Mathieu, Catherine; Sterdyniak, Henri

**Article**

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Intereconomics

*Suggested Citation:* Mathieu, Catherine; Sterdyniak, Henri (2022) : Towards New Fiscal Rules in the Euro Area?, Intereconomics, ISSN 1613-964X, Springer, Heidelberg, Vol. 57, Iss. 1, pp. 16-20, https://doi.org/10.1007/s10272-022-1022-0

This Version is available at:
https://hdl.handle.net/10419/262932

DOI: 10.1007/s10272-022-1022-0

*Intereconomics*, 2022, 57(1), 16-20

JEL: E62, H63, H77

Catherine Mathieu and Henri Sterdyniak

# Towards New Fiscal Rules in the Euro Area?

On 19 October 2021, the European Commission relaunched the review of economic governance in the European Union. Among the numerous proposals made so far, a consensus seems to emerge in favour of a public expenditure rule, aiming at bringing the public debt-to-GDP ratio down to 60%. In our opinion, numerical rules should be avoided. Euro area member states should be able to choose their domestic fiscal policy in an open coordination framework. This contribution provides a critical assessment of the current state of the debate on European fiscal rules and makes recommendations.

## The need to improve the euro area fiscal framework

Due to northern member states' fears and lack of trust, the launch of the single currency was accompanied by binding rules on domestic fiscal policies in the monetary union. These rules have been complexified, reinforced and softened over the years. The rules state that member states must not run public deficits higher than 3% of GDP and public debts higher than 60% of GDP. They must present stability programmes showing four-year projections of public finances with a return towards a structural deficit below 0.5% of GDP if their public debt is above 60% of GDP, and below 1% of GDP if their public debt is below 60% of GDP. The correction must be larger than 0.5% of GDP per year (measured in terms of primary structural balance, as calculated by the Commission). This pace should be agreed upon by the Commission, which may account for the structural reforms implemented. Once the structural balance reaches the equilibrium, it should be maintained at that level. Public expenditure should grow less rapidly than the medium-term potential growth of the economy. Member states should introduce independent fiscal institutes (IFIs) in charge of checking domestic fiscal policy compliance with EU rules.

These rules do not make economic sense. They are not an economic policy coordination framework. They do not account for the whole area situation as restrictive policies run in some member states are not counterbalanced by expansionary policies in other member states. They do not account for monetary policy's room for manoeuvre, which is very limited when interest rates are already near zero. The rules were designed to address situations with inflationary risks, and they are not relevant when the main risks are deflation and economic stagnation. The implementation of the rules depends crucially on potential output estimates – but the latter are debatable and unstable (see Mathieu and Sterdyniak, 2015). They have obliged some member states to run inappropriate fiscal policies in view of their economic situation. The IFIs have an ambiguous role: Should they assess the relevance of fiscal policy in the current cyclical situation, or should they simply check that this policy complies with EU rules?

In 2018, the Commission committed to launch an economic governance review in 2020, albeit specifying that rules should remain in conformity with the European Treaties. Due to the COVID-19 crisis, the review has been postponed until 2022. The implementation of fiscal rules was suspended in 2020, 2021 and 2022. Member states have been able to provide a massive fiscal support to their populations, workers and companies. Thus, in 2022, according to the Autumn 2021 Commission forecasts, public debt will reach 98% of GDP on average in the euro area, exceed 60% in 12 countries and surpass 100% in six of them (Greece, Italy, Portugal, Spain, France, Belgium). The structural public deficit would be 3.9% of GDP at the euro area level; only Luxembourg would achieve its medium-term objective. Re-implementing fiscal rules in 2023 without reforming them would imply either restrictive policies in the euro area, which would break the recovery as in 2011-2014, or strong tensions between member states and European institutions.

## A public expenditure rule

Some consensus seems to have emerged among European institutions and European economists to replace the existing rules with a single rule: a public expenditure rule. Public expenditure (excluding interest payments, conjunctural rises in unemployment benefits, one-off expenditures) shall rise less rapidly in a given time period, five years in general, than the sum of the inflation rate and potential growth rates so as to bring the public debt-to-GDP ratio down to 60%. However, the member states could choose to increase public expenditure as



Open Access funding provided by ZBW – Leibniz Information Centre for Economics.

