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Between high ambition and pragmatism: Proposals for a reform of fiscal rules without treaty change

STUDY

European Economic
and Social Committee

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Study

General information

STUDY FOR	*The European Economic and Social Committee (EESC)*
REQUESTING SERVICE	*EESC Workers' Group*
STUDY MANAGING SERVICE	*Foresight, Studies and Policy Assessment Unit*
DATE	*November, 2021*
MAIN CONTRACTOR	*Hans-Böckler-Stiftung* *Executive Agency:* *Macroeconomic Policy Institute (IMK)* *of the Hans-Böckler-Stiftung*
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IDENTIFIERS

		ISBN	doi
STUDY			
Print	*QE-01-21-510-EN-C*	*978-92-830-5475-7*	*10.2864/91318*
PDF	*QE-01-21-510-EN-N*	*978-92-830-5474-0*	*10.2864/355255*

Abstract

This study examines major reform proposals of EU fiscal rules from an economic and legal perspective. We disassemble the reform proposals in their components and analyse them in their specific proposed form in comparison, thereby shedding light on what is legally possible, economically sensible, and which parameters are to be looked at when putting together a final reform package. We show that quite far-reaching reforms of EU fiscal rules are feasible without treaty change as current secondary legislation restricting member states' fiscal policies are much more detailed and often much stricter than the original treaty provisions. Especially proposals that shift the current rules towards expenditure rules and which provide for limited borrowing for public investment can be implemented by changing secondary legislation only, provided the parameters are set such that the original deficit thresholds in the treaty are not violated. The same holds for measures lending greater importance to the Macroeconomic Imbalance Procedure. Increasing the reference value on the debt ratio would require a unanimous vote in the Council after consultation of the European Parliament and the ECB. Proposals that try to shift fiscal rules from rules to standards and focus on empowering independent bodies are instead legally much more difficult to reconcile with the EU treaties.

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Executive Summary

The reform debate on the EU fiscal rules is fuelled by the findings on at least five deficiencies: First, the current set of rules consisting of provisions in the EU treaties and several secondary regulations has become extremely complicated, so that it is often only fully understood by a handful of experts in the EU Commission and national finance ministries. Second, the current rules have not succeeded in preventing the rise of public debt ratios in many countries. Third, public investment in particular has often become the subject of austerity programmes in the member states, which dampens prospects for economic growth. Fourth, the targets for reducing the debt ratio by 1/20 of the distance to the 60% limit of the Maastricht Treaty are too ambitious for countries with – after the Corona crisis – particularly high debt ratios. Fifth, the technical conception of the rules has led to pro-cyclical fiscal policy in many countries, i.e., the rules were on average too loose in good years and too tight in bad times.

To understand the limitations and reform options of EU fiscal rules, it is helpful to consider the different levels of regulation and the preconditions for a respective reform. In particular, four levels should be distinguished:

1. The EU treaties (widely known as "Maastricht rules") prescribe in Art. 126 TFEU that member states must avoid "excessive deficits". The extent to which a deficit is "excessive" is assessed in a complex political procedure. According to the Treaty, one criterion is that specific reference values for deficits and debt ratios (laid down in a protocol) are exceeded. However, merely transgressing these values is insufficient to qualify as an excessive deficit. Ultimately, an excessive deficit is determined politically by the Council with a majority vote and after weighing all factors, including those that ease the burden. Article 126 TFEU further stipulates that the presence of a downward movement of the respective ratios may already exclude the finding of an excessive deficit. In this context, the EU Treaty can only be amended with unanimity in the European Council and with the approval of all Member States in accordance with their constitutional requirements, which is why a referendum may be necessary in some Member States.
2. A protocol to the EU treaties sets the reference values for the Maastricht rules at 3% of GDP for the deficit and 60% of GDP for the debt ratio. The values in the protocol can be changed without Treaty amendment by unanimity in the European Council according to a special procedure laid down in the EU Treaty.
3. There are a large number of rules in secondary legislation that specify, among other things, how excessive budget deficits and macroeconomic imbalances are to be prevented and corrected. The limitation of the structural deficit to the medium-term budgetary objectives (MTOs) of 0.5% of GDP for countries with a debt ratio higher than 60% and the requirement to reduce the debt ratio by 1/20th of the deviation to the 60% each year derive from these secondary laws. These rules can be changed in the regular EU legislative procedure, partly by qualified majority and partly by unanimity in the Council, and they have been changed several times since the introduction of the euro.
4. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (also known as "Fiscal Compact") codifies some of the rules from EU secondary legislation, partly even more restrictive, in an intergovernmental treaty among 25 of the EU Member States. Since this treaty is outside EU law but affects the EU's areas of competence, a conflict of EU secondary legislation with this treaty would lead to the rules of the Fiscal Compact to be

overruled. In other words, the Fiscal Compact does not stand in the way of a reform of EU secondary law.

There are numerous reform proposals for the fiscal rules on the table. In fact, the number of proposals is so large that a thorough review of all these proposals is beyond the scope of this (or any short) study. Yet, many of the proposals contain similar reform elements. Therefore, we have selected three representative proposals, two on the corners of the current spectrum of the debate and one which is between the two. The "corner proposals" we have selected are the widely discussed proposal by the European Fiscal Board (2018, 2020) on the more conservative side and the far-reaching Blanchard et al. (2021) call for a move to fiscal standards on the other side. As a third proposal, we have chosen the proposal by Dullien et al. (2020). The rationale for this choice is that the Dullien et al. proposal is in some of its basic ideas close to the EFB's yet provides more fiscal space, highlighting the importance of specific parameter choices and policy options.

We identify five major reform elements in the selected reform proposals. These are i) the replacement of the current annual structural deficit targets by an expenditure rule, ii) changes relating to the government debt anchor, iii) proposals for strengthening public investment, iv) the strengthening of the Macroeconomic Imbalance Procedure within the economic governance structure, and v) the replacement of the fiscal rules by fiscal standards. The study analyses and contrasts the single reform elements both from an economic and a legal perspective. By first disassembling the reform proposals in their components and then analysing them in their specific proposed form in comparison, we shed light on the question of what is legally possible, economically sensible, and which parameters are to be looked at when putting together a final reform package. In the legal analysis, we have focused on how far the elements of the reform proposals could be implemented without changes in primary EU law.

Without amending the EU Treaties and thus touching the core of the Maastricht rules, there are several options for agreeing on the goal of sustainable public finances, a prospective reduction in the public debt ratio, and more scope for public investment by amending EU secondary law. Sensible and important options would be:

- Shifting the operational target of annual fiscal policy from restricting cyclically-adjusted deficits to an expenditure rule in which non-investment, non-cyclical expenditure may only grow at a certain rate per year if it is not financed by discretionary tax increases. This could be implemented by changing secondary legislation only, provided the parameters are set so that the original deficit thresholds in the treaty are not violated.
- The same holds for measures lending greater importance to the Macroeconomic Imbalance Procedure.
- Prioritising growth-enhancing public investment, for example, by introducing a golden rule for investment that does not count to the expenditure path but is allowed to be financed, at least partly, through borrowing.
- A change in the 1/20th rule for adjusting the debt ratio, for instance, with longer adjustment paths or a temporary suspension so that even highly indebted countries can meet the requirements without macroeconomic damage.

A more far-reaching reform proposal to increase the reference value on the debt ratio would require a unanimous vote in the Council after consultation of the European Parliament and the ECB. However, a Treaty change would not be necessary.

These reforms would continue to correspond to the basic idea of the Maastricht Treaty, which provides for a limitation of deficits and a gradual reduction of high debt ratios. At times, when changing the corrective arm of the SGP or when modifying the protocol on the excessive deficit procedure, unanimity within the Council is required. At other times, when amending the preventive arm of the SGP or the Macroeconomic Imbalances Procedure, the ordinary legislative procedure with a qualified majority within the Council is to be followed. Hence, the realisation of reform options depends more on the political willingness of the relevant decision-makers than on overcoming major legal barriers.

From an economic perspective, replacing the current operational target of structural balances with expenditure rules and a golden rule that safeguards public investment would improve the framework significantly. If parameters are set appropriately, the reformed set of rules could provide a more anti-cyclical fiscal policy, a smoother path for public expenditure, a higher quality of public spending (by preventing excessive cuts to public investments) without jeopardising fiscal sustainability. Concerning public debt, the fundamental change in the relationship between the real interest rate and the real growth rate of the economy has major implications for debt sustainability analyses since it means that a higher debt-to-GDP ratio is now sustainable over the long term whatever the specified primary surplus or deficit. It can be argued that the 60% Maastricht debt-to-GDP ratio – which is even more unrealistic in the light of the increase of debt levels in many countries during the Covid19 pandemic – should be adjusted to reflect changes in the macroeconomic environment that have already existed for several years.

However, a word of caution is warranted: A combination of the discussed reform options may require additional limitations on the expenditure rule, the ‘Golden Rule’, or the temporary deviation for MIP recommendations. These should be set in relation to the debt level of the Member State in question.

Proposals that try to shift fiscal rules from rules to standards and focus on empowering independent bodies may have a lot to recommend from a purely economic perspective. They are, however, legally much more difficult to reconcile with the EU treaties. Moreover, the current legal framework already suffers from a technocratic decision-making bias that undermines its persuasive power within the Member States. A complete switch to standards would only strengthen technocratic decision-making in fields that relate to the core of democratic decision-making within national Parliaments: the adoption of national budgets.

The reform elements without treaty change discussed in this study would simplify the EU fiscal framework, render it more counter-cyclical and symmetric in application, and open a fiscal margin of manoeuvre for public investment. Such reforms will make the framework more persuasive to national policymakers and are vital to achieving the transformation of the EU’s economies against the background of climate change and the digital economy while at the same time avoiding unsustainable public finances and macroeconomic imbalances.

1. Introduction

Despite a significant number of changes to the EU fiscal rules over the past decades, the general perception is that these rules are not fit for purpose. There has been a long-standing criticism that the current rules result in pro-cyclical or at least a-cyclical fiscal policy as well as in reduced public investment and that, at the same time, they have not managed to prevent debt-to-GDP ratios from further increasing. After the pandemic-induced increase in debt levels, a particular problem is seen in the requirement to reduce the debt-to-GDP ratio by 1/20th of the difference to 60% per year, which is perceived as overly restrictive for many countries.

Reform proposals for the fiscal rules abound. In fact, the number of proposals is so large that a thorough review of all of these proposals is beyond the scope of this (or any short) study. Yet, many of the proposals contain similar elements.

This study has therefore chosen an approach different from a simple overview of reform proposals. We have instead selected three representative proposals, two on the corners of the current spectrum of the debate and one which is between the two. For these proposals, we have analysed and contrasted the single reform elements both from an economic and a legal perspective. In the economic analysis, we have focused on the most discussed questions: a) Can the reforms lead to more counter-cyclical fiscal policies and a better stabilization of member states' economies through fiscal policies? b) Can the reforms help to improve the quality of public finances and especially lift the level of public investment? c) Are the reforms compatible with the goal of preventing unsustainable public finances in single member states? In the legal analysis, we have focused on the question in how far the elements of the reform proposals could be implemented without changes in primary EU law.

By first disassembling the reform proposals in their components and then analysing them in their specific proposed form in comparison, we hope to shed light on the question what is legally possible, economically sensible, and which parameters are to be looked at when putting together a final reform package.

The "corner proposals" we have selected are the widely discussed proposal by the European Fiscal Board (2018, 2020) on the more conservative side and the far-reaching Blanchard et al. (2021) call for a move to fiscal standards. As a third proposal, we have chosen the proposal by Dullien et al. (2020). The rationale for this choice is that the Dullien et al. proposal is in some of its basic ideas close to the EFB's, yet provides more fiscal space, therefore allowing to highlight the importance of specific parameter choices and policy options.

The study is structured as follows: We first provide an overview of existing fiscal rules and their legal basis. In a second step, the reform elements of the three proposals under examination are described. In a third step, each of these reform elements is evaluated first from an economic, then from a legal perspective. The conclusion pulls together the different analytical strands and examines in how far there might be legal limits for combining single reform elements even if the single elements by themselves are legally possible.

Outside of this general structure, the study contains a box (on p. 16) on the question in how far a reform of the methodology to compute potential output and structural balances within the existing fiscal rules would provide another politically feasible alternative to the expenditure rules found in the EFB and Dullien et al. proposal.

2. Description of the current EU legal framework of fiscal rules

2.1 Imperative Treaty objectives and requirements for the EU legal framework of fiscal rules

The fiscal policies of the Member States are subject to a coordination at Union level (Article 5(1) TFEU). Coordination of national policies means that the Union may adopt measures, but these do not supersede Member States' competences in the policy areas that are coordinated (Article 2(5) TFEU). Fiscal policies, which in the terminology of the Treaties are covered by the term 'economic policies', are coordinated under Article 121(1) TFEU in accordance with Article 120 TFEU, which establishes that Member States must conduct their fiscal policies with a view to contributing to the achievement of the objectives of the Union (Article 3 TEU), in the context of the broad guidelines that the Council adopts under Article 121(2), in accordance with the principle of an open market economy with free competition, and in compliance with the guiding principles set out in Article 119(3) TFEU; these are stable prices, sound public finances and monetary conditions and a sustainable balance of payments.

In legal terms, Articles 119, 120 and 121 TFEU 'do not impose on the Member States clear and unconditional obligations which may be relied on by individuals before the national courts. What is involved is a general principle whose application calls for complex economic assessments which are a matter for the legislature or the national administration' (Case C-9/99, para. 25). Their legal qualification as principles means that they bind Member States as 'optimization precepts' (*Optimierungsgebote*), which means that Member States must strive towards realising them but are free in how they prioritise them and how they manage conflicts between these principles. Legally non-binding recommendations from the Union give guidance as to how these 'optimization precepts' can be best realised from the Union's perspective. The general Treaty rules on economic policy do not therefore provide for any clear legal requirements with regard to how Member States conduct their fiscal policies. Legally binding requirements can only be found in more specific rules.

