



EU fiscal rules: an assessment of recent reforms

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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**

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

Challenge	Measure taken to address the challenge	Measure in greater detail	Application
Conventional view on fiscal policies in EMU – pre-crisis	Stronger SGP	<ul style="list-style-type: none"> • Introduction of expenditure rule, debt benchmark (<i>6-P</i>) and balanced budget rule (<i>TSCG</i>) • Possibility of imposing earlier/ more gradual sanctions (<i>6-P</i>) • Surveillance of DBPs (<i>2-P</i>) 	✓
	National fiscal frameworks	<ul style="list-style-type: none"> • Mandatory min. requirements at the national level (<i>6-P</i>) 	✓
	Macro surveillance	<ul style="list-style-type: none"> • Prevention/correction of macroeconomic imbalances via the introduction of the new Macroeconomic Imbalance Procedure (<i>MIP</i>) (<i>6-P</i>) 	being implemented
Revising the role of fiscal policy in EMU – post-crisis	Crisis resolution mechanism	<ul style="list-style-type: none"> • European Stability Mechanism (<i>ESM</i>) 	✓
	Better articulation of fiscal rules	<ul style="list-style-type: none"> • More flexibility in applying the rules • Euro area fiscal stance 	✓
	Breaking sovereign/banks nexus	<ul style="list-style-type: none"> • Banking Union • Capital Markets Union 	to be completed

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).

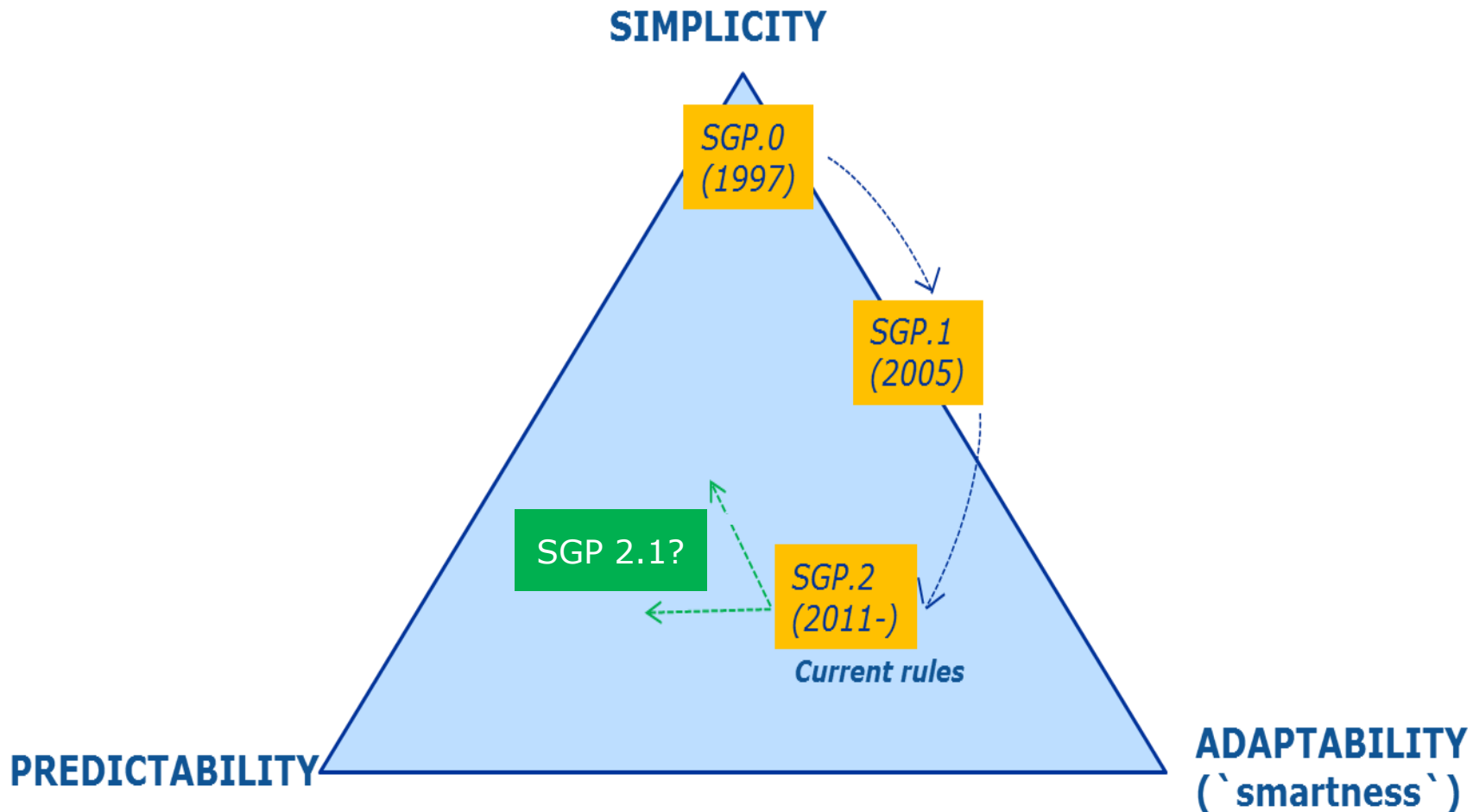
Remaining vulnerabilities

- ***Have the financial sovereign doom loops been sufficiently severed?***
 - Banking union not completed yet
 - ***Will the revised governance framework be effectively implemented?***
 - Limits to the application of rules/peer pressure on democratically elected governments
 - ***Has EMU the capacity to withstand the next large shock?***
 - ESM remains entirely dependent on national Treasuries and slow decision-making
 - 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?***
 - 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?***

