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Making sense of the European Commission's fiscal governance reform plan

Lucio Pench

Executive summary

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THE EUROPEAN COMMISSION'S April 2023 proposals for the reform of European Union fiscal governance revolve around the principles of fiscal sustainability and national ownership. While the criterion of sustainability is at the centre of the proposals, its practical implications for the assessment of compliance of national medium-term fiscal-structural plans with the new fiscal rules have been blurred by a proliferation of additional criteria or safeguards. These include a requirement for a country's debt level at the end of the medium-term horizon to be lower than at the beginning.

THIS POLICY BRIEF argues that the fiscal sustainability criterion, which the legislative proposals formulate in broad qualitative terms (public debt being on "*a plausibly downward path ... or ... staying at prudent levels*") can be operationalised to ensure the objective of de-risking of public debt, ie the eventual removal of situations in which debt poses a high sustainability risk. Specifically, for a plan to satisfy the sustainability criterion, it should ensure that the country in question graduates out of the high-risk category or does not fall into it.

IT IS FURTHER argued that the additional criteria or safeguards have limited value added and hamper the overall readability of the proposed reform. This proliferation of criteria should not be taken as compromising the fundamentals of the reform, however: a careful textual and contextual reading of the relevant legal provisions allows for an 'overall assessment' by the Commission and the Council of the medium-term plans submitted by EU countries, in which compliance with the additional safeguards could be given a subordinated role relative to the sustainability criterion. Ideally, a clarification of the methodology for assessing compliance with the debt-sustainability criterion would allow the additional safeguards to be dispensed with.

POLITICAL CONCERNS LAY behind the demand for additional safeguards, but these should be addressed through institutional rather than rule-based solutions. Implementation and enforcement will be critical. This Policy Brief offers proposals to enhance institutional self-commitment to implementation, with reputational consequences for non-implementation.

1 Introduction

In April 2023, the European Commission published long-awaited proposals on reform of European Union fiscal governance – the system for monitoring the budgetary frameworks in EU member countries. The proposed reform is informed by two high-level principles: fiscal sustainability and national ownership. Unsustainable fiscal policies in EU countries pose risks for the smooth functioning and ultimately the integrity of the euro. This provides the rationale for an EU fiscal framework on the top of national frameworks put in place by countries according to their national preferences. Meanwhile, enhancing national ownership of the EU fiscal framework – meaning active buy-in and participation of EU countries rather than just a rule-taking role – is necessary for the framework to be implemented effectively. Fiscal sovereignty in Europe’s economic and monetary union, notwithstanding a prohibition on excessive government deficits, remains firmly in the hands of national governments.

Under the Commission’s proposals, the two high-level principles would be delivered on by EU countries issuing medium-term fiscal-structural plans. These would set out fiscal-adjustment paths that reflect national preferences, subject to constraints intended to prevent risks to sustainability. Once endorsed by EU countries meeting in the Council of the EU, the adjustment paths in the plans would become the benchmark against which national policies are measured.

Compliance would then be assessed through a single indicator: primary expenditure net of discretionary revenue measures and cyclical unemployment expenditure (‘net expenditure’). As the new approach can only occur within the boundaries set by the EU Treaty, the natural means of enforcement will be the existing Excessive Deficit Procedure (EDP)¹, under which countries with excessive debts can be required to take corrective action. This includes retaining the 3 percent of GDP government deficit threshold, beyond which the EDP is triggered automatically for countries with debt in excess of 60 percent of GDP.

Prior to the publication of the proposals, the Commission set out the main elements and their underlying economic and political philosophy in an outline plan published in November 2022 (European Commission, 2022). EU finance ministers responded to this outline in a March 2023 communique (Council of the EU, 2023). When the April 2023 proposals were published, they included a regulation amending the EDP and a regulation on the medium-term structural fiscal plans (European Commission 2023b, 2023c), thus encompassing the two ‘arms’ of the Stability and Growth Pact (SGP), which sets out the EU’s fiscal governance rules.

In a number of respects, the April 2023 proposals differed from the reform that was communicated in November 2022. This reflected the need for legislation to be formulated differently to a policy communication, but some changes also arguably represent a substantive departure from the reform’s high-level principles. In particular, the proposed reform lacks an explicit methodology by which EU countries’ medium-term plans will be assessed, and adds new fiscal criteria EU countries must meet. These changes threaten to undermine the balance between fiscal sustainability and national ownership, compromising the latter without improving on the former.

This Policy Brief analyses the legislative proposals in light of the objective of guarding against risks stemming from irresponsible behaviour of fiscally sovereign countries, while giving those countries as much autonomy as possible to act according to their preferences. It focuses in particular on the process prior to submission by countries of their medium-term plans and the European Commission’s involvement in this, on the precise meaning of the sustainability criterion, and on potential tension between the main objective of the reform and new fiscal criteria included in the proposals.

The proposed reform lacks an explicit methodology by which EU countries’ medium-term fiscal-structural plans will be assessed

¹ See https://economy-finance.ec.europa.eu/economic-and-fiscal-governance/stability-and-growth-pact/corrective-arm-excessive-deficit-procedure_en.

2 Who needs early fiscal guidance?

The Commission's reform plan envisages countries with certain risk characteristics receiving guidance from the Commission before they draft their medium-term plans. Early guidance would take the form of a so-called "*technical trajectory*", or a stylised simulation of a trajectory for the primary balance² that would ensure convergence of debt to prudent levels by the end of the adjustment period.

