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The Frugals, the Free-Spenders and the Friendly Hawks

In Search of a New European Fiscal Policy Consensus

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Executive Summary

Since the activation of the General Escape Clause of the Stability and Growth Pact (SGP)[1] in response to the COVID-19 pandemic in 2020, EU Member States have enjoyed a greater degree of flexibility in applying fiscal policy in response to the economic challenges of the pandemic than they had done during previous periods of crisis.

However, with the EU set to discontinue the activation of the General Escape Clause from the beginning of 2023, the EU faces an important and potentially acrimonious debate on the future of its fiscal rules.

The debate will require a level of compromise between governments who favour a return to the pre-pandemic fiscal rules, those who strongly favour greater flexibility in applying the rules, and governments whose positions lie somewhere in between – or are ambiguous at the time of writing.

Reaching an agreement will be crucial for Member States to obtain some level of certainty regarding their future fiscal positions. Moreover, the outcome of the debate in advance of the deactivation of the General Escape Clause will be a key litmus test for the degree to which the pandemic has shifted the conventional economic policy priorities and thinking of certain Member States, most notably Germany and the so-called 'frugal' countries, traditionally including Austria, Denmark, the Netherlands and Sweden – and occasionally Finland.

1. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020DC0123&from=EN

Introduction

In the coming months, the EU will undergo an important debate regarding the future of its economic governance framework which will contemplate the future of its fiscal rules. In 1992, when the Maastricht Treaty was signed, the Treaty introduced convergence criteria which dictated that countries who wished to join the euro should not have an annual deficit greater than 3% of GDP, and that government debt should not exceed 60% of GDP.[2] Following the adoption of the Stability and Growth Pact in 1997,[3] these rules were formalised for all existing countries within the euro area.

The current rules, which were amended in 2011 and 2013[4] in response to the global financial crisis, stipulate that, where countries have a government debt level that exceeds 60% of GDP or a deficit exceeding 3% of GDP, they are required to adjust the government balance by 1/20 of the respective deviation from target per annum. Failure to do so, in theory, leads to a Member State being entered into the Excessive Deficit Procedure (EDP). This Procedure requires governments to adopt a path of debt and/or deficit reduction towards the Maastricht targets or else face financial sanctions.[5] In addition, governments are required to meet a medium-term objective (MTO) for their budget balance when adjusted for economic cycles. Member States must also meet criteria which stipulate that the growth of expenditure must not exceed potential output growth, i.e., the level of output that an economy can sustain without inducing higher inflation.

The Stability and Growth Pact also contains a General Escape Clause which allows the Maastricht Treaty's debt and deficit targets to be suspended temporarily in response to a severe economic downturn in the EU. As such, after the onset of the pandemic, the General Escape Clause was activated. This allowed governments within the EU the flexibility to implement fiscal supports for citizens and businesses at the national level in ways that they could not do had the terms of the Stability and Growth Pact been applied during the pandemic. However, the General Escape Clause is designed to be only temporary, and the Commission is fully intent on returning to some form of an EU-wide fiscal framework from 2023.

In October 2021, the Commission relaunched its economic governance review which initiated a public debate on the future of the EU's fiscal policy, with the goal of reaching a consensus on the future of the EU's fiscal framework by 2023.[6]

But what form might such a framework take? What ideas have been proposed to reform the EU's fiscal policy and what is the Irish Government's position? How long will it take for the EU to agree on the future of its fiscal policy? This paper will explore some of these central questions and draw some tentative conclusions.

What is Wrong with the Current Fiscal Rules?

Since the recovery from the global financial crisis and the Eurozone sovereign debt crisis in the previous decade, a growing consensus has emerged within the political and economics communities that some aspects of the EU's current fiscal rules are not fit for purpose with respect to the modern-day realities of the EU economy.

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2. https://www.ecb.europa.eu/explainers/tell-me-more/html/25_years_maastricht.en.html
3. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31997Y0802(01)&from=EN
4. https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/history-stability-and-growth-pact_en
5. https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/corrective-arm-excessive-deficit-procedure/assessment-effective-action_en
6. https://ec.europa.eu/commission/presscorner/detail/en/ip_21_5321

Firstly, many influential members of the College of Commissioners and national Governments now believe that the adherence to strict debt and deficit targets during the global financial crisis and the Eurozone sovereign debt crisis meant that fiscal policy did not play its intended countercyclical role in responding to the crises. When reflecting on the future of EU fiscal policy at an IIEA webinar in September 2021, European Commissioner for the Economy, Paolo Gentiloni declared that "we cannot repeat what happened in the previous crisis", with regard to the EU's response to the COVID-19 economic crisis.[7]

Furthermore, the intended debt reduction path, which would in theory require all Member States to reduce their debt to GDP ratios to below 60% over a period of 20 years, would represent too rapid a fiscal adjustment for a large number of countries and would act as an impediment to future economic growth (See Figures 1 & 2 below).

