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The future of European fiscal governance: a comprehensive approach

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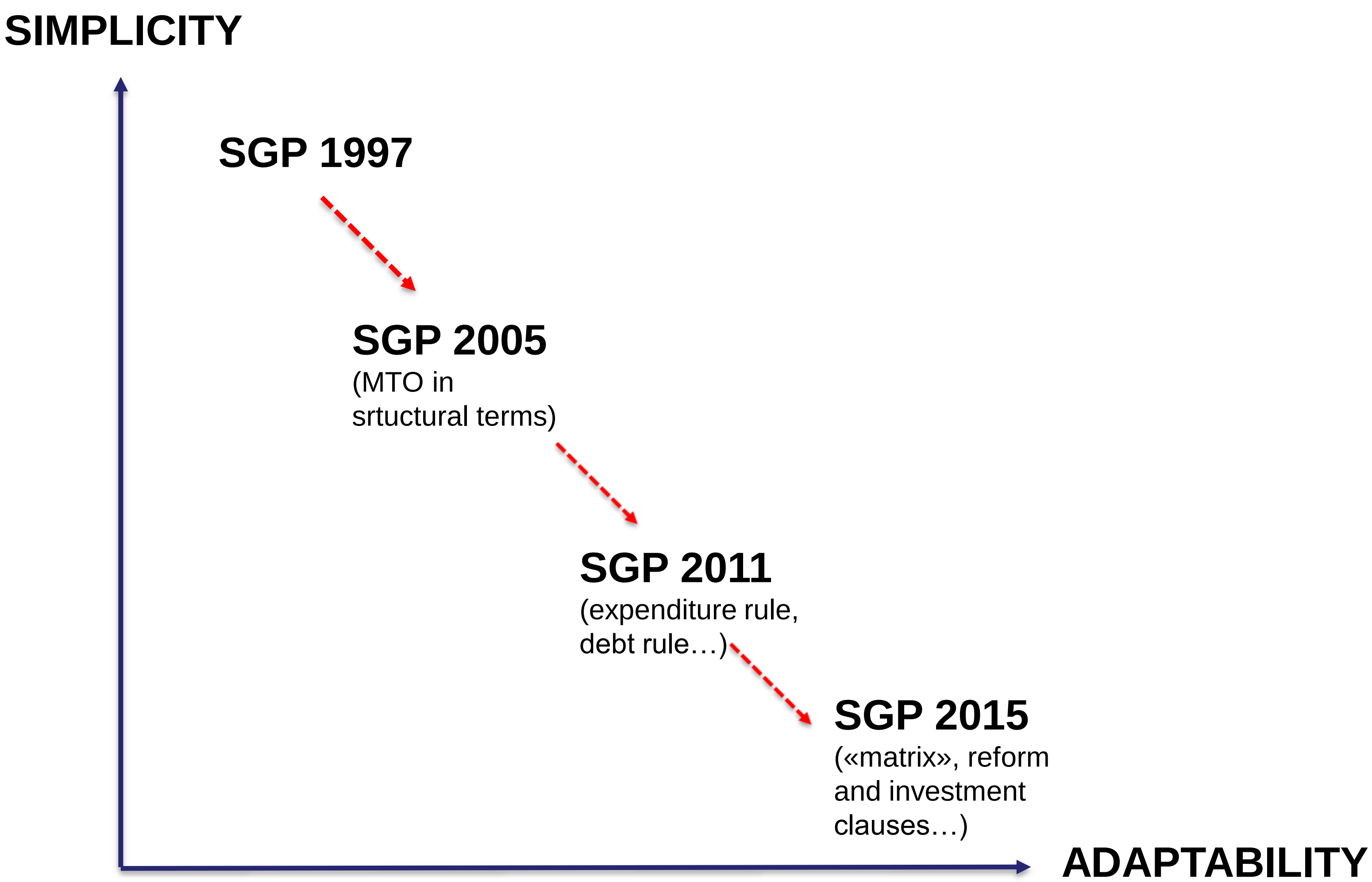
PLAN OF THE TALK

1. **Critical issues concerning the current SGP**
2. **Main reform proposals: an emerging “consensus”**
3. **Towards a Sustainability Pact?**
4. **Beyond the SGP: *NGEU-like contingent facility***

Critical issues concerning the current SGP: how we got here?

