EUROPE'S NEW FISCAL RULES

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IMF-ECB "Reforming EU Fiscal Governance" Conference
13-14 December 2012

OECD
BETTER POLICIES FOR BETTER LIVES

Background of paper

- Crisis/rising debt-to-GDP ratios lead to reform of EU fiscal governance
- SGP “Six Pack” and “Fiscal Compact” treaty

- Discussion very procedural or theoretical
- Anchoring in terms of debt dynamics unclear
- System based on multiple rules is complex

EU fiscal rules – what's new?

Enforcement mechanism	**Fiscal rule[1]**
Corrective arm of the	3% of ceiling for the general government (GG) deficit
	60% of ceiling for the GG gross debt
	Reduce debt by 1/20th of excess over 60% ceiling
Preventive arm of the	Medium-Term Objective (MTO) for the structural GG budget balance
	Improve the structural budget balance by 0.5 percentage point of if MTO not met
	Benchmark for expenditure to grow in line with trend
"Fiscal Compact"	GG structural budget balance as MTO
	Improve structural budget balance by 0.5 percentage point of if MTO not met

- New debt convergence rule
- New expenditure benchmark
- Enforcing MTO would be a new departure

Simple simulation model - assumptions

- OECD medium-term macroeconomic scenario (May 2012)
  - ≈ EDP/Stability Programme fiscal assumptions in short term
  - simulations start from 2014; OECD EU countries only
  - No feedback fiscal stance => GDP
  - Interest rates are exogenous, include risk premium

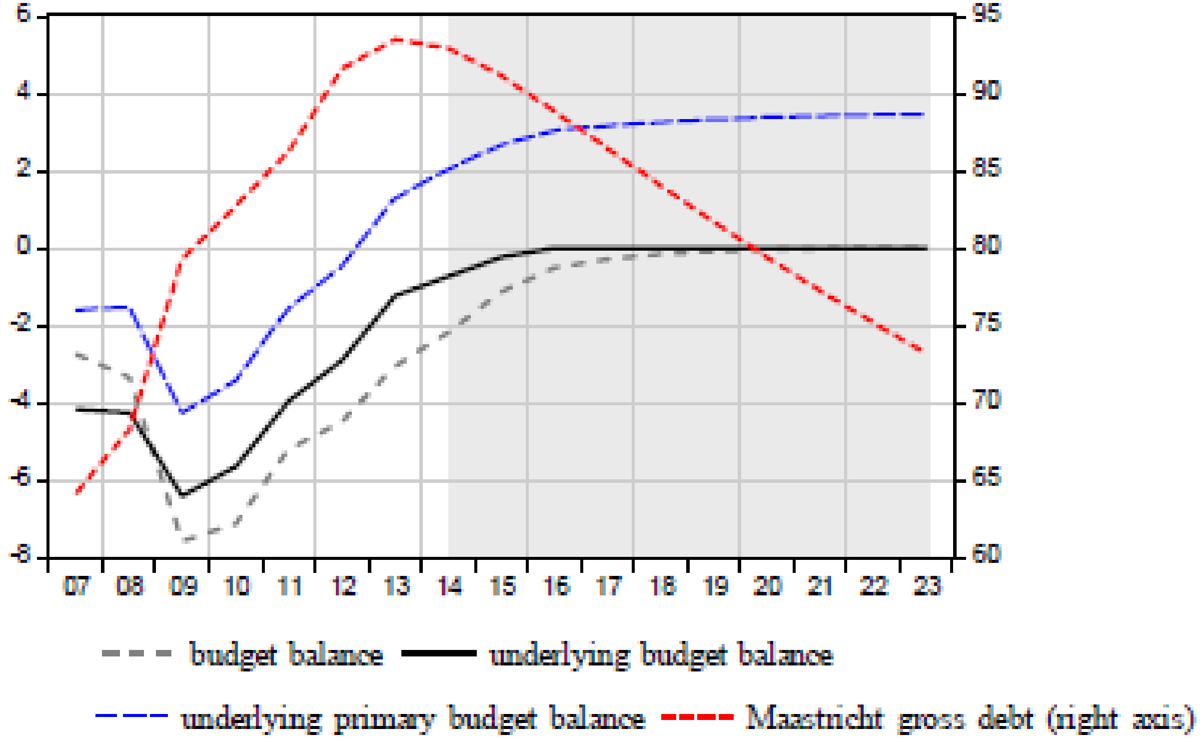
- Fiscal projections
  - interest payments reflect rates + historic debt turnover
  - semi-elasticity of budget balance to gap (Girouard & André, 2005) and otherwise balance constant as a share of GDP
  - constant financial assets/GDP
  - zero statistical discrepancy

