Piazza A. Diaz, 6
Milano, 20123
Cell 328 8871062
E-mail: studiolegalebruccoleri@gmail.com

Studio Legale
Avv. Maria Bruccoleri

Via Gioacchino di Marzo 5
Palermo, 90144
Tel. 091 309131
Tel/Fax 091 308038
PEC: avvmariabruccoleri@legamail.it

THE EUROPEAN SCENE – SETTER AND SOME ELEMENTS FOR A REVAMPED FISCAL FRAMEWORK FOR SPAIN AND OTHER EU MEMBER STATE

Scene-setter

- **As Spain continues its economic recovery, reducing the crisis public debt legacy remains one of its main challenges ahead**. After three years of growing above 3% in real terms, current estimates suggest that Spain may be at the onset of a new economic cycle, with the output gap coming back to positive territory in 2018 or early 2019. However, public debt remains at record-high levels hovering around 100% of GDP.

- In this context, debt sustainability remains a key challenge. Spain should take advantage of favorable cyclical conditions to generate fiscal buffers that could accommodate future shocks.

Scene-setter

- **The current fiscal framework (both at the EU and domestic level) appears insufficient to ensure an adequate debt-reduction path for Spain**. After being subject to the corrective arm of the Stability and Growth Pact since 2009, Spain is expected to enter its preventive arm shortly. At the national level, public authorities are subject to the Organic Law on Budgetary and Financial Stability, passed in 2012. Both sets of provisions suffer from flaws that could lead to either wrong policy recommendations or limited implementation.

Scene-setter

- At the EU level, the preventive arm excessively relies upon unobservable indicators and its enforcement has been weak. At the national level, the current formulation of the expenditure rule does not ensure adequate progress towards the MTO when the structural balance is distant from it.
- Moreover the two set of provisions are not fully consistent with each other, thus creating a convoluted regulatory framework.
- As a result, the monitoring and enforcement of the different provisions has become extremely cumbersome.

Scene-setter

- **The on-going revision of the euro area architecture provides a window of opportunity for Spain to revise its domestic rules.** Last December the Commission set out several proposals for deepening the Economic and Monetary Union. Prominent among them is the proposal for a Council Directive laying down provisions for strengthening fiscal responsibility and the medium-term budgetary orientation in the Member States, which opens the door for possible changes in the national legislation.

Scene-setter

- It establishes that each Member State shall set up a framework of binding numerical fiscal rules which are specific to it and effectively promote compliance with its obligations deriving from the Stability and Growth Pact.

The rationale for fiscal rules

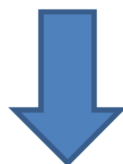
The case for rules over discretion arises from the problem of time inconsistency of policy. First brought forward in the seminal paper of Kydland and Prescott (1977), the problem of time inconsistency arises since policymakers can announce a certain course of policy action to influence expectations, and then renege on their announcement at a later stage.

Understanding this time inconsistency, private decisionmakers may be led to distrust policy announcements altogether.

Thus, one way of solving this problem is to replace policymakers' discretion with a credible commitment to a policy rule.

The rationale for fiscal rules

The time inconsistency of fiscal policy is crystalized in the deficit bias, also linked to the common pool problem.



Although many reasons have been advanced by the large literature that tries to pin down the deficit bias (Calmfors and Wren-Lewis, 2011) two explanations seem to dominate. Both relate to the common pool problem, by representing a different temporal dimension of it.

The rationale for fiscal rules

The intertemporal common pool problem relates to the tendency to push out the burden of fiscal discipline to future governments or future generations. Instead, the intratemporal dimension has to do with the fact that deficit-increasing measures typically tend to favor relatively small groups (Wyplosz, 2012).

The rationale for fiscal rules

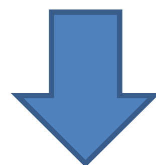
These groups lobby for tax reductions or spending increases with insufficient regard to the full budgetary costs these measures will imply. (Re)election probabilities are enhanced by catering to interest groups and hence the tendency for fiscal profligacy.

