Assessment of the EU’s fiscal framework and the way forward: persisting tensions between risk reduction and risk sharing

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Abstract

The ongoing debate that seeks to reform the EU’s fiscal framework is characterised by two different perspectives. Those who point to the lacklustre compliance of some Member States with current fiscal rules calling for a more stringent practice intent on reducing risks at the national level. And those who emphasise the lack of risk sharing at the EU level arguing in favour of a central fiscal capacity. Against this backdrop, this paper lays out the evolution and performance of the EU’s fiscal framework over the past decades in order to frame the current political negotiations of reform. It highlights a fundamental challenge for further fiscal integration namely the idea it can be achieved without better cooperation or representation.

Key words: European Union, fiscal policy, fiscal governance, fiscal rules, public debt.


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1. Introduction

Launched in the 1990s, the EU’s fiscal framework was meant to contribute to a smooth functioning of the single currency area. Successive economic crises put pressure on the original design of the framework triggering a series of reforms. At inception, the framework was geared towards protecting centralised monetary policy making from the possible fall-out of unsustainable national fiscal policies. Risk reduction rather than risk sharing was the main theme embodied in the Maastricht Treaty and subsequently in the secondary legislation underpinning the SGP.

The Global Financial Crisis of 2008-09 and the subsequent euro-area sovereign debt crisis marked a clear paradigm shift. Confronted with the perceived risk of an imploding single currency, the EU opened the door to elements of risk sharing such as the ESM, which was preceded by the European Financial Stability Facility (EFSF) and European Financial Stability Mechanism (EFSM). To appease the sceptics of risk sharing and address concerns of ‘moral hazard’, access to the new instruments was subject to strict policy conditions and new elements of risk reduction were introduced including the Fiscal Compact, an attempt to hardwire key elements of the EU’s fiscal framework into national law.

The introduction of new elements of risk sharing and risk reduction also came at the price of blending different governance models. In the wake of the Global Financial Crisis, the time-tested but very involving community-method was complemented with nimbler yet ad hoc inter-governmental elements, and new national actors, national independent fiscal institutions (IFIs), were added. The Covid-19 pandemic has brought further instruments of risk sharing such as the SURE and the RRF initiative, albeit of a temporary nature.

Academics have for a very long time been converging on the view that, ideally, an Economic and EMU (EMU) needs both elements of risk reduction and risk sharing including in particular a central fiscal transfer instrument. And indeed, common instruments to cover country-specific shocks do make a lot of sense in a single currency area and would no doubt find the necessary political support if shocks were random. However, the history of EU economic integration is characterised by persisting differences in economic performance and persisting degrees of economic resilience to shocks. It was precisely this history of diverging economic and policy performance across Member States that motivated the architects of the single currency at the beginning of the 1990s to insist on arrangements aimed to bridle the discretion of national fiscal policies.

Three decades later, the political arena remains divided about the relative importance of risk reduction and risk sharing. Those pushing for more risk sharing view the current architecture of EMU as incomplete and see the need for a permanent central fiscal capacity. Others do not see the need for further economic integration and double down on the prime objective of risk reduction including through fiscal rules. For them, lack of structural reform efforts and lacklustre compliance with the commonly agreed rules are the main challenges to be addressed. Hence, the future of the EU fiscal rules is stuck between the high-minded aspirations of those who see solidarity and a complete EMU as the key objective of the European project and the more mundane concerns of those who insist on national responsibility as the basis for sustaining the current level of economic integration.

This paper reviews the performance of the current EU’s fiscal framework against the background of the persisting tensions between risk reduction and risk sharing. The paper concludes by discussing the current state of the economic governance review and how it can or cannot affect the current balance between risk reduction and risk sharing.
2. Fiscal policy in Economic and Monetary Union: a brief history

Throughout the history of EU economic integration, views on how fiscal policy could best support a monetary union have diverged across Member States. While some countries and observers have been in favour of more risk sharing possibly via elements of a fiscal union, others remained more inclined towards risk reduction with fiscal policy remaining firmly in the hands of national governments. The Maastricht Treaty clearly reflects this division. Member States agreed to the introduction of a single currency as the ultimate way to overcome the destabilising effects of the exchange rate movements. At the same time, Member States could not agree to a closer integration of fiscal policy. The time was not right for fiscal risk sharing. However, to ensure a smooth functioning of such a hybrid construction, the architects of the Maastricht Treaty underscored the need to address risks of harmful spill-overs from countries that allow public debt to rise to very high levels or do not sufficiently internalise the effects of their fiscal policies on euro-area inflation.

To that end, the Treaty includes two types of provisions. The first aims at directly constraining national fiscal policies. In Article 121, the Treaty outlines a process of policy coordination with the ultimate aim to keep national economic policies including fiscal policies on a virtuous path, while Article 126 defines a process for the correction of excessive deficits should they arise. In that context the Treaty also refers to the two well-known reference values for government deficit and debt, of 3% and 60% of GDP, respectively.ii

The second strand of Treaty provisions deals with the risks of moral hazard. It establishes the so-called ‘no-bail-out clause’, which bans third parties from taking on liabilities of national governments, and prohibits monetary financing of government debt by the European Central Bank (ECB). Hence, each Member State bears full responsibility for its own debt.

The limits on national fiscal policymaking of the Maastricht Treaty were operationalised in 1997 with the SGP. It details and reinforces the provisions contained in Articles 121 and 126. It has two arms. The preventive arm requires Member States to maintain or adjust towards a medium-term budgetary position that ensures sustainability while allowing for the stabilisation of output under normal cyclical fluctuations (see Council Regulation (EC) 1466/97). The corrective arm, which clarifies the implementation of the excessive deficit procedure as per Treaty Article 126 (see Council Regulation (EC) 1467/97).

In the first years of implementation, some Member States succeeded in maintaining progress towards the targets prescribed by the SGP while others stalled or increased their annual deficits. When growth slowed at the beginning of 2000, fiscal balances in some countries quickly deteriorated to reach levels close to or above the reference value of 3% of GDP. This placed a considerable strain on the implementation of the SGP, especially when in November 2003 the ECOFIN Council decided to de facto ignore the Commission’s recommendations under the excessive deficit procedures of France and Germany, by calling for less ambitious deficit paths for the two countries. The Council’s action was later overturned by the European Court of Justice.

