EconPol
POLICY BRIEF

15
2019

March
Vol. 3

# Applying nominal expenditure rules in the euro area

*Clemens Fuest and Daniel Gros*

EUROPE
econPOL
European Network for Economic
and Fiscal Policy Research

headed by

ifo INSTITUTE
Leibniz Institute for Economic Research
at the University of Munich

KOF Swiss Economic Institute

uc3m | Universidad Carlos III de Madrid
Instituto Universitario de Economía

ZEW

EconPol POLICY BRIEF
A publication of EconPol Europe
European Network of Economic and Fiscal Policy Research

Publisher and distributor: ifo Institute
Poschingerstr. 5, 81679 Munich, Germany
Telephone +49 89 9224-0, Telefax +49 89 9224-1462, Email Dolls@ifo.de
Editors: Mathias Dolls, Clemens Fuest
Reproduction permitted only if source is stated and copy is sent to the ifo Institute.

**EconPol Europe: www.econpol.eu**

# Applying nominal expenditure rules in the euro area

**Clemens Fuest and Daniel Gros**

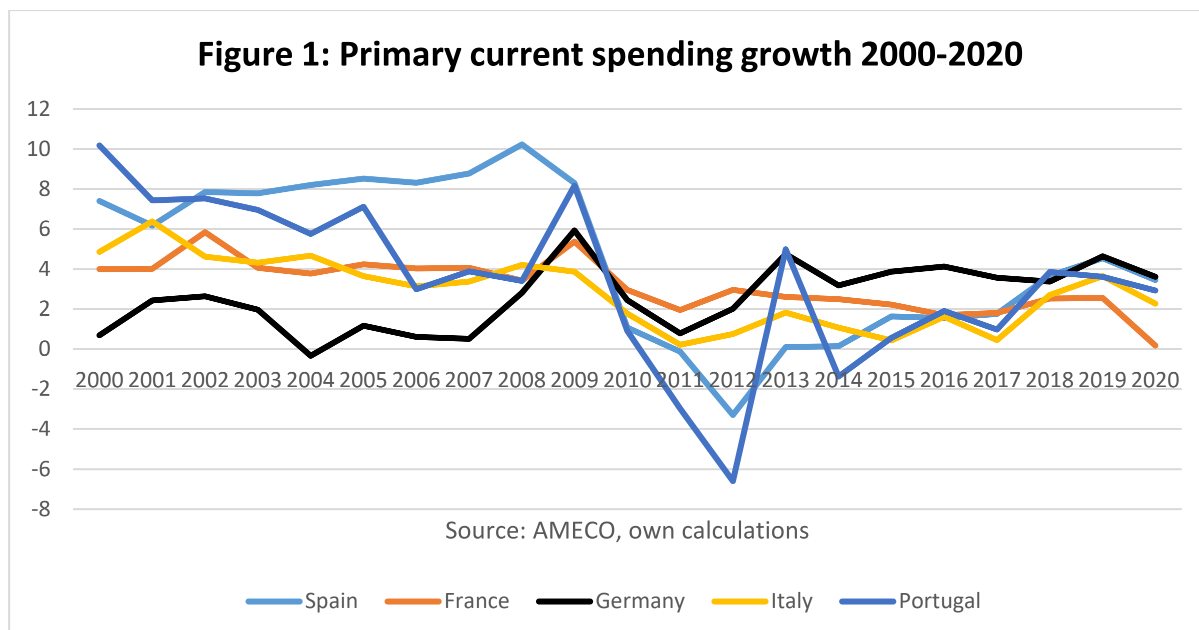
## 1. Introduction: The debate on deficit versus spending rules

In the debate on euro area fiscal governance, the current deficit rules of the EU have repeatedly been criticised for a number of reasons, one of them being that they have a pro-cyclical effect, leading to overly lax fiscal policies in good times and a too restrictive regime in bad times. The shift towards structural deficits has mitigated this problem, but created another one, namely how to measure potential output. Another important critique is that the current rules do not distinguish between consumption and investment spending, discouraging the latter.

Spending rules are a widely discussed alternative to the existing deficit rules. For instance, the influential Eurozone reform proposal of 14 French and German economists (Bénassy-Quéré et al., 2018) includes a rule that focuses on nominal current expenditure ceilings.

