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THE FUTURE OF EUROPEAN FISCAL GOVERNANCE: A COMPREHENSIVE APPROACH

by Marzia Romanelli[*], Pietro Tommasino[*] and Emilio Vadalà[*]

Abstract

We review the reasons for limiting the discretion of national fiscal policies in the context of a monetary union and, on this basis, we assess the shortcomings of the current Euro area fiscal framework as well as the merits of the main proposals for its reform. Taking into account the elements of consensus that emerged in the debate, we outline a possible revision of the European fiscal rules. The framework we propose aims at public debt sustainability – focusing on those policies which are clearly harmful to member countries – and it is simple and transparent – avoiding the use of unobservable variables. The new framework would be based on a medium-term debt target and a multi-annual headline deficit profile consistent with that target. The new rules should be complemented with a common fiscal capacity, to compensate for the loss of policy discretion at the national level and to internalize cross-country fiscal spillovers. In particular, we suggest introducing a contingent facility, which would be activated only in cases specified ex ante or for the realization of common projects of exceptional nature (e.g. in the energy sector).

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1. Introduction[1]

The next few months will be crucial for rethinking the economic governance of the European Union. Last October, the European Commission resumed the debate on the *Economic Governance Review*,[2] which was suspended shortly after its launch – in February 2020 – due to the outbreak of the Covid-19 pandemic. The Commission added the large and abrupt increase in government debts due to the pandemic crisis to the critical issues it had already identified at the beginning of the review process (relating to the effectiveness of the rules to guarantee sustainable public finances and to prevent macroeconomic imbalances, excessive complexity and lack of national 'ownership').

The review should also be an opportunity to consider the possible future role of the common fiscal instruments – initially conceived as extraordinary and temporary – introduced at European level to face the economic consequences of the pandemic. The two most important examples are the Support to mitigate Unemployment Risks in an Emergency (SURE), through which the European Union can provide up to €100 billion of loans to EU member states for financing expenses for employment support, and Next Generation EU (NGEU), which makes over €800 billion available to EU member states in the form of grants and loans for supporting economic recovery and investments for the green and digital transitions.

The reaction of monetary and fiscal authorities to the pandemic crisis has been strong and timely. As a result, before the Russian invasion of Ukraine, most European countries had already recovered or were close to recovering pre-pandemic production levels. National fiscal policies were able to act decisively thanks to the activation, in March 2020, of the 'general escape clause', which has de facto suspended the numerical rules of the Stability and Growth Pact (SGP) until the end of 2022.[3] The decision to launch NGEU, signalling the firm intention to prevent divergences among member states from widening as a consequence of the crisis, had immediate and positive effects on investor confidence and on the sovereign debt markets, especially for countries with less fiscal space.

A window of opportunity is opening now. It is in the common interest of all member states to use the time until the reactivation of the Pact to rethink the rules and to complete the economic architecture of the Union, building a fiscal framework which is simpler, more growth-friendly and less procyclical, without imposing unrealistic fiscal consolidation efforts on still convalescing economies.

This paper aims to contribute to this effort by outlining a possible new fiscal framework centred on a 'sustainability pact' that each high-debt country would agree and co-sign with the Commission

[1] The views expressed in this paper do not necessarily reflect those of the Bank of Italy. The authors thank Andrea Brandolini and Stefania Zotteri for the comments received. The work benefited from the constant exchanges of opinion with – and the encouragement of – Fabrizio Balassone. Any errors remain the responsibility of the authors.

[2] European Commission (2021). On 1 December 2021, the Governing Council of the European Central Bank published its position on the Commission Communication. The Governing Council agrees on the conclusions of the analysis and reiterates the need to complete the institutional architecture of the Union, also with reference to a permanent central fiscal capacity (see European Central Bank, 2021).

[3] The deactivation of the general escape clause could be postponed due to the developments of the Ukrainian crisis (see European Commission, 2022).

and the Council of the European Union. This pact would include a medium-term debt target and a multi-year nominal deficit path consistent with the debt target itself. The deficit path would be binding and deviations would only be excused if, in the assessment of national and European independent fiscal institutions, they were due to macroeconomic surprises.

The new constraints would be flanked by a central fiscal capacity which would only be activated in the event of contingencies specified *ex ante* or for the realization of common projects exceptional in nature (e.g. in the energy sector).

The proposal could be implemented without changing the Treaties.

The new fiscal framework would have at its core the overarching objective of public debt sustainability, only preventing those national choices that represent a clear danger for the country itself or for its partners. Simplicity and transparency would be guaranteed by the use of observable indicators. The procedure for defining the objectives – grounded on information sharing and fair discussion – would strengthen national ownership and at the same time would result in a pact fully agreed upon by European institutions and other member states. Supervision by independent fiscal institutions would guarantee the fairness of the whole process.

The paper is organized as follows. In Section 2 it is argued that well-designed fiscal rules are useful – especially in the context of a monetary union – but they are not sufficient to guarantee adequate fiscal policies. Section 3 traces the evolution of the European fiscal framework and the results achieved so far. Section 4 reviews the main reform hypotheses for the European fiscal framework currently on the table. The next two sections outline our own reform proposal: a different set of fiscal rules (Section 5) and the introduction of a (contingent) central fiscal capacity (Section 6). Section 7 provides some concluding remarks.

2. The case for fiscal rules

When an unfavourable shock hits the economy, a temporary worsening of the budget balance and recourse to public debt are warranted to mitigate the downturn and its impact on households and businesses. It may be appropriate to resort to public debt, even in normal times, to finance investments that generate social benefits greater than private ones, or have return profiles which – although positive in terms of net present value – are not affordable for the private sector (either due to their scale, risk or time horizon).

However, economic analysis and the history of many countries remind us that collective choices can determine levels of deficit and debt that are higher than those granted by economic circumstances. Political economy distortions may also affect the composition of the public budget (for example by excessively favouring current over capital spending) and the timing of budgetary choices, resulting in procyclical policies.[4]

[4] Surveys of this literature can be found in Alesina and Passalacqua (2016) and Yared (2019).

There may be several causes of the deficit bias. First, policy makers can be tempted to exploit the fact that citizens only have partial information on the state of the public finances.[5] Second, difficulties may arise in reconciling the divergent interests of different social groups or different geographical areas. At any given moment, if there are conflicting preferences regarding the size or composition of the public budget and uncertainty about the electoral results, the current political majority has the incentive to resort to debt in order to increase its probability of being re-elected or – in the event that it is voted out of power – to reduce the room for manoeuvre available to subsequent majorities. In a dynamic setting, if public spending only benefits some specific areas or groups, but it is financed by general taxation, each group will tend to ask for an excessive share of resources, without fully internalizing the effects that this has on the overall budget.[6] Third, excessive deficits might be due to current generations not taking the well-being of future ones sufficiently into account.

Imposing constraints on fiscal policy can limit the deficit bias and contribute to a more transparent and forward-looking budgetary process.[7] These constraints are not necessarily only numerical. Indeed, in the literature, the concept of 'fiscal framework' encompasses, in addition to numerical rules (such as those that set quantitative limits to debt and deficit ratios in the EU), procedural requirements (for example, those about the deadline for the presentation of the budget, the information it must contain, the time span it has to cover, as well as provisions concerning who has the power to amend it) and the institutions involved in the drafting, approval and execution of the budget.[8]

In the short term, however, strict fiscal constraints can hamper the ability to respond to macroeconomic shocks. It is therefore necessary to strike the right balance between discretion and rules.[9] A credible fiscal framework, which also provides for exceptions in the event of adverse events beyond the control of the policy authorities, helps to anchor the expectations of households, businesses and financial investors in the medium term, thereby supporting the effectiveness of an expansionary manoeuvre when it is warranted.

In a monetary union, the importance of an adequate fiscal framework is even greater, as the sustainability of the public finances of each country is a fundamental condition for the stability of the whole area.[10] In each country, the deficit bias can be fuelled by the expectation of receiving

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[5] Puviani ([1903] 1973), Buchanan (1967), Oates (1988), Rogoff and Sibert (1988), Shi and Svensson (2006).

[6] Shepsle and Weingast (1981), Tabellini and Alesina (1990), Velasco (2000).

[7] Although the available evidence seems to confirm that there is a positive effect of the rules on fiscal discipline, it is not easy to exclude that this effect does not depend on other hard-to-measure variables. In particular, both the reduced propensity to run deficits and the very presence of rules could be due to structural characteristics (social cohesion, a stable political system and so on). See e.g. Burret and Feld (2014), Wyplosz (2014), Heinemann et al. (2018).

[8] Alesina and Perotti (1996), Hallerberg et al. (2007).

[9] To be fair, in some cases this trade-off is only apparent: in highly indebted countries, the positive effects of a fiscal expansion on private sector consumption and investment might be very limited, due to the growth in precautionary savings and the increase in risk premiums.

