

One Framework to Rule Them All

The European fiscal framework
in five questions

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Key points

- **The EU fiscal framework reinforces fiscal policy short-termism.** A complex web of rules constraining Member States' fiscal policy, the framework leaves out factors such as spending quality and impacts from environmental and social imbalances on long-term debt sustainability. It also tries to take into account, but inefficiently, economic cycles.
- Highly intertwined with a system of governance aimed at enforcing these rules, the framework **prevents us from reaching our social and environmental goals** and could **make or break economic recovery**.
- **Many reform proposals were tabled in the last decade** to (i) reduce reliance on arbitrary numerical fiscal rules, (ii) improve quality of spending, (iii) better take context into account and to (iii) prioritise long-term social and environmental sustainability over short-term fiscal sustainability.
- **Momentum now builds** to align the EU fiscal framework with fiscal, social and environmental sustainability.
- **Member States and European political groups remain divided** on the direction the framework should take. Given this, a renewed fiscal framework will **require European civil society to join forces**.

1. Why is the European fiscal framework so important?

The European fiscal framework is a set of rules constraining EU Member States' fiscal policy. It forms part of a design deemed needed to thwart some of the risks of being part of an incomplete monetary union, such as contagion risks.¹

Under scrutiny by many critics are the framework's numerical fiscal rules, which limit Member States' debt stock to 60% of their gross domestic product (GDP), budget deficits to 3% of their GDP and structural budget deficit² to 0.5-1.0% of their GDP (see table 1). These rules are completed by a series of correction mechanisms aimed at tackling deviations from these limits,³ country-specific caps to public expenditure growth,⁴ and by a complex system of flexibility arrangements⁵ (more information in box 1).

Table 1 - The EU numerical fiscal rules

Debt rule	≤60% of the GDP
Deficit rule	≤3% of the GDP
Structural deficit rule	≤0.5-1% of the GDP

The EU Fiscal framework is highly intertwined with the “European Semester”, a three-pillar system of economic governance aimed at enforcing these rules and at coordinating EU Member States' fiscal and economic policies:

- Fiscal surveillance** – As part of this annual cycle of coordination and surveillance, Member States must submit their fiscal plans to the European Commission – Stability Programmes (for euro area Member States) or Convergence Programmes (for non-euro area Member States) by April, and, additionally, Draft budgetary Plans by mid-October for euro area countries. The Commission then assesses compliance of these plans with EU fiscal rules. In the case of non-compliance by a Member State, the Council can launch a series of escalating measures following recommendations from the European Commission. Those include submission of a revised budget draft, non-public recommendations, public recommendations, and even financial sanctions.
- Macroeconomic surveillance** – During the European Semester, the European Commission also monitors macroeconomic imbalances and economic policies, and publishes country-specific analysis and recommendations to be adopted by the Council in the form of country reports and country-specific recommendations. In case of excessive macroeconomic imbalances, the Commission produces in-depth reviews and recommendations.

1 In the context of a monetary union, contagion risk is defined as the risk that a sovereign debt crisis in one or more Member State(s) spills over to other(s). The European monetary union is coined as incomplete as it lacks a lender of last resort and fiscal transfers.

2 The structural deficit is that part of the deficit not related to the state of the economy and that would exist even if the economy were at full employment. A structural deficit target is therefore one that takes into consideration business cycle swings – such as smaller tax revenues and larger unemployment benefit pay-outs in a recession – and filters out the effects of one-off and other temporary measures such as bail-outs of banks. The Fiscal Compact set a structural budget deficit rule for euro area Member States at 0.5% of their gross domestic product, with a possibility to run a structural deficit up to 1.0% of GDP for countries with debt ratio significantly below 60%.

3 If the public debt-to-GDP ratio is higher than 60%, it must decline by at least one twentieth of the gap to the 60% target every year. In case of non compliance with the debt or deficit limits, the Member State will be required to achieve a minimum annual improvement in its structural balance of at least 0.5% of GDP per year.

4 Introduced in 2011 as part of the Six-Pack, the expenditure benchmark caps public expenditure growth to help countries meet their structural budget balance objectives (MTO).

5 There are, first, general exceptions in case of economic recession or extraordinary events and, second, a series of flexibility clauses aimed at promoting structural reform and investment, among other things. Lastly, there is some flexibility also for cyclical conditions that applies to the fiscal adjustment path – the so-called matrix of requirements.

3. **Socio-economic coordination** – Member States submit each year [national reform programmes](#) that are expected to be aligned with the Commission's analyses and recommendations. **Member States are also expected to coordinate fiscal and economic policies** to boost positive spillovers while reducing negative ones. If well-coordinated fiscal policies reinforce each other – such as a joined-up fiscal stimulus during recession – then the opposite occurs for poorly coordinated ones. For an example, look no further than after the great financial crisis and eurozone mess. The EU economy since then has suffered from massive spending cuts in most countries not offset by rises in spending by countries able to afford it.

