The Czech Fiscal Council

The EU fiscal rules – where now?

Notes for the Informal ECOFIN, 10 September 2022, Prague, Working session II

Mojmír Hampl, Chairman of the Czech Fiscal Council

A) A brief history of the EU fiscal rules

- At the start of the process of deeper European economic and monetary integration, we set universal and essentially "acyclical" fiscal rules (the Stability and Growth Pact – SGP). They came into existence in 1997. **They are relatively straightforward and easy to understand and were designed to ensure "monetary policy dominance"**. The problem with them right from the start was that they don't react well to the business cycle.[1]
- Nonetheless, we gradually came to realise that this acyclicality is a weakness. On top of that, we failed to comply even with these rough rules (see below).
- This, coupled with the fact that we weren't actually sure ex post whether nominal convergence of interest rates and yields is a good thing or a bad thing,[2] fostered rather pro-cyclical fiscal policy. It also amplified the European impacts of the financial and fiscal crises of 2008 and 2010 respectively.
- The pro-cyclicality of fiscal policy was neatly described by Charlie McCreevy, the former Irish Minister of Finance and later European Commissioner: "When I have the money, I spend it. When I don't, I don't". Pro-cyclicality was clearly visible after 2010 (when fiscal policy was too tight in many countries) and recently after 2019 (when it was too easy in some).
- This experience in times of financial crisis led to efforts to create **better counter-cyclical rules** in the form of (i) targets for the structural deficit (the deficit adjusted for the business cycle) and (ii) other methods of supervision and enforcement set out in the Six-pack and Two-pack reforms.
- However, as the European Fiscal Board's assessment of the rules[3] shows, **fiscal policy remained pro-cyclical in most cases even after the reform**. To that we added **a new problem: we made the fiscal rules complex and often hard to understand and**

[1] Even though the SGP deficit rule takes into account alternating good times and bad times and is rather the general lower limit for bad times.

[2] The prevailing ex post assessment was that excessively fast convergence of nominal interest rates/yields in the heterogeneous monetary zone had contributed to the creation of imbalances (also fiscal) between the South and North, only for us to then – rather paradoxically – do everything during the crisis exacerbated by these imbalances to ensure that the interest rate/yield divergence between the South and the North was not too large. This story repeats again and again.

[3] European Fiscal Board: Assessment of EU fiscal rules with a focus on the six and two-pack legislation, Brussels, August 2019 (https://ec.europa.eu/info/publications/assessment-eu-fiscal-rules-focus-six-and-two-pack-legislation_en).

unintuitive. A fair amount of expert knowledge is needed to decipher them to the detail, even among the policymakers who are supposed to be guided by them.

- On top of that, it turned out that policymakers often see the fiscal rules **as a desirable objective, not as a limit for the worst possible situation**. In my country, the public debate typically runs along the lines of "we're still a long way off 60% of GDP, so we can keep borrowing 'safely' for a long time yet". (Back then in 1997, that famous 60% of GDP was the average level in the countries that wanted to adopt the SGP rules).
- The main difficulty now, though, is **right that the medium-term objectives** (MTOs) are **defined for structural deficits. This means we need information on the steady state of the economy and the deviation from it, i.e. on potential output and the output gap**. These are not directly measurable. We often have to make complex estimates of them. Those estimates are inaccurate and often fail to generate clear conclusions. What is more, they are repeatedly revised, sometimes very substantially (see the Czech case in Charts 1 and 2). As is widely known, **for economists it is not only the future that is uncertain, but also the past. This is particularly true for data on the real economy.**
- To cap it all, the estimates are **least accurate in "bad times", or when breaks occur in business cycles. This is when we need them the most as a compass.**

