The role of fiscal policies in the Covid-19 crisis: scope and limitations

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The fiscal response to the Covid-19 pandemic was comprehensive and bold nationally and innovative through unprecedented joint borrowing by the EU with part of the proceeds to be transferred to Member States. The scope for fiscal policies proved to go far beyond what was envisaged in the Maastricht Treaty, reflecting a fundamental shift in the perspective of mainstream economics, accentuated by shifts in political preferences. The current policies mark a return to the confidence in the potential of fiscal policies of the first attempt at EMU, the Werner Plan of 1970, but today in a more promising environment. Still the limitations to such confidence in the shape of unprecedented debt levels should be closely watched, though they may seem remote.

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Fiscal policies proved essential in mitigating the Covid-19 crisis and in preparing the recovery of the European economies. The fiscal response in the Member States of the European Union (EU) was unprecedented in size and supplemented by efforts at the EU-level well beyond what could have been foreseen prior to the pandemic. In the aggregate EU government budgets worsened by 8% of GDP, evenly divided between the automatic deterioration in a downturn and discretionary measures. The debt ratio rose from 86 to 102% in 2020, reversing more than double the slow downward movement since the sovereign debt crisis. Fiscal policies were bold, but also essential, and the expansionary stance is not about to end; the balance of comments is tilted to the view that they may still be insufficiently aggressive. We are at a point in time where scope for fiscal policy is valued highly, while limitations to them are seen as superfluous.

The Maastricht Treaty in 1992 focused more on limitations than on scope

The Treaty did not foresee such scope for fiscal policies. Three decades ago the attitude to fiscal policies was to limit the risks of spill-overs across borders of financial instability arising from the accumulation of sovereign debt; the future Economic and Monetary Union (EMU) should not become a club for highly-indebted countries. In return for accepting constraints – an “external anchor” – for national fiscal policies the latter countries saw the contours of an acceptable counterpart: eliminating exchange-rate risks and moving into an environment of low and stable inflation and lower interest rates than they could achieve on their own. There was concern whether the reference value of 3% of GDP for the headline government deficit would leave enough room for national automatic stabilisers; some, narrowly defined, flexibility was left for the interpretation in the Council of Ministers of such a ceiling. The norm of 60% for the debt ratio, roughly the average level by 1990, was recognised as distant for at least two Member States (Belgium and Italy), so the emphasis was on approaching safe levels “at a satisfactory pace”.

In retrospect, the Treaty provisions on constraining the scope for fiscal policies may look surprising. However, at the time, as I had the privilege to observe as an independent Member of the so-called Delors Committee on EMU and in later preparations for the Treaty, it seemed a natural response to the experience of nearly two decades of inflation and often pro-cyclical fiscal policies and, not least, to the way in which mainstream views in the Economics profession interpreted this experience. Fiscal policy was seen as too difficult to manage for the purpose of cyclical stabilization, and government deficits and debt were feared to be on a trendwise rise. This was a risk to EMU which had to be contained. The future central banking system should focus on medium-term price stability and refrain from developing lender-of-last-resort functions for national governments. Independence from both national and EU political authorities was essential in minimising the risk of “fiscal dominance” from which several national central banks had begun to liberate themselves. It was no surprise that most governors were sympathetic to constraining fiscal scope; it was more remarkable that a number of finance ministers shared the view that an external anchor through fiscal rules might be helpful in their efforts to dampen bold and popular spending initiatives of government colleagues at home.

The preferences of key economic policy makers reinforced the swing in analytical views of economists towards a framework based on medium-term commitments to rules for both monetary and fiscal policies, hence limiting both the cyclical and the trend-wise scope for the latter. This perspective, and the bargain between weaker and stronger economies underpinning it, seemed to be broadly confirmed both in the (only) seven years from the signing of the Treaty to the start of EMU on 1 January 1999, and over the first decade thereafter. There were

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1 For a review of the main features of EMU and of the reasons why it was decided to move beyond the previous stage of monetary integration, see Gros and Thygesen (1998).
rebellions, notably from France and Germany, against mechanical implementation of the rules which inspired refinements; and there was a neglect of mounting dangers to the cohesion due to shifts in competitiveness inside EMU. But the basic framework survived.

