

Priewe, Jan

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# Searching for new fiscal rules in the euro area: a new proposal

Jan Priewe\*

Professor Emeritus of Economics, Hochschule für Technik und Wirtschaft Berlin – University of Applied Sciences, Germany

*While the European Union (EU) fiscal rules are suspended in the years 2020–2022, new rules are in the making and might be activated in 2023. If the old rules were used again, massive austerity would be required in the face of the strongly elevated level of public debt and the gap to the 60 per cent debt cap in the EU Treaty. A new proposal is suggested in this article which requires only small changes in the Treaty and/or the Fiscal Compact, but a strong overhaul in secondary law, that is, the Stability and Growth Pact. The key ideas are to use net interest payments, as a share of GDP, as the new metric for defining debt sustainability rather than gross public debt. This would allow the adjustment of the rules to changing monetary environments, especially interest-rate levels, and changing differentials between interest rates and growth rates. This way, much more fiscal space would be generated both for higher-debt and lower-debt member states and the entire euro area.*

**Keywords:** *fiscal policy, Stability and Growth Pact, public debt, fiscal deficits, monetary union, debt sustainability*

**JEL codes:** *E43, E62, H62, H6*

## 1 AT THE CROSSROADS

The euro area has a complex system of fiscal rules for member states (MSs), including an escape clause which can be activated in ‘exceptional circumstances’. The latter are defined by unusual events that impact public finances and are outside the control of government, or severe economic crises. Due to the COVID-19 pandemic the clause was activated for the years 2020, 2021, and 2022. There is widespread consensus that reactivating the rules in 2023 without changes is not advisable, due to the impact of the pandemic in MSs and independently from this due to massive but diverse critiques from academia, think tanks, supranational institutions like the IMF, and some policymakers in the European Union (EU) (see the overview in Priewe 2021a). It is feared that the old rules could trigger massive and long-standing fiscal austerity which would endanger the viability of the currency union and the currency itself. The COVID-19 crisis has led to a crossroad. A new proposal of the Commission is expected to be presented before the end of the year 2021, rumours say after the German general elections in autumn.

The COVID-19 crisis will raise the debt-to-GDP ratio in the euro area on average by 16 percentage points (p.p.) to above 100 per cent (2022), with a range of 11 p.p. in Germany and 28 p.p. in Spain (AMECO database with estimates from the EU

\* Email: jan.priewe@posteo.de.

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Commission). Three of the four large economies, altogether accounting for 75 per cent of the area's GDP, reach debt levels far above 100 per cent, with Italy on top (159 per cent), leaving aside Greece at 200 per cent. Only six small economies remain below the 60 per cent benchmark of the EU Treaty (TFEU). Due to the thrust of the pandemic the EU leaders agreed on a seven-year recovery programme (EU Commission 2021) by doubling the size of the traditionally small EU budget with a strong element of redistribution among MSs, a taboo before COVID-19. At first glance this move looks like the nucleus of a supranational treasury, although it started as a temporary emergency fix. Undoubtedly the extended budget has a bearing on fiscal rules. Is a true fiscal union *ante portas*?

This essay argues that the old fiscal policy rule set is on all counts outdated, and needs for the sake of the survival of the currency a deep overhaul, which is difficult to achieve since a Treaty change – primary EU law – is necessary, requiring unanimity of the 27 EU MSs. Without Treaty change, the scope for change by secondary EU law is narrow. Besides the TFEU, the Treaty on Stability, Coordination and Governance (TSCG henceforth, or FC for 'Fiscal Compact') in the Economic and Monetary Union needs fundamental change too, an inter-governmental treaty of almost all MSs outside EU primary law which was transferred into national basic law; in a few MSs (among them Germany) change requires a two-thirds majority in national parliaments. The gap between economic challenges and the institutional constraints seems unbridgeable.

In what follows, a proposal for fiscal reform is presented that requires only small Treaty changes but allows much more leeway for fiscal policy in the euro area, both for high-debt and low-debt MSs. Before this is done in Section 3, I recall in Section 2 the core fiscal rules that exist in the EU and hint briefly at their shortcomings. Due to space limits, other proposals cannot be discussed here (see Priewe 2021a; 2021b). Section 4 concludes.

## 2 THE PRESENT RULE SET

The euro area is built on the premise that a common currency with a common central bank is established without a common fiscal policy including a treasury, hence without a federal state. This means that the MSs remain, in principle, nation states with national fiscal sovereignty but with a national central bank that has morphed into a subsidiary of the European Central Bank (ECB). This implies that national sovereign bonds are no longer as safe as they were before the inception of the currency union, in contrast to other advanced OECD countries with central governments' public debt in their own currency. There, state insolvency due to illiquidity is virtually impossible and has occurred nowhere after World War II. The only exceptions are EU MSs Greece and Cyprus. In the euro area, there is no central bank that is capable and has a mandate to stabilize the value of a MS's sovereign bonds which is key for liquidity provision and the functioning of the entire national financial system. Since such a system is inherently at risk, common rules for national fiscal policy are indispensable. MSs have the ECB as an incomplete substitute for their former sovereign central banks. The system resembles more a currency board or the Gold Standard than a federal state with a common currency. The fiscal rules undermine national fiscal sovereignty so that MSs resemble, with respect to fiscal policy, regional or provincial states with strongly narrowed fiscal space because of their subordination to national treasuries. This peculiarity of the currency union exposes sovereign bonds of MSs more than elsewhere and more than before the advent of the euro to the behaviour of bondholders, thus creating systemic vulnerability.

