FISCAL RULES IN EUROPE

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1

Introduction
WHY IS FINANCIAL SUSTAINABILITY IMPORTANT?

The intricate relationship between economic growth, well-being, and the health of public accounts has sparked an intense and ongoing debate in recent years. This discussion has particularly focused on the contentious issue of whether governments should adopt more austere programs or, conversely, implement less austere, more expansionary policies. Proponents of austerity argue that it is essential for maintaining fiscal discipline and ensuring long-term economic stability. On the other hand, critics contend that austerity measures can undermine economic growth and social well-being by reducing public investment and social spending, thus exacerbating inequalities and slowing down recovery during economic downturns. This debate is further complicated by the varying economic contexts of different countries, where the impacts of austerity versus expansionary policies can differ significantly based on factors such as existing debt levels, economic structure, and social conditions. As such, policymakers face the complex challenge of balancing fiscal responsibility with the need to foster sustainable economic growth and enhance the well-being of their populations.

Therefore, the issue of why financial sustainability is crucial for governments stands as a central element in this debate. Financial sustainability involves managing fiscal policies and public debt to meet current and future obligations without excessive borrowing. Proponents of austerity argue that financial sustainability maintains investor confidence and economic stability, fostering long-term growth. By ensuring that public finances are in order, governments can avoid the risks associated with high levels of debt, such as increased interest rates and reduced fiscal space for future needs. Austerity measures can help prevent economic crises, ensuring that governments have the resources to respond effectively to emergencies. Furthermore, disciplined fiscal policies can promote a stable economic environment, encouraging private investment and economic growth. In this context, maintaining a balanced budget and controlling public expenditure are seen as necessary steps to achieve long-term prosperity. Thus, the emphasis on financial sustainability through austerity and balanced budgets is not merely an economic necessity but a fundamental aspect of responsible governance. It ensures that future generations are not burdened with excessive debt and can enjoy stable and sustainable economic growth.

In the literature, there are as many as three theories on public debt. The first of these, the neoclassical school, considers that public spending or tax cuts are neutral on GDP. That is, any fiscal policy, due to Ricardian equivalence, would have its equivalence in the form of private savings. The second hypothesis, the hysteresis theory, suggests that austerity could be counterproductive to achieve a positive fiscal balance in the long run, so that a certain level of public spending is necessary to achieve a positive effect on growth. Finally, conventional theory points to the existence of an inverted U-line whereby a small level of government borrowing has a positive effect on demand and output, but beyond a certain threshold, the relationship becomes negative. [1]

Reinhart and Rogoff (2010)[2] tested the conventional theory on the relationship between public debt and economic growth. They found a threshold at which public debt levels, exceeding roughly 90 percent of GDP, are associated with notably lower economic growth rates. Specifically, median growth rates for countries with public debt above this threshold are about one percent lower, while mean growth rates are several percent lower. This finding holds for both advanced and emerging economies, although the relationship between public debt and inflation varies. High public debt is linked with higher inflation in emerging markets but not in advanced economies.

The study's significance is underscored by the recent global financial crisis, which led to a substantial increase in public debt. In countries severely affected by the crisis, public debt rose dramatically due to large deficits and substantial bank bailouts. This surge in public debt raises concerns about the long-term macroeconomic impacts, particularly as populations age and social insurance costs rise. The study's empirical approach leverages a new historical dataset covering 44 countries over 200 years, providing a robust basis for analyzing the relationship between public debt, growth, and inflation.

1 Vicente Esteve and Cecilio Tamarit, "Public debt and economic growth in Spain, 1851-2013", *Cliometrica* 12 (2018): 219-249.

2 Carmen M. Reinhart and Kenneth S. Rogoff, "Growth in a Time of Debt", *American Economic Review: Papers & Proceedings*, 100 (2010): 573-578.

For advanced countries, the study found no clear link between debt and growth until debt levels reached 90 percent of GDP. Beyond this threshold, growth rates dropped significantly, with median growth rates about one percent lower and mean growth rates nearly four percent lower. The analysis revealed no consistent pattern of rising inflation associated with higher debt levels in advanced economies. However, individual country experiences varied, with some nations managing high debt levels without adverse growth effects, particularly in the post-World War II period.

In emerging markets, the study observed a similar pattern regarding the debt-growth relationship, with growth rates significantly declining once debt exceeded 90 percent of GDP. Additionally, higher debt levels in these economies were associated with significantly higher inflation rates. The study also highlighted that external debt thresholds are more stringent for emerging markets. When external debt exceeds 60 percent of GDP, annual growth declines sharply, and surpassing 90 percent results in growth rates being halved. These findings underscore the critical importance of managing public and external debt levels to avoid severe economic consequences.

In conclusion, Reinhart and Rogoff's research provides compelling evidence that high public debt levels are detrimental to economic growth, particularly when exceeding the 90 percent of GDP threshold. The study emphasizes the need for policymakers to carefully balance fiscal policies to maintain sustainable debt levels while fostering economic growth. The insights from this research are particularly relevant in the context of post-crisis economic recovery and long-term fiscal planning.

The cost of debt in Europe

This work focuses on the member countries of the European Union, and the results obtained by Reinhart and Rogoff are also valid when only European countries are analyzed. At least, this is the conclusion reached by Mencinger et al. (2014)[3]. They empirically explore the transmission mechanism regarding the short-term impact of public debt on economic growth within the EU. Their analysis includes a panel dataset of 25 EU member states, divided into 'old' and 'new' member states, covering the periods 1980-2010 and 1995-2010, respectively. They find a statistically significant non-linear impact of public debt on annual GDP per capita growth rates, confirming a concave (inverted U-shape) relationship. The threshold at which debt negatively impacts growth is between 80 percent and 94 percent of GDP for old member states, and between 53 percent and 54 percent for new member states.

The empirical results indicate that high public debt levels are associated with reduced economic growth potential. For old EU member states, debt levels above 90 percent of GDP significantly reduce growth, aligning with the findings of Reinhart and Rogoff. For new member states, the threshold is lower, indicating a higher sensitivity to debt accumulation. The study employs a generalized economic growth model augmented with a debt variable, addressing issues of heterogeneity and endogeneity through fixed effects panel regression and instrumental variable (IV) techniques. This robust methodological approach strengthens the validity of their findings.

The study also reveals that the negative impact of public debt on growth is not uniform across all EU countries. The differences between old and new member states highlight the importance of considering country-specific factors when evaluating fiscal policies. The higher debt sensitivity in new member states suggests that these countries may require more stringent fiscal measures to maintain sustainable economic growth. Additionally, the study underscores the importance of implementing effective fiscal consolidation strategies to reduce debt levels and avoid adverse effects on growth.

Overall, Mencinger et al. (2014) provide valuable insights into the relationship between public debt and economic growth within the EU context. Their findings support the need for prudent fiscal management and the implementation of debt reduction policies to foster long-term economic stability. The study contributes to a better understanding of the complexities associated with high public debt and its implications for economic policy, offering a comprehensive analysis that is highly relevant for policymakers aiming to ensure sustainable growth in the European Union.

The Cato Institute[4] has conducted an in-depth review of the literature on the cost of public debt, focusing its analysis on the results for the European Union. The review covers studies published between 2010 and 2020 that examine the relationship between public debt levels and economic growth. One notable pattern that emerges from this research is that high levels of public debt have a negative impact on economic growth. This is particularly relevant for EU countries, where sovereign debt crises have been a significant concern.

Studies reviewed by the Cato Institute indicate that there is a non-linear debt threshold, beyond which debt has a significant detrimental impact on growth rates. For advanced EU countries, this threshold is generally around 80 percent of GDP. In comparison, for developing or emerging countries within the EU, this threshold is lower, at between 50 percent and 60 percent of GDP. This suggests that countries with more fragile economies are more sensitive to the negative effects of high debt.

The analysis also highlights that the quality of domestic institutions and policies can moderate the negative effects of high debt. Some studies show that good institutions and sound economic policies can mitigate to some extent the adverse impacts of high debt. In general, however, the accumulation of public debt beyond the critical threshold tends to reduce private investment, raise long-term interest rates, and raise distortionary taxes, which together lower economic growth.

In conclusion, the Cato Institute's review underscores the importance of maintaining sustainable public debt levels to foster economic growth in the European Union. The results suggest that EU countries should strive to keep their debt ratios below the identified critical thresholds to avoid negative effects on growth.

Therefore, fiscal sustainability is desirable. And for this, it is essential to consider the impact and implementation of fiscal rules. In Europe, fiscal rules play a vital role in the management of public finances. These rules, which include limits on fiscal deficits and public debt, are designed to promote fiscal discipline and prevent the accumulation of unsustainable debt. Strict enforcement of these rules can help governments avoid the levels of indebtedness that Reinhart and Rogoff, and other authors identify as detrimental to economic growth. Thus, fiscal rules are not only financial control mechanisms, but also tools to foster a stable and predictable economic environment. In the following sections, we will describe in detail the various fiscal rules that have been implemented in Europe, as well as their effectiveness and the challenges associated with their application. It will analyze how these rules have influenced the fiscal policies of European countries and their impact on the sustainability of public debt. In addition, the need to adjust and strengthen these rules in response to changing economic and demographic conditions will be discussed, ensuring that they continue to meet their goal of maintaining sound public accounts and supporting robust and sustainable economic growth.

The organization of this work is as follows. Section 2 makes a review of the fiscal rules and fiscal discipline followed by the European Union countries until 2020. Section 3 seeks to explain the reason for fiscal non-compliance by member countries. Section 4 focuses on the period of the Covid-19 pandemic and how it has aggravated the problem of financial sustainability. Section 5 critically describes the new framework of fiscal rules. Section 6 provides a review of the best rules to ensure greater sustainability of public accounts. Section 7 concludes.

3 Jernej Mencinger, Aleksander Aristovnik, and Miroslav Verbic, "The Impact of Growing Public Debt on Economic Growth in the European Union", *Amfiteatru Economic Journal* 16:35 (2014): 403-414.

4 Cato Journal, "The Impact of Public Debt on Economic Growth". Available at: https://www.cato.org/cato-journal/fall-2021/impact-public-debt-economic-growth.

2

A REVIEW OF FISCAL DISCIPLINE IN EUROPEAN COUNTRIES

The first section of this work addresses the importance of fiscal sustainability in ensuring a long-term economic growth path. But how does this financial sustainability relate to fiscal rules? Compliance with the fiscal rules of the EU Stability and Growth Pact (SGP) is not an end in itself. Its purpose is to safeguard the proper functioning of the Economic and Monetary Union (EMU) and to contribute to the overall stability of the euro area. The economic governance of EMU combines two opposing models of macroeconomic policymaking. Monetary policy is delegated to a central institution, the European Central Bank (ECB), while fiscal policy remains in the hands of the EU member states. To avoid cross-border spillovers of national budgets and obstacles to the ECB's monetary policy, governments agreed on a set of fiscal rules. This agreement is based on the realization that, with an advanced degree of economic integration such as that achieved in the EU, national governments cannot ignore the cross-border impact of their budgetary decisions, as they could jeopardize the functioning of EMU.[5]

Compliance with the fiscal rules of the SGP aims to keep public finances on a sustainable path and prevent national budget deficits and excessive public debts from hampering the common monetary policy. The Pact came into force at the end of the 1990s, and its implementation was based on simple rules, which were based on keeping the budget deficit below 3 percent of GDP and public debt below 60 percent of GDP, to ensure legal discipline. However, as will be shown in the following pages, compliance with these rules has been mixed, with significant differences between countries and periods. These rules are intended not only to prevent fiscal crises, but also to avoid negative effects on other member countries and to ensure that national fiscal policies do not compromise the economic stability of the euro zone.

In 2005, the Stability and Growth Pact (SGP) underwent a significant reform motivated by the need to balance fiscal sustainability with economic stabilization. This reform was triggered by events in November 2003, when the Council refused to follow the Commission's proposal to intensify the Excessive Deficit Procedure (EDP) for Germany and France. The initial SGP, formulated in nominal terms, prioritized the sustainability of public finances without having regard to the economic cycle. During recessions, such as the one that occurred in the early 2000s (the tech bubble), budget balances deteriorated even without discretionary government interventions. Therefore, complying with deficit rules in a recession could lead to procyclical tightening. To address this problem, the 2005 reform introduced the cyclically adjusted budget balance as a key benchmark for defining budgetary policy in EU member states.

The 2005 reform also sought to provide more flexibility to the SGP to have regard to country-specific economic circumstances. Exceptions were introduced that enabled member states to temporarily exceed the 3 percent of GDP deficit limits in the event of severe recessions or major structural reforms that entailed an upfront cost but generated long-term fiscal benefits. This flexibility sought to avoid pro-cyclical fiscal adjustments that could exacerbate economic downturns. In addition, enhanced surveillance and monitoring mechanisms were put in place to ensure that member states corrected their deficits in a timely and sustainable manner.

In 2011, the SGP underwent a further reform known as the six-pack reform. This reform was a response to the global economic and financial crisis that began in 2007 and revealed that compliance with nominal deficit rules had not prevented the build-up of dangerous imbalances. The six-pack reform introduced the expenditure criterion, which imposes a limit on the growth rate of government spending. This limit is based on the medium-term potential growth rate, providing a more stable anchor than the structural deficit estimate. In addition, the reform also defined more precisely the satisfactory pace of debt reduction required to comply with the 60 percent of GDP debt rule.

The six-pack also included the creation of new surveillance mechanisms and stricter sanctions for member states that did not comply with the fiscal rules. The reform introduced a macroeconomic imbalance procedure to identify and correct potentially harmful macroeconomic imbalances at an early stage. In addition, economic governance rules were improved and national and independent fiscal institutions were strengthened, with the aim of promoting greater fiscal discipline and ensuring that budgetary policies were consistent with the long-term goals of stability and growth.

5 Martin Larch, Janis Mazubris, and Stefano Santacroce, "Numerical Compliance with EU Fiscal Rules: Facts and Figures from a New Database" *Intereconomics* 58:1 (2023): 32-42.

Thus, the SGP establishes four numerical fiscal rules: the deficit rule, the balanced structural budget rule, the expenditure rule and the debt rule. This section follows the work of Larch et al. (2023) to show the degree of compliance with these numerical rules by EU member countries. These rules have the common goal of keeping public finances on a sustainable path in the medium to long run, although they may imply different fiscal performances in the short run depending on the macro-financial context. Understanding compliance patterns over time and across rules enables an assessment of their effectiveness and the challenges faced by member states in their implementation.

The definitions of fiscal rules

Defining in detail the fiscal rules is crucial to be able to analyze the degree of compliance of EU member countries with the Stability and Growth Pact. These definitions enable a clear and precise assessment of each country's fiscal performance, highlighting whether they remain within the limits set by common fiscal policies. In addition, a clear measure of compliance facilitates the identification of areas for improvement and the design of corrective policies. In this sense, it is essential to have both qualitative and numerical indicators to assess compliance with these fiscal rules.

The first fiscal rule is the deficit rule, which states that the general government budget deficit should not exceed 3 percent of GDP. If a country exceeds this limit, it is considered to have violated the rule, unless the deviation is small (maximum 0.5 percent of GDP) and limited to a single year. A qualitative measure of compliance will take the value of 1 if the country complies with this rule, while a positive value in the numerical measure indicates that the budget balance is above -3 percent of GDP. A negative value would signal a deficit larger than enabled.

The second rule is the structural balanced budget rule, which focuses on the cyclically adjusted budget balance, excluding temporary measures and business cycle effects. A country is considered compliant if the general government structural budget balance is at or above the medium-term objective (MTO). If not yet achieved, compliance refers to the annual improvement in the structural fiscal balance equal to or above 0.5 percent of GDP, or the distance from the MTO is less than 0.5 percent. A value of 1 in the qualitative measure indicates compliance, while a positive value in the numerical measure means that the country is above the MTO or that the structural effort exceeds the requirement of 0.5 percent of GDP.

The third rule is the expenditure rule, which limits the annual growth rate of primary government expenditure (excluding discretionary revenue measures and extraordinary expenditures) to the medium-term potential growth rate. This growth must be less than the ten-year average potential growth rate minus a convergence margin necessary to ensure alignment with the structural balance rule. A value of 1 in the qualitative measure signals compliance, and a positive value in the numerical measure indicates that spending growth is below the enabled limit, showing adequate control of public spending.

