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Article

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EconPol Forum

Provided in Cooperation with:
Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Kopits, György (2023) : EU fiscal rules: Do they destabilize and inhibit economic activity?, EconPol Forum, ISSN 2752-1184, CESifo GmbH, Munich, Vol. 24, Iss. 4, pp. 21-25

This Version is available at:
https://hdl.handle.net/10419/279976

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EU Fiscal Rules: Do They Destabilize and Inhibit Economic Activity?

Fiscal rules are often viewed as a straitjacket on policymaking. Permanent constraints on the government's budget deficit are deemed to be destabilizing and growth-hindering. The logic—built mainly on the caricature of a strictly balanced annual headline budget—is that, by disallowing the operation of automatic stabilizers or blocking discretionary fiscal intervention, such rules magnify the effect of shocks or cycles on the economy. In addition, the rules stifle potential growth by limiting the scope for public investment (Haldane 2023). As a corollary, a companion claim is that lower growth fails to reduce the public debt-to-GDP ratio, undermining the fiscal rule's ultimate objective of ensuring debt sustainability.

This argument seems implicit in the context of the ongoing reform of the EU economic governance framework, which aims at endowing the fiscal rules with greater flexibility and simplicity, with added space for public investment and structural reforms. In the words of the European Commission President, "Member States should have more flexibility on their debt reduction paths. … There should be simpler rules that all can follow. … With more freedom to invest. … Let us rediscover the Maastricht spirit—stability and growth can only go hand in hand" (European Commission 2022b).

On the basis of these goals, the European Council has issued orientations for the framework's reform (European Council 2023), in line with guidelines from the Commission and drawing from a wide range of recommendations from various internal and external sources (European Commission 2022a and 2022c). More recently, the Commission published a set of legislative proposals to amend the regulations and directives of the European Parliament and the Council regarding the Stability and Growth Pact (SGP) (European Commission 2023a, 2023b and 2023c). While they are welcome as an important step toward enhancing the effectiveness of the Pact, the orientations and the enabling proposals can be interpreted as an attempt to correct some weaknesses of the rules, including their allegedly pro-cyclical and anti-growth properties. It is, therefore, timely to examine the major macroeconomic consequences of fiscal rules that have been implemented in the European Union. The results of this inquiry should help shed light on the Commission's proposals for reform.

KEY MESSAGES

- **EU member states that have continuously complied with the Stability and Growth Pact's budget deficit reference value have experienced much lower volatility and higher growth rates than those which violated the reference value. Also, most complying member states recorded a pronounced decline in the public debt-to-GDP ratio in the subperiods before and after the EU debt crisis**
- **Therefore, adherence to the reference values for the general government deficit and debt, as proposed by the European Commission for the reform of the EU fiscal framework, are compatible with the overarching stability, growth, and debt sustainability goals**
- **Encouragement is warranted of growth-friendly structural reforms and of public investment in the member states' medium-term structural-fiscal plans while complying with the deficit and debt reference values, as envisaged by the European Commission**
- **The proposed shift to the government net expenditure benchmark as the single operational rule, as long as it is consistent with convergence to the debt reference value, is an important step toward simplicity, transparency, and greater stability**
- **Conversion of the Recovery and Resilience Facility into a permanent central stabilization mechanism should be considered for adoption in the new fiscal framework, to mitigate multi-country shocks and to strengthen stability and sustained growth within the Union**

EVIDENCE

Empirical research devoted to testing the effect of discretionary fiscal policy has documented procyclicality across a large sample of advanced and emerging-market economies (Fatas and Mihov 2003). Recent estimates of a policy reaction function on rich cross-country panel data corroborate this result, but do not detect a discernible effect of fiscal rules on the economic cycle. Moreover, among potential drivers of these results, high public indebtedness seems to play a role in limiting the fiscal space available for adopting a countercyclical stance (Larch et al. 2021).

The effect of fiscal policy on economic growth can be traced through specific budgetary components, on the basis of the endogenous growth theory. Estimates on a panel of OECD countries sug-

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* The author is indebted to Roel Beetsma and Martin Larch for useful comments.

gest that a boost in non-distortionary indirect taxes or a reduction in distortionary taxes have a positive effect on potential growth. Likewise, an increase in productive expenditures (infrastructure investment, education, healthcare) or a decline in non-productive spending (social benefits, wages, transfers) stimulate growth (Kneller et al. 1999). Additional OECD cross-country estimates indicate that governments tend to mitigate a recession by sacrificing investment in favor of current expenditures, thereby hindering growth over the medium term (Larch et al. 2022). This implies that, instead, compliance with fiscal rules, preferably through reform measures—for example, by rationalizing the social security system—is likely to be growth-friendly.

What follows is an attempt to verify the above results by taking a closer look at the track record of EU member states over the past two decades, prior to the coronavirus pandemic when the rules were suspended. The focus is on member states that have continuously complied with the SGP's deficit reference value, as opposed to states that had violated the rule at any time during this period. Specifically, the issue under consideration is whether complying member states have experienced greater or lesser output volatility and higher or lower real growth rates than non-complying members.

