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Reform of EU-fiscal rules: Lindner's ideas have merit

Jürgen Matthes / Samina Sultan, 25.04.2023

The German government's proposal to introduce a fixed limit on government spending growth for highly indebted member states in the course of the reform of the Stability and Growth Pact makes sense. Given the macroeconomic environment, such a minimum requirement does not appear overambitious. This would ensure a steady reduction in the government deficit and debt level.

A reform concept for the European Stability and Growth Pact (SGP) should be available by the end of the year. In November 2022, the European Commission presented its plan (European Commission, 2022a). It is based on country-specific debt sustainability analyses and medium-term fiscal-structural plans, but gives the Commission considerable political leeway. The German government has now responded to this in a non-paper for the upcoming consultations in the Council (BMF, 2023).

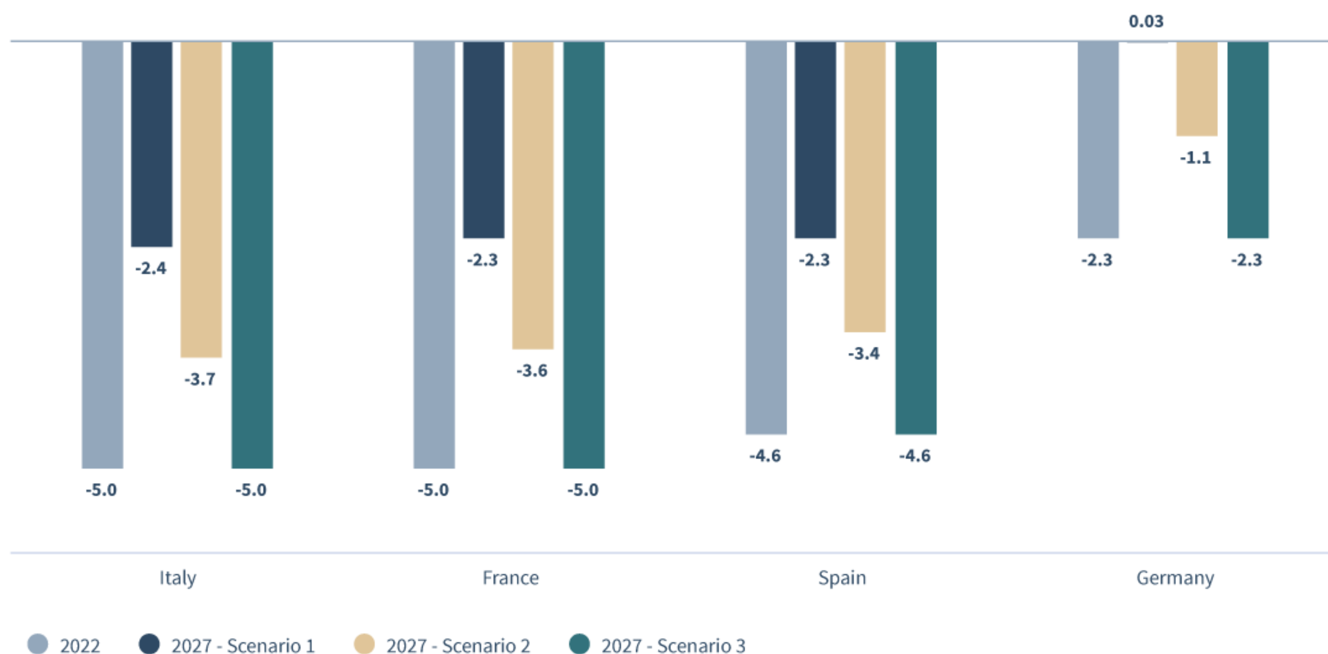
The German government's proposal aims to give the European Commission's reform plan a tighter framework through quantitative benchmarks in order to preserve the multilateral character of the SGP, to ensure the reduction of debt levels and deficits, and to limit the European Commission's discretion. Some of the demands were criticised as too harsh (Blanchard/Zettelmeyer, 2023; Greive et al., 2023). In the following, three major proposals of the German government will be analysed in more detail.

One noticeable deviation from the Commission's reform concept is a fixed **limit on expenditure growth**, which in the opinion of the German government is necessary for sufficient debt reduction. Therefore, the minimum consolidation requirement for countries with higher public debts is that net primary expenditure growth must be lower by a certain margin than the economy's potential growth. The German government proposes, for example, 1 percentage point as the difference between the two growth rates for highly indebted countries. This criterion would apply until the government budget can be considered sufficiently balanced.