Over time, **more constraints** and **more exceptions** have been added, increasing **complexity**



Source: based on Deroose et al. (2018)

Improving the status quo: not easy as it seems

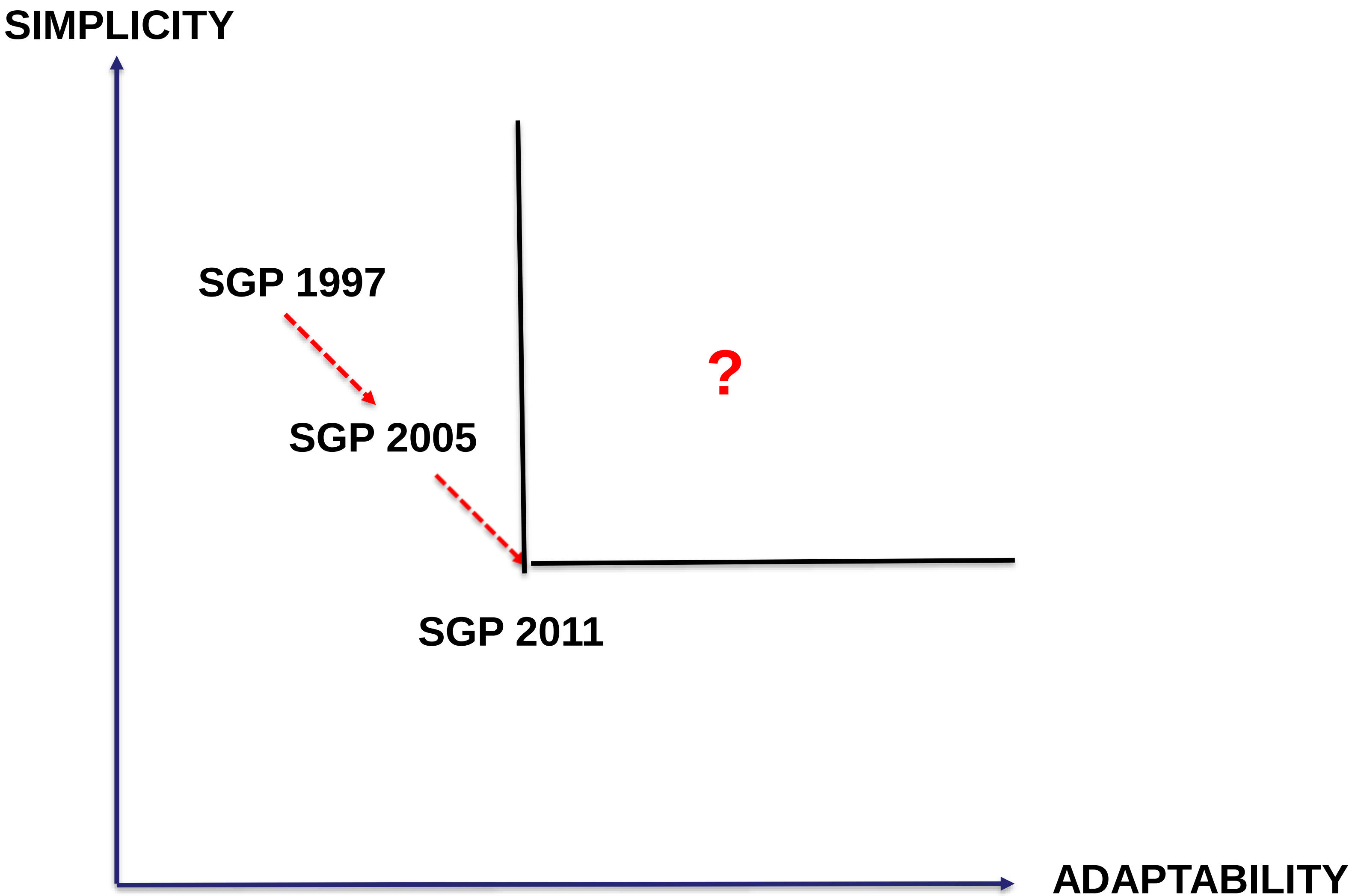
<u>We have learned that complexity is costly…</u>

