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Proposals for a reform of the EU's fiscal rules and economic governance

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REPORT

IMK Report 159e, June 2020

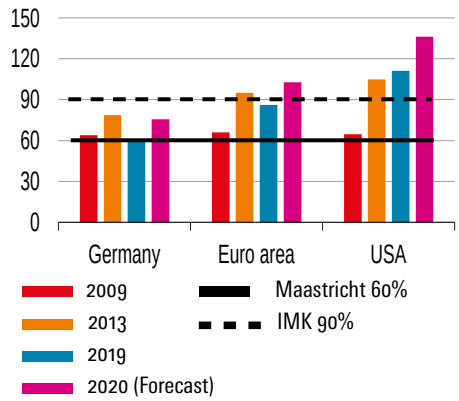
PROPOSALS FOR A REFORM OF THE EU'S FISCAL RULES AND ECONOMIC GOVERNANCE

Sebastian Dullien, Christoph Paetz, Andrew Watt, Sebastian Watzka

AT A GLANCE

- Debt-to-GDP ratios are set to rise significantly all over the world as a result of the coronavirus crisis. This will pose a huge challenge for the EU's member states and in particular the euro area countries, because of the strict fiscal rules that apply to them. In a consultation process that began earlier this year, the European Commission is inviting proposals for reforms to the rules.
- The IMK advocates a reform focused on appropriate fiscal rules that promote short-term macroeconomic stabilisation and the long-term modernisation of the public capital stock, while still keeping the sustainability of public debt in mind.
- We propose an expenditure rule for non-cyclical, non-investment expenditure coupled with a Golden Rule for public investment. As a pragmatic solution, the permissible debt-to-GDP ratio should be increased to 90%, while escape clauses should apply during times of crisis. The proposed rules should replace the EU's current fiscal rules.
- The Macroeconomic Imbalance Procedure should also be reformed at the same time. As a key part of such a reform, we advocate the establishment of a Macroeconomic Dialogue in order to ensure compliance with the reformed rules and consistency of the national strategies.

Public debt ratios in times of crisis
in % of GDP



Sources: AMECO, European Commission (2020b), Macrobond.

IMK

PODCAST

Sebastian Watzka on the reform of the European fiscal rules
https://bit.ly/2AtY13v

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AUTHORS

Prof. Dr. Sebastian Dullien
Research Director (IMK)
sebastian-dullien@boeckler.de

Christoph Paetz
Research Associate Tax and Fiscal Policies
christoph-paetz@boeckler.de

Dr. Andrew Watt
Head of Unit European Economic Policy
andrew-watt@boeckler.de

PD Dr. Sebastian Watzka
Head of Unit European Business Cycle Analysis
sebastian-watzka@boeckler.de

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INTRODUCTION

Coupled with the measures adopted to stabilise the economy, the sharp global economic downturn caused by the coronavirus crisis is already placing a huge strain on the budgets of the EU's member states. Having recently started to come down again for the first time since the major financial and eurozone crisis in 2008, debt-to-GDP ratios are now inevitably set to rise once more. The necessary measures enacted by the State to take over some of the financial burden on the private sector will significantly increase government debt in the EU's member states for years to come (Draghi 2020; European Commission 2020b; IMF 2020). Although the EU has already approved some support measures and is discussing others, these will not be enough to prevent a sharp increase in national debt (►Infobox 4, p. 21). Figure 1 shows the debt-to-GDP ratio trends for the euro area. The increase in the debt-to-GDP ratios and their spread as a result of the financial crisis are both clearly apparent. The coronavirus crisis will result in a similar if not even greater increase in debt-to-GDP ratios.

In the past, the European Union's fiscal rules have frequently been criticised for being too restrictive. Under the current circumstances, it seems inevitable that the disparity between the fiscal rules and economic policy necessity will grow even wider, with all the tensions that this entails within the EU. In the face of growing criticism of the EU in countries such as Italy, it is possible that the euro area might not survive another bout of austerity. The fiscal rules must therefore be reformed to ensure that they do not constrain growth and employment in Europe. The public discussion of the economic governance review launched by the European Commission in February of this year (European Commission 2020a) provides an excellent opportunity to carry out a critical assessment of the current rules and contribute our own proposals to the debate.

The IMK strongly advocates a reform focused on appropriate fiscal rules that promote short-term macroeconomic stabilisation and the long-term modernisation of the public capital stock, while still keeping the sustainability of public debt in mind. We propose an expenditure rule for non-investment expenditure that takes the sustainability of public debt into account (Benasssy-Quere et al. 2018; Claeys et al. 2016; Darvas et al. 2018a), coupled with a Golden Rule for public investment (Blanchard et al. 2020; Truger 2016). The proposed expenditure rules would replace the EU's current fiscal rules. A reform of the Macroeconomic Imbalance Procedure (MIP) is equally important. A key element of such a reform would be the establishment of a Macroeconomic Dialogue for the euro area as a whole and in the individual member states, in order to ensure compliance with the reformed rules and consistency of the national strategies (Koll and Watt 2019).

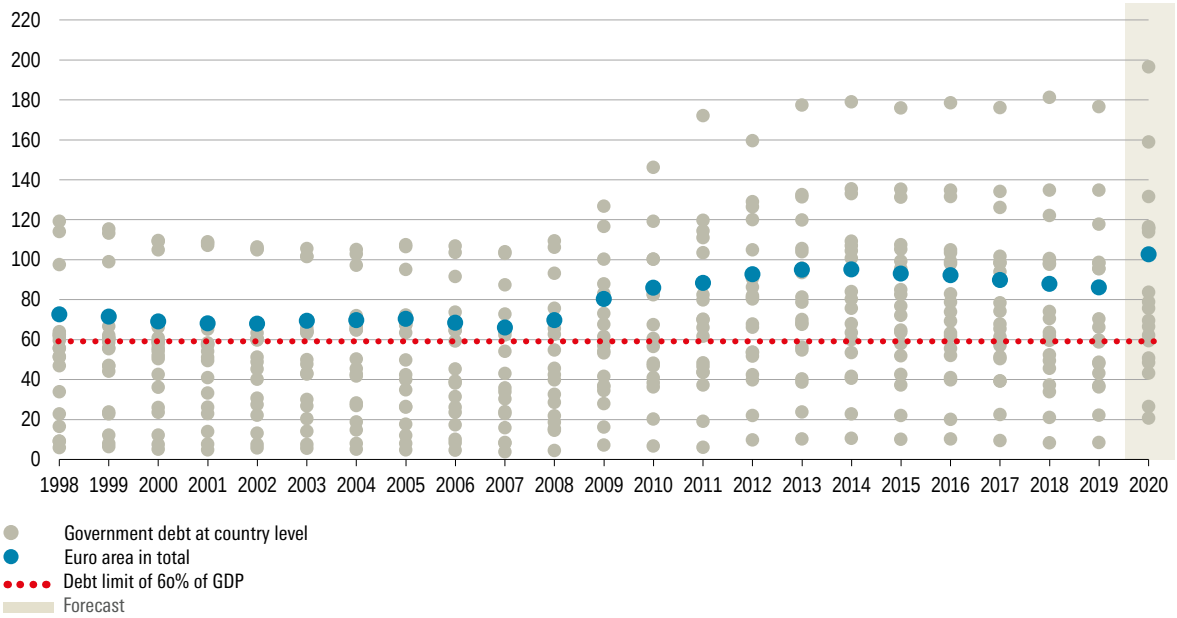
This report is structured as follows:

►It begins with a critique of the current rules.

►The next section discusses the criteria that

Figure 1

Government debt ratios in the euro area
in % of GDP



Source: AMECO, European Commission (2020b), Macrobond.

should be met by the fiscal rules of a single currency area.

- Following on from this, we outline proposals for a reform of the fiscal rules and also
- present proposals for a reform of the MIP.

A CRITICAL REVIEW OF THE ECONOMIC GOVERNANCE RULES

The origins of the EU rules

Ever since 1991, when the Maastricht Treaty set out convergence criteria for joining the Economic and Monetary Union in the form of upper limits on government deficits and debt, there have been almost constant changes to Europe's – and in particular the euro area's – fiscal and economic policy rules. However, these amendments have done little to stem the controversy surrounding the rules.

The Stability and Growth Pact (SGP) of 1997 made the Maastricht criteria for members of the Economic and Monetary Union (EMU) into a permanent de facto rule, according to which public debt had to remain below 60% of gross domestic product (GDP) or at least approach this value "at a satisfactory pace" (Article 126 TFEU). It also stipulated that government deficits could not exceed 3% of GDP except during major recessions. The idea was that the budgets would be balanced during normal times – the deficit limit would allow the automatic stabilisers to operate during downturns.

In the years leading up to the eurozone crisis, Germany and France repeatedly exceeded the 3% limit. Although they escaped sanctions, they had to tighten their fiscal policy in spite of the ongoing stagnation of their economies. At the same time, the rules failed to enforce a more restrictive policy in countries such as Greece, Spain and Portugal, which were achieving high nominal growth, in part due to above-average price and nominal wage cost inflation. A reform in 2005 attempted to address these problems by switching the focus to "structural" deficits (i.e. deficits that have been adjusted for cyclical and one-off effects).

Debt-to-GDP ratios rose sharply in the aftermath of the eurozone financial crisis. After a very brief phase of Keynesian fiscal expansion, the majority of EU member states embarked upon a premature and in many cases extreme austerity policy aimed at rapidly bringing government deficits and debt under control. This resulted in a double-dip recession, followed in most countries by a prolonged period of weak macroeconomic performance compared, for example, to the US and the EU member states that were not members of the single currency. Particular hardship was experienced in the countries worst affected by the crisis, which were operating within the constraints of the Economic Adjustment Programmes coordinated by the EU. The sluggish recovery meant that deficits and debt-to-GDP ratios were also slow to improve.

Two legislative packages commonly referred to as the six-pack and two-pack were introduced in 2011 and 2013. These had two main goals. The first was to improve compliance with the fiscal rules. Greater emphasis was placed on prevention, with the establishment of medium-term objectives aimed at achieving a 0.5% annual reduction of the structural balance. A tougher sanctions regime was also introduced. Moreover, the reform placed a particular requirement on countries to reduce the amount by which their debt-to-GDP ratio exceeds 60% by at least 5% a year. This followed a long period during which debt had played almost no practical role as a fiscal surveillance criterion. In addition, the Fiscal Compact (officially known as the "Intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union") required countries to enact legislation modelled on the German debt brake in order to anchor fiscal discipline in national law.

