Hertie School
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Policy Brief

"It's the politics, stupid"
Don't squander this golden opportunity for reforming the fiscal rules

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#FiscalRules
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On the reform of fiscal rules, the EU risks letting a once-in-a-decade opportunity slip. The time window for a successful reform is tight. And the Commission's current proposal is economically sound but politically overconfident. This risks drawing the Commission into political fights it cannot win, and would repeat some of the mistakes of the last reform process. At the same, current rules remain impossible to apply. Those who romanticize the old framework therefore need to realize that a retreat to the old system is not an option. The EU thus needs a compromise and needs it fast. To get there in the little time left, we propose four improvements: first, the system needs some numerical benchmarks for debt reduction in the adjustment period; second, it should include a clear definition of the scope of possible deviations through growth-oriented reforms and investments; third it should come with explicit carve-outs for national expenditures linked to some EU programs; and fourth, it needs credible enforcement through better ownership not only at the national but also at the European level.

1) Introduction

The EU risks letting a once-in-a-decade opportunity slip when it comes to reforming the fiscal rules. For the first time in years, member states agree on the need for ambitious reform and a broad direction of travel. The European Commission put forward the main contours of a reform proposal in its Communication last November and finance ministers have now officially accepted it as the basis for negotiations. The next step is the presentation of a concrete legislative proposal by the Commission. These are all good signs. Even so, the reform process could still fizzle out for two reasons.

First, the current proposal is economically sound but politically overconfident. It includes significant advances toward more realistic, economically meaningful, and enforceable debt paths. However, it also suggests outsourcing many of the EU's fiscal policy discussions to seemingly technocratic processes and bilateral negotiations with member states. In the short run, this makes it hard to build the political backing to get a reform across the finishing line. Talks among finance ministers at the ECOFIN meeting in mid-March confirmed that some capitals expect

substantial changes before agreeing to any legislative proposal. In the long run, the Commission could be drawn into political fights it cannot win and mistakes made in the last reform process could be repeated.

Second, the timeline for a successful reform is tight. Legislative discussions on the file need to start in the coming weeks and be concluded by the end of the year. Otherwise, they risk getting bogged down in the politics of next year's European elections – effectively put on hold until a new Parliament and Commission are in place. In the meantime, those who romanticize the old framework need to realize that current rules remain impossible to apply. The alternative to reform therefore is not a retreat to the old system. It is, put bluntly, no fiscal rules at all.

Putting political tactics aside, the EU faces a simple choice: either national capitals find a common position and enact the necessary legislative change with the European Parliament in the coming months, or they give up on fiscal coordination for the foreseeable future. Given that financial markets remain nervous about the debt prospects of individual member states and need a clear signal on the soundness of national fiscal policies, failure would inevitably come with high costs.

The EU thus needs a workable compromise and needs it fast. This also means that all sides need to move. We present the main elements of such a compromise. It builds on the Commission Communication and its economic rationale for reform but, reflecting the Council Conclusions of the ECOFIN meeting in mid-March, addresses concerns about the politics thrown up by bilateral bargaining. For that, we suggest four changes to the current proposal:

1. Minimum numerical benchmarks for debt adjustment during adjustment periods.
2. A clear definition of the scope of growth-oriented reforms and investments.
3. Explicit exemptions for some national expenditures in EU-linked programs.
4. Credible enforcement through better ownership at the national and the European level.

2) The Commission's current proposal

The deficiencies of the EU's maligned fiscal rulebook have been widely discussed: The current system is ineffective and in part economically misguided. It is overly complex, prescribes economically harmful and politically unrealistic debt adjustment paths, suffers from procyclicality, and has failed to safeguard public investments from spending cuts. On top of all that, national compliance with the rules has been at best sporadic.

The Commission now plans to address these shortcomings through a broad-based governance reform. In brief, it would maintain the Treaty-based references to annual deficit and overall debt limits of 3 and 60 percent of GDP. Beyond that, however, it would replace the universal and largely fixed rules that govern how much member states need to reduce their debt-to-GDP ratios each year with a focus on country-specific multi-year budget plans. The proposed process would embrace three steps: first, a technical analysis of debt sustainability by the Commission; second, political negotiations about national fiscal structural plans; and third, largely automatic enforcement of the agreed plans.