The key fiscal rules are summarized in Table 1. Only a few originate in the EU Treaty, but are summarized in the Stability and Growth Pact (SGP), set in force in 1997, reformed

*Table 1 Key fiscal rules in the European Economic and Monetary Union*

No	Rule	Source
1	3% cap on headline fiscal deficits, including sanctions	TFEU, Protocol 12
2	60% cap on public debt, as a share of GDP (including a broad uniform demarcation of state entities)	TFEU, Protocol 12
	‘Debt Brakes’ at 60%, anchored in national basic law	TSCG, national law
3	Maximum structural deficit 0.5% if debt is at 60%	TSCG, SGP
4	Maximum structural deficit 1.0% if debt is ‘significantly below 60%’	TSCG, SGP
5	1/20th rule: debt ratio above 60% minus 60 shall be reduced by 5% p.a.	TSCG, SGP
6	Country-specific medium-term budgetary objective (MTO, regarding structural balance) is defined by a matrix depending on output gap	SGP
7	Adjusted primary expenditure must not rise faster than potential output, less with high debt (expenditure benchmark)	SGP
8	Methodology for measuring potential output and structural balances defined by Commission (Production Function Approach)	SGP
9	Cyclical balances without one-off measures permitted as automatic stabilizers, discretionary cyclical stimulus prohibited, except in severe recession	SGP
10	Procedural rules for European Semester and Excessive Deficit Procedure	SGP
11	Flexibility clauses in SGP related to investment and structural reforms	SGP
12	Two escape clauses (suspension of main rules)	TSCG, SGP
13	No-bail-out clause in Article 125 TFEU	TFEU
14	European Stability Mechanism (special financial support for MSs under conditionalities)	Treaty on ESM
15	Prohibition of ‘monetary financing’ of MSs, defined by European Court of Justice	TFEU
16	Collateral accepted by ECB for liquidity provision must be rated investment grade or better by defined rating agencies	ECB

in 2005 (since then, with a focus on structural rather than headline budget balances) and 2011 with the Six-Pack and Two-Pack legislation (EU Commission 2019). The cornerstones are condensed in the Fiscal Compact (2013) which functions as a bridge to national law by the commitment to institute national ‘debt brakes’. The complex rule set is a permanent construction point, much like cathedrals in the middle ages (Blanchard et al. 2020).

The backbone of the rule set is the ‘sound finance’ philosophy, using the guiding principles of close-to-balance structural budgets, combined with debt and deficit caps. The latter twin rules converge – on the assumption of a 3 per cent nominal growth trend – to debt ratios of 33 per cent in all MSs. This implies, together with the 1/20th rule, an inherent contractionary bias of the rule set which includes leaning to pro-cyclicality or limited counter-cyclicality. All five of the cap-numbers – 3 per cent, 60 per cent, 0.5 per cent, 1.0 per cent and 1/20th (numbers 1–5 in Table 1) – are arbitrary and non-coherent. They pretend to guarantee ‘fiscal sustainability’, a concept without sound economic justification (cf. Priewe 2020a; 2020b).

The tragic irony of the concept is: it doesn't work in line with the intentions. The paradox of saving, applied to public finances, induces self-defeating austerity, thus 'unsound finance', and divergence of indebtedness among members to the detriment of MSs with high legacy debt. The flipside is that the fiscal space of high-debt countries is limited by the rules and in lower-debt countries it is not sufficiently used. Thus, public investment tends to be crowded out by the debt brakes, structural change is subdued, and green and digital innovations are impeded. Monetary policy is overburdened if compelled to take over, in part, fiscal policy functions. Furthermore, discontent with the European economic performance – falling back compared to the US and China, not to mention from huge employment problems – is growing, giving rise to nationalist and anti-European sentiments. European integration is at risk of tipping over into disintegration. The challenge of the COVID-19 pandemic is the litmus test for the cohesion of Europe and for using the junction for change.

### 3 A NEW PROPOSAL

The basic idea of the proposal is allowing more fiscal space for all MSs irrespective of their level of public debt, to be used both for counter-cyclical fiscal policy and for permanent debt-financed expenditure, without jeopardizing debt sustainability in the sense of the capability to pay interest on debt and facilitate the smooth roll-over of maturing debt. It is accepted here that for the time being there is no European Treasury or a relevant capacity to issue debt and that monetary financing of debt in the prevailing legal definition (mainly Article 123 TFEU and the judgements of the European Court of Justice (ECJ) in this regard)<sup>1</sup> is given as a constraint. Therefore, more non-inflationary fiscal leeway of MSs, without fine-tuning, should unburden monetary policy as the 'the only game in town'. The implicit assumption in the present fiscal framework that fiscal sustainability requires interest rates on debt ( $r$ ) exceeding nominal growth of GDP ( $g$ ) is dropped,<sup>2</sup> as is the assumption that 60 per cent is a proper threshold for maintaining state solvency. Furthermore, national fiscal policy shall be better linked to the prevention of macro-economic imbalances, addressed – unsatisfactorily – in the 'Macroeconomic Imbalance Procedure' (MIP) of the EU.

