NOTRE EUROPE
Jacques Delors Institute
Penser l'Europe • Thinking Europe • Europa denken

ECONOMICS & FINANCE

POLICY BRIEF
JANVIER 2024

#reform
#europeancommission
#budget
#fiscalrule

European fiscal framework reform – a compromise, for better or worse

Andreas Eisl,
Senior Research Fellow, European economic policy at the Jacques Delors Institute

In this Policy Brief, I discuss the recent advancements on the long-awaited reform of the European fiscal framework, with the Stability and Growth Pact (SGP) at its centre. Following a short overview of the reform process, this brief presents key modifications introduced by the Council position adopted in late December 2023. These modifications include new or reinforced common safeguards for deficit and debt reduction, a more specified control account and transitory features that temporarily soften some of the fiscal consolidation requirements. I subsequently discuss whether the reform will be fit for the next quarter of a century, focusing on three aspects: (1) the hybrid logic of the new SGP, (2) the question of formal vs. actual fiscal consolidation requirements, and (3) the reform implications for public investment. The concluding section of this policy brief reflects on what to expect from the upcoming trilogue meetings, what the European Parliament can potentially still achieve in the negotiations, and on the future of the European fiscal framework.

I • The reform of the European fiscal framework enters into its final stretch

Just before the end of 2023, the EU finance ministers finally managed to agree on a common position for the reform of the European fiscal framework[1]. It was the result of lengthy deliberations and negotiations that were launched with the European Commission's 'economic governance review' in 2020/2021, leading to the publication of reform orientations in November 2022 and a more detailed legislative proposal in April 2023. The ensuing talks between the EU member states were difficult, with Germany being reluctant in making concessions from

1 According to the Commission, "fiscal frameworks are rules, regulations and procedures that influence how budgetary policy is planned, approved, carried out, monitored and evaluated". The Maastricht rules and the SGP are, supported by a few other regulations and directives, the key features of the European fiscal framework.

its initial demands until autumn 2023. But extensive bilateral talks between France and Germany and successful brokering by the Spanish Council Presidency helped to reach an agreement.

With this joint position, the Council will go in the trilogue negotiations, hoping to reach a deal with the European Parliament by the end of the first trimester of 2024, ahead of the upcoming EU elections. This would allow the reformed European fiscal framework to be fully applied from 2025 onwards, starting with the submission of the first round of national fiscal-structural plans by April 2024.

II • Key modifications introduced by the Council position

The most important part of the European fiscal framework reform is a complete overhaul of the Stability and Growth Pact's (SGP) preventive arm (which needs approval from the European Parliament), while it also modifies the corrective arm and the 2011 Directive on national budgetary frameworks.

The key elements of the original Commission proposal survived the Council negotiations of the last months relatively unscathed (see here for an analysis of the legislative proposal). Given the concerns of Germany and a few other member states regarding the new central features of the SGP's preventive arm (a **net expenditure trajectory based on a debt sustainability analysis (DSA)** replacing the 0.5% structural deficit rule), this is somewhat surprising.

At the same time, the reform sceptics managed to introduce several so-called common 'safeguards' in the Council position. While the Commission's legislative proposal already contained some concessions (the Maastricht Treaty's 3% deficit and 60% debt-to-GDP fiscal rules remained untouched, common benchmarks for debt reduction and expenditure growth were suggested), Germany managed to reintroduce two more concrete numerical fiscal rules in the SGP's preventive arm. First, the **debt sustainability safeguard** will require the technical trajectory to "ensure that the projected general government debt-to-GDP ratio decreases by a minimum annual average amount": 1% of GDP for member states with public debt above 90%, and 0.5% of GDP for member states with a public debt ratio between 60%-90%. Second, the **deficit resilience safeguard** will require the technical trajectory to "ensure that fiscal adjustment continues, where needed, until the Member State reaches a deficit level that provides a common resilience margin in structural terms of 1.5% of GDP relative to the 3% of GDP deficit Treaty reference value. The annual pace of improvement to achieve this 1.5% structural deficit rule is set at 0.4% of GDP (slightly lower than the 0.5% structural deficit improvement of the existing European fiscal framework) but can be reduced to 0.25% when making use of the new extension clause.

Beyond these two safeguards, the Council position also provides more details on the planned **control account**. This control account will be used to record deviations from the fiscal trajectory that are defined by the national fiscal structural plans. If there is an annual deviation of more than 0.3% of GDP from the next expenditure path or a cumulative deviation of more than 0.6% of GDP over the course of a fiscal-structural plan, a **debt-based excessive deficit procedure (EDP)** might be launched, requiring member states to correct such deviations.

