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Reforming Economic Governance in the Eurozone: Shifting Spending Instead of Expanding Debt Margins

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Key Messages

- In view of the very high public debt ratios and rising inflation, expanding debt leeway in the Eurozone is the wrong way.
- What is needed is a modified handling of the existing rules, not a change in the rules themselves.
- Fiscal policy coordination should focus more on expenditure reallocations and thus on improving the quality, not the quantity of public spending.

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Reforming Economic Governance in the Eurozone: Shifting Spending Instead of Expanding Debt Margins

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In February 2020, the European Commission announced that it would present a plan for reforming the economic governance of the Eurozone, including the rules for public debt. The project was postponed by the outbreak of the corona pandemic, but now the reform is to come. There is a widespread demand to expand debt leeway, for example for climate protection spending. In view of the already very high national debt and rising inflation, this is the wrong way to go. Fiscal policy coordination should focus more on expenditure reallocations and thus on improving the quality, not the quantity of public spending. What is needed is a modified handling of the existing rules, not a change in the rules themselves.

Rising inflation and public debt

The economic conditions for fiscal and economic policy in Europe have changed in recent years. Due to the corona pandemic, public debt has increased considerably - in Italy it is more than 150 percent of the gross domestic product, in Greece almost 200 percent (see Figure 1). If you add the debt of the Corona bailout fund Next Generation EU, the ratio rises to 155 percent for Italy and to more than 200 percent for Greece.

Rising energy prices and the outbreak of the Ukraine war further aggravate the situation of public finances. The economic recovery is delayed, and at the same time many countries are taking measures to help vulnerable parts of the population in the face of rising energy costs. In addition, defence spending is on the rise. Germany, for example, has just decided to spend an additional 100 billion euros on armaments, financed entirely by new public debt.

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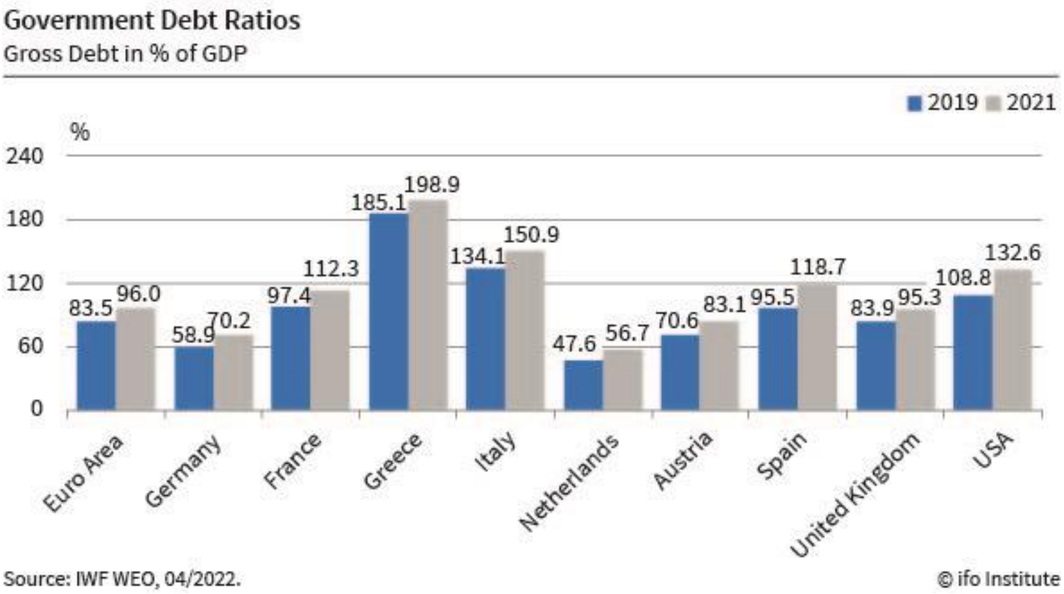
Figure 1: Public debt ratios, 2019 and 2021



Inflation and interest rates have also changed. Inflation has returned with force. In May 2022, it reached 8 per cent in the Eurozone. The most important drivers are the prices for energy and food. However, there are other factors, such as the disruption of value chains due to the pandemic-related lockdowns in China. Core inflation, which excludes energy and food prices, is now at 4 per cent. Against this background, the European Central Bank has decided to end its currently still extremely expansionary monetary policy in the summer and to raise interest rates. On the financial markets, interest rates have been rising since the beginning of the year.

