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How stringent would the new Stability and Growth Pact be? And for who?

ECONOMICS & FINANCE

POLICY BRIEF
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#stabilityand-growthpact
#budget
#debt

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Abstract

This policy brief engages with the ongoing debate on whether – and to which extent – the reform of the Stability and Growth Pact (SGP) will make fiscal adjustment requirements for EU Member States more lenient and flexible. Based on the European Commission's legislative proposal and recently published additional information, the policy brief shows that the new – more country-specific – risk-based approach is actually requiring significant fiscal adjustment from Member States with high debt sustainability risks. In addition, the revamped debt-based excessive deficit procedure is considerably strengthening the enforceability of fiscal adjustment plans. In contrast, fiscal adjustment requirements for lower debt countries are relaxed, highlighting that the new SGP would strongly differentiate between Member States depending on their fiscal sustainability risks. Reform-skeptical countries should be cautious in pushing even stricter consolidation requirements in the forthcoming negotiations. Otherwise, rather than Germany, it might be some of the high-debt countries which could derail the reform process in the end.

I • A perceived 'softening' and flexibilization of the EU fiscal framework

Following the publication of the Commission orientations on the reform of the Stability and Growth Pact (SGP) in November 2022 a major debate broke out between the EU Member States and the Commission about whether and to which extent the proposed reform would flexibilize or make the existing European fiscal framework more 'lenient'. **The move from a rules-based to a risk-based fiscal framework** was perceived very critically in countries such as Germany, which has a long-standing preference for numerical fiscal rules. Concerns were also

fuelled by the fact, that the actual fiscal adjustment requirements for Member States under the new system remained very vague. While outlining the use of debt sustainability analysis (DSA) to derive country-specific fiscal adjustment paths, the Commission did not detail how this would work in practice nor provided any concrete examples for the adjustment needs implied by the new fiscal framework. Because of this vagueness, many commentators framed the reform proposal as unequivocally giving more fiscal leeway to Member States.

II • A push towards more common fiscal rules

When it was up to the ECOFIN and the European Council to endorse the overall reform direction in March 2023, Germany made a major push (which was supported by other countries skeptical of the reform) to restrict the extent of country-specific differentiation in fiscal adjustment paths and to reintroduce, what it called, 'common safeguards'. Options for such safeguards were laid out most prominently in Germany's early-April non paper. They included a 1% annual-debt reduction requirement and an expenditure rule, which was to become increasingly more stringent for high-debt countries, requiring net primary expenditure growth to be lower than potential growth by a debt-dependent margin.

III • A legislative proposal which reduces the vagueness around actual fiscal consolidation requirements

In response to these concerns, the Commission's legislative proposal, published in late-April 2023, integrates several numerical minimum requirements for the central expenditure rule, which will apply for countries with public debt above 60% and/or a deficit above 3% of GDP. Beyond the requirements already included in the 2022 reform orientations, the current draft requires, amongst other elements, that (1) public debt should be lower at the end of a national fiscal-structural plan than at its beginning and that (2) net expenditure growth should be below medium-term output growth over the horizon of a plan. In addition, the Commission also integrated the corrective arm's (3) annual 0.5% deficit reduction requirement into the preventive arm. **The legislative proposal draft thus reintroduces elements of a more rules-based approach into the Commission's risk-based reform approach.**

IV • Better specified criteria for the definition of fiscal adjustment requirements in line with DSA

