

Jakob de Haan* and Fabian Amtenbrink

The Reform of the European Fiscal Rules: In Search of Mechanisms Ensuring Sustainable Debt Levels

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Abstract: Central to the recent European Commission's proposals for the reform of the current fiscal rules is the introduction of national medium-term fiscal structural plans. The proposed emphasis on compliance with country-specific net expenditure trajectories aimed at government debt sustainability is to be welcomed. However, several details of this expenditure path are either not clear or run the risk of political manipulation. What is more, maintaining the one-size fits all 3 % threshold for the budget balance undermines several of the acclaimed advantages of the proposed new governance system, including that it would be simpler and less pro-cyclical. Furthermore, enforcement under the proposed framework is also unlikely to be stronger than under the current framework. Last, but not least, the proposal does not discuss the need for an EU framework for debt restructuring.

Keywords: stability and growth pact; economic governance; European Union; debt sustainability; expenditure rule; debt restructuring

JEL Classification: H50; H60; E62

1 Introduction

In April 2023, the European Commission published three proposals for the reform of the Stability and Growth Pact (SGP), introduced in 1997 on the eve of the introduction of the Euro, as well as for a further tightening of the EU requirements for the Member States' budgetary frameworks.¹ The Commission mainly proposes to put the

¹ Proposal for a Regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council regulation (EC) No 1466/97, COM(2023) 240 final; Proposal for a Council Regulation amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, COM

***Corresponding author: Jakob de Haan**, University of Groningen, Groningen, The Netherlands; and CESifo, Munich, Germany, E-mail: jakob.de.haan@rug.nl

Fabian Amtenbrink, Erasmus University, Rotterdam, The Netherlands

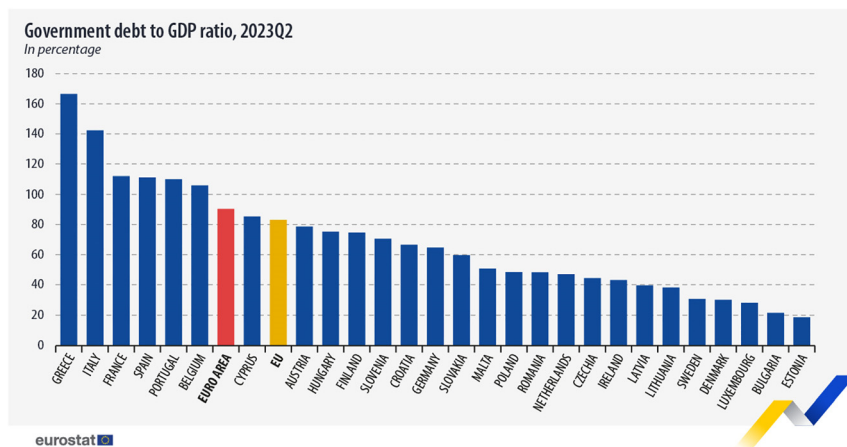


Figure 1: Government debt in EU member states in the second quarter of 2023 (% of GDP).

sustainability of public debt at the centre of the future fiscal surveillance framework of EMU, as the declared aim is to achieve ‘... a credible and substantial reduction of high debt levels’ and to promote sustainable and inclusive growth (European Commission 2023). In doing so, it is acknowledged that higher and more diverse debt levels in Member States can be observed in the euro area for some time (see Figure 1).

This development can be observed despite the fact that the legal framework laid down in the EU Treaties has been designed from the start with the aim to, first, prevent excessive government deficits levels from emerging, and second, to have Member States address any existing excessive deficits and debts within a rather tight time frame laid down in the corrective arm of the SGP. While the 2011 and 2013 post-sovereign debt crisis reform of the economic governance framework has introduced additional governance layers, thereby adding to the complexity of the system, across the board it has not nudged Member States into more sustainable budgetary policies. In fact, fiscal policies tend to be procyclical, as observed by de Haan and Gootjes (2023), as Member States have used the 3 % deficit-to-GDP threshold for establishing an excessive deficit as a point of reference for the establishment of their budgetary policies, rather than as an upper ceiling that should not be exceeded (Caselli and Wingender 2018; Kamps and Leiner-Killinger 2019). Member States’ deficits hovered around the 3 % of GDP-mark even in economic good times, so that the reference value was regularly exceeded in cyclical downturns (Amtenbrink and de Haan 2023).

(2023) 241 final; Proposal for a Council Directive amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, COM (2023) 242 final.