Finally, the debt rule requires that public debt should not exceed 60 percent of GDP, or that any excess over this value should decline at a satisfactory rate, specifically 1/20 of the excess on average over the previous three years. Complying with this rule is crucial for long-term fiscal sustainability. A value of 1 on the qualitative measure reflects compliance, while a positive value on the numerical measure for countries with debt above 60 percent of GDP indicates that actual debt is below the level required by the debt reduction rule. For countries with debt below 60 percent, the positive value reflects the distance to the 60 percent benchmark.

These detailed definitions enable a clear assessment of member countries' fiscal performance and provide a basis for improving fiscal discipline in the EU, thus contributing to the region's economic stability. With these definitions it is possible to who information on the degree of compliance since the year in which the first numerical rules (deficit and debt) came into force, i.e., since 1998. The latest available data go up to the year 2023, however, as will be addressed below, the fiscal rules went into abeyance in 2020, so from this year onwards, referring to the degree of compliance is a purely informative exercise and one that serves to show trends, rather than as a measure of actual non-compliance with the fiscal rules.

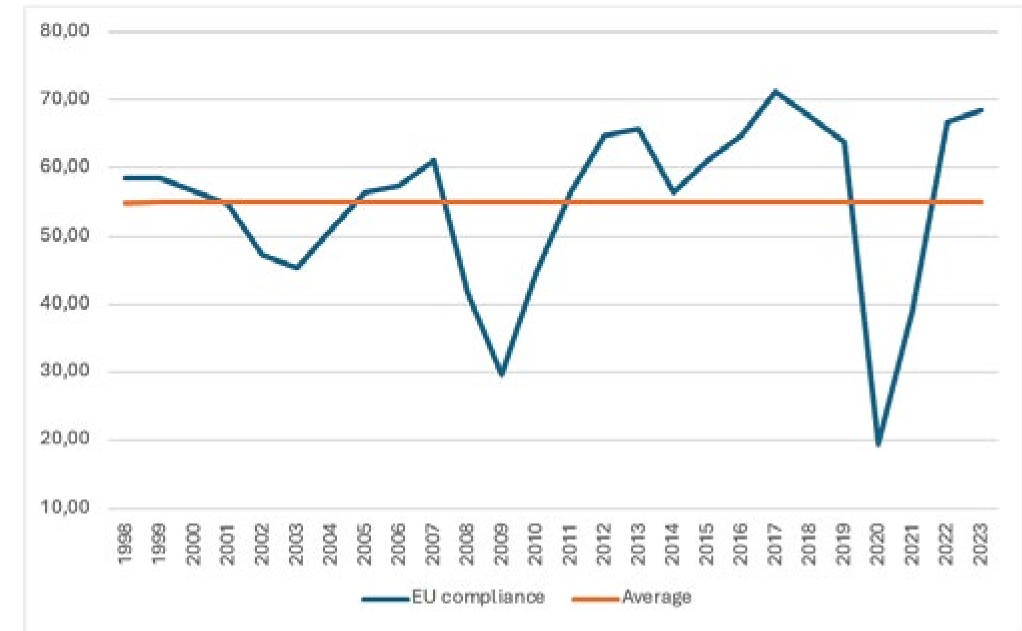
Fiscal compliance in the European Union between 1998 and 2023

The first figure shows the historical record of the degree of compliance on an aggregate basis for the 27 countries that currently make up the European Union. As can be seen, the average degree of compliance for the period 1998-2023 is 55%. This means, as indicated by Larch et al. (2023), that:

- On average, only one in two countries have complied with the fiscal rules each year; or
- all countries have complied with all fiscal rules every two years; or
- all countries have complied with half of the fiscal rules every year.

Obviously, this analysis is superficial, as it ignores the differences between countries, since it only shows the average degree of compliance of the member countries of the European Union. Furthermore, as shown in Figure 1, the trend over time has varied considerably, since although in the early years the degree of compliance was in line with the average for the period as a whole, it can also be seen that compliance is related to the economic cycle. Specifically, in the crisis periods (2008-2009 and 2020), there is a large deterioration in the percentage of compliance. Thus, it is necessary to make a more detailed exercise of compliance by country.

FIGURE 1.
Average compliance with fiscal rules, 1998-2023, in percent.



Source: European Commission.

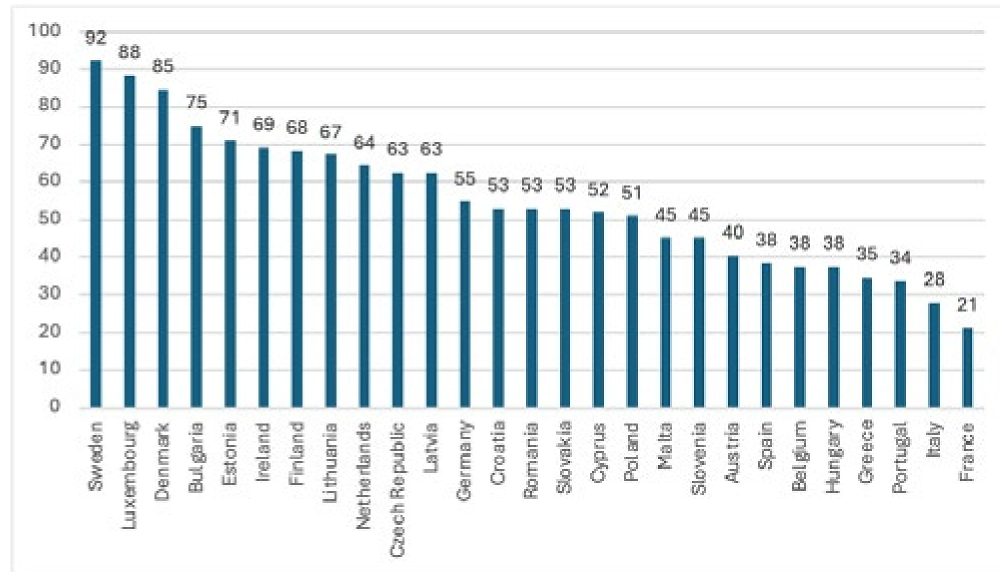
Figure 2 shows the large differences between countries. For example, Nordic countries such as Sweden or Denmark, or Central and Eastern European countries such as Luxembourg or Bulgaria, are at the forefront as the most compliant countries. Their percentage varies between 92 percent and 71 percent, i.e., there is a high degree of fiscal sustainability with respect to the 4 fiscal rules considered. On the other hand, Spain, Belgium, Hungary, Greece, Portugal, Italy and France show a very poor performance, with a compliance rate below 40 percent.

It is also possible to show the degree of compliance by level of debt to GDP for the 2011-2019 period. In this case, following the exercise made by Larch et al. (2023), countries can be grouped by low level of debt (less than 60 percent of GDP), high level of debt (between 60 percent and 90 percent of GDP), and with a high level of indebtedness (above 90 percent of GDP). Following this classification, the first group of countries includes Bulgaria, Czech Republic, Denmark, Estonia, Latvia, Lithuania, Luxembourg, Malta, Poland, Romania, Slovakia, Finland, Sweden. The middle group includes Germany, Ireland, Croatia, Hungary, the Netherlands, Austria and Slovenia. Finally, the most indebted countries are Belgium, Greece, Spain, France, Italy, Cyprus and Portugal.

As can be seen, the degree of compliance decreases as the level of indebtedness increases. In this case, countries with a debt level below 60 percent have a compliance ratio of 67 percent. Countries with an intermediate level of indebtedness are also close to the European Union average. The most indebted countries have a compliance ratio with fiscal rules of 35 percent. This result is as expected. Consistent non-compliance with fiscal rules leads to an accumulation of government debt.

FIGURE 2.

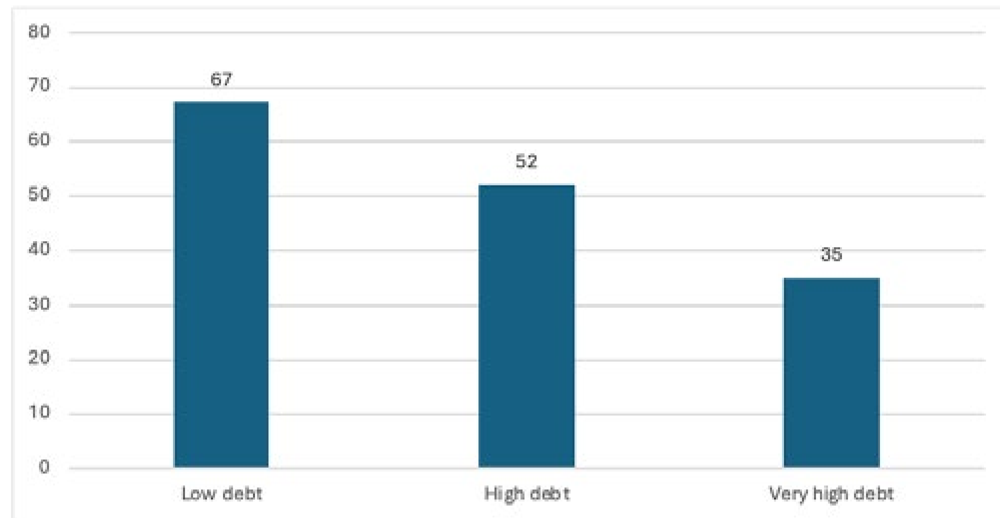
Average Fiscal compliance with fiscal rules across countries, 1998-2023, in percent.



Source: European Commission.

FIGURE 3.

Fiscal compliance with fiscal rules by level of indebtedness, 1998-2023, in percent.



Source: European Commission.

It is also important to show the evolution of Fiscal compliance by type of rule, as interesting insights can also be obtained. First, it is observed that compliance with the deficit rule and the debt rule tends to be higher but shows a clear procyclical pattern. During periods of economic expansion, budgets automatically improve and, consequently, so do debt-to-GDP ratios. However, in periods of recession, these indicators deteriorate. A notable example of this is the 2011-2013 period, when, despite adverse economic conditions, compliance with the deficit rule improved due to market pressure and economic adjustment programs.

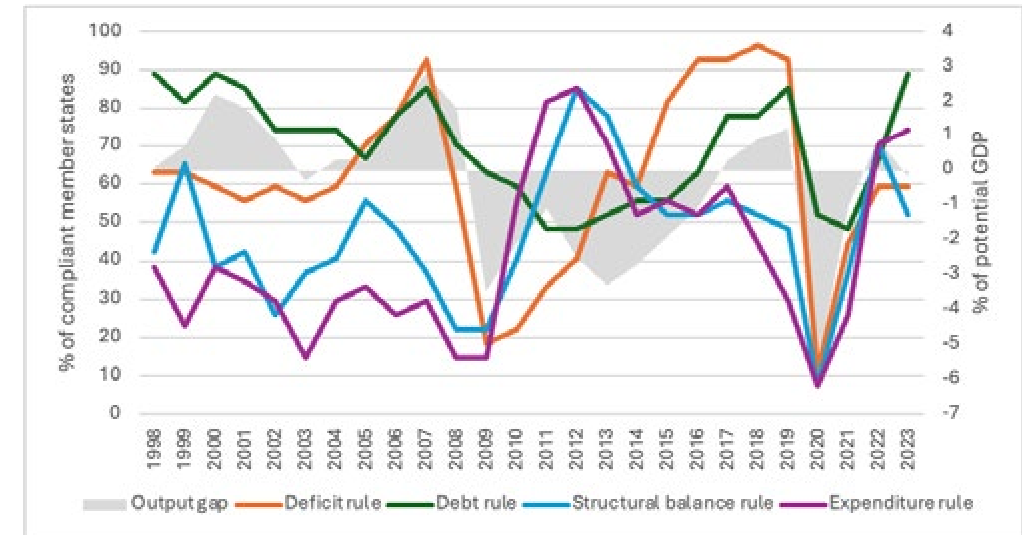
Second, in the early years of the study period, the expenditure rule exhibited the lowest compliance rate. Only a small fraction of member states adopted fiscal policies that kept net expenditure growth anchored to a prudent rate of potential growth over the medium term. This compliance gap narrowed after the introduction of the rule in 2011 with the "six-pack" reform of the Stability and Growth Pact. Since then, the structural balance and expenditure rules follow a very similar pattern.

Third, compliance with the structural balance rule and, especially, the expenditure rule is, on average, significantly lower than that of the other two rules targeting nominal variables. This is especially evident before the global financial crises and the COVID-19 pandemic. In 2007, for example, more than 80% of member states were in compliance with the deficit and debt rules, but compliance with the structural balance rule was much lower, and only a few countries had net expenditure growth aligned with the underlying economic growth rate.

This finding highlights an important and highly relevant difference between the numerical compliance measured through Larch et al. (2023) and the formal compliance assessment conducted by the Commission and the Council in the context of the EU fiscal surveillance framework. The clear drop in numerical compliance with the structural balance rule and the expenditure rule during the economic recoveries should have triggered alarm bells. However, the formal assessment of compliance, which involves a high degree of discretion, often used favorable balance sheets and debt ratios as a pretext for leniency, leading to pro-cyclical fiscal policies.

FIGURE 4.

Fiscal compliance with fiscal rules and business cycle in the European Union, 1998-2023.



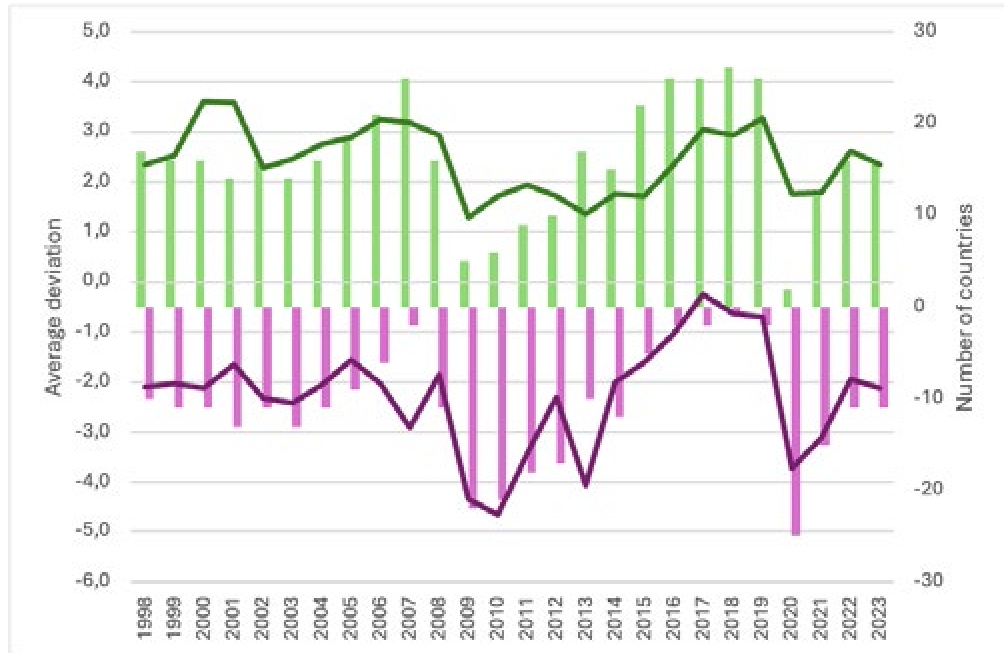
Source: European Commission and AMECO.

In addition to paying attention to qualitative compliance with fiscal rules, the data constructed by Larch et al. (2023) also show the degree of over- and under-compliance. The following 4 figures show the average deviation of compliant countries (green line) and non-compliant countries (purple line). The number of compliant (green bars) and non-compliant (purple bars) countries is also added.

