ESM & CEPR Joint Workshop: Rebuilding an Agenda for Europe

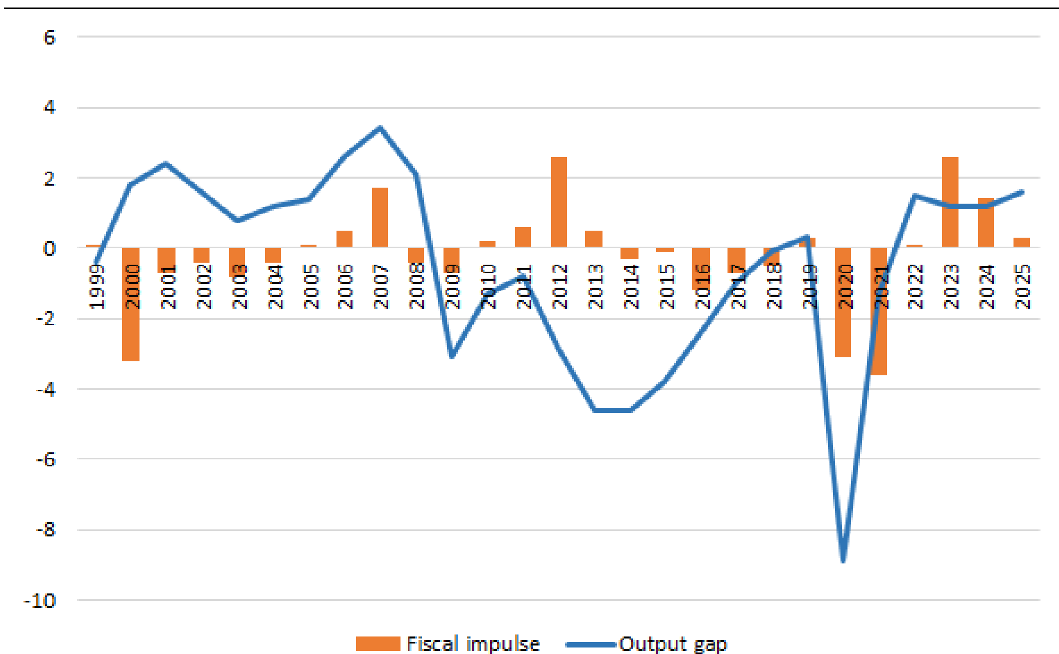
Lilia Cavallari – Chair of Parliamentary Budget Office

Luxembourg, Thursday 1st February 2024

This talk is about the importance of solid fiscal institutions for good fiscal policies. The experience of Italy since the launch of the euro provides a good case in point: fiscal policy is mostly pro-cyclical in the first half of the euro life, under weak fiscal rules, while turning mostly counter-cyclical in the second half, when fiscal institutions become more solid and flexibility is allowed (when needed).

In Figure 1, bars indicate the change in the structural primary deficit as a percentage of potential GDP, a measure of the discretionary fiscal stance: a positive value indicates a restrictive impulse on the economy, a negative value an expansionary impulse. Fiscal policy is counter-cyclical when the bars and the output gap move in the same direction (positive output gap and fiscal restriction, for instance).

Figure 1 – Fiscal Impulse and output gap – Italy
(per cent of potential GDP)



Source: European Commission.

Fiscal policy is pro-cyclical for most of the time in the first 15 years of the euro. It is expansionary in good times (2000-2007), failing to create fiscal buffers for the rainy days, and it is restrictive in bad times (2008-2015), especially after the sovereign debt crisis. The missed opportunity in good times coincides with a period in which the Stability and Growth Pact GP does not seem to bind (hence the reform of 2005).

The perception of weak fiscal rules has contributed to orientate policy toward austerity in the decade of large financial crises (one global and the other largely self-inflicted). By that time, the incompleteness of the European construction becomes apparent together with the importance of tools for the orderly resolution of crises. Big steps have been made for strengthening European financial institutions and ensuring financial stability in the euro area since the sovereign debt crisis. On the fiscal side, major steps involve the renewed fiscal compact and the establishment of independent fiscal institutions.