The rationale for fiscal rules

Fiscal rules aim at correcting distorted incentives and containing pressures to overspend. Since finding political support to rein in deficits may be difficult to achieve, the political process that drives the preparation, adoption and execution of the budget is intervened through the adoption of fiscal rules. Furthermore, in a currency union supranational rules are aimed at internalizing the regional cost of fiscal indiscipline and establish a framework for better coordination of the policy mix (Kumar et al, 2009). Along with fiscal rules, countries increasingly rely on independent fiscal institutions to curb the deficit bias (Beetsma et al, 2018).

The rationale for fiscal rules

Generally, fiscal rules share the feature of imposing numerical norms, usually expressed in terms of deficit caps, debt limits and expenditure ceilings.



Numerical fiscal rules are widespread and come in a large variety of forms that can be systematized in few categories: debt rules, budget balance rules, structural budget balance rules, expenditure rules or revenue rules (IMF, 2018).

The rationale for fiscal rules

Since the different types of rules have pros and cons there has been a tendency to combine two or more of them in later generations of fiscal rules. Thus, they tend to be more complex (Schaechter et al, 2012). The current set up of the Stability and Growth Pact is rather illustrative in this respect.

The rationale for fiscal rules

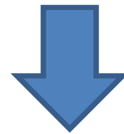
Fiscal rules are generally assessed against a set of desired features initially proposed by Kopits and Symansky (1998). Combined, these criteria are meant to ensure that the rules perform their tasks effectively – ensuring sustainability and economic stabilization – and efficiently – through simple prescriptions that are easy to communicate and enforce.

The rationale for fiscal rules

Since these criteria are often found in clash with each other, selecting a fiscal rule involves determining the costs and benefits of different alternatives and trying to minimize possible trade-offs (IMF, 2018). An alternative approach places explicit weights on each criterion according to the country preferences (Carnot, 2014).

The rationale for fiscal rules

A renewed appreciation for simple fiscal rules is spreading, particularly across the EU.



Reforms that made the EU fiscal framework more flexible and growth friendly have resulted in an overly sophisticated architecture. Its complexity makes it difficult to understand and enforce (Eyraud et al, 2017). Against this background, the case for simple fiscal rules structured around a fiscal anchor and one or two operational targets is becoming ever stronger.

Lessons from Spain's past

- **It is widely acknowledged that, during the first years of the 2000s, Spain's fiscal stance aggravated the macroeconomic imbalances that built up during that period**. Recent estimates indicate Spain's positive output gap rapidly widened in the first half of the 2000s until it reached a maximum of 5.6% in 2007.

- At the same time Spain's private debt and current account deficit rose sharply. AIReF's bottom-up estimates of the fiscal stance indicate that expansionary measures cumulatively amounting to around 9% of GDP were taken in the period 2001-2008.

Lessons from Spain’s past

- **This partly related to wrong output gap estimations at the time**. Current output gap estimates suggest the structural deficit was hovering around 2% for the most part of the period 2000-2007. Thus, with the structural balance below Spain’s MTO, an effort should have been required. Instead, real-time estimates wrongly pointed to a moderate structural surplus for those years. The MTO was persistently perceived to be overachieved.

Lessons from Spain's past

- **While the expenditure benchmark partly solves this by measuring the fiscal effort with a more observable indicator, it is unlikely that it would have resulted in a more countercyclical policy at the time.** The expenditure benchmark would have shown that fiscal policy was being lax and procyclical instead of neutral or even restrictive as perceived then. However, it is highly unlikely that it would have resulted in a more countercyclical fiscal policy.

Lessons from Spain's past

Given that the level of the structural balance was persistently perceived to overachieve the MTO, the expenditure rule would have been suppressed at least until the structural surplus was estimated to decline to the MTO level. Government expenditure would thus have been allowed to grow above the economy's medium-term potential performance resulting in a deterioration of the underlying fiscal position.

