Automatic Stabilisers as a Building Block of the Fiscal Union Architecture

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Outline

- Role of automatic stabilisers
- Automatic stabilisers at national level
- Room for stabilisation in the EU fiscal framework
- Deepening EMU to complement national stabilisers
- Private sector stabilisation in EMU
- Public sector stabilisation in EMU

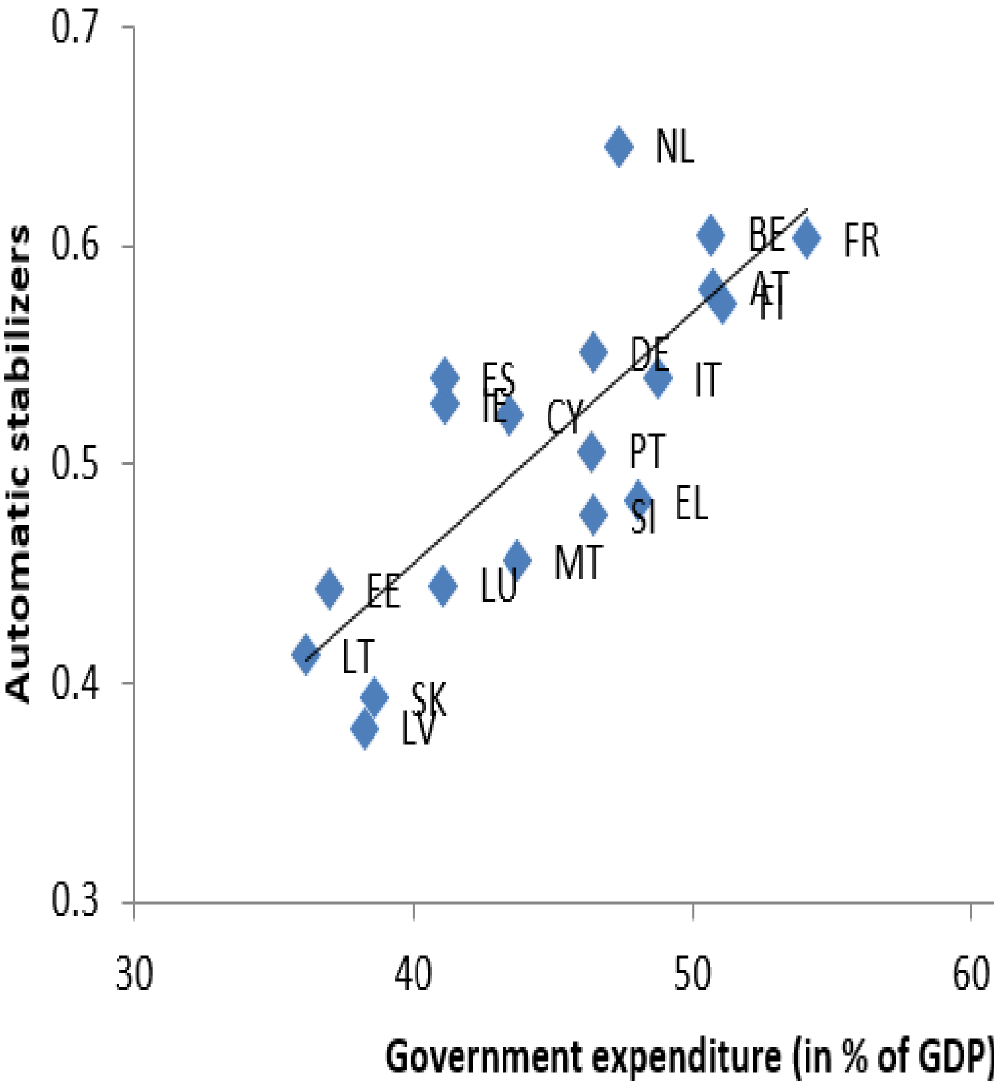
Role of automatic stabilisers

- Automatic stabilisers allow for fiscal reaction…
  - … quickly
  - … independent of un-observable indicators
  - … independent of political discretion

- Positive impact on long term growth, as impact of long downturns and hysteresis effects can be reduced

Automatic stabilisers at national level

- Automatic stabilisers are correlated with the size of government
- Country-specific spending and tax structures matter
- Enhancing national stabilisers is possible, e.g. through changes in unemployment benefits and personal income tax
- Size and effectiveness of national stabilisers are not necessarily adequate, especially in a monetary union



