Consistent Flexibility: Enforcement of Fiscal Rules Through Political Incentives

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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)
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- 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 \((k, \delta)\) requires:

\[
\frac{\text{deficit}}{\text{output}} \leq k + \delta \times \left( -\frac{\text{tax shock}}{\text{output}} \right),
\]

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

- 3 Results
  - Tightness
  - Flexibility
  - Effect of present bias on flexibility

- Discussion of results
Result: Tightness

1. The optimal rule requires a balanced budget: \( k^* = 0 \)
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- Tax choices affect output by distorting labor supply decisions
- If $k = 0$, no impact of output on probability that a violation of rule occurs
  $\Rightarrow$ 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: $\delta^* < 1$. 
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- 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

Normal shock
Mean = 0
Variance = 1

Probability of Punishment

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

Delta = 0.25
3. Any optimal fiscal rule prescribes more flexibility to governments that have a stronger present bias.
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- 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)
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?
Table 2.7: Assessment of compliance of the draft budgetary plans with the preventive arm of the SGP

<table>
<thead>
<tr>
<th>Year</th>
<th>Country</th>
<th>SB</th>
<th>EB</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>BE</td>
<td>-0.3</td>
<td>-0.5</td>
</tr>
<tr>
<td></td>
<td>DE</td>
<td>1.4</td>
<td>1.1</td>
</tr>
<tr>
<td></td>
<td>EE</td>
<td>-0.2</td>
<td>-0.2</td>
</tr>
<tr>
<td></td>
<td>IE</td>
<td>0.1</td>
<td>-0.1</td>
</tr>
<tr>
<td></td>
<td>ES</td>
<td>-0.6</td>
<td>-1.1</td>
</tr>
<tr>
<td></td>
<td>FR</td>
<td>-0.7</td>
<td>-0.6</td>
</tr>
<tr>
<td></td>
<td>IT</td>
<td>-0.8</td>
<td>-0.7</td>
</tr>
<tr>
<td></td>
<td>CY</td>
<td>0.0</td>
<td>0.2</td>
</tr>
<tr>
<td></td>
<td>LV</td>
<td>0.0</td>
<td>0.4</td>
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<tr>
<td></td>
<td>LT</td>
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<tr>
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<tr>
<td></td>
<td>FI</td>
<td>-0.3</td>
<td>0.3</td>
</tr>
</tbody>
</table>

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 accommodation of shocks
- More flexibility for countries with stronger deficit bias