# New economic governance and fiscal policy decision-making: the role of fiscal councils

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# Outline

- Key principles of the new fiscal framework
- The role of fiscal councils
- The experience of Italy’s PBO
- Macroeconomic forecasts
- Budgetary forecasts
- DSA
- Open questions and challenges ahead

# Key principles

- Focus on debt dynamics
  - ✓ Debt sustainability is inherently a dynamic problem and multi-annual budgetary planning is important for ensuring stability and growth
- Country-specific medium-term structural plans
  - ✓ Consolidation plans are highly dependent on initial debt conditions as well as on macro and financial medium-term projections, which are highly heterogeneous across countries. Country-specific plans can strengthen commitment, accountability and effectiveness
- Simplification
  - ✓ Net primary spending indicator

# The basic trade-off

- The new framework strikes a balance between the **need for ownership** (commitment to country-specific plans) and the **need for symmetry** (equal conditions across countries), in the attempt to align country-specific and European objectives.

- In this delicate balance, a third-party independent assessment is key for the transparency and effectiveness of the whole process.

- IFIs have a "comparative advantage" in terms of expertise and independence.

# A strengthened role for IFIs?

- Main tasks as of Art. 8.4 of the Council directive amending Directive 2011/85/EU:

✓ Produce or endorse annual and multi-annual macroeconomic and budgetary forecasts;
✓ Produce debt sustainability assessment underlying the structural plans;
✓ Assess or endorse the impact of policy on fiscal sustainability and sustained and inclusive growth;
✓ Monitor compliance with country-specific numerical fiscal rules;
✓ Monitor compliance with the Union fiscal framework;
✓ Conduct reviews of the national budgetary framework, including sub-sectors of general government;
✓ Participate in regular hearings and discussions at the national Parliament;

- discussion still open

- Lessons from experience

✓ The Office's mandate
✓ Macroeconomic forecasts
✓ Budgetary forecasts
✓ DSA

# Macroeconomic forecasts

- The PBO’s mandate comprises endorsement of the macroeconomic forecasts of the Government (EFD and Update)

✓ The office produces its own macroeconomic forecasts and coordinates a panel of four independent forecasters. The endorsement procedure involves interactions with the MEF on preliminary versions of the forecasts. The whole process has a wide public outreach.

- Evaluation draws on prudential criteria

✓ Over the history, the Government’s forecasts have not been endorsed on two occasions, fall 2016 and fall 2018, and the Government has subsequently complied.

# Is there a bias in Government's macroeconomic forecasts?

- Excessive optimism may create artificial fiscal space

- A retrospective analysis compares GDP forecasts of MEF, EC and PBO with realizations ex post over the period 2018-2022

- Main results:

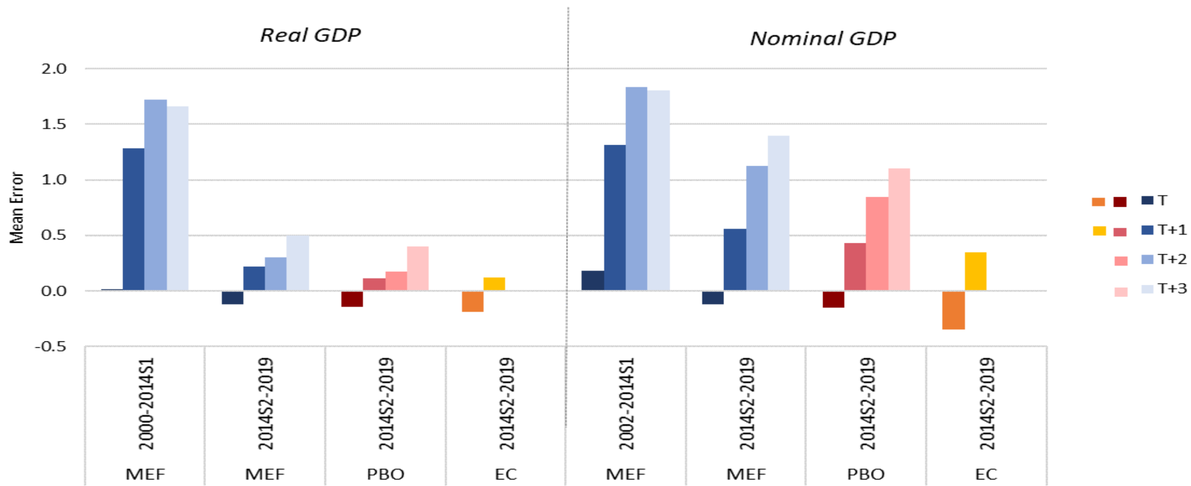
✓ There is an optimistic bias in Government's forecasts, especially at time t+1

