EU fiscal governance and cyclical stabilisation
Searching for a lasting arrangement

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Views are those of the speaker only.
Two views on EU fiscal policies

• Fiscal policies should focus on sustainability
  – MS need to maintain prudent medium-term positions
  – Discretionary fiscal policy fraught with problems
  – Own house in order first

• The macroeconomic role of fiscal policies is essential
  – Crucial to give weight to the stabilisation objective
  – At country level: individual MS have 'lost' monetary policy
  – At euro area level: complements monetary policy
    (at least in some circumstances, poss. more generally)
Conciliating the two views

- How does current framework fare?
- Could one do better?
Assessing the current framework

• Coming from 1st view but increasingly including 2nd

• Mixed past record
  – SGP disciplined policies, but only partly
  – Pro-cyclical tendencies. In downturns but also upswings. At MS level and overall

• Recent evolution
  – Latest SGP rendition giving more weight to growth
  – But consensus eroding: criticisms from all sides: too austere, too lax, too complex...
  – Limited ability to influence aggregate stance if needed

Question of stabilisation remains Achilles' heel of (revised) framework?
A better framework?
Not under-estimate the challenge …

• Entrenched differences of views (and interests?) over proper conduct of fiscal policies

• National politics the (main) game in town, limited ownership of requirements of belonging to EMU

• Objective situation difficult: legacy of high debts, low growth prospects, lack of policy space

Good framework can help address the challenges, but no substitute for difficult policies
Three conceivable avenues for medium-term evolution

(1) Insist current framework strikes (broadly) correct balance. Make best use of it (European Commission, 2015; 2016)

(2) Use more 'economic' rules
   - Single rule based on "net" expenditure and debt anchor (Carnot, 2014; Andrle et al, IMF, 2015; Claeys et al, 2016)
   - Rule of thumb squarely confronting sustainability/stabilisation trade offs (Carnot, 2014)

(3) In a revamped architecture, combine
   - Simplified fiscal rules focused primarily on sustainability
   - A common stabilisation capacity for smoothing large shocks
Inspecting a bit route (3) ...

Few quick remarks on a common stabilisation capacity ...

Value-added of a stabilisation capacity

Topping up national stabilisers

Country specific shocks

Common shocks

(for large shocks)

Strengthening fiscal rules

Making it easier to implement rules geared towards fiscal discipline
Thinking together fiscal rules and stabilisation capacity

- **Joint working** is what matters
  - In downturns:
    Transfer from stabilisation capacity increases space under constraining fiscal rules, allowing more spending, or less pro-cyclical cuts
  - Conversely in upturns:
    Transfer from MS to stabilisation capacity subject to constraining fiscal rules forces constitution of buffers
Thinking together fiscal rules and stabilisation capacity (cont'ed…)

• **Joint working** is what matters

• **Example of consequence:** how does a common unemployment benefit system really work?
  
  – Main effect is **NOT** to increase spending on UB
  
  – Direct effect is **substituting** EU financing to national financing on UB
  
  – Indirect effect is **increasing room** under constraining fiscal rules ... allowing extra spending ... but **elsewhere**!
  
  – From **demand stabilisation** perspective, indirect effect is most important one
Cyclically-sensitive aggregates or active stabilisation?

• Even with cyclically sensitive spending and revenues, a small common budget brings limited "spontaneous" stabilisation
  – A 10% cyclical variation of a permanent budget of 2% of GDP brings only 0.2% of GDP stabilisation

• "Active stabilisation" against large shocks provides much more significant bang for the buck
  – Contributing every year 0.2% of GDP to a common pot allows active stabilisation payments of 2% of GDP every 10 years

→ Finding 'cyclical base' not so important. Allowing "active stabilisation" under some circumstances is game changer.

→ Next question: what trigger for active stabilisation?
EXAMPLE TRIGGER FOR ACTIVE STABILISATION:
DOUBLE CONDITION (Carnot, Kizior, Mourre, forthcoming)

- **High U** = higher than past 15 years average. **Low U** = the opposite
- **Increasing U** = higher than previous year. **Falling U** = the opposite

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Good design features of a stabilisation capacity ... and uneasy choices

• Restricting stabilisation capacity to large shocks

• Symmetric functioning good times / bad times

• Automaticity versus discretion in functioning
  – Very difficult choice

• Allowing limited borrowing and saving
  – Otherwise unworkable ... but can this be accepted?

• Ensuring cross-country neutrality over long term
  – Need to be 'patient' given 'long cycles' ...but again, can this be accepted?
Some "conclusions" ...

• Latest incarnation of SGP has given considerably more weight to stabilisation (more generally growth) concerns

• In short term: sensible and credible implementation of current fiscal framework critical under any scenario

• For long-term: combining rules (re)focused on sustainability with common stabilisation capacity against large shocks could prove a more effective arrangement

• Essential to conceive together the stabilisation capacity and the rules-based fiscal framework. Too often forgotten point.

• Some good design features help raising the effectiveness and the credible functioning of a stabilisation capacity

• Even assuming good features, there are some trade-offs and hard choices when designing a common stabilisation capacity
References

• Carnot N., M. Kizior and G. Mourre (forthcoming), A credible stabilisation capacity for the euro area.
• Claeys G., Z. Darvas and A. Leandro (2016), A proposal to revive the European fiscal framework, Bruegel policy contribution, 2016/7, March.
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