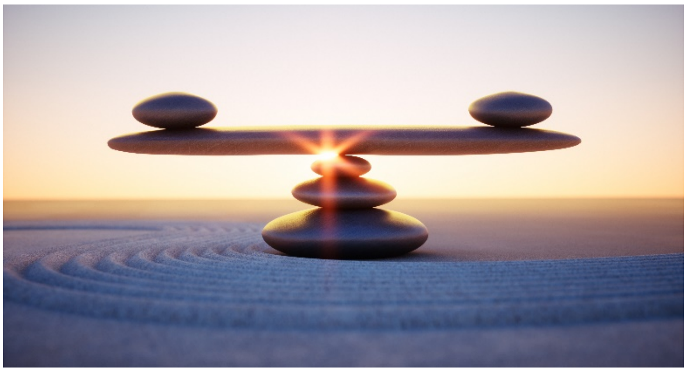
Introduction to the fiscal framework of the EU

The Maastricht Treaty, the Treaty on Stability, Coordination and Governance, and the Stability and Growth Pact



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The Maastricht Treaty, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, and the Stability and Growth Pact

Almost 30 years ago, the Maastricht Treaty laid the basis for economic and monetary union (EMU). Its fiscal provisions have been further developed by subsequent primary and secondary legislation – in particular, the Stability and Growth Pact with its preventive and corrective arms, and the Treaty on Stability, Coordination and Governance in EMU. These instruments together constitute the fiscal framework of the European Union. In early 2020, the European Commission launched a review of the EU's economic governance, seeking in particular to establish how effective the surveillance provisions have been in achieving their objectives. This paper aims to provide an introduction to the Union's economic governance, starting from a brief overview of the economic literature, and concluding with a look at possible developments that might follow from the review, not least examining the various calls for its amendment that have been put on the table. While the Commission's review has been put to one side while the immediate issues of the coronavirus pandemic are addressed, the economic consequences of the pandemic are themselves changing the context for the review.

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Executive summary

Over a period spanning some 20 years, the Maastricht Treaty, the Stability and Growth Pact (SGP) and the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) established the main elements of the supranational EU fiscal framework.

The present paper aims to give an overview of this framework. It starts by presenting the EU's fiscal policy and then by summarising its main elements. There is a rich literature on fiscal rules that is grounded in specific economic theories; these are also summarised in the introductory part. However, EU fiscal rules are not only the result of theoretical speculations, but also of economic and political evolutions that have taken place over the past 30 years. Those are therefore presented succinctly to provide some background relative to the existing choice of rules.

The paper then presents the three main pieces of primary and secondary legislation: the Maastricht Treaty, the TSCG and the SGP. Building on the Maastricht Treaty, the SGP is composed of two 'arms' – a preventive one that aims to ensure that Member States adopt and implement sound budgetary policies over the medium term, while taking into account the variations of the economic cycle, and a corrective one that deals with the appropriate policy responses Member States must take in order to correct excessive deficits and/or debts. The study presents the main elements of these arms: the medium-term objective and the expenditure benchmark (the preventive part), as well as the excessive deficit procedure (the corrective part).

The fiscal articles of the Maastricht Treaty, the main primary legislation behind the EU's fiscal framework, have remained remarkably stable over the past three decades. The SGP, however, has been extensively amended since its inception – once in 2005, then in 2011 with the six-pack and again in 2013 with the two-pack, sets of legislation. These changes, together with a number of 'soft-law' amendments, such as the flexibility interpretation adopted in 2015 and the focus on the expenditure benchmark in 2016, are presented in Chapter 3 of this paper.

The paper also takes account of the steps taken as part of the EU's strategy to respond quickly, forcefully and in a coordinated manner to the current coronavirus pandemic, with the European Commission proposing and the Council of the EU endorsing the activation of the general escape clause of the SGP. This activation allows Member States to take measures to deal adequately with the crisis, while departing from the budgetary requirements that would normally apply under the SGP. One question that is still being debated is when to deactivate the clause. The paper summarises three positions on this matter.

The fiscal framework has been the target of numerous criticisms since its inception. While an account of all proposals for change would be too lengthy, this paper summarises the main proposals formulated by institutions and academia over the past two years (including possibly 'greening' of the SGP rules), as well as the review of the six-pack and two-pack, launched by the Commission at the beginning of 2020. This review is ongoing, with the deadline for consultation delayed due to the pandemic. Possible revisions are expected, including with a view to simplifying the complex framework.

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1. Fiscal policy and fiscal rules

1.1. Introduction

Modern economies tend to experience variations in economic activity over time. They see shifts from periods of increasing economic activity (economic expansion) to periods of decreasing economic activity (recessions).[1] According to an established school of economic thought, authorities in countries with market economies have two major tools at their disposal to influence the pace and direction of overall economic activity: fiscal policy and monetary policy.[2]

Fiscal policy is 'the use of public expenditures and revenues by the governments with the intention of influencing the economy'.[3] Before proceeding further, it is useful to define some of the elements that make up fiscal policy.

Government **revenues** serve the purpose of financing the provision of public goods and services to the population (such as health care and defence), as well as allowing the government to carry out its redistributive role (through subsidies and social benefits). The main sources of government revenues are taxes (on consumption, income, wealth, property and capital) and social contributions (such as contributions for pensions, health and social security), while a smaller share of revenues comes from sales by the general government (e.g. user fees charged for the provision of services), or grants.[4] Yet another share comes from transfers from the EU and other international institutions or even Member States (for instance, the funds received under financial assistance programmes).

Government **expenditures** serve a wide range of purposes. They include, for example, *social protection* (e.g. old age, disability, or sickness pensions, housing and unemployment benefits), *health care* (comprising medical products, appliances and equipment, or hospital services) education, justice, public order and safety. Looking at expenditures by function can show a government's priorities and challenges, as well as track their evolution over time. Changes in the structure of government expenditures can stem from policy choices or socioeconomic trends, such as demographic changes (e.g., an aging population). Furthermore, government expenditures reflect past and current policy decisions guaranteeing entitlements and rights.[5] Annual transfers to the EU and to other international institutions (or Member States) must also be considered in the context of government expenditures.

A government incurs a **deficit** when its expenditures exceed its revenues. It generates a *surplus* if revenues are greater than expenditures. If its revenues equal its expenditures, then it is running a *balanced budget*.[6] Public deficits are financed by additional revenues (new debt), mostly through the issuance of public bonds that have to be repaid by their respective maturity dates.

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1 The movement of the economy through these alternating periods of growth and contraction is known as the business cycle. See Jeffrey M. Stupak, 'Fiscal Policy: Economic Effects', Congressional Research Service, 2019.

2 Benjamin M. Friedman, 'Monetary Policy', National Bureau of Economic Research Working Paper, December 2000. For an introduction to monetary policy and a history of the European Central Bank's tools and strategies, see briefing by Angelos Delivorias and Carla Stamegna on 'Understanding monetary policy and the European Central Bank', EPRS, European Parliament, forthcoming.

3 J. Miranda Sarmento, 'Public Finance and National Accounts in the European Context', *Financial and Monetary Policy Studies* 47, Springer Nature Switzerland AG 2018, p. 1.

4 OECD, 'Government at a Glance 2019', OECD Publishing, Paris, 2019, pp. 64-66.

5 ibid., pp. 68-70.

6 When a government collects more in tax revenue than it spends, especially during times of economic prosperity, it creates a restraint on the expansion of the economy as a consequence of tax policy, to help ward off inflation. On the other hand, when it spends more than it takes in revenue, it needs to raise taxes or borrow, creating a stimulus for the

Debt is the money that the government owes to its creditors. These can include private citizens, institutions, or foreign governments. Debt measurements represent the accumulation of all previous net government borrowing activities.[7]

The real economy contributes to public debt and deficits: better economic times in theory produce lower deficits (or higher surpluses), as there is an increase in tax revenues and lower expenditures due, for instance, to decreased demand for public assistance. The opposite effect occurs during recessions: as incomes and employment fall, the tax system collects less revenue, and spending on mandatory income security programmes (such as unemployment insurance) rises.

At the same time, deficit and debt interact. Budget deficits increase debt levels, given that, in order to finance them, a country's Treasury will usually sell debt securities (sovereign bonds). However, the need to service higher interest payments on a country's debt may, in turn, increase its future deficits.[8]

Fiscal policy is said to be *expansionary* when spending is higher than revenue. In this case, the budget may be in deficit, due to increases in government spending,[9] decreases in tax revenue,[10] or a combination of the two. Such a policy is expected to *increase* economic activity (i.e. the gross domestic product (GDP) and those economic indicators that tend to move with it, such as employment and individual incomes). It is said to be *contractionary* when revenue is higher than spending. This happens when the government budget is in surplus, as a result of a decrease in government spending, an increase in tax revenue, or a combination of the two. Such a policy is expected to *slow* economic activity (if there are fears that the economy may be overheating).[11]

Fiscal policy can affect:

- the *total (or aggregate) demand* for goods and services. This can happen directly (if the government increases its purchases but keeps taxes constant) or indirectly. In this latter case, the government can, for instance, cut taxes, thus increasing households' disposable income and leading them to spend more on consumption, which in turn increases demand.
- the *exchange rate and trade balance*. In the case of an expansionary fiscal policy, government borrowing normally leads to a rise in interest rates. This attracts foreign capital, which in turn leads to an increase in the value of the currency, at least in the short run.[12]
- the *burden of future taxes*. When the government runs a deficit, it adds to its stock of debt. Since this increases the interest on the debt, it also increases the burden on future taxpayers.[13]

Through its fiscal policy, the State intervenes in the *allocation of resources* for the provision of those goods and services that are not efficiently and satisfactorily provided by the market, thus seeking to satisfy social needs. The policy can also be used to contribute to correcting *income distribution*. Lastly, fiscal policy has a macroeconomic stabilisation function, as it can also affect employment,

economy. Lastly, in general, a balanced budget tends to have a neutral effect on the economy, in that it will neither stimulate nor diminish aggregate demand, as a result of taxes and government spending. See Aman Khan, *Fundamentals of public budgeting and finance*, Palgrave Macmillan, 2019, p. 21.

7 Grant A. Driessen, 'Deficits, Debt, and the Economy: An Introduction', Congressional Research Service, 2019.

8 ibid.

9 Government spending takes the form of both purchases of goods and services by the government, which directly increase economic activity, and transfers to individuals, which indirectly increase economic activity as individuals spend those funds.

10 Decreased tax revenue via tax cuts indirectly increases aggregate demand in the economy. For example, an individual income tax cut increases the amount of disposable income available to individuals, enabling them to purchase more goods and services.

11 David N. Weil, 'Fiscal Policy', entry in *The Library of Economics and Liberty* (Econlib).

12 Nevertheless, *persistent* deficits can result in a significant accumulation of external debt. This, in turn, can lead foreigners to distrust the country's assets in the long run and can cause a depreciation of the exchange rate.

13 David N. Weil, op. cit.

price level stability or the equilibrium of the balance of payments.[14] Those three functions of policy can be assigned differently across levels of government.[15] As can be seen below, the decision to establish the economic and monetary union (EMU) was linked to making the stabilisation function the prerogative of Member States, but subject to multilateral surveillance.

As mentioned above, the balance between total public expenditure and revenue in a specific year is the **budget balance** (or fiscal balance). The budget balance shows the extent to which the government expenditure is financed by the revenue collected in a given year.[16]

The budget balance has a **cyclical component**, the part of the change that follows automatically from the cyclical conditions of the economy. It also has a **discretionary** component, this being the change in the budget balance (and in its components) that is under the control of government. This 'voluntary' impulse induced by fiscal policy is measured through the concept of *fiscal stance*,[17] as opposed to that of 'automatic stabilisers'.[18][19] As fiscal policy in general (see above), the fiscal stance can be considered to be either expansionary, neutral or contractionary.

A **pro-cyclical** fiscal policy corresponds to a fiscal stance that amplifies the economic cycle by increasing the structural primary deficit[20] during an economic upturn, or by decreasing it during a downturn. A **neutral** fiscal policy keeps the structural balance (see definition two paragraphs down) unchanged over the economic cycle, but lets the automatic stabilisers work.

The government's fiscal balance can be significantly affected by economic cycles and one-off events. Government revenues (particularly tax revenues) tend to decline during economic downturns, as there is less economic activity subject to the corresponding taxes. At the same time, public spending may increase as more people become unemployed and qualify for social assistance or unemployment benefits. The government could also decide to incur additional expenditure (e.g. investment) to counterbalance the effects of lessened private activity. As such, the general government fiscal balance alone does not give a full picture of the government's underlying fiscal position.[21]

An indicator that better captures structural trends – so as to better assess the sustainability of public finances in the long run – is the **structural balance**. It is defined as the actual budget balance net of the cyclical component and one-off and other temporary measures. **One-off and temporary measures** are government transactions having a transitory budgetary effect that does not lead to a sustained change in the budgetary position.

14 J. Miranda Sarmento, pp. 2-3.

15 According to Marco Cangiano and Eric Mottu, the allocative function can be centralised or decentralised. The redistributive function should be carried out at central government level because the mobility of individuals would lead to a concentration of low-income earners in the most generous regions, reducing the ability to finance the redistribution policy. The macroeconomic stabilisation function should also be centralised, because sub-central governments would not have the incentive to provide optimal stabilisation, as they would free-ride on fiscal efforts carried out beyond their jurisdiction. ('Will fiscal policy be effective under EMU?' IMF working paper, December 1998).

16 OECD op. cit., p. 52.

17 The fiscal stance is generally calculated as the variation of the structural balance as a percentage of potential output.

18 Automatic stabilisers are features of the tax and spending regime that react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance as a percentage of GDP tends to improve during high economic growth and deteriorate during economic slowdown.

19 Agnès Bénassy-Quéré, Euro-area fiscal stance: definition, implementation and democratic legitimacy, paper requested by the European Parliament's Economic and Monetary Affairs Committee, July 2016.

20 The primary deficit is the (fiscal) deficit minus interest on public debt. The structural deficit is the part of the deficit, which is not related to the state of the economy in the business cycle.

21 OECD 'Government at a Glance 2019', p. 56.

The primary balance is the budget balance net of interest payments on general government debt. The primary balance is a critical indicator of short-run sustainability.

The primary structural balance is therefore the budget balance net of the cyclical component of one-off and other temporary measures and net of interest payments on general government debt.

1.1.1. Theory developments

Fiscal policy gained prominence after the 1950s as a tool for demand management in the context of Keynesian economics, which influenced economic thinking from the years following WWII until the beginning of the 1970s.[22] Until then, the dominant theory, Classical Macroeconomics, recognised that a capitalist market economy could deviate from its equilibrium level of output and employment, but was of the view that such deviations would be temporary, as the market would restore full employment equilibrium. As such, government intervention was not necessary.[23]

Keynesian economics is mainly oriented towards the short term and views total consumption as determined by current disposable income.[24] According to Keynesians, by increasing aggregate demand in order to offer companies the opportunity to sell larger quantities of products at profitable prices, budgetary policies have a key role in reducing unemployment[25] and bringing income to the level of full employment. Any increase in total income will be associated with private savings, as only a part of the additional income will be consumed. Given that an increase in deficit is expected to increase total demand and by extension additional private savings, it should not affect private investment or the current account. This implies that the effect of a (temporary) deficit on national income should be small.[26]

In the mid-1970s, however, the role of fiscal policy as a stabilisation tool started being increasingly questioned.[27] During this period, many advanced economies suffered from a combination of inflation and slow growth (stagflation), for which Keynesian Theory had no appropriate policy. The first challenge to the Keynesian Theory came from another school, that of Monetarism.

Monetarism

Contrary to Keynesians, monetarists maintained that the money supply is the main determinant on the demand side of short-run economic activity.[28] They argued as a result that the authorities cannot and should not be given discretion to vary the strength of fiscal and monetary policy as and when they see fit, due to lags associated with fiscal and monetary policies.[29] An illustration of the shift from one school to the next can be seen in two versions of the Optimal Currency Area (OCA) Theory.

[22] Public finances in EMU 2004, European Economy institutional papers, European Commission, January 2004, pp. 143-160.

[23] Brian Snowdon and Howard R. Vane, *Modern Macroeconomics*, Cheltenham, Gloucestershire: Edward Elgar Limited, 2005, p. 37.

[24] Disposable income is defined as the income of households after taking into account net interest and dividends received and the payment of taxes and social contributions.

[25] Consumption expenditure is spending by resident institutional units – including households and enterprises whose main economic centre of interest is in that economic territory – on goods or services that are used for the direct satisfaction of individual needs or wants or the collective needs of members of the community.

[26] A temporary deficit can be covered by increased demand (and increased output). To absorb a permanent deficit, aggregate output and demand should grow continuously.

[27] Marco Buti and Paul van den Noord, Fiscal policy in EMU: Rules, discretion and political incentives, European Commission, Economy Papers, July 2004.

[28] Encyclopaedia Britannica, 'Monetarism'. See also Sarwat Jahan and Chris Papageorgiou, 'What is Monetarism?' *Finance & Development*, International Monetary Fund, March 2014.

[29] Snowdon and Vane, *Modern Macroeconomics*, p. 25.

According to Paul De Grauwe, the traditional OCA Theory[30] is very much a Keynesian theory, stressing that in a world of price and wage rigidities, monetary policies, including exchange rate policies, can be used effectively to stabilise the economy. Another paper of Mundell, however, published in 1973 and influenced more by monetarist ideas, stressed that activist monetary policies become sources of instability and that central banks should focus on their core business, which is to maintain price stability. In this monetarist vision, the costs of a monetary union were small.[31]

New Classical Economics

Both Keynesians and monetarists came under scrutiny during the mid-1970s. At that time, another theory, – New Classical Economics – placed emphasis on the forward-looking behaviour of agents (long run) and the requirement of rationality in forming their expectations. In line with the monetarists, new classical economists believed that the economy is inherently stable, unless disturbed by erratic monetary growth, and that when subjected to some disturbance, it would quickly return to its natural level of output and employment. However, the new classical case against discretionary policy activism and in favour of rules, was based on a different set of arguments to those advanced by monetarists. Three insights in particular shaped the new approach:

1. *the policy ineffectiveness proposition*,[32] which implies that only random or arbitrary monetary policy actions undertaken by the authorities can have short-run real effects, because they cannot be anticipated by rational economic agents. Given that such actions will only increase the variation of output and employment around their natural levels, increasing uncertainty in the economy, the proposition provides an argument against discretionary policy activism in favour of rules;
2. *Lucas' critique of economic policy evaluation*,[33] which questions the proposition that traditional Keynesian-style macroeconomic models can accurately predict the consequences of various policy changes on key macroeconomic variables;
3. *Kydland and Prescott's analysis of dynamic time inconsistency* [34], which implies that economic performance can be improved if discretionary powers are taken away from the authorities, provides another argument in the case for monetary policy being conducted by rules, rather than discretion.[35]

In 1974, Robert Barro wrote an influential paper[36] showing that, in the context of an overlapping generations model of the economy,[37] whether a government raises taxes or takes on additional debt

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30 What De Grauwe calls 'Mundell I', i.e. the theory pioneered by Robert A. Mundell (1961) and further elaborated by Ronald I. McKinnon (1963), Peter Kenen (1969) and others, determines the conditions that countries should satisfy to make a monetary union attractive, i.e. to ensure that the benefits of the monetary union exceed its costs. According to the theory, countries in a monetary union should experience macroeconomic shocks that are sufficiently correlated with those experienced in the rest of the union (symmetry). These countries should have sufficient flexibility in the labour markets to be able to adjust to asymmetric shocks once they are in the union. Finally, these countries should have a sufficient degree of trade integration with the remaining members of the monetary union, so as to generate benefits from using the same currency. According to the author, the presumption of many economists at the end of the 1980s was that, given the degree of integration achieved in the EU, there was too much asymmetry and too little flexibility for the EU to form a monetary union whose benefits would exceed the costs.

