DOI: 10.1007/s10272-017-0664-9

End of previous Forum article

Nicolas Carnot*

European Fiscal Governance and Cyclical Stabilisation: Searching for a Lasting Arrangement

A perennial issue in European fiscal arrangements has been to find an admissible balance between disciplining rules and cyclical stabilisation concerns. Starting from a brief assessment of the present rules-based framework in this respect, this piece stresses that the possible addition of a common stabilisation capacity has to be considered in deep connection with (possibly revised) fiscal rules. Some recommendations of appropriate design are also offered.

Two views on EU fiscal policies

The conundrum to be addressed in the specific context of the Economic and Monetary Union (EMU) can be appreciated by contrasting two legitimate views, namely the "sustainability view" and the "stabilisation view".

The sustainability view contends that the deficit bias is the problem to address.[1] Monetary union increases that problem by opening possibilities of mutualising the costs of deficits, notwithstanding the no-bailout rule. The basic purpose of fiscal arrangements is therefore to incentivise the maintenance of prudent fiscal positions conducive to moderate debts in each constituency under an "own house in order" approach. Using fiscal policy actively is fraught with known problems and should be restricted to exceptional circumstances.

The stabilisation view asserts that the macroeconomic role of fiscal policy is essential.[2] Monetary union enlarges that role by depriving individual countries of monetary autonomy. At a minimum, the automatic fiscal stabilisers must be unrestricted in order to enable each country to smooth shocks, and active countercyclical fiscal policy may be warranted in certain circumstances. Moreover, the aggregate fiscal stance of the euro area should be considered. This is especially clear when monetary policy nears the zero lower bound, and it may hold more generally, as fiscal policy and monetary policy are imperfect substitutes with differentiated effects, for instance on the external accounts.

Both of these views are rooted in experience, although reasonable people can differ on their relative relevance. Our premise is that they both make essential points. They are not necessarily in conflict but easily can be, if considered separately. The conundrum is to design a govern-

* European Commission, DG Economic and Financial Affairs. The views are those of the author and should not be attributed to his institution.

1 See for instance J. von Hagen: The sustainability of public finances in the EMU, in: CESIFO DICE Report 3/2011, pp. 3-9. For a theoretical underpinning, see V. Chari, P. Kehoe: On the need for fiscal constraints in a monetary union, in: Journal of Monetary Economics, Vol. 54, No. 8, pp. 2399-2408.

2 C. Allsopp, D. Vines: The macroeconomic role of fiscal policy, in: Oxford Review of Economic Policy, Vol. 21, No. 4, pp. 485-508.

Nicolas Carnot, European Commission, Brussels, Belgium.

ance system that adequately recognises both. To a large extent, the evolution of the European fiscal framework over the past 25 years can be read as such an attempt.

The current fiscal framework

The rules-based framework enshrined in the Treaty on the Functioning of the European Union and the ensuing secondary legislation, i.e. the Stability and Growth Pact (SGP), originates in the sustainability view. Acknowledging subsidiarity, the rules are of a proscribing nature: they set minimum requirements for prudent fiscal policies in each country. Member states are free to exceed the minima. Excessive deficits are assessed with respect to reference values for headline deficits and debt ratios (three per cent and 60% of GDP respectively). Another key notion is the medium-term budgetary objective (MTO), by and large a requirement to balance the budget in cyclically adjusted terms. The MTO is also the centrepiece of the intergovernmental treaty known as the Fiscal Compact.

This framework has been amended several times to better integrate the stabilisation view. The increased emphasis on the structural balance is a case in point. A continuous respect of the MTO allows automatic stabilisers to play out under ordinary shocks without breaching the excessive deficits criteria. More flexibility has been recently added. For example, escape clauses provide leeway to cope with unusual events or severe downturns affecting a particular country and for managing extraordinary circumstances at the euro area level. The clauses could be triggered when monetary policy, the tool of choice for managing the area-wide macroeconomic condition in normal times, would benefit from fiscal policy support.

Those features combined together a priori offer a solid compromise of the two views. However, the SGP's track record with regard to its objectives of curbing debts and maintaining stabilisation is mixed at best. The SGP has acted in some instances as a safeguard on undisciplined policies,[3] but it has not prevented the build-up of large public debts in several countries. There are now doubts that the future primary balances required to stabilise that legacy of debt can be delivered. Meanwhile, procyclical tendencies have become apparent, both in cyclical upswings and downturns.[4] The narrative regarding the role that automatic stabilisers can play once the MTO has been achieved is partially flawed.[5] Besides, the enduring predominance of headline balance targets in many circumstances compromises the conduct of steady and sound policies. Finally, at the aggregate level, the euro area fiscal stance may also occasionally be damagingly procyclical. This was particularly true in the "double dip" recession of 2012-13.

