Some elements of a revamped fiscal framework for Spain

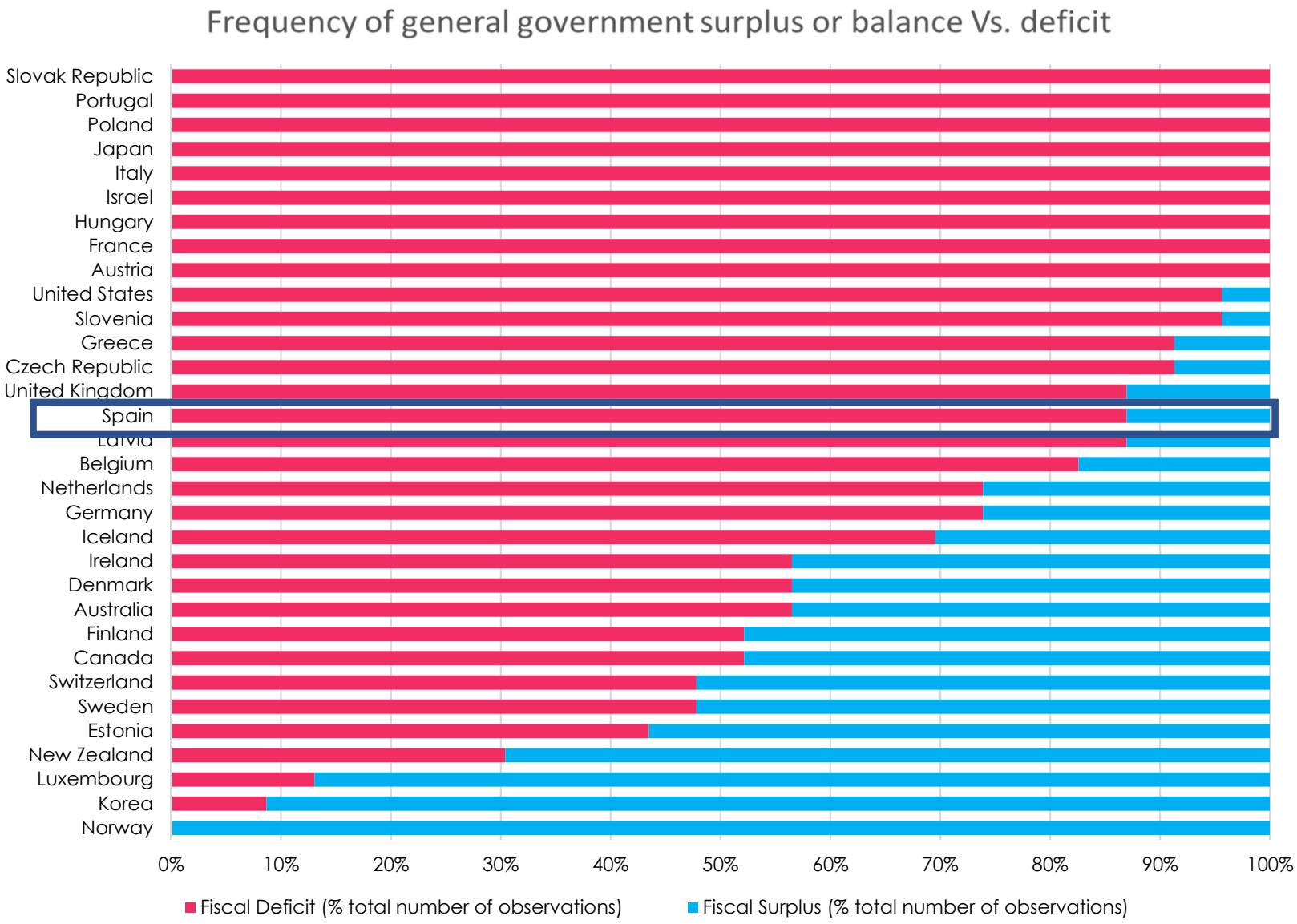
Independent Fiscal Institutions in the EU Fiscal Framework

