

Three risks that must be addressed for new European Union fiscal rules to succeed

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Executive summary

The reform of the European Union's fiscal rules, the Stability and Growth Pact, has largely focused on their design. This nearly exclusive focus has distracted attention from the equally, if not more, important issue of implementation. The reform, completed in April 2024, left implementation unaddressed, or at least open to very different potential outcomes.

First, the reform failed to clarify the interplay between EU countries' medium-term fiscal structural plans (MTFSPs), which embody the new focus on debt sustainability, and the excessive deficit procedure (EDP), which remains the main enforcement tool under the rules. The need for clarification is urgent as several countries are set to enter EDPs for breaching the SGP's 3 percent of GDP deficit threshold at the same time as their first MTFSPs are endorsed in autumn 2024.

Second, that the adjustment paths prescribed by EDPs may be at least temporarily less demanding than the debt-sustainability requirements of the MTFSPs would normally imply. Even if consistency between EDPs and MTFSPs is ensured from the start, inconsistencies may arise over time and be resolved in a way that further postpones the necessary adjustment.

Third, it is that the 3 percent of GDP deficit might be perceived as the only target that matters for countries that enter EDPs in 2024, as repeated revisions of the MTFSPs undermine the cogency of the debt sustainability requirements. This scenario is likely to materialise if the countries are allowed to exit their EDPs upon bringing their deficits to or below 3 percent of GDP, while being still far from the necessary correction of the debt trajectory.

Finally, to shape countries' expectations on the implementation of the upcoming EDPs in a way that is conducive to the immediate internalisation of the debt sustainability constraint implied by the new rules, rather than allowing it to be viewed as a distant objective. This change in expectations could be achieved by clarifying that, even if a country has been placed in an EDP only for breach of the deficit criterion, it should also satisfy the debt criterion for the procedure to be abrogated.

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1 Introduction

The rules meant to constrain government deficits and debt in the European Union, known as Stability and Growth Pact (SGP), consists of two 'arms'. Under the preventive arm, all countries are expected to stick to the same medium-term objective of keeping their budgetary positions close-to-balance or in surplus. Under the corrective arm or excessive deficit procedure (EDP), meanwhile, countries with deficits in excess of 3 percent of GDP (deficit criterion) or debts in excess of 60 percent of GDP that are not falling fast enough (debt criterion) are subject to specific adjustment requirements to remedy the situation. Compliance with the preventive arm is backed by soft-law recommendations. The corrective arm is more intrusive and, for euro-area

While maintaining these common risk-based requirements, the April 2024 reform has introduced two further numerical constraints ('safeguards'), which apply to countries with both debt above 60 percent of GDP and deficits above 3 percent of GDP. Specifically:

- A debt sustainability safeguard requires the projected debt-to-GDP ratio to decrease by a minimum annual average amount of 1 percent of GDP for countries with debt ratios above 90 percent, and by 0.5 percent of GDP for countries with debt ratios between 60 percent and 90 percent of GDP, over the adjustment period. However, if a country is subject to the

Specifically, preliminary simulations by Darvas et al (2024) suggest that if the debt-sustainability based adjustment requirements are applied rigorously, in about half a dozen cases the MTFSPs will have to set an annual fiscal adjustment in excess of 0.5 percent of GDP (in terms of structural primary balance), to be sustained for as long as seven years, something for which there is hardly any precedent. At the same time, about a dozen countries are expected to immediately enter the EDP and receive adjustment prescriptions because of deficits persistently in excess of 3 percent of GDP. Several countries, including in particular Italy, France, Spain and Belgium, will likely be affected by both sets of prescriptions. Note that high-debt countries are not immediately exposed to the debt-based EDP, because under the reform, the procedure can be triggered only by an accumulated deviation from the adjustment path in the MTFSP, while the first cohort of MTFSPs will be endorsed by the EU more or less simultaneously with the opening of the EDPs, which therefore will be only deficit-based. Although there is still some uncertainty on the timing of the procedures, the expectation is that EDPs will be opened and MTFSPs endorsed in autumn 2024.

Last but not least, the interplay between the EDP and the new preventive arm cannot be properly understood if one neglects two essential contextual elements, which do not stem from the new rules as such but can be inferred from a systematic reading of the EU fiscal-governance legal framework (Pench, 2024):

- In spite of the common-parlance distinction between deficit-based and debt-based EDPs, legally there is only one procedure. This means that, once the EDP has been opened based on one criterion, a second procedure based on the other criterion cannot be super-imposed on the existing procedure. Conversely, the closure ('abrogation') of an EDP opened based on one criterion should or even must be subordinated to the satisfaction of both criteria.
- The wide discretion enjoyed by the European Commission and Council in setting, and, if necessary resetting, adjustment paths, including departures from the apparently rigid benchmarks in the corrective arm, as long as a country is subject to an EDP. A further implication is that the application of the provisions on fiscal-structural plans should not result in undue restraint on the operation at 5h5

Taken together, these elements point to serious risks that need addressing when launching and implementing the forthcoming EDPs. Hopefully, they also suggest possible responses.

