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Making the Best of EU Fiscal Rules and Structural Reforms[1]

An insufficient level of structural reforms remains a perennial phenomenon in the EU. Some of these reforms are critical for the growth and sustainability of the eurozone as a whole, as they imply positive externalities across countries. At the same time, laxity in applying fiscal rules has been viewed as a major cause of sovereign debt turmoil in the euro debt crisis. This reveals a dilemma: strict application of fiscal rules may be counterproductive in cases where economic policy measures may improve the fiscal stance in the long term, the short-term fiscal burden notwithstanding. This applies particularly to two instances: First, public investment may stimulate growth and thus improve the debt-to-GDP situation, while giving rise to numerous controversial issues regarding nature, size, and crowding-out (Mouragne et al. 2016). Second, structural reforms are widely claimed to be necessary in order to foster growth (Griffith and Harrison 2004; International Monetary Fund 2017), while less attention has been given to the fiscal implications of structural reforms.

We address the latter strand of literature by examining the interaction between legal and economic insight in the relationship between fiscal rules and structural reforms. The analytical approach is to indicate avenues of legal interpretation inspired by economic analysis on the impact that structural reforms have on a country's fiscal position. Given political constraints in changing the EU legal fiscal framework (both through modifications to EU Treaties as well as secondary law), this analysis seeks an economic interpretation of the existing EU rules governing fiscal conduct. Put differently: How can legal interpretation lend itself to incorporating economic insight?

Relevant legal questions regarding the enforcement of fiscal rules are: How can fiscal rules be interpreted to the extent that structural reforms should be accounted for under the fiscal governance regime? Can fiscal leeway be granted in exchange for structural reforms? And how can vague legal terms as laid out in EU regulations – such as "prompt" positive budgetary effect of structural reforms or "major" structural reforms (European Commission 2015a; European Commission 2019) – be interpreted with a sound economic rationale? The claim is to make these legal questions addressable through economic analysis. To understand whether a government should invest time and public expenditure on the costs of structural reforms, it is important to compare the potential short-run fiscal costs to the effects of those reforms on public finances in the long run. In particular, reforms that boost economic growth can improve the fiscal balance in the long run, and so be self-financing despite the fiscal costs in the short run. Methodologically, this can be shown by simulating reform scenarios within a structural model of the euro area.

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THE LEGAL STANCE ON FISCAL RULES

Relevant economic questions are: To what extent do structural reforms alter the fiscal position of a country? What is the short-term versus long-term effect of structural reforms on the fiscal position? Do size and type of the structural reforms matter? These questions are embedded into a legal framework. The EU offers a suitable case to study the interaction of legal and economic questions. More specifically, the Stability and Growth Pact (SGP) is the key instrument of fiscal policy coordination, featuring binding rules and sanction mechanisms (Steinbach 2013). In the past, application of the SGP focused on fiscal policy and compliance with numerical budget rules. Even though the rules have not always been applied consistently due to political reasons, there is a strong inclination in legal and economic scholarship towards strict enforcement of fiscal rules. This stance has been subject to criticism pointing, inter alia, at other elements promoting growth and positive long-term budgetary effects, such as structural reforms. The call for structural reforms has been raised broadly by the IMF, OECD and the EU Commission (European Commission 2015).

In principle, under EU rules the fiscal regime allows integration of non-fiscal considerations at two stages of the fiscal surveillance. Under the preventive arm of the SGP (i.e., ensuring sound budgetary policies over the medium term), the relevant legal provision explicitly states that the Commission and Council shall "take into account the implementation of major structural reforms" when defining the adjustment path to the medium-term budgetary objective.

