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The path to the reformed EU fiscal framework: a monetary policy perspective

No 349

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Abstract

This paper reviews the main arguments underpinning the reform of the EU's fiscal framework, which has culminated in the adoption by the EU legislators of a revised set of rules for the European economic governance including the Stability and Growth Pact (SGP). It takes a chronological approach by first discussing the Commission's legislative proposals of April 2023 against the pre-reform set of fiscal rules, before assessing the final political agreement which has materialised in the revised set of rules. In view of the multi-dimensional reform outcome, it is argued that the success of the reform of the fiscal framework will ultimately depend on its future implementation by the Commission and the Council. Combining the reform of the fiscal rules with better fiscal coordination through the establishment of a permanent euro area fiscal capacity was not proposed in the context of this reform. This paper argues that completing the architecture of Economic and Monetary Union (EMU) is an important missing element and should remain a policy priority.

Keywords: Fiscal rules, Stability and Growth Pact (SGP), Economic and Monetary Union (EMU)

JEL codes: H6, H11, H50

Non-technical summary

A robust common framework for fiscal policy coordination and surveillance is essential for ensuring sustainable and growth-friendly fiscal policies, which are a prerequisite for price stability and economic growth in a smoothly functioning Economic and Monetary Union (EMU).

The discussion on reforming the European fiscal rules, notably the SGP, has therefore been hugely important from a monetary policy perspective. This paper argues that the SGP should deliver on three fundamental objectives. First, it needs to promote a realistic, gradual and sustained adjustment of public debt towards sound and sustainable levels. Second, it should support fiscal policy in becoming sufficiently countercyclical. Third, it should foster sound incentives for growth-friendly economic policies.

The pre-reform SGP fell short of the mark in achieving these objectives, at times resulting in a burden for monetary policy. It failed to prevent the emergence of excessive levels of public debt and overly heterogeneous debt ratios across the euro area, and nor did it manage to avoid the tendency of fiscal policies to be pro-cyclical. Moreover, inadequate enforcement of the rules meant that fiscal buffers were not built up in time. Meanwhile, significant cuts in government investment following the Great Financial Crisis (GFC) and the sovereign debt crisis – which have detrimental longer-term effects – were also a by-product of a fiscal framework that was not designed to protect investment. However, more recently, the COVID-19 pandemic and the energy crisis have shown that at least some lessons have been learned from previous crises. The application of the pre-reform SGP framework proved to be flexible enough to deal with such exceptionally large economic shocks, while the agreement on Next Generation EU (NGEU) in 2021 was designed to boost growth-enhancing government investment and structural reforms.

As the many different proposals that contributed to the debate on SGP reform show, there is no easy, one-size-fits-all solution to ensuring fiscal sustainability, stabilisation, and growth-friendliness within a euro area post-crisis economy that is characterised by heightened debt heterogeneity, headwinds to long-term growth and massive investment needs. When in April 2023 the European Commission proposed a major overhaul of the SGP – the largest since its inception in 1997 – it factored in the main elements of this broad-based debate. The proposed reform included a number of key features. First, it proposed the use of a *single expenditure-based indicator* for fiscal surveillance, which has the potential to improve the cyclical properties of the framework and support its implementation, albeit with certain limitations, including the absence of a common methodology for evaluating discretionary revenue measures. Second, it proposed that fiscal adjustment requirements be linked to a comprehensive analysis of the risks to debt sustainability. Such *risk-based fiscal surveillance* is economically meaningful, as debt sustainability analysis (DSA) captures relevant aspects, including ageing costs and other implicit liabilities, which are not captured at a contemporaneous

government debt level. At the same time, DSA-based surveillance introduces complexity and assumption dependency. This calls for a transparent and commonly agreed approach, along with complementary and consistent safeguards to ensure that high debt is put on a sufficiently diminishing path. Third, the proposed reform sought to strengthen *national ownership via the adoption of medium-term fiscal-structural plans*, with incentives for much-needed reforms and investment, which should support compliance with the rules. However, relying on long adjustment periods also raises new challenges – especially if they would stretch beyond typical electoral cycles. Fourth, it foresaw a *more effective enforcement of the rules*, which is essential in preventing increased national ownership from resulting in an overly decentralised approach to fiscal surveillance. Relatedly, the proposed reform sought to enhance the role of independent assessment at both European and national level – through the European Fiscal Board (EFB) and national independent fiscal institutions (IFIs). Such independent assessments have the potential to provide governments with important advice and guidance on their policies, and to enhance transparency and support implementation. Following the Commission's proposals, the Economic and Financial Affairs Council (ECOFIN Council) reached a compromise agreement on the economic governance review in December 2023. While this compromise agreement maintained the Commission's general approach, it introduced some key changes, most notably in the definition of safeguards. The subsequent agreement reached in the "trilogue" between the Commission, the Council and the European Parliament in February 2024 left the Council's compromise largely intact, with the most tangible amendment being to accommodate national co-financing of EU funds and to introduce a somewhat stronger role for investment.

To explain the functioning of the new fiscal framework, this paper presents illustrative ECB staff simulations of fiscal adjustment requirements among euro area countries as well as related debt developments, drawing some comparisons with the pre-reform SGP. These simulations are based on the Commission's 2023 autumn forecast, ageing costs that stem from the 2021 Ageing Report and the methodology as described in the European Commission's 2022 Debt Sustainability Monitor. The simulations do not provide a direct link to the reference trajectories of fiscal adjustment that would serve as basis for the first batch of medium-term fiscal structural plans.

Now that an agreement has been reached, it will be essential to ensure the timely and effective implementation of the new fiscal rules, which will become more credible over time only if they are embraced by national governments and enforced by the Commission and the Council.

Lastly, this paper recalls that the reform did not combine the reform of the fiscal rules with a more effective coordination of fiscal policies in the euro area. A functioning fiscal framework could increase confidence in, and the impetus for, EMU deepening. From a monetary policy perspective, *enhanced coordination of the fiscal policy stance at aggregate euro area level* is important for a smooth interaction between monetary policy and the fiscal policies of Member States. This would also require the establishment of a well-designed, permanent euro area central fiscal capacity (CFC),

as a missing element for a complete EMU. Such an instrument would support the single monetary policy by doing a better job at achieving the dual objective of fiscal sustainability and macroeconomic stabilisation. In addition, a centrally managed fund could also facilitate investment in public goods that would benefit the European economy, particularly the green and digital transitions as well as defence.

1 Introduction

The fiscal governance framework is of key importance for the smooth functioning of the Economic and Monetary Union, and so any debate about its reform matters also when it comes to monetary policy. There is now a broad consensus that the pre-reform fiscal framework had weaknesses, despite numerous adjustments made to address evolving challenges. In its February 2020 review of the Six- and Two-pack regulations, the Commission identified four such weaknesses: (1) high debt in some Member States; (2) pro-cyclical fiscal policies; (3) complex rules and lack of ownership; and (4) insufficient attention to public investment. Following a delay due to the pandemic, the Commission relaunched the Economic Governance Review (EGR) in October 2021 and found that the key challenges it had identified earlier had become even more pressing because of the COVID-19 crisis and rising public debt levels, largely due to the fiscal response needed to counter the pandemic. The debate on reforming the fiscal governance framework gained further impetus following the publication of the Commission's orientations for a reformed EU economic governance framework in November 2022, which fed into the Commission's legislative proposals released on 26 April 2023. These underwent intense discussions among EU governments, the EU and international institutions, and within the Council of the EU. On 5 July 2023 the European Central Bank (ECB) published an Opinion on the European Commission's proposal for economic governance reform in the Union.[1] Following the ECOFIN Council's compromise agreement on 20 December 2023, the trilogue between the Commission, the Council and the European Parliament was successfully concluded on 10 February 2024. On 30 April 2024, the new economic governance framework entered into force.

This paper takes stock of the path to reforming the EU's fiscal framework, focusing on aspects relevant to the interaction between fiscal policies and monetary policy in the euro area. While the Commission's legislative proposals involved a more encompassing reform of the economic governance framework, covering aspects related to structural reforms and macroeconomic imbalances, this paper focuses solely on the fiscal aspects of the economic governance review. The paper is organised as follows. First, it reviews the main elements of the EU's pre-reform fiscal framework and identifies issues related to its functioning (Section 2). It then provides an overview of the wide-ranging and rather fractious reform debate by highlighting key issues which featured prominently (Section 3). Subsequently, the main fiscal elements of the reformed EU governance framework are reviewed (Section 4). Section 5 addresses the euro area dimension of the reform debate, before Section 6 concludes.

[1] Opinion of the European Central Bank of 5 July 2023 on a proposal for economic governance reform in the Union ECB (https://www.ecb.europa.eu/pub/pdf/legal/ecb.leg_con_2023_20.en.pdf).

2 The starting point: the functioning of the EU's fiscal framework so far

This chapter first provides a brief overview of the pre-reform EU fiscal framework and explains how it has evolved over time. The second part of the chapter highlights aspects of the framework that have worked and those that have not proved useful in achieving its objectives.

2.1 The EU's fiscal framework so far: main elements

Fiscal policy, and particularly high deficits and debt levels, can have profound implications for monetary policy. Fiscal policies can affect the ability of central banks to achieve price stability.[2] Firstly, fiscal expansion (contraction), which boosts (lowers) domestic demand, affects inflation developments. Secondly, unsound fiscal policies have the potential to complicate a price stability-oriented monetary policy. When it came to designing EMU, the central concern was that government over-borrowing, resulting in an unsustainable build-up of government debt, may lead to expectations that such borrowing will ultimately have to be financed by money creation, which in turn could push up inflation expectations.[3]

EMU, as first established by the Maastricht Treaty, envisaged that the single monetary policy would be complemented by decentralised fiscal policies coordinated by a set of common fiscal rules. Essentially, these rules were supposed to maintain fiscal discipline and counteract so-called deficit bias, thus avoiding excessive increases in aggregate demand and the subsequent rise in inflation. Such inflation would pose negative externalities for other euro area members, as it would necessitate monetary policy interventions to ensure price stability, such as raising interest rates. These elements can be considered the background of the so-called "Maastricht criteria", which were themselves rather vague. Article 126(1) of the Treaty on the Functioning of the European Union (TFEU) states that "Member States shall avoid excessive government deficits", while Article 126(2) of the TFEU provides that "with a view to identifying gross errors", compliance

[2] The ECB has pointed to this relationship for many years; see, for example, ECB Occasional Paper No 56 "Assessing fiscal soundness: theory and practice"

[3] Given the state-dependent nature of monetary-fiscal interactions, the relationship between the two policies is more complex. For instance, if monetary policy is at the Effective Lower Bound and/or the economy has been hit by a major deflationary shock, properly designed expansionary fiscal policies may back price stability rather than giving rise to inflationary pressures. Moreover, properly calibrated unconventional fiscal policies (defined as the set of fiscal measures, possibly expansionary, motivated by a desire to mute the effects of the increase in energy prices and to lower inflation) may help mitigate an inflationary spiral and improve inflation smoothing, as the most recent experience with the energy crisis resulting from Russia's invasion of Ukraine has confirmed (Dao et.al. (2023)). For a general discussion on the role of fiscal policy in backing price stability in the presence of "tail events", see Del Negro and Sims (2015), and Maćkowiak and Schmidt (2022) for a similar discussion in the context of EMU.

with budgetary discipline is to be based on two criteria, namely whether government deficit and debt exceeds “a reference value”. The 3% and 60% of GDP reference values for government deficit and debt are, in turn, defined in Protocol No 12 on the excessive deficit procedure. The Treaty provisions were operationalised by the SGP, which entered into force in July 1998, in the form of regulations: (i) the SGP preventive arm, i.e. Council Regulation (EC) No 1466/97[4], which aims to ensure sound budgetary policies over the medium term and thus prevent governments from accumulating excessive deficits; and (ii) the SGP corrective arm, i.e. Council Regulation (EC) 1467/97[5], which describes the excessive deficit procedure (EDP) enshrined in Article 126 of the TFEU.

The 2005 reform of the SGP introduced the concepts of the structural balance and the Medium-Term Budgetary Objective (MTO).[6] The structural balance, which aims to capture the underlying budgetary position by removing from the budget balance the effect of the economic cycle as well as one-off measures, was introduced following criticism that concentrating excessively on nominal budget balances was procyclical. Meanwhile, the MTO, defined in terms of the structural balance, aimed to provide an anchor for fiscal policy. Achieving the MTO would ensure, among other benefits, adequate margin for national automatic stabilisers to operate[7] without exceeding the 3% of GDP deficit threshold, while also accounting for country-specific long-term public finance challenges related, for example, to ageing.

The governance framework was further amended through the “six-pack” reform[8] in 2011 and the “two-pack” reform[9] in 2013 to address some of the

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4 Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 209, 2.8.1997, p. 1.

5 Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L 209, 2.8.1997, p. 6.

6 Council Regulation (EC) No 1055/2005 of 27 June 2005 amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 174, 7.7.2005, p. 1, and Council Regulation (EC) No 1056/2005 of 27 June 2005 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L 174, 7.7.2005, p. 5.

7 Draghi (2023) remarks that given the size of national budgets in Europe, automatic stabilisers can provide substantial stabilisation of local shocks.

8 The six-pack comprises: (1) Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 306, 23.11.2011, p. 12; (2) Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L 306, 23.11.2011, p. 33; (3) Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area, OJ L 306, 23.11.2011, p. 1; (4) Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, OJ L 306, 23.11.2011, p. 41; (5) Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances, OJ L 306, 23.11.2011, p. 25; and (6) Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area, OJ L 306, 23.11.2011, p. 8.

9 The two-pack comprises: (1) Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area, OJ L 140, 27.5.2013, p. 11; and (2) Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability, OJ L 140, 27.5.2013, p.1.

shortcomings that had been identified in the aftermath of the Global Financial Crisis (GFC). The short-lived coordinated EU fiscal expansion that took place in 2009 in response to the GFC quickly turned into strong fiscal consolidation as a result of the sovereign debt crisis that followed. The fiscal adjustment resulted, among other factors, from the fact that the authorities had failed to take full advantage of the good economic times prior to the crisis to build up sufficient buffers such that fiscal policies could then act in a sufficiently countercyclical manner during a crisis (see Box 1)[10]. To ensure greater buffer building when times are good, the six-pack reform introduced (i) the significant deviation procedure, aimed at correcting insufficient structural efforts towards the MTO, and (ii) an expenditure rule to help ensure that revenue windfalls arising during boom times do not fuel excessive government spending (as observed during the pre-crisis period). The six-pack reform also introduced a debt reduction rule ("debt rule"), which called for a 5% ("1/20th") reduction, on average over three years, in the excess of debt above the 60% of GDP threshold. This was meant to operationalise the Treaty's requirement for government debt to be "sufficiently diminishing" and "approaching the reference value at a satisfactory pace". In addition to the six-pack and two-pack, the Treaty on Stability Coordination and Governance (TSCG)[11], which includes the "Fiscal Compact", was agreed in 2012 and entered into force in 2013.

Soft law instruments have also played an important role in the framework. A notable addition in 2015 was the matrix of structural effort requirements for countries that had not achieved their MTOs (see Chart 1). [12] This matrix granulated the structural adjustment needs according to the size of the country's output gap as well as its debt level. In addition, flexibility was provided in the implementation of the SGP's preventive arm, whereby Member States had the option of pursuing lower structural adjustment requirements if they undertook structural reforms or additional public investment.[13]

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10 Bankowski, K. (2023) evaluates the actual fiscal policy conducted in the euro area and shows that while the fiscal measures undertaken were successful in alleviating the adverse consequences of the GFC, they deepened the second downturn amid the sovereign debt crisis.

11 The main goal of the TSCG, which came into force in 2013, was to strengthen national fiscal discipline and foster national ownership of the EU governance framework. Under the TSCG, Member States were obliged to transpose to their national legislation the commitment that general government budgets be balanced or in surplus, i.e. the MTO must not exceed a structural deficit of 0.5% of GDP. In case of significant deviations from the MTO or the adjustment path towards it, the TSCG insisted that this should automatically trigger a correction mechanism. A main benefit of the TSCG was that it required transposition of key elements of the SGP (secondary law) into national law (preferably into the constitution).

12 Communication from the Commission to the European Parliament, the Council, the European Central Bank, the Economic and Social Committee, the Committee of the Regions and the European Investment Bank making the best use of the flexibility within the existing rules of the Stability and Growth pact, COM (2015) 12 final.

13 In 2018 the Commission introduced further flexibility through the so-called "margin of discretion", which reduced the structural adjustment requirements below the matrix requirements for countries under the preventive arm, with the reasoning that in certain cases the size of the output gap underlying the specification of the structural effort requirements was understating the weakness in the macroeconomic situation.

Chart 1

Matrix of structural effort requirements under the SGP's preventive arm

Condition	Debt ratio <60% and no sustainability risk	Debt ratio >60% or sustainability risk
Exceptionally bad times (1)	No adjustment needed	No adjustment needed
Very bad times (2)	0	0.25
Bad times (3)		
Growth below potential	0	0.25
Growth above potential	0.25	0.5
Normal times (4)	0.5	>0.5
Good times (5)		
Growth below potential	>0.5	≥0.75
Growth above potential	≥0.75	≥1
(1) Real GDP growth<0% or output gap <-4. (2) -4≤output gap<-3. (3) -3≤output gap<-1.5. (4) -1.5≤output gap<1.5. (5) Output gap≥1.5. Output gap figures as a percentage of potential GDP		

Source: SGP Code of Conduct.

2.2 The performance of the EU fiscal framework: specific weaknesses and a broader assessment

2.2.1 Weaknesses

Various shortcomings have emerged in the implementation of the EU fiscal framework over the past 25 years. These have resulted from: (a) the inherent inconsistency of the Maastricht fiscal criteria, especially at low nominal growth rates; (b) the sub-optimal functioning of the MTO and the preventive arm matrix; (c) measurement issues surrounding the unobservable output gap used in the calculation of the structural balance; (d) a degree of bias to procyclicality; and (e) the inability to protect public investment.

a) Maastricht criteria

The deficit and debt reference values have proven to be inconsistent on average over the preceding two decades. The initial 3% of GDP deficit – by now well-anchored in public communication and often tending to serve as a guidepost/target for fiscal policies rather than a ceiling[14] – and the 60% of GDP debt thresholds are consistent only in an environment where nominal growth amounts to 5% on average. However, average growth has been significantly lower over the period 1999-2023, implying that the 3% deficit threshold taken as a target would be consistent with convergence to a debt ratio not at 60% of GDP, but above.

[14] For more details, see Kamps and Leiner-Killinger (2019).

b) Medium-Term Budgetary Objective and preventive arm matrix

The changes made to the framework, which aimed to address various challenges identified during its application, led to many complexities and inconsistencies. Notably, consistent compliance with the MTOs (requiring structural deficits of no more than 0.5% or 1% of GDP) would lead to debt-to-GDP ratios converging to levels considerably below the 60% of GDP threshold.[15] This contradicts the SGP's debt rule, which targets a 60% debt reference value.[16]

In fact, the enforcement of the SGP's debt rule did not last long and was soon replaced with the preventive arm matrix. While the debt rule had the double advantage of requiring larger adjustments in countries with higher indebtedness and of having an inherent memory function, i.e. accounting for accumulated shortfalls in complying with its adjustment requirements, it was effectively discontinued, one of the reasons being that it had turned out to be procyclical in an environment of low growth and inflation, because, in the period following the GFC, low growth and inflation had made it difficult for countries to comply with the debt rule. In such times the distance to the 60% of GDP reference value increases as deficits accumulate into higher debt while nominal GDP, which is the denominator of the debt-to-GDP ratio, increases slowly. This therefore raises fiscal adjustment requirements at a time when the economy would benefit from additional fiscal support.