Simple simulation model – algorithm

- Minimum compliance with EU rules
  - 3% headline deficit ceiling
  - Country-specific MTO for underlying balance
    - 0.5pp adjustment until reach MTO
    - Constant MTOs
  - Debt-to-GDP ratio reduction
    - ≈ 1/20th of pp excess over 60%, but exact forward/backward-looking version is modelled
  - Expenditure benchmark is not modelled

- ***Most binding rule in terms of level of structural GGB is applied***
  - Debt convergence only applies 3 years after end of EDP

An example - France



- 3% deficit would be reached in 2013
- Debt/GDP would be falling by more than 1/2o^th of (92-60)
- Consolidation needed to 2015 to reach MTO (balance)
  - Small headline deficit persists

Results – binding rules

	current deadline for EDP correction	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Austria	2013	..	..	..	->MTO	debt	=	=	=	=	=
Belgium	2012	3%	..	..	->MTO	->MTO	->MTO	->MTO	=	=	=
Estonia	..	..	..	..	=	=	=	=	=	=	=
Finland	..	..	..	..	=	=	=	=	=	debt	=
France	2013	3%	3%	..	->MTO	->MTO	=	=	=	=	=
Germany	2013	..	..	..	=	debt	=	=	=	=	=
Greece	2014	3%	3%	3%	3%	trans.	trans.	=	=	=	=
Ireland	2015	3%	3%	3%	3%	3%	trans.	->MTO	->MTO	=	=
Italy	2012	3%	..	..	trans.	trans.	debt	debt	debt	=	=
Luxembourg	..	..	..	..	=	=	=	=	=	=	=
Netherlands	2013	3%	3%	..	->MTO	trans.	=	=	=	=	=
Portugal	2013	3%	3%	3%	3%	trans.	trans.	trans.	debt	=	=
Slovak Rep.	2013	3%	3%	..	->MTO	->MTO	->MTO	->MTO	->MTO	->MTO	=
Slovenia	2013	3%	3%	..	->MTO	=	=	=	=	=	=
Spain	2013	3%	3%	3%	3%	trans.	=	=	=	=	=
Czech Rep.	2013	3%	..	..	=	=	=	=	=	=	=
Denmark	2013	..	3%	..	=	=	=	=	=	=	=
Hungary	2011	..	..	..	trans.	debt	=	=	=	=	=
Poland	2012	3%	..	..	->MTO	->MTO	=	=	=	=	=
Sweden	..	..	..	..	=	=	=	=	=	=	=
United Kingdom	2014	3%	3%	3%	3%	trans.	->MTO	->MTO	=	=	=

“3%" = 3% deficit rules; “debt” is the debt convergence rule;
“->MTO” is adjustment towards the MTO, "=" marks that the MTO is reached and maintained. The MTO is assumed to dominate the debt convergence rule where differences in requirements are small.
“Trans” = transition rule where debt rule would be binding if EDP had not been in place within the past three years.