Figure 5 illustrates the evolution of average deviations from the deficit rule, distinguishing between compliant and non-compliant countries since 1998. In the early years of the period under analysis, considerable variability in deviations is observed, with some countries significantly exceeding the 3% of GDP threshold. During the 2008-2009 financial crisis, negative deviations were amplified, reflecting the widespread deterioration of fiscal balances. Subsequently, with the implementation of adjustment programs and fiscal consolidation policies, average deviations in non-compliant countries declined, although without reaching widespread compliance levels. The sovereign debt crisis in the Eurozone and market pressures forced many countries to adopt strict fiscal measures, resulting in a gradual reduction of negative deviations, although compliance remains a challenge in several member states.

FIGURE 5.

Differences in average deviation in percentage points of GDP from the deficit rule between compliant and noncompliant countries, 1998-2023.

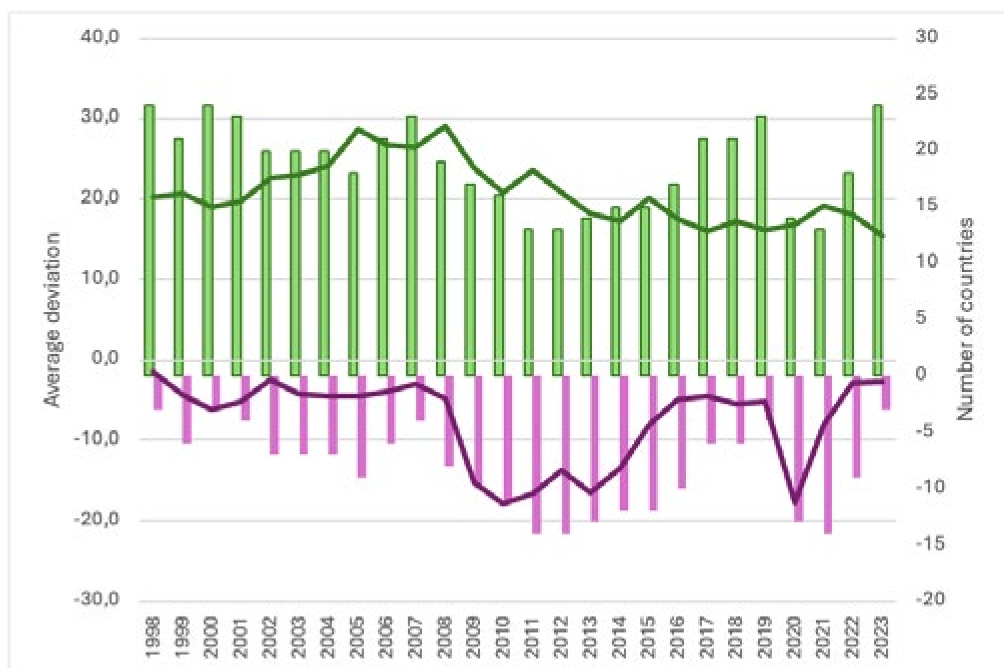


Source: European Commission.

Figure 6 shows the average deviations from the debt rule, which establishes a limit of 60% of GDP for public debt. In the initial years, deviations were not as pronounced due to relatively low debt levels. However, the global financial crisis caused a dramatic increase in debt levels, reflected in significant negative deviations post-2008. Highly indebted countries exhibit larger deviations, especially during the European sovereign debt crisis. Despite structural reforms and fiscal consolidation efforts, debt reduction has been slow and uneven across member states. This figure highlights the difficulty of complying with the debt rule in a context of low economic growth and high levels of inherited debt.

FIGURE 6.

Differences in average deviation in percentage points of GDP from the debt rule between compliant and noncompliant countries, 1998-2023.



Source: European Commission.

Figure 7 presents deviations from the structural balance rule, which adjusts for the business cycle and excludes temporary factors. Prior to the financial crisis, many European economies failed to adjust structurally, which is reflected in significant negative deviations. The crisis accentuated these deviations due to falling tax revenues and increased automatic spending. Austerity measures and subsequent structural adjustments managed to partially reduce these deviations, although the recovery has been uneven. This figure underscores the importance of maintaining sound structural balances to ensure long-term fiscal sustainability and avoid procyclical policies that exacerbate economic fluctuations.

FIGURE 7.

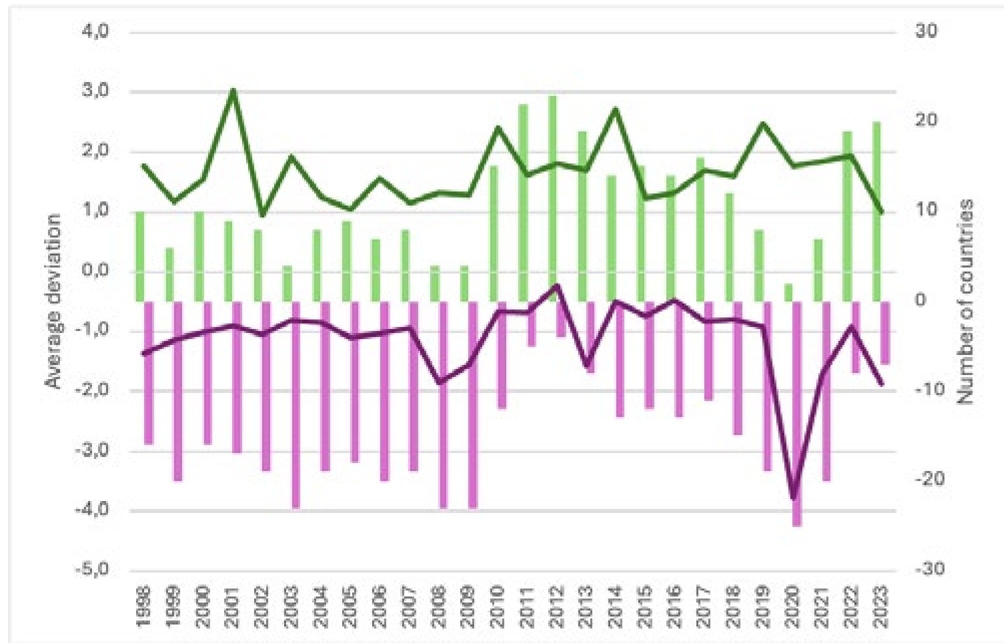
Differences in average deviation in percentage of potential GDP from the structural balance rule between compliant and noncompliant countries, 1998-2023.

Source: European Commission.

Finally, Figure 8 shows deviations from the expenditure rule, which limits public spending growth to a prudent rate based on medium-term potential growth. Initially, deviations were minor, but the financial crisis and the resulting expansionary fiscal responses caused an increase in negative deviations. The introduction of the expenditure rule with the "six-pack" reform in 2011 sought to moderate expenditure growth, but implementation has been heterogeneous across member states. In subsequent years, a reduction in negative slippages is observed, although full compliance remains a challenge due to pressures to increase spending in response to economic and social challenges. This figure highlights the need for strict discipline in expenditure control to ensure fiscal stability.

FIGURE 8.

Differences in average deviation in percentage of GDP from the expenditure rule between compliant and noncompliant countries, 1998-2023.



Source: European Commission.

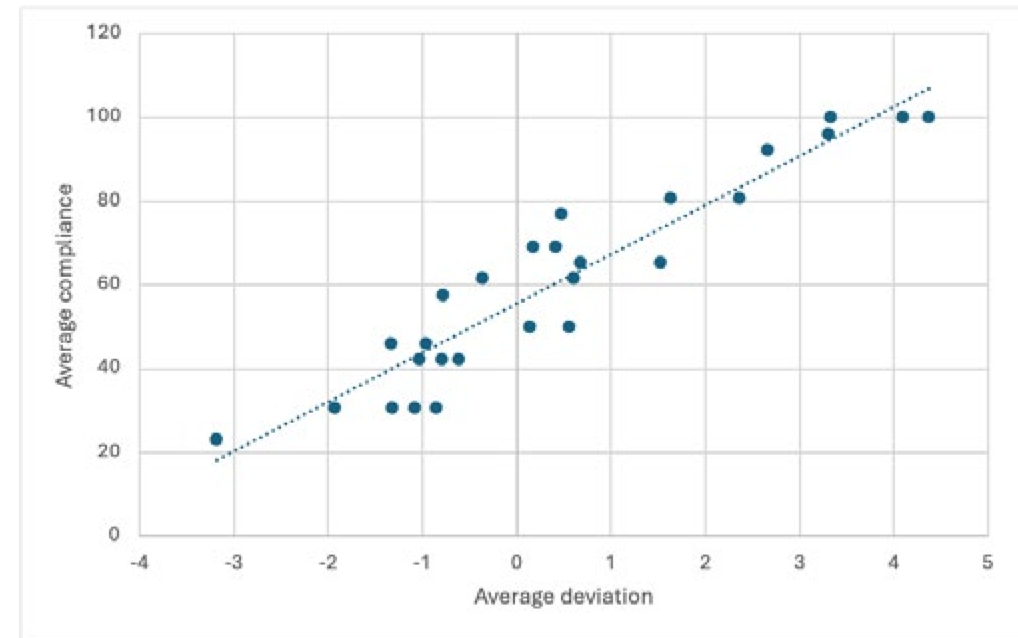
Finally, before concluding this section, it is also important to examine the four figures presented that plot the correlation between the average annual compliance and the average deviation for each of the fiscal rules. As can be observed, the regression line in these figures is positive, indicating a clear trend: non-compliant countries tend to deviate significantly from the fiscal rules, while compliant countries often exhibit compliance to a notable extent in the opposite direction.

This pattern underscores the substantial heterogeneity and asymmetry among EU member states regarding their fiscal performance. Specifically, it highlights the existence of a diverse range of fiscal behaviors, with some countries consistently maintaining healthy government accounts and adhering to the established fiscal guidelines. Conversely, other countries experience considerable fiscal deterioration, failing to comply with the rules by wide margins.

This variation can be attributed to different economic policies, levels of fiscal discipline, and external economic pressures faced by each country. Consequently, the figures illustrate the broader challenge of achieving uniform fiscal compliance across the EU, reflecting the diverse economic realities and fiscal strategies employed by member states. This heterogeneity necessitates a nuanced approach to fiscal policy and monitoring within the Union, acknowledging the diverse fiscal capacities and economic conditions of its member states.

FIGURE 9.

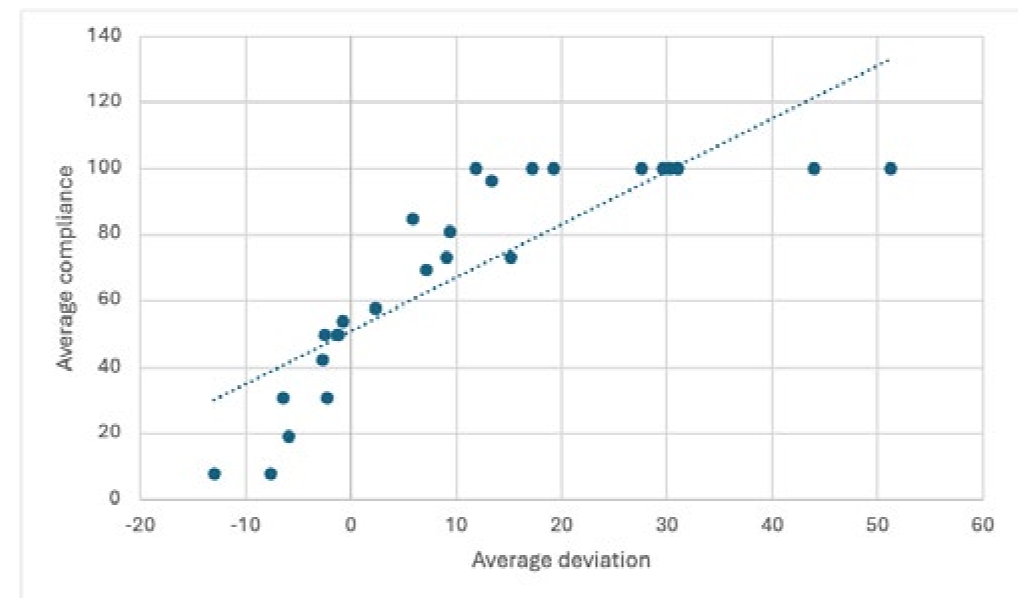
Relationship between average compliance rates and deviations from the deficit rule, 1998-2023.



Source: European Commission.

FIGURE 10.

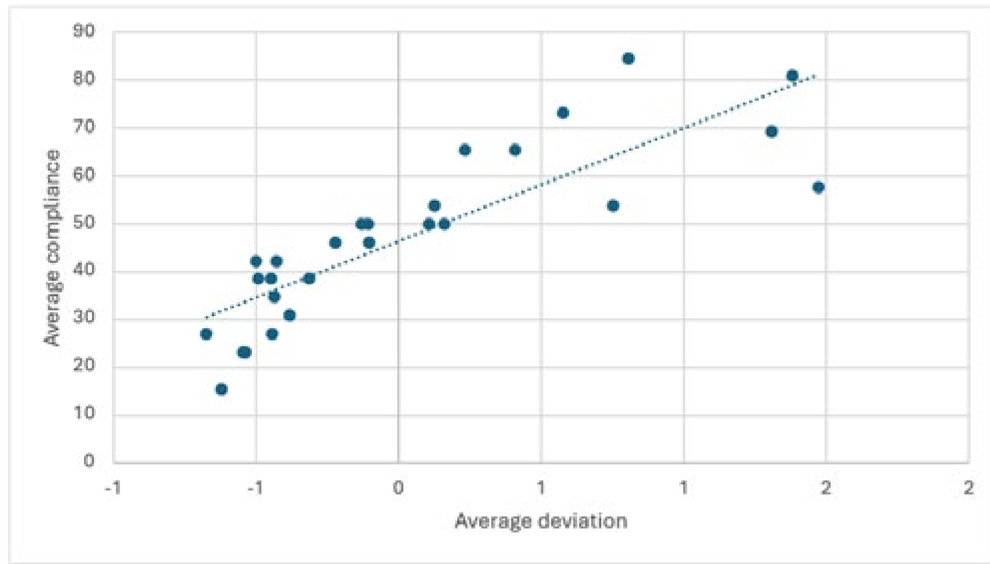
Relationship between average compliance rates and deviations from the debt rule, 1998-2023.



Source: European Commission.

FIGURE 11.

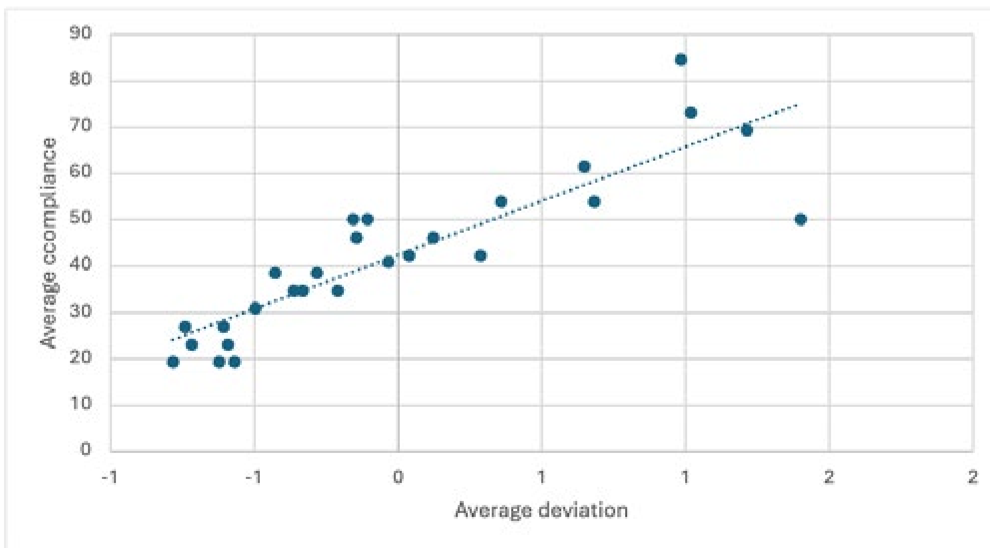
Relationship between average compliance rates and deviations from the structural balance rule, 1998-2023.



Source: European Commission.

FIGURE 12.

Relationship between average compliance rates and deviations from the structural balance rule, 1998-2023.



Source: European Commission.

