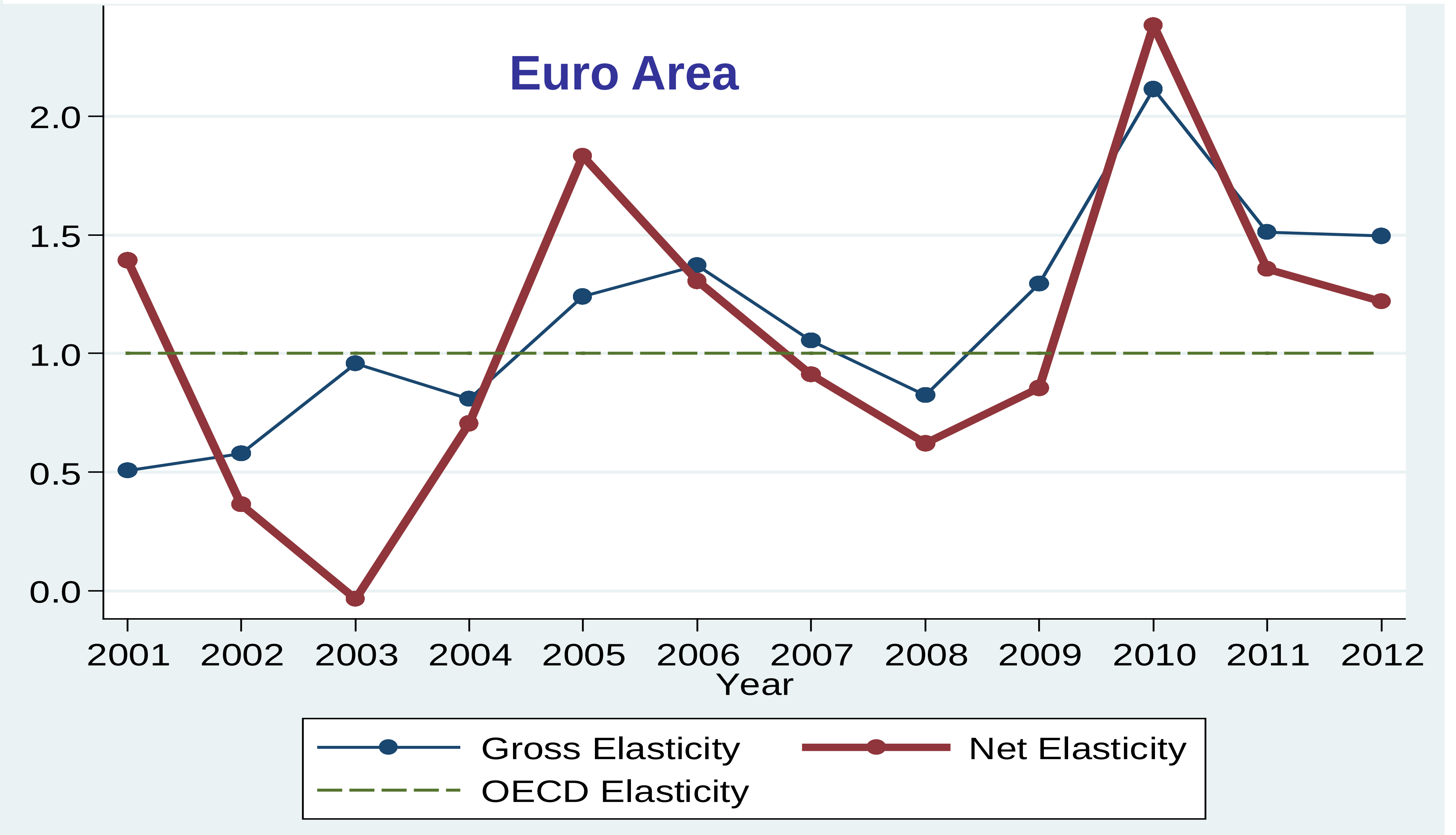


II. Difficult implementation

2. Short-term fluctuations in tax elasticities

Gross apparent elasticities and elasticities <u>net of discretionary fiscal measures</u> over time

