Improving economic policy

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EU fiscal rules: is there a feasible improvement?

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The status quo ante (2015-2021)

Academics/thinktanks/EFB: Need better design and application. Rules are …

- Procyclical
- Unfriendly to public investment, including Green investment
- Inefficient: require fiscal adjustment when it may not be needed, and do not require adjustment when it may be needed.
- Regularly ignored.

"South": Need more flexible rules for stabilization and investment.

"North": Rules fine—if anything, too flexible. Just need to be better enforced.

European Commission: kept mum, but sympathy with academics

- started working on a review in 2019. Derailed by pandemic.

What is new?

1. The gap between North and South has narrowed.
   - 2022 Papers by Dutch and Spanish governments (yes, jointly!) and German government.
2. Two new proposals—by IMF and EFB—which could be helpful to closing the remaining gap.
3. European Commission: proposal expected on October 26, 2022

The Dutch, Germans and Spanish appear to agree on 4 propositions. This is progress.

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1. Core objective of reform: to ensure debt sustainability "in a more effective and efficient manner".
2. Other fiscal policy objectives (stabilization and public investment) also matter. Fiscal rules should aim at getting that trade-off right
3. Bilateral deals between the European Commission and member states are not an acceptable way of figuring out the optimal compromise.
4. Better implementation of the fiscal rules is critical. This requires better national ownership of the rules.

The key question: is there a reform that can meet all four objectives?

Two challenges in particular

1. Is it possible to BOTH ensure debt sustainability with high probability in an even-handed way (same rules for all), AND allow compromises between fiscal adjustment and investment/stabilisation objectives that must inevitably reflect country-specific circumstances?
2. How to achieve much better implementation than in the past without fundamentally changing the means by which rules are enforced at the EU level (as the latter would require Treaty change).

Answer from two new papers (IMF, EFB, September 2022): maybe

Challenge 1. Reconciling debt sustainability and flexibility

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The IMF's answer:

- Annual debt sustainability analysis based on agreed methodology is the first step in the application of the rules. Countries classified into high/medium/low risk.
- *High risk* countries: medium-term fiscal plans must target 0 percent headline deficit within 3-5 years.
- *Medium risk* countries (or low risk countries with debt>60 percent of GDP) must target declining debt path within 3-5 years.
- *All* countries must plan for a deficit < 3 percent of GDP in every year.
- To avoid counterproductive fiscal adjustment following large recessions—there would be an escape clause. Could be country-specific.

Why the IMF's answer might work

1. "Risk based approach"
   - Makes trade-offs more efficient. Do not waste adjustment effort where it is not needed.
2. Commonality in methods (leading to risk classification) + a numerical rule (for given risk classification)
   - Helps meet even-handedness requirement.
3. Room to accommodate investment/stabilization via several channels
   - Some flexibility on the adjustment period (3-5 year horizon).
   - No special treatment for investment, but rules would allow a temporary increase in debt, provided the MT target is met (0 deficit for high risk; lower debt for medium risk)
   - Country-specific escape clause for severe downturns.

Challenge 2. Improving implementation through national ownership—while avoiding a free-for-all

The IMF's and EFBs answer:

1. Empower independent fiscal institutions at the *national* level. They would be the first line of defense against member state violation of the rules.
   - this requires "a substantial strengthening of the IFIs in many, if not all, countries"(EFB) —likely via an EU Directive laying out minimum standards.
2. Focus EU-level surveillance only on the correction of "gross policy errors".
   - Makes effective enforcement by Council and Commission more credible
   - Commission would focus on (1) the adequacy of national fiscal frameworks; (2) establishing whether an excessive deficit is present and conducting the EDP
3. IMF additionally wants to upgrade EFB, which would conduct independent surveillance along with the Commission.
   - Will make Commission unhappy, but may reassure some MS.

Conclusion

There is a feasible improvement, but it involves a narrow path.

1. Rely on all available information, not a rule, to define medium term adjustment objectives, using a common methodology.
2. Use rules to define operational targets in the pursuit of these objectives.
3. Increase national ownership by giving more autonomy to member states
4. Prevent abuse of this autonomy by
   - strengthening national fiscal frameworks – including the role of national IFIs
   - Focusing the role of the European Commission on “gross errors”
   - Strengthening the role of the EFB as coach of national IFIs and arbiter of the system.

Thank you!

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