The proposed three-step governance procedure

The first step focuses on a technical analysis of individual debt risks. For that, the Commission would compute a debt-sustainability analysis for each member state. In doing

so it would put member states in three different risk categories (substantial, moderate, or low public debt challenge) and develop country-specific fiscal reference paths for each country. These reference paths would be set in terms of net primary expenditures (i.e., government spending net of discretionary revenues and excluding interest payments and cyclical unemployment benefit costs) and cover at least four years. For member states with substantial debt risks, the Commission wants to design paths that ensure that after an initial adjustment period of four years debt ratios are plausibly tapering for a decade. In the case of member states with moderate debt challenges, the decline in debt ratios would only need to start seven years after the plan's start. All these estimations would assume no policy change. In other words, they would rest on the assumption that no reforms or investments take place that have a direct impact on debt sustainability. The Commission would publish the results, methodology and data underpinning its analysis.

Politics takes center stage under step two. Based on the reference paths, member states would develop their four-year fiscal structural plans in terms of net primary expenditures and corresponding annual spending ceilings. These plans could also include investment and reform commitments that would allow national capitals to ask for an extension of the initial adjustment period for up to three years. Here the proposal takes inspiration from the process of designing National Recovery and Resilience Plans (NRRPs) in exchange for grants and loans under the Recovery Instrument. The proposed plans would then feed into bilateral negotiations between the Commission and member states. The Commission would evaluate if the plan fulfilled its requirements. If yes, it would send it to the Council for approval. If not, it would ask member states to improve the plan. If member states and Commission failed to agree on a plan, the Commission's original reference expenditure path would revert to being the basis for fiscal surveillance and enforcement (if the Council agrees).

The third step is the implementation and quasi-automatic enforcement of the agreed plans. Unless exceptional events make the original one unfeasible, the adjustment path will remain unchanged for at least four years. However, if member states with a substantial public debt challenge fail to stick to the agreed annual expenditure ceilings, the Commission will open an excessive-deficit procedure. Here, the Commission proposes broadening the spectrum of possible sanctions by including new reputational (e.g. forcing national finance ministers to show up in the European Parliament and explain their policies) or less costly financial sanctions. At the same time, any failure to implement the agreed reforms and investments would automatically lead to revising the plan cancelling the more prolonged adjustment period.

Crucially, the Commission Communication leaves some questions deliberately open. It remains, for example, unclear how binding the original DSA (debt sustainability analysis)-based reference path would be, what types of investment would allow for an extension of the adjustment period or the precise nature of any new sanctions. That's all left to the draft legislation.

3) The key issue of the current proposal

On the economic side, the proposal gets a lot of things right. It would replace the rigid and ever more complex formulas of the existing preventive arm with more flexible, more realistic and, thus, more enforceable debt adjustment paths. It explicitly embraces reforms and investments within the discussion of debt sustainability and provides more incentives to tackle the denominator of the debt-to-GDP ratio. Moreover, annual net-expenditure ceilings provide easier to estimate and simpler to observe policy targets than the hard-to-communicate and error-prone cyclically adjusted fiscal balance. Medium-term adjustment

plans give more room to factor in fiscal policy trade-offs than yearly targets. Finally, the idea of letting member states develop their own fiscal structural plans builds on the experience of the Recovery and Resilience Facility (RRF) and is a clear attempt to answer the long-standing call for more national ownership as a critical prerequisite for better compliance.

Politically, however, it is overconfident. At its core, it proposes to replace rigid universal rules with flexible country-specific fiscal policy prescriptions. Analytically, this makes sense. National fiscal space and desirable debt paths depend on many contextual factors such as projected growth and interest rates that are impossible to capture with static codified rules. Institutional decision-making is better at dealing with these complexities. However, in practice, the proposed system would put the Commission in charge of much of the discretionary decision-making with the Council rubber stamping the outcome of the bilateral negotiations (rather than showing "European ownership" for the objectives of fiscal coordination and closely scrutinising the proposed agreements). Three main issues are especially important.

3.1) Debt sustainability analyses cannot escape politics

It is impossible to keep politics out of the development of reference paths. DSAs are not a purely technical tool and come with a lot of analytical degrees of freedom. Depending on the model the Commission chooses and the projections it makes on variables like future growth, inflation, or borrowing costs, it could end up with very different reference paths. The Commission's own DSA toolkit consists of five different models accounting for various scenarios and a stochastic debt projection to capture the wide uncertainty around the baseline. Full transparency about the methodology and the publication of the individual DSA paths makes them more verifiable. Yet, DSAs will keep an element of judgement.

