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Europe's fiscal rules contradict themselves

For the EU's fiscal rules to actually guarantee sustainable public finances, they urgently need to be reformed — and allow for more public investment

The EU's existing fiscal rules are an obstacle to urgently needed public investment, concluded French President Emmanuel Macron and Italian Prime Minister Mario Draghi in a joint op-ed in December. On the contrary, such investment would actually contribute to debt sustainability in the long run, they argued. In their current form, Europe's fiscal rules do not guarantee sustainable public finances; they are therefore failing to fulfil their original purpose.

This insight is nothing new. The aftermath of the sovereign debt crisis of 2010 had already demonstrated clearly that the rules neither protected member states from economic crises nor promoted long-term recovery. Above all, they have not led to a significant reduction in member states' debt levels.

As a result, the ability of states to achieve debt sustainability – to service their debts and avoid bankruptcy – is increasingly linked to a reform of the rules rather than the rules themselves, as reflected in the new German government's coalition agreement, for instance.

The rules are against the rules

The rules aren't fulfilling their original purpose because of the very nature of the rules themselves. The preventive arm of the EU's Stability and Growth Pact (SGP) places a limit on a state's annual cyclically adjusted deficit. The underlying idea is that it should enable each member state to pursue an anticyclical economic policy. This way, states should be able to save during upturns to prevent overheating, which would lead to inflation. During downturns, meanwhile, they can take on more debt to boost the economy via government demand and thereby maximise economic potential.
It is, however, impossible to precisely determine whether that economic

potential – the economy's potential output – has already been maximised or offers room for growth; this can only be estimated. The amount of deficit member states are allowed to carry depends on the extent to which this estimate differs from actual gross domestic product (GDP).

Estimates of potential output are based on various factors, including the potential labour force. These input factors are, in turn, estimated on the basis of past behaviour. If, for instance, women have hitherto worked less than men, it is assumed that this will remain the case in future. But if more women work, then the gap between GDP and potential output will shrink; this would point towards overcapacity and the state would need to save.

Public finances would be healthier if member states were able to use deficits to stimulate demand so that capacity is fully utilised.

The upshot is that the fiscal rules have a procyclical amplifying effect on economic trends: if recent years were good, potential output, which is based on past data, is high – the state can thus stimulate the economy. If recent years were bad, potential output is low and the size of the permissible deficit drops. This procyclical amplification means a country like Spain has to live with an unemployment rate of 12.5 per cent, seen as the rate at which economic potential has been maximised. Quite apart from the psychosocial impacts on the individuals concerned, this level of joblessness deprives the state of tax receipts and the economy of consumer demand – generally, those not in work spend less – while public expenditure on welfare increases. The consequences for public finances are dire.

In the long run, public finances would be healthier if member states were able to use deficits to stimulate demand so that capacity is fully utilised. In such a scenario, all those seeking work would find it, and they'd be sufficiently productive to support themselves financially. Decent wages and a low unemployment rate would increase tax receipts and reduce welfare spending. This would allow for sustainable public finances – even with deficit – and enhance the prosperity of society as a whole.

Learning from the US

To see the impact fiscal policy can have on labour markets, we only have to look at the United States: if we compare Covid recovery packages across the globe, we find the US ranks first – not least thanks to Biden's

USD 1.9 trillion rescue plan. While other countries have primarily concentrated on supporting businesses, the US has bolstered demand by providing financial assistance to its citizens. It's a strategy that's already paying dividends: unemployment is falling while wages are rising.

The Stability and Growth Pact, too, needs to allow states to pursue a fiscal policy that isn't at odds with the aims of labour market policy, namely good jobs and decent wages for as many people as possible. The way economic potential is estimated needs to change: instead of equating the potential labour force with past employment levels, we should estimate the actual point at which the labour market's potential would be maximised and economic capacity fully utilised – when all those who can and want to work do. Such a shift would give Europe greater room for manoeuvre in its fiscal policy.

In recent years, our economy has been far from operating at capacity, in part due to the ongoing impact of the sovereign debt crisis. Simulations reveal that adjusting the way we estimate economic potential could allow Germany alone, for instance, to run a deficit of around €70 to 90bn between 2023 and 2025. Such a move would not just better reflect both the original intention of the fiscal rules and the European Union's aims, which include full employment, but it would be a key first step towards sustainable public finances in Europe.



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