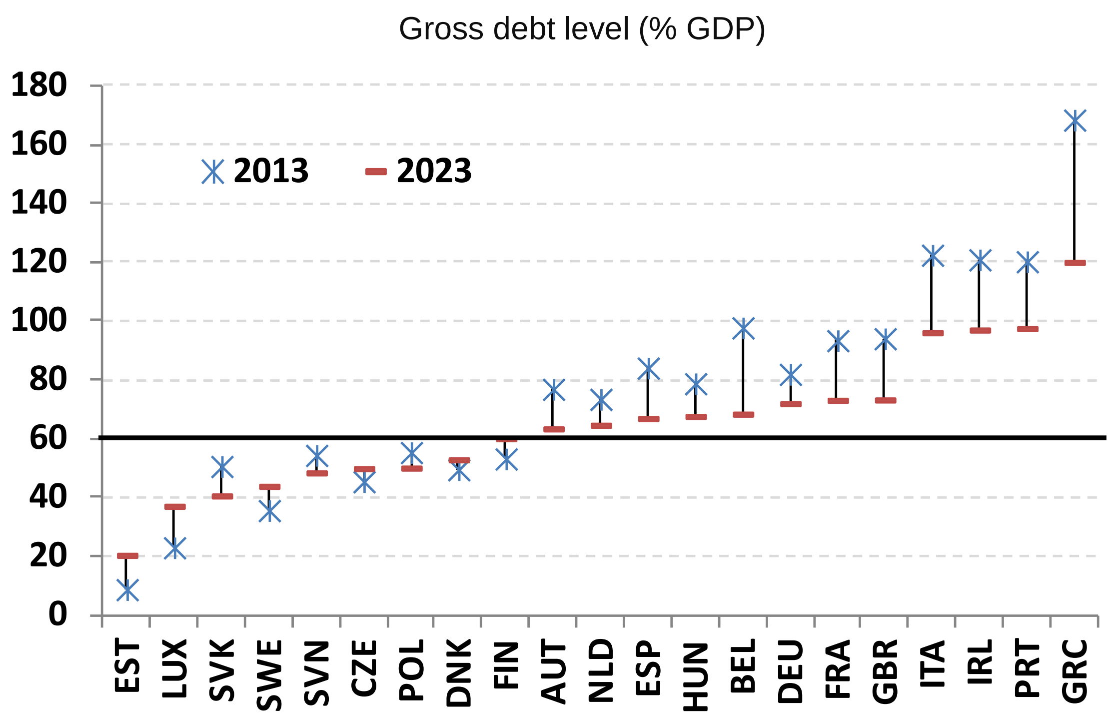
What are the binding rules?

- MTOs is almost always the binding rule from 2014
- EDPs do much of the work to get there
  - Half of EU countries meet MTO by 2014
  - Current deficits include large cyclical component
  - ***Given recession, EDPs likely to last longer than assumed***
- Debt rule binds rarely and only for short spells

  eg Italy and Portugal
- MTO requirement dominates easily

  eg if {D/Y = 100, i = 5%, g=4%}, an overall balance of zero implies a primary surplus of 5% and 4pp reduction in D/Y
- Rule not very demanding if debt not too far from 60%

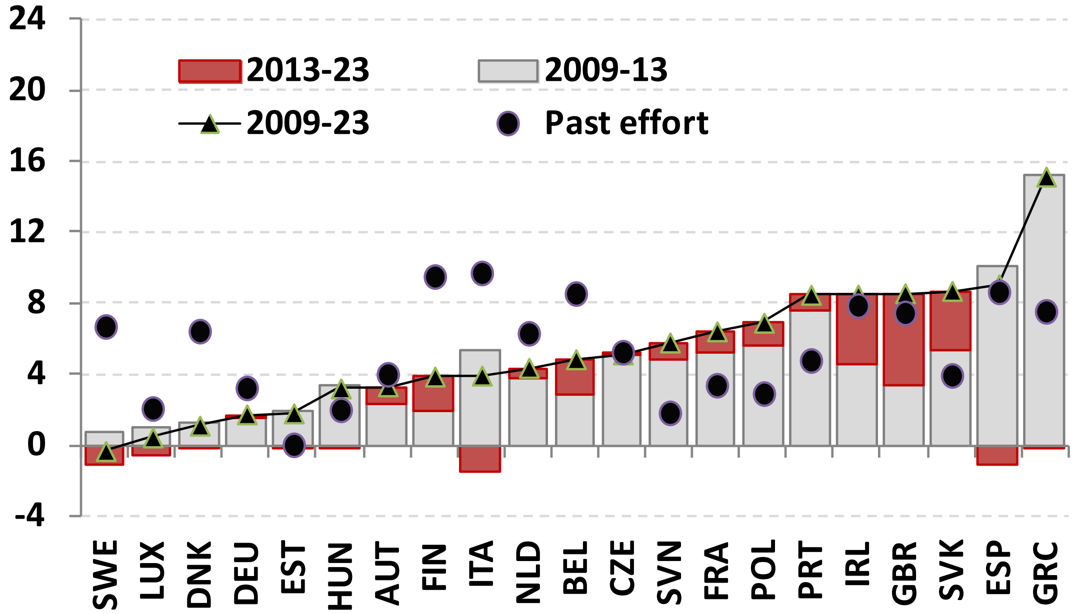
Debt reduction under the rules



- Rules would deliver major debt/GDP reduction
  - But, more than half of countries would not be below 60%
- Steep downward trajectories

Are the rules an "Austerity Pact"?