Elasticity = tax content of economic growth =ratio of tax growth to GDP growth

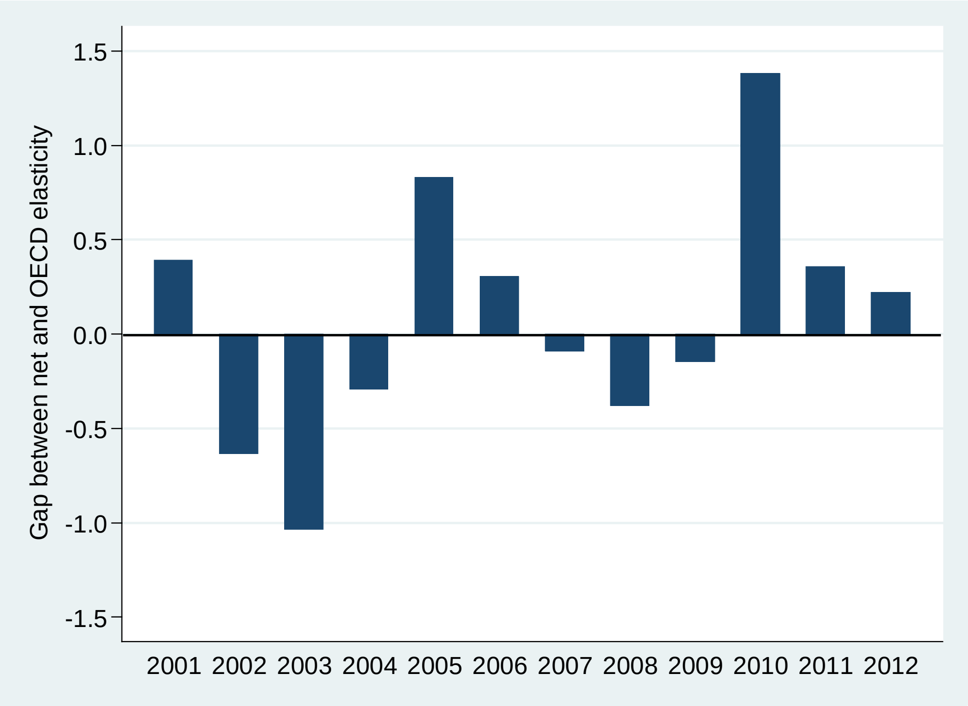


II. Difficult implementation

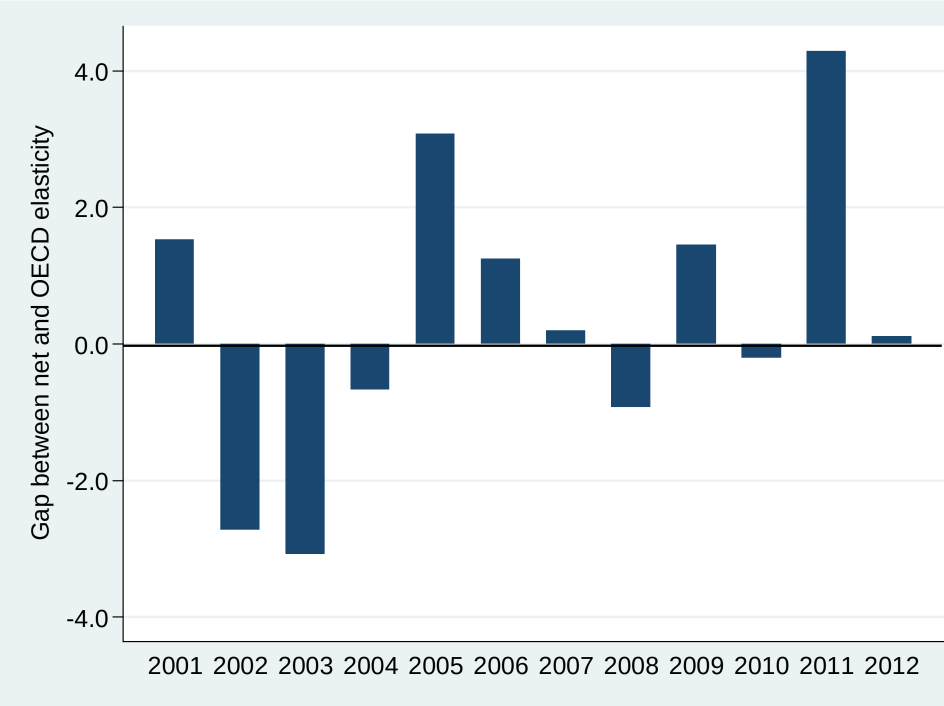
2. Short-term fluctuations in tax elasticities

Gap between short-term net and long-term (OECD) elasticity in euro area

Total taxes



Direct taxes
(smaller scale- bigger effects!)



