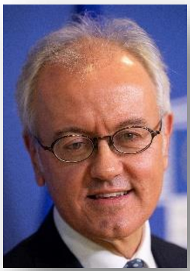
Belgian Financial Forum

Reforming the European Fiscal Rules: Old Wine in New Bottles?



Marco Buti
Head of Cabinet
of the Commissioner for the Economy

ABSTRACT

On November 25th, 2022, Marco Buti, head of Cabinet of Paolo Gentiloni, EU Commissioner for the Economy, presented the view of the European Commission on the current European fiscal rules and how they are to be reinforced, at a Conference organised by the Belgian Financial Forum, a platform organisation for the Belgian financial sector represented by Febelfin[i], Assuralia[ii], and FSMA[iii], and with the support of the National Bank of Belgium (NBB).

Rehashing the title of the Conference, I would summarize my message as “New Wine in Old Bottles”: the Treaty’s reference values and the Excessive Deficit Procedure (EDP) remain, but the proposals of the Commission mark a significant reform of the present rules. The current fiscal framework in the European Union emanates from a series of reforms to the original 1997 Stability and Growth Pact (SGP), notably in 2005 (introduction of Medium-Term Objectives, MTOs), 2011 & 2013 (Six Pack and Two Pack, Fiscal Compact). Despite the extensions and refinements, the rules have not performed as they could and should have, for several reasons. Thus, proposals have been suggested for improvement. Exhibit 1 lays out their main elements of the current fiscal framework and the problems encountered in its implementation.

The current fiscal framework is comprised of a preventive and a corrective arm. The preventive arm is built around the anchor of an MTO defined in structural terms, meaning that any measure needs to take into account the state of the business cycle and must disregard the effect of one-off measures. Even though the rules provide some flexibility depending on the state of the economic cycle and there exist structural reforms and investment clauses, the rules imply a quasi-uniform adjustment towards the medium-term objective. In an effort to avoid an excessive deficit before it happens, there also is a Significant Deviation Procedure. The 3 per cent deficit reference value has *de facto* become an upper threshold. The public debt ratio should approach the 60 per cent reference value at a sufficient pace which has been quantified via the “1/20th rule”: the gap between the debt to GDP ratio and the 60 per cent is supposed to be reduced on average by 5 per cent a year. Should the deficit exceed the 3 per cent deficit ceiling or the public debt not diminish sufficiently towards the 60% reference value, the EDP[iv] kicks in: whilst the deficit-based EDP has been applied frequently, the debt-based EDP has never been applied.

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Exhibit 1: The Current EU Fiscal Framework

Preventive arm	Corrective arm
• Anchor = Medium-term objective in structural terms • Quasi-uniform adjustment of the structural balance towards the MTO, with spending rule and structural reform and investment clauses • Significant deviation procedure	• Deficit based EDP: 3% ceiling • Debt-based EDP based on debt reduction benchmark (1/20th rule)

<u>**Problems**</u>

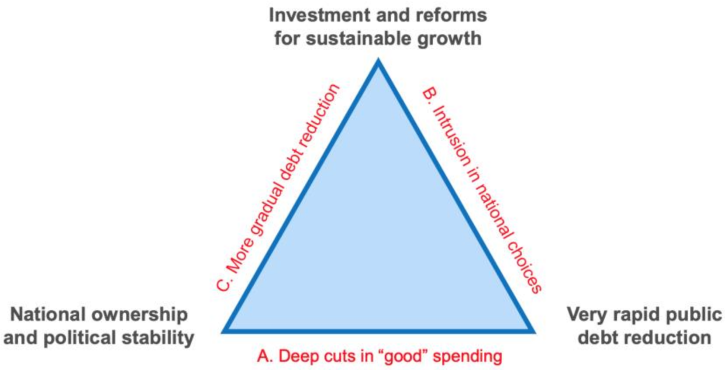
- **Complexity**: many indicators and rules (Structural balance, net expenditure growth, ...)
- **Unrealistic pace of debt reduction implied by 1/20th debt rule**
- **Pro-cyclical bias** in good and bad times
- **Limited incentives** for reforms and investment
- **Lack of ownership**: Adjustment common across the board, ‘determined by the EU’
- **Low enforcement**: half of the MS never met the MTO. Debt-based EDP never opened.

Six problems can be identified with the current fiscal framework:

- First, the framework is **complex**. Several indicators are involved, and this leads to “arbitrage” among indicators according to national conveniences.
- The 1/20th rule has proved to be **unrealistic**. The amount of adjustment that is required to meet the 1/20th rule is too large.
- The fiscal rules carry a **pro-cyclical bias** in both good and bad times, even though countries who respected the rules tend to have a more anti-cyclical behaviour.
- The fiscal framework offers **limited incentives** for reforms and investments.
- There is a clear **lack of ownership.** Politicians in many countries, even big ones, tend to see the rules emanating from “Brussels” rather than been a common good, which lead to low acceptance.
- As a result, there has been a **low enforcement** both in the preventive and in the correct arm of the SGP.

