Reforming EU economic governance

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Key elements of the COM proposal

Goal: Limited debt stock

Analytical means: Debt sustainability analysis

Operational indicator: Net expenditure path over four years

Net expenditure = net of discretionary revenue measures & excluding interest expenditure and cyclical unemployment expenditure;
## Process for countries with a substantial debt challenge

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Sources: EU-Commission
How much do we know about the future?

Stochastic DSA Italy

Vintage 2021, updated 2022

Forecast starts

DSA starts

Projections start to be based on LT assumptions

Range within which debt lies with 80% probability

Aim: Debt needs to fall until t+17

Sources: EU-Commission
One-sided perception of risks?

Requirements to pass the DSA test

- Plausibly and continuously falling debt
- Debt to fall in all shock scenarios
  1. Structural primary balance -0.5pp
  2. Interest growth rate differential increases by 1pp
  3. Interest rate increase by at least 1pp., calibrated based on fundamentals (Schuster, forthcoming: ECB collateral framework matters)
- Debt to fall with 70% probability

There is no safety in high surpluses, only a walk on a tight rope balancing growth and fiscal consolidation

Sources: Pamies et al., 2021, Flickr
Incompatibility of goals?

- Multiple cost pressures
  - Higher financing costs
  - Higher defense spending reaching 2% p.a. in 2031
  - Spending needs for decarbonisation at 1% of GDP p.a.
- Competition from the USA with the Inflation Reduction Act

Sources: EU-Commission, own calculations
What follows from this?

Three suggestions

• Countries that meet a common fiscal parameter are not required to undergo full process
  • Primary balance calibrated based on current growth/interest environment
  • Growth and fiscal risks weighted equally
  • Focus on gross errors

• If you keep unobservables reform them
  • Instead of defining potential output/growth in a backward looking way, estimate them based on reforms and investment

• Retain sovereignty of national legislatures
  • Approve fiscal paths and DSA assumptions every year with the budget & before sent to the EU-COM (where applicable)
  • Publish underlying calculations to make assumptions and process transparent

Open questions

• How to meet all spending needs
• Interaction with the ECB
Kontakt

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What are the assumptions?

Example debt sustainability analysis

Key assumption I: Interest rate = ECB rate + risk premium

Key assumption II: growth, converging to potential growth

Sources: EU-Commission, EU-Commission
Variability of projections?

Debt to GDP projections Italy

Sources: EU-Commission
How to project (non-discretionary) tax revenue?

Germany tax revenue projections
In % of GDP, vintages from 2017 to 2021

Sources: Federal Ministry of Finance, Germany
Where does the recovery stand?

**European Union**
*Real GDP per capita*

**Euro Area**
*Real GDP per capita*

**United States**
*Real GDP per capita*

Data: Eurostat, Fred