Much of the more specific EU legal framework of fiscal rules is determined by secondary law and therefore open to amendment by the Union legislator in accordance with the applicable legislative procedure. This includes the protocol on the excessive deficit procedure (EDP), which defines the reference values. The Treaties impose one explicit legally binding requirement for Member States' budgets. According to Article 126(1) TFEU, they must avoid excessive deficits. This requirement is, however, open to interpretation. A Member State only fails to comply with this requirement if the Council has decided so (Article 126(6) TFEU). The Treaty has opted for a political and procedural way to determine whether an excessive deficit exists. The Council has thereby full political discretion whether it adopts a proposal of the Commission suggesting the existence of an excessive deficit. The Commission has no legal claim to force the adoption of such a decision if it observes such a deficit on the basis that certain indicators exceed certain reference values. This understanding makes it clear from the very outset that the Union legislator, and the Council in particular, dispose over a broad political discretion when determining the meaning of excessive government deficits and how to avoid or correct them.

Article 126(3) TFEU establishes an assumption that a Member State may have accumulated an excessive deficit if either the ratio of the planned or actual government deficit[1] to GDP exceeds a reference value, the ratio of government debt to GDP exceeds a reference value, or both exceed these references values. The legal consequence of this is the preparation of a report by the Commission. The reference values are not defined by Article 126 TFEU itself but by the Protocol on the excessive deficit procedure annexed to the Treaty, which introduces the 3%-criterion for the government deficit and the 60%-criterion for government debt. These values can, as mentioned earlier, be changed by a unanimous vote in the Council without a formal Treaty change procedure. The mere transgression of these reference values does not in itself violate the Treaty requirement. The presence of a downward movement of the respective ratios may already exclude a finding of excessive deficit and the Commission has to take other relevant factors that can justify such transgression into consideration before proposing that the Council determine the existence of an excessive deficit.

This leads to two preliminary conclusions: first, there is no simply numerical requirement for Member States' budgets in the TFEU itself. Second, although the Treaty speaks of excessive *deficits*, the requirement is not limited to deficits. It looks at both annual government spending and overall government debt. This must be read in conjunction with the Treaty objective in Article 3(4) TEU, according to which the Union (as a whole) establishes an economic and monetary union whose currency is the euro (de Witte 2020, p. 289). Given that the requirement to avoid excessive deficits is embedded in the objective of a currency union, the main Treaty objective for Member States' budgets becomes clear: Member States have to ensure the sustainability of public finances that is necessary for the financial stability of a currency union in which the Member States do not dispose over monetary policy instruments anymore (see in that regard also CJEU, Case C-370/12 Pringle, paras. 135-7 relying on Article 125(1) TFEU). Hence, Member States must not become indebted to an extent that they cannot sustain themselves financially anymore and must remain able to deploy fiscal policy instruments where monetary policy instruments are not available. In determining how to achieve this objective, the EU institutions dispose over a broad political discretion, which is confirmed by the fact that the existence of an excessive deficit is determined by a political decision of the Council.

2.2 Design of the current EU legal framework of fiscal rules and interactions between the multiple layers

The EU legal framework relating to fiscal policies consists of multiple layers of hard rules and soft recommendations and communications. These rules are located at different levels of a legal hierarchy, which can be distinguished according to the way they can be amended. There are Primary law rules, which can be found in the EU Treaties and the protocols annexed to it. These rules can only be amended by a Treaty change, following the procedure set out in Article 48 TEU, unless a Treaty rule itself provides explicitly for a different, modified amendment procedure. Next, there are Secondary law rules, which can be found in regulations and directives based on competences conferred upon the Union within

[1] Deficit is thereby understood as 'net borrowing' as defined in the European System of Integrated Economic Accounts. According to Annex A of Regulation (EU) No 549/2013 on the latest version of the European System of National accounts 'net borrowing' is the difference between total general government revenue and expenditure.

the Treaties.[2] They can be amended in accordance with the legislative procedure foreseen by the legal base, on which the secondary legal act was originally adopted. In situations in which either Primary law or Secondary law empowers the Commission to act, the Commission may limit its own discretion, derived from these legal acts, in the form of soft law communications.[3] In these documents the Commission makes its understanding of certain technical terms and rules public. These communications can be amended by the Commission itself. Moreover, the Economic and Financial Committee (EFC), which is tasked under Article 126(4) TFEU to formulate an opinion on the existence of an excessive deficit, has issued a communication on the implementation of the Stability and Growth Pact (SGP), which is in rank below secondary law and provides relevant information on how the application of the SGP takes place.[4] Finally, there is extra-EU law in the form of international agreements concluded between (a subgroup of) the EU Member States. The agreements can only be amended in accordance with the specific change procedure foreseen by these agreements (mostly, ratification by all concluding Member States).

These different rules can be conflicting with each other. In such a situation, there are conflict rules that determine which rule is actually applicable to a given situation. Within the EU legal framework, there is one conflict rule that is a hierarchical one: a higher ranked rule prevails over a lower ranked rule. In other words, Primary law prevails over secondary law and Commission communications. Secondary law prevails over Commission communications. Yet, the mere existence of a conflict is not sufficient that a secondary law rule is rendered inapplicable by a Primary law rule. The Court of Justice has the monopoly to declare a secondary law rule void (Articles 263(1), 264, 344 TFEU).

Applying these principles to the EU rules on fiscal policy, the following legal picture emerges: all rules have to comply with Article 126 TFEU and the protocol on the excessive deficit procedure. Changes to this protocol underlie, however, not the regular Treaty change procedure, but can be introduced by means of a special legislative procedure after a unanimous vote in the Council and consultation of the European Parliament and the ECB (Article 126(14)(2) TFEU). The existing secondary law can be divided into those rules that relate to correcting existing excessive deficits (Regulation (EC) No 1467/97 [the so-called corrective arm of the SGP]) and those that apply to fiscal rules before a Member State's government deficit is considered excessive (Regulation (EC) No 1466/97 [the so-called preventive arm of the SGP]) and the macroeconomic imbalances procedure (Regulations 1174/2011 and 1176/2011). The former can be amended by means of a special legislative procedure after a unanimous vote in the Council and consultation of the European Parliament and the ECB (Article 126(14)(2) TFEU). The latter can be amended or newly introduced as part of the economic policy coordination on the basis of the ordinary legislative procedure (Article 121(6) TFEU) with the possibility to adopt special rules only applicable to euro area countries (Article 136(1)(a) TFEU).

[2] Concretely, these are SGP regulations: Regulation (EC) No 1466/97 (the preventive arm of the SGP), Regulation (EC) No 1467/97 (the corrective arm of the SGP); the 'six pack' regulations: Regulation (EU) No 1173/2011 on the effective enforcement of budgetary surveillance in the euro area, Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, Regulation (EU) No 1174/2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area, and Directive 2011/85/EU on requirements for budgetary frameworks of the Member States; and the 'two pack' regulations: Regulation (EU) No 472/2013 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, and Regulation (EU) No 473/2013 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.

[3] Most notably, Commission Communication on making the best use of flexibility within the existing rules of the SGP (COM(2015) 12 final).

[4] Most notably, Code of Conduct of the SGP of 15 May 2017, available online: https://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf.

2.3 Implications of changes to EU secondary law for the TSCG

The picture is slightly different when it comes to the relationship between EU law and non-EU law such as international agreements of the EU Member States, in particular those that were exclusively concluded amongst EU Member States. Legally speaking, international agreements are part of the national law of the Member States, since they need to be ratified by a national law in order to enter into force. As national rules, their relationship with EU law is governed by the principle of supremacy. In case of a conflict between a rule of an international agreement concluded between EU Member States and EU law, it is the latter that prevails. The legal consequence is the disapplication of the rule of the international agreement and the application of the EU law rule instead. It must, however, be noted that this is only the case for international agreements, to which no third country is a party.

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) with the 'Fiscal Compact' is hence subject to changes made in the EU legal framework. Being non-EU law adopted within the scope of an existing Union competence, any conflicts that arise from the TSCG because of changes made to EU Primary law or EU Secondary law result in a disapplication of the affected TSCG rule (Repasi 2013, p. 63; de Witte 2019 p. 13 ff.).

2.4 'General Escape Clause' in the existing Stability and Growth Pact

Under the preventive arm of the SGP, in the event of 'an unusual event outside the control of the Member State concerned which has a major impact on the financial position of the general government or in periods of severe economic downturn for the euro area or the Union as a whole' Member States may temporarily be allowed to depart from the adjustment path towards the MTO 'provided that this does not endanger fiscal sustainability in the medium term' (Article 5(1)(10) of Regulation 1466/97). Such deviation is consequently left out of consideration when assessing the adjustment path under Article 6(3)(3) (the rules are replicated for non-Euro countries in Article 9(1) and 10(3)).

Under the corrective arm of the SGP, three situations must be distinguished. The existence of a severe economic downturn can already preclude the conclusion that there is an 'excessive deficit' under Article 126(2)(a), second indent TFEU because planned or actual government deficit is then considered 'only exceptional and temporary' (Article 2(1) of Regulation 1467/97). Even then, however, the ratio needs to remain close to the reference value. If the deficit goes beyond this limitation, or if the Commission concludes, despite the presence of a 'severe economic downturn', that according to its forecasts, the deficit will not fall below the reference value following the assumed end of the unusual event or the severe economic downturn (Vademecum 2017, p. 13), an excessive deficit procedure against the Member States concerned will be initiated. Then, the second situation comes into play. Once the Commission observes an excessive deficit, it prepares a report, in which it can then consider 'other relevant factors' that mitigate the excess over the deficit or debt criterion. Such other relevant factors cover unusual events and severe economic downturns and can become the basis for a Council decision rejecting that an excessive deficit exists under Article 126(6) TFEU. Only thereafter can the third situation apply, which is addressed by Article 3(5) of Regulation 1467/97. As a consequence of the Council's decision that an excessive deficit exists, the Council must adopt a recommendation addressed to the Member State concerned under Article 126(7) TFEU with concrete measures, the non-compliance with which may trigger the sanctions foreseen by the Treaties. Yet, in a severe economic downturn or unusual events, the Council may revise its original recommendation under Article 3(5) of Regulation

1467/97. In such a revision, the Council may, in particular, extend the deadline by which a Member State has to take corrective action.

What is relevant here is that this escape clause only applies after an excessive deficit procedure is opened. With regard to the ‘severe economic downturn’ as a consequence of the Covid-19 pandemic, only one country has fallen under this rule since only Romania was subject to an excessive deficit procedure. Interestingly, all these ‘escape clauses’ in the SGP do not address the solution that the Commission actually adopted for the treatment of the Member States during the pandemic. The Commission adopted country-specific reports in 2020 and an omnibus report (COM(2021) 529 final) under Article 126(3) TFEU in 2021, in which it concluded that the pandemic implies for all Member States that they exceed the reference value of 3% of GDP and that the conditions for the exception in Article 126(2)(a), second indent TFEU are not met. When discussing ‘other relevant factors’, the Commission concluded, for 2021, that 24 Member States have an excessive deficit due to excess of the deficit criterion and that 13 Member States have an excessive deficit due to an excess of the debt criterion. This conclusion would mean that the Commission should prepare a proposal for the Council to decide on the existence of an excessive deficit under Article 126(6) TFEU.

Yet, the Commission never drafted such proposals. This lack of proposals led in spring 2020 to a discontinuation of the excessive deficit procedure. This situation is not mentioned by any of the ‘escape clauses’. The Commission simply uses its political discretion (not) to draft a proposal for the decision on the existence of an excessive deficit to put an excessive deficit procedure on hold. Legally, this behaviour of the Commission is remarkable as it could be argued that under Article 126(3) TFEU, the Commission is obliged to draft a proposal for the Council to decide on the existence of an excessive deficit after it concluded that the reference value is exceeded and no mitigating ‘other relevant factors’ are to be considered. Yet, the existence of such an unwritten ‘escape clause’ under the corrective arm could nevertheless be defended by reference to the existing ‘escape clause’ under the preventive arm. It would namely be a contradictory result if a Member State were allowed to temporarily deviate from the adjustment path towards the MTO by making use of the ‘escape clause’ in Regulation 1466/97 but would be put under an excessive deficit procedure at the same time. This means that the Commission can revive the EDP by simply drafting proposals for decisions of the Council under Article 126(6) TFEU to decide on the existence of an excessive deficit since all the preparatory work still done by the Commission precisely insinuates this (European Commission 2021).

3. Overview of reform elements and their individual design forms

This section outlines the similarities and differences of three selected reform proposals for European fiscal rules, ranging from a relatively conservative proposal – the widely discussed proposal by the European Fiscal Board (2018, 2020) - to a very far-reaching overhaul - the Blanchard et al. (2021) proposal where the rules are to be replaced by fiscal standards. The middle spectrum is covered by Dullien et al. (2020)’s proposal, which broadly resembles the EFB proposal but allows for more fiscal leeway. We do so by breaking down the reform proposals into elements and comparing them in their respective variations.

We identify five major reform elements in the selected reform proposals. Namely, i) the replacement of the current annual structural deficit targets by an expenditure rule, ii) changes relating to the government debt anchor, iii) proposals for strengthening of public investment, iv) the strengthening of the Macroeconomic Imbalance Procedure (MIP) within the economic governance structure, and v) the replacement of the fiscal rules by fiscal standards. Table 1 provides a general overview of the individual characteristics of each proposal, and the following subsections describe the design options in greater detail.

3.1 Expenditure rules as the single operational target

Both the proposal by the European Fiscal Board (2018, 2020) as well as the one by the *Institut für Makroökonomie und Konjunkturforschung – IMK* (Dullien et al. 2020) favour the replacement of the current annual structural deficit targets (including the path to reach these targets as defined in the secondary legislation and the Vade Mecum) by an expenditure rule.[5] In both proposals, the expenditure rule only applies to countries with a debt-to-GDP ratio of more than the reference value (at the moment 60%).[6] For countries with debt-to-GDP-ratios below this threshold, only the deficit ceiling of the Maastricht treaty's protocol of 3% holds, but no restrictions are put on the nominal growth of government expenditure.

