

Towards new fiscal rules in the euro area?

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Abstract

The 2020-21 COVID-19 crisis has shown the need for strongly active fiscal policies. The government deficits in advanced countries increased by 8 percentage points of GDP on average in 2020, under the effect of automatic stabilisers or discretionary measures. After the COVID-19 crisis, public debts in advanced economies will stand on average at 120% of GDP. EU fiscal rules were suspended during the crisis, and their reform will be under discussion at the EU level in 2022.

Section 2 discusses the principle of fiscal rules. Fiscal rules cannot be relevant in all situations and therefore are in practice often impossible to comply with. This is especially true for EU fiscal rules, which lack economic rationale. Section 3 analyses various proposals to reform EU fiscal rules. Some consensus seems to be emerging on public expenditure rules, where public expenditure would need to grow less rapidly than nominal GDP, so as to bring the public debt-to-GDP ratio down to 60%. Public expenditure rules have advantages, but also entail risks, especially as their implementation would be monitored by the Commission and independent budgetary committees. There is a risk that these projects will “change everything so that nothing changes”. In Section 4, we make a proposal inspired by functional finance. In the euro area, Member States should be able to run the fiscal policy appropriate to the macroeconomic situation, while fulfilling the inflation target set by the ECB. Their public debts should be guaranteed. Member States could only be requested to change their fiscal policy if the latter is shown to be harmful to partner countries.

1. Introduction

The 2020-21 COVID-19 crisis has shown the need for strongly active fiscal policies. The government deficit in advanced countries increased by 8 percentage points of GDP on average in 2020, under the effect of both automatic stabilisers and discretionary measures. After the COVID-19 crisis, public debts will stand on average at 130% of GDP in advanced economies (table 1). The fight against climate change requires strong public investment (of around 2% of GDP per annum¹). These expenditures can support economic recovery in low growth economies, where a high unemployment level has been accepted in the name of public finance sustainability, competitiveness and fight against inflation. Public investments are facilitated by the current and probably future, a low interest rate level. However, these expenditures need to be managed to avoid excessive inflationary pressure and need to be

¹ The European Commission working document (2020) mentions a need for investment amounting to around 4.3 percent of GDP per year to tackle environmental transition without splitting them between public and private.

coordinated to avoid a rise in current account deficits in some countries; in the euro area they should be compatible with the single monetary policy. More fundamentally, there is a need to handle the contradictions between GDP growth ensuring full employment and the environmental constraints, between relaunching economies as they were before the pandemics and a swift implementation of the environmental transition, between country-level autonomy and the need for coordinated strategies.

1. The situation of public finances in 2019 and 2022 In % of GDP

	2019		2020 or 21	2022*		2020-22**	
	Gov. balance	Gov. debt	Gov. balance	Gov. balance	Gov. debt	GDP losses	Fiscal support
Euro area	-0.6	84	-7.7	-3.4	96	16.6	9.1
Germany	1.5	59	-6.8	-1.8	70	13.8	11.2
France	-2.2	98	-9.2	-4.8	114	18.9	7.9
Italy	-1.6	135	-10.2	-4.7	150	17.5	11.7
Spain	-2.9	96	-11.0	-5.0	116	26.5	2.7
The Netherlands	2.5	48	-6.1	-2.0	56	19.9	13.7
Belgium	-1.9	98	-9.4	-4.4	113	14.8	10.4
Austria	0.6	70	-8.8	-2.9	81	20.7	10.1
UK	-2.3	85	-12.5	-5.6	107	19.5	14.3
USA	-5.7	108	-14.9	-6.9	131	15.5	12.4
Japan	-3.1	235	-10.3	-3.9	252	11.8	8.8
G20 Advanced	-3.6	113	-11.7	-5.4	130	11.4	10.8

*According to IMF forecasts, October 2021; ** Cumulated fiscal support over those 3 years, sum of the structural deficits compared to their level in 2019, authors' calculations

The issue is especially difficult for euro area countries. As we already wrote (see for instance Mathieu and Sterdyniak, 2019), monetary Europe is a chimera which cannot have satisfactory functioning rules. There is an incompatibility triangle between a single currency, autonomous fiscal policies and country-specific economic situations. The incompatibility grew over time insofar as the single currency did not lead the economic convergence, but on the contrary widened disparities between successful countries, the Northern countries, and the other ones. The single currency necessarily creates strong solidarity between member states; surplus countries always have to finance deficit countries. As a result, surplus countries may consider they are entitled to supervise the policies of the latter, albeit considering themselves entitled to run non-cooperative competitiveness policies. As an aggravating circumstance, national and European political and business elites consider that the European model should be reformed, that MS should be given an incentive to cut public expenditure in order to cut taxes, which is hardly compatible with environmental transition needs and raises social and democratic issues (should the EU be allowed to constrain an MS to cut social expenditure against the will of its population?).

Contrary to what was advocated by some of its proponents, the single currency did not allow more leeway for fiscal policies, to offset the loss of autonomy in terms of interest rates and

exchange rates. Speculation on exchange rates were replaced by speculation on domestic public debts. Some MS (like Italy) still suffer from hardly justified interest rate spreads. The launch of the single currency was accompanied by the introduction of binding fiscal rules lacking economic rationale. These rules generated tensions between the EU Commission and the MS, when policies irrelevant in the domestic contexts were required to fulfil the rules; the more fragile MS were obliged to commit to the rules while larger MS (starting with France) could disobey. The rules were modified several times, they were made more complicated, strengthened, softened. The Commission has intended to review fiscal rules in 2020, while remaining in conformity with the European Treaties.

The COVID-19 crisis obliged EU authorities to suspend fiscal treaties for three years. MS accumulated huge government deficits; government debts are above 60% of GDP in a large number of MS. The experience from 2011-2012 shows that it would be counter-productive to ask MS to fulfil the fiscal criteria rapidly. At minimum, the 60% of GDP debt rule will have to be amended. Besides, uncertainties on output and potential output will be large, which will make it even more difficult to implement existing fiscal rules. Last, through SURE and the RRF (Recovery and Resilience Facility), the Commission issued an 850 billion euros fund on behalf of the EU. Will these funds be repaid or will they become a permanent component of EU functioning?

Many proposals to reform fiscal rules have been made, either by EU bodies (the European Fiscal Board, the Parliament), or by *European* economists or by economists such as Blanchard (an analysis of the first proposals may be found in Mathieu and Sterdyniak, 2019). More recently, a consensus seems to have emerged on a public expenditure rule, where public expenditure would grow less rapidly than potential GDP growth and target a 60% of GDP debt. However, the proposals differ on major issues, especially on how to account for public investment, on the speed of convergence towards the target, on the target itself. This proposal maintains an arbitrary target for the public debt. It does not give to MS fiscal the desirable autonomy. There is no unanimity among MS, neither to change the current fiscal rules, nor on any of the proposals

Section 2 discusses the principle of fiscal rules. Fiscal rules cannot be relevant in all situations and therefore are in practice often impossible to comply with. This is especially true for EU fiscal rules, which lack economic rationale. Section 3 analyses various proposals to reform EU fiscal rules. Some consensus seems to be emerging on public expenditure rules, where public expenditure would need to grow less rapidly than nominal GDP, so as to bring the public debt-to-GDP ratio down to 60%. Public expenditure rules have advantages, but also entail risks, especially as their implementation would be monitored by the Commission and independent budgetary committees. There is a risk that these projects will change “everything so that nothing changes”. In Section 4, we make a proposal inspired by functional finance. In the euro area, MS should be able to run the appropriate fiscal policy given the macroeconomic domestic situation, while fulfilling the inflation target set by the ECB. Their public debts should be guaranteed. MS could only be requested to change their fiscal policy if the latter is shown to be harmful to partner countries.

2. On fiscal rules²

2.1. Do we need fiscal rules?

Fiscal rules may be defined as constraints on fiscal policies, which impose or restrain the level of variables such as fiscal deficits, public debt, public expenditure, either in absolute terms, or depending on some economic variables. Rules may be considered from several criteria:

- Rules may bear on government balance (but the latter fluctuates with business cycle conditions), structural government balance (which is difficult to estimate), public spending (but a country should always be able to increase public expenditure as long as it increases public revenues at the same time), government debt (but adjusting the debt to the desired level can only be a long-term objective).
- Some rules set the value of fiscal variables on a permanent basis (such as: the structural government balance should equal net investment), but the value may be irrelevant in the event of unforeseen economic circumstances. Other rules set numerical limits (such as: the public deficit should not be higher than 3% of GDP); they play episodically and in asymmetric way and their limits set are often arbitrary. Other rules set vague objectives, such as in the French constitution: “the pluriannual orientations of public finances are enshrined in the target of bringing government deficits to balance.”
- Some rules are simple declarations of intent by government or components of a political programme (cutting public deficits or tax-to-GDP ratios); others may be under the surveillance of the Parliament or of an independent expert committee (but the surveillance may consist in observing that the rule is breached and taking note of the government’s explanations); other rules may be set in law (such that a Parliament’s vote is needed to breach or modify the rules) or in the Constitution (the debt brake in Germany, which becomes a problem when rules are no more relevant); other rules may be set under an international agreement (this is sometimes the case for rules set by the IMF, and even more for EU fiscal rules). The experience has shown that the modalities of rules’ enforcement is more important than the rules themselves: a strict but not enforced rule has a limited effect.