Box 1 - Main components of the European fiscal framework

- **The Maastricht Treaty debt and deficit rules** – Building the European Monetary Union was understood as requiring not only to create the European System of Central Banks but also to create the condition to avoid negative spillovers inside the future euro area. Following a “battle of ideas” between the French vision of a “gouvernement économique” and the German preference for a non-discretionary and rules-based economic governance architecture⁶, a compromise was found by setting in stone in the 1992 Maastricht Treaty both the debt and budget deficit rules (now Article 126 and protocol n°12 of the Treaty on the Functioning of the European Union, or TFEU), and a basic coordination of economic and fiscal policies (now Article 121 of the TFEU).
- **The two arms of the Stability and Growth Pact (SGP)** – Built on Article 126 TFEU and true core to the EU fiscal framework, the Stability and Growth Pact was born in 1997 with the EU Member States' agreement to better enforce deficit and debt limits of the Maastricht Treaty. Two elements were clarified and reinforced. First, the surveillance and coordination of national fiscal policies (i.e. the preventive arm of the SGP)⁷ and, second, the *Excessive Deficit Procedure* (i.e. the corrective arm of the SGP).⁸ Both arms of the Pact were reformed in 2005⁹, and in 2011 and 2013 – respectively as part of the so-called *Six-Pack* and *Two-Pack*.
- **The reformed governance framework of the European Semester** – Following the creation in 2010 of a coordination cycle – called *European Semester* – euro area Member States must now submit draft budgetary plans to the European Commission that assess their compliance with the EU fiscal rules¹⁰, among other things. While a form of monitoring and coordination of fiscal and economic policies was already present in the Maastricht treaty and the SGP, the European Semester brought governance to another level by synchronising and streamlining existing processes, extending surveillance to a broad set of macroeconomic indicators (as part of the new 2011 *Macroeconomic Imbalances Procedure*), among other things. The EU Semester was revamped in 2015 to increase its focus on the euro area, the social dimension as well as improve its democratic “ownership”, such as via better involvement of Member State and European parliaments, trade unions and other stakeholders.



6 BRUNNERMEIER, M., JAMES, H., LANDAU, J.-P., “The Euro and the Battle of Ideas”, Princeton edition, 2016, 448 p.

7 [Regulation \(EC\) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.](#)

8 [Regulation No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure](#)

9 [Regulation \(EC\) No 1055/2005 amending Regulation \(EC\) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.](#)

10 [Regulation \(EU\) No 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.](#)

- **The national fiscal framework** – A set of legislation establishing how national budgets must be prepared, submitted to the European Commission, and then executed.¹¹ As part of the 2012 Fiscal Compact, euro area Member States also agreed to implement into their national law a structural deficit rule flanked by automatic correction mechanisms based on the German's debt brake model. They also agreed to create independent national surveillance institutions, also known as National Fiscal boards.

For more information on the key components of the European economic governance, and particularly the EU fiscal framework, see our guide “Navigating The Maze” (2021).

Figure 1 - Key elements of the EU fiscal framework

Policy coordination (fiscal & macroeconomic): EU Semester				
Fiscal framework			Macroeconomic framework	
Stability and Growth Pact (SGP)		National fiscal frameworks	Statistical governance	Macroeconomic Imbalances Procedure (MIP)
Preventive arm	Corrective arm			
<ul style="list-style-type: none"> Definition of country-specific Medium-Term Objectives (MTOs). EC review Member States' Stability or Convergence Programme (SCPs). Evaluation of compliance with: <ul style="list-style-type: none"> → debt/deficit limits. → adjustment path towards MTO. 	<ul style="list-style-type: none"> Decisions on existence of excessive deficit or debt. Launch of an Excessive Deficit Procedure (EDP). <ul style="list-style-type: none"> → Recommendations for correction of excessive deficit and/or debt. → Possibility of financial sanctions. 	Mandatory minimum requirements for: <ol style="list-style-type: none"> (1) <i>Budgetary statistics</i>; (2) <i>Numerical fiscal rules</i>; (3) <i>Multiannual budgetary frameworks</i>; (4) <i>Independent national fiscal institutions</i>; (5) <i>Budgetary procedures</i>; 	Minimum requirements for the independence of national statistical authorities (+ possibility of sanctions).	<ul style="list-style-type: none"> Surveillance of macroeconomic imbalances. Early warning scoreboard (15 indicators: public debt, private debt, trade balance, etc.). Country-specific qualitative analysis. Excessive imbalance procedure: corrective plan with possibility of fines.

¹¹ Member States agreed in 2011 to a set of minimum requirements for national fiscal frameworks. The Fiscal Compact added one year later a series of commitments for euro area Member States. Those commitments included a balanced budget throughout the economic cycle, a correction mechanism, and an independent national surveillance institution. In 2013, euro area Member States agreed to prepare their budgets according to common standards and a common timeline, submitting drafts to the European Commission as part of the European Semester. Nowadays, the five key blocks of this framework are: (i) Budgetary statistics supplying detailed information on budgetary developments; (ii) Numerical fiscal rules setting in stone quantitative thresholds for budgetary aggregates; (iii) Multiannual budgetary frameworks setting strategic budget planning; (iv) Independent national fiscal institutions that assess the quality of budget-making; and (v) Budgetary procedures laying down processes such as the forecasting methodology.

2. What's wrong with the EU fiscal framework?

Why do governments fail to plan investments necessary to avoid climate change? And why do they forgo outlays to restore nature or build out enough infrastructure for society and economy to flourish? Blame falls partly on the current design of our fiscal framework.