- **Complex rules are difficult to implement.** Redundancies and inconsistencies encourage opportunistic behaviour («cherry-picking»). Even for governments with the best intentions, it might be difficult to comply with rules based on unobservable indicators, often subject to large ex post revisions.
- **Complex rules are difficult to communicate to the general public**. If the public opinion does not understand them, the reputational cost for non-compliant governments is reduced.

<u>…but we strive for more adaptability.</u>

- **The usefulness of discretionary fiscal policy as a macroeconomic stabilization tool has been reassessed**:
  - ✓ It can contribute to long-run public finance sustainability by avoiding **hysteresis effects**
  - ✓ In some circumstances, it can **complement monetary policy**

Improving the status quo: not easy as it seems



Main reform proposals: European Fiscal Board (2018, 2020)

- Both arms of the SGP would be substituted by **a single «fiscal anchor» – the debt/GDP ratio – and a single intermediate instrument – the growth rate of expenditures –** which has to be in line with potential output growth, except for a factor which ensures convergence of high-debt countries toward the debt target.

- The EU Council would indicate for each Member State an adjustment path towards the 60% target. **Every three years the Council would reassess the adequacy of the adjustment path.**

- **The speed of convergence toward the 60% target could be country specific.** Within limits, **a higher growth rate of expenditures** could be allowed **if the extra spending is for investments**.

Main reform proposals: Blanchard et al. (2021)

- The fiscal framework should **focus on avoiding «gross errors»** – policy choices potentially harmful for neighbouring countries – instead of trying to engineer the optimal policy in every country at every point of the cycle.

- Given the impossibility to foresee ex ante all the relevant contingencies, the fiscal framework should **grant sufficient discretion to EU authorities**

- As a consequence, the authors suggest to **move from the current rule-based approach to a standard-based one**. In particular, they advocate the following standard (.i.e. a qualitative prescription that leaves room for judgment): “a country’s fiscal policy should ensure public finance sustainability with high probability”. Such probability should be assessed through **stochastic debt sustainability analyses.**
- country-specific debt-to-GDP target to be set by the national fiscal council using a debt sustainability framework developed by the European Commission and/or the European Fiscal Board

Main reform proposals: Martin et al. (2021)

- Martin et al. (2021) share most of the underlying principles of Blanchard et al. (2021), but their proposal is less radically transformative.

- The 3% deficit limit and the MTO structural balance target would be abandoned. **The debt-to-GDP target would become *country-specific*** and it would be **determined on the basis of a stochastic DSA**.

- The (S)DSA methodology would be defined by the European fiscal board (EFB) and would be applied by the national *fiscal board*

- If the debt ratio exceeds the DSA-based threshold, the Member state will have to respect **an expenditure growth target** which allows to bring the debt ratio in line with its debt target.

Main reform proposals: Giavazzi et al. (2021), Hauptmeier et al. (2022) and Francová et al. (2021)

- As in EFB (2018,2020) and in Martin et *al.* (2021), these papers envisage a debt anchor coupled with an expenditure rule.

