STABILITY AND GROWTH PACT REFORM

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European fiscal framework should ensure resilient recovery and future growth

The COVID-19 crisis has shown how interdependent European economies are and how effective strong economic and fiscal coordination in the EU can be. The creation of the Recovery and Resilience facility is, in fact, a new approach and further fiscal policy coordination at the EU level. With this, we have created a "temporary mechanism" to stimulate the implementation of the reforms and to support the transition of the economies into digital and green future. This has an impact also on the structure of the public expenditures, particularly in the members states with large scale plans. Finding an appropriate link between the quality of public finance to safeguard investments and structural reforms is crucially important to ensure sustainable public finance, competitiveness, and convergence.

During the COVID-19 crisis, the SGP proved to be efficient, as the activation of the general escape clause enabled the much-needed swift introduction of extensive fiscal measures. In this moment, it is equally important to ensure a resilient recovery in mid-term. A country-specific appropriate length of the recovery path is needed. Too fast and too large fiscal efforts could hinder the recovery.

It is without doubt that fiscal rules are needed. Having rules is better than not having them. As the recent review shows, the existing rules had certain positive effects on fiscal positions in the member states. After the financial and sovereign debt crisis, the nominal deficits decreased; however, debts expressed in % of GDP did not. It also became obvious that the adjustment path in the preventive arm is unrealistically demanding in some cases. In the past year, debts substantially increased. Considering we are no longer in the world of Maastricht, a revision of the European fiscal framework is warranted. As shown during the crisis, fiscal coordination is also essential.

At the heart of the application of the Pact is the principle of equal treatment of all member states. Equal treatment, however, does not mean "one-size-fits-all" rules. Sustainability of public finance very much depends on country specific factors, and rules should acknowledge this. While the Pact envisages certain extent of flexibility in the way rules are applied, revised framework ought to show more serious commitment to consideration of countries' underlying public finance position, level of economic development, and their (to fiscal policy exogenous) characteristics.

The Fiscal rules ought to promote long run growth.

The structures of the economies are different today than 25 years ago when the reference thresholds governing the corrective arm of the Pact were agreed. Current low interest payments and limited effectiveness of monetary policy, as a result of very low or even negative natural rate of interest, call for re-evaluation of the role of fiscal policy in reducing both permanent and persistent shortfalls in aggregate demand. Debts indeed need to be reduced to (or kept at) sustainable level, but the debt reduction target should not jeopardise growth, as this oftentimes leads to raise in debt-to-GDP ratio. In the light of this, more weight on country-specific debt reduction targets could also prove to be efficient.

Also, the preventive arm of the Pact should more realistically capture the economic environment. The preventive arm relies heavily on the unobservable variables. The estimations of the medium-term objective, fiscal efforts, and structural balance are highly uncertain, as estimates of potential output have proved to be very biased and are subject to frequent revision, especially in bad times. The preventive arm is also not realistic in terms of the determination of the speed of the adjustment path as indicated above. We should focus more on parameters that are within the control of the government, like nominal growth of expenditures.

Fiscal rules ought to promote long run growth. Hitting the fiscal objectives should in no way result in hampering productive spending as we have commonly seen in the past. Excluding net public investment from the considered expenditure aggregate in bad times, for instance, could create valuable extra fiscal space. Separating current and investment budgets with investment costs being distributed over the entire service-life, for example, is also an intriguing option. It is important, however, that fiscal rules remain simple and that they do not provide much space for political debate. The distinction between investment expenditures and other growth-enhancing expenditures could, for example, do just that.

An introduction of joint fiscal incentives could be an important step toward ensuring that crises do not lead to prolonged demand shortfalls or to a structural lack in public investment. In this regard, the efficient implementation of Recovery and Resilience Facility will have important implications for the future fiscal framework.

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Any SGP changes should enhance, not undermine fiscal sustainability

The coordination of economic policy is one of the main pillars of the Union, giving rise to positive spill-overs and fostering convergence. Despite a comprehensive review of the SGP in 2011, there is still room for improvements. As the pandemic subsides, the question of fiscal coordination and governance is as important as ever, given the recent developments, especially elevated public debt levels in many Member States and the need to start gradually rebuilding buffers as economic recovery strengthens.

In this vein, we should approach the review of our fiscal framework with an open mind, making it more adapted to the post-pandemic realities. At the same time, we should not weaken our rules-based framework or engage in a fundamental overhaul of the key principles underpinning it. Furthermore, there is no merit in trying to rush the process by aligning it with the upcoming General Escape Clause deactivation, as the SGP review should be geared towards addressing longer-term challenges, not merely short-term ones.

It is evident that the current framework has some issues worth reconsidering, such as its complexity and ambiguity, element of discretion in formal surveillance procedures, challenges in determining the business cycle, and rules enforcement. In practice, these issues tend to obscure effective implementation of the framework and may lead to undesirable fiscal situation in individual countries and the EU as a whole.

The re-evaluation of fiscal rules should lead to a more effective framework. Certain fundamental elements of the framework need to be retained, namely ensuring fiscal sustainability over the medium-long term and avoiding the build-up of macroeconomic imbalances. Our common aim should be to make the rules more effective, while ensuring enhanced transparency of their application, their predictability and increased commitment of the Member States to comply. In other words, the outcome of the review should be a transparent and predictable rules-based system with equal treatment and objective implementation, avoiding the need for discretionary decisions as much as possible.

We must not forgo and forget the "G" in the "SGP".