**Catherine Mathieu**, OFCE, Paris, France.

**Henri Sterdyniak**, OFCE, Paris, France.

long as they increase tax revenues simultaneously; they could cut taxes only if they decrease public expenditure. In fact, the rule is very close to a rule concerning the change in the structural primary balance (SPB), which would have to increase depending on the debt gap (the difference between the debt ratio and 60%). But it is not neutral to set a fiscal rule as constraining public expenditure growth: It puts downward pressure on public and social expenditure rather than on the possibility of raising taxes (which some refuse to take into account; European Stability Mechanism, 2021).

According to its proponents, this rule would prevent the problems associated with the estimations of potential output, structural balance and fiscal stimulus. However, it would remain necessary to estimate potential growth, which is problematic in a situation of depression. As witnessed after 2011, there is a risk of a vicious circle: an underestimation of potential growth inducing restrictive policy, weak growth and, according to the Commission's estimation methods, a drop in potential growth estimates.

The proposals differ on how to account for inflation: observed, expected or at the ECB's 2% target. The latter is the most stabilising choice since fiscal policy would be more or less expansionary depending on the level of inflation.

Bringing public debt down to 60% of GDP would imply a long time period of restrictive fiscal policies in most member states. There is no guarantee that the resulting public spending cuts will be offset by higher private spending. There is no guarantee that the 60% arbitrary level is compatible with the medium-term macroeconomic equilibrium. Should member states try to cut their public debt to 60% of GDP, although this level is arbitrary and largely exceeded by countries outside the euro area and when there is an urgent need to finance environmental transition? Several authors have questioned the 60% level, which will be out of reach in 2023, and suggest instead 90% (Dullien et al., 2020) or 100% (European Stability Mechanism, 2021), or even a five-year rolling target specific to each country (Darvas et al., 2018), which makes the rule less restrictive but more vague.

In some proposals (Claeys et al., 2016), net public spending growth would have to follow a rigid formula: Public expenditure shall not rise more rapidly than the ECB's inflation target (2%) plus medium-term potential growth, minus a correcting term of 0.02 times the difference between the public debt level in the previous year and 60% of GDP. Whatever its economic situation, a country with a debt of 120% of GDP would have to cut its public spending by 1.2% and therefore make a fiscal effort of around 0.6% each year. In other proposals, public expenditure growth would be set by negotiation between the member state, the Commission, the European Fiscal Board (EFB) and the IFI (Bénassy-Quéré et al., 2018; Darvas et al., 2018). Compliance with the rule would be overseen by the EFB and the IFI, setting up a technocratic, opaque and complicated monitoring of national fiscal policies, which would not respect member states' autonomy.

Failure to comply with the rule would be sanctioned by suspending access to European Stability Mechanism loans in some proposals or to transfers from the EU budget in others (Bénassy-Quéré et al., 2018; Darvas et al., 2018), or by the obligation to finance expenditure above the target by issuing junior debt. It would be a dangerous financial innovation: an advanced country would issue debt that it has declared risky. This would lead to speculation that there is a risk that a euro area member state may (even partially) default.

Finally, the ill-conceived rule relates to the change in SPB and not to its level. The rule does not set an equilibrium level for the SPB and hence does not lead to a well-defined long-term equilibrium. A country initially running a public debt of 100% of GDP and a primary deficit of 2% of GDP must increase its primary balance each year. After 20 years, its debt will reach 60% of GDP while the SPB would reach 4.5% of GDP surplus. The rule says nothing about what should be done afterwards, whether public debt should be kept at 60% of GDP, which would allow the fiscal surplus to rapidly come down to zero, with a strong expansionary effect, or whether a large fiscal surplus should be maintained, which would progressively bring public debt down to zero.

This rule may seem satisfactory, since it lets automatic stabilisers act via tax receipts (and unemployment benefits). However, it imposes a fiscal policy that does not fully account for the economic situation and prohibits discretionary policies (although they are necessary as the COVID-19 crisis has shown). It maintains a technocratic supervision of national policies by EU institutions, with the support of ad hoc committees, based on arbitrary rules. Compared to the current situation, to paraphrase *The Leopard*, "everything must change so that everything can stay the same".

