Reform of fiscal rules to improve stability prospects in the euro area

Giuseppe Pisauro

Parliamentary Budget Office

International Conference of Councils on Economic Policy

organized by CPB Netherlands Bureau for Economic Policy Analysis and German Council of Economic Experts

The Hague, 22 June 2018

Euro zone fiscal rules: the state of art

- In the aftermath of the crisis , at the same time: tightened the surveillance of the rules and broadened their flexibility.
- This actually has made rules more "intelligent" by strengthening their economic rationale.
- But at the price of complexity and more discretion (up to a point that it may endanger the very rule-based nature of the framework) and a problem of transparency.

The implementation of fiscal rules

- If we look at the aggregate fiscal stance for the euro area, on the whole the final result appears to be appropriate (EFB Report 2017).
- Difficult to obtain the same result without using discretion
  - in the absence of a larger central budget (which in general would be the optimal instrument to perform the stabilization task) and
  - in a context without any coordination among countries in defining their individual stance: countries with fiscal space not willing to use it and countries with sustainability problems having a stronger need of stabilizing their economies

An example: Italy

Summary statistics 2017

Economy

- GDP growth: real 1.5%, nominal 2.1%
- Current account surplus: 3.1%
- Unemployment rate: 11.2%
- Compared to 2007:
  - real GDP is still 5.5% lower, nominal GDP is just 6.6% higher

Public finance:

Headline deficit -1.9

Primary balance +1.9

Structural balance: -1.1

Public debt: 131.8 (99.8 in 2007)

Italy and fiscal rules: the main beneficiary of «flexibility» (discretion?) in the implementation of fiscal rules

- A summary: Deviations from the path of adjustment towards the MTO due to flexibility granted to Italy, 2015- 2018

	% GDP				Absolute values (billions of euros)				
	2015	2016	2017	2018	2015	2016	2017	2018	Total 2015-18
a) Economic cycle [(1)]	0.25				4.1				4.1
a) Structural reforms		0.50				8.4			8.4
a) Investment		0.21				3.5			3.5
b) Migrant flows	0.03	0.06	0.16		0.5	1.0	2.7		4.3
b) Security		0.06				1.0			1.0
b) Seismic activity			0.18				3.1		3.1
c) Margin of discretion				0.30				5.3	5.3
Total	**0.28**	**0.83**	**0.34**	**0.30**	**4.6**	**13.9**	**5.8**	**5.3**	**29.7**
Nominal GDP (DBP 2018)					*1,652.2*	*1,680.5*	*1,716.5*	*1,770.3*	

Source: PBO, *Focus* n. 3/2018, tab. 1.

Medium term fiscal plans

Planned Net borrowing (% GDP)							
	2014	2015	2016	2017	2018	2019	2020
DBP 2014	-3,0	-2,9	-1,8	-0,8	-0,2		
DBP 2015		-2,6	-2,2	-1,1	-0,2	+0,3	
DBP 2016			-2,4	-2,3	-1,2	-0,2	
DBP 2017				-2,1	-1,6	-0,9	-0,2

Planned Structural balance (% GDP)							
	2014	2015	2016	2017	2018	2019	2020
DBP 2014	-0,9	-0,9	-0,4	0,0	0,0		
DBP 2015		-0,3	-0,7	-0,3	0,0	0,0	
DBP 2016			-1,2	-1,6	-0,7	-0,2	
DBP 2017				-1,3	-1,0	-0,6	-0,2

A strategy?