The limited differentiation of fiscal adjustment requirements resulting from the SGP's preventive arm contributed to heterogeneity in debt ratios. The lack of differentiation in adjustment requirements based on the level of debt led to situations such as the one observed in 2019, where a country like Estonia, with a debt ratio of 8.6% of GDP, had to pursue structural adjustment of around 0.3% of GDP (see Chart 2).[17] Meanwhile, Italy and Latvia, with large differences in their debt ratios and having sustainability risks at opposing ends of the Commission's debt sustainability analysis, were asked to pursue the same amount of structural adjustment. Such practice lacks economic rationale and runs the risk of perpetuating heterogeneity in debt ratios. Fiscal heterogeneity, among other factors, may result in diverging financing costs between sovereigns, which may complicate the ECB's monetary policy, such as through a potential impairment of monetary policy transmission. Unevenly distributed fiscal space to counter economic shocks may also result in suboptimal stabilisation outcomes.

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[15] The pre-reform Regulation (EC) 1466/97 specifies that euro area and ERM2 Member States must have an MTO of at least -1% of GDP. The contracting parties to the Treaty on Stability Convergence and Governance (TSCG) have further committed themselves to MTOs of at least -0.5% of GDP, unless their debt ratio is significantly below 60% of GDP and the risks in terms of the long-term sustainability of their public finances are low. In those cases, the lower limit for the balance remains at -1% of GDP.

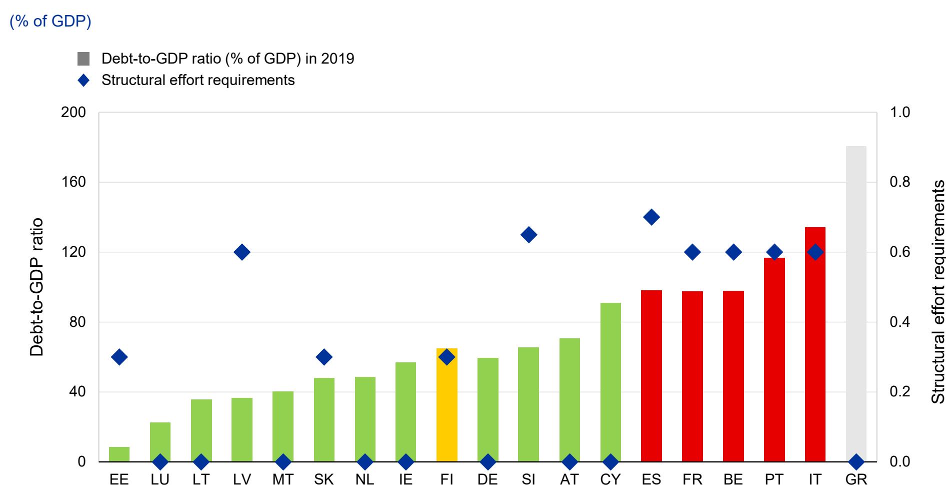
[16] For a discussion see Kamps and Leiner-Killinger (2023).

[17] For a discussion on this subject, see Hauptmeier and Leiner-Killinger (2020).

Chart 1

Debt-to GDP ratios and structural effort requirements in 2019

(% of GDP)



Sources: Ameco, ECB calculations.

Notes: The colour coding of countries is based on the European Commission's 2019 Debt Sustainability Monitor classification. Colours in the chart correspond to fiscal sustainability risk categories: low (green), medium (yellow) and high (red). Following the integration of Greece into the EU regular surveillance framework after its economic adjustment programme, the 2019 edition of the Debt Sustainability Monitor provided an analysis of Greece's debt sustainability challenges. However, given the specificities of the Greek debt structure, notably the large share of official sector lending, the European Commission highlighted that its analysis differed from the standardised horizontal approach followed in the rest of the report. Consequently, no colour coding is provided for the case of Greece.

c) Structural balance

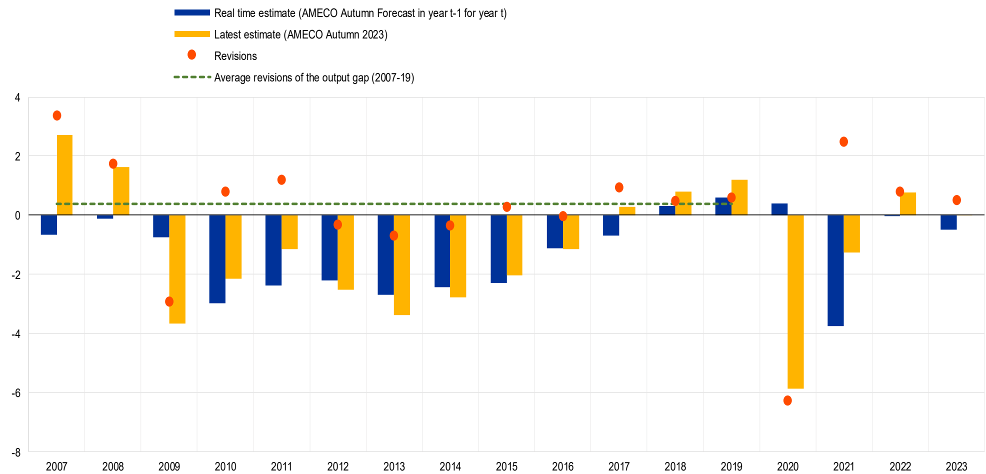
The framework's continued reliance on the unobservable output gap constrained its cyclical properties. An illustrative example can be found in the run-up to the GFC. The real-time estimates of the euro area output gap were negative or close to zero in the years 2007-2008, thus indicating a euro area economy performing below capacity or close to capacity, and suggesting, therefore, that fiscal policy should not have been restrictive for growth (see Chart 3). However, later estimates revealed positive output gaps prior to the GFC, implying that the euro area had been operating above its potential. This discrepancy suggests that reliance on real-time estimates in the context of fiscal surveillance may imply tendencies for procyclical fiscal policies. The previous example shows that countries should have been building fiscal space ahead of the GFC, while real-time output gaps may have signalled the opposite. Generally, the challenge of accurately gauging the output gap may intensify due to complications resulting from, inter alia, the Next Generation EU programme or, relatedly, the impact of the digital transition.[18] Although the significance of the output gap was diminished following the introduction of an expenditure rule in the 2011 "six-pack" regulations, the coexistence of both metrics has led to selective use, ensuring that the structural balance remained relevant.

[18] For example, in 2023 statistical offices in Italy and the United Kingdom revised upwards the level of GDP for 2021, reflecting a stronger than initially expected economic performance . See "Britain's statisticians fix a blunder and find a bigger economy", *The Economist*, 9 April 2023.

Chart 2

Euro area output gap revisions

(Deviation of actual output from potential output as % of potential GDP)



Source: AMECO.

d) Procyclicality

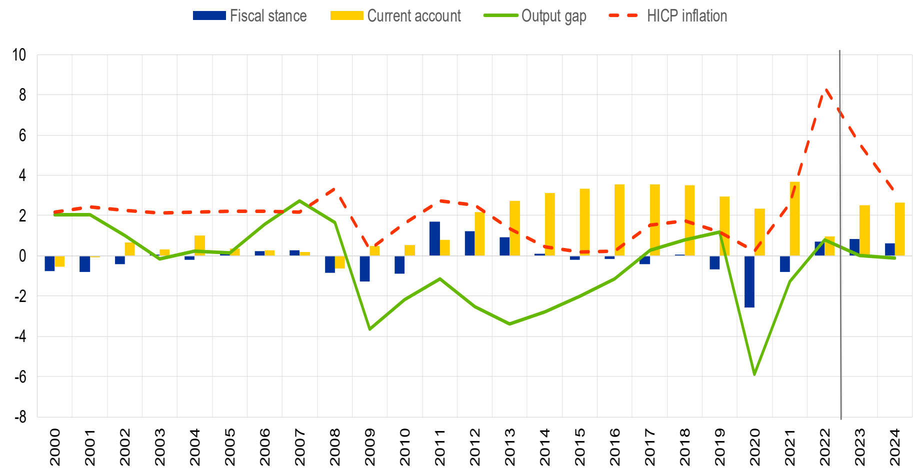
The pre-reform SGP aimed to ensure fiscal discipline while not necessarily promoting an appropriate fiscal stance at the euro area level thus risking putting the burden of stabilisation on the ECB (see, for example, Lane, 2021). The SGP framework is designed to proscribe excessive deficits and to steer governments towards their MTOs. The SGP cannot, in a symmetric manner, prescribe that euro area Member States with fiscal space pursue supportive fiscal stances. Therefore, in the absence of a permanent central fiscal capacity, the steering of the aggregate euro area fiscal stance can only be achieved through soft coordination of national fiscal policies. The asymmetric nature of the fiscal rules in conjunction with procyclical tendencies have at times limited the ability of euro area fiscal policy to respond counter-cyclically in the period preceding the COVID-19 pandemic (see Chart 4). When confronted with lasting lower bound episodes and persistent inflation undershooting, as happened in the years prior to the COVID-19 pandemic, the effectiveness of monetary policy may depend on appropriate fiscal stabilisation, supported by strong fiscal multipliers at unchanged policy rates[19] and, therefore, the ability of the fiscal framework to facilitate sufficient coordination.

[19] See ECB Occasional Paper Series No 273 / September 2021.

Chart 4

Euro area aggregate fiscal stance, output gap, inflation and current account balance

(percentage of GDP except output gaps, which are expressed as a percentage of potential GDP)



Sources: AMECO and ECB calculations.
Notes: Fiscal stance is measured as the change in the cyclically adjusted primary balance. The solid vertical line refers to the beginning of the forecast period.

e) Public investment

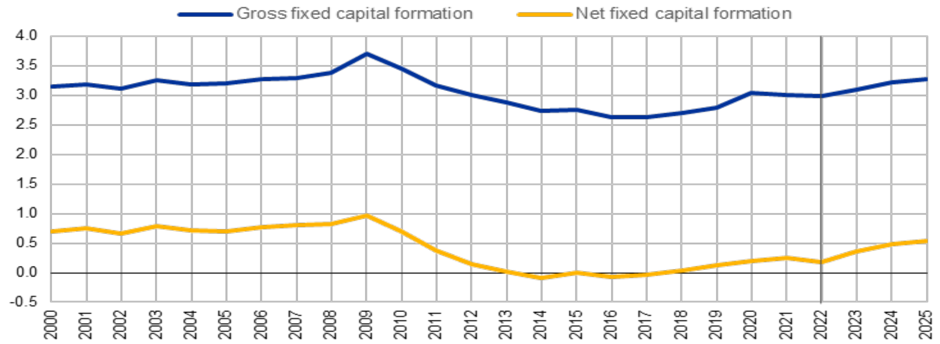
The SGP was not designed to protect public investment and was therefore unable to prevent euro area governments from cutting it following the GFC and the sovereign debt crisis. Notably, euro area government net fixed capital formation dropped below zero into negative territory, especially among high-debt euro area Member States, indicating reductions in the public capital stock (see Chart 5, panel a). This took place despite the pronounced trend decline in the equilibrium real interest rate over the previous 20 years, which should have facilitated the use of available fiscal space due to the drop in government interest payments to GDP ratios (see Chart 5, panel b). The largest reductions in investment expenditure were registered in the euro area Member States that faced the largest debt sustainability challenges, arguably limiting potential growth and aggravating sustainability risks (see Chart 5, panel c).

Chart 5

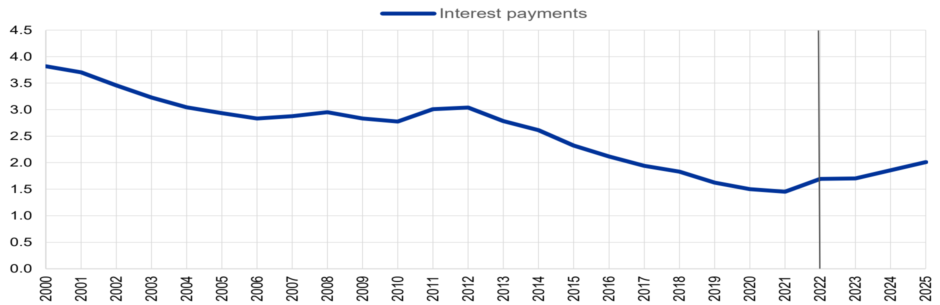
Euro area government investment and interest payments

(% of GDP)

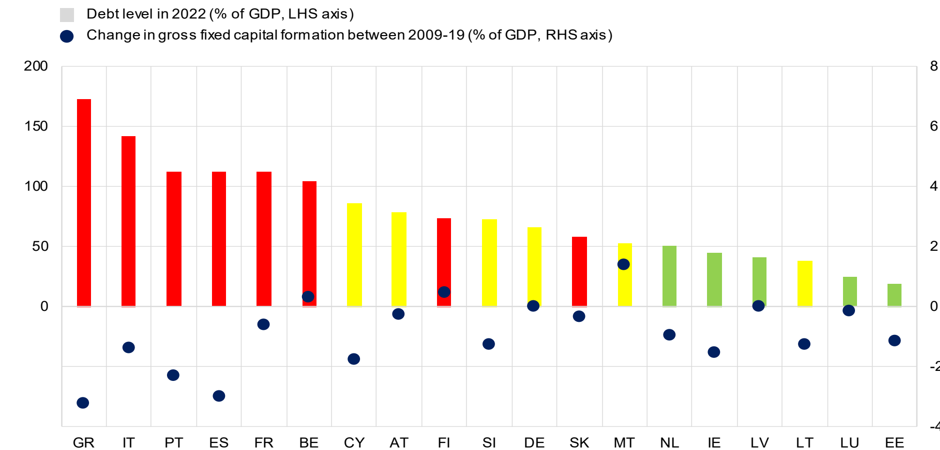
a) Government investment



b) Interest payments



c) Debt sustainability and change in investment



Sources: AMECO and ECB calculations.

Notes: The solid vertical line refers to the beginning of the forecast period. In panel c), the colour coding of countries is based on medium-term fiscal sustainability risk from the European Commission's Debt Sustainability Monitor of 2023. Colours in the chart correspond to fiscal sustainability risk categories: low (green), medium (yellow) and high (red).

Insufficient and procyclical public investment can raise challenges, notably for monetary policy. The reduction in public investment levels following the sovereign debt crisis reduced domestic demand during a time of recession while also undermining the growth potential. Panetta (2022) stresses the detrimental impact of low public investment levels on the resilience of the euro area economy, notably in the presence of supply shocks. Public investment has also become increasingly important for the green transition, which carries specific relevance from a price stability viewpoint.[20]

2.2.2 Overall assessment

Notwithstanding the weaknesses mentioned above, the SGP framework proved flexible enough to address the major economic shock caused by the COVID-19 pandemic and the more recent energy crisis. In response to the severe economic downturn resulting from the pandemic, in March 2020 the European Commission and the Council activated the SGP's so-called general escape clause.[21] The European Commission clarified that its activation did not suspend the procedures of the SGP, but rather allowed them "to undertake the necessary policy coordination measures within the framework of the SGP, while departing from the budgetary requirements that would normally apply, in order to tackle the economic consequences of the pandemic". Following the activation of the general escape clause, EU Member States were able to adopt the necessary fiscal measures, which in turn allowed the euro area to pursue an expansionary fiscal stance in response to the demand and supply shocks they were confronted with (see Chart 4). According to the September 2021 ECB staff macroeconomic projections for the euro area,[22] the magnitude of the euro area COVID-19-related emergency measures was estimated at around 4.2% of euro area GDP in 2020 and 4.6% of GDP in 2021. The fiscal response to the pandemic was followed by the measures taken in response to the energy crisis resulting from Russia's invasion of Ukraine. According to the Eurosystem staff projections of December 2022,[23] the total fiscal stimulus in the euro area related to the energy crisis and the war in Ukraine incorporated into the projections amounted to around 2% of GDP in 2022. A gradual unwinding of these measures began in 2023.

Broadly speaking, any balanced general assessment of the current fiscal framework requires a careful distinction between issues related to insufficient enforcement and issues pertaining to malfunctioning. In this regard it is important to acknowledge that, had the rules been fully complied with and enforced,

[20] Aside from presenting multiple physical risks to ecosystems and humans (International Panel on Climate Change, 2022), the climate crisis also poses economic and fiscal risks to EU Member States (Gagliardi et al., 2022) and would affect price stability (Heemskerk et al., 2022).

[21] This clause had been introduced as part of the "six-pack" reform of the SGP in 2011, drawing on the lessons learned from the GFC.

[22] ECB staff macroeconomic projections for the euro area September 2021, available at: https://www.ecb.europa.eu/pub/projections/html/ecb.projections202109_ecbstaff~1f59a501e2.en.html#toc5.

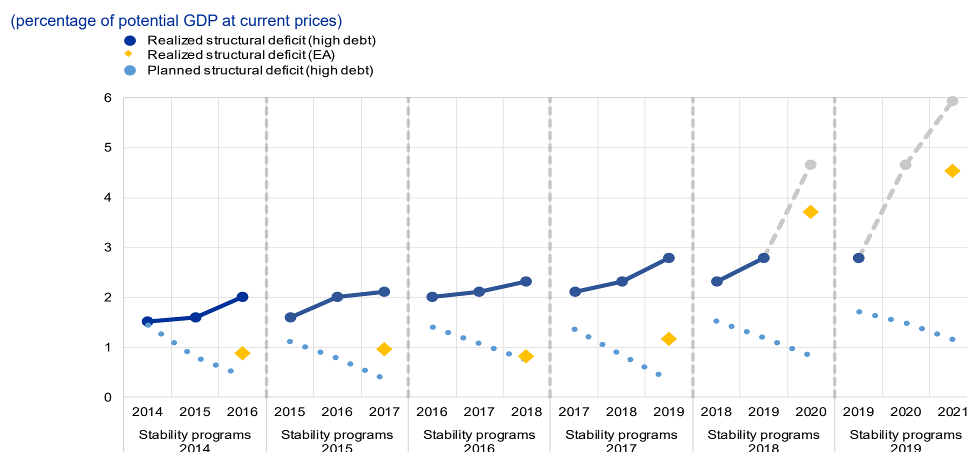
[23] Eurosystem staff projections December 2022, available at: https://www.ecb.europa.eu/pub/projections/html/ecb.projections202212_eurosystemstaff~6c1855c75b.en.html#toc6.

the authorities would have been able to achieve more favourable euro area fiscal positions than those that actually materialised in the run-up to the GFC and in the aftermath. This is shown by counter-factual model-based analysis for the euro area aggregate (see Box 1), which finds that had the rules been complied with, even with the real-time output gap estimates, the euro area would have built significant fiscal buffers in good economic times. The failure to do so is widely viewed as the SGP's Achilles' heel.[24] Had these buffers been built in the years prior to the summer of 2007, they could have been used to counter economic downturns, thus allowing for greater countercyclicality and more growth-enhancing government investment.[25] These findings are commensurate with the observation that especially those countries with high government debt frequently failed to comply with their own fiscal plans. As shown in Chart 6, such fiscal underperformance also became apparent in the period 2014-2019, when the output gap was approaching zero. Although the high-debt euro area countries were planning to bring down their structural deficits as part of their stability programmes, in line with SGP requirements, in practice the structural deficits increased – thus making the structural deficit reduction a moving target. The failure to deliver on the planned – usually SGP-compliant – fiscal objectives tends to reflect both insufficient national ownership of the fiscal rules (especially in countries with high debt) and obstacles to the enforcement of the SGP's rules at European level.

Chart 6

Structural deficits as moving targets

(percentage of potential GDP at current prices)



Sources: Stability programs & AMECO.
Notes: GDP-weighted average of high-debt countries: BE, CY, ES, FR, GR, IT and PT. The grey lines refer to the realised structural deficits in the years that the SGP's general escape clause was active and where adhering to initially planned structural deficits was not necessarily possible or optimal given the need for fiscal policy to respond to the COVID-19 crisis.

