Hearing as part of the examination of the Communication "The EU economy after COVID-19: implications for economic governance" from the European Commission

Summary

The Chair of the Parliamentary Budget Office (PBO), Lilia Cavallari, spoke at a hearing of the Budget Committee of the Chamber of Deputies as part of the examination of the Communication "The EU economy after COVID-19: implications for economic governance" from the European Commission.

In her remarks, the PBO Chair focused on the reform of the fiscal rules to be introduced before the deactivation, expected for 2023, of the general escape clause introduced in March 2020 to counter the effects of the COVID-19 pandemic on euro-area economies.

In its winter forecast, the European Commission projected that GDP would return to pre-pandemic levels by the end of this year for all Member States, hence the deactivation of the clause for 2023 and the renewed application of the fiscal rules. However, given the uncertainty triggered by the war in Ukraine and its effects on the European economy, the Commission has already announced that it will reassess the deactivation of the clause on the basis of the forthcoming spring forecast.

The restoration of the Stability and Growth Pact should in any case be accompanied by a reform of the fiscal rules and, in general, of the economic governance of the European Union to adapt them to the profoundly altered economic environment. The public debate that has developed on the reform of fiscal rules takes on particular importance for Italy which, in the ranking of countries with the highest debt/GDP ratio, is second only to Greece.

Despite the reforms of 2005 and 2011, the rules governing the application of the Stability and Growth Pact (SGP) have also displayed a number of problems:

- the pro-cyclical nature of the numerical rules and the associated fiscal policies, which means that countries are asked to consolidate their budgets in adverse cyclical conditions and have few disincentives for budget easing in periods of expansion (in addition to the absence of binding procedures to encourage countries with room for budgetary manoeuvre to use it during economic slowdowns). This helps increase the amplitude of cyclical fluctuations, causing output and employment to diverge from trend values;

- the very sharp contraction in public investment as a fraction of GDP due to budgetary restrictions (the EU average decreased from 3.8 per cent in 2009 to 2.8 per cent in 2016, and then climbed to 3.3 per cent in 2020; in Italy the ratio went

from 3.7 per cent in 2009 to 2.1 per cent in 2018 and only subsequently rose to 2.6 per cent in 2020, still below the EU average);

- the extensive use of unobservable indicators that need to be estimated (output gap and elasticity of the cyclical components of the budget with respect to the tax base, among others);
- the significant flexibility and scope for interpretation of the rules, based on decisions often taken and announced only in the autumn, therefore after the preparation of the Stability Programmes. In the case of Italy, this has reduced the scope of the Economic and Financial Document not only as a medium-term public finance policy document, but also as a tool for setting targets for the main budget aggregates for the following year.

The acknowledgement of the problems and the public debate that followed led to a series of reform proposals that are partly reflected in certain key issues, on which a consensus could be found among Member States. Starting with the view that the new fiscal framework should ensure debt sustainability and promote growth through support for investments and reforms.

The first of the key issues under discussion concerns the role of public investment and the introduction of some form of "golden rule" into the fiscal rules, allowing the use of deficit funding to finance expenditure with long-term benefits (for the climate transition and digital transformation, for example) or to finance European public goods (research and innovation, defence, security, energy independence, financial stability).

The possible effects of a golden rule are illustrated with a stylised exercise based on a simplified application of the fiscal rules. The basic scenario is represented by the application without modification of the structural balance rule for achieving the medium-term objective (MTO). This scenario is compared with one that accompanies the adjustment of the structural balance with an annual expansion of 0.5 percentage points of GDP in public investment starting from 2023 which cumulate until 2030, with two different investment assumptions associated to the golden rule: one regarding all public investment; and a second involving a selective increase in investment with the greatest multiplier impact, such as public investment in renewable energy.

The impact on GDP in the two scenarios, estimated respectively using the multiplier of the Memo-IT model used by the PBO and a multiplier estimated by the International Monetary Fund on the basis of data for a range of countries, is significant in both cases: in the first scenario, real GDP would be 3.8 per cent higher in 2030 than in the scenario with the structural adjustment alone; in the second case, real GDP would be 5.4 per cent higher in 2030.

