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Analysis of current proposals and their critiques

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Contents

1. **Executive summary** 5

2. **Main elements of the current system of fiscal rules in the EU and its critique** 7

   Basic elements of the current system of fiscal rules in the EU 7

   Main problems of the current system 13

3. **Main elements of the EU Commission's 9 November 2022 proposal and its critique** 15

   The EU Commission's 9 November 2022 proposal for reforming the fiscal rules 15

   Main critiques of the proposal answered by the Commission 18

   Further pros and cons of the Commission's proposal 20

4. **Main elements of the EU Commission's 26 April 2023 proposal and its critique** 24

   The EU Commission's 26 April 2023 proposal for reforming the fiscal rules 24

   Pros and cons of the Commission's proposal 26

5. **An alternative proposal** 27

6. **ANNEXES** 31

   Excerpts from the 9 November 2023 Communication of the European Commission on orientations for a reform of the EU economic governance framework 31

   Excerpts from the European Commission's 26 April 2023 proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97 34

   Excerpts from the European Commission's 26 April 2023 proposal for a COUNCIL REGULATION amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure 37

   Excerpts from the European Commission's 26 April 2023 proposal for a COUNCIL DIRECTIVE amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States 38

   Targeting real debt as a fiscal rule 41

   References 44

ABBREVIATIONS AND ACRONYMS

AIReF	Independent Authority for Fiscal Responsibility (Spain)
Budgetdienst	Parliamentary Budget Office (Austria)
EDP	Excessive Deficit Procedure
EU	European Union
Fiskalrat	Fiscal Council (Austria)
GDP	Gross Domestic Product
IFI	Independent Fiscal Institution
MTO	Medium Term Objective
PAYGO	Pay As You Go (prohibition of any deliberate deteriorating of the fiscal balance)
RRZ	Council for Budget Responsibility (Slovakia)
SCP	Stability and Convergence Programs
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union
UPB	Ufficio Parlamentare di Bilancio (Italy)

1. Executive summary

Any good fiscal rule system must find the balance between flexibility and enforceability. It must be flexible enough to avoid any form of procyclical fiscal policy, yet it must be enforceable to maintain credibility and long-term debt sustainability. Systems of fiscal rules that are good from an economic point of view cannot be simple, no matter how much simplicity would be desirable from a political point of view.[1]

Policymakers and experts generally agree that the European Union's (EU) economic governance structure is not simple. Instead, it is overly complicated yet rigid and prone to drive domestic fiscal policies into pro-cyclicality. Furthermore, the rules have not contributed to the debt sustainability of EU Member States with particularly high domestic debt ratios, evidenced primarily during the Covid-19 crisis.

The European Commission presented a proposal (in the form of a communication in November 2022 and then in a codified version in April 2023) to reform the economic governance structure. Key elements of the reform under discussion include (i) improved debt sustainability, (ii) stronger fiscal surveillance by the Commission in the frame of the European Semester, (iii) development of medium-term national fiscal plans (while evoking analogies with national recovery and resilience plans under the Recovery and Resilient Facility) with corresponding annual progress reports, and (iv) increased national ownership through empowered national Independent Fiscal Institutions (IFIs).

Nevertheless, there are important elements in the proposal that have less than full support from all Member States. Misuse of political bargaining on behalf of more influential or noto-

1 As pointed out by Reuter and Debrun (2022), "designing good fiscal rules is hard, as they must be simple, flexible, and enforceable. Debrun and Jonung (2019) argue that only two of these properties can be simultaneously met." While Debrun and Jonung (2019) consider simplicity as a requirement for a good fiscal rule (and then state that it is impossible), the present author's view is that only flexibility and enforceability are the economic requirements, whereas simplicity is a fundamentally political economic consideration. Namely, fiscal rules need social support (political capital) for enforceability and simplicity significantly mitigates the challenge to build social support. However, there are other ways to build social support as well, as the case of monetary policy exemplifies.

riously problematic Member States or methodological inconsistencies are examples of threats that the proposal does not seem to fence off.

At the end of the paper, an alternative proposal is presented that preserves the broadly supported features of the Commission's proposal and attempts to solve its most important problems unrelated to the peculiarities of collective decision-making in a community of sovereign countries.

2. Main elements of the current system of fiscal rules in the EU and its critique

Basic elements of the current system of fiscal rules in the EU

The most fundamental principle of the EU fiscal governance system is to prevent unsustainable national fiscal policies that might jeopardize the proper functioning of the monetary union.

Already in the 1992 Maastricht Treaty, the abstract economic concept of sustainable fiscal policy has been operationalized by the twin requirements of fiscal deficit permanently below 3% of the GDP and government debt permanently below 60% of the GDP. It was further operationalized in the 1997 Stability and Growth Pact (SGP) by the requirement of structural fiscal balances close to balance or in surplus, where the structural balance is defined as the cyclically adjusted balance without the effect of one-off factors.

To be able to enforce these rules *ex ante* as much as possible, the system of so-called Stability and Convergence Programs has been introduced with a set of compulsory tables presenting the medium-term numeric macro-fiscal assumptions and plans of the Member States. Practically, the constraints that the Stability and Convergence Programs and the annual budget bills have to comply with, the procedural rules for their review, constitute the so-called preventive arm of the SGP. Once the fact figures are published, a new round of reviews starts. If there is any *ex post*

violation of the rules, the so-called corrective arm is activated with a plethora of further procedures, the most well-known (but not the only one) being the so-called excessive deficit procedure.

In the current EU fiscal surveillance system, there are no less than five rules:

1. The headline general government deficit should not exceed 3% of the GDP.
2. The so-called structural budget balance has to attain the so-called medium-term objective (MTO) over the medium-term horizon (3 years).

   The country-specific MTOs may diverge from the requirement of a close to balance or in surplus position, while (a) providing a safety margin with respect to the 3 % of GDP government deficit ratio, (b) ensuring the sustainability of public finances or a rapid progress towards such sustainability, and (c) allowing room for budgetary manoeuvre, considering in particular the need for public investment. Originally the MTOs were calculated based on the country-specific standard deviation of the output gap and the semi-elasticity of the budget balance with respect to the output gap, but nowadays debt sustainability analysis (including the effect of ageing, climate and other long-term factors) plays the central role. Annual debt sustainability reports by the Commission quantify short-, medium-, and long-term risks. Long-term sustainability is at low, medium or high risk depending on the fiscal effort needed to keep/push the debt/GDP ratio below 60% by 2070 and to stabilize the debt/GDP ratio for an infinite horizon.

   If the structural balance is below the MTO, an appropriate adjustment path is defined based on a number of considerations. The 3% headline deficit limit must be observed even if it implies a structural balance stricter than the MTO.
3. For Member States that have attained their MTOs, annual expenditure growth should not exceed a medium-term reference rate of potential GDP growth unless the excess is matched by discretionary revenue measures, thus, allowing the Member State to remain at its MTO.
4. The government gross public debt at face value at the end of the year should not exceed 60% of the GDP.
5. If the country's debt-to-GDP ratio is above 60% (this is currently true for about half of the Member States), then this ratio has to be reduced each year by at least 1/20 above the 60% (e.g. if the ratio is 100%, then by (100-60)/20=2 percentage points).

On top of the many rules, practically for each of them, there are escape clauses for circumstances such as severe recessions or existence of temporary effects of structural reforms.[2]

Though from an outsider's perspective it is of limited importance, a peculiar feature of the European fiscal surveillance system is the legal technique of directives. At the EU level, Member States adopted the above-mentioned fiscal rules. However, Member States are still required to adopt national fiscal rules within their national laws, that comply with the following EU-level regulation:

2 Regulation (EC) 1466/97 allows Member States that implement major structural reforms to deviate temporarily from the MTO or the adjustment path towards it, if those reforms have a positive budgetary impact in the long term, including higher potential growth.

COUNCIL DIRECTIVE 2011/85/EU
of 8 November 2011
on requirements for budgetary frameworks of the Member States

NUMERICAL FISCAL RULES

Article 5
Each Member State shall have in place numerical fiscal rules which are specific to it and which effectively promote compliance with its obligations deriving from the TFEU in the area of budgetary policy over a multiannual horizon for the general government as a whole. Such rules shall promote in particular:

(a) compliance with the reference values on deficit and debt set in accordance with the TFEU;
(b) the adoption of a multiannual fiscal planning horizon, including adherence to the Member State's medium-term budgetary objective.

Article 6
1. Without prejudice to the provisions of the TFEU concerning the budgetary surveillance framework of the Union, country-specific numerical fiscal rules shall contain specifications as to the following elements:

(a) the target definition and scope of the rules;
(b) the effective and timely monitoring of compliance with the rules, based on reliable and independent analysis carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities of the Member States;
(c) the consequences in the event of non-compliance.

