Towards a better fiscal policy in the EU and Germany: Opportunities and Obstacles

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Input for the TUREC meeting
„Reform of Fiscal Rules – Lessons learnt?
AK Europa & ÖGB Europa“, 29 September 2021

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Towards a progressive EMU fiscal governance

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Nacho Álvarez, *et al.*

Working Paper 2019.13

etui.

DOI: 10.1007/s10272-020-0915-z

Forum

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

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

PUT FORWARD FOR DISCUSSION: TWO DIFFERENT VIEWS ON THE APPLICATION AND REFORM OF EUROPEAN FISCAL RULES

207. In the following section, council members put forward for discussion two different approaches to the application and reform of the European fiscal rules.

3. European fiscal rules (Monika Schnitzer and Achim Truger)

107. In the wake of the coronavirus crisis, the European Commission, with the approval of the European Council, **activated** the **general escape clause** for the years 2020, 2021 and 2022 for the first time since the introduction of the European Stability and Growth Pact (SGP) in 1997. ↘ BACKGROUND INFO 6 As soon as this clause is **no longer** applied, the rules of the preventive and corrective arm of the SGP that currently apply – such as those for the general government budget deficit, the structural deficit, the debt ratio and expenditure growth – become relevant once again.

Under the preventive arm of the SGP, i.e. for Member States that are not under an EDP, the rule applies that a country's structural deficit must be more or less in line with the country-specific medium-term objective (MTO) or on a path towards it at an appropriate pace (European Commission, 2019, p. 15). The necessary pace of adjustment depends on the national economic situation and normally requires a **reduction in the structural deficit in steps of** 0.5 % of GDP per annum. Under the corrective arm of the SGP, an EDP is opened as soon as the general government deficit of a Member State exceeds 3 % or a deficit of this magnitude is planned. While a violation of the rule to limit public debt can also trigger the opening of an EDP, so far the interpretation has been more flexible in practice. **In the corrective arm of the SGP**, more detailed monitoring rules and requirements with regard to planned national fiscal measures apply.

108. It is **an undisputed fact** that **fiscal rules** are **needed** in light of **political economy considerations** to contain the **deficit bias**, and also for the purpose of fiscal and monetary policy coordination within a monetary union. More recent deliberations on fiscal policy in times of low interest rates (Blanchard, 2019; von Weizsäcker and Krämer, 2021) make little difference to this. Rather, analyses concerning sustainability and interest rate risks ↘ ITEMS 100 FF. demonstrate the continued need to limit debt ratios in the euro area and that the notion of perennially low interest rates, and therefore of self-financing deficits, is anything but convincing.

109. However, it does not therefore ensue that the fiscal rules in the euro area would need to remain unchanged after the crisis and that fiscal policy should pursue an intensified course of consolidation. Rather, the broad range of economic and financial impacts that continue to be felt in many Member States as a result of the

Overview

A. some flaws of the existing rules

B. recent additional arguments

C. towards implementing the reforms

some flaws of the existing rules

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- 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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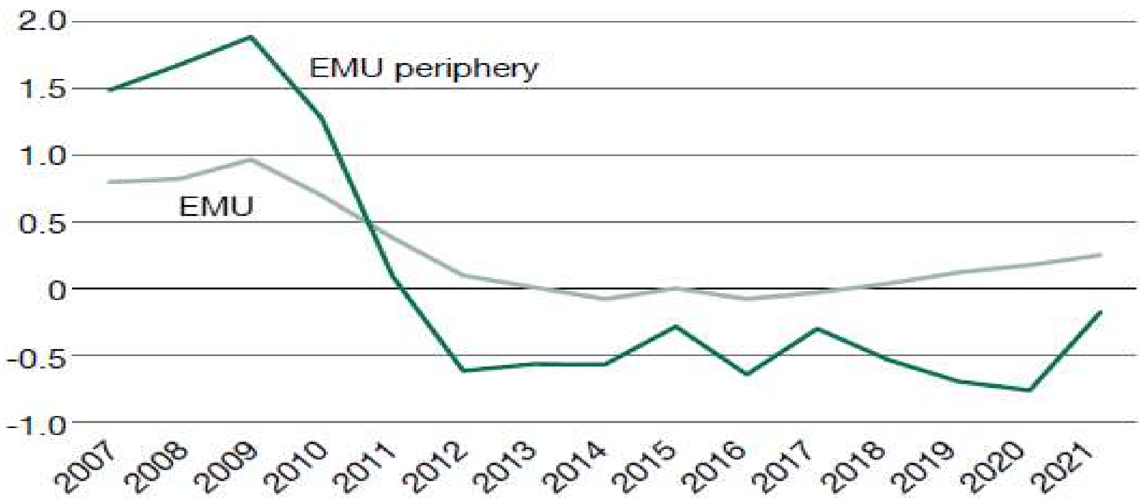
Figure 2

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; unweighted arithmetic average.

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

Procyclicality of potential output calculations!