The SGP was modified in 2005 with the aim to enhance its economic rationale. Under the preventive arm, the concept of medium-term objectives (MTO) already present in Regulation 1466/97 was operationalised as country-specific and expressed net of cyclical factorsiii. Moreover, the economic rationale was also shored up in the corrective arm by moving in the ex-post assessment from an outcome-based approach to an effort-based one. In particular, a new provision allowed for adopting revised Council recommendations if a country verifiably had implemented the recommended fiscal consolidation, but still deviated from the recommended adjustment path due to a worsening in the...
macroeconomic environment or other developments outside its control. Finally, specifying a wide range of ‘other relevant factors’ when identifying excessive deficits or debt positions also added more flexibility and room for economic judgement under the corrective arm. While these changes allowed a more pertinent application of the rules, they increased the complexity of the SGP and the degree of discretion of the Commission and the Council.

The Global Financial Crisis that erupted in 2008 and the subsequent euro-area sovereign debt crisis in 2010-2012 revealed several new significant challenges. First, it became clear that sound fiscal positions could go along with serious macroeconomic imbalances which, once reversed, would jeopardise the overall macro-financial stability as governments are forced to undertake massive support packages from public coffers. Second, the twin crises confronted EU policymakers with an existential policy choice: namely, either to insist on the no-bail-out provision of the Treaty and risk the possible meltdown of some euro-area economies (and possibly the entire currency area) or create new tools for crisis resolution.

The policy response was broad-based, combining new elements of risk sharing with efforts to strengthen risk reduction. Starting with the latter, EU economic governance was strengthened through the so-called Six-Pack and Two-Pack reforms, and the requirement to enact some key provisions, such as a structural budget balance rule, in national law through the intergovernmental Fiscal Compact; all these elements entered into force between 2011 and 2013. These legal amendments or innovations aimed at (I) giving more prominence to the debt criterion in order to avoid unsustainable fiscal positions, (ii) enhancing enforcement through a more granular set of fines, (iii) strengthening the surveillance cycle for euro-area countries, and (iv) assigning more important roles to national IFIs. Finally, responding to the lesson learned during the financial crisis that macroeconomic imbalances would eventually weigh on public finances, the EU decided to introduce the macroeconomic imbalances procedure.

As to crisis resolution, the euro-area Member States established a temporary rescue fund, the EFSF, and later on the permanent one, the ESM. While this collective action of financial support among countries shows some elements of risk sharing, it has been subjected to strict conditionality. Because the post-2007 crises originated in the financial sector, Member States also agreed on the set-up of several crisis prevention and management mechanism for the banking sector notably stronger and centralised prudential supervision, a crisis resolution fund and the establishment of a euro-area deposit insurance scheme. Nevertheless, some of these initiatives have remained largely incomplete due to lack of interest in more risk sharing elements.

The recovery from the financial and sovereign debt crisis was protracted and heightened growing economic and political divergences leaving a significant mark on the effectiveness of the reformed EU’s fiscal framework. Countries that had entered the crisis with low or moderately high debt levels recorded more sustained economic growth rates and managed to bring debt back to pre-crisis levels, also by complying with the reformed EU fiscal rules. In contrast, countries with very high debt levels found it difficult to comply with the debt reduction rule, introduced as part of the 2011-2013 reforms, or did not see the political or economic need to engage in fiscal consolidation.

The Commission and the Council tried to address diverging public finance developments by making extensive use of established margins of flexibilities and by agreeing on new ones. The most notable initiative was the Commission communication of January 2015 on ‘Making the best use of flexibility within the existing rules of the Stability and Growth Pact’. Additionally, in 2017, the Commission offered an additional layer of flexibility by introducing the so-called margin of discretion. In practice,
all these initiatives aimed to accommodate a growing spectrum of circumstances of those Member States who found it difficult to comply with the main course of actions required by the SGP.

To a large extent, the growing recourse to flexibility was meant to be a temporary fix. It was predicated on the expectation or assumption that economic growth would eventually pick up across the EU, making compliance with the reformed rules less challenging. However, while growing flexibility did accommodate diverging developments for several years, the growing differences in public finances across the EU turned into a major problem at the onset of the Covid-19 crisis when some Member States did not have enough fiscal space to respond to the ensuing sharp and deep economic downturn.

Following comparatively short but difficult discussions, the EU agreed on common solidarity initiatives giving Member States access to concessional loans and/or grants financed by EU lending: notably the SURE initiative and the RRF. Both initiatives were based on Article 122 of the Treaty which empowers the Council to grant temporary assistance to Member States that are in difficulty or are threatened with severe difficulties.

Although offering important contributions, the SURE and RRF initiative are small in relation to the overall fiscal response deliberated by most Member States. In number of euro-area countries, which had not managed to reduce their debt ratio during the recovery from the financial crises, the fiscal response was only made possible by the ECB’s Pandemic Emergency Purchase Programme (PEPP). Via this dedicated programme the ECB purchased large quantities of government bonds, which in the case of some Member States reached the total amount of new debt issued in the wake of the Covid-19 pandemic. The programme was discontinued in early 2022, just to be followed by the announcement of a new initiative, the Transmission Protection Instrument (TPI), as lenders started reassessing sovereign risks.

At the time of writing this contribution, the EU was in the middle of an intense debate on whether and how to reform of the EU’s fiscal framework. The debate on the economic governance review was officially launched by the Commission in early 2020 as part of a legally mandated, regular review of the Six- and Two-Pack reforms. The process was put on hold during the Covid-19 pandemic and relaunched in autumn 2021. Although a growing number of stakeholders is converging on the view that the current EU’s fiscal framework no longer fits post-pandemic circumstances, deep divisions persist across Member States about the right mix of risk reduction and risk sharing.

For some the time is ripe to make a new step towards a complete EMU by establishing a permanent central fiscal capacity; others want to see fiscal responsibility at the Member States level and/or more political representation at the EU level. Before offering an assessment of where the EU’s fiscal framework may be heading in the coming years, the next three sections present a condensed overview of how the SGP performed in the last 25 years. Such an overview is crucial to understand options for the future.

3. The effectiveness of the EU’s fiscal framework

After having covered the evolution of the EU’s fiscal framework and the underlying tensions between the concept of risk reduction and risk sharing, this section zooms in on the performance of the EU’s fiscal framework with regard to three main dimensions: (i) the long-term sustainability of public finances, (ii) the stabilisation the economy over the economic cycle, and (iii) the quality of public finances.
3.1. Sustainability of public finances

The primary purpose of the EU’s fiscal framework is to ensure a smooth functioning of the single currency area. National governments are responsible for a prudent fiscal management by complying with the commonly agreed fiscal rules. The sustainability of public finances is the ability of a government to sustain current and future payment obligations without exceptional financial assistance or going into default. In practice, the government debt-to-GDP ratio is the most used indicator to gauge the sustainability of public finances, as it sets out the size of government liabilities against a country’s total income. Combined with macroeconomic forecasts and projections of aggregate spending it offers insights into the government’s ability to control its debt level over time.