Thus, reference paths will be politically contentious. The Commission will face the charge of making more lenient assumptions about the debt sustainability of some member states than others. National governments will find it difficult to rally support for challenging fiscal structural plans that might have looked very different if you tweaked a couple of inputs in the Commission's models. And projections will change over time, making it hard to justify why member states should stick to a plan based on outdated data.

Discussions on solving this issue focus on two strategies. First, some have suggested handing the analytical tasks of modeling individual debt sustainability to independent national fiscal councils or the European Fiscal Board. The idea is that technocratic institutions could ward off political pressure and hence arrive at more objective conclusions. However, the problem with a DSA-centered system is not that the Commission would develop better or worse models than independent financial institutions (IFIs). Rather the issue is that no matter who undertakes the analysis, the models come with too much uncertainty and discretion to generate political backing for stable fiscal plans. Moreover, the ECOFIN conclusions of mid-March show how lukewarm finance ministers are about strengthening the IFIs.

Alternatively, the Commission could reduce the political weight of its own DSA by making its calculations less binding. The ECOFIN conclusions indicate that this is the current direction of travel. In the process of translating the reference path to national plans, the Commission and member states would in this case discuss the plausibility of key parameters and adjust them if capitals, for example, "duly justify" why their growth projections should be more optimistic than the Commission's. This approach would give governments a greater say on expenditure ceilings and certainly increase national ownership. However, it would in turn supercharge the potential for unequal treatment.

The shift from codified rules to a common methodology for developing context-specific fiscal paths is a welcome attempt to move from pure rules to more institutional decision-making. However, the hard truth is that the institutional and political preconditions to make this move work are not at hand. A workable compromise, therefore, must take some weight off the DSA.

3.2) Plans need clearer guidance on the scope and criteria for deviations through investments and reforms

The design of national fiscal structural plans is the main moment of politics in the new system. These plans will also have to solve a central conundrum prompting the investments and reforms in the first place: how to square the need to ensure debt sustainability with the requirement to massively increase public investments in the green transition. The current idea is to achieve this through bilateral negotiations between the Commission and individual member states on the assumptions feeding into the DSA and possible extensions of the adjustment periods. However, this is unlikely to do the trick for two reasons.

First, the proposal de facto gives the Commission little *leverage* to push member states towards more investment-oriented fiscal policies. Member states with a moderate or substantial debt challenge can extend their initial adjustment period by up to three years by committing to national reform and investment plans. However, the deal's attractiveness will depend on many unknowns, such as the expenditure ceilings in the reference paths, the scope for additional investment that they provide, the extent that member states can convince the Commission that some reform and investment plans change the forecasted variables in the model and the amount of required annual savings that can be postponed through extending the adjustment periods. At the same time, the Commission has nothing to offer to member states that do not or cannot apply for an extension (such as those with a low debt challenge). And even for those that want one, all carrots disappear after the first couple of years. At the initial adjustment period, the new system comes with zero formalised incentives to improve the quality of national budgets.

Second, the proposal lacks guidance on the *kind* of investments and reforms that could lead to exemptions on the reference paths. This is not a trivial question. For example, whether a public investment generates more revenues than it costs and, thus, contributes to debt sustainability, in the long run, is often hard to predict. Moreover, a lot of the public investments Europe needs most, for example, to support the climate transition, have a small fiscal multiplier. They are, thus, unlikely to contribute to debt sustainability in a strict sense whilst constituting an indispensable investment in European public goods. The current proposal comes with a lot of discretion about how to define the kind of investments that qualify for an extension. Whether this is judged to be a good solution or not ultimately depends on trusting the Commission and member states to find the right kind of compromises. Given that the decision is deeply political and has important economic consequences this is simply not good enough. Investment criteria need more *ex ante* legislative guidance.

3.3) Automaticity will not solve the issue of enforcement

The core of the proposal is greater flexibility in the definition of fiscal paths in exchange for more rigorous enforcement. For that, the Commission has suggested some new instruments plus the suggestion that deviations from the agreed path will, by default, lead to an Excessive Deficit Procedure. Moreover, a combination of reputational and financial sanctions is proposed that are meant to have a lower hurdle to cross. However, a central lesson from the current system is that implementation ultimately does not depend on the form of sanctions but on national ownership for compliance and European ownership for

enforcement. The current proposal has issues on both fronts.

