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Almost-new fiscal rules for an old Europe

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The European Commission has adopted a communication to the European Parliament for upgrading the fiscal rules associated with economic and monetary union, suspended since 2020 amid large economic shocks. The commission's intention is to design a framework that is 'simpler, more transparent and effective, with greater national ownership and better enforcement, while allowing for strategic investment and reducing high public debt ratios in a realistic, gradual and sustained manner'.

The proposal is the outcome of long negotiations and public consultation, beginning well before the pandemic and the energy crisis and involving economists, governments and other institutions. Jan Priewe surveyed the main proposals that were on the table this week in *Social Europe*. The next step is discussion of the commission's proposal by member-state governments and the European Parliament.

The main aim of the new rulebook is to force member states to reduce public debt along a path that is more feasible (and credible) than that set in the Stability and Growth Pact. This prescribed a reduction of the ratio of debt to gross domestic product by 1/20th of the amount exceeding 60 per cent of GDP every year, keeping the 'structural' budget deficit close to an esoteric threshold called the medium-term objective (MTO).

Involved and ineffective

The commission admits that the current pact was strongly focused on fiscal discipline instead of growth, as even the position papers of three orthodox European governments (Spain and the Netherlands jointly and Germany) articulated. It also concedes that the sanctioning procedure was so involved and ineffective that while almost every member state failed to respect the rules at least once during the last decade none was really punished. Just a glance at the multi-layer 'pyramid' of steps required to effect the excessive-deficit procedure (in the 2019 edition of the commission's ready reckoner on the pact) indicates why this happened. Moreover, the MTO has been notorious for volatile and incorrect guidance to national governments, helping amplify rather than smooth the business cycle.

Thus, the commission decided to focus on a more transparent measure for evaluating deviation from a prudent fiscal policy, the 'expenditure benchmark'. This is total public expenditure net of discretionary revenues, excluding interest payments and cyclical spending

related to unemployment. The benchmark does *not* however exclude expenditure on investment, as many stakeholders and scholars had proposed it should.

Formally, the 1/20th debt reduction rule, the 'structural' budget deficit based on the controversial 'output gap' measure and the MTO thus disappear from the new European fiscal framework. The 3 per cent ceiling for the budget deficit is maintained (since it is prescribed by the Treaty on the Functioning of the European Union) but this would be evaluated over a four-year span, instead of being a yearly target exposed to short-term perturbations.

Stable and sustainable

National debt-reduction plans prescribed by the new rules would then have (deliberately) the same average duration as a government, four years, and be revised only in exceptional cases. Thus, each government would pass on a sound fiscal position to the next one. The commission proposes a unified approach (likely very similar to the current methodology) to these multiannual programmes, although they would be subject to modification by the member states through bilateral negotiation. There would be yearly targets for net public expenditure, instead of the budget deficit, consistent with foreseen revenues, debt reduction and GDP.

In the commission's view, the plans must still ensure that the debt/GDP ratio is put on a stable and sustainable declining path at unchanged policies, and that the budget deficit is below 3 per cent of GDP for the next ten years, albeit with some easing for moderately indebted countries. Member states are classified as high-debt (and high-risk) according to a methodology inspired by the International Monetary Fund, whose main benchmark is a debt/GDP ratio above 90 per cent.

The plan can be extended over a seven-year horizon if the member state is committed to implementing a programme of reform and investment recommended by the commission. Each member state must present an annual report on the plan's realisation. In evaluating progress, the commission would take into (serious) account other issues included in the Macroeconomic Imbalance Procedure, such as unemployment and territorial disparities. Independent national and European fiscal boards would have a stronger role in assessing deviations from the plan.

The sanctions system would also change. The excessive-deficit procedure would be maintained for breaches of the 3 per cent rule (and opened and closed mechanically for high-risk countries). Nevertheless, fines would be reduced, while a suspension of European funds (including the Recovery and Resilience Facility) and some reputational sanctions would be introduced—such as calling a minister from the state before the European Parliament.

Misleading assessment

A jaundiced observer might say of the new rules what a character in the novel *Il Gattopardo* (The Leopard) said about Italian unification: 'If we want things to stay as they are,

things will have to change.’ The ‘expenditure benchmark’ seems a rewording of the ‘structural’ deficit criterion, and ‘potential output’ replaces the controversial ‘output gap’ for adjusting fiscal policy to the business cycle in the ten-year projection of debt. The commission will likely take into account some variant of the MTO when it proposes and assesses stabilisation plans. Highly indebted countries may hardly depart from the plans designed by the commission, to avoid negative reactions on the financial markets, which is not so different from the effects of the ‘reinforced surveillance’ foreseen by the current pact.

Discriminating among member states according to their risk level would be a reasonable approach if debt accounting were perfectly comparable across member states. Yet debt measured according to the Maastricht-treaty standard may offer a misleading assessment of the risk each country presents.

Consider the liabilities of public corporations classified outside general government expenditure (in particular, state-owned investment banks). According to Eurostat, in 2020 these liabilities varied as a ratio of GDP, with the conventional Maastricht debt/GDP ratio in brackets, thus: Greece 171 per cent (206 per cent), Germany 101 (68), the Netherlands 89 (55) and Italy 65 (155). Where the former ratio was higher than the European average, the published debt ratio would represent a comparative underestimate and *vice versa*.

The average official debt in the European Union was about 90 per cent of GDP in 2020, at the floor of high-risk designation under the new scheme. But that would rise to 156 per cent with the inclusion of these other liabilities—making Germany a high-risk country, while Spain would not be, even though its official debt is 120 per cent of GDP.

Furthermore, there are at least two missing points in the commission’s proposal. The first is the co-ordination of national policies, required by the substantial spillover of fiscal policies across European economies. Thus, the new rules could still be procyclical and risk spreading recessions across the EU, because low-debt countries are still not encouraged to pursue expansive fiscal policies.

Secondly, the ‘expenditure benchmark’ implicitly continues to assume that the fiscal multiplier—the impact on national income of government spending—is zero: otherwise it would be meaningless to monitor expenditure without taking account the effect on revenues and GDP. Yet austerity is acknowledged as counterproductive when the debt/GDP ratio multiplied by the fiscal multiplier exceeds one.

Important achievement

A fair view is however that trying to reform the pact after 25 years is an important achievement in itself. Further good news is the admission that fiscal consolidation is not feasible

without economic growth, and that imbalances other than the budget deficit should be taken into serious consideration.

Pursuing multi-annual targets could encourage forward-looking, structural policies instead of short-term items of legislation (sometimes flawed by window-dressing of the public accounts). Increasing the reputational costs and streamlining the penalties for deviations from plans is a strong incentive for governments to be accountable to citizens.

The motivation for enhancing public investment and implementing structural reforms is still weak—holding out only a postponement of fiscal consolidation—but it is a way to focus on the quality of public expenditure and encourage more productive use of tax revenues. Linking the European facilities to the results achieved, as in the NextGenerationEU programme, is good practice. Finally, the new proposal (almost) wipes out from European jargon the 1/20th rule, the 'output gap' and the MTO.

Of course, on many issues improved is needed. But we are on the right way.