

Towards a golden rule of public finance in Europe?

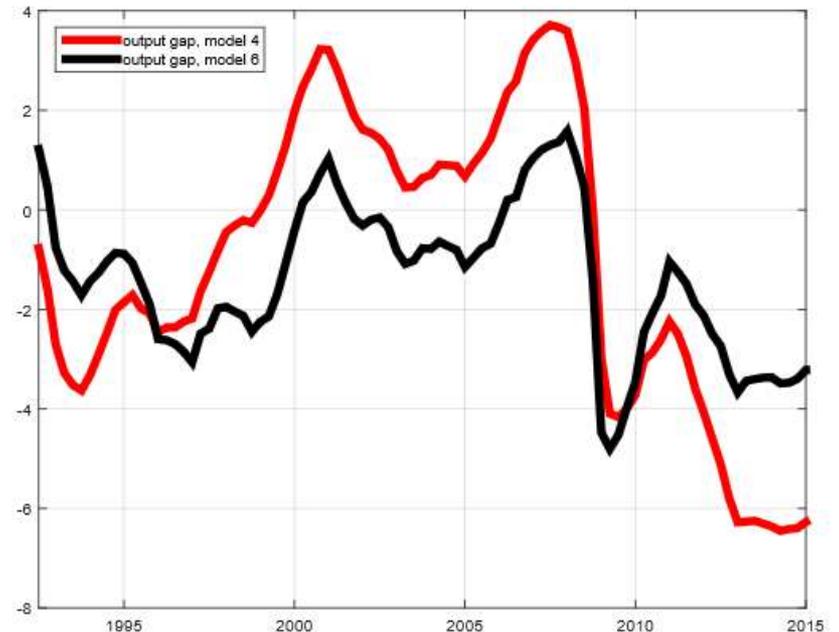
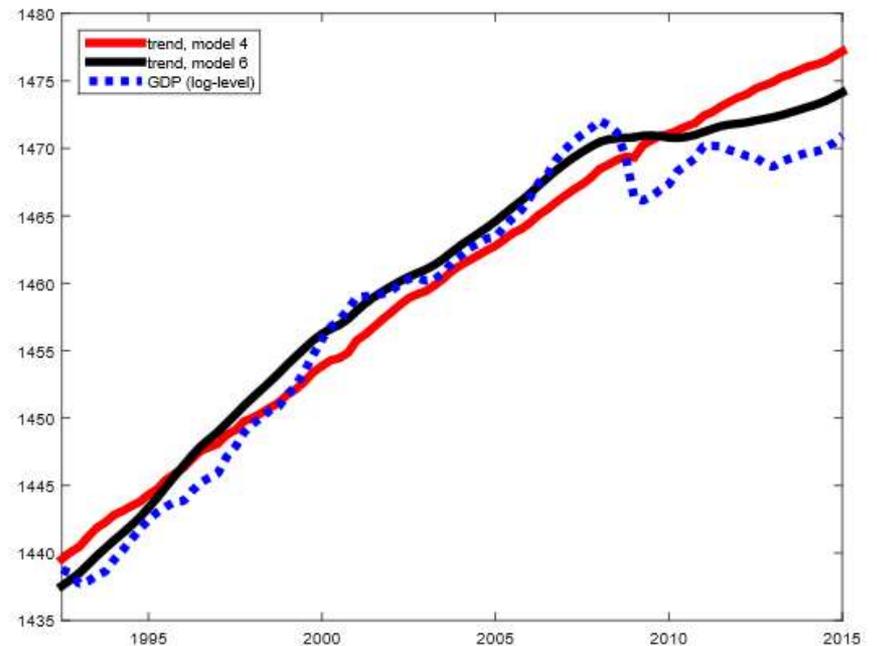
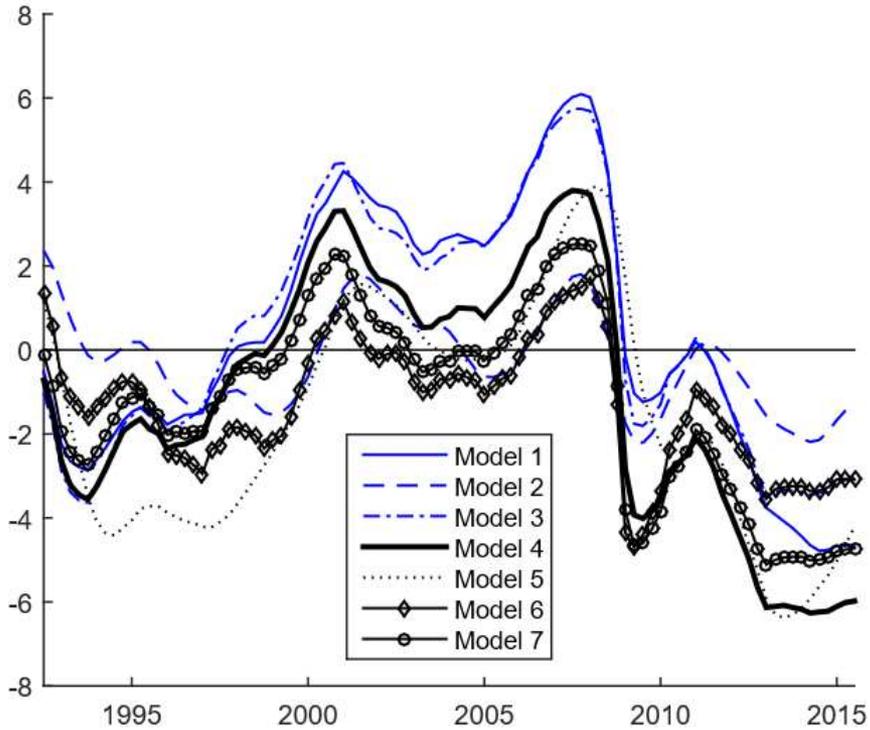
Jérôme Creel
OFCE & ESCP Europe

