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Federal Fiscal Discipline with Uncertainty:

Applications to the EU

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by

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Chapter 6

Conclusion

"The illusion that one has understood the past feeds the further illusion that one can predict and control the future. These illusions are comforting. They reduce the anxiety that we would experience if we allowed ourselves to fully acknowledge the uncertainties of existence."

– Daniel Kahnemann

Fiscal disciplinary measures are now common practice in Europe, both at the country level and the regional level. Nonetheless, profound uncertainty surrounds fiscal policy and often standard point estimates are superseded by current day methodologies. Therefore, in order to answer the question how fiscal discipline is to be preserved without hampering economic efficiency, this thesis extended the existing paradigm for assessing the stringency of fiscal rules to include uncertainty.

The first part of this thesis examined the types and magnitude of uncertainty that may impede the compliance with fiscal targets. Even though European member states' fiscal rules themselves are found to be effective, it is argued that their assessment accounts insufficiently for the difference in uncertainty characteristics of member states. In particular, in **chapter 2** I addressed two issues impeding the success of these measures: macroeconomic uncertainty and fiscal policy reaction. First, member states' macroeconomic uncertainty was found to be substantial. Simulation results, for example, indicated that Spain and Italy are more prone to output shocks than their European counterparts. In fact, as the result of historically larger variances in its macro drivers, Italian debt was found to be affected the most by macro uncertainty in the short-term.

Second, while fiscal policy was generally found to be countercyclical, policy makers may deviate from their historically expected fiscal behavior. The share of this policy uncertainty in the total uncertainty of the debt-to-GDP ratio was found to be considerable relative to macro shocks. Therefore, omitting policy uncertainty, as previously done, would distort the analysis' robustness and conclusions.

The impact of all these uncertainties on fiscal responsibility can then be captured by a more policy relevant measure: the fiscal rule infringement risk. For instance, taking into account the behavioral uncertainty of fiscal policy makers, Spain is found to have the highest upward risk of its debt-to-GDP ratio. Overall, however, the risk measures show that Italian fiscal policy portrays a disturbingly high medium-run uncertainty in comparison to other member states. Consequently, unless sufficient precautions, infringement risk measures may impel the enforcement of stricter surveillance to hedge against disadvantageous outcomes.

Furthermore, **chapter 3** illustrated that similar problems hold for lower levels of government. Although policy makers will always be confronted by more uncertainty the longer the horizon, the results showed that the volatility of the Flemish budget has decreased as a result of the 6th State Reform. Specifically, the range of required cyclical corrections has narrowed after the reform. With the decentralization of a considerable part of personal income taxes, nonetheless, came a higher volatility in regional tax revenues. Before the reform this volatility was part of the volatility of the regional grants via a personal income tax grant for the regions. The increase in regional tax revenue volatility, however, is compensated by a decrease in grant volatility, thereby limiting the overall volatility of the Flemish budget.

The simulation results also suggested that the standard EU methodology for cyclical corrections underrepresents the characteristics of regional budgets. In particular, the semi-elasticities used for cyclical corrections are found to account too little for the specific characteristics of the regional budget. Nonetheless, the PROSPER model presented provides an opportunity. It can be used by policy makers to improve upon the determination of the regional cyclically adjusted budget balance and, consequently, the distribution of required fiscal adjustments over the different levels of government and its regions.

Having established the presence and magnitude of uncertainty, the second part of the thesis shifted the focus toward alternative ways to deal with it. In a federation, for example, penalties are helpful in providing flexibility in fiscal adjustment. **Chapter 4** examined how the trade-off between flexibility and the enforcement of political commitment (via borrowing constraints) is affected by uncertainty. Results indicated that strongly asymmetric uncertainty in a federation's regional budgetary policies makes a borrowing constraint undesirable. The latter was stressed as exceptionally disturbing as EMU member states are still considered to be asymmetric in their stochastics, while stressing borrowing constraints as the principal instrument for fiscal discipline. Uniformity moreover adds to the shortcomings of the fiscal rules in place. Therefore, asymmetric uncertainty may push policy makers towards alternative instruments in a multitier government setup.

Finally, the optimal size of the required adjustment is uncertain. Hence, the electorate and its delegates have to rely on their own (limited) information (about the optimality) when deciding on the fiscal path. Therefore, the last chapter of this thesis considered the importance of information for the institutional organization of fiscal responsibility. In fact, whether to leave technical decisions to an elected politician or an appointed fiscal council, is not only a matter of accountability. The uncertainty in the electorate's preferences was found to be detrimental for the institutional organization of the required fiscal adjustments.

Specifically, in **chapter 5**, I showed that a more than advisory role for fiscal councils is often desirable. A limited informedness of voters about the optimal fiscal policy allows politicians to pander to the public opinion. Moreover, as the superior information of the delegates becomes more costly (i.e. the policy issue becomes more technical) pandering occurs more often, thereby making a fiscal council more preferable. On the other hand, if only an advisory council is feasible, the funds attributed to such councils are found to be below the welfare optimizing level. Yet, an advisory council would increase welfare, either via better informed politicians or as a result of increased fiscal transparency. Hence, a council would accommodate the optimal fiscal adjustment when the information of policy makers is clouded by uncertainty.

In sum, this thesis lends support to the literature emphasizing uncertainty as essential to the appraisal of a country's fiscal position. It established the presence and significance of uncertainty at different levels of government. Moreover, it illustrated the importance of uncertainty for the optimality of the decisions on disciplinary instruments and fiscal adjustments. As a result, it provides fruitful soil for future research on, for example, the institutional features shaping uncertainty or strategies for hedging against volatility.