24 The European Fiscal Board Annual Report of 2020 highlights the tendency to relax the fiscal adjustment effort in a procyclical manner. Moreover, in its Annual Report of 2021 the European Fiscal Board indicates that the two waves of SGP reforms prior to the current one "attempted to plug a few consensual gaps 'revealed' by analyses of fiscal performance under the Pact, such as pro-cyclicality in good times and weak enforcement in all times".

25 Counterfactual analysis, such as the one presented in Box 1, does not account for the fact that output gaps, and thus structural fiscal positions, sent inaccurate signals in real time. The cyclical indicators in real time pointed to a smaller need for a fiscal adjustment compared to those available ex post. Any analysis based on an ex post assessment of cyclical conditions thus likely overstates the degree of impact of a debt reduction in the run-up to the GFC. That said, compliance with the SGP, even with the real-time output gap estimates. would still have led to the building of significant fiscal buffers.

Box 1: Counterfactual analysis for the euro area as a whole: fiscal outcomes in the case of full SGP compliance

Prepared by Krzysztof Bańkowski

Assessing the SGP through the lens of the realised economic outcomes is inherently difficult. One of the main challenges has to do with the fact that the observed outturns reflect not only the modalities of the framework but also, next to macroeconomic shocks, non-compliance by policymakers. This box attempts to illustrate a counterfactual macroeconomic scenario, in which countries would on average have entirely followed the provisions of the SGP throughout the EMU. The framework in the simulations is represented by the required path of a structural balance.

The counterfactual scenarios presented in this box are constructed by means of simulations with macroeconomic models. The first step of the analysis aims to gauge the additional amount of fiscal adjustment needed to fully comply with the SGP. Once known, step two is to simulate alternative paths of main macroeconomic variables that are consistent with the newly formulated fiscal policy.

Complying with the SGP would have required non-negligible fiscal effort in the first years of the EMU and the maintenance of a broadly balanced structural fiscal position thereafter. This conclusion is reached by simulating small country-individual models, which embed SGP provisions.[26] [27] Given that the EMU's inception in 1999 is associated with a noticeable structural deficit, a structural adjustment is called for (see Chart A). Significantly, the standard requirements are temporarily lifted amid the Great Financial Crisis so that the fiscal stimulus can be accommodated.[28] As fiscal positions differ across Member States, the contribution of countries to the euro area fiscal adjustment is uneven (see bars on Chart A).

[26] The small individual-country models are similar to those featuring into the Eurosystem's debt sustainability analysis (see Bouabdallah, O., Checherita-Westphal, C., Warmedinger, T., De Stefani, R., Drudi, F., Setzer, R. & Westphal, A. (2017), "Debt sustainability analysis for euro area sovereigns: a methodological framework", Occasional Paper Series No 185, European Central Bank) or those used in the analysis of spending rules conducted by the European Commission (European Commission (2019), Report on Public Finances in EMU 2019, Part II – Performance of spending rules at EU and national level – a quantitative assessment). They feature the SGP provision in their most recent form, most notably the flexibility matrix.

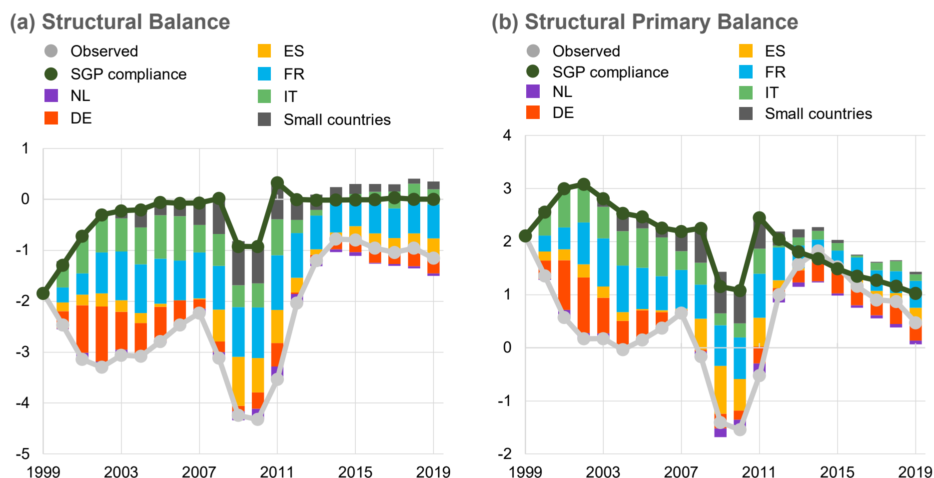
[27] A crucial adjustment to determine an SGP-stipulated adjustment is the output gap, which is unobserved and subject to significant revisions.

[28] The extent of the deviation from the balanced structural budget requirement is based on the size of the European Economic Recovery Plan (EERP) implemented at the time to counter the effects of the economic downturn.

Chart A

Additional fiscal adjustment, as captured by the euro area structural balance, needed to fully comply with the SGP

(percentage of GDP)



Source: Own calculations using small individual-country models featuring SGP provisions.
Note: The bars represent the country contributions to the euro area structural balances.

Once known, the additional fiscal adjustment can be used in euro area macroeconomic simulations. The analysis of the second step makes use of the semi-structural model for the euro area ECB-BASE, which contains a rich specification of the general government.[29] The actual fiscal policy is replaced in the model by the one consistent with full SGP compliance. The model is then re-simulated for the EMU period until 2019 and a counterfactual scenario is obtained. The simulations are conducted under the assumption of an exogenous monetary policy, notably with the policy rate remaining unchanged regardless of the fiscal policy course.[30]

According to the simulations, full compliance with the SGP would have markedly changed the past macroeconomic situation of the euro area. The initial fiscal adjustment would have tamed the brisk output growth seen during the early years of EMU (see Chart B). Significantly, the SGP would have ensured that sufficient buffers were in place, thus enabling an unfettered fiscal counter-response to the Great Financial Crisis. Furthermore, maintaining a broadly balanced structural position throughout the EMU period would have done away with the need to consolidate public finances. In reality, a major fiscal retrenchment took place amid the sovereign debt crisis and it aggravated the downturn, as illustrated by the simulations.

Adherence to the SGP would have left public finances in a significantly sounder shape than the state they were in. The maintenance of a structurally balanced fiscal position would have implied consistently higher headline balances, even with surpluses having been reached in good times. This would have kept the government debt ratio on a much more stable trajectory than what ultimately transpired.

The findings of the simulations rely heavily on the assumption that policymakers know in real time the prevailing cyclical conditions and are able to adjust policies accordingly. Given

[29] For a description of the model, including its fiscal block, see Bańkowski, K. (2023), "Fiscal policy in the semi-structural model ECB-BASE", *Working Paper Series* 2802, European Central Bank.

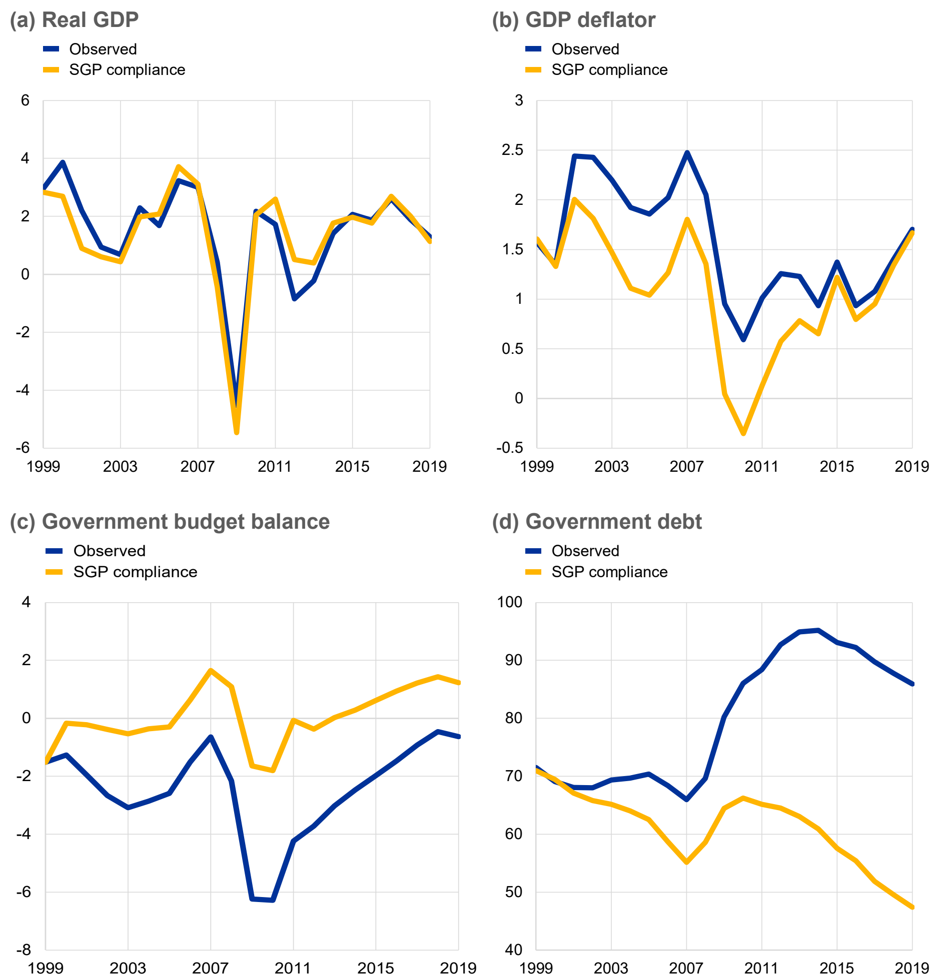
[30] See Bańkowski, K., Haroutunian, S. and Leiner-Killinger, N. (2023) for a description of the simulations.

the sizeable revisions to the output gap, accurate fiscal policy fine-tuning is very difficult in practice. Moreover, the cyclical indicators in real time pointed to a smaller need for a fiscal adjustment compared to those currently available ex post. In this context, the simulations likely overstate actual debt reduction in the run-up to the GFC. Nevertheless, even with the real-time estimates of the output gaps, compliance with the SGP requirements would have led to the build-up of significant fiscal buffers.

Chart B

Counterfactual scenarios assuming full SGP compliance with ECB-BASE

(percentage of GDP except real GDP and GDP deflator, which are expressed in percentage year-on-year growth rates)



Source: Own calculations using the ECB-BASE model.
Notes: The SGP compliance scenario assumes the degree of structural fiscal adjustment, as identified by the small country-individual models. The adjustment takes place on the expenditure side and it is broadly distributed equally over social transfers, government purchases and government investment. The selection of these fiscal instruments is predicated upon their somewhat discretionary nature and their notable historical contribution to shifts in fiscal policy stance.

3 The debate on fiscal reform

3.1 Dimension for SGP reform

The public debate on the review of the economic governance framework had been put on hold during the pandemic but was relaunched by the Commission with its Communication of 19 October 2021.[31] Some key challenges were identified in relation to the weaknesses already cited in the European Commission's launch of the review: (i) achieving a gradual, sustained and growth-friendly reduction in government debt – which had risen further during the pandemic – to prudent levels; (ii) achieving a necessary increase in public investment to support the green and digital transformation; (iii) ensuring the build-up of fiscal space, allowing for more countercyclical discretionary fiscal policy; (iv) enabling stronger policy coordination; and (v) achieving less complexity. The Commission invited all parties involved, including national central banks and the ECB, to engage in the public debate and to submit their contributions to the consultation by 31 December 2021.

In recent years, there have been manifold contributions to the debate on SGP reform, showing that there is no single "silver bullet" reform. Obviously, views in this debate were wide-ranging, covering many dimensions of the fiscal framework and avenues for reform.[32] Given the breadth of the debate, the below overview is inevitably incomplete.

To start with, it was generally accepted that the fiscal framework had become highly complex, with many calls to reform it. Ilzetzki E. (2021) cited a survey carried out by the Centre for Macroeconomics and the Centre for Economic Policy Research (CfM-CEPR), where only 2% of the surveyed fiscal experts were of the opinion that the fiscal rules should remain unchanged. The majority favoured a move towards a combination of greater reliance on independent fiscal institutions and having more flexible, countercyclical, expenditure-based rules; a preference was also expressed for a fiscal capacity at the EU level.

Certain elements featured regularly in the reform debate. The four elements that were, according to our reading, most frequently highlighted were: (i) the choice of the operational indicator guiding fiscal adjustment; (ii) the debt reduction path as the framework's objective, as well as the choice of its "debt anchor"; (iii) the role of the fiscal framework in incentivising government investment; and (iv) the governance and enforcement of the framework. This section looks at each of these four elements.

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[31] Commission Communication, "The EU economy after COVID-19: implications for economic governance," COM (2021) 662 final.

[32] See, for example, Anderson, J. and Darvas, Z. (2020), Hernández de Cos, P. (2021) and Maduro et al. (2021).

3.1.1 Choice of the operational indicator guiding fiscal adjustment

So far, two operational indicators – the change in the structural balance and the expenditure benchmark[33] – have been used in the SGP framework. The reliance on two indicators, which can give conflicting readings, at times led to cherry-picking of indicators when assessing compliance, as well as increased complexity. Consequently, to simplify the framework, it was argued that reliance should be placed on a *single* operational indicator.[34]

While there is no perfect operational indicator, the expenditure benchmark is less volatile, has better cyclical properties, and can be better controlled by governments than the structural balance.[35] First, unlike the structural balance, the expenditure benchmark does not rely on a real-time estimate of the annual output gap, but rather on a ten-year average nominal potential growth rate which is less prone to ex post revisions, thus reducing volatility. Second, revenue developments – except for discretionary tax changes – are disregarded, which avoids the procyclicality of the structural balance related to the occurrence of revenue windfalls and shortfalls. Lastly, expenditures are under the direct control of the government, which facilitates implementation. It should be noted, however, that the structural balance has gained acceptance in some Member States, as it is a concept based on the budget balance and thus directly linked to the debt level. Moreover, the expenditure benchmark is not a perfect indicator itself, as there is no common methodology when it comes to evaluating discretionary revenue measures, among other reasons.

Some of the advantages of the expenditure benchmark over the structural balance were evident when looking at the fiscal performance of euro area countries over the preceding decade. For example, during the sovereign debt crisis the measurement of the fiscal stance based on the expenditure benchmark shows significantly more tightening in some of the high-debt euro area countries compared to the structural balance (see Chart 7). This is because the fiscal stance, as measured by the change in the structural balance, was affected by revenue shortfalls, which worked against the actual consolidation effort made by those countries. Conversely, the expenditure benchmark, which is far less affected by

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[33] According to the European Commission's Vade Mecum of the SGP (2019), the structural balance is defined as the cyclically-adjusted general government balance net of one-off and other temporary measures. The cyclically-adjusted balance in turn removes from the budget balance the impact of the economic cycle and thus provides a view on the underlying budgetary position. The expenditure benchmark aims to ensure that Member States' policies are consistent with either remaining at the MTO or being on an appropriate adjustment path towards it. For Member States that have attained their MTOs, annual expenditure growth should not exceed a reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures. For Member States that have not attained their MTO, annual expenditure growth should not exceed a specific lower rate, which is set below the reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures. The difference between the appropriate growth rate for net expenditure and the reference medium-term rate of potential GDP growth is referred to as the convergence margin and is set so as to ensure the appropriate adjustment towards the MTO. The expenditure benchmark applies to an expenditure aggregate that excludes interest expenditure, expenditure on EU programmes fully matched by EU fund revenue, and cyclical elements of unemployment benefit expenditure. In addition, nationally-financed government investment is averaged over a four-year period to smooth the impact of any large investment projects.

[34] See, for example, Benalal et al. (2022) and Alloza et al. (2021).

[35] See Mohl and Mourre, 2020.

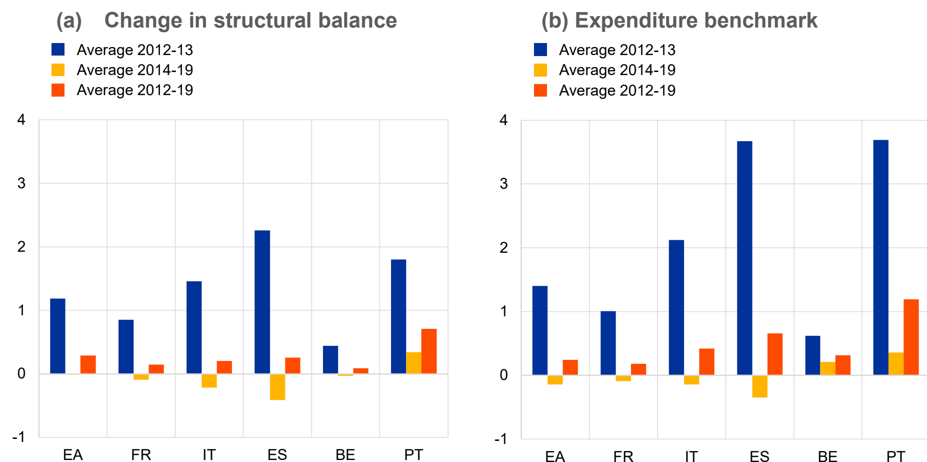
revenue shortfalls, painted a more accurate picture of the underlying fiscal effort. The differences between the two indicators in measuring the fiscal stance were considerably smaller over the period 2014-19, when the euro area was returning to more normal economic times following the crisis years. Detailed analysis by Benalal et al. (2022) of the differences between the two indicators when measuring the fiscal stance shows that the key drivers are revenue windfalls and shortfalls as well as revisions in potential output.

Overall, there appears to have been rather broad support for the expenditure benchmark in the literature, which is cited as having important advantages over the structural balance. Therefore, many reform proposals, including those emanating from the European Commission (see Section 4), the European Fiscal Board (2020a), and Hauptmeier et al. (2022), have advocated the expenditure benchmark as the best available operational indicator in the SGP framework.[36]

Chart 7

Fiscal stance measures (Expenditure Benchmark (EB) and change in structural balance (ΔSB)), 2012-19

(% of GDP)



Sources: AMECO and ECB computations.
Note: Calculations are based on ex post data.

3.1.2 A "debt anchor"

Ensuring the sustainability of public finances lies at the core of the SGP, and reform proposals have acknowledged and built around this central principle. The vast majority of proposals to reform the SGP favoured having the debt-to-GDP ratio as the anchor rather than the MTO. A notable exception was the proposal of Blanchard et al. (2021), who called for an abandonment of fiscal rules in favour of fiscal standards, i.e. qualitative prescriptions together with a potentially judicial

[36] Buettner (2023), by contrast, stresses the advantages of the MTO over the expenditure benchmark. He considers that a move away from the MTO would imply the absence of "simple benchmarks that define whether public finances are complying with the rules".

process to decide whether the standards are met. Many proposals (Bénassy-Quéré et al., 2018; Giavazzi et al., 2021; Hauptmeier et al., 2022; etc.) argued in favour of maintaining a uniform debt target of 60% of GDP, implying no need for Treaty change. Francová et al. 2021 also proposed a uniform debt target, but raised it from 60% to 100% of GDP. Other proposals called for medium-term country-specific debt targets which, in some cases, are subject to revision at regular intervals (e.g. Bénassy-Quéré et al., 2018). The proposal by Martin et al. (2021) was an exception among the group of proposals surveyed, because, in addition to calling for medium-term country-specific debt anchors, it also explicitly advocated the at least de facto (and in time de jure) removal of the numerical criteria on public debt (60% of GDP) and deficit (3% of GDP), as laid down in Protocol 12 annexed to the TFEU.[37]

In addition, several proposals foresaw a reform of the SGP's debt rule given that it implied overly large adjustment requirements for some highly indebted countries. Francová et al. (2021) proposed maintaining the 1/20th pace of adjustment but only after the debt anchor was raised to 100% of GDP. Meanwhile, Hauptmeier et al. (2022) proposed a slower pace of adjustment, such as 1/33rd of the excess over the 60% of GDP threshold, while keeping the Treaty's 60% of GDP debt anchor unchanged and tiering it with the expenditure benchmark. This approach maintained the debt rule's advantage of differentiating the actual size of the required adjustment with the size of the gap to the debt anchor. Giavazzi et al. (2021) proposed that debt be decomposed into a fast- and a slow-speed portion, with a 1/20th and 1/50th pace of adjustment, respectively. The latter pace of adjustment would be for debt accumulated for financing public investment and expenditures that contribute to European public goods ("spending for the future").[38] The EFB proposed an adjustment speed that declines with the level of debt and the interest-growth differential towards a uniform target. Chopin et al. (2022) generally proposed suspending the debt reduction rule for as long as economic activity remains below potential.