Lessons from Spain's past

Any rule that sets the magnitude of fiscal policy changes by comparing a target value for the structural balance with its projected level risks delivering wrong policy advice. It also risks distorting the overall discussion around fiscal policy, which should focus on the policies implemented rather than on technical aspects related to the estimation of unobservable variables. This has frequently been the case in the past. A similar problem may face us in the new cycle.

Lessons from Spain’s past

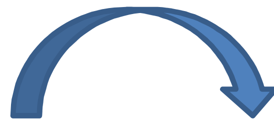
Drawing lessons from the past includes rethinking what is achievable in terms of levels of some fiscal variables. Government debt reached a minimum of 36% of GDP in Spain in 2007, after seven years of primary surpluses amounting to between 2% and 3% of GDP. Later events proved that this was not enough. While any framework that asked for higher primary surpluses would have been considered excessively restraining at the time, the extra buffers would have come in useful some years down the line.

Lessons from Spain’s past

AIReF’s goal is to anchor the fiscal framework in a way that, first, helps avoid another round of procyclical fiscal policies and, second, sufficiently reduces debt levels. The abrogation of the Excessive Deficit Procedure together with improved economic prospects can easily lead to procyclical fiscal policies which Spain cannot afford, now less than ever. Spain’s economy has proven to be fairly volatile, so there is an impending need to build enough fiscal buffers before the next shock hits again.

The general rule

The framework departs from the premise that ensuring debt sustainability while allowing room for the automatic stabilizers to operate constitutes the final goal of fiscal policy.



The outstanding liabilities of the consolidated government sector are generally seen as an encompassing indicator of fiscal vulnerability. In a country that faces a large government debt burden fiscal rules should target reducing the debt ratio and then stabilizing it at a prudent level. At the same time, fiscal rules should allow automatic stabilizers to perform their function of partly offsetting economic fluctuations without direct government intervention.

The general rule

Given that goal and following Kopits and Symansky's seminal contributions, the framework should be defined in a way that is transparent, simple, flexible and internally consistent.

The transparency feature is related to the use of observable indicators that are easy to trace and communicate. Simplicity relates to the use of few, distinct indicators against which governments' fiscal policy actions can be assessed.

The general rule

Flexibility implies the capacity to accommodate shocks beyond the control of the authorities by envisaging well-defined escape clauses triggered by independent institutions. Finally, the internal consistency feature requires that fiscal policy is yearly constrained in a way that is linked to its ultimate goal, i.e. ensuring sustainability while letting automatic stabilizers operate.