Even the outbreak of the international financial crisis from 2007-8 did not modify in fundamental ways the perspective on the balance between scope and limitations for fiscal policies. In 2009-10 a recovery programme, involving a partly coordinated expansion of national fiscal policies, was agreed, but on the understanding that “at the latest by 2011” consolidation would take over. The crisis was used for an urgent filling of gaps in EMU: a safety net for governments to provide conditional loans to countries with limited or very costly access to financial markets, the European Stability Mechanism (ESM), and early steps towards banking union to limit the risks to national public finances from future financial recues. Procedures for Commission fiscal surveillance were reinforced, while some additional flexibility was introduced to better reconcile longer-run sustainability with the cyclical position of countries. The concept of a satisfactory pace of debt reduction was supposedly operationalized by linking it mechanically to the distance from the 60% - the “one-twentieth rule”; the average debt ratio had jumped by about 30 percentage points to app. 94 % of GDP, making a recommended downward debt path the most binding constraint on the scope for national fiscal policies. Despite the new flexibility in implementation, compliance with the rules was only moderately improved. A review of the fiscal framework which had started just before the pandemic struck did not suggest that major modifications of the scope for fiscal policies were likely to be agreed, nor that proposals for a central stabilization mechanism, or even for a slightly enlarged EU budget to modify structural imbalances, would be adopted.

How did the 2020 reassessment of fiscal policies become possible?

In this perspective of basic loyalty to the Treaty framework and high uncertainty about the ability to agree to reform it, the events of 2020 become even more surprising. Two basic elements explain the dramatic widening of the scope for fiscal policies: the truly exceptional circumstances of the Covid-19 pandemic; and a major reassessment of the role of fiscal policies more generally, reflecting once more a swing in analytical perspectives, reinforced by the current interest of most policy makers in being liberated from past constraints. In this process, the original bargain in the Treaty appeared obsolete: low and stable inflation and interest rates did not seem to require constraints on the scope for fiscal policies for the foreseeable future.

Examining the two elements in turn, the size of the Covid-19 shock was far beyond any earlier experience; it justified the activation of a general escape clause, designed in 2011, for cases of “severe downturn” in EMU as a whole. That gave the Commission freedom to implement flexible surveillance of fiscal policies, leaving scope for national efforts. The size and the truly exogenous nature of the shock had crowded out the relevance of past reproaches to countries that had failed to build fiscal buffers in the better times prior to crisis. An unusual degree of a common narrative emerged among policy makers. Furthermore, all countries saw an interest in not allowing others to be prevented, due to strained public finances, from taking mitigating action in the crisis.

These motives made it possible to go beyond allowing more scope for national fiscal policies by agreeing to raise on behalf of all EU countries funds to be in part transferred outright, in part relent, to governments on the basis of criteria linked to growth-enhancing public expenditures of EU priority, with redistribution of resources in favour of countries particularly affected by the crisis. These initiatives contain elements of a macroeconomic stabilization function, but particularly of strengthening the longer-term EU growth potential.

However, all initiatives of 2020 were agreed to be temporary. The general escape clause will disappear when the recovery is well under way, most likely in the course of 2022. The joint budgetary steps will taper off over a few
years. Whether any of them will have a longer future depends above all on the way in which the current steps find a balance between national ownership of decisions on public expenditure – the basic premise for fiscal policies in an EU which is not a federal entity – and a more intrusive surveillance of how stronger resilience and cohesion are integrated into national decision making. The jury will remain out for some time on this issue.

Can a new balance between scope and limitations be found?

In a medium-term perspective the scope for and the limitations to fiscal policies in the EU will have to find a trade-off in an environment very different from that of three decades ago. The current mood among policy makers, encouraged by most economists, is to see limitations to fiscal policy as outdated, also beyond the recovery from the Covid-19 crisis. There is a new confidence in active fiscal policies not only in the face of major shocks, where the need became obvious; the role of governments in cyclical stabilization around the economy’s potential growth rate is seen as reinforced by a responsibility for raising that rate itself. It has become difficult to find finance ministers who subscribe to the premise of the Treaty that fiscal rules – external anchors in particular – would help to limit expenditure growth.