Workshop organized by the European Fiscal Board

Carlos Cuerpo, AIReF, Economic Analysis Division

February, 2019

Deficit bias: balanced budgets are not the rule…

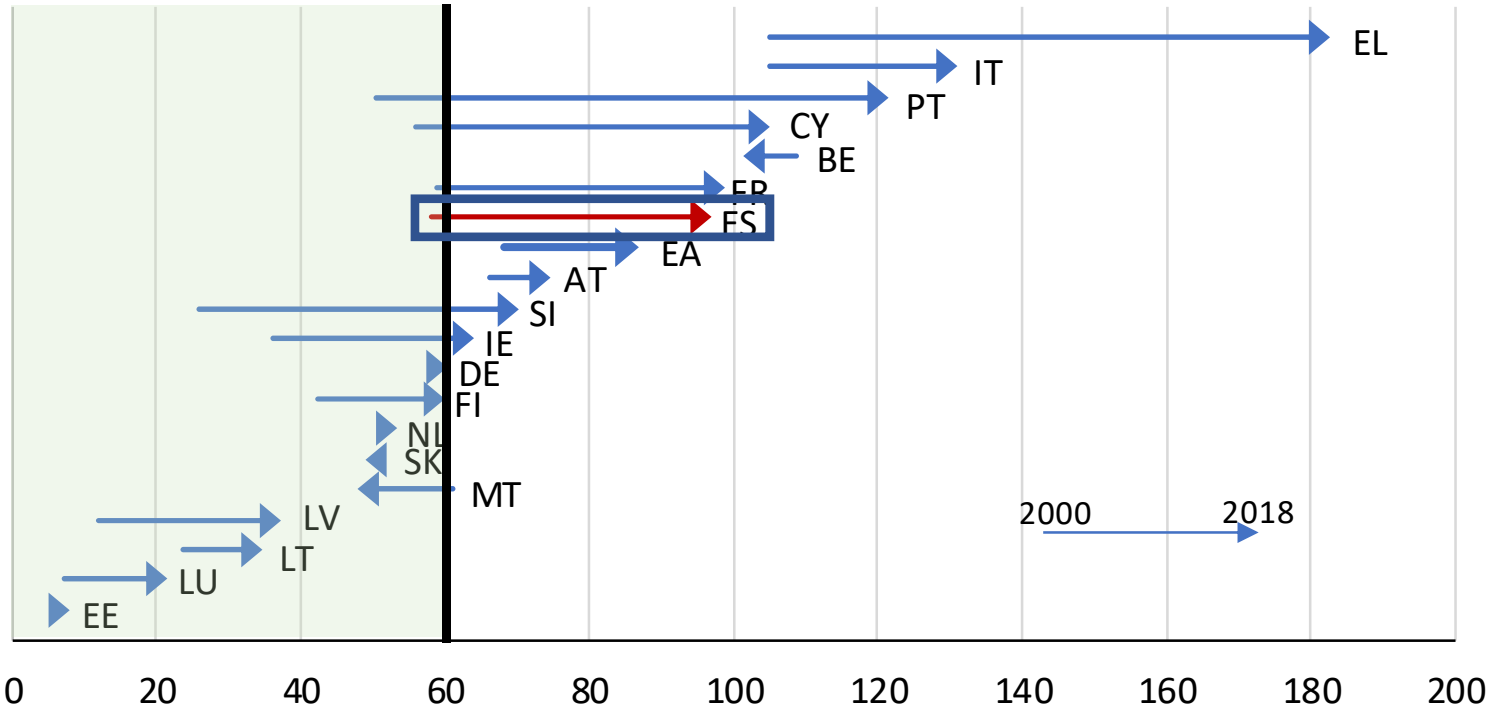


Source: IFAC, OECD

Note: data since 1995

…increasing debt stocks and raising sustainability concerns

General Government Debt (% GDP), 2000 vs. 2018, euro area countries



Source: AMECO

Common rules framework but heterogeneous results

⇨ **There is more to fiscal performance than just numerical rules: institutional quality**

Scene-setter

The rule

AIReF's role

Takeaways

Real-time exercise

Fiscal rules framework is not sufficient to generate buffers

Identified flaws: leading to instability and wrong policy advice

1. Convoluted framework: EU and national rules not fully aligned
2. Relying too much upon unobservable indicators
3. Shortsighted with no medium-term view
4. Debt as an anchor is not factored in
5. Too much room for disretionary actions
6. Too complex and without realistic goals

Fiscal rules need to be complemented with enhanced institutions: IFIs as the natural candidate

IFIs can play a complementary role in reducing the deficit bias

AIReF's proposal: main features

Relevance and benchmarking

Window of opportunity: making it consistent with EU reform trends

- Fiscal Compact
- 2017 Directive Proposal, to strengthen fiscal responsibility and medium-term view

Main inspiration: Dutch model

Defining features

Long-term anchor and medium-term focus

Transparent, simple, flexible and internally consistent

Enhanced institutional role for IFIs: limit discretion

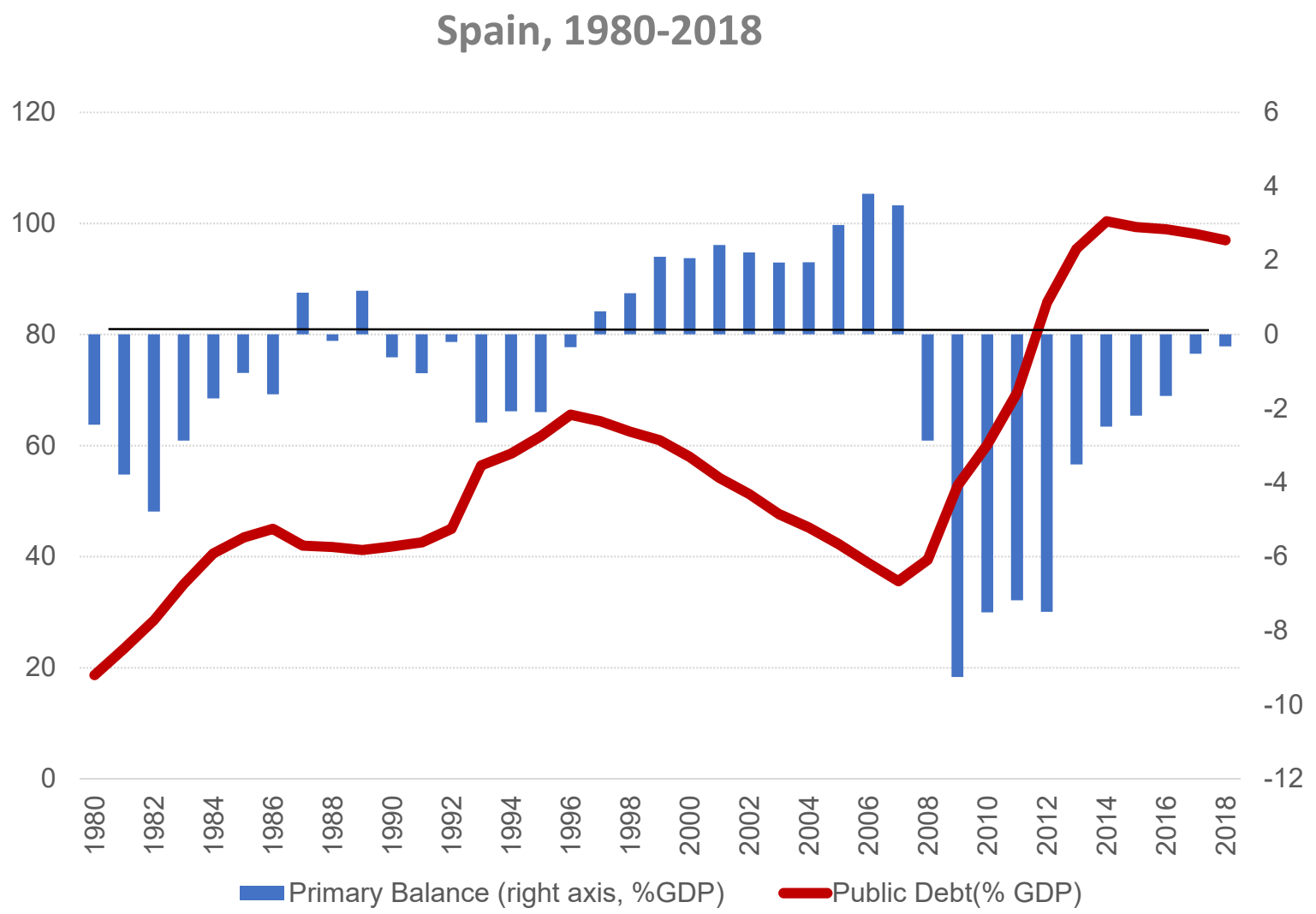
3x3 design: 3 time references associated with 3 indicators

