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EC's new fiscal framework: step in the right direction

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ABSTRACT

With its just-published ideas for reforming the European fiscal framework, the European Commission (EC) is taking a step in the right direction. Replacing almost all existing complex rules with a norm for spending that is directly impacted by policymakers represents a drastic simplification and sharpens the accountability of policymakers. Integrating fiscal policy, economic reform, investment plans, and, where applicable, macroeconomic stability into a single policy plan with a medium-term focus can enhance policy coordination. By including country-specific public debt reduction requirements in that multi-year plan, considering the sustainability risks of existing public debt, fiscal consolidation objectives and the strengthening of economic growth potential can, in principle, be reconciled. Thus, tricky issues in the current framework are remediated.

But the new way of working would also create new, complex, and sometimes politically charged discussions, with margin for discretionary decisions. The EC's role in the new policy framework is similar to its role in allocating NextGenerationEU support to member states. The EC consolidates and expands that role, inevitably further increasing its political character, with no proposals to strengthen its democratic legitimacy. There are also no proposals for a larger central budget (fiscal capacity) - a necessary cornerstone for a stable currency union. Thus, the EC's ideas do not bring the missing link for a fully-fledged, stable currency union. They are a step in the right direction, but certainly not the final step.

Inadequate fiscal framework ...

The European Commission (EC) released its ideas on reforming the European fiscal framework on 9 November 2022. That framework should help prevent the stability of the European currency union from being undermined by a derailment of member states' public finances. To this end, the Maastricht Treaty, which conceived the euro in 1992, stipulates that a euro area country's public finance deficit should not exceed 3 per cent of GDP and public debt should not exceed 60 per cent of GDP, or should at least move in that direction if it is higher.

These principles were elaborated even before the effective introduction of the euro in 1999 in the Stability and Growth Pact (1997), and were updated and refined several times since then, not least of which being shortly after the major eurozone debt crisis in 2011. As a result, the two basic rules in

the treaty have evolved into a particularly complex set of rules. Almost all observers agree that these rules need to be simpler and more transparent.

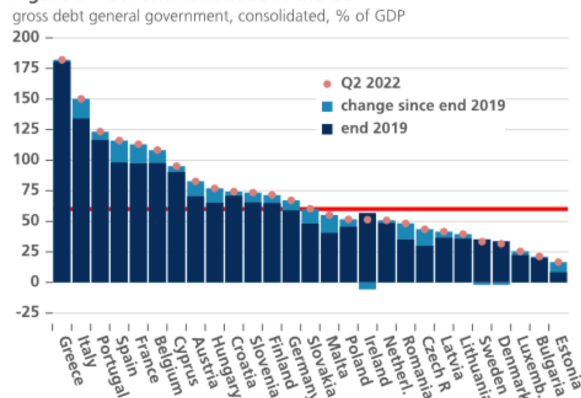
Moreover, the framework suffers from substantive shortcomings. A recent [IMF paper] states unequivocally that the framework has failed to deliver on its most essential objective: to reliably manage fiscal risks and the associated contagion risk vis-à-vis other member states. The framework failed to ensure that member states built fiscal buffers during economic good times that could be drawn on during economic downturns. Cyclical stabilisation at the European level, through a central budget, is completely non-existent.

The framework is also insufficiently friendly to public investment, which, despite a recovery in 2018-2019, remains at historically low levels (relative to GDP) in the euro area. After all, cuts in public investment do not have immediate major drawbacks as, effects of public investment – both positive and negative – typically take time to materialise. Hence, in fiscal consolidation, they often come into focus first. This happened on a large scale in the aftermath of the debt crisis in the previous decade (Figure 1).

Figure 1 - Public investment in the euro area
gross fixed capital formation, % of GDP

Source: KBC Economics based on DG ECFIN

Figure 2 - Government debt in the EU
gross debt general government, consolidated, % of GDP



Source: KBC Economics based on Eurostat

In the long run, however, the lack of public investment undermines the economy's growth potential. Today in particular, there are concerns that reducing public debt within the existing fiscal framework would hamper necessary investments for the transition to a green and digital economy.