As many critics have emphasized, there should be one debt-anchor rule, one or two operational rules, and an escape clause for special circumstances – instead of a lengthy handbook of rules and codes of conduct. Furthermore, all rules should not be almost unchangeable like quasi-eternal laws, hence legally anchored either in primary law with the option of qualified majority voting or in secondary EU law, that is, directives and regulations.

The proposal has six components:

- a new debt anchor with a new concept of debt sustainability;
- adjusting the rules to different  $r - g$  differentials;

1. Article 123 TFEU prohibits direct purchases of debt instruments from national governments. The term 'monetary financing' is not used in the Treaty. The ECJ made judgements on legal actions regarding direct purchases of sovereign securities in the case of two asset-purchase programmes (OMT and the PSPP) of the ECB. In these rulings, restrictions for secondary market purchases of the ECB were clarified.

2. The conventional assumption is that  $g > r$  leads to Ponzi games, which contradict the notion of inter-temporal budget constraints and debt sustainability (cf. Prieue 2020a: 22–30). Authors from the ECB hold that the average or 'normal'  $r - g$  differential in OECD countries is around –1 p.p. (Checherita-Westphal 2019), including Blanchard et al. (1991), but in clear contrast to Blanchard (2019).

- targeting the primary balance, not the structural budget balance;
- reforming the definition of the cyclical component;
- an accommodating monetary policy; and
- a central fiscal capacity in the EU or the eurozone.

The components will be explained step by step.

### 3.1 Debt anchor and sustainability of national debt

In the present fiscal framework, gross debt was chosen as the metric for debt sustainability with the 60 per cent threshold. If one understands this as the ability of the state to carry debt, then it is about the permanent ability to finance debt servicing, that is, to pay interest and repayments, the latter normally being a roll-over of old debt. *Ergo*, sustainability is also dependent on the interest rate on national debt, and of course also on the denominator, that is, economic growth. Without the interest rate and without the relation between  $g$  and  $r$ , one cannot seriously talk about debt sustainability. There is neither a reliable threshold for public debt nor a line of optimal debt. For this reason, the interest-burden ratio, that is, the average ('implicit') nominal interest rate on public debt multiplied by the public-debt-to-GDP ratio, is a better metric (see also Furman/Summers 2020), if ever rising debt relative to GDP is ruled out, which is only imaginable if debt is held entirely by the central bank. Here an alarm line, not a precise cap, is proposed when the interest burden reaches 3 per cent of GDP.<sup>3</sup>

The debt-burden indicator should be a forecast. It has to include a forecast of debt, GDP growth and interest rates. If government expenditures in the MSs of the EU were 40 to 50 per cent of GDP, an interest-burden ratio of 3 per cent of GDP corresponds to an interest-expenditure ratio between 6.0 and 7.5 per cent, which – measured against the past – is considered difficult, but can still be seen as acceptable if one excludes tax increases or primary expenditure cuts and also excludes retiring bonds by central-bank purchases with permanent roll-over (more on this below). The interest-burden ratio may be higher in episodes with high demand for public goods, especially infrastructure, and lower in other periods. A higher interest-payment burden does not necessarily imply higher interest spreads or even state insolvency, but reallocation in the budget or tax increases without distorting side effects may become more difficult. If interest rates were a stable variable, a kind of Wicksellian natural rate that is normal in the long term, the sole focus on the debt ratio could be justified. Even believers in natural rates, however, do not believe that they are stable. Since the implicit interest rate on government debt is an average rate for old and new vintages of government bonds, it changes only slowly, even when there are sudden changes in the bond yields of new issues. At least for the medium term,  $r$  appears to be predictable, and monetary policy is doing everything it can to build and maintain stable expectations ('forward guidance'). Even if interest-rate hikes due to tightening monetary policy occur, the effect on the implicit interest rate is limited and most likely the nominal GDP growth rate rises more or less at the same rate due to inflation, so that changes in the  $r - g$  differential are small and temporary.

3. Italy recorded the historically highest gross interest burden in 1995 with 11.1 per cent of GDP or 21.5 per cent (*sic!*) of total government spending, with an implicit interest rate of 10.3 per cent (inflation at 5.4 per cent). After reunification, Germany had the highest interest burden after World War II with 3.5 per cent in 1995 at an average interest rate of 6.4 per cent (1996). In the US the gross interest burden peaked in the early 1980s and early 1990s at 4.3 per cent, if the average of short-term and long-term rates is used as a proxy for the implicit rate (cf. Prieue 2020b: 421).

Monetary policy dominance is not undermined by high sovereign debt as long as the possibility of debt roll-over is not disturbed.

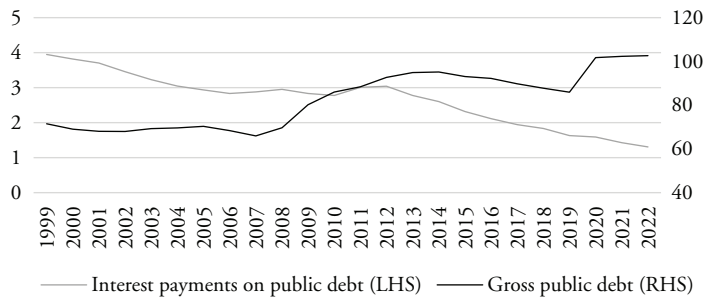
To be more precise, the *net interest burden* should serve as the new sustainability indicator, including revenues from taxing coupons or transfers of interest revenues from the central bank to the treasuries if sovereign bonds are owned by the central bank (there is only scant and not always comparable information on tax revenues from interest payments, so the data shown in the following focus on the gross interest burden).

