An overhaul of the European fiscal framework?

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An analysis of the Commission proposal and key issues for the negotiations on a reformed Stability and Growth Pact

#european commission #stabilityand growthpact #economy

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• Introduction

This policy brief has two main objectives. First, it analyses the key elements of the recent European Commission proposal to reform the European fiscal framework. It highlights a switch in the overall logic of the Stability and Growth pact (SGP), an attempt to increase national ownership of European fiscal rule requirements, and the inclusion of an incentive structure for public investment and reforms. Second, the blogpost raises several issues of particular relevance for the forthcoming political negotiations on a reformed SGP. Due to the European fiscal framework's high degree of complexity and technicality, if focuses on three key aspects of the Commission's reform proposal. This includes (1) open questions regarding the actual minimum fiscal consolidation requirements imposed on member states, (2) challenges of the new fiscal-structural plans for democratic choice, and (3) the potential inadequacy of the incentive structure to ensure sufficient public investment in light of the climate crisis. The blogpost will conclude with some final remarks on the forthcoming negotiations.

I • At last—a detailed reform proposal for EU fiscal rules

After several years of consultations and discussion, the Commission finally presented its orientations for the reform of the EU economic governance framework on the 9th of November 2022. At the heart of the proposal is a substantial revision of the SGP, which is a cornerstone of EU economic governance since the late 1990s. A more 'cosmetic' reform of the Macroeconomic Imbalance Procedure (MIP) is equally envisaged.

Despite several reforms (2005, 2010-2013), the current set-up of the European fiscal framework (consisting of fiscal rules, institutions and mechanisms to ensure rule compliance) has been increasingly questioned by policy-makers, public officials and experts over the course of the last years. Growing experience with the implementation of the SGP together with new economic realities due to the Covid-19 crisis and the 2022 energy price crisis have triggered a reflection process, which was further institutionalised with the Commission's EU economic governance review.

The Commission proposal is largely in line with several recent high-level publications by national governments and international organisations on European fiscal framework reform, such as the Spanish-Dutch Joint Paper from April 2022 and the IMF Proposal from September 2022. It also reflects—for the most part—a consensus among economists, which has formed in recent years on the fiscal rules design most adequate to guide policy-making.

II • The key elements of the Commission proposal

With its long-awaited orientations for a new European fiscal framework, the Commission proposes the most substantial reform since the original SGP was adopted in the 1990s. While a legislative proposal is only scheduled for early 2023, the 27-page communication provides already a rather detailed description of the reform plans.

A SWITCH IN THE OVERALL LOGIC OF THE EUROPEAN FISCAL FRAMEWORK

Most importantly, the Commission proposal aims to introduce a major switch in the logic of the European fiscal framework. It envisages to **move from a system with stringent fiscal rules combined with lax and politicised enforcement towards a system with more lenient fiscal rules together with a more automatic and credible enforcement.** *De jure*, the current European fiscal framework actually has strong enforcement mechanisms at its disposal. But as the Commission deemed compliance with at least some of the existing rules as economically detrimental for member states with high public debt levels, it used its discretion to not enforce parts of the fiscal rules. It *de facto* replaced them with fiscal consolidation requirements it considered more realistic and economically sensible for these countries, negotiating the minimum consolidation requirements in bilateral discussions with the concerned member states.

The Commission's reform proposal aims to formalise this informal practice by giving a greater role to economic expertise in determining individual national fiscal consolidation trajectories based on a common methodology. This approach will likely reduce the formal discretion constraint of the European fiscal rules for most—if not all—member states. **In exchange for this flexibilisation of the SGP, the Commission wants to introduce a broader set of monitoring and enforcement mechanisms, which are also supposed to be applied in a more consistent and automatic manner across countries.** A key element in this regard would be to accompany the deficit-based excessive deficit procedure (EDP), which will remain in place as is, more effectively with the debt-based EDP. Under the new rules, the latter would be triggered whenever a country was not complying with its structural-fiscal plans. Acknowledging political and economic challenges in applying significant financial sanctions for non-compliant countries, the Commission proposal seeks to draw more upon reputational rather than financial costs, including at the national level. This approach is supposed to help make the European fiscal framework more credible and effective, while also appeasing member states critical of a flexibilisation of fiscal policy constraints.

