ECONOMIC GOVERNANCE REVIEW – THE FUTURE OF FISCAL RULES

Presentation at conference "Public debt dynamics: the search for optimal levels"

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AGENDA :

- Purposes/objectives of EU economic/fiscal governance
- Approaches to governance – limits to decentralization
- How do the current reform proposals fit in?

PURPOSES OF GOVERNANCE

- The Maastricht Treaty objectives were limited: fiscal governance should focus on limiting the risks of destabilising spill-over effects from high and/or rapidly rising national public indebtedness
- The Treaty was agreed at the end of two decades of often pro-cyclical and divergent national fiscal policies – they had become discredited, in sharp contrast to the Keynesian optimism as to their potential in the Werner plan for Economic and Monetary Union in 1970
- By 1990, the view that discretionary fiscal policy for stabilization could be left out the framework had prevailed; the evidence of a deficit bias and of information deficiencies pointed to prudence

PURPOSES OF GOVERNANCE ctd.

- The emphasis in policy-making had shifted to defining medium-term credible commitments, to constrain also fiscal policies through targets
- This perspective in mainstream macroeconomics was reinforced by the finance ministers and central bankers who wrote the Treaty
- The perception that the coming central bank had to be protected against risks of “fiscal dominance” further underlined that national fiscal policies should be constrained by rules, rather than mobilized
- Nevertheless, the “Maastricht bargain” looked potentially promising for all: weaker economies would get lower and more stable inflation and interest rates - in return for some additional fiscal prudence

PURPOSES OF GOVERNANCE ctd.

- National fiscal policies have objectives beyond stabilization (while maintaining sustainable public finances), Musgrave (1959):
- to raise the potential growth rate of the economy – not just to minimize fluctuations around it - by making the allocation of public (and private) expenditures more efficient; and
- to bring about, through expenditure, tax and transfer policies, a distribution of incomes seen as fairer, more inclusive
- The two purposes were to be reserved for national decision-making; the subsidiarity and proportionality principles in the Treaty Arts. 3 & 5 hardly left room to argue that EMU should change that