However, all types of fiscal rules raise a number of problems:

- As was shown by the 2008 financial crisis, the zero lower bound for ECB’s interest rates since 2014, and the COVID-19 crisis, fiscal rules are very unlikely to account for all possible economic contexts. Hence fiscal rules cannot (and should not) be met in all circumstances, and they must be reviewed, halted or simply not met.
- Fiscal rules aim at showing how fiscally serious governments are, and they lead governments to commit to run contractionary policies, at the expense of the objective of growth and full employment.
- They depart from the basic principle of functional finance (which Modern Monetary Theory has reminded us of): public finances should not be managed for themselves, but for macroeconomic stabilisation.

²² This section draws on Mathieu and Sterdyniak (2013).

- Fiscal rules aim at reassuring financial markets, international institutions and creditor countries; they always reveal some degree of mistrust towards democratically elected national governments. They aim at preventing the latter to run demagogic policies that would induce unsustainable deficits, obliging the Central Bank to let inflation accelerate (fiscal dominance) or that would lead to debt default. Fiscal rules, when they are met, prevent expansionary policies, such as the policies of the left in France in 1981 or of Biden in the US in 2021. This may be viewed as an advantage (preventing adventurous policies) or as a drawback (preventing needed economic policy measures).

- In theory fiscal rules should allow governments to implement the needed stabilisation policies (taking monetary policy) and should treat differently public investment (but the definition of the latter is problematic, and accounting for public investment should not be done at the expense of education and social expenditure). Fiscal rules should be an incentive to meet intergenerational fairness, but the latter is difficult to define insofar as a generation does not inherit from the previous generation only a public debt, but also physical assets (net assets over the rest of the world), human capital and environmental capital. The rules should ensure fiscal policy sustainability, but the latter is also difficult to assess (box 1)

- Fiscal rules may be viewed as guidelines that the country (or government) sets to themselves, that they may be entitled not to fulfil in specific circumstances under the condition that they are aware they breach a principle and should explain why they do so. Fiscal rules may be shown to voters as components of a political programme, such as “cutting public expenditure” or “cutting taxes”, but the 2020-21 crisis has shown that it is difficult to fulfil such commitments. Fiscal rules may be set to ensure the Central bank, that governments will avoid fiscal prevalence, but in this case, they should be consistent with the Central banks’ objectives: the government should commit to implement restrictive policies if the inflation rate and the interest rates are above the Central bank’s objective.

The simplest rules, such as requesting a structural budgetary position in balance, running public deficits below X% of GDP, or public debts below Y% of GDP, do not make sense since they rely on arbitrary numbers, 0, X, or Y. A more satisfactory rule would be: a country should run a structural public deficit (corrected from debt depreciation induced by inflation) equal to its net public investment (this is the *golden rule for public finances*, see Mathieu and Sterdyniak, 2013). But measuring the structural balance remains problematic; the rule should allow for a wide definition of investment to include education and research spending; short-term stabilisation measures should be excluded from the structural balance, and consequently the rule would be hardly binding. Such a rule would moreover imply that the neutral equilibrium of the golden rule is optimal, but this is not sure. Another rule may be preferred: the government balance should aim at maintaining full employment (employment consistent with the natural unemployment rate), under the constraint that inflation will not raise above the ECB’s target, and that the interest rate equals nominal growth (the sum of potential growth and inflation). A public deficit is excessive if it requires to set interest rates above the nominal growth rate, in order to stabilise inflation. Thus, the public balance must have four elements: a structural deficit equal to net public investment (and to the depreciation of the

debt induced by inflation), the automatic cyclical balance, and possibly temporary measures to support activity, and a structural balance intended to fill a structural surplus (or deficit) in demand.

Box 1: Fiscal policy sustainability

Fiscal policy should be considered unsustainable if it entails a risk of losing control of public finances, which would induce a strong inflation, public debt default or merely a swift and costly major change of economic policy. But a policy increasing public debts and deficits to counteract weak private demand, in a situation of low interest rates and inflation cannot be viewed as unsustainable. The same applies to a situation where public debt increases because households wish to hold more safe assets, in a context of population ageing and financial markets instability.

Let d , the debt to GDP ratio, $r-g-\pi$, the real rate interest corrected from growth, and s , the primary public balance. Public debt will vary as: $d=(1+r-g-\pi) d_{-1}-s$, such that debt stabilisation requires: $(r-g-\pi) d = s$. Let s_M , the maximal primary public surplus that may be reached, sustainability requires that, taking all possible scenarios into account, the probability that $(r-g-\pi) d > s_M$, is low.

It is difficult to assess the future values of the real interest corrected from growth. If the value is negative, the primary deficit of $(r-g-\pi) d$ allows for debt stabilisation. The debt ratio converges towards: $-s/(r-g-\pi)$, and the question becomes: is such a debt level acceptable? For instance, if $(r-g-\pi)=-2\%$ et $s=-3\%$, public debt converges towards 150% of GDP.

But if the debt to GDP ratio is 150%, and if in an overheating economy the Central Bank raises $r-g-\pi$ to 2%, the government will need to bring the government balance to a 3% of GDP surplus. But this may be done if the economy is really overheating.

Thus, public finance sustainability depends on both fiscal policy (which must be run in line with the economic situation), and monetary policy (which may run low interest rates and tolerate some inflation to facilitate government borrowing - this is fiscal prevalence -, or maintain its inflation target to constrain the government to run more restrictive policies, this is monetary prevalence), on private demand and from time to time on financial markets (which may increase interest rates because of a fear of inflation or debt default).

Debt sustainability is not really an issue in a country with sovereign monetary policy, where the Central bank is independent but guarantees public deficits financing, insofar as there is no default risk, but only a risk of uncontrolled inflationary financing, in fact by an implicit coordination between the Central bank and the government (like in the US, UK, Japan).

2.2 Euro area fiscal rules

Euro area countries must comply with the Stability and Growth Pact (SGP) and the Fiscal Treaty (TSCG). This is a unique example of a fiscal rule enshrined in an international Treaty, and it raises a delicate issue: can an international Treaty resulting from a political compromise, necessarily with simple specifications, contain binding economic constraints which may come

in contradiction with economic principles, and with relevant fiscal policy needs? If a country does not comply with the fiscal rules in this case, does this mean it does not honour his signature?

The euro area fiscal framework should fulfil several contradictory principles:

- Member states should be allowed to run autonomous fiscal policies, in line with the democratic choices of their population and cyclical conditions.
 - MS economic policies should not be detrimental to partner countries, either through being too inflationary, which will lead the ECB to set too high interest rates, either in being too restrictive, which would induce insufficient global demand, too low interest rates and external deficits in partner countries.
 - MS public debts must be fully guaranteed to avoid speculation on a default risk and interest rates spreads between MS. This guarantee implies that EU institutions (Commission, Council) have a right to monitor MS fiscal policies.
 - MS are committed to economic policy coordination which here also gives EU institutions right to monitor domestic policies. However, if one abandons the technocratic vision of economic policy (“there is no alternative”), the question is about economic policies guidelines by Brussels (is their neo-liberal stance democratically agreed?) and of the possibility for a MS to deviate from it.
- Negotiations between MS followed by the influence of the Commission have led to introduce fiscal rules in the Stability and Growth Pact (1997), the Six-pack (2011), the Two-pack (2013), the fiscal Treaty (2013), the January 2015 reform. These rules have become more and more complex over time -see the 108 pages of the [vademecum on the SGP](#), 2019).
- MS are should not run higher than 3% of GDP public deficits, and higher than 60% of GDP public debts.
 - The European Commission launches an excessive deficit procedure (EDP) when a public deficit breaches the 3% of GDP limit (except if this is a temporary breach). MS are given a certain delay to bring their deficit below 3% of GDP. MS under a EDP must submit their budget and structural reforms programmes to the Commission and the Council which may monitor their implementation. The Commission and the Council may fine MS who do not follow their recommendations.
 - MS must present Stability programmes showing projections of public finances 4 years ahead with a return to a structural deficit below 0.5% of GDP, if public debt is above 60% of GDP, 1% of GDP if debt is below 60% of GDP. The correction must be larger than 0.5% of GDP per year (measured in terms of primary structural balance, as calculated by the Commission). This pace should be agreed by the Commission, which may account for the structural reforms implemented. Once the structural balance reaches the equilibrium, it should be maintained at that level.
 - Public expenditure should grow less rapidly than medium-term potential growth; any rise in expenditure above the latter should be offset by a discretionary increase in public revenues; any discretionary cut in revenues should be offset by lower expenditure.