Jumping now into reality for a moment, a comparison of gross debt and the interest burden in the eurozone shows how misleading the debt ratio can be (Figure 1). Although gross debt in the euro area reached record levels in 2020, the interest burden has never been so low in all MSs; besides, the figure shows that the interest-burden line moves smoothly (even in countries like Greece with extreme temporary spikes). If, in the absence of reliable and comparable data, one takes the gross interest burden, it can be seen for 2020 that only Italy and Greece had to bear an interest-burden ratio above 3 per cent (3.6 per cent and 3.1 per cent respectively). The average interest burden of the 19 MSs of the euro area was only 1.6 per cent, tending further downwards in the next few years.

Critics from ‘modern monetary theory’ (MMT) might reject the new metric, since they claim that interest payments can be controlled by monetary and/or fiscal policy in three ways (cf. Kelton 2020, representative for many others): nominal interest rates can indeed be lowered or reduced to zero by conventional monetary policy (following standard post-Keynesian assumptions), at the short end with repercussions at the long end if exchange-rate effects are ignored; under quantitative easing (QE), the central-bank purchases bonds and recycles the interest directly to the treasury (furthermore, less interest is paid on required bank reserves which are remunerated with the main refinancing rate, which is below the long-term bonds rate); and additional interest payments can be paid by incurring more debt since *any* concept of debt sustainability is rejected if limitless public debt is considered possible. Japan’s high debt is often seen as a key witness for this monetary–fiscal policy mix. Assuming this can be done similarly elsewhere irrespective of institutional differences,<sup>4</sup> the concept – in Japan not a free choice but an emergency due to deflation – has several downsides: exit from the zero lower bound is extremely difficult; it is monetization of debt *ex post*, if done via purchasing bonds on secondary markets, which are *de facto* prohibited in the EU beyond one-third of a MS’s bonds and also restricted by other criteria;<sup>5</sup> it is more or less abandoning monetary policy and replacing it by – or subordinating it under – fiscal policy; wealth owners lose interest-bearing net wealth and are forced to hold instead domestic currency cash or to shift to foreign assets, inducing a chronic current-account surplus; and persistent zero interest rates induce carry trade and strengthen asset-price inflation. In certain circumstances this may be acceptable, as well as direct monetary financing, but it is not a blueprint for a long-standing optimal policy mix. Actually, it is again ‘the only game in town’. Yet the proposal made here – with its focus on *net* interest payments – does not exclude the option that the ECB purchases sovereign bonds and takes them away from

4. The institutional setting of the ECB differs significantly from the Federal Reserve (Fed) and other leading central banks (cf. Bodea/Huemer 2010). So-called monetary financing is more restrictively defined in the ECB Statute (part of the EU treaties) and by the ECJ. In contrast, in the US constitution, monetary financing depends in the end on Congress; there is no dual mandate to the ECB as assigned to the Fed; central-bank independence is ‘independence within the government’ in the US, while the ECB faces strong restrictions on the fiscal agent function for government finance, not least due to the absence of a central government; and there is a strict separation of the payment system from government finances.

5. Cf. the restrictions in the PSPP programme in the face of fearing further legal conflicts (ECB 2020; ECJ 2018).



Source: AMECO (22 March 2021), estimates from EU Commission for 2020–2022.

Figure 1 Gross public debt and gross interest payments on debt in the euro area (percentage of GDP)

the market. But the new rule proposed here does not rely on this remedy for high-debt countries.

### 3.2 Operational rules adjusted to $r - g$ differentials

Using the interest burden as the anchor for public debt allows us to assess the impact of different constellations of  $r$  and  $g$ . Regimes  $r < g$  make primary deficits possible if the prevailing debt ratio remains stable, following the well-known and broadly accepted Domar equation.<sup>6</sup> It is like a tailwind for the speed of an aeroplane as it has inherent expansionary effects. Even in  $r = g$  regimes or only a slight excess of  $r$  over  $g$ , the burden of public debt is mitigated compared to a permanent  $r > g$  as stipulated in the EU rulebook when it comes to setting the country-specific medium-term objectives (MTOs). Constellations of  $r < g$  are considered Ponzi-financing and incompatible with debt sustainability (cf. for Blanchard et al. 1991 it was a rare ‘theoretical curiosum’; Priewe 2020a: 64–70). Significant continuous primary surpluses in the case of  $r > g$  tend to be fiscal austerity with contractionary demand and supply-side effects, unless compensated by expansionary counter-effects.