In the years following the introduction of the euro (2000-2008), the average debt-to-GDP ratio of the EU Member States hovered just above the EU Treaty’s reference value of 60% of GDP. The global financial crisis and the sovereign debt crisis brought it up to around 90% of GDP. After declining between 2015 and 2019 by some 10 percentage points, the debt ratio spiked again during the Covid-19 crisis, reaching again 90% of GDP in 2021 on average in the EU.

However, aggregate debt developments mask substantial differences among Member States (see Graph 3.1.1). At one end, there are many countries that, broadly speaking, implement budgetary policies by the book: they let government debt increase on the back of recessions, to compensate the drop in private demand, and bring debt back down during upturns. This group encompasses low-debt Member States with very solid fiscal positions maintaining their debt ratios at around 40% of GDP also throughout the crisis periods (2008-2014). It also encompasses a second group of Member States, with an average debt ratio of close to 60% of GDP before 2008 and marked increases of the debt ratio during the crisis periods, followed by a reversal during the recovery in 2014 to 2019.

Graph 3.1.1: Debt ratios by group of Member States

Graph 3.1.2: Contribution to debt ratios over 2000-2019 on average by group of Member States

Note: Countries are grouped by their average debt-to-GDP ratio over 2011-2019: (1) Very high-debt countries = above 90% of GDP (Belgium, Greece, Spain, France, Italy, Cyprus, Portugal); (2) High-debt countries = between 60% and 90% of GDP (Germany, Ireland, Croatia, Hungary, The Netherlands, Austria, Slovenia); (3) Low-debt countries = below 60% (Bulgaria, Czechia, Denmark, Estonia, Latvia, Lithuania, Luxembourg, Malta, Poland, Romania, Slovakia, Finland, Sweden).

Source: European Commission, own calculations

In contrast, there is a third group of countries accounting for more than 45% of euro-area GDP with an average debt ratio of around 80% of GDP before 2008, posting further and particularly strong
increases during crises episodes and limited or no moderation in 2014-2019. Unsurprisingly, these countries found themselves in great difficulty when the Covid-19 pandemic triggered a severe recession. They are also among the largest net beneficiaries of the RRF and the ECB’s PEPP.

As one may expect, debt servicing costs and primary deficits stand out as the main factors of the diverging trends among the three groups of countries (see Graph 3.1.2). Higher debt levels imply a higher share of public resources devoted to debt service which could be offset by the effect of economic growth and a primary surplus. However, over the period 2000-2019 the EU countries with very high debt levels recorded on average primary deficits, not surpluses. Their weaker fiscal performance drove the upward trend in government debt levels and fuelled mounting sustainability challenge.

Differences in fiscal performance are reflected in the way countries comply (or not) with the EU fiscal rules. Since 2019, the EFB secretariat updates a compliance tracker that assesses whether the relevant fiscal aggregates of EU Member States (the budget balance, the debt-to-GDP ratio or government expenditure growth) evolve in line with the main course of action implied by the rules. The average compliance rate across countries and across rules was only 54% in 1998-2021. As one may expect, the rate was significantly higher for countries with lower debt levels, while non-compliance was much more prevalent among countries with very high debt (see Graph 3.1.3). Their average compliance rate was at a dismal 33% in 1998-2021, as opposed to 67% in low debt countries. Of note, countries with debt above 90% of GDP had a weaker compliance record across all rules. Lower compliance rates also tend to go along with a larger country size and a weaker tradition of national IFIs as noted in the EFB 2019 assessment report and in the relevant empirical literature.

Graph 3.1.3: Average compliance with EU fiscal rules by country groups

Graph 3.1.4: Compliance with fiscal rules and output gap developments, EU

Note: For the classification of countries by debt level see notes to Graph 3.1.1.
Source: Compliance tracker of the EFB secretariat, European Commission.

Compliance also exhibits a clear pro-cyclical pattern: it is higher in normal and good economic times and tends to plummet during downturns (Graph 3.1.4). Compliance with the deficit rule is particularly pro-cyclical as headline balances automatically improve during upturns, fostering the correction of excessive deficits. The years 2011-2013 were notable exception, when compliance with the deficit rule improved despite a worsening of economic conditions as most of the EU Member States were in Excessive Deficit Procedure (EDP) and/or under an economic adjustment programme.
However, from 2014 compliance rates of the different rules started diverging again, as governments found it easier to correct their nominal deficits during the economic recovery, while showing lower compliance with the structural balance and expenditure rules. This behaviour has been referred to as ‘nominal strategy’ (EFB, 2019). Countries with very high debts missed the opportunity to preventively strengthen the fiscal positions during good economic times by lagging in compliance with the fiscal rules (Graph 3.1.3).

A poor compliance record for some countries is not just an issue of poor budgetary implementation. It is also reflects issues in medium-term budgetary planning. The Six-Pack reform of 2011 invited Member States to further enhance their multiannual perspective of budgetary planning. While some countries managed to better align medium-term plans with outcomes, others stuck to the moving-target approach (Graph 3.1.5). Specifically, in countries with high or very high debt-to-GDP ratios budget balances turned out consistently lower than initially planned by a significant margin. While missing fiscal targets during unexpected downturns is understandable, the significant and continuous gaps between plans and outcomes point to a clear bias.

**Graph 3.1.5: Budget outcomes versus plans in stability and convergence programmes (SCPs)**

(a) Countries with government debt below the EU average in 1998-2019 (75% of GDP) (1)

(b) Countries with government debt above the EU average in 1998-2019 (75% of GDP) (2)

Note: (1) Bulgaria, Czechia, Denmark, Germany, Estonia, Ireland, Spain, Croatia, Cyprus, Latvia, Lithuania, Luxembourg, Hungary, Malta, The Netherlands, Austria, Poland, Romania, Slovenia, Slovakia, Finland, Sweden. (2) Belgium, France, Italy, Portugal. (3) Graphs exclude Greece, which was exempt from submitting stability programmes while under macroeconomic adjustment programmes.

Source: European Commission and successive vintages of stability and convergence programmes.