MORE NATIONAL OWNERSHIP THROUGH BINDING FISCAL-STRUCTURAL PLANS

A key feature of the SGP reform proposal is to improve national ownership by giving member state governments a more active role in the formulation of their own fiscal consolidation trajectories. The main tool to achieve this are so-called "medium-term fiscal structural plans", through which the Commission aims to emulate the approach developed for the disbursement of Next Generation EU's Recovery and Resilience Facility (RRF). Member states and the Commission negotiated national recovery and resilience plans (NRRPs) which laid down national investments and reforms which governments were to undertake in exchange for EU money. Also the Council had to adopt these plans.

The proposed fiscal-structural plans are supposed to combine this contractual approach between member states and the European institutions with the medium-term perspective of the existing stability programmes and a new and reduced set of fiscal rules. The main target in the fiscal-structural plans would be annual compliance with four-year expenditure ceilings in line with long-term public debt sustainability.

In addition to the fiscal-structural plans, **the Commission also suggests to increase national ownership by further strengthening the role of independent national fiscal institutions/councils**, which are active in all member states since the SGP reforms of the early 2010s. They should further facilitate the appropriation of budgetary constraints by political decision-makers and also serve as a domestic actor to incur reputational costs on national governments that do not comply with the fiscal policy trajectories set by politicians in line with the European requirements.

AN INCENTIVE STRUCTURE TO IMPROVE PUBLIC INVESTMENT AND REFORM EFFORTS

The Commission proposal attempts to create an incentive structure for public investments and reforms that would, on the one hand, have positive long-term effects on fiscal sustainability but, on the other hand, also commit member states towards the achievement of EU priorities. These include, most importantly, investments towards the green and digital transition as well as reforms from the country-specific recommendations of the European Semester process. **The 'carrot' in the proposed reform is that investment and reform commitments by national governments, in the framework of their fiscal -structural plans, can lead to lengthen their fiscal adjustment path from four to seven years.** Similar to the NRRPs, member states would have to include clear commitments for these investments and reforms to benefit from more accommodating fiscal consolidation requirements. The 'stick' in this approach would be the triggering of an enforcement mechanism when member states would not fulfil their investment and reform commitments, leading to a tightening of fiscal consolidation trajectories and financial sanctions.

III • Key issues for the forthcoming political negotiations

Based on this overview of key elements of the Commission's reform proposal for the European fiscal framework, this blogpost identifies several issues that might be contentious among member states or could pose problems in the implementation phase and should thus be addressed early on in the forthcoming negotiations.

THE EXTENT OF DISCRETION CONSTRAINT REMAINS VAGUE FOR THE MOMENT

Most of the immediate political and mediatic reactions on the Commission communication have framed the reform proposal as significantly flexibilising the European fiscal framework in terms of fiscal discretion constraint. This might well be true for countries with low levels of public indebtedness but is, so far, considerably less clear for countries with very high debt levels. While the 60% debt-to-GDP limit will not be touched, it will be effectively replaced by a fiscal risks approach which focuses on public debt sustainability. The Commission demands that the fiscal-structural plans prescribe "multiannual net primary expenditure path[s] should ensure that debt is put or kept on a downward path at the latest by the end of the adjustment period or stays at prudent levels, while ensuring that the budget deficit is maintained below 3% of GDP over the medium term" (Commission proposal 2022:8).

