The 5th Committee of the Senate of the Republic (Economic Planning and Budget)
and the 5th Committee of the Chamber of Deputies (Budget, Treasury and Planning),
sitting jointly

Review of the European Commission's proposals for economic governance

Bank of Italy Memorandum

Rome, 8 November 2023

The Bank of Italy thanks the 5th Committee of the Chamber of Deputies and the 5th Committee of the Senate for being invited to express its views on the proposals for a reform of the EU's economic governance presented by the European Commission on 26 April.

This memorandum illustrates the main points of the new regulatory framework, addressing in particular the new elements compared with what was in the European Commission's communication of November 2022.[1] It also reports on the issues raised during the debate in the Council of the EU and provides additional assessments to those expressed in the Bank of Italy's Parliamentary Hearing last February.[2]

1. Introduction

At a time of frequent and significant macroeconomic and financial shocks, fiscal policy often needs to reconcile the need to ensure the sustainability of public finances with the need to stabilise the economic cycle. There is a high degree of consensus among economists[3] on the fact that this difficult balancing act can be made easier by a set of rules that, while leaving policymakers adequate room for manoeuvre, limit the excessive use of their discretionary powers: this prevents short-sighted decisions and at the same time helps to anchor the expectations of households, firms and financial markets. In a monetary union, there is also the need to ensure that each country takes due account of the implications of its domestic choices for monetary policy and financial stability in the whole currency area.[4]

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1 European Commission, 'Communication on orientations for a reform of the EU economic governance framework' (COM(2022) 583 final).

2 See 'Review of the Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, 'Communication on orientations for a reform of the EU economic governance framework'' (only in Italian), testimony by S. Nicoletti Altimari, Director General for Economics, Statistics and Research at the Bank of Italy, before the 5th Committee of the Chamber of Deputies (Budget, Treasury and Planning), Rome, 14 February 2023.

3 See, for example, P. Yared (2019), 'Rising Government Debt: Causes and Solutions for a Decades-Old Trend', *Journal of Economic Perspectives*, vol. 33(2), pp. 115-140, Spring.

4 See M. Romanelli, P. Tommasino and E. Vadalà (2022), 'The future of European Fiscal governance: a comprehensive approach', *Economia italiana*, vol. 2, pp. 211-264.

These arguments form the basis of the EU's decision to adopt common budgetary rules from the outset. However, this framework of rules – which has been amended several times over the years[5] – has gradually revealed its shortcomings (including excessive complexity and gaps in its implementation), which have undermined its credibility and ultimately its effectiveness.

These issues have sparked a wide-ranging debate, involving experts, academics and national and international institutions.[6]

On 26 April, the European Commission presented proposals for economic governance reform, following its communication of 9 November 2022 and the ECOFIN Council conclusions of 14 March 2023.

The communication outlined a structural reform aimed at ensuring the medium-term sustainability of the public finances and closer integration of budgetary and structural policies. The reform focuses on the process of formulating and implementing 'national medium-term fiscal-structural plans', which usually last four years and have to set out the Member States' commitments in terms of budget, reforms and investment.

These plans should take account of each country's individual features and ensure that 'government debt is placed or maintained on a plausible downward path by the end of the adjustment period, or stays at prudent levels, and the budget deficit is reduced or remains below the 3 per cent of GDP reference value over the medium term'. From an operational point of view, the national plans define specific paths for 'net primary expenditure'

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[5] The Maastricht Treaty (1992) introduced reference values of 3 per cent for the deficit-to-GDP ratio and 60 per cent for the debt-to-GDP ratio. The Stability and Growth Pact (SGP, 1997) added the requirement for each country to achieve a medium-term budgetary position close to balance or in surplus (the 'preventive arm' of the SGP). The preventive arm of the SGP was reviewed in 2005, and since then, Member States have been required to achieve a medium-term objective (MTO) expressed in terms of a structural budget balance (i.e. cyclically adjusted and net of one-off and temporary measures). The 'Six Pack' (2011) and 'Two Pack' (2013) reforms introduced further constraints: countries with a debt-to-GDP ratio above the 60 per cent threshold are required to reduce this gap by 1/20 per year on average over a period of three years; in order to achieve the structural balance objective, the growth rate of expenditure (net of interest, the cyclical component, expenditure for European programmes co-financed by the EU and the effect of discretionary measures on revenues) should not exceed the potential GDP rate (and should be lower for countries that have not achieved their MTOs yet). Further changes have been made to the implementation of this regulatory framework in an attempt to restore a certain degree of flexibility, such as the 'matrix of requirements' (which specifies the variation in the structural balance to be achieved depending on the cyclical economic conditions and the debt-to-GDP ratio) and the two clauses on investment and structural reforms (which actually ease the requirements for compliance with the preventive arm).