Three conceivable avenues

If one admits that finding an accepted balance between the two views is essential, what paths can be envisaged for the future? Three conceivable avenues can be depicted.

The first avenue, an immediate necessity in any event, is to credibly and sensibly implement the present legal European fiscal framework. The current framework can be seen as an acceptable compromise between considerations of sustainability and stabilisation.[6] Perhaps the above tensions are exaggerated and do not stem from bad design – indeed, no alternative design could be perfect, either. However, a growing concern with the present SGP is that the (always fragile) consensus over its content is being increasingly questioned.[7] This erosion of legitimacy suggests that there is a case for at least exploring alternative frameworks which have a chance of being more effective.

In this vein, a second possible avenue would be to undertake a fundamental rethink of the rules. Previous SGP reforms have followed an incremental approach that does not directly address the conundrum. Any proscribing rule primarily aimed at sustainability is in fact bound to be attacked for being both excessively tight (in the short term) and insufficiently binding (in the long run). An alternative approach would shift the emphasis from proscribing behaviours to prescribing sound policies. This could be best attempted by using a "fiscal Taylor rule" as a benchmark, explicitly combining the objective of debt sustainability with that of cyclical stabilisation. In essence, such a rule would connect the long-run objective of controlling debt to a governable operational target (the growth of primary expenditure, net of discretionary revenue measures) while plainly arbitrag-

3 This can hold even in the presence of deviations from the rules, since even when the rules are not strictly met, their existence may exert a restraining influence.

4 A. Bénassy-Quéré: Euro area fiscal stance: definition, implementation and democratic legitimacy, In-Depth Analysis, European Parliament, July 2016; L. Eyraud, V. Gaspar, T. Poghosyan: Fiscal politics in the euro area, IMF Working Paper No. 17/18, 2017; C. Alcidi, G. Thirion: The Stabilising Role of US Federal Fiscal Institutions – What Lessons for the Euro Area?, in: Intereconomics, Vol. 52, No. 3, 2017, pp. 137-142.

5 One problem is that countries must first attain the MTO via consolidations that themselves may be ill-timed. Another issue is that countries may benefit from large revenue windfalls that make it temporarily too easy to meet the MTO. In general, the level of the structural balance is too uncertain and prone to revisions for serving as reliable metric to the operational conduct of annual budgets.

6 The current body of interpretation of the SGP is captured in European Commission: Vade Mecum on the Stability and Growth Pact, European Economy Institutional Paper No. 52, March 2017.

7 Tellingly, the SGP is simultaneously criticised as too "austere" and too "lax". Observers can only agree that it has become too complex, missing the point that complexity acts as a veil masking more fundamental divides.

ing the possible trade-offs with output stabilisation.[8] A single prescribing rule of that kind, substituting for the current plethora of rules, could be used as a reference for conducting fiscal policies if considered together with significant institutional changes, including entrusting the assessment of economic conditions and fiscal forecasts to credibly independent bodies.

A third conceivable avenue, with which the rest of this piece is concerned, would involve the introduction of a targeted stabilisation function at the European level.[9] Assigning the function of macroeconomic stabilisation to the federal level is in line with time-honoured principles of fiscal federalism. In the EMU context, the more specific intention would be to combine simplified rules (re)focused on sustainability for national budgets with a common stabilisation capacity acting as an absorber of large (positive or negative) shocks. The simplified rules could correspond to a version of the net expenditure rule-cum-debt anchor alluded to above, but without the introduction of a fiscal Taylor rule as a stabilisation instrument.

In what follows, we focus on this third route and discuss some considerations regarding the proper design of the stabilisation capacity for complementing the working of national stabilisers.

Value added of a stabilisation capacity

The principal objective of a common fiscal stabilisation capacity is to complement the national stabilisers in smoothing out large economic shocks. There are justifications for addressing both country-specific shocks and common area-wide shocks.