[10] Important early contributions are European Commission (1997), Artis and Winkler (1997), Eichengreen and Wyplosz (1998).

support from other partners or from the common central bank in the event of financial difficulties, because a public debt crisis in one country poses serious risks for the financial stability of the union. Bailout expectations reduce the perceived cost of a deficit increase, and therefore incentivize profligate national policies.[11]

Ideally, fiscal rules in a monetary union should also guarantee that each country's discretionary response to domestic cyclical economic conditions leads to an appropriate aggregate stance for the area as a whole. This is in general far from guaranteed, as national authorities do not fully internalize the impact of their decisions on other countries' aggregate demand[12] and on the average inflation rate. Having to deal with this externality may complicate the common monetary policy.[13] As we will argue below, however, the most effective tool to ensure policy coordination in a currency union is the introduction of a common fiscal capacity.

3. Fiscal rules in the EU: evolution over time and effects

The marginal cost of increasing debt is the interest rate required by investors on sovereign bonds. This rate incorporates a risk premium that reacts to the state of the public finances. Irresponsible fiscal policies should therefore first be discouraged by the increase in the cost of financing.

The EU Treaty includes two important safeguards that are meant to give bite to market-based fiscal discipline: the 'no-bail out' clause (Article 125), which prohibits member countries from taking on the debt of another country, and the prohibition of monetary financing (Article 123), which prevents the European Central Bank and the national central banks from financing governments.

However, the Delors Commission had already warned in 1989 that "the constraints imposed by market forces might either be too slow and weak or too sudden and disruptive".[14] Accordingly, with the Maastricht Treaty, the EU countries agreed to ensure national budgetary discipline by committing themselves to a common framework of rules instead of relying on the operation of financial market mechanisms alone.

The EU fiscal framework has been changed several times (Table 1). The Maastricht treaty (1992) introduced the reference values of 3 per cent for the deficit-to-GDP ratio and 60 per cent for the debt-to-GDP ratio;[15] the Stability and Growth Pact (1997) added the requirement that in the medium term each country should be close-to-balance or in surplus (the 'preventive arm' of the Pact). The intention was to prevent deficit levels very close to 3 per cent also in good times, with

[11] Balassone and Franco D. (2001), Krogstrup and Wyplosz (2010), Chari and Kehoe (2007), Aguiar et al. (2015), Halac and Yared (2018). The marginal cost of borrowing is reduced also because an integrated financial market is more liquid than the national ones.

[12] This externality is small in normal times, but it becomes significant if monetary policy is accommodative or production slack is ample. See: Auerbach and Gorodnichenko (2013), Hebous and Zimmermann (2013), Blanchard et al. (2017), Goujard (2017).

[13] Beetsma and Uhlig (1999).

[14] Committee for the Study of Economic and Monetary Union, 'Report on Economic and Monetary Union in the European Community', 1989, p. 20.

[15] These values are specified in Protocol No. 12 of the Treaty.

the risk of exceeding the threshold in bad times, ending up with excessive debt levels on average and procyclical fiscal policies.

The preventive arm of the Stability and Growth Pact was overhauled in 2005. Since then, member states have been required to achieve a medium-term objective expressed in terms of the structural budget balance (i.e. net of one-off and cyclical components). This modification was deemed appropriate from the point of view of economic analysis (the structural budget position should indeed reflect the underlying fiscal trends more closely), but brought an unobservable variable into the framework – i.e. the structural balance – whose estimate is subject *ex ante* to great uncertainty and *ex post* to significant revisions.[16] The reform put a strain on the transparency of the procedures and ultimately undermined their perceived legitimacy.

In the midst of the sovereign debt crisis, the reforms known as 'six pack' (2011)[17] and 'two pack' (2013)[18] introduced further constraints.[19] First, for countries with a debt-to-GDP ratio exceeding 60 per cent, the indication of the Treaty (Article 126) to converge towards this threshold "to a sufficient extent and ... at an adequate pace" was operationalized, requiring this gap to be reduced by 1/20th per year on average over a three-year period. Second, an expenditure rule was added to the objective in terms of structural balance, as an auxiliary element in the evaluation of the compliance with the preventive arm of the SGP. The rule requires that the growth rate of the expenditure, net of interests, of the cyclical component and of the effect of discretionary revenue measures, does not exceed that of potential GDP. The procedures for assessing and correcting deviations from the rules were also strengthened and the obligation to submit national draft budgetary plans to the European institutions in autumn, before obtaining parliamentary approval, was introduced; the 'European Semester' (a common timeline for the elaboration, approval and surveillance of the economic policies of the member countries) [20] was created; countries were required to establish independent national bodies (Independent Fiscal Institutions, IFIs) with the task of verifying the

[16] Computing the structural balance requires estimates of the output gap (the percentage difference between the level of actual GDP and that of potential GDP) and of the elasticity of the budget balance to the output gap. Potential GDP is the value of the output that the economy would have produced in conditions of stable inflation if labour and capital had been fully employed. This is an unobservable quantity, the measurement of which is subject to considerable uncertainty; there is no consensus on the most appropriate methodology for its estimation.

[17] Regulations No. 1177/2011 (8 November 2011), No. 1173/2011, No. 1174/2011, No. 1175/2011 and No. 1176/2011 (16 November 2011) and Directive no. 2011/85/UE (8 November 2011).

[18] Regulations No. 472/2013 and No. 473/2013 (both 21 May 2013).

[19] In 2012, EU countries (with the exception of the United Kingdom and the Czech Republic) signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, of which the Fiscal Compact is part. This Treaty strengthened the commitments already undertaken in the context of the reform of the Stability and Growth Pact, providing, among other things, for: the adoption of numerical rules in national budgetary procedures, preferably at the constitutional level; the introduction into national legislation of the structural balance objective, with the definition of mechanisms for the automatic correction of any deviations from this objective; and the establishment of independent bodies to be entrusted with the assessment of the compliance of policies with national objectives and rules and Europeans. Access to financial assistance from the European Stability Mechanism is subject to signing the Fiscal Compact.

[20] The European Semester was initially established by a decision of the European Council in 2010, based on a proposal from the European Commission. Subsequently, with the six-pack reform package, the European Semester was introduced into European secondary legislation.

realism of the macroeconomic forecasts underlying government programmes and providing assessments on these programmes and on the state of the public finances.[21]

Consequently, the complexity of the regulatory framework has increased significantly (Table 2). Due to mistrust between countries and between them and the European Commission, more and more details were added to the rules,[22] and at the same time more and more exceptions,[23] unintentionally giving more discretion to European institutions in their application. As a result, compliance assessments have often been controversial (it is not obvious, for example, how the Commission must reconcile the 'expenditure rule' with that relating to the structural balance if they give conflicting indications, as has happened on several occasions).

It is difficult to judge the effectiveness of the EU fiscal framework in influencing the behaviour of member countries. There are indeed numerous cases of countries that have run into an Excessive Deficit Procedure (EDP), but this does not mean that the rules have been ineffective. Despite the difficulty of identifying a 'counterfactual' scenario as a benchmark for measuring the impact of the rules, some studies suggest that the 3 per cent deficit limit was effective in anchoring behaviour, although more as a target value than as the maximum level.[24]

In any case, we believe that some important lessons can be drawn from the European experience of recent years. First of all, it is impossible to define a 'complete contract', that is, having rules that account for all the possible states of the world; not just because the result would be excessively complex, but above all because some contingencies, such as the pandemic, and their consequences, are genuinely impossible to figure out *ex ante*. Rather than trying to fine-tune the economic policy of individual countries, the rules should aim at avoiding 'gross errors', i.e. national choices and behaviours capable of damaging the rest of the Union.

4. The main reform proposals: a critical review

Last October, the European Commission resumed the debate on the *Economic Governance Review* with the aim of collecting opinions on possible changes to the economic governance framework and of achieving a broad-based consensus on the way forward, in good time for 2023. It is in the common interest of all member states to reach an agreement as soon as possible in order to reduce the

[21] Kopits (2013) and Beetsma et al. (2019).

[22] The growing complexity of the European fiscal framework is highlighted by the increase in the length of the *Vade Mecum on the Stability and Growth Pact* prepared by the European Commission, which almost doubled between the first edition of 2013 and that of 2018, reaching 220 pages. Currently, the legal basis of the Stability and Growth Pact consists of three articles from the Treaty on the Functioning of the European Union (TFEU), including Protocol No. 12 annexed to the Treaty, eight Regulations and one Directive. This legislation is supplemented by numerous other documents (the Vade Mecum, the code of conduct, communications from the European Commission, the opinions of the Economic and Financial Committee and so on).

[23] For example, the 1/20th debt rule has several exemptions, including 'unusual events' beyond the control of governments, 'severe economic downturns', and the implementation of structural reforms ('structural reform clause') or investment plans ('investment clause').

[24] Caselli and Wingender (2021).

uncertainty for governments, businesses and households about how fiscal constraints will look and also to prevent the risk of excessively restrictive policies in the coming years.

The debate on the reform of the European fiscal framework is wide-ranging and complex at the academic and institutional level (see Table 3). In terms of the degree of 'innovation', the proposals are positioned on a continuum ranging from limited adjustments to a complete overhaul of the existing framework. In what follows, we will focus on those key elements that have gathered the greatest consensus.