The general rule

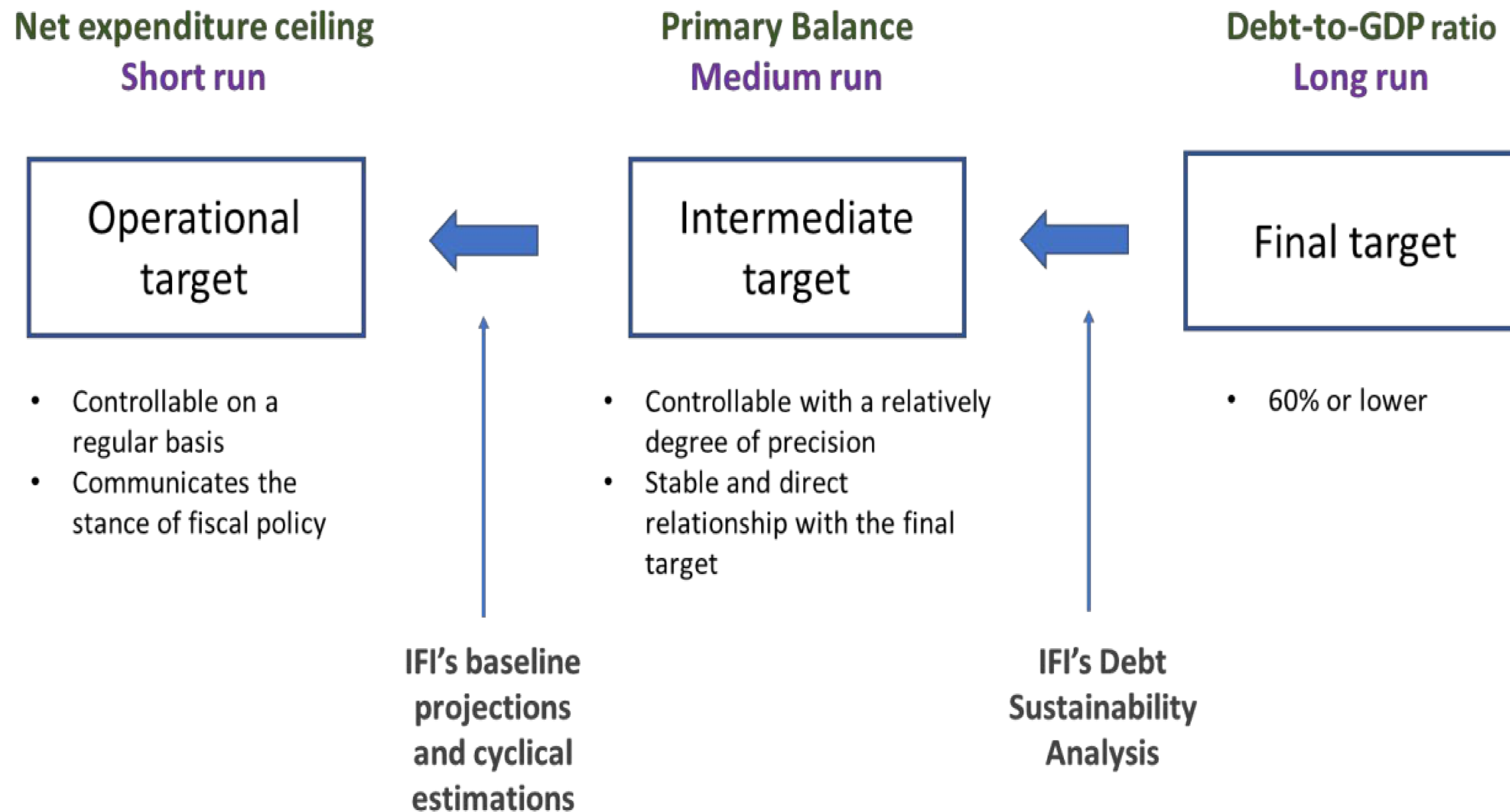
The framework is articulated around a triple time dimension – short, medium and long run – and three indicators, each characterizing one of the three horizons. Analogous to monetary policy the framework embeds an annual operational target for the short term, an intermediate target for the medium run and a final target in the long run.

Following Bindseil (2004) the operational target can be defined as an economic variable, which the authorities want to control, and indeed can control to a very large extent on a regular basis through the use of its fiscal policy instruments (i.e. the budget).

The general rule

It is the variable the level of which communicates the stance of fiscal policy to the public and, as such, includes an indication of the discretionary element of fiscal policy. In turn, the intermediate target is an economic variable that the fiscal authorities can control with a relative degree of precision, and which is in a stable or at least predictable relationship with the final target of fiscal policy.

The three horizons of the fiscal policy framework. Determining fiscal stance ex ante (every four years)



Assessing internal consistency ex post (every four years)

Net expenditure ceiling Short run		Primary Balance Medium run		Debt-to-GDP ratio Long run
Operational target		Intermediate target		Final target
• Controllable on a regular basis • Communicates the stance of fiscal policy	↑ IFI's reassessment of underlying budgetary trends	• Controllable with a relatively degree of precision • Stable and direct relationship with the final target	↑ IFI's reassessment of sustainability risks	• 60% or lower

The general rule

Gross government debt operates as the final target and long-term anchor, crystallizing the ultimate goal of fiscal policy. The final target is expressed as a ceiling for the gross debt- to-GDP ratio towards which government debt should decline. A measure of gross rather than net debt is favored because the valuation of government assets is usually debatable, thus weighing on the transparency of the framework.