As regards *country-specific shocks*, the large national budget stabilisers constitute the first line of response, but they may be constrained or ineffective.[10] Depending on their design, fiscal rules may limit the scope for providing support in bad times and may not provide enough incentives for building up buffers in good times. Moreover, liquidity-constrained governments may face high marginal borrowing costs in the event of shocks, triggering financial market disruptions. Concerning *common shocks*, monetary policy actions may be usefully complemented by fiscal policy in unusual circumstances, such as large downturns or at the zero lower bound. The aggregate fiscal stance is an undetermined outcome in the euro area, and voluntary coordination may not suffice to overcome this limitation. Stabilising the area-wide position is also helpful to stabilise national shocks, given the existence of a common component in national business cycles.[11]

Importantly, a stabilisation capacity forced to maintain a balanced budget on an annual basis would run into severe problems in practice. For example, in the event of a common downturn, it would imply transfers from countries in bad times to countries in very bad times, a feature bound to generate controversies. Instead, the stabilisation capacity must be able to achieve surpluses when the euro area as a whole is experiencing good times, and it must be allowed to run a deficit in bad times.

Design options for a stabilisation capacity

Conceptually, there are two broad approaches: a dedicated stabilisation fund and a genuine euro area budget (see Figure 1).

- A stabilisation fund effectuates transfers to national budgets under adverse circumstances. In its pure form, member states remain free to allocate the extra funding to expenditures of their choice. This is an insurance device. One key design consideration is to credibly ensure the avoidance of moral hazard and permanent transfers.
- A full euro area budget moves competences up to the European level, with the concerned policies elaborated and democratically legitimised at that level. This could include a common unemployment benefits system and public goods related to cross-border investments, security or the environment, for example. This would be a more ambitious project by nature, since it implies giving allocative functions to the EU level, with stabilisation a by-product of the construction, not its main (or sole) objective.

There are also hybrid options. For example, a stabilisation fund can be subject to certain conditions of use, such as the earmarking of funds to particular outlays. This could include investment-related spending, unemployment benefits, or more generally labour-market related expenditures. Such earmarking could be a step towards a genuine euro area

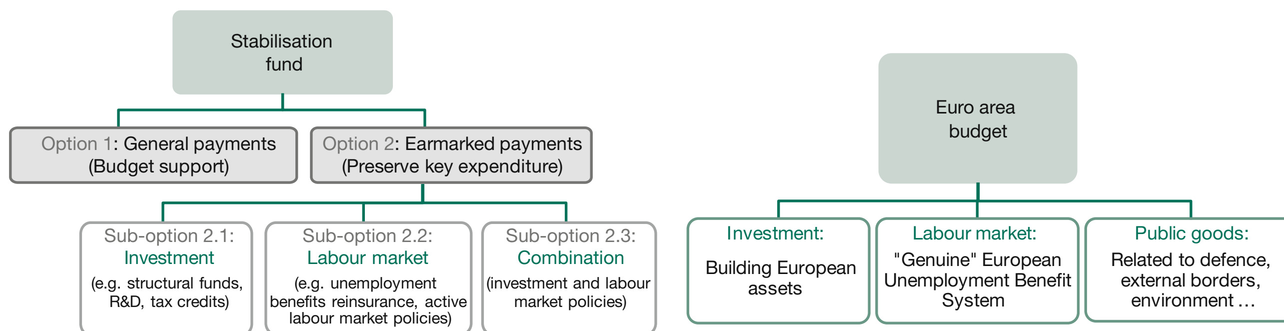
8 A fiscal Taylor rule is presented in N. Carnot: Evaluating fiscal policy in EMU: a rule of thumb, European Economy Economic Papers No. 526, 2014. The use of a (net) expenditure rule as an operational target together with a long-run debt anchor is also taken up in M. Andrle, J. Bluedorn, L. Eyraud, T. Kinda, P. Koeva Brooks, G. Schwartz, A. Weber: Reforming fiscal governance in the European Union, IMF Staff Discussion Note, SDN/15/09, 2015; and G. Claeys, Z. Darvas, A. Leandro: A proposal to revive the European fiscal framework, Bruegel Policy Contribution No. 7, 2016.

9 The setting up of a stabilisation capacity in EMU is an old idea. It has been revived over the past years at the policy level, most recently in the Five Presidents' Report; see J.-C. Juncker, D. Tusk, J. Dijsselbloem, M. Draghi, M. Schulz: Completing Europe's Economic and Monetary Union, European Commission, 2015.

