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Reforming EU Fiscal Rules

More Leeway, Investment Orientation and Democratic Coordination

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Input for the Webinar
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Forum

Achim Truger

Reforming EU Fiscal Rules: More Leeway, Investment Orientation and Democratic Coordination

In February 2020, the European Commission started its Economic Governance Review, in which EU fiscal rules obviously play a prominent part. The unprecedented economic crisis caused by the COVID-19 pandemic has understandably shifted attention away from the fiscal framework. In March, the European Council activated the general escape clause of the Stability and Growth Pact (SGP) and since then the debate focused on EU level emergency measures to overcome the crisis. After a somewhat shaky start, the EU responded with collective financial support. Safety nets worth €540 billion were approved in April, with credit lines for all member states. Encouraged by the joint initiative of Emmanuel Macron and Angela Merkel, a one-off recovery plan for Europe with €750 billion was approved – part of which is earmarked in particular as direct support for heavily affected states. The funds are to be raised through borrowing in the name of the EU, to be serviced through the EU budget – partly through its to-be-created own tax revenues. The agreement reached at the EU summit in July 2020 represents a major breakthrough on the road to reforming the EU's fiscal governance, which had largely come to a standstill before the crisis.

EU fiscal rules, however, still urgently need a reform in order to strengthen the role of fiscal policy. First, the abolition of national monetary policy in the euro area means that fiscal policy must play a much larger role in stabilising national economies. The ECB has to orient its interest rate policy by the Economic and Monetary Union (EMU) average and therefore is unable to respond to specific economic circumstances in individual countries. In the absence of fiscal countermeasures at the national level, this threatens to create persistent boom-bust cycles capable of endangering the stability of the EMU. Second, particularly during periods of crisis, fiscal policy must support monetary policy, whose stabilisation possibilities are restricted at the zero lower bound for interest rates. Third, as recent empirical results for the fiscal multiplier show, fiscal policy is much more effective macroeconomically than previously assumed, especially in periods of crisis. Fourth, fiscal policy must enable strong long-term productivity growth through high and consistent public investment in traditional and ecological infrastructure and in education and research.

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The threat of further austerity

The crucial importance of fiscal policy for macroeconomic development in the euro area is illustrated by the fact that the acute economic crisis in the countries of the European periphery could – at least for the time being – only be overcome by relaxing fiscal rules and thus by a much less restrictive fiscal policy stance. After the tightening of European fiscal rules (six-pack, Fiscal Compact, two-pack) had led to a strict austerity policy in these countries (Seikel, 2016), the EU Commission under Jean-Claude Juncker interpreted and applied the rules in a more relaxed way (European Commission, 2015; European Council, 2015). This, together with the ECB's willingness, declared in 2012, to provide guarantees for the government bonds of the affected countries, finally paved the way for an economic recovery.

Figure 1 uses the EMU's and the average of four crisis countries' (Greece, Italy, Portugal and Spain) structural budget balance[1] to show the orientation of fiscal policy. If structural balances rise (decrease), this signals a restrictive (expansive) fiscal policy. With the austerity policy in place between 2010 and 2013, the structural budget balance was reduced by more than 6% of GDP in only three years, dragging the periphery into a severe double-dip recession. The initially weak and then somewhat stronger upswing since 2014 was driven by domestic demand and coincides with a perceptible relaxation of the consolidation policy: in 2014, fiscal policy switched to a neutral stance. Brussels' budgetary surveillance ultimately tolerated the deterioration of the structural budget balance. This was partly also a consequence of the reinterpretation of the rules of the SGP.

Another important aspect relates to the development of

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MATERIALIEN ZU WIRTSCHAFT UND GESELLSCHAFT

Überblick

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A. some flaws of the existing rules

B. recent additional arguments

C. towards implementing the reforms

some flaws of the existing rules

- arbitrary one-size-fits-all targets for fiscal policy (60%, 3%, 0.5%)
- neglect of the Golden Rule for Public Investment
- pro-cyclicality because of problematic cyclical adjustment
- complexity and lack of transparency which hinders effective monitoring of compliance
- technocratic and lack welfare orientation & democratic procedures