On national ownership, the proposal will significantly improve the current system. The fact that member states will design the individual fiscal structural plans helps to create commitment to the fiscal trajectory. Moreover, the ECOFIN conclusions underlined that the plans should be synched with national electoral cycles and that incoming governments should be allowed to renegotiate their commitments. However, much of the current plan for ownership rests on the idea of an analogy between fiscal structural reform plans and the NRRPs within the Recovery and Resilience Facility. However, with no EU money upfront, the Commission can hardly expect the same level of national commitment to detailed plans. As a result, these plans and how they are monitored should be much less detailed and ambitious.

On European ownership, the current system shows that enforcement requires political judgement. No rule can be applied outside its political or economic context. The problem with the current system is that the move towards quasi-automatic enforcement in the Council through reversed qualified majority voting *de facto* outsourced this required judgment to the Commission to evaluate. While this was supposed to lead to stricter enforcement it did not. In practice, it forced the Commission to politicise the assessment of whether member states followed the rule or not and undermined the system's credibility. The current proposal risks repeating the same mistake by suggesting that deviations from the national plans will lead to more automatic sanctions and by putting the Commission in charge of identifying such deviations. Rule enforcement needs both assessment and political ownership at the European level, most importantly by the Council.

4) Way forward – elements of a workable compromise

A workable compromise needs to build pragmatically on the existing proposal and ensure that the legislative procedure can start as quickly as possible. It also needs to take pertinent criticisms into account. We propose that this can be achieved through four changes:

1. Add a numerical anchor for DSA-based reference paths that defines the minimum fiscal adjustment required under the assumption that there is no policy change.
2. Add a fixed margin for how much member states can deviate from the reference path in exchange for reforms and investments.
3. Include explicit exemptions for some EU-linked national expenditures that finance European public goods.
4. Strengthen a realistic plan through a pragmatic focus on big-ticket reforms alongside greater European ownership.

4.1) Include a numerical benchmark as minimum lower bound for the reference paths

First, we propose adding a numerical benchmark for the minimum fiscal adjustment member states must undertake during the adjustment period in the absence of reforms and investments. This benchmark would absorb some of the political weight of the DSA, serve as a political backstop for the required adjustment, increase transparency, and reduce the risk of unequal treatment. It would also be a concession to those member states that fear that the Commission's estimations would set unambitious fiscal benchmarks.

The benchmark's primary purpose would be to serve as political insurance. In that sense, it would constitute a limited return to more codified rules – not because they are economically smart but politically indispensable. In practice, there are different ways to operationalise this benchmark based on the existing literature (e.g. here, here, and here). It could, for example, require member states to reach a positive or zero primary balance in the

adjustment period. It could also be defined as a structural balance rule or the provision that the rate of increase in net primary expenditures should not exceed real potential growth adjusted for inflation.

From a technical perspective, there are certain criteria that the benchmark should fulfil. First, it should demarcate a minimum. Given its role as a political backstop, it should not replace the DSA-based ceiling by default but provide a higher expenditure ceiling in most cases. Second, it should avoid pro-cyclicality and target (or be translated into it) net primary expenditures to be compatible with the new system. Third, it should be differentiated across countries according to their debt levels. Fourth, it should be easy to communicate as an economic minimum.

Ultimately, there must be a political consensus on the economic choice of minimum adjustment. This choice should not be the outcome of a technical modelling decisions. Instead, the details of the benchmark must be politically discussed and agreed in the negotiations on the legislative proposal.

4.2) Add a fixed margin for how much member states can deviate from the reference path in exchange for reforms and investments.

The system needs a more explicit definition of how much additional fiscal space it provides in exchange for reforms and investments. And it needs better incentives to make member states use it. At the moment, reforms and investment discussions would likely be mushed together into bilateral negotiations about model projections and possible adjustment extensions with uncertain outcomes and weak incentives. We propose addressing this by letting politics decide *ex ante* on a fixed margin for how much member states can deviate from their reference paths in exchange for reforms and investments (i.e. through policy change) at a maximum. This comes with four advantages.

First, it would change the currency for policy change from temporal extensions to clear numerical deviations. On the one hand, this increases the transparency of the political bargain by clearly defining the additional fiscal space that member states can generate through reforms and investments. On the other hand, it would absolve the Commission from extending its debt sustainability analyses further into the future, adding even greater uncertainty.

Second, it would define the purpose of the reforms and investments that fall under this category. Since they qualify for deviations from the country-specific DSAs, policy changes should replace fiscal consolidation by fostering future growth and investments.