3.1.3 Incentives for government investments

The reform debate also addressed how a reformed fiscal framework could provide incentives for investment, while ensuring fiscal sustainability. It reflected two dimensions. First, avoiding past experiences of debt reduction coming

[37] Martin et al. (2021) make the point that uniform numerical criteria are misplaced because debt sustainability depends fundamentally on the interest-growth differential and on a country's capacity to maintain a sufficient primary surplus. They argue that these determinants of debt sustainability are all very much country specific. They therefore propose setting a country-specific debt target based on an assessment of the sustainability risk.

[38] More specifically, Giavazzi et al. (2021) define the slow-adjusting portion of debt as the sum of debt accumulated in response to "crises" (defined as periods when the EU general escape clause is active) and the debt accumulated to finance "spending for the future", for example public investment that is beneficial for the long-run growth prospects and expenditures that contribute to some European public goods that will benefit future generations. The fast-adjusting portion of debt would then be the residual stock of debt. Their proposal can be viewed as a golden rule approach that favours "spending for the future" in two ways. First, by making certain categories of spending not subject to the spending ceiling and second, by having the same categories of spending contribute to the computation of the slow-adjusting portion of debt.

at the cost of lower government investment and second, catering for sizeable future investment needs.

Public investment needs related to long-term challenges featured prominently in the debate. This reflected the fact that the EU and its Member States have undertaken binding commitments under the Paris Agreement to reduce greenhouse gas emissions, with this objective having been transposed into the EU legal order through the European Climate Law. While estimates differ and other climate policies, such as carbon pricing, influence the required amount of public investment, annual additional public investment needs in the EU in the period 2021-30 could reach 1.0 to 1.8% of GDP (Delgado-Téllez et al., 2022). Other public investment needs that have been identified relate to the digital transition and more generally to increasing the resilience of Member States following Russia's war of aggression against Ukraine and increased geopolitical instability. The latter comprise investment needs relating to defence, energy security and broader open strategic autonomy. Overall, the European Commission (2023) estimated that €620 billion of additional annual investment, both private and public, will be needed to meet the objectives of the Green Deal and REPowerEU, meaning that there are considerable long-term public investment needs and efforts to be made – reaching well beyond the horizon of the NGEU's Recovery and Resilience Facility (RRF).[39]

The reform discussions addressed various proposals to incentivise investment, revealing also that use of the provisions entailed in the pre-reform framework had been limited. Among these proposals was the possible introduction of a (green) golden rule.[40] One rationale for excluding green public investment from fiscal rules indicators is that such investment may be more affected in times of fiscal consolidation due to its delayed political payoff and the potential for some countries to free ride on others' efforts (Darvas and Wolff, 2022). Arguments against such a mechanism included, inter alia, mixed practical experiences (Delgado-Téllez et al., 2022), incompatibility with the core objectives of EU fiscal rules (German Government, 2022), or being less desirable than an EU-level approach (European Fiscal Board, 2022). Bénassy-Quéré (2022) indicated that the "investment clause", which had been introduced as a flexibility mechanism for the SGP in 2015, had some notable strings attached[41] and thus "seems to be of little help for the problem at stake, which is the need to heavily co-invest (along with the private sector) in the green transformation of the economy".

[39] Beyond 2030 and up to 2050, investment needs in energy systems would reach 3.2% of EU GDP, compared with 1.7% of GDP for actual investments in 2011-2020 (European Commission, 2024).

[40] Some proposals also looked into excluding, from fiscal rules, investments related to public goods and those taking place through EU programmes, such as climate- and energy-related loans under the RRF and REPowerEU (Lindner & Redeker, 2023).

[41] Bénassy-Quéré (2022) highlights that only those investments that are co-financed by the EU are eligible, with recourse to the clause being limited to only when the output gap is below -1.5%. Moreover, only limited and short-lived deviations of the structural deficit are allowed.

3.1.4 Governance and enforcement

A key issue identified regarding the governance, implementation and enforcement of the SGP was the degree of centralisation or decentralisation involved in the process. While the Commission plays a prominent role in fiscal surveillance, the decision-making process for the implementation and enforcement of the framework involves both the Commission and the Council of the European Union. In fact, the latter may decide to follow or to reject Commission proposals or recommendations, as happened in the case of Germany and France in 2003, when the Commission proposed to step up their excessive deficit procedures.[42]

Some called for a clearer delineation of the roles between European institutions and bodies involved in fiscal surveillance to reduce dilution of accountability. Bénassy-Quéré et al. (2018) advocated a clear allocation of responsibilities, coupled with a separation between the role of the fiscal watchdog (prosecutor) and the political decision-taker (judge). Currently, the Commission combines both roles. A gradual move towards further supranational decision-making on fiscal policy, based on common institutions, was already part of the proposals formulated in the Five Presidents' Report, followed by a Commission communication on a European Minister of Economy and Finance.[43] However, the idea did not garner sufficient political support among Member States.

A bigger role for national independent fiscal institutions was frequently advocated, as a means of strengthening national ownership. It was argued by many that country-specific expertise should play a greater role, which would entail a greater decentralisation of fiscal surveillance, through greater involvement of national independent fiscal institutions (IFIs), along with a stronger role for the European Fiscal Board in fiscal surveillance. Giavazzi et al. (2021) proposed that projections on the achievement of debt targets should be prepared by governments but certified by a national IFI. Meanwhile, Martin et al. (2021) called for the adequacy of national debt targets to be assessed by IFIs based on a common methodology for assessing national fiscal sustainability, which in turn would be defined by the European Fiscal Board. Bénassy-Quéré et al. (2018) called for the debt target and nominal expenditure path to be proposed by IFIs and then approved by a euro area fiscal watchdog. The European Fiscal Board (2020b) suggested differentiating the adjustment speed towards the debt anchor based on the IFI's expertise, with the role of assessing compliance with the expenditure ceiling and calculating deviations from the rule being reserved for the Commission. Blanchard et al. (2021) proposed a country-specific stochastic debt sustainability analysis to be carried out by the IFIs or

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[42] This led to a dispute between the Commission and the Council that ultimately had to be resolved by the Court of Justice of the European Union. See Case C-27/04 Commission v Council, ECLI:EU:C:2004:436. The degree of the Commission's autonomy in matters of fiscal surveillance has varied over time. While the 2005 reform of the SGP constrained the Commission's flexibility by increasing the number of rules, the 2011 reform introduced reversed qualified majority voting, which was intended to strengthen the Commission's role in the decision-making process by making it more difficult for the Council to reject a Commission recommendation (Benassy-Quéré et al., 2018). Reversed qualified majority voting was further extended through Article 7 of the TSCG.

[43] "A European Minister of Economy and Finance", COM(2017)823, 6 December 2017.

the Commission, which would then also assess whether the “fiscal standards” had been met in collaboration with the European Fiscal Board.

It was argued that there are limits to a significant decentralisation of surveillance, as there is also a need to harmonise the IFIs’ capabilities before greater reliance can be placed on them in EU surveillance procedures. Box 2 suggests that there is heterogeneity in the IFIs’ capabilities and resources across different EU Member States. Harmonising their capabilities and standards would thus be crucial before they can play a more central role in EU surveillance procedures.

It was also acknowledged that greater decentralisation and reliance on independent assessment should not undermine the decision-making powers conferred on the Commission and the Council by the Treaties. A more decentralised approach to fiscal surveillance would therefore need to be counterbalanced with more effective central enforcement. For instance, any delegation of tasks would have to stay within the confines of the Meroni doctrine.[44] Indeed, these calls for further decentralisation tended to relate more to the assessment and surveillance phases of governance, while the reform debate typically recommended that decision-making and enforcement be attributed to the Council.[45]

Lastly, some proposals addressed the observation that the use of sanctions and fines had proven politically difficult. Ideas were put forward on the merits of using positive incentives as a way to ensure fiscal discipline. Kamps and Leiner-Killinger (2019), Francová et al. (2021) and Benassy-Quéré et al. (2018) argued that linking disbursement of EU funds or access to a potential central fiscal capacity to compliance with the fiscal rules could be effective in incentivising fiscal discipline. The latter proposal also advocated a greater role for market discipline, with spending in excess of targets to be financed by junior bonds and with stronger institutional and legal underpinnings for sovereign debt restructuring (see also Fuest et al., 2016). The IMF called for greater automaticity in enforcement, with a gradual step-up of monitoring and constraints (Andrle et al., 2015). Some suggested increasing the powers of the European Parliament to improve SGP enforcement and compliance (Mohl et al., 2021; Fasone, 2014; Alcidi et al., 2014).[46]

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[44] The CJEU has recognised the possibility for Union institutions to delegate powers to independent executive or regulatory bodies, insofar as the delegation relates to clearly defined executive competences, meaning that no power for making policy choices may be granted to the delegated body. According to the Meroni case law (Case 9/56 Meroni), a delegation involving “discretionary power implying a wide margin of discretion which may, according to the use which is made of it, make possible the execution of actual economic policy” would imply an illegal transfer of responsibility by substituting the choices of the delegator with those of the delegate.

[45] For example, Martin et al. (2021) contend that the Council should take the ultimate decision on national debt targets plus the option to reject national budgets if fiscal sustainability is put at risk. The European Fiscal Board (2020b) also argues that the Council’s agreement on adjustment speed and the related expenditure growth ceiling towards the debt anchor is necessary. Deutsche Bundesbank (2019) argues that the Council should continue to decide on the existence of excessive deficits. Maduro et al. (2021) argue that the Commission and the Council should maintain their roles in the governance and enforcement spheres and that this should be complemented by a greater role for IFIs.

[46] From a legal perspective, extending the role of the European Parliament also has its limits, given that the SGP concerns national government, and not EU-level, policy decisions, meaning the European Parliament would likely be restricted to providing accountability and oversight checks on the Commission and Council only.

Box 2: Role of independent fiscal institutions in supporting SGP compliance

Prepared by Marguerite O'Connell, Andrei-Bogdan Sterescu and Stephan Haroutunian

Empirical research suggests that independent fiscal institutions (IFIs) have a positive impact on fiscal outcomes,[47] **and that efforts to strengthen their role in the economic governance framework would be warranted.**[48] For instance, there is suggestive evidence that the presence of IFIs seems to eliminate optimistic biases in budgetary forecasts and to improve their accuracy, thereby fostering compliance with budget-balance and expenditure rules.[49] The success of IFIs in promoting compliance does vary between Member States, which can be attributed to various factors, including "local ownership" of the IFI, their tasks, resources, access to information, functional independence, and relations with stakeholders, i.e. the legislature, executive and media[50]. However, countries with a priori stricter fiscal rules may tend to exhibit a higher degree of compliance regardless of the relative strengths of IFIs.[51] Thus, it is important to acknowledge the broader political context in which IFIs operate. This context affects the overall effectiveness and impact of IFIs, which should be seen as one component in supporting national ownership and compliance with the SGP.

Despite the positive impact of IFIs on fiscal outcomes, there is considerable heterogeneity in their resources and experience across EU Member States. Although the metrics presented in Chart A below do not paint the full picture of the capabilities and effectiveness of IFIs, they still show that experiences with IFIs differ across EU countries. Whereas countries like Austria, Belgium, Denmark and the Netherlands have a comparatively long history with such institutions, in the majority of EU Member States this type of institution was set up relatively recently. There also appears to be significant differences in terms of the resources at the disposal of these institutions, as proxied by the number of staff per ten million of population, as well as the scope of their activities, as measured by the Commission's Scope Index of Fiscal Institutions.

[47] See Reuter (2019) and Dimitra (2021).

[48] The framework first obliged Member States to establish national IFIs through Council Directive 2011/85/EU, and thereafter strengthened the role of IFIs for euro area Member States through Regulation (EU) No 473/2013 and the Fiscal Compact in 2013.

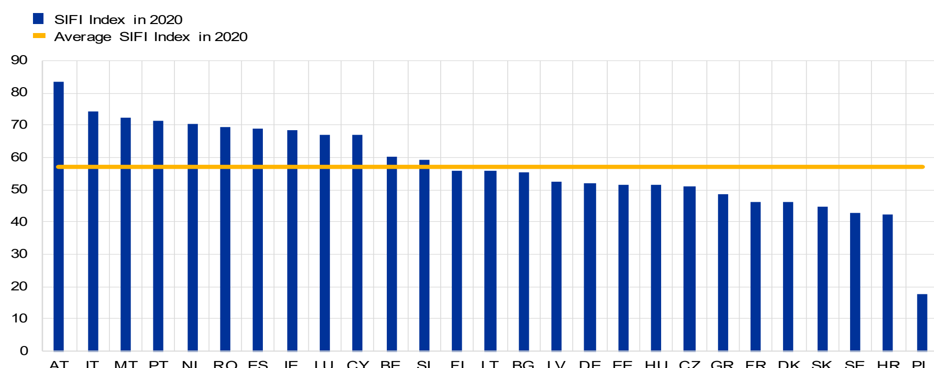
[49] See Beetsma et al. (2019).

[50] See Larch et al. (2021) and Horvath (2018).

[51] See Debrun et al. (2014).

Chart A

Heterogeneity in Independent Fiscal Institutions



Country	AT	IT	MT	PT	NL	RO	ES	IE	LU	CY	BE	SI	FI	LT	BG	LV	DE	EE	HU	CZ	GR	FR	DK	SK	SE	HR	PL
Start of activity	1970	2014	2015	2012	1945 and 2014	2010	2014	2011	2014	2014	1989 and 1994	2015	2013	2015	2015	2014	2013	2014	2009	2017	2010	2013	1962	2012	2007	2013	-
Number of employees per 10 million of population	23.4	3.6	57.7	21.3	80.7	7.9	7.6	15.7	124.2	54.3	93.5	33.2	265.6	32.0	12.3	52.8	1.8	60.1	7.2	14.3	13.4	1.6	78.8	37.6	11.5	15.5	-

Sources: IMF Fiscal Council Dataset: 2021 Update, European Commission's Scope Index of Fiscal Institutions 2020 Vintage, and Eurostat.
Notes: As of 2015, as part of the new Fiscal Governance Database methodology, the European Commission introduced a Scope Index of Fiscal Institutions (SIFI) that aims to measure the breadth of tasks discharged by Independent Fiscal Institutions (IFIs). The SIFI index is calculated only for "core IFIs", based on information reported by these institutions themselves. Six separate groupings of tasks constitute the SIFI index: (1) monitoring of compliance with fiscal rules; (2) macroeconomic forecasting; (3) budgetary forecasting and policy costing; (4) sustainability assessment; (5) promotion of fiscal transparency; and (6) normative recommendations on fiscal policy. The latest vintage of the SIFI index refers to the year 2020 (the first vintage refers to 2015). The index offers a relevant image of the mandate of various institutions but should not be taken as a full proxy of their effectiveness.

Several changes have been recommended to enhance the role of IFIs, thereby fostering national ownership and accountability and ultimately promoting better fiscal outcomes. These include improving access to information among IFIs;[52] enhancing their public and media presence, such as by requiring IFIs to attend hearings before national parliaments;[53] and providing for a legally binding and robust "comply or explain" mechanism for governments, obliging them to react to the recommendations made by IFIs[54]. It has also been proposed that IFIs should play a bigger role by raising awareness of the interaction between national fiscal policies and the aggregate euro area fiscal stance, alongside the EU IFI Network and the European Fiscal Board. There have also been calls for the role and institutional set-up of the European Fiscal Board to be strengthened so as to align its set-up with the principles applicable to national IFIs.[55]

[52] See Horvath (2018), Dimitra (2021), Davoodi et al. (2022), OECD (2017), IFI Network (2022) and Fromage (2017).

[53] See IFI Network (2021), Larch et al. (2021), OECD (2017) and Fromage (2017).

[54] See ECB (2018) and Horvath (2018).

[55] See Tesche (2021), ECB (2015), European Court of Auditors (2019) and Asatryan et al. (2018).

3.2 The contributions of the Eurosystem and other stakeholders to the debate on SGP reform

Many governments contributed to the reform debate. Following the invitation by the European Commission for all stakeholders to engage in the public debate on the economic governance review, various governments communicated on the issue, mostly through non-papers. These communications revealed some rather differing views. For example, on the issue of the mechanism of fiscal adjustment, the German Government's non-paper[56] indicated that this should be based on common rules with full compliance with the SGP's preventive arm being sufficient to qualify as compliance with the SGP's debt rule. In a joint article in the Financial Times in December 2021, French President Macron and the then Italian Prime Minister Draghi referenced the article by Giavazzi et-al (2021), which also called for common rules, with the Commission having the power to grant a temporary reduction of adjustment speed if the rules called for excessive fiscal effort. Meanwhile, in a joint non-paper the Spanish and Dutch governments indicated a preference for country-specific medium-term fiscal plans which combine investments and ambitious reform commitments with appropriate safeguards to ensure minimum standards. While a greater focus on expenditure rules gained traction, in the first of two German non-papers (2022) an explicit reference was made to keeping the MTO and the structural balance at the heart of the framework. In April 2023, the German Government released a further non-paper in which it advocated the use of certain numerical benchmarks.[57]

In 2021, the Eurosystem outlined its high-level principles regarding the economic governance review and the completion of EMU. In its reply to the European Commission's communication dated 1 December 2021, the Eurosystem stressed the importance of sustainable fiscal positions for price stability and sustainable growth in a smoothly functioning EMU. It underlined the need for the fiscal framework to guide a realistic, gradual and sustained adjustment of public debt. It noted that beyond reducing debt heterogeneity this would help to rebuild fiscal space, which is crucial for ensuring the countercyclicality of fiscal policy. The reply also indicated that greater transparency, predictability and simplification of the framework could be achieved through reduced reliance on the unobservable output gap and an increased role for expenditure rules. The need for common rules was stressed as well as the possibility for broadened, fully independent assessment by strong independent fiscal institutions. Improving the growth-friendliness of public finances was also highlighted, given the need for a green and digital transition. Last but not least, completing EMU through an appropriately designed central fiscal capacity was seen as a necessary means to enhance macroeconomic stabilisation and convergence in the euro area in the longer run.

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[56] 05/08/2022 "Proposed principles to guide the German government in deliberations on the reform of EU fiscal rules".

[57] Among other suggestions, this second German non-paper proposed that all countries where debt exceeds 60% of GDP should keep the growth rate of expenditure below potential growth. The difference between potential growth and net primary expenditure growth ("convergence margin") would increase depending on the debt-to-GDP ratio (e.g. the convergence margin should be 1% at least for high-debt countries).

3.3 Legal feasibility and procedural requirements for reform

A key consideration underpinning the reform debate related to the legal feasibility and procedural requirements for amending the various elements of the SGP. A hierarchy of legal provisions underpins the SGP framework, ranging from Treaty provisions to non-binding soft law instruments, such as communications or opinions.[58] Thus, these legal and procedural considerations had a significant influence on the scope and ambition of the reform proposals. Further details are provided in Box 3 below.

