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Sustainable Fiscal Policy Calls for More Restrictive Debt Rules for Eurozone*

One of the key issues on the table in the Jamaica coalition negotiations is the next German federal government's position on reforming European Monetary Union. One of the highly controversial topics under discussion is the future of European debt rules. Critics claim that the current rules are too restrictive and will hamper public investment. In reality, a serious application of the existing concepts for ensuring sustainable fiscal policy would call for stricter, not softer debt rules.

What does sustainability mean in terms of public finance? There are two approaches to this idea: the first strategy consists of demanding that public debt should not rise faster than overall economic output, or in other words that the debt to GDP ratio should remain stable.

Secondly, the state can be viewed as a company preparing its balance sheet and it can be argued that there is nothing wrong with public debts if they are offset by public assets. By this logic fresh borrowing should be allowed, but only insofar as it is covered by *net investment*. Investment that replaces depreciated capital must be financed by ongoing tax revenues, otherwise the debts accumulated rise faster than state assets.

When the Eurozone was founded, its member states opted for the first approach outlined above. The public debt rate should not exceed 60 percent. Under normal economic conditions, the government budget should be balanced. Even in poor economic conditions, fresh borrowing should not exceed 3 percent of gross domestic product (GDP). From the outset the 3 percent was presented in the public debate as less of an upper limit in times of crisis, than as a guideline figure for the deficit under normal economic conditions. In economic terms this is completely justifiable. With a permanent budget deficit of 3 percent, it is possible to maintain the debt rate at 60 percent provided that nominal economic growth is at 5 percent (which could be broken down into real growth of 3 percent and inflation of 2 percent). In the 1990s nominal growth in the Eurozone was just over 5 percent.

In the meantime, however, conditions have changed. Firstly, the average debt rate of euro member states is no longer at 60 percent, but around 90 percent. Secondly, economic growth has slowed down. During the period from 2000 to 2010 nominal growth in the former 12 euro member states was no longer 5 percent, but a mere 3 percent; and between 2010 and 2018 it is expected to be just over 2 percent. This has two implications for debt rules: it highlights the need to clarify whether a debt rate of 60 percent should remain the target. The fact remains that countries who are members of a currency union and do not have their own independent monetary policy are more prone to crises of confidence than states with

their own central bank to turn to for additional borrowing. Secondly, it seems unrealistic that there will be any return to an average nominal growth rate of 5 percent in the foreseeable future. Assuming things go well, a rate of 3 percent is more likely. If a country is running a longstanding budget deficit of 3 percent, its debt rate will rise to 100 percent of GDP. To hit the 60 percent target, its deficit can amount to no more than 1.8 percent. So if EU states wish to hold onto 60 percent limit, they will have to abandon the notion that a 3 percent budget deficit is acceptable; and that may not go down very well.

During the latest reforms of the Stability and Growth Pact it was agreed that heavily indebted countries like Italy should do more to reduce their debts by lowering all debt in excess of 60 percent by 5 percent on an annual basis. According to this rule, Italy should currently be balancing its budget. The deficit could gradually be increased to 1 percent of GDP by 2030. If Italy were to abide by this rule and achieve nominal growth of 3 percent – its growth rate has been below 1 percent since 2010 – its debt rate would be just under 100 percent of GDP by 2030. It would take decades for Italy to reach the goal of 60 percent, but at least it would be headed in the right direction.

Critics repeatedly point out that the existing debt rules do not take into account whether the money borrowed is used for investments or consumption. The rules supposedly crowd out public investments and constrain growth. They therefore demand that Europe should switch to the second concept of sustainable fiscal policy, namely the investment-based debt rule that is also described as the "golden rule." The state's assets change every year by total investments minus amortisations. According to this concept, fresh borrowing is permissible, as long as it does not exceed net investments. What would a switch to this so-called "golden rule" mean? In 2016 Italy posted a budget deficit of 2.5 percent, while public net investments were negative at 0.5 percent. An investment-based debt rule would mean that Italy would have to make draconian cutbacks to government spending or increase taxes by a total of 3 percent of GDP. By contrast, governments could borrow to make more public investments. This has limited potential though. Public gross investments totaled just 2.1 percent of GDP in 2016. The situation in Portugal is particularly serious: net investments in 2016 were at -1.4 percent with a deficit of 2 percent of GDP. To abide by investment-based debt rules, Portugal would have to reduce its public spending on consumption by 3.4 percent of GDP, or raise its taxes accordingly. Many critics of the existing debt rules hope that the switch to an investment-based system would finally create greater scope for an expansive fiscal policy. In fact, the opposite would occur and there would initially be massive austerity programmes to deal with.

In view of loud complaints over alleged austerity policy in Europe, the call for tougher debt ceilings seems untimely. It is often argued that we only need to give ourselves a few years to spread out public debt, and growth would then rise and debts would finance themselves. Japan has repeatedly tried this approach in recent years, but the outcome has unfortunately been a dangerous combination of persistently weak growth and rising debts. Today Japan's government debt ratio has reached 240 percent. Its budget deficit totaled over 4 percent of GDP in 2016, while growth rates were at 1 percent. Europe should not follow in Japan's footsteps.

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