



BANCA D'ITALIA
EUROSISTEMA

20th Banca d'Italia Workshop on Public Finance

***Fiscal challenges for the Euro area:
institutional and policy fixes***

Rome, March 21st-23rd 2018

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Daniele Franco

A 20-year journey into fiscal policy



Perugia, 28-29 November 1998



- **Just after the creation of the ECB (June 1998) and just before the start of EMU (January 1999), as well as that of the ESCB's Working Group of Public Finance**
- **In the following two decades the Workshops tracked the evolution of fiscal policy priorities and technical developments**
- **The basic idea was that of asking fiscal experts to present their new policy relevant research in a rather informal context**

20 years in figures

- **440 papers**
- **760 participants (many came several times)**
- **from 56 countries**
- **from 52 central banks**
- **from the ministries of economics/finance/treasury of 26 countries**
- **from the economic institutes of 12 countries**
- **from all the main international organizations**
- **from 52 universities**



Fiscal policy: theory and practise

- Fiscal policy is about use of government revenues and expenditures to influence the economy.
- As Musgrave and Musgrave (1976, xv-xvi) noted, “**Our study ... must combine a thorough understanding of fiscal institutions with a careful analysis of the economic issues which underlie budget policy.** There is no way of doing the one without the other.”
- Public finance should focus both on what governments do (positive approach) and what government should do (normative approach). Either way it should help policymakers in taking decisions.
- The Workshop aimed at being **a forum for fiscal experts working in public institutions:** central banks, ministries, economic research institutes, international organizations.
- It aimed at **making theoretical and empirical analysis helpful for policymakers.**

A central bank is obviously biased ...

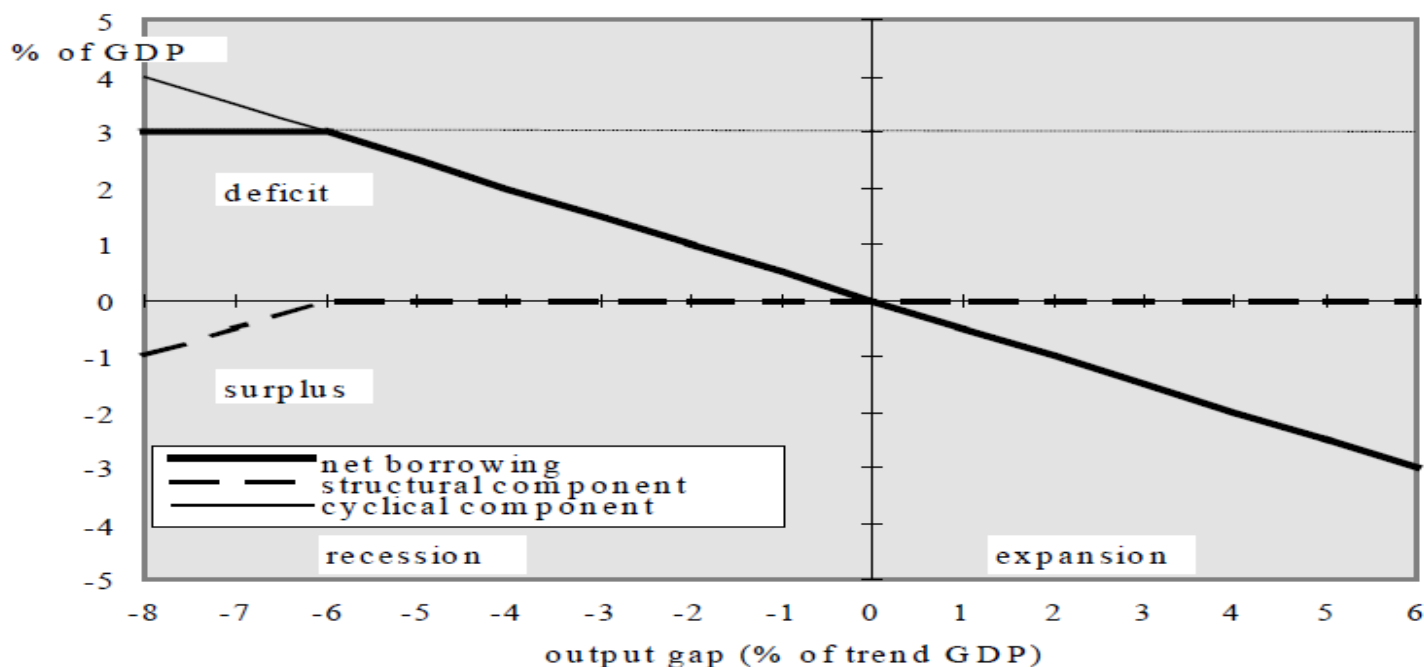
- **The allocation and stabilisation functions were given more prominence than the distribution function** (but a session was devoted to inequality issues in 2015).
- **Sustainability issues were repeatedly examined.**
- **EU (euro area) issues were given a lot of importance.** Core issue: fiscal policy in a single currency area.
- The analysis of fiscal institutions was often focused on the **role of fiscal rules in ensuring budget discipline.**
- **Macro issues were given more prominence than micro issues**, such as education and health policies, regulations, fiscal incentives and subsidies, etc.

