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How EU Fiscal Norms Will Become a Safety Net for the Failure of National Golden Rules

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If introduced successfully, national Golden Rules will completely overturn fiscal governance in the eurozone. Golden Rules would almost always be more stringent than EU-level fiscal norms. EU fiscal norms will hence evolve into a safety net in case a Golden Rule fails. The possibility of such a failure is, indeed, not to be dismissed. Because of the severity of the Golden Rules, eurozone leaders should reflect on their design. There is a real risk that they will undercut public investment, which would be at the cost of the EU's other long-term challenges.

Introduction

Achieving more fiscal discipline has been at the top of the political agenda ever since financial markets started to question the sustainability of public finances in the eurozone. In an attempt to show the eurozone's resolve, EU leaders have agreed to adopt an Intergovernmental Treaty. This Treaty is likely to lead to major changes in the eurozone's fiscal rules.

Prior to the sovereign debt crisis, the EU did not wish to intervene too much in Member States' national fiscal legislation, as this was seen as contrary to the subsidiarity principle. The eurozone sovereign debt crisis has overturned this reasoning and has led to calls for more national ownership. The Intergovernmental Treaty will indeed result in an important step-up in the EU's interference in national fiscal rules. It will most notably require participating eurozone countries to adopt a so-called Golden Rule.

This paper provides a comparison between the Golden Rule and existing EU fiscal norms (i.e. the 3% deficit ceiling, the Medium-Term Objective and the Debt-reduction Rule). The paper first zooms in on the future national Golden Rule. Then, the Golden Rule is compared to the three European level fiscal norms. Based on this

comparison, we describe how EU fiscal norms' role will evolve from a normative role in into that of a safety net for the national Golden Rules. Before drawing a conclusion, the paper considers the stringency of the Golden Rule, which could prove problematic in the future.

1. The Golden Rule

At the European Summit of December 2011, eurozone leaders agreed to sign the new Intergovernmental Treaty by March of the following year. One of the few major innovations of the Treaty is that it will require participating eurozone countries to introduce a so-called Golden Rule at the national level[1]. Other participating Member States can adopt such a rule on a voluntary basis. Non-eurozone countries are hence only subject to EU norms, unless they themselves decide otherwise.

Putting in place Golden Rules is mainly meant as a short-term signal to financial markets. The Golden Rules are to underline the eurozone leaders' resolve to pursue prudent future fiscal policies, which was often not the case before. At their December meeting, the eurozone leaders already laid down the Golden Rule's basic framework.

On the one hand, they agreed on the main content of the rule. The Golden Rule is defined as a structural deficit of 0.5% of GDP or less. It is important to indicate that this does not correspond with the traditional meaning of a fiscal Golden Rule, i.e. deficits can only be used to finance investments that are to the benefit of future generations[2].

While the structural deficit concept is not without difficulties, it refers to over-the-cycle deficits. The structural deficit concept tries to filter out temporary fiscal measures, as well as fiscal evolutions that are purely due to cyclical changes in the economy. This implies that the structural fiscal position of a Member State will typically be better than the actual fiscal position in case of economic downturns, and worse in case of economic upturns.

More precise requirements and exceptions to the Golden Rule will be included in the Intergovernmental Treaty. A draft version of the Treaty states that the normal Golden Rule does not apply to countries with a debt level "*significantly below*" 60% of GDP, although this threshold is not defined more precisely. Instead, eurozone countries with debt significantly below 60% of GDP would be allowed to have a maximum structural deficit of 1%.

As most eurozone countries currently have deficits levels well above the Golden Rule, the draft Treaty allows for a transition period. During this period, countries are allowed to converge gradually, but rapidly, towards the deficit target.

Another important nuance to the Golden Rule is that it may temporarily be disregarded in case of economic downturns that go beyond normal cyclical evolutions, or in case of other major unforeseen events. Such exceptions could allow Member States to dilute the Golden Rule (see infra).

Besides the content of the Rule, eurozone leaders agreed on the Golden Rule's legal

[1] European Council, Statement by the Euro Area Heads of State or Government, 9 December 2011.