This has been criticised as an attempt by the Commission to pre-empt the choices of EU countries on how they intend to bring debt down to prudent levels, thus clashing with the principle of national ownership (Blanchard *et al*, 2022). However, there are legal and technical reasons why the envisaged guidance is meant to be just that: only guidance.

Legally, the only reference for assessing a country's compliance with the EU fiscal rules is the adjustment path that is eventually included in the Council decision endorsing that country's medium-term plan. This is irrespective of what the early guidance issued by the Commission, or even the requirements on adjustment set in the legislation, might say³.

Technically, the adjustment path eventually endorsed by the Council can be expected to differ from the Commission's technical trajectory, even if both are intended to satisfy the same sustainability criterion. This is because the starting point for the Commission's projections are standard assumptions for the estimate of potential output, notably excluding the effects of reforms and investments (other than those already included in the Commission's short-term forecasts). The Commission's projections also incorporate one-size-fits-all assumptions on the closure of the output gap, the response of (non-discretionary) revenue to the cycle and the size of multipliers. Inflation and interest rates are also projected based on (market-derived) assumptions. But when these standard assumptions are replaced by assumptions reflecting country-specific situations, there may be valid reasons⁴ why national plans differ from the projections. To allow for this, the fiscal governance reform proposals envisage a technical dialogue phase, involving national authorities and the Commission services, before the official submission to the Commission of national medium-term plans.

Critics of the proposal who accuse the Commission of trying to pre-empt the choices of EU countries might have overlooked these legal and technical issues around the Commission guidance because they can only be inferred from a careful reading of the legislative proposals and because they were only implicit in the November 2022 outline plan. What did change, however, between the outline plan and final proposals, was the approach to selecting the countries that would be given "*technical trajectories*".

Selecting a subset of countries for early guidance based on risk characteristics makes sense, as higher risk justifies a greater degree of intrusiveness from the EU level. In its 2022 outline plan, the Commission said early guidance ("*reference multiannual adjustment path*") was intended for countries characterised by high or medium sustainability risk, according to

2 The legislative proposal (European Commission, 2023b, Art. 2) defines the technical trajectory in terms of "*net expenditure*", ie primary expenditure net of discretionary revenue measures and cyclical unemployment expenditure. Taking into account the standard assumptions incorporated in the construction of the trajectory, net expenditure can be equated with the primary balance.

3 To illustrate with an example, the adjustment prescribed in the recommendation addressed by the Council to a member state country that is subject to the EDP will prevail over the general provisions of the EDP regulation on the content of such recommendation, such as the requirement for a "*minimum annual adjustment of at least 0.5% of GDP as a benchmark*".

4 The legislative proposal explicitly acknowledges the possibility for the adjustment plan to differ from the technical trajectory, while requiring the concerned member state to provide an economic justification (European Commission, 2023b, Art. 11 (2)): "*Where the national-medium-term fiscal-structural plan includes a higher net expenditure trajectory than in the technical trajectory issued by the Commission pursuant to Article 5, the Member State shall provide in its plan sound and verifiable economic arguments explaining the difference*".

the Commission's risk assessment methodology⁵. But the legislative proposals replaced this categorisation with one based on the Treaty reference values: the Commission would issue early guidance in the form of “*technical trajectories*” to countries with debt in excess of 60 percent of GDP or a deficit in excess of 3 percent of GDP.

Singling out countries that are in apparent breach of the deficit and debt thresholds in the Treaty has the apparent advantage of simplicity. However, it creates potential confusion about the meaning of the risk signal, and, relatedly, of fiscal sustainability, which continues to be the central criterion for assessing fiscal-structural plans. The reason for the potential confusion is that countries might have a deficit in excess of 3 percent of GDP or even debt above 60 percent of GDP while their fiscal trajectories do not pose risks to sustainability. Probably less frequently, countries might also have deficits and debts below the thresholds, but fiscal trajectories that do raise sustainability concerns. The reason for this dissonance is that fiscal sustainability is essentially a directional concept, requiring the evaluation of the underlying trajectory of debt, which cannot be captured adequately by a snapshot figure for debt (and even less by that for a deficit).

In practice, how problematic is this change between the outline plan and the final proposals in the approach to selecting countries for early guidance? A tentative answer can be given by comparing the current positions of EU countries according to the deficit/debt classification and the sustainability risk classification (Table 1).

Table 1: Countries that would be selected for early guidance according to sustainability risk classification and deficit/debt classification

	Debt >60% of GDP AND/OR deficit > 3% GDP (2024)	Debt < 60% of GDP AND deficit < 3% of GDP (2024)
High sustainability risk (2033 horizon)	<u>BE</u> , <u>EL</u> , <u>ES</u> , <u>FR</u> , <u>IT</u> , <u>PT</u> , <u>HU</u> , <u>SK</u>	
Medium sustainability risk (2033 horizon)	<u>DE</u> , <u>CY</u> , <u>HR</u> , <u>MT</u> , <u>NL</u> , <u>SI</u> , <u>FI</u> , <i>PL</i> , <i>RO</i>	CZ, BG
Low sustainability risk (2033 horizon)	<u>AT</u>	DK, EE, IE, LV, LT, LU, SE

Source: Bruegel based on European Commission (2023a) and European Commission (2023e). Note: Countries underlined have debt > 60% of GDP, countries in *italics* have deficits > 3% of GDP.

The answer looks reassuring: nearly all the countries in the high or medium sustainability risk categories would be captured by the debt/deficit signal. Conversely, countries at low sustainability risk are generally shown to comply with the debt/deficit criterion.