Risk 1: Defining the initial corrective path for countries subject to the EDP

It stands to reason that, if EDPs are opened at about the same time as MTFSPs are endorsed by the Council, the prescribed fiscal adjustment path should be the same, at least as long as the periods covered by the two procedures coincide.

It is not sure, however, that adjustment paths will be fully in line with the debt-sustainability requirements of the new preventive arm.

The principle of the primacy of the EDP over the preventive arm suggests that the adjustment in the MTFSPs would have to be aligned to that prescribed in the EDP. This conclusion is confirmed by a provision in the new preventive arm requiring that the trajectories that should serve as a reference for the MTFSP show “consistency with the corrective path” in the applicable decisions under the EDP (Regulation 1263/2024, Article 6(d)). In turn, for deficit-based EDPs, the reformed EDP regulation specifies only a “minimum annual structural adjustment of at least 0,5 percent of GDP as a benchmark” (Regulation 1264/2024, Article 3(4)). Moreover, for 2025-2027, the regulation contains an ad-hoc provision allowing a downward departure from the 0.5 percent of GDP benchmark adjustment. The reading of the provisions is complicated further by the fact that the 0.5 percent of GDP benchmark adjustment is defined in terms of total structural balance, while the individual adjustment path prescribed to the countries by the EDP and the MTFSPs should be in terms of net expenditure, that is, approximately, in terms of structural primary balance.

Bearing also in mind the wide discretion enjoyed by the Commission and the Council in setting the individual adjustment path under the EDP, there is reason to be concerned that the adjustment paths in the forthcoming EDPs will focus on the deficit target of 3 percent of GDP, while falling short of the adjustment required, on an annual basis, to satisfy the debt sustainability requirements of the new preventive arm. This would paradoxically result in more favourable treatment of the countries subject to an EDP, relative to countries that have already brought their deficits below 3 percent of GDP. Nor would demanding that

Risk 2: Divergence from the MTFSP during the implementation of the corrective path agreed under the EDP

The consistency in principle between individual adjustment paths under the EDP and in MTFSPs set out at start of the process does not mean that inconsistencies might not arise, for two reasons.

First, the narrow focus of the debt-based EDP on bringing down the debt to 3 percent of GDP introduces a 'nominal bias' in the working of the procedure: a government that is on its way toward the nominal target of 3 percent of GDP does not have to face demands for budgetary correction, irrespective of whether or not it has delivered on the prescribed structural adjustment included initially in the MTFSP. Specifically, as long as a country achieves its nominal debt targets, escalation of the EDP – potentially leading to sanctions – is not an option⁸. It is therefore not difficult to imagine a scenario in which a country complies with the EDP recommendation – or, more precisely, it cannot be penalised for departing from it – while deviating from the adjustment path, for example, through recourse to temporary measures, or thanks to windfall revenues. This may be less of a problem than it seems, at least as long as it does not lead to the country exiting the EDP (see Risk 3). If the EDP covers several years, which is bound to be the case for countries starting from high debts, it is anyway not very likely that a country will hit nominal debt targets year after year without a corresponding structural adjustment.

A more serious reason why the initial structural adjustment may fall by the wayside is the existence of another bias in implementation of the procedure, as distinct from its design. This is a 'no-escalation bias,' referring to the reluctance of the Commission and the Council to escalate the EDP even when a country deviates from the structural and the nominal adjustment path. Instead, the practice has been to issue a revised EDP recommendation with an extended deadline. While the adoption of a single indicator should make it easier to determine whether the adjustment has been delivered or not, incentives to fudge would persist, especially given the heavy penalties, both direct and indirect, that could accompany the escalation of an EDP (Box 2).

⁸ This conclusion is reached by recursive reasoning starting from the observation that, in the case of an EDP covering a single year, if the country has brought the debt below 3 percent of GDP, the debt criterion of the EDP has been satisfied and the country cannot continue to be subject to the EDP on grounds of the debt criterion, irrespective of whether or not the prescribed structural adjustment has been delivered. This has been consistently interpreted to imply that, for an EDP covering more than one year, the procedure cannot be escalated as long as the country can be considered to be on its way to eventually achieve the 3 percent of GDP debt. Intermediate nominal targets were introduced to operationalise the otherwise ambiguous notion of being on the way toward the 3 percent of GDP. For reasons of symmetry in the operation of the procedure, intermediate debt targets equally apply to debt-based EDPs. This approach was confirmed explicitly by the Code of Conduct of the Stability and Growth Pact endorsed by the ECOFIN Council (Council of the EU, 2017, p. 15): "Following legal opinion, a debt-based EDP cannot be extended if the Member State achieves it in the media headline debt target, even when the recommended change in the current account balance is not achieved. At the same time, although a careful analysis would still be conducted to be undertaken and hence the underlying budgetary developments." While intermediate debt targets are no longer specifically mentioned in the reformed EDP regulation, and the Code or analogous specifications will have to be revised to reflect the reform of the SGP, it is difficult to see how the 'nominal bias' could be eliminated, since it is a consequence of the role of the 3 percent of GDP debt threshold in the EDP, which remains unchanged.

