ANALYSIS

ECONOMY AND FINANCE

REFORMING THE EUROPEAN RULES

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A reform of the fiscal policy rules must in any case take into account the changed situation also caused by the pandemic.

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1 THE EUROPEAN ECONOMIC AND MONETARY UNION'S FISCAL RULES ARE THIRTY YEARS OLD.

Why does a monetary union need fiscal rules? In short, to safeguard member states against the externalities generated by the fiscal policies of other member states in the absence of such protective barriers as flexible exchange rates and limited capital mobility. This is even more the case for the EMU, which lacks a federal government, with fiscal sovereignty remaining with member state governments (Gros 2021). This fundamental principle was enshrined in the Maastricht Treaty which came into force in 1992 and was then structured into a series of rules set down in the 1997 Stability and Growth Pact (SGP), which is still today the fiscal cornerstone of the EMU, although significant changes took place overtime, culminating in the 2012 Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, referred to as the **Fiscal Compact.**

The three late 20th and early 21st century decades in which the EMU's fiscal rules were conceived were characterised by profound economic, social and political change bound up with three global-scale crises: the 2001 attack on the New York Twin Towers, the global financial crisis and the 2008–9 Great Recession and the 2020 Covid-19 pandemic. The debate over the EMU's »fiscal constitution« is ongoing and both its successes and its failings are singled out (for example Regling 2021). However, analyses of European crisis and stagnation in the last decade and the exceptional challenge brought by the pandemic have shifted the judgement pendulum in the direction of a growing anachronism of the existing fiscal rules and the unfeasibility of a restoration of the pre-pandemic status quo.

The pre-Covid rules were the product of the cultural climate prevailing in the 1980s and 90s when belief in the effectiveness of fiscal policies on GDP and employment levels was limited and monetary policy was seen as a universal panacea. We have known that this is not the case for some time now. Above all now that interest rates are close to (or even below) zero and the economy is in depression, fiscal policy is a necessary and indeed powerful tool to trigger recovery and ensure it is stable and sustainable over time. The old European fiscal rules – suspended in March 2020 – envisaged only one type of externality, namely excess debt and/or deficit by one or more nations jeopardising the Union's financial stability and generating debt monetisation pressure on the ECB or transfers between states to save one or the other from default (Martin et al., 2021, p. 2).

The stabilisation policy was, in principle, entirely a matter for the central bank despite it being common knowledge that the latter is not fully up to the task in a monetary union when shocks are asymmetric, i.e. hitting the various member states to different extents and/or in different directions (Bofinger, Mayer, 2007). Furthermore, such a policy substantially ignored the macroeconomic externalities of the unilateral changes in the fiscal policy implemented by a single country (especially a large one) in a continent where trade is intense and value chains are increasingly integrated. Moreover, rules applied rigidly on a national level in an un-coordinated way can potentially exacerbate the macroeconomic externalities referred to above, culminating in an overall Euro Area fiscal stance which is too restrictive more frequently than it is too expansionary. Rather than generating stability, the old rules actually generated instability, including by destabilising expectations.

An example relevant to the future is of use in illustrating this point. Germany plans to reduce its net debt from 240 billion in 2021 (forecast 6.95% of GDP) to 80 billion in 2022 (forecast 2.22% of GDP) in a single year and get rapidly back to the balanced budget *(Schuldenbremse)* enshrined in its Fundamental Law apparently without taking account of the impact this will have on other Eurozone countries, just as it did from 2011 onwards. Such an economic package is fully in line with the old European fiscal rules and the quintessence of fiscal orthodoxy. But is this ultimately compatible with a monetary union characterised by wide-ranging and profound macroeconomic externalities?[1] What might be the impact of such a drastic reduction in quantities of »safe« financial assets (such as German Bunds) on the ECB's monetary policy choices?

