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Philippe Martin[a], Jean Pisani-Ferry[b]
and Xavier Ragot[c]

Reforming the European Fiscal Framework

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Despite dramatic transformations in the macroeconomic environment, Europe's fiscal framework has barely changed. The conceptual framework underpinning its rules, characterised by disbelief in expansionary fiscal policies, was already being challenged before the Covid-19 shock. It appears even more outdated in the post-Covid context of massive increases in public debt, low interest rates and new joint European debt and recovery plans.

The fiscal rules have been temporarily suspended since March 2020 to enable Member States to take emergency measures against the unprecedented economic crisis. This should be an opportunity for an ambitious reform of the fiscal framework. To avoid the mistakes of 2010-2011, we recommend a reformed system of rules be reinstated only after two conditions are met: GDP-per-capita should be back to its pre-crisis level, and Member States should have reached a political agreement on a new fiscal framework.

Rules are necessary because in a monetary union, a Member State's fiscal policy affects its partners via two channels: insolvency risk in one country induces collateral damage on the others, in particular through pressure for monetisation or a bail-out; a member's fiscal policy affects the growth of its partners, through demand externalities.

We recommend putting these two externalities at the core of the new European fiscal framework, i.e. of both the rules and the institutional architecture of fiscal surveillance. Debt sustainability would be the cornerstone of the renewed Stability Pact, which implies getting rid of uniform numerical criteria (for public debt and the deficit). In practice, each government would put forward a debt target, whose adequacy would be assessed by a national independent fiscal institution (IFI), on the basis of a common methodology, before being validated by the Ecofin Council. This debt target would serve as a basis for the medium-term programming of public finances, *via* a corresponding expenditure rule.

The reform we are proposing implies an increased role for the national IFIs and the European Fiscal Board, while preserving the prerogatives of the Commission and the Council.

Finally, The Commission should be able to address cases of markedly insufficient demand both by proposing the activation in exceptional circumstances of an EU fiscal support instrument. It should also be empowered to recommend the reorientation of a Member State's fiscal policy (whether too restrictive or too expansionary) that risks aggravating macroeconomic imbalances in the Union.

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[a] Sciences Po, Member of the CAE; [b] Sciences Po, European University Institute, Bruegel and Peterson Institute;
[c] OFCE, Sciences Po, Member of the CAE.

Since the Maastricht Treaty, the European fiscal rules have been constantly revised (without Treaty changes), in order to take into account the economic cycle and either tighten common fiscal discipline or introduce flexibility.[1] But the underlying framework has broadly remained the same. Even before the Covid-19 crisis, many economists and officials were calling to change the European fiscal framework.[2] The post-Covid context is further exacerbating the discrepancy between these rules and an economic reality that is characterised by soaring public debts, low interest rates, a new complementarity between fiscal and monetary policy and the creation, at least temporarily, of a debt-financed common European fiscal capacity. An overhaul of the fiscal framework, i.e. of both the rules and the institutional architecture of budgetary surveillance, is now indispensable.

We are no longer in the world of Maastricht

The conceptual framework prevailing when the Maastricht Treaty was drafted was based on disbelief in the capacity of fiscal policy to promote growth domestically, let alone in partner countries. The dominant view was that an increase in the budget deficit of a Euro Area country would raise interest rates in all the countries, thereby penalising investment. Moreover, it was considered necessary to prevent the risk that sovereign insolvency would threaten monetary policy independence (fiscal dominance) or trigger transfers (bail-outs). In other words, it addressed mainly the externality of financial markets, while demand externalities were considered secondary. In this framework, the macroeconomic stabilisation role was meant to be carried out by monetary policy, and limiting the capacity for discretionary fiscal policy was considered relatively harmless.

This fiscal framework has not –or barely– been adapted to a macroeconomic environment characterised by four new trends: a strong increase in public debts, very low or even negative interest rates, a limited effectiveness of monetary policy in the vicinity of the effective lower bound*,* and common debt issuance with the adoption of the European recovery plan in 2020. These fundamental changes do not mean that the risk of another Euro Area debt crisis has disappeared, but they do imply that its scenario would be different.

An unprecedented and heterogeneous increase in debt

The first change is the increase in public debt levels in advanced countries, which took place in two stages: the financial crises of 2007-2012 and then the Covid-19 crisis. Eurozone debt amounted to 66% of GDP in 2007. It reached 100% in 2020. This average increase has been accompanied by strong heterogeneities: while all countries experienced rises in their debt level in 2009 and again in 2020, the rest of the time differences across countries widened. While Sweden's debt has remained below 50% since 2000, Italy's and Greece's have risen from around 100% to 160% and 207% respectively. A Franco-German divergence has developed from 2010 onwards: French debt is currently 116% of GDP, compared to 71% in Germany.

The new European fiscal framework must take this heterogeneity into account. It should provide further incentives to reduce excessive debt. At the same time, a framework that would lead to hasty adjustments in the most indebted countries would be both economically counterproductive, as discussed below, and politically perilous.

A disconnect between the level of debt and its cost

The mere observation of public debt levels is not sufficient to assess their fiscal cost, for two reasons. The first is the reduction in the effective (or implicit) interest rate on public debt, i.e. the weighted average rate on past issuances. Mechanically, this reduction contributes to a decrease in the interest burden, despite the increase in debt volumes. The nominal interest burden of the Euro Area countries was close to 4% of GDP in 1999 but it only amounted to 1.6% of GDP in 2019.

The second reason is the holding of government debt securities by the Eurosystem (mainly national central banks, within the framework of the ECB's asset purchase policy). This holding can be analysed as a swap of about 25 percentage points of GDP of bond debt for monetary debt issued by the Eurosystem to finance its bond purchases. Interest payments received by the national central banks on these bonds are returned to their respective Treasuries through annual dividend payments, while the cost of the monetary debt is currently zero or negative. In current circumstances (which may not necessarily last), the effective interest burden on public debt is therefore reduced by about a quarter.

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[1] Main reforms: 2005 (introduction of structural variables); 2011 (Six-Pack); 2012 (Fiscal Compact); 2013 (Two-Pack); 2015 (flexibility clauses). For a more detailed presentation, see Bennani H. and B. Savatier (2021): "Le cadre budgétaire européen, son architecture institutionnelle et son évolution dans le temps", *Focus du CAE*, no 056-2021, April.