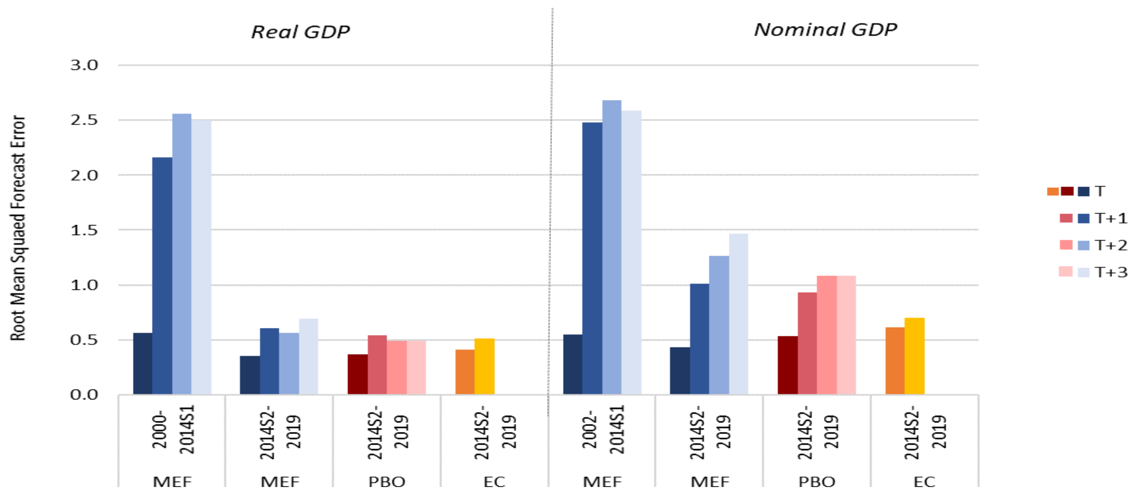
✓ Forecasts for the current year tend to be prudent

✓ The bias - measured by the arithmetic mean error or the frequency of optimistic forecasts- reduces significantly after 2014, when the PBO was established

