Reforming Stability and Growth pact: three suggestions to Commission proposal

The European Commission put forward a proposal to reform the European fiscal rules. The proposal is a step in the right direction. However, it fails to address a number of important shortcomings and it creates a number of new problems.

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Our suggestions

1. Establish a more clear governance
2. Simplify procedure around growth investments
3. Consider setting up a new crisis fund.

1. Establish a more clear governance

It is ineffective to have the same debt reduction requirement for every member state. The debt reduction is then often unrealistically large, making it impossible for a national politician to implement, or ineffectively small, resulting in too little debt reduction. Effective is to have a tailor-made debt reduction path for each member state. This, however, means that the Commission should have the leeway to determine what this debt reduction path is.

With the proposal, the Commission gives itself this leeway. This is shaped in a two-step process: the Commission establishes a 'reference path' for each member state, showing the expected path of debt. The Commission then assesses whether member states are doing enough to reduce debt in their plans (see box for explanation). This gives the Commission a lot of influence over national processes.

The Commission also gains influence in another way. Because in anything that is not hard-wired, the Commission has room to decide how something should be interpreted, unclear rules and processes mean more power for the Commission. And there are some ambiguities in the proposal. For instance, it is not clear what the role of the 3% deficit rule is. Also it is not well defined when enforcement will take place in case of deviation from the expenditure path.

More power for the Commission means there is more to be gained for member states in influencing the Commission. Previously, this often resulted in a more lenient handling of the rules. We make some suggestions to improve the *governance* side of the Stability and Growth pact.

- **Provide more oversight and transparency on the process.** Political influence can be countered by more transparency. Everyone can then see what choices have been made and thus identify unfair treatment. It would be good to make agreements on which process steps become public and when. More supervision of the European Commission could also be considered.
- **Agree on reference path methodology.** The reference path the Commission draws up is made using a Debt Sustainability Analysis (DSA). In a DSA, assumptions strongly influence the resulting debt path. There must therefore be clear

agreements on the assumptions to be used. The danger is that we find out that we have made too gloomy or rosy assumptions for member states with major implications for national policies. The same could then happen as with the output gap calculations needed to work out the structural fiscal balance. This was performative for many southern member states: in downturns, low growth forecasts gave less fiscal space which led to lower government spending and therefore, due to the decline in effective demand, lower economic growth. The reverse happened in boom times where member states were given too much fiscal space.

Functioning of European Commission proposal

The fiscal rule that becomes leading is the expenditure rule. This sets a net expenditure path as the norm, with policy-induced increases in expenditure raising the path and leaving cyclical unemployment and interest expenditure out of the path. We previously wrote about this expenditure rule. See our earlier report and our earlier analysis on it.

A drawback of an expenditure rule as a fiscal rule is that it does not automatically lead to debt reduction. An appropriate debt reduction path has to be constructed. The European Commission proposes a process where member states themselves have a large stake in what this debt reduction will look like. Depending on whether a member state has a substantial, medium or low level of debt, the expenditure path must meet different requirements.

1. Commission establishes framework

- Depending on size of public debt, member states fall into different categories

Substantial
(Debt > 90%)
After 4 years, the 10-year debt path should be declining and fiscal deficit is max. 3% of GDP (deficit rule)

Gemiddeld
(60% > Schuld < 90%)
After 3 years, the 10-year debt path should be declining and deficit rule is achieved

Low
(Debt < 60%)
Deficit rule is achieved

2. Member state submits plan

- Impact of reforms and investments are taken into account
- Requirements from macro-economic imbalances procedure (MIP) should be included in the plan

Request for easing of rules

- Member state can extend debt reduction path by 3 years
- The member state has to implement 'priority' reforms and investments
- A new tool is being developed to enforce this

3. Commission assesses and Council decides

- Commission may demand new plan from member state
- Council must agree to plan
- In case of diagreement 'reference path' applies

Possibility of new path

- If expenditure path is no longer 'feasible', Commission can propose new expenditure path to Council

4. Annual monitoring

- Monitoring at European Semester whether member states is on its path

5. Procedure in case of violation

- Existing rules for excessive deficit procedure (EDP) in case of deviation from deficit rule remain the same (where Commission can consider 'all relevant factors')
- Debt EDP on violation of expenditure rule automatically triggered in member states if deviation is 'substantial'

- **Define via a standard when a procedure starts.** A member state enters an excessive deficit procedure if the deviation from the expenditure path is 'substantial'. This means there is a lot of room for the Commission to judge when something can be considered 'substantial'. This tempts member state governments to push the edge. A government can deviate more and more from the expenditure

path to see how far it can go, until the Commission shows its teeth. This can be avoided by defining (by taking a certain percentage, for example) when a deviation is 'substantial'.

- **Create clarity on the role of the 3% deficit rule.** It seems that the 3% deficit rule is only used to test whether *projected* deficits do not exceed 3% in the medium term. This prevents the state of the business cycle from influencing rule violations. This is a good step: it prevents member states from being forced to make cuts in downturns. But the proposal does not state this explicitly, which may leave ambiguity as to what to do if a member state's deficit exceeds 3% because of a cyclical shock.

2. Simplify the procedure around growth investments

A drawback of current European fiscal rules is that they do not take investment properly into account. In recent years, when member states had to make cuts to comply with European fiscal rules, they often did so by reducing public investment, which hit the longer-term growth capacity of the member state. The Commission's proposal solves this by including the impact of investment on growth and debt in member states' fiscal plans. This is a good step. For this to work properly, however, clear agreements are needed, for instance through a European working group, on how these investment effects will be quantified.

But the Commission also makes it unnecessarily complex. Under the Commission's proposal, a country can request relaxation of its debt path if it is matched by investment or reforms. To check whether a member state will actually implement this, it wants to develop a new 'tool'. It is unclear what this tool will look like.

Besides the possibility of introducing an excessive deficit procedure, there is then yet *another* avenue where compliance can be disputed. It is simpler and more effective that any approval of additional reforms and investments leads to a correction of the already established expenditure path, just as policy burden increases do. This keeps it to one guiding fiscal rule with one enforcement procedure.

3. Consider setting up a new crisis fund

The elephant in the room is the design of a new crisis fund. The effects of a major crisis on member states cannot be solved with fiscal rules and in practice require additional support. It is remarkable that the Commission does not propose what a new crisis fund should look like.

During the corona crisis, it became clear that the current crisis fund instruments were inadequate. The European Stability Mechanism (ESM) was bypassed; to dampen rising panic in the sovereign bond market, it was decided to create new funds in the short term, such as the Recovery and Resilience Facility (RRF) and the SURE Fund.

Another fiscal crisis is inevitable. It is important to think now about what emergency support will look like then. Deciding how to help member states under the high pressure of a crisis could result in a fund that does not work optimally.