Progressive Economy Workshop, 12 January 2017

Context

- Secular stagnation, on the demand side
- Monetary policy has done a great deal of job
- The output gap remains negative
- *New* fiscal policy? Yes, actively required!
 - Fiscal space?
 - Lack of net public investment during downturns advocates the adoption of a golden rule of public finance
 - with possible extension to green investment and social investment

Striking!



“(T)he results suggest that reconciling the secular stagnation hypothesis with the core inflation data is a challenge and may imply that policies aimed at stimulating demand should complement supply side policies in the economic policy mix.” (Jarocinski & Lenza, 2016, ECB WP)

Fiscal policy

- It has been back since the Global financial crisis!

The screenshot shows the VOX CEPR's Policy Portal website. The header includes the logo 'VOX CEPR's Policy Portal' and navigation links for 'Create account', 'Login', and 'Subscribe'. Below the header is a search bar and a menu with options like 'Columns', 'Video Vox', 'Vox Talks', 'Publications', 'People', 'Debates', 'Events', and 'About'. The main content area features an article titled 'The New View of fiscal policy and its application' by Jason Furman, dated 02 November 2016. A portrait of Jason Furman is shown next to the article title. Below the article title is a social media sharing bar with icons for Facebook, Twitter, LinkedIn, Email, and a plus sign, along with a view count of 351. To the right of the article is a 'Don't Miss' section with a red header, containing a link to 'Public policy in a zero-growth scenario' by Perotti.

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The New View of fiscal policy and its application

Jason Furman

02 November 2016

The landscape of the fiscal policy debate has changed over the past decade, with academics and international organisations moving away from an 'Old View' of fiscal policy as ineffective. This column uses examples from the US and Europe to highlight the five principles of a 'New View' of fiscal policy, which increasingly appreciates that expansionary fiscal policy is effective in a world of persistently low interest rates, low growth, and strong international linkages.