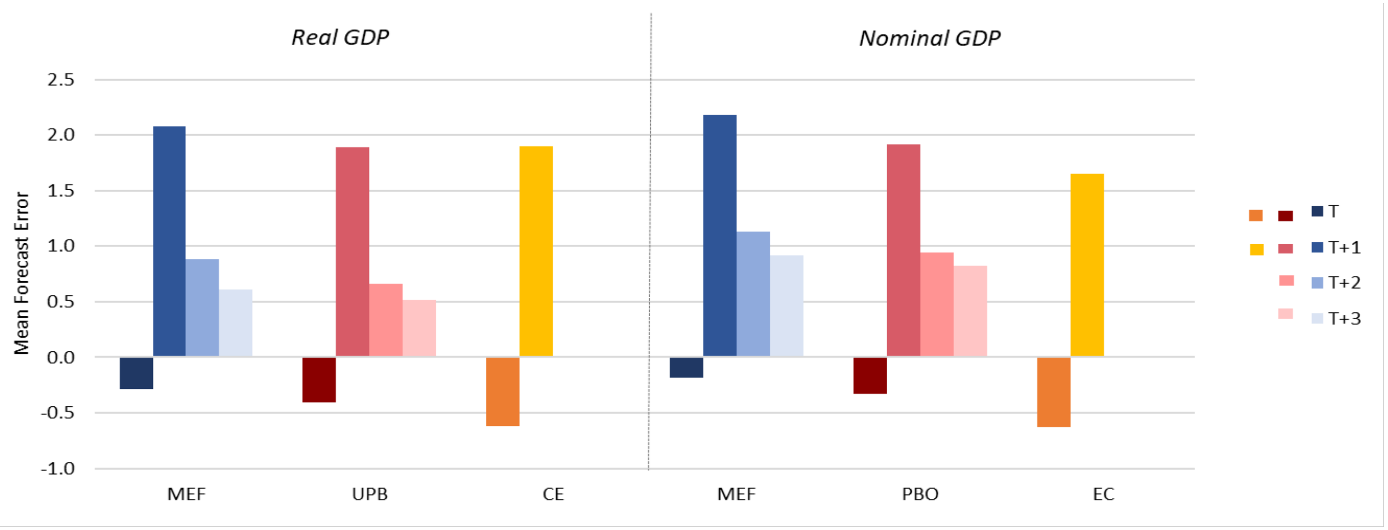
✓ Accuracy improves after 2014

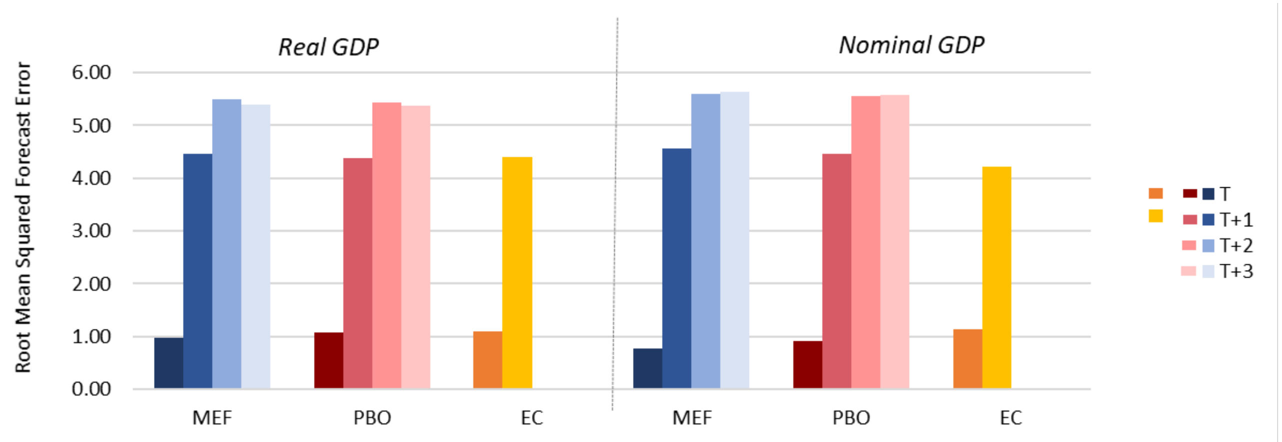
# The forecast bias has reduced since 2014



# Close up on 2018-2022




Over the past five years, the government's forecasts have been only marginally more optimistic than those of the PBO and the EC.

# Budgetary forecasts

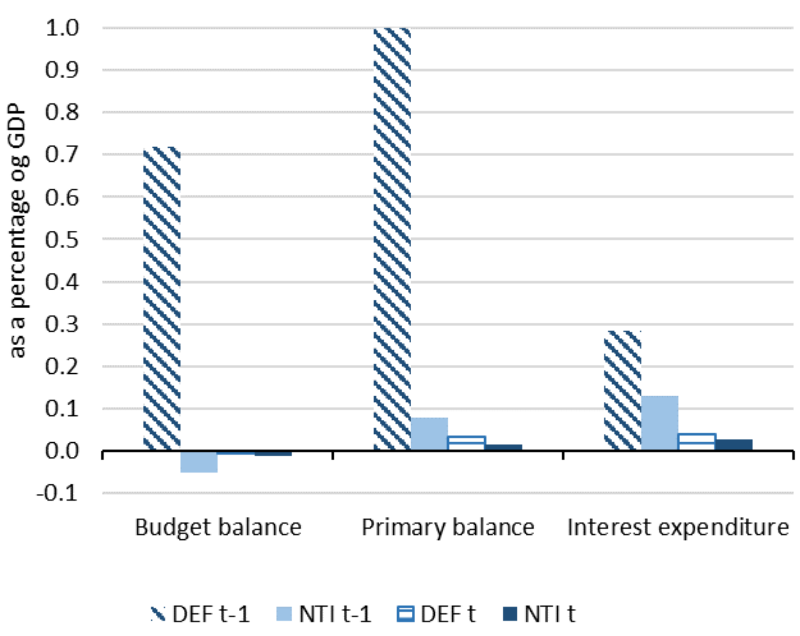
- A retrospective analysis compares the budgetary forecasts in the official planning documents with the realizations ex posts over the period 2015-2019.