When setting the path of future expenditure, budgetary authorities need to make assumptions about government revenues, which in turn are directly linked to the projected level of economic activity. Once agreed, spending programmes exhibit a high degree of inertia; they are not adjusted in the event of lower-than-expected economic growth, at least not immediately. As a result, optimism in forecasting economic growth contributes to the notorious deficit bias of fiscal policymaking (Larch et al., 2021a).
3.2. Short-term stabilisation of output

The stabilisation of economic activity close to its potential throughout the economic cycle is a key objective of macroeconomic policymaking. The EU’s fiscal framework is mainly concerned with fiscal sustainability. However, the SGP acknowledged the desirability of fiscal policy contributing to the stabilisation of economic output over the cycle, but crucially subject to the sustainability constraint.\footnote{Symmetric stabilisation policies are consistent and even conducive to long-term fiscal sustainability. Expansionary fiscal policy during a downturn should not have a negative effect on the sustainability of public finances as long as governments also build up sufficient fiscal buffers during the economic good or normal times. In practice however, tensions between short-term stabilisation and long-term sustainability are observed. Past performance in the EU shows instructive patterns of how stabilisation policies play out in practice (Graph 3.2.1a and Graph 3.2.1b). The two major crises of the past decades, namely the Global Financial Crisis of 2008/09 and the start of the Covid-19 pandemic in 2020, are the only periods of sizable counter-cyclical expansion. Both periods are characterised by a coordinated fiscal expansion to contain the economic repercussions of the shock. By contrast, countries performed much more heterogeneously in terms of counter-cyclical tightening. Some Member States achieved counter-cyclical tightening on occasion, but in particular very high debt countries failed to lean against the wind during good times. Given the share of this group in the euro area, fiscal policy for the aggregated euro area has not experienced any episode of sizable counter-cyclical tightening either (see Graph 3.2.1b).

The only phase of widespread pro-cyclical consolidation took place in 2012-2013 and was driven by market pressures and mounting sustainability concerns in Member States that had exited the Global Financial Crisis with highly elevated debt levels. In fact, most of the extreme pro-cyclical impulses during that period were countries with a large debt burden that came under consolidation pressure. This is intuitive, as countries with high debt face pressure to consolidate irrespective of the cyclical conditions. Graph 3.2.1a illustrates this point: very high debt countries in the EU ran more pro-cyclical fiscal policy over the past two decades.

Graph 3.2.1a: Stabilisation policy at Member State level, 2001-2019

[Graph showing annual change in the structural primary balance (% of potential GDP) vs. annual change in output gap, in % of potential GDP. The graph distinguishes between pro-cyclical and counter-cyclical impulses, as well as between pro-cyclical and counter-cyclical restrictions. The data is color-coded by debt levels: low/medium debt in blue and high debt in yellow.]

Graph 3.2.1b: Euro area fiscal impulse, 2005-2021

[Graph showing annual change in the structural primary balance (% of potential GDP) vs. annual change in output gap, in % of potential GDP. The graph highlights pro-cyclical and counter-cyclical impulses and impulse fiscal policy. The data is color-coded for different years and regions.]

Notes: (1) A single dot represents a single year of a EU15 country. (2) Blue dots refer to countries with a debt-to-GDP ratio above 90% of GDP; yellow dots to countries with debt ratios below 90% of GDP. (3) Data from EU15 countries (Belgium, Denmark, Germany, Greece, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland and Sweden) but excluding the United Kingdom and Ireland.

Source: European Commission.
This finding is confirmed by more involving statistical analysis. Studies estimating fiscal reaction functions find a significant positive coefficient for debt, which confirms that a high debt level weighs on the country’s ability to stabilise output (Bohn 1998, Organisation for Economic Co-operation and Development (OECD) 2003, Westphal and Zdarek 2017, Larch et al. 2020). On the other side, there have been two episodes of clear pro-cyclical fiscal expansions: the expansion in the lead-up to the Global Financial Crisis and, years later, in the runup to the Covid-19 pandemic. The remaining years have been characterised by primarily broadly neutral (a-cyclical) fiscal policy. Overall, the failure to build up fiscal buffers, particularly in the very high debt countries, during good times (foremost 2003-2007 and 2017-2019) has brought to the fore long-term fiscal sustainability as the ultimate constraint of fiscal policy in some euro-area Member States. As indicated in Section 2, after the outbreak of the Covid-19 pandemic, these constraints were addressed by launching temporary fiscal initiatives at the EU level and thanks to dedicated asset purchase programmes of the ECB.

Overall, the experience of EU Member States under the SGP does not corroborate the claim that pro-cyclical fiscal policy outcomes can be attributed to limits of the fiscal rules. In fact, over the past several decades pro-cyclical fiscal episodes have been as frequent outside the EU as in the EU Member States (Larch et al. 2020). The rules contain several elements that allow fiscal stabilisation, for instance by focusing on cyclically adjusted variables and by modulating fiscal adjustments across the cycle. However, political economy considerations remain strong especially in economic good times and not all Member States have been effective building up fiscal buffers. If all Member States had stuck to the commitments under the SGP, stabilisation policy would have been more effective (Darvas 2018, EFB 2019, Gootjes and De Haan 2022).

Assessing stabilisation policy using information available at the time of budget planning shows a comparatively less pro-cyclical reaction of fiscal policies; that is, politicians at least aim to be more counter-cyclical than their policies end up being. Nonetheless, recent studies suggest that even ex-ante EU fiscal policy tends to be a-cyclical at best (Larch et al. 2020, Gootjes and De Hahn 2022). Larch et al. 2021b show that even when evaluating discretionary fiscal policy against observable and politically more tangible variables (e.g. unemployment rate or business confidence indicators), procyclicality remains prominent. Another reason for pro-cyclicality is a persistent optimism concerning the expected economic growth rate for the current year and especially the following years (Beetsma et al., 2022). This bias directly affects revenue projections which in turn are used to justify higher expenditure plans.

### 3.3. Quality of public finance

The quality of public finances (QPF) is a contributing factor determining the growth potential of an economy, but the QPF has also implications for short-term growth via fiscal multipliers (see e.g. Afonso et al. 2005, Barrios and Schaechter 2008, Fournier 2016, Kurtasi and Marton 2020, Espinoza et al. 2020). The concept of QPF contains many dimensions. It essentially captures policies that aim to raise potential GDP and the resilience to shocks while ensuring long-term fiscal sustainability. In practical terms, QPF can be broadly characterised by indicators such as the size of the government, the fiscal positions and trajectory, and crucially the composition and efficiency of public revenues and expenditures (see Graph 3.3.1).
While not being its focal point, the EU’s fiscal framework encompasses elements intent on improving the QPF. For instance, Treaty Article 126(3) explicitly points to government investment to be taken into account when assessing the existence of an excessive deficit. Moreover, the calibration of the country-specific MTO in the preventive arm of the SGP considers the role of investment (\(x\)). The application of flexibility provisions of the SGP can also play a role in shaping budget allocations. The so-called ‘investment clause’, which builds on the structural reform clause, allows for a temporary deviation from the MTO or the adjustment path towards it. The investment clause is a potentially powerful instrument to incentivize governments to favour public investment. However, in practice the clause had so far only a limited impact. In fact, so far, the clause has only been used twice (Italy in 2016 and Finland in 2017), partly due to the strict eligibility criteria.

