Fiscal governance in the European Union and the Central and Eastern Europe

Martin Gregor

IES, Charles University in Prague
Web: http://ies.fsv.cuni.cz
E-mail: gregor@fsv.cuni.cz

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INSTITUTE OF ECONOMIC STUDIES
FACULTY OF SOCIAL SCIENCES
CHARLES UNIVERSITY IN PRAGUE

Introduction

Selected proposals to prevent another European debt crisis

- Orderly default; voluntary debt swap is not a technical default and can be assisted by the IMF (Persaud 2010); restore no-bailout clause from Maastricht Treaty; thereby, allow the markets to price bonds better (Melitz 2010)
- European Monetary Fund (Burda, Gerlach 2010; Gros 2010); European Consolidation Pact with automatic tax increase laws (Bofinger, Ried 2010)
- Independent fiscal committees (e.g., fiscal stability council, Eichengreen et al. 1999; Wyplosz 2005)
- Sovereign risk regulation: control of the roll-over risk, multi-level transparency requirements (Burda, Gerlach 2010)
- Marginal deficit tax (e.g. through withholding EU transfers or agricultural subsidies or a VAT surcharge)
- Abolish/modify sovereign ratings (Reisen 2010)
- Revise the Stability and Growth Pact (Franz, Fuest, Hellwig, Sinn 2010)

Second generation of the SGP (Franz et al. 2010)

1. Quasi-insolvency: haircut and an EC-IMF rescue program
   - haircut of 5 percent of the original claims
   - European Commission works out a rescue program
   - funds disbursed contingent on compliance with the program
   - unanimity of EMU countries
   - IMF assistance (conditionality "machinery")
2. Rules: a modified deficit limit in SGP
   - the limit tightened by 1 pp for each 10 pp of debt-to-GDP ratio over 60%
   - penalties for excessive deficits: covered bonds collateralized with privatisable state assets, withdrawal of voting rights, a country may be asked to leave the Eurozone by a majority of the members
   - voluntary exit possible

SGP II and dark reality (EC Spring 2010 Economic Forecast)

	2007	2008	2009	2010	2011
BE	0,38	-1,18	**-6,67**	**-5,9**	**-6,09**
DE	2,7	2,4	-1,62	-3,88	-3,86
IE	6,6	-2,69	**-11,7**	**-10,43**	**-11,83**
EL	**-5,67**	**-8,62**	**-16,11**	**-12,79**	**-14,29**
ES	7,28	0,93	**-7,52**	**-7,29**	**-7,05**
FR	-0,08	-1,05	**-6,26**	**-7,36**	**-7,26**
IT	-2,85	-4,31	**-7,88**	**-8,12**	**-7,89**
LU	11,93	10,53	6,85	3,6	2,74
NL	4,65	3,88	-2,39	-3,93	-3,06
AT	2,65	2,34	-1,05	-2,72	-2,89
PT	0,04	-0,43	**-8,08**	**-8,08**	**-8,01**
SI	6,66	5,04	-0,09	-1,26	-0,74
FI	10,68	9,78	2,4	0,15	0,61
MT	0,61	-1,87	-1,71	-2,45	-1,85
CY	6,57	5,06	-2,72	-4,33	**-5,46**
SK	4,17	3,93	-1,37	-1,08	-0,8
BG	7,28	9,39	3,62	4,46	4,92
CZ	5,4	3,3	-0,44	-0,68	-1,05
DK	11,06	8,98	2,14	-1,1	-0,85
EE	11,22	5,84	6,58	5,64	5,36
LV	7,8	2,95	-3,61	-4,45	**-6,63**
LT	6,31	4,14	-2,83	-3,26	-4,04
HU	-2,59	-2,09	-2,83	-2,99	-2,78
PL	2,6	0,58	-3,2	-3,69	-3,93
RO	5,24	2,27	-1,67	-2,05	-1,98
SE	8,72	7,67	4,27	2,64	3,19
UK	1,73	-1,1	**-9,31**	**-10,91**	**-9,69**

National fiscal institutions

Broad definition (Hallerberg et al. 2007)

- preparation stage: quantitative rules, medium-term budget frameworks (MTBF), agenda-setting power and reconciliation of disputes by FM/PM
- authorization stage: limits on amendments, sequence of decision-making, the relative power of the Legislature
- implementation stage: rules for revenue shortfalls, transfer of unused funds

Narrow definition (von Hagen 2010)

- numerical targets: degree of political commitment to the targets, the length of the time horizon, conditional adjustment rules

OECD Budget Survey covers currently 300 items (formerly only 12-20 items).

Advantages

- directly address the domestic deficit and spending biases
- effectively apply in the absence of supranational institutions
- MTBF are not front-loaded consolidation measures (Corsetti et al 2010, AER): gradual implementation allows the central bank smooth the rise in policy rates
- consolidation announcements (of pay freezes and benefit scheme reforms) more credible if planned within the MTBF
- in contrast, supranational deficit rules interact with domestic politics and generate distortions to productive public spending (Krogstrup, Wyplosz 2010)
- the rules conform with Ten Commandments (Blanchard, Cottarelli 2010):
  - Commandment I: A credible medium-term fiscal plan with a visible anchor.
  - Commandment VIII: Strengthen fiscal institutions.
- distributional consequences tackled domestically

Disadvantages

- epiphenomena? a product of contemporary politics, hence stronger rules may be inconsistent with the domestic political procedures and divisions
- proximate causes? a product of an external constraint (EMU entry, EU entry), hence ineffective without "conditionality machinery"
- the effect is spurious given omitted variable bias
- the effect is country-specific (lack of time variation)
- complex and arbitrary aggregation of fiscal governance indices
- delay in implementation
- numerical targets only motivate creative accounting

Argument 1: Do national fiscal institutions matter?

world	Woo (2003)
EMU	Hallerberg, von Hagen (1999), Hallerberg et al. (2007)
Latin America	Alesina et al. (1999), Stein et al. (1999), Filc, Scartascini (2005)
US	Poterba (1994)
Asia	Lao-Araya (1997)
CEEC	Gleich (2003), Fabrizio, Mody (2006)
country studies	Belgium (Stienlet 2000), Sweden (Molander 2000), Germany (Strauch, von Hagen 1999), Argentina (Abuelafia et al. 2005), Norway (Hagen, Vabo 2005)

Argument 2: Is the effect economically meaningful?