- The impact of discretionary tax measures
- Respective tax bases may evolve in the short term very differently than GDP/OG (composition effects)…
- …. and individual tax yield affected by lags or complex dynamics

II. Difficult implementation

3. Identifying and removing one-offs

- Not cyclical, so affect both CAB and nominal budget balance
- Risk of "creative accounting" (Drazen, 2002)
- Distort/embellish the signal in CAB, as they don't have a permanent impact on Medium-Term orientation of public finance and on sustainability
- Main problem: no definitive definition, no exhaustive lists possible to capture moving reality, ROOM for judgement

⇒ risk of arbitrariness and cross-country inconsistency

4. Correcting for windfalls/short-falls (from asset markets)

- Beyond cyclical movements in real activity,
- … need for controlling for extra revenue (revenue loss) arising from boom (burst) in asset prices
- E.g. VAT on new housing, extra consumption taxes due to wealth effects, stamp duties on securities, etc.

III. Fix it, Don't break it*

1. Measuring the output gap in real time

- Trend TFP method: switching from HP (univariate) to Kalman Filter (bivariate, linking cyclical TFP to capacity utilisation)

- Leading to more stable estimates of OG: OG in the euro area for 2009/2010 in Autumn 2009 forecast **identical** (-3 ¼%) to Autumn 2011 forecast figures!

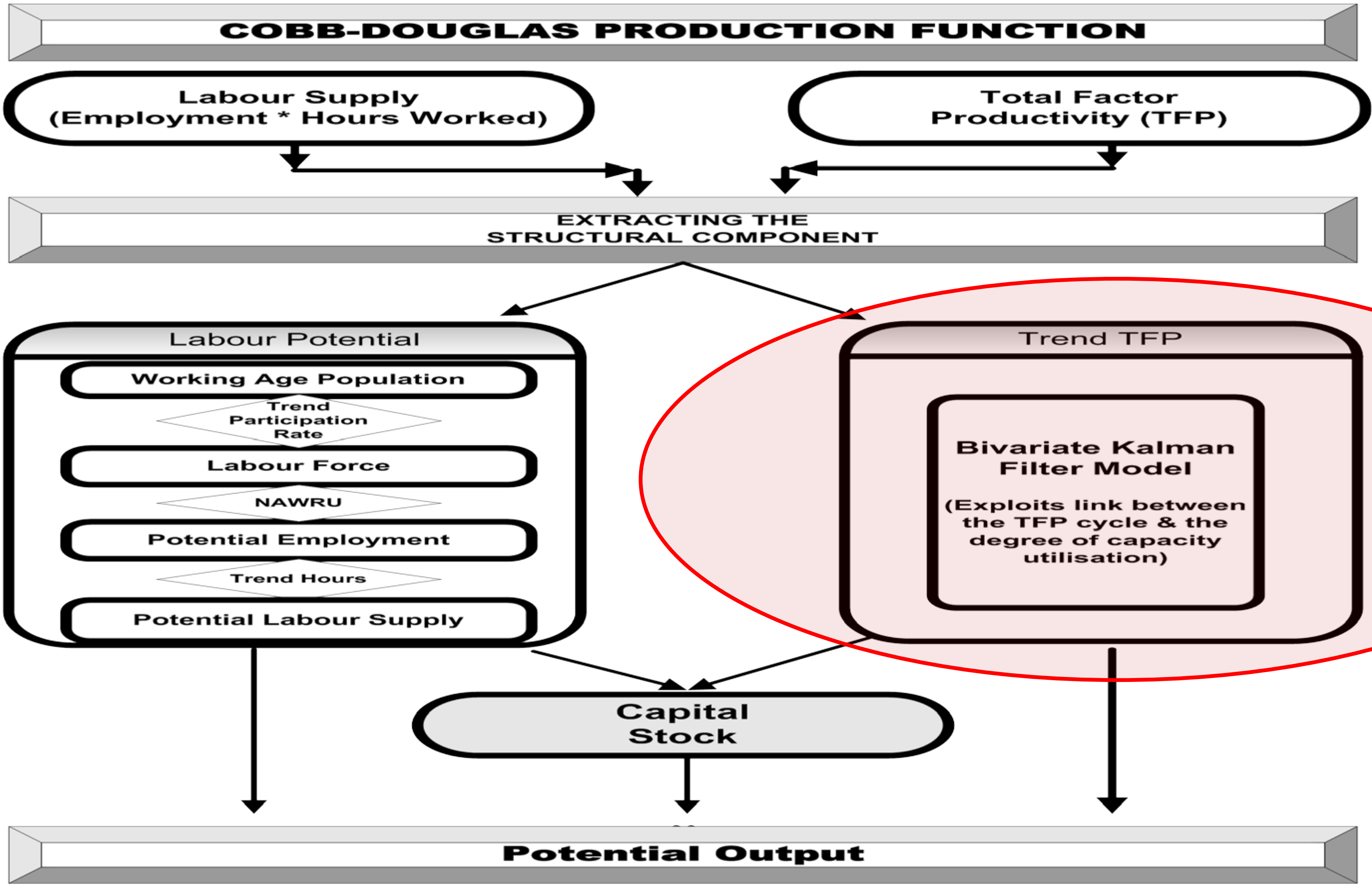
- … and substantial reduction in revisions

