Österreichische Gesellschaft
für Europapolitik

Does Rational Economic Policy Require a Stability and Growth Pact?

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Policy Recommendations

1. Formulation of a euro area wide economic policy stance with a view to promoting the objectives of the European Treaty.

2. Formulation of a "soft" expenditure rule, taking account of future investment needs.

3. A separate formula for dealing with the COVID-19 incurred additional government debt.

Abstract

The Stability and Growth Pact which has been suspended since the beginning of the COVID-19 pandemic has a number of major deficiencies: it acts pro-cyclically, it has a mainly defensive character to avoid negative spill-overs from "profligate" countries and its direction to individual countries makes the formulation of a policy stance for the euro area as a whole very difficult.
However, coordination of member states' policies is necessary, also in order to arrive at an "optimal" macroeconomic policy mix in line with the European Central Bank.
An expenditure rule would fulfil this requirement, taking account of the priority to invest into the future (green objectives, digitalisation, employment objectives). Contrary to the present set-up, such a rule would be enforced by peer pressure, popular discussion and pressure from financial markets. A separate rule would apply to the debt burden incurred by fighting the COVID-19 pandemic.

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Österreichische Gesellschaft
für Europapolitik

Does Rational Economic Policy Require a Stability and Growth Pact?

1. Status Quo

Economic policy-making in the European Union (EU) consists of various, frequently contradicting objectives and instruments. Macroeconomic policy, i.e. fiscal policy for which EU finance ministers are responsible – and which is one of the constitutionally determined competences of member states' finance ministers – is regulated by the Stability and Growth Pact (SGP). In its actual application it does not constrain expenditures during boom times but restricts expenditures in times of recession thus acts in a pro-cyclical way. The SGP is geared towards individual member states, thus neglects the formulation of a fiscal stance for the euro area as a whole. This would be a pre-condition for the determination of an appropriate euro area macroeconomic policy mix, to be jointly implemented with the European Central Bank (ECB). These weaknesses in the institutional setup[1] and its underlying conception of economic policy show up in the comparison of the gross domestic product (GDP) growth rates between the USA and the euro area after the 2008 financial crisis: since 2007, the last year before the crisis until 2019, the year before the onset of the COVID-19 crisis, US GDP in real terms grew by 48.4%, euro area GDP by only 18.3%.

The present "von der Leyen Commission" has initiated two new important policy directions[2]: the Green Deal as a major component of the objectives of macro and micro policy-making, and the NextGenerationEU fund and economic recovery package[3] which for the first time enables the joint European financing of the Green Deal and the necessary COVID-19 response. The latter objective has been accompanied by the temporary suspension of the SGP. This is an important acknowledgement by the European Commission that significant investment needs exist in the EU/euro area which cannot be accommodated given a strict interpretation of the SGP[4].

The role of the SGP in the EU has been a topic of discussion ever since its inception. In 2020, the European Commission issued a communication with a view to a potential reformulation[5]. As a result of the emergence of the COVID-19 pandemic and the ensuing decision on the Resilience and Recovery Fund (RRF), on 19 October 2021, the European Commission re-launched a review on "economic governance after COVID-19"[6]. Its purpose is to renew the debate on the macroeconomic framework of the EU, already communicated in 2020 but now with an emphasis on the lessons learned from COVID-19 and the launching of the RRF. The European Commission asked stakeholders and the general public for inputs into this debate, with a deadline for answers by 31 December 2021, structured into 11 questions[7] which deal with short and long-term

1) From the beginning, fiscal discipline was always intended to be supported by financial market pressure, formalised by the "no bail-out clause".

2) Actually, the European Commission prioritises 6 objectives 2019-2024: 1. A European Green Deal, 2. A Europe fit for the Digital Age, 3. An economy that works for the people, 4. A stronger Europe in the world, 5. Promoting our European way of life and, 6. A new push for European democracy.

