

# FISCAL POLICY AND LONG-TERM ECONOMIC GROWTH: LESSONS FROM THE EURO AREA<sup>1</sup>

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## ABSTRACT

At the beginning of 2020, the European Union embarked on a process of reviewing its macroeconomic policy strategy and economic governance framework. While the review of the monetary policy framework was approved in July 2021, the review of the fiscal policy framework was put on hold as a result of the outbreak of the covid-19 pandemic and the ensuing economic crisis. The Covid-19 crisis led to a breach of fiscal rules in the European Union and an unprecedented increase in the size of fiscal imbalances. In this context, there is a need for a radical reform of the fiscal rules still in force to allow for a more active role of national fiscal policies and to avoid the serious economic problems resulting from the fiscal austerity policies emanating from the Maastricht Treaty, the Stability and Growth Pact and the successive reforms of the latter.

**KEYWORDS:** European Union; Euro area; Fiscal policy; Coordination and surveillance of national fiscal policies.

## 1. INTRODUCTION

Among the determinants of the processes of development, economic growth and long-term structural change, the Structural Development Macroeconomics highlights the key role played in these processes by the macroeconomic policy regime (the strategy of fiscal, monetary and exchange rate policies) applied in the different economies (Oreiro, da Silva and Dávila-Fernández, 2020).

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Although Structural Development Macroeconomics has focused on the study of developing and emerging economies, mainly in Latin America, this article focuses on the effects generated by macroeconomic policy strategies on the long-term economic growth path in the European economies that make up the euro area. The reason for this is the growing consensus that macroeconomic policy in the euro area, especially fiscal policy, based on strong economic orthodoxy, has adversely affected economic growth, while at the same time generating growing economic and social imbalances. Thus, some economists argue that the macroeconomic policy is of the main causes of the secular stagnation affecting the euro area and its lower dynamism compared to other advanced and emerging economies (Blanchard, Felman and Subramanian, 2021).

In this sense, at the beginning of the year 2020, the European Union embarked on a process of reviewing its macroeconomic policy strategy and economic governance framework. The economic recovery, that began in the middle of the previous decade, was showing clear signs of exhaustion. The economic growth rate in the European Union in 2019 was 1.6%, 1.3% in the case of the euro area, with Germany growing at a rate of 0.6%, and Italy at 0.3%. Indeed, in eight countries (Ireland, Greece, Spain, Italy, Cyprus, Luxembourg, Denmark and Sweden), unemployment rates were still higher than those recorded before the global financial crisis.

At that time, just before the outbreak of the COVID-19 pandemic, there was a broad consensus in Europe on the need to review the general macroeconomic policy framework in force in the European Union, based on the monetary policy strategy designed by the European Central Bank and the fiscal rules of the Maastricht Treaty and the Stability and Growth Pact, in order to ensure a return to a long-term path of sustained growth.

However, at that time there was no consensus on the nature of the problems affecting the effectiveness of this strategy. In the field of monetary policy, some voices argued that the problems of the European Central Bank's monetary policy were explained by the existence of temporary problems, derived from the difficulties of applying traditional measures (based on the management of interest rates) in an environment of low interest rates and inflation rates close to zero and potential new episodes of financial instability. However, other voices raised the need to reformulate the objectives and instruments of monetary policy arguing that the mentioned problems of low equilibrium interest rates and low inflation were not temporary but permanent, which could lead to unconventional measures of mone-

*FISCAL POLICY AND LONG-TERM ECONOMIC GROWTH:  
LESSONS FROM THE EURO AREA*

---

tary policy becoming an ordinary instrument of monetary policy.

In the case of fiscal policy, the debate was of greater depth between those in favour of maintaining the fiscal rules in force and adopting reforms to ensure compliance and those who defended the need for a radical reform of these rules.

Thus, the latter argued that a large part of the economic problems of the EU and the euro area, especially the low economic growth, were a direct consequence of the austerity policies derived from those rules.

Although the review of the monetary policy strategy ended in July 2021<sup>2</sup>, the review of the fiscal policy strategy process was early suspended because the outbreak of the Covid-19 pandemic<sup>3</sup>. The crisis generated by the pandemic led to the suspension of the fiscal rules in force in the European Union in view of the imperative need to tackle the economic effects of the pandemic through the unprecedented use of fiscal stimulus measures. The aim is to finish this review process by 2023.

The aim of the article is to show the negative economic effects of the current macroeconomic coordination and surveillance of national fiscal policies in the European Union and the euro area, which may help the desirable reform of these rules<sup>4</sup>. To this end, in the next section we will present the economic and political underpinnings of the current framework of fiscal governance in the euro area. Subsequently, we analyse the main negative effects arising from the application of fiscal rules in the euro area. The last section presents the main conclusions of the article.