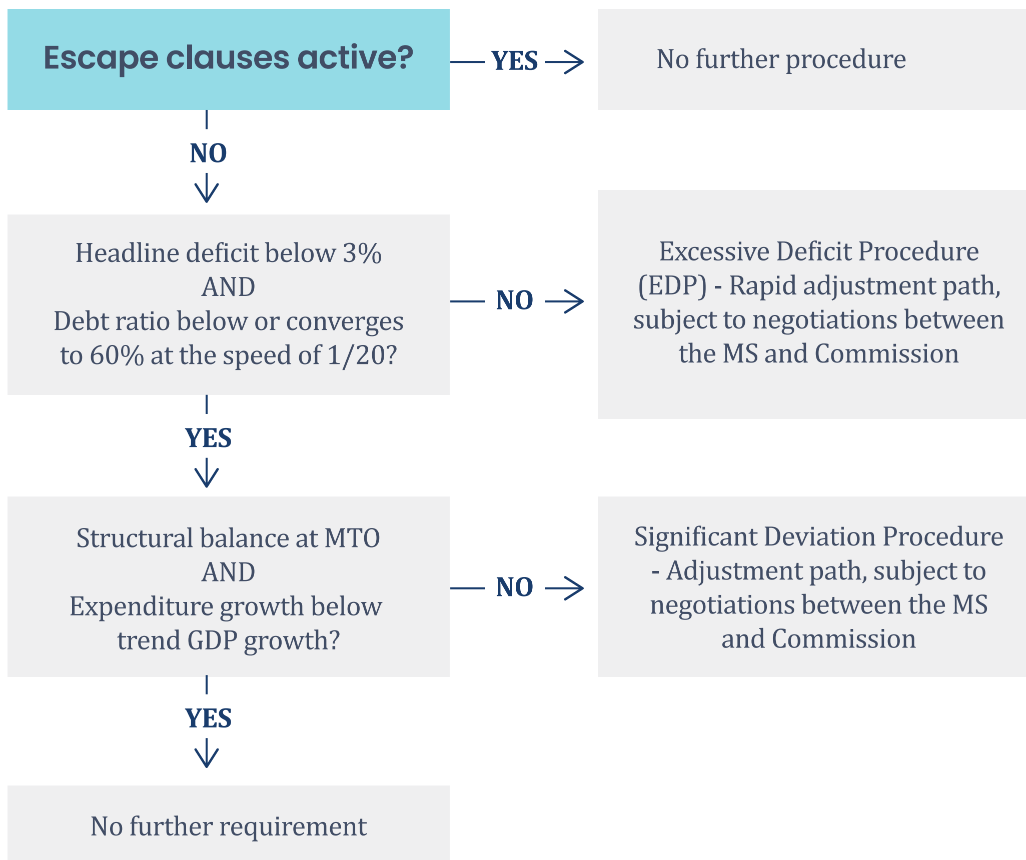
2. If numerical fiscal rules contain escape clauses, such clauses shall set out a limited number of specific circumstances consistent with the Member States' obligations deriving from the TFEU in the area of budgetary policy, and stringent procedures in which temporary non-compliance with the rule is permitted.

Article 7
The annual budget legislation of the Member States shall reflect their country-specific numerical fiscal rules in force.

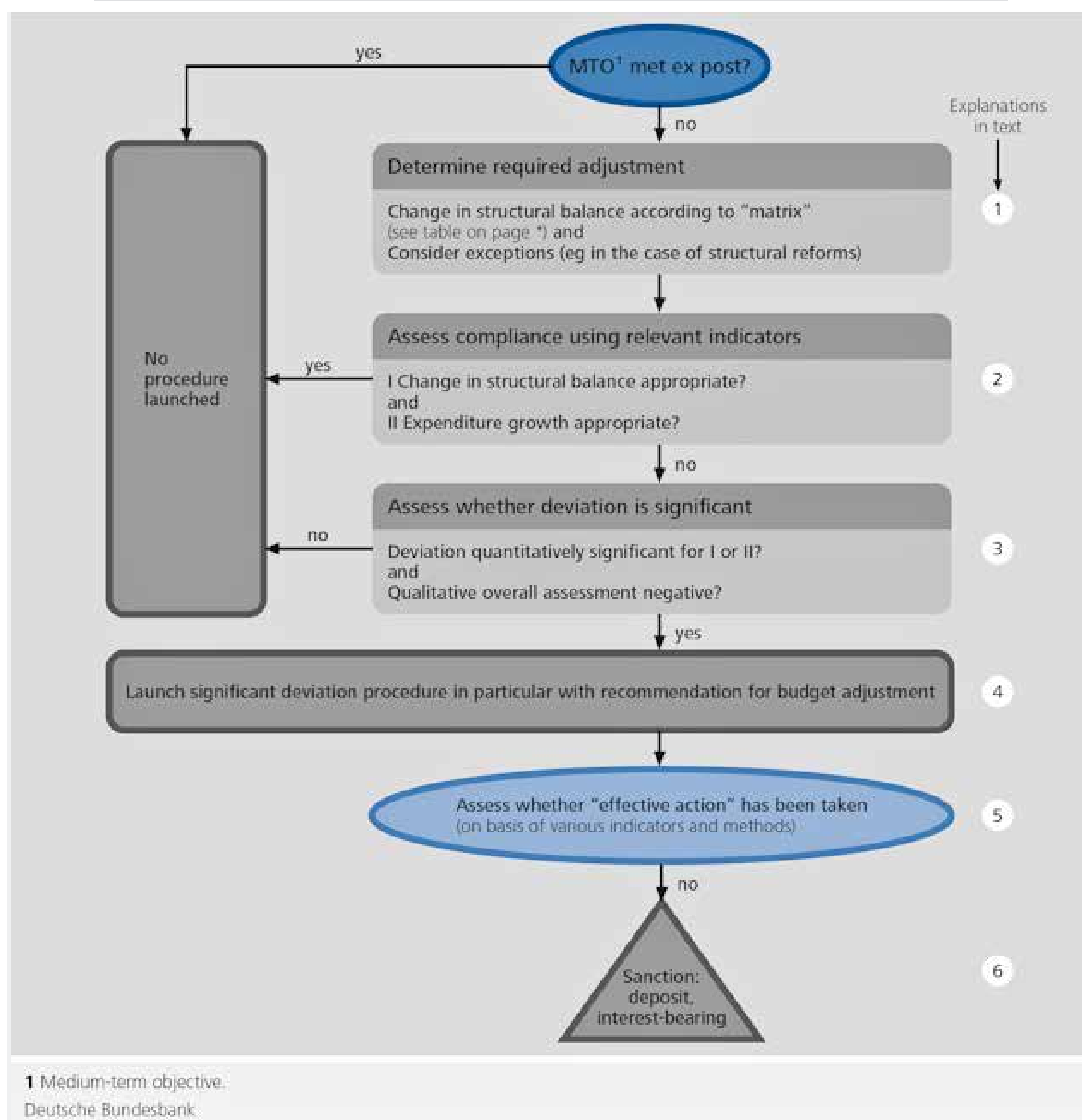
If a Member State either breached or is at risk of breaching the deficit threshold of 3% of GDP, or violated the debt rule by having a government debt level above 60% of GDP, which is not diminishing at a satisfactory pace (this means that the gap between a country's debt level and the 60% reference needs to be reduced by 1/20th annually on average over three years), then a so-called Excessive Deficit Procedure (EDP) can be launched. Many such procedures were initiated over the last three decades (since the 1992 Maastricht Treaty). Still, none ended up in a real monetary fine (as it was originally legislated).

As most of the procedures surrounding the numeric fiscal rules are fundamentally designed for the rather peculiar relation between the "One Commission + Many Member States" political structure, where the Commission is supposed to enforce the rules while the ultimate power remains with the community of the Member States' political leaders, the procedural part might not be adaptable to single country situations even in the case of federal countries. This is why here below we will focus more on the numerical rules and the so-called preventive arm, which might be at least partially adapted for other, non-EU contexts.

FISCAL RULES in the SGP

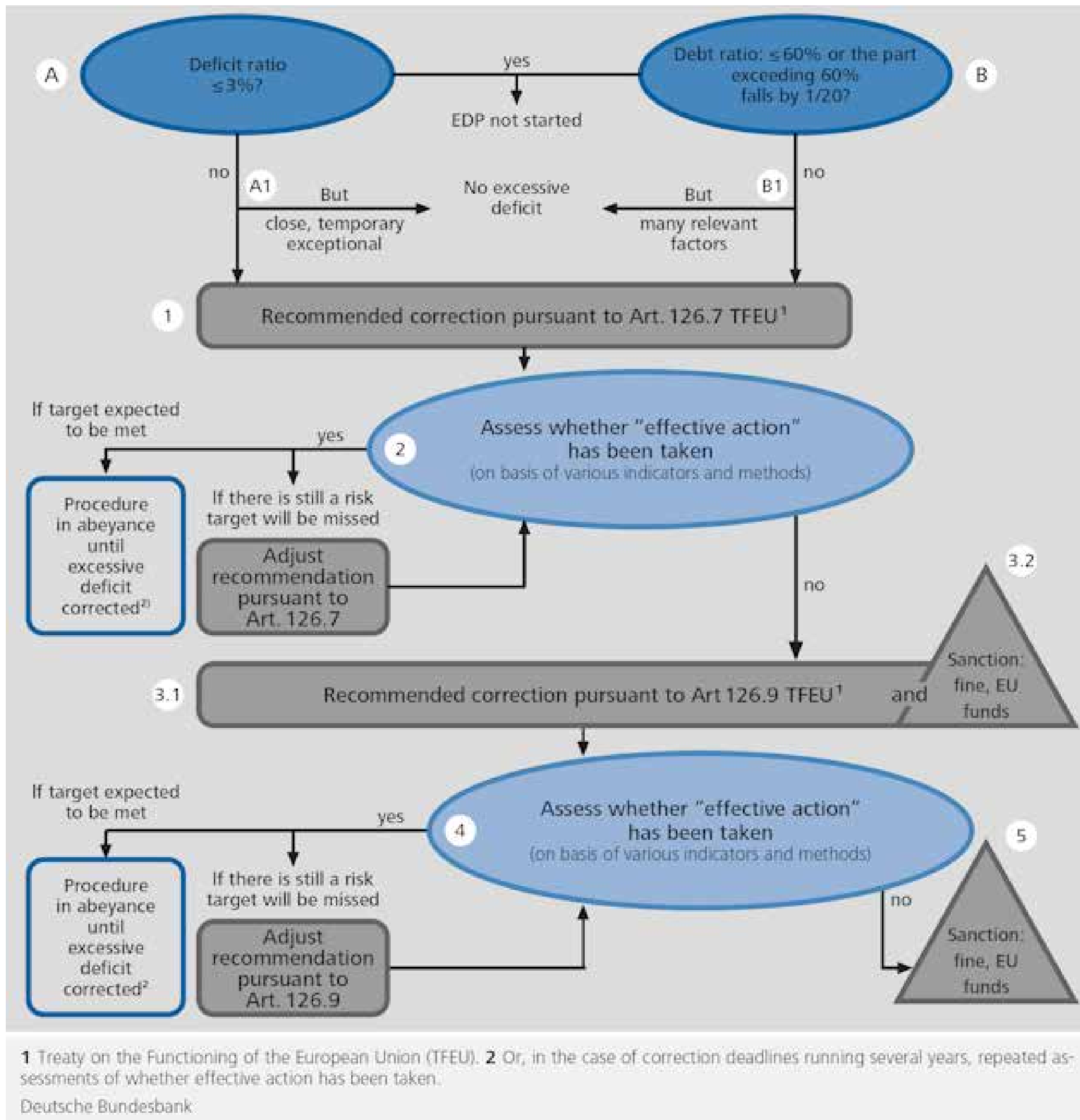


Simplified diagram on assessment in the preventive arm of the Stability and Growth Pact



Source: design and implementation of the European fiscal rules (Deutsche Bundesbank, Monthly Report, June 2017, pp 29-47). Available at: https://bit.ly/3mzKXRG.