The impact would also be favourable in terms of the reduction in the debt/GDP ratio. Until 2025, the reduction of the ratio in both scenarios with the golden rule would be greater than in the scenario with only structural adjustments. Subsequently, the decline would continue to be greater in the scenario with public investment in renewable energy: in 2030, the reduction in the ratio compared with 2022 in the scenario with only the structural adjustment would be 8.6 percentage points, while in the scenario with the golden rule for public investment in renewable energy the decrease would be 10.9 percentage points.

In essence, a well-crafted golden rule could make it easier to combine debt consolidation with growth.

Another key issue under discussion concerns the use of the debt/GDP ratio as the anchor of the new framework and a revision of the target level for the debt/GDP ratio and the pace at which it should be achieved. Given the debt levels reached at the end of 2021, a number of options are on the table: increasing the debt/GDP ratio limit envisaged by the Maastricht Treaty to the current EU average of close to 100 per cent. Alternatively, a longer period could be allowed to achieve the goal, for example 40 years instead of 20 (as required under the current debt reduction benchmark). Another possibility would be to establish a more gradual path of reduction for debt generated by exogenous events such as a pandemic or adverse macroeconomic conditions.

To evaluate the implications of a rule featuring a medium-term debt target and the related adjustment path, a stylised exercise was conducted in which one of three possible configurations of the debt reduction rule is reintroduced: 1) the first assumes the current public debt reduction rule contained in the SGP (the debt/GDP ratio must be reduced by one-twentieth of its excess over 60 per cent per year); 2) the second assumes that the ratio falls by one-fortieth of its excess over 60 per cent per year; and 3) the third assumes that the ratio falls by one-twentieth of its excess over 100 per cent per year.

In all scenarios, compliance with the rule would require a significant improvement in the primary balance in 2023 compared with 2022. In the first one, a primary surplus of around 4 per cent of GDP would be required in 2023, an improvement of almost 7 percentage points compared with 2022. In the scenario with a slower rate of adjustment, the primary balance needed in 2023 would be negative, i.e. a deficit of around half a percentage point, which would nevertheless represent an improvement of almost 2.5 percentage points compared with 2022. In the third scenario (target debt-to-GDP ratio of 100 percent to be achieved in 20 years), the primary budget required would be in balance, an improvement of just under 3 points of GDP over the previous year. For the following years, the required primary surplus would remain high in the first scenario (around 2 per cent of GDP on average from 2024 to 2030), while in the other two the necessary primary surplus would average around half a percentage point of GDP, a lower but ambitious level if rapid achievement were to be requested.

Regarding the possible corresponding reductions in the debt/GDP ratio, in the first scenario debt would decrease by more than 31 percentage points of GDP in 2030 compared with 2022; in the other two scenarios, the reduction compared with 2022 would be around 16-17 percentage points of GDP.

It is important to emphasise that these scenarios have been estimated without considering the possible impact of the budgetary adjustments on GDP and the related feedback effects on public finances. Considering these effects, the adjustments in the primary balance would produce a smaller reduction in the debt/GDP ratio.

In addition to the use of the debt/GDP ratio as an anchor for the new framework, another issue that has received numerous proposals concerns the simplification of the current system of rules. In practice, it is assumed that only one indicator, similar to the current expenditure rule, is used for monitoring. This indicator would therefore represent an operational or intermediate target, established on the basis of certain criteria and assumptions. Compared with the current expenditure benchmark, the permitted growth rate would be calculated to allow the target level of the debt anchor to be achieved within the specified adjustment horizon. If the effective debt/GDP ratio is above the anchor, the nominal growth in net expenditure would have to be below the nominal GDP growth rate, where the latter is calculated on the basis of estimates of actual, potential or trend real GDP growth in future years and an inflation rate assumption. The rate could be the expected rate or one consistent with the objectives of the European Central Bank (ECB).