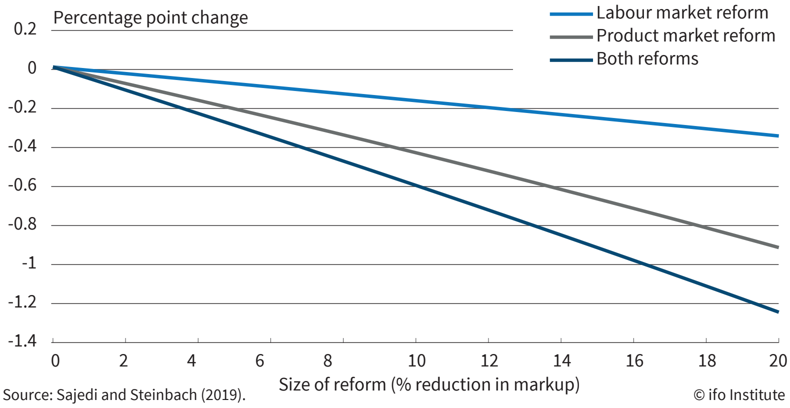
Thus, "major structural reforms'' may, under specific circumstances, justify a temporary deviation from the medium-term budgetary objective of the concerned Member State or from the adjustment path towards it. Less clarity, however, exists as regards the relevant norms of the corrective arm (i.e., correction of excessive deficits). The provisions are silent on the treatment of structural reforms. The only legal term potentially allowing the incorporation of structural reforms into the assessment under the corrective arm states that the Commission "[…] shall take into account all relevant factors […] in so far as they significantly affect the assessment of compliance with the deficit and debt criteria by the member state concerned".

[1] The article contains personal views only and builds on Sajedi R. and A. Steinbach (2019), Fiscal Rules and Structural Reforms, International Review of Law and Economics 58, 34-42.

The legal terms have been subject to legal interpretation and implementation. A first legalistic approach to interpretation is to account for the "purpose and spirit" of legal rules as element of the standard teleological method of interpretation. There is no indication that interpreting structural reforms as "relevant factors" would be incompatible with the overall purpose of the excessive deficit procedure, which is to ensure the correction of excessive deficits, that is, making sure that member states return to a sustainable fiscal position. Second, on the basis of its discretionary power, the EU Commission finds that structural reforms can be recognized provided they have a long-term positive budgetary effect, where this effect can have direct budgetary savings from reforms (e.g., pension reform) or through increased revenues (e.g., as a result of increased employment). The plausibility of this interpretation of fiscal rules can be explored by economic methods as presented below. Third, the legal text requires reforms to be "major" in relation to their effect on growth and the sustainability of public finances. Requiring a significant impact enables the EU Commission to request sizeable and effective reforms and the appropriate choice of policy mix. The soundness of this requirement can be assessed through economic modelling. Finally, according to the legal requirement, structural reforms must account for the main purpose of the corrective arm of the SGP, which is to ensure the "prompt" correction of excessive deficits.

Figure 1

Long-run Effects of Reforms



Source: Sajedi and Steinbach (2019).

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ECONOMIC ANALYSIS

The legal requirements and interpretations can be subject to an economic review by rephrasing the legal reasoning in economic questions: Do structural reforms alter the deficit-to-GDP both in the short and long run? Only if they do is there rationale to discuss the integration of structural reforms into the fiscal regime, because if, in the short run, deficit-to-GDP increases, this would require flexibility in the enforcement of fiscal rules. And if, in the long run, structural reforms lead to a lower post-reform deficit-to-GDP ratio compared to the non-reform scenario, this offers rationale for granting leeway due to a better ex-post fiscal position.

In our model economy, imperfect competition in product markets leads to a markup of prices over marginal costs, and imperfect competition in labor markets leads to a markup of wages over the marginal disutility of labor. These markups represent the distortions caused by regulations, and structural reforms will be defined as reductions in these markups. We label a reduction in price markups as "product market reform" (PMR), and a reduction in wage markups as "labor market reform" (LMR). Both of these reforms boost output in the long run by removing distortions created by the excess regulations.

Long-run and Short-run Effects of Reforms

To answer the relevant legal questions, we first look at the long-run effects of reforms on deficit-to-GDP. Figure 1 shows the decline in the deficit-to-GDP ratio for different size reforms, measured here by the percentage reduction in markups. It presents the case of LMRs and PMRs separately and if both reforms are combined. Naturally, the deficit-to-GDP ratio falls further for larger reforms, and falls the furthest when both reforms are carried out. However, it is clear that most of the gains in deficit-to-GDP come from the PMRs, with even very large LMRs having only small effects. On the other hand, LMRs and PMRs together – reducing the markups by 15–16 percent, which would bring the periphery countries in line with core countries in the euro area – can cut the deficit-to-GDP ratio by a full percentage point. Nonetheless, for small reforms of either type, the gains are small.

