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The European Union fiscal policy framework and fiscal sustainability - challenges for the post-crisis environment

Abstract

The fiscal policy framework in the European Union was originally agreed upon in the Maastricht Treaty 30 years ago. In the following years it has been supplemented (Stability and Growth Pact) and modified, influenced by the experience of its application practice and external shocks, such as the financial crisis. However, the essence of this framework remained the same - member states are obliged to conduct a disciplined fiscal policy, which, in a nutshell, is assessed by comparing the ratio of budget deficit and public debt to GDP in a given country to the reference values.

Even before the outbreak of the Covid-19 pandemic, the need to change the mechanisms for disciplining fiscal policy was widely recognized. High and persistent levels of public debt, procyclicality of fiscal policy, shortage of public investment and the complexity of fiscal rules and their weak enforceability are indicated as unfavorable features of public finance.

In 2019 the COVID-19 pandemic came as the biggest shock to the world community since World War II. In the context of the provisions on fiscal discipline, in May 2020 the Commission and the Council activated the general escape clause of Stability and Growth Pact, for the first time ever. This has allowed member states to take the necessary fiscal measures to deal with the crisis.

On 19 October 2021, the European Commission adopted a Communication relaunching the public consultation, put on hold in March 2020, on the EU's economic governance framework. The new governance framework should be tailored to the challenges the EU is facing, including the challenge of achieving a fiscal stance that is appropriate for the euro area as a whole.

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There is a fairly widespread belief in the need to move away from rigid reference values, which should be replaced by solutions that ensure the sustainability of public debt in the differing circumstances of member states. The proposed options for the revision of the EU fiscal framework, although justified in theory, have a fundamental flaw - they strengthen the position of supranational institutions and, moreover, open the door to discretion and potentially unequal treatment of member states. These proposals can be seen in a broader context - the federalization of the EU, which would limit the sovereignty of nation states.

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1. National fiscal policy and the issue of its coordination in the European Union

In formulating the concept of the Economic and Monetary Union (EMU), agreed in the Maastricht Treaty², it was assumed that a prerequisite of the stable functioning of the single currency area is the prior co-ordination of the member states' economic policies aiming at convergence of their economic structures. The Treaty stipulated that the advancement level of such convergence, conditioning participation of a given country in the EMU will be assessed by means of the so-called convergence criteria. The said criteria concerned the monetary sphere (inflation rate and long-term interest rate related to the lowest values in the group of candidate countries), the sphere of public finance (maximum budgetary deficit and public debt to GDP ratios) and stability of the currency exchange rate.

In defining the foundations for a future centralized and single monetary policy it was assumed that fiscal policy will remain the responsibility of individual member states. It was mainly due to the political reasons. The member countries have different preferences as far as fiscal re-distribution and the scope and intensity of the "welfare state" idea implementation are concerned which is expressed by the diversified degree of fiscal redistribution and different structures of budget expenditure

² Treaty on the European Union, signed on 7 February 1992, after having been ratified in 12 EEC countries came into force on 1 November 1993. The Treaty assumed three stages of the EMU implementation; the last, third stage started on 1 January 1999 by establishing the irreversible conversion rates of national currencies in relation to the Euro and lasted until the end of February 2002, when the last of 12 hitherto national currencies qualified for the EMU lost their status of the legal means of payment.

and revenues. These differences have always been perceived as the ones impossible to eliminate in the foreseeable future. Hence, giving up sovereignty in the sphere of fiscal policy seemed and still seems to be unacceptable both to governments and societies of individual member states.

In the absence, at that time, of any prospects of fiscal federalism that, within the supranational budget, would enable implementation of transfer mechanisms of resources between the Union countries, an important economic argument in favor of retaining fiscal policy as a (relatively) autonomous sphere of decision making for member state governments was a prospect of the necessity of using the tools of this policy to relieve the differences in the course of cyclical conditions and to respond to asymmetric shocks. Adoption of the common currency means not only losing the opportunity of carrying out the country's own, national, discretionary monetary and fiscal policy. Another equally important fact is that the single currency area with the centralized monetary policy does not offer financial markets a chance of automatic, "natural" response to economic depression in a given country, the response in the form of decreased interest rates or a drop in the currency exchange rate. As the "common market" is still rather a sum of the relatively separate national markets, on account of such phenomena as low mobility of the working force, poor flexibility of prices and wages, the need to retain an economic "shock absorber" in the form of the autonomous national fiscal policy seemed obvious.

