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## Research Report

# A proposal for reforming the Stability and Growth Pact

Fachtexte

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## A proposal for reforming the Stability and Growth Pact

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### Executive Summary

There is consensus that the Stability and Growth Pact (SGP) needs to evolve. In this paper, we put forward reform ideas aimed at reducing debt levels, enabling sustainable growth and strengthening Europe's sovereignty without a change in primary legislation. The current fiscal framework leads to a suboptimal trade-off between austerity and growth. Our proposals therefore focus on two ideas: first, putting more emphasis on the primary deficit in both the corrective and the preventive arm of the SGP; and second, simplifying and revising the preventive arm, in particular the estimation of potential output. These reforms would make the SGP more effective in reducing debt ratios, reduce the risk of contractionary austerity while allowing for growth, and contribute to economic convergence. A clearer focus of fiscal policy on primary deficits would also sharpen the distinction between fiscal and monetary policy, as monetary policy has no direct influence on the primary balance. Finally, we argue that substantive progress towards European sovereignty would require major reform. Given today's understanding of monetary policy transmission mechanisms, mechanically limiting sovereign credit at an arbitrary debt-to-GDP ratio seems particularly problematic as it can no longer be justified with the aim of avoiding fiscal dominance.

#EUROPE

#FISCAL POLICY

#MONETARY POLICY

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## Introduction and Overview

There is consensus that the European fiscal rules need to evolve. In the following, we outline (i) the current macroeconomic context in the EU with a focus on the Eurozone, (ii) objectives for reforming the Stability and Growth Pact (SGP), and (iii) a reform proposal for both the corrective and the preventive arm of the SGP. The objective of our proposal is to turn both arms of the SGP into more effective guardrails for a fiscal policy that reduces debt levels, enables sustainable growth, and strengthens Europe's sovereignty without changing primary legislation.

The analysis shows that the fiscal rules were quite effective in terms of deficit reduction in the years before the Corona crisis. However, the same cannot be said for debt ratios, which mostly continued to rise, especially in countries in *Excessive Deficit Procedures* (EDP). This is partly due to (1) a suboptimal trade-off between the budget balance and growth and (2) high risk premia on some government bonds that have emerged since the debt crisis. These new risk premia are a result of the Eurozone's institutional design.

To address both (1) and (2), we propose a three-step procedure for the deficit criterion of the corrective arm of the SGP. The first step is – as before – to ask whether member states comply with the 3% deficit limit. If not, the second step asks whether member states comply with a publicly-known primary deficit threshold, which would be communicated in advance. If they do, the European Commission (EU-COM) will not declare the deficit to be excessive. The primary deficit threshold will be set with the goal of maximising the likelihood of debt reduction given the current interest rate environment and growth prospects. Public communication of this threshold would reduce uncertainty and problematic market reactions. Should member states also exceed this primary deficit threshold, the Medium-Term Budgetary Objective (MTO) and the Fiscal Effort from the preventive arm will be used as decision criteria in a third step, as is already the case today.

In order for the preventive arm to not result in counterproductive fiscal policy, we propose revising the method for estimating potential output. The notion of potential output is used to estimate how far an economy is from utilising its total capacity and hence how large a deficit the government may run. To avoid a situation in which the preventive arm locks economies into a sub-optimal equilibrium with permanent slack, it is essential that the estimate of potential output at least approximates the actual potential of the economy. Finally, we propose a reform of the Investment Clause, which should be adapted to the priorities codified in NextGenEU as well as to the changed geopolitical situation.

The proposed reforms should lead not only to a more effective reduction in debt ratios, but also to a clearer division of tasks between fiscal and monetary policy.

Should politicians seek to actively pursue a strengthening of European sovereignty, the proposals listed here will not suffice. This would require more fundamental reforms, especially concerning the mechanical limitation of public debt. This would not only be necessary, but possible: the rationale behind limiting the debt ratio is based on a theory of fiscal dominance that has since been refuted.

## Macroeconomic and institutional context

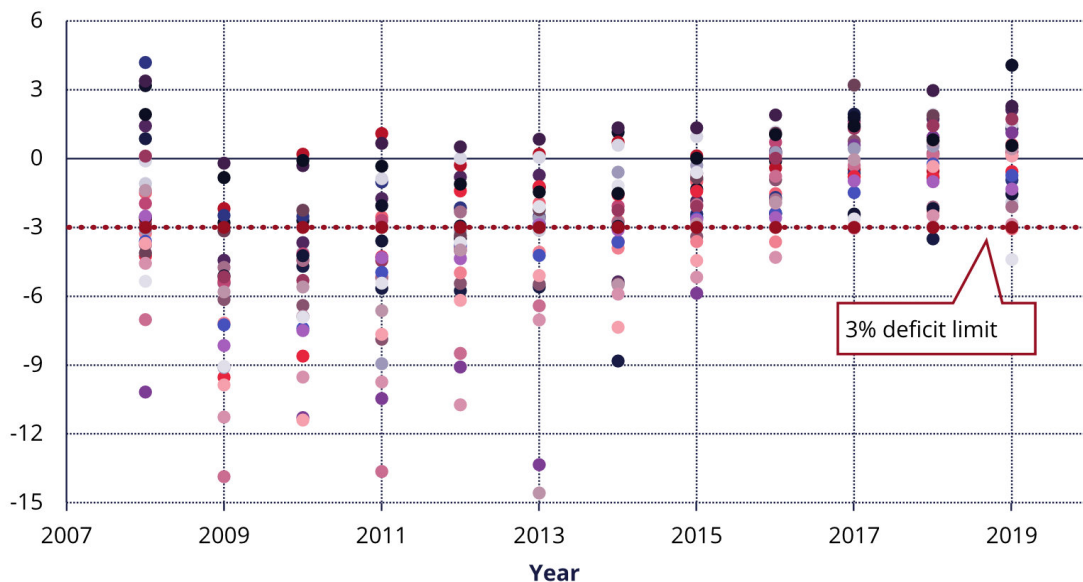
**Effectiveness of the fiscal policy framework:** Since the existence of the SGP, there has been a debate regarding its effectiveness. The discussion intensified during the European debt crisis, which some economists see as the result of insufficient budgetary discipline (for example [Schuknecht 2011](#)).<sup>2</sup>

If one defines effectiveness of fiscal rules as the degree to which they actually influence fiscal policy choices of governments, the 3% deficit limit in particular can be considered to be effective. According to the European Fiscal Board (EFB), it is a focal point of budget monitoring by the EU Commission.<sup>3</sup> This is evident both from a historical perspective and in comparison with developments in the USA and Japan ([Kamps and Leiner 2019](#)).

### Deficit

*In % of GDP; points correspond to individual states*

Percent



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**Figure 1:** Deficit; Source: Ameco

It is striking how quickly European countries reduced their primary deficits – the part of the budget they directly control, i.e. deficits minus financing costs – after the financial crisis despite weak economic growth. From 2014 until the beginning of the Corona crisis (see Figure 2)<sup>4</sup>, they generated primary surpluses. Kamps and Leiner-Killinger attribute the effectiveness of the 3% value to the fact that it is easy for both the markets and the public to understand and monitor.

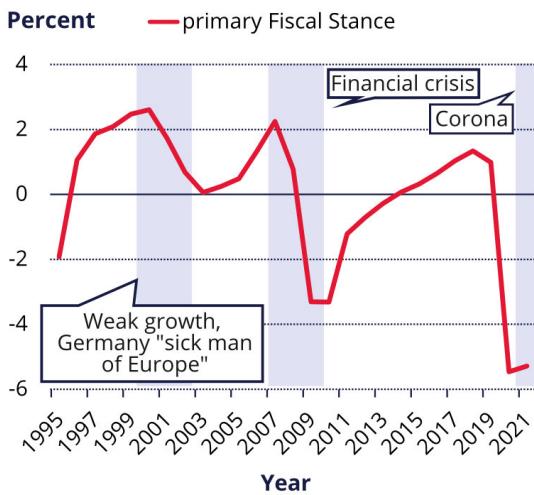
<sup>2</sup> Another explanation with broad resonance in academia is the sudden stop of cross-border private capital flows, amplified by inadequate banking regulation as well as the Eurozone's monetary policy architecture ([De Grauwe 2013](#), [Baldwin et al. 2015](#)).

<sup>3</sup> "...the 3% deficit ceiling will remain a focal point of Commission monitoring and it will remain in the centre stage of the political interactions within countries, among governments and of governments with the Commission" ([EFB, 2021](#)).

<sup>4</sup> Accordingly, the number of countries complying with the deficit limit increased very rapidly after the financial crisis, see [Larch and Santacroce \(2020\)](#).