Attempts to address these deficits and the resulting debts with the help of the enforcement mechanisms available in the SGP have failed due to a lack of political commitment to act decisively and – in some instances – the economic inability of Member States to take the necessary corrective (reform) measures.

The question discussed in this contribution is, whether the proposed reforms can remedy this situation by providing a governance framework that can more effectively address the emergence of unsustainable government debt ratios, while at the same time offering viable solutions to deal with the vast amount of debt that some Member States have accumulated (Section 2). With regard to the latter, the question arises whether the EU is not also in need of a debt restructuring mechanism (Section 3).

2 The European Commission Proposals: Reducing National High Public Debt Levels in a Realistic, Gradual and Sustained manner?

The aims that the European Commission (2023) pursues with its proposal for a reform of the EU economic governance framework are multiple and rather ambitious, as the governance framework is not only supposed to become simpler and more transparent, but also more effective ‘... with greater national ownership and better enforcement, allowing for reform and investment while reducing high public debt ratios in a realistic, gradual and sustained manner’. Limiting our observations in this contribution to the proposed framework to reduce debt ratios, it can be observed that the reduction of public debt takes centre stage in a new economic surveillance system that is built around the introduction of national medium-term fiscal structural plans (MFSP). Member States have to commit to a 4-year net primary government expenditure plan, whereby the expenditure path will need to ensure that government debt is on a plausible downward trajectory or maintained at a prudent level no later than the end of the period covered by the structural plan. Moreover, the plans must ensure that any existing government deficit is brought to or maintained below the 3 % deficit-to-GDP threshold over the medium term. Not only do these national plans have to identify planned reforms but also planned public investments. At the same time, discretionary measures on the revenue side and interest expenditures and cyclical unemployment expenditures would be excluded from the calculation of net public expenditure.

Gearing budgetary surveillance towards the development of net expenditure paths instead of (structural) budget balance is, as we have argued elsewhere (Amtenbrink and de Haan 2023), a significant improvement. This is because it has been observed (European Fiscal Board 2019; Feld et al. 2018) that governments can

directly influence most of their own spending, which speaks in favour of the use of a spending rule rather than a budget deficit rule, the latter also being more difficult to forecast accurately. By recognising the need for investments in the adjustment paths, the proposed new economic governance framework would also distance itself more clearly from primarily focusing on austerity measures potentially at the expense of growth. Still, it would be preferable if the final legal act would provide more clarity on the requirements for the definition of the net expenditure path that ensures the reversal of the debt-to-GDP ratio, given that the Commission's proposal is rather vague in this regard. Problematic is also the exclusion of cyclical unemployment spending from the calculation of government net spending, as this may not only result in forecasting errors but also opens the door for manipulations (de Haan and Amtenbrink 2023). Moreover, the extent to which public investments are taken into account in the establishment of the MFSPs (e.g. should only fixed capital be considered?) and the possibility to take investments into account in calculating the deficit adjustment benchmark in the context of the excessive deficit procedure (EDP) should be taken into consideration.

While the regular adjustment period in the MFSP is 4 years, it is foreseen that countries can extend this period by up to three years if meaningful reform and investment commitments are made that *inter alia* support fiscal sustainability and address common EU policy priorities (Amtenbrink and de Haan 2023). However, for some of the high-debt countries identified in Figure 1, even a seven-year adjustment period may not suffice to restore debt sustainability.²

Member States with deficits and/or debt ratios above the reference values would become subject to a more stringent procedure for the adoption of their MFSP's. The establishment of the MFSP would require that the European Commission puts in place a so-called technical trajectory for net expenditure that covers an adjustment period coinciding with at least the four-year duration of the MFSP. The technical trajectory is supposed to ensure that the government debt ratio is brought or kept on a plausible downward trajectory below the 60 % debt-to-GDP threshold, or at prudent levels. The same applies for the government deficit level that has to be brought and kept below the 3 % of GDP reference value. In contrast, countries without excessive government deficits and debts would only have to take into account so-called technical information relating to the structural primary balance required to ensure that, without additional policy measures, the deficit actually remains below the 3 % reference value over a 10-year period following the expiration of the MFSP.

² In its annual fiscal sustainability report published since 2006, the European Commission provides updates of fiscal sustainability challenges across different time horizons (short, medium and long term) faced by Member States. In the 2021 report, nine Member States (Belgium, Czechia, Spain, Italy, Luxembourg, Hungary, Malta, Slovenia and Slovakia) appear at high risk over the long term, driven by the notable projected increase of ageing costs.