[2] See, for example, Bénassy-Quéré A., M. Brunnermeier, H. Enderlein, E. Farhi, C. Fuest, P.O. Gourinchas, P. Martin, J. Pisani-Ferry, H. Rey, I. Schnabel and N. Véron (2018): "Reconciling Risk Sharing with Market Discipline: A Constructive Approach to Euro Area Reform", *CEPR Policy Insight*, no 91; Darvas Z., P. Martin and X. Ragot (2018): "Reforming European Budgetary Rules: Simplification, Stabilization and Sustainability", *Notes du CAE*, no 47, September; Thygesen N., R. Beetsma, M. Bordignon, S. Duchêne and M. Szczurek (2018): *Second Annual Report of the European Fiscal Board*, European Budget Committee; Feld L., C. Schmidt, I. Schnabel and V. Wieland (2018): "Refocusing the European Fiscal Framework", *VoxEU*, 12 September.

While uncertainty remains around medium– to long–term interest rates, the nominal interest burden is likely to remain low in the coming years: in 2020, the implicit rate on French public debt was indeed almost two percentage points higher than the rate on 10-year government bonds. This inertia ensures that interest payments will remain low for several years, even if debt rises and long-term rates increase.

The relationship between debt dynamics and interest payments is also mitigated by the endogenous reaction of governments. Empirically (see Box 1 and Martin and Savatier, 2021),[3] Euro Area governments react to changes in interest charges by reducing the primary balance when the interest burden falls, and by increasing it when the interest burden rises. As for the central bank's purchases of government securities, these will contribute to lowering the effective interest burden as long as the central bank's policy rate remains lower than the effective rate of bond debt. This effect could diminish, disappear or even be reversed if monetary policy is normalised.

The possibility of a debt crisis in the Euro Area

The tensions on sovereign debt in 2011-2012 in Europe highlighted the possibility of self-fulfilling debt crises (i.e. induced by insolvency expectations that are not justified by fundamentals). This possibility, initially regarded as theoretical,[4] proved real when Italian and Spanish rates rose dramatically in 2011-2012.

We consider that the ECB has, since Mario Draghi's "Whatever it takes" in 2012, taken on the responsibility of blocking self-fulfilling debt crises. It renewed this commitment in March 2020, as the first alarms about the value of Italian bonds rang. This *de facto* change in the ECB doctrine does not preclude a sovereign debt restructuring, but it makes it a decision of last resort. With the ECB effectively preventing self-fulfilling debt crises, we can focus our analysis on the risk of solvency crises based on economic "fundamentals".

More frequent use of fiscal policy to stabilise the economy

The context of low interest rates and limited effectiveness of monetary policy in the vicinity of the effective lower bound has led to rehabilitating the concept of policy mix.[5] Over the last twenty years, the international consensus on the role of fiscal policy has shifted, as illustrated by the difference between the views of Taylor (2000),[6] according to whom "it is best to let fiscal policy have its main countercyclical impact through the automatic stabilisers", and those of Furman (2016),[7] for whom "fiscal policy is a critical complement to monetary policy and [...] we have used it too little, especially given its effectiveness and given the greater fiscal space".

1. How does the primary deficit react to changes in interest payments on the debt?

In the spirit of the literature on empirical determinants of primary balances (see Bohn, 1998, and Debrun and Kinda, 2016), we have tested for the Euro Area how primary balances react to changes in the interest payments-to-GDP ratio (see Martin and Savatier, 2021). The dynamics of the debt-to-GDP ratio (d_t) depend first on the differential between interest payments on the debt $r_t d_{t-1}$ and the growth rate of the economy $g_t d_{t-1}$ that reduces the denominator in the debt-to-GDP ratio, and second on the primary balance sp_t, according to the formula: $d_t - d_{t-1} \approx r_t d_{t-1} - g_t d_{t-1} - sp_t$

The tested model (over the period 1995-2019) is: $sp_t = \alpha r_t d_t + \gamma X_t + \delta$ where we use interest payments as a percentage of GDP for $r_t d_t$. δ represents country- and year-fixed effects and X_t controls. The main results are:

- In the Euro Area, an increase by one percentage point of GDP in interest payments is associated with an improvement of about 0.5 percentage points in the primary balance. The response is symmetrical (fall or rise in interest payments);
- The result is similar, albeit smaller (0.4), for the structural primary balance;
- The response of the primary balance is weaker for higher levels of interest payments, but this empirical result lacks robustness;
- Fiscal rules do not seem to be the cause of this reaction, as it does not increase when the total deficit approaches the 3% limit;
- While governments respond systematically to changes in interest payments, the primary balance appears insensitive to the other determinant of debt dynamics, namely the rate of growth that reduces the debt-to-GDP ratio, $g_t d_t$.

Bohn H. (1998): "The Behavior of US Public Debt and Deficit", *Quarterly Journal of Economics*, vol. 113, no 3, pp. 949-963 and Debrun X. and T. Kinda (2016): "That Squeezing Feeling: The Interest Burden and Public Debt Stabilization?", *International Finance*, vol. 19, no 2, pp. 147-178.

[3] Martin P. and B. Savatier (2021): "Primary Balance and Debt Dynamics: The Role of Interest Payments", *Focus du CAE*, no 055-2021, April.

[4] Calvo G.A. (1988): "Servicing the Public Debt: The Role of Expectations", *The American Economic Review*, no 647-661 and Cole H.L. and T.J. Kehoe (2000): "Self-Fulfilling Debt Crises", *The Review of Economic Studies*, vol. 67, no 1, pp. 91-116.

[5] Bartsch E., A. Bénassy-Quéré, G. Corsetti and X. Debrun (2021): "Is It All in the Mix?", *Geneva Report on the World Economy*, no 2.

[6] Taylor J.B. (2000): "Reassessing Discretionary Fiscal Policy", *Journal of Economic Perspectives*, vol. 14, no 3, pp. 21-36.

[7] Furman J. (2016): "The New View of Fiscal Policy and its Application", *VoxEU*.org, vol. 2.

This new context, which also results in higher fiscal multipliers, can, at least in part, be analysed in the light of the "secular stagnation" hypothesis put forward by Larry Summers to explain the economic situation in the 2010s:[8] fiscal policy proves to be a necessary instrument when economies are stuck in low activity and deflationary equilibria.[9] In such cases, a fiscal stimulus has powerful effects.[10] Recent analysis has also reassessed the persistence of negative demand shocks when these are not countered by fiscal support.[11] The macroeconomic consensus has thus shifted towards giving a greater role to fiscal stabilisation. A structural role for fiscal policy is even contemplated in response to the risk of a persistent demand deficit leading to continued underemployment and a decline in potential output.