Simplified diagram on assessment in the corrective arm of the Stability and Growth Pact



1 Treaty on the Functioning of the European Union (TFEU). **2** Or, in the case of correction deadlines running several years, repeated assessments of whether effective action has been taken.

Deutsche Bundesbank

Source: design and implementation of the European fiscal rules (Deutsche Bundesbank, Monthly Report, June 2017, pp 29-47). Available at: https://bit.ly/3mzKXRG.

Main problems of the current system

There are several fundamental problems with the current system.

1. According to the original text of the Maastricht Treaty (1992), the 3% limit on the deficit/GDP ratio was meant to be a "maximum" that should not be surpassed even in economically bad times. It would have implied a fiscal policy that strives for a budget "close to balance or in surplus" in normal times. However, as there was no punishment for not saving enough in good times, the only punishment was envisaged for the case of surpassing the 3%, many countries interpreted this as a goal that has to be attained at all times. By definition, this turned the rule into a constraint that, instead of preventing, rather reinforces procyclical fiscal policy.
2. As a remedy for this problem, the EU introduced in the frame of the Stability and Growth Pact the notion of the structural balance, which is the cyclically adjusted balance adjusted for one-off items. The main aim of the new rule was to capture the good times and enforce appropriate fiscal tightening, i.e. accumulation of fiscal space for bad times. However, the methodological uncertainties and the instability of the assessments of the fiscal stance severely undermined the reliability of the system and pushed more and more into the domain of political bargaining.
3. As the sanctions have to be based on factual data, the delay in the processes due to the nine-month lag in the publication of the data undermined the accountability of the politicians responsible for the fiscally imprudent decisions.
4. As a remedy to the methodological problems of the structural deficit, the 2011 amendment of the SGP (in the frame of the so-called Six-Pack) introduced the expenditure benchmark. It is more operational than the structural deficit, but still, it relies on the European Commission's data inputs and judgement not available in real-time, significantly reducing transparency and domestic enforceability. Moreover, the methodology to calculate trend GDP growth for the expenditure benchmark differs from the methodology to calculate the output gap for cyclical adjustment of the budget balance. It can easily lead to inconsistencies in the assessment of the fiscal stance.
5. As opposed to the 3% deficit rule, the 60% debt/GDP limit was an ambitious goal already at its birth. At the time of the Maastricht Treaty, many EU member countries had gross government debt above 60%. As the EU did not want to launch Excessive Deficit Procedures (EDP), the rule was (re)interpreted that even if the debt/GDP ratio is above 60%, no EDP is started if the ratio is declining fast enough. There was no specific number for what is fast enough – starting a long series of issues where underspecified rules open the door for political bargaining.
6. The problem was solved in the 2012 Fiscal Compact, which has set this value to 1/20 of the debt/GDP ratio above the 60% limit. Still, right from the beginning, it became subject to case-by-case negotiations because of the softening rules to take into account.
7. Theoretically, in order to increase transparency and predictability, the Commission gradually designed a table to determine the appropriate adjustment path. As shown below, the table defines five different states of the economy, mostly by the level of the output gap. In the worst situation, when the output gap is below -4% and the economy is still shrinking, the general escape clause

steps in: no constraint whatsoever is imposed on fiscal policy. This can lead to a ratchet effect if the probability distribution of economic growth shifts downward as it did after the 2008-2012 crisis. If there are too many years when no constraint applies, government debts will jump up (as they did during the 2020-2021 pandemic and in some countries during the 2022 Russian aggression against Ukraine), and "good years will not be enough to fully compensate for these shocks."

		Required anual fiscal adjustment (pp of GDP)	
	Condition	< Debt 60% and low/ medium sustainability risks	Debt > 60% or high sustainability risks
Exceptionally bad times	Real growth <0 or output gap <-4	No adjustment needed	
Very bad times	-4< output gap <-3	0	0.25
Bad times	-3 < output gap <-1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1.5 output gap <1.5	0.5	> 0.5
Good times	Output gap ≥1.5	>0.5 if growth below potential, ≥0.75 if growth above potential	≥0.75 if growth below potential, ≥1 if growth above potential

Source: Vade Mecum on the Stability & Growth Pact 2019.

The inefficient complexity of the rules and the low credibility of the envisaged penalties created the demand for reforms.

3. Main elements of the EU Commission's 9 November 2022 proposal and its critique

The EU Commission's 9 November 2022 proposal for reforming the fiscal rules[3]

The fundamental logic of the proposed system consists of three steps:

1. A ten-year horizon no-policy-change scenario reveals if there is a debt-sustainability problem. There is certainly a problem whenever the debt ratio is above 60%, but the problem can be moderate or substantial.
2. Fiscal adjustment measures must be identified, by which the debt/GDP ratio can be brought on a plausibly downward path after the adjustment period. The no-policy--change scenario and the macro-fiscal effect of the adjustment measures add up to the medium-term plan.
3. In order to guide short-term policy decisions without limiting the automatic stabilizers to perform their role, not some deficit, or debt indicator is fixed as a fiscal rule, but an expenditure category derived from the plan. Though the no-policy-change pro-

3 The whole proposal of the Commission covers not only fiscal rules, but more general issues of economic governance as well.

jection would be prepared for a ten-year horizon, expenditure limits would be set only for a four-year period.

In practice, first, the Commission would perform the whole exercise and publish its final result: a reference expenditure path for each member country.

After this, the member countries would have to submit their own "national medium-term plans" to the Commission which, after possibly some negotiations and amendments, would submit them (together with its own assessment) to the Council (where the member countries are represented by their government politicians) for approval.

The no-policy-change scenario of the Commission and the Member States must rely on the same assumptions set by the Commission.

The debt/GDP ratio is on a plausibly downward path if it remains sustainable under various stress scenarios and guarantees that the deficit/GDP ratio is continuously below 3%.

The reference path produced by the Commission must ensure that the adjustment period is not longer than three years in the case of moderate sustainability problems and four years in the case of substantial sustainability problems. The different reference paths prepared for different Member States should be based on some common EU framework.

National medium-term plans prepared by the Member States can assume a (maximum by three years) longer adjustment period than in the reference path produced by the Commission, if they can demonstrate that the longer period is needed for some well specified measures to exercise their positive effect on fiscal sustainability.

For countries below the 60% debt limit, only the deficit-based EDP remains relevant, and this would be triggered by the 3% headline deficit/GDP threshold.

For countries above the 60% debt limit, "the implementation of the medium-term fiscal-structural plans would be monitored against the respect of the agreed multiannual net primary expenditure path endorsed by the Council."

Enforcement mechanisms would be reinforced in three ways:

- Financial sanctions would be lowered in order to increase the likelihood of their actual use.
- Reputational sanctions, e.g., Ministers of Member States in EDP could also be required to present in the European Parliament the measures to comply with the EDP recommendations.
- EU financing could also be suspended.

The Commission's proposal defines a category called "nationally financed net primary expenditures" as "expenditure net of discretionary revenue measures and excluding interest expenditure as well as

cyclical unemployment expenditure". This new notion, which is supposed to play a central role in enforcing the new system, deserves some explanation.

On both sides of the budget, there are three main types of items:

(1) Primary items that significantly depend on short-term macroeconomic fluctuations
   a. Automatic stabilizers (e.g. tax revenues or unemployment benefits).
   b. Items that do not function as automatic stabilizers but still significantly depend on some macroeconomic variables (e.g., pensions if they are automatically indexed).

(2) Primary items that do not depend on short-term macroeconomic fluctuations (e.g., IT spending or traffic fines).

(3) Interest payments.

The separation of budget items that significantly depend on the short-term fluctuation of macroeconomic variables is crucial from the point of view of accountability of the executive, as only those not relying on short-term macro fluctuations can be considered under the full control of the government.

This means that in terms of the above categories, in order to calculate the "domestically financed net primary expenditure", from the sum of expenditures under categories (1) and (2) three items have to be subtracted:

1. Expenditures fully refinanced by the EU.
2. The cyclical part of unemployment benefits.
3. The effect of so-called "discretionary revenue measures."

REVENUES	EXPENDITURES
EU-funds financing government expenditures	
	Cyclical part of unemployment benefit
	"domestically financed net primary expenditure"
Effect of discretionary revenue measures	
DEFICIT	

Once the expenditure limits are set, they become "the fiscal rule", i.e., they and only they become subject to *ex post* monitoring and eventual sanctioning. All other auxiliary variables used in the calculations (including balance, debt, structural deficit, etc.) can be published but completely lose their role in the surveillance system.

