Comments on three "European fiscal rules " session papers

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EFB-CEPR-ACES conference Rethinking the European Fiscal Framework"

Basic questions of fiscal rules in Eurozone

- Why do we need fiscal rules in a monetary union?
- Because non sustainable debt of one country may lead to risk of exit/financial crisis (collateral damage), ex-post efficient bailouts or pressure on ECB

- What was the role of fiscal rules in the mismanagement of the fiscal response to the GFC and EZ crisis?
- Technical issues (measurement, pro-cyclicality, structural deficit vs expenditure rules) are important but rules reflect macro view that discretionary fiscal policy cannot/should not be used to tackle (persistent) growth shortfalls

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Main messages of theory paper (Dotti and Janeba)

- No tradeoff between fiscal discipline (tightness of rule) and flexibility
- Fiscal rule to constrain deficit biased politician: punishment (fixed cost) if:

$$\frac{deficit_1}{Gdp_1} > \underbrace{k}_{level} + \underbrace{\delta}_{flexibility} x \left(- \frac{shock}{Gdp_1} \right)$$

- Main result: More deficit bias requires more flexibility (to unexpected shocks) not less
- Intuition: *at the margin* threshold to punish (incentive not to deviate) depends more on expected deficit (to constrain deficit *systematic* bias) than on shock
- Close to structural deficit rule
- Very interesting result and intuitive
- Could be seen as rationale for going from Maastricht (3% rule) to SGP (2005) with structural deficit

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What are the key assumptions behind this result?

1. Shock ϵ to tax revenues is perfectly observable to "punisher" ex-post: what if only noisy signal on ϵ ?
   - Punisher will make mistakes: not clear that linear rule can implement optimal allocation (incentives of biased politicians change)
   - Could biased politicians manipulate the signal? Tradeoff between flexibility and discipline reappears
2. Restrictive flexibility: no possibility to change fiscal policy after shock is observed: no discretionary policy so only "automatic stabilizers" are allowed
   - If discretionary policy allowed would traedoff between flexibility and discipline reappear?
   - Pro-cyclical fiscal policies (2010-14) completely eliminated benefits of automatic stabilisers (Larch, Orseau and van der Wielen paper)

- Enforcement of rules: Is there a tradeoff between flexibility and fiscal discicipline?
- No if fiscal policy is constrained to automatic stabilzers; yes if use discretionary fiscal policy

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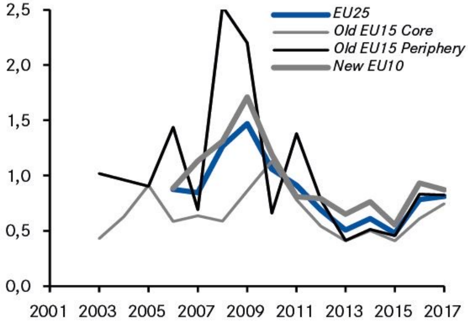
Revisions on structural balance are large (starting point of Larch, Orseau and van der Wielen paper)

Average absolute revision of the change in structural budget balance from last year to current year one year later, % GDP



Note: e.g. the last value for 2017 shows the difference between the May 2018 and May 2017 estimates for the change in the structural balance from 2016 to 2017. EU25: EU members in 2004; Old EU15 Core: pre-2004 EU members excluding Greece, Ireland, Italy, Portugal and Spain; OLD EU15 Periphery: Greece, Ireland, Italy, Portugal and Spain; New EU10: ten countries joined in 2004. Bulgaria, Croatia and Romania and are excluded due to shorter available time period.

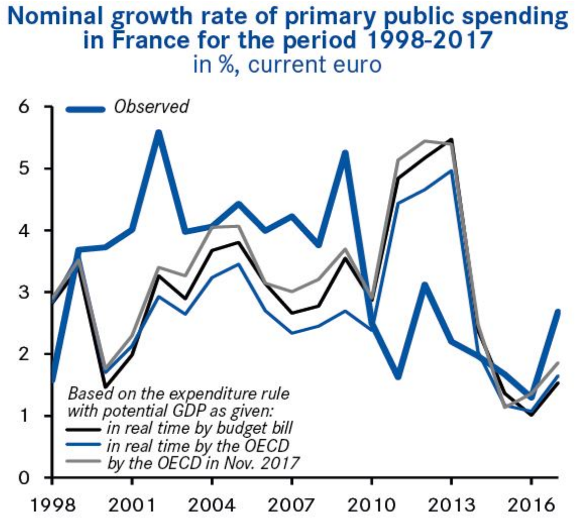
Source: Our calculation using European Commission forecasts

