Report on fiscal governance

State of play, problems and possible solutions

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IBA’s: national independent budgetary authorities

ECB: European Central Bank

EBC: European Fiscal Board

CCE: Central Economic Council (Belgium)

EC: European Commission

ECJ: European Court of Justice

CSF: High Council of Finance (Belgium)

ECOFIN: Economic and Financial Affairs Council

MTO: Medium-term budgetary objectives

GDP: Gross Domestic Product

SGP: Stability and Growth Pact

BCR: Brussels-Capital Region

EMU: European Monetary Union

EU: European Union

TFEU: Treaty on the Functioning of the European Union

A word from the President

By taking initiatives, through the Central Economic Council of Belgium, for the launching of a public debate on fiscal issues in Belgium, representative organisations of employers and workers in our country are willing to participate actively in the discussions on the European and Belgian fiscal processes, framed by the European Stability and Growth Pact. They also want this debate to be conducted in depth and in collaboration with academic and scientific experts[1].

For almost a year, the sharing and cross-fertilisation of opinions expressed at conferences organised by the Council and within the academic expert group have made it possible to address the European and Belgian fiscal framework in an analytical manner, to identify the problems encountered in their implementation and the possible pathways for change, with the advantages and disadvantages of each.

This synthesis report is addressed to the various political and social dialogue bodies in Belgium, but also to the European bodies, particularly in view of the European negotiations on the review of the European fiscal and economic governance framework. It is a contribution but also an invitation to continue the debate on collective responsibility towards the euro area in a post-COVID context which will be marked by a high level of public debt for several Member States and by important needs in terms of ecological and digital transition and societal challenges.

I would like to thank my fellow members of the academic expert group who kindly provided their time and expertise to the discussions throughout the initiatives. Of course, my thanks also go to the speakers for their stimulating and engaging presentations that form the backbone of this report and to the many participants at the conferences. Finally, I would like to highlight the involvement of the staff of the Central Economic Council secretariat in the organisation of the public debate and the follow-up of the work.

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Executive Summary

The European fiscal framework has been overhauled several times since the Maastricht Treaty was signed in 1992. While each reform was intended to address specific problems, the process has ultimately resulted in complex regulation that does not necessarily lead to the desired results. The European Commission (EC) is aware of the possibilities for improving the current fiscal framework and has launched a public consultation on this issue. Understanding the problems of the current framework and possible solutions is essential in this respect.

Both Belgium and many other Member States have deviated from the European fiscal rules in recent years. The problem also lies in the inability of the current rules to stabilise the economy sufficiently. In the past few years, the gap between countries with high and low debt levels has widened, and fiscal policy in the euro area is usually pro-cyclical. The ECB has therefore been forced to ensure stability, although this may conflict with its inflation objectives. One of the reasons for the inadequacy of fiscal stabilisation would potentially be the distortion of the indicators aimed to detect imbalances and the sanction mechanisms that pay more attention to current account and fiscal deficits than to surpluses. The tendency of Member States not to take sufficient advantage of growth periods to eliminate budget deficits and the fact that the EC does not have a central fiscal capacity with stabilising features are not likely to help. European fiscal rules may also act in a pro-cyclical way when the structural fiscal rule forces savings in periods of low economic activity because the unobservable output gap used as an indicator of the economic situation is more negative than its estimate indicates. The underestimation of potential economic growth in periods of low economic activity can explain this over-optimistic assessment of the *output gap*. The resulting insufficient stimulation of the economy may also have permanent negative effects on the economy.

Furthermore, the fiscal framework does not seem to provide sufficient incentives for Member States to invest. This has a negative impact on growth, which is particularly problematic in the light of the huge investments that will be needed to achieve the climate objectives. It is not clear to what extent this is a choice of Member States who are quick to cut back on investment in times of restraint, or rather a consequence of EU rules that are not investment friendly. It is clear, however, that the current flexibility of the European fiscal rules, which is intended to create room for investment, is hardly used.

Gradually, the fiscal framework has been modified to make it more flexible and to allow it to take into account a large number of factors with sanction mechanisms. As a result, however, the rules have become extremely complex, making compliance difficult. And there is doubt as to whether it is possible to create rules that are flexible, simple and enforceable.

Furthermore, there is a debate about the role that technicians should play in setting and interpreting fiscal rules. Should technicians be relied upon with the concretisation of fiscal norms, for example through the calculation of the *output gap*, the estimation of public debt sustainability or the assessment of structural reforms, or are these issues a matter of political choice for elected officials? In this respect, some believe that the EC and the Council of the European Union are reluctant to impose heavy sanctions.

A final difficulty lies in the lack of differentiation between the various policy instruments and objectives. The Maastricht standards are uniform and therefore do not take into account the impact of different structural features on the sustainability of public finances. There is also no safeguard clause, no European fiscal coordination and no support for countries affected by asymmetric shocks. In this respect, the ECB's ability to intervene in a manner commensurate with individual Member States is very limited.

The assessment of the various possible reforms of the European fiscal framework should not be limited to examining their ability to solve the current problems, but should extend to the question of whether they require more or less far-reaching changes to the current rules and are therefore politically feasible.

The simplest intervention is a reinterpretation of the current rules and a wider use of the available flexibility. While such a limited revision is easy and avoids tense negotiations, some problems require deeper reforms and some rules that are considered unrealistic, such as the debt threshold of 60%, would still apply. The liability of the EC would increase further in case of flexible interpretation of the rules, which can cause legal and political problems.

A relatively simple adaptation would be to improve the calculation of the output gap, for example by combining several estimation models. Instead of estimating potential output on the basis of past observations, it could be calculated on the basis of a full employment situation, i.e. when the number of employed persons is equal to the current level plus the long-term unemployed. This would create more room for fiscal stimuli in times of economic downturns and avoid that a temporary slowdown in growth is interpreted as a structural phenomenon. This would make fiscal policy more consistent with policy objectives and give greater responsibility to elected politicians rather than technocrats. The risk of this approach is the need for additional surveillance of the sustainability of public finances.

Another relatively simple reform would be to reduce the number of indicators and focus mainly on medium-term developments. This should encourage a longer-term policy focus. In addition, a single expenditure benchmark covering several years (e.g. three) could be used, taking into account the debt and economic situation and excluding or spreading out cyclical or one-off expenditures. If its adaptation is not politically feasible, the deficit norm (3% of GDP) could be maintained as well as the debt threshold of 60% but the pace at which it is to be approached can be revised (e.g. 1/40 of the gap per year) and included in the expenditure benchmark. Such a rule would be a clear policy directive and would be accompanied by more credible sanction mechanisms than is the case in the current situation with multiple rules and exceptions. The disadvantage of such a simple rule covering several years is its lack of flexibility in the face of unforeseen shocks and the risk of slippage in public finances. The fact that uniform, unrealistic debt rules would be maintained is also criticized. To remedy this, deeper reforms are needed.

Various authors argue in favour of excluding investments, or only green investments, from the 3% deficit norm. From a political point of view, this is not self-evident because it would require a revision of Protocol 12 of the Treaty on the Functioning of the European Union (TFEU). Such a "golden rule" should prevent savings from being made at the expense of these investments and contribute to the achievement of the climate objectives. However, the difficulty lies in determining which investments would be eligible, and there is a risk that governments will try to misclassify current expenditure as investment. To the extent that these investments are not recouped in the form of higher growth, this could also jeopardise the sustainability of public finances or require savings in other areas in order to meet the debt criterion.

A less radical but politically sensitive reform would be a significant increase in the EU budget through higher contributions from the Member States. A more far-reaching option, however, requiring a treaty change, would be to give the EU more resources through the EC, perhaps with the possibility to raise money on financial markets. An increase in EU resources would give the EC and the Council of the European Union more control over the EU's objectives, for example by giving each Member State an envelope for green investments. It would also allow the EC to redistribute in the event of asymmetric shocks and make adjustment processes less painful, which is especially important for euro area countries. A central fiscal capacity would also make it possible to support the economy in several countries simultaneously, thus avoiding individual countries under-stimulating their economies for fear that the positive effects would flow abroad. The biggest concern with such a reform is that it could lead to a 'transfer union' where some Member States, relying on European means, would abandon their budgetary discipline. An alternative proposal is the creation of a European leasing entity that would be able to draw funds from the financial markets and which individual Member States could call upon to lease public infrastructure that meets European standards and objectives. This would give them access to advantageous interest rates - at the same time a potential advantage if the EC could borrow itself - and benefit from economies of scale.

It is also possible to move away from specific fiscal rules and proceed according to budgetary norms. In this case, the rules would be replaced by a general objective, such as the prevention of excessive government deficits, without specifying ex ante how to achieve it. While the TFEU does not necessarily need to be amended to introduce such a norm, secondary legislation would have to specify the exact content of the norm as well as possible additional provisions, e.g. on how to deal with certain risks, the timeframe for implementing corrections, etc. Stochastic studies could, for example, establish how high the risk of uncontrolled expansion of government debt is in the context of different primary balances, which would then make it possible to impose on each Member State a minimum primary balance that countries would have to respect in order to stabilise their debt sufficiently safely or, if this standard were to be maintained for political reasons, to move towards the 60% criterion, provided that “sufficiently close to or sufficiently diminishing towards that level at a satisfactory pace” is based on a stochastic analysis of the sustainability of public debt. The advantage of such an approach would be that it allows for a diversified approach that can be quickly adjusted in the light of new information or circumstances. Policy would be better able to cope with uncertainty and refocus using detailed information. If the EC or the Council of the European Union were to impose corrective measures, the TFEU would not have to be amended but Member States would have to amend their national legislation to allow an independent institution to block their budget in the event of non-compliance with the standard. If the ECJ were to act as an arbitration body, the TFEU would have to be amended. The advantage of this is that it would allow case law to emerge around budgetary norms, with credible sanction mechanisms. Others, however, believe that sanctions are a political decision that should remain in the hands of democratically elected politicians. In any case, technocrats bear a great responsibility for this proposal, which is both complex and not very transparent.

As a variant on the previous proposals, the debt rule would be adjusted per Member State, based on an analysis of sustainability risk in accordance with a methodology set by the European Fiscal Board (EFB), applied by the national independent budgetary authorities (IBAs) and monitored by the EC. National governments must then translate the debt rule into an expenditure benchmark, excluding interest charges and unemployment benefits, under the supervision of the IBA's. Both targets are set for a period of 5 years but can be revised in case of unforeseen developments. Investments would not be excluded from the expenditure benchmark but as the benchmark takes into account potential growth, growth-enhancing investments would allow for higher spending. The EC monitors infringements and the Council of the European Union takes the final decision on possible sanctions. This reform requires an adaptation of Protocol 12 TFEU and secondary legislation. It allows for a diversified and flexible policy taking into account a lot of current information. Removing the deficit rule would eliminate the requirement to make savings in times of economic downturns and the restriction to a single expenditure benchmark provides a clear guideline for policy makers. However, the calculation behind the debt and expenditure benchmark is not very transparent.

1 The context

Even before the consequences of the economic crisis caused by the Covid-19 pandemic, there was some academic and institutional consensus on the need to rethink and reform European economic and fiscal governance. With this in mind, the European Commission adopted a Communication[2] which assesses the implications of the changed circumstances for economic governance and relaunches the public debate on the review of the EU's economic and fiscal governance framework.

The definition and monitoring of European fiscal rules are among the reforms considered, notably on how to guarantee the sustainability of public finances[3] , how to prevent and correct macroeconomic imbalances, how to simplify the existing rules and how to improve their transparency, ownership and application. The post-Covid context has reinforced the urgency of these reforms given the unprecedented mismatch between the existing EU rules and the public finance situation in many Member States, which is marked by large deficits and increasing public debts as a result of fiscal policies implemented to mitigate the consequences of the crisis. The debates on the reform of the rules are all the more justified since, compared to the context of the Maastricht Treaty, interest rates are extremely low and public authorities have to cope with large investment needs within the framework of the green transition as well as with the ageing of the population. A major reform has already taken place since, as part of the European recovery plan, Europe has acquired a common European debt and intervention capacity.

In order to allow for a credible budgetary response to the health and economic crisis, the European Commission activated the flexibility clause[4] in March 2020, allowing for a temporary suspension of the application of the sanctions provided for in the Stability and Growth Pact (SGP) while maintaining the budgetary monitoring of the States. This flexibility clause has been extended for the year 2022. The end of the flexibility period now opens a debate on the basis, principles and application of the rules of the Stability and Growth Pact. Will it be applied as it stands from 2023 onwards? Will use be made, for example, of all the existing flexibilities provided for in the current economic governance framework? Will these flexibility clauses be

[2] COM(2021) 662 final
[3] The sustainability of public finances is the ability of a government to sustain its current expenditure, taxes and other policies over the long term without jeopardising its solvency or failing to meet some of its commitments or promised expenditure.
[3] COM (2020) 123 final
[4] COM(2020) 123 final

extended? Or will the Pact be substantially modified and therefore what changes will be made to it? The activation of the flexibility clause only concerns the objective of balancing public finances in the medium term and the procedures for returning to a balanced budget. As soon as the flexibility period ends, the application of the Pact in the area of public debt and deficits will be reactivated unchanged and excessive deficit procedures - the corrective but also the preventive arm of the Pact - could be launched against many Member States. However, this prospect now seems to contradict the political discourse aimed at mobilising budgetary means to relaunch investment, support activity and economic transition in Europe and to avoid repeating the consequences of the austerity policies that had been implemented too quickly after the financial crisis.

