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EU Fiscal Rules: Further Reform or Better Implementation?

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Roel Beetsma and Martin Larch¹ EU Fiscal Rules: Further Reform or Better Implementation?

INTRODUCTION

The roots of EU fiscal rules reach deep into the foundations of the single-currency area's governance framework. When the blueprint for the euro was drawn up in the late 1980s, the prevailing paradigm was built around the understanding that macroeconomic stability would hinge on two conditions: sound public finances and low and stable inflation. To achieve the latter, policy makers agreed to centralize and delegate monetary policy to the ECB, an independent institution with a clear mandate. With regard to sound public finances, policy makers could not agree on centralizing fiscal policy, but they concurred that commonly agreed rules should limit the discretion of national fiscal policies.

Twenty years after the introduction of the euro, the understanding that national fiscal policies should be bound by rules to safeguard the sustainability of public finances and the smooth functioning of the single currency remains uncontested. What has changed, though, is the assessment of whether the current set of EU fiscal rules is effective. When the Stability and Growth Pact (SGP) entered into force in 1997, most policy makers and pundits assumed that member states participating in the common currency project would show the necessary commitment to the agreed rules. After all, the introduction of the euro was a major political step, signaling the determination to go and think beyond national borders. Several countries had undertaken important reforms and made important sacrifices to qualify for the euro. However, reality caught up with expectations fairly quickly. Compliance with the rules turned out to be weak right from the start. Attempts to strengthen or improve the rules, mostly in the wake of major difficulties, have solved some problems but given rise to new ones.

Today, observers and policy makers are deeply divided. Some are of the view that EU fiscal rules are fine and do not need to undergo yet another reform, while others think the fundamental problem is not the design of the rules but a lack of commitment on the part of some member states. As a result, revisiting the current set of rules is not at the top of the policy agenda. In December 2017, when the European Commission updated the roadmap for completing Europe's

Economic and Monetary Union (EMU), precedence was given to the completion of the banking and capital market union (European Commission 2017). A reform of EU fiscal rules is mentioned, but as a possible step to be taken once all the other elements have been put in place.

While giving priority to the banking union is justified on economic and political grounds, the debate on the effectiveness of the current EU fiscal framework has not abated. It is actually being fueled by a series of Commission and Council decisions that have further increased the divide between member states over how the SGP should be implemented. Pushing out the debate on what to do with the SGP in the context of the broader project of deepening the EMU may gain some time, but it does not solve the underlying problem. The proverbial silver bullet has not been found yet, but a discussion on how to make EU fiscal rules work needs to continue.

The remainder of this paper is structured as follows: Section 2 presents a brief history of EU fiscal rules, highlighting the main trends and innovations since the inception of the SGP. Section 3 turns to the current situation, reviewing the main challenges and shortcomings of EU fiscal rules and how they are implemented. Section 4 discusses possible options for reform, pointing to a growing convergence of views among experts coupled with persisting political differences across member states.

AN ABRIDGED HISTORY OF EU FISCAL RULES

The tendency of politicians to run high deficits is well documented. If a country were completely disconnected from the rest of the world, one could argue that, no matter how badly it affects its own population, such a deficit bias is a domestic problem and there is no compelling reason for other countries or supranational authorities to interfere with profligate budgetary policies. However, this is not the reality. Fiscal profligacy is a common concern in the EMU because of the advanced degree of economic integration and, linked to that, the adverse spillovers to other countries. These spillovers take several forms. While the original focus was on increased inflationary pressure in the monetary union, over time, the focus shifted to the unavailability of implicit (via the ECB) or explicit bailout when the financial system (in particular the banking sector) faces the threat of a collapse. Because the negative consequences of adverse spillovers are not (or are only partially) internalized by national governments, increased monetary and financial integration will exacerbate pre-existing deficit biases. Hence, as long as fiscal policy making continues to be conducted at the national level, the EMU needs constraints on national fiscal policies. In fact, the rationale for such constraints is not confined to the euro area: because there are spillovers to and from non-participating member states, these, too, ought to be subject to constraints.



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¹ The views expressed in this paper are not necessarily those of the European Commission, the European Fiscal Board, or other institutions the authors are associated with.