According to the *golden rule for public finances*, intergenerational equity allows the financing of public investments through public deficit (Truger, 2015). More precisely, the structural public deficit must be equal to the net investment plus the depreciation of the public debt induced by inflation (Mathieu and Sterdyniak, 2013). Some authors

recommend removing investments from public expenditure governed by the rule and including only public capital consumption (which is difficult to measure, however). This is crucial in present times when large public investments are required to tackle climate change. The golden rule would prevent these investments from being sharply reduced in times of fiscal austerity. However, this raises the issue of public investment definition. According to some proposals, the national accounts definition should be broadened to comprise all expenditure (including on education and research) increasing potential growth. But economic policy must have more important goals, e.g. reducing greenhouse gas emissions and preserving biodiversity. Therefore, one can instead advocate broadening the investment definition to expenditure required for environmental transition. The golden rule logically requires public debt to be assessed net of public capital. Moreover, the golden rule is not a macroeconomic stabilisation rule; member states must also be able to adjust their fiscal policies for stabilisation purposes. Finally, the emphasis on investment spending should not increase downward pressure on social spending.

### Debt sustainability

For Blanchard et al. (2021), the European fiscal framework should mainly be concerned with debt sustainability. The authors propose abandoning numerical rules and adopting standards, i.e. qualitative general principles, and we strongly agree. But they also propose that the EFB or IFIs use stochastic methods to assess the risk of default on public debt. This risk should be kept below 5%, which would put a specific ceiling on each member states' debt-to-GDP ratio. They propose constraining member states in order to converge towards this limit, either by allowing the Commission or the IFI to block a non-compliant budget, or by allowing the Commission to lodge a complaint with the European Court of Justice.

The suggested calculation makes little sense. Debt sustainability depends on the central bank's support. No one is wondering about government debt sustainability in the United States or Japan. Lessons from the COVID-19 crisis show that a common shock poses no default risk, given the ECB's support. How does one assess the risks of a specific shock, such as a major political turn, that the European authorities and the other member states refuse to endorse? Moreover, no sovereign country will accept that a committee of experts like the IFI or a judicial body like the Court of Justice of the EU could exercise a veto right over its budget. How would judges assess compliance with such a vague standard as public debt sustainability? The required public debt level should logically be low for a low-growth country like Italy (which would therefore be subject to strong constraints) and high for northern countries (which would not use their room for manoeuvre).

### Towards a fiscal Europe?

The European institutions (EFB, 2020, European Stability Mechanism, 2021) advocate increasing the EU's fiscal capacities in order to (i) give the EU budget a stabilisation role for the whole euro area (by running deficits when monetary policy is paralysed); (ii) use debt to finance conditional transfers to some countries such as the 2021 Recovery and Resilience Facility; and (iii) organise the provision and the financing of common public goods (such as the fight against climate change). As a counterpart, national fiscal rules would be significantly tightened. In our opinion, this is not economically realistic. The COVID-19 crisis has shown that member states can react quickly, while the EU has only refinanced to a small extent domestically financed measures. Can we imagine the same EU-level fiscal policies applied to countries in different situations or different policies decided centrally? Social and economic disparities are large between member states, and the political debate takes place mainly at the country level. Fiscal Europe would be a step towards a federal Europe, which does not meet the current wishes of the populations.

The conduct of national fiscal policies would be facilitated if a European budget was financing European common goods (such as the fight against climate change), by common resources (such as a financial transactions tax or carbon border tax) and by issuing euro bonds. But this should not be a pretext for adding constraints on national budgets.

### Coordinated but autonomous policies

In our view, fiscal policy in the euro area should draw on functional finance principles (Mathieu and Sterdyniak, 2019; Alvarez et al., 2019; Costantini, 2020). Public finances must target economic and social objectives, both in terms of macroeconomic stabilisation and financing of public spending and investments, in particular those necessary for environmental transition. Unfortunately, the European institutions, northern member states and some European economists demand numerical rules on public finances.

