European fiscal rules: an end to the 60% limit?

- **There is a broad consensus on the need to reform European fiscal rules, which are too complex, unpredictable and insufficiently sensitive to the state of the business cycle.**
- **In fact, the COVID-19 crisis has forced their suspension and the Commission is debating their reform.**
- **The design of fiscal rules must take into account all the factors that affect debt sustainability and must be flexible enough to enable the stabilising role of fiscal policy.**

European fiscal rules, which dictate the maximum deficit and debt that European countries can have, were suspended in March 2020 (until at least the end of 2021) due to the COVID-19 crisis.

As we explained in a Focus last year,[1] prior to this crisis there was already consensus that the rules were inadequate (even after several reforms over the years) and at the beginning of 2020 the European Commission had begun a debate process with the aim of reforming them. If the rules, which centred around a public debt ceiling of 60% of GDP, were already inadequate before the pandemic, this latest crisis has left them clearly obsolete. In fact, it is estimated that the euro area's public debt in 2020 exceeded 100% of the bloc's GDP, while in some countries it reached ratios of around 120% (Spain) or even 160% (Italy). Faced with such high levels of debt, the current fiscal rules would require a huge and sustained fiscal effort from many countries (see first chart). For instance, for a country with a public debt of 160% of GDP, primary surpluses of greater than 3% of GDP would be needed for the next 20 years, even in a relatively favourable growth and interest rate scenario. Such a fiscal effort is rather infeasible, and perhaps even counterproductive, as it would pose a substantial restriction for growth.

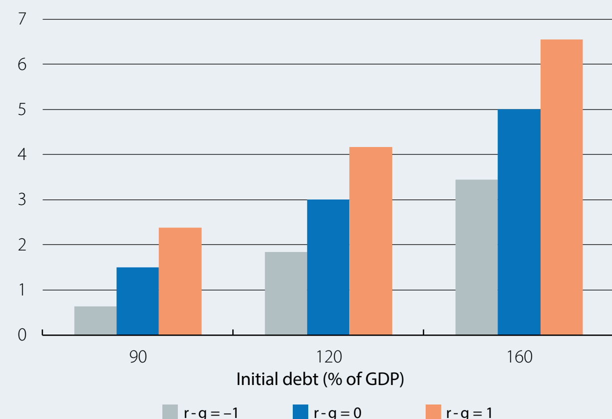
Debt sustainability cannot be reduced to a single number

The above example illustrates the fundamental problem with Europe's fiscal rules: they are based on debt and deficit criteria which do not vary by country or over time and do not take into account potential changes in the factors that determine debt sustainability. This characterisation is overly simplistic, as the level of debt and deficit are not the only factors that determine debt sustainability, for at least four reasons.

First, debt sustainability depends not only on its level as a percentage of GDP and the deficit, but also on future growth and interest rates. In Italy, for example, the debt ratio continued to rise due to weak growth and a high interest burden despite the country maintaining an almost

Primary balances required to reduce debt to 60% of GDP in 20 years (with different assumptions about growth and interest rates)

Primary balance required (% of GDP)



Note: *r is the average interest rate of public debt, g is nominal GDP growth and r-g is the difference between these two variables. The assumptions for r-g were chosen to illustrate different scenarios. In 2019 r-g was equal to -1.96% in Germany, -1.81% in France, -0.82% in Spain and 0.25% in Italy, according to Eurostat and the International Monetary Fund's GDP growth forecasts. The primary fiscal balance pb_t^* required to reduce the debt ratio d_t to a target d^* in n years is calculated as follows: $pb_t^* = \left(\frac{r_t - g_t}{1+g_t}\right) d_{t-1} + \frac{1}{n}\,(d_{t-1} - d^*)$, where r_t and g_t are assumptions for interest rates and growth.*

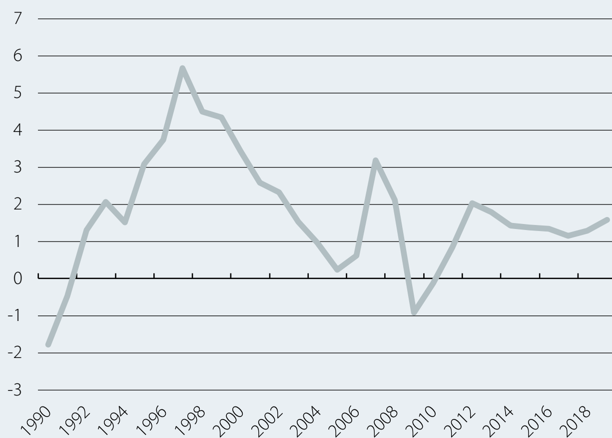
Source: *CaixaBank Research, based on data from Eurostat and the International Monetary Fund.*

