Review of the EU economic governance framework: a focus on the revision of the SGP fiscal rules

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Premise: this note discusses how the European fiscal rules included in the Stability and Growth Pact (SGP) should be redesigned from an economic point of view. It does not attempt to assess whether redesigning those rules along the lines suggested below would require a Treaty change. We leave this task to legal experts. However, we note that, over the last two decades, deep changes in the design of the European fiscal rules were introduced with no need for changing the Treaty. We trust that this could be the case again. The focus is on redesigning the fiscal rules, while we do not discuss the issue of the penalties attached to a breach of the rules.

a. General Principles

1. European fiscal rules should be **credible and more binding** than in the past. To this ends they must be **non-invasive as possible** and focus on the goal for which they were introduced when the monetary union was set up. This is also in line with the general principle of subsidiarity in the European Union.
2. Consequently, in re-designing the SGP, it is necessary to keep in mind the reason why fiscal rules are needed in a monetary union. Monetary unions need fiscal rules primarily to **avoid the free riding/common pool problem**: thus, the main purpose of fiscal rules is to avoid gross fiscal misbehavior (excessive deficits and debt) that would force other members of the Union (or its central bank) to intervene in support of the misbehaving country. Thus, it would not be appropriate to use the revision of the SGP as a way to introduce, surreptitiously, a fiscal policy that, for all countries, was "optimal" also from a cyclical point of view. Indeed, different countries may have different preferences on how active fiscal policy be over the economic cycle.
3. If there is a need (and we believe there is) for supporting monetary policy in the euro area in controlling the economic cycle, this should be done by creating **a central fiscal capacity** through a European budget that can run deficits and by centralizing some tax and spending tools that could play a counter cyclical role.
4. Fiscal rules need to be **clear and simple**: this means that they will likely to be analytically inferior with respect to fiscal standards that that into account all relevant information (as the ones proposed by Blanchard, Leandro and Zettelmeyer).[1] However, more sophisticated approaches would lead to endless discussions on how to incorporate all the required information, for example to assess whether debt is sustainable or the speed at which sustainability should be restored. Moreover, while in principle discretion is superior to rules, discretion can be abused, particularly in a context in which short-term interests may prevail over the consideration of the fundamental interest of a nation.
5. The case for excluding **public investment spending** from the fiscal rules is weak for at least three reasons. First, not all public investment is good and not all current spending is bad (e.g. education, health, research). Second, to some extent, excluding investment spending from the rules may lead to artificially turning current spending into investment spending. For example, the government may support a certain sector of the economy through transfers (current spending), or by building infrastructure that would favor that sector. Third, there is no evidence that fiscal crises are affected by the level of public debt excluding the borrowing that was incurred to finance public investment. Econometric evidence suggests that what affects fiscal risks is gross debt, regardless of its origin. Indeed, we are not aware of any study that links fiscal crisis risks to the debt component related just to current spending. Finally, market analysts and rating agencies seem to focus on gross debt.

[1] See "Redesigning EU fiscal rules: From rules to standards" by Olivier Blanchard (PIIE), Álvaro Leandro (CaixaBank Research) and Jeromin Zettelmeyer (PIIE; International Monetary Fund), Working Paper 21-1, February 2021.

6. **Pro-cyclical policies** (i.e. not allowing automatic stabilizers to operate) should be avoided. However, in framing the rules, there should be full awareness that distinguishing between cycle and trend is at the same time absolutely necessary and very difficult. It is necessary because a slowing down of growth which is cyclical (i.e. lasting no more two or three years) requires a fiscal expansion to support aggregate demand; if instead the slowing down is structural, it requires the opposite policy, i.e. a gradual tightening of fiscal policy to insure sustainability in the face of lower present and future GDP. The distinction is, however, very difficult to identify ex ante. This means that there will always be a margin of judgment, hence possible conflicts among Member States and with the Commission. There is no simple solution to this fundamental problem; however in the next section we propose a procedure to deal with this problem.
7. Fiscal rules need to use **observable variables**: the complexity of estimating potential output growth, required under the current SGP, should be avoided. In this respect, the often-advocated solution of replacing the existing rule requiring a decline in the structural deficits at a certain speed with a spending ceiling addresses the problem of estimating potential output growth only apparently.[2]
8. In any case, **terminologies such as "expenditure rule" or "spending rule" should be avoided** because they suggest that the EU wants to put a limit to the size of governments, which is outside its mandate and is not the intention of those who propose such rule. Indeed the rule proposed by the European Fiscal Board could be labelled "deficit rule" because it proposes to target expenditure net of discretionary changes in taxes, which is essentially the discretionary part of the deficit.
9. No fiscal rule will even be right when facing unusually strong country-specific or common shocks. Therefore, fiscal rules should be suspended in case these shocks occur. **Escape clauses** should exist, suspending the operation of the fiscal rules until the exceptional circumstances persist.

b. Implications: a hybrid approach

Overview: the key feature of the proposed framework is a hybrid approach combining the two main approaches to ensuring fiscal sustainability adopted by advanced economies in the world over the last few decades. We propose to combine the approach of fiscal rules (followed in the European Union) and the approach of medium-term budgetary plans (followed in other advanced countries such as Australia and New Zealand). The combination is implemented by constraining the numerical features of medium-term budgetary plans to meet a certain debt reduction rule in countries where public debt exceeds certain thresholds.