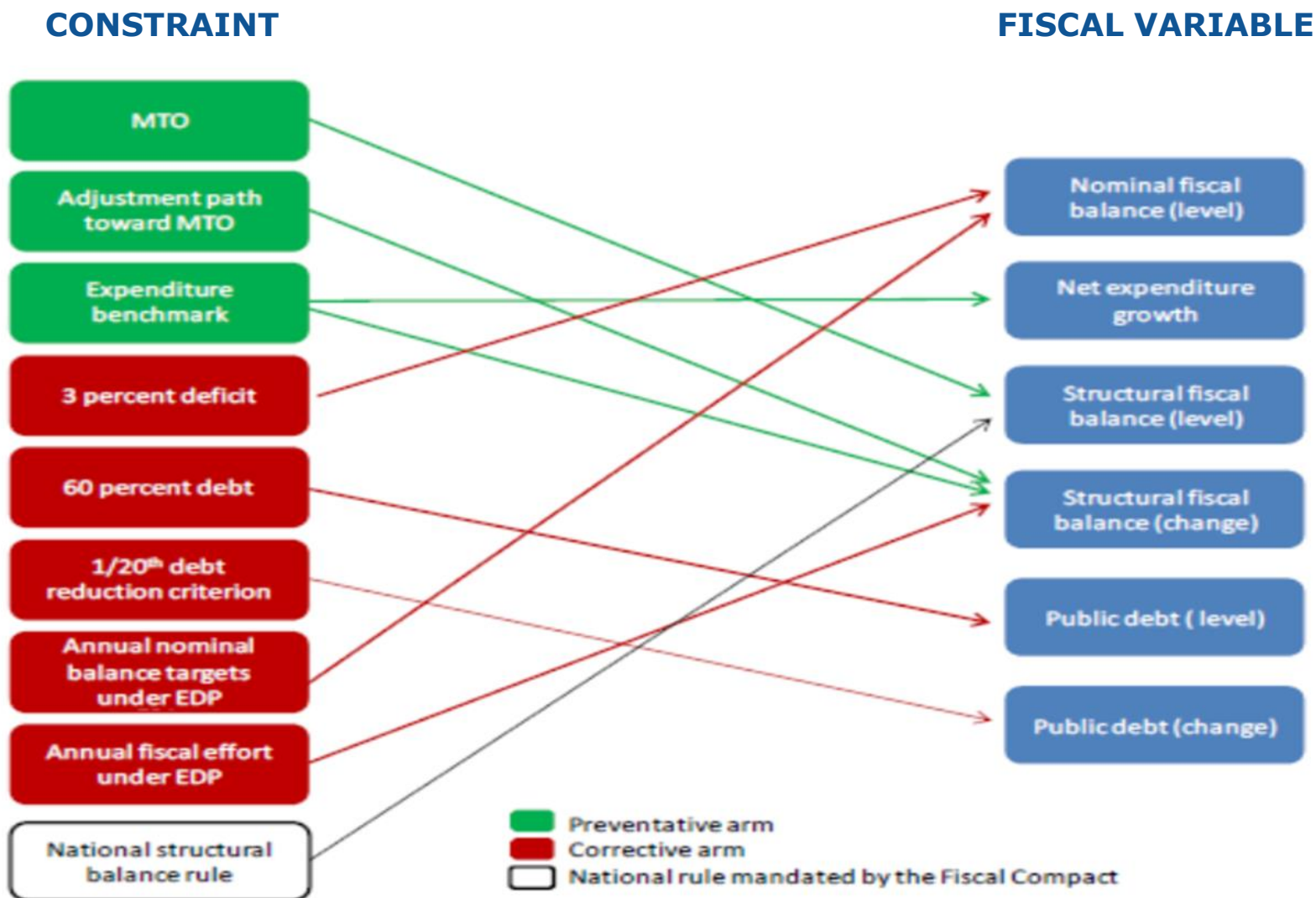
a) Complexity

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

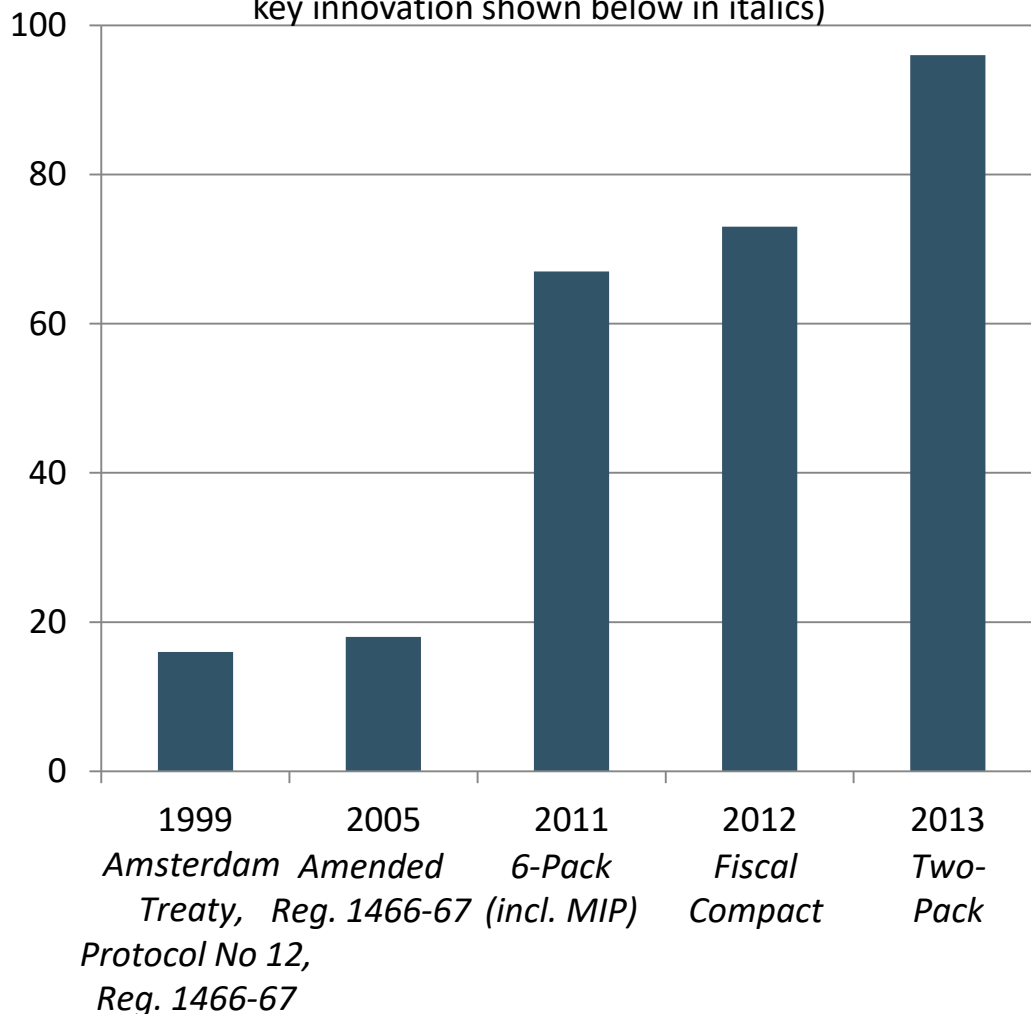


Resulting in a multiplicity of indicators...



...and a complex fiscal architecture

Number of pages in the entire framework