The general rule

The actual ceiling can certainly be no higher than 60% to fulfil the requirements of the Stability and Growth Pact, but could be lower if additional buffers are deemed necessary. While a limit on the gross debt-to-GDP ratio can be interpreted as a broad measure of fiscal sustainability, year-to-year debt targets are unlikely to be credible or operational since they are often exposed to valuation changes and other factors outside the control of the authorities.

The general rule

- **The intermediate target is a flow indicator of fiscal performance, that is, a level for the primary balance-to-GDP ratio. It is set relative to a norm and as a function of the economic situation.**

The general rule

- The primary balance has a straightforward, direct and stable relationship with the final target. Leaving aside stock-flow adjustments, there are just two ways of reducing debt: first, through a favorable snowball effect or second, by accumulating primary surpluses. Since relying on the former cannot be considered an adequate course of policy action, any fiscal framework that has debt reduction as its final target should focus on the evolution of primary balances.

The general rule

Given the debt target and the number of years to attain it – i.e. given a pace of debt reduction that is considered adequate – it is straightforward to derive the constant primary balance consistent with it (hereinafter, the primary balance norm). Since primary balances are expected to automatically deteriorate in downturns and improve in upswings, attaining the primary balance norm on average requires outperforming it during upswings.

The general rule

Thus, the intermediate target (IT) is a medium-term level for the primary balance-to-GDP ratio – valid for 4 years – that is derived, relative to the norm (PBN), as a function of the economic situation.

The general rule

The primary balance intermediate target acts as an anchor for expectations ex ante, but does not imply that the government is held accountable for attaining a specific level of that variable. The latter would not be consistent with the final goal of the framework, which includes letting automatic stabilizers operate. In fact, if the government's actions were assessed against a primary balance reference, the effect of automatic stabilizers would need to be constantly counteracted.

The general rule

Furthermore, the control of the primary balance by the fiscal authorities is imperfect because there are lags. Instead, the primary balance intermediate target acts as an anchor for expectations and sets a benchmark for medium-term budgetary planning. Furthermore, it is the pivotal element that allows effectively translating the final target (debt reduction) into a specific metric for the operational target. It is against the latter that government's actions will be assessed (see below).

The general rule

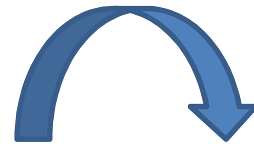
Ex post, the comparison of observed primary balances with the intermediate target allows to periodically re-evaluate the internal consistency of the framework. Assuming the required fiscal measures are implemented, if the primary balance of the previous four years missed the intermediate target on average, the cyclical calculations or revenue projections should be revised.

The general rule

The relationship between the three levels of the framework needs to be reassessed for the following round of 4 years. Thus, the intermediate target provides a reference against which the internal consistency of the framework can be periodically reassessed to ensure annual fiscal requirements stay aligned with the final target.

The general rule

Net expenditure ceilings serve as the operational target.



The difference between the baseline primary balance projection for the following year and the intermediate primary balance target yields the amount of measures to be implemented by the government on a given year. In order to avoid requiring extremely large measures, which will not be credible, some absolute limits can be added to the framework – a maximum and minimum adjustment of 1% and 0% of GDP is assumed in this case.