Finally, in the Commission proposal it is foreseen that the growth rate of national net expenditures over the plan horizon would have to remain lower on average than economic growth (de Haan and Amténbrink 2023).

In the proposed new economic governance framework, compliance with MFSPs would also take centre stage in the context of monitoring and enforcement. Here, the Commission proposes a different treatment of excessive deficits and debts. As to debt: rather than to rely on the standard 60 % debt-to-GDP threshold for the opening of an EDP that applies indiscriminately to all Member States regardless of their debt sustainability and specific fiscal situation, the Commission's proposal puts the emphasis on (non-) compliance with the country-specific net expenditure trajectories laid down in the MFSPs. This is to be welcomed as it gives Member States with sustainable debt levels more freedom to determine their fiscal policies, thereby creating an additional incentive for Member States under heightened policy surveillance to work towards sustainable public finances by adhering to their debt reduction adjustment paths. Rather than the breach of the 60 % threshold, it would be the deviation from the individual net spending path agreed in the MFSP that would result in the opening of the EDP. The Commission proposal refers in this context to 'substantial public debt challenges' being 'a key factor' that should lead to the opening of an excessive deficit procedure as a rule. As MFSP are envisaged to be tailor-made, the proposed new EDP has the potential to more realistically consider the overall economic situation in a Member State. In view of this new approach, it is only logical that today's 1/20 rule, according to which a debt-to-GDP ratio above 60 % can currently only be considered exceptional if government debt has declined by an average of one-twentieth per year over the previous three years, would be abolished. The Commission's proposal does not provide a specific debt reduction target, as it is only stated in rather general terms that a country's net spending path should redirect the debt ratio in a plausible downward direction or maintain it at a prudent level, whereby countries will have to achieve an average annual fiscal adjustment effort in the first three years that is at least as high as the average annual fiscal effort of the total adjustment period.

As to deficits: today's regime, in which the infringements of the 3 % threshold can in principle directly result in an EDP, would remain in place. This also includes the possibility to consider a deficit above 3 % exceptional if the Council has determined that there is a severe economic downturn in the euro area or the EU as a whole or that there are exceptional circumstances beyond the control of the Member State that have a significant impact on its public finances. Leaving aside the question of whether this rule has indeed effectively influenced fiscal policy and is well understood by policymakers and the general public, as claimed by the Commission, its main effect in the past has been to focus nominal adjustment strategies too strongly on this threshold rather than on medium-term objectives (de Haan and Amténbrink 2023). In the future, in the case of an EDP based on a breach of the 3 % deficit-to-GDP

threshold, countries would continue to be obliged to establish a corrective net expenditure path consistent with a minimum annual adjustment of at least 0.5 % of GDP as a benchmark. This implies that the revised framework would not rule out procyclical fiscal policy, thereby undermining one of the benefits of the proposed focus on the net expenditure rule. Keeping the current EDP procedure for the 3 % threshold in place also does not seem to be necessary, given that the proposed MFSP would not only focus on fiscal adjustment necessary to reduce debt ratios but also deficits. By making the activation of the EDP exclusively subject to a deviation from the agreed upon adjustment path would thus also cover deviations from the adjustment paths for deficits. From an economic perspective, it would have been more consistent to abolish the 3 % deficit reference value altogether and to make the opening of an EDP only depend on non-compliance with the country-specific net expenditure trajectories laid down in the MFSPs (Amtenbrink and de Haan 2023). If the Commission feels that this can be done for the debt criterion without a Treaty change, why can it not be done for the deficit criterion? Such a step would also be more in line with the basic idea underlying the reform proposal that economic policy coordination should entail more differentiated fiscal adjustment paths that are more tailored to the economic situation of individual Member States.

Somewhat paradoxically, while one of the European Commission's declared aims is to strengthen enforcement, it is proposed to reduce the sanctions non-compliance with the requirements under the EDP, by limiting any fine to 0.05 % of GDP for a period of six months and to be paid every six months until it is considered that the Member State has effectively complied with the recommendation. Moreover, the cumulative amount fined may not exceed 0.5 % of GDP. Given that any financial sanctions have yet to be imposed under the EDP, one may wonder about the practical relevance of these proposed amendments. Earlier suggestions by the Commission (European Commission 2022) to introduce macroeconomic conditionality to the EDP like what can be found for example in the context of the Recovery and Resilience Facility at the heart of NextGenerationEU are absent in the current Commission proposal. The introduction of such an enforcement mechanism could provide a positive incentive for Member States to comply with their MFSPs.