Fiscal policy turns mostly counter-cyclical since 2016. This reflects in part lessons learnt from previous mistakes (too much austerity may be counter-productive), more solid fiscal institutions (stronger rules together with EU and national watchdogs) and the "benign coincidence" of a moral-hazard-free shock like the COVID pandemic that allows flexibility when it is needed (general escape clause). Flexibility is once again key for allowing massive support to households and firms after the energy shock and the return of inflation. Nowadays, in a scenario of declining inflation, support measures are gradually phasing out in most European countries, Italy included, relieving public finances.

The general escape clause will be repealed this year and fiscal rules will be back in force. The governance framework emerged from the Ecofin council of last December is a modified version of the original proposal of the European Commission. Is it fit for purpose? Overall, the balance between pros and cons is positive.

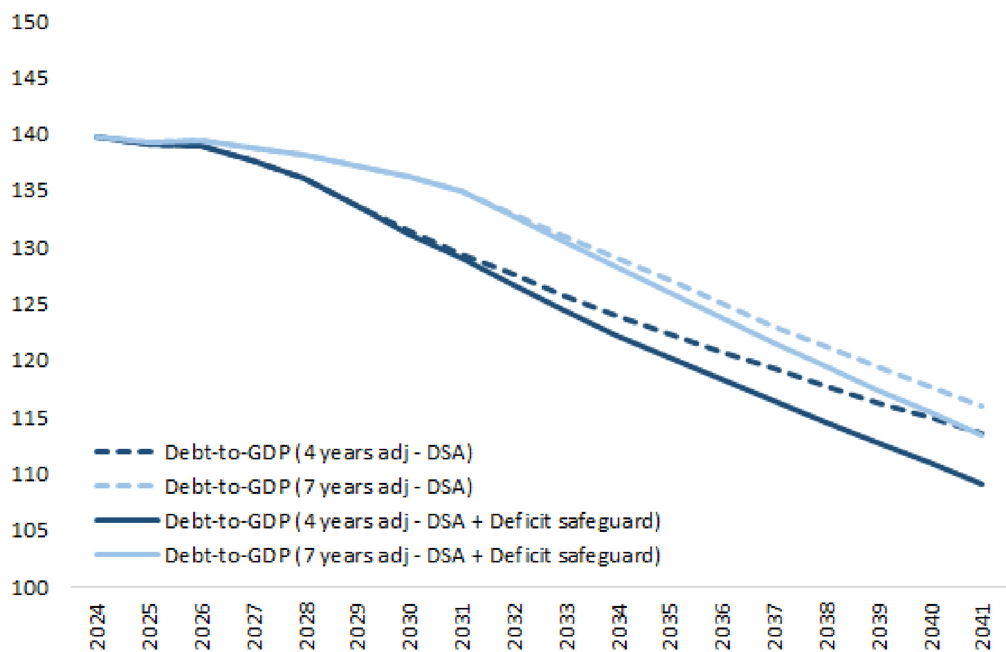
On the positive side, the new framework focuses on debt dynamics, which is what matters for sustainability. Country-specific adjustment plans allow consolidation efforts tailored on the needs of each member country. A stronger sense of national ownership reinforces the commitment to sustainable public finances and the credibility of the adjustment. A simplified monitoring mechanism – based on a net primary spending indicator – makes it easier to trace the effective implementation of the plan, striking a reasonable balance between complexity (before the plan is defined) and simplification (thereafter).

On the downside, the introduction of common safeguards on debt and deficit, aimed at striking a balance between country-specific consolidation efforts and the need for a level playing field in the common area, might induce a pro-cyclical bias in fiscal policy.

In order to see the implications of these safeguards, consider the medium term dynamics of debt and deficit (in percentage of GDP) under 4-year and 7-year adjustment plans with and without the deficit resilience safeguard (the debt safeguard is not binding over the entire horizon) in Figures 2-4.[1] All trajectories are based on the DSA methodology of the Commission, and reflect UPB projections for macro-financial variables.