The EU fiscal framework earned criticism in recent years for being:

1. **Insufficiently responsive to the context** – The debt and deficit limits within EU fiscal rules have been criticized from the start for being procyclical.¹² As many EU countries face a debt-to-GDP ratio well above the 60% limit¹³, **governments are required to cut spending and investment regardless of any other consideration** such as the economic cycle – namely boom or recession –, interest rate level, or the gradual building up of long-term fiscal risks such as those arising from environmental or health crises. Additionally, the rule constraining public deficit to 3% of GDP can limit the possibility for Member States to sufficiently boost discretionary spending or to make full use of automatic stabilisers such as unemployment benefits in crisis times.

Procyclicality concerns led in 2005¹⁴ to the creation of a structural deficit rule focused on the part of the deficit not related to the economic cycle. Each Member State now negotiates a country-specific structural deficit target, the so-called *Medium-Term Budgetary Objectives (MTOs)*, for which some cyclical wiggle room was later granted.¹⁵ In other words, most governments must cut spending and investment, but less so in bad times and more during good.

Meanwhile, this new structural deficit rule and its country-specific target came **on top of the general deficit rule of 3% – not instead of – making the fiscal framework even tighter** while bringing a raft of measurement issues.¹⁶

While **escape clauses** rightly created in 2011¹⁷ allow for rules relaxation in case of unexpected crises, **no mechanism exists to deal with the negative side effects of the additional stock of debt** once the crisis concludes and the escape clause lifted: the reactivation of automatic pressures to cut public spending and investment that can bring detrimental effects to the recovery.

2. **Indifferent to spending quality** – The excessive focus on numerical limits **incentivises undifferentiated reduction of government spending without regard for its quality**: was it wasteful or useful spending? Reckless or necessary investment? With a **public investment gap estimated at €100 to €190 billion per year**,¹⁸ this lack of differentiation proves problematic as it is often politically easier to abstain from investing than to cut regular spending, such as for civil servant salaries and social services.

12 Fiscal rules are coined as procyclical when they do not prevent the government from spending too much in good times, while forcing it to cut investment and spending during a recession – or in the recovery phase.

13 This is notably due to an important socialisation of private debt in the aftermath of the 2009 financial crisis, as well as an important stock of "legacy" debt. As illustration, the level of Italian public debt is not due to any excessive spending from the last 20 years but to legacy debt from the 1980s and 1990s. Indeed, the Italian government has achieved since 1995 a substantial primary surplus almost continuously. Source: HEIMBERGER, P., "Italy is of systemic importance - European solutions are needed", 2020.

14 Council Regulation (EC) No 1055/2005 of 27 June 2005 amending Regulation (EC) No 1466/97.

15 The adjustment effort made to reach the MTO should be equal to 0.5% of gross domestic product per year as a benchmark. Since the addition in 2015 of some cyclical modulation via the so-called Matrix of requirements, the adjustment effort should be higher in good times, and possibly less in bad.

16 The structural deficit is an unobservable variable, of which calculation depends on highly contestable and contested hypotheses. See for example: HEIMBERGER, P., KAPPELLER, J., "'Output Gap Nonsense' and the EU's Fiscal Rules", January 2020; BUTI, M., CARNOT, N. et al., "Potential output and EU fiscal surveillance", September 2019.

17 The general escape clause is set out in Articles 5(1), 6(3), 9(1) and 10(3) of Regulation (EC) 1466/97 (as amended by Regulation (EU) 1175/2011), and Articles 3(5) and 5(2) of Regulation (EC) 1467/97 (as amended by Regulation (EU) 1177/2011).

18 European Commission, "Identifying Europe's Recovery Needs", SWD(2020) 98 final, 2020.

The negative impact of EU fiscal rules on public investment being in the spotlight in the aftermath of the financial and euro crises, **some flexibility for investment and structural reforms have been conceded** by the Council in 2015.¹⁹ But the conditions appear **far too restrictive²⁰ to have a significant impact on the public investment gap**. Only Italy and Finland have benefited so far from the investment clause in 2016.

3. **Blind to environmental and social concerns** – While the European Semester now includes a monitoring of social²¹ and environmental²² trends, **long-term environmental and social sustainability are still made secondary to short-term fiscal sustainability**. While macroeconomic and fiscal surveillance have dedicated and binding procedures²³ (hard law), socio-economic and environmental concerns only have a process of coordination (soft law). While this can be partly explained by the existence of other mechanisms of surveillance and coordination for environmental²⁴ and social policies, significant socio-economic aspects within those policies justify a connection to the EU Semester. As environmental and social sustainability are interconnected with long-term fiscal sustainability, these two aspects should arguably benefit also from dedicated procedures linked to the EU fiscal framework.

This becomes even more true as **the EU fiscal rules constrain public spending and investment regardless of their impact on Union environmental or social objectives**. Considering the growing certainty of the impact that climate change and social issues will have on society and on long-term public budgets' sustainability, **shouldn't we rather have a procedure that precautionarily excludes some types of green and social investment from the debt and deficit rules** in the first place?

4. **Asymmetric** – While the EU fiscal framework constrains deficits and can force spending cuts (i.e. fiscal contraction), it is not equipped to force spending increases (i.e. fiscal expansion) in countries with excessive commercial surplus and comfortable budgetary position. The consequences of this asymmetry can be a downward spiral which reduces aggregate demand and **creates deflationary pressure**.
5. **Overly complex** – Composed of more than 10 regulations and directives, several articles of the European Treaties and one annexed protocol, **the EU fiscal framework is the outgrowth of debate during the past three decades**. Those debates were dominated by a tension between three principles: *simplicity*, *adaptability* and *enforceability*. While additional complexity²⁵ was justified by the need to better adapt to economic cycles, successive reforms failed to do so while **reducing compliance and transparency**.
6. **Short-termist** – **The EU fiscal framework reinforces fiscal policy short-termism** by forcing cuts regardless of Member States socio-economic needs, of the importance of quality public investment for long-term growth and sustainability, and of long-term risks, such as climate or health crises.