Estimates by the European Fiscal Board (EFB, 2020) show that, if the European fiscal rules were activated at the end of the general escape clause, the efforts to be made by certain States to reduce their public debt levels would have very significant socio-economic consequences, jeopardising the recovery in the EU. This could lead to turbulence in the sovereign bond markets and destabilise the single currency.

It is in this context that the Central Economic Council of Belgium (CCE), in collaboration with academic experts, decided to work on the organisation of a debate on public finances, from the perspective of European fiscal governance and the Belgian fiscal and institutional framework. This debate, organised around a series of conferences aims to stimulate a public discussion on areas that have a major impact on all levels of society and whose consequences for citizens are not only the concern of experts or public authorities but also of society as a whole.

Annex 1 contains an overview of the webinars organised to enrich and stimulate the debate. The various speakers shared their expertise on specific topics and then answered questions from the audience. The discussions initiated during these conferences provided a better understanding of the main challenges ahead and of the different proposals with their advantages and disadvantages. The debate was further fuelled by various contributions from the public.

These elements were incorporated in this report, which was validated by the accompanying academic expert group. The following professors were part of this group: Benoît Bayenet (ULB and ULG), André Decoster (KUL), Marcus Dejardin (UNamur and UCL), Christel Dumas (ICHEC and UNamur), Roland Gillet (Sorbonne and ULB), Freddy Heylen (UGent), Wim Moesen (KUL, em.).

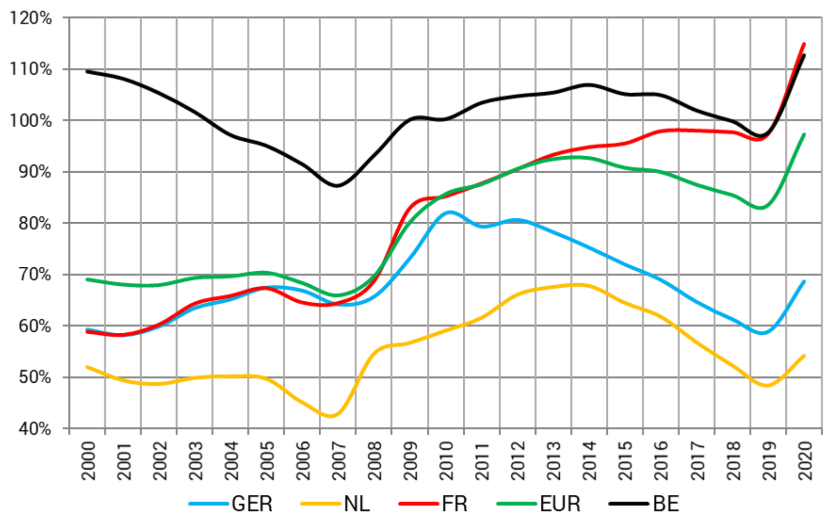
The CCE hopes that this report can be a reference tool for discussion and reflection, with a view to building a new consensus, which should be as broad as possible, so that States can meet the socio-economic challenges that we will be facing in the coming years. To this end, the report starts with a description of the current Belgian and European fiscal framework, then identifies the different problematic areas of this framework and then proposes possible solutions, highlighting the associated risks, advantages and disadvantages.

2 State of Belgian and European public finances

The European fiscal rules of the Stability and Growth Pact (SGP) have, more than ever in recent years, been the subject of debate within the European Union. The 60% public debt - 3% budget deficit rule is a challenge for several countries in the current context of the coronavirus crisis, the climate crisis and an ageing population that is leading to increased expenditure. In Belgium too, a debate has been raging for some time on the state of our public finances, particularly in the context of European fiscal rules, with some putting the situation into perspective while others describe it as unsustainable. We will not comment on this issue and will limit ourselves here to an international and intra-Belgian comparison of public finances.

2.1 The Belgian situation in comparison with our neighbours and the euro area

Chart 2-1: Development of consolidated public debt (% of GDP)



Source: Eurostat

The debt of the Belgian public authorities has been propelled by the coronavirus crisis to a level approaching 113% of GDP, which represents an increase of 15 percentage points compared to the previous year and the highest public debt - in relation to GDP - since 1999. Although the health crisis has had a negative influence on Belgian public finances, even before the crisis broke out, these were far from the Maastricht criteria drawn up by the European Commission in 1993, namely a maximum public debt and budget deficit of 60% and 3% respectively.

As the graph above shows, Belgium is by no means the only country that does not meet the parameters set out in the SGP. A comparison of the Belgian figures with those of our neighbours shows that our country, together with France, can be described as the 'worst' pupil in the class, but also that the euro area has not managed to comply with the 60% rule since the rules were introduced. The Netherlands is the only neighbouring country - and indeed one of the few countries in the Union - that has largely managed to keep its debt below 60%. For some time, especially in the early 2000s, Germany neglected the limit. Then, by systematically reducing its debt from 2010 to 2019, it managed to comply with it again. But these efforts were dashed when the coronavirus crisis broke out.

We see a similar debt explosion across the euro area. In addition, the budget balance has also fallen (Table 2-1), undergoing a strong downward movement in the wake of the financial consequences of the pandemic-related support measures. Given the very negative impact of the coronavirus crisis on the European economy, the European Commission activated the general escape clause regarding compliance with the SGP rules. As far as the budget balance is concerned (Table 2-1), it can also be said that Belgium and France perform worse on average than their neighbours; however, in the past, Belgium was more often in line with Germany, the Netherlands and the euro area. Both in 2010, as part of the recovery from the 2008 banking crisis, and in 2020, when the coronavirus crisis broke out, large deficits were recorded and no country managed to meet the 3% SGP rule. Provided that these deficits are temporary, this will not have a significant impact on the long-term sustainability of public finances (Baert et al., 2020; Decoster, 2020).

Table 2-1: Evolution of budget balance (% of GDP)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
BELGIQUE	-4,1%	-4,3%	-4,3%	-3,1%	-3,1%	-2,4%	-2,4%	-0,70%	-0,8%	-1,9%	-9,1%
FRANCE	-6,9%	-5,2%	-5,0%	-4,1%	-3,9%	-3,6%	-3,6%	-3,0%	-2,3%	-3,1%	-9,1%
GERMANY	-4,4%	-0,9%	0,0%	0,0%	0,6%	1,0%	1,2%	1,3%	1,9%	1,5%	-4,3%
NETHERLANDS	-5,3%	-4,5%	-4,0%	-3,0%	-2,3%	-2,0%	0,0%	1,3%	1,4%	1,7%	-4,2%
EUROZONE	-6,3%	-4,2%	-3,7%	-3,0%	-2,5%	-2,0%	-1,5%	-0,9%	-0,4%	-0,6%	-7,2%

Source: Eurostat

Belgium's debt interest burden is high by European standards. It has consistently been among the highest in the Union in recent years. However, we note that interest burden is generally very low in our neighbouring countries and in the euro area compared to what it was in recent years (Chart 2-2). This reduces the pressure on the public debt and on the budget balance. The lower the interest rates, the lower the primary balance required to stabilise the debt and the lower the risk of a snowball effect. Such an effect occurs when a country is heavily indebted and has to repay this debt at a high interest rate; the budget deficit increases year by year and the debt swells exponentially each year as a result of these high interest rates, just like a "snowball" rolling down a mountain (Bogaert, 2010).

The interest rate on government bonds has fallen sharply over the past ten years in the euro area and is currently at a very low level (Table 2-3). A possible rise in interest burden could therefore be particularly harmful in countries with high public debt, such as France and Belgium.

Table 2-2: Compliance with the MTOs (average ex-ante gap over 7 years, 2014-2020, as % of GDP)

	SB	EB
BELGIUM	-0,4%	-0,6%
FRANCE	-0,6%	-0,7%
GERMANY	1,4%	1,2%
NETHERLANDS	0,1%	0,3%

Source: EFB (2021, p. 28)

Table 2-2 shows the extent to which Belgium and its neighbouring countries comply with the medium-term objectives (MTOs). These are targets specifically set by the

EC in relation to a country's fiscal situation (see below). SB (structural balance) refers in Table 2-2 to the budget balance, while EB refers to the expenditure benchmark. Thus, we find that the Belgian structural government balance over the period 2014-2020 was on average 0.4 percentage points below the MTO. Over the same period, Belgian public spending was on average 0.6 percentage points of GDP above the MTO.

European indicators of sustainability of national public finances

When setting the MTO, the EC takes into account the sustainability of the public debt of the Member State concerned. To analyse this, the EC has developed a number of indicators, namely S0, S1 and S2, which quantify the sustainability of national public finances in the short, medium and long term respectively, taking into account the specific characteristics of each Member State. These indicators are published in the *Fiscal Sustainability Report* and are used not only to define the MTO but also throughout the European fiscal framework. They are also used, for example, to assess whether an excessive deficit procedure should be initiated against a Member State under the corrective arm of the SGP or when using the flexibilities that have been defined under the SGP (see below).

Table 2-3 presents the S2 indicator for Belgium and neighbouring countries from the *Debt Sustainability Monitor 2020*. It shows that Belgium would have to increase its structural primary financing balance by 3.7 percentage points of GDP to ensure the long-term sustainability of its public finances, taking account of the cost of ageing. There are large differences between countries. The favourable position of France is due to the negative cost of ageing in that country.

Table 2-3: S2 indicator on the long-term sustainability of public debt

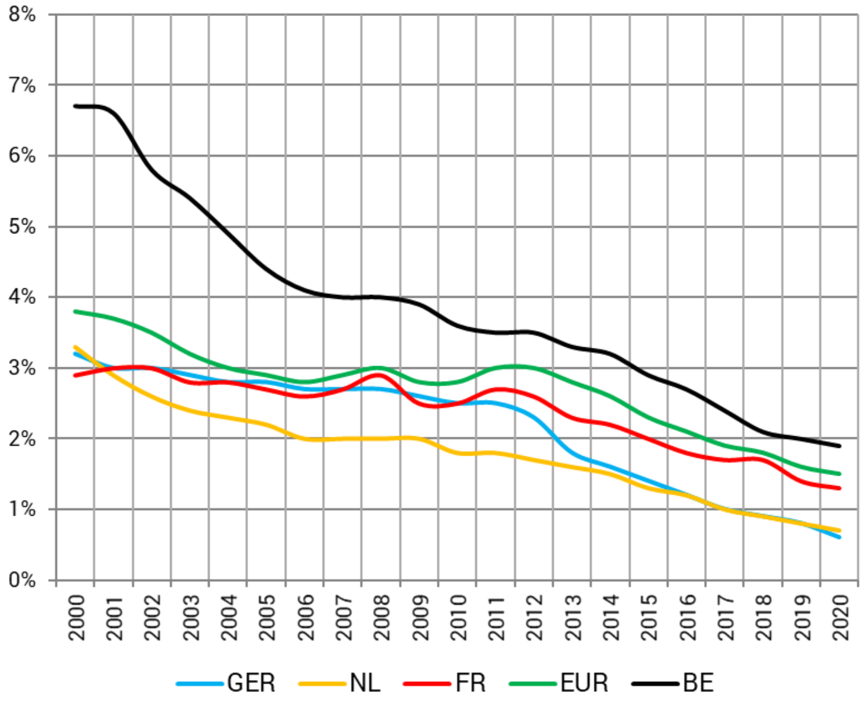
	BE	GER	NL	FR	EA	EU
S2	3,7	2,1	3,3	-1,1	1,2	1,5

* The figures show by what percentage of GDP the structural primary financing balance would have to increase to stabilise the public debt as a percentage of GDP over an infinite horizon, taking into account the cost of ageing.
Source: Debt Sustainability Monitor 2020 (EC, 2021, p. 67)

On the basis of these charts and tables, we can conclude that Belgium regularly deviates from European rules. Together with France, it has for many years had great difficulty in achieving the European rules of the SGP, recording deficits and debts that were often far from the Commission's medium-term objectives. In fact, Belgium has rarely complied with the rules, but it is far from being alone in this respect. On average, the euro area as a whole does not meet the targets set. The Netherlands and Germany comply more often with the rules, but they also break them on occasion. These figures clearly indicate that a discussion on the SGP rules is necessary and that it would be factually incorrect to claim that the Belgian situation is unique in this respect.

These figures therefore raise questions about the feasibility and effectiveness of European fiscal rules. The years preceding the pandemic were characterised by relatively strong economic growth, but even during this period the euro area as a whole did not make a clear fiscal effort. The rules should encourage countries to conduct a counter-cyclical policiy, i.e. to build up reserves when the economy is doing well and use them in times of crisis. In practice, however, it often appears that the opposite is true, with pro-cyclical policies being conducted (EFB, 2021).