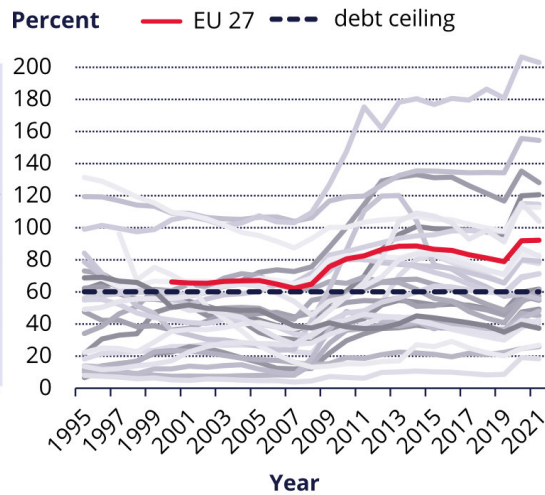
## EU primary Fiscal Stance

In percent of GDP



## Debt-to-GDP ratio, EU states

In percent of GDP, coloured: EU, dotted: 60% debt ceiling



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**Figure 2:** EU primary Fiscal Stance + Debt-to-GDP ratio, EU states; **Source:** Ameco

While compliance with the 3% deficit limit could be regarded as a success, Kamps and Leiner-Killinger are rather critical in their assessment, arguing that some states have converted the 3% limit from a ceiling to a target. According to the authors, states often made an insufficient fiscal effort under the preventive arm and achieved the 3% simply through GDP growth with a constant structural deficit.

There are numerous reasons for weak compliance with the preventive arm: First, the calculation of the structural deficit, which the preventive arm limits, is based on the unobservable concept of potential output. The methodology for estimating potential output is controversial (see for example [Heimberger and Kapeller 2017](#), [Schuster et al. 2021](#)) and viewed critically especially in states with labour market slack (see for example [Calviño 2019](#)). In addition, the calculation of the required Fiscal Effort lacks transparency and is highly complex as well as heavily dependent on the interpretation of the EU-COM due to numerous detailed provisions which are aimed at addressing the different circumstances in EU member states ([Bundesbank 2017](#)).

Limited adherence to the preventive arm of the SGP is one of the reasons often cited for why debt ratios have not declined. For example, although the EU's debt-to-GDP ratio fell by four percentage points between 2000 and 2008 to 62%, it rose to 79% by 2019 and now stands at 92% (see Figure 2). Moreover, debt ratios have continued to diverge.

In addition to debt reduction, a mixed picture emerges regarding the original objectives of the fiscal rules as set out in the Delors Report. The Report focuses on the coordination of national budgets to ensure monetary stability, the avoidance of imbalances in the real economy and the financial sector, as well as the coordination of the EU-wide budget balance to compensate for cyclical fluctuations and to ensure an appropriate mix of fiscal and monetary policy. Monetary stability has been achieved, at least as long as this is defined as inflation not exceeding 2%.<sup>5</sup> However, imbalances in the real economy and the financial sector

<sup>5</sup> Supply side price increases since 2021 triggered by disrupted supply chains, high energy prices and the Russian war of aggression are excluded.

have not been prevented. Moreover, according to the EFB, national fiscal policies have not resulted in a European fiscal stance appropriate for the economic environment. Instead, the stabilisation function of monetary policy was overburdened (EFB 2017). The situation has hardly changed despite the creation of the EFB, which was supposed to address this problem (EFB 2019).

Thus, the SGP has had a significant influence on fiscal policy, especially on budget balances, but only achieved its goals to a limited extent overall. This is often blamed on the conflict between cyclical stabilisation and the reduction of debt ratios. While some argue that insufficient fiscal stabilisation (i.e. too low a deficit) led to subdued growth, others consider insufficient deficit reduction the main culprit for today's high debt ratios. Even though the two arguments may seem contradictory, they come down to the same issue: optimising the trade-off between budget balance and growth.

In the following, we discuss these two aspects as well as another occasionally-overlooked driver of the development of the debt ratio: financing costs, and in particular risk premia on government bonds. Building on this discussion, we then suggest further reforms to the SGP.

**The trade-off between budget balance and growth:** A reduction in the budget deficit has an ambiguous effect on the debt ratio. If a less expansionary fiscal policy stance reduces growth excessively, the debt ratio - the ratio of general government debt to gross domestic product (GDP) - increases despite a lower deficit. The EU-COM for instance assumes that a reduction in the deficit by one percentage point reduces growth by 0.5 percentage points in the same year.<sup>6</sup>

The decisive factor for the risk of contractionary austerity to adversely affect the debt ratio is the state of the economy when the deficit is reduced. As long as there is slack in the economy, reducing the deficit most likely has a negative effect on growth. According to [Jordà and Taylor \(2013\)](#), a fiscal consolidation of 1% of GDP in a downturn leads to a loss of 4% in real GDP over five years.

In an economy with its own central bank, the risk of contractionary austerity should be limited to times when monetary policy has already reached the Zero Lower Bound ([Mian et al. 2022](#)). Otherwise, the central bank can ensure full capacity utilisation<sup>7</sup> by cutting interest rates and thus enabling a reduction in the fiscal deficit while avoiding negative side effects for growth. In the Eurozone, however, the danger of growth-damaging deficits also exists beyond the Zero Lower Bound, as the monetary policy of the Eurosystem applies to the entire currency area and the capacity utilisation rates of its constituent economies differ considerably: for example, in the states with the highest labour market slack, an average of 31% of the labour force would have preferred to work more in the time since 2009, while in states with least labour market slack, this figure is only 8%.<sup>8</sup>

The SGP could take better account of the fact that deficit reduction can also have a debt-increasing effect in three ways. First, the deficit criterion of the corrective arm does not yet systematically take this consideration into account. By considering only the total deficit and not the primary deficit (budget balance

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<sup>6</sup> In the context of the SGP Institutional Scenario of its fiscal sustainability analysis for states not in an EDP ([EU-COM 2014](#)).

<sup>7</sup> We prefer to use the term "capacity utilisation" instead of "full employment", as making the best use of economic resources available is not just about minimising the unemployment rate.

<sup>8</sup> Average maximum and minimum quarterly Labour Market Slack from 2009 to the end of 2019, see [Eurostat](#).



excluding financing costs), which has the strongest impact on the real economy,<sup>9</sup> states with high financing costs may face unintentional austerity. Second, the SGP propagates the concept of "safety margins": in order to ensure that the set limits are not exceeded, states should reduce their deficits beyond the actual threshold, i.e. maintain a safety margin. This makes sense when deficit reductions are risk-free, but is misguided when there is a trade-off between growth and the budget balance. In such times, there is little safety in safety margins. Thirdly, although the definition of the Fiscal Effort under the preventive arm should account for the cyclical position of the economy and thus prevent pro-cyclical fiscal policy, it has so far not been able to live up to this aim due to methodological problems.

**Need for growth and convergence:** As discussed previously, growth is key for reducing the debt-to-GDP ratio, but may come at the cost of a higher deficit. Thus, from a purely fiscal perspective, one might argue for restrictive fiscal policy at the expense of growth. However, as the European debt crisis has shown, the political legitimacy of the EU depends heavily on so-called output legitimacy, i.e. the extent to which the institutional construct of the EU serves the community. This is reflected for instance in the communication of the European Council, which shifted from its sole focus on stability to also talk about growth after 2012 (Schmidt 2015). As Larch et al. (2021) show, growth not only promotes political legitimacy, but also enhances compliance with fiscal rules. The effectiveness and durability of the SGP therefore seems to depend not insignificantly on its ability to enable growth. It is therefore not surprising that the Dutch government, according to its coalition agreement, explicitly intends to promote high growth rates and upward convergence in the European context.

Moreover, it is questionable whether a scenario without growth and convergence, but also without budget deficits, would really entail lower fiscal risks in the long run: if convergence is a prerequisite for a discussion of risk-sharing mechanisms (as argued, for example, by Cœuré 2017) and risk-sharing mechanisms are needed to cushion asymmetric shocks, resilience to asymmetric shocks will depend heavily on substantial growth in states like Italy.<sup>10</sup>

Thus, for reasons of risk minimisation as well as political legitimacy, growth and convergence appear to be essential. However, growth has not been Europe's strong suit since the financial crisis: the EU has not managed to return to its pre-crisis growth trajectory. While 3% growth was still expected in the 1990s, only 1.6% was actually achieved between 2010 and 2019. Hence, despite falling market interest rates and sharply declining primary deficits, the debt ratio had only fallen by 3 percentage points by 2019 (see Figure 3).

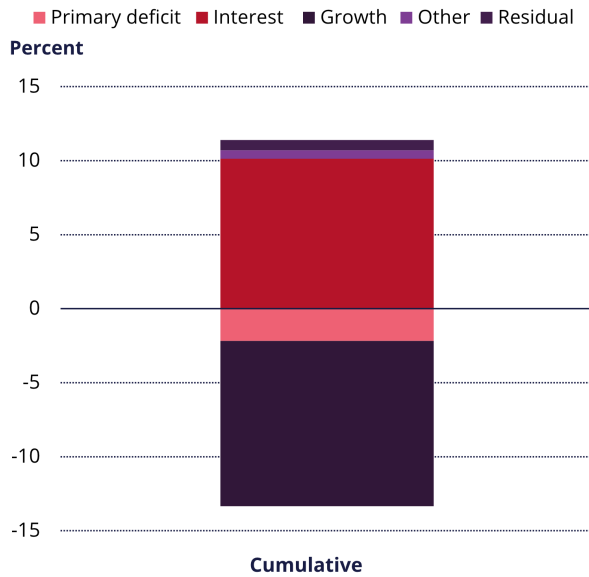
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<sup>9</sup> One of the reasons why the primary deficit is better suited to measure how much fiscal policy stabilises the economy is the nature of the recipients of the interest payments, i.e. the financing costs. In the case of Eurozone countries, government bonds are predominantly held abroad or by central banks. Therefore, this share of interest expenditure does not flow into the domestic economy. In the case of Italy, 54% of outstanding government debt is held abroad or by central banks, in the case of Germany, Portugal and Belgium more than 70%, and in the case of Greece, Ireland, Austria and Slovenia more than 80% (IMF Sovereign Debt Investor Base for Advanced Economies). In addition, domestic government bond holdings are directly or indirectly concentrated in wealthy households whose marginal propensity to consume is rather low (Arbogast 2020), such that only weak demand impulses can be expected from higher interest payments via this channel as well.