All in all, there is considerable heterogeneity in compliance among EU Member States. Some countries, such as Sweden and Denmark, show high adherence to fiscal rules, maintaining healthy and sustainable government accounts. However, other countries, such as Greece and Portugal, show significant deviations, reflecting a notable fiscal deterioration. This disparity in compliance highlights the diverse fiscal capacities and economic challenges faced by member states, underscoring the need for differentiated approaches tailored to country-specific conditions.

The exercise presented in this section also reveals that Fiscal compliance with fiscal rules is closely linked to economic cycles. During periods of economic expansion, Fiscal compliance tends to improve due to higher tax revenues and lower unemployment benefit expenditures. In contrast, during recessions, adherence to fiscal rules declines, as observed during the 2008 financial crisis and the COVID-19 pandemic. This pro-cyclical pattern indicates that current fiscal rules may need adjustments to improve their effectiveness in different phases of the business cycle.

Moreover, the existence of rules such as the 3% of GDP deficit limit and the 60% of GDP public debt, while essential, have proven to be insufficient to prevent the buildup of significant fiscal imbalances in certain periods.

Finally, this section sets the stage for the discussion in section 3, where the causes of fiscal default in European countries will be analyzed. It is crucial to understand not only the degree of compliance, but also the underlying factors that lead some countries to deviate from fiscal rules. Factors such as the quality of governance institutions, economic structure and domestic fiscal policies play significant roles in fiscal performance. Exploring these causes will enable the development of more effective recommendations to improve fiscal discipline and ensure long-term economic sustainability in the European Union.

3

WHY ARE EUROPEAN COUNTRIES IN FISCAL NON-COMPLIANCE?

This section addresses a fundamental question for the economic stability of the European Union: why do some European countries fail to comply with established fiscal rules? Despite efforts to implement stringent fiscal rules, such as those contained in the Stability and Growth Pact, non-compliance remains a recurrent problem. This analysis is essential to understand the causes of fiscal slippages and to develop more effective strategies to encourage greater fiscal discipline in the future. The heterogeneity in compliance across member states suggests that there are multiple factors, both internal and external, that influence a country's ability to adhere to fiscal rules.

A simple exercise is presented below, as made by Larch et al. (2023). More specifically, simple relationships between average compliance and two institutional quality variables are presented. Why is institutional quality important to ensure a higher degree of compliance with fiscal rules?

Institutional quality is critical to ensuring greater compliance with fiscal rules because it provides an effective governance framework that ensures implementation and rigorous monitoring of fiscal rules. Strong and transparent institutions, such as efficient finance ministries, independent oversight bodies, and strong judicial systems, are essential for the formulation and implementation of coherent and responsible fiscal policies. These institutions not only design and enforce fiscal rules, but also ensure that they are respected over time. The transparency and accountability provided by high-quality institutions generate confidence among investors and citizens, which is crucial for maintaining economic and fiscal stability.

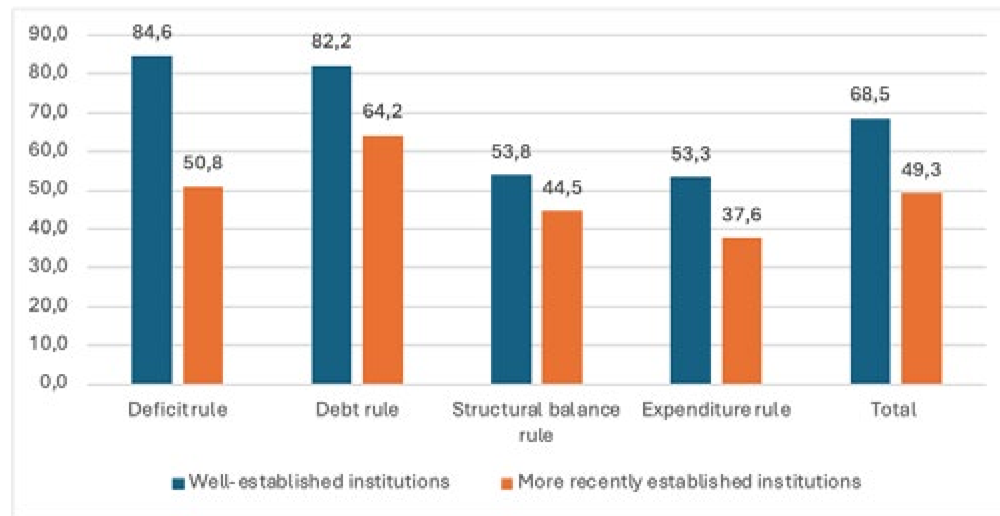
Moreover, institutional quality directly influences a country's ability to resist political pressures that could lead to irresponsible fiscal decisions. In environments with weak institutions, governments are more likely to succumb to pressures to increase public spending unsustainably or to fail to raise tax revenues adequately, with the aim of gaining short-term political support. Robust institutions, on the contrary, act as a counterweight to these pressures, promoting prudent and sustainable fiscal policies. This includes the implementation of checks and balances, regular audits and the application of sanctions in case of non-compliance, which discourages irresponsible fiscal behavior and reinforces compliance with established rules.

Finally, institutional quality also affects the ability of countries to adapt to unforeseen economic and financial changes. Well-designed and functioning institutions enable a rapid and effective response to economic crises, ensuring that necessary fiscal adjustment measures are implemented in a timely manner and with the least possible negative impact. This is crucial for maintaining confidence in the government's ability to manage public finances, which in turn facilitates compliance with fiscal rules. In short, high-quality institutions provide the necessary framework for effective fiscal governance, promoting long-term fiscal sustainability and discipline, and ensuring that fiscal rules are not only established, but consistently enforced.

Two indicators are used to approximate institutional quality. The first is based on the classification made by Larch et al (2023) that groups countries with respect to the number of years since each country established its national independent fiscal body. Thus, the countries with well-established institutions would be Belgium, Denmark, Estonia, Lithuania, Luxembourg, the Netherlands, Austria and Sweden. On the other hand, the countries that have more recently established their institutions are Bulgaria, Czech Republic, Germany, Ireland, Greece, Spain, France, Croatia, Italy, Cyprus, Latvia, Hungary, Malta, Portugal, Romania, Slovenia, Slovakia, and Finland.

As can be seen in the following figure, countries with well-established independent fiscal institutions have a higher degree of compliance with fiscal rules. Specifically, the average difference with respect to countries with more recently created institutions is approximately 20 percentage points. Having institutions that monitor government behavior seems to be an indication of healthy government accounts.

FIGURE 13.
Average fiscal compliance with fiscal rules by type of fiscal institutions, 1998-2023, in percent.



Source: European Commission.

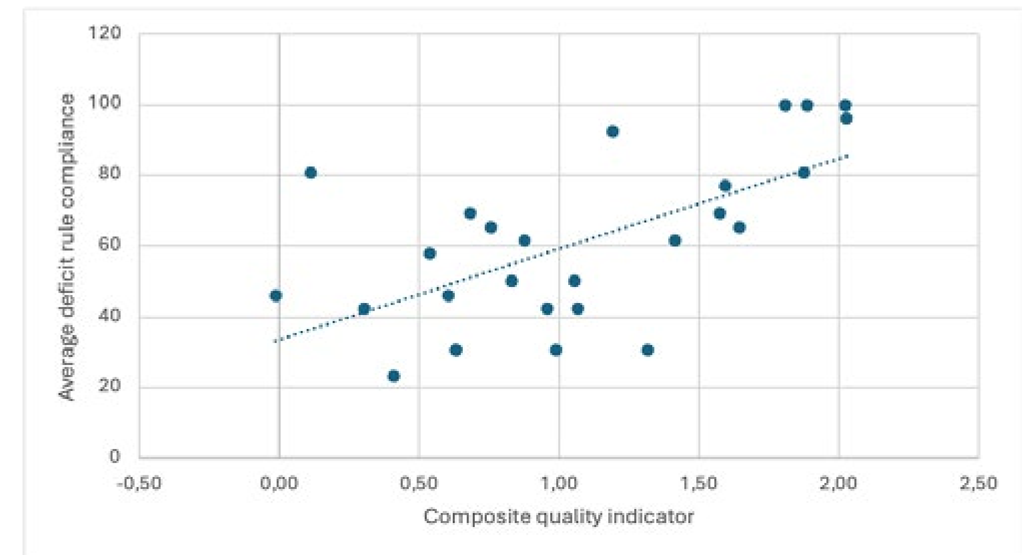
The second of the institutional quality indicators used is a composite made from a series of Worldwide Governance Indicators (WGI), estimated by the World Bank. The WGI is a set of aggregate indicators that assess the quality of governance in more than 200 countries and territories. These indicators are composed of six key dimensions: Control of Corruption, Government Effectiveness, Political Stability and Absence of Violence/Terrorism, Regulatory Quality, Rule of Law, and Voice and Accountability. Each of these indicators is measured on a scale ranging from -2.5 to 2.5 points, where higher values indicate better governance quality. The methodology is based on the aggregation of data from multiple sources, including surveys of citizens, companies and experts, which provides a broad and detailed view of governance in each country.

To measure the relationship between institutional quality and compliance with fiscal rules in European Union countries, the results of three of these indicators have been averaged for the period 1998-2022: Control of Corruption, Government Effectiveness and Regulatory Quality. These three indicators were selected for their direct relevance to the management and implementation of fiscal policies. Averaging these results yields a composite index that reflects the overall institutional quality of each country, enabling analysis of how this quality influences their ability to adhere to established fiscal rules.

Control of Corruption measures the degree to which public power is used for private benefit, Government Effectiveness assesses the quality of public services and policy implementation, and Regulatory Quality reflects the government's ability to formulate and enforce regulations that promote private sector development. These categories are essential because low corruption, effective government, and good regulatory quality are fundamental to prudent and sustainable fiscal management. High institutional quality in these areas tends to be associated with better fiscal outcomes, as they facilitate efficient management of public resources and compliance with fiscal rules, thus promoting long-term economic and fiscal stability.

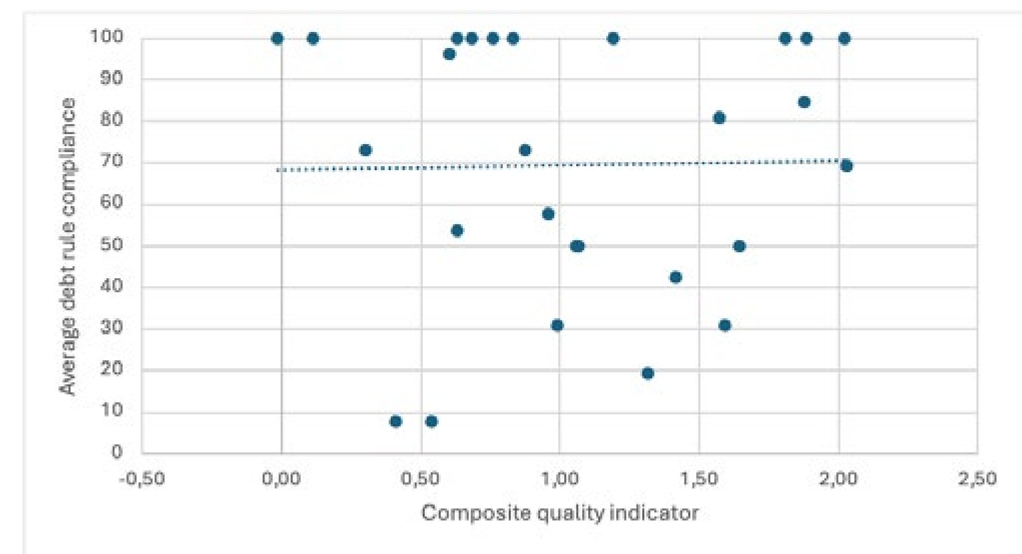
As can be seen in the four figures below, there is a clear positive relationship between institutional quality and for three of the four fiscal rules. The only one for which there is no clear relationship is the debt rule. Since this is a rule on a stock variable, it is plausible to think that there are other variables of the same type, such as the accumulation of debts in the past, that have a greater force in explaining the non-compliance with this specific rule. However, for the three flow rules, the relationship is remarkable, which corroborates the importance of having independent and strong institutions to control public accounts.

FIGURE 14.
Relationship between institutional quality and average compliance with the deficit rule, 1998-2023.



Source: European Commission and World Bank Group.

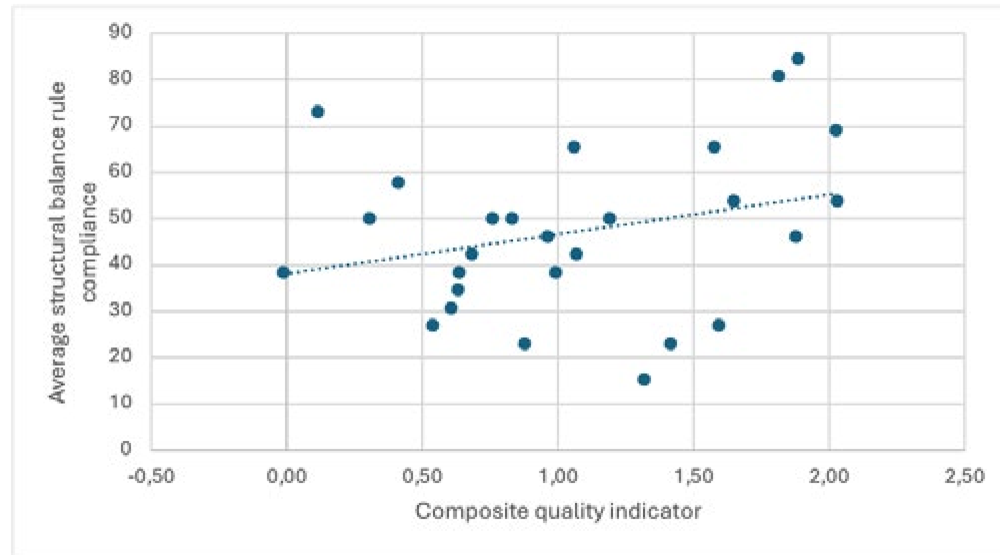
FIGURE 15.
Relationship between institutional quality and average compliance with the debt rule, 1998-2023.



Source: European Commission and World Bank Group.

FIGURE 16.

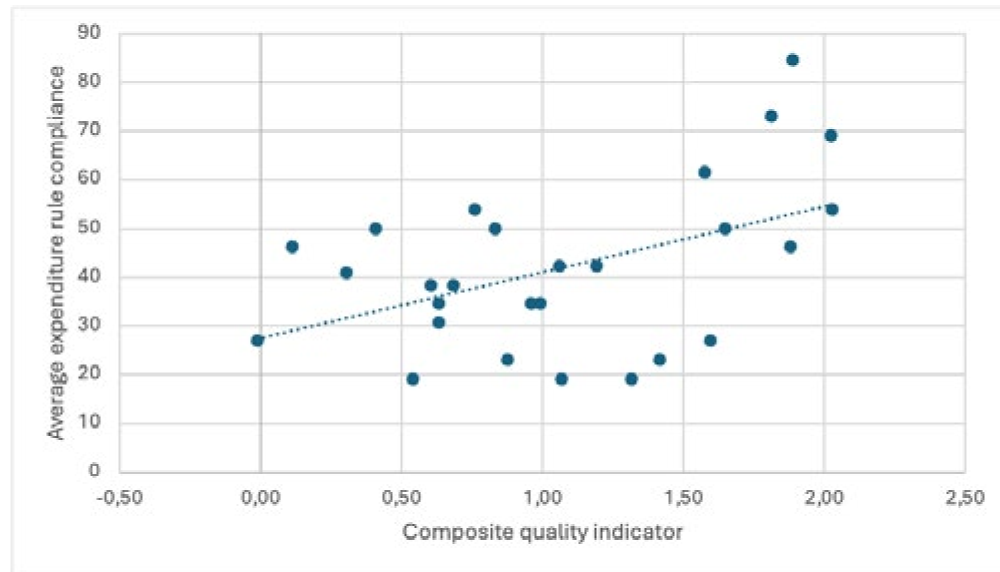
Relationship between institutional quality and average compliance with the structural balance rule, 1998-2023.