Jason Furman
Chairman, Council of Economic Advisers

Don't Miss
Public policy in a zero-growth scenario
Perotti

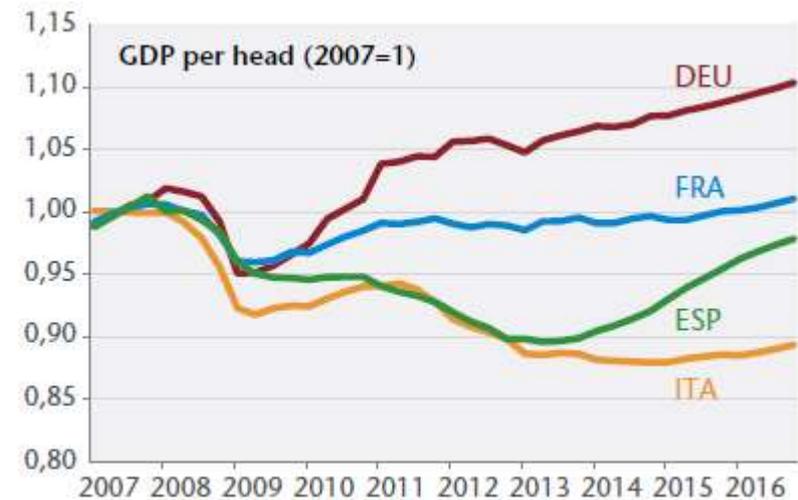
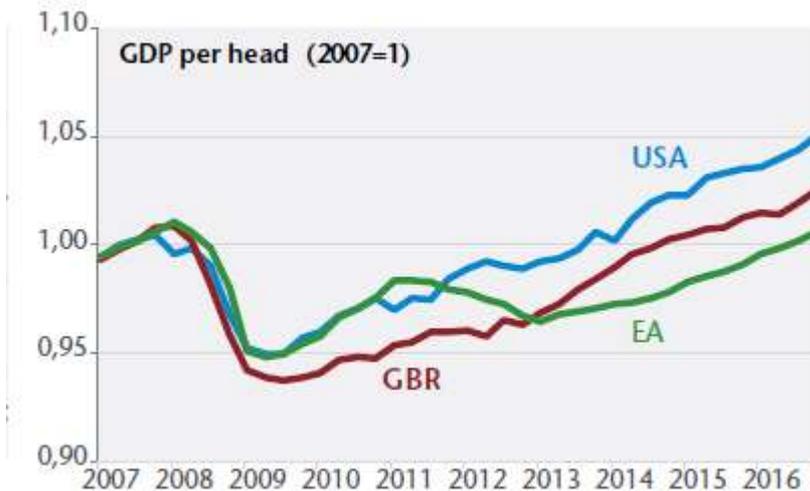
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Fiscal policy (cn'd)

- Many questions, still
 - On-going discussion about the value of fiscal multiplier over the cycle
 - Barnichon & Matthes (CEPR WP, 2016): multiplier larger in recessions only because *contractionary* multiplier larger during recessions
 - High deficits since GFC have produced large debts
 - Crowding-out or crowding-in?
 - Ricardian or non-Ricardian consumers?
 - Should fiscal austerity continue?
 - Should another set of fiscal rules be applied?

Dealing with austerity

- iAGS (independent Annual Growth Survey) project has shown austerity was self-defeating
- The “defeat” was a double-dip recession



Sources: iAGS 2017 with OECD data

- We need another fiscal framework

Why a golden rule of public finance?