Nevertheless, the comparison highlights two cases of misleading signals regarding the need for early fiscal guidance. Czechia and Bulgaria would not be issued technical trajectories, since currently their debts are below 60 percent of GDP and their deficits fall below 3 percent of GDP. However, their fiscal trajectories are a cause for concern in the medium term, mainly owing to increasing pensions-related expenditure with no adequate measures being taken to contain it.

⁵ The Commission's November 2022 outline plan used the terms “*substantial debt challenge*” and “*moderate debt challenge*”, instead of ‘high’ and ‘low’ sustainability risk, which are the terms used in the Commission's risk assessment methodology (European Commission, 2023b). This Policy Brief retains the terminology of the Commission risk assessment methodology because it is clearer.

These cases could be characterised as ‘false negatives’⁶. Austria, by contrast, would be a ‘false positive’: according to the sustainability risk methodology, its debt trajectory gives no reason for concern. However, Austria would be issued a technical trajectory because its debt ratio is currently in excess of 60 percent of GDP.

If 2022 observed data is applied instead forecasts for 2024, an even clearer false positive emerges. Estonia, the country with the lowest debt ratio in the EU, would be singled out for early guidance, owing to a deficit still in excess of 3 percent of GDP. This would clearly make little economic sense. More generally, for a country with a debt ratio that is projected to stay below 60 percent, any fiscal trajectory that keeps the debt ratio below 60 percent (and the deficit ratio below 3 percent) should in principle be satisfactory. Faced with such false positive cases, the Commission might wish to refrain from issuing early guidance, for example by indicating that any trajectory not in breach of the two numerical references would do. This would however contradict the ostensible prescription of the legislation.

To conclude, the change between the November 2022 outline plan and the April 2023 proposals in the approach to selecting the countries that should receive early guidance from the Commission has resulted in a degradation of the signal that guidance is supposed to give about the state and prospects of the public finance of those countries⁷. However, as long as fiscal sustainability remains the central criterion for the Commission to design the trajectories and, more importantly, for it to assess the actual fiscal plans submitted by EU countries, the loss of analytical rigour at the early stage of the process might be considered a relatively minor concession to a political demand for simple numerical benchmarks. It is important therefore to evaluate the sustainability criterion and its operational meaning.

3 Making sense of the sustainability criterion

At the core of the proposed new fiscal framework is a sustainability criterion, which is meant to serve two purposes. First, it is a requirement for the technical trajectory to be issued by the Commission in advance of the submission by EU countries of their medium-term plans. Second, it serves as a reference for the assessment by the Commission of the plans, with a view to eventual endorsement by the Council.

Reflecting these two different though related functions, the sustainability criterion is included in two separate chapters of the legislative proposal⁸, with the same formulation (emphasis added):

6 To some extent, the ‘false negative’ case of countries not captured by debt/deficit classification while being at medium or high risk according to the sustainability risk classification is addressed by the following additional provision on early guidance (European Commission, 2023b, Art. 7 (2)): “For Member States having a government deficit below the 3% of GDP reference value and public debt below the 60% of GDP reference value, the Commission shall provide technical information regarding the structural primary balance necessary to ensure that the headline deficit is maintained below the 3% of GDP reference value without any additional policy measures over a 10-year period after the end of the national medium-term fiscal-structural plan”.

7 One may wonder whether or not the result was intended. It is worth noting that the conclusions adopted by EU finance ministers (Council of the EU, 2023) following the presentation of the November 2022 Commission outline, do not contain demands in this sense. However, the change may reflect the concerns of countries keen to avoid the stigma of being labelled high risk in the application of the EU fiscal framework, for example because of a risk of downgrading by rating agencies. At the same time, countries with low debt may not be averse to, and may even welcome, early guidance from the Commission, for domestic political reasons, namely, in the expectation of receiving support for fiscal trajectories that are more demanding than objective consideration of sustainability risk would justify. This expectation however will be disappointed, if the Commission acknowledges that any trajectory will do, provided the breach of the two numerical references (60 percent and 3 percent of GDP) is avoided.

8 Respectively, Chapter III (The Technical Trajectory) and Chapter IV (National Medium-term Fiscal-Structural Plans), in European Commission (2023b).

*“whether the national medium-term fiscal-structural plan ensures that **public debt** is put or kept on a **plausibly downward path** by the end of the adjustment period at the latest, or stays at prudent levels ...*

“whether the government deficit is maintained below the 3% of GDP reference value in the absence of further budgetary measures over a period of 10 years”⁹.

As far as the technical trajectories are concerned, an annex to the regulation¹⁰ gives two conditions for “the methodology for assessment of plausibility”:

“[the] public debt ratio should be declining, or stay at prudent levels, under the deterministic scenarios of the Commission’s medium-term public debt projection framework described in the Debt Sustainability Monitor 2022;

“the risk of the public debt ratio not decreasing in the 5 years following the adjustment period of the national medium-term plan is sufficiently low. The risk is assessed with the help of the Commission’s stochastic analysis.”

The provision on maintaining the deficit below the 3 percent of GDP threshold does not demand particular explanation. The meanings of “downward path” or “prudent levels”, however, are left unspecified.

It seems reasonable to interpret the sustainability criterion on the basis of the Commission’s medium-term risk-assessment methodology (European Commission, 2023a). This is based on a consideration of both the projected level of debt and its trajectory (augmented by the deterministic and stochastic stress tests referred to under the ‘plausibility’ qualification). This methodology allows operational meaning to be given to the notion of “*downward path ... or ... prudent levels*”.

