

Pench, Lucio R.

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

Lucio Pench

Executive summary

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

THE DEBATE ON 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.

IN PARTICULAR, 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.

THERE IS A RISK 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.

THE MAIN RISK 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.

IT IS IMPORTANT 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 situation¹. Compliance with the preventive arm is backed by soft-law recommendations. The corrective arm is more intrusive and, for euro-area countries, potentially backed by financial sanctions.

In April 2024, following protracted negotiations between governments and with the European Parliament, the EU enacted new rules that overhaul the SGP’s preventive arm (Box 1)². The one-size-fits-all balanced budget target is dispensed with, and more focus is put on debt sustainability in each country. Countries must pursue debt sustainability through EU-endorsed, so-called medium-term fiscal-structural plans (MTFSP), which set out their intended fiscal adjustment paths.

For high-debt countries, deviating from the adjustment path can trigger the opening of an EDP with ensuing adjustment requirements. In other words, for these countries, the (debt-based) EDP is repurposed as an enforcement instrument of the new preventive arm. Countries with debt below the 60 percent threshold and no plans to exceed it are essentially left alone by the new rules, unless they breach the 3 percent of GDP deficit threshold.

Box 1 : The new preventive arm of the SGP (Regulation (EU) 2024/1263)

The principal aim of the new preventive arm of the SGP is to ‘de-risk’ public debt.

Each country should submit a medium-term fiscal-structural plan (MTFSP) setting out an adjustment path, expressed in terms of net expenditure (primary expenditure net of discretionary revenue measures, cyclical unemployment expenditure and one-off and temporary items), and covering in principle the same period as the term of that country’s legislature (four or five years). By the end of the adjustment period (ie four years at a minimum with the possibility of an extension of up to a maximum of seven years, conditional on investment and reform commitments), debt should be on a plausibly downward path or staying below 60 percent of GDP, with the deficit remaining below 3 percent of GDP over the medium term (defined as the 10-year period after the end of the adjustment). This forward-looking requirement is verified at the time of the endorsement of the plan, based on projections with unchanged policies, carried out according to a European Commission debt sustainability analysis (DSA) methodology.

The budgetary targets implied by the requirements can be expected to differ substantially across countries, depending on the starting level of debt and the projected rates of interest and GDP growth.

1 Each arm of the SGP corresponds to an EU regulation. The EDP is based on specific Treaty provisions (Article 126 of the Treaty on the Functioning of the EU), the application of which is further specified by Regulation (EC) No 1467/97. The rules of the preventive arm meanwhile were first formulated through Regulation (EC) No 1466/97, based on the general Treaty provisions on the coordination and surveillance of economic policies (Article 121 TFEU). SGP reforms in 2005 and 2011 amended both regulations. The 2011 reform (included in the so-called ‘six-pack’ package) sought in particular to strengthen the enforcement of the fiscal rules and implement the hitherto ignored EDP debt criterion (see Boxes 2 and 3). The April 2024 reform of the SGP replaces the preventive arm regulation with Regulation (EU) 2024/1263 and amends the EDP regulation.

2 See Council of the EU press release of 29 April 2024, ‘Economic governance review: Council adopts reform of fiscal rules’, <https://www.consilium.europa.eu/en/press/press-releases/2024/04/29/economic-governance-review-council-adopts-reform-of-fiscal-rules/>.

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 excessive deficit procedure (EDP) on grounds of a deficit in excess of 3 percent of GDP, the requirement does not apply before the year in which the country is projected to exit the procedure.
- A deficit resilience safeguard requires that the overall deficit should eventually reach a level of no more than 1.5 percent of GDP in structural terms. Countries with higher deficits are required to adjust by a minimum of 0.4 percent of GDP per year (or 0.25 percent of GDP per year, if the adjustment period is extended to seven years).

Compliance with these requirements is verified by the European Commission and the Council of the EU, which can, if necessary, ask for revisions. Once a plan is endorsed by the Council, the net expenditure path becomes the sole reference for assessing compliance with the fiscal rules. Positive and negative deviations from the net expenditure path are accumulated in a notional 'control account'. If the balance reaches a certain threshold (0.3 percent of GDP in one year or 0.8 percent in two years), countries with debt in excess of 60 percent of GDP are liable to be subject to the EDP for breach of the debt criterion, with the associated prescriptions and eventual penalties. Countries that keep debt below the threshold of 60 percent of GDP are not liable to consequences under the new rules, other than the possibility of warnings and soft-law recommendations, unless they breach the 3 percent of GDP deficit threshold³.

