ECONOMIC GOVERNANCE IN THE E.U.

Aspects of Effectiveness and Legitimacy

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ASYMMETRY #1

Pillar I : Fiscal Management and Stabilization

- European Fiscal Board, EU level
- National Fiscal Boards: Established
- Institutional Framework : Stability Pact
- Policy Framework : Instruments (Fiscal Compact)

Pillar II : Competitiveness and Productivity developments

- Competitiveness Board, EU level: NONE
- National Competitiveness Boards: Vague
- Institutional Framework : NONE
- Policy Framework : Vague (CA limits)

ASYMMETRY #2

FISCAL MANAGEMENT REQUIRES:

**Fiscal policy should be used to suck purchasing power out of the market,
or to pour purchasing power into the market,
through a primary surplus or deficit
of government revenue over government expenditures respectively.**

**Thus far:
Fiscal Policy cares only about Deficit excesses,
NOT about Surplus excesses**

➔ This instills a recession bias in EU economies.

Fiscal Policy should become bi-directional

**➔ Spillovers from surplus-reducing expansions will mitigate
the recessionary effects suffered by deficit-containing countries**

ASYMMETRY #3

The Expenditure versus Taxation debate

Managing Public Expenditure

Government expenditures are designed for specific purpose (defence, health, education, social benefits, etc)

➔ this makes it operationally risky and/or politically difficult to turn these flows of expenditure on and off in the interests of general control over the debt burden.

Government expenditures are directed toward certain groups,

➔ their change is bound to have asymmetric effects across the various sectors of society

This impact differentiation may pose extra political difficulties in fine tuning public expenditure (especially downwards) and give rise to issues of unequally spreading the burden of adjustment.

Tax adjustment: The adjustment of tax rates may include:

- The general rate of income tax,
- The VAT rate,
- Lump-sum taxation
- Compulsory national insurance contributions

➔ **A change in taxation is impacting across all the sectors of the economy**

But not always in a unified way, and not without distortions!