[2] ARTIS, M., 2002, "The Stability and Growth Pact: Fiscal Policy in the EMU". In BREUSS, F., FINK, G. and GRILLER, S. (eds.), Institutional, Legal and Economic Aspects of the EMU. Wien: Springer, 101-116.

form. Preferably, the Golden Rule is to be introduced in Member States' constitutions[3]. This binding and even constitutional nature of the Golden Rule is to ensure that it is effectively applied by the Member States. As former Belgian Prime Minister Leo Tindemans famously stated: "*The constitution is not some scrap of paper*[4]".

2. EU fiscal norms will be overshadowed by the Golden Rule

The Golden Rule comes in addition to the existing EU fiscal rules. These EU-level rules essentially comprise three norms: the 3% deficit-to-GDP ceiling, the Medium-term Budgetary Objective (MTO) and the Debt-reduction Rule. In comparing these norms with the Golden Rule, it becomes clear that the latter will impose significantly stricter fiscal rigour than is required by EU-level norms.

2.1. The 3% deficit ceiling

The 3% deficit ceiling was introduced by the Maastricht Treaty. The norm indicates that, in principle, Member States cannot have an annual public deficit-to-GDP ratio of more than 3%. Because it was the clearest and most explicit, the 3% deficit ceiling has been the prime fiscal norm prior to the sovereign debt crisis.

To a large extent, this focus on the 3% deficit limit was detrimental to other fiscal rules. Indeed, the 60% debt-to-GDP limit and the Medium-Term Budgetary Objective (see infra) would, in many cases, have required much more prudent fiscal policies by the Member States. However, both of these fiscal norms were left largely unapplied.

If the Golden Rule is effectively put into practice, the 3% ceiling will play a very different role. Instead of avoiding deficits surpassing 3% of GDP in difficult times, Member States would be forced to have quasi-balanced budgets in normal times. Such smaller deficits would render it much less likely that a deficit of more than 3% is reached during economic downturns[5]. If the 3% ceiling would nonetheless be reached due to a recession, EU legislation permits the deficit ceiling to be exceeded temporarily. So the 3% ceiling will only apply in case of a considerable economic downturn that is not a recession. In any case, due to the Golden Rule, the relevance of the 3% ceiling will decrease considerably.

2.2. The Medium-term Budgetary Objective

The Golden Rule is in fact very similar to the existing Medium-term Budgetary Objective. This EU norm also requires over-the-cycle budgets to be close to balance or in surplus[6]. The 2005 revision of the Stability Pact allowed for differentiated medium-term objectives, which can range from a budget deficit of 1% of GDP to a budget in surplus. Similar to the Golden Rule, exceptional circumstances can allow for a temporary deviation from the MTO.

For countries with debt significantly below 60% of GDP, the Golden Rule would be as

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[3] The draft versions of the Treaty are less demanding than the December Declaration by eurozone leaders. The latter required the Golden Rules to be at the constitutional or equivalent level.

[4] Remarks by Leo Tindemans in the Belgian Parliament, 11 October 1978.

[5] BUTI, M., SAPIR, A. (eds.), 1998, Economic Policy in EMU: A Study by the European Commission Services. Oxford: Oxford University Press.

[6] Article 2a of Regulation 1466/97 (consolidated version).

restrictive as the MTO. For the other eurozone countries, it is clear that the Golden Rule is stricter than the MTO. It imposes a maximum structural deficit of 0.5% of GDP, instead of 1% provided for in the EU norm. In practice, future MTOs will have to be in line with the 0.5% limit imposed by the Golden Rule. Eurozone countries could still decide to commit to an even stricter over-the-cycle budget deficit. However, this is not likely to happen often, as 0.5% is already a remarkably far-reaching commitment.

2.3. The Debt-reduction Rule

The Maastricht Treaty stipulated that countries with debt above 60% of GDP should reduce their debt level at a sufficient pace. However, as this requirement has never been defined more precisely, it has been of little relevance. Hence, the Debt-reduction Rule that was incorporated in the November 2011 six-pack on economic governance was seen as an important achievement that made the Treaty's debt requirement operational after all[7].