This revision has the strongest potential implications for the Euro Area, as its macroeconomic policy framework is more than elsewhere based on the separation between monetary and fiscal policy, and the ultimate predominance of the former (monetary dominance). This framework also prioritises the prevention of unsustainable fiscal behaviour while giving little weight to stabilisation objectives. Nowhere else has the assignment of macroeconomic policy instruments been codified as extensively on a premise that now appears clearly obsolete. The underpinnings of macroeconomic policy have in recent years been updated to a much larger extent in the United States.

In the light of recent experience of *de facto* complementarity between ECB policy and national fiscal policies, calls for a deeper revision of the Stability and Growth Pact have emerged. Echoing Mario Draghi, who in 2014 recommended in Jackson Hole that "it would be useful for the overall policy stance if fiscal policy could play a greater role alongside monetary policy",[12] ECB Executive Board member Isabel Schnabel recently called for rethinking the relationship between monetary and fiscal policy when interest rates can no longer be reduced, saying that "effective macroeconomic stabilisation in the vicinity of the lower bound requires both unconventional monetary and fiscal policies".[13] In February 2020, the European Commission launched a public debate on the reform of the economic governance of the Eurozone.

The emergence of a common debt

Finally, the latest change in the European fiscal environment has been the creation of a significant common debt capacity. In response to the pandemic shock, the European Union has introduced *Next Generation EU*, a package of €750 billion, composed of €390 billion in transfers and €360 billion in loans. This programme will mobilise funds backed by a temporary increase in the EU's own resource ceiling to 2 per cent of gross national income. These funds will be used mainly to support Member States through investment and reforms.

In the absence of new European own resources, these initiatives increase the states' implicit liabilities without increasing their financial debt. However, loans should be distinguished from grants: the Union's loans will be repaid, and therefore have no impact on its net debt, while transfers to Member States are yet to be financed by new own resources. Funding for these transfers thus falls onto Member States in proportion to their future contributions to the Union's budget. Absent identified new resources, an option would be to record these implicit liabilities as financial debt of the Member States. This would however be inapplicable: this debt does not legally constitute an explicit financial commitment, and the future apportionment of the burden will depend on both the amount of new own resources and the relative national income of the Member States. At this stage, therefore, the liability should be assigned to the Union, it being understood that, absent a decision on new resources, its repayment will ultimately rest on the states.

For a comprehensive overhaul of the fiscal rules

What fiscal rules should a currency area be equipped with in the current macroeconomic context? Our view is that rules remain necessary, but that those of the current Stability and Growth Pact have become deeply inadequate. Even before the health crisis, proposals were converging on simplifying the Pact and substituting the fine-tuning of structural balances with national spending rules.[14] However, these proposals questioned neither

[8] Christiano L., M. Eichenbaum and S. Rebelo (2011): "When Is the Government Spending Multiplier Large?", *Journal of Political Economy*, vol. 119, no 1, pp. 78-121.

[9] Eggertsson G.B., N.R. Mehrotra and J.A. Robbins (2019): "A Model of Secular Stagnation: Theory and Quantitative Evaluation", *American Economic Journal: Macroeconomics*, vol. 11, no 1, pp. 1-48.

[10] Particularly in the US: Romer C.D. and D.H. Romer (2010): "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks", *American Economic Review*, vol. 100, no 3, pp. 763-801; Auerbach A.J. and Y. Gorodnichenko (2017): "Fiscal Stimulus and Fiscal Sustainability", *NBER*, no w23789; in the United Kingdom: Cloyne J. (2013): "Discretionary Tax Changes and the Macroeconomy: New Narrative Evidence from the United Kingdom", *American Economic Review*, vol. 103, no 4, pp. 1507-28; and in Germany: Hayo B. and M. Uhl (2014): "The Macroeconomic Effects of Legislated Tax Changes in Germany", *Oxford Economic Papers*, vol. 66, no 2, pp. 397-418.

[11] Fatás A. (2019): "Fiscal Policy, Potential Output, and the Shifting Goalposts", *IMF Economic Review*, no 67.

[12] Draghi M. (2014): *Unemployment in the Euro Area*, Speech at the Annual Central Bank Symposium in Jackson Hole, 22 August.

[13] Schnabel I. (2021): *Unconventional Fiscal and Monetary Policy at the Zero Lower Bound*, Speech at the Third Annual Conference organised by the European Fiscal Board.

[14] See Bénassy-Quéré A., X. Ragot and G. Wolff (2016): "Which Fiscal Union for the Euro Area?", *Notes du CAE*, no 29, February.

the debt criteria nor the secondary role of fiscal policy in the architecture of the European economic policy system.

Two priority objectives

The purpose of a system of fiscal rules is to ensure that the externalities of national policies are accounted for in government decisions.

A monetary union regime is characterised by two main fiscal externalities. The first, which was at the heart of the Euro Area crisis, is the risk to the area's financial and monetary stability posed by the insolvency of a Member State, and even more so by its possible exit (as was the case with the threat of Greece leaving the euro). This risk is less significant today than it was ten years ago, as measures have been taken to strengthen the banking system, breaking the doom loop between sovereign and banks solvency, and also because low interest rates make higher debts sustainable. Yet the risk remains.

A Member State's insolvency would inflict collateral damage upon other members through contagion (from the insolvent state to banks, and to other states), and through the threat of a break-up of the Euro Area. It would result in a call for assistance, to the ECB through monetisation and to the other Member States through transfers. Without binding rules on public indebtedness, states might thus take the risk of accumulating excessive debt (and markets might fail to impose a sufficient risk premium) if they expect a bail-out to take place in response to increased risks of insolvency or exit from the Euro Area.[15] Again, it should be noted that we are speaking here of fundamental insolvency resulting from excessive debt, not of the threats resulting from self-fulfilling expectations, which, as explained above, are and should remained addressed by the ECB.

The second externality, that was largely neglected in the design of the EMU, pertains to aggregate demand. As long as fiscal support to aggregate demand is called for and no central budget exists to take on this role, a question arises: how to take into account the impact of national fiscal policies on partner countries?[16] As shown by Blanchard *et al.* (2017)[17] and Dabla-Norris *et al*. (2017),[18] these externalities were long considered secondary because of opposite spillover effects on the goods and capital markets, yet they are strong when the central bank's policy rate can no longer be reduced due to the effective lower bound.

