



Fiscal frameworks in Europe: Striking the right balance between centralisation and decentralisation

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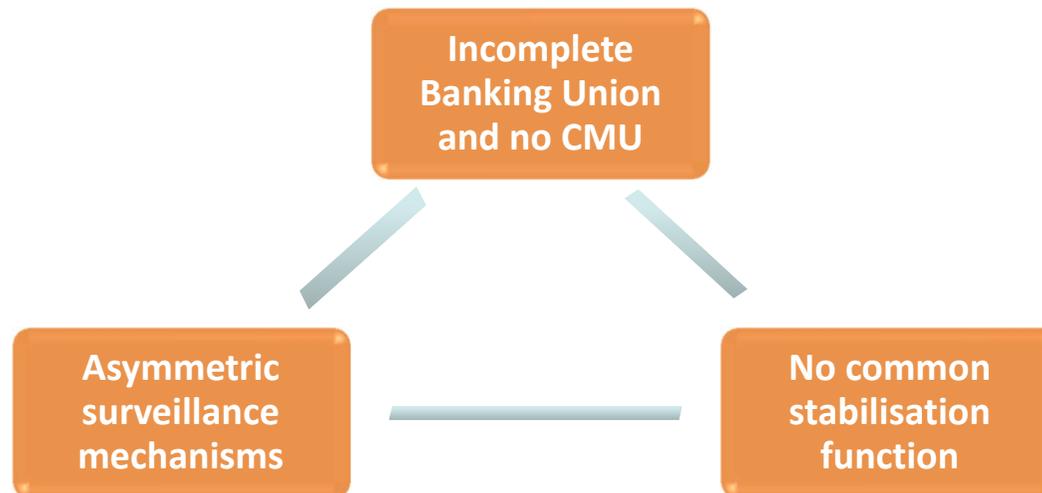
Outline

- 1. Reflection paper on EMU**
- 2. Key challenges for fiscal policies in EMU**
- 3. Fiscal framework: what has changed?**
- 4. Facing cracks and trade-offs**
- 5. Concluding remarks**





EMU today: An unsustainable equilibrium



Insufficient private and public risk-sharing

Impossible to achieve simultaneously:

- **an appropriate fiscal stance for the euro area as a whole**
- **an optimal distribution of the fiscal effort**

*Leads to the **overburdening of monetary policy***

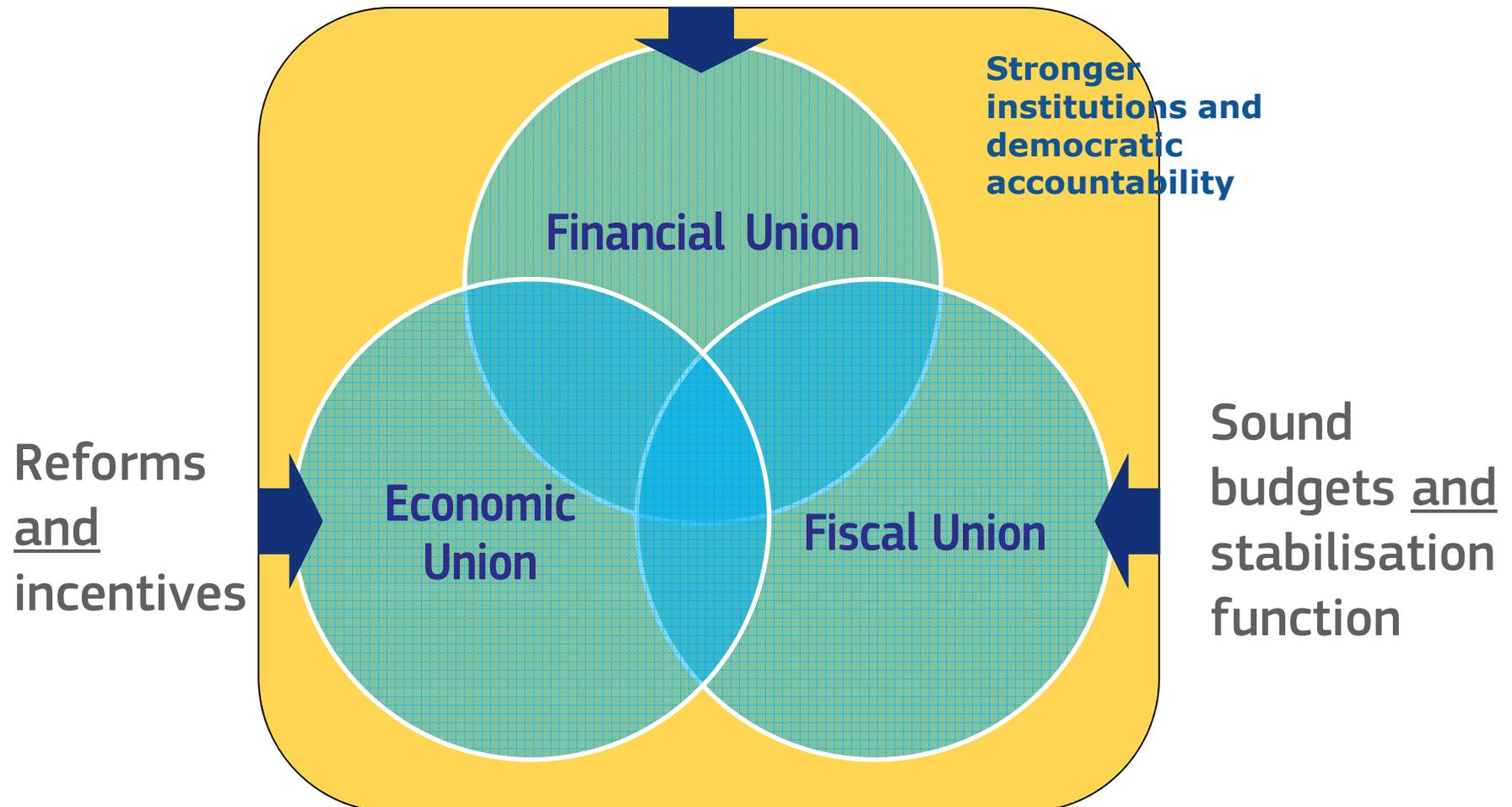
*Risk of renewed **financial instability***

