EU fiscal rules:
An assessment of trends and prospects against
the backdrop of the ongoing
economic governance review

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Head of Secretariat
European Fiscal Board, European Commission

JVI, 20 March 2023

Disclaimer: Views expressed are not necessarily those of the EFB or the Commission.
Outline

Scene setter: SGP under review!

Looking back: Has the SGP worked?

Looking ahead: some adjustments or a regime shift?
EU economic governance under review

5/2/2020
Evaluation of 2011 und 2013 Reforms of the governance framework: comprehensive results published

28/03/2022
Online public consultation: results published

14/03/2023
Council conclusions on the Commission orientations

19/10/2021
New Commission communication re-launching the review

9/11/2022
Latest Commission communication: Orientations for a reform of the economic governance framework
Review process has taken lots of time

Member States are divided

- ‘Frugal north’ vs ‘profligate’ south
- Risk reduction vs risk sharing
- Adjust fiscal policies to rules? vs Adjust rules to new fiscal reality?

Commission orientations imply major change

- No requirements for countries with low public debt challenges (except 3% of GDP reference value for deficit)
- Tailor-made and less onerous adjustment requirements for countries with high and moderate public debt challenges => stronger ownership
- Better enforcement in the event of deviations: lower financial sanctions, reputational sanctions and macroeconomic conditionality
A very concise fiscal history of the EU

Ratcheting-up effect: government debt levels increase during crisis but never return to pre-crisis levels.

Note: EU15= BE, DK, DE, IE, EL, ES, FR, IT, LU, NL, AT, PT, FI, SE, UK

Source: European Commission, own calculations
Why EU fiscal rules?

To: M. Lamfalussy

Copy to: Dr. Baer

From: Claudio Borio

Macro-fiscal policy co-ordination in an EMU

- the need to avoid disproportionate use of Community savings by one country;
- a possible bias towards lack of fiscal restraint;

Looking back

Did EU fiscal rules work?

Gross government debt (in % of GDP)

Note: Countries are grouped based on their average debt levels in 2011-2019. Low debt = EU countries with government debt <= 60% of GDP (in 2011-2019 on average). High debt: EU countries with 60% of GDP > government debt >= 90% of GDP. Very high debt: EU countries with government debt > 90% of GDP.

Source: European Fiscal Board
**Bad luck or bad behaviour?**

Average compliance score, 1998-2021

Source: Compliance tracker, Secretariat of the European Fiscal Board
Bad luck or bad behaviour?

Draft budgetary plans vs outcomes (euro area)

(a) Countries with government debt below the EU average in 1998-2019 (75% of GDP): EE, LU, LV, RO, LT, CZ, BG, DK, SL, SK, SE, PL, FI, HR, NL, IE, MT, DE, HU, ES, CY, AT

(b) Countries with government debt above the EU average in 1998-2019 (75% of GDP): FR, PT, BE, IT

Source: European Commission
Looking back

Bad luck or bad behaviour?

Assessment of draft budgetary plans (euro area countries)

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Ex-ante average deviation

-0.4 -0.6
1.4 1.2
-0.1 -0.3
0.1 -0.1
-0.7 -1.2
-0.6 -0.7
-0.8 -0.8
0.2 -0.1
0.0 -0.6
0.4 -0.3
0.9 0.3
0.1 -0.4
0.1 0.3
-0.2 -0.1
-0.5 -1.0
-0.7 -0.7
-0.3 -0.2
-0.3 -0.3

Notes: (1) Green, yellow and red correspond respectively to an assessment of ‘compliance’, ‘broad compliance’ and ‘risk of non-compliance’. (2) The assessment of compliance following the Commission’s ‘overall assessment’ also includes deviations over two years and the possible application of unusual event clauses. (3) ‘SB’ refers to the structural balance; ‘EB’ to the expenditure benchmark.

Source: European Fiscal Board
Major downturns produce significant scarring effects

Source: Larch, M, P Claeys, W van der Wielen (2022) Scarring effects of major economic downturns: the role of fiscal policy and government investment, EFB conference 2022
Looking back

Sustainability vs stabilisation

Current spending

Budget balance

Government investment

26 OECD countries of which 14 EU, since 1970 or earliest available year (annual data): AUS, CAN, CHE, GBR, ISL, JPN, KOR, MEX, NOR, NLZ, TUR, USA, AUT, BEL, DEU, DNK, ESP, FIN, FRA, GRC, IRL, ITA, LUX, NLD, PRT, SWE

Real GDP
**Sustainability vs stabilisation**

Possible solution safety margin. Examples: ‘Zalm rule’ in the NL, UK Treasury in 1980s and 1990s

Source: Larch, M, P Claeys, W van der Wielen (2022) Scarring effects of major economic downturns: the role of fiscal policy and government investment, EFB conference 2022
Looking back

The early view: *Tie the hands of fiscal policy makers*


John William Waterhouse, Ulysses and the Sirens (1891), National Gallery of Victoria (Melbourne, Australia)
Updated view: *Hands of policy makers cannot be tied, but they need advise and ownership*
Looking forward

Changing assessment

**2020**

2011 und 2013 reforms of SGP strengthened the framework but...

Rules are too complex (too many operational rules, unobservable variables, etc.)

