EU fiscal rules: an assessment of recent reforms

Marco BUTI
Director-General
European Commission, DG Economic and Financial Affairs

National Conference on Public Accountancy
Pisa, 6 December 2018
Outline

1. Key changes of EMU's fiscal architecture since the crisis

2. Assessment of the current EU fiscal framework
   A) Complexity
   B) Have the rules ensured sound fiscal positions?
   C) Achieving an appropriate fiscal stance at EA level

3. The future of EU fiscal governance
Part 1: Key changes in EMU's fiscal architecture

Fiscal policy in EMU: an evolving view

Conventional view on fiscal policies in EMU – pre crisis

"Put own house in order..."

- Rules to tame deficit bias in absence of national exchange rate policy
- Automatic stabilisers: let them play
- Risk of debt monetisation dominates monetary-fiscal relations
- Low spillovers because of offsetting monetary policy reaction
- Threat of financial sanctions helps discipline governments
- Negative coordination suffices

Revising the role of fiscal policy in EMU – post crisis

"...and strengthen the joint foundation"

- Discretionary fiscal policy needed in case of large shocks
- High multipliers and spillovers when monetary policy is constrained
- Aggregate fiscal stance and differentiated fiscal space matter
- Sovereign-banks nexus
- Institutions / rules / markets
- Links fiscal policies/ structural reforms
- Difficult to sanction sovereign states
# Institutional changes in EMU since 2011

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Measure taken to address the challenge</th>
<th>Measure in greater detail</th>
<th>Application</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Conventional view on fiscal policies in EMU – pre-crisis</strong></td>
<td><strong>Stronger SGP</strong></td>
<td>• Introduction of expenditure rule, debt benchmark (6-P) and balanced budget rule (TSCG) • Possibility of imposing earlier/more gradual sanctions (6-P) • Surveillance of DBPs (2-P)</td>
<td>✔</td>
</tr>
<tr>
<td></td>
<td><strong>National fiscal frameworks</strong></td>
<td>• Mandatory min. requirements at the national level (6-P)</td>
<td>✔</td>
</tr>
<tr>
<td></td>
<td><strong>Macro surveillance</strong></td>
<td>• Prevention/correction of macroeconomic imbalances via the introduction of the new Macroeconomic Imbalance Procedure (MIP) (6-P)</td>
<td>being implemented</td>
</tr>
<tr>
<td><strong>Revising the role of fiscal policy in EMU – post-crisis</strong></td>
<td><strong>Crisis resolution mechanism</strong></td>
<td>• European Stability Mechanism (ESM)</td>
<td>✔</td>
</tr>
<tr>
<td></td>
<td><strong>Better articulation of fiscal rules</strong></td>
<td>• More flexibility in applying the rules • Euro area fiscal stance</td>
<td>✔</td>
</tr>
<tr>
<td></td>
<td><strong>Breaking sovereign/banks nexus</strong></td>
<td>• Banking Union • Capital Markets Union</td>
<td>to be completed</td>
</tr>
</tbody>
</table>

*Note: Key reforms steps taken in the area of fiscal and macroeconomic policies are shown in italics in brackets, namely 6-Pack (6-P), Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), 2-Pack (2-P).*
Part 1: Key changes in EMU's fiscal architecture

Remaining vulnerabilities

• *Have the financial sovereign doom loops been sufficiently severed?*
  o Banking union not completed yet

• *Will the revised governance framework be effectively implemented?*
  o Limits to the application of rules/peer pressure on democratically elected governments

• *Has EMU the capacity to withstand the next large shock?*
  o ESM remains entirely dependent on national Treasuries and slow decision-making
  o No tool for smoothing large asymmetric shocks and managing the euro area fiscal stance when needed

• *Is the appropriate fiscal stance at the EA level being achieved?*
  o Bottom-up coordination does not work

→ *Sustaining euro area falls too much on the shoulders of the ECB*
→ *Missing piece: minimum fiscal capacity to secure macroeconomic and financial stability*
→ *Better ownership of fiscal rules: reform of the SGP?*
Part 2: Assessment of the current EU fiscal framework

a) Complexity

The rules have evolved to respond to economic developments... but at the cost of increased complexity

Inherent trade-offs in design of a fiscal framework

SIMPLICITY

SGP.0 (1997)

SGP.1 (2005)

SGP.2 (2011-)

Current rules

PREDICTABILITY

ADAPTABILITY (``smartness``)
Part 2: Assessment of the current EU fiscal framework

Resulting in a multiplicity of indicators...

<table>
<thead>
<tr>
<th>CONSTRAINT</th>
<th>FISCAL VARIABLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>MTO</td>
<td>Nominal fiscal balance (level)</td>
</tr>
<tr>
<td>Adjustment path toward MTO</td>
<td>Net expenditure growth</td>
</tr>
<tr>
<td>Expenditure benchmark</td>
<td>Structural fiscal balance (level)</td>
</tr>
<tr>
<td>3 percent deficit</td>
<td>Structural fiscal balance (change)</td>
</tr>
<tr>
<td>60 percent debt</td>
<td>Public debt (level)</td>
</tr>
<tr>
<td>1/20th debt reduction criterion</td>
<td>Public debt (change)</td>
</tr>
<tr>
<td>Annual nominal balance targets</td>
<td></td>
</tr>
<tr>
<td>Annual fiscal effort under EDP</td>
<td></td>
</tr>
<tr>
<td>National structural balance rule</td>
<td></td>
</tr>
</tbody>
</table>

- Preventative arm
- Corrective arm
- National rule mandated by the Fiscal Compact
Part 2: Assessment of the current EU fiscal framework

...and a complex fiscal architecture

Reasons for increased complexity

- Sui-generis character of the EU system resulted in multiple and complex "checks and balances"
- Increased competencies at EU level (e.g. DBP review)
- New rules or bodies were established over time, often in response to emergencies
- Learning (evolving view on the role of fiscal policy in EMU)
- But above all: Lack of trust entailing the “Curse of Complete Contract”.