The Covid-19 pandemic caused public debt to rise sharply in most countries, starting from a level that already exceeded 60% of GDP in 12 of 27 EU countries by the end of 2019 (Figure 2). This did not pose an acute problem as the fiscal framework's strict rules on budget deficits and debt reduction were temporarily suspended in 2020 due to the exceptional circumstances of the pandemic by applying the so-called escape clause. A special ECB purchase programme for (among other things) government bonds (Pandemic Emergency Purchase Programme or PEPP) ensured that the sharply rising budget deficits of euro area countries were smoothly financed and that no one had to worry about the sustainability of government debt.

The application of the escape clause is due to expire in 2024, according to current decisions. From then on, the strict rules around deficit reduction and debt reduction would come back into force. On the one hand, this does not seem like a luxury, as the end of the PEPP and rising interest rates bring the sustainability of public finances back to the fore. On the other hand, there is a widespread perception that the rule stating that the difference between the current debt ratio and the 60% threshold should be reduced by 1/20th annually is an unachievable target in particular. Based on the EC's recent projections, for Italy, for example, this would imply a debt reduction of over 4% of GDP by 2024; for Belgium, it would imply a debt reduction of 2.4% of GDP.

Against the background of the energy crisis and major investment needs for the digital and green transition, among others, this is not only unfeasible but also undesirable. Admittedly, the NextGenerationEU programme provides that some of the public investment to bring about the green and digital transition of European economies will be funded through the European budget. But the member states themselves must also make a significant contribution. In other words, there is a need for a fiscal framework that leaves more room for growth-enhancing investment without compromising the sustainability of public finances.

Box – No golden rule

The EC is not proposing to introduce the so-called golden fiscal rule. That rule leaves out public investment when assessing the budget deficit due to the idea that to finance investment, the government is allowed to take on debt. Many observers had expected the introduction of a golden rule, but the EC rightly omits it. Indeed, such a measure risks in practice creating an explosion of so-called "public investment" that is in fact consumer spending. Moreover, while some current spending, for example on education, can also contribute to strengthening growth potential, this is not necessarily the case for all public investment. This is not captured by the golden rule. The temptation for creative accounting would guarantee endless discussions, though. Moreover, an economically orthodox application of the golden rule requires that depreciation on government assets be accounted for in the budget. This would again add complexity to the fiscal framework. Finally, the golden rule as such does not take into account the size of existing debt. For countries with high debt, this could be a problem.

…up for renewal

The EC proposal for the new fiscal framework has that ambition. Virtually all existing rules would be scrapped. Only the 3% budget deficit rule and the 60% public debt rule remain. This is because these cannot be changed without a treaty change, and such a treaty change is currently considered unfeasible. All other rules in the fiscal framework would be replaced by the EC with one new operational standard. This would cover government spending, excluding interest expenses and cyclical unemployment spending. Only expenditure to be financed from national resources would be considered. Discretionary revenue measures are also taken into account. The focus is thus entirely on expenditure and revenue that a government has maximum control over. The impact of the business cycle on the budget is disregarded.

For all such spending, the EC would set a growth norm for each country based on its analyses of the sustainability of their public debt. For each country, it would outline a reference path of at least four years with maximum allowed growth in public spending, as described above. The spending norm should ensure that (in principle) after the end of the four-year path, the budget deficit under unchanged policies would remain below 3 per cent of GDP for the following 10 years and, for countries with a debt ratio of more than 60 per cent of GDP, the debt ratio would be on a steadily declining path. Countries with low or medium risk as regards the sustainability of their public debt will be given a somewhat longer fiscal consolidation period than those with high risk.