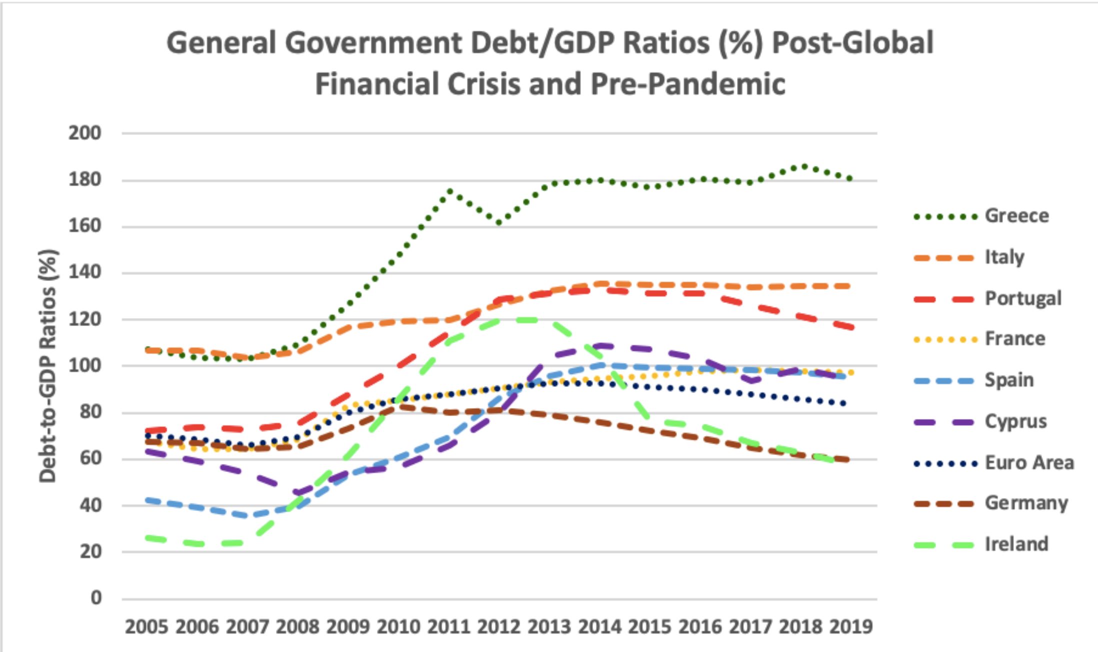

Figure 1 – Source: Eurostat

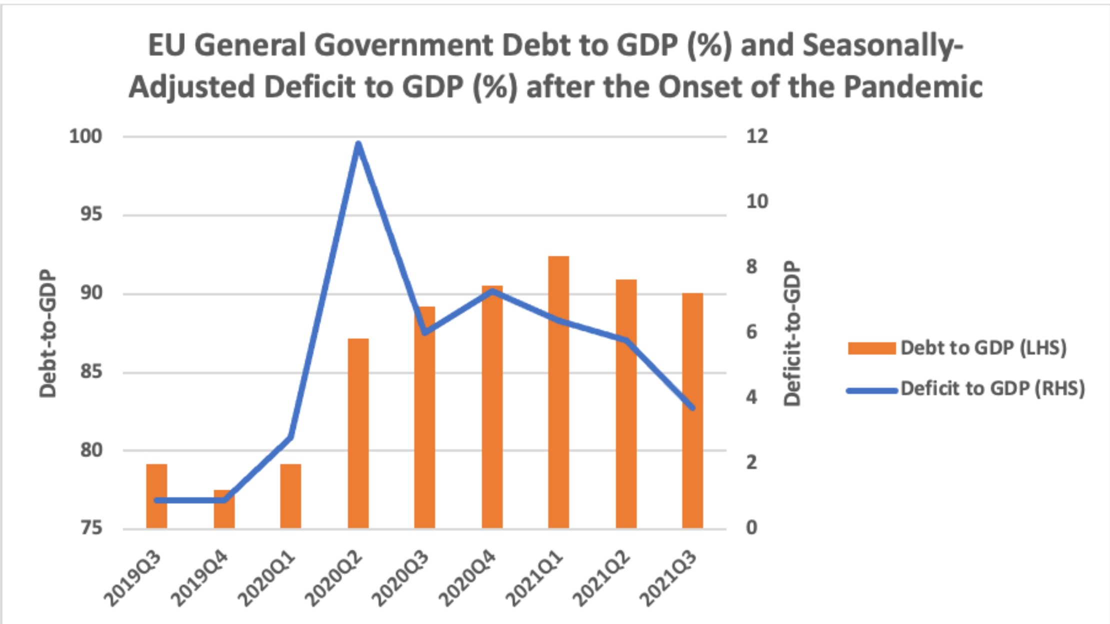

Figure 2 – Source: Eurostat

7. https://www.iiea.com/events/fostering-a-fair-recovery-and-building-resilience-the-path-forward-for-ireland-and-the-eu

At a meeting of the Eurogroup on Monday, 17 January 2022, European Commission Executive Vice-President, Valdis Dombrovskis, noted that there was "broad agreement" amongst EU finance ministers regarding the need for a more gradual debt reduction path for EU Member States.

In addition, there is broad acceptance, according to Executive Vice-President Dombrovskis, that the use of economic indicators in the Commission's MTOs, such as regarding output gaps and structural balances, which are not directly observable and prone to frequent fluctuations in response to economic shocks, should be reformed.[8]

As Klaus Regling, Managing Director of the European Stability Mechanism (ESM), noted in an IIEA webinar in February 2021, "the problem is that, after the global financial crisis and the euro crisis, we no longer have a good system to calculate output gaps and potential growth rates, which are needed to calculate the structural fiscal balance".[9] As such, the current technical framework which is used to underpin the MTOs that are set for EU Member States does not now provide a high level of precision with regard to Member States' individual economic circumstances.

Fault Lines in the Fiscal Policy Consensus

A central concern which anchors the debate surrounding the future of fiscal policy in the EU, and indeed globally, relates to the sustainability of national debt. Proponents of a less restrictive fiscal policy which favours higher levels of government spending argue that a long-run decline in equilibrium real interest rates caused by structural shifts in the global economy and reduced debt service costs mean that governments can sustain higher levels of debt than was previously the case when the Maastricht Treaty's debt and deficit targets were first designed. Moreover, under this perspective, a more expansionary fiscal policy is necessary during economic downturns to compensate for the limits placed on monetary policy by the effective zero lower bound of central bank policy rates and higher levels of national debt may actually be conducive to higher levels of potential growth.[10]

