ECONOMY AND ECOLOGY 05.01.2022 | Andrea Boitani & Roberto Tamborini

Breathing in new life into the European fiscal monster

Covid-19 has shown how European fiscal rules are based on outdated economic assumptions. These need to be reworked

Europe's pre-Covid fiscal rules were the product of a cultural climate prevailing in the 1980s and 90s. Back then, the belief in the effectiveness of fiscal policies on Gross Domestic Product (GDP) and employment was limited, and monetary policy was seen as a universal solution. We have known that this is not the case for some time now. The existing rules also had well-known technical bugs that made them procyclical, whatever the intended contrary effects.

After the disastrous consequences of the Covid-19 pandemic, the lesson is that not only do the fiscal rules need to be amended, but the new rules must also be complemented by a system of safeguards designed to protect the integrity of the European Monetary Union (EMU) in the event of systemic shocks. As argued in our recent paper, any reform must take account of four changed circumstances.

First, interest rates are much lower than they were in the 1990s when the existing rules were drawn up. The Eurozone expenditure on interest payments is now a much smaller percentage of its GDP despite debt being significantly higher. Given the persistence of excess savings worldwide, which exerts downward pressure on real interest rates, this means that higher debt to GDP ratios would remain sustainable for some time.

Secondly, post-pandemic debts of all EMU members have grown considerably relative to GDP, making the 60 per cent threshold enshrined in the Stability and Growth Pact (SGP) entirely out of the reach for many of them (in Southern Europe but also in France, Belgium, and Austria), except at the cost of a demand squeeze capable of throwing the continent back into recession.

Interest rates have stuck close to zero for almost a decade: a clear sign of the weaknesses of monetary policy in tackling widespread negative shocks.

Third, in a cyclical downturn of GDP, the debt/GDP ratio increases even if debt does not. Expecting the ratio to go down always and for a long period of time is thus entirely illogical. While it is true that the SGP allows the rules to be suspended in the event of 'exceptional circumstances' (such as the 2008 financial crisis or the pandemic), its macroeconomic impact over time can be quite asymmetrical (like in the 2011-14 period) and this makes the application of a uniform rule vulnerable and practically unworkable.

Fourth, interest rates have stuck close to zero for almost a decade: a clear sign of the weaknesses of monetary policy in tackling widespread negative shocks, including those of a symmetrical nature. Increased use of fiscal policy for the purpose of stabilisation and related macroeconomic externalities must be carefully considered. In the wake of the pandemic, it has become clear that the future economic sustainability of EMU members is bound up with an extraordinary (but anything but temporary) budgetary effort.

Expanding the involvement of the Commission

It should by now be clear that maintaining fiscal policy entirely at the level of individual member countries, constrained by a set of rules which ignore macroeconomic externalities, is no longer possible. The era of 'do your homework alone' is over. As Buti and Messori, among others, have stressed, individual state budgetary policies must not only be controlled but also be co-ordinated and harmonised to maintain a balanced Eurozone fiscal stance. This can serve to minimise negative spill-overs from individual budgetary policies onto other member states via macroeconomic externalities.

Moreover, as existing federal unions such as the US show, a sufficiently large and flexible central budget is a necessary precondition to keep members' budgets small and disciplined. If NGEU and, in particular, SURE (the shared funding tool for cyclical unemployment benefits) were to become permanent European Union tools, national budgetary constraints might immediately gain political acceptability and be easier to control. That's because a significant part of the macroeconomic stabilisation task would be entrusted to the common budget, which would be mainly funded by nations' own resources.

Whenever technical evaluation must be translated into political decisions competence should be assigned to politically responsible institutions.

We should resist perpetuating the harmful illusion that in a democratic Europe, an automatic algorithm may, or should, replace the so-called 'political discretion'. Rules are useful to create a framework for *technical evaluation* of the state of public finances in the various member states and of the EMU as a whole. Whenever technical evaluation must be translated into political decisions, however, competence should be assigned to politically responsible institutions.

In the EMU, political responsibility stays with member state governments. However, national governments must agree to share sovereignty with an institution capable of guaranteeing the EU's collective interests. In our view, this can only be the European Commission. Of course, the Commission must make use of independent technical structures such as the European Fiscal Board (EFB) and the national parliamentary budget offices for technical analysis and the formulation of guidelines for the implementation of standards.

Dealing with public debt

We entirely agree with the suggestion by Blanchard et al. (2021) that the focus should be public debt sustainability. This would eliminate all reference to fixed targets valid for all member states without distinction and, even more importantly, it would break free the sustainability analysis from the weight of non-observable variables, such as potential GDP and the output gap, requiring ongoing (and retrospective) review.

Sustainability analysis should be performed on individual member states periodically and be designed to assess the probability that debt is sustainable, taking account of the specific features of each nation with reference to growth, population dynamics, interest rate trends (and thus overall debt servicing spending) but also current budgetary policies and those planned for the future.

This type of analysis is by no means straightforward and should thus be entrusted to a strengthened European Fiscal Board (EFB) in conjunction with national institutions. If debt sustainability analysis should reveal a high likelihood that debt may become unsustainable, the Commission – based on a proposal by the EFB – would have to negotiate a deficit reduction trajectory over several years with the country concerned. That would require 'the debt sustainability risks to be balanced against the costs of adjustment in terms of production', with the explicit goal of

averting a debt crisis for the individual country concerned and the EMU as a whole.

Back in 2019 the EFB suggested that, in the event that debt reduction should require it, a primary spending ceiling could be resorted to, also preserving a predetermined investment spending quota (*the golden rule*). However, the energy transition, for example, requires huge and long-term investment that cannot realistically be done while simultaneously maintaining significant primary surpluses in all European nations. It has been noted that post-pandemic resilience and recovery are based on capital build-up and growth (especially human and social capital), which require increases in spending. Accounting conventions would classify this spending as current expenditures, but it could also be seen as investment expenditure. Think of health and education spending. Reforms of the European fiscal rules and the introduction of the golden rule could, not unreasonably, be accompanied by a (at least experimental) modification of certain key spending classifications.



Andrea Boitani
Milan

Andrea Boitani is a professor of economics in the Department of Economics and Finance at the Catholic University in Milan.



Roberto Tamborini
Trento
Roberto Tamborini is professor of economics in the Department of

Economics and Management at the University of Trento.