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EU FISCAL FRAMEWORK

More ownership and flexibility in the adjustment: will it work?

Today, the European Commission unveiled proposals for a reformed EU economic governance framework, which will be discussed with Member States. Consensus should be reached ahead of the start of the 2024 budgetary process. Proposals include simplifying the rules, with the nationally-financed net primary expenditure becoming the single operational indicator anchored on debt sustainability. In addition, the new framework would allow financing for strategic initiatives, such as the green transition, and more ownership and leeway to Member States to set their adjustment path. This would come together with stronger ex-post enforcement. The proposal makes a lot of sense to me, but will it work? What would be the implications for financial markets? As usual, the devil is in the not-yet-specified detail, the implementation of the new framework, and its effectiveness. It should enhance the credibility of fiscal policies and reassure financial markets. In turn, this should favour a reduction of government bond yield spreads of high-debt countries. But there are also potential critical issues.

- **To make a long story short.** The review of EU fiscal rules was scheduled in the context of the planned revision of the so-called 'Fiscal Compact', but it took a completely different route with the outbreak of Covid. As a result, rules were 'suspended' and the debate put on hold. In October 2021, the Commission relaunched the public discussion on reviewing the EU's economic governance framework, inviting all key stakeholders to contribute, including the Council (ECOFIN), the Eurogroup, the European Parliament and relevant committees. Today, European Commissioners Valdis Dombrovskis and Paolo Gentiloni presented a reform proposal aiming for "a simpler and integrated architecture for macro-fiscal surveillance to ensure debt sustainability and promote sustainable and inclusive growth."

- **Changing the approach?** Admittedly, the old rules have not worked very well in promoting counter-cyclical behaviour, especially given repeated shocks to the economy. The aim is now to promote "prudent fiscal strategies" and growth-enhancing investment and reforms that are "indispensable and mutually reinforcing in ensuring fiscal sustainability and enabling the transition towards a climate-neutral, digital and resilient economy." In addition, they should reduce "high public debt in a realistic, gradual and sustained manner," given the state of the economy, by "improving national ownership, simplifying the framework and moving towards a greater medium-term focus, combined with stronger and more coherent enforcement." Finally, "the framework should be robust to changing economic conditions and uncertainty, requiring a solid and predictable rule book and escape clauses for exceptional circumstances."

- **Where do we stand, and where do we want to go?** Debt sustainability is back[1] following a long period in which low inflation, low interest rates and quantitative easing have put financial markets under anaesthetics. Is the new proposal up to the task of addressing the 'new normal' after the recent spike in inflation, the lifting of QE and maybe QT around the corner, the higher cost of borrowing, and the risk of lower potential growth despite NG-EU? The Commission identifies as fundamental problems (1) the lack of differentiation between Member States despite different fiscal positions, (2) the pro-cyclical stance of national fiscal policies, (3) the lack of prioritisation on growth-friendly measures, (4) complexity (multiple indicators, reliance on unobservable variables, and lack of transparency, ownership, and predictability). Moreover, the links between the various strands of surveillance "had not always been fully exploited." Recent counter-cyclical fiscal support and policy coordination in times of crisis is instead seen as a positive example. Finally, the green and digital transition, building increased social and economic resilience, energy security and the build-up of defence capabilities will require a sustained level of investment that needs to be financed in the years to come. Thus fiscal rules have to accommodate these

[1] See Codogno, L. and G. Corsetti, "Shifts in expectations may undermine debt sustainability", VoxEU CEPR, 3 November 2022, Shifts in expectations may undermine debt sustainability | CEPR.; Codogno L., and P. Reichlin, "Rethinking debt sustainability?", and L., and G. Corsetti, "Debt sustainability analysis is back. Sudden shifts in underlying factors may push high-debt countries into a bad equilibrium", in Economia Italiana, October 2022, Rethinking Debt Sustainability? – ECONOMIA ITALIANA.

additional needs. The recipe proposed by the Commission calls for more ownership at the national level and a medium-term approach to debt reduction. Here are the key features.