Regarding short-run effects of structural reforms, in the first scenario we consider, No Stabilization, where fiscal policy remains fixed, there are short-run output costs from the reform. Notice that these short-run output costs lead to movements in the deficit-to-GDP ratio even without any active fiscal policy response. In the second scenario, Active Stabilization, governments spend to offset the short-run output costs of reform. While output is stabilized in this scenario, additional fiscal costs arise due to the excess spending.

Table 1 reports the results. An active fiscal stimulus can offset the short-run output costs of reform, but with an additional rise in the deficit. In particular, we find that the PMRs have the highest fiscal costs from active stabilization. In this case, the deficit-to-GDP can rise by 0.3 percentage points, with a total fiscal cost of

Table 1

Short-run Costs of Minor Reforms

1% Reforms (minor)	Long-run Gain (percentage points)	Peak Deficit-to-GDP Deviation (percentage points)		Total Excess Deficit (% Initial GDP)	
		No Stabilization	Active Stabilization	No Stabilization	Active Stabilization
PMR	0.04	0.04	0.30	0.01	0.58
LMR	0.02	0.03	0.08	0.03	0.22
Both	0.06	0.06	0.34	0.02	0.72

Source: Sajedi and Steinbach (2019).

almost 0.6 percent of the initial GDP. In contrast, the LMRs require a rise in deficit-to-GDP of only 0.08 percentage points and a total excess deficit of 0.22 percent to offset the short-run output costs.

Given the positive budgetary long-term effect of structural reforms, the legal rules should be applied with a degree of leniency, allowing for a short-term deterioration of the fiscal position in return for a stronger long-term fiscal position. Further, the above applies not only to accepting the fiscal deterioration due to the immediate short-term contraction from structural reforms, but also extends to fiscal stabilization. While active stabilization amplifies the fiscal deterioration in the short-term, it allows a return to the same post-steady-state fiscal position (and a better fiscal state than without the structural reforms being carried out) as in the scenario of no stabilization, that is, strict enforcement of fiscal rules. Moreover, unlike the no stabilization scenario, if active stabilization is pursued, the output losses associated with structural reforms are fully offset, offering a desirable macroeconomic smoothing effect. In other words, leeway granted to the enforcement of fiscal rules comes at a considerable, but recoverable, fiscal cost in return for a significant macroeconomic benefit.

The results reported in Table 1 for minor structural reforms (size: 1 percent) appear to be in line with the European Union's current enforcement practice. As set out in European Commission (2019) and European Council (2017), the EU ties the flexibility under the SGP to certain conditions. The temporary deviations must not exceed 0.5 percent of GDP and, in addition, the cumulative temporary deviation granted under the structural reform clause must not exceed 0.75 percent of GDP. Our analysis shows that even if structural reforms are adopted cumulatively, the peak deficit-to-GDP remains below 0.5 percent of GDP and the total excess deficit does not exceed 0.75 percent.

Gauging Prompt Correction of Deficits

EU law has been specified to require that deviation is temporary only and that Member States invoking the structural reform clause return to their MTO.[2] Specifically, the EU implementation practice foresees that in the fourth year of the adjustment period, the deviation is no longer applied and the Member States is required to adjust (European Council 2017; European Commission 2019).

To capture whether the reforms lead to a "prompt" correction of deficits, we report two statistics in Table 2. First, we report the number of periods before the deficit-to-GDP falls below its initial level, in other words, the time before the fiscal gains from the reform materialize. Second, we calculate the ratio of the total excess deficit to the long-run gains from the reform, which captures the number of periods that it would take for the reduced deficit in the long run to repay the excess deficit in the short run. Again, we calculate these for different types of reform and under the alternative short-run policy scenarios.

Looking first at the time for the fiscal gains to materialize, we see that without active stabilization it can still take between 9 and 18 months (3–6 quarters) for deficit-to-GDP to fall below its initial level. With active stabilization, this rises to 18–24 months (6–8 quarters). Despite the smaller fiscal cost, we see that the LMR takes the longest to provide any fiscal gains,

[2] Article 1 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure provides that the main purpose of the corrective arm of the Pact is to ensure the prompt correction of excessive deficits.