## **2. ECONOMIC AND POLITICAL FOUNDATIONS OF THE FISCAL POLICY FRAMEWORK IN THE EURO AREA**

Before analyzing the current framework that defines the fiscal policy strategy in the European Union, it is convenient to make a brief presentation of the theoretical and political foundations of the current framework of coordination and surveillance of national fiscal policies.

The theoretical foundations of this strategy are based on New Keynesian Economics also known as New Consensus Macroeconomics (Arestis, 2010, 2011a, 2011b and 2017). Macroeconomic policy is based on monetary policy, specifically on inflation targeting strategies. This strategy would allow reaching economic equilibrium (matching current activity to potential), guaranteeing the existence of low and stable inflation rates, making inflation expectations coincide with the infla-

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2 The interested reader can consult the ECB's Monetary Policy Strategy Review at the ECB's website: <https://www.ecb.europa.eu/home/search/review/html/index.en.html>.

3 The interested reader can consult the EU Economic Governance Review at the European Union website: [https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/economic-governance-review\\_es](https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/economic-governance-review_es).

4 In this article we will not go into the desirable or probable lines of reform for reasons of space.

tion target, and stabilising economic fluctuations generated by demand shocks by bringing current output closer to potential, thus eliminating inflationary pressures.

Fiscal policy takes on a secondary, non-active role, focused on avoiding potential distortions arising from large fiscal imbalances. To avoid these problems, it is considered necessary to abandon monetary or privileged financing schemes and to finance public deficits by issuing public debt at market conditions. Fiscal policy, and budget balances, is based exclusively on automatic stabilisers, in such a way that the generation of structural deficits is prevented, which means that in the long run a balanced budget would be guaranteed.

This strategy does not to have a negative impact on economic activity, since the fiscal policy multiplier would be zero, so that expansionary fiscal policies would not have a stimulating effect on the economy. There are several reasons for this: Ricardian equivalence, crowding-out effects on private investment, greater inflationary pressure, expulsion due to exchange rate appreciation, non-Keynesian effects, etc.

On the other hand, the expansionary fiscal adjustment hypothesis suggests that, budgetary consolidation processes could have a stimulating effect on economic activity, especially if the adjustment of public deficits takes place in an environment of high level of public debt, and if fiscal adjustment is accompanied by tax cuts, especially in the most distorting taxes, such as direct taxes and social security contributions.

Finally, as advocated by supply-side economics and certain approaches in the literature on the quality of public finances, there would be an optimal size of the public sector, above which public spending would negatively affect economic activity and long-term economic growth, a size that, in the case of European economies would have been exceeded in several countries.

But, besides these economic reasons, it must be emphasized the political foundations of fiscal rules in the European Union. These rules are heirs to the process of European integration, a process that is marked by a series of problems derived from the poor coordination of national policies and that translate into poor results in terms of growth and employment and unemployment.

In 1986 the Single European Act was signed. Its aim was to culminate the process of European integration, achieving full economic liberalisation in 1993. The final objective was to accelerate economic growth in the European Union, solving the problem of low economic growth (the so-called Eurosclerosis). This stagnation was attributed to the low degree of economic integration of the national markets, so that progress in the integration process was considered an essential condition for bringing European economic performance closer to that of the most dynamic advanced and emerging economies.

*FISCAL POLICY AND LONG-TERM ECONOMIC GROWTH:  
LESSONS FROM THE EURO AREA*

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The full liberalization of international capital movements (achieved in 1991) gave way to the crisis of the European Monetary System in 1992 and 1993. Full financial liberalization showed the problems of maintaining a fixed exchange rate regime without a proper coordination of national monetary and fiscal policies.

It must be emphasized that, from the very beginning of the process of European integration in the 1950s, exchange rate stability was considered an essential element for progress in the process of economic integration. The Bretton Woods regime guaranteed this stability, and its breakdown in the early 1970s gave way to a series of initiatives to guarantee exchange rate stability in Europe that led to the creation in 1979 of the European Monetary System.

The problems of exchange rate instability stemmed from the autonomy of national monetary and fiscal policies, whose discrepancies led to frequent adjustments of exchange rate parities. These adjustments were not very large because of the controls of international capital movements. However, when Germany raised interest rates to finance the huge public expenditures resulting from the reunification process, the differences in national economic policies led to unsustainable tensions in capital and exchange markets, exacerbated by the full freedom of international capital movements, which led to the collapse of the EMS.