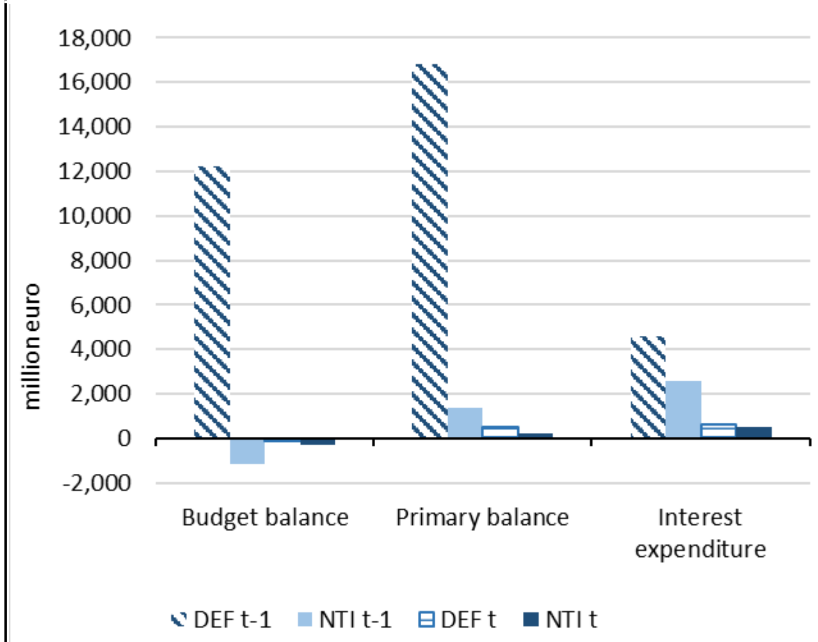
- The forecast errors of the deficit in the current year and one-year ahead are moderate on average (around 0,13 percentage points) and decline over time (except for 2020). Over and underestimates tend to offset each other on both the revenue and expenditure side.

- Forecast errors are particularly small for documents close to the budget law, i.e. for the Update Note of the EFD released in autumn. The Update draws on more accurate information compared to the EFD and this helps to forecast the deficit one year ahead.

- A non-negligible bias remains for budgetary forecasts at longer horizons: deficit targets are typically revised in a more expansionary direction over time, and the revision is larger the longer the planning horizon.

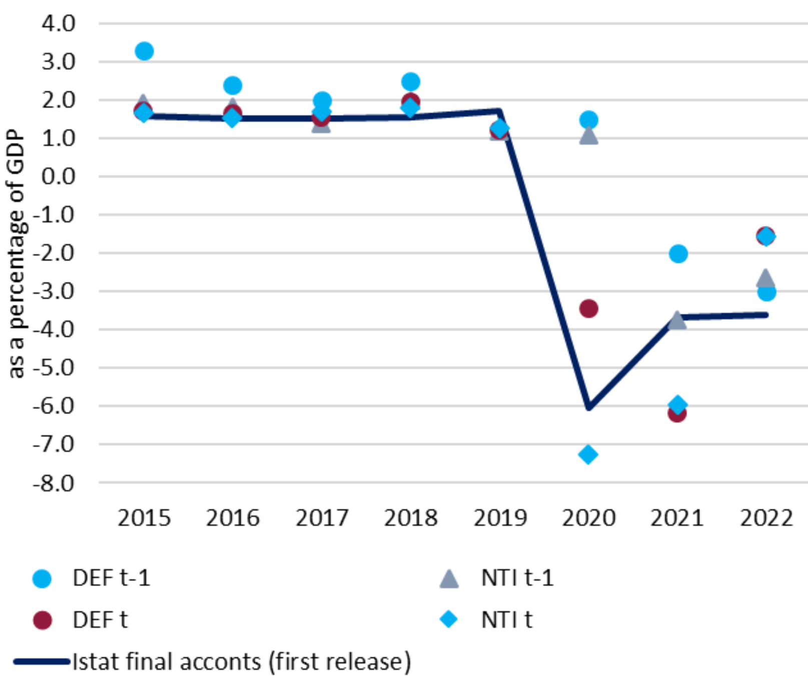
# Mean error of the budget balance, primary balance and interest expenditure forecasts (2015-2019)