The fear of adverse spillovers from undisciplined policies resulted in the SGP, which has undergone a number of important changes since its inception more than 20 years ago. In the triangular trade-off between simplicity, adaptability, and predictability, it started as a reasonably simple and predictable set of rules. Member states were expected to achieve balanced budgets in the medium term. In light of the sustained rates of nominal GDP growth observed at the time, this also ensured a declining trend of the debt-to-GDP ratio. To address gross policy errors, which were defined as a deficit in excess of 3 percent of GDP or a debt ratio that would not decline at a satisfactory pace toward 60 percent of GDP, the SGP included the excessive deficit procedure (EDP), a structured sequence of policy guidance that, if not followed, would ultimately escalate toward sanctions. Although strictly speaking not part of the SGP, the architects of the euro area also added a no-bailout clause to the governance framework with the intent of keeping member states clear of any situation that would put the sustainability of public finances at risk.

The lack of flexibility of the SGP mark I became evident quite quickly when, in the early 2000s, most euro-area economies took a nosedive after the dot-com bubble of the late 1990s eventually burst. Built around the headline budget balance, the agreed fiscal rules forced member states into successive rounds of pro-cyclical tightening. While smaller countries swallowed the bitter pill, France and Germany, supported by Italy, defied the “stupid” prescriptions of the Pact and, in November 2003, staged a stand-off with the European Commission. This eventually led to the first reform of the Pact in 2005. Two additional reforms followed: one in 2011, in the wake of the post-2007 financial and economic crisis, which revealed important gaps and blind spots in the SGP, and the other in 2013, on the back of the euro-area sovereign debt crisis.

While reviewing the details of the successive reforms goes beyond the scope of this short paper, four main themes in the evolution of the Pact deserve to be mentioned (European Fiscal Board 2018). First, the original SGP clearly prioritized debt sustainability over fiscal stabilization. The rules were meant to be followed independently of prevailing cyclical conditions. Successive reforms led to a significant rebalancing of the almost lexicographic order of priorities of the early years: the weight attached to stabilization increased progressively and rules increasingly catered for additional contingencies outside the control of the government. Second, successive

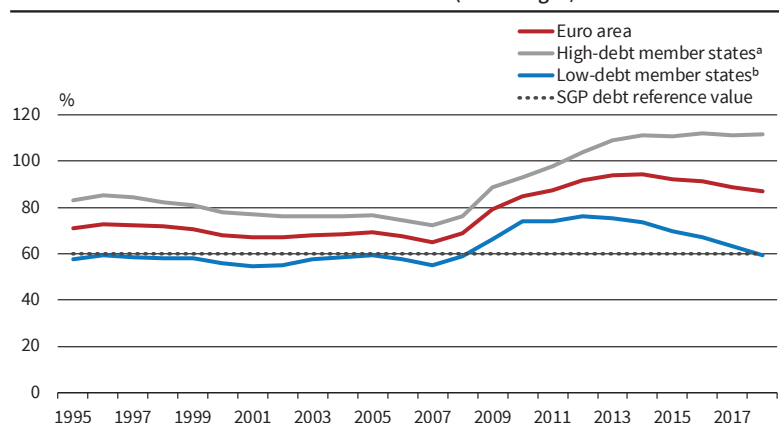
reforms had a major impact on the surveillance process. The early rules defined a fairly light surveillance system. Member states were expected to communicate medium-term budgetary plans in the autumn of each year and the Commission would issue formal guidance only if countries went off course. Over time, fiscal surveillance turned into a tight-meshed annual cycle – the European Semester – with a rapid succession of *rendez-vous* involving reporting, monitoring, granular policy guidance, and, in theory, a progression of sanctions. The tightening of surveillance was intended as a counterweight to more flexible and intelligent rules coupled with the realization that, contrary to initial expectations, member states would not spontaneously comply with the rules. Third, the Commission’s role in implementing the rules has grown in importance over time, turning EU fiscal surveillance into an increasingly unilateral process as opposed to a multilateral one. In parallel, the Commission decided to take a more political stance in relation to the application of fiscal rules, departing from its original role as the guardian of the treaties. Fourth, while the original set of rules was exclusively managed and implemented from the center by the Commission and the Council, the 2011 and 2013 reforms complemented EU rules with a call for national fiscal rules and independent national bodies mandated to provide a non-partisan assessment of certain aspects of national fiscal policy making.