Reforming Eurozone public debt rules?

How should the European debt rules be reformed against this background? Public perception focuses on the maximum limits for the current budget deficit of 3 percent and for the debt level of 60 percent. One popular idea is to raise the 60 per cent limit to 90 or 100 per cent because many countries in the Eurozone have no realistic chance of reducing their debt to 60 per cent in the foreseeable future. Other proposals want to exempt public investment or spending on climate protection from the 3 percent limit for the deficit. At a more general level, it is criticised that the rules would neither adequately take into account the individual situation of the individual member states nor the use of the debt taken on and would offer too little flexibility.

These demands overlook the fact that the ceilings of 60% for the debt level and 3% for the budget deficit have long had only symbolic significance for the practice of economic and fiscal policy monitoring and coordination. At the core of economic governance are the negotiations within the framework of the 'European Semester', in which the member states regularly report on how they want to shape their economic and fiscal policy. The European Commission then makes country-specific recommendations for fiscal policy and other economic policy reforms. Differences in the starting position of the individual member states are taken into account as well as the current economic situation. Country-specific medium-term targets for the current budget deficit and the development of government spending play a central role.

The weaknesses of the current rules are not that they are too rigid or do not take into account the individual economic situation of the member states. They lie in two other points. First, the process of fiscal surveillance based on these rules has become so complex that the general public no longer understands it and consequently there is little public pressure to comply with the rules. Secondly, national governments hardly comply with the recommendations. The European Commission reviews implementation at regular intervals. The most recent report is from the pre-crisis year 2019, and the results are sobering. Only a minority of countries comply with the requirements.

It therefore seems obvious to demand a simplification of the rules and better enforcement from a reform. However, the problem here is that simplicity also means taking less account of the current economic situation and the very different situations of the member states. Better enforcement of the recommendations is also difficult to achieve. Ultimately, the decision-making power on economic policy reforms and public debt lies with the national parliaments. That is where the democratic legitimacy lies. Experience shows that national governments and parliaments disregard European debt limits and economic policy recommendations in case of conflict.

In view of this situation, one could ask whether the European debt rules and the associated negotiation process should be abolished altogether. However, this would mean throwing out the baby with the bathwater. As a point of reference for the discussion and coordination of national fiscal and economic policies, the debt rules are useful, despite all their weaknesses. Abolishing the rules would be a signal to pay even less attention to sustainability and pan-European interests in fiscal policy than before. That would be counterproductive.

Need for a modified handling of existing rules

In the reform, member states should primarily try to form a consensus on the basic direction of fiscal policy in the coming years. The existing rules are flexible enough to then implement this consensus as far as possible. Finding this consensus will not be easy though. Various governments would like to further expand the scope for debt to deal with challenges such as climate protection, digitalisation and the Ukraine war. This overlooks a number of factors that argue against a further increase in government debt.

First, rising inflation shows that, unlike a few years ago, fiscal policy can no longer rely on rising government spending being serviced by abundant production capacity. Today, the economy is strongly affected by supply constraints. Higher private spending thus crowds out private spending to a greater extent. Accordingly, this spending contributes much less to economic growth.

Second, the era of loose monetary policy is over for now. At present, inflation is rising even more strongly than nominal interest rates, so real interest rates are falling. But if the central banks want to seriously fight inflation, they will have to raise real interest rates significantly. So government debt becomes more expensive. The focus on fighting inflation also means that the central banks have fewer opportunities to prop up highly indebted countries through government bond purchases. Therefore, it is becoming more important again to convince private investors that government debt will remain under control.

Thirdly, higher debt for 'green' investments would be more acceptable if these investments led to higher tax revenues in the future. In fact, this is only partly the case. To a considerable extent, it this investment is about replacing existing capital, not creating additional capital. Public buildings are getting new heating systems that run on electricity instead of oil. Vehicles with combustion engines are replaced by electric vehicles. Coal-fired power plants are replaced by wind turbines. These are important expenditures that serve climate protection, but additional economic growth and additional tax revenues are not created. Therefore, these expenditures cannot be permanently financed by debt. Instead, the central task of fiscal policy in the coming years is to restructure expenditure, i.e. to reduce or at least freeze government spending that may be useful but is not really a priority.

The structure and thus the quality of public finances is already a relevant criterion in the context of fiscal policy coordination. It should be weighted much more strongly in the future. The upcoming reform should therefore not aim to change the rules themselves, but their handling.