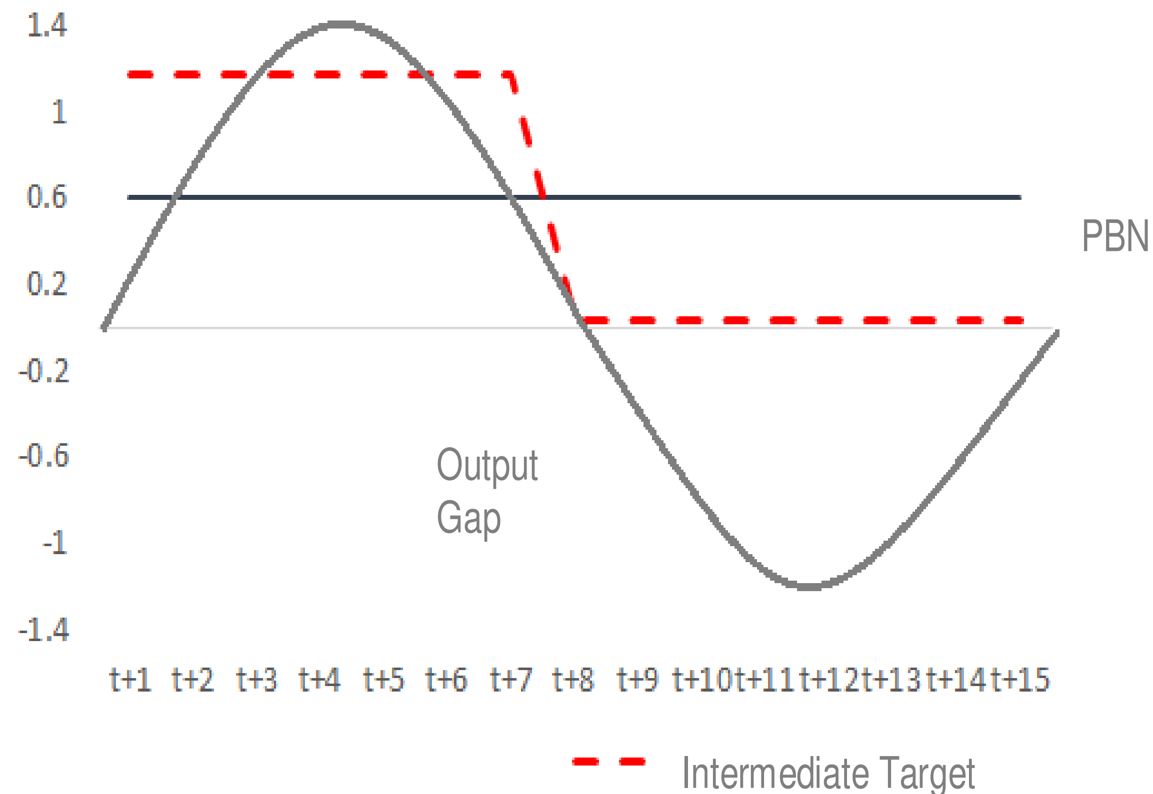
The general rule

While the upper limit precludes the framework from requiring exceptionally large adjustments, it does not mean these are proscribed by it. On the contrary, they remain a policy option.

