European Economy: Fiscal policy

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Fiscal policy basics

When countries join a monetary union they give up on one of their macroeconomics instruments namely monetary policy. But they retain autonomy over setting fiscal policy. Therefore in a monetary union fiscal policy will be the only instrument the government can use to deal with asymmetric shocks. Unfortunately, fiscal policy is not really a good alternative to monetary policy for two main reasons

1. The budget needs to be balanced
   - Consider the case where a government wants to increase private spending by cutting taxes
   - This will create a budget deficit which needs to be accounted for, so the government borrows
   - Borrowing of course will lead to a debt which needs to be paid off, likely through a future tax increase
2. It is slow to implement
   - Establishing the budget is a long political process

Undisciplined fiscal policy can lead to high levels of public indebtedness.

One important factor of fiscal policy is that it tends to be counter-cyclical, meaning that when the economy slows down tax revenue will decline and spending on unemployment benefits will increase. If the budget worsens, fiscal policy will automatically be expansionary: one average a 1% decrease in economic growth corresponds to a 0.5% deterioration in the budget balance relative to GDP.[1] These features of the government budget, which help dampen the impact of fluctuations in the business cycle, are known as automatic stabilizers. In contrast to automatic stabilizers there is also discretionary policy actions, where the government takes active action. Since, as discussed, taking these kind of actions might be slow, most countries tend to keep some budget on the side as a sort of rainy day fund to use when the economy contracts. Note that the budget figures might obscure what the government is actually doing with its fiscal policy as the budget can change for two reasons

Note that counter-cyclical fiscal policies can be effective as the government, when deemed credit worthy, can borrow money more easily compared to firms and households. Also note that in an optimum currency area, in lieu of actual transfers, a country hit by a shock could borrow money from a country unaffected by the shock.

[1] Note that there are of course differences across countries, depending on the tax and welfare system.

1. Discretionary policy action; the budget can improve due to spending cuts or increased taxes
2. Automatic stabilizers; the budget improves due to the fact that the economy is in a boom state

To disentangle these two factors we therefore use the cyclically-adjusted budget balance, which relies on the output gap to measure the performance of the economy relative to its potential output. The difference between the measured budget balance and the cyclically-adjusted budget balance is the work of the automatic stabilizers. Figure 1 shows this for the Netherlands, it illustrates that in general the budget balance moves in tandem with the output gap, which indicates the effect of the automatic stabilizers.

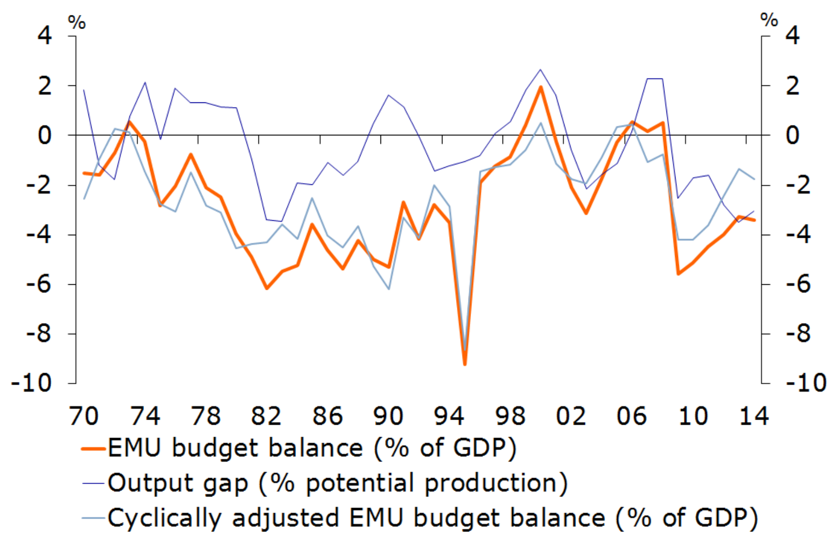


Figure 1: Actual and cyclically-adjusted budget balance along with the output gap for the Netherlands. Source: Rabobank

