Building on the proposal by the EU-Commission for reforming the Stability and Growth Pact

Jasper Van Dijk, Florian Schuster, Philippa Sigl-Glöckner, Vinzenz Ziesemer

In the following, we very briefly sketch out the reform proposal put forward by the EU-Commission and make five suggestions on how this could be developed further. The annex contains two short papers covering (1) the EU methodology for computing debt sustainability and (2) expenditure rules in practice drawing on the Dutch experience.

The reform proposal

The proposal of the EU-Commission[1] for reforming the Stability and Growth Pact suggests focusing fiscal surveillance on the reduction of debt levels. To implement this, the Commission would conduct a debt sustainability analysis (DSA) for each country. Countries that are judged to face a moderate or substantial debt challenges would be provided with a fiscal adjustment path covering at least four years. This adjustment path would be expressed in terms of net primary expenditure and should ensure that debt is plausibly on a downward path for ten years after the adjustment period[2] as well as limiting the deficit to 3%. Countries would be able to apply for an extension of the adjustment path for up to three years if they present a plan for reforms and investments strengthening growth and debt sustainability. Once the adjustment path is agreed, the respective country would have to translate it into annual budgets. Bar exceptional events the adjustment path should remain unchanged for four years at least. If a country with substantial debt challenges failed to adhere to the expenditure path, an EDP would automatically be opened. For all other countries with debt levels beyond 60%, not sticking to the adjustment path opening an EDP would be considered. The following sketches five suggestions on how the proposal by the EU-Commission could be developed further.

[1] European Commission (2022): "Communication on orientations for a reform of the EU economic governance framework", online available under: https://economy-finance.ec.europa.eu/system/files/2022-11/com_2022_583_1_en.pdf [Last access: 01.12.2022].

[2] After three years for countries facing moderate debt challenges, after four years for countries facing substantial debt challenges

Suggestions

1. Put in place safeguards for democratic legitimacy

The EU-Commission proposes to play a key role in national fiscal policy by (a) setting the expenditure path for four years and (b) deciding which investments and reforms allow for an extension of the adjustment path for all countries. Key tool for decision making by the Commission is a DSA.

Several safeguards should be put in place to ensure this process has democratic legitimacy. First, it should be possible to reset medium term budgetary plans after elections, even if four years have not passed yet. Second, national parliaments should have to sign-off on the budgetary plans negotiated with the EU-Commission. To make this more than a rubber stamp exercise, national parliaments require adequate analytical capacity. One way of ensuring this would be for national independent fiscal institutions (IFIs) to provide analytical support to Parliament like the Congressional Budget Office does in the US. Not all IFIs are adequately resourced to fill this role, and many lack sufficient access to data and information.[3]

Third, DSAs are not apolitical algorithms calculating the optimal fiscal policy. DSAs can show what may happen *given* certain assumptions. Several factors make the assumptions going into DSAs particularly important: First, the outcome of DSAs is highly sensitive to small changes in assumptions, especially when they have to project debt dynamics for a time horizon as long as fourteen years. Figure 1 shows an example for how variable projections can be, even in the short term and in non-crisis times.

[3] The Network of Independent Fiscal Institutions (2022): "The capacity of national IFIs to play an enhanced role in the EU's fiscal governance", online available under: https://www.euifis.eu/publications/30 [Last access: 01.12.2022].