The Rule's content

The Debt-reduction Rule is a numerical rule that determines the required pace of debt-to-GDP reduction for countries whose debt exceeds 60% of GDP. The rule stipulates that these Member States have to reduce the difference between their debt level and the 60% debt target by 1/20th per year on average.

In practice, a country with a debt-to-GDP level of 70% will thus have to reduce its debt to 69.5% of GDP by the next year; a country with a 100% debt-to-GDP would have to cut its debt to 98% of GDP[8]. To take into account yearly fluctuations, debt reduction is measured on a three-year basis. The Debt-reduction Rule hence constitutes a medium-term norm, like the MTO and the Golden Rule.

This numerical rule is not an automatic one, as certain exceptions can be invoked to allow a less strict application. These exceptions notably include a cyclical slowdown of economic activity. Other reasons for deviating from the rule concern the medium-term economic position (e.g. potential growth) and budgetary indicators (such as the primary balance and adjustment to the MTO)[9].

Comparison with the Golden Rule

When the original Stability and Growth Pact was designed, introducing an operational debt-reduction requirement was already considered. However, such a rule was not adopted. Partly, this was due to political difficulties, but the introduction of the MTO (see supra) also played a role. Applying a medium-term objective was expected to make a debt-reduction rule redundant[10]. Indeed, there is an overlap in reducing the debt-to-GDP level and restraining fiscal deficits. As a consequence, there is also a close relation between the Debt-reduction Rule and the Golden Rule.

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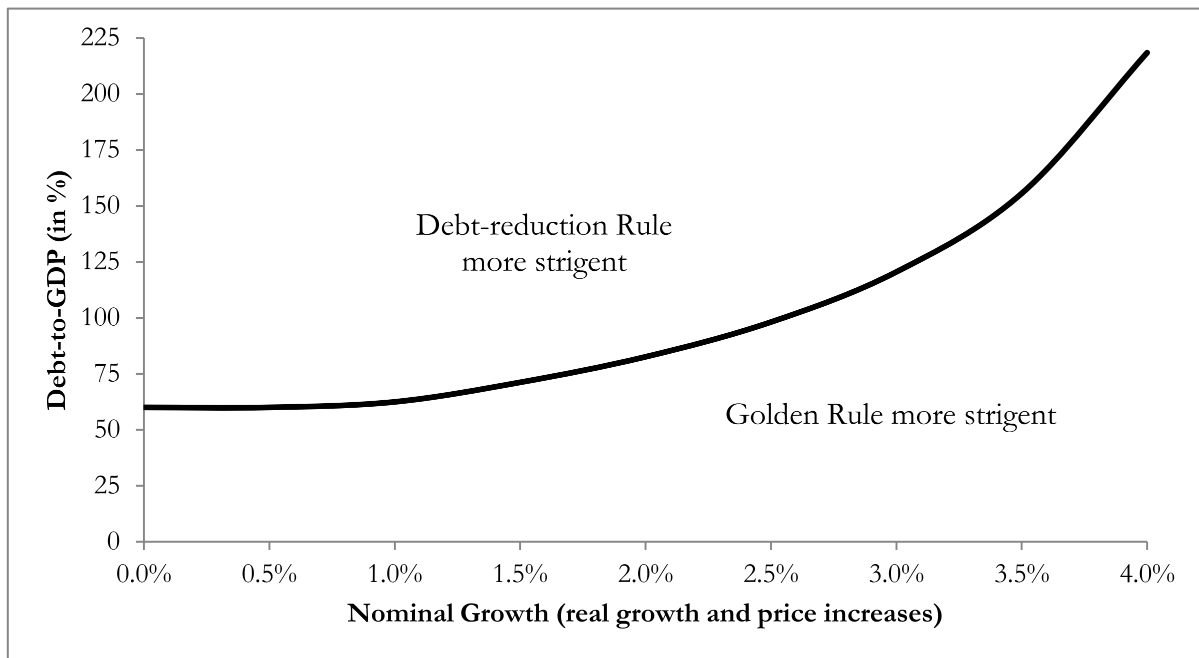
7 See: Article 2(1a) of Council Regulation No 1467/97 (consolidated version).