Source: European Commission and World Bank Group.

FIGURE 17.

Relationship between institutional quality and average compliance with the expenditure rule, 1998-2023.



Source: European Commission and World Bank Group.

It is important to highlight, as Ulloa-Suárez (2023)[6] does, that fiscal rules can be a decisive factor in reducing deficit and public debt levels, but it is not a sufficient condition. As highlighted in the previous pages, despite the fact that fiscal rules have operated in all EU member states, not all countries have followed the same path of fiscal stability. It is therefore important to analyze the underlying causes of governments' good performance in balancing their public accounts. This author identifies up to three factors that explain the greater or lesser probability of compliance with fiscal rules:

- Fiscal compliance with fiscal rules is influenced by the motivations or reasons behind their implementation. Countries often adopt fiscal rules as tools to improve the sustainability of public finances and as commitment devices. Changes in the macroeconomic landscape, which affect the sustainability of public finances or the country's accessibility to finance, can influence government behavior and thus compliance with the rules. These changes in the macroeconomic environment can alter fiscal priorities and, consequently, affect adherence to established fiscal rules.

- Protecting fiscal policy from corruption and potential principal-agent problems between voters and authorities is also a crucial factor in fiscal rules compliance. Different political configurations may lead to different results in terms of compliance. For example, a more stable and less corrupt political environment tends to favor greater adherence to fiscal rules, as it reduces incentives to divert public funds and ensures that fiscal decisions are made based on technical and long-term sustainability criteria.

- The efficiency and quality of institutions play a fundamental role in compliance with fiscal rules. When governments have the capacity to manage and enforce their fiscal rules effectively, these can contribute significantly to reducing the procyclicality of fiscal policy and improving overall fiscal performance. Strong, well-designed institutions enable better implementation and monitoring of fiscal rules, ensuring that they are enforced even in adverse economic situations. In addition, features such as transparency and accountability in the design of fiscal rules can increase the likelihood of compliance by making fiscal policies more predictable and subject to public scrutiny.

An interesting work by Alesina and Passalacqua (2016)[7] explores and analyzes the reasons why governments accumulate more debt than would be consistent with optimal fiscal policy. In addition, the study examines numerical rules or institutional designs that could lead to a moderation of these distortions. The research focuses on identifying the political and economic factors that explain debt accumulation and assesses possible solutions to limit excessive deficits and improve countries' fiscal sustainability.

Among the causes behind higher indebtedness are:

- Suboptimal fiscal policies in democracies. Democratic governments often prioritize public spending to gain popularity and ensure their re-election, resulting in fiscal deficits and long-term debt accumulation. This behavior is incentivized by voter expectations and the structure of the democratic system, which favors short-term spending over long-term fiscal sustainability.

- Social conflict and wars of attrition also contribute significantly to debt accumulation. In highly polarized contexts, different groups within a country may resist accepting the measures needed to reduce the deficit and stabilize debt. This phenomenon, known as war of attrition, occurs when each group expects others to bear the costs of adjustment measures, which delays the implementation of responsible fiscal policies and increases the total debt burden due to interest accumulation.

- The global macroeconomic environment is another crucial factor in debt accumulation. Global interest rates, economic growth expectations and country-specific economic vulnerabilities affect the ability of nations to manage their debt. For example, low interest rates can facilitate debt accumulation by reducing the immediate costs of borrowing but can lead to unsustainable accumulation if economic conditions worsen. In addition, emerging economies face greater risks due to their exposure to global market fluctuations and their own structural vulnerabilities.

On the other hand, the factors behind good performance:

- Countries that exhibit better performance in debt management share several key characteristics. The quality and efficiency of institutions are key. Countries with robust institutions have better fiscal control and oversight mechanisms, which helps avoid overspending and implement prudent fiscal policies. Institutions that promote transparency, accountability and efficiency in public administration contribute to a more stable and predictable fiscal environment.

- The adoption of prudent and sustainable fiscal policies is also crucial. This includes the implementation of fiscal rules that limit public deficits and debt, such as balanced budget rules or debt limits. In addition, countries that make fiscal adjustments in a timely manner and adopt structural reforms to improve the efficiency of public spending and tax revenues tend to show better fiscal performance. These policies enable governments to keep debt under control and respond effectively to economic shocks.

- Political stability and a political environment conducive to consensus and collaboration in fiscal decision making are essential. Countries where governments can implement long-term policies without the constant pressure of abrupt political and electoral changes tend to manage their debt better. The ability of governments to resist populist pressures and focus on long-term fiscal policies also contributes significantly to good debt management performance.

In conclusion, debt accumulation in countries is influenced by a combination of suboptimal fiscal policies, social conflicts and wars of attrition, and the global macroeconomic environment. However, those countries that achieve better performance in debt management share characteristics such as strong and efficient institutions, prudent and sustainable fiscal policies, and a stable political environment. These characteristics not only help to avoid excessive debt accumulation, but also enable a better response to economic fluctuations and financial crises, ensuring long-term fiscal sustainability. These findings, moreover, relate to the simple correlations shown above that demonstrate that institutions matter in explaining greater compliance with fiscal rules.

6 Carolina Ulloa-Suárez, "Determinants of compliance with fiscal rules: Misplaced efforts or hidden motivations?", *European Journal of Political Economy* 78 (2023): 102399.

7 Alberto Alesina and Andrea Passalacqua, "The political Economy of Government Debt", *Handbook of Macroeconomics* 2B (2016): 2599-2646.

4

FISCAL SUSTAINABILITY DURING AND AFTER COVID-19

Fiscal compliance with fiscal rules up to the Covid-19 pandemic has been analyzed so far. This distinction is important because, as Bökemeier and Wolski (2022)[8] explain, the pandemic and the resulting economic crisis led governments to take extraordinary measures to mitigate its effects. Strict containment measures rapidly reduced economic activity and increased public interventions in major economies. Business and consumer confidence indicators fell to unprecedented levels, and March 2020 saw the highest number of credit rating downgrades in twenty years. Companies faced major challenges due to the deteriorating operating environment and economic shutdowns, which put pressure on fiscal balance sheets. Public debt in the EU increased from 78.8% of GDP in 2019 to 92.1% in 2021, reaching in the Eurozone the size of its economy for the first time in history. This shows a clear countercyclical response by policymakers, although it is unclear whether the rise in debt is due to the economic contraction alone or a change in the fiscal reaction function.

One of the measures taken during these years was the suspension of fiscal rules in March 2020 by the European Commission, which was taken in response to the severe economic crisis caused by the COVID-19 pandemic. This suspension, by activating the general escape clause, enabled EU member states to temporarily deviate from their fiscal goals in order to be able to implement extraordinary public spending and economic support measures without the usual restrictions. The main goal was to give governments the necessary flexibility to cushion the negative economic effects of the pandemic, maintaining economic and social stability by significantly increasing spending on health, social protection and support for companies and workers, thus facilitating a rapid and forceful response to the crisis. This suspension was maintained until the spring of 2024, when a new fiscal discipline framework came into effect, which will be discussed in the next section.

The following two figures show the substantial change in the public deficit during these years. In the European Union as a whole, the mismatch between revenues and expenditures reached 7 percent of GDP, above the levels reached during the financial crisis of the previous decade. It can also be seen that public deficit levels remain remarkably high, far from pre-pandemic levels. By country, a notable heterogeneity is also observed, since in 2020 countries such as Greece or Malta the difference between public revenues and expenditures increased by more than 10 percentage points of GDP, while the impact on public accounts in countries such as Sweden or Denmark was much more moderate.

FIGURE 18.

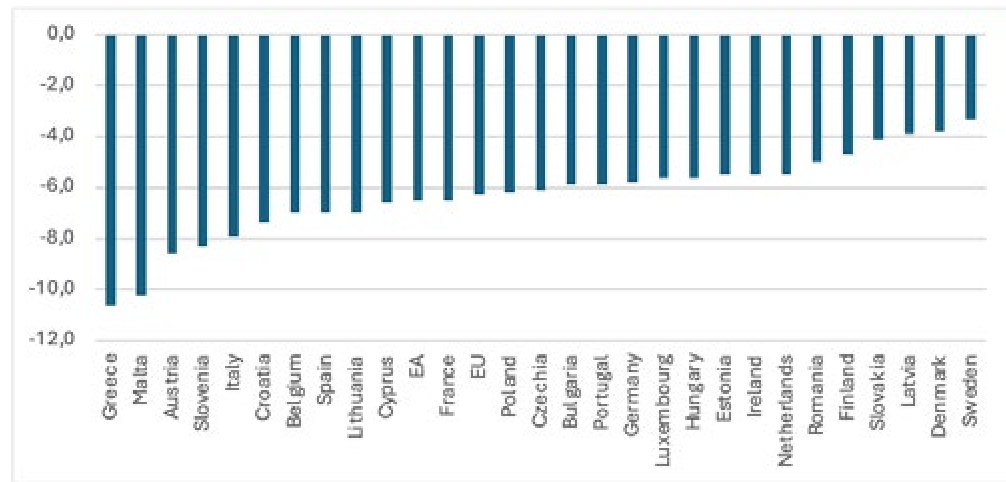
Evolution of the public deficit in the European Union and the Euro Area, as a percentage of GDP.

Source: Eurostat.

8 Bettina Bökemeier and Marcin Wolski, This time is different: Fiscal response to the COVID-19 pandemic among EU countries, *International Economics* 172 (2022): 217-226.

FIGURE 19.

Change in percentage points of GDP of the public deficit in European Union countries between 2019 and 2020.

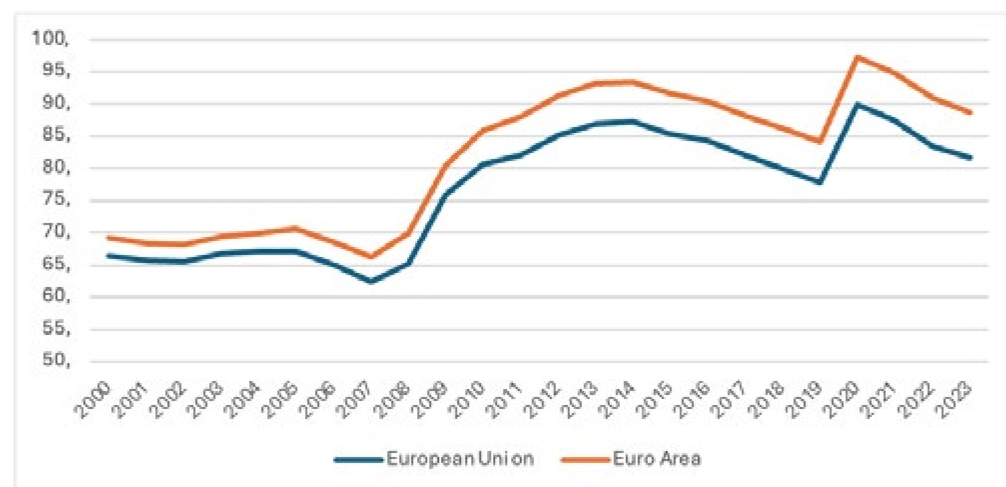


Source: Eurostat.

Public debt levels also followed a similar trend of unprecedented increase. In fact, the increase during 2020 reached more than 20 GDP points in Greece, Spain, Cyprus and Italy, while in the European Union as a whole the increase was 12.2 GDP points. Thus, the current level of public debt still exceeds annual output in 5 countries: Greece, Italy, France, Spain and Belgium.

FIGURE 20.

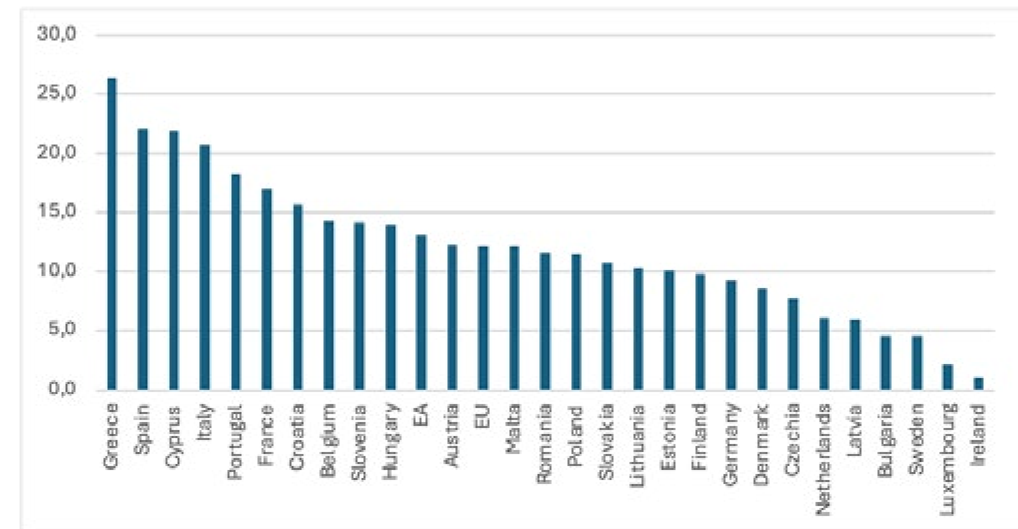
Evolution of the public debt in the European Union and the Euro Area, as a percentage of GDP.



Source: Eurostat.

FIGURE 21.

Change in percentage points of GDP of the public debt in European Union countries between 2019 and 2020.



Source: Eurostat.

As Beetsma (2022)[9] points out, in the year before the coronavirus crisis, the European Fiscal Board (EFB, 2019) offered President Juncker of the European Commission some recommendations. The EFB concluded that high debt ratios had not been reduced sufficiently, especially in periods conducive to it; that national fiscal policies were too often procyclical; and that flexibility in the rules had not prevented governments from cutting public investment or, more generally, growth-friendly spending. Failure to take advantage of good times to create buffers resulted in unwarranted budget contractions during bad times, the most pronounced example being the period 2011-2013, when countries recorded large improvements in their structural balance at a time of highly negative output gaps.

Beetsma's analysis reveals that spending slippages were directed toward higher current spending, not investment. The Stability and Growth Pact had numerous problems: the rules were complex and opaque, based on unobservable indicators, and the use of multiple indicators enabled arbitrary selection of data to benefit countries when necessary. In addition, medium-term planning was weak and planned adjustments were postponed, while political considerations interfered with economic evaluation, making monitoring increasingly bilateral between the Commission and the monitored country.

Consequently, the lack of buffers during favorable economic periods led to unnecessary budget contraction during recessions, adversely affecting public investment and growth-oriented spending. The EFB criticized that the flexibility of the rules was not sufficient to prevent these cuts and stressed that procyclical fiscal policies exacerbated economic difficulties during downturns. Political interference in economic assessments and the complexity of the SGP rules contributed to ineffective implementation of fiscal policies, which prevented an adequate and coordinated response to economic fluctuations in the EU.

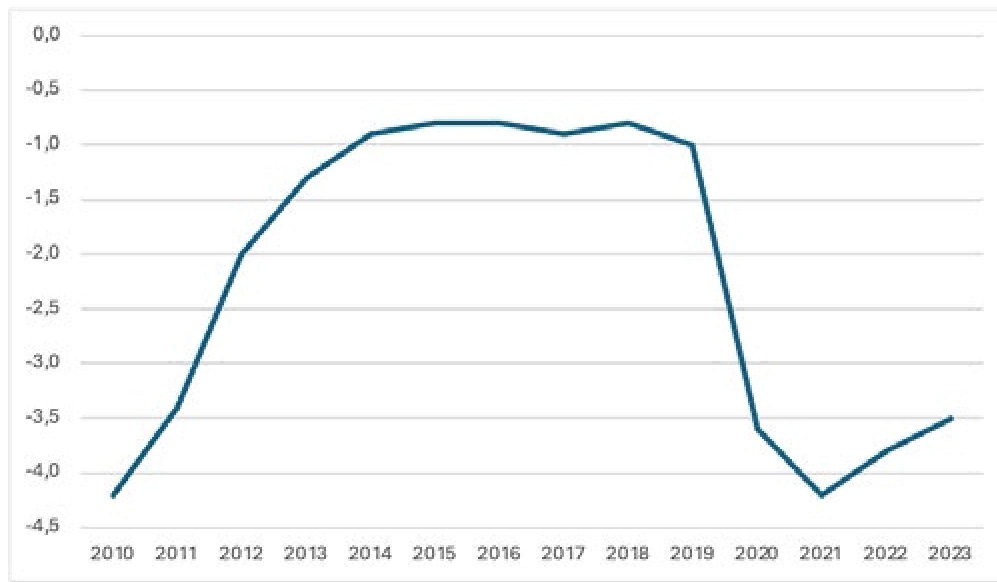
Indeed, although numerous fiscal measures were introduced, in principle, on a temporary, i.e., one-off basis, the cyclically-adjusted structural budget shows a marked deterioration during the pandemic. These exceptional measures, while necessary to mitigate the immediate economic effects of the health crisis, have not been sufficient to counteract the negative impact on public finances. The cyclically adjusted structural budget, which should reflect the fiscal situation excluding the effects of the economic cycle, has shown a concerning trend towards deterioration. This decline suggests that fiscal policies have failed to stabilize public accounts in a sustainable manner.