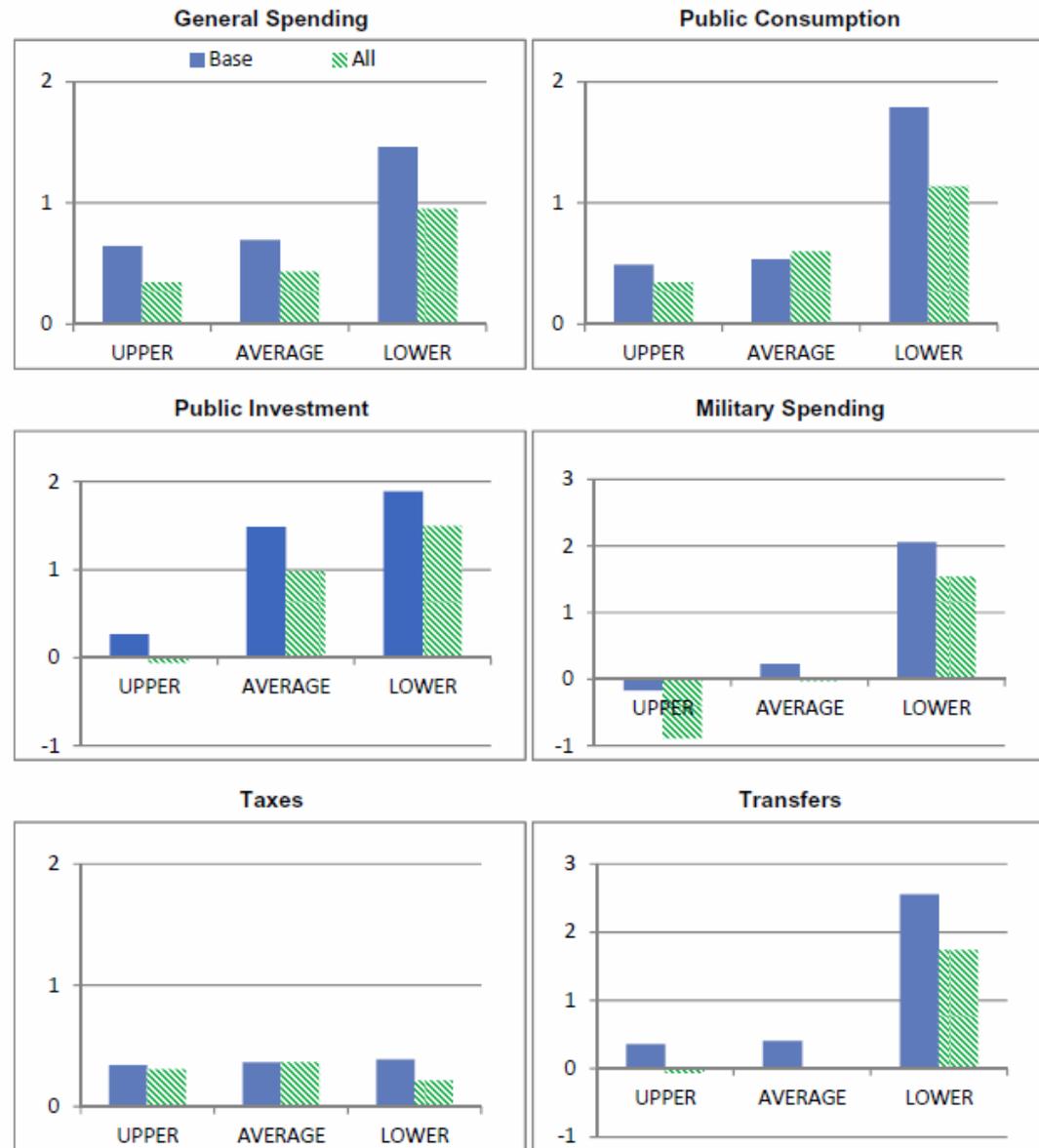
- **Implementation:** Net public investment exempted from SGP rules and the Fiscal compact
- **Summary of main arguments and counter-arguments**
- The pros:
 - economically sensible;
 - fiscal leeway;
 - end of sharp net investment decrease;
 - possibly positive for potential output
- The cons:
 - crowding-out;
 - incentivising tangible assets at the expense of intangible assets;
 - creative accounting bias;
 - debt increase

A golden rule for the short run

- Multiplier effect: the composition effect
- The impact on GDP: an example with French data
- Crowding-out vs. crowding in: an example with French data

Why a fiscal stimulus on investment?

- Most effective tool on average, very effective during downturns!



Source: Gechert and Rannenberg (2014) [meta-analysis]

Why a fiscal stimulus on investment? (cn'd)

- Positive impact of a 1-pt-of-GDP increase in public investment in France (without impact on the supply side)

Tableau 2. Effet comparé sur le PIB d'une hausse de 1 point de PIB de l'investissement public

	Année 1	Année 2	Année 3	Année 4	Année 5
OFCE	1,0	1,1	1,1	0,9	0,8
INSEE	1,1	1,3	1,3	1,1	1,0
FMI	0,5	0,8	1,0	1,4	1,5

Sources : (Abiad *et al.*, 2014), (Klein & Simon, 2010), OFCE, *e-mod.fr*.