10 J. von Hagen, C. Wyplosz: EMU's decentralised system of fiscal policy, European Economy Economic Paper No. 306, 2008.

11 P. De Grauwe, Y. Ji: Flexibility Versus Stability: A Difficult Tradeoff in the Eurozone, in: Credit and Capital Markets – Kredit und Kapital, Vol. 49, No. 3, 2016, pp. 375-413.

Figure 1
Conceptual options for a stabilisation capacity



Source: Author's illustration.

budget, although most allocative decisions would remain in national hands.

Cyclically sensitive bases or "active stabilisation"?

Noticeably, the above approaches may not be equally effective in providing stabilisation. A common budget is assumed to offer stabilisation through the working of automatic stabilisers. This requires that the revenue and/or expenditure sides of the budget be cyclically sensitive. Even then, however, the amount of stabilisation automatically achieved by a budget would be limited. For example, a massive cyclical variation of 25% of the revenues of a budget that was two per cent of GDP would support the economy to the tune of 0.5% of GDP. That is non-negligible but unimpressive, given the implicit magnitude of the shock.

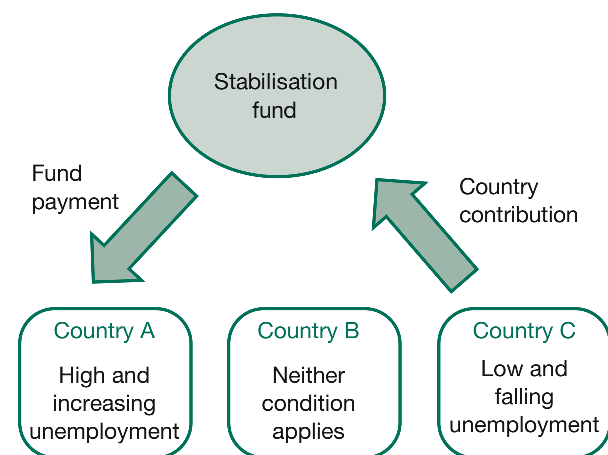
By contrast, the approach of a dedicated fund specifically designed for stabilisation purposes provides more "bang for the buck". As a rough illustration of that point, one can imagine a common pot to which countries contribute 0.25% of GDP annually. These accumulated funds would allow the payment of up to about 2.5% of GDP every decade, a support more commensurate to the stabilisation needs associated with large downturns.

This elementary reasoning, while rough, suggests that relying solely on the automatic stabilisers from a euro area budget of modest size is an unconvincing way to provide meaningful stabilisation. Some centralisation of budgetary functions might be relevant from an allocation viewpoint and pursued for that reason. But that move is neither necessary nor sufficient for delivering central stabilisation. For that purpose, what is required is "active stabilisation", whereby support and restraint are activated under specific circumstances.

Given this conclusion, a decisive question concerns the choice of an appropriate trigger for initiating and withdrawing support. The output gap is not the most auspicious indicator in this regard, given the large uncertainties and controversies in its measurement, in particular in attempting to obtain an accurate real-time reading. A more credible trigger could be found by relying on a so-called "double condition" for the unemployment rate (Figure 2).[12] A double condition would be based on both the level and the rate of change of the unemployment rate. It could convincingly restrict the operation of the stabilisation function to large downturns, during which support would usefully complement national stabilisers.

12 N. Carnot, M. Kizior, G. Mourre: A credible stabilisation capacity for the euro area, European Economy Economic Papers, forthcoming.

Figure 2
The double condition for unemployment rates



Note: High unemployment refers to an unemployment rate higher than the average of the past 15 years, while low unemployment means the opposite. Increasing unemployment refers to an unemployment rate higher than the previous year, while falling unemployment means the opposite. Country B could have high but falling or low and rising unemployment, but it would neither contribute to nor receive payments from the fund.

Source: Author's illustration.

Moreover, because it is based on observed variables only, the double condition can credibly be applied symmetrically. This enables the financing of the fund through contributions raised during economic upswings, thereby alleviating the political economy problem of saving windfall revenues in good times. In this approach, there is no need for an external resource to finance the stabilisation capacity: it is self-financed by contributions that are an integral part of the stabilisation function. It also convincingly ensures intertemporal budget neutrality.

The interaction with fiscal rules

As noted earlier, a refocusing of fiscal rules on the discipline objective could be a counterpart to the introduction of a common stabilisation capacity. A natural outcome would be to confine the consideration of the stabilisation objective to the working of automatic stabilisers. That simplification could be a prerequisite for a credible implementation that would not be perennially contested on economic grounds. Nevertheless, it would still require the common stabilisation capacity to be powerful enough. If, for example, it were restricted to catastrophic, "once-in-a-century" shocks, it might not be sufficient to assuage requests for providing some stabilisation through the rules for national budgets.

