FISCAL POLICY OF THE EUROPEAN UNION. THE ROLE OF THE EUROPEAN FISCAL BOARD

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Abstract: *Fiscal discipline has always been considered a necessary prerequisite for the orderly functioning of a monetary union geared towards price stability. However, there is no consensus about which is the most appropriate policy mix to achieve it: the debate on fiscal austerity vs. growth is bitter now among researchers and international policymakers. In this paper we review the effects of different fiscal policies from the European Fiscal Board perspective.*

Cuvinte cheie: *fiscal policy, public debts, taxes, European Fiscal Board.*
JEL Classification: *H3, H6.*

1. The fiscal policy

Fiscal policy is the use of government spending and taxation to influence the economy. Governments typically use fiscal policy to promote strong and sustainable growth and reduce poverty. The role and objectives of fiscal policy gained prominence during the recent global economic crisis, when governments stepped in to support financial systems, jump-start growth, and mitigate the impact of the crisis on vulnerable groups. In the communiqué following their London summit in April 2009, leaders of the Group of 20 industrial and emerging market countries stated that they were undertaking "unprecedented and concerted fiscal expansion." What did they mean by fiscal expansion? And, more generally, how can fiscal tools provide a boost to the world economy?

Historically, the prominence of fiscal policy as a policy tool has waxed and waned. Before 1930, an approach of limited government, or laissez-faire, prevailed. With the stock market crash and the Great Depression, policymakers pushed for governments to play a more proactive role in the economy. More recently, countries had scaled back the size and function of government - with markets taking on an enhanced role in the allocation of goods and services - but when the global financial crisis threatened worldwide recession, many countries returned to a more active fiscal policy.

The original architecture for economic governance in Europe's Economic and Monetary Union (EMU), established with the Maastricht Treaty of 1992, included a series of provisions aimed at fostering fiscal discipline: the prohibition of excessive deficits, the prohibition of monetary financing, the no bailout clause and the prohibition of privileged access to financial institutions.

The original EMU architecture, however, neglected the importance of macroeconomic imbalances, which can be a source of fiscal risks for national governments. Furthermore, in the run-up to the global financial crisis of 2008, a loose implementation of fiscal rules failed to encourage Member States to build up sufficient fiscal buffers. Public debt ratios in a number of high-debt Member States were not adequately reduced under these relatively favorable economic circumstances.

The Greek sovereign debt crisis highlighted the important role of national institutions in ensuring an effective and transparent enforcement of fiscal rules.

The emergence of the sovereign-bank nexus in the euro area made clear that banking crises can have detrimental consequences for public finances and, conversely, that undisciplined fiscal policies can be a source of bank distress and impair the functioning of EMU.

Based on the lessons learned during the crisis, the six and two-pack reforms aimed at strengthening the EU economic governance framework in five ways, by: (i) reorienting fiscal rules towards a greater focus on debt developments and expenditure control; (ii) strengthening enforcement through sanctions; (iii) expanding economic governance to the monitoring of macroeconomic imbalances; (iv) establishing independent fiscal institutions at the national level; (v) completing the EMU architecture, most notably by introducing crisis-resolution mechanisms and establishing a banking union.

Since the six and two-pack reforms, EU fiscal rules remained subject to continued refinements and interpretative innovations, which added to the complexity of an already elaborated system.

Greater complexity and judgement in the implementation of the Stability and Growth Pact (SGP) heightened frictions between different institutional players over who ultimately exercises discretion. While flexibility is desirable, the growing complexity of the functioning of the SGP has become problematic, raising questions about transparency, equal treatment among countries, and communicability to the public.

2. How the economy is influenced

When policymakers seek to influence the economy, they have two main tools at their disposal - monetary policy and fiscal policy. Central banks indirectly target activity by influencing the money supply through adjustments to interest rates, bank reserve requirements, and the purchase and sale of government securities and foreign exchange. Governments influence the economy by changing the level and types of taxes, the extent and composition of spending, and the degree and form of borrowing.

Governments directly and indirectly influence the way resources are used in the economy. A basic equation of national income accounting that measures the output of an economy—or gross domestic product (GDP)—according to expenditures helps show how this happens:

$GDP = C + I + G + NX$.

On the left side is GDP—the value of all final goods and services produced in the economy. On the right side are the sources of aggregate spending or demand—private consumption (C), private investment (I), purchases of goods and services by the government (G), and exports minus imports (net exports, NX). This equation makes it evident that governments affect economic activity (GDP), controlling G directly and influencing C, I, and NX indirectly, through changes in taxes, transfers, and spending. Fiscal policy that increases aggregate demand directly through an increase in government spending is typically called expansionary or “loose.” By contrast, fiscal policy is often considered contractionary or “tight” if it reduces demand via lower spending.

