HAS THE EU BEEN SUPPORTING GOOD FISCAL POLICIES?

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POLAND

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The EU has had an overwhelming influence on Central European economies and institutions for much longer than the last 15 years. The mere prospect of EU accession accelerated and anchored the economic and institutional transition, strengthened long-term trade and capital links and improved growth and living standards in these countries.

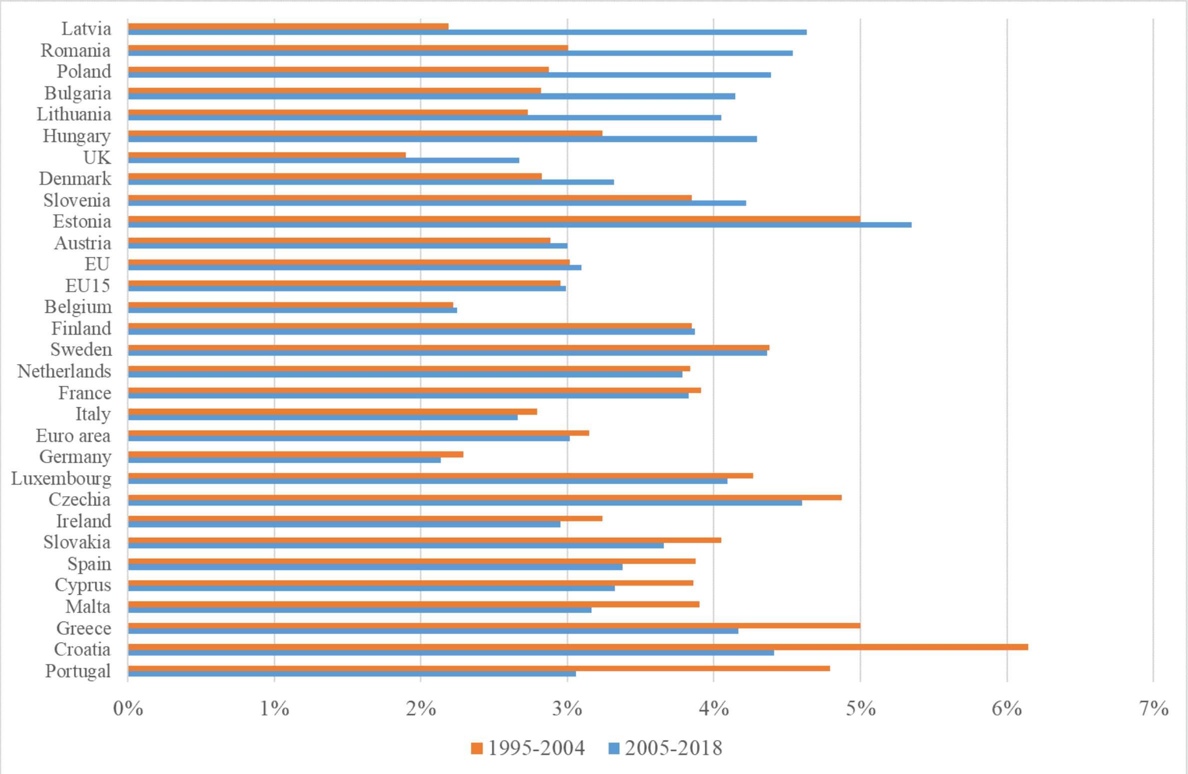
In this piece, I would like to concentrate on only one aspect of the role of the EU in the Central European convergence process – its role in influencing national fiscal policy. Has the EU helped run a counter-cyclical macroeconomic policy, supported debt sustainability or otherwise improved the quality of public finances?

The answer to these questions are relevant not just for the Member States that joined the EU in the 2000s. They are crucial for the entire EU against the background of the frequent challenges to the fiscal framework under the reformed Stability and Growth Pact. President Juncker has tasked the European Fiscal Board, of which I am a member, with the evaluation of the "six-pack" and "two-pack reforms". Some of the articles in this e-book prove that such evaluation is very apt.

At the same time, the boom years and the great 2009-2015 recession that followed proved a formidable test for any policy maker and any policy framework. In the turbulence of the last fifteen years there were simply no easy policy choices. Sometimes, matching fiscal sustainability and financial system resilience with macroeconomic stabilisation involved serious compromises. Fortunately, low initial public debt level in most of the Central European countries limited the conflict between stabilisation and market pressure in crisis.