The basic channel of interaction would be as follows. In significant downturns, the stabilisation capacity effectuates a transfer to member states that increases the space available under constraining fiscal rules. To the extent that the rules are binding, that additional space allows the conduct of a more supportive stance than would otherwise be possible. Depending on the parameters, this would avoid procyclical cuts in spending or low quality tax hikes, and could even permit a modicum of countercyclical action.[13]

Conversely, during upturns, a transfer from member states to the stabilisation capacity reduces the space under constraining fiscal rules. That forces the construction of additional buffers in the upper part of the cycle, alleviating in particular the standard political economy problem of wasted

13 A noteworthy corollary concerns the mechanism through which a common unemployment benefits scheme, or a reinsurance system for national unemployment benefits, actually works for supporting demand. Crucially, the main effect would not be to increase total spending on unemployment benefits, but rather to substitute EU financing for national financing of unemployment benefits. In turn, that substitution would free space under constraining fiscal rules that would enable the conduct of a less restrictive policy elsewhere. That induced effect elsewhere in the budget is the one that matters in terms of support to the real economy. But it can be similarly and more simply obtained by just "sending cheques" to the general budget.

Box 1
The interaction of fiscal rules and a stabilisation capacity

As an example, we envisage three possible simplified fiscal rules:

i. Headline balance rule (HBR): This rule consists in meeting a given target for the headline balance of general government.

ii. Expenditure rule (ER): This rule requires adherence to a given path of general government expenditure. It is adjusted for the yield of new revenue measures. This rule is in the spirit of the recent evolution of the SGP and the proposals for simplification mentioned earlier.

iii. Fiscal Taylor rule (FTR): Like the previous rule, this one requires adherence to an expenditure target (net of revenue measures), but it arbitrages this sustainability element with a stabilisation component.

In cases (i) and (ii), a stabilisation capacity can be introduced: HBR-SC (headline balance rule with stabilisation capacity) and ER-SC (expenditure rule with stabilisation capacity). For case (iii), this is not envisaged, as the rule for national budgets already makes explicit provisions for stabilisation.

Figures 3 and 4 plot the response to an adverse exogenous shock that is forecasted to increase the headline deficit by €1bn, starting from a position where the rule is met and the stabilisation capacity is inactive. The parameters are illustrative but realistic.[1] Figure 3 shows the extent to which additional measures must be taken in the national budget. With a headline balance rule, restrictive measures must be adopted to continue meeting the headline target, resulting in a procyclical contraction. Fewer restrictive measures are needed if the stabilisation capacity is at play. The chart assumes that half of the cyclical effects of the shock on the deficit are absorbed by the stabilisation capacity, but the size of that effect depends on the strength of the scheme.

1 For simplification purposes, the feedback effects on the economy of fiscal measures are ignored, though this is a gross simplification.

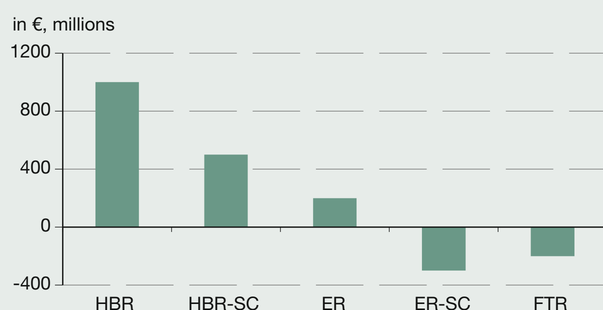
Box 1 (contiued)

The interaction of fiscal rules and a stabilisation capacity

With an expenditure rule, the amount of measures to be taken is more limited, even in the absence of a stabilisation capacity. That is because only a small fraction of expenditure is cyclically sensitive. Put differently, the automatic stabilisers play out on the revenue side, as is evident in Figure 4, which shows the national borrowing needs. If the expenditure rule is combined with the stabilisation capacity, it is even possible that no contractionary measures need to be taken, or even, as shown in Figure 3, that a modicum of countercyclical action can be undertaken (again, depending on the precise parameters). While the presence of the stabilisation capacity permits a more supportive stance, it does not involve additional national borrowing – instead, borrowing happens at the fund level (not represented in the figures).