Secondly, EU surveillance of euro area members' economic policy was expanded in order to address the problem of macroeconomic imbalances, especially competitiveness and current account imbalances. This belatedly recognised the role of issues relating to the balance of payments and adjustments between countries (Allsopp and Watt 2005) in the eurozone crisis. Within the European Semester, the member states' economic – and social – policies were evaluated more holistically rather than in purely fiscal terms. In 2015, the Commission slightly relaxed the fiscal framework by permitting greater leeway when assessing breaches of the deficit rules (European Commission 2015).

Critique of the current rules

All these developments were fiercely debated among both academics and the general public, and have also been discussed in previous IMK publications (Horn et al. 2012; Watt and Watzka 2018). The assessments of the six-pack and two-pack carried out by the European Commission (2020a), the European Fiscal Board (2019) and the research community highlighted a number of weaknesses in the rules. Some have already been accepted by the European Commission, while others are still disputed. The following sets of problems provide the starting point for our proposed reforms:

- Despite the reforms, the fiscal framework was always confronted with the problem of striking a balance between longer-term sustainability and short-term stabilisation. Ultimately, it failed on both counts: it did not prevent potentially unsustainable levels of debt in certain countries, and it was also unable to ensure the necessary stabilisation.

- In practice, the rules frequently resulted in procyclical policy measures (Infobox 1), either because this was prescribed by the fiscal rules' nominal upper limits and the asymmetrical indicators in the MIP, or due to technical cyclical adjustment issues. This procyclical bias was particularly pronounced during the austerity years in the "programme countries", where it had dramatic economic and social consequences. However, the rules also fail to ensure an adequate level of anticyclical consolidation during the "good times".
- Despite efforts to coordinate policy within the European Semester, the rules fail to ensure the appropriate fiscal stance for the euro area as a whole. To do this, they would need to provide for a more expansionary policy in countries with fiscal leeway.
- In spite of the 2015 reform, which has in any case had little effect in practice, the rules pay almost no attention to the quality of public spending (European Commission 2020a). In particular, public investment (which will at least partly finance itself in the long term) is essentially treated in the same way as current expenditure.[1]
- The rules have become excessively complex. There are overlaps between some of the indicators (deficits, debt) and rules (EU rules vs. national rules based on the Fiscal Compact). Some of the indicators used are not observable and are frequently amended (e.g. for structural deficits) or are not really under the control of national governments in the short term (budget deficits). Rules introduced to allow greater flexibility have resulted in a highly politicised process. In general, it can be difficult to resolve the conflict between ensuring clarity and transparency on the one hand and ensuring that the rules are sufficiently sensitive to countries' individual situations on the other.
- The sanctions regime has proven to be unworkable, partly as a result of the complexity and lack of transparency alluded to above, but also due to more fundamental political factors (the difficulty in imposing financial sanctions on sovereign states, usually at times when they are experiencing economic difficulties).
- Linked to the tension between sustainability and stabilisation, there is a lack of clarity concerning the relationship between the MIP – which includes public debt among its indicators – and the fiscal rules.
- The MIP suffers from a number of problems, including the fact that the scoreboard for evaluating national policies uses asymmetrical indicators. The most obvious example is that the upper threshold for current account surpluses is set at 6% of GDP, whereas the lower threshold for deficits is -4%. The MIP uses a large suite of indicators, yet there is no clear order of importance. Social indicators (such as long-term unemployment) have been added to the list, even though they are at best only weakly linked to macroeconomic imbalances between different countries.
- The recommendations made to the member states through the MIP have been largely ignored, even though on paper they are every bit as binding as the fiscal rules (European Commission 2020a). The excessive imbalance procedure, which – just like the excessive deficit procedure – includes the possibility of sanctions, has not been activated on one single occasion. Perhaps most blatantly of all, the repeated current account surpluses significantly exceeding the asymmetrical upper threshold of 6% in Germany and the Netherlands have not been sanctioned or corrected.

1 A concern that has recently come to the fore is that, unless the budget rules change, many countries will be unable to finance the public investment called for under the European Green Deal.

Infobox 1: The cyclical stance of national fiscal policy in the euro area

Fiscal policy is especially important to the members of the European Monetary Union, since they do not have the option of using other macroeconomic stabilisation instruments such as national monetary policy and exchange rate adjustments. However, the EU rules limit the flexibility of national fiscal policy.

In order to establish how discretionary fiscal policy in the euro area countries behaves with regard to the economic cycle and whether the direction of the economic cycle has been modified by the implementation and extension of the fiscal rules, we estimated various fiscal reaction functions for a panel of eleven euro area members[1] between 1985 and 2015.[2] By distinguishing between economic upturns and downturns, we also investigated whether the fiscal reaction was symmetrical or asymmetrical over the course of the economic cycle. It should be noted that our analysis focuses on the ex post results of fiscal policy rather than on ex ante fiscal planning. In other words, we consider the actual outcomes of government policy and whether on average it was effectively procyclical or anticyclical.

Our econometric panel analysis is based on the approaches of Galí and Perotti (2003), Candelon et al. (2010) and Huart (2012). In its simplest form, the fiscal reaction function (FRF) is estimated as follows:

$$FP_{it} = \alpha_i + \beta Cycle_{it} + \gamma D_{it-1} + \delta FP_{it-1} + \epsilon_{it},$$

where *FP* is an indicator of the discretionary fiscal impulse, *Cycle* is a proxy for the development of the economic cycle, *D* denotes the public debt-to-GDP ratio, and the indices $i=1,\ldots,N$ and $t=1,\ldots,T$ respectively denote the country and time dimensions of the observation. The coefficient β represents the fiscal reaction in relation to the economic cycle and is thus the key variable in our analysis. D_{it-1} is included in the model in order to account for a sustainable long-term debt trend (Bohn 1998), while the lagged dependent variable FP_{it-1} controls for policymaking inertia. α denotes the country-fixed effect, while ε is the error term.

The identification of exogenous fiscal shocks is key to the investigation of discretionary fiscal policy. Consequently, it is not possible to use the actual budget balance for the *FP* indicator, since changes in its value include automatic fluctuations in budget components that are outside policymakers' direct control. Instead, we use the cyclically adjusted primary balance (CAPB) as a percentage of potential output as a proxy for *FP*. CAPB is an unobserved, statistically derived measure, calculated by subtracting a cyclical component (based on assumptions about budgetary elasticities and the macroeconomic output gap) from the actual primary balance.[3] It thus excludes interest payments.

In order to estimate the fiscal reaction function, we use an instrumental variable (IV) model that has been adopted in the literature as the standard for excluding endogeneity between the fiscal impulse and the economic cycle (Jaimovich and Panizza 2007). A country's output gap at time *t* is used as a proxy for the "Cycle" variable. Through the lagged country-specific and US output gaps, this is in turn used to provide a proxy for the global economic cycle.

When it comes to interpreting the results, if $\beta>0$ it means that fiscal policy is anticyclical, if $\beta<0$ it is procyclical, and if $\beta=0$ (not statistically significant) it is neutral. Based on the assumption that governments wish to stabilise the public debt in the long term, it is expected that γ will be positive, in other words that a higher public debt will lead to lower primary deficits. It is furthermore expected that there will be a degree of autocorrelation between budgetary decisions, and that δ will therefore also be positive.

In other specifications, two further dimensions are added to the basic model described above. Firstly, in order to control for asymmetry over the course of the economic cycle, we allow our β-coefficients to vary between economic upturns and downturns. These are defined as positive (upturn) or negative (downturn) variations in the output gap in a given year. Secondly, we estimate model specifications where all the model's coefficients can vary between before and after implementation of

1 Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal and Spain.

2 The estimates are not completely up-to-date, since they are based on the Fiscal Rules Dataset of the International Monetary Fund (IMF), which only provides data up to 2015.

3 We should point out that there has been some criticism of the methods and assumptions used to calculate the cyclically adjusted primary balance (Carnot and de Castro 2015; Heimberger and Kapeller 2017; Truger and Will 2012). The literature proposes the narrative approach of Romer and Romer (2010) as an alternative to CAPB for identifying exogenous discretionary fiscal shocks. This approach identifies the shocks directly by analysing legislative texts and other historical documents. The Discretionary Fiscal Effort (DFE) published by the European Commission is a time series based on the narrative approach (Carnot and de Castro 2015). Unfortunately, however, the DFE only began in 2010 and thus covers a very limited period of time. Moreover, there are no other comprehensive, long-term time series that identify fiscal shocks using the narrative approach for the countries in our analysis. We therefore opted for CAPB as a yardstick to augment the observations of our panel analysis.

Fiscal Reaction Functions (FRF): The cyclical reaction of discretionary fiscal policy in the EMU

	Dependent variable: CAPB						
	Baseline	Asymmetry	MT	SGP	BBR	DR	ER
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
OG	-0,158*						
	(0,083)						
$OG * recession$		-0,332***					
		(0,093)					
$OG * expansion$		-0,104					
		(0,121)					
D_{t-1}	0,032***	0,033***					
	(0,01)	(0,01)					
FP_{t-1}	0,62***	0,621***					
	(0,032)	(0,033)					
$Election$	-0,303	-0,304					
	(0,230)	(0,230)					
$OG^{before} * recession$			-0,275*	-0,007	0,111**	0,089*	-0,408**
			(0,150)	(0,099)	(0,053)	(0,051)	(0,163)
$OG^{after} * recession$			-0,316***	-0,337***	-0,395***	-0,392***	-0,130
			(0,092)	(0,059)	(0,059)	(0,060)	(0,112)
$OG^{before} * expansion$			-0,197***	-0,071	-0,136**	-0,154***	-0,015
			(0,046)	(0,095)	(0,059)	(0,054)	(0,141)
$OG^{after} * expansion$			-0,078	-0,052	-0,127	-0,118	-0,149
			(0,162)	(0,229)	(0,157)	(0,164)	(0,138)
D_{t-1}^{before}			0,076***	0,043***	-0,012	-0,009	0,033**
			(0,019)	(0,011)	(0,013)	(0,013)	(0,014)
D_{t-1}^{after}			0,04***	0,052***	0,036***	0,036***	0,041**
			(0,013)	(0,015)	(0,011)	(0,012)	(0,016)
FP_{t-1}^{before}			0,487***	0,612***	0,587***	0,66***	0,676***
			(0,138)	(0,122)	(0,112)	(0,121)	(0,062)
FP_{t-1}^{after}			0,588***	0,552***	0,567***	0,567***	0,274***
			(0,029)	(0,038)	(0,028)	(0,027)	(0,067)
$Election^{before}$			-1,119**	-0,513**	-0,982***	-1,021***	-0,221
			(0,455)	(0,202)	(0,349)	(0,317)	(0,350)
$Election^{after}$			-0,124	-0,144	-0,193	-0,167	-0,163
			(0,266)	(0,326)	(0,267)	(0,276)	(0,160)
Crisis dummy	-1,511***	-1,81***	-1,991***	-2,363***	-2,275***	-2,264***	-2,276***
	(0,437)	(0,559)	(0,531)	(0,589)	(0,481)	(0,485)	(0,773)
Observations	315	315	315	315	315	315	315
Adjusted R^2	0,535	0,535	0,530	0,546	0,541	0,540	0,548

Notes: Fixed-Effects IV panel estimations of fiscal reaction functions for the EMU-11 over the sample 1985-2015. Robust standard errors are given in brackets. * p<0,1; ** p<0,05; *** p<0,01 indicate that the coefficient is at 10%, 5% or 1% level statistically significant. Coefficients for fixed-effects are not reported. Recession limits the effect to negative variations and expansion to positiv variations of the output gap. We add a financial crisis dummy to the model, as well as a dummy for the political cycle, which signals 1 in an election year and 0 otherwise. „before" limits the effects to periods with the respectative fiscal rule, while „after" limits the effects to periods without the respective rule. We analyse the Maastricht Treaty (MT) and the Stability and Growth Pact (SGP) with structural breaks in the years 1992 and 1999 respectively as well as national balanced budget (BBR), debt (DR) and expenditure rules (ER) using the IMF Fiscal Rules Dataset. There are not enough observations for revenue rules in the sample. Data for fiscal variables and OG (output gap) come from the OECD and are in % of potential output. Debt ratios are supplemented by the IMF's Historical Public Debt Database (HPDD). The election year dummy is from electionresources.org and was extended by us. The panel is unbalanced due to partially missing data on CAPB and OG.