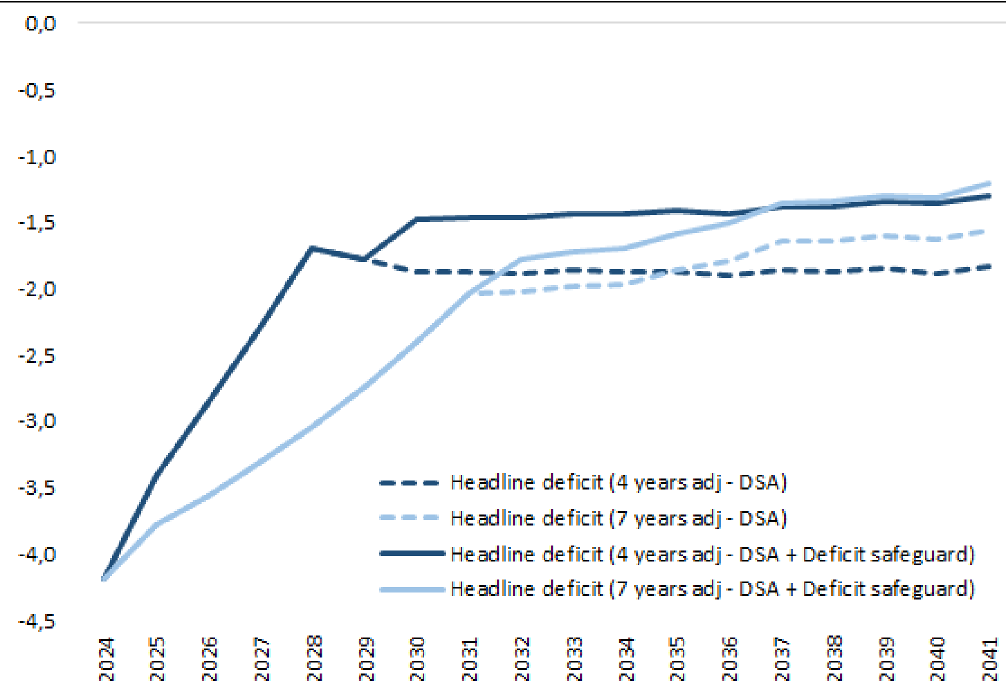
[1] Forthcoming in Nota di Lavoro 1/2024, The reform of the EU governance framework: Illustrative scenarios for Italy.

Figure 2 – Debt to GDP ratio
(per cent of GDP)



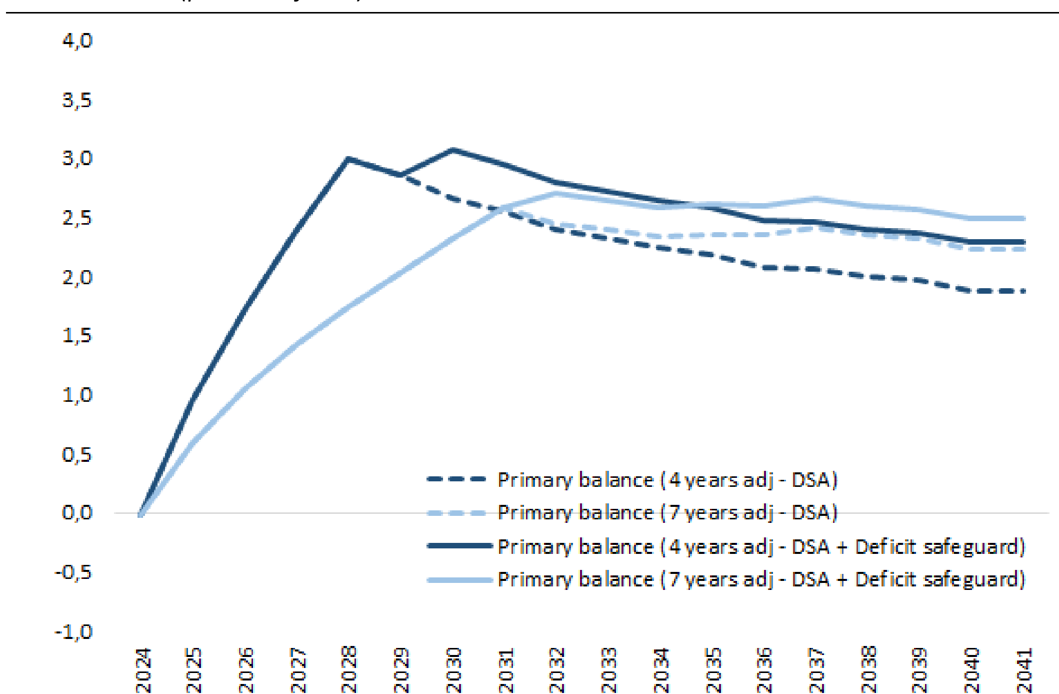
Source: Data from the 2023 Update of the Economic and Finance Document of Italy, Bank of Italy and Istat.