(in primary/secondary legislation,
key innovation shown below in italics)

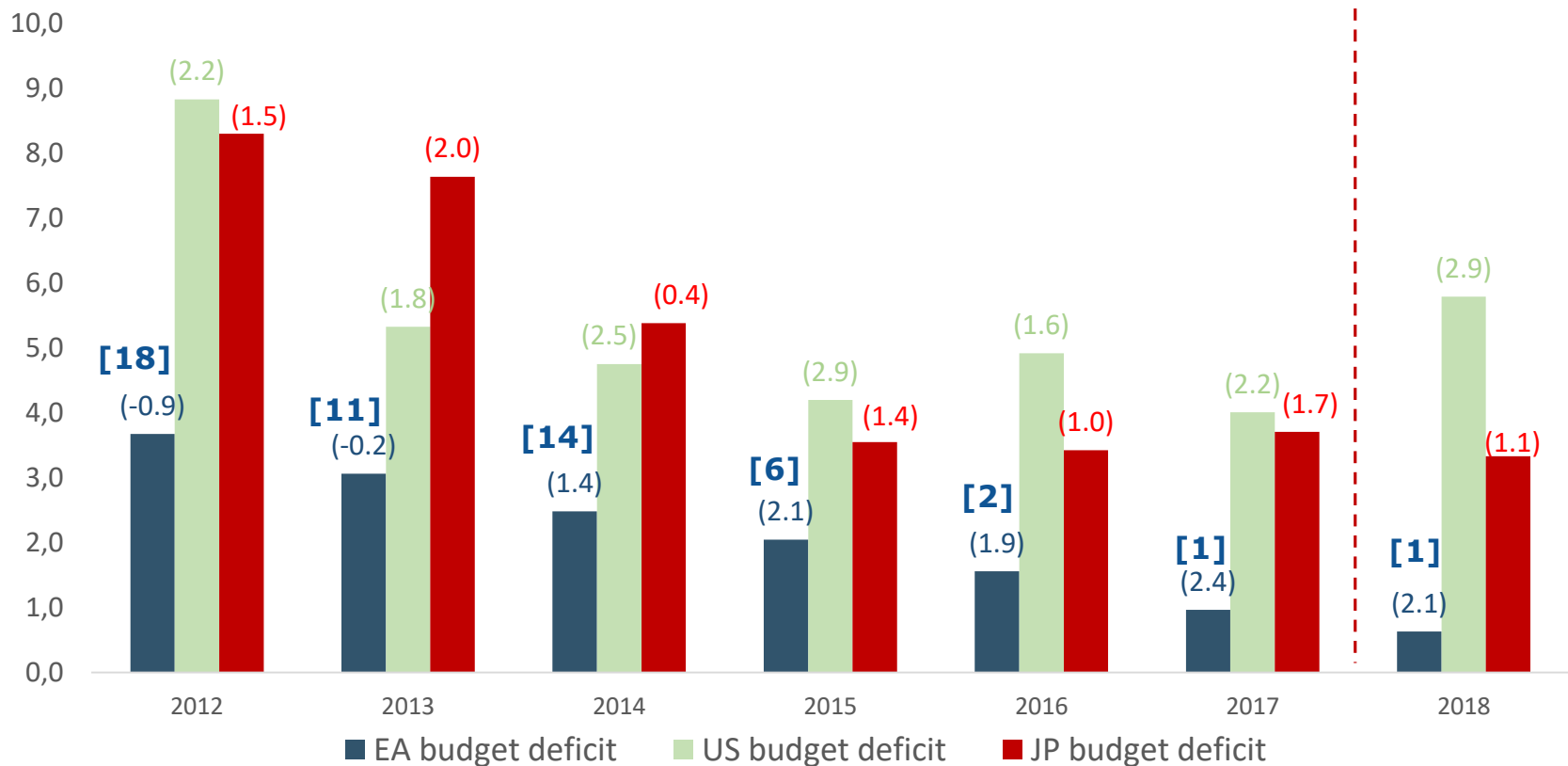


Reasons for increased complexity

- 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".**

b) Have the rules ensured sound fiscal positions?