1. Fiscal constraints affecting annual budget deficits should apply **only to countries whose fiscal accounts are in need of a fiscal correction** over the medium term, as evidenced by a public debt-to-GDP ratio that exceeds (or is expected to exceed over the planning period; see below) a certain threshold. Countries whose debt ratio is below the threshold would be able to manage their macroeconomic policies in the way they deem appropriate.

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[2] The spending rule requires public spending, adjusted for discretionary changes in taxation, to grow at a certain speed, taken to be the long-term growth rate of the economy, so as to ensure the desired spending ratio beyond cyclical fluctuations of the economy. In such an approach the estimation of the potential growth rate of the economy is thus avoided. However, there is no reason to use the past GDP growth rate if in the future GDP is expected to grow at a different rate than in the past because the potential growth rate of the economy has changed. It is just a convenient assumption. But then one might as well continue to follow the structural adjustment rule, with no need of estimating potential output growth through the current complicated method, by using the same long-term GDP growth rate as a proxy of the potential growth rate. Indeed, it can be shown that the structural adjustment rule and the spending rule are mathematically equivalent under the assumption that the potential growth rate ii equal to the long-term growth rate. See Carlo Cottarelli, "How could the Stability and Growth Pact be simplified?", A contribution requested by the Economic Governance Support Unit and Policy Department A, Directorate-General for Internal Policies, European Parliament, PE 614.503 - April 2018, especially p. 15.

2. In this respect, two options may be followed:
   - Option A: **a unique threshold for all countries**. The 60 percent threshold that was included in the Annexed Protocol of the Maastricht Treaty seems to be outdated given: (i) the lower interest rate –growth differential that has prevailed over the last twenty years with respect to that prevailing during the 1980s and the 1990s; and (ii) the emergence of new fiscal needs, such as those related to climate change, that would justify taking somewhat higher fiscal risks that expected in the early 1990s.[3] A threshold in the range of 80-100 percent seems now to be appropriate. The threshold should be set by the European Council, following a recommendation by the Commission, and revised every five-ten years in light of long-term trends in the level of global interest rates and of GDP growth and other relevant factors (such as aging prospects).
   - Option B: **different threshold across countries**, also set by the European Council following a recommendation by the Commission**,** in light, for example, of their different proven ability to maintain a given growth rate. Other factors can be taken into account (such as long term spending trends). If individual thresholds were preferred, these should be revised only with a qualified majority to reduce the risk of collusion among high debt countries. This option is preferable in theory, but may be difficult to implement without major tensions among Member States and with the Commission.
3. Given the developments during the Covid crisis, consideration should be given to excluding from the public debt figures relevant for assessing compliance with the debt threshold **the amount of public debt purchased by the ECB under the PEPP facility**. This can be justified by the exceptional nature of the recent crisis. However, this exclusion should be done only in tandem with an increase in mandatory reserve requirement, so as to freeze the base money created through those purchases. Indeed, such a freeze would allow the ECB could continue to roll over in perpetuity the PEPP bonds as the corresponding liquidity could not be used, in the future, to fuel a rise in bank loans and deposits. Moreover, as interest on those bonds is returned to governments as profit distribution, they would become just an accounting item, and thus irrelevant from the point of view of public debt sustainability. This would justify their exclusion from the assessment of compliance with the debt threshold.
4. Each country whose debt exceeds the public debt threshold, would have to present to the European Council **a four year fiscal adjustment plan**.
5. This plan would have to follow, ex ante, **just one fiscal rule**: the public debt-to-GDP ratio should decline annually by at least a certain minimum amount. This level should be related to the initial level of the debt ratio through an appropriate formula, but we believe it should not exceed 2-3 percentage points of GDP. A different rule (focusing on the deficit or the primary balance) could be followed without altering the fundamental feature of our proposal, which is the focus on a medium-term adjustment plan. However, expressing the rule that the plan needs to comply with directly in terms of debt reduction has advantages in terms of communicating the ultimate goal of the SGP for countries with high debt.
6. This medium term fiscal adjustment plan should be based on **reasonable growth, interest rate and other relevant assumptions** (e.g. on privatization revenues), as assessed by the Commission, and possibly the European Fiscal Council (in addition to national fiscal councils).
7. In order to resolve the potential conflict between policies required in the face of cyclical or a structural change in the growth rate, the following procedure could be envisaged:

[3] See Carlo Cottarelli, "The role of fiscal rules in relation with the green economy", A contribution requested by the Economic Governance Support Unit and Policy Department A, Directorate-General for Internal Policies, European Parliament, PE 651.364 - August 2020.

a. As long as **the unemployment rate** remains significantly (say, more than 1 percentage point) higher that the long-term (say last ten years) average no decline in the public debt ratio could be considered.
b. The plan would be **approved by the European Council** upon a recommendation of the Commission and is not expected to be revised during its execution. However, its revision after four years (possibly a shorter, say three years, revision deadline could be envisaged) would allow to incorporate any relevant information regarding permanent changes in the growth rate.
c. However, should GDP levels be different than initially assumed, in order to allow the automatic stabilizers to operate fully, **the annual deficit targets included in the plan would be revised** (symmetrically for upward and downward revisions). The revisions, for the current and following years, would be equal to the difference between the planned GDP level and the revised GDP projection times the elasticity of the deficit with respect to GDP.

This approach would allow the automatic stabilizers to operate fully, while **discretionary fiscal expansions** in the presence of negative deviations of GDP from the plan would not be allowed to operate. This said, if so desired, some limited discretionary countercyclical action could be envisaged.

8. In any case, the fiscal rules should be suspended, for the whole area or for individual countries, in case of **exceptional circumstances**, following a decision by the European Council, under the recommendation of the European Commission.