

New life for an old framework: redesigning the European Union's expenditure and golden fiscal rules

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Goal

- EU fiscal framework suffers from numerous problems
- Our goal is to recommend a major revision which:
 - Would lead to marked improvement of the framework
 - Possible without EU Treaty revision

Problems with the EU fiscal framework (1)

- Complexity, transparency, predictability, consistency across countries and time, weak ownership
- Weak compliance and enforcement
- Dependence on unobserved variables (output gap and structural balance)
- Frequently leading to pro-cyclical fiscal policy
- Not allowing repeated fiscal stimulus when a recession lingers for years

Problems with the EU fiscal framework (2)

- In case of hysteresis effects, pro-cyclical tightening in a recession can undermine the growth potential
- Not protecting the quality of public spending
- Not restrain fiscal policies in good times, leading to vulnerable fiscal position
- Too much emphasis on annual, rather than longer-term performance indicators
- Public expenditures are under the direct control of governments, while the structural balance is not
- An expenditure rule has an ‘embedded’ cyclical stabilisation property

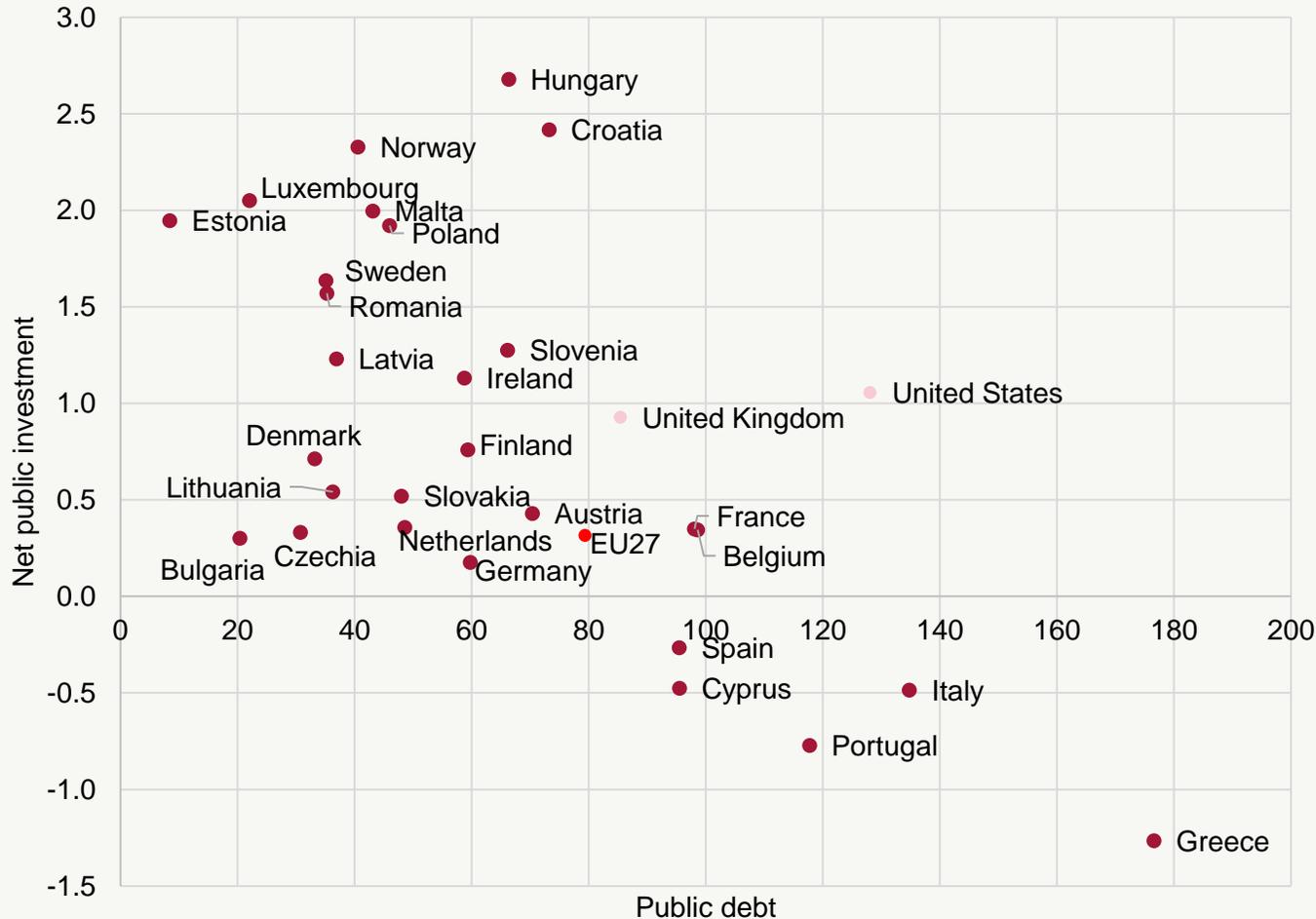
Certainly, European fiscal rules are not the only culprit for fiscal misbehaviour

- National institutions, national fiscal rules and a stability-oriented fiscal culture matter perhaps even more, as several EU countries with low public debt ratios demonstrate
- But EU fiscal rules can play an important role in countries with weaker national institutions when these national institutions do not ensure stability-oriented policies
- EU fiscal rules can also play important roles for countries with stronger institutions when a guidance is sought in a deep recession

Growing consensus on expenditure rules in the literature

- Carnot (2014), Andrieu *et al* (2015), Claeys *et al* (2016), Benassy-Quéré *et al* (2018), Feld *et al* (2018), Darvas *et al* (2018) and OECD (2018), European Fiscal Board (2019), Darvas and Anderson (2020), among others, criticise various aspects of the EU's current fiscal framework and made reform proposals
- The gist of these proposals is the same:
 - a properly designed expenditure rule as the main operational target
 - which is linked to an appropriate medium-term public debt level target
 - and underpinned by a proper institutional setup

Net public investment and public debt in 2019 (% GDP)



- Public debt and public investment correlates
- But: Germany and the Netherlands: low debt & low public investment → low public investment seems to be a political choice, not the result of fiscal rules
- Low investment in high-debt countries: fiscal space or fiscal rules?

Our recommendation for the EU fiscal framework (1)

- **Anchor:** five-year ahead or seven-year ahead debt ratio change objective
- **Operational target:** multi-year ahead ceilings for public expenditure corrected for discretionary unemployment expenditure, interest expenditure and discretionary revenue changes, while public investment is treated as discussed in the next point
- **The ceiling for the operational target** should be compatible with the debt ratio objective
- **Public investment:** an asymmetric golden rule

Our recommendation for the EU fiscal framework (2)

- **Institutional framework:**
 - Strengthened independent national fiscal councils
 - Establishment of a European Fiscal Council (similarly to ECB Governing Council),
 - Commission remains the institution that proposes recommendations to the Council of Ministers for adoption
- **Financial sanctions:** to be replaced with various instruments related to surveillance, positive incentives, market discipline and increased political cost of non-compliance
- **A single general escape clause** (applicable country by country)

Thank you for your attention

Paper available at:

<https://www.bruegel.org/2020/10/new-life-for-an-old-framework-redesigning-the-european-unions-expenditure-and-golden-fiscal-rules/>