The Commission proposal introduces more flexibility into the EDP, evidence of which also derives from the fact the current timeframe for the correction of excessive deficits and debts (to be completed in the year following its identification unless there are special circumstances) is abolished in favour of a rather open rule that the Council must establish a deadline for the correction of the excessive deficit or debt. This proposal is likely to be rooted in the inability of Member States in the past to actually complete the necessary adjustments within the period prescribed in the SGP, but the proposed new rule leaves a lot of discretion on parts of the Council to be lenient on countries without providing any clear legal framework.

Overall, as we have observed elsewhere (Amtenbrink and de Haan 2023), little in the current Commission proposal suggests that enforcement will be stronger than under the current framework. Returning to the first question formulated in the introduction of this contribution, an improvement of the track record of the European economic governance framework in addressing deficits and debts, if any, will not result from an enhanced enforcement framework, but from increased national ownership of and commitment to the MFSP and the individual adjustment paths that can be achieved steering government spending. At the same time, the fact that the proposal currently foresees in the possibility for an incoming new government to submit a new MFSP may weaken this commitment while possibly also resulting in strategic behaviour by Member States. It also remains unclear how the Commission proposal would work out for Member States with high debt levels that will either find themselves in extremely long adjustment periods or will be confronted with unrealistic fiscal adjustment burdens. Put differently, the current Commission proposal does not provide a viable answer how to deal with highly indebted countries. This then raises the question of whether a successful reform of today's economic governance system does not also require a debt restructuring of some shape or form.

3 Debt Restructuring

According to the latest Eurostat figures, Italy's government debt-to-GDP ratio stood at 142 % in the second quarter of 2023 (see Figure 1). The Italian government has set its fiscal deficit for 2023 to 5.3 % of GDP, up from an earlier target of 4.5 %. Next year's expected deficit is 4.3 % of GDP, up from the 3.7 % target it set in April this year.³ In October 2023, the Italian spread, i.e. the interest rate differential with Germany, was around 2 % points. Without the Eurosystem as a major buyer in the markets and with the fiscal woes in Italy itself, it seems likely that this spread will increase, which will put further pressure on the sustainability of Italian fiscal policy. Higher interest rates will not have an immediate effect though. The residual maturity of Italian government debt is around 8 years, as a consequence of which it will take some time before maturing debt will need to be refinanced with the higher interest rate. Still, it is obvious that the fiscal sustainability of Italy is at risk. And, as Figure 1 suggests, Italy is not the only EU Member State facing this problem. If sustainability is not restored, the ECB may in the end be forced to activate the Transmission Protection Instrument (TPI).⁴

3 <https://www.ft.com/content/e2c0cf09-ad93-4aba-954d-e6e4971a59f1>

4 Although the TPI instrument is officially aimed to ensure that the monetary policy stance is transmitted smoothly across all euro area countries, it is clear that it is meant to provide the ECB with an instrument to purchase sovereign debt of a country facing fiscal sustainability problems.

What will happen when the proposed fiscal framework will not result in debt sustainability? Would the necessary reduction of the debt-to-GDP ratio require sovereign debt restructuring similar to what could be observed for Greece in 2012?⁵ A sovereign debt restructuring can be defined as an exchange of outstanding sovereign debt instruments, such as loans or bonds, for new debt instruments or cash through a legal process. The new claims have different characteristics, such as lower principal value, lower coupons, or longer maturity. The European Commission proposal is silent on this issue. However, in our view, it is of utmost importance to think about sovereign debt restructuring mechanism framework at the EU level. A first step has been set by the introduction of collective action clauses (CACs) in EU sovereign debt, but the absence of an EU-level framework covering sovereign debt restructuring implies that each situation in which a Member State faces an unsustainable debt stock is likely to be dealt with on an ad hoc basis.