Chart 1

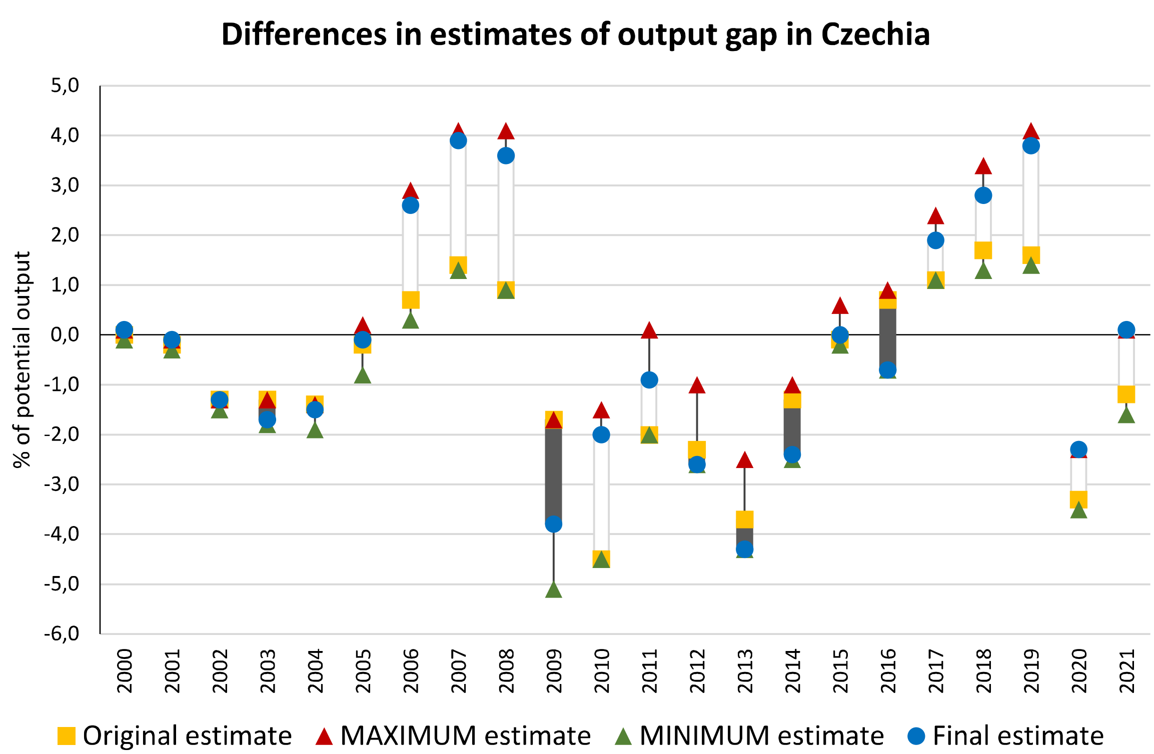
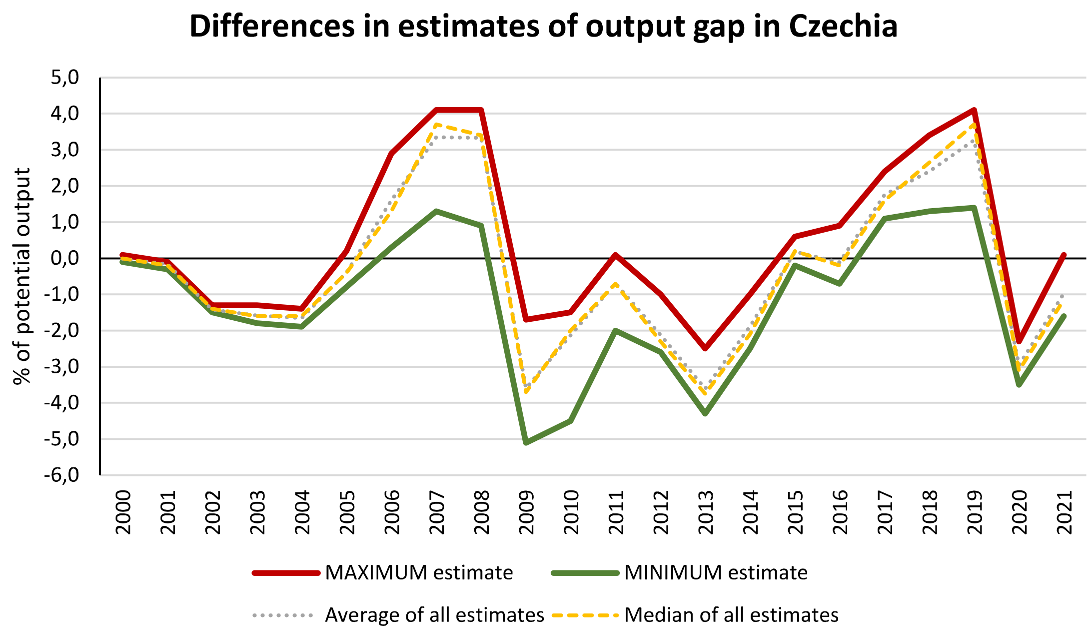