While preserving the decentralized nature of fiscal policy it was deemed necessary to define the rules of this policy and mechanisms disciplining individual member states in such a way as to counteract the existence of an excessive budgetary deficit and the increase of public debt. The motivation behind accepting such rules and mechanisms can be seen on two levels: that of individual countries and of the whole single currency area (Buiter, 2003).

With reference to the national level the ultimate targets of fiscal policy which should be enhanced by the adopted regulations are: retaining the country's solvency, ensuring possibilities of financing public expenditures and ensuring macroeconomic balance by eliminating undesirable fluctuations in the economic activity level. These issues are of essential significance for the stability of individual national budget functioning; therefore defining and observing adopted regulations is in their interest and should be in their competence. While analyzing the national level only it is difficult to find economic justification for adopting supranational regulations.

In the case of the single currency area countries there is, however, one additional aspect. The fiscal policy regulations should enable identification and limitation of a potentially negative impact of the irresponsible policies

of individual member states on the functioning of the remaining ones and the euro area as a whole. What is meant here is avoidance of all types of unfavorable externalities of national fiscal policy and the so called “free riding” at the expense of other EMU members while implementing the “national” objectives. These unfavorable externalities can refer to:

- Impact of excessive budgetary deficits on interest rates in the single EU financial market. Increased demand on loan funds, resulting from the necessity to finance the deficit of the country neglecting the public finance discipline creates the pressure to increase interest rates not only in the country in question but in the entire territory of the Union, which results from the nature of the single market. Countries of healthy public finances experience the drainage of savings and increased costs of financing. This means that the expenditures of their private sector are crowded out by the public expenditure of the country revealing an excessive deficit. These redistribution effects lead to reduced effectiveness of economy and slower economic growth in the Union's territory.
- Unfavorable impact of an excessive deficit on the conditions of the centralized implementation of single monetary policy. Fiscal expansion entailing the increase in global demand causes inflation pressure, which makes the central bank to aggravate the monetary policy. This more restrictive monetary policy is applied in all countries, also in those where the budget discipline is not infringed. At the same time, because higher interest rates mean higher costs of the public debt servicing, the central bank is under pressure to adopt a more lenient kind of monetary policy. This worsens the relationships between the central bank and the governments of member states.
- Effects of the higher risk of insolvency or possibility of being insolvent by the member state. On the one hand, what is meant here is the possible effect of “infecting” the other member countries with the crisis; on the other – incurring the costs of preventing such a crisis. Particular significance is attached here to the fact that irresponsible fiscal policy of one member state may undermine credibility of the whole single currency area and lead to the collapse of the common currency value.

The above mentioned reasons resulted in adopting the Treaty regulations which provide a framework for the national fiscal policy in the Economic and Monetary Union.

2. Fiscal policy framework in the EMU

Specific regulations for public finance directed at ensuring the stability of the single currency area³, were originally contained in the Treaty establishing the European Union – now Treaty on the functioning of European Union TFEU⁴ - fiscal convergence criteria to qualify for full EMU membership, then further developed in the Stability and Growth Pact (SGP).

The main provisions of the TFEU, concerning fiscal policy (Art. 126), read as follows:

1. Member States shall avoid excessive government deficits.
2. The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:
 - (a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless:
 - either the ratio has declined substantially and continuously and reached a level that comes close to the reference value,
 - or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;
 - (b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

Protocol 12 of the TFEU gives details on the EDC, including the reference values on budget deficit: 3% for the ratio of the planned or actual government deficit to gross domestic product at market prices (GDP), and 60% for the ratio of government debt to GDP. The said values are perceived as arbitrary as there is no economic justification that they mark the real border of the public finance stability. However, the reference values are mutually consistent – in light of the formula: $d = g \times b$, where d is the government budget deficit (as a percentage of GDP), g is the growth rate of nominal GDP, and b is the (steady state) level at which the government debt is to be stabilized (as a percentage of GDP). The formula shows that in order to stabilize the government debt

³ These regulations apply to all members of the EMU, including the countries with a derogation that are obliged to adopt the single currency, but do not apply to Denmark, which has an “opt-out” clause.