Finally, the existing requirement to reduce public deficits above the **3% nominal deficit rule** (based on the Maastricht Treaty) by an annual structural improvement of 0.5% of GDP will continue to kick in whenever a country is in a **deficit-based EDP**. Due to successful political haggling by France, there will be a temporary softening of these fiscal consolidation obligations for the years 2025-2027, allowing the Commission to deduce the rise in interest payments from the 0.5% structural improvement benchmark, thus reducing the annual fiscal consolidation requirements.

Depending on the results of the DSA and the current and forecasted economic and budgetary situation of a country, each of these four different criteria might become the most binding rule for budgetary policy-making for individual member states, as the most recent calculations by Bruegel

(Darvas, Welslau, Zettelmeyer 2023) show. Looking at the calculations covering 4-year fiscal-structural plans, the DSA would result in the most constraining net expenditure trajectory for 11 member states (10 for 7-year fiscal-structural plans), the debt sustainability safeguard for 2 (1), the deficit resilience safeguard for 9 (11) and the 3% deficit rule would require most fiscal consolidation for 5 (5) countries. This highlights that the new 'safeguards' and the 3% deficit rule will imply more restrictive fiscal trajectories than the ones resulting from the DSA for a majority of member states.

Importantly, while the DSA is more binding than the debt sustainability safeguard in most of the cases, the deficit resilience safeguard becomes the most restrictive rule especially for EU member states with low public debt levels. At the same time, for such countries, the deficit resilience safeguard should not apply, as there is no technical trajectory applying to countries with a public debt level below 60%. Such member states can request the provision of '**technical information**' from the Commission which is equivalent to the 'technical trajectory' but is not binding. As long member states stay below a public debt of 60% and a deficit of 3%, no additional rules would restrict their fiscal policy-making, in contrast to the existing SGP, in which even member states with low public debt levels should not run structural deficits higher than 1% of GDP.

III • A reform fit for the next quarter of a century?

In the joint press conference of the French and German finance ministers on the eve of the adoption of the common Council position, Bruno Le Maire stated that the reform of the European fiscal framework is supposed to provide the basis for fiscal policy-making in the EU for the coming twenty-five years. Given the frequent revisions of the SGP in the past this seems to be a tall order, especially as the reform in its current reform really is a mixed bag. While it is definitely an important step in the right direction, the reform is less path-breaking than it could have (and probably should have) been. As the Commission and the Council did not link the SGP reform to a broader revision of European economic governance, it was difficult to find more radical and creative reform solutions.

A HYBRID FISCAL RULE SYSTEM

First, while the reform will be the biggest overhaul of the EU's fiscal rules since their inception in the 1990s, the new DSA-based logic is significantly limited by the preservation of the Maastricht rules (during the negotiations, there was an early agreement on not changing the Treaties) and various newly introduced common safeguards in the SGP's new preventive arm. The result is a hybrid system, which might be able to protect the system against some unanticipated kinks of the new DSA-based approach (basically if it, against its intentions, fails to ensure debt sustainability), but at the same time restricts its – in principle – powerful new economic logic. If implemented well, the reform could serve as a test-bed for this more risk-based approach to fiscal rules and could potentially, in a few years, allow for a removal of the various common safeguards that are part of the current SGP reform. If implemented poorly, we might she a push-back towards more common numerical fiscal rules in the future. In this regard, much depends on the quality and suitability of the DSA. The Commission should thus work hard to provide a robust final DSA tool and be ready to rework it if it doesn't function as intended.

FORMAL VS. ACTUAL FISCAL CONSOLIDATION REQUIREMENTS

Second, while the reform softens **formal fiscal consolidation requirements** for basically all member states, it does not necessarily flexibilise fiscal policy-making for some countries when comparing it to the **actual application of the existing SGP** in the years up to the Covid-19 pandemic. The now infamous 1/20th reduction rule for public debt above 60%[2], for example, was not applied to the letter especially for EU countries with high public debt levels. In the case of Italy, simply reducing public debt levels year-on-year was sufficient for the

2 According to the existing rules, "a country is compliant if the general government debt-to-GDP ratio is below 60% of GDP or if the excess above 60% of GDP has been declining by 1/20 on average over the past three years".

government to avoid a debt-based EDP in the period between the eurozone crisis and the pandemic. While the 1/20th rule would have required Italy to reduce its public debt level, on average, by more than 3.5% annually in the period 2014-2019, the country only achieved an annual debt reduction of 0.2% (from 135.4% to 134.2% of GDP). The 0.5% annual structural improvement rule towards the 0.5% structural deficit limit was, in practice, the more constraining rule for Italy, but also lacked bite as long as the country was below the 3% nominal deficit limit.