To avoid interference with the political choices of the member countries about the size of the government, total expenditures can be increased, but only if the effect of this increase on the domestically financed net primary expenditure is fully compensated by some new revenue side measure(s).

The notion of "domestically financed" refers to the EU-funds that flow through the budget. Their amount is supposed not to influence the category under annual control.

On 15 February 2023, EU finance ministers gathered in Brussels for their regular ECOFIN meeting and discussed the Commission's proposal but did not get to any conclusion beyond the fact that there are significant differences among countries' preferences.

Main critiques of the proposal answered by the Commission[4]

The description of the Commission's proposal deliberately uses the "technique of strategic ambiguity" meaning that many important questions are not even raised, or purposefully formulated in a way that makes possible several interpretations. Critiques formulated by various researchers must be evaluated with this ambiguity in mind. In various papers, the following main points have been raised:

1. The bilateral approach between the Commission and the Member States in the assessment of the national fiscal-structural plans undermines transparency and equal treatment.

   The Commission's answer:

   > *"the Commission will operate within a common EU framework consisting in common requirements that the fiscal adjustment path of a Member State should respect. (…) while being common, these requirements would be differentiated on the basis of the Member States' debt sustainability challenges"*
   >
   > *"the role of the Commission ends with its assessment, while the decision on whether to endorse the plans or not lies with the Council, which is a more direct role than the opinion and recommendations by the Council for Stability and Convergence Programmes in the current setting."*

2. The Commission can be too intrusive when it comes to assessing whether reforms and investment are good enough to justify a more gradual adjustment path.

   The Commission's answer:

   > *"it is for the Member State to commit and provide solid evidence of their beneficial impact, but would make the criteria clearer: the set of reforms and investments should support growth and debt sustainability (in line with the country-specific recommendations as part of the EU Semester)."*

3. Reference paths undermine political ownership by Member States of their fiscal adjustment strategies.

4 This chapter is based on Marco Buti, Jakob W. Friis and Roberta Torre (10 Jan 2023): The emerging criticisms of the Commission proposals on reforming the European fiscal framework: A response (https://bit.ly/3YGsv7S).

The Commission's answer:

> *"The reference paths should not be seen as quantitative minimum requirements computed and imposed by the Commission. Nor they should be seen as providing a maximum fiscal effort. They are, instead, a practical translation of the common requirements that is meant to provide concrete guidance to Member States before they prepare and submit their own plans."*

4. National IFIs should have a bigger role.

The Commission's answer:

> *"the Commission intends to strengthen the role of the independent national fiscal councils which were created via a directive on national fiscal frameworks. These institutions will play a greater role in assessing the assumptions underlying the plans, providing an assessment on the adequacy of the plans with respect to the debt sustainability and the country-specific medium-term goals, and monitoring compliance with the plans."*

5. Lack of transparency in the debt sustainability analysis.

The Commission's answer:

> *"The DSA is a well-known and well-documented methodology that is already widely used by international and national institutions to determine the risks associated to the debt trajectory (European Commission 2022, International Monetary Fund 2021). Hence, it allows to focus not only on the debt levels but also on the dynamics and risks. In the Commission proposals, this toolkit is set to play a role only at the very beginning of the process, i.e. in the identification of the sustainability challenges and the design and assessment of the adjustment path that Member States would put forward as part of their plan. Once the plan is endorsed by the Council, the focus shifts to monitoring compliance with the endorsed path and assessing any deviations from it, over the four years when the plan is binding."*

6. The structural balance is simpler, well known, and, contrarily to net expenditure ceilings, it does not impose any limits to the size of the government sector in the economy.

The Commission's answer:

> *"An indicator based on net primary expenditure is under the direct control of the government, while allowing revenues to fluctuate in line with cyclical conditions. Hence, it is not only more observable than the structural balance, but it is also more countercyclical. Moreover, this indicator would be net of new discretionary revenue measures, so it is neutral vis à vis the public sector share in the economy: a government can decide to increase public spending as long as appropriate financing is found."*

7. National medium-term plans that are binding or at least four years long are too rigid. Both legislation and economic conditions may change over such a long period.

The Commission's answer:

> *"The Commission proposal is justified by the need to avoid setting opportunistic behaviour by governments leading to backloading the adjustment effort. Frequent revisions would undermine the credibility of the plans as an anchor for prudent policies."*
>
> *"This is balanced by the possibility to reopen the plan in the event of objective circumstances that make compliance with the plan impossible. While any change of government will not be a reason per*

se to change the plan, new elections could be one such circumstance leading to a new medium-term plan to be proposed. It would have to undergo the same validation process."

" The General Escape Clause (allowing suspension of the rules under severe shocks, as was done at the outset of the pandemic) would also continue to exist to cater for severe economic downturns, together with a country-specific clause for exceptional circumstances at country level."

8. The 3% and 60% reference values for deficit and debt would impose a persistent deflationary bias on the economy.

   The Commission's answer:

   "The Commission decided not to call into question the reference values enshrined in a Protocol annexed to the Treaty, which would have required cumbersome and politically controversial ratification procedures."

   " Moreover, the 3% reference value for the budget deficit has acquired a useful public visibility and 'magnetic power' (Buti and Gaspar 2021)."

   " In addition, the net expenditure path would be designed to allow public debt to continue to decrease beyond the time frame of the fiscal-structural plans (four to seven years) without further fiscal restrictions."

9. The proposed framework should provide new common resources, which would (1) incentivize Member States to abide by their commitments, (2) help rebalance the policy mix, and (3) if focusing on supply-side oriented European public goods, could help tame the current inflation burst.

   The Commission's answer:

   "establishing a central fiscal capacity remains politically controversial, so putting it forward as part of the governance reform could have overcharged the boat and made it more difficult to find agreement."

Further pros and cons of the Commission's proposal

There are several important positive features of the proposal.

1. It focuses on debt sustainability by requiring that the national medium-term plans must imply a long-term downward trend in the debt ratio.
2. Much debated (because unstable) statistical methods of cyclical adjustment are mostly removed from the system.
3. Annual surveillance is based on an indicator that is much more under the control of the government than the indicators used before (most importantly the headline and the structural deficit).
4. The new system lets the automatic stabilizers work without relying on contemporaneous data that should be nowcasted.

Nevertheless, there are significant drawbacks.

1. The proposal significantly reduces most of the problems of the current system, but actually does not eliminate any of them:
    a. Cyclical adjustment is still needed to determine the cyclical component of the unemployment benefit.
    b. The debt sustainability analysis as a starting point in determining the country-specific debt target is not less, but even more complex than the methodology to calculate the structural balance.
    c. The so-called common methodology used for the debt sustainability analysis was developed precisely to eliminate differences among Member States. It is inconsistent to use it now for differentiating among the Member States, as the Commission's proposal claims.
    d. Again, the only "real" fiscal rules remain the 3% deficit and the 60% debt limit.
        i. Neither the requirement to put the debt/GDP ratio on a plausible downward path after some adjustment period nor the four-year limits on domestically financed net primary expenditures is a fiscal rule in the original Kopits-Symansky sense. The constraint on the debt (at least in its current form) is not a well-defined limit, as it depends on unspecified stress tests, while the expenditure limit is not permanent, as it is only set for four years.
        ii. Moreover, the downward path for the debt ratio is a requirement only for countries with – moderate or severe – sustainability problems. The proposal does not tell practically anything about numeric constraints (beyond the 3% deficit limit) for countries below the 60% debt limit. If the ever-declining debt ratio as a goal were maintained below 60%, it would imply that the ultimate goal is 0 debt, which the proposal clearly does not say.
        iii. There is no PAYGO rule on mandatory budget items. The domestically financed net primary expenditure as a target instrument only seems to prevent unfunded spending increases, but does not prevent unfunded tax cuts.
    e. Political-type debates still remain an inherent part of the system.

        As mentioned above, assessing the plausibility of the decreasing debt ratio path is based on stress tests. However, it is likely that this assessment will still retain some element of expert and/or political judgement, opening the door for negotiations with the member country. E.g., the elasticities of the various budget items with respect to the macroeconomic variables used in the stress tests will certainly be a matter of debate, as these elasticities might easily change due to the measures incorporated in the reference adjustment path. The same is true for assessing the fiscal impact of new tax legislation. Tax changes might have very different fiscal effects in different business cycle phases; hence, the adequacy of compensatory measures can be debatable. Whenever there are political disputes, national governments might simply start some seemingly technical debate about the "appropriate value of elasticities", or something similar.
    f. The escape clauses of the Maastricht limits would remain valid, i.e. under a serious crisis (e.g. the financial crisis of 2008-2012 or the COVID-crisis of 2020-2021) the system would still be left without any anchor, though the new system claims to leave full freedom to the automatic stabilizers (as opposed to the clearly procyclical 3% deficit-limit). The only remaining task would be to put some limit on discretionary stabilization, but this problem is not mentioned in the proposal.

2. The proposal does not seem to care about the budget items that do not act as automatic stabilizers but still depend on macroeconomic variables. Most notably, such items are the entitlement programs, which in many countries are subject to automatic (typically inflationary) indexation. E.g., pension expenditures in EU countries are in the order of magnitude of 10% of the GDP. This means that a 2 percentage points uncertainty in the rate of inflation used for budget preparation translates into a 0.2% of GDP uncertainty in the net expenditures. It is clearly not under the control of the government. The spending limits could be fixed in real terms, but that would also create significant problems because a large part of total spending does not and should not depend on inflation. Nothing else can be a clear solution for such problems than the clear separation of macro-sensitive and non-macro-sensitive items.