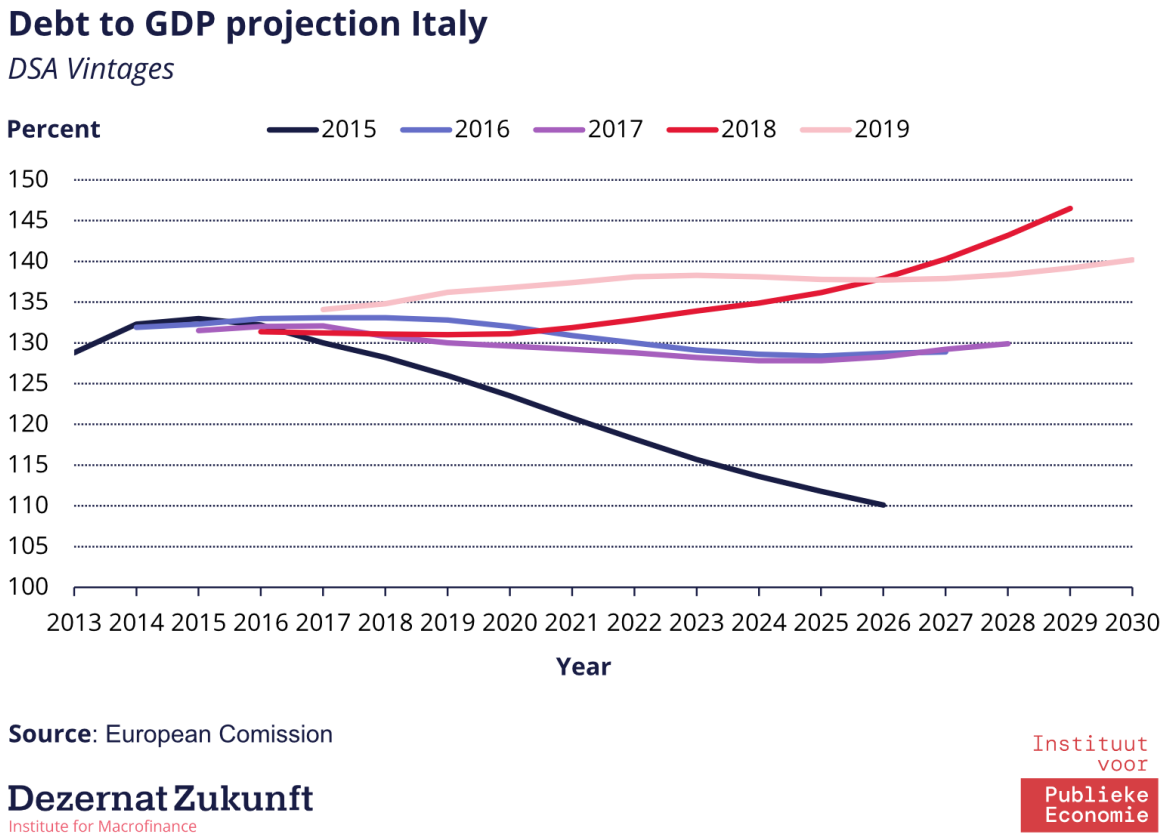


Figure 1: Debt to GDP projections for Italy based on EU-Commission data

Second, there is not one correct DSA, there are various possible fiscal stance/growth combinations – multiple equilibria. Third, the result of a DSA may very well end up influencing outcomes: If the EU-Commission declares debt sustainable investors are likely to buy bonds of the respective country. If the EU-Commission comes to the opposite conclusion this could set off a doom loop. Fourth, several assumptions will reflect policy choices. For more detail on the assumptions going into DSAs, see annex 1.

Given their importance and the fact that there is not one unique, correct set of assumptions they should be set to (1) be aligned with the goals of the EU-Treaties, especially growth and convergence,[4] and (2) be agreed upon in a political process, ideally by the Council and Parliament (like the budget). As with potential output calculations, inputs and code for DSAs should be published online, so that an external review of the results is possible.

[4] TEU, Article 3(3), TEU preamble, https://eur-lex.europa.eu/resource.html?uri=cellar:2bf140bf-a3f8-4ab2-b506-fd71826e6da6.0023.02/DOC_1&format=PDF.

2. Judge fiscal prudence based on a common benchmark where possible

A common currency area without centralised fiscal policy inescapably faces tensions between respecting national sovereignty and protecting the stability of the currency. A well-designed fiscal framework strikes the balance between the two objectives, guarding against fiscal risks on the one hand and being not more intrusive than necessary on the other. Hence Art. 126 of the TFEU identifies the goal of fiscal surveillance by the EU-Commission as "monitor[ing] the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors".[5]

Using DSAs to set four-year expenditure ceilings for every individual country could be seen as a more intrusive than necessary way of identifying and preventing such gross errors: The Commission would use a process which is not purely technical and involves significant judgement calls. Both the DSA assumptions and the review of investments and reforms to be negotiated with countries on a bilateral basis tie the hands of sovereigns for four years, in many cases an entire government term.

Further, expenditure rules are analytically demanding as they require estimating the impact of discretionary revenue measures and judgement calls on the credibility of proposed measures. See annex 2 for more detail on expenditure rules.

Instead of defining the expenditure path for every country, one could use a DSA to calibrate a *common benchmark* for responsible fiscal policy. A country which meets the benchmark would not be required to enter into the bilateral negotiation with the Commission. If the benchmark is missed, the governance procedure would proceed as in the Commission's proposal.

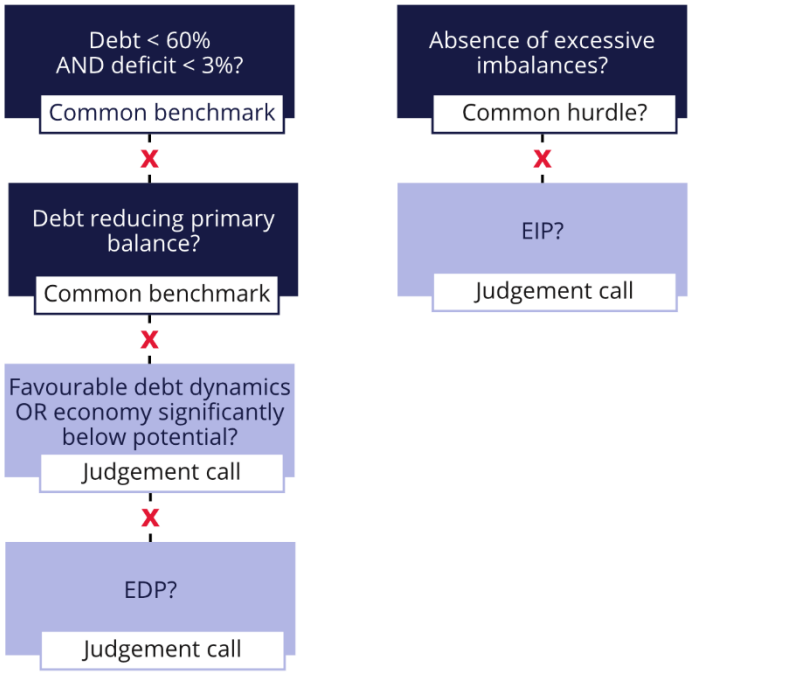
The benchmark could for instance be defined as primary balance that makes a falling debt to GDP ratio for EU-countries with the highest financing costs very likely.[6] Another option would be to use a structural balance as the benchmark, since it is already referenced in the Commission's proposal, but this would make addressing the issues with computing potential output even more important (which we describe under point 3 below). To ensure the benchmark is well understood -a factor that made the 3% deficit rule effective[7]- it may make sense to update it only every three or four years unless there is a clear break in