The most crosscutting but soft instrument to influence the QPF are the country-specific recommendations (CSRs). Public finances and by extension budgetary composition fall under the remit of the CSRs. Aside from the fiscal policy advice pertaining to the SGP, the Commission also outlines recommendations on economic policy ranging from taxation to labour market and investment dossiers, which could affect budgetary allocation. The CSR channel primarily relies on peer pressure. If a Member State conducts policies at odds with the Council recommendations, the Commission and Council may issue an early warning to the respective government. However, this instrument has not been employed much and overall compliance with CSRs has been disappointing and deteriorating over time (see European Court of Auditors, 2020). Alongside this trend, the QPF has not improved across Member States.

Public investment serves as a prime example. A shift in the allocation of expenditure towards investment is likely to have a growth-enhancing effect (Fournier 2016). Regrettably, investment tends to be the first to fall victim of government consolidation efforts as it is politically less costly than cutting current expenditure or raise taxes. Empirical evidence suggests that fiscal rules have not been the constraining factor. Rather, market pressure, high public debt and an ageing society seem to be the main drivers (Bacchiocchi et al. 2011, Vuchelen and Caekelbergh 2010, Jäger and Schmidt 2016). In practice government investment in the EU has been chronically anaemic ever since the Great Financial Crisis of 2008 (see Graph 3.3.2). The RRF is expected to uplift investment rate marginally by close to 1/6 of the percent of GDP annually over the next years for the EU as a whole. While the impact on the EU is modest, some Member States experience a very large jump in public investment due to RRF grants. In Greece investment financed by the RRF grants nearly doubled the

**Graph 3.3.1: Allocation of government spending by functions of government (COFOG), EU**

![Graph showing allocation of government spending by functions of government (COFOG), EU](image-url)
investment rate while others saw increases by a quarter compared to the pre-pandemic average. In any case, the RRF is at best a temporary respite.

**Graph 3.3.2: Low government investment and impact of RRF**

![Graph showing government investment and RRF impact](image)

Notes: The high impact group is composed of those countries with RRF-grant-financed investment of more than 0.4% of GDP in 2022-2023: Bulgaria, Czechia, Greece, Croatia, Cyprus, Latvia, Hungary, Malta, Portugal, Romania, Slovenia and Slovakia. Investment rates for groups are GDP weighted.

Source: European Commission

Overall, the QPF plays only a minor role in the EU’s fiscal framework. Investment has received increasing attention and some tools to promote public investment through the framework have been added but with limited practical impact. The QPF has remained largely in the national domain.

### 4. Governance of the fiscal framework

To complete the discussion of the EU’s rules-based fiscal framework, its governance also deserves to be reviewed. The changes adopted since its inception in the late 1990s, and in particular the emergence of risk sharing elements in the EMU architecture, are reflected in the institutional design and decision-making responsibilities both at the EU and the national level.

#### 4.1. EU governance

Since inception, the EU’s fiscal framework has experienced a clear shift: at the outset solely based on the ‘Community method’, it turned into a system where the EU’s classical model of governance co-exist with intergovernmental arrangements. In parallel, national budgetary institutions, and most notably independent fiscal councils, have become officially involved in the coordination process.

Starting with the SGP, which is firmly anchored in the Community method, the vast majority of implementing decisions are taken by the Council (typically with qualified majority) on a recommendation from the European Commission. The country under discussion does not participate in the vote. In most cases, non-euro-area countries do not participate in the voting on euro-area countries. EU fiscal surveillance has a distinctive enforcement system including a graduated system of sanctions and financial penalties. However, most acts adopted by the Council or the Commission leading up to sanctions belong to the realm of soft law, in the sense that they do not produce clear
binding effects. Their impact mostly relies on the idea that peer pressure and reputational costs will encourage Member States to adjust their policies to Council recommendations (see Dermine, 2021).

While the 2005 reform did not amend the governance side of the SGP, the reforms of 2011-2013 brought about notable modifications. By that time, it had been widely acknowledged that national ownership was essential to strengthen compliance with the rules. The strengthening of national fiscal rules can also be seen as a balance to the creation of jointly financed assistance programmes and the concomitant creation of the ESM as an instrument of risk management involving risk sharing. The Six- and Two-Pack reforms and the intergovernmental Fiscal Compact introduced a set of new minimum standards for national fiscal systems as a form of risk reduction (see details in the next section). The Fiscal Compact, and in particular its requirement to have in place a comprehensively designed national structural budget balance rule mimicking the main requirement of the SGP was a clear quid pro quo for the ESM. The two institutions were even legally interconnected: the preamble of the intergovernmental Treaty stipulated that access to financial assistance from the ESM “will be conditional, as of 1 March 2013, on the ratification of this Treaty by the Contracting Party concerned.”

Another element of the Six-Pack reform impacting governance was the introduction of reverse qualified majority voting (RQMV) to impose the more granular SGP sanctions. It means that it would require a qualified majority of voting Member States to overturn a Commission recommendation; thereby in the event of a broadly split Council, it implies a more decisive role for the Commission. The introduction of this voting arrangement was motivated by previous difficulties of reaching decisions on policy recommendations in the Council, and most notably, the notorious case of not adopting the Commission’s recommended course of actions against Germany and France in 2003. However, albeit this innovation was widely anticipated to lead to a quasi-automatic implementation of the stricter SGP rules, it did not bring about a more forceful implementation record by the Commission (EFB, 2019).

Irrespective of the precise voting modalities, the College of Commissioners has continued to emphasise the political implications of their decisions, as illustrated by the 2016 decision to de facto relinquish SGP sanctions for non-compliance against Spain and Portugal (by setting their level at zero). One explanation for this hesitant approach put forward by Kamps and Leiner-Killinger (2019) is that the Commission has internalised the Council’s long-standing lack of ownership of the fiscal framework. Other papers linked this leniency to the prevalent perception of any SGP sanction, even quasi-automatic ones, as limiting national sovereignty by a supranational body (e.g. Mangov et al., 2019).

A further strengthening of the enforcement toolbox was achieved in 2013 when the macroeconomic conditionality was significantly extended in the so-called ‘Common Provision Regulation’ – an overarching legislation governing most EU funding programmes. The link between EDP compliance and EU grants was introduced in 1994, but until the 2014-2020 multiannual financing period, it applied only to the Cohesion Fund. It was legislated to incur financial consequences in case a Member State did not take effective action in response to an EDP recommendations by suspending commitments. Such elements are meant to reduce the discretion around sensitive decisions, against the background of the inherent political difficulty of sanctioning sovereign countries.