The response was the Maastricht Treaty, which raised the need to advance in the process of monetary unification to guarantee full economic integration and liberalisation. The way to guarantee exchange rate stability was the replacement of national currencies by a new single currency: the euro. Monetary unification meant changing the monetary policy strategy by giving way to a single monetary policy managed independently by the European Central Bank, based on an inflation targeting strategy, and setting rules to coordinate and supervise national fiscal policies, rules that affected both the process of transition to monetary union (the so-called nominal convergence criteria) and the functioning of monetary union once it had been created.

Monetary union, however, did not imply a federal or centralised fiscal policy. Fiscal policy remains in the hands of the member states, among other reasons because the competences in the field of taxation in the European Union are exclusive to the member states. The role played by the EU budget is very small due to its small size, which cannot exceed 1.4% of the gross national income of the EU (exceptionally and temporarily after the pandemic it can reach 2%). In fact, for the period 2021-2027, if we add to the EU budget the funds of the Next Generation EU Programme, all these resources only amount to about 3.5% of the European GDP.

This means that the European budget cannot work serve as an instrument of economic stabilization, a function that is left to national fiscal policies. Hence the need to propose a framework for coordination and monitoring of these policies to avoid the dysfunctions that could result from the lack of coordination of these policies.

The existence of a single monetary policy without a genuine single fiscal policy within the euro area (remember that the budget of the European Union cannot exceed 1.2% of the gross national income of the EU) made it necessary to establish rules that would guarantee an adequate coordination of national fiscal policies with each other and with the single monetary policy.

Thus, the Maastricht Treaty established fiscal rules that affected both the candidates to join the Eurozone (the nominal convergence criteria) and the member countries, establishing sanctions for the latter in the event of non-compliance. The aim of these rules was to avoid the generation of Excessive Public Deficits (object of sanctions), understood as the existence of public deficits higher than 3% of GDP and a gross public debt of all public administrations higher than 60% of GDP.

Furthermore, the Maastricht Treaty prohibited monetary or privileged financing of fiscal imbalances in both Community and national budgets, as well as the bail-out of a country by other States or European institutions (the non bail-out clause), which implies the absence of international solidarity.

It must be emphasized that the fiscal numerology of the Maastricht Treaty, that is, the choice of the specific figures for government deficit and government debt that characterise fiscal imbalances as excessive, was not only an economic question, linked to the need to guarantee the sustainability of these imbalances, but also a political one, explained by the desire of some countries (especially Germany) to limit the number of states participating in the monetary union by tightening the conditions of access.

In this sense, we must remember that given a certain size of the public debt as a percentage of the GDP ( $\overline{b}_t$ ) the size of the public deficit as a percentage of the GDP ( $\overline{d}_t$ ) that guarantees the sustainability of the public debt, that is that the size of the public debt remains constant is equal to the product of the stock of the public debt at the beginning of the period  $t$  times the nominal rate of growth of the GDP ( $\overline{y}_t$ ):

$$d_t = y_t \times b_t \quad (1)$$

This equation implies for a public debt equivalent to 60% of GDP, if the economy grows at a annual rate of 2% with a 3% inflation rate, we need to have a deficit of 3% of GDP to maintain the stock of debt (60% GDP x 5% = 3% GDP). In other words, with those nominal growth rates, the sustainability of my fiscal imbalances is guaranteed.

*FISCAL POLICY AND LONG-TERM ECONOMIC GROWTH:  
LESSONS FROM THE EURO AREA*

---

It is important to understand the implications of these figures: if nominal economic growth is 4%, to keep public debt constant at 60% of GDP, the public deficit can not exceed 2.4% of GDP; and with the same growth, a deficit of 3% would imply a public debt of 75% of GDP.

Why do we say that these figures were designed to limit the number of members of the monetary union? To understand this we must remember the other convergence criteria: countries could not have an inflation rate 1.5 points higher than that of the least inflationary countries, and the long-term interest rate (measured by the interest rate on long-term public debt) should not be 2 points higher than that of the 3 countries with the lowest inflation rate.

The public deficit and debt and also of nominal growth were close to the figures recorded in Germany before the signing of the Maastricht Treaty. On the other hand, Germany also recorded one of the lowest inflation rates in the European Union. On the contrary, the European Union countries with the largest fiscal imbalances (the Mediterranean countries and Ireland, among others) were the countries with the highest inflation rates. Meeting the inflation criterion meant applying tight monetary and fiscal policy, raising interest rates and adjusting public deficits. Raising interest rates meant not meeting the interest rate criterion, and the anti-inflationary policy would have a negative effect on economic growth, affecting the control of fiscal imbalances. On the other hand, a severe fiscal adjustment policy would entail a drastic decline in nominal economic growth, making fiscal imbalances unsustainable.