*Weak/challenged **democratic accountability***



A new political synthesis is needed

Risk sharing and risk reduction



Reflection paper on EMU deepening

By 2019 elements already discussed, agreed or requiring urgent implementation, inter alia:

- Further risk reduction measures
- NPL strategy
- Common backstop for SRF
- EDIS: agreement
- CMU finalisation
- First step toward common capital market supervisor
- Work towards SBBS



- Further strengthening EU Semester
- Technical Assistance
- Work on convergence standards
- Preparation of the new MFF



• Stabilisation function: reflection



- More formalised dialogue with the EP
- Progress towards external representation
- Steps to integrate the Fiscal Compact into EU law



2020-2025: implementation and reflection on further elements, inter alia:

- Continuous implementation of CMU
- EDIS: roll-out
- Transition to the issuance of a European Safe asset
- Changes to the regulatory treatment of sovereign exposures

- New convergence standards and link with central stabilisation function
- New MFF: stronger focus on incentives for reforms

Stabilisation function: decision & implementation
SGP: simplification

- EG: formalised with a permanent chair
- Unified external representation
- Euro Area Treasury including EMF



Fiscal policy in EMU: an evolving view

**Conventional view
on fiscal policies in
EMU – pre crisis**



**"Put your house
in order"**

- Rules to tame deficit bias in absence of national exchange rate policy
- Automatic stabilisers: let them play
- Risk of debt monetisation dominates monetary-fiscal relations
- Low spillovers because of offsetting monetary policy reaction
- Negative coordination suffices

**Revising the role of
fiscal policy in EMU
– post crisis**



**"Augustinian
view"**

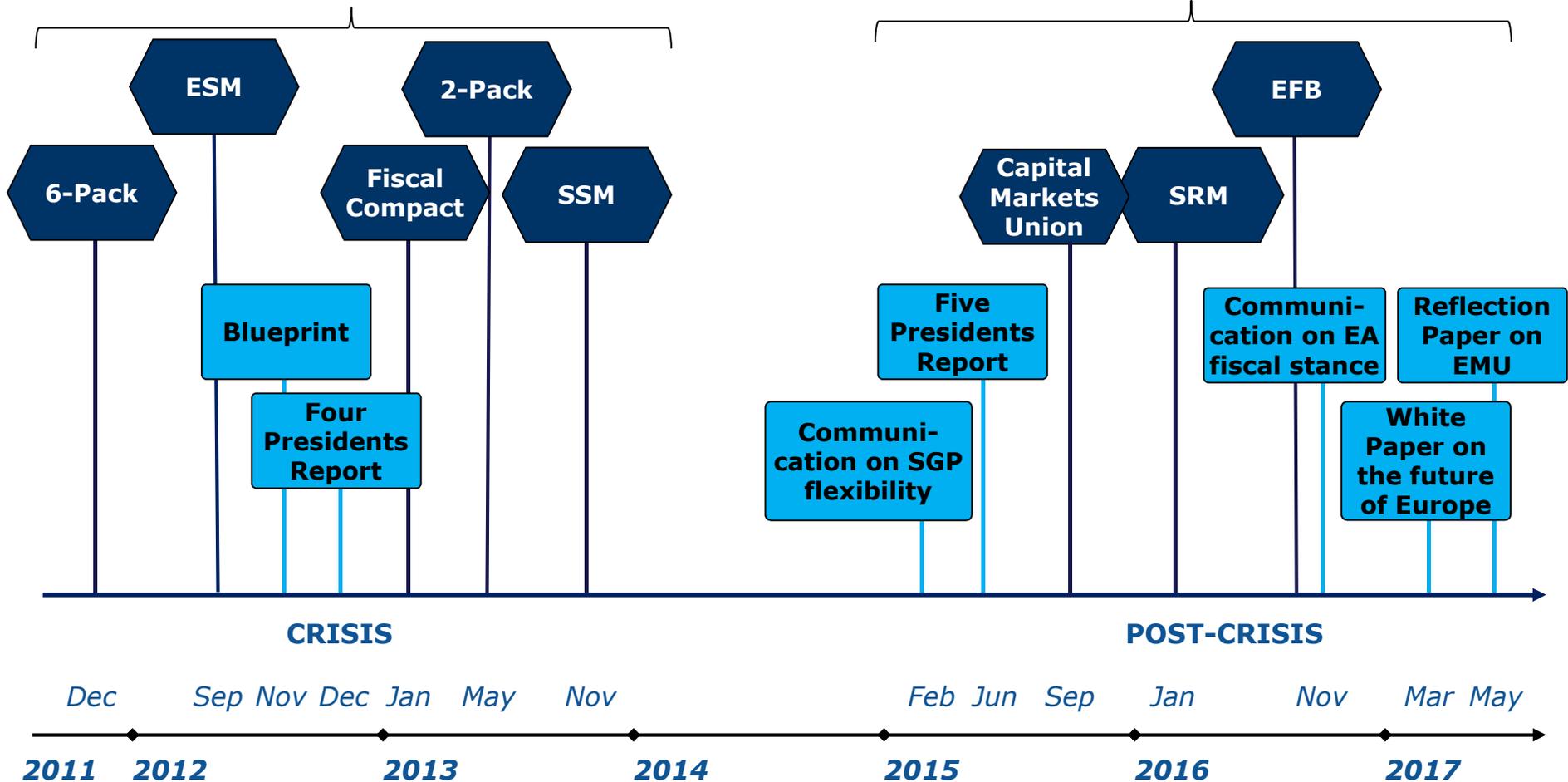
- Discretionary fiscal policy needed in case of large shocks
- High multipliers and spillovers when monetary policy is constrained
- Aggregate fiscal stance and differentiated fiscal space matter
- Sovereign-banks nexus
- Institutions vs. rules
- Links fiscal policies/ structural reforms
- Difficult to sanction sovereign states