- MS running debts at above 60% of GDP should bring down this ratio by 1/20th of the difference per year (the cut being assessed on the average of last three years). An EDP may be launched if this constraint is not met.
- MS should introduce Independent National Fiscal Councils (NFC), in charge of checking the conformity of fiscal policy with EU rules.

The drawbacks of this scheme have been analysed many times:

- The 3% limit makes no sense in times of economic depression. A country hit by a specific recession may need a higher than 3% of GDP deficit to counterbalance a large fall in domestic private demand. *A priori* this will have no negative impact on euro area inflation.
- The MTO does not make economic sense. It is a more binding constraint than the golden rule or debt stability. In a situation of weak demand, and of interest rates already at 0 lower bound, running a government balance at 0 is inconsistent with a satisfactory demand level. A deficit kept in permanence at 0% of GDP would lead nominal public debt to be stable in level and declining as a percentage of GDP. Public debt would reach 0% of GDP in the longer term. But savers, in particular pension funds, need to own long-term, liquid and safe assets, i.e. public assets.
- The 60% of GDP ceiling for public debt is arbitrary. It does not account for private agents' wish to own public debt, for public capital needs, for interest rate levels as compared to output growth.
- A fiscal rule must have a satisfactory long-term in terms of its internal consistency and of the macroeconomic equilibrium. Today, the EU rule requires the structural fiscal deficit to be cut by 0.5 percent of GDP per year until it falls below 0.5% of GDP, although it may remain at 1% of GDP if the public debt is below 60% of GDP. Therefore, the long-term is: Structural deficit = 1% of GDP; public debt = 33.3% of GDP (under the assumption of a long-term nominal growth at 3%). There is no certainty that running a fiscal policy to meet those criteria is consistent with full employment and an interest rate at 3%. A 60% of GDP public debt target would allow for a 1.8% of GDP structural deficit. But the 60% ceiling remains arbitrary.
- The implementation of the device depends crucially on the potential output estimates. But the latter is fragile, debatable and varies over time (see Mathieu and Sterdyniak, 2015³). Fiscal impulses estimates cannot be precise, as on top of the uncertainties around potential estimates, one has to account for the uncertainties on expenditure (which expenditure are exceptional?) on tax revenues (how to deal with unexpected fluctuations?). The method used by the Commission implies that potential output will remain close to observed output. Consequently, the deficit will be often estimated to be mostly structural.
- The initial framework did not account for the stabilisation role of fiscal policy. Thus, a MS could be asked to implement a 0.5% of GDP restrictive policy, while its economy was in (or entering) a recession. In January 2015 the Pact was amended, so that the requested fiscal effort was accounting for the cyclical situation. Thus, a MS running a structural deficit higher

³ Thus, at the end of 2019, the French output gap was estimated at +0.7% by the Commission, with an unemployment rate at 8.5%. At the end of 2020, the output gap was estimated at +1.9% for 2019.

than 0.5% of GDP was not requested to make a fiscal effort if the output gap was larger than -4% of GDP. A fiscal effort of 0.25% of GDP was requested for a negative output gap smaller than 1.5% and observed growth lower than potential growth; 0.5% in normal times; 0.75% for output gaps is larger than 1.5% and even 1% if in addition to that growth is higher than potential growth.

- Different rules coexisting on deficit, structural deficit, debt, public expenditure introduces a hardly manageable complexity. On top of this come the uncertainties on potential output and hence on the fiscal impulse. This generates complex negotiations between EU and national technocracies, negotiations that policy makers often do not take seriously into account.

- The independent NFC have an ambiguous role. Should they assess the relevance of fiscal policy in the current cyclical situation, or simply check that this situation is in conformity with EU rules?

- Rules are not an economic policy coordination framework. They do not account of the whole area situation, restrictive policies run in some MS are not counterbalanced by expansionary policies in partner MS. EU rules do not account for monetary policy's rooms for manoeuvre, which are very limited when interest rates are already practically zero EU rules were designed to address a situation of inflationary threat, and they are not relevant in a situation of interest rates at almost 0 when deflation and economic stagnation are the main risks.

The mechanism, in itself, did not account for current account balances, competitiveness, private borrowing, financial or housing bubbles. Since 2010, a « European Semester » has been introduced. In October of year n-1, MS present their budget plans for year N. In November, the Commission releases an Annual growth survey (AGS) setting economic policies objectives for year n+1 and giving instructions to MS. The Commission makes assessments of national budget plans. Simultaneously, it produces a scoreboard showing the macroeconomic imbalances of each MS based on 14 indicators (competitiveness, current account deficit, public and private debts, unemployment). Some MS may be placed under a deep analysis, then on an excessive macroeconomic imbalances procedure (MIP). But surveillance is asymmetrical: the Commission often asks MS to cut their public deficits and debts; to increase their competitiveness by lowering wages or social contributions. The Commission is not very critical of MS exerting a negative external effect on partner MS by implementing too restrictive wage and fiscal policies. Since 2013, however, German and Dutch current account surpluses have been pointed out, although neither Germany nor the Netherlands modified their policies. Until now, the Commission has rather signalled MS problems they were well aware without having the capacity to influence the policies implemented.

The SGP and TSCG fiscal rules are arbitrary. They can constrain MS to run restrictive policies although domestic demand is insufficient, while the restrictive effects of these policies cannot be offset by lower interest rates. Fiscal policy should target (or maintain) the appropriate employment level while allowing inflation and interest rates to remain at satisfactory levels. According to the functional theory of public finances (box 2), public debt and deficit must derive from this objective and not from arbitrary norms.

Box 2: The functional theory of public finances

A certain level of government deficit may be necessary to reach a satisfactory demand level, compatible with a stable inflation. Let us write: y , the output level (in deviation from the potential level), a , an indicator of private demand, d , a government deficit indicator, r , the interest rate, g , the nominal growth trend (in value terms), h , the public debt to GDP ratio, l the public debt desired by the private sector (when $r=g$).

Hence:

Two cases should be distinguished. **If the country controls its interest rate**, fiscal policy is a priori not very useful. The interest rate will simply need to be set as:

A negative private demand shock, an increase in the desired public debt will allow for a decrease in the interest rate (which allows specifically to stimulate investment).

A positive demand shock may be offset by a rise in interest rate (but this is detrimental to investment) or by a restrictive fiscal policy (which does not have the same drawback).

The rule is: fiscal policy should allow to maintain full employment and an optimal interest rate.

In the long-term, the public debt to GDP ratio is stable, such that: $d=0$

The country can make a trade-off between low interest rate and public debt levels, and a high level of interest rate and public debt. It may be relevant to run a restrictive policy if the latter is accompanied by a cut in interest rates. But if a country has an objective of a low public debt as compared to the debt level private agents wish to own, this will imply a very low interest rate (which may be impossible to reach if the interest rate cannot be negative).

If the country does not control its interest rate (because the interest rate is already nil or below the optimal level or set outside the country in the case of a euro area member), the appropriate stabilisation fiscal policy in the short-term is:

If this policy is implemented and if regulation is perfect there is no link *ex post* between the deficit and the output gap, which remains nil. The deficit, d , will be deemed structural according to the OECD's or European Commission's estimates, which does not make sense.

In the long term, $d = 0$ and

The long-term public debt level is not arbitrary but depends on what private agents wish to own: public debt must be equal to the debt desired by the private sector at a given interest rate.

A fiscal rule such as: cannot be proposed, since it would mean abandoning full stabilisation, and because the government cannot set a debt target independently of private agents wishes. The public debt level desired by private agents is likely to have increased during the crisis since households wish to own fewer risky financial assets while companies wish to reduce their debt levels. Structurally, population ageing implies more appetite for safe public assets.