31 Paul De Grauwe, 'What Have we Learnt about Monetary Integration since the Maastricht Treaty?', *Journal of Common Market Studies*, 2006, pp. 711–730.

32 Thomas J. Sargent and Neil Wallace, 'Rational expectations and the theory of economic policy', *Journal of Monetary Economics*, April 1976, pp. 169-183.

33 Robert E. Lucas Jr., 'Econometric policy evaluation: A critique', Carnegie-Rochester Conference Series on public policy, 1976, pp. 19-46.

34 Finn E. Kydland and Edward C. Prescott, 'Rules Rather than Discretion: The Inconsistency of Optimal Plans', *Journal of Political Economy*, June 1977 pp. 473-492.

35 Snowdon and Vane, *Modern Macroeconomics*, p. 26.

36 Robert J. Barro 'Are government bonds net wealth?', *Journal of Political Economy*, 1974.

37 See here for a summary of the model and here for a short lecture on it.

to finance higher government spending, this is bound to have the same effect on private spending. This is due to the fact that, as the government gets more indebted, people will put aside more money in expectation of higher taxes in the future.[38]

Real business cycles

A further step against the prominent role of fiscal policy as a tool for demand management was made by the Real Business Cycle Theory.[39] Real business cycle models tend to explain aggregate fluctuations in business cycles without reference to monetary policy, market failures, fiscal policies or even significant changes to preferences or demographics.[40] Proponents of the theory shared the view that economic fluctuations were predominantly caused not by unanticipated monetary (demand-side) shocks to the economy, but rather, by persistent real (supply-side) shocks – such as the oil shocks of the 1970s and the quick technological evolution taking place during the same period – that result in fluctuations in relative prices, to which rational economic agents optimally respond by altering their supply of labour and consumption.[41] According to Snowdon and Vane, the most controversial feature of this approach is that fluctuations in output and employment are Pareto-efficient[42] responses to real technology shocks in the aggregate production function. This implies that observed fluctuations in output are viewed as fluctuations in the natural rate of output, not as deviations of output from a smooth deterministic trend. As such, the government should not attempt to reduce these fluctuations through stabilisation policy, not only because such attempts are unlikely to achieve their desired objective, but also because reducing instability would reduce welfare.[43] As Buti et al. note, 'if the business cycle is an equilibrium response to supply side shocks, fiscal policy is unnecessary and may even be damaging being itself a source of shocks'.[44] In addition to the above, a 1981 paper by Thomas Sargent and Neil Wallace showed that, under certain circumstances, 'the monetary authority's control over inflation in a monetarist economy is very limited even though the monetary base and the price level remain closely connected', because

38 This is the Ricardian Equivalence Theory (from David Ricardo, the 19th century economist). According to Aman Khan, the theory argues that it does not matter whether government raises taxes or borrows (which will eventually be financed out of taxes), the effect will be the same on the economy (private spending will go down). The theory was based on the notion that consumers are rational, in that, when government borrows to finance spending, while cutting taxes to induce savings and investment, consumers tend to save more than usual, to pay for higher taxes in the future. See Khan, Aman, *Fundamentals of public budgeting and finance*, Palgrave Macmillan, 2019, p. 20.

39 According to Jakub Gazda, real business cycle theory 'is built on the assumption that ... business cycle fluctuations might be driven by real factors. [Furthermore,] ... the transition from monetary to real theories of the business cycle was further stimulated by ... the supply shocks associated with the two OPEC oil price increases during the 1970s [,] ... together with the apparent failure of the demand-oriented Keynesian model to account adequately for rising unemployment accompanied by accelerating inflation'. See 'Real Business Cycle Theory – Methodology and Tools', *Economics & Sociology*, Vol. 3, No , 2010, pp. 42-48.

40 Alan C. Stockman, 'Real business cycle theory: a guide, an evaluation and new directions', *Federal Reserve Bank of Cleveland Economic Review*, Vol. 24, No 4, pp. 24-47, 1988.

41 Stockman, for example, notes in the above-mentioned article, that 'Real business cycle analysis is important and interesting for several reasons. First, the evidence that monetary policy affects real output is much weaker than most economists had thought. Second, even if monetary policy affects real output, the evidence that it is the dominant influence on business cycles is also much weaker than previously thought. Third, even if monetary disturbances play a major role in many real-world business cycles, most economists believe that supply shocks and other non-monetary disturbances originating from sources such as oil price changes and technical progress, also play important roles in some aggregate fluctuations'.

42 In other words, they make at least one person better off, without making anyone worse off.

43 Edward C. Prescott, 'Theory ahead of business-cycle measurement', Carnegie-Rochester Conference Series on public policy, 1986, pp. 11-44.

44 Marco Buti and Paul van den Noord, 2004.

persistent fiscal imbalances put pressure on the central bank to finance the government budget deficits.[45]

The Fiscal Theory of the Price Level

The last theory of interest is the Fiscal Theory of the Price Level (FTPL), which was mainly developed in the mid-1990s. Proponents of the theory argued that a commitment of the central bank to maintain price stability and to not monetise public debt may not be sufficient.[46] In addition to this, there must be an appropriate *fiscal policy*, otherwise the goal of price stability may remain elusive no matter how tough and independent the central bank is.[47] Since fiscal policy received so much attention in this new view of price-level determination, Michael Woodford called it the Fiscal Theory of the Price Level.[48]In simple terms, this theory states that inflation control by the central bank through the interest rate is jeopardised by an excessive fiscal stance[49] that disturbs household expectations and unsettles private sector budget constraints. Public demand substitutes private demand and artificially expands total demand, eventually causing the price level to rise. Hence, monetary independence and the effectiveness and credibility of monetary policy need to be supported through the fiscal regime. Therefore, rules to constrain a Member State's fiscal stance appeared desirable as a way of *safeguarding the credibility* of ECB independence.[50]

1.1.2. Developments in public finances and the real economy in the run-up to EMU

After staging a remarkable recovery and a rapid catch-up to the United States from 1950s to 1971, the EU's economy slowed down sharply in 1973. The immediate cause was the sharp increase in oil prices imposed by the OPEC, compounded by an increase in world commodity prices. These 'supply shocks' induced a surge in inflation, followed by high interest rates and a sharp decline in growth. At the same time, the EU faced a slowdown in productivity growth that triggered stagflation.

45 Thomas J. Sargent and Neil Wallace, 'Some unpleasant monetarist arithmetic', *Federal Reserve Bank of Minneapolis Quarterly Review* 5: 1–17, 1981. 'The monetary authority's inability to control inflation permanently under these circumstances follows from the arithmetic of the constraints it faces. Being limited simply to dividing government debt between bonds and base money and getting no help from budget surpluses, a monetary authority trying to fight current inflation can only do so by holding down the growth of base money and letting the real stock of bonds held by the public grow. If the principal and interest due on these additional bonds are raised by selling still more bonds, so as to continue to hold down the growth in base money, then, because the interest rate on bonds is greater than the economy's growth rate, the real stock of bonds will grow faster than the size of the economy. This cannot go on forever, since the demand for bonds places an upper limit on the stock of bonds relative to the size of the economy. Once that limit is reached, the principal and interest due on the bonds already sold to fight inflation must be financed, at least in part, by seignorage, requiring the creation of additional base money. Sooner or later, in a monetarist economy, the result is additional inflation.'

46 Roger Farmer and Pawel Zabczyk define the Fiscal Theory of the Price Level as 'the claim that, in a popular class of theoretical models, the price level is sometimes determined by fiscal policy rather than monetary policy'. For further details, see Narayana Kocherlakota and Christopher Phelan, 'Explaining the Fiscal Theory of the Price Level', *Federal Reserve Bank of Minneapolis Quarterly Reviews*, Fall 1999.

47 See Lawrence J. Christiano and Terry J. Fitzgerald, 'Understanding the Fiscal Theory of the Price Level', *Federal Reserve Bank of Cleveland Economic Review*, second quarter, 2000. For a more comprehensive explanation of the above, see Michael Woodford, 'Control of the public debt: a requirement for price stability?', National Bureau of Economic Research Working Paper, July 1996.

48 Snowdon and Vane, *Modern Macroeconomics*.

49 The fiscal stance measures the direction of fiscal policy by summarising the effect of various discretionary policy actions taken by fiscal authorities. It is defined as the change in the cyclically adjusted primary balance relative to the preceding period. If the change is positive, the fiscal stance is said to be expansionary. If it is negative, it is said to be restrictive.

50 Martin Heipertz and Amy Verdun, 'The dog that would never bite? What we can learn from the origins of the Stability and Growth Pact', *Journal of European Public Policy*, 11:5, 2004, pp. 765-769.

Contrary to the United States, however, the EU found it more difficult to adjust to this slowing down of productivity growth and its economy could not grow fast enough to restore full employment. [51]

Also, from the 1970s through to the mid-1990s, the average share of the general government sector in the economies of the then Member States of the EU increased from 36 % to around 52 % of GDP.[52] The growth in the size of the public sector occurred in tandem with the emergence and persistence of large government deficits, the strong rise in government expenditures not being matched by a commensurate improvement in revenues.[53] Moreover, deficits did not fall as expected during periods of high economic growth, implying that countries offset the working of the automatic stabilisers via discretionary tax cuts or expenditure increases. At the same time, the pro-cyclical[54] loosening in good times took the form of the establishment of permanent entitlements,[55] which contributed to the trend increase in the government's share in the economy, hampered structural flexibility and made the task of regaining control of public finances difficult.[56]

Almost without exception, the average general government deficit for the countries that initially formed the euro area has been above 3 % of GDP from 1975 onwards.[57] High and persistent budget deficits in turn led to rapidly increasing government debt and a mounting interest burden.[58] The ratio of government debt to GDP for the euro area increased from less than 30 % in the late 1970s to nearly 75 % in 1997.[59]

1.2. Why fiscal rules?

Every government in the world faces a budget constraint: any increase in public expenditures must be financed, either by raising additional revenues or by borrowing extra funds. In the latter case, the government's access to borrowing depends on a credible commitment to honour in full all its existing financial obligations. To respect its budget constraint, a government must ensure that the present value of all its future balances is perceived by the financial market players as being sufficient to cover its existing financial obligations. When this is not the case, the government will, at some point, face an adverse event: inflation, debt restructuring or a default.[60]

[51] Martin Neil Baily and Jacob Funk Kirkegaard, 'Europe's postwar success and subsequent problems', Chapter 2 in *Transforming the European Economy*, PIIE press, September 2004. It should be noted that 'full employment' refers to the situation where all people who are available and searching for work can find a job at the prevailing remuneration rates and conditions. It does not mean zero unemployment, as there are always some who may be temporarily unemployed, either because they are moving from one job to the other or for other reasons. See International Labour Organization, 'Moving towards full employment: An interview with Aurelio Parisotto', November 2019.

[52] This increase in the share of public spending in the economy by almost half was largely the result of expanding social transfers and interest payments.

[53] George Kopits and Steven Symansky, 'Fiscal policy rules', IMF occasional papers, 1998.

[54] A pro-cyclical fiscal policy is a fiscal stance that amplifies the economic cycle by increasing the structural primary deficit during an economic upturn, or by decreasing it in a downturn. It can be contrasted with (discretionary) counter-cyclical policy that has the opposite effect. A neutral fiscal policy keeps the cyclically adjusted budget balance unchanged over the economic cycle, but lets the automatic stabilisers work.

[55] Such as pensions or social security.

[56] Public finances in EMU – 2001, European Economy papers, European Commission, 2001, pp. 61-63.

[57] In the aftermath of German reunification and the strong recession of the beginning of the 1990s, the budget deficit for the euro area surged, attaining a historical high of 5.5 % in 1993.

[58] The interest burden can be defined as the general government interest payments on public debt as a share of GDP.

[59] Public finances in EMU – 2000, European Economy papers, European Commission, 2000, p. 11.

[60] Assessment of EU fiscal rules with a focus on the six and two-pack legislation, European Fiscal Board, September 2019, p. 26.

According to Marc Hallerberg et al (2001) 'a fiscal rule is a combination of a fiscal target, with a set of prescriptions of what governments are supposed to do to achieve this target'. Zsolt Darvas et al.[61] define them as constraints on a government's fiscal policy that impose numerical limits on public finance aggregates (expenditures, revenues, budget balance[62] and/or public debt). Their two main objectives are the long-term *sustainability of public finances*[63] and the *stabilisation of economic activity*.[64]

Four interlocking lines of reasoning feed into the fiscal rules movement. One is the argument that sound budget procedures often produce unsound budget outcomes. Fiscal rules deal with substantive budget outcomes, in contrast to procedural rules,[65] which deal with how the tasks of budgeting are carried out and are indifferent to outcomes.[66] As such, the latter are inadequate to regulate public finance. The second line of reasoning is linked to burgeoning evidence that budgeting in democratic countries is inherently biased to produce expansionary outcomes (see below the 'deficit bias'), because of the political imbalance between concentrated benefits and dispersed costs,[67] the sway of interest groups, incrementalism in budget decisions,[68] and 'sticky' expenditure.[69] The third is the realisation that abandonment of strict balanced budget rules has left budget-makers without firm guidance on appropriate fiscal aggregates. Lastly, a body of research argues that differences in budget outcomes among countries are due to differences in the rules under which governments make tax and spending decisions.[70]

A fiscal rule can be useful for ensuring the credibility of government policy over time. This is crucial in countries with a track record characterised by periods of poor fiscal performance alternating with market-imposed adjustments, followed again by unsustainable deficit spending, and so forth.[71]

Historically, fiscal rules have been mainly utilised at various levels of government for the avoidance of negative spill-overs within a federation, confederation, or currency area. A fiscal rule restraining subnational government deficits prevents externalities from fiscal misbehaviour in one jurisdiction from being transmitted, through credit downgrading and concomitantly higher interest charges, to

61 Zsolt Darvas, Philippe Martin and Xavier Ragot, 'European fiscal rules require a major overhaul', Bruegel policy contribution, October 2018.

62 The budget balance is the balance between total public expenditure and revenue in a specific year. A positive balance indicates a surplus and a negative balance indicates a deficit. 'Public finances in EMU – 2000', European Economy papers, European Commission, 2000.

63 Kopits and Symansky point to Switzerland and Japan as examples of countries where fiscal rules were adopted to prevent a potential future increase in public debt associated with population ageing. It should be noted in this context that Japan's debt exceeds 200 % of GDP.

64 Kopits and Symansky note that in several western European countries and Japan, the budget balance rule currently in existence was largely enacted to support post-WWII macroeconomic stabilisation.

65 The main common principles are: i) comprehensiveness (the budget should include all revenue and expenditure); ii) accuracy (the budget should accurately record transactions); iii) annularity (each budget should span a single fiscal year); iv) authoritativeness (public funds should be spent as authorised in law); and v) transparency (the government should publish timely information on receipts and expenditures).

66 In this regard, due process in budgeting is analogous to due process in litigation. If proper judicial procedure is applied, the ensuing verdict must be accepted.

67 One of the well-known biases of budgeting is that the benefits of expenditure are concentrated while the costs of taxes are dispersed.

68 The common pattern is for spenders to seek increases, to have a portion of the requested increase denied by the Finance Ministry (or the budget agency), and to get more than it had last year.

69 In most developed countries, more than half of central government expenditure is mandated by permanent laws that entitle citizens to ongoing payments from government. These entitlements must be paid regardless of the condition of the budget or of other demands for public funds.

70 Allen Schick, 'The Role of Fiscal Rules in Budgeting', *OECD Journal on Budgeting*, OECD, 2003.

71 George Kopits and Steven Symansky 'Fiscal policy rules', IMF occasional papers, 1998.

other subnational jurisdictions and to the national government. This argument has been applied to member countries of a monetary union.[72]

A fiscal rule can assist other financial policies, especially the utilisation of monetary instruments in pursuing the goal of stabilisation. It has been suggested that a rule that reduces budget deficits – while allowing automatic stabilisers to work – tends to lessen the burden on monetary policy.[73]

1.3. EU fiscal rules

The original motives for creating a common currency in Europe were both economic[74] (collapse of the Bretton Woods system in the 1970s, oil shocks, common currency necessary to complement the single market, as it would remove exchange rate risks and conversion costs) and political in nature (need for a reunified Germany to be firmly anchored in the EU).[75]

On the economic front, integration rested on a convergence of views across different countries related to the virtues of stable money and sound finances – a 'Brussels–Frankfurt consensus',[76] encompassing those policies that followed *macroeconomic stability* (balanced budgets, price stability, and, for developing countries, exchange rate stability), *supply-side structural reforms* aimed at increasing competition and openness, and the neglect of any possible trade-off between present and future growth.[77] The consensus was based on two of the theories mentioned above. The first was the Monetarism Theory, in which the central bank cannot do much to stabilise the economy. If it tries too hard to 'fine-tune' the economy, it will end up with more inflation. Thus, the best thing a central bank can do is to stabilise the price level. This will have the incidental effect of producing the best possible outcome in terms of stability of the economic cycle. The second theory was the Real Business Cycle Theory, according to which the sources of economic cycles are shocks in technology (supply-side shocks) and changes in preferences. Again, there is very little the central bank can do about these movements.[78] The best is to keep the price level on a steady course, thus anchoring private sector expectations and minimising deviations from the optimal path of the economy, to lessen the effects of these shocks. Similarly, in this context, fiscal and monetary rules are justified because they avoid policy-induced uncertainty, minimise the risk of biases in government action, and provide a stable environment for investment and growth.[79]Lastly, an additional theory was influential in Member States choosing fiscal rules: this New Political Macroeconomics studied the various forms of interaction between politics and macroeconomics. Its models showed that while the scope for opportunistic or ideological behaviour is more limited in the rational expectations setting, political distortions still have an impact on macroeconomic policymaking, given the presence of imperfect information and uncertainty about the outcome of elections.[80] As such, their

[72] ibid.

[73] ibid.

[74] In this context, it is interesting to read the study 'One Market, One Money, An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union' commissioned by the European Commission, which evaluated the benefits and costs of forming an economic and monetary union.

[75] Marco Buti, Servaas Deroose, Vitor Gaspar and João Nogueira Martins, *The Euro: the First Decade, Commission of the European Communities*, Cambridge University Press, 2010.

[76] Erik Jones, 'The collapse of the Brussels–Frankfurt consensus and the future of the euro', chapter 5 in Schmidt, Vivien A. and Thatcher, Mark (eds.), *Resilient liberalism in Europe's political economy*, Cambridge University Press, 2013.

[77] Francesco Saraceno, 'The Lessons of the Crisis for EU Policy-Making', *Politique européenne*, 2015, pp. 70-80.

[78] Paul De Grauwe, op. cit., 2006, pp. 711–730.

[79] Francesco Saraceno, op. cit., pp. 70-80.

