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FISCAL RULES: TIMING IS EVERYTHI

by Benedicta Marzinotto
Research Fellow at Bruegel
benedicta.marzinotto@bruegel.org

and André Sapir
Senior Fellow at Bruegel
andre.sapir@bruegel.org

POLICY CHALLENGE

The EU fiscal framework has come under attack more because of the timi
of the application of the new rules than because of shortcomings of the ru
The framework entered into force when most eAn

THE TIGHTENING OF EUROPEAN UNION FISCAL RULES through the Fiscal Compact, which was signed in March 2012, and through the so-called six-pack regulations that entered into force in December 2011, comes at a time of worsening economic conditions in Europe. This unfortunate timing has re-opened the debate about the relationship between fiscal discipline and growth, and has provoked a wave of criticism from governments and academics about the EU's perceived obsession with fiscal discipline, and the potential in bad times for this to be self-defeating[1].

It is certainly the case that the new, tougher rules on excessive

1. See, for example, the Vox Debate 'Has austerity gone too far?', available at http://www.voxeu.org/debates/has-austerity-gone-too-far.

2. Exceptions are made for countries under programme (ie Greece, Ireland and Portugal), whose commitments are defined in their respective adjustment programmes.

3. European Commission (2012b).

	2012	2013	2014 onwards
Potential sanctions under preventive arm	Estonia, Finland, Luxembou	Belgium, Cyprus, Estonia, Finland, Germany, Luxembo	All countries
Potential sanctions under corrective arm	Austria, Belgium, Cyprus, France, Germany, Greece, Ireland, Italy, Malta, Netherlands, Portugal, Slovakia, icntis0 8.5 114.97460(ceriony90r[(i 0 84(h26.9(.0TJ T*pa).1 k)14.9l90ri)112c0001 T.0T.1 k)0(t)28.9		

10. Ireland held a referendum on 31 May 2012, voting in favour of ratification.

11. See footnote 7.

12. Article 7 of the TSC states: "The Contracting Parties whose currency is the euro commit to supporting the proposals or recommendations submitted by the European Commission where it considers that a Member State of the European Union whose currency is the euro is in breach of the deficit criterion in the framework of an excessive deficit procedure. This obligation shall not apply where it is established among the Contracting Parties whose currency is the euro that a qualified majority of them... is opposed to the decision proposed or recommended"

government, provided the country remained committed to a deficit lower than 3 percent of GDP in 2013. Moreover, the Commission announced on 30 May that it is prepared to grant Spain a one-year extension to the deadline in the light of poor growth conditions in the framework of the presentation of the country-specific recommendations which the Commission publishes every year under the European Semester process[14]. On 20 July, the Council approved the one-year extension at the same summit in which Spain was granted EU financial assistance to recapitalise its banking system.

The size of the correction

The Commission's May 2012 forecasts provide a good indication of which countries are under pres-

13. 'Spain defies EU over deficit rules', *Financial Times*, 2 March 2012.

14. Under the European Semester, EU member states must submit by 30 April every year their Stability or Convergence Programmes and their National Reform Programmes. The Commission assesses the documents and provides country-specific recommendations. The Council adopts the country-specific recommendations based on the Commission proposal.

15. Only Spain was granted an extension up to 2014.

16. For all countries for which the deadline for correction is 2013 the distance from the 3% target is simply the difference between the 2012 deficit in the Stability Programme and the level in the Commission's Spring Forecast, as the Commission's forecast for 2013 includes fiscal measures not yet approved. In other words, we assume very optimistically that the correction in the following year will lead to exactly the same result that has been forecast by the government in the latest Stability Programme.

of 2013 compared with the level in 2011, implying an annual nominal fiscal cut-back of close to 1.4 percent of GDP. It is not desirable to retrench in extremely slow growth periods but the figure is probably not dramatic either. But the extra effort necessary to meet the targets in some countries and its likely impact on neighbours, which is not normally quantified by EU institutions, are more worrying. Cyprus, France, Slovakia, Slovenia, the Netherlands and Spain need to introduce additional measures above those already planned in their 2012 Stability Programmes, leaving the total (planned plus extra, where necessary) and cumulated consolidation effort in 2012 and 2013 at an impressive 6.6 percent of GDP in Spain[17], 6.1 percent in Cyprus, 4.7 percent in Slovenia, and at a more moderate 2.3 percent in France, 2 percent in Slovakia, and 1.9 percent in the Netherlands.