However, the leading classes and national and EU technocracies support these fiscal rules, even if these rules reduce demand, even if they lack economic rationale: being enshrined in the Treaties (which can be hardly amended), these rules prevent expansionary fiscal policies in southern MS or by left governments which would come into power. These rules require MS to try and find growth through competitiveness gains, in duplicating the German strategy. In theory, MS remain last resort decision makers of their fiscal policies, but the EU pressure can be strong when a MS tries not to comply with the rules (as was the case for Italy in 2019), even more as it is accompanied by tensions on the domestic public debt markets. The pressure was not entirely efficient in the case of France, which often did not comply with the fiscal rules.

Box 3: A Keynesian fiscal rule?

Net public investments (I_{pn}) must be financed by borrowing; the budget balance needs to be corrected for inflation-induced debt depreciation; fiscal policy must play a countercyclical role: a 1% output gap justifies a deficit of 0.75% of GDP, more than the automatic effect; fiscal policy be restrictive when monetary policy is restrictive (when the interest rate set by the ECB exceeds the "growth golden rule" rate, according to Phelps, i.e. the inflation target plus the potential growth rate. . Or for an inflation target of 1.9% and for a potential growth of 1.3%:

$$s = -I_{pn} - \pi D\% + 0.75 \text{ output gap} + 0.5 (i - 3.2)$$

With this fiscal rule, which guarantees that in the long term the public debt does not exceed the public capital, by taking the official output gap (which is only -0.9%), the public balance of France in 2017, should have been $0.0 - 0.9 - 0.75 * 0.9 - 1.6 = -3.2\%$. In fact, it was -2.7%. But this rule does not allow complete stabilization; it does not consider the link between fiscal policy and the output gap; it depends on the estimates of the output gap and potential growth.

Although the single currency resisted the 2008 financial crisis, the sovereign debt crisis in 2010, the overall performance is mediocre. After the financial crisis, the euro area was unable to implement a coherent macroeconomic strategy and recover the 8 percentage points of output lost in the crisis. Under the Commission's pressure, southern Europe MS had to implement drastic cuts of public deficits. The other MS were asked by the Commission to fulfil the SGP criteria, and made strong budgetary efforts, fearing their public debt could come under attacks on financial markets. For the euro area as a whole, fiscal restriction measures amounted to the 1.6% of GDP in 2011, 2.3% in 2012, 1.1% in 2014 and 0.7% in 2014. Thus, GDP was in the euro area at the same level in 2014 than in 2007, while it was 5.4% higher in the UK and 8.2% in the US.

Interest rates spreads remained significant for a long time: in 2016, the 10-year rate was 0.1% in Germany, 0.3% in the Netherlands, 0.5% in France and Belgium, 1.4% in Spain, 1.5% in Italy, 3.2% in Portugal, 8.4% in Greece.

From 1990 to 2019, GDP grew on average by 20.3% in the euro area, versus 37.5% in the US, 34.9% in Sweden, 25% in the UK. There were wide disparities in the euro area: GDP per capita grew by 88.8% in Ireland, 29.1% in Finland, 27.5% in Germany, around 24% in Belgium, Austria, the Netherlands, 22.8% in Spain; but GDP per capita grew by 18.8% only in France, 18.3% in Portugal, 5.6% in Greece and a mere 1.8% in Italy.

3. How to reform the euro area fiscal framework?

3.1 Reforms proposals before the Covid Crisis

EU Treaties and the reforms introduced since the financial crisis have led to a complex and rather unsatisfactory architecture. The surveillance of domestic fiscal policies involves tense technocratic activity, often lacking economic rationale and is followed by tough negotiations between the Commission and the MS.

From 2012 to 2018, EU institutions (the Commission, Council, Eurogroup) released many papers making suggestions to reform the EU economic policy framework (see Mathieu and Sterdyniak, 2019). EU institutions have been critical of the MS lack of discipline: they deplore

that MS are last resort decision makers of their fiscal policy, while EU institutions are only entitled to an advisory, surveillance, criticizing role; they admit that current fiscal rules are “stupid”, but they consider that moving towards an intelligent way of running fiscal policies, i.e. without arbitrary rules would require (in their view) the EU authorities to control domestic fiscal policies. Reform proposals made by the EU authorities often aim at increasing their own power at the expense of the MS. Their logic is to monitor MS as concerns macroeconomic policies or structural reforms, which comes in contradiction with national sovereignty. They meet MS reluctance, as the latter wish to keep their power and their autonomy; Northern MS do not want fiscal Europe, which would be according to them lead to an “EU of debts and transfers”; smaller MS wish to keep their specificity and do not want to have to comply with bigger MS dictatorship. Besides, EU authorities refuse to question the SGP and TSCG which restricts the possibilities to reform and of fiscal coordination.

EU authorities’ proposals have varied over time, depending on MS reluctances. The Commission would like fiscal discipline to be strengthened, and asks to be entitled to oblige MS to revise their budget plans. The Commission wishes a euro area fiscal capacity, so that transfers may be implemented between MS through an insurance mechanism to absorb specific shocks (based on output gaps, unemployment rates in deviation from natural unemployment rates, or on an unemployment reinsurance scheme), so that it will be able to issue Eurobonds to finance a European Stabilisation Mechanism (ESM) which could give conditional support to MS in difficulty. The Commission would like to introduce a competitiveness and convergence instrument (CCI) that would provide subsidies to MS implementing structural reforms. It insists on the finalisation of the Banking Union and on the introduction of a Union capital markets. It would like to launch a European safe financial asset while banks would be discouraged from owning domestic assets. The introduction of a European minister of economy and finance, or a Euro area treasury is often mentioned: they would be responsible for euro area economic and fiscal surveillance, manage the ESM and ensure coordination on issuance of the EU safe asset.

In November 2017, the European fiscal board (EFB) published its first report, devoted to a reflexion on the implementation of the SGP and TSCG. The report does not question the existing architecture. It supports rules implemented in an imperfect manner as the absence of rules would be detrimental to public finance sustainability and a strict implementation would be detrimental to EU economic recovery. The report considers that rules more in line with economic needs would be paid by more complexity and discretionary judgement possibly in contradiction between the Commission and the Council. The report’s proposals for improvement are limited : requesting MS to build rooms of manoeuvre in good times in the prospect of bad times; strengthening the implementation of fiscal rules by introducing fiscal sanctions ; obliging MS to explain the reasons why they deviate from the recommendations of their national fiscal councils; tighten and make the rules simpler albeit introducing precise suspension clauses in exceptional circumstances; to remove investment of the deficit threshold but only in times of recession; implementing structural reforms to strengthen economic resilience. Last, the report makes the proposal of a European fiscal capacity, either

through a reinsurance system of unemployment benefits; or to finance some public investment in times of recession

Some economists have made accounting proposals to turn the SGP and Fiscal treaty rules, such as not accounting for unemployment benefits or public investment (net or gross) in the 3% of GDP rule, introducing temporary funds in good times to allow for more deficits in bad times, etc. For instance, Truger (2015) proposes "a golden rule for public investment". Net public investment would be removed from deficit limits (the 3% limit and the 0.5 % objective). This would prevent public investment from being the first victim of austerity policies. Conversely, it would encourage a rise in public investment which would be useful for the short as well as for the long term. However, this rule, as such, forgets the cyclical and structural stabilization needs, unless it is agreed that public investment can be used for that purpose, which is problematic.

According to us, it would be better to write simply: a public deficit can be accepted if it is needed to support output when the inflation rate is below the target, when the interest rate is below the normal level (potential growth plus inflation target), when the external deficit is below a certain targeted level.

3.2 A public expenditure rule

Today, the preferred reform for most *European* economists consists in replacing existing rules with a single rule: a public expenditure rule.

Thus, Claeys, Darvas and Leandro (2016) make a proposal of a public expenditure rule "nominal expenditure excluding interest expenditure, labour-market related expenditure and one-off expenditure, while public investment expenditure should be smoothed over several years and accounted for in the same way that corporate investment is accounted for" shall not rise more rapidly than "medium-term potential growth rate plus the central bank's inflation target (2 percent in the euro area), "reduced by 0.02 times the difference between the debt level in the previous year and the 60 percent of GDP debt criterion".

However, MS could choose to increase public expenditure as long as they increase tax revenues at the same time; the country could cut taxes only if it decreases public expenditure. In fact, the rule is very close to a rule of the variation of the corrected structural primary balance, which would have to increase each year according to the debt gap as compared to a debt ratio of 60% of GDP. However, a spontaneous rise of tax receipts does not make the fiscal constraint less binding⁴. But showing the fiscal rule as constraining expenditure is not neutral: pressure is placed on public and social expenditure more than on possibly increasing taxes.