Fiscal policy in the EU

Although the EU member states have autonomy over their fiscal policy, one could imagine that fiscal policy has spillover effects generating externalities for other countries.[2] As such, it might be beneficial for the member states to coordinate their policy measures, at least to some extent. Which brings us back to the Economic and Monetary Union (EMU) Among the 28 members of the European Union there is an agreement to facilitate and maintain the stability of the EMU. Recall from the last lecture that for a country to join the EMU there were a number of entry conditions which included

[2] Business cycles are transmitted via imports and exports.

Likely to be 27 in the near future.

- Having a budget deficit no more than 3% of GDP
- A public debt less then 60% of GDP

But what are the rules when a country is already a member of the EMU? An important pillar of the Maastricht Treaty was fiscal discipline and the rules concerning setting fiscal policy are set out

- the Stability and Growth Pact (SGP)
- the Excessive Deficit Procedure (EDP)

The EDP is part of the SGP (corrective arm) and was adopted in 1997 and meant to be strictly enforced, there have been some issues with this however. Currently 11 of 28 member states are subject to and EDP

The Stability and Growth Pact

The Stability and Growth Pact (SGP) was established in 1997 to improve the coordination and monitoring of fiscal and other economic policies of the member state, and importantly to enforce the deficit and debt limits as established by the Maastricht Treaty. The main objective of the SGP is to ensure that EU member countries pursue sound public finances and coordinate their fiscal policies. The SGP has evolved over time along with EU's economic governance rules

- 1998: Preventive rules of SGP enter into force
- 1999: Corrective rules of SGP enter into force
- 2005: Amendment to SGP for better consideration of national circumstances[3]
- 2011: Six pack added
- 2013: Two pack and Fiscal Compact added
- 2014: Review of SGP
- 2015: SGP flexibility; European Commission issuing guidance on how rules will be applied

[3] Also added more economic rationale to the rules to be complied with.

The SGP as established in 1997 was based on three main elements

1. Prevention
   - Entered into force in 1998
   - Each EU member state is set a budgetary target in order to bind the government to their commitment towards sound fiscal policy and coordination
   - Budget deficit is defined in structural terms[4]
   - The member state has to provide an annual budget outlining how to reach the targets, which is assessed by the European Commission and the EU governments

This is known as the Medium-Term Budgetary Objective (MTO) which are updated every three years.

[4] This means that it takes into account the business cycle and filters out one-off or temporary measures.

Recall that these rules apply to both Eurozone countries and all other EU member states.

2. Correction
   - Entered into force in 1999
   - This is where the Excessive Debt Procedure (EDP) enters into play
   - The EDP ensures the correction of excessive budget deficits ($> 3\%$ of GDP) or public debt levels ($> 60\%$)

According to the European Commission public debt levels are excessive when it exceeds 60% of GDP and does not diminish at an adequate rate of 5% per year on average over the last three years

- The EDP is a step-by-step procedure

3. Enforcement

- Sanctions may follow when countries fail to respect the preventive and corrective rules
- For Eurozone countries these could be fines
  - 0.2% of GDP, if they fail to abide by either the preventive or the corrective rules
  - 0.5% of GDP, if they repeatedly fail to abide by the corrective rules
- For all member states the penalty could be suspension of commitments/payments of the structural and investment funds

Strangely, the UK is excluded from these penalties. In general, one criticism is that the rules are hardly ever enforced on Germany and France, who were much in favour for the SGP.