Chart 2



- This makes the rules less understandable and hence reduces their disciplinary effect. On top of that, in extraordinary times (such as the Covid-19 pandemic) we can switch them off altogether. By doing so, we signal that they are not built for big shocks anyway.
- **Generally speaking, if there's no great pressure from the financial markets, there's no great pressure to comply**.
- So over time, we have been observing a gradual growth in debt-to-GDP in EU countries and a dawning realisation that the idea of "monetary policy dominance" (preferred at the time the SGP was created) may no longer be valid, and that **fiscal policy is conversely capable of dominating and constraining monetary policy in complicated times**.

B) A brief assessment of alternatives for the future

- The radical position – very rarely heard in the EU debate – would be to argue against having any rules (finance as you go/finance as you can).[4] A rather softer position would be to say that if the rules are not being complied with, there's no need to worry about them. Let me disagree with both, **because even if they aren't being complied with, it's good to know how far we are from the ideal**. When you're flying a plane, it's good

[4] As favoured, for example, by some advocates of Modern Monetary Theory.

to know how far you are from the optimum cruise altitude and what the risk of crashing is. With public finances, it's not always clear exactly where the rocks are and how far off the ground you are. **But even so, it's good to have a guide, because it will at least indicate you have a problem and tell you how much time you have to return to a safe level**. It's too late to define the safe level when the plane has gone into a tailspin. In addition, the maxim of rules rather than discretion still applies of course.[5]

- The opposite radical position would in theory require **a highly prescriptive, detailed rules totally binding national discretion with very severe and directly enforceable sanctions**.

None of the above represents the future for the EU. So what might actually happen?

- One of the debated proposals is that the EU should in the future have (looser) standards rather than rules. This has been suggested, for example, by Blanchard et al.[6] According to this line of thought, the focus should be on **proper tailor-made interpretation and application of the standards to specific economic situations and countries**.
- However, at the Czech Fiscal Council we are rather advocates of **simplicity and clarity, even at the cost of imperfect respect for the economic reality of the cycle**, which changes before our eyes anyway.
- We would strongly support a greater emphasis on **spending rules and benchmarks**.[7] This is clearly a different way of thinking compared to the idea of fiscal standards.
- This should be done ideally with the fewest possible exemptions. Rough and ready rules with few exceptions are typically better than precise but hard to understand rules requiring a lot of discretion and "switching off" or radical adjustment in crises.
- It is worth considering a compromise combining sophisticated rules derived from potential output and the structural balance (to the extent necessary) with **a clear, simple and understandable spending rule**.[8] Understandability is crucial for policymakers and especially for voters, because it is voters that ultimately decide fiscal policy.
- Last but not least, when talking about the fiscal rules we need to point out that **the fiscal rules, no matter how defined, should be complied with in the first place**. The average rate of compliance with the fiscal rules between 1998 and 2019 was slightly above 50%.[9] That's not an impressive score.

[5] Kydland, F. E., Prescott, E.: Rules rather than discretion: The inconsistency of optimal plans, Journal of Political Economy 85, No. 3., 1977.

[6] Blanchard, O., Leandro, Á., Zettelmeyer, J.: Ditch the EU's fiscal rules, develop fiscal standards instead, VoxEU, 22 April 2021.

[7] Proposed principles to guide the German government in deliberations on the reform of EU fiscal rules, German non-paper, 2022 (mimeo).

[8] This rule, however, cannot **remedy public finance collapses caused by revenue-side erosion**. For such cases, a safeguard would need to be added to the rule – for instance "a new revenue for each new expenditure" or "an equal expenditure sacrificed for each revenue sacrificed".

[9] Larch, M., Santacrose, S.: Numerical compliance with EU fiscal rules: The compliance database of the Secretariat of the European Fiscal Board, Brussels, May, 2020.

- And we also need to reiterate that even when the fiscal rules are complied with, **they often don't in themselves provide a quantitative guide to exemplary fiscal policy. They merely set limits that have to be complied with regardless of the weather**.
- In any event, a single golden fiscal policy rule – one that is more powerful than the SGP and the reforms made to it – applies irrespective of all the reform deliberations: **no rules and no new institutions can ever or will ever be a substitute for the pure will to maintain fiscal responsibility at national and European level**.