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Centralisation or Decentralisation of European Fiscal Rules?

When EU countries adopted the euro, they were aware of the challenges posed by decentralised fiscal policy in a monetary union. In particular, this arrangement raises concerns that individual countries will greatly expand their public debt in the common currency, thus complicating and undermining monetary policy. Furthermore, excessive public debt in one country could require large-scale financial assistance from other countries. To prevent the emergence of such fiscal policy externalities, limits on public deficit and debt levels were set in advance.

Initially, monitoring adherence to the reference values was centralised: the European Commission was tasked with acting as guardian of the Treaties, and, together with the European Council, was also given the authority to impose sanctions in the event of rule violations. However, the obligation to adhere to the reference values on a permanent basis proved difficult to enforce as member states considered the values to be targets rather than limits. A reform in 2005 introduced an explicit target in the form of the medium-term budgetary objective (MTO), which envisaged a structural deficit of up to 1% of GDP, i.e. a budget that is close to balance in structural terms.

After the failure of central enforcement of fiscal rules had become obvious, the Fiscal Compact of 2012 introduced the obligation of decentralised compliance monitoring with respect to fiscal rules. Each member state has since been required to establish its own formal rules for a structurally balanced budget. The subsequent “two-pack” regulations strengthened this decentralised approach by stipulating that independent national fiscal institutions (IFIs) must be involved in monitoring compliance with the fiscal rules. Subsequently, many member states have developed corresponding institutions, and before the COVID-19 pandemic we witnessed an emerging structure of decentralised enforcement. As this process is not yet complete, the debate on reforms of EU fiscal rules has intensified in recent years.

Recently, the European Commission has developed a legislative proposal for the reform of the EU’s “economic governance rules”. The proposal suggests dropping the obligation for a broadly structurally balanced budget as defined by the MTO. In the future, the Commission will instead determine an upper limit for the net primary expenditure path through bilateral negotiations with the member states, which is to be endorsed by the Council, taking into account planned measures in the respective country. This path is to apply for a period of four to seven years.

Putting the technical aspects aside, with the intended bilateral negotiations to determine the respective limits, the proposal includes a new procedural approach. The role of the Commission will be expanded. Beyond budgetary surveillance, it is to be involved in the determination of the fiscal policy of the respective country. According to the Commission, this new approach intends to make the member states more willing to adhere to the fiscal rules – in the jargon of the Commission, the “national ownership” of fiscal rules is to be strengthened. While national ownership would generally be a merit, scepticism is warranted here because there remains a fundamental conflict between the goals of the national fiscal policy and the joint perspective of the union. Moreover, the envisaged involvement of the Commission in determining a country’s permissible expenditure path opens up new opportunities for the Commission to influence national fiscal policy in a way that works against national ownership.

In the past, the European Commission and the European Council themselves have repeatedly shown that Brussels has not really taken ownership of the task of monitoring compliance with the EU fiscal rules, and the rules have been publicly discredited by Commission presidents as non-sensical or irrelevant. From an economic perspective, it should be emphasised that the Commission – in line with its mandate – is pursuing an own economic policy agenda. It sees its role, for example, in strengthening the cohesion of member states, and it is pursuing ambitious decarbonisation targets. In pursuing its agenda, the Commission depends, however, on the Council and on the participation of the individual member states. Even though the objectives of the Commission are shared by most member states, the Commission's own agenda is in conflict with strict enforcement of fiscal rules. As the Commission needs the support of the Council, a generous interpretation of fiscal rules is instrumental for the Commission in gaining approval for its proposals. Moreover, the Commission is dependent on the member states to finance its tasks, and it needs their approval even when setting up the budget. These two channels open up numerous opportunities for the member states to exert pressure on the Commission. Because of these and other conflicting objectives, even if the proposal for the new rules strengthens its bargaining power, the Commission cannot credibly commit to enforcing the rules. Accordingly, even *ex ante*, member states have little incentive to comply with the rules.

It seems problematic, therefore, that the European Commission's recent proposal foresees a more important role of the Commission in assessing member states' budgets and their development. It also creates a risk that the independent scrutiny of countries' budgetary policies by their national IFIs will be undermined. Currently, it is common practice for national IFIs to examine whether budgets are in line with the MTO, whether they are sustainable in the long term, and what budgetary effects certain reforms have. In the future, there will be no simple benchmarks that define whether public finances are complying with the rules, and therefore national IFIs may lack leverage to effectively assess the fiscal policy and the national budgets.

Currently, the decentralised enforcement of EU fiscal rules rests primarily on ensuring a structural deficit in line with the MTO. Under the proposal outlined by the Commission, however, national fiscal rules in the form of a structural balanced-budget requirement will no longer be consistent with EU fiscal rules. A simple fix is not available: replacing the national balanced budget requirements with an upper limit for the net-expenditure path is not practical, as the net-expenditure paths will differ across countries and years. The lack of consistency with EU fiscal rules is likely to undermine the effectiveness of the national rules.

As the net expenditure path is a macroeconomic concept that has no counterpart in public budgets, it would be necessary to spell out in detail for each national and subnational authority what the net expenditure path requirement actually implies. If it has been agreed between a member state and the Commission that certain reforms will be undertaken by the member state, and if the Commission has then extended the spending path accordingly, what spending path should apply to the different levels of government? Should national and subnational governments be allowed to increase their spending accordingly? Does that apply even if the reforms are primarily reflected in the national government's budget? Political solutions must be found for all these problems. In the end, it will always be a matter of interpretation whether rules are followed or not. Practical experience suggests that this will make fiscal rules less binding.

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In light of the aforementioned complications, the path to a more effective decentralised budgetary surveillance initiated by the Fiscal Compact is undermined by the European Commission's recent proposal. Moreover, the Commission's proposal may lead to even greater political capture of budgetary surveillance at the European level. In sum, the proposal does not help in improving compliance with the reference values and is likely to damage existing enforcement structures.