A step towards a reform of the fiscal rules in Europe?

- **The European Commission has initiated a review of the EU's fiscal framework, with the aim of proposing changes to the fiscal rules at the end of 2020.**
- **The need to reform the fiscal rules arises in response to a certain discontent over how they have been applied since the financial crisis, as well as to transformations which Europe must address (climate change, population ageing, inequality and the digital era).**

In February, the European Commission officially launched a review of the EU's fiscal framework. In addition to the requirement (under law) to evaluate them every five years, there are two main reasons for reviewing the current European fiscal rules:[1] a certain discontent over how they have been applied since the financial crisis and a need to adapt them to the new challenges laid down by the European Commission. In particular, the new Commission aims to make Europe the first «climate neutral» continent,[2] to adapt it to the digital era, to reduce inequality and to alleviate the effects of the ageing of the population. These challenges will be difficult to overcome without significant public investment (among other reasons, because of the public goods nature of some of the necessary investments, such as sustainable transport, the renovation of public buildings to make them more energy efficient, etc.). Such an increase in public investment is not feasible under the current fiscal rules.

The revision of the European fiscal framework has begun with an assessment of the rules by the Commission, which will involve reviewing their effectiveness in recent years. Following the publication of this assessment, which we set out below, the Commission will then begin a discussion period with stakeholders (national parliaments and governments, central banks, academics, fiscal authorities, the public, etc.). Finally, at the end of this period, proposals to change the fiscal framework will be presented.

What was the conclusion of the European Commission's assessment?

In its assessment, the Commission highlighted the strengths and weaknesses of the European fiscal framework, which was already updated in 2011 and 2013 under the Six Pack and Two Pack reforms.[3]

According to the Commission, the budget rules have been effective in reducing excessive deficits. After the economic and financial crisis, 24 member states were in the excessive deficit procedure (a procedure established in order for countries with a deficit of more than 3% of GDP to reduce it). In 2020, in contrast, no country has an excessive deficit (Spain emerged from the excessive deficit procedure in June 2019). At the aggregate level, public debt in the euro area has also been reduced since the crisis, albeit slowly and with high levels of debt persisting in some countries.

On the other hand, the preventive arm of the rules, which serves to prevent fiscal policies that could lead to excessive deficits, has been less successful. Today, many member states have a structural deficit in excess of the medium-term target. Additionally, one of the weaknesses identified by the Commission is that fiscal policy has been too procyclical in many countries, with an excessive increase in deficits during good times and an overly hasty fiscal consolidation during the crisis. Moreover, this consolidation was largely carried out through a drastic reduction in investment – a source of growth in the medium term. The Commission also admitted that the rules are too complex and unpredictable, as they are based on unobserved variables (such as the output gap and the structural balance) which are very difficult to estimate. Finally, the Commission considers that the rules take insufficient account of the state of the overall euro area economy. For instance, with ECB interest rates at an all-time low, the rules prevent a fiscal stimulus precisely at a time when fiscal policy should take on a more important role.

The questions for a reform in 2020

The Commission's assessment raises various questions for a future review of the rules: how to ensure the sustainability of public debt in the long term and, at the same time, enable economic stabilisation in the short term; how to encourage investment and structural reforms; how to simplify the rules and improve their transparency and how to take into account the state of the euro area economy as a whole?

Providing answers to all these questions before the end of 2020 is an ambitious task. In any case, the starting point is an encouraging one: the Commission has identified the main problems and is posing the right questions. The big question is whether member states will reach agreement on making the necessary changes to the rules.

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1. These include the deficit and debt limits (3% and 60% of GDP, respectively) and the requirement to adjust the structural balance towards a medium-term target.
2. By «climate neutral», the Commission refers to net zero greenhouse gas emissions.
3. These two reforms, among other adjustments, introduced the possibility for sanctions to be imposed on countries that fail to follow the rules relating to the reduction of public debt and the procedure for macroeconomic imbalances.