Why 3 and 60 per cent? The rationale of the deficit and debt criteria in the Euro area – and fiscal policy alternatives

Jan Priewe

HTW Berlin – University of Applied Sciences and Senior Research Fellow at Macroeconomic Policy Institute (IMK), Düsseldorf

AISSEC Conference on *Economic Development and Inequalities*

Urbino, 8 October 2020

Agenda

- Origins of the 3 and 60 percent caps
- Rationale
- Present EU fiscal rules
- Criticisms
- Alternative

Origins of the 3 and 60 percent caps

- 3% Maastricht Treaty 1991: measure against too high inflation
- Germans: normal deficit zero, cyclical space 3%; compromise with France; unclear whether cap or average (e.g. „golden rule“ for public investment)
- SGP 1998: 3% cap, structural balance close to zero (balanced budget)
- 60% debt cap: average of EU12 1990, consensus no further increase
- Germans: 3 and 60 must be included in Treaty → German veto
- long-term balanced budget → debt/GDP zero (James Buchanan)
- hence: 3 and 60 are not a consistent pair
- why 60% as an eternal cap, cast in stone?
- Rules are simply arbitrary! Poor economics.

Present Euro area fiscal rules

- Changes of Stability and Growth Pact (SGP) 2005 and 2012, Fiscal Compact 2013, more then 10 rules, key rules:
  1. 3 and 60% in Protocol 12 of Lisbon Treaty
  2. Medium term budgetary objective (MTO) is **structural** balance target since 2005, 3% is **headline** cap
  3. MTO -0.5% for MS with debt ≤ 60%
  4. MTO -1.0% for MS with debt << 60%
  5. debt cap 60%, 1/20 rule for MS with debt >60% → austerity, long-term primary surplus
  6. escape clauses for severe crises, disasters
  7. several flexibility options
- 60% is justified by need for „fiscal sustainability“ = preventing „insolvency“