Similar arguments surrounding growth potential reference the lack of any form of decoupling between consumption expenditure and growth-enhancing investment expenditure within the fiscal framework. Some proposals to address this call for the establishment of a 'golden rule' whereby certain investments, such as funding for the green and digital transitions to support the Commission's 2019-2024 priorities,[11] would be exempt from the debt and deficit rules. For example, one notable proposal by leading economics think tank, Bruegel, which was presented at September 2021's Economic and Financial Affairs Council (ECOFIN) meeting of European finance ministers, argues for the establishment of a 'green golden rule' to prioritise growth-enhancing investment in climate change mitigation and adaptation.[12]

A more radical and hotly debated reform proposal by former Chief Economist of the IMF, Olivier Blanchard, calls for the concept of 'fiscal rules' to be replaced by a framework of 'fiscal standards'. Within such a framework, the application of 'fiscal standards' would entail an ex-post evaluation of Member States' fiscal policies with respect to a set of agreed standards, such as, for example, Article 126 of the Treaty on the Functioning of the European Union (TFEU), which states that "Member States shall avoid excessive government deficits".[13]

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8. https://www.irishtimes.com/business/economy/euro-zone-eyes-slower-debt-reduction-rule-among-ways-to-boost-compliance-1.4778921
9. https://www.iiea.com/events/webinar-reforming-the-esm-implications-for-european-financial-stability-and-resilience
10. See, for example, 'A Reconsideration of Fiscal Policy in the Era of Low Interest Rates' by Summers and Furman (2020) https://www.piie.com/system/files/documents/furman-summers2020-12-01paper.pdf
11. https://ec.europa.eu/info/strategy/priorities-2019-2024
12. https://www.bruegel.org/wp-content/uploads/2021/09/PC-2021-18-0909.pdf
13. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN

What constitutes an "excessive government deficit" could then be determined by secondary EU legislation and adjudicated by either the Council of the European Union or the Court of Justice of the European Union.[14]

However, many of the Member States who raise concerns about radical reform of the EU's fiscal policy governance argue that, within a monetary union, and in the absence of a complete fiscal union, fiscal rules must anchor the level of euro-denominated debt in order to protect against a sovereign debt crisis, such as that which occurred from 2010 to 2012.