Besides providing goods and services like public safety, highways, or primary education, fiscal policy objectives vary. In the short term, governments may focus on macroeconomic *stabilization*—for example, expanding spending or cutting taxes to stimulate an ailing economy, or slashing spending or raising taxes to combat rising inflation or to help reduce external vulnerabilities. In the longer term, the aim may be to foster sustainable growth or reduce poverty with actions on the *supply side* to improve infrastructure or education. Although these objectives are broadly shared across countries, their relative importance differs, depending on country circumstances. In the short term, priorities may reflect the business cycle or response to a natural disaster or a spike in global food or fuel prices. In the longer term, the drivers can be development levels, demographics, or natural resource endowments. The desire to reduce poverty might lead a low-income country to tilt spending toward primary health care, whereas in an advanced economy, pension reforms might target looming long-term costs related to an aging population.

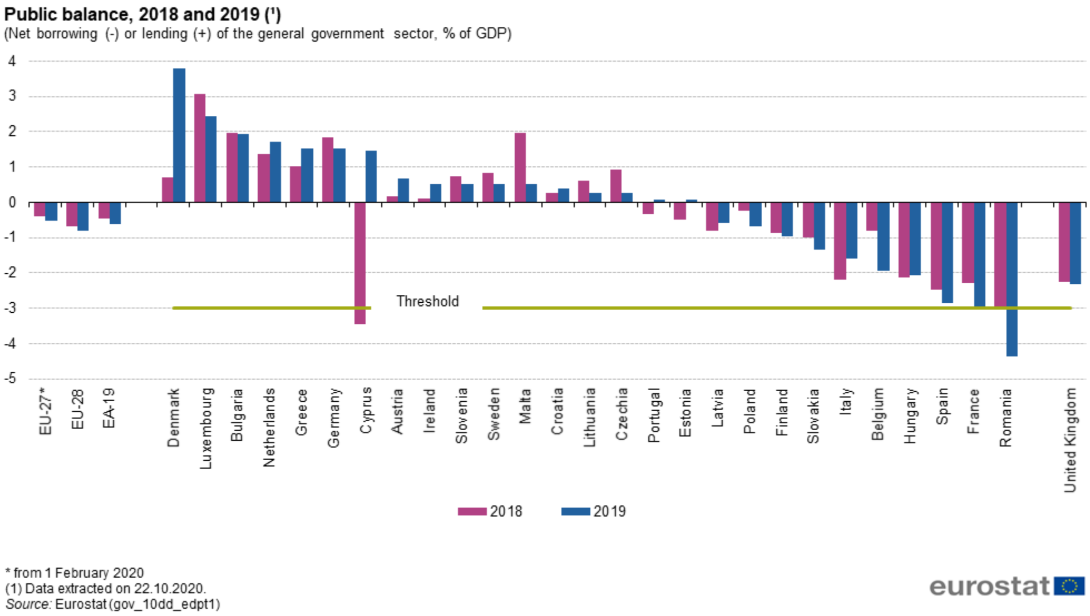
General government surplus/deficit

The EU-27's government deficit-to-GDP ratio increased from -0.4 % in 2018 to -0.5 % in 2019, while this ratio also increased in the EA-19 from -0.5 % to -0.6 %. For 2018, at the level of the EU-27 and euro area, the lowest deficits in the available time series were observed.

Seventeen EU-27 Member States — Denmark (+3.8 %), Luxembourg (+2.4 %), Bulgaria (+1.9 %), the Netherlands (+1.7 %), Greece, Germany and Cyprus (all +1.5 %), Austria (+0.7 %), Ireland, Slovenia, Sweden and Malta (all +0.5 %), Croatia (+0.4 %), Lithuania and Czechia (both +0.3 %) as well as Portugal and Estonia (both +0.1 %) — registered government surpluses in 2019.

There were eight EU-27 Member States, namely Latvia, Poland, Finland, Slovakia, Italy, Belgium, Hungary and Spain, that recorded deficits in 2019 that were smaller than 3.0 % of GDP. Two EU-27 Member States had deficit equal to or higher than 3.0 % of GDP: France (-3.0 %) and Romania (-4.4 %), (see Figure 1).

Figure nr. 1. Public balance, 2018 and 2019



Source: https://ec.europa.eu/eurostat/statistics explained/index.php/Government_finance_statistics#General_government_surplus.2Fdeficit

3. The role of European Fiscal Board (EFB)

Fiscal deficits and public debt ratios (the ratio of debt to GDP) have expanded sharply in many countries because of the effects of the crisis on GDP and tax revenues as well as the cost of the fiscal response to the crisis as well as the last years world economy evolutions. Support and guarantees to financial and industrial sectors have added to concerns about the financial health of governments. Many countries can afford to run moderate fiscal deficits for extended periods, with domestic and international financial markets and international and bilateral partners convinced of their ability to meet present and future obligations. Deficits that grow too large and linger too long may, however, undermine that confidence.