However, the application of this risk-assessment methodology to the assessment of the medium-term plans, rather than use for risk classification of countries, would require adaptation, which would need to be discussed and agreed. The need to adapt arises because the original risk classification methodology is applied to a 10-year extension of the Commission short-term (two years) forecast with unchanged policies, whereas for assessing countries’ plans, it should be applied to a 10-year unchanged-policy extension of the plans, which themselves would contain the policy adjustment needed to reduce the sustainability risk. The Commission might want to assess the plans simply by comparison with the technical trajectories, using an algorithm that simplifies the risk-assessment methodology. However, as explained in section 2, there are valid reasons why countries’ plans might depart from the technical trajectories.

In the light of these lacunae in the proposed legislation, we have attempted to derive the sustainability criterion from the Commission risk assessment methodology (see the Annex for details). Specifically, a country’s compliance with the debt-sustainability criterion is taken to mean it would avoid being classified as high-risk according to the Commission medium-term risk assessment methodology or, to put it concisely, de-risking of public debt. Being based on a well-defined methodology, this definition would give a conceptually more robust answer to the questions that are bound to arise about the meaning of “*downward path ... or ... prudent levels*” than a simple reference to the technical trajectories produced by the Commission, for which the underlying algorithm, moreover, is left unexplained by the proposed legislation.

Whether explicitly deduced from the Commission risk-assessment methodology or

9 European Commission (2023b), Art. 6 (a) and (b) and Art. 15 (2) (a) and (c). The provision on maintaining the deficit below the 3 percent of GDP threshold reflects the idea, already set out by the Commission in November 2022, that, irrespective of the degree of risk posed by the level and the trajectory of debt, the fiscal structural plan should ensure ex-ante respect for the commonly acknowledged reference limit for the deficit introduced by the Maastricht Treaty.

10 European Commission (2023b), Annex V.

inferred inductively from the design of the technical trajectories, the sustainability criterion is meant to be sufficient to ensure the de-risking of public debt.

However, in the legislative proposal the sustainability criterion is supplemented by additional fiscal criteria or ‘safeguards.’ These are examined in section 4.

4 Are the additional safeguards meaningful and worthwhile?

Like the sustainability criterion, the formulation of the additional fiscal criteria (or safeguards) plays two roles in the legislative proposal: as a requirement for the technical trajectories, and as a reference for the assessment of the medium-term plans. However, the requirements for the technical trajectories include a criterion related to the growth of net primary expenditure relative to the growth of the economy, which is not found among the references for the assessment of the medium-term plans. Moreover, its formulation does not make sense for countries for which debt is already on a trajectory that complies with the sustainability criterion, and it is redundant for the others¹¹. Conversely, the references for the assessment for the medium-term plans include a criterion (related to the adjustment toward the 3 percent of GDP deficit threshold), which is not found among the requirements for the technical trajectories. Moreover, its formulation potentially interferes with the EDP¹². The formulation of these two criteria contains redundancies and inconsistencies that are likely to prevent their effective application. The examination below therefore focuses on

11 The additional fiscal criterion, which applies only to the requirements for the technical trajectories, relates to the fiscal adjustment over the horizon of the plan (Art. 6 (e): “*National net expenditure growth remains below medium-term output growth, on average, as a rule over the horizon of the plan*”). The formulation is equivalent to requiring a positive adjustment in the primary structural balance over the horizon of the plan. This is already required by the sustainability criterion if the country concerned has not yet reached the level of the primary balance resulting in a debt trajectory that satisfies the “*downward path ... or ... prudent level*” condition. In this case, the additional criterion is simply redundant. However, if the country concerned has already reached the required level of the primary balance (for example, because its debt ratio is projected to stay below 60 percent), then the additional criterion should simply not apply.

12 The additional fiscal criterion, which applies only to the assessment of the medium-term plans, relates to the respect of the 3 percent of GDP deficit threshold throughout the duration of the medium-term plan (European Commission 2023b, Art. 15 (2) (b) and (c): “*whether the government deficit is maintained below the 3% of GDP reference value throughout the duration of the plan or whether the government deficit returns swiftly below the 3% of GDP reference value at the latest by the end of the adjustment period when the deficit is above this reference value at the time of submission of the national medium-term fiscal-structural plan ...*” and “*whether for the years that the Member State concerned is expected to have a deficit above the 3% of GDP reference value, and the excess is not close and temporary, the fiscal adjustment is consistent with the benchmark referred to under Article 3 of Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure*”). The meaning of this criterion is difficult to ascertain, specifically, against the concurrent provisions in the same proposal and the EDP regulation. The sustainability criterion already contains a provision requiring that the fiscal position to be reached at the end of the adjustment period ensures that the deficit stays below 3 percent of GDP at unchanged policies for the following ten years. This requirement alone should be more than sufficient to ensure that a country starting from a deficit above 3 percent of GDP should be reducing it throughout the adjustment period. Therefore, the additional criterion appears redundant with respect to provisions already contained in the proposal. It also introduces a potential interference with the provisions in the EDP regulation. One could expect a breach of the 3 percent of GDP deficit threshold to result in the country concerned being placed in an EDP, in which case the fiscal adjustment would be exclusively dictated by the relevant EDP recommendation. Should the breach of the 3 percent of GDP deficit threshold not result in the country concerned being placed in an EDP (a carefully circumscribed possibility under the EDP regulation), this would signal that its public finance situation does not give cause for concern, in which case it would make little sense for the fiscal adjustment to be dictated by the law. In conclusion, the additional criterion related to the 3 percent deficit threshold appears devoid of *effet utile*, if not actually contradicting other provisions of EU law.

the two additional criteria that are meant to apply to both the technical trajectories and the assessment of the medium-term plans: the no-backloading criterion and the initial debt level criterion.