⁴ From 1 December 2009 (date of entry into force of the Lisbon Treaty, signed 13 December 2007) the title of the „Treaty establishing the European Community” is replaced by the „Treaty on the functioning of the European Union”.

at 60% of GDP the budget deficit must be brought to 3% of GDP if and only if the nominal growth rate of GDP is 5% ($0.03=0.05\times 0.6$)⁵.

The reference values are arbitrary on two counts. Firstly, it is unclear why the debt should be stabilized at 60%. Other numbers, e.g. 70% or 50%, would do as well. In that case, the deficit to be aimed at should also be different, i.e. 3.5% and 2.5%, respectively. The only reason why 60% seems to have been chosen at Maastricht was that at that time this was the average debt-GDP ratio in the EU (Buti, Gaspar, 2021). Secondly, the rule is conditioned on the nominal growth rate of GDP. Lower nominal growth rate require lower budget deficit that stabilize the debt at 60%.

In the event of exceeding the reference value established for the budgetary deficit, the European Commission assesses if the critical situation is exceptional and temporary in nature or what the prospects of reaching the reference value are. The Treaty specified also procedures for the reaction of the European Commission and the EU Council (Ecofin) in the event the excessive budgetary deficit is identified and the sanctions which may be applied towards a given member state. It must be emphasized here that the sanctions stipulated in the Treaty are discretionary in nature – their application is at the Council's discretion. Besides, further steps in the procedure concerning excessive budgetary deficit are not applied automatically – each time a qualified majority of the Council members' votes is required. Consequently, the Treaty regulations have not created a stable, "tough" measure restricting fiscal policy of the .

With reference to the public debt, the Treaty does not contain a provision requiring the public debt to GDP ratio to be close to the reference value. In the event this value is exceeded it is assessed if the debt to GDP ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace. However, the Treaty does not specify the term of "satisfactory pace".

Such an approach to the public debt was conditioned by the fiscal positions of the member states at the time when the criteria of future EMU membership were agreed. In 1991 the public debt exceeding 60% of GDP was reported in Denmark, Netherlands, Greece and Ireland. In two countries it even exceeded the GDP itself: in Belgium (119.9%) and Italy (116.7%). It was difficult then to expect that the period

⁵ The growth of nominal GDP, g , can be expressed roughly as the sum of the growth of real GDP and inflation. During the negotiations of the Maastricht Treaty, a reasonable assumption for nominal GDP growth was 5%. That corresponded to a real growth of 3% (or more) and a norm for price stability requiring inflation below 2%.

of few years will be sufficient to reduce the public debt index to the reference value level.⁶

Treaty provisions were of major significance in the mid-term perspective, preceding qualifying for the EMU. The necessity of fiscal adjustments in order to meet convergence criteria appeared in majority of the candidate countries⁷ and they took up the challenge. As a result, in spring 1998, 11 countries were qualified (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain). Greece was one of the countries which sought for the membership but was denied it. However, in 2001 Greece joined the euro area⁸. The euro area today consists of 19 members, and the „newcomers” are: Slovenia (2007), Cyprus (2008), Malta (2008), Slovakia (2009), Estonia (2011), Latvia (2014) Lithuania (2015)⁹.

“Softness” of the regulations aimed at disciplining public finances and discretionary character of the sanctions provided by the TEC caused that Germany started to fear that after the countries have fulfilled the convergence criteria and qualified for the EMU membership the mechanisms preventing excessively relaxed fiscal policy will prove ineffective. Therefore, in November 1995, the German Minister of Finance presented a proposal for strengthening these mechanisms by the so called Stability Pact. Due to the influence of France, this proposal was officially adopted as the Stability and Growth Pact at the European Council’s summit in Amsterdam in June 1997. Its aim was to detail the issue of applying the excessive deficit procedure and principles of imposing sanctions.

⁶ On the determinants of the adoption of public finance benchmarks, see Buiter (2006).

⁷ The candidate countries did not include Great Britain and Denmark. Under the Maastricht Treaty both countries obtained the so called “opt-out” clause which gave them the right of choice in the matter of common currency. Sweden at first did not fulfill the exchange rate criterion; then in September 2003, in the national referendum, the Swedish society rejected the idea of the EMU membership. Great Britain left the European Union on 31 January 2020.