The Maastricht system posited a coincidence of the insolvency externality and the demand externality, under the implicit assumption that excessive public deficits penalise other Member States through their effect on interest rates. The new context invalidates this hypothesis, whose empirical evidence is anyway scarce.

It is obviously difficult to design a system of rules that simultaneously responds to the two potentially contradictory imperatives of ensuring sustainability and supporting demand. In the absence of an additional instrument such as a central budget, the only possibility is to define *ex ante* how to respond to trade-offs between them. A possible option is to focus on the insolvency imperative and to disregard the demand externality, as in Blanchard *et al.* (2021).[19] However, failing to explicitly address the demand externality within the rules-based EU policy framework would very likely result in its neglect. This would be counterproductive.

Rules or standards?

While the need for a reform is now fairly consensual, the nature of this reform remains fiercely debated. Blanchard *et al.* (2021) advocate a radical option consisting in replacing budgetary rules by qualitative standards. They propose to rid EU legislation of all numerical criteria that have accumulated over time and to replace them with the sole principle that Member States "ensure that their public debts remain sustainable with high probability".

Compliance with this commitment would be subject to stochastic sustainability analyses (see Box 2 on this method) conducted by European institutions. In case of non-compliance (i.e. when the analysis determines that the probability of sustainability is below a certain threshold, for example 95%), the Member State would be invited to correct its budgetary path: the lower the probability, the faster the pace of consolidation would be. As for implementation, in the most streamlined version of their proposal Blanchard and his co-authors suggest replacing the mechanism of gradual sanctions decided by the Ecofin with the standard procedure in Community matters: an action for infringement of EU laws brought by the Commission before the Court of Justice, which could then decide on sanctions against the Member State in breach of its obligations.[20]

As we explain below, we agree with these authors on giving a central character to the analysis of sustainability

[15] Gourinchas P.O., P. Martin and T.E. Messer (2020): "The Economics of Sovereign Debt, Bailouts and the Eurozone Crisis", *CEPR Discussion Paper*, no 14891, estimate that during the Euro Area crisis transfers ranged from 0.5% of GDP (Ireland) to 43% of GDP (Greece).

[16] See Micossi S. (2020): "Raising Growth in the Euro Area" in *Strengthening the Institutional Architecture of the Economic and Monetary Union*, Buti, Giudice and Leandro (eds) (2020), VoxEU.org eBook, CEPR Press.

[17] Blanchard O.J., C.J. Erceg and J. Lindé (2017): "Jump-Starting the Euro-Area Recovery: Would a Rise in Core Fiscal Spending Help the Periphery?", *NBER Macroeconomics Annual*, vol. 31, no 1, pp. 103-182.

[18] Dabla-Norris M.E., P. Dallari and M.T. Poghosyan (2017): "Fiscal Spillovers in the Euro Area: Letting the Data Speak", *International Monetary Fund Working Paper*, no 17/241.

[19] Blanchard O.J., Á. Leandro and J. Zettelmeyer (2021): "21-1 Redesigning EU Fiscal Rules: From Rules to Standards", *PIIE Working Paper*, no 21/1.

[20] This would obviously require an amendment to the TFEU.

2. Stochastic methods for assessing sustainability

International institutions, such as the IMF, the World Bank and European institutions regularly assess the sustainability of public debt and provide comprehensive presentations of their analytical framework and of lessons from experience.[a] Their analyses are based on an central scenario and an assessment of the risks around this scenario. The central scenario is based on a few key variables, such as the nominal growth rate of the economy, the interest rate path and variables related to the political acceptability of the interest payments burden. The Commission also takes into account demographic ageing as a long-term variable.

Two political acceptability variables are used. The first is the maximum primary surplus that the country can maintain over a long period. The second has been recently discussed in an environment of low interest rates. It is the debt service-to-GDP ratio. Thus, in the case of the United States, Furman and Summers (2020)[b] propose dropping the debt-to-GDP ratio, which they criticise for ignoring the interest rate and more fundamentally for comparing two variables of different nature, i.e. a stock (debt) and a flow (GDP). They recommend replacing it with, either a stock/stock or more operationally a flow/flow (namely interest payments/GDP ratio). In practical terms, they suggest setting the maximum level of interest payments-to-GDP at 2%. Applied to the United States, this rule would lead asymptotically to a maximum debt of 125% of GDP, at the current level of long-term rates (1.60%).

In the case of France, Ragot (2021)[c] uses historical values of the interest payments/GDP ratio to determine a maximum fiscal space. Over recent years, an average value of 2% seems realistic. It is similar to the value found by Furman and Summers for the US.

The interest payments-to-GDP ratio is an important component of debt dynamics, along with the primary balance and the economy's growth rate. However, these three components are not mutually independent. For example, in the Euro Area, we have empirically verified that the primary balance reacts to changes in the interest payments/GDP ratio: an increase (decrease) of one percentage point in interest payments is associated with an improvement (deterioration) of about 0.5 percentage point in the primary balance, both expressed as a percentage of GDP. This result suggests that the impact of interest payments on debt sustainability is partly reduced if taken into account the endogenous reaction of primary balances to interest charges.

Moreover, the use of the interest payments-to-GDP ratio does not lend itself to a numerical legal constraint. Indeed, when doubts about fiscal sustainability emerge the response of market rates is abrupt. Debt crises are characterised by strong non-linearities in the interest rate/debt relationship, and can quickly block access to the refinancing of debt rollover.[d]

Stochastic analyses of debt sustainability capture the uncertainty surrounding deterministic debt trajectories. This probabilistic tool has become part of fiscal policy assessments in many international institutions. It most often uses the historical volatility and co-movement of the macroeconomic variables in the debt accumulation equation to produce a fan chart around the deterministic debt path. These charts can be used to calculate the probabilities attached to some sustainability indicators.[e]

Finally, the 2008 subprime crisis and the Covid-19 crisis show that risk assessment around the central scenario must take into account large-scale crises, which occur once every ten or twenty years. Evaluations of public debt sustainability must therefore take into account extreme events that are modelled like macroeconomic stress tests.

[a] See European Commission (2021): « Debt Sustainability Monitor 2020 », *Institutional Paper*, no 143, February and Bouabdallah O., C. Checherita-Westphal, T. Warmedinger, R. de Stefani, F. Drudi, R. Setzer, and A. Westphal (2017): "Debt Sustainability Analysis for Euro Area Sovereigns: A Methodological Framework", *ECB Occasional Paper*, no 185 for the framework used by European institutions. See also IMF (2021): *Debt Sustainability Framework for Low-Income Countries*. Available at www.imf.org/en/About/Factsheets/Sheets/2016/08/01/16/39/Debt-Sustainability-Framework-for-Low-Income-Countries, for a presentation of the joint IMF-World Bank methodology.

