9 September 2019

Informal ECOFIN 13-14 September

EU fiscal rules

- Presidency Issues Note for the Informal ECOFIN Working Session IIa -

- The intention of the discussion in the informal ECOFIN is to take stock of the functioning of the current set of EU fiscal rules. This could provide input to the Commission's review of the EU fiscal framework, due at the end of the year. The discussion could also be an opportunity to assess whether ministers see a need to make amendments to the current framework, a consideration that is part of the upcoming Commission review as well.

Introduction

- The Stability and Growth Pact (SGP) has evolved over two decades through successive layers of reform to respond to economic developments, most recently in 2011-2013 – following the economic and financial crisis – through the adoption of the six-pack and two-pack legislative packages and the Fiscal Compact.
- In line with the legislation, the Commission shall publish a review of the six- and two-pack by the end of 2019 and, if appropriate, the review shall be accompanied by a proposal for amendments to the regulations.[1]
- In this regard, the ECOFIN discussion could inform the Commission's work both on experience with the application of the rules and on whether there is appetite to amend the framework.

Experience with the fiscal rules

- The modifications of the SGP have addressed perceived shortcomings, including via a more preventive element and reinforced national fiscal

[1] As per the regulations, these reports on the application of the regulations take place every five years and evaluate, inter alia, the effectiveness of the regulations and progress made to ensure closer coordination of economic policies and sustained convergence of economic performances. The first review of the six-pack and two-pack took place at the end of 2014. The conclusion of the review was: "The ability to draw conclusions on the effectiveness of the regulations is limited by the short experience of their operation, with the six-pack entering into force in end-2011 and the two-pack only in mid-2013. Not only is this time period short, but it has also been characterised by a severe economic crisis. This leaves the rules untested in normal economic times."

frameworks. These modifications have however increased the framework's complexity and changed the framework from a set of rather simple rules, albeit subject to interpretation, into an elaborate collection of rules and procedural steps.

- The corrective arm of the Pact, which prohibits the Member States from breaching the 3% of GDP nominal deficit threshold and requires them to convergence towards the 60% of GDP debt limit at a sufficient pace, is the element in which most experience has been gained, in particular as regards the deficit criterion. The debt rule and the preventive arm of the Pact, which requires the Member States to improve their structural balances until they reach their national Medium-Term Objectives (MTOs), were strengthened following the crisis. Experience with the implementation of these elements since the crisis remains limited, with many countries only recently entering the preventive arm and thus being subject to the debt rule.
- The same applies for the respective procedures – the Excessive Deficit Procedure (EDP) in the corrective arm and the Significant Deviation Procedure (SDP) in the preventive arm – as numerous Member States have entered and exited deficit-based EDPs over the years but the SDP has been applied only a few times and never for a euro-area country.
- Looking at fiscal performance, some observations can however be made:

  Corrective arm:

    - Deficit criterion: Nominal deficits have declined significantly since the introduction of the SGP (with the exception of the crisis). Today, there are no Member States in EDP. In this sense, the deficit criterion could be considered effective.
    - Debt criterion: Debt developments have been less benign, despite the recent decrease in the EU average debt ratio. Indeed, debt ratios are close to historic peaks in the majority of Member States. Debt developments and their drivers have proved to be highly country-specific during the last decade. Compliance with the debt reduction benchmark remains a challenge. This could, to some extent, be explained by the highly pro-cyclical nature of debt developments as well as low growth and inflation in some Member States but also partly by the limited adjustment efforts made to reach the MTOs.[2]

  Preventive arm:

    - Member States have made significant progress since 2011 in closing the gap with their MTOs, but fiscal efforts have slowed in recent years, while at the same time, large divergences in underlying fiscal positions remain. Primary expenditure growth has been below or close to potential growth in most Member States since 2011.

[2] The adjustment path towards the MTOs is designed to be consistent with a sufficiently diminishing debt-to-GDP ratio.

- The extent to which this performance can be credited to the rules is difficult to assess. The behaviour of the bond markets during the crisis, imposing large yield spreads on some Member States, has certainly also had an influence on the design of fiscal policies. Further considerations include how the rules have contributed to the appropriateness of the fiscal stance in Member States or in the euro area and EU as a whole, and how the euro-area/EU fiscal stance should be constructed. Challenges in assessing the state of the economy in real time may have contributed in part to sub-optimal fiscal stances, both before the financial crisis and afterwards.[3]

Functioning of the fiscal framework

- While the general trend in fiscal outcomes has been positive, the improvement has not been universal and compliance issues have been raised. Some see this as a reflection of rather weak enforcement efforts, despite (or because of) the possibility of sanctions. Others blame the use of non-observable indicators, such as potential growth rate, output gap and fiscal elasticities, which play a large role in determining fiscal targets and measuring compliance in real time. Indeed, these indicators are volatile and subject to considerable revisions, which may have contributed to non-compliance, despite attempts to improve the methodology used.
- Since the 2011-2013 reforms, the application of the framework has been further specified and clarified, partly in response to the ongoing debate on whether the rules adequately cater for e.g. the economic situation (and in particular the environment of slow growth and inflation), country-specific elements, investment needs and possible structural shifts in interest rates. As a result, the annual surveillance cycle now provides more granular guidance to national fiscal policies.
- There have been calls for simpler fiscal rules both from the inside and from outside observers. Complexity does not help the conduct of national budgetary processes and communication, and thus contributes to a lack of ownership. However, while simplicity, flexibility and predictability are all desirable characteristics of a well-designed fiscal framework, there are inherent trade-offs between these characteristics. Combining ex-ante full predictability with detailed flexibility options in a changing economic environment comes at the expense of added complexity. Conversely, a simple and predictable framework will not be able to respond flexibly to changing economic conditions. Finally, combining simplicity with flexibility is only possible through further elements of discretion, which would reduce predictability.

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[3] See e.g. Darvas, Z., Martin, P., Ragot, X.: *European fiscal rules require a major overhaul*. Policy Contribution, Issue no 18, October 2018, Bruegel.

- Fundamentally, the choice of the fiscal rules depends crucially on what purpose the rules and the broader framework are expected to serve. There are still different views on this question. While the original rules had the sole objective of ensuring sound and sustainable government finances, increasing emphasis is being placed by some on the role of fiscal policy in economic stabilisation and in setting the right policy mix at the euro-area level – especially with monetary policy being perceived as more and more constrained. The capacity of EU rules to deliver the appropriate fiscal stance at euro-area level has gradually become part of the debate.

Issues for discussion

- In your view, have the current EU fiscal rules delivered what they are supposed to deliver? How do you see the contribution of the framework to the fiscal outcomes?
- Which elements of the current framework do you consider most useful? How important are the national rules as an element of the overall fiscal framework?
- In your view, should possibilities for changing the framework be discussed at this stage? If so, what should the discussion focus on?