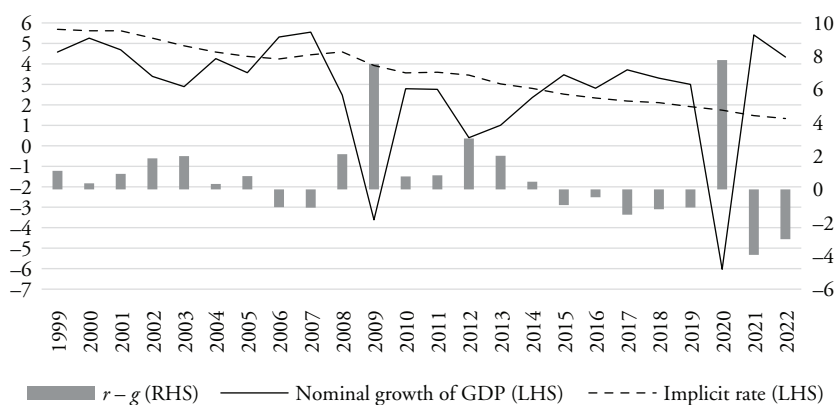
Since a forward-looking approach is necessary, medium-term forecasts for  $r$  and  $g$  are needed, with subsequently adjusted prescriptions for primary balances.<sup>7</sup> If the  $r - g$  differential changes, policy changes are advised which should be made for the medium term.

Figure 2 shows the  $r$  and  $g$  performance for the euro area, and Figure 3 shows that the nominal long-term interest rates (yields), which feed bit-by-bit into the implicit interest rates, have tended to decline since the early 1980s, both in the US and in Germany (representing euro-area countries). Lee/Werner (2018) had shown that in the five major advanced countries nominal growth rates and interest rates move by and large in tandem over half a century, with growth in a lead position and interest rates in a follower position.

6. According to Domar (1944), the change of debt–GDP ratio  $b$  against the previous period depends on the growth-adjusted interest rate  $(r - g)$  multiplied by the debt ratio of the previous period, and the primary balance  $p$ :  $b_t - b_{t-1} = \frac{r-g}{1+g} b_{t-1} - p_t$ . If  $r > g$ , a primary surplus is needed to keep the debt ratio stable, and vice versa for  $r < g$ .

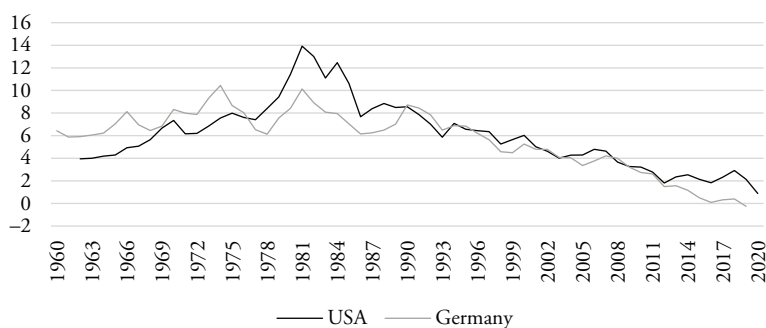
7. The  $r - g$  differential in the euro area (before the COVID-19 crisis in which  $g$  plummeted), especially in Germany, must not be seen as the new normal, since it involves negative real interest rates, at the short and the long end, with negative side effects; it reflects insufficiently expansionary fiscal policy and a problematic policy mix.





Source: AMECO (17 March 2021), EU Commission estimates for 2020–2022.

Figure 2 Implicit gross interest rate ( $r$ ) and nominal growth rates of GDP ( $g$ )



Source: FRED (17 December 2020).

Figure 3 Yields of ten-year sovereign bonds 1960–2020, USA and Germany

This does not exclude different  $r$  and  $g$  constellations in certain episodes or amongst countries. Therefore, it is unlikely that the erstwhile high interest rates might return if now-reduced growth is expected, compared to previous times. The implicit interest rates in the euro area stood at almost 6 per cent at the inception of the euro, and the long-term bond yields at the time were around 5 per cent. When the Maastricht Treaty was signed (in 1992), the monetary environment for fiscal policy was light years away from the early 2020s.

Historically, there have been numerous episodes under the regime  $g > r$  (see Blanchard 2019 for the USA; generally Barro 2020; historically Eichengreen et al. 2019; Mauro/Zhou 2020; Priewe 2021a). Yet the historical (unweighted) average of the  $r - g$  differential of 36 OECD countries may have been +1 p.p., as Checherita-Westphal (2019) from ECB holds, but 28 of them are EU members with an unfavourable constellation compared to the US. Without analysing the determinants of government bond yields here, it is sufficient in this context to assume that  $r$  can be foreseen in the medium term with an acceptable margin of uncertainty and that  $r > g$  constellations should not be excluded in the

future. Furthermore,  $r$  and  $g$  should not be dealt with as exogenous givens. Both can be influenced by monetary as well as fiscal policy, apart from other growth-enhancing policies. It is worth noting that growing out of debt does not require permanently high growth; a certain period may suffice. The real growth rate is not the critical variable; what matters is the nominal growth rate relative to nominal interest rates.

Improving the  $r - g$  differential can be facilitated by various policies, whereby the volatility of  $g$  and the presence of recessions play the key role. Suitable policy measures are, among others, reducing country-specific risk premia in MSs, for instance by making all sovereign bonds safe or nearly safe; unifying the euro-area bond markets and promoting the internationalization of the euro with stronger external demand for euro-denominated securities; making extreme monetary tightening unnecessary for inflation control by easing wage-profit conflicts or by income policy; avoiding deflation pre-emptively; improving counter-cyclical fiscal policy and bolstering productive public investment (or innovations not classified as investment) by deficit-financing. A higher degree of financial stability in the eurozone would lower the average interest rate over the long term. More resilience in periods of high uncertainty could reduce vulnerability to adverse shocks. Better protection against asymmetric shocks helps especially in weaker MSs. All this can help to generate and exploit  $g > r$  constellations, even if outright 'repressed finance' by administrative interest-rate caps or monetary policy with QE are excluded.