The trend of recent years confirms the procyclical tendency of this indicator, meaning that fiscal policies have tended to exacerbate economic cycles rather than smooth them. Ideally, a cyclically adjusted budget should be close to fiscal balance, indicating prudent and sustainable fiscal management. However, many European countries have not achieved this goal. Only Denmark, Cyprus, Ireland, Portugal, Lithuania, Sweden, and Luxembourg have attained a cyclically adjusted balance, demonstrating more resilient and effective fiscal management. These countries stand out for their ability to maintain a structural balance, which is crucial for long-term economic stability. Therefore, it is imperative for other countries to adopt more balanced fiscal strategies to ensure fiscal sustainability and avoid future financial crises.

9 Roel Beetsma, "The Economics of Fiscal Rules and Debt Sustainability", *Intereconomics* 57:1 (2022): 11-15.

FIGURE 22.

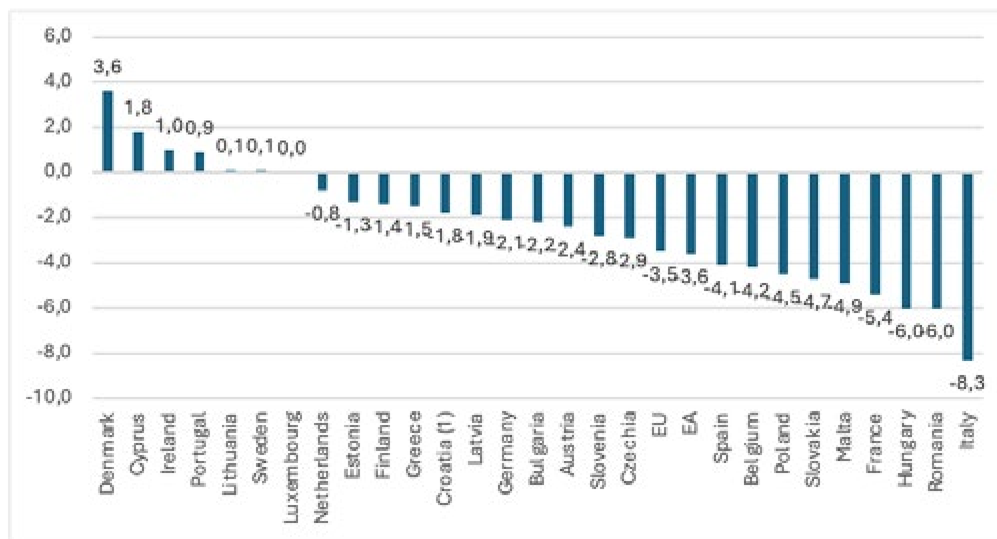
Evolution of the structural balance in the European Union, as a percentage of potential GDP.



Source: AMECO.

FIGURE 23.

Structural balance in European Union countries in 2023, as a percentage of potential GDP.



Source: AMECO.

As has just been demonstrated, the crisis caused by the coronavirus has aggravated this situation with a significant increase in public debt ratios. The combination of falling GDP, the activation of the general escape clause and the operation of automatic stabilizers generated a significant expansion of public spending and a drastic reduction in tax revenues. This context of health and economic emergency led governments to implement unprecedented economic stimulus measures to mitigate the effects of the pandemic, resulting in a considerable increase in national deficits and debts.

EU member countries were able to temporarily exceed the established deficit limits, thus facilitating the adoption of extraordinary measures to combat the crisis. However, this increase in public debt raises serious concerns about long-term fiscal sustainability, especially in those countries that already had high levels of debt before the pandemic. The ability of these countries to reduce their debt in the future will be constrained by the need to maintain a balance between fiscal consolidation and supporting economic growth in an environment of prolonged economic uncertainty.

Sustainability must remain the main goal for EU countries. However, as noted, the reality is that the debt ratios of several countries exceed 100% of GDP, making the current 60% ceiling unattainable for a long period. Demanding severe adjustments to return to the pre-pandemic path seems politically and socially unrealistic.

As Beetsma points out, calls from certain quarters to eliminate the 60% debt benchmark and enable much higher debt levels are not surprising. These proposals are motivated by current low nominal interest rates and the expectation in financial markets that interest rates will remain low in the future. Allowing higher debt would reduce pressure for disruptive consolidation and enable governments to make the necessary investments in the energy transition and digitization of their economies.

However, this is only one side of the debate. This author pointed out that there are sensible counterarguments. First, financial markets tend to be myopic and can be wrong in their assessment of future interest rates. Inflation has risen sharply recently. While this may not be the baseline scenario, there is a non-negligible possibility that inflation will remain elevated due to continued supply constraints, high demand and labor shortages driving wages higher. In addition, current loose monetary policy conditions affect inflation with a considerable lag and could therefore cause more inflation in the medium term than currently expected.

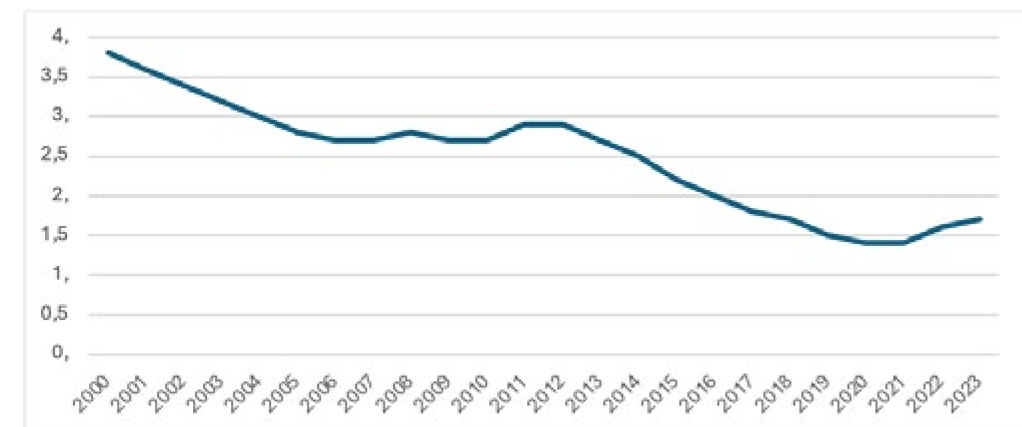
A worldwide increase in investment in climate transition and digitalization, or aging, could change the savings-investment balance, leading to higher long-term interest rates. Higher debt levels increase the sensitivity of government finances to rising interest rates. The speed of this effect depends on the time profile of debt maturity. Also, notes Beetsma, major new crises can occur. The three crises since the turn of the century were largely unforeseen. A new crisis in the next decade is more than a theoretical possibility. All of these arguments argue for a conservative approach to public debt.

Indeed, growth and interest rates can negatively affect the financial sustainability of EU countries in several ways (Ikonen and Lehmus, 2024)[10]. First, an increase in interest rates can significantly raise the cost of servicing public debt. This translates into higher interest payments that must be covered by national budgets, thus limiting the resources available for other crucial areas such as education, health and infrastructure. This financial pressure can lead to an increase in the fiscal deficit and, consequently, to a further accumulation of public debt.

As can be seen in the figure below, interest costs in the European Union are low compared to the levels recorded during the first years of the century; however, an upturn in the cost of debt can be noted from 2020 onwards. Although this increase is still limited, complacency or overconfidence could further aggravate this situation. It is important to note that the cost of borrowing has grown by more than 20% in just three years, which represents a worrying trend for long-term fiscal sustainability. This situation underscores the need for prudent debt management and responsible fiscal policies to avoid further deterioration in the public finances of EU member countries. The figure not only illustrates the recent increase, but also serves as a reminder of the risks associated with inaction or underestimation of emerging financial pressures. In this context, it becomes imperative to closely monitor these developments and adjust fiscal strategies proactively to maintain economic stability.

FIGURE 24.

Evolution of the expenditure on public debt interest in the European Union, as a percentage of GDP.



Source: Eurostat.

Second, insufficient or slowing economic growth affects countries' ability to generate adequate tax revenues. When economic growth is slow, tax revenues decline, which further hampers the government's ability to finance its obligations and reduce its debt. This situation is exacerbated if interest rates are high, as the combination of lower revenues and higher

10 Pasi Ikonen and Markku Lehmus, "Fiscal policy and debt sustainability in the euro since the COVID-19 pandemic and energy crisis", *Bank of Finland Bulletin*. Available at: https://www.bofbulletin.fi/en/2024/1/fiscal-policy-and-debt-sustainability-in-the-euro-area-since-the-covid-19-pandemic-and-energy-crisis/

interest payments can result in a vicious cycle of increasing indebtedness.

Third, disparity in economic growth rates among EU member countries can generate significant imbalances. Countries with slower growth and higher debt levels may face higher borrowing costs compared to their more prosperous neighbors. This divergence can weaken economic and political cohesion within the EU, making it difficult to implement effective and coordinated fiscal and monetary policies.

In conclusion, while enabling higher debt levels may provide some short-term flexibility and facilitate needed investments, it is essential to consider the associated risks. Recent history shows that economic conditions can change rapidly, and optimistic projections may not be realized. Taking a prudent and conservative approach to public debt, balancing the need for investments with long-term fiscal sustainability, will be crucial to maintaining economic stability and avoiding future financial problems.

Thus, the pandemic has further tightened the fiscal space of European Union countries, adding another layer of difficulty to the achievement of sustainable public finances. The economic impact of the pandemic has led to increased public spending on health care, social support, and economic stimulus packages, while simultaneously causing a significant reduction in tax revenues due to the slowdown in economic activity. As a result, many EU countries have seen their budget deficits and public debt levels rise sharply, complicating efforts to maintain fiscal sustainability.

With this in mind, policymakers have recognized the need for a more adaptable and resilient fiscal framework. Consequently, a new set of fiscal rules has been proposed, aimed at providing greater flexibility while ensuring long-term fiscal discipline. These rules are designed to allow for temporary deviations from fiscal targets in times of economic distress, such as during a pandemic, while still maintaining a commitment to medium-term fiscal sustainability. The new framework came into force in the spring of 2024, reflecting lessons learned from the pandemic and the need for a more balanced approach to fiscal policy. The effectiveness and implications of these new rules are evaluated in the following section, where their potential to enhance fiscal stability and promote economic recovery is thoroughly assessed.

5

THE NEW FRAMEWORK OF FISCAL RULES

As mentioned above, due to a combination of the economic and fiscal crisis caused by the pandemic and a systematic non-compliance by certain countries with the fiscal rules in force up to that time, new fiscal rules came into force at the end of April 2024. This new fiscal governance framework is based on Article 126 of the Treaty on the Functioning of the European Union (TFEU) and its protocol number 12.

This regulation implies that EU Member States must avoid excessive government deficits and maintain fiscal discipline. Article 126 of the TFEU establishes the procedures and criteria for identifying and correcting excessive deficits, using the reference values specified in Protocol No. 12. Specifically, the government deficit should not exceed 3% of GDP and government debt should not exceed 60% of GDP, subject to justified exceptions.

Protocol number 12 details these reference values and defines "government" as the aggregate of central, regional, local government and social security funds, excluding commercial operations. In addition, "deficit" refers to net borrowing, "investment" to gross fixed capital formation and "debt" to total gross debt at nominal value consolidated within the government sector.

To ensure the effectiveness of the excessive deficit procedure, member states are responsible for their government deficits and must ensure that their national budgetary procedures comply with their obligations under the Treaties. States must report their deficits and debt levels to the European Commission on a timely and regular basis, using statistical data provided by the Commission.

In the event that an excessive deficit is identified, the Council, based on a recommendation from the Commission, may issue recommendations to the Member State concerned to correct the situation within a specified timeframe. If no effective action is taken, the Council may make its recommendations public and eventually impose sanctions, such as fines or interest-free deposits, to ensure compliance with the corrective measures.

How does the new fiscal framework that came into effect in 2024 differ from the previous one? Darvas et al. (2024)[11] explain that the new framework is based on country-specific debt sustainability analyses and uses a single indicator, government spending net of tax policy changes, as the annual fiscal policy goal. This represents a significant change from the previous framework, which focused on multiple operational goals.

The process for determining each country's net expenditure trajectory includes several steps. First, the European Commission will provide member states with debt above 60% of GDP or deficits above 3% of GDP with a "reference trajectory for net spending" covering a four-year adjustment period and its possible extension for up to three additional years. This path must meet all the requirements of the new framework and is normally provided by January 15 of the year in which the net spending paths are negotiated, although in 2024 it will be provided by June 21.

Next, all EU members must submit medium-term structural fiscal plans outlining their fiscal, reform and public investment commitments for the next four to five years. These plans must align with the reference path provided by the Commission, although countries can propose different paths if they provide sound, data-driven economic arguments.

The new framework introduces several numerical safeguards to ensure a minimum pace of debt and deficit reduction. These safeguards include: a prohibition on increasing the annual adjustment during the adjustment period (no backloading), a minimum reduction in the debt ratio and an annual improvement in the structural primary balance. Non-backloading means that the annual fiscal adjustment cannot increase during the adjustment period. This ensures that countries maintain a steady pace of fiscal consolidation without postponing larger adjustments to the future.

The debt sustainability safeguard requires a decline of at least one percentage point of GDP per year in the debt ratio for countries with debt ratios above 90% of GDP, and half a percentage point for those with ratios between 60% and 90% of GDP. Additionally, the deficit resilience safeguard states that for countries with an overall structural deficit above 1.5% of GDP, an annual improvement in the structural primary balance of at least 0.4% of GDP over a four-year adjustment period, or 0.25% over a seven-year adjustment period, is required.

The new framework also maintains an excessive deficit procedure (EDP) requirement from the previous system: countries with deficits above 3% of GDP must adjust by at least 0.5% of GDP per year, measured in terms of the structural

11 Zsolt Darvas, Lennard Welslau, and Jeromin Zettelmeyer, "The implications of the European Union's new fiscal rules", *Bruegel* Policy Brief 10/24 (2024).

primary balance in 2025-2027, and in terms of the overall structural balance from 2028 onwards. This requirement ensures that countries with high deficits make significant fiscal adjustments to reduce their deficits to sustainable levels.

Under the previous framework, the main goal was the structural balance, which adjusted the government's budget balance for cyclical factors and one-off fiscal measures. This system was criticized for its complexity and for relying on unobservable and poorly estimated variables, such as the output gap and the structural budget balance. In contrast, the new framework focuses on a single medium-term net expenditure path, which simplifies monitoring and implementation.

A key difference in the new framework is the flexibility enabled to adjust fiscal paths in exchange for investments and reforms that enhance fiscal sustainability and economic growth. This flexibility is expected to incentivize public investment and enable its financing without making drastic cuts in other areas, something the previous framework did not adequately achieve.

The new framework is expected to require substantial fiscal adjustments for countries with high levels of debt, although less stringent than those required by the previous framework. The numerical safeguards will help ensure that countries maintain a minimum pace of fiscal adjustment, which should improve debt sustainability and long-term fiscal credibility.

Another important difference in the new framework is the review and possible modification of the DSA methodology, which now involves member states in a working group. This seeks to increase transparency and acceptance of the methodology among member states and external observers, thus mitigating the perception of political manipulation.