The reform has left the EDP for breach of the deficit criterion (deficit-based EDP) practically unchanged. This reflects its popularity. Fiscally conservative governments see it the only element of the SGP that reliably constrains the fiscal behaviour of their more deficit-prone partners (hence the insistence of fiscal hawks on retaining other numerical fiscal constraints). High-debt, high-deficit countries, meanwhile, appreciate the bespoke nature of the procedure, including the opportunities it offers for renegotiation if the corrective path is not met. Importantly, the relative effectiveness of the deficit-based EDP, which is confirmed by empirical evidence (De Jong and Gilbert, 2020; Caselli and Wingender, 2021), appears to depend more on the stigma associated with governments being made subject to the procedure, rather than on the hypothetical possibility of financial sanctions. Stigma may include the impact of the EDP on government debt risk premia (Diaz Kalan *et al*, 2018).

The debate on the reform has focused on the design of the rules, in particular the tension between the original objective of medium-term debt sustainability and the numerical constraints ('safeguards') that have been added to the requirements of the plans. This has distracted attention from the equally, if not more, important aspects of implementation, which the reform has left unaddressed, or at least potentially open to very different outcomes.

In particular, the reform has failed to clarify the interplay between the EDP and the new preventive arm in important respects. This risks compromising the functioning of the new framework from the outset. Many countries currently have both high debts and high deficits. Addressing these is urgent, requiring smooth coordination in the deployment of the SGP's old and new tools.

3 For further details and an overall economic assessment of the new rules, see Pench (2024) and Darvas *et al* (2024). See also Jeromin Zettelmeyer, 'Assessing the Ecofin compromise on fiscal rules reform', *First Glance*, Bruegel, 21 December 2023, <https://www.bruegel.org/first-glance/assessing-ecofin-compromise-fiscal-rules-reform>.

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 2024⁴.

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 EDP⁵. A further implication is that the application of the provisions on fiscal-structural plans should not result in undue restraint on the operation of EDPs, and in case of apparent conflict the latter should prevail. This principle, which has been described as 'the primacy of the EDP' reflects the strength of the respective legal bases and is firmly established in surveillance practice⁶.

4 The European Commission (2023c) stated that the EDP would be reactivated in spring 2024, following the official release by Eurostat, by end-April 2024, of the deficit and debt outturns for 2023 (see Eurostat release of 22 April 2024, 'Euro area government deficit at 3.6% and EU at 3.5% of GDP', <https://ec.europa.eu/eurostat/web/products-euro-indicators/w/2-22042024-ap>). According to the EDP regulation, this would normally imply opening of EDPs within the subsequent four months. However, the final text of the new preventive arm contains a provision on the submission of the first MTFSPs, according to which countries "*should submit their medium-term fiscal-structural plans by 20 September 2024*" (Regulation 1263/2024, Article 36(a)), instead of the normal deadline of 30 April. Considering that the same regulation envisages a maximum of six weeks for the Commission to assess the plans, and that presumably initial consistency will be ensured between the adjustment path in the EDPs and the MTFSPs, it seems reasonable to expect that the opening of the EDP and the endorsement of the MTFSPs will take place at the same time in autumn 2024.

5 Possibly most graphic example of departure from the rules of the corrective arm in the individual prescriptions addressed to countries under an EDP concerns the EDPs opened in 2009-10 in the wake of the Great Financial Crisis, when countries were urged to temporarily accommodate the increase in public deficits and even adopt expansionary policies, in contrast to the immediate fiscal consolidation in principle envisaged by the rules once a country is subject to the procedure (European Commission, 2010).

6 The primacy of the specific prescriptions of the EDP over the general provisions of the preventive arm is illustrated by the practice whereby, for countries subject to an EDP, the 'annual fiscal recommendation', part of the annual country-specific recommendations in the context of the European Semester (based on Article 121(3) TFEU), is limited to simply stating that they should respect the EDP recommendation that they have received (regardless of the provisions of the preventive arm that would apply otherwise).

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*” [sic] (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 adjustment⁷. 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, approximatively, 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 the countries make up for the gap relative to the debt sustainability requirements after they have brought their deficits below 3 percent of GDP be a satisfactory solution, because of the obvious questions of credibility it would raise.

The logical way to address this risk, from both the economic and legal points of view, would be to clarify that the minimum benchmark adjustment under a deficit-based EDP (including the temporary exception for 2025-2027) should not be interpreted as allowing for individual adjustment paths inconsistent with the debt-sustainability requirements of the preventive arm.