Box 3: Legal considerations

Prepared by Marguerite O'Connell and Iñigo Arruga Oleaga

The legal feasibility and procedural requirements for the reforms were dependent on where the provisions had been codified in the hierarchy of legal provisions governing the SGP (Chart A). First, Article 126 TFEU sets out the obligation on Member States to avoid excessive deficits, to be assessed by the Commission and the Council based on whether the ratios of deficit or debt to gross domestic product exceed certain reference values. Second, Protocol No 12 specifies those reference values as 3% and 60% respectively. Third, secondary legislation – the "six-pack" and the "two-pack" – further specified the legal framework, including the Regulation on the preventive arm of the SGP[59], the Regulation on the corrective arm of the SGP,[60] a Council Directive on requirements for budgetary frameworks of Member States,[61] and a Regulation on common provisions for monitoring and assessing the budgetary plans of euro area Member States.[62] Fourth, in 2013 the SGP was reinforced by an intergovernmental agreement with the official title "Treaty on Stability, Coordination and Governance" (TSCG), which includes the "Fiscal Compact". Lastly, soft law instruments such as the SGP Code of Conduct and the Commission's Vade Mecum on the SGP set out further requirements for the interpretation and application of the legal texts.

Some of the reform proposals outlined during the overall debate on the reform of the European fiscal rules would have required recourse to specific procedures for the amendment of primary Union law. For instance, increasing or decreasing the numeric 3% or 60% reference values would have required an amendment to Protocol No 12 by means of a special legislative procedure. Such amendment would have required adoption by the Council under Article 126(14) TFEU, after consulting the European Parliament and the ECB. However, going further and

58 In the context of the EU legal order, "soft law" instruments can be understood as non-binding acts, such as opinions, recommendations, guidelines, notices or communications. For reasons of transparency, and in order to ensure equal treatment and legal certainty, the Commission or other Union institution may publish acts of "soft law" with a view to announcing how it interprets, applies and/or intends to make use, in certain situations, of discretion in the legal framework. See Opinion of Advocate General Wahl in Case C-526/14 – Kotnik and Others, ECLI:EU:C:2016:102, para. 38.

59 Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 209, 2.8.1997, p. 1.

60 Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L 209, 2.8.1997, p. 6.

61 Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, OJ L 306, 23.11.2011, p. 41.

62 Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area, OJ L 140, 27.5.2013, p. 11.

abolishing the requirement to comply with reference values altogether would have required a simplified Treaty revision under Article 48(6) Treaty on European Union (TEU). Under the simplified Treaty revision procedure, the European Council may decide by unanimity to amend Article 126 TFEU, after consulting the European Parliament, the Commission and the ECB. Such a decision could only enter into force following approval by the Member States in accordance with their respective constitutional requirements. The simplified Treaty revision procedure had already been used to amend Article 136 TFEU, in the context of the European Stability Mechanism.[63]

By contrast, other reform proposals could be achieved through amendments to secondary Union law. This was the approach taken by the Commission's package of proposals published on 26 April 2023, and ultimately adopted by the Union on 29 April 2024 (see Chart B and section 4 below).

For instance, aspects such as the reform of the debt rule could be achieved by amending the SGP corrective arm by means of a special legislative procedure. Such an amendment requires the Council to act unanimously, after consulting the European Parliament and the ECB, in accordance with Article 126(14) TFEU. While the debt rule was also enshrined in the TSCG, a corresponding amendment to that intergovernmental agreement is not actually required. Amending the TSCG requires unanimous agreement among the parties to that intergovernmental agreement, and national ratification in accordance with their constitutional requirements. However, the unique nature of the Union legal order, in particular the principle of supremacy, obviates the need for a corresponding amendment of the TSCG. The TSCG itself explicitly acknowledges that its interpretation and application is subject to the principle of supremacy,[64] and requires compliance with the debt rule "as provided for in Article 2" of the SGP corrective arm.[65] This careful deference to the provisions of secondary Union law was designed to ensure consistency of the TSCG with the SGP and with the case law of the Court of Justice of the European Union (CJEU).[66] When delivering its ruling on another intergovernmental agreement, namely the ESM Treaty, the CJEU held that Member States are entitled to conclude agreements between themselves "provided that the commitments undertaken by the Member States who are parties to such agreement are consistent with European Union law." Moreover, the CJEU emphasised that "Member States are prohibited from concluding an agreement between themselves which might affect common rules [on economic and monetary policy] or alter their scope". Thus, the TSCG must be read in accordance with the related provisions of prevailing secondary Union law as they may be in force from time to time. Any provisions of the TSCG which contradict or undermine secondary Union law must be disapplied by the Member States,[67] as agreements such as the TSCG are subordinated to both primary and secondary Union law.[68] Therefore, in principle, the TSCG would not be an obstacle to

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63 European Council Decision 2011/199/EU of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro, OJ L 91, 6.4.2011, p. 1.

64 Article 2(1) of the TSCG requires that the TSCG must be applied and interpreted by the contracting parties in conformity with the Treaties on which the European Union is founded, in particular Article 4(3) of the Treaty on European Union and with Union law, including procedural law whenever the adoption of secondary legislation is required. Moreover, Article 2(2) of the TSCG states that the TSCG applies insofar as it is compatible with the Treaties on which the European Union is founded and with Union law, and that it must not encroach upon the competence of the Union to act in the area of the economic union.

65 Article 4 of the TSCG.

66 Case C-370/12 Thomas Pringle v Government of Ireland, ECLI:EU:C:2012:756, paras. 101 and 109.

67 Dullien et al. (2022).

68 Weismann (2021). See also Case 237/87 Matteucci, ECLI:EU:C:1988:460, para. 22; Case C-103/06 Derouin, ECLI:EU:C:2008:185, para. 25.

the evolution of the SGP in accordance with TEU and TFEU provisions in matters covered by the TSCG.

Amendments to the SGP preventive arm could address aspects such as the move away from the concept of the structural balance towards an expenditure rule. The SGP preventive arm can be amended by the European Parliament and the Council, acting by means of the ordinary legislative procedure, with the Council voting by qualified majority, in accordance with Article 121(6) TFEU. As noted above, the structural balance and output gap were features of the assessment of compliance with the MTOs under the SGP preventive arm.[69]

Amendments to soft law instruments would have offered some possibilities to recalibrate the focus on the structural balance, or to use flexibility within the legal framework. Soft law instruments provide clarity on how the legal framework will be interpreted and applied by Union institutions. For instance, the implementation of the SGP, including the calculation of the structural balance under the SGP preventive arm, has been further specified in the Code of Conduct on the SGP.[70] Further soft law instruments include the Vade Mecum on the SGP[71] and Commission communications.[72] In principle, soft law instruments do not require formal adoption, beyond the requirements of the rules of procedure of the committees or institutions from which they emanate. However, both the Council and the Commission – as the institutions responsible for the application of the SGP under Article 126 TFEU – need to at least tacitly agree on the interpretative and methodological approaches set out under such soft law instruments.[73]

Lastly, strengthening the role of independent fiscal institutions (IFIs) could be achieved through amendments to the Council Directive on requirements for budgetary frameworks of the Member States. Amendments to the Council Directive can be adopted by the Council, acting by qualified majority voting, after consulting the European Parliament, in accordance with the third subparagraph of Article 126(14) TFEU. Strengthening the role of IFIs in euro area Member States could have been achieved through amendments to the “two-pack” Regulation on common provisions for monitoring and assessing the budgetary plans of euro area Member States. Regulation (EU) No 473/2013 can be amended by ordinary legislative procedure, with only euro area Member States participating in the vote in the Council.[74]

[69] Article 5 of the SGP preventive arm. See also Article 3(1)(b) of the Fiscal Compact.

[70] Opinion of the Economic and Financial Committee of the Council (EFC) on Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes.

[71] European Commission (2019), Vade Mecum on the Stability and Growth Pact.

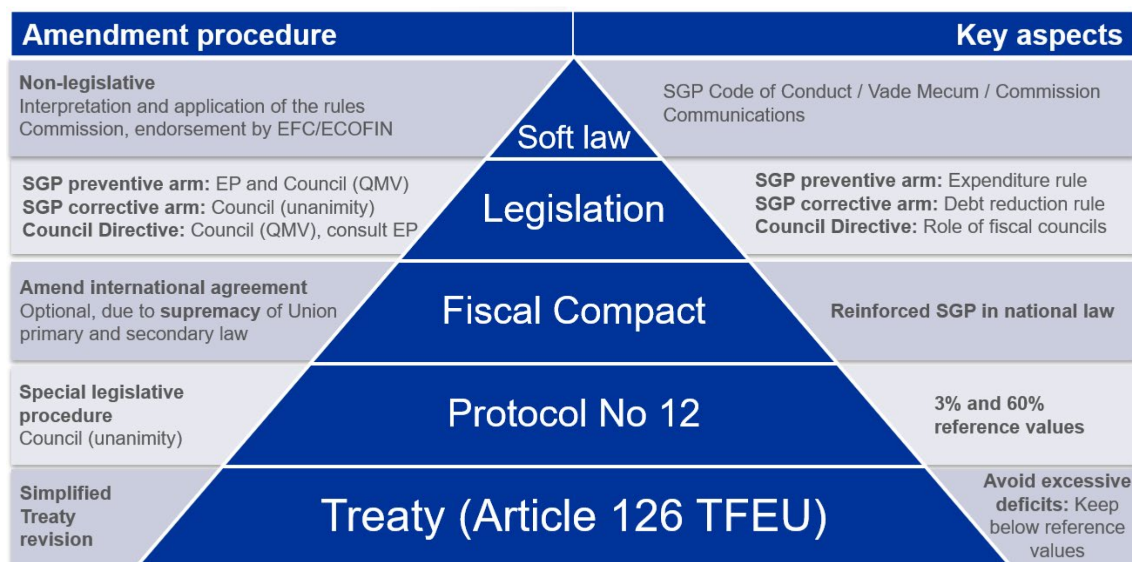
[72] European Commission (2015), “Making the best use of flexibility within the Stability and Growth Pact”, COM (2015) 12 final.

[73] For instance, the Council explicitly endorsed the EFC opinion setting out the SGP Code of Conduct on 16 June 2017.

[74] Articles 136 and 121(6) TFEU.

Chart A

Legal boundaries affecting the reform debate



Source: ECB Staff.
Note: The acronyms denote the following: EFC (Economic and Financial Committee), ECOFIN (Economic and Financial Affairs Council configuration), EP (European Parliament), QMV (Qualified Majority Voting), EA (euro area).

Chart B

The European Commission's legislative proposals of 26 April 2023

Source: ECB Staff.

Note: The acronyms denote the following: IFIs (Independent Fiscal Institutions); MIP (Macroeconomic Imbalance Procedure); ES (Enhanced Surveillance); QMV (Qualified Majority Voting); EP (European Parliament); EDPs (Excessive Deficit Procedures).

4 The European Commission's legislative proposals and the reformed framework

Building on the rich debate among governments and academia, the European Commission presented its legislative proposals for a reform of the European economic governance framework on 26 April 2023.[75] These proposals followed the Commission Communication of 9 November 2022, in which initial orientations for the reform had been outlined,[76] as well as extensive discussions in European fora, which had culminated in the adoption of ECOFIN Council conclusions on 14 March 2023. These Council conclusions had taken stock of the discussions and had highlighted areas of convergence and issues where further discussion and clarifications were deemed necessary.[77] The Commission's legislative proposals broadly echoed its earlier reform orientations while also reflecting its intention to address some of the issues highlighted in the ECOFIN Council conclusions. The latter had most notably referred to "the appropriateness and design of common quantitative benchmarks to support the reformed framework".

The Commission proposals served as the basis for discussions within European fora, which ultimately led to the provisional political agreement reached by the Council and European Parliament negotiators on 10 February 2024. In this section, the key elements of the initial Commission proposal are outlined, including a discussion of the main topics which featured heavily in the negotiations on the reform. The section then outlines the key changes to the Commission's proposal that were introduced in the final agreement of the reform by the ECOFIN Council in December 2023. Lastly, the section reviews the changes that were introduced in the subsequent political agreement reached with the European Parliament.

4.1 Key elements of the Commission's reform proposal

The Commission's proposals – which covered the preventive and the corrective arms of the SGP, as well as the Council Directive on national budgetary frameworks – were built on the following elements (see also Box 3 Chart B, and Chart 8):

Risk-based surveillance: fiscal surveillance would be largely based on risks to debt sustainability, assessed on the basis of the Commission's debt sustainability analysis

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[75] See https://ec.europa.eu/commission/presscorner/detail/en/ip_23_2393. The package comprised proposals to: (i) replace Council Regulation (EC) No 1466/97 on the preventive arm of the SGP; (ii) amend Council Regulation (EC) No 1467/97 on the SGP corrective arm; and (iii) amend Council Directive 2011/85/EU on national budgetary frameworks.

[76] European Commission Communication on orientations for a reform of the EU economic governance framework (https://economy-finance.ec.europa.eu/system/files/2022-11/com_2022_583_1_en.pdf).

[77] See https://www.consilium.europa.eu/en/press/press-releases/2023/03/14/economic-governance-framework-council-agrees-its-orientations-for-a-reform/.

(DSA) and differentiated across countries. As a first step, the Commission would put forward a so-called “technical trajectory” for gradual debt reduction, spanning a horizon of four years and laying down adjustment requirements which would then serve as a basis for discussion with Member States.

National medium-term fiscal-structural plans: the fiscal adjustment path as outlined in the technical trajectories could be spread out by lengthening the adjustment period from four to up to seven years, where countries commit to additional structural reforms and investment. This would be based on negotiations between the Commission and the country concerned. The agreed national medium-term fiscal-structural plan would be required to “ensure the fiscal adjustment necessary to put or keep public debt on a plausibly downward path by the end of the adjustment period at the latest, or remain at prudent levels, and to bring and maintain the government deficit below the 3% of GDP reference value over the medium term”.

Simpler rules: nationally financed net primary expenditure[78] was envisaged as the single operational indicator guiding the fiscal adjustment path and for carrying out annual fiscal surveillance.[79] It would replace the preventive arm matrix, the structural balance, and the 1/20th requirement under the debt rule.

Stronger enforcement: The Commission’s proposals foresaw *that the deficit should drop below 3% by the end of the adjustment period at the latest.* The original framework set a stricter deadline for correction of the excessive deficit, i.e. in the year following its identification (although in the past it usually took longer periods to achieve the correction).

Debt-based EDP would be strengthened. For Member States that face substantial public debt challenges, departures from the agreed fiscal adjustment path would, by default, lead to the opening of an EDP.

A *control account* would be used to record debits and credits, depending on how the actual net expenditure compares with the agreed expenditure path. As this would allow the tracking of cumulative deviations from the agreed expenditure path over time, it would enhance the “memory” of the framework over the medium term and prevent relatively small deviations from amassing to form large deviations. However, a threshold for accumulated deviations from the agreed fiscal adjustment that would ultimately result in the opening of a debt-based EDP was not specified in the Commission proposal.

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78 Defined as government expenditure net of interest expenditure, discretionary revenue measures and other budgetary variables outside the control of the government, which in turn consist of expenditure on Union programmes fully matched by Union funds revenue and cyclical elements of unemployment benefit expenditure. In the discussions that followed the Commission legislative proposals and culminated in the ECOFIN Council agreement in December 2023, it was agreed that one-offs and other temporary measures would also be excluded from net expenditure. Lastly, during the trilogue between the European Parliament, the European Council and the European Commission, it was agreed that national expenditure on co-financing of programmes funded by the Union would also be netted out.

79 While Member States have the option to use alternative indicators for national budgetary purposes (e.g. the structural balance), EU surveillance would be carried out solely on the basis of net primary expenditure. The debt reduction benchmark, the benchmark for reduction in structural balance, the significant deviation procedure and the matrix of requirements would no longer exist.

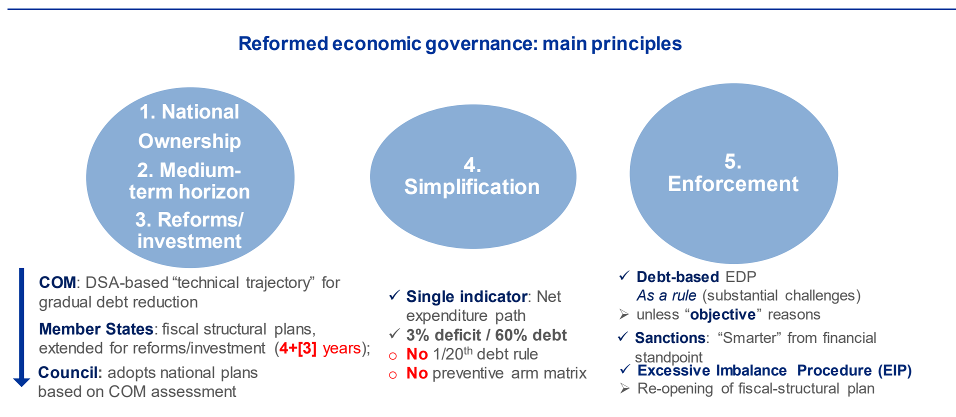
Escape clauses, in line with the original SGP, would allow for temporary deviations from the medium-term fiscal adjustment path when fiscal sustainability is not endangered: (a) in the event of major shocks to the euro area or EU as a whole (general escape clause); (b) country-specific clauses that cater for exceptional circumstances outside the control of the government and with a major impact on the public finances of an individual Member State.[80]

The *sanctions* toolbox would consist of financial penalties with lower amounts than in the current regulation.[81]

More independent assessment: under the Commission's proposals, IFIs would play a bigger role in national budgetary processes by, for example, producing debt sustainability assessments, producing or endorsing macroeconomic and budgetary forecasts, and participating in regular hearings before the national parliament. Budgetary authorities would follow a "comply-or-explain" approach in dealing with such IFI assessments. IFIs would also monitor compliance with the Union fiscal framework and with country-specific numerical fiscal rules. Lastly, while not included in the package of legislative proposals, the Commission also indicated that it would reconsider the mandate and role of the European Fiscal Board.

Chart 8

Elements of the European Commission's proposed reform of the fiscal framework



Source: ECB.