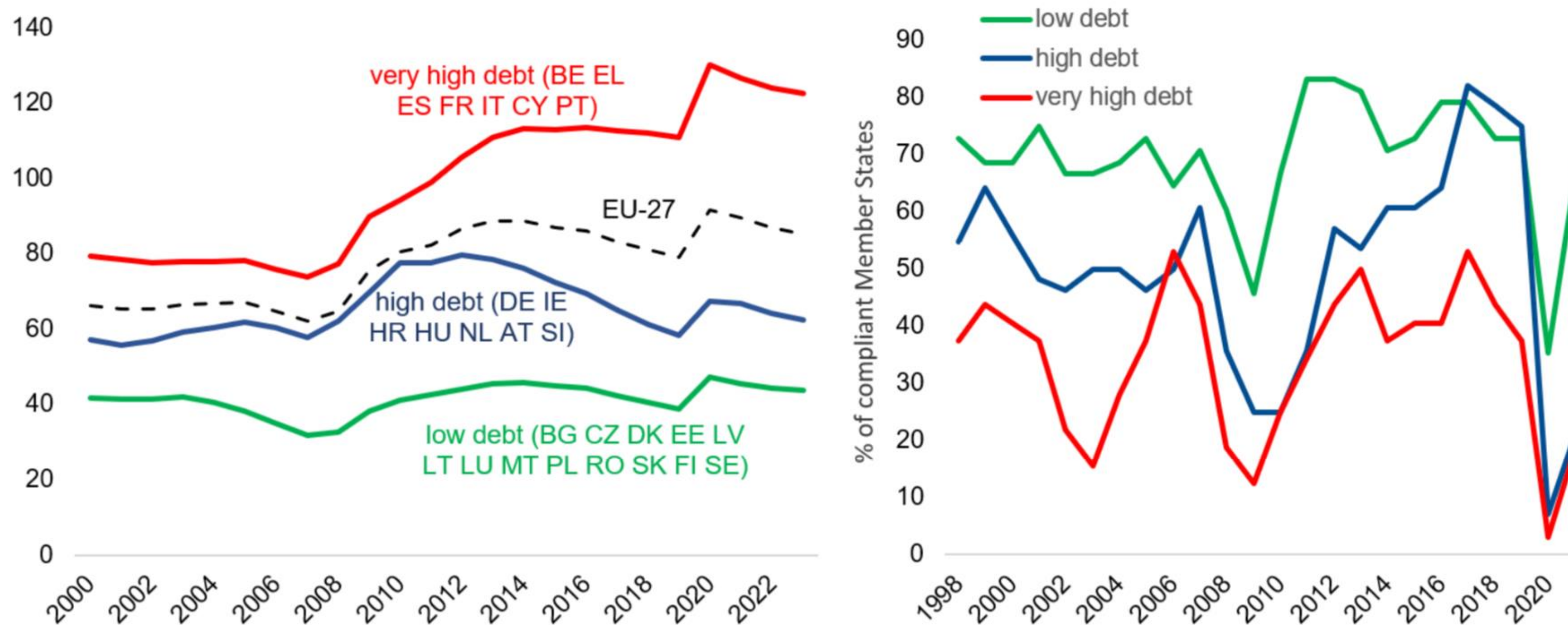
APPROACHES TO GOVERNANCE

- A one-dimensional objective greatly simplifies the approach to implementation: set “reference values” (upper guidelines) for debt and deficits close to then average values, monitor them with limited flexibility, and (ultimately) enforce them if not complied with
- So, some scope for judgement by ECOFIN Council on Commission recommendations - but discretion was taken further by both, first in the Franco-German “revolt” in 2003, then by Commission from 2015
- Two more purposes of a fiscal framework came back, mainly due to perceived policy failures after the crises of 2008-12: (1) avoid pro-cyclical policies, and (2) protect “growth-friendly” public expenditures

APPROACHES TO GOVERNANCE ctd.

- Multiple objectives require an expanded rule book to manage trade-offs - but neither of the two newer ones was well served in the pre-pandemic years, EFB (2019); sustainability somewhat better
- Compliance with rules was weak, particularly in high-debt countries, see graph; building fiscal buffers seemed unattainable in 2015-19
- Ever lower interest rates eased concerns about sustainability; monetary policy reached its lower bound, the ECB even asked for help from more "complementary" fiscal policies to deliver 2% inflation
- Little appetite for reforming governance prior to the pandemic – the outbreak of which led to activation of the severe downturn clause, developing into a *de facto* suspension of the framework for four years

Graph 1: Government debt to GDP ratios and compliance record across country groups



Note: Countries are grouped by their average debt-to-GDP ratio over 2011-2019: (1) Very high-debt countries = above 90% of GDP (Belgium, Greece, Spain, France, Italy, Cyprus, Portugal); (2) High-debt countries = between 60% and 90% of GDP (Germany, Ireland, Croatia, Hungary, The Netherlands, Austria, Slovenia); (3) Low-debt countries = below 60% (Bulgaria, Czechia, Denmark, Estonia, Latvia, Lithuania, Luxembourg, Malta, Poland, Romania, Slovakia, Finland, Sweden).

APPROACHES TO GOVERNANCE ctd.

- Two massive external shocks faced by the EU – a pandemic from March 2020, and rising inflation with accelerated energy transition linked to the Russian aggression - are fading away over 2023-24
- However, a double legacy for EU fiscal governance remains: (1) public debt was ratcheted up in most EU countries, requiring commitments to medium-term debt reduction strategies to limit future risks; (2) recognition that public action/expenditures at times will have to rise sharply to perform essential functions
- How are the current reform proposals coping with these challenges?

HOW DO THE CURRENT REFORMS FIT IN?

- The double legacy imposes two partly conflicting demands: (1) a stronger commitment to debt reduction strategies where needed – a return to the central Treaty objective, (2) more emphasis on growth-friendly and other priority expenditures and on structural reforms – the allocative objective of fiscal policy
- On (1): Will strategies for medium-term debt reduction outlined by Commission DSA, monitored through expenditure plans developed by governments, agreed with Council, be seen as “nationally owned”?
- On (2): Will merging fiscal and structural surveillance to assess the impact of public investments and of structural reforms on public finances and on potential growth help - or erode - compliance?

HOW DO THE CURRENT REFORMS FIT IN? ctd.

- Ambitious proposals from the Commission on each of these two elements and on their combination – can they be agreed? And by end-2023?
- Major questions relate to the transparency of the proposed surveillance, and to the ambition of integrating fiscal and structural surveillance
- Can the advanced analysis of the risks of unsustainable public finances become the essential starting point for policy recommendations?
- Can the “virtue” of the numerical nature of the macroeconomic SGP be merged with the more qualitative and microeconomic recommendations of the CSRs/MIP which have had a poor past record of compliance?

HOW DO THE CURRENT REFORMS FIT IN? ctd

- The Commission chose to leave out the longer-term issues of an EU central fiscal capacity (CFC) to provide jointly some stabilization and strategic public goods, and the future role of a crisis lender (ESM)
- These issues can hardly be long postponed, but raising them now might have blocked the efforts to reform the rules-based framework
- The reform would soften the distinction between EU and national tasks by stressing “national ownership”; the proposals could be seen as a final version of decentralized surveillance, respecting subsidiarity
- However, the rapid evolution of challenges to provide EU public goods will advance the need to agree on complentary joint efforts

HAS THE REFORM LEARNT FROM THE PAST?

- The reform debate has brought back elements of past fiscal rules not easy to reconcile with the reform core perspectives: a medium-term perspective, focus on “gross errors”, strong national differentiation
- An annual common benchmark for headline deficit reduction looks reassuring and transparent, but could, even at a modest rate, become a distraction from the key compliance with the national expenditure plan agreed with the Council. Why not use the control account?
- A basic lesson of humility from the past 25 years: adopting rules that fiscally weaker countries do not comply with - and stronger ones seem unable or unwilling to enforce - may prove counterproductive

THANK YOU FOR YOUR ATTENTION!