In sum, entry into monetary union implied a high cost for the most inflationary and indebted economies. The economic (and social) cost of implementing severe adjustment policies in a short period of time was supposed to have a deterrent effect on countries with larger macroeconomic imbalances. It was expected that they would join the euro much later, once these economies had corrected their internal imbalances. Therefore, it was expected that only a small number of economies, the most stable ones, would give way to the creation of the euro area.

Although monetary union was initially scheduled to begin in 1997, with a majority of states complying with the convergence criteria, the economic crisis resulting from the crisis of the European Monetary System meant that by the end of 1996 only Luxembourg met all the criteria. This delayed the start of monetary union to 1999, the year in which monetary union could begin regardless of the number of countries starting this stage.



In 1996 it was already clear that the launch of the euro area was going to imply a lax discretionary interpretation of compliance with the convergence criteria. This increased the fears of those who thought that once monetary union had begun, the member countries would relax their fiscal policies, making it difficult to coordinate them.

For this reason, in 1997 the Stability and Growth Pact was signed, setting the fiscal rules to be applied once monetary union had been formed, clarifying the circumstances under which a deficit could be defined as excessive. The Pact defined the exceptional circumstances under which budgetary imbalances above the reference values could not be defined as “excessive deficits” (avoiding the corresponding sanctions), as well as the maximum admissible duration of such imbalances (elements that were not specified in the Maastricht Treaty).

The signing of the Stability and Growth Pact (SGP) in 1997 implicitly reformed the Maastricht Treaty by obliging the candidate countries and members of the euro area to adopt a much more restrictive budgetary policy than that set out in the Treaty. The SGP used automatic and discretionary criteria to assess the situation of national public finances. Thus, a deficit above 3% of national GDP would not be considered as excessive in the case of a decline in real GDP of more than 2%, and any deficit above 3% of GDP would be considered as excessive if real GDP growth exceeds -0.75%. However, if the fall in real GDP ranges between -2% and -0.75%, the interpretation of a deficit above the reference values would be subject to a discretionary decision by the European Council. In addition, the SGP stipulated that the duration of the exceptionality is limited to one year irrespective of the length of the recessionary period.

In addition, the SGP set a medium-term objective (MTO) for countries to achieve a budget balance in surplus or at least close to balance. In 2005, the SGP was reformed, obliging countries to set specific medium-term budgetary objectives. These targets vary for each euro area Member State or candidate country depending on national economic and budgetary positions and developments, as well as the fiscal risk to the sustainability of public finances, including the prospect of demographic changes.

These medium-term objectives are set in structural terms, discounting the effects of the business cycle on government revenue and expenditure and one-off fiscal measures. National medium-term structural balance targets can range from a structural balance (or surplus) to a structural deficit of 1% of potential GDP.

Clearly, the ultimate purpose of the fiscal rules affecting the euro area is to ensure long-term budgetary stability by minimising, if not preventing, the genera-



*FISCAL POLICY AND LONG-TERM ECONOMIC GROWTH:  
LESSONS FROM THE EURO AREA*

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tion of structural deficits. In this way, the active use of discretionary fiscal policy as an instrument of macroeconomic policy was reduced to a minimum, so that fiscal policy was limited to the operation of automatic stabilisers.

Although the outbreak of the Global Financial Crisis and the ensuing Great Recession led to the widespread implementation of expansionary policies, this action was purely temporary. In fact, in order to reinforce fiscal austerity, as of 2011 the European Union approved new measures to ensure that European states adopt the necessary budgetary measures to reduce their fiscal imbalances, bringing them closer to the limits established in the Maastricht Treaty and, in the long term, to ensure that the budget balance is in surplus, or at least close to a balanced budget. In 2011 the Directive on Requirements for budgetary frameworks of euro area countries (known as the “Six pack”) was adopted. A year later, in 2012, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union was approved, of which the so-called Fiscal Compact forms part. Finally, in 2013, the “Two pack” was approved, two regulations that regulate the procedure for the supervision of budgetary plans and measures for the adjustment of excessive deficits in the euro area countries.

The implications of these provisions for fiscal policy are clearly set out in Article 3 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, according to which general government budget balances shall be in balance or in surplus. Budgetary stability will be considered to be achieved even if a country records a deficit, provided that the structural balance complies with the medium-term objective (which may not be less than -0.5% of GDP). It also establishes that deviation from the medium-term objective or from the adjustment path towards it can only be recorded temporarily under “exceptional circumstances”.