For Poland, EU membership proved a major stabiliser in the fiscal sphere. First, it facilitated higher investment during the crisis. Second, it contributed to the cohesion funded public investment boom, which started for good only after the global financial crisis hit. The state's capacity building related to project selection and management, changes in public procurement rules, the necessary legal framework related to land ownership all took some time following accession. But the EU funds, combined with this state capacity, coupled with the catalyst of the Euro 2012 football championship, proved a formidable force. Counter-cyclical demand stabilisation and a higher quality of public spending came exactly when they were needed. I would not underestimate properly managed EU funds as a powerful policy tool. Figure 1 shows that the investment share in public spending increased the most in countries benefiting from the cohesion funds.

Figure 1 Public investment as a share of GDP in 1995-2004 and 2005-2018



Source: Ameco

Note: The countries are sorted according to the change between 2005-2018 and 1995-2004 with countries exhibiting highest public investment growth on top.

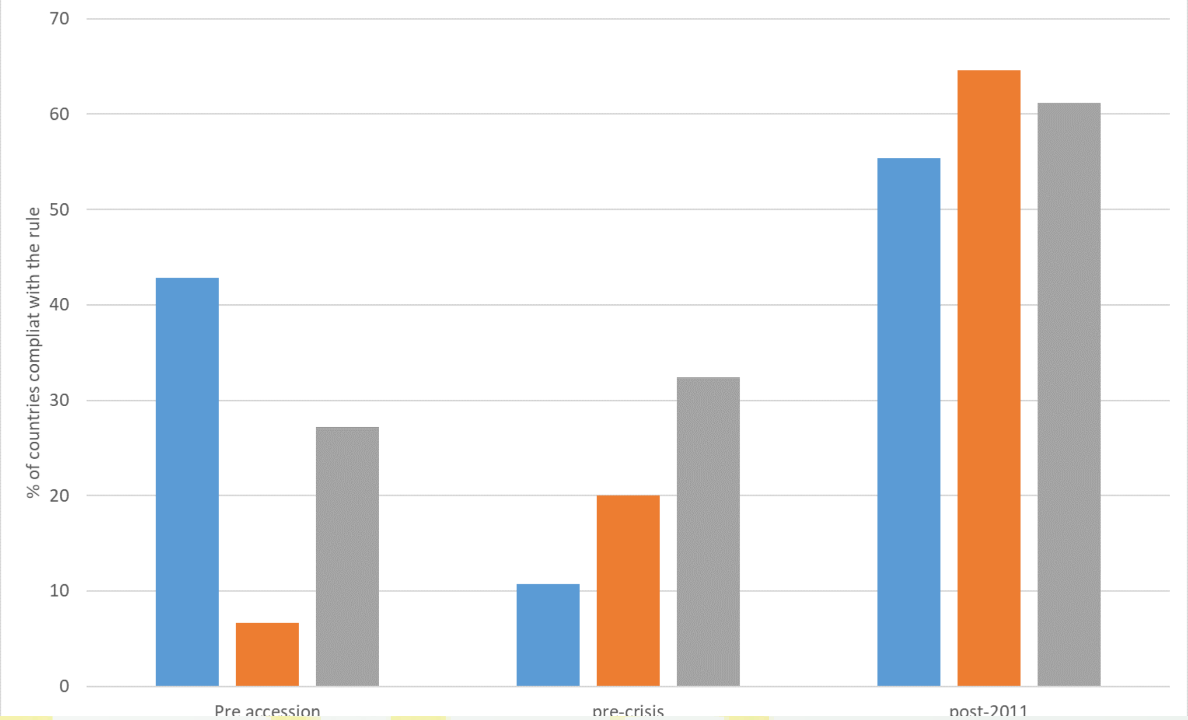
Still, the usefulness of any public investment spending in the role of helping to stabilise an economy is limited by state capacity. The gradual move away from grants to financial instruments in the EU budget places an even larger burden on the member states. The financial structuring and selection of projects will be far more difficult than today. As a consequence, some refinancing and the sale of bankable existing state assets might be necessary to free up resources for other investments.

The role of broad fiscal policy during the recent crisis is perhaps the most controversial aspect of the macroeconomic framework of the EU. Some researchers accuse the EU fiscal rules of being too pro-cyclical. Others see them as unenforceable and as such not strict enough[1]. The European Fiscal Board (2018) has been arguing that the fiscal rules to be insufficiently powerful in "good times". It is only in good times thatsanctions could be credible, it is only in good times that the asymmetrical nature of the fiscal rules (only excessively large deficits or spending can be penalised) could unequivocately lead to better macroeconomic policy.

