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**On the need for stabilizing and sustainable fiscal policy in EMU[[1]](#footnote-1)**

With the creation of the European Economic and Monetary Union (EMU), Member States abandoned domestic monetary and exchange rate policies to respond to country-specific shocks, so that fiscal policy is one of the few tools left for macroeconomic stabilization at the national level in these countries. If the economy is in a recession, say, government may increase spending and/or lower taxes and finance its revenues shortfall by issuing government debt. This expansionary policy will stimulate the economy, just like a cut in monetary policy rates would. Likewise, during an economic boom, the government may decide to increase taxes and/or lower spending to reduce government debt (i.e., contractionary fiscal policy). Fiscal policy that stabilizes the business cycle is countercyclical, while it is neutral if it has no systematic impact on the cyclicality of economic activity or pro-cyclical if it tends to amplify fluctuations.

A distinction is often made between discretionary fiscal policy and automatic stabilizers. Discretionary changes in taxes and spending require decisions by the policymaker, whereas automatic stabilizers are mechanisms that automatically loosen the fiscal stance when the economy slows down and that tighten the fiscal stance when the economy is booming (e.g., unemployment benefits).The strength of automatic stabilizers depends on factors such as the progressivity of the tax and transfer system. Both types of fiscal policy impact aggregate demand, but the automatic stabilizers are more predictable and work more quickly than discretionary fiscal policy actions.This is due to several lags: the legislative lag, the implementation lag, and the impact lag. Under normal circumstances, these long lags make discretionary fiscal policy a less effective stabilization tool than monetary policy. Furthermore, until recently, most economists considered monetary policy was strong enough to do the job. Fiscal policy was simply not necessary. And some economists had doubts about its effectiveness.

At the beginning of this century, most economists therefore dismissed discretionary fiscal policy and argued that automatic stabilizers should be relied upon. However, more recently views have changed. Notably when policy interest rates reached their effective lower bound it became clear that conventional open-market operations were not powerful enough to accomplish the desired stabilization of aggregate demand. The experience of several countries during the COVID-19 pandemic showed that discretionary fiscal policy measures can contribute to economic stabilization. Furthermore, recent research suggests that fiscal policy may be quite effective as fiscal multipliers were found to be higher than in the past. The fiscal multiplier is the impact on GDP of a one-unit increase in the government deficit. Research suggests that multipliers depend on several factors. First, several studies report a reduced effect of fiscal policy when sovereign debt levels are high.Second, multipliers tend to be higher when the interest rate is at its effective lower bound. Finally, there is evidence that the size of the multiplier is state-dependent and nonlinear: multipliers vary over the business cycle, and are significantly larger during downturns than during expansions, while countries operating with fixed exchange rate systems have larger multipliers than countries with flexible exchange rate systems.

 For fiscal policy, be it via automatic stabilizers or via discretionary decisions, to be effective in stabilizing the economy, symmetry in the fiscal response between good and bad times is important for three main reasons: (1) rebuilding buffers ahead of the next cyclical downturn; (2) reducing the risk of overheating; and (3) avoiding a ratcheting up of public debt over successive cycles.

The Maastricht Treaty focused on sustainability of fiscal policy to ensure a stable and successful euro in face of potential risks of spillovers among Member States and possible free-riding behaviour leading to excessive government deficits and debt levels. This, in turn, could threaten price stability and might ultimately force the central bank to use monetary policy to finance budget deficits. The Treaty established a requirement for Member States to avoid government deficits exceeding 3 % of GDP and to keep public debt levels below 60 % of GDP. In addition, it establishes elements to maintain market discipline, notably the no-bailout-principle according to which governments should not repay each other’s debt, and it prohibits monetary financing of government debt by the central bank.

Sustainable fiscal policy enables national fiscal policy to play a stabilizing role: Safe levels of debt allow automatic stabilisers to operate (e.g., higher expenditure on unemployment benefits and lower tax revenues during downturns) without leading to fiscal or financial market stress. In other words, sustainable public finances are a requirement for fiscal stabilization, be it via automatic stabilizers or through discretionary measures.