8 For 70% debt-to-GDP: (70-60)/20=0.5.; for 100% debt-to-GDP: (100-60)20=2.

9 See Recital 13 and 14 and Article 1(2)(b) last paragraph of Council Regulation No 1177/2011.

10 COSTELLO, D., 2001, "The SGP: How Did We Get There?". In BRUNILA, A., BUTI, M. and FRANCO, D. (ed.), The Stability and Growth Pact - The Architecture of Fiscal Policy in EMU. New York: Palgrave Macmillan.

Figure 1: Comparison between the Golden Rule and the Debt-reduction Rule



Source: own calculations

Before comparing the two rules in detail, it is useful to note that eurozone countries with debt-to-GDP levels below 60% constitute a particular case. The Debt-reduction Rule does not apply to these countries. This is different for the Golden Rule, as it will apply to all countries whose debt is not *significantly* below the 60% GDP threshold. For such countries, the Golden Rule would therefore be more relevant than the Debt-reduction Rule in any case.

For countries with debt above 60% of GDP, a comparison is less straightforward. The essential difference between the Debt-reduction Rule and the Golden Rule is that the former is based on the debt-to-GDP level, while the latter concerns the deficit-to-GDP. Yet, both are influenced by a country's GDP and thus its GDP growth. In fact, given a specific debt-to-GDP level, the economic growth of a country will determine whether it is subject to either the Debt-reduction Rule or the Golden Rule. On the basis of this finding, we can calculate which of the two rules is more stringent in specific circumstances[11]. The results are shown in Figure 1.

It is important to bear in mind that growth in Figure 1 concerns nominal growth. Nominal growth includes both real growth and price evolutions[12]. It is thus typically higher than real economic growth. During the period 2000-2010, the average yearly price increase was 1.8%[13]. Given that level of price increase, 2% real economic growth equals a nominal growth of 3.9%[14].

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[11] See the technical annex available on our website.

[12] Price evolutions in GDP are measured using the GDP deflator, which measures price evolutions of products and services produced in a country. It is closely linked to the concept of inflation, although the latter measures price evolutions of products and services that are consumed (not necessarily produced) in a given country.

[13] Measured by GDP deflator. Source: Ameco database and own calculations.

[14] Low nominal growth would normally be due to low real economic growth, as the ECB will intervene to keep inflation below, but close to, 2%.

For a given nominal growth rate, the curve in Figure 1 indicates at what level of debt-to-GDP the Golden Rule and the Debt-reduction Rule are equally restrictive (that is, when both require a deficit of maximum 0.5% of GDP). Any point above the curve signals a situation in which the Debt-reduction Rule is more stringent than the Golden Rule. For countries that are situated below the curve, the Golden Rule will be more restrictive. In theory, the Debt-reduction Rule can thus apply if a country suffers from high debt and/or low growth. In practice, this is very unlikely.

The Golden Rule is more stringent in almost all economic circumstances. Even for countries with debt-to-GDP of 100%, nominal economic growth needs to fall below 2.6% in order for the Debt-reduction Rule to be more stringent than the Golden Rule. Given an average price increase of 1.8%, a nominal growth of 2.6% implies only 0.7% of real economic growth[15].

The past shows that nominal growth only falls below 2.6 per cent in extraordinary circumstances. In the period 1992-2008, average yearly nominal GDP growth has been 3.9% in the eurozone[16]. Nominal growth has only fallen below 2.6% of GDP in some eurozone countries at the peak of economic slowdowns. Such peaks, furthermore, are brief. As the Golden Rule and the Debt-reduction Rule apply to the medium-term, such temporary peaks are not taken into account. For both rules, low growth only becomes relevant over a period of more than three years[17].

In the period 1992-2008, only two eurozone countries experienced a prolonged period during which average nominal growth stayed below 2.6%. Firstly, Finland underwent a harsh recession in the early 1990s[18]. However, because such a period can qualify as a (severe) cyclical downturn, the Debt-reduction Rule would not have applied. Hence, the rule would not have been more stringent than the Golden Rule. The same would have been true for the deficits that occurred after the economic crisis of 2009.