⁸ The progress in diminishing the budgetary deficit and public debt to GDP ratios in the case of many countries was closely related to the “creative accounting”, especially in Greece. The Greek authorities supplied inaccurate data concerning the budgetary deficit to GDP ratio for many years.

⁹ Outside the euro area remain: Bulgaria, Croatia, Czechia, Poland, Romania, Sweden, Hungary and Denmark. Four non-members have a monetary agreement with the EU allowing them to make the euro its official currency, and permitting it to issue euro coins: Andorra, Monaco, San Marino, Vatican. Additionally, Montenegro and Kosovo have unilaterally adopted the euro in 2002 as their de facto domestic currency. This means that the euro is not a legal tender there, however it is treated as such by the government and the population.

The SGP is implemented through secondary legislation in the form of Regulation (EC) N° 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and Regulation (EC) N°1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure. Those two Regulations respectively specify the so-called preventive arm and corrective arm of the SGP (with the latter being also known as the Excessive Deficit Procedure).

The SGP has evolved over the years through amendments to the legislation (European Commission, 2018, pp. 12-16).

The first amendment of the SGP occurred in 2005 and involved changes to both the preventive and the corrective arms. The main aim of those changes was to better take into account economic circumstances and country-specific characteristics. In the preventive arm, the horizontal requirement of achieving a budgetary position of close to balance or surplus in nominal terms was replaced by a country-specific objective set in structural terms (net of cyclically-driven expenditure and revenue and of one-offs). Those objectives take into account Member States' gross government debt level and the magnitude of the fiscal challenge posed by population ageing. In the corrective arm, the possibility of extending the EDP deadline was introduced for Member States that had taken effective action but were faced with unexpected adverse economic circumstances with a significant impact on their public finances – a principle labelled “conditional compliance”. For both arms, the legislation indicated a benchmark adjustment for the size of the correction to be made for Member States either not at their medium-term budgetary objective – MTO (preventive arm) or with an excessive deficit (corrective arm). Furthermore, in order to enhance the growth-oriented dimension of the Pact, the adjustment path to the MTO could take the implementation of major structural reforms into account, provided that they have a verifiable impact on long-term public finance sustainability, either directly (such as for pension reforms) or by raising the growth potential (and thereby lowering the level of public debt as a percentage of GDP).

Following the onset of the economic and financial crisis in 2008 and the further experience with the implementation of the Pact, the SGP was amended for a second time in 2011, as part of a package of legislation known as the Six Pack. The package amended both Regulations and added a system of graduated enforcement mechanisms (financial sanctions for the euro area Member States), to address the weaknesses in the surveillance framework that the crisis exposed. In particular, the changes strengthened the preventive arm of the Pact to ensure that good economic times were used to pursue policies leading to healthy public finances. A new expenditure benchmark was added, involving

an analysis of government expenditure net of discretionary revenue measures, as a complement to the change in the structural balance. Moreover, a key innovation was the specification of when deviations from the adjustment path to the MTO are deemed to be significant, making them a trigger for a corrective mechanism (within the preventive arm) which could lead to sanctions for the euro area Member States. The corrective arm was changed by putting the debt requirement on an equal footing to the deficit one, in light of the damaging impact of sovereign sustainability concerns during the crisis. A key plank of the Six Pack reform is the “operationalization” of the public debt criterion via the introduction of a debt reduction benchmark. When the debt to GDP ratio exceeds the reference value of 60%, the benchmark requires a reduction of the excess at an average pace of 1/20th (5%) per year. The sanctions for the euro area Member States were strengthened and extended to the preventive arm in case of significant deviation.

The amendments to the key Regulations were designed to increase both the economic credibility and the flexibility within the rules of the Pact. At the same time, however, they have made the rules more complex and introduced some room for judgement, so as to adapt to ever-changing and complex economic reality, while avoiding an ex ante over-specification. That inevitable need for discretion within the rules calls, as a necessary counterpart, for further transparency.

3. Budgetary situation in euro area countries

Data in Table 1 indicate that the Pact, as a mechanism for disciplining national fiscal policies, has not been effective - after a period of prosperity lasting since 2004, in 2007, 10 out of 19 of the current euro area countries had budget deficits. The total government budget balance in the euro area was also negative, accounting for 0.6% of the area's GDP. The total government debt (65.9% of GDP) exceeded the reference value, with 8 countries being above it.