[6] On this point too, see Romanelli et al., op. cit.

(i.e. government expenditure excluding interest expenditure, discretionary revenue measures and other budgetary variables outside governmental control), consistent with the deficit and debt objectives.

The reform, as intended by the Commission, should increase ownership at national level; for example, although it is for the Commission to present an initial adjustment profile for a country's accounts, that country may propose a different profile, as long as it is in line with the medium-term sustainability objectives. At the same time, it aims to promote structural policies that support potential growth; it is in fact possible to extend the adjustment period granted to each country from four to seven years, if their plan is underpinned by an appropriate set of reforms and investments.

The first outcome of the debate between Member States on the Commission's communication was the EU Council's conclusions of 14 March 2023. On that occasion, the Council generally welcomed the new governance structure, though it raised specific issues on which it asked the Commission to reflect further. Those issues included: (i) the procedures used by European authorities to establish reference net expenditure paths and (ii) the possible introduction of quantitative parameters common to all countries.[7]

The Council's conclusions were followed by a German non-paper proposing the adoption of common safeguards of a numerical kind.[8] Specifically, this document proposes two binding provisions: the first concerning the net expenditure aggregate which, for Member States with a debt-to-GDP ratio above 60 per cent, should grow at a lower rate than that of potential growth (up to around 1 percentage point lower in the event of high sustainability risks); the second concerning debt-to-GDP ratios, which must decline by 1 percentage point per year (0.5 percentage points for countries with moderate sustainability issues) from the first year that the plan is implemented.

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[7] Specifically, in its conclusions, the Council 'concurs that further clarifications and discussions are needed, including, when it comes to the definition of the Commission trajectory, the requirements for Member States deemed to have small debt difficulties, possibly including a fiscal trajectory, the definition of the expenditure aggregate, the appropriateness and design of common quantitative benchmarks to support the reformed framework, the principles for an extension of the fiscal path, the role of the country-specific recommendations, the enforcement of national plans and the incentives for reforms and investment'.

[8] See 'German technical non-paper following up on selected issues identified by the ECOFIN conclusions', April2023; https://www.bruegel.org/sites/default/files/2023-04/German%20technical%20non%20paper.pdf.

2. The Commission's legislative proposal

The Commission's legislative proposal transposes the content of the communication into regulatory acts: while it confirms the key points of the communication, it also introduces a number of changes to address some unresolved issues, which are still being debated by the Member States and between the Member States and the European authorities.

The legislative package includes proposals to: (i) replace Council Regulation (EC) No 1466/97 on the preventive arm of the Stability and Growth Pact (SGP); (ii) amend Council Regulation (EC) No 1467/97 on the corrective arm of the SGP and (iii) amend Council Directive 2011/85/EU on national budgetary frameworks.

The texts presented confirm a multi-phase process.

During the first phase, i.e. preparation of the fiscal-structural plans, the Commission – based on the country's macroeconomic and public finance conditions – presents a reference 'technical trajectory' for net expenditure that covers a minimum adjustment period of four years so as to ensure that, if policies remain unchanged, the public debt ratio is put or remains on a plausibly downward path or stays at prudent levels and that the government deficit is brought and maintained below the 3 per cent of GDP reference value.[9] The technical trajectory is then made public and drawn up using a common methodology based on the debt sustainability analysis (DSA) carried out by the Commission, thus taking into account safety margins against the risks associated with interest rates, GDP growth, the primary balance and exchange rates.[10] When setting the trajectory for net primary expenditure, Member States with a government deficit above 3 per cent or a public debt above 60 per cent of GDP shall also comply with some numerical requirements. Specifically:

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9 For Member States with a government deficit below 3 per cent of GDP and a public debt below 60 per cent of GDP, the Commission shall provide technical information regarding the structural primary balance (i.e. cyclically adjusted and net of temporary measures) necessary to ensure that the headline deficit is maintained below the reference threshold with no further policy measures over a ten-year period after the end of the Plan.

