Lucio Pench (lucio.pench@bruegel.org) is a Non-resident Fellow at Bruegel

1 Introduction

In April 2023, the European Commission published long-awaited proposals on reform of European Union fiscal governance – the system for monitoring the budgetary frameworks in EU member countries. The proposed reform is informed by two high-level principles: fiscal sustainability and national ownership. Unsustainable fiscal policies in EU countries pose risks for the smooth functioning and ultimately the integrity of the euro. This provides the rationale for an EU fiscal framework on the top of national frameworks put in place by countries according to their national preferences. Meanwhile, enhancing national ownership of the EU fiscal framework – meaning active buy-in and participation of EU countries rather than just a rule-taking role – is necessary for the framework to be implemented effectively. Fiscal sovereignty in Europe's economic and monetary union, notwithstanding a prohibition on excessive government deficits, remains firmly in the hands of national governments.

Under the Commission's proposals, the two high-level principles would be delivered on by EU countries issuing medium-term fiscal-structural plans. These would set out fiscal-adjustment paths that reflect national preferences, subject to constraints intended to prevent risks to sustainability. Once endorsed by EU countries meeting in the Council of the EU, the adjustment paths in the plans would become the benchmark against which national policies are measured.

2 Who needs early fiscal guidance?

e Commission's reform plan envisages countries with certain risk characteristics receiving guidance from the Commission before they draft their medium-term plans. Early guidance would take the form of a so-called " ", or a stylised simulation of a trajectory for the primary balance[2] that would ensure convergence of debt to prudent levels by the end of the adjustment period.

is has been criticised as an attempt by the Commission to pre-empt the choices of EU countries on how they intend to bring debt down to prudent levels, thus clashing with the principle of national ownership (Blanchard , 2022). However, there are legal and technical reasons why the envisaged guidance is meant to be just that: only guidance.

Legally, the only reference for assessing a country's compliance with the EU scal rules is the adjustment path that is eventually included in the Council decision endorsing that country's medium-term plan. is is irrespective of what the early guidance issued by the Commission, or even the requirements on adjustment set in the legislation, might say[3].

Technically, the adjustment pathLTE0(y, the3258 (, or a s)uid)1 (ance is)2 (nc)1.1 (lu-1.444n (ance isex036

ese cases could be characterised as ‘false negatives’[6]. Austria, by contrast, would be a ‘false positive’: according to the sustainability risk methodology, its debt trajectory gives no reason for concern. However, Austria would be issued a technical trajectory because its debt ratio is currently in excess of 60 percent of GDP.

If 2022 observed data is applied instead forecasts for 2024, an even clearer false positive emerges. Estonia, the country with the lowest debt ratio in the EU, would be singled out for early guidance, owing to a de cit still in excess of 3 percent of GDP. is would clearly make little economic sense. More generally, for a country with a debt ratio that is projected to stay below 60 percent, any scal trajectory that keeps the debt ratio below 60 percent (and the de cit ratio below 3 percent) should in principle be satisfactory. Faced with such false positive cases, the Commission might wish to refrain from issuing early guidance, for example by indicating that any trajectory not in breach of the two numerical references would do. is would however contradict the ostensible prescription of the legislation.

To conclude, the change between the November 2022 outline plan and the April 2023 proposals in the approach to selecting the countries that should receive early guidance from the Commission has resulted in a degradation of the signal that guidance is supposed to give about the state and prospects of the public nance of those countries[7]. However, as long as scal sustainability remains the central criterion for the Commission to design the trajectories and, more importantly, for it to assess the actual scal plans submitted by EU countries, the loss of analytical rigour at the early stage of the proJ-1.444 ,ia37sal(bilit)-Ee(ion for a58.52.3(os)-3er)15 (T(o)4

public debt
on a plausibly downward path
, or stays at prudent levels ...
3%
10

As far as the technical trajectories are concerned, an annex to the regulation[10] gives two conditions for “the methodology for assessment of plausibility”:

> [the] , ,
> *S* *2022*
> *5*

e provision on maintaining the de cit below the 3 percent of GDP threshold does not demand particular explanation. e meanings of “downward path” or “prudent levels”, however, are left unspeci ed.

It seems reasonable to interpret the sustainability criterion on the basis of the Commission’s medium-term risk-assessment methodology (European Commission, 2023a). is is based on a consideration of both the projected level of debt and its trajectory (augmented by the deterministic and stochastic stress tests referred to under the ‘plausibility’ quali cation). is methodology allows operational meaning to be given to the notion of “ ... ... ”.