Thus, a country like France running a public debt close to 120% of GDP would have to set public expenditure growth 1.2 percentage point below potential growth, i.e. an annual rise by

⁴ This requires to distinguish the spontaneous variation in tax revenues from new measures. As concerns the income tax, for instance, does the spontaneous change result from fixed brackets, from price indexation or indexation on households' per capita average income?

0.6 percentage point of structural primary public expenditure, until the public debt comes down to 60% of GDP.

This rule may seem satisfactory, since it lets automatic stabilisers play on tax receipts (and unemployment benefits); it becomes less binding if inflation is below 2% (inflation 1 percentage point below 2% would allow public expenditure to rise by 1.5%, i.e. an additional 0.5 percentage point of structural deficit). It relies on medium term potential growth, which would be easier to estimate than potential output (which is arguable in a depressed situation). Conversely, the output impact of a restrictive policy is not taken into account. The needs for a discretionary fiscal policy are not accounted for, the 60% limit remains entirely arbitrary. In the short-term a restrictive policy increases the debt to GDP ratio, due to the fall in GDP; piloting such a rule is not easy. Public investments are not considered immediately, but in the long-term since they increase public debt.

The rule does not set an equilibrium level for the primary fiscal surplus, and hence does not lead to a long-term in equilibrium. A country running a 100% of GDP debt initially and a structural primary deficit of 2% of GDP must increase its structural balance each year. After 20 years (assuming that the interest rate is equal to growth, and without accounting for the multiplier effects on output), its debt stands at 61.5% of GDP and its primary surplus at 4.5% of GDP. The rule says nothing about what should be done afterwards, whether remaining with a debt at 60% of GDP (which would allow to bring rapidly the structural balance to 0, with a strong expansionary effect) or maintaining a large surplus and progressively bringing public debt down to 0. The proposed rule does not lead to a stable long-term. Yet, any fiscal rule should lead to stable debt and deficit levels, levels which should be compatible with the macroeconomic balance. Besides, one can hardly imagine that a country may launch such an austerity programme (cutting by 13% its public expenditure in the medium term) solely to reach an arbitrary level of public debt.

Bénassy-Quéré *et al.* (2018) suggest a similar rule “replacing the current system of fiscal rules focused on the ‘structural deficit’ by a simple expenditure rule guided by a long-term debt-reduction target”; “nominal expenditures should not grow faster than long term nominal income (that is, the sum of potential output growth and expected inflation), and they should grow at a slower pace in countries that need to pay down their debts”. They do not subtract public investment. The MS would be entitled to increase public expenditure if they are financed by structural receipts. The rule thus is: the structural deficit must remain stable. It should even diminish in countries where debt ratio is too high. But how to define an excessive debt ratio, when the rise in public debts, since the financial crisis is due to macroeconomic stabilisation needs? Let us assume that a country decides to promote pensions funds instead of pay as you go pensions. This may lead to a rise in households’ savings and, at fixed interest rates and exchange rates imply a rise in the equilibrium public deficit. This is not taken into consideration in the proposed rule. The authors add “. Monitoring compliance with the fiscal rule should be devolved to national fiscal watchdogs supervised by an independent euro area-level institution. In case of no compliance, a government should be compelled to finance excess spending through the issuance of junior sovereign bonds (first to be restructured in

case a debt reduction)”. But the so-called excessive expenditure should be financed by a guaranteed public debt if they are needed to stabilise output. Should markets be asked to impose a fine to discourage countries to increase their public deficit even if this is needed for macroeconomic stabilisation or to save companies in difficult situations? What would be the interest of this dangerous financial innovation: an advanced MS would issue government bonds declaring it is a risky bond. How could an advanced country envisage to declare (even partial) debt default? This would only lead speculators to consider that there is a risk that euro area sovereign States may (even partially default).

Darvas, Martin and Ragot (CAE, 2018) make a similar proposal: structural primary public expenditure (corrected from permanent tax increases) should grow less rapidly than potential growth plus expected inflation less a term aiming at reducing the gap between the debt ratio and its target level. However, they observe that a correction term proportional to excessive debt induces a too strong initial effort for MS running a high debt ratio. Hence, they recommend a country-specific 5-year moving debt target, which makes the rule less restrictive but more vague. All will depend on the level of the moving target. However, implementing the rule would lead output to fall immediately which cannot be offset by lower interest rates (they are already at a minimum). The rule does not account for macroeconomic stabilisation needs, although the authors say that the rule may be suspended in case of “exceptional circumstances”. Should France set itself as the main fiscal objective to bring public debt below 60% in 20 years, i.e. to run an average primary surplus of 2% of GDP knowing that the 60% target is arbitrary and widely breached by non-euro area countries, while the main objective should be to finance environmental transition? The national fiscal council would control that MS comply with the expenditure rule. MS obeying the rule would be rewarded, through access to ESM loans, but this would make sense only if MS cannot borrow on financial markets. Unfortunately, the authors also make the proposal to oblige MS breaching the rule to issue junior bonds.

Ducoudré et al. (2018) show that an expenditure rule with a debt target of 60% cannot be applied to MS with too high initially debts. They advocate country-specific rules and fiscal coordination supervised by the European Fiscal Board.

The Commission had committed to launch a review of the fiscal rules in 2020. It asked the advice of the EFB (2019). The EFB considers the proposal of a ceiling for public expenditure growth, net of tax increases and unemployment benefits rises due to the conjunctural situation, based on potential output, with a correcting term to lead the debt ratio to converge towards the 60% target at a given pace. This pace would be negotiated between the government, the national fiscal council, and the Commission. The pace would be less rapid if the public debt is elevated and if the interest is high relative to the growth rate, such that the primary public balance required is below 3%. Some investment, stimulating growth in particular from EU projects could be subtracted from net public expenditure. The rule would be suspended in times of recession, as observed by the NFC, the EFB and the Commission. MS breaching the rules would be deprived of the funds of EU budget. MS with a public debt below

than 60% of GDP would be encouraged to develop investment pro-growth (hoping they would have a stimulus impact for the whole EU).

3.3 Since the COVID19 crisis started

The COVID19 crisis obliged EU authorities to suspend the EU fiscal Treaties for three years. MS accumulated large public deficits. Public debts are above 60% of GDP in most EU MS (15 over 19), they are close to or above 120% of GDP in several MS (Italy, Greece, Portugal, France, Spain, Belgium); the experience from 2011-12 shows that it would be counterproductive to request MS to fulfil rapidly the rules. Besides, the uncertainty surrounding output and potential growth is going to remain large; this will make even more difficult to implement fiscal rules.

MS could borrow without difficulty and run public deficits at around 10 percentage points of GDP; interest rates remain negative in most MS and interest rate spreads diminished (1 percentage point between Italy and Germany in September 2021), notably because the ECB bought a large amount of bonds, which led banks reserves to rise in national central banks (NCBs). Thus, bonds acquired by the NCBs are not financed at the long-term interest rate but at the Central bank's reserve rates (-0.5% currently). These huge amounts bought by the ECB reduce the influence of financial markets: sovereign debt sustainability has become an issue less for financial markets sentiment than for the ECB and European instances.

The MS responded promptly to the COVID-19 crisis in implementing plans to support companies and workers (especially part-time unemployment schemes). The EU authorities' response was slower and relatively weak. In April 2020 the ESM introduced a lending scheme of up to 2% of GDP for MS in difficulty; but no MS asks to borrow from this scheme, given its conditions. In May 2020, the EU Commission introduced the SURE scheme (temporary support to reduce the unemployment risks in urgent situations), allocated 100 billion euro and lending to MS so as to contribute to fund part-time unemployment schemes. From October 2020 to May 2021 17 MS asked to benefit from it for a total amount of 95 billion funded to bond issuance branded as 'social'.⁵ Let us note that these financial supports became available after MS launched and financed the expenditure concerned.