To remedy the woes of the current fiscal framework, the EU Commission proposes a new approach in its communication[v] of November 9th, 2022. The spirit of the Commission’s proposals can be captured by what one can call SGP Trilemma (see <u>Exhibit 2</u>).

Exhibit 2: The SGP Trilemma



A trilemma exists when you want to reach three objectives but only reach any two can be met simultaneously, excluding the third one. In principle, an "ideal" supra-national fiscal framework would lead to a rapid reduction of high public debt levels, promote better quality of public finances and reforms for sustainable growth, and be compatible with national political ownership and stability [vi].

In economic theory, trilemmas have been identified before. The Mundell-Fleming trilemma[vii,viii] is one of the tenets of macroeconomic and monetary theory and lies at the basis of the creation of the Economic and Monetary Union. The "SGP Trilemma" is more "evocative", but it may be considered as a good way of presenting the practical problems facing the implementation of the SGP.

How to solve this trilemma? If you want to reduce debt levels and keep national political stability, you have to go for deep cuts in public spending. Unfortunately, the constituency behind bad public spending tends to be stronger than the constituency behind good public spending and, in particular, investment. If you impose deep cuts, you typically end up with deep cuts in "good" spending, or solution "A" at the bottom of the trilemma in Exhibit 2.

When you want to combine investment and reforms and ensure a very rapid public debt reduction, you will need solution "B" which would require a very heavy intervention by European authorities. This would impose national choices violating national policy ownership, thereby undermining political stability.

So, the only way forward which allows to achieve better composition of fiscal policies and safeguard national ownership is solution "C" that implies a more gradual, but sustainable path of debt reduction. That allows to free sufficient resources for investment and provide incentives for structural reforms. It safeguards stronger national ownership and political stability.

The gist of the Commission's proposed fiscal framework is presented in Exhibit 3.

Exhibit 3: A Suggested New Fiscal Framework

National ownership embedded in EU framework	Simplification and focus on fiscal risks	Enforcement
1. Commission puts forward reference adjustment paths 2. Member States propose medium- term fiscal structural plans 3. Annual budgets will commit to follow the fiscal trajectory and ensure that debt will start converging to prudent levels within horizon of the plan 4. Member States can request a longer adjustment period underpinned by reforms and investments 5. Council endorsement of the plan 6. Stronger role of national IFIs	1. Net expenditure path anchored on debt and agreed by Council will be the single fiscal indicator 2. Surveillance and enforcement will be risk-based 3. Debt reduction benchmark, benchmark for reduction in structural balance, significant deviation procedure and matrix of requirements no longer exist	1. Deficit-based EDP (3% of GDP threshold) maintained 2. Debt based EDP will be operationalised and strengthened, as a tool to ensure compliance with the agreed net expenditure path 3. Financial sanctions toolbox will be enriched with smarter sanctions 4. Macroeconomic conditionality will be maintained 5. A new tool to ensure delivery of reforms and investments underpinning gradual adjustment path

In a nutshell: the new fiscal framework aims at strengthening national ownership, simplify the rules and ensure a stronger enforcement.

How would the system, according to the Commission proposals, work?

The process kicks off when the Commission puts forward **reference adjustment paths** in terms of net primary public spending: interest payments are taken out, as well as discretionary changes in tax rates. The degree of adjustment embodied in the reference adjustment paths would depend on the severity of the fiscal sustainability challenges which are assessed via the Debt Sustainability Analysis (DSA). Such reference paths constitute the kick-off of the process. Next, member states draw up their medium term fiscal structural plans covering at least four years, taking into account the Commission reference path. These plans are then translated in annual budgets.

The new proposal comes with an incentive: a lengthening of the adjustment period from 4 years to at most 7 years. This provides a smoother adjustment, based on reforms and investment put forward by member states themselves. There would be intense dialogue with the Commission and eventually endorsement by the Council of the plans. There also would be a stronger role for independent national institutions.

The proposal by the Commission implies a strong simplification of the rules as the focus falls on the net expenditure path. Stronger surveillance and stricter enforcement will result for countries where debt and sustainability of public finances are more at risk. In practice, we simplify by *inter alia* doing away with the1/20th debt reduction benchmark and the significant deviation procedure.

Stronger enforcement is also part of the deal. As the 3 per cent and the 60 per cent criteria are in the Treaty of Maastricht, and in the Protocol, they remain but the debt based EDP would more likely be open in the future. Financial sanctions would become less harsh, but more implementable. If a member country does not respond properly to an excessive deficit recommendation, cohesion funds and other funds may be cut off. In the same line, the Commission is going to introduce a new tool to ensure the delivery of the reforms and investments which underpin the more gradual path of reduction of the debt, if we broaden the window for adjustment for up to 7 years.

Since its publication on November 9th, the Commission proposals have been discussed in various institutional fora and widely commented in the press. Exhibit 4 presents the main questions and criticisms that have arisen.

