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policy paper

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The ***Policy Paper*** *series of the Centro Studi sul Federalismo includes analyses and policy-oriented research in the field of domestic and supranational federalism. The papers aim to stimulate scholarly and political debate on topical issues by presenting original data, ideas and proposals.*

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Towards a revision of the Stability and Growth Pact

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After the pandemic, and the launch of NextGenerationEU (NGEU), a revision of the fiscal rules of the Stability and Growth Pact (SGP) and the Fiscal Compact is a necessity. The situation in the Union has changed dramatically, with the application of the general escape clause, and the financing of the NGEU through the issuance of €750 bn worth of bonds onto the market, notwithstanding that these are extraordinary and time-limited measures.

These support measures have generated significant increases in public debts accumulated by EU Member States (MS). The current average level of the public debt/GDP ratio reached in the EU (over 90%) makes a revision of European fiscal rules more of a necessity; the original debt/GDP target of 60% was derived from the average debt/GDP ratio of MS in 1990, and is now, therefore, unrelated to today’s figures. Furthermore, rigid fiscal consolidation rules, applied uniformly across all MS would be counterproductive to the objective of debt sustainability, promoting pro-cyclical measures that undermine the growth component.

The rule of 1/20th debt reduction per year should be replaced with a more gradual and decentralised approach. To reach the debt target, constraints over the evolution of nominal public expenditure should be introduced, so that a sustainable debt reduction path is respected, within limits set by each MS, and as approved by EU institutions. The (new) expenditure rules stipulate that, in upturns of the cycle, public spending should grow less than output, measured in monetary terms and net of one-off measures, so that the debt stock gradually shrinks without putting an excessive burden on economic growth. An opposite pattern should be observed in the case of a recession. The reference variable should be expected GDP growth and not potential GDP, as the latter is too difficult to estimate, especially in the current pandemic circumstances.

In addition, the debt/GDP ratio could be raised to 100%, thus introducing a less traumatic debt reduction rule than the extant 60%. This proposal would become even more relevant if a share of the debt currently held by the European System of Central Banks were to be purchased by the European Stability Mechanism (ESM) – as proposed by Stefano Micossi[1]. This would prevent debt reduction from imposing excessive spending restraints, especially on investment spending, making

it unnecessary to introduce a golden rule that would be politically difficult for some countries to accept.

These additional proposals, on the nature of the debt rule and the value of reduction targets, should not preclude a more progressive reflection on the reform of economic governance. Blanchard, Leandro and Zettelmeyer[2] recently proposed a shift from fiscal policy characterised solely by rules, towards one that includes discretionary measures, thus abandoning the system of one-size-fits-all rules and moving to a country-specific assessment. This would entail the contribution of the European Fiscal Board (EFB) and national fiscal institutions, and would only be valid at a more advanced stage of the European fiscal policy structure. It presupposes that: firstly, the competences and powers of national fiscal institutions, as well as the EFB, will have been strengthened to be able to provide analyses and data adapted to the macroeconomic situation of the country; secondly, a governance capacity of the Union that is currently absent since, according to the logic of the Maastricht Treaty, fiscal policy remains a competence of the MS.

In line with Blanchard *et al.*'s proposal, the 60% debt/GDP value should not be considered as a one-size-fits-all rule; differentiated MS targets could be considered in respect of specific macroeconomic situations, and in the light of the return to a defined target, within a process shared between the MS and the European institutions. In fact, the Treaty on the Functioning of the EU (TFEU) only stipulates a general rule in Article 126 that "Member States shall avoid excessive government deficits", while it is only in Protocol No. 12 on the excessive deficit procedure that we find a clearer definition of the targets. Here it is stated that "the reference values referred to in Article 126(2) of the Treaty on the Functioning of the European Union shall be: - 3 % for the ratio of the planned or actual government deficit to gross domestic product at market prices; - 60 % for the ratio of government debt to gross domestic product at market prices".

As such, the idea put forward by Blanchard *et al.*, referring to the general principle contained in the Treaty, seems reasonable, since putting a value on constraints – and any subsequent tightening – is closely linked to the evolution of public finance in the euro area. However, the application of this hypothesis requires a significant step forward towards the completion of fiscal union, with the recognition of powers to determine new own resources – seen as a priority for financing investment in EU MS. This would require a decision-making mechanism involving a majority decision in the Council and the European Parliament, without ratification by national parliaments, which should instead be involved in the preparation of the Multiannual Financial Framework (MAFF), from which the Union's annual budgets are then determined.

In conclusion, a gradual reform is advocated: in the short term replace the current rule with a constraint on expenditure growth. This is provided that, once fiscal union is completed, we can finally move from the application of rules set *ex ante* (which, to be applied, require a series of changes that make their implementation extremely complex and inefficient) to an active fiscal policy determined at the Union level. It will require the adoption, in parallel with the MAFF, of a Financial Plan: which, in addition to other measures to ensure the financing of the MS's budget and the determination of expenditure, includes – following preparation by the EFB – indications from the independent fiscal institutes of each MS regarding deficit levels compatible with financial stability, and the pathway towards reducing the stock of excess debt.

The MS's Financial Plans should be approved by a majority at the beginning of each legislative term by the Council and the Parliament, sitting in a Convention with representatives of the national parliaments, and subsequently updated annually on the basis of economic developments in the Union[3]. This would finally lead to a solution defined at the European level, but which respects the principles of subsidiarity and proportionality, with decisions taken with the active participation of the EU's different levels of government and within the framework of a fiscal federalism mechanism.

To deepen economic and monetary union, it is essential to proceed with the creation of a permanent stabilisation function at the European level, which would be activated automatically when a MS is in certain crisis conditions. This stabilisation function should be adequately financed to cope not only with an asymmetric shock, such as the sovereign debt crisis, but also with shocks affecting the EU as a whole, as the pandemic crisis proved to be. This extends the parameters of the problem from being eurozone-only, to gaining an EU dimension. A similar approach could be taken with the climate change crisis, whose effects go beyond the distinction between eurozone and non-eurozone members.

The ESM, an instrument created for financial stability during the euro crisis to lend to MS with particular financing difficulties on the market, has a number of limitations, including that of conditionality with respect to fiscal consolidation measures. This made it an unattractive instrument during the pandemic, when MS preferred to turn to non-intergovernmental, but Community instruments. The novel feature introduced by the NGEU, of providing support to MS by relying on financing through European debt securities purchased on the markets, is on the other hand a suitable prototype for the creation of a macroeconomic stabilisation function. The NGEU as an instrument for redistribution and/or stabilisation should be made permanent.

In contrast the European budget should focus more on expenditure related to European public goods, with a view to the strategic autonomy of the EU, with more

spending on supranational projects in infrastructure and advanced technologies in the areas of digital and energy transition, border control, migration management and an investment plan for Africa – in the framework of a lasting European Union - African Union partnership.

Note

1 Stefano Micossi, "On the selling of sovereigns held by the ESCB to the ESM - A revised proposal", CEPS Policy Insights No 2021-17 / November 2021.

2 Olivier Blanchard, Álvaro Leandro, and Jeromin Zettelmeyer, "Redesigning EU Fiscal Rules: From Rules to Standards", Peterson Institute for International Economics, Working Paper 21-1, February 2021.

3 Alfonso Iozzo, "Un nuovo contesto istituzionale per il Quadro Finanziario Pluriennale 2021-2025", Centro Studi sul Federalismo, Policy Paper n. 30, Febbraio 2018.

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