CACs define procedures and conditions for initiating and negotiating a restructuring process. More specifically, CACs as currently embodied in international bonds, allow a qualified majority of creditors to modify bonds' financial conditions. Collective action clauses therefore help overcome creditor coordination problems. They facilitate a debt restructuring by making the amendments binding on all debt holders without any court supervision and outside a rules-based statute. In the past, most sovereign bonds under domestic law by EU Member States did not include CACs. However, established in response to the sovereign debt crisis, rather than EU law itself, the intergovernmental Treaty establishing the European Stability Mechanism (ESM) requires that as of 1 January 2013, all new euro area government securities, with maturity above one year include CACs in a way which ensures that their legal impact is identical.⁶

The latest ESM Treaty reform (which faces political opposition from Italy, which has not ratified the reform) determines that all bonds issued by Member States of the euro area after 1 January 2022 should contain so-called single limb CACs (SLCACs).⁷ This implies that in case of modifications that refer to several series of bonds, a modification is approved if bondholders representing two-thirds of the principal amount of all series of relevant bonds is met. In the previous version of the CACs, the outcome of the voting per separate series was also taken into account to determine

5 After a bailout in 2010, Greece experienced the largest restructuring operation in the history of sovereign debt in March 2012. The debt reduction was more than 50 % for private creditors and also implied a lengthening of maturity (EPRS 2017; see also Zettelmeyer et al. 2013).

6 Art. 12(3) ESM Treaty.

7 As the amended ESM Treaty is not yet fully approved by all Member States, the Member States agreed to introduce the changes two months after the date on which the ratification of the ESM amendment agreement by all relevant Members States is effective and not on 1 January 2022. Source: <https://english.dsta.nl/subjects/cacs>.

whether a majority had been reached. This recent change makes it thus easier to restructure sovereign debt.

Apart from the harmonization of CACs, there is no EU framework for debt restructuring. Several proposals for such a framework have been suggested in the past that are geared towards providing for a legal framework for an orderly debt restructuring in case of crisis (see EPRS 2017; see also Rossi 2019; Fuest, Heinemann, and Schröder 2016). In our view, this debate should be re-opened. The introduction of a sovereign debt restructuring mechanism can be useful to avoid that financial distress in one Member State compromises financial stability in other EU Member States or even the whole Union (through a contagion effect). An important consideration in this debate should be the potential consequences of sovereign debt restructuring for domestic banks. If domestic banks hold a large amount of outstanding debt, debt restructuring might cause a banking crisis due to write-downs. As shown in Figure 2,⁸ at the end of 2022, government debt was mainly held by domestic financial corporations in several Member States for which data is available. For instance, 64 % of Italian government debt is owned by Italian financial institutions. This may seriously hamper debt restructuring, even if that may be needed to restore the sustainability of fiscal policy.

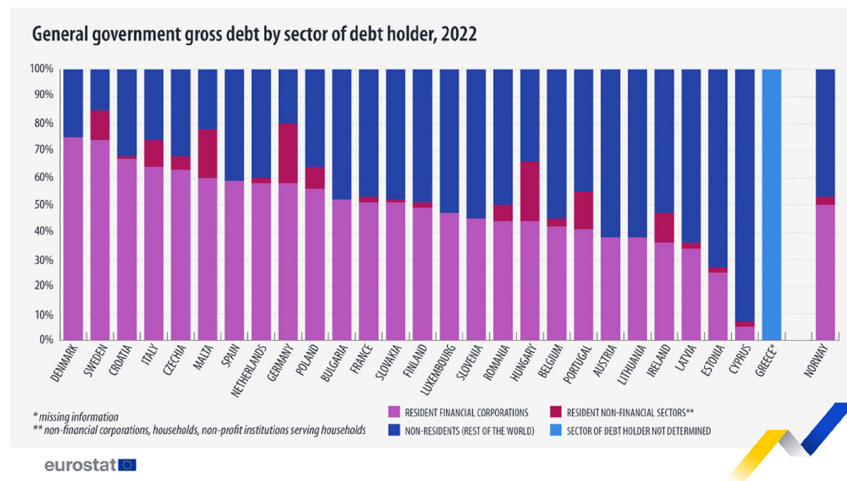


Figure 2: Ownership of government debt in the EU and Norway, 2022 (% of total debt).

⁸ Taken from: https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Structure_of_government_debt#Breakdown_by_sector_of_debt_holder

In conclusion, the focus in the recent proposals of the European Commission for the reform of the current fiscal rules on compliance with country-specific net expenditure trajectories aimed at government debt sustainability is to be welcomed. However, maintaining the one-size fits all 3 % threshold for the budget balance undermines several of the acclaimed advantages of the proposed new governance system, including that it would be simpler and less pro-cyclical. Furthermore, enforcement under the proposed framework is probably as weak as under the current framework. Last, but not least, the proposal does not discuss the need for an EU framework for debt restructuring.

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