Too many objectives for one instrument (sustainability, stabilization, quality of public finances)

Some MS with very high public debt. Not all MS take advantage of good times to build buffers

Equal treatment not ensured

**2022**

Not level of public debt is main problem but debt trajectory

Not enough leeway for public investment (green and digital transitions)

One-size–fits all rules; 1/20 the rules for debt reduction too demanding

Different circumstances require differentiated treatment

Existing financial sanctions under SGP unrealistic

Ownership needs to be strengthened
The stylised basic structure
(2\textsuperscript{nd} generation fiscal rules)

- Triggered with input from independent assessor
- Country-specific debt reduction plan negotiated with country (ownership)
- Deviation from expenditure path that triggers a corrective procedure
- Speed limit on primary government expenditure

Anchor

= goal

one escape clause

one threshold

one operational rule

The stylised basic structure (2\textsuperscript{nd} generation fiscal rules)
## Looking ahead

<table>
<thead>
<tr>
<th>Current rules</th>
<th>New rules</th>
<th>Anchor</th>
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<tbody>
<tr>
<td>MTO</td>
<td>Public debt ratio</td>
<td><strong>Anchor</strong></td>
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<tr>
<td>Annual benchmark $\Delta SB$ 0.5% of GDP and or $1/20^{th}$ of $Dt$ - 60%</td>
<td>Bespoke path (4 or 7 years) towards plausible reduction of debt ratio</td>
<td><strong>Adjustment</strong></td>
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<tr>
<td>Deficit, debt, SB, EB</td>
<td>EB</td>
<td><strong>Operational rule</strong></td>
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<tr>
<td>Structural</td>
<td>Nominal (?)</td>
<td><strong>Metric</strong></td>
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<td>Annual check</td>
<td>Check over medium term with notional control account</td>
<td><strong>Compliance</strong></td>
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<td>Very restrictive conditions</td>
<td>Additional 3 years to complete fiscal adjustment</td>
<td><strong>Reforms and investment</strong></td>
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<td>Unusual events, severe economic downturns, cycle, debt ratio, other relevant factors</td>
<td>One escape clause (EU-wide and national)</td>
<td><strong>Flexibility</strong></td>
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Aspiration and Reality (1)

Do the COM orientations provide the right answers?

- Important vs urgent
- Simple vs complex
- Equal treatment vs discrimination
- Multilateral vs bilateral
- Medium term orientation vs backloading of adjustment
Aspiration and Reality (2)

Will orientations find a majority in Council?

- First reactions confirm division of Member States
- 400+ questions raised on COM orientations
- Compromise by March 2023 difficult (some key elements of orientations require unanimity)
Aspiration and Reality (3)

What if Council cannot find a common landing zone?

- Escape clause deactivated end 2023 (?)

- In spring 2023 COM and Council will propose/adopt new CSRs for 2024

- New interpretation of current laws by COM

- Gap between letter and practice of the SGP increases further

- What are the limits of a rules/law-based economic governance framework?
Economic and Monetary Union (status quo)

- Risk sharing
  EU budget, temporary instruments

- Risk reduction
  fiscal rules, no bail out, no monetary financing, IFIs, FC, conditionality
Economic and Monetary Union (as it should be)

Risk sharing
bigger EU budget +
conditional monetary
financing + permanent
central fiscal capacity (CFC)

Risk reduction
fiscal rules, conditionality
IFIs
Advantages and challenges of more risk sharing

- CFC would close important gap in current EMU architecture. Predicament well known for more than ½ a century

- Economies of scale, positive externalities

- Why no or very little progress?

- Distribution of risks across MS not random

- Moral hazard: ex-ante conditionality vs time consistency

- Risk sharing at EU level without proper political representation and accountability
Advantages and challenges of more risk sharing

Source: European Commission
Advantages and challenges of more risk sharing

Source: ECB, European Kommission
Thanks for your time!

Visit the EFB at:
https://ec.europa.eu/european-fiscal-board
Persistence of old habits

Source: European Commission, own calculations
Bad luck or bad behaviour?

Average compliance score (two subperiods)

Source: Compliance tracker, Secretariat of the European Fiscal Board
Implementation: compliance with EU fiscal rules

% of compliant Member States

% of potential GDP

Output gap (rhs)  Deficit rule  Debt rule  Structural balance rule  Expenditure rule
Advantages and challenges of simplified SGP

The role of the expenditure benchmark

- $d_0 = 150\%$, $i_t = 5$, $y_p t = 5$
- **EB**: speed limit on primary expenditure ($g = 5 - 0.35$), $d = 70$ in 40 years
- Debt rule: $1/20*(d_{t-1} - 60)$, yields $d = 70$ in 40 years
- Linear debt reduction: $d_t - d_{t-1} = (d_0 - 60)/40$
- **SPB**: $p_b_t - p_b_{t-1} = 0.5$ until $p_b$ yields $d = 70$ in 40 years
Advantages and challenges of simplified SGP

The role of the expenditure benchmark

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Advantages and challenges of more risk sharing

- PEPP announcement
- COM NGEU proposal
- FR-DE initiative
- PEPP extension
- Political agreement on NGEU
- RRF regulation in force
- PEPP extension
- Russian invasion on Ukraine

Source: Thomson Reuters DataStream