19 While some of these flexibilities were already existing, they were largely clarified in this communication: European Commission, "Communication – Making the best use of the flexibility within the existing rules of the stability and growth pact", 2015.

20 "The condition that a Member State must be experiencing bad economic times to benefit from the investment clause limited its use significantly. The need to respect the safety margin vis-à-vis the 3% deficit ceiling for three years has also proven constraining for some Member States." in: COM(2018) 335 final, "Communications on the review of the flexibility under the Stability and Growth Pact", 2018, p. 3; Also: NBB, "Public investments – Analysis and recommendations", National Bank of Belgium, October 2017, p. 21.

21 The monitoring of a set of social indicators (e.g. exclusion rate, rate of youth unemployment, early leaving from school), i.e. the social scoreboard, has been added as part of the European Pillar of Social Rights and of the 2015's reform of the European Semester.

22 As part of the European Green Deal, a series of indicators monitoring the Member States progress towards achieving the SDGs have been added to the European Semester.

23 These two procedures are the 1997's Excessive Deficit Procedure (EDP) and the 2011 Macroeconomic Imbalances Procedure (MIP).

24 E.g. governance of the Energy Union and Climate action, Environmental Implementation Review <https://eur-lex.europa.eu/legal-content/EN/TXT/?toc=OJ:L:2018:328:TOC&uri=uriserv:OJ.L.:2018.328.01.0001.01.ENG> https://ec.europa.eu/environment/eir/index_en.htm

25 As a matter of illustration, the vademecum designed to clarify the application of the fiscal framework has now more than 240 pages covering every situation through detailed rules.

3. Why should you care about reforming the fiscal framework?

While the constraints imposed by the EU fiscal framework to national level policymaking and spending impacts everyone, it can appear distant from the everyday problems of most people. Meanwhile, these questions are all but separated. Here's why civil should care about reforming the fiscal framework:

I. It prevents us from reaching our environmental targets

- **A wide green funding gap** – For Europe to meet its 2030 climate and environmental targets, the European Commission recently estimated **the funding gap to be around €470 billion a year until 2030.**²⁶
- **Private finance will only bridge the profitable part of this gap, not the more risky bit** – Private finance will close a fraction of this gap if change occurs to some fundamentals, such as higher carbon prices, better environmental regulations and taxation. But private money has limits, and will only finance activities offering stable revenue streams and appropriate risk/return ratio. And **the funding gap occurs precisely for investments that do not generate (enough) revenue streams, are perceived as too risky, and/or must be conducted by the public sector or by households** – e.g. residential energy efficiency represents €115 billion of the estimated green funding gap.²⁷
- **Closing the funding gap requires unlocking public finance** – Governments are able to operate with a longer-term horizon than most financial institutions, are less risk-averse than corporations and households and are not profit-driven. Theoretically, **this combination gives public budgets the ability to close the remaining green funding gap** by directly financing unprofitable necessary investments, guaranteeing risky ones, and by providing grants and support to small entrepreneurs and most vulnerable households.

But **the EU fiscal framework constrains what governments can do** – among other constraining factors on the public revenue side such as tax evasion and optimisation. With additional public spending being required to meet the EU's environmental goals, increasing public debt and revenue will be needed.

II. It prevents Europe from reaching needed social objectives

- **European social challenges require more than monitoring and recommendations** – While the European social model is a unique achievement, **a fifth of the EU population is at risk of poverty or social exclusion and a twentieth is directly touched by severe material deprivation.**²⁸ Europe's social resilience faces other challenges such as an ageing population, a high level of unemployment in many countries, a need for better life-long educational systems, better access to quality healthcare, and increased competition from economies with lower social standards.

Following its revamping in 2015 and the proclamation of the European Pillar of Social Rights in 2017, **the European Semester now contains monitoring of social trends across the EU**²⁹, which feeds into the

26 Comprising €240 billion for climate and energy, €100 billion for transport infrastructure and €130 billion for the other environmental objectives. Source: EC, "SWD(2020) 98 final - Identifying Europe's recovery needs", Communication accompanying the document 'Europe's moment: Repair and Prepare for the Next Generation', 27 May 2020, p. 14-16.

27 EC, "SWD(2020) 98 final - Identifying Europe's recovery needs", Communication accompanying the document 'Europe's moment: Repair and Prepare for the Next Generation', 27 May 2020, p. 14-16.

28 The EU's average rate of people at risk of poverty or social exclusion is 20.9%, with only one country below 15%. The severe material deprivation rate (SMD) is at 5.4% in Europe (min. 1.8%; max. 19.9%). Source: Social scoreboard 2019

29 The European Pillar of Social Rights is accompanied by a 'social scoreboard' which monitors the implementation of the Pillar by tracking trends and performances across EU countries in 12 areas and feeds into the European Semester.

