



## The reform of the EU fiscal framework and the transition for its re-implementation

**Klaus Regling** - Managing Director, European Stability Mechanism (ESM)

**Tuomas Saarenheimo** - President of the Eurogroup Working Group and the Economic and Financial Committee, Council of the European Union

**David Wright** - President, Eurofi

### David Wright (Chair)

The Chair welcomed participants to a debate on the reform of the EU fiscal framework and the transition for reimplementation and introduced the speakers. The discussion would consider the reform of the fiscal framework.

There are a few initial assumptions to consider: first, this is not in the context of treaty change, nor, hopefully, in a context of perpetual monetisation of public debt, and some form of coordination framework is needed. These are basic principles. He asked Tuomas to look at the outlook and how to move towards a firmer and more stable situation.

### Tuomas Saarenheimo

Tuomas Saarenheimo considered that there is a recognition that something needs to be fixed and that colleagues are unanimous on this. Moving on from there gets more complicated. An issue is the increasing complexities that have been introduced into the rules over the years, much of which came with the Two Pack and, particularly, Six Pack reforms around 10 years ago. That has already started and there are all kinds of unmeasurable variables that the assessments are based on.

Behind this complexity lies the fact that fiscal policy is complicated, and situations vary. Rules set up sensibly in one set of circumstances might be completely nonsensical in another set. Over the years, attempts to pre-programme for all eventualities has led to complexity. There has not been the willingness to provide the Commission the discretionary powers to adapt its assessment to various situations, but rather member states have wanted to have clear rules for every situation. That has led to the current situation.

It is not about providing the EU tools to discipline misbehaving countries. The idea of creating a framework that forces fiscal discipline on countries through the

use of sanctions is a fallacy. Rather, better ways have to be found to work with countries and to engrain the European fiscal framework in national budgetary practices, in a manner that facilitates intelligent discussion, increases transparency and honesty of budgetary policy and communication at the member-state level, and creates support for responsible fiscal policies. This is the challenge faced.

### Klaus Regling

Klaus Regling noted that this is a clear explanation of why the framework that has been developed over the years needs to be reformed. It is clear from the introduction that there is an assumption that fiscal coordination is needed in a monetary union, which makes sense. In the end, monetary union is still unique in the sense that it centralises monetary policy completely, while fiscal responsibilities continue to be with national governments and parliaments, so it requires coordination.

First, it is important to be clear about the aim of fiscal surveillance, framework or governance, because there are many good reasons to have it. There are many objectives that people try to reach. One is debt sustainability, but also many want to use it to promote growth or the green economy. Some want to prevent divergences in the monetary union, and some want to create space for cyclical stabilisation. These are all good objectives, and it is difficult to disagree with them.

At the same time, it is not feasible to reach five objectives with one rule, so the discussion must be broadened, remembering that other instruments exist, like the EU budget. The EU budget provides permanent, continuous transfers from richer to poorer countries and can be used to prevent divergences among countries and to promote convergence. It can also be used to promote greening of the economy. The annual country specific recommendations could also be used. There are many instruments – not only the Stability

and Growth Pact – to reach several objectives linked to budgetary and fiscal policies.

To make it even more complex, it is important to remember that assessing the value of a fiscal framework is a question not only of debt levels or deficits but also of quality of expenditures, of revenues, which can be growth-friendly or less so, and of the size of the public sector. Jacques noted in an article in the Eurofi magazine that the size of the public sector – if, say, expenditure to gross domestic product (GDP) is 10 percentage points higher in one country than in others – is more important than higher debt. It is a complex issue to find a system that ensures that the entire public finance is good and, in this broad sense, achieves all these objectives.

There is no silver bullet to achieve all of that and no model ready in the drawer that can be adopted and fix all the problems. It will not be that simple, but something is needed. Tuomas mentioned some principles that could be subscribed to, such as simpler rules and using observable variables. Expenditure rules should be used, as others such as the European Fiscal Board have proposed. The primary balance should maybe be used as an anchor for countries that have particularly high debt levels.