[80] Alberto Alesina and Nouriel Roubini, 'Political Cycles in OECD Economies', *The Review of Economic Studies*, October 1992, pp. 663-688.

work pointed towards the need for greater transparency in the conduct of fiscal policy and the introduction of central bank independence for the conduct of monetary policy[81][82].

This translated into two main elements characterising the EU fiscal framework: on the one hand, rules to tackle the deficit bias, and, on the other, a move from a single-year to a longer-term budget perspective.

1.3.1. The deficit bias

The EMU fiscal rule framework is based on the idea that, in the absence of policy measures, government deficits and debt will further increase in the medium and long term. As mentioned above, the deterioration in public finances on the way to Maastricht was perceived to be caused by a *deficit bias*, which was caused by three general factors:[83]

- *the 'fiscal illusion'*: individuals (voters) tend to see the short-term benefits they can get from lower taxes and increased government spending but are not always fully aware of the possible long-term costs of such policies. Therefore, their behaviour would provide incentives for opportunistic politicians to improve their chances to be re-elected through the implementation of unfinanced tax reductions or expenditure increases;[84]
- *the influence of strategic actions by political parties*: for instance, governments with slim chances of being re-elected may be tempted to run deficits and accumulate debt in the course of their term, so as to prevent future governments from engaging in ambitious programmes or in activities inconsistent with the priorities of the administration currently in power;[85]
- *the 'common pool' problem*: this problem arises when several players representing different interest groups bargain on the allocation of public resources with a view to satisfying their own group. Each player tends to maximise appropriation, without respecting the overall budget constraint.[86]

As mentioned earlier, at the time, theory held that the reduction in public savings associated with budget deficits would result in a reduction in private investment (the 'crowding out effect'),[87] or in

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81 Alberto Alesina and Roberto Perotti, 'Fiscal Discipline and the Budget Process', *The American Economic Review – Papers and Proceedings of the Hundredth and Eighth Annual Meeting of the American Economic Association San Francisco*, May, 1996, pp. 401-407; and Brian Snowdon, 'Politics and the Business Cycle', *The Political Quarterly*, December 2002.

82 Snowdon and Vane, *Modern Macroeconomics*, op. cit., 2005.

83 Public Finances in EMU 2006, European Economy institutional papers, European Commission, January 2006, pp. 141-149.

84 An alternative argument why voters would not punish excessive lending has to do with intertemporal redistribution. As per this argument, the current generation may prefer leaving the burden of debt to future generations while taking advantage of today's lower taxes and higher public spending. Since the current generation is the only one that votes, such preferences may provide incentives for undesirable policies from a societal point of view.

85 As a result, the larger the probability of an electoral defeat for the administration in power and the larger the difference in preferences between parties, the larger the deficit bias may be.

86 This problem found expression in voting rules and political systems exercising an influence on budgetary outcomes. Under this theory, in the absence of a clear delegation of powers to a strong finance minister or of preliminary agreements or pacts within the government to decide on budgetary allocations in a centralised manner, this situation can lead to a deficit bias.

87 Increased deficits increase public debt. To service the increasing amount of debt, a country's government would have to increase taxes or impose a higher demand for funds in the capital markets, therefore causing interest rates to rise. Increased interest rates would reduce the amount of savings available for private investors and decrease the expected rate of return of private capital (this is the 'crowding-out effect' on private investment). For a discussion on the potential crowding-in and crowding-out effects of investment, see António Afonso and Miguel St. Aubyn, 'Macroeconomic rates of return of public and private investment – crowding-in and crowding-out effects', ECB working paper, February 2008.

a worsening of the current account (the 'twin deficit hypothesis'),[88] or both. This, in turn, would lead to lower future income, either through the reduction in future potential output or via a lower net stream of interest payments from abroad.[89]

In addition to the above, it was thought that, since the real cost of debt repayment for the government can, at least temporarily, be reduced by means of inflation, when the debt level is high, government pressure to create inflation is stronger. Relative to this, the Fiscal Theory of the Price Level showed that, even an independent central bank committed to keeping inflation low, may not be sufficient to prevent inflation if fiscal policy is not conducted in such a way as to avoid persistent excessive deficits. This is so, because debt may eventually accumulate up to a point in which default occurs or in which debt sustainability is achieved through a reduction in its real value obtained via an increase in the price level.[90]

Lastly, risk premia on sovereign bonds tend to increase with debt-to-GDP ratios. Once debt is no longer deemed sustainable, a country's government can either implement fiscal consolidation or declare default on its debt. Given that fiscal consolidation is politically costly, investors in financial markets tend to assign a higher probability to the risk of the country defaulting on its debt. Therefore, it was thought that an increasing deficit will probably lead to increased interest rates on sovereign bonds, and even to sudden and massive capital outflows.

In this context, the EU fiscal framework focused initially on numerical fiscal rules guiding or constraining the discretion of policymakers[91] and on independent bodies or institutions providing forecasts or analysis and formulating recommendations in the area of fiscal policy.[92]

1.3.2. The medium-term budgetary frameworks

Most fiscal policy decisions have economic and budgetary implications that only show up one year later. In addition, it is recognised that a single-year budget perspective constitutes a poor basis for both strategic budgetary planning and the implementation of structural reforms, as their positive effects are only felt in the medium term. Moreover, it is not difficult for creative budget-makers to dress up one year's accounts so that they appear more favourable than they really are.[93]

These considerations have led many EU countries to supplement their budgetary institutions with medium-term budgetary frameworks, i.e. institutional policy instruments allowing their fiscal

88 According to the twin-deficit hypothesis, when a government increases its fiscal deficit, domestic residents use some of the income windfall to increase consumption, causing private and public national saving to decline. The decline in saving requires the country either to borrow from abroad or reduce its foreign lending, unless domestic investment decreases enough to offset the saving shortfall. Thus, a wider fiscal deficit typically should be accompanied by a wider current account deficit. See Leonardo Bartolini and Amartya Lahiri, 'Twin Deficits, Twenty Years Later', Federal Reserve Bank of New York, October 2006, or Michele Cavallo, 'Understanding the Twin Deficits: New Approaches, New Results', *Federal Reserve Bank of San Francisco Economic Letter*, July 2005.

89 Public finances in EMU 2004, European Economy institutional papers, European Commission, January 2004, pp. 143-160.

90 With regard to why low inflation is good for the economy, see Price stability – why is it important for you?, European Central Bank, 2011.

91 For instance, limits on the deficit or debt of entities from the general government sector, on a yearly basis or on average over a given period. Alternatively, limits on some categories of government expenditure or tax revenues.

92 While those institutions are not mandated to carry out any particular fiscal policy tasks, they can ensure that fiscal policy is based on unbiased forecasts, provide analysis on issues such as the cost of policy measures, and release regular assessments and recommendations related to fiscal policy in order to increase the 'reputation costs' for the conduct of unsound policies.

93 When pressured to abide by fiscal constraints, some governments have shortened the fiscal year to 11 months or lengthened it to 13; some have made spending or revenue provisions temporary in order that the current budget fit into the constraints; yet others have used one-off revenue gains or spending cuts to defer the bad news to the future.

authorities to extend the horizon for fiscal policy-making beyond the annual budgetary calendar.[94] Medium-term budgetary frameworks are typically based on a macroeconomic scenario that determines the medium-term availability of government resources to finance policies. On this basis, the fiscal authorities provide medium-term projections for the main aggregates of government finances,[95] for either a part of or the whole general government.[96]

Among the various benefits of medium-term budgetary frameworks is that they contribute to addressing the aforementioned deficit bias[97] and common pool problems,[98] which are among the main reasons behind overspending and accumulation of deficits and debt over time.

The literature has pointed out a number of key conditions for the effectiveness of medium-term budgetary frameworks. These include the need for making cautious macroeconomic assumptions underpinning budgetary projections, by means of introducing 'prudence factors'[99] in the frameworks, or for delegating the preparation of the scenario for these projections to independent bodies. In addition, medium-term budgetary targets should be vested with a sufficient degree of political commitment by all actors playing a role in the conduct of fiscal policy, there should be a clear link between the framework and the annual budget law;[100] and there should be a high degree of transparency concerning the nature of the budgetary projections formulated in the context of the framework.

A type of medium-term budgetary framework that has existed since the beginning of EMU are the *stability* or *convergence programmes* prepared by the Member States every year.[101] The programmes provide macroeconomic and budgetary projections for the current year and at least the three following years, for all the main budgetary aggregates.[102] They must be based on realistic and cautious macroeconomic forecasts and describe the budgetary and other economic policy

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94 In the EU, Council Directive 2011/85/EU (the Fiscal Frameworks Directive) on requirements for budgetary frameworks of the Member States, defines such a framework as a specific set of national budgetary procedures that extend the horizon for fiscal policy-making beyond the annual budgetary calendar. It includes setting policy priorities and medium-term budgetary objectives.

95 Government balance and debt; government expenditure and revenue, and their composition.

96 Public finances in EMU — 2007, European Economy, European Commission, 2007, p. 152.

97 Medium-term budgetary frameworks help address the deficit bias by enhancing the transparency of Member States' medium-term budgetary objectives and allowing to better take into account future budgetary implications of policy measures in the decision-making process. Moreover, they contribute to addressing the issue of time inconsistency in the conduct of fiscal policy, because the existence of a developed medium-term budgetary framework will make it more difficult for governments to hide or understate the multiannual budgetary effects of new policy measures or to postpone the implementation of difficult fiscal consolidation measures.

98 They help address the common pool problem of public resources by allowing to better take into account future consequences of budgetary decisions and to shift the focus from the size of total government spending to the possibilities for reallocations within programmes over a pre-defined period.

99 This is done either through a systematic downward adjustment of economic assumptions compared to the central scenario or by incorporating contingent reserves that can only be activated in case of a negative surprise regarding macroeconomic or government revenue developments.

100 In the sense that the preparation of the annual budget should start by considering the projections elaborated in the preceding year(s) in the context of the medium-term budgetary framework. Deviations from previous plans should be explained and justified.

101 For an overview of the 2020 stability and convergence programmes, with an assessment of the euro area fiscal stance, see the European Commission institutional paper of the same title (No 131), July 2020. For an example of what needs to be supplied in a stability and convergence programme, see Numerical examples and technical aspects for 'hands-on' experts –2019 edition, European Commission, pp. 5-11.

102 More specifically, Member States are obliged to present, among other things, information on their medium-term budgetary objective and the adjustment path towards it, the expected path of the general government debt ratio, the planned growth path of government expenditure, including the corresponding allocation for gross fixed capital formation, the planned growth path of government revenue at unchanged policy, and a quantification of the planned discretionary revenue measures. For more information, see 'Report on Public Finances in EMU 2014', European Economy, September 2014, pp. 69-89.

measures being taken or proposed in order to achieve the medium-term budgetary targets. Council Directive 2011/85/EU (the Fiscal Frameworks Directive) adopted in the context of the six-pack reform (see below), provided further details regarding those frameworks. A further step was taken with the two-pack reform (see below), which provided that (euro area) Member States should make public their national medium-term fiscal plans[103] at the same time as their stability programmes and national reform programmes, no later than 30 April.[104]

[103] National medium-term fiscal plans are documents laying down the national fiscal strategy in line with the medium-term budgetary framework defined by the Fiscal Frameworks Directive. They must contain at least the information required for the stability programmes (and in fact they can be the same document) and include information on how the reforms and measures that have been set out are expected to contribute to the targets and national commitments established within the framework of the EU strategy for growth and jobs.

[104] Report on Public finances in EMU 2014, op. cit.

2. The Maastricht Treaty

2.1. The convergence criteria

The Maastricht Treaty has been described as an incomplete incentive contract,[105] which, by structuring the sequence of actions and the procedures for the decisions governing the transition to EMU, as well as by creating deadlines and institutions, organised the convergence of fiscal and economic indicators that had to take place before the launch of EMU.[106] The Treaty introduced four convergence criteria that Member States' should meet within a fixed time period,[107] as a condition for obtaining EMU membership: a set of macroeconomic indicators, focusing on price, exchange rate, long-term interest rate and fiscal developments.[108] The fiscal criteria were spelled out in terms of reference values for the deficit-to-GDP ratio and the debt-to-GDP ratio.[109]While the reasons for the general choice of criteria were explained above, a search for the economic rationale behind the specific numbers of the convergence criteria brings few results outside the EU institutional circles. Conversely, some academics heavily criticised these criteria at the time as arbitrary and inflexible,[110] as bringing on undesirable pro-cyclical effects and as excluding various EU countries from EMU.[111]

It helps therefore to see them also as the outcome of political negotiations, balancing the interests of EU countries with a traditionally weak financial discipline with those with a traditionally strong financial discipline.[112] In this context, the criteria conform to the preferences of northern Member States of the time, and especially Germany,[113] whose main priority in the negotiations was to establish an EU currency that would be just as stable as the Deutsche Mark. To do so, it insisted that the other EMU member states, with their widely differing monetary and budgetary traditions, conform to disciplined monetary and budgetary policies.[114]

105 Since important variables (such as 'sound public finances') were not directly verifiable.

106 Bernhard Winkler, 'Of Sticks and Carrots – Incentives and the Maastricht Road to EMU', EUI Working Paper, February 1997.

107 On 2 May 1998, the Council of the European Union – in the composition of Heads of State or Government – unanimously decided that 11 Member States had fulfilled the conditions necessary for their participation in the third stage of EMU and adoption of the single currency on 1 January 1999. These Member States were Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

108 A good overview of the convergence criteria is provided on the relevant page of the European Central Bank.

109 The Treaty thus left the allocative and distributional aspects of fiscal policies to the Member States. Annual Report 2019, European Fiscal Board, p. 73.

110 Among others, see Willem Buiter, Giancarlo Corsetti and Nouriel Roubini, 'Excessive deficits: sense and nonsense in the Treaty of Maastricht', *Economic Policy*, April 1993, pp. 57–100.

111 A. L. Bovenberg and A. H. M. de Jong, 'The Road to Economic and Monetary Union', *KYKLOS*, 1997.

112 In their paper 'Taking stock of the functioning of the EU fiscal rules and options for reform', Christophe Kamps and Nadine Leiner-Killinger note that 'Reportedly, the 3% of GDP deficit reference value … was not derived from in-depth economic analysis but was born from political considerations in France in the early 1980s. President François Mitterrand was looking "for an easy rule, that sound[ed] as coming from an economist, and [could] be opposed to the ministers that walk[ed] into his office asking for money". According to a person involved in the preparations at that time, they "came up with this number in less than an hour ... without any theoretical reflection". They were looking for "something simple", with a 1% of GDP government budget deficit being "too difficult to achieve", 2% of GDP putting them "under too much pressure" and 3% of GDP being "a good number" that finally made its way into French fiscal policymaking'. Similarly, in 1989, the aggregate EU debt-to-GDP ratio stood at around 50 % of GDP, so the 60 % debt reference value 'did not seem overly ambitious' when compared to that.

113 According to Bovenberg and de Jong, it was believed that the costs and benefits of EMU would not be equally distributed among the potential participants: countries with relatively little monetary and budgetary discipline had the most to gain from EMU, Germany would benefit least because it was already pursuing credible monetary policies. These considerations gave Germany an exceptionally strong position in negotiating the specific institutional structure of EMU.

114 A.L. Bovenberg and A.H.M. de Jong, op. cit.

The role of the convergence period was twofold: to oblige Member States with a weak(er) financial discipline to demonstrate their willingness and ability to live by the demands of disciplined financial policies, and to allow the EMU candidates to adapt their institutions to the financial discipline required by EMU.[115]

The Treaty also established a system of multilateral economic surveillance to strengthen the coordination of Member States' policies. Under this system, the Council issues 'broad guidelines' for the economic policies of Member States and monitors the consistency of national policies with such guidelines, issuing a warning to deviating Member States'.[116]

Since fiscal policy remained in the domain of national governments, there was the fear that, if a country's fiscal situation became unsustainable, other countries could be forced to bail it out of the insolvent state, or the European Central Bank could be forced to monetise national debts and in so doing could create additional inflation in the EU.[117] To prevent the first risk from materialising, the Treaty established that each Member State would be responsible for repaying its own debts to prevent moral hazard. The clause implied that lenders would face the costs of a possible default; it sought therefore to strengthen market discipline by leading investors to weigh borrowers based on their creditworthiness.[118] To prevent the second risk from materialising, monetary financing was prohibited. By forbidding 'monetary bailouts', the prohibition of monetary financing implies that governments face the full costs of their sovereign risks, as these costs are determined by the market.[119]

2.2. The excessive deficit procedure

Article 126 of the Treaty on the Functioning of the European Union (TFEU)[120] states that Member States shall avoid excessive government deficits. It furthermore sets out both the procedure to be followed to identify and correct situations of excessive deficit, and the voting modalities in the course of the procedure.[121]

The first four steps of the excessive deficit procedure (EDP), corresponding to the provisions of paragraphs 3 to 6 of Article 126 TFEU, concern the *identification* of situations of excessive deficit.

1. The excessive deficit procedure is triggered if the deficit or debt-to-GDP ratio of a Member State exceeds – or is forecast to exceed – a reference value of GDP, unless the excess is considered temporary or exceptional. If a Member State breaches at least one of both ratios, the Commission adopts a report in accordance with Article 126(3), reviewing in detail the economic and budgetary situation of the Member State considered.
2. As foreseen in Article 126(4) and Regulation (EC) No 1467/97, the Economic and Financial Committee formulates an opinion on this report within two weeks.

115 ibid.

116 Michael J. Artis and Marco Buti, 'Close-to-Balance or in Surplus: A Policy-Maker's Guide to the Implementation of the Stability and Growth Pact', *Journal of Common Market Studies*, November 2000, p. 563-592; Assessment of EU fiscal rules with a focus on the six and two-pack legislation, op. cit.

117 R. M. W. J. Beetsma and A. L. Bovenberg, 'The Interaction of Fiscal and Monetary Policy in a Monetary Union: Balancing Credibility and Flexibility', Working Papers, Tilburg Center for Economic Research, 1995.

118 Assessment of EU fiscal rules with a focus on the six and two-pack legislation, op. cit., p. 10.

119 Assessment of EU fiscal rules with a focus on the six and two-pack legislation, European op. cit.

120 This Article corresponds to Article 104 of the Treaty of Maastricht. Going forward, references will only be made to the TFEU.

121 'Implementing the Stability and Growth Pact' in Public Finances in EMU 2005, European Economy papers, European Commission, 2005, pp. 31-33.

3 The Commission takes this opinion into account and, if it considers that an excessive deficit exists, addresses an opinion under Article 126(5) to the Member State concerned and informs the Council.
4 On the basis of the Commission's opinion and after having considered any observations from the Member State, the Council itself decides on the existence of an excessive deficit under Article 126(6).

The subsequent steps of the procedure are dedicated to the *correction* of excessive deficits.

- When it decides that an excessive deficit exists, the Council adopts a recommendation from the Commission, in accordance with Article 126(7). The recommendation is addressed to the Member State concerned. In it, the Council sets two deadlines: one for the Member State to take effective action to correct the excessive deficit, and one for the correction of the excessive deficit itself.[122]
- Should the Council consider that no effective action has been taken, it may decide, as stated in Article 126(8) of the Treaty, to make public its above recommendation.
- Where action by the Member State concerned leads to the correction of the excessive deficit, the Council abrogates, in accordance with Article 126(12), its decisions under the excessive deficit procedure (the procedure is closed).