Furthermore, there is indeed room to simplify the rules, making them easier to comprehend for policymakers and the general public. However, simplification should not be the end goal in itself. Arguably, some level of simplification could be achieved by putting more emphasis on observable indicators, such as growth rate of government expenditure, in the assessment process. At the same time, it is important to retain indicators, which allow capturing the state of the business cycle in order to avoid unwarranted pro-cyclicality of fiscal policy. We should also strive to reinforce the counter-cyclicality of the current framework both during "bad times", when fiscal expansion is needed, and during „good times", when the focus should be on reducing debt and deficit levels, and on the build-up buffers in preparation for future shocks.

Our fiscal framework should not only ensure sustainability of public finances, but also foster economic growth, as well respond to long-term structural challenges, such as ageing populations and the need to foster green and digital transitions. One of the ways to strengthen fiscal sustainability is to increase potential as well as actual economic growth. In this regard, it would be feasible to consider a certain degree of flexibility regarding the treatment of productive public investments. Such a "golden rule" should come with appropriate safeguards to ensure fiscal sustainability and expenditure quality. Ultimately, if we want strong commitment to comply from all Member States, we need to provide a clear and sustainable path to growth and prosperity. We must not forgo and forget the "G" in the "SGP".

Last but not least, there is scope to improve our main instrument in coordinating economic policy – the European Semester. It is a success story when it comes to identifying fiscal, macroeconomic and structural issues. However, in terms of actually solving these issues it has proven less effective. Hopefully the introduction of the RRF will make a real qualitative difference in this respect. As numerous complex issues are identified under the Semester's procedures, covering a broad range of policy areas, strict prioritisation is important, especially in a rather short time frame of one year to implement the necessary changes. Hence, a leaner Semester with more focused recommendations could be more efficient in reaching the desired outcomes. A more targeted approach could arguably also better contribute to the prevention of macroeconomic and fiscal imbalances in the short run and as a result – to long term sustainability.

To conclude, the EU has faced many challenges yet every time it has emerged stronger and united. I firmly believe that the challenges of today and the future will be met with sufficient resolve and solidarity as they have been in the past. The particular issue of an effective common fiscal framework is no different.

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The European fiscal framework: Quo Vadis?

It's a well-established practice that European regulation gets reviewed every five years. The review of the fiscal rules was due end of 2019. First, the review was delayed by the establishment of the new European Commission. Then, the pandemic disrupted public consultations. Notably, also elections in big Member States can delay European processes. Currently, the review is expected for autumn 2021.

Meanwhile, and as a response to the economic effects of the pandemic, the general escape clause (GEC) was activated, with full support by Member States. Thus, only soft fiscal guidance is currently applied by the European Commission, with the notable exception of one excessive deficit procedure, which was opened already before the crisis.

The good news about the de facto non-application of fiscal rules is that markets and rating agencies are - at most – only slightly concerned, despite the addition of significant public debt, in most countries to record-high levels. The obvious reason is that a big buyer of public debt stepped-up its effort, the ECB. Could this be the end of the story?

Yes, if you believe the Europe is like Japan. I don't think that we can compare the European set-up with Japan. Nor, do I think that Europe would politically survive 30 years of economic stagnation.

The other reason for market calmness could be that a one-off debt increase does not change fiscal sustainability, as, whatever the debt level currently is, the debt-to-GDP ratio would converge to the (long-run) deficit ratio (or medium-term objective) divided by nominal GDP-growth. As public debt was mostly used to preserve the productive potential, returning to the original debt and growth trajectories is not out of reach. The most recent forecasts by the European Commission, the ECB or international organisations seem to confirm this view.

So keeping the existing rules would be a reasonable option. Under the impression of the pandemic, some policy makers, advisors and academics have found arguments, why one should not/cannot continue with the existing rules. Thus, the debate on the optimal fiscal rule-set will continue.

Whatever the outcome of the discussion, credible implementation will be key.

Whatever the outcome of the discussion, credible implementation will be key. Whilst one could think that implementation was a weaker point of in the last decade, actually only two Member States did not manage primary fiscal surpluses in any year. Two thoughts on that: 1) Any adjustment of the framework that accommodates full debt financing of interest payments for a considerable period would not appear economically or politically sustainable. 2) If 25 of 27 Member States can do (partly much) better, why should any Member State be allowed to take the others plus the ECB hostage in the event of a next crisis? (To take an analogy from the pandemic: Is there a good reason why the 80 % vaccinated people shall suffer from lockdowns/restrictions and/or pay for the remaining 20 % not willing to be vaccinated?).

The green transition will be on the political agenda for the next two decades. Is there any need to accommodate the fiscal rules to this policy priority? My answer is no: fiscal policy has always been there to reflect political priorities. If those priorities shift, also the budget composition will change. If you want to do away with "brown" public activities, instruments like spending reviews will create savings on the expenditure side or create extra tax revenues. So, unlike the difficult choices that politicians usually have to take as regards social equilibrium, the green transition itself will create its financing. This does not mean that there cannot be any policy mistakes, but this responsibility has to be kept in the Member States. Moreover, the greening of the economy cannot be managed by fiscal policy alone. Regulations across many political fields have to be changed too.

Is there a risk that the GEC would be applied for a long time because of long negotiations on the (new) rules? I don't think so: there is regular reporting on deficit and debt developments. The argument of a deep economic recession has become weaker already. With each fiscal notification date more Member States will resume fiscal normality. For the most likely few remaining Member States the argument that something might have to be fixed there will become stronger and stronger.