10 More specifically, the plausibility of the trajectory for net expenditure would be assessed based on the following conditions: the public debt ratio is declining, or stays at prudent levels, under the deterministic scenarios of the Commission's medium-term public debt projection framework described in the Debt Sustainability Monitor 2022; the risk of the public debt ratio not decreasing in the five years following the adjustment period of the national medium-term fiscal-structural plan, under the Commission's stochastic scenarios, is sufficiently low.

(i) the public debt ratio at the end of the planning horizon must be below the public debt ratio in the year before the start of the plan; (ii) the fiscal adjustment effort must be distributed at least proportionally throughout the entire adjustment period (whether covering a four- or a seven-year horizon), preventing adjustments from being excessively backloaded; (iii) national net expenditure growth must remain below medium-term output growth as a rule, on average over the horizon of the plan. Under the corrective arm of the Stability and Growth Pact, when the deficit exceeds 3 per cent of GDP, these three safeguards are supplemented by two additional ones: (iv) the next expenditure path shall be consistent with a 'minimum annual adjustment of at least 0.5 per cent of GDP as a benchmark' for as long as the deficit remains above the Maastricht threshold; and (v) to avoid backloaded adjustments, 'the corrective net expenditure path shall ensure that the average annual fiscal adjustment effort in the first three years is at least as high as the average annual fiscal effort of the total adjustment period.'

The second phase opens a bilateral dialogue between a Member State and the Commission, during which the fiscal adjustment path can be extended from four to up to seven years, provided that the path is underpinned by a set of reform and investment commitments that support growth and debt sustainability. The commitments shall be commensurate with the degree of public debt challenges, and sufficiently detailed, frontloaded, time-bound and verifiable. When the dialogue is closed, each Member State submits its medium-term plan to the Commission and the Council. Where the plan includes a higher net expenditure trajectory than that of the Commission, the Member State shall provide sound and verifiable economic arguments to explain the difference.

In the third phase, the Commission approves the national plans using a common assessment framework and the Council subsequently endorses them; once approved, the plans may not be revised for the following four years, unless there are exceptional and objective circumstances or there is an explicit request by a new government. In the event of no agreement, the technical trajectory put forward by the Commission shall be applied.

The fourth phase is monitoring. Member States shall submit annual progress reports on the implementation of their plans. The Commission also monitors net expenditure paths through a control account, which keeps track of cumulated deviations in the actual net expenditure in a Member State from the agreed expenditure path. In the event of significant deviations and

taking into consideration the relevant factors, the debt-based excessive deficit procedure (EDP) may be activated. High sustainability risks are considered as a relevant factor that normally triggers the activation of the EDP. The deficit-based excessive deficit procedure would instead remain unchanged and would therefore be activated when the deficit exceeds the 3 per cent threshold, except under exceptional circumstances of a temporary and minor nature. Finally, failure to implement the reform and investment commitments that underpin the extension of the adjustment period may lead to a revision of the net expenditure path with a shorter adjustment period. For major shocks to the entire euro area or the EU as a whole, the general escape clause is maintained, and the possibility for individual Member States to invoke a country-specific escape clause to deal with exceptional circumstances outside the control of their government that have a major impact on their national public finances is reinforced. The triggering of either of the two clauses requires the Council's consent.[11]

The legislative proposal also envisages a stronger role for Independent Fiscal Institutions (IFIs). Specifically, IFIs should play a greater role in the national budgetary process, for instance by producing debt sustainability assessments, by formulating or endorsing the macroeconomic and public finance forecasts underlying government plans and by regularly participating in hearings before the national parliament. Moreover, when dealing with IFI assessments, the fiscal authorities shall follow a comply-or-explain approach. Finally, IFIs shall evaluate compliance with the agreed net expenditure path ex post. Given the important role played by IFIs, Member States shall ensure that they have adequate and stable resources to fulfil their mandate effectively.