[5] Complete TFEU, Art 126 here: https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:12008E126.
[6] For more detail see Sigl-Glöckner et al. (2022): „A proposal for reforming the Stability and Growth Pact", Dezernat Zukunft, online available under: https://www.dezernatzukunft.org/wp-content/uploads/2022/06/Sigl-Gloeckner-et-al.-2022-A-proposal-for-reforming-the-Stability-and-Growth-pact.pdf [Last access: 30.11.2022].
[7] ECB (2019): "Fiscal rules in the euro area and lessons from other monetary unions", ECB Economic Bulletin, 03/2019, online available under: https://www.ecb.europa.eu/pub/economic-bulletin/articles/2019/html/ecb.ebart201903_02~e835720b96.en.html [Last access: 01.12.2022].

interest rate or growth dynamics like the EU is currently witnessing. All countries with a balance exceeding the benchmark would by default be seen as compliant with the SGP.

For countries with a primary balance below the threshold and a debt ratio substantially above 60%, the bilateral process with the Commission to define a fiscal adjustment path would commence as proposed. It needs to be possible to review this fiscal adjustment path including reforms and investments after a parliamentary election.

Schematic overview over the proposed four step process



Source: Own illustration

Dezernat Zukunft
Institute for Macrofinance

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Figure 2: Schematic overview over the proposed four step process

3. Reform the potential output estimation

The use of DSAs does not eliminate the need for unobservable variables. On the contrary, potential output/elements of its calculations feature at least three times in the DSA methodology of the EU-Commission. Hence, it would be key to reform the way potential output and especially labour market potential is estimated. Currently labour market potential is estimated based on actual labour market performance in the past regardless of policy which may reduce or grow potential.

The change to a forward-looking methodology for defining the fiscal adjustment path by the EU-Commission is an opportunity to resolve these issues. The effect of actual policy

could be incorporated in projections as suggested by Schuster et al. (2021)[8] If governments conduct policy which contributes to the expansion of the labour market, potential fiscal space should expand correspondingly. For policy diminishing potential, the opposite should be true. Incorporating forward looking policy is always fraught with difficulties surrounding projections. Yet, this should not result in a bias against growth-oriented policies.

Linking fiscal space to potential would provide an incentive to invest in one's economy without the need to rely on arbitrary accounting categories, which are in many cases not a good proxy for productive expenditure. The adjustment of potential output based on reforms and productive spending could offer an alternative to the Commission's suggestion of extending the adjustment period by up to three years. It would also do away with the need to introduce a new tool to monitor investment and reforms, which would add yet another fiscal surveillance mechanism.

4. Retain the fiscal stance

The proposal by the EU-Commission is very focused on fiscal surveillance to limit the debt stock. Yet, in a currency union coordinating the fiscal stance is key for monetary stability (Delors Report) and growth. Thus, the fiscal stance should still play a role under the fiscal rules. This could be operationalised in the following way: For countries breaching the common threshold the interpretation of article 126(3) should consider as other relevant factor whether the fiscal stance matches current utilisation of economic potential. If the economy runs beyond or close to potential, a large deficit is hard to justify. If the economy runs below potential, there may be a good reason for a substantial deficit, as tightening the fiscal stance may lead to contractionary austerity. To ensure this procedure does not lock in hysteresis effects, the assessment should be based on a reformed assessment of potential output as suggested under (3). The Macroeconomic Imbalance Procedure could be used to judge whether primary surpluses are harmful. Countries running excessive current account surpluses could be asked to commit to a more expansionary fiscal stance to reduce imbalances.

[8] Schuster et al. (2021): "The cyclical component of the debt brake: analysis and a reform proposal", Dezernat Zukunft, online available under: https://www.dezernatzukunft.org/en/the-cyclical-component-of-the-debt-brake-analysis-and-a-reform-proposal/ [Last access: 01.12.2022].

5. Resolve the contradiction between shrinking balance sheets and increasing investments

In the above, we have focused on the fiscal rulebook. To meet the challenges of our time, such as climate change, it is just as important to find the fiscal space for much needed investment. The EU-Commission seems to assume that reducing debt levels and increasing investment is compatible. This assumption may be false. Preliminary analysis suggests that rising financing costs and growing costs of ageing will cause the debt ratio to rise to the level of 2021 – even *without any incremental* climate and defence spending.[9] *With* incremental public climate spending of 1% of GDP[10] and an increase in defence spending to 2% of GDP by 2031, debt to GDP is likely to rise significantly above its prior peak of 92% in 2020, see figure 3.[11]

Limiting the public balance sheet also stands in stark contrast to what the United States do: two thirds of the spending under the Inflation Reduction Act (IRA) is allocated to financial incentives whose fiscal volume is *uncapped*.[12]

Hence the discussion on a fiscal capacity for Europe is as relevant as ever, especially if one would really like to make a serious attempt at limiting national debt stocks.