### 3.3 Primary, not structural, balances should become the main operational rule

As mentioned, the Fiscal Compact and the SGP (after the reform in 2005) use structural budget balance caps of  $-0.5$  per cent and  $-1.0$  per cent, respectively, and for countries with debts above 60 per cent MTOs of zero or higher when applying the 1/20 rule. However, structural budget balances – that is, cyclically adjusted deficits and surpluses – are only relevant for counter-cyclical budgeting, not for changes in the debt level. The change of the debt *level* depends on the primary balance, following the Domar equation. The difference between the structural balance ( $h_{st}$ ) and the (structural) primary balance ( $p_{st}$ ) is the interest-burden ratio  $z_t$  in year  $t$ , which is the product of the implicit interest rate  $r$  and the debt ratio  $b$ :  $p_{st} = h_{st} + z_t$  and  $z_t = rb_{t-1}$ .

The focus on the primary balance rather than the structural balance is important for the following reasons: (i) a small structural budget deficit or surplus does not necessarily lower or keep the current debt level stable; (ii) the structural balance can only partially be changed by fiscal policy because the interest burden  $z$  – usually the greater part of the structural balance in the case of high debt levels – is given by  $r$  and can only be influenced in the longer term by monetary policy (apart from a few measures mentioned above which are more of a structural nature); (iii) the primary balance expresses the actual fiscal room for manoeuvre of policy-makers; and (iv) the primary balance takes into account the ratio of  $r$  and  $g$ , while the structural balance ignores it. In the following, for the sake of simplicity, it is assumed that the cyclical component of the headline budget balance  $b$  is zero, so that cyclical deficits and surpluses balance out in the long term. Likewise,  $p$  is defined as the cyclically adjusted longer-term primary balance. In actual business cycles, however, cyclical surpluses are often smaller than cyclical deficits (see below).

Choosing the primary balance as the operational variable can be explained best in an example. What is the present rule for a country with a 150 per cent debt load, 90 p.p. above 60 per cent? In principle, strictly following the rules, the structural balance required is a 4.0 per cent surplus ( $-0.5$  per cent +  $90 \times 1/20$ ). Assuming the interest rate on debt is 2.0 per cent, the interest burden would be 3.0 per cent of GDP ( $1.5 \times 0.02$ ). The primary balance would then be a 7.0 per cent surplus ( $4 + 3$  per cent)! Since the economy would

likely collapse, one or more rules of the game must be breached, for instance the adjustment period could be extended from 20 to 50 years, as proposed – as an option – by the European Fiscal Board (EFB 2020). Even then, primary surpluses in the order of 3 per cent would be required over an extended period, despite the fact that the prospective growth may be 3 per cent (1 per cent plus target inflation) and  $r - g = -1$ ; hence, a continuous primary deficit of 1.5 per cent could sustain the given debt level (following the Domar equation). Any primary balance above  $-1.5$  per cent would lower the debt level, given the  $r - g$  difference of  $-1$ . Of course, the flipside is a very long debt reduction period. But does it matter whether it is 50 years or 70 or 100? What is more important is that the debt service would be tenable. If  $r - g$  shifts to zero, any primary balance slightly above zero would move the debt level downward.

However, the interest burden would shift to 4.5 per cent, if  $r$  leaps from 2 to 3 per cent, but instead of a leap, a gradual crawl upward is more likely. The downside would also apply to the present rule, but would be aggravated by the high primary surplus. To cope with the 4.5 per cent interest burden, special country-specific measures are needed, such as reducing the interest burden by central-bank purchases of national bonds, debt relief, special taxes on coupons – or decisions to carry the higher interest load for a certain period with a special tax.

Using the new rule for countries with debt close to 60 per cent – say the Netherlands or Germany – and an  $r - g$  differential of  $2 - 3 = -1$  would allow a continuous primary deficit of 0.6 per cent and a continuous structural balance of  $-1.8$  per cent. If the debt ratio of 60 per cent were frozen, debt service would only be 1.2 per cent and there would be much more fiscal space than under the present rule. These MSs might also choose a higher debt and interest burden than 60 per cent with more room for deficit financing. The present rule would require – irrespective of the  $r - g$  constellation, hence irrespective of the monetary conditions – a cap on the structural balance of 0.5 or 1.0 per cent and a primary surplus of 0.7 or 0.2 per cent, respectively. The surplus is needed to arrive at a hidden debt target of 33 per cent, as explained above. Of course, the fiscal space for public investment would be small, except by raising taxes or cutting expenditure.

On all counts, the new rule delivers more fiscal space, but does not solve all problems. Very high debt remains a burden, especially the combination of high debt and  $r > g$  constellations. What is needed for implementing the new rules is the suspension of the 1/20th rule and the 60 per cent cap for the debt level. Actually, the 1/20th rule has already undermined the 60 per cent threshold, since running debt for 20 years above 60 per cent implies that this debt is not actually linked to the risk of insolvency. Since the speed for approaching 60 per cent is not mentioned in the TFEU, only in the SGP and the FC, it is not a breach of primary EU law.