Source: Buti and Gaspar (2015), voxeu.org ; Mourre et al. (2014);

A stabilisation framework for the EA

Stabilisation tool / Type of shock	Monetary	Fiscal	Financial
Asymmetric	–	National stabilisers + discretionary policy	Portfolio reallocation and capital flows
Symmetric	Conventional +unorthodox (*)	National stabilisers + discretionary policy (*) + Fiscal Capacity (*)	External portfolio reallocation and capital flows

(*) In case of severe shocks

Room for stabilisation in the EU fiscal framework

- Fiscal rules allow for stabilisation
  - Structural balance as anchor allows for full play of stabilisers once at MTO …
  - …On the way to MTO, annual required effort modulated across business cycle
- But the SGP does not cater for the very unusual circumstances like those of today, with very low inflation and monetary policy at the zero lower bound
- Lack of fiscal space <u>during</u> the crisis was due to lack of sufficient fiscal retrenchment <u>before</u> the crisis

Deepening EMU to complement national stabilisers

Private sector stabilisation

- private sector risk sharing and risk reduction in EMU (via banks) could partly absorb asymmetric shocks, cushion business cycle

-> ***Banking Union and Capital Markets Union***

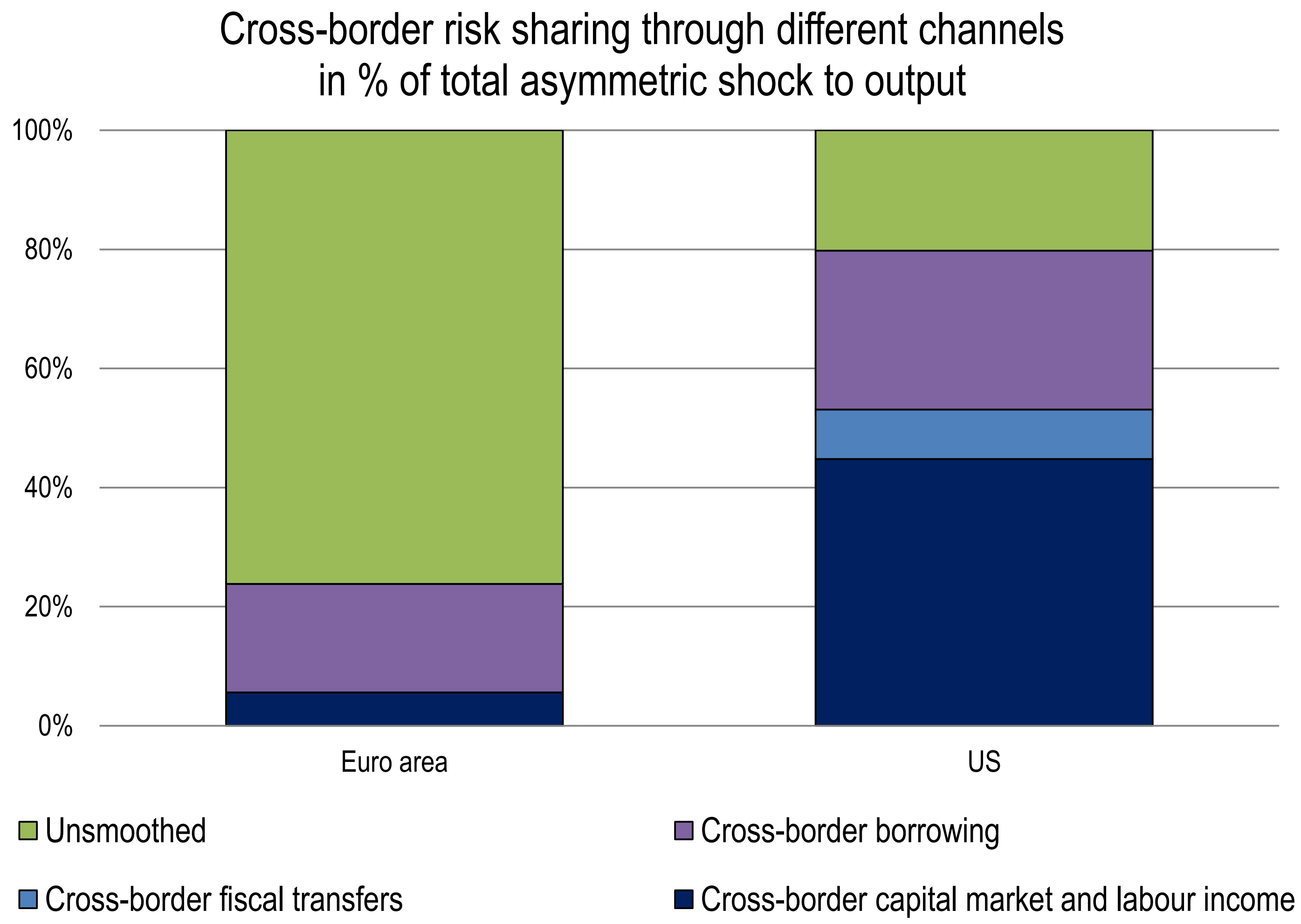
Public sector stabilisation

- Member States sometimes impaired in operation of automatic stabilisers (in long consolidation periods/ high sustainability risks)
- More stabilisation needed at zero lower bound (nominal rigidity)