Germany is the second country that suffered from sustained low growth in the period 1992-2008. The country suffered from almost a decade of low growth: between 1996 and 2005, average nominal growth was only 1.9 per cent. Germany's unification definitely played a significant role, which makes this country a particular case. Even so, in line with the Stability and Growth Pact, the Debt-reduction Rule would most likely not have been enforced in a strict sense during such a protracted period of remarkably sluggish economic growth[19] . It would thus not have been stricter than the Golden Rule.

In sum, it is highly unlikely that the Debt-reduction Rule would be relevant for a eurozone country with a debt level of less

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[15] With higher price increases, or lower debt (most often the case), the tipping point is even lower. It would then become even more unlikely that the Debt-reduction rule would be more stringent than the Golden Rule.

[16] Figures are for the initial twelve eurozone countries.

[17] The Debt-reduction Rule is based on average evolutions during three years. However, the numerical rule can be disregarded in case of a cyclical economic slowdown. In practice, growth would thus have to be below 2.6% for at least four years.

[18] From 1992 to 1994, Finland's nominal GDP decreased by 2% per year on average. Recessions would also imply that other fiscal norms, including the Golden Rule, are not applied in a strict sense.

[19] Article 2(2) of Regulation 1467/1997 (consolidated version).

than 100% of GDP. This is the case even for countries with prolonged periods of low growth.

Besides low growth, high public debt could potentially result in the Debt-reduction Rule being more restrictive than the Golden Rule. Due to the financial and economic crisis, elevated public debt has become more common in the EU. Six eurozone countries are even set to have debt levels of more than 100% of GDP in 2013 (see Table 1).

Table 1: Gross Public Debt-to-GDP in 2013

Country	Debt-to-GDP
Belgium	101%
France	104%
Greece	184%
Ireland	122%
Italy	127%
Portugal	124%

Source: OECD Economic Outlook December 2011

Even for countries with debt-to-GDP around 120%, it would only require a three per cent nominal growth in order for the Golden Rule to be more stringent than the Debt-reduction Rule. If we take into account an average price increase of 1.8%, this implies 1.1% real economic growth. Such nominal growth is still remarkably low.

Besides the specific cases of Finland and Germany discussed above, only two other eurozone countries had exactly one drawn-out episode of average nominal growth falling below 3% of GDP during the period 1992-2008[20]. In all other eurozone countries, average nominal growth did not fall below 3% for more than two consecutive years[21]. Therefore, it seems highly improbable that the Debt-reduction Rule would be relevant for countries with a debt level as high as 120% of GDP.

Even if a country's debt is 150% of GDP, the Debt-reduction Rule would only be relevant if average nominal growth fell below 3.4%. Given an average price increase of 1.8%, real growth would then have to fall below 1.6%. This is still rather slow economic growth, but somewhat less improbable. However, Greece is currently the only country in the EU with a debt-to-GDP level of more than 150% of GDP. Furthermore, Greece's debt burden is likely to diminish due to a restructuring of its debt[22].

In the very rare case that a country would have both high debt and sustained lacklustre growth, it is still not sure whether the Debt-reduction Rule will be more stringent than the Golden Rule. EU legislation allows for a more flexible interpretation of the Debt-reduction Rule when the primary balance (which excludes interest expenditure) suggests so. Highly indebted countries typically have significant interest payments. Their primary balance will thus be in a major surplus if the actual deficit would be only 0.5% of GDP. In practice, this means that the Debt-reduction Rule is likely to be

[20] Austria's nominal was 2.6% on average in the period 2002-2004, while France's economy grew only 2.7 per cent in nominal terms in the period 1993-1997.

[21] Ameco database and own calculations.

[22] The fact that the Debt-reduction Rule can apply for countries with very high debt in fact signals the inappropriateness of the rule for such countries. The Golden Rule is already very demanding, so we can wonder whether stricter requirements are a wise thing to impose. See: MAYSTADT, P., keynote speech at EGMONT-CCECRB expert seminar "The Financial and Economic Crisis: Overcoming the Shortcomings of the European Framework", 6 December 2010.

disregarded if highly indebted low-growth countries meet the Golden Rule.

3. EU fiscal norms as safety net for the Golden Rule

As has been argued above, EU fiscal norms will be less strict than the national Golden Rule in the vast majority of situations. The importance of EU fiscal norms will, as a consequence, diminish considerably. However, this does not render them completely irrelevant.