As reported in Table 1, compliance with the budget deficit rule was accompanied by much higher stability (shown by lower output volatility) and higher growth, as compared to non-compliance. Greater macroeconomic stability reflects absence or low degree of procyclicality, which is not surprising given that the 3-percent-of-GDP deficit limit provides ample space for the operation of automatic stabilizers, and in some countries even for adoption of a discretionary countercyclical stance.[1] By the same token, a high growth rate is presumably an indication of a budgetary adjustment consisting of an increase in non-distortionary taxation and in productive public investment and/or a cut in distortionary taxes and in nonproductive public expenditures. Beyond these general points, it is noteworthy that growth and stability indicators are somewhat dispersed across complying member states, yet all apparently managing to overcome the impact of the 2008-12 debt crisis. Within the euro area, smaller economies, such as Estonia, Ireland and Luxembourg, displayed strong growth performance over the entire period under scrutiny. Outside the euro area, Bulgaria and Poland have recorded high growth rates, admittedly from a lower output base.

Although the evidence suggests that compliance with fiscal rules contributes to stability and growth, this should not be interpreted as causality, insofar as a range of potential country-specific determinants are excluded from the analysis. In particular, monetary policy, which consists de facto of a uniform inflation targeting regime within the euro area—namely, a Taylor rule reaction function that incorporates the output gap[2]—, is manifest in differences in real interest rates across member states (Mayer 2012).

The relation between the level of indebtedness and compliance with the deficit rule deserves further scrutiny from two perspectives. The first posits that a highly indebted member state is likely to adopt a procyclical stance to meet the deficit limit, or simply

[1] On average, in member states, a 1 percent GDP contraction leads to a budget deficit of roughly ½ percent of GDP, allowing for automatic stabilizers. Therefore, for a government targeting a balanced budget at trend GDP, it would take a 5 percent shortfall from trend GDP to reach a deficit equivalent to nearly 3 percent of GDP, all else remaining unchanged.

[2] Poland and Sweden also follow inflation targeting, while Bulgaria conducts a discretion-based monetary policy.

Table 1

Economic Performance of EU Member States Complying with Reference Value for Budget Deficit, 1998–2019

	Volatility [a/]	Growth [b/]
Euro area		
Austria	1	1.7
Belgium	0.7	1.7
Estonia	1.5	3.6
Finland	1.6	1.8
Ireland	1	5.5
Luxembourg	0.8	3.7
Netherlands	1.1	1.7
Spain	1.2	2.1
Other EU members		
Bulgaria	0.7	3.6
Poland	0.4	3.8
Sweden	1	2.3
Non-complying EU members		
Average	1.9	0.9

[a/] Coefficient of variation of percentage change in real GDP.
[b/] Geometric mean of percentage change in real GDP.

Sources: IMF World Economic Outlook and calculations by the author.

to exceed the limit, given the lack of sufficient fiscal space. Indeed, the high public debt burden has challenged policymakers in Italy and Greece from the very outset. Yet, as an "original sin" in the initial years of membership, both governments indulged in a loose fiscal stance by fully allocating interest savings—stemming from the vanished exchange risk premium—to finance tax cuts and primary expenditure hikes. Thus, they exacerbated an already procyclical expansion, which eventually contributed to the debt crisis. By contrast, for example in Belgium and Spain, governments earmarked the interest savings for a significant reduction in public debt.[3]

The second perspective involves the extent to which compliance with the deficit limit helps reduce the public debt-to-GDP ratio. Table 2 shows that complying member states achieved a decline in the debt ratio during the subperiods before and after the financial crisis, which may reflect not only the actual fall in debt stock, but also the relatively high growth rate—both trends attributable to compliance with the budget deficit rule. By and large, containment of the debt ratio has been somewhat less successful since the financial crisis. In any event, these results suggest that fiscal rules can help restore debt sustainability through a stepped-up adjustment effort toward budgetary discipline, but more importantly, they can help to improve the budgetary structure.

IMPLICATIONS

Overall, evidence on the macroeconomic consequences of the existing EU fiscal rules is suggestive of association with stability and growth, as well as with greater public debt sustainability. But to be sure, this should not lead to complacency. Instead, the findings support the view that there is scope for improving the fiscal governance framework broadly along the orientations advocated by the Council and the proposals issued by the Commission. Besides continued adherence to the existing debt and deficit reference values—though with greater flexibility—the Council correctly calls for transparency and simplicity in design, effective coordination and surveillance, supported by growth- and resilience-enhancing structural measures and public investments (European Council 2023).

The proposed net government expenditure benchmark as an operational rule, anchored to a debt-to-GDP target ratio converging to the reference value of 60 percent of GDP, represents not only a step toward simplicity and transparency, but also toward greater stability. Indeed, since the expenditure path is defined as a proportion of medium-term GDP growth or lower—to provide a safety margin and to prevent procyclical expansion—, while revenue is cyclically determined, the rule would help ensure a cyclically neutral fiscal policy stance.