-> ***Fiscal capacity as solution?***

Private sector stabilisation

Insurance against income shocks in EMU remains low



Source: Buti et al. (2016). Smoothing economic shocks in the Eurozone: The untapped potential of the financial union, voxeu.org, August 2016

Public sector stabilisation (1): A Fiscal Capacity

What for? Limited to unusual circumstances, no going back to fine-tuning. But to stabilise large country-specific shocks and/or common shocks

Key challenges:

- No permanent transfers
- Beware of moral hazard – ensure stricter fiscal discipline
- Respect the subsidiarity principle
- What degree of automaticity and conditionality?
- What conditions for eligibility?

Public sector stabilisation (2):
A Fiscal Capacity

How? Different dimensions and concepts

Stabilisation function based on unemployment

- Cushion both symmetric and asymmetric shocks
- Permanent tool for enhanced stabilisation

Investment capacity

- Short term demand support and long term productivity push
- Crucial when monetary policy is at zero lower bound

Provision of public goods (e.g. security-related)

- Additional stable expenditure at centre
- Stabilisation function and investment capacity can also be considered public goods

Conclusions: How to achieve political consensus?

- Higher private risk sharing allows for lower public risk sharing

- Stronger fiscal stabilisation helps the ECB to go back to "orthodoxy" more quickly

- A Fiscal Capacity at the euro area level and stricter enforcement of the SGP go hand in hand

Thank you!