In sum, the fiscal rules approved after the outbreak of the Global Financial Crisis accentuated the restrictive character of the fiscal rules set in the Maastricht Treaty and the Stability and Growth Pact. These new rules further limit the possibility of applying discretionary fiscal measures, reducing fiscal policy to the operation of automatic stabilisers.

In addition to the measures to reinforce compliance with the medium-term budgetary objectives, determining that countries must meet this objective or be in the process of achieving it by adjusting their structural balance annually at a rate of 0.5% of GDP, the establishment of an Expenditure Benchmark was also approved. According to this expenditure rule, if a country strictly complies with its MTO, the growth rate of public spending must not exceed the potential growth rate in the medium term unless this higher spending is accompanied by discretionary fiscal measures that increase public revenue.

### 3. THE ECONOMIC EFFECTS OF FISCAL POLICY IN THE EURO AREA

Although it is clear that the fiscal rules in the euro area are based on the principle of fiscal austerity, understood as the absence of budget deficits, from the orthodox point of view that underpinned this strategy it was considered that it would not have a significant negative impact, at least in the long term. On the one hand, the principle of expansionary fiscal consolidations was accepted, in such a way that by reducing public deficits, economic growth would be accelerated by favouring lower interest rates and by allowing the use of capital dedicated to financing public indebtedness by the private sector, especially by private investment. On the other hand, it was accepted that the level of public spending was excessive, focused on unproductive items, so that a fiscal adjustment strategy based on spending cuts would stimulate economic growth. If, in addition, spending cuts were accompanied by tax cuts, especially in direct taxes<sup>5</sup>, the economic stimulus would be even greater (Ferreiro, Carrasco and Gomez, 2014).

However, after two decades of the monetary union, the results of this process in terms of boosting economic growth are far from positive.

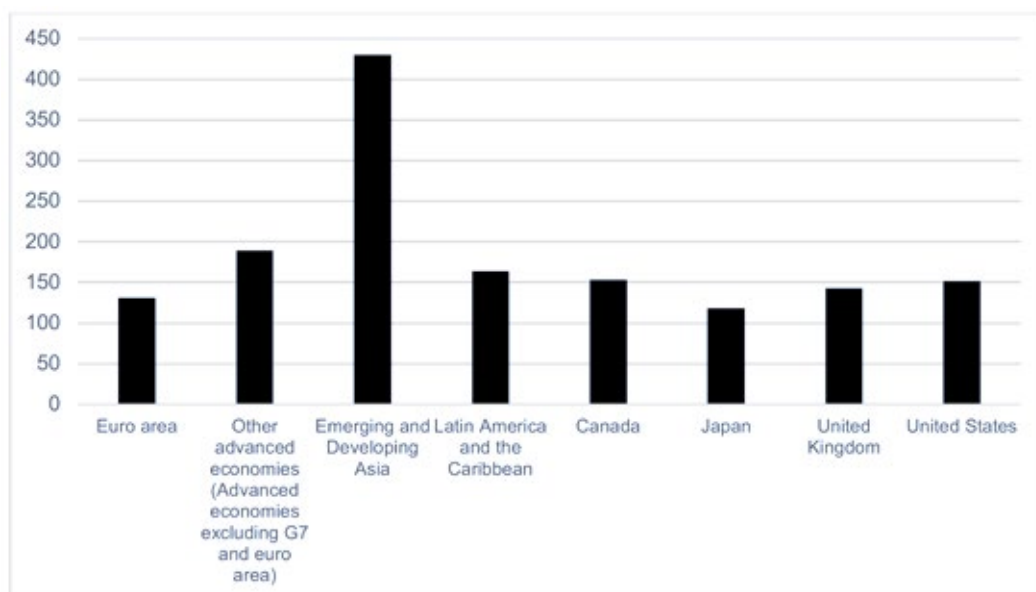


Figure 1 – Gross Domestic Product in 2019 (GDP year 1999=100)

Source: Our calculations based on International Monetary Fund, World Economic Outlook Database, April 2021.

<sup>5</sup> Obviously, this implies that, in order to avoid a negative effect in the form of higher deficits, tax cuts must be accompanied by at least an equivalent decrease in public spending.

FISCAL POLICY AND LONG-TERM ECONOMIC GROWTH:  
LESSONS FROM THE EURO AREA

Figure 1 shows the growth of the GDP of various countries and world regions between the years 1999 and 2019. The results are clear, reflecting the weaker dynamism of the euro area not only compared to emerging and developing economies but also compared to other developed economies, including other European countries that are not part of the euro area<sup>6</sup>.