THE CURRENT STATE OF AFFAIRS

Overall, the SGP changed from a relatively simple set of rules to a complex framework in which simplicity has been sacrificed to adaptability and discretion, at the cost of making the application of the rules much less predictable and transparent. On paper, the successive reforms of the SGP were aimed at achieving a double objective: (i) improving the economic rationale of the fiscal rules by adding elements of flexibility; and (ii) strengthening the surveillance framework with addi-

Figure 1

Government Debt-to-GDP Ratio in the Euro Area (GDP Weight)



^a Belgium, Greece, Spain, France, Italy, Malta, Portugal.

^b Germany, Estonia, Ireland, Cyprus, Latvia, Lithuania, Luxembourg, Netherlands, Austria, Slovenia, Slovakia, Finland.

Source: Eurostat (2019).

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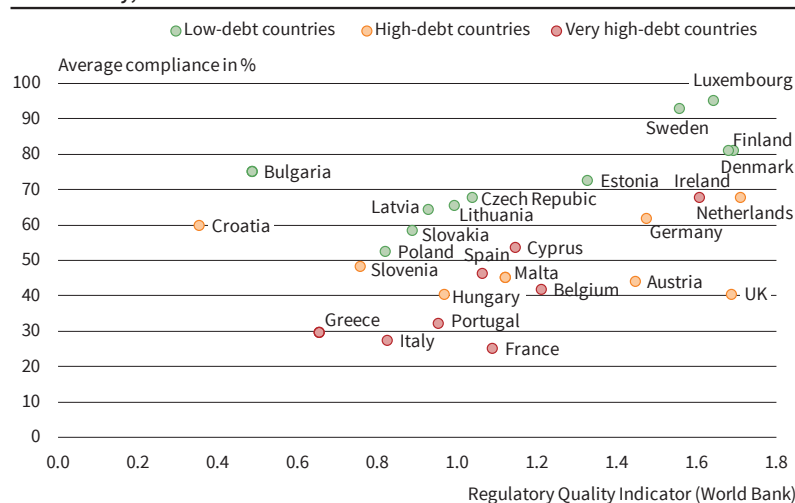
tional elements of discipline. The six-pack reform of 2011 is a particularly evident example. On the one hand, it opened up the possibility of lowering or waiving the required budgetary adjustment in exceptional circumstances (such as natural disasters or during severe economic downturns); on the other hand, it paved the way for new financial sanctions, a new correction mechanism for significant deviations from the required fiscal adjustment, and the possibility to launch an excessive deficit procedure based on the debt criterion. In actual practice, however, decision-makers did not exploit the full spectrum of new possibilities. They largely used new degrees of flexibility and discretion to soften adjustment requirements, but generally shied away from making use of the new set of disciplining instruments or options to tighten the fiscal adjustment requirements.

The debt criterion to launch an excessive deficit procedure is probably the most obvious case in point. Already included in the Maastricht Treaty, there was no need to make it operational in the initial phase because, at the rates of nominal GDP growth prevailing at the time (around 5 percent on average), the deficit threshold of 3 percent of GDP was actually more binding than keeping the government debt ratio below 60 percent of GDP or on a declining path toward it. The tide turned on the back of the secular decline in nominal GDP growth. It became clear that, for high-debt countries with slow economic growth, keeping the government deficit below 3 percent of GDP would no longer suffice to ensure a declining debt ratio, and the six-pack reform of 2011 offered the first opportunity to address the shortcoming. However, when the new constraint started to bite, expedients were found not to apply the tighter rules on the assumption that low inflation would be temporary. As inflation and, in some countries, economic growth did not recover, new forms of flexibility had to be found. In a recent prominent case, flexibility ultimately meant giving the benefit of the doubt to manifestly overoptimistic budget plans to avert a major political crisis.

Such forbearance in the application of the rules has exacerbated a long-standing division between member states, which has become exceedingly apparent in their aggregate fiscal performance. Those with a preference for fiscal discipline succeeded, on average, in bringing government debt as a percentage of GDP back to pre-crisis levels (see Figure 1) and are increas-

Figure 2

Compliance with the Stability and Growth Pact (SGP) and Structural Conditions of the Economy, 1998–2018



Note: A higher value for the Regulatory Quality Index indicates a higher degree of regulatory quality. Average compliance = percent of years in the reference period for which a member state complied with at least one of the four rules of the SGP: the deficit rule, the debt rule, the required structural adjustment and the expenditure benchmark. Low-debt countries = EU member states with an average debt ratio of less or equal to 60% of GDP in 1998–2018. High-debt countries = EU member states with an average debt ratio of more than 60% and up to 90% of GDP in 1998–2018. Very-high debt countries = EU member states with an average debt ratio of more than 90% of GDP.

