How the EU's fiscal rules should be reformed

Two key principles have sat at the heart of the EU's fiscal rules since the Maastricht Treaty: that governments should run budget deficits no higher than 3% of GDP and maintain a public debt no higher than 60% of GDP. **Piotr Arak**, **Łukasz Czernicki** *and* **Jakub Sawulski** *argue the use of broad fiscal targets of this kind is no longer sustainable and that a new system is needed for the post-pandemic world.*

Current fiscal rules in the EU are unsustainable. Almost every member state is in breach of the fiscal rules introduced some three decades ago to create the single currency but also to keep public finances in shape across the bloc. The Covid-19 pandemic has shifted debt and deficit rates to another dimension and going back to business as usual is now unrealistic.

The pandemic has pushed Italy's debt close to 160% of GDP while France and Spain are nosing 120%. There is zero chance these debt levels will get anywhere near the EU's 60% limit without austerity. The kind of debt levels that we are seeing are likely to persist for decades and could have a large impact on the economic growth of some member states if austerity policies are imposed.

A new generation of economic policy

Incentives for fiscal and monetary conservatism were hard-coded into the Maastricht treaty that created the common currency. Until the pandemic, policymakers held to their principles. Even after the global financial crisis, the European Central Bank increased interest rates in 2011, just as every euro government tightened their fiscal policies, resulting in a double-dip recession.

But things have changed since. The European Central Bank's default mode has become less hawkish. Its deposit rate has been negative since 2014. The pandemic blew away any remaining caution as the central bank doubled down on bond purchases with a new trillion euro programme.

On the fiscal side, the EU's tough budget rules have been suspended because of Covid-19. Already before the pandemic, growing doubts that the regulations were not fit for purpose were fuelling a debate about a wholesale revision. A new generation of economists with a more pragmatic and less dogmatic worldview have become the decision-makers, particularly in Germany – among them the Bundesbank President Jens Weidmann and Jörg Kukies, Deputy Minister of Finance.

The fiscal policies pursued in the EU over the last decade were wrong – such a conclusion can be read either directly or between the lines of statements of European policymakers during the current crisis. The main message is that we must not repeat the mistake of austerity in the recovery phase. Instead, it will be necessary to invest more to boost the economy. This is what Olaf Scholz is pledging, the head of the German Ministry of Finance. Even the new Chairman of the ruling CDU, Armin Laschet, says it is "certain" that the escape clause in the German debt brake will also be used in 2022 delaying any austerity.

Fiscal rules are not universal laws of nature

But if we're going to agree that the fiscal policies of the past were wrong, does that mean we should abandon the rules that these policies were based on? The short answer is yes. These rules are not inviolable principles. They were approximate indicators giving guidance as to optimal levels of debt and deficit for most advanced economies based on the prevailing understanding at the time they were created. They were a conceptualisation of economic thought onto a legal framework, not a universal law of nature.

And they can be proven to be harmful. Researchers from the Inter-American Development Bank recently published a study in which they prove that rigid fiscal rules – i.e. with numerical limits on fiscal targets – harm public investment. More precisely, in countries with rigid rules, fiscal consolidation of at least 2% of GDP is associated with an average 10% decrease in public investment.

This result fits perfectly with what has been observed in the euro area during the last decade. Net public investment (taking into account the depreciation of public infrastructure) in the euro area was close to zero in the whole 2011-2020 period. This means that there was no progress in the quality of public infrastructure, and in some countries there was decay.

According to that paper, in countries with flexible fiscal rules the negative effect of fiscal adjustments on public investment vanishes. This implies that flexible rules can protect public investment even during periods of fiscal consolidation. This conclusion is a strong argument against the Maastricht criteria. There is nothing more inflexible than the injunction to always keep a country's deficit below 3% of GDP and the debt below 60% of GDP.

These are the requirements for all the member states – they are suspended for the moment, but if we do not change anything, they will return shortly after the crisis. After all, seven EU countries reached public debt exceeding 100% of GDP at the end of last year. Can you imagine them reducing their debt below 60% of GDP – a level established as "safe" 30 years ago?

This would require an enormous effort with the burden falling ultimately on society, as was the case in Greece in the aftermath of the financial crisis. Putting consolidation as the main public policy goal is undesirable both economically and politically. Economically, because it causes downturns. Politically, because it leads to higher political polarisation and support for populist movements.

What can Europe do?

Olivier Blanchard, the former chief economist of the IMF, advocates fiscal standards instead of fiscal rules. He gives the example of New Zealand, which has qualitative prescriptions that leave room for judgement together with a process to decide whether the standards are met.

Central to this process would be country-specific assessments using a stochastic debt sustainability analysis methodology, led by the European Commission. Violations of the standard should preferably be adjudicated by an independent institution, such as the Court of Justice of the European Union (or a specialised chamber), rather than by the European Council. We would not argue that we should go directly down this route, but there are a few principles that European leaders must take into account when forming a response to the crisis.

First, we *must accept higher levels of debt*, at least in the medium term. Consolidating public finances too fast will disrupt the return to economic growth. In this context, it is necessary to consider whether or not to deviate from the limit of 60% in relation to GDP in the EU's fiscal rules, the more so as debt levels vary greatly in the EU.

Second, *rules must be redesigned to create significant space for public investment*. The last decade has had a particularly negative impact on levels of public investment, which is important for the quality of life of ordinary citizens, but also affects the competitiveness of individual economies and, consequently, the entire economy. Public investment is also an effective measure for stimulating the economy after the pandemic through the so-called the crowding-in effect of private investments. High fiscal multipliers of public investment will help to keep the fiscal impact of such activities in check.

Third, *we should not differentiate the paths for returning to the EU's fiscal rules*, depending on the depth of the recession in a given country. In our opinion, it would be a mistake to ignore many sensible observers, including the IMF and OECD, who have stated that countries with fiscal space should increase spending in order to accelerate growth in the coming years. Doing so would run counter to the idea of European solidarity: those countries that can afford to finance additional public expenditure issuing new debt should do so to increase aggregate demand for goods and services across the EU and support the recovery in countries in the worst fiscal situations.

Fourth, *we should move away from the concept of a structural deficit in the rule book*. A structural deficit is the amount by which a government's spending is more than it receives in taxes in a particular period, whether the economy is performing well or not. This is the technical measure of deficit level used by the European Commission, which carries a high risk of error in 'normal times' and even more so during the pandemic.

Finally, *we should aim to develop effective expenditure rules*. This is an approach already incorporated in some member states. What we propose is that rather than focusing on debt and deficit levels, the goal should be to put unproductive spending under control. Current EU-wide fiscal rules regulate the development of public budget deficits and surpluses, without explicit reference to the purpose of certain expenditures, which makes them blind to the macroeconomic footprint of additional budgetary spending. Explicit expenditure rules with clear divisions between productive and unproductive expenditure may help make the fiscal rules more effective in the post-pandemic world. A similar framework has been proposed by Zsolt Darvas and others.

European fiscal rules are currently suspended. When they are implemented again, they might provoke premature fiscal consolidation because of their faulty design. This occurred after 2008 and we need to learn from that experience. To avoid this, the current period of suspension of the EU's fiscal rules should be used to design a better fiscal framework which can come into force once the pandemic-induced suspension ends.

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