Chart 2-2: Evolution of interest burden (as a % of GDP)



Source: Eurostat

Table 2-1: Evolution of interest rates on government bonds

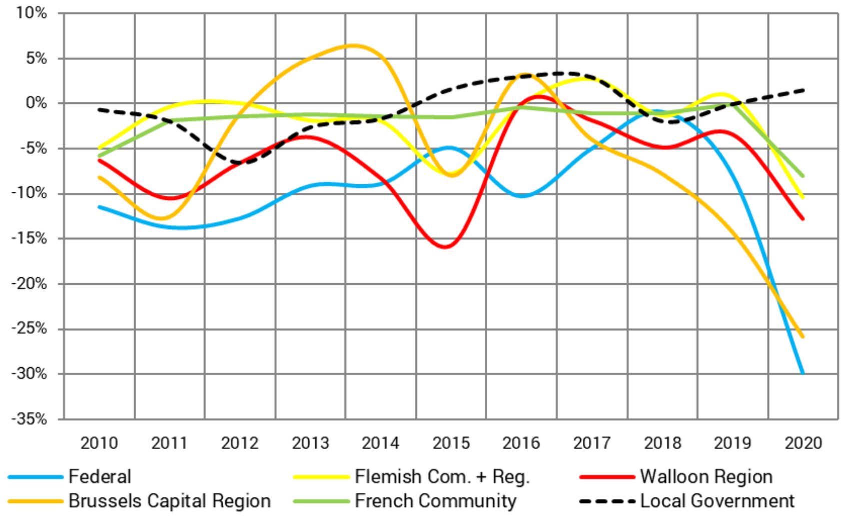
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
BELGIQUE	3,46%	4,23%	3,00%	2,41%	1,71%	0,84%	0,48%	0,72%	0,79%	0,19%	-0,15%	-0,01%
FRANCE	3,12%	3,32%	2,54%	2,20%	1,67%	0,84%	0,47%	0,81%	0,78%	0,13%	-0,15%	0,01%
GERMANY	2,74%	2,61%	1,50%	1,57%	1,16%	0,50%	0,09%	0,32%	0,40%	-0,25%	-0,51%	-0,37%
NETHERLANDS	2,99%	2,99%	1,93%	1,96%	1,45%	0,69%	0,47%	0,81%	0,78%	0,13%	-0,15%	0,01%
EUROZONE	3,60%	4,34%	3,86%	2,99%	2,04%	1,21%	0,86%	1,09%	1,12%	0,44%	0,05%	0,07%

Source: AMECO

2.2 The Belgian situation

Chart 2-3 gives a picture of the relationship between the annual budget balance and the total revenue of the federated level concerned. This shows which levels of government spend relatively more than they receive annually. It is immediately apparent that the federal government (including social security) traditionally has the highest expenditure in relation to its revenue. In the Brussels Capital Region (BCR), the situation has significantly deteriorated, especially in recent years. Unsurprisingly, the year 2020 was a particularly bad year for all levels of Belgian government, with a sharply rising deficit. Only the local public authorities that have had a positive or slightly negative budget balance several times in recent years were still able to report a positive percentage in 2020.

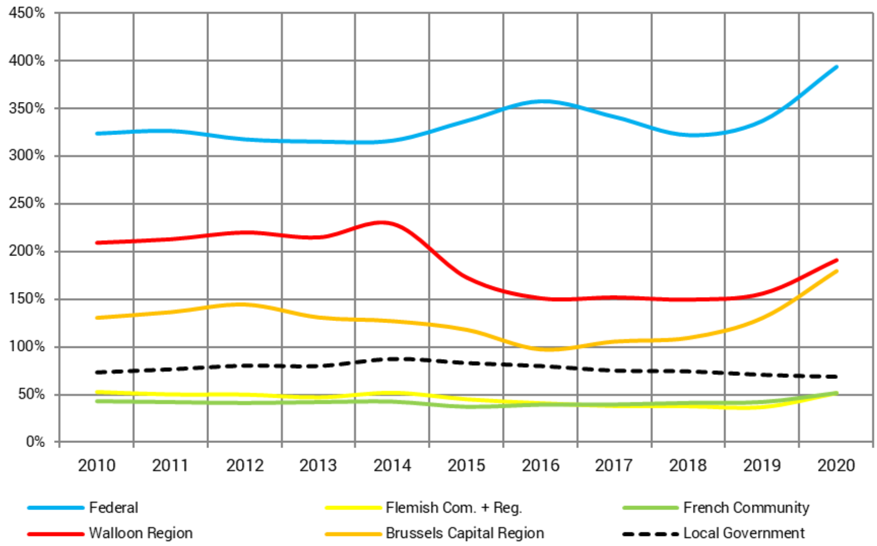
Chart 2-3: Evolution of the budget balance by federated level (as a percentage of revenue)



Source: NBB.stat

The same trend can be seen in Chart 2-4, which compares the total debt of the various Belgian levels of government with its share of their annual revenues since 2010. Such parameters give a clearer picture of the size of the public debt in the federated entities. Here too, the federal government, the Walloon Region and the BCR recorded the least favourable figures.

Chart 2-4: Debt as a percentage of annual revenue



Source: NBB.Stat

The structure of Belgian public finances has changed significantly several times in recent decades. The last major change took place with the 6th State Reform which came into force in 2014. The adjustments made to public finances in 2014 were mainly based on improved financial coordination between the various federated levels. The fiscal policy of each federated level has an impact on the other authorities; it is therefore important that the federated entities coordinate their fiscal policies in order to meet certain fiscal targets. This is the aspect that the last State reform focused on by introducing a number of new measures aimed at strengthening this fiscal coordination.

Until the 6th State Reform, fiscal coordination in Belgium was mainly achieved through a cooperative approach between the various levels of government on the basis of the opinions and recommendations of Belgium's High Council of Finance (Conseil supérieur des finances, or CSF), the traditional advisory body in Belgium for fiscal policy and public finances at the various federated levels. Intra-Belgian fiscal coordination mechanisms have existed for a long time - since the late 1980s and early 1990s - when Belgium officially evolved into a federal state. Not only did the division of fiscal competences and the increased fiscal autonomy of the federated levels oblige Belgium to strengthen its fiscal coordination, but the European level also made things evolve in this direction, due to the introduction of the SGP and the Maastricht criteria (Van Rompuy, 2005).

For example, long before the 6th State Reform, the Consultation Committee (Comité de concertation) was created with the aim of facilitating the pursuit of an overall budget balance or consolidation. This consultation body consists of the Prime Minister and all the ministers concerned from the various entities and aims to reach a consensus on budgetary/fiscal matters. However, the committee's decisions are in no way binding. Reaching agreements has always been particularly difficult within the Consultation Committee. The aim of the 6th State Reform was therefore to ensure the participation of the various federated levels and to step up efforts to achieve greater fiscal coordination.

The various public authorities have therefore agreed to seek a structural budget balance in the medium term, known as the 'golden rule' (Bayenet, Bourgeois & Darte, 2017). More specifically, a general budgetary trajectory has been drawn up between the various levels of government on the basis of the CSF's opinion. This opinion must be accepted by the Prime Minister and the Ministers-Presidents of the federated governments in the Consultation Committee. In addition, it is the task of the CSF to monitor and evaluate compliance with these agreements. If an administration deviates significantly from these agreements, it should rectify the situation within 18 months.

The content of this formal framework established by the 6th State Reform could be favourable to fiscal coordination and Belgian public finances, but the reality shows that it is not fully applied. What is more, the Consultation Committee has so far only managed to reach agreement on the distribution of the budgetary trajectory on one occasion. Belgian fiscal coordination therefore exists mainly on paper and not in practice. In this way, the CSF has also been sidelined for years, since its correction mechanisms cannot be applied as long as there is no agreement between the public authorities.

Strong fiscal coordination is also important for Europe. The European Commission is only interested in the overall result, i.e. the fiscal figures for Belgium as a whole. Europe is not engaged in directly controlling or adjusting public finances in the federated states of its Member States. The European Commission will therefore not negotiate with, for example, the Walloon or Flemish region. It will limit itself to the national level. Member States organised according to a federal fiscal system are supposed to coordinate their budgets internally in such a way that each federated government or subsidiary public authority contributes to the achievement of the overall national fiscal objectives (Van Hecke, 2013). However, the most recent Belgian fiscal figures show that this is not yet the case, or that it is not yet the case to a sufficient extent.

3 The main principles of European fiscal governance[5]

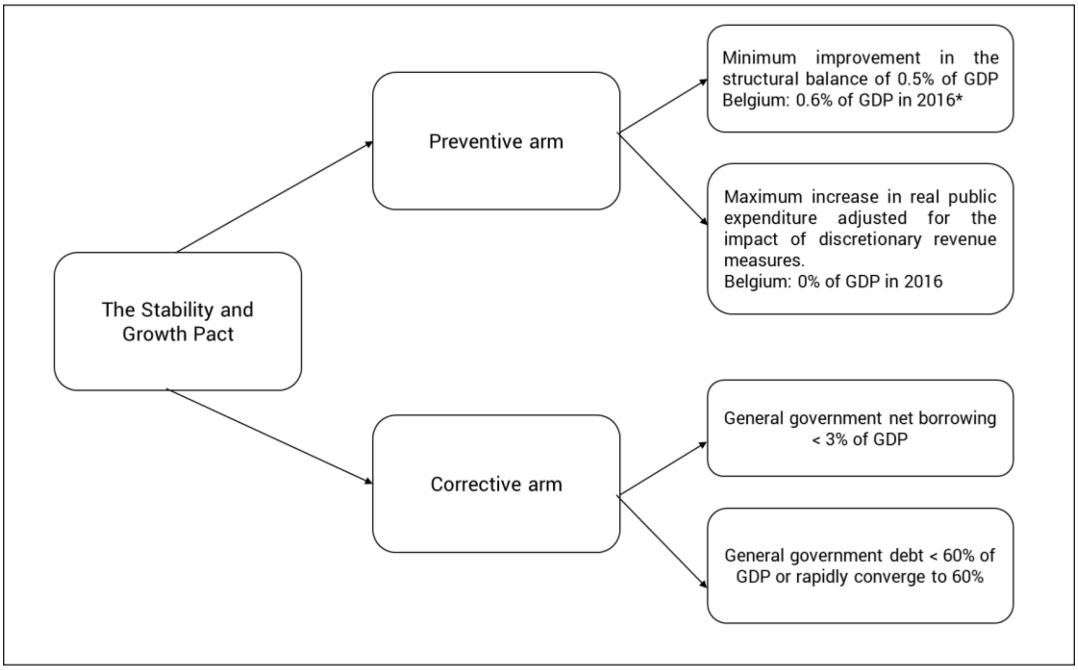
The SGP was established at the same time as the single currency in order to ensure sound public finances in the euro area[6] . However, the crisis of 2008-2009 revealed the weaknesses of the European framework for fiscal governance. The SGP proved to be ineffective during the crisis, as 24 out of 28 EU States were under the excessive deficit procedure. In other words, these Member States did not respect the reference criterion for public deficits, i.e. a nominal deficit level of less than 3% of GDP. The European Union therefore quickly implemented numerous measures to improve fiscal governance in Europe and to organise solidarity mechanisms that did not exist at the time of the crisis. The new European fiscal governance is the result of an "addition" of rules adopted as the European public finance and debt crisis unfolded over the last decade. These include the Six Pack (entered into force in December 2011), the Two Pack (entered into force in May 2013), the European Semester, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (entered into force in January 2013).

[5] For a historical analysis of the implementation of Belgian fiscal governance and its application in Belgium, see in particular the chapter "Assainissement des finances publiques en Belgique et gouvernance budgétaire européenne" in Bayenet B., Bourgeois M. and Darte D., Les finances et l'autonomie fiscale des entités fédérées après la sixième réforme de l'État, Larcier, 2017, pp. 993.

[6] European Commission, "Beyond the Six Pack and the Two Pack: Economic Governance in Plain English", Memo, 10 April 2013 (http://europa.eu/rapid/press-release_MEMO-13-318_fr.htm).

Strict numerical fiscal rules...

Figure 3-1: Fiscal rules under the Stability and Growth Pact



* In 2016, the Belgian authorities made an extra effort to achieve a budget balance of 0.6% of GDP.
Source: Bayenet et al, 2017

European States must meet the requirements for both the *preventive* and *corrective arm* of the SGP. The practice of designating two arms (parts) was legally enshrined in Regulation (EU) No 1173/2011 of the European Parliament and of the Council of the European Union of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area[7] .

The preventive arm of the Stability and Growth Pact aims to ensure sound budgetary policies over the medium term by setting parameters for Member States' fiscal planning and policies during normal economic times, while taking into account the variability of the economic cycle[8]. The preventive arm therefore concerns all Member States, regardless of whether their deficit is below or above 3% of GDP.