Sources: IWF, OECD, electionresources.org, calculations by IMK.

a fiscal rule.[4] This allows us to distinguish between periods of different supranational fiscal rules within the euro area. We also link the estimates to the IMF's Fiscal Rules Dataset. This allows us to investigate individual countries' national fiscal rules so that we can explore additional heterogeneity linked to different types of fiscal rule design. It also allows us to test whether some individual designs result in stronger anticyclical stabilisation than others.

Table 1 summarises the results of the estimates. Overall, the discretionary fiscal policy of the EMU-11 was on average slightly procyclical during the period analysed (column 1). However, this was mainly attributable to contractionary measures during economic downturns – on the whole, the reaction during upturns was neutral (column 2). The results for the other variables are as expected – a statistically significant debt stabilisation motive [5] and fiscal policy persistence.

The fiscal rules appear to have only a limited effect on the direction of the economic cycle. It is true that in some cases fiscal rules lead to a slight improvement in fiscal policy discipline during economic upturns, thereby making fiscal policy more anticyclical. They also strengthen the debt stabilisation motive and make governments less likely to engage in pork barrel politics during election campaigns. However, these improvements must be set against the huge macroeconomic costs during economic downturns. At these times, the rules result in a fiscal policy that is significantly more procyclical and thus destabilising. These findings hold true for the supranational rules in the euro area (columns 3 and 4) and become even more apparent when analysing national fiscal rules. In terms of the goal of macroeconomic stabilisation, the expenditure rules (column 7) are more successful than the deficit or debt rules (columns 5 and 6). The coefficient for the direction of the economic cycle prior to implementation of an expenditure rule in an economic downturn is -0.4, i.e. it is procyclical to a statistically significant degree. However, this procyclicality disappears during periods when an expenditure rule is implemented, while the coefficient remains unchanged during economic upturns, indicating a neutral fiscal policy reaction. The reverse is true for deficit and debt rules – the coefficients prior to implementation during an economic upturn are procyclical to a statistically significant degree (-0.14 and -0.15 respectively)[6] and become statistically insignificant once the rule has been implemented. The stabilising influence of the rules during an upturn is counteracted by a stronger destabilising influence during a downturn (a highly statistically significant -0.4). Before the deficit and debt rules were introduced, fiscal policy during economic downturns was on average still anticyclical (0.1).

4 An important caveat of our analysis is that it controls for the existence of a rule but not for compliance with it. Consequently, any structural changes are brought about entirely exogenously – by a fiscal rule coming into force.

5 Our results were of a similar magnitude to those generally found in the empirical literature (Checherita-Westphal and Žďárek 2017).

6 It should be noted that there is a strong correlation between the implementation of deficit rules and debt rules. Accordingly, the results for these two categories are virtually identical and it is difficult to clearly separate them from each other.

CRITERIA FOR EFFECTIVE FISCAL RULES AT EUROPEAN LEVEL

In macroeconomics, fiscal rules refer to permanent fiscal policy restrictions that typically take the form of simple numerical limits for budgetary aggregates (Kopits and Symansky 1998). As such, fiscal rules must attempt to reconcile the conflicting goals of combatting the politico-economic relaxation of the government budget constraint (better known as the deficit bias) and ensuring optimal orientation of fiscal policy. Fiscal rules promote fiscal discipline in order to limit public sector activity and achieve a sustained stabilisation or reduction of public debt. At the same time, however, the rules should not stand in the way of essential cyclical stabilisation or adequate levels of public investment.

In addition to the general provision of public goods and the pursuit of redistribution objectives, the role of fiscal policy from a macroeconomic perspective is to achieve stable aggregate demand in line with the economy's potential. If fiscal rules result in suboptimal fiscal outcomes for individual members of a currency union like the euro area, they can encourage the emergence of macroeconomic imbalances. For example, if a member state pursues an overly restrictive fiscal policy for a lengthy period of time, this will cause a drop in domestic demand that could lead to a current account surplus. The same also applies symmetrically to an overly expansionary fiscal policy and its potential to result in a current account deficit. If this continues for a long period of time, it can lead to the accumulation of potentially huge macroeconomic imbalances (for more on this, see the section on the reform of the MIP).

A narrow focus on fiscal discipline overlooks the role of fiscal policy in both the short-term and long-term stabilisation of the economy as a whole (Furman 2016). An effective fiscal policy must allow the automatic stabilisers to take full effect during economic downturns and upturns rather than procyclically counteracting them.[2] A discretionary fiscal policy can also actively influence the current economic situation.

Current fiscal multiplier estimates confirm the traditional Keynesian thesis that fiscal stabilisation measures are effective, and also indicate that the short-term multipliers were significantly underestimated in the past (Blanchard and Leigh 2013; House et al. 2019; Gechert 2015). The multiplier effect is particularly high at times when monetary policy approaches the zero lower bound (Auerbach and Gorodnichenko 2012) and for changes in public spending (Gechert and Rannenberg 2018). Spending cuts hold back growth in the short term and can even lead to an increase in the public debt-to-GDP ratio over the medium to long term (Cottarelli and Jaramillo 2012). Premature consolidation leads to output losses that can cause a lasting fall in potential output (Fatás and Summers 2018; Gechert et al. 2019).

Optimal fiscal rules should allow a discretionary, short-term fiscal policy response to shocks, in order to maintain overall economic output close to the level required to meet the inflation target and keep external imbalances within check. In the long term, high public debt-to-GDP ratios should gradually be reduced to an agreed reference value without the need for continual tax increases or spending cuts.

An optimal fiscal policy should also facilitate an adequate level of public investment. These investments are especially important for long-term economic growth (Bom and Ligthart 2014) and their benefits are to a large extent enjoyed by future generations. Accordingly, there are sound economic reasons to borrow in order to finance public investment, particularly in the widest sense of the term (infrastructure, education, decarbonisation) (Hein and Detzer 2014).

Strict fiscal rules can be an impediment to appropriate levels of public investment. Public investment can come under particular pressure during fiscal crises, since it can be cut quickly and at relatively little political cost. This can also be observed empirically in Europe. Over the last decade, public investment levels in the euro area have been disappointing. In Germany and France, the public capital stock has remained at a similar level for a number of years, while net investment in Italy and Spain has actually undergone a significant decline. Bardt et al. (2019) identify a huge investment backlog in Germany and calculate that approximately €450 billion of extra public investment will be required over the next ten years.

As described at the beginning of this section, the goal pursued by the implementation of a fiscal rule is politico-economic rather than macroeconomic in nature. A trend of rising public debt-to-GDP ratios has been apparent since the 1970s. This problem is often linked to the "deficit bias", a phenomenon whereby politicians tend to neglect consolidation of the public finances primarily during economic upturns, for politico-economic reasons.[3]

2 The inference that public debt should increase in the event of a negative shock is not a purely Keynesian conclusion. Barro (1979), for instance, argues that public debt should absorb macroeconomic shocks, without referencing Keynesian income effects.

3 The literature proposes a variety of explanations for the deficit bias, including conflicts of interest, election campaigning, time inconsistencies and informational problems. For a detailed discussion, see e.g. Portes and Wren-Lewis (2015) or Wyplosz (2011). Similar arguments are proposed in the public choice literature, e.g. in Imbeau (2005).

Over and above the purely national reasons for following fiscal rules, additional arguments are often presented in favour of limiting public debt among the members of a currency union. Firstly, there is a danger that an overly expansionary fiscal policy in one member state could prompt a rise in interest rates that causes negative external effects in the rest of the currency union. A common fiscal framework enables more efficient coordination of national fiscal policies, optimising the fiscal stance of Europe as a whole. In conjunction with the common monetary policy, this results in a better policy mix (Claeys et al. 2016). It is also argued that individual member states could pursue an unsustainable fiscal policy for strategic reasons, in the hope that the other currency union members will ultimately bail them out. The thinking behind this argument is that the individual member states do not have a central bank of their own that can step in as a lender of last resort and print money to finance high levels of public debt. As the eurozone crisis demonstrated all too well, the trade and finance interdependence within a single currency area means that a debt crisis can have a devastating economic impact for all its members. Consequently, the other members may have little choice but to bail out an overindebted country.

Notwithstanding these arguments, it remains unclear whether the benefits of focusing on fiscal discipline outweigh the costs of a suboptimal fiscal policy. Simplistic rules are fundamentally unable to reconcile the conflicting goals. At the same time, dispensing with fiscal rules altogether is unlikely to be politically realistic in the EU's multi-level system. Ideally, fiscal rules should therefore mimic an optimal fiscal policy as closely as possible while still allaying concerns about a deficit bias (Portes and Wren-Lewis 2015).

Named after the type of fiscal aggregate that they limit, the four basic types of fiscal rule are deficit, debt, expenditure and revenue rules. Many countries combine two or more fiscal rules in order to compensate for the individual shortcomings of different fiscal rule types in relation to the relevant objectives. This occurs both at national level and in the context of supranational rules such as those established by the European Union's SGP.

Other key characteristics of fiscal rules include their legal basis, coverage of government and coverage of the relevant aggregates, cyclical adjustment of the targets, escape clauses, automatic correction mechanisms and sanctions, and supporting institutional arrangements (Schaechter et al. 2012).