Table 1. General government net lending (+) or net borrowing (-) and consolidated gross debt (% of GDP at market prices)

	Budget deficit 2007	Budget deficit 2019	Budget deficit 2020	Public debt 2007	Public debt 2019	Public debt 2020	Change in debt ratio 2019-22*
Austria	-1.4	+0.7	-9.6	65.0	70.5	84.2	14.6
Belgium	+0.1	-5.9	-5.8	87.3	98.1	117.7	20.6
Cyprus	+3.2	+1.5	-6.1	54.0	94.0	112.6	8.8
Estonia	+2.7	+0.1	-5.9	3.8	8.4	17.2	18.0
Finland	+5.1	-1.0	-7.6	33.9	59.3	69.8	13.3
France	-2.6	-3.0	-10.5	64.5	98.1	115.9	21.3
Germany	+0.3	+1.5	-6.0	64.0	59.6	71.2	9.3
Greece	-6.7	+1.5	-6.9	103.1	180.5	207.1	14.3
Ireland	+0.3	+0.5	-6.8	23.9	57.4	63.1	8.7
Italy	-1.3	-1.6	-10.8	103.9	134.7	159.6	24.5
Latvia	-0.6	-0.6	-7.4	8.5	36.9	47.5	8.6
Lithuania	-0.8	+0.3	-8.4	15.9	35.9	47.2	13.6
Luxembourg	+4.4	+2.4	-5.1	8.2	22.0	25.4	6.9
Malta	-2.1	+0.5	-9.4	61.9	42.6	55.2	16.7
Netherlands	-0.1	+1.7	-7.2	43.0	48.7	60.0	17.2
Portugal	-2.9	+0.1	-7.3	72.7	117.2	135.1	10.0
Slovakia	-2.1	-1.4	-9.6	30.3	48.5	63.4	19.1
Slovenia	0.0	+0.5	-8.7	22.8	65.6	82.2	14.2
Spain	+1.9	-2.9	-12.2	35.8	95.5	120.3	28.4
Euro area-19	-0.6	-0.6	-8.8	65.9	85.9	101.7	16.7
EU-27	-0.5	-0.5	-8.4	62.2	79.2	93.9	15.6

*European Commission autumn 2020 forecast.

Sources: European Commission (2020, pp. 160-161, 164-165; 2021, p.13).

The global economic crisis, which began in the United States in 2007, has dramatically changed the situation of public finances in the euro area. The total budget deficit amounted to 2.2% in 2008, 6.2% in 2009, and 6.3% of total euro area GDP in 2010. The widening of the deficit resulted from the negative impact of the cyclical factor (economic downturn¹⁰)

¹⁰ While annual GDP growth in the euro area was 5.5% in 2007, it slowed to 2.4% in 2008, and a 3.6% drop in GDP was recorded in 2009. In 2010 there was a return to economic

and discretionary measures – rescue packages supporting both the financial market institutions and the real sphere; the increase in government spending was aimed at sustaining (halting the decline in) economic activity.

Higher budget deficits and the need to finance the unbudgeted costs of bank recapitalization, sovereign guarantees, or concessional loans to the private sector caused a spike in the size of public debt and its ratio to shrinking GDP – public debt represented 86.0% of GDP in the euro area in 2010 and continued to rise until 2014, when it represented 95.2% of GDP.

Once the financial crisis was overcome, growth continued until 2019, when the public debt-to-GDP ratio declined from its 2014 value to stand at 85.9%, still well above the reference value. The most difficult situation was in Greece, Italy, Portugal, France, Belgium, Spain, and Cyprus (Table 1).

In 2019 the COVID-19 pandemic came as the biggest shock to the world community since World War II. Euro-area GDP contracted by 6% in 2020. The crisis' impact has been alleviated by sizeable measures at national level - this reflects both the impact of automatic stabilizers and the substantial discretionary fiscal policy response. The coordinated response at the EU level has complemented the actions taken by national governments.

In the context of the provisions on fiscal discipline, in May 2020 the Commission and the Council activated the general escape clause of Stability and Growth Pact¹¹, for the first time ever. This has allowed Member States to temporarily depart from their fiscal adjustment paths and take the necessary fiscal measures to deal with the crisis.

