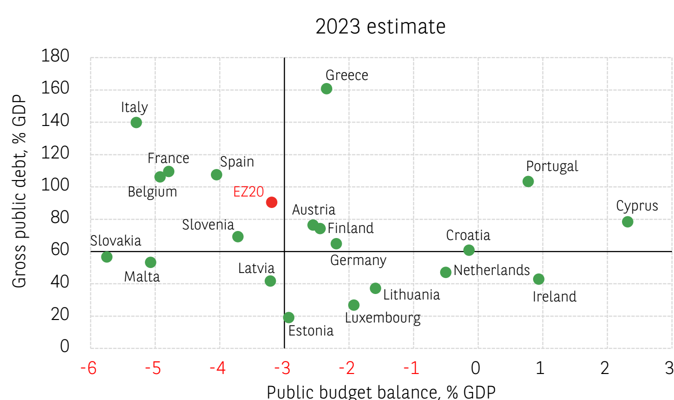
ADDRESSING THE PUBLIC DEBT CHALLENGE IN THE EU: THE ROLE OF THE NEW ECONOMIC GOVERNANCE

Recently an agreement has been reached between representatives of the European Council, the European Parliament, and the European Commission on a new economic governance framework. It focuses on risk-based surveillance, differentiation between member states based on their specific situation, the integration of fiscal, reform and investment objectives in a medium-term fiscal plan. The single operational indicator in the form of a net expenditure path should facilitate communication and emphasizes the key role of discretionary primary spending rather than tax increases in bringing public finances under control. The reference trajectory, in combination with the debt safeguard and the deficit resilience safeguard, implies that many EU countries will have to undertake a sustained adjustment effort lasting several years.

With the Treaty of Maastricht of 1992, an EU economic governance framework was established to coordinate economic policies to achieve the EU's economic objectives[1]. The latter concern the soundness and sustainability of public finances, sustainable economic growth and convergence, addressing macroeconomic imbalances as well as reforms and investments to enhance growth and resilience. A key component of the framework is the Stability and Growth Pact (SGP) -adopted in 1997- and its rules for the monitoring and coordination of national fiscal and economic policies.[2] Its preventive arm sets for each EU member state a budgetary target. In addition, Eurozone countries are also subject to the corrective arm, which *"ensures that member states adopt appropriate policy responses to correct excessive deficits (and/or debts) by implementing the Excessive Deficit Procedure."*[3]

Economic convergence and sustainable public finances are important because they bring economic stability and reduce the contagion risk between countries. It is crucial in the Eurozone in view of its influence on the transmission of monetary policy. Healthy public finances also provide fiscal policy leeway to address the consequences of adverse shocks and avoids that monetary policy would be the only instrument that can be deployed. In February 2020, a debate was launched on reviewing EU economic governance. On that occasion, the European Commission argued that *"the surveillance framework has supported the correction of its existing macroeconomic imbalances and the reduction of public debt"* and considers that it has also promoted sustained convergence of economic performances and closer fiscal policy coordination in the Eurozone.[4]However, looking at the Commission estimates for 2023 budget deficits and public debt, one is struck by the huge dispersion (chart). Moreover, the Commission also noted that the fiscal stance had often been pro-cyclical and that member states had consistently favoured current expenditures rather than investments.

EUROZONE: PUBLIC BUDGET BALANCE AND DEBT



CHART

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

Recently, an agreement has been reached between representatives of the European Council, the European Parliament, and the European Commission on a reform of the fiscal rules.[5] Reducing debt ratios and deficits should be done *"in a gradual, realistic, sustained and growth-friendly manner while protecting reforms and investment in strategic areas such as digital, green, social or defence."* Member states must submit national medium-term fiscal structural plans.

1 Source for this paragraph: Economic governance framework - Consilium (europa.eu). The framework focuses on policy coordination and the surveillance of member states' economic policies and *"relies on the principles of monitoring, prevention and the correction of imbalances that could pose risks for member states' economies."*

2 The other components are the Treaty on the Functioning of the EU and its reference values for government deficit and public debt levels (3 % and 60 % of gross domestic product respectively, the so-called Maastricht criteria), the six-pack and two-pack regulations -fiscal surveillance, macroeconomic imbalance procedure- and the code of conduct documents with guidelines to interpret the six-pack and two-pack regulations.

