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A mixed assessment of the functioning of the EU’s fiscal framework

The Stability and Growth Pact (SGP) has undergone a number of reforms in the last decade, to strengthen the economic underpinning of the EU’s fiscal rules and their adaptability to changing economic conditions. The reforms have allowed for a better understanding and monitoring of Member States’ fiscal policy actions. By doing so, they have also addressed a number of shortcomings of the structural balance, a key indicator that nonetheless may lie beyond the control of governments.

The reforms have put greater emphasis on aggregate expenditure developments and revenue-increasing (or decreasing) measures, that is, on what is more directly under the control of the government. In parallel, the Commission has enhanced transparency, for instance, through an annual update of the Vade mecum on the SGP, the production of detailed country reports and sharing the data and calculations underlying surveillance decisions with national authorities.

However, there is a widespread perception that the fiscal rules have become too complex and too numerous and that they face a range of implementation difficulties in relation to the measurement and robustness of key surveillance indicators. This has also led to questions over equal treatment over time and across countries and reduced the understanding, predictability and acceptance of the framework.

Options to improve the implementation of the fiscal framework under the current rules

The current rules are embodied in primary and secondary legislation and in national legal orders, including via the implementation of the Fiscal Compact. As set out in the 21 October 2015 Communication on *Steps towards Completing Economic and Monetary Union*, the Commission’s technical contributions explore ways for simplifying the assessment of compliance with the SGP with no change in legislation, feeding the discussion with the Member States.

There is no panacea that would allow improving the operation of the fiscal framework in all its desirable dimensions – *simplicity*, *flexibility/adaptability to economic conditions* and *predictability*. Examples of trade-offs abound. Having full predictability and adaptability to a complex and changing economic environment means developing an exhaustive code of sub-provisions catering for each and every situation ('the curse of complete contracts'). Having full simplicity and predictability reduces the adaptability to changing economic conditions. This was a criticism addressed to the SGP before the 2005 reform. Simplicity and adaptability could be combined by relying on discretion to decline the (simpler) rules on a case-by-case basis but this would hamper predictability.

The October Communication identified three pathways in this respect. Firstly, there is a need to ensure the consistency of methodology between the debt rule of the Excessive Deficit Procedure (EDP) and Member States' medium-term budgetary objectives. Secondly, for Member States in EDP, it can be considered to treat deteriorations and improvements in economic conditions in a symmetric manner, respectively leading to a postponement or an advancing of the deadline for correcting the excessive deficit. Thirdly, there is a need to streamline the methodologies for assessing compliance with the rules of the SGP. Currently, different sets of budgetary indicators are used to assess compliance with the preventive arm of the Pact and the EDP, which has led to a multiplicity of indicators, a complex formulation thereof and increased complexity.

In relation to this third aspect, the overall number of *operational* indicators used could be reduced by placing a stronger focus on aggregate expenditure developments. Further technical work and endorsement at the political level would be needed before such an approach could be used in practice. Specifically this could mean:

- In the preventive arm, it could be envisaged to base the assessment of compliance primarily on the expenditure benchmark pillar. The consistent application for all countries of such a change in practice (in the remit of the existing rules) would help streamline the use of indicators, while retaining the structural balance as useful information.

- In the corrective arm of the Pact, the existing budgetary indicators (the so-called '*adjusted* structural balance' and 'bottom-up approach') could be streamlined by making use of an expenditure rule for government primary expenditure which would take into account also revenue-increasing measures. A key feature of the current effective action methodology, namely the role played by the headline deficit and the (non-adjusted) change in structural balance, would be preserved, consistent with the legislation.

These changes would be a step towards more simplicity and predictability. They would reduce the overall *complexity* of the assessment of effective action by substituting an expenditure rule to two complex indicators that make communication challenging. The *consistency* between the two arms of the Pact would also be strengthened. Secondly, the approach would ensure *predictability* in the sense that expenditure rules, in setting an upper limit for the growth rate of government expenditure, constitute an operational target that could usefully guide the preparation of annual budgets and help monitor their in-year execution. It sets a clear target ex ante which does not change over time, is measurable ex post and, in general, is not affected by revenue windfalls or shortfalls. Thirdly, the *economic rationale* behind the assessment of compliance with the SGP rules would be made clearer, insofar as expenditure rules provide a good picture of the country's fiscal policy, since they capture the policy levers that are meant to be in the hands of governments.

At the same time, expenditure rules may have their own weaknesses and face similar challenges with other budgetary indicators. In particular, a number of design issues would have to be carefully looked at, to avoid unintended new complexity and ensure smooth implementation of surveillance. An expenditure rule would also require a long-term sustainability anchor to set the requirements. Similarly, it would reduce the need for, but not dispense fully with, an estimate for cyclical conditions. The issue of stabilizing the economy in the short run would also need to be considered.

Given the broad convergence of views on the merits of focusing on expenditure rules, the ECOFIN could give a mandate to continue the discussion at the technical level along these lines and set an indicative timetable for these discussions.