Luigi Federico Signorini: Fiscal stabilisers, fiscal rules and fiscal union

Speaking notes by Mr Luigi Federico Signorini, Senior Deputy Governor of the Bank of Italy, at the EMU Lab seminar on "Enhancing fiscal stabilisation in EMU", Villa Schifanoia, Florence, 22 March 2024.

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Fiscal stabilisers

Fiscal measures[1] to stabilise the cycle should be timely, temporary and targeted. In this perspective, automatic stabilisers are preferable to discretionary measures (see e.g. Taylor, 2000). They do not suffer from the lags due to legislative approval and implementation; they do not need explicit action to be terminated. Many of the channels through which they operate inherently benefit those most in need. This largely holds even when a shock is asymmetric, i.e., it selectively affects certain businesses or areas. The literature also points to potential political-economy biases affecting selective discretionary action (see e.g. the survey by Alesina and Passalacqua, 2016).

Automatic fiscal stabilisation is explicitly provided by cycle-sensitive budgetary items. Such items are driven by their cyclical macroeconomic bases: unemployment for unemployment benefits, household income for personal taxation, turnover for VAT, profits for corporate taxes. They react promptly to a shock. At the micro level, they go to those that are more directly hit. In a progressive tax system (provided inflation is low) personal income tax revenues also typically decline more than GDP, as some households fall into a lower tax bracket; this supplies an additional short-term boost, (in addition to a redistributive effect).

Implicit output stabilisation is also provided by non-cyclical items, especially on the spending side. Most existing government expenditure – such as wages, transfers or intermediate consumption – hardly react to short-run changes in output; thus, they tend to rise as a share of GDP in recessions and decline in booms.

The case has been made that, with very large and persistent demand shock, the risk of "hysteresis" effects may justify the recourse to discretionary fiscal measures (see Christiano et al., 2011; De Long and Summers, 2012). However, any discretionary interventions would need to be carefully crafted to avoid unintended distortions, and to provide for appropriate sunset clauses (so that policies, given the usual decision lags, do not end up being out of phase with the cycle, or having an undesirable longer-term impact on the equilibrium of public finances). These conditions are not easy to stick to in practice.

An intermediate possibility, of which Professor Blanchard is a proponent, is to make any non-automatic fiscal response to very large shocks not fully discretionary, i.e., to have specific measure triggered by pre-defined exceptional circumstances.

The idea is not in fact totally new; it dates back to one of the earliest paper on the subject (Musgrave and Miller, 1948): "The flexibility of the tax system might be increased if provision was made for automatic adjustment in tax rates with changes in income but this could hardly be called built-in flexibility in the usual sense of the term". However, it has been explored more rigorously in recent years (e.g. Eichenbaum, 2019; Blanchard and Summers, 2020 and Boushey et al., 2019).

Basically, the idea consists in changing the parameters of fiscal policy (e.g. the generosity of the unemployment benefit scheme or the tax rates) for a period of time, when one or more business-cycle indicators (like the unemployment rate or the output gap) exceed certain thresholds. This approach reduces the distortions and delays typically implied in fully discretionary measures.

One can think of several objections. Defining appropriate indicators and thresholds, for instance, may be tricky, both on theoretical and practical grounds. (Professor Blanchard discusses certain key details in his joint 2020 paper). Issues of statistical measurement may arise. The possibility of ex-post tampering with duration and parameters may re-introduce some of the problems inherent in pure discretionary action. Various potential practical pitfalls will have to be taken into account.

Still, I understand that an arrangement of this type is actually in place at least in the case the US unemployment benefits scheme. It might be useful to explore the possibility of making use of a similar arrangement in a supranational context, with an open mind and a very pragmatic attitude.

Fiscal rules

Fiscal rules in a monetary union are needed to ensure the stability of the area by preventing harmful spillovers caused by public-finance tensions in member states. For this reason, members are required to pursue sound forward-looking fiscal strategies to guarantee long-term sustainability. This will make public finances in each country more resilient to negative shocks, thanks both to the fiscal space accumulated in good times, and to the confidence of markets given by credible long-term commitments. While rules originate as a reciprocal guarantee among members of the union, they are also a useful reference for political deliberations in each member state.

Pursuing these aims requires careful design. The crux of the matter consists in operationalising the concepts of 'forward looking' and 'long term'. One would like to have rules that are strong enough to ensure that extra fiscal resources are accumulated in good times, but flexible enough to avoid imposing undue pro-cyclical fiscal contractions in bad times.