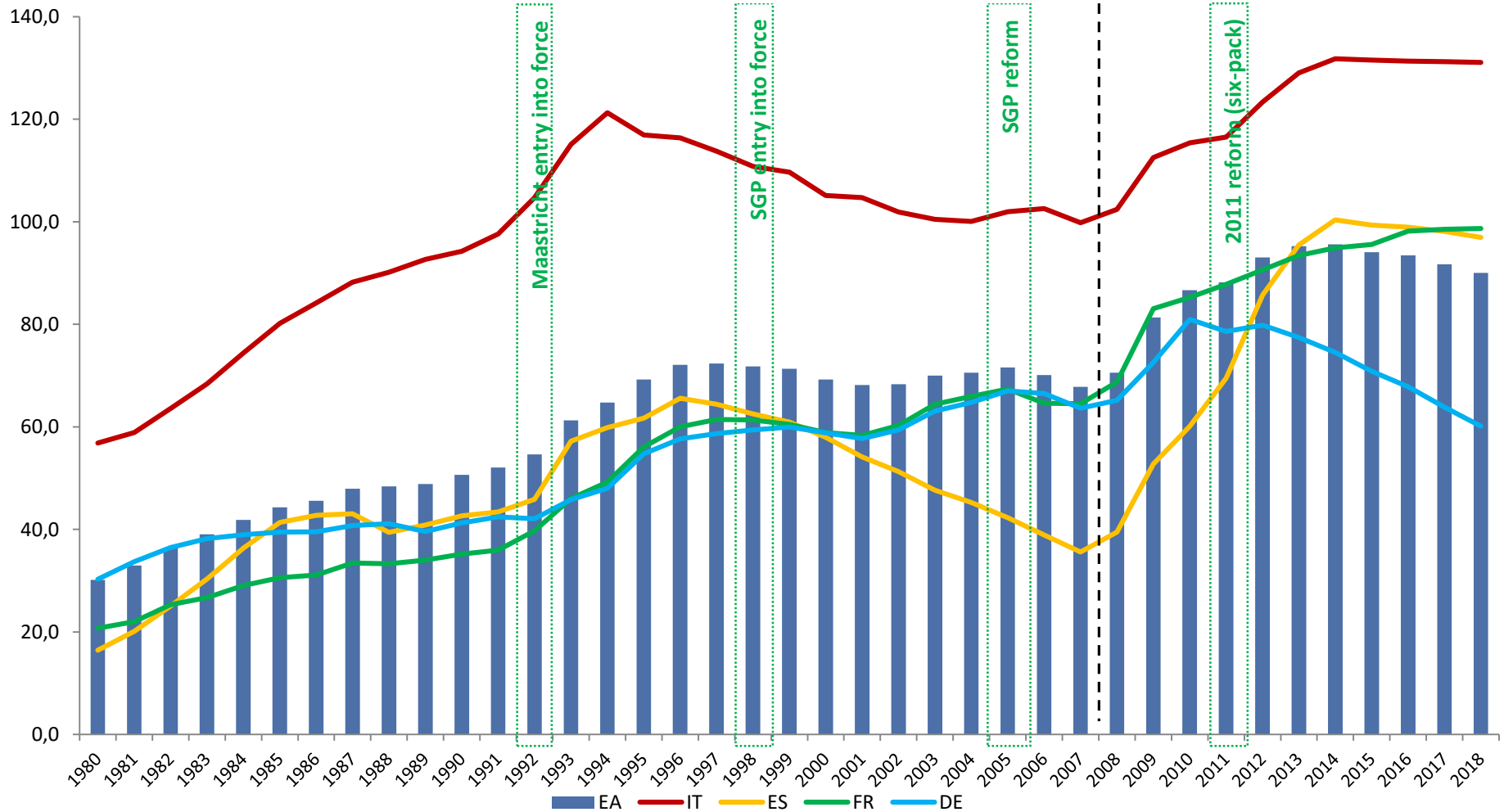
Aggregate budget deficit in the euro area fell from over 6% of GDP in 2010 to below 1% in 2018, much lower than US/Japan



*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*

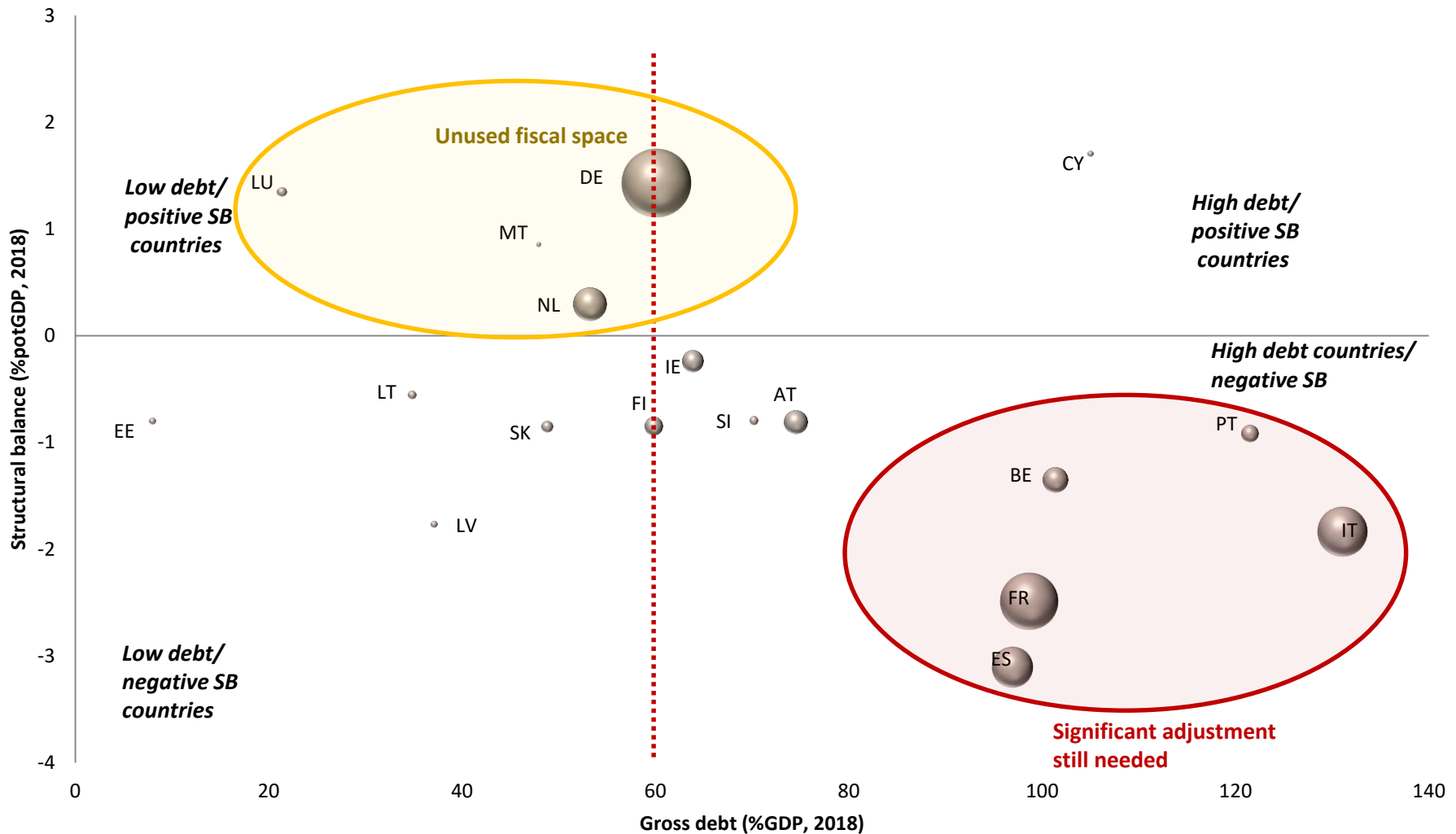
b) Have the rules ensured sound fiscal positions?