4.2 Technical trajectory for gradual debt reduction

The basic technical trajectory should ensure an adjustment in terms of net primary expenditure growth such that government debt is put on a plausibly

80 The triggering and extension of general and country-specific clauses would require the consent of the Council.

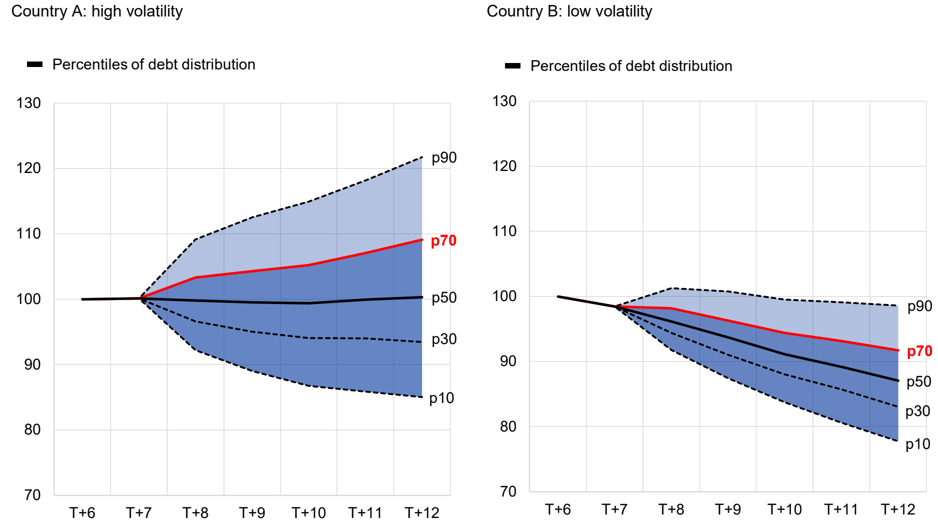
81 The revised corrective arm regulation sets the amount of the fine in the case that a Member State consistently fails to put into practice the Council's recommendations, at up to 0.05% of the latest estimate of the previous year's GDP for a six-month period. This fine will be payable every six months until the Council determines that the Member State concerned has taken effective action. In the pre-reform framework, the amount of the fine comprised for euro area Member States a fixed component equal to 0.2 % of GDP, and a variable component.

declining path at the end of the national fiscal-structural plan's time horizon. To ensure that government debt is "plausibly declining", a number of stochastic and deterministic risk scenarios are run, starting at the end of the national fiscal-structural planning horizon. For the deterministic analysis, debt is required not to increase over the subsequent 10-year horizon, not only under the baseline assumption of the Commission's debt sustainability analysis, but also under a set of three adverse scenarios: less favourable financial assumptions, adverse interest rate differential developments, and lower structural primary balance scenarios.[82] For the stochastic analysis, which would result in a fan chart of five-year debt trajectories (see Chart 9), the debt ratio is considered to be on a plausibly downward path if its distribution, after the required adjustment has been made, shows a sufficiently high probability of debt stabilisation. The larger the width of the fan, which may be the case for smaller countries with a history of more volatile debt-to-GDP ratios, the higher the fiscal effort required to ensure a "plausibly declining path". Conversely, the narrower the width of the fan, which may be the case for countries with more stable past government debt developments, the smaller the fiscal effort required to ensure that the debt ratio declines, even from high levels – leading to a higher likelihood that the debt stabilises, including at high levels. The required fiscal adjustment would be calculated as the annual improvement in the structural primary balance over the national planning horizon that would ensure both: (i) that debt does not increase under the four deterministic scenarios (the baseline and a set of three adverse scenarios mentioned above) and (ii) that debt is on a declining path with a sufficiently high probability. Establishing this specific structural primary balance trajectory would reveal the required change in the net primary expenditure aggregate over the years covered by the national fiscal-structural plan.

[82] For more detailed description see the Debt Sustainability Monitor (2022).

Chart 9

An illustration of the technical trajectory based on stochastic analysis



Source: ECB.
Notes: The chart depicts two illustrative debt distributions for two countries, both having an initial debt level of 100% of GDP. Country A has historically higher volatility in terms of debt-driving variables, making the probability to see debt declining lower than in the case of country B, which has a more stable performance. The 70% is in line with the threshold used in the Commission's standard DSA (European Commission Debt Sustainability Monitor 2023).

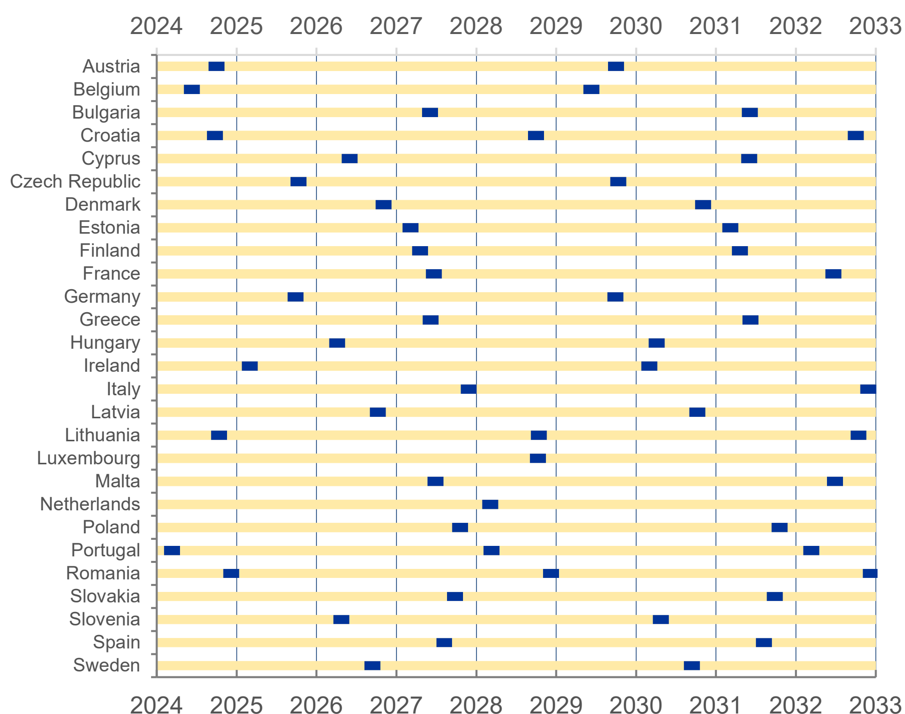
4.3 Reasoning for complementing the debt trajectory with "safeguards"

Following concerns expressed by some Member States that the Commission's orientations of November 2022 could have potentially led to overly optimistic results, the Commission heeded the criticism and included a safeguard for debt reduction and a no-backloading safeguard in its proposals. The aim of the safeguard for debt reduction was to dispel concerns that a purely DSA-based technical trajectory might imply too small a reduction in government debt levels.

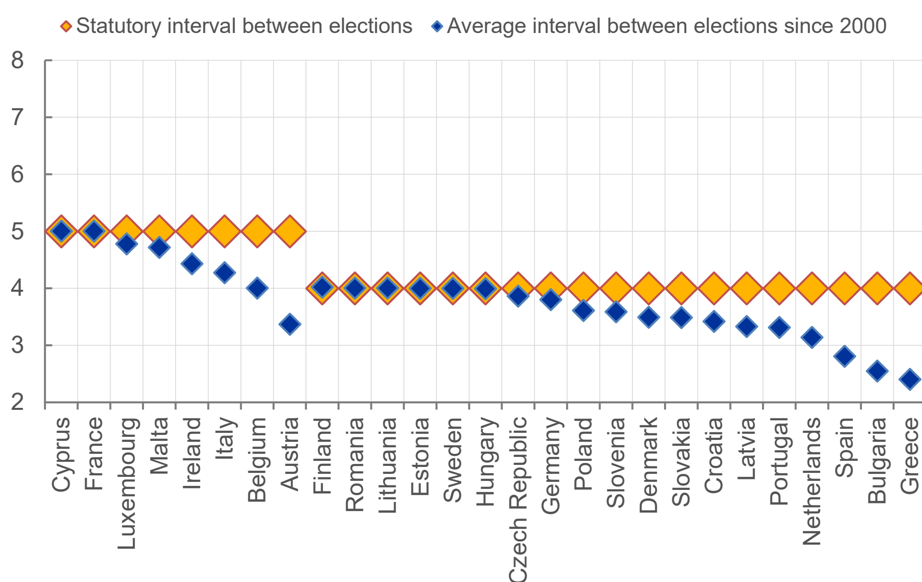
Chart 10

Election cycles and duration of national medium-term fiscal-structural plans

a) Planned election dates



b) Statutory vs actual election cycles



Sources: Panel a) ECB calculations; panel b) ParlGov project, ECB calculations.
Notes: Panel a) blue blocks indicate planned or expected elections (based on latest election date and statutory interval in MS). Yellow bars indicate two back-to-back four-year cycles starting in 2024.

One particular concern related to the potential tension between the length of a national medium-term fiscal-structural plan and election cycles. Numerous elections are already due to take place within the first few years of the new framework, which carries a risk of backloading of fiscal adjustment and of the reforms and investment commitments being renegotiated (Chart 10, panel a). In practice, actual election cycles have proven to be shorter than statutory ones. Since 2000 the average interval between elections has ranged from 2.4 years (Greece) to five years (France and Cyprus) (Chart 10, panel b).

The Commission's proposals stressed that if a new government asked to submit a revised plan, the new technical trajectory should not allow for backloading of the fiscal adjustment and not lead to lower fiscal adjustment efforts. Even so, any reopening of plans carries an additional risk of further backloading of reforms and investment.[83] Shorter plan horizons would tend to have the advantage that they (i) come closer to actual electoral cycles, and (ii) reduce the risk of backloading the fiscal adjustment and delaying structural reforms.

Other arguments brought forward for complementing the technical trajectory with safeguards related to the DSA tool playing a central role in the new framework. The DSA is an important and useful tool in identifying risks associated with sovereign debt which may not be apparent by just observing debt levels. For example, debt levels alone do not account for future fiscal risks, including from an ageing population. To this end, all major international institutions have set up their own assessment framework to regularly monitor risks to debt sustainability. Differentiating the magnitude of fiscal adjustment according to such risks is economically meaningful. Still, the complexity of DSA and its sensitivity to underlying assumptions pose communication challenges and may undermine simplicity and predictability. Concerns have been voiced that public communication in terms of risks to debt sustainability and failure to achieve the adjustment requirements needed to reduce such risks could be market sensitive and trigger undue financial market pressures. It was also highlighted that giving the DSA a disproportionate role in the new framework could lead to pressure on its underlying assumptions. In that respect Blanchard et al. (2021), among others, foresaw a very strong role for independent assessments and tasked them with setting up the technical trajectory. While such assumptions can be made transparent, thus allowing for more rational and transparent policy debates, the DSA-based technical trajectories would serve only as a basis for bilateral discussions with Member States. As Blanchard and Zettelmeyer (2023) argued, larger Member States might be better positioned to exploit the room for discretion, for instance by arguing over the assumptions, which in turn could undermine a consistent cross-country implementation of the framework. Lastly, based on recent experience, it was argued that risks may materialise earlier than after the national fiscal-structural plan's potential horizon of up to seven years.

To cater to the concerns mentioned above, the Commission, in its legislative proposals, adjusted its initial orientation on the technical trajectory in two important respects. First, as regards the coverage of countries receiving a

[83] Fuest (2023) considers that the possibility of extending the plan horizon if additional reforms and investment are undertaken gives rise to discretion.

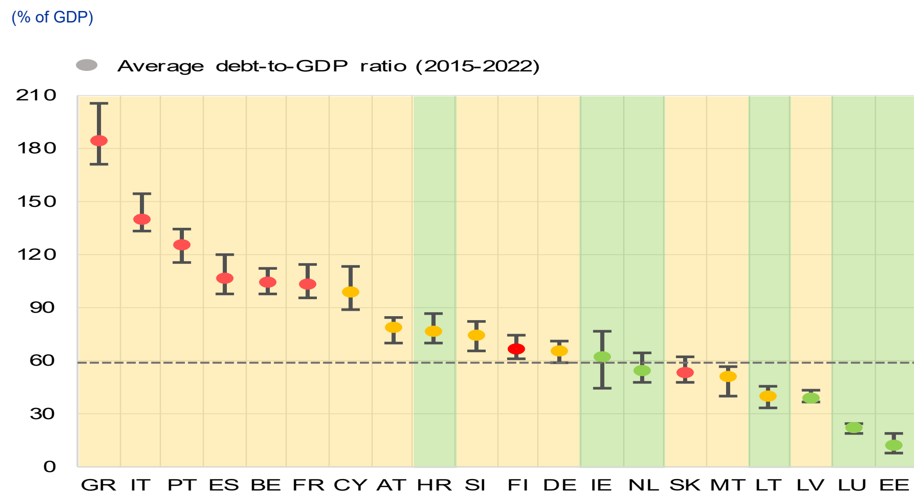
technical trajectory and second, by introducing specific “safeguards” to ensure a sufficiently declining debt ratio.

4.3.1 Country coverage

According to the Commission’s proposals, the Treaty deficit and debt thresholds (the Maastricht criteria) would be used to sort countries into two groups: those Member States that comply with both thresholds and those that exceed at least one of those thresholds. By contrast, in the November 2022 Commission communication, Member States had been sorted into three groups of high/medium/low debt sustainability risks based on the Commission’s DSA.[84] Member States compliant with the thresholds would receive technical guidance[85] from the Commission only if requested by the country, while for the remaining countries, a technical trajectory would be prepared.

Chart 11
Risk classification and debt level (% of GDP)

(% of GDP)



Sources: AMECO, European Commission 2023 Debt Sustainability Monitor, own calculations.
Notes: Bars indicate minimum and maximum of debt-to-GDP ratio in the period 2015-2022. Colour coding of dots based on the European Commission's overall DSA assessment from Debt Sustainability Monitor 2023 (March 2024). Background colours reflect the treaty-based classification. Green countries exhibit both a deficit < 3% of GDP and a debt-to-GDP ratio < 60% in 2024 (Commission Autumn 2023 forecast).

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[84] In its November 2022 Communication, the Commission had drawn a distinction between Member States with substantial/moderate/low public debt challenges, with the classification of Member States in these groups being based on the Commission DSA. For Member States with substantial public debt challenges, the technical trajectory should ensure that by the horizon of the plan, (i) the 10-year debt trajectory at unchanged policies is on a plausibly and continuously declining path and (ii) the deficit is maintained below the 3% of GDP reference value at unchanged policies over the same 10-year period. For Member States with a moderate public debt challenge, the technical trajectory should ensure that, (i) at most 3 years after the horizon of the plan, the 10-year debt trajectory is on a plausibly and continuously declining path at unchanged policies; and (ii) by the horizon of the plan, the deficit is maintained below the 3% of GDP reference value over the same 10-year period. For Member States with a low public debt challenge, the deficit should be maintained below the reference value at unchanged policies over a 10-year period at most three years after the horizon of the plan.

[85] In the form of technical information regarding the size of the structural primary balance which in a no-policy-change scenario would ensure, at the end of the national medium-term fiscal-structural plan, that the deficit ratio remained below 3% over a 10-year period.

As Chart 11 shows, the vast majority of countries would receive a technical trajectory from the Commission. There is a rather close link between a country coverage based on debt sustainability challenges and one based on the Treaty's deficit and debt criteria. One important difference compared to the Commission's initial orientations pertains to the fact that countries compliant with the Maastricht criteria but presenting high risks to debt sustainability, perhaps because of rising ageing costs, would no longer receive a technical trajectory. While it can be argued that a nice feature of the DSA – its capability to detect risks to debt sustainability at an early stage – is being ignored, it may still be considered that the debt levels would remain overall at low levels.[86]

4.3.2 Commission proposals for "safeguards"

The Commission's legislative proposals foresaw that the technical trajectories, which would be made public, should ensure certain requirements were met. Not only should they ensure that (i) the public debt ratio is put or remains on a plausibly downward path, or stays at prudent levels[87] and that (ii) the government deficit is brought and maintained below the 3% of GDP reference value,[88] but also that:

(iii) the fiscal adjustment effort over the period of the national medium-term fiscal-structural plan is at least proportional to the total effort over the entire adjustment period (no-backloading safeguard);

(iv) for countries with deficits above 3% of GDP, an adjustment of "at least 0.5%" should be delivered in line with the benchmark adjustment foreseen under the EDP;

(v) the public debt ratio at the end of the planning horizon is below the public debt ratio in the year preceding the start of the technical trajectory (safeguard for debt reduction); and

(vi) national net expenditure growth remains below medium-term output growth, on average, as a rule over the plan horizon.

The issue of safeguards was subject to intense discussion in the Council. Member States were divided over the adequate balancing of, on the one hand, flexibility to take into account country-specific circumstances and, on the other, common numerical safeguards for debt reduction. In a statement from 15 June 2023, a group of 11 countries argued that "quantitative criteria that apply to all Member States help by formulating clear minimum requirements that allow consolidation and

[86] Pench (2023) notes that this Treaty-based country coverage results in "a degradation of the signal that the Commission's guidance is supposed to give about the state and prospects of the public finances". He observes that, inter alia, countries may receive a technical trajectory although the DSA may not point to any concerns in particular.

[87] The Commission defines this as a requirement that "by the end of the adjustment period, at the latest, the 10-year debt trajectory in the absence of further budgetary measures is on a plausibly downward path or stays at prudent levels".

[88] The Commission defines this as a requirement that "the government deficit is brought and maintained below the 3% of GDP reference value in the absence of further budgetary measures over the same 10-year period" mentioned in the previous footnote.

support growth”. Moreover, these countries voiced scepticism regarding “timeframes for necessary consolidation efforts extending far beyond the cycle of a legislative period”. However, several Member States were opposed to common constraints in view of, inter alia, limited flexibility to incentivise investment and reforms and, therefore, insufficient national ownership. In fact, the precise implications of the suggested safeguard that the public debt ratio at the end of the planning horizon should be below the public debt ratio in the year preceding the start of the technical trajectory would depend on the initial level of the structural primary balance. It would become binding and may imply a sizeable lifting beyond the DSA-based adjustment requirement or the 0.5% of benchmark adjustment under the EDP, mostly for countries with significant structural primary deficits at the time the plans were agreed upon.

4.4 The ECB’s opinion on the Commission’s legislative proposal for economic governance reform in the Union

In its opinion published on 5 July 2023, the ECB welcomed the Commission’s legislative proposals on the reform of the Union’s economic governance framework. The opinion considered that a greater focus on debt sustainability challenges could translate into reduced debt heterogeneity, which is of key relevance in the EMU. The opinion outlined that the intention to incentivise reforms and investments through stronger ownership could trigger additional growth and enhance debt sustainability, especially if enforcement becomes more effective.

The opinion also offered specific, technical observations and suggestions with a view to further enhancing the new framework and ensuring transparency and predictability.

(1) With regard to the DSA methodology, the opinion emphasised that the methodology should be specified in consultation with Member States and the European Fiscal Board. Moreover, to ensure that debt is “sufficiently diminishing and approaching the reference value at a satisfactory pace” (as required by the Treaty), the opinion recommended that the key parameters and assumptions underlying the methodology for the assessment of plausibility be further elaborated.

(2) Given the need to prevent debt from stabilising at high levels, the opinion welcomed the fact that the Commission proposals included some safeguards to support debt and deficit reduction, while acknowledging that the issue of safeguards was subject to ongoing discussion at the time the opinion was issued. The opinion broadly noted that a balance would be needed between complexity and ownership on the one hand, and effectiveness of debt reduction on the other, to ensure that debt would be put on a sufficiently diminishing path that was appropriately differentiated.

(3) The opinion emphasised that productive investment is a prerequisite for the economic growth that would support the long-term sustainability of public finances. Hence, the opinion outlined that it would be crucial that fiscal adjustment should not

be to the detriment of investment, especially investment that supports the common priorities of the Union. Thus, the opinion called for an effective assessment and monitoring framework and prudent use of any extensions to the adjustment horizon to help ensure frontloading of the policy commitments.

(4) Regarding compliance and enforcement of the proposed framework, the opinion called for a well-defined and transparent methodological approach in the context of the excessive deficit procedure (EDP). The opinion also recommended further clarifications on the functioning of the control account that would be used to record cumulative deviations from national expenditure targets. The opinion recommended the introduction of a threshold for deviations of actual net expenditures from the net expenditure path recorded under the control account. If breached, this would trigger a requirement for the Commission to prepare a report under Article 126(3) TFEU.

(5) Last but not least, the opinion called for a bigger role to be given to both the national IFIs and the European Fiscal Board in matters of fiscal surveillance.

4.5 ECOFIN Council agreement of December 2023 and political agreement between the Council and European Parliament of February 2024

Following lengthy discussions on the Commission proposal, the ECOFIN Council reached a compromise agreement on the reform of the economic governance framework in December 2023. The compromise[89] was thus reached shortly before the deactivation of the SGP's general escape clause, which had been previously activated and repeatedly extended in response to the COVID-19 pandemic.

While the compromise agreement maintained the Commission's overall approach, it introduced some key changes, most notably regarding the safeguards. This section outlines these key changes. Firstly, some Member States insisted on the need for safeguards, over concerns that a purely DSA-based technical trajectory may prove to be overly "optimistic". Meanwhile, other Member States considered that the safeguards included in the Commission's proposals – most notably the requirement that the public debt ratio at the end of the planning horizon be below the public debt ratio in the year preceding the start of the technical trajectory – were too demanding for Member States with very high deficit levels that would add to their debt in the initial years of adjustment. The compromise ultimately reached on the safeguards thus reflects a balancing act between the above considerations.