This slow growth has meant that both short and long-term economic growth rates in the euro area have been declining over time. Thus, if we approximate the long-term growth potential with the potential growth rate, as shown in figure 2, the potential growth rate of the euro area has been progressively weakening, reaching 1.1% in 2019.

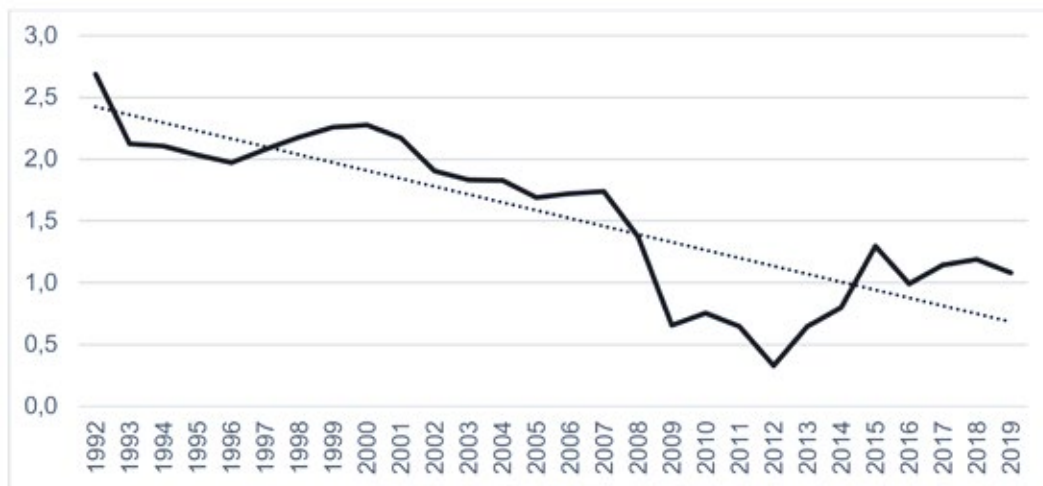


Figure 2 – Growth rate of potential output in the euro area (12 countries) (%)  
Source: Our estimations based on AMECO Database

It must be noted that this poor performance is replicated in the case of the largest euro economies: Germany, France, Italy and Spain. According to the AMECO's estimations, in 2019 the rate of growth of potential GDP in Germany would have been 1.1% in Germany, 1.2% in Spain, 0.8% in France, and -0.1% in Italy (in Greece, that rate would have been -0.5%).

This lower growth has not come with a higher degree of macroeconomic stabilisation. As figure 3 shows, the business cycle in the euro area is not smoother (as measured by the output gap), and consequently it can not be argued that the strategy of economic and fiscal policy has contributed to smoother evolution of euro economies.

<sup>6</sup> Between 1999 and 2019, the GDP in the euro area rose by 31%. During these years, GDP rose by 42% in the United Kingdom and by 57% in Sweden.

Jesus Ferreiro, Carmen Gomez



Figure 3 – Output gap in the euro area (12 countries) (% potential GDP)  
Source: Our estimations based on AMECO Database

One factor that may explain why the current macroeconomic policy strategy in general and fiscal policy in particular in the euro area has not contributed to a smoothing of economic fluctuations is the fact that fiscal policies in euro area countries have been characterised by a pro-cyclical orientation<sup>7</sup> (Carnot and De Castro, 2015; Ferreiro, Galvez and Gonzalez, 2015; Claeys, 2017; Darvas, Martin and Ragot, 2018; Francová et al., 2021; Larch, Orseau and van der Wielen, 2021).

This pro-cyclical stance of fiscal policy implies that euro countries have tended to apply expansionary policies in phases of expansion, increasing expenditures and reducing taxes in these periods. On the contrary, in phase of downturns or recessions, when fiscal imbalances have increased as a result of the recession due to the working of built-in stabilizers, countries have tended to adopt adjustment measures, mainly based on spending cuts to reduce these imbalances.

This pro-cyclical working of fiscal policy, especially during recessions, would be a key element in understanding how the negative shocks affecting the euro area have a lasting, if not permanent, impact on long-term growth, as well as in understanding the scale of the structural imbalances affecting these economies, such as unemployment, among others.

It must be emphasized that fiscal adjustments in the euro area have been based not so much on increasing revenue as on cutting expenditure (Ferreiro, Galvez and Gonzalez, 2015; Ferreiro, Galvez, Gomez and Gonzalez, 2016). Contrary to

<sup>7</sup> The pro-cyclical bias of fiscal policy in the euro area does not occur, at least with the same intensity, in non-euro EU countries (Ferreiro, Galvez and Gonzalez, 2015).

