Concluding remarks

Rethinking the European Fiscal Framework

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European Fiscal Board
Brussels, 28 February 2020

Rethinking the European Fiscal Framework

- Three topics:
- 1) Fiscal Rules
- 2) Fiscal capacity
- 3) Blue-sky paper

- What did we learn?

- Where do we go?

Fiscal rules

- 1) *Larch et al: defending the rules*.
- Observed pro-cyclicality of fiscal policy *cannot be imputed* to the use of uncertain indicators (output gap); the same would happen using observables (unemployment). Pro-cyclicality is a result of *not respecting the rule* in good times and therefore having to adjust in the wrong time.

Fiscal rules

- *2) Mohl & Mourre*: *improving the rules*.
- Is the *expenditure benchmark* (EB) a better rule then *structural balance* (SB)? Yes. Had the EB be in place since the beginning we would have had: 1) lower debt levels and 2) less pro-cyclicality than with SB. Plus, EB is not less reliable than SB in terms of forecast errors.

Fiscal rules

- But M&M assumes that countries obey the rules; while for Larch et als. the true problem is *compliance*, particularly in the EU contest.
- How can one enforce fiscal rules when sanctions are de facto not applicable?
- You can, according to *Dotti & Janeba*, provided that there is at least some *reputational cost* (perhaps some market discipline?) for politicians in breaking them.

Fiscal rules

- Optimal fiscal rules should be based on a *zero structural deficit* and only be *partially* corrected for the cycle.
- However, they should also allow for *more flexibility* to countries with a *higher* deficit bias (so that citizens can discipline governments ex post).
- Hence, no *trade off* between fiscal discipline and flexibility. An interesting insight.

Fiscal capacity

- Do we need *a Euro(pean) fiscal capacity* to insure member countries against asymmetric shocks?

Fiscal capacity

- ***Yes***, according *to Dolls* (and many others..).
- Cycles are not completely synchronized in the euro area. Simulations using labor micro-data shows that even a *limited fund* could have absorbed (an impressive) 15% of income shocks in 2000-16.
- The fund is not in equilibrium along the period, but *no permanent* contributor/recipient either and also very limited net contributions by countries (less than 0.1% of GDP).

Fiscal capacity

- ***No***, according to *Feld (&GCEA).*
- No clear advantages from a fund (almost synchronized cycles), difficult to identify triggering conditions in real times, serious moral hazard problems etc..

- *Marimon et als* somewhat in between.

Fiscal capacity

- In a multi-country computable general equilibrium framework (with behavioral reactions), *all countries* would benefit from a basic EU unemployment insurance system characterized by 1) unlimited duration of eligibility 2)very low replacement rate.
- Institutional differences leading to permanent transfers could be eliminated by specific *payroll taxes* at country level.

Fiscal capacity

- But once this system were in place, not much advantages from further risk insurance across countries.
- Hence, more benefits from *harmonization* than *insurance*.
- Interesting.

Blue sky

- However all these versions of EU fiscal capacity only consider the possibility of *co-insurance* across countries in presence of *asymmetric shocks.*

- But are asymmetric shocks the only problem the Eurozone faces?

Blue sky

- No according to *Blanchard et al*.
- If the problem is **lack of aggregate demand -** and monetary is constrained- then one would need a *EU fiscal capacity* to increase spending even with *symmetric shocks*.
- Voluntary spending by Euro countries is suboptimal: with *demand externalities* in a Nash equilibrium each country has an incentive to curtail spending as a part of it would support other countries.

Blue sky

Blanchard et al. make three points:

1) $r < g$ in most Euro countries and it is likely to remain so for a long time. Hence D/Y falls.
2) Net public investment has fallen in the euro area and new challenges (climate, new technologies..) requires *huge new public investments*, some even with zero private (but *positive social*) returns.
3) With monetary policy at an "effective zero bound", *demand externalities* are likely to be more important than *debt externalities* – the only ones considered in the EU fiscal rules.

Blue sky

- And propose three solutions:

1) r<g implies giving *less weight* to debt sustainability and *more weight* to support public investment and fiscal macroeconomic policy. A EU *fiscal capacity* would be ideal (no *overheating* for some countries); but if not political feasible, then fiscal surveillance needs become *more symmetric*, also *imposing countries to spend more* when needed.

Blue sky

2) Numerical fiscal rules suffers from Knigthian uncertainty; there is no way to make them right *ex ante*. Better *fiscal standards* (principles..), legally enforceable and *adjudicated ex post* by an authority (EJC).

3) To better protect investment, introduce (at the European level) *capital accounting*, distinguishing between a current and a capital account.

Blue sky

- Problems could also addressed differently:
- A (limited) golden rule (as suggested by EFB) implicitly requires some form of capital accounting;
- A 7 year agreement + a rainy day fund (all proposals by EFB) + revamped MIP could also force countries to spend more when needed;
- Given this, exchanging numerical fiscal rules with standards really needed?

Where do we go?

- So this is the debate. And where do we go from here?
- We do not know. Lack of trust & different economic and ideological positions between countries have led to a *stalemate*; many ideas and reasonable proposals but *very little progress* so far. Difficult to be too optimistic.
- However, there is a new Commission with a bold program and a new Commission initiative relaunching the debate on how to reform fiscal governance in the Euro area.

Where do we go?

- And this workshop shows that at least among economists some consensus on how to proceed emerges, contributing to the Commission’s initiative.

- Which means that is surely worth keep discussing.

Greetings

- THANK CEPR AND ACES FOR THEIR COOPERATION
- THANK JEROMIN ZETTELMEYER FOR HELPING US TO SET UP A WONDERFUL PROGRAM AND ALL THE EFB SUPPORT STAFF - POLY IN PARTICULAR - FOR THE HUGE ORGANIZATIONAL EFFORT
- THANK TO ALL SPEAKERS, DISCUSSANTS AND PANEL PARTICIPANTS
- AND THANK ALL OF YOU FOR COMING. WE HOPE TO WELCOME YOU AGAIN AT THE NEXT EFB WORKSHOP.