Number of pages in the entire framework (in primary/secondary legislation, key innovation shown below in italics)
Part 2: Assessment of the current EU fiscal framework

b) Have the rules ensured sound fiscal positions?

*Aggregate budget deficit in the euro area fell from over 6% of GDP in 2010 to below 1% in 2018, much lower than US/Japan*

![Graph showing budget deficits for different years and countries]

*Note: Figures between brackets above the columns represent real GDP growth rates. Figures in bold between square brackets represent the number of MS with deficit >3% of GDP.*
b) Have the rules ensured sound fiscal positions?

Debt developments are less benign
Part 2: Assessment of the current EU fiscal framework

b) Have the rules ensured sound fiscal positions?

Large divergences in fiscal positions between Member States

Source: European Commission autumn forecast 2018
Part 2: Assessment of the current EU fiscal framework

b) Have the rules ensured sound fiscal positions?

*Slowdown in fiscal adjustment, especially in the corrective arm*

---

**Note:** Figures between brackets represent the output gap % of potential GDP
Part 2: Assessment of the current EU fiscal framework

c) Achieving an appropriate fiscal stance at EA level

- Relevant concept from different points of view:
  - Economic:
    1. Coordination of fiscal policies is crucial in a monetary union. Lack of central budget reinforces this need, given spillovers.
    2. Currently, there is no instrument to manage the aggregate orientation of the fiscal stance.
  - Legal: The Two Pack requires the Commission to “make an overall assessment of the budgetary situation in the euro area as a whole”.

- However, an appropriate fiscal stance is not an objective of the Pact
  - SGP focusing mainly on sustainability
  - SGP sets limits on decentralized policy: Member States can over-achieve requirements even if not economically optimal.
Part 2: Assessment of the current EU fiscal framework

c) Achieving an appropriate fiscal stance at EA level

Pro-cyclicality has not been avoided

Aggregate euro area fiscal effort versus requirements and output gaps (% of potential GDP)

Source: European Commission autumn forecast 2018
Note: euro area excluding Greece.
A counterfactual: benefits of a central stabilisation capacity in 2012-2013
In their "pure" form, the two views don't pass the test.
Part 3: The future of EU fiscal governance

Searching for the right balance

**Elements of centralisation**
- Simplified fiscal rules
- A common fiscal capacity
- Last resort backstop to the banking union
- Reinforced ability to intervene in case of gross errors

**Elements of decentralisation**
- Operational national rules with links to the EU framework
- More binding nature of medium-term fiscal planning at MS level
- Empowered independent national fiscal institutions
- Reinforced market discipline

Fiscal federalism by exception vs No bail out/market discipline

→ Essential to conceive the different elements of the framework together
Commission proposal (May 2018)

- Up to €30 bn of back-to-back loans to stabilise investment under large asymmetric shocks.
- Focus is on euro area and ERM II countries.
- Can be complemented with ESM facility.

The EISF could be complemented with a **euro area budget** as proposed by FR and DE (*Proposal on the architecture of a Eurozone Budget*, November 2018).

*Prefilled with contributions by Member States based on their monetary income (“seigniorage”).*
Italy: Fiscal Situation and the SGP

- DBP assessment: risk of significant deviation from the adjustment path towards the MTO for 2018 and particularly serious non-compliance for 2019.

- 126(3) report concluded that the debt criterion should be considered as not complied with and that a debt-based EDP is warranted.

- 126(4) report by EFC confirms this conclusion.

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PREVENTIVE ARM</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in structural balance</td>
<td>-0.3</td>
<td>0.0</td>
<td>-1.2</td>
</tr>
<tr>
<td>Compliance with requirements of the preventive arm</td>
<td>Some deviation</td>
<td>Significant deviation</td>
<td>Significant deviation</td>
</tr>
<tr>
<td><strong>CORRECTIVE ARM</strong> (Debt criterion)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General Government Debt</td>
<td>131.2</td>
<td>131.1</td>
<td>131.0</td>
</tr>
<tr>
<td>Gap to the debt reduction benchmark</td>
<td>6.6</td>
<td>6.6</td>
<td>6.7</td>
</tr>
<tr>
<td>Compliance with the debt rule</td>
<td>Not complied</td>
<td>Expected not to comply</td>
<td>Expected not to comply</td>
</tr>
</tbody>
</table>

Note: % of GDP (unless stated)
Source: Commission services, European Commission autumn forecast 2018
Conclusions

• The crisis revealed fault lines in original EMU design and steps have been taken to breach those, but the present set-up remains vulnerable to shocks and leaves too heavy responsibilities on the ECB

• Find right balance between EU and national levels, and between rules, institutions and market discipline

• Reforms have to pass the political, economic and market stability test: sequencing is key but challenging

• Everybody agrees that fiscal rules have become too complex, but often mix cause and effect

• Better ownership and enforcement of fiscal rules to go hand in hand with creating a central fiscal capacity
Thank you very much for your attention