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On Reforming the EU Fiscal Framework

A contribution to the European Commission Review of the EU Economic Governance Framework

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Since its establishment in 2001, Astrid Foundation has devoted a significant part of its research programme to the analysis of the European economic institutions and policies, including the reform of the Stability and Growth Pact. Recently, this last topic has been specifically addressed by two papers, drawn up for the purposes of the public consultation held by the EU Commission on the reform of the European economic governance rules: <https://ec.europa.eu/eusurvey/runner/Public-debate-on-the-review-of-the-EU-economic-governance> .

The first paper, The New EU fiscal framework: how to harmonise rules and discretion, is authored by Giuliano Amato, Franco Bassanini, Marcello Messori and Gian Luigi Tosato. The second paper, reproduced below, is authored by Massimo Bordignon and Giuseppe Pisauro.

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Introduction

It is not only a matter of reforming the fiscal rules. There is a more general necessity to revise the economic governance of the European Union (EU) taking account of: 1) *New challenges* (e.g. large crises hitting repeatedly the EU economy in the last decade and the need for large future investment spending to address climate changes and energy transition; Buti, 2021). 2) *New economic conditions* (lower growth rates and lower interest rates that put debt sustainability concerns in a different light and requires structurally a more active fiscal policy; Blanchard et al., 2020; Buti and Messori, 2021). 3) *Past negative experience* (in terms of EU economic governance and coordination of national fiscal policies). 4) *New common tools*, in particular the Ng-EU program, introduced to fight the pandemics. This program and particularly its main component, the Recovery and Resilience facility (R&R), does not only address a specific problem, the recovery and convergence of the EU economies after the Covid pandemic, but provides a template for an effective re-definition of the EU's economic governance, including the new European fiscal rules. In this context:

1. Why change the fiscal rules?

- a. *They did not work well before the pandemic; it is even more difficult they will work well after.* Specifically, trying to apply the present rules in the post Covid world would put the EU Commission, and therefore EU fiscal surveillance, in a very difficult position.

Before the pandemics: (EFB, 2019) rules suffered of lack of internal coherence, excessive complexity, lack of transparency and too much weight given to *unobservable* indicators reducing ownership and accountability of the rules. In terms of outcomes, fiscal policy remained largely *pro-cyclical* and the *quality of public expenditure* did not improve. Indeed, it worsened for the countries more affected by the rules.

After the pandemics, if the Growth and Stability Pact (GSP) were to remain unchanged, these problems would only escalate. Suppose the GSP is reintroduced unchanged starting from 2023 and the Commission tried to implement its rules:

1. *Debt rule* (1/20th of the difference between actual level and the target of 60% to be reduced yearly). However, following the pandemic, debt over GDP has increased by 14 points on average in the EU, more than 20 points in high debt countries. The debt rule is clearly too restrictive (except perhaps for the present economic rebound) for high debt countries.
2. *Closing the gap with the Medium Term Objective (MTO)*. This objective is based on estimations of an unobservable, *structural deficit*, which in turn to be determined requires estimations of *potential output*, *output gap* and *spending and taxing quasi-elasticities*. All these elements were very difficult to estimate in real terms before the Covid; after the pandemic, any estimation would be even more unreliable, as the pandemic is likely to have long run effects on the production frontier, therefore also affecting potential output. Similarly for aggregate demand, concerning budget elasticities.
3. *Expenditure benchmark*. How is the Commission going to treat the expenditures funded by the R&R facility in the benchmark? What about the expenditure financed by grants with respect to the ones funded by loans? Should they be treated differently?
4. *Deficit rule (below 3% of GDP)*. Can this constraint be applied, or be applied in the same way, when countries are borrowing from the EU itself? For instance, according to its plan, Italy needs to borrow about 1,5-2% of GDP annually in the next five years just to implement the R&R plan; how are these loans to be treated in the context of the deficit rule?

Obviously, the EU Commission can use some *discretion* in applying the rules; but if it goes too far from legally agreed common rules, the Commission has not legitimacy. There is then the risk of an application of the rules that is either wrong on economic grounds or too discretionary implying a loss of any residual trust in the rule framework.

- b. Need to protect investment and growth enhancing expenditure more. Even to take care of long term spending needs for climate transition.

