Will the national ‘golden rule’ eclipse the EU fiscal norms?

Stijn Verhelst
1 March 2012


Eurozone countries have recently agreed to adopt a ‘golden rule’ for fiscal policy, forcing governments to be stricter about balancing their books. This column compares the golden rule to existing EU fiscal policies. It argues that the successful implementation of the golden rule would overturn much of the existing economic governance in the Eurozone to become the main determinant of fiscal discipline.

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 a new intergovernmental treaty – the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

The Treaty does not contain that many new elements. Nonetheless, its obligation for Eurozone countries to adopt a so-called golden rule in their national legislation is likely to have a very significant impact. As Whelan (2012) argues on this site, the golden rule would transform Eurozone economic governance. This column looks at how the new and old rules compare under various macroeconomic conditions (mostly initial debt ratios and GDP growth).

The golden rule

The intergovernmental Treaty defines the golden rule as a structural deficit of 0.5% of GDP or less. It applies to all Eurozone countries whose debts are not significantly below 60% of GDP.

The structural deficit tries to filter out temporary fiscal measures and fiscal evolutions that are purely due to cyclical changes in the economy. It therefore refers to over-the-cycle deficits. Yet putting this concept into practice could prove difficult.

It is useful to indicate that the new golden rule does not correspond with the academic meaning of a golden fiscal rule, ie deficits can only be used to finance investments that are to the benefit of future generations (Artis 2002).

A major nuance to the golden rule is that it can temporarily be disregarded due to economic downturns that go beyond normal cyclical evolutions, or other major unforeseen events. These exceptions, along with the conceptual difficulties, could allow Eurozone countries to dilute the golden rule. However, the golden rule’s firm anchoring in national legislation and the German resolve to impose Eurozone-wide fiscal discipline are likely to counterbalance those loopholes. While the golden rule’s success is far from evident, it thus seems overly presumptive to already write it off as irrelevant.

A comparison with EU-level fiscal norms
The golden rule comes in addition to the existing EU fiscal norms (i.e., the 3% deficit ceiling, the medium-term objective and the debt-reduction rule). In comparing these norms to the golden rule, it becomes clear that the latter will impose significantly stricter fiscal rigour, as I show in Verhelst (2012).

The 3% deficit ceiling and the medium-term budgetary objective

If the golden rule is effectively put into practice, the 3% deficit ceiling will play a very different role than it played in the past. Instead of avoiding deficits surpassing 3% of GDP in difficult times, Eurozone countries would be forced to have balanced budgets in normal times. This would render it much less likely that a deficit of more than 3% is reached during economic downturns (Buti and Sapir 1998).

The existing medium-term budgetary objective (MTO) is in fact very similar to the golden rule. The MTO requires member states to adhere to a country-specific structural balance that can range from a structural deficit of 1% of GDP to a budget in surplus. 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. However, this is not likely to happen often as 0.5% is already a remarkably far-reaching commitment.

The debt-reduction rule determines the required pace of debt-to-GDP reduction for countries whose debt exceeds 60% of GDP. To take into account yearly fluctuations, debt reduction is measured on a three-year basis (see also Cafiso and Cellini 2011 on this site).

There is a close relationship between the debt-reduction rule and the golden rule. In fact, given a specific debt-to-GDP level, economic growth will determine whether a country is subject to either the debt-reduction rule or the golden rule. Based on this finding, we can calculate which of the two rules is more stringent in given circumstances. The results are shown in Figure 1.

**Figure 1.** Comparison between the golden rule and the debt-reduction rule

![Diagram](image-url)

*Source: own calculations.*
For a given nominal growth rate, the curve in Figure 1 indicates the level of debt-to-GDP at which the golden rule and the debt-reduction rule are equally restrictive (that is, when both require a medium-term deficit of 0.5% of GDP at most). In theory, the debt-reduction rule would apply to countries that are situated above the curve and thus suffer from high debt and/or low growth. In practice, it is very unlikely that the debt-reduction rule will be stricter than the golden rule.

It is important to bear in mind that growth in Figure 1 concerns nominal growth, which includes both real growth and price evolutions. Furthermore, as the golden rule and the debt-reduction rule apply to the medium term, neither takes into account temporary economic slowdowns. For both rules, low growth only becomes relevant if it is drawn out over a period of more than three years.

Average Eurozone public debt is set to peak at 91% of GDP in 2013. Given such a debt level, nominal growth needs to be at least 2.3% in order for the golden rule to apply rather than the debt-reduction rule. Given an average yearly price increase of 1.8% (the average during the period 2000–10), this implies a mere 0.5% in real economic growth – which is extraordinarily low.

For countries with debt-to-GDP as high as 120%, it would only require a 3% 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% in real economic growth. Such growth is still remarkably low. During the period 1992–2008, only four Eurozone countries had nominal growth below 9% on average during a period of at least four years.

Even in such rare cases of lacklustre growth, the debt-reduction rule would most likely not be applied in a stricter manner than the golden rule. The Stability Pact explicitly foresees a flexible interpretation of its fiscal rules in case of a protracted period of very low growth. In those circumstances, both the debt-reduction rule and the golden rule would thus be applied in an ad hoc manner.

Finally, if a country has a debt level well above 120%, the debt-reduction rule would again probably not be more stringent than the golden rule. EU rules allow for a less strict application of the debt-reduction rule when the primary balance (which excludes interest expenditure) suggests so. For highly indebted countries, the primary balance will be in a major surplus if the actual deficit would be only 0.5% of GDP. Even for Greece, the debt-reduction rule would hence be of little relevance if it meets its national golden rule.

**Conclusion**

A successful introduction of national golden rules would overturn the Eurozone’s fiscal setting. As I argue, the golden rule will easily surpass the fiscal discipline required by the EU-level norms in the vast majority of situations. Consequently, the golden rule will effectively determine the future fiscal discipline to which Eurozone countries have to adhere.

The role of EU-level fiscal norms will decrease considerably. They will serve to counter the inadequacy of a specific golden rule. In the likely event that 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. The golden rule risks obstructing public investments that address long-term challenges such as ageing and the shift towards a green economy. It seems therefore preferable that the implementation of the golden rule considers public investments. If not, Eurozone countries will, perhaps sensibly, be inclined to circumvent their golden rule.
References


European Council (2012), “Treaty on Stability, Coordination and Governance in the Economic and Monetary Union”.


---

1 The debt-reduction rule stipulates that member states with debt of more than 60% of GDP have to reduce the difference between their debt level and the 60% debt target by 1/20\(n\) 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.

2 Measured using the GDP deflator. Source: Ameco database and own calculations.

3 The four countries are: Finland in the period 1992-1994 (-2% annual nominal growth); France in the period 1993-1997 (2.7% annual nominal growth); Germany in the period 1996-2005 (1.9% annual nominal growth); Austria in the period 2002-2004 (2.6% annual nominal growth).

This article may be reproduced with appropriate attribution. See Copyright (below).