The aforementioned steps are common for all EU Member States. For the euro-area ones, however, there are further steps.[123]

- Article 126(9) stipulates that, provided the Council adopts a decision under Article 126(8), it may decide to give notice to the Member State concerned to take the necessary measures to reduce its deficit. The recommendations in Article 126(9) of the Treaty include a deadline for the correction of the excessive deficit. Furthermore, Regulation (EC) No 1467/97 specifies that the deficit reduction measures deemed necessary by the Council have to be taken by the Member State concerned within two months at the most from the adoption of the notice under Article 126(9).[124]
- If the Member State fails to comply with the recommendations, the Council may decide to impose sanctions no later than two months after notice has been given. In the case of compliance with the recommendations formulated in the notice under Article 126(9), the decisions taken under Article 126(6 to 9) are abrogated with a Council decision in accordance with Article 126(12), and the procedure is closed.

2.2.1. Protocol (No 12) on the excessive deficit procedure

Protocol No 12 specifies that the reference values referred to in Article 126(2) TFEU are 3 % of GDP for the deficit and 60 % of GDP for the debt.

For the EDP to be effective, the article entrusts the governments of the Member States with the responsibility for their deficits, sets that Member States must ensure that national procedures in the budgetary area enable them to meet their obligations in this area and obliges them to report their

[122] Regulation (EC) No 1467/97 specifies that the latter deadline shall be the year following the identification of an excessive deficit, unless there are special circumstances.

[123] Non-euro-area Member States are not exempt from the obligation to avoid excessive deficits, but the latter steps of the excessive deficit procedure do not apply to them. When a Member State outside the euro area in a situation of excessive deficit fails to respect the recommendations made in Article 104(7), it cannot be targeted by the measures in the last two steps of the excessive deficit procedure, namely the notice foreseen in Article 104(9) and the imposition of sanctions foreseen in Article 104(11). Non-compliance with a recommendation under Article 104(7) may lead to a renewed recommendation according to Article 104(7).

[124] This step constitutes a move towards even closer surveillance, and is the ultimate step before the possible imposition of sanctions.

deficits and debt levels to the Commission. Lastly, the Commission (Eurostat) provides the necessary statistical data.

2.2.2. Protocol (No 13) on the convergence criteria

The protocol explains the remaining convergence criteria, i.e. the criterion on price stability, the criterion on the government budgetary position, the criterion on participation in the exchange rate mechanism of the European Monetary System and the criterion on the convergence of interest rates.

2.2.3. Protocol (No 14) on the Euro Group

The protocol states that the ministers of the Member States whose currency is the euro meet informally, to discuss questions related to the specific responsibilities they share with regard to the single currency. The Commission takes part in the meetings and the European Central Bank is invited to take part in them as well. The meetings are prepared by Commission representatives and the euro area finance ministers. In addition, the euro area finance ministers elect, by a majority, a Eurogroup president for two and a half years.

3. The Stability and Growth Pact

The Treaty establishing a European Community (TEC), signed in Maastricht in 1992, provided the monetary constitution for EMU. However, while the convergence criteria were clear, the question remained: once EMU became a fact, how could the convergence momentum be sustained? While the threat of exclusion from the first wave of EMU had acted as a powerful incentive and co-ordination device for most countries to satisfy the convergence criteria, there were concerns that the Maastricht framework alone would not be enough to induce fiscal discipline, macroeconomic stability and co-ordination on an ongoing basis.[125]

In 1992, a large majority of the then Member States still had a budget deficit far in excess of the reference value of 3 % of GDP.[126] In addition, while between 1993 and 1997 almost all[127] of them improved their budgetary position and succeeded in bringing their budget deficit down to 3 % of GDP or less, the deficit was just below the reference value in 1997 and, in some cases,[128] it had been obtained through non-recurring measures (albeit with limited impact).[129] Lastly, while the government debt on average for the EU-15 in 1992 was just below the reference value of 60 % of GDP, this number increased slightly over the following years.[130]

From a political standpoint, it was noted that at the time, Germany and the Netherlands, in particular, favoured a more explicit, rule-based system that would restrict budgetary deficits once EMU was fully operational. Their preference was seemingly shaped by two factors. The first factor included the prospect that more – and less disciplined – Member States would be joining EMU and that the date of EMU was not postponed any further. The second factor was that the German and the Dutch leaders were being pressured by the political reality at home to move forward with further rules.[131]

From the viewpoint of economics, several arguments were brought forward in favour of more stringent rules: a need for consolidation, following the expansionary fiscal stance taken by many countries during the 'golden age' of welfare-state expansion;[132] concerns about negative effects of

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[125] See in this context, Bernhard Winkler, 'Is Maastricht a Good Contract?', *Journal of Common Market Studies*, March 1999, pp. 39-58.

[126] Except for Germany, where the deficit was already slightly below the reference value in 1992 and remained more or less unchanged thereafter.

[127] Apart from Greece, which, at that stage, intended to join EMU only later.

[128] France can be used to illustrate both points, as this Member State only managed to reduce its budget deficit to exactly 3 % of GDP in 1997, and then only thanks to a substantial one-off capital transfer from France Télécom, totalling around 0.5 % of GDP, in exchange for the French government's assumption of that company's pension liabilities.

[129] Geert Langenus, 'The stability and growth pact: an eventful history', *National Bank of Belgium Economic Review*, June 2005.

[130] Ultimately, though, none of the original 11 candidate members were excluded from EMU on the basis of the convergence criterion relating to government debt.

[131] Martin Heipertz and Amy Verdun, 'The Stability and Growth Pact – Theorizing a Case in European Integration', *Journal of Common Market Studies*, 2005, pp. 986. The authors note that the German Council of Economic Experts had already demanded in its 1992 annual report that the sanctions be made more precise and be applied in a strict manner. This became the subject of a public debate orchestrated by Bundesbank President, Hans Tietmeyer, which picked up and had many notable contributions made to it (see, for instance, this one by the Kiel Institute for the World Economy, IfW Kiel). The arguments reappeared as demands for a 'budgetary pact' in the 1995 report of the German Council of Economic Experts. Meanwhile, public opinion about EMU was becoming negative and the SPD opposition was using the dangers to stability stemming from the project at its advantage. This situation pressured the German Finance Minister, Theo Waigel, to move forward and propose a stability pact to his EU peers.

[132] The authors note that high interest rates, which were the result of high inflation rates at the time, reduced investment and contributed to weak growth and underemployment. Similarly, government revenues flew into debt servicing at the same time as ageing populations required a fundamental reallocation of public spending.

fiscal spill-overs on increasingly interdependent participating economies;[133] the fear that excessive deficits could undermine central bank independence;[134] and the need for a more coherent framework of economic policy coordination.[135]

The three options to move forward were: i) renegotiate Maastricht; ii) move forward with an intergovernmental treaty, or iii) adopt secondary legislation. The first option seems not to have been met positively; the reaction of the leaders and the Commission to the idea of an intergovernmental treaty was not positive either.[136] The Council therefore prompted the Commission to propose a solution within the Community framework. The Commission proposal, released in October 1996,[137] developed the 'surveillance arm' of the SGP as a device for economic policy co-ordination. However, it did not include automatic fines, but reduced the sanctions to a discretionary measure of the Ecofin Council.

The principal aim of the Stability and Growth Pact was to enforce fiscal discipline as a permanent feature of EMU. It was implicitly recognised that the loss of the exchange rate instrument in EMU would imply a greater role for automatic fiscal stabilisers at national level to help economies adjust to asymmetric shocks. This is, according to the Commission, the rationale behind the core commitment of the SGP, i.e., to set the '… medium-term objective of budgetary positions close to balance or in surplus…', which would '…allow Member States to deal with the normal cyclical fluctuations while keeping the government deficit within the 3 % reference value'. The approach of the Commission built on a contemporary body of literature that stressed the complementarity between fiscal discipline and fiscal stabilisation. Sound fiscal behaviour in 'good' times when economic conditions are favourable provides room for the effective use of automatic fiscal stabilisers in 'bad' times.[138]

3.1. Elements of the SGP

Formally, the SGP consists of three types of elements:

- *preventive elements* contained in Council Regulation 1466/97,[139] which – through multilateral surveillance of budgetary plans and coordination of economic policies – aim at preventing budget deficits going above the 3 % reference value;
- *dissuasive elements* contained in Council Regulation 1467/97,[140] which require Member States to take immediate corrective action if the 3 % reference value is breached and, if necessary, allow for the imposition of sanctions (the 'excessive deficit procedure');

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133 A bond-financed increase in government spending would cause the money supply in the euro area to rise, thereby fuelling inflationary pressures. In response, the ECB would be forced to increase interest rates, depressing investment and consumption. Furthermore, the higher interest rate would cause the common currency to appreciate and the trade balance to deteriorate.

134 Stakeholders at the time were worried that ECB independence and specifically the 'no bail-out' clause would be endangered by the unsustainable fiscal paths of certain Member States. Sargent and Wallace's model of debt monetisation supported this view, while the fiscal theory of the price level argued in a similar direction.

135 Martin Heipertz and Amy Verdun, 'The dog that would never bite? What we can learn from the origins of the Stability and Growth Pact', op. cit.

136 The authors note that the Commission's reaction was based on the understanding that such a solution 'would imply the marginalization of Community institutions and procedures'.

137 See Commission proposals for a Stability Pact, European Commission press release, 16 October 1996.

138 Public finances in EMU – 2000, European Economy Papers, European Commission, 2000, p. 45.

139 Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.

140 Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.

- *a political commitment* by all parties involved in the SGP (Commission, Member States, Council) to the full and timely implementation of the budget surveillance process.[141]

3.1.1. The preventive function

The cornerstone of the SGP's preventive arm is the country-**specific medium-term objective** (MTO). The medium-term objective represents a structural (general government) budget position, net of one-off and other temporary measures.[142] Originally, Council Regulation (EC) 1466/97 stipulated that the MTO should be set so as to contribute to a budgetary position of close to balance or in surplus in *nominal* terms for the entire euro area. Following the 2005 reform (see below) the regulation stipulated that the MTO in *structural* terms and in a country-specific way could diverge from this requirement, but it should still be set so as to provide a safety margin with respect to the 3 % of GDP deficit limit,[143] ensure sustainability and allow room for budgetary manoeuvre.[144]

Under the SGP, the medium-term objective acts as an anchor for setting medium-term policy. When a significant deviation from it (or from the convergence path towards it) is observed, the Member State has to correct such a deviation.[145] Both an ex-ante[146] (for the current year and the following year) and an ex-post[147] (for the previous year) assessment is conducted.

In the European Semester cycle, Member States present their medium-term objectives in their annual **stability or convergence programmes**,[148] where they lay out their short and medium-term budgetary strategies to reach and sustain budget positions that are 'close to balance or in surplus'. The programmes are subject to peer review and monitoring by the Commission and the Council, with a view to identifying any 'significant divergence' either from the medium-term budget target

[141] Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997.

[142] The Commission notes that 'Removing one-off and temporary measures from the cyclically adjusted balance is important in order to better assess the underlying budgetary positions, as the improvement in the fiscal balances stemming from one-off or temporary measure does not necessarily imply an improvement in the inter-temporal budgetary position of a country'.

[143] For each Member State, this safety margin is estimated in the form of the minimum benchmark, which takes into account past output volatility and budgetary sensitivity to output fluctuations.

[144] Specifically, euro area and ERM2 Member States must have a medium-term objective that corresponds to at least -1 % of GDP. After 2012, contracting Parties to the TSCG further committed themselves to MTOs of at least -0.5 % of GDP. However, if their debt ratio is significantly below 60 % of GDP and the risks in terms of long-term sustainability of public finances are low, the lower limit for the structural balance is set at -1 % of GDP.

[145] Member States that have not yet reached their medium-term objective use 0.5 % of GDP as their benchmark. Member States faced with a debt level exceeding 60 % of GDP or with a pronounced risk of overall debt sustainability must make stronger efforts.

[146] The aim of the ex-ante assessment is to alert Member States of possible deviations from the requirements and provide them with guidance on further adjustments they should implement either in the current year's budget, through additional budgetary measures, or in the following year's one.

[147] The aim of the ex-post assessment is to determine cases of 'significant deviations' for the previous year. If the Commission finds evidence of significant deviation from the MTO or the adjustment path towards it, the Commission will, in order to prevent the occurrence of an excessive deficit, issue a warning to the Member State concerned. The latter is followed by a Council recommendation within one month on how to return to the adjustment path towards the MTO. In case a Member State does not act upon the recommendation, it can be followed by a Council decision on lack of effective action and, possibly, a revised recommendation on policy measures. In the case of persistent non-compliance by a euro area Member State, the Council, on the recommendation of the Commission, will impose a sanction equal to an interest-bearing deposit of 0.2 % of GDP.

[148] Euro-area Member States must submit *stability* programmes on an annual basis, whereas those outside the euro area must submit *convergence* programmes. In these multiannual programmes, usually covering a three-year period, Member States set their medium-term target, as well as the adjustment path – i.e. the profile of projected budgetary adjustment over the medium term – towards the target. For more information on how the stability and convergence programmes fit in the annual cycle of EU coordination, see Angelos Delivorias and Christian Scheinert, 'Introduction to the European Semester: Coordinating and monitoring economic and fiscal policies in the EU', in-depth analysis, EPRS, European Parliament, 2019.

or the adjustment path towards it.[149] This surveillance not only consists of verifying whether nominal budgetary targets are met, but also involves a close examination of the underlying budget position taking account of cyclical economic conditions.[150]

Each programme is assessed by the Commission, which then proposes a recommendation to the Council. On the basis of the recommendation, the Council examines the programmes and delivers an opinion on each of them – if, for example, the Council identifies a significant divergence from a budget target, it will address a recommendation to the Member State concerned so as to give an early warning in order to prevent the occurrence of an excessive deficit.[151] A second recommendation to take prompt corrective measures can be addressed to the Member State(s) concerned, if the Council judges that the divergence is persisting or worsening. This second recommendations can be made public.[152]

3.1.2. The corrective function

The main corrective element of the SGP is the aforementioned **excessive deficit procedure** (EDP). Under the EDP, the Commission monitors budgetary developments and examines compliance with budgetary discipline on the basis of two criteria: a 3 % limit to the actual or planned government deficit to GDP and a 60 % limit to the ratio of government debt to GDP ('unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace').[153]

The recommendation that the Council adopts and addresses to the Member State concerned with a view to bringing the situation to an end within a given period, must contain two deadlines: i) a four-month deadline for the Member State to take effective action;[154] and ii) a deadline for the correction of the excessive deficit position, which '... should be completed in the year following its identification unless there are special circumstances'.[155] Failure to take corrective action can trigger

[149] Originally, the Council regulation did not define what constitutes a 'significant divergence' from budgetary targets or the conditions under which the early-warning mechanism is to be activated. To ensure consistency, the Commission has developed and used three factors in deciding whether to activate the early warning mechanism: i) the extent to which budget positions diverge from the targets set down in stability or convergence programmes; ii) whether the divergence of actual balances from the target can be explained by cyclical or discretionary factors; and iii) whether there is a risk of breaching the 3 % of GDP reference value.

[150] Public finances in EMU – 2003, European Economy papers, European Commission, 2003, p. 59.

[151] ibid. In the context of the SGP and unless otherwise specified, all decisions are taken with the use of qualified majority voting (QMV).

[152] Public finances in EMU – 2000, op. cit., p. 47.

[153] A nominal deficit above 3 % of GDP does not imply a country is automatically placed in an excessive deficit position. Indeed, the provisions of the Treaty and the Stability and Growth Pact give some room for interpretation to take account of 'exceptional circumstances', that is, circumstances 'resulting from an unusual event outside the control of the Member State concerned and which has a major impact on the financial position of the general government or when resulting from a severe economic downturn' (Article 2(1) of Council Regulation (EC) No 1467/97). With regards to this last point, a 'severe economic downturn' is considered exceptional if 'there is an annual fall of real GDP of at least 2 %'. This exception clause has been invoked during the coronavirus pandemic (see below).

[154] The concept of 'effective action' was clarified with the 2011 six-pack reform. The recommendations issued as part of the reform included adopting annual nominal targets that would be consistent with a minimum annual fiscal effort of at least 0.5 percentage points of GDP as a benchmark. Also, Member States going through an EDP would have to prepare a report on the action taken in response to the Council's recommendation under Article 126(7) or notice given under Article 126(9). The report would have to include the targets for government expenditure and revenue and for the discretionary measures on both the expenditure and the revenue side, consistent with the Council's recommendation, as well as information on the measures taken and how they would contribute to achieving the targets. Reports of Member States that have received a notice under Article 126(9) would also have to include information on the actions being taken in response to the specific Council recommendations.

[155] It is worth highlighting the fact that the initial requirement imposed on the Member State concerned is to take corrective action rather than achieve immediate results.

the next stage of the EDP and move the Member State closer to the stage when it may receive sanctions.[156]

Sanctions are only applied to euro area members. In the first year of sanctions, the Member State concerned must make a non-interest-bearing deposit that can reach up to 0.5 % of GDP.[157] As a rule, a deposit is converted into a fine within two years, should the excessive deficit persist.[158]

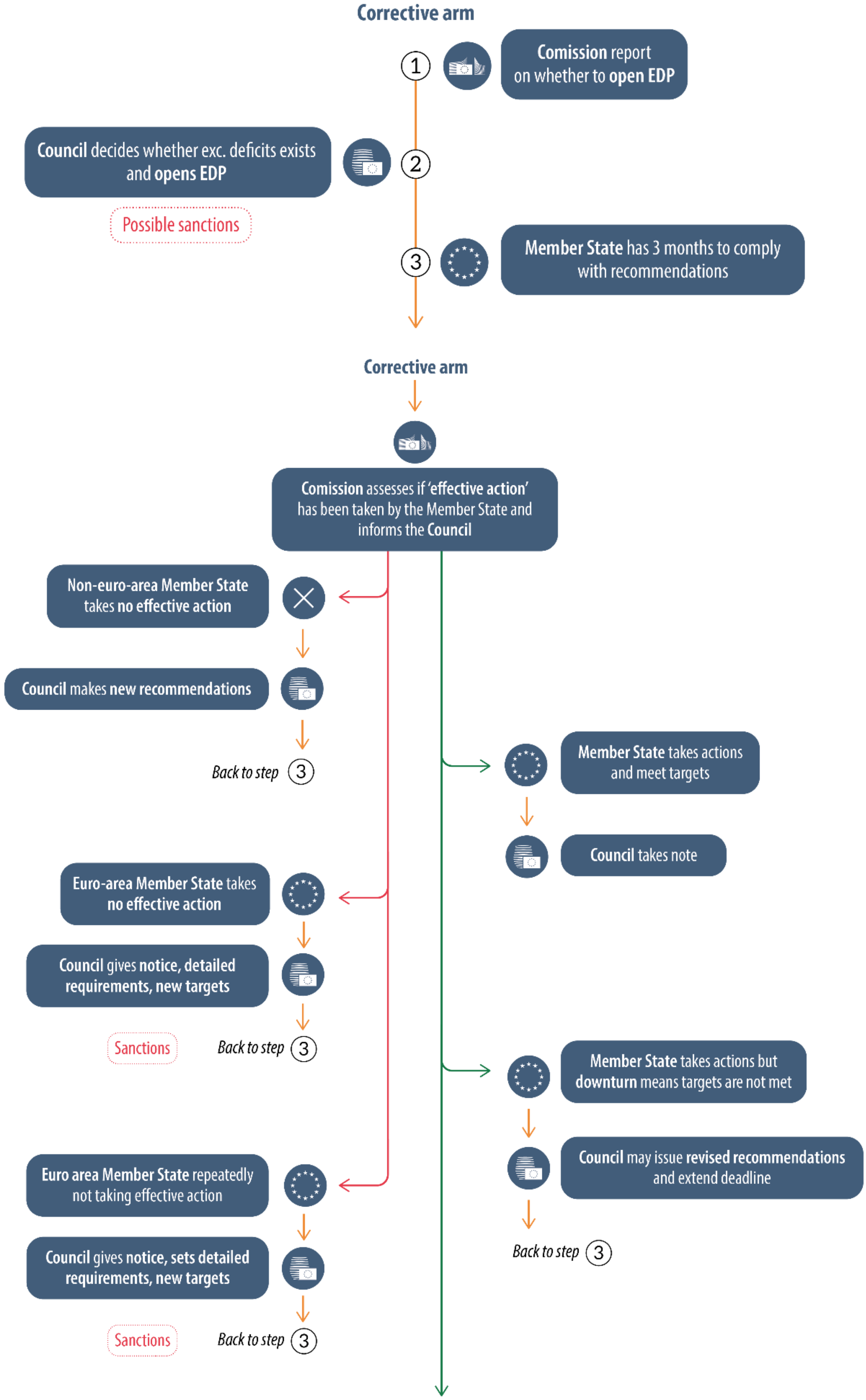
If the Member State concerned acts in compliance with recommendations made or notices given, then the procedure is held in abeyance. Lastly, sanctions are abrogated if the decision on the existence of an excessive deficit is abrogated.

