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

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Based on an EP ECON Committee study co-authored with Julia Anderson

EP ECON Committee Shadows Meeting ‘The review of the macroeconomic legislative framework for a better impact on Europe’s real economy and improved transparency of decision-making and democratic accountability’

13 November 2020
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


- 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