3) https://europa.eu/next-generation-eu/index_de

4) See most recently, Mario Draghi, Emmanuel Macron. The EU's Fiscal Rules must be Reformed, Financial Times, Dec. 23, 2021, https://www.ft.com/content/ecbdd1ad-fcb0-4908-a29a-5a3e14185966

5) https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/economic-governance-review_en

6) https://ec.europa.eu/info/sites/default/files/economy-finance/economic_governance_review-communication.pdf

7) The questions are as follows: 1. How can the framework be improved to ensure sustainable public finances in all Member States and to help eliminate existing macroeconomic imbalances and avoid new ones arising?

budget sustainability, the financing of the Green Deal, the role of the RRF, the EU and country relations, simplification and enforcement questions. This re-evaluation should initiate a new framework for economic policy-making. At the beginning of 2022, this discussion is in full swing.

Taking up this call, this note discusses the following problems of the SGP (as the major element of economic governance): its role in shifting the EU/euro area policy agenda towards prioritising austerity against growth (as witnessed by the growth gap between the euro area and the USA after the 2008ff financial crisis); its "defensive" focus on preventing budgetary spill-overs from deficit countries against a forward-looking joint euro area policy agenda; its focus on individual countries as opposed to a focus on the total EU/euro area economy. Its over-complexity (as witnessed by 300 pages of "guidance") is a major procedural issue not directly discussed here.

2. Do we need a Fiscal Rule at all?

"Policy formulation becomes especially difficult, if it needs to be made for a number of countries, like the EU or the euro area."

Ideally, economic policy by a country or group of countries should be made on socio-economic science-based grounds, as circumstances demand: short-term stabilisation, social cohesion, economic well-being, safeguarding the environment and preparing for future societal requirements are the main objectives[8]. Reality often prioritises political objectives, however, to maintain or gain power. Policy formulation becomes especially difficult, if it needs to be made for a number of countries, like the EU or the euro area. Then the different requirements and interests of these countries must be taken into account, in addition to the interests of various constituencies. The euro area is a special case insofar as its monetary string of macroeconomic policy is conducted for the area as a whole by the European Central Bank, while the fiscal policy string is fragmented by leaving its conduct to (today) 19 separate finance ministers. While the five-year programme of a newly appointed European Commission sets clear medium-term guidelines, and is replicated by member states' programmes based on the Council Guidelines, the short-term programming of member states' surveillance mechanisms, manifested in European Semesters, two-packs, six-packs, constitutional

2. How can the framework ensure responsible fiscal policies that safeguard long-term sustainability, while allowing for short-term macroeconomic stabilisation? 3. How can the framework incentivise Member States to undertake the key reforms and investments needed to deliver on the Green Deal and help tackle today‹s and tomorrow‹s economic, social, and environmental challenges such as the twin transition while preserving safeguards against risks to debt sustainability? 4. How can one simplify the EU framework and improve the transparency of its implementation? 5. How can surveillance focus on the Member States with more pressing policy challenges and ensure quality dialogue and engagement? 6. In what respects can the design, governance and operation of the RRF provide useful insights in terms of economic governance through improved ownership, mutual trust, enforcement and interplay between the economic, employment and fiscal dimensions? 7. Is there scope to strengthen national fiscal frameworks and improve their interaction with the EU fiscal framework? 89. In light of the wide-ranging impact of the COVID-19 crisis and the new temporary policy tools that have been launched in response to it, how can the framework – including the Stability and Growth Pact, the Macroeconomic Imbalances Procedure and, more broadly, the European Semester – best ensure an adequate and coordinated policy response at the EU and national levels? 10. How should the framework take into consideration the euro area dimension and the agenda towards deepening Economic and Monetary Union? 11. Considering how the COVID-19 crisis has reshaped our economies, are there any other challenges that the economic governance framework should factor in beyond those identified so far? https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_5322

8) Budget considerations are instruments, rather than primary objectives as in the EU.

Österreichische Gesellschaft
für Europapolitik

debt brakes and other strings, frequently override these programmes.

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As long as there is no common euro area fiscal policy, with its own commissioner/minister and (adequate) budget, plus coordinating powers, a coordination mechanism (rule) will be needed in order to arrive at a semblance of common policy among 19 very different countries. Unless a joint euro area stance of fiscal policy direction is reached, coordination with the ECB is not possible, due to a lack of a single negotiating partner[9]. Monetary and fiscal policy might go in obverse directions, causing harm to reaching growth and employment objectives.