As the calculations of Bruegel highlight, the annual fiscal adjustment requirements will be at least as demanding, or even more demanding, for some member states than the old rules when considering their actual application by the Commission. Even when making use of the new SGP's extension clause, the annual fiscal adjustment needs can reach up to 1% (Slovakia), with stringent consolidation obligations also for Romania (0.76%), Belgium (0.71%), Italy (0.61%) and Spain (0.56%). The key question then is, to which extent the new rules will be applied. While this is difficult to answer ex ante, the overall reform direction will make it more likely that the gap between formal rules and actual application will narrow and thus imply considerable fiscal consolidation from numerous EU member states.

As the new rules are more credible (less economically counterproductive) than parts of the old ones, it's more difficult for member states to argue against their application. In addition, the reworked sanctions mechanism will make the imposition of fines more politically and economically feasible. With the reform, the system of deposits that can subsequently turn into very hefty fines, especially for countries that are already in fiscal troubles, is removed. It is replaced by a more nimble system that can lead more quickly to the imposition of – smaller – fines. While annual fines in the old system could reach potentially up to 0.5% of GDP annually (but at least 0.2%), the new fine system allows for the imposition of a fine of 0.05% of GDP every 6 months (so 0.1% annually). To illustrate the changes in the sanction mechanism with a concrete case, a single fine for France would amount to €1.32bn in the new system, rather than up to €13.20bn (and at least €5.28bn) in the old one. In addition, there is an incentive to actually impose fines in case of rule non-compliance as these fines will directly feed into the general EU budget, which has previously not been the case.

Whether the new system does not equally impose too ambitious fiscal consolidation requirements on certain countries remains to be seen in the coming years. Especially from 2027/2028 onwards, the reformed SGP will actually further tighten, as some temporary exemptions (regarding the RRF and increases in interest rate payments) will expire. With these transitory rules, governments have kicked some hard questions on the overall design of the new SGP down the road, leaving it up to future governments to deal with them. It is thus not unlikely, that we will see at least minor adaptations to the new European fiscal framework in a few years' time.

PUBLIC INVESTMENT

Third, while the reform will provide considerably stronger incentives for public investment and reforms than the existing SGP, it will not provide sufficient budgetary space for the necessary investments to achieve the EU climate objectives across the EU. For EU member states with low public debt levels the reform might provide sufficient leeway, even without having to resort to the extension clause, but this will be considerably less the case for countries with high public debt levels, because the underlying consolidation requirements will be stringent, even when making use of the planned extension clause. A key question here is, to which extent a reform solely focused on modifying the European fiscal framework is actually capable of addressing this issue on its own.

A 'golden rule', excluding public investment from rule coverage would have been one potential option to provide more fiscal space for member states in the green transition and has been pushed by various organisations. Following the decision of the German constitutional court, which declared a number of workarounds the German government had introduced to bypass its stringent national 'debt brake' unconstitutional, the Board of Academic Advisers of the Federal Ministry for Economic Affairs and Climate

Action published a report, in which it proposed the introduction of a 'golden rule plus'. This rule would allow to exclude net public investment from the rules coverage and thus facilitate spending to achieve the EU climate objectives. The recent budgetary upheaval in Germany, requiring budgetary cuts to comply with the ruling of the constitutional court has triggered intense discussions on a reform of the debt brake in Germany. In my view, we will likely see some changes to the German fiscal rules in the next years (probably only after the next parliamentary elections in 2025) or at least the development of different workarounds that might survive judicial control. But these reflections will come most likely to late to influence the negotiations of the European fiscal framework reform that are almost finished.

In conceptual terms, it would make little sense to add a golden rule to a system that is now – in principle – based on a logic of debt sustainability, where any exemptions would basically imply that member states could spend beyond what would be considered a sustainable trajectory in terms of public debt (one could, of course, question the operationalisation of debt sustainability chosen in the Commission's DSA). The Commission has very much pushed this approach, which aims at including public finances in their entirety rather than having carveouts for specific spending categories. Also the extension clause is designed in a way that remains in line with the overall reform logic and also provides the Commission and member states with an instrument to ensure better compliance with, for example, the country-specific recommendations of the European Semester process. As I deem it unlikely that this system will be put in question again by the Council in the trilogue negotiations, pushing for more room for public investment should probably focus on two elements: pushing for the removal of superfluous safeguards and to set-up the DSA in a manner in which it does not end up being more constraining than necessary to ensure the long-term sustainability of public finances.