The Commission communication suggests to draw on the existing debt sustainability analysis (DSA) framework and that national fiscal adjustment paths "for member states with a substantial public debt challenge" would be acceptable as long as "the 10-year debt trajectory beyond the plan's horizon were on a plausibly and continuously declining path" (*ibid.*:22). While this fiscal rule approach would be more lenient than the infamous debt reduction rule (demanding a yearly reduction of 5% of any debt beyond 60% of GDP), which was informally already abandoned by the Commission for member states with high public debt levels before the Covid-19 crisis due to its economically counterproductive effects, **the proposed fiscal rule approach could nevertheless lead to significant fiscal consolidation requirements for highly indebted countries.**

The actual extent of discretion constraint for member states will depend a lot on the calibration of the DSA framework for the use as a debt anchor in a reformed SGP and the operationalisation of a "plausibly and continuously declining path". By how many percentage points of GDP should public debt decline to be deemed in line with this approach? And how much fiscal consolidation would different calibrations of debt sustainability analyses require from individual member states, especially those with high public debt levels? **To provide answers to these questions, the Commission should soon provide clarifications and present model calculations to show how stringent fiscal adjustment paths would be for individual member states in different scenarios, also drawing on historical data.** This would help to better inform the negotiation process between member states with different preferences for a reformed SGP to ensure that fiscal adjustment paths will actually be realistic and economically sensible.

POTENTIALLY DELETERIOUS CONSEQUENCES FOR DEMOCRATIC CHOICE

As fiscal rules serve to reduce the fiscal policy discretion of political decision-makers, there is always the risk that they might overly constrain democratic choice. While the Commission proposal attempts to make the European fiscal rules more lenient for a majority of member states, **the approach based on binding medium-term fiscal-structural plans could actually pose some new challenges for democratic budgeting.** This is mainly linked to the Commission's intention to allow fiscal-structural plans to be revised only "after a minimum period of four years" (Commission Proposal 2022:8). Emulating the design of the RRF, the only exception for an earlier revision would be "in case of objective circumstances making the implementation of the plan infeasible" (*ibid.*), which would normally exclude the possibility for an incoming government following national elections to revise active plans.

While the Commission stresses that "frequent revisions would undermine the credibility of the plans as an anchor for prudent policies" (*ibid.*), four-year binding plans can create serious problems for democratic choice. A government could, for example, develop and agree on a very constraining fiscal consolidation path with the European institutions, far beyond the minimum requirements demanded by a reformed SGP. If elections would lead to the formation of a new government with different policy preferences before the end of the fiscal-structural plan, it would nevertheless be bound by the budgetary approach chosen by the previous government. This would considerably hamper democratic choice.

Should a government opt for a seven-year fiscal-structural plan including specific investment and reform priorities, this could become even more constraining as a follow-up government would need to implement priorities that might go against its own preferences and the platform on which it was elected. The non-compliance with certain reform and investment milestones/targets could lead to stricter consolidation demands from the European institutions, putting further pressure on democratic decision-making.

To avoid such situations, **the current reform proposal should be amended to allow incoming governments to negotiate a new or revised fiscal-structural plan with the Commission.** Policy credibility should not be undermined by a plan revision as these plans are, in any case, supposed to be in line with minimum consolidation requirements to achieve long-term public debt sustainability.

INSUFFICIENT INVESTMENT IN THE GREEN TRANSITION REMAINS LIKELY

While the Commission's reform proposal for the SGP aims to address the challenges that fiscal rules pose for public investment, most importantly to finance the green transition, the incentives to do so might be insufficient in the absence of new European

funding which could replace the RRF from 2026 onwards. Ahead of the publication of the Commission's orientations for a revised European fiscal framework, two reform options to help increase public investment seemed plausible. The first option was the one now presented, entailing a certain flexibilisation of national fiscal policy constraints in exchange for investment and reform commitments made by member states. The second option would consist of a reform—but not necessarily a flexibilisation—of European fiscal rules paired with a new European public investment instrument which would have handed out grants in exchange for investments and reforms in common priorities. While the latter option would have maybe arrived 'dead on arrival' due to member state resistances towards new common debt or own resources, it might be preferable to the one pushed by the Commission to avoid underinvestment.