Source: OFCE (2016, Investissement public, capital public et croissance, Rapport pour la FNTP)

Why a fiscal stimulus on investment? (cn'd)

- Crowding-out vs. Crowding-in: estimates for France point to a *positive* impact of public investment on private investment

Tableau 1. Effet sur l'investissement privé

Effet linéaire		
Investissement Public	1.02***	
Effets non-linéaires		
	<i>Investissement Public élevé</i>	<i>Investissement Public faible</i>
Investissement Public	0,99***	2,83***
	<i>Output gap positif</i>	<i>Output gap négatif</i>
Investissement Public	0,35	1,51***
	<i>Stock de Capital Public élevé</i>	<i>Stock de Capital Public faible</i>
Investissement Public	1,44***	0,6***

Note : *** indique la significativité statistique à 1 %.

Source: OFCE (2016, Investissement public, capital public et croissance, Rapport pour la FNTP)

Why not a fiscal stimulus *only* in countries with “fiscal space”?

Table 17. Using fiscal space in Germany, Austria and Netherlands: +1% of GDP public spending expenditures from 2017

	Public debt (% of GDP)	Structural balance % of GDP)	Cumulative fis- cal impulse (%)	Cumulative out- put gap (%)
	(1) 2035	(2) 2035	(3) 2015-2035*	(4) 2016-2035
DEU	17	-1.5	1.0	1.1
FRA	0	0.0	0.0	0.0
ITA	0	0.0	0.0	0.0
ESP	0	0.0	0.0	0.0
NLD	14	-1.2	1.0	3.0
BEL	0	0.0	0.0	0.1
PRT	0	0.0	0.0	0.0
IRL	0	0.0	0.0	0.0
GRC	0	0.0	0.0	0.2
FIN	0	0.0	0.0	0.0
AUT	15	-1.3	1.0	2.6
EA	7	-0.6	0.4	0.6

Source: iAGS model.

Source: iAGS 2017 [variants from the baseline scenario]

A golden rule for the long run

- The long run effect of public capital
- The issue of debt sustainability
- The impact of a small but steady rise in public investment in the Euro area

The long run effect of public capital on growth

WHAT HAVE WE LEARNED FROM THREE DECADES OF RESEARCH ON THE PRODUCTIVITY OF PUBLIC CAPITAL?

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Journal of Economic Surveys (2014) Vol. 28, No. 5, pp. 889–916