156 Public finances in EMU – 2003, op. cit., p. 62.

157 The deposit amount is calculated by adding to a 'fixed' component of 0.2 % of GDP, a 'variable' component equal to one-tenth of the difference between the deficit and the 3 % reference value. Deposits are lodged with the Commission.

158 Marco Buti and Daniele Franco, 'The Maastricht Treaty and the Stability and Growth Pact', Chapter 2 in 'Fiscal Policy in Economic and Monetary Union: Theory, Evidence, and Institutions', Edward Elgar Publishing, 2005, p. 21.

Figure 1: The corrective arm of the Stability and Growth Pact



Source: European Commission.

In addition to the above, a Resolution of the European Council on the Stability and Growth Pact[159] provided political guidance to the parties tasked with implementing the Stability and Growth Pact, i.e. the Member States, the Council and the Commission.

3.2. First reform (2005)

Given that in 1997 Member States were in the middle of pursuing important fiscal adjustments to satisfy the Maastricht euro-related criteria, adherence to the SGP fiscal requirements was very high during its first few years in force.[160] In 2000, the EU-15 even recorded a surplus of 1 % of GDP, although this result could be partly attributed to the improvement in the general economic conditions and partly to a non-recurring factor.[161] When the cycle reached a turning point in 2001 and the UMTS proceeds had largely disappeared', budget balances deteriorated again.[162]

During the period up to 2003, on the Commission's initiative,[163] and with further impetus provided by the Barcelona European Council,[164] further work was done to strengthen economic policy

[159] Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997, OJ C 236, 2.8.1997.

[160] According to the European Fiscal Board, 'the cyclically-adjusted deficit of euro-area Member States that adopted the single currency in 1993 (a calculation of what the government's budget deficit would be if the economy was at a normal level of activity) declined from 6.7 % to 1.6 % of GDP between 1995 and 2000. See Assessment of EU fiscal rules with a focus on the six and two-pack legislation, op. cit., p. 26.

[161] In that year, many Member States collected substantial proceeds from the sale of universal mobile telecommunications service (UMTS) licences; corrected for this non-recurring factor, government accounts in the EU-15 showed a deficit of 0.3 % of GDP on average in 2000. See Geert Langenus, 'The stability and growth pact: An eventful history', *Economic Review*, June 2005.

[162] In 2003, the EU-15 recorded an average deficit of 2.8 % of GDP.

[163] In February 2001, the Commission adopted a communication on strengthening economic policy coordination within the euro area. This led to several positive developments, including better and more timely statistics covering the euro area, a quarterly report on the euro area prepared by the Commission, the establishment of a Eurogroup working party attached to the Economic and Financial Committee (EFC) to help prepare debates and regular communiqués (terms of reference) from the Eurogroup on important policy issues.

[164] The European Council of March 2002 concluded that the euro area needed to make further progress in the domain of policy coordination, and invited the Commission to present proposals to reinforce economic policy coordination in time for the 2003 spring European Council.

coordination.[165] In this context, in November 2002, the Commission adopted a communication on strengthening the coordination of budgetary policies.[166]

Despite the above communication and in the context of an economic slowdown following the burst of the dot-com bubble, the Member States' commitment to the SGP began to weaken. In 2001 and 2002, 'early warnings' were given, and the excessive deficit procedure was opened against a number of Member States, such as Portugal, Germany and France, that were running deficits in excess of 3 % of GDP. These Member States were supposed to correct their excessive deficits within a year, which Portugal did, but Germany and France did not. In 2003, the Commission proposed that the next step of disciplinary action, which envisages the imposition of sanctions, be taken against France and Germany, but the Economic and Financial Affairs Council (Ecofin) decided in November 2003 not to adopt the Commission proposal and instead to interrupt the application of the SGP for France and Germany, effectively putting the excessive deficit procedure for these two countries into limbo. The Commission challenged Ecofin's decision before the European Court of Justice.[167] In July 2004, the Court ruled that the Council indeed had the right not to adopt the Commission's proposal, but it could not adopt provisions on its own without a proposal by the Commission.[168] In the light of the resulting difficult political situation, it was considered necessary to review the SGP, a review eventually initiated in September 2004 with a Commission communication.[169] After several months of discussion, the EU ministers of finance reached a consensus on 20 March 2005 and two days later, the EU Heads of State or Government endorsed the Ecofin report.[170] The report identified five areas where improvements could be made.[171] While the fundamental rules remained unchanged,[172] the amendments introduced more economic judgment and flexibility in the application of the EU fiscal framework and encouraged Member States to achieve the necessary budgetary consolidation when economic conditions are favourable.[173]

3.2.1. Reform of the preventive arm

The new consensus introduced four major changes to the preventive arm:

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165 Public finances in EMU – 2003, op. cit., p. 126.

166 In the communication, the Commission provided a diagnosis of the main shortcomings of the SGP. In this context, it proposed that i) in establishing budgetary objectives at EU level and in carrying out the surveillance of Member States' budgetary positions, due account should be taken of the economic cycle; ii) countries with underlying deficits would be required to achieve an annual improvement in their underlying budget position of at least 0.5 % of GDP each year until the 'close-to-balance or surplus' requirement of the SGP has been reached; iii) the sustainability of public finances should become a core policy objective at EU level; to this end, greater weight should be attached to government debt ratios in the budgetary surveillance process; and iv) the 'close to balance or in surplus' requirement should be applied more flexibly, so as to contribute in achieving the goals of the Lisbon strategy (growth and employment). See 'Assessment of EU fiscal rules with a focus on the six and two-pack legislation', op. cit., pp. 73-79.

167 Amy Verdun, 'Economic Developments in the Euro Area', *Journal of Common Market Studies*, 2006 pp. 199–212.

168 Assessment of EU fiscal rules with a focus on the six and two-pack legislation, op. cit., p. 10.

169 Communication from the Commission to the Council and the European Parliament – Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact, COM (2004) 0581 final.

170 See Council Report to the European Council, Improving the implementation of the Stability and Growth Pact, March 2005.

171 Those areas were as follows: i) enhance the economic rationale of the budgetary rules to improve their credibility and ownership; ii) improve 'ownership' by national policy-makers; iii) use more effectively periods when economies are growing above trend for budgetary consolidation in order to avoid pro-cyclical policies; iv) take better account in Council recommendations of periods when economies are growing below trend; and v) in the surveillance of budgetary positions, give sufficient attention to debt and sustainability.

172 Reference values as set out in the Treaty, excessive deficit procedure if values exceed the deficit limit.

173 Public Finances in EMU 2006, European Economy institutional papers, European Commission, January 2006, pp. 141-149.

- the definition of country-specific medium-term objectives within a given range and the procedure to set and revise them.[174] Following the reform, MTOs were set in structural (and no more in nominal) terms. In addition, they were country-specific and not anymore defined for the euro area as a whole;
- the minimum annual budgetary effort for countries that have not yet reached their medium-term objectives;[175]
- a broadening of the grounds on which the Commission would address the Council to include the cases of unjustified deviations from the adjustment path towards the MTO;
- the treatment of structural reforms.[176]

3.2.2. Reform of the corrective arm

The main modifications in the corrective arm of the SGP concerned:

- the definition of 'excessive deficits', including the revision of the concept of 'severe economic downturn'[177] and the role of 'other relevant factors';[178]
- the possible extension by one year of the 1-year deadline for the correction of an excessive deficit following its identification and the introduction of repetition of steps in the EDP;[179]
- considerations related to the assessment of specific pension reforms in the EDP.[180]

3.3. Second reform (2011) – The six-pack

While the situation of Member States with regards to the SGP criteria improved between the 2005 SGP reform and the global financial crisis of 2008, better fiscal outcomes in these years were mostly the result of a strong cyclical upswing in the EU economy. Following 2008 however, Member States' fiscal positions deteriorated significantly, and most countries ended up in the corrective arm of the

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174 The country-specific MTO must be specified within a range between a structural deficit of 1% and balance or surplus, in cyclically adjusted terms, net of one-off and temporary measures.

175 Member States within the euro area and the ERM II that had not yet reached their MTO agreed to achieve, as a benchmark, an **annual adjustment of 0.5 % of GDP**. All Member States that had not yet reached their MTO were expected to achieve it over the cycle, by implementing more ambitious fiscal adjustment during good times.

176 With a view to eliminating possible disincentives for structural reforms, the Council agreed that, under certain conditions, certain (major) **structural reforms can justify a temporary deviation** from the medium-term objective and, for Member States that have not yet reached their MTO, temporary deviations from the adjustment path towards the MTO.

177 Both the Commission and the Council, when assessing and deciding on the existence of an excessive deficit, may consider as exceptional an excess over the reference value 'which results from a negative growth rate or from the output loss accumulated during a protracted period of very low growth relative to potential growth'.

178 Including the following: potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda, policies to foster research and development and innovation, fiscal consolidation efforts in 'good times', debt sustainability, public investment and the overall quality of public finances. In addition, the Commission must give 'due consideration' 'to any other factors, which in the opinion of the Member State concerned are relevant in order to comprehensively assess the excess over the reference value in qualitative terms.

179 As a rule, an excessive deficit should be corrected the year after it is identified by the Council (that is, usually the second year after it occurs). However, in cases where a correction in the consecutive year would be unwarranted for economic reasons and effective action has been taken, the Council could decide to set the deadline for the correction of the excessive deficit in the second year after its identification. To counterbalance this added flexibility, the Council agreed that as a benchmark, countries in excessive deficit would have to implement a minimum adjustment of at least 0.5 % of GDP.

180 The 2005 Ecofin report committed the Council and the Commission to 'consider carefully' in the context of the excessive deficit procedure an excess close to the reference value caused by the introduction of a multi-pillar pension system that includes a mandatory, fully funded pillar. Over the first five years after the implementation of such a reform and following a regressive mode, the deficit figures can be corrected for the net costs of the pension reforms in the following way: 100 % of the net costs in the first year, for 80 % in the second year, and for 60, 40, and 20 % in the third, fourth and fifth year respectively.

SGP. Furthermore, from 2011 onward, the significant market pressures during the sovereign debt crisis prompted a pro-cyclical fiscal consolidation in some Member States.[181]

To tackle those issues, the 'six-pack' reform – given this name because it included five regulations and one directive – overhauled EU economic and fiscal surveillance.[182]

3.3.1. Impact of the reform on the preventive arm

The reform[183] had a significant impact on the preventive arm.

- the **expenditure benchmark** was introduced to complement the structural balance as an indicator to assess compliance with the adjustment path towards the medium-term objective.[184] According to the rule, for those Member States having achieved their medium-term budgetary objective, the benchmark would be deemed to be complied with when the annual growth of government expenditure, net of discretionary revenue measures, did not exceed a reference medium-term rate of potential GDP growth.[185] For Member States that had *not yet* reached their medium-term budgetary objective, the benchmark would be deemed to be complied with, when the annual growth of government expenditure, net of discretionary revenue measures, did not exceed a rate below the reference medium-term rate of potential GDP growth.[186]
- with regards to the above two indicators, it was also decided that both would be assessed on an ex-ante[187] and on an ex-post basis;[188]
- the *significant deviation procedure* was introduced, establishing a corrective mechanism already in the context of the preventive arm, with sanctions in the form of interest-bearing deposits (see below);
- the European Semester, which streamlined the calendar of economic surveillance for EU Member States, was codified and introduced in secondary legislation.

181 Assessment of EU fiscal rules with a focus on the six and two-pack legislation, op. cit.

182 Regulations (EU) 1176/2011 and (EU) 1174/2011, which established the macroeconomic imbalance procedure (MIP), are not examined in this study. For more information on them and an introduction to the MIP, see Angelos Delivorias, 'The Macroeconomic Imbalance Procedure', EPRS, July 2020. Lastly, Council Directive 2011/85/EU sets out minimum requirements for Member States' fiscal frameworks in five key areas – accounting and statistics, macroeconomic and budgetary forecasting, numerical fiscal rules, medium-term budgetary frameworks and transparency – so as to ensure consistency between national fiscal governance and budgetary discipline provisions set out in the EU Treaties and the Stability and Growth Pact.

183 Regulation (EU) 1175/2011.

184 To see a numerical example of the expenditure benchmark, see Numerical examples and technical aspects for 'hands-on' experts – 2019 edition, op. cit. pp. 20-22.

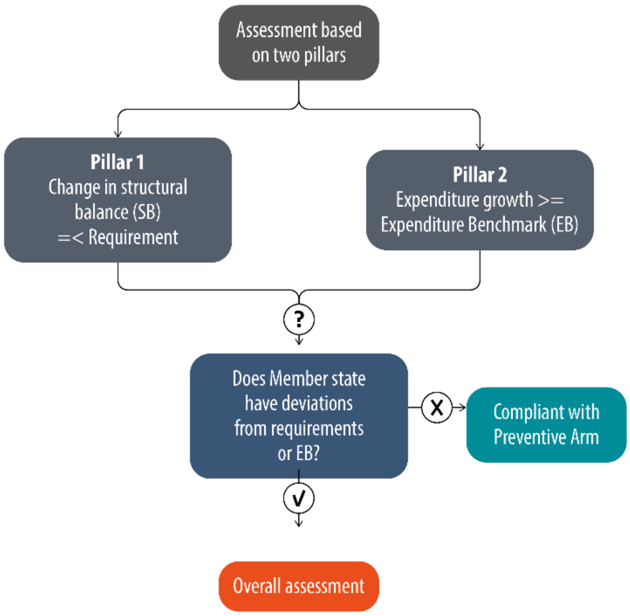
185 For a good summary on potential GDP and how it is calculated, see Clàudia Canals, 'How is potential GDP calculated?', CaixaBank Research, May 2013.

186 Report on Public finances in EMU 2012, European Economy, European Commission, 2012p. 70. In the latest Commission report on public finances in EMU (see below), there is a quantitative assessment of expenditure rules in the EU and the Member States. The authors find that, at EU level, public debt ratios would be lower today if Member States had applied the expenditure benchmark consistently since the beginning of EMU. In addition, they find that, if this benchmark had been applied (instead of the structural balance requirement), whatever necessary fiscal adjustments would have been more conducive to growth. Furthermore, the expenditure benchmark is deemed more effective in reducing pro-cyclicality than the change in structural balance.

187 The ex-ante assessment will take place when examining Member States' plans as set out in their stability or convergence programmes, where there is a possibility for the Member States to be ordered to strengthen their programmes in case of the planned adjustment towards the medium-term objective is found to be insufficient.

188 The ex-post assessment will take place when assessing whether there has been a significant observed deviation on the basis of actual data.

Figure 2: The two indicators of the preventive arm



Source: European Court of Auditors.

The significant deviation procedure

For a Member State that has not reached the MTO, the deviation is considered significant, if both: i) the deviation of the structural balance from the appropriate adjustment path corresponds to at least 0.5 % of GDP in one single year or at least 0.25 % of GDP on average per year in two consecutive years ; and ii) an excess of expenditure growth has had a negative impact on the government balance of at least or 0.5 % of GDP in a single year or cumulatively over two years. In case only one of the two requirements above is verified, the deviation will be considered significant if the overall assessment establishes that there has been limited compliance also with respect to the other requirement.

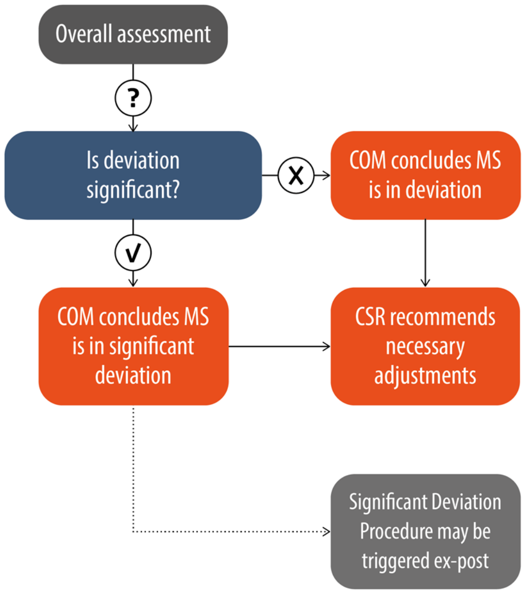
1. In the event of a significant observed deviation, the Commission addresses an early warning letter to the Member State concerned, as per Article 121(4) TFEU.

2. Following this warning, the Commission addresses to the Council a recommendation for a Council recommendation 'with a view to correcting the significant observed deviation from the adjustment path toward[s]' the MTO. The Council adopts, by qualified majority, the recommendation and addresses it to the Member State concerned. The deadline for the Member State to adopt the necessary policy measures is normally set at five months.

3. The Member State concerned has to report to the Council on action taken in response to the recommendation within the deadline established by the Council.

4. If the Member State fails to take appropriate action in response to the Council recommendation under point 2 above, the Commission recommends immediately to the Council a decision (again by qualified majority) establishing that no effective action has been taken. At the same time, the Commission may recommend to the Council to adopt a revised recommendation under Article 121(4) on necessary policy measures. In this case, if the Council does not take the decision that no effective action has been taken and failure to comply with the recommendation persists, a month after its previous recommendation, the Commission adopts a new recommendation to the Council to take a decision that no effective action has been taken. At the same time, the Commission may in this case recommend to the Council to adopt a revised recommendation.

Figure 3: The significant deviation procedure



Source: European Court of Auditors.

In the case of euro-area Member States, a financial sanction (an interest-bearing deposit of 0.2 % of GDP as a rule) may be imposed if the Commission recommends and the Council decides by reversed qualified majority that no action has been taken to address the Council recommendation.

