



Finance Watch

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Fiscal Mythology Unmasked

Debunking eight tales about
European public debt and fiscal rules

Executive summary of the report
"Fiscal Mythology Unmasked"



September 2021

Executive summary

Europe faces serious environmental, economic and social challenges that require a rethink on public intervention. Not free to do as they wish, European governments devise fiscal and socio-economic policies constrained by a self-imposed maze of economic governance rules. Those rules are built on a series of debatable conceptions about public debt and the role played by the state.

This paper focuses on debunking eight often-espoused conceptions:

INFLATION

MYTH

A growing concern centres on inflation possibly returning, driving up interest rates, which would render debt unsustainable.

2

Meanwhile, analysis shows a different story: a situation where this risk is not the most pressing one as **inflation and interest rates are driven by structural factors unlikely to change in the near future**. Temporary, measured inflation can be expected in the short-run, not a sustained rise of inflation and interest rates.

FUTURE BURDEN

MYTH

Public debt often gets framed as an unfair burden on future generations.

3

The “intergenerational equity” story overplays the liability trope around debt while overlooking three fundamental arguments.

First, **intergenerational equity commands investment that builds a resilient and sustainable world**. Without that investment, governments will fall short when trying to provide for the most basic needs of future generations. Investment costs will weigh less on future generations’ shoulders than the cost of failing to do so.

Second, **debt provides a legitimate way of spreading costs across all benefiting generations** when it provides financing for investments in education, research, innovation, sustainable and resilient infrastructures and productive capacities.

Third, the current ultra-low interest rate environment provides the **opportunity to lock-in low, long funding costs**, which relieve the debt burden for future generations.

Intergenerational equity commands to discern debt sustainability as intertwined with the sustainability of the world. In a context where there can be no such thing as sustainable debt without a sustainable world, **Europe must shift from an excessive focus on public spending quantity to a pledge to ensure its quality**.

DEBT OVERLOAD

MYTH

The public debate overly relies on arbitrary debt-to-GDP thresholds to gauge debt sustainability, overlooking true explanatory factors.

1

Those include evolution of government revenue, interest rate, debt composition (i.e. currency denomination, ownership, maturity structure), differential between interest and growth rates and the building up of fiscal risks. **Interest payment-to-public revenue (flow-to-flow) seems a more meaningful proxy indicator of debt sustainability** than *debt-to-GDP* (stock-to-flow).

CROWDING OUT EFFECT

MYTH

Public investment often gets brushed off under the argument that it would crowd out more productive private investment.

4

In fact, this portrait overlooks three core arguments.

First, a crowding-out effect cannot exist in the current world-wide **environment of excess liquidity and savings**.

Second, **public goods provision, resilience building, and climate change mitigation requires public money**, as related investments cannot be expected to be solely privately financed.

Third, **quality public investments can boost and steer the economy towards socially desirable goals**. Captured by the fiscal multiplier, this crowding in effect proves particularly strong during recessions and low interest rate periods.

Far from being antagonistic, public and private investments must be seen for what they are: namely complementary.

SPENDTHRIFTS

MYTH

EU countries with comparatively high stocks of government debt to fellow Member States often get accused of living “beyond their means”.

5

A closer look shows a more nuanced picture. While no evidence exists showing excessive social spending or lower working hours, **significant shares of public debt appear to be a legacy from unexpected events** such as the financial crisis of 2007-2009 or the current Covid-19 pandemic. In a number of cases, high levels of public indebtedness embody the **legacy from the high interest rates that prevailed in the 1980s and 1990s** and not from supposedly reckless fiscal policies conducted since then. Italy provides a case, for instance, as it suffered an average yield on 10-year government bonds of 14% between 1980 and 1993, with a peak surpassing 20% in 1982, and reached continuous primary surpluses during the recent decades.

BUDGET SURPLUS ANALOGY

MYTH

Building on the household analogy, public budget surplus is often presented as a necessity to repay debts and build “fiscal space”.

6

This debate reveals two main flaws: First, a public budget surplus means the government takes from society more than it gives to society. Seeking budget surpluses proves counterproductive when **interest rates fall below growth rate** and when **economic depression hits**, and is always of secondary importance in comparison with **investing to build a sustainable and resilient society** – as evidenced by the importance of sustainability-related fiscal risks. Second, **intra-EU trade imbalances** continue to hamper the prospects for every Member State to run concomitant budget surpluses.

Rather than trimming back spending to comply with arbitrary numerical fiscal rules, the European Union and its Member States should **focus on investments that contribute to building a sustainable and resilient economy**, pouncing on the current rock-bottom interest rate environment to lower fiscal risks, extend debt maturities and bring down debt servicing costs. **Protecting public budgets better from swings in market sentiment** requires monetary policy that ensures permanent market access for sovereigns at favourable conditions as well as a stronger “lender of last resort”. **Orderly sovereign debt restructuring should be facilitated** when debt becomes unsustainable. Lastly, **policy should address intra-EU trade imbalances**.

FENCED IN RULES

MYTH

EU fiscal rules are presented as a package of sound limits designed to eschew the deficit bias of politicians.

7

Meanwhile, the chosen fiscal limits **lack economic justification**: while the 60% debt-to-GDP limit was only a rough average of the then 12 EU countries, the 3% deficit limit is the economically unjustified heritage of its prior usage in France. Whilst the “debt-to-GDP” ratio suffers important **conceptual flaws** – such as non-commensurability and time-inconsistency – **debt sustainability requires more than reaching a specific threshold**.

AMPLE WRIGGLE ROOM

MYTH

European fiscal rules usually get depicted as flexible enough.

8

In fact, flexibility is sparse and the rules dampen growth and employment while holding back Europe from reaching its environmental and social goals. Reforms must aim to **improve quality of spending**, take context better into account and prioritise long-term social and environmental **sustainability over arbitrary fiscal constraints**.

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Acknowledgements: We are grateful to the Members of Finance Watch for their invaluable input and feedbacks. Many thanks in particular to Ollivier Bodin (Greentervention) and Frank van Lerven (New Economic Foundation) for the fruitful exchanges.

Cover photo: Venetian carnival mask, vkara / Adobe Stock

Graphics and typeset: by Camila Dubois

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Finance Watch has received funding from the European Union to implement its work programme. There is no implied endorsement by the EU or the European Commission of Finance Watch's work, which remains the sole responsibility of Finance Watch.



Co-funded by
the European Union



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