Table 2

Prompt Correction of Deficits under Baseline Reforms

1% Reforms	Time until Fiscal Gains Materialize (quarters)		Time until Fiscal Costs are Repaid (quarters)	
	No Stabilization	Active Stabilization	No Stabilization	Active Stabilization
PMR	3	6	0.25	16
LMR	6	8	2.50	19
Both	4	7	0.45	15

Source: Sajedi and Steinbach (2019).

but again the two reforms together can provide complementarities that make the fiscal gains materialize faster than the LMR alone.

Looking at the time to repay the total excess deficit with the long-run fiscal gains from the reform, we see a similar pattern, with LMRs implying the longest time to repay. This is due to the fact that the long-run gains are smaller for LMRs, meaning that even the smaller long-run costs take longer to be repaid. Still, without active stabilization these numbers are small, with a maximum of 6–9 months to repay the costs of the LMR. On the contrary, with active fiscal stabilization, these numbers are much larger. It can take 4–5 years (16–19 quarters) to repay the costs of either reform alone, and still close to 4 years (15 quarters) to repay the cost of the reforms together.

Given that EU fiscal enforcement practice requires states to reach their MTO within the four-year horizon, this requirement is largely compatible with the realistic pace of positive budgetary effects from structural reforms. In most cases, fiscal recovery remains within the four-year period, but additional flexibility would be needed if (labor market) reforms are sidelined by active fiscal stabilization.

Defining "Major" Structural Reforms

Finally, to gauge what should count as a "major" reform with significant fiscal implications (as required by European Commission 2019; European Council 2017), in Table 3 we compare the baseline reforms against two larger reforms of 5 percent and 10 percent reductions in markups. Firstly, as seen earlier in Figure 1, the long-run gains from the reforms increase almost exactly linearly with the rise in the size of the reform. For the most part, the short-run costs of reforms also increase with the size of the reform, but costs increase proportionally less than gains as structural reforms become more substantial. The increase in the deficit-to-GDP that is implied by the larger reforms rises marginally in the case of no active stabilization, but increases almost linearly with the size of the reform in the case of active stabilization. Even for the 5 percent reforms, there are now sizeable increases in the deficit-to-GDP of around 1.5 percentage points implied by the PMRs and the joint reforms.

Hence, the "major" requirement attached to the size of structural reforms can be determined on the basis of the economic analysis. In principle, excluding minor structural reforms from being eligible for fiscal leniency does not seem compatible with the linear relationship of short-term costs and long-term benefits across different sizes of structural reform. That is to say that minor structural reforms also produce higher benefits than costs and should generally be accepted. Also, while larger reforms typically produce larger absolute benefits and should thus be preferable over small size reforms, they also require proportionally more fiscal leniency in the short run. Finally, the economic analysis further refines our understanding of the type of structural reform that should be implemented. PMR tend to produce larger deficit-reducing effects than LMR and should, from this perspective, be preferred. Also, there is an indication that a combination of both PMR and LMR offer fiscal advantages, as the total excess deficit is less than the sum of the individual reforms, suggesting complementarities between the reforms. Hence, the legal term "major", from a perspective of teleological interpretation, should not only be indifferent for the size of the reform but also account for the type of reform to be pursued.

However, the results reveal significant differences in fiscal costs associated with active stabilization, implying higher peak deficit-to-GDP deviations and total excess deficit. In case of no stabilization, the thresholds set by EU fiscal enforcement practice are met (0.5 percent peak deviation and 0.75 percent cumulative temporary deviation), and this even holds true for major structural reforms (as defined as 5 percent and 10 percent reductions in markups). Yet there is a clear violation of the fiscal rules if active fiscal stabilization is pursued to sideline structural reforms (up to 2.87 percent peak deficit-to-GDP deviation). This shows that the current rules allow for an active fiscal policy by which government consumption expenditures react to the output gap only in the case of minor structural

Table 3

Short-run Costs of Major Reforms

Reform Scenarios (major)	Long-run Gain (percentage points)	Peak Deficit-to-GDP Deviation (percentage points)		Total Excess Deficit (% Initial GDP)	
		No Stabilization	Active Stabilization	No Stabilization	Active Stabilization
5% Reforms					
PMR	0.21	0.12	1.43	0.03	2.79
LMR	0.09	0.10	0.33	0.14	1.01
Both	0.30	0.22	1.50	0.07	3.16
10% Reforms					
PMR	0.44	0.21	2.68	0.01	5.03
LMR	0.17	0.16	0.45	0.21	1.24
Both	0.61	0.39	2.87	0.05	6.01

Source: Sajedi and Steinbach (2019)

reforms (size: 1 percent), with active fiscal policy for major structural reforms (size: 5 percent and 10 percent) ruled out due to its significant impact on budget deficit. This approach under EU fiscal rule enforcement is contradictory. On the one hand, it ties eligibility for fiscal flexibility to the performance of major rather than minor structural reforms. On the other hand, it does curtail fiscal expenditures smoothening the impact on output gap due to structural reforms. Hence, the current fiscal regime does not appreciate the positive effect of active fiscal policy as a tool to counteract the adverse fiscal effects of structural reforms.