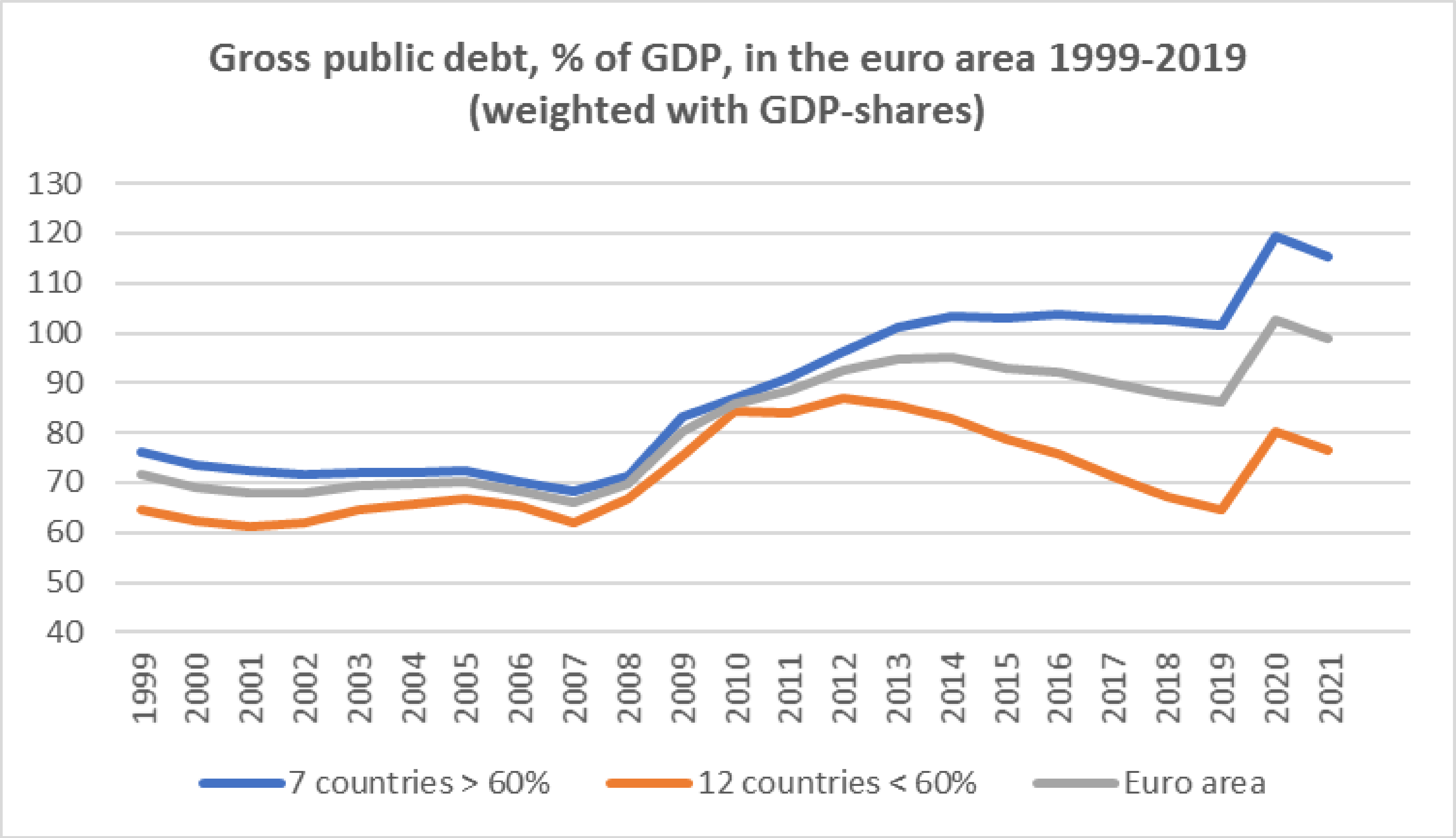
10 criticisms

1. too complex, arbitrary, strong impact of 60% debt cap
2. 60% has nothing to do with solvency, there is no debt threshold
3. distinction of cyclical and structural balances impossible
4. rules hamper public investment or require higher taxation
5. rules dampen growth & employment
6. rules impair disparity of low-debt countries and high debt countries (graph 1)
7. deficit rules assume implicitly $r > g$; but: if $g > r$ permanent primary deficits sustainable

   Hence: rules inappropriate for environment of low interest rates (graph 2 and 3)

   Hence: rules inappropriate if monetary policy is at zero lower bound
8. Rules inappropriate under deflation risks
9. Debt target inappprpriate for monetary union with heterogenous debt levels (legacy debt)
10. Rules lead to inappropriate fiscal stance on the **EMU level** (procyclical policy)