<sup>10</sup> It could be argued that the Covid crisis partly refuted this argument, as new risk-sharing mechanisms were introduced even without convergence, perhaps also because the experience of the debt crisis had illustrated the essential role of a successful recovery from economic crises for the continued existence of the EU.

## Contributions to the change in the debt ratio 2010-2019

In percent of GDP



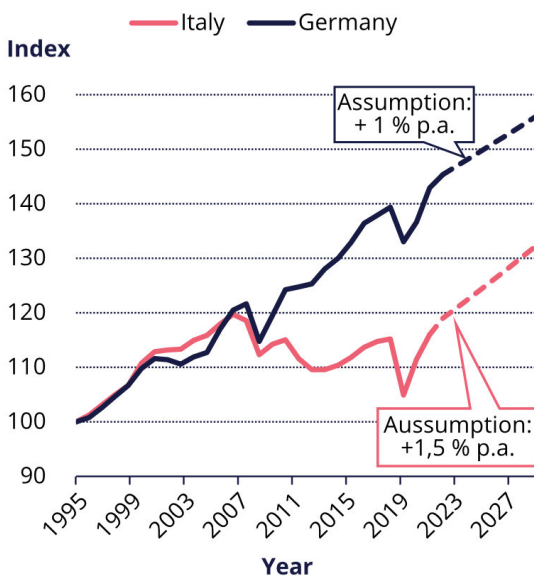
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**Figure 3:** Contributions to the change in the debt ratio 2010-2019;  
Source: Ameco, own calculations

Moreover, it is not convergence but divergence that has characterised the Eurozone since the beginning of the financial crisis; see Figure 4 for a comparison between Germany and Italy. Assuming a growth rate of 1% for Germany from 2024 onwards, an Italian growth rate of 2% would only lead to a re-convergence of growth paths by 2043. With an Italian growth rate of 1.5%, this wouldn't be the case until 2064.

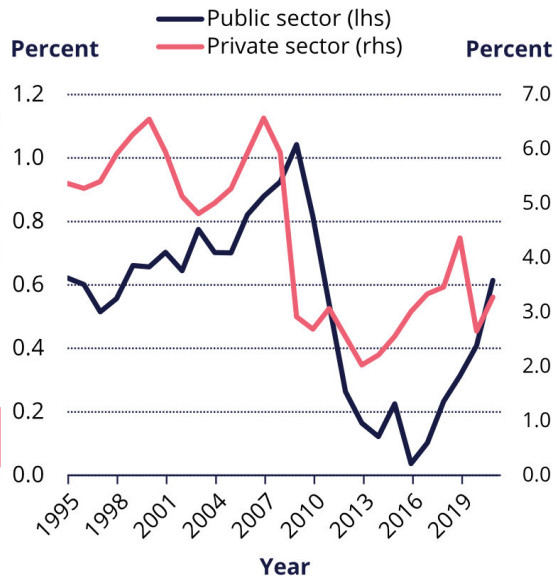
### GDP

Indexed at 100 in 1995, constant prices, up to 2023 Ameco



### EU net fixed asset investments

In percent of GDP



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**Figure 4:** GDP + EU net fixed asset investments; Source: Ameco



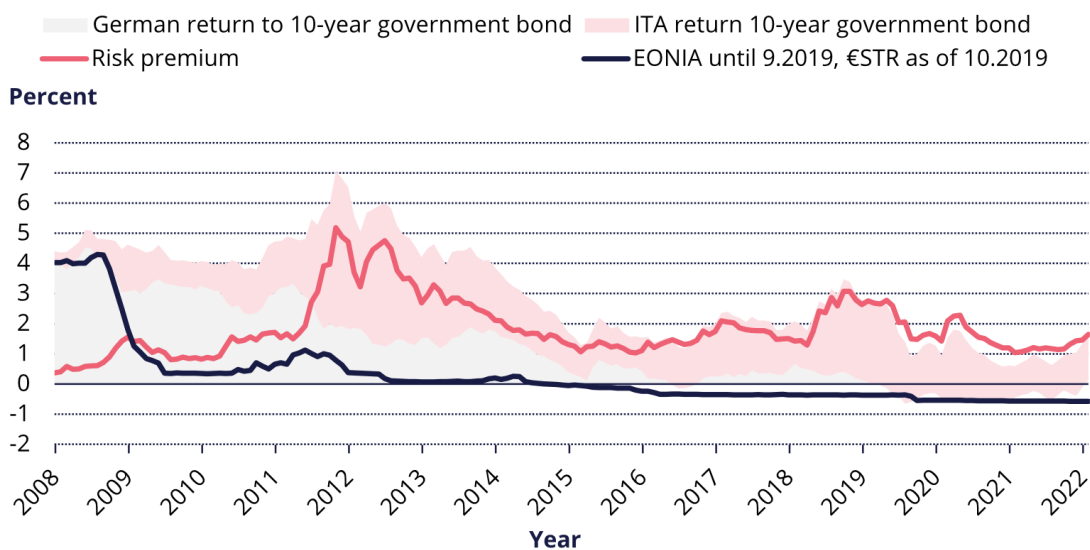
Yet more growth does not seem impossible: the EU's untapped labour potential stands at 16.8%, barely lower than during the financial crisis.<sup>11</sup> In 2020, 72% of the EU population between 20 and 64 were in employment; the Porto summit set a target of 78%.<sup>12</sup> In addition, net private investment as a share of GDP in 2021 was still 50% below the level of 2007, while public investment was 30% lower (see Figure 4).<sup>13</sup> Thus, substantial growth potential exists. It should urgently be exploited to stabilise the currency area and reduce debt levels in the long term.

**Risk premia:** The difficulty of the trade-off between the budget balance and growth depends on the cost of government debt: the higher the financing costs, the greater that the positive effect of deficit spending on growth must be in order for the debt ratio to fall. Considering, as [Blanchard \(2019\)](#) does, that growth mostly exceeds financing costs, one can conclude that government debt is not always as problematic as widely assumed.

However, Blanchard assumes a risk-free interest rate in his calculations. Financing costs in the Eurozone depend not only on the interest rate level but also on a country-specific risk premium. Risk premia are a comparatively new phenomenon: when the euro was introduced, there was only a liquidity premium ([Schwendner et al. 2015](#)). While the average yield differential in the euro area was nine basis points between 2002 and 2007, it was 57 basis points between 2015 and 2019 ([OECD Long-term interest rates](#)).<sup>14</sup> Figure 5 uses the example of Italy to illustrate the dominant role that risk premia play today in the euro area with respect to financing costs.

## Risk premium ITA vs. interest level

*Risk premium compared to German bonds*



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**Figure 5:** Risk premium ITA vs. interest level; Source: Fred

<sup>11</sup> Eurostat, data code: LFSI\_SLA\_A. Unutilised labour potential refers to people aged 15-74 and includes the unemployed, people available for work but not actively seeking it, those looking for work but not available within the next two weeks, and those underemployed part-time, see also [Eurostat](#).

<sup>12</sup> T0220\_10, <https://ec.europa.eu/social/main.jsp?langId=en&catId=89&newsId=10004&furtherNews=yes>.

<sup>13</sup> Net Fixed Capital Formation.

<sup>14</sup> Median of the Eurozone without Greece.

[De Grauwe et al. \(2017\)](#) analyse the changes in risk premia of the so-called "periphery countries" from 2008 to 2015 (excluding Greece) and find that these were not principally driven by macroeconomic fundamentals, and in particular not by the debt level. Instead, the time factor – interpreted by the authors as a change in market sentiment and the emergence of liquidity concerns – plays a significant role. A precondition for liquidity concerns is the possibility of a default on the government bond in question. Before the financial crisis, this appeared to be theoretically possible in the Eurozone, as sovereigns were now no longer issuing debt in their own currency. However, the absence of risk premia at that time suggests that investors essentially regarded the bonds as sovereign and default-proof. Yet, at least after the political decision to impose losses on the holders of Greek government bonds, default risk became a reality. Risk premia began to play a major role in bond yields issued by so-called "periphery states" such as Italy, Spain and Portugal.

Liquidity concerns also explain the significant impact of events that do not affect macroeconomic fundamentals on the development of risk premia and thus on yields. For example, Christine Lagarde's announcement in March 2020 that the ECB was not there to "close yield differentials" led to an increase in the Italian risk premium to 297 basis points.<sup>15</sup> The opening of an Excessive Deficit Procedure (EDP) produced an average yield increase of 119 basis points since 2009 ([Kalan et al. 2018](#)).<sup>16</sup>

Since the financial crisis, risk premia have thus played a major role in the financing costs of European "periphery states". These risk premia are the result of the political decision to attach default risk to European government bonds. This does not necessarily imply that policymakers could easily abolish default risk. It may for instance be needed to discipline national fiscal policy. It remains important to note that risk premia are both the result of political decisions and a major driver of financing costs and have thus stood in the way of a larger reduction in debt ratios since 2008, alongside weak growth.