In this note we discuss the application of a variant of such a rule to the euro area today. We show that all the major countries including Germany are currently over-spending, relative to a standard expenditure rules. The extent of over-spending depends of course on the exact values of the parameter of the rule, but the general result is that these countries are budgeting increases in current expenditure that are not compatible with the goal of slowly reducing debt levels towards 60% of GDP. This holds even with relatively lax expenditure rules. There is a high sensitivity with respect to the choice of the base year, though. Our results also show that spending rules tend to have a greater disciplinary effect in good times compared to deficit rules.

It is instructive to consider the development of public spending in the countries considered in this note since the year 2000. Figure 1 illustrates the yearly nominal growth rates of public primary current spending, i.e. spending excluding investment and interest on public debt) between 2000 and 2020, for France, Germany, Italy, Spain and Portugal.




Before the global financial crisis and the Eurozone debt crisis, pubic spending was increasing very quickly in some Eurozone countries, in particular in Spain, at rates of around 8 per cent. German spending growth, in contrast, was significantly below that of the other countries. After the crisis, this changed. Germany became the country with the highest growth of spending. Spending growth in other countries, in particular those who were most affected by the Eurozone debt crisis, was significantly lower until 2017. Since 2018 spending growth has been raised in these countries as well.

The data thus shows that the countries hardest hit by the crisis followed a pro-cyclical expenditure path: increasing it during the boom and then retrenching when the recession started. Germany's expenditure path, by contrast, was counter-cyclical, lower expenditure growth during the boom and strong expansion after the crisis.

The key reason why Germany, in contrast to the other countries considered in figure 1, was able to follow a counter-cyclical policy is that public debt in Germany is significantly lower.

But even measured against an expenditure rule which takes into account debt levels, Germany spending in recent years has become excessive, as will be shown in greater detail below.

This contribution concentrates on expenditure rules. Although the focus is on the euro area, we leave aside the existing euro area rules on fiscal policy. This seems justified in the face of the serial violations of the limits on deficits (the so-called Stability and Growth Pact) and the rules on debt reductions (the Fiscal Compact). Cordes (2015) find that the compliance rate with expenditure rules is greater than for budget-balance rules. Moreover they find that expenditure rules are "associated with stronger fiscal performance, that is a higher primary balance—after taking into account conventional determinants—and countercyclical policies."

## 2. How could the spending rule be designed?

There are various ways in which spending rules can be designed. We focus on the proposal made by a group of 14 French and German economists, Bénassy-Quéré et al. (2018) who argue that:

"Fiscal rules should (1) be as transparent and simple as possible; (2) set targets in terms of fiscal indicators under the direct control of the government; (3) allow countercyclical fiscal policy to stabilise

macroeconomic shocks; (4) generate incentives to reduce excessive public debt; and (5) embed an escape clause in case of very large shocks."[1]

In concrete terms this would mean that fiscal rules should focus on primary expenditure, which is under the direct control of the government and not much affected by the business cycle, certainly much less so than deficits.

Labour market related and some social security spending is of course affected by the business cycle. But for the purpose of this concrete application there should be no need to make any adjustment for this expenditure category since unemployment is actually continuing to decline (despite the weakening of the euro area economy).

Another issue is which types of spending are included. In this note, the expenditure ceiling refers to current spending and exempts (gross) investment.[2] In principle, one could argue that consumption of capital (by the government) should be included in current expenditure. Consumption of fixed capital does not create debt, but reduces the stock of public capital, which needs to be offset by (gross) investment expenditure. For most of the countries considered here the results would not be much affected by the inclusion of investment spending, which has tended to be rather stable. The exception is Italy, where the capital stock is declining rapidly (Gros, 2018).

