Consistent Flexibility: Enforcement of Fiscal Rules Through Political Incentives

Valerio Dotti[1] and Eckhard Janeba[2]

1 Washington University in St. Louis

2 University of Mannheim

Conference "Rethinking the European Fiscal Framework"
Brussels, February 2019

Reform issues

- Debate on design of fiscal rules in EU

    - Simplification of SGP and Fiscal Compact (EU COM 2017, EFB, 2019)

    - Role and use of flexibility (European Commission 2015, 2018; Benassy-Quere et al. 2018)

    - Italy vs. EU COM about compliance with and enforcement of SGP

Research Questions

1. Is there a trade-off between *fiscal discipline* and *flexibility* in the design of a deficit rule?

2. How *tight* (=*maximum deficit*) and how *flexible* (=*response to shocks*) should an optimal deficit rule be?

Approach

- Economic theory can provide guidance on trade offs
  - e.g., Halac and Yared (2014, 2018, 2019), Azzimonti, Battaglini, Coate (2016)

Approach

- ▶ Economic theory can provide guidance on trade offs
    - ▶ e.g., Halac and Yared (2014, 2018, 2019), Azzimonti, Battaglini, Coate (2016)

- ▶ Necessary ingredients of theoretical framework
    - ▶ the need for economic stabilization in presence of shocks
    - ▶ the danger of excessive deficits due to present bias in politics
    - ▶ optimization over parameters of fiscal rule

Key Assumptions

- Politicians compete for office with fiscal policy platform (labor income tax and planned deficit)
- Present bias in spending results in "excessive" deficit (future generations do not vote today)
- Fiscal rule limits fiscal choices; compliance is stochastic because
- Tax revenue shock (normally distributed) occurs after fiscal policy is proposed
- Ex post violation of rule lowers rent from holding office in next period ("political punishment")

Deficit Rule

▶ Deficit rule described by parameters (k, δ) requires:

$$\frac{deficit}{output} \leq \underbrace{k}_{level} + \underbrace{\delta}_{flexibility} \times \left(-\frac{tax\ shock}{output} \right),$$

where tax shock takes a positive value when revenues are larger than expected and vice versa

▶ Violation of rule happens when shock to tax revenues below some level that depends on output

Overview

Result: Tightness

1. The optimal rule requires a balanced budget: $k^* = 0$

Result: Tightness

1. The optimal rule requires a balanced budget: $k^* = 0$

► Tax choices affect output by distorting labor supply decisions

► If $k = 0$, no impact of output on probability that a violation of rule occurs
=> imposing zero structural deficit is sufficient to ensure that tax choices are not distorted
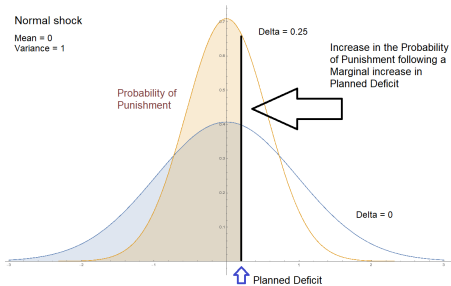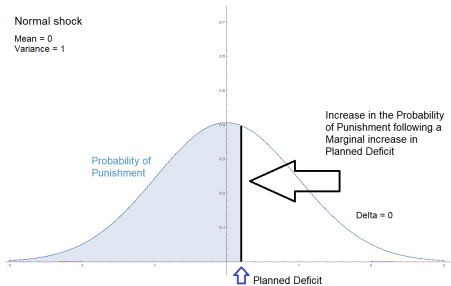
Result: Flexibility

2. The optimal rule accounts only partially for the tax shock: $\delta^* < 1$.

Result: Flexibility

2. The optimal rule accounts only partially for the tax shock: $\delta^* < 1$.

- ▶ More flexibility is equivalent to a lower perceived variance of the tax shock by the policymaker
- ▶ A full consideration of tax shocks (given $k^* = 0$) is not optimal because
  - ▶ either expected marginal "political" cost of increasing debt become too large => debt level too small
  - ▶ or probability of punishment approaches 1 => fixed expected cost of rule violation, independent of fiscal policy

Illustration

Normal shock
Mean = 0
Variance = 1

Probability of
Punishment

Increase in the Probability
of Punishment following a
Marginal increase in
Planned Deficit

Delta = 0

Planned Deficit

Normal shock
Mean = 0
Variance = 1

Delta = 0.25

Probability of
Punishment

Increase in the Probability
of Punishment following a
Marginal increase in
Planned Deficit

Delta = 0

Planned Deficit

Result: Role of present bias

3. Any optimal fiscal rule prescribes more flexibility to governments that have a stronger present bias.

Result: Role of present bias

3. Any optimal fiscal rule prescribes more flexibility to governments that have a stronger present bias.

▶ The more flexible the rule is, the larger is the marginal effect of increasing planned deficit on probability of being punished

▶ More flexible rule is more effective in disciplining the politician (stronger link between fiscal choices and probability of punishment)

Discussion 1

- Result 1 ($k^* = 0$) is close to many fiscal rules such as Fiscal Compact

- Reason for (near) balanced budget rules in practice probably simplicity and intuitive appeal

- By contrast, our argument is based on interaction of violation of rule and tax distortions

Discussion 2

- ▶ Result 2 ($\delta^* < 1$) speaks to role of accounting for business cycle
- ▶ SB rules are criticised because i) OG is hard to estimate in real time and ii) subject to substantial revision, and iii) too often leads to procyclical policies
- ▶ Our results indicate that full flexibility is not optimal even when OG estimation is not an issue

Discussion 3

- ► EU COM (2015) introduces flexibility regarding fiscal adjustment towards MTO
- ► COM is concerned with *adjustment* to MTO, while our model concerns *level* of deficit target
  - ► A lower adjustment speed can be interpreted in our framework as a looser deficit target
- ► When EU fiscal rules account for cycle, additional flexibility suggests more than full responsiveness to shocks, which is in contrast to our results

Discussion 4

- ▶ Result 3 suggests that a trade-off between fiscal discipline and flexibility of deficit rule does not always exist
- ▶ Hard to analyze empirically
  - ▶ number of SGP violations before and after 2015 does not provide clear evidence
- ▶ Does this justify more lenient treatment of some member states?

▶ Source: EFB Annual Report 2019

Table 2.7: Assessment of compliance of the draft budgetary plans with the preventive arm of the SGP

	2014	2015	2016	2017	2018	2019	SB	EB
BE							-0.3	-0.5
DE							1.4	1.1
EE							-0.2	-0.2
IE							0.1	-0.1
ES							-0.6	-1.1
FR							-0.7	-0.6
IT							-0.8	-0.7
CY							0.0	-0.2
LV							0.0	-0.4
LT							0.3	-0.5
LU							1.2	0.4
MT							0.0	-0.7
NL							0.0	0.3
AT							-0.3	-0.2
PT							-0.6	-1.1
SI							-0.8	-0.9
SK							-0.3	-0.2
FI							-0.3	-0.3

Ex-ante average deviation: SB, EB

Notes: (1) Green, yellow and red correspond respectively to an assessment of 'compliance', 'broad compliance' and 'risk of non-compliance'. (2) The assessment of compliance following the Commission's 'overall assessment' also includes deviations over two years and the possible application of unusual event clauses. (3) 'SB' refers to the structural balance; 'EB' to the expenditure

Conclusion

- ► Economic theory useful in thinking about design of fiscal rules
- ► Novel argument for zero SB rule with less than full flexibility in terms of accomodation of shocks
- ► More flexibility for countries with stronger deficit bias