- The main innovative element is **a numerical twist in the debt rule formula**:
  - ✓ Giavazzi et al. (2021) introduce **two speeds of adjustment: “bad debt”** should be reduced faster than **“good debt”**, i.e. the fraction of debt which finances growth-enhancing expenditures. These expenditures are also excluded from the relevant budget balance (like in a “golden rule”).
  - ✓ Hauptmeier et al (2022) propose a reduction of the adjustment speed (from 1/20 to 1/33) and **the use of the ECB target inflation rate** (2%) instead of the expected price increase.
  - ✓ Francová et al. (2021) keep the adjustment speed unchanged (1/20) but the debt-to-GDP reference value from 60% to 100%

Some stocktaking

All in all, **the proposals go in the right direction, and they suggest that a "consensus" is emerging**.

PROS

- All **focus on medium-term debt sustainability**

- **They significantly simplify the set of rules and leverage the skills and reputation capital of independent fiscal authorities**

- They include ***country-specific*** elements and recognize the importance of national «ownership» and of interacting ex ante with member countries.

Some stocktaking (II)

<u>CONS</u>

- **Excessive reliance on DSA exercises is dangerous**.
  - ✓ These methodologies are very sensitive to the underlying modelling assumptions.
  - ✓ They are not very transparent and their results are difficult to communicate to the general public (and to investors).
  - ✓ To the extent that they use a precise sustainability thresholds they might induce destabilizing and self-fulfilling market behaviour

- **The advantages of an expenditure growth target seem over-emphasized** (more on this below)

Towards a «sustainability pact»? (Romanelli *et al* 2022)

- Our proposal is based on **bilateral «sustainability pacts» between the Commission and high-debt member countries.** Each pact would have to be approved by the Council.

- **The pact includes a medium-term** (3/5 years) **debt target and a headline deficit profile consistent with the target.** The debt rule, the expenditure rule and the MTO are eliminated.

- It is based on macroeconomic and public finance **forecasts validated by the national fiscal council and the EFB**

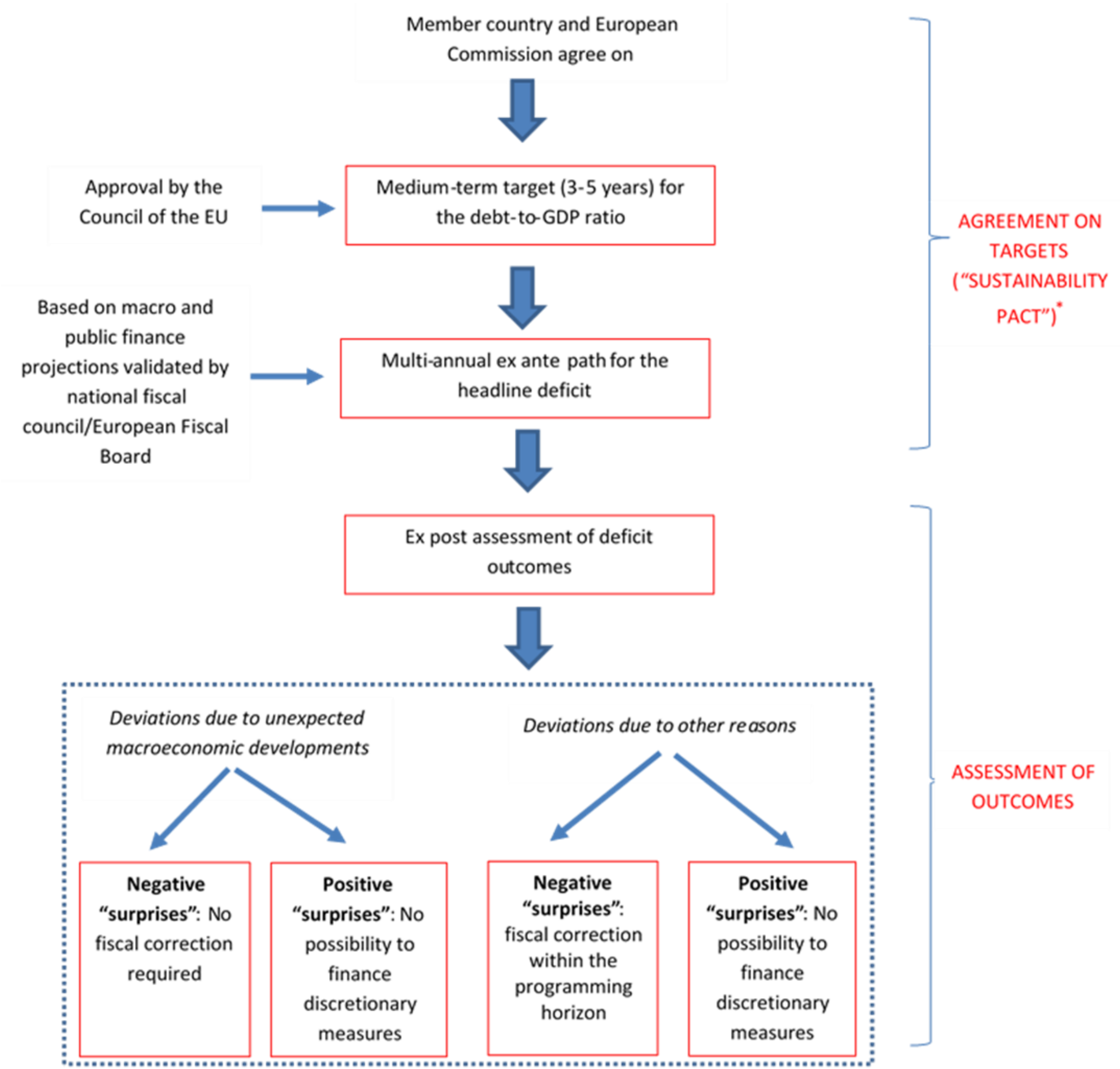
- **Importance of the «disagreement point»: in case an agreement is not reached, the current debt rule would be applied**