⁷ Regulation 1263/2024, Recital 23. The smaller adjustment is meant to take into account the ongoing increase in the average interest rate on debt (making a 0.5 percent of GDP adjustment in terms of overall balance more demanding than the same adjustment in terms of the primary balance) and “*not to compromise the positive effects of the Recovery and Resilience Facility.*”

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 deficit-based EDP on bringing down the deficit 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 deficit 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 deficits, it is anyway not very likely that a country will hit nominal deficit targets year after year without a corresponding structural adjustment.

A more serious reason why the initial structural adjustment may fall by the wayside is 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 deficit below 3 percent of GDP, the deficit criterion of the EDP has been satisfied and the country cannot continue to be subject to the EDP on grounds of the deficit 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 deficit. 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 deficit 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): “For legal reasons, a deficit-based EDP cannot be stepped up if the Member State achieves its intermediate headline deficit target, even when the recommended change in the structural balance is not achieved. At the same time, though, a careful analysis should still be conducted to better understand the nature of the underlying budgetary developments.” While intermediate deficit 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 deficit threshold in the EDP, which remains unchanged.

Box 2: Escalating an EDP; a ‘nuclear option’ that will never be 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 introduced further sanctions, of 0.2 percent of GDP, at an earlier stage in the procedure – after the finding that the country had not taken effective action in response to the initial adjustment recommendations received under the EDP. Moreover, the sanctions were expected to be triggered ‘automatically’ by the Commission once the Council had established, based on a Commission proposal, that the country had not taken effective action under the EDP.

The new enforcement provisions were tested first in 2015, following a substantial apparent deviation by France from the adjustment recommended under the EDP. On that occasion the Commission resorted to a double-negative formulation – “*Overall ... the available evidence does not allow to conclude on no effective action*” – to avoid proposing to the Council that it should establish that France had not taken effective action (European Commission 2015). This episode provided the background to the controversial statement by then Commission President Juncker, who said the apparent breach of the fiscal rules by France was ignored by the Commission “*because it is France*”⁹.

The second test of the enforcement provisions occurred in 2016, when the Commission and the Council found Portugal and Spain liable for no effective action with respect to their respective EDP recommendations. The Commission however evaded the obligation to trigger the imposition of a fine of 0.2 percent of GDP by recommending that the Council simply cancel the fine (Council of the EU, 2016, 2017a). Critics of the decision presented the episode as the “*death*” of the six-pack reform¹⁰.

The enforcement provisions have not been invoked since, though they remain in force and were left largely untouched by the 2024 reform¹¹.

In addition to the above sanctions, which apply only to euro-area countries, the decision to escalate the EDP has become the potential trigger for the suspension of funds under the European Structural and Investment Funds (ESIF) and the Recovery and Resilience Facility (RRF). It could also result in the loss of eligibility for government security purchases by the European Central Bank under the Transmission Protection Instrument.

The decision to escalate the EDP may therefore be seen as a ‘nuclear’ option, a perception that would likely reinforce the observed no-escalation bias.

Since the no-escalation bias essentially reflects a tendency to depart from what the rules would prescribe when this would lead to politically awkward consequences, it is hard to tackle the problem by looking only at the rules and suggesting a different interpretation. The reputational cost of refraining from escalation could be increased, for example by asking the European Fiscal Board (EFB), the independent advisory body established by the Commission, to provide its advice, a possibility introduced by the reform. Note however that, since the right

9 Francesco Guarascio, ‘EU gives budget leeway to France ‘because it is France’ – Juncker’, *Reuters*, 31 May 2016, <https://www.reuters.com/article/idUSKCN0YM1MZ/>.

10 Daniel Gros, ‘The second death of the Stability Pact and the birth of an inter-governmental Europe’, *CEPS Commentary*, 28 July 2016, <https://www.ceps.eu/ceps-publications/second-death-stability-pact-and-birth-inter-governmental-europe/>.

11 Regulation 1264/2024 (Article 12) reduces the sanctions envisaged by the Treaty (Article 126(11) TFEU) as an ultimate consequence of repeated non-compliance with EDP decisions from a minimum of 0.2 percent of GDP per year to 0.005 percent every six months. However, the sanctions introduced by the six-pack reform in connection with an escalation of the EDP remain unchanged at a default amount of 0.2 percent of GDP.

to ask for an EFB opinion is limited to the Commission and the Council, this reputational risk could be safely ignored if the Commission and the Council agreed to pretend that there has not been deviation from the structural adjustment path, and to extend the deadline for correcting the excessive deficit via a new EDP recommendation. Another possibility would be that of reducing the potential fines attached to the escalation of the EDP to symbolic amounts, to give them a purely reputational effect.