European Commission country reports (CRs) and country-specific recommendations (CSRs). No less than 55% of the recommendations in 2019 were related to social issues.³⁰

At the same time, **monitoring and making recommendations proves irrelevant if it does not lead to concrete actions**. While research shows that implementation of social country-specific recommendations have deteriorated over recent years³¹, short-term fiscal sustainability and competitiveness objectives continue to have priority over social goals³² – which is actually an explicit doctrine from the Council of EU economic and finance ministers (ECOFIN).³³

- **An important social investment gap that private finance is not meant to fill** – The EU suffers from a **social infrastructure³⁴ investment gap estimated in 2018 at minimum EUR 142 billion per year.**³⁵ With the recent Covid crisis revealing sub-investment in healthcare capacities, one might wonder whether the gap is not even higher.

Growing investment gaps and constrained public purses have laid the ground for **calls to private finance to fill the gap**. Leaving aside the debate on the desirability of private involvement, there is a limit to this approach: if some economic infrastructures produce stable revenue streams that can make them attractive for private finance,³⁶ **social infrastructures and services are not meant to generate cash flows** but equal access and long-term social resilience.

Place attention on ensuring an optimal level of public spending in social infrastructures and services that allow for a socially resilient Europe, rather than on ways to privatise them.

- **Public finance needs to be unlocked to fill this funding gap** – The current EU fiscal framework prescribes **balanced budgets irrespective of other considerations such as increasing social needs, or health crisis**. While the activation of the 'general escape clause' temporarily enables governments to ease the impacts of the current health crisis, the reactivation of the fiscal rules will mean an increased stock of debt requiring cuts in public spending and investment.

A deep overhaul of the EU fiscal framework is required if we are to fill these gaps and ensure a socially resilient EU.

III. It will impact the post-Covid recovery

- **National recovery plans will be impacted by EU recommendations** – In the framework of the European Semester, **Member States have to present their economic and fiscal plans** in April of each year – i.e. respectively their National Reform Programs and their Stability or Convergence Programs. Based on their analysis, **the European Commission drafts country-specific recommendations (CSRs)**.

30 Such as wage-setting mechanisms, employment protection, social protection system, pension reforms, childcare facilities, etc. Source: ETUI, ["The country-specific recommendations \(CSRs\) in the social field. Update CSRs 2019-2020"](#), 2019

31 AL-KADI, R., CLAUWAERT, S., ["Socialising the European Semester? Measuring Member States' implementation of country-specific recommendations in the social policy field"](#), ETUI, Working Paper 2019.08, 26p., p. 20.

32 HACKER, B., ["A European Social Semester? The European Pillar of Social Rights in practice"](#), 2019, ETUI

33 ["Council Conclusions on Alert Mechanism Report 2016"](#), 15 January 2016.

34 The term 'Social infrastructure' includes physical facilities and spaces where the community can access social services. These include health-related services, education and training, social housing programs, police, courts and other justice and public safety provisions, as well as arts, culture and recreational facilities.

35 This estimation only cover health and long-term care (€70 billion), education and life-long learnings (€15 billion) and affordable housing (€57 billion). The total minimum investment gap is estimated at around EUR 1.5 trillion between 2018- 2030. Source: FRANSEN, L., DEL BUFALO, G., REVIGLIO, E., ["Boosting Investment in Social Infrastructure in Europe - Report of the High-Level Task Force on Financing Social Infrastructure in Europe"](#), 2018, 116p.

36 Economic infrastructure, such as toll roads, ports, airports or power generation plants, usually collect revenues from end users.

While most of these recommendations are politically but not legally binding,³⁷ they appear to be only followed when they fit the agenda of the Member State's ruling party. The Resilience and Recovery Facility (RRF) could change this situation for a simple reason. In order to receive financial support under the RRF, Member States need to prepare National Recovery and **Resilience Plans (NRRPs)** setting out a coherent package of reform and investment for the years 2021-23 that **will have to be aligned with the CSRs 2019 and 2020** – among other criteria.³⁸

While the content of the latest country-specific recommendations will partly shape the direction of the recovery, **ensuring that the future recommendations are well balanced** between economic, fiscal, social and environmental concerns will become increasingly key if the Resilience and Recovery Facility is to become a permanent component of the European toolbox and/or inspire a future common budgetary tool.³⁹

- **The reactivation of the EU fiscal rules could break the recovery** – The Covid crisis leading to swelling budget deficits for the years to come and an increased debt stocks, **reactivation of fiscal rules and its requirement to cut spending could have a detrimental effect on the recovery**. In fact, some Member States might have underreacted to the crisis by fear of forthcoming austerity measures.

³⁷ The country-specific recommendations (CSRs) are underpinned by various surveillance and coordination instruments with different legal bases: the Stability and Growth Pact (SGP), the Macroeconomic Imbalance Procedure (MIP) and the employment policy coordination. While the CSRs related to the SGP and the MIP are more often followed by Member States as failure to comply could lead to sanctions, it is less the case for recommendations related to employment, social or environmental concerns.

³⁸ European Commission, SWD(2020) 205 final, Part 1/2, "Guidance to Member States Recovery and Resilience Plans", 17 September 2020.

³⁹ As recommended by the European Central bank's president, Christine Lagarde said in a 19 October 2020 interview in French daily newspaper Le Monde: "We should discuss the possibility of it remaining in the European toolbox so it could be used again if similar circumstances arise [...] I hope that there will also be a debate about a common budgetary tool for the euro area, and that it will be enriched by our current experience." . C. Lagarde also expressed a hope "that there will also be a debate about a common budgetary tool for the euro area, and that it will be enriched by our current experience."