The old fiscal rules also had technical bugs which made them procyclical, whatever the intended contrary effects (Darvas, 2019). With the 2005 reform of the SGP the key tool in public budget control became the structural budget balance to GDP ratio, i.e. the government budgetary balance (in relation to GDP) net of the business cycle effects (the balance tends to improve with expansion and worsen with contraction) and of one-off and temporary measures. This was intended to eliminate the obvious procyclical nature of calculating the deficit-GDP relationship alone[2]. A key role in calculating the structural balance is played by what is referred to as the output gap. The more negative this is (i.e. thedeeper the recession) the less the structural deficit with a given effective (or »nominal«, in the jargoon) balance. The problem is that the output gap – as the difference between real and potential GDP – is not an observable variable and potential GDP is, in turn, not observable but rather estimated on the basis of past data (Heimberger, Kapeller, 2017). Output gap values were thus reviewed on the basis of past GDP trends which were used for fresh potential GDP forecasts[3]. Thus, after a period of prolonged recession, potential GDP forecasts were adjusted downwards in such a way as to narrow the gap between real and potential GDP (i.e. a reduction in the output gap) and a worsening of the structural balance, with a given nominal balance. Frequent forecast reviews generated signif-

1 Buhl, Cohen-Setton and Vallée (2021) have estimated that the negative fiscal impact on the Euro area of this German packageb would be in the region of 0.6% of its GDP.

2 When GDP shrinks in recession, the deficit/GDP ratio increases even if the deficit remains constant. The ratio grows all the more because, in a recession, tax revenue declines and spending on social welfare increases.

3 The same was true of a further important variable for the Stability Pact: the rate of unemployment compatible with non-accelerating inflation (NAIRU).

icant uncertainties and errors in the definition of a country's cyclical position and consequently in the budgetary policies enacted in accordance with the constraints set by the SGP. It could and did happen that restrictive policies were advised and, on some occasions, implemented in economies in full recession solely on the grounds that the forecasts showed a reduced potential GDP and thus an increased structural deficit.

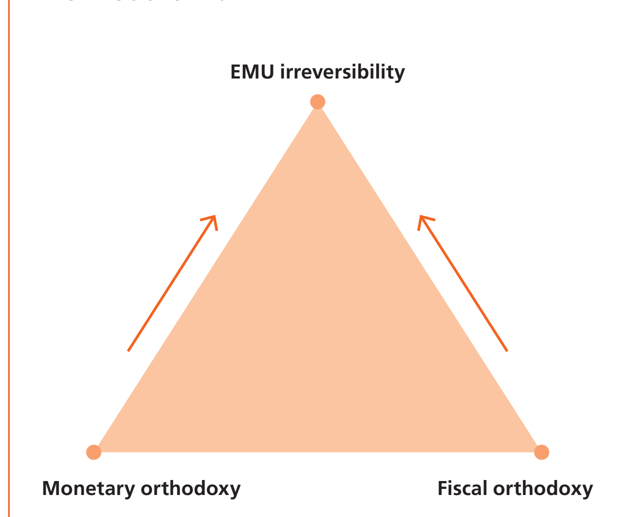
2 THE EMU'S »TRILEMMA«

The lasting legacy of the second decade of the twenty-first century goes well beyond the role of the fiscal rules. It is a situation which Della Posta and Tamborini (2021) have referred to as the **EMU's »trilemma«** (see figure 1). Both following on from the »Europeanisation« of the 2008–9 global crisis and the outbreak of the pandemic, we have seen that when significant **systemic shocks** hit the EMU only two of its three pillars can be salvaged: 1) the integrity of the Monetary Union; 2) monetary orthodoxy (the price stability priority and the ban on the monetising of public debt); fiscal orthodoxy (national fiscal sovereignty subject solely to deficit and debt constraints with the addition of debt market discipline).

On both these occasions the initial defence of the twin orthodoxies led to the brink of the Euro collapse or, put it mildly, to the break of the single currency **irreversibility** principle. In the acute sovereign debt crisis phase the temptations of »exit« gained ground and European governments and institutions struggled to combat these (and in some cases initially shored them up). The financial and currency markets began to price the risk of redenomination, i.e. the risk of a nation's exiting the Euro and reverting to its national currency (Di Cesare et al., 2012, De Santis, 2015). The EMU was saved only by the ECB's financial stabilisation programmes announced in the summer of 2012 (Wyplosz, 2014). These programmes could be seen as a deviation from the EMU's monetary orthodoxy (the arrow to the left of the triangle in figure 1)[4], although perfectly aligned with the functions of a central bank as generally understood in the rest of the world. On the fiscal front, on the other hand, the budgetary rules and fiscal consolidation plans were tightened up and not only in the nations with the highest risk of falling into a debt crisis. The result was a contradictory mix of economic policies which contributed to the protracted stagnation of the 1910s, a decline in confidence in the EMU and the strengthening of sovereigntist and anti-Euro movements.