- **investment uncertainty**
- **factor costs**
- **inflation effects**

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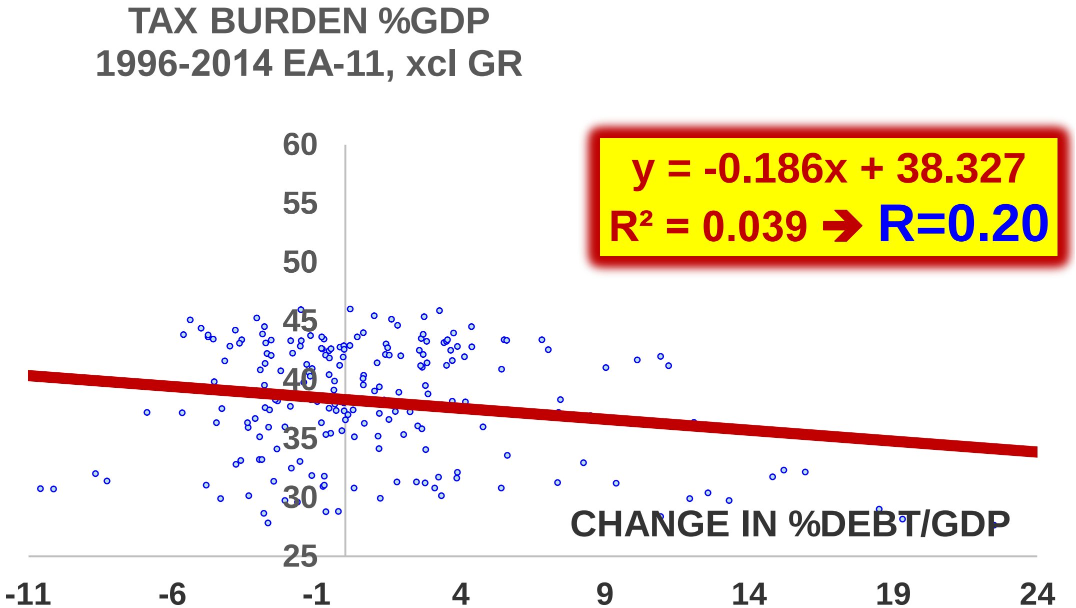
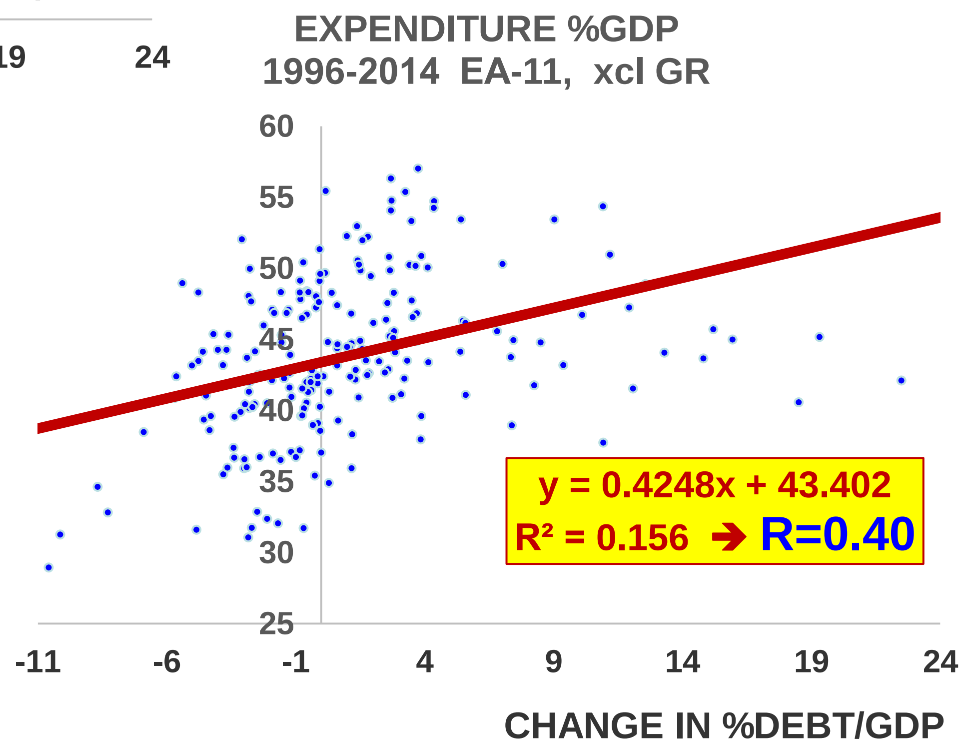
THE EFFECTIVENESS OF FISCAL INSTRUMENTS:



Tax changes, not very effective for debt containment



Public expenditure, seems more effective for debt containment

ASYMMETRY #4

POLICY ANCHORS

Collective paper: IMF May 2015

"Reforming Fiscal Governance in the European Union"
By Andrle, Bluedorn, Eyraud, Kinda, Koeva-Brooks, Schwartz, and Weber

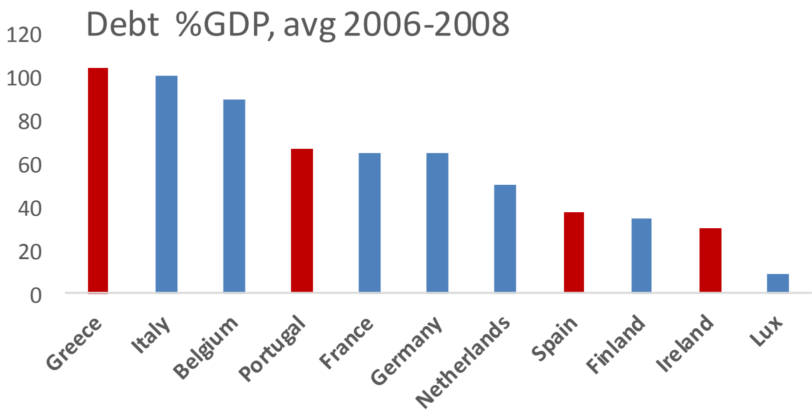
"As a stock variable, the public debt-to-GDP ratio is considered **a natural anchor** for capturing repeated (cumulative) fiscal slippages that flow variables, like the budget deficit, would not capture."