Debt developments are less benign



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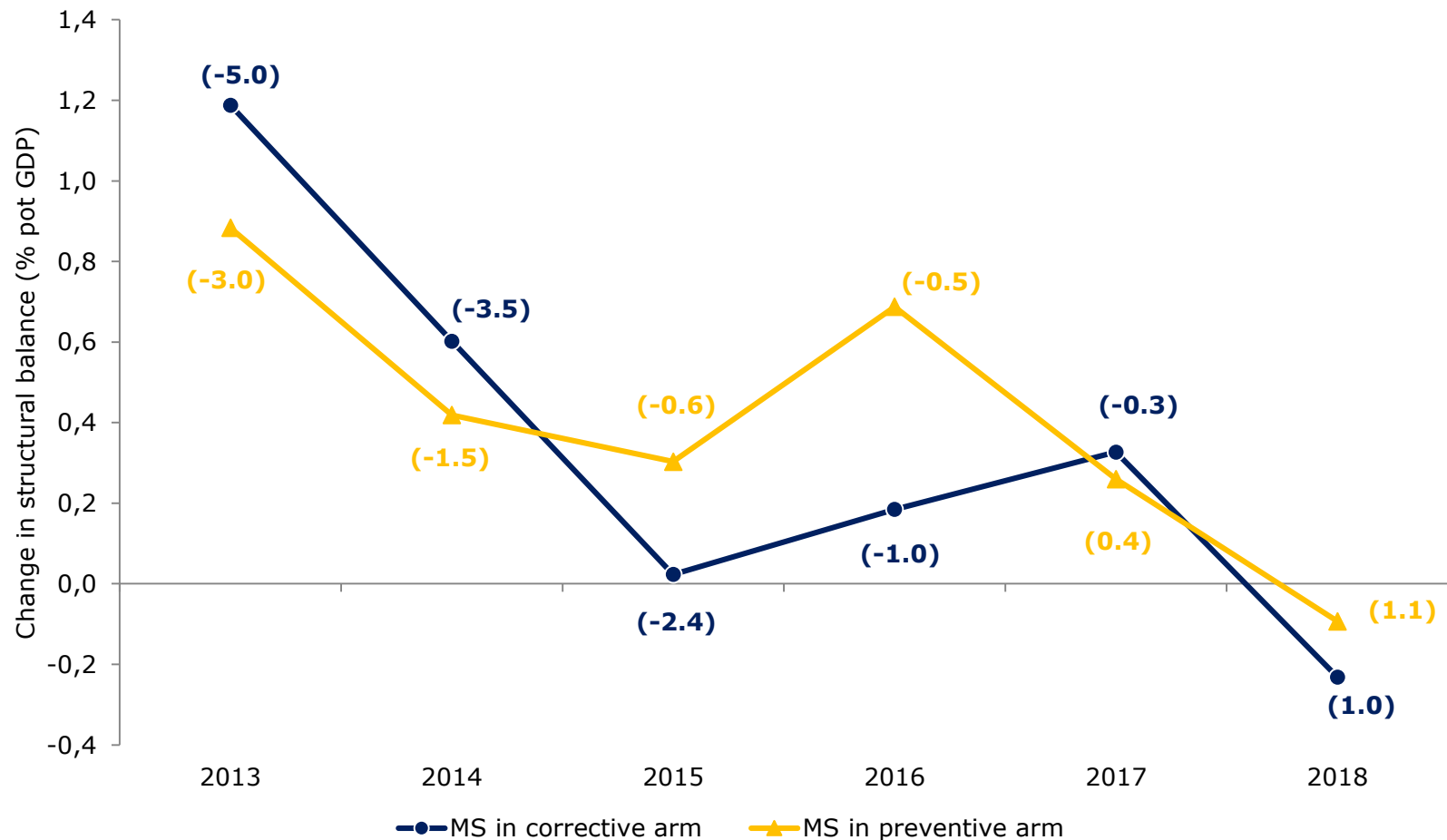
Large divergences in fiscal positions between Member States