The function of EU fiscal norms will change. In future, these fiscal norms are likely to serve as a safety net in case a national Golden Rule proves ineffective. Indeed, for several reasons, the latter cannot be excluded.

Ineffectiveness could be due to difficulties in putting the Golden Rule into practice. An evaluation of whether a Member State meets the Golden Rule is based on presumed future growth. The fact that this is uncertain could render the Golden Rule rather difficult to apply. It can furthermore be challenging to make abstraction of temporary fiscal measures.

It would be more damaging if the Golden Rule were deliberately diluted by a Member State – as occurred with the Stability and Growth Pact. Given the fact that eurozone countries preferably are to enshrine the Golden rule in their constitutions, manifest disrespect seems less likely than was the case for the Stability and Growth Pact. Yet, more subtle ways of circumventing the Golden Rule are conceivable.

Eurozone countries could, for instance, overestimate future growth or apply the exceptions to the Golden Rule in an excessively flexible manner. Here, the Commission and eurozone peers are to play a crucial role in correcting overly rosy growth forecasts and ensuring the correct application of the Golden Rule. Nonetheless, whether this will be successful remains to be seen.

In case the Golden Rule is not effective, be it due to practical difficulties or manifest disrespect, EU-level fiscal norms would step in. They would then offer ways to require budgetary actions by the country. EU norms are hence to become a safeguard to national Golden Rules. If, on the other hand, the Golden Rules prove successful, EU fiscal norms would become very much a side issue.

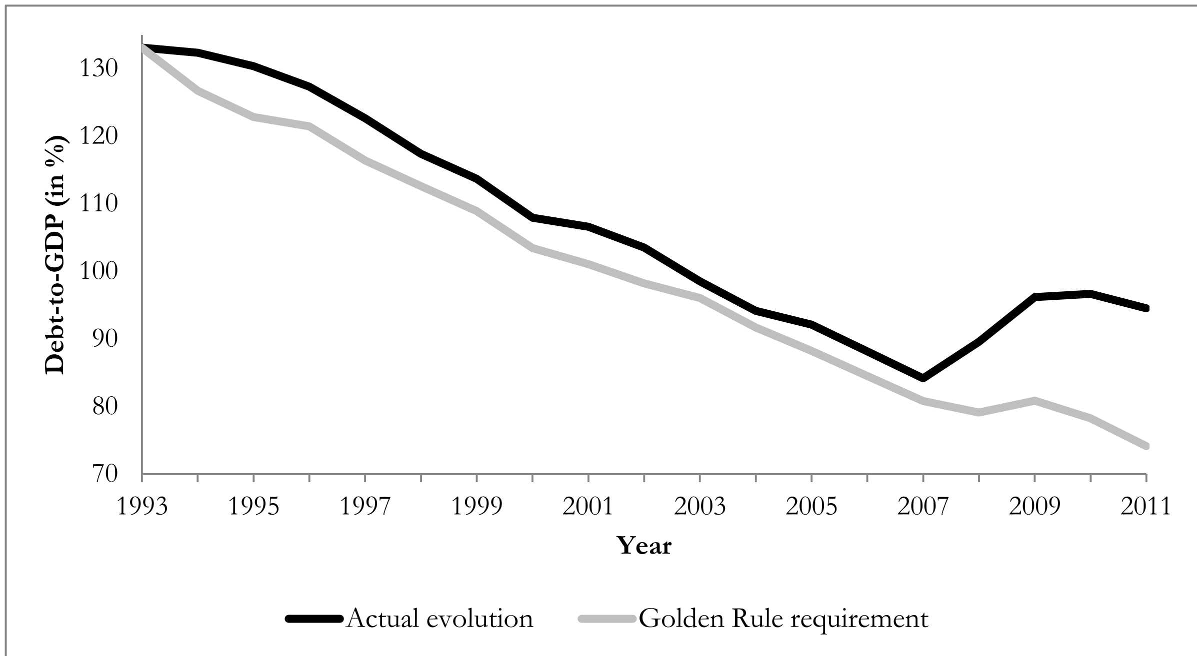
4. Too strict a Golden Rule?