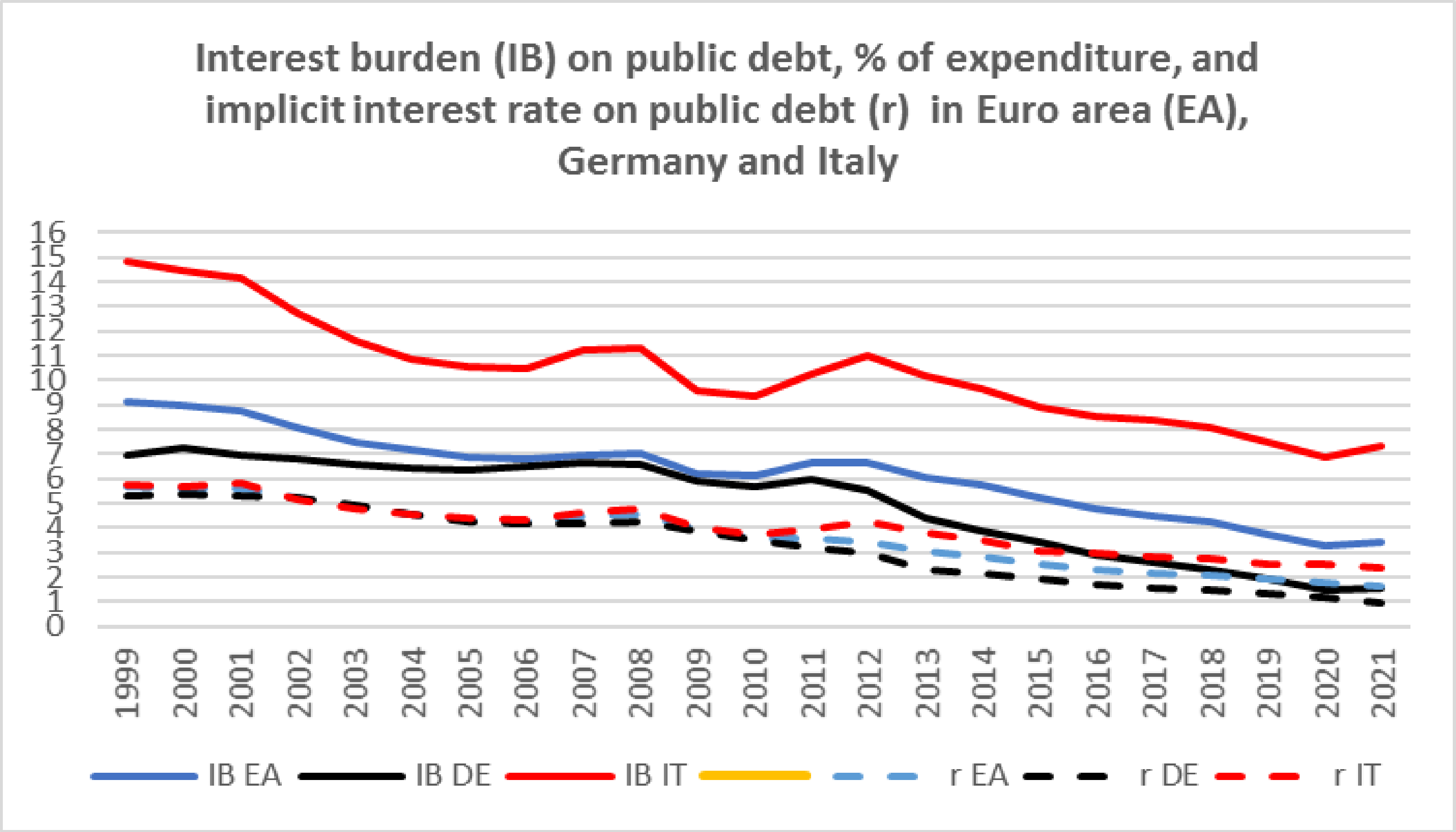
Graph 1: Divergence of debt levels in EMU since 2010