Moreover, the argument follows that due to the high levels of public debt which have accumulated during the pandemic, there is the possibility that equilibrium real interest rates may not remain low indefinitely and may indeed rise sharply and suddenly, should markets begin to question the sustainability of Member States' sovereign debt levels. This would further accelerate the deterioration of Member States' fiscal positions due to higher debt service costs.

In addition, a further factor that could increase Member States' cost of borrowing is an unwinding of the European Central Bank's (ECB) quantitative easing programmes. ECB holdings of euro area public sector bonds within its Public Sector Purchase Programme (PSPP)[15] and its Pandemic Emergency Purchase Programme (PEPP)[16] now equate to more than €4 trillion, or over one-third of euro area government debt.[17] Bond prices move inversely to yields and as such, if the ECB chose to unwind its asset purchase programmes at too rapid a pace, it could lead to an increase in Government borrowing costs. The institutional separation of fiscal and monetary policy means that monetary policy decisions by the ECB are beyond the remit of elected governments.

Building a Consensus – The Hour of the 'Friendly Hawks'?

Reaching a consensus on the future of EU fiscal policy will require a meeting of minds among the Member States and a level of compromise between those Governments who support a less restrictive fiscal framework and those that favour a return to pre-pandemic norms as well as those who find themselves somewhere between these two camps.

Influential Member States who will dictate the tone of the debate have already provided an indication of their views at this early stage.

In an opinion piece published in the Financial Times last December, French President, Emmanuel Macron, and Italian Prime Minister, Mario Draghi, leading the 'free-spenders', jointly argued for a relaxation of the EU's fiscal rules, writing that government borrowing to finance investments "which undeniably benefit the welfare of future generations and long-term growth, should be favoured by the fiscal rules, given that public spending of this sort actually contributes to debt sustainability over the long-run".[18] The opinion piece followed the signing of the 'Quirinale Treaty', an agreement which foresees a new axis of enhanced cooperation between the French and Italian Governments in the post-Merkel era.[19]

France's intervention into the debate was particularly significant, given that it will hold the rotating Presidency of the European Council for the first half of 2022, and, as such, will preside over any discussions on fiscal policy reform that take place in ECOFIN during that time.

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14. https://www.piie.com/sites/default/files/documents/wp21-1.pdf
15. https://www.ecb.europa.eu/mopo/implement/app/html/index.en.html
16. https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html
17. https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=325.GFS.Q.N.I8.W0.S13.S1.C.L.LE.GD.T._Z.XDC._T.F.V.N._T
18. https://www.ft.com/content/ecbdd1ad-fcb0-4908-a29a-5a3e14185966
19. https://www.euractiv.com/section/global-europe/news/italy-france-sign-quirinale-treaty-as-merkels-exit-tests-european-diplomacy/

On the other side of the aisle, many of the EU's more 'frugal' governments favour a return to the discipline imposed by the pre-pandemic fiscal rules with only some minor adjustments. A joint position paper, published by eight Member States in September 2021, states that "reducing excessive deficit ratios has to remain a common goal".[20]

The election of a new Government in Germany, traditionally a fiscally conservative Member State, has added a fresh dynamic to the debate. Within the German tripartite governing coalition, the Finance Ministry is held by Christian Lindner, the leader of the Free Democratic Party (FDP), a pro-enterprise economically conservative party. The coalition is also comprised of two centre-left-leaning parties, the Social Democratic Party of Germany (SPD), and the Greens, and is led by former Finance Minister, Chancellor Olaf Scholz of the SPD. On a recent visit to Italy, Chancellor Scholz signalled Germany's reluctance towards agreeing to any relaxation of the fiscal rules, stating that the current rules "had always shown great flexibility [and] are still doing so", adding that "we will be able to use them for the future".[21] However, in what may be interpreted as a harbinger of the German Government's willingness to consider a compromise in this debate, Minister Lindner indicated that "Germany wants to be part of solutions and not part of the problem", labelling himself as a "friendly hawk" – but a hawk no less – with regard to the upcoming fiscal rules debate.[22]

Such 'friendly hawkishness' appears to be reflected in the more recent statements of several of the Member States who had previously signed the September 2021 joint position paper, including three of the so-called 'frugal four', namely: the Netherlands, Sweden and Denmark.[23] Of the 'frugal four', only Austria remains steadfastly of the view that the EU should implement its traditionally strict fiscal framework once the General Escape Clause is deactivated.[24]

How will the Irish Government Approach the Debate?

