

# **Fiscal Discipline: From Theory to Practice**

Charles Wyplosz

The Graduate Institute, Geneva

Independent Fiscal Institutions in the EU Fiscal Framework

European Fiscal Board, First Workshop, February 28, 2019

# A bit of theory (1)

- Two good reasons for fiscal rules
  - Deficit bias
  - Self-fulfilling crises
- One definition of fiscal discipline
  - Stay out of trouble, a.k.a. avoid crises
  - i.e. ex ante solvency
- Three good reasons for independent councils
  - Solvency is impossible to formally assess
  - Translating solvency into policy technically is challenging
  - Many assumptions and judgments

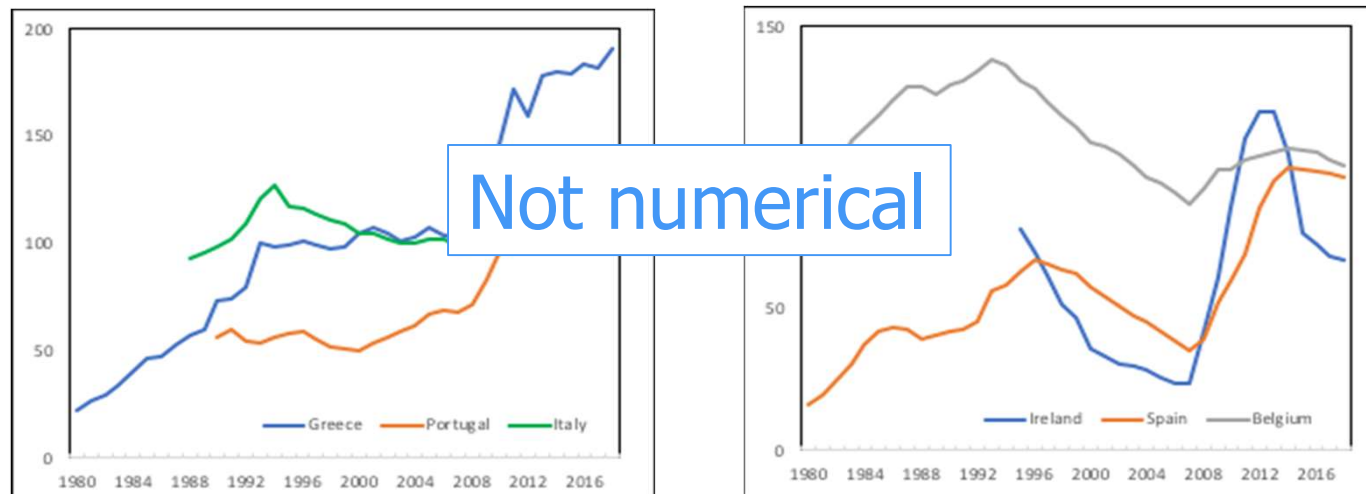
Note: entirely forward looking

## A bit of theory (2)

- Targets and instruments
  - A frequent mix-up with 'rules', 'anchors', 'references' etc.
- Target can only be given by solvency
  - Theory: at infinite horizon, debt is non-positive
  - Practice: at finite horizon, debt is 'not too large'
- Instrument
  - Controlled by government
  - Directly affects target
- Rule must be acceptable
  - Simple
  - Understandable
  - Flexible (e.g. counter-cyclical)

# Implication: choice of target

- Target
  - Long-run debt to GDP ratio
  - A few years ahead are irrelevant
  - Path of debt over (very) long run
- The eyeball test    Ex post insight can be helpful

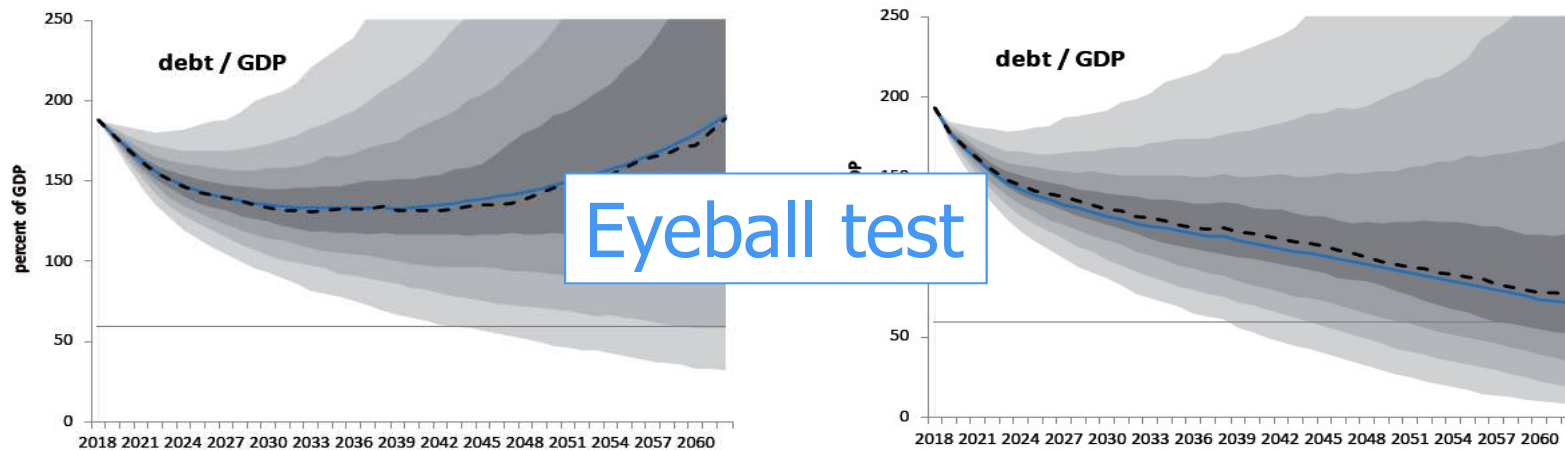


# Implication: choice or instrument

- Theoretically sound instrument
  - Structural primary budget balance
    - Ruled out by lack of precision
- Bad instrument
  - Public expenditures
    - Orthogonal to discipline
    - Lack of precision
- Compromise instrument
  - Primary budget balance
  - Simple, understandable, flexible, verifiable

# How to do it (1)

- Make and justify assumptions
  - Interest rate, long-run growth rate, feasible budget balances
  - Assess likelihood of assumptions (fan chart)
  - Explore alternative assumptions



Source: Eichengreen et al. (2018)

## How to do it (2)

- Make assumptions
- Derive underlying balances over whole horizon
  - Infinite possibilities
  - Allows for counter-cyclical policies
  - Bygones not to be bygones (account of deviations)
- Assumptions + eyeball test
  - Not for government
  - Independent council
- Note 1: one target, one instrument
- Note 2: nothing numerical

Doable?

Done in New Zealand

# Application to the Eurozone

- Align authority and responsibility
  - Decentralize fiscal discipline to national level
  - Restore no bailout clause
- Each country to adopt its framework subject to:
  - Fiscal discipline: a constitutional obligation
  - Parliament in charge of obligation
  - Independent council embedded in parliament
- European oversight
  - National frameworks to be approved (EFB, Commission)
  - EFB: watchdog of watchdogs



# Lots of important details overlooked

Please read paper!