***The medium-term fiscal anchor.* –** There is a very large consensus about the need to simplify the framework, moving from a plurality of quantitative objectives (currently including headline deficit, structural deficit, expenditure and debt) that are almost identical for all countries[25] to a single medium-term anchor expressed in terms of the debt-to-GDP ratio. We agree with this approach, as it would also make it clear that the ultimate goal is debt sustainability.

The existing proposals, however, differ with respect to the procedures through which the debt target should be defined.

In some proposals, the reference value of the debt-to-GDP ratio is set at a value higher than 60 per cent or the adjustment speed is slower than in the existing rules.[26] In a recent contribution,[27] a 'double' adjustment speed is proposed: the debt accumulated in response to major crises (such as the pandemic) or due to expenses that increase the growth potential should be reduced at a slower rate (1/50th per year on average), while for the rest of the debt, the adjustment speed would remain unchanged (1/20th per year on average).

Some proposals confirm the reference value of 60 per cent for the debt-to-GDP ratio as a long-term objective, but also suggest adopting country-specific medium-term targets over a 5-15-year horizon,[28] not based on a predefined formula but on a comprehensive debt sustainability analysis. In setting such medium-term targets, it is proposed that – in addition to the distance from the 60 per cent reference value – a plurality of factors be taken into consideration: the composition of the debt, the differential between the growth rate and the average cost of the debt, the expected effects of structural reforms on potential growth and on the public finances, and the costs of ageing.

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[25] The existing rules only require the medium-term objective (MTO) for the structural balance to be country-specific, based, among other things, on the level of public debt and the expected impact of demographics on the sustainability of public finances.

[26] Francová et al. (2021) suggest increasing the reference value for the debt-to-GDP ratio from 60 to 100 per cent, while keeping the adjustment speed unchanged (1/20th on average per year). According to the authors, in addition to being in line with the current euro-area average debt value, the new reference value would be consistent with a deficit ceiling of 3 per cent in a macroeconomic scenario with real growth at 1 per cent and inflation at 2 per cent. Philip Lane, a member of the Executive Board of the ECB, proposed reducing the rate of adjustment from 1/20th to about 1/33rd per year and extending the assessment horizon from the current three-year period to a decade; see Lane, P. (2021).

[27] Giavazzi et al. (2021).

[28] See for example Bénassy-Quéré et al. (2018). In the proposal of the European Fiscal Board (2020), the differentiation between countries concerns the adjustment speed towards the 60 per cent target and not the target itself; although the authors consider the two solutions to be equivalent, the differentiation in the debt target would entail more controversial legal and institutional issues.

Some economists have suggested setting the target for the debt-to-GDP ratio for each country at a threshold that makes the probability of unsustainable trajectories sufficiently small. Such a threshold would be identified by estimating the joint probability distribution for the evolution of the product, the interest rates and the primary balances.[29] In our view, an important pitfall of this proposal is that explicitly defining a threshold, above which the risk to sustainability is considered 'excessive', could generate destabilizing tensions on the sovereign debt market if the debt-to-GDP ratio gets close to the threshold.

Finally, some proposals suggest that the debt-to-GDP target should be set on the basis of a joint effort by national authorities (the country's government and the national IFI) and European institutions (the European Fiscal Board and the European Commission), taking into account the specific situation of each country, and then approved by the Council of the European Union.[30] This seems to us the best approach, as it would improve both national ownership and the commitment of European authorities.

The operational target. – As mentioned before, the operational targets (i.e. the variables that the yearly fiscal plans should adjust in order to converge toward the medium-term fiscal anchor) for the preventive arm of the Stability and Growth Pact are currently the structural budget balance, the headline balance and the 'adjusted' expenditure growth rate. Most proposals, with very few exceptions, suggest the adoption of a single operational target defined in terms of a ceiling on the growth rate of expenditure. This limit would be set for a multi-year period (usually three years), in order to strengthen the medium-term orientation of the fiscal framework.

In general, the proposals suggest that the nominal growth rate of expenditure should be in line with the growth rate of potential output[31] plus the expected inflation rate, with a corrective factor consistent with the achievement of the medium-term debt target. Some authors[32] suggest setting the spending limit by using the ECB's medium-term inflation target (2 per cent) instead of the expected inflation rate, in order to increase the cyclical stabilization function of the rules and support the ECB in pursuing its price stability mandate.

The expenditure rule is usually applied to primary nominal expenditure net of cyclical components, such as job retention schemes or unemployment benefits, and net of the estimated impact of any

[29] See Blanchard et al. (2021) and Martin et al. (2021).

[30] Darvas et al. (2018), Darvas and Anderson (2020), Martin et al. (2021). In Amato et al. (2021), the member country and the European Commission agree on an adjustment plan with a ten-year time horizon (Fiscal and structural plan), which must then be approved by the Council of the EU.

[31] Bordignon and Pisauro (2021) suggest replacing the growth rate of potential output with real GDP growth rate projections over a medium-term period (three years). Francová et al. (2021) propose the use of real growth trends as a benchmark.

[32] Claeys et al. (2016), European Fiscal Board (2018), Benassy-Quéré et al. (2018), Darvas and Anderson (2020), Lane (2021), Bordignon and Pisauro (2021) and Hauptmeier and Kamps (2022).

discretionary revenue measures.[33] Some scholars also provide for some form of golden rule,[34] reserving a special treatment for investment spending in order to prevent it from being systematically undersized and, during consolidation phases, subject to sharp cuts. Other things being equal, the exclusion of some expenditures from the rule mechanically requires an increase in the correction on other budget items necessary to ensure the coherence of the fiscal policy with the medium-term target for the debt-to-GDP ratio.

The expenditure growth rate is generally considered the most convenient operational target for several reasons: 1) it is under the government's control and subject to budgetary decisions; 2) it is relatively easy to communicate and to monitor; and 3) it incorporates countercyclical stabilization features.[35] Furthermore, it is argued that the estimate of the potential growth rate, on which the spending rule is often based, is more robust and less subject to revisions than that of the annual output gap (on which the calculation of the structural balance is based).[36]

Several proposals, alongside the expenditure ceiling, provide for the introduction of a compensation/adjustment account, in which any deviations of the actual growth rate from the target are recorded, with an upper limit (often set at one per cent of GDP) beyond which the rule is considered not complied with and a fiscal correction is required. Although useful for keeping track of deviations from the target, this mechanism would make the rules more complex and could force governments to implement contractionary policies in bad times in order to compensate for past deviations.

There have been several criticisms, which we believe are well founded, of the expenditure rule (in its various formulations) as a single operational target. Its alleged superiority over the structural balance in terms of transparency, communicability and robustness seems questionable.[37] In fact, the expenditure rule would in any case be based on variables that are difficult to forecast *ex ante*

[33] The correction for discretionary revenue measures would allow, among other things, national preferences to be preserved in terms of the size of the government budget.

[34] Darvas and Anderson (2020) suggest, for example, the introduction of an 'asymmetric' golden rule, with the exclusion of net public investments from the spending rule only in economic downturns. In the proposal of the European Fiscal Board (EFB, 2018, 2020), the golden rule is limited to growth-friendly expenditure considered a priority at European level, while in Francová et al. (2021) the golden rule only applies to countries - identified by the European Commission and the European Investment Bank, with the approval of European Council - that are experiencing an investment 'gap'. In Giavazzi et al. (2021) the golden rule covers the 'spending for the future', which includes not only investment spending but also spending on European public goods that benefits future generations. In Amato et al. (2021), spending related to exceptional events beyond the control of governments (e.g. expenditure for green transition) would be financed by European grants, de facto determining its exclusion from the deficit and debt.

[35] Countercyclical stabilization features stem not only from the exclusion of cyclical components from the expenditure aggregate, but also from the fact that the benchmark with which the expenditure growth rate is compared is generally based on the growth rate of potential output: in the event that actual GDP growth rate is greater than (below) the growth rate of potential output, the expenditure-to-GDP ratio will decrease (increase) with a stabilizing effect on the economic activity.

[36] The expenditure rule usually takes a ten-year average of the potential GDP growth rate as a benchmark, while the structural balance is based on the estimate of the output gap of a specific year. Furthermore, the structural balance is affected by the uncertainty of the estimate of the elasticity of the headline deficit to the output gap.

[37] See for example Gros and Jahn (2020).

and to measure *ex post*, such as, for example, potential GDP or the revenues deriving from discretionary budgetary measures. Furthermore, the primary expenditure net of cyclical components and of discretionary revenue measures is de facto a (partial) budget balance, no less distant than the structural budget balance from the change in the debt-to-GDP ratio, which is the ultimate target of the fiscal framework.

In some proposals, the operational target is based on the nominal (primary) deficit, with the definition of a multi-year path consistent with the achievement of the (country-specific) medium-term debt-to-GDP objective.[38] As we will argue below, this seems the more promising way forward.