As part of the preventive arm of the Pact, the structural balance of each State must respect a medium-term objective (MTO). The minimum MTO levels for each State are

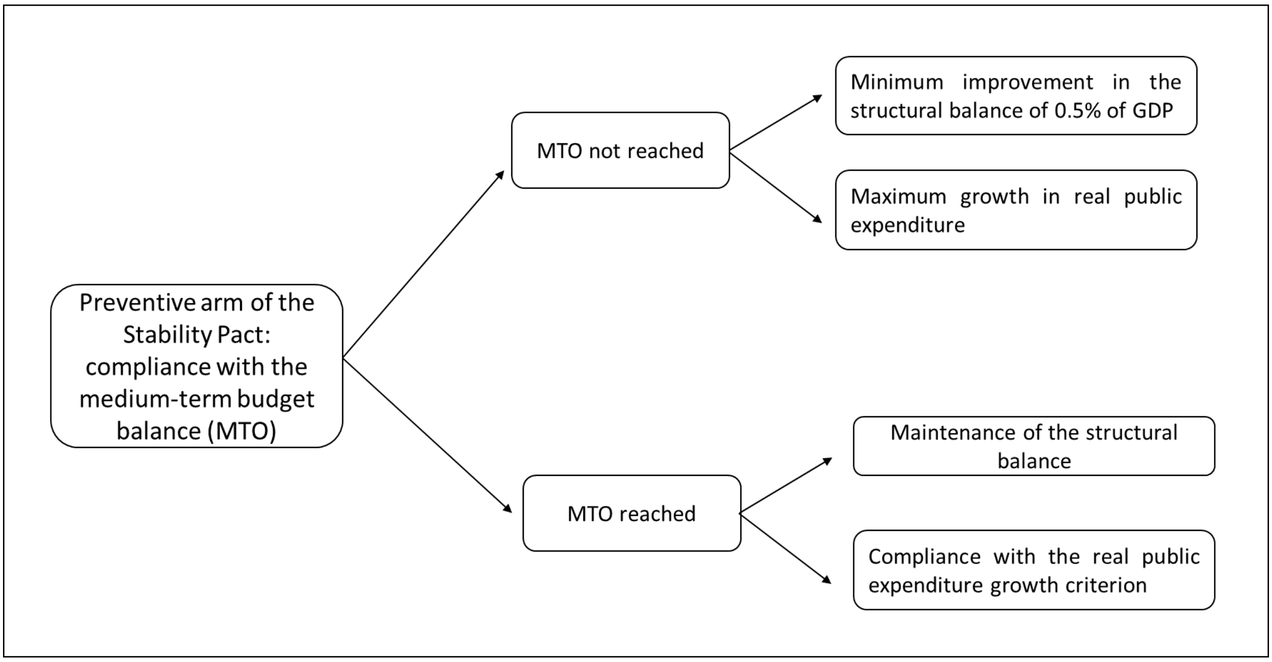
[7] Report No. 22 on behalf of the Finance Committee on the draft law adopted by the French National Assembly after the accelerated procedure authorizing the ratification of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, Ordinary session 2012-2013, Senate, France, p. 33.

[8] This means, for example, that all states pursue a prudent fiscal policy in good economic times as part of a countercyclical policy. It also implies that they keep their debt levels under control in times of strong growth.

calculated every three years by the European Commission[9]. States that have not yet reached their MTO should progress towards it at an appropriate pace and respect an adjustment path. Progress is assessed by analysing the evolution of the structural balance and the evolution of government expenditure (net of discretionary revenue measures). The improvement in the structural balance is determined on the basis of the cyclical situation and the finances of the State concerned. If it has not reached its MTO, it must improve its structural balance by at least 0.5% of GDP per year (the effort is greater if the State has a debt level of over 60% of GDP).

The rule on public expenditure growth requires that the growth rate of public expenditure (in real terms) may not exceed a reference rate set according to the potential growth rate of the economy over the medium term. For countries that have not reached their MTO, the increase in public expenditure cannot exceed the reference rate (unless the excess growth is offset by new revenues) set to ensure sufficient progress towards the MTO.

Figure 3-2: The preventive arm of the Stability and Growth Pact



Source: Bayenet et al, 2017

When countries fail to meet their MTO and their expenditure benchmark, they may be subject to a significant deviation procedure by decision of the Council of the

[9] This determination can be made more frequently if a Member State undertakes structural reforms likely to influence the sustainability of its public finances (MELYN et al., *op. cit.*, 2015, p. 90).

European Union. This can lead to sanctions whereby Member States must make an interest-bearing deposit of 0.2% of their GDP. This procedure allows Member States to correct a deviation from their MTO or from the adjustment path towards their MTO in order to avoid being subject of the corrective arm of the SGP.

Under the corrective arm of the Pact, Member States must avoid excessive deficits and/or debts. Deficit and debt criteria are placed on an equal footing to assess compliance with fiscal discipline. These criteria relate to a debt that exceeds 60% of GDP and that does not sufficiently decline[10] , or to a fiscal deficit and expenditure trend that is deemed insufficient. The Council of the European Union decides whether a Member State is turned over to the corrective arm, also known as the excessive deficit procedure, which involves stricter conditionality and monitoring.

The corrective arm contains the following rules:

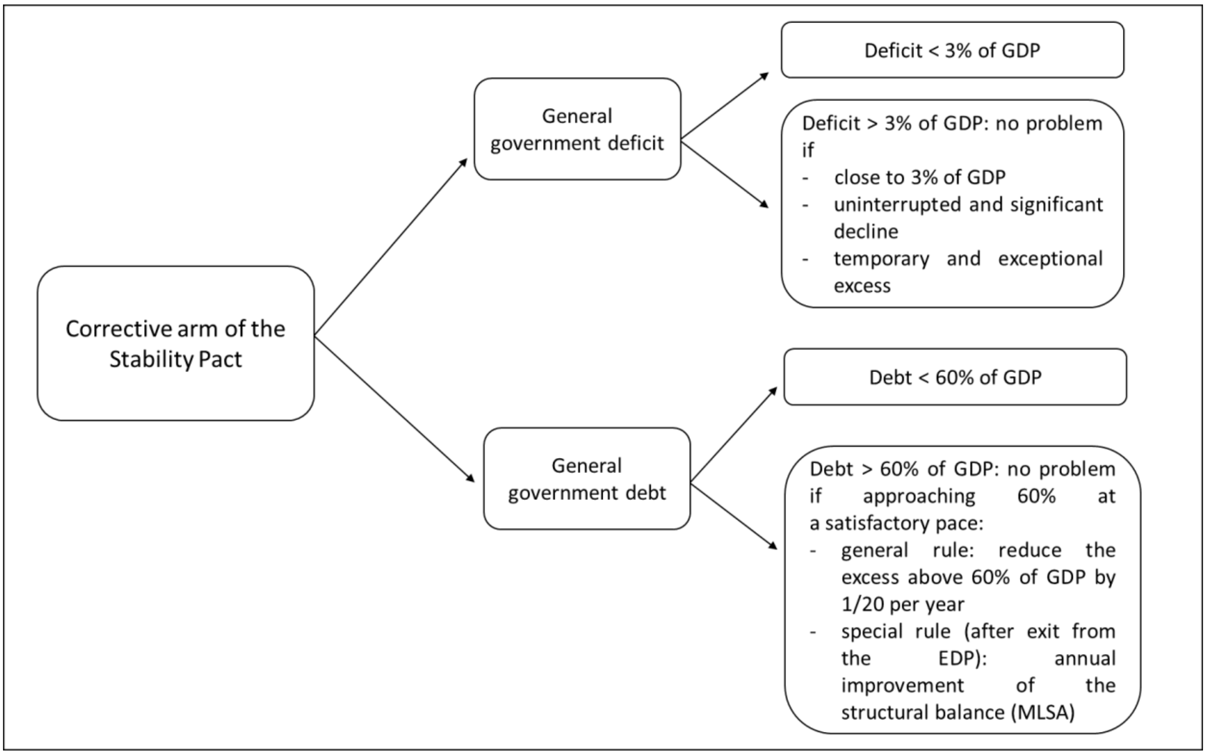
- the deficit criterion: the nominal balance may not exceed the reference value of 3% of GDP unless the excess is of a limited and temporary nature and is due to exceptional circumstances (beyond the control of government or resulting from a severe economic downturn)[11];
- the debt reduction criterion or debt criterion: the difference between the debt ratio and the reference rate (60%) must be reduced by $1/20^{th}$ per year on average over three years (according to a retrospective approach or, failing that, a prospective approach[12]).

[10] The excess over 60% should decrease by 5% a year on average over three years.

[11] Article 126(2) TFEU.

[12] The retrospective approach calculates the 1/20th reduction based on data from the current year and the previous two years, whereas the prospective approach assesses the same reduction based on data from the current year and the following two years (CSF, op. cit., November 2014, p. 24).

Figure 3-3: The corrective arm of the Stability and Growth Pact



EDP: excessive deficit procedure; MLSA: minimum linear structural adjustment
Source: Bayenet et al, 2017

The procedure ends when the deficit falls below 3% of GDP on a permanent basis and the government debt follows an appropriate path, determined by the EC. If a Member State does not respect the conditions of the excessive deficit procedure, sanctions can be imposed by the Council of the European Union. The sanctions start with the obligation to pay an interest-free deposit of 0.2% of GDP to the EC. This deposit will be converted into a fine of up to 0.5% of GDP if the recommendations to correct the excessive deficit are not respected.

...with room for flexibility...

In order to be able to take account of exceptional economic circumstances and to leave room for structural reforms or strategic public investments, a certain amount of flexibility has been incorporated into the fiscal rules. The MTO refers to the structural fiscal deficit and therefore already takes into account the current economic situation. On 13 January 2015, the European Commission published a communication providing guidance on how best to use the flexibility within the existing rules of the Stability and Growth Pact (SGP)[13] .

[13] COM(2015)12: Making the best use of the flexibility within the existing rules of the Stability and Growth Pact

- Taking account of the economic situation

The modulation of the fiscal adjustment over the economic cycle is represented by a "matrix of requirements" (Table 3-1). This matrix gives a detailed breakdown of the required annual adjustment taking into account the economic cycle, the debt level and the risks to the sustainability of public finances in each Member State. The economic cycle is captured by the output gap, i.e. the difference between actual output and estimated potential output. The larger the positive (negative) output gap, the greater (lower) the required adjustment effort[14]. Unfavourable overall fiscal positions require a faster fiscal adjustment, specifically in case of fiscal sustainability being at risk or the debt-to-GDP ratio above the 60% of GDP reference value.

Table 3-1: Structural balance improvement required in the MTO path

	Condition	Required annual fiscal adjustment	
		Debt ≤ 60% and no sustainability risk	Debt > 60% and no sustainability risk
Exceptionally bad times	Real growth < 0 or output gap < -4	No adjustment needed	
Very bad times	-4 ≤ output gap ≤ -3	0	0,25
Bad times	-3 ≤ output gap < -1,5	0 if growth below potential, 0,25 if growth above potential	0,25 if growth below potential, 0,5 if growth above potential
Normal times	-1,5 ≤ output gap ≤ 1,5	0,5	>0,5
Good times	-3 ≤ output gap Output gap ≥ 1,5	>0,5 if growth below potential, ≥ 0,75 if growth above potential	≥ 0,75if growth below potential, ≥ 1 if growth above potential

Source: Henk Van Noten Webinar 6 May 2021 (DG ECFIN)

- Taking account of structural reforms

A temporary and limited relaxation of the required fiscal adjustment was introduced to support the implementation of structural reforms. This relaxation was introduced in both the preventive and corrective arm of the SGP.

In the preventive arm of the Pact, the Commission now takes into account the positive fiscal impact of structural reforms, provided that these reforms (i) are major, (ii) have verifiable and direct long-term positive budgetary effects, including an increase in potential growth and (iii) are fully implemented.

[14] It should be noted that the required fiscal adjustment can be temporarily interrupted but not reversed. Flexibility is therefore limited to the operation of automatic stabilisers.

For reforms to be considered eligible, Member States must present a dedicated structural reform plan containing detailed and verifiable information, with credible timelines for adoption and delivery. The Commission then examines this reform plan to see if it can recommend allowing a temporary deviation from the MTO or the adjustment path towards it.

In the corrective arm of the Pact, the Commission shall take into account the existence of a dedicated structural reform plan, providing detailed and verifiable information, as well as credible timelines for adoption and delivery, when recommending a deadline for the correction of the excessive deficit or the length of any extension to that deadline.

- Taking account of investment programmes

Member States can promote investment by temporarily deviating from their medium-term objective or the fiscal adjustment path in the preventive arm of the SGP. However, Member States can only apply this so-called investment clause under very strict conditions. It only applies to countries with negative GDP growth or where GDP remains well below its potential, resulting in a negative output gap greater than 1.5% of GDP. National investment expenditure is also only eligible if the projects are co-financed by the EU under the Structural and Cohesion policy, Trans-European Networks and Connecting Europe Facility, or if they are co-financed by the European Strategic Investment Fund. Investment levels must effectively increase.

The deviation may not lead to an excess over the 3% fiscal deficit threshold and a safety margin must be preserved. The deviation must also be compensated within the timeframe of the Member State's Stability or Convergence Programme, i.e. within four years of the entry into force of the investment clause. The Commission applies the latter criterion by virtue of the requirement that the deviation between the structural budget balance and the medium-term objective may not exceed 1.5 percentage points of GDP.

Member States subject to the corrective arm of the Pact, and thus to the excessive deficit procedure, cannot benefit from this flexibility, although small and temporary deviations from budgetary paths are allowed under the code of conduct adopted by ECOFIN.

...for the proper functioning of monetary policy and the single market...

The logic of not allowing public debt to increase further was that national savings would be a constant share of GDP, so that increasing public debt would eventually lead to foreign debt or debt at the expense of domestic private investment (Creel et al., 2021).

However, it is also questionable why the EU sets rules for national public finances. This may be explained by the need for a stable monetary framework for the proper functioning of the single market. Within the EMU, monetary policy is centralised at the level of the ECB, while fiscal policy is decentralised to the Member States. This means that an unhealthy fiscal policy in one euro area country could lead to higher interest rates for other countries (negative externality). Furthermore, the aim was to avoid a situation where countries would no longer be able to repay their debts, which would require a bail-out by the other countries or the ECB and therefore undermine confidence in the whole euro system. We saw this during the euro crisis from 2010 onwards, when several euro area countries were targeted in the financial markets and the ECB's independence was compromised when it was forced to intervene[15] . Moreover, if the ECB finds itself forced to use all possible means, a conflict may arise with its 2% inflation target over the medium term in the euro area.

It is also important for EU Member States outside the euro area that the value of their currency does not fluctuate significantly, as this would considerably disrupt the movement of goods, services and capital. A credible fiscal policy is an essential pre-condition in this respect[16] .