A second important reason to change the rules is that the Euro economy as a whole is not doing well. After the financial crisis, EU area lost grounds in term of growth rate with respect to the US; productivity growth also stalled and the EU is lagging behind both US and China on innovative technology (e.g. A.I. and quantic computers). Behind these problems, insufficient public and private investments; specifically, *net public investment* has been zero or negative in many countries in the 2010-2019 period. Moreover, the EU is now facing a *new emergency*, the climate transition; to address it

and reduce the consequent social costs, there will be the need of extensive public spending in the future.

- c. The bottom line is that we need simpler and more transparent rules (based on observables) and with built in strong counter-cyclical fiscal components. They also need to be designed to protect investment and growth enhancing expenditure, specifically concerning future spending needs for climate transition.

2. How to change the rules?

- a. Reaching the above objectives requires modifying the present framework in three directions. First, the framework needs *simplification*, overcoming the current situation of overlapping and contrasting different rules and targets that also makes the system incomprehensible. There should be a *single target* and a *single operational rule* based on observables and not sensible to the economic cycle in order to avoid pro-cyclical biases. This would imply eliminating all those indicators referring to unobservable factors, such as potential GDP, output gaps and structural budgets. As the main problem that the European fiscal rules try to address is debt sustainability for each member country - to avoid imposing negative externalities on other EU members (particularly, for Euro countries) - it is instead sensible to maintain a long-term *target* defined in terms of debt over GDP.

As well known, the current target for debt over GDP is 60%, a threshold that has been determined 30 years ago in a completely different economic situation. This target could be changed by modifying the Protocol (12) that defines the numerical thresholds of 3% (for deficit over GDP) and 60%. According to legal experts (Tosato, 2021b), this could be done without changing the Treaties, but via unanimity voting in the European Council. However, while there are arguments (lower structural growth and lower interest rates for the Euro area) that would support an increase in the 60% target (e.g. ESM, 2021) this is not strictly necessary for improving the working of the fiscal framework. What is important is that the *speed of adjustment to the target* will be redefined (the 1/20 rule), as addressed in point c) below. It should be also noted that in order to modify the 1/20 rule, it is enough to revise the secondary legislation (e.g. the Regulations) not the Treaties themselves or the annexed protocols (Tosato, 2021b).

- b. The operational rule should be based on an indicator not sensible to the cycle in order to avoid any pro-cyclical bias in the rule. The obvious candidate, as suggested by a large literature (e.g. EFB, 2021), is *expenditure* net of cyclical components and of discretionary tax changes. The reference for computing the admissible growth rate for spending should not be *potential income* as currently used by the Commission to apply the expenditure benchmark, but rather realistic real GDP growth forecasts for the medium term period (say, three years) endorsed by an independent technical body such as the national fiscal council (e.g. Giavazzi et al., 2021). The inflation rate to compute nominal GDP growth should be set at the ECB target (e.g. 2%) (e.g. Lane, 2021) in order to strengthen the anti-cyclical component of the scheme.
- c. Second, the process to reach the target must become *country specific*, taking into account the initial situation, sustainability risks, and devising an adjustment path that is compatible with maintaining a satisfactory level of growth for each country. This means overcoming the current debt rule (the 1/20) that has already proved to be not implementable for high debt countries and would become even more difficult to apply after the pandemics for the reasons stressed above. The process must also be enforceable, devising *credible sanctions* for countries that do not follow the agreed adjustment path. Finally, the new framework must also pay more attention at the *quality of public expenditure*, in particular concerning public investment and growth enhancing spending. In practical terms, this objective could be reached by subtracting from the expenditure rule as defined in point b) above, spending for specific national and European projects, such as the green transition.

The experience with the Ng-EU plan and particularly with its main component, the Recovery and Resilience Facility (RRF), provides a useful template for defining how to reach the objectives under point c). The RRF requires that each of the EU's member states set up a plan, the National Recovery and Resilience Plan (NRRP) that is then examined by the Commission and finally approved by the EU Council. A similar methodology could be utilized to define *national adjustment plans* to reach the debt target, particularly for high debt countries.