[b] Furman J. and L. Summers (2020): *A Reconsideration of Fiscal Policy in the Era of Low Interest Rates*, Discussion Draft, Harvard University.

[c] Ragot X. (2021): "More or Less Public Debt in France", *OFCE Policy Brief,* no 86, March.

[d] Mauro P. and J. Zhou (2021): "r – g < 0: Can We Sleep More Soundly?", *IMF Economic Review*, no 69, pp. 197-227.

[e] See Collard F., M. Habib and J-C. Rochet (2015): "Sovereign Debt Sustainability in Advanced Economies", *Journal of the European Economic Association*, vol. 13, no 3, pp. 381-420, for an analysis of the debt sustainability of developed countries in the presence of refinancing risk.

and on removing the multiple numerical criteria that have accumulated in the European fiscal framework. However, we consider unrealistic a complete break with the Pact and the substitution of Council decisions with judicial procedures. We deem important that given the nature of the risk, Member States be directly involved in the decision to place one of them in breach of the rules.

Beyond the European numerical criteria

We do not propose to rewrite the central provisions of the Treaty on the Functioning of the European Union (TFEU). This applies first of all to Article 126 ("Member States shall avoid excessive government deficits"), to the gradual pressure its procedures entail, including the possibility –never used– of financial penalties. While other fiscal monitoring mechanisms could be devised, the fact that market discipline alone cannot be trusted to prevent insolvency risks requires a principle of good behaviour and a gradual pressure procedure.

Similarly, we do not propose to eliminate the central provision of Article 121 ("Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council") upon which the preventive arm of the Stability Pact was built. Neither the spirit nor the letter of this article prejudge the nature of externalities or the desirable direction of national policies.

However, we believe it is essential at least *de facto* (and in time *de jure*) to remove the numerical criteria on the debt (60% of GDP) and deficit (3% of GDP) thresholds from Protocol 12 annexed to the TFEU.

The debt threshold sets a target that is too far removed from the reality of the Euro Area and too deprived of analytical foundations to be maintained. Before the Covid-19 crisis, the European Fiscal Board (2019)[21] had concluded that the attempt to operationalise this criterion (requiring that the debt be reduced towards the 60% threshold by one-twentieth per year) had been *de facto* abandoned (see Bennani and Savatier, 2021). In practice, the European surveillance system works without operational reference to the level of public debt, although it ought to primarily control the risk of insolvency.

We therefore propose making debt sustainability the cornerstone of a reformed Stability Pact. Like Blanchard *et al.* (2021), we consider that the prohibition of excessive deficits should be interpreted as a legally binding obligation to maintain the risk that the public finance path becomes unsustainable at a very low level.[22] This risk should be assessed by stochastic analyses that measure the probability, in different states of nature, that a public finance path ends up in insolvency (Box 2).

Such an approach precludes the application of uniform numerical criteria. Debt sustainability depends fundamentally on the capacity to maintain a sufficient primary surplus, so as to prevent the debt ratio from diverging in a context of unfavourable growth and interest rates. Yet both the maximum level of the primary surplus sp_{max} and the spread between interest rates and growth rates $(r-g)$ are country-specific:

- The first, sp_{max}, because the maximum achievable primary surplus is not the result of economic analysis, but of political economy assessment. Empirical analysis shows that the ability to sustain a primary surplus above 5% of GDP is very rare, but the precise limit may vary from country to country;
- The second, $(r-g)$, because growth and real interest rate differentials between countries are substantial. Even when the nominal interest rate is the same, an exchange rate appreciation along a convergence path generates differentials in equilibrium inflation and real interest rates. Growth rates also differ because of differences in potential.

Overall, protracted differences in nominal growth, and thus differences in $(r-g)$, have been considerable over the period 1999-2019 between countries with high nominal growth (Ireland, Spain) and countries with low nominal growth (Italy, Greece).

We therefore propose to set a country-specific debt target based on an assessment of the sustainability risk. In setting this target, the interactions between fiscal policy, growth and interest rates must naturally be taken into account, as well as the need to maintain a safety margin.[23]

Regarding the deficit criterion, the need for a reform could appear less pressing. The fall in the interest payments burden observed over the recent years has resulted in a parallel increase of the size of primary deficits that remain compliant with the 3% threshold. However, maintaining this threshold would have important perverse effects. Apart from lacking analytical basis, this approach could overly constrain fiscal policies at a time when these may persistently be required to play a supporting role. Last but not least, it would undermine the logic of our proposal, which is to give a central role to the debt criterion.

As for the structural criteria underlying the Pact's preventive arm since the 2005 reform, these have not proved sufficiently reliable to guide fiscal policies in a context of severe economic turmoil. They need to be replaced by a more robust framework (see below).

Debt limit and the spending rule

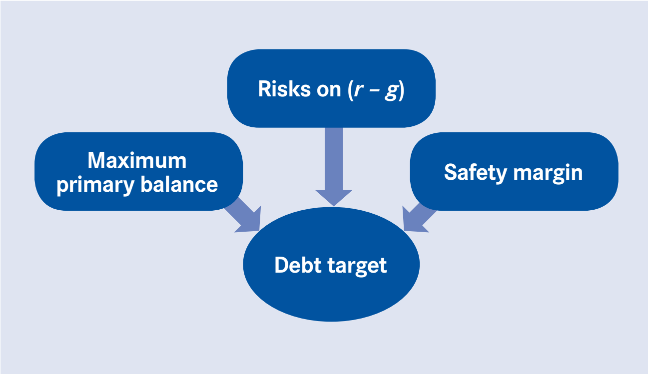
We therefore propose that based on a common methodology, each government set a medium-term debt target, the relevance of which would be assessed by the Member State's independent fiscal institution (IFI) and by the European Union. This target should be explicitly based on assessments of the maximum primary balance and the risks to the interest rate –growth rate $(r-g)$ differential. For example, the government could set the maximum primary surplus, while the probabilistic scenarios for interest rates and growth assumptions would be the responsibility of the independent

[21] Thygesen N., R. Beetsma, M. Bordignon, S. Duchêne and M. Szczurek (2019): *Assessment of EU Fiscal Rules with a Focus on the Six and Two-Pack Legislation*, European Fiscal Board.