The introduction of a golden rule at the EU level would likely make more sense in line with the logic of the existing SGP (that aims to ensure low public deficit and debt levels without any deeper debt sustainability reflections), while removing some of its unworkable elements, such as the 1/20th debt reduction rule and replacing it with something more reasonable. Given the advancement of the negotiations, the support of the Commission for the DSA approach, and the expected advantages of this approach especially for low debt member states, will make it very unlikely that even a limited golden rule could be included in the final reform compromise.

Regardless of the potential usefulness of a (green) golden rule, it is not only fiscal frameworks which constrain the budgetary space of member states, but also their actual public deficits and debt. Even in the absence of any fiscal rules, especially highly indebted countries would have difficulties in the coming years to finance the green transition as they face increasing debt service costs and significant expenditures related to the war in Ukraine. This situation will be further aggravated by the end of the RRF at the end of 2026.

Given the likely outcome of the SGP reform, it will be key to think about European solutions to ensure sufficient spending in the green transition. In my view, a follow-up instrument to NGEU/RRF would make the most sense, as it would address common priorities with common funding. This instrument could, again, be debt-financed, as it is justified to split the costs of safeguarding a liveable planet for future generations across time. The agreement on such a new green investment fund will be politically most feasible in unison with the agreement on the next multi-annual financial framework for the period 2028-2034 and could then also linked to another reform/adaptation of the SGP.

IV . Concluding remarks

WHAT TO EXPECT FROM THE TRILOGUE NEGOTIATIONS?

The Council needs to negotiate with the European Parliament only parts of the reform plans for the European fiscal framework, namely the planned changes to the SGP's preventive arm. But will the European Parliament be able to significantly alter and improve the current Council position in the upcoming negotiations? I'm doubtful about the Parliament's capacity to do so. The Council position is now a tightly balanced compromise between quite opposing member state views and it would be very challenging to put into question any of the major reform elements. In the absence of a broader package deal that could be struck between the Council and the Parliament, little moving parts remain. One way for the Parliament to reach significant concessions would be to threaten to completely block the reform. It is, however, unlikely that the parliamentary parties could align themselves on such an obstructive stance, as the current reform plans are still considerably better than the status quo.

WHAT SHOULD THE EUROPEAN PARLIAMENT AIM FOR?

The European Parliament should nevertheless work hard to improve on the current Council position, even if it will likely only succeed to push for marginal changes. As discussed above, it seems highly improbable that a (green) golden rule could find its way in the final reform compromise, given the differences in preferences and the overall reform approach. Limiting the discretion constraint of the proposed common safeguards and influencing the final design of the DSA could help to allow member states to spend more on public investment, especially towards the green transition.

The Parliament should use the negotiations to highlight once more the public investment needs the EU and its member states have to achieve the green and digital transitions and to improve security on the continent. It should subsequently demonstrate how the planned reform fails to provide numerous member states with the budgetary space to do so, while others are in a budgetary situation where it will be difficult for them to sufficiently invest towards the achievement of the common objectives and priorities even in the absence of rules. This should further the reflection on the means and design of instruments to jointly reach our ambitions. In my view, a new green investment fund is the best solution in this regard.

AN IMPORTANT STEP FORWARD THAT NEEDS TO BE FOLLOWED BY OTHERS

The reform of the European fiscal framework is a significant change to the existing rules and definitely a step in the right direction. It is highly likely now that the proposed reform will be implemented in a very similar form to its current state. But it is surely not the solution for the next quarter of a century. Instead it can be a test-bed for a new logic of fiscal policy coordination and surveillance in the EU, which can then be further developed in the next few years. The proposed reform is not capable to fully resolve the tensions between debt sustainability and climate sustainability. Instead of being able to render both concepts complementary, it at least reduces the tensions to a certain extent. Additional instruments, such as a new European green investment fund, will be needed to align them further in the future. •

Institut Jacques Delors
Penser l'Europe • Thinking Europe • Europa Denken
18 rue de Londres 75009 Paris, France • www.delorsinstitute.eu
T +33 (0)1 44 58 97 97 • info@delorsinstitute.eu

This project is funded by the European Commission's Citizens, Equality, Rights and Values Programme (CERV) under project number 101104850 – IJD 2024