Towards a «sustainability pact»? (Romanelli *et al* 2022)

- **Ex post, in case of slippages:**
  - ✓ If they are due to unforeseen macroeconomic developments, the Country *should not* react.
  - ✓ In case the effect of some discretionary expenditure or revenue measure was miscalculated, the Country *should* act to compensate «bad» (i.e. deficit increasing) deviations.

- **In case of non compliance, the EDP applies.**

Towards a «sustainability pact»? (Romanelli *et al* 2022)



Towards a «sustainability pact»? (Romanelli *et al* 2022)

<u>Advantages vis-à-vis the other «consensus» proposals</u>

- **Transparency**: non-observable variables (especially the notorious «potential GDP») play no role in the definition of the pact
- **Ease of communication**
- **Apparent and shared political ownership**. The reputation of both parties is put "on the block"

Focus: deficit vs expenditure rule

Focus: horizontal equity

Beyond the SGP: from constraints to opportunities

- **Besides advocating a "sustainability pact", we argue for the introduction of a common fiscal capacity**

- Taken in isolation, a **common fiscal capacity is an insurance** against country-specific shocks. By issuing common debt - it is also useful in the case of severe and prolonged symmetrical shocks, ensuring an appropriate fiscal stance for the area as a whole.

- The **debt issued by the capacity could also alleviate the current safe asset scarcity**. This would help European banks to diversify their sovereign portfolios, facilitate the implementation of the common monetary policy and foster the international role of the Euro.