Buti and Larch (2018) stress some key political economy considerations around the EU fiscal surveillance regime, which in particular hamper its enforcement capacity. Their analysis points to the inherent heterogeneity of the Council as a decision-making body, as it comprises of different and often diverging interests that could even change over time. The economic and finance ministers are
accountable to their domestic constituencies, and they are motivated by their specific political objectives and national re-elections prospects, and not the interest of the EU as whole. Furthermore, it could be rationally expected that Member States at greater risk of non-compliance with fiscal rules would prefer greater discretion in SGP implementation and more Council involvement in the enforcement design. Indeed, this hypothesis was empirically corroborated by Franchino and Mariotto (2021), in particular for Member States with higher voting power. Finally, one should bear in mind that the EU is a multipurpose institution. It means that fiscal policy is just one of the many domains that are administered in the same governance framework. In such an arrangement, package deals involving even distant policy areas is a typical solution to make progress during the political process.

Overall, the current framework of EU economic governance is characterised by growing imbalance between the degree of economic integration on one side, and political integration on the other. While the economic and financial side of the integration has been increasingly deepened with the adoption of ever closer supranational institutions, political integration has been lagging behind. The resulting incomplete policy-making structures do not have the determination and accountability to systematically enforce SGP rules.

### 4.2. National fiscal governance

Until the outburst of the Global Financial Crisis, there were no straightforward legal provisions for Member States’ fiscal governance frameworks. There was a broad reference in the Treaty to adequate national budgetary procedures, and the recommendations issued by the Council on SCPs or in the context of EDPs had increasingly contained invitations for enhancing national fiscal rules and institutions. After the Global Financial Crisis, the determination to strengthen national fiscal governance rested on a vast body of economic and empirical literature documenting the benefits of rules-based frameworks for conducting sound fiscal policies. It was increasingly recognised that to achieve better risk reduction, the centralised EU procedures and rules should be complemented with robust domestic fiscal arrangements to contain the deficit bias. Therefore, reinforcing national budgetary frameworks had become an integral part of the economic governance reform drive.

The successive reform waves between 2011 and 2013 provided a significant impetus for the development of national fiscal frameworks. Overall, they were meant to support compliance with EU budgetary obligations, and thereby risk reduction in the public sector. As was explained earlier, these steps were corollary of the risk sharing schemes adopted in parallel, and this link was even made explicit in the Fiscal Compact. It should also be stressed that Member States were allowed to retain a significant degree of freedom in terms of designing their own national frameworks.

- First, one component of the Six-pack, the Budgetary Frameworks Directive set minimum standards for domestic fiscal governance arrangements in 2011. Specifically, it established essential requirements for (i) public accounting and fiscal statistics; (ii) macro-fiscal forecasts; (iii) numerical fiscal rules; (iv) medium-term planning; (v) transparency and comprehensive scope of budgetary frameworks. The Directive also introduced a broad reference to the need for involving IFIs or ‘bodies endowed with functional autonomy’ in the monitoring of compliance with national fiscal rules.
- Second, the intergovernmental Fiscal Compact was signed in 2012 to anchor the EU framework more robustly and harmoniously in national law. Concretely, it obliges the contracting parties to establish a structural balanced-budget rule, equipped with an automatic correction mechanism in case of deviations. The Commission was officially
empowered to issue accompanying common principles\textsuperscript{xx} to set minimum requirements for these national correction mechanisms as well as a number of independence safeguards for the independent monitoring institutions in terms of, among others, legal underpinnings, nomination procedures for members, access to information and resources.

- Finally, in 2013, one of the Two-Pack Regulations\textsuperscript{xx} introduced a common budgetary timeline for euro-area Member States, involving the synchronised preparation of national fiscal plans and the adoption of policy recommendations at the EU level, chiefly to allow for a better coordination of fiscal policies. Moreover, it established the requirement for these national planning documents to be based on independently produced or endorsed macroeconomic forecasts. For the set-up of these national IFIs, it broadly incorporated the Fiscal Compact's independence safeguards in the EU law.

Notwithstanding the significantly enhanced national fiscal governance regimes, and in particular the fact that the supranational provisions made it practically compulsory for all Member States to have in place numerical rule(s), a medium-term budgetary framework and an independent fiscal institution benefitting from a certain degree of minimum requirements, there has not been a clear improvement in compliance with the SGP rules compared to earlier periods as detailed in the subsection 3.1 discussing the compliance record. This being said, the reforms of the national frameworks could have worked as signalling devices. Based on panel of 25 European countries, Jalles (2019) found a beneficial impact of the quality of fiscal institutions on government bond yields (and consequently on sovereign debt financing costs). The paper argues that more robust rules give credibility to the financial investors that the government will meet its obligations.

There have been two notable national framework elements from the reform package which were expected to promote stricter adherence to EU fiscal requirements: (i) the better design of structural balance rules in the Fiscal Compact countries, including an automatic correction mechanism, and (ii) increased involvement of IFIs in the budgetary process, most notably, their validation role for the macroeconomic forecasts.

As to the former, a subgroup of this paper’s authors looked into the possible determinants of national correction mechanisms on the basis of a dedicated IFI survey that revealed a great variety of design choices across countries; see Larch et al. (2021c) for details. They found that better compliance tends to be associated with a superior design of the correction mechanism, higher government efficiency and a stronger media presence of IFIs. Nevertheless, they underlined that many countries have linked the trigger of their correction mechanism to formal decisions at the EU level (often characterised by forbearance and ad-hoc discretion as detailed earlier) rather than to independent assessors at the national level. This choice seems to defeat the original purpose of correction mechanisms, namely, to decouple key fiscal policy decisions from political considerations.

5. The future of the EU’s fiscal framework: more fiscal integration without cooperation?

The mixed results of the EU’s fiscal framework documented in this paper corroborate a fundamental tenet of mainstream economic thinking: rational decision makers driven by self-interest will free ride on public goods and/or not internalise external effects produced by their actions. Cooperation is not the natural outcome; it requires binding contracts or outside enforcement. After all, it was this fundamental insight, together with a history of persisting differences in economic performance and resilience, which back in the early 1990s motivated the then 12 EU Member States to agree on
arrangements - anchored in the Maastricht Treaty and later on detailed in secondary EU legislation - aimed to avert significant spill-overs from national fiscal policies on other EU countries and to safeguard the effectiveness of centralised monetary policy.