Counterfactuals paper on spending rules (Mohl and Mourre)

- Main message: A spending rule would have reduced pro-cyclicality of fiscal policy
- Similar results in CAE note (2018) with Darvas and Ragot on spending rule:

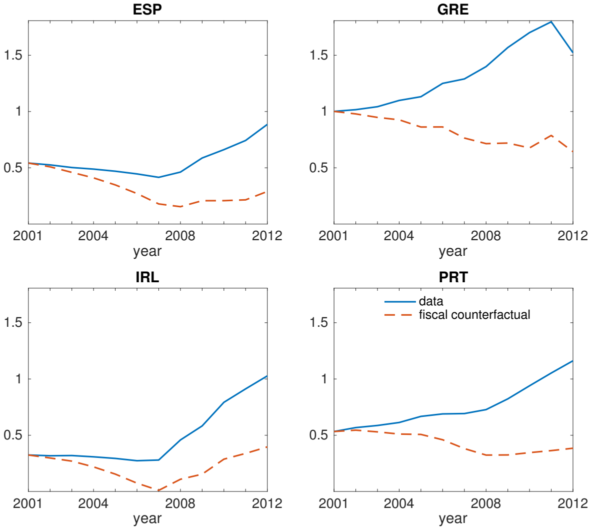
  growth of expenditures net of discretionary tax changes = potential growth + debt brake
- More conservative fiscal policy in boom years would hhave allowed more fiscal space in crisis (Martin and Philippon, AER 2017)

Counterfactual with expenditure rule (Darvas, Martin and Ragot, CAE, 2018)

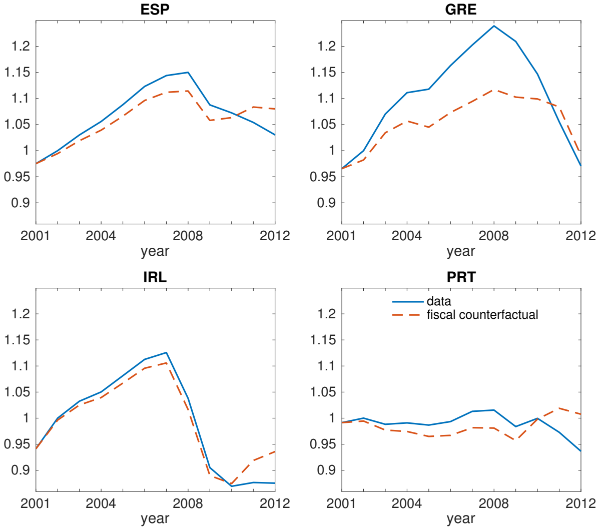


Sources: INSEE, OECD, Budget Bill, OFCE's calculations.

Public debt counterfactuals with more conservative expenditure rule (Martin and Philippon, AER, 2017)



GDP counterfactuals with more conservative expenditure rule (Martin and Philippon, AER, 2017)



Expenditure rules are better

- Expenditure rule based on potential growth: revisions much smaller than on output gaps
- Nominal expenditure rules are better with demand shocks (lower inflation than expected means higher real expenditure): what role in Mohl and Mourre paper?
- Expenditure rule with debt brake: cannot be homogenous parameter; otherwise unrealistically high frontloaded fiscal effort
- Need escape clauses for large crises : need more flexibility
- Assumption that public debt above 60% negatively affects output??

Larch, Orseau and van der Wielen

Empirical determinants discretionary fiscal policy:
$\Delta capb_{i,t} = \beta_1 capb_{i,t-1} + \beta_2 cycle_{i,t} + \beta_3 X_{i,t} + \theta_t + \delta_i + u_{i,t}$

- $\beta_1 < 0$: overturn last year discretionary fiscal policy; what if persistent shocks?
- Shocks to the economy are not persistent: rules are based on a neo-keynesian framework with no persitent demand deficits (secular stagnation excluded)
- β_2: negative for output gap and positive for unemployment (procyclical discretionary fiscal policy)
- Interpretation? : Errors on output gaps not guilty? Yes but only if regression included both output gaps and unemployment
- Fatas (2019, IMFER): forecast errors on potential output do predict contractionary fiscal policies (2010-2014)
- Rules are based on the assumption that fiscal policy cannot affect the level of potential output (Fatas argument)

EU Fiscal rules are silent on consequences of persistent lower interest rate

In case of persitent fall in interest rates and $r < g$:

- Rules do not imply any change in the sustainable debt target or in the speed of adjustment towards the target : contrary to what basic economic analysis implies on debt sustainability
- But they allow to use saving due to lower spending on interest charges in spending or lower taxes: no built in incentive to invest

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