The first additional criterion can be interpreted as a reinforcement of the sustainability criterion, in the sense of avoiding backloading of the adjustment needed to reach the fiscal position that would satisfy the sustainability criterion:

“the fiscal adjustment effort over the period of the national medium-term fiscal structural plan is at least proportional to the total effort over the entire adjustment period”¹³.

In other words, while the overall amount of adjustment is meant to reflect national preferences subject to the constraint of debt sustainability, the distribution of the adjustment is expected to be broadly proportionate across the adjustment period, ie one that avoids shifting the burden of the adjustment to the future¹⁴.

The second additional fiscal criterion, by contrast, has the potential to interfere with the sustainability criterion. It relates to the (initial) level of debt:

“the public debt ratio at the end of the planning horizon is below the public debt ratio in the year before the start of the technical trajectory”¹⁵.

An immediate problem emerges in the case of countries that, based on their current positions, would be classified as low risk. For these countries, satisfying the sustainability criterion would essentially require confirming that the projected debt level will not exceed 60 percent of GDP and that the deficit will stay below 3 percent of GDP. Adding a criterion requiring the debt ratio at the end of the adjustment period to be lower than at the start of it would amount to a fundamental distortion of the sustainability criterion. The case of Estonia (section 2) is illustrative. Reading the additional debt level criterion in isolation would imply that Estonia, a low-risk country with one of the lowest debt ratios in the EU, should not contemplate any increase in the debt ratio from its current levels, eg to finance a defence programme. This would be clearly at odds with the rationale of the reform of fiscal governance – to ensure debt sustainability while otherwise giving countries the flexibility to set their own policies – and would arguably be even in violation of the general principles of proportionality and subsidiarity.

Less clearcut is the case of countries that are expected to adjust to put their debts on a downward trajectory in order to satisfy the sustainability criterion. It is essentially an empirical question whether or not the adjustment required to satisfy the sustainability requirement will be enough to bring the debt to its pre-adjustment level by the end of the adjustment. For high-risk countries, satisfying the debt-sustainability criterion implies putting the debt ratio on an unambiguous downward trajectory. However, adding the condition that the debt ratio should be already lower at the end of the adjustment period than at the beginning may in some cases require additional adjustment, which might stand in the way of the reforms and investments that the proposed fiscal framework is meant to encourage¹⁶.

¹³ European Commission (2023b), Art. 6 (c) and Art. 15 (2) (d).

¹⁴ A literal reading of the formulation of the no-backloading criterion would seem to allow for any distribution of the total adjustment within the default four-year adjustment period (while imposing that, in case of extension of the adjustment period to seven years on account of reforms and investments, broadly four sevenths of the total adjustment should take place in the first four years). A systematic and contextual interpretation of the legislation, as favoured in this Policy Brief, would solve the ambiguity (noted by Darvas, 2023).

¹⁵ European Commission (2023b), Art. 6 (d) and Art. 15 (2) (e).

¹⁶ Darvas *et al* (2023) presented simulations of the technical trajectories showing that France would be the only country for which the debt-level criterion would imply additional adjustment, in the case of a four-year adjustment period. Bulgaria would also be included, assuming that the criterion would apply also to low-debt countries, which is what its literal formulation would imply, but which would not make economic or legal sense, as explained.

In sum, the additional criterion related to the debt level at the end of the adjustment period appears superfluous, especially as the concern that governments may fail to adjust early enough is already addressed by the no-backloading criterion.

Arguably, however, the proliferation of criteria, likely motivated by political concerns (discussed below), would not, as currently framed, compromise the fundamentals of the proposed reform. The reason for this is that the legislative proposal makes a clear distinction between: 1) the early guidance to be provided by the Commission in the form of technical trajectories, and 2) the medium-term plans submitted by countries for assessment by the Commission and eventual endorsement by the Council. Although related, the two exercises are separate. Crucially, the difference extends to the role played in the two exercises by the sustainability criterion and the additional criteria. Compliance with the criteria is a requirement for the production of the technical trajectories by the Commission, but only a reference for the endorsement of the medium-term plans by the Council, following their assessment by the Commission. Concretely, this means that even if the current formulation of the additional criteria is maintained, for the purposes of assessing and endorsing the plans, the Commission and the Council should be able to make an overall assessment of the medium-term plans submitted by EU countries, in which compliance with the additional fiscal criteria, in particular, the initial debt level criterion, could be given a subordinated role relative to the sustainability criterion.

The central role of the sustainability criterion conforms to the systematic logic of the reform. It is also supported by a careful reading of the proposed legislative provisions. In particular, the sustainability criterion is explicitly included among the requirements that EU countries shall comply with in the national medium-term fiscal plans, which is not the case for the additional fiscal criteria¹⁷. The proposed approach would therefore be in line with the terms of the proposed legislation. Moreover, it is clearly supported by a contextual or systematic interpretation, ie one that is “*based on the premise that the legislator is a rational actor*” (Leanerts and Gutiérrez-Fons, 2013).

5 Conclusion and policy implications

The Commission’s EU fiscal governance reform proposals revolve around the principles of fiscal sustainability and national ownership. While the criterion of sustainability remains at the core of the proposals, its practical implications for the assessment of the compliance of national medium-term plans with the new fiscal rules have been blurred by additional criteria. The blurring of the sustainability criterion corresponds with an apparent intent to downgrade the role of the Commission debt-sustainability methodology, which however remains the principal tool to give operational meaning to fiscal sustainability in a comprehensive and consistent manner.