Finally, as regards the four-year period set out in EU fiscal enforcement practice (European Council 2017), larger reforms require similar periods for fiscal deficit to be repaid. However, since the fiscal gains of larger reforms increase more quickly than the fiscal costs compared to minor reforms (as can be seen from Tables 1 and 3), the fiscal costs of larger reforms should be recoverable slightly more rapidly than those of minor reforms.

CONCLUSIONS

Structural reforms are generally desirable within an economic union, as they offer positive spillovers for other countries as well. They may, however, go along with fiscal burden in the short term. An imminent issue of economic policy is how fiscal discipline and (costly) structural reforms can be reconciled. This analysis offers the economic underpinning necessary to sustain an economically sound legal interpretation of EU fiscal governance rules. Given the nature and size of the positive fiscal long-term effects, there is a strong indication towards employing an interpretation of fiscal rules in light of these effects. Hence, the analysis rejects a rigid application of fiscal rules ignoring the effects of structural reforms in the long-term. Rather, there is scope for a "stick-and-carrot" application of fiscal rules rendering structural reforms a suitable incentivizing device for fiscal leeway (and thus sparing the country from sanctions for rule violation).

The results may further inform the ongoing debate on reforming EU economic surveillance. Recent policy proposals have stressed the importance of structural reforms and pointed at the use of existing instruments in implementing structural reforms (European Commission 2018). We provide insight for designing fiscal rules in a way that permits the effect of structural reforms to be taken into account. Our results also feed into the debate on reforming the SGP. To date, a significant part of the relevant policy practice examined in this analysis has emerged through administrative practice – mainly in the guise of non-legal and non-binding but practically relevant enforcement guidelines (European Commission 2015a, 2019) or Codes of Conduct (European Council 2017) rather than being stipulated as precise and operational legal rules in EU law. Both from a legitimacy as well as a predictability perspective, a reform of the SGP should abandon this practice of administrative dominance and instead incorporate the insight from this analysis into the relevant legal rules of the SGP (i.e., on the level of EU secondary law). This requires changes to the current legal SGP rules in three regards.

First, while maintaining the objective of ensuring long-term fiscal viability as the primary goal of EU fiscal rules, there should be sufficient discretionary margin to allow short-term fiscal leniency for structural reforms on the condition that they are suitable to improve long-term fiscal viability. Requirements related to the size of the structural reform must correspond with sufficient policy flexibility on the budgetary effect, without ruling out counter-cyclical expenditures sidelining structural reform in order to smooth its impact on output gap. This requires the current caps on permissible peak deviation and cumulative temporary deviation (0.5 percent and 0.75 percent, respectively) to be loosened, as these caps curtail fiscal smoothing of the output gap disruptions due to structural reforms.

Second, reference to the prompt correction of excessive deficit should be integrated into SGP rules, with a further concretization added that excess deficit due to structural reforms should generally be repayable within five years (rather than the current period of four years). As seen even if fiscal reforms are sidelined by active fiscal counter-cyclical policy (fully offsetting output losses associated with structural reforms), fiscal gains from major structural reforms exceed the cumulated deficits after the period of five years at the latest.

Third, references to the desired size of the reform ("major") should be abandoned given that minor structural reforms also produce positive fiscal effects. However, legal rules should ask for an appropriate combination of both PMR and LMR given the complementarities between the reforms, as highlighted in this analysis.

On a more general note, our analysis calls for a coordination of economic policies recognizing the interdependent nature of fiscal policy and structural economic policies. Future institutional arrangements should reflect that enforcement of fiscal adherence should not be pursued as a short-term objective per se. Rather, such arrangements should incorporate the positive long-term fiscal effects associated with sound structural policies.

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