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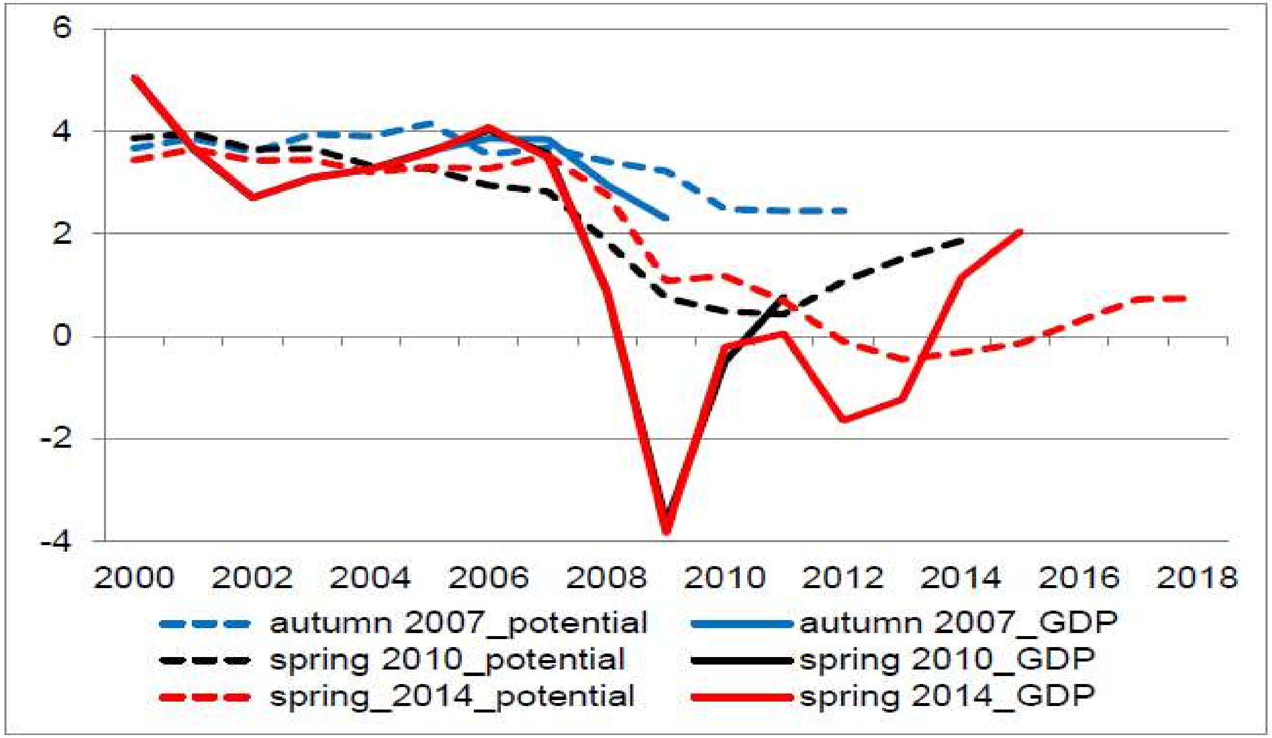
Figure 1: **Real actual and potential GDP in Spain as of different European Commission's forecasts, annual growth rate in % 2000-2018**



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

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- 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)

Überblick

A. some flaws of the existing rules

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(minimum?) requirements for reforms

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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
- (make RRF permanent or use new climate RRF)

➔ 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!

Towards implementation: Opportunities

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- Experience of Covid-19-shock and the common vulnerability may have changed some minds!
- same with challenge of ecological transformation
- There is broad support by European economists, think tanks, EP, EESC, EC, EFB, ESM, IMF, ECB.
- (by now even half of the German Council of Economic Experts now call for the reforms…)
- many countries have called for such reforms. And the resistance in „the North“ is not too strong: German coalition agreement says rules should be developed further.
- Legal barriers (treaty change, unanimity) not as large as previously thought: IMK / Repasi study commissioned by EESC

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

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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.

Towards implementation: Risks

- Improvements may have to be „bought“ with concessions of strict expenditure rules and stronger national or European fiscal boards
- new rules (and RRF!) may come with further losses in national autonomy and democratisation
- backlash in terms national prejudices, misunderstanding of countries‘ successes and failure
- Current debate on and fear of inflation may lead ECB to make mistakes

➔ The whole Euro project is still unstable!

German Fiscal Policy

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- the old „black zero“-policy (headline budget balance = 0) is over
- massive fiscal support and stimulus in the covid-19-crisis
- now the challenge is cyclical „normalisation“ + return to fiscal rules + massive public investment needs for socio-ecological transition
- New government has set itself unnecessary limits: No tax increases + no changes in „debt brake“
- Coalition agreement nevertheless allows for massive investment spending by using extra budgetary items + some leeway in the interpretation of the debt brake.
- Government may be lucky again as tax projections have been revised upwards
- Unfortunately „normal“ spending still procyclical and federal states and municipalities are may be confronted with tight limits

VIELEN DANK FÜR IHRE AUFMERKSAMKEIT.

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