"The handling of the euro area crisis of 2011 serves as a warning signal."

Ideally, this coordination of fiscal policy with the monetary policy institutions would happen as a regular economic policy dialogue in order to arrive at the optimal policy-mix. Given the reality of very different starting points and policy priorities of the 19 euro area countries, such a continuous negotiation would crowd out other important policy issues and lead to more and more divisions among the member states. There is no deciding arbiter in the EU. This permanent discussion and negotiation of the "correct" fiscal policy would leave – as has happened since the financial crisis of 2008 – the macro policy field to the ECB. Given the fact that the ECB has more or less exhausted its conventional and unconventional instruments by multiplying its balance sheet and negative interest rates, this policy would – faute de mieux – fall into the unstable hands of financial markets – which have no economic policy mandate, no responsibility for the fate of economy and society, but rather work for individual profit. The handling of the euro area crisis of 2011 serves as a warning signal.

If joint rational economic-policy setting is elusive due to different political positions by member states, common rules will be necessary. The present rules are laid down in the Maastricht Treaty and have grown into a monster of more than 300 pages, a result of a number of revisions and "flexibilisations". They are so complex that very few experts can navigate them. All recent reviews have called for simplification, such that the rules can be understood by the public. Of course, simple rules cannot *ex ante* take account of all the specificities of member states and actual and potential circumstances, thus will probably have to be "one size fits all", with a number of specified exceptions taking account of a few foreseeable circumstances.

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3. What Type of Rule?

The present Maastricht rules are formulated as ratios: budget deficit and government debt as percentage of GDP. This "normalisation" by GDP makes sense in so far as it allows one to compare budgetary stances across different-sized countries. However, governments can directly only influence and control the numerator (budget) of this ratio, while the denominator (GDP) is subject to a number of influences, many of which are beyond the finance ministers' control.

With respect to the debt ratio, at present around 100% in the euro area, a consensus has emerged that the Maastricht 60% target is out of medium-term reach that a revision is necessary and that the time span for reaching that new target needs to be increased. The discussion is influenced by considerations about "debt sustainability", the risk that financial markets may no longer be willing

9) This is reminiscent of Henry Kissinger's famous confusion of whom to call when negotiating with the European Union.

to accept government bonds, and the risk that an increase in the presently low interest rates may endanger individual countries' budgetary sustainability.

The budget deficit itself is composed of the difference between partially plannable (discretionary) government expenditures (most of them public investment) and tax revenues, where finance ministries can at least set tax rates (if not revenues: these depend on the strength of demand, competitiveness of enterprises, possibilities of legal and illegal tax avoidance, in short: tax elasticities).

"The present Maastricht rules are formulated as ratios: budget deficit and government debt as percentage of GDP."

Accepting the criterion of the ability to control, it makes sense to change the budget rule from a ratio to an **expenditure rule**[10], i.e. set government expenditures to grow at a rate equal, higher or lower than (potential?) GDP over the business cycle. Based on "functional" expenditure criteria[11], the rule should allow for the necessary investment needs (green transition, pandemics, material and immaterial infrastructure), also for social cohesion (school buildings, hospitals, kindergardens), in the sense of "Golden Rule[12]" exemptions[13]. In this way, the rule would distinguish between public consumption and investment expenditures. It would make sense to record both of them but apply the rule to consumption, while deficits, i.e. public borrowing would be permitted for investments.

The austerity bias of the existing SGP has led to a significant fall in the share of public investment in GDP, with the well-documented effects on material and non-material infrastructure, the health system, climate and biodiversity. It took the EU suspension of the SGP in 2020 to allow the massive government expenditures to fight COVID-19. It was only the implementation of the Green Deal with the creation of the RRF to, at least temporarily, change the austerity-led economic policy paradigm of the EU and most of the EU/euro area finance ministers. At the time of this writing, however, first voices can be heard demanding a quick return to the application of the old SGP rules.