- **Furthermore, a common fiscal capacity is an indispensable complement to national fiscal constraints**:

  ✓ if an adequate common capacity is in place, simpler fiscal rules are possible, because the former can provide the necessary adaptability

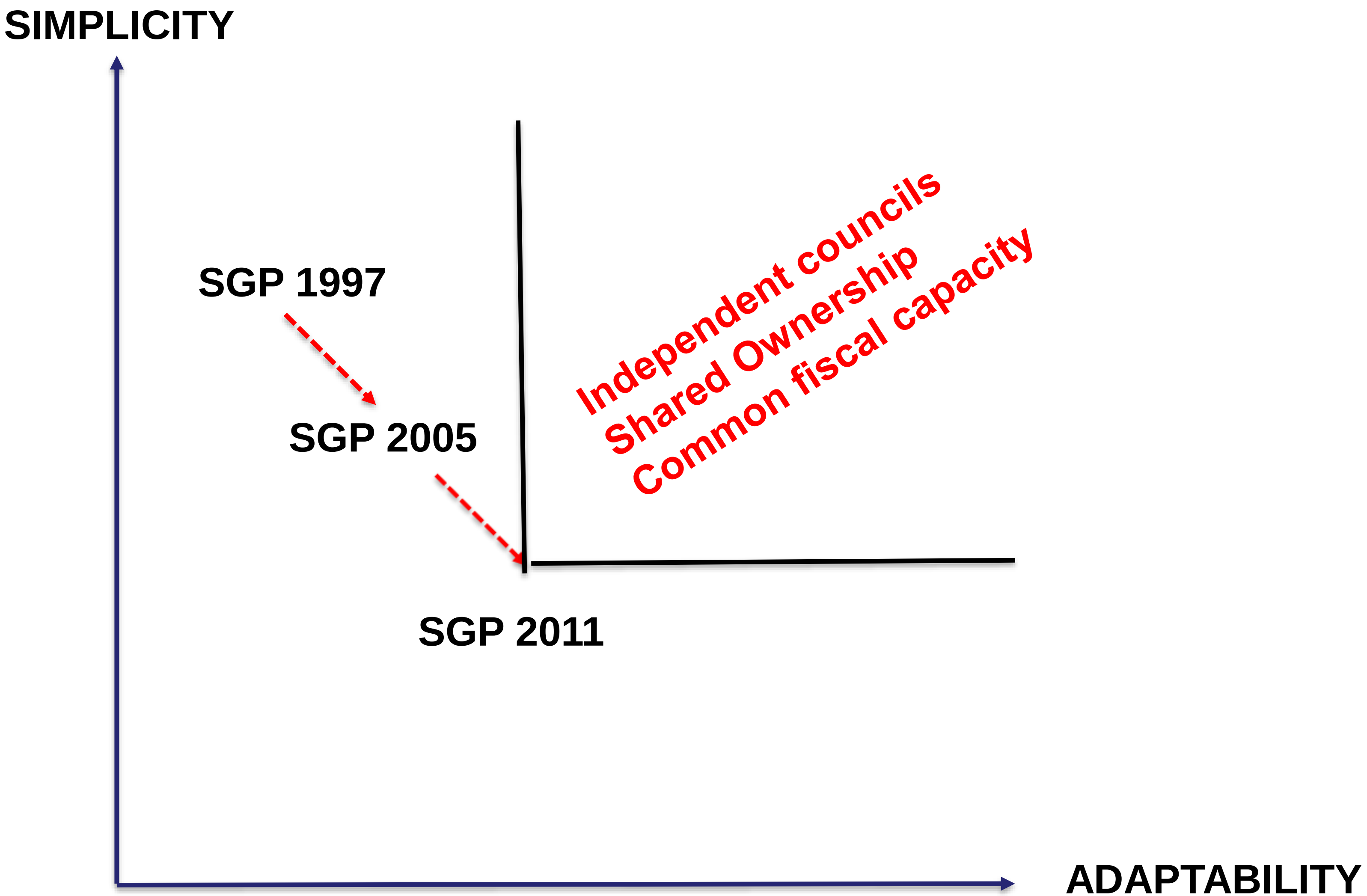
  ✓ if investments are partly financed by the fiscal capacity, it is less necessary to introduce "golden rules " at the national level.