89 Council of the EU Press release of 21 December 2023 "Economic governance review: Council agrees on reform of fiscal rules".

4.5.1 Key changes made to the Commission's legislative proposals

4.5.1.1 Revised safeguards

Significant modifications were made to the Commission's proposed safeguards, most notably with the introduction of the so-called "deficit resilience safeguard". The compromise agreement contains the following safeguards:

(A) The debt sustainability safeguard: according to this safeguard, the technical trajectory must ensure that the projected general government debt-to-GDP ratio decreases by a minimum annual average amount of:

(i) 1 percentage point of GDP as long as the general government debt-to-GDP ratio exceeds 90%;

(ii) 0.5 percentage points of GDP as long as the general government debt-to-GDP ratio remains between 60% and 90%.

The compromise specifies that the average decrease should be computed from the year preceding the start of the technical trajectory or the year in which the excessive deficit procedure is projected to be abrogated, whichever occurs last, until the end of the adjustment period. This specification, as detailed in the preventive arm, has a significant bearing on the adjustment requirements of some of the high deficit countries that are expected to face the opening of Excessive Deficit Procedures in spring 2024.

(B) The deficit resilience safeguard: according to this particular safeguard, the Commission's technical trajectory must ensure that fiscal adjustment continues, where needed, "until the Member State reaches a deficit level that provides a common resilience margin in structural terms of 1.5% of GDP relative to the 3% of GDP deficit Treaty reference value". Moreover, the speed of adjustment towards the structural deficit of 1.5% of GDP is defined as an annual improvement in the structural primary balance of 0.4% of GDP, reduced to 0.25% of GDP if the adjustment period is extended from four to seven years. This safeguard is reminiscent of the pre-reform MTO under the SGP. However, while the MTO of the pre-reform SGP was differentiated across Member States and in most cases required Member States to achieve budgetary positions that were close to balance in structural terms, the current agreement entails homogeneity across Member States[90] and is significantly less ambitious, although it would lead to debt moving closer to and below the 60% of GDP debt-to-GDP threshold.

In addition, a linearity requirement was introduced to help avoid the backloading of fiscal adjustment. Whereas the no-backloading safeguard included

90 The ECOFIN Council agreement also specifies that the technical information to be provided by the Commission to those Member States whose deficit and debt-to-GDP ratios do not exceed the 3% and 60% of GDP thresholds (at the request of these Member States), and who would thus not receive a technical trajectory from the Commission, would be consistent with the deficit resilience safeguard.

in the Commission's legislative proposal highlighted that the fiscal adjustment effort over the period of the national medium-term fiscal-structural plan should be at least proportional to the total effort over the entire adjustment period, the compromise agreement specifies that the effort should be linear, as a rule.

4.5.1.2 Length of the adjustment period

The conditions for the extension of the adjustment period of the first set of fiscal-structural plans have been relaxed when compared with the Commission's legislative proposals. More precisely, the Council agreement foresees that, in the case where Recovery and Resilience Plans include ambitious reforms and investments – most notably with regard to economic growth and fiscal sustainability over the medium term – Member States can be considered to comply with the requirements for the extension of the adjustment period. There is a call that a Member State "commits to continue the reform effort over the remainder of the national medium-term fiscal-structural plan, as well as to maintain the nationally financed investment levels realised on average over the period covered by the Recovery and Resilience Plan". An additional point is that the legislation specifies that the fiscal-structural plans cover a period of four or five years, depending on the regular length of the national legislature.

4.5.1.3 Functioning of the control account

Further details have been given regarding the functioning of the control account, which has important implications in relation to the debt-based excessive deficit procedures. More specifically, the Council agreement envisions the Commission drawing up a report in accordance with Article 126(3) TFEU when the government debt-to-GDP ratio exceeds the reference value, when the budgetary position is not close to balance or in surplus, and when the deviations recorded in the control account of the Member State either exceed:

(a) 0.3 percentage points of GDP annually; or

(b) 0.6 percentage points of GDP cumulatively.

Moreover, it is specified that the control account will not be used to record deviations as long as the general or national escape clauses remain activated and it will be reset following endorsement by the Council in the event of a new medium-term fiscal-structural plan, which is typically the case when new a government is sworn in.

4.5.1.4 Excessive deficit procedures

The compromise agreement includes less automaticity in the opening of debt-based excessive deficit procedures when compared with the Commission's proposal. More automaticity in the opening of debt-based EDPs was an integral part

of the stronger enforcement which was intended to go hand in hand with the more risk-based approach to surveillance. The Commission's proposals highlighted that if a Member State faces substantial public debt challenges according to the most recent Debt Sustainability Monitor, the Commission would then consider this a "key factor leading to the opening of an excessive deficit procedure *as a rule*". Under the compromise agreement, while the reference is maintained that substantial public debt challenges will be considered a key aggravating factor in the Council's and the Commission's overall assessment of compliance with the deficit and/or debt criteria, the reference to "as a rule" is dropped. Moreover, the list of relevant factors has been extended and now includes the increase of government investment in defence, and inflation and potential growth developments.

An attempt has been made to ensure that the adjustment path under the corrective arm in the case of a debt-based EDP is at least as demanding as that under the preventive arm. In the case where the EDP is opened on the basis of the debt criterion, the legislation calls for the corrective net expenditure path adopted under the corrective arm to be at least as demanding as that adopted under the preventive arm regulation, with the additional requirement that it must, as a rule, correct for the accumulated deviations of the control account. In a deficit-based EDP the corrective net expenditure path shall be consistent with a minimum annual structural adjustment of at least 0,5% of GDP as a benchmark. However, it remains to be seen whether previous practices, whereby Member States followed nominal targeting through the achievement of nominal deficit targets without the delivery of the recommended fiscal adjustment, will be tolerated.

4.5.1.5 Institutional aspects

The compromise agreement foresees a weaker role for national independent fiscal institutions than originally envisaged in the Commission's legislative proposals. While the Commission's proposals called for national independent fiscal institutions to play a bigger role in the economic governance framework of the Union, the Council agreement of December did not call for any change in their role. For example, while it was originally envisaged that independent fiscal institutions would provide an assessment of compliance with the net expenditure path and any factors underlying deviations from it, the Council agreement indicates that this may occur only upon the request of a Member State and that any such assessment would be considered non-binding. At the request of the Council, the relevant independent fiscal institutions may also deliver an opinion on the extension of national escape clauses. Under the original Commission proposal, IFIs would also produce debt sustainability assessments underlying the government's medium-term planning or endorsing those provided by the budgetary authorities, while also producing assessments on the impacts of policies on fiscal sustainability and sustainable and inclusive growth or endorsing those provided by the budgetary authorities. However, these additional functions were dropped in the final agreement.

The EFB has been strengthened somewhat. The Council agreement calls for a "permanent and more independent" EFB playing a stronger advisory role in the

economic governance framework of the Union. It contends that the EFB's access to information should be improved and that the EFB should continue to evaluate the implementation of the SGP, assess the prospective fiscal stance for the euro area as a whole, and provide advice to the Commission and the Council. The EFB may also deliver an opinion, if requested by the Council, on the extension of the general escape clause. The Council should also be consulted on the appointment of the chair and the members of the EFB.

4.5.1.6 Transitory provisions

Transitory provisions have been included in both the preventive and corrective arm regulations, which are applicable to the first cohort of the medium-term fiscal-structural plans.

Preventive arm:

Projects related to Recovery and Resilience Facility loans as well as national co-financing of EU funds in 2025 and 2026 must be taken into account whenever a Member State requests an exception to the no-backloading safeguard, provided that this does not endanger fiscal sustainability in the medium term. This comes in addition to the provision that reforms and investments carried out under the Recovery and Resilience Plans of Member States qualify them for the extension of the adjustment period by up to three years.

Member States will be allowed to use potential growth estimates that are "more stable series than the ones resulting from the commonly agreed methodology, provided that such use is duly justified by economic arguments and that the cumulated growth over the projection horizon remains broadly in line"[91].

Corrective arm:

Whereas the rules of the deficit-based Excessive Deficit Procedure remain unchanged, with a minimum annual structural improvement of at least 0.5% of GDP as a benchmark, for the period 2025 to 2027 the Commission may adjust that benchmark by taking into account the increase in interest payments (i.e. the adjustment requirements would refer to the structural primary balance) when setting the proposed corrective path within the Excessive Deficit Procedure.

4.5.2 The results of the trilogue between the European Parliament, the Council of the European Union and the European Commission

The subsequent agreement reached with the European Parliament in February 2024 left the Council's compromise agreement largely intact. The "trilogue" between the European Parliament, the Council and the European Commission

[91] Article 36 of Regulation (EU) 2024/1263 of the European Parliament and of the Council of 29 April 2024 on the effective coordination of economic policies and on multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97

regarding the preventive arm regulation culminated in a political agreement on 10 February 2024.[92] Under the new agreement, which entered into force on 30 April, the contentious issue of safeguards and the functioning of the control account as a trigger for a debt-based EDP remained untouched. The main parametric change agreed during the trilogue related to the treatment of national expenditure to co-finance EU programmes. The agreement was that such expenditure would be netted out of the relevant expenditure aggregate used to calibrate the fiscal adjustment under the new framework. The European Parliament also insisted on a more substantial inclusion of the social dimension, including as regards investment. Lastly, the technical trajectories were renamed as reference trajectories.

4.5.3 Assessment of adjustment requirements under the revised framework

When assessing the adjustment requirements under the new governance framework, it is necessary to compare the adjustment requirements stemming from the DSA tool with those arising from the various safeguards, while also taking into account whether a country is under an EDP. The basic philosophy of the safeguards is that they are binding if the adjustment requirement resulting from the safeguard is higher than that arising from the DSA tool, i.e. that the maximum requirement is considered binding.[93] That said, it is also specified that the debt sustainability safeguard must be computed with reference to either the year before the start of the reference trajectory or the year in which the EDP is projected to be abrogated, whichever occurs last. This implies that the requirements of the debt sustainability safeguard are de facto only binding once a country is out of an EDP.

The adjustment requirements under the Council agreement, and the corresponding debt developments, are illustrated for the four largest high-debt euro area economies. The illustrative ECB staff simulations are carried out on the basis of the Commission’s 2023 autumn forecast, not yet including the updated ageing costs that the Commission released in spring this year.[94] They do not provide a direct link to the reference trajectories that would serve as basis for the first batch of medium-term fiscal structural plans. For the four largest high-debt euro area economies the simulations (see Chart 12) cover a seven-year period stretching from 2025 to 2031. The debt levels are normalised to 100% of GDP in 2024 to illustrate, in a more comparable manner, the debt developments across the four countries. They are run under a scenario of full compliance (red dashed line) and under a “minimum compliance” scenario (blue dotted line). The latter assumes that the four Member States make full use of the control account threshold such that they would ex post be

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[92] Council of the EU Press release of 10 February 2024 “Economic governance review: Council and Parliament strike deal on reform of fiscal rules”.

[93] The adjustment requirements for the structural primary balance arising from the DSA tool, which are expressed in terms of expenditure growth ceilings, are such that the “…debt trajectory beyond the plan’s horizon [4+3 years] is on a plausibly and continuously declining path”, with debt: (a) not increasing in the presence of three deterministic shocks (interest-growth differential, financial stress, lower structural primary balance) over ten years; and (b) stabilising with 70% probability over five years according to stochastic analysis.

[94] European Commission (2024), “The 2024 Ageing Report Economic & Budgetary Projections for the EU Member States (2022-2070)”, Institutional Paper 279, April.

assessed to have deviated cumulatively by 0.6 percentage points of GDP from their adjustment requirements in the first two years of their medium-term fiscal-structural plans. It is also assumed that all four Member States will be under an EDP starting in 2024 due to the fact that their deficits are above the 3% of GDP threshold in 2023.

These simulations show that, for the high-debt countries, for the time being, the DSA requirements tend to be more demanding than adjustments that would ensure compliance with the debt sustainability safeguard. The simulations for the four largest high-debt euro area countries presented in Chart 12, as well as the corresponding simulations for all euro area countries (see Table 1), indicate that at least for the first batch of medium-term fiscal-structural plans, the debt sustainability safeguard is not applicable, either because the adjustment requirements arising from the DSA tool are more ambitious (thus rendering the debt sustainability safeguard non-binding), or because it is expected that the Member States will be placed under an EDP, making the debt sustainability safeguard non-applicable.[95] Only in the case of Finland does the debt sustainability safeguard have

[95] According to ECB staff calculations and assessment, the results for the four large high-debt euro area countries are as follows:

Italy: the adjustment requirement for the structural primary balance arising from the DSA tool (0.7% of GDP) is higher than the adjustment requirement arising from the EDP minimum adjustment (0.5% of GDP for the years 2025 to 2027 and 0.67% of GDP for the years 2028 to 2031) and from the deficit resilience safeguard (0.25% of GDP). Consequently, the DSA-based requirement is binding with Italy having to improve its structural primary balance by 0.7% of GDP for each of the seven years in the simulations (see Chart 12, panel a). Given that, resulting from this purely mechanical exercise and applying the usual multipliers, Italy would only be expected to exit the deficit-based EDP in 2031, the debt sustainability safeguard is not applicable. Under the scenario of full compliance, Italy should manage to reduce its debt level by 4% of GDP by the end of the seven-year simulation horizon, while under the “minimum compliance” scenario, debt would remain roughly unchanged at the end of the horizon while increasing in the years in between.

France: the adjustment requirement for the structural primary balance arising from the EDP (0.5% of GDP for the years 2025 to 2027 and 0.7% of GDP for the years 2028 to 2030) is higher than the one arising from the DSA tool (0.5% of GDP) and the deficit resilience safeguard (0.25% of GDP) in the period up to 2030, when France is simulated to exit the deficit-based EDP (see Chart 12, panel b), resulting from the purely mechanical exercise and applying standard multipliers. In the first post-EDP year, i.e. 2031, the deficit resilience safeguard is the binding safeguard as France would not have achieved a structural deficit of 1.5% of GDP after having delivered the entire adjustment arising from the DSA tool in the first six years of the plan (given that the EDP minimum adjustment requirement is higher than the adjustment requirement arising from the DSA tool). The debt sustainability safeguard would be applicable for 2031 only, although the debt reduction achieved in 2031 on the basis of the adjustment arising from the deficit resilience safeguard and the adjustment delivered over the previous year would allow debt to drop by more than 1% of GDP. This means that the debt sustainability safeguard would not be binding in 2031. However, the simulations under both scenarios indicate that the 2031 debt level would be higher than the 2024 level.

Belgium: the adjustment requirement for the structural primary balance arising from the DSA tool (0.6% of GDP) is higher than the adjustment requirement arising from the EDP minimum adjustment (0.5% of GDP for the years 2025 to 2027) and is thus the binding requirement (see Chart 12, panel c). Once the transitory period ends, the minimum adjustment requirement in terms of the structural primary balance under the EDP rises due to the fact that the increases in interest payments will need to be taken into account so as to achieve a minimum improvement of the structural balance by 0.5% of GDP. This would then be slightly higher than the adjustment requirement arising from the DSA tool and would thus be the binding safeguard. Under the simulations, Belgium would exit the EDP in 2029, as resulting from the purely mechanical exercise and applying the usual multipliers. Having not yet delivered its full seven-year DSA-based adjustment over the previous five years, it would continue to deliver its DSA-based adjustment requirement, which is higher than the 0.25% of GDP adjustment requirement under the deficit resilience safeguard and which helps to deliver, in the two post-EDP years of our simulations, a reduction in the debt-to-GDP ratio of more than 2% of GDP. Over the last two years of the simulations, the DSA-based adjustment requirements would be binding. Only in the full compliance scenario would Belgium be able to achieve a debt reduction of close to 4% of GDP while in the “minimum compliance” scenario, debt would be close to its 2024 level.

a binding effect. Overall, as indicated by the simulations, this may lead to debt stabilising at high levels for some countries. As can be seen from Chart 12, the adjustment under the new framework implies hardly any debt reduction for Italy and Belgium when factoring in available flexibility ex post through the control account. In the case of France, the debt ratio is projected to increase in the period up to 2031. In the case of Spain there would be some tangible debt reduction over the seven-year adjustment period.

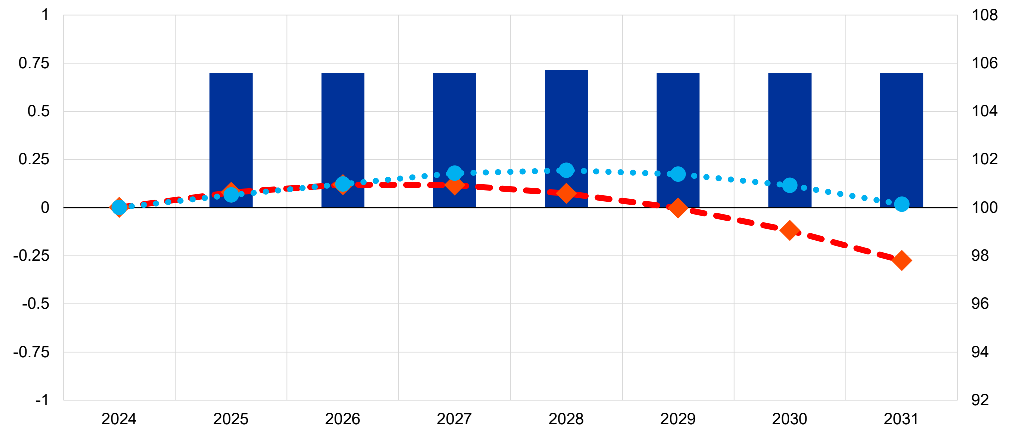
Spain: in the case of full compliance, Spain would be expected to exit the deficit-based EDP in 2026 (as resulting from this purely mechanical exercise when applying the usual multipliers) and thus the EDP minimum adjustment safeguard which proves to be binding is relevant only for 2025 (see Chart 12, panel d). In the following years of the plan, the DSA-based adjustment requirement of almost 0.5% of GDP is higher than the deficit resilience safeguard adjustment requirement of 0.25% of GDP and is able to deliver a debt reduction of 6% of GDP over the period 2026 to 2031, when the debt resilience safeguard would be applicable but not binding. Among the four largest high-debt euro area countries, the projected debt reduction of Spain is projected to be the largest.