The Irish Government's position on the possibility of reform of the EU fiscal rules thus far remains somewhat unclear, likely in part due to the leading role that Finance Minister, Paschal Donohoe will play in building a consensus amongst euro area members as President of the Eurogroup. The Eurogroup held its first discussion on the implications of the EU's economic governance framework for the euro area on Monday, 17 January 2022, and will hold further discussions on this during its work programme for the first half of the year.[25]

Nonetheless, Minister Donohoe has stated previously that he believed that any future discussion of the EU's fiscal framework would centre around a rules-based approach rather than any approach based on standards, given the architecture of the Eurozone's currency union.[26]

However, it remains to be seen whether the Irish Government will favour a return to a fiscal framework that rigorously applies the rules of the Stability and Growth Pact, as was suggested in Minister Donohoe's letter of motivation during his successful campaign to become Eurogroup President in 2020,[27] or if a growing shift in attitudes across the EU will likewise result in the Irish Government embracing broader reforms of the EU's fiscal rules.

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20. https://www.euractiv.com/section/politics/short_news/fiscally-conservative-member-states-strike-back/
21. https://www.politico.eu/article/germany-and-italy-vow-to-strengthen-ties-but-disagree-on-budget-rules/
22. https://twitter.com/BloombergTV/status/1483447347644354571?t=8sg-C4i-bGZwjFs78JGDPg&s=19
23. https://www.euractiv.com/section/economy-jobs/news/coalition-against-eu-debt-rule-reform-shows-cracks/
24. https://www.euractiv.com/section/politics/short_news/austria-seeks-germanys-support-for-return-to-strict-budgetary-rules/
25. https://www.consilium.europa.eu/media/52767/secretariat-issues-note-review-of-the-economic-governance-framework-item-1-eg.pdf
26. https://www.youtube.com/watch?v=F1A3XJuRpBw
27. https://www.consilium.europa.eu/media/44703/letter-from-minister-donohoe-re-eurogroup-president.pdf

Conclusion: A New Unity of Purpose?

With discussions beginning in earnest after the close of the Commission's public consultation on the EU's economic governance framework at the end of 2021, the Commission is due to publish a set of draft proposals which will form the basis of future discussions this spring. It has been reported that the Commission intends to publish draft proposals in mid-April 2022 which will form the basis of preliminary discussions and debate amongst Member States. Following this, the Commission intends to outline its final proposal in June, with the hope of securing agreement in principle from the European Council at its meeting from Thursday, 23 June 2022 to Friday, 24 June 2022.[28]

Given the scale of the differences that are required to be overcome, despite the softening in positions of traditionally 'frugal' Member States, the above timeline to reach an agreement is ambitious. Furthermore, it is plausible that negotiations could stretch later into 2022 and possibly further into 2023.

Should EU Member States fail to reach an agreement by the beginning of 2023, a clear and potentially divisive dilemma would present itself. In such a scenario, the EU would be faced with the binary choice of either reimplementing its pre-pandemic fiscal framework or extending the period of activation of the General Escape Clause. The potential political acrimony, as well as the potential adverse reaction in the sovereign debt markets, resulting from such a crossroads highlights the importance of a timely agreement by Member States.

The result of the negotiations on the future of the EU's fiscal rules will be critical in determining Ireland's and the rest of the EU's scope to rely on debt financing to fund public services and future investment needs. A compromise between the 'frugals', the 'free-spenders' and the 'friendly hawks' in 2022 is far from a foregone conclusion, but a timely agreement would at least deliver certainty to governments and international markets regarding Member States' budgetary positions going forward. In 2020, the EU collectively embraced the principle of common debt issuance for the first time by agreeing on its unprecedented NextGenerationEU recovery fund. This illustrated a newfound unity of purpose on behalf of Member States with regard to the EU's economic policy.

2022's discussions on the fiscal rules will once again require a similar unity of purpose and a level of compromise amongst all Member States. Their outcome will be a further indication of whether the Union can respond decisively and effectively to contemporary economic challenges. Furthermore, it will signal whether the harmony witnessed in 2020 is an artefact of the pandemic's long shadow or if the EU will move towards a new era of unity in its economic policy.

28. https://www.politico.eu/article/europe-is-ready-to-shed-its-fiscal-straitjacket/

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