Exceptional circumstances

The size of the fiscal correction in 2012 and 2013 is considerable, especially for some countries, and raises concern about extreme austerity in the euro-area countries with excessive deficits. While the

17. This is now spread over three years instead of two.

18. See for example IMF (2010), which calculates that a fiscal consolidation equal to 1 percent of GDP typically reduces GDP by about 0.5 percent. A key point of the research on non-Keynesian effects builds on the role of expectations. The idea is that fiscal adjustment may generate economic growth if rational economic agents also expect their own government to be virtuous in the future (leaving fiscal pressure unchanged) and would in turn continue to consume and invest even under austerity. Yet, the possibility of continuing consumption and investment even at times of diminishing aggregate demand is a function of

POLICY IMPLICATIONS

Some of the apparent weaknesses in the EU's new fiscal governance framework underestimate the flexibility of the framework and do not relate to substance but concern the timing of the application of the new rules. Euro-area fiscal governance should address this timing issue, which arises because:

- The enforcement of final sanctions on excessive deficits precedes the exercise of surveillance of underlying fiscal positions, a problem related to transition times from the old to the new regime.
- Exceptional circumstances apply in the current low-growth environment, but it is important that the EU uses fully its provision on the general economic situation, and that the one-year extension in the correction of the deficit is decided in a timely manner.

Policy recommendations

The fiscal framework is not too stringent, and may be successwork. It should however be a non-political process. At present, the one-year extension is granted if the Council backs the Commission's recommendation by a qualified majority. But there is no reason for not also having RQMV at this stage, meaning the Council is not asked to confirm a Commission's proposal but can only block it. RQMV would more visibly leave the decision in the Commission's hands, strengthening the perception of markets that the procedural change has a technical and not a political motivation. The rules laid down in the TSCG may support this, as we explain below.

The role of the Fiscal Compact

There are two important aspects of the Fiscal Compact that make it desirable for economic policy coordination. First, while aligned with the surveillance mechanism envisaged in the six-pack, it emphasises the structural-balance rule, thus reinforcing the idea that underlying budgetary positions are more important than nominal deficits. Second, it advocates the application of RQMV at every stage of the EDP, possibly also where the six-pack does not provide for it. Its successful ratification will thus allow RQMV to be used in all cases in which an extension is allowed for deficit reduction, without a formal revision of the six-pack. There is however a drawback in the Treaty that relates to the obligation for each of the contracting parties to adopt a quasi-constitutional debt brake rule. The risk is that national fiscal policy becomes too restrictive, at least in some countries, undermining the flexibility that the fiscal framework enjoys at the EU level.

The new EU fiscal framework has been designed to strengthen surveillance and sanctioning in the case of severe deviations from the reference value, whether the deviation concerns nominal deficits, structural balances or debts. However, the timing of the new rules is unhelpful. First, sanctions do not apply for structural balances until excessive deficits are corrected. Second, the new rules enter into force in a recession when most euro-area countries are under EDP. The first problem can be dealt with by extending the new preventive arm to countries that are under EDP. The second problem can already be dealt with in the existing rules. A one-year extension to the deadline for deficit correction may be granted in case of negative growth in the EU, or in specific countries. For 2012, given the general economic situation, the one-year extension should be granted to all countries before they finalise their budgets for 2013. Thereafter, it is only important that the decision is taken earlier than normal, ideally at the beginning of April, and that it is mostly in the hands of the Commission, as are other steps in the EDP.

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