3. The fixed four-year period for which the expenditure limits have to be binding is a proper medium-term plan only in the first year. In the second year, it is only a three-year plan, etc.; in the last year, it is just an annual budget. Moreover, if new elections might lead to a new medium-term plan, then they probably will. This means that even in a best-case scenario, each Member State will have its four-year program in tandem with its electoral cycle. E.g., what shall the French MoF assume in its new four-year plan about the European economy, if that happens to be the last year in the four-year plan of Germany and there is no new German four-year plan yet?

4. The future role of stability and convergence programs is unclear.

   It is unclear from the proposal what role the national stability and convergence programs might play in the future, given that the SCPs are produced and submitted to the Commission on a three--year rolling window basis, while the national medium-term plans are on a fixed four-year term.

5. The proposal undermines the role and respect of national IFIs.

   Implicitly there is a triangle between any national government, the IFI of the same country, and the Commission. At home, the IFI is supposed to be the balance against the government. At the EU level, the Commission is a balance against the national government. This would imply that the Commission and the national IFIs are on the same side, but it seems the Commission wants to avoid this when it writes:

   > *"To increase ownership and transparency at the national level, independent fiscal institutions could play a role in the monitoring of compliance with the national medium-term fiscal-structural plans in support of the national governments."*

   The Commission could have written at the end of the sentence "in support of the Commission to hold the government accountable", but instead, the proposal pushes the IFI on the same side as the government. Possibly the Commission's proposal did not want to undermine the national ownership of the IFIs by rendering them an agent of the Commission. Still, the current wording, instead of supporting, jeopardizes the national IFIs. Namely, whenever there is a dispute between the IFI and the government, the government can always argue: " The government will not consider what the IFI says about the adequacy of the offsetting measures if my proposal is accepted by the Commission", and as it was mentioned above, there is a high chance for a political type of debates about these issues.

An even more detrimental side-effect is that since 2012 the macro assumptions behind the national budgets must be endorsed by the IFIs. If the medium-term plans are binding, then practically, the endorsement must be given to the medium-term plan itself. In the proposal, it is completely ignored what happens if the IFI endorsed the macro indicators, but the Commission disputes them.

The only solution is, if the roles of the national IFIs and the Commission are clearly separated, excluding any situation when, about the same problems, both institutions have to give their "quantitative, objective, and impartial assessment". As the national IFIs have a clear advantage over the Commission in producing baseline (no-policy-change) scenarios and fiscal impact assessments for their own country, these positive roles should be left with them, and all the normative roles (e.g. is the proposed fiscal adjustment growth enhancing enough?) should be left with the Commission. In order to harmonize the national baseline scenarios across the EU, the Commission could provide central assumptions about the main indicators of the world economy or some EU-level variables. It certainly would not be a problem for the national IFIs, as they anyhow have to take these assumptions from somewhere (e.g., World Economic Outlook).

Simply speaking, whatever calculations the national IFIs have to perform and publish shall not be subsequently disputed by anybody else, including the EU Commission. Otherwise, the IFI's not infallible, but still objective, well-informed, and non-partisan analysis will be degraded to the status of "an opinion".

6. The assessment of the plausibility of the permanently decreasing debt-ratio is checked with stress tests with various macroeconomic scenarios. Still, neither ageing nor climate effects are represented in the calculations, given that they will probably affect the fiscal path well beyond the 10-year horizon. Even if the baseline projection is lengthened beyond the ten-year horizon, it will not reveal such problems if these issues are not incorporated into the models used for the projection. The neglect of pension or climate problems is even more serious if new policy measures are introduced which have such indirect effects beyond the ten-year horizon (e.g., reintegrating private pension funds into the state-run PAYGO system).

4. Main elements of the EU Commission's 26 April 2023 proposal and its critique

The EU Commission's 26 April 2023 proposal for reforming the fiscal rules[5]

The EU Commission has published a package of proposals comprising two regulations and a directive. In the EU, legal system regulations – upon approval by the Council and the Parliament – become directly and automatically part of the national legal systems, while directives have to be implemented by each Member State via a national piece of legislation. In the latter case, the Commission has to certify in the case of each and every Member State that the local regulation is a valid implementation of the EU directive.

The first regulation (replacing Regulation EC 1466/97) deals with the "coordination of economic policies and multilateral budgetary surveillance", including fiscal rules and monitoring procedures. This is the so-called preventive arm of the system. The second regulation (amending Regulation EC 1467/97) focuses on the so-called excessive deficit procedure (EDP), which is called the corrective arm. The directive (amending Directive 2011/85/EU)

5 The whole proposal of the Commission covers not only fiscal rules, but also the role of independent fiscal institutions, but this latter topic is covered in the parallel paper.

covers topics related to the information system of budgeting: accounting, statistics, reporting, forecasting, and impact assessment.

The preventive arm practically codifies most of the content of the November 2022 proposal.

Stronger national ownership with national medium-term fiscal-structural plans that "bring together fiscal, reform and investment policies of each Member State, within a common EU framework. These reforms and investments should help build the green, digital, and resilient economy of the future and make the EU more competitive" (p. 12).

An important change in the 25 April version compared to the 9 November version is that the debt sustainability analysis is no longer the cornerstone of the procedure; it is not the basis for categorizing problematic countries into countries with moderate or substantial debt sustainability challenges. Instead, the only criterion is whether the debt/GDP ratio is above or below the 60 percent threshold.

The corrective arm goes one step further into details beyond the November 2022 communication, namely:

> *"The 3% and 60% of GDP reference values for deficit and debt will remain unchanged. The ratio of public debt to GDP will have to be lower at the end of the period covered by the plan than at the start of that period; and a minimum fiscal adjustment of 0.5% of GDP per year as a benchmark will have to be implemented so long as the deficit remains above 3% of GDP. Furthermore, Member States benefitting from an extended fiscal adjustment period will need to ensure that the fiscal effort is not postponed to the outer years." (Excerpt from the communication of the EU Commission[6])*

The Directive

It expands practically all the requirements that had to be met up to now only by countries whose currency is the euro to all Member States of the EU. Moreover, national IFIs will have to monitor the compliance of their respective governments not only with the national fiscal rules but also with the regulations at the EU level. To help national IFIs to live up to the broader mandate and become more effective, the directive introduces:

> *"New EU-wide minimum standards for independence and technical capacity and tasks for national Independent Fiscal Institutions as well as a comply-or-explain principle for national authorities regarding recommendations by those institutions."*

It is a less spectacular but still very important part of the directive that over the coming years gradually (last deadline 2030), all EU Member States will have to produce (1) quarterly deficit and debt data according to the EU statistical methodology (2) information on tax expenditures, (3) information on the financial consequences of natural disasters, (4) comparable financial data of the public sector entities outside the general government and (5) accrual-based accounting data for the general government in all its subsectors (central, state, local and social security). If adopted, this will significantly increase the level of analytical capacity and, hopefully, the quality of fiscal policy decisions.

6 https://ec.europa.eu/commission/presscorner/detail/en/ip_23_2393

Pros and cons of the Commission's proposal

The intention to raise the quality of information available for fiscal policy is clearly warranted, even if we consider that the road will be long and full of challenges in most countries.

The part on fiscal rules remains still problematic:

1. According to the proposal, there are three fiscal rules to be enforced:
   a. deficit/GDP ratio below 3%.
   b. debt/GDP ratio below 60%.
   c. decline in the debt/GDP ratio over a ten-year horizon, if the ratio is currently above 60%. (without specification "decline" can only mean at least 0.1 percentage point, because fiscal indicators are published up to 1 decimal place, but it is not explicit in the rule proposed)

The first two rules are clear enough, but the third one is not explicitly named as a fiscal rule. However, this is the only constraint that meets the standard definition of a fiscal rule: a permanent constrain on some overall fiscal indicator. (Only indirectly we can infer that "mathematically" the minimum requirement is 0.1 percentage point decrease in the debt ratio, as all these indicators are usually published with one decimal digit.) All the other rules are either of a procedural nature or are subject to regular country-specific negotiations. E.g., Christian Lindner, the German minister of finance, openly criticized the proposal saying "Germany wants clear rules, with numerical references and benchmarks,"[7]

1. As the directive has to be somehow implemented by the Member States, the Commission must certify in each case that the national legislation under no circumstances is laxer than the constraints spelled out in the directive. It is more than a theoretical possibility that some Member States will just keep their current regulation based on the structural balance. It would be difficult for the Commission to refuse certification, bringing back exactly the same type of debates that the Commission and most Member States want to get rid of.
2. On the other hand, there is a very high chance that the new system based on the debt sustainability analysis will be subject to Goodhart's Law: "Any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes." One of the main channels through which Goodhart's law might penetrate the system is the fiscal impact assessment of supply-side policy measures, as their effect might dramatically vary depending on:
   a. Capacity utilization (not only on the situation in the labor market).
   b. Expected course of monetary policy (in the eurozone, dependent on other national fiscal policies as well).
   c. Spending efficiency, etc.

This might be one of the arguments why the debt sustainability analysis has partially lost its weight in the codified version.

7 https://bit.ly/3pTKqM3

5. An alternative proposal

It is important to emphasize that no fiscal rule can properly function without a number of other well-functioning elements of the public financial system. We apply the following principles:

1. Medium-term budgeting, fiscal rules, the role of the independent fiscal institution, and the use of performance information must be organized in a coherent ecosystem guiding the design of fiscal documents and the budget calendar as well.
2. The more immediate the consequences of a political decision, the more likely it is that eventual conflicts will be solved at the expense of future generations (in order to minimize the loss of the loser). This implies that the binding parliamentary decision on the overall deficit has to be made well before the start of the fiscal year.
3. In the long run, efficient reallocation in the budget can expand the fiscal space, usually more than the maximum amount of deficit deterioration tolerated by the financial markets. For this, a good budgeting system helps to shift the focus of regular political debates towards reallocation and away from the question of the maximum permissible deficit or debt.
4. Efficient reallocation requires thorough analysis, which is time-consuming. Proposals for reallocation must be prepared well in advance, and they must have a place in the budget calendar.
5. Tax and entitlement legislation needs time both for preparation and implementation. Private actors also need time to adapt. This implies that it is good to close the window for tax and entitlement legislation well before the beginning of the fiscal year.
6. At every moment, there shall be a medium-term plan adopted by the parliament to limit "daily" decision-making from a fiscal sustainability point of view. This implies that no fixed window system can be appropriate, because fixed time-window systems cease to have a medium-term perspective in the last year(s).

