



Independent Authority
for Fiscal Responsibility

The EU Fiscal Governance Framework: towards a more decentralized model?

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The euro area crisis: above all the collapse of a flawed framework

Only when the tide goes out do you find out
who's been swimming naked...

The tide actually went out and.....

2nd Nudeness on the financial system

Severe liquidity and solvency problems in the absence of a banking union

Negative feed-back loops aggravate the crisis compounded by a poor crises management

Very low potential growth and lack of shock-absorbing mechanisms

1st Nudeness on the fiscal front

Failure of the mechanisms to prevent free-riding

3rd Nudeness on economic activity

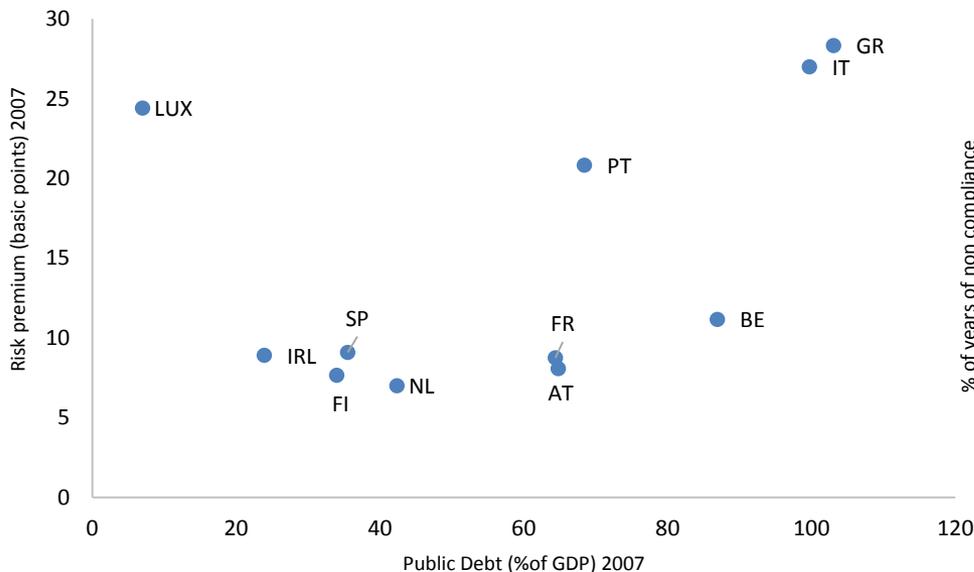
The challenge: breaking these loops by addressing the flaws in the framework

The euro area crisis: above all the collapse of a flawed framework

Nudeness on the fiscal front: failure of the mechanisms to prevent free-riding

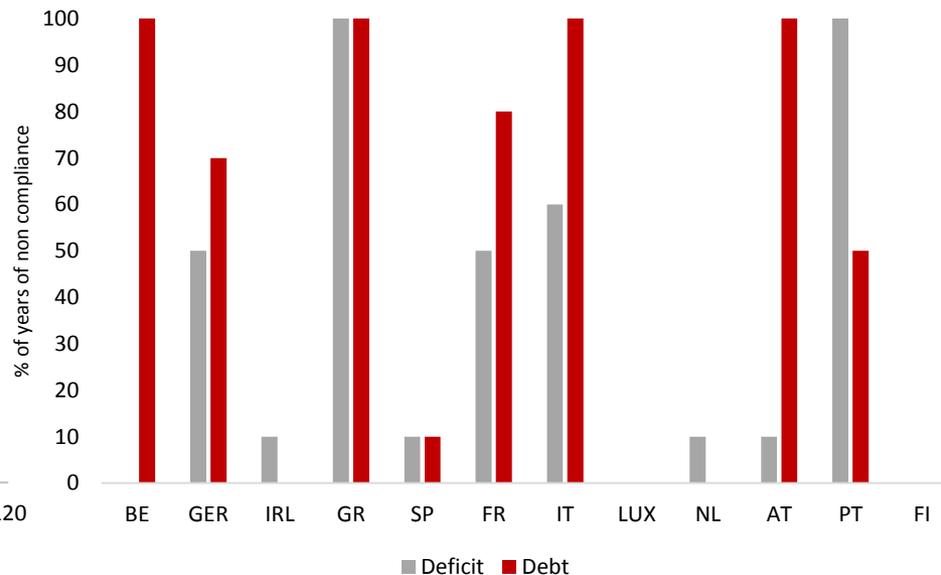
- ✓ Non credible non bail-out clause and risk underpricing