Since the Maastricht Treaty, the European fiscal framework has evolved. In 1997, the Stability and Growth Pact (SGP) was introdced which has a corrective and a preventive arm. The corrective arm aimed to ensure that Member States adopt appropriate policy responses to correct excessive deficits by implementing the Excessive Deficit Procedure (EDP), which provides Member States with binding and operational recommendations on the fiscal adjustment needed to correct the excessive deficit situation within a given timeframe. The preventive arm of the SGP requires that Member States attain a country-specific medium-term budgetary objective (MTO), which takes into account the economic cycle, thus allowing for automatic stabilisation while it is conducive to sustainable public finances.

In the early 2000s, adherence to the nominal deficit targets of the SGP proved difficult for some Member States in a recessionary environment. The SGP was reformed in 2005 to allow for greater consideration of economic conditions. The reform placed greater emphasis on the structural fiscal effort, with the aim to account for the impact of the economic cycle on government finances. In addition, if offered opportunities to take country-specific economic and budgetary positions into account.

The framework has subsequently been rivised by legislative packages known as the six-pack (2011) and two-pack (2013). These packages aimed at a closer coordination of economic policy and sustained convergence in economic performance by strengthening budgetary surveillance under the SGP, and by requiring Member States to establish national fiscal frameworks.

Although there is very popular perception that the (revised) SGP has failed, academic research has shown that notably the EDP had the intended effect on Member States’ policies. For instance, one study suggests that the overall compliance record was slightly above 50 percent, although this number masks stark cross-country differences. Another analysis also concludes that compliance of Member States with the Council recommendations in the context of the EDP has been quite satisfactory. Although not all recommendations were fully implemented, most Member States improved their structural budget balance in line with the recommended changes under the ‘corrective arm’ of the economic governance framework. The main weakness of the current fiscal framework is its preventive arm: Member States failed to make necessary fiscal adjustments during economic good times so that they were not in a position to implement stabilizing policies during bad times. In fact, evidence suggests only two clear-cut episodes when fiscal policy was countercyclical: the European Economic Recovery Plan of 2009 and the fiscal response to the COVID-19 pandemic (see Figure 1).

Figure 1. The average fiscal stance in the euro area, 1999-2021

Note: The output gap and the change in the cyclically-adjusted primary budget balance (ΔCAPB) are measured in percentage of GDP. When the output gap and the ΔCAPB have opposite signs, fiscal policy is considered procyclical.

This procyclicality is problematic because pro-cyclical fiscal policies during an economic downswing only make bad times worse. This argument has received considerable attention in the literature, but recently the other side of the coin has also become relevant: pro-cyclical fiscal policy can further overheat the economy that is in an upswing, thereby making the job of the ECB to keep inflation on target more difficult. Furthermore, business cycle stabilization is important because macroeconomic volatility can hamper medium-term growth. Pro-cyclical fiscal policy may also undermine the sustainability of public finances.

Pro-cyclical fiscal policies in the EMU reflects, amongst others, that the deficit reference value of the SGP has acted as a guidepost for national fiscal policies. As the national government deficits hovered around the 3% of GDP even in economic good times, cyclical improvements in the budget balance were eaten up by discretionary fiscal loosening rather than to be utilised to achieve the country-specific MTO which in principle is geared towards achieving a close to balance or in surplus position. Maintaining deficits just below 3% of GDP is not sufficient for high debt Member States to avert unsustainable debt dynamics, and forces those Member States to implement pro-cyclical fiscal consolidation in bad times.

It should also be noted that the current fiscal framework within EMU is not able to enforce the appropriate fiscal stance for the euro area as a whole. While there are (complicated) procedures for the correction of high public deficits, neither the Commission nor the Council has the ability to steer the fiscal stance for the euro area.