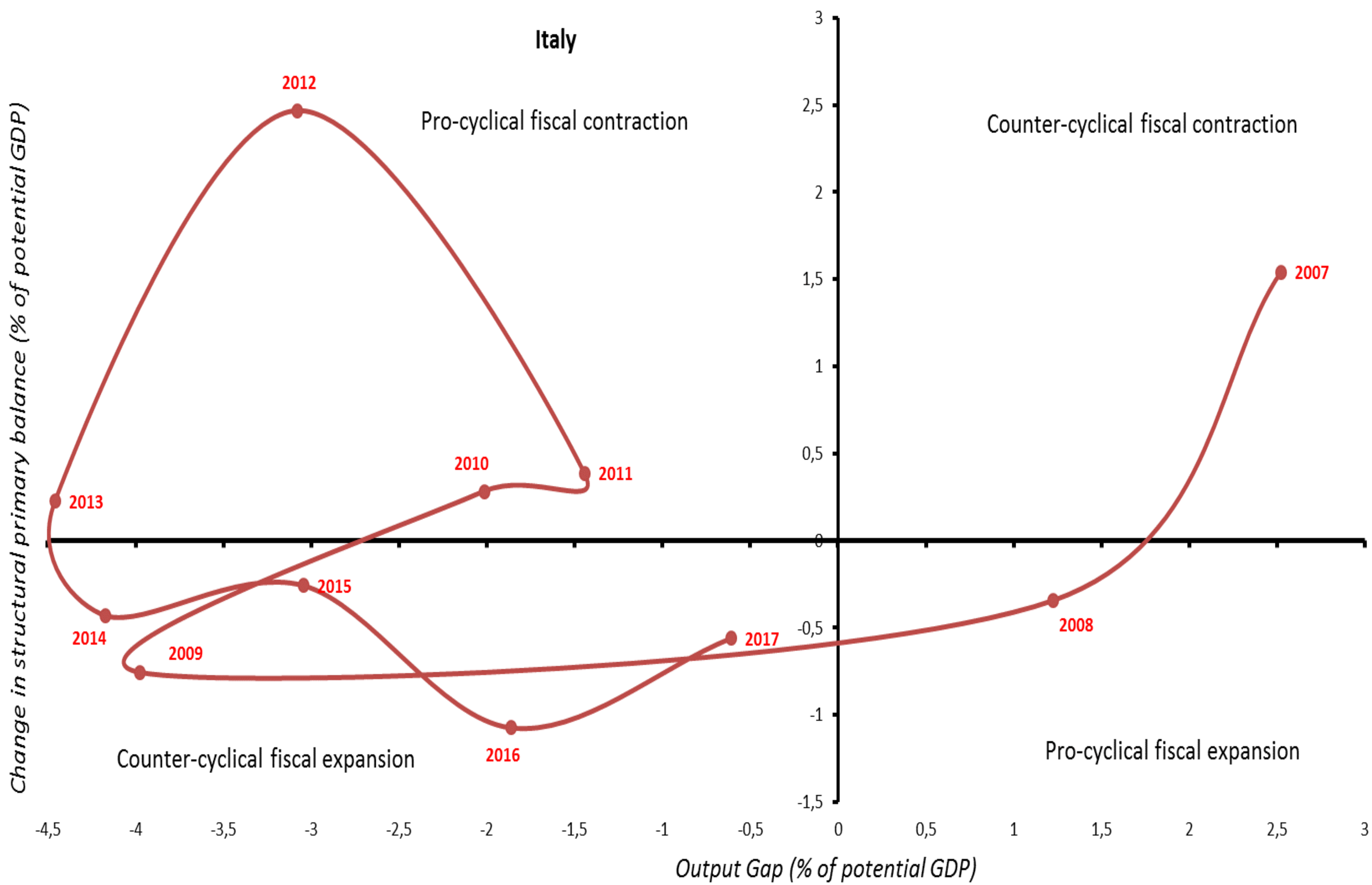
Since your desired fiscal plan is beyond what is allowed by the current framework, place yourself on the “frontier of flexibility” at the time of the plan and bargain in order to move the frontier

Structural balance in years t and t+1			
	Year t	Year t+1	Allowed deviation
Spring 2014	-0,6	-0,1	
Autumn 2014	-0,9	-0,9	0,28
Spring 2015	-0,5	-0,4	
Autumn 2015	-0,3	-0,7	0,83
Spring 2016	-1,2	-1,1	
Autumn 2016	-1,2	-1,6	0,34
Spring 2017	-1,5	-0,7	
Autumn 2017	-1,3	-1,0	0,30

The outcome?

- Not a best practice in terms of compliance with rules.
- However, the final outcome of such strategy does not point to fiscal profligacy.
- Look at the fiscal stance (as defined by the EC) and at the actual fiscal effort (measured by the primary balance).