However confusing, the departures from the sustainability criterion may be less important than they seem, as the letter and the spirit of the proposed legislation effectively allow the additional criteria to be set aside if an overall assessment of a country’s fiscal plan concludes that it plausibly meets the requirement of ensuring that debt is set on a downward path, or stays at a prudent level.

To increase the conceptual consistency and the overall readability of the reform proposals, the following changes should be made:

- Restore the sustainability risk classification, which is regularly updated by the Commission in its Debt Sustainability Monitor, as the screening device for selecting the countries that should

¹⁷ European Commission (2023b), Art. 12: “*The national medium-term fiscal-structural plan shall: (a) ensure the fiscal adjustment necessary to put or keep public debt on a plausibly downward path by the end of the adjustment period at the latest, or remain at prudent levels, and to bring and maintain the government deficit below the 3% of GDP reference value over the medium term.*” None of the additional fiscal criteria are included.

be issued with technical trajectories. Merging the high-risk and medium-risk categories could help assuage concerns about stigmatisation. If this move is considered politically not viable, it should at least be clarified that a deficit in excess of 3 percent of GDP should not be a sufficient reason for issuing a technical trajectory, if the country is classified as low risk.

- Clarify the methodology for assessing whether the debt sustainability criterion of “*plausibly downward path ... or staying at prudent levels*” is satisfied, in particular how it relates to the analogous concepts in the Commission medium-term risk assessment methodology.
- Following a clarification of the methodology underlying the debt-sustainability criterion, do away with the additional criteria or safeguards, other than the no-backloading criterion. If an additional safeguard in the form of a numerical rule is considered necessary, this could be a requirement for the debt ratio to decline by 1 percent each year from the end of the adjustment period, for as long as it exceeds 60 percent of GDP.

There may however be an unstated reason behind the demand for additional safeguards: the concern that the Commission might not be sufficiently rigorous in assessing national medium-term plans, especially those of countries at high risk in terms of fiscal sustainability.

Guidance in the form of technical trajectories is meant to pre-empt gross slippages from the fiscal sustainability criterion before EU countries submit their plans for examination by the Commission and the Council. However, as explained in section 2, this can only be indicative, for legal and technical reasons. The question is therefore how to allow ‘reasonable’ departures of the national plans from the technical trajectories while excluding abuse, ie the endorsement of plans that ostensibly respect the sustainability criterion, but only as a consequence of biased macroeconomic and fiscal assumptions. This is essentially a question of judgement and therefore best addressed by institutional rather than rule-based solutions.

Three not necessarily mutually exclusive solutions suggest themselves:

- The Commission and the Council should assess plans and correct for bias, at least beyond a certain threshold. This is the natural solution consistent with the institutional balance in the EU Treaties, and explicitly envisaged by the Commission in its outline proposals of November 2022.
- National fiscal councils (independent fiscal institutions, IFIs) should be required to vet the national plans before their submission to the EU. The Commission in November 2022 envisaged the fiscal councils providing opinions on national plans as inputs into the Commission’s and Council’s assessments. The legislative proposals dropped this provision, probably reflecting the negative language on the IFIs in the March 2023 ECOFIN Council conclusions (Council of the EU, 2023)¹⁸. However, one could expect a strengthening of the role of IFIs as a result of the proposal for amending the directive on budgetary frameworks, which the Commission presented at the same time (European Commission, 2023d). The proposed revision of the directive reflects the broader aim of enhancing national ownership of EU fiscal governance by favouring the development of complementary home-grown rules and institutions. In particular, the revision would allow IFIs to assess fiscal trajectories in the medium term, including in terms of de-risking of public debt, if there is a will to do so¹⁹.

¹⁸ The Council conclusions explicitly stated that “*IFIs should not play a role in the design phase of the national plans*” (Council of the EU, 2023).

¹⁹ Specifically, Art. 8(4) of the revised budgetary framework directive entrusts the IFIs with “*producing the annual macroeconomic and budgetary forecasts underlying the government’s medium-term planning or endorsing those used by the budgetary authorities*” and with “*producing assessments on the impacts of policies on fiscal sustainability and sustainable and inclusive growth or endorsing those provided by the budgetary authorities*”. Moreover, Art. 8(5) prescribes that “*Member States shall ensure that the budgetary authorities of the Member State concerned comply with the assessments or opinions issued by the institutions in the context of the tasks referred to in paragraph 4. Where such budgetary authorities do not comply with those assessments or opinions, they shall publicly justify the decision not to comply within a month from the issuance of such assessments or opinions.*”

- An independent advisory body at EU level could provide an assessment of the plans, in particular for evidence of bias, ahead of the official assessments by the Commission and the Council. The Commission proposals do not elaborate on this solution. However, the Commission's November 2022 outline proposals, and the text introducing the current legislative proposals²⁰, contain a reference to a possible review of the role of the European Fiscal Board (EFB), the Commission's in-house independent advisory body on fiscal policy surveillance. The ECOFIN Council conclusions also suggested that "*a stronger role for the European Fiscal Board in the economic governance should be explored*" (Council of the EU, 2023). Upgrading the legal status of the EFB, currently based on a decision of the Commission in principle revocable at will, could be a significant step in this direction.

A final consideration relates to the exclusive focus of the additional safeguards that are being sought on the conditions that national plans should satisfy *ex ante*, as opposed to those for their implementation and enforcement. However, as also acknowledged by the Commission in its review (European Commission, 2020), enforcement has been the weakest link of the entire EU fiscal framework, especially where it was most needed²¹.