In this attitude they are encouraged by mainstream economics. The emphasis on limitations to fiscal policies in order to contain undesirable spill-over effects of high and growing sovereign debt do seem outdated at a time of a still weak recovery. With monetary policy nearing limits to its capacity to provide stimulus, positive spill-overs from fiscal stimuli become more important. The ECB has been calling for more fiscal expansion even before the pandemic, a development that was certainly not anticipated by those who designed EMU. But the perspective of mainstream economics goes beyond the short term: the real costs of borrowing seem destined to be low for a long time. And if inflation rises, central banks will tolerate it as long as it is moderate; if it should persist, that should help reducing the debt ratios.

A further optimistic twist to this benign economist scenario for the scope of fiscal policies is imparted by policy makers, anxious to show their electorates that they are capable of decisive action. It is well justified that past indicators of sustainability of government finances are due for a major update due to the favourable constellation of a trend-wise decline of real interest rates and continuing high degree of monetary accommodation. Ways will have to be found, in particular, of reinterpreting how to take into account the debt norm of 60% in the Treaty, or, at a minimum, a revised “satisfactory pace” of moving in its direction; the European Fiscal Board has developed proposals for how this might be done, (EFB 2020).

It would be a major oversight to believe that the evolution of sovereign debt ratios has become irrelevant as a limitation to fiscal policies in the EU; variable national risk premia on debt will remain a reality for the foreseeable future. Member States that leave themselves too little fiscal space to react to future crises subject themselves to the tail risk of market suspicions which could prove too strong or too permanent for central bank actions to contain them. A degree of commitment to a strategy of debt reduction will remain helpful in preventing more sudden appearances of limitations on fiscal policies. But as long as such appearances are seen by policy makers as highly unlikely, it will be an uphill fight to agree on even duly modified rules.

A rediscovery of the fiscal confidence of the Werner Report on EMU of 1970?

The current confidence in leaving very major scope for fiscal policies in a way brings the EU back towards the mood that inspired the first effort to strengthen the EU policy framework. Half a century ago, the Werner Report of 1970 proposed the creation of EMU over a decade, reflecting above all confidence in fiscal policies in helping to
sustain rapid growth consistent with moderately low inflation over a long upswing. The proposal included vesting authority in the Council of Finance Ministers to override national decisions. Such confidence, well beyond political realities at the time – and today – was encouraged by the assurance of mainstream economics at the time that there was a well-documented analytical and empirical basis for designing appropriate policies, including reliable forecasts. With public debt at still low levels – about 30% of GDP on average in the six original Member States – and independent central banks an unknown aspiration, the limitations to fiscal policies seemed remote and manageable through discretionary decisions made by well-informed and well-intended policy makers – a vision readily accepted and reinforced by the latter. However, brutal and unanticipated international disturbances in 1971-73, followed by major divergences within the EU over how to react to them, effectively removed EMU from the agenda for 15 years, not least because the experience undermined confidence in fiscal policies.

**Major scope, few limitations in fiscal policy: mainstream economics and politics**

The foundations for rediscovering such confidence do look more solid today than 50 years ago. Above all, the EU institutional framework has been strengthened greatly by the start of EMU, notably by the presence of a federal central banking system capable of addressing financial stability risks and gaining time when tensions arise in sovereign debt markets. A sense of collegiality has become extended beyond the circle of central bankers to those of finance ministers and other national officials, while procedures of mutual surveillance and of the capacity of the Commission to conduct them have become well established.

Yet vulnerabilities in the European construction remain and they are bound to be exposed further, as the bargain underlying the Treaty is pushed further into the background. That bargain between groups of countries that have remained dissimilar was for the weaker economies to agree to some limitations on the scope for fiscal policies in return for a more stable and unified monetary and financial framework. It can be argued fairly that the Treaty model for coordinated policy making was in itself a product of the swing in mainstream economics in the direction of emphasizing longer-term commitments and prudence in both monetary and fiscal policies. The swing was reinforced by the perceived self-interest of central bankers and other key officials at the time. If so, a correction is inevitable and appropriate; mainstream economics is progressing over time, and even if that process tends to occur in spirals, to use an image of Schumpeter, rather than more linearly, it should be taken into account in designing policy responses. But if the swings then become reinforced by political cycles, a need for an inertial element of continuity in the policy framework could become valuable. In the present context that would require a recognition of the case for defining some limitations to the scope for fiscal policies in order to avoid painful and more improvised future corrections.

**References**


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