Far-reaching institutional changes since 2011

*Political economy:
"ultima ratio"*

*Political economy:
Better articulation of national/EA fiscal policies*





E(M)U fiscal rules: a living framework

From the past

Treaty and legacy of original SGP and 2005 reform

Crisis innovations

- **Expenditure rule**
- **Debt benchmark**
- + ***Stronger national fiscal frameworks***

- **Escape clause in case of EU/EA downturn**
- **Investment and flexibility clauses**

- **Reinforced EA dimension**
- **European Stability Mechanism (ESM)**
- **Surveillance of Draft Budgetary Plans**

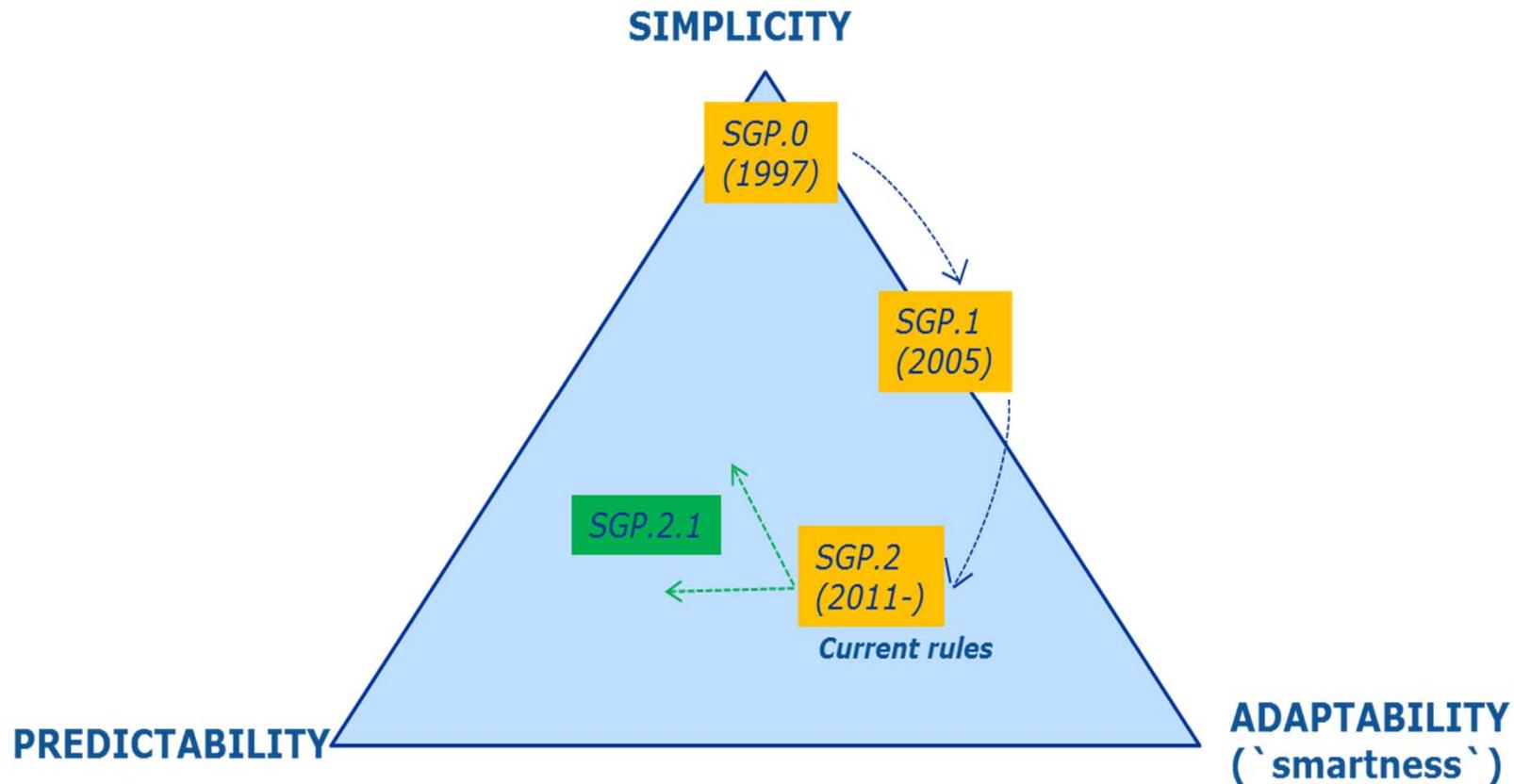
- Requirements on:
- Nominal balance
 - Structural balance
 - Expenditure growth
 - Debt ratio development
- + *Supporting building blocks to be tailored according to MS specificities*