In the Commission's November 2022 outline plan, greater leeway for national governments in setting out adjustment was balanced explicitly by the recognition of the need for greater enforcement. In particular, the Commission envisaged that, in case of material deviations from the adjustment path in the national plan as endorsed by the Council, the opening of the EDP should be the default option, specifically, for high sustainability risk countries. The legislative proposals for the reform of the EDP regulation essentially reflect the same position, in particular, by highlighting the risk to sustainability ("*substantial debt challenge*") as a discriminating relevant factor when deciding whether to open an EDP following a deviation from the adjustment path.

Experience however may suggest a certain scepticism about the effective willingness of the Commission and the Council to adhere to the prescription of starting an EDP for a country that has not breached the 3 percent of GDP deficit threshold. The Treaty envisages this possibility for countries in breach of the 60 percent of GDP debt threshold, but the lack of specification of the conditions under which the breach of the debt threshold should lead to an EDP was long taken as a reason for ignoring the provision. The attempt to operationalise the debt criterion of the EDP in the 2011 reform package known as the Six-Pack, through the so-called 1/20 debt reduction rule²² was a failure, as ways were always found to avoid its application. Following the protracted suspension of the EU fiscal rules since the outbreak of the COVID-19 crisis through recourse to the so-called General Escape Clause, some may even doubt the willingness of the Commission and the Council to place in EDP the countries still in breach of the 3 percent of GDP deficit threshold, in spite of the explicit commitment of the Commission to do so from 2024.

Enforcing fiscal rules on fiscal sovereigns is an inherently difficult, if not intractable, problem (Debrun and Jonung, 2019). An approach based on self-commitment and reputational consequences is more likely to work than one based on external impositions and sanctions. The Commission in November 2022 was already clearly leaning in the direction of reputational sanctions, by acknowledging that macroeconomically visible pecuniary sanctions are counterproductive and symbolic penalties stand a better chance of being applied effectively.

Self-commitment and reputational consequences, however, should be enhanced at each stage of implementation and for all the parties involved. In this connection, while clearly not solving all problems, a useful initiative might be to revisit the European Council's 1997 resolution on the Stability and Growth Pact, in which, at the inception of

20 European Commission (2023b), Explanatory Memorandum, point 5.

21 "*These observations ... suggest the enforcement of the fiscal rules did not make a material difference in cases where the enforcement of fiscal discipline was most necessary*" (European Commission, 2020, p.7).

22 The debt reduction rule, more properly characterised as a benchmark, since it provides a numerical trigger for the overall assessment of the case for opening an EDP, prescribes that the gap between a country's debt level and the 60 percent reference should be reduced by 1/20th annually (on average over three years).

the SGP, EU countries, the Council and the Commission committed to timely and rigorous implementation of the Pact (European Council, 1997). The content of the resolution should be updated to reflect the reformed fiscal framework, eg references should be updated to include the medium-term fiscal plans, and the conditions for triggering the EDP should include not only the breach of the 3 percent of GDP deficit threshold, but also a material deviation from the adjustment path in the plan, specifically, for countries with “*substantial debt challenges*”. Unambiguous commitments on the part of the Commission and the Council should help counter doubts about their willingness to open deficit-based EDPs, and to deploy the debt-based EDP to enforce the necessary correction of the deviations from the adjustment path in the medium-term plans. In this connection, EU countries should vote in line with the proposals of the Commission to place a country in an EDP, including in cases of debt-based EDPs. A genuine commitment to enforce the new rules, grounded in fiscal sustainability and national ownership, seems a more promising reform avenue than insisting on the application of extra layers of rules that lack clear economic rationale and sincere political buy-in.

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Annex: Deriving the sustainability criterion from the Commission sustainability risk assessment methodology

The way the level of debt and its trajectory are jointly considered in the Commission risk assessment methodology combines two risk categorisations: one based on debt thresholds and the other based on the shape of the trajectory. Specifically:

- Based on debt thresholds, countries are classified as high, medium or low risk, depending on whether the debt ratio at the end of the projection period is above 90, between 90 and 60, or below 60.
- Based on the shape of the trajectory, countries are classified as high, medium or low risk, depending on whether the trajectory during the projection period is failing to decline (or declining only at the end of the projection period), declining at least from mid-point of the projection, or continuously declining throughout the projection period.

Note that projected debt levels and their trajectories are evaluated based on unchanged policies, ie excluding the effect of measures additional to those already in place on the primary balance, which is the driver of the debt trajectory, given the assumptions on growth and interest rates. Note also that the projections assuming unchanged policies are made over a horizon of ten years from the end of the adjustment period.

Jointly considering the risk categorisation for the level of debt level and its trajectory allows for a consistent interpretation of the “*downward path ... or ... prudent levels*” sustainability criterion. Specifically:

- A country at high risk based on the projected debt level will satisfy the sustainability criterion only if the projected debt trajectory can be characterised as low risk. In other words, since the projected debt level cannot be considered prudent, the projected debt trajectory should be unambiguously downward;
- A country at medium risk based on the projected debt level will satisfy the sustainability criterion provided that the projected debt trajectory cannot be characterised as high risk. In other words, the projected debt level can be considered prudent if the projected debt trajectory is not upwards;
- A country at low at low risk based on the projected debt level will satisfy the sustainability criterion regardless of the projected debt trajectory. In other words, as long as the projected debt level can be considered to be unambiguously prudent, there is no reason to be concerned with the trajectory.