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Additional slides

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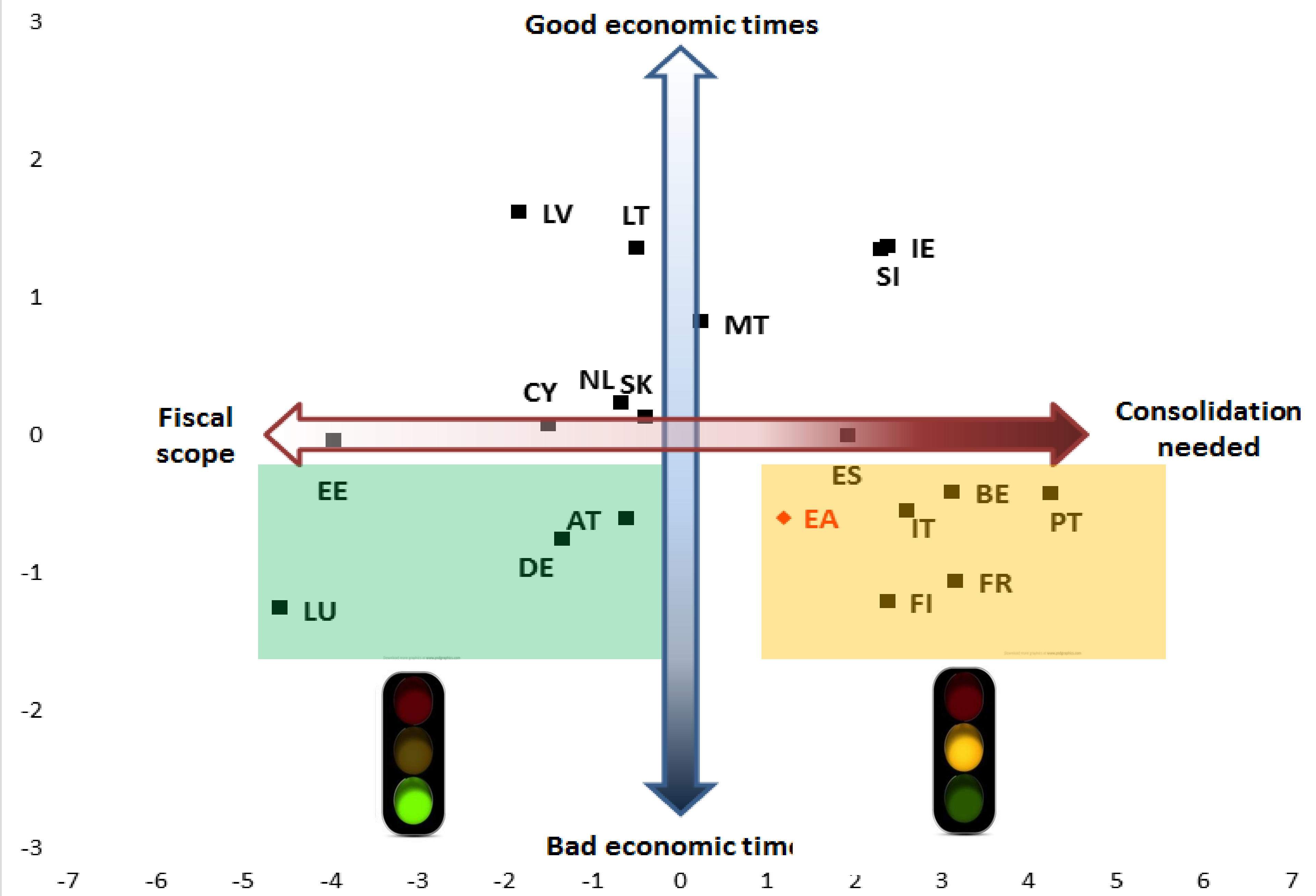
A "fiscal map" of challenges for 2017



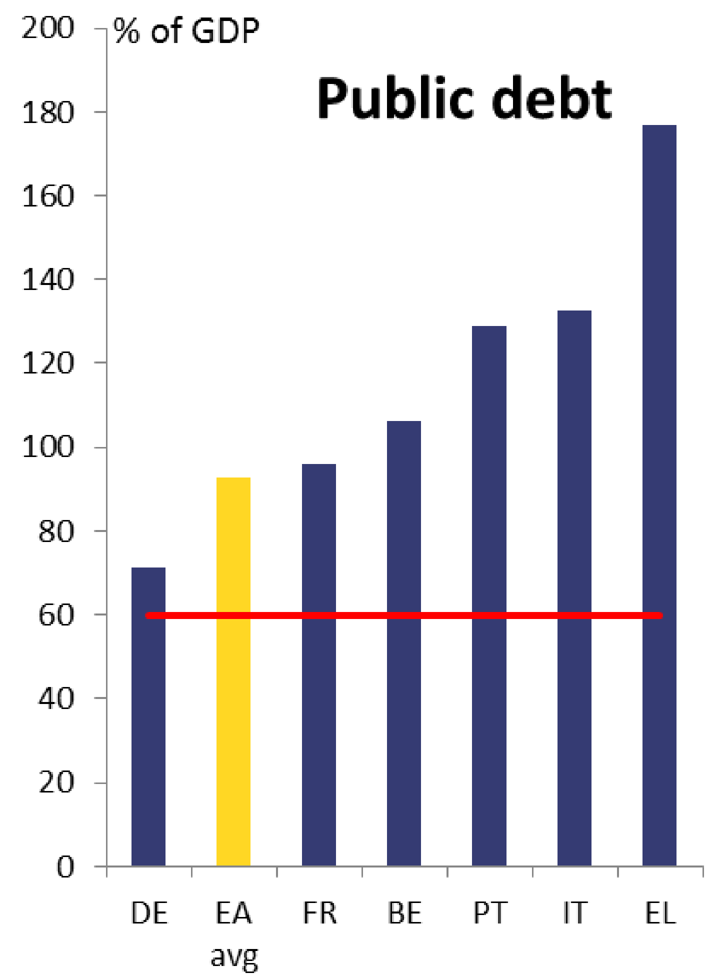
Fiscal policy challenges

- High levels of public debt reduce fiscal room for manoeuvre in some Member States, especially in downturns

- Limited (fiscal) risk sharing

- Implementation of Fiscal rules is challenging

- National fiscal policies don't always add up to adequate euro area fiscal stance



How to enhance automatic stabilisers on national level?