Changes in the underlying budget balance (% potential GDP)

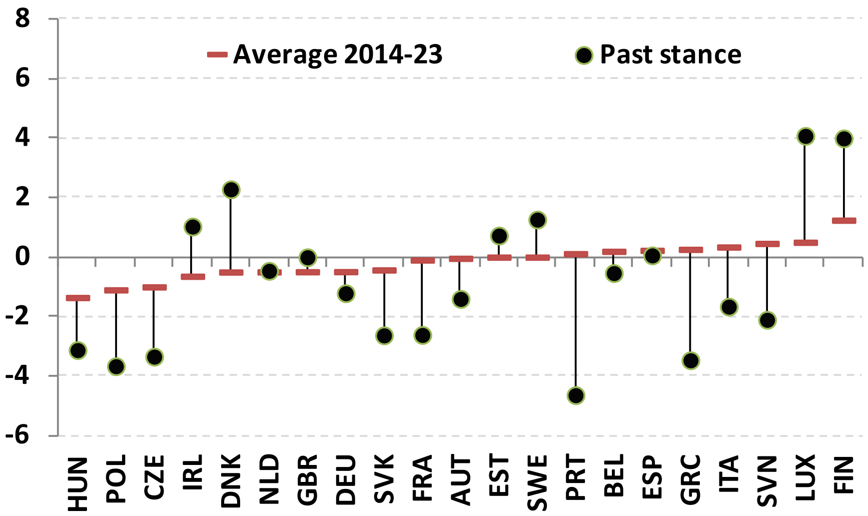


• Past effort denotes the largest consolidation effort in that country since 1987 (Guichard *et al.* 2007)

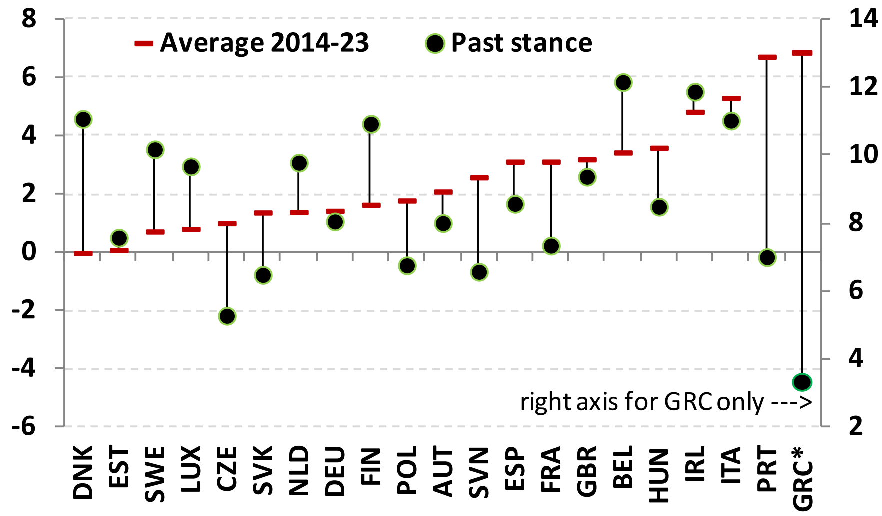
- Consolidation will be large and sustained by historical standards
- But, most of this would be achieved under EDP programmes