Enrique Feás (2024)[12] has succinctly analyzed the new European fiscal rules, highlighting three successes and three mistakes. According to this author, the successes would be the following:

- An outstanding success is the implicit recognition of the ineffectiveness of the previous fiscal rules, suspended since the beginning of the pandemic. This agreement shows a common sense among the Member States, evidencing the need to adapt the tax rules to the current reality. This step is crucial, as it enables a more pragmatic and realistic approach to fiscal management in the European Union.

- Another important achievement is the replacement of the structural deficit with the concept of net primary expenditure as an essential variable for determining compliance with the rules. This change simplifies the evaluation of Fiscal compliance, avoiding theoretical debates and enabling a more direct and practical observation of spending, excluding extraordinary measures and certain types of cyclical and interest spending.

- In addition, the flexibility introduced in the fiscal adjustment path is a significant achievement. It enables each Member State to adapt its pace of expenditure reduction according to its particular circumstances. This flexibility includes the possibility of extending adjustment plans for up to seven years, provided that structural reforms and sustainable productive investments are undertaken, thus avoiding the unnecessary sacrifice of crucial investments for development.

On the other hand, there are not minor errors to be considered:

- However, one of the errors identified is the incorporation of safeguards that increase complexity and limit flexibility, reintroducing requirements such as the reduction of the structural deficit by 0.4% per year. These safeguards add multiple control variables, contravening the goal of simplification and increasing the risk of arbitrary or politicized decisions by the Commission and the Council.

- Another mistake is the lack of improvement in the credibility of the system. The persistence of rules such as 3% deficit and 60% debt, considered obsolete in the current context, and the lack of reinforcement of independent fiscal institutions undermine confidence in the effectiveness of the new rules. Penalties for non-compliance also remain low, which does not contribute to their credibility.

In conclusion, the view on the new fiscal rules proposed by Feás is remarkably balanced. Although it improves certain aspects of the previous fiscal framework, there remain certain uncorrected shortcomings that call into question the ultimate fulfillment of the sustainability goals. While the recognition of the need for change, the adoption of a more practical control variable and the flexibility in the adjustment path are positive developments, the increased complexity, the lack of credibility and the absence of a debate on European funds represent significant challenges. The effective implementation of these new rules will require ongoing adjustments and discussions to ensure that they truly benefit the European Union as a whole.

12 Enrique Feás, "Nuevas reglas fiscales europeas: tres aciertos y tres errores", *Voz Populi* (2024). Available at: https://www.vozpopuli.com/opinion/nuevas-reglas-fiscales-europeas-tres-aciertos-tres-errores.html.

6

IMPLICATIONS OF THE NEW FISCAL RULES

The following is an approximation of the implications of the new fiscal rules framework estimated by Darvas et al. (2024). The European Commission's debt sustainability analysis (DSA) methodology for fiscal adjustment in 2024 is based on May 2024 forecasts, market expectations for interest rates and inflation, and aging cost projections. This approach establishes net expenditure growth paths derived from an aim structural primary balance at the end of the four- or seven-year adjustment period. This methodology is designed to ensure that the fiscal policies of member states are aligned with long-term debt sustainability while also considering short-term economic fluctuations and demographic changes.

The structural primary balance is essential as it excludes interest payments from the structural balance, thereby providing a clearer picture of the underlying fiscal position of a country. Table 1 summarizes the main results of the fiscal adjustments required under the new EU fiscal rules framework. The key components of this table are described below.

The first three columns of the table show the European Commission's most recent forecasts for 2024, including debt, fiscal balance and structural primary balance (SPB). These forecasts set the basis for calculating the necessary fiscal adjustments. For example, the first column presents the debt ratio as a percentage of GDP, the second column shows the fiscal balance as a percentage of GDP, and the third column indicates the initial structural primary balance.

The following columns show the required structural primary balance at the end of the four-year and seven-year adjustment periods, respectively. These values represent the final goals that countries must achieve to comply with the different safeguards of the new fiscal framework. These figures combine the requirements of all relevant safeguards, providing a comprehensive view of the required adjustment.

In addition, the average annual fiscal adjustment required over the adjustment periods of four and seven years, respectively, are presented. These values indicate how much the structural primary balance must be adjusted annually to achieve the final stated goals. This adjustment reflects the magnitude of the fiscal effort required from each country to ensure debt sustainability and compliance with deficit limits.

For eight of the twelve countries with debt above 60% of GDP, the requirements of the debt sustainability analysis determine the fiscal adjustment in both the four-year and seven-year adjustment periods. These countries include Austria, Belgium, Germany, Greece, Hungary, Portugal, Slovenia, and Spain. For France and Italy, the debt sustainability analysis requirement is also binding in the four-year period. This indicates a significant but necessary effort to ensure long-term fiscal health and stability within these high-debt countries.

Cyprus is expected to have a budget surplus of 2.9% of GDP in 2024, enabling it to make a fiscal stimulus in the coming years under the new fiscal rules, limited by the requirement to keep the deficit below 3%. This surplus provides Cyprus with a unique opportunity to boost economic growth while adhering to fiscal rules, demonstrating the potential flexibility within the new framework for countries in favorable fiscal positions.

Numerical safeguards will generally not be binding during the adjustment period, with exceptions such as Finland and France, where certain safeguards such as debt sustainability do apply. These safeguards are designed to prevent excessive fiscal tightening or loosening, ensuring a balanced approach to fiscal policy. However, they can also impose additional constraints on countries with more challenging fiscal situations, requiring careful management and planning.

The average annual fiscal adjustment requirements for several high-debt countries are substantial. For example, Italy requires an adjustment of 1.08% per year over a four-year period, and 0.59% over a seven-year period. France requires adjustments of 0.94% and 0.54% respectively, and Spain 0.89% and 0.52%. These figures highlight the significant fiscal efforts needed to align with the new rules, representing a considerable but necessary fiscal consolidation to achieve debt sustainability.

Countries such as Greece and Portugal, which already have considerable primary surpluses, face smaller adjustment requirements. In contrast, countries such as Slovakia, Poland, and Romania, with high deficits but debt below 60%, must make significant adjustments. This disparity reflects the different starting points and fiscal conditions of member states, requiring tailored approaches to fiscal adjustment under the new rules.

TABLE 1.

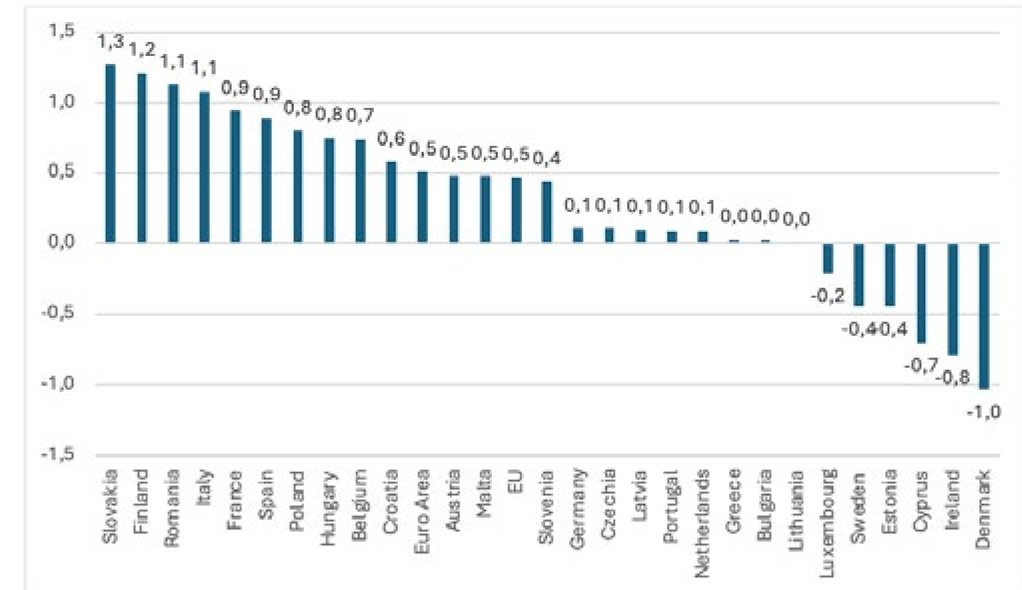
Fiscal adjustments under the new fiscal governance framework, as a percentage of GDP.

		European Commission forecast for 2024		Minimum SPB satisfying all criteria		Average annual fiscal adjustment need	
	DEBT	FISCAL BALANCE	SPB	4 YEARS	7 YEAR	4 YEARS	7 YEARS
Greece	153.9	-1.2	1.7	1.9	2.1	0.03	0.05
Italy	138.6	-4.4	-1.1	3.3	3.1	1.08	0.59
France	112.4	-5.3	-3.0	0.8	0.8	0.94	0.54
Spain	105.5	-3.0	-0.8	2.7	2.8	0.89	0.52
Belgium	105.0	-4.4	-1.9	1.1	1.1	0.74	0.43
Portugal	95.6	0.4	2.2	2.6	2.3	0.09	0.01
Finland	80.5	-3.4	-0.5	4.3	3.3	1.21	0.55
Austria	77.7	-3.1	-1.1	0.8	0.7	0.48	0.26
Hungary	74.3	-5.4	0.0	3.0	3.3	0.75	0.47
Cyprus	70.6	2.9	3.5	0.7	0.3	-0.70	-0.46
Slovenia	68.1	-2.8	-1.2	0.5	0.5	0.44	0.25
Germany	62.9	-1.6	0.0	0.4	0.1	0.11	0.02
Croatia	59.5	-2.6	-2.0	0.3	0.5	0.58	0.36
Slovakia	58.5	-5.9	-4.3	0.8	1.1	1.27	0.77
Poland	53.7	-5.4	-2.6	0.6	0.9	0.80	0.50
Malta	52.0	-4.3	-2.9	-1.0	-1.0	0.48	0.26
Romania	50.9	-6.9	-4.4	0.1	0.9	1.13	0.75
Netherlands	47.1	-2.0	-0.6	-0.3	-0.4	0.09	0.04
Czechia	45.2	-2.4	-0.1	0.3	0.6	0.11	0.10
Latvia	44.5	-2.8	-1.4	-1.0	-0.7	0.10	0.10
Ireland	42.5	1.3	2.5	-0.6	-0.6	-0.79	-0.45
Lithuania	38.9	-1.8	0.0	0.0	-0.2	0.01	-0.02
Sweden	32.0	-1.4	0.7	-1.0	-1.7	-0.44	-0.34
Luxembourg	27.1	-1.7	0.1	-0.7	-0.9	-0.21	-0.13
Denmark	26.5	2.4	2.9	-1.2	-1.6	-1.03	-0.64
Bulgaria	24.8	-2.8	-2.3	-2.2	-1.8	0.03	0.08
Estonia	21.4	-3.4	-0.3	-2.1	-1.9	-0.44	-0.23
EU	83	-3.0	-0.9	0.9	0.9	0.47	0.25
Euro Area	90	-3.0	-0.9	1.1	1.0	0.51	0.28

Source: Darvas et al. (2024).

FIGURE 25.

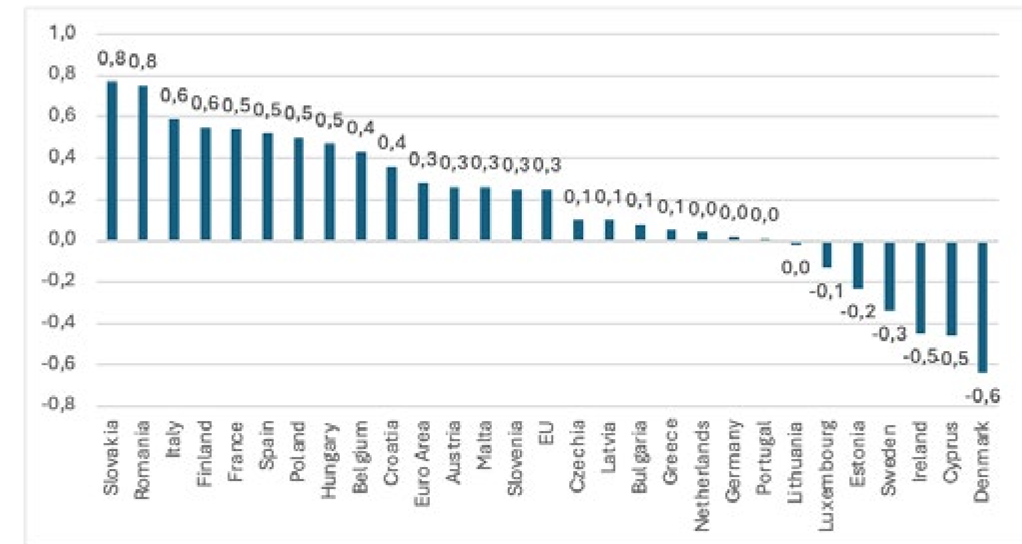
Four-year average fiscal adjustments under the new fiscal governance framework for European Union countries, as a percentage of GDP.



Source: Darvas et al. (2024).

FIGURE 26.

Seven-year average fiscal adjustments under the new fiscal governance framework for European Union countries, as a percentage of GDP.



Source: Darvas et al. (2024).

The European Commission should develop a methodology for deciding the quantitative impact of proposed investments and reforms on the fiscal adjustment required under the new rules, judging the plausibility of any plan that argues for higher net spending paths based on such reforms. This methodology would ensure that investments and reforms are effectively integrated into fiscal planning, supporting sustainable growth while maintaining fiscal discipline.

Although the numerical safeguards have not been shown to require more stringent fiscal adjustments than the debt sustainability analysis initially, procyclicality risks and the need to compensate for higher investments may become an issue in the future. It is crucial to monitor these risks and adjust policies as needed to prevent adverse economic impacts while supporting necessary investments.

In conclusion, the new fiscal rules framework requires significant fiscal adjustments from high-debt countries to ensure long-term debt sustainability. While there are challenges, the framework also provides opportunities for countries with sound fiscal positions to stimulate growth. The

successful implementation of these rules will depend on careful management and the development of robust methodologies to integrate investments and reforms into fiscal planning.

For comparison, the differences with respect to the fiscal adjustments of the previous fiscal framework are also provided. Figures 27 and 28 show how the fiscal adjustment requirements would have differed if the old Stability and Growth Pact (SGP) had been reinstated. In these figures, the differences in terms of structural balance for adjustment periods of four and seven years are presented. These differences are calculated by subtracting the adjustments required under the old framework from the adjustments required under the new framework.

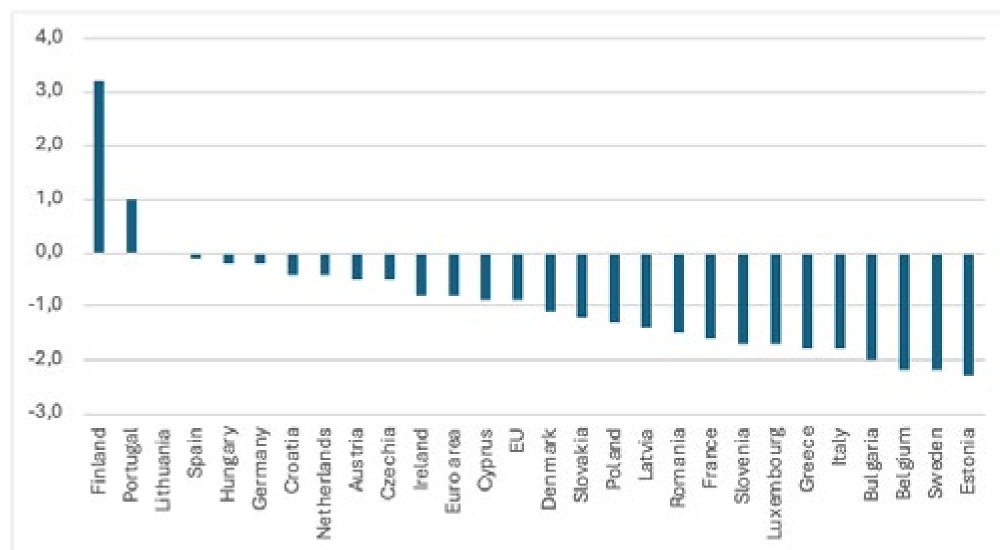
The figures show the specific differences between the adjustment requirements under the new fiscal framework and the old one. A negative value i indicates that the new framework requires less adjustment than the old framework, suggesting that the new framework is less restrictive in terms of required fiscal adjustment. For example, if a country shows a value of -1.5%, it means that the new framework requires a 1.5% lower adjustment to GDP compared to the old framework.