Short-run	Medium-run	Long-run
Operational Target	Intermediate Target	Final Target
Net Expenditure Ceiling	Primary Balance (% GDP)	Gen. Govt. Debt (% GDP)

- Stable and predictable relationship with the intermediate target
- Controllable to a large extent and on a regular basis
- Communicate fiscal stance

- Stable and predictable relationship with the final target
- Controllable with a reasonable time lag and a relative degree of precision

Step 1: from debt to primary balance



Source: AIReF, BdE, INE

Step 1: from debt to primary balance

From the debt accumulation equation:

$$b_t = \frac{1 + i_t}{1 + gn_t} b_{t-1} - pb_t$$

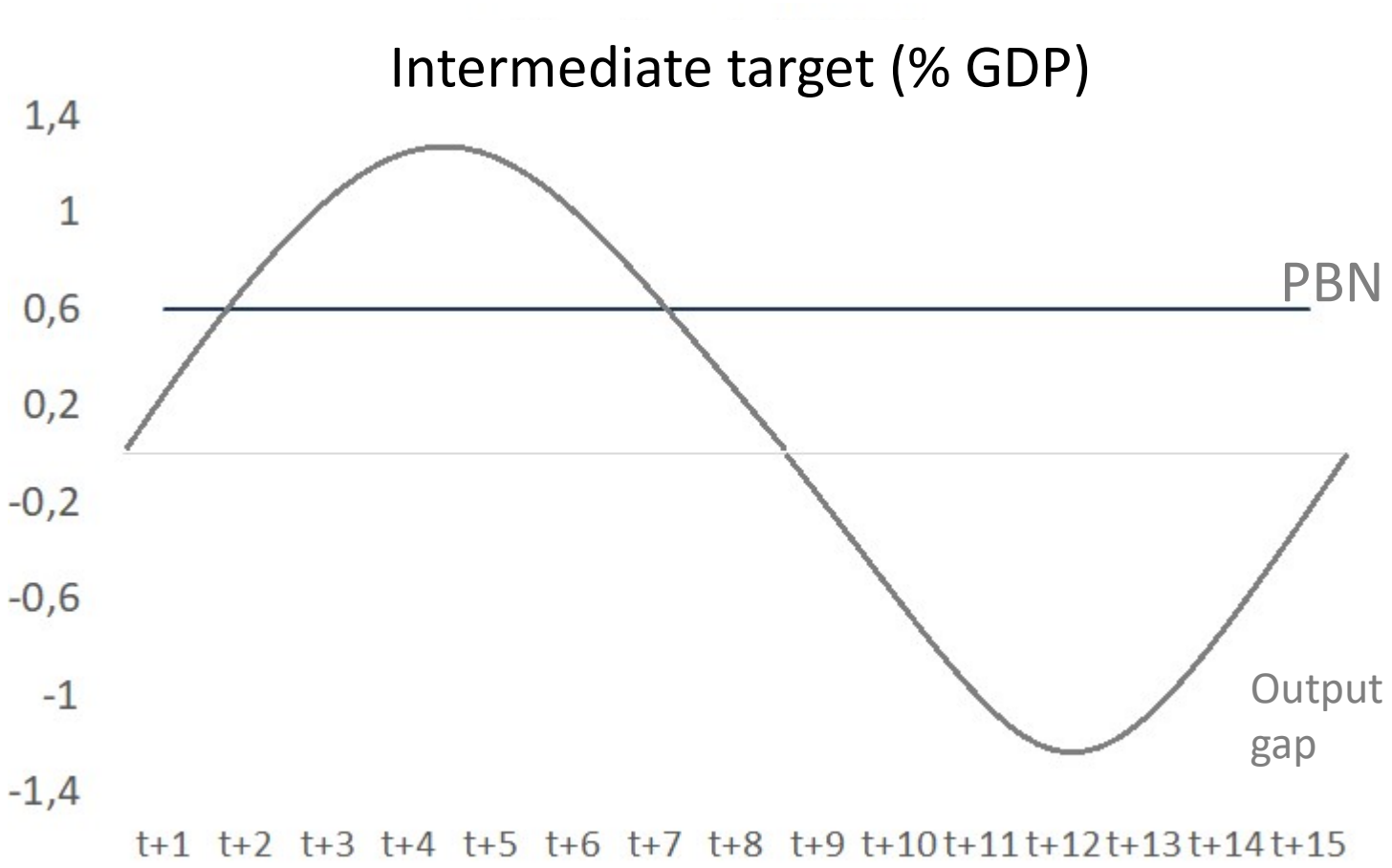
Under the assumption that $(i_t = i;\ gn_t = gn)$ and defining:

$$1 + \lambda = \frac{1 + i}{1 + gn}$$

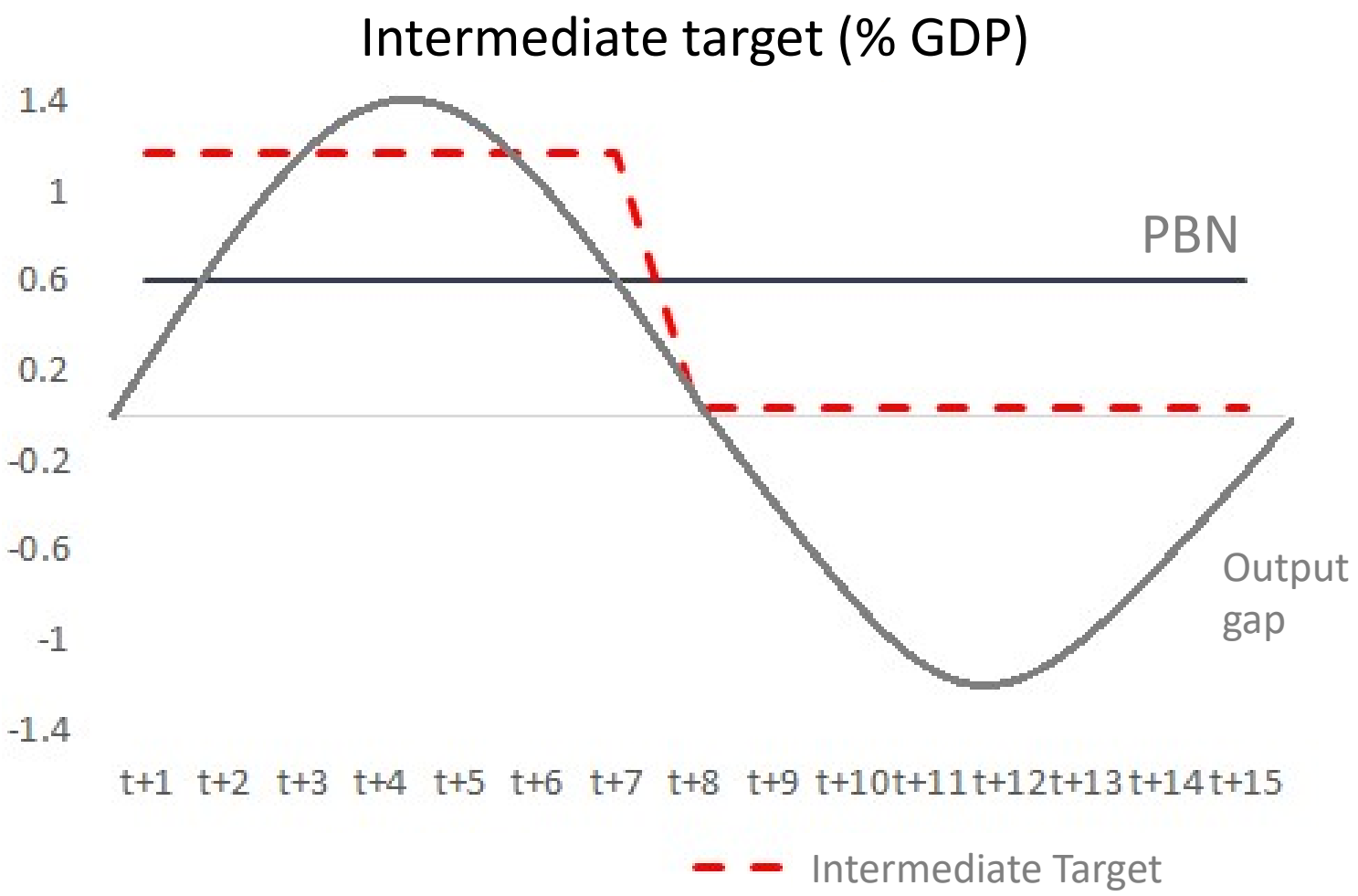
It follows:

$$PBN = \frac{\lambda}{(1 + \lambda)^{-N} - 1}\left((1 + \lambda)^{-N} b_N^* - b_0\right)$$