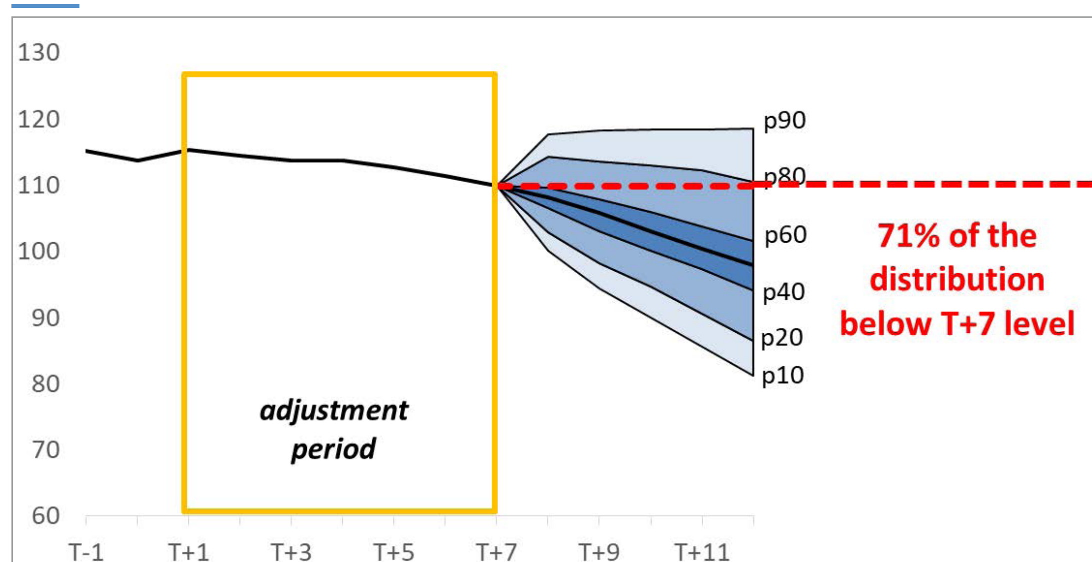
The reform proposal reduces, to a certain extent, the vagueness around the fiscal adjustment requirements that would result from the DSA. Already in its reform orientations, the Commission stated that Member States' fiscal-structural plans would have to ensure that "by the end of the adjustment period, at the latest, the 10-year debt trajectory in the absence of further budgetary measures is on a plausibly downward path or stays at prudent levels." It did, however, not explain how this would be operationalized exactly. Annex V of the new Regulation for the SGP's preventive arm, as presented in the legislative proposal, attempts to define the methodology for the evaluation of compliance with this requirement in more detail. First, it specifies that public debt has to decline "under the deterministic scenarios of the Commission's medium-term public debt projection framework". And second, it also adds the requirement that "the risk of the public debt ratio not decreasing in the 5 years following the adjustment period of the national medium-term fiscal-structural plan is sufficiently low. The risk is assessed with the help of the Commission's stochastic analysis". Such stochastic analysis is based on the joint simulation of a large number of shocks, "based on the historical volatility of each economy and correlation of shocks".

Beyond the legislative proposal, the most recent Debt Sustainability Monitor, published in April 2023, contained some modifications in light of the ongoing reform debate, especially to its medium-term and long-term DSA framework. However, as for the Commission reform orientations of late 2022, none of the documents published by the Commission did provide concrete examples of the actual country-specific fiscal adjustment paths that would result from the DSA exercises.

Fortunately, some further clarifications on the utilisation of the DSA and illustrations of its implications for fiscal adjustment requirements were provided during the latest edition of the European Fiscal Board's annual conference on the 11th of May 2023 in a presentation by Stéphanie Pamies (Head of Unit for the sustainability of public finances at DG ECFIN).

First, the Commission representative stated that debt would need to decline with respect to four of the deterministic scenarios presented in the latest Debt Sustainability Monitor. These scenarios include the so-called base-line scenario as well as two stress tests and one of the two policy scenarios. The two stress test scenarios capture fiscal risks stemming from (1) a more adverse interest-growth rate differential than assumed in the baseline and from (2) temporary turmoil on financial markets. The included policy scenario finally assumes a lower structural primary balance. All of these scenarios are thus capturing downside risks in comparison to the baseline scenario.

Figure 1. Debt: stochastic projections around technical trajectory



▲ Source: Pamies (2023)

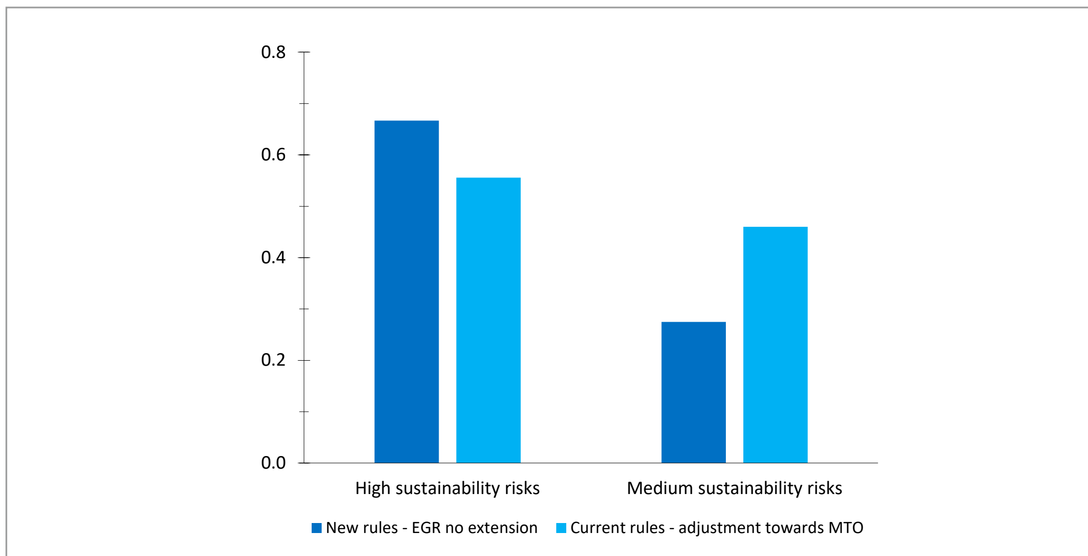
Second, regarding the stochastic DSA, the Commission stated that – in line with the Debt Sustainability Monitor 2022 – a 'sufficiently low' risk for increasing debt would be attained when the probability of debt declining is at or superior to 70% of the 2000 simulated projections, which are based on a broad set of potential shocks. Figure 1 illustrates this requirement for an example country's fiscal adjustment path.