In order to ensure more effective fulfilment of fiscal policy's stabilisation function, the targets need to be cyclically adjusted. In principle, this allows the automatic stabilisers to take full effect and means that governments must keep spending in check during economic upturns and do not need to implement procyclical countermeasures during economic downturns. Despite these cyclical adjustment procedures, however, there is still a risk that fiscal rules will demand procyclical measures, triggering a downward spiral during a recession due to endogeneity in the calculation of potential output (Truger and Will 2012). As well as being extremely sensitive to current cyclical factors, the potential output figure is often revised retrospectively (Claeys et al. 2016). As a result, the cyclical element of the economy's development is understated and treated as structural. The danger is that this can prevent the proper functioning of the automatic stabilisers, resulting in the pursuit of a procyclical policy due to purely technical reasons. Fiscal rules should therefore employ a methodology that minimises cyclical sensitivity when calculating potential output.

Escape clauses have proven useful as a means of buffering serious shocks such as natural disasters, major emergencies and severe recessions. Extensive use is currently being made of escape clauses in the context of the economic policy measures introduced to tackle the Covid-19 pandemic. While escape clauses are generally uncontroversial, there is some debate as to the circumstances that justify triggering them, how the decision to trigger them is taken, and in particular the details of the path back to the rule. It is important that the loan repayments should reflect the current economic situation, without necessitating politically unrealistic adjustments.

THE REFORM OF THE FISCAL RULES

Based on the criteria for effective fiscal rules set out in the previous section, this section outlines our proposals for a reform of the EU's fiscal rules. The proposals are based on a combination of measures that have already been discussed for many years in the academic and economic policy debate, and make no claim to completeness. The proposed measures could be said to combine the minimum requirements for reducing the risk of ongoing stagnation and over-indebtedness within the currency union as much as possible without introducing an actual common European fiscal policy. The aim is for the member states to pursue a fiscal policy that is both sustainable (i.e. that prevents excessive deficits and debt-to-GDP ratios) and sufficiently flexible. This should enable the provision of an appropriate level of public goods (including a modern public capital stock) and services, while at the same time permitting anticyclical measures to stabilise the economy during upturns and downturns.

The most important element of the proposals is an expenditure rule for non-investment expenditure (excluding cyclical expenditure on e.g. unemployment benefit) in countries with high public debt, coupled with a Golden Rule for public investment. When deciding on the level of public expenditure, it

is important to ensure the long-term sustainability of public debt. Given the changes in the macroeconomic environment, the level of this sustainable long-term debt-to-GDP ratio should have been increased to well above the 60% Maastricht figure. If the debt-to-GDP ratio exceeds the long-term reference value, adjustment rules should come into force in order to curb the growth in expenditure. In order to get round the difficulty in imposing financial sanctions, these should be replaced with clearly defined incentives geared towards ensuring compliance with the rules within the European Semester. The equally necessary reform of the MIP is outlined in the section beginning on ►page 17. These two reform packages complement each other: the relationship between the fiscal rules and the MIP/European Semester is discussed in the Summary and Conclusion.

An expenditure rule for non-investment expenditure and a Golden Rule for public investment

The fundamental goal of an expenditure rule is to curb the growth in (nominal) government spending in order to achieve a sustainable long-term debt-to-GDP ratio. One key advantage of this type of rule compared to the current deficit rules is that the automatic stabilisers can, to a large extent, operate freely. In other words, the rule supports macroeconomic stability (Benassy-Quere et al. 2018; Brück and Zwiener 2006; Darvas et al. 2018a). If cyclical factors cause tax revenue to decline (in a recession) or rise extremely sharply (in a boom), the rule promotes stability by ensuring that government expenditure only increases within the stipulated limits. An expenditure rule generates a budget deficit during a recession and a budget surplus during a boom.[4]

The rule proposed by the IMK limits increases in non-cyclical, non-investment (nominal) public expenditure as soon as a country's public debt exceeds a certain threshold.[5] As in the expenditure rule proposed by authors such as Benassy-Quere et al. (2018), increases in this type of expenditure would then be limited by the medium-term growth of nominal potential GDP, calculated as the sum of the medium-term growth in real potential output and the ECB's inflation target.[6] The use of the inflation target instead of the medium-term national inflation rate reflects the fact that it is unsustainable for a member state's inflation rate to deviate from the inflation target in the long run. The expenditure rule should also include a correction mechanism. If a euro area member is considered to have an excessively high debt-to-GDP ratio, there should be more leeway for it to curb spending increases so that it can still meet the target in the long term (Benassy-Quere et al. 2018; Darvas et al. 2018a).[7]

Expenditure in excess of the established limit should only be allowed if it is budget-neutral, i.e. if spending is cut by the same amount elsewhere or if tax revenue increases. Similarly, only budget-neutral tax cuts should be allowed. Our proposal thus incorporates both a limit on spending increases and a ban on tax cuts that have not been offset.[8] The restrictions should be lifted as soon as a country's public debt falls below the reference value for the public debt-to-GDP ratio or the structural primary balance reaches a level that guarantees a rapidly falling debt-to-GDP ratio even without further spending restraint. Furthermore, escape clauses should continue to be included in order to allow member states to temporarily deviate from the expenditure rule in the event of major economic crises or other emergencies. Exemptions could be approved by a qualified majority of the Eurogroup, for example.

It should be reiterated that the proposed expenditure rule would only apply to non-investment public expenditure. In the case of public investment, on the other hand, we propose a Golden Rule to enable debt-financed net investment (Truger 2016; Bardt et al. 2019, Blanchard et al. 2020). The Golden Rule is a well-established public finance princi-

4 In the euro area countries, the automatic stabilisers operate primarily at national level (unemployment insurance, cyclical tax revenue, etc.). In order to achieve wider macroeconomic stabilisation at European level, these national stabilisers could be significantly expanded, while European-level reinsurance or pooling would extend the relevant effects to the entire euro area (Dullien 2017).

5 Cyclical expenditure on e.g. unemployment benefit and basic social security provision would be exempted from this rule.

6 Measuring the potential growth rate is fraught with difficulty, particularly under the current circumstances (Tooze 2019). However, this problem is not as pronounced for expenditure paths as for deficits, since in this case only the growth rates are included in the calculations and not the level of the estimated potential output (which is far likelier to be revised).

7 This type of expenditure rule could be formally expressed as $g_t = y^* + \pi^* - \delta(d_t - d^*)$, where gt is the growth rate of nominal non-investment public expenditure, y^* is the long-term growth in potential output, π^* is the expected long-term inflation rate (e.g. the 2% inflation target) and $d_t - d^*$ is the difference between the actual and target debt-to-GDP ratios. The parameter δ determines the rate at which the actual debt-to-GDP ratio is adjusted to the target ratio. There is some disagreement in the literature regarding the exact value of δ. Claeys et al. (2016), for example, propose a value of 0.02. On the other hand, IMK simulations for Italy show that a δ of 0.01 would bring the Italian debt-to-GDP ratio down to below 90% in the long run without the need to reduce non-investment expenditure in real terms. Different δ values should be used for different countries in order to reflect the different conditions in the member states (Darvas et al. 2018b).

8 See also the PAYGO rule in the US, that only allows additional non-investment government spending or tax cuts if they have been offset (Center on Budget and Policy Priorities 2019).

ple that allows public investment to be financed by borrowing. It ensures that the future generations that will benefit from a larger, more modern capital stock also share in its financing. The Golden Rule also serves to increase long-term investment and provides a more secure basis for private sector planning (Hüther 2019).

When employing a Golden Rule, it is important to define what is meant by investment. Traditionally, the national accounts definition of public investment is used. This focuses mainly on tangible assets (equipment, buildings, infrastructure and other investment goods with an economic life of more than one year). Overall, these assets can be said to stimulate growth (Bom and Ligthart 2014). The adoption of the national accounts definition would thus undoubtedly be a pragmatic solution (Truger 2015). However, we argue that a broader definition of investment should be considered. On average, spending on education and human capital, for example, also increases potential output in the long run.

Simulations show that if a Golden Rule had been applied in the past, euro area GDP would have grown significantly more strongly without compromising debt sustainability (Infobox 2).

The proposed combination of an expenditure rule and a Golden Rule for investment constitutes an effective tool for limiting public spending to sustainable levels while at the same time allowing the automatic stabilisers to operate and enabling governments to take discretionary measures.

Infobox 2: Macroeconomic effects of the Golden Rule in the euro area

What would have happened if the euro area countries had incorporated the Golden Rule into the fiscal framework after the financial crisis? The rules that were in place at the time have been shown to be at least partly responsible for the austerity measures that led to a drastic reduction in public investment in many euro area countries (Blanchard et al. 2020). With this in mind, we carried out a counterfactual simulation for the euro area, in which the Golden Rule of fiscal policy is introduced simultaneously in Germany, France, Italy and Spain. Since these four countries account for over 80% of the euro area's output, the results can be extrapolated to the whole of the euro area with some confidence. To this end, our simulation employs a modified version of NiGEM, a macroeconometric, multi-country policy simulation model that is widely used around the world.[1] The model simulates past economic behaviour, and any deviations from actual past behaviour can thus be attributed to specific policy measures that were not implemented in reality. The simulation is based on quarterly data and covers the period from 2011 to 2017. We use the target of 1.5% of GDP proposed by Truger (2016) for debt-financed net public investment. Investment is increased linearly to this target value over a period of three years.