...coordinated by the European Semester

The *European Semester* is the main framework for economic and social policy coordination. It aims to provide an integrated approach by blending the various strands of economic policy surveillance—fiscal, structural and financial policies—under a common timeline and framework for the annual surveillance cycle (EC, 2020). The European Semester leads to the validation and adoption of country-specific recommendations by the Council of the European Union. These recommendations are drawn up by the Commission on the basis of the national reform programmes and stability or convergence programmes submitted by the Member States. Their content is the subject of a dialogue between the Commission and each Member State. The Semester therefore goes well beyond a simple coordination framework: it allows the Union to influence the content of national socio-economic policies. On the other side, it also allows the authorities of some Member States to insert reforms into these recommendations in order to facilitate their adoption at national level.

[15] Countries such as Portugal, Ireland and Spain were mainly targeted because of their financial sector problems, but sound public finances were ultimately crucial to restoring confidence.
[16] Another possible reason for European rules on national public finances concerns demand externalities, whereby stimulus policies or savings in one country lead to higher or lower macroeconomic demand in its trading partners respectively. However, this consideration is unlikely to have played a major role in the design of the European fiscal framework (see below).

4 Main problems identified by the different actors and preliminary evaluations

The EC recognises that there are problems with the way EU finances are organised today, which is why it has launched a wide-ranging public debate on the issue. The European Fiscal Board (EFB) has also highlighted a number of problems. In this chapter we distinguish as far as possible between the problems raised by the EC and the EFB, and additional problems identified by third parties.

Macroeconomic stabilisation

On average, fiscal policy in the euro area has been pro-cyclical in recent years, especially during economic downturns. The European fiscal rules have therefore not been able to achieve a macroeconomic stabilisation policy. (IMK 2020, Creel et al. 2021, EC 2020, EUIFI 2021)

The current rules are not only inadequate to mitigate economic cycles, but they also fail to cope with divergent economic developments within the EU. Indeed, in the past, fiscal dynamics in the EU have not always been able to absorb asymmetric shocks and avoid destabilising the financial and monetary system. This has forced the ECB to take on this stabilisation task. It also shows that the current rules do not sufficiently take into account the negative spillover effects on other euro area Member States.

In its review of European economic governance, the EC highlights a number of factors that complicate its macroeconomic stabilisation policy. For example, while the EC and the Council of the European Union can outline measures to reinforce the co-ordination of budgetary and macroeconomic policy at the euro area level, they cannot enforce the appropriate fiscal stance for the euro area as a whole. This limits the impact of European recommendations and helps explain why the euro area dimension is still not central to Member States' policies.

The Stability and Growth Pact requires a minimum budget balance of 3% of GDP. However, as André Sapir pointed out in the webinar on 23 September 2021, this is a threshold that should not be exceeded, and in normal circumstances Member States should aim for a balance or surplus[17] . In addition, there is a distortion in that there are EU procedures for the correction of large public deficits but no fiscal policy to

[17] As a result, the minimum structural budget balance according to the MTO is higher (i.e. -0.5% or -1% of GDP), except in exceptional circumstances where the escape clause is activated.

support economic activity can be enforced. The procedure surrounding macroeconomic imbalances is also problematic because the scoreboard for evaluating imbalances uses asymmetric indicators. For example, a current account surplus would be a potential risk if it exceeds 6% of GDP, while a deficit would already be a problem at 4% of GDP (IMK 2020).

There is therefore a mismatch that makes a budget surplus much less problematic under European rules than a deficit[18] . However, the question can be asked whether a government is right to run a surplus when it could be investing in growth-enhancing, self-financing projects. This is not a problem as long as the private sector is willing to absorb the surplus (i.e. borrow) and can invest it profitably. However, when excess savings are invested in unproductive activities or, in search of profitability, in risky activities that can lead to speculative bubbles, this becomes a problem.

Surplus savings in one country can be absorbed by the lack of savings in other countries and again this should not be a problem as long as they are used productively, but again there is a risk that this will lead to unsustainable debt and problems in the financial markets. This risk is all the greater in the euro area as there is no automatic correction of macroeconomic imbalances, with the value of a currency rising (falling) when there is a current account surplus (deficit). Therefore, as European fiscal rules do not set limits on budget surpluses, it may be necessary to examine their impact on the private sector and the current account.

In addition, a government's fiscal policy affects the economy of other countries through foreign trade. After all, public savings have an impact on economic growth and on imports and exports[19] . When the governments of several trading partners are forced to make savings at the same time, this may reduce growth and imports in each of these countries, which puts pressure on their exports as well, further lowering growth and leading to a painful vicious circle. On the other hand, the impact of a country's fiscal savings could be offset to some extent if their trading partners pursue expansionary policies. Blanchard et al (2021) point to demand externalities in this respect: as some of the positive effects of demand-side policies are exported, each country tends to under-utilise its fiscal space. This is even more problematic within a monetary union such as the euro area, because monetary policy cannot be used to offset the cross-border effects of a fiscal stimulus. Similarly, Martin et al

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[18] According to a number of authors, this distortion is linked to the negative moral connotation of the word *schuld*, which means debt as well as guilt in particular in German and Dutch (see for example Graeber, 2011), which O. Blanchard also confirmed in the webinar on November 8th 2021.

[19] The exact effects depend on many factors. For example, savings may be offset if they induce consumers to save (i.e. Ricardian equivalence) and/or reduce the interest rate and encourage private investment. In practice, however, public savings do not seem to be fully offset by private savings (see below).

(2021) point to the existence of demand externalities that were largely ignored in the Maastricht Treaty. The main concern at the time was the effect of fiscal policy on interest rates in other Member States and on trust in the euro system.

After the financial crisis, the Six Pack and the Two Pack sought to improve economic policy coordination within the euro area. The scope of economic surveillance was extended to macroeconomic imbalances, rules were introduced for the monitoring and (multilateral) evaluation of the budgetary plans of the euro area Member States, and a framework was created for those euro area Member States that are facing difficulties, or are at risk of facing difficulties, with regard to their financial stability. However, this did not prevent Member States' fiscal policies from remaining largely pro-cyclical and the distribution of the fiscal stance across Member States was not appropriate in light of specific sustainability and stabilisation needs (EC 2020).

As mentioned earlier, the surveillance and correction mechanisms of European governance are mainly aimed at avoiding budget deficits and not so much surpluses. The EC (2020) considers that the limited ability to steer the fiscal stance for the euro area as a whole, with the appropriate differentiated fiscal effort among Member States, is also hampered by the lack of prudent policies in good economic times. The European Fiscal Board (2021) agrees that prior to the pandemic, Member States were too lax in implementing the EU recommendations and that growth was not sufficiently used to eliminate deficits. The latter, according to the EC, is partly due to the fact that it rests exclusively on the coordination of Member States' fiscal policies. The absence of a central fiscal capacity with stabilising features also limits the EC's ability to use fiscal policy to withstand large shocks.

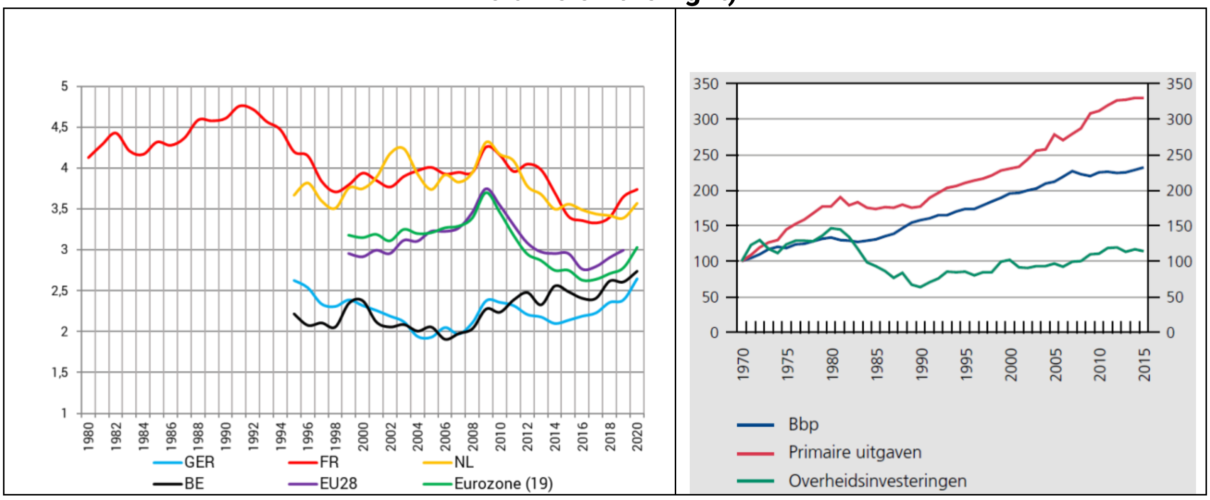
Consequently, European fiscal rules do not yet sufficiently take into account the cross-border effects of public finances, and in particular public savings, on other countries. It is therefore not surprising that the EC (2020) notes that the procedure for macroeconomic imbalances has been more successful in reducing current account deficits s than it has been in reducing persistent and large current account surpluses. Furthermore, the EC states that the current surveillance framework and its implementation did not ensure a sufficient differentiation between Member States that have markedly different fiscal positions, sustainability risks or other vulnerabilities, and that the interplay between Union fiscal rules and national fiscal frameworks is another area of improvement.

Investments

General rules for budget deficits, expenditure growth or public debt have no bearing on how revenues are raised and on the quality of public spending. However, there are provisions that allow for this to be taken into account. For instance, when assessing whether an excessive deficit exists, the EC must take into account government investment expenditure and, according to the SGP, the overall quality of public finances in terms of growth-friendliness of the tax system and government expenditure must be taken into account. The need for public investment is also underlined in the context of the medium-term budgetary objective. Overall, however, the current fiscal framework did not prevent a decline in the level of public investment during periods of fiscal consolidation, nor did it make public finances more growth-friendly. (EC, 2020)

The EC attributes this to policy choices in the Member States.**Erreur ! Source du renvoi introuvable.** 4-1 shows that the evolution of public investment has been fairly constant over the last decades, with the exception of a decline in the majority of Member States after 2010, which cannot be explained solely by European fiscal rules. Similarly, Member States' low use of the investment clause that protects investment in the event of a deep recession and of the structural reform clause would indicate that they are reluctant to invest more or that this clause is difficult to use[20] .

Chart 4-1: Evolution of public investment (in % of GDP on the left, Belgium 1970 = 100 in volume on the right)



Sources: Eurostat, ICN and BNB (Rapport sur les investissements publics, October 2017)

The EC (2020) is aware that investments are currently too low to support growth and make the EU economy climate-neutral by 2050, and is therefore exploring with Member States the greater use of green budgeting tools.

[20] Only two Member States used the investment clause in 2016 and the structural reform clause has been used only five times so far.

Darvas and Wolff (2021) argue that fiscal rules disadvantage public investment too much. They note that (net) public investment has declined significantly during periods of fiscal consolidation in the EU. Between 2009 and 2013, for example, gross public investment fell by 0.8 pp. In the EU and in countries that faced heavy market pressure, such as Greece and Ireland, public investment was cut more dramatically. This is all the more problematic in view of the annual investments needed to meet climate targets, which Darvas and Wolff estimate would have to increase immediately by about 2% of GDP to gradually increase to about 5.3% to 7.0% of GDP after 2030[21]. About a quarter of this amount will have to be public investment. When it comes to reducing the fiscal deficit, politicians prefer to save on investments rather than on current expenditure, because the future generations who would benefit most are under-represented in the electorate and because investments are treated as current expenditure in the fiscal rules, while their returns are spread over longer periods. However, it is difficult to know to what extent European fiscal rules are the cause of low public investment.

Complexity, flexibility and applicability

In its review of European economic governance, the EC recognises that the current EU framework has grown excessively complex. This complexity results from the framework pursuing multiple objectives and the need to cater for a wide variety of evolving circumstances, including by the use of flexibility, in a context of divergences of views among Member States. It is reflected in a very detailed codification, encompassing several operational indicators of which a number are non-observable and frequently revised, as well as a variety of escape clauses. This requires the use of economic judgement. In addition, the framework relies heavily on variables that are not directly observable. The complexity and lack of transparency of the rules hampers ownership, communication and political buy-in. The EC also notes that medium-term budgetary objectives are not sufficiently achieved, perhaps because of the focus on compliance with annual requirements, and that it is not easy to get Member States to change their plans at the end of the year.

Many others, including the European Fiscal Board, have also highlighted the very high level of complexity of the current EU fiscal framework (IMK 2020, EUIFI 2021). Debrun and Jonung (2018) point out that the initial rules, that were relatively simple, have become progressively more complex as new, more flexible rules have been introduced, notably through the SGP, to better take into account the economic context[22]

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[21] Jean Pisani-Ferry has made a similar estimate of the investments needed (webinar 17/11/2021).
[22] This was also explained in the webinar with Xavier Debrun: https://ccecrb-debat.com/quels-problemes-le-cadre-budgetaire-europeen-actuel-engendre-t-il/

. Additional clauses were then introduced to prevent abuse. In the end, there are norms for almost all public finances indicators (debt ratio, budget deficit, expenditure...). Strict sanction mechanisms have also been attached to these criteria. Ultimately, this becomes unenforceable. Complex and opaque rules stop being a reliable compass for policymakers, and the temptation to abandon them looms large. This may help explain why many fiscal rules are regularly breached, undermining their credibility. Debrun and Jonung argue that there is a trilemma in that only two of the three following basic properties of fiscal rules can be simultaneously achieved: simplicity, flexibility and enforceability.