V • Concrete illustrations of fiscal adjustment requirements based on the legislative proposal

REQUIREMENTS FOR AN EXAMPLE COUNTRY

Third, and very importantly, the presentation also provided some concrete illustrations of what the reformed fiscal framework would mean in terms of fiscal adjustment requirements, especially for countries with high and medium sustainability risks. To this end the Commission presentation showed the fiscal adjustment requirements for what was called a "random high-debt country" (the presented data looks suspiciously like France), both for a four-year fiscal-structural plan and its extended seven-year version. The technical trajectory in line with the various new rule requirements for this country would mean **an annual fiscal effort of 0.65% of GDP over the four year adjustment period.** Making use of the extension option would demand annual fiscal consolidation of 0.4% over a seven-year period. The presentation also provided information on the required net expenditure growth rate, which would be the operational instrument for constraining annual budgets.

Figure 2. Illustration of fiscal adjustment requirements for Member States with high and medium sustainability risks



▲ Source: Commission services based on Commission Autumn Forecast 2022, cited in Pamies (2023).

REQUIREMENTS FOR COUNTRIES WITH HIGH AND MEDIUM SUSTAINABILITY RISKS

Beyond the 'stylized results' for an individual Member State, the Commission representative also presented some average fiscal adjustment requirements for countries facing high and medium sustainability risks. Figure 2 shows the results derived from the rules of the proposed new preventive arm of the SGP and compares it with the adjustment requirements of the existing preventive arm. As the data highlights, **the new more risk-based EU fiscal framework would actually demand more annual fiscal consolidation than what is required currently** by the adjustment rule towards the preventive arm's medium-term objective (MTO) for Member States with high sustainability risks. In contrast, the reform would quite considerably lower fiscal consolidation requirements for country with medium sustainability risks.

It has to be acknowledged that the fiscal consolidation requirements for high-debt countries would be higher if the analysis included the 1/20th debt reduction rule which is currently part of the SGP. But at the same time it also needs to be stated that this rule has not been applied in any meaningful way already before Covid-19 pandemic due to the expected counterproductive macroeconomic consequences. Instead, the structural deficit adjustment requirement towards the MTO (0.5% on an annual basis until the MTO's achievement) was, *de facto*, the most important rule in the EU fiscal framework before the outbreak of the Covid-19 pandemic. Subsequently, the Commission makes a 'realistic' comparison between the old and new EU fiscal framework.

FISCAL ADJUSTMENT REQUIREMENTS FOR HIGH DEBT COUNTRIES REMAIN HIGH, MORE LEEWAY FOR LOWER DEBT COUNTRIES

The illustrations presented by the Commission thus highlight that the proposed new EU fiscal framework would – in practice – generally not be more lenient. Instead the main consequences would be **a stronger differentiation between countries with high, medium and low sustainability risks.** For high sustainability risk countries, as pointed out, the new requirements would actually be even more 'ambitious' than the existing ones. The extension possibility would attenuate this strengthening of rule requirements, but it would demand the implementation of reforms and investments which are supposed to reduce sustainability risks. Based on the Debt Sustainability Monitor 2022, **especially Belgium, Croatia, France, Greece, Italy, Portugal, Spain and Slovakia (as eurozone Member States) would be affected by the proposed reform.**