Average reduction (%) in revisions (from a year to the next))

	BE	DE	DK	EL	ES	FR	IE	IT	NL	PT	UK
Output gap	**17%**	**21%**	**44%**	**12%**	**8%**	**16%**	**19%**	**46%**	**2%**	**33%**	**8%**

* See Larch & Turrini (2008)

MEASURING POTENTIAL OUTPUT USING A PRODUCTION FUNCTION APPROACH

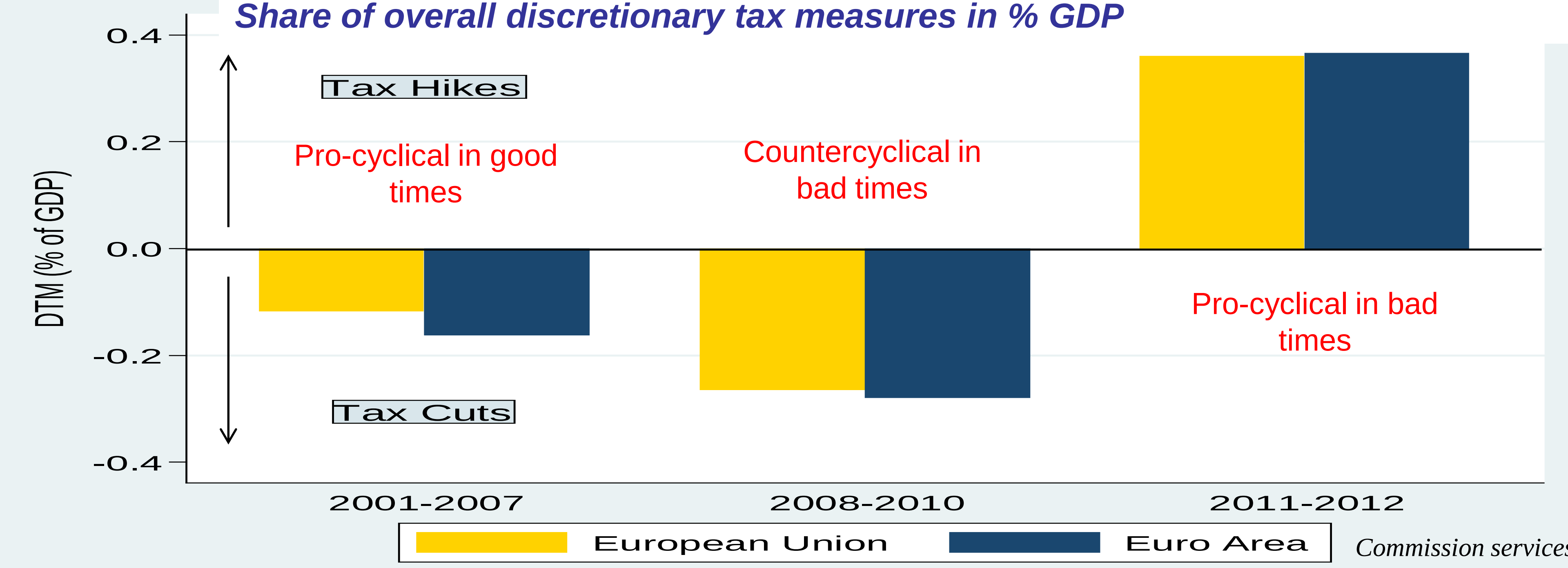


III. Fix it, Don't break it

2. Short-term fluctuations in tax elasticities