The rules lock in a tight budget stance

A. Level of the underlying budget balance

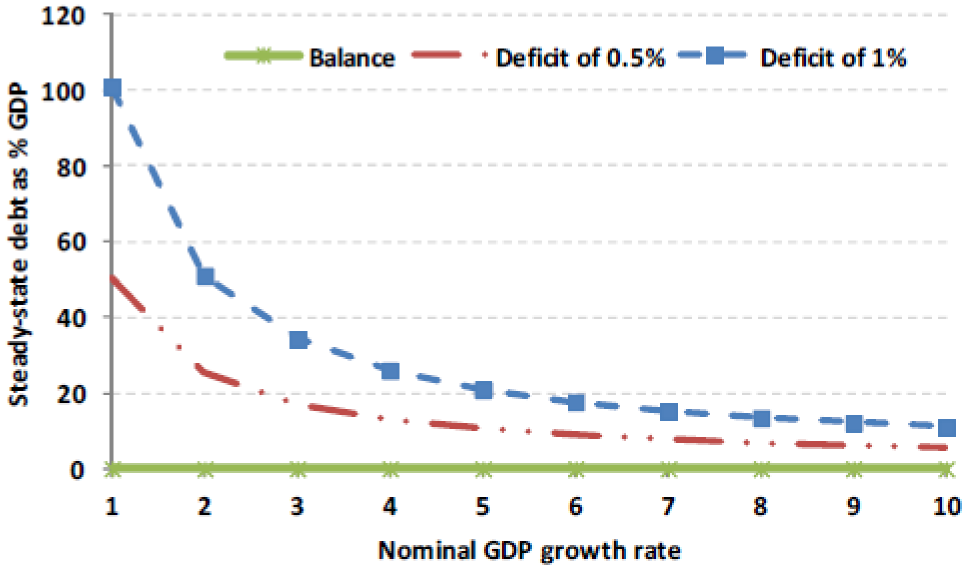


B. Level of the underlying *primary* budget balance



- Budgetary stance will need to be kept tight for many years
  - Most countries have not achieved in recent history
  - All countries will need to achieve what the best performers did
  - This will be more difficult with higher debt + no revenue buoyancy

Rule design: (1) low steady-state debt



- *Overall* budget balances close to zero imply low steady-state D/Y ratio
  - MTO leeway is bounded from below at 1%…
    … although this be helpful given ageing liabilities
  - Debt rule is specified in *gross* terms
  - Unsuitable for rule of "permanent character" ?

Rule design:(2) MTO formula

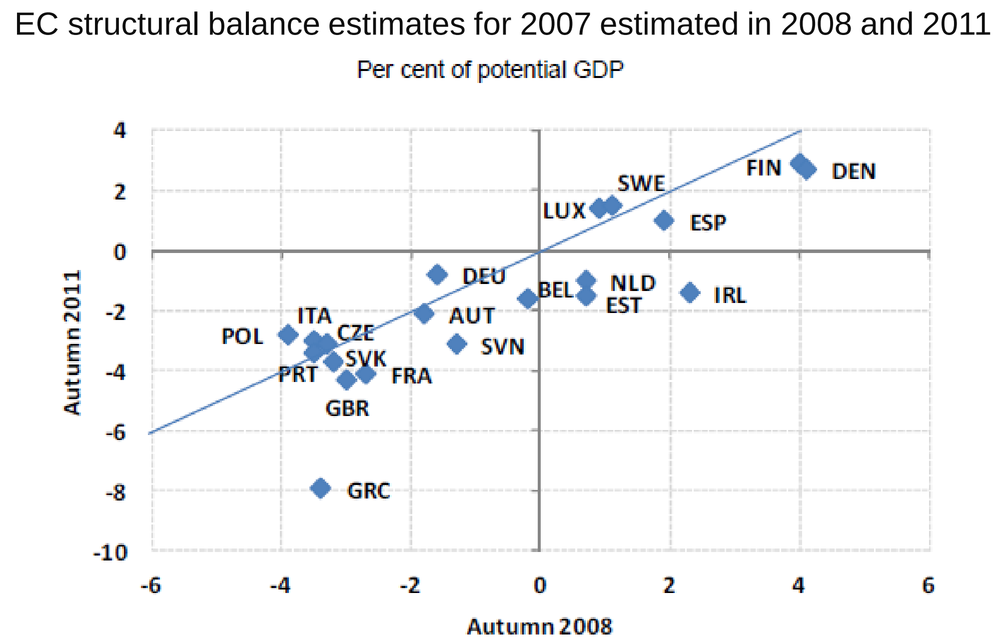
- MTO set by (undisclosed) formula
- Biraschi et al. (2010) derive as

  MTO = -(60 * g)/(1 + g) + 0.033 * (d - 60) + 0.33 * S2E

- MTOs would need to be tightened
  - Sizeable increases in many cases
  - Mostly due to higher d ratio

- Coefficient on d may be unnecessary
  - Rate of debt reduction increases by i*(⊿d) in any case for given balance

Rule design: (3) Estimating potential



- Structural balances play a central role in the rules
- ***Real time*** estimation of output gap/trend growth/elasticity of balance to cycle is difficult
  - All errors loaded onto estimated structural balance
- Huge potential for policy errors/loss of credibility

Rule design: (4) Complexity

- Complexity without obvious gains
  - Hard to operate
  - Limits buy in
  - Lack of credibility if weak foundations
- Was debt rule necessary?
  - Procedural justification
- Crowding out of national rules
- Risk that judgement will come to play a large role