- **Simplification, ownership, and medium-term-oriented gradual debt adjustments.** The Commission document presents the "main contour" of a possible reform of the economic governance framework, meaning that much technical work would be needed to translate the proposal into legally binding provisions. When the Commission puts on the table a proposal, it means that sufficient consensus has already been reached among the major stakeholders. However, some disagreement, especially on crucial details, is still possible. At any rate, the key features of the proposal are very much in line with expectations.[2] First, it is a full-fledged revision of the governance architecture with a greater focus on the medium term (at least four years) and not just fiscal rules. It aims to integrate "fiscal, reform and investment objectives into a single holistic medium-term plan." The following scheme taken from the Commission's communication summarises the revised framework.

Figures 1. The revised fiscal framework the Commission suggests

National ownership embedded in EU framework	Simplification and focus on fiscal risks	Enforcement
0. Commission puts forward reference adjustment paths 1. Member States propose medium-term fiscal-structural plans 2. Annual budgets will commit to follow the fiscal trajectory and ensure that debt will start converging to prudent levels within the adjustment period 3. Member States can request a longer adjustment period underpinned by reforms and investments 4. Council endorsement of the plan 5. Stronger role of national IFIs	1. Net expenditure path anchored on debt sustainability and agreed by Council will be the single fiscal indicator 2. Surveillance and enforcement will be risk-based 3. Debt reduction benchmark, benchmark for reduction in structural balance, significant deviation procedure and matrix of requirements no longer exist	1. Deficit-based EDP (3% of GDP threshold) maintained 2. Debt-based EDP will be operationalised and strengthened, as a tool to ensure compliance with the agreed net expenditure path 3. Financial sanctions toolbox will be enriched with smarter sanctions 4. Macroeconomic conditionality will be maintained

Source: European Commission, "Communication on orientations for a reform of the EU economic governance framework", COM(2022) 583 final 9/11/2022.

- **Commission proposes, but the country decides.** The cornerstone of the framework is a "National medium-term fiscal-structural plan" that each country would prepare and approve nationally, also by looking at the Commission's country-specific reference adjustment path. As already happening in the context of the European semester, there would be an intense dialogue between the Member State and the Commission on the plan's contents. The plan should ensure consistency, a streamlined process and deliverables. It would be discussed with the Commission, and once positively assessed, it would be endorsed by the Council, with the possibility for the Member State to revise it only after a minimum period of four years or earlier in case of objective circumstances making the implementation of the plan unfeasible. Finally, there would be a single operational indicator anchored on debt sustainability: **the nationally-financed net primary expenditure, i.e. expenditure net of discretionary revenue measures and excluding interest expenditure as well as cyclical unemployment expenditure**. This aggregate is under the direct control of the government and allows the operation of automatic stabilisers. Moreover, it is supported by a large body of economic literature. Finally, this would be monitored via annual progress reports. It would become the new buzzword in Brussels.

- **More stringent enforcement?** The 'deficit-based EDP', i.e. the excessive deficit procedure for the breach of the 3% of GDP deficit reference value, would remain unchanged compared to the current framework. However, the focus will be a forward-looking assessment over the next ten years. Instead, the 'debt-based EDP' would be strengthened for activation and abrogation, with departure from the agreed 10-year debt-reduction path opening an EDP automatically for high-debt countries. The same would happen to countries with moderate public debt challenges, but only if 'gross policy errors' are found. This division may well prove controversial. Sanctions would

[2] See also European Fiscal Board, Annual Report, 2022.

be broadened, for example, by adding 'reputational sanctions' besides going for (lowered) financial sanctions. They would also include restricting structural funds and the RRF for which macroeconomic conditionality applies. Robust escape clauses are perceived to be essential to deal with exceptional situations, both at the EU and the national level. They would allow temporary deviations from the medium-term fiscal path, provided the shock exceeds a 'normal range' not yet defined. Any such decision would have to be authorised by the Council. The acid test would only come by practising the new framework. Politically, going for sanctions has always been very delicate, and in my view, it will remain as tricky as in the past (although hopefully, there would be less need for that).