The disastrous economic consequences of the arrival in Europe of the Covid-19 pandemic in early 2020 were initially taken on (once again) by the ECB alone with an extraordinary quantitative easing plan (*Pandemic Emergency Purchasing Programme,* PEPP). The EU fiscal response was hesitant. National governments and the Commission decided to temporarily suspend budgetary rules, as is provided for by the pacts in the presence of exceptionally adverse events, and it became increasingly clear that leaving the capacity for a health, economic and social response to each single state's »fiscal space« would rapidly increase the risk of collective catastrophe. Lengthy and tense intergovernmental negotiations followed, until July 2020, designed to draw up a large scale EU fiscal plan whose purpose was to supplement monetary policy (*Next Generation EU,* NGEU) encompassing significant »heterodox« elements such as raising financial resources via the issue of EU bonds (the arrow along the right-hand-side of the triangle in figure 1).

Figure 1
The EMU's trilemma



The lesson for the EMU's future is that not only do the fiscal rules need to be amended if undesirable consequences are to be avoided but the new rules must also be complemented by a system of safeguards designed to protect the EMU's integrity in the event of systemic shocks.

»For extreme adverse events, excessive emphasis on individual liability is counterproductive; in such circumstances the solidarity principle should dominate. The European community thus needs a discussion of the extent to which it is willing to assume tails risks for its members. A commonly acceptable cut-off needs to be identified, agreed upon, clearly communicated, and enforced in future crises« (Brunnermeier et al. 2016, p. 117).

3 RULES *VERSUS* DISCRETION ONCE AGAIN?

The old fiscal rules were also shaped by a series of »neoliberal« doctrinal arguments – widely accepted in the academic community in the late seventies and eighties – in favour of tightening the government hands by means of strict rules of conduct designed to avoid erratic and discretionary action (underlining that such action was by definition harmful to economic stability and people's wellbeing) (Kydland, Prescott, 1977; Barro, Gordon, 1984). Until recently theoretical

4 And, in fact, as is well known, the announcement of these programs led to appeals to the German Constitutional Court and a dispute between the latter, the ECB and the European Court of Justice.

and empirical studies highlighting the shortcomings of this doctrine were not very influential (Lohman 1992) – especially when the contingencies faced by governments and other worldwide policy institutions are uncertain in nature –. In such circumstances the ability to martial an optimal response requires **flexibility,** i.e. a range of options rather than a single predetermined action.

As Mario Draghi noted in his Bologna University honorary degree lecture (2019) an entirely rules-based approach is ineffective first and foremost because the rules are static, i.e. »they cannot be updated quickly when unforeseen circumstances arise, whereas institutions can be dynamic and employ flexibility in their approaches« when economic conditions change suddenly. Furthermore, the rules lose credibility if applied in a discretionary manner or with a frequently opaque flexibility. »This is why there are always tensions when it comes to economic policies that follow the rules-based approach«. Moreover, trusting entirely to (even the best-designed) rules flies in the face of the fact that even those in government and those drawing up the rules have limited knowledge of future economic developments and all potential scenarios are replete with the utmost uncertainty (and not simply probabilistic risk). In Keynes's words (1937), in the majority of significant economic and social situations »we simply do not know«. On this point contemporary neo-liberals, distrustful of (what they see as) the »traps« inherent in Keynesian thought might consider the remarks of such an arch-liberal as Friedrich von Hayek in his Nobel Prize lecture:

»If man is not to do more harm than good in his efforts to improve the social order, he will have to learn that in this, as in all other fields where essential complexity of an organized kind prevails, he cannot acquire the full knowledge which would make mastery of the events possible« (»The Pretence of Knowledge«, Nobel Memorial Prize Lecture, reprinted in *American Economic Review,* 1989, vol. 79, p. 7)«.

