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# Fiscal is local: EU standards for national fiscal frameworks

**Xavier Debrun, Wolf Heinrich Reuter** 24 January 2022

The European fiscal governance framework has grown into an arcane machinery. Yet, experts' convergence on the need for a more effective and simpler system falls on political deaf ears. Greater reliance on national fiscal frameworks could significantly strengthen European fiscal governance while passing political hurdles. The authors of this column see value in further strengthening national ownership of fiscal responsibility while keeping central safeguards against risky fiscal behaviour.

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*Editors' note: This column is a lead commentary in the VoxEU debate on euro area reform [5].*

The activation of the "general escape clause" (GEC) of the Stability and Growth Pact (SGP) temporarily paused the review of EU fiscal governance. The GEC is now expected to be lifted by the end of 2022, recently prompting the European Commission to relaunch the review. Yet, governments' appetite for reform is low. A predictable outcome is that no significant reform will be enacted by 2023.

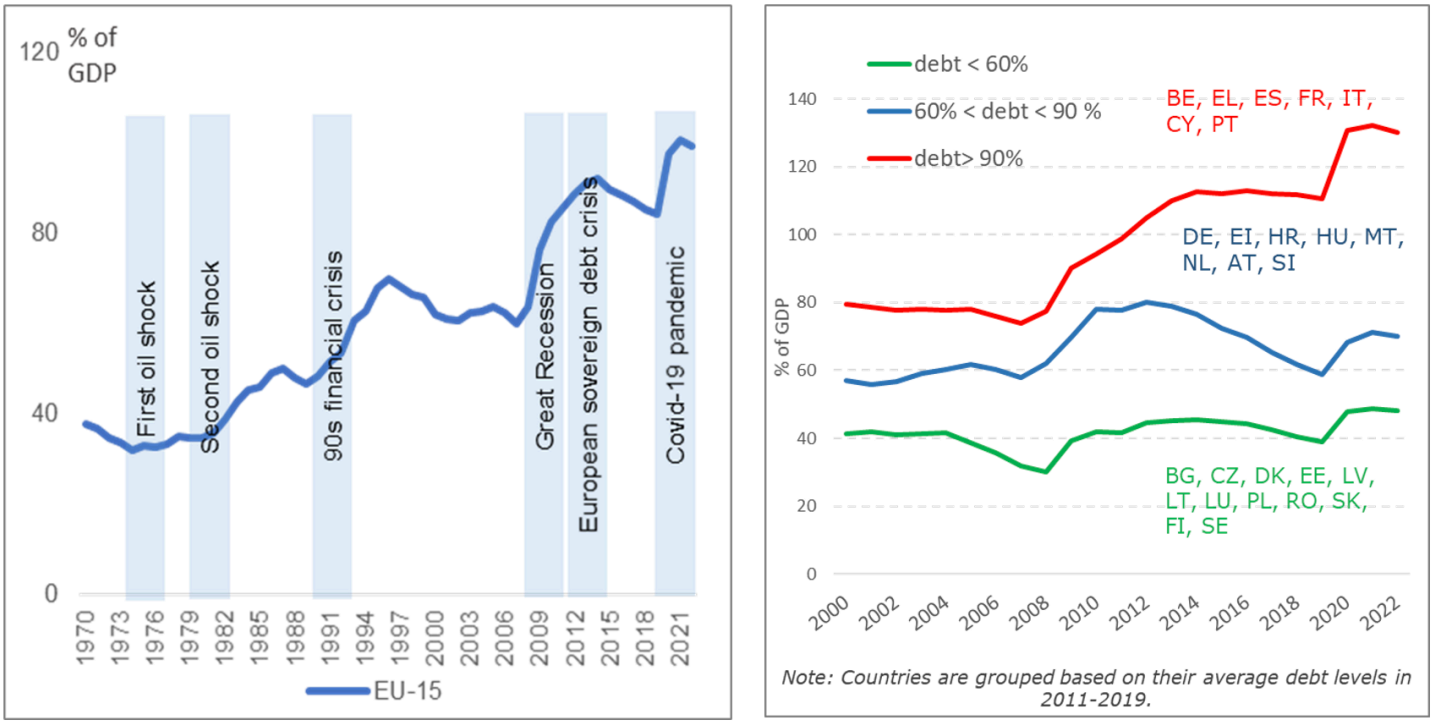
However, further delaying the much-needed overhaul of EU fiscal governance carries tangible risks. In particular, the delay ignores two obvious lessons from the crisis: (1) fiscal space is essential to absorb large shocks and it should be rebuilt going forward, and (2) the overall policy

framework needs to be credible if the exit from current emergency policies is to be smooth (Bartsch et al. 2020). A rules-based fiscal framework delivers such credibility only if it effectively ties future budgets to sustainable debt paths.