Enforcement. **–** There is a general consensus that the financial sanctions provided for by the Stability and Growth Pact have proved ineffective, as they are subject to the political discretion of the Council (as we recalled, the sanctions have never actually been applied).[39] For this reason, in addition to making them more automatic and less subject to political bargaining, some proposals, including our own, which we describe in the following Sections, outline a system of incentives ('positive conditionality') such that, for instance, access to a future EU fiscal capacity and, more generally, to European funds is subject to full compliance with the rules. In some proposals it is also suggested that, in the case of fiscal programmes not in line with the rules, it should be possible to block or delay the parliamentary approval of the budget or to impose the financing of excess spending with junior bonds.[40]

Finally, there is also a very broad consensus on the need to drastically reduce the number of exemptions and exceptions, limiting them to cases of major events beyond the control of the government (severe economic crises, natural disasters), and to strengthen the role of national IFIs and of the European Fiscal Board.

5. The reform of the Stability and Growth Pact: our proposal

This Section outlines a possible reform of the rules which – starting from the main elements of consensus that have emerged so far – aims at two goals. First, a radical simplification of the framework (also in terms of procedures), avoiding in particular the use of unobservable variables (not only the output gap and the structural deficit, but also potential GDP). Second, a strengthening of national ownership and the full endorsement of the fiscal targets at the European level.

The core of the proposal consists in setting country-specific medium-term targets as part of a sustainability pact between a member state and the EU institutions (the European Commission and the Council) and entrusting independent technical bodies with the validation of the macroeconomic and public finance assumptions underlying the pact (national and European IFIs). Our proposal does

[38] See for example Blanchard et al. (2021). Francova et al. (2021) suggest adopting a primary balance target along with a spending rule for countries with a debt-to-GDP ratio above the medium-term objective (100 per cent).

[39] Andrle et al. (2015) propose keeping financial sanctions only to be applied in good times, while in bad times they would be replaced by administrative sanctions (for example constraints on new hires by public administrations).

[40] On the possibility of blocking or delaying the approval of the budget, see Blanchard et al. (2021) and Martin et al. (2021), while for the financing of overspending with junior bonds, see Bénassy-Quéré et al. (2018), Kopits (2018) and Darvas and Anderson (2020).

not require any change to the Treaties;[41] it shares the basic principles outlined in Amato et al. (2021): the need for a bilateral agreement between the Commission and each member state and the requirement that the new rules are complemented by a common fiscal tool. Differently from Amato et al. (2021), we also outline the operational details, the procedural steps and the role that national and European authorities will play. Furthermore, in our proposal, the pact only includes the macro fiscal targets (debt and budget balance), while in Amato et al., the agreement between the member state and the Commission would also concern the 'quality' of public finances and the 'structural reforms'.

The medium-term fiscal anchor. – As argued by most of the proposals examined so far, having the debt-to-GDP ratio as the only anchor seems the most appropriate way to focus on the key objective of the system of rules, namely the sustainability of the public finances. The debt-to-GDP ratio and – even more so – its medium-term dynamics are the key elements that financial investors and rating agencies take into account. They can decisively affect the risk of market tensions, which in turn can harm other member states. Having a single anchor also provides a simpler regulatory framework, making policy choices and the related assessments more transparent and understandable for the general public.

The adoption of the debt-to-GDP ratio as the medium-term anchor does not require a change to the current reference threshold of 60 per cent (established by Protocol No. 12 of the Treaty on the Functioning of the European Union). It is instead sufficient to change the definition of the convergence process towards this threshold (a modification of secondary legislation). The 60 per cent figure is indeed arbitrary and reflects the macroeconomic context prevailing at the time it was established. Today it appears excessively restrictive. In any case, any new threshold would be as arbitrary as the '60 per cent' and would likewise not stand the test of time.[42]

In our proposal, the 60 per cent threshold would only be used to identify the countries that must sign a sustainability pact and would no longer have a role in defining the speed of debt reduction. For countries with a debt ratio higher than 60 per cent, the pact defines country-specific debt reduction targets over a multi-year horizon (3-5 years), taking into account the starting conditions and the macroeconomic prospects.[43] These targets should be agreed between the European Commission and the individual member state and then approved by the Council of the EU as part of the procedures under the European Semester (see the box: The 'sustainability pact' in the context of the European Semester).

[41] For a review of the legal requirements concerning the proposals discussed in Section 4, see Maduro et al. (2021).

[42] Bordignon (2021) suggests that the threshold could be revised periodically (for example every 15 years), in order to take into account the changed macroeconomic conditions. However, as mentioned, this would require a unanimous agreement to be found within the Council each time.

[43] Over such a horizon, the agreement would also be binding in the event of changes in the government coalition.

The 'sustainability pact' in the context of the European Semester

For countries with a debt-to-GDP ratio greater than 60 per cent, the sustainability pact would replace the Stability Programme (Convergence programme for countries that have not adopted the euro), which member states are required to submit to the European Commission by 30 April each year. The sustainability pact' would have elements similar to the Stability Programme, but it would differ from it in some important aspects, in particular with reference to the degree of involvement in its definition of the various actors (member states, Commission and European Council).

The Stability Programme already includes multi-year fiscal objectives (for the current year and for the following three years), it must be based on macroeconomic forecasts produced (or validated) by independent institutions and it is presented to the Commission well ahead the definition of the budget law and its submission to national parliaments. However, unlike our sustainability pact, the Programme is not the result of an agreement on fiscal objectives between the European Commission and the country concerned; instead, it is unilaterally prepared by the member state, in compliance with rigid rules equal for all countries and with limited room for taking into account specific national situations.[44] Furthermore, the involvement of independent fiscal institutions in the validation of the macroeconomic and public finance assumptions underlying the Programmes is less intense than what we envisage for the 'sustainability pact'. Finally, the Stability programmes are not subject to approval by the Council of EU, which is eventually called upon only in the event that the European Commission identifies a serious breach of the rules.

Replacing the Stability Programme with the sustainability pact in the context of the European semester would not require changes, even at national level, to the deadlines and procedures. The pact would also serve, in the event of violation of agreements, to define an adjustment path, replacing de facto the Excessive Deficit Procedure as well. Compared with the sustainability pact, the EDP is less sensitive to the national context in the definition of deadlines and objectives (normally, the correction of an excessive deficit must occur within the year following that in which its existence is established) and does not require the latter to be the result of an agreement between the country and the Commission.

Failure to agree on the content of the sustainability pact would imply that the country has to respect the current 1/20 debt rule.

The sustainability pact would not include objectives relating to the quality of the public finances, which would remain part of the National Reform Programmes (currently, these programmes are presented together with the Stability Programme and are subject to an evaluation by the Commission).

[44] The matrix of adjustment, introduced in 2015 by the European Commission, specifies the size of the fiscal adjustment required based on the country's cyclical position, its debt-to-GDP level and the risks to the sustainability of the public finances.

For countries with a debt-to-GDP ratio below 60 per cent, only the 3 per cent deficit-to-GDP limit would be kept in place. The debt rule,[45] the medium-term objective for the structural balance and the expenditure rule would disappear for everyone.

The operational target. – On the basis of the targets identified for the debt, a multi-year profile for the headline balance would be defined, in principle determining adjustments which are uniformly distributed over time (and in any case not too back-loaded towards the end of the programming horizon). The choice of the overall budget balance as an operational tool has a twofold advantage with respect to an expenditure rule: (i) it is an observable indicator, whose *ex post* measurement is subject to careful validation by Eurostat and (ii) its link with the evolution of the debt, which – as mentioned – is the ultimate goal of the European budget rules, is more straightforward compared with a (modified) expenditure aggregate.

Taking into account interest expenditure within the operational tool has both pros and cons. On the one hand, it seems reasonable, as lower interest expenditure reduces the need for fiscal adjustment and vice versa. On the other hand, it is a variable outside the immediate control of the fiscal authority and, if the ultimate goal of the fiscal rules is to ensure debt sustainability, high-debt countries should use any savings on interest spending arising from cuts in the interest rate to achieve more ambitious debt targets. Should this latter view prevail, the adjustment path could be defined in terms of the primary balance.

Country-specific medium-term debt objectives are meant to prevent excessive adjustment requirements in bad times (and insufficient ones in good times) and allow for countercyclical discretionary measures. The debt target and the resulting deficit profile should be based on reasonable macroeconomic and public finance projections. To this end, as envisaged in various proposals, the role of national IFIs and the European Fiscal Board should be strengthened. The former should be entrusted not only with the validation of the projections but also of the quantification of the effects of the discretionary measures proposed by the countries to achieve the agreed objectives. The European Fiscal Board, which should be made fully autonomous from the Commission, should carry out the analyses and technical assessments underlying the Commission's decisions, also ensuring coordination and harmonization of the activities carried out by the national fiscal councils.[46]

Once the *ex ante* adjustment path has been agreed, the member state should take the necessary actions to achieve it. *Ex post*, if the country deviates from the path, the consequences will depend on the reason for the deviation. Differences due to unexpected macroeconomic developments would be treated symmetrically: higher deficits should not be compensated for, just as unexpected revenue windfalls and expenditure shortfalls (typically unemployment benefits) should not be used

[45] As already mentioned, the debt rule requires a 1/20th reduction on average over a three-year horizon of a debt ratio in excess of 60 per cent. In our proposal the rule would be only applied to those high-debt countries that fail to adhere to a sustainability pact (see the box: The 'sustainability pact' in the context of the European Semester).