Under expenditure rules, the annual growth of government expenditure is limited to a certain value which lies below the expected medium-term nominal potential GDP growth. As government revenue can be expected to grow in the medium and long-term at least at the rate of nominal GDP growth (as tax systems usually are at least partially progressive), such a rule leads over time, in the absence of tax cuts, to shrinking government deficits and falling debt-to-GDP ratios. The extent to which the growth rate of government expenditure is mandated to remain below the growth rate of potential GDP is set in relation to the deviation of actual debt from the debt reference value. The higher current debt ratios are, the more government expenditure growth is limited.

Both proposals include escape clauses which allow countries to deviate from the expenditure rules in times of grave adverse economic events. While the EFB proposal includes an "independent body" in the process of allowing a member state to activate the escape clause, the IMK proposal is rather reticent, on this matter suggesting, as an example, a decision-making process within the euro-group.

Both proposals allow an upward deviation from the originally defined expenditure path provided it is financed by discretionary tax increases.

The two proposals differ in regard to which expenditure is targeted. The EFB proposal targets nominal expenditure net of interest payments (that is "primary expenditure") net of "cyclical unemployment benefits" and of EU-funded investments (European Fiscal Board 2018, p. 18). The IMK proposal targets non-cyclical, non-investment expenditure.

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[5] There is already a form of expenditure rule embedded in the determination of the adjustment path to the MTO, but it plays in practice a subordinate role.

[6] European Fiscal Board 2018, p. 79, Dullien et al. 2020.

Table 1: Overview of the three reform proposals

<table>
<tr><th>Current Framework</th><th colspan="2">Reform features</th><th>EFB (2018, 2020)</th><th>IMK (Dullien et al. 2020)</th><th>Blanchard et al. (2021)</th></tr>
<tr><td rowspan="4">Structural deficit targets

Expenditure benchmark</td><td rowspan="10">Expenditure rule</td><td>Expenditure ceiling replacing current structural deficit targets</td><td>Limit primary nominal expenditure growth</td><td>Limit nominal expenditure growth</td><td rowspan="4">No specific expenditure rule proposed

Fiscal standards instead of fiscal rules</td></tr>
<tr><td>Applies only when a countries' debt-to-GDP ratio > debt-to-GDP ratio reference value</td><td>Yes, debt-to-GDP ratio reference value = 60%</td><td>Yes, debt-to-GDP ratio reference value = 90%</td></tr>
<tr><td>Exclusion of cyclical expenses</td><td>Target net of cyclical unemployment benefits</td><td>Target net of cyclical spending</td></tr>
<tr><td>Deviation from ceiling due to discretionary tax changes</td><td>Yes</td><td>Yes</td></tr>
<tr><td>Investment clause</td><td>Strengthening of public investment</td><td>No explicit exemption of public investment from proposed expenditure rule</td><td>Expenditure ceiling excludes net public investment (capped at 1.5% of GDP), ESA definition shall be extended by spending on education</td><td>Introduce capital budgeting (different fiscal standards for the current and capital account)</td></tr>
<tr><td>Escape clause</td><td>Escape clause</td><td>Yes, activated by decision of independent body</td><td>Yes, decision in euro-group</td><td rowspan="4">country-specific assessments by national independent fiscal councils employing stochastic debt sustainability analysis

One institution for monitoring and one for final adjudication</td></tr>
<tr><td rowspan="3">Medium-term objective (MTO)</td><td>Adjustment requirements</td><td>Does not rule out actual year-on-year reductions of nominal expenditures</td><td>Safeguard-clause preventing cuts to nominal government expenditure</td></tr>
<tr><td>Adjustment speed</td><td>2018: target set so debt anchor is reached in 15 years
2020: degree of restriction to be determined</td><td>Adjustment periods longer than 20 years are possible</td></tr>
<tr><td>Adjustment limits</td><td>No, unrestrained</td><td>Expenditure rule deactivated if surplus ratio overshoots a threshold</td></tr>
<tr><td rowspan="2">60% debt-to-GDP target

1/20 debt reduction target of debt overhang</td><td rowspan="2">Debt anchor</td><td>Changing the debt anchor</td><td>Country-specific adjustment speeds toward the 60% reference value</td><td>Universal increase of debt ceiling to 90% of GDP</td><td rowspan="2">No specific proposal

Debt ratios significantly higher than 60% considered sustainable</td></tr>
<tr><td>Decision process</td><td>Two options: 1) set debt anchor according to key macroeconomic indicators; 2) case-by-case decision by the Council</td><td>Political determination of the seriousness of a member state's economic situation rather than relying on a single indicator (output gap)</td></tr>
<tr><td>Macroeconomic Imbalance Procedure (MIP)</td><td>Role of MIP</td><td>Increase role of the MIP in the revised fiscal framework</td><td>Vary speed of adjustment to MTO in light of MIP recommendations</td><td>Strengthen MIP and give greater weight to MIP recommendations in evaluate fiscal stance</td><td>No specific proposal</td></tr>
</table>

Source: EFB (2018, 2020), Dullien et al. 2020, Blanchard et al. (2021); own illustration.

While the difference in the treatment of interest payments and cyclical expenditure other than unemployment benefits can be assumed to be of rather marginal relevance, the different treatment of investment is more important. As will be discussed in section 6, the IMK proposal allows a debt-financed investment programme which the EFB proposal does not explicitly permit.

Another relevant difference is in how far the proposed expenditure rule requires actual cuts in government expenditure if a country starts from a high debt-to-GDP ratio. The EFB's proposal does not rule out actual year-on-year reductions of expenditure and the example provided actually shows that they might be necessary in the case of Italy (European Fiscal Board 2020, p. 90). In contrast, the IMK proposal contains an explicit safeguard-clause which prevents forced cuts to nominal government expenditure.

Moreover, the proposals differ in the extent to which government expenditure growth is limited to reach the debt anchor. The EFB's original proposal from 2018 proposed to set expenditure growth so that the reference value would be reached within 15 years. As the Covid19-induced increase in debt-to-GDP ratios has rendered this time frame unrealistic for a number of countries, the European Fiscal Board (2020) has proposed to either adjust the limit according to a preannounced formula or according to a case-by-case evaluation. These 2020 proposals by the EFB would thus limit expenditure growth much less than the original 2018 proposal, while the actual degree of restriction would depend on details still to be determined. Similarly, the IMK proposal does not include specific details on the degree of restriction but holds that much longer adjustment periods than 20 years are necessary, which in turn would mean a lower degree of restriction than the original EFB proposal.[7]

Finally, the IMK proposal limits the primary surplus in the adjustment process: According to the proposal, when a certain primary surplus (relative to GDP) is reached, government expenditure growth is not restricted anymore as long as the primary surplus remains above the threshold (Dullien et al. 2020, p. 11). This safeguard is supposed to prevent overshooting in the primary surplus which is a feature of unrestrained expenditure rules (see section 5.1 for details on this point).

3.2 Reforms to the debt anchor

An important role for sustainable public debt-to-GDP ratios to safeguard the soundness of public finances and prevent bailouts is a feature of all three proposals. The reference value for the ratio would continue to serve as an anchor, providing a long-term target for countries whose debt-to-GDP ratio currently exceeds it. Nevertheless, given major changes in the macroeconomic environment that have occurred since the adoption of the Maastricht Treaty, the reference value and the rules governing adjustment towards it will need revision.

Blanchard et al. (2021) discuss at length the implications of the changed macroeconomic environment, notably the negative interest-growth differential, for sustainable government debt ratios. They present calculations showing that debt levels substantially higher than the current reference value of 60% would be sustainable under current macroeconomic conditions. But, taking into account uncertainty and the possibility of debt default, they conclude that "the debt limit (the debt level at which debt was sustainable with high probability) would be much lower than 162 percent." (Blanchard et al. 2021, p. 11). The authors go on to stress the importance of demand externalities in a closely integrated monetary union

[7] The relative restrictiveness of the IMK proposal and the 2020 EFB proposals are hard to evaluate as they both lack specific details.

where fiscal policy in one country generates spill-over effects in other countries. However, despite these important considerations and given the difficulties involved, Blanchard et al. (2021) refrain from making any proposals on how the current EU fiscal rules should be changed. Instead, they advocate scrapping fiscal rules altogether in favour of using fiscal standards (see Section 8 for a detailed analysis of the proposal of fiscal standards).

The European Fiscal Board first presented its proposal of how to reform the EU fiscal framework in 2018 (European Fiscal Board 2018). The initial proposal consisted of a medium-term debt ceiling which was to remain at 60% of GDP combined with an expenditure rule as discussed above. In subsequent amendments the EFB proposed allowing for country-specific debt reference values in the Treaty protocol or for country-specific adjustment speeds toward the reference value in secondary legislation (European Fiscal Board 2019, 2020). While acknowledging the similar effects of reduced adjustment speeds and increased debt reference values, the EFB most recently seems – for legal reasons – to prefer differentiating the adjustment speeds (European Fiscal Board 2020, p. 88 and footnote 141). To settle on different adjustment speeds the EFB proposes two options: the first is a set of predefined adjustment parameters depending on key macroeconomic variables (European Fiscal Board 2020, Table 5.3), the second involves a case-by-case decision by the Council taking into account the analysis of an independent economic council.[8]

The key element of the IMK proposal concerning the treatment of government debt in the EU's fiscal framework is to increase the reference value to 90%. To some extent, any reference value for government debt will necessarily be arbitrary. Increasing it to 90%, it is argued, is a plausible solution to overhaul the outdated 60%, whilst at the same time still allowing for a safety buffer for unforeseen crises.

Following the EFB's proposal on country-specific adjustment paths, the IMK proposal consists of an expenditure rule, as discussed above, which should limit expenditure more strongly in those euro area countries whose debt-to-GDP ratio exceeds the target ratio to the greatest extent or that are considered to have the least sustainable debt levels. In other words, expenditure in countries that are a long way above the debt threshold should be curbed more strongly than in countries that are only slightly over the threshold. Countries with debt-to-GDP ratios well below the upper limit should be allowed a correspondingly higher level of expenditure, as should countries that still have a high level of debt but where the debt-to-GDP ratio is already falling rapidly due to a substantial primary surplus.

3.3 Strengthening public investment in a revised framework

A central question that appears in all reform proposals is how to encourage public investment in a revised framework. A conceptual starting point is the well-known public finance principle of the Golden Rule which allows debt-financing of government investment that expands productive capacity. The idea is that future generations that will benefit from a better capital stock also contribute to its financing via interest payments.

Currently the fiscal rules mostly do not distinguish between investment purposes and other public spending. Although, there is an investment clause under current rules, Member States can only apply for the investment clause if they record a negative growth forecast or a negative output gap of more than

[8] The range of proposed adjustment parameters extends from 0,02 (1/50) to 0,06 (1/16,67), encompassing the current SGP value of 0,05 (1/20).

1.5% of potential GDP. Due to the restrictive conditions, so far only two member states have been granted some flexibility. Consequently, the track record of the so-called investment clause is disappointing.

The initial reform proposal by the European Fiscal Board (2018) does not include any favouring of government investment in a reformed rule book. However, the EFB has recently become more open to considering public investment when compliance with the expenditure rule is assessed (European Fiscal Board 2020, p. 92). But then again, it should be noted that given its strong emphasis on the risks associated with excluding public investments from the expenditure target, the EFB remains somewhat sceptical and refrains from clearly including a Golden Rule for public investment in its reform package.

In contrast to the EFB, in the IMK proposal the Golden Rule plays a central part. The expenditure rule would only apply to non-investment spending, and thus, capital spending would be deducted from the expenditure ceiling. The IMK does not take a clear position whether there should be an upper limit for debt-financed public investment to prevent a conflict with the goal of stabilising public debt. Nevertheless, on the one hand, the 3% deficit limit would represent an upper limit because the deduction would only apply to the expenditure rule and not the deficit rule. On the other hand, the IMK refers to the Golden Rule proposal by Truger (2016), who proposes an upper limit of 1.5% of GDP for net public investment which can be financed via debt. In this regard, it should also be mentioned that the EFB is silent on whether the exemption from the expenditure rule should apply to gross or net public investment, while IMK explicitly states net investment.

In contrast to the IMK, the EFB argues that if public investment receives special treatment in a reformed framework, the preferential treatment should be limited to additional public investment, which would preferably be determined by the change of the public investment level relative to the country-specific average in past years (European Fiscal Board 2020, p. 92).

When implementing a Golden Rule, the exact definition of public investment must be specified. As a first step, both the IMK and the EFB favour a pragmatic solution and suggest the traditional definition according to the system of national accounts. The focus is mainly on tangible assets (equipment, buildings, infrastructure, and other investment goods with an economic life of more than one year). Both institutions, however, argue for an extension of the definition to other expenditure categories which arguably increase the long-run potential of the economy. In particular, the coverage of spending on education and human capital could be rethought. When it comes to defining what classifies as public investment, the EFB is explicitly in favour of the involvement of national independent fiscal watchdogs to cautiously monitor what member states declare as deductible investment spending. The IMK proposal contains no reference to the involvement of fiscal councils.

Blanchard et al. (2021) want to introduce explicit capital budgeting to protect public investment. The idea is to separate the total government account into the current and the capital account. Based on this differentiation, varying fiscal standards could be set for the current and capital accounts. The current account would be generally requested to be balanced, and the capital account could be partly financed by the issuance of debt.

Blanchard et al. (2020b, p. 26) clarify that the capital budgeting they propose is conceptually different from the Golden Rule approach, which they are relatively critical of. According to the authors, the capital account would consist of the government's gross investment and the interest payments on the debt owed by the capital account. The income of the capital account is composed of transfers from the current account and returns on investment. Transfers from the current account are, in turn, determined by capital depreciation and the difference between financial returns and market returns. The gross investment would then be excluded from overall government spending. Similar to the EFB, Blanchard et al. (2020b, p. 28) want a fiscal council to monitor capital budgeting to prevent misuse. However, they see this institution best located at the supranational level.