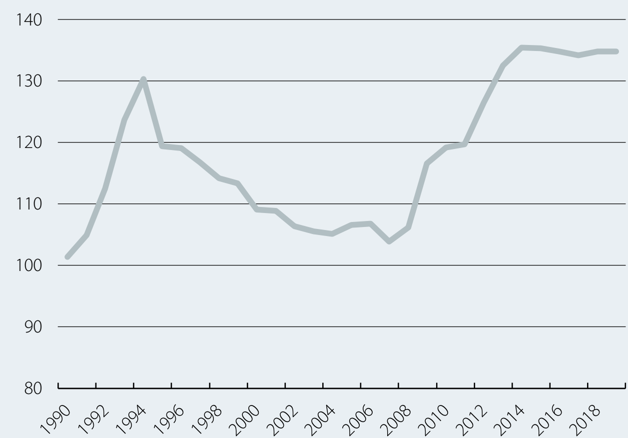
uninterrupted primary fiscal surplus over the past 25 years (see second chart). In contrast, in a case where the interest rate of the debt is lower than nominal GDP growth, a country can reduce its debt ratio despite having a deficit.

Second, there is uncertainty over future growth and interest rates. In particular, a given primary balance may no longer be sufficient to stabilise the debt ratio if interest rates rise or growth falls. Even if interest rates are low today, the factors behind this phenomenon are complex and their future path is uncertain. Therefore, we cannot rule out a reversal of the decline in interest rates seen in recent decades, a shift that would have significant fiscal implications.

Third, the fiscal effort that is feasible depends on many factors, such as the type of government, the level of taxes at the outset, and many other political, economic, and social considerations. As a result, a level of debt that is sustainable in one country may not be so in another country if it requires an infeasible fiscal effort (remember the questions about the political and economic feasibility of the fiscal adjustments that Greece

1. See the Focus «A step towards a reform of the fiscal rules in Europe?» in the MR03/2020, in which we pointed out that the rules were too complex, unpredictable and insufficiently sensitive to the state of the business cycle.





Source: *CaixaBank Research, based on data from Eurostat.*

was required to undertake in order to receive European aid, requiring a high primary balance for more than 20 years).

Fourth, investor confidence is also important for debt sustainability. The current environment, with low interest rates and long debt maturities, favours investor confidence because it makes the burden of this debt more bearable (in terms of payment flows). However, a loss of investor confidence in a country's ability to repay its debt could result in interest-rate stress and a «self-fulfilling prophecy» as the feedback from interest-rate rises drives up the debt towards unsustainable levels.[2] Although the ECB can avoid these situations in some cases, it cannot eliminate differences in the credibility of different countries' fiscal policies.

These four elements show that debt sustainability should not be reduced to a single number. Its evaluation is more complex, full of nuances and must take into account many other factors such as expected growth and interest rates, as well as other economic, political, and institutional factors.

A broader view of sustainability in fiscal rules

If debt sustainability cannot be whittled down to a single number, fiscal rules should not be reduced almost entirely to a debt target either. Fiscal rules should take into account all the factors affecting sustainability mentioned in this article, and they should be flexible enough to enable the stabilising role of fiscal policy (the rules had to be suspended in 2020 precisely because they would not have allowed the fiscal measures required to combat the COVID-19 crisis).

Nevertheless, the debt limit of 60% of GDP is stipulated in the EU Treaty, so the revision of the fiscal rules is unlikely to eliminate it. Unless it is decided to alter the Treaty (which is unlikely), ways will have to be found to reduce the importance of this limit, perhaps, as proposed by the European Fiscal Board,[3] by dictating different correction speeds by country, taking into account all the factors that are important for debt sustainability. However, it will be a challenge to achieve this more holistic view of sustainability without losing transparency and predictability in the rules. Transparency and predictability are important for allowing more effective application and monitoring, as well as for better comprehension of the rules by the rest of society.

All in all, we expect that this debate will play an important role in 2021, given the urgency of reforming the rules before their suspension comes to an end. The process of reforming the European fiscal framework (which was originally due to be completed by the end of 2020) has been interrupted by the COVID-19 crisis and the Commission has not yet decided on a new date to re-start it, but the debate will undoubtedly intensify during the course of the year given its importance. In this new world of high public debt in most European countries, the new fiscal rules will need to encourage a gradual reduction in debt to safer levels, but without damaging the recovery or the green and digital transformations of the European economy. It will be a difficult balance to achieve, but not an impossible one.

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2. The speed at which interest rate rises result in increases in debt depends on the debt maturity profile: in a country with more longer-term debt, this increase will occur more slowly.

3. See European Fiscal Board. «Annual Report 2020».