The European Commission’s legislative proposals on reforming the EU economic governance framework: a first assessment

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Policy pointers

• The proposed economic governance rules should match the elevated importance they attribute to public investment, with fewer constraints on Member States to undertake the necessary investment to meet pressing common priorities, such as the just green transition and upward social convergence.

• More flexible safeguards on net public expenditure and/or special treatment of types of public investment, especially those explicitly combining green and social objectives (‘ecosocial public investment’) and those aimed at high quality jobs, by means of a ‘golden rule’ or a different amortisation of their cost over a longer period, would be ways forward.

• Eventually, a more permanent and powerful EU fiscal capacity should be established to complement national efforts to meet common priorities.

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1. Introduction

On 26 April the European Commission presented a long-awaited package of legislative proposals for reforming EU economic governance rules. The package included proposals for two regulations and one directive. One regulation aims at amending the effective coordination of economic policies and multilateral budgetary surveillance (or the so-called ‘preventive arm’ of the Stability and Growth Pact [SGP]) and another is intended to speed up and clarifying implementation of the excessive deficit procedure (the so-called ‘corrective arm’ of the SGP). The proposed directive aims at amending the Member States’ budgetary frameworks to align them with the new fiscal framework set out in the proposed regulations. According to the European Commission the objective of the proposed rules is to strengthen debt sustainability and promote sustainable and inclusive growth through reforms and investment.

The shortcomings of the current economic governance rules are multiple. They had a ‘procyclical’ effect: they pushed governments into fiscal austerity, making fiscal savings when the economy was not growing. Public investment expenditure turned out to be one of the foremost victims of this fiscal austerity as Member States strove to comply with EU fiscal rules, especially in the aftermath of the global financial crisis. The existing rules overly constrained Member States, especially those with high public debt ratios, in using their fiscal policy to stabilise their economies when large and/or long-lasting shocks hit them. Ultimately the rules proved to be fairly ineffective as regards inducing Member States to reduce their public debt ratios and helping to prevent other macroeconomic imbalances. In addition, the surveillance framework had become overly complex and opaque, making its consistent enforcement difficult and politicised, while raising important questions about the democratic accountability of the fiscal surveillance process.

Application of the fiscal rules was suspended in the wake of the Covid-19 pandemic in Europe in spring 2020, as the ‘general escape clause’ was activated to allow Member States to deploy the massive public resources needed to keep their economies afloat and prevent public health care systems from (completely) collapsing. Consequently, budget deficits ballooned and public debt ratios increased almost everywhere in the EU. As the pandemic situation improved, the risk has been that, if Member States resumed planning their national fiscal policies in line with the fiscal rules, the rate at which they would need to start making savings would stifle economic recovery and prevent them from investing at the scale necessary to meet a number of EU policy priorities, such as decarbonisation and energy security, implementing the action plan for the European Pillar of Social Rights and pursuing upward social convergence.

According to the European Commission’s autumn 2022 forecasts (European Commission 2022), in 2024, 13 out of 27 Member States would be expected to have public debt ratios above 60 per cent, including four out of the five biggest economies (Italy, France, Spain and Germany), whose performance weighs heavily in the economic performance of the EU and the Euro area. Six of these 13 Member States, including three of the biggest ones, would even be expected
to have public debt ratios over 100 per cent of GDP.

This policy brief provides an overview of the proposed changes in the economic governance rules and an assessment from the perspective of whether they are likely to trigger a return to fiscal austerity and narrow the space for the public investment needed to tackle the policy challenges facing Europe.

2. **Key elements of the proposed fiscal surveillance framework**

The proposed economic governance rules would be embedded in the European Semester. In this context of fiscal, economic and employment policy coordination, each Member State will have to submit its national medium-term fiscal-structural plan (FSP). This plan will spell out the Member State's fiscal, investment and reforms plan for the next four years at least, starting from its endorsement by the Council following a Commission recommendation, and under certain conditions for up to three more years if the Member State requests an extension of the programme. The duration of a FSP is called the ‘adjustment period’.