[9] As described further down, the estimation of debt dynamics is highly sensitive to assumptions used. Thus, one analysis cannot prove that reducing debt ratios is incompatible with scaling up investment.
[10] Darvas and Wolff (2021): "A green fiscal pact: climate investment in times of budget consolidation", Policy Contribution 18/2021, Bruegel. This estimate by Bruegel precedes the rise in interest rates which commenced in 2022. Rising interest rates lead to rising financing costs for private investors. This is particularly problematic for capital intensive projects like wind parks, which may not generate sufficient returns under existing subsidy schemes. Hence an increase in public subsidies for private investments could add to public spending pressures.
[11] Ameco, data code: UDGG.
[12] Credit Suisse (2022): "US Inflation Reduction Act US Inflation Reduction Act - A Tipping Point in Climate Action", ESG Report.

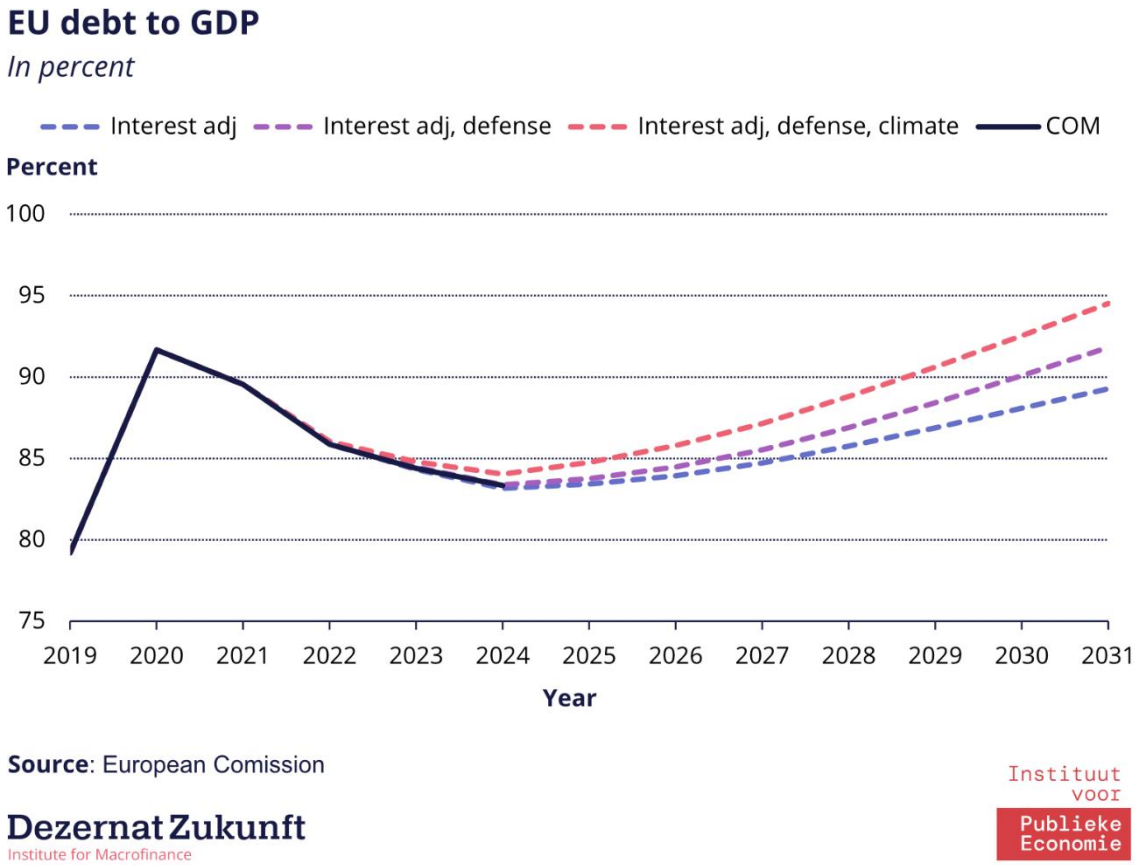

Figure 3: Debt to GDP in the European Union

Annex 1: The EU methodology for computing debt sustainability

The EU-Commission's method for computing Debt Sustainability Analyses

Debt Sustainability Analyses (DSAs) are used to estimate the development of the debt to GDP ratio based on the fiscal balance of the government, i.e. spending minus expenditures, interest payments, growth and inflation. The main assumptions required for DSAs come from the Economic Policy Committee (EPC's) technical Output Gaps Working Group (OGWG) and the Working Group on Ageing Populations and Sustainability (AWG) (European Commission [EUC] 2021a, p. 18). In the following we will describe how the EU-Commission conducts its DSAs focusing in particular on the assumptions behind key inputs.

The EU-Commission structures DSAs into three blocks as figure 1, the DSA for Germany shows: (1) the **primary balance**, i.e. the fiscal balance excluding interest payments, (2) the **snowball effect**, which summarises the debt dynamics resulting from interest rates, growth and inflation and finally the (3) **stock-flow adjustment**, which reflects all (historical) changes in the debt level that cannot be explained by the other two blocks, e.g. financial transactions such as bank bailouts.