4. What should new rules look like?

A renewed EU fiscal framework would need to...

1. **Reduce reliance on arbitrary numerical fiscal limits** – The 60% debt-to-GDP and 3% deficit limits have come under growing criticism over the years. First, **these limits are arbitrary anchors, not scientifically defined optimal ratios.**⁴⁰ Conceived as convergence criteria at a time of higher growth rates than today as well as divergent interest rates among Member States, they are widely considered – in the current low growth and even lower interest rates context – as **dampening growth and employment while failing to account for variables that truly impact debt sustainability.** Those variables include, for example, the interest rate, growth rate, structure, maturity and ownership of the debt, external shocks – admittedly surrounded by significant levels of uncertainty.

Considering these shortfalls, the last decade has seen more and more proposals to reduce the reliance on these numerical fiscal limits by:

- Replacing these numerical fiscal rules by more flexible **fiscal standards.**⁴¹
- Replacing these numerical fiscal rules by **an unique 'expenditure rule'** that would cap the growth rate of nominal public expenditure around **country-specific fiscal targets.** For example, a rolling five-year country-specific debt reduction target and/or ceiling on expenditure growth in order to reach **a common fiscal anchor** such as 60% debt-to-GDP.⁴²
- Shifting the focus from debt-to-GDP ratios towards **debt servicing-cost-to-GDP**⁴³ or interest cost-to-GDP ratios.
- Or at least by **relaxing these limits**, for example, from 3% to 5%, or from 60% to 90%.⁴⁴

40 They were, respectively, the median debt-to-GDP ratio in the 1990s, and an invention of two civil servants in the French Ministry of Finance in 1981. "Tietmeyer, a key German negotiator from the German Ministry of Finance, recollected that in the debates a "rough connection" was seen between the 3% and the 60 percent criteria. With expected average 5 percent nominal growth and an average deficit of 3 percent the 60 percent debt level could be maintained (Tietmeyer 2005, p. 164); yet Tietmeyer admitted that this was no precise scientific reasoning." Source: PRIEWE, J., "Why 60 and 3 percent? European debt and deficit rules - critique and alternatives", IMK Study, Nr.66, February 2020, Hans-Böckler-Stiftung; The limit of 60% level of GDP was derived as the average debt-to-GDP ratio of the EU member states in 1990. "With the same procedure, a reference value of 70 per cent could be calculated for 2000, of 86 per cent for 2010 and 101 per cent for 2020." In: BOFINGER, P., "Easing the EU fiscal straitjacket", December 2020, Social Europe.

41 E.g. BLANCHARD, O., LEANDRO, A. ZETTELMEYER, J., "Redesigning the EU Fiscal Rules: From Rules to Standards", October 2020, Presented at the 72nd Economic Policy Panel Meeting, p. 3-10.

42 Expenditure minus cyclical unemployment expenditure, interest payment, and in some cases 'EU-funded investments. In: BEETSMA, R., THYGESEN, N., et al., "Reforming the EU fiscal framework: A proposal by the European Fiscal Board", October 2018, VoxEU; DARVAS, Z., MARTIN, P., RAGOT, X., "The economic case for an expenditure rule in Europe", September 2018

43 FURMAN, J., SUMMERS, L., "A Reconsideration of Fiscal Policy in the Era of Low Interest Rates", November 2020

44 TRUGER, A., "Reforming EU fiscal rules: more leeway, investment orientation and democratic coordination", Intereconomics, Vol. 55, 2020, Nr 5, p. 277-281.

2. **Improve spending quality by accounting for it** – As previously discussed, the current lack of regard for quality of spending reinforces a bias against public investment. The IMF database shows that **the general government net worth has, on average, worsened in euro area countries since 2000**. Against this background, many proposals have been made these past 10 years, such as:

- **Distributing the cost of public investment** over future years, during the service life of investment, similarly to the way corporate investment is treated in corporate accounting.⁴⁵
- **Targeting public sector net worth (PSNW) rather than public sector debt.**⁴⁶ Better accounting for both public liabilities and assets would allow to capture the full benefits of public sector interventions in the economy. A rule that would target a certain level of PSNW-to-GDP could incentivise governments to (i) increase investment in public assets such as infrastructure, hospitals and schools; (ii) better account for future liabilities including areas related to an ageing population and future environmental crises.
- **A “Golden Rule” of public finance exempting public investment** from the constraints of the fiscal framework.⁴⁷ Along a similar line of thought, the European Fiscal Board proposed the introduction of a “Golden rule” protecting specific growth enhancing public investment.⁴⁸
- **A “Green Golden Rule” (GGR) that would only exempt green public investment** from the constraints of the fiscal framework – for example taxonomy-compliant investment and/or green public investment foreseen in Member States’ National Energy and Climate Plans (NECPs).

