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# An insufficient reform of the EU's fiscal rules

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## Theme

On 26 April 2023 the Commission presented a legislative proposal to reform the European fiscal framework. It has several positive aspects but serious limitations in terms of simplicity, flexibility and effectiveness, especially in the current geopolitical context.

## Summary

This paper analyses the advantages and disadvantages of the EU Commission's legislative proposal to reform the EU fiscal rules, presented on 26 April 2023. Although the reform is a step in the right direction of setting flexible fiscal targets and using a control variable based on primary expenditure, the result is just a partial solution to Europe's fiscal problems and, like all partial solutions, it has consequences that are not necessarily positive.

## Analysis

The Stability and Growth Pact was suspended during the pandemic and at the start of the war in Ukraine and will have to be resumed in 2024 under very different circumstances. In November 2022 the Commission issued a Communication with orientations on the reform of the European fiscal framework, after which it held lengthy discussions with Member States. The outcome, summarised in the Council conclusions of 14 March 2023 (endorsed by the EU's leaders on 23 March), led to a legislative proposal being presented on 26 April 2023.

In November we pointed out that the Communication was a good proposal for a geopolitical scenario that no longer exists. The legislative proposal, while maintaining many positive aspects, incurs in the same limitations and adds some others. The main elements of the proposal and their overall assessment are summarised below.

### The framework

The EU system of fiscal rules, which seeks to minimise the negative external effects of Member States' fiscal imbalances on the rest of the Union, has three components: (a) a set of fiscal sustainability criteria and targets; (b) a compulsory fiscal adjustment path towards a sustainable fiscal position; and (c) sanctions in the event of non-compliance.

Figure 1 shows the new set of fiscal rules. The fiscal sustainability criterion will be set in terms of debt levels (classifying countries by risk level), and an adjustment path towards a fiscal balance will be established in the form of four-year plans that will set targets and use a net primary expenditure rule as the control variable. Measures in the event of non-compliance include an excessive deficit procedure and various sanctions.

**Table 1. The Commission's proposal for the reform of fiscal rules**

| Element | PROPOSAL |
|---|---|
| **(1) Debt sustainability analysis** | Classification of countries by risk level based on a debt sustainability analysis (DSA) with a transparent methodology agreed with Member States. |
| **(2) Fiscal adjustment path** | Customised and negotiated between the EU Commission and each Member State and approved by the EU Council. To be implemented within a maximum period of 4 years (extendable to 7 years with justified cause). |
| **(3) Long-term objective** | 3% deficit and 60% of GDP. |
| **(4) Medium-term objective (4-7 years)** | Sustainable deficit and debt levels. |
| **(a) Control variable: expenditure rule** | Cap on net primary expenditure (excluding discretionary measures and European funds, debt interest and cyclical unemployment expenditure). Investments financed by EU funds in green and digital transition or other authorised investments will not be considered expenditure. |
| **(b) Rate of reduction** | The 1/20 rule is suppressed, but an annual structural deficit adjustment of 0.5% will be required for Member States with a deficit above 3% (whether they are in the excessive deficit procedure or not). |
| **(4) Corrective mechanism in case of non-compliance** | Excessive deficit procedure, with smaller fines but stricter enforcement. Reputational sanctions such as bringing ministers before the European Parliament in case of non-compliance ('comply or explain'). Possibility of freezing EU funds and macroeconomic conditionality. |
| **Other elements:** | |
| **Institutional framework** | Greater role for independent national fiscal institutions. Their assessment of debt reduction programmes must be considered by the EU Commission and Council, but recommendations will be non-binding. |
| **Transparency** | The Commission will make public the debt sustainability analysis, the multi-annual adjustment path, and the corresponding level of the structural primary balance at the end of the 4-year adjustment period. |
| **Other issues** | Possibility of an escape clause in 'exceptional circumstances'. Revision of the Macroeconomic Imbalances Procedure with a similar approach to the fiscal rules. |

Source: the authors.