*FISCAL POLICY AND LONG-TERM ECONOMIC GROWTH:  
LESSONS FROM THE EURO AREA*

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the optimistic view on the effects of austerity policies on economic activity, most studies on fiscal policy multipliers carried out since the outbreak of the Global Financial Crisis conclude that fiscal policy multipliers are higher than 1, with these multipliers being much higher in periods of recession. This is why the fiscal adjustment measures applied in recessionary phases would have had a profound negative impact on economic growth in the euro area (Ferreiro, Gomez and Serrano, 2014). This negative effect would have been aggravated by the composition of the spending cuts, which would have focused on the items that the literature on the quality of public finances considers as “productive spending”, i.e. spending that favours economic growth, such as public investment, education, training, healthcare, etc. In this way, long-term economic growth potential would have been equally affected by fiscal adjustment measures (Ferreiro, García del Valle, Gomez and Serrano, 2011).

On the other hand, fiscal adjustment and austerity policies will have generated a strong increase in inequality in income distribution and poverty (Furceri, Lounгани, Ostry and Pizzuto, 2021; Canale and Liotti, 2021; Zouhar, Jellema, Lustig and Trabelsi, 2021). Increasing inequality in personal, but also functional, income distribution would be another element that would help explain the negative effect of fiscal austerity policies on economic growth, both in the short and long run.

Fiscal austerity policies, by having a negative effect on economic growth, paradoxically affect the objective of achieving a balanced budget and the process of reducing the size of public debt, objectives whose achievement depends not only on the adoption of measures to reduce the nominal size of budgetary imbalances but also on the existence of a context of economic expansion that reduces the nominal value of public deficits through the play of automatic stabilisers and the size in relative terms, as a percentage of GDP, thanks to the increase in economic activity.

Jesus Ferreira, Carmen Gomez

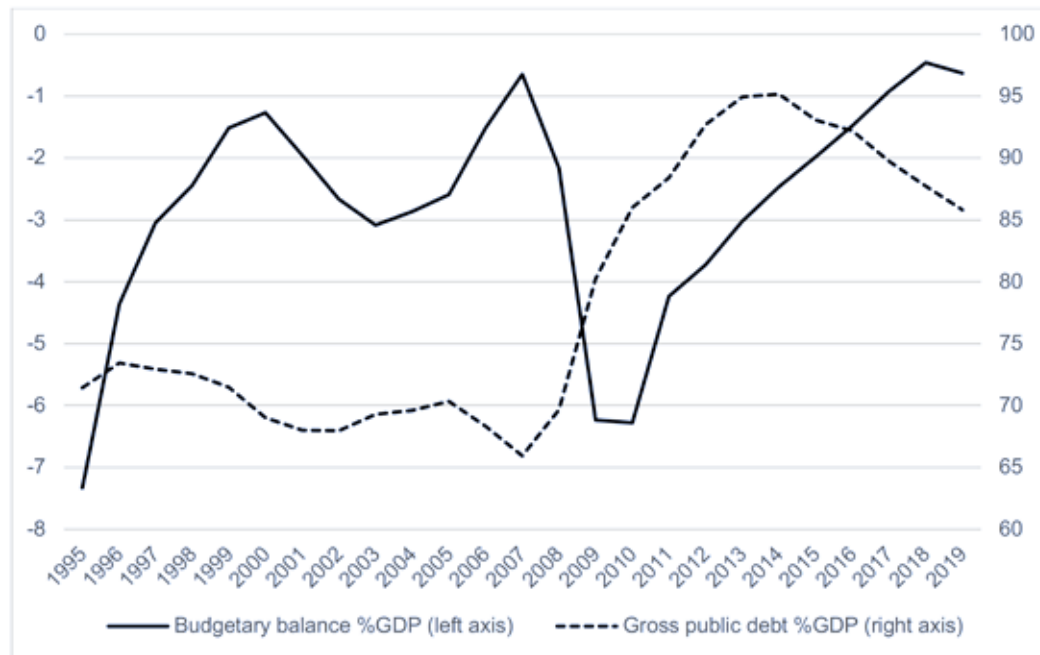


Figure 4 – General government balance and gross debt in the euro area (% of GDP)  
Source: AMECO Database

Figure 4 shows the evolution between the years 1995 and 2019 of the size of the fiscal imbalances in the euro area. In the case of the public debt, its size has never been below the threshold of the 60 percent of GDP. The Global Financial Crisis led to an enormous increase in its size, peaking 95% of GDP in 2014; and although since then began a process of decline, in the year 2019 it amounted to 86 % of GDP, with countries like Greece, Italy and Portugal recording figures well above 100% of GDP.