This implies that one does not need to make adjustments for these expenditure categories and thus can take overall nominal, current primary expenditure as the appropriate target.[3]

It should be noted that expenditure rules do not have the purpose to determine the overall level of public spending in a country, only the spending that can be financed with a given level of taxes. If countries take discretionary revenue measures like increasing or cutting taxes, the level of spending allowed by the rule is adjusted accordingly. Tax cuts reduce room for spending and vice versa.[4]

Below we provide a rough application of a simple expenditure rule to the concrete cases of France, Germany, Italy, Portugal and Spain today. The underlying assumption is that the rule was put in place in 2018, taking 2017 as the base year. The numbers from the November 2018 forecast of the European Commission for (primary current) expenditure can then serve as a basis to calculate whether in 2018, 2019 and 2020 these countries would exceed their expenditure targets. For France, the November 2018 forecasts for expenditure were augmented by an additional €7.4 billion per year for 2019 and 2020, taking into account the increase in spending following the *gilets jaunes* protests.[5]

A key issue in the design of fiscal rules in general is how they will be enforced. The Franco-German group proposes that any excess of actual expenditure over the targets should be financed by issuing

---

[1] Bénassy- Quéré et al (2018), p.10.

[2] Bénassy-Quéré et al. (2018) propose to include investment, but exclude spending on transfers to the unemployed.

[3] Another point made by the Franco-German group was that:
"In the European context, monitoring should occur to a significant extent at the national level – by an independent national fiscal council – under the oversight of a euro area fiscal watchdog (see the final section of this blueprint for details). Finally, enforcement cannot rely solely on the threat of penalties that are unlikely to be credible."

[4] In the calculations in this paper we take into account discretionary revenue measures as reported in the AMECO database but this data does not include bracket creep. In countries without automatic correction for bracket creep like Germany this implies we understate tax increases.

[5] This number is taken from the report of the Cour des Comptes (2019), p. 34.

special junior bonds, called ‘accountability bonds’ (AB).[6] The expenditure above the targets should thus correspond to issuance of these bonds.

For the calculation of expenditure ceilings the Franco-German group proposes the following:

“The basic principle underlying an expenditure rule of this type is easy to describe: nominal expenditures should not grow faster than long-term nominal income (that is, the sum of potential output growth and expected inflation), and they should grow at a slower pace in countries that need to pay down their debts.”[7]

This implies that nominal expenditure should grow in line with trend nominal GDP growth plus an adjustment depending on the debt level of the country concerned. We use the following adjustment formula:

$G=Y-(D-0,6)q+T$.

G is the target growth rate for public spending, Y is trend growth of nominal GDP, D is the debt to GDP ratio, T is an adjustment for discretionary revenue measures and q is an adjustment parameter requiring countries with debt-to-GDP levels above 60% to reduce spending growth below trend growth of GDP. For countries with debt-to-GDP ratios below 60% the spending rule would not require any extra limitation of spending to bring down the debt ratio. In these cases the rule is applied with $q=0$.

In the following calculations, trend growth of nominal GDP is taken to be 3.5% for France, Spain, Portugal and Germany (1.5% real growth + 2% inflation). For Italy, trend real growth is assumed to be only 1%, resulting in trend growth of nominal GDP of only 3%. For the adjustment parameter q two cases are considered: a more restrictive rule with $q=0.05$ and a less restrictive one with $q=0.02$, as proposed by Clayes et al. (2016).

These parameters are actually rather generous.  The 2% inflation target looks unlikely to be achieved for a long time. Inflation swap rates are now only 1.2% even for ten years.  The adjustment parameter of 0.05 is enshrined in the so-called Fiscal Compact and would thus be compatible with obligations all euro area member states have subscribed to.  However, an adjustment parameter for the debt ratio of only 0.02 would stretch the adjustment period to half a century, and thus be very permissive.

## 3. Results

On the basis of the European Commission’s forecasts for public spending we can now calculate whether the countries under consideration would comply with the spending rule and, if not, by how much they would have to correct their spending to achieve compliance.[8]

As a baseline scenario we consider the case with treaty conform adjustment (Table 1).

[6] See Fuest and Heinemann (2017).

[7] Bénassy-Quéré et al. (2018), p.10.