Hayek underlies the inevitable incompleteness of any »contract« between sovereign nations. Drawing up rules capable of taking account of all potential future events is thus impossible and even simply increasing the number of contingencies leads swiftly to highly complex rules which are difficult to apply and easier to manipulate and even circumvent (Blanchard et al., 2021). It is no coincidence that democratic constitutions are systems of general and abstract principles rather than specific rules and translating principles into rules of contingent conduct is a legal process which in turn follows applicative rules and measures which necessarily leave a controlled discretionary margin. This discretionary element might be said to be a necessary evil in incomplete contracts and the purpose of constitutions is to regulate not remove it.

The difficulties referred to are exacerbated in a two-level (central and national) framework like that of the EMU. Cyclical stabilisation policies in the United States of America and those used to tackle great recessions are clearly a matter for government and the federal parliament, as well as the Federal Reserve. The states are subject to relatively rigid budget (and debt) constraints and such a rigidity is justified and made credible precisely by the fact that macroeconomic shocks are tackled primarily by using federal rather than state funds. On paper the old SGP imposed rules on its member states but neither the Commission nor the Council had the budgetary tools needed to prevent individual states from increasing their deficits and national public debts when facing a recession.

A progressively weaker defence of the rules and denial of discretion has simply pushed discretion behind the closed doors of opaque and arbitrary bargaining and sometimes even full-blown strong arm tactics between states and the European Union in which politics inevitably and justly returns to the fore. It should not be forgotten that in democratic countries it is the electoral mandate which legitimises government and parliament to exert its powers. Voters want governments to govern, to take the necessary and appropriate decisions in each condition although un-specifiedand not provided for in their (incomplete) constitutional contracts. Democracy falters in both dictatorship of the majority and impotence of the majority situations. In this way, the doctrine which ties a government hand, alongside the overweening power of the global markets, acts to undermine elected governments, both effectively and in popular perceptions, and with them democracy's most tangible expression of voters' will. These are phenomena which would now seem, perhaps not by chance, to be fuel to the sovereigntist fire.

As early as 2014 Nobel laureate Michael Spence said that »power games hinging on unrealistic parameters fixed when the situation was very different no longer make sense«. This is even truer today because these parameters are now even more unrealistic (think first of all of the 60% debt/GDP ratio, when the Eurozone average is around 100%) and because such power games have been shown to be a dead end. If we are to avoid falling into the stupidity trap once again the fiscal rules must be radically overhauled to take account of both the changed economic and political context and of the new theoretical and empirical knowledge which has since emerged. There is now widespread scholarly agreement on this[5]. But we also need to set up currently absent channels for an appropriate relationship between the »technical« rules and the legitimate economic policy discretionary decision-making spaces (inherent to parliamentary democracy) within a multilevel framework such as the EMU.

4 LOOKING AHEAD

Any reform of the public finance rules must take account of changed circumstances.

1) Interest rates are much lower than they were in the 1990s when the old rules were drawn up, to such an extent that the Eurozone's spending on interest payments is a much smaller

5 For a summary see the recent European Stability Mechanism paper by Francová, Hitaj et al. (2021).

percentage of its GDP than it was in the 1990s, despite debt being significantly higher. This means that the sustainability threshold has been raised and will probably remain high for some time, given the persistence of excess savings worldwide which exerts downward pressure on real interest rates.

2) Post Covid the debts of all EMU nations have grown considerably relative to GDP, making the 60% threshold enshrined in the old SGP entirely out of the reach of many nations (in Southern Europe but also in France, Belgium and Austria), except at the cost of a demand squeeze capable of throwing the continent back into recession (Francovà et al., 2021). The primary surplus needed to satisfy the one-twentieth rule set out in the 2012 Fiscal Compact would be extraordinarily high. For example, to accord with the one-twentieth rule a nation with a debt/GDP ratio of 160% (100 percentage points above the 60% threshold) would have to reduce its debt/GDP ratio by 5% in the first year and to a gradually diminishing extent in subsequent years. This would still leave it with a debt/GDP ratio of around 75% in 2060. Even if nominal interest rates were the same as nominal growth rates and remained so at length, the application of the rule enshrined in the old Fiscal Compact would require a primary surplus of 5% of GDP in the first year and this would need to remain over 3% until 2031. These are values which would increase considerably with a nominal interest rate higher than the growth rate. It is a truly non-credible trajectory, in any case.