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<th>Glossary of technical terms</th>
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<td><strong>‘Net public expenditure’</strong>: nationally-financed net primary public expenditure. This expenditure is ‘net’ of discretionary revenues; ‘primary’ as it excludes the interest that a government has to pay on existing debt; excluding cyclical unemployment benefit payments and any public expenditure to match EU funded projects.</td>
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<td><strong>‘Adjustment period’</strong>: the duration of a national medium-term fiscal-structural programme (FSP). The baseline duration is four years but it can be extended for up to another three if a programme of investments and reforms is proposed and approved in line with certain criteria.</td>
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<td><strong>‘Technical trajectory’</strong>: the evolution of ‘net public expenditure’ for the four years of a Member State’s next fiscal-structural programme with a public debt ratio greater than 60 per cent or a budget deficit exceeding 3 per cent of GDP, as proposed by the European Commission.</td>
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A Member State’s fiscal policy will be summarised in the FSP by the evolution, for the duration of the programme, of nationally-financed net primary public expenditure (henceforth ‘net public expenditure’). ‘Net public expenditure’ will be ‘net’ of discretionary revenues (that is, tax revenues that do not vary automatically GDP fluctuations, for example, tax revenues resulting from a change in legislation or regulation); excluding the interest that a government has to pay on existing debt (hence, ‘primary’); excluding cyclical unemployment benefit payments and any public expenditure to match EU funded projects. Member States will have to state in their FSPs how their net public expenditure will evolve over the duration of the FSP and this evolution will define the adjustment path of their fiscal policy in order to meet the
requirement of maintaining sound public finances. What is changing in the legislative proposal compared with the current framework is how sound public finances are operationalised and therefore what Member States should aim for when setting out the path of their net public expenditure.

Member States with a public debt ratio under 60 per cent of GDP and a budget deficit below 3 per cent of GDP will have to set their net public expenditure path so that it satisfies two requirements. First, that by the end of their FSP’s adjustment period, it results in the structural primary balance – that is, the government budget balance excluding all cyclical revenue and expenditure, such as unemployment benefits and income tax, as well as interest payments – that the European Commission will have specified for them based on its forecasts about their public debt (effectively, the Commission’s Debt Sustainability Analysis). Second, that their general budget deficit (that is, the overall difference between public revenues and public expenditure) is below the 3 per cent of GDP reference value specified in one of the Protocols attached to the Treaty for the Functioning of the EU (TFEU) and, according to the Commission’s forecasts, expected to remain so for 10 years following the end of the FSP adjustment period without any additional policy measures.

For Member States with public debt higher than 60 per cent of GDP or a general budget deficit greater than 3 per cent of GDP, the European Commission will propose in advance a so-called ‘technical trajectory’, that is, a path for the Member State’s net public expenditure for the FSP’s adjustment period. This technical trajectory will have to meet certain requirements. First, it should ensure that, at the latest by the end of the adjustment period, the Member State’s public debt ratio will be lower than the year before the beginning of the FSP and on a ‘plausibly downward path’ for the 10-year period following the end of adjustment period, even if the Member State does not take any additional policy measures. The analysis provided in the European Commission’s Debt Sustainability Monitor, illustrating the forecast evolution of the public debt ratio under different assumptions and deterministic and stochastic scenarios regarding fiscal policy and the economy will be the basis for determining what technical trajectory would result in putting the public debt ratio on a ‘plausible downward path’.

Second, the evolution of net public expenditure should also bring to or maintain the government deficit at 3 per cent of GDP or below over the medium term and ensure that it remains under this reference value for the 10-year period following the end of the adjustment period, even if the Member State does not take additional policy measures. Third, if the budget deficit is greater than 3 per cent of GDP during the adjustment period, the evolution of net public expenditure should ensure that this deficit is reduced by 0.5 per cent of GDP per year until it falls below 3 per cent. Fourth, the evolution of net public expenditure should be planned so that the necessary fiscal adjustment effort to meet the public debt sustainability criterion (on which see more below) and the deficit reference value of 3 per cent of GDP is, on average, evenly spread over the adjustment period, rather than backloaded. Fifth, net public expenditure should be growing by less than the expected medium-term output growth.

Each Member State, regardless of its debt ratio and public budget balance,
will also propose in its FSP a set of reforms and investments and show how they will address the Country-specific Recommendations issued by the Council to each Member State in line with the Broad Economic Guidelines and the Employment Guidelines and any recommendations issued under the preventive or corrective arms of the Macroeconomic Imbalances Procedure. The proposed reforms and investments should also address what the proposed legislation calls the ‘Common Priorities’ of the EU, which comprise the European Green Deal, including the transition to climate neutrality by 2050 and the policy priorities included in the Member State’s National Energy and Climate Plan to implement the energy union; the European Pillar of Social Rights, including the targets on employment, skills and poverty reduction for 2030; the Digital Decade Policy Programme and respective National Digital Decade Strategic Roadmaps; and last but not least the Strategic Compass for Security and Defence. The set of reforms and investment in the FSP should be aligned with the reforms and investment planned under the Member State’s national Recovery and Resilience Plan.