These differences highlight how the new framework can be more flexible and enable countries to make less severe fiscal adjustments compared to the old GSP. This may be particularly beneficial for countries with high debt levels or large deficits, as it enables them to implement adjustment measures in a more gradual and sustainable manner. However, for some countries, the differences may be minor or even positive, indicating that the new framework may require more stringent adjustments in certain specific cases.

In summary, the comparison between the two fiscal frameworks provides a clear picture of the changes in EU fiscal policy. The differences highlighted in Table 2 indicate how the new framework aims to be more adaptable to current and country-specific economic conditions, promoting fiscal sustainability without imposing excessively stringent adjustments that could negatively affect economic growth and well-being.

FIGURE 27.

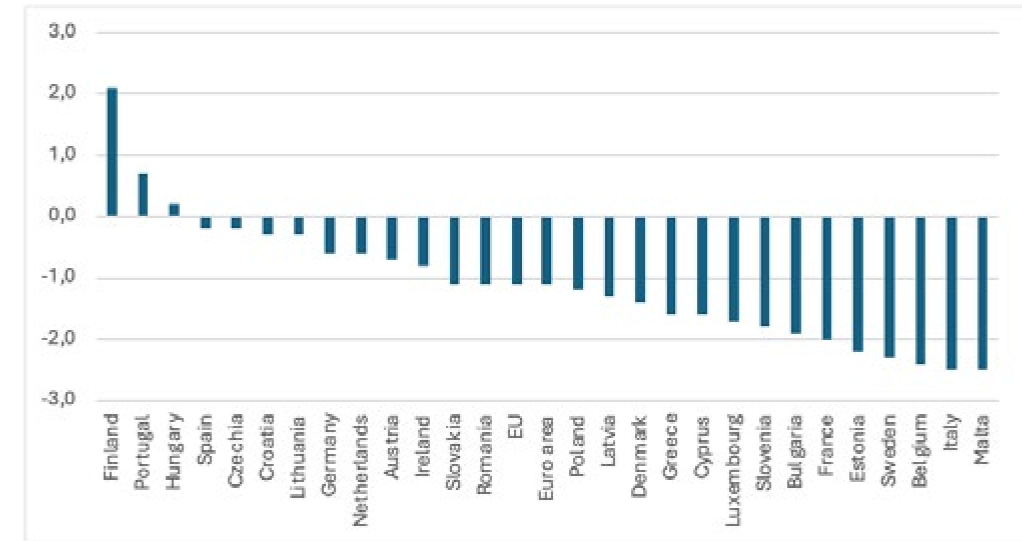
Difference between the four-year fiscal adjustment of the old and new fiscal rules framework, as a percentage of GDP.



Source: Darvas et al. (2024).

FIGURE 28.

Difference between the seven-year fiscal adjustment of the old and new fiscal rules framework, as a percentage of GDP.



Source: Darvas et al. (2024).

According to Pench (2024)[13], the adjustment path under the new fiscal rules faces major challenges. The reform of the European Union's Stability and Growth Pact, although innovative in its design, presents significant risks that could compromise its effectiveness. These risks are linked to the implementation of the new medium-term structural fiscal plans and their interaction with the excessive deficit procedure. The complexity of the fiscal rules and the application of corrective and sanctioning measures are critical elements that need to be adequately addressed to ensure fiscal sustainability and avoid the disintegration of the reformed framework.

The first risk identified is the possibility that the adjustment paths prescribed by the excessive deficit procedure are less demanding than the debt sustainability requests set out in medium-term structural fiscal plans. This could result in excessive deficit countries not making the necessary adjustments to ensure a sustainable debt path, which would be counterproductive to the goals of the reform. The lack of alignment between the two sets of rules could create incentives for countries to prioritize deficit reduction over long-term debt sustainability, thus weakening the effectiveness of the fiscal framework.

Inconsistency between EDP adjustment paths and medium-term structural fiscal plans may lead to unequal treatment across countries. Those subject to the excessive deficit procedure could benefit from less stringent adjustment requirements compared to countries that have already reduced their deficits below the 3% threshold. This situation could encourage opportunistic behavior and undermine fiscal consolidation efforts across the European Union, making the reform perceived as ineffective and generating distrust in its implementation.

The second risk relates to the possibility of countries deviating from their medium-term structural fiscal plans during the implementation of the excessive deficit procedure. The structure of the EDP, which focuses on reducing the nominal deficit, introduces a bias that enables governments to meet the nominal goals without making the necessary structural adjustments. This can lead to a situation where countries do not face demands for budgetary correction as long as they achieve their nominal deficit goals, even if they have not implemented the structural reforms initially committed to.

The "lack of escalation" is another problem in the implementation of the excessive deficit procedure. The reluctance of the European Commission and the Council to escalate the procedure, even when a country deviates from its structural and nominal adjustment, can lead to the issuance of revised recommendations with extended deadlines instead of imposing sanctions. This approach may perpetuate non-compliance and procrastination in fiscal correction, which in turn undermines the credibility of fiscal rules and the authority of European institutions in fiscal surveillance.

The third risk concerns the conditions for exiting the excessive deficit procedure. If the exit from this procedure is based solely on deficit reduction below 3% of GDP, without considering compliance with debt sustainability criteria, it could lead to an early disintegration of the reform. This situation would enable high-debt countries to evade long-term sustainability requests, perpetuating a culture of default and putting the fiscal stability of the European Union at risk.

13 Lucio Pench, "Three risk that must be addresed for new European Union fiscal rules to succeed", *Bruegel* Policy Brief 08/24 (2024).

To address this risk, according to the author, it is essential that the abrogation of the excessive deficit procedure is contingent on both the deficit and debt criteria being met. This implies that, even if a country has been subject to the procedure only for exceeding the deficit threshold, it must also meet the debt sustainability requirements to exit the procedure. Clarifying this condition and ensuring that adjustment paths are consistent with debt sustainability requests is crucial to maintaining the integrity and effectiveness of the reformed framework.

In conclusion, the implementation of the new fiscal rules faces significant challenges that require effective coordination between the European Commission and the Council. Ensuring that adjustment paths are strict and consistent with debt sustainability, avoiding procrastination in fiscal correction and establishing clear criteria for exiting the excessive deficit procedure are key steps for the success of the reform. Only through a common understanding and rigorous application of the rules can fiscal stability be guaranteed.

7

CONCLUSIONS

The analysis of fiscal rules in Europe reveals a complex interplay between financial sustainability, fiscal policies, and contemporary economic challenges. These rules are designed to ensure that governments maintain prudent budgetary practices while fostering economic growth and stability. Over the years, the European Union has implemented various fiscal frameworks to harmonize the diverse economic landscapes of its member states. This endeavor underscores the need for a coordinated approach to managing public finances, which is crucial for the overall stability of the Eurozone.

The COVID-19 pandemic has highlighted the fragility of public finances in many EU countries, leading to a significant increase in deficits and public debt levels. The unprecedented fiscal response to the pandemic, including substantial public spending to support healthcare systems, businesses, and households, has strained national budgets. Consequently, many EU countries are grappling with the dual challenge of stimulating economic recovery while managing soaring debt levels. This situation has sparked debates on the adequacy and adaptability of existing fiscal rules in responding to extraordinary economic shocks.

In this context, the implementation of new fiscal rules in 2024 seeks to balance the need for economic flexibility with the imperative of maintaining long-term fiscal discipline. These new rules aim to provide member states with the flexibility to respond to economic crises while ensuring that fiscal policies remain sustainable over the long term. The reformed framework is expected to include mechanisms for more effective debt management and enhanced fiscal oversight, reflecting lessons learned from the pandemic. By doing so, the EU hopes to safeguard economic stability and foster resilience against future financial disruptions.

The importance of financial sustainability

Financial sustainability is crucial to ensure economic stability and the well-being of future generations. This concept encompasses the ability of governments to manage their resources efficiently, ensuring that current expenditures do not compromise future financial stability. By maintaining sustainable public finances, governments can respond effectively to emergencies and economic crises without resorting to unsustainable levels of indebtedness. Such preparedness is essential in mitigating the adverse impacts of unforeseen events, such as natural disasters, pandemics, or economic downturns, which can strain public resources.

Maintaining sustainable public finances also plays a vital role in strengthening investor confidence. When investors perceive that a government is managing its finances responsibly, they are more likely to invest in that country's economy. This, in turn, reduces the risk of financial crises, which are often precipitated by sudden shifts in investor sentiment. A stable economic environment, bolstered by responsible fiscal management, is conducive to long-term growth as it encourages investment, innovation, and consumption, driving economic progress.

Moreover, responsible fiscal management entails not only keeping debt levels in check but also ensuring that public spending is efficient and targeted towards growth-promoting activities. Investments in infrastructure, education, and healthcare are examples of public spending that can yield long-term economic benefits. By prioritizing such expenditures, governments can enhance their economic resilience and capacity for sustainable growth.

In this regard, theories on public debt offer various perspectives on the impact of spending and debt on economic growth. Neoclassical theory, for instance, suggests that government spending is neutral for GDP in the long run. According to this view, any increase in government spending is offset by a decrease in private spending, resulting in no net effect on the overall economy. However, this theory has been contested by other economic schools of thought that argue for a more nuanced understanding of public spending's impact.

Hysteresis theory, for example, warns that austerity measures can be counterproductive in the long run. It suggests that cutting government spending during economic downturns can lead to permanent damage to the economy, such as long-term unemployment and reduced productive capacity. Instead, this theory advocates for a certain level of government spending to boost economic growth and prevent such negative outcomes. By maintaining adequate public investment, economies can recover more robustly from recessions and sustain long-term growth.

On the other hand, conventional theory points out that there is an optimal point of public debt beyond which economic growth is negatively affected. This optimal level varies depending on

various factors, including a country's economic structure, institutional quality, and external environment. Exceeding this optimal debt level can lead to higher borrowing costs, reduced investment, and slower economic growth, emphasizing the need for careful debt management.

The study by Reinhart and Rogoff highlights that when public debt exceeds 90% of GDP, economic growth rates are significantly reduced. This finding underscores the importance of maintaining debt levels below this critical threshold to avoid adverse effects on economic growth. It suggests that high debt levels can lead to higher interest rates, increased inflation, and reduced investor confidence, all of which can stifle economic progress.

Moreover, the relationship between debt and growth varies between advanced and emerging economies. Advanced economies may have more leeway in managing higher debt levels due to their more developed financial markets and stronger institutional frameworks. In contrast, emerging economies often face higher borrowing costs and greater vulnerability to external shocks, necessitating more cautious fiscal policies. This indicates that fiscal policies need to be tailored to country-specific economic contexts to be effective.

Fiscal sustainability is not just about maintaining low debt levels but also about ensuring that the debt is used productively. Borrowing for investments that generate future economic returns, such as infrastructure projects or human capital development, can enhance an economy's growth potential. Conversely, borrowing to finance current consumption or unproductive expenditures can lead to a debt spiral, where increasing debt levels necessitate further borrowing, undermining long-term financial stability.

In conclusion, achieving financial sustainability requires a balanced approach that considers the short-term needs and long-term implications of fiscal policies. Governments must carefully manage public finances, prioritize growth-enhancing expenditures, and tailor their fiscal strategies to their specific economic contexts. By doing so, they can foster economic stability, enhance investor confidence, and ensure the well-being of future generations, laying the foundation for sustained economic growth and prosperity.

The role of fiscal rules

Fiscal rules are fundamental tools for achieving financial sustainability, as they establish clear norms for managing public finances. These rules help maintain fiscal discipline, prevent excessive deficits, and control the level of public debt, which is essential for ensuring long-term economic stability. Since the late 1990s, various fiscal rules have been implemented in Europe to promote fiscal responsibility and financial sustainability.

One of the most well-known fiscal rules is the Stability and Growth Pact of the European Union, introduced in 1997. This pact set clear limits for fiscal deficits (3% of GDP) and public debt (60% of GDP) for member states. The purpose of the pact was to prevent excessive debt accumulation and promote macroeconomic stability within the euro area. However, despite these efforts, compliance with these rules has been uneven among member countries.

During the early years of the Stability and Growth Pact, many countries managed to keep their deficits and debt levels within the prescribed limits. However, the financial crisis of 2008 tested the effectiveness of these rules. Several countries, including Greece, Spain, and Italy, significantly exceeded the deficit and debt limits, leading to a series of financial bailouts and austerity programs. These events highlighted the limitations of the pact and the need for greater flexibility and adaptability in fiscal rules.

The 2005 reform of the Stability and Growth Pact introduced the concept of the structural budget balance, adjusted for the economic cycle, to provide a more accurate assessment of countries' fiscal positions. Additionally, automatic correction mechanisms were implemented to ensure that countries deviating from their fiscal targets would adopt corrective measures. Nevertheless, compliance with these structural rules has also been mixed, with many countries struggling to adjust their fiscal policies promptly.

The introduction of the six-pack and two-pack regulations in 2011 and 2013, respectively, further strengthened European fiscal rules. These reforms included new rules on public expenditure growth and debt reduction, as well as stricter monitoring and sanction mechanisms for non-compliant countries. Despite these improvements, the level of compliance remained variable, with some countries demonstrating stronger fiscal performance than others.

The degree of compliance with fiscal rules has been influenced by various factors, including the quality of institutions, political stability, and the specific economic conditions of each country. For instance, countries with strong and transparent fiscal institutions, such as Germany and Sweden, have shown higher compliance levels. In contrast, countries with weaker institutional structures and persistent economic problems, like Greece and Portugal, have faced more significant challenges in adhering to fiscal rules.

Institutional quality plays a crucial role in ensuring higher compliance with fiscal rules. Effective governance frameworks, transparent institutions, and robust fiscal oversight bodies are essential for the formulation and implementation of coherent and responsible fiscal policies. Countries with well-established independent fiscal institutions tend to exhibit better fiscal discipline and adherence to established rules.

Political factors also contribute significantly to fiscal compliance. Political instability, frequent changes in government, and corruption can undermine fiscal discipline. In politically unstable environments, governments may prioritize short-term public spending to gain popular support, resulting in fiscal deficits and long-term debt accumulation. Conversely, stable political environments with accountable governance structures tend to favor better compliance with fiscal rules.

Another significant factor affecting compliance is the ability of countries to adapt to unforeseen economic and financial changes. Countries with strong institutions and governance frameworks are better equipped to respond to economic crises effectively, ensuring that necessary fiscal adjustment measures are implemented in a timely and efficient manner. This ability to adapt is crucial for maintaining investor confidence and economic stability.

In conclusion, fiscal rules are essential for achieving financial sustainability, but they must be designed flexibly and adaptably to be effective. The success of fiscal rules depends not only on their design but also on the quality of fiscal institutions, the credibility of sanctions, and the ability of countries to adapt to changing economic conditions. The experience of the past decades highlights the need for a balance between fiscal discipline and flexibility to address unexpected economic challenges. By improving institutional quality and ensuring political stability, countries can enhance their compliance with fiscal rules and achieve long-term economic sustainability.

The role of the Covid pandemic

The Covid-19 pandemic had a significant impact on the sustainability of public finances globally. In response to the health and economic crisis, governments implemented a range of emergency measures to support their economies, resulting in a substantial increase in public spending. These measures included direct subsidies to businesses and workers, expansion of social protection systems, and additional healthcare expenditures to address the health emergency. This sudden and massive increase in public spending, combined with a decline in tax revenues due to the economic recession, deteriorated public finances in many countries, increasing fiscal deficits and debt levels.

In Europe, the activation of the general escape clause of the Stability and Growth Pact allowed member states to increase their spending without being subject to the usual strict fiscal