3 Source: European Commission.

4 Source: Commission presents review of EU economic governance and launches debate on its future, European Commission, 5 February 2020 (Commission presents review of EU economic governance (europa.eu)).

5 Source: Economic governance review: Council and Parliament strike deal on reform of fiscal rules - Consilium (europa.eu), 10 February 2024. This came after the presentation by the Commission on 26 April 2023 of its proposals for a reformed economic governance and the approval on 21 December 2023 by the European Council of a mandate for negotiations and consultation with the European Parliament.

The reference trajectory, in combination with the debt safeguard and the deficit resilience safeguard, implies that many EU countries will have to undertake a sustained adjustment effort lasting several years.

When government debt exceeds 60% of gross domestic product (GDP) or where the government deficit exceeds 3% of GDP, the Commission will submit a 'reference trajectory', indicating *"how member states can ensure that by the end of a fiscal adjustment period of four years[6], government debt is on a plausibly downward trajectory or stays at prudent levels over the medium-term."* The agreement contains two safeguards that the reference trajectory must comply with. Under the debt sustainability safeguard, the *"projected general government debt-to-GDP ratio decreases by a minimum annual average amount of 1 percentage point of GDP as long as the general government debt-to-GDP ratio exceeds 90% and 0.5 percentage point of GDP as long as the general government debt-to-GDP ratio remains between 60% and 90%."*[7] To this end, a net expenditure path is determined and incorporated in the national medium-term fiscal structural plans.[8] The plans and expenditure paths need to be endorsed by the Council. The net expenditure path would be such that it brings the general government deficit below 3% by the deadline set by the Council. The minimum annual structural improvement is set at 0.5% of GDP. The deficit resilience safeguard requires that fiscal adjustment would continue until a structural resilience margin of 1.5% of GDP relative to the 3.0% of GDP reference value of the Maastricht Treaty has been built. Under this safeguard, the annual improvement in the structural primary balance to achieve this margin is set at 0.4% of GDP (0.25% if the adjustment period has been extended to 7 years).[9]

Finally, a control account set up by the Commission will keep track of the annual and cumulative deviations of net expenditures compared to the target path. Under specific circumstances, the Council, upon a recommendation from the Commission, could allow deviations from this path.[10]

To conclude, the new economic governance framework has several key characteristics: risk-based surveillance, differentiation between member states based on their specific situation, the integration of fiscal, reform and investment objectives in a medium-term fiscal plan. The single operational indicator in the form of a net expenditure path should facilitate communication and emphasizes the key role of discretionary primary spending rather than tax increases in bringing public finances under control. The reference trajectory, in combination with the debt safeguard and the deficit resilience safeguard, implies that many EU countries will have to undertake a sustained adjustment effort lasting several years.

William De Vijlder

6 *"Member states will be allowed to ask for an extension of the four-year fiscal adjustment period to maximum seven years, if they carry out certain reforms and investments that improve resilience and growth potential and support fiscal sustainability and address common priorities of the EU. These include achieving a fair, green and digital transition, ensuring energy security, strengthening social and economic resilience and, where necessary, the build-up of defence capabilities."*

7 Source: European Council, Proposal for a regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97 - Mandate for negotiations with the European Parliament, Brussels, 20 December 2023.

8 More specifically, the path concerns *"nationally financed net primary expenditure, that is to say expenditure net of discretionary revenue measures and excluding interest expenditure, cyclical unemployment expenditure as well as expenditure on Union programmes fully matched by revenue from Union funds."* One-offs and other temporary measures are excluded from net expenditure.

9 Source: see footnote 7.

10 *"In the event of a severe economic downturn in the euro area or the Union as a whole, or in the event of exceptional circumstances outside the control of the government with a major impact on the public finances of the Member State concerned, provided that it does not endanger fiscal sustainability in the medium term."* The increase of government investment in defence should also be considered as a relevant factor.