The reform is silent on what would happen to an MTFSP in case the EDP recommendation is revised. The principle of the primacy of the EDP suggests that in case a revised EDP recommendation is made, an MTFSP, including in particular the adjustment effort, should be revised correspondingly, in spite of the provisions in the preventive arm that are meant to discourage changes in the structural adjustment path. This would restore consistency between the MTFSP and the EDP, at the price of a delayed adjustment. One could note that what matters for debt sustainability is the size of the total adjustment; simulations suggest debt dynamics would hardly change if the fiscal adjustment took a few more years. Therefore, it might be concluded that the problem is less serious than it at first appears, provided that pressure to adjust under the EDP is maintained. This proviso is crucial and coincides with the main risk to be addressed when launching and implementing the forthcoming EDPs.

Risk 3: Exit from an EDP might be based only on achieving the 3 percent of GDP deficit, turning the framework into a ‘free for all’

Possibly the most important question that the SGP reform has left unaddressed concerns the conditions for exiting an EDP (‘EDP abrogation’), in particular in cases when the EDP was opened based only on the deficit criterion (which, as noted, will be the case for all the forthcoming EDPs, including for high-debt countries).

The formulation of the relevant provisions in the new EDP regulation seems to suggest that, in case an EDP was not opened based on the debt criterion, ie it was opened only for breach of the 3 percent of GDP deficit threshold, the procedure should be closed as soon as the deficit has been durably brought under 3 percent of GDP. The relevant provision (Regulation 1264/2024, Article 8(3)) is worth quoting more fully:

“A Council decision shall only be taken pursuant to Article 126(12) TFEU [Council decision abrogating decisions or recommendations under the EDP “to the extent that the excessive deficit ... has in the view of the Council been corrected”] where the deficit has been brought below the reference value and is projected by the Commission to remain so in the current and following year and, where the excessive deficit procedure was opened on the basis of the debt criterion, the Member State concerned respected the corrective net expenditure path set by the Council in accordance with Article 3(4) or Article 5(1) of this Regulation” [Council recommendation for the correction of the excessive deficit or Council decision to give notice to take measures for deficit reduction (escalation of the EDP in case of no effective action in response to the recommendation)].

The previous sections have highlighted the risk that the forthcoming EDPs may fail to achieve compliance on the part of high-debt countries with the debt-sustainability requirements that are central to the reform, either because the initial adjustment path may not be sufficiently stringent (Risk 1) or because the countries may deviate from the adjustment path without facing serious consequences (Risk 2).

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 deficit would undermine this reassuring conclusion.

If, as the formulation of the provisions on abrogation may lead them to expect, high-debt countries are able to exit the EDP solely by bringing the deficit below 3 percent of GDP, irrespective of where they stand relative to the debt-sustainability requirements, there is reason to be afraid that the debt-sustainability requirements will never be enforced.

One might argue that a high-debt country that exits a deficit-based EDP with an accumulated deviation relative to the adjustment path in its MTFSP (although likely revised from its initial version, to reflect intervening revisions in the EDP), should immediately face the (re-) opening of the EDP based on breach of the debt criterion.

Evoking this scenario explicitly is equivalent to showing its implausibility. Against the unpalatable prospect of revolving-door EDPs, the temptation will be simply too strong to exploit all the leeway available under the rules. In particular, the Commission and the Council might leverage the ambiguities in the provisions allowing for the revision of MTFSPs and the resetting of the ‘control account’ in which the deviation from the adjustment path is recorded, to make a ‘clean slate’ of all past deviations when countries exit the EDP. The Commission and Council might ask those countries simply to submit an entirely new MTFSP.

A clean-slate scenario for high-debt countries after achieving the 3 percent of GDP deficit is likely to have substantial negative ramifications for the working of the entire framework.

Besides constituting a source of moral hazard, it would exacerbate the inequality of treatment across countries. Compared to those starting from lower deficits, the countries initially made subject to an EDP for breach of the 3 percent of GDP deficit threshold would effectively be granted a potentially much longer adjustment to satisfy the debt-sustainability requirements of the preventive arm.

It is not difficult to imagine that, to mitigate this inequality of treatment, the Commission and the Council would adopt a comparably lenient attitude toward deviations from the adjustment path by countries with deficits below 3 percent of GDP. Specifically, such deviations might never be considered sufficient reason for opening debt-based EDPs against these countries, even if their debts exceeded the 60 percent of GDP threshold. In this connection, one should recall that, although the EDP regulation contains a presumption that, for countries facing “*substantial public debt challenges*”¹², a deviation from the adjustment path in the MTFSP should lead to the opening of the debt-based EDP, the presumption is far from absolute. The Commission and a Council continue to enjoy wide discretion in assessing all the “*relevant factors*” before deciding the opening of the EDP for breach of the debt criterion. This stands in contrast with the ‘quasi-automatic’ opening of the EDP for breach of the 3 percent of GDP deficit threshold.