A fundamental question, however, is the degree and manner of flexibility in implementation of the new governance framework.[4] Specifically, the projection of the debt ratio target over the medium term, incorporating corrections for any deviation from the expenditure path, would be subject to bilateral negotiation between the Commission and each member state in the context of the European Semester. Such an approach is deemed excessively flexible by some member governments, on the grounds that it lacks transparency and uniform enforcement of the rules across the membership.[5]

[3] From 1998 through 2005, Greece and Italy recorded interest savings equivalent to around 5 percent of GDP, and Belgium and Spain of some 3 percent of GDP; see the analysis of the crisis in Kopits (2017).

[4] See the critical review by the European Court of Auditors (2019).

[5] See the objection raised by Christian Lindner (2023), Germany's Minister of Finance.

Table 2

Public Debt of EU Member States Complying with Reference Value for Budget Deficit, 1998–2019 [a/]

	Pre-debt-crisis		Post-debt-crisis	
	1998	2007	2013	2019
Euro area				
Austria	68	64	81	71
Belgium	119	64	106	97
Estonia	8	4	10	8
Finland	54	35	56	59
Ireland	51	25	120	57
Luxembourg	7	7	24	22
Netherlands	69	42	68	48
Spain	64	36	100	98
Other EU members				
Bulgaria	75	17	18	19
Poland	48	45	56	47
Sweden	75	40	40	35

[a/] Outstanding gross liabilities of the general government at year-end, as percent of GDP.

Sources: IMF World Economic Outlook and calculations by the author.

National independent fiscal institutions remain in the frontline of real-time surveillance of public finances of member states, for accountability and for enforcement purposes. Hence, the Council and the Commission emphasize the need to strengthen them, including possibly with the application of international standards of good practice. But the continued threat of financial sanctions for rule violations and the attendant excess deficit procedure—even at the proposed reduction to a maximum rate to 0.5 percent of GDP—are unlikely to materialize as an effective enforcement tool, given the weakness of peer review at the Council, and may contribute to a procyclical contraction if imposed during a recession. A far more effective deterrent to fiscal misbehavior would be to increase exposure to market discipline, manifest in the risk premium on government bonds (Kopits 2018). In this regard, a practical innovation would consist of a market-imposed penalty if member states were obliged to issue junior bonds to finance deficits that exceed the reference value (Fuest and Heinemann 2017).

The current reform could be complemented with an additional component which, while not considered in the envisaged reform, would be clearly consistent with the subsidiarity principle stressed in the Commission's proposals. As part of the new architecture, with a view to enhancing the EU's overall stability and growth objectives, the Recovery and Resilience Facility (RFF) could serve these goals at a higher level, as a permanent central fiscal capacity (Beetsma and Kopits 2020). Whereas, in its current design, the RRF provides funding for much-needed infrastructure projects, its scope falls short of functioning as a permanent EU-wide stabilization instrument. Instead of operating as a one-off temporary facility created solely in response to the coronavirus crisis—with actual disbursements delayed beyond the impact of the initial shock—a permanent stabilization scheme could be activated semi-automatically to help offset regional shocks affecting multiple member states simultaneously.

POLICY CONCLUSIONS

At least four policy conclusions can be derived from the foregoing empirical evidence and from the implications for the current reform of the EU Stability and Growth Pact. First, the experience of the member states that have complied with the budget deficit limit of 3 percent of GDP suggests that the rules neither destabilize nor inhibit economic activity, as compared to member states that violated the limit. Furthermore, the public-debt sustainability of member states that observed the deficit limit has improved, or not deteriorated significantly, except during the financial crisis. Therefore, the basic design of the reference values, despite their apparent numerical arbitrariness, does not need to be overhauled.

Second, the contours of the envisaged reform as regards simplicity and transparency seem appropriate to strengthening the Pact. The specification, as the operational rule, of the medium-term limit on the net government expenditure path as a ratio of medium-term GDP growth should help the stabilization goal. The expenditure path needs to be consistent with a country-specific gradual convergence of the debt-to-GDP ratio toward the debt reference value of 60 percent of GDP. However, an issue that remains contentious is the proposed bilateral negotiation—incorporating a number of considerations—of the trajectory of the net government expenditure and debt reduction target over the medium term between the Commission and each member state. While some member governments welcome as much flexibility as is possible, others want to preserve a uniform, transparent treatment of all member states.

Third, enforcement of the rules has been widely recognized as the weakest link of the fiscal framework. Financial sanctions have been ineffective as a deterrent for noncompliance, insofar as they have never been imposed for violations of the rules and the excess deficit procedure. Besides, the application of sanctions, even if reduced in size, would be likely to aggravate a downward procyclical stance during a recession. As an alternative, highly indebted and profligate member states are to be exposed to market pressures, manifest in the risk premium on government paper. An efficient approach would consist of obliging such member states to finance with junior bonds government deficits that exceed the reference value.

Fourth, although absent from the proposed fiscal framework, there is a strong case for creating a permanent central stabilization scheme—incorporating growth-oriented public investments—to be activated semi-automatically to offset the impact of symmetric or asymmetric shocks and cyclical fluctuations that hit simultaneously several member states with regional externalities. Such a facility would build on the experience accumulated from the track record of the RRF and strengthen the stabilizing and growth-friendly qualities of the fiscal framework.

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