It must be said that the procyclical impact of inflexible fiscal rules can be overstated, especially in a crisis. When a government faces a loss of the market's confidence in the long-term sustainability of its finances, there is no flexibility in formal rules that can spare it the need for forceful action.

Still, adequately accounting for the conjunctural situation remains a desirable feature of effective rules. Let me say it once again: this works both ways. Tough rules that require extra prudence and the build-up of fiscal buffers when times permit are a key condition to allow for easier constraints when times so require.

Nobody says that devising such rules is an easy task. There is a potentially vast choice of indicators, parameters, procedures and institutional structures, all of which have pros and cons. One has to be prepared to accept second-best solutions, also taking account of the need for reaching tricky political agreements.

Europe has long had such rules – and a lively debate about them. This is not the occasion for a retrospective assessment of existing rules, not even from the specific point of view of stabilisation policies. Let me just say that, with all their limits and complications, on balance they are likely to have positively contributed to budget processes, not least by providing reference points and calling for improved domestic procedures – including at the constitutional level.

Still, especially after the Covid crisis called for a suspension, there was a consensus that the system had become too complex and unworkable and that a reform was necessary. This process is now coming to a close, following the political agreement reached in February.

A positive element of the new framework appears to be its explicit medium-term orientation, entailing a full-fledged debt sustainability analysis performed by the Commission.

The reform also provides for more room for bargaining between the European Commission and each Member State. This is good to the extent that it actually increases national 'ownership' of the plans, as the legislators intend, and it does create some useful flexibility. However, it may also imply a highly politicised process, and the way it will work in practice cannot be fully anticipated. A farsighted attitude on all sides will be essential for this approach to succeed.

Numerical safeguards are also envisaged. The final compromise includes a minimum structural budget target (1.5 per cent of GDP) and a minimum annual debt reduction target (up to 1 per cent of GDP, depending on the starting point). The role of the 3 per cent deficit threshold has never been questioned. Experience will show how this set of safeguards is actually going to work.

(I shall not comment on the details. The choice of parameters and reference levels is always debatable and rather complex, thus undoubtedly detracting from one of the aims of the reform, which was simplification.)

Let me just say that, in principle, having safeguards in the procedure is a bit like having output floors and leverage ratios in banking regulation. If the conceptually superior process (risk-sensitive models in banking, well-developed, realistic sustainability models and effective medium-term plans in public finance) works as intended, and if the 'rule-of-thumb' thresholds are well chosen, the latter can be seen as rough 'guardrails', useful to maintain the operations of the main mechanism within reasonable limits. Again, experience will tell.

Fiscal union

Let me finally make a quick point about fiscal union.

If a significant central budget were in place, having simpler rules at the national level would be possible. Any residual procyclical effect could by counteracted by a system of EU-level stabilisers, automatic or (just possibly) semi-automatic (see Romanelli et al, 2022).

For common shocks, one key advantage of such an arrangement would be the possibility of simplifying the rules and making them more transparent.

For idiosyncratic shocks, it would additionally entail the benefits of mutual insurance (Balassone et al., 2018). National fiscal policies can only spread the effect of a shock on private consumption and GDP over time; a common EU-level stabilising mechanism would also provide a degree of budget insurance against country-specific shocks, i.e., across member countries.

(As has been argued, such insurance can also be provided through the capital and credit markets, to the extent that individuals in each country hold a diversified investment portfolio and have access to opportunities to smooth consumption through cross-country lending. In the US, financially-based cross-state insurance has been shown to be even more powerful than that provided by the federal budget (Alcidi et al., 2023). To me, however, this is not necessarily an either/or issue: it is an argument to pursue more financial market integration, as well as more fiscal integration.)

No explicit mutual insurance scheme is conceivable without safeguards against moral hazard, opportunistic behaviour or stacked odds.

(And of course, in case a more significant common budget is established, safeguard for a sound, forward-looking management at the supranational level will be called for).

However, tools can be devised to mitigate moral hazard, equate ex-ante expected benefits (Cioffi et al., 2019; Amato et al., 2023), or put limits on central expenditure or debt. The economic case for a reasonable degree of EU-level fiscal stabilisation, in my opinion, fundamentally stands; the more automatic, the better.

In political terms, of course I am under no illusion that this would be an easy or quick route to take.

My view is simply that an increased EU-level fiscal capacity with some stabilising effect would be useful. One hopes that it may it become politically feasible in due course.

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[1] Thanks to Pietro Tommasino and Stefania Zotteri for very valuable input. Opinions are mine.1 Thanks to Pietro Tommasino and Stefania Zotteri for very valuable input. Opinions are mine.

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