However, the application of this risk-assessment methodology to the assessment of the medium-term plans, rather than use for risk classi cation of countries, would require adaptation, which would need to be discussed and agreed. e need to adapt arises because the original risk classi cation methodology is applied to a 10-year extension of the Commission short-term (two years) forecast with unchanged policies, whereas for assessing countries’ plans, it should be applied to a 10-year unchanged-policy extension of the plans, which themselves would contain the policy adjustment needed to reduce the sustainability risk.

e Commission might want to assess the plans simply by comparison with the technical trajectories, using an algorithm that simpli es the risk-assessment methodology. However, as explained in section 2, there are valid reasons why countries’ plans might depart from the technical trajectories.

In the light of these lacunae in the proposed legislation, we have attempted to derive the sustainability criterion from the Commission risk assessment methodology (see the Annex for details). Speci cally, a country’s compliance with the debt-sustainability criterion is taken to mean it would avoid being classi ed as high-risk according to the Commission medium-term risk assessment methodology or, to put it concisely, de-risking of public debt. Being based on a well-de ned methodology, this de nition would give a conceptually more robust answer to the questions that are bound to arise about the meaning of “ ... ” than a simple reference to the technical trajectories produced by the Commission, for which the underlying algorithm, moreover, is left unexplained by the proposed legislation.

Whether explicitly deduced from the Commission risk-assessment methodology or

9 European Commission (2023b), Art. 6 (a) and (b) and Art. 15 (2) (a) and (c). e provision on maintaining the de cit below the 3 percent of GDP threshold re ects the idea, already set out by the Commission in November 2022, that, irrespective of the degree of risk posed by the level and the trajectory of debt, the scal structural plan should ensure ex-ante respect for the commonly acknowledged reference limit for the de cit introduced by the Maastricht Treaty.

10 European Commission (2023b), Annex V.

the two additional criteria that are meant to apply to both the technical trajectories and the assessment of the medium-term plans: the no-backloading criterion and the initial debt level criterion.

e rst additional criterion can be interpreted as a reinforcement of the sustainability criterion, in the sense of avoiding backloading of the adjustment needed to reach the scal position that would satisfy the sustainability criterion:

[13].

In other words, while the overall amount of adjustment is meant to re ect national preferences subject to the constraint of debt sustainability, the distribution of the adjustment is expected to be broadly proportionate across the adjustment period, ie one that avoids shifting the burden of the adjustment to the future[14].

e second additional scal criterion, by contrast, has the potential to interfere with the sustainability criterion. It relates to the (initial) level of debt:

[15].

An immediate problem emerges in the case of countries that, based on their current positions, would be classi ed as low risk. For these countries, satisfying the sustainability criterion would essentially require con rming that the projected debt level will not exceed 60 percent of GDP and that the de cit will stay below 3 percent of GDP. Adding a criterion requiring the debt ratio at the end of the adjustment period to be lower than at the start of it would amount to a fundamental distortion of the sustainability criterion. e case of Estonia (section 2) is illustrative. Reading the additional debt level criterion in isolation would imply that Estonia, a low-risk country with one of the lowest debt ratios in the EU, should not contemplate any increase in the debt ratio from its current levels, eg to nance a defence programme. is would be clearly at odds with the rationale of the reform of scal governance – to ensure debt sustainability while otherwise giving countries the exibility to set their own policies – and would arguably be even in violation of the general principles of proportionality and subsidiarity.

Less clearcut is the case of countries that are expected to adjust to put their debts on a downward trajectory in order to satisfy the sustainability criterion. It is essentially an empirical question whether or not the adjustment required to satisfy the sustainability requirement will be enough to bring the debt to its pre-adjustment level by the end of the adjustment. For high-risk countries, satisfying the debt-sustainability criterion implies putting the debt ratio on an unambiguous downward trajectory. However, adding the condition that the debt ratio should be already lower at the end of the adjustment period than at the beginning may in some cases require additional adjustment, which might stand in the way of the reforms and investments that the proposed scal framework is meant to encourage[16].

13 European Commission (2023b), Art. 6 (c) and Art. 15 (2) (d).

14 A literal reading of the formulation of the no-backloading criterion would seem to allow for any distribution of the total adjustment within the default four-year adjustment period (while imposing that, in case of extension of the adjustment period to seven years on account of reforms and investments, broadly four sevenths of the total adjustment should take place in the rst four years). A systematic and contextual interpretation of the legislation, as favoured in this Policy Brief, would solve the ambiguity (noted by Darvas, 2023).