A recent paper[12] estimates the structural primary balance adjustments necessary to meet all the requirements set out in the Commission's reform proposal for Member States with a debt above 60 per cent or a deficit above 3 per cent of GDP in 2024, according to the forecasts issued by the Commission

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11 The current framework of budgetary rules also allows Member States to temporarily 'depart from the adjustment path towards the medium-term budgetary objective [...], provided that this does not endanger fiscal sustainability in the medium term', 'in the case of an unusual event outside the control of the Member State concerned which has a major impact on the financial position of the general government of that Member State'. Unusual events are actually natural disasters (see European Commission, 'Vade Mecum on the Stability & Growth Pact', Institutional Paper, 101, April 2019, p. 26). The Commission's legislative proposal would instead strengthen this option by allowing deviations 'under exceptional circumstances outside the control of the Member State'.

12 See Z. Darvas, L. Welslau and J. Zettelmeyer, 'A quantitative evaluation of the European Commission's fiscal governance proposal', Working Paper, Bruegel, 16, 2023.

in May. The paper considers both a four-year adjustment period and a longer adjustment period of seven years, and uses the Commission's DSA reference framework described in the Debt Sustainability Monitor 2022, assuming that the adjustment is evenly distributed over the horizon of the plan (unless otherwise provided for by the safeguards).

On average, the overall structural primary balance adjustment required as of 2024 would exceed 2 per cent of GDP; however, for many high-debt countries, these requirements are below those required by the current framework (at least for the years covering the adjustment period and those immediately thereafter). For Italy, the adjustment would be around 3.5 and 3 percentage points over the four-year and seven-year horizons respectively.

The paper also shows that, in the case of a shorter adjustment horizon, the safeguards are only binding in a few cases, including France, while in the case of a longer horizon, they lead to stronger adjustments than would have been determined using the DSA alone for more than half of the Member States considered (including Italy).

Some Member States have expressed strong criticism vis-à-vis the Commission's legislative proposals. In mid-June, a joint op-ed piece by the finance ministers of 11 Member States of the EU[13] pointed out that the new rules might result in adjustment paths that are too slow and reiterated the need for minimum quantitative criteria that apply to all Member States equally.

In order to focus the discussion on the most controversial aspects of the reform so as to reach an agreement by the end of the year, at the beginning of its mandate, the Spanish Presidency of the Council of the EU set out four issues for which a compromise solution was needed: (A) deciding on common safeguard provisions to ensure sufficient debt reduction; B) clarifying the rules for extending the adjustment period from four to seven years in order to safeguard investments and reforms; (C) achieving an efficient and balanced allocation of tasks and decision-making powers among all the institutions involved; and D) ensuring enforcement and ownership by better clarifying the role of the control account and identifying the appropriate procedures and relevant factors to be considered to activate excessive deficit procedures.

[13] 'Reform of Europe's fiscal rules', op-ed, 15 June 2023, signed by the Finance Ministers of Germany the Czech Republic, Austria, Bulgaria, Denmark, Croatia, Slovenia, Lithuania, Latvia, Estonia and Luxembourg. https://www.bundesfinanzministerium.de/Content/EN/Standardartikel/ Press_Room/Namensartikel/2023-06-15-reform-of-europes-fiscal-rules.html

3. Some considerations

The approach of the Commission's legislative proposal is broadly similar to that already presented in the communication published last November. Overall, the considerations made at the time of the Bank of Italy's Parliamentary Hearing in February 2023 therefore remain valid. Taken as a whole, the reform constitutes a major step forward. The new governance framework rightly focuses on the medium-term sustainability of debt rather than on the precise and continuous calibration of fiscal policy, seeking a better balance between rigour and realism in each country's adjustment path.[14] This results, among other things, in more room for countercyclical policies, partly thanks to how the operational tool for spending is defined.

National ownership of fiscal choices is increased. Indeed, a has already been pointed out, the core of the proposal lies in the process of negotiation between the Commission and each Member State, which becomes a plan to then be approved by the Council, putting the reputation of all the parties concerned at stake.