Source: Authors' calculations based on data from the World Bank.

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ingly frustrated with the lopsided application of the reformed EU fiscal rules. Other countries that, on average, barely managed to stabilize government debt-to-GDP ratios at high levels are very much content with the increased margins of flexibility or may even find the rules still too restrictive.

Unfortunately, the division does not stop at budgetary policies and performance. It is reflective of a broader shortcoming in the EU economic governance framework, namely the failure to safeguard a sufficiently homogenous degree of competitiveness across member states via structural reforms. The single currency was built on the expectation that the loss of the exchange rate instrument would leave national governments with no choice but to push through structural reforms to sustain productivity growth. This expectation turned out to be sound in some countries and completely flawed in others. A quick look at the data does not reveal an unambiguous correlation between fiscal performance and structural conditions. However, one thing is clear: countries where compliance is particularly low are typically also those with a low score for regulatory quality; they find themselves with their back against the wall of even the most flexible interpretation of the SGP (see Figure 2). Member states that combine lower regulatory quality with higher compliance are typically catching-up countries that still benefit from higher nominal GDP growth – but for how long?

The macroeconomic imbalance procedure (MIP) introduced with the six-pack reform of 2011 constituted a very sound attempt at going beyond fiscal rules. Its objective was and still is to spot, early on,

developments – such as credit and housing bubbles – that would directly or indirectly affect the macro-financial stability of a member state, with adverse systemic consequences. While it may be too early to draw final conclusions as to whether the MIP has worked or not, it has certainly not helped in narrowing the above-mentioned divide between member states.

On the contrary, the divide has polluted and very much hampered efforts to deepen and complete the Economic and Monetary Union (EMU). The fiscally more virtuous countries are unwilling to take new steps that involve more fiscal integration. They condition any future agreement on new forms of risk sharing on tangible progress with risk reduction, which is simply a code for saying: if you want more solidarity, first prove you are (i) prepared to comply with the fiscal rules we all signed up to and (ii) capable of implementing structural reforms. The Hanseatic League, led by the Netherlands, is the most evident manifestation of this view.²

OPTIONS FOR THE FUTURE: PUNDITS CONVERGE, POLITICIANS DON'T

What is the way out of the current state of affairs: a new reform of the SGP or more resolve in implementing the existing rules? The answer and motivations vary depending on whom one asks: pundits or politicians.

Economists and experts largely concur that the current set of rules has run its course and a new chapter needs to be written.³ A wide range of more or less elaborate proposals has been advanced in the recent past (e.g., Bénassy-Quéré et al. 2018; 2019, Darvas et al. 2018, Eyraud et al. 2018, EFB 2018, Feld et al. 2018, Heinemann 2018, and Kopits 2018). Despite the inevitable idiosyncrasies, there are quite a few common themes. Starting with the diagnosis, all agree that the current system lacks effectiveness as a result of having grown far too complex with a multitude of objectives (the government deficit and debt), more than one way of defining the adjustment toward the medium-term budgetary target (the structural budget balance and the expenditure benchmark), different indicators or methods for assessing whether a country has complied with the recommended adjustment, and many very detailed exceptions and contingencies.

Proposals on how to move forward also largely overlap. A reformed system of fiscal rules should (i) be transparent and simple, (ii) target fiscal indicators directly under the government's control, (iii) allow for countercyclical fiscal stabilization, and (iv) offer an escape when a very large shock hits. A combination of government debt as the long-term anchor and a cap on net expenditure growth as the operational rule to move

toward the anchor is generally considered to satisfy these conditions. Numerical simulations illustrating the properties and benefits of such a combination can be found in EFB (2018).