15 European Commission (2023b), Art. 6 (d) and Art. 15 (2) (e).

16 Darvas *et al* (2023) presented simulations of the technical trajectories showing that France would be the only country for which the debt-level criterion would imply additional adjustment, in the case of a four-year adjustment period. Bulgaria would also be included, assuming that the criterion would apply also to low-debt countries, which is what its literal formulation would imply, but which would not make economic or legal sense, as explained.

be issued with technical trajectories. Merging the high-risk and medium-risk categories could help assuage concerns about stigmatisation. If this move is considered politically not viable, it should at least be clarified that a deficit in excess of 3 percent of GDP should not be a sufficient reason for issuing a technical trajectory, if the country is classified as low risk.
- Clarify the methodology for assessing whether the debt sustainability criterion of "[illegible] … [illegible]" is satisfied, in particular how it relates to the analogous concepts in the Commission medium-term risk assessment methodology.
- Following a clarification of the methodology underlying the debt-sustainability criterion, do away with the additional criteria or safeguards, other than the no-backloading criterion. If an additional safeguard in the form of a numerical rule is considered necessary, this could be a requirement for the debt ratio to decline by 1 percent each year from the end of the adjustment period, for as long as it exceeds 60 percent of GDP.

There may however be an unstated reason behind the demand for additional safeguards: the concern that the Commission might not be sufficiently rigorous in assessing national medium-term plans, especially those of countries at high risk in terms of fiscal sustainability.

Guidance in the form of technical trajectories is meant to pre-empt gross slippages from the fiscal sustainability criterion before EU countries submit their plans for examination by the Commission and the Council. However, as explained in section 2, this can only be indicative, for legal and technical reasons. The question is therefore how to allow 'reasonable' departures of the national plans from the technical trajectories while excluding abuse, ie the endorsement of plans that ostensibly respect the sustainability criterion, but only as a consequence of biased macroeconomic and fiscal assumptions. This is essentially a question of judgement and therefore best addressed by institutional rather than rule-based solutions.

Three not necessarily mutually exclusive solutions suggest themselves:

- The Commission and the Council should assess plans and correct for bias, at least beyond a certain threshold. This is the natural solution consistent with the institutional balance in the EU Treaties, and explicitly envisaged by the Commission in its outline proposals of November 2022.
- National fiscal councils (independent fiscal institutions, IFIs) should be required to vet the national plans before their submission to the EU. The Commission in November 2022 envisaged the fiscal councils providing opinions on national plans as inputs into the Commission's and Council's assessments. The legislative proposals dropped this provision, probably reflecting the negative language on the IFIs in the March 2023 ECOFIN Council conclusions (Council of the EU, 2023)[18]. However, one could expect a strengthening of the role of IFIs as a result of the proposal for amending the directive on budgetary frameworks, which the Commission presented at the same time (European Commission, 2023d). The proposed revision of the directive reflects the broader aim of enhancing national ownership of EU fiscal governance by favouring the development of complementary home-grown rules and institutions. In particular, the revision would allow IFIs to assess fiscal trajectories in the medium term, including in terms of de-risking of public debt, if there is a will to do so[19].

18 The Council conclusions explicitly stated that "*IFIs should not play a role in the design phase of the national plans*" (Council of the EU, 2023).

19 Specifically, Art. 8(4) of the revised budgetary framework directive entrusts the IFIs with "*producing the annual macroeconomic and budgetary forecasts underlying the government's medium-term planning or endorsing those used by the budgetary authorities" and with "producing assessments on the impacts of policies on fiscal sustainability and sustainable and inclusive growth or endorsing those provided by the budgetary authorities*". Moreover, Art. 8(5) prescribes that "*Member States shall ensure that the budgetary authorities of the Member State concerned comply with the assessments or opinions issued by the institutions in the context of the tasks referred to in paragraph 4. Where such budgetary authorities do not comply with those assessments or opinions, they shall publicly justify the decision not to comply within a month from the issuance of such assessments or opinions.*"

- An independent advisory body at EU level could provide an assessment of the plans, in particular for evidence of bias, ahead of the o cial assessments by the Commission and the Council. e Commission proposals do not elaborate on this solution. However, the Commission's November 2022 outline proposals, and the text introducing the current legislative proposals[20], contain a reference to a possible review of the role of the European Fiscal Board (EFB), the Commission's in-house independent advisory body on scal policy surveillance. e ECOFIN Council conclusions also suggested that " " (Council of the EU, 2023). Upgrading the legal status of the EFB, currently based on a decision of the Commission in principle revocable at will, could be a signi cant step in this direction.