The RRF (Recovery and Resilience Facility) was agreed in July 2020: the Commission may issue bonds for 850 billion euros (6.3% of EU GDP), i.e. 360 billion euros of loans to governments, 390 billion of common debt, of which 312 billion of government subsidies⁶ (2.3% of GDP). Let us note that this allows to cut fictively EU MS debt by 2.3% of GDP. The Commission is entitled to issue net loans only until the end of 2026. There is no certainty that MS will effectively use this borrowing capacity of 360 billion included in the plan; some MS will perhaps be able to

⁵ MS who asked for the larger support were, in billions euros: Italy (26.7 billion euros), Spain (20), Poland (6.7), Belgium (6.2). As a percentage of GDP, smaller MS received around 2% of GDP (Cyprus, Malta, Croatia, Slovakia), the larger (Italy, Spain, Portugal, Greece) 1.5% of GDP. Germany, France, the Netherlands, Austria, Sweden, Finland and Denmark did not request support

⁶ These subsidies benefit particularly the poorest countries in the EU. They represent more than 10% of the GDP for Bulgaria and Croatia; 10% for Greece; 7% for Romania and Portugal; 6% for Spain; 5% for Hungary and Poland; 4% for Italy; 4% for Slovenia; 3% for the Czech Republic; from 1.5 to 0.5% of GDP for other countries.

issue bonds at a lower rate than those offered by the Commission; other MS will prefer to keep a direct link with lenders. Thus, this debt mutualisation may be viewed as positive (protecting MS from financial markets) or worrying (if it prevents MS to borrow freely on markets). The 312 billion euros will be used to finance subsidies that will be reimbursed between 2028 and 2058, by MS or by new resources (tax on single use plastics, tax on large companies, tax on GAFA, part of the carbon tax, border-adjustment tax, financial transactions tax). This list of potential tax revenues is oversized in view of the sums to be reimbursed (0.1% per year). One may consider that the Commission has increased its capacity to raise resources at the expense of MS; one may be satisfied to see new relevant taxes on the European agenda. Three scenarios may be considered for the future : the scenario written in the agreement, but this is the less likely, is that the EU effectively repays this debt in introducing EU taxes before abolishing them; one may think that these taxes once introduced will never be abolished and that once the debt is repaid, they will serve to finance an increase in the European budget; one may also consider that the debt will become perpetual, like domestic public debt and that a common fund borrowing to subsidize MS will become a permanent component of EU functioning, which would be a way to turn fiscal rules and move towards fiscal Europe.

3.4 Monetary policy during the crisis

The ECB has set its refinancing rate at 0 since March 2016. Since 2014, the ECB has put a downward pressure on interest rates through buying and owning public or private bonds. These purchases were increased in March 2020 and as a result in September 2021 the 10-year government bonds rates varied between -0.35% for Germany, 0.65% for Italy and 0.75% for Greece, i.e. levels well below the expected nominal growth rates. These low interest rate levels should be incentives for households' and companies' investment. However, they do not translate in lower profitability demanded by financial markets. Low interest rates contribute to rising financial and housing bubbles, which increases wealth inequalities. Monetary policy becomes a hostage, as it cannot raise interest rates without increasing the risk of bubbles burst. In addition, interest rates were already very low before the Covid crisis, so they could fall only to a limited extent: zero for the refinancing rate, the decrease was only 0.8 point for the rate. German 10-year rate, 0.9 point for the French rate). The lack of demand in the euro area should have been fought with more expansionary fiscal policies (but the latter are constrained by fiscal treaties), or better by more ambitious wage policies (especially in MS running external surpluses, Germany, the Netherlands).

In the COVID19 crisis, households saw their incomes mostly maintained, while their expenditure were constrained to fall. Households accumulated financial savings whereas government deficits widened. Households' financial savings led to a rise in banking deposits; while governments were issuing public bonds, that banks had to buy. Given the low interest rates levels, banks preferred to re-sell their bonds to the ECB, increasing their deposits in the ECB's assets. Thus, at the end of 2021, the ECB (in fact the NCBs) own government bonds amounting to around 27.8% of euro area GDP, financed by bank notes for 10.2 % of GDP and banking deposits (net of refinancing) for 16.5% of GDP.

This situation has led to two debatable proposals. According to some, the ECB can cancel the public debt it owns. But they forget that this measure would have no impact as no private agent would be affected, the NCBs would have unbalanced assets, and this unbalance would be part of the public debt as NCBs have no other shareholder than their government. If interest rates rose, the NCB would run current account in deficit; instead of paying dividends to the State, it would need to receive a subsidy, which would weaken it; public debt interest payments would still bear on the State. If demand becomes excessive, the authorities would still have to make a trade-off between increasing interest rates or taxes. The only channel through which this measure could have an impact would be if European authorities were blind and would not count the NCBs imbalance in MS public debts.

Other authors (Martin *et al.*, 2021) observe that the ECB did its best to raise inflation. Strangely, they recommend that the ECB makes helicopter money measures, giving sums sporadically to all the euro area citizens. However, this kind of measure is a fiscal policy measure. This is not the central banks' role. The Central bank cannot have this role since households do not have accounts at the Central bank. By nature, the ECB supervises and refinances banks; it guarantees the public deficit financing; it guarantees the public debt, it sets credit conditions so that the inflation target is reached. It does not pay social benefits. When monetary policy becomes ineffective, fiscal policy should be used.

Helicopter money is not different from a situation where the government would pay transfers to households, while the Central bank guarantees public deficit financing. But the Central bank would decide about transfers, and not the State. But the CB has no democratic legitimacy to make social expenditure. Households receiving this money would not keep it as bank notes, they would spend it. The final owners of the savings resulting from purchasing power boost would keep it in the form of banking deposits and this would require the Central Bank to borrow from banks. The NCB would distribute subsidies and not loans, which would lead to imbalances in its balance sheets; it would be weakened; its current account would be in deficit if interest rates rose. In each country, the NCB's imbalanced balance sheet would be affected to its unique shareholder, the government, and would become part of the public debt. Such a proposal cannot be accepted, both for NCBs (which would become indebted) and for MS (who would lose the control of their fiscal policy).

In fact, the only reason why helicopter money may make sense, is if ECB's intervention was replacing the absence of fiscal policy coordination, but a uniform transfer dictated by a federal authority is not coordination. The euro area would enter a new framework where the ECB would be in charge of fiscal policy and would have a large net debt (10% of GDP in a first time according to the authors) without any mechanism allowing steps backwards (such as the ECB may raise a tax on households in case of too strong inflation). One may think that the authors have in mind a purely European target: moving toward federalism.

3.5. After the COVID-19 sanitary crisis, the public expenditure rule again

The debate on fiscal rules has continued during the COVID-19 crisis. The major issue now is: how to exit the rules' suspension period.

Thus, Dullien *et al.* (2020) propose to increase the public debt target to 90% of GDP (since a 3% of GDP deficit is consistent with a public debt at 100% of GDP if nominal GDP grows by 3%, but they forget that the 3% of GDP is a ceiling, and not a target). They also consider the idea of norm for structural public expenditure nominal growth below the sum of potential output plus the ECB's inflation target. Net public investment would be deducted from this norm and would be financed through borrowing. The concept of investment would be enlarged (but the authors do not consider investment for environmental transition). The authors seem to consider that public investment expenditure will be used for macroeconomic stabilisation, which we do not find relevant. For us, governments should be able to use current expenditure, transfers and taxation for the stabilisation objective.

The August 2020 European Fiscal Board's report considers that the ECB's important role in the public debts financing justifies that fiscal rules are in place to control public debts evolutions. The EFB proposes to increase the EU budget, with own resources and a borrowing capacity to help countries in difficulty by supporting their investments. As concerns the fiscal rule, MS should set themselves a rule for their net public expenditure growth that would allow the debt ratio to converge towards 60% at a given pace. This pace would be smaller if the interest rate is high and if the interest rate is high in relation to the GDP growth rate, so that the required public balance does not exceed 3% of GDP. Growth-friendly investments (especially those co-financed by the EU) would be removed from the public expenditure rule but would play a role in the long term through their impact on debt. Finally, the rule would be suspended in the event of depression, characterized by the national fiscal council, the European Fiscal board and the Commission. Member States not complying with the rule would lose access to aid from the EU budget. MS with debts below 60% would be encouraged to develop growth-friendly investments (hoping for stimulus effects across the EU).

Anderson and Darvas (2020), in favour of the expenditure rule, propose to strengthen the NFCs influence, to create a European Fiscal Council (with six governors and the NFCs directors. (but do we really need another body that would duplicate the EFB?), to strengthen sanctions (here also, requirement to issue junior debt, no access ESM credit facilities, obligation to report to the European Parliament).

3.6. A Keynesian viewpoint

Furman and Summers (2020) recall the Keynesian theory applied to the current context. The authors show that the current low level of interest rates results from a structural imbalance between savings and investment. Monetary policy is ineffective to support output when nominal interest rates are already close to 0. Monetary is also dangerous as low interest rates induce high private debts and facilitate speculative bubbles. In this situation, fiscal policy should support output, in particular with investments increasing potential growth (the authors forget the need for green public investments that do not aim to increase growth, but to reduce greenhouse gas emissions).