Lack of market discrimination



- ✓ SGP failed to promote fiscal discipline. Weak enforcement

Non-compliance with the deficit and public debt ceilings (3%; 60% of GDP) 1999-2008



Source: AMECO and Banco de España

The answer on the fiscal front has been a mixture of continuity and some innovative elements

1. Continuity with the centralized approach: reinforcing EU fiscal rules and its enforcement

- ✓ Particular focus on the **preventive arm** (need for buffers in economic expansions)

New rules:

Expenditure rule → complements the (structural) balance rule

Debt rule → on equal terms to public deficit

Existing rules: more precisely defined and more stringent (ie, maximum MTO for FC signatures from -1% of GDP to -0,5% of GD unless low sustainability risk)

- ✓ **Enforcement:**

Council discretionary limited RQM for sanctions

Commission autonomy reinforced DBP opinions; autonomous recommendations

2. Novelty by fostering decentralized elements: national ownership of fiscal discipline

- ✓ Budgetary data requirements

- ✓ Realistic forecasts

- ✓ National fiscal rules

- ✓ **National IFIs**

- ✓ Medium-term budgeting

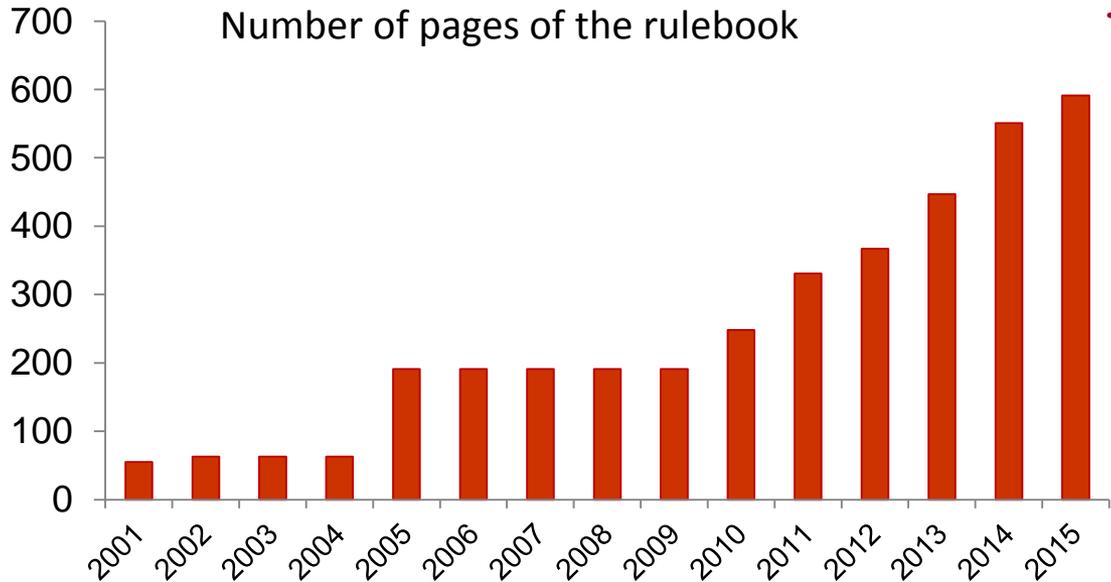
- ✓ Transparency

- ✓ Coordination mechanisms across administrations



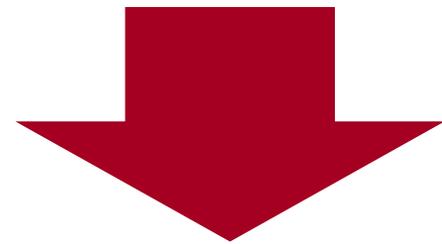
Is this reinforced centralized system of rules being effective?