From “Indicators of structural budget balances” (1998)...

- **The new EMU framework enhanced the importance of structural budget balances:**
 - i) medium-term targets are expressed in terms of structural balances
 - ii) estimates are essential for the effectiveness of multilateral surveillance mechanism
 - iii) this should lead to more cautious policies in good times
- **The SGP stylised fiscal policy framework** (assuming government maintains a balanced budget position when the output gap is zero) **appeared pretty simple:**

Budget balance through the cycle

No discretionary policy
Balanced budget as medium-term target



... to “Fiscal policy and macroeconomic imbalances” (2013)

- The 1998 Workshop highlighted the **complexity of the factors underlying the use of indicators of structural budget balances**
 - the output gap can be measured in different ways
 - new data and new assumptions about future developments **can change the output gap of a certain year** (and the structural balance)
 - the composition of the budget is also important
- In the following years **the close link between macroeconomic and fiscal imbalances became evident**. Asset price cycles, raw material price cycles, and construction and investment booms may temporarily improve fiscal balances and then lead to sudden economic downturns and pressures on fiscal policy.
- Gradual losses of competitiveness can quickly turn unsustainable and affect fiscal balances. In turn, growing fiscal imbalances can impact on financial and macroeconomic developments, sometimes in nonlinear ways. These issues were examined in the 2013 Workshop.

Fiscal sustainability: setting the ground (2000) ...

- The 2000 Workshop examined the **theoretical and empirical problems involved in the assessment of fiscal sustainability**.
- While for a long time sustainability was addressed in terms of the effects of public debt on the economy, **in recent decades it has been associated with the future implications of current budgetary policies**. This reflected demographic trends and outstanding public liabilities.
- **New analytical tools were developed** (e.g. tax gaps, intertemporal budget constraint, generational accounting, implicit liabilities). Long-term projections became common and increasingly sophisticated.

... and broadening the analysis (2008)

- The 2008 Workshop broadened the focus to **the impact of health and long-term care, to environmental issues** and the efforts to inform the public via regular sustainability reports.
- These issues still remain crucial, together with the threats to sustainability stemming from **macro imbalances and financial crises** (examined in recent Workshops).
- Is there room for further progress? We should focus on:
 - **social sustainability issues** (poverty, inequality).
 - **the factors underlying growth, productivity, competitiveness**
 - **the role of taxation in a globalized economy**

Fiscal rules and institutions: from a confident approach (2001) ...

- **The 2001 Workshop provided an overview of the theoretical and empirical problems involved in the design and in the implementation of fiscal rules. It examined the role of rules at different levels of government and the experiences of some countries.**
- **Why do we need rules?** Rules vs discretion. Myopia.
Which rules? Procedural vs numerical. Budget balance, debt, expenditure rules. Central vs subnational governments.
What are the critical aspects of rules? Credibility vs flexibility.
- **Several contributions pointed to the need to complement numerical rules with institutions and procedures.**

... to a more cautious and broader approach (2011)

- We came back to the issue in 2011 in the context of the crisis. Procedures and institutions guiding the fiscal consolidation process and ensuring an effective allocation of resources were even more necessary than ten years before.
- The debate focused on medium-term budget orientation, constitutional rules, top-down budgeting, automatic correction mechanisms. **New directions: expenditure rules** (easier to implement, less pro-cyclical) **and independent fiscal institutions** (can better information strengthen fiscal discipline?)
- The basic issue is always the same: **how to make democracies more focused on medium-long term issues.** We have learned that **institutions and procedures matter**, but also that **there are no simple solutions.**

The impact of fiscal policy, from stabilisation (2002 and 2010) ...