The authors criticize the target of a debt to GDP ratio and propose to draw the lessons from the low interest rate levels relative to the growth rate. In the long-term equilibrium, the debt

to GDP ratio equals: $d = -(r-g) s_p$ where r is the real interest rate, g , GDP growth rate and s_p , the primary balance. When the interest rate was 3 percentage point higher than the growth rate, stabilising the debt to GDP ratio at 60% was requiring running a primary surplus at 1.8% of GDP. On the contrary, when the gap between the interest rate and the growth rate is -2%, a debt at 120% of GDP is compatible with a primary deficit of 2.4% of GDP. In theory, when the interest rate is below the growth rate, any primary deficit will lead to a stable debt ratio (thus, with a 2% gap, a primary deficit of 4% of GDP leads to a stable debt at 200% of GDP). But this calculation does not account for the fact that the gap between the interest rate and the growth rate is unstable (if the gap moves to 1%, the equilibrium debt ratio increases to 400%) and from the fact that the risk remains that financial markets and public debt owners worry if the debt ratio exceeds a certain level.

The authors advocate a much more active role of fiscal policy, both on cyclical and structural purposes. Strangely, they propose a guideline where the government should not worry about the budgetary position as long as real interest rate payments are expected to remain below 2% of GDP over the forthcoming decade. Thus, in the case of France, in 2019, government net interest payments were amounting to 1.25% of GDP (i.e. an apparent rate of 1.43%, with inflation at 1.3%); i.e. interest payments amounting to 2.8 billion, 0.11% of GDP in terms of real interest rates. But this rule is entirely arbitrary (why 2%? why real interest payments and not interest payments corrected from GDP growth?). If a country borrows at negative real interest rates, the debt ratio compatible with a 2% of GDP real interest charges strongly depends on the assumption on future interest rate and reaches easily infinity.

Ragot (2021) proposes that the nominal interest paid by public administrations should not exceed 2% of GDP. Assuming that the apparent nominal interest rate on the debt converges to 1%, the public debt could reach 200% of GDP. Here also, the rule is arbitrary; it does not account for growth and inflation. By the way, the author advocates a 5% increase in the public deficit, with no clear link with the 200% rule.

3.7 Finally, Blanchard came ...

Blanchard *et al.* (2021) consider that the European fiscal rule should mainly be concerned with debt sustainability. They show that the conditions for sustainability have changed since 1982: the interest rate is significantly below the nominal growth rate, which makes sustainability much easier to achieve. At the same time, it remains necessary to assess the risks of rising interest rates and the risks of shocks such as the Covid shock. They argue that a rigid rule of public expenditure growth can be too restrictive if discretionary fiscal policy is needed; no rule can be adequate in the face of all possible shocks; a too rigid rule prevents the necessary support policies; a rule allowing for economic stabilisation can lead to a too high debt level. They therefore propose to move from rules to standards, qualitative general principles. In the article 126 TFEU, "Member States shall avoid excessive public deficits", one could add: "When there is doubt as to whether public debts remain sustainable with high probability, members shall reduce their primary deficits at a speed that balances risks to sustainability and short-term risks to output".

The Commission, the EFC, the national fiscal council would be responsible for using stochastic methods to assess the risk of default, which should be kept below 5%. At the same time, Blanchard *et al.* recognize that this assessment is difficult. Their standards do not give incentives for a too rigid country to spend more; therefore, they rely on a fiscal capacity at the EU level to implement an expansionary policy, if necessary. They propose to constrain Member States to comply with the standards, either by allowing the Commission, the Council, or the national fiscal council to block a non-compliant budget, or by allowing the Commission to lodge a complaint with the European Court of Justice (albeit recognizing that this institution is not competent in economic matters).

Although one can only agree with the proposal to replace rules with standards, the proposal is problematic (see also Dani *et al.*, 2021). The suggested calculation, which would be done according to opaque criteria, makes little sense. How to calculate a probability of default in a situation of strong uncertainty (see Box 1)? Neither the United States, nor the United Kingdom, nor Japan calculate a risk of default of their public debt. The experience shows that a common shock poses no default risk, given the ECB's support: risk premiums demanded by markets have, in fact, declined since the Covid shock. How to assess the risks of a specific shock, such as a major political turn, that the European authorities and the other Member States would refuse to endorse? Moreover, no sovereign country will accept that a veto right over its budget be given to a committee of experts like a national fiscal council or to a judicial body like the ECJ. How would the ECJ assess compliance with such a vague standard as the public debt sustainability?

Martin *et al.* (2021) rightly show that the European fiscal rules aimed mainly at constraining fiscal policies, preventing discretionary policies, and relying on monetary policy to support demand are outdated when monetary policies are paralysed, and fiscal policies are needed. They recognize that the European fiscal rules have become too complex, that potential output estimates are fragile. Nevertheless, they believe that rules are necessary in a monetary union. They consider that fiscal rules should focus on the risk of default, assessed by stochastic methods. They estimate that these methods would lead to different debt levels depending on countries, levels which would be translated into 5-year targets. But they do not assess these different levels.

They take up the idea of a standard for net primary public expenditure growth based on growth and inflation assumptions, which would allow the target to be reached within 5 years. This standard would be defined by the government at the beginning of the legislature (which comes in contradiction with a target set by stochastic methods). It would be amended, only at the initiative of the government, in the event of a persistent economic shock, a change in the country's political orientation, or the implementation of an escape clause⁷. But in the past, stability programmes were rarely effectively implemented, because governments do not really consider they are constrained by this kind of document which quickly becomes obsolete

⁷ In France, the Constitutional Council considers that annuality is a principle of the budget vote and has a constitutional value. Hence a rule over 5 years would only have an indicative value.

due to unanticipated economic and social developments. In fact, under the authors' proposals, national fiscal policies would be tightly controlled: the national fiscal council would choose the macroeconomic scenario and validate the debt target that the government would propose, according to a method set by the EFB and under its control.⁸ The budget would be submitted for approval to the Commission and the Ecofin Council, who could reject it, deprive the MS of the possibility to benefit from European aid, oblige the MS to issue junior bonds. Conversely, a MS would benefit from a certain indulgence if it undertook structural reforms. MS would not be able to decide on their own of a more expansionary economic policy, but the Commission could suggest to the Council to accept flexibility of the MS expenditure rules, to recommend MS more or less expansionary fiscal policies. The Commission could use the FRR (Facility for Recovery and Resilience), which would be made permanent.

Logically, the required level of public debt should be low for a low-growth country like Italy (which would therefore be subject to strong constraints) and high for Northern countries (which will not use their room for maneuver). What if the stochastic calculation results in a sustainable debt level much higher (or much lower) than the actual level? How can we imagine countries setting their public spending decisions on the basis of such calculations? Above all, the text proposes to set up a technocratic, opaque and complicated process to control national fiscal policies, which does not respect the Member States' autonomy.

3.8 The state of the debate

On July 8, 2021, the European Parliament (2021) adopted a motion on the review of the European macroeconomic framework. The Parliament calls for a reform before the end of the general escape clause, a reform "while fully respecting the Treaties". It recognizes that applying the current fiscal rules would have depressive effects for many countries. But the text is placed both in the objective of green growth and the control of public debts. It accepts the theory according to which countries should have sound public finances in order to be able to undertake supportive policies when necessary (which the example of the United States and United Kingdom denies). Demand support measures could / should encourage investment so as to also have favorable effects on potential growth and avoid the build-up of public debt; the fall in debt ratios could thus be achieved without macroeconomic cost. The contradiction between ecological goals and strong growth based on "productivity and competitiveness" is not addressed. The Parliament proposes to use "innovative tools and techniques such as stress tests and stochastic analysis to better understand the risks to the dynamics of public debt". Finally, it takes up the EFB's proposal: "an expenditure rule with a ceiling on nominal public expenditure when a country's public debt exceeds a certain threshold can provide more transparent fiscal rules within the EU; considers that the growth rate of the expenditure ceiling would depend on the expected potential output growth, expected inflation and the distance from the debt anchor; notes that debt servicing costs and unemployment benefit payments (at unchanged rates) are excluded. and expenditure growth is adjusted for the impact of

⁸ The text proposes to expand the tasks and powers of the current French Independent Fiscal Council, without questioning its composition, which places it, in practice, under the Court of Auditors' control.

discretionary changes in government revenues (i.e. direct and indirect tax rates)". The Parliament adds: "An appropriate country-specific trajectory and membership of Member States will enhance credibility and encourage States to better respect the rules; the country trajectories must be the result of a transparent and comprehensive economic analysis and of a debate between the Member States and the European Commission, as part of the European Semester process, during which a consultation with the European Fiscal Board and national independent fiscal institutions could be considered whenever this is justified ", so that it appears that the trajectory will be imposed by the European authorities. Parliament adds that "Certain clearly defined and viable growth-generating expenditure would be excluded from the ceiling on net primary expenditure", without clearly stating that these are investments part of the ecological transition. It supports "the EFB's proposals that, on the basis of mutual agreement, countries with a high current account deficit would see their spending targets lowered, while countries with an excessive external surplus would have a higher floor for the rate of spending growth". It notes that the EFC is strongly advocating "for a central fiscal capacity at European level, which would encourage better compliance with the Union's fiscal rules" but "underlines that the Next Generation EU and SURE instruments under their current form are intended to be temporary and underlines the importance of a transparent repayment plan for the debt arising from the Next Generation EU and SURE obligations", which seems rather contradictory. The Parliament complains about the lack of national ownership of the European framework for economic governance, such as the European Semester; he would like national actors, in particular national parliaments, to take them more into account, which is not currently the case, given their technocratic nature and their inappropriateness to national situations.