Beyond the SGP: from constraints to opportunities (II)

While a full-fledged federal budget would run into **legal and political obstacles**, a **«permanent but *contingent* NGEU» could represent a second-best solution**

- It would be activated in circumstances and with modalities defined ex ante
  - ✓ particularly adverse macroeconomic conditions (as measured e.g. by GDP and/or employment dynamics)
  - ✓ common EU projects of an exceptional nature (e.g. in the energy sector)
- Access to the contingent fiscal facility funds could be conditional on compliance with the reformed fiscal framework
- A contingent facility **should not require changes to the Treaties**
- **Timeliness and design of interventions would improve, economic agents' uncertainty would be reduced** (cfr. the literature on quasi-automatic fiscal stabilizers)

TO CONCLUDE…


SIMPLICITY
SGP 1997
SGP 2005
SGP 2011
Independent councils
Shared Ownership
Common fiscal capacity
ADAPTABILITY

Thank you for your attention!

Some references

MAIN REFORM PROPOSALS
(in order of appearance ☺)

- European Fiscal Board (2020), *Annual Report 2020*

- Blanchard, O., Leandro, Á. and Zettelmeyer, J. (2021), “Redesigning EU Fiscal Rules: From Rules to Standards”, *Economic Policy*, vol. 36(106), pp. 195-236.

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- Hauptmeier, S., Leiner-Killinger, N., Muggenthaler, P. and Haroutunian, S. (2022), “Post-COVID fiscal rules: a central bank perspective”, ECB Working Paper Series No 2656.

Some references (II)

OUR PROPOSAL

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BEYOND SGP: FROM CONSTRAINTS TO OPPORTUNITIES

- Balassone, F., Momigliano, S., Romanelli, M. and Tommasino, P. (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.
- Cioffi, M., Rizza, P., Romanelli, M. andTommasino, P. (2019) « Outline of a redistribution-free debt redemption fund for the euro area», Occasional Papers n. 479, Banca d' Italia. (https://www.bancaditalia.it/pubblicazioni/qef/2019-0479/QEF_479_19.pdf)
- Caprioli, F., Romanelli, M. and Tommasino, P. (2020), «Discretionary fiscal policy in the Euro area: Past, present and future», *Economia pubblica*, vol. 2020(1), pages 55-85

Focus: deficit vs expenditure rule

Why we prefer a (nominal) deficit target?

- Simplicity and transparency: no reference to unobservable indicators in setting targets
- Easy to communicate
- Directly linked to the change in debt-to-GDP ratio, which is the ultimate target of the fiscal framework

Main criticism: lack of (ex-ante) countercyclical stabilization features

- Countercyclical features play a role in the ex-post valuation: the deficit profile is binding (deviations adjusted within a set timeframe) unless deviations due – based on the assessments of independent national and European fiscal councils – to macroeconomic surprises
- National automatic stabilizers can operate freely and symmetrically
- **Differences are often over-emphasized.** A deficit target would be *de facto* equivalent to an expenditure rule based on GDP growth rate projections (Bordignon and Pisauro, 2021), instead of the growth rate of potential; Francová et al. (2021) propose the use of real growth trends as a benchmark.

Focus (II): Horizontal equity

Why no pre-determined benchmark for setting targets?

- To avoid the "Complete contract loop": having an explicit benchmark unavoidably leads to what we are trying to overcome, a stratification of rules and exceptions
- To increase ownership: targets are jointly agreed and cannot be perceived by the public opinion as externally imposed

Will this worsen horizontal equity? No, since the reformed governance should increase:

- Technical bodies involvement:
  - National IFIs should be entrusted with the validation of the projections and assumptions (including quantification of the discretionary measures).
  - the EFB should carry out the analyses and technical assessments underlying the Commission's decisions, besides coordinating the activities of the national IFIs.
- "Peer-to-peer scrutiny": targets agreed between the Commission and the country must be approved by the Council as part of the procedures under the European Semester
- "Default option": failure to agree on the content of the sustainability pact would imply that the country has to respect the current 1/20 debt rule