[46] The key role that the IFIs would play in defining the targets requires their independence to be guaranteed (also through allocation of greater resources) and the full adoption of best practices.

to 'finance' discretionary measures.[47] In this way, the national automatic stabilizers would be allowed to operate freely and symmetrically, leading to a countercyclical orientation of the fiscal policy and favouring macroeconomic stabilization. On the other hand, deviations from the targets not due to unexpected macroeconomic developments would be treated in a non-symmetrical way: the negative ones should be compensated within the programming horizon, while the positive ones should contribute to a faster debt reduction. The asymmetry would find its raison d'être in the fact that the ultimate goal of the pact is to bring the debt back to more prudent levels.

Escape clauses would be limited to cases of major events beyond the control of the government (severe economic crises, natural disasters, wars) in line with most of the reform proposals discussed in Section 4.

Figure 1 summarizes the rules and procedures just described. It would be a much simpler and more linear system than the current one. The process would make the political responsibility of the member state more explicit, with benefits in terms of national ownership of the rules. The distinction between the preventive and corrective arm of the Stability and Growth Pact would lose its relevance: there would in fact be a single procedure that would provide for a correction mechanism in the event that the member state does not achieve the agreed targets for reasons other than unexpected negative macroeconomic dynamics or other exceptional events outside the government's control.

***Enforcement.* –** Regarding the enforcement of the rules, it is clear that the current system can and should be improved. Financial sanctions have proved difficult to apply and it is no coincidence that they have never been imposed. To replace them, participation in European funded programmes, such as semi-permanent mechanisms designed in a similar way to NGEU, could be made conditional on compliance with fiscal rules. This type of scheme will be the subject of the next Section.

Procedures such as those of the European Semester have proven useful: discussing budget plans with the European authorities sufficiently in advance of their presentation to the national Parliament can discipline governments, even without going to the extreme of giving the European institutions a veto power (which in any case would require legislative interventions at constitutional level in the member states).

To be clear, there is a prerequisite without which neither our proposal nor any other arrangement can work: the mutual trust between the member states and between them and the European institutions, which has been lacking in the past and which will necessarily take time to consolidate. An important responsibility in this respect lies with those countries that more than others have recorded behaviours that are not in line with the rules.

[47] If, regardless of their nature, unexpected changes in interest expenditure were treated in the same way as unexpected macroeconomic developments, using the overall balance or the primary balance as an operational tool would be equivalent. Note that significant deviations in interest expenditure that are not due to macroeconomic shocks (e.g. resulting from discretionary changes in average debt maturity) are very unlikely.

6. Beyond the reform of the Stability and Growth Pact: an integrated approach

Being part of a monetary union cannot only mean more constraints. It should be an opportunity to deal more effectively with adverse events affecting individual countries or – as the pandemic crisis reminds us once again – common shocks. Not taking advantage of this opportunity and avoiding setting up risk-sharing tools just because this could lead countries to indulge in opportunistic behaviour are mistakes for which Europe could pay a heavy price in the future. As in the case of the trade-off between 'discretion' and 'rules', the point is to seek and find – this time *before* the arrival of the next crisis – a balance between the need to avoid opportunistic behaviour and that of building mutually beneficial forms of insurance.[48]

As Tommaso Padoa Schioppa pointed out in the aftermath of the decision to create the Economic and Monetary Union, "the Union has full competence on microeconomic issues (open borders, rules on goods and services, antitrust), while its capability in terms of macroeconomic policy is, except for the currency, embryonic and unbalanced: it can prevent evil (excessive deficits) but cannot do good (a fully-fledged fiscal policy on its own)".[49]

Without further steps towards the completion of the European economic architecture, no system of rules can be satisfactory. In the end, an approach based on a few simple rules - such as those outlined in the previous section - will only be fully effective if it is possible to establish an adequate common fiscal capacity.

In a monetary union, a common fiscal capacity constitutes a mutual insurance against shocks hitting a single member. Not surprisingly, historical experience shows that successful monetary unions are generally also fiscal unions. Indeed, while national fiscal policies can at most smooth the cost of an adverse event over time among the generations who live and will live in a given country, a fiscal union would also allow the effects of adverse shocks to be smoothed 'across space'. This possibility is beneficial for all participants in the union *ex ante*, as long as they are sufficiently homogeneous in terms of risk levels.[50]

Of course, as in any other form of insurance, insured parties may engage in irresponsible behaviour, increasing the likelihood that adverse events will happen. To limit the risks, the central capacity shall intervene only in the face of particularly severe shocks (this is basically the principle underlying the deductibles included in most insurance contracts), and net transfers between countries must be substantially nil in the medium run. Furthermore, the budgetary rules would remain in place, which at that point could focus on countering opportunistic behaviour.

If a fiscal capacity is able to issue common debt, it would also be very useful in the event of particularly severe and prolonged symmetric shocks. In these cases, it could ensure an adequate fiscal stance for the euro area as a whole. The sum of the national responses may not in fact be optimal, as already discussed, as the decisions of individual countries do not take into account

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[48] Balassone et al. (2016), Visco (2015), in particular Chapter 3, and Balassone and Visco (2018).

[49] *Il passo più lungo*, Corriere della Sera, May 3, 1998 (our translation).

[50] Balassone et al. (2018).

spillover effects. In this way – as the ECB has repeatedly pointed out – the common fiscal policy could complement the common monetary policy, especially when nominal rates are close to their lower limit. [51]

In the same article cited above, Padoa Schioppa highlighted that "national central banks do not benefit from operating in a vacuum, without functioning political power, fiscal policy or banking and financial markets supervision. For the European Central Bank, the real pitfall would not be the lack of independence, but too much loneliness".

A common fiscal capacity could also finance specific investment programmes, in order to ensure that some European 'public goods' are provided efficiently and to an adequate extent, for example in the case of environmental protection, digital investments or R&D. In other words, the fiscal capacity could take on not only the stabilization function but also the allocative one, albeit in exceptional situations and in collaboration with national policies.

With NGEU, the Union can tap international financial markets for the first time to help its member states, through transfers and loans, to counter the effects of the pandemic shock and to finance the green and digital transition. Given its extraordinary and temporary nature, NGEU is a tool consistent with the Treaties. [52]

The establishment of a permanently active fiscal capacity, with both countercyclical and structural goals would instead require a change to the Treaties.[53] As of now, it seems more expedite both from a political and legal point of view to set up a budgetary tool that is not permanently active, but it stands ready to be activated promptly in case of need, as a sort of NGEU-like contingent facility. [54] This would allow the EU to have an instrument in its toolkit to intervene in the event of extraordinary situations, without having to reach a unanimous consensus every time within the Council. [55]

The facility could serve a dual purpose. First, it would be similar to a quasi-automatic fiscal stabilizer: in the event of particularly negative macroeconomic conditions described *ex ante* (also regarding a single country), it would issue common debt to finance grants to member states, for example to support job retention schemes. Second, the facility could also finance exceptional pan-European investment plans (such as those relating to the energy sector). In the latter, more encompassing case, it would be less necessary to include in the budgetary rules applied at national level some clauses to 'protect' public investments (for example forms of the golden rule).

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[51] Caprioli et al. (2020). On possible complementarities between monetary and fiscal policies, see Bartsch et al. (2020) and Eurosystem Workstream on monetary-fiscal policy interactions (2021).

[52] See Tosato (2021) and Maduro et al. (2021).

[53] The permanent transfer to the central level of a fair amount of power to tax and spend would pose the problem of closer forms of political union, articulated in an effective system of checks and balances. On the link between fiscal and political union, see Signorini (2016).

[54] See for example Mack (2021) and, for legal aspects, Maduro et al. (2021).

[55] The Council Decision on the system of own resources of the European Union could be revised by establishing that the temporary increase in the annual limit (by 0.6 percentage points of GNI), currently foreseen to finance NGEU, becomes permanent and is aimed at repaying the debts incurred by the possible activation of the facility.

Scholars have recently paid some attention to tools that can reduce the typical delays in fiscal policy, thereby making countercyclical stimulus timelier.[56] Establishing *ex ante* the modalities and duration of the intervention would also reduce the risks of distortions due to the political process, which could lead to a sub-optimal composition or an excessive duration of the stimulus. Finally, the uncertainty faced by the private sector would be reduced. Of course, if the basic idea is accepted, the next step would be defining the details: the trigger (GDP or unemployment), the relative threshold levels for the activation and deactivation of the scheme, and the target of European transfers (investments or transfers to households). These points, however, are technical in nature and, as already mentioned, there is a growing body of literature to draw upon.