❖ Wide consensus it has become **too complex and intractable**



Source: Central Planning Bureau (CPB), the Netherlands

- Too high number of fiscal rules
- Increasingly sophisticated
- Frequent changes
- Consistency not guaranteed



- ✓ **High discretionary margin** for the Council
- ✓ Time and country **inconsistent implementation** of the SGP

- ❖ Transparency and communication.....hindered
- ❖ Effectiveness and ultimately credibility.....at risk

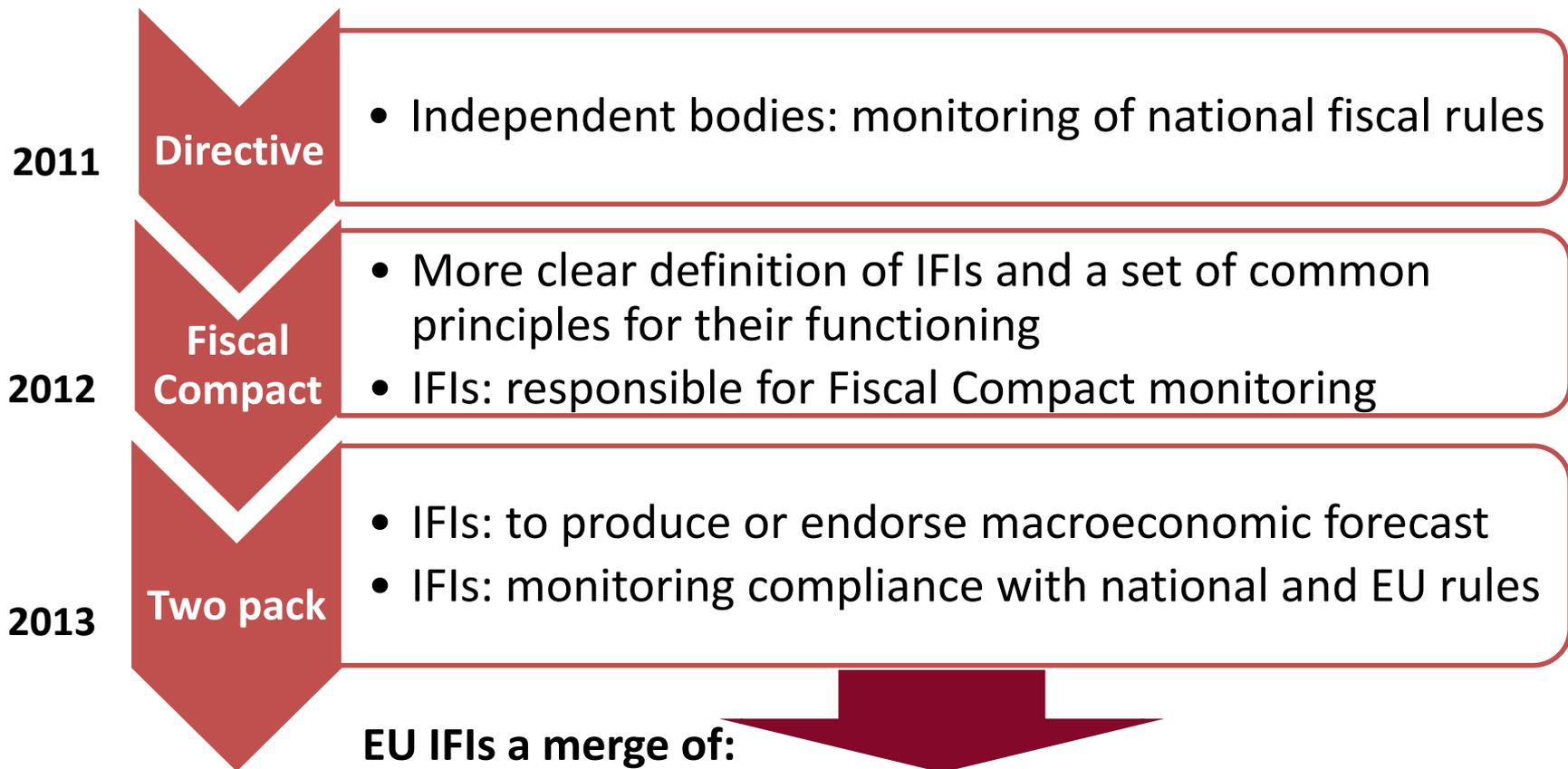
Is the decentralized approach progressing?