[8] The reform proposal of the Franco-German group of economists implies that spending in excess of the ceiling defined by the spending rule would have to be financed via accountability bonds. In this context numbers may be interpreted as the volume of these bonds that would have to be issued.

| Table 1: Treaty conform spending rule (q=0.05), base year 2017 | | | | |
|---|---|---|---|---|
| | Spending Growth Target | Actual Spending Growth | Excess Spending per Year (bn Euros) | Excess Spending (in % of overall spending) |
| Spain | 1,50 | 3,65 | 19,0 | 4,20 |
| France | 1,50 | 1,85 | 37,0 | 3,11 |
| Germany | 3,50 | 4,17 | 16,4 | 1,18 |
| Italy | -0,50 | 3,27 | 55,1 | 7,33 |
| Portugal | 0,25 | 3,73 | 5,4 | 6,93 |
| *Source*: Own Calculations, Data: AMECO Database. | | | | |

If a Treaty conform adjustment of the debt ratio is required, all five countries would overshoot their spending targets over the three-year period considered. The highest amount of excess spending would be for Italy, reaching 7.3 per cent of actual spending. Over the three years, overspending would accumulate to over €165 billion, which is more than 10% of GDP for Italy. In relative terms, excess spending would be almost as high in Portugal, somewhat lower in Spain, significantly lower but still positive in France, and even positive in Germany although the spending target for Germany is much higher, given that the country's debt ratio is below the 60 per cent limit. This reflects the fact that German fiscal policy has been expansionary in recent years, despite the positive economic situation. If excess spending had to be financed through accountability bonds as proposed by Bénassy-Quéré et al. (2018), the volume of bonds issued over these three years from the 5 countries would be equal to €400 billion, with roughly 40 per cent coming from Italy.

Unsurprisingly, applying the much lower adjustment parameter q=0.02, as proposed by Clayes et al. in 2016,[9] would lead to different results (Table 2). Excess spending would be much smaller, roughly half as high for all countries taken together. For Germany excess spending would be the same because the debt adjustment parameter plays no role. For Italy, excess spending over the three-year period 2018-2020 would be €75 billion whereas for Spain the total amount would fall to roughly €25 billion. The necessary adjustment would still be significant, with more than 3 per cent of overall spending in Italy and Portugal.

| Table 2: Permissive spending rule (q=0.02), base year 2017 | | | | |
|---|---|---|---|---|
| | Spending Growth Target | Actual Spending Growth | Excess Spending per Year (bn Euros) | Excess Spending (in % of overall spending) |
| Spain | 2,70 | 3,65 | 8,6 | 1,9 |
| France | 2,70 | 1,85 | 9,3 | 0,8 |
| Germany | 3,50 | 4,17 | 16,4 | 1,2 |
| Italy | 1,60 | 3,27 | 25,3 | 3,4 |
| Portugal | 2,20 | 3,73 | 2,5 | 3,3 |
| *Source*: Own Calculations, Data: AMECO Database. | | | | |

[9] http://bruegel.org/wp-content/uploads/2016/03/pc_2016_07.pdf

As a further variant, Table 3 illustrates the excess spending for the case where 2016 is used as a base year, again with the more restrictive rule. The results show that the choice of the base year plays an important role.

| **Table 3: Permissive spending rule (q=0.02), base year 2016** | | | | |
|---|---|---|---|---|
| | Spending Growth Target | Actual Spending Growth | Excess Spending per Year (bn Euros) | Excess Spending (in % of overall spending) |
| Spain | 2,70 | 3,35 | 3,1 | 0,7 |
| France | 2,70 | 1,71 | -10,1 | -0,9 |
| Germany | 3,50 | 3,79 | 14,0 | 1,0 |
| Italy | 1,60 | 2,26 | 6,5 | 0,9 |
| Portugal | 2,20 | 2,86 | 1,4 | 1,8 |
| *Source*: Own Calculations, Data: AMECO Database. | | | | |

In 2017 spending growth was low in the countries under consideration. Therefore excess spending defined relative to the base year 2016 is lower compared to the expenditure rule with base year 2017. For Italy excess spending would be 6,5 billion Euros per year, which is just over one fifth of what it would be with base year 2017. For France we would get no excess spending at all, relative to 9,3 bn Euros with base year 2017. Only for Germany excess spending would have roughly the same magnitude. This sensitivity with respect to the base year suggests that careful thinking about the details of the expenditure rules is important. A rolling average for the base year would be a possible solution.

## 4. Conclusions

This note proposes a set of simple calculations to explore the implications of introducing a spending rule to guide public finances in the euro area. The combination of low growth and the objective of bringing down debt levels do not allow for much growth in (current) expenditure.