Chart 12

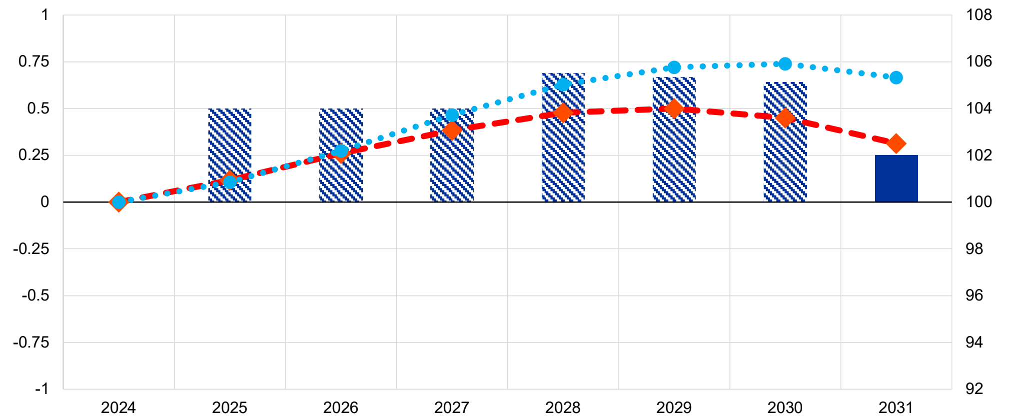
Adjustment requirements (LHS) and corresponding debt developments (RHS) under full (red dashed line) and minimum (blue-dotted line) compliance

% of GDP

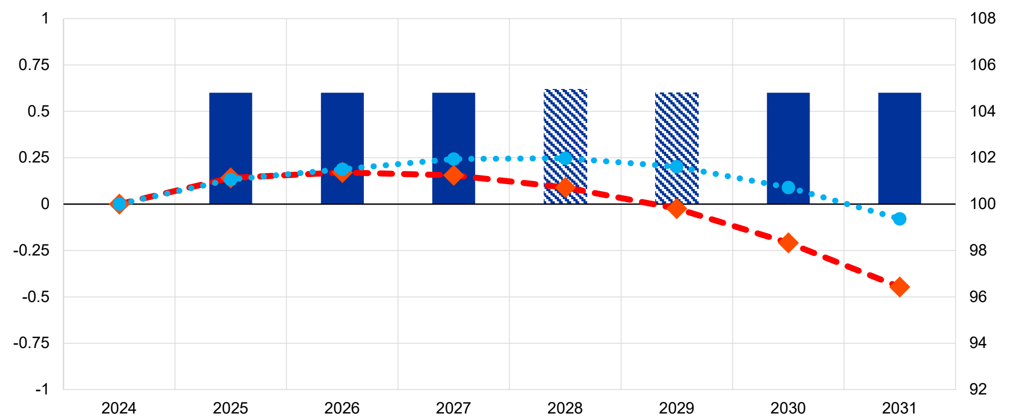
a) Italy



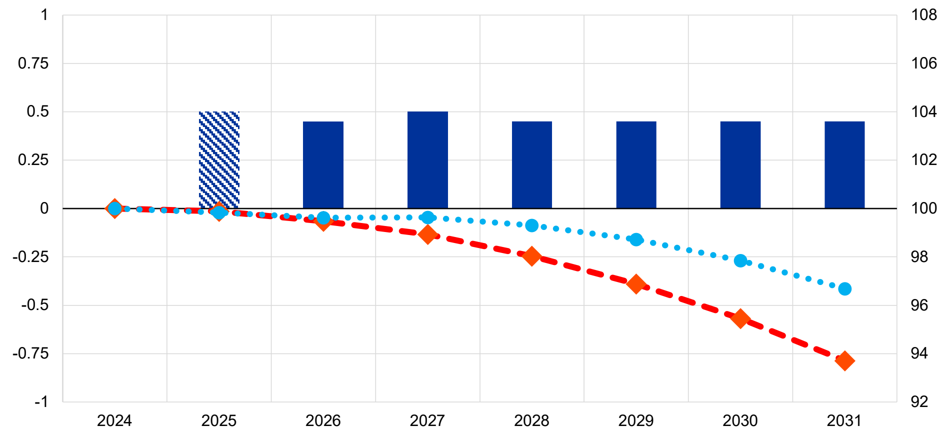
b) France



c) Belgium



d) Spain



Sources: European Commission (Autumn 2023 forecast) and ECB calculations.
Notes: Bars are shaded where the EDP requirement is more demanding than the DSA-based requirement. Δ SPB ≈ Maximum (DSA, EDP) and deficit resilience and debt sustainability safeguards. "Minimum compliance" scenario entails a deviation of 0.6 pp in the adjustment in the first two years of the fiscal-structural plan. The simulations still include estimates for ageing costs that stem from the 2021 Ageing Report. The methodology on which the simulations are based is described in the European Commission's 2022 Debt Sustainability Monitor.

The deficit-resilience safeguard is binding especially for the low-debt euro area Member States if they choose a fiscal adjustment path spanning seven years. Table 1 below highlights that, based on the Commission's 2023 Autumn Forecast, this safeguard would then be binding for six out of the nine euro area Member States whose debt levels are projected to be at, or below, the 60% threshold in 2024 in the case of a seven-year adjustment. While the deficit resilience safeguard has made the framework more complex, there was a desire for low-debt Member States to receive guidance from the Commission on their fiscal path. While the request for technical information for those Member States who are not breaching the 3% and 60% of GDP thresholds is voluntary, the design of the deficit-resilience safeguard helps to stabilise their debt-to-GDP ratios at below but closer to 60% of GDP when compared to the MTO of a broadly balanced budget in the pre-reform SGP.[96] Overall, if a Member State opts for a four-year adjustment, the requirement on average will be higher.

[96] There is thus an inconsistency between the debt sustainability safeguard, which aims to ensure a reduction in the debt level to the Treaty's 60% of GDP reference value, and the deficit resilience safeguard which would lead to debt below the 60% of GDP reference value.

Table 1

Fiscal adjustment needs for seven- and four-year adjustment period (underlying expenditure growth paths)

(% of GDP)

	2024			2031				
	Debt	Budget Balance	SPB	Debt	Budget Balance	SPB	Min. annual adjustment 7 years (Δ SPB)	Min. annual adjustment 4 years (Δ SPB)
Greece	152	-0.9	2	123	-1.5	2.3	0.04	0.00
Italy	141	**-4.4**	-0.9	137	-2.5	4	0.7	1.20
France	109	**-4.4**	-2.4	112	-2.5	1.3	0.54	0.80
Spain	106	**-3.2**	-1	100	-1.7	2.3	0.46	0.60
Belgium	106	**-4.9**	-2.4	103	-1.9	1.8	0.6	1.00
Portugal	100	0.1	2.1	79	0.1	2.1	0	0.00
Finland	**77**	**-3.2**	-1	75	-0.7	1.6	0.37	0.65
Austria	**76**	-2.4	-0.7	68	-1.2	1.1	0.25	0.50
Cyprus	**71**	2.1	3.4	38	2.2	3.4	0	0.00
Slovenia	**68**	**-3.3**	-1.1	55	0.2	2.1	0.45	0.75
Germany	**64**	-1.6	-0.2	57	-0.7	0.8	0.15	0.25
Slovakia	60	**-6.5**	-5.1	65	-0.7	2.2	1.05	1.65
Croatia	59	-1.8	-1.2	55	-1.5	0.6	0.25	0.40
Malta	56	**-4.6**	-2.7	52	-1.8	0.4	0.44	0.51
Netherlands	47	-1.8	-0.5	43	-0.8	0.2	0.11	0.20
Latvia	42	**-3.1**	-1.7	44	-1.4	0.3	0.29	0.43
Ireland	41	0.6	0.8	29	0.1	0.8	0	0.00
Lithuania	38	-2.3	-0.5	36	-0.9	0.2	0.11	0.20
Luxembourg	29	-2.1	-0.6	29	-0.7	0.1	0.11	0.20
Estonia	21	-2.4	0	22	-0.7	0	0	0.00
Euro area	88	-2.8	-0.9	83	-1.4	1.6	0.36	0.57

Binding safeguards:

None (DSA);Debt sustainability safeguard;Deficit resilience safeguard

Sources: AMECO, ECB calculations.
Notes: SPB = Structural Primary Balance. Countries in bold receive technical trajectory (debt > 60% of, or fiscal balance < -3% of, GDP in 2024 according to COM's 2023 Autumn forecast). Light blue for the adjustment denotes countries where the debt sustainability safeguard is binding. The yellow figures denote countries where the deficit resilience safeguard is binding at least for one year. This is the case for FR, where, for the years from 2025 to 2030, the requirement would be driven by the EDP minimum adjustment and in 2031 only the deficit safeguard would be binding.

4.5.4 Comparison of adjustment requirements with pre-reform SGP

Looking forward, the adjustment requirements for the period 2025-2031 under the revised framework, in case of seven-year adjustment paths, would be broadly lower than those that would have applied under the pre-reform SGP rules. This is the case for all the high-debt euro area Member States with the exception of Portugal, as can be seen if we compare the blue and yellow bars in Chart 13.

Looking backwards, for some high-debt countries, the adjustment requirements under the revised framework would have been higher than those under the pre-reform SGP. However, this is not the case for France and Portugal. The comparison is made with the adjustment requirements for the period 2014 to 2019 and can be seen by comparing the blue bars with the green lines in Chart 13. It

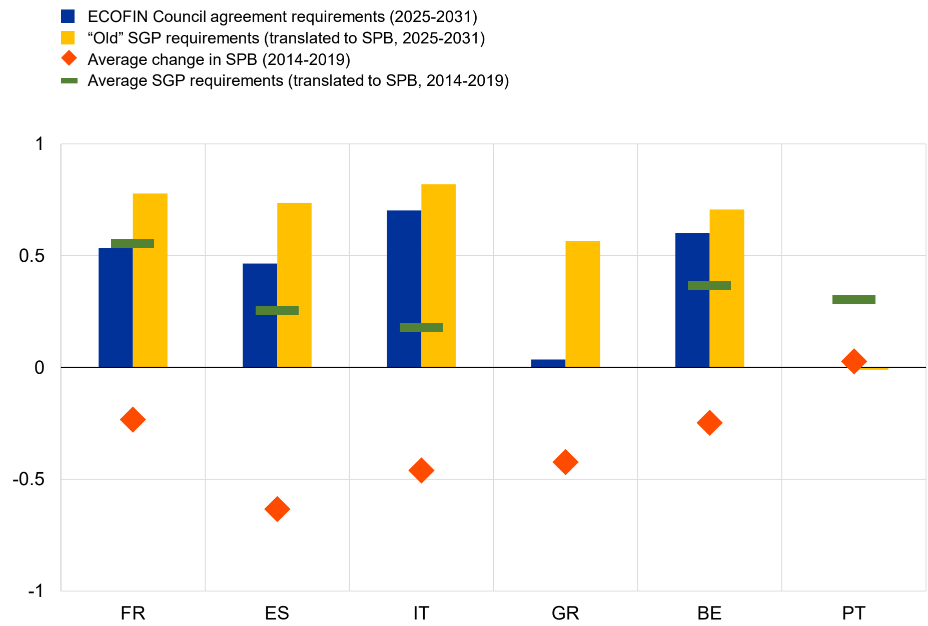
should be noted that the adjustment requirements under the pre-reform SGP were set in terms of the changes in the structural balance, which also incorporates developments in interest payments. To make the requirements comparable, in Chart 13, they are expressed in terms of the changes in the structural primary balance. The fact that interest payments as a percent of GDP fell considerably over the period 2014 to 2019 in all the countries shown in Chart 13, meant that these “windfalls” reduced the improvement that needed to come from the structural primary balance. The reversal of the interest windfalls going forward is a major factor in explaining why the adjustment requirements under the pre-reform SGP would become more demanding than in the past (comparison of the yellow bars with the green lines). Still, both the pre-reform SGP and the revised framework would imply a fiscal adjustment that is, in most of these countries, far more than they delivered between 2014 and 2019, i.e. ahead of the pandemic and energy crises, where, except for Portugal, the structural primary balance even declined. However, the above comparison of the adjustment requirements under the reformed and pre-reform SGP is made at face value and does not take into account that the macroeconomic and fiscal situation prior to the COVID-19 pandemic and the energy crisis was different. Past experience has shown that actual implementation and enforcement of the rules is the key determining factor when it comes to the amount of adjustment achieved. This is clearly illustrated when we compare the required adjustment with the adjustment actually delivered over the period 2014 to 2019. A comparison of the green lines with the red dots in Chart 13 reveals that the adjustment effectively delivered was considerably lower than what was required.

Under the reformed fiscal framework, any interest dividends would no longer contribute to meeting the adjustment requirements, as these requirements are set in terms of the structural primary balance. Consequently, any surprise developments in interest payments that might arise in the period of the fiscal-structural adjustment plans would have no bearing on the compliance assessment.[97]

[97] The treatment of interest spending in the context of the surveillance indicators also has implications for the interaction of fiscal and monetary policy. Villeroy de Galhau, F. (2021), for example, argues that interest payments could be included in a net expenditure rule. In such a setting it is argued that a rule based on total government expenditure growth would incorporate a fiscal response to changes in the interest burden. For example, if interest rates decline (e.g. in the event of an economic downturn), thus leading to a reduction in the government interest burden, primary expenditure could be adjusted upwards and amplify the countercyclical effects of the monetary policy decision. Conversely, if rates rise (as in an economic recovery), governments would have to make more of an effort on primary expenditure.

Chart 13

Annual adjustments (seven years): “New” versus “old” SGP
(% of GDP)



Sources: European Commission (Autumn 2023 forecast) and ECB calculations.
Notes: Member States with debt levels projected to exceed 100% of GDP in 2024. The adjustment requirements under the “old” SGP are 0.5 pp of GDP under the corrective arm and the matrix adjustment under the preventive arm, translated into SPB. Greece without SGP requirements for 2014-2019.

5 The euro area dimension

Looking beyond the current reform of economic governance, the single monetary policy would benefit from a more effective coordination of fiscal policies in the euro area, notably through the creation of a central stabilisation instrument.[98] Such an instrument should be designed to ensure an appropriate euro area aggregate fiscal stance that is complementary to monetary policy insofar as possible. Past discussions within the Council on moving towards common instruments have proved highly controversial, as the debate surrounding NGEU in 2020/21 demonstrated. These considerations may explain why the Commission did not include any references to such an instrument, or how it could be designed, in its legislative proposals.

A credible fiscal framework that anchors expectations on sustainable national fiscal policies can raise confidence in further fiscal integration in the euro area as the two dimensions are interlinked. Draghi (2023) considers that EMU's fiscal setup will remain underdetermined until such time as a permanent central fiscal capacity (CFC) is established. In his view, fiscal credibility requires not only credible – e.g. automatic – rules, but also fiscal transfers and federal spending on common projects to fund shared goals and address unforeseen common shocks. He explicitly refers to the US experience, with "broadly inflexible" balanced budget rules at state level, which he considers credible because of (co-existing) fiscal transfers and federal spending on common projects. Such considerations would have spoken in favour of discussing SGP reform and the prospect of EMU deepening in the fiscal area in tandem. This is in line with earlier proposals (see Kamps and Leiner-Killinger, 2019), which suggest that access to a CFC could provide positive incentives for compliance with fiscal rules.

From a monetary policy perspective, completing the architecture of Economic and Monetary Union (EMU) is an important missing element and should remain a policy priority. Failing to consider the euro area dimension in the SGP runs the risk of adversely affecting the single monetary policy. The ECB opinion therefore highlighted (i) the prerequisites for a functioning fiscal framework that reduces vulnerabilities due to high debt at Member State level and ensures the building of fiscal buffers, and (ii) the need for further progress on euro area-related aspects of the Union's economic governance framework. The latter would be accompanied by the establishment of an appropriately designed CFC.

Going forward, it would be important to further improve the coordination of fiscal policies in terms of the aggregate euro area fiscal stance. Firstly, the proposed move towards bilateral discussions of national plans may insufficiently cater for spill-over effects across euro area countries. A stronger focus on policy priorities – fiscal, reforms and investment – at the national level and the intention to

[98] See, inter alia, "Completing Europe's Economic and Monetary Union", report by Jean-Claude Juncker, in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz, 22 June 2015, p. 4.

raise national ownership might at times conflict with achieving common euro area policy priorities. The preventive arm regulation therefore specifies that the set of reforms and investment commitments underpinning an extension of the adjustment period should seek to address and fulfil the common priorities of the Union, among other pursuits. Secondly, the agreed set-up, which will build to a lesser extent on common annual fiscal targets, might make it more difficult for monetary policy to judge the planned aggregate fiscal stance which – even more than in the past – will be an incidental by-product of the budgetary plans of euro area countries. It will thus be of the essence that the annual Draft Budgetary Plan (DBP) process is preserved, as the Commission proposes. This would help to ensure that the euro area fiscal stance is properly discussed and gains sufficient traction. Thirdly, from a monetary policy perspective, any soft, non-binding coordination of the euro area fiscal stance, as observed during the activation of the SGP general escape clause, remains second best to an appropriately designed CFC for stabilisation purposes.

As also pointed out in ECB (2021), further scope exists for joint EU-wide action to address key investment needs. Next Generation EU has brought innovations on the spending and revenue side that could offer valuable lessons for delivering more in the way of European public goods (Buti and Papaconstantinou, 2022; Dorrucci and Freier, 2023). Once it expires and in the absence of a new initiative, funding for investment provided at the EU level will significantly decrease. This is particularly relevant as some public goods are at risk of being underprovided due to the potential for free riding and the limited fiscal space in some Member States in financing them (Panetta, 2022). Programmes directly managed at the EU level and the provision of funding to Member States – prioritising cross-border projects that provide high European added value – could be combined (e.g. in the area of green transition and energy security; see Abraham et al., 2023). Making further progress towards existing proposals for new EU own resources and designing new ones would help increase the size of the EU budget to support long-term investment priorities, along with reprioritisation of spending programmes where possible. Drawing from the experience gained in implementing the Recovery and Resilience Facility,[99] the related funds should be absorbed and deployed by the Member States in an efficient way,[100] which would help crowding-in much needed private investment. From a monetary policy viewpoint, such an instrument – which could be under an increased EU budget – would need to be appropriately designed and coordinated with the euro area fiscal stance to ensure its countercyclicality.

99 See European Commission, February 2024, Mid-term evaluation of the Recovery and Resilience Facility (RRF): https://commission.europa.eu/about-european-commission/departments-and-executive-agencies/economic-and-financial-affairs/evaluation-reports-economic-and-financial-affairs-policies-and-spending-activities/mid-term-evaluation-recovery-and-resilience-facility-rrf_en.

100 See Kamps et al. (2009) and Capella-Ramos et al. (2020), who point to the possibility that EU funds aimed at convergence may at times have a procyclical impact on the economy, notably when they are absorbed when the output gap is large and positive.

6 Conclusion

This paper discusses the reform of the EU's economic governance, focusing on its fiscal elements and the euro area dimension. The EU's pre-reform fiscal framework has had material consequences for the economic performance of the euro area both because of certain limitations but also due to a lack of effective implementation. Deficiencies have emerged especially before and after the global financial and sovereign debt crises.

The paper has also shown that there have been wide-ranging views among stakeholders regarding the proper function of the European fiscal governance framework. Some have been placing particular emphasis on the need to return to lower government indebtedness via more prudent fiscal policies, while others have been emphasising the need to achieve more sustainable public finances through stronger investment and reform-led growth. Moreover, while all participants in the debate are aware of the sizeable government investment needs in the years to come, some insisted on aspects such as the need to enhance the quality of public finance at the national level, and others on the need to develop a central fund to achieve that aim.

The reform proposal put forward by the Commission in April 2023, which has led to the adoption by the EU legislator of the package of reforms to the EU fiscal rules on 29 April 2024 and its entry into force on 30 April 2024, can be regarded as the most significant overhaul of EU fiscal governance since the inception of the SGP in 1997. It follows a multitude of parametric changes which, over time, had made the framework complex and somewhat inconsistent. While such a wide-ranging reform entailed a lengthy political negotiation process, now that an agreement has been reached, it will be essential to ensure timely and effective implementation of the new fiscal rules. The reformed fiscal rules will only gain credibility over time if they are owned by national governments and better enforced by the Commission and the Council.

From a monetary policy standpoint, it is crucial that the implementation of the reformed fiscal framework ensures fiscal policies in the euro area that effectively complement the ECB's monetary policy. Priorities in the short and medium term are the reduction of high debt and cross-country debt heterogeneity, as well as further countercyclicality and more growth-friendly fiscal policies. In the longer run, a better coordination of fiscal policies in EMU should be achieved by establishing an appropriately designed permanent central fiscal capacity. The two dimensions – credible fiscal rules that anchor expectations and a central fiscal stabilisation instrument – are interlinked. The more successful the new fiscal framework proves to be in reducing fiscal vulnerabilities and incentivising growth-enhancing reforms and investment, the higher the trust among Member States in taking further steps towards deeper fiscal integration in the euro area.

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