"'Clumsy' solutions which are acceptable to all are the most (and second-best) that can be achieved."

Procedure: A joint declaration by the EU/ euro area finance ministers stating the objectives of a forward-looking common economic policy – wellbeing, good jobs, social safety net, safeguarding nature – would form the basis for future fiscal policy. This should be followed by a broad discussion, structured in citizens' fora with experts and politicians (just like the present consultation) dealing with questions of implementation, of appropriate instruments, about binding or non-binding rules and, especially, how some degree of commitment towards common aims can be achieved. The EU must realise that "elegant" corner solutions cannot be achieved among 19/27 countries with 350/500 million citizens, of where the economy should go and by which means this should happen. "Clumsy"

10) This is also the option preferred by the European Fiscal Board, as described in its 2021 Annual Report, https://ec.europa.eu/info/publications/2021-annual-report-european-fiscal-board_en

11) See Lerner, Abba P., Economics of Employment, McGraw Hill, 1951.

12) "Golden Rule" takes all or certain public investment expenditures out of the rule-required target values. Thus, roughly, public consumption needs to be financed by taxes, while borrowing is allowed for investments.

13) In a previous ÖGfE Policy Brief "Returning to a 'new normal': revising the EU fiscal rulebook" (Jan. 28, 2022) Karl Pichelmann warns that exemptions for certain types of investment will lead to never-ending discussions on how to classify individual expenditures; see also the most recent decision on "taxonomy". https://www.oegfe.at/policy-briefs/returning-to-a-new-normal-revising-the-eu-fiscal-rulebook/?lang=en

solutions which are acceptable to all are the most (and second-best) that can be achieved[14].

4. Binding Rule and Sanctions?

"From an economic policy point of view it would be best to consider the rule as a rough guideline (as an interpretation of the Maastricht Treaty would allow)."

The rule discussion also needs to refer to the question how binding such a rule should be and whether and which realistic sanctions should follow possible non-compliance. It should be remembered that up to now no sanctions have ever been applied to violations of the SGP, apart from offending countries being put under "excessive deficit procedures", i.e. special forms of supervision. It should also be remembered that the first offenders of the existing SGP rules were Germany and France, both of which were politically strong enough to avoid sanctioning.

From an economic policy point of view it would be best to consider the rule as a rough guideline (as an interpretation of the Maastricht Treaty would allow). No sanctions would be necessary. This implies that finance ministers act rationally (from an economic point of view), instead of following political expediency. This would also presuppose that a joint view exists, what at the given time the economically rational solution would be, both for the country and for the euro area as a whole. This precondition does not exist, as different theories, different viewpoints, different interpretations of economic rationality are held by various ministers, in addition to how to trade off winning from losing groups, environment versus business, digital solutions versus labour, and others more. Rationality would also imply that each minister were able to put the wellbeing of the Eurogroup as a whole before that of his or her country.

The present formulation of the SGP, and its implementation, has a "defensive" bias: to prevent spill-overs of "irresponsible" budget policies to other countries, by means of sanctions. The effects have been abundantly discussed: lower growth, „balanced-budget-fetishism", emphasis on "structural" supply-side reforms instead of sensible macro-economic policies, loss of trust in the EU in many countries.

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A "pro-active" economic policy rule/guideline would give priority to the wellbeing of the euro area as a whole, accept that different viewpoints exist of what constitutes a "correct" economic policy and use positive incentives (like the new conditionality in the RRF) to guide individual member states towards the joint euro area objective. Coercive measures, like the troika conditionality for Greece (and others) are counter-productive and need to be avoided.

5. Summary

Fiscal policy is an integral part of macro-economic policy making, with important micro effects of the composition of public expenditures and the tax structure. Fiscal policy also influences total demand as a budget surplus reduces effective demand, and a deficit increases it, thus supplementing private (consumption plus investment plus net export) expenditures.