Here we have to make explicit that this principle of rolling medium-term window goes directly against another principle: governments should not bind the hands of the next government beyond what is enshrined in appropriate legislation, or put in another way, new governments should be able to implement their policies (just opted for by the electorate) without unnecessary delays caused by the previous government (just voted out).

7. Politicians do not need much incentive to conduct countercyclical fiscal policy in bad times. The most important value added by fiscal rules is hence to enforce countercyclical tightening in good times. This accumulation of reserves in terms of financial capacity and credibility can provide the resilience necessary not only for automatic stabilization in bad times but also for non-action in some other cases. Namely, some shock may be detectable in the budget figures, but its origin is still unclear. It might be some business cycle phenomenon, but it might also be something else, such as planning error, unforeseen tax arbitrage, complex international transactions, etc. International experience shows that it is impossible to produce a reliable real-time estimate of the business cycle, hence it takes time to analyze the data before an adequate fiscal reaction can be selected.
8. *Ex post* sanctions on governments are not credible if the reasons behind the situation triggering the sanctions are disputable. From this follows that:
   a. Governments should be *ex post* liable only for the evolution of variables that are under their full short-term control.
   b. Any undesirable evolution in a broader economic policy context should be prevented (instead of *ex post* sanctioned).
   c. The system must be designed with a reserve to buffer short-term negative shocks in the broader domain of fiscal policy[8].
9. The IFI shall perform all possible positive analytical tasks providing impartial and well-informed analysis for the parliament whenever needed.

An alternative proposal can be formulated by keeping the most fundamental principles of the EU proposal but changing some important features. Deliberately, here we focus only on features unrelated to the peculiarities of collective decision-making in the community of EU member countries.

The alternative system could consist of the following elements:

1. While agreeing with the EU proposal's focus on debt sustainability, the alternative ultimate goal would be to stabilize the real value of debt accumulated in the past and not to increase it in the future either directly via too high current fiscal deficits or indirectly through an increasing future cost of ageing or climate change (that will also lead to higher deficit and debt in the future).

8 E.g. there is no point in sanctioning the government if in a specific year too many active people have retired and for this tax revenues fell and pension expenditures increased. It is detrimental to compensate for this deterioration of the fiscal balance in other areas, such as cutting investment or other forms of social assistance. If this is a starting point for a longer-term negative trend in the pension system, then the government should be obliged by law to analyze the problem and table an appropriate bill in the parliament to fix it.

2. For this, both a medium-term macro-fiscal model to quantify business-cycle effects and (potentially two) long-term models to quantify ageing and climate effects must be used in a coherent system.
3. A three or four-year rolling window system would imply that there is always a medium-term perspective in fiscal policy.
4. Each year a new year is added to the end of the window, and this is where the fiscal rule, the "permanent numeric constrain on some overall fiscal aggregate", has to be imposed. (In this sense, the fiscal rule is only ex ante binding.)
5. Within the horizon of the window, medium-term budgeting is the name of the game, which focuses on various revenue and expenditure categories. The medium-term budgeting system shall gradually narrow down the fiscal indicators to be fixed. If year t is to be controlled, then
   a. In t-3, only the limit on debt at the end of t and the required primary balance in t shall be fixed based on the fiscal rule.
      From this point onward, the primary balance is only controlled, fiscal policy does not have to react to changes in the total stock of debt due to exchange rate changes, or, e.g., does not have the right to ease fiscal stance due to privatization revenues.
   b. In t-2, the primary balance shall be split into separate balances of macro-sensitive and not-macro--sensitive items[9]. The balance of non-macro-sensitive items shall be fixed in nominal terms, while for the macro-sensitive items a PAYGO rule would apply. The PAYGO rule means that no package of policy measures can deteriorate the balance of macro-sensitive items in any of the years t-2, t-1, or t. Due to external factors (most notably business cycle fluctuations), the balance can get worse, but no policy measure can make it worse.

      From this point onward, fiscal policy does not have to react to changes in the forecasted budget balance due to changes (or prospected changes) in macro-sensitive items. On the other hand, savings on the budget items directly under the short-term control of the government, cannot be given away in the form of tax cuts or entitlement hikes. Simply, automatic stabilization can work at full capacity.
   c. In t-1 the detailed annual budget for t can be produced within the nominal limit for non-macro-sensitive items. (Budget items for macro-sensitive items are anyhow only estimates, real decisions in the frame of the budget debate are only made about non-macro-sensitive budget items.)

9 In the US terminology these are called mandatory and discretionary items, but there this distinction is only applied for expenditures, while here we propose to apply it also for the revenue side.
Mandatory vs macro-sensitive: both names have advantages and disadvantages.

Tax revenues and entitlement expenditures (pensions, family allowances, unemployment benefit, sick pay, etc.) are the most important mandatory items, but depending on country specificities, some other items might also qualify. E.g., royalty revenues on mining activities can be treated as mandatory revenue, or contributions based on membership in international organizations such as the EU, can be mandatory expenditure. There are also items, where on the short run the main uncertainty is not due to macroeconomic fluctuations, but due to demographics (e.g., number of pensioners, or newborn babies). In this respect the name macro--sensitive might be misleading. On the other hand, the name mandatory might suggest the meaning that it cannot be changed. This is certainly not true, most mandatory budget items can be changed, just not on the short run and by a simple government decree. (This is why only entitlement programs sufficiently regulated in primary legislation should qualify for a mandatory status.)

It is important that mandatory revenues and expenditures have to be reasonably forecastable based on macroeconomic and demographic assumptions as well as relevant primary (!) legislation made by the parliament. If secondary legislation made by the government can substantially influence to revenue/expenditure (e.g. fees and fines), then they have to be categorized as discretionary items. The terminology mandatory, or macro-sensitive are treated here as synonyms.

Such a gradual system (1) allows the automatic stabilizers to work in the last two years (for longer horizon forecasts are too uncertain anyhow), (2) gives early warning to the government and to the parliament to prepare the necessary measures, (3) gives enough time for the private sector to prepare for the new policy measures, (4) holds accountable the government only for the items that are really under its control and (5) contains an element of error-correction by the pure fact that the real value of debt cannot grow compared to the last fact year, i.e., slippages in the current year will be "punished" very soon. If there is a change of government in year t, the new administration can immediately introduce reallocations that do not deteriorate any of the two sub-balances or measures that reallocate between the two categories from t+2. It seems to be a better compromise than neglecting all the previously announced decisions or imposing on the new government the four-year size straight jacket prepared by the previous government, possibly months before the elections.

6. All the baseline and fiscal impact calculations shall be controlled by the national IFI, while the Commission shall ensure that national medium-term plans are both growth-friendly and in line with overall EU policies. The Commission could use the already existing network of national IFIs to communicate any information (external assumptions, output format, fundamental principles of methodologies, etc.) that helps national calculations be comparable and coherent with each other.

ANNEXES

Excerpts from the 9 November 2023 Communication of the European Commission on orientations for a reform of the EU economic governance framework

"The Treaty reference values of 3% of GDP budget deficit and 60% debt-to-GDP ratio remain unchanged."

"The revised common EU framework would set the requirements that ensures that public debt is put onto a downward path, or remains at prudent levels."

"As part of the common framework, the Commission would put forward for Member States with a substantial or moderate public debt challenge, a reference multiannual adjustment path in terms of net primary expenditure covering at least four years."

"The reference adjustment path would be anchored on debt sustainability meaning that for Member States with substantial and moderate fiscal challenges, it should ensure that, even in the absence of further fiscal measures, debt would remain on a plausibly downward path after the fiscal adjustment period and that the deficit would be maintained below the 3% of GDP threshold."

"For Member States with a substantial public debt challenge, the reference net expenditure path should ensure that by the horizon of the plan (4 years), i) the 10-year debt trajectory at unchanged policies is on a plausibly and continuously declining path and ii) the deficit is maintained below the 3% of GDP reference value at unchanged policies over the same 10-year period."

"For Member States with a moderate public debt challenge, the reference net expenditure path should ensure that, i) at most three years after the horizon of the plan, the 10-year debt trajectory is on a plausibly and continuously declining path at unchanged policies; and ii) by the horizon of the plan, the deficit is maintained below the 3% of GDP reference value over the same 10-year period."

"…each Member State would submit a medium-term fiscal-structural plan for assessment by the Commission and endorsement by the Council."

"To assess plausibility, the Commission would use stress tests and stochastic analysis, simulating common shocks related to short and long-term interest rates, nominal GDP growth, the primary budget balance and nominal exchange rates."

"When assessing the plan, the Commission will also evaluate whether it is credibly ensured that the deficit is maintained below 3% of GDP over a 10-year period."

"The Member State could request and be granted an extension of the adjustment period by a maximum of 3 years, provided it underpins its plan with a set of reforms and investments that supports sustainable growth and debt sustainability."

"The Commission would assess the plan against the revised common EU framework and could only provide a positive assessment of fiscal-structural plans if debt is put on a downward path or stays at prudent levels, and the budget deficit is maintained below the 3% of GDP reference value over the medium term."