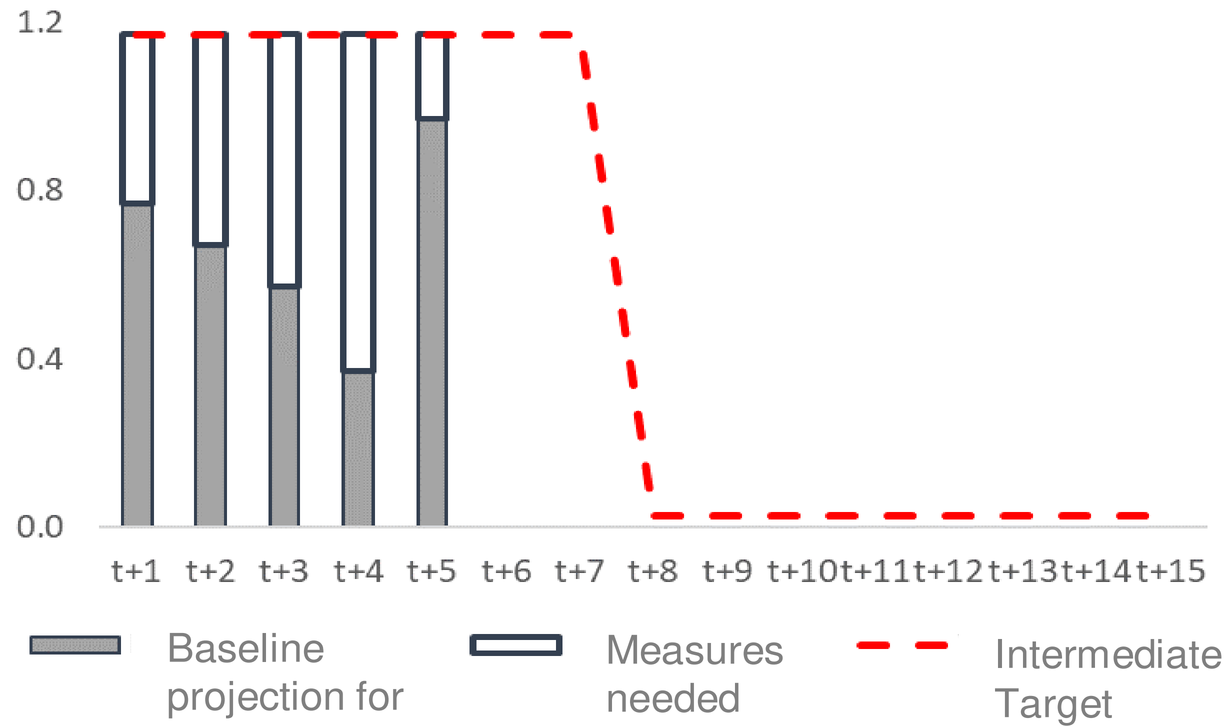
The general rule

Thus, fiscal policy is set to be contractionary or neutral. Under specific circumstances, expansionary measures can be envisaged (see below) but are in principle ruled out in the current context of normalized economic conditions and excessive debt levels.

Determining the fiscal stance
Determining the primary balance norm and the intermediate target (% GDP)



2.2. Determining the annual measures (% GDP)



The general rule

An escape clause to be triggered by the independent fiscal institution caters for the occurrence of exceptional circumstances. Certain situations may warrant the suspension of the general framework and the adoption of expansionary measures. However, preserving the integrity and internal consistency of the framework advises that the occurrence of such circumstances be gauged by an independent institution.

The general rule

The magnitude by which fiscal policy can depart from the general rule – that is, from the yearly nominal ceiling resulting from the expression above – can be left open instead of resulting from an algorithm. Therefore, the independent institution could be responsible of both triggering the escape clause and recalibrating the stance of fiscal policy depending on the economic circumstances and the sustainability of the country's public finances.

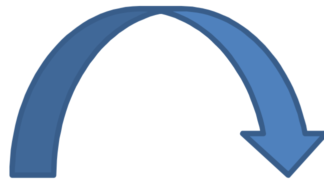
The general rule

This framework is transparent, simple, flexible and internally consistent.

It is transparent because it is based on fundamentally observable variables, easy to replicate and communicate. It is simple because it hinges upon three indicators, clearly connected to each other and distinctly placed relative to each other. It is flexible because it allows for exceptional circumstances to be taken into account. And finally, it is internally consistent because the fiscal stance is set and periodically reevaluated so that progress towards attaining the final debt target is ensured.

Escape clauses

When designing fiscal rules, escape clauses are instrumental in striking the right balance between credibility of commitment on the one hand and flexibility to respond to shocks on the other hand.