Catastrophic fall in public investment during the Euro crisis

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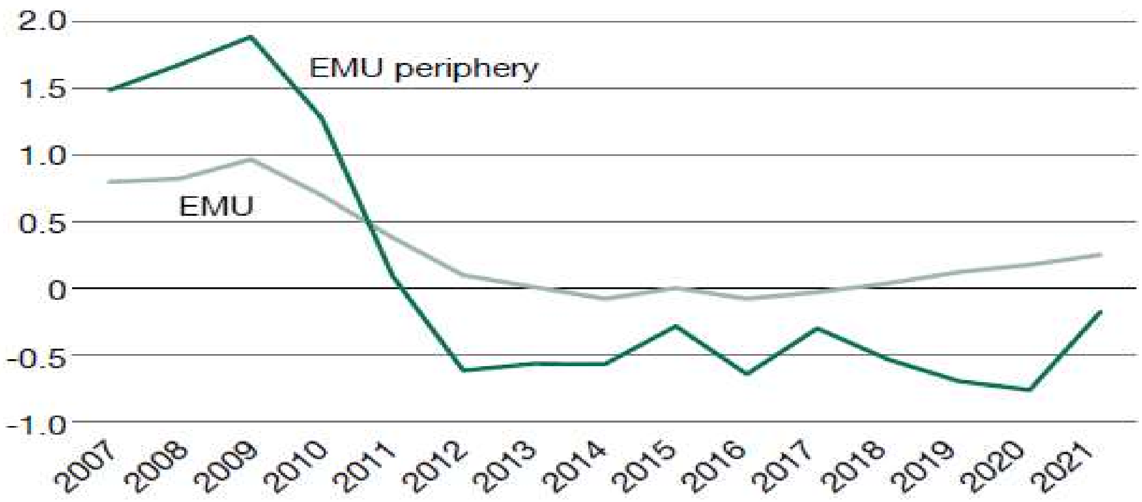
Figure 2

General government net capital formation, EMU and EMU periphery, 2007-2021

in % of GDP



Note: The EMU periphery refers to Greece, Italy, Portugal and Spain; un-weighted arithmetic average.

Source: European Commission (2020); author's calculations.

Procyclicality of potential output calculations!

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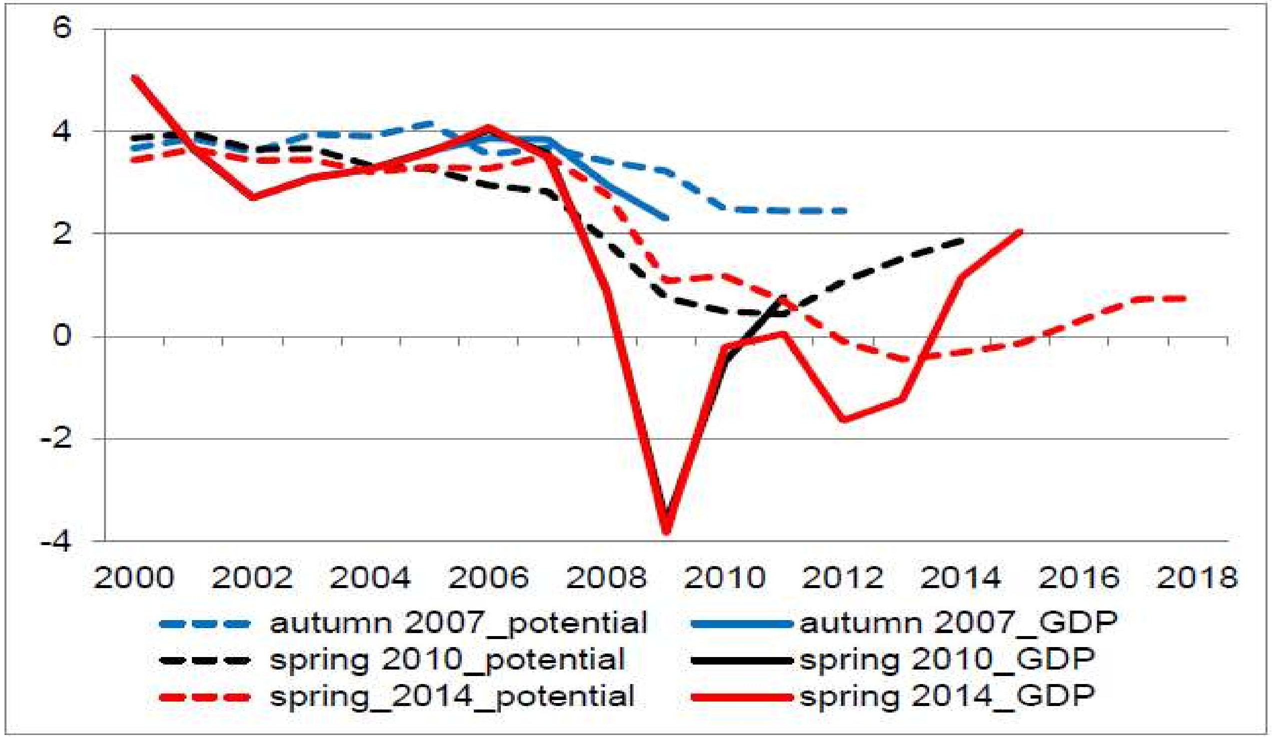
Figure 1: Real actual and potential GDP in Spain as of different European Commission's forecasts, annual growth rate in % 2000-2018