Then there is the difficult question of what debt target to aim for. The current world is different from when the Maastricht Treaty was negotiated. At that point, the 60% debt-to-GDP level was a reasonable target. It happened to be the average of the member states at that time and was also consistent with a nominal growth rate of around 5%. Interest rates were also much higher than today. In the future, interest rates will be lower than in the past. They will not remain as low as they are now, but on average they will be lower than 20 or 30 years ago. That indicates that higher debt-to-GDP ratios can be accepted as something to aim for. The 60% should be raised. This will be a controversial issue but there are good economic arguments for that.

In addition, a fiscal-stabilisation facility should be added to this new framework so that, in exceptional circumstances – when, for instance, the Commission declares that a country is in exceptional circumstances and there is a reason to activate the escape clause – additional fiscal space from the European side is made available to the country. These are all elements where it will not be easy to find a consensus in the Eurogroup.

That is one reason, but there is a second reason for thinking about a transition period. The general escape clause in the current year will also apply in the next. In 2023, when it will probably no longer apply, there will not be many countries with a deficit below 3%. Several will have deficits close to 10% and will need and should have a number of years, for economic reasons, to reduce them. A recent proposal from Jean Pisani-Ferry and his colleagues is to look at plans country by country for how to manage public finances in the future.

For the steady state it is preferable to have a new set of rules, but they cannot apply immediately, because the situation in 2022-23 will make that impossible. A transition period could be envisaged, where something like Jean Pisani-Ferry's recommendations is used: country-specific adjustment or consolidation plans proposed by the Commission, discussed in the Eurogroup and agreed in the Council, in order to bridge

the time until a new common framework is reached, perhaps after three or four years, where some of the principles mentioned are reflected.

### David Wright

The Chair noted that that is quite a long timeframe before any new rules would start to apply. It is a long transition period. He asked Jacques de Larosière to outline some of the thoughts mentioned in his paper on the elements that could be useful in the future fiscal framework in order to improve discipline.

Jacques de Larosière, Honorary President, Eurofi

Jacques de Larosière felt in harmony with the previous speakers' comments. First, the accepted rules of the stability pact are now so far away that it may be tempting to 'throw the baby out with the bathwater'. That would be a major mistake. It is precisely because of the turmoil of enormous deficits and massive debt ratios that rules to help countries normalise and better their position have been conceived. It is indispensable to work on this subject and not wait for the future to happen.

A second idea, which is close to what Klaus said, is that the situation is more complicated than it was 20 years ago. This complexity must be considered, as mentioned by the first speaker, who carefully explained the importance of this complexity. This is right.

It is vital to be intelligent and not get percentages and rules out of the blue. To work on this complexity, first it is critical to understand what could be called the legitimate heterogeneity. If Greece is on one side and Germany the other, the structures, histories and capabilities are different. Homogeneity will not be attained because of a 3% rule or a 60% rule. It is important to distinguish between legitimate heterogeneity, which is, in many cases, the product of history, and abnormal heterogeneity, which is the incremental heterogeneity that has been created by public action or inaction. This has to be analysed carefully. If abnormal heterogeneity is detected, it can be worked on, not necessarily to erase it in a couple of years but to start working marginally on that element.

The third idea is that the amount and quality of public expenditure is probably more important than the level of debt to GDP. In many cases – and in the case of France, for instance – the abnormality of public expenditure related to GDP compared to other countries is such that it is practically impossible to regain, with that abnormality, a path of gradual normalisation and of industrial competitiveness. Proposals have been made in France to reduce a little more sharply this abnormality in order to be able to regain something more reasonable.

Public expenditure has to be worked on, both on the quality and whether it is to pay for the end of the month of current expenditures or to increase the capital base of the country through valuable investments. Attempts have to be made to move it towards valuable investments and to reduce the part of those public expenditures that are related to current expenditure, while acting on the quantity or the size.