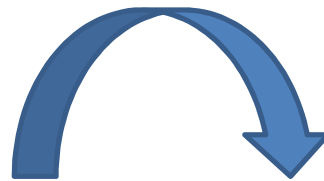
It is generally acknowledged that fiscal frameworks should have sufficient flexibility in their design to allow for an appropriate response to large negative unpredictable shocks.

Escape clauses

This, however, should not jeopardize the discipline imposed by the rules and their benefits in terms of credibility of government commitment. In principle, this can be achieved with well-defined escape clauses that cater for the occurrence of such shocks.

Escape clauses

Careful design is important to avoid the abuse of escape clauses to circumvent fiscal rules. The literature on the effect of escape clauses is inconclusive. On the one hand, they can lead to lower compliance probabilities, creating loopholes that ultimately allow general government debt to rise (Reuter, 2016).



However, it is also found that well-defined escape clauses render fiscal frameworks less procyclical (IMF, 2013).

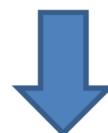
Escape clauses

When it comes to their design, there are five main relevant dimensions:

1. **the nature and magnitude of the shocks to be accommodated;**
2. **the magnitude of the fiscal response to the shock;**
3. **the length of period during which the rule would be relaxed or put into abeyance;**
4. **a path of return to full observance of the rule;**
5. **and the responsibility for activating the clause and monitoring its implementation (Ter-Minassian, 2010).**

Escape clauses

Several reasons speak to the need for escape clauses to have some country-specific elements.



Country-specific circumstances should be taken into account, such as the type of shocks the country is most exposed to and the sensitivity of certain fiscal aggregates to such shocks. Likewise, the fiscal space available to accommodate them depends on the public finances situation of the concerned country (Public Finances in EMU - European Economy 4/2010). This calls for the involvement of independent fiscal institutions in the implementation of escape clauses.

Escape clauses

Summary of the proposed escape clause

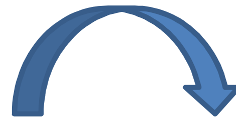
	What?	Who?	When?
Trigger	Acute economic recession	Fiscal Council	At the request of the MoF or on the fiscal council's own initiative
	Other events outside govt's control with a deficit-increasing impact of at least 1% of GDP		
Allowance	Neutral fiscal policy by default	Fiscal Council	One year by default and possibility to reevaluate
Return to rule	Possibility of modulating the requirement resulting from general framework	Fiscal Council	After one year by default

The trigger

Only truly exceptional circumstances should allow for the triggering of the clause. It is proposed that flexibility is closely-circumscribed to (i) acute economic recessions, or (ii) natural disasters or other events outside government's control with a negative impact in the general government balance of at least 1% of GDP. The latter threshold ensures that the extraordinary event has a major impact on public finances and thus, its occurrence is exceptional.

The trigger

An independent institution could be tasked with gauging the conditions that trigger the escape clause, based on a combination of indicators.



Making independent institutions responsible for triggering the escape clause is one key area where their involvement can contribute to striking the right balance between flexibility and credibility of commitment. Traditionally the projected cyclical position of an economy is gauged by looking at point forecasts of the output gap level. However large output gap revisions are found to be both frequent and asymmetric across expansions and recessions.

The trigger

Relying on real GDP growth forecasts is not likely to improve the accuracy in estimating the projected cyclical position. In fact, it is found that output gap revisions – both in levels and changes – are mainly driven by GDP growth forecast errors rather than potential GDP growth revisions (Hernández de Cos et al, 2016). This implies that fiscal policy should be evaluated in the context of a distribution of forecasts that accounts for uncertainty.

Piazza A. Diaz, 6
Milano, 20123
Cell 328 8871062
E-mail: studiolegalebruccoleri@gmail.com

Studio Legale
Avv. Maria Bruccoleri

Via Gioacchino di Marzo 5
Palermo, 90144
Tel. 091 309131
Tel/Fax 091 308038
PEC: avvmariabruccoleri@legamail.it

Thanks for your attention

www.avvocatobruccoleri.it