- Modulation of country-specific adjustment on the basis of an increasing number of factors; but...
- No tool to address large asymmetric shocks and to manage the aggregate fiscal stance

- Attention to EA aggregate stance
- Rescue fund with a total lending capacity of 500 bn euro
- Closer supervision of national budgets
- Sanctions, more articulated system

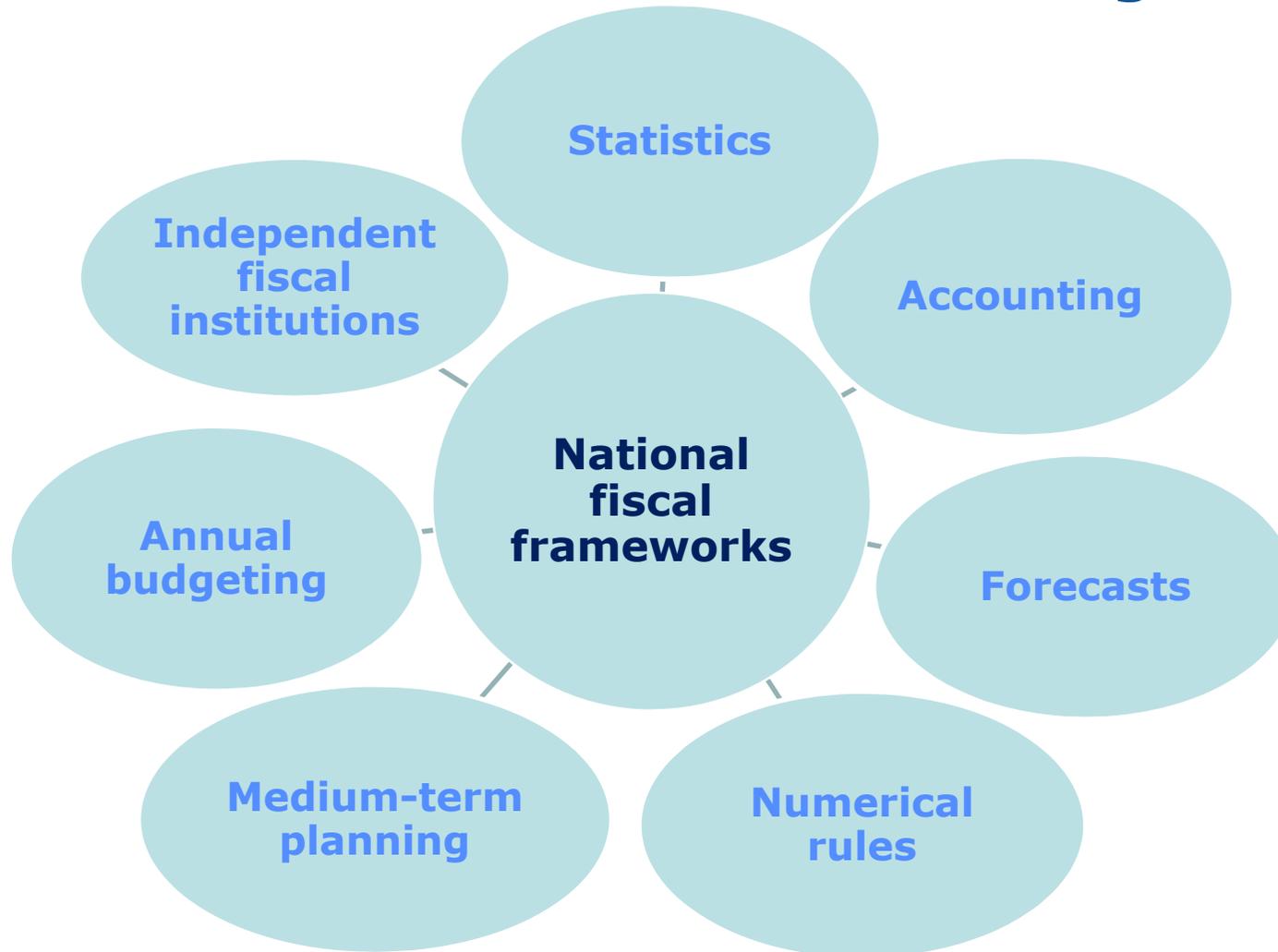


Trade-offs in design of a fiscal framework



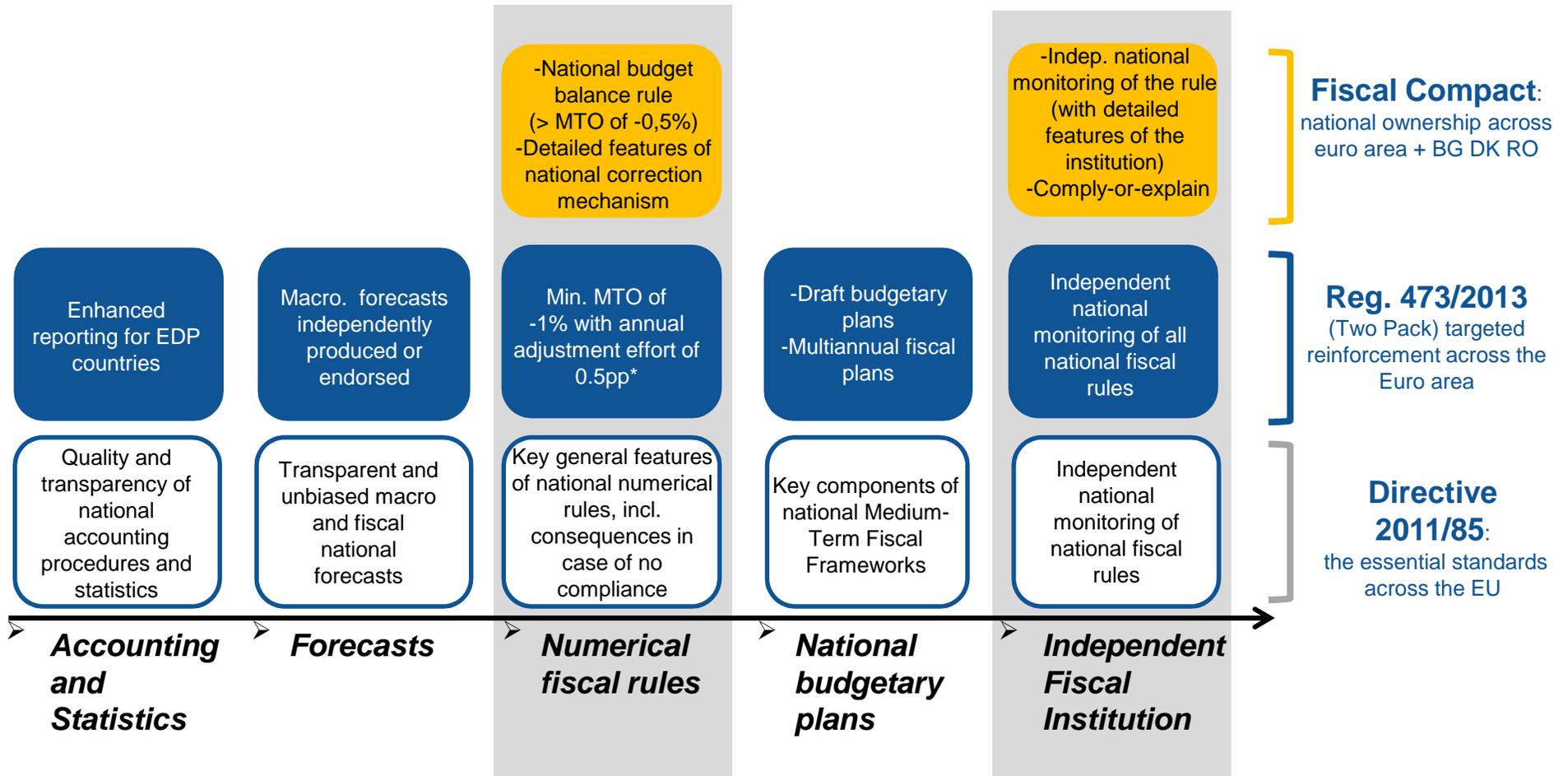


National fiscal frameworks: building blocks





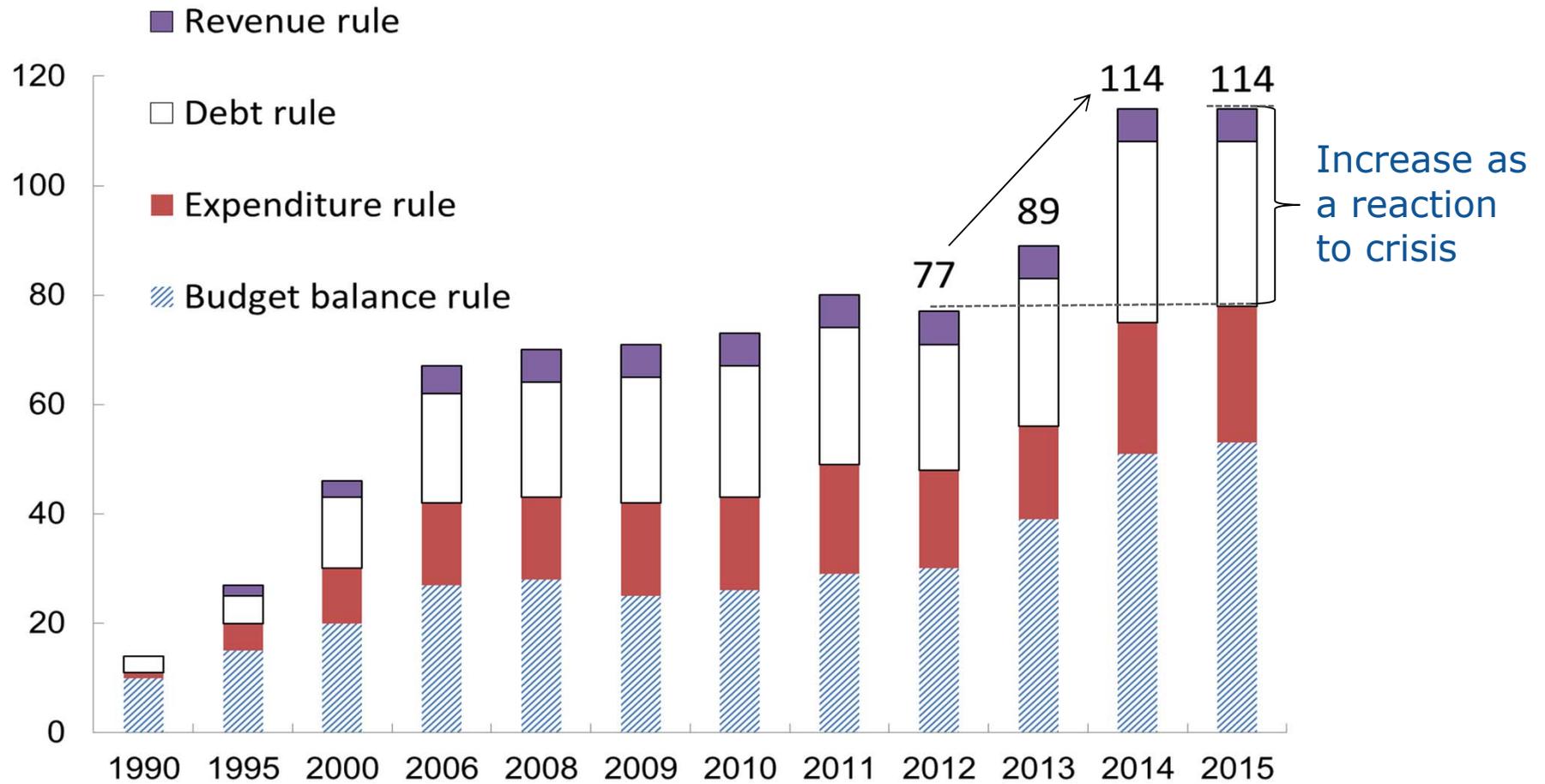
Promoting stronger national frameworks



* Also applies to DK as ERM2, Introduced by Reg. 1055/05 and confirmed in the Six Pack)



National fiscal rules (EU-28)