Box 2: Escalating an EDP; a 'no clear option' has still never been exercised?

The EU Treaty envisages the possibility of sanctions, including fines, only after the repeated failure by a country subject to an EDP to take effective action to correct the excessive deficit (Article 126(11) TFEU). The SGP was initially limited to specifying the amount of the potential fines.

To strengthen the enforcement of the fiscal rules, the 2011 'six-pack' reform of the SGP

Our analysis of the second risk concluded, however, that even if the required adjustment was less than fully complete and was delayed relative to the initial timeline, the EDP should eventually be able to put the debt dynamics on a safe path.

An exit from an EDP based only on achieving the 3 percent of GDP de cit would undermine this reassuring conclusion.

Box 3: The lack of enforcement of the 1/20th rule: a cautionary tale

One of the main features of the 2011 ‘six-pack’ reform was the so-called ‘1/20th rule’ – a requirement for countries with debt above 60 percent of GDP to reduce it by an annual average of at least 5 percent of the difference between the debt level and 60 percent. Countries that failed to make this minimum adjustment were to be placed in a debt-based EDP. The question was how to treat countries that had been placed in the EDP on the basis of the deficit criterion before the entry into force of the reform. It was decided that these countries would be given a three-year transition period, during which they would not be liable for a debt-based EDP, provided that they made sufficient progress towards compliance with the benchmark. The Commission was even tasked with producing a numerical indicator to gauge progress towards compliance¹³

Effectively, however, once countries exited the deficit-based EDP, non-compliance with the debt criterion, either in its transitory or permanent formulation, never resulted in an EDP being opened based on the debt criterion. Even when the Commission clarified that compliance with the preventive arm of the SGP would be considered a key relevant factor in assessing compliance with the debt criterion (effectively sidelining the debt-reduction benchmark), no debt-based EDP was activated, irrespective of the persistent lack of compliance with the preventive arm, in particular, by countries with the highest debt ratios (Commission, 2020).

There is however a solution that would avoid the risk of an early degeneration of the reform. It would require a clarification that, even if a country has been placed in an EDP only for breach of the deficit criterion, it should also satisfy the debt criterion of the EDP for the procedure to be abrogated. At first sight this specification would seem to contradict the provisions quoted above, which seem to entitle a country to exit the procedure once it has brought its deficit below 3 percent of GDP, if the EDP was opened based on the deficit criterion. However, the provisions could be read as implying that, for countries with debt in excess of 60 percent of GDP, the deficit condition should be considered as necessary, but not sufficient for the abrogation of the EDP. An argument supporting this reading is that it would be fully in line with the specifications on the abrogation of the EDP agreed by the Council in the aftermath of the ‘six-pack’ reform, which posed for the first time the question of the interplay between a deficit-based and debt-based EDP.

To make the proposed solution work, two further questions would need to be addressed.

The first concerns the adjustment path that debt-based EDPs should prescribe to countries with debt in excess of 60 percent of GDP. If the adjustment is to be conducive to satisfying also the debt criterion, then it would seem evident that, even if opened for breach of the 3 percent deficit threshold, an EDP should cover the entire adjustment period under the MTFSP, the rationale of which is to achieve debt sustainability. It would reinforce the conclusion that the adjustment path under an EDP should not be inconsistent with the debt-sustainability requirements of the preventive arm (Risk 1).

The second question is how to define the condition for abrogation of the debt-based EDP, which would have to apply to all countries subject to an EDP, if their debt exceeds 60 percent

¹³ The indicator was meant to measure the distance between the current structural position of the country and the position consistent with the respect of debt reduction benchmark at the end of transition period (see European Commission, 2019).

¹⁴ A specific provision in the EDP Regulation 1264/2024 seems to confirm the possibility that an EDP opened on the

of GDP. The abrogation provisions quoted above make sufficiently clear that a debt-based



One might object that the understanding proposed under 1), while fully in line with the overall logic of the reform, would run, in the author's view, against an apparent tacit understanding reached at the time of the adoption of the reform allowing for some backloading of adjustment (as reflected in particular by the temporary relaxation of the normal adjustment requirement under the EDP). Irrespective of the existence or the value of such a tacit understanding, allowing any temporary deviation from the debt-sustainability requirements would make even more important to affirm the understandings proposed under 2) and, crucially, 3).

Enforcement has consistently proved the weakest link in the system of EU fiscal rules. The 2024 reform will be judged a success not for having managed to achieve a fragile consensus on new rules, but if the new rules are shown to improve the incentives for countries to avoid potentially unsustainable debt trajectories.

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