European Union has created European Fiscal Board esspecially to adress some of the main issues of european countries. The Board was set up following the Five

Presidents' Report Completing Europe's Economic and Monetary Union", with the aim to strengthen the current economic governance framework.

The main responsibilities of EFB are:

- evaluate the implementation of the Union fiscal framework and the appropriateness of the actual fiscal stance at euro area and national level
- make suggestions for the future evolution of the Union fiscal framework
- assess the prospective fiscal stance appropriate for the euro area as a whole based on an economic judgment, as well as the appropriate national fiscal stances, within the rules of the Stability and Growth Pact
- cooperate with the National Independent Fiscal Councils
- provide ad-hoc advice to the Commission President

In April 2019, the European Commission decided to renew the mandate of the European Fiscal Board for a second and final three-year period taking effect on 20 October 2019.

In august 2019, the EFB report "Assessment of EU fiscal rules", made at the request of the European Commission, revealed many of the problems that European Union faces in the last years and bring some solutions.

First, evidence on what would have happened, if the EU had continued to rely on the pre-crisis rule book is not available, so conclusions are necessarily tentative. Yet, the EFB specialists report that – underpinned by the major analytical efforts undertaken, in particular, by our Secretariat – the six and two-pack reforms have moderately advanced sustainability. However, the reforms have been unable to significantly reduce pro-cyclical elements in national fiscal policies and to improve the quality of public finances. In particular, the reforms have not protected investment against bearing the brunt of the cutbacks in public expenditures since the crisis started from 2008-2009.

Second, the EFB has found it useful to supplement the rich documentary evidence available by collecting well-informed, often divergent, views through a series of conversations with policy officials who have been involved in designing and in implementing the EU fiscal rules, including some of the 'architects' of the six and two-pack reforms

While the simplification of the rules that have been asked to propose may seem analytically feasible, the EFB understands that political agreement on how to advance could be easily achieved; the agenda may at the same time be too narrow and too divisive.

As to the former and the more analytical aspects, the EFB sees itself as part of an emerging consensus in understanding simplification as focusing on one anchor – the longer-term evolution of the ratio of public debt to GDP – and one main instrument – the expenditure benchmark – while replacing some of the piecemeal elements of flexibility which have been introduced, mostly through negotiations between the Commission and individual Member States since 2015, by a general escape clause. The use of such a clause should be embedded into a clearer demarcation than in current practice between economic analysis and the political arguments that European Fiscal Board will occasionally have to override it.

EFB already presented some of these ideas in the Annual Report 2018. Simplification along the lines suggested would, in the view of the EFB, be desirable, even when viewed in isolation. But it is easy to anticipate the resistance to it and to understand why the current Commission envisages a revision of the rules after 2020. Member States, which have relied on delaying fiscal adjustments, want to retain well-known, but opaque procedures, while other Member States fear that the later could risk becoming (even) more flexible. Both groups seem to share the view that the current practices have not been sufficiently destabilizing to make a revision a high priority. Given this stalemate, a narrow agenda may become a constraint – as it was when the six and two-pack reforms were adopted. At that time, agreement on a major clarification of the fiscal rules and on tighter monitoring of them was facilitated by its coincidence with an agreement on a safety net, later the European Stability Mechanism (ESM), to provide conditional financing, if things were to go badly wrong, despite efforts to observe the rules.

Circumstances in 2019 are, fortunately, less ominous than nearly a decade ago, mainly because much of a banking union and a wider safety net have come into existence. Yet some of the original flaws persist: despite a substantial recovery over the past couple of years, a number of high-debt Member States have not used the good times to build fiscal buffers, making their public finances vulnerable once more to even a modest slow-down of activity; at the same time, monetary policy has limited scope for further accommodation.

EFB have reviewed the challenges of such a shorter-term scenario in the report of June 2019 on the appropriate fiscal stance in the euro area. Looking beyond the next one or two years, a simplification of the fiscal rules with carefully targeted scrutiny of a general escape clause could be easier to implement if accompanied by some allowance for a stabilization capacity at the joint level of the euro area, as was argued already in the Annual Report 2017.

The EFB identified multiple sources of unnecessary complexity in the current framework. First, there is an excessive reliance on European Fiscal Board unobservable indicators and real-time data – both often subject to major revisions ex-post. Second, with the benefit of hindsight, flexibility was often badly timed, also due to political considerations thus facilitating pro-cyclicality, while at the same time it failed to protect public investment. Third, there is a tendency to rely on annual rather than longer-term plans. Member States continue to postpone adjustments to the outer years in their stability and convergence programs.