DE - Debt projections baseline scenario	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
Gross debt ratio	61.8	59.6	71.2	70.1	69.0	69.1	68.7	67.8	66.4	64.6	62.6	60.7	58.7	57.1
Changes in the ratio (-1+2+3)	-3.3	-2.1	11.5	-1.1	-1.1	0.1	-0.4	-0.9	-1.4	-1.8	-2.0	-2.0	-1.9	-1.6
of which														
(1) Primary balance (1.1+1.2+1.3)	2.8	2.3	-5.3	-3.4	-1.9	-1.5	-1.0	-0.6	-0.2	0.3	0.3	0.4	0.3	0.2
(1.1) Structural primary balance (1.1.1-1.1.2+1.1.3)	2.1	1.7	-2.7	-2.1	-1.3	-0.9	-0.5	-0.1	0.3	0.7	0.6	0.5	0.3	0.2
(1.1.1) Structural primary balance (bef. CoA)	2.1	1.7	-2.7	-2.1	-1.3	-0.9	-0.5	-0.1	0.3	0.7	0.7	0.7	0.7	0.7
(1.1.2) Cost of ageing						0.0	0.0	0.0	0.0	0.0	0.2	0.3	0.5	0.7
(1.1.3) Others (taxes and property incomes)						0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1
(1.2) Cyclical component	0.9	0.6	-2.6	-1.3	-0.6	-0.5	-0.5	-0.5	-0.5	-0.5	-0.3	-0.2	0.0	0.0
(1.3) One-off and other temporary measures	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(2) Snowball effect (2.1+2.2+2.3+2.4)	-0.9	-0.9	2.6	-2.8	-2.2	-1.3	-1.4	-1.5	-1.5	-1.5	-1.7	-1.6	-1.6	-1.5
(2.1) Interest expenditure	0.9	0.8	0.7	0.6	0.6	0.4	0.3	0.3	0.2	0.2	0.1	0.1	0.1	0.1
(2.2) Growth effect	-0.8	-0.3	3.4	-2.4	-1.7	-0.7	-0.7	-0.7	-0.6	-0.5	-0.6	-0.6	-0.5	-0.4
(2.3) Inflation effect	-1.1	-1.3	-1.5	-1.0	-1.0	-1.1	-1.1	-1.1	-1.1	-1.2	-1.2	-1.2	-1.2	-1.2
(2.4) Exchange rate effect linked to the interest rate	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(3) Stock-flow adjustments	0.4	1.0	3.6	-1.7	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(3.1) Base	0.5	0.9	3.7	-1.7	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(3.2) Adjustment due to the exchange rate effect	-0.1	0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pro memoria														
Structural balance	1.1	0.9	-3.4	-2.7	-1.9	-1.4	-0.8	-0.4	0.1	0.6	0.5	0.4	0.2	0.1

Figure 1: General Government Gross Debt projections under baseline scenario, using the example of Germany (EUC 2021, p. 133)

The primary balance consists of three components: First, the **structural primary** balance which is calculated based on the **structural primary balance ex costs of ageing**, **costs of ageing** and **others**. The structural primary balance ex costs of ageing is -bar Covid years- "broadly consistent" with a no-policy-change scenario, i.e. projected based on past values. To estimate the historical unobservable structural primary balance, the cyclical component of the budget needs to be estimated. This requires estimating potential

output (EUC 2021a, p. 18f.). Potential output is estimated based on the methodology of the OGWG, which comes with severe issues as outlined here. At the heart of the issue are normative assumptions for the inputs to the potential output calculation -especially for labour force potential- which are hard to justify.

Costs of ageing aim to capture **healthcare-**, **long-term care-**, **education-**, and **public pension costs** related to demographic change. Assumptions on population development play a central role, as they not only influence the four items mentioned above, but also the GDP projections (via labor input), which in turn influence the first three items (EUC 2021b, p. 2). Population projections are provided by Eurostat[1] and are mainly determined by fertility rates, mortality rates and net migration (EUC 2021b, p. 14). It is assumed that policy does not change in the future, e.g. that there is no change in the method of calculating the pension age (EUC 2021b, p. 2).

Long term care and health expenditures are estimated based on the development of certain population characteristics like age, gender, education, need of long/short term care[2] (EUC 2021b, p. 115). Education costs are mainly determined by demographic change and the average number of years of education (EUC 2021b, p. 124). Pension costs are estimated based on national data and common assumptions about demographic and macroeconomic developments.

The **snowball effect** – also called interest rate - growth differential – (EUC 2021a, p. 130) covers the impact of **interest expenditure**, **growth effect** and **inflation effect** on the development of debt to GDP. It reflects the changes in debt that are not attributable to the fiscal balance of the government. Particularly relevant for debt dynamics is the development of interest payments in comparison to GDP growth (EUC 2021a, p. 36).[3]

The estimation of **interest expenditure** strongly depends on the assumptions on the development of interest rates. Projecting the interest rate a government pays in the Eurozone is particularly challenging since one really has to project three components: One, the development of the risk-free interest rate, two, term premia and three, the risk spread over the risk-free rate for the government bond concerned. All three depend strongly on monetary policy.[4] Risk spreads are also heavily dependent on the institutional

[1] A detailed list of Eurostat's estimation methods can be found here: https://ec.europa.eu/eurostat/cache/metadata/en/proj_esms.htm. Eurostat itself does not speak of forecasts, but of 'what-if' scenarios.
[2] An example here would be that if the group with the characteristic "need for care" increases, depending on the indicator "type of care" the long-term care costs increase as well.
[3] More details in EUC (2021, p. 230ff.).
[4] More on interest rates and risk spreads can be found here: Kern (2022): "Zinsaufschläge sind das Ergebnis (geld-)politischer Entscheidungen", Geldbrief, Dezernat Zukunft, online available under: https://www.dezernatzukunft.org/zinsaufschlaege-sind-das-ergebnis-geld-politischer-entscheidungen/ [Last access: 16.11.2022].

setup of the Eurozone. Thus, if the EU-Commission did a bottom-up projection of interest rate development, it had to forecast ECB behaviour and political decision making (including its own).