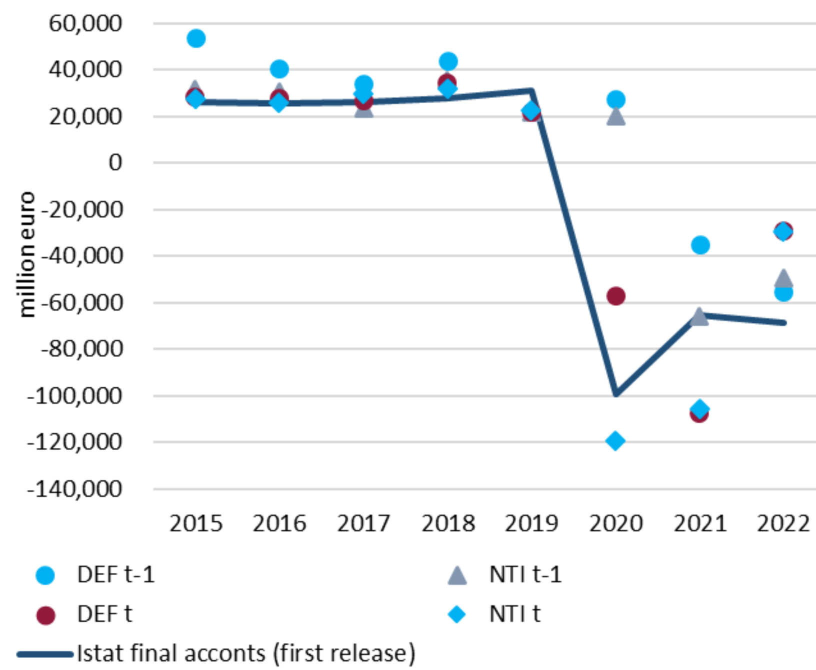



Source: elaborations on MEF and Istat data.

# Primary balance: forecasts and results




Source: elaborations on MEF and Istat data.

# Debt Dynamics

- Simulations of medium-term deficit and debt trajectories with and without an adjustment plan illustrate the implications of the new framework for Italy and the consolidation effort that would be required. The simulations draw on the Commission's methodology and our own medium-term projections.

- Two main points: in the absence of a structural adjustment plan, debt would soon start increasing; the consolidation effort is feasible and in line with the government's targets in the latest Economic and Financial Document (EDF).

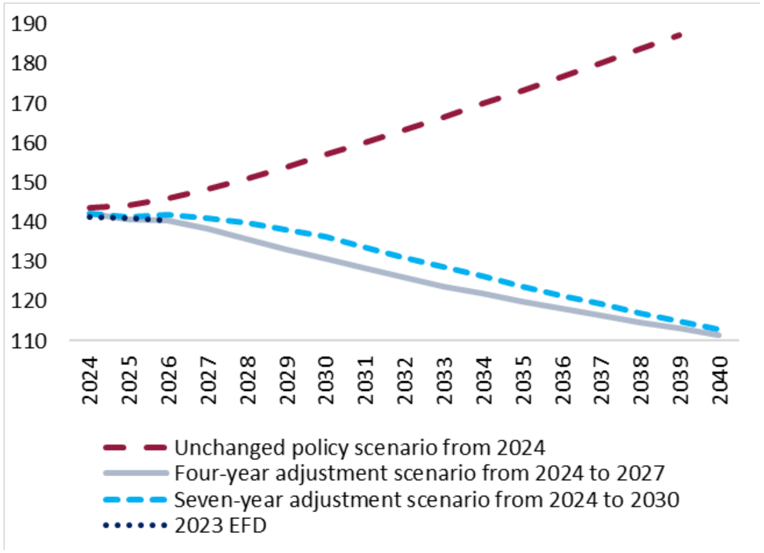
- Simulations results are highly sensitive to underlying macro and financial projections, suggesting a prudent approach. They depend on model specification and calibration of key parameters: for example, debt composition, structure, and maturity; spending and tax elasticity.

- Need for transparency. It is important that all methodological details and underlying hypotheses are publicly available and undergo a third-party, technical assessment. This requires timely information and adequate resources.