Adjustments to the Stability and Growth Pact

Over the years some adjustments have been made to the SGP in order to make it more comprehensive, predictable, and efficient. Most importantly the economic governance rules were adjusted following the sovereign debt crisis with a set of new law known as the Six Pack The Six Pack rules stipulate the following for EU goverments

1. Operate public accounting systems that comprehensively cover all areas of income and expenditure
2. Make the fiscal data publicly available (monthly basis for central and state governments, quarterly for local governments)
3. Ensure their fiscal planning is based on realistic macroeconomic and budgetary forecasts, using the most up-to-date data
4. Operate specific fiscal rules to help ensure the overall government budget complies with European rules
5. Establish a credible, effective medium-term budgetary framework that includes a 3 year fiscal planning horizon
6. Ensure consistency and coordination of all accounting rules and procedures across all areas of government activity

These must be subject to internal control and independent audits

The objective of this set of additional rules was to

- Enhance marcoeconomic surveillance
- Improve procedures to address public deficits and other macroeconomic imbalances

An additional set of rules were implemented in 2013 with the Two Pack which is a set of regulations that require member states to increase reporting frequency to enhance surveillance. In 2013 the EU also implemented a law called the Fiscal Compact which is basically a stricter interpretation of the SGP concerning the importance of the budgetary targets set out in the SGP's preventive arm.[5]

[5] I.e. the medium-term budgetary objectives. The Fiscal Compact is part of a larger treaty; Treaty on Stability, Coordination, and Governance. This treaty was signed by all member states except for Czechia, the United Kingdom, and Croatia (a recent new member).

Fiscal compliance

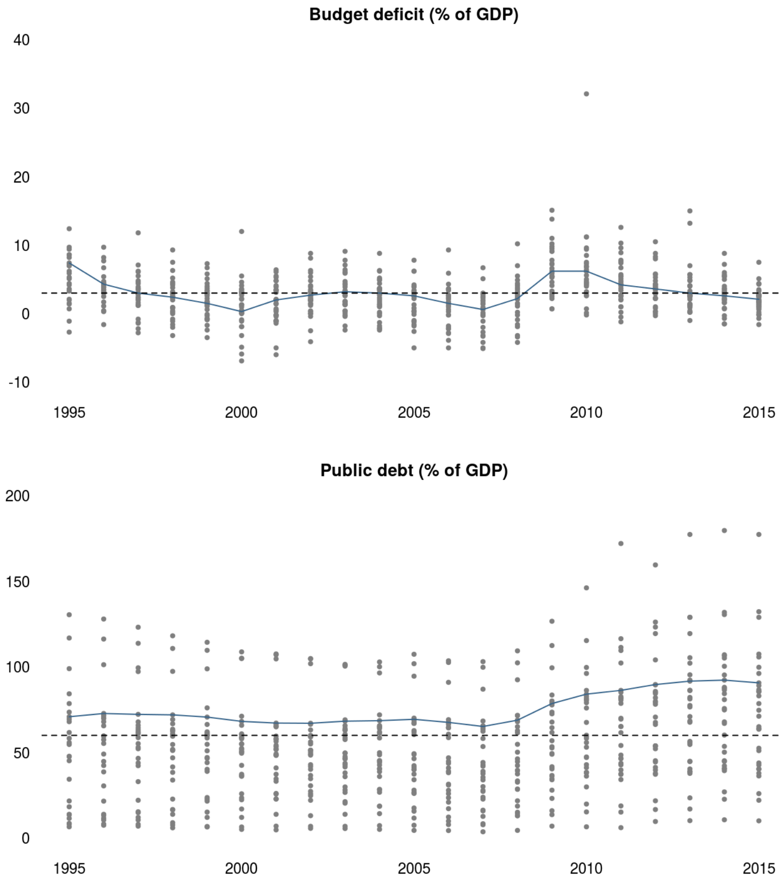
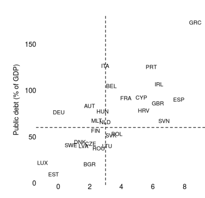


Figure 2: Development of budget deficit (*top*) and public debt (*bottom*) as percentage of GDP over time. Blue line indicates the average for 17 Eurozone member states, dotted horizontal line indicates the 3% and 60% criteria of the Maastricht Treaty repsectively. Data: Eurostat

Figure 3: Average budget deficit and public debt during 2011-2015. Data: Eurostat



The Excessive Deficit Procedure

The Excessive Debt Procedure is the corrective arm of the SGP. This is a step-by-step procedure where the European Commission, using the data from Eurostat, examines the issue at hand and sets deadlines for the member country for which the procedure is started to reach the target level as defined in the MTO. The procedure takes the following steps

So it is initiated when deficit exceeds 3% of GDP or when debt exceed 60% of GDP and is not sufficiently diminishing.