To compound the problem, there is a large overlap of states with low capacity utilisation and high risk premia (Figure 6). Particularly affected are Portugal, Cyprus, Italy and Spain, which together account for 37% of Eurozone government debt and 34% of EU debt. In these states the risk of growth-damaging fiscal consolidation is most severe, but at the same time, they also have the highest costs of taking on new debt.

The limited capacity of individual states to stabilise the economy through countercyclical fiscal policy might be problematic not only for their own domestic situations, but can also lead to a suboptimal fiscal/monetary policy mix for the Eurozone, especially if monetary policy has reached the effective lower bound:<sup>17</sup> if this is the case, states with low financing costs would have to ensure appropriate fiscal policy stabilisation of the Eurozone economy. However, they have little incentive<sup>18</sup> to do so while the debt criterion of the corrective arm of the SGP sets strong incentives to limit debt issuance and 'keep the powder dry'. Fiscal policy externalities remain unconsidered ([EFB 2018](#)).

The result of all this is that risk premia impede the reduction of debt in the Eurozone in three ways. First, they increase financing costs. Second, they reduce the fiscal space precisely in those states where it is needed the most. And third, in the absence of a European mechanism to ensure a budget balance corresponding to the economic cycle, they contribute to a lack of demand in the Eurozone as a whole.

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<sup>15</sup> Fiscal policy indicators, which did not change at the time of these statements, cannot explain such market movements. Also, while Italy may be highly indebted in the European context, its interest costs relative to GDP are only marginally higher than those of the United States. Unlike US Treasury bonds, however, it is conceivable that Italian government bonds could go into default.

<sup>16</sup> The opening of an EDP does not change the underlying data, nor is this effect intended: EDPs were originally intended to monitor fiscal policy developments more closely, not to punish them with higher debt costs ([Leandro 2019](#)).

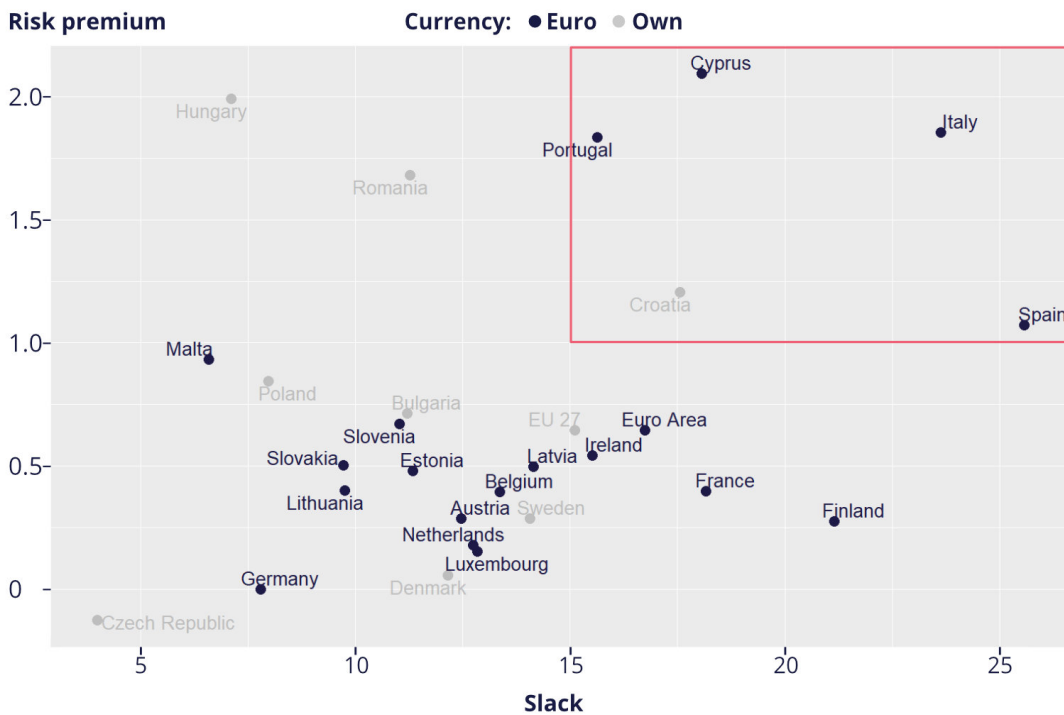
<sup>17</sup> The Effective Lower Bound is defined by the fact that at this point a further rate cut no longer has a growth-enhancing effect.

<sup>18</sup> The Macroeconomic Imbalance Procedure, which is supposed to draw attention to when the economic policies of individual states lead to imbalances, has so far had little binding effect.

Therefore, if one wants to effectively reduce debt ratios in the Eurozone, then uncertainty regarding the liquidity of Eurozone members, and thus risk premia, have to be reduced – at least insofar as this is possible without creating the wrong incentives. The SGP can and should contribute to this outcome by providing a predictable process for evaluating national fiscal policies and clearly indicating under which conditions national debt levels are considered to be safe.

## Risk premia vs Slack 2016-2020

*In percent, state 2020*



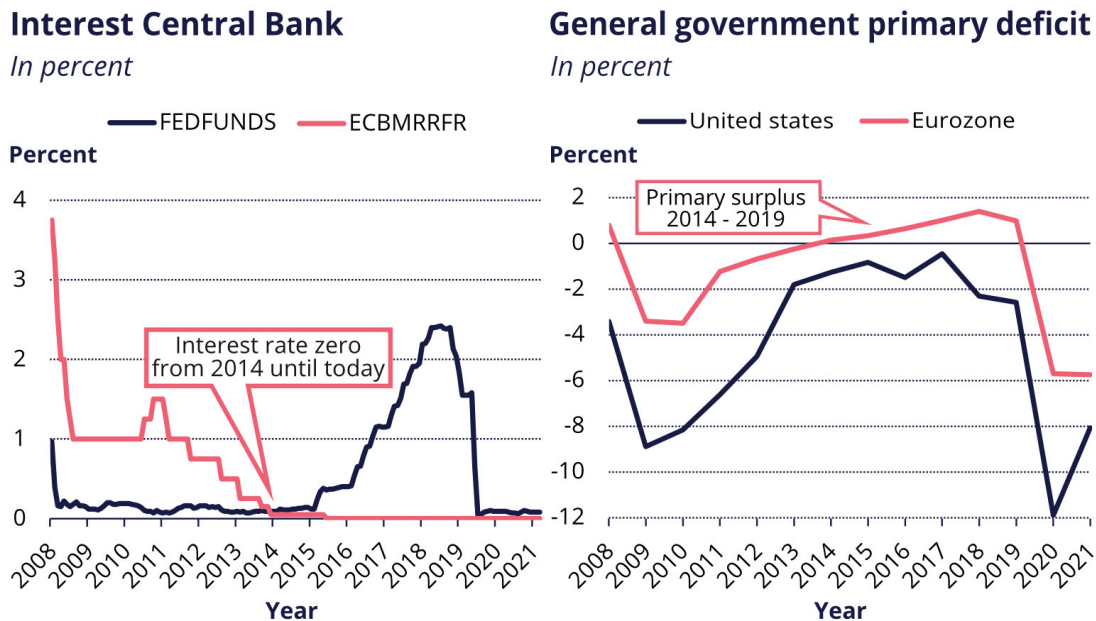
Notes: Excluding Greece; for Estonia, the risk premium value is listed for 2020, as only one bond was issued in this year.

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**Figure 6:** Risk premia vs Slack 2016 - 2020; **Source:** Amceo, Eurostat

**Consequences for monetary policy:** Since European fiscal policy can only stabilise demand to a limited extend, the stabilisation function has largely been left to the Eurosystem. The extraordinary role of the Eurosystem with regard to cyclical stabilisation is particularly striking in comparison with the USA. While the Eurozone maintained primary surpluses from 2014 and the Eurosystem set the interest rate for main refinancing operations at zero from 2016, US fiscal policy was consistently expansionary, and the Fed raised the key interest rate in 2015.



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Figure 7: Interest Central Bank + General government primary deficit; Source: Fred, Ameco

Highly expansionary monetary policy, as necessitated by European fiscal policy, comes with significant side effects, including negative interest rates and overvalued assets. Its effectiveness is disputed in research and does not contribute to strengthening the legitimacy of the Eurosystem. The ability of a central bank to stabilise the economy is limited, if not exhausted, at the effective lower bound ([Furman and Summers 2020](#)). Moreover, interest rate policy cannot effectively address varying stabilisation needs in the Eurozone. Therefore, it seems desirable that states – as prescribed by Delors – are able to undertake part of the economic stabilisation themselves.

In addition, risk premia on government bonds can lead to highly heterogeneous financing conditions across the Eurozone, given that government bonds serve as a benchmark for the pricing of many private bonds and bank loans ([Lane 2021](#)).<sup>19</sup> This applies all the more if the magnitude of the risk premia changes with the interest rate level, i.e. if, for example, an interest rate increase comes with rising risk premia. In order to ensure that the financing conditions necessary to achieve its own mandate are uniformly available, the Eurosystem may (and must) reduce or eliminate risk premia, for example by purchasing government bonds.<sup>20</sup>

<sup>19</sup> The importance of financing conditions is again illustrated by the case of Italy, where private investment fell from 18% of GDP in 2008 to just under 15% in 2012. One third of this decline was due to tight credit supply ([Briguglio et al. 2019](#)).