Are national budgetary frameworks becoming stronger?

- ❖ **Heterogeneous** progress across countries and issues
- ❖ **Countries are dragging their feet in particular regarding:**
 - ✓ Medium-term budgeting: two pack solution disappointing
 - ✓ Transparency: too much to do on fiscal benefits and contingent liabilities
- ❖ **More positive developments on:**
 - ✓ Budgetary data requirements
 - ✓ Macro forecasts
- ❖ **And the creation and consolidation of IFIs: a bumpy path along the road**

IFIs establishment

❖ Successive legal reforms



Anglo-Saxon model

German rules-based model

IFIs as providers of objective unbiased inputs for the policy process: positive role

IFIs guardians of national and EU rules: normative role

5 Presidents' Report: towards fiscal (economic, financial and political) union

Post- crisis reforms	5 Presidents' Report
SGP reinforced: more rules, more sophisticated and more stringent	Admits rules have become too complex. Forthcoming reform ?
Focused on sustainability of national public finances	More attention to stabilization function and euro area dimension
IFIs: decentralization of fiscal surveillance	EFB: risk of recentralization ?

Rules-based coordination system

Sovereignty sharing and common institutions



Is this project feasible?

- ❖ **Several authors support a fully decentralized fiscal discipline model**
 - **Wyplosz: a US-type model with a credible non bail-out clause**
 - **Kiss and Odor: deficit bias explained by different drivers in each country. Proposal:**

National
Level

- Fully responsible for defining and monitoring fiscal rules
- Rules are country specific
- National IFIs: best suited for monitoring

EU
Level

- Focused on common interest issues
- Rules at EU level: avoid gross errors (free riding, pro cyclicity)
- EU IFI: minimum standards check; gross errors monitoring; fiscal stance for euro area

IFIs EU Network position on the 5 Presidents' Report

- ❖ **The Network supports efforts to review and reinforce the EU fiscal framework:**
 - seeking to better exploit synergies between rules and institutions and between national and EU institutions
 - respecting the principle of subsidiarity
 - enhancing **national ownership** and accountability

- ❖ **Three conditions for an effective EU fiscal governance system:**
 1. Reinforcing the **role of independent bodies** at the national level
 2. Streamlining EU **fiscal rules**
 3. Building **effective fiscal frameworks** at the national level

1. Reinforcing the role of national IFIs

- ❖ Need for a **strong position** to effectively conduct their tasks (information access, adequate resources, effective implementation of CoE, safeguards to political pressures)

- ❖ **EFB set-up raises many issues:**
 - **On its mandate:**
 - advisor and watchdog: potential conflict?
 - fiscal stance?

 - **On its institutional setting:**
 - independent, transparent enough?
 - sufficient resources?

- ❖ **EFB and national IFIs: conflicting institutions?**
 - **Subsidiarity** to be respected
 - Efficient **division of tasks**
 - **EFB advice not to jeopardize:**
national IFIs' role & rules enforcement

2. Streamlining fiscal rules

❖ Initiatives to **reduce complexity** welcome

Feasibility: higher compliance

Simplicity: higher transparency, easier supervision

Easier implementation: monetary policy as a benchmark

Consistency: short-term stability and long-term sustainability

3. Building effective national fiscal frameworks

- information
- adequate budgetary procedures
- medium-term perspective
- cooperation agreements between different levels of public administrations

CONCLUSIONS

- ✓ Fiscal union: transfer union not feasible at any horizon and risk sharing and EU-wide fiscal stabilization mechanisms only over the long-term
- ✓ A credible non-bail out clause seems also hard to develop in a currency union with the track record and rescue systems of the euro area and systemic countries (too big to fail) The widening of spreads during the crisis was primarily due to redenomination risk. Will the default of a large euro area country be ever significantly priced-in?
- ✓ The euro area is bound to rely on a hybrid model where the most promising element should be national commitments to strengthen local frameworks, as a pre-condition to sustain sound and responsible fiscal policies
- ✓ Better use of the energy of the center if directed towards promoting robust fiscal frameworks at the local level, rather than fostering one-size-fits-all solutions and recentralization trends (EFB)
- ✓ IFIs can play a relevant role in this context. Protection from the center to facilitate its consolidation will be decisive



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