"Member States would be able to commit to a set of reforms and investment that help bring debt on a sustainable path and therefore could underpin a longer adjustment period and a more gradual adjustment path.

"The use of nationally-financed net primary expenditure, i.e. expenditure net of discretionary revenue measures and excluding interest expenditure as well as cyclical unemployment expenditure, as the single operational indicator for surveillance would allow for the operation of automatic stabilisers, including revenue and expenditure fluctuations outside the direct control of the government."

"The Commission would use notional control accounts for each Member State to keep track cumulative deviations from the agreed multiannual net primary expenditure path over time."

"The adjustment path, the reforms and investments will be discussed with the Commission and, once positively assessed, will be adopted by the Council."

"When assessing such a request, the Commission would use the following criteria to assess the set of reform and investment commitments put forward by Member States. They should:

- *be growth enhancing and support fiscal sustainability.*
- *address common EU priorities, including the National Energy and Climate Plans (aligned with the targets of the EU Climate Law), the National Digital Decade Roadmaps, (14) and the implementation of the European Pillar of Social Rights, and ensure that the fiscal-structural plan addresses all or a significant subset of relevant CSRs, including, where applicable, recommendations issued under the MIP.*
- *be sufficiently detailed, frontloaded, timebound and verifiable.*
- *ensure that country-specific investment priorities can be addressed without leading to investment cuts elsewhere over the planning horizon."*

"The path would be set in a way to ensure that a significant part of consolidation needs are met within the adjustment period and not left to future governments."

"The plan could be revised earlier in case of objective circumstances making the implementation of the plan infeasible, but would have to undergo the same validation process. Frequent revisions would undermine the credibility of the plans as an anchor for prudent policies."

“The deficit-based EDP would be maintained, while the debt-based EDP would be reinforced and become a key tool for enforcing continued compliance with the agreed multiannual net primary expenditure path. The existing rules for the opening and closing of a deficit-based EDP would remain unchanged. The process for launching a debt-based EDP under the reformed rules would be activated when a Member State with debt above 60% of GDP deviates from the agreed multiannual net primary expenditure path set out in the medium-term fiscal plan endorsed by the Council.”

“For a Member State with a substantial public debt challenge, a deviation from the agreed path would result by default in the opening of an EDP. The path under the EDP would in principle be the one originally endorsed by the Council. In case this original path is no longer feasible, due to objective circumstances, the Commission could propose to the Council an amended path under the EDP.”

“Robust escape clauses are needed to address exceptional situations where the endorsed adjustment path could not realistically be adhered to.”

“…an exceptional circumstances clause would allow for temporary deviations from the medium-term fiscal path in the case of exceptional circumstances outside the control of the government with a major impact on the public finances of an individual Member State.”

Excerpts from the European Commission's 26 April 2023 proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97

"It lays down detailed rules concerning the content, submission, assessment and monitoring of national medium-term fiscal-structural plans as part of multilateral budgetary surveillance by the Council and the Commission so as to promote debt sustainability and sustainable and inclusive growth in the Member States and prevent the occurrence of excessive government deficits, by medium-term planning."

"The legislative package aims at making the EU governance framework simpler (by using a single operational indicator in the form of a net expenditure path and by simplifying reporting requirements in particular through the introduction of a holistic, single, integrated medium-term fiscal-structural plan)."

"The proposed Regulation simplifies reporting requirements for Member States by using a single operational indicator in the form of a net expenditure path and by introducing a holistic, single, integrated national medium-term fiscal-structural plan that replaces the Stability or Convergence Programmes and the National Reform Programmes of the Member States."

"It should also ensure that the public debt ratio at the end of the planning horizon declines below its level in the year before the start of the technical trajectory. The sustainability of that debt reduction should result from appropriate fiscal policies."

"The technical trajectory put forward by the Commission should also ensure that the government deficit is brought and maintained below the 3% of gross domestic product (GDP) reference value."

"Since Member States could face additional costs at the end of their medium-term fiscal-structural plan such as ageing costs or an unfavourable interest-growth differential, they should ensure that the headline balance at the end of the adjustment period will be sufficient to ensure that the deficit durably stays below the 3% of GDP reference value."

"The Commission shall update the technical trajectories and the quantitative guidance at least once every 4 years in time for the submission of the next cycle of medium-term fiscal-structural plans."

"Prior to the submission of its national medium-term fiscal-structural plan, the Member State concerned shall hold with the Commission a technical dialogue, with the objective of ensuring that the national medium-term fiscal-structural plan complies with Articles 11, 12 and 14."

"A Member State may request to submit a revised national medium-term fiscal-structural plan to the Commission before the end of its adjustment period if there are objective circumstances preventing the implementation of the original national medium-term fiscal-structural plan or if the submission of a new national medium-term fiscal-structural plan is requested by a new government."

"Where a Member State has been granted an extension of its adjustment period but fails to satisfactorily comply with its set of reform and investment commitments underpinning the extension referred to in

Article 13(1), the Council may on a recommendation from the Commission, recommend a revised net expenditure path with a shorter adjustment period."

"Each Member State shall submit to the Commission an annual progress report on the implementation of its national medium-term fiscal-structural plan, by 15 April each year at the latest."

"The Commission shall set up a control account, functioning in accordance with Annex IV, and shall keep track of cumulative upward and downward deviations of actual net expenditures from the net expenditure path."

"ANNEX II.

A national medium-term fiscal-structural plan shall contain the following information:

(a) The national net expenditure path referred to in Article 11. The other budgetary variables outside the control of the government that are part of the definition of net expenditure referred to in Article 2 consist in expenditure on programmes of the Union fully matched by Union funds revenue and cyclical elements of unemployment benefit expenditure.

(b) The projected growth path of government revenue at unchanged policy.

(c) The projected path of the public debt ratio.

(d) Information on implicit liabilities related to ageing, and contingent liabilities with a potentially large impact on government budgets, including government guarantees, non-performing loans, and liabilities stemming from the operation of public corporations, including the extent thereof, potential expenses and obligations arising from court cases and, to the extent possible, information on disaster and climate contingent liabilities.

(e) The main assumptions about expected economic developments and main economic variables which are relevant for ensuring consistency with a convergence of public debt towards prudent levels and maintaining the government deficit below the 3% of GDP reference value.

(f) In case the Member State makes use of assumptions referred to under point (e) that differ from the Commission's assumptions over the adjustment period of the national medium-term fiscal-structural plan and the subsequent 10-year period in the absence of further budgetary measures, due explanations and justifications based on sound economic arguments of these differences.

(g) An analysis of how changes in the main economic assumptions would affect the budgetary and debt position of the Member State.

(h) If applicable, the duly substantiated reasons (with relevant sound and verifiable economic arguments) for deviating from the technical trajectory put forward by the Commission.

(i) Reform and investment priorities to respond to the main challenges as identified in the country-specific recommendations, taking into account the state of play of implementation of those country-specific recommendations.

(j) Total public investment expenditure, as well as reforms and public investment expenditure addressing the common priorities of the Union referred to in Annex VI.

(k) If applicable, information on a specific, time-bound and verifiable set of reform and investment commitments underpinning an extension of the adjustment period pursuant to Article 13, a timeline for its implementation, as well as sound economic arguments that this set of reform and investment commitments fulfil the criteria under Article 13 taking into account the assessment criteria in Annex VII.

(l) A quantification, as much as possible, of the expected impacts of reforms and investment referred to under point (k) on fiscal sustainability, growth and employment, where applicable in line with commonly agreed methodologies.

(m) The medium-term budgetary and potential medium-term growth impact of those reform and investment commitments referred to under point (k) where possible.

(n) If applicable, reforms and investment to correct the identified macroeconomic imbalances under the Macroeconomic Imbalance Procedure.

(o) The planned overall level of nationally financed public investment covering the period of the national medium-term fiscal-structural plan.

(p) For Member States with low public debt challenges but large implicit liabilities due to population ageing, the national net expenditure trajectory and the reforms in the national medium-term fiscal-structural plans should take due consideration of long-term fiscal sustainability challenges of public finances.

(q) Information on the consultations of social partners, civil society organisations and other relevant stakeholders in view of the preparation of the plan."

Excerpts from the European Commission's 26 April 2023 proposal for a COUNCIL REGULATION amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure

"It streamlines the list of relevant factors to decide on the existence of an excessive deficit."

"Independent fiscal institutions referred to in Article 8 of Council Directive [on the national budgetary frameworks], should provide an opinion on the relevant factors."

"In order to enhance national ownership, the role of independent fiscal institutions, traditionally mandated to monitor compliance with the national framework, should be expanded to the economic governance framework of the Union."

"For the years when the general government deficit is expected to exceed the reference value, the corrective net expenditure path shall be consistent with a minimum annual adjustment of at least 0,5% of GDP as a benchmark."

Excerpts from the European Commission's 26 April 2023 proposal for a COUNCIL DIRECTIVE amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States

"Strengthening national ownership: it is proposed to add or clarify requirements on IFIs …"

"… These include the preparation or endorsement of budgetary forecasts as well as assessing sustainability analyses and the impact of policies. Finally, some proposed provisions ensure the independence and accountability of IFIs to reflect standards identified by international organisations, as recommended in the report of 2019 of ECA"

"require Member States to publish data to the extent possible on disaster and climate-related contingent liabilities as well as on economic losses incurred from natural disasters and climate-related shocks"

"stronger monitoring role of national fiscal rules for IFIs, to be enforced through an obligation for governments to systematically take into account IFIs' assessments, along with a more structured dialogue between IFIs and EU institutions"

"The key objectives of the orientations are to improve national ownership, simplify the framework and move towards a greater medium-term focus, combined with stronger and more coherent enforcement "

"Complete and reliable public sector accounting practices for all subsectors of general government are a precondition for the production of high-quality statistics that are comparable across Member States…."