Specifically, each high debt country would present a plan to reduce debt over GDP for some specified amount in a given time span (say, 5-10 years). Three years plans (on a rotating basis) would be defined according to this long-term plan. As suggested by Martin et al. (2021), the national fiscal council and the Commission should be involved

in assessing the economic validity of each country plan and its potential debt sustainability risks (e.g. Gros, 2021). Once these checks have been successfully performed, the national plan would then be approved by the Council following a proposal by the Commission. Hence, on political grounds, each high debt EU country would take a commitment to follow the plan in the prescribed period. The Commission will then check the implementation of the plan annually by using its operational tool (e.g. the expenditure rule). This would represent the “preventive arm” of the revised fiscal framework. Limited yearly deviations from the plan would be allowed as long as the path is maintained along the three-year period. Consequently, all currently existing flexibilities mechanisms for the implementation of the rules, as now stated in the secondary legislation, would be eliminated. However, a *single national escape rule*, to be invoked only in extreme circumstances, would remain as part of the framework.

Second, let us recall that the current NRRPs also specify in detail spending in public investments and in other related projects. According to the RRF, each country plan must follow the European priorities, with (at least) 37% of the funds spent on the green transition and 20% on digital innovation. The plan must also respect the Commission’s recommendations to the country. The Commission checks the implementation of the plan, both on the intermediate objectives (the “milestones”), that might also require the passing of legislative reforms, and on the achievement of the final objectives. EU Commission transfers money to countries, in different instalments, only if these objectives are reached according to the agreed upon timetable.

By analogy, the country plan for debt reduction might also spell out in detail the reforms and the public investments that the country intends to perform in the given time period, according to European priorities and national necessities. The Commission would then assess these plans and treat more favourably the spending associated with these projects, subtracting (part of) it from the expenditure rule used to check the adherence of the country to the plan. The larger *ex ante* involvement of the Commission in the assessment of the plans would minimize the risks of manipulation that are usually associated with the application of golden rules. A differential treatment of the *stock* of debt, (implying a slower rate of debt reduction for the debt raised to finance this “spending for the future”) in addition to the *flow* component (the elimination of these spending from the expenditure rule), as suggested by Giavazzi et al. (2021) could also be considered. However, it would add further complexities at an already complex mechanism, with the risk of creating further conflict in the relationships between the country and European institutions.

This framework, again in analogy with the current practise of the RRF facility, also suggests a natural way to enforce the national plans, by specifying the potential sanctions. If a country heavily deviates from its proposed plan (e.g. it commits “gross errors”, to use the terminology of the Treaties), the exceptional circumstances for an escape clause are not satisfied and/or if the projects announced are not carried forward, the Commission revises the country’s plan. And it takes the initiatives of imposing the adjustment required (following an approval by the Council) until the country is again on its debt reduction path. This would represent the “corrective arm” of the revised fiscal framework.

3. Permanent common fiscal capacity

- a. The above framework would apply even in the absence of a *common fiscal capacity*. However, it would be obviously much simpler to enforce fiscal rules if a part of the investment projects and related expenditure (in EU defined policies, such as green transition) was financed at the EU level with common debt, using a template similar to the current (temporary) Ng-EU. A country deviating by its defined plan, not enforcing the agreed upon reforms and investments, would simply be denied the funding, as already stated in the current R&R facility.
- b. The existence of a permanent common fiscal capacity would also help solving several other problems that have so far negatively affected the functioning of the monetary union (e.g. Maduro et al., 2021). It would allow for *common fiscal insurance* at the EU level versus symmetric /asymmetric shocks, thus easing the concerns of financial markets on the long-term sustainability of the common currency. The existence of a permanent large stock of EU debt would also make it easier to implement the common monetary policy by the ECB, also offering a *safe asset* for investors. This would also increase the international standing of the euro. The appetite that financial markets have shown concerning the current issues of common debt proves the validity of this proposal.
- c. Consistently, we propose that the 390 billion of EU debt that currently remains on the EU budget should not be repaid when it expires, as currently envisaged (e.g. Fuest and Pisani-Ferry, 2021). Rather, this debt should be rolled over and used to finance EU policies implemented at a national level using a template

similar to the current R&R facility. In case of a large crisis, this financial instrument could be further expanded using a simpler decision rule (for example, unanimity in the Council following a proposal by the Commission) than the one currently used for approval of the EU budget (Maduro et al., 2021).

- d. One remaining difficulty is that the current funding of the Ng-EU, allowing for the issuing of common EU debt guaranteed by the EU budget, has been legally justified by the existence of an emergency, the Covid pandemic. However, the climate transition is certainly another emergency that will affect EU countries in the next decades, requiring a new “green” fiscal pact across member countries (Darvas and Wolff, 2021). This emergency could then provide the legal basis for extending the Ng-EU beyond its currently stated period (Tosato 2021a).

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