3.4 The MIP within the economic governance regime and its critique

Academic studies and analyses by European institutions, including the European Commission (2020), the European Fiscal Board, and the (European Parliament 2021, p. 49ff.) have identified serious weaknesses in the Macroeconomic Imbalance Procedure (MIP) and/or in its relationship to other EU institutions and processes, especially the fiscal rules.

The MIP is frequently criticised because of its asymmetry regarding the indicators in the scoreboard and the threshold values chosen: The current account, for instance, is to lie between -4% and +6% of GDP, and there is only an upper limit on nominal unit labour cost increases (European Commission 2020, p. 13; Bénassy-Quéré and Wolff 2020, p. 11; Dullien et al. 2020, p. 17). Reform proposals are correspondingly for the thresholds for three indicators to be changed: for the current account to +/-4%, the net international investment position to +/-35% of GDP, and the rate of change of nominal unit labour costs to +/-9% over a three-year horizon.

The MIP scoreboard – its latest vintage has 14 main quantitative indicators with thresholds, supplemented by no less than 28 auxiliary indicators – is excessively complex and lacks internal coherence (European Parliament 2021, §50; Bénassy-Quéré and Wolff 2020, p. 18ff; Dullien et al. 2020, p. 18). Reform proposals seek to reduce its complexity and focus on matters of genuine cross-border concern, by some combination of reducing the number of indicators, prioritising some over others, and changing the definitions. Bénassy-Quéré and Wolff (2020) examine a streamlined indicator set with six variables – current account, net international investment position, change in unit labour costs, credit growth, government debt, and unemployment – and show that it would generate at least equally reliable results in terms of crisis prediction while reducing complexity. Dullien et al. (2020, p. 17f) go further, suggesting that the Alert Mechanism could focus only on three main indicators: inflation (as measured by the GDP deflator to remove the impact of import prices), unit labour costs (in each case symmetrically around the ECB target) and the current account. Other indicators could be retained as contextual indicators and are thus deprioritised.

The MIP follows a country-by-country approach and pays too little attention to defining an appropriate overall stance for the euro area and then clearly identifying the role to be played by the different member states within that overall stance (European Commission 2020, p. 18; European Parliament 2021, §50; Bénassy-Quéré and Wolff 2020, p. 11). The MIP confuses "competitiveness", in a general sense, with the fundamental issue of relative competitiveness – price level and interest rate differentials – within the monetary union (Bénassy-Quéré and Wolff 2020, p. 13; Koll and Watt 2018, p. 18). The country-specific recommendations (CSR) from the MIP should therefore be more clearly distinguished from other recommendations under the European Semester and targeted towards avoiding or correcting imbalances and avoiding spillovers between countries, rather than trying to initiate more general (supposed) improvements to economic policy via "structural reforms". The MIP recommendations to member states should be consistent with the overall stance required for the euro area, set out explicitly in the section of the CSR's dealing with the euro area (Bénassy-Quéré and Wolff 2020, p. 33).

The Excessive Imbalance Procedure (EIP) has never been activated, and more generally, the MIP is widely seen as lacking the "political traction necessary" (European Commission 2020, p. 13). To ensure greater traction of the MIP process and improve economic governance more generally, Koll and Watt (2018) and Dullien et al. (2020) call for a reorientation of the national productivity boards that were set up following a Council recommendation in 2016, and their better coordination with the MIP. Boards act autonomously, setting their own agendas and methodologies (Bénassy-Quéré and Wolff 2020, p. 33), and there is no EU-level institution that seeks to coordinate their analyses or recommendations in order to avoid negative cross-border spillovers (e.g. competitive races to the bottom) and encourage positive spillovers. Such a European-level institution could be established, or the mandate of the European Fiscal Board could be expanded to that end (Koll and Watt 2018, p. 25, who propose renaming the productivity boards Advisory Boards for Macroeconomic Convergence, and Dullien et al. 2020, p. 19).

Last but not least, the relationship between the MIP and the fiscal rules is unclear and potentially inconsistent (Koll and Watt 2018, p. 12). The process of fiscal monitoring and that of monitoring macroeconomic imbalances are separate. Yet policy recommendations for the one will certainly affect outcomes for the other and might be contradictory (European Fiscal Board 2019, p. 91).

The EFB has tabled a proposal to make an explicit link between the fiscal rules and the MIP. Specifically, the European Fiscal Board (2019, p. 55) proposes to do so "by regulating the speed of adjustment towards the MTO in relation to Member States' macroeconomic imbalances". For example, Member States with large private debts and current account deficits could be required to speed up their adjustment towards the MTO or even to achieve a higher MTO. Conversely, Member States with persistent current account surpluses could be allowed to slow down their adjustment towards the MTO or to aim for a lower MTO."

Overall, there is a substantial consensus among academic and policymaking observers that the MIP is an important part of the economic governance regime, but that flaws in its operationalization and weak institutional embeddedness mean that it fails to a large extent to fulfil its potential and, in some respects at least, may exacerbate existing problems, notably a deflationary bias.

3.5 Replacing the fiscal rules by fiscal standards

In a series of contributions, Blanchard, Leandro, and Zettelmeyer, hereinafter BLZ, have called for a fundamental re-think of the fiscal framework to recentre it on fiscal standards rather than rules (Blanchard et al. 2020a, 2020b, 2021). The focus here is on the most recent version.

By standards the authors mean "qualitative prescriptions that leave room for discretion" (BLZ 2021, p. 1). The standards are to be embedded in a monitoring process involving "country-specific assessments using stochastic debt sustainability analysis, led by national independent fiscal councils and/or the European Commission" (BLZ 2021, p. 1). Stochastic debt sustainability analysis is the tool to be used to operationalise the prohibition of excessive government deficits in Article 126 TFEU.

Incremental reform of the fiscal rules as proposed by the other studies considered here is rejected. Fiscal rules, it is argued, cannot be simplified, as reformers desire, because of the diversity of situations that

EU Member states might find themselves in in the future. Even a very complex set of rules, which are likely to be politically unworkable will not achieve this.

The authors discuss the economics of debt sustainability based on the familiar variables: existing debt ratios, the primary balance and the differential between the (nominal or real) growth (g) and interest (r) rates. The overall conclusion is that there is no single number for either deficits or debt ratios that could sensibly be applied to different countries at different points in time. Assessing debt sustainability requires assessments of the future course taken by key variables and is thus inherently probabilistic. There is high uncertainty about the course of r and g and about the ability of governments to obtain, given the other parameters, the necessary primary balance, also in view of the feedback effects of consolidation on demand and output. Because of this uncertainty "rules that attempt to codify the trade-off between debt risks and stabilization benefits of fiscal policy ex ante will get it wrong" (BLZ 2021, p. 15). In particular they risk being too restrictive on average (because they are defined with a view to avoid risk), but at the same time too lax in specific cases where there is an acute danger of snowballing debt dynamics (because they have to allow an adequate space for stabilisation policy).

In practice the distinction between rules (in which a norm is defined precisely ex ante, like 'do not have a deficit above 3% GDP') and standards (in which the norm is defined ex post, as in 'avoid excessive deficits') is not so clear cut (BLZ 2021, p 20). The authors cite approvingly the fiscal framework in New Zealand, which is standards-based. The authors consider that broad standards would need to be codified in EU legislation, but do not propose a single set of fully formulated standards. Instead, they give examples showing how this might be achieved.

In terms of economic analysis, the key idea is to perform a debt sustainability analysis for each country individually, based on assessments of the balances of probabilities for the key variables (stochastic debt sustainability analysis). This analysis should deliver probability "distributions for the debt ratio n years out, for the actual primary balance, and for the debt-stabilising primary balance, conditional on expected policies (but allowing for uncertainty about how these policies would affect the economy)." (BLZ 2021, p 21f.) On this basis countries would be recommended to engage in fiscal adjustment if the probability of debt unsustainability exceeds a given level.

Enforcement would be split between an institution responsible for monitoring and one for final adjudication. The former could be an independent national fiscal council or, at EU level, the EU Commission or the European Fiscal Board. This institution could block – pending adjudication – national fiscal legislation. If it is a national institution doing the monitoring the Commission or EFB should have the right to appeal to an adjudicator, and vice versa if monitoring is a European competence. Adjudication could be the responsibility of the Council or the European Court of Justice (or a specialised legal institution).

The authors prefer solutions in which the adjudication is done by a legal body, but this would require treaty changes. Adjudication by the Council – which BLZ see as likely to be subject to excessive politicization, as in the current system – would require above all changes in national legislation, including in some cases national constitutions, but also in EU secondary legislation.

4. Expenditure rules to reduce the procyclicality of EU fiscal rules

4.1 Economic Analysis

Compared to current EU deficit rules, expenditure rules are usually credited with being less pro-cyclical (Ayuso i Casals 2012; Gros and Jahn 2020; Bénassy-Quéré et al. 2018; Brück and Zwiener 2006; Darvas et al. 2018a). The reason is that following a steady path of non-cyclical expenditure will by itself lead to an overall counter-cyclical fiscal policy. For the policy stance, the overall deficit is the relevant variable. If non-cyclical expenditure grows at a steady rate, revenue varies over the cycle (as it does if taxes are not changed) and cyclical expenditure grows in a downturn and shrinks in an expansion, the aggregate deficit automatically moves counter-cyclically. While this resulting counter-cyclical movement in the overall deficit only reflects the automatic stabilisers and hence the structural deficit will not react to the cycle, this is clearly an improvement over the experience with the current deficit rules which have often resulted in an overall destabilising pro-cyclical fiscal policy (Dullien et al. 2020).

When comparing an expenditure rule which excludes all cyclical expenditure (as the IMK proposal does) with an expenditure rule which excludes only unemployment benefits (as the rule from the EFB), the first can be expected to be more counter-cyclical than the second, providing more macroeconomic stabilization. As a trade-off (and a consequence), however, excluding all cyclical expenditure means that the debt trajectory might be more volatile and sustainability problems might be more of an issue (Ayuso i Casals 2012).

In principle, the problem of pro-cyclical policies could also be tackled under deficit rules if nominal deficits are corrected for cyclical fluctuations and structural deficits are targeted (as is the idea under the current EU framework). However, all currently used methods for correcting for the business cycle have stability problems: The estimated position in the cycle is often revised ex post, in some cases even turning a past structural deficit into a structural surplus or vice-versa and thus massively shifting the goal-post for current and future deficits (Darvas et al. 2018b, and Box 1 below).

Under an expenditure rule, not the position in the cycle, but only the trend growth of potential GDP is of importance. While the estimates of trend growth of potential GDP suffer also from the risk of ex post revisions, these revisions tend to be much smaller than those for single-year output gaps.

Another, related point is that the growth of non-cyclical government expenditure is usually under clear political control and can be more easily monitored by the public (Ayuso i Casals 2012; Gros and Jahn 2020). Expenditures are regularly legislated in a budget and overshoots can be prevented by just not spending more than is in the budget. A direct and exact deficit control is much more difficult as the deficit is the difference between expenditure and revenue, and in the short run revenues vary to a considerable degree outside the control of governments. Hence, an expenditure rule can be more easily complied with and governments can be more readily held to account.

Just as deficit rules, expenditure rules can cause macroeconomic damage. A mandated cut in nominal expenditure, for example, will depress aggregate demand. Whether such excessive austerity is imposed by a specific expenditure rule depends on the parameters of the rule. The more strongly a rule reacts to deviations from the debt anchor, the greater the risk of creating a harmful macroeconomic environment. Among the design options discussed in the proposals of the EFB and the IMK, the safeguard against outright expenditure cuts lowers the risk of causing such damages. Beyond this safeguard, neither the current (2020) version of the EFB proposal nor the IMK proposal specifies the exact parameters of the rule so that it cannot be evaluated to what extent they would generate excessive austerity. If current reforms of EU fiscal rules should include an expenditure rule as a central instrument, care should be taken to choose parameters to prevent damaging austerity.

While thus expenditure rules have a number of advantages over deficit rules, they carry an additional problem: As can be seen in the examples provided by the European Fiscal Board (2018, 2020), they lead to a continuous increase in the size of the primary surplus way into the consolidation process. The reason for this phenomenon is that a constant revenue-to-GDP ratio combined with expenditure growth below potential GDP growth automatically leads to a growing primary surplus. Thus, the surplus grows until expenditure growth accelerates again to the level of potential GDP growth. If primary surpluses are seen as a measure of sacrifices a society makes during a consolidation period (as the surplus represents the taxes paid which are not used to provide services or transfers by the public sector), such a path is suboptimal; under an optimal adjustment, one would rather expect a relatively even distribution of these sacrifices over time. An addition to the rule which pauses the application of the expenditure growth restriction as soon as a certain primary surplus is reached might mitigate this problem but comes at the expense of a delayed reduction in debt-to-GDP ratios.

Box 1: Improving the measurement of structural balances

Our study concentrates on proposals that recommend replacing the current focus on structural budget balances in EU fiscal rules either by an expenditure rule (Dullien et al. 2020; European Fiscal Board 2019, 2020) or by fiscal standards (Blanchard et al. 2021). A widely discussed alternative approach would be to improve the measurement of structural budget balances within the current framework. This box briefly reviews why we judge this to be a second-best option only.

Clearly, improving the measurement of structural balances is a desirable goal. The current estimates are frequently revised, and the revision tends to be procyclical, meaning that the underlying potential output is often revised downwards in a recession and upwards in a boom, resulting in fiscal procyclicality with more fiscal space in an upswing and more strongly mandated budget cuts in a crisis (Heimberger and Kapeller 2017). Most of the necessary revisions stem from revisions of potential GDP. Hence any improvement of the measurement of potential GDP would improve not only the rules based on structural balances but also the expenditure rules which are based on potential output too.