Step 1: from debt to primary balance

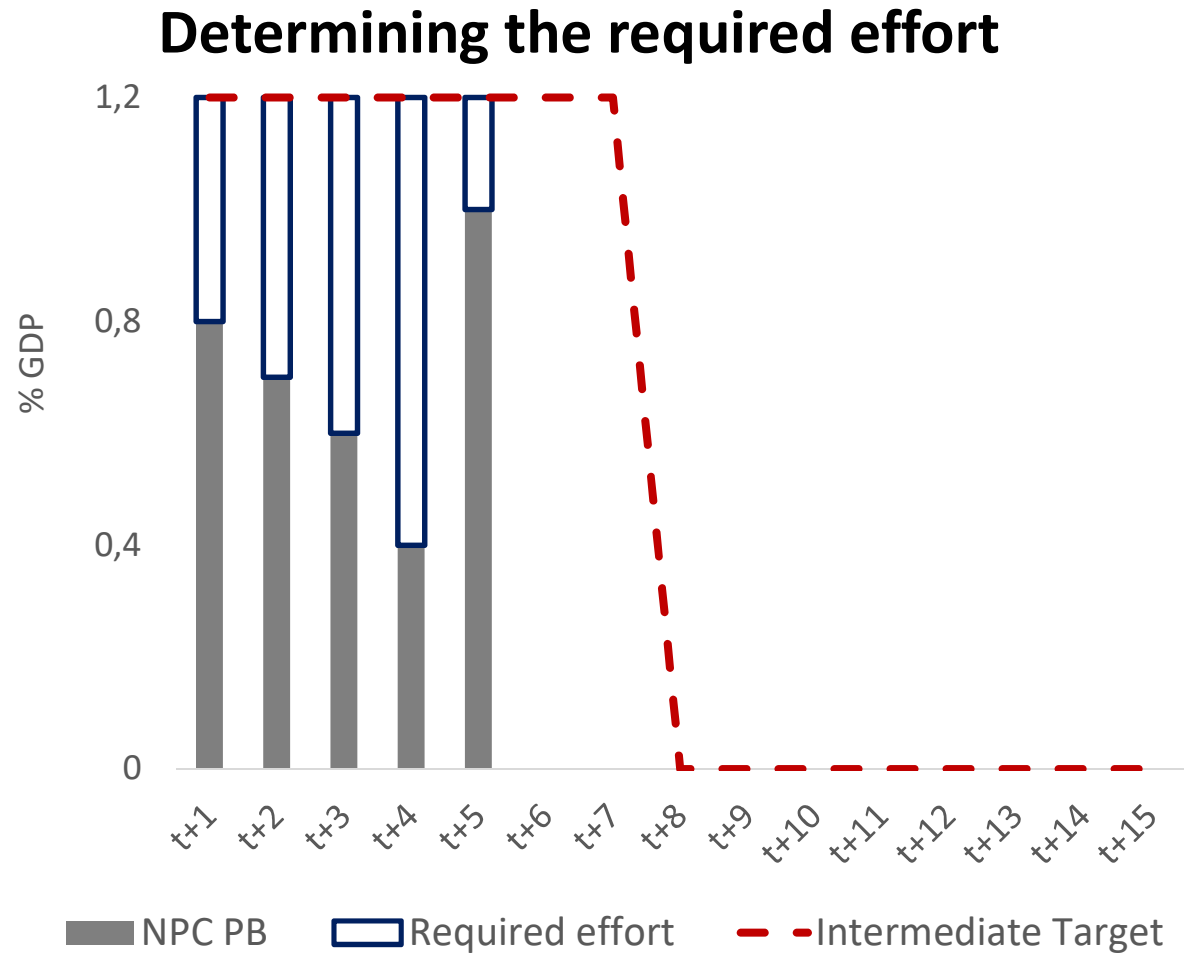


Step 1: from debt to primary balance



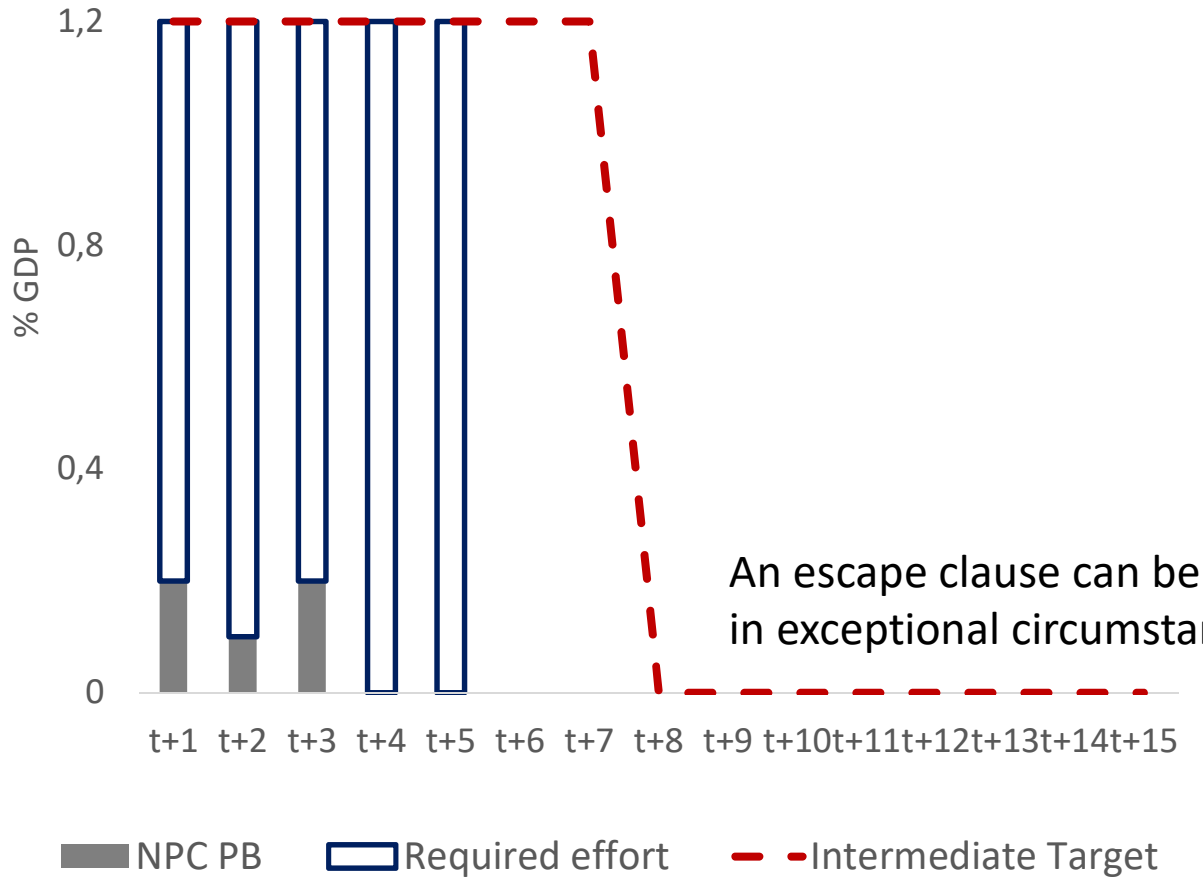
$$IT_{t,t+4} = PBN + \varepsilon * OG_{t,t+4}$$

Step 2: from primary balance to expenditure ceilings



Step 2: from primary balance to expenditure ceilings

Determining the required effort



$$FE_{t+i} = \begin{cases} min\left[1; \left(IT_{t,t+4} - PB_{t+i}^{t+i-1}\right)\right] & ,if\ IT_{t,t+4} > PB_{t+i}^{t+i-1} \\ 0 & ,if\ IT_{t,t+4} < PB_{t+i}^{t+i-1} \end{cases}$$

Step 2: from primary balance to expenditure ceilings

Determining the maximum level of net expenditure

- Ceiling for discretionary expenditure (net of DRMs) computed with potential growth as a reference and taking into account the FE

- Why potential growth?

$$\Delta SB_t = \Delta\cancel{\left(\frac{CAR}{Y^p}\right)_t} - \Delta\left(\frac{CAG}{Y^p}\right)_t - \Delta\cancel{\frac{oo_t}{Y_t}}$$

- Thus, the underlying budgetary position:
  - Remains constant if expenditure grows in line with potential GDP
  - Improves if expenditure grows below potential GDP
  - Deteriorates if expenditure grows above potential GDP

Step 2: from primary balance to expenditure ceilings

Determining the maximum level of net expenditure

For period t:

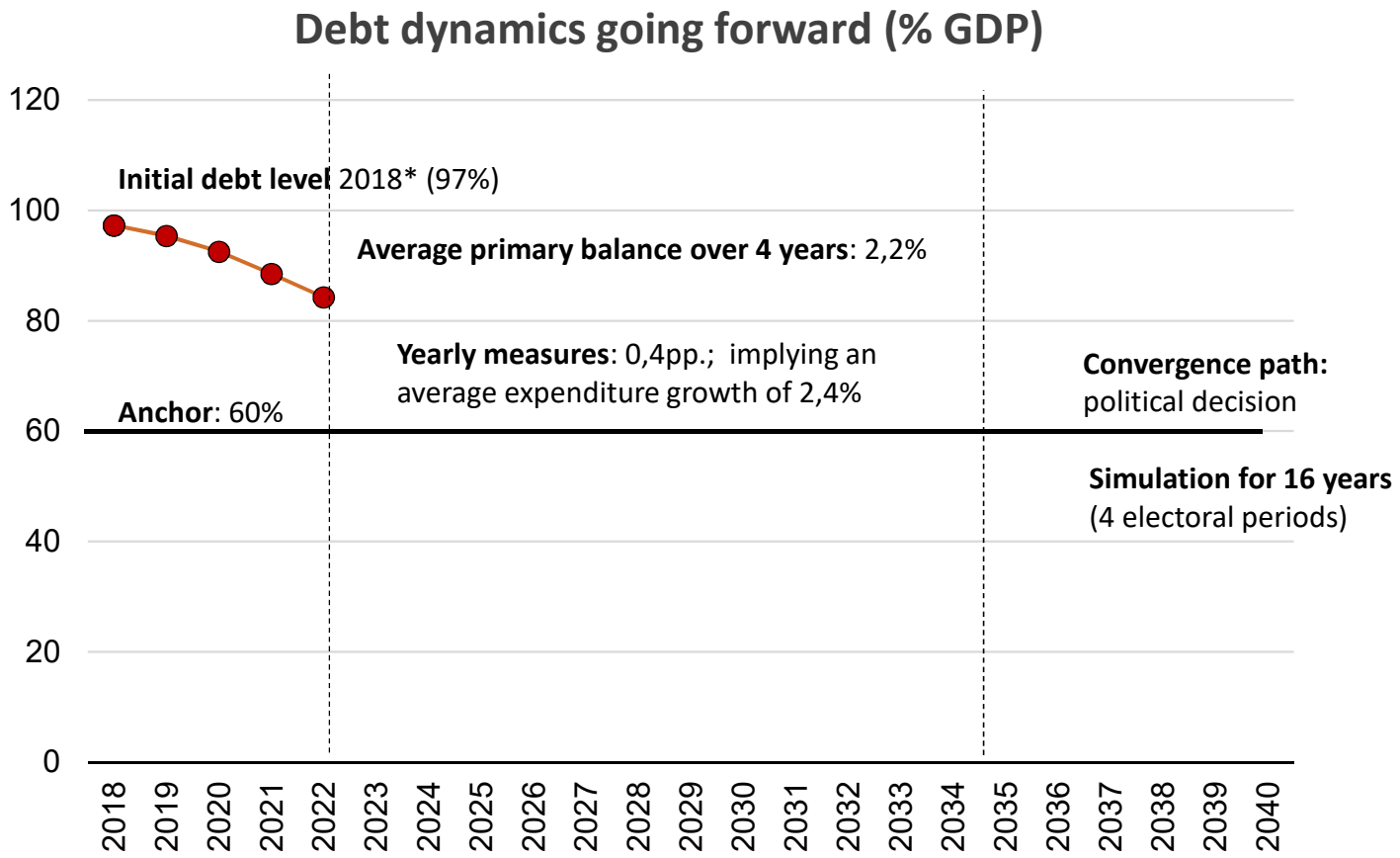
$$NE_t = E_{t-1} * \left[1 + pot_t - \left(\frac{FE_t}{PExp_t} * 100\right)\right]$$

For period $t+i$:

$$NE_{t+i} = E_{t-1} * \prod_{i=0}^{3} \left[1 + pot_{t+i} - \left(\frac{FE_{t+i}}{PExp_{t+i}} * 100\right)\right]$$

Where $NE_{t+i} = E_{t+\mathrm{i}} - DRM_{t+i}$

Implementation of the rule: medium-term orientation



What role for policymakers and IFIs?

Determining fiscal stance ex-ante

Short-run	Medium-run	Long-run
Operational Target	Intermediate Target	Final Target

Net Expenditure Ceiling ⇐ **Primary Balance (% GDP)** ⇐ **Gen. Govt. Debt (% GDP)**

What role for policymakers…

- Discretionary measures
- Medium-term fiscal strategy
- Debt reference
- Convergence path

… and IFIs? Limiting discretion

- Impact assessment
- Escape clauses
- Cyclical position
- Inertial scenarios
- Macro assumptions
- Sustainability analysis

Scene-setter

The rule

AIReF's role

Takeaways

Real-time exercise

Assessing internal consistency ex-post

Short-run	Medium-run	Long-run
Operational Target	Intermediate Target	Final Target
Net Expenditure Ceiling	Primary Balance (% GDP)	Gen. Govt. Debt (% GDP)

What role for policymakers…

- Budget adoption and execution
- Coherent with Stability Programme

… and IFIs? Limiting discretion

- Compliance assessment

Reassess:

- Cyclical position
- Inertial scenarios

- Sustainability risks
- Keep internal consistency

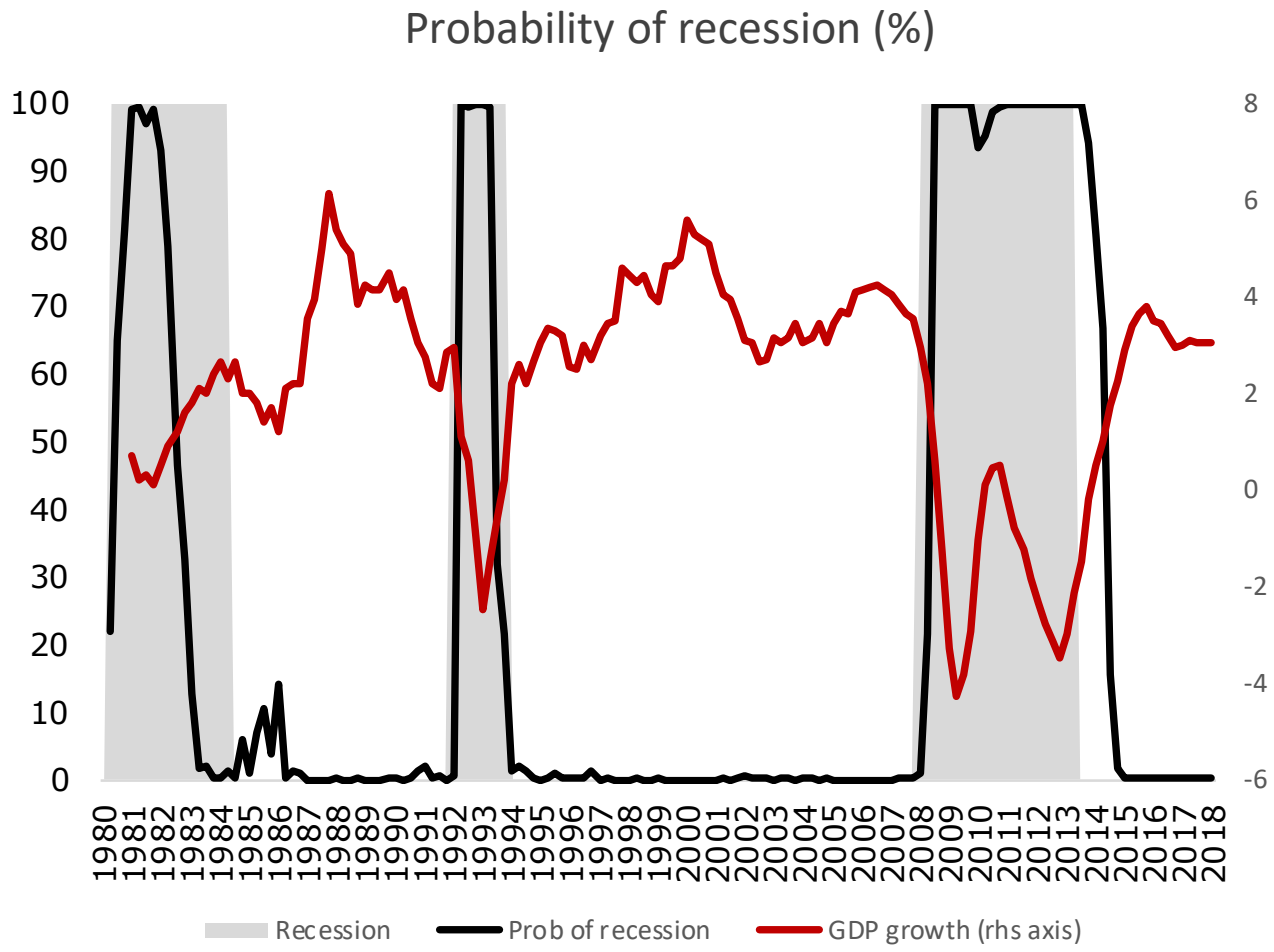
A case in point: escape clauses

Main elements to consider and relevant actors

	What?	Who?	When?
Trigger	Acute economic recession	Fiscal Council	At the request of the MoF or on the fiscal council's own initiative
	Other events outside govt's control with a deficit-increasing impact of at least 1% of GDP		
Allowance	Neutral fiscal policy by default	Fiscal Council	One year by default and possibility to reevaluate
Return to rule	Possibility of modulating the requirement resulting from general framework	Fiscal Council	After one year by default

A case in point: escape clauses

Trigger: independently gauge exceptional circumstances



Source: AIReF and INE

Note: shaded areas represent periods of economic recession in Spain according to the Economic Cycle Research Institute (ECRI)

A case in point: escape clauses

Allowance: calibrating the magnitude of the response

It can be accomodated within the general framework

$$IT_t^{escape\ clause} = PBN + \varepsilon * OG_{t,t+4} - allowance$$

$$FE_t^{escape\ clause} = IT_t^{escape\ clause} - PB_t$$

Return: calibrating the phasing out

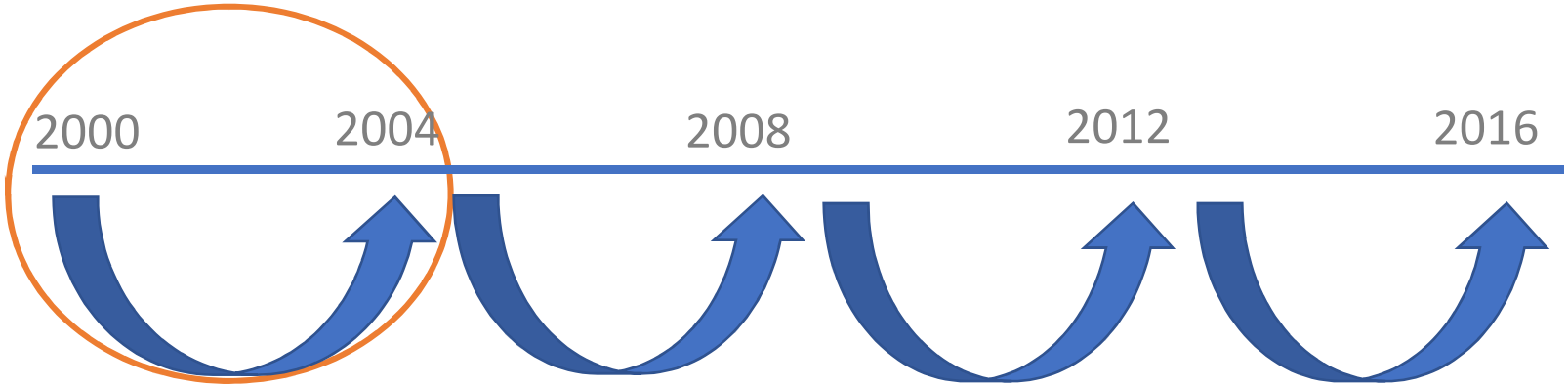
- Procedure should be transparent
- Avoid abrupt policy reversals

Main advantages of the proposed framework

Current framework	Our proposal
Simplicity	
Multiple operational targets	One operational target
Internal consistency	
Requirements not consistent by design	Ensured by design and periodically reassessed
Stability	
OG revisions heavily influence the required effort	Robust to variability of OG
Transparence and credibility	
	Enhanced role for AIReF limiting discretion and ensuring compliance

A pseudo- real time exercise: how would it have worked?