Figure 3

Consolidation (+) or supporting (-) measures in response to a severe shock



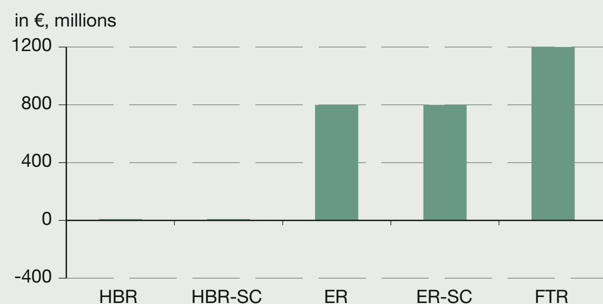
Note: The exogenous shock is assumed to increase the headline deficit by €1bn if policy is unchanged. With a headline balance rule (HBR), the government takes offsetting measures of €1bn, which is reduced to €500m where the stabilisation capacity provides support of €500m (HBR-SC). With an expenditure rule (ER), offsetting measures are needed to the extent (€200m) that the shock increases spending, e.g. on unemployment benefits. When combined with the stabilisation capacity, the expenditure rule can in fact allow policy to remain neutral, or even provide a modicum of countercyclical support (-€300m, ER-SC). With a fiscal Taylor rule (FTR), policy balances between maintaining a primary balance conducive to debt stabilisation and smoothing out the cyclical shock. The precise net effect (-€200m on the chart) depends on the parameters used.

Source: Author's illustration.

With a fiscal Taylor rule, a broadly neutral or even mildly countercyclical policy can be implemented, just as in the case of an expenditure rule combined with the stabilisation capacity. The difference is that it involves additional borrowing at the national level. To counter excessive liquidity constraints, there might be a case for a stabilisation capacity that provides credit, if not transfers.

Figure 4

Additional national borrowing needed in response to a severe shock



Note: With a headline balance rule (HBR), the national financing needs are unaffected by the shock due to the adoption of offsetting contractionary measures (HBR and HBR-SC). With an expenditure rule, the national borrowing needs are increased to the extent that automatic stabilisers are allowed to play out, in particular on the revenue side (ER and ER-SC). The cases with a stabilisation capacity (HBR-SC and ER-SC) differ from their non-SC scenarios because of the existence of EU borrowing (not represented), which enables a more supportive policy. With the fiscal Taylor rule (FTR), the shock accommodation is entirely financed at the national level.

Source: Author's illustration.

good times. In this respect, the stabilisation capacity can play a role similar to a national rainy day fund, but in a more effective manner.[14]

If proposals for a stabilisation capacity were to move forward, a full-fledged technical analysis of its combined effect with the fiscal rules would be necessary. To a point, there is a degree of substitutability between what can be achieved through rules for national budgets and what is delivered by a stabilisation capacity. However, that substitutability is imperfect. The stabilisation capacity brings two features that cannot be achieved at the national level: a stronger commitment device, which as noted may be particularly useful in order to construct fiscal buffers, and a dimension of risk-sharing by substituting EU borrowing for national borrowing.

Box 1 provides only a brief sketch of the needed analysis. The upshot of this exercise is that, from the perspective of the stabilisation objective, the joint design of simplified fiscal rules and a common stabilisation capacity should take two questions into consideration. First, concerning demand support, what is the total effect of the national budget and the stabilisation capacity as a response to a severe shock (Figure 3)? Second, what is the split of that response between national and EU borrowing (Figure 4)? There is a bi-dimensional range of responses to these questions, as a function of the specifications of both the fiscal rules and the stabilisation capacity.

14 The effectiveness of national rainy day funds in incentivising buffers in good times is limited by a technical reason – the national account treatment of national rainy day funds, which are consolidated with the general government accounts. In addition, national rainy day funds can easily be interrupted as a result of political pressures in the national polity; this would be more difficult where there is a commitment to a European stabilisation fund.

Conclusion

The latest incarnation of the SGP has given considerably more weight to stabilisation concerns and growth issues in general. In the short term, the sensible and credible implementation of the current fiscal framework is critical under any scenario. For the long term, rules which are (re)focused on sustainability in combination with a common stabilisation capacity against large shocks could prove a more effective arrangement. In such an arrangement, it is essential to design the stabilisation capacity and the rules-based fiscal framework in tandem, including in their detailed specifications. Moreover, good design features would help to raise the effectiveness and the credible functioning of the stabilisation capacity, including in particular an appropriately symmetric trigger for generating support and contributions.