3.3.2. Impact of the reform on the corrective arm

Council Regulation (EU) No 1177/2011[189] introduced the following changes to the corrective arm:

- the debt requirement of the Treaty was operationalised by introducing a numerical benchmark for debt reduction[190] and by putting the violation of the deficit and the debt criteria on an equal footing;
- a 'comply-or-explain' principle was introduced for the Council vis-à-vis Commission recommendations and proposals under the corrective arm;
- an escape clause in case of 'severe economic downturn in the euro area or the Union as a whole' was introduced.

A graduated system of sanctions was established for euro area Member States found to be non-compliant with the rules.[191] As mentioned above, sanctions could now be applied already under the

[189] Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

[190] Debt as a percentage of GDP is considered to be approaching the reference value at a satisfactory pace if the differential with respect to the reference value has decreased over the previous three years at an average rate of the order of 1/20 per year as a benchmark, based on the changes over the last three years for which data are available.

[191] Regulation (EU) 1173/2011. Under this regulation, if a Member State has already been called to lodge an interest-bearing deposit due to lack of effective action to correct a significant deviation from the adjustment path towards the MTO, this deposit is transformed into a non-interest bearing deposit upon the decision to place the Member State in excessive deficit. Even in absence of an interest-bearing deposit, a 0.2 % of GDP non-interest-bearing deposit can be invoked at the time of the launch of the EDP (only for euro-area Member States), if the Commission identifies

preventive arm of the SGP and were rendered semi-automatic via reverse qualified majority voting (RQMV). According to this principle, Commission proposals for sanctions are deemed to be automatically adopted, unless a qualified majority in the Council votes against. [192]

3.4. The Treaty on Stability, Coordination and Governance

At the European Council of 8-9 December 2011, most EU Member States decided to open the way to an intergovernmental treaty designed to ensure greater fiscal surveillance and economic coordination within the European Union. The option of an international treaty allowed those Member States that were willing to proceed with commitments going beyond what is currently envisaged by the EU Treaties, to do so despite those other Member States that wished to remain outside the process.

The Treaty on Stability Coordination and Governance (TSCG) was part of a broader political agreement where stronger fiscal commitments would enable the provision of further financial assistance and was created to stave off the market pressure experienced by crisis-hit Member States.[193]

Following a period of negotiations that involved all 27 Member States, as well as consultations with the European Parliament, the Commission and the European Central Bank, the Treaty was signed on 2 March 2012 by 25 Heads of State or Government. The 25 signatories[194] of the TSCG focused their efforts to achieve greater budgetary and economic coordination on three main dimensions: fiscal discipline, deepening of economic policy coordination and convergence, and reinforcing the governance of the euro area.[195]

With regards to fiscal discipline, under Articles 3 to 8 of the Treaty (the 'fiscal compact') Member States commit to translate at the national level[196] the obligation for their budget to reach a 'balanced or in surplus' position.[197] In case of significant observed deviations from the medium-term objective or the adjustment path towards it, correction mechanisms are triggered automatically.[198] With regards to debt, in case their general government debt exceeds 60 % of GDP, Member States undertake the obligation to reduce the difference between their debt-to-GDP ratio and the 60 % threshold at an average rate of one-twentieth per year as a benchmark. In addition, before the issuance of new debt, they must report their issuance plans to the Council and the Commission. Lastly, Member States subject to an excessive deficit procedure have to present an economic partnership programme detailing the structural reforms that are deemed necessary to support an effective and durable correction of the excessive deficit (see also below, under the 'two-pack' reform).

particularly serious non-compliance with the SGP. In case of lack of compliance with a Council recommendation to correct the excessive deficit issued under Article 126(7), following the Council decision establishing such non-compliance (Art. 126(9)), a 0.2 % of GDP fine is imposed on the euro-area Member State concerned (if the Member State had already lodged a deposit, the deposit is converted into a fine.)

192 Assessment of EU fiscal rules with a focus on the six and two-pack legislation, op. cit., p. 16.

193 Assessment of EU fiscal rules with a focus on the six and two-pack legislation', op. cit.

194 The United Kingdom and Czechia did not sign the Treaty.

195 Report on Public finances in EMU 2013 European Economy, European Commission, 2013, pp. 81-82.

196 This is a twofold obligation: Member States need to enshrine those rules in national law through binding and permanent provisions, and to put national independent bodies in charge of monitoring compliance with the balanced-budget rule.

197 This is deemed respected if the annual structural balance of the general government matches the country-specific medium-term objective.

198 Indeed, sanctions are triggered under a recommendation of the Commission, unless a qualified majority of Member States opposes them.

In Title IV of the TSCG, commitments are made to deepen economic policy coordination and convergence. These include increased recourse to enhanced cooperation on matters essential for the smooth functioning of the euro area, as well as greater ex-ante coordination of the major economic policy reforms planned by the signatories.

Lastly, provisions were also introduced to reinforce the governance of the euro area (Title V of the TSCG). The TSCG makes provision for regular informal meetings to take place between the Heads of State or Government of euro-area Member States, together with the president of the Commission. The objective of those euro summit meetings, which shall take place at least twice a year, would be to discuss issues concerning EMU governance, as well as strategic orientations to increase economic convergence among euro-area Member States. A president of the euro summit, appointed by the euro-area Heads of State or Government, would ensure the preparation and continuity of the meetings in close cooperation with the president of the Commission.

On 6 December 2017, the Commission made a proposal for a Council directive laying down provisions for strengthening fiscal responsibility in the Member States by integrating the TSCG in the Union legal framework. On 11 May 2018, the ECB published an opinion generally welcoming the proposal, but proposing several amendments.[199] Nevertheless, the Ecofin Council of 23 January 2018 concluded that the proposal to integrate the Fiscal Compact into the EU legal framework was not yet at a stage where it could be taken up in the Council.

3.5. Third reform (2013) – Two-pack

Two years after the six-pack reform, two more regulations ('two-pack') were adopted, which applied *only to euro-area* Member States. These two regulations were a partial translation into EU law of the commitments undertaken under the TSCG[200] and were aimed at enhancing policy coordination within the euro area by introducing a new surveillance process that monitored compliance with the SGP requirements.

Until the two-pack reform, a euro-area Member State only reported on its fiscal strategy to correct its excessive deficit a few months after the opening of a procedure, in addition to the annual updates of its stability programmes. Once positively assessed by the EU, the Member State was left to implement this strategy, more or less until the deadline by which it was expected to have completed the correction in a lasting manner. The Commission monitored the Member State's progress with regard to its EDP, based on the country's bi-annual fiscal notifications and the Commission services' forecasts.

The two-pack reform's enhanced reporting provided greater detail on the budgetary execution, including on intra-annual developments, and detailed information on the measures being taken, enabling a closer monitoring of the progress of countries under the EDP.[201] Member States are required to submit to the Commission and the Council their draft budgetary plans (DBPs) in the autumn of each year.[202] The Commission has the right to issue a negative opinion on a plan and to request the Member State to revise it.

[199] Amongst others, an explicit reference to the obligation to have a budgetary position of general government that is in balance or in surplus should be included.

[200] Report on Public finances in EMU 2013, op. cit.

[201] The two-pack reform has addressed the information gap with i) a better understanding of the initial point of departure; ii) a more regular transmission of information on the implementation of the correction strategy; and iii) a possibility for the Commission to launch an audit of the public accounts or to request any additional information needed for a proper understanding of the situation of the Member State.

[202] The draft budgetary plans are synthetic documents presenting the main aspects of the budgetary situation in the general government sector and detailed information on budgetary policy measures as planned in the draft budget

Within a few months after the opening of the excessive deficit procedure against a Member State, the latter must prepare and submit an economic partnership programme produced and implemented by its national authorities. This programme serves as a roadmap for the fiscal structural reforms deemed necessary by the Member State to ensure an efficient and lasting correction of the excessive deficit.[203]

In addition to the above, a regime of enhanced surveillance was introduced for Member States facing severe difficulties with their financial stability, receiving financial assistance, or exiting a financial assistance programme.[204] A Member State under enhanced surveillance has to take measures to address the sources or potential sources of difficulties. In addition, the Commission can request specific measures to implement the enhanced surveillance regime (e.g. banks' stress test, audit of public accounts of all sub-sectors of the general government). The Commission regularly monitors the progress made in implementing all those measures, in liaison with the European Central Bank and the relevant EU supervisory authorities and, where appropriate, the International Monetary Fund. If the assessment of progress made concludes that further measures are needed and that the financial situation of the Member State has significant adverse effects on the financial stability of the euro area, the Council can recommend to the Member State concerned to adopt precautionary corrective measures or prepare a draft macro-economic adjustment programme.[205]

3.6. The Commission's flexibility communication

In January 2015, the Commission published a communication on flexibility within the Stability and Growth Pact, in which it provided an interpretation on the degree of flexibility in the existing rules of the *preventive arm* of the SGP.[206] The following main elements were specified in the communication:[207]

With regard to **structural reforms**, it was clarified that the SGP allows Member States that are implementing major structural reforms to deviate temporarily from the medium-term objective or the adjustment path towards it. For this to happen, two conditions need to be in place: first of all, the Member State must remain in the preventive arm of the SGP and not exceed the 3 % threshold; and the adopted[208] reforms must have a verifiable major positive impact on the long-term sustainability of public finances, separately or together. Member States that wish to request the activation of the clause must present a comprehensive and detailed[209] medium-term structural reform plan on the basis of which compliance with the eligibility criteria is assessed (ex ante).

The size of the deviation allowed depends on the type of reform: in the case of a pension reform, the allowed deviation from the medium-term objective or from the adjustment path towards it is equal to the direct incremental impact of the reform on the general government balance. In the case of other structural reforms, however, the allowed deviation cannot exceed 0.5 % of GDP.

for the following year. They are a detailed development of the SCPs for the year to come, focussing on the measures to be adopted to reach the targets set by either the preventive or the corrective arm of the SGP.

203 Report on Public Finances in EMU 2013, op. cit., pp. 81-82.

204 Regulation (EU) 472/2013.

205 Report on Public Finances in EMU 2013, op. cit., pp. 89-93.

206 Communication on Making the best use of the flexibility within the existing rules of the Stability and Growth Pact, European Commission, COM(2015) 12 final, Strasbourg, 13.1.2015.

207 Report on Public Finances in EMU 2015, European Economy, European Commission, December 2015, pp. 66-75. Specifically for the introduction of the output gap in one of the flexibility clauses, see Lorenzo Navarini and Alice Zoppè, 'Potential output estimates and their role in the EU fiscal policy surveillance' EGOV briefing, February 2020.

208 It was specified that reforms can only be considered for eligibility for the clause *after* they have been adopted, and that their implementation must be monitored.

209 The plan must include well-specified measures and credible timelines for adoption and delivery.

Like structural reforms, certain types of **investment** justify a deviation from the rules of the preventive part of the SGP. And just as in the case of the structural reform clause, the investment clause is also subject to certain conditions, namely: the deviation must be the result of national expenditure on projects that are i) co-funded by the EU,[210] and ii) are expected to have positive, direct and verifiable effects on growth. In addition, a Member State needs to be considered to be in 'bad economic times', or worse.[211] Lastly, the Member State's headline and structural balance must remain within certain limits if the investment clause is being applied.

The investment clause is activated ex ante as soon as a Member State makes a request in its stability or convergence programme. Activation of the clause is subject to the Member State's compliance with the eligibility conditions.[212] The temporary deviation allowed ex ante depends on the commitments made from the EU structural funds in favour of the Member State concerned and on the level of planned co-financing.[213]As a safeguard, the allowance is reviewed ex post to allow the actual level of co-financing to be taken into account.

Lastly, the communication proposed to better take into consideration the economic cycle, as well as the debt level and sustainability needs of each Member State, in the calculation of the annual adjustment towards the medium-term objective. After the Council endorsed a commonly agreed position on the communication in February 2016, it updated accordingly the Code of Conduct,[214] which gives a detailed breakdown of the required annual adjustment.

3.7. The 2016 focus on the expenditure benchmark

Since its introduction in 2005, the concept of structural balance gained a relevant role in defining, and assessing compliance with, Member States' obligations under the SGP. The Commission noted, however, that the structural balance can fail to capture the real fiscal efforts made by governments, essentially due to methodological and measurement issues.[215]From an operational perspective, this difficulty in correctly measuring the structural balance implies important challenges for the conduct of fiscal policy and raises issues of assessing the delivery of the required fiscal effort in the context of surveillance procedures that can ultimately lead to financial sanctions.[216]

The introduction of the expenditure benchmark in the context of the six-pack reform aimed at mitigating the shortcomings of the structural balance approach. However, the expenditure

[210] Including structural and cohesion policy, the Connecting Europe Facility and the European Fund for Strategic Investments. Moreover, co-financed expenditure should not be used to substitute for nationally financed investment.

[211] This means that GDP growth is negative or that output is sufficiently below its potential to result in a negative output gap of over 1.5 % of GDP.

[212] To be eligible to benefit from the clause in the year t+1, Member States should include the following information in their SCPs for year t: i) the forecast path of national co-financing expenditure; ii) detailed information on the positive, direct and verifiable long-term budgetary effects of the expenditure covered by the clause; and iii) the 'corrected path' that the structural balance would follow were the clause applied. Moreover, in the year following the year during which the clause has applied, the Member State should report on the actual level of co-financing in its SCP.

[213] The allowed deviation from the MTO or the adjustment path towards it is equal to the total amount of co-financing in the first year of application of the clause. In the following years, given that the national co-financing of EU-funded projects constitutes recurrent expenditure, only positive incremental changes would be added to the temporary deviation originally allowed, provided that the Member State continues to meet the other eligibility criteria.

[214] Revised Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes, (Code of Conduct of the Stability and Growth Pact), Council of the European Union, Brussels, 18 May 2017.

[215] The output gap is unobserved and is subject to frequent and often significant revisions. Also, the crisis has shown that the structural balance can be seriously affected by revenue shortfalls/windfalls, in the event of large annual volatility of revenues.

[216] Report on Public Finances in EMU 2017, European Economy institutional papers, January 2018, European Commission, pp. 45-56.

benchmark was only introduced in the *preventive* arm of the SGP, while the corrective arm of the SGP kept the structural balance approach (albeit with certain adjustments).[217] As a result, two different sets of indicators were used in assessing compliance with each of the two SGP arms.

In that context, the Commission has, together with the Member States, explored ways to increase the transparency and predictability of the rules of the SGP and reduce their complexity, while remaining within the existing legal framework, in line with the Commission communication on Steps towards Completing Economic and Monetary Union[218] and the conclusions of the informal Ecofin meeting of 22-23 April 2016. As a result of the subsequent discussion that took place in the Economic and Financial Committee of the Council, it was agreed to introduce the preventive arm's expenditure benchmark in the corrective arm of the SGP,[219] is expressed in the form of two opinions of the Economic and Financial Committee, which were endorsed by the Ecofin Council on 6 December 2016.[220]

3.8. The coronavirus crisis: Temporary departure from the rules

To limit the economic damage during the confinement imposed as a way to contain the spread of the coronavirus, Member State governments have put in place large programmes to support companies (to avoid bankruptcies), and workers (to dampen income losses and avoid a surge in unemployment), as well as measures to avoid a financial meltdown.

To allow Member States to undertake the necessary measures to deal adequately with the crisis, the Commission proposed, in a communication from 20 March,[221] to activate the general escape clause of the SGP, in order to allow Member States to temporarily depart from the budgetary constraints that normally apply under the EU fiscal framework.

Specifically, for the preventive arm, Articles 5(1) and 9(1) of Regulation (EC) 1466/97 state that 'in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term'. For the corrective arm, Articles 3(5) and 5(2) stipulate that in the case of a severe economic downturn in the euro area or in the Union as a whole, the Council may also decide, on a recommendation from the Commission, to adopt a revised fiscal trajectory. In the above-mentioned March communication on the activation of the SGP general escape clause, the Commission further clarified that 'The general escape clause does not suspend the procedures of the Stability and Growth Pact. It will allow the Commission and the Council to undertake the necessary policy coordination measures within the framework of the SGP, while departing from the budgetary requirements that would normally apply'.

A key question for the moment is until when the clause should remain active.

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[217] In particular, revisions affecting the estimates for potential output and the response of revenues to economic developments are taken into account at the time of assessment.

[218] Communication On steps towards Completing Economic and Monetary Union, European Commission, COM(2015) 600 final, Brussels, 21.10.2015.

[219] When a Member State receives a recommendation under the EDP, the Commission is required to assess whether the Member State in question has taken effective action to address the Council recommendation. If the Member State is compliant with the headline deficit target and the underlying improvement in the structural balance, the procedure is held in abeyance. However, in case of non-fulfilment of either the headline or structural deficit targets, the expenditure benchmark will be used to determine whether the Member State concerned has taken effective action.

[220] Report on Public Finances in EMU 2017, op. cit., pp. 45-56.

[221] Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact, COM(2020) 123 final, Brussels, 20 March 2020.

Luisa Lambertini[222] is of the view that the pre-Covid-19 economic conditions in each Member State should be used as a reference for lifting the clause: each Member State should revert to the prescription of the SGP when its output gap has returned to its pre-Covid-19 level For a successful transition, the general escape clause (common to all Member States) should be deactivated first, and those Member States falling short of their pre-Covid-19 economic conditions should invoke the clause for unusual events.[223]

Philippe Martin and Xavier Ragot[224] stress that the deactivation of the clause should be state- not time-dependent. Specifically, the clause should be exited only when the EU-wide GDP per capita or employment rate has returned to its level of the fourth quarter of 2019. Similar to Lambertini, they note that Member States that individually do not fulfil this economic condition, should activate the 'unusual event clause' on a country-specific basis.

Both Lambertini and Martin and Ragot stress the importance of taking the opportunity of the general escape clause to discuss the future design of the EU's fiscal framework and amend it accordingly.

Klaus-Jürgen Gern et al.[225] instead propose a transitional arrangement following the deactivation of the general escape clause, where no new excessive deficit procedure would launched.[226] During this period, the authors are of the view that the Commission should negotiate a reasonable path of consolidation, reflecting the uncertainty over the longer-term effects of the crisis on the productive capacity of the economy, which will persist for some time during the recovery.

222 Luisa Lambertini, 'When and how to deactivate the SGP general escape clause?', in-depth analysis requested by the ECON committee of the European Parliament, December 2020.

223 See Commission Q&A 'Commission proposes activating fiscal framework's general escape clause to respond to coronavirus pandemic', 20 March 2020.

224 Philippe Martin and Xavier Ragot, 'When and how to deactivate the SGP general escape clause?', in-depth analysis requested by the ECON committee of the European Parliament, January 2021.

225 Klaus-Jürgen Gern, Stefan Kooths and Ulrich Stolzenburg, 'When and how to deactivate the SGP general escape clause?', in-depth analysis requested by the ECON committee of the European Parliament, December 2020.

226 The authors note that 'The fiscal framework does not require the Commission to launch excessive deficit procedures for Member States with significant deviations from fiscal objectives as long as such a step is deemed inappropriate.'.

4. Towards a reform of the Stability and Growth Pact

4.1. The contribution of the European Fiscal Board

In its 2017 annual report,[227] the European Fiscal Board provided a couple of general reflections on the possible directions of reform. These reflections were only partially focused on simplification[228] issues and aimed to address other imperfections of the SGP.[229]

The following year, the European Fiscal Board published a more detailed proposal[230] aimed at putting debt reduction at the centre of the rules, strengthening the transparency and predictability of economic governance in the EU and radically simplifying the existing framework.