Another difficulty is to reconcile the objective of stabilising public finances with that of sustainability. The public debt sustainability mandate is long term and imposes fiscal discipline on Member States. For example, the S2 indicator used by the EC in its assessment of sustainability identifies the permanent ex ante fiscal adjustment that is required to stabilise a Member State's public debt in the long run, taking into account future age-related expenditure. Counter-cyclical fiscal interventions have a shorter time horizon and presuppose fiscal autonomy. It is not easy to achieve both through a single set of numerical rules.

The 2012 Fiscal Pact aimed to strengthen the enforceability of EU fiscal rules by introducing automatic correction mechanisms in case of deviations from the medium-term objective by a Member State. However, the EFB (EFB, 2021) notes that these correction mechanisms differ significantly across Member States. According to the EFB, their effectiveness is mainly limited by the fact that the mechanisms are not triggered by the national surveillance authority but as a result of decisions by the EU institutions, which have a relatively high tolerance for slippages in public finances. However, the EBC believes that the solution does not lie in strengthening the role of national surveillance institutions, as they are too heterogeneous and minimum standards would not be met.

Indicators used

As mentioned, the EC recognises that the indicators used are biased, may have a pro-cyclical effect and contribute to greater complexity and less transparency.

During the webinar on 24 November 2021, Philipp Heimberger explained how the current method used to estimate potential output leads to pro-cyclical fiscal rules. The statistical model used by the EC to estimate potential GDP is based on the historical trend. This method is pro-cyclical because an improvement in the economy automatically leads to a higher estimate of potential output and vice versa (Schuster et al., 2021). Consequently, the output gap is underestimated when the economy is in rapid decline. This is reflected in how frequently the output gap has been revised for years of poor growth. As the EC decides whether or not to relax fiscal targets on the basis of the estimated output gap, this leads to overly tight fiscal policies during economic downturns.

An additional danger that Heimberger (2020) warns against is that the underestimation of potential output - and thus the overestimation of the structural budget deficit - in times of economic downturn and the subsequent under-stimulation of the economy have permanent negative consequences on the economy (hysteresis effects) and thus diminish potential growth. In other words, pessimistic assessments of potential growth have a self-reinforcing effect, which gets worse the longer a crisis lasts. This is also a statistical problem, as it is difficult if not impossible to determine whether underestimating potential growth even reduces it ex post.

The European fiscal framework puts a lot of responsibility on experts to estimate potential output. This is all the more problematic as there are often disagreements between the EC and some Member States on the size of the structural deficit (as with Italy in 2018). Philipp Heimberger raised the question of whether a democratic economic policy should depend on non-transparent and regularly revised statistical models. Mr Sapir, for his part, stressed the need for simple and enforceable rules.

The EBC (EFB, 2021) considers that there will always be a great deal of uncertainty around the indicators used, especially in the current framework where the emphasis is on annual reviews and recommendations. It therefore believes that the EU needs to move away from what it describes as 'fiscal micromanagement'.

Problems arise not only in the assessment of cyclical developments and structural fiscal efforts, but also in the determination of the size of the efforts needed to ensure the sustainability of public finances. Indeed, the long-term sustainability of public finances is determined by the evolution of primary balances, real interest rates and growth[23]. The larger the difference between interest rates and growth and the higher the current public debt ratio, the larger the primary surplus needed to avoid a derailment of public finances. Therefore, even if the measurement and application of the fiscal effort were not problematic, the extent of the effort remains uncertain. The EC indicator S2 aims to quantify the effort required. Based on an estimate of future revenues and expenditures, it calculates the primary balance that would allow for the stabilisation of public debt in the long run. This does not mean, of course, that the debt will automatically derail or disappear if the primary balance is below or above this debt stabilisation level, as this will also be determined by future primary

[23] See Blanchard and al (2021) or Krugman (2020) for a more detailed discussion.

balances. In other words, sustainability is an intertemporal criterion that implies both an additional uncertainty and a certain degree of freedom with respect to the required primary balance.

When European fiscal rules were first developed, it was thought that real interest rates were systematically higher than real growth, so that primary surpluses were necessary to avoid derailing public finances. However, over the last few decades, there has been a gradual decline in the neutral real interest rate (with aggregate demand equal to potential output)[24]. So we see that as a percentage of GDP, the total public debt of many EU Member States has increased in recent years while the interest burden has decreased. Currently, the difference between the real interest rate and growth is even negative for many EU Member States. Based on an empirical study of the structural determinants of the difference between the interest rate on public debt and economic growth for 17 OECD countries, and future projections of these determinants, Heylen et al. (2022) conclude that this difference could remain negative for more than a decade in most EU countries[25]. In this context, permanent fiscal deficits are compatible with sustainable public finances. This does not mean that the sustainability of public finances should no longer be monitored. For example, an increase in public debt can push up the interest rate (e.g. through a higher risk premium or because of the limited amount of savings available) and economic shocks can quickly increase public debt. While there is no consensus on the sustainable level of fiscal deficit and public debt, most authors agree that the current criteria are too strict, especially the maximum public debt of 60% of GDP. Moreover, there is no reason why the maximum sustainable public debt should be the same in all countries. It varies from country to country because of structural differences in their interest rates, growth and future primary balances. This is also reflected in the wide variation across countries in the S2 indicator, which quantifies the sustainability of public debt for each Member State. Uniform rules do not take this into account.

One of the reasons why fiscal rules would be relatively strict is that these rules were established on the assumption that there would be a crowding-out effect, with public debts absorbing available savings at the expense of private investment. However, since then, a new consensus has emerged that any increase in public debt need not be problematic, for example if it results from borrowing for investment. The large surplus of private savings is then used productively, with beneficial effects on the

[24] Common explanations for falling interest rates are an ageing population and rising income inequality, which lead to higher savings, or lower productivity growth, which reduces demand for (profitable) investments. (Rachel and Summers, 2019)

[25] These structural determinants include the rate of technological progress, the growth of the employment rate, inequality in society, demographic variables such as life expectancy and the level of public debt.

economy[26]. A fall in interest rates with an increase in public debt would also indicate that there is no shortage of savings. Moreover, the euro area has experienced low inflation in recent years, despite the ECB's stimulus policies. It is therefore clear that there is no economic rationale for capping public debt at 60% of GDP. (Creel et al., 2021; Heylen et al., 2022) The finding that several countries have not respected the 60% rule for years and that many countries will have a public debt above 100% of GDP after the COVID-19 crisis undermines the credibility of European fiscal rules. Martin et al (2021) also point to the sharp increase in public debt, largely due to the financial crisis from 2008 onwards and the COVID-19 crisis[27], with great heterogeneity between euro area countries. In this context, insisting on the need to move quickly to a debt ratio of 60% of GDP is likely to be harmful both economically and politically. A possible example of this was seen during the euro crisis, when severe austerity measures were imposed on Greece and some other countries, amplifying the crisis[28].

This problem is linked to the statistics used, which do not take into account assets in relation to debt. Although there is some flexibility around investment spending (see above), the public debt rule does not take into account public assets[29]. These assets increase the potential growth of the economy. There is also a problem when private debt is not taken into account (see André Sapir's webinar). It rose sharply in Spain and Ireland, for example, before the financial crisis and forced the government to intervene to stabilise the economy, which led to a rise in public debt. The evolution of private debt is one of the indicators to detect macroeconomic imbalances, but it has no other impact and therefore does not prompt the authorities to intervene in case of problematic developments[30].

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[26] Rachel and Summers (2019) also point to a reduced effect of public saving on private saving, as it has a different impact on working and retired individuals, whose saving behaviour differs. However, they point out that the real interest rate would have fallen much more due to changes in private saving and investment behaviour if public debt had not increased.

[27] The combined public debt of the ero area countries has risen from 66% of GDP in 2007 to 100% of GDP in 2020.

[28] The most stringent conditions, however, were linked to the provision of emergency funds and thus to a crisis situation requiring urgent and drastic action. The fact that these countries had to make the main effort also reflects the distortion that large budget and current account deficits are seen as a bigger problem than surpluses and the perception in the northern Member States, especially in Germany, that they themselves were the cause of their problems (see also Peter Praet's webinar).

[29] A difficulty here is the determination of this value.

[30] In the framework of economic surveillance of all imbalances, private debt indicators (debt of private actors, credit flows) are included at the same level as those relating to public debt. This is a step forward as the sustainability of debt (whether public or private) must be ensured at all times. Bad debts held by financial institutions are an issue that needs to be addressed to improve the transmission of monetary policy and the financing of the economy (ECB Economic Bulletin, 4/2017).

Integrated policy

We have already seen that the impact of one country's fiscal policy on others is still not sufficiently taken into account. In its assessment of European economic governance, the EC states that important links between individual surveillance instruments are not sufficiently taken into account, in particular where public debt sustainability issues are intrinsically linked to wider macroeconomic imbalances or low potential growth.

There is also a problem of uncoordinated fiscal and monetary policies within the euro area (see the webinar with Peter Praet for a more detailed discussion). Firstly, the ECB can only set a common interest rate for all euro area countries, so in the absence of a central fiscal capacity, euro area countries have to rely on fiscal policy to stabilise their economy when the interest rate is too high or too low[31]. In addition to the heterogeneity of the economic cycles among euro area countries, monetary policy also depends on fiscal policy to stabilise the economy when interest rates cannot fall any further. Fiscal policy is more effective than monetary policy in stimulating the economy in such a situation, which is associated with larger fiscal multipliers (Martin et al., 2021). We are in such a situation today, as the real interest rate is even negative for some countries. This was not foreseen when the Maastricht Treaty and the SGP were drawn up.

There is an ongoing debate within the ECB as to whether the rules should be adjusted to allow for more targeted interventions in the financial markets after the pandemic, in order to ensure that its interventions have the desired effect for individual Member States and to be able to act in a stabilising manner when Member States are being targeted by financial markets. One difficulty, however, is to distinguish between speculative movements, which justify stabilising intervention by the ECB, and fundamental developments in the sustainability of public finances, which do not justify intervention without strict conditions. This discussion is important not only for the ECB but also for the other European institutions.

The EC also raises the question of whether the surveillance framework should help tackling today and tomorrow's pressing economic, demographic and environmental challenges. The current EU framework for economic governance pays little attention to the policy mix in the euro area and offers little support or guidance for desirable economic, environmental and social developments.

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[31] The ECB's statute states that it cannot intervene in the bond markets of individual Member States in a targeted manner. Through *Outright Monetary Transactions* (OMT), it is possible to buy bonds of individual Member States on the secondary markets, but this involves a cumbersome procedure whereby Member States have to apply for support and fulfil various conditions.

One aspect of this issue that was raised during the webinar with Zsolt Darvas on 6 October 2021 concerns public revenues. While the European fiscal framework looks at the evolution and composition of public expenditure, it does not really take into account how revenues are generated. However, this interacts with the objectives on the expenditure side. The revenue from a carbon tax, for example, contributes to the transition to a carbon neutral economy.

5 Possible improvements in European fiscal policy

Some want to return to the situation before the COVID crisis once the escape clause is deactivated. Spokespersons for the FDP, the party of the German Finance Minister, said at the end of 2021 that the SGP had already proved its flexibility with the temporary suspension of the rules and that the 3% and 60% rule should not change. They call for a better implementation of the current rules, with automatic sanction mechanisms. They also believe that the excess over 60% should be eliminated in 20 years, but not necessarily on a linear path. The German coalition agreement would leave room for a possible reform of the SGP, focusing on growth, sustainable finances, investment and simpler enforcement[32].

The EFB (2021), on the other hand, considers that a genuine reform of the European fiscal framework is needed and that tweaks in the implementation of the existing rule book will not be enough. In the absence of a thorough reform, the EU institutions should spell out transparently how the necessary flexibility and constrained discretion vis-à-vis the 'Maastricht numbers' will be applied.

Such far-reaching reforms, which require changes to the current rules, depend of course on the political will to adopt them. An adjustment of the European treaties and national rules is much more difficult to achieve than a change in the application or interpretation of the current rules. Any modification of a European treaty requires the agreement of each Member State. The assessment of the solutions proposed here to the problems with the current European fiscal rules should therefore take into account their political feasibility[33] .

5.1 Exploiting the flexibility of the current rules

European fiscal rules are not defined in detail in the various European treaties. There are built-in flexibilities and room for interpretation around many rules. For example,

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[32] Source: https://www.euractiv.com/section/economy-jobs/news/germany-rejects-relaxation-of-eu-fiscal-rules/
In addition, one FDP member felt that there was room for flexibility with regard to future-oriented investments.
[33] During the webinars organised by the CCE, more radical ideas such as government revenue standards (Darvas) or structural indicators other than those related to the output gap (Heimberger), for example, were considered unrealistic.

the general escape clause of the Stability and Growth Pact provides for flexibility in the event of a severe economic downturn in the euro area or the Union as a whole. It has also been stipulated that the 3% deficit rule does not have to be respected when justified by economic circumstances, but the nature of these circumstances is not specified. The SGP also does not set a timeline for the elimination of excessive deficits, but only states that they must be reduced by at least 0.5% of GDP per year until the overall deficit falls below 3% of GDP. The European Commission could go further by using the flexibility available in the current rules.

Maintaining the current rules would avoid the need for further negotiations that could create tensions between European Member States. However, it would mean that unrealistic or undesirable measures, such as the need to achieve a debt-to-GDP ratio of 60% within 20 years, would remain in place.

