CPB Netherlands Bureau for
Economic Policy Analysis

Position paper EU fiscal governance framework

Economic and financial stability of the EMU is best served by simple fiscal rules that are geared to the medium term, such as the multiannual expenditure framework that is applied in the Netherlands. Such a framework should be in line with a long-term objective for debt sustainability. It is therefore important to choose a debt target that keeps the financial risks manageable and also represents a debt reduction pathway that is both feasible and credible for Member States with excessive debt levels. Effective enforcement is essential, in this respect.

At the request of the Dutch House of Representatives' Standing Committee on Finance, CPB Netherlands Bureau for Economic Policy Analysis is participating in the Round Table on 'The Future of EU fiscal rules: reforming the Stability and Growth Pact'. This position paper contains CPB's contribution to the Round Table.

CPB Communication

Pieter Hasekamp, Bert Smid

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CPB's contribution to the Round Table on The Future of EU fiscal rules: reforming the Stability and Growth Pact

- The financial stability of the Economic and Monetary Union (EMU) requires fiscal rules and economic policy coordination, because of the interdependence of the EU Member States. However, the current rules are arbitrary, complex and, partly as a result of this, lack credibility.
- Economic and financial stability would be best served by simple fiscal rules that focus on the medium term, such as the multiannual expenditure framework that is used in the Netherlands. Such a framework should be consistent with a long-term target for debt sustainability.
- It is difficult to provide an economic foundation for such a precise debt limit. It is therefore important to set a debt target that, on the one hand, will keep financial risks manageable, while allowing for a feasible and credible debt reduction pathway for Member States with excessive debt levels, on the other. Effective enforcement is essential in this regard.

Current European fiscal rules are arbitrary, complex and, as a result, also lack credibility. At the core of the Stability and Growth Pact (SGP) are a few reference values (60% of GDP for debt, 3% of GDP for the deficit), a country-specific objective for the medium-term structural balance and an escape clause in the event of a crisis. The implementation and further development of the SGP has led to a complex structure of rules, procedures and exceptions.[1] There is no clear economic foundation for the reference values, which also seem less relevant at currently low government interest rates. In practice, compliance with the SGP rules has been limited. This is partly caused by the complexity of the rules, but is also due to the governance framework, which makes it difficult to impose fines on countries.

Fiscal rules and economic policy coordination are needed for the Member States that form the EMU. Policy choices made by one Member State may have implications for one or more other Member States or for the eurozone as a whole.[2] For example, a loss of confidence in the financial sustainability of government finances in one EMU Member State may have implications for the financial stability of the entire Economic and Monetary Union (EMU). Budget policy in one Member State may also have either positive or negative spillover effects in other Member States through economic growth. The increases in government debt have increased the risks, particularly increasing the vulnerability to rising interest rates. Coordination of economic policy is also important, in addition to EU fiscal rules. The recommendations in the Macroeconomic Imbalance Procedure (MIP) should address the interdependencies between Member States.

The level of risk sharing amongst EMU countries is relatively limited, which increases the importance of sound fiscal rules and economic policy coordination. In the eurozone, relatively many country-specific shocks have a delayed impact on consumption in the country where they occur. In the United States, these shocks are to a larger extent absorbed between states.[3] This happens to a lesser degree in the eurozone, due to lower labour mobility and less risk sharing via capital markets. In addition, in the United States, there is also a certain level of contribution via federal transfers, whereas budgetary transfers between EU Member States hardly contribute to the absorption of country-specific shocks. Added fact is that of the EMU banking union not yet having been completed, which means that the interconnectedness between European banks and governments is still higher than necessary.[4] The limited extent of cross-border shock absorption and the high degree of interconnectedness between European banks and governments increase the risks of financial instability. These risks can be attentuated through effective fiscal policy that does not allow any excessive accumulation of government debt and through economic coordination which will counter any imbalances.