Period 2000-2016: simulate 4 rounds of 4 years each



- Starting from real-time value of debt, debt anchor set at 60% , reference period 16 years
- Semi-elasticity of 0.5
- Real-time OG estimations and NPC primary balance projections (OECD)
- Absolute limits of 0 and 1% to anual fiscal effort

Real-time exercise

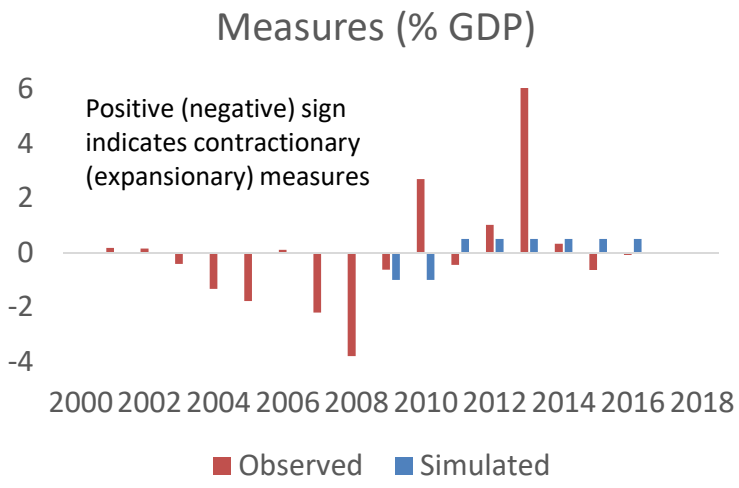
A pseudo- real time exercise: how would it have worked?

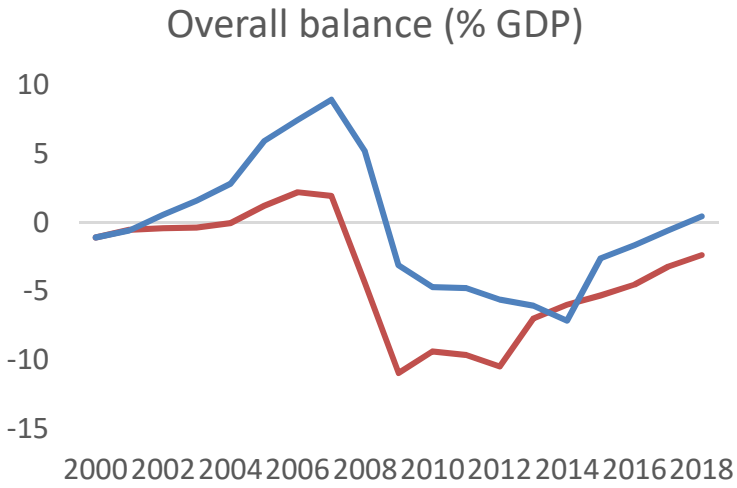
Period 2000-2004: first round

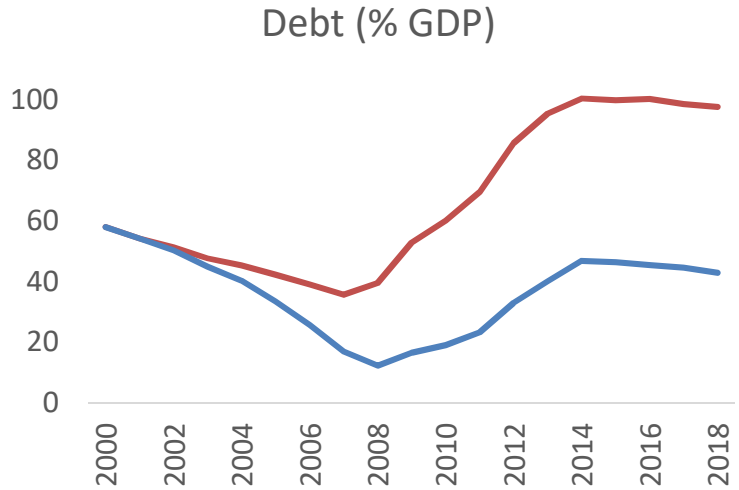
1st round	2000	2001	2002	2003	2004	(...)	2015	Average

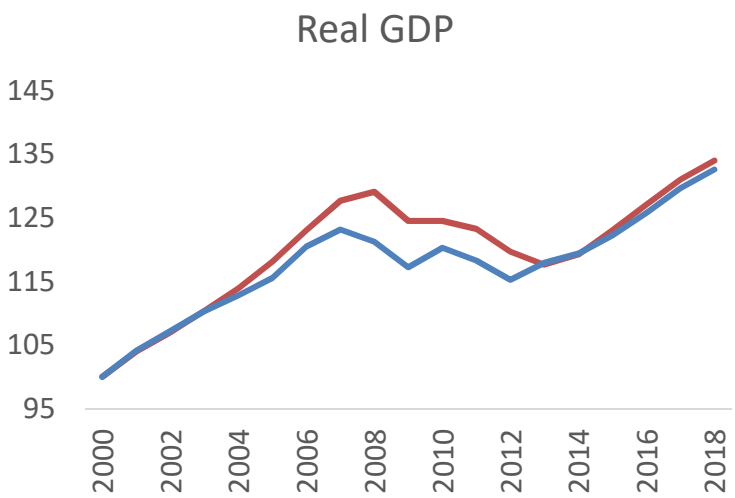
Real-time exercise

A pseudo- real time exercise: how would it have worked?









Real-time exercise

A pseudo- real time exercise: sensitivity analysis

Framework's outcomes can change for three different types of reasons:

1. Calibration of parameters of the framework (eg 60%)
2. Macro-financial assumptions (eg snowball effect)
3. Revisions to baseline projections

Main parameters of the framework					Macro-financial assumptions		Baseline projections	
Debt target	Escape Clause		Limits to effort		Sball effect	Multipliers	Output gap	Primary balance
	Trigger	Allowance	Max (1%)	Min (0%)				
++	++	+++	+	+++	+++	+	+	+

WWW.AIREF.ES

@AIREF_ES