3. **Better take into account context** – **The debt and deficit rules are insufficiently responsive to economic cycles and other contextual components.** Attempts to add cyclical flexibility to the framework failed to address this issue, resulting instead in a tightened fiscal framework. Designing a fiscal framework that better accounts for the context will be key. Possible framework reforms include:

- Replacing ‘structural deficit’ by **‘adjusted nominal expenditure growth’ as the main operational target** and excluding spending related to automatic stabilisers and interest payments.⁴⁹
- **Reinforcing and harmonising automatic stabilisers**, such as unemployment benefits,⁵⁰ and excluding related spending from the deficit (or expenditure growth) calculation.
- **Differentiating debt reduction paths** rather than sticking to a one-size-fits-all debt-reduction benchmark.⁵¹

45 CLAEYS, G., DARVAS, Z., LEANDRO, A., “[A proposal to revive the European Fiscal Framework](#)”, Bruegel, Issue 2016/07

46 Discussed in: HUGHES, R., et al., “[Totally \(net\) worth it: The next generation of UK fiscal rules](#)”, Resolution Foundation, Oct 2019; GASPAR, V., “[Future of Fiscal Rules in the Euro Area](#)”, keynote address by the director of the International Monetary Fund’s Fiscal affairs department during the DG ECFIN workshop “Fiscal rules in Europe: Design and Enforcement”, January 28 2020.

47 BLANCHARD, O., GIAVAZZI, F., “[Improving The SGP Through a Proper Accounting of Public Investment](#)”, CEPR Discussion Paper Series N° 422, 2004; BOGAERT, H., “[Improving the Stability and Growth Pact by integrating a proper accounting of public investments: a new attempt](#)”, Federal Planning Bureau, 2016, 40p.; TRÜGER, A., “[The golden rule of public investment – a necessary and sufficient reform of the eu fiscal framework?](#)”, Hans-Böckler-Stiftung, WP no.168, 2016; FEIGL, G., TRÜGER, A., “[The Golden Rule of Public Investment Protecting fiscal leeway and public infrastructure in the EU](#)”, ETUI Policy Brief N° 12, 2015.

48 EUROPEAN FISCAL BOARD, “[Assessment of EU fiscal rules with a focus on the six and two-pack legislation](#)”, August 2019, 129p., p. 7.

49 CLAEYS, G., DARVAS, Z., LEANDRO, A., “[A proposal to revive the European Fiscal Framework](#)”, Bruegel, Issue 2016/07.

50 ORSZAG, P. R., RUBIN, R. E., STIGLITZ, J. E., “[Fiscal Resiliency in a Deeply Uncertain World: The Role of Semiautonomous Discretion](#)”, PIIE, January 2021; COSTANTINI, O., “[The Eurozone as a Trap and a Hostage: Obstacles and Prospects of the Debate on European Fiscal Rules](#)”, Intereconomics, Vol. 55, 2020, Nr.5, p. 284-291.

51 THYGESEN, N., BEETSMA, R., et al., “[Reforming the EU fiscal framework: Now is the time](#)”, VoxEU.org, 26 October 2020.

4. Prioritise long-term environmental and social sustainability over short-term fiscal sustainability –

Reforms aimed at accounting for the quality of public spending could do much to allow Member States to close their share of the green and social infrastructure funding gaps, therefore reducing sustainability-related long-term fiscal risks. Meanwhile, **the current framework does not bring any attention to these gaps nor any obligation to precautionarily bridge them**. While procedures exist to ensure that macroeconomic and fiscal imbalances are noticed and resorbed – namely the *Macroeconomic Imbalances Procedure* and the *Excessive Deficit Procedure* – one might argue that there are good reasons to:

- Create a **Social Imbalances Procedure**⁵² and an Environmental Imbalances Procedure. These new procedures would rely on the existing monitoring of related indicators (i.e. Sustainable Development Goals (SDGs) and social scoreboard). Breaching certain thresholds would launch a procedure requesting the Member State to correct the related environmental or social imbalance, via issuance of binding related country-specific recommendations (CSRs)⁵³ and potential sanctions. The procedures could also clarify under which conditions green and social public spending could be exempted from the fiscal rules.

Designing a renewed EU fiscal framework that takes into account these priorities marks a crucial task undertaken before fiscal rules are reinstated.

Finance Watch will release in the first half of 2021 its own proposal in a forthcoming report.

52 CORTI, F., SABATO, S., VANHERCKE, B., "The European (Social) Union is in need of a Social Imbalances Procedure", EuVisions, 2019.

53 While country-specific recommendations (CSRs) related to the Excessive Deficit Procedure (EDP) and to the Macroeconomic Imbalances Procedure (MIP) are binding for Member States, creating these two additional procedures would give some strengths to European Commission's environmental and social CSRs.

5. Why should you care now? What can you do?

While these discussions have been stuck for quite some time:

1. **Legislative momentum exists with the launch of the 2020 EU economic governance review** – The European Commission has launched a **public consultation on the review of the EU economic governance**, which covers the fiscal framework, macroeconomic framework and socio-economic coordination and was foreseen to run from February to June 2020.⁵⁴ Meanwhile, with the change of the parameters of the debate brought by the Covid crisis, the process has been put on hold until further notice.
2. **The Covid crisis pushes public deficit higher and bulging new debt** – With an EU real GDP forecast to fall by almost 8% in 2020, the European Union has rightly deactivated the fiscal rules via activation of the “general escape clause”, to allow Member States to spend as much as they deem needed. Average EU Member State fiscal measures in response to the pandemic reached 4.2% of gross domestic product in 2020. While these necessary measures are expected to lead to **an aggregate deficit of EU Member States of almost 6% of GDP and a debt-to-GDP ratio of around 100% in 2021**,⁵⁵ the reinstatement of the fiscal rules will force governments to reduce spending and investment. Considering the risk that such cuts could break the recovery, there is both debate on the appropriate timing to reactivate the rules as well as growing understanding of the momentum to change them.
3. **Growing agreement among experts on the need for a renewed EU fiscal framework** – There is a growing consensus on the need for a less complex, easier to enforce, more responsive and investment-friendly fiscal framework. **A significant amount of reform proposals have been made** to tackle all or some of the related issues by groups of experts such as the European Fiscal Board, the German Council of Economic Experts, the French Council of Economic Analysis, International Monetary Fund staff, the Organisation for Economic Cooperation and Development, but also think tanks such as the Peterson Institute for International Economics and Bruegel.

Meantime, the review could remain a public consultation exercise leading to **no proposals from the Commission if no sufficient political support builds for reforms**.⁵⁶ Divergences still exist among EU Member States and European political families:

→ **EU Member States remain divided on the need for reform and on what road to follow** – The **Netherlands** first stressed during their 2016 Council presidency the need to simplify rules and strengthen their medium-term orientation. **Spain, Portugal and Italy** have thrown support for some time to include a “Golden Rule” that excludes certain types of investments from fiscal rules. While acknowledging the need for more public investments in public infrastructure, **Germany’s** finance minister recently showed less appetite towards reforming the fiscal framework, noting how fiscal rules had demonstrated their flexibility.⁵⁷ While **France** had been cautious in the past, it recently stated that the fiscal rules were needed but required revision. **Poland’s** Finance Minister also called recently for shutting out green investment from the EU limits on budget deficits, as well as excluding some debt taken on during the pandemic from the general government debt going forward.

54 Its legal basis stems from the planned one-off review of the suitability of the Directive 2011/85 establishing minimum requirements for national fiscal framework. While the European Commission is also entitled to periodically assess the Six-Pack and Two-Pack, it has used this opportunity to expand the discussion on the suitability of the entire EU economic governance framework.

55 COM(2020) 750 final, “Communication of the European Commission on the 2021 Draft Budgetary Plans: Overall Assessment”, 18 November 2020

56 Commission Executive Vice President Valdis Dombrovskis made clear that a review of the EU’s fiscal rules would only take place if an agreement seemed possible: “We should avoid the scenario where we just open legislation without knowing how we’ll close it and then have a long and divisive debate on this and not achieve results”.

57 He rather emphasized that it was a step forward that the EU could now borrow funds collectively and that repayment was to begin during the Multiannual Financial Framework’s term.

- **European Parliament split appears along a traditional left-right axis** – Left-leaning European political groups appear, on average, in favour of reforms aimed at simplifying fiscal rules, reducing their procyclicality, and excluding some type of public investment from the debt and deficit rules.⁵⁸ While no European political group is homogenous, **the right side of the political spectrum generally opposes flexibility for public investment**, considering instead that less flexibility would be desirable “in order to increase the transparency, enforceability and credibility of the SGP”, and calling for “fiscal orthodoxy” and “unambiguous implementation of the SGP”.⁵⁹ The Renew Europe group shows mixed positions.⁶⁰

While the changing macroeconomic situation could facilitate a long-overdue reform of the fiscal framework, **we yet to see fully expressed political will.**

Next steps

1. **Our position** – Finance Watch plans to release in the first half of 2021 its own reform proposal in a forthcoming report. We also recently launched an international campaign aimed at connecting the need for a better short-term recovery with the need for long-term oriented reform of the EU Fiscal Framework: [rethink the recovery](#).
2. **Reactivation of fiscal rules** – At the time of writing this publication, EU Ministers of the Economy and Finance are expected to decide on the timing for reactivating the fiscal rules in an upcoming Economic and Financial Affairs Council (ECOFIN) meeting due to be held during the Portuguese presidency of the Council. The Commission has given [preliminary indications](#) that the fiscal rules should remain deactivated in 2022.
3. **Reopening of the economic governance review** – The question of whether or not to reform the EU economic governance, and more precisely the fiscal framework, is highly intertwined with the ECOFIN discussion on the appropriate timing to reactivate the Stability and Growth Pact, or SGP. Once and if reopened, [the review](#) is expected to continue at least throughout 2021 and most probably throughout 2022.
4. **Reform of the fiscal rules** – Depending on the outcome of the ECOFIN debate, the review could lead to no reform, slight tweaks to extra-legislative interpretive documents, or to a deep and meaningful reform of the European economic governance. For more detail and discussion, read the Finance Watch guide Navigating the Maze (2021).

••► To support our effort:

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Support the campaign: rethinktherecovery.org

58 E.g. [Amendment n° 449 to the Draft Report 2020/2058\(INI\)](#) (Socialists & Democrats [S&D Group]), [Amendments n° 232 and 210 to the Draft Report 2019/2211\(INI\)](#) (respectively Greens/EFA and GUE/NGL).

59 Using respectively the wording of Members of the European Parliament (MEPs) from the European People's Party (EPP), European Conservatives and Reformists (ECR), and Identity and Democracy Party (ID) political groups. Source: [Amendments n° 231, 233, 235 to the Draft Report 2019/2211\(INI\)](#).

60 E.g. [Amendments to the Draft Report 2019/2211\(INI\)](#): While amendment 229 states that the “SGP should be accompanied by rules that avoid procyclicality and incentivize countercyclical policy measures”, amendment 27 proposes to suppress the call to establish a golden rule.

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Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org

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