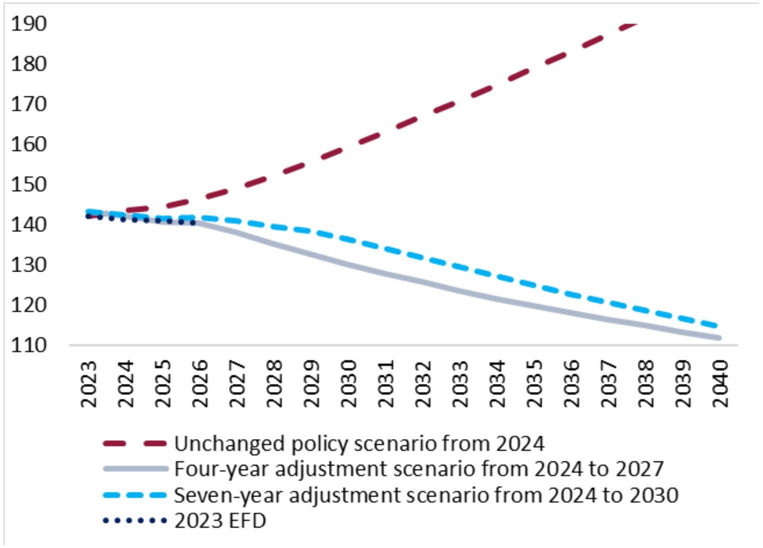
# Debt sustainability analysis

## Debt-to-GDP ratio

### Baseline scenario




### Lower trend scenario

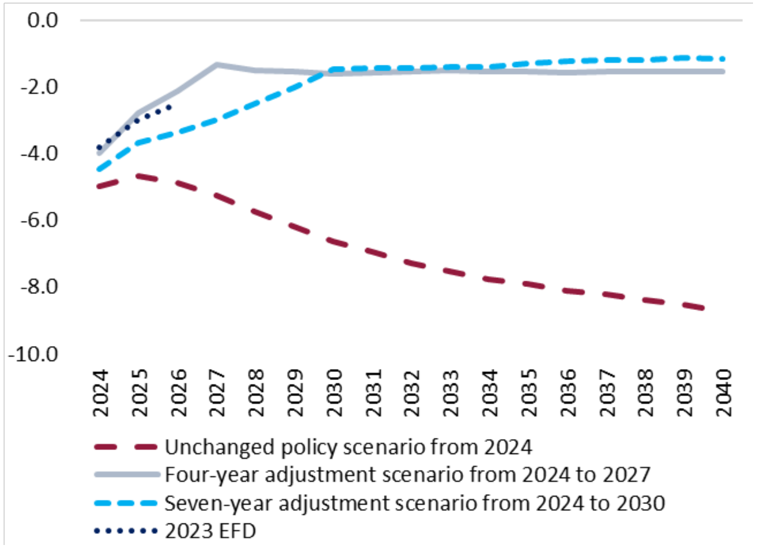



- In the absence of a structural adjustment plan, debt would soon start increasing

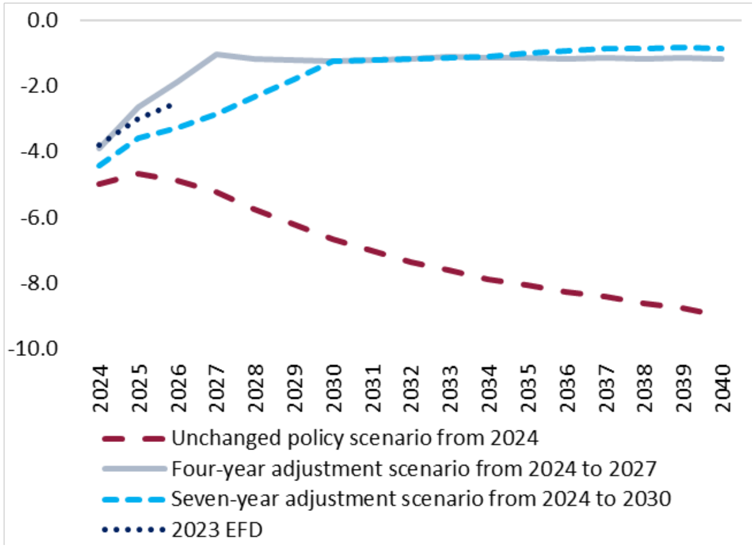
# Debt sustainability analysis

## General Government balance

### Baseline scenario




### Lower trend scenario




- The consolidation effort is feasible and in line with the government's targets in the latest Economic and Financial Document (EDF).

# Third-party assessment of Government's forecasts: lessons learnt

- Disciplining effect

✓ Assessment versus endorsement
✓ Comply or explain
✓ Assessment of structural plans
✓ Ex ante and ex post assessment

- Transparency

✓ Disseminate technical information (f.e., DSA)
✓ Credibility
✓ Public outreach & awareness

# Open questions

- Fiscal stance at the EU level

✓ Reduce risks of excessive restrain (or excessive looseness) in the common area

✓ A supra-national institution, like the EFB, can help internalize cross-country spillovers. For example, assessment of conditions justifying the general escape clause at EU level; link between correction of fiscal and macroeconomic imbalances

✓ Ensure strategic investments and European public goods

✓ Cope with extreme events and large common shocks

✓ Need for a common fiscal capacity

- Transition

✓ what happens in 2024

✓ IFIs heterogeneity

✓ Best practices and minimum standards