Source: European Commission (2014b), author's calculations.

Überblick

A. some flaws of the existing rules

B. recent additional arguments

C. towards implementing the reforms

recent additional arguments

- conciousness of importance and effectiveness of fiscal policy has increased (multiplier debate)
- monetary policy at zero lower bound + low/negative interest rates
- need for public investment has increased (ecological transition)
- it will be impossible to return to the current rules (1/20th debt rule!) after corona
  - rules cannot strictly be enforced because this would mean a return to austerity
  - or else rules would have to be bent extremely undermining credibility (EFB)

Deutsche Bundesbank

- seems ready to accept bending of the rules…

No compelling case for general escape clause in 2022 as things stand today, but decision at a later date based on a more certain outlook prudent

Government measures have been a major factor in addressing this exceptional crisis. The high deficit and debt ratios that these are bringing about do not contravene European fiscal rules. Activation of the general escape clause suspended the rules of the Stability and Growth Pact (SGP) for 2020. The suspension of these rules was extended in October 2020 so that they would not be reimposed this year, either.

At the start of March 2021, the Commission proposed already deciding on the continued application of the general escape clause in 2022 in June 2021. In the Commission's view, the decision should be made following an overall assessment of the state of the economy by the Council, particularly of the real GDP level of the European Union and the euro area in 2022 compared with pre-crisis levels. At that time, the Commission concluded that the general escape clause should remain in place in 2022.

The Commission revised its expectations upwards in its latest forecast. Real GDP is set to shows that 2022 will not be a crisis year. It also shows that the fiscal policy envisaged will not hinder a strong economic upswing.

Compliance with rules would not place any strain on economic growth

Moreover, economic growth would likely not be impeded by the deactivation of the general escape clause in 2022. Under the SGP, Member States are generally required to lower their structural deficit by 0.5% of GDP per year until their medium-term budgetary objective (MTO) is achieved.[27] Depending on a country's specific situation, this target can be adjusted. For example, the level of correction required could be

25 The Commission has stated that around half of the total amount of €70 billion in RRF grants made available to Spain will be absorbed over the forecast horizon.
26 For other countries, the effect appears to be greater in 2022 than in 2021. The key factor here is the year-on-year change in NGEU grants. However, there is a lack of precise information about the time profile. The Commission only goes so far as to present expenditure and other costs (per country) financed by RRF grants, as incorporated into the forecast, in a graph. The level of other NGEU grants is neither depicted nor specified.
27 Compliance with the debt criterion (corrective arm) requires that the part of the debt ratio above the 60% threshold be reduced by an average of 1/20th per year. Violation of this rule has never resulted in an excessive deficit procedure (EDP) being launched. Even where debt ratios have been very high, non-compliance has so far been excused as long as a country has not significantly deviated from its adjustment path towards its MTO.

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Towards implementation

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- country-specific (intermediate) targets at least for debt level / speed of adjustment
- Investment-orientation: correcting deficit targets for net investment / expenditure rule
- use more stable potential output estimates / use average growth rates in expenditure rule

➔ should be implemented as result of the current review of the fiscal rules

➔ much of it should be possible without treaty change and maybe even without the requirement of unanimity!

➔ as fast implementation which is effective already for 2023 is politically improbable it should be made clear that the return to the current rules would only be preliminary and transitory

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Thank you very much!

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