A nal consideration relates to the exclusive focus of the additional safeguards that are being sought on the conditions that national plans should satisfy ex ante, as opposed to those for their implementation and enforcement. However, as also acknowledged by the Commission in its review (European Commission, 2020), enforcement has been the weakest link of the entire EU scal framework, especially where it was most needed[21].

In the Commission's November 2022 outline plan, greater leeway for national governments in setting out adjustment was balanced explicitly by the recognition of the need for greater enforcement. In particular, the Commission envisaged that, in case of material deviations from the adjustment path in the national plan as endorsed by the Council, the opening of the EDP should be the default option, speci cally, for high sustainability risk countries. e legislative proposals for the reform of the EDP regulation essentially re ect the same position, in particular, by highlighting the risk to sustainability (" ") as a discriminating relevant factor when deciding whether to open an EDP following a deviation from the adjustment path.

Experience however may suggest a certain scepticism about the e ective willingness of the Commission and the Council to adhere to the prescription of starting an EDP for a country that has not breached the 3 percent of GDP de cit threshold. e Treaty envisages this possibility for countries in breach of the 60 percent of GDP debt threshold, but the lack of speci cation of the conditions under which the breach of the debt threshold should lead to an EDP was long taken as a reason for ignoring the provision. e attempt to operationalise the debt criterion of the EDP in the 2011 reform package known as the Six-Pack, through the so-called 1/20 debt reduction rule[22] was a failure, as ways were always found to avoid its application. Following the protracted suspension of the EU scal rules since the outbreak of the COVID-19 crisis through recourse to the so-called General Escape Clause, some may even doubt the willingness of the Commission and the Council to place in EDP the countries still in breach of the 3 percent of GDP de cit threshold, in spite of the explicit commitment of the Commission to do so from 2024.

Enforcing scal rules on scal sovereigns is an inherently di cult, if not intractable, problem (Debrun and Jonung, 2019). An approach based on self-commitment and reputational consequences is more likely to work than one based on external impositions and sanctions. e Commission in November 2022 was already clearly leaning in the direction of reputational sanctions, by acknowledging that macroeconomically visible pecuniary sanctions are counterproductive and symbolic penalties stand a better chance of being applied e ectively.

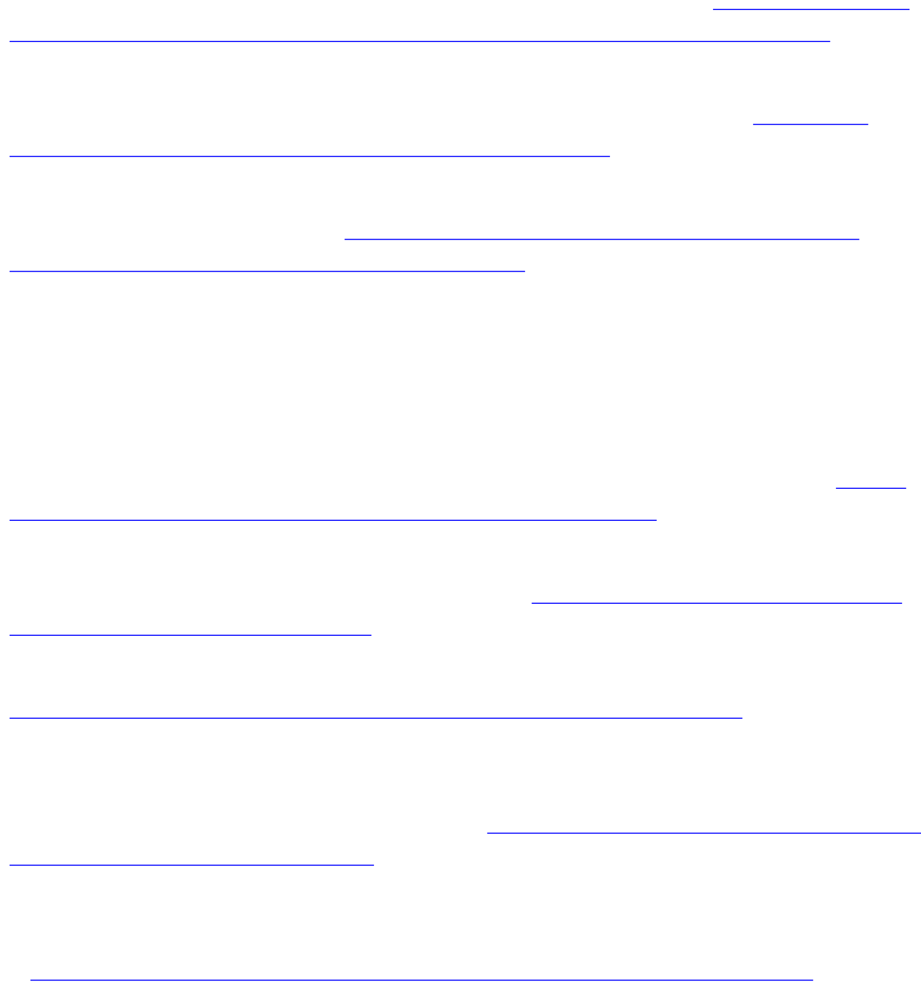
Self-commitment and reputational consequences, however, should be enhanced at each stage of implementation and for all the parties involved. In this connection, while clearly not solving all problems, a useful initiative might be to revisit the European Council's 1997 resolution on the Stability and Growth Pact, in which, at the inception of