Most proposals underscore the importance of rethinking governance as well as the rules. They see the increasing mix-up of objective analysis and political consideration as an integral part of the current predicament. The wide margins of discretion allowed by the current system are perceived as being used to fix political problems rather than economic ones. Hence, a simplification of the rules *per se* would not be sufficient. Governance would have to be adapted in such a way as to clearly demarcate the assessment of how fiscal policy fares compared to agreed rules from the final political decision on how to apply the rules. The latter will and should remain with those who have the democratic/institutional legitimacy. However, there is scope for independent entities – such as national fiscal councils – to take a more prominent role in providing objective analysis and advice. Politicians may still decide to ignore independent advice, but the input of independent advice (and its publication) enhances the transparency of decision-making and, in turn, the accountability of the decision-maker. Currently, the role of independent fiscal councils in the EU is largely limited to assessing the macroeconomic forecasts that underpin the government budget. Going forward, many observers see merit in strengthening their role. For instance, the EU Independent Fiscal Institutions Network (2019) argues in favor of incorporating adequacy standards on the design and operational capacity of the independent fiscal institutions (IFIs) into EU legislation, and of a more effective application of the comply-or-explain principle with sufficient procedural detail on the interaction between IFIs and the administrations. Following the example of the Office for Budgetary Responsibility in the United Kingdom, IFIs could also be tasked with making the official budgetary projections.

The broad agreement among economists stands in sharp contrast with the thinking of policy makers. Most policy makers in the EU member states oppose a reform of the SGP, although for different reasons. There are those who very much appreciate the adaptability of the rules and the political approach taken over the years to their implementation. Others see a reform of the SGP as highly risky with no guarantee of coming up with a better framework; they have a strong preference for simply implementing existing rules with greater determination and less politics.

However, insisting on the status quo will not help. The current economic juncture very much underscores the limits of the current fiscal framework in the EU. Following an extended period of recovery, economic growth is starting to slow once more, at a time when neither centralized monetary policy nor decentralized fiscal policies have regained the leeway to comfortably respond to any further slowdown, let alone a new eco-

² The Hanseatic League encompasses eight EU member states: Ireland, the Netherlands, Denmark, Sweden, Finland, Estonia, Latvia, and Lithuania. The Czech Republic and Slovakia have occasionally associated themselves with the positions of the Hanseatic League.

³ However, the intensity of this view is not uniform. The ECB (2019) suggests in its overview article that the reforms induced by the debt crisis have had a disciplining effect, although it gives most of the credit to the wave of balanced budget rules produced by the Fiscal Compact.

conomic recession in the euro area or significant parts of it. At the same time, there is still no fiscal capacity at the central level. We may again face a situation where, for countries with very high debt, neither additional flexibility nor sudden fiscal rigor may bring much comfort, and where countries with fiscal space may not be willing to deploy buffers for the benefit of others. The limits and constraints of the single currency may undergo a new and difficult test.

To make progress, both sides will have to move. As indicated in Beetsma and Larch (2018), new elements of risk sharing will have to be combined with new elements of risk reduction. The important point to highlight here is that such a bargain would need to go beyond the redesign of fiscal rules as such. The redesign – and strengthening – of fiscal rules can be made palatable to the proponents of risk sharing only if it is combined with some form of a central fiscal capacity (CFC). Conversely, proponents of risk reduction tend to overlook the fact that a CFC can stimulate fiscal discipline if access is conditional on adhering to credible fiscal rules. However, for this bargain to work in practice, the design of both the rules and the governance has to be right. The current rules need to be simplified, while the monitoring of whether a country adheres to the rules needs to be conducted by an independent entity. The latter is crucial to avoid having political considerations determine whether a country can make use of the CFC. In addition, market-disciplining mechanisms and mechanisms that encourage structural reforms need to be strengthened, for example by differentiating the risk weighting of sovereign debt in bank asset portfolios and by making EU expenditure conditional on structural reforms.

CONCLUDING REMARKS

We have reviewed the history of the EU fiscal framework, its flaws, and proposals for reform. The consensus is that, in the absence of sufficient budgetary powers at the central EU level, fiscal rules are needed to limit adverse spillovers from national fiscal policies. While the weaknesses of the current rules are broadly acknowledged, policy makers' appetite for reform is limited for various reasons. In contrast, experts seem to concur on the necessary reform elements. However, to overcome the current deadlock, both sides of the debate – those in favor of enhanced risk sharing and those in favor of more risk reduction – will need to agree on a deal where each side needs to give up some of its objections to the other side's demands. In fact, enhanced risk sharing and fiscal rule reform can be made complements if the reform is designed properly and the appropriate conditionality is applied for participating in risk-sharing arrangements.

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