The EU-Commission avoids explicitly forecasting the behaviour of the ECB and other policy setters by projecting bond rates based on market expectations for the coming ten years. This does not really prevent circularity though since market expectations are formed based on what the ECB and politicians are expected to do. After ten years, interest rates are assumed to converge to 2% within 20 years (EUC 2021a, p. 18).

Using market forecasts may contribute to making DSAs procyclical since, if current rates are low, market participants are likely to think that future rates will probably be low as well (and vice versa).

The **growth effect** captures real GDP growth, which is estimated based on EU-Commission data for the first two years of the projection. For the following three years GDP growth is assumed to converge to potential growth -calculated using the OGWG methodology- if there is no fiscal adjustment. A fiscal adjustment of one percentage point changes growth by 0.75 percentage points in the same year (EUC 2021a, p. 18). To account for the impact of Next Generation EU, the EU-Commission has adjusted medium terms growth paths starting in 2023. This adjustment is based on the results of the EU-Commission's QUEST model[5] and assumptions on when funds will be spent.[6]

The **inflation effect** is estimated based on the assumption that inflation converges from the current value to 2% in t+10 (EUC 2021a, p. 18).

Not all historical changes in debt can be explained by the factors discussed above though. To reconcile the results of the primary balance and snowball effect with the actual value of the debt stock, a **stock-flow adjustments** may be necessary. Amongst other factors this may include the net acquisition of financial assets, any debt adjustments effect, statistical discrepancies (Eurostat 2020, p. 2f.)[7] and exchange rate effects which affect both, interest rates and the valuation of the debt stock. This can have a strong impact on the development of debt (EUC 2021a, p. 79/EUC 2017, p. 40ff.).

[5] Find more details about the new Keynesian DSGE model here: European Commission (last update 2022) "Macroeconomic Model QUEST", online available under: https://economy-finance.ec.europa.eu/economic-research-and-databases/economic-research/macroeconomic-models/quest-macroeconomic-model_en [Last access: 15.11.2022].

[6] Starting on page 125 in European Commission (2022): "Fiscal Sustainability Report 2021", Institutional Paper 171, online available under: https://ec.europa.eu/info/sites/default/files/economy-finance/dp171_en_vol1.pdf [Last access: 15.11.2022].

[7] More can be found in Eurostat (2020).

The role DSAs can play

DSAs are extremely sensitive to the assumptions that go into them and involve significant uncertainty, even in the short term (see below). Tweaking growth or interest rate assumptions can easily lead to a very different debt trajectory. Secondly, it is very difficult to argue for a certain set of assumptions clearly being superior to another. On interest rates the EU-Commission for instance uses market expectations, the IMF expert judgement. Which method is „right"? Thirdly, DSAs may produce self-fulfilling prophecies: If debt is judged to be unsustainable risk premia and thus financing costs are likely to increase very significantly, leading to a fast increase in debt. Equally, a low projected growth rate and the associated tight fiscal stance may lead to contractionary austerity. Hence, DSAs are not very well suited to determine one specific debt path.

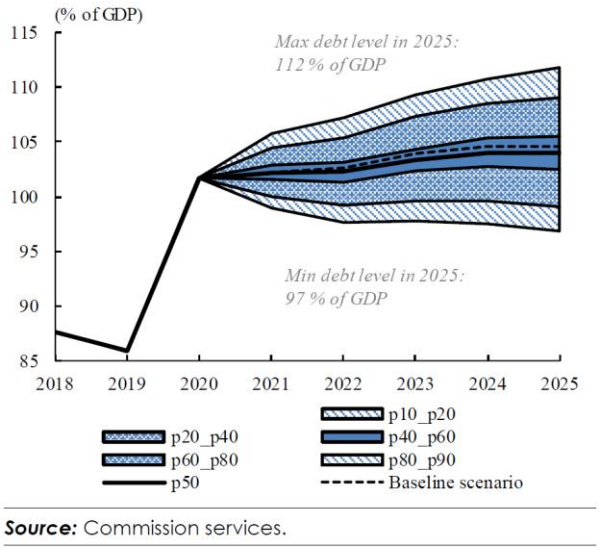

Figure 2: Gross public debt (% of GDP) from symmetric stochastic projections (2020 – 25), Euro Area (Debt Sustainability Monitor 2020, p. 50)

However, DSAs can be very useful analytically, showing what may happen *given* certain assumptions (e.g. low growth high, interest rates etc.). As such a DSA might be a useful tool for calibrating/updating a fiscal rule that leads to debt reduction in the current growth/interest rate environment, see for instance Sigl-Glöckner et al. (2022).[8]

References

[8] Sigl-Glöckner et al. (2022): „A proposal for reforming the Stability and Growth Pact", Dezernat Zukunft, online available under: https://www.dezernatzukunft.org/wp-content/uploads/2022/06/Sigl-Gloeckner-et-al.-2022-A-proposal-for-reforming-the-Stability-and-Growth-pact.pdf [Last access: 30.11.2022].

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European Commission [EUC] (2021a): "Debt Sustainability Monitor 2020", Institutional Paper 143, online available under: https://economy-finance.ec.europa.eu/document/download/f123307e-2883-4328-aaa6-c20f7a359291_en?filename=ip143_en.pdf [Last access: 15.11.2022].