- Correcting for discretionary tax measures (DTMs), affecting the tax content of growth (although DTMs are difficult to measure!)
- Analysing the change in CAB when taking short-term empirical elasticities instead of (time-invariant) standard elasticities
- Correcting for the composition effects of tax bases (non-necessarily synchronised with GDP) on tax revenues: see 2008 PFR (Part II, Chp 2) and Larch and Turrini (2008)

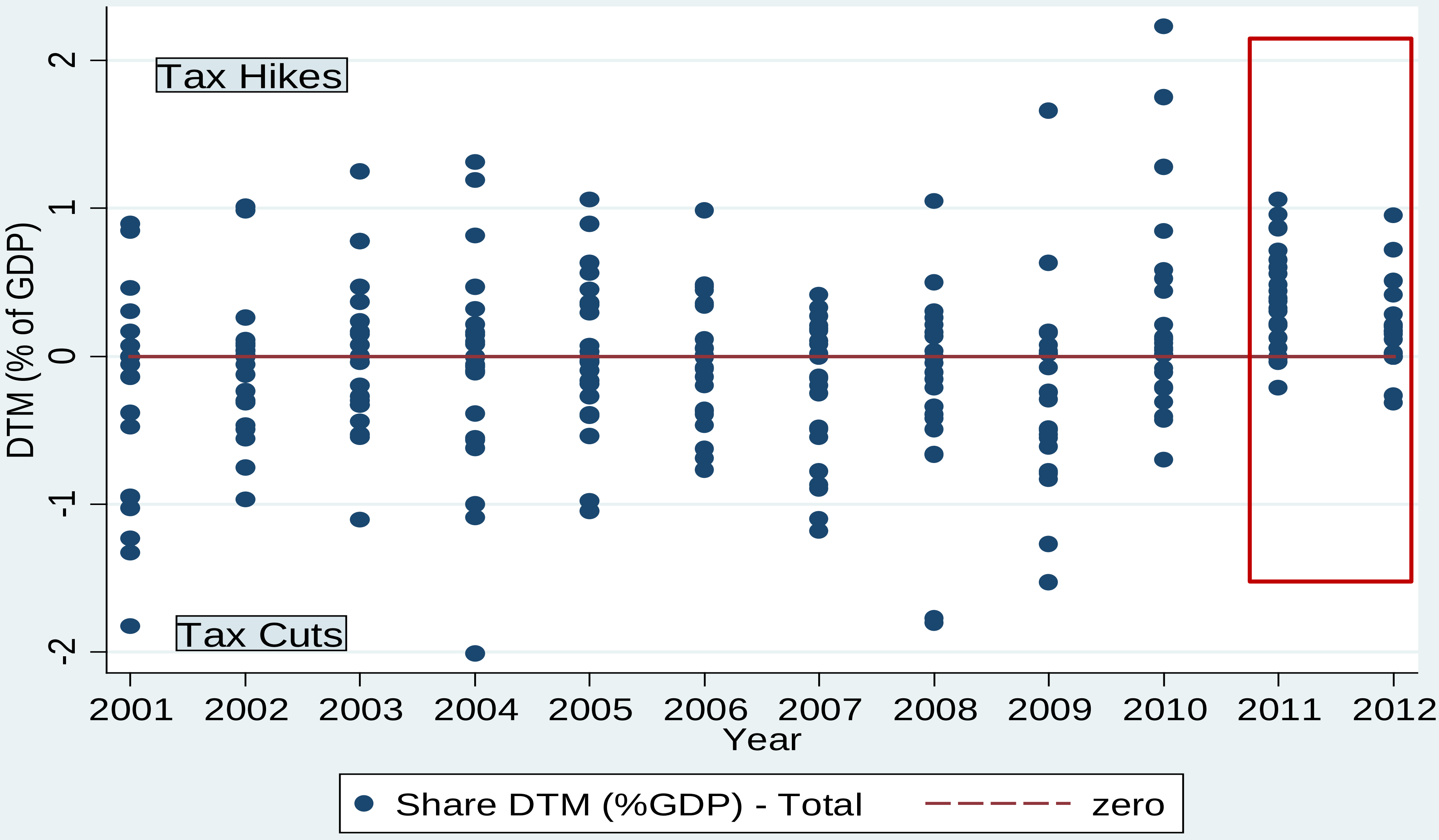
Share of overall discretionary tax measures in % GDP