Source: European Commission autumn forecast 2018

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

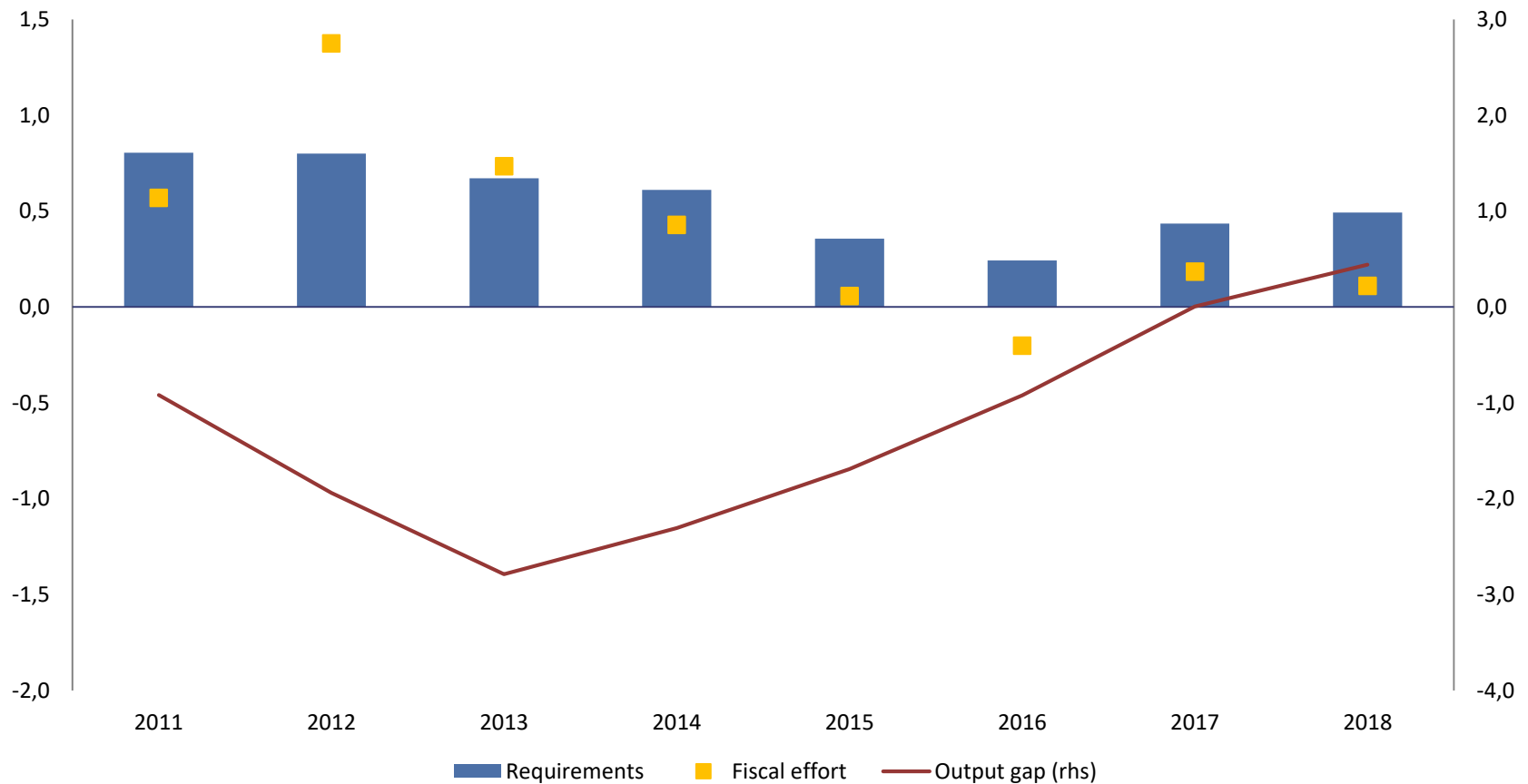
c) Achieving an appropriate fiscal stance at EA level

- 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.

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)