Such a facility would not aim to guarantee that the aggregate fiscal stance of the euro area is adequate at all times, as it would be asymmetric (it would not cool the economic cycle in expansionary phases) and would only be activated in the presence of extreme events. However, these limits would be counterbalanced by a system of rules that better responds to individual country conditions, such as the one proposed in Section 5.

In general, it is crucial that the two pillars of fiscal governance (supranational constraints on individual countries' policies and a common fiscal capacity) are designed jointly, taking into account the interdependencies between them. A fully-fledged fiscal capacity would allow simpler rules, as in the US federation, where states are subject to simple balanced budget rules (in principle strongly pro-cyclical), but in adverse economic phases the federal level intervenes with expansive discretionary measures. Conversely, leaving states more room for manoeuvre can allow for a leaner central capacity. At the moment, this second option seems more politically and legally feasible in the European case.

Before concluding, it is worth mentioning two further aspects that, although very important, are outside the scope of this paper.

First, the debt issued by the fiscal capacity (whether permanent or contingent) would reduce the safe asset shortage that currently characterizes global financial markets. It would make it easier for European intermediaries to diversify their portfolios of sovereign securities,[57] and it would facilitate the implementation of monetary policy and strengthen the role of the euro as an international currency. In the event of an increase in investors' risk aversion, the destabilizing of capital outflows towards member countries perceived as more reliable would be attenuated.

Second, there is the issue of the debt accumulated by euro-area countries due to the Great Recession and the pandemic.[58] The joint management of a part of these liabilities, for example through a redemption fund, would strengthen the financial stability of the area, reducing the risk of self-fulfilling crises. It would also immediately add depth and liquidity to the European safe asset market. Clearly, the political and legal obstacles to be overcome in order to move in this direction

[56] Eichenbaum (2019), Blanchard and Summers (2020) and Boushey et al. (2019).

[57] The poor diversification of these portfolios, biased in favour of the domestic sovereign, is often considered a danger to financial stability. For a critical review on the issue, see Lanotte et al. (2016).

[58] See Cioffi et al. (2019), Visco (2021), Micossi (2021), Giavazzi et al. (2021).

are significant; in this case too, they reflect the trade-off between risk sharing and risk reduction. However, from a technical point of view, there are solutions that minimize the possibility of a systematic redistribution between countries and preserve the incentive for fiscal discipline. Steps forward in this area are also a necessary precondition for making progress on the prudential treatment of public securities held by banks as well,[59] and the strengthening of the credibility of the no-bail out clause.[60]

7. Conclusions

In a monetary union, in which budgetary policies remain the responsibility of individual member countries but their fallouts affect the area as a whole, constraints on the discretion of national policies are necessary. However, the current European rules are far from perfect, and the pandemic crisis has highlighted their shortcomings. Most of the recent reform proposals in the academic and institutional debate rightly go in the direction of simplifying the overall picture. All of them agree that the ultimate goal must be the control of public debt and that the rules must allow for an economically sustainable consolidation path.

The reform blueprint presented in this paper aims at increasing ownership of the budget objectives both at national and European level. Country-specific medium-term debt targets would be enshrined in a sustainability pact agreed between each member state and EU institutions (European Commission and Council) and the underlying macroeconomic and public finance assumptions would be validated by independent technical bodies (national IFIs and European Fiscal Board). The operational objective would be in terms of the nominal deficit. This choice has the advantage of relying on an indicator that is observable and closely linked to the evolution of the debt.

In any case, the rules are only one element of the European economic architecture. A monetary union cannot be based only on constraints on the choices of individual countries. A common budgetary capacity is needed to reconstitute at the central level those degrees of freedom that the member states have agreed to give up. Designing the two elements (national rules and the area-wide capacity) in an integrated way is not only more efficient from a strictly economic point of view, but also has a better chance of overcoming the political and legal obstacles that any attempt to change the current status quo will inevitably come up against.[61]

Building on the experience of NGEU, the EU should equip itself with a budgetary instrument that is ready to be activated in case of need, without having to obtain the unanimous agreement of the member countries every time.

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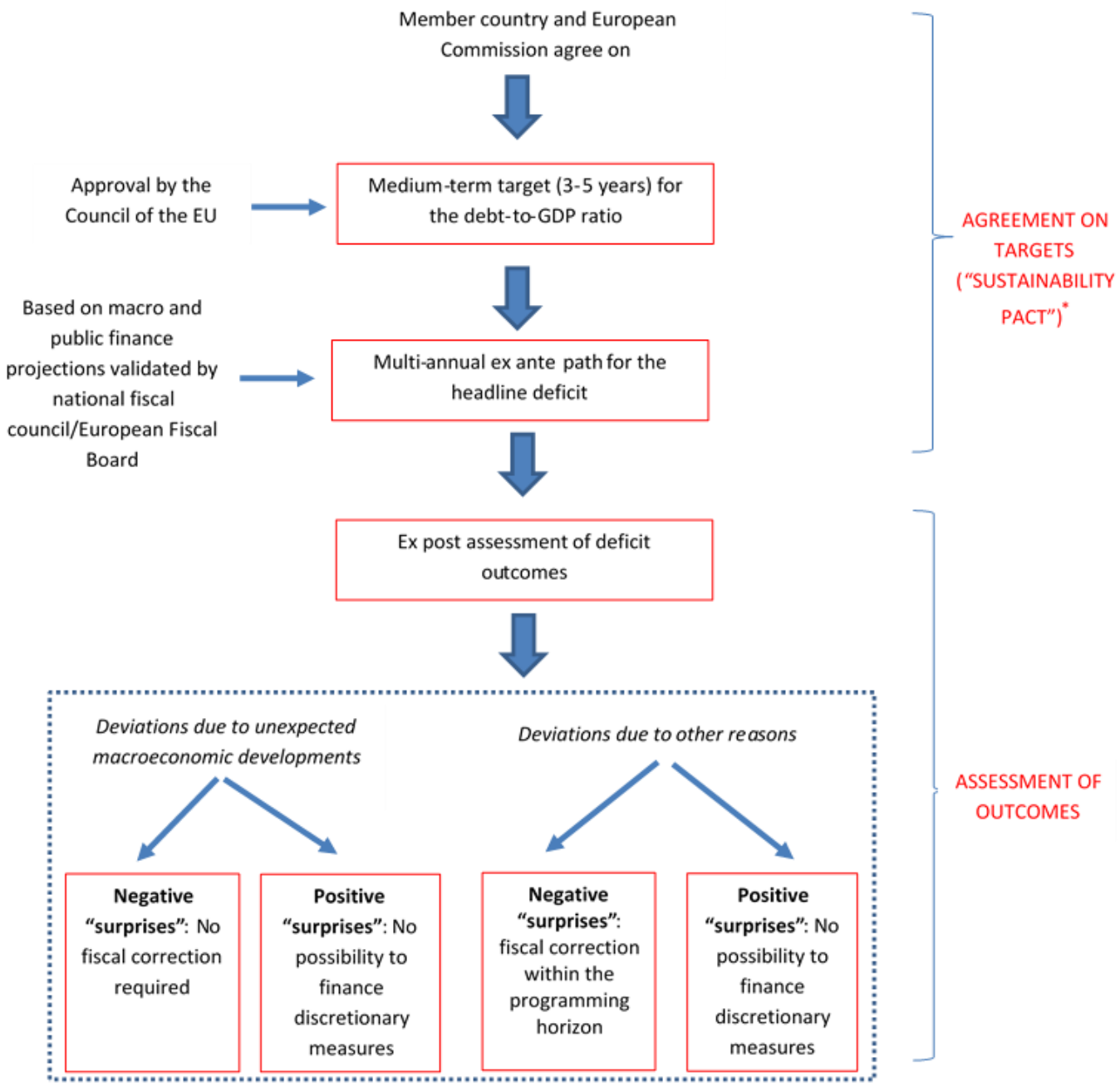
[59] Lanotte et al. (2016).

[60] Committeri and Tommasino (2018).

[61] To have a good chance of success, an EU economic governance reform proposal will need to be economically sound, institutionally appropriate (requiring an acceptable reallocation of decision-making powers between the different levels of government of the Union) and secure the consent of a large majority of European citizens. The joint achievement of these three conditions would satisfy what Buti (2021) calls the 'Monnet compatibility test'.

TABLES AND FIGURES

Figure 1 – Outline of the proposed SGP reform



*In the event that the agreement is not reached, the current 1/20th debt rule applies.