The literature that discusses reforms in the estimation methods of structural budget balances has two aims: One part of the literature, such as Göttert and Wollmershäuser (2021), tries to make the estimates of these structural budget balances more stable to prevent procyclical and erratic fiscal policy. The other strand of the literature, such as Krahé et al. (2021), tries to change the methodology to provide more fiscal space on average over the cycle.

However, even if the output gap estimates are improved, part of the fluctuations and incorrect signals will remain. In particular, the revisions and measurement errors of structural balances will remain larger than those of potential GDP growth., It is the latter which enters into the expenditure rules as proposed by Dullien et al. (2020) or by the European Fiscal Board (2019, 2020). Structural balances are overall budget balances, corrected by the output gap times a so-called semi-elasticity minus one-off effects. The semi-elasticity by itself is subject to measurement problems, varies over time and has the potential to be itself a source of procyclical fluctuations and biases, even if the extent is disputed (Fatás 2019; Mourre et al. 2019). Hence a rule that is based on potential GDP growth can be expected to be more stable than a rule based on structural balances because one potential source of instability is eliminated. Moreover, revisions to the level of potential output tend to be larger than those to the growth rate of potential GDP, which again increases the relative stability of expenditure rules vis-à-vis rules based on structural balances (Claeys et al. 2016).

Finally, improvements in the methodology of estimating output gaps to provide more fiscal space over the cycle might make sense if the output gap is on average negative over the cycle, for which good arguments can be made (Aiyar and Voigts 2019). However, constructing an asymmetric output gap measure as an input to fiscal rules comes at the expense of endangering fiscal sustainability. Under the current approach of targeting a given structural budget balance, with a symmetric measure of the output gap, the average headline deficit over the cycle can be expected to be close to the structural deficit target. With such an average headline deficit, the debt-to-GDP-trajectory can be easily evaluated for different nominal GDP growth rates. This would not be the case with an asymmetric output gap measure, and any given target for the structural budget balance could in principle both mean a sustainable or an unsustainable debt-to-GDP trajectory. In contrast, an expenditure rule-based framework would guarantee debt sustainability as it necessarily leads to declining debt-to-GDP ratios.

A solution that so far has not been widely researched might be to explicitly model the impact of specific government expenditure such as public investment or on measures to increase labour force participation on potential output. As such expenditure can be expected to raise potential output (Gechert et al. 2019), this approach would allow governments to increase borrowing under the condition that the funds are used in such a supply-capacity-enhancing way.

4.2 Legal Analysis

The proposal to introduce an expenditure rule into the EU legal framework on fiscal rules aims at setting one benchmark to assess whether a Member State avoids excessive government deficits, as required by Article 126(1) TFEU. It serves, furthermore, as an instrument to prevent the occurrence of excessive deficits. It applies whenever a Member State's overall government debt exceeds the reference value, currently set at 60% of GDP. It should be noted, at the outset, that the switch to the debt-anchor in the preventive arm of the SGP does not relieve Member States from complying with the deficit-criterion, being the other criterion to establish the existence of an excessive deficit. All expenditure allowed under the expenditure rule must ultimately respect the upper limits under the deficit criterion when determining excessive deficits under Article 126 TFEU.

As explained earlier, the transgression of the 60% reference value with regard to the debt ratio can be considered an excessive deficit, provided that the debt-to-GDP ratio is not sufficiently diminishing and approaching the reference value at a satisfactory pace. When measuring these efforts with regard to the debt criterion, the proposed expenditure rule becomes relevant. Legally speaking, the rule intends to establish a legal assumption that compliance with the expenditure rule represents a sufficient diminishment of debt approaching the reference value at a satisfactory pace so that a compliant Member State cannot be placed under an Excessive Deficit Procedure.

Currently, an assumption that a Member State diminishes its debt sufficiently at a satisfactory pace is established under Article 2(1a) of Regulation 1467/97 'if the differential with respect to the reference value has decreased over the previous three years at an average rate of one-twentieth per year as a benchmark, based on changes over the last three years for which the data is available. This rule is based on the assumption that the debt reference value will be reached within 20 years. The expenditure rule proposed by both the EFB and IMK suggests longer adjustment paths than 20 years (or, in the case of the EFB proposal: country-specific debt targets). The question, therefore, arises whether longer adjustment paths would infringe the Treaty requirement of avoiding excessive deficits. As mentioned earlier, the purpose of this requirement is to ensure the sustainability of public finances. It is, therefore, necessary to provide evidence that a longer adjustment path than 20 years still guarantees sustainable public finances. Calculations made by the EFB (2019, p. 86) show that such longer adjustment paths would not undermine the sustainability of public finances. It could even contribute to it as Member States would still have some spending leeway besides the debt reduction in order to mitigate an economic recession that has negative implications for the sustainability of public finances. Therefore, a longer adjustment path with a lower annual debt reduction goal can still be considered 'sufficiently diminishing'. As long as the expenditure rule includes an obligation for Member States to determine an adjustment path with a view to reducing government debt that is over 60% of GDP, such a rule is in compliance with the objective to avoid excessive deficits as established by Article 126(1) TFEU.

Besides the purpose of being used as a benchmark for assessing the existence of excessive deficits in relation to the debt criterion, the expenditure rule, first and foremost actually, serves as an instrument to prevent excessive deficits. As part of the general economic policy coordination, Member States budgets should provide for a safety margin with respect to the 3%-reference value for the annual government deficit. This safety margin is currently assessed against two benchmarks: the country-specific medium-term budgetary objective (MTO), which is based on the structural balance (Article 2a of Regulation 1466/97), and the expenditure net of discretionary measures without interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure (Article 5(1)(3) and (4) of Regulation 1466/97). The expenditure rule is meant to replace these current benchmarks for sound public finances in the preventive arm of the SGP.

Under the proposed expenditure rule, the annual government deficit of a Member State can be above the current MTO, whose upper limit is set at 1% of GDP by Regulation 1466/97 and even lower by the TSCG at 0.5% of GDP for Member States whose debt is not 'significantly below 60%', and the adjustment paths towards it. This is due to several reasons. First, Member States with a debt level below the reference value of 60% of GDP are not bound by any other restriction than the deficit ceiling of 3% (as it is already today the case for non-Euro area and non-ERM2 countries, see Article 2a(2) of Regulation 1466/97). Second, expenditure is composed of different items than the structural balance that underlies the MTO. Third, the method of calculating the adjustment path might allow for more spending than the adjustment path towards the MTO.

The question, therefore, arises whether these differences undermine the Treaty objective to avoid excessive deficits and put the sustainability of public finances as expressed by this requirement in doubt. One has now to distinguish between countries with a government debt that exceeds the current reference value of 60% of GDP and those below this value. The latter benefit the most from the expenditure rule, and they are relieved from the obligation to set a MTO of maximum 1% of GDP. Just as non-Euro area and non-EMR2 countries, these Member States would only have to provide a safety margin with respect to the 3% of GDP government deficit, as required by Article 2a(1) of Regulation 1466/97. However, this rule still applies from a purely legal perspective, so the Treaty requirement is met.

Once the debt level exceeds the current reference value of 60% of GDP, the requirement to define an adjustment path towards debt reduction for expenditure also ensures, in principle, that the Treaty requirement is met as this adjustment path caps public spending. A problem might, however, arise in relation to the scope of the expenditure rule. The scope of the deficit rule covers all public expenditure, whereas the expenditure rule excludes, under the EFB proposal, interest expenditure, expenditure on Union programmes fully matched by Union funds revenue, and non-discretionary changes in unemployment benefit expenditure. The IMK proposal excludes beyond unemployment benefits all cyclical expenditure. Moreover, it also excludes debt-financed investment programmes, the legality of which will be discussed in section 6.2. This could lead to a situation where the expenditure rule still allows for government spending beyond the 3% of GDP. This situation arises when either the expenditure rule is made applicable at a moment, in which a given country is already running a high deficit, or – as a result of a significant economic shock – revenues plunge and expenses shoot up, or when a government adopts a massive public investment programme. The first situation would, however, not present a legal problem as the expenditure rule would also then require a limitation of expenditure and lead to a decline of the deficit. Article 126(2)(a), first indent TFEU tolerates a deficit beyond 3% if the ratio 'has declined substantially and continuously and reached a level that comes close' to 3% of GDP. The second situation would be an exceptional and temporary one, which is covered by the exception in Article 126(2)(a), second indent TFEU. The third situation cannot be excluded but requires, as mentioned in the economic analysis, a volume that goes beyond any previous investment packages by Member States in the past and must therefore be considered as rather unlikely.

Finally, both proposals refer to a 'general escape clause', the activation of which leads to a temporary suspension of the expenditure rule. The purpose of 'escape clauses' is to allow states a larger fiscal margin of manoeuvre than allowed under the general rules, in order to enable this state to react to a severe economic crisis with the appropriate fiscal measures. As explained above, the current rules also know such 'escape clauses' (without them being called that).

The description of the existing 'general escape clauses' in section 2.4 reveals two things: First, there is actually no 'escape clause' in the sense that the application of the SGP is suspended. Both the preventive and the corrective arm remain fully applicable. Member States are only allowed to deviate from their existing obligations temporarily. Once the 'unusual event' or the 'severe economic downturn' are considered to be terminated, the deviations cannot be applied anymore. In terms of governance under the current rules, it is the Commission that considers the existence of an unusual event or a severe economic downturn, which is ultimately approved by the Council when adopting the country-specific recommendations under Article 121(4) TFEU or the country-specific decision on the existence of an excessive deficit under Article 126(6) TFEU by qualified majority. Second, the current rules allow to distinguish between temporary deviations based on the economic situation in a single Member State and those that relate to the economic situation in the euro area or the Union as a whole. This means that a 'general escape clause' that provides for a temporary deviation from the expenditure rule, as proposed by the EFB and the IMK, could be created by means of secondary law. It can be included in the existing governance of the SGP in that the Council adopts a decision or recommendation by a qualified majority without the need to change the Treaties. However, when deciding on any deviations, due attention must be paid to ensure that they still guarantee the sustainability of public finances in the medium term. Including national fiscal boards or other expert bodies in the procedures leading to the activation of the general escape clause is not precluded by the existing Treaties provided that it remains the Commission that triggers the formal procedure by a recommendation or a proposal and that Council remains the competent decision-making body without its discretion being limited by the assessments of independent expert bodies. In any event, given the divergence of the existing ‘escape clauses’ in the preventive and the corrective arm as described above, it would be recommended, for the sake of legal certainty and clarity, to synchronise the ‘escape clauses’ in both arms within the secondary law.

In sum, the legal arguments presented hereinabove lead to the conclusion that the expenditure rule as proposed by the EFB and IMK is in line with Primary law, and its introduction would not require any Treaty changes. Yet, the expenditure rule differs – consciously – from the benchmarks currently defined in secondary law. It intends to allow for a more counter-cyclical fiscal policy within the Member States and avoid pressure toward pro-cyclical policies that the current benchmarks entail. Whilst one could even argue that such counter-cyclical policy is even desired by the Treaty objective to ensure the financial stability of the euro area, and also by the Macroeconomic Imbalance Procedure (see section 7.1), it clearly means that both Regulation 1466/97 and Regulation 1467/97 must be amended in order realise this switch. Whilst the former can be changed by making use of the ordinary legislative procedure (Article 121(6) TFEU), the latter requires unanimity within the Council after a consultation of the European Parliament and the ECB (Article 126(14)(2) TFEU). After an amendment of the secondary law rules, the TSCG would also have to be amended accordingly. Alternatively, the MTO rules (Article 3 TSCG) and the debt reduction rule (Article 4) in the TSCG would have to be disapplied within the legal orders of the Member States as they would be contrary to the amended EU secondary law (see about this argument *infra*).

5. Remove or reform the rules relating to government debt

5.1 Economic Analysis

When discussing changes in the reference levels for debt, it is important to keep in mind the economic rationale of such a reference level, namely, guaranteeing debt sustainability (or at least lowering the probability of solvency crises). Hence, the underlying question is which debt level can be considered to be sustainable and to remain so even if the macroeconomic environment changes. Debt sustainability analyses are always subject to uncertainty, especially with regard to future interest rates, the growth outlook of and the political situation in the economies in question. Moreover, there is no academic consensus on the level above which higher government debt becomes problematic. However, some of the variables affecting the sustainability of government debt have changed so fundamentally since the adoption of the Maastricht Treaty that reviewing and adjusting the reference debt-to-GDP ratio has become a matter of basic economic sense.

The sustainability or stability of the public debt-to-GDP ratio is largely determined by the relationship between real interest rates and real GDP growth and by the primary government surplus.[9] At the time when the Maastricht Treaty was adopted, the real interest rate in the euro area was higher than the real growth rate. To prevent national debt-to-GDP ratios from mushrooming, the Treaty therefore set the permissible debt-to-GDP ratio at what was considered to be a sustainable level at that time (Priewe 2020).

[9] In the long run, a stable government debt ratio b^* can formally be expressed as $b^* = p/(r - y)$, where b^* is the stable debt ratio, p the (constant) primary surplus of the government, r the (constant) real interest rate, and y the (constant) real GDP growth rate of the economy. The primary government surplus is the difference between revenue and expenditure (minus interest payments on government debt).

However, in the intervening years, the difference between the real interest rate and the real growth rate has been steadily declining. Since 2014 – and with the only exception of the year the Corona crisis hit Europe – the real interest rate in the euro area has remained consistently below the real growth rate (Dullien et al. 2020). This change in the relationship between the real interest rate and the real growth rate of the economy has major implications for debt sustainability analyses, since it means that a higher debt-to-GDP ratio is now sustainable over the long term, whatever the specified primary surplus or deficit.