The main objectives of the reform are to achieve simple rules, clearer than those that existed, but flexible and effective, guaranteeing compliance and credibility. Major changes include the easing of the adjustment path for each country, the use of a primary expenditure rule as a control variable (instead of the structural deficit) and the replacement of a debt-based rhythm of adjustment by a deficit-based one, as well as other additional measures.

However, despite progress, the reform does not guarantee an adequate simplicity, flexibility or credibility of the rules.

## The problem of simplicity

A framework of fiscal rules needs to be relatively simple, because excessive complexity encourages interpretative debates (the current fiscal framework requires a vade mecum of over 100 pages).

Unfortunately, the Commission's proposal does not seem to escape the debate on the calculation of the structural deficit (linked to potential GDP), as the debt sustainability analysis (DSA) will require a calculation of potential GDP in order to classify countries as high, medium or low risk. Although the Commission promises a 'transparent methodology' to be 'agreed with Member States', most initial assumptions and calculation procedures will probably be the subject of bitter debates (as is currently the case).

The replacement of the structural deficit by the net primary expenditure as a control variable is a major step forward, as the latter focuses on the elements of discretionary fiscal policy that governments can control. A solution based on the mere exclusion of certain items from the deficit (a 'golden rule') would not have suited the purpose: it would have required new vade-mecums (green, digital...) and encouraged a risky game of accounting transfers between items.

However, the primary expenditure rule, although much simpler, does not avoid the need for estimates of potential GDP, both by the Commission (with the exclusion of the 'cyclical unemployment expenditure', which makes it necessary to estimate a structural component) and by Member States (when making revenue forecasts).

Some complexity is unavoidable, given the very nature of modern economies. Another part, however, just stems from inaccuracies. For example, sometimes the terminology used by the Commission does not help, with concepts such as the 'plausible downward path', which is subject to interpretation.

## The problem of flexibility

The Commission's proposal introduces a significant margin of flexibility by establishing an adjustment path that is not homogeneous but negotiated between the Commission and each Member State and endorsed by the EU Council. The 'medium-term fiscal structural plan' of each Member State will set out the fiscal adjustment, the reforms and public investment commitments, and even an element of additional gradualism over the standard four-year horizon, provided it is backed by a set of priority reforms and investment commitments. The Commission would be responsible for assessing the balance between reforms/investment and adjustment, estimating the growth impact of proposed reforms or investments (which could offset higher initial deficits).

This flexibility is, however, subject to two important restrictions.

On the one hand, the preservation of the references of 3% deficit and 60% debt as long-term objectives. These are arbitrary values but incorporated in the treaties and therefore difficult to change. Their existence, a legacy from the time of the creation of the euro (a very different world indeed), is shocking in a geopolitical context where investment needs are very different from those of 1999. The flexibility of the four-year plans partially cushions the rigour of these figures, but they are still there, and they are enforceable.

On the other hand, the logical removal of the requirement for an annual reduction of 1/20th of the debt (easier to implement, as it is secondary legislation, not included in the treaties) has been replaced by another measure that further reduces flexibility: the obligation to reduce the deficit (structural, not observable) at a minimum rate of 0.5% per year for Member States with a deficit above 3% (whether or not they are in the excessive deficit procedure). The measure, of course, has a certain logic: if we started –for example, like Spain– with a structural deficit of around 4% of GDP, its elimination at a rate of 0.5% per year would take no less than eight years. In that period, it would be difficult to avoid an economic slowdown during which (despite automatic stabilisers) any government would be reluctant to adjust its primary spending.

Therefore, although it is true that the absence of a minimum rhythm of adjustment tends to delay hard policy decisions, the cost of setting an arbitrary figure such as 0.5% also reduces flexibility and remains pro-cyclical: when a country suffers a crisis, its cyclical deficit will increase, and the required adjustment would cause an additional fall in GDP that would worsen the indicator even further.

In any case, the true flexibility problem comes at the EU level. In their current design, fiscal rules will constrain public investment in highly indebted Member States. This will have two effects: on the one hand, an increase in real divergences between Member States with greater fiscal capacity and those forced to make strict fiscal adjustments (divergences added to those derived of the asymmetrical amount of State aid authorised since the start of the pandemic); and, on the other hand, an insufficient overall EU investment to finance supranational public goods.