A Member State can request that its FSP adjustment period be extended by up to three years by proposing reforms and public investment for which it makes the case that, in addition to pursuing the abovementioned purposes, they will also enhance growth, support fiscal sustainability and result in higher nationally-financed public investment for the lifetime of the FSP than would otherwise have been the case over the medium term. A Member State can also propose an alternative net public expenditure path than the technical trajectory proposed by the European Commission. In both cases (request for an FSP extension and a counter-proposal of a net public expenditure path), the Member State should duly document the data and substantiate the assumptions and forecasts that would result in similar outcomes with regard to the public debt ratio, the deficit and investment. The Member State’s national fiscal council should offer an opinion on these alternative calculations.

The legislative proposals also include reform of the so-called ‘corrective arm’ of the fiscal rules, which aims at forcing Member States to correct their fiscal policies when they do not comply with ‘budgetary discipline’ and generate ‘excessive deficits’, most notably by altering the operationalisation of the criterion that defines ‘excessive public debt’. Under the proposals, a public debt ratio above 60 per cent will be considered not to be falling sufficiently and approaching the 60 per cent reference value at a satisfactory rate (that is, the definition of ‘excessive public debt’) if net public expenditure deviates from the path set out in the Member State’s endorsed FPS. This operationalisation proposes to link a Member State’s compliance with the public debt fiscal rule with the European Commission’s debt sustainability analysis framework.

A budget deficit over 3 per cent of GDP will require correction by 0.5 per cent of GDP per year. This requirement, according to the proposed reform of the ‘corrective arm’ of the SGP will be waived if the deviation of the budget deficit over 3 per cent of GDP is deemed to be small enough and temporary (that is, resulting from a recession and forecast by the Commission to be eliminated by the end of the recession) or caused by any exceptional circumstances outside the Member State’s control that have a significant impact on its public finances.
These exceptional circumstances beyond government control could be either Member State–specific or EU/Euro area–wide. The proposed legislation effectively provides for escape clauses in these circumstances.

The first ever FSPs will be submitted 'soon' after the adoption of the revised legislation, and the subsequent ones by the end of April of the respective year. The European Commission will be charged with providing technical information (medium-term public debt projection framework and results, its related macroeconomic forecasts and assumptions, and either the technical trajectory, if necessary, and the corresponding structural primary fiscal balance), as well as a 'technical dialogue' with Member State administrations to guide them in preparing their FPSs. The Commission will assess the FSP two months after its submission and produce a recommendation, to be adopted by the Council for endorsement or revision by the Member State. Member States should submit, every year by mid-April, their annual progress report on the implementation of their FSP instead of the annual national stability, convergence and reform plans.

Last but not least, the legislative package does not propose any changes that would substantially increase the role of the European or national parliaments, let alone of the social partners, in the preventive or corrective arms of the SGP. By contrast, an enhanced role is introduced for national independent fiscal institutions ('fiscal councils') which will provide their independent opinions on whether a Member State has been complying with the net public expenditure path set out in its FSP and if not, why not.

3. Assessment

The proposed economic governance rules have several advantages over the existing ones.

First, they allow for some differentiation and tailoring in Member States' fiscal adjustment paths, following a common risk-based framework for assessing its public debt sustainability. This contrasts with a mechanical public debt reduction rule prescribing an average rate of reduction over three years (the notorious ‘1/20th rule’) for all Member States with a public debt ratio over 60 per cent. In several cases, that should prevent the emergence of a situation in which fiscal policy aims at reducing public debt too fast and for too long, thus stifling GDP growth and ultimately undermining public debt sustainability.

Second, the fact that net public expenditure is proposed to be the key indicator that defines the path of national fiscal policy is within direct government control should simplify the EU’s multilateral budgetary surveillance and make it more transparent.

Third, they acknowledge in principle and more broadly the need for public investment and reforms to meet important challenges facing European economies and societies, but also to contribute to public debt sustainability.

Fourth, the proposed rules are aimed at coordinating more closely the multilateral budgetary surveillance and macroeconomic imbalance procedures by incorporating and adjusting the policy actions necessary to comply with the recommendations that Member States receive for each into one national plan,
the FSP. That should in principle maximise synergies between preventing and correcting fiscal and other macroeconomic imbalances.

Last but not least, giving Member States the opportunity to set up their own FSPs combining fiscal, economic and structural policies over several years into coherent plans, while also enhancing the role of national independent fiscal councils in the assessment thereof, should improve the national ownership of and, hopefully, compliance with the FSPs compared with the current economic governance framework.

These improvements are subject to some important limitations, however. First, there is still the risk that some Member States will be forced into fiscal austerity, that is, budget savings when their economies are slowing down or in recession in response to the requirement that they must keep their general budget deficits below 3 per cent of GDP at all but ‘exceptional’ times, and when this reference value is exceeded, even during the FSP adjustment period, that they reduce their budget deficit by 0.5 per cent of GDP per year.