To give an example, if the real growth rate of the euro area economy was to consistently remain 2 percentage points above the real interest rate,[10] a primary government deficit of 2% of GDP will be sustainable over the longer term even with a debt-to-GDP ratio of 100%. Applied to the EU rules, this means that a debt-to-GDP ratio of 100% would be sustainable over the long term in a scenario with a headline budget deficit of 3% (Maastricht deficit rule), a long-term inflation rate of 2% (ECB target) and a long-term real GDP growth rate of 1% (Dullien et al. 2020, p. 15f.). It can therefore be concluded that the 60% Maastricht debt-to-GDP ratio – which is even more unrealistic in the light of the increase of debt levels in many countries during the Covid19 pandemic – should be adjusted to reflect changes in the macroeconomic environment that have already existed for several years.

Recent research highlights the importance and desirability of increasing government debt in economies stuck at the zero-lower-bound on interest rates with negative interest-growth differential and insufficient demand (Mian et al. 2021). A so-called goldilocks range of government debt levels exists in which increasing the deficit is a “free lunch” in that the economy can simply grow out of the debt without the need to raise taxes. For Germany, Mian et al. (2021) estimate this goldilocks zone of the debt ratio to be below 150% of GDP; for Italy, the estimate is below 190%. In other words, the 90% debt reference value proposed by Dullien et al (2020) is set at a rather conservative value, allowing for uncertainties about, for instance, future growth-interest differentials and crises that may unexpectedly hit public finances in the EU.

5.2 Legal Analysis

The current Treaty rules on Member States’ budgets consider debt as one of the two criteria that can lead to a finding of an excessive deficit, which is prohibited under Article 126(1) TFEU. As explained earlier, the Treaties refer to a reference value, the transgression of which establishes an assumption that there is an excessive deficit. Yet, the mere transgression of this value does not in itself constitute a violation as also higher debt levels do not imply excessive deficits as long as the debt-to-GDP ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace. This already shows that the currently defined reference value is not a hard upper limit that is sanctioned by the Treaties. The reference value is currently set at 60% of GDP in the protocol on the excessive deficit procedure. This protocol can be amended and even entirely be replaced by means of a decision adopted under the special legislative procedure with a unanimous vote in the Council after consultation of the European Parliament and the ECB (Article 126(14)(2) TFEU). A Treaty change would not be necessary.

The upper limits for any change to the reference values in the protocol would be the avoidance of excessive deficits as required by Article 126(1) TFEU and the change’s potential to undermine the sustainability of public finances under the conditions of a currency union. A total abolition of the debt

[10] The average interest-growth differential (r-g) in the euro area between 2014 and 2019 was in fact -1,9 (Dullien et al. 2020).

reference value is, however, ruled out as the Treaty defines the debt-to-GDP ratio as one of the two criteria that can lead to a country being considered to have an excessive deficit. Nevertheless, the 60% criterion is not as such "protected" by the Treaties. As discussed in the economic analysis, under the current economic conditions, a significantly higher debt-to-GDP ratio can still be considered not to undermine the sustainability of public finances. Yet, it seems doubtful that the Treaties would allow for a reference value of, say, 160% of GDP as the sustainability of such a debt level depends highly on volatile real economy developments. The requirement to avoid excessive deficits seeks to exclude criteria that are too volatile as it is precisely this volatility that might quickly lead to unsustainable public finances. From a legal perspective, it is difficult to draw a hard numerical line. As economic research has shown, however, a debt-to-GDP ratio of less than 100% seems to be sustainable even under changing situations in the real economy. Provided that there is a political will to increase the reference value to such a level, Primary law would not preclude it. The IMK proposal could therefore be implemented by a change of the protocol on the excessive deficit procedure.

Moreover, the Treaties do not require that the reference value is a uniform one. Provided that country-specific debt levels can ensure the medium-term soundness of the respective national public finances, replacing the 60% reference value by country-specific reference values does not meet Primary legal concerns. Such a bold shift is already supported by the wording of Article 126(14)(2) TFEU that allows for an entire replacement of the protocol, which includes a switch from a uniform reference value to country-specific reference values. The proposal made by the EFB could therefore also be implemented without Treaty change. This is certainly the case when the country-specific reference value is based on a set of predefined parameters. The alternative, according to which the Council decides on a case-by-case basis, could overstretch the limits. In this alternative, the reference value becomes part of the political bargaining in the Council. Whilst the Treaties clearly foresee a role for the Council in determining whether an excessive deficit exists, its authors wanted to withdraw the reference value from the political process by placing it at the beginning of the procedure to determine the existence of excessive deficits and to make it transparent that other political considerations than reference values were guiding the Council in case it refuses to decide that there is an excessive deficit although the reference value was transgressed. The transparency and control function that underlies the reference value as expressed by the structure of Article 126 TFEU would be rendered meaningless if the determination of the reference value would become part of political bargaining in the Council. A replacement of the protocol requires a unanimous vote in the Council after a consultation of the European Parliament and the ECB.

6. Strengthening public investment

6.1 Economic Analysis

The central question for the justification of safeguarding public investment under the fiscal rules is whether it is productivity- and growth-enhancing. Theoretically, public investment should play an essential role in long-term economic development. For example, the state modernises the transport infrastructure, promotes digitalization, and implements measures to combat climate change. The provided infrastructure is an important factor in the competition for the most attractive industrial locations. Hence public investment should matter for the productivity of the private capital stock and thus also influences private investment activity.

An expansion of public investment can affect economic growth on the one hand by increasing aggregate demand, and on the other hand, by increasing the production potential of the economy as the public capital stock grows more strongly. There is now a growing empirical literature quantifying the short-run demand and long-run productivity-enhancing effects of public investment.

Interestingly, the short-run effects of discretionary changes to public investment on growth and employment are generally higher than other spending categories or tax changes, especially when the economy is in a downturn (Auerbach and Gorodnichenko 2012; Gechert 2015; Gechert and Rannenberg 2018). Due to the positive effect on aggregate demand and GDP, public investment also crowds in and stimulates business investment activity (IMF 2020; Belitz et al. 2020). Regarding longer-term productivity, a meta-analysis of existing studies by Bom and Ligthart (2014) suggests a positive long-run output effect of all public capital, with implied marginal returns to capital of over 20% on average (Truger 2016).[11] In the current environment of low interest rates and substantial public investment needs across Europe, e.g., in terms of environmental transformation or digitalization, it should be possible to define many projects where the long-term marginal return is far higher than the short-term costs. Importantly, when the multiplier effect of public investment is particularly strong, the public debt-to-GDP ratio may decrease (Abiad et al. 2016; Jaramillo and Cottarelli 2012; Dullien et al. 2021).

Given these theoretically and empirically grounded welfare-enhancing effects of public capital, optimal fiscal policy should facilitate an adequate level of public investment spending. However, it is often argued that the current fiscal rules are harmful to the level of public investment. Reducing public investment is comparatively easier and faster to implement for governments under fiscal pressure than cutting social spending or public sector salaries as well as lowering taxes. That is because public investment can be cut discretionarily at relatively low political costs and without long time lags (Ardanaz and Izquierdo 2017). Suppose politicians have a shorter planning horizon than the electorate. In that case, they might have an incentive to prioritise non-investment government spending and transfers over investment expenditure because the benefits of other spending accrue at once. In contrast, returns on public investment might materialise over a longer time horizon (Dullien et al. 2021).

Consequently, fiscal consolidations have a strong composition effect on government expenditures to the detriment of public investment (Bamba et al. 2020). This effect is particularly strong when public debt is high and in economic downturns. The euro crisis has clearly shown that public investment is cut back particularly sharply in periods of strong consolidation. This especially holds for countries that were under considerable fiscal pressure, but it was not limited to them (Truger 2020). Ardanaz et al. (2021) provide empirical evidence that fiscal rules with investment-friendly design features effectively protect against public investment cuts in periods of fiscal consolidation.

Against the background of these results, one can argue that due to the pressure to consolidate the public finances over the last decade, the lack of public investment protection in the current framework led to a substantial public investment deficiency in Europe. The public capital stock stagnated for several years over the last decade in Germany and France, and in Italy and Spain, the public capital stock has even shrunk. On top are the immense additional investment needs ahead for the green transition. Darvas and Wolff (2021) estimate the necessary additional annual public investment for the energy and transport

[11] The first seminal papers on the empirical estimation of the long-run impact of public capital using a production function approach are Aschauer 1989 and Baxter and King 1993. Note, Ramey 2020 provides a comprehensive review of the literature on the short- and long-run effects of public investment.

transition over the upcoming decade for Europe at around 100 billion euros. Moreover, there are substantial needs for digitalization and the health sector. For example, a group of German economists quantify the total public investment needs over the next ten years in Germany at around 460 billion euros (Bardt et al. 2019).

The Corona pandemic caused a significant rise in public indebtedness. Given the described massive public investment needs, Europe cannot afford another fiscal consolidation to the detriment of public investment. Accordingly, all reform proposals discussed in this report emphasise the vital role of public investment (see Section 3). The principle of the Golden Rule of public finance is to finance net public investment through credit. The theoretical and empirical results described above provide arguments in favour of credit financing of investments because many of the upcoming tasks promise high macroeconomic and fiscal returns in the long term (Dullien et al. 2021; Krebs and Scheffel 2017), which are significantly higher than the current low interest rates on government bonds. Although credit financing public investment can be assessed positively from an economic point of view, it is highly controversial politically. It is often claimed that this method of financing would shift excessive burdens onto future generations. However, if future generations benefit from a more extensive capital stock, they should participate in its financing via the debt service. Thus, the Golden Rule is a sensible principle of fiscal policy in terms of intergenerational equity and for the stabilization of the investment activity of the public sector, which in turn provides a more stable planning horizon for the private sector (Hüther 2019).

Macroeconometric simulations have shown that euro area GDP would have been significantly more dynamic if a Golden Rule with a target for annual net public investment of 1.5% of GDP had been applied in the past, without compromising debt sustainability (Dullien et al. 2020, p. 12ff.). Thus, these econometric model-based simulations confirm earlier, more pragmatic multiplier-based simulations of a Golden Rule in practice (Truger 2016).

In sum, deficit-financed public investment that increases potential output is an economically sensible option and, accordingly, the principle of the Golden Rule should be considered as part of a reformed fiscal framework. Policymakers can find pragmatic solutions to defining public investment and more technical aspects such as calculating depreciation to determine net investment.

6.2 Legal Analysis

Public investments financed by debt are, legally speaking, ‘net borrowings’ and are, therefore, included in the calculation of ‘deficit’ under Article 126(2) TFEU. They contribute, therefore, to a potential excessive government deficit prohibited under Article 126(1) TFEU. In order to be in line with this Treaty requirement, any preferential treatment of public investments must ensure that the overall government deficit remains below the reference value, currently defined at 3% of GDP. The proposal for introducing a Golden Rule presented by the IMK seeks to exclude public investments from any mechanism that limits public spending due to the achievement of certain budgetary objectives and allow for a deviation from adjustment paths for this category of public spending.

The current secondary law rules set out five ways how a certain expenditure is excluded from the upper limitations that it defines for government spending: (1) a certain expenditure is excluded by means of calculating the structural balance, on which the MTO and the adjustment path are determined; (2) explicit exclusions of certain categories of expenditure; (3) expenditure for major structural reforms (‘structural reform clause’); (4) public investments that are treated equally with ‘major structural reforms’ and (5) expenditure necessary to react to ‘unusual events outside the control of the Member State’ or to a ‘severe economic downturn’ (‘escape clause’).

Under the first category, ‘one-off and other temporary measures’ are not taken into account when calculating the structural balance (Art. 5(1)(1) of Regulation 1466/97, Art. 3(4) of Regulation 1467/97). In order to qualify for a ‘one-off measure’, such measure must be intrinsically non-recurrent, should consist of volatile components of revenue or expenditure, not be a deliberate policy action that increases the deficit, and should have a significant impact on the general government balance (European Commission 2015, p. 52ff.). This definition of ‘one-off measures’ clearly excludes many categories of public investment. The most prominent example for a ‘one-off measure’ is the initial cash contributions to the ESFI (Commission 2015, p. 7). Under the second category, ‘interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure’ are explicitly excluded from the expenditure aggregate (Article 5(1)(4) of Regulation 1466/97). More relevant are the third and fourth categories, the so-called ‘investment clause’ and the ‘structural reform clause’ (Art. 5(1)(7) of Regulation 1466/97). According to these clauses, ‘a temporary deviation’ from the MTO can be allowed by the Commission and the Council if additional expenditure is necessary for ‘the implementation of major structural reforms which have direct long-term positive budgetary effects, including by raising potential sustainable growth’ and has a ‘verifiable impact on the long-term sustainability of public finances’.

In the ‘Flexibility Communication’ (Commission 2015), the Commission further specified the meaning of this open clause. ‘Major structural reforms’ are, according to the Commission, ‘well-designed and comprehensive packages of reforms addressing structural weaknesses’ (Commission 2015, p. 10). The Commission mentions ‘pension reforms’ as an example. Expenditure for such reforms is capped at 0.5% of GDP with an appropriate safety margin. Other public investment (‘investment clause’) is considered as equal to a ‘structural reform’ if the GDP growth of a Member State is negative or GDP remains well below its potential, the deviation does not lead to an excess over the reference value of 3% of GDP, and, most importantly, if it is linked to national expenditure on projects co-funded by the EU under the Structural and Cohesion policy, Trans-European Networks and Connecting Europe Facility, and to national co-financing of investment projects also co-financed by the EFSI, which have direct long-term positive and verifiable budgetary effects (Commission 2015, p. 8). Moreover, the deviation from the MTO under both clauses is time-limited, and after four years, the Member State concerned must return to its original MTO. Under the corrective arm of the SGP, a ‘structural reform clause’ and an ‘investment clause’ do not exist. Yet, ‘major structural reforms’ are taken into consideration as ‘relevant factors’ in terms of Article 126(3) TFEU (Commission 2015, p. 13). Article 2(3)(b) of Regulation 1467/97 specifies that ‘relevant factors’ are ‘developments in primary expenditure, both current and capital, […] the implementation of policies in the context of the common growth strategy of the Union, and the overall quality of public finances’. Under these conditions, expenditure in excess of the 3%-criterion can be accepted provided that the deficit in general declines substantially and continuously and has reached a level close to the 3% threshold. Finally, the fifth category, the escape clause, is of no relevance for a potential Golden Rule.