Member states will have to translate the EC's reference path into a medium-term fiscal and structural reform plan. That plan would become the centrepiece of the new fiscal framework. It will replace the current stability or convergence plans and structural reform plans. The plan should translate the reference path for spending into annual expenditure ceilings. Economic reforms and public investment should also be specified in the plan. If these enhance economic growth and improve public debt sustainability, fiscal consolidation could be spread over a period of up to three additional years. This moderation could help reconcile fiscal consolidation objectives and the strengthening of economic growth potential through investment and reforms.

The medium-term plan would be assessed by the EC and adopted by the Council. Countries with large macroeconomic imbalances should also include measures to address them. This would better align the fiscal framework not only with measures to strengthen economic growth potential, but also with monitoring macroeconomic imbalances.

Each member state should prepare an annual progress report, which will serve as a basis for monitoring by the EC and the Council. The procedure in case of an excessive budget deficit would remain unchanged regarding the follow-up of the 3% standard but would be tightened for the application of the 60% standard. Thus, any deviation from the predetermined debt reduction path for countries with high sustainability risks would automatically trigger the procedure. Greater effectiveness of sanctions is also envisaged by refining and expanding the arsenal. On the other hand, the possibility of activating an escape clause (as currently applicable) would be preserved for exceptional circumstances.

A step in the right direction

The EC's ideas undoubtedly address important shortcomings of the current framework. Rules of the existing framework that use very theoretical concepts, such as the output gap and the structural budget deficit, which in practice have little transparency and are highly uncertain[1], are replaced by a single measure on which policymakers have a much more direct operational impact. This improves simplicity and makes policymakers more directly accountable. Excluding cyclical expenditure and revenue in a simple way also contributes to this. This is a step in the right direction.

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[1] For an illustration of this during the boom period, before the Covid-19 pandemic, see KBC Economic Opinion of 20 September 2018.

On the other hand, estimates of the sustainability of public debt, from which the expenditure norm would be derived, are no more straightforward than the theoretical concepts currently used. Estimating debt sustainability according to alternative methods is clearly an expert exercise, which the EC can take relatively neutrally. But the choice of the debt ratio reduction path and its translation into an expenditure norm also imply policy choices. These are likely to give rise to new, complex and sometimes politically charged discussions, with room for discretionary decisions. In doing so, the EC is potentially entering even more political territory than in the current framework.

This is also true when it will assess member states' medium-term plans, not least when considering the extent to which investment and economic reforms would allow for a more staggered reduction of government debt and deficit. That trade-off is potentially the biggest lever of the new framework. It allows member states to work not only on the numerator (debt as such) of the debt ratio[2], but also on the denominator (GDP, in other words, the size of the economic base for the debt). Not least in light of rising ageing costs, it is crucial to strengthen the economic support base. Moreover, centralising fiscal plans, structural economic reform, and macroeconomic imbalance adjustment policies in a single medium-term plan for each member state can increase the effectiveness of policy coordination.

But since economics is not made up of laws of Medes and Persians, the assessment of medium-term plans can also get bogged down in stalling political discussions. The role the EC sees for itself in the assessment is clearly inspired by its role in assessing the Recovery and Resilience Plans prepared by member states in the recent past to get NextGenerationEU support. The EC proposes to consolidate and expand that role. In doing so, it increases its political role but without accompanying proposals to further legitimise that role democratically. We will have to see in practice to what extent this will affect the effectiveness of the fiscal framework.

Nor does the EC propose an extension to common debt financing, as in NextGenerationEU. Proposals for a larger central budget (fiscal capacity), a necessary capstone for a stable currency union and recommended by many reports on fiscal framework reform, are missing.
The EC ideas, which have yet to be translated into legislative proposals, thus by no means bring the missing link for a fully-fledged, stable currency union. They are a step in the right direction, but certainly not the last step.

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[2] The debt ratio is a fraction with debt in the numerator and GDP in the denominator.