Second, despite acknowledging the importance of public investment, the proposed fiscal surveillance framework maintains, through two safeguards, significant pressure on Member States to build up fiscal savings in the course of implementing their FSPs, especially in the discretionary part of their budgets, which includes public investment. All Member States will need to manage their net public expenditure so that by the end of the adjustment period the general (headline) budget balance should be forecast to remain below 3 per cent of GDP in the 10-year period that follows, even without any additional policy measures. Additionally, in Member States with a public debt ratio over 60 per cent or a budget deficit more than 3 per cent of GDP, net public expenditure will have to grow by less than the (expected) medium-term output growth.

To add to these concerns, the only requirement regarding public investment levels in the proposed framework is that Member States seeking an extension of their FSP adjustment period will have their request approved if, among other things, they show that, following implementation of their plan, the overall level of nationally financed public investment over the lifetime of the FSP will be higher than the medium-term level in the period preceding the FSP. As public investment in the criterion is not measured as a share of GDP, this requirement would not even ensure that the level of public investment would grow with the economy, especially during times of slow growth.

These considerations leave open whether governments will have the capacity and incentives to sustain the rate of additional investment necessary to meet other policy priorities, such as a just transition to a climate-neutral economic model and upward social convergence. According to some estimations (Mourre, Poissonnier and Lausegger 2019), budget deficits increase (or budget surpluses shrink) in the EU on average by 0.5 percentage points of GDP when GDP drops by 1 per cent (with the economy at full employment), with considerable variation across individual Member States, depending on the size of automatic stabilisers. Moreover, given the gap especially of public investment that several Member States experienced in the 2010s, and insofar as public investment is important for building productive capital stock that affects...
medium-term output growth, some Member States may become trapped in a vicious cycle whereby their net public expenditure, which includes investment, grows more slowly because of the investment gap they experienced earlier. This will be a bigger concern once the NGEU comes to its end without any further fiscal capacity in place.

Meanwhile, additional public investment to the tune of 1.8 per cent of GDP (2019) per year will be necessary in the EU, on average, for climate investment and energy security alone for the period 2021–2030, without including any fiscal costs associated with making the transition a ‘just’ one (Baccianti 2022). Additional investment equivalent to another 1.3 per cent of GDP (2018 levels) will be needed annually until 2030 to close the investment gap in social infrastructure (Fransen, del Bufalo and Reviglio 2018), which is essential for building lifelong human capital (Hemerijck, Mazzucato and Reviglio 2022). Investment in these areas will have to be sustained for decades given the EU’s ambition on climate change and challenges such as demographic ageing. Of course, these are not the only areas mentioned in the EU’s common priorities. The ongoing relaxation of state aid legislation, most recently the new Temporary Crisis and Transition Framework, has granted Member States additional flexibility in adopting state aid support measures in sectors that are key to the transition to climate neutrality and net-zero industry (in line with the Green Deal Industrial Plan).

While building up buffers to allow space for robust fiscal policy support in the event of an economic shock is in principle a sound practice, it is not clear how the optimal choice will be made between this need and facing other pressing policy challenges. This is of particular concern as the reference value of 3 per cent of GDP for the budget deficit which tips the direction of policy in favour of fiscal savings is not based on any theoretical grounds for defining the sustainability of public finances.

4. Conclusions

What has been said so far points to a fundamental omission in the proposed fiscal surveillance framework, namely, the reservation of, in effect, special treatment for at least some types of public investment, either in the form of a golden rule for public investment, whereby public investment is partly or wholly excluded from the calculation of deficits, or in the amortisation of its costs over a longer period, so that it does not overly increase outlays in the year(s) it is undertaken. While the proposals attribute an elevated importance to public investment (and reforms) by making them part of the assessment of fiscal structural plans and the net public expenditure trajectory, they do not go far enough in allowing space for the necessary additional public investment to take place across Member States. This should be remedied if the future fiscal surveillance framework is to serve environmental and social sustainability and not only a narrow definition of financial sustainability, as it does now. To that end, granting special treatment to public investments that explicitly integrate green and social objectives from the outset (cf. Sabato and Theodoropoulou 2022), including job quality – that is, eco-social public investment – would be a smart way forward.
Given that allowing Member States more leeway to borrow and increase their public debt in order to invest can have negative spillover effects, however, a complementary or even substitute solution for special treatment of investment at the national level would be to establish further enhanced EU fiscal capacity at the EU level before or at the end of the Next Generation EU instrument.

References