The proposal contained the following elements: i) the replacement of the structural medium-term objective with a medium-term debt ceiling at 60 % of GDP as the anchor of the framework;[231] ii) a ceiling on the growth rate of primary expenditure net of discretionary revenue measures, to simplify the assessment of compliance; iii) a more effective system of sanctions applying to both SGP arms; iv) a streamlined surveillance cycle with fewer steps;[232] v) escape clauses, triggered on the basis of independent judgement (the country's IFI and the Commission's), to replace the complex system of waivers and flexibility within the current rules; and vi) a clearer separation between the analytical assessment of the rules and their enforcement, including the introduction of the comply-or-explain principle.

In the beginning of 2019, the Commission President, Jean-Claude Juncker, asked the EFB to carry out an assessment of the EU fiscal rules, to see whether and how to simplify them, taking into account three broad objectives: i) the long-term sustainability of public finances, ii) the stabilisation of economic activity in a counter-cyclical fashion, and iii) the improvement of the quality of public finances. The complete report was published in September 2019.[233]

In its assessment, the EFB notes that on average, the sustainability of public finances had improved between 2012 and 2019. Against the backdrop of a long period of economic growth, three achievements are noteworthy: i) no Member State remained subject to an excessive deficit procedure; ii) headline deficits had been reduced sharply from over 6 % of GDP to below 1 % of GDP on average since their peak in 2010; and iii) government debt ratios had on average edged downwards since 2014. Additionally, 'gross errors' in the evolution of public finances had largely been corrected. Nonetheless, the EFB also observes that the pace of debt reduction in a group of

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227 European Fiscal Board, Annual Report 2017.

228 On the subject of simplification, the board laid out the general principles without going into detail. These principles comprise the identification of one fiscal anchor ('deficit or debt'), the resolution of inconsistencies between the preventive and the corrective arms, an agreement on one operational indicator for assessing compliance, and a clear benchmark for the required annual fiscal adjustment. Lastly, it argued that escape clauses should be well defined and only be used 'depend[ing] on the assessment by an independent body'.

229 The board recommended a more symmetric treatment of adverse and positive shocks and proposed an account modelled on the Swiss or German debt brake, where past target overruns are documented and then have to be compensated for in subsequent years.

230 Annual Report 2018, European Fiscal Board.

231 The authors note that 'The Maastricht Treaty first introduced the 60 % of GDP reference value for the debt ratio in 1992, based on the consideration that such a value was consistent with the average debt ratio in the Union at the time. Although not underpinned by solid theoretical considerations, this value is now broadly accepted by the public, and maintaining it will avoid the need for changes to the Treaty'.

232 In particular, the authors propose to fix fiscal targets for three years in order to strengthen the medium-term orientation of fiscal policies, and to use a compensation account to track deviations from fiscal requirements, thus avoiding the need for a continuous monitoring of budgetary implementation.

233 Assessment of EU fiscal rules with a focus on the six and two-pack legislation, op. cit.

countries with a very high level of debt had been slower than desirable, or had stalled, and that in recent years the annual improvement in structural budget balances had declined. In addition, the EFB mentions that the overall compliance rate with rules (including the MTO and the expenditure benchmark) was low. The EFB further notes that the current EU fiscal framework is characterised by four main sources of complexity that are the result of its gradual evolution:

- heavy reliance on unobservable indicators of fiscal performance when issuing guidance, monitoring implementation and making the final assessment of compliance. Therefore, a move towards a single and better-defined indicator would reduce the risk of policy mistakes and make it easier to communicate the fiscal policy stance to the public;[234]
- reliance on annual, rather than longer-term indicators, due to the fact that the annual budget deficit is easily observable (even if it is subject to cyclical fluctuations);
- the Commission and the Council have had difficulties in getting the timing of flexibility right;[235]
- the balance between the Commission and the Eurogroup has been tilted towards the Commission; as a result, fiscal surveillance and the compliance assessment have become subject to bilateral negotiations between the Commission and the Member State concerned.[236] To restore the balance, the EFB suggests abandoning the RQMV and/or nominating a full-time president of the Eurogroup who is neither a national finance minister nor a member of the Commission.

Lastly, in its 2019 annual report[237] the EFB proposed, in addition to the above remarks and to its 2018 suggestions, to:

- create a sizeable central fiscal capacity for stabilisation purposes, subject to appropriate conditionality;
- with regards to the 60 % of GDP debt rule, improve the implementation of the envisioned debt-reduction strategy[238] by making the adjustment of government debt country-specific.[239]

Moreover, the EFB proposes to make the application of this rule symmetrical: on the one hand, Member States with a high debt would commit to lower net government expenditure over a credible path of seven years. On the other, Member States with a low debt would commit to a binding net expenditure path that would include growth-enhancing public investments with cross border effects, over that same period.

[234] For example, already since 2005, the structural government deficit has been analytically superior to the more observable headline deficit, as it measures policy efforts. However, estimating it requires an assessment of both the degree of resource utilisation in any given year (summarised in the output gap) and assumptions about how the budget reacts to changes in the economic environment (summarised by budgetary elasticities). While significant work on estimating those two elements has been ongoing, estimates can vary significantly over time.

[235] The original intention to introduce more flexibility was appropriate, but flexibility was applied too late during the recovery, and it promoted pro-cyclicality.

[236] The EFB conjectures that the decision-making process has evolved in favour of adopting the Commission's proposals without major discussion. This is partly due to the RQMV and partly to the shorter career of finance ministers, which makes it difficult for them to challenge the outcome of the Commission's bilateral negotiations with a government. The rise of the 'political' Commission raises two important concerns: that there is insufficient separation between the independent economic analysis by expert staff in the Commission and the political deliberations; and that the only body that debates political considerations is the College of Commissioners.

[237] Annual Report 2019, European Fiscal Board, October 2019.

[238] The EFB notes that compliance with the rule for Member States that are well below the 60 % of GDP debt reference value provides no guidance, while the rule looks unattainable even over a longer time span for Member States with a very high debt.

[239] This can be achieved either by changing the reference values in the Treaty protocol, or by differentiating the speed of adjustment towards the current debt reference value.

4.2. The viewpoint of the European Commission prior to the review of the governance framework

In its yearly report on Public Finances in EMU, published in January 2019,[240] the Commission attempted to reply to three questions relative to the EMU fiscal governance framework.

Have EU fiscal rules been associated with more sustainable public finances?

The Commission noted that the question whether the EU fiscal rules ensure sustainable public finances (and notably to avoid excessive public deficits and debt) is challenging.[241] To allow for a tentative assessment of the impact of EU rules, it chose to compare the developments relative to the key fiscal outcome variables before and after the introduction of the rule.

With regards to the 3 % of GDP deficit criterion, the developments suggest that it contributed to better fiscal outcomes than before the introduction of the SGP, in Member States that had a high public deficit.[242] By contrast, there seems to be no clear-cut impact of the 3 % deficit criterion on Member States that had headline surpluses or low deficits before the introduction of the SGP. Expenditure dynamics seem to have been better controlled since the introduction of the expenditure benchmark in 2011.[243] Lastly, while an increasing number of Member States comply with the debt reduction benchmark,[244] a few Member States still do not. Moreover, while many Member States witness a public debt lower than or close to 60 % of GDP, some Member States show much higher debt ratios, and in particular some large Member States combine high debt with relatively high structural deficit.

Have EU fiscal rules mitigated pro-cyclicality?

The Commission is of the view that empirical evidence on the cyclicality of fiscal policy in the EU is inconclusive, as the findings for the EU are sensitive to the time period covered and the indicators used to measure fiscal policy and the economic cycle.[245] Confirming previous literature on the subject, the Commission's findings point to a mild pro-cyclical tendency of fiscal policy in the EU on average since 2000, with pro-cyclicality occurring in particular in good times. At the same time, respect for fiscal rules in the EU seems to have mitigated the pro-cyclicality across its territory.[246]

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240 Report on Public Finances in EMU 2018, European Economy institutional papers, European Commission, January 2019, pp. 110-143.

241 Looking at the developments of public debt in the EU may suggest that debt ratios declined in the years after the various steps taken to reform the EU fiscal governance framework. Nevertheless, the EU fiscal rules have not prevented debt ratios from increasing to very high values. In addition, it is difficult to disentangle the impact of the institutional changes from the economic cycle, since periods of debt reduction have frequently coincided with good economic conditions. Lastly, causality can be difficult to establish for endogeneity reasons (for instance, countries with fiscal rules may have a preference for a prudent conduct of fiscal policy whether or not a rule is in place).

242 Member States with a large headline deficit just before the launch of the SGP reduced their deficit significantly, with the exception of the period encompassing the global financial crisis and the sovereign debt crisis.

243 The pre-crisis period showed that in most Member States primary expenditure grew much faster than the average potential growth rate. Since the introduction of the expenditure benchmark, most Member States have witnessed primary expenditure growth below or close to potential growth. On top of this, discretionary revenue measures increased over the 2011-2017 period in almost all Member States.

244 As explained above, the debt reduction benchmark was introduced in 2011 with the six-pack SGP reform, with the aim to put a stronger focus on fiscal sustainability.

245 Over several years preceding 2001, studies found evidence of a pro-cyclical fiscal tightening. In the first decade of EMU, the findings ranged from a-cyclical to pro-cyclical fiscal policy. More recent studies have shown that fiscal reaction has become more prudent since the Great Recession, resulting in a-cyclical or countercyclical fiscal policy.

246 Member States that met the requirements of the preventive arm of the SGP benefited from reduced pro-cyclicality of the fiscal effort. Also, avoiding a high headline deficit appears to reduce pro-cyclicality of the fiscal effort. Lastly, keeping public debt below 60 % of GDP mitigates the pro-cyclical pattern of the fiscal effort.

Has ownership of EU fiscal rules been strengthened by national fiscal frameworks?

In recent years, the number of national fiscal rules has increased significantly in the EU, with most of the new ones targeting the general government sector.

The Commission notes that, while the merits of strong independent fiscal institutions (IFIs) have long been documented in the academic literature, it was only after the impetus given by the recent EU fiscal governance initiatives that the number of IFIs in the EU started to noticeably increase. Indeed, between 2010 and 2017 the number of independent fiscal institutions in the EU increased more than three-fold.

The Commission also found that all Member States now have in place a national medium-term budgetary framework grounded in national legislation and connected to the annual budgetary process. Furthermore, the features of the new or reformed national frameworks have improved in recent years.[247]

The empirical analysis conducted by the Commission found that both fiscal rules and medium-term budgetary frameworks have a positive and statistically significant impact on the structural primary balance.

4.3. The 2020 Commission review of the economic governance framework

The von der Leyen Commission decided, at the start of its mandate, to assess the effectiveness of the current fiscal framework.[248] The purpose of the review is to start a public debate on the subject, thereby providing an opportunity for stakeholders – citizens and institutions – to offer their views on the functioning of surveillance so far and on possible ways to enhance the effectiveness of the framework in delivering on its key objectives.

According to the review, the SGP's corrective arm has been an effective tool in reducing and maintaining government deficits below the 3 % of GDP threshold.

At the same time, the Commission notes that the corrections of excessive deficits happened during helpful macroeconomic conditions. In addition, despite the reduction in excessive deficits, public debt ratios remain above the Maastricht ceiling in several Member States. It also notes that some highly-indebted Member States remain below their objectives, despite the aforementioned favourable economic conditions; that they have used the deficit reference values as a target rather than a ceiling; and that they have not built sufficient buffers to provide themselves with a safety margin vis-à-vis the 3 % of GDP deficit threshold in the case of deteriorating macroeconomic conditions. These observations lead the Commission to suggest that the reformed SGP has *not* been successful in bringing the level of debt down sufficiently in the most vulnerable Member States.

With regards to the pro-cyclicality of fiscal policy in the Member States, the Commission notes that empirical evidence suggests that compliance with EU fiscal rules contributes to its mitigation.

Regarding the ownership and governance of EU fiscal rules, the accumulation of rules, indicators and implementation procedures over time has made the SGP increasingly complex and has harmed predictability. The current framework relies heavily on variables (e.g. potential growth and output gap) that are not directly observable and are frequently revised, which also hampers ownership.

247 The frameworks are overall stronger in terms of coverage, connectedness of targets with the annual budget process, involvement of national parliaments and of IFIs, and the level of detail included in fiscal planning documents.

248 For more information, see the Commission webpage, Economic governance review, which contains links to the communication on the economic governance review, the report on the application of the economic governance framework and the review of the suitability of Council Directive 2011/85/EU.

Furthermore, despite Directive 2011/85/EU and Regulation No 473/2013, discrepancies have emerged between EU and national fiscal rules, undermining the credibility of both and adding to complexity. Lastly, the Commission and the Council have been reluctant to launch enforcement procedures against Member States and to impose financial sanctions. Therefore, the Commission notes that a simpler framework and implementation could help to increase ownership, improve communication, and reduce the political costs of enforcement and compliance.

4.4. The viewpoint of other experts

According to Christophe Kamps and Nadine Leiner-Killinger from the European Central Bank,[249] 'between 1998 and 2017, the euro area deficit-to-GDP ratio averaged below the reference value at 2.6 %', with the euro-area average budget deficit having been more than halved in comparison to the 1980-1997 period. The authors add that this is noteworthy, also because the environment during the past 20 years has been one of far lower average nominal GDP growth, which may have contributed – both in the United States and Japan – to a rise in the average budget deficits over these time periods.[250]

The authors also note that Member States seem to have a preference for the reference value of 3 % of GDP deficit over the medium-term objective under the SGP preventive arm. They point out, however, that the 3 % and 60 % references held in a macroeconomic environment characterised by higher growth and inflation.[251] In today's conditions, targeting a 3 % of GDP deficit does no longer ensure the stabilisation of the debt ratio at 60 % of GDP, but instead, at around 100 % of GDP. Similarly, assuming nominal growth equals 3 %, to reach the 60 % debt, the deficit limit should be lowered to 1.75 % of GDP.

The authors further note that while compliance with the SGP structural effort requirements appears at first glance satisfactory overall in the 2011-2017 period,[252] the result hides significant differences in effort: between 2012 and 2013, in the context of significant financial market pressures and uncertainty, Member States actually achieved a markedly larger structural effort than prescribed by the SGP;[253] when those tensions subsided over the 2015- 2017 period, the average structural effort was below that foreseen by the SGP (0.1 % versus 0.2 % of GDP). Also, the average effort for the euro area hides significant differences between Member States with regards to structural effort requirements.

In addition to the above, the authors noted that the 60 % of GDP debt-reference value did not affect the conduct of fiscal policies, and the picture did not change with the introduction of the debt reduction rule in 2011.[254] At the same time, the fact that the rule can take different forms (e.g. be backward-looking, be forward-looking and account for the cycle) and account for a number of relevant factors, renders it complex and difficult to communicate and monitor.

Taking into consideration the above, the authors propose, among other things, to i) make the fiscal framework's indicators coherent by reviewing the three rules (the 3 % of GDP deficit reference value,

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[249] Christophe Kamps and Nadine Leiner-Killinger, Taking stock of the functioning of the EU fiscal rules and options for reform, ECB Occasional Paper Series, August 2019.

[250] In this respect, the authors note that 'The observation that budget deficits in the United States and Japan remained at levels far above those recorded on average in the euro area may be taken as a first indication that the EU's budget deficit rule "has worked" to contain budgetary imbalances'.

[251] On the road to Maastricht, the assumption of 5 % growth was plausible. However, in the period 1998-2017, nominal GDP growth in the euro area was lower, averaging 3 %.

[252] Euro area countries had to deliver an annual average aggregate structural effort of 0.5 % of GDP over that period.

[253] On average, about 1 % of GDP versus 0.75 % of GDP per year.

[254] According to this rule, countries with government debt above the 60 %-of-GDP debt reference value should reduce the gap to the reference value by 1/20th on average over three years.

the 60 % of GDP debt reference value as well as the MTO of a close-to-balanced budget); ii) reducing the SGP's complexity with a view to reducing reliance on structural balance/output gap estimates; and iii) exploring options for achieving higher fiscal discipline by way of financial rewards instead of sanctions.

With regards to the excessive deficit procedure, De Jong and Gilbert directly analyse the impact of EDP recommendations on forecasted and actual fiscal policy. The authors find that – except in cases of countries subject to financial support programmes[255] – EDP recommendations significantly affect both planned[256] and actual[257] fiscal policy. They furthermore present some suggestive evidence that 'medium-sized' recommendations are lived up to better than either less important ones or, conversely, extensive ones.[258] Overall, their results suggest that, in particular in the post-2009 period, when a large majority of Member States were subjected to an EDP, the SGP has shaped fiscal policies in the euro area.[259]

4.5. Further recent academic contributions

Coen Teulings[260] is of the view that the EU fiscal rules contained in the SGP are too strict and must be revised. He focuses on the demographic situation in the current context of secular stagnation, and notes that the debt requirement of 60% of GDP represents more of a lower bound than an upper bound. In addition, the recent crises show, in his view, that the deficit rule could be relaxed during recessions to 5-6% of GDP, without significant reaction from the financial markets.

Xavier Debrun et al.[261] focus on the ability of fiscal rules to contain excessive deficits. After presenting the theoretical foundations of fiscal rules, they go over the process that led to the transition from 'first-generation' fiscal rules (in place before the global financial crisis) to 'second generation' ones. They note that, in this context, policy makers face a 'trilemma' relative to fiscal rules, in that the rules' ideal properties – simplicity, flexibility and enforceability – are difficult to achieve simultaneously. In the quest to balance those needs, the authors identify three main guiding principles: 1) fiscal frameworks should include a debt anchor establishing a medium-term objective combined with a small number of operational rules that guide annual fiscal policy; 2) flexibility can be allowed in simpler ways, for example, by using clear escape clauses and placing more emphasis on expenditure rules that allow automatic stabilisers to operate; and 3) compliance could be more effectively promoted by raising reputational costs for non-compliers and creating more tangible benefits for compliers rather than relying predominantly on financial penalties.

Another proposal was formulated by 14 French and German economists.[262] The authors suggest a two-pillar approach consisting of 1) a long-term target debt level, such as 60% of GDP, or a more

255 For this group they find that, while they implemented substantial consolidation measures, the exact amount was not connected to the demanded adjustment.

256 A 1 % of GDP larger EDP recommendation leads to about 0.8–0.9 % of GDP of forecasted additional fiscal consolidation.

257 A 1 % of GDP larger EDP recommendation leads to 0.6–0.7 % of actual consolidation.

258 They believe that non-compliance with small recommendations can arguably be relatively easily set aside as the result of data measurement problems, while large required adjustments might be too difficult or politically painful to be carried out in full.

259 Jasper F.M. De Jong and Niels D. Gilbert, 'Fiscal discipline in EMU? Testing the effectiveness of the Excessive Deficit Procedure', *European Journal of Political Economy*, October 2019.

260 Coen Teulings, 'The EU's fiscal rules urgently need a revision', VoxEU blog post, 13 September 2018.

261 Luc Eyraud, Xavier Debrun, Andrew Hodge, Victor Lledó and Catherine Pattillo, 'Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability', IMF Staff Discussion Notes, 2018. See also their background paper.

262 Agnès Bénassy-Quéré; Markus Brunnermeier, Henrik Enderlein, Emmanuel Farhi, Marcel Fratzscher, Clemens Fuest, Pierre-Olivier Gourinchas, Philippe Martin, Jean Pisani-Ferry, Hélène Rey, Isabel Schnabel, Nicolas Véron, Beatrice

bespoke objective taking into account, for example, implicit liabilities arising from pay-as-you-go pension systems; and 2) an expenditure-based operational rule to achieve the anchor.