<sup>20</sup> See [EuGH \(ECJ\), Gauweiler](#), Rn. 78

This has politicised the work of the Eurosystem. The legality of its monetary policy is being challenged in court. The core question is whether monetary policy illegally influences fiscal policy. The European Court of Justice concluded in *Gauweiler* that asset purchase programmes must not weaken the incentive of member states to pursue a sustainable fiscal policy ([ECJ, \*Gauweiler\*, para. 109](#)). The German Federal Constitutional Court considers precisely this requirement to have been violated in the case of the public bond purchase programme (PSPP). According to its assessment, "it was already foreseeable in 2015 that numerous member states of the Eurozone would increase their deficit in order to bolster the economy with investment programmes." ([BVerG, 2020, para. 171](#)). However, it criticises not only the ECB but also the European Court of Justice for not making a clear distinction between economic/fiscal and monetary policy, which, however, would be absolutely central for democratic legitimacy and political control ([BVerG 2020, Rn. 159](#)).<sup>21</sup> And indeed, lowering risk and term premia and hence financing costs for governments through bond purchase programmes such as the PSPP increases the fiscal space available for government expenditures under the 3% deficit criterion.<sup>22</sup> If governments use that additional leeway for additional expenses, they generate demand and thus contribute to the intermediate goal of the central bank, as central banks use expansionary policy measures like asset purchase programs to bolster aggregate demand with the goal of achieving price stability.<sup>23</sup>

For it to be possible that the ECB can act as required by its mandate without at the same time exerting disproportionate influence on fiscal policy, there is a need for fiscal policy parameters that cannot be influenced by the central bank.

## Objectives

Based on the above findings as well as the political discussions of recent months, a reform proposal for the fiscal rules should fulfil the following criteria:

- 1) Enabling growth-friendly debt consolidation. This requires optimising the trade-off between budget balance and growth. Starting points are the consideration of the primary balance, an MTO geared towards full capacity utilisation, and measures to lower risk premia.
- 2) Enabling targeted, transformative investment. This requires a coherent set of rules that does not have the overall effect of discouraging investment.
- 3) Improved compliance. This requires a reduction in the complexity of the existing rules so that compliance can be verified, as well as adjusting the rules to today's economic reality so that improved compliance leads to the intended consequences and can thus be credibly demanded.
- 4) Improved predictability and reduced complexity. Unclear processes and a complex set of rules have politicised the SGP and reduce the effectiveness of market discipline.
- 5) Depoliticisation of monetary policy and reduction of legal risks. This requires fiscal rules that allow for more stabilisation as well as a clear separation between fiscal and monetary policy.

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<sup>21</sup> See also the [OMT judgment](#), para 109: "Since it follows from Article 119(2) TFEU, Article 127(1) TFEU and Article 282(2) TFEU that the ESCB shall, without prejudice to the objective of price stability, support the general economic policies in the Union, the activities of the ESCB on the basis of Article 123 TFEU must not be such as to run counter to the effectiveness of those policies by depriving Member States of the incentive to pursue sound budgetary policies."

<sup>22</sup> [Gagnon, J., Raskin, M., Remache, J., & Sack, B. P. \(2010\)](#). Large-scale asset purchases by the Federal Reserve: did they [work?](#). FRB of New York Staff Report (441).

<sup>23</sup> [Transmission mechanism of monetary policy \(europa.eu\)](#).

Beyond this, there looms a bigger question as to whether restricting one's own access to sovereign credit (through limited debt-to-GDP ratios) is still adequate given the current geopolitical situation. However, before any conclusions for the macroeconomic framework can be drawn, a political consensus is required.

## Reform proposal

### *I. The corrective arm*

The deficit criterion in its current form cannot be used to steer growth-friendly fiscal consolidation, as it does not focus on the actual fiscal stance – i.e. the extent to which fiscal policy contributes to stabilising the economy. Instead, it limits the sum of financing costs and fiscal stance (as expressed by the primary balance). In the case of Italy, Portugal, Spain and Cyprus, all countries with high financing costs and slack in the economy, this might lead to fiscal policies that are likely to further increase debt ratios through contractionary austerity. Conversely, in countries with economies running at close to full capacity and with low risk premia, running a deficit close to 3% might lead to overheating and inflation.

But today's deficit criterion is not just unsuitable for controlling growth-friendly consolidation – it also targets a variable that is not under the control of individual governments. Governments only control the primary deficit. Financing costs – as described above – depend strongly on other factors, including the decisions of European actors to guarantee government bonds, limit risk premia or raise/lower interest rates.

Therefore, if one wants to make the SGP more growth-friendly and more effective, **the primary deficit should be consulted for the deficit criterion**. The primary deficit not only fulfils Delors' objective of coordinating the European fiscal stance much more effectively, but also represents a target under governments' control, which is particularly important in times of fluctuating interest rate levels. For this reason, it is also a common measure used by both academics and ECB authors to measure the fiscal stance of a state (e.g. [Plödt and Reicher 2015](#), [Bańkowski and Ferdinandusse 2017](#)).<sup>24</sup>

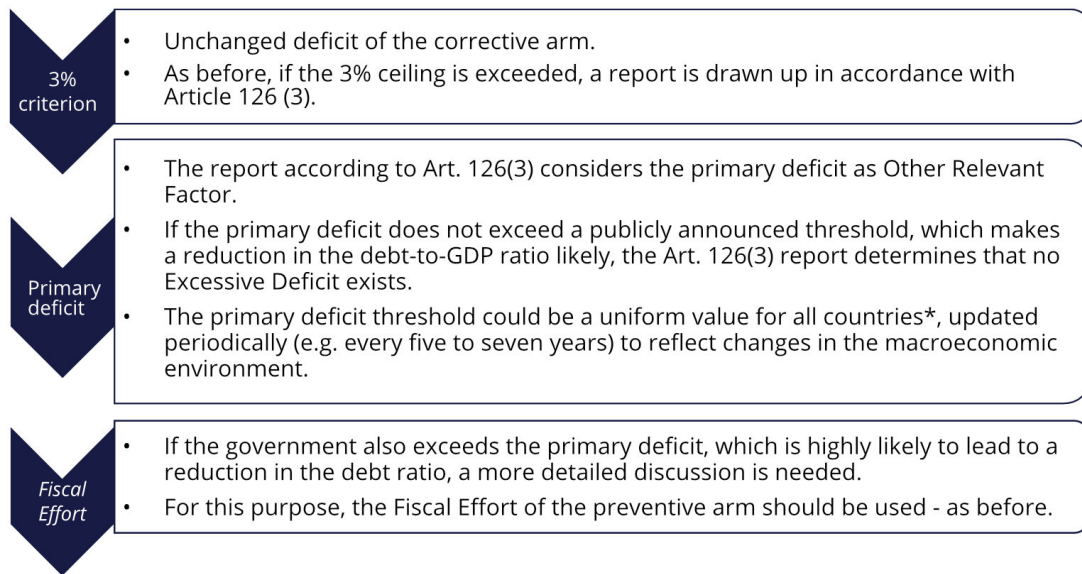
Taking the primary deficit into account does not require changing primary law. The 3% threshold could remain as it was before while the primary deficit could serve as a key benchmark<sup>25</sup> for the Article 126 (3) of the TFEU report, which the EU Commission must produce when the deficit ceiling is exceeded in order to determine whether an Excessive Deficit exists (see Figure 8, Step 2).

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24 The fact that it has not been used in the European fiscal rules so far is primarily the consequence of a theoretical criticism: [Sargent and Wallace \(1981\)](#) argued that in the absence of an absolute limit on the deficit (which does not exist in the case of a limit on the primary deficit), the money supply is not limited and - since a close connection between the price level and the money supply was assumed - that this leads to inflation. However, recent research has shown that this relationship does not hold. Central banks have therefore also moved away from the money supply as a central indicator for monetary policy and today focus on the analysis of monetary policy transmission channels (see the ECB strategy review).

25 Legally speaking, the primary deficit would be considered as an Other Relevant Factor. In order for such Other Relevant Factors to be taken into account even with a debt ratio above 60%, the deficit must be interpreted as 'temporary' or 'close to the reference value'. Since the primary deficit, as described in the following text, is to be calibrated in such a way that it is as likely as possible to contribute to lowering the debt ratio and thus to lowering the financing costs, it is easy to justify why the deviation is of a temporary nature, as long as 'temporary' is not equated with one year, as has been the case so far. This definition can be adapted by a communication of the EU Commission.





\* A tailor-made benchmark for each country would again increase complexity and make the process less transparent, less predictable for financial markets, and more political.

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Figure 8: Reform proposal; Source: own representation

Regarding the primary deficit, we propose to calibrate **one** benchmark value for all states that is periodically – about every five years – adjusted to the macroeconomic environment. Alternatively, the benchmark could also be calibrated for individual states. However, this would increase complexity and politicise the institution or process entrusted with the calibration.

Additionally, if a uniform, clearly-communicated primary deficit benchmark is used, this could increase the binding effect of the rules and significantly reduce complexity and procedural uncertainty, as numerous different, imprecisely specified factors no longer need to be considered. In the past, the 3% deficit criterion has already shown the binding effect that clearly-communicated metrics can have.