1. European Commission reports on whether to open the EDP

2. The European Council decided whether an excessive deficit exists, and if so opens an EDP
   - At this stage recommendations are made followed by deadlines and targets
   - In some cases sanctions can be issues
3. The member state has 3-6 months to comply with the recommendations
4. The Commission assesses if the member state has taken effective action and informs the council
   - Member state has taken effective action and the targets are met $\rightarrow$ Council takes note
   - Member state has taken action but targets aren't met $\rightarrow$ council revises recommendation, extend deadlines $\rightarrow$ Back to 3
   - Member state has not taken effective action $\rightarrow$ Council gives new recommendations etc. $\rightarrow$ Back to 3
   - In the case the the member state is also part of the Eurozone, additional sanctions follow when no effective action is taken
5. European Commission proposes EDP abrogation, Council takes final decision

Background: Calculating the Medium-Term Budgetary Objective

Taken from Report on Public Finances in EMU 2013

The Medium-Term Budgetary Objectives are calculated taking into account the fluctuations in the business cycle, specifically the reaction of a member state's budget to these fluctuations. The final MTO is based on a number of components. Concerning the budget deficit, for each country a MTO is calculated that ensures a safety margin, called the minimum benchmark, which accounts for past volatility and the sensitivity of the budget to fluctuation in output.[6] The minimum benchmark MTO is calcualted the following way

$$MTO^{MB} = -3 - \epsilon ROG$$

In this formula ϵ is the semi-elasticity of the budget to the output gap and ROG stands for the representative output gap. The ROG accounts for the fact that different countries face different magnitudes of the business cycle and is calculated as

$$ROG = \frac{N_i}{(N_t + N_i)} P_{5\%} country + \frac{N_t}{(N_t + N_i)} P_{5\%}(EU27)$$

Here $P_{5\%}$ represents the 5% percentile of the distribution of the output gap series of either the country or all member states. N_i and N_t stand for the country-specific observations available, where t is, data permitting, set to 25 years. Moving on to public debt, for each member state a minimum value for the MTO is set that helps the country to converge to a prudent debt level (60% of GDP) and is calculated accounting for implicit liabilities and debt (ILD) following

$$MTO^{ILD} = Balance_{debt-stabilizing(60\% of GDP)} + \alpha AgeingCosts + Effort_{debt\ reduction}$$

The three terms on the right hand side of the equation represent (in order)

1. The budget balance that would stabilise the debt ratio at 60% of GDP[7]
2. An adjustment required to cover a fraction of the present value of the projected increase in age-related expenditure[8]
3. A supplementary debt-reduction effort for countries with debt above 60% of GDP[9]

Besides these two MTOs accounting for the main criteria set out in the SGP there is an extra MTO for Euro area and ERM2 member states which is

$$MTO^{Euro/ERM2} = -1\% GDP$$

All the MTOs are then combined to compute a country-specific lower bound according to

$$MTO = max(MTO^{ILD}, MTO^{MB}, MTO^{Euro/ERM2})$$

[6] I.e. a country that experiences a lot of volatility and where the budget is very sensitive to fluctuation in the business cycle will need a more demanding MTO to ensure that they stay within the 3% limit.

[7] This is calculated as the product of 60% with the forecast average nominal growth over the next 50 years

[8] $\alpha = 33\%$

[9] This is 0.2% if debt is above 60% and 1.4% when the debt reaches 110%.