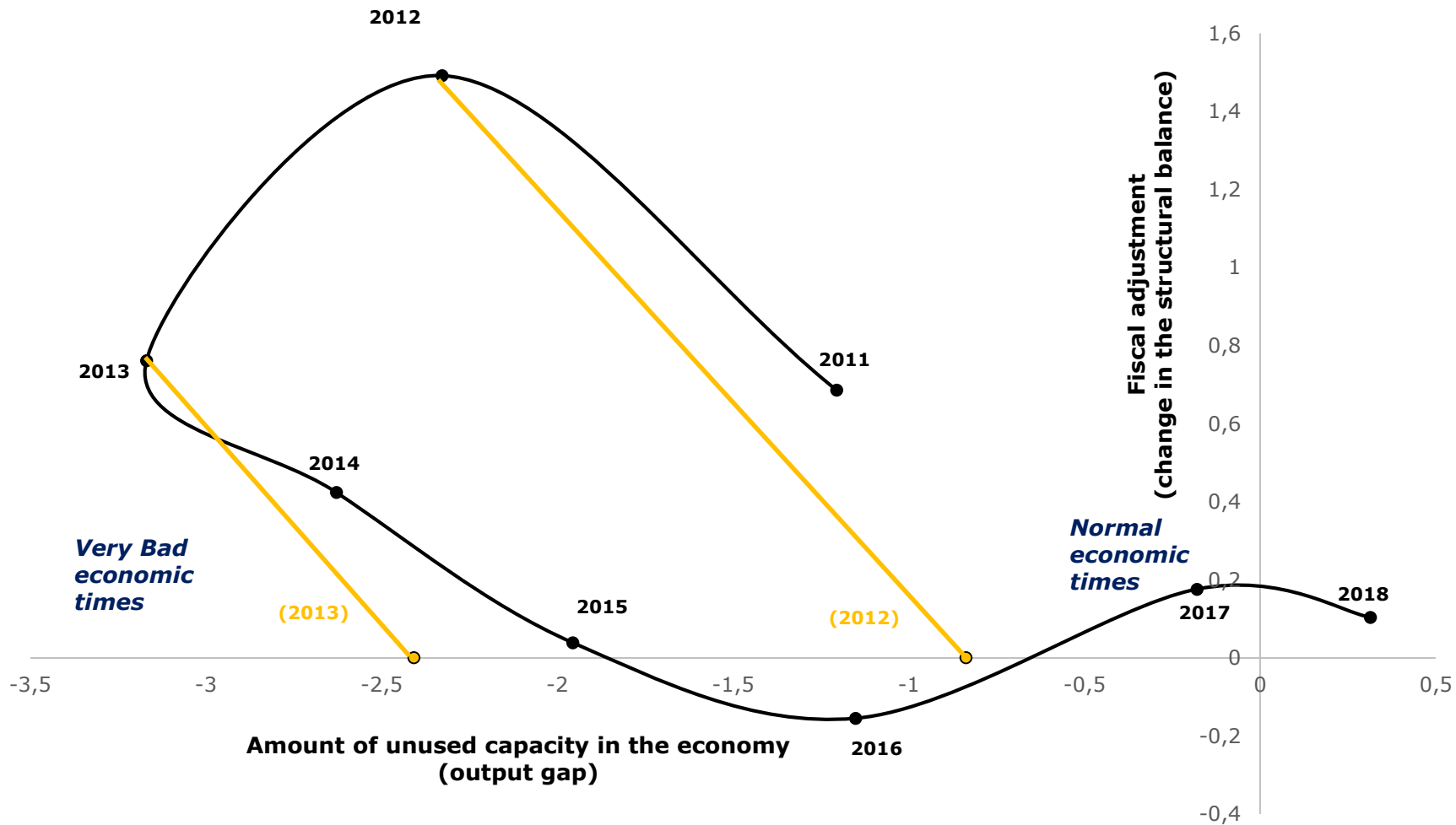


Source: European Commission autumn forecast 2018

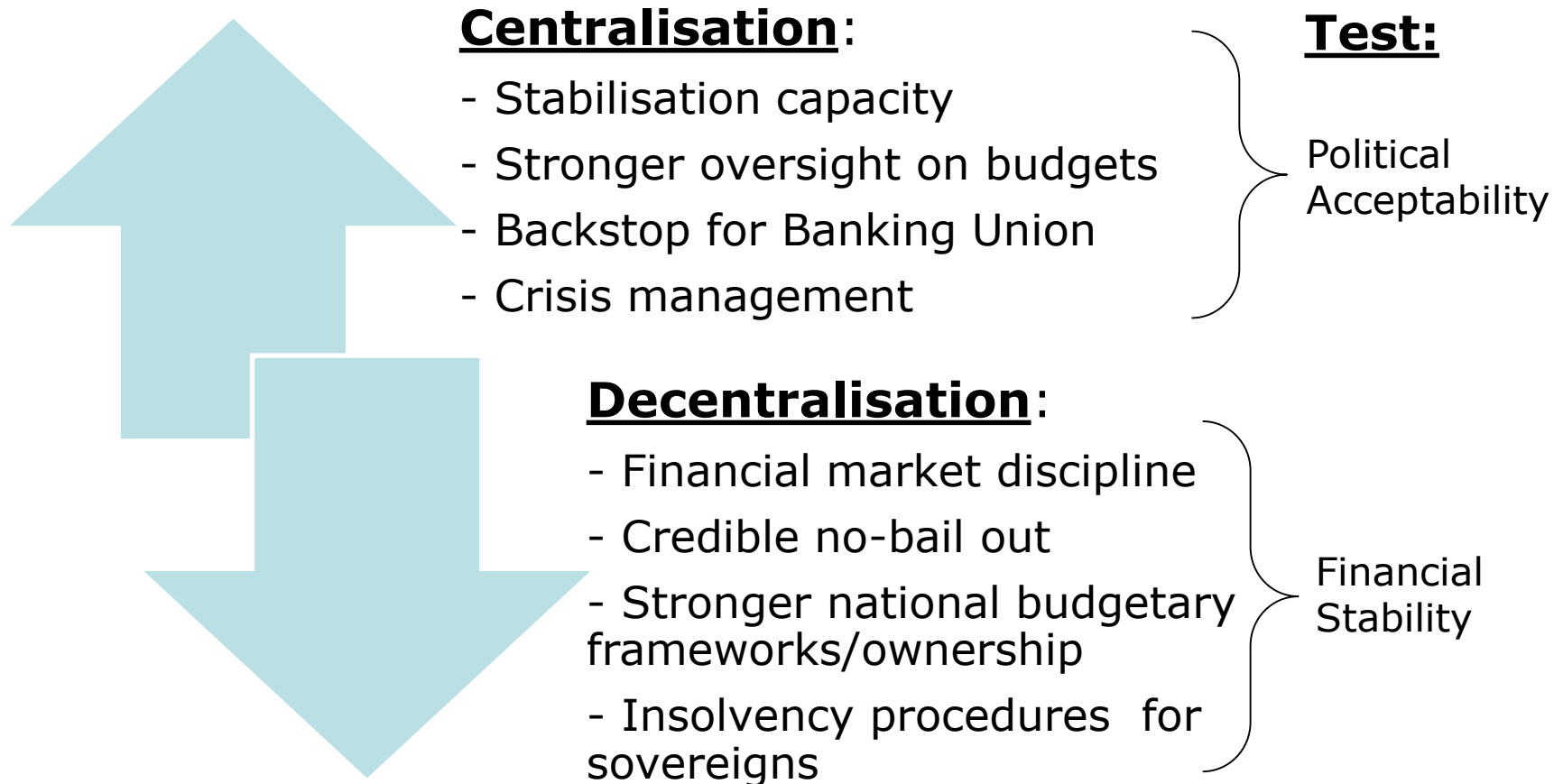
Note: euro area excluding Greece.