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Eurostat (2020): "Stock-flow adjustment for the Member States, the euro area (EA-19) and the EU-27, for the period 2016-2019", Stock-flow adjustment note – October 2020, online available under: https://ec.europa.eu/eurostat/documents/1015035/11406895/SFA-PR-2020-Oct.pdf/b052d9b2-eaa6-7fe7-c6dd-f4d0ddc40aa1 [Last access: 16.11.2022].

Annex 2: Expenditure rules in practice drawing on the Dutch experience

New European fiscal rules: lessons from the Netherlands on setting expenditure paths

The European Commission's proposed new fiscal rulebook looks much like the Dutch fiscal framework. That framework produces an a-cyclical fiscal stance in theory, but is not without its challenges. What can we learn from the Dutch experience?

The proposal

The European Commission's proposed reform of the European fiscal rulebook leans heavily on four-year expenditure paths. That represents a big change from the current fiscal rulebook: The current fiscal rules rely heavily on concurrent quantities. But the new framework requires a forward-looking analysis of the credibility of fiscal plans. Will governments really deliver the expenditure paths and tax reforms they propose, and will they deliver them in time? In the new setup, the task of making these judgment calls will fall to the European Commission.

Several elements are close to the current Dutch fiscal framework, which i) sets expenditure paths once, at the beginning of a cabinet period, ii) sets a path for discretionary income measures, iii) does not react to cyclical expenditures or fluctuations in income that are not due to policy changes, and iv) contains a general escape clause for temporary, timely and targeted measures in times of crisis. Other countries' fiscal frameworks use similar elements (see Manescu and Bova 2020), but the Dutch case has been documented extensively (Bos 2008).

So what should the Commission learn from the Dutch experience?

Lessons from the Dutch experience

Some features of the Dutch context that are crucial for the functioning of the fiscal framework may prove hard to reproduce in a European context. We discuss a number of such issues.

1. The Dutch setup relies on a uniquely strong fiscal council

Dutch budgetary policy relies heavily on the CPB Netherlands Bureau for Economic Policy Analysis, an Independent Fiscal Institution (IFI). The CPB has more powers and is better equipped than its counterparts elsewhere in Europe (see table 1). For example, the government is bound by law to base its budget on the CPB's macro-economic forecasts, including the assumption of economic GDP growth that is an important determinant of fiscal deficit and debt projections.

The current proposal leaves the task of forecasting macro-economic variables to the European Commission. Contrary to an IFI however, the Commission lies outside the realm of the individual Member States' democracy. As a consequence, a transfer of power will take place – as the following two points elaborate.

		NLD	GBR	ESP	DNK	SWE	ITA	DEU	FRA
Analysis	Forecast preparation	Yes	Yes	Yes	Yes	No	No	No	No
	Forecast assessment	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
	Normative analysis	Yes	No	Yes	Yes	Yes	No	No	No
	Recommendations	Yes	No	Yes	Yes	Yes	No	Yes	No
	Costing of measures	Yes	Yes	No	No	No	Yes	No	No
	Monitoring of rules	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
	Long-term sustainability	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Budget process	Forecasts used in budget	Yes	Yes	No	No	No	No	No	No
	Binding forecasts	Yes	No	No	No	No	No	No	No
	Comply or explain	No	Yes	Yes	No	No	No	No	No
Admin	Right to select staff	Yes	Yes	Yes	Yes	Yes	Yes	No	No
	Members and other FTE staff	120	20	36	46	12	21	15	11

Table 1: Comparison of Fiscal Councils; copied from Arnold et al. (2022)

2. Not all expenditure paths are credible

When assessing the government's fiscal stance, the CPB makes judgment calls. For example, when the current Dutch cabinet was incoming it presented a budget that showed a steep increase in expenditures over the entire cabinet period. However, about half of the increase was scheduled by the incoming cabinet to 'disappear' at the start of the next term, essentially tasking the next cabinet with significant budget cuts. This made half of new spending look incidental, reducing the drag on fiscal sustainability –at the expense of a yet to be elected future government. The CPB decided that the presented expenditure path was not credible, and assumed a 'no policy change' scenario in which the extra spending would be continued. The resulting projection for long-term debt/GDP

came out at over 90%, whereas the government had aimed for 60%.

In the Commission's proposal, it would fall to the Commission to make judgment calls on the credibility of expenditure paths.

As an aside, one consequence in the Netherlands is that the CPB uses a different reference path than the government. The proposal by the Commission reads as if the goal was for the Commission and each country to adopt the same expenditure path and share assumptions on how expenditures and revenues will develop. In light of the Dutch experience achieving this looks very challenging, especially bearing in mind that the Commission may not be seen as having the same legitimacy in all EU countries as the CPB in the Netherlands. Thus, realistically the Commission will also end up keeping an entirely separate set of government accounts, and it would have to do so for each Member State. This may prove hard to do well from afar.

3. Measuring discretionary revenues requires independent costing

Discretionary revenue measures count towards fiscal space, both in the Netherlands and in the Commission's proposal. What revenues such measures bring is not a straightforward question however. Contrary to expenditure paths, which can be tightly controlled in principle, the budgetary impacts of changes to tax laws are mere estimates. These revenues are subject to business cycles and there is often considerable uncertainty around them: if you increase excise taxes on tobacco, how many people stop smoking? To avoid creating a budgetary loophole for the government, the CPB provides an independent certification of the government's costing of discretionary measures. This also serves as a useful counterweight when civil servants come under pressure from government ministers to change their estimates.