"… It is therefore necessary to improve the collection of accrual data and information needed to generate accrual-based statistics in a way that is integrated, comprehensive and harmonised across all subsectors of general government."

"The availability of high frequency data can reveal patterns warranting closer surveillance and improve the quality of budgetary forecasts. Member States and the Commission (Eurostat) should publish cash-based data, quarterly deficit and debt data applying the definitions set out in Article 2 of the Protocol (No 12) on the excessive deficit procedure annexed to the Treaty on European Union (TEU) and to the TFEU. Publication of budgetary data with higher frequency that are tailored to national budgetary definitions should be determined on the basis of national transparency requirements and user needs, to improve national ownership."

"macroeconomic and budgetary forecasts of the Member States should be endorsed or produced by an independent fiscal institution"

"Macroeconomic and budgetary forecasts should be subject to regular, objective and comprehensive evaluations performed by an independent body in order to enhance their quality"

"Regulation (EU) No 473/2013 of the European Parliament and of the Council requires Member States whose currency is the euro to have independent fiscal institutions tasked with the endorsement or production of macroeconomic forecasts and establishes specific safeguards regarding their independence and technical capacity. Given the positive contribution to public finance of independent bodies, those requirements should be extended to all Member States."

“To improve budgetary planning, due attention should be paid to the macro-fiscal risks from climate change and to the implications of climate-related policies on public finance over the medium and long term.”

“particular attention should be given to operations of those general government bodies and funds which do not form part of the regular budgets at subsector level and that have an immediate or medium-term impact on Member States’ budgetary positions. The values of the combined impact on general government balances and debts of those operations should be presented in the framework of the annual budgetary processes and in the medium-term budgetary plans, capturing impacts stemming from future operations and outstanding and expected new liabilities.”

“transparency regarding the type and size of tax expenditures and resulting revenue losses is necessary”

“Member States should publish data and descriptive information separately for expenditure, tax expenditure and revenue items. Member States are invited to publish information on the distributional impact of budgetary policies and take into account employment, social and distributional aspects in the development of green budgeting.”

“collecting and publishing information on the economic losses and fiscal cost of past events as well as information on the budgetary arrangements and financial instruments used for that matter“

“Member States shall have, by 2030, integrated, comprehensive and nationally harmonised accrual financial accounting systems covering all subsectors of general government and containing the cash and accrual information needed to prepare data based on ESA 2010. Those public sector financial accounting systems shall be subject to internal control and independent audits.”

“quarterly debt and deficit data separately for central government, state government, local government and social security funds”

“macroeconomic and budgetary forecasts shall be either produced or endorsed by independent fiscal institutions established in accordance with Article 8. They shall be compared with the most updated forecasts of the Commission. Significant differences between the macroeconomic and budgetary forecasts of the Member State and the Commission’s forecasts shall be explained, including where the level or growth of variables in external assumptions departs significantly from the values contained in the Commission’s forecasts.”

“Member States shall specify which institution is responsible for producing macroeconomic and budgetary forecasts”

“The macroeconomic and budgetary forecasts for annual and multiannual fiscal planning produced by the national institutions shall be subject to regular, objective and comprehensive evaluation by an independent body, including ex post evaluation.”

“Each Member State shall establish its specific numerical fiscal rules to effectively promote compliance with its obligations deriving from the TFEU in the area of fiscal planning over a multiannual period for the general government as a whole. Such rules shall promote in particular:

(a) compliance with the reference values and provisions on deficit and debt set in accordance with the TFEU;

(b) the adoption of a multiannual fiscal planning period, consistent with the provisions of Regulation [XXX preventive arm of the SGP].”

"Member States shall establish a credible, effective medium-term budgetary framework providing for the adoption of a fiscal planning period of at least 4 years to ensure that national fiscal planning follows a multiannual fiscal planning perspective"

"Annual budget legislation shall be consistent with the national budgetary objectives over the medium term as referred to in Article 2, point (e). Any departure shall be duly explained."

"This Directive shall, in no way, prevent a Member State's new government from updating its medium-term budgetary plan to reflect its new policy priorities. In such case, the new government shall indicate the differences between the previous and the new medium-term budgetary plan."

Targeting real debt as a fiscal rule

In its simplest, deterministic version, when there are no business cycles, the real debt rule requires that nominal net government debt does not grow faster than the price level:

$$D_t \leq (1+\pi_t)D_{t-1}$$

where D is the nominal stock of net debt and π is the rate of inflation measured by the GDP deflator against the previous period.

Assuming no valuation effects, the law of motion for the nominal debt is

$$D_t = (1+i_{t-1})D_{t-1} - B_t$$

where i is the nominal average interest rate on government debt, and B is the primary budget balance.

Combining the two constraints, we get the rule for the primary balance as a share of the GDP:

$$\frac{r_{t-1}}{1+\rho_t}\frac{D_{t-1}}{Y_{t-1}} \leq \frac{B_t}{Y_t}$$

where r is the real average interest rate on government debt, and ρ is the real growth rate of GDP. The inequality implies that the higher the primary balance required, (i) the higher the initial debt, (ii) the higher the real interest rate, and (iii) the lower the real growth (though this latter effect is very small).

To take the textbook case combination of parameters of the Maastricht system, if the initial debt is 60% of GDP, the nominal interest rate is 5%, the inflation is 2%, and the real growth rate is 3%, then the real interest rate is 3%, and the primary balance must be at least 1.2% of the GDP.

If the parameters are similar to the eurozone environment, where the debt ratio is 93%, the average nominal interest rate paid on government debt is 1.5%, inflation is expected at about 3%, and real growth is 1.5%, then primary balance has to be at least -3.1%.

If we subtract from the primary balance the net interest payment, we get the lower constraint for the overall balance. Still, we do not need any lengthy inference, as the fiscal rule will directly tell the result: the overall net balance in nominal terms cannot exceed the product of the initial debt and the inflation rate.

$$D_t - D_{t-1} \leq \pi_t D_{t-1}$$

In other words, the overall deficit (change in the nominal stock of debt) cannot exceed the inflationary compensation part of the interest payment. This is also called the operational balance.

An important side-effect of this rule is that inflation does not have an effect on the primary balance (i.e. the room for manoeuvring of the government) through the changes in interest expenditure; hence there is no temptation to pressure the central bank to lower interest rates when it is not warranted by free capacities in the economy. In the traditional Maastricht system, higher nominal interest rates increase the cost of financing of government debt and reduce the fiscal space.

When there are stochastic business cycles, the real debt rule can be applied to the outermost year of a medium-term rolling window:

$$E_{t-1}\{D_{t+3}\} \leq E_{t-1}\{(1+\pi_{t+3})D_{t+2}\}$$

Assuming a credible monetary policy, the inflation target will be achieved by the end of t+2, hence for the rate of inflation we can use the inflation target.

$$E_{t-1}\{D_{t+3}\} \leq (1+\bar{\pi})E_{t-1}\{D_{t+2}\}$$

The constraint on the nominal primary balance target for year t+3 is

$$\overline{B_{t+3}} \geq E_{t-1}\{i_{t+2}D_{t+2}\} - E_{t-1}\{D_{t+3} - D_{t+2}\} \leq E_{t-1}\{(i_{t+2} - \bar{\pi})D_{t+2}\}$$

The higher the expected real interest paid on the government debt, the higher has to be the primary balance. For this calculation, a baseline projection has to be prepared and/or endorsed by the IFI.

Once this value is fixed, no valuation effect or other factor beyond the primary budget items or "below the line" will change it.

Next year (year t), a new baseline projection has to be prepared (and/or endorsed by the IFI) for the window [t+1,t+4]. Besides performing the above calculation for year t+4, now the balance of discretionary / macro-insensitive items has to be determined for year t+3. For this, simply the projected balance of mandatory / macro-sensitive items has to be subtracted from the primary balance inherited from the previous year. From this point onward, the so-called PAYGO rule applies to the mandatory items: no package of policy measures is allowed to deteriorate the balance of mandatory items. For the PAYGO rule to be enforced, all proposal submitted to the parliament that might affect mandatory items has to be assessed for their fiscal impact. The fiscal impact assessment has to be either prepared by the government and endorsed by the IFI before the final vote or directly prepared by the IFI in case of proposals submitted by individual MP who are usually not obliged to attach fiscal impact assessments.

In year t+1, the already determined discretionary balance has to be allocated among the main spending areas. At this point, baseline projections for the discretionary items are also very important (e.g., how many six-year-old children will enter primary schools and how many will leave the education system). If the projection already shows different spending pressures and rooms for saving, this is where

decisions have to be made about where to save and where to spend. If significant saving is prescribed in an area, a spending review might be warranted.

Finally, in year t+2, the fully detailed annual budget bill can be submitted to the parliament, where the debate is no longer about the deficit and debt, but about how to use the healthcare or education budget most efficiently. For this debate, the ministries already had almost a full year to prepare their evidence-based proposals, because they knew how much money they would have in year t+3.

It can well be that some major factors (e.g., ageing, climate change, or digital transition) are expected to affect the fiscal space in the longer run. Their effect might not be significant within the next three years; hence the medium-term baseline projection cannot allow for them. In this case, a long-term debt-sustainability analysis can be used to quantify the necessary adjustment in the medium-term fiscal path in order to smooth out the burden of future pressures. Once the annually required effort () is determined, it can be easily built into the system through fiscal rule:

$$D_t \leq (1-\varepsilon)(1+\pi_t)D_{t-1}$$

and the primary balance requirement is simply adjusted as if the real interest rate went up:

$$\frac{r_{t-1}+\varepsilon}{1+\rho_t}\frac{D_{t-1}}{Y_{t-1}} \leq \frac{B_t}{Y_t}$$

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