Zsolt Darvas, Philippe Martin and Xavier Ragot[263] would replace the numerous and complex existing rules with one simple rule focused on limiting the annual growth rate of expenditure. This rule could stipulate that the growth rate of nominal public spending – net of interest payments and of unemployment spending and taking into account public investment – would be equal to the sum of real potential growth and expected inflation, minus a debt brake that would take into account the difference between the observed debt-to-GDP ratio and the 60 % debt rule. This rule would be based on a rolling five-year country-specific debt reduction target, so as to take into account the speed at which Member States would have to converge to the long-term target.

A proposal by Desiree Christofzik et al.[264] would keep a long-term debt limit (for example, the 60 % debt limit) and an obligation to avoid excessive structural deficits in the medium term (the current structural budget rule), but to ensure compliance with this rule, a multi-purpose adjustment account would be created, which would capture deviations from the rule that Member States would be required to offset within a certain period of time. These goals would be operationalised by an annual growth ceiling on nominal expenditure (a modified version of the expenditure benchmark). In addition, the number of exemptions and escape clauses would be reduced, as would discretion with regard to the imposition of sanctions, to increase their credibility.

4.6. Background papers for the European Parliament

Three background papers commissioned by the European Parliament's Committee on Economic and Monetary Affairs (ECON) provide further input to the reform of the SGP by examining it from the viewpoint of complexity.[265] It has indeed been noted that, 'No other fiscal rule system remotely compares with the complexity of SGP fiscal rules not only with regards to the number of rules[266] but also to the conditions under which each rule can be waived'.[267]

The background papers have identified several sources that contribute to the complexity of the SGP:

- *the underlying assumption of the SGP's approach*: namely, as it has been explained in the beginning of this paper, that rules are necessary to compensate for the ineffectiveness of market discipline and the cross-border externalities of imprudent fiscal policies;
- *the absence of trust in the impartiality of the institution responsible for the SGP (the Commission)*: as a result, the other players involved seek to adopt more and more detailed and constraining rules;

Weder di Mauro and Jeromin Zettelmeyer, 'Reconciling risk sharing with market discipline: A constructive approach to euro area reform', CEPR Policy insight, January 2018.

263 Zsolt Darvas, Philippe Martin and Xavier Ragot, 'Réformer les règles budgétaires européennes: simplification, stabilisation et soutenabilité', Les notes du conseil d'analyse économique, September 2018.

264 Désirée Christofzik; Lars P. Feld; Wolf Heinrich Reuter and Mustafa Yeter, 'Uniting European fiscal rules: How to strengthen the fiscal framework', Sachverständigenrat zur Begutachtung der Gesamtwirtschaftlichen Entwicklung, Wiesbaden, 2018.

265 Carlo Cottarelli, How could the Stability and Growth Pact be simplified?, In-depth analysis requested by the Economic Governance Support Unit of the European Parliament, April 2018; George Kopits, How could the Stability and Growth Pact be simplified?, In-depth analysis requested by the Economic Governance Support Unit of the European Parliament, April 2018; and Friedrich Heinemann, How could the Stability and Growth Pact be simplified?, In-depth analysis requested by the Economic Governance Support Unit of the European Parliament, April 2018.

266 In their contribution, 'Constraints on Subnational Fiscal Policy' (Chapter 3 of the book *Designing a European Fiscal Union*, Routledge ed., 2015), Luc Eyraud and Raquel Gomez Sirera find that in fiscal federations, sub-national governments are constrained on average by two fiscal rules, against four main ones in the SGP.

267 It is noted that the manual published by the European Commission to illustrate those rules, the Vade Mecum on the Stability and Growth Pact, is more than 200 pages long.

- *the 'battle of ideas' among Member States and political parties*: this finds reflection in the fact that, every time the SGP is reformed, there are more and more detailed fiscal constraints on the one hand, and an increasingly large set of escape clauses on the other;
- the effort to obtain a rule that strikes *a balance between short-run stabilisation*[268] *and long-run sustainability* (e.g. the '1/20 rule' for debt reduction in the corrective arm);
- the fact that the SGP is designed to also capture non-economic events outside the control of national policymakers, which may impact government budgets, through its various escape clauses.

In turn, this complexity:

- hampers communication to the public and weakens the potential of public oversight;
- reduces transparency and the perception of legitimacy of the system;
- allows countries to cherry-pick some target variables (such as the 3 % deficit), while delaying others (such as the debt-reduction target);
- reduces the chances of market discipline, as the noise created by too many targets blurs interpretable signals for bond markets;
- leaves external observers (and perhaps even main stakeholders) with the impression that the fiscal adjustment that is required from Member States is subject to annual negotiations – the opposite of what the existence of fiscal rules would imply – and therefore fosters the belief that rules can be adjusted at will;
- while originally the rules were designed to be internally consistent, at times, they may be in conflict with each other, requiring a judgment call by the Commission as to how to prioritise them.[269]

To simplify the SGP, Carlo Cottarelli proposes three options, ranging from 'housekeeping' changes to amendments that would fundamentally alter the existing framework.

An example of simplifications that can be made without requiring legal changes, but would not change the status quo, is the focus on the expenditure benchmark in 2016.

A second group of measures would not keep the overall system as it is, but would alter the balance between *stringency* and *flexibility* needs. Relevant changes include removing the dependency of the speed of adjustment in the preventive arm on the state of the economy, or requesting that compliance with the debt rule only be based on the backward-looking criterion. Given that such simplifications would reduce the room for flexibility, Cottarelli also proposes to relax the MTOs; introduce a general escape clause that would suspend the adjustment as long as the country is experiencing a decline in GDP; or remove either the MTO rule or the expenditure benchmark, as both rules aim to keep a certain structural fiscal variable at a certain level, while allowing the automatic stabilisers to fully play.

Lastly, in the ambitious category, Cottarelli suggests to replace the current four-rule system with a single formula in which a flow 'operational target'[270] would respond to the deviation of public debt (the 'final anchor') from its target and, possibly, to the magnitude of the output gap.[271] He notes that

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268 In spite of some countries being in obvious and significant non-compliance with this rule, no excessive deficit procedure has ever been started on those grounds. The reason is that, as interpreted by the Commission, other rules dominate the one-twentieth rule, so it is effectively bypassed as an autonomous criterion.

269 To illustrate this point, Cottarelli refers to one example given in the 2017 report of the European Fiscal Board: in a low-growth environment, meeting the medium-term objective under the preventive arm of the SGP may not ensure compliance with the debt criterion under the corrective arm and might lead to an excessive deficit procedure.

270 The deficit, the primary deficit, the revenue-adjusted expenditure, all corrected for cyclical effects.

271 According to Lorenzo Navarini and Alice Zoppè potential output is a concept used in economic analysis to measure the highest level of production (GDP) that an economy can reach without generating inflationary pressures. The output gap is the difference between real and potential output. For more information, see '[Potential output estimates and their role in the EU fiscal policy surveillance]', EGOV briefing, February 2020.

such an approach is 'analytically simple, ensures the consistency of the deficit target with the goal of achieving the debt target, and allows changes in the structural balance, which, in principle, make the fiscal stance more adequate to the business cycle than just allowing automatic stabilizers to operate'.

George Kopits identifies three options to simplify the design of the SGP rules, while serving the overarching goals of fiscal discipline and public debt sustainability in Member States.

The first option ('partial consolidation') replaces the structural balance and debt convergence targets with a debt-stabilising (or reducing) primary surplus target, while retaining the expenditure benchmark. Exemptions are to be well specified and streamlined, subject to less discretionary judgment by the Commission.

The second option (and, according to the author, the simplest) consolidates all current rules into one 'operational debt rule', by setting a limit on the discretionary budget deficit, derived from a debt reduction target – all expressed in nominal amounts – announced three years in advance. Besides simplicity (as it eliminates the need to estimate the structural balance and the underlying output gap), the rule has a number of practical advantages over the 'partial consolidation' option: it ensures accountability by providing authorities with direct, real-time control over the operational target; it is inherently flexible in that it allows the operation of automatic stabilisers; it serves as an early indicator on the need to regain fiscal space for discretionary action through periodic expenditure reviews and, if necessary, through structural reforms in taxation and mandatory spending programmes.

The third and most radical option consists in reverting to an autonomous, rather than a coordinated or centralised regime of rules. This system would be underpinned by Member States enshrining home-grown fiscal rules in their constitutions, creating (or enhancing) well-functioning independent fiscal institutions, and taking the necessary measures to ensure that the Maastricht rules of 'no debt monetisation' and 'no bailout' are reinforced. To reach this stage, though, the author notes that there is a need for both EU-wide measures (central budget for EU-wide stabilisation) and for Member State reforms (an orderly drawdown of a significant portion of legacy debts, as well as meaningful structural reform efforts targeting taxation, public pensions and health care).

Further background papers commissioned by the Economic and Monetary Affairs (ECON) Committee of the European Parliament provide useful information on the benefits and the drawbacks of an 'expenditure rule' and a 'golden rule' in the EU fiscal framework.

In their paper,[272] Daniel Gros and Marvin Jahn note that the debate about expenditure rules and cyclically adjusted balance rules will need to be re-assessed once the full impact of the coronavirus crisis is known. What can be anticipated is that the post-crisis environment will mean higher public debt and expenditure generally. Given that following the crisis, both expenditure rules and structural balance rules will be more difficult to apply,[273] focusing on debt reduction might at that point be more appropriate. With regards to a golden rule, the authors note that the economic argument for such a rule is that debt can be used to finance the creation of public capital. This is often read as implying that all investment spending should be exempted from the computation of

[272] Daniel Gros and Marvin Jahn, 'Benefits and drawbacks of an "expenditure rule", as well as of a "golden rule", in the EU fiscal framework', study requested by the ECON committee of the European Parliament, July 2020.

[273] Existing expenditure rules start from a baseline under which expenditure is allowed to grow along with potential GDP, which is then adjusted downwards for the need to reduce debt levels. However, in a post-COVID-19 environment, one might have to introduce another adjustment for an unusually high starting level of expenditure, thus complicating the application of an expenditure rule. Rules based on cyclically adjusted deficits might also become more difficult to apply because the usual methods to measure the output gap will be affected by the current crisis as well.

the deficit. However, the authors note that, from an economic point of view, this is a misunderstanding, because public capital creation must take into account the depreciation of the public capital stock that reduces the value of capital. This implies that a golden rule should be based on net and not gross investment spending. In practice, this could be achieved by deducting negative net investment from the allowable deficit.

In his paper,[274] Wolf Heinrich Reuter notes that focusing the fiscal framework on an expenditure rule could help to increase transparency, compliance and ownership. In various other respects, like estimation errors or counter-cyclicality of prescribed fiscal policy, expenditure rules are similar to structural balance rules. Their main advantages are that the constrained variable is more directly controlled by governments and is more transparent, and the ceiling set by the rule for fiscal policy is less volatile. With regards to a golden rule, the author notes that the main challenge of introducing one is to clearly and narrowly define the deductible expenditures. Furthermore, to avoid increasing debt and to preserve long-term fiscal sustainability the author proposes that a cap should be set on the amount of expenditures that is deductible, which would result in a system of two rules: one setting a limit on total expenditures (deductible and non-deductible), and another setting a lower limit on the non-deductible portion of expenditures.

4.7. Greening the rules?

One of the flagship priorities of the von der Leyen Commission has been the European Green Deal.[275] In its latest Public Finances in EMU Report,[276] the Commission notes that public finances will be impacted by climate change,[277] but will also play a central role in the climate transition. In this context, the report notes that the Commission services are exploring ways to integrate climate change impacts into their debt sustainability analysis framework. In parallel to the report, several proposals have been formulated by academics.

Grégory Claeys[278] notes that the European Green Deal should include a sustainable investment strategy 'that will help companies switch technologies and citizens change behaviour, offsetting the rising costs they will face because of higher carbon prices'.[279] The author is of the view that the main tool for the EU Commission to do this is the European fiscal framework, through the introduction of a 'golden rule' that would allow financing such investments. One way to introduce such a rule would be to revise the investment clause of the European fiscal framework to make it much more flexible in order to exempt public investment that mitigates or adapts to climate change from the fiscal rules. Claeys notes that the current investment clause could be tweaked to also apply to green investments, but underlines that it should be refined to be transformed from a temporary

[274] Wolf Heinrich Reuter, 'Benefits and drawbacks of an "expenditure rule", as well as of a "golden rule", in the EU fiscal framework', study requested by the ECON committee of the European Parliament, September 2020.

[275] In its latest Report on Public Finances in EMU, the European Commission notes that 'With the European Green Deal, the Commission stated the ambition for the EU to lead the transition to a 'climate-neutral and healthy planet'. This includes an endorsement of the objective of climate neutrality by 2050, which will be enshrined into a European Climate Law. The speed of the carbon emission reductions is to be stepped up. By autumn 2020, the Commission will present a plan to increase the EU's greenhouse gas emission reductions target for 2030 from the current 40% to at least 50% and towards 55% in a responsible way'.

[276] European Commission 'Role of public finances in the transition to a climate-neutral and healthy planet', Report on Public Finances in EMU 2019, European Economy Institutional Papers, July 2020, pp. 37–42.

[277] Due to a surge in losses resulting from extreme weather events, measures to help citizens, regions and industries but also the necessary efforts for climate transition.

[278] Grégory Claeys, 'The European Green Deal needs a reformed fiscal framework', December 2019.

[279] Grégory Claeys, Simone Tagliapietra and Georg Zachmann, 'How to make the European Green Deal work', Bruegel policy contribution, November, 2019.

exemption that can only be used in bad times to a permanent exemption that can also be applied in good times.

Carlo Cotarelli[280] sees three possible options:

- The first option would be to maintain the current approach of not differentiating between different types of spending. This would lead to the relaxation of overall fiscal ceilings. This would mean, for example, raising the deficit ceiling from 3 to, say, 3.5 % of GDP without a specific flexibility clause related to the implementation of green investment spending. The rule would be simple(r) than introducing a specific rule for green investment, but would not guarantee that extra spending goes to green projects.
- Another possibility would be to introduce a specific flexibility clause that would apply to green public investment up to a certain level of spending for the latter.[281] If such a clause were introduced, adjustments would have to be made to the SGP rules with regards to the MTO and the pace of convergence towards it, the expenditure benchmark and the assessment of compliance with the public debt ceiling.
- Lastly, in the context of the broader efforts under the Next Generation EU, green spending could be undertaken, directly or indirectly, at the EU level. This way, it would not lead to higher Member State deficit and public debt. This approach would be logically coherent with the challenges faced[282] and would allow to leave SGP rules unaffected by the need to boost green public investment.

Lastly, Atanas Pekanov and Margit Schratzenstaller[283] discuss another three approaches for a reform of the fiscal rules:

- The most straightforward approach would be to include a green public investment definition in the existing investment exemption clause of the SGP, and thus enable short-run deviations from deficit targets and MTOs similar to the deviation allowed through the investment flexibility clause or the structural reforms clause. The clause would be applied to countries that can present verifiable and detailed plans for green public investment reforms as well as specific deadlines and milestones. The plans would require clear evidence – resting on the green taxonomy[284] – that the investment in question will help the economy improve its climate sustainability. This solution would have the advantages of being relatively easy to implement, not requiring Treaty changes and retaining much of the structure of the SGP. It would, however, complicate an already complex set of fiscal rules further and would not ensure that Member States indeed invest the necessary amount towards greening their economies. It would thus sustain the current status quo, while not sufficiently contributing to the stated goal;
- A second approach would be to implement a golden rule[285] for green public investment in the existing fiscal framework. A golden investment rule in that sense would allow green public

280 Carlo Cottarelli, 'The role of fiscal rules in relation with the green economy', in-depth analysis requested by the ECON committee of the European Parliament, August 2020.

281 In other words, the deficit ceiling would remain 3 %, but in assessing compliance with this ceiling green public investment would not be counted as spending up to a level, say 0.5-1 % of GDP. That ceiling in turn would be estimated based on the green public investment ideally needed to address climate change challenges.

282 It could be argued that environmental damage is not contained within national frontiers and that everybody in the European Union would benefit from green public investment made in one Member State.

283 Atanas Pekanov and Margit Schratzenstaller, 'The role of fiscal rules in relation with the green economy', study requested by the ECON committee of the European Parliament, September 2020.

284 For more information on the green taxonomy, see the Final report of the Technical Expert Group on Sustainable Finance, March 2020.

285 The authors note that a classical investment golden rule consists of classifying government spending either as current expenditure or capital expenditure and then not taking into account the latter in the calculations regarding the deficit criteria. The current expenditure would have to be balanced by current revenues, while the capital expenditure would be financed via debt.

investment to be undertaken through the issuance of additional debt, and the deficit accrued for this would not be counted towards deficit statistics kept for EU fiscal rules. While this would also constitute a further complication of the fiscal framework, a golden rule for green public investment will be efficient in incentivising governments to transform as much as possible of their spending into spending for green public investment. At the same time, this would create an administrative burden. It would also bear the risk of governments abusing this opportunity by classifying everything as 'capital investment';

- Lastly, a third approach would be for the European Commission to recommend a benchmark for each Member State as a share of government public expenditures that will be committed to green public investment.[286] The European Commission would recommend such a benchmark share for each country, based on an estimated country-specific green investment gap and also considering the country-specific general public investment gap. The authors note that such an approach would not constitute an excessive breach of the fiscal-policy sovereignty of the Member States, as it would not prescribe the size of government spending, but rather, only direct a part of its composition. The benefit of such an approach would be that it could address the current asymmetry resulting from the fact that the SGP does not address cases in which spending in specific areas, such as fighting climate change, is considered insufficient. The difference compared to the previous two options would be the proactive recommendation by the Council to Member States that a certain share of their expenditures should be in the form of green public investments. The authors note, however, that there are also problems with this approach, namely that the similar approach regarding debt rules has not only proven to be complex but has also failed to ensure that countries comply with the given recommendations.

With regard to implementing green public investment, the authors propose to either streamline the existing projects within the European Semester or to use the recovery and resilience plans and the EU recovery instrument.

In the first case, the green goals could be part of the EU country-specific recommendations (which could include a specific section on green public investment) or the draft budgetary plans submitted by EU governments. In the second case, Member States would have to include green projects in their recovery and resilience plans to obtain funds from the recovery and resilience facility.

[286] For example, a certain percentage of all government public investment / expenditure.

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Almost 30 years ago, the Maastricht Treaty laid the basis for economic and monetary union (EMU). Its fiscal provisions have been further developed by subsequent primary and secondary legislation – in particular, the Stability and Growth Pact with its preventive and corrective arms, and the Treaty on Stability, Coordination and Governance in EMU. These instruments together constitute the fiscal framework of the European Union. In early 2020, the European Commission launched a review of the EU's economic governance, seeking in particular to establish how effective the surveillance provisions have been in achieving their objectives. This paper aims to provide an introduction to the Union's economic governance, starting from a brief overview of the economic literature, and concluding with a look at possible developments that might follow from the review, not least examining the various calls for its amendment that have been put on the table. While the Commission's review has been put to one side while the immediate issues of the coronavirus pandemic are addressed, the economic consequences of the pandemic are themselves changing the context for the review.

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