While legal texts can sometimes confound underlying motives, the most concise formulation of the underlying commitment can be found in declaration 30 of the intergovernmental conference which adopted the Treaty of Lisbon in 2007. It includes the following two plain sentences: “The conference reaffirms its commitment to the provisions of the Stability and Growth Pact as the framework for the coordination of the budgetary policies in the Member States. The conference confirms that a rules-based system is the best guarantee for commitments to be enforced and for all Member States to be treated equally.”

The declaration, which echoes concepts laid out in the Council resolution of 1997 heralding the entry into force of the SGP, emphasises the idea of an even-handed implementation of a commonly-agreed, rules-based system: in essence, cooperation through reciprocity and enforcement, a key insight of all social sciences linked to the management of commons.

However, while built on the right premisses, today the prevailing perception is that the SGP did not live up to its original expectations, at least not in all parts of the Union. The basic truth encapsulated in the popular expression that governments have no friends only interests, clearly overshadowed solemn declarations. As a result, today views continue to diverge about how to revisit the EU’s fiscal framework. The protracted and still ongoing economic governance review - the official assessment process at the EU level launched at the beginning of 2020 - testifies to the lack of consensus. Notwithstanding very intense and detailed discussions among Member States in the Council of the European Union and a wide range of reform proposals by academics and other pundits, no common landing zone for a possible reform of the SGP has emerged as of yet.

To start with, many observers tend to generalise when it comes to the performance of the EU’s fiscal framework suggesting that the SGP has not worked across the board. As highlighted in Section 3, such a generalisation does not reflect reality. The majority of the EU Member States has followed a course of fiscal policy which, even if not always compliant with the letter of the SGP every year, entails a sustainable and virtuous path of public finances. Many countries aptly used government debt as a buffer over the cycle: it increased during downturns to stabilise economic activity and receded during recoveries. This is what fiscal rules are ultimately meant to achieve. Other countries, by contrast, followed an asymmetric approach: they let government debt increase during difficult times, but did not manage to bring it back down during upturns. Hence, the rules seem to have worked for most countries but not for others and the key question is why. Obviously, in a single currency area with highly integrated economies serious problems in one country are enough to rock the whole boat.

While the spectrum of views is fairly wide, it is characterised by two opposing schools of thought. The dispute is around the fundamental question of how to ensure cooperation among national fiscal policy makers in a single currency area. On one side of the spectrum, there are those who insist the commonly agreed rules are basically fine, they simply need to be implemented and enforced properly, possibly through more automaticity. In clear contrast, the rival school of thought argues that in a multilateral context such as the EU, enforcement of rules will never work because there is no outside enforcement, i.e. decisions are taken at the level of peers. The only way to achieve any degree of buy-in from national governments is to adjust rules to national needs and preferences and to absorb spill-over risks with a central fiscal capacity.
As is often the case with opposing views, both sides make some valid and some less valid points. Those insisting on enforcement do not want to accept the plain fact that although sanctions under the SGP have formally been strengthened and widened over the course of successive reforms, they have never been applied. Of course, sanctions are meant to have a dissuasive effect ideally discouraging Member States from deviating from the course of fiscal policy implied by the commonly agreed rules. Hence, a history without recourse to sanctions under the SGP may not necessarily be a bad sign. However, in combination with a dismal compliance record in some EU Member States, which over time ended up accumulating very high levels of government debt relative to GDP, it certainly is.

The incontrovertible truth is that albeit formally empowered, the Council never found the necessary majority to apply the sanctions laid down in the commonly agreed fiscal rule. However, as stressed in Section 4, enforcement of EU fiscal rules can also be strengthened through links with other EU policy instruments. Conditionality under the EU’s cohesion policy, which absorbs the largest relative share in the budget of the Union, is a prime example. Relevant EU law includes provisions of macroeconomic conditionality which, as highlighted in Section 4, have been significantly extended over time. They oblige the Commission to propose the suspension of European Structural and Investment Funds (ESIF) in case of non-effective action under the EDP. While this provision has never led to an actual loss of funds, it can be considered to be the only instrument with a credible bite.

Those disputing the viability of any kind of enforcement and insisting on bespoke commitments, possibly negotiated individually for each country, underestimate the importance of reciprocity. The resolution of 1997 mentioned above may not produce any legal effects, but it highlights a crucial point that has been consistently present in the implementation of the SGP since inception: a rules-based system aimed at equal treatment. The coordination of national fiscal policies can only be effective if its application across Member States is perceived as fair, in line with pre-defined rules that are applied consistently across time and countries. If discretion trumps rules and some members consistently get away with a more lenient treatment than others, the overall commitment to cooperate weakens.

Since there are no free lunches, we are currently faced with the price of the very uneven compliance with the SGP; the central monetary authority is confronted with a choice that it has tried to avoid since inception: price stability versus integrity of the single currency area. To be clear, the strong surge of consumer price inflation in the euro area in 2022 is mostly caused by the energy crisis linked to the Russian invasion of Ukraine, less by expansionary fiscal policies. However, if all euro-area Member States had kept debt-to-GDP ratios below say 80%, the ECB and the Member States would have had much more policy space to fight the economic impact of the Covid-19 pandemic or the latest terms-of-trade shock ensuing from the Russian invasion of Ukraine.

The ingenuous or disingenuous solution envisaged by those who question the viability of enforcing common rules through peers is to call for a permanent fiscal stabilisation capacity aimed at absorbing large common or idiosyncratic shocks. In theory, allocating more power to the central level would be the most extreme form of enforcement involving the loss of national sovereignty. However, it is probably no coincidence that most proposals advocating a permanent central fiscal capacity are not very specific about governance. They seem to be predicated on the assumption that a central fiscal capacity can be established at unchanged governance. In other words, the EU simply gets access to more resources to be distributed in some way, while national governments and parliaments maintain current fiscal policy prerogatives including the freedom to free ride.
Would such an innovation solve current challenges and lead to a politically stable solution? In all likelihood not. To be clear, ever since Mundell formulated the theory of optimal currency areas in the 1960s we know that a central fiscal transfer mechanism should be part and parcel of a single currency area. But we also know that achieving the common sense of political purpose and the political majorities needed to establish a fiscal transfer mechanism or central fiscal capacity is very difficult.