EC 21 Oct. 2015: "Completing Europe's EMU", p3

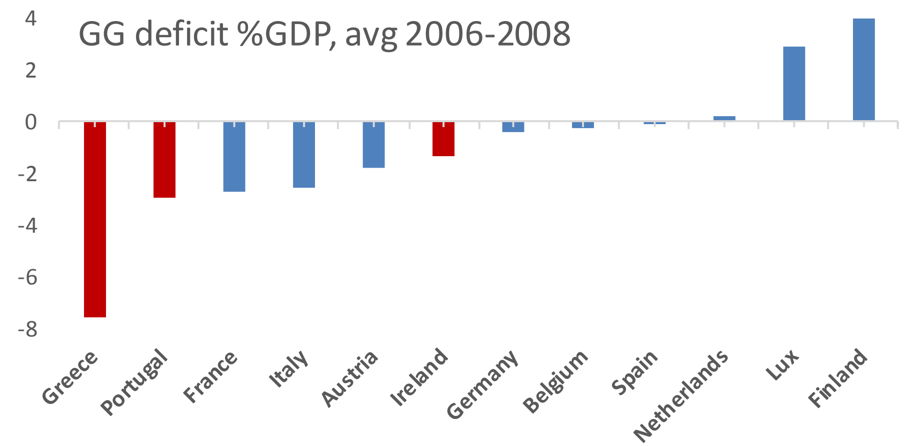
Better rules: "A stronger focus on debt: the limit 60% operational…"

Shortcomings: Slow in capturing oncoming risks

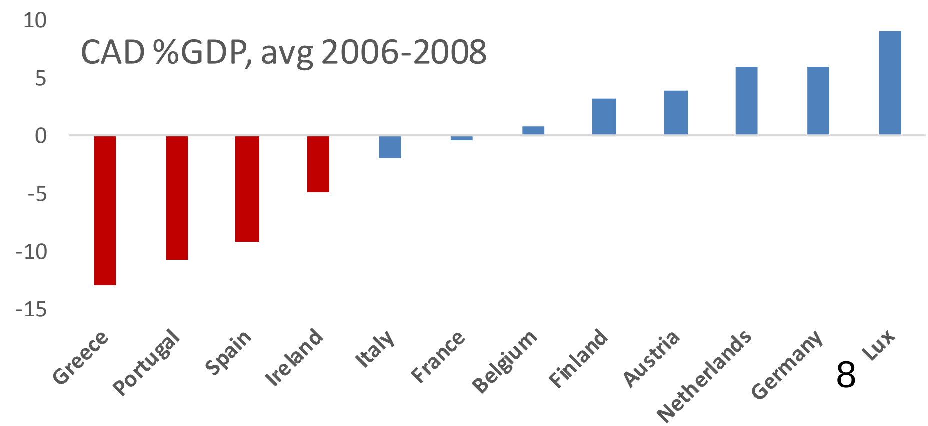
Unnecessary contractionary effects



**If the Debt criterion were used to thwart the incoming crisis in 2009/10,
only Greece would have been picked up.
Not Portugal, Spain, Ireland**



**A Deficit criterion would pick up Greece and Portugal.
Not Spain or Ireland**



An External Deficit criterion would pick up all four bail-outs !!!

ADOPT FURTHER POLICY ANCHORS

Employ a simple combination of Fiscal, External deficits, and Debt burden:

GG balance as % GDP

Current Account as %GDP

Change in Debt stock

A periodic review of debt profiles and deficit trends which takes account of the forward probabilities of borrowing costs.

Actual versus Structural (i.e. cyclically-adjusted) profiles.

INSTRUMENTS

Employ a simple combination of fiscal instruments with the following structure:

In public expenditure, mark some categories as flexible and conditional upon overall fiscal stance. For example, performance bonuses, overtime pay, auxiliary benefits, travelling allowances, etc.

In the tax revenue side, adopt a flexible margin on VAT, income tax and social security contributions that will vary conditionally on the overall fiscal stance.

Note: Changes in the VAT rates are more easily accepted by the public to serve various EU objectives.

A periodic review (e.g. an annual budget) of expenditure plans which takes account of the forward probabilities of the need for general fiscal expansion or restriction, combined with arrangements for frequent and prompt feedback adjustments of certain general tax rates, may well be the most satisfactory procedure.

NATIONAL COMPLEMENTS

Constitutional rules on debt & deficit limits

… But also provide some clear-cut exceptions for emergency cases.

Reform Program

How the economy becomes more competitive worldwide

Investment Policy

Attract some major foreign investments to kick-start the economy

Set them PROACTIVELY to avoid being labelled as an 'unwilling follower'