The current reform proposal might lead to continued insufficient investment in the green transition due to two factors. First, the Commission conditions a lengthening of fiscal adjustment paths to "reforms and investments that foster long-term sustainable growth and, therefore, help improve debt dynamics". It might, however, be **difficult to conclusively show—for a number of areas in need of significant public investment—that investments would actually improve long-term growth. Especially for green investments, the methodologies of DSA frameworks would need to be adapted to account for the negative economic, societal and ecological consequences of climate change.** There is, however, a strong pushback from public finance experts and practitioners who would prefer to keep debt sustainability and climate sustainability concerns apart. This might undermine the capacity of national governments to propose investments that can fulfil the requirements, not unlike the largely unused 'investment clause' currently included in the SGP. Second, **in the absence of additional funds, member states with high public debt levels might use the incentives provided by the proposed SGP reform for public investments in other policy areas than the green transition in the search of pushing up domestic potential growth.** This might even lead to investments that are not in line with the priorities for reducing greenhouse gas emissions.

A new European fund to finance the green transition, but also other EU priorities such as the digital transition and the reduction of economic dependencies, would definitely help to ensure sufficient public investment in the most relevant policy areas from a European perspective. It should not be off the table from the outset of the negotiations on a revised European fiscal framework, as the current proposal might not provide a diverse-enough set of policy options to develop win-win-solutions for EU member states with different policy preferences.

IV • Final remarks

The orientations provided by the European Commission on the reform of the European fiscal framework provide a solid basis for the forthcoming political negotiations. The proposal draws heavily on the feedback provided by fiscal policy experts and practitioners during the EU economic governance review as well as the Commission's own experience with the RRF governance. It also attempts to formalise some of the Commission's practices which have been informal parts of its annual fiscal surveillance and enforcement exercises at least since the mid-2010s.

The forthcoming political negotiations will nevertheless be very difficult. Strong differences in policy preferences for a reformed European fiscal framework remain between member states, notably regarding the role given to expertise vs. numerical fiscal rules in defining fiscal consolidation trajectories. This also raises the question of who should be allowed to make 'expert' decisions on fiscal policy constraints. Countries like Germany have long-standing preferences for simple, clear and uniformly applied numerical rules and are rather sceptical of delegating the definition of fiscal adjustment paths to expert bodies, which might lead to more politicised decisions than fixed rules would. They see the recent Commission practices in (non-)enforcing European fiscal rules as a case in point. Other member states, such as France, have long been critical of an exclusively rules-based approach, considering it to be not 'smart' enough to deal with complex economic conditions, subsequently leading to suboptimal policy outcomes.

The agreement on a substantial revision of the European fiscal framework strongly depends on the capacity of any proposal to address the concerns of both camps. The Commission proposal attempts to do so by flexibilising and individualising fiscal adjustment paths in exchange for more stringent enforcement. Whether the SGP reform will be acceptable for countries with high public debt levels depends crucially on the question, whether the new approach will provide them with sufficient leeway to engage in ambitious investment policies. And whether the 'frugals' can be convinced to abandon their preferences on fiscal rules depends largely on the capacity of the SGP reform to commit countries with high debt levels to credible fiscal adjustment trajectories and significant domestic reforms.

Addressing the three key issues of the Commission proposal identified in this blogpost would help facilitate the process of finding a compromise between member states. To summarise, the Commission needs to, first, rapidly clarify the discretion constraint implied by the new fiscal rules to help dispel fears on both sides and lay the ground for negotiations on the exact design of the debt anchor and how it translates into multi-annual fiscal adjustment paths. Second, the current proposal needs to be modified in a way that minimises negative effects on democratic choice. While fiscal rules always constrain fiscal policy discretion, it is important to leave sufficient room for politics to be able to set different policy priorities inside the common framework. And finally, while the reform proposal provides better incentives for public investment than the existing European fiscal framework, it is unlikely to ensure sufficient public investment in the context of the climate crisis and the need for more strategic autonomy. In this regard, a new European fund to finance the green transition and other priority areas should definitely be included in the SGP reform negotiations.

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