The outcome of this scenario would be an early disintegration of the SGP reform into a ‘free for all’, with the 3 percent of GDP deficit threshold remaining, effectively, the only fiscal rule that countries would need to care about. While assessments of the likelihood of this scenario might differ, it should be noted that it retraces almost exactly the history of the first attempt to operationalise the debt criterion of the EDP by the ‘six-pack’ reform: the adoption of a transitory regime before the full application of the newly introduced ‘debt rule’ ended up in the rule never being applied (Box 3).

12 Regulation 1264/2014 Article 2(4). Substantial debt challenges are understood to refer to countries classified as ‘high-risk’ according to the medium-term sustainability risk classification of the Commission Debt Sustainability Monitor (European Commission, 2023a). In the 2023 Monitor, this category included Belgium, Greece, Spain, France, Croatia, Italy, Hungary, Portugal and Slovakia.

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 deficit-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 sustainability¹⁴. This 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 basis of the deficit criterion may extend beyond bringing the deficit below 3 percent of GDP. Specifically, Article 3(4) of the Regulation amending the EDP regulation prescribes that (emphasis added): “Where the excessive deficit procedure was opened on the basis of the deficit criterion, for the years when the general government deficit is expected to exceed the reference value, the corrective net expenditure path shall be consistent with a minimum annual structural adjustment of at least 0,5% of GDP as a benchmark” (sic).

of GDP. The abrogation provisions quoted above make sufficiently clear that a debt-based EDP cannot be abrogated if the country does not respect the structural adjustment (“*net expenditure*”) path. The provisions are not equally clear, however about the length of the period during which compliance with the net expenditure path should be ensured, before the EDP can be abrogated.

If it is accepted that the period covered by the EDP should in principle coincide with that covered by the MTFSP, this would seem a natural reference for verifying that the abrogation condition has been satisfied. Two further specifications could be added to complete the conditions to qualify for abrogation: allowing for early abrogation of the EDP in case the sustainability requirements have been achieved (an unlikely scenario for high-debt countries); and requiring a minimum period of uninterrupted adherence to the net expenditure path before abrogation. Note that the latter specification was explicitly envisaged in the original Commission proposal for reforming the EDP regulation¹⁵. It could be reintroduced in the revision of the Code of Conduct or analogous specifications following the entry into force of the reform. Finally, it would be desirable that the conditions for escalating the EDP should be clarified, in particular whether the above-described ‘nominal bias’ (Risk 2) should continue to constrain the operation of the debt-based EDP.

Conclusion

There is a risk that implementation of the forthcoming deficit-based EDP could lead to an unravelling of the entire reform. This could happen if the implementation allows high-debt countries: i) to undertake, at least initially, less fiscal adjustment than they would be required to under the new preventive arm, that is, if they were outside an EDP; ii) to further postpone the adjustment in the course of an EDP without having to face consequences; and, above all, iii) to exit an EDP purely based on the achievement of the 3 percent of GDP deficit threshold.

This may not be the intention of the prescriptions that countries will receive when the EDPs are opened. It may well be the outcome by the time the EDPs are closed, based on past experience with the implementation of the SGP.

Preventing this requires a common understanding between the Council and the Commission that:

1. The adjustment path prescribed under the deficit based-EDPs should be consistent with the debt-sustainability requirements of the preventive arm.
2. A deviation from the initial adjustment path should not result in a revised path that moves further away from the debt-sustainability requirements and does not trigger any penalties under the EDP.
3. Even if a country has been made subject to an EDP only for breach of the deficit criterion, it should also satisfy the EDP debt criterion for the procedure to be abrogated. The conditions for abrogation and escalation of the debt-based EDP should be clarified.

A common understanding on these points could be put forward by the European Commission and endorsed by the Council.

¹⁵ The Commission proposal for revision of the EDP regulation (European Commission 2023b) required (Article 8(3)) that for the abrogation of a debt based EDP: “*the Member State concerned respected the corrective net expenditure path set by the Council in accordance with Article 3(4) or Article 5(1) of this Regulation [Council recommendation for the correction of the excessive deficit or Council decision to give notice to take measures for deficit reduction (escalation of the EDP in case of no effective action in response to the recommendation)] over the previous 2 years and is projected to continue to do so in the current year on the basis of the Commission forecast.*”

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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