Ufficio Parlamentare di Bilancio – European Fiscal Board

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Panel Discussion

Simplifying the rules and improving enforcement: easier said than done

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1. Key Messages in the Report

1. too much (biased) judgement by the Commission
2. this is the consequence of complex/opaque rules …
3. … which need to be simplified
   a. one operational target (expenditure benchmark) + one medium-/long-term anchor (Debt/GDP)
   b. implementation focused on important deviations over the medium term
   c. clear separation of assessor and decision-maker roles

My Comments

A. two important issues I won't discuss

- ✓ EC: biased judgement or prudence after a deep and long recession?
- ✓ separating assessor and decision-makers: how?

B. focus on a single issue: no simple rule can do a complex job

- ✓ is the proposed expenditure rule truly simple?
- ✓ can it be effective?

Simple Rules and Complex Jobs: How "Simple" is the Expenditure Benchmark?

- ✓ "The reason for the current complexity is that the economic reality itself is complex" (EFB Report: sect. 6, p. 81)
- ✓ The expenditure ceiling is computed on the basis of
  - on the basis of "**assumptions about real GDP growth, inflation, interest rates**" and
  - assuming that "**output is at its potential rate**"
  - so as "**to ensure that gross debt reaches 60 % of GDP in *t*+15**" (EFB Report: sect. 6, p. 79)
- ✓ "**If a Member State's budget deficit exceeds 3 % of GDP** and the breach is not exceptional and temporary, **an excessive deficit procedure will be launched" unless** the MS
  - **is complying with the expenditure ceiling**, or
  - **has a debt ratio projected to stay below 60 % of GDP**" (EFB Report: sect. 6, p. 83).

Simple Rules and Complex Jobs: How "Effective" Can the Expenditure Benchmark Be? (I)

✓ The operational target chosen is further away from the m/t anchor than the deficit (nominal or structural)

- <u>present situation</u>:

$\Delta(D/Y) = -(D/Y)_0\,[g/(1+g)] + \textbf{deficit/Y} + \textbf{sfa/Y}$

Deficit = interest + $(E\text{-}R)_{\text{Non-cyclical}}$ + $(E\text{-}R)_{\text{Cyclical}}$ – Discretionary measures

(structural deficit)

- <u>EFB proposal</u>:

Deficit = Primary Deficit + **Interest Expenditure (int)**

Primary Deficit = $(\textbf{E}\text{-}\textbf{R})_{\text{Non-cyclical}} + (\textbf{E}\text{-}\textbf{R})_{\text{Cyclical}}$ – **Discretionary measures**

Simple Rules and Complex Jobs:
How "Effective" Can the Expenditure Benchmark Be?

$$\Delta(D/Y) = -(D/Y)_0\,[g/(1+g)] + SFA/Y + int/Y$$

$$+\ \underbrace{[(E)_{\text{Non-cyclical}} - \text{Discretionary measures}\,]}_{\text{EFB Operational target}} + \underbrace{(E-R)_{\text{Cyclical}}}_{\text{Cyclical component}} + \underbrace{[\,(R)_{\text{Non-cyclical}}\,]}_{\text{Revenue windfalls/shortfalls}}$$

- ✓ Compared to present situation, besides SFA, we lose track of
  - ✓ cyclical component (the same as with structural deficit)
  - ✓ interest payments
  - ✓ windfalls/shortfalls
- ✓ NB: the compensation account is also based only on $E_{\text{non-cyclical}} - DM$
- ✓ Estimation of **Discretionary Measures** likely to become the "new output gap"

A Deficit Rule in Disguise?

- ✓ The problem with the structural balance is … estimating potential output
- ✓ The EFB proposes to replace it with an "ad hoc", more stable variable (a moving average of potential output) and apply it to "net expenditure" only over a 3-year horizon
- ✓ **Why not apply the "ad hoc" and stable variable to the whole primary balance (possibly including SFA) to determine "nominal primary surplus targets" over the same 3-year horizon?**
- ✓ Deviations from the targets would be allowed only in so far as actual growth differs from the one assumed for computing the targets (a cyclical correction based on the "ad hoc variable") …
- ✓ … while further excesses would feed into the compensation account

Why a Simple Deficit Rule Does Not Work?
Is There Another Way?

- ✓ "For Member States whose debt is already below 60 % of GDP, the only requirement is to ensure that their budget deficit remains below the 3 % reference value, in line with Treaty requirements." (EFB Report: Sect.6, p. 79)

- ✓ Fear of moral hazard lead us to part with this "old" simple rule
  a. stock flow adjustments
  b. no credibility of "no-bailout" if national debts have systemic relevance

- ✓ Possible "Solution":
  a. reduce national debt below systemic relevance (e.g. USA)
     - how? debt rule plus "insurance mechanisms" (debt redemption fund plus a centralised stabilization capacity)
  b. monitor change in debt (close to our "fabbisogno"), not the deficit ("indebitamento netto")

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

US State and Local Government Gross Public Debt
(%GDP; 2015)

	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