Applying this legal framework to the proposals made, it becomes clear that Regulation 1466/97 would need to be adapted in order to introduce a ‘Golden Rule’ as proposed by the IMK. The structural clause is limited to ‘major structural reforms’, whereas the IMK proposal goes beyond this limitation although a clarification of what is covered by the term ‘major structural reforms’ in a revised Flexibility Communication would still allow for extending eligible investments under this category. It seems conceivable that public infrastructure investments that are necessary to reach the global climate protection goals could be understood as ‘major structural reforms’. The second barrier in the existing framework for the introduction of the ‘Golden Rule’ is the capping of expenditure for major structural reforms at 0.5% of GDP. This cap is, however, not explicitly mentioned in the Regulation 1466/97, which only refers to the ‘appropriate safety margin with respect to the deficit reference value’ and to the ‘return to the medium-term budgetary objective within the programme period’. In making these criteria operable, the Commission introduced the cap of 0.5% in the ‘Flexibility Communication’. It could therefore be increased by means of a revision of the Commission communication, provided that the new upper limitations meet these requirements. The upper limit of 1.5% of GDP in the IMK proposal might overstretch the discretion of the Commission to interpret these limitations due to the close link to the MTO, which is set at 0.5% of GDP. It is therefore recommended that the upper limit of 1.5% of GDP is explicitly mentioned in the secondary rules, which would require a change of Regulation 1466/97 on the basis of Article 121(6) TFEU by means of the ordinary legislative procedure. Regulation 1467/97 would not have to be adapted, as the consideration of public investments under a ‘Golden Rule’ in the preventive arm of the SGP can sufficiently be considered as ‘relevant factor’ for the excessive deficit procedure, given that the IMK proposal acknowledges that the excessive deficit threshold limits the ‘Golden Rule’.

A ‘Golden Rule’ must then finally comply with Primary law. As mentioned earlier, the only limits to the fiscal rules in EU secondary law are the obligation to avoid excessive deficits to ensure sustainable public finances. In the economic model of the IMK, this is ensured as the ‘Golden Rule’ should respect the upper reference value for the annual deficit, currently defined as 3% of GDP. Yet, the combination of an expenditure rule, the exclusion of all cyclical expenditure, and an additional Golden Rule for public investments capped at 1.5% of GDP could lead – especially in case of high-debt countries that start at a high deficit level – into a situation, in which the combination of all three elements could lead to a transgression of the 3% threshold. A Golden Rule would therefore need to have additional elements that ensure a sustainable compliance with the requirement to avoid excessive deficits. This includes a clear definition of which public investments are covered by the Golden Rule. This could be done by reference to the investment category in the system of national accounts (ESA) or by reference to funding lines established under the Union budget. Moreover, the Golden Rule could be limited to net public investments. In sum, provided that a Golden Rule ensures credibly that a safety margin to the 3% threshold for the annual government deficit is respected by introducing an upper limit and additional limitations, such rule could be introduced without violating Primary law.

7. Strengthening Macroeconomic Imbalance Procedure (MIP) and ensuring consistence with the fiscal rules

7.1 Economic Analysis

In its “European Economic Governance” Communication of February 2020, which launched the economic governance reform process, the EU Commission noted that the main objectives of the policy regime, in addition to “ensuring sustainable government finances” include “avoiding macroeconomic imbalances (…) closer coordination of economic policies in particular in the euro area, and (…) promoting the convergence of economic performances among Member States.” (European Commission 2020, p. 5). The run-up to the euro crisis clearly showed the importance of avoiding the build-up of imbalances. The MIP, building on the provisions already in the Treaties, was a belated recognition of this. Yet, as analysed in 3.4, the MIP is inadequate for the task. Therefore, reforms to render the MIP more symmetrical, more effective, and more integrated within the overall economic governance regime are desirable, and they are also achievable.

Regarding symmetry, while it is true that for a single country, current account surpluses and low inflation are more sustainable than deficits and high inflation, such a view ignores the adding-up constraints of monetary union. It is undesirable (and ultimately unsustainable) for the Euro Area as a whole to run large current account surpluses, or – as is unavoidable in a currency union – for other member states to run correspondent current account deficits and higher inflation. Symmetry is necessary to avoid a deflationary bias while spreading adjustment pressure between member states.

Regarding the simplification of the Alert Mechanisms scoreboard, policymakers face trade-offs. A reduced indicator set increases transparency and may improve the traction of the recommendations. The risk of misdiagnosing countries may increase, however. Annual changes in unit labour costs and the GDP deflator, as discussed in 3.4, perform quite well on past data at identifying a needed change in the overall euro area stance and the individual “contributions” by member states. However, the focus on current price and wage inflation, examined annually, can be misleading, essentially starting the clock anew every year. It is insensitive to past accumulations of imbalances.

For this reason, the European Fiscal Board and Bénassy-Quéré and Wolff (2020) emphasise the current account as the decisive measure, arguing that it captures the extent of any imbalance between domestic saving and investment. An issue here, though, is that bilateral current account relations between euro area member states are not currently available. A pragmatic solution for euro area countries would be to incorporate as an indicator the price level starting from when the country joined the euro, benchmarked against an index for the ECB target inflation rate.

From an economic point of view, an approach that gives greater weight to such indicators with clear information content regarding the extent of imbalances between the member states is preferable to the current proliferation of equally-ranked variables. In any case, the scoreboard is and should remain the first stage in determining whether countries exhibit excessive imbalances, which requires an in-depth review.

Compliance by member states will be enhanced if country-specific recommendations are focused on targeting imbalances cross-border externalities. Member states should be permitted as much leeway as possible as to how they achieve given objectives. A stripped-down (and symmetrical) approach implies that there should be less reluctance to invoke the so far unused EIP. Under the EIP, member states themselves have to draw up an action plan with a timetable for measures to correct specific imbalances while leaving them policy discretion with regard to the means.

The MIP can be strengthened further by clarifying and deepening the relationship with other EU institutions. For instance, the European Systemic Risk Board (ESRB) is tasked with identifying financial risks and monitoring macroprudential policies, so the recommended removal of the financial indicators from the MIP scoreboard would not mean that issues such as house price developments disappear from the policymaker radar screen. The ESRB could issue its own CSRs, on a timescale aligned with the European Semester process. Coordination with the MIP could be achieved by a mixed

Commission/ESRB delegation meeting with national macroprudential authorities, as proposed by Bénassy-Quéré and Wolff (2020, p. 32).

Strengthening the existing EU Macroeconomic Dialogue (MED) and ensuring the link to (reformed) productivity boards, as proposed in 3.4, would also enhance the effectiveness of the MIP. At the EU level, the MED brings together representatives of fiscal policy, the social partners, the ECB, and the EU Commission, i.e., all the actors responsible for the policy mix (fiscal, incomes, monetary and macroprudential policies) needed to avoid and correct imbalances. The MED needs "foundational" institutions at national level that parallel the EU MED to establish the necessary articulation between national and European levels. In addition, a specific MED for the euro area is needed, where – unlike the existing dialogue – all finance ministers should be present. This institutional deepening has found political support in the recent European Parliament (2021, §61) resolution. The productivity boards should remain expert advisory bodies. Still, they should have their remit extended from supply-side issues to consider macroeconomic requirements, notably that of keeping national inflation rates close to the overall price stability target of the ECB. In contrast to the situation with the MED, the national productivity boards lack a European "roof" to coordinate their activities, which should be established (cf. 3.4).

The relationship between the existing MIP and the existing fiscal rules is widely recognised as unsatisfactory, as discussed in section 3.4. What would be the implications for the relationship if the MIP were to be materially strengthened by implementing some of the proposals set out previously? A conflict can occur notably if a country is constrained by the fiscal rules to run contractionary fiscal policies, although the MIP indicates expansionary policies to correct imbalances. This was the case in Germany in some years prior to the financial crisis, for instance. While such conflicts cannot be ruled out, by encouraging balanced economic growth at inflation rates close to the ECB target, in a symmetric way, and thus reducing the risk of corrective crises, a reformed MIP would contribute to the reduction over time of debt-to-GDP ratios. A reformed MIP would complement the fiscal rules by constraining countries in "good times", particularly if a sensibly designed expenditure rule made fiscal policy more symmetrically counter-cyclical (at least on the spending side). This may not be the case considering debt rules which can be in tension with cyclical stabilization concerns. Fiscal-rule reforms pertaining to debt ratios, as discussed above, will reduce the likelihood of tensions with recommendations under the MIP.

The EFB proposal discussed in 3.4 would establish a formal link between the MIP and the speed of adjustment to the MTO. For those countries for which macroeconomic imbalances have been identified, this would amount to a partial and time-limited override of this aspect of the fiscal rules. This would follow, at a lower level, the same logic as the suspension of the fiscal rules during the pandemic. The Council would ascertain that an exceptional circumstance – here the existence of substantial and persistent macroeconomic imbalances – pertain for a given set of countries. These would then be permitted to deviate from an adjustment path otherwise prescribed by the fiscal rules and follow instead a trajectory agreed by the Council.

The EFB proposal would go some way – depending on the precise modalities perhaps a considerable way – to a better anchoring of the MIP within the economic governance framework. The asymmetric wording of the EFB proposal should be noted, however. Deficit countries are "required", surplus countries "allowed" to deviate from their adjustment path. From an economic point of view, the MIP-SGP link only makes sense if the constraints on both sets of countries are the same.

7.2 Legal Analysis

The MIP was introduced in 2011 by means of secondary legislation (Regulations 1174/2011 and 1176/2011) on the basis of Article 121(6) TFEU. There is no Primary law rule that explicitly requires the existence of a MIP and that defines objectives for a MIP. Being part of the general coordination of Member States' economic policies, the MIP must serve the general objectives of economic policy coordination, which are the principle of an open market economy with free competition, favouring an efficient allocation of resources (Article 120 TFEU), and stable prices, sound public finances and monetary conditions and a sustainable balance of payments (Article 119(3) TFEU). These broad objectives already show that the Union legislator has a broad discretion when designing the MIP.

In terms of the proposed reform elements, some changes to the existing secondary law would be necessary. Such changes can be introduced in accordance with the ordinary legislative procedure as both regulations concerning the MIP were adopted on the basis of Article 121(6) TFEU. The proposed changes to the scoreboard must be reflected by the rules on the scoreboard in Article 4 of Regulation 1176/2011. Currently, Article 4(3) of Regulation 1176/2011 requires that the 'scoreboard shall, inter alia, encompass indicators which are useful in the early identification of internal imbalances[12] and of external imbalances.[13] A reduction of the number of indicators requires changes to this rule. With regard to the introduction of a symmetry of thresholds for these indicators it is recommended to delete the rule that '[t]he assessment of Member States showing large current-account deficits may differ from that of Member States that accumulate large current-account surpluses' in Article 3(2) of Regulation 1176/2011. Although the wording of this rule already allows for a symmetric application of the thresholds of the indications ('may differ'), a deletion would clarify that a symmetry is now intended to be applied as a rule. No conflicts with Primary law can be identified as none of these changes would undermine the sustainability of public finances.

The proposals made with regard to the content of the country-specific recommendations (CSR) do not require any legislative action as the structure and the content of the CSR is determined by the Commission practice. The proposals for deepening the relationship with other institutions require changes to the EU legal act establishing the EFB in order to expand it, but there are no further limitations to such changes. If, however, fora such as the 'Macroeconomic Dialogue' should be created by Member States and if such national fora should be coordinated with each other and the EU MED, this would require a new directive on the basis of Article 121(6) TFEU, which would establish such an obligation for the Member States and which would determine how national MEDs and the EU one interact with each other. Given that these fora have no legally binding influence on the decision-making of EU Member States, EU law does not provide for further limitations to the implementation of these proposals.

Legally more complex to implement is the proposal to regulate the relationship between MIP and fiscal rules. Currently, Article 2(3)(b) of Regulation 1476/97 requires the Commission to take 'the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalance' into consideration as a 'relevant factor' in terms of Article 126(3) TFEU when proposing to

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[12] Explicit reference is made to imbalances 'that arise from public and private indebtedness; financial and asset market developments, including housing; the evolution of private sector credit flow; and the evolution of unemployment'.

[13] Explicit reference is made to imbalances 'that can arise from the evolution of current account and net investment positions of Member States; real effective exchange rates; export market shares; changes in price and cost developments; and non-price competitiveness, taking into account the different components of productivity'.

the Council that an excessive deficit exists in a given Member State. This consideration of obligations under the MIP, however, only becomes relevant once a Member State's budget exceeds one of the two reference values for the annual government deficit or debt. The preventive arm of the SGP does not contain a comparable obligation to consider efforts to implement the MIP when assessing the compliance with the MTO and the adjustment path towards it. Against the background of the existing rule in the corrective arm of the SGP, it seems recommendable to also include a possibility to deviate temporarily from the MTO and the adjustment path towards it in the preventive arm if such deviations are necessary for the implementation of recommendations made under the MIP. Such deviations under the preventive arm must still provide for a safety margin with regard to the 3%-threshold of the annual government deficit, since otherwise the Treaty objective of avoiding excessive government deficits would be undermined. The deviation may therefore also only be temporary and must foresee a return to original adjustment path. It is worth mentioning at this point that the EU fiscal rules can establish upper limits for the public spending of Member States. This may, however, not force Member States to run a more expansionary fiscal policy if the national Parliament, exercising its budgetary sovereignty, has decided that it does not want to deviate from its adjustment path. Such a requirement would be too far-reaching with regard to the budgetary autonomy of the Member States. It is worth mentioning that such a requirement could also not be deduced from the existence of an obligation on Member States to present a corrective action plan once an excessive imbalances procedure is initiated against them (Article 7 of Regulation 1176/2011). The existence of an excessive macroeconomic imbalance does not allow the Council to impose any obligations on the Member State concerned such as increasing its public spending. According to Article 7 of Regulation 1176/2011, it is the Member State that submits a corrective action plan with concrete measures setting out how it intends to remedy excessive macroeconomic imbalances – including possible increases of public spending –, which is either approved by the Council or rejected. In the latter case, the Member State has to submit a revised corrective action plan. But it is not for the Council to adopt changes to the draft corrective action plan. This shows the need to align the SGP with the MIP in case a Member State voluntarily proposes to increase its public spending, which is approved by the Council, so that EU fiscal rules do not undermine such corrective action. But it is not possible to argue that an obligation to spend can be deduced from the existing MIP rules. Legally, such an alignment – that is as mentioned earlier already foreseen in Regulation 1467/97 – implies changes to Regulation 1466/97, which is based on Article 121(6) TFEU in accordance with the ordinary legislative procedure.