NiGEM does not enable direct modelling of net public investment. With reference to the actual investment figures, gross public investment is adjusted using the following formula:

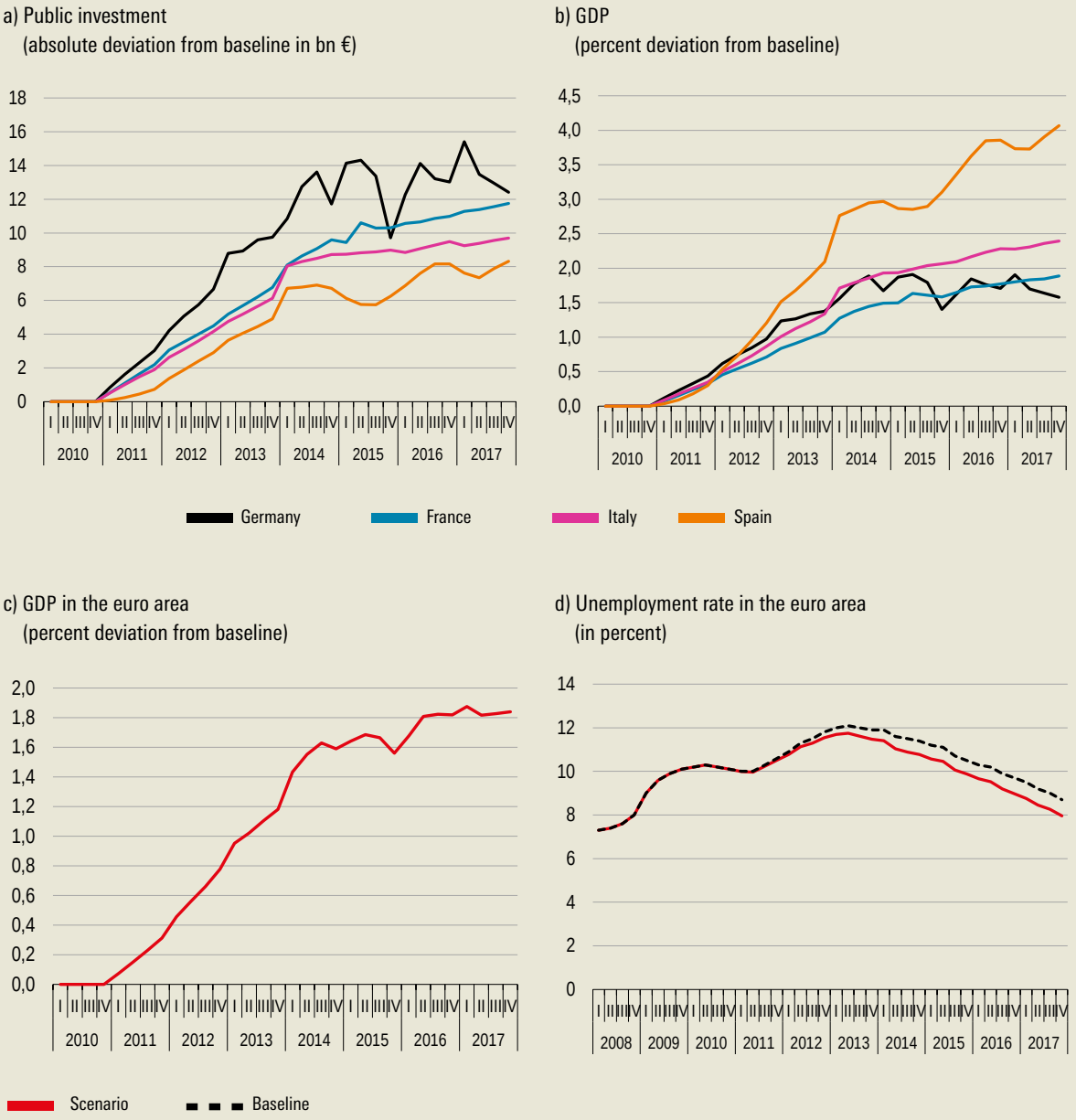
$$GI_t = GI_{t,Basis} + 0{,}015\, Y_t - (KG_t - KG_{t-1})$$

where GI is the newly specified gross investment figure, GI_{Basis} is the actual gross investment figure, Y denotes GDP and KG denotes the public capital stock. This adjustment reflects the desired simulated net investment figure of 1.5% of GDP. In view of the actual negative economic cycle in the euro area during the simulation period, we also assume that monetary policy behaves as in the baseline simulation and does not react with measures to dampen the economy.

Figure 2 provides an overview of the key indicators in our counterfactual simulation of a Europe-wide Golden Rule during the simulation period. Figure 2a shows the difference between gross public investment in the individual countries and the baseline simulation in billions of euros. By the end of the counterfactual simulation, the Golden Rule would have resulted in approximately €8 billion of additional public investment per quarter in Spain, over €9 billion in Italy and around €12 billion in France and Germany. The macroeconomic effects of this increase on the euro area are clearly visible. The GDP of the euro area as a whole is just over 1.8% higher at the end of the simulation period (Figure 2c). While Germany's GDP is 1.5% higher in the last quarter of 2017, the biggest impact of the Golden Rule is in Spain, where GDP ends up more than 3.5% higher than in the baseline simulation. GDP is also 2% higher in Italy and 1.8% higher in France (Figure 2b). It is not entirely surprising that the impact is strongest in Spain and Italy – the fact that these countries made particularly drastic cuts to actual public investment during the simulation period amplifies the shocks in the simulation. Finally, Figure 2d shows how the increase in public investment results in a lower unemployment rate

1 In the modified NiGEM model, the original NIESR model was adjusted to reflect up-to-date empirical estimates, particularly with regard to the import and labour market equations. See Behrend et al. (2019) for a detailed description and derivation.

Macroeconomic indicators of the simulation of a Golden Rule simultaneously implemented for Germany, France, Italy and Spain



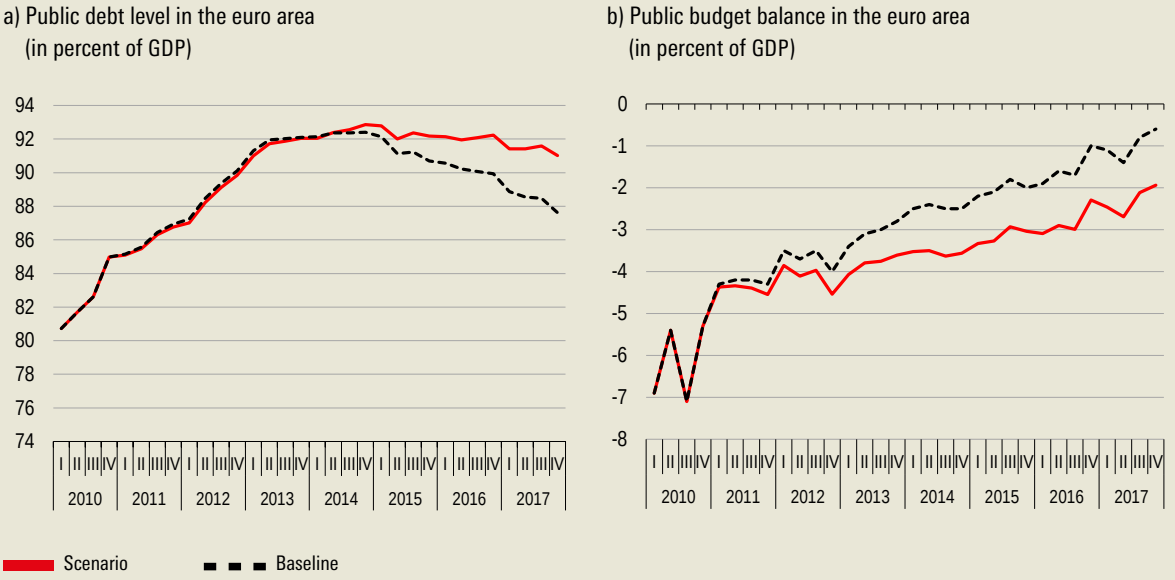
Source: Calculations by IMK using NiGEM.

in the euro area. Unemployment would not have risen above 12% in 2013 as it did in reality. On average, it would have been 0.5% lower than the actual figures.

Figure 3 shows the behaviour of the euro area's budget balance and public debt in the simulation. Both indicators improve in the simulation, as they also did in reality. However, the fiscal indicators improve more slowly than in the baseline scenario. The deficit only passes the 3% threshold at the end of 2016 in the simulation, compared to the beginning of 2014 in the baseline scenario. And although the debt-to-GDP ratio starts to fall in 2015 in both the simulation and in reality, the fall is somewhat less pronounced in the simulation. However, it is important to note that the specific way in which NiGEM models government expenditure practically rules out self-financing through investment. A greater improvement in the fiscal variables would therefore be expected in practice.

Figure 3

Fiscal policy implications of the Golden Rule for the euro area



Source: Calculations by IMK using NiGEM.

IMK

Adjusting the debt target to the new macroeconomic environment

Not least in view of the problems with the cyclical adjustment of budget balances, a reference value for the public debt-to-GDP ratio that is widely regarded as sustainable and viable would appear to be the least problematic basis for a fiscal rule, and is thus included in our proposals.[9] The ratio would continue to serve as an upper limit, providing a long-term target for countries whose debt-to-GDP ratio currently exceeds it. However, the reference ratio must be adjusted to reflect the major changes in the macroeconomic environment that have occurred since the adoption of the Maastricht Treaty.

Debt sustainability analyses are always subject to some uncertainty, especially with regard to future interest rate trends on the financial markets, the growth outlook and the political situation in the economies in question. Moreover, there is no academic consensus on the level above which higher government debt becomes problematic. However, some of the variables affecting the sustainability of government debt have changed so fundamentally since the adoption of the Maastricht Treaty that reviewing and adjusting the reference debt-to-GDP ratio has become a matter of basic economic sense.

The sustainability or stability of the public debt-to-GDP ratio is largely determined by the relationship between real interest rates and real GDP growth and by the primary government surplus (Infobox 3).[10] At the time when the Maastricht Treaty was adopted, the real interest rate in the euro area was higher than the real growth rate. To prevent national debt-to-GDP ratios from mushrooming, the Treaty therefore set the permissible debt-to-GDP ratio at what was considered to be a sustainable level (Priewe 2020).[11]

However, in the intervening years, the relationship between the real interest rate and real growth rate has been turned on its head (Infobox 3). The real GDP growth rate in the euro area has remained consistently above the real interest rate ever since the financial market crisis of 2008/09 (Blanchard et al. 2020). This change in the relationship between the

9 One possible alternative would be to replace it with a more comprehensive debt sustainability analysis carried out by the European Commission. The advantage of such an indicator is that it would potentially provide a more accurate reflection of the situation. However this needs to be set against the procedure's lack of transparency, a major drawback that makes it politically contentious.

10 The primary government surplus is the difference between revenue and expenditure (minus interest payments on government debt).

11 The 60% debt-to-GDP ratio limit was calculated on the basis of a long-term budget deficit of 3% of GDP, a stable inflation rate of 2% and long-term real GDP growth of 3%.

real interest rate and the real growth rate has major implications for debt sustainability analyses, since it means that a *higher* debt-to-GDP ratio is now sustainable over the long term, whatever the specified primary deficit (or primary surplus).

Blanchard et al. (2020) specifically show that if the real growth rate consistently remains 2-3% above the real interest rate, a primary government deficit of 2-3% of GDP will be sustainable over the longer term even with a debt-to-GDP ratio of 100%. Applied to the EU rules, this means that a debt-to-GDP ratio of 100% would be sustainable over the long term in a scenario with an actual budget deficit of 3% (Maastricht deficit rule), a long-term inflation rate of 2% (ECB target) and a long-term real GDP growth rate of 1% (Infobox 3). It can therefore be concluded that the 60% Maastricht debt-to-GDP ratio – which is even more unrealistic in the light of the coronavirus crisis – should be adjusted to reflect changes in the macroeconomic environment that have already existed for several years. Based on this analysis, we argue that the Maastricht ratio should at the very least be significantly increased and propose a pragmatic solution of a 90% public debt threshold, which includes a safety buffer for unforeseen crises.

