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Euro Area Research

New fiscal rules in the EU – aligning theory and practice?

The EU's fiscal rulebook is under review. Since the start of the COVID-19 pandemic in the beginning of 2020, the EU's current rulebook that limits public budget deficits of more than 3% and implies a convergence of debt-to-GDP levels to below 60% has been suspended. During that period, the EU Member States have been negotiating a new set of fiscal rules for the EU countries allowing for a less restrictive understanding of the rules. Currently there is no agreement on the new fiscal rules and the clock is ticking, as the old rules will otherwise come into force again from 1 January 2024.

We expect that the EU Member States will most likely not sign a final legal set of rules before year-end, however, we expect that they will agree on a "landing zone" for the new rules at the ECOFIN meeting on 8 December. The "landing zone" will allow the Commission to interpret fiscal rules according to this agreement instead of the old rules even though the final legal text is to be finalised. That said, the fiscal stance in the euro area becomes tighter in the coming years as sustainable public finances get renewed focus.

New rules – an evolution not a revolution

Based on the EU Commission proposal and communication from EU officials we expect that the "landing zone" will reinstate the old 3% deficit and 60% debt targets, but with greater flexibility to adapt country specific fiscal adjustment paths. The current EC's proposal sets out to scrap the uniform 1/20th rate of debt reduction rule (which implies that countries must bring down the debt level by 1/20th of the debt to GDP level exceeding 60% each year) and replace it by country-specific fiscal pathways with four-year horizons. The fiscal adjustment path will dictate that debt-to-GDP is lower after four years and that the structural budget balance improves by 0.5 percentage points each year as long as the deficit is below 3% of GDP. **The exact calibration of the numerical targets on the fiscal path may deviate after the final negotiations between Member States.**

A new and central element of the fiscal rules will likely be that the **reforms and investments which "enhance sustainable and inclusive growth" will allow for member states to have a more gradual fiscal adjustment path up to seven years.** Member states must then comply with certain criteria such as supporting structural growth and fiscal sustainability and address key EU priorities like green transition, digitalisation and defence.

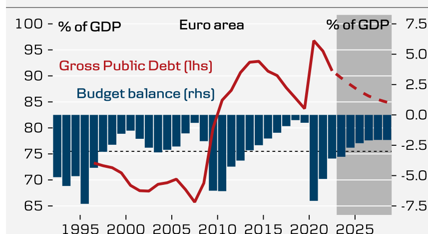
Old EU fiscal rules	New EU fiscal rules (EC proposal)
* Key metric: 3% budget deficit, 60% debt-to-GDP, structural deficit above -0.5% (-1.0% if debt below 60% of GDP). * Reduction by 1/20th of debt above 60% p.a * Potential for escape clause activation * Excessive deficit procedure (EDP) could lead to fines of 0.2-0.5% of GDP, but no have fines ever been imposed	* Key metric 3% budget deficit, 60% debt-to-GDP, net primary expenditures * Risk based assessment * Potential for escape clause activation * Automatic opening of EDP if adjustment path is breached. Fines every six months of 0.05% of GDP up to a cumulative 0.5%of GDP * Certain investments and reforms extent adjustment path up to seven years * If breached: Four-year fiscal adjustment path 0.5 p.p p.a. improvement in structural balance * Debt must be lower at end of path

Source: Danske Bank

EU fiscal rules

- EU fiscal rules dates to the Maastricht treaty (1992) and Stability and Growth Pact (1997)
- The rules have been changed two times, in 2005 and 2011, which have introduced "structural deficits" to the rules, a debt reduction rule of 1/20 of public debt above 60%, and sanctions
- The rules are complex and have not functioned well in practice, allowing risks to in fiscal instability to emerge
- Key dates to follow: 8 December (ECOFIN meeting) and 14-15 December (EU Summit)

Fiscal developments have not been compliant with rules



Source: IMF Fiscal Monitor, Macrobond Financial

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Increasing flexibility – and based on scores

