



Fiscal consolidation and reforms: trade-offs and complementarities

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Complementarity vs. substitution between fiscal consolidation and structural reforms: the debate

“Either/or view”

- Budgetary losses of reforms: direct or indirect, to compensate reform losers (e.g., Eichengreen & Wyplosz, 1998; Beetsma & Debrun, 2004, Wyplosz & Delpla, 2007...).
- Fiscal expansions to offset temporary output losses induced by reforms (e.g., Hughes-Hallett et al., 2004; Banerji et al., 2017...).

“Brussels-Frankfurt consensus” (Sapir et al. 2004)

- Direct budgetary gains of reforms.
- Back against the wall/ “TINA” (e.g., Bean, 1998; Calmfors, 2001...).

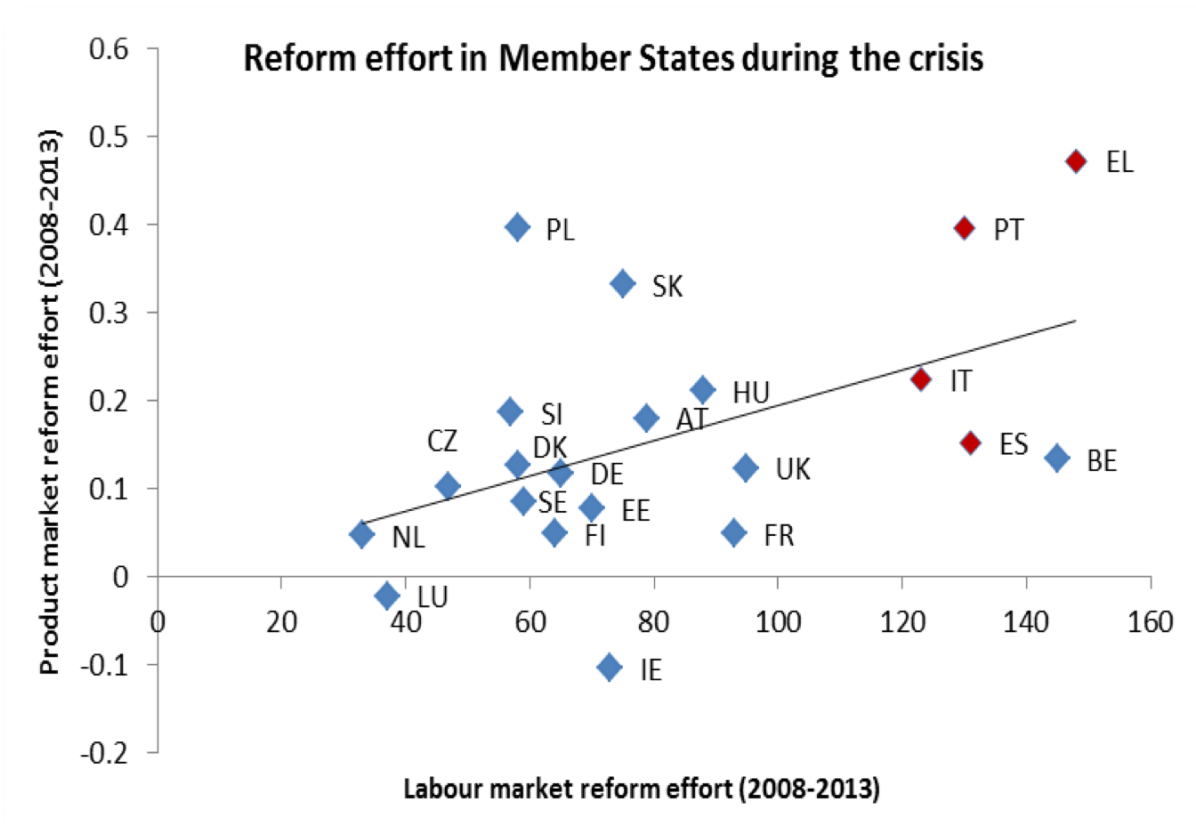
Encompassing view

- Complementarity of substitution may both arise, depending on policy makers' time horizon (Buti et al., 2009).