Figure 3 – General Government Deficit
(per cent of GDP)



Source: Data from the 2023 Update of the Economic and Finance Document of Italy, Bank of Italy and Istat.

Figure 4 – Primary Balance
(per cent of GDP)



Source: Data from the 2023 Update of the Economic and Finance Document of Italy, Bank of Italy and Istat.

The common safeguards are irrelevant for the first adjustment plan (the medium-term fiscal-structural plan should cover a period of 4 or 5 years, depending on the regular length of the national legislature. In case of extension, the second plan incorporates the fiscal adjustment path in the previous plan). With a 4-year adjustment period, the overall deficit would fall below 3 per cent of GPD in 2026 and reach 1.7 per cent in 2028. The primary balance would reach a surplus of 3 per cent of GDP in 2028 (3.4 in structural terms). With a 7-year adjustment period, the deficit would reach 3 per cent of GDP in 2028, with a primary balance of 1.7 per cent (1.6 in structural terms).

In both cases, the debt safeguard would be irrelevant: debt would decline slightly more than 1 percent on average with adjustment in 4 years, reaching 136 per cent in 2028. With a 7-year adjustment, the debt safeguard would not apply because the deficit would remain above the 3 per cent threshold until the end of the plan. Note that the debt ratio would be on a descending path well beyond the end of the adjustment (and remain so even under stress).

The deficit resilience safeguard would bind after the first period of adjustment. It requires an additional annual adjustment (equal to 0.4 percentage points of GDP in case of an adjustment path of 4 years or 0.25 in case of an adjustment path of 7 years) till the overall structural balance is below 1.5 per cent of GDP.

In our simulations, an additional adjustment of 0.4 percentage points of GDP would be required in 2030 under 4-year adjustment plans (to offset rising aging costs). The overall

deficit would decrease to 1.5 per cent of GDP in 2032, with a primary surplus of 2.8 per cent (2.9 per cent in structural terms). The debt-to-GDP ratio would fall slightly below 127 per cent in 2032. With 7-year adjustment plans, the deficit resilience safeguard would bind in 2032, requiring an additional adjustment of 0.25 percentage points of GDP with respect the no-policy change scenario. The structural primary surplus would then reach 3.1 per cent.

The deficit safeguard would contribute to reduce the debt-to-GDP ratio by almost 4 percentage points more than in the absence of the safeguard clause in the case of a 4-year adjustment whereas, in the case of a 7-year adjustment, the deficit safeguard would reduce the debt-to-GDP ratio slightly less than 3 percentage point of GDP at the end of the projection period. A higher primary balance is required after the end of the first plan compared to what needed for ensuring fiscal sustainability on a risk basis. Hence, the possibility that austerity turns excessive is not negligible, especially in a scenario of weak growth (when it is, of course, less desirable).

Moreover, there is a potential issue with the adequacy of the fiscal stance in the euro area. In fact, while many euro members will be required to pursue restrictive policies in the medium term (even more restrictive than what needed for ensuring sustainability), the incentive for using available fiscal space in other countries is weak. An adequate fiscal stance in the euro area requires not only good rules and coordination mechanisms but also a common fiscal capacity for ensuring the provision of European public goods, and coping with the global challenges ahead.

Striking a balance between fiscal capacity and fiscal discipline is not an easy task, especially in the presence of moral hazard and weak credibility. Solid fiscal institutions, based on strong rules and independent fiscal authorities, are important for ensuring feasible and credible adjustments paths. The actual compromise appears to miss the opportunity for achieving a common standard of solid, independent fiscal institutions across all member states.