# Designing fiscal rules: Trade-offs in the euro area

As the crisis did not deliver a genuine central treasury for the euro area, the single monetary policy continues to face heterogenous fiscal policies and fragmented sovereign debt markets. Existential threats from such fragmentation might periodically emerge unless fiscal policy coordination can secure debt sustainability and a sufficient contribution to macroeconomic stability. Mitigating such threats has always been the purpose of the SGP. However, although the SGP instilled a degree of fiscal responsibility that would likely not exist otherwise (e.g. Caselli and Wingender 2018), public debt ratios remained stubbornly high in too many countries (Figure 1). The fiscal stance also continued to be procyclical in good times. A ratchet effect in debt ensued, undermining the organic regeneration of fiscal space.

**Figure 1** Public debt ratios in the EU: Still rising in too many member states




*Source*: European Fiscal Board.

Designing good fiscal rules is hard, as they must be simple, flexible, and enforceable. Debrun and Jonung (2019) argue that only two of these properties can be simultaneously met. Two waves of SGP reforms (in 2005 and 2011) illustrate the logic of the trilemma. Efforts to increase and better balance enforceability and flexibility destroyed simplicity and transparency. As contingencies and interpretative provisions were added to augment flexibility, new safeguards against the possibility for governments to disingenuously exploit the resulting loopholes were introduced. Today's opaque and inconsistent rulebook provides poor policy guidance and soft ground for enforcement, which was then mired in political games. In the end, the misuse of policy discretion that rules were supposed to constrain migrated to their interpretation.

# Basic architecture of a hybrid reform

Obviously, the system is broken. A solution requires going back to basics, rejecting the urge to design a complete contract, where every good thing under the sun can motivate a special provision, and increasing compliance, either by ameliorating enforcement or – better – promoting self-compliance. Concretely, an effective reform should follow three principles: (1) accept a lexicographic ordering of objectives: debt sustainability is existential, so it comes first; (2) do not come in the way of automatic fiscal stabilizers; and (3) facilitate enforcement and/or nurture self-compliance.

In our view, these three principles are best served if the basic reform architecture combines supranational and national roles. These two levels should be complements, not substitutes. Specifically:

- Debt sustainability should be the shared aim of national and supranational fiscal frameworks, with supranational provisions remaining the ultimate backstop against gross fiscal errors.
- Without prejudice to debt sustainability, the room for short-term flexibility should reflect national preferences and needs.
- Enforcement should, in the first instance, be set by national processes reflecting specific political and institutional features.

What about simplicity? The point of simple fiscal rules is clarity of purpose and predictability of fiscal trajectories. The current system fails on both counts. A consistent set of national frameworks internalising the public good nature of debt sustainability should be simpler than a supranational arrangement trying to accommodate a diverse fiscal landscape. Furthermore, by limiting enforceability to well-designed national rules, one would substantially mitigate the risk of cacophony emanating from the juxtaposition of enforceable national and supranational frameworks (as is the case now).

Concretely, we propose:

- Primary reliance on national fiscal frameworks meeting clear EU-level standards. A revised Directive on national fiscal frameworks should be the legal instrument to ensure that national arrangements can credibly meet the EU-wide aim of debt sustainability. Existing national fiscal rules are uneven and need serious vetting.
- Only countries unable or unwilling to adopt an adequate national rules-based fiscal framework would be subject to the reformed preventive arm of the SGP. The presumption is that agreement on streamlining those EU rules and beefing up their enforceability — for example, along the lines proposed by EFB (2020) — would be easier if countries had the option to opt out and design a national framework that suits them better.
- As even the best rules can fail to deliver, the Excessive Deficit Procedure in the context of a streamlined SGP would remain the ultimate backstop against gross fiscal errors. Markets and citizens should remain confident that unjustified or persistent violations of the deficit reference value of 3% of GDP would ultimately entail material costs – reputational and political if not pecuniary – for non-compliant governments.

# Compliance, effectiveness, and national ownership

Tying elected policymakers' hands to enforceable numerical caps has always been farfetched. Worldwide, governments subject to numerical fiscal rules only comply half of the time on

average (Eyraud et al. 2018, EFB 2019, Reuter 2015), regardless of whether sanctions apply. In practice, however, fiscal rules look effective – i.e. policy is materially better with a rule than without – despite low compliance (Eyraud et al. 2018, Heinemann et al. 2018, Reuter 2015).

This suggests that reputational and political costs matter more than formal sanctions or the remote shame of an infringement procedure under EU law. Because they are imposed by voters, such costs are local by essence. Their legitimacy rest on the broad acceptance that breaching certain limits or standards of behaviour reflects bad policies, making it difficult to hide behind bad luck or blaming others.