As far as the behaviour of budget balances is concerned, it is clear that the ultimate goal of reaching a balanced budget is far from being achieved. As the European Mechanism Stability points out, the 3% of GDP limit for public deficits seems to have acted not as a ceiling but as a magnet or target, in such a way that, although it would have contributed to avoiding the generation of large fiscal deficits or surpluses, it would nevertheless have meant that, on average over the long term, the normal behaviour of public finances would have oscillated around this negative balance of 3% of GDP and not around a balanced budget (Francová et al., 2021).

#### **4. CONCLUSIONS**

The experience of the euro area clearly shows how the existence of fiscal rules that promote the indiscriminate application of fiscal austerity policies can have a negative effect on economic activity and long-term growth, as well as another series of collateral negative effects (in terms of employment, inequality, welfare, etc.). In fact, the existence or even the strengthening of these rules does not even guarantee the objectives of achieving a balanced budget and reducing the size of public debt.

The enormous impact that the economic crisis resulting from the covid 19 pandemic has had on the public finances of the countries of the European Union and the euro area must be taken into account. According to the latest economic forecasts produced by the European Commission available at the time of writing this article (Autumn 2021), the public deficit in 2022 for the euro area as a whole will reach 3.9% of GDP, with six countries registering deficits in excess of 5% of GDP. In the case of public debt, the projected size in 2022 will be 97.9% of GDP, with 6 countries exceeding 100% of GDP.

Indeed, in March 2020, when the European Commission was projecting falls in the European Union's real GDP of 1% for that year, the Commission approved, for the first time, the activation of the general safeguard clause of the Stability and Growth Pact (which was approved in 2011 in the "Six Pack"), allowing States to deviate from the medium-term budgetary objectives and, therefore, to apply expansionary discretionary fiscal policies aimed at mitigating the economic impact of COVID-19. The activation of this clause implies that fiscal rules within the European Union are nowadays suspended. And, although the European Commission expects to deactivate the clause in 2023, the bad economic forecasts presented in Autumn 2021 does not rule out the possibility that it will continue to apply in 2023.

It is clear that the current fiscal rules are impossible to apply, not only in the current context of economic crisis and post-Covid 19 recovery, but also in the longer term, that is, in a future scenario of stable and sustained growth. This requires a reformulation of the strategy of coordination and surveillance of European fiscal policies, and a profound revision of the current fiscal rules.

This reality implies that the reforms to be proposed in the fiscal surveillance framework of the European Union, and therefore of the euro area, must necessarily be more far-reaching than those that might initially have been in the European Commission's mind in January-February 2020. Thus, for the European Commission the European fiscal rules had fully demonstrated their effectiveness, requiring



only minor reforms to guarantee that the main problems affecting compliance with the rules could be corrected, such as the existence in some countries of a public debt higher than the reference criterion (60% of GDP) and the adoption by many countries of pro-cyclical fiscal policies<sup>8</sup>.

Despite the rising consensus on the need to reform fiscal rules in force, it is not clear that there is a political will to radically reform them due, first, to the lack of consensus among countries and, second, to the need to approve any reform with the unanimous support of all EU countries, and thus the medium and long-term economic outlook in the medium and long term is far from optimistic. In other words, it is difficult to believe that the predictable reform of fiscal rules in the European Union and the euro area is in line with the growing body of opinion that, even within the economic mainstream, advocates the need to reformulate fiscal policies in the interest of greater fiscal activism (see Blanchard, 2019; Blanchard, Felman and Subramanian, 2021; Blanchard and Summers, 2017 and 2019; Orszag, Rubin and Stiglitz 2021).

However, there is a widespread fear that the fiscal situation of European countries may worsen in the event that the economic recovery is slower than expected, that the cost of public debt may rise, especially if the expansionary stance of monetary policy changes and the ECB starts to taper or withdraw its asset purchase programmes or raises official interest rates, or, more seriously, if European economies suffer a new crisis. This may accelerate the reform of fiscal rules. Otherwise, the current exceptional situation would turn into a new normal, which would imply a de facto repeal of fiscal rules.

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<sup>8</sup> See the documents available at: [https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/economic-governance-review\\_es](https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/economic-governance-review_es)

FISCAL POLICY AND LONG-TERM ECONOMIC GROWTH:  
LESSONS FROM THE EURO AREA

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Jesus Ferreira, Carmen Gomez

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