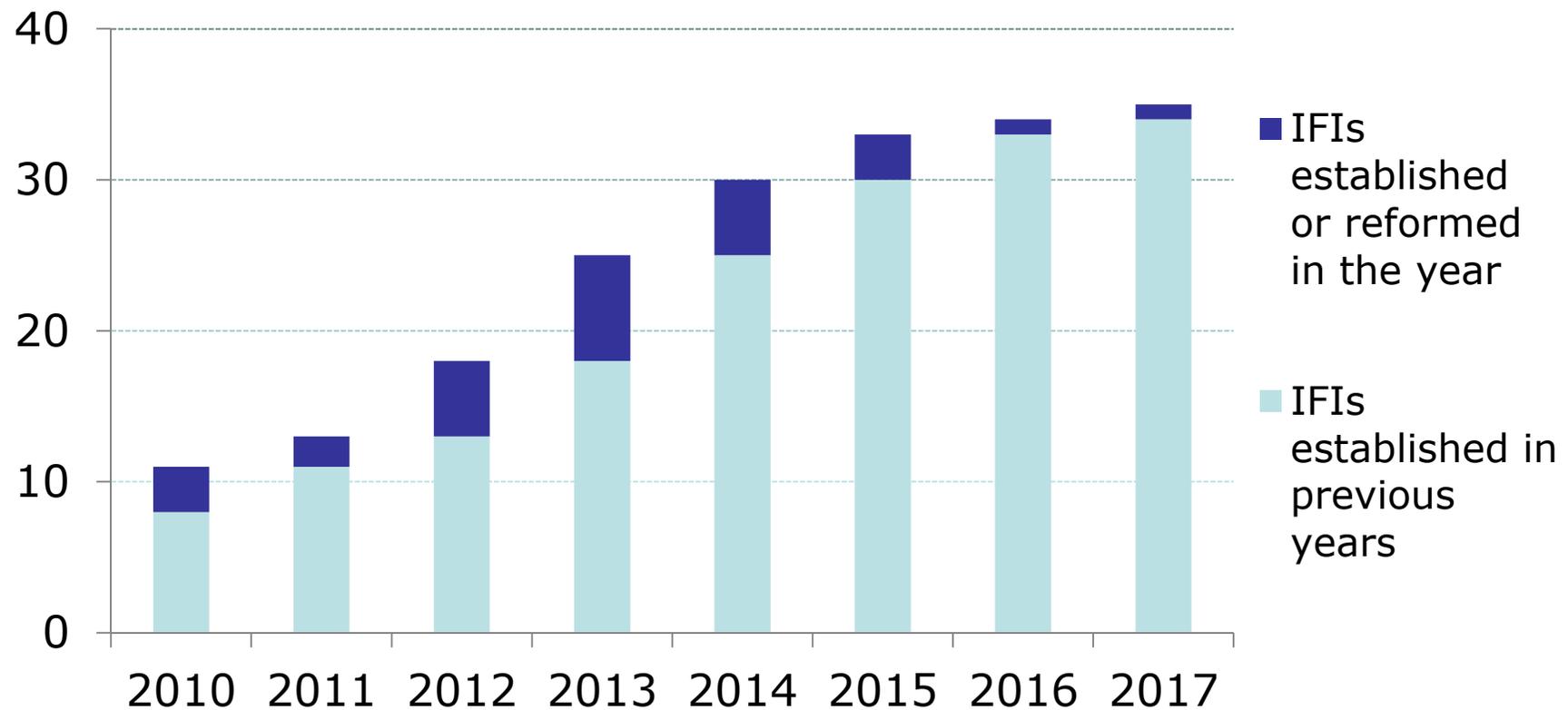


Source: European Commission