Policy proposals intent on simply adding a permanent fiscal capacity at the EU level without flanking governance reforms do not address the underlying issue of cooperation or lack thereof. They take it for granted that rules-based cooperation will never be enforced at the level of peers and see a central fiscal instrument as the only way to stabilise the system as a whole. But there lies the catch 22: the majorities required to establish a permanent fiscal stabilisation capacity to address instability, including the one stemming from insufficient cooperation, are a fairly distant prospect. At unchanged governance, the current tension between the two rival groups would simply resurface around the size, the trigger and the degree of redistribution of a permanent central fiscal capacity. Without the adequate level of political representation and accountability at the EU level, combined ideally with tighter limits on national fiscal policy discretion, a central fiscal capacity would remain a barren arrangement ultimately bound to fail. More money from the centre but no credible commitment to strengthen cooperation seems a tall order.

As should have become clear by now, the fundamental disagreement about the opportunity and effectiveness of enforcement of EU fiscal rules largely overlaps with the relative importance attached to risk reduction versus risk sharing. Past reforms of the EU’s fiscal framework typically involved concessions on both sides: new elements of risk sharing or flexibility around rules came together with new elements of risks reduction. There was a clear awareness that progress can only be achieved when moving ahead on both fronts. In the current context of the economic governance review the willingness to make concessions to the other side is largely missing. The two rival positions are entrenched.

By the very nature of the impasse, the two camps are both right and wrong at the same time. Insisting on a system that is not enforced may be principled but not expedient. By the same token, it is misleading to assume macro-financial stability in EMU can be safeguarded through more fiscal power at the supranational level, on the premise it would suppress entrenched conflicts of interest over the appropriate balance between risk sharing versus risk reduction without adjusting governance and accountability and without addressing free-riding.

At the time of writing, it is difficult to anticipate what the final outcome of the ongoing reform debate will be. So far, agreement has been reached on a number of high-level guiding principles such as simplifying the EU fiscal rules, focusing on the sustainability of public finances, ensuring a growth-friendly debt reduction, strengthening the medium-term orientation of budgetary policies and improving enforcement. Translating these broad principles into a concrete reform plan is another matter. When the economic governance review was formally launched in early 2020, times were fairly stable and the urgency to act with a major reform correspondingly low. The Covid-19 pandemic first and the war in Ukraine after have radically changed the context amplifying pre-existing challenges and adding new ones. The current focus of EU policy makers is understandably on energy and security creating considerable political pressure to make sure the EU’s fiscal framework is not holding back progress on much more existential issues. In other words, circumstances may eventually push the two rival camps to agree on a compromise to be able to invest national and collective political capital in tackling bigger challenges.
The Commission communication of 9 November 2022 outlining orientations for a possible reform of the SGP supports this narrative. It charts out an evolution of the SGP which, if agreed, would introduce some significant innovations in the way the common fiscal framework will be implemented in practice, while keeping the underlying philosophy of coordination largely unchanged. In particular, it is predicated on the assumption that less demanding and more differentiated adjustment requirements will improve the willingness to cooperate. Admittedly, the orientations also refer to the intention of applying sanctions more rigorously. However, while the proposal on how to modify adjustment requirements is very detailed, the part on sanctions is at this stage a pledge similar to the one of 2011 when the Commission and the Council introduced new and more gradual sanctions. Moreover, the orientations for reform turn debt sustainability analysis into the linchpin of EU fiscal surveillance, shifting the balance towards more discretion and possibly altering the understanding of equal treatment. While such an approach can certainly offer respite at the current juncture it is unlikely to solve the underlying tensions among Member States discussed above, and sooner than later those tensions will resurface.

In the final analysis, tensions can only be resolved once fiscal policy is built around a governance system that safeguards the appropriate enforcement or political accountability at the EU level. Right now, the determination to hold ‘free-riders’ accountable is limited. The spectrum of possible ways forward is delimited by two scenarios: one in which enforcement is eventually achieved without major changes in EU governance; the other where fiscal cooperation is accompanied by governance reforms strengthening political responsibility and accountability at the EU level. Until then, major not self-inflicted crises affecting the stability of the euro area will be tackled by temporary EU fiscal instruments.
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The Fiscal Compact is Title III of the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, signed in March 2012. This specific part of the Treaty lays down obligations for the 19 euro area countries, while Bulgaria, Denmark and Romania are bound by the same requirements on a voluntary basis.

It is important to understand that these two numbers were the result of political decision rather than based on economic calculations (Kamps and Leiner-Killinger 2019).

This innovation was made possible by an agreement on EU's commonly agreed methodology of calculating the potential output and output gap estimates. The method was endorsed by the ECOFIN Council in July 2002.


Compliance tracker measures numerical compliance with the four main rules of the Stability and Growth Pact – deficit rule, debt rule, structural balance rule and expenditure rule. This assessment abstracts from legal interpretations and flexibilities applied in specific cases. Results of the tool are available at this link: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/european-fiscal-board-efb/compliance-tracker_en.


Regulation 1466/97, Recital 14: “Whereas the Council, when examining and monitoring the stability programmes and the convergence programmes and in particular their medium-term budgetary objective or the targeted adjustment path towards this objective, should take into account the relevant cyclical and structural characteristics of the economy of each Member State”.

While safeguarding sustainability the MTO should also be set to “allow room for budgetary manoeuvre, in particular taking into account the needs for public investment” (see European Commission, 2019).

Under the so-called community method, the Council is the ultimate decision-maker when it comes to the implementation of EU laws. It acts on the Commission’s proposals, which are prepared to fulfil the classical ‘Guardian of the Treaty’ role.
Specifically, it is true for all decisions under the SGP’s corrective arm, and this is also the case in the preventive arm’s sanctioning decisions under the Significant Deviation Procedure (see for details European Commission (2019)).

The text of Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

In a notorious 2016 media interview Jean-Claude Juncker, then President of the European Commission, admitted that the Commission’s lenient approach toward France’s past breaches of the rules was linked simply to the fact that ‘because it is France’.


Specifically, Protocol No 12 on the excessive deficit procedure annexed to the Treaties requires Member States to ‘ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from these Treaties’.

Concerning numerical rules, both Debrun et al. (2008) and Nerlich – Reuter (2013) found statistically significant positive impacts of fiscal rules on budgetary aggregates. As to the impact of independent fiscal institutions (IFIs), Debrun and Kinda (2014) concluded that well-designed IFIs were associated with better fiscal outcomes and less biased forecasts (outsourcing macroeconomic forecasts to an independent institution has for long been considered to contribute to their greater objectivity, see e.g. Jonung and Larch (2006). Beyond these classical elements of rules-based frameworks, the overall quality of domestic budgetary procedures was also shown to contribute to better budgetary performance (Fabrizio and Mody (2006)).


Communication from the Commission: Common principles on national fiscal correction mechanisms (COM/2012/0342 final).


Commission communication on orientations for a reform of the EU economic governance framework.