Therefore, in sum, 'deficit' countries could be required to adhere to tighter limitations of their public spending whilst 'surplus' country 'may' only deviate from their adjustment paths (as suggested by the EFB) upon previous approval.

8. Scrap fiscal rules in favour of fiscal standards and fiscal councils

8.1 Economic Analysis

In purely economic terms this proposal has a lot to recommend it. Simple debt and deficit-based rules are indeed inadequate to the task of ensuring an adequate national fiscal policy in the context of a monetary union. Delegating this task to an independent body applying a set of pre-established technical criteria offers the potential of an assessment of debt sustainability that is economically less contentious than under the existing rules and less prone to errors in the direction of either excessive stringency or laxity in specific cases.

Granting independent national bodies or the Commission the power to block national fiscal legislation, pending adjudication, is likely to be politically highly controversial, however. In the solutions preferred by the authors, in which adjudication is done by a legal body, treaty change would be required, while the version with the Council responsible for adjudication is less demanding politically and legally (see following sub-section 8.2).

From an economic point of view, it should be noted that the BLZ proposal while quite radical, is, in another regard, rather limited. It is explicitly focused only on debt sustainability. “The purpose of EU fiscal rules or standards should only be to contain adverse debt-related externalities across members, by ensuring that each country’s debt is indeed sustainable, and they should impose only the constraints needed for debt sustainability” (Blanchard et al. 2021, p. 5). Other fiscal spillovers between countries are recognised (p. 13) but the idea of forcing countries to run more expansionary policies for reasons of maintaining internal balance within the euro area is rejected (p. 24). This is justified by pointing to political constraints.

However, as shown in section 7.1, it is vital for the stability of a monetary union that countries avoid macroeconomic imbalances, and the demand spillovers and competitive relations between countries are taken into account. Therefore, it is important that the economic governance rules encourage precisely what is rejected here: that the fiscal stance is set in accordance with such spillovers in mind.

8.2 Legal Analysis

The switch from rules to standards that Blanchard et al. propose (Blanchard et al. 2021, p. 20) can also be considered ‘calling a child by its name’ when it comes to the EU legal framework on fiscal rules. As shown in the previous sections, the main legal requirement for the coordination of Member States’ budgets is to avoid excessive government deficits in Article 126(1) TFEU, which is, as Blanchard et al. realise as well (BLZ 2021, p. 20), a standard and not a rule. The transgression of reference values mentioned by the Treaties (a rule) does not establish the existence of an excessive deficit but triggers an obligation on the part of the Commission to take a closer look at a Member State’s public spending. When doing so it has to consider a series of non-specified ‘other relevant factors’ before proposing to the Council to decide that an excessive deficit exists. The Council is not bound by the evaluation made by the Commission and may conclude ‘after an overall assessment’ that there is actually no excessive deficit. The factors, on which the Commission report and the final Council decision are based, are undefined by Primary law. When it comes to the excessive deficit and the corrective arm of the SGP (Regulation 1467/97) we can already speak of a system of standards rather than of rules (with exceptions such as the rule to reduce debt by an average rate of one twentieth per year, Article 2(1a) of Regulation 1467/97).

The more rule-based approach in the current legal framework is not to be found in Article 126 TFEU and the Excessive Deficit Procedure, but in the secondary law (especially Regulation 1466/97) that is adopted on the basis of Article 121(6) TFEU as part of the economic policy coordination. In order to prevent Member States’ budgets from coming close to an excessive deficit, they have to define their MTO ‘within a defined range between -1% of GDP and balance or surplus’ and an adjustment path towards it. Deviations from this objective and the adjustment path towards it must be justified by the Member State vis-à-vis the Commission and the Council. It is important to note that any non-compliance of the Member State with Council decisions under the preventive arm of the SGP only lead to warnings from the Commission and further recommendations from the Council (Article 6 of Regulation 1466/97).

In case of further non-compliance, the Member States concerned has at worst to face financial sanctions in the shape of interest-bearing deposits (Article 4 of Regulation 1173/2011). No EU-level institution has the right to block or to delay the adoption of Member States' budgets. This is the consequence of the fact that Member States' budgets is a matter of coordination under EU law.

The proposal made by Blanchard et al. wants to change this rule-based approach under the preventive arm of the SGP. Naturally, when switching from rules to standards, procedures become more important. When opting for rules, conditions for certain legal consequences are defined *ex ante* by the competent legislator (in the case of the preventive arm of the SGP: the European Parliament and the Council in the ordinary legislative procedure). When opting for standards, the legislator delegates the definition of the very content of the requirements for Member States' budgets to the executive branch. This means that the exercise of the power to define concrete requirements for Member States' budgets is also shifted from the legislator to the executive. The executive must therefore work under higher standards of legitimacy and accountability when acting on the basis of standards than when implementing rules. It is therefore also no surprise that the New Zealand system of fiscal standards is based heavily on parliamentary and public scrutiny (BLZ 2021, p. 24). When it comes to the EU, where it is a matter of supervising national budgets that were adopted under national budgetary sovereignty, a similar degree of Parliamentary and public scrutiny as in a purely national context such as New Zealand is not possible under the current legal framework. Blanchard et al. do not discuss a strengthening of the role of national Parliaments or of the European Parliament. On the contrary, they seem to insinuate that giving a stronger role to the CJEU would compensate for the lack of Parliamentary and public scrutiny. The emphasis on judicial accountability compensating for the lack of political accountability of independent expert bodies is something EU law is familiar with when it comes to the ECB and its monetary policy mandate. When looking at the judicial control of the ECB by the CJEU in matters relating to the economic expertise of the ECB, the CJEU grants the ECB a broad discretion due to the very technical nature of the decisions that the ECB has to take (see cases C-62/14 Gauweiler and C-493/17 Weiss). Ultimately, judges refrain from judging on the legality of expert decisions. This is a consequence of the switch from rules to standards. Courts interpret and apply rules. When it comes to standards, they grant the expert bodies tasked with specifying standards a broad discretion in doing this. They do so because they lack concrete legal benchmarks against which courts could evaluate the use of discretion. This judicial self-restraint was, by the way, the source of the conflict between the German Constitutional Court and the ECB/CJEU in the PSPP case. Since the CJEU was the only institution that could properly hold the ECB to account, its self-restraint vis-à-vis the self-definition of the monetary policy mandate by the ECB seemed unacceptable for the German court. A similar stand-off between the German Constitutional Court and EU law can be expected if the governance framework for national budgets proposed by Blanchard et al. would be introduced without Treaty change.

In the context of the current rules on budgetary supervision, the already existing lower level of Parliamentary and public scrutiny of the Commission and the Council (which is already a subject of critique) could always be justified by the fact that the EU cannot legally block or delay the adoption of national budgets. Ultimately, national Parliaments could always overrule EU institutions, albeit at the cost of financial sanctions. This is supposed to change under the proposal by Blanchard et al., according to which independent expert bodies or the Commission 'should be empowered to block or at least delay parliamentary approval of budget legislation' (BLZ 2021, p. 25). This element combined with the switch of power from the Union legislator to the executive branch triggers the need for a Treaty change in order to implement any variant of their proposal. The current legal framework only allows for a coordination of Member States' budgets but not for a veto. This goes beyond the restrictions that fiscal rules currently impose on Member States (contrary to BLZ 2021, p. 27) as Member States currently remain free in deviating from the recommendations made by the Council under the preventive arm of the SGP.

In sum, although the switch from rules to standards is in reality no fundamental change of the current legal framework, its implementation by independent expert bodies that would not only be empowered to specify the criteria for application of standards but also have a right to block or at least delay the adoption of national budgets goes beyond the current Treaty rules that only allow for a coordination of national budgets. Even if a Treaty change would provide for such a switch and strengthen the role of the CJEU in the supervision of Member States' budgets, a weak legitimacy of the bodies tasked with the execution of standards and weak parliamentary control would raise serious constitutional questions by national constitutional courts.

9. Challenges associated with combining different elements of reform

The previous sections have shown that many reforms with regard to the EU's fiscal framework can be implemented without Treaty change. At times, when changing the corrective arm of the SGP or when modifying the protocol on the excessive deficit procedure, unanimity within Council is required. At other times, when amending the preventive arm of the SGP or the macroeconomic imbalances, procedure, the ordinary legislative procedure with a qualified majority within Council is to be followed. Hence, the realisation of reform options depends more on the political willingness of the relevant decision-makers than on overcoming major legal barriers.

An expenditure rule that is capped, for Member States with a debt level above the reference value of 60% of GDP, at the level of the expected medium-term nominal potential GDP growth avoids effectively excessive government deficits that are prohibited under Article 126(1) TFEU. The ceiling provides for a sufficiently large safety margin with regard to the reference value of an excessive deficit of 3% of GDP, which continues to cap government spending of Member States whose debt levels are below 60% of GDP. The exclusion of cyclical expenditure and interest payments does not change this finding, as such expenditure is compensated for over the business cycle. The exclusion of public investments from the expenditure rule is economically convincing as it allows for the continuation of public investments in times of economic downturn. Yet, given the volume of public investments, in times of economic downturn where debt levels rise and the expenditure rule allows for lesser expenditure, the combination of an expenditure rule capped at the nominal potential GDP growth with an investment rule that allows for public spending up to 1.5% of GDP can lead in case of Member States that are highly indebted to a structural violation of the Treaty requirement to avoid excessive deficits. It might therefore become necessary to either add additional limitations to the expenditure rule or to the 'golden rule' that ensure a safety margin with regard to the reference value of 3% of GDP.

Such additional limitations become even more pertinent if a deviation from an expenditure rule would be included in a package of reforms of the EU fiscal framework for spending that becomes necessary in order to implement recommendations made under the Macroeconomic Imbalance Procedure. Whilst the inclusion of a possibility to temporarily deviate from the adjustment path under the preventive arm and the debt reduction path under the corrective arm does not meet as such legal barriers in Primary law, the combination of an expenditure rule, the 'Golden Rule' and a temporary deviation possibility to comply with MIP recommendations could under certain circumstances lead to a violation of the requirement to avoid excessive deficits under Article 126(1) TFEU, especially for high-debt countries.

Overall, a combination of the discussed reform options may therefore require additional limitations on the expenditure rule, the 'Golden Rule' or the temporary deviation for MIP recommendations, which should be defined in relation to the debt level of the Member State in question.

Finally, as the discussion in section 8 has shown, any combination of concrete reforms of the existing legal framework of fiscal rules is to be preferred over a switch from fiscal rules to fiscal standards. The current legal framework already suffers from a technocratic decision-making bias that undermines its persuasive power within the Member States. A complete switch to standards would only strengthen technocratic decision-making in fields that relate to the core of democratic decision-making within national Parliaments: the adoption of national budgets. The reform elements discussed in this paper would lead to a simplification of the EU fiscal framework, render it more counter-cyclical and symmetric in application, and open a fiscal margin of manoeuvre for public investment. Such reforms will make the framework more persuasive to national policymakers and are vital to achieve the transformation of EU's economies against the background of climate change and the digital economy, while at the same time avoiding unsustainable public finances and macroeconomic imbalances.

10. Conclusion and policy recommendations

This study has shown that quite far-reaching reforms of EU fiscal rules are feasible without treaty change as current secondary legislation restricting member states' fiscal policies are much more detailed and often much stricter than the original treaty provisions. Especially proposals that shift the current rules aimed at restricting cyclically-adjusted deficits towards expenditure rules and which provide for limited borrowing for investment purposes can be implemented by changing secondary legislation, provided the parameters are set that the original deficit thresholds in the treaty are not violated. The same is true of measures lending greater credence to the Macroeconomic Imbalance Procedure. A more far-reaching reform proposal to increase the reference value on the debt ratio would require a unanimous vote in the Council after consultation of the European Parliament. Again, a Treaty change would not be necessary. Proposals that try to shift fiscal rules from rules to standards and focus on empowering independent bodies are legally much more difficult to reconcile with the EU treaties.

From an economic perspective, changing the EU's fiscal rules towards expenditure rules such as those proposed by the European Fiscal Board (2020) or Dullien et al. (2020) and a golden rule that safeguards public investment would improve the framework significantly. If parameters are set appropriately, the reformed set of rules could provide a more anti-cyclical fiscal policy, a smoother path for public expenditure, a higher quality of public expenditure (by preventing excessive cuts to public investments) without jeopardising fiscal sustainability. Policymakers should thus push for such a reform agenda. However, a word of caution is warranted: If parameters are set in a suboptimal way, even expenditure rules can result in excessively restrictive fiscal policies, not much different from those experienced in the years after the euro crisis. Therefore, great care needs to be taken with the specific design issues.

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European Economic
and Social Committee

Rue Belliard/Belliardstraat 99
1040 Bruxelles/Brussel
BELGIQUE/BELGIË

Published by: "Visits and Publications" Unit
EESC-2021-73-EN
www.eesc.europa.eu

Print
QE-01-21-510-EN-C
ISBN 978-92-830-5475-7
doi:10.2864/91318

Online
QE-01-21-510-EN-N
ISBN 978-92-830-5474-0
doi:10.2864/355255

EN