A flexible interpretation of the current rules gives a great deal of responsibility to the European Commission, which can lead to legal and political problems, as has been seen regularly in recent years.

The European Recovery and Resilience Facility (RFF)

Many of the problems highlighted in this report are related to the lack of fiscal capacity at EU level. For example, euro area countries may find themselves in difficulty when hit by asymmetric shocks and, due to the centralisation of monetary policy, cannot be supported by a flexible monetary policy, which ultimately threatens to destabilise the whole monetary union.

With the creation of the RRF, a step towards a central European fiscal capacity has been taken. Its importance should not be underestimated, as evidenced for example by the immediate decline in risk premiums on the sovereign debt of a number of European countries, which had risen at the beginning of the COVID-19 crisis, immediately after the announcement of the facility[34] . The creation of this fund sent a strong signal that the EU was ready to support countries facing asymmetric shocks. This importance was reinforced by the fact that almost half of the funds provided were in the form of a grant, that the most severely affected countries received the most support, and that part of the funds were financed by a loan from the European Commission on behalf of

[34] A second factor that caused spreads to fall was the ECB's aggressive and targeted intervention in domestic debt markets, notably through the Pandemic Emergency Purchase Programme (PEPP).

the European Union on the money markets. This is therefore a strong signal of cohesion and solidarity within the EU. However, this signal wouldn't be as strong if the EC loan were not to be financed by new funds but by a reduction in other EU expenditure or by higher contributions from Member States.

However, the RRF was not created as a permanent instrument. It was created at a time of crisis when, unlike the European debt crisis of 2010-2012, it was considered that the crisis was not the responsibility of individual Member States as it was caused by an exogenous shock. This reinforced the willingness of all EU countries to share the cost of the recovery. However, nothing is set in stone for the future, and it is not clear whether there will be a return to the previous model after the pandemic or whether this is a first step towards a centralised EU fiscal capacity. The success of the RRF will probably play a major role in this respect. Both Peter Praet and André Sapir have stressed the importance of a proper implementation of the RRF, especially in Italy, which has received by far the largest share of the funds. It is therefore crucial that the RRF funds are well spent, in line with its objectives. In this way, they will effectively contribute to the climate transition, digitalisation and potential growth.

Indicators used

If it is not possible to revise the current indicators of fiscal governance, Philipp Heimberger believes that the estimation model that is used to calculate the *output gap* should at least be improved. Currently, *the output* gap - the difference between current and potential GDP - is measured as the level of output at which unemployment equals the NAWRU[35]. The NAWRU is estimated using historical data in arbitrary statistical models whose methodology is subject to debate. Schuster et al (2021) propose to calculate potential GDP based on a full employment situation, namely when the number of workers is equal to the current level plus the long-term unemployed, leaving only frictional unemployment[36] . Similarly, the number of hours worked and the participation rate in a situation of potential output - i.e. full employment - should no longer be estimated by models but replaced by official employment targets (e.g. increasing the female participation rate). These employment values must then be

[35] *Non-accelerating wage rate of unemployment*, i.e. the level of unemployment for which there is an equilibrium in the labour market such that there is no acceleration (or deceleration) in wage developments.
[36] The authors acknowledge that long-term unemployment also has a cyclical component, but they consider this indicator to be a good proxy for non-cyclical unemployment and the political goal of full employment.

introduced into the production function that the EC uses to estimate potential GDP. This would lead to larger output gaps, with a larger contribution of labour to potential growth, and thus create more room for counter-cyclical policies in the event of a downturn.

They prefer these indicators because they are determined by the democratic process and not by technocratic actors through an opaque model. They argue that this would increase the coherence of economic and fiscal policies. In this context, the authors note that the historical average of employment is not a good benchmark for the degree of full employment in the current context where employment rates, labour market participation and hours worked should increase to address the fiscal challenges related to population ageing and climate change. However, such an improved calculation of the output gap cannot guarantee the sustainability of public finances, which would require further monitoring.

The EFB (EFB, 2021) believes that due to their low degree of reliability, less reliance should be placed on narrow indicators to make policy recommendations on an annual basis. Furthermore, they point out that the threat of sanctions for minor transgressions of the rules is not credible, especially since these sanctions are to be imposed by politicians who risk being targeted themselves in the future. The EFB therefore advocates that the EC should focus on gross deviations over a medium-term period; this would also better take into account longer-term developments such as climate change and population ageing. However, the EFB is in favour of maintaining concrete reference values such as a maximum fiscal deficit of 3% of GDP or the debt norm of 60% of GDP, as this gives clear guidance to national policy makers.

Adapting or abolishing the 3% and 60% reference values requires an amendment to Protocol 12 of the TFEU. Many proposals therefore advocate maintaining these criteria but with adapted, simpler and less pro-cyclical framework rules. The numerous rules concerning the MTO, flexibility, the excessive deficit procedure, etc. would then be replaced by a simple expenditure benchmark, which would vary according to whether or not a country exceeds the 60% norm and where the budget deficit can fluctuate according to the cyclical situation. In addition, the requirement for an annual reduction of $1/20^{th}$ of the debt exceeding 60% could be replaced by an annual adjustment of $1/40^{th}$ or $1/60^{th}$. The EFB (EFB 2021, Beetsma et al., 2018) has a similar proposal, whereby the 3% deficit ceiling is maintained for all Member States, and if the 60% debt norm is exceeded, an expenditure ceiling is introduced, over a three-year period, to ensure that the debt reaches 60% over a given period. The length of this period may, however, be longer for countries with initially higher debt ratios. There would be no rules other than this expenditure benchmark, which would be calculated on the assumption that GDP follows its potential growth path and that inflation is 2%. The benchmark covers expenditure that is not matched by discretionary revenues[37] and the impact of cyclical unemployment benefits would not be included in the benchmark. GFCF expenditure would be spread over a four-year period. In addition, the independent European and/or national fiscal authority could trigger a national or general escape clause when justified by exceptional circumstances.

Martin et al (2021, see below) also support setting a target for the debt ratio and achieving it gradually by imposing an expenditure benchmark. In their view, however, the debt ratio target cannot be a uniform target (e.g. 60%) for each country.

Blanchard et al (2021) do not support the limited adjustments that remain in the current framework. In times of economic downturn, they may be too tight by not allowing discretionary fiscal stimulus beyond the prescribed maximum expenditure growth rate. In other circumstances, they could be too loose to the extent that the threat of derailing a country's public finances does not lead to the imposition of urgent measures. Similar to the trilemma of Debrun and Jonung, Blanchard et al. argue that providing sufficient flexibility to absorb shocks without jeopardising the sustainability of finances cannot be done without increasing the complexity of the fiscal framework and tailoring it to the context of each Member State, which goes against the proposals for simplification.

The main problem that Blanchard et al. see in a limited adjustment of fiscal rules is that, however complex, they do not fit well with the high uncertainty in the trade-off between macroeconomic stabilisation and fiscal sustainability. Because of this uncertainty, rules aimed at ensuring ex ante sustainability would leave almost no room for stabilisation and rules aimed at providing sufficient scope for ex ante stabilisation would quickly put public finances at risk.

5.2 A change in the fiscal framework

Investments

One way to prevent the deficit norm from being at the expense of investment and thus future growth is to go back to the famous 'golden rule', according to which current expenditure must be financed by current revenue and public debt can only be

[37] These are revenues that (as opposed to "automatic" changes due to changing economic conditions) result from government decisions to change certain revenue parameters. Expenditure can therefore increase by more than the allowed growth rate, provided that this increase is offset by new permanent revenue.

incurred to finance public investment[38]. Several authors, including Darvas and Wolff (2021), suggest introducing a variant of this rule into the European fiscal framework. Specifically, they argue that (net) green investments should not be included in the deficit norm. This would avoid savings being made at the expense of these investments, which are necessary to achieve the EU's climate objectives.

One of the difficulties is determining which investments should be considered green. The danger is that an unwise definition allows policy makers to label current expenditure as green investment in order to run excessive deficits without any future return. The EC has tried to avoid this by outlining a number of conditions that public expenditure must meet to be considered a green investment[39]. However, such a list leaves little room for nuance and is open to criticism[40].

There is also a debate about whether green investments ultimately promote growth and therefore increase public debt without, in the long run, improving financing capacity through increased GDP. However, there is a consensus that the absence of green investments and investments to deal with the effects of climate change would result in high costs in countries like Belgium, so they are cost-effective[41]. Nevertheless, green investments increase public debt and the impact on the sustainability of public finances should not be overlooked.

Another problem with a golden rule for green investments is that it could come at the expense of other necessary investments if the debt ceiling is kept at the same level and forces governments to make savings. This can be avoided by extending the golden rule to all investments. Another golden rule could then be that all investments that increase potential growth are not included in the deficit norm. This should avoid that the deficit norm comes at the expense of future growth, which would ultimately be detrimental to the sustainability of public finances. Martin et al (2021) are not in favour of this because there is too much discussion about which investments should be considered as productive (e.g. education and training). The economic codes of the European System of Accounts could help to prevent abuse. This is a decimal code that assigns a number to each expenditure item, depending on the nature of the transaction. For example, only expenditure that includes the code for public fixed

[38] In Belgium, this rule was respected for several decades after the Second World War but was abandoned in 1975 at the time of the oil crisis.
[39] For more information, see: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en
[40] For example, the EU taxonomy has been criticised for over-protecting certain polluting sectors due to political influence; for disadvantaging strategic sectors that do not have access to sustainable energy networks; for wrongly considering investments in nuclear and gas facilities as sustainable; for creating an unsustainable bubble in green assets, etc.
[41] The enormous damage caused by floods in the summer of 2021 is an example of this.

investment (code 7) would qualify as investment. If investments are excluded from the deficit norm but the debt ceiling is maintained, there is a risk that these investments will require further cuts in current spending that will undermine public support for these investments.

During his webinar, Olivier Blanchard did not favour an exemption clause for green investments because they would not be paid for by increased growth, which could harm the sustainability of public finances. Peter Praet also said that exemptions for (green) investments should be treated with caution because, to the extent that they are financed by the government, they have an impact on public finances. Several authors therefore believe that it is important to budget for the impact of investments and that more attention should be paid to the quality of investments.

The EFB calls for an expansion of the EU budget so that it can provide each Member State with an envelope for EU-wide investments, such as green investments and transnational infrastructure projects. Darvas and Wolff (2021) propose a similar reform, where all climate spending would be funded at EU level. One advantage would be that the EC and the Council of the European Union would then have greater control over national green investment plans to make sure that they are in line with EU objectives.

Vanhoudt and Moesen (2020) have an alternative proposal, in which a European leasing institution ('Public Investment Lease Europe' or PILE), under the guarantee of the Member States or the European institutions, can call upon the financial markets to invest in capital goods and services. Member States could then use it, against payment of an annual operating fee, to lease public infrastructure. This would have the advantage of allowing PILE to generate economies of scale. It would also allow PILE to verify that investments are in line with European standards and objectives. Member States that use it have the advantage that they only have to include the annual lease fee in their budget, not the entire investment. The authors expect that PILE would be able to borrow on attractive terms and attract international funding by issuing (near) risk-free bonds with long maturities. It would also give the ECB an additional tool to intervene in European financial markets and indirectly in national sovereign debt.

The option of giving the EU, through the EC, additional own resources so that it has greater control over its objectives and can also redistribute them is more general and far-reaching. A central fiscal capacity would help cushion asymmetric shocks - when the economy of a limited number of countries is hit hard. Such a shock would put less pressure on the public finances of euro area countries, which can no longer absorb those shocks by depreciating their currency, and would be less likely to force them into a painful adjustment process. Additional resources for a European fiscal policy could also provide an answer to the sub-optimal situation in which Member States do not support the economy sufficiently because some of the support is diverted abroad. This is all the more problematic when, as at present, the ECB interest rate is at the lower limit and therefore cannot support demand further. Blanchard et al (2021) favour such a central fiscal capacity. They think that there would be less support for coordinating national fiscal policies to take into account the cross-border effects of fiscal policies on demand. In such a scenario, where Member States would be urged to pursue an expansionary fiscal policy, more attention would be paid to the outflow of domestic resources abroad, whereas the benefits would be clearer if the economies of several countries were simultaneously supported by a central budget. The EFB (EFB, 2021) also advocates a European fiscal capacity to promote stability and public investment. The RFF could be a first step towards a centralised fiscal policy (see box).

Differentiated policy

An increase in own resources would obviously allow the EU to pursue a more integrated policy. A second path to a more integrated fiscal policy is a better coordination of the rules that apply at national level. According to Blanchard et al (2021), these rules should be limited to what is strictly necessary to ensure the sustainability of public finances, as this represents a risk for other Member States, and should leave individual countries free to further develop their fiscal policies. On the other hand, they are in favour of increasing the resources for a European fiscal policy (see above).

Blanchard, Leandro and Zettelmeyer (2021) argue for enforceable fiscal standards to ensure the sustainability of public finances, taking into account the situation of each Member State. Within the framework of fiscal standards, they envisage general objectives, coupled with a process for assessing whether member policies meet the standard. The main difference with the usual fiscal rules is the extent to which the standards to be met are set in advance[42]. Standards define an objective such as "Member States shall avoid excessive government deficits"[43] , but the way to achieve it is not defined ex ante. Strict rules, which lay down the details ex ante, have the advantage of making clear from the outset what a country must comply with. On the other hand, strict rules make it difficult to develop a diversified approach that takes

[42] We note that some flexibility is also built into the current rules and that they take into account the national sustainability situation, notably via the MTO and the S2 indicator.
[43] Article 126(1) of the Treaty on the Functioning of the European Union (TFEU).

into account the specific country context or to adjust policies quickly in response to new information or circumstances.