Country-specific adjustment rules

Fundamentally, the expenditure rule should limit expenditure more strongly in those euro area countries whose debt-to-GDP ratio exceeds the target ratio to the greatest extent or that are considered to have the least sustainable debt levels. In other words, expenditure in countries that are a long way above the debt threshold should potentially be curbed more strongly than in countries that are only slightly over the threshold. Countries with debt-to-GDP ratios well below the upper limit should be allowed a correspondingly higher level of expenditure, as should countries that still have a high level of debt but where the debt-to-GDP ratio is already falling rapidly due to a substantial primary surplus. This would respond to calls for the rules to distinguish between more problematic and less problematic cases (European Commission 2020a, p. 18).

Accordingly, the rule should continue to take account of the economic situation of each member state and of the EU as a whole, ensuring that countries experiencing major crises do not have to curb their expenditure even more.[12] This would be facilitated by maintaining a general escape clause such as that already contained in the current fiscal rules.

12 In order to address the problems alluded to earlier in this report in connection with the procyclical bias of the current rules, we propose that a political determination of the seriousness of a member state's economic situation by the Eurogroup would be preferable to the use of specific indicators.

Infobox 3: Debt sustainability analysis in the new macroeconomic environment

If a country's debt is sustainable, this essentially means that it is in a position to service its (due) debt at all times. This requires the country to be both solvent and liquid. Liquidity is a short-term concept that refers to a government's ability to maintain access to financial markets whenever it does not have sufficient liquid assets. Solvency, on the other hand, is a longer-term concept which requires fulfilment of the government budget constraint (ECB 2017).

On the basis of the government budget constraint, this Infobox sets out the conditions under which a country can achieve long-term solvency and service its debt.[1] The debt-to-GDP ratio trend can be formally expressed as follows:

$$\mathbf{d}b(t)/\mathbf{d}t = [r(t) - y(t)]b(t) - p(t) \qquad (1)$$

where *b(t)* is the debt ratio, *r(t)* is the real interest rate, *y(t)* is the real GDP growth rate and *p(t)* is the

1 In practice, analysing a country's debt sustainability requires extensive data and is influenced by a wide range of factors from which it is necessary to abstract in this Infobox. For example, it is assumed that both long-term growth and long-term interest rates are not influenced by the primary deficit. More detailed analyses may be found e.g. in ECB (2017), Illing (1997), Ley (2010), Priewe (2020) and Wyplosz (2007).

primary balance of the government.[2] The debt ratio rises

- if the real interest rate is higher than the real GDP growth rate and
- if the government runs a primary deficit.

We define debt sustainability as a debt ratio b^* that is stable in the long run, formally expressed as:

$$b^* = p/(r - y) \qquad (2)$$

This equation shows that a country's debt sustainability ultimately depends on the future long-term level of its primary balance and the relationship between real interest rates and real growth. A higher primary balance and lower gap between real interest rates and real growth enables a higher debt ratio that is stable in the long run. It is also evident that a lengthy period in which real growth is higher than the real interest rate (r<y) allows the State to maintain a long-term primary deficit while still sustainably stabilising its debt ratio.

In order to provide a sense of what sustainable debt ratios that meet the conditions of Equation (2) might look like, Figure 4 plots real interest rates and real growth in Germany and the euro area since the early 1990s. At the time when the Maastricht Treaty was being drafted during the early 90s, real interest rates were still significantly higher than the real GDP growth rate. Since then, however, the gap between the two has closed almost continuously. Indeed, real interest rates in Germany have actually been lower than the real growth rate for the last ten years or so. As far as the debt sustainability analysis is concerned, and more specifically in terms of Equation (2), the narrowing of the gap between the interest and growth rates results in a significantly higher sustainable debt ratio for countries with a primary surplus. And in cases where the difference between the interest and growth rates is negative, even a long-term primary deficit still leads to a sustainable debt ratio.

Finally, using Equation (1) and the definition of the real interest rate as *(r(t)=i(t)-π(t))*, it is possible to derive a further relationship between the long-term debt ratio and the government deficit (including interest payments):

$$\begin{aligned} db(t)/dt &= [i(t) - \pi(t) - y(t)]b(t) - p(t) \\ &= [i(t) - \pi(t) - y(t)]b(t) - [\tau(t) - g(t)] \\ &= g(t) - \tau(t) + i(t)b(t) - [\pi(t) + y(t)]b(t) \\ &= d(t) - [\pi(t) + y(t)]b(t) \end{aligned}$$

where *d(t)* is the government budget deficit defined as the primary deficit plus interest payments *(g(t)-τ(t)+ i(t)b(t))* and *π(t)* is the inflation rate.

A debt ratio that is stable in the long run must now fulfil the following condition:

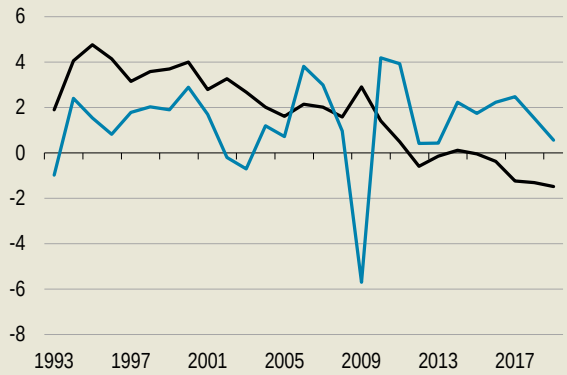
$$b^* = \frac{d}{\pi + y}. \qquad (3)$$

Assuming a real GDP growth rate of 1%, which corresponds to the euro area average since 2008, and a long-term inflation rate of 2% (ECB target), Equation (3) shows that a government deficit of 3% gives a long-term debt ratio of 100%.

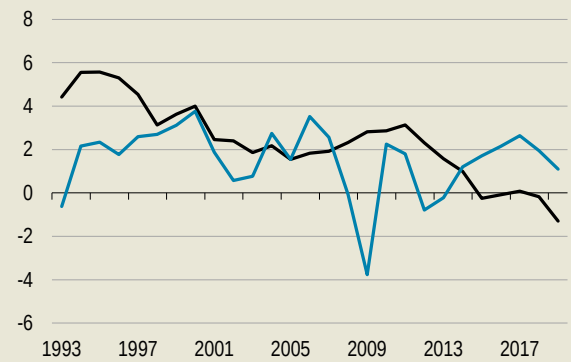
Figure 4

Real interest rate and real growth rate (in percent)

a) Germany



b) Euro area



Real interest rate (r)
Real growth rate (y)

1 Real interest rate for Germany: Current yield of public sector bonds minus rate of change of VPI; Real interest rate for the euro area (EA 12): GDP weighted and deflated with GDP deflator; Real growth for the euro area based on BNE data and likewise GDP weighted.

Sources: AMECO, Bundesbank, Federal Statistical Office of Germany, Calculations by IMK.

2 The primary balance, i.e. the difference between revenue and expenditure minus interest payments, is already expressed here as a ratio to GDP. Furthermore, we abstract from current revenue from money creation (Illing 1997 and Ley 2010).

REFORM OF THE MACROECONOMIC IMBALANCE PROCEDURE

In principle, the introduction of the Macroeconomic Imbalance Procedure (MIP) as part of the six-pack was an appropriate response to the lessons of the eurozone crisis. However, the MIP continues to suffer from a number of major weaknesses. These can be summarised under the three headings of asymmetry, excessive complexity and a lack of ownership of the policy recommendations made to member states on the basis of the MIP. Here, we propose a reform that would resolve these structural problems, allowing the MIP to perform its intended economic governance role. We also argue that the MIP should have a stronger preventive focus, transforming it into a macroeconomic *balance* procedure (European Commission 2016).

Symmetry

The first improvement would be to make the MIP symmetrical. This would require changes to its indicators and numerical targets.[13] Two of these indicators are particularly important. Firstly, the (three-year average) threshold for current account surpluses should be lowered from 6% to 4% in order to ensure symmetry with the deficit threshold of -4%. Since over a long period of time even these thresholds are indicative of a potentially serious imbalance between domestic supply and demand (Obstfeld 2017), it would be preferable to narrow the corridor to +/-3%.

It is also essential to modify the indicator for nominal unit labour costs, which currently only has an upper threshold (a three-year average of 9% for euro area countries and 12% for non-euro area countries). Nominal unit labour costs should be shown as (three-year average) annual rates. The upper and lower thresholds for the euro area countries should be set symmetrically either side of the ECB's inflation target. Experience during the period before the eurozone crisis suggests that values of 1% and 3% would be appropriate.[14]

Similar adjustments could also be implemented to make other indicators symmetrical, for example the net international investment position, which currently only has a lower threshold of -35% of GDP. However, our preferred option is to dispense with these indicators altogether.

A sharper focus

The number of indicators included in the scoreboard should, namely, be significantly streamlined in order to provide a sharper focus on the key goals and prevent a situation where the excessive number of policy recommendations jeopardises their implementation. If it proves impossible to reduce the number of indicators for political reasons, they should at least be clearly prioritised. To determine the order of priority, it is necessary to consider which variables can be directly influenced and which effectively influence developments in the currency union as a whole.

Unit labour costs are determined by nominal wages and productivity. On a balanced path, nominal wages should increase in line with productivity plus the ECB's inflation target (the golden rule of wage and price growth, Koll and Watt 2018, p. 14ff.). Unit labour costs are an important component of inflation, while prices are a key determinant of relative competitiveness among the euro area members. The GDP deflator is preferred to the HICP as an indicator, since the latter is influenced by external economic factors that are outside national control (notably oil and other raw material prices).[15]

The current account balance is a critical variable for net external debt and the main indicator of balanced macroeconomic development within the euro area. It is ultimately determined by the relationship between domestic supply and demand. Prices influence the current account balance through two channels – a quantity channel and a price channel. The quantity channel describes how the real interest rate (i.e. the nominal interest rate adjusted for inflation) influences all interest-sensitive macroeconomic aggregates, especially domestic demand. The price channel directly influences price competitiveness, i.e. the real effective exchange rate within the euro area.