It is possible to be agnostic on the number of years. Each country will probably have its own views on the duration

of the process that will lead it towards an acceptable, reasonable path. This period has to be discussed as an essential part of the framework. Klaus is right that a specific, tailor-made process must be done, especially in the first years, and then, when some normality in the primary budget has been regained, it will be time to think of a common framework for everybody. It is too early now, and it has to be done country by country. Jean Pisani-Ferry's study has made that point.

First, this is a necessary process that has to start quickly. There is no time to waste. Second, the complexities of nations have to be delved into. Third, that has to be done collectively. It cannot be a state-by-state or member-by-member thing. An element of agreement on the direction of movement and on the timeframe must be instilled in that nationally based process. These are not original ideas but are in line with what the two previous speakers have said. It is difficult work that needs a great deal of attention and dialogue with the country. It is not only the photograph of the country's views; it has to be negotiated.

#### **David Wright**

The Chair asked Tuomas Saarenheimo for comments about a transitional period, without being precise about timing, and whether peer pressure could be ratcheted up, with the Commission playing a bigger role.

#### **Tuomas Saarenheimo**

Tuomas Saarenheimo believed that rules are needed, although it would be more precise to say that a framework is needed. The framework is more important than the precise rules, if 'rules' means a set of numbers. A set of numbers is not going to solve the credibility problem for the framework. What will be helpful is finding ways for countries to better internalise the framework in their domestic systems.

Regardless of the criticism that the framework has received, in general, quite a number of good examples have also been received. The best examples come precisely from countries where the European fiscal framework is an integral part of the domestic budgetary process and is present from the first domestic discussion. A situation where the European framework comes into play only when the draft budgetary plan is presented and then either accepted or rejected is too late. It has to be part of the domestic discussion.

The spirit of what Klaus and Jacques said is, essentially, the same. Jacques spoke about legitimate heterogeneity, which links to not focusing on rules and numbers but on frameworks, targets and goals. The question is one of where Europe wants to move towards and then of considering the situation in a country. It is vital to consider expenditure needs, the structure of the economy and ways to improve competitiveness. The most important thing is to get an honest, visible discussion on each country and then have the courage, if a country puts forward a set of bad policies, to 'call a spade a spade' and to say that these are bad policies, and to try to affect the domestic discussion. There are many ways to get there, but this is key.

#### **David Wright**

The Chair asked whether this could include public statements.

#### **Tuomas Saarenheimo**

Tuomas Saarenheimo agreed. The European framework primarily works through publicity and media attention, while hesitating to call it naming and shaming, but it ultimately is that. No country or government wants it known that it has bad budgetary policies. No country wants to read it in the Financial Times or domestic newspapers. Media and publicity are a key part of this. An important part of this endeavour is to find ways to open up the discussion. There is no need to be cagey or to soften blows so as not to trigger an escalation. Honesty must be a big call of this exercise.

#### **David Wright**

The Chair asked Klaus Regling for comment on Jacques' idea of some form of early warning mechanism.

#### **Klaus Regling**

Klaus Regling recalled the idea of the transition period. 2022 will start with a situation that is heterogeneous and difficult, and which will require time to adjust and return to a more common framework. That is unavoidable and can be done only country by country. Tuomas is right that disagreements should be discussed in the Eurogroup – that is the kind of peer pressure that leads to results – but it should also become public. The Commission has also done that in the past. There were sometimes statements at press conferences about the budgetary plans in certain countries. The European Semester provides a framework to talk early and before final decisions are taken in a country and the Commission can indicate early whether policies are good or need to be improved.

The European Fiscal Board has not been mentioned, but it has played a positive role and can also be helpful in giving input into the process, together with national, independent councils. In principle, every country should have one, and maybe they can be better used. From experience, when there is negative publicity, markets react. It is true that governments then react, as they see that it can be costly to ignore the advice or comments coming from the European Commission or the Eurogroup.

#### **David Wright**

The Chair thanked all the speakers for their interesting input into the discussion.