Commission services

III. Fix it, Don't break it

DTM patterns across countries



III. Fix it, Don't break it

3. Identifying and removing one-offs

Risk of arbitrariness and cross-country inconsistency

Agreement on a number of principles about what measures qualify as "one-offs" to ensure equal treatment across MSs:

- **Significant impact** on budget balance: > 0.1% GDP
- **Temporary impact:** one year or so
- **Non-recurring measures**
- **Only deficit-reducing measures**

Examples of one-offs:

i) tax amnesties with temporary effects

ii) sales of non-financial assets (real estates, licences and concessions)

iii) securitisation operation reducing the deficits

iv) exceptional revenues arising from pension obligation transfers

v) financial impact of court rulings

III. Fix it, Don't break it

4. Correcting for windfalls/short-falls from asset markets)

- Use of expenditure benchmark to complement the CAB

- Progress towards MTO shall be evaluated based an overall assessment with the CAB as the reference, <u>including</u> an analysis of expenditure <u>net of discretionary revenue measures</u> *(Art. 5, revised regulation 1466/97, SGP* Preventive arm*)*

- so as to avoid that temporary windfalls in revenues are used to finance or justify expenditure rises

- For MSs (not) achieving their MTO, annual expenditure growth does not exceed (a rate below) a reference medium-term rate of potential GDP growth, unless <u>the excess is matched by discretionary revenue measures</u>

- For MSs not reaching their MTO yet, <u>discretionary reductions of revenue</u> are matched either by i) expenditure reductions or by ii) discretionary increases in other government revenues or iii) both

