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
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

Financial Union

Stronger institutions and democratic accountability

Sound budgets and stabilisation function

Reforms and incentives

Economic Union

Fiscal Union
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

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

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

- Stabilisation function: reflection

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

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

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

- Stabilisation function: decision & implementation
  SGP: simplification

- EG: formalised with a permanent chair
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  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"

- ESM
- 2-Pack
- Fiscal Compact
- SSM
- Blueprint
- Four Presidents Report

Political economy: Better articulation of national/EA fiscal policies

- EFB
- Capital Markets Union
- SRM
- Five Presidents Report
- Communication on SGP flexibility
- Communication on EA fiscal stance
- Reflection Paper on EMU
- White Paper on the future of Europe

CRISIS

- Dec 2011
- Sep 2012
- Nov 2012
- Dec 2012
- Jan 2013
- May 2013
- Nov 2013

POST-CRISIS

- Feb 2015
- Jun 2015
- Sep 2015
- Jan 2016
- Nov 2016
- Mar 2017
- May 2017
E(M)U fiscal rules: a living framework

From the past

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

Treaty and legacy of original SGP and 2005 reform

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

SIMPLICITY

SGP.0 (1997)

SGP.1 (2005)

SGP.2 (2011-)

Current rules

PREDICTABILITY

ADAPTABILITY ("smartness")
National fiscal frameworks: building blocks

- Statistics
- Accounting
- Forecasts
- Numerical rules
- Medium-term planning
- Annual budgeting
- Independent fiscal institutions
Promoting stronger national frameworks

- National budget balance rule (> MTO of -0.5%)
- Detailed features of national correction mechanism
- Min. MTO of -1% with annual adjustment effort of 0.5pp*
- Draft budgetary plans
- Multiannual fiscal plans
- Key general features of national numerical rules, incl. consequences in case of no compliance
- Key components of national Medium-Term Fiscal Frameworks
- Indep. national monitoring of the rule (with detailed features of the institution)
- Comply-or-explain

**Accounting and Statistics**
- Enhanced reporting for EDP countries
- Quality and transparency of national accounting procedures and statistics
- Macro. forecasts independently produced or endorsed
- Transparent and unbiased macro and fiscal national forecasts

**Forecasts**
- Min. MTO of -1% with annual adjustment effort of 0.5pp*

**Numerical fiscal rules**
- Draft budgetary plans
- Multiannual fiscal plans
- Key components of national Medium-Term Fiscal Frameworks

**National budgetary plans**
- Indep. national monitoring of all national fiscal rules

**Independent Fiscal Institution**
- Indep. national monitoring of the rule (with detailed features of the institution)
- Comply-or-explain

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**Fiscal Compact:**
National ownership across euro area + BG DK RO

**Reg. 473/2013**
(Two Pack) targeted reinforcement across the Euro area

**Directive 2011/85:**
The essential standards across the EU

* Also applies to DK as ERM2, Introduced by Reg. 1055/05 and confirmed in the Six Pack)
National fiscal rules (EU-28)

Increase as a reaction to crisis

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?*
  o Banking Union not completed yet
  o Exposure of national financial sectors to sovereigns remains high

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

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

• *Is the appropriate fiscal stance at the EA level being achieved?*
  o 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

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

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

Test:
- Political Acceptability
- Financial Stability
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 focusing 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