Acceptance and legitimacy call for tailoring the rules to country conditions. In the fiscal realm, relevant country specificities include voters' preferences, accountability procedures and checks-and-balances built into the political system, the extent of political fragmentation, the exposure to macroeconomic shocks (determining the necessary size of safety buffers), the design and extent of automatic stabilizers, and public investment needs.

The enforcement of the current one-size-fits-all supranational rules negate that reality. On the one hand, EU toughness encourages scapegoating, blurring the link between bad outcomes and poor policies and ultimately, undermining democratic accountability. On the other hand, efforts to internalise local specificities at the enforcement stage make the latter too discretionary and, in the end, captive to political games. Thus, when strict enforcement is impossible, violating supranational rules is less likely to trigger sufficient reputational or political costs to make rules effective.

National enforcement should, all else equal, promote compliance and effectiveness. However, the framework in which member states choose rules that suit them must remain consistent with the fiscal precondition for sharing the same currency. This implies a coordinated approach to national rules-based fiscal frameworks and central safeguards against local failures to design and implement such frameworks.

# European standards for national fiscal frameworks

For fiscal governance to deliver on its core mandate, the EU should set qualitative standards for national rules-based fiscal frameworks, leaving member states the responsibility to specify their commitments, legal provisions, and institutions involved. Discussing the specifics of the standards is beyond our scope as there is already a vast body of economic literature providing guidance on economically sound fiscal rules (e.g. Eyraud et al. 2018, EFB 2020).

Similarly, enforcement can come in many forms that should be left to countries to decide. Some governments could rely on constitutional provision potentially involving the judiciary, or a comply-explain obligation followed by a confidence vote in Parliament in case of infraction. Others might prefer softer means, such as specific features of the numerical rule itself. For instance, expenditure ceilings are self-enforceable through the budget law, while error-correction mechanisms automatically tighten the rule in case of cumulative deviations, augmenting reputational embarrassment of serial deviations. In some locales, a competent and respected international financial institution (IFI) might succeed in raising reputational costs through its monitoring of fiscal performance against rules-based commitments. In others, like countries with highly decentralised government systems, pragmatic ways to ensure intergovernmental coordination should be in place. In all cases, countries should remember that enforceability often stands to benefit from the intrinsic merit of simple numbers. Like speed limits, they do not require 'scientific' precision, but rather broad acceptance as safeguards against gross fiscal policy errors.

A natural legal vehicle for the standards would be a Directive balancing specificity in the provisions that define sound fiscal frameworks with room for country-specific tailoring. Directives are enforceable: failure to transpose its provisions into national law leads to an infringement procedure before the European Court of Justice (ECJ). Although EU law (e.g. Directive2011/85 on requirements for budgetary frameworks) already provides some guidance, it begs for clarification, a richer set of options and stricter monitoring. Once again, the economic literature has formulated many elements of good practice that could inform EU standards. In our view, inputs from independent fiscal institutions (the EFB and national IFIs) could provide the substantive backbone of the legislation.

## EU-wide safeguards against gross errors

The risk that inadequate implementation of national rules either threatens debt sustainability or systematically delivers an inadequate fiscal stance calls for safeguards. A straightforward option is to preserve the corrective elements of the SGP as a backstop against gross fiscal errors. Concretely, deficit and debt reference values could continue to guide fiscal surveillance in the context of the European Semester. The purpose of national frameworks would be to ameliorate compliance by increasing ownership of common goals, not to dispose of EU fiscal surveillance and coordination processes. The SGP's streamlined preventive arm would apply only to those countries which were deemed not to have adopted a national framework fully compliant with the EU Directive, either because they need time to transition or because they choose to stick to the SGP if such an external anchor suits them (SGP 'opt-in'). By contrast, those with fully compliant national frameworks would be treated as if an escape clause continuously applied to them.

This approach would spare the EU a politically tedious and time-consuming overhaul of the SGP. Furthermore, the approach would not need any change at the treaty level. At the same time, it would relax political constraints on either streamlining the SGP – for example, along the lines of the three-pillar model mentioned above – or at a minimum codifying its implementation – for example, by graduating the expenditure benchmark as an EDP trigger and de-emphasizing unobservable indicators as well as the debt reduction criterion.

## Conclusion

Securing debt sustainability in the euro area requires an approach that is not hostage to lengthy EU-level bargaining around an Nth reform of the SGP. Reliance on national frameworks would relax the political constraints on streamlining the SGP and building a sensible EU backstop against gross fiscal errors. Proximity of fiscal rules to national conditions would enable adequate tailoring of the rules and foster compliance through either more credible enforcement procedures and higher political and reputational costs for infractions. The streamlined preventive arm of the SGP would only apply for countries that do not (or do not wish to) have an adequate national framework fully compliant with an EU Directive. Overall, such an approach could deliver a European fiscal framework better aligned with national fiscal policies. Such a two-tier system would foster compliance, while preserving a common backstop against spillovers of gross fiscal errors.

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