As other advanced countries, euro area member states should be able to issue safe public bonds at an interest rate controlled by the central bank, and their public debt should be guaranteed by the ECB. Member states should

be allowed to run a government balance consistent with their macroeconomic needs. A member state should be requested to amend its fiscal policy only if there is evidence that this policy has negative spillovers for the other member states. The mutual guarantee of public debts should be complete for member states agreeing to take part in an open coordination process (without prior rules); this coordination can be done through a negotiation. Member states should present a policy strategy to meet the inflation objective (at least to remain within a certain margin around the common inflation objective, which should be increased in times when a recovery is needed). The strategy should also meet a wage growth target: In the medium term, wages should grow in line with labour productivity, and in the short term, adjustment processes should be implemented in member states where wage growth has been too or not sufficiently rapid. Rises or cuts in social contributions (and value added tax as a counterpart) could be used to facilitate the adjustment process but should be coordinated. Member states should present and negotiate their current account targets, and countries initially running large current account surpluses should agree to lower them or to finance projects, preferably industrial projects in deficit countries. The coordination process would allow for autonomous but compatible fiscal policies.

The Treaty should keep a mechanism in the event where negotiations would not lead to an agreement, for instance in a situation where a member state would run an unsustainable fiscal policy. In this case, following the European Council's decision based on reports from the Commission and the ECB, the newly issued debt of a member state's government outside the agreement would not be guaranteed anymore, but this case should never occur. Besides, the ECB should keep interest rates below growth rates in order to reduce the weight of public borrowing, knowing that member states should implement restrictive policies in the case of excessive demand. In order to prevent the rise of financial bubbles, the ECB should give banks strong incentives to avoid speculative activities and to finance productive activities.

### Institutional views

The Commission asked for the advice of the EFB (2020, 2021). The EFB proposes a ceiling for net public expenditure growth below potential growth so that the debt ratio would converge towards 60% at a pace negotiated between the member state, its IFI, the EFB and the Commission. The 3% limit for public deficit would remain to signal the continuity of the rules. Growth-friendly investments (especially those co-financed by the EU) would be removed from the public expenditure rule but, in the medium term, they would weigh on other spending through their impact on the debt. The emphasis is not on the expenditure required for environmental transition. Member states that do not comply with the rule would lose access to aid from the EU budget. States with debts below 60% of GDP would be encouraged to develop growth-friendly investments (hoping for stimulus effects across the EU). The EFB proposes increasing the EU fiscal capacity and enhancing the IFIs' role on public finance surveillance in each member state, which raises democratic issues: How will their members be appointed knowing that there are different schools of thought among economists? Will IFIs, as in the past, need only to check that member states' fiscal policies comply with European rules? Will they have to assess the opportunity to deviate when these rules do not meet the needs of the member states, both for cyclical stabilisation and for structural policy reasons?

On 8 July 2021, the European Parliament took up the EFB's proposal. The European Parliament (2021) proposes the use of "innovative tools and techniques such as stress tests and stochastic analysis" to determine the debt level objective. "On the basis of mutual agreement, countries with a high current account deficit would see their spending targets lowered, while countries with an excessive external surplus would have a higher floor for the rate of spending growth". The Parliament adds that "Certain clearly defined and viable growth-generating expenditure would be excluded from the ceiling on net primary expenditure", without clearly stating that these investments are part of the ecological transition. "A central fiscal capacity at European level would encourage better compliance with the Union's fiscal rules".

Several views were opposed at the 11 September 2021 Ecofin meeting. For a coalition of "frugal" member states, led by Austria and including the Netherlands, Finland, Slovakia, Latvia (and strangely Denmark, Sweden and the Czech Republic, who are not euro area members), current rules are necessary and reasonable: "Sustainable public finances create confidence and fiscal space for political priorities and for dealing with future crises and challenges…. reducing excessive debt ratio has to remain a common target" (Blümel et al., 2021).

For the southern countries and France, the public debt constraint should be relaxed, for example by raising the limit to 100% of GDP (the euro area current average), and by giving high-debt level countries more time to bring their debt ratios down to that level. This would avoid obliging these countries to run highly restrictive policies

in 2023. Above all, some investment spending should be removed from the fiscal rules.

Faced with the impossibility of reaching a political agreement to review the fiscal treaties, the Commission could limit itself to applying the current rules with flexibility, which would maintain an ambiguous situation: much ado about nothing.

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