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[1] CPB (2020), SGP: evaluatie, ook (r)evolutie? [*SGP: evaluation, also (r)evolution?]* (link)

[2] Network of Independent EU Fiscal Institutions (2021), EU Fiscal and Economic Governance Review (link)

[3] Smid B. and S. van Veldhuizen (2019), A budgetary stabilisation function, CPB Policy brief (link)

[4] K. van der Wiel et al. (2018), Towards an EMU banking union: three scenarios (CPB risk assessment of financial markets (link))

Adjusting policies takes time, which pleads in favour of simple medium-term fiscal rules.[5] Current fiscal rules are partly based on unobservable variables, such as potential economic growth and the natural unemployment rate. These indicators are estimated using statistical methods and are revised often and to a considerable degree, including those that concern years in the past. A focus on these variables increases the likelihood of pro-cyclical policies. This pleads in favour of simple rules with a focus on the medium term, such as the multiannual expenditure framework that is applied in the Netherlands. A medium-term focus reduces the need for ad-hoc adjustments and also improves the quality of budget-related decision-making. Expenditure frameworks should be consistent with a long-term objective for debt sustainability.

It is difficult to provide an economic foundation for such a precise debt limit. This also applies to the time frame within which overindebtedness is to be reduced. The current Maastricht Treaty reference value of 60% of GDP for government debt has no clear foundation and is probably considerably lower than would be necessary to ensure financial stability. Many EMU countries now have debt levels that are above or even far above this 60% of GDP, and, for some countries, achieving the 60% level within twenty years would require very drastic measures. In the economic literature, there is no consensus about the debt level that would be an acceptable risk under current low interest rates. The time frame within which the excess debt should be reduced is also debatable. A shorter time frame would require certain countries to make substantial spending cuts, with a negative cross-border impact on economic growth and would probably meet with limited political support. A longer time frame means that stability risks continue to exist for a longer period.

Simplification of budget rules increases the importance of an independent assessment of country-specific conditions. Most national Independent Fiscal Institutions (IFIs) have extensive knowledge about the national economy and government finances, and are able to assess whether there are good reasons for a temporary deviation from EU fiscal rules. It is worth considering including these IFI assessments in the assessment by the European Commission. Introducing minimum requirements for IFIs would ensure that all of them in all Member States are able to fulfil this role effectively. These requirements concern mandatory reporting, timely access to relevant information, sufficient staffing levels and protection against political pressure.

Enforcement of the fiscal rules is crucial. Current EU fiscal rules have a 'triple lock', consisting of a firm ceiling for budget deficit and debt, the fines for violations, and the no-bailout clause, under which countries cannot count on any support from other Member States. In practice, this triple lock has not been very effective.[6] In the event of non-compliance, it has proved politically unfeasible to impose fines, and the financial interconnectedness between governments and the financial sector proved too great to fully apply the no-bailout clause. Without a proper enforcement of fiscal rules, countries are very likely to continue to break them.

Replacing the fines, in cases of non-compliance, by conditional transfers and subsidies from the European Commission could be considered. With the establishment of the Recovery and Resilience Facility, such transfers to Member States have become more substantial. It could be worth considering making the disbursement of such transfers conditional on compliance with the EU fiscal rules and recommendations in the Macroeconomic Imbalance Procedure. More EU transfers could both increase shock absorption within the EMU and act as an incentive for Member States to comply with the EU fiscal rules. Ultimately, this will only be successful if there is the political will to show solidarity with other EU Member States, on the one hand, and for consistent enforcement of the agreed fiscal rules, on the other.

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[5] CPB (2020), SGP: evaluatie, ook (r)evolutie? [*SGP: evaluation, also (r)evolution?]* (link)

[6] See C. Teulings et al. (2011), Europa in crisis: Het Centraal Planbureau over schulden en de toekomst van de eurozone [*Europe in crisis: CPB Netherlands Bureau for Economic Policy Analysis about debts and the future of the eurozone*]