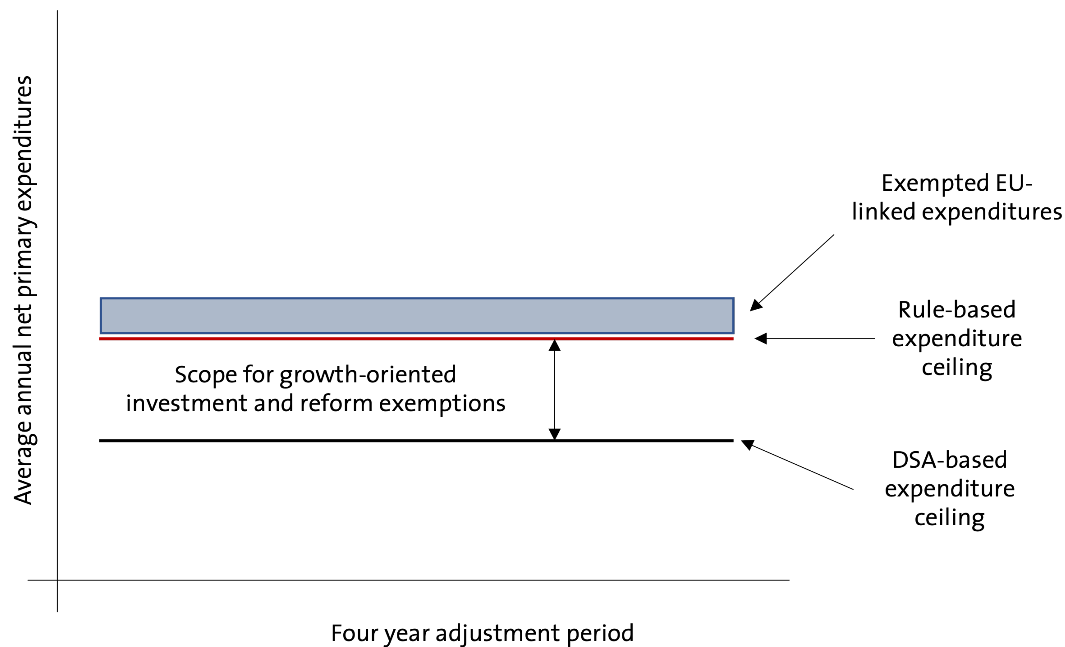
Third, it would provide the system with clear reform and investment incentives without an expiration date. A central problem of the current proposal is that it only offers such incentives for countries that would enjoy a big increase in fiscal room for maneuver via an extension of the initial adjustment and only provides them during that initial period. Our proposal would broaden the scope of beneficiaries and extend investment and reform incentives to all future fiscal structural plans. This also means that the maximum possible deviations should be sizeable. The larger the margin, the better the incentives for productive reforms and investments.

Finally, a fixed margin for deviations provides room for a compromise between the diverging interests of member states on the fiscal framework: A numerical anchor would assure more stability-oriented member states that fiscal adjustment does not go below a certain minimum and that the reference paths provided by the Commission are not subject to further negotiations. At the same time, it would reassure highly indebted member states that they can deviate from DSA-based ceilings they find too restrictive through productive

investments and reforms.

Box 1

One option would be to combine the need for a numerical backstop for the reference path and a better definition for the scope of deviations in exchange for policy change through a single numerical benchmark. In this case, the numerical benchmark would set out the minimum adjustment required in the fiscal structural plans and the difference between this numerical benchmark and the country-specific DSA path would define the scope for possible deviations through investment and reforms (see Figure 1).



This would simplify the governance framework and provide a common political backstop for the DSA in the first state of the process and its translation into national plans in the second stage. It would also add further reform and investment incentives for member states with substantial debt challenges since their DSA-based reference paths are more likely to lie substantially above the numerical anchor. However, the requirement of combining both in one would make defining the proper benchmark even more challenging.

4.3) Create explicit exemptions for EU-linked programs geared towards the provision of European public goods

Beyond stimulating domestic growth and debt sustainability, public investments are desirable, if not imperative, for the provision of European public goods. This applies especially to goals such as the green transition or energy independence for which investments may not generate big fiscal multipliers but are politically compelling.

Ideally, the EU would jointly finance such investments at the European level. In recent years, many, therefore, have argued that the economic governance review should include a bigger fiscal capacity for common investments at the EU level. Given that there is as yet no political consensus among member states on pursuing this route, the Commission refrained from putting it forward. Nonetheless, the issue remains critical.