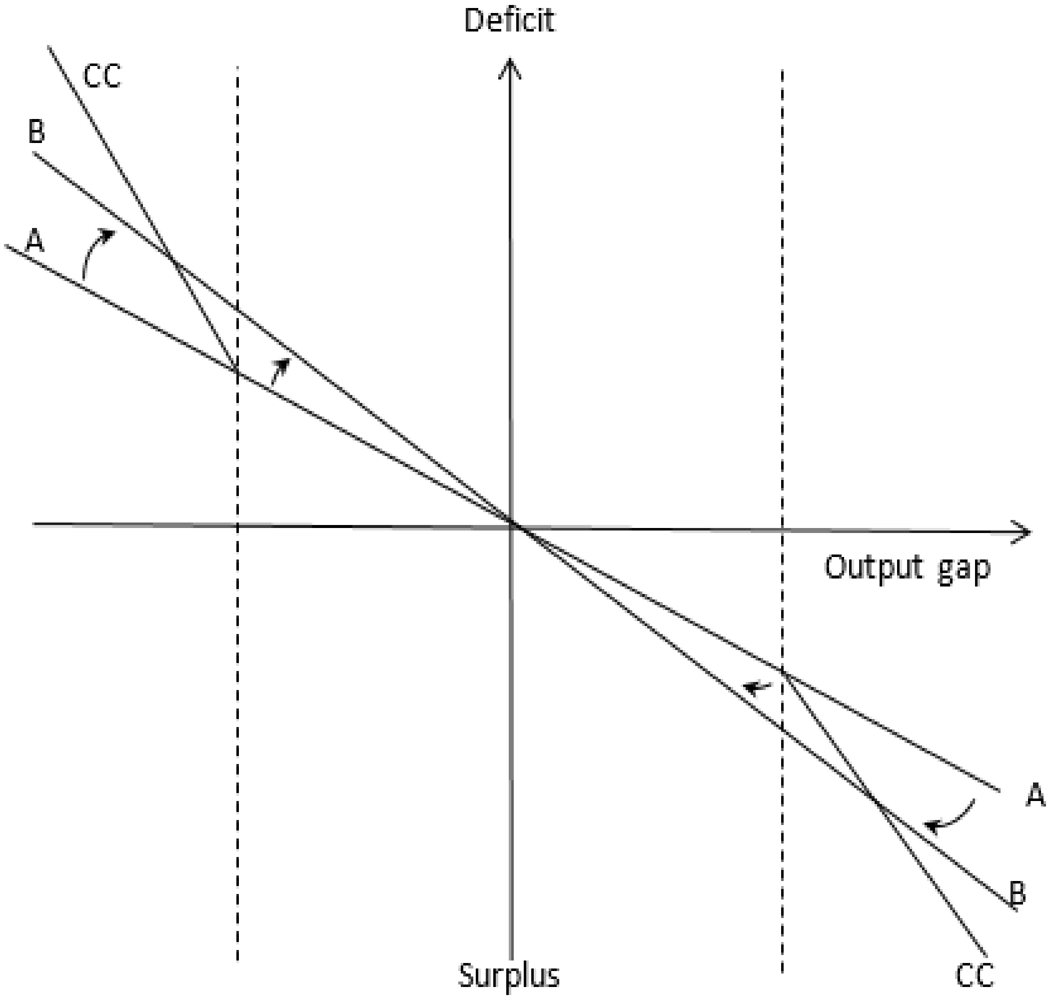
What can Member States do?

More conventional:

- Increase responsiveness to economic activity (A->B)
- e.g. more progression in personal income tax, re-modulate unemployment benefits

More heterodox:

- Engineer a kink in automatic stabilisation in bad times (A->CC)
- e.g. unemployment benefit top-ups, tax deductions for investment



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