The pandemic and the large fiscal policy response have led to higher budget deficits and debts. The average general government deficit in the euro area accounted for 8.8% of GDP in 2020. The impact of the COVID-19 crisis is therefore even greater than that of the global

growth (GDP grew by 2.8%), but the situation varied across economies, with declines in Greece, Latvia and Ireland (European Commission, 2020, p. 22).

¹¹ On 20 March 2020, the Commission adopted a Communication setting out its view that given the expected severe economic downturn resulting from the COVID-19 outbreak the conditions were met to activate the general escape clause. On 23 March 2020, the Member States' Finance Ministers agreed with the Commission's assessment. The activation of the clause allows for a temporary departure from the adjustment path towards the medium-term budgetary objective of each Member State, provided this does not endanger fiscal sustainability in the medium term. As a result, while the general escape clause does not suspend the SGP and its procedures, its activation provides the Member States with the fiscal space necessary to respond to the pandemic.

financial crisis in 2008. The average level of general government debt represented 101.7% of GDP in 2020 and is forecast to rise by 16,7 percentage points to nearly 103% of GDP in 2022. The projections, however, are subject to significant uncertainty and elevated risks, predominately linked to the evolution of the pandemic.

The public debt situation varied across countries. In 2020, the public debt-to-GDP ratio was over 200% in Greece, exceeded 150% in Italy, and was over 100% in Portugal, Spain, Belgium, France and Cyprus. On the other hand, the lowest debt-to-GDP ratio, below 60%, was recorded in Estonia, Luxembourg, Lithuania, Latvia and Malta. These figures clearly demonstrate the lack of convergence in the state of public finances in EMU, which threatens the ability to formulate and conduct a common monetary policy appropriate for all countries and undermines the stability of the single currency area. The existing differences and imbalances between individual economies may deepen, making the single market less efficient. Growing inequalities may lead to social and political tensions.

Thus, there is an urgent need for reorientation - a revision of the EMU fiscal policy framework.

4. Fiscal policy framework of the EMU - challenges ahead

Even before the outbreak of the Covid-19 pandemic, on 5 February 2020, the European Commission published its review of the EU economic governance framework (European Commission, 2020a). The analysis covers two decades of implementation of this framework with a focus on the last decade.

The report's major findings, regarding the fiscal framework and its implementation, are discussed below.

1. High and persistent public debt levels. While public finances in the euro area improved in the years to 2019, some countries did not sufficiently build fiscal buffers and reduce public debt in good economic times. In 2019, recorded deficits reached their lowest levels since the creation of EMU. This could mean that the 3% of GDP threshold has acted as an efficient anchor. However, a number of countries corrected their excessive deficits thanks to favorable macroeconomic conditions rather than through structural fiscal adjustments. These countries pursued a "nominal strategy" using the 3% reference value as a target rather than a ceiling.
2. Pro-cyclicality of fiscal policy. The amendments of the SGP aimed to ensure that countries adjust their fiscal policies during good economic times. Such adjustments would have allowed to build sufficient fiscal space to allow automatic stabilizers to operate and to provide fiscal support during downturns. However, national fiscal policies remained

largely pro-cyclical after the reforms, both in good and in bad times, respectively by not building sufficient buffers in some periods or not making sufficient use of fiscal space in others.

3. The composition of public finances, which are far too often unfriendly to growth and investment. Public investment has an essential role in delivering public goods and supporting sustainable public finances. The EU has faced a widespread and persistent decline of public investment over the last decade¹². If not reversed, this fall will result in a substantial reduction of the public capital stock.
4. The complexity of fiscal rules, and their lack of enforcement. The fiscal rules have become increasingly complex¹³. The amendments for the SGP and development of “smarter” rules and a broadening of their focus has come at the cost of increased complexity. There are currently multiple rules, with different indicators for measuring compliance, and various clauses allowing for deviations from the required adjustments. Moreover, the desire to make the framework more adaptable to changing economic conditions has led to a reliance on variables that are not directly observable and that are frequently revised, such as the output gap and the structural balance. This hampers the provision of stable policy guidance.

Conclusions

Thirty years after Maastricht, macroeconomic conditions are fundamentally different than they were then. While in the decade 1991-2000 the average rate of nominal GDP growth in the euro area countries (EA-12) was 4.7%, this declined to 3% between 2001 and 2010 and to 1.6% between 2011 and 2020. The formula defining the relationship between the public deficit and debt (both in relation to GDP) and the GDP growth rate $d=g \times b$ shows that a 3% deficit with a growth of GDP at 1.6% stabilizes the debt at 187.5% of GDP.