Thus, the European institutions and many European economists are in favor of a rule imposing public expenditure growth below potential GDP growth and aiming at a public debt target of 60% of GDP⁹. This rule would avoid the problems associated with estimating potential output, structural balance, and fiscal stimulus (but it would remain necessary to estimate potential growth, which is also problematic). The public expenditure growth (net of permanent resources evolution) would be a variable fully controlled by the government. The various proposals differ on how to account for public investments: some proposals remove public investment from public expenditures governed by the rule, some proposals even remove public investment from the public debt, some include only public capital consumption. The proposals also differ on how to account for inflation: observed, anticipated or the 2% ECB's target, the latter being the most stabilising for the economy, but the least for debt stabilisation); on the speed of convergence towards the debt objective of 60% of GDP (some even questioning the 60%). Conversely, this rule focuses on controlling public expenditure knowing that the latter will need to be increased to finance ecological transition, not to

⁹ However, it should be noted that MS could stabilize their debt at 60% of GDP with a public deficit equal to 60% multiplied by its nominal growth rate (i.e. 1.8% of GDP for nominal growth of 3%). The objective of a balanced budget in the medium term disappears.

mention the population ageing. The rule does not account for short- and long-term macroeconomic stabilization needs, at country level at the euro area level. When the arbitrary 60% target for the debt-to-GDP ratio is maintained, the rule would imply a long period of austerity. The risk is great that the emphasis on investment spending puts increased pressure on social spending.

Darvas and Wolff (2021) gave a presentation at the Ecofin Council, 11 September. In fact, the authors abandon the ambition of reforming rules. They pretend to protect green investments in the re-implementation of European fiscal rules, saying that this can be done through a flexible implementation of the fiscal rules. They consider that the investment needed to reach EU CO₂ emissions targets would amount to 2%, of which 0.8% public investment. They consider that the rise in CO₂ emissions prices will be a sufficient incentive for companies to choose green rather than brown investment; such a low increase in public investment will not be difficult to finance; but is it credible? The authors recommend to abandon the 60% of debt target and to restrict constraints to a fiscal effort of 0.5% of GDP per year, excluding green investment. The latter would be taken into account neither for debt nor deficit evaluation. The authors assume that supply-side effects linked to the good quality of public investments will offset the negative effects on demand. For instance, for France, the public deficit would be at 4.7% of GDP in 2022. An annual 0.5% of GDP effort would bring the deficit to 0.5% of GDP in 9 years. According to the authors, it is unnecessary to request a larger effort more rapidly. The authors do not raise the question: what shall be done in the event of a new economic shock? Nothing is said on the question of the fiscal effort measurement is not addressed. Economic policy coordination and debt issues are hardly mentioned.

Several views were opposed at the Ecofin meeting of 11 September 2021. For the Commission and some MS, the 60% rule should be less binding, in giving more time to MS with high debt levels to bring their debt to the 60% target. This would allow not to request MS to run too restrictive policies in 2023 (but MS would however have to commit to sustained cuts of debt levels). Besides, some MS consider that public investments should be withdrawn from the deficit rules (green investments, but also, according to some, investment increasing potential growth and R&D expenditure).

For a coalition of 'frugal' MS, led by Austria and including the Netherlands, Finland, Slovakia, Latvia, and strangely Denmark, Sweden, and the Czech Republic, who are not euro area members, existing rules are necessary and sound; debt reduction should remain a common target; public debt sustainability should be ensured in the prospect of future shocks.

However, Klaus Regling, ESM managing director, declared in an interview with *Der Spiegel* published on October 15, 2021 that the 60% criterion is "economically nonsensical" today. "The rule, according to which member states are allowed to run yearly deficits of no more than 3% of economic output, has proven its worth. It should be kept. The debt-to-GDP ratio of 60%, on the other hand, is no longer relevant and should be adjusted to reflect the changed environment".

On October 19, the European Commission (2021) launched the consultation process on the review of EU economic governance. The Commission insists on the need for “a gradual, sustained and growth-friendly reduction to prudent debt levels”, as well as on the need to maintain sustained levels of public investment, on the need to create budgetary margins in order to be able to use stabilisation fiscal policy when necessary, on the importance of fiscal policies, on the risks of divergences in the EU, on “the difficulties associated with using indicators that are not observable and attempting to design rules that seek to cater for all possible circumstances”. The task will not be easy.

The Commission seems to accept that no political agreement can be reached to review fiscal treaties and so rules would be continued to be implemented with a lot of flexibility. “Much ado about Nothing”.

4. In favour of coordinated but autonomous policies in the euro area

In advanced economies, the system which worked until 1999 is unity between the government, the Central Bank and commercial banks. The central bank is the lender of last resort, for the Government and commercial banks. The government may issue public bonds, with no limits. This debt is considered as safe, and so is issued at the lowest market price. This allows to guarantee the banking system.

The introduction of the euro area led to a hardly manageable framework. On the one hand, governments lose control of their interest rates and their exchange rates and this makes active fiscal policies more necessary. In addition, since 1973 and even more since 2007, the macroeconomic equilibrium requires some level of public deficit and some level of public debt. On the other hand, in a monetary union, macroeconomic imbalances have spillover effects on partners: excessive deficits (and surpluses) should be avoided. But how to characterize those imbalances? Last, the financial markets’ weight requires that public debt become safe assets again, while Northern MS refuse to allow unlimited guarantee to their partners.

In our view, fiscal policy in the euro area should draw on functional finance principles (Mathieu and Sterdyniak, 2019, Alvarez *et al.*, 2019). Public finances must target economic and social objectives, both macroeconomic stabilization and the financing of public spending and investments, in particular those necessary for the ecological transition. Unfortunately, the European institutions, Northern MS and some European economists demand rules on public finances and not on macroeconomic standards; they can rely on European Treaties.

Euro area MS should be able to issue safe public bonds, at an interest rate controlled by the ECB; the public debt should be guaranteed by the ECB. MS should be allowed to run a government balance consistent with their macroeconomic needs. A MS should be requested to amend its fiscal policy only if there is evidence that this policy has negative spillovers for the other MS.

The mutual guarantee of public debts should be entire for MS agreeing to take part to an open coordination process (without prior rules). This coordination can only be done through a coordination process between MS. It should target growth, full employment, and ecological transition ; it should examine all macroeconomic variables; MS should present an economic

policy strategy allowing to meet the inflation objective (at least to remain within a certain margin around the common inflation objective, the latter should be increased in times when a recovery is needed), to meet a wage growth target (in the medium term, wages should grow in line with labour productivity, in the short term adjustment processes should be implemented in MS where wage growth has been too or not sufficiently rapid; rises or cuts in NIC (and VAT as a counterpart) could be used to facilitate the adjustment process but should be coordinated; MS should present and negotiate their current account targets; MS running initially current accounts large surpluses should agree to lower them or to finance explicitly projects, preferably industrial in deficit countries. The coordination process should allow for autonomous but compatible fiscal policies.

The Treaty should keep a mechanism in the event where negotiations would not lead to an agreement, where a MS would run an unsustainable fiscal policy. In this case, after a European Council's decision based on reports from the Commission and the ECB, the newly issued debt by a MS government outside the agreement would not be guaranteed anymore, but this case should never occur. Besides, the ECB should keep interest rates at low levels, below growth, to reduce the public debt ratio, knowing that MS should commit to implement restrictive policies in case of excessive demand. At the same time, in order to prevent the rise in financial bubbles, the ECB should give banks incentives to avoid speculative activities and to finance productive activities (especially in order to finance reindustrialisation and environmental transition).

The conduct of domestic fiscal policies would be facilitated if a European budget was financing common European goods (such as the fight against climate change), by common resources (such as a financial transactions tax or carbon frontier tax) and by issuing euro-bonds. But this may not be a pretext for adding constraints on national budgets.

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