

20th Banca d'Italia Workshop on Public Finance
Fiscal challenges for the Euro area: institutional and policy fixes

Panel Discussion:

An assessment of the EU Fiscal Framework

**Simplify the Rules and Improve Enforcement:
easier said than done**

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1. A Complex System: Too Many Rules (and Escape Clauses)

- ✓ 3% of GDP ceiling for **nominal deficit** (*overruns ok if small, temporary, and due to force majeure; correction based on “effort”*)
- ✓ **structural deficit**: medium term objective of close-to-balance or in surplus (*required improvement depends on cyclical conditions; structural reform clause, investment clause*)
- ✓ 60% of GDP ceiling for **gross debt** (*unless declining at a predetermined pace; backward and forward assessment; economic cycle and other “relevant factors”*)
- ✓ benchmark for **expenditure growth** (*rise not faster than medium-term potential GDP, net of discretionary tax increases*)

2. A Poor Enforcement Record

Initial members of the Euro area: deficit/GDP 1998-2016

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Belgium	0,9	0,6	0,1	-0,2	0,0	1,8	0,2	2,8	-0,2	-0,1	1,1	5,4	4,0	4,1	4,2	3,1	3,1	2,5	2,5
Germany	2,5	1,7	-0,9	3,1	3,9	4,2	3,7	3,4	1,7	-0,2	0,2	3,2	4,2	1,0	0,0	0,1	-0,3	-0,6	-0,8
Ireland	-2,0	-2,4	-4,9	-1,0	0,5	-0,4	-1,3	-1,6	-2,8	-0,3	7,0	13,8	32,1	12,7	8,0	6,1	3,6	1,9	0,7
Spain	2,9	1,3	1,1	0,5	0,4	0,4	0,0	-1,2	-2,2	-1,9	4,4	11,0	9,4	9,6	10,5	7,0	6,0	5,3	4,5
France	2,4	1,6	1,3	1,4	3,1	3,9	3,5	3,2	2,3	2,5	3,2	7,2	6,8	5,1	4,8	4,1	3,9	3,6	3,4
Italy	3,0	1,8	1,3	3,4	3,1	3,4	3,6	4,2	3,6	1,5	2,7	5,3	4,2	3,7	2,9	2,9	3,0	2,6	2,5
Luxembourg	-3,2	-3,5	-5,9	-5,9	-2,4	-0,2	1,3	-0,1	-1,9	-4,2	-3,3	0,7	0,7	-0,5	-0,3	-1,0	-1,3	-1,4	-1,6
Netherlands	0,9	-0,3	-1,9	0,3	2,1	3,0	1,7	0,3	-0,2	-0,2	-0,2	5,4	5,0	4,3	3,9	2,4	2,3	2,1	-0,4
Austria	2,7	2,6	2,4	0,7	1,4	1,8	4,8	2,5	2,5	1,4	1,5	5,3	4,4	2,6	2,2	2,0	2,7	1,0	1,6
Portugal	4,4	3,0	3,2	4,8	3,3	4,4	6,2	6,2	4,3	3,0	3,8	9,8	11,2	7,4	5,7	4,8	7,2	4,4	2,0
Finland	-1,6	-1,7	-6,9	-5,0	-4,1	-2,4	-2,2	-2,6	-3,9	-5,1	-4,2	2,5	2,6	1,0	2,2	2,6	3,2	2,7	1,7

Cyclically adjusted deficit: 2007

	2007
Belgium	1,6
Germany	0,8
Ireland	2,3
Spain	-0,3
France	4,3
Italy	2,9
Luxembourg	-1,9
Netherlands	1,1
Austria	2,7
Portugal	3,7
Finland	-2,6

Can we do better? Three underrated issues

- ✓ can we do better given the institutional set-up?
- ✓ three underrated issues
 - causes of complexity of the rules
 - working details of alternative rules
 - side-effects of market discipline

1: The Causes of Complexity

- ✓ use both deficit and debt rules
 - some events affect debt without going through the budget
- ✓ cyclical adjustment
 - targeting nominal variables may induce procyclical policies
 - uncertainty and revisions \Rightarrow additional contingencies and exceptions

2: The Illusion of Simplicity

- ✓ the alleged advantages of an expenditure rule
 - allows countercyclical stabilization
 - can be used to reduce excessive debt
 - no need to use cyclical adjustments
- ✓ the devil in the details
 - need an anchor in terms of deficit or debt
 - need to assess potential output and initial cyclical conditions
 - need to take into account deficit-debt adjustment
 - need escape clauses

3: The Problem with Market Discipline

- ✓ enforcement is weak because no bail-out clause lacks credibility
 - significant spillovers from default
 - amplified by banks' sovereign exposures and disorderly resolution
- ✓ the solution
 - limit banks' sovereign exposure
 - define pre-set restructuring procedures for sovereigns
 - let market discipline work its magic
- ✓ the problems with the solution
 - initial conditions matter
 - spillovers do not work only through banks
 - markets “too slow and weak or too sudden and disruptive”
(Delors, 1989)

Why does it work in the US?

- ✓ US state debts are relatively small
- ✓ the “local” economy is shielded by federal fiscal policy and capital markets integration

	State	Local	State and Local
New York	9.50	14.44	23.94
S. Carolina	7.49	14.02	21.51
Rhode Island	16.18	4.68	20.86
Kentucky	7.18	13.67	20.85
Nevada	2.38	17.95	20.32
Illinois	8.32	10.92	19.24
...			
North Dakota	3.69	7.08	10.77
Iowa	3.48	7.04	10.52
Oklahoma	4.73	5.33	10.06
N. Carolina	3.49	6.54	10.03
Idaho	5.63	4.06	9.69
Wyoming	2.12	2.91	5.02

What then?

- ✓ simplification is possible
- ✓ fiscal rules can be a tool for good policy making, but they cannot substitute for good policy makers
- ✓ better enforcement through stronger democratic legitimacy
- ✓ writing a complete contract is not feasible
- ✓ a more flexible system?
 - politically agreed fiscal targets (accountability)
 - independent scrutiny (transparency/moral hazard)
 - parliamentary approval (democratic legitimacy)

Two open questions ... and a quote

- ✓ debt redemption funds?
- ✓ what after the transition to lower debt levels?
- ✓ *“eleven countries managing together that common good that is the currency, will inexorably realize that it will be necessary to manage other things in common”*

*“the euro is an example of **power to the imagination** [...] yet even **more creative imagination is needed now** to combine in an efficient institutional set elements of national sovereignty and supranationality, of states and federation, of unity and diversity”*

Carlo Azeglio Ciampi, 1998