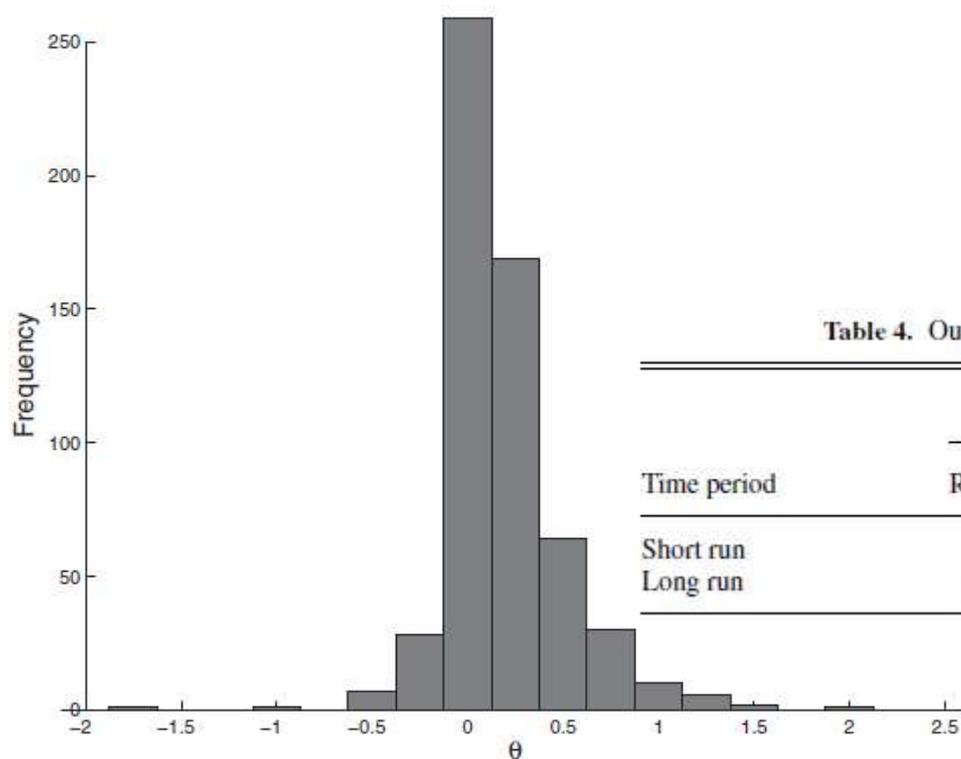


Table 4. Output Elasticities of Public Capital for Various Study Dimensions.

Time period	All Public Capital		Core Public Capital	
	Regional	National	Regional	National
Short run	0.106	0.083	0.154	0.131
Long run	0.145	0.122	0.193	0.170

Figure 1. Histogram of the Output Elasticity of Public Capital.

Notes: The histogram consists of 578 estimates obtained from 68 studies on the production function approach.

Why doesn't the golden rule threaten debt sustainability?

- First, the golden rule must aim at generating a higher GDP
- Second, the golden rule inherently includes a self-correcting device (Creel, 2003)
 - Under the golden rule of public investment, the cyclically-adjusted deficit target would not account for expenditures on net investment.
 - But the deficit target would not be free of interest payments.
 - A higher net investment financed with public debt leads to higher interest payments (all else equal) which weigh on the deficit target.
 - Matching the deficit target requires that if interest payments grow, cyclically-adjusted primary expenditures would have to decline.
 - Interest payments would face a ceiling due to the existence of a floor on cyclically-adjusted primary expenditures.
 - The ceiling on interest payments is, at constant interest rates, a ceiling on debt to GDP ratio.
 - Consequently, the golden rule does not prevent effective debt management
 - It also incentivizes the implementation of the most-productive investments as they will facilitate debt stabilization and sustainability *via* economic growth.

The impact of a rise in public inv. to GDP in the Euro area: fiscal space for (almost) all!

Table 18. Fiscal space and Public investment (2017-2035) – impact on public debt and assets

% of GDP

	DEU	FRA	ITA	ESP	NLD	BEL	GRC	PRT	IRL	AUT	FIN	EA
Add. public investment per year	0.11	0.15	0.11	0.21	0.13	0.16	0.0	0.11	0.07	0.09	0.10	0.12
Gross Public debt variation, 2035	1.0	1.0	1.0	1.0	1.0	1.0	nc	1.0	1.0	1.0	1.0	1.0
Gross Public assets variation, 2035	1.2	1.9	1.4	2.6	1.6	2.0	nc	1.4	0.9	1.1	1.3	1.6
Net public assets variation, 2035	0.2	0.9	0.4	1.6	0.6	1.0	nc	0.4	-0.1	0.1	0.3	0.6

Note: Gross Public assets variation is computed with a 5% depreciation scheme hypothesis for public capital.

Source: iAGS model.

Source: iAGS 2017

Main assumptions: annual increase of 0.1 % of GDP of public investment during 20 years; long run elasticity of GDP vis-à-vis public capital equal to 0.1; non-linear fiscal multiplier; backloading; no risk premia; symmetric nominal adjustments to limit EA current account imbalances; € appreciation to 1.2 from 2020 onwards

Conclusions (1)

- Change of fiscal rule (pro-investment) to:
 - benefit potential output
 - boost demand and prices under low inflation
 - increase public bond's supply under high demand or increase (future) interest rates under ZLB (would help escape the so-called secular stagnation)
- Possible?
 - Needs close cooperation btw gvts & the ECB
 - No retaliation from the ECB required
 - The most challenging issue would be to target public inv. impacting potential output
 - Micro issue

Conclusions (2)

- Feasability in the short run
 - Public investment and capital are not only favourable on the demand side, but also on the supply side
 - Structural reforms are planned to enhance the supply side
 - Then public investment can be “ancillary to structural reforms”
 - A public investment stimulus would strengthen the investment rule of the SGP
- Feasability in the long run
 - The impetus for public investment needs to be long-lasting to produce full effects
 - A Treaty change is certainly required to move to a golden rule...