The proposal from the Commission aims at adding flexibility to the rules by scraping the 1/20th debt reduction rules and instead have a single operational indicator for fiscal adjustments, namely net primary expenditures. The proposal sets this as **all public expenditure elements under direct government control, thus net of discretionary revenue measures and excluding interest, as well as cyclical unemployment expenditure.** However, one drawback of the measure is that large uncertainties surround the estimates of potential output used to adjust the expenditures for cyclical expenditures. Revisions to the structural balance are extensive and often larger than the policy action required by the new proposal; see *Buti et al (2019)*.

In the proposal, countries will be categorized into high, medium, or low risk based on both the level of debt and the expected evolution. This together with a stress test on the fiscal projections will dictate how debt should develop thereby increasing flexibility.

A central criticism of the old rules has been on the lack of enforcement. Specifically, that no monetary fines have ever been imposed on countries breaking the rules. In the new proposal, an Excessive Deficit Procedure would automatically open if Member States depart from their agreed fiscal adjustment path. Fines of 0.05% of GDP every six month up to a cumulative of 0.5% of GDP will be given. This will speed up the process compared to the old rules where it could take up to 16 months from a budget breach to a fine.

European Commission proposal on fiscal adjustment path for Member States with a deficit above 3% or debt above 60% of GDP (April 2023 proposal)

Fiscal adjustment spread over 4 years

The deficit remains or is brought to and maintained below 3% of GDP

- Debt must be lower at the end of the period covered by the plan and is put on a plausibly downward path or stays at prudent levels by the end of the adjustment period.
- A minimum fiscal adjustment of 0.5% of GDP per year as a benchmark is to be implemented so long as the deficit remains above 3% of GDP.

Fiscal adjustment spread over 7 years

Member States may benefit from a more gradual fiscal adjustment path up to seven years to fulfil the criteria above if they commit reforms and investments that support the adjustment.

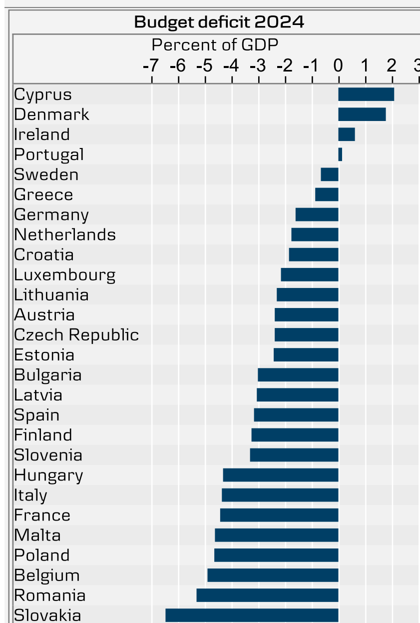
- They still need to deliver a sizeable adjustment during the first four years covered by the plan

16 out of 27 countries would breach proposed rules in 2024

Based on the Autumn 2023 Economic Forecast from the European Commission (15 November) 16 out of 27 countries will not comply with either the 3% or the 60% rule in 2024 and must therefore outline a "fiscal adjustment path". However, as many countries had large budget deficits in 2023 due to energy subsidies and tax reliefs related to the energy crisis the change in the cyclically adjusted primary balance (CAPB) will be larger than 0.5 p.p in 2024 in most countries. Yet, Belgium, Bulgaria, Finland, France, Latvia and Slovakia will not comply with the adjustment path in 2024. In 2025, the expected fiscal improvements are smaller and no countries with projected deficit above 3% of GDP will comply with the change in the CAPB. **Hence, the fiscal stance in the euro area is set to become tighter in the comings years as sustainable public finances get renewed focus.**