Overall results: fiscal stance

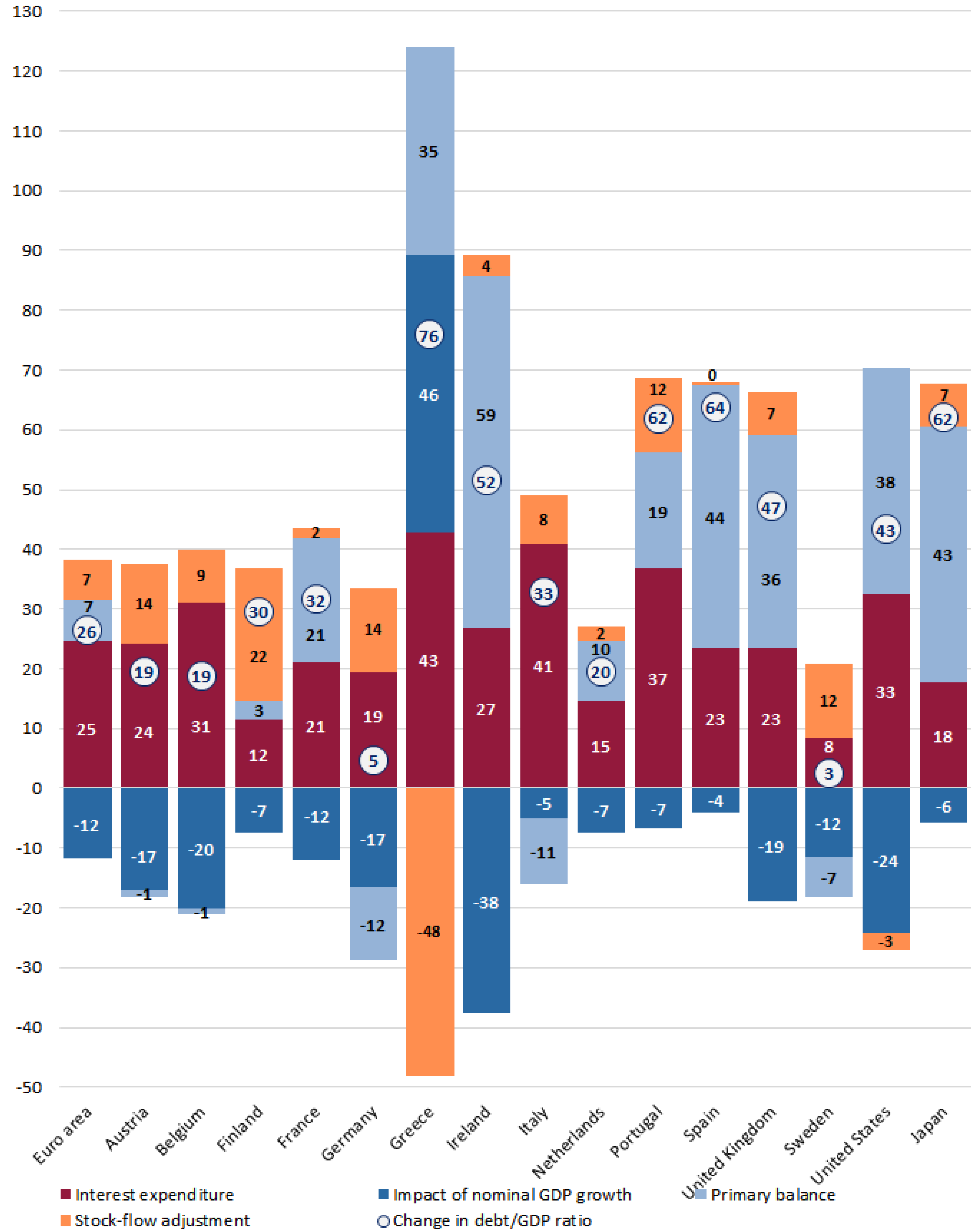


Fiscal effort in a comparative perspective

Breakdown of the change in the debt/GDP ratio – Cumulative figures 2008-2016

(percentage of GDP)

The only country (neglecting Greece) where the sum of primary surplus and stock-flow adj. has contributed to a *decrease* in the ratio



You need a fiscal buffer

In the previous decade (1996-2007), fiscal effort in a comparative perspective was intense but just enough to decrease the debt ratio by 17 points.

But one (only one) country did better in terms of fiscal effort.

D/Y: 1995 Belgium 130,5, Italy 116,9

2007 Belgium 87, Italy 99,8

Primary surplus 1996-2007: Belgium 61 points, Italy 37 points

(Other factors, nominal GDP growth, interest expenditure and stock-flow adj. are the same in the two countries)

PBO*, Flash n. 2, 2017*

http://www.upbilancio.it/wp-content/uploads/2017/08/Flash-2_2017.pdf

Prospect for a reform

- In any case, this cannot be a stable set-up
- Poor functioning of fiscal rules (e.g. reliance on the cyclical adjustment of deficits, which is imprecise and difficult)
- Need to reform fiscal rules
- **Expenditure rule with a debt target**
  - EC proposal for a Directive (December 2017)
  - Paper by 14 French and German economists (CEPR, January) 2018

How will the appropriateness of the debt target be assessed?

- Not clear what would happen to present debt rule, which set the pace of approaching the 60% threshold
- EC proposal for a Directive uses exactly the same wording as in Maastricht Treaty: «*approaches it at a satisfactory pace*» while leaving the task of assessing whether the MTO chosen by the country is appropriate to national fiscal councils.
- The recent paper by 14 (French and German) economists is more explicit: the debt reduction target is proposed by the national fiscal council for approval to the euro area fiscal watchdog (the EFB?)

The right solution for debt externality?

- Excessive debt accumulation in one country can lead to financial instability triggering contagion for all members → need for a debt rule.
- Surrender ownership to a technical body? Democratic accountability. The choice of the precise value of the target is always somewhat arbitrary, and **it is** a political choice. An independent body can advise on the consequences of choosing different values and should monitor the path toward a target once it has been set. But it should not be in charge of setting the target itself.
- A sensible way: coordination among countries in order to internalize the externality (European Council, European Commission).

Anything missing?

- A centralized fiscal stabilization function (investment protection scheme?)
- Take the issue of eurozone fiscal stance more seriously. Rely solely on a measure of the output gap to assess it?

Nawru and unemployment rate (EFB 2018)
alias The macroeconomics of Dr. Pangloss