The maximum permissible primary deficit should be calibrated in such a way that it is not detrimental to growth, but also does not permit a quicker build-up of debt than the economy can grow out of. Only then will the debt ratio fall. The range of likely debt-reducing primary deficit values depends on the level of interest costs, especially risk premia.

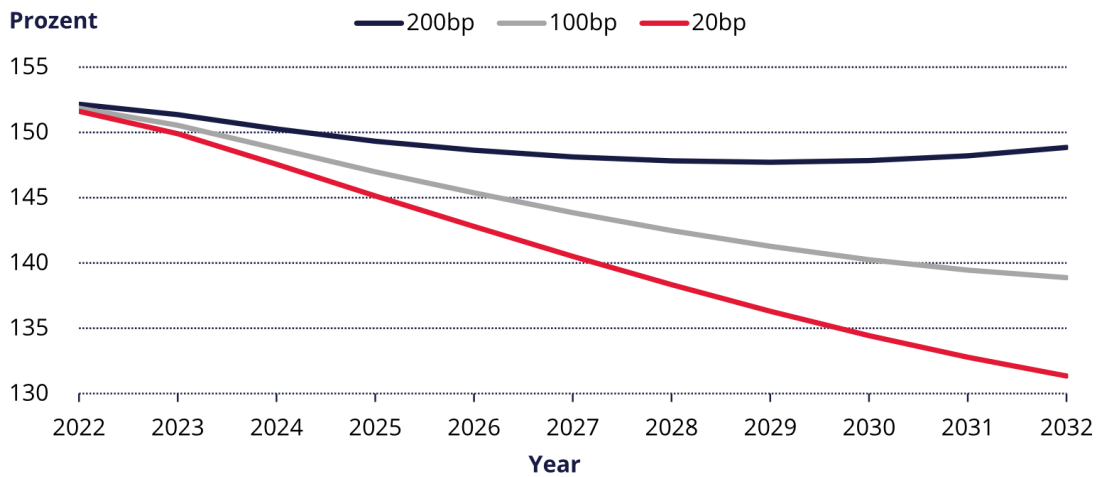
Should states exceed this primary deficit limit, the sustainability of the fiscal stance is not clear-cut. Hence, a more in-depth evaluation of the specific case is required. For this – analogous to the current procedure – the MTO of the preventive arm could be used (see Figure 8, Step 3).

For the MTO to provide a meaningful analytical framework, it also requires simplification as well as adaptation to today's challenges and scientific findings (see next section).

One way of calibrating the maximum permissible primary deficit could be to calculate which primary deficit can still plausibly result in a declining debt-to-GDP ratio for the state with the highest financing costs. Today that state is Italy. A primary deficit of 1% combined with growth of at least 1.5%<sup>26</sup> (which is needed to make at least small progress towards convergence) and a risk premium of 100 basis points over German government bonds would reduce the Italian debt-to-GDP ratio by 13 percentage points by 2032. With a risk premium of 20 basis points, debt would fall by 20 percentage points. If the risk premium amounts to 200 basis points, the debt ratio would fall by only 3 percentage points by 2032.

## ITA debt ratio

*In percent of GDP, assumptions: as of 2025 1% primary deficit, 1.5% growth, 2% inflation, Bund yield with linear increase to 2% in 2032*



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**Figure 9:** ITA debt ratio; Source: IMF, Ameco, circabc, Eurostat, own calculations

However, the proposed limit for the primary deficit should not be set in stone at 1%, but receive periodic updates based on key macroeconomic variables such as interest rate levels, risk premia, inflation and the broader macroeconomic environment. Compliance with this threshold could then be used to establish the absence of an Excessive Deficit under Article 126 (3) of the Report.<sup>27</sup>

<sup>26</sup> There are several scenarios under which real growth of 1.5% appears realistic. The prerequisite is a continued increase in private and public net investment, which collapsed in 2007 and only recovered in 2021. However, this only seems possible on the basis of effective institutional reforms, including the judicial system (IMF 2014), see also Krahé and Leusder (forthcoming). First steps in this direction have been taken (FT 2021). Moreover, if the participation rate of Italian women in the labour market reaches the European average of 59% by 2032, growth would already exceed 1.5% p.a. even without a further reduction in the unemployment rate (currently at 9.8%). Higher immigration or productivity increases offer further growth opportunities. An alternative plausibility check is provided by the rule of thumb used by the EU-COM to link changes in the fiscal stance to growth. A one percentage point more expansionary fiscal stance increases growth by 0.5 points: from 2015 to 2019, Italy's growth was 1%, its primary balance 1.54%. A primary balance of -1% would therefore result in growth of 2.28%, a value far greater than 1.5%.

<sup>27</sup> It would be questionable whether one would also want to determine for states with low interest costs whether they exceed the primary deficit threshold. This could be worth considering if the MTO - as described below - is designed more qualitatively.

## II. The preventive arm

While the corrective arm serves to identify gross errors in the fiscal policy of states, the preventive arm has more ambitious goals: to encourage states to pursue a sustainable fiscal policy ex ante, to promote the reduction of excessively high debt ratios, and to preserve fiscal space for investment (see also [Regulation 1466/97](#)).

However, the preventive arm does not meet these objectives today due to weak compliance and a pro-cyclical method for estimating potential output. The latter leads to a suboptimal trade-off between budget balance and growth: if states run a surplus while the economy is running below capacity, this results in contractionary austerity which harms the economy while undermining the legitimacy of the SGP. Therefore, there is an urgent need for a **revision of the method for estimating potential output**.

As the structure of the preventive arm shows, estimating potential output plays a central role in defining the target: each state is to define an MTO for itself that is to be achieved in the medium term and, depending on the economic situation, triggers an obligation for fiscal adjustment, the so-called Fiscal Effort. Both the MTO and the Fiscal Effort are defined in terms of the cyclically-adjusted deficit. The estimate of the cyclically-adjusted deficit as well as determining whether the economy is running under or over capacity is based on the output gap, the difference between estimated potential output and GDP.

Today, potential output is basically equated with average economic performance in the past. Thus, for example, the Spanish economy is already considered to run over capacity as soon as less than 13 % of the labour force is unemployed. If unemployment falls below 13%, the state is supposed to run a surplus in order to put more people back into unemployment and thus reduce the risk of inflation. In retrospect, estimates of potential output are often wrong (if their aim is to actually reflect the potential of the economy). Projections for the German labour market illustrate this: while in 2011 the potential labour force for 2018 was estimated at close to 41 million, in 2018 it actually approached 45 million, i.e. almost 10% more than originally estimated ([Federal Government Projections 2011 - 2021](#)). In the worst case, a restrictive fiscal policy can become a self-fulfilling prophecy if unemployment caused by austerity becomes entrenched through hysteresis.

Fiscal policy which stands in the way of every person working as much as she or he would like does not only counteract other EU policy goals such as full employment (TEU 3(3)); it also stands in the way of sustainable public finances which depend on workers who pay taxes and are able to sustain themselves without government support. [Schuster et al. \(2022\)](#) suggest one possible option for reforming potential output. Instead of equating potential output with average economic performance in the past, one could attempt to arrive at an empirically-based estimate of labour market capacity. This would not only address some major issues with the methodology, but also strengthen fiscal sustainability: in ageing societies, the sustainability of pension systems very much depends on all those wanting and able to work earning enough to fund retirement.

Today, one should potentially also consider explicitly accounting for energy in the estimation of potential output. This would not only reflect the fact that energy is currently a factor limiting production, but may also promote discussion regarding possibilities for expanding energy supply. [Steve Keen \(2016\)](#) shows various possibilities for integrating energy into the production function. However, with or without an explicit energy factor, an estimate of potential output that reflects, rather than impedes, key political and economic objectives seems central to the political legitimacy of the MTO.

If the potential output estimate is reformed, it also makes sense to adapt the following components of the MTO (see Figure 10):

First, the target balance for the MTO could be tightened from -0.5% to 0%. Since the MTO only has to be achieved in the medium term and the Fiscal Effort is only required if the economy is not running below capacity, the risk of pro-cyclical adjustment (assuming an appropriate cyclical adjustment procedure!) is much lower than in the case of the corrective arm. The MTO could therefore be calibrated based on projected financing costs so that it implies a **cyclically-adjusted primary deficit of 0%** for all countries with excessively high debt ratios. This should not be problematic as an economy running at full capacity does not require fiscal stimulus and could be accomplished via adjusting [Regulation 1466/97](#).<sup>28</sup> A crucial precondition is designing the Fiscal Effort in a way that does not lead to pro-cyclical fiscal policy. Otherwise, the objective of the preventive arm will be not be achieved.

	Status Quo	Proposal for reform
The overall objectives...	<ul style="list-style-type: none"> <li>• Appropriate safety margin to 3% deficit limit</li> <li>• Convergence of debt levels</li> <li>• Enable investment</li> </ul>	<ul style="list-style-type: none"> <li>• Appropriate safety margin to 3% deficit limit</li> <li>• Convergence of debt levels</li> <li>• Enable investment</li> </ul>
...are translated into a...	MTO (strictest value based on four different procedures)	MTO ( <b>definition based on primary deficit</b> )
...which results in a required...	Fiscal Effort (defined via matrix/thresholds for output gap & debt ratio)	Fiscal Effort (defined via matrix/ <b>analysis based on</b> output gap & debt-ratio)
...which is defined as...	Structural deficit (exclusive one-offs and temporary measures)	Structural deficit (exclusive one-offs and temporary measures)
...which is calculated based on...	Potential output estimation (+quantitative plausibility check)	<b>Revised</b> potential output estimation + <b>comprehensive analytic</b> plausibility check
... and can account for...	Investments, structural reforms in a shrinking economy	<b>Growth-enhancing</b> investments, structural reform

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Figure 10: Reform proposals MTO; Source: own representation

<sup>28</sup> The Fiscal Compact would not need to be adapted due to the primacy of European law, see [Repasi \(2013\)](#).

