sweden 2023.eu Swedish Presidency of the Council of the European Union

Presidency Issues Note for Working Session II:

A LONG-TERM PERSPECTIVE ON FISCAL STABILISATION POLICIES AND SUSTAINABLE PUBLIC FINANCES

Fiscal policy in the longer term – balancing objectives and instruments

Faced with the aftermath of the COVID-19 pandemic and Russia's unprovoked aggression against Ukraine, the European Union and its Member States must respond to multiple, complex challenges. Action is needed to curb inflation; promote growth while speeding up the green, digital and energy transitions; protect employment; safeguard financial stability and fiscal sustainability; strengthen military capacities and ensure a strong competitive base for European businesses.

While navigating these challenges, we should ask ourselves what national fiscal policy can and should do in the longer term. This means going beyond the direct response to today's challenges and discussing the broader orientations of how fiscal policy can contribute to a better functioning European economy and the mix of instruments that could best achieve this.

A key question is what role fiscal policy should play in overall stabilisation. There are several dimensions to balance: responding to asymmetric shocks, promoting future-oriented public investment, safeguarding the sustainability of public finances, and instilling confidence. Clearly, in an optimal mix of measures, fiscal policy should not undermine monetary policy or burden financial stability, where the respective authorities each have their responsibility.

Furthermore, it should be recognised that there is no inherent contradiction between strong public finances on the one hand, and employment and growth on the other hand. Strong public finances build confidence in the economy, by providing firms, investors, and households with stable conditions for financial decision-making.

What will be the long-term trend for interest rates?

Interest rate levels are a key issue for fiscal policy. They affect debt service, the sustainability of public finances and the effectiveness of fiscal stabilisation. Neutral interest rates that neither stimulate nor squeeze the economy should correspond to a level that applies when the economy is in balance (equilibrium employment and price stability). The neutral rate cannot be observed directly. The global downward trend in nominal and real (and arguably also neutral) interest rates that has accompanied the fall in inflation in advanced and emerging economies since the mid-1980s has been driven by a host of factors affecting the saving-investment balance. These factors include globalisation with savings surpluses in emerging economies, demographic changes with ageing populations underpinning a higher need to save, weaker potential growth, and a fall in the relative price of investment goods implying lower investment demand. The downward trend in interest rates was abruptly reversed last year following the spike in inflation.

The question arises as to whether the current higher interest rate environment is a temporary interruption or a changing trend. Whereas many argue that we will not see a return to near-zero interest rates, an environment of relatively modest rates may emerge if pre-existing underlying driving forces come to prevail over short-term disturbances again. However, a partial reversal of these drivers, due to factors such as de-globalisation and market fragmentation or structurally higher uncertainty, may imply higher interest rates for a longer time.

The implications for fiscal policy are profound. If, on the one hand, we return to a situation with low interest rates where monetary policy is closer to an effective lower bound, fiscal policy may need to take on a more active role in sustaining demand if conditions require. Consequently, in a situation with a negative output gap, fiscal policy should be expansionary enough to help lift the interest rate above the effective lower bound with enough margin to allow monetary policy room for manoeuvre. If, on the other hand, higher interest rates prevail, especially in a situation of stagflation, debt-service expenditure will increase and debt sustainability will need to have a higher priority, thus constraining the role of fiscal policy in demand stabilisation.

Discretionary fiscal policy or automatic stabilisers?

Recent exceptional crises have been met with sizeable packages of discretionary fiscal measures, including coordinated action and EU-level programmes. A key downside of discretionary fiscal measures in stabilisation is that they are implemented with variable and not fully known lags, and thus prone to over- and undershooting and may in the current environment fuel inflation. This applies, in particular, to measures with the largest positive structural impact, such as productive public investment. Moreover, discretionary fiscal measures have a well-documented expenditure bias. Also, fiscal policies in EU Member States have tended to be procyclical.

Automatic stabilisers offer a rapid response to cyclical fluctuations as they are temporary by nature and therefore automatically reversing. However, there are downsides to automatic stabilisers as they may potentially be too weak in some countries or conversely excessively strong. They could, for example, increase aggregate demand in a stagflation episode and thereby complicate the fight against inflation. High marginal taxes and permanently high replacement ratios may also have a negative effect on the functioning of the labour market.

Against this background, attention has been drawn to 'semi-automatic stabilisers'. These may comprise targeted tax or spending measures that are activated when a certain pre-defined threshold for unemployment or growth is reached. Examples include short-time work policies, longer or higher unemployment benefits, social transfers, public investment in infrastructure, temporary job programmes, income tax credits or time-limited decreases in indirect taxes. Such measures were successfully used in the EU during the COVID-19 pandemic, suggesting they could have a more prominent role in future stabilisation, given the overall aim to improve the sustainability and resilience of public finances.

Growth-enhancing structural reforms and their relation to fiscal policy

Raising potential growth through structural reforms and public investments with a sufficient societal return has beneficial effects on public finances. Growth normally leads to stronger public finances, both through the expenditure and revenue sides. In addition, it has a favourable impact on the interest rate–growth differential. If growth is higher than the interest rate, debt dynamics will be positive, increasing the room for manoeuvre for fiscal policy.

However, the inherent uncertainty in assessing the impact of reforms or making interest rate and growth projections warrants prudence in estimating policy space. The productivity-enhancing effects of new expenditure are sometimes exaggerated.

Weak productivity growth and related concerns regarding innovation remain major challenges for our economies. There is a need to accelerate investment and improvements in economic structure and implement growth- and productivity-enhancing reforms to enable the green, digital and energy transitions. A step-up towards robust and sustainable finances will support the associated growth-enhancing effects, regardless of the role assigned to active fiscal policy in addressing shorter term fluctuations. The longer term prospects for inflation and interest rates will shape the way in which the public sector can contribute directly to promoting productivity and competitiveness. Another role, which is at least equally important, concerns improvements in the functioning of our economies that will allow the EU to compete successfully in tomorrow's world market. Such a reform focus involves the mobilisation of private investment and financing (which will be discussed in Working Session I), alongside public sector investment. It will require efforts to improve efficiency in public spending and preserve a level playing field in the EU and globally to reap the unique benefits of the single market.

Questions for discussion:

- What priorities should apply to fiscal policy under scenarios of low and higher interest rate levels?
- What is an optimal mix between automatic (or semi-automatic) stabilisers and discretionary fiscal policy?
- How should Member States allow for the necessary future-oriented public investments supporting the long-term sustainability of their public finances? What role should productivity-enhancing structural reforms play when it comes to increasing the room for manoeuvre for fiscal policy?