For a country whose debt or deficit levels exceed the Maastricht thresholds, the definition of an appropriate adjustment path is rightly based on an in-depth analysis of debt sustainability. It is thereby possible to avoid setting predefined numerical objectives ex ante, an approach which has proved to be too rigid and at the same time not very effective in influencing a country's choices. In order not to alter the spirit of the reform, the adjustment path should not be determined mechanically by the DSA, also because this type of analysis is very sensitive to underlying modelling assumptions and subject to high margins of uncertainty.

Similarly, the numerical safeguards introduced by the Commission in its legislative proposal to address the legitimate concerns of some Member States must be calibrated so as to not always, or not in most cases, be de facto binding. From this point of view, the legislative proposal is less flexible than envisaged in the Commission's communication; a further tightening is not advisable.

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[14] See also F. Panetta 'Investing in tomorrow: Future-proofing fiscal policies and governance in Europe', speech at the 'European fiscal policy and governance reform in uncertain times' workshop, organised by the European independent fiscal institutions and the European System of Central Banks, 20 September 2023.

Another important element in the new regulatory framework, as already pointed out, is the link between budgetary plans and reform and investment commitments. The aim is to avoid making accounting corrections to the detriment of policies in favour of potential growth and of the green and digital transitions. To ensure that this objective, in itself a valid one (if the time frame for consolidating the accounts is too tight, the risk is that it is implemented by reducing investment expenditure), does not result in an unjustified watering down of the adjustment programmes, a longer time frame is only allowed for reforms and investments that significantly affect potential growth and thus debt sustainability. This in turn requires the definition of the analytical assessment framework to be rigorous, transparent and agreed. Once high quality standards and sufficient resources and competences have been achieved in all countries, IFIs and the European Fiscal Board could be called upon to play a useful technical role in this area.

The two main limits, to both the current and the new frameworks, are the lack of effective coordination of fiscal policies for managing the euro-area macroeconomic cycle as a whole and to guarantee adequate investments at European level where there are significant economies of scale and externalities between countries.[15]

Both these problems could be tackled by creating a suitably designed permanent central budget capacity (possibly by drawing inspiration from certain elements of the NGEU programme).[16]

As regards the first aspect, the European budget could be expanded to deal with adverse shocks common to all countries and be reduced during positive phases, in support of monetary policy.[17]

As regards investments, the issuance of common debt instruments could finance digital, energy, environmental or defence projects so as to enable more

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15 These are two separate problems. In the theory of public finances, the former is linked to the stabilising function of the budget and the latter to that of allocative efficiency. See F. Panetta, ‘Investing in Europe’s future: The case for a rethink', speech at the Institute for International Political Studies (ISPI), 11 November 2022.

16 On the need for a fiscal capacity, see for example, F. Balassone, S. Momigliano, M. Romanelli and P. Tommasino (2018), ‘Just Round the Corner? Pros, Cons, and Implementation Issues of a Fiscal Union for the Euro Area”, *Economia pubblica*, vol. 2018(1), pp. 5-34. See also F. Panetta, op.cit.

17 See F. Caprioli, M. Romanelli and P. Tommasino (2020), ‘Discretionary fiscal policy in the euro area: Past, present and future’, *Economia pubblica*, vol. 2020 (1), pp. 55-85.

effective action (ensuring that these public assets are provided in sufficient quantities) and more efficient action (by reducing expenditure overlaps).

Finally, the common debt is a safe asset that indirectly facilitates the conduct of monetary policy in the euro area and promotes the development of a single capital market at European level (Capital Markets Union) and therefore the international role of the euro. The Bank of Italy has expressed its views on this subject on several occasions,[18] as has the ECB Governing Council.[19]

It is accepted in the Commission communication that a fiscal capacity would be useful, but this is not in the legislative proposal.

It is to the good that the reform of economic governance discussed in this memorandum is approved, as it is a step forward compared with the current unsatisfactory situation. Completing the EU's architecture will nevertheless remain an objective to be pursued over the next few years.

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18 See, for example, the 'Concluding Remarks of the Governor of the Bank of Italy for 2022', Rome, 31 May 2023.

19 See the Eurosystem's response of 1 December 2021 to the European Commission's communication, 'The EU economy after COVID-19: implications for economic governance' of 19 October 2021, and the ECB's opinion of 5 July 2023 on the proposal to reform the economic governance of the European Union (OJ C 290, 18.8.2023, p. 17).

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