Exhibit 4: Main Criticisms

- With DSA and risk analysis, the new framework is more complex than the current SGP
  >> *No, DSA only at the outset in identifying risk category and adjustment path*
- Too intrusive Commission role in deciding ‘good’ investments and reform
  >> *No, it’s up to MS to select them, within a common framework*
- There is a risk of ‘bilateralism’, lack of transparency and unequal treatment
  >> *No, the Commission will operate within a clear common framework*
- Better keep the structural balance instead of focussing on expenditure
  >> *No, net primary expenditure is clearer, more controllable and anti-cyclical*
- Not having changed the 3%/60% imposes a deflationary bias for many years
  >> *No, after 4/7Y, the debt will continue to go down without further restrictions*
- A Central Fiscal Capacity is missing
  >> *Yes, but the reform of the fiscal rules is not the end of the game*

First, on the criticism that the DSA would make the framework more rather than less complex, it has to be pointed out that the DSA plays a role only at the beginning of the process. Once a net expenditure path has been adopted, the surveillance would only focus on the implementation of and compliance with that path.

Second, about the objection that the role of the Commission in defining the investment and reforms is too intrusive, one must stress that, although the EU defines the big objectives, and that country-specific recommendations are formulated as part of the European Semester, it is up to the member country to select the reforms and investments.

A third kind of criticism has been dubbed "bilateralism", meaning that the national adjustment requirements would be set by the Commission and each member state individually, rather than reflecting a common set of rules. To avoid this risk, the communication has made clear that rules would respect common principles applying to all member states and the Commission would operate in a clear and transparent framework. All methodologies will be published as well as the DSA itself.

Some countries prefer to keep the structural balance instead of focussing on expenditure. This critique is particularly relevant in Germany as this country has inserted the MTO – which is defined in terms of the structural balance - in its Constitution, and even put a limit of 0.35 per cent of GDP at the most. The Commission makes clear that it is perfectly possible to translate the net expenditure path in terms of the structural balance if that is desirable from a domestic national perspective. However, it stresses also that a rule expressed in net primary expenditure automatically behaves in an anti-cyclical way. It is a much more controllable indicator than t structural balance as the latter depends on unobservable variables like the output gap.

Another criticism is that the 3 per cent / 60 per cent norm will not be touched, and that in so doing, a deflationary bias will be permanently built in into the European fiscal framework. This is not the case, because at the end of the adjustment period (four years, or possibly seven years), the country would have achieved a level of primary balance entailing a continuous reduction in public debt without the need of further adjustment.

Finally, it has been pointed out that **central fiscal capacity** for the EU is still missing from the European fiscal framework. Actually, it was suggested by the European Fiscal Board, as well as by the IMF, the ECB, the OECD and many economists during the public consultation on the reform of economic governance launched by the Commission. Certainly, central fiscal capacity would strengthen the European Union as much as it would help support member states, but it remains a controversial step ahead that may be quite difficult to take. For that reason, the Commission decided not to propose it as part of the reform of the fiscal rules.

What are the next steps? The Ecofin Council will discuss the Commission proposals with the goal to find a consensus at political level in the course of 2023. Eventually, given the political importance of the subject matters, there will need to be political ownership by the European Council. Depending on the degree of political consensus, the Commission will come forward most likely in Spring 2023 with legislative proposals amending the existing fiscal framework. Finding an agreement on the modifications of the legislative framework will take some more time, as one of the two regulations of the Pact, as well as the directive on national fiscal frameworks, are require unanimity.

The debate on the fiscal rules will take place in parallel with the coordination of national fiscal policies. In the first quarter of 2023 the Commission will come forward with the orientations for the preparation of the Stability and Convergence Programs, as usual in April, the European Semester, in May-June, and the Draft Budgetary Plans, October. In 2023 we will still be under the General Escape Clause (GEC)[ix] so the adjustment requirements under the SGP are still suspended. Barring further bad surprises, the GEC would be repealed as of 2024. The Commission intends to apply the "spirit" of the new fiscal framework already for the 2024 national fiscal policies.

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i The umbrella organisation for financial institutions in Belgium: https://www.febelfin.be/en

ii The representative for (nearly all) domestic and foreign insurance companies operating in Belgium: https://www.assuralia.be/nl/home

iii Financial Services and Markets Authority in Belgium: https://www.fsma.be/en

iv Excessive Deficit Procedure: https://economy-finance.ec.europa.eu/economic-and-fiscal-governance/stability-and-growth-pact/corrective-arm-excessive-deficit-procedure_en

v Communication with the Orientations for the EU Governance Framework, Nov 9, 2022: https://ec.europa.eu/commission/presscorner/detail/en/ip_22_6562

Buti, Marco, Friis, Jakob, and Roberta Torre (2022), "How to make the EU fiscal framework fit for the challenges of this decade", Vox CEPR, 10 November.

vii Mundell, Robert A. (1963). "Capital mobility and stabilization policy under fixed and flexible exchange rates". Canadian Journal of Economics and Political Science. 29 (4): 475–485.

viii Fleming, J. Marcus (1962). "Domestic financial policies under fixed and floating exchange rates". IMF Staff Papers. 9: 369–379.

ix https://www.europarl.europa.eu/thinktank/en/document/EPRS_BRI(2020)649351