In contrast to those described above, some of the other current scoreboard indicators are at best of secondary importance. If they are used at all, it should only be as a qualitative aid to interpretation. The real exchange rate indicator is, as far as the relationship between the euro area countries is concerned, is already covered by the monitoring of nominal unit labour costs and the HICP. Fluctuations in this indicator that are due to exchange rate movements vis-à-vis the rest of the world are outside the control of the member states. Consequently, it should not be used as a primary indicator. The same applies to the global export market

13 A detailed description of the MIP's scoreboard and other modalities is provided in European Commission (2016).

14 The MIP indicators are highly relevant for the direction of national economic policy in the euro area countries. Accordingly, the remainder of this section will focus on the euro area. Certain indicators could in some cases allow greater latitude for non-EMU countries. This would depend chiefly on whether and by when the country in question intends to join the euro.

15 Real unit labour costs calculated using the GDP deflator can also reveal shifts in functional income distribution (i.e. between labour and capital). These are important both from a distributional perspective and for assessing price and wage path sustainability (Watt 2017, pp. 61, 102).

share, while government debt as a percentage of GDP is already monitored through the fiscal rules. While the sectoral indicators (house prices, private sector debt and financial sector liabilities) are reciprocally connected to the real economic indicators, their main value is as guides to financial market supervision. They could thus be used as supplementary indicators to aid interpretation.

However, the three "social" indicators that were added to the scoreboard in 2015 (activity rate, long-term unemployment and youth unemployment) only serve to cloud the picture. Social matters are – quite rightly – addressed by other EU procedures, where they should potentially be given greater weight. We recommend the introduction of employment labour market indicator as a measure of domestic equilibrium and a leading indicator of wage and price trends. For this purpose, we favour the use of the unemployment rate (current level and year-on-year change) as a fundamentally uncontroversial yardstick. Although it requires interpretation, it is preferable to the NAIRU (non-accelerating inflation rate of unemployment), given the issues with this concept's implementation.

Table 2 presents an overview of our proposal for a reformed scoreboard based on the above observations. This scoreboard would ensure that the monitoring carried out by the European Semester focuses on outcomes that can be meaningfully influenced by the decisions of policymakers at member state level and that have significant external impacts on other euro area members and on the currency area as a whole.

Table 2

IMK Recommmendations for MIP-Scoreboard

Indicators	Upper limit	Lower limit
Nominal unit labour costs, three-year moving average	3%	1%
GDP deflator, three-year moving average	3%	1%
Current account balance, % GDP, three-year moving average	3%	-3%
Additional indicators	Forward-looking interpretation without threshold values	
Fiscal stance	Current and expected development of domestic demand	
Labour market indicators (level and annual change in the unemployment rate)	Current utilisation of productive capacity and inflation forecast	
Position of international net investment	To assess possible risks of current account development	
Financial market indicators (house prices, credit/liabilities in the private sector, liabilities of the financial sector)	To assess future risks	

Source: Description of IMK.

IMK

Increasing ownership through a reformed European Macroeconomic Dialogue

Symmetry and a sharper focus on relevant indicators that can be influenced by the member states are two key requirements for the third improvement to the functioning of the MIP: significantly increasing ownership. This will call for modest institutional reforms that can be accomplished by modifying existing institutions.

Unlike the fiscal rules, which are primarily and unequivocally aimed at national fiscal policy, it is not possible to attribute responsibility for compliance with the MIP rules to any single actor at national level. For instance, responsibility for countering the emergence of a bubble in a financial subsector would typically rest with specific supervisory authorities or the national central bank. On the other hand, the *social partners* play a key role in wage-setting, which has a direct impact on unit labour costs and an indirect but important influence on domestic prices. Nevertheless, as the actor to which the MIP policy recommendations are formally addressed, the State does have a range of instruments at its disposal to influence wages and prices. For example, it can reinforce or counteract general wage and price trends by adjusting the statutory minimum wage, public sector wages and prices and public procurement regulations, or through schemes that declare collective agreements binding on all firms in a sector. The number and effectiveness of the different measures vary significantly between the member states (for a detailed discussion, see Watt 2017, p. 79ff.).

However, the State's chief instrument for influencing the quantity and price components is national *fiscal policy*. An expansionary fiscal policy can, for example, reduce excessive current account surpluses and increase wage and price inflation via the Phillips curve relationship, further reducing the current account balance (Horn et al. 2017).

Accordingly, the symmetrical, anticyclical policy promoted by the proposed reform of the fiscal rules described in the previous section also supports the attainment of the MIP goals. As well as reducing disparities between domestic supply and demand, it curbs undershooting or overshooting of the inflation target. Both of these effects help to stabilise the economy as a whole and contribute to external equilibrium.[16]

Finally, *monetary policy* operates independently at the euro area level with the primary goal of price stability. However, insofar as the member states' wage and fiscal policy is geared towards stability, the TFEU states that monetary policy can and

16 See the key recommendation of the European Fiscal Board (2019) regarding the economic governance reform, which calls for the elimination of conflicts between the MIP and SGP so that they can mutually reinforce each other.

must support the general economic policies in the Union by ensuring that monetary conditions are as favourable as possible.

These and other external effects within the currency union mean that it is necessary to ensure coordination of and cooperation between the relevant policy actors.[17] A coherent joint approach – both between and within the national and euro area levels and between the economic policy instruments – is required in order to prevent macroeconomic imbalances and adopt and adhere to balanced, mutually consistent growth paths. Below, we propose a number of institutional reforms that are geared towards achieving this goal and reflect the interdependence of the actors.

The European Union's Macroeconomic Dialogue (MED), which has brought together monetary, fiscal and wage policy actors at EU level for over twenty years (Koll 2005), should be significantly strengthened and enhanced. In order to address the specific coordination requirements of the euro area countries, a MED for the euro area (Euro-MED) should be established and effectively incorporated into the European Semester. Its members would include the national finance ministers, the President of the ECB, and representatives of the Commission and the European trade unions and employers' associations. In addition, each euro area member state should establish an equivalent body at national level (MEDNAT), building on existing institutions as appropriate. These bodies could develop and build a political consensus in favour of national strategies[18] aimed at achieving a balanced growth path, thereby significantly increasing ownership among the member states (Koll and Watt 2019). The Euro-MED would perform a coordinating role, ensuring that the national strategies are consistent with each other and comply with the rules.

Groundwork for the MEDNATs could be carried out by national committees of experts, that could be developed out of the existing national councils for productivity.[19] These committees would draw up alternative, quantitatively supported economic development and policy scenarios for discussion by the policy actors in the MEDNAT. The existing European Fiscal Board could perform this function at the euro area level, although its remit would need to be expanded and its staffing increased accordingly.

By following this approach, it would be possible in almost all of the above cases to ensure the enhanced discussion and policymaking functions of a Macroeconomic Dialogue at both the euro area and member state levels by adapting existing institutions rather than creating new ones.[20]

SUMMARY AND CONCLUSIONS

The EU's fiscal rules and other areas of economic policy coordination in the currency union failed to prevent the emergence of a major crisis and to ensure that its consequences were adequately addressed by all the member states together. This situation is now being exacerbated by the coronavirus crisis and the challenges that it poses for the public finances. Once the pandemic is over, it will no longer be possible to use the rules in their current form. Measured against the criteria for an optimal fiscal policy, the highly destabilising, procyclical implementation of the rules by policymakers is particularly problematic. Moreover, the rules are both excessively complex and insufficiently flexible or discriminating to meet the member states' different needs. Their lack of clarity and transparency tends to result in arbitrary implementation and in a lack of consequences for non-compliance. As far as economic governance is concerned, there is a lack of effective coordination between the national and euro area levels. Furthermore, most of the instruments are corrective rather than preventive. The fiscal rules in particular are unsuitable for achieving the necessary combination of short-term stabilisation and long-term sustainability.

Several institutions, including the IMK, have put forward various proposals to address these problems. At the beginning of this year, the European Commission carried out a general review of economic governance in connection with the six-pack and two-pack. Based on the review's findings, it produced an extensive list of questions about the required reforms and potential solutions (European Commission 2020). In this report, we provide answers to many of the questions raised by the Commission.

17 For instance, overheating of the housing market can be countered by using fiscal policy to reduce demand or through macroprudential measures that generally fall under the responsibility of the national central bank. In the event of excessive nominal wage growth, in countries with the appropriate institutional conditions it is better in economic terms to moderate nominal wage growth through "concerted action" by the social partners rather than through a restrictive fiscal policy and higher unemployment. Meanwhile, a combined fiscal and wage policy strategy can help if wages are not growing strongly enough (Horn et al. 2017; Pereira and Mojon 2019).

18 BIS economists Pereira and Mojon refer to "consensus packages" that are required to counter deflationary tendencies in the current situation (Pereira and Mojon 2019).

19 While these councils undoubtedly fulfil a useful role, they are primarily concerned with longer-term supply-side questions that are of limited relevance to macroeconomic coordination among the member states.

20 Koll and Watt (2018) provide an in-depth description of the conceptual and institutional framework and the specific details.

We recommend replacing the current fiscal rules with an expenditure rule, coupled with a Golden Rule for debt-financed public investment. This allows the automatic stabilisers to take full effect. The automatic stabilisers should be strengthened both nationally (Watt 2011) and transnationally, for instance through EU-wide reinsurance of national unemployment insurance systems. The necessary flexibility is ensured through a differentiated approach to the expenditure rule that reflects a country's debt sustainability. While a degree of flexibility is built into the existing rules, the implementation of these reforms would require legislative changes.

Given the importance of macroeconomic imbalances, a reform of the MIP is also required. The principal focus of our proposed reforms in this area is on symmetry in the MIP's design, thresholds and implementation, and on ensuring that its indicators are more sharply focussed on variables that can be influenced by policymakers. We also recommend greater involvement of the social partners due to their influence on wages and prices, since these play a key role in enabling sustainable, balanced economic growth both in the individual member states and throughout Europe as a whole. Successful coordination and cooperation with regard to monetary, fiscal and wage policy requires a consensus regarding the details of an effective strategy. A significantly enhanced Macroeconomic Dialogue can provide a platform for building such a consensus with the support of the relevant experts and provided that the independence of the economic policy actors is guaranteed. This will require the establishment of similar dialogue forums at national and euro area level, as called for in the Five Presidents' Report (Juncker et al. 2015).

Financial sanctions should not be used to enforce the reformed rules. Instead, incentives should be provided to ensure that the rules are complied with as closely as possible under the current circumstances. One possibility would be to promise payments through the EU's structural development programmes that will only be granted if the fiscal rules and the European Semester's economic policy recommendations are adhered to.

These reforms would allow the fiscal rules and the MIP to work together in a coherent, effective and preventive manner, since the fiscal rules' focus on symmetrical stabilisation is also consistent with the goals of the MIP. Conversely, the fiscal goals will be easier to achieve if a reformed MIP is able to nip macroeconomic imbalances in the bud. In this scenario, the role of the euro area level would be confined to ensuring an appropriate policy mix for the euro area as a whole and to subsidiary interventions designed to complement and balance the actions taken by the member states. Accordingly, the reforms of the fiscal rules and MIP must be fully integrated into the European Semester and coordinated with its other instruments.