The previous direction of euro area fiscal policy has been based on a "defensive" interpretation of the Maastricht criteria and has not delivered[15]. During the financial crisis it led to severe impoverisation

14) See Kurt Bayer, Economists Should Learn from Plural Rationality Theory, https://kurtbayer.wordpress.com/2008/12/15/economists-should-learn-from-plural-rationality-theory/, Dec. 15, 2008.

15) GDP in 2020 is only slightly above that in 2007 (before the financial crisis); unemployment is higher, the share of investment in GDP is two percentage points lower.

in affected member states, to a significant fall in important public investment flows (both as financier and leverage-provider) and as a result has neglected important investments into the future of the euro area (environment, poverty, public health, physical infrastructure, education). By pushing back the role of the state, it has opened the field to the dominance of financial markets, quasi-directing economic policy[16], at the same time increasing the risk of instability for the real economy. It has contributed to increasing discrepancies with respect to income and wealth distribution and inequality in access to public services. The latter threatens to destroy social cohesion within and between countries. The rapid response by the EU with the suspension of the SGP and the establishment of the RRF has not changed the basic defensive, austerity-prone nature of the SGP.

"However, a 'new rationality' in EU/euro area economic policy-making must try to have the well-being of the vast majority of EU citizens in mind, and push for that."

All this is reason enough, as the European Commission is proposing, to re-consider this mis-direction of economic policy-making. It would be naive to ignore the power factor in a reformulation of economic governance. Beneficiaries of the present rule will try to hold on to it. However, a "new rationality" in EU/euro area economic policy-making must try to have the well-being of the vast majority of EU citizens in mind, and push for that. A broad discussion on the future of the EU/euro area can – with participation of citizens and institutionalised stakeholders – lead to a jointly "acceptable" direction of economic policy, based on broad guidelines/ rules for stabilisation, growth, distribution and environments objectives of the euro area and the member states. The question of whether sanctions need to enforce such joint understanding should be informed by the present discussion on increasing the share of COVID-19 vaccinated persons: positive incentives seem to work better than sanctions.

Economic policy discussions should be aware that economies are social constructs (and not guided by "iron laws"), where necessary flexibility must be maintained. This forbids overly legalistic procedures. In the end, economic policy will always be a political decision, not a legal one.

6. Recommendations

- A broad discussion process among euro area finance ministers and the ECB about the future economic policy direction should be accompanied by a public discussion, organised in citizens' groups with the aid of economic experts which can lay out the effects of different policy directions[17]. Future investment needs and debt sustainability objectives need to be accommodated. The purpose of this public discussion should be to re-direct the economic policy direction towards the well-being of populations, safeguarding nature and investing into a better future.

- The primary focus on economic policy for the euro area as a whole will define a desirable euro area fiscal stance as a pre-condition to arrive at an appropriate macro policy mix with the ECB.

- A forward-looking formulation of economic policy will dominate, the existing "defensive" spill-over-oriented bias of fiscal policy will be weakened.

- The SGP deficit criterion will be expressed as a simple "soft" expenditure rule for the budget, set as a guideline for the euro area as

16) See e.g. the current debate on how Central Banks can reduce their bond purchases and increase interest rates with the least negative effects on financial markets.

17) This is along the lines of the Conference on the Future of Europe, https://ec.europa.eu/info/strategy/priorities-2019-2024/new-push-european-democracy/conference-future-europe_en

a whole[18]. The expenditure rule will be set with a view to maintaining euro area debt levels within acceptable limits (to be newly defined). "Golden rule" exemptions will be formulated for financing the green transition.

- A separate rule would apply to COVID-19 incurred debt by countries, to be worked out together with the ECB. Its exclusion from "normal" debt targets will lessen the downward pressure on the expenditure rule.

- Individual country guidelines will be set. They define 2 to 3 country-specific budget-financed priorities for the next five years.

- Adherence by countries to the commonly agreed objectives will be achieved by peer pressure and positive monetary incentives, privileged access to common EU/euro area financial means (positive conditionality), instead of the (so far never enforced) sanctions of the present SGP.

18) The placement of joint EU bonds for refinancing parts of the RFF will put some indirect pressure on setting "appropriate" fiscal policies on policy makers. This market pressure, however, will not suffice.

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