- **Is everyone free?** As the governance framework is moving towards a country-specific approach, the issue of consistency and equal treatment will surely emerge. Moreover, when there are few guiding principles, translating those into policy action may prove controversial due to different views between Brussels and each country's government. Yet, sufficient experience has developed over the year to suggest that this process could go smoothly if goodwill exists. The focus will be on "gross errors" in the conduct of fiscal policy, i.e. those that can have negative spillovers to other Member States and the currency union as a whole. Debt sustainability becomes the core of the exercise. The fiscal adjustment and surveillance become risk-based and differentiated by country while preserving the 3% deficit and 60% debt reference values embedded in the Treaty. Member States could request a three-year extension of the adjustment period, underpinning the request with extra reforms. Finally, the text says, "In case there would be no agreement between the Member State and the Commission, the reference multiannual net expenditure path would be used by the Commission and the Council for fiscal surveillance and enforcement." In other words, the onus of convincing the Commission and the other countries is on the Member State, and if the change is not agreed upon, the existing multiannual path will remain the reference. I saw some commentators announcing the end of fiscal austerity: they may have seen a different film. The new framework does not represent a loosening of the existing rules. It is a different approach, and it may even be argued that the policy framework would be strengthened, not loosened. There is more leeway for Member States to set their adjustment paths and more vigorous ex-post enforcement. Moreover, the debt-based EDP would be reinforced, which matters greatly, especially for high-debt countries.

- **If more national responsibility, will the commitment be more credible?** While very much welcome, the reform might give rise to different valuations and controversies between the Member State and the Commission, as there will be fewer reference points. In this regard, the National Fiscal Councils will play an expanded role in evaluating ex-ante and ex-post compliance with the plans. This approach adds to the overall onus and ownership at the national level. If the ownership is placed at the national level, the commitment becomes more credible, which should play well in financial markets. We will see whether governments will live up to their commitments.

- **Three potential issues.** First, national independent fiscal institutions would become crucial in the new framework. It is well-known that national fiscal councils' quality, competence, public profile, staffing and resources vary widely across the EU. The reform includes "reconsidering the mandate and role of the European Fiscal Board." Second, an enhanced dialogue would be needed to reach a common understanding of the challenges identified under the Macroeconomic Imbalance Procedure (MIP), making the analytical framework more forward-looking and focused on the evolution of risks and policy implementation. This is undoubtedly another much-welcome development, but it may well lead to controversies, and, as usual, the actual implementation of the framework would be the testing ground. Third, the Commission would conduct public stress tests and stochastic analysis, simulating common shocks related to short and long-term interest rates, nominal GDP growth, the primary budget balance and nominal exchange rates. Moreover, it will make public the reference net expenditure path and all the related methodology and underlying data. This is not new, as many of these exercises are already performed and made public at the national and European levels. Still, it would probably attract the same interest (and potentially financial market reaction) as the original stress tests on the European banking sector.

- **Bottom line: welcome developments with potential critical points.** First, this proposal is not yet final. Member States and the Commission should first reach a consensus; thus, some changes are possible. Then the Commission will table legislative proposals, which the European Parliament and the Council will examine. Consensus should be reached ahead of the Member States' budgetary process for 2024. Proposed changes will require some amendments to the legal framework but not Treaty changes. However, there is little granularity in the proposal's specifics, and as we all know, the devil is always in the detail. Having dealt with these issues in great detail over my nine years at the Italian Treasury, I have to say that I very much agree with the proposed changes. They will enhance the credibility and effectiveness of fiscal policies while addressing current problems. Yet, how the new

framework will be implemented is what counts, and tiny details might be more important than grand designs. I suspect that financial markets will want to test the resolve of national and European policymakers at some point. But, if implemented correctly, the reform should enhance credibility and thus reduce government bond yield spreads, especially for high-debt countries. But it is still too early to tell. For now, and from outer space, this proposal makes sense to me.

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