## The problem of effectiveness

Even if a simple and flexible set of rules were to be established, the success of reform ultimately depends on the effectiveness of enforcement. This is linked to two factors: the credibility of the objectives and the role of incentives.

We have already mentioned the preservation of the 3% deficit and 60% debt references as long-term objectives. The problem is that these values are not optimal, but simply reflect the impossibility of modifying the treaties. It is debatable whether 3% is a logical figure or not, but clearly the 60% debt rule is not credible in a eurozone with an average public debt of 93%. It is understandable that the Commission did not want to discuss the logic of these figures, but their preservation is the evidence that there are rules which will not be complied with. Therefore, they represent a serious damage to credibility.

The second limit to the reform's credibility has to do with the functioning of the corrective arm, which remains unclear. On the one hand, the opening of the excessive deficit procedure (EDP) based on debt (and not just deficit) sustainability grounds increases the effectiveness of the mechanism.

Regarding sanctions, fines are preserved, but their amount is reduced, with a stricter enforcement. However, they will continue to operate in a pro-cyclical manner (ie, further reducing the sustainability of the indebted country's finances), undermining their credibility. The possibility of freezing European funds also works in the same direction. The use of moral sanctions, such as the obligation for ministers to appear before the European Parliament in the event of non-compliance –following the so-called 'comply or explain' principle– is a good idea, but its effectiveness is uncertain.

As for incentives, much emphasis is placed on the need for 'ownership' of adjustment commitments by Member States. However, it is very likely that Member States will still consider, at the political level, that the adjustment path is 'imposed' by the Commission.

On the other hand, much of the flexibility of the reform lies in a more active role for the Commission at setting adjustment paths. The problem is that the Commission has suffered a certain loss of credibility at linking reforms and Recovery and Resilience funds, as it has mainly concentrated on legislative milestones regardless of the impact of funds on economic transformation. The Commission has strong incentives to make the Next Generation EU experience a success that can be repeated, and this leads it to a relative tolerance in assessing milestones. Some countries believe that were the Commission to be offered a leading role in the assessment of reforms (allowing, for example, adjustment paths to be extended), it would incur a similar conflict of interest.

Finally, the increased role of national independent fiscal institutions in assessing debt reduction programmes is interesting, but it is limited by the fact that their recommendations are not binding (which would require much deeper legal reforms).

## Conclusion

### The risk of a partial reform of the European fiscal framework

Ultimately, the real problem with the current reform of the fiscal rules is that it still does not propose a solution for the financing of the enormous European investment requirements in the coming years. In the Q&A document on the reform (published on the same day and no less interesting), the answer to one of the questions posed by Member States ('How will the reform stimulate investment?') is considerably vague and does not get to the heart of the issue.

The problem is that the EU faces massive investment needs for which it has only four weakened financial tools:

- Next Generation EU funds, which apparently will not be extended.
- Ordinary European structural funds, which are clearly insufficient in amount and too slowly implemented.

- Member States' public investment, constrained by fiscal rules and, by definition, insufficient (the investments target will be set not in terms of needs, but in terms of debt sustainability, leading to underinvestment in highly indebted countries).
- Private investment, hampered by the absence of a genuine Banking Union and a functional Capital Markets Union.

In conclusion, the problem with the reform of fiscal rules is not its strictness, which might be justified, but its approach, ie, the absence of parallel discussions on financing mechanisms for common European investments. The Commission argues that, for the time being, the Recovery and Resilience Funds are sufficient to address investment needs and that this is not the time to consider additional EU financing mechanisms. In other words, before proposing any joint fiscal capacity, it will be necessary to demonstrate that countries are able to comply with fiscal rules.

While agreeing with this logic, we cannot agree with the timetable: once again, postponing fundamental European debates could result in the definitive loss of crucial races for the future and survival of the Union. Perhaps it is time to put much more ambitious objectives on the negotiating table, both in terms of common resources and in terms of control of national finances, even if this means reforming the treaties.