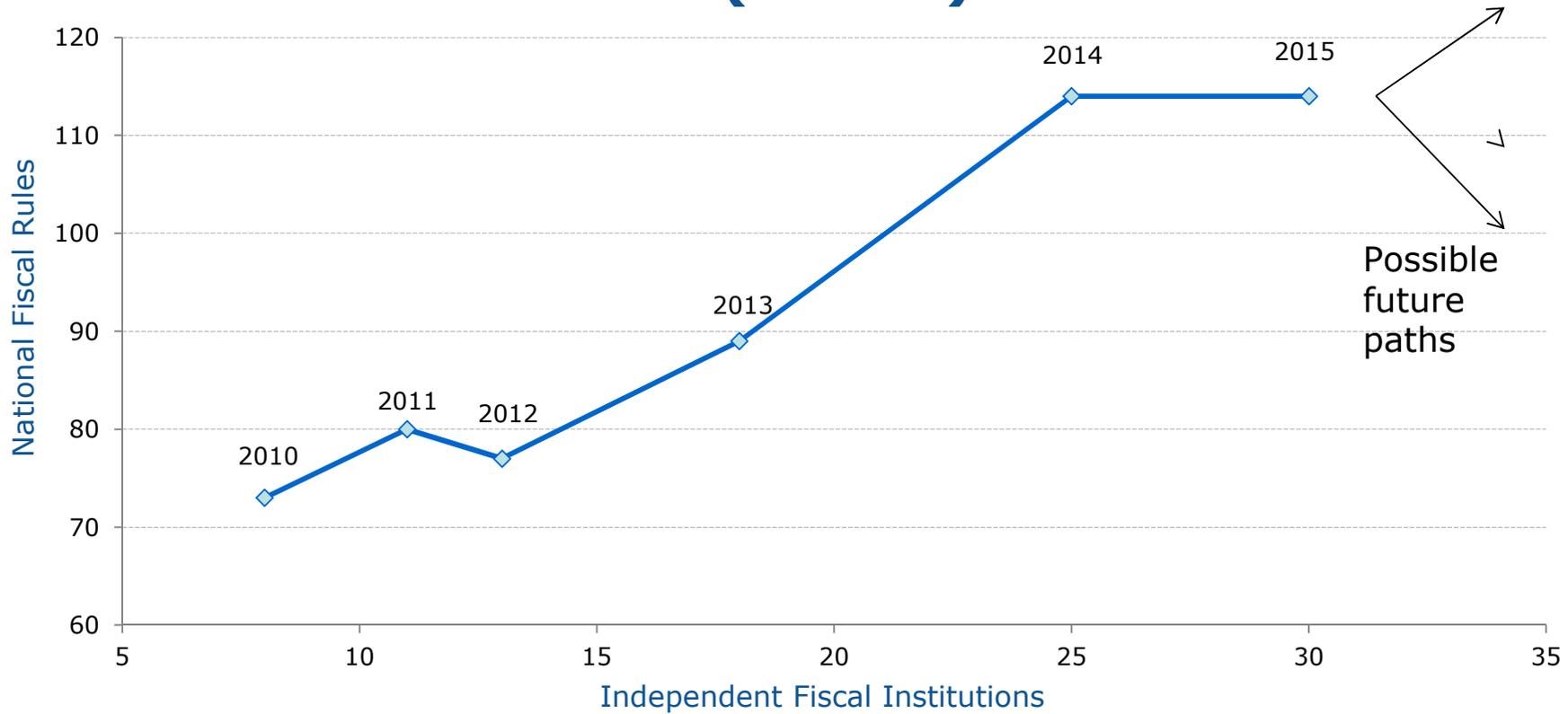
The rise of Independent Fiscal Institutions (EU-28)