The focus on the primary balance and the  $r - g$  differential does not contain an explicit *golden rule* for public investment. However, there is an *implicit* golden rule, which is even better than the explicit rule. The latter needs to define investment and earmarks certain budget categories to special financing. In the proposal shown here, all object-oriented deficit rules are overcome. What counts is the budget as a whole. Structuring taxation and expenditure in a way that supports growth, employment and structural change is an imperative underlined by Evsay Domar time and again (Domar 1993).

### 3.4 Reform of the definition of the cyclical component

Since the empirical observation of potential output and thus the output gap as well as structural budget balances is not possible, it needs to be estimated using a considerable

number of assumptions (cf. Heimberger et al. 2020). In order to circumvent the present measurement based on the neoclassical production function approach, many authors, including the EFB, propose an expenditure rule (EFB 2019). In principle, it exists already in the present rule set (No 7 in Table 1).

A modified expenditure rule may be more advantageous. According to this, primary expenditure without cyclical components (in particular unemployment benefits) should grow in tandem with the expected medium-term growth of potential output (with prices corresponding to target inflation). The idea is that the growth rate of potential output involves fewer measurement errors than the absolute value of potential output. Critical is the use of the expenditure rule in upswing phases when inflation is below target. If potential output is underestimated and the fiscal stance switches to contraction mode, there is a risk that the economy will break off prematurely. With falling unemployment and wage pressure, inflationary risks are feared, although these symptoms are not – or not yet – visible. A backward-looking estimation of potential output growth, taken as the growth trend, could reinforce a poor growth performance in the future and contribute to hysteresis. One should not use a schematic expenditure rule like an econometric robot, but allow discretionary decision-making, similar to monetary policy. Looking only at the automatic stabilizers in recessions and upswings tends to underestimate cyclical deficits and surpluses. The possibilities of discretionary fiscal policy based on the motto ‘timely, targeted and temporary’ would be excluded (cf. IMF 2008; Oberhauser 1985; 1996). At best, automatic stabilizers compensate only for fluctuations in aggregate demand from taxes and unemployment benefits, but not for those that come from the corporate sector. It is not understandable that discretionary fiscal policy should only come into play in severe recessions, although there may be high unemployment without the risk of inflation beyond target in other times. In this way, more national fiscal leeway can be generated, which has an important complementary function to monetary policy which is applied uniformly in the euro area. Such modified expenditure rules would support growth and employment and thus reduce the  $r - g$  difference. This way, the combination of automatic stabilizers and discretionary fiscal policy can relieve monetary policy and improve the policy mix between monetary and fiscal policy.

Most other proposals for expenditure rules include a rule for high-debt MSs which are required to let primary expenditure grow at a rate below potential output (EFB 2019). This would aggravate austerity since it implies that primary balances grow year-by-year. It would likely end up in self-defeating austerity (cf. the critique in Priewe 2021a: 25–26).

With high debt levels, structural budget deficits, capable of stabilizing the debt level, are much higher than with low debt levels (cf. the Domar equation); and they would be higher in the reform proposal than under the current rules which let debt converge to 33 per cent, as mentioned. If cyclical deficits of the size of around 3 p.p. are required on top of structural deficits, the 3 per cent reference value of the EU Treaty would be too narrow. Hence, in the reform proposal, temporary cyclical deviations beyond 3 per cent should be allowed in the secondary European legislation.

### 3.5 Accommodating monetary policy and the monetary–fiscal policy mix

The proposed new set of rules needs flank protection by monetary policy, which must take into account both the increased debt levels and the increasing polarization and divergence between the MSs. Because it is not known how the capital markets will react to higher debt levels and because they are already prone to cyclical, often late and abrupt reactions (‘sudden stop’), support of monetary policy in the roll-over management is needed when

debt is maturing (similar proposals by De Grauwe 2011; Krugman 2012). This can avoid or at least mitigate hikes in interest-rate spreads. By signalling to bondholders that it is countering emerging interest-rate divergences because these weaken financial stability and exacerbate the transmission of monetary policy, it could practise clearer forward guidance in this regard. It would also be helpful to announce that, if necessary, bond purchases can be made in the future that do not necessarily correspond to the capital key of the ECB (as already announced in the pandemic emergency purchase programme (PEPP) for monetary policy support during the pandemic) (ECB 2021). It would also be helpful if the ECB did not rely on the rating of the major agencies when assessing the quality of sovereign bonds as collateral for its lending. Although this practice was eased during the pandemic, the ECB should rely entirely on its own judgement. A monetary union that has become more heterogeneous, with more risks from asymmetric shocks, also needs more country-specific interventions - including from the ECB.

### 3.6 A central fiscal capacity in the EU or the eurozone

In its 2020 annual report, the EFB proposed a permanent central fiscal capacity for the EU as a whole, which should follow the 'Next Generation EU' programme and, in particular, the Recovery and Resilience Facility. In contrast to previous proposals, it should include a substantial increase in the budget volume within the framework of the EU's Multiannual Financial Framework, both with a stabilization function in the event of strong symmetric and asymmetric shocks and with allocation and distribution functions. This suggestion goes in the right direction, but still leaves many questions unanswered (see also Kenen 1969; Arnold et al. 2018; Berger et al. 2018; Buti/Carnot 2018).