Although the budget should be roughly balanced in the medium term, it was quite common to treat the 3% of GDP reference value as a target rather than a hard ceiling. As a result, in the absence of building up savings in good times, fiscal policy became procyclical.

The terms for servicing public debt are also fundamentally different. Due to disinflation and low interest rates, the cost of servicing the growing debt has declined as a proportion of GDP. In 2000 the debt in the current euro area countries was 69% of GDP and interest was 3.8% of GDP,

¹² Gross fixed capital formation in euro area amounted to 3,7% of GDP in 2009, and to 2,8% in 2019 (European Commission, 2020, p. 154).

¹³ On the trilemma faced by EU fiscal rules (between adaptability, enforceability and simplicity) see Deroose et al. (2018).

in 2010 the figures were 86% and 2.8% respectively, and in 2020 101.7% and only 1.6% (European Commission, 2020, p. 140). However, since July 2021 inflation (HCPI, year-on-year) has accelerated - while in July it was 2.2% in the euro area, in November it was already 4.9%. This is the highest value since the beginning of EMU. While it is difficult to predict future price developments, like the general economic situation, the conditions for financing public debt will certainly change. Higher inflation will increase the cost of servicing newly issued debt, while on the other hand reducing the share of already issued debt in the increased nominal GDP.

These different macroeconomic conditions make it necessary to revise the fiscal policy framework initiated in Maastricht and evolving in the following years. This necessity also stems from the fact that current regulations are perceived as outdated, complicated, opaque, discretionary and difficult to enforce.

On 19 October 2021, the European Commission adopted a Communication relaunching the public consultation on the EU's economic governance framework (See: Verwey, Monks, 2021). This consultation had been put on hold in March 2020 in order to focus on the Covid-19 pandemic. The new governance framework should be tailored to the challenges the EU is facing, including the challenge of achieving a fiscal stance that is appropriate for the euro area as a whole.

While the need for reform is increasingly recognized, its nature remains vigorously debated. There is a fairly widespread belief in the need to move away from rigid reference values, which should be replaced by solutions that ensure the sustainability of public debt in the differing circumstances of member states. Thus, Martin et al. (2021) propose the use of country-specific debt targets. In this solution, each government sets a medium-term debt target, the appropriateness of which would be first assessed by the domestic independent fiscal institution on the basis of a common methodology, and second endorsed (or rejected) by the EU. This target should be based on estimates of the maximum primary balance and the risks to the interest rate–growth rate differential. Once debt targets have been set, they should serve as anchors for expenditure rules. The path for primary nominal expenditure net of new discretionary tax measures (and excluding automatic stabilizers on the expenditure side) would be determined accordingly. This approach would change the hierarchy of objectives giving priority to a country-specific debt target over the deficit criterion.

Buti and Messori (2021) propose a “vertical” fiscal policy coordination between the national and the EU level. This coordination requires building a central fiscal capacity within a coherent “European budgetary system”. Such a central fiscal capacity could provide non-mutually exclusive goals: creating a central stabilization function, increasing the supply of EU public

goods and setting up conditional transfers from the EU budget. Such a solution is an expression of a desire to federalize the EU, which is advocated by Olaf Scholz, former Minister of Finance of Germany, from 8 December 2021 German Chancellor. For some member states it is not acceptable.

Blanchard et al. (2021) call for replacing fiscal rules by qualitative standards. They propose to abandon all numerical criteria, to replace them with the sole principle that member states “ensure that their public debts remain sustainable with a high probability”. Qualitative standards mean qualitative prescriptions that could leave room for judgement together with a process to decide whether the standards are met. Central to this process would be country-specific assessments using debt sustainability analysis, led by national independent fiscal councils and/or the European Commission. Disputes between member states and the European Commission on application of the standards should preferably be adjudicated by an independent institution, such as the European Court of Justice (or a specialized chamber).

The proposed options for the revision of the EU fiscal framework, although justified in theory, have a fundamental flaw - they strengthen the position of supranational institutions and, moreover, open the door to discretion and potentially unequal treatment of member states. These proposals can be seen in a broader context - the federalization of the EU, which would limit the sovereignty of nation states.

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