3) Furthermore the 3% total deficit/GDP limit – capable of stabilising the debt/GDP ratio at 60% in a *hypothetical economy growing at a nominal 5% rate* – is now lacking in any logical underpinning, both because the Eurozone's average debt/GDP ratio is around 100% but also because a 5% nominal growth rate (with inflation at 2%) is totally out of reach, except in the very first post-pandemic year. But the 3% deficit is compatible with a 100% debt/GDP rate in the more realistic hypothesis of a 3% nominal growth rate (1% real growth and 2% inflation).

4) The debt/GDP ratio is exactly that, a ratio. Its rate of change over time is obtained by subtracting the rate of change in the denominator from the rate of change in the numerator. Thus, recession increases the ratio even when the numerator (i.e. the debt) does not increase. Expecting the ratio to go down always and for a long period of time is thus entirely illogical. Whilst it is true that the old SGP allowed the rules to be suspended in the event of very widespread aggregate shocks (such as the 2008 financial crisis or Covid) the macroeconomic impact over time can be profoundly asymmetrical (like in the 2011–14 period) and this makes the application of a uniform rule calibrated to a ratio in which the denominator varies considerably between member states vulnerable and practically unworkable.

5) The fact that interest rates have been close to zero for some time means that monetary policy's effectiveness has waned the world over and that it is of limited usefulness in tackling widespread negative shocks, including those of a symmetrical nature. A greater use of fiscal policy for the purpose of stabilisation and related macroeconomic externalities must be carefully considered. In the wake of the pandemic, it has become clear that the future economic sustainability of European nations is bound up with an extraordinary (but anything but temporary) budgetary effort. Until 2026 there is the NGEU. And then?

This is not the place to go into the frequently highly technical details of the many European rules reform proposals on the table. The whole of the considerations set out here, however, shows that the direction of profound change is essentially political rather than technical[6]. It is a change whose primary goal must be guaranteeing monetary union's future.

A) FROM »HORIZONTAL« TO »VERTICAL« CO-ORDINATION.

It should, by now, be clear that delegating fiscal policy entirely to individual member countries only constrained by a set of rules which ignore macroeconomic externalities is no longer possible (Blanchard et al., 2021; Buti and Messori, 2021). The homework alone era is over. Individual state budgetary policies must be more effectively controlled and, at the same time, co-ordinated and harmonised to maintain a balanced Eurozone fiscal stance in order to minimise negative spillover from individual budgetary policies onto other member states. It should also be clear that there is a trade-off between the rigours and rigidities of individual nation state budgetary policies, on one side, and the existence of a common fiscal facility, on the other, namely an adequate federal budget to be used for the recessionary episodes which may strike the EU symmetrically or individual member states asymmetrically. If NGEU and, in particular, SURE (the shared funding tool for cyclical unemployment benefits) were to become permanent EU tools, national budgetary constraints might immediately gain political acceptability and be easier to control because a significant part of the macroeconomic stabilisation task would be entrusted to the common budget which would be mainly funded by nations' own resources. If the will for this is not there, we will need to accept that the »rules« should be very flexible and subject to constant political renegotiation.

B) TECHNICAL EVALUATION AND POLITICAL RESPONSIBILITY

We have argued that we should resist substituting political discretion with automatic algorithms. Replacing the whole rule-based framework with one based on standards, as suggested by Blanchard et al. (2021), would seem to be an interesting one, however unlikely its implementation may appear in the current European Treaty framework. However, we do not agree with Blanchard et al. (2021) suggestion that judgements (and sanctions) regarding failure to abide by the standards should be referred to the European Court of Justice after these standards have been drawn up by a (strengthened) European Fiscal Board (EFB). This would be moving in the opposite direction from that set out in this paper, whose objective is a clear distinction between technical assessment

6 We have already attempted to outline this in Boitani, Tamborini (2021).

and political responsibility. Whenever technical evaluations on the state of public finances in the various member states and the EMU as a whole must be translated into political decisions competence should be assigned to politically responsible institutions. In the EMU political responsibility stays with member state governments. However, national governments must agree to share sovereignty with a higher order institution capable of guaranteeing the EU's collective interests. In our view such an institution can only be the European Commission. For sure the latter must make use of independent technical structures such as the EFB and the national parliamentary budget offices for technical analysis and the formulation of guidelines for the implementation of standards.