The European Commission's economic governance review and the German presidency of the Council of the European Union in the second half of 2020 provide an ideal opportunity to adopt the proposals presented in this report as a basis for the implementation of pragmatic reforms.

Infobox 4: The economic policy measures taken by the EU in response to the coronavirus pandemic

In keeping with their respective mandates and responsibilities, the European institutions have already taken a range of measures to combat the economic impacts of the coronavirus crisis. At the time of writing, other measures are being finalised or are the subject of negotiations on the European Council, most recently and importantly the European Commission's proposal for a €750 bn Recovery Plan for Europe.

Already in mid-March the European Commission triggered the Stability and Growth Pact's general escape clause. The classification of the coronavirus crisis as an "unusual event outside the control of government" means that all member states are temporarily exempted from the constraints of the fiscal rules when formulating and implementing national policies to combat the pandemic and its economic impacts.

Similarly, the Commission acted swiftly to lift statutory restrictions on State aid that could prevent national governments from supporting businesses affected by the crisis. A "Temporary Framework" was created in order to accelerate the Commission's approval procedures for member states wishing to adopt national support measures (subsidies, guarantees, etc.).

These moves by the Commission created greater legal certainty and eliminated obstacles to the rapid provision by member state governments of financial support for businesses, including small and medium-sized enterprises (SMEs) and the self-employed. However, although both measures remove the immediate legal constraints, they do nothing to prevent the financial markets from imposing fiscal constraints. There is a danger that the increase in public debt as a result of the fiscal measures could

cause investors to demand higher risk premiums for government bonds. And interest rate spreads did indeed increase as the crisis escalated in Italy and Spain. A combination of monetary policy support and fiscal solidarity is required in order to mitigate the vicious circle of rising interest rates and debt servicing difficulties, with all the dangers that this entails.

In terms of monetary policy support, the ECB initially responded with a package comprising measures to support banks by offering more favourable terms for long-term refinancing operations (LTROs), the expansion of targeted longer-term refinancing operations (TLTROs) and an expansion of quantitative easing (QE). However, these measures were deemed insufficient to prevent an increase in government bond spreads. As a result, on 18 March the ECB announced a new scheme known as the Pandemic Emergency Purchase Programme (PEPP), which significantly expands the ECB's QE programme by €750 billion in 2020; in early June this was increased by a further €600 billion and the scheme extended to mid-2021. Bond buying can temporarily deviate from the ECB's capital key, enabling targeted support for the worst-affected countries.

With this measure, the ECB has taken a big step towards mitigating the immediate danger to individual countries' public finances from self-fulfilling prophecies. It should be stressed that this is a temporary measure and falls short of the ECB fully assuming the role of lender of last resort. It remains to be seen for how long and to what extent deviations from the capital key will be permitted. Moreover, if a country's credit rating is downgraded to below investment grade, it will have to apply to the ECB for a waiver such as that already granted to Greece. The recently reignited dispute between the ECB/ECJ and Germany's Federal Constitutional Court casts a further shadow over a European strategy that relies chiefly on monetary policy.

In view of the above, the only solution is to reduce the burden on the member states' national budgets by providing fiscal support at European level. However, the discussions concerning fiscal support have been held up by political disagreements.

The Commission initially announced that it intends to reprioritise certain budget items in order to provide support e.g. for SMEs. However, the extent of these funds is limited. The scope of the EU Solidarity Fund, which was created for natural disasters, could be extended to include the coronavirus crisis. However, less than €1 billion is currently available through this fund. The Commission proposed to make a much larger sum available (around €37 billion in total) by drawing on unused Cohesion Fund money. However, there are doubts about the extent to which this will actually enable additional expenditure and whether it will ease the burden on budgets where this is most urgently necessary.

The role of the European Investment Bank (EIB) has been strengthened with the establishment of a Pan-European Guarantee Fund on top of the €40 billion package announced in March. By providing €25 billion of extra guarantees, the member states will support an additional €200 billion of EIB lending. These loans will primarily be made available to SMEs.

A third element is the European Commission's proposed SURE programme (Temporary Support to Mitigate Unemployment Risks in an Emergency). Established to provide financial support for national short-time work schemes and other similar measures, the programme has a sizable budget of up to €100 million. The member states must only provide guarantees and are not required to provide capital upfront. Only subsidised loans are provided, not grants. This means that national debt burdens will only be reduced to the extent that the interest rates and terms of these loans are more favourable than on the bond market. For as long as the ECB is ready to keep yield spreads within narrow margins via PEPP and other measures, it is hard to see how the fiscal support provided by the improved credit terms can be macroeconomically significant.

Debate on the provision of fiscal support initially focused on the European Stability Mechanism (ESM), an intergovernmental institution founded after the euro crisis to help countries that have lost access to the financial markets to finance necessary public spending. As with the IMF, ESM loans are subject to conditionality and thus constrain national economic policy. This made using the ESM attractive to member states concerned about debt mutualisation, such as the Netherlands and Austria, but politically toxic in others.

Following tense negotiations, a compromise was struck making ESM crisis loans available to all euro area member states up to an amount of 2% of their GDP, without the usual conditionality. However, this new credit line (Pandemic Crisis Support) will only be available until the end of the Covid-19 crisis, without it being clear how this endpoint will be determined. It will also be restricted to financing of direct and indirect healthcare, cure and prevention costs. Yet such costs account for only a small percentage of the expected impacts on the public finances, most of which will result from the decline in economic output. Moreover, these fiscal effects will endure long beyond the end of the immediate public health crisis.

As in the case of the SURE programme, the expanded ESM facility will in principle do little more than offer low-interest loans in a situation where, thanks to the ECB, market access and interest rates are not the main problems. Moreover, the obligation to repay ESM loans will limit the options of future fiscal policy. Domestic political opposition and the prospect of being stigmatised on the financial markets mean that there is very little incentive for countries to take advantage of these loans.

Pressure grew for the EU to respond to the coronavirus crisis by making changes to its seven-year budget, known as the Multiannual Financial Framework (MFF). The EU budget is equivalent to approximately 1% of the European Union's GDP and has only a limited redistribution effect and a negligible impact in terms of stabilisation (Pasimeni and Riso 2016). Since the next MFF (for the period 2021-2027) is currently being negotiated, there is an opportunity to rethink and adapt it in the light of the current challenges. Policymakers have been discussing various proposals involving a significant temporary increase in the budget contributions, potentially to as much as 2% of GDP. This could also create space for the EU Commission to borrow on the markets and distribute funds, as grants or loans, to the individual member states. The joint debt would be serviced out of the EU budget. This would constitute an alternative to issuing joint bonds: there have been proposals for joint-and-several-liability coronabonds or recovery bonds in various shapes and forms (Dullien et al. 2020; Theobald and Tober 2020), but these have met with considerable political opposition.

The Spanish government took the lead with a proposed €1.5 trillion recovery fund that would be financed in this way.[1] On 18 May the French and German governments issued a joint proposal which included a €500 billion recovery fund providing grants to hard-hit countries (Bundesregierung 2020). Shortly after, on 27 May, the European Commission presented its recovery fund proposal, under the title Next Generation EU, which will be the basis for negotiations in the coming weeks (European Commission (2020c). The plan takes on board the substance of the Merkel-Macron statement, and embeds the recovery fund in the EU budget, which would be used as a guarantee to raise €750bn on financial markets. According to the proposal these funds will then be transferred (€500bn) or lent (€250bn) to Member States. The maximum funding available to each Member State is calculated as a function of population, GDP per capita and unemployment (rather than the shorter-run crisis impact. Spending is to be channelled using existing EU programs (such as structural and cohesion funds) and following national recovery plans drawn up by the member states and approved by the Commission. The disbursement is frontloaded to the period 2021-2024. Reimbursement is foreseen to begin in 2028 for a duration of 30 years. If the Commission will not have succeeded in obtaining additional own resources (such as a web tax, plastic tax, or carbon border levy), Member states will need to increase their contribution to the EU budget.

1 https://english.elpais.com/politics/2020-04-20/spain-proposes-a-15-trillion-coronavirus-recovery-fund-financed-through-perpetual-eu-debt.html

Evaluation

It appears that lessons have been learned from the eurozone crisis. The ECB reacted swiftly, massively increasing liquidity support and relaxing its bond purchasing rules. The European Commission has relaxed potentially restrictive rules and begun to mobilise resources at EU level to combat the immediate impacts of the Covid-19 crisis. However, almost all the support measures actually implemented come in the form of loans. In practice, any benefits for the countries in question will be mainly confined to the difference between the interest rates (and terms) of the loans made available through these different programmes and the conditions that they could have obtained on the financial markets. If the ECB's current measures go unchallenged, the actual level of support provided to countries through these loans will be relatively minor in macroeconomic terms. The measures serve to take the pressure off the ECB and supposedly demonstrate the member states' political will to take action. This makes it easier for the ECB to carry on with the same policies, which in the wake of the ruling by the German Constitutional Court is important.

However, the scale of the support implicit in the programmes that have been decided to date fails to come even close to what is needed to tackle the enormous challenges facing the member states.

European policymakers have now recognised that, given the severity of the current crisis, if lasting damage is to be averted it will be necessary to communitarise (part of) the additional public debt accumulated by the member states as a result of the coronavirus pandemic. The MFF-based proposals culminating in the Next Generation EU initiative of the EU Commission represent a major breakthrough for two reasons: first, they put in place a common macroeconomic stabilisation capacity; second, they establish the principle that this capacity is used according to need rather than to the size of contributions. While the Recovery Fund is explicitly conceived to be temporary, it can be used as blueprint for future discussions about a permanent Eurozone fiscal capacity.

The proposal is, however, still awaiting approval from the Council, which will need to be unanimous. Opposition is confined to a small and dwindling number of smaller member states, but some loss of ambition is to be expected in the final version accepted by member states.

What is still lacking is a genuinely European answer to the longer-run, intertwined challenges facing Europe. A major programme of EU-wide public investment in areas such as the transport infrastructure, power grids and decarbonisation programmes, and, not least, public health, as proposed in Creel et al 2020 , is needed to lead Europe out of the crisis and towards the Union's longer-run climate and other goal.

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Macroeconomic Policy Institute (IMK)
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Georg-Glock-Straße 18, 40474 Düsseldorf, Germany
Phone +49 (2 11) 77 78-31 2

imk-report@boeckler.de
http://www.imk-boeckler.de

Press contact
Rainer Jung, +49 (2 11) 77 78-15 0
rainer-jung@boeckler.de

Author contact
PD Dr. Sebastian Watzka, sebastian-watzka@boeckler.de

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