In the European setup, this task would fall to the Commission. The same applies to discretionary measures that affect spending on cyclical items, since that must still count towards fiscal space. For example, a reform of unemployment law in any Member State will require independent costing by the Commission.

4. Dutch fiscal policy is still procyclical

The Dutch 'trend-based fiscal policy' aims to deliver a neutral fiscal stance, but it only applies to the four-year cabinet period. This does not avoid procyclical fiscal policy decisions when a new cabinet comes to power. Indeed, the setting of ceilings by incoming governments in the Netherlands is rather pro-cyclical. The graph below shows the magnitude of these decisions. They tend to dwarf decision making during cabinet periods. This then leads to fiscal policy that is pro-cyclical on the whole, much like in the rest of the OECD (Homan and Suyker 2015).

There are lessons in this for Member States and the Commission. For Member States, introducing the Dutch framework in a European context makes a-cyclical fiscal policy compatible with European fiscal rules, but will far from guarantee a-cyclical policy choices. For the Commission, the lesson is that the setting of the ceilings is as important as adherence to them, and that this decision will coincide with often messy periods of government formation (if the Netherlands is any indication).

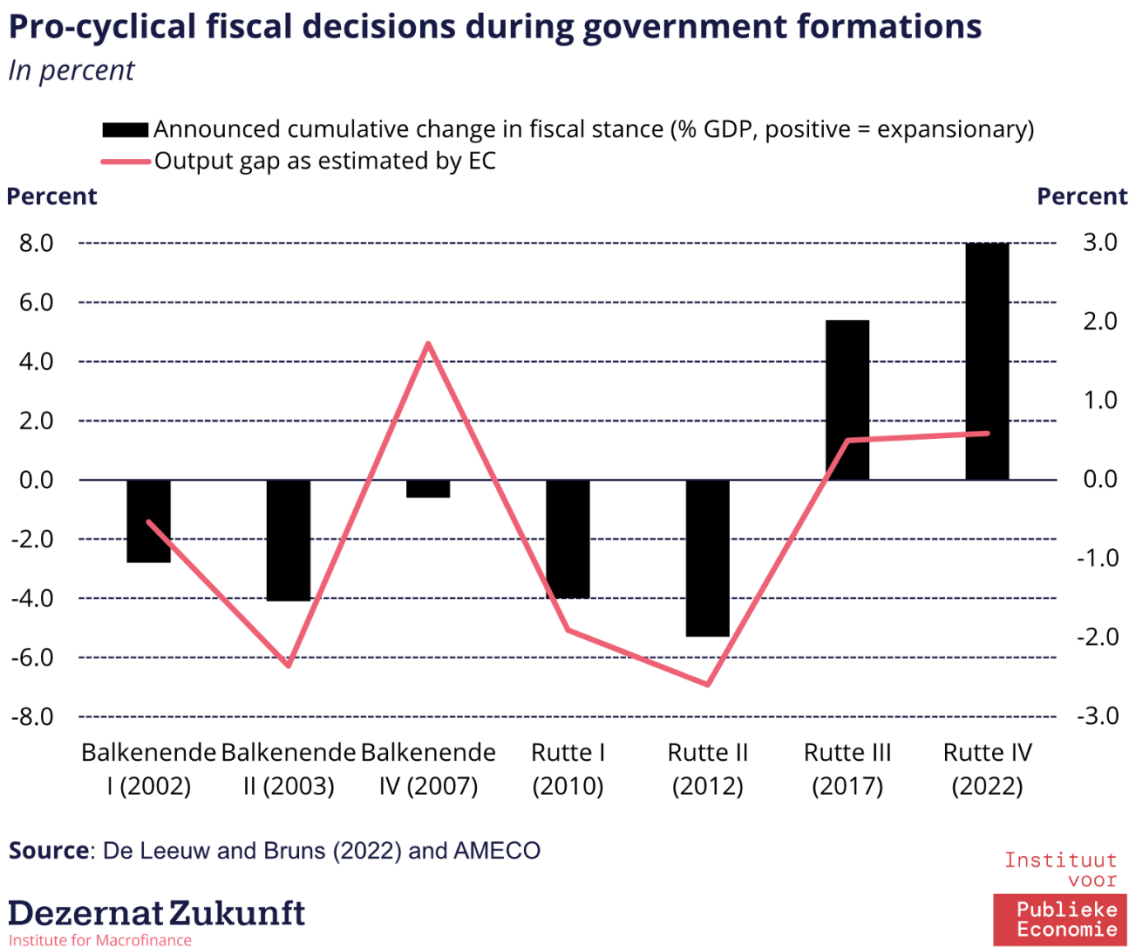

Figure 1: Pro-cyclical fiscal decisions during government formations

The Commission will require more legal rights than Europe's most powerful IFI

While the CPB has more rights than any of its European counterparts (see table 1), its power largely derives from culture rather than law. Recent experience in the Netherlands proves this: during the most recent coalition formation, parties decided to simply exclude the CPB from their process. They presented a budget; the CPB presented an analysis sometime later. This analysis had consequences in public debate, but did not change the government's fiscal plan. If the Commission wants to establish an effective governance process, it will need to enshrine its role more fundamentally.

Conclusion

Forward-looking fiscal rules have many benefits, but carry a heavier burden in terms of governance. As Europe decides on new fiscal rules, it should be aware of the judgment calls and power balances these require. At a minimum, knowing what to expect may avoid negative surprises or extended power struggles after a reform has taken place.

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