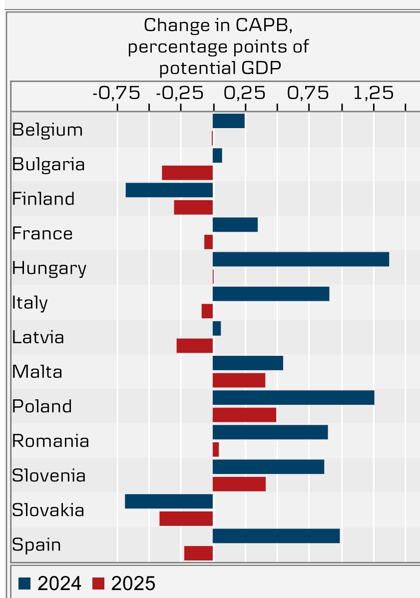
The overhaul of the fiscal rules is welcomed as the previous framework failed to contain the rise in sovereign debt ratios. **However, it is difficult to judge the impact of any new fiscal rules before they are put into practice and enforced. Especially the enforcement on larger countries like France, that is expected to be in breach of the proposed rules, will tell whether theory and practice align in the future.**

13 countries are expected to have budget deficits above 3% of GDP in 2024



Source: EU Commission, Macrobond Financial

Countries with deficit above 3% of GDP and expected change in cyclically adjusted primary balance



Source: EU Commission, Macrobond Financial

Disagreements remain in the negotiations…

The ongoing negotiations try to balance the conflicting views between Member States such as Germany that wants strict numerical targets each year versus France and Italy that prefer more leeway. France and Italy argue that automatic measures that force Member States to immediately cut spending will harm activity and innovation while Germany wants confirmation that high debt is tackled. Another conflict is the exception of certain investments from the debt calculations. For example, German Finance minister Christian Linder has taken a hard line saying that *"As far as the capital markets are concerned, debt is debt"* while the EU Commission in their proposal wants to allow investments in key EU priorities like the green transition, digitalisation, and defence to extend the fiscal adjustment period by up to seven years. In Germany, the recent court ruling on the debt brake has most likely softened their stance and thus increased the likelihood of a compromise, see *Strategy: The German budget and issuance target for 2024 and the target for the Bund spread* , 22 November.

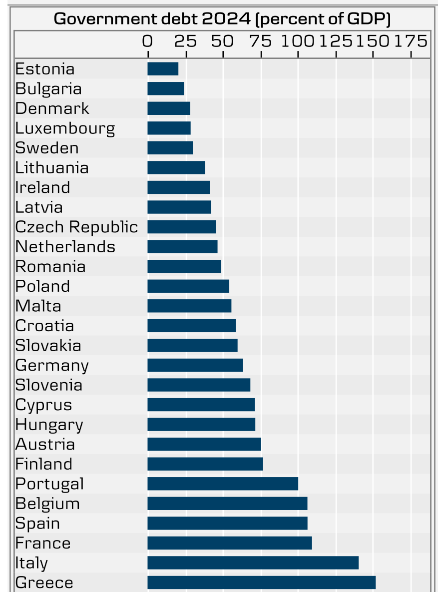
… but politicians are optimistic on a deal before New Year

Although division over the rules remains comments from EU leaders are positive. French finance minister Bruno Le Maire said, *"The mood is an excellent one. We are moving in the right direction"* while the Spanish economy minister Nadia Calvino who chairs the negotiations in the European Council said she is confident they will reach a deal by year-end and that *"we see an agreement on the core elements and mechanisms of the new fiscal rules"*. **The EU Member States will most likely not sign a final legal set of rules before year-end; however, we expect that they will agree on a "landing zone" for the new rules at the ECOFIN meeting on 8 December.** If disagreement still exist at that point a final chance for a deal will be at the European Council summit on the December 14-15 before the old rules reactivates in January 2024.

Key dates to follow

- December 8: ECOFIN meeting
- December 14-15: European Council summit

Many countries have a public debt larger than 60% of GDP



Source: EU Commission, Macrobond Financial

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Rune Thyge Johansen, Analyst, and Piet Haines Christiansen, Director.

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