All the major euro area countries (including Germany) are increasing spending by more than what would be compatible with the official target of the so-called Fiscal Compact, namely to bring debt levels down to a target of 60% of GDP in about 20 years. In the period 2018-2020, excess spending in the five countries under consideration in this paper would be equal to 400 billion Euros, with half of that sum coming from Italy. But even a much laxer rule, allowing half a century to reach the 60% target, would imply overspending. Excess spending would be roughly half as high. Again, all countries would be above target. However, our analysis also shows that the choice of the base year is important. If the base year is 2016 instead of 2017, excess spending would be much lower for some countries, especially Italy, and France would stay below the ceiling. Nevertheless, Italy as well as Germany would still breach such a very lax rule. This is particularly worrying in the case of Italy: the only country where public sector capital stock is falling because consumption of capital far exceeds gross investment spending. Another insight generated by this analysis is that spending rules foster fiscal discipline in good times, when a deficit rule does not help. This is best illustrated by the case of Germany.

How can spending rules be enforced? Requiring countries to finance spending above the ceiling by issuing accountability bonds could increase market pressure to adjust spending (particular for Italy). Whether that assessment is correct would have to be tested in the capital market. An alternative would be to require automatic increases in taxes. This approach has only been tried in one country, Italy, where it has been largely unsuccessful (Fontana et al., 2019).

## References

Bénassy-Quéré, A., M. Brunnermeier, H. Enderlein, E. Farhi, M. Fratzscher, C. Fuest, P.-O. Gourinchas, P. Martin, J. Pisani-Ferry, H. Rey, I. Schnabel, N. Véron, B. Weder di Mauro and J. Zettelmeyer (2018), "Reconciling risk sharing with market discipline: A constructive approach to euro area reform", CEPR Policy Insight No. 91, 2018.

Claeys, G., Z. Darvas and Á. Leandro (2016), "A proposal to revive the European Fiscal Framework", Bruegel Policy Contribution, March.

Cordes, Till with Tidiane Kinda, Priscilla Muthoora, and Anke Weber (2015) "Expenditure Rules: Effective Tools for Sound Fiscal Policy?", IMF Working Paper, WP 15/29, https://www.imf.org/external/pubs/ft/wp/2015/wp1529.pdf

Cour des Comptes (2019), La situation d'ensemble des finances publiques (à fin janvier 2019), https://www.ccomptes.fr/system/files/2019-02/01-situation-ensemble-finances-publiques-Tome-1.pdf.

Fontana, Alessandro wwith Andrea Montanino e Lorena Scaperrotta (2019) "Clausole di salvaguardia alla deriva", Nota del Centro Studi Confindustria, 02/19, Rome, February 15, https://www.confindustria.it/home/centro-studi/temi-di-ricerca/valutazione-delle-politiche-pubbliche/tutti/dettaglio/clausole-di-salvaguardia-storia-significato-valutazione

Fuest, C. and F. Heinemann (2017), "Accountability Bonds – Reconciling Fiscal Policy Based on Market Discipline with Financial Stability", EconPol Europe Policy Brief 03/2017.

Gros, Daniel (2018), "Investment spending and European Deficit rules", Blog post LUISS Open, http://open.luiss.it/en/2018/06/11/investment-spending-and-european-deficit-rules/

## EconPol Europe

EconPol Europe – the European network for economic and fiscal policy research – is a network of 14 policy-oriented university and non-university research institutes across 12 countries, who contribute scientific expertise to the discussion of the future design of the European Union. The network's joint interdisciplinary research covers sustainable growth and best practice, reform of EU policies and the EU budget, capital markets and the regulation of the financial sector, and governance and macroeconomic policy in the European Monetary Union.

The network was founded in spring 2017 by the ifo Institute, along with eight renowned European research institutes. A further five associate partners were added to the network in January 2019.

Our mission is to contribute our research findings to help solve the pressing economic and fiscal policy issues facing the European Union, and to anchor more deeply the idea of a united Europe within member states.

With our cross-border cooperation on fiscal and economic issues, EconPol Europe promotes growth, prosperity and social cohesion in Europe. In particular, we provide research-based contributions to the successful development of the European Economic and Monetary Union (EMU).

Our joint interdisciplinary research covers:

- Sustainable growth and best practice
- Reform of EU policies and the EU budget
- Capital markets and the regulation of the financial sector
- Governance and macroeconomic policy in the European Monetary Union

We will also transfer our research results to the relevant target groups in government, business and research, as well as to the general public.