C) FROM ANNUAL BUDGETS TO DEBT SUSTAINABILITY

Blanchard et al.'s (2021) suggestion that the focus should be public debt sustainability is, on the other hand, one we entirely agree with. This would eliminate all reference to fixed targets valid for all member states without distinction and, even more importantly, it would break free sustainability analysis from the weight of non-observable variables requiring ongoing (and retrospective) review, such as potential GDP and the output gap. Sustainability analysis should be performed on individual member states periodically and designed to assess the existence of a high probability that debt is sustainable, taking account of the specific features of each nation with reference to growth, population dynamics, interest rate trends (and thus overall debt servicing spending) but also current budgetary policies and those planned for the future. »Stochastic analysis enables the uncertainty surrounding deterministic debt trajectories to be captured … it has become part of the fiscal policy assessments of numerous international institutions« (Martin et al., 2021, p. 6). This type of analysis is by no means straightforward and should thus be entrusted to a strengthened EFB in conjunction with national institutions.[7] If debt sustainability analysis should reveal a high likelihood that debt may become unsustainable (on EFB proposal) the Commission would have to agree a deficit reduction trajectory over several years with the country concerned, requiring »the debt sustainability risks to be balanced against the costs of adjustment in terms of production« (Blanchard et al., 2021, p. 21), with the explicit goal of averting a debt crisis for the individual country concerned and the EMU as a whole.

D) PRIMARY SPENDING CONTROLS AND PUBLIC INVESTMENT SAFEGUARDS

Back in 2019 the EFB suggested that, in the event that debt reduction should require it, a primary spending ceiling could be resorted to, also preserving a predetermined investment spending quota (*the golden rule,* Truger, 2016). Energy transition requires huge and long term investment which cannot realistically be done while simultaneously maintaining significant primary surpluses in all European nations, starting from Germany. It has been noted that post-pandemic resilience and recovery are based on »capital reconstitution and growth (especially human and social capital) which require increases – in a specific time frame – in spending which accounting systems classify as current expenditure but which can, on closer examination, be seen to be full-blown investment expenditure« (Boitani, Giovannini, 2021). Think of health and education spending. National accounting is a contract but one which reflects and transmits a society's values. Reforms in the European fiscal rules and the introduction of the golden rule could, not unreasonably, be accompanied by an (at least experimental) modification of certain key spending classifications.

The reform direction we recommend satisfies the twin criteria of simplicity and variables observability and leaves room for stabilisation policies when necessary and to the extent to which these are not covered by common fiscal capacity. The viability and thus credibility and political acceptability of this model consists precisely in its leaving behind fixed universally applicable numerical objectives – together with a reasonable degree of flexibility which enables exceptions to be thoroughly assessed. It is important to highlight that any excessive debt reduction trajectories would have to be compatible with the maintenance of a suitable fiscal stance across the whole EU in order to minimise negative macroeconomic externalities. This would require co-ordinated economic policies in the various countries within a framework of shared sovereignty.

5 RECOMMENDATIONS

In a nutshell, what should European policymakers be doing now?

- Taking stock of the fact that, in the wake of Covid-19, reinstating an array of procyclical measures based on universally valid numerical parameters, in a sort of Maastrict 2.0, could jeopardise the stability, and perhaps even the very survival, of monetary union precisely at a time at which the ECB has limited room for manoeuvre.
- Taking swift action to make a »federal« budget permanent of a size that allows for cyclical stabilisation policies based on the EU's new fiscal capacity.
- Making unequivocally clear that policymakers will not abdicate their decision-making responsibilities. National government sovereignty can and must be shared with the Commission but not with the technocracy, which should appropriately be entrusted with technical assessment tasks even broader than those currently existing.
- Acknowledging that the rules must first and foremost deal with the externalities deriving from the unsustainable nature of public debt. Setting new fiscal »standards« in such a way as to ensure medium term national public debt sustainability, drawing up return to sustainability

7 The technical complexity of the indicators is tolerable if they do not automatically translate into political precepts, as they do in the old framework, but constitute an assessment basis for agreed political decisions.

trajectories for each individual nation which do not penalise employment.
- Acknowledging the central importance of macroeconomic externalities and accordingly defining an appropriate European fiscal stance.
- Reforming (at least experimentally) national accounting agreements in such a way as to make national primary spending control credible and workable, net of investment spending, for the purposes of encompassing health and education spending as proper investment.

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