[22] Or, equivalently, to ensure the sustainability of public finances with a high degree of probability (the usual IMF formulation).

[23] A differentiation of the pace of convergence of the debt ratio was recommended in the 2020 Report of the European Fiscal Board, but within the reference to the 60% target.

fiscal institution. To be able to counter shocks, this target would also take into account a necessary safety margin with respect to the maximum sustainable debt level. It should not be fixed once and for all (like the current 60% ceiling) but should vary, notably with the risks on the differential $(r - g)$. The following figure illustrates this approach.



Recommendation 1. Replace the uniform numerical criteria of the current fiscal framework with a five-year debt target set by each Member State on the basis of a country-specific assessment of debt sustainability.

Once this debt target has been set, it should serve as an anchor for the medium-term programming of public finances,[24] according to the mechanism described in Bénassy-Quéré *et al*. (2018) and Darvas, Martin and Ragot (2018). The growth rate of the ceiling for nominal[25] primary expenditures, excluding expenditure-side automatic stabilisers, and net of new discretionary tax increases, should be set in accordance with the 5-year debt target on the basis of output growth and inflation assumptions.

We propose that the ceiling on nominal expenditure growth be calculated net of interest payments, unemployment insurance expenditures (except for discretionary benefit changes) and the estimated impact of new revenue measures (changes in tax rates and tax bases). The first two adjustments are designed to allow for more countercyclicality, while excluding the effect of structural measures that increase spending. The latter is designed to enable governments to make fiscal choices that reflect their political preferences.

After European-level endorsement (as described below), this ceiling would serve as an upper bound for annual budget laws over a parliamentary term.[26] It would only be modified, at the initiative of the government, in the event of a persistent economic shock, a change in political orientation, or the application of the general escape clause.

Recommendation 2. Set a nominal expenditure ceiling (net of discretionary measures on revenues) for fiscal programming over five years, taking potential growth and the debt target into account. Make this ceiling an upper bound for annual budget laws. Subject to compliance with this requirement, leave room the automatic stabilisers to operate fully.

Budget planning based on the expenditure ceiling, itself derived from the debt target, would thus replace the debt target/deficit target duality, which has never worked well in the European system. It would also replace the targeting of structural balances which is based on unobservable and volatile variables and has introduced too much noise in fiscal surveillance. Along with the structural balance rule, the 3% nominal deficit threshold should also be abandoned in favour of an integrated logic. This would offer much more transparency and help better appropriation by policy-makers.

Obviously, expenditure programming would still be based on assumptions for potential growth. However, it has proved more stable and less reliant on error-prone, unobservable variables than structural balance-based programming (Darvas and Anderson, 2020).[27]

We do not favour introducing a golden rule that would treat investment expenditures differently from other public expenditures. This type of rule generates too many practical difficulties, not least in defining public investment. For example, spending on education and training is not counted as public investment, even though its impact on potential growth is decisive. Nevertheless, it will be the role of the IFIs[28] and of the EFB in their respective debt sustainability analyses to take into account the impact on potential growth of public investment in a broad sense. The assessment of public finance sustainability should also take into account the time profile of climate investments (beyond the 5-year limit) in order to avoid creating incentives to postpone them beyond the programming horizon.

[24] On this point as well as on the counter-cyclical role of discretionary fiscal policy, our proposal is consistent with the ideas recently expressed by the European Commission. See Gentiloni P. (2021): *High Debt, Low Rates and Tail Events: Rules-Based Fiscal Frameworks under Stress*, Speech at the Third Annual Conference organised by the European Fiscal Board, February 26.

[25] A nominal rather than real spending rule is stabilising in nature because a negative demand shock generates lower than expected inflation. As the nominal growth rate of public expenditure is based on the initial inflation forecast, such a shock leads to a higher volume growth rate of expenditure and thus a positive fiscal impulse.

[26] And, in the French case, for social security financing laws.

[27] Darvas Z. and J. Anderson (2020): *New Life for an old Framework: Redesigning the European Union's Expenditure and Golden Fiscal Rules*, Bruegel.

[28] These institutions, such as the High Council for Public Finance, were established in all Member States following the entry into force of the Fiscal Compact and the Two-Pack.

Turning to implementation, the actual evolution of public finances will likely deviate from the expenditure ceiling. However, these deviations should remain limited and they should not have a systematic character. Taking inspiration from German practice, this could be ensured by creating an account that would record positive or negative balances with respect to the spending rule, and whose cumulative deficit would be limited.

Recommendation 3. To ensure consistency between multi-year public finance programming and annual budget laws, provide for an adjustment account with a deficit ceiling: it would be credited when spending net of discretionary tax cuts is lower than the expenditure ceiling and debited when exceeding it.

Space for discretionary policy

As mentioned, discretionary fiscal policy has an important role to play in a regime of low interest rates and therefore limited effectiveness of monetary policy. The question is what role it can play in a rule-based system.

At a national level, a spending rule based on a debt target will enable automatic stabilisers to fully operate. In a coordinated European framework, it should also leave room for discretionary or possibly expansionary fiscal policy in countries with a low insolvency risk. In other words, the sustainability of the Member States' public finances must become the main objective of the European fiscal framework. But as long as this objective is not at risk, the framework must leave room for demand management.

We therefore propose that, in the absence of an insolvency risk, the expenditure ceiling be revised in case of a pronounced euro-wide recession that monetary policy cannot counter alone. In practical terms, the Union could adopt a flexibility factor that would apply to national spending rules. This would allow for the flexible coordination of national policies.

However, experience has shown the difficulties of such coordination. In particular, the procedure on macroeconomic imbalances created in response to the Euro Area crisis has not been able to contain surpluses in the balance of payments.

Partly for this reason, the European Union has developed a new instrument to provide a structural response to the Covid crisis. *Next Generation EU* is not based on coordination but on Community-level borrowing to finance priority investments in Member States. It is too early to say whether this radical innovation will achieve its goals, namely contribute to specified common objectives and to help struggling economies recover. This will depend in particular on the quality of the programmes proposed and implemented by the Member States.[29] However, as Guttenberg *et al.* (2021)[30] point out, the response to the Covid crisis has already settled two debates that had remained hitherto unresolved: the feasability of joint borrowing as well as the construction of a common "fiscal capacity". It is indeed at the level of the Union, using the Community budget, and not within the framework of the Euro Area, that these responses are being implemented.