However, any methodology for the quantitative estimation of potential output should be viewed with a grain of salt and cross-checked using alternative methodologies. The EU-COM for instance uses the so-called Plausibility Tool ([EU-COM 2017](#)). Unfortunately, it has very similar problems to other purely statistical methods.

Instead of deploying another purely quantitative procedure for cross-checking, one could calculate sensitivities and compare the results to alternative indicators to get a sense of the range of plausible results. Alternative indicators for labour market utilisation would be particularly important since potential output builds on the rather controversial concept of the NAIRU (see for example [Heimberger et al. 2017](#)) as well as the more general assumption that the labour market never runs below capacity for a prolonged period of time. Instead, it always fluctuates around full capacity utilisation (see for example [Blanchard and Summers 1986](#) and [Friedman 1993](#)). In contrast to fiscal policy, neither European nor American monetary policy relies solely on the NAWRU and NAIRU respectively due to methodological concerns (see [ECB 2021](#) and [Federal Reserve 2020](#)).

Possible indicators for the labour market could be, for example, the new *Labour Market Slack Indicator* maintained by Eurostat ([Eurostat 2021](#)) or the *Aggregate Hours Gap* ([Faberman et al. 2020](#)). But a more differentiated view would also be conceivable, using a combination of various labour market indicators. In addition, since the theory of potential output is based on the idea that inflation occurs when an economy runs above capacity, wage and price data should be considered. Finally, estimating potential output requires defining purely statistical parameters which have no economic meaning but heavily impact the result of the calculation ([Schuster et al. 2021](#)). Hence, it would appear important to show ranges for various input values rather than point estimates.

Given how uncertain and variable output gap estimates are, the fine-grained matrix for determining required Fiscal Efforts seems hard to justify (for a debt level above 60% of GDP, no adjustment is needed for an output gap of -4%, for -4% to -3% an adjustment of 0.25 % of GDP, for -3 % to -1.5 % an adjustment of 0.25 % to 0.5 % of GDP, for -1.5 % to 1.5 % an adjustment of at least 0.5 % of GDP, and for a positive output gap of at least 1.5 %, a GDP adjustment of at least 0.75 %).<sup>29</sup> Estimates of the output gap vary so significantly over time that Fiscal Effort requirements would have often looked very different ex post. To give an example: the estimate of the German output gap for 2018 varied between -0.05% in the annual forecast for 2017 (relevant for budget preparation) and +2.45% in the 2020 spring forecast.

Second, the **Fiscal Effort Matrix should be simplified**, and the required Fiscal Effort should be defined based on an analytically-expanded determination of the output gap – see above. For example, it could be determined that economies running significantly below capacity do not have to make a Fiscal Effort that acutely threatens their growth. Economies which do not clearly perform below potential should reduce their structural deficit by 0.25 percentage points to get closer to their MTO; economies running clearly above potential should reach the MTO.<sup>30</sup>

Thirdly, it would also make sense **to adapt and simplify the Investment Clause of the preventive arm on the basis of the investment criteria used for NextGenEU and the new geopolitical situation**.

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<sup>29</sup> The full matrix can be found on p. 17 of the 2019 Vade Mecum on the SWP.

<sup>30</sup> Since the MTO itself already takes the business cycle into account, one could also argue that there is no need to differentiate the required Fiscal Effort on the basis of economic capacity utilisation. However, if one takes into account that estimates of potential output are subject to significant uncertainty and that a reduction in the fiscal stimulus is particularly harmful in periods of economic weakness, it may make sense to continue to differentiate the Fiscal Effort according to the degree of capacity utilisation.

The Investment Clause was introduced based on the vague requirement in [Regulation 1466/2011](#) that investment needs to be taken into account when determining the MTO in order to reinforce the EU's efforts to increase the level of investment. It allows states to deviate from their MTO, or Fiscal Effort, under certain conditions.

However, due to the very restrictive application criteria set out in an [interpretative communication](#), the Investment Clause has only been used twice so far ([EU-COM 2018](#)).

The conditions set out in the Communication and the [Code of Conduct](#) are: negative growth or an output gap greater than 1.5%, a deficit below 3% including an appropriate safety margin, a cumulative deviation of no more than 0.75% of GDP, no further use of the Investment Clause until the MTO has been reached, once a cumulative deviation of 0.5% has been reached, co-financing of the relevant projects by an EU fund, a verifiable long-term positive impact of the investment on the national budget, no reduction in the national investment volume, and finally, the deviation must be compensated and the MTO be reached within four years.

As long as the method for estimating potential output is revised in order to actually provide a reasonable estimate for when the economy is running at full capacity, the first criterion (negative growth or the economy running significantly below capacity) should be kept. That way, states running below capacity could make use of the Investment Clause. At the same time, inflation risks, which do certainly exist given the very significant investment needs for decarbonisation, would not be lost sight of. States with large investment needs would have an incentive to push for supply-side capacity expansions (e.g. in female employment), which are required to realise significantly increased investment volumes.

Further quantitative restrictions on the investment volume as well as the condition of co-financing by the EU, on the other hand, seem difficult to rationalise<sup>31</sup> from an economic perspective. A sustainable and coherent fiscal policy might actually be better served if those rules were replaced by the investment criteria from NextGenEU. Thus, there could be a requirement that investments fall under one of the six pillars<sup>32</sup> of NextGenEU (in particular the ecological and digital transformation) and are in line with the recommendations of the European Semester ([Regulation 2021/241](#)). In addition, as for the National Recovery Plans, the long-term positive effects of the investment as well as its impact on debt dynamics should have to be outlined ([EU-COM 2021](#)). A link to the EU taxonomy for sustainable investments could also be created. Finally, it might make sense to consider exemptions for military procurement, possibly based on the criteria for the newly created German special fund to strengthen the German Federal Armed Forces.

### *III. Interaction with the Eurosystem*

Limiting the primary deficit in the corrective arm of the SGP could also help depoliticise the Eurosystem's monetary policy and strengthen its legitimacy: the primary deficit is not influenced by monetary policy, so the Eurosystem would not create additional fiscal space by lowering risk premia. Likewise, this indicator, which cannot be influenced by the Eurosystem, could be used to decide whether a state's public finances

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<sup>31</sup> Especially since the corrective arm already sets quantitative limits. A large number of indicators increases the danger that fiscal policy will be oriented primarily towards compliance with indicators instead of focusing on substantive sustainability. Therefore, the number of indicators should be limited as much as possible and focused on those that represent the best possible proxy for the actual objective. Otherwise, one may risk running into the same issues as other comprehensive state planning systems.

<sup>32</sup> Green transition; digital transformation; economic cohesion, productivity and competitiveness; social and territorial cohesion; health, economic, social and institutional resilience; and policies for the next generation.



are considered sustainable. Once there has been a decision that the finances of a certain state are deemed sustainable based on its primary balance, the Eurosystem could then buy its government bonds without exposing itself to the accusation of propping up unsustainable public finances. The exact process leading up to the decision that a state has sustainable finances should be determined by policymakers.<sup>33</sup>

One possibility would be to link it to the EDP. Government finances could be considered sustainable if the Fiscal Effort has been complied with and no Excessive Deficit was identified. An open question would be whether and under what conditions the ECB would be able to buy the bonds of governments whose finances are not deemed sustainable. The only remaining option might be Outright Monetary Transactions (OMT). The latter presupposes a European Stability Mechanism (ESM) programme (which is supposed to guarantee sustainable finances and prevent an unintended expansion of fiscal space).

Structuring the interaction between monetary and fiscal policy in this way would not only help to address legal issues and questions of legitimacy; it may also contribute to a more effective reduction of debt ratios. On the one hand, the prospect of the ECB limiting risk premia represents a significant positive incentive to comply with the fiscal rules; on the other hand, more moderate risk premia would themselves make a decisive contribution to the reduction of debt ratios in highly indebted countries (see Figure 9).

A counter-argument would be that the disciplining effect of markets who punish governments for irresponsible policy might be lost. However, this argument is based on the assumption that the cost of government debt is largely influenced by fundamentals, i.e. economic performance, fiscal policy and especially the level of government debt. As De Grauwe et al. show, this is not the case in the Eurozone: the development of risk premia is dominated by market sentiment detached from fundamentals.<sup>34</sup> Anticipating the strong influence of market sentiment and the faint and untimely link to fundamentals, the Delors Report concludes that fiscal rules are unsuitable to discipline governments in currency union ([Delors Report 1989, p. 20](#)).

The focus on the primary deficit would adapt the fiscal rules for a world in which the existence of risk premia currently blurs the line between monetary and fiscal policy. Especially in geopolitically uncertain times, it seems more important than ever that a Central Bank does not face a conflict between fulfilling its mandate and its own institutional legitimacy. Otherwise, the currency area itself becomes vulnerable, with public campaigns or legal actions potentially exerting seriously destabilising effects.