Blanchard et al. argue that standards are better suited than rules to the legal framework of fiscal policy because they better take into account all the uncertain economic and political factors that determine debt sustainability. Strict and unambiguous rules cannot take into account all these factors ex ante. Fiscal standards allow for a more qualitative, ex-post analysis, based on much more information than strict rules can take into account, including unforeseen developments, and with some room for discretion.

They do not advocate a single, pure rule, but fiscal standards accompanied by criteria, procedures, and methods that describe how to apply them. For example, the TFEU standard (Art. 126: "Member States shall avoid excessive government deficits") can be maintained with secondary legislation specifying exactly what constitutes an excessive deficit. This could be, for example, a deficit that is highly unlikely to be sustainable under current and projected policies. In addition, it is possible to specify how to deal with sustainability risks or the impact of savings on GDP, etc. Standards can also be set for the speed with which adjustments should be made. They consider that possible sustainability problems are best identified through stochastic analyses for current and projected policies, which take into account a wide range of variables such as the evolution of primary balances, interest rates, growth, ageing liabilities, debt maturity... This should lead to a distribution for future debt ratios, for the actual primary balance and for the debt stabilizing primary balance. When there is a certain probability that the debt stabilizing primary balance is higher than the current primary balance, corrective measures should be taken. The probability that the primary balance is insufficient to ensure a stable debt ratio should be sufficiently low (e.g. 5%) to prevent financial markets from anticipating and thus precipitating future problems.

Blanchard et al (2021) see different options for a framework based on fiscal standards, depending on which body assesses the (non-)sustainability of public finances (the independent national fiscal authorities or the EC or the EFB) and imposes the corrective measures (the Council of the European Union or the European Court of Justice). Allowing the Council of the European Union to decide which countries should take action does not necessarily require a change in the EU Treaties, but Member States would have to change their national legislation to allow an independent institution, namely the national fiscal authority or the EC, to block their budget if it does not meet the standards. If the ECJ were to act as an arbitration body, an amendment to the TFEU would be necessary[44]. However, the latter option is preferred by Blanchard et al. as it would be less politically motivated and could create case law around fiscal standards. It is also pointed out that the 3% and 60% norms could possibly be maintained in a fiscal framework based on fiscal standards, provided that the assessment of whether the fiscal deficit is (sufficiently) close to the 3% norm and whether the debt ratio is declining fast enough and approaching the reference level is based on a stochastic analysis of the sustainability of public debt.

These rules, based on fiscal standards, do not comply with the preference of P. Heimberger and A. Sapir, among others, for transparent and simple rules. However, Mr Blanchard considers this inevitable, as the estimation of debt sustainability is very complex. Trust in the institutions in charge is therefore essential[45] .

Martin, Pisani-Ferry and Ragot (2021) also argue that the sustainability of public finances should be more central to the fiscal framework, that the numerous numerical criteria should be abandoned and that norms should be allowed to vary according to the context of each Member State. However, they find unrealistic the proposal of Blanchard et al. which breaks with the SGP and makes the ECJ the final arbiter, and believe that decisions on sustainability risk belong to the EU Council. Unlike the proposal of Blanchard et al. their proposal does not require major changes to the existing treaties. According to them, a modification of Protocol 12 of the TFEU setting the debt and deficit ceilings[46] and a thorough revision of secondary legislation (the SGP, the *Six-Pack and* the *Two-Pack*) would suffice.

They advocate a different debt norm for each Member State. Indeed, the maximum politically attainable primary balance, the real interest rate and growth differ from one country to another, which means that the debt ratio at which the sustainability of public finances can be problematic also differs from one country to another. These differences are also reflected in the EC's *Fiscal Sustainability Report* and the S2 indicator. On the basis of a sustainability risk analysis that takes this into account, it is therefore necessary to determine the sustainable debt ratio for each country, allowing for a safety margin to absorb unforeseen shocks. According to Martin et al, this debt ratio should be a medium-term norm and should be assessed by the independent national fiscal authority and the EC, with possible revisions depending on interest rate developments and economic growth. A focus on the debt ratio would be

[44] The limited role of the ECJ in the current European fiscal framework is said to be the result of a political compromise to compensate for the introduction of the strict fiscal norms of 3% and 60%. (Blanchard et al., 2021)
[45] As a comparison, he gave the example of vaccination against COVID-19 during the webinar, which is not easy to explain either, but is nevertheless necessary and must be based on trust in the institutions involved.
[46] Or their interpretation should be reconsidered (see above).

preferable to the current limit on the government deficit to 3% of GDP, which can have perverse effects when it blocks necessary support to the economy. Furthermore, it avoids the problems associated with estimating the output gap when working with structural criteria. Investments would not be excluded from the expenditure benchmark, but their impact on potential growth would be taken into account so that they could lead to a higher expenditure benchmark. Research suggests that an expenditure benchmark based on potential growth is less destabilising and error-prone than using structural norms.

Once a country's target debt ratio has been established, a nominal primary expenditure benchmark (i.e. excluding interest charges) can be determined on this basis[47]. To increase the countercyclical effect, unemployment benefits (which are not the result of discretionary interventions) would not be covered by the benchmark. As in the EFB proposal, this is a net expenditure benchmark that takes into account discretionary changes in revenues, so that they can be modified according to the policy preferences of national decision-makers. The annual expenditure benchmark would then be determined by legislature, after European approval. Exceptions can be made in the case of persistent economic shocks, changing political trends or the application of the general escape clause. Thus, the EU should be able to increase the expenditure benchmark for all Member States, with the exception of countries where this could jeopardise the sustainability of public finances, in times of deep recession.

To put this into practice, Martin et al. suggest that the EFB should develop a methodology to assess the sustainability of public finances and translate it into a debt norm and an expenditure benchmark over a 5-year horizon. The independent national fiscal authority should then determine the national debt norm on this basis and verify that the expenditure benchmark, which the national government should set according to this debt norm, is consistent with the debt norm[48]. The EC would remain responsible for monitoring and identifying transgressions of the rules, with the final decision on any sanctions remaining with the Economic and Financial Affairs Council (ECOFIN).

Martin et al. also advocate a European investment capacity focused on specific transnational objectives, financed by pooled loans complemented by own resources

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[47] Martin et al. advocate a nominal rather than a real expenditure benchmark, as this would have a stabilising effect. The reasoning is that a negative demand shock is associated with lower inflation, so that real spending, which is based on the initially expected (higher) inflation, can increase more strongly.

[48] For efficient use of public funds, this exercise could be carried out by the existing public administration under the supervision of the independent national fiscal authority.

or a contribution from Member States. This should focus more on European public goods than NextGen EU.

Indicators used

To get a better idea of the sustainability of public finances, some authors suggest taking into account the interest burden as a percentage of GDP. This method has the advantage of taking into account the interest rate and of providing a more homogeneous picture by comparing two flow variables (interest charges and GDP) (i.e. by measuring them over a certain period of time), unlike the debt ratio. However, Martin et al (2021) argue that this indicator would add little value compared to the current indicators. Indeed, policy-makers would adjust and the primary balance would rise or fall with the interest burden, so that there is no unambiguous relationship with the sustainability of public finances. Moreover, it is difficult to introduce norms on the share of interest charges in GDP, especially as these can rise very quickly when a government is targeted by the financial markets and the government has little control over them.

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Annex 1: Overview of webinars

06/05/2021, Henk van Noten (Expert to the European Commission) - Presentation of the European fiscal framework.

18/05/2021, Henk van Noten (Expert to the European Commission) and Xavier Debrun (Member of the European Fiscal Board) - Problems with the European fiscal framework.

10/09/2021, Peter Praet (former Chief Economist of the European Central Bank) - Current key issues in the interaction between monetary and fiscal policy.

23/09/2021, André Sapir (member of the High Level Advisory Group on Post-Covid Economic and Social Challenges) - Current issues arising from the construction and implementation of the European fiscal framework and the impact of COVID-19.

06/10/2021, Zsolt Darvas (Bruegel) - The European fiscal framework and green investments.

08/11/2021, Olivier Blanchard (former IMF Chief Economist) - An alternative European fiscal framework based on fiscal standards.

17/11/2021, Jean Pisani-Ferry (Bruegel) - An alternative European fiscal framework based on diversified debt norms.

24/11/2021, Philipp Heimberger (Vienna Institute for International Economic Studies) - The problems with using and calculating the output gap in the European fiscal framework and possible solutions.

08/12/2021, Pierre Wunsch (Governor National Bank of Belgium) - Assessment of the Belgian fiscal framework.

20/01/2022, Olaf Sleijpen (Director of Monetary Affairs and Financial Stability at De Nederlandsche Bank)

25/01/2022, Roland Gillet (Sorbonne)

Annex 2: Overview of possible reforms to the fiscal framework

PROPOSITION	ADVANTAGES	DRAWBACKS AND RISKS
Recalculation of the output gap: potential output is estimated on the basis of a full employment situation (i.e. actual employment + long-term unemployed) where labour market policy objectives are met.	Does not require adaptation of EU legislation.	Requires additional surveillance with regard to the sustainability of public finances.
	Creates a margin for stimulative policy and avoids underestimation of potential GDP and possible hysteresis effects in the event of a downturn.	
	Facilitates consistency between fiscal policy and labour market objectives.	
	Assigns responsibility to elected politicians.	
Fewer indicators, over a longer term (e.g. 1 expenditure benchmark, taking into account the debt level and the economic situation), while maintaining the 3% (deficit) and 60% (debt) criteria.	Does not require major changes in legislation, certainly if the deficit and debt criteria are maintained.	Little flexibility.
	Clear directive, increased transparency.	The 60% criterion is maintained. This criterion is ad hoc, undifferentiated and extremely strict in the current context where the difference between the real interest rate and growth is structurally negative for many countries and where investment needs are high. The pace at which the target is to be achieved could be reviewed.
	More credible sanction mechanisms.	
	The use of (few) indicators over several years avoids continuous reorientation and allows for a long-term perspective.	

	The removal of cyclical, one-off or investment expenditure does allow for some flexibility.	
Adapted debt norm per Member State, based on a sustainability risk analysis (according to the methodology set by the ECB). Translation of the debt norm into an expenditure benchmark by the national government, under the supervision of the national fiscal authority. The EC monitors transgressions and the Council decides on sanctions. The standards are valid for 5 years; intermediate revisions are possible. Abolition of the deficit rule.	Allows a diversified approach, taking into account a lot of information and country-specific circumstances.	Requires adaptation of Protocol 12 TFEU and secondary legislation.
	Investments that enhance potential growth have a positive influence on sustainability and thus also on the expenditure benchmark.	The EU Council would be reluctant to impose sanctions because Member States would fear being sanctioned themselves in the future.
	Clear directive.	The calculation behind the debt and expenditure benchmarks is not very transparent if a clear methodology is not available.
	Flexible.	
	The absence of a deficit norm avoids restrictions in times of economic downturn.	
Fiscal standards: a general ex ante objective that is progressively translated into specific standards (example of objective: sustainable public finances; standard per country: primary balance).	Allows a diversified approach, taking into account a lot of information and country-specific circumstances.	Requires adaptation of secondary European legislation, and if there is EC or Council control, of national legislation.
	Flexible: possibility to make corrections quickly."	Complex, not transparent. Important role for technocrats.
	The 60% debt rule could remain in place (for political reasons), provided that "sufficiently close to or sufficiently diminishing towards the reference level" is based on a stochastic analysis of the sustainability of public debt.	
If sanctions are imposed by the European Court of Justice	Credible sanction mechanisms with a jurisprudential framework.	Requires adaptation of the TFEU.
	"	Sanctions can be seen as a political decision and should be in the hands of those who have been democratically elected.
Excluding (green) investments from the deficit norm.	Avoids restrictions on investments that have positive long-term effects.	Requires adaptation of Protocol 12 TFEU.
	Can contribute to the achievement of climate targets.	To the extent that investments are not recouped through enhanced growth, this constitutes a risk to the sustainability of public finances.
		May be at the expense of other expenditure if necessary to meet the debt criterion.

		Difficulty to define investments and to prevent governments from using this rule for current expenditure.
Increase in the EU budget.	Does not require treaty change but is politically sensitive.	Fear that national public authorities will relax fiscal discipline by relying on European resources, leading to a so-called ""transfer union"".
	Gives the EC and the Council more control over the EU's objectives.	
	Complementary to monetary policy: - possibility of redistribution in case of asymmetric shocks; - possibility to stimulate the economy when interest rates are at the lower limit.	
	Allows internalisation of demand externalities (when domestic support policy trickles down abroad) through centralised fiscal policy, which would be politically more feasible than through coordination of national budgets.	
through additional own revenues	Avoids regular and painful negotiations on the EU budget that could cause political tensions.	
with the possibility of raising money on the financial markets.	The EC may be able to provide loans at attractive interest rates, which can then benefit individual Member States.	This could create a risk for the EU Member States, who are ultimately the guardians of EU's finances.
through an independent European leasing institution which national public authorities can call upon.	Can contribute to EU objectives if access for Member States depends on it.	The European institutions or the Member States should be the guarantors in this area.
	Investments can be made by means of an annual payment in the form of a lease instead of entering the total cost in the budget.	
	Could benefit from scale advantages in financial services.	