We are convinced that the still missing European fiscal instrument will be developed on the basis of this experience. It will not be a budget in the usual sense, and the stabilisation of business cycles will continue to rely on monetary policy and on the Member States' fiscal policies. Nevertheless, the experience of the Recovery and Resilience Facility could provide the basis for rarer yet more fundamental fiscal initiatives in response to crises leading to prolonged demand shortfalls (as opposed to cyclical fluctuations) or to a structural lack in public investment.

What must be envisaged and developed jointly is a European instrument to finance specific public investment programmes by means of mutualised debt. The counterpart should be either a commitment by Member States to contribute to the Community budget in proportion to their national income, up to the amount of this debt, or the creation of new own resources.[31]

In comparison to the Recovery and Resilience Facility, this instrument will certainly devote a larger share of its funding to European public goods, which were largely forgotten in the negotiation of the *Next Generation EU* initiative. *Ex post*, it is clear that the Union should have made common resources available as early as the summer of 2020 with a view to invest in research and vaccine production. The EU will also need to clarify how common debt will be financed –whether through future contributions from Member States or new own resources– and to ensure proper control over its debt level. Repayment of Union debt ultimately falls on the same taxpayers as national public debt.

Recommendation 4. On the basis of experience with the Recovery and Resilience Facility, gradually set up a permanent European fiscal instrument with a medium-term borrowing capacity backed by own resources. This instrument should be used when facing exceptional situations by financing common initiatives deemed as a priority, or programmes to correct serious economic divergences between Member States.

[29] On this, see Pisani-Ferry J. (2020): "European Union Recovery Funds: Strings Attached, but not Tied up in Knots", *Bruegel Blog Post*, October.
[30] Guttenberg L., J. Hemker and S. Tordoir (2021): "Everything Will Be Different: How the Pandemic is Changing EU Economic Governance", *Policy Brief Hertie School*, 11 February.
[31] See in this regard Fuest C. and J. Pisani-Ferry (2020): "Financing the European Union: New Context, New Responses", *Bruegel Policy Contribution*, September.

A new institutional framework

The current institutional arrangement for budgetary surveillance assigns responsibility for evaluation to the Commission, and decision-making to the Council. Over the years, it has evolved from a model combining supervision by the Commission and full discretion left to the Council, to a model that leaves more flexibility to the Commission and ties the hands of the Council more tightly (due to the application of the reverse qualified majority rule). The inclusion of fiscal standards in national constitutions or legislation, and the creation of IFIs in Member States (such as France's High Council for Public Finance), show that decentralisation of fiscal discipline has to some extent taken place. Finally, the Commission has set up an independent advisory body, the European Fiscal Board (EFB).

The reform we propose will have to be accompanied by a redefinition of institutional responsibilities. While the European Union should stop micro-managing national fiscal choices, we recommend strengthening the resources, the independence and the surveillance capacities of national IFIs, in order to further anchor the culture of fiscal responsibility within domestic institutions. Sustainability analyses would thus be carried out under the responsibility of the IFIs. However, in order to avoid administrative duplication, the technical work could be carried out by the competent government services under the responsibility of the IFI. This type of cooperation between the administration and the IFI can take inspiration from the United Kingdom's IFI, namely the Office for Budget Responsibility (OBR).

To ensure sustainability, we propose that:

- The EFB defines a common methodology to assess national fiscal sustainability, and the IFIs control its implementation;
- Each government sets a debt target and an expenditure ceiling over a five-year horizon in accordance with the sustainability standards set by the EFB;
- National IFIs assess the adequacy between the government's debt target and sustainability objectives. Their public and detailed assessment should be based on the common methodology defined by the EFB and submitted to the Commission for endorsement;
- The Commission's roles of surveillance and recommendations to the Council, be upheld. The Council would take the ultimate decision on accepting or censoring the national debt target and the associated primary expenditure ceiling. The Commission would also be responsible for monitoring the compliance of Member States' actual fiscal policies with the expenditure ceiling. Finally, it would make a recommendation to the Council on the overall orientation of fiscal policy in the EU and the Euro Area;
- The Ecofin Council's current role as the ultimate decision-maker in the surveillance of national fiscal policies be also maintained. In line with the general thrust of our proposal, this surveillance would focus on debt targets and primary expenditure ceilings. In this context, we recommend building on the 2013 Two-Pack legislation and giving the Council the possibility to reject a national budget that would put at risk the sustainability of a Member State's public finances.

For the management of demand externalities, we propose to entrust the Commission with the responsability for:

- Making a recommendation to the Council on the overall fiscal stance of the Euro Area both at one year and five year horizons, and if necessary, for proposing to adjust the Member States' expenditure ceiling. It could also recommend the reorientation of a fiscal policy (too restrictive or too expansionary) of a Member State that aggravates current account imbalances within the zone;
- Proposing the activation of exceptional European support through the to-be-constructed common fiscal instrument.

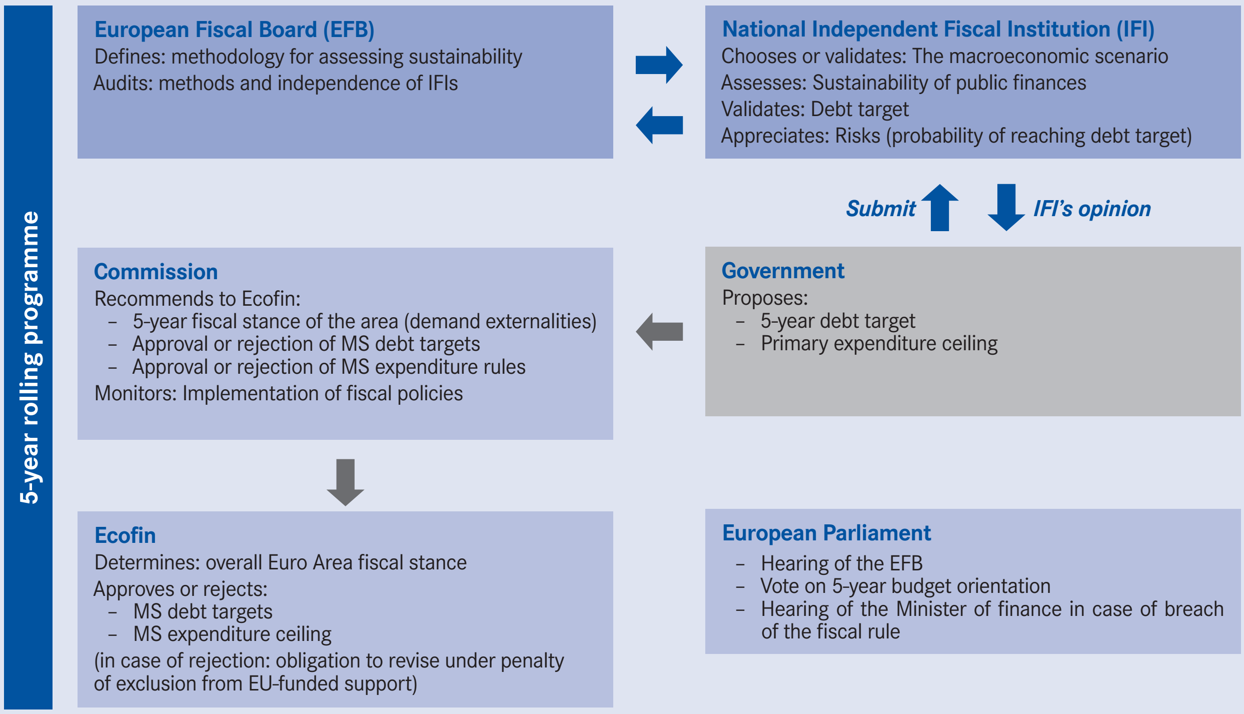
Our proposals also give a new role to the EFB, which would be dual: defining the methodology for sustainability assessment and monitoring the IFIs. It would remain linked to the Commission but be made independent. Its new role of validating IFI methods would require a change in its governance: the Board could, for example, be composed of ten members (instead of five now), appointed for three years. Five would be IFI Chairs, elected among themselves. Five others would be independent experts selected for their competence.