IV. Conclusion

1. Need to apply structural budget balance rules = adjusting toward MTO in Europe ASAP

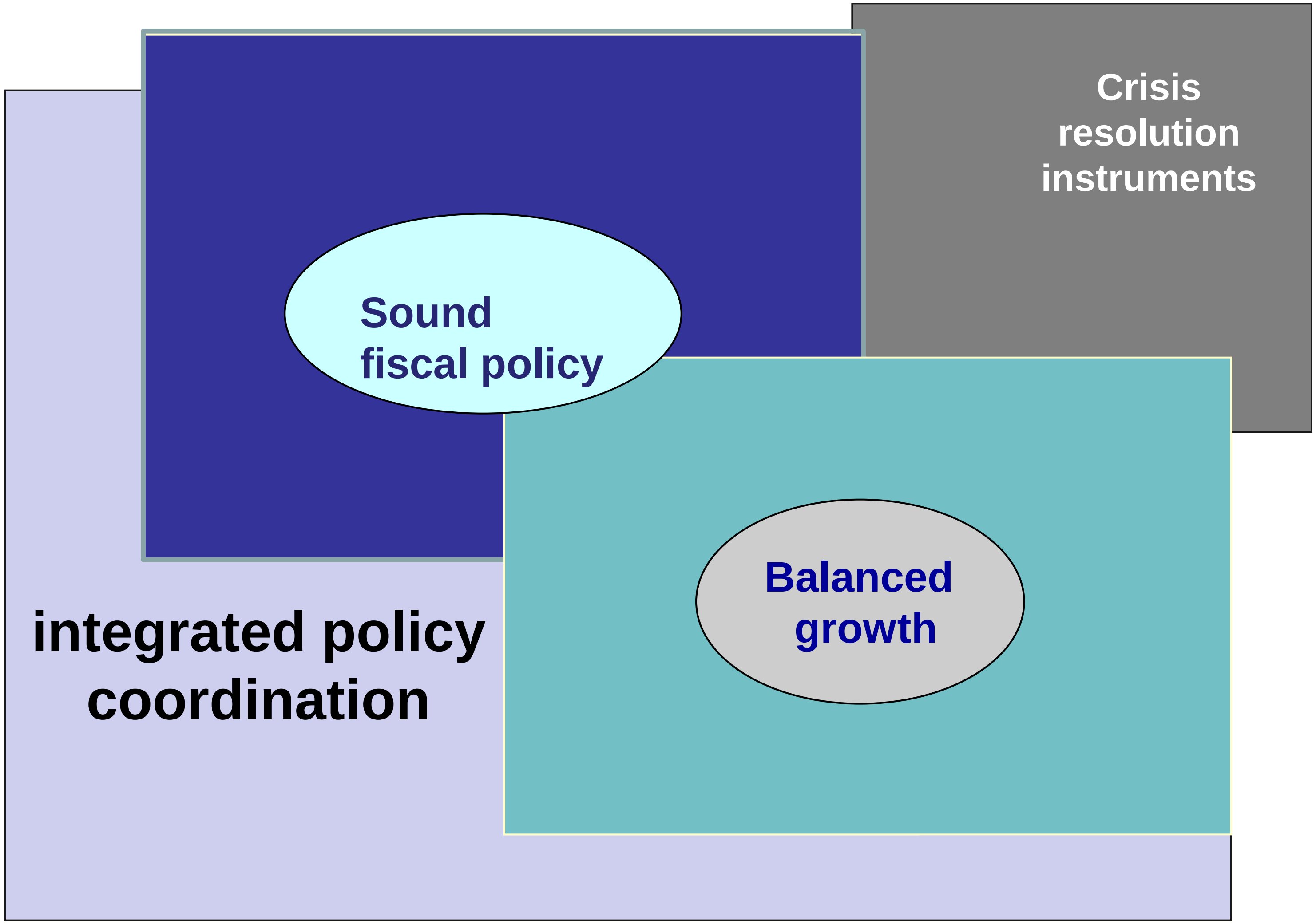
- Already enshrined in Stability and Growth Pact (and its revisions) and Fiscal Compact
- …made even more urgent with the debt crisis and the need to apply the new debt benchmark for public indebtedness reduction
- … complemented by the expenditure benchmark

2. SBB measurement issues could be overcome

- These issues are shared by any rules-based surveillance and assessment framework, rather than only being relative to the SBB indicator itself …
- Need to also involve informed & evidence-based judgement and a wide set of indicators and evidence to buttress the assessment.
- Despite drawbacks, SBB definitely less volatile than nominal budget balance
- EU strategy: improving and complementing SBB

THANK YOU FOR YOUR ATTENTION !

The crisis: new challenges



The multidimensional response to the crisis

Crisis resolution instruments

- EFSM/EFSF: temporary
- ESM: permanent

Sound fiscal policy

More effective prevention of gross policy errors

- Expenditure benchmark
- Monitoring of draft budgetary plans

Focus on debt developments

Debt reduction benchmark as EDP criterion

Better enforcement of SGP rules

-Sanctions at rQMV
- National layer: Directive on national fiscal frameworks, Fiscal Compact (TSCG)

Balanced growth

Prevention and correction of macro imbalances

Procedure and sanctions

More effective supervision and regulation of the financial system

EBA, ESMA, EIOPA - ESRB - CRD III/IV - Banking Union

Structural reform strategy (Europe 2020)

Growth Compact

(EIB, Structural funds, Projects bonds, FTT)

European Semester for economic policy coordination