The EU: raider of the lost fiscal rules

30 years ago, the countries that founded the EU committed themselves to restricting and coordinating their fiscal policies with a common set of rules, best known for the debt and deficit limits of 60% and 3% of GDP. The aim was to avoid negative externalities between the public accounts of individual states and the consequent risks of financial instability.[1] These reasons are still valid today, but the rules have become outdated following a global financial crisis, a sovereign debt crisis in Europe, and a pandemic.[2] In fact, despite having been adjusted over the years,[3] the rules finally had to be formally suspended in March 2020.

The reform proposed by the European Commission

In this context, last November the European Commission presented a proposal to reform the fiscal rules with a view to their re-implementation in 2024. The proposal does not change the debt and deficit targets of 60% and 3% (they are laid down in the EU treaties and changing them is rather infeasible); instead, it establishes them as medium-term targets and focuses on reforming the system to steer us towards them. In particular, the Commission proposes placing at the heart of the system a series of «structural fiscal plans», which would be drawn up at the national level and would revolve around three major axes: (i) investment priorities, (ii) structural reforms, and (iii) a fiscal path. Taken together, these three pillars would serve as the basis for assessing each state's debt and ensuring its sustainability.

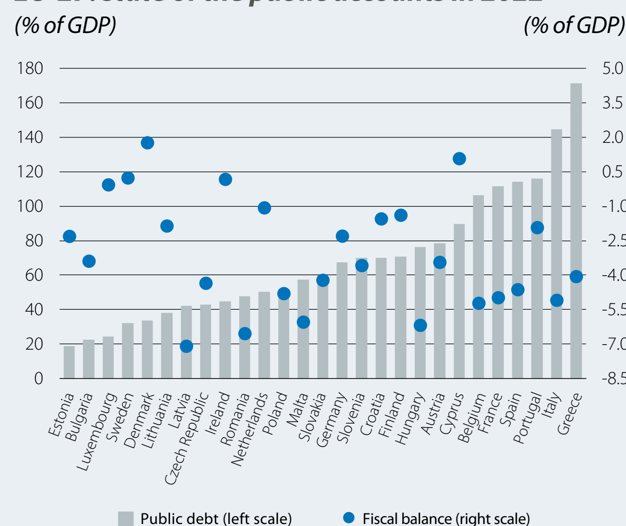
In more detail, each national government would draw up its «structural fiscal plan» based on a four-year time horizon. The Commission would evaluate the plan and discuss it with the country in question, before approval is finally sought from the European Council. The fiscal path that would guide the evolution of the public accounts would be defined on the basis of a net primary expenditure rule,[4] adjusting to the specific situation of each state and its debt sustainability analysis. Once in place, the plans would be monitored and evaluated, both by the Commission and by the independent fiscal authority of each country. Moreover, given this personalised approach, it would be necessary to establish a common framework with a clear set of rules and transparent criteria to guide the evaluation of each country's public accounts.

Finally, the European Commission proposes to maintain the system of «excessive deficit procedures» (EDPs) for breaches of the 3% deficit target, as well as to extend the range of sanctions in the event of non-compliance (reducing the pecuniary damage in order to make their implementation more credible, but accentuating the reputational damage). In the event of extraordinary economic events, the plan also envisages the activation of escape clauses to freeze the rules (at both the European and the country level).

Factors to consider and next steps

Firstly, the Commission is moving away from the uniformity of the current rules in favour of a more personalised approach to the sustainability of each

EU-27: state of the public accounts in 2022



Source: *CaixaBank Research, based on data from the European Commission (European Economic Forecast, autumn 2022).*