- **Can fiscal policy influence economic activity?**
What should be the role of automatic stabilisers (vs discretionary action)?
Does the composition of fiscal policy matter?
- In the last decades of the 20th Century, an activist approach to fiscal action was replaced by a more cautious attitude. It was argued that under some circumstances expectations can even reverse the standard impact of fiscal action. **Automatic stabilisers were generally considered preferable to discretionary action.**
- To counteract the 2008-09 recession governments took unprecedented action. **Discretionary measures were approved in many countries to complement stabilisers.** In some countries rules were adjusted to create wider room for fiscal manoeuvres.
- The 2010 Workshop highlighted the **difficulties in estimating multipliers** and their change of size in different contexts (anticipating the following debate: e.g. Blanchard-Leight, 2013). Initial fiscal conditions matter. **More empirical work is necessary.**

... to growth (2012)

- During the downturn, rising debt levels shifted the focus of the debate to the policies likely to regain control of public finances. **Structural reforms** became more prominent.
- The 2012 Workshop provided an overview of the theoretical and empirical work on the link between public policies and economic growth.
- As to **short-term growth**, it examined the new studies on fiscal multipliers, pointing – inter alia – to the fact that they are context- and time-specific.
- As to **long-run growth**, it examined the role of the structure of government budgets, growth-enhancing tax reforms, spending for human and physical capital, regulation, the management of public services, sound public finances.
- While there are no easy recipes to boost growth, **efficient public services, a good fiscal and regulatory framework, investment in human capital certainly contribute to growth (and fiscal sustainability)**. Reforms are necessarily country-specific, but there is a lot to learn from other experiences.

EMU: analytical work, reforms, policy debates. From 1998 ...

- **New development: many sovereign countries share a common currency but retain responsibility for fiscal policy.**
- **Sound public finances are at the core of EMU. The Treaty of Maastricht and the SGP have set fiscal rules and monitoring procedures. These are geared at restraining deficit and debt levels while allowing room for fiscal stabilisation.**
- **The SGP has evolved significantly along with the EU's economic governance rules**
 - 2005: SGP amended**
 - 2011: Six Pact**
 - 2013: Two Pact and Fiscal Compact**
- **Since its start in 1999 EMU has strongly influenced fiscal policies in Europe. It has also pervasively affected economic analysis and policy discussion.**
- **EMU represents the leitmotif of the Workshops.**

... to the current Workshop

- **EMU rules: strong and weak points**
- **EMU and national fiscal rules and institutions**
- **EMU and stabilisation. Interaction between monetary and fiscal policies**
- **Tax policy in EMU**
- **Quality of public expenditure in EMU**
- **Sovereign debt crises in EMU**

The debate is still open, the context evolves but the basic issues do not change

- **How effective and efficient are the EU numerical rules? Are there better rules?**
- **How can we improve national institutions & procedures?**
- **Should we have more co-ordination at EU level? Or a bigger federal budget?**
- **What is the role of financial market discipline? Should we strengthen it?**

This Workshop tries to push forward the debate on the future of EU rules.

The future (1)

- The last 20 years confirmed that **fiscal issues are complex** from a technical point of view and even more complex from a political point of view ⇒ **fiscal analysis should support the decision making process.**
- The Workshop can represent a **bridge between analytical research and policymakers** ⇒ central banks, international institutions & universities should contribute **together with ministries** & national research institutes.
- We also learned that **fiscal analysis cannot be pursued in isolation**: macro and micro issues matter, institutions matter, financial markets matter, etc. ⇒ the Workshop should be open to experts in other fields.
- Fiscal sustainability reflects both fiscal and macro factors ⇒ the Workshop should also examine **how fiscal policies affect macro factors** (e.g. productivity, competitiveness, labour market, demography).

The future (2)

- Euro Area fiscal issues still represent a major topic, but the EA is part of a globalized economy \Rightarrow the Workshop should **remain very much open to global issues and participants.**
- **Micro issues** (e.g. efficiency of expenditure programs, design of taxation, regulations, etc.) **are crucial for growth, welfare and fiscal sustainability.** In the end, most policymaking is about micro issues.
- **Informing the general public about fiscal issues** (e.g. sustainability) **is a major challenge.** Decisions are affected by the broader political debate, which is frequently influenced by what people perceive as relevant.
- **The journey has not come to an end ...**

20 YEARS: COLLEAGUES AND FRIENDS