For provision of such good at the national level, a (green) golden rule would seem useful, but it is prone to misuse. The information asymmetry between member state

administrations and Commission will make it hard to monitor closely the adequacy of classifying certain expenditure as linked to, say, the green transition. Incentives for a wide-ranging interpretation of the golden rule and reclassification are high. Introducing a golden rule option has thus not been pursued by the Commission.

We propose ensuring that such investments do take place by creating explicit carve-outs for some EU-linked programs within the fiscal framework. This takes its lead from the proposal of the German government and the provisions under the current investment clause but keep it linked to public goods, in particular in climate and energy. Above all, it would exclude climate- and energy-related EU loans under the RRF and RePowerEU. The national co-financing for other relevant EU budget projects and programs, such as those under the Green Deal, could also be considered.

It would come with several advantages. First, it would avoid the pitfalls of generalised exemptions under a golden rule. Instead, exemptions would hinge on the existing programs at the EU level with their definitions, regulations, and monitoring frameworks. Second, it would ensure that all member states have incentives to engage in relevant EU-linked investments. Third, it would not only adopt the current temporary framework of the RRF but also set incentives for the future to address common challenges with common EU-wide spending. Fourth, it would further strengthen the role of EU expenditure as a vehicle for compliance with European rules: by excluding the loans and co-financing from fiscal rules, it increases the attractiveness of European programs. It thus sets positive incentives for following the rules instead of issuing fines. These last two elements should appeal to the European Parliament in its deliberation of the legislative proposal.

4.4) Make enforcement more realistic by aligning plans with national government terms, focus more clearly on big-ticket reforms and increase European ownership

National ownership can only be ensured if the results of democratic processes are taken into account in the length of the plans. In the case of RRPs the political commitment written into the original agreement generally has been weighty enough to survive government change. However, in the absence of European money, the length and commitment of the new fiscal structural plans must take on board the realities and results of national elections. They should ideally be aligned with parliamentary terms. This would allow for adjustments in case of a change in governments as forseen in the ECOFIN conclusions.

Similarly, the investment and reform commitments will need to be embedded in national political choices and retain some flexibility in their implementation. These commitments will be of a big-ticket nature rather than RRP-like detailed plans. Implementation should be monitored at the European level as a second line of defense but most enforcement rooted in national politics.

Nevertheless, national ownership needs to be matched with European ownership. The dynamics of peer pressure have often led to a disengagement of the Council the monitoring and enforcement procedure. The Commission, on the other hand, often comes under immense political pressure to internalise possible objections from powerful and possibly affected member states at the level of the College. As a result, there is not enough ownership for getting serious about rule-enforcement in the two most important EU institutions of the process.

Accountability should be the answer. First, the European Parliament should be able to push the Commission and Council to explain their conduct in implementing and enforcing the surveillance framework. Strengthening the "economic dialogue" and stepping up the

scrutiny capabilities of the European Parliament (akin to the Congressional Budget Office in the United States), therefore, need to be part and parcel of the reform. Second, for the Council to take up its collective role, the link to the Heads of State or Government could be strengthened. Under the current system, the European Council takes note of the outcome of the European Semester process at its June meetings before the Council adopts the country-specific recommendations in July. This is mostly a formality. The reform should establish a more formal escalation procedure whereby one or more member states can ask for a discussion at the leaders' level where they disagree with a decision not to trigger sanctions or censor deviations from the expenditure path. Such a procedure was also included in the RRF Regulation upon request of of those member states that were keen not to leave the assessment of the RRPs and their implementation at the technical level.

5) Outlook: Still a partial package but a necessary step now

It is high time for a reform of the economic governance framework. Given the different interests and economic situations of member states, this reform was always going to be complicated. Now there is a real risk that the process gets stuck and postponed until after the European elections. As this would essentially push the EU into a situation without fiscal coordination for several years, this is in no one's interest.

We contour the main elements of a compromise that could help to avoid this. It builds on the economic rationale of the current proposal but takes up legitimate concerns that the politics of bilateral bargaining could overburden the Commission. It could also help address the central conundrum of how to marry economic rigor with political ownership and common oversight.

A critical omission remains the absence of a fiscal capacity at the EU level. Our proposal seeks to address this to a certain extent. The exclusion of some EU-linked spending from the rules recognises the need for more expenditures on common European challenges and the pressing urgency to fight climate change collectively. However, this is clearly a second-best solution for propping up common spending on common European issues. In the medium term, the EU's economic governance framework will remain incomplete without returning to the discussion on a common capacity.

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