Having thus reached a preliminary risk classification based on the level of debt and its trajectory under the baseline projection, its plausibility is tested through stress tests, both deterministic and stochastic. Note that stress tests can only ‘notch up’ (but not down) the preliminary risk classification. In particular, a country classified initially as at medium risk would be reclassified as high risk, if either one of the alternative deterministic stress tests or the stochastic stress test gives a high-risk signal²³. A ‘notching up’ of the risk classification due to the stress tests implies that the country concerned should plan a larger adjustment in order to pass the stress tests. Note also that the construction of the stochastic stress test implies that, in order to comply with it, countries classified as medium-risk on the projected debt level are effectively bound to exhibit a continuously declining debt trajectory²⁴.

Table 2 summarises the process for reaching a conclusion on the compliance of the adjustment path with the sustainability criterion²⁵.

Table 2: Assessing compliance with the sustainability criterion

Projected baseline debt level (10 years after the end of adjustment period)	Projected baseline debt trajec- tory (over 10 years from the end of adjustment period)	Stress tests on baseline projection (deterministic and stochastic*)	Compliance with sustainability criterion
Debt level staying above 90% of GDP (high risk)	Continuously decreasing trajectory (low risk)	No (alternative) deterministic scenario yielding high-risk classification nor stochastic stress test giving high proba- bility of debt not stabilising*	Compliance
		Any other case	Non-compliance
	Any other trajectory (medium or high risk)	Any	Non-compliance
Debt level staying between 60% and 90% of GDP (medium risk)	Continuously decreasing trajectory (low risk)	Any	Compliance
	Debt peaking by mid-point of projection y (or earlier) (medium risk)	No (alternative) deterministic scenario yielding high-risk classification nor stochastic stress test giving high proba- bility of debt not stabilising*	Compliance
		Any other case	Non-compliance
	Any other trajectory (high risk)	Any	Non-compliance
Debt level staying below 60% of GDP (low risk)	Any trajectory	Any	Compliance

Source: Bruegel based on European Commission (2023a). Note: [*] The stochastic stress test is differentiated based on the initial, not end-period, debt level.

23 Likewise, a country classified as low risk would be reclassified as medium risk if either one of deterministic stress tests gives a high-risk signal, or two of the deterministic stress tests give a medium-risk signal, or the stochastic stress test gives a medium-risk signal (by construction, the stochastic stress test cannot give a high-risk signal for a low-risk country). Note however that a notching up from low to medium risk is not relevant for the assessment for the sustainability criterion, the rationale for which is that of ensuring that countries avoid a high-risk classification.

24 The stochastic stress test is formulated in terms of probability of debt not stabilising over the initial five year of the projection period. For countries with an initial debt ratio between 60 and 90, the test gives a high-risk result if the probability exceeds 60 percent. This will be necessarily the case if the debt ratio is increasing in the baseline projection.

25 The Commission risk assessment methodology includes, in addition to the debt level and the debt trajectory, a third criterion for assessing the baseline projection, namely the fiscal consolidation space. This is assessed based on the percentile rank of the average structural primary during the projection calculated against the historical record for the country (the lower the percentile rank, intuitively, the less space the country has to improve on its historical record). This criterion is omitted in the interpretation of the sustainability criterion because it refers to unchanged policy projections as opposed to adjustment plans: it would be internally inconsistent to fail an adjustment plan because it incorporates an adjustment that is ‘too ambitious’ by historical standards.

Note that compliance with the debt-sustainability criterion is taken to mean avoidance of high-risk classification according to the Commission medium-term risk assessment methodology or, to put it concisely, de-risking of public debt. While this interpretation is not confirmed explicitly by the April 2023 draft legislation, only by keeping in the background the Commission risk assessment methodology it is possible to make overall sense of the proposal for the reform of the EU fiscal framework and in particular of the “*downward path ... or ... prudent levels*” sustainability criterion. Specifically, readings of the sustainability criterion that ignore the Commission risk assessment methodology tend to run into internal inconsistencies. For example, it would hardly make sense to require a downward projected debt trajectory from a country with a projected debt level that is considered to be prudent, ie staying below 60 percent of GDP, and therefore not to pose a risk to the euro.

Note also that, while not explicitly mentioned in the context of the “*downward path ... or ... prudent levels*” sustainability criterion, the relevance of the Commission risk classification, specifically, as regards the distinction between ‘high risk’ member states and the others, is confirmed by at least two provisions in the Commission reform proposals, namely, on the intensity of the reform and investment commitments required for an extension of the adjustment period²⁶, and on the materiality of a deviation from the adjustment path for the opening of an excessive deficit procedure²⁷.

In sum, a reading of the sustainability criterion in terms of de-risking of public debt, in turn operationalised based on the Commission risk assessment methodology, appears justified on both substantive and contextual grounds.

²⁶ European Commission (2023b), Art. 13 (2). It reads (emphasis added): “*The set of reform and investment commitments underpinning an extension of the adjustment period, shall be commensurate with the degree of public debt challenges and challenges to medium-term growth in the Member State concerned*”.

²⁷ European Commission (2023c), Art. (3). It reads (emphasis added): “*The Commission, when preparing a report under Article 126(3) TFEU, shall take into account as a key relevant factor the degree of debt challenges in the Member State concerned. In particular, where the Member State faces substantial public debt challenges according to the most recent Debt Sustainability Monitor, it shall be considered a key factor leading to the opening of an excessive deficit procedure as a rule. The Commission shall also take into account all other relevant factors as indicated in Article 126(3) TFEU, in so far as they significantly affect the assessment of compliance with the deficit and debt criteria by the Member State concerned*”.