In an economic and monetary union such as the euro area, where fiscal policies remain the responsibility of national governments, the return of fiscal rules is important as they are one of the tools for coordinating economic policies between Member States in an economic environment that has been deeply marked by the pandemic, the war in Ukraine and the challenges of the ecological transition. In this changed context, the reinstatement of the SGP rules is a crucial opportunity for a far-reaching reform to eliminate or at least reduce their most troublesome features.

The new rules should help to reconcile the need for debt sustainability with those of stabilising economic fluctuations and promoting growth. This means requesting budgetary adjustments tailored to the macroeconomic, financial and public finance situation of each country and of the Union as a whole.

Rules that preserve or strengthen productive expenditure and public investment are welcome both for their higher multiplier and for the contribution they can make to medium-term growth. It is also important that the rules be consistent with the need for targeted investments to accompany the energy, environmental and digital transition. However, preserving investment requires the pursuit of budgetary adjustment over the next few years through reductions in current expenditure or increases in the tax burden: a significant effort will be required to select spending priorities and increase their effectiveness and to broaden tax bases by intensifying the fight against tax evasion and rationalising the tax system.

Among the changes in the parameters on which to base the debt reduction process, the most convincing ones are those that indicate different targets and adjustment paths based on the specific conditions of each individual country. A more complex challenge is in assessing proposals that suggest a simplification of the rules, using the debt/GDP ratio only as a medium-term benchmark and net expenditure growth as the sole indicator for annual monitoring.

A simplified framework of rules, preferably based on observable and more decentralised indicators could improve the understanding of the EU surveillance process by national authorities and the general public. However, the medium-term debt target will need to be credible, consistent with a path of rapid and sustainable growth, and revisable in the event of changes in macroeconomic and financial conditions (either favourable or unfavourable) with respect to the initial assumptions. The use of net expenditure for annual monitoring reduces the problems of observability and understandability compared with the structural balance but does not eliminate them.

In the pre-pandemic years, the complexity of the rules required a significant degree of interpretation, which in many cases led to decisions that were only announced in the autumn. It is desirable that, with the reform of the surveillance framework, any new criteria for interpreting the rules be provided at the EU level before the Member States draft their Stability Programmes and that the medium-term strategies contained in these documents regain their central role and that any changes be adequately justified. Furthermore, it is necessary to ensure the consistency of the annual Draft Budgetary Plans approved in the autumn with the multiannual strategies established in the spring. It is therefore important to ensure the timely flow of information and the indication of clear guidelines for the preparation and monitoring of adjustment plans and public finance documents.

Re-establishing effective rules is only one of the tools to enhance the economic governance of the European Union. The reform of the system of rules cannot neglect to strengthen coordination between fiscal policy and monetary policy, the so-called policy mix. Indeed, the pandemic crisis has shone even greater light on the need for and benefits of stronger coordination between monetary and fiscal policy.

The Union's institutional architecture already incorporates significant mechanisms for coordinating economic policies, such as the European Semester for ensuring the consistency of the area's macroeconomic framework and the European Fiscal Board for the coherence of the common fiscal stance. It is desirable that these tools be reinforced effectively.

Coordination would be even more incisive with greater common fiscal capacity both for macroeconomic stabilisation purposes in the euro area and to finance European public goods. It would therefore be desirable to create a common fund that, together with national policies, would facilitate the determination of a consistent fiscal stance in the euro area that could respond both to shocks common to the entire area and to asymmetric shocks affecting different countries in differing ways. With regard to European public goods, the experience of the Next Generation EU programme can serve as a valid model. It is necessary that the program fully achieves the objectives it has set itself so that it can be considered for renewal or expansion after 2026. A greater common fiscal capacity would also have favourable repercussions on the functioning of monetary policy, which would no longer be working in isolation in its macroeconomic stabilisation task and would acquire more room for manoeuvre for interest rates.

The review of the economic governance of the EU represents a unique opportunity to explore these fundamental issues.