1. The formation of the EU increased the degree of «substitutability» among the sovereign bonds of the different countries. The benefits (costs) of a good (bad) fiscal policy at the national level would thus have an impact on the rest of the countries. For example, a lavish country would face lower interest rates than it would suffer if it were outside the EU, but it would cause higher interest rates in the rest of the countries.
2. Among other shortcomings, the rules: (i) have failed to prevent the deterioration of public accounts which they sought to avoid, (ii) induce an overly procyclical fiscal policy which penalises investment, and (iii) are overly complex and based on variables that cannot be observed (e.g. the output gap or the structural balance). See the Focus «A step towards a reform of the fiscal rules in Europe?» in the MR03/2020 and «European fiscal rules: an end to the 60% limit?» in the MR03/2021.
3. See the Dossier «The EU in 2022: fiscal rules reform back on the table» in the MR12/2021. For example, a set of medium-term budgetary objectives (MTOs) were introduced, which the 2005 reform of the Stability and Growth Pact called for to be maintained throughout the business cycle in order to provide margin for manoeuvre in times of recession. Another example is the «1/20 rule» relating to debt reduction, which was introduced as part of the so-called «six-pack» of 2011, requiring countries to cut their excess debt above 60% of GDP by one twentieth each year. For a country with a debt ratio of 160% today, this would require primary surpluses of over 3% for the next 20 years.
4. That is, spending net of discretionary income, and excluding interest payments and disbursements related to cyclical fluctuations in unemployment, such that the rule would not interfere with the functioning of automatic stabilisers.

European Commission proposal to reform the EU's fiscal rules

Starting point	The current rules (deficit of 3%, debt of 60%, debt correction rate of 1/20) are suspended until the end of 2023.
Medium-term targets	Deficit < 3% of GDP. Debt < 60% of GDP.
How to achieve the targets	National structural fiscal plans based on: • Investment plans. • Structural reforms. • Fiscal path.
Structural fiscal plans	• Fiscal path based on a net primary expenditure rule. • 4-year time horizon to place debt on a declining path and to bring the deficit < 3% (+3 additional years conditional on reforms). • Bilateral negotiation with the European Commission and subsequent approval by the European Council. • Monitoring by the national independent authorities for fiscal responsibility and the European Commission.

Source: *CaixaBank Research, based on the European Commission's communication of 09/11/2022.*

country's debt. This is a vision that is much better suited to the current environment and in particular to the disparity that exists between the public accounts across the EU (see chart).

Moreover, the Commission presents a broader view of debt sustainability, explicitly stating that it also depends on investment and reforms (i.e. on an economy's ability to grow and its resilience). In this regard, the new rules would help create space for fiscal policy. In other words, the sustainability of the public accounts is a constraint which fiscal policy must adhere to, but it is not its primary objective. Fiscal policy must help to stabilise the business cycle,[5] and it can also help to foster stronger, more resilient and more inclusive long-term economic growth.[6]

Thirdly, the proposal simplifies the current fiscal framework (e.g. the use of indicators based on unobservable variables, such as structural deficits, would no longer be mandatory). However, it does so in a limited way and, given that many details are yet to be defined, it remains to be seen whether the final version will really involve less complexity and uncertainty.

On the downside, the time horizons appear somewhat generous: the plans would allow up to four years for the fiscal path to bring the deficit below 3% and for debt to be placed on a sustainably downward trajectory. Moreover, this timeframe could be extended by another three years depending on the country's reform and investment programme. Thus, the plan would likely extend beyond the mandate of the current government, which means that adhering to it would require a high degree of national commitment, as well as commitment, coordination, and legitimacy among all the actors involved (governments, independent fiscal authorities, the European Commission and the Council).

In any case, it is worth acknowledging the Commission's ambition: at a time when there is no consensus among the major European capitals on how to reform the fiscal rules, it has proposed a reform which goes far beyond marginal adjustments. Beginning in December, Member States must employ the same level of ambition in their negotiations, and when the fiscal rules are reinstated in 2024, they should incorporate a redesign that reflects the lessons of the past 30 years and which fits Europe's current reality.

5. Especially in a monetary union, given that there is only one central bank and it cannot cope with idiosyncratic shocks between different countries.
6. e.g. by facilitating the energy and digital transitions.