In November 2022, the European Commission published it orientations for a reform of the EU economic governance framework. The European Commission acknowledges that the current framework is complex, based on unobservable indictors (such as the output gap and the structural budget balance), and that it could not ensure that: fiscal policy was not pro-cyclical, that investment was protected, and that debt of Member States was sustainable. The Commission also concludes that the current debt reduction benchmark (the so-called 1/20th rule) implies a fiscal adjustment that is too demanding, pro-cyclical, and frontloaded. This would have a very negative impact on growth and thereby on debt sustainability itself. The orientations therefore propose to move towards a medium-term framework that puts debt sustainability at its core and differentiates between countries by taking into account their public debt sustainability challenges.

Centre piece of the proposed revision of the economic governance framework is the introduction of so-called national medium-term fiscal plans (NMFPs) that are envisaged to “bring together the fiscal, reform and investment commitments” of Member States. The key variable in the NMFPs should be a time path, covering a period of four years, for nationally-financed net primary expenditure, i.e., “expenditure net of discretionary revenue measures and excluding interest expenditure as well as cyclical unemployment expenditure…”. The expenditure path is supposed to be set so to “ensure that debt is put or kept on a downward path at the latest by the end of the adjustment period or stays at prudent levels, while ensuring that the budget deficit is maintained below 3% of GDP over the medium term.” The envisaged expenditure paths would differ across Member States, depending on their debt position. Departures from the agreed fiscal path would by default result in the opening of the EDP for Member States with a substantial public debt challenge. Next to this, the excessive deficit procedure would remain applicable for infringements of the 3% deficit reference value.

According to the European Commission, the proposal has several advantages. First, it is argued that it would simplify the existing framework and make it more transparent. Second, it is argued that national automatic stabilisers geared towards automatically loosen (tighten) the fiscal stance when the economy slows down (booms) would benefit from this new approach, resulting in a higher degree of macroeconomic stabilisation.

The proposal of the Commission to focus on a medium-term perspective and on a net expenditure rule makes perfect sense and is consistent with proposals put forward by others, like the European Fiscal Board, to reform the current European fiscal framework. Likewise, the proposed differentiation across Member States based on their debt sustainability is an important improvement.

Having said that, there are some elements in the Commission proposal that, in my view, should be reconsidered. First, the Commission wants to keep the excessive deficit procedure for infringements of the 3% deficit reference value in place, as it is “a well-established element of EU fiscal surveillance that has been effective in influencing fiscal behaviour and is well understood by policy makers and the general public.” This may be correct, but has resulted in nominal adjustment strategies focusing too much on the 3% threshold instead of medium-term objectives. Furthermore, using the 3% threshold in the same way as in the past makes the framework pro-cyclical, thereby undermining one of the acclaimed advantages of the proposed focus on the net expenditure rule. In my view, it would be preferrable to make the start of the EDP procedure only dependent on breaching the expenditure path as agreed upon in the NFMP.

The Commission Communication states that for a Member State with a substantial public debt challenge that departs from the agreed NFMP, an excessive deficit procedure would be opened “by default”. In contrast, for a Member States with a moderate public debt challenge, this would depend on an assessment by the Commission whether the deviation from the agreed-upon adjustment path has to be considered to give “rise to ‘gross errors'”. This, for sure, needs clarification.

What I also find worrisome, is that the Commission proposal refers to a correction in net expenditure for cyclical unemployment spending; it also refers to the implied level of the structural primary budget balance as part of the framework. This goes against the aim of making the framework less reliant on unobservable variables. It would have been better if these concepts would play no role at all in the proposed European fiscal framework.

The largest unknown in the Commission proposal is whether under the new framework enforcement will be as problematic as it is under the current framework, in which finance ministers have no incentive to cast a negative vote on another colleague’s policies, as at some future moment, they may need the support of this very colleague.

1. This position paper is based on some of my recent papers (written with several co-authors) on this topic. To keep the paper short, it does not provide references to the academic literature on which it is based. [↑](#footnote-ref-1)