For example, the proposal of the EFB brought several advantages resulting in a simplification. In its annual report 2018 the EFB has made a proposal that relies on a simple medium-term debt ceiling and one operational target, namely, a ceiling on the growth rate of primary expenditure net of discretionary revenue measures, and an escape clause triggered on the basis of independent economic judgement. This proposal would focus more clearly on underpinning sustainability, improve observability, simplify the rules and reduce pro-cyclicality. Net primary expenditure growth is linked to potential growth and thus would have an implicit stabilizing effect on the economy. The EFB proposal encourages a focus on the medium run by fixing the net primary expenditure growth ceiling for a period of three years ahead. Furthermore, the use of flexibility to reconcile stabilization better with sustainability, while improving the quality of public finances, remains an appropriate objective. The EFB proposes that any flexibility should be based on independent economic judgement. Finally, the EFB concludes that the 'matrix approach', which determines the speed of adjustment towards to the medium-term objective, has not worked and could be abandoned.

Further efforts need to be undertaken to improve the quality of public finances. The EFB's proposes the introduction of a limited Golden rule to protect public investment, while avoiding overburdening the EU fiscal rules with too many conflicting objectives. A variant of the Golden rule would exclude some specific growth enhancing expenditure from the net primary expenditure growth ceiling. The selection of relevant expenditure would take into account projects already identified by the EU budget. The EFB proposes that Member States could voluntarily top-up expenditures on projects beyond their co-financing commitments. These could then be deducted from the calculation of the net primary expenditures. National independent fiscal institutions could monitor the classification of growth-enhancing expenditure. This would further reduce the risk that governments unduly classify certain expenditure items as public investment.

There are certain governance issues that need to be addressed.

First, the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission should play a more independent role, to be defined in secondary legislation, in carrying out economic analysis and providing advice to the College of Commissioners.

Second, after the introduction of the reverse qualified majority voting (RQMV) the Commission appears to have become more reluctant in following through with the enforcement of the fiscal rules. RQMV might also have contributed to the involvement of politics of the Commission and the ambivalence of fiscal surveillance at the expense of multilateral peer review. The RQMV should be abolished.

Third, the EFB is convinced that the functioning of the Eurogroup could be improved if it was chaired by a full-time president, who is neither a national Finance Minister nor a member of the Commission.

Considering the relatively high turnover of Finance Ministers in the Eurogroup this would improve continuity and the governance of the euro area as a whole.

Financial sanctions in case of non-compliance with the EU fiscal rules framework have been politically difficult to enforce. The EFB has been a strong advocate of introducing a common fiscal capacity at the European level. One of the eligibility criteria to access funds could be compliance with the EU fiscal rules. Incentivizing compliance in this way might be more effective than financial sanctions. Going beyond uniform rules, one could imagine closer coordination of fiscal policies across Member States. Based on a mutual agreement between Member States over a seven year cycle, staggered against the multiannual financial framework of the EU, medium-term debt targets could be made country-specific. High-debt countries would commit to reduce their debt, and symmetrically low-debt countries would commit to increase growth-enhancing government expenditure, in particular those that have positive cross-border spillovers. The proposed agreement would effectively implement a euro area aggregate fiscal stance. Finally, the creation of links between net expenditure growth and the MIP could be explored.

4. Conclusions

In general, in the absence of a movement towards either a central fiscal capacity or other features of a deeper Economic and Monetary Union (EMU) and coordination of national policies, a burden will continue to be put on the fiscal rules as a partial substitute.

EFB have tried to outline a major simplification of the rules and a revision of the governance framework within which they operate. They would help in reconciling the objectives of sustainability of public finances and of economic stabilization. But it is necessary to go beyond pure simplification by trying to accommodate, through a variant of a Golden Rule, stronger incentives for public investment into the rules than have been provided so far.

More attention to stimulating growth-enhancing spending is warranted by the likely persistence of a low interest rate environment as well as by the increasingly specific nature of EU investment initiatives.

The 2019 EFB Report looked at how EMU deepening might reconcile the heterogeneity of the euro area with the need to give more meaning to its aggregate economic performance, as represented by the notions of the euro area fiscal stance and the macroeconomic imbalance procedure. This would involve recognition of diversity by collective negotiation of country-specific debt targets for the longer run.

These latter subjects were gone well beyond immediate mandate of EFB and required much further reflection. They must be addressed in future work, as well as to addressing links from fiscal rules to financial integration and to the strength of crisis mechanisms in the euro area to lessen the risks for public finances. This will be in the benefit of all member states, future part of the euro area.

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