Fiscal consolidation and reforms: “Schäuble’s curse”

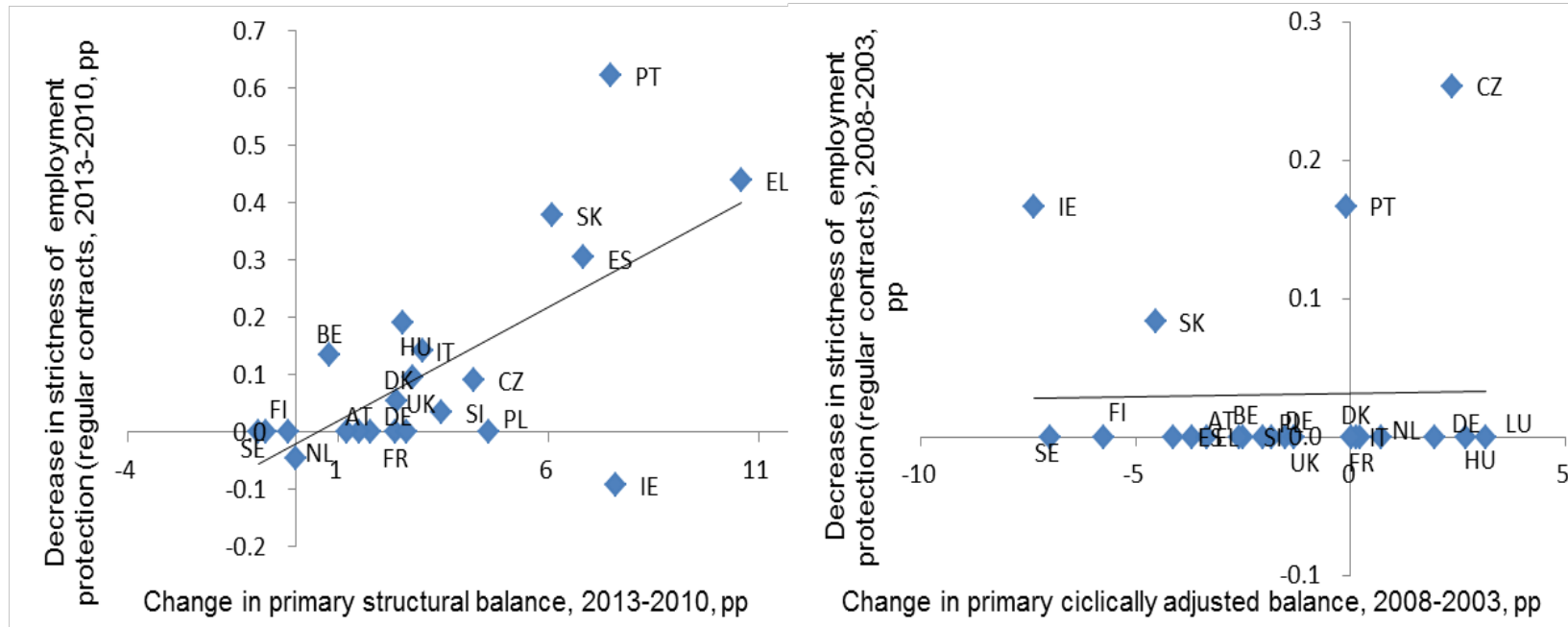
- The arguments debated among economists have recently surfaced in the policy debate.
- “Efforts to consolidate public finances have lost momentum more recently” ... “An effective combination of structural reforms and growth-friendly consolidation will ensure (...) sustainability (...) long-term growth perspectives” (W.S., 2017 IMFC statement). “The problem of moral hazard is crucial” (W.S., "Growth and Austerity: Can the Eurozone Have Both?" conference, Bertelsmann Foundation, Washington, DC October 9, 2014).
- “Schäuble's curse”: consolidation and reforms are either there at the same time or they disappear together. What matters is overcoming moral hazard via market-based discipline or institutional mechanisms. Corollary: expansionary macroeconomic policies come with a slackening of the reform effort.

Reforms have been undertaken since the crisis, especially in crisis-hit countries