Table 1 – Evolution over time of the European fiscal framework

1992	1997	2005	2010
Maastricht Treaty	***SGP***	***SGP reform***	***European semester (1)***
▪ 3% deficit-to-GDP limit and 60% debt-to-GDP limit ▪ no-bail out clause; prohibition of monetary financing; prohibition of privileged access to financial institutions	▪ preventive arm: budgetary position over the medium term of 'close to balance or in surplus'; Stability and Convergence Programmes ▪ corrective arm: procedural steps, including sanctions, aimed at correcting an excessive deficit	▪ preventive arm: a) country-specific MTO in structural terms (taking into account debt-to-GDP level and long-term ageing costs); b) structural balance as main operational target; c) 'major structural reforms clause' (emphasis on pensions reform)	▪ streamlined calendar of economic coordination and surveillance of fiscal, macroeconomic and structural policies
2011	**2012**	**2013**	**2015**
SGP reform (Six-pack) (2)	***Fiscal compact***	***Two-pack reform***	***EC communication on flexibility***
▪ preventive arm: a) expenditure benchmark; b) significant deviation procedure, with sanctions (interest-bearing deposits) ▪ corrective arm: a) 1/20th debt benchmark ▪ general escape clause (in the event of 'severe economic downturn in the euro area or the Union as a whole') and unusual events clause ▪ tightening of sanctions and reverse qualified majority voting principle ▪ involvement in fiscal surveillance of independent fiscal institutions (IFIs)	▪ minimum MTO (-0,5% of GDP; -1% if the debt ratio is significantly below 60%) ▪ strengthening of IFIs' role ▪ automatic correction mechanism in the event of significant deviations from SGP requirements ▪ transposition of the essential elements of the preventive arm into national legislations (increasing national ownership)	▪ Draft Budgetary Plans (DBPs) submitted to the Commission and the Council by EA member states (the Commission can request the submission of a revised DBP in the event of a particular serious non-compliance with the SGP rules) ▪ strengthening of IFIs' role	▪ matrix of requirements (adjustment effort, ranging from 0 to 1% of GDP, depending on the cyclical position, the debt level and the risks to public finance sustainability) (3) ▪ flexibility clauses (investment and reform clauses)

(1) The European Semester was initially established by the European Council in 2010, based on a Commission proposal. With the six-pack reform, it was then introduced into EU secondary legislation. - (2) The six-pack reform included five regulations and one directive. Two regulations amended the preventive and corrective arm, while a third regulation established a graduated system of sanctions for euro-area member states; the other two regulations introduced the macroeconomic imbalances procedure (MIP). The directive established the minimum requirements for national budgetary frameworks. - (3) In 2018, a further innovation was introduced by the Commission, which applied the 'margin of discretion', thus reducing the adjustment effort required by the matrix when stabilization needs prevail.

Table 2 - The European fiscal framework today: a summary

Fiscal aggregate	Rule	Exceptions/flexibility	Sanctions	Legal references
1) headline deficit	▪ 3% limit	a) in the event of exceptional circumstances (unusual events and/or severe economic downturns) small and temporary deviations admitted; b) the deficit has declined substantially and continuously and has reached a level close to 3% of GDP	Excessive deficit procedure (EDP), with financial sanctions (corrective arm)	EU Treaty (Protocol No. 12 to Maastricht Treaty) and SGP
	▪ nominal targets under EDP	'relevant factors' (that can justify non-compliance)		
2) structural budget balance	▪ country-specific 'medium term objective' (MTO) (1)	a) in the event of exceptional circumstances (unusual events and/or severe economic downturns); b) systemic pension reforms and major structural reforms; c) investment clause; d) non-significant deviations (defined in the six-pack reform: deviation lower than 0.5% of GDP over one year or 0.25% of GDP on average over two years)	Significant deviation procedure (SDP), with financial sanctions for EA countries (preventive arm)	SGP (as reformed in 2005 and in 2011 with the six-pack); Fiscal compact (2012); European Commission - Communication on flexibility (2015)
	▪ MTO not lower than -0,5% (-1% if the debt ratio is significantly below 60%) for EA countries			
	▪ adjustment path towards MTO based on the state of the economy and the level of public debt (2)			
	▪ annual "fiscal effort" under EDP	a) in the event of exceptional circumstances (unusual events and/or severe economic downturns)	Excessive deficit procedure (EDP), with financial sanctions (corrective arm)	
3) expenditure benchmark (3)	▪ benchmark: 10-year average of the growth rate of potential GDP; for countries not at their MTOs, the benchmark is lower than potential growth, in order to ensure an appropriate adjustment towards the MTO	overall assessment (together with the structural budget balance adjustment)	Significant deviation procedure (SDP), with financial sanctions for EA countries (preventive arm)	SGP (as reformed in 2011 with the six-pack)
	▪ Expenditure benchmark target under EDP	Expenditure target in addition to nominal and structural budget balance targets	Excessive deficit procedure (EDP), with financial sanctions (corrective arm)	Commission and Council joint opinion (2016)
4) Debt-to-GDP ratio	▪ 60% limit	a) in the event of exceptional circumstances (unusual events and/or severe economic downturns)	Excessive deficit procedure (EDP), with financial sanctions (corrective arm)	EU Treaty (Protocol No. 12 to Maastricht Treaty - 1992), Fiscal compact (2012) and SGP (as reformed in 2011 with the six-pack)
	▪ if debt-to-GDP ratio higher than 60%, 1/20th debt reduction benchmark per year on a three-year average (backward or forward looking, adjusted for the impact of the cycle) of the gap between the actual debt level and the 60 percent reference value	'relevant factors' (that can justify non-compliance)		

(1) Before the 2005 SGP reform, the MTO was defined in nominal terms and was identical for all countries ('close to balance or in surplus in the medium term'). - (2) Before the Communication on flexibility, the adjustment effort was equal to 0.5 per cent of GDP per year as a baseline, with a higher adjustment effort in economic good times and a more limited effort in bad times. - (3) Total expenditure net of: interest payments; fully-matched EU programmes; non-discretionary unemployment benefit; discretionary revenue measures. The benchmark is applied to the nominal expenditure growth deflated by the GDP deflator forecast.

Table 3 - Reforming the European economic governance: a comparison of the main proposals

Proposal	Need for Treaty changes	Fiscal anchor				Operational target				Adjustment/compensation account	Escape clauses	Incentives/sanctions (enforcement of the rules)	EU fiscal capacity
		fiscal aggregate	target	adjustment speed	target setting procedure	fiscal aggregate	special treatment for investment expenditure	benchmark	time horizon				
Andrle et al. (2015)	yes	debt/GDP ratio	not specified	not specified	not specified	total (real) expenditure	no	potential output growth rate with a debt-level feedback mechanism	not specified	no	a) exceptional circumstances (natural disasters, periods of severe economic downturns); b) prolonged period of low inflation or deflation	administrative sanctions in bad times (e.g. constraints on new hiring by government) and financial sanctions in good times	-
Claeys et al. (2016)	no (changes to the SGP and the Fiscal Compact)	debt/GDP ratio	60%	1/50th per year	fixed target	nominal primary expenditure net of labour-market related expenditure, one-off expenditure and discretionary revenue measures	cost spread over the service life of the investment	medium-term potential growth rate plus the central bank's inflation target (with debt correction factor)	multiannual	no, but overrun expenditure must be corrected in subsequent years	exceptionally deep recessions and natural disasters	no financial sanctions	-
Benassy-Quéré et al. (2018)	not specified	debt/GDP ratio	60%	country-specific 5-year medium-term target: fixed every year based on the distance between the actual debt-to-GDP ratio and the long-term target and a broader analysis of fiscal sustainability (e.g. taking into account major reforms expected to raise potential growth)	independent national fiscal council (validated by an independent euro area-level institution)	nominal primary expenditure, net of unemployment spending and of the estimated impact of any new discretionary revenue measures	no	expected potential output growth plus inflation consistent with the ECB's price stability objective	1 year	yes, with a deficit ceiling of 1% of GDP; if breached, excess spending financed by junior bonds	exceptional circumstances (e.g. very large shocks); the activation agreed by the Eurogroup, after consultation with the euro-level independent institution	excess spending (ex ante or ex post) financed by junior bonds; access to the fiscal stabilisation scheme/preferred access to ESM loans conditional to compliance with rules	fiscal stabilisation scheme that makes one-off transfers in case of large downturns affecting one or several MSs financed by national contributions based on GDP and the probability of receiving the funds (no borrowing)
Christofzik et al. (2018); Feld et al. (2018)	no	1) long term fiscal anchor: debt/GDP ratio; 2) medium-term fiscal anchor: structural balance budget	1) debt/GDP: 60%; 2) structural balance budget: -0.5% of GDP (-1% of GDP if the debt ratio is significantly below 60% and low risks to long-term fiscal sustainability)	1/50th (or 1/75th) per year	fixed targets	nominal primary expenditure, net of cyclical unemployment expenditures and discretionary revenue measures	no	growth rate of potential GDP plus the forecast of GDP deflator, adjusted by a constant in order to comply with the structural balance limit	1 year	yes (multi-purpose adjustment account); annual inflows to be offset within 5/10 years	natural disasters and severe economic crises	automatic financial sanctions in case of non-compliance (no intervention of the European Commission; final vote with reversed qualified majority of the Council); access to precautionary lines of ESM only for compliant MSs	-
European Fiscal Board (2018, 2019a, 2020) and Beetsma et al. (2018)	no (important changes to the secondary EU legislation and Fiscal Compact)	debt/GDP ratio	60%	country-specific 3-year ahead adjustment speed (1)	a) set ex ante based on a matrix according to key macroeconomic variables (e.g. initial debt level, interest rate-growth differential) or b) set taking into account a comprehensive independent economic judgement (prepared by the Commission and the country's government, incorporating the views of national fiscal council, and adopted by the Council)	nominal primary expenditure, net of cyclical unemployment benefits, EU-funded investments and discretionary revenue measures (2)	a) investment smoothed over a 4-year period; b) limited golden rule (exclusion of some specific growth-enhancing expenditure prioritised at the EU level)	GDP potential growth plus ECB inflation target (2%) (expenditure path consistent with the 3-year debt reduction target)	3 years	yes, annual deviations to be corrected in subsequent years; non-compliance if the compensation account>1% of GDP	a) exceptional circumstances (severe economic downturn and unusual events outside the government's control); b) pension reforms. Escape clause triggered on the basis of independent economic judgement (provided both by the national fiscal council and the Commission staff)	access to central fiscal capacity subject to full compliance with the rules/suspension of EU funds/financial fines	central fiscal capacity financed by "genuine" own resources and - in case of large shocks - with debt. Spending focused on EU investment priorities

