4th Joint Workshop of European Independent Fiscal Institutions and the European System of Central Banks

Policy panel on Economic governance reform and the role of the Independent Fiscal Institutions

Lilia Cavallari

Chair of Parliamentary Budget Office

European Central Bank, Frankfurt, 20 September 2023

Round 1 on the Commission's legislative proposals

- Based on my experience as academic economist and chair of Italy's fiscal council, the new framework appears largely acceptable. The key strengths are the focus on debt dynamics and country-specific medium-term structural plans. We all know that debt sustainability is inherently a dynamic problem and multi-annual budgetary planning is important for ensuring stability and growth. 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.

- Overall, the new framework strikes a balance between the need for ownership on the one side (commitment to country-specific plans) and the need for symmetry on the other side (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 this respect thanks to their expertise and independence. I will illustrate the point through the lens of the experience of Italy's PBO.

- The PBO already performs some of the tasks foreseen in the Commission's proposal. In particular, it endorses the macroeconomic forecasts of the Government in the main policy documents. It produces its own macroeconomic forecasts and coordinates a panel of four independent forecasters. For ease of comparison, all forecast scenarios incorporate common economic information and the same exogenous variables of the MEF. 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 PBO has not endorsed the Government's forecasts on two occasions, in the fall 2016 and the fall 2018, and the Government has subsequently complied.

- We have done a retrospective analysis of government's forecasts before and after the establishment of the PBO in 2014. The analysis reveals that Government's forecast for real and nominal GDP display an optimistic bias, especially at time t+1 (the most relevant horizon for budgetary planning), while forecasts for the current year tend to be prudent. Interestingly, the bias - measured by the arithmetic mean error or the frequency of optimistic forecasts- reduces significantly after 2014 (the mean error is around 1.5 percentage points in the period 2000-2014 and less than 0.3 points thereafter, excluding the pandemic). Moreover, the accuracy of the forecasts, as measured by the RMSE, improves significantly in the post-PBO period, especially for real GDP. Over time, the Government's forecasts have become less optimistic and in line with PBO forecasts. Lesson n.1: endorsement by national IFIs appears to play a disciplining role for government's macroeconomic forecasts.

- In a number of parliamentary hearings this year, we have provided simulations of medium-term deficit and debt trajectories, together with the net primary spending indicator, with and without an adjustment plan. The objective is to 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 the calibration of key parameters: for example, debt composition, structure, and maturity; spending and tax elasticity. This leads me to stress the first point for improvement: transparency. It is important that all methodological details and underlying hypotheses are publicly available and undergo a third-party, technical assessment. Of course, this requires timely information, and adequate resources.

- The second point for improvement concerns consistency of the fiscal stance at the EU level. This is important for two reasons. First, for reducing risks of excessive restrain (or excessive looseness) in the common area. In this respect, linking the correction of fiscal and macroeconomic imbalances more strictly would help align national and EU-wide objectives. Second, consistency at the EU level is important for ensuring strategic investments, European public goods, and for coping with extreme events and large common shocks. This requires common fiscal capacity.

Round 2 on the role of the Independent Fiscal Institutions (IFIs)

- I have already argued in favour of the role IFIs for fiscal governance. Let me share a further piece of experience that might be of help for the general discussion. The PBO produces its own budgetary forecasts, while it does not have an endorsement mandate. We typically assess the government's budgetary forecasts or the revision of debt and deficit targets in parliamentary hearings.

- We have done a retrospective analysis comparing the budgetary forecasts in the official planning documents with the realizations ex posts over the period 2015-2019. The forecast errors of the deficit for the current year and one-year ahead are moderate on average (around 0,13 percentage points) and they decline systematically after 2014. 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. Of course, the Update draws on more accurate information compared to the EFD and this helps to forecast the deficit one year ahead. However, 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.

- This evidence suggests that budgetary planning focuses mostly on the short term, if not the current year. Lesson n.2: a third-party assessment of budgetary forecasts can help to reduce the "short term" bias**,** and recognize the relevance of medium-term fiscal perspectives. Our experience suggests that this can be achieved even in the absence of formal endorsement**.** I would keep a role for IFIs in the assessment of budgetary forecasts, even if not involving formal endorsement.

- Of course, IFIs are largely heterogeneous across countries in terms of size, structure, resources, and the specific tasks they perform (for example, not all IFIs provide their own macroeconomic and budgetary forecasts or endorse the forecasts in the official planning documents). The new framework would imply a broader mandate for some IFIs and require adequate resources. Identification of minimum standards and best practices would be useful for the transition.

- As for the EFB, the comparative advantage of a supra-national institution is capacity to internalize cross-country spillovers. In the new framework, in which structural plans reflect country-specific conditions, ensuring coherence of the fiscal stance in the common area is even more important than before, and stronger the need for cooperation.