Even though it is true that the SGP sanctions were never imposed upon a member state, it is unfair to say that they do not work. Their power is (or at least was) soft, but still non-negligible. I remember well that in 2013 and 2014, the threat of a freeze of the EU funds was an important element in the budget discussions. Of course, such soft power tends to soften further over time – with each case of a country "getting a free pass", the sanction threat becomes easier to ignore.

Figure 2 shows that the growth of net fiscal expenditure in the countries that joined the EU in the 2000s was much more in line with potential output growth following their membership than prior to EU accession.

Figure 2 Compliance with expenditure rule: percentage of countries joining in 2000s



Source: Stefano Santocroce and European Fiscal Board (2019), mimeo.

Note: A country is judged as non-compliant if the change in primary expenditure, net of discretionary revenue measures and one-offs and considering investment smoothing is greater than 10yr average potential output growth + convergence margin + GDP deflator. EA CEE indicate countries that joined the Euro Area before 2018.

The difference became visible after the crisis and after the introduction of the expenditure benchmark rules (with 60% of the countries compliant with the expenditure rule). The true test of the improvement of the fiscal frameworks comes in good times (let's say post-2015), and here, the results seem to indicate "a qualified success" – 51% of countries managed to keep spending under control with good cyclical revenues.

The national dimension of the EU fiscal rules was an important element of the "six-pack" reforms. The call to give the rules of the SGP a strong underpinning in national legislation (preferably in the constitution) was a reaction to the above-mentioned difficulties being faced by the EU Council and/or the Commission in enforcing the SGP.

In my time as the finance minister, I always resisted the temptation to "blame Brussels" when justifying unpopular decisions. It is a cheap excuse that eventually hits back - Brexit style. While the introduction of the Polish expenditure rule was, to some extent, inspired by the "six-pack", we always marketed it as an own tool (which it was), introduced to safeguard long-term Polish interests. I sincerely hope that this important policy tool survives longer than just one Polish election cycle.

At the same time, the automatic transposition of the entire SGP into national law is not a perfect solution. In order to convincingly say "we do it, because it is good for us and not because we're ordered by the Commission to do it", the rules themselves a) must make sense and b) must be explainable to the public. The 3% Maastricht deficit limit satisfied b), and is now quite well entrenched in national policy debates. Unfortunately, it fails to satisfy a), being too lax in good times and possibly too strict in bad times. At the same time, the complexity of the EU fiscal framework has become overwhelming. Copying SGP regulations ad verbatim into national constitutions was never really an option – not only because even the radically shortened 2019 SGP Vade Mecum remains 108 pages long, but also because interpretations of the rules tend to change rather fast. A case in point was the shift away from structural budget balance towards the expenditure benchmark, itself hampered by legal arrangements in Germany and Lithuania.

A simplification of the rules, keeping the right balance between counter cyclicality, fiscal responsibility and the internal balance of the monetary union; ensuring national ownership while keeping horizontal consistency in place will inevitably involve significant trade-offs. The task of building a resilient fiscal structure of the EU is far from being finished.

Admittedly, the positive experience of Poland in the EU cannot hide the fact that in some areas, the EU can face its members with additional challenges and a stricter policy regime. Relative price adjustment on the way to regain competitiveness can be slower if internal devaluation is required instead of the nominal adjustment. Real interest rates can become ill-suited to the requirements of some member states. All this increases the importance of running a countercyclical macroprudential and fiscal policy, and of keeping ample fiscal space – all of which are promoted by the EU fiscal framework.

The crucial lesson from the first 15 years' influence of the EU on the macroeconomic policy of the Central European member states is that the ultimate determinant of the policy quality has been and will stay national. The EU is no panaceum. A determined national government can still run a pro-cyclical fiscal policy, put long-term fiscal sustainability at risk, bungle the crucial institutions, waste the structural funds and put financial sector stability at risk.

However, the EU framework provides extremely useful instruments and can help member states move in the right direction. The common market, the EU budget and its instruments, common competition policy, and institutional standards all provide formidable vehicles for convergence of the Central European countries.

Endnotes

1. Sometimes both these accusations coincide in the same paper, see e.g. Bénassy-Quéré et al. (2018), "Reconciling risk sharing with market discipline: A constructive approach to euro area reform", CEPR Policy Insight No. 91.