In order to roughly illustrate the consequences of this requirement, a simplified calculation is made for selected euro countries. For each country, data for the budget deficit and the shares of government expenditure and government revenue in gross domestic product (GDP) in 2022 of the European Commission (2022b) are used. Potential growth is approximated by the average nominal GDP growth rate for the period 2022 to 2028 as forecast by the International Monetary Fund (IMF, 2023). On this basis, the further development of the budget deficit is extrapolated. It is assumed that the growth in government revenues is equivalent to potential growth. Three scenarios are modelled for expenditure growth:

Government budget balance: Current status and possible developments

Figures in per cent of GDP



Sources: European Commission, 2022b; IMF, 2023; Institut der deutschen Wirtschaft

- **Scenario 1**: Government spending growth is 1 percentage point below potential and revenue growth. This would correspond to the German government's exemplary proposal for highly indebted member states.
- **Scenario 2**: Expenditure growth is 0.5 percentage points below potential and revenue growth. This would imply a somewhat less ambitious consolidation.
- **Scenario 3**: Expenditure growth is equivalent to potential and revenue growth. Thus, the fiscal deficit remains constant at the level of the baseline year.

The figure shows the budget deficit in the baseline year 2022 and in 2027 according to the three scenarios for Italy, France, Spain and Germany. The first three countries are considered to be highly indebted with debt levels of over 100 per cent of GDP, while Germany has a moderate debt level of around 67 per cent.

In assessing the German government's proposal, the decisive factor is whether or not the minimum requirement of 1 percentage point leads to too much consolidation. The figure shows that the budget deficit decreases only moderately in the five years between 2022 and 2027 in scenario 1 – with an annual average reduction of around 0.5 percentage points. A comparison with the European Commission's current forecast (2022b) for the development of the budget deficit shows that Spain and Italy are already roughly on this reduction path. This means that the proposed rule for these highly indebted member states does not appear overambitious in the current situation. France, on the other hand, would be required to pursue a more ambitious fiscal policy. However, the French government has also recognised the need for this and is planning in this direction (Waschinski, 2023)

In the other two scenarios, the fiscal deficit in the highly indebted countries under consideration remains above 3 per cent of GDP even after five years. This pace of consolidation is too slow as long as macroeconomic conditions do not deteriorate.

In principle, the thrust of the German government's proposal seems sensible. A fixed numerical target, such as the minimum margin of 1 percentage point mentioned as an example, is theoretically sensible as a rule. However, it appears somewhat questionable whether it

can be implemented in the current political debate. An alternative would be a more vague rule that places somewhat higher demands on more heavily indebted countries than on less indebted ones. In addition, deviations from the minimum requirement must be permissible for recessionary phases.

Another core demand of the German government is that the **reduction in the public debt ratio** – from the first year of the introduction of the reformed SGP – should be 1 percentage point per year for highly indebted member states and 0.5 percentage point for moderately indebted member states. In contrast, the Commission's proposal is interpreted in such a way that a debt ratio reduction has to start only after four to seven years. This is an important difference and once again raises the question of whether the German government's proposal is overambitious.

Looking at the current IMF current forecast (2023) for the development of the government debt ratios of the selected countries for the years up to 2028, the requirement of at least a 1 per cent reduction in the debt ratio per year is partially met. For Italy, the IMF forecasts – after only –0.2 percentage points in 2024 – a debt ratio decline from 2025 to 2028 that even slightly exceeds the 1 percentage point mark. Spain also meets the target until 2024, partially in 2025 at –0.4 per cent, and no longer thereafter when the debt ratio is forecast to increase. France's debt level is already rising steadily from this year onwards according to the IMF forecast, which again points to a lack of consolidation.

In view of the current macroeconomic environment, with growth recovering in the next few years, average interest rates on government debts remaining low (albeit with a slight upward trend) and inflation remaining quite high, debt reduction should be possible without overly harsh fiscal austerity. Against this background, the four to seven years in which according to the Commission's proposal, no debt reduction is required would be wasted years.

Nevertheless, the German government's minimum debt reduction requirement does not seem indispensable. As the expenditure path is drawn up on the basis of a sound debt sustainability analysis under the current macroeconomic conditions and if the spending growth cap outlined above acts as a backstop, it is sufficiently likely that continuous debt reduction will already result. Thus, a further explicit regulation on this would be obsolete in this case. Therefore, the minimum condition regarding the expenditure path seems to be sufficient – especially since the debt ratio reduction requirement is politically quite controversial.

The third core demand of the German government is to **reform the existing investment clause** in the SGP (Council of the European Union, 2017) in order to enable future-oriented investments. Certain investment-related government expenditures receive special treatment will thus not be counted under the SGP. So far, the investment clause is very narrow, as it is only intended for EU co-financed projects in phases of economic downturn – and limited in time and amount.

The current non-paper of the German government remains relatively vague regarding this reform. However, in August 2022, the Federal Ministry of Finance (2022) had been more specific and favours a certain softening of the investment rule: The application should not be limited to recessions, it should allow for more leeway for public investment and additional EU-programmes should be able to be taken into account. Such an extended application of the investment clause is justified in view of the green and digital transformation. Another argument in favour of linking the investment clause to EU-programmes is that the funds are more likely to be used sensibly than in the case of purely national projects.