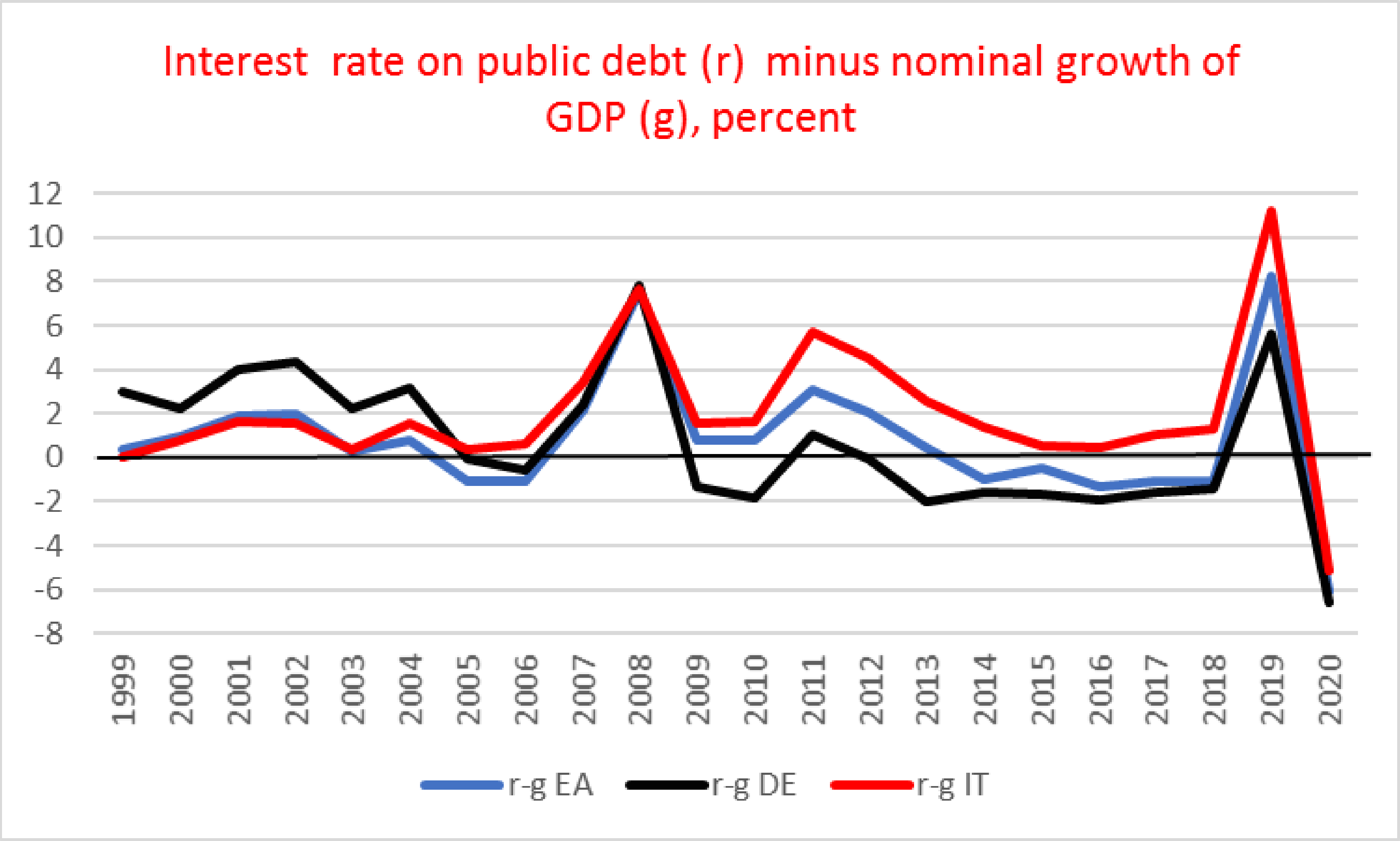
Source: AMECO, October 2020, own calculations.

Note: estimations for 2020 and 2021 by EU-Commission

Graph 2: Falling interest rates on public debt (r), reduced burden of interest payments in public expenditure



Graph 3: r-g has turned negative in most EMU countries - except in Italy



SMECO October 2020, estimations by EU-Commission for 2020 and 2021

Alternative

- only rule that is appropriate under conditions g > r, assuming that r remains low or for an extended period and g is around 3% p.a.

  → **excape clause**

- → extension of escape clause since Covid19 for 2021 and 2022
- → replace old rules by new temporary, coordinated, simple rules outside primary EU law, country-specific with focus on economic recovery and transition, employment and target inflation of ECB
- empower ECB to continue using PEPP, including controlling sovereign bond spreads of high-debt countries
- establish a larger EU-budget entitled to issue EU-bonds and raise taxes
- prepare new fiscal rules for MS after 2022

Literature

Jan Priewe, Why 3 and 60 per cent? The rationale of the reference values for fiscal deficits and debt in the European Economic and Monetary Union. European Journal of Economics and Economic Policies: Intervention. (EJEEP), Vol. 17(2), 2020, pp. 111-126.

Jan Priewe, Why 60 and 3 percent? European Debt and Deficit Rules – Critique and Alternatives. IMK Study 66, Hans-Böckler-Foundation. Düsseldorf 2020. [*https://www.imk-boeckler.de/de/faust-detail.htm?sync_id=8829*](https://www.imk-boeckler.de/de/faust-detail.htm?sync_id=8829)