Recommendation 5. Entrust an independent European Fiscal Board (EFB) with defining the methodology for assessing a Member State's fiscal sustainability and with monitoring its implementation by the IFIs. The IFIs themselves should be reinforced and put in charge of assessing the debt target.

As far as France is concerned, our proposals are partly in line with those of the Arthuis report (multi-annual spending target, protection of forward-looking spending, broadening of the HCFP mandate).[32] The change of the HCFP mandate could be implemented without delay, before the end of 2021.

[32] Arthuis J. (2021): Report of the Commission on the future of public finances.

Institutional organisation of budgetary surveillance



Recommendation 6. Extend the HCFP's mandate to the assessment of fiscal sustainability, to the choice of the underlying macroeconomic scenarios, as well as to the assessment of the adequacy of the debt target.

The technical work required for sustainability analysis could be carried out by government services at the request and under the responsibility of the HCFP, on the basis of common methodologies established at the European level.

All of these changes could essentially be made within the framework of the existing treaties. As mentioned, the framework that we advocate remains compatible with the basic provisions of Article 126 and Article 121. The numerical values in Protocol 12 would have to be modified or, short of such a change, the conditions for compliance would have to be reinterpreted. However, all secondary legislation (Stability Pact, *Six-Pack* and *Two-Pack*) and the associated regulatory texts should be thoroughly reviewed.

Transition to new rules

On March 23, 2020, the Council activated for the first time the general escape clause (GEC) of the EU fiscal framework. The decision was motivated by the context of severe economic downturn experienced across the Union, and the need to give Member States maximum leeway to adopt emergency fiscal measures. Conditions for the deactivation of the GEC and the reactivation of fiscal rules must be rapidly clarified, so that Member States, firms and households can better anticipate the fiscal constraints of the coming years. Uncertainty is already extreme on the health and economic fronts; it must not be aggravated. The expectation that the fiscal adjustment can be premature or abrupt as was the case in 2011 has not been fully addressed. Without clarification from Europe on the new rules and the transition path, Member States could be induced to lower their fiscal support too quickly.

We consider that the lifting of the GEC, now foreseen in 2023, should be made contingent on the state of the economy.[33] Deactivation should depend on both an institutional and an

[33] See the communication of the Commission March 3, 2021 and the detailed analysis by Martin P. and X. Ragot (2021): *When and How to Deactivate the SGP General Escape Clause?*, Report to the European Parliament, 15 January.

economic condition. The institutional condition is a political agreement between Member States to reform the Stability and Growth Pact (SGP) in the direction explained above. The debate on what rules to (re)activate cannot be separated from debate about the timing of their re-activation.

As for the economic condition, the objective is to avoid repeating the mistake of the 2011 fiscal adjustment, which was decided despite Commission forecasts that anticipated that the economy would still be below pre-crisis levels at the time of the consolidation. When decided in 2010, the adjustment was not considered pro-cyclical, because growth was positive and the output gap was underestimated (see Fatas, 2019). Deactivating the escape clause on the basis of an output gap measure would be even more dangerous today, since the health crisis prevents any robust measurement of potential output. We therefore recommend to condition the deactivation on the return to a normal level of the economy and to base the assessment on a simple measure of the economy such as GDP per capita.

Recommendation 7. Condition the deactivation of the general escape clause of the Stability Pact on a political agreement on the new European fiscal framework and on the effective return of the EU economy to the end-2019 level of GDP per capita.

The heterogeneity in he Member States' situations must also be taken into account. Once the GEC is deactivated, the same economic condition (GDP per capita back to its Q4-2019 level) will have to be applied for each country individually. If a member does not meet this condition, the "unusual event clause" will be activated and the new fiscal rules will not apply to that country. In return for this flexibility, the country should not undertake any permanent increase in its structural deficit during this period, unless it is motivated by investments or reforms that increase growth in the medium term.

The reforms we propose are substantial but compatible with the essential provisions of the European Treaties. They aim to avoid policies that would endanger the stability of the Euro Area, whether through excessive debt or a lack of fiscal support. We believe that the European economic policy system must learn all the lessons of the new economic and financial environment. The overhaul of the European fiscal framework that we are proposing aims both to make Member States more autonomous in their fiscal choices, and to foster responsible fiscal behaviour.

conseil d'analyse économique

The French Conseil d'analyse économique (Council of Economic Analysis) is an independent, non partisan advisory body reporting to the French Prime Minister. This Council is meant to shed light upon economic policy issues, especially at an early stage, before government policy is defined.

Publisher Philippe Martin
Editor Hélène Paris
Electronic Publishing Christine Carl

Contact Press Christine Carl
Ph: +33(0)1 42 75 77 47
christine.carl@cae-eco.fr

TSA 20727 75334 PARIS Cedex 07 (France) **Ph: +33(0)1 42 75 76 84** **Fax: +33(0)1 42 75 51 27** **@CAEinfo** **www.cae-eco.fr**