Fiscal consolidation and reforms

Fiscal consolidation vs. EPL reforms in crisis and non-crisis periods



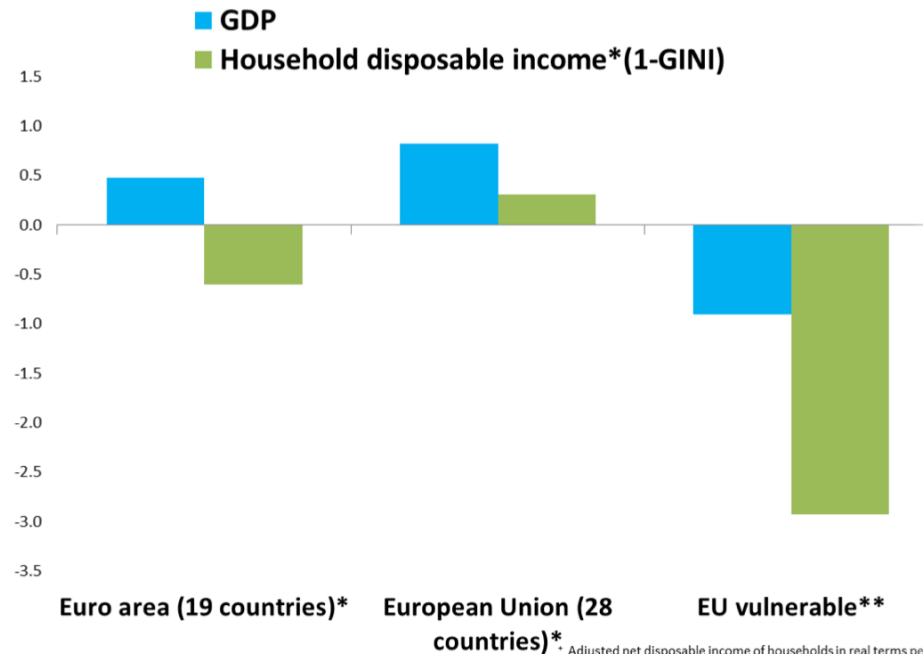
Fiscal consolidation mostly going hand in hand with reforms over the crisis, no clear pattern before.

Looking ahead: will “Schäuble’s curse” win?

- a) **Tackling social implications of the crisis.** Addressing the re-distribution impact of the crisis poses constraints to policy makers that want to cut budgets and undertake growth-enhancing reforms. The room for reforms reducing the generosity of welfare payments has narrowed.
- b) **Reforms needed for growth have budgetary costs.** The flexibility agenda will not be sufficient to tackle the expected reduction in growth potential. Human capital formation, tangible and intangible investment will be key (OECD 2015, 2017).
- c) **Consolidation and expenditure composition.** Recent consolidation episodes came at the expense of growth-friendly items.

a) The crisis affected income distribution

Per-capita GDP vs. household disposable income weighted by the Gini index
(average annual growth rate, 2010-2015)



Income growth became less inclusive.

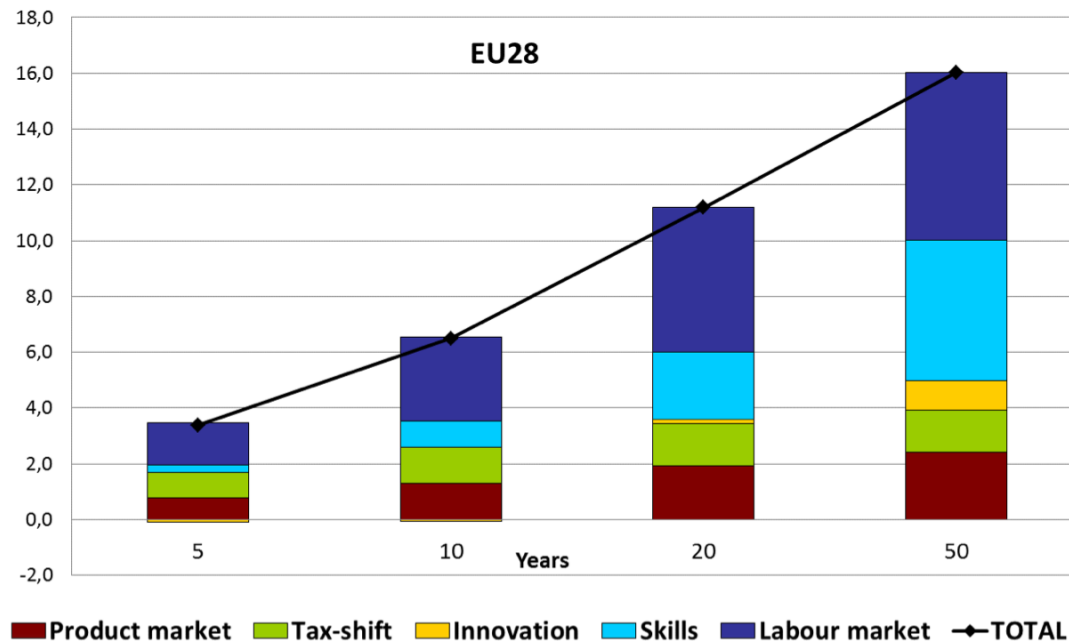
Recessions were often matched by worsening income distribution in vulnerable countries.

