The fiscal responsibility pillar in AGS 2015

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Overview

- Definition of ‘fiscal responsibility’ in AGS 2015
- Critique I: fiscal consolidation as a policy priority in spite of evidence about its negative role in the current crisis
- Critique II: negligence of aggregate macroeconomic considerations esp. in EZ
- Policy implications
Fiscal responsibility: AGS2015 definition

- ‘The growth in government debt must be reversed\(^1\) in the years to come in line with the Member States’ obligations under the Stability and Growth Pact’
- Combination of responsible fiscal policies and economic growth:
  - First, the pace of fiscal adjustment should be differentiated according to the fiscal challenges faced by different Member States.
  - Second, the composition of fiscal strategies needs to be designed in a growth-friendly manner: expenditure cuts vs. tax hikes; investment vs. consumption spending
Fiscal responsibility: misinterpreting the evidence?

- Reduction of public debt/GDP ratio through lower deficits/higher surpluses put on same (if not higher) priority and time-horizon as restoring recovery in output growth
- Yet, fiscal efforts since 2010 have been largely responsible for continued recession
- Study by Gechert et al. (2015) suggests that fiscal consolidation in Europe led to 7.7% lower GDP by 2013 compared to a baseline scenario
- Have not delivered lower spreads (ECB did from 2012 with OMT-’whatever it takes’ statement)
- Have not reduced debt/GDP ratios
Figure 1.9. Fiscal policy stance in the EU, 2010-2014

Source: own calculations using AMECO data (UBLGBPS).
Evolution of fiscal austerity in the EU and EA18, 2010-2016 (f)

Source: AMECO (series: UBLGBPS)
Figure 2.3. Unemployment rate and output gap in the EU28 and EA

Source: AMECO, ZUTN, AVGDGP.
Figure 1.5. Gross public debt/GDP ratios, 2010-2015 in the EU

Source: own calculations using AMECO data (UDGG).

(Source: AMECO(series: UDGG))
Figure 1.6. Headline and core inflation rates, EU and euro area, 2008 M01-2014 M012

Source: Eurostat (prc_hicp_manr).
Fiscal responsibility: neglecting the big picture

- Aggregate fiscal stance and broader macroeconomic conditions largely neglected fiscal responsibility among objectives.
- Very low inflation/deflation and virtually zero nominal interest rates due to prolonged weak demand → monetary policy not much traction - uncertain QE effects.
- Under current circumstances: fiscal policy is The tool to stabilise EU/EZ economy.
- Yet, average EU and esp. EZ fiscal stance still too tight given output gap.
- Rules do not force some member states to run more expansionary fiscal policy with same rigour as they enforce fiscal consolidation on others.
Policy implications

- In the absence of federal fiscal policy, some fiscal rules are necessary in the EU.
- In the medium-to-long term the most effective way for ensuring sustainable public finances is output growth, not fiscal austerity, esp. when the latter undermines the former.
- The content and interpretation/implementation of the rules should allow not only for national adjustments to shocks but also enforce national stances that deliver an appropriate aggregate fiscal stance in the EZ/EU, esp. when it comes to running larger deficits/smaller surpluses.
- With interest rates at virtually zero, a negative output gap and the economy at the brink of deflation, fiscal policy is the main tool that can effectively restart the EU/EZ economy and it should be allowed to do so.