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New fiscal rules in the EU: A Delicious Gruyere Cheese

24-02-14

The new EU fiscal rules, or more formally: the new framework for the EU's economic governance, risks not achieving healthier public finances nor a sustained drive for structural reforms and much needed investments. Hence, these new rules are a disappointment at a moment that the EU and its member states are desperately in need of fiscal space and augmented growth.

The Stability and Growth Pact (SGP) was sealed in 1997 to ensure that countries in the European Union pursue sound public finance policies and coordinate their fiscal policies. The specific provisions of the SGP have been revised on several occasions but two basic principles remained: budget deficits of individual member states could not be larger than 3% of GDP (Gross Domestic Product); and the debt to GDP ratio of member states should over time tend to 60% of GDP.

In 2020 the European Commission suspended the SGP so that member states had more fiscal (or budgetary) room to deal with the overwhelming nature of the Covid-19 pandemic. The war in Ukraine and the sudden outbreak of inflation inspired the Commission to prolong the suspension of the SGP rules for a further three years. In April 2023 the Commission produced a proposal

intended to overhaul the suspended framework of economic governance. As was to be expected, the Commission proposals recalled the tale of Goldilocks. They were too tough for the mostly Southern member states of the EU, and too lax for the Nordic “frugals”. Last week the complex and excruciatingly difficult negotiations among government heads in the Council, within the European Parliament and between these two institutions were concluded. A provisional agreement on a new set of rules for economic governance was agreed.

Given Belgium’s presidency of the Council of the European Union during the first six months of this year, it was Belgian Deputy Prime Minister and Minister of Finance Vincent Van Peteghem who acted as the Council’s negotiator during the final trilogues. Van Peteghem claimed that “the new rules will significantly improve the existing framework and ensure effective and applicable rules for all EU countries. They will safeguard balanced and sustainable public finances, strengthen the focus on structural reforms, and foster investments, growth and job creation throughout the EU”. Let’s do a little check whether such high expectations are warranted by the factual evidence surrounding the new rules.

The basic objective of the new framework, so the provisional agreement stipulates, is the reduction of fiscal deficits and debt ratios in a gradual, realistic, sustained and growth-friendly manner. It should achieve this reduction while protecting reforms and investment in strategic areas such as digital, green, social, or defense. On top of all this, appropriate fiscal space for counter-cyclical policies has to be foreseen.

The starting point of the evaluation process in the context of this new framework will be the “reference trajectory”. The Commission has to develop this “trajectory” for countries with debt ratios exceeding 60% of GDP or where the

government budget deficit exceeds 3% of GDP. By mid-2023, 13 of the 27 EU member states had debt ratios in excess of 60% of GDP. This list was headed by Greece (166.5%), Italy (142.4%), France (112.4%), Spain (111.2%), Portugal (110.1%) and Belgium (106%). At the other end of the debt spectrum we find Estonia (18.5%) and Bulgaria (21.5%). Ten member states are showing annual deficits in excess of 3% of GDP, with France, Belgium, Spain and Slovakia "in the lead" here. The Commission will thus be very busy developing reference trajectories for the multitude of offenders of the new rules.

The "reference trajectory" will foresee a four year period for government debt to be brought onto a plausibly downward trajectory, taking into account a deficit resilience safeguard. This safeguard means that a buffer needs to be foreseen, or at least can be foreseen, on top of the 3% deficit reference value in order to create extra fiscal room. This "reference trajectory" then becomes the subject of a discussion between the member state and the Commission, a discussion that will lead to the final plan for fiscal adjustment. All these national plans need to be endorsed by the Council. If "certain" reforms and investments are carried out by member states the adjustment period of four years can be prolonged to seven years.

Got it? Well, then you should realize this framework very much resembles a Gruyere cheese, with as many holes as solid substance. The room for discussion and wheeling and dealing, most of all by the larger member states, is eye-popping. Vague definitions and concepts, potential exceptions, unclear conditionality: the provisional agreement has it all. What, for example, exactly is a plausibly downward trajectory of government debt? How will be determined what a possibly-needed fiscal buffer in excess of a 3% deficit is, and how large that extra buffer can/should be? But most of all: the interplay between the

trajectory and reforms and investments in green, digital, social and defense related items. This is the ultimate gourmet box, full of delicacies for those reluctant, for whatever reason, to put their public finances on a structurally sound basis. Last, but not least, there is the final endorsement by the Council. Even dubious plans will tend to pass here since vetoing one country's plan can easily lead to revengeful counteraction. You scratch my back, I'll scratch yours.

Member states will be extremely creative in arguing that reforms A, B and C and investments X, Y and Z justify extension of the adjustment period from four to seven years. Some of these claims might be justified. More likely is that the Commission might see the emptiness of some other claims but lacks the political "degrees of freedom" to act accordingly. If the practices under the old rules are any form guide, not much good is to be expected. In the past the Commission showed its teeth very selectively, preferring to target smaller member states and skirting confrontation with larger member states. Believe me as former minister of Finance for Belgium: I was there, I've seen it.

Moreover, there is nothing in the new rules that give the Commission *real* power to forcefully intervene. The new rules contain an abundance of possible excuses that can be used in order to exonerate even serial offenders of the "reference trajectory". The baseball bat that Theodore Roosevelt, American president from 1901 till 1909, liked to have at this side during negotiations is still missing for the Commission. But even if it had been created, it would have been interesting to see whether the next Commission would really use it.

The optimism that Belgian minister of Finance Vincent Van Peteghem displayed immediately after the deal on the new rules was finalized, is commendable but unfortunately devoid of credibility. Despite the dire economic forecasts of this moment, we might get lucky (forecasters tend to be increasingly

on the wrong side of reality). We might see more sustainable public finances and more growth, investments and job creation becoming a reality. But that brighter picture will most certainly not come about as a direct consequence of the new fiscal rules.

There is another most important issue directly related to these new fiscal rules that has remained to a large extent absent in the first comments. A solid fiscal framework aiming at healthy public finances is crucial for the efficient functioning of the monetary union and the euro. Politicians and economists pleading for laxer rules do not seem to realize that such an argument undermines the monetary union in a fundamental way. If and when public finances of one or more member states derail, the choice will be simple. Either these countries will have to leave the monetary union (which will inevitably be a very messy process) or the European Central Bank (ECB) will have to come to the rescue on a massive scale (which will inevitably also be a messy process). Mario Draghi's "whatever it takes" slogan will gain a new dimension when one or more of the larger member states go, so to say, "the Greek way".

Resisting a rigorous and binding framework for the public finances of member states of the European monetary union boils in the end down to creating life-threatening risks to the existence and continuation of that monetary union.