Example of CZ (Svejnar, Dusek, Semerak 2010)

- estimates of the effects of stronger rules on budgets: Hallerberg et al. (2007) and Fabrizio, Mody (2006)
- data: OECD Survey of Budget Procedures 2007
- comparison to the benchmark of Estonia (or, 3rd quartile of the old EU)

→ low-quality institutions in CZ contribute about **0.24% GDP** to the primary budget balance and increase the annual growth of the government debt by about **0.33% GDP** (ibid, p. 12)

Argument 3: Is it only a country characteristic?

Time-variation in a sample of CEEC countries over 1997–2003 is sufficient to use fixed effects, hence separate time-invariant country characteristics (Fabrizio, Mody 2006).

	(1)	(2)	(3)	(4)	(5)	(6)
Lagged debt-to-GDP ratio	0.05	0.03				
	(0.05)	(0.04)				
Unemployment rate	–0.34	–0.41				
	(0.17)*	(0.15)**				
Inflation	0.06	0.14				
	(0.06)	(0.06)**				
Openness index	4.78	7.89				
	(4.91)	(4.42)*				
Fiscal institutions index		7.52				4.27
		(2.08)***				(2.13)**
Government fragmentation			–0.82		6.23	4.27
			(1.81)		(2.74)**	(2.82)
Government ideology:						
Left/right				0.16	0.49	0.42
				(0.12)	(0.19)**	(0.18)**
Nationalism				–0.39	–0.66	–0.57
				(0.15)***	(0.18)***	(0.18)***
Fiscal centralization				0.30	0.48	0.40
				(0.20)	(0.20)**	(0.20)*
Time dummies	Y	Y	Y	Y	Y	Y
Observations	63	63	63	63	63	63

Argument 4: Isn't the aggregation arbitrary?

The rankings are robust to decomposition, yet economic effects are more discernible in composite indices. (Fabrizio, Mody 2006)

Year Country	1997 Overall	2003 Preparation	2003 Authorization	2003 Implementation	2003 Overall
Estonia	1	3	2	1	1
Poland	6	3	1	4	1
Slovenia	2	1	4	7	3
Latvia	3	2	9	1	4
Czech Republic	4	5	2	8	5
Lithuania	5	5	5	5	6
Romania	7	8	7	3	7
Bulgaria	9	5	10	5	8
Slovakia	10	10	6	9	9
Hungary	8	8	7	10	10

Argument 5: One-size-fits-all?

With a large variety of nation states, Europe is a perfect showcase of institutional diversity. Two different modes of governance stand out:

Delegation

- a strong agenda-setter (FM/PM) internalizes costs and benefits
- more frequent for the single-party or two-party governments, and for less competitive elections
- AUT, ESP, FRA, GBR, GER, GRE, ITL

Contract/commitment

- coalitional negotiation and commitment to detailed multiannual fiscal targets
- more frequent for multi-party or minority governments
- BEL, DEN, FIN, IRL, LUX, NLD, POR, SWE

Argument 6: Conductive to creative accounting?

Projection error in national forecasts of the annual budget balance (EU-15, 1998–2004)

Source: von Hagen (2010), Table 4, p. 497

Horizon	t	$t+1$	$t+2$
Constant	0.58**	0.75***	1.4***
Election	0.16	0.86***	0.69
Rules	−0.80***	−0.51	−0.19
Contracts	−0.05	−0.79***	−1.31**
R^2	0.21	0.32	0.42

1. Numerical rules generate pessimistic bias (precautionary budgeting).
2. Contract mode is more pessimistic than delegation mode.

→ The rules reduce the inherent optimistic projection bias of the governments.

Example: Planned budget cuts 2011–2015

Excess cuts: residua from an estimate of the *planned budget cut* 2011–15 for an average EMU+UK country, once controlled for debt-to-GDP, primary balance, overvaluation of the exchange rate, and current account (Manasse 2010)

Do high-index countries generate larger excess cuts?

Correlation of excess cut with:	Greece included	Greece excluded
Delegation index 1991	0,19	0,06
Rules index 1991	-0,27	-0,40
Total index 1991	-0,10	-0,27
Delegation index 2004	-0,27	-0,59
Rules index 2004	**0,44**	**0,74**
Total index 2004	-0,06	-0,27
Delegation improvement	-0,36	-0,45
Rules improvement	**0,35**	**0,52**
Total improvement	0,09	0,22

Conclusions

- National fiscal institutions have a significant and sizeable economic effect.
- Multi-annual targets address part of the inherent optimistic forecast bias and reduce fiscal electoral engineering.
- These institutions can be improved independent on international fiscal rules.
- Contract mode of fiscal governance is in line with precautionary (conservative) budgeting (see van der Ploeg 2010).
- The ideal is a combination of a supranational deficit ceiling with strong domestic fiscal institutions that allow for commitment to productive public spending (see Krogstrup, Wyplosz 2010).

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