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The EU's fiscal hamster wheel

Europe's fiscal rules must be changed. Yet the European Commission's attempt to balance two opposing economic views risks going full circle

The European Commission is calling for it, the French president sees it as a priority of his country's EU Council Presidency, and even the Dutch and German finance ministers can warm up to the idea of reforming the EU's Stability and Growth Pact (SGP). The pact has been suspended since the beginning of the pandemic and will remain suspended until the end of this year – to allow for economic support against the downturn without looking too closely at deficit and debt levels. In the collapse of the century in economic growth when the pandemic first hit, pragmatism triumphed over strict adherence to the rules.

Now, as the war in Ukraine may result in EU member states' higher expenditure for national defence, the suspension of the pact could be extended until 2023. The German government has already announced a €100bn special fund for the *Bundeswehr*, which sits outside the regular budget planning. But even if the national debt brake could be elegantly circumvented in this way: according to the old EU budget rules, they would still carry weight at the European level.

On average in the EU-27, public debt was around 90 per cent of gross domestic product (GDP) in 2021, whereas in 2019 it was only 77 per cent – while the permissible specified limit is 60 per cent.

Therefore, an extended non-application of the SGP would be very convenient for some states in the context of the current geopolitical upheavals. Since, even before the outbreak of the pandemic, there was dissatisfaction with the fiscal rules laid down in regulations and resolutions 25 years ago. On the one hand, this was because of their complexity, which had grown over the course of several reform steps. On the other hand, there's a big question mark when it comes to their effectiveness.

As early as February 2020, the Commission therefore launched a review process for economic governance, and after a pandemic-related interruption, continued it in October 2021. Addressing the EU's fiscal

rules right now seems more important than ever, as an economic slump and supporting demand have driven up the debt levels of the member states: on average in the EU-27, public debt was around 90 per cent of gross domestic product (GDP) in 2021, whereas in 2019 it was only 77 per cent – while the permissible specified limit is 60 per cent.

Rigidity versus flexibility

Clearing the regulatory thicket of economic governance in the EU is a project that has met with broad approval, regardless of national interests or economic approach. In particular, the aim is to take the benchmarks added to the SGP – like the medium-term structural deficit of 0.5 per cent of GDP, the reduction path of public debt ratios by 1/20 per year in the event of excessive deficits, and several procedural preventive and corrective components including tougher sanction options– and bring them in line with other processes of economic policy coordination such as the Macroeconomic Imbalance Procedure and the European Semester.

However, the limits of this large consensus quickly becomes apparent when one looks at the rules in greater detail, and in particular their purpose and effectiveness as a steering mechanism. This is where a reform camp and a group supporting the status quo are at odds with each other. Apart from the need for greater clarity and transparency, the latter see little need to question the SGP. Instead, they criticise the timid enforcement of its rules. According to their point of view, the main goal is the fiscal stability of the EU and the eurozone, which primarily translates into economical budget management.

The 'frugal four' – the Netherlands, Austria, Denmark, and Sweden – who were completely opposed to intra-European financial transfers in the negotiations on the NextGenerationEU investment package, belong to this group, as do Finland, Latvia, and Czechia. Last autumn, the finance ministers of these countries published a joint position on the reform of the SGP. While they emphasises their openness to reform, they actually mean a better application and greater enforcement of the existing set of rules – and in no way a loosening up or watering down the common goal of debt reduction.

In contrast, member states such as France, Italy, Spain, Portugal, and Greece want to put the existing procedures to the test. Southern Europe in particular still clearly remembers the experience of managing the euro crisis. On the basis of the budget rules that were tightened at the time and expanded to include the Fiscal Compact, a procyclical economic policy was set in motion that required consolidation steps in the middle of the downturn. The socioeconomic consequences are still being felt to this

day in the countries hit hardest by the crisis.

In addition to the pro-cyclicality of the Compact, other concerns focus on an economically and politically unsustainable adjustment path to reduce public debt to the benchmark of a maximum of 60 per cent of GDP. In all of the countries mentioned, the debt ratio in the third quarter of 2021 was over 115 per cent of GDP; in Italy it amounted to over 150 per cent, in Greece 200 per cent.

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On the basis of the existing regulatory framework, these countries would be primarily concerned with budget consolidation for many years to come. From their perspective, this seems unrealistic in view of the investment challenges to be met in the coming years by the public sector with regard to climate-neutral production methods and mobility, as well as the digital transformation of the economy and the world of work. In an op-ed in the Financial Times at the end of 2021, French President Emmanuel Macron and Italian Prime Minister Mario Draghi listed the necessary transformations of European states through far-reaching investments in infrastructure, digitalisation, and defence. And they call for room to manoeuvre in revised stability rules for future investments.

Finding compromises

Despite appearances to the contrary, the two groups are not expressing their desire for a reform of the SGP solely out of self-interest based on their respective national economic situations. The conflict goes back much further and is deeply rooted in the integration history of the economic and monetary union, which from the outset lacked a coordination of economic policies that extended beyond budgetary rules.

During the euro crisis, this gap turned out to be significant. It forms the backdrop for a series of plans, roadmaps, and scenarios from various European institutions in the 2010s on how the architecture of the monetary union could be completed. The fact that little of this was implemented is due to the ongoing split between supporters of a stability union and supporters of a fiscal union on a theoretical description of the goals of the eurozone. The hardening of the SGP was seen by one side as a solution and by the other side as an insufficient measure for averting

procyclical undesirable developments.

The European Commission is therefore making efforts to involve both sides. For the public debate on the future of economic governance at the end of 2021, it has explicitly asked about measures to improve the sustainability of public finances and to prevent and resolve macroeconomic imbalances. One solution could be to leave the agreed target values in place, but to re-formulate some of the benchmarks added later, such as the measurement of the structural deficit, which is prone to error due to the elusiveness of potential growth, and the rigidity and thus inherent procyclicality of the prescribed path of debt reduction.

If there existed the option of leaving the recovery and resilience facility for investment challenges in the EU permanently in place – along with the close economic policy coordination that this entails –, future investments could be made despite foreseeable efforts to reduce debt. This would be the most far-reaching restructuring of the applicable budget rules; they would in effect be merged into an overall macroeconomic tableau of European governance. The requirements of climate protection, digitalisation, and social cohesion in the EU would then take precedence over the current focus on coordinating budgetary policies.

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However, since a permanent Community budget for purposes of investment and, to a certain extent, redistribution paves the way to fiscal union, we must assume some resistance from the stability-oriented actors. Among them is German Finance Minister Christian Lindner, whose new chief adviser Lars Feld has just warned against 'loosening the stability pact', despite the red-green-yellow government's commitment in the coalition agreement to 'further develop economic policy rules' or for defence spending deemed necessary in view of the changed geopolitical security situation.

If, however, the basic rules of the SGP are not to be changed at the same time, the only option would be to introduce a golden rule that calculates future public investments to be determined from deficits and debt levels up to an upper limit for each member state, for example for the climate-neutral restructuring of the economy.

Even in its draft form, its basic assumption sounds like a typical EU project: It enables growth policy through investments and strengthens demand, but it also fits into the regulatory design of the ordoliberal concepts of an economic and monetary union. And it will open up controversies between member states and EU institutions about definitions and demarcations, and about exceptions and whether dealing with it should be rigid or flexible. That would be almost like a return to the old SGP before the pandemic.



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