



Europe's new fiscal framework

Description

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Europe's fiscal rules were suspended in 2020 in the wake of the Covid crisis, the outbreak of war in Ukraine and the energy crisis it triggered. A new fiscal framework is due to be reinstated at the beginning of 2024. The European Commission presented a final proposal for the reform of the fiscal framework in April this year. The old framework is in many ways outdated and was never really fully implemented. It consisted of a complicated rules-based approach, debt and deficit levels and adjustment requirements that were sometimes too strict for some countries. The new framework is a break with the rules-based tradition. It is more flexible and gives member states more autonomy in designing their fiscal adjustment paths.

However, the new macroeconomic environment that is emerging will be more challenging than the one it replaces. Higher inflation, tighter monetary conditions and slower economic growth may make it harder to achieve fiscal sustainability, making it difficult for some member states to avoid the austerity that the new framework was designed to prevent. This is particularly relevant given that, in many cases, debt ratios are now higher than when the rules were suspended almost four years ago. We discuss the new framework against this background and conclude that further fiscal integration may ultimately be unavoidable, as fiscal space for public investment in key policy areas remains insufficient in some member states. Cyprus is not in a bad position in this respect but will need to remain vigilant on macroeconomic developments and its debt dynamics.

The new framework

The central guiding principle of the new fiscal framework is debt sustainability analysis on a country-by-country basis. Debt sustainability analysis assesses the likelihood that debt will become unsustainable on current policies and identifies a medium-term fiscal adjustment target that is needed to reduce the budget deficit and ensure debt sustainability. The underlying principles of the new framework are very simple. There is a rule that the deficit must be below 3% at the end of the adjustment period of four years, or seven years under certain conditions. Then there is the debt sustainability requirement, that after the adjustment period, debt must be on a firm downward trajectory that is highly likely to materialise.

The procedure consists of three steps. First, the European Commission publishes technical trajectories of net expenditure over a four-year adjustment period for all Member States with debt and/or deficit ratios above the Treaty reference values of 60% and 3% respectively. Second, after a technical dialogue with the Commission, Member States submit their “national medium-term fiscal structural plans”, which include a net expenditure trajectory for the four-year adjustment period and fiscal structural measures underpinning the proposed fiscal path. These plans are discussed with the Commission and the adjustment period can be extended from four to seven years if the country commits to a set of reforms and investments that together would support growth, improve the sustainability of public finances, and address common priorities of the European Union. In a final step, the Commission assesses the national medium-term budgetary plans and makes recommendations to the Council, which endorses the plans or asks for revisions.

Additional safeguards

For countries with debt ratios above 60% or deficits above 3% of GDP, there are additional requirements, called safeguards. Cyprus falls into this category with a higher debt ratio. These safeguards require that, at the end of the four-year adjustment period, the debt ratio is lower than at the beginning of the period and that expenditure growth is slower than GDP growth over the same period. In addition, countries with a budget deficit above 3% of GDP will reduce it by 0.5% of GDP per year as long as it remains above 3%. Member States will have to ensure that their government debt remains on a downward path for the ten years following the adjustment period.

Comparing the old and new frameworks

Comparing the old and the new fiscal frameworks, there are some very significant changes. The old framework was highly complex, consisting of multiple and overlapping rules, and was essentially driven by the so-called structural budget balance of the general government. This is the budgetary position that will prevail for a given set of policies when the economy is operating at full potential. In good times, when the economy is growing above potential, revenues will be higher and expenditures lower. When the economy is slowing down below potential, revenues will be lower, and expenditures higher. The structural budget balance is calculated on the basis of potential output, which excludes cyclical factors. However, this indicator is very difficult to measure and is largely unobservable, as its calculation requires estimates of potential output, which by definition is never observed. As a result, the process is subject to potentially large measurement errors, making the structural budget balance a very unreliable indicator as a policy anchor. Often, the old framework would lead to fiscal adjustment requirements for individual countries that would be too austere.

In the new fiscal framework, the control variable will be “net expenditure”, an observable, more transparent and more precise variable. The net expenditure variable consists of discretionary expenditure controlled by the government and will exclude interest payments and certain other well-defined expenditure items. The 3% deficit limit and the 60% debt ratio benchmark will remain in the new framework as they are part of the Treaty. However, the focus will be on the medium term and Member States will have more discretion and ownership over their fiscal adjustment paths.

And fiscal integration at the end

The reform proposal aims to gradually reduce debt levels and fiscal imbalances across the European Union, while creating more fiscal space for public investment in key policy areas and avoiding painful austerity measures. But while the new framework gives member states some freedom in planning their debt reduction paths, it doesn't reduce the nominal size of the required adjustment and doesn't remove the potential for dispute and disagreement.

Member States start from very different positions. In 2022, for example, about half of the member states had debt ratios above the 60% reference value and almost another half had budget deficits above the 3% reference value. Around a quarter of Member States exceeded both the debt and deficit benchmarks, including Italy, France, Spain and Belgium. Debt ratios for 2022 averaged 91% in the euro area and were as high as 170% in Italy. These differences will be more pronounced in an environment of high interest rates, and therefore higher borrowing costs, after the rules have been suspended for the first time in 2020.

In this environment, public investment in areas such as green energy and decarbonisation, industry and defence will be more difficult to pursue. Higher levels of public spending will be required, which current EU funds, such as the EU's Next Generation Post-Pandemic Fund, can only partially cover.

In this context, some southern and eastern member states may have to postpone key policy priorities or break fiscal rules. Divisions will intensify and the design architecture of the EU will come to the fore, with southern states, including Italy and France, likely to push for deeper fiscal integration or common financial instruments to finance key projects of common interest.

Conclusion

The new fiscal framework is a very significant positive improvement on the old rules-based framework. Member States will have more ownership of the process and more discretion in setting their fiscal paths. However, large differences in fiscal and debt positions across Member States, a more adverse environment with tighter liquidity conditions and higher borrowing costs, and significant differences in spending needs for priority investments will create divisions and ultimately challenge the effectiveness and adequacy of the new fiscal framework. The EU will once again be confronted with the need for greater fiscal integration.

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