VI • The role of enforcement mechanisms for fiscal consolidation

But not only the numerical and other fiscal rule requirements are relevant in analysing whether a fiscal framework is stringent or lenient, also the design of enforcement mechanisms plays a very important role. No matter how stringent fiscal rules would be, if there are no consequences for non-compliance then such rules will likely not develop any strong discretion constraint on fiscal policy-makers. In this regard**, the legislative proposal of the Commission largely aims to make the overall framework more stringent.** This is mainly due to the fact that non-compliance with the new fiscal-structural plans, which are replacing the current preventive arm of the SGP, is tied more strongly to the corrective arm than previously through the opening of a debt-based excessive deficit procedure (EDP). So far, while being stringent in terms of fiscal adjustment requirements, there were little means to effectively enforce the preventive arm's MTO. The Six-Pack legislation and the Fiscal Compact attempted to strengthen the implementation of the MTO at the national level by requiring the introduction of national fiscal frameworks in line with the European fiscal framework. In the absence of additional enforcement mechanisms, this, however, did not work particularly well as shown by the EFB's compliance tracker.

VII • A major strengthening of enforcement mechanisms in the revamped SGP

The amendment of the Council Regulation of the corrective arm basically requires Member States to prepare and execute annual budgets in line with the medium-term fiscal-structural plans if they do not want to risk the opening of a debt-based EDP. As the corrective arm of the SGP has generally been viewed as being effective in bringing down public deficits through the deficit-based EDP, the legislative proposal aims to extend this logic to high public debt levels. By laying out more realistic fiscal adjustment paths than those provided by the previous debt-based fiscal rules, the Commission sees the opportunity to strengthen the enforcement of debt-reducing fiscal policies. As stated in the Regulation amendment, especially countries with "substantial public debt challenges according to the most recent Debt Sustainability Monitor" are more likely to face a debt-based EDP, considering such challenges to be a 'key factor' when deciding to open such an EDP.

Beyond the revamped debt-based EDP, **the legislative proposal also develops a stronger 'reputational cost' model for non-compliant Member States and makes the existing sanction possibilities more operational.** To this end, the reform gives, on the one hand, a larger role to 'comply-or-explain' mechanisms and national independent fiscal institutions. On the other hand, it also **reduces the size of financial sanctions to make their eventual implementation less politically and financially costly**. For illustrative purpose, for France, an individual fine for rule non-compliance in the existing fiscal framework would amount to, at least, €6bn and reach up to €15bn. Under the new system, any individual fine could not be higher than about €1.5bn, which can subsequently add up for repeated non-compliance. It remains an open question whether the Commission and the Member States will actually be willing to use the sanction instrument, but the reform proposal makes it a more credible threat. The planned reallocation of fines to the EU budget might also create bigger incentives than previously to actually go through with financial sanctions.

• Conclusion: fiscal adjustment requirements remain high, especially for high debt countries

Taken together, the analysis presented in this policy brief thus suggests, in contrast to concerns of Germany and other skeptical countries, that the SGP's fiscal adjustment requirements would remain stringent especially for high-debt countries. The approach based on DSA and supplemented by several common safeguards would actually require significant fiscal consolidation among countries with high sustainability risks, while giving more fiscal leeway to Member States with lower debt sustainability concerns. Regarding rule enforcement, the more realistic fiscal adjustment requirements and the strengthening of the debt-based EDP will likely improve rule compliance across all Member States.

This more differentiated approach would be a major improvement in comparison to the existing framework, which combined macroeconomically counterproductive consolidation requirements for high debt countries with unnecessarily stringent structural deficit requirements for low debt countries. Pronounced country-specific differentiation would help to increase macroeconomic convergence over the long-term, as less restrictive fiscal policies among lower-debt countries would lead to positive growth spill-over effects to and facilitate debt reduction among high-debt countries.

NOT ONLY GERMANY, BUT ALSO HIGH DEBT COUNTRIES COULD DERAIL THE REFORM PROCESS

Given the 'ambitious' fiscal adjustment requirements for countries with high sustainability risks and the basic sense of a more differentiated approach, reform-skeptical Member States should be careful in pushing for even stricter fiscal rules based on common numerical benchmarks. While Germany has played so far the role of the biggest critic of the Commission's reform proposal for the SGP, in the end it might be high-debt countries which will oppose the reform. While, in this case, the EU would revert to the existing EU fiscal framework, which was suspended temporarily due to the Covid-19 pandemic and the energy price crisis, in practice it would create a EU fiscal rules vacuum. Among many Member States, the existing SGP has lost its legitimacy while the Commission would refrain from going back to a more literal application of the rules in a situation, where public debt levels in numerous Member States are considerably higher than before 2020, making major parts of the existing SGP unfit for the task. This means that both sides in the reform debate need to be careful that the other won't derail the reform process. Otherwise, the result may be uncoordinated fiscal policies and increased divergence between Member States when we should strive for the opposite.

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