Source: European Commission



National Fiscal Rules and Independent Fiscal Institutions (EU-28)



Source: European Commission





Some cracks

Two-tier surveillance EU level vs. national level

Complementarities:

► Technical

Credibility of forecast (growth, elasticities), grey areas (e.g. one offs), evaluation of measures

► Political

Foster ownership and rational debates on fiscal policies, share pressure with EU as guardian of the rules

But potential for divergences:

► Differences in 'technical appreciation'

e.g. on structural balances, triggering of escape clauses

► Differences (perceived or real) in mandates

e.g. strength of corrective action, structural reform clause





More significant cracks: Remaining vulnerabilities

- *Have the financial sovereign doom loops been sufficiently severed?*
 - Banking Union not completed yet
 - Exposure of national financial sectors to sovereigns remains high

- *Will the revised governance framework be effectively implemented?*
 - Limits to the application of rules/peer pressure on democratically elected governments

- *Has EMU the capacity to withstand the next large shock?*
 - ESM remains entirely dependent on national Treasuries
 - No tool for smoothing large shocks

- *Is the appropriate fiscal stance at the EA level being achieved?*
 - Bottom-up coordination does not work



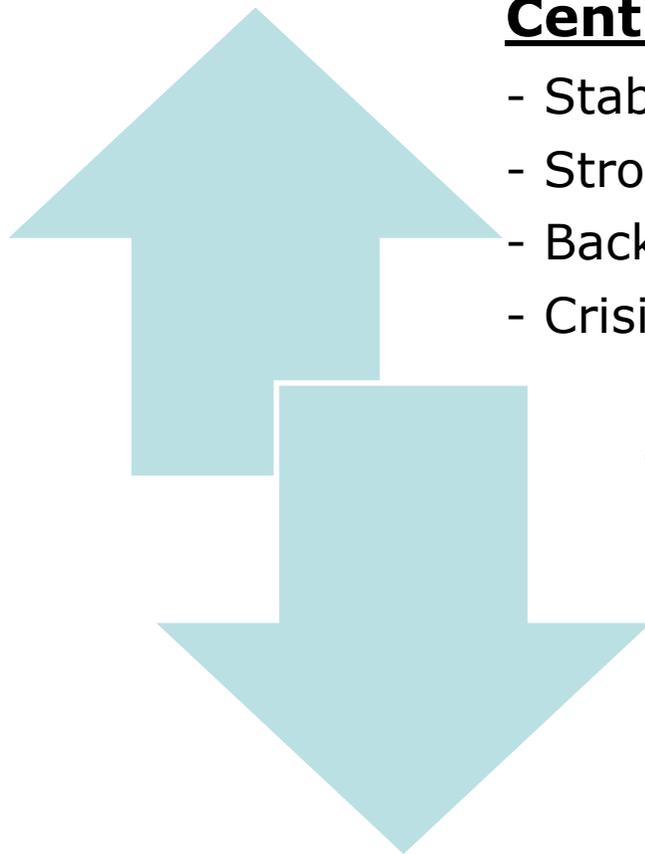


How to improve the framework? Do not underestimate challenges and trade-offs

- Entrenched differences of views (and interests) over proper conduct of fiscal policy
- National politics the (main) game in town
- Fiscal rules are pro-cyclical? Financial markets too (even more)
- Legacy of high debts, low growth prospects, lack of policy space



Two opposite visions for the way forward



Centralisation:

- Stabilisation capacity
- Stronger oversight on budgets
- Backstop for Banking Union
- Crisis management

Test:

Political
Acceptability

Decentralisation:

- Financial market discipline
- Credible no-bail out
- Stronger national budgetary frameworks/ownership
- Insolvency procedures for sovereigns

Financial
Stability

→ In their "pure" form, the two views don't pass the test



Searching for the right balance

Elements of centralisation

A "fiscal federalism by exception", with a simplified and less intrusive EU fiscal framework

A common fiscal capacity

Crisis management, including very last resort backstop to the banking union

Elements of decentralisation

More operational national rules linked to the EU framework and effective correction mechanisms

More binding nature of medium-term fiscal planning at MS level

Well-established independent fiscal institutions

→ Essential to conceive the different elements of the framework together



In sum

- Steps have been taken to bridge the fault lines in original EMU design revealed by the crisis
 - Yet, the present set-up remains vulnerable to large shocks and leaves too heavy responsibilities on the ECB
 - A large EU budget is not in the cards
 - A new balance between centralisation and decentralisation is needed:
 - On the one hand, common fiscal capacity. The limited size of the fiscal capacity suggests focussing on stabilisation;
 - On the other hand, stronger national fiscal frameworks, to flank a simplified and less intrusive EU fiscal framework.
- **The EMU reflection paper lays out the path to go**





Thank you very much for your attention