As the successful introduction of the Golden Rule would overturn current fiscal rules in the eurozone, it is important to consider its consequences. However, a debate to this effect among eurozone leaders largely seems to be missing.

The fact that Golden Rules would overshadow the current fiscal norms is already a clear indication of the Rule's stringency. The Golden Rule implies that all eurozone countries whose debt is not significantly below 60% have to reduce their debt-to-GDP permanently and swiftly. Efforts would even have to be more far-reaching than the fiscal consolidation that Belgium undertook after 1993 (see Figure 2). Of course, as the Golden Rule allows for a gradual move towards the 0.5% target, the Belgian fiscal consolidation would probably not have been sanctioned.

Yet, achieving such a performance under current circumstances seems even more difficult than was the case then, as Belgium achieved its fiscal consolidation thanks to international economic growth and

Figure 2: Belgian fiscal consolidation from 1993 onwards



Source: Ameco Database and own calculations

decreasing interest rates. Both of these beneficial factors are likely to be much less pronounced in future recovery. For this reason, it is probable that such fiscal consolidation will not be feasible in some countries. This makes it highly controversial to legally require fiscal consolidation to an extent that outclasses Belgium's applauded performance.

Even for countries that can abide by the Golden Rule, it is doubtful whether the Rule is desirable from an economic point of view. Again referring to Belgium, it is clear that the demanded level of fiscal rigour risks undercutting public investments[23]. In the period 1992-2008, public investment in Belgium has been markedly below the eurozone average (1.7% of GDP versus 2.6% in the eurozone).

The Golden Rule's emphasis on fiscal rigour can lead to a neglect of Europe's other long-term challenges. Aging, infrastructure and the shift towards a green economy (R&D, smart power grids, renewable energy, etc.) are all likely to require huge public investments in the coming years. The strong and continued rigour imposed by the Golden Rule is likely to crowd out much-needed investments. A Golden Rule that takes public investments and a country's debt-to-GDP level into account seems more appropriate[24].

In spite of these doubts, the Golden Rule is to be enshrined in national law, as well as in an international treaty. This makes it most difficult to change the Golden Rule in future. If the Golden Rule turns out to be a suboptimal rule, eurozone leaders could end up with few options. They can adhere to the Golden Rule and would hence be forced into counterproductive policies. Alternatively, they could choose not to abide by their

[23] See also: IMF, 2004, Public Investment and Fiscal Policy.

[24] This was already recognised by the Commission in 1990. See: Commission of the European Communities, 1990, Economic and Monetary Union. SEC (90) 1659.

Golden Rule, and thus turn both their national law and the Intergovernmental Treaty into a mere *scrap of paper*.

Conclusion

A successful introduction of Golden Rules in eurozone countries' national legislation will overturn the EU's fiscal setting. The Golden Rules will effectively determine the future fiscal discipline to which eurozone countries have to adhere. The role of EU-level fiscal norms will then decrease considerably.

As was demonstrated in this paper, EU norms will only rarely require more fiscal discipline than the national Golden Rules. This would concern specific cases, such as a significant fiscal expansion during a pronounced economic downturn (while not a recession), or periods when a country itself commits to lower budget deficits. For countries with both genuinely high debt and lacklustre growth, EU norms could, in rare situations, also be more stringent. In all other situations, i.e. the vast majority, the Golden Rule will easily surpass EU-level norms.

EU fiscal norms will therefore have a different function than before. They will serve to counter the inadequacy of a specific Golden Rule. If a Golden Rule proves impracticable or is diluted by a eurozone country, EU fiscal norms can step in to restrict the country's deficits. In the eurozone, EU fiscal norms will therefore evolve from their current normative function into a safety net – only to apply when a Golden Rule proves defective.

The stringency of the Golden Rule compared to EU fiscal norms raises questions about the soundness of its design. These questions are especially pressing as the Golden Rule is to be anchored firmly in national and international law. Eurozone leaders should therefore carefully consider whether the short-term signal they are seeking to give the financial markets will not result in more long-term harm. Redefining the Golden Rule, so that it takes into account public investments and debt-to-GDP levels is still possible. But time for such changes is running out.

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