c) Achieving an appropriate fiscal stance at EA level

A counterfactual: benefits of a central stabilisation capacity in 2012-2013

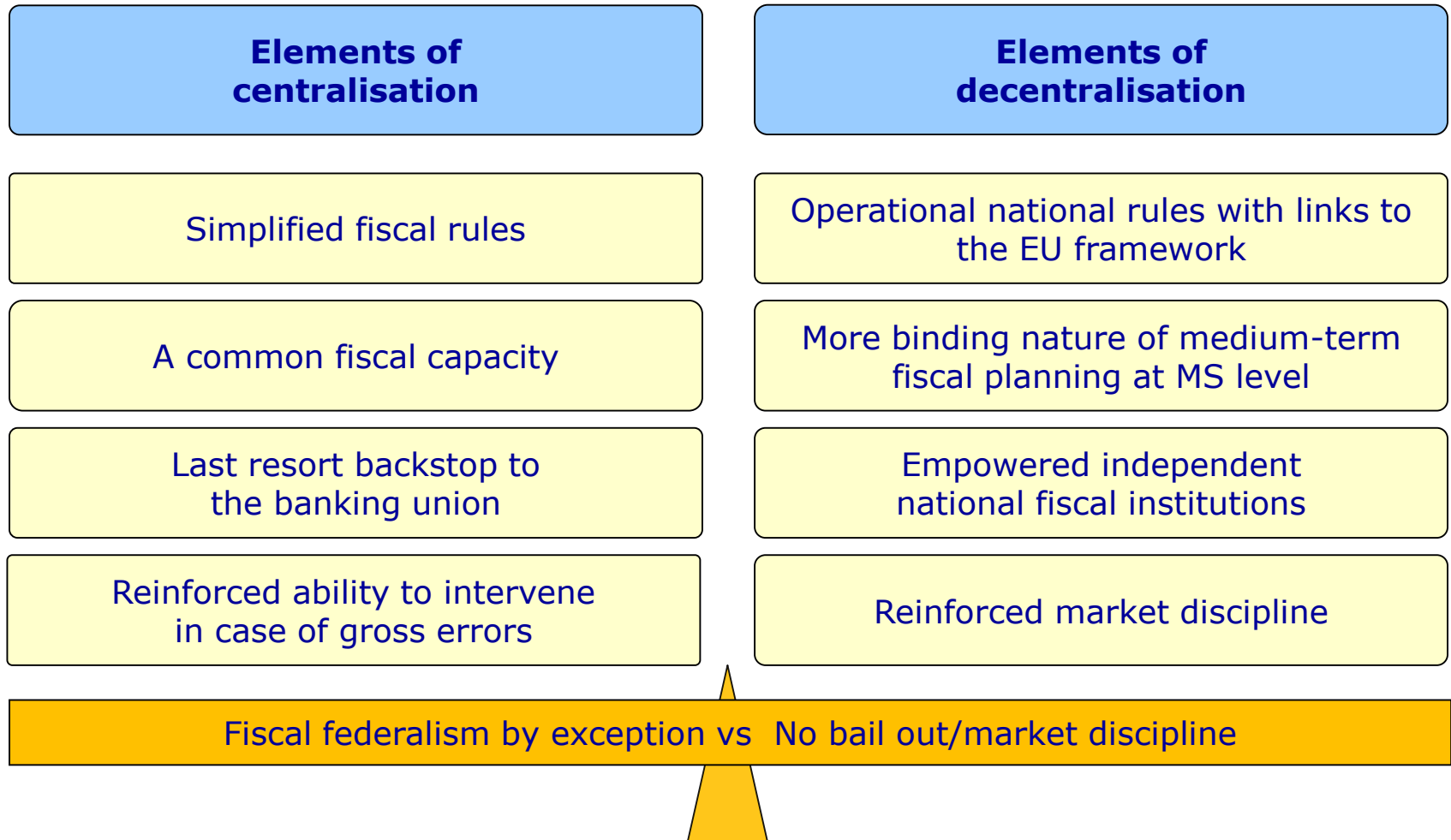


Two opposite visions for the way forward



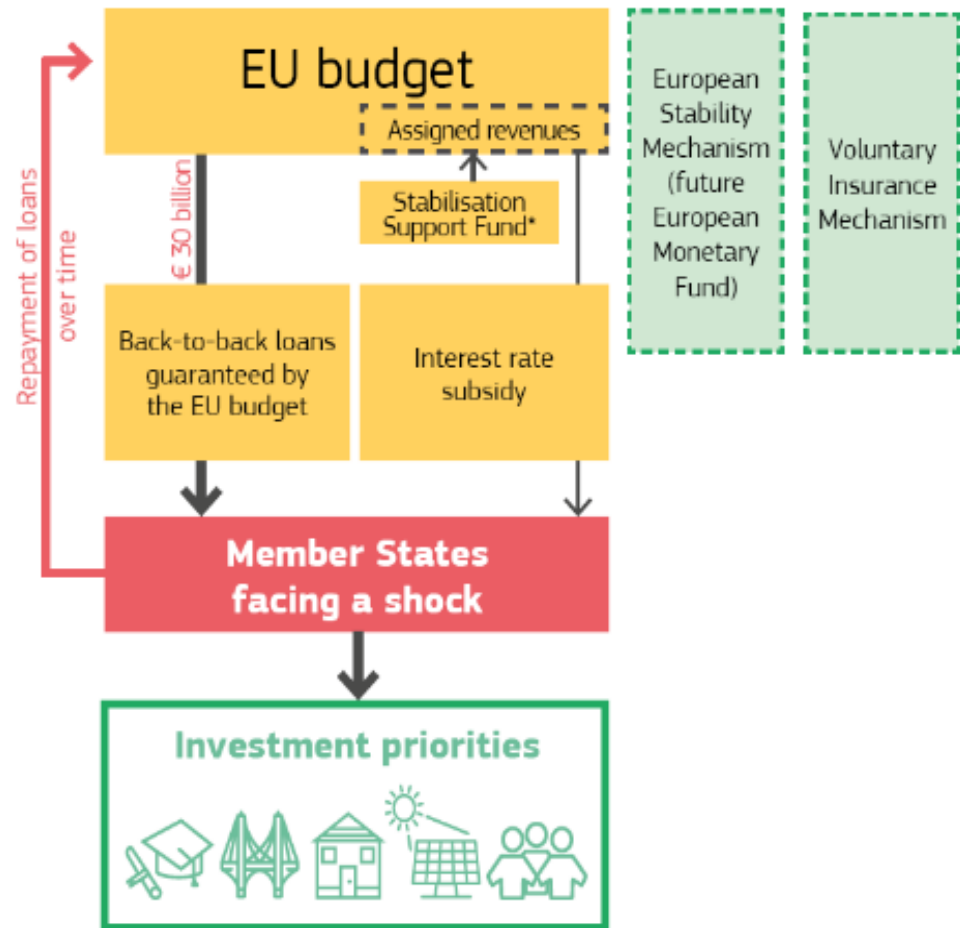
→ In their "pure" form, the two views don't pass the test

Searching for the right balance



→ **Essential to conceive the different elements of the framework together**

European investment stabilisation function (EISF)



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.

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

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