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BULLETIN

Prospects for a Modification of EU Fiscal Rules

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Confronted with the economic crisis provoked by the COVID-19 pandemic, EU Member States decided to increase public spending which, due to low interest rates, they could finance through debt on attractive terms. These circumstances favour the calls for reform of EU fiscal rules that impose limits related to deficit and public debt. Modifications will most probably focus on making more room for growth-enhancing spending (green and digital transitions, education).

EU fiscal rules, centred on the Stability and Growth Pact signed in 1997, are spelled out in the treaties and secondary law. They oblige the Member States to coordinate economic policies and avoid excessive indebtedness. Rules on government deficit and debt are fundamental parts of the framework: they should stay below the level of 3% and 60% of GDP, respectively. Should governments fail to stay within these boundaries, they are obliged to implement spending cuts according to suggestions formulated by the European Commission (EC) and the Council of the EU. They could also face financial penalties. The rules were, however, were not adhered to by many Member States while the EC used the exceptions written into the system to grant permission for a slower pace of debt reduction. This was done in most cases out of fear that excessive cuts could lead to stronger support for Eurosceptic movements. As a result, between 2014 (when the debt-to-GDP ratio peaked in the EU) and 2019, the majority of members did not manage to reduce their debts significantly (see table at the end).

New Context Created by the Pandemic. In spring 2020, the EC initiated a partial suspension of the rules in order to enable the Member States to spend more and thus prop up their economies constrained by COVID-related restrictions. It also set up a fund (dubbed SURE) worth €100 billion from which governments could borrow in order to finance various employment protection schemes. At the same time, the European Central Bank (ECB) started a new programme to purchase large quantities of eurozone government bonds. In this way the bank prevented an increase in bond yields and ensured governments had access to cheap money. By July, the ECB had spent €1.1 trillion for this purpose. The programme is scheduled to continue until March 2022. A negative corollary of these emergency measures was a spike in indebtedness: at the end of 2020, the debt-to-GDP ratio in the EU reached 90.7% compared to 77.5% in 2019. Between 2028 and 2058, the Union will also have to repay the recovery fund about €750 billion. These problems, however, remained in the background as the fundamental challenge of saving the economy took centre stage.

Arguments of the Proponents of Reform. In the circumstances of the crisis, the pleas for reform of the rules gained traction. They come mainly from Southern Europe and a large group of economists, including the European Fiscal Board (an advisory body of the EC). The advocates of change emphasise that the rules complicate the conduct of countercyclical fiscal policy. In times of crises, they impede higher spending, while in periods of prosperity they do not provide sufficient incentives to make savings. The "reformists" argue that while states become indebted on favourable terms and the economic forecasts are promising, the focus on reducing spending is wrong. By increasing investments, even if the way to do it is taking on more debt, states can accelerate economic growth and, consequently, facilitate repayment of their liabilities.

Making large investments is important not only because of the recession but also the green and digital transitions being implemented by the EU. These projects require considerable funding. Southern European states refer to the experience of the financial crisis a decade ago. In their view, the excessive focus on austerity policy provoked many social problems and thwarted the economic rebound. Consequently, political forces that question European integration gained prominence.

Proponents of reform of the rules suggest modifications of the assessment of Member States' economic condition. They claim that the importance of the debt-to-GDP ratio is overweighted. An improved analysis is needed of individual Member States' capacity to reduce debt. They also argue that the approach to public spending should be altered. States should have more room to increase the deficit if they carry out undertakings that promote modernisation and growth.

The ECB's actions strengthen the "reformist" camp. The large-scale purchases of government bonds demonstrate that the bank appreciates the necessity to support the economy through increased spending and accepts a temporary increase in debt. A significant proportion of government bonds issued since the beginning of the pandemic was purchased by the ECB alone (90% in 2020). Thus, the Member States gained additional protection against a sudden jump in yields that could occur if private entities decided to sell a large number of the bonds.

The proponents of changes call for granting the Union a permanent right to issue bonds. That would provide a way to raise funds for completing the largest EU projects on attractive terms and strengthen the international status of the euro. In addition, the EU could react quicker to crises like the pandemic.

Defenders of the Rules. Several states that are net payers to the EU budget and have a relatively low public debt (including Austria, Finland, and the Netherlands) oppose the push to change the fiscal rules. This group includes Germany where the purchase of government bonds by the ECB and the creation of the recovery fund were challenged before the constitutional court. This camp emphasises that the option to suspend some of the rules used by the EC enabled the Member States to increase spending when Europe was hit by the sudden crisis.

The defenders of the rules concede that in the current circumstances expansionary fiscal policy is justified. They stress, however, that in the near future, actions to reduce debt will be necessary, especially in the countries where it significantly exceeds 60% of GDP. The net payers are apprehensive that if the most indebted members fail to cover their liabilities, the story of the financial crisis will repeat itself and the remaining members will have to share the burden of emergency measures. By the same token, the idea of eurobonds is criticised as a step towards Member States taking responsibility for their peers' debt—an evolution prohibited by EU treaties.

Opponents of the changes argue that an exaggerated fiscal stimulus could lead to inflation, which in August was expected to reach 3% in the euro area. That would force the ECB to reduce the purchases of public and private bonds, which in turn would make the financing of investments and debt by many states (especially Southern European) much more costly, and the prospect of insolvency more real. Yet the EC, in its summer economic forecast, claimed that in the euro area inflation will not exceed 2%, neither this year nor the next. States from outside the area are more affected by rising prices. Furthermore, the new ECB strategy published in summer shows that it is ready to tolerate inflation higher than 2% for a short period.

Conclusions and Prospects. The fiscal rules have not prevented Member States from running up debts that far exceed the level considered safe. Recent years have shown that in times of low interest rates and growing investment needs, reducing spending is not an optimal solution. Changing key elements of the rules (limits related to deficit and debt) will be difficult. They are included in the Treaty on the Functioning of the EU and can only be modified by unanimous vote. Yet, other elements of the procedure could be adjusted, such as how the deficit is calculated to create more space for growth-enhancing spending. Another challenge will be to reconcile the calls for simplifying the set of rules that have grown increasingly complex over time with proposals for designing individual debt reduction paths for Member States.

The ECB's intervention has shown that euro-area members enjoy a powerful support mechanism. This could constitute an argument in the Polish debate on joining the common currency. Meanwhile, the growing critique of strict limits on public spending could spark a discussion on modifying or abolishing the rule in the Polish constitution stating that public debt must not exceed three-fifths of GDP.

Public Debt in Selected EU Member States (where it exceeded 60% of GDP in 2014).

State	**Debt-to-GDP (%)**	
	2014	**2019**
No reduction		
France	95	97
Greece	180	180
Reduction of 15 percentage points or less		
Spain	100	95
Belgium	107	98
Italy	135	134
Cyprus	109	94
Austria	84	70
Hungary	76	65
Croatia	84	72
Slovenia	80	65
Reduction of more than 15 percentage points		
The Netherlands	67	48
Ireland	104	57
Germany	75	59
Malta	61	42
Portugal	132	116