Source: Eurostat, National accounts

* Adjusted net disposable income of households in real terms per capita (nominal values deflated using CPI).
* MT, LU, and HR dropped due to missing data.
** Simple average of CY, EL, ES, IE, IT, SI, and PT

b) Reforms needed for growth will cost on the budget

Closing ½ gap with best performers: GDP impact
(source: QUEST simulations, see Varga and in't Veld, 2014)



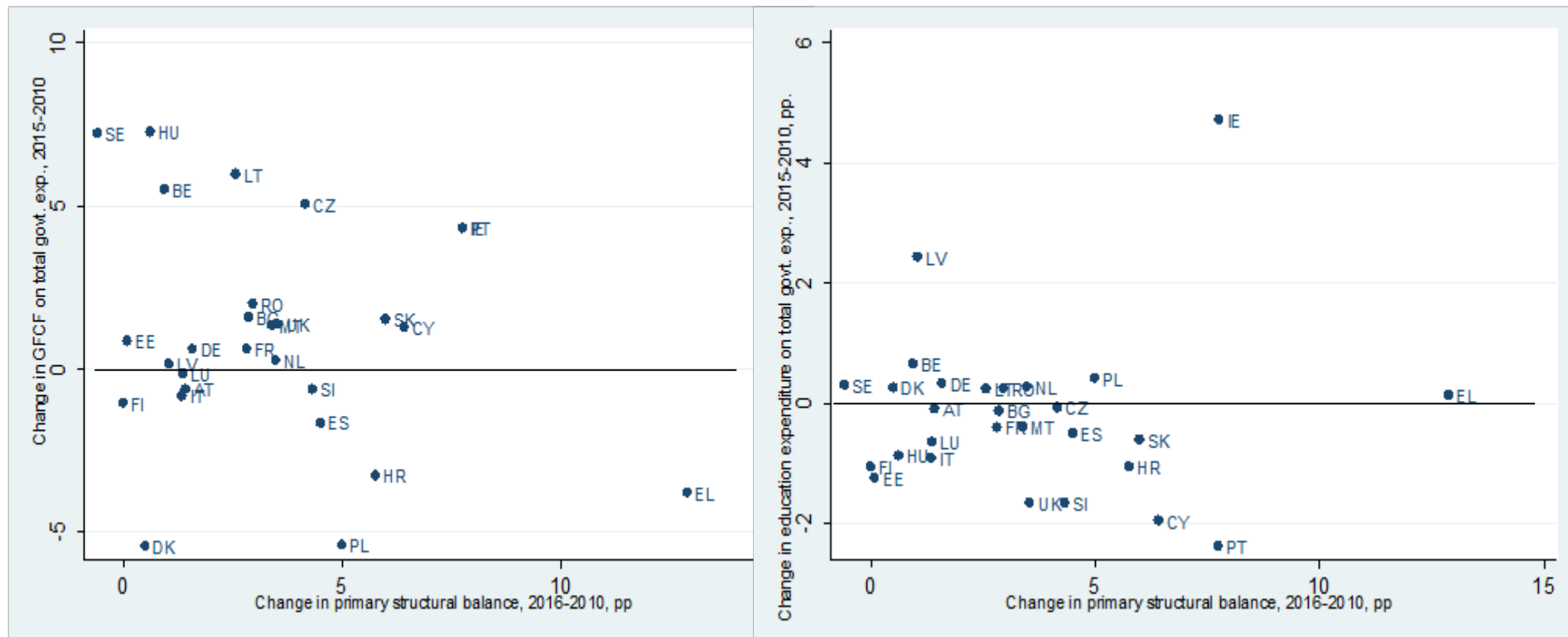
Labour participation enhancing reforms and skills creation are main sources of unexploited GDP gains.

Achieving gains from higher skills would cost on budgets in terms of frontloaded education spending.

c) Consolidation and expenditure composition: the quality of public finances suffered

Fiscal effort and share of govt. investment on total govt. spending, EU post 2010

Fiscal effort and share of govt. education spending on total govt. spending, EU post 2010



Tackling Schäuble's curse

- Reasons for a substitution relation between consolidation and reform getting stronger. This has a number of implications for EU surveillance.
- The application of clauses in the SGP poses a number of challenges.
 - Asymmetric functioning of clauses. Conceived for bad times, what about good times?
 - Ex-post monitoring and enforcement. Clauses granted on the basis of reform plans, which raises an issue of asymmetric information and ex-post enforcement.
- Need to strengthen positive incentives for structural reforms in applying EU surveillance.
 - Focus recommendations on key reforms that matter for the EA and EU, taking account of the heterogeneity of preferences across Member States.
 - Alternative instruments. Incentivize reforms through the EU budget (conditionality).
- But "discount rates" cannot be imposed by Brussels. Governments are not bound by the EU fiscal rules to choose policies that strengthen the growth potential and improve public finances over the long term, which calls for creating positive incentives.