On average, the OECD countries have a central government with a central budget of 46 per cent of total public expenditure, with Switzerland ranking at the lower end with 15 per cent (OECD 2012). At just over 1 per cent, the EU budget is too small to take on relevant stabilization, allocation and distribution functions if one disregards concentrated support for a few small countries. The relatively large central budget in the OECD countries is the institutional prerequisite for counter-cyclical fiscal policy, which, in combination with monetary policy of the respective central bank in stand-alone currencies, takes over macroeconomic control.

Among the three functions, the stabilization function is probably the most difficult one to realize in a large currency union with so many heterogeneous MSs and a small budget. In the tradition of optimum currency area theories, attention was mainly paid to *asymmetric* shocks, as if symmetric shocks could be managed easily by monetary policy alone. So the EU should be concerned about symmetric shocks in the first place, and not only in severe crises, apart from asymmetric shocks which often emerge in combination with symmetric shocks. The assignment of stabilization to the central level or to MSs, or a combination of both, is a key issue. The principle 'timely, targeted and temporary' needs to be applied. It can be implemented by targeting special MSs according to unemployment or other indicators, either by transfers earmarked for general purposes like public investment. The much-discussed unemployment reinsurance could be one option. Additional discretionary spending as a supplement to automatic stabilizers at national and at EU level could be appropriate too.

As far as the allocation function is concerned, the concentration on genuinely European goods with a strict subsidiarity principle should apply (see Ebert/Schmidt 2020). The support should be for the medium or long term. A broad shift of national tasks to the European level is not expedient. The distribution function, which is a major point

of contention in view of the fear of a ‘transfer union’, is essentially about more convergence between the MSs, that is, more ‘structural’ cohesion, regardless of the level of economic activity. So far, only countries with an average income per capita below 90 per cent of the EU average have received support through the relatively small Cohesion Fund. Spain is now also below this threshold, and Italy is not far from it. Given the challenges of the next decade and the collateral damage from the pandemic, convergence, if taken seriously, can hardly be achieved in the weaker MSs alone, but it is likely to be achievable with some support from the more affluent MSs. Much less redistribution would be necessary if MSs with a significant chronic current-account surplus were forced to reduce their surpluses, especially if the surplus occurs vis-à-vis other MSs with deficits. Furthermore, if taxation of corporations could be harmonized at a common level, EU-wide tax competition could be contained. A fully fledged federation is not necessary, but key rules need to be established and complied with.

After all, a higher degree of federalism in the EU is hardly justifiable without greater democratic legitimization by the respective parliament, especially if separate EU taxes are levied and a genuine debt option is created for the EU. However, there is still a lack of conclusive concepts for a political union. Churchill’s old vision of the United States of Europe, with the US as a blueprint, would be misleading, for four reasons: First, the central budget in Europe will most likely never reach the size, relative to GDP, of the US, and does not need to.<sup>8</sup> Second, the lion’s share of the three fiscal functions of states can and should be realized on the national level, and not all rules need to be unified. Third, a two-speed Europe with a divide into two blocs might be avoided if a precise functional assignment of policies is pursued, with macroeconomic, trade, climate and industrial policies at the centre of communalization. Fourth (and foremost), European states have divergent histories, contrary to the 50 US states, with different cultures and languages – and a large part of Europe’s diversity is Europe’s uniqueness and treasure. In other words, a thin rather than a deep political union may suffice for a successful foreseeable future of Europe in the monetary union.

Yet many questions remain. In the past, political debates about a fiscal union, besides a banking union and a capital market union,<sup>9</sup> and a corresponding political union had been muted by knee-jerk attitudes driven by fears of a ‘transfer union’ or a ‘European super-state’, particularly in the largest country of the union and in the UK. The rethinking must begin with the ‘Next Generation EU’ experiment.

#### 4 CONCLUSIONS

How could the proposal be implemented? There are two avenues, changing the EU Treaty (TFEU) Protocol 12 with the reference values 3 and 60, or integrating the TSCG (Fiscal Compact) into EU secondary law. The main changes have to be made in both cases in the secondary law, that is, in the SGP. The key point here is looking at primary balances rather than at structural balances. This requires looking at different  $r - g$  regimes and hence redefining fiscal sustainability. If we were to follow the first avenue, the reference values should be erased and definitions relocated to the SGP, thus being adjustable in

8. In 2019, the US federal budget embraced 21 per cent of GDP, total public spending 34 per cent. Thus, 62 per cent is spent at the central level.

9. Many debates on further European integration after the global financial crisis focused on the capital market union as if capital markets were a substitute for a fiscal and political union, as emphasised rightly by Draghi (2019).

EU secondary law to changing interest-rate environments. This could be done in a simplified procedure by unanimous consent of the Council. As a consequence, the TSCG would be disregarded, as it is not European law. Besides, in Article 16 of the TSCG it is stated that within five years, that is, in 2018, the treaty should be integrated into European law. This date has passed. If we were to follow the second avenue, the TSCG would be – belatedly – directly integrated into EU law, but in secondary law and thereby rendered redundant as a separate treaty. Protocol 12 TFEU would remain unchanged, but the numbers 3 and 60 would have to be interpreted differently. The Protocol allows us to look also at other indicators than deficits and debt, and the speed of reaching the 60 per cent debt level is undefined. The key problem for a thorough reform is the political will, not the law. The COVID-19 crisis might serve as a catalyst.

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