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<sup>33</sup> After all, the sustainability of public finances cannot be gauged from fiscal figures alone, but also depends heavily - especially in more complex cases - on whether politicians have confidence in the government: this lowers financing costs and ensures access to the financial market, two essential factors for states with high debt.

<sup>34</sup> And even if risk premia were more strongly driven by a sovereign's debt-to-GDP ratio, it is questionable to what extent this would have a timely disciplining effect on the incumbent government: After all, apart from shocks that challenge a sovereign's liquidity, risk premia will rarely rise fast enough to have an immediate significant impact on the cost of funding.

## European sovereignty

If the European Union were to seriously seek greater political sovereignty, especially in light of Russia's attack on Ukraine, a more fundamental reform of the European fiscal framework would be required.

Firstly, fiscal capacity is closely interwoven with state sovereignty ([Tilly 1990](#)), Brewer even calls fiscal capacity "sinews of power" ([Brewer 1989](#)). The Eurozone is a **historically special case** in the sense that it largely stripped itself of the ability to issue sovereign, non-defaultable debt without risk premia and moved towards bonds with default risk and higher financing costs. Whether it was the Netherlands in the 16th century, the British in the 18th century ([Tilly 1990](#)) or the United States in the 19th century, rising powers historically did everything they could to reduce the cost of their own borrowing and minimise or eliminate their risk of default by collateralising or introducing a lender of last resort.

Secondly, the initial justification for limiting debt-to-GDP ratios in the European context no longer applies: according to the European Fiscal Board ([EFB 2019](#)), the aim of this limitation in the debt ratio was to avoid fiscal dominance. The EFB refers to [Sargent and Wallace's \(1981\)](#) description of fiscal dominance. In Sargent and Wallace's model, fiscal policy dominates monetary policy if the central bank has to finance deficits and the money supply consequently increases. Sargent and Wallace assume a "monetarist economy" in which inflation rises when the Central Bank money supply increases. In 2004, Bindseil showed that such a relationship is not tenable ([Bindseil 2004](#)). The asset purchase programmes of major central banks since the financial crisis of 2008 have also shown that the money supply by itself has no influence on the price level and that the Fed and the Eurosystem instead influence aggregate demand and thus the price level via interest rates. Specifically, the Fed and the Eurosystem both set an interest rate floor for short-term interest rates ([for details see Kern 2022](#)) and influence longer-term rates through forward guidance and asset purchases. As long as the central bank can do this independently, the autonomy of monetary policy is guaranteed. There is no reason to doubt its independence. The historical theoretical basis for limiting the debt ratio is therefore no longer valid today.<sup>35</sup> It cannot be used to justify limiting the debt-to-GDP ratio to 60%.

A sovereign Europe capable of acting would therefore not only significantly benefit from a secure, ex ante unlimited supply of credit, but there are also no valid theoretical arguments today as to why debt should be capped at a certain debt-to-GDP ratio. The limitation of the debt ratio is nothing more and nothing less than a self-imposed corset.

Likewise, risk premia are home-made. Political economy reasons can be found for both debt-to-GDP ratio limits and risk premia – for example, risk premia could be interpreted as gradual escalation steps towards the rejection of a sovereign bond as Eurosystem collateral – but they are not necessary.

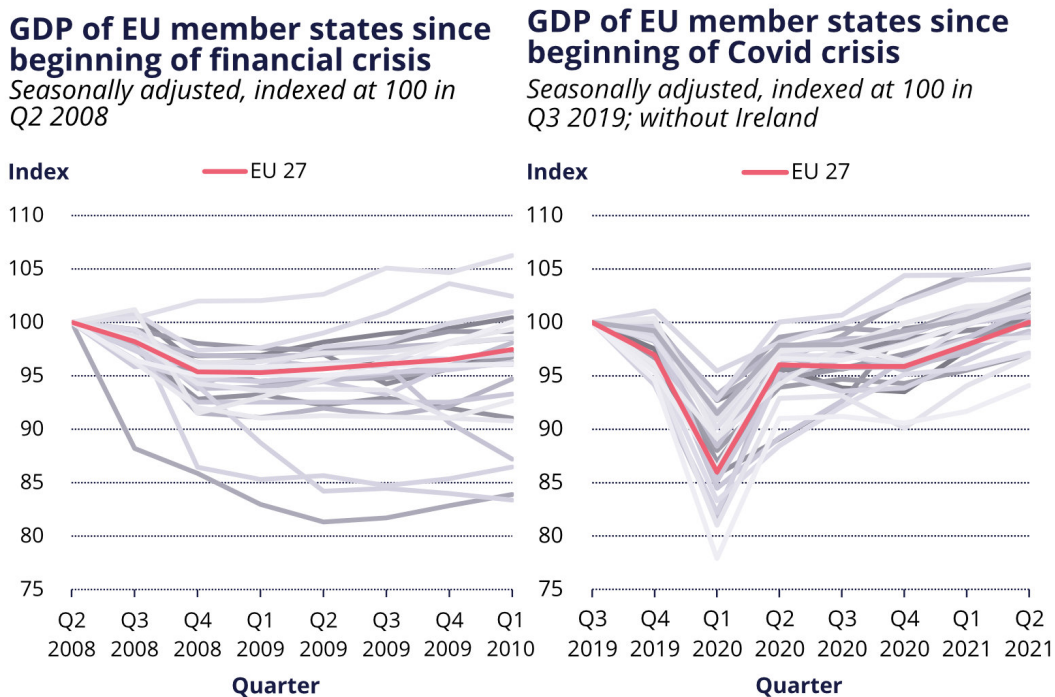
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<sup>35</sup> Another possible rationale is provided by Jens Weidmann, who recasts the term Fiscal Dominance. He argues on the basis of the Fiscal Theory of the Price Level (FTPL), according to which the value of outstanding government debt corresponds to the present value of all future primary surpluses. If debt is increased without an increase in the expected primary surplus, bond prices should fall or the cost of debt should rise. According to Weidmann, in such a situation, governments could put pressure on the central bank to stabilise the market value of debt ([Weidmann 2020](#)). A detailed discussion of this argument is beyond the scope of this paper. However, we would like to make two observations: First, it seems at least worth discussing whether the valuation of government debt, as argued by the FTPL, follows a similar principle as the discounted cash flow analysis often used for business valuation. Second, it takes very large interest rate hikes or a very large increase in debt for the central bank's interest rate policy to have a significant impact on a sovereign's current financing costs: for example, only **one seventh** of Italy's sovereign debt matures in an average year. Four interest rate hikes by the central bank totaling 100 basis points would therefore lead to an increase in the Italian government's financing costs of only 0.14 percentage points. Interest rate increases of such magnitudes rarely cause immediate problems, but they can become problematic in the medium or long term if the higher rates affect the entire government bond portfolio. Therefore, fiscal policymakers would have to act with some foresight if they were willing to influence the central bank to keep interest rates low out of concerns about higher financing costs in the future. However, it is precisely this forward thinking that is denied to fiscal policymakers who take on high levels of debt or tolerate higher inflation.

## Outlook

Since the financial crisis, Europe has been stuck in a sub-optimal equilibrium with low growth, high debt ratios, increasingly divergent economic growth paths and imbalances. Since the Russian attack on Ukraine, the extent of Europe's geopolitical dependency has also become evident. The unclear institutional fiscal framework, partly the result of a challenging political situation, has contributed to this.

However, in the wake of the Covid pandemic, considerable steps have been taken to return Europe to a higher and more sustainable growth path: the difference compared to the financial crisis is already clearly visible. In contrast to 2010, European GDP has already returned to pre-crisis levels, and the divergence of national growth paths is also significantly lower (see Figure 11).



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**Figure 11:** GDP EU states since beginning of financial crisis + GDP EU states since beginning of Covid crisis;  
**Source:** Ameco

Further developments will strongly depend on geopolitical factors. Energy and commodity supplies will have a significant impact on the growth and stability of the European economy and finances. However, the fiscal framework could play a part in ensuring that Europe is as well-positioned as possible for the challenges ahead.

We therefore propose that the effective but pro-cyclical deficit criterion of 3% should be complemented by a primary deficit ceiling. This should be calibrated in such a way that it leads to a decline in the debt ratio with the highest possible probability. Simulations show that a 1% primary deficit could be a suitable value.

The definition of a fiscal policy target on the basis of the primary fiscal stance enables monetary policy to pursue its mandate with legal certainty. A clearer division of tasks between monetary and fiscal policy would be re-established.

Should the 1% primary deficit be exceeded in the corrective arm, determining the sustainability of government finances would require a more detailed examination, which should take place within the framework of the MTO.

The preventive arm and especially the MTO already provide the framework for this, but should urgently be further developed and simplified. Key to our proposals is overhauling the estimation method for potential output, a simplification of the Fiscal Effort Matrix, and an adjustment of the Investment Clause, which should be adapted to NextGenEU as well as military and energy policy requirements.

Our proposals not only remain within the current primary law framework, but they could also help to make the current regulatory framework more sustainable, enforceable, coherent and comprehensible for all stakeholders.

If a political decision is taken that SGP reform should be not only about optimising fiscal rules within the existing legal framework, but also about strengthening European sovereignty, the explicit limitation of fiscal capacity by debt ratios in the EU should be reconsidered, especially since the original theoretical rationale for limiting the debt ratio is now obsolete.

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