Proposal	Need for Treaty changes	Fiscal anchor				Operational target				Adjustment/compensation account	Escape clauses	Incentives/sanctions (enforcement of the rules)	EU fiscal capacity
		fiscal aggregate	target	adjustment speed	target setting procedure	fiscal aggregate	special treatment for investment expenditure	benchmark	time horizon				
Kopits (2018)	yes	debt/GDP ratio	60%	3-year ahead debt reduction objective	not specified	option 1: (structural) primary surplus (along with expenditure rule); option 2: annual ceiling on the discretionary budget deficit in nominal amount (given by the difference between non-tax revenue and non-mandatory expenditures) announced three years in advance (3)	no	(structural) primary surplus/discretionary budget deficit compatible with medium-term debt reduction target	3 years	no	national emergency (e.g. natural disasters and severe financial crises) and structural reforms	shortfalls in the primary surplus requirement/excess expenditure financed by junior bonds; shortfalls can be compensated with excess surpluses realized in the past	EU budgetary authority with a common EU-wide stabilization function
Deutsche Bundesbank (2019)	no	structural budget balance	country-specific MTO (as in the existing SGP's rules)	as in the existing SGP's rules	as in the existing SGP's rules	total expenditure (net of discretionary revenue measures)	symmetrical capped golden rule for net investment	expenditure ceiling compatible with the structural balance target	1 year	control account in which positive and negative deviations from the MTO or from the adjustment path are recorded, with a maximum threshold (if breached, to be offset in subsequent years)	national rainy day funds to be used in bad times	not specified	-
Darvas and Anderson (2020)	no (changes to the Six-Pack regulations and the Fiscal Compact)	debt/GDP ratio	country-specific	country-specific 5/7-year ahead debt reduction target	joint effort of the government of the country, the national fiscal council, the European Fiscal Council and the European Commission, approved by the Council	total primary expenditure net of unemployment expenditure discretionary revenue changes	a) asymmetric golden rule (exclusion of net public investment only in bad times); b) cost spread over the entire service-life of the investment	GDP potential growth plus ECB inflation objective (2%); expenditure ceiling compatible with the debt reduction target	multi-year ahead	not specified	general escape clause, possibly applied to each MS separately, triggered by the Council, based on the recommendation of the Commission, taking into account the opinions of the independent national fiscal council and the European Fiscal Council	access to funds of a potential central fiscal capacity (or ESM low cost credit line) conditional upon compliance; issuance of junior bonds in the case of non-compliance; MSs finance minister to publicly testify in front of the national/European parliament in case of serious breaches	-
Blanchard et al. (2021)	yes (one option put forward in the proposal might not require Treaty change)	debt/GDP ratio	country-specific and based on a stochastic debt sustainability analysis (stochastic DSA)	adjustment speed set in such a way to balance the output cost of adjustment with the risks of delay, taking into account the risks to sustainability, the state of the economic cycle and the capacity of monetary policy to offset the contractionary impact of adjustment	national fiscal council or European Commission/European Fiscal Board using a debt sustainability framework developed by the European Commision and/or the European Fiscal Board	nominal primary blance	no	-	not specified	no	in case of large adverse shocks	power to block/delay parliamentary approval of budget; enforcement based on financial sanctions by the Commission or the Council of the EU or on a judicial decision of the European Court of Justice	EU fiscal capacity funded by common borrowing

Proposal	Need for Treaty changes	Fiscal anchor				Operational target				Adjustment/compensation account	Escape clauses	Incentives/sanctions (enforcement of the rules)	EU fiscal capacity
		fiscal aggregate	target	adjustment speed	target setting procedure	fiscal aggregate	special treatment for investment expenditure	benchmark	time horizon				
Martin et al. (2021)	yes	debt/GDP ratio	country-specific and based on a stochastic debt sustainibility analysis (stochastic DSA)	5-year ahead country-specific debt target	each government sets a medium-term debt target using a common methodology developed by the European Fiscal Board; the adequacy of the target assessed/validated by the national indipendent fiscal institution and the Ecofin	nominal primary expenditure net of cyclical unemployment insurance and of new discretionary tax increases	no	GDP potential growth plus inflation expectations; the growth rate of net expenditure to be set in accordance with the 5-year debt target on the basis of output growth and inflation assumptions	5 years	yes, with a deficit ceiling	in case of a pronounced euro-wide recession (that monetary policy cannot counter on its own)	the Council can reject a national budget that would put at risk the sustainability of a MS's public finances; exclusion from EU-funded support	permanent European fiscal instrument with a medium-term borrowing capacity (backed by EU own resources) used in exceptional circumstances for financing common priority initiatives or correcting serious economic divergences among MSs
Francová et al. (2021)	no (changes to the Protocol No. 12 and suspension of certain provisions of the Fiscal Compact)	debt/GDP ratio	100%	1/20th per year	fixed target	1) primary expenditure net of discretionary revenue measures, EU funds co-financing, the cyclical impact of automatic stabilisers and one-offs; 2) primary balance (only for countries with debt/GDP ratio higher than 100%)	for countries - identified by the EC and the EIB and approved by the European Council - experiencing an investment gap	real growth trend; for countries breaching the deficit or debt reference value, expenditure growth below the trend	3 years (revised annually)	yes, with a pre-defined limit	in case of exceptional circumstances (seriorus economic downturn and unusual event outside MS's control) or an investment gap, based on the EC's proposal and approval by the European Council; in the event of a severe downturn, the primary balance rule temporarily suspended in favour of the expenditure rule and no pre-set debt reduction requirement	access to funds from a new fiscal stabilization instrument/EU funds taking into account compliance with the rules	Euro area fiscal stabilization instrument to be activated in exceptional circumstances (based on ESM loans)
Giavazzi et al. (2021)	not specified	debt/GDP ratio	60%	10-year debt reduction target with a speed of 1/50th per year for the "slow-adjusting" part (debt accumulated in response to crises and to finance "spending for the future") and 1/20th per year for the "fast-adjusting" share (the residual share)	fixed target	primary expenditure net of automatic stabilizers (taking into account discretionary changes in revenue)	golden rule for "spending for the future" (investments that have a positive effect on potential growth and/or spending on European public goods that benefits future generations)	no; the expenditure path in line with the 10-year debt reduction target (under macroeconomic assumptions validated by the national fiscal council)	10 years (revised every three years)	no	1) possibility to ask the European Commission to reduce the adjustment speed if the rules imply an excessive adjustment; 2) general escape clause	-	European Debt Management Agency issues debt to buy a certain share of MSs' government debt in proportion to their GDP (national bonds canceled and replaced by a commitment to pay a flow of contributions to the Agency)
Amato et al. (2021)	no	1) debt/GDP ratio; 2) deficit/GDP ratio	1) debt/GDP:60%; 2) deficit/GDP:3%	in the event of a breach of one or both reference values, country-specific 10-year adjustment plan (revised annually)	Fiscal and Structural Plan (FSP) agreed between the MS and the European Commission, approved by the Council of the EU	not specified	spending related to exceptional events beyond the control of governments (e.g. expenditure for green transition) financed with European grants	not specified	not specified	no	FSP revised in case of unforeseen events with a significant impact (recognized as such by the European institutions)	Excessive Deficit Procedure (as in the existing SGP's rules); suspension of European funds in the event of failure to adopt "effective action"	European grants in case of exceptional events beyond the control of national governments (e.g. green transition)

(1) EFB (2008) and Beetsma et al. (2018) initial proposal envisaged a fixed adjustment speed equal for all countries (e.g 1/15th per year).
(2) The expenditure rule would not apply to MSs with debt-to-GDP ratio below 60%; in this case, the 3% deficit ceiling would remain the only constraint.
(3) Kopits (2018) outines a third (more radical) option for SGP reform, consisting of a market-based approach with no European-level fiscal rules.

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