20 European Commission (2023b), Explanatory Memorandum, point 5.

21 "*ese observations ... suggest the enforcement of the scal rules did not make a material di erence in cases where the enforcement of scal discipline was most necessary*" (European Commission, 2020, p.7).

22 e debt reduction rule, more properly characterised as a benchmark, since it provides a numerical trigger for the overall assessment of the case for opening an EDP, prescribes that the gap between a country's debt level and the 60 percent reference should be reduced by 1/20th annually (on average over three years).

the SGP, EU countries, the Council and the Commission committed to timely and rigorous



European Commission (2023d) 'A proposal for amending Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States,' COM/2023/242 nal, available at https://economy- nance.ec.europa.eu/system/ les/2023-04/COM_2023_242_1_EN.pdf

European Commission (2023e) Statistical Annex,' – S 2023, available at https://economy- nance.ec.europa.eu/system/ les/2023-05/SF_2023_Statistical%20Annex.pdf

European Council (1997) 'Resolution of the European Council on the Stability and Growth Pact Amsterdam,' 17 June, available at https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A31997Y0802%2801%29

Annex: Deriving the sustainability criterion from the Commission sustainability risk assessment methodology

e way the level of debt and its trajectory are jointly considered in the Commission risk assessment methodology combines two risk categorisations: one based on debt thresholds and the other based on the shape of the trajectory. Speci cally:

- Based on debt thresholds, countries are classi ed as high, medium or low risk, depending

Having thus reached a preliminary risk classi cation based on the level of debt and its

Note that compliance with the debt-sustainability criterion is taken to mean avoidance of high-risk classification according to the Commission medium-term risk assessment methodology or, to put it concisely, de-risking of public debt. While this interpretation is not confirmed explicitly by the April 2023 draft legislation, only by keeping in the background the Commission risk assessment methodology it is possible to make overall sense of the proposal for the reform of the EU fiscal framework and in particular of the “ , , … , , , , ” sustainability criterion. Specifically, readings of the sustainability criterion that ignore the Commission risk assessment methodology tend to run into internal inconsistencies. For example, it would hardly make sense to require a downward projected debt trajectory from a country with a projected debt level that is considered to be prudent, ie staying below 60 percent of GDP, and therefore not to pose a risk to the euro.

Note also that, while not explicitly mentioned in the context of the “ , , … , , , , ” sustainability criterion, the relevance of the Commission risk classi cation, speci cally, as regards the distinction between ‘high risk’ member states and the others, is con rmed by at least two provisions in the Commission reform proposals, namely, on the intensity of the reform and investment commitments required for an extension of the adjustment period[26], and on the materiality of a deviation from the adjustment path for the opening of an excessive de cit procedure[27].

In sum, a reading of the sustainability criterion in terms of de-risking of public debt, in turn operationalised based on the Commission risk assessment methodology, appears justi ed on both substantive and contextual grounds.

26 European Commission (2023b), Art. 13 (2). It reads (emphasis added): “ *e set of reform and investment commitments underpinning an extension of the adjustment period, shall be commensurate with* **the degree of public debt challenges** *and challenges to medium-term growth in the Member State concerned*”.

27 European Commission (2023c), Art. (3). It reads (emphasis added): “ *e Commission, when preparing a report under Article 126(3) TFEU, shall take into account as a key relevant factor the degree of debt challenges in the Member State concerned.* **In particular, where the Member State faces substantial public debt challenges according to the most recent Debt Sustainability Monitor, it shall be considered a key factor leading to the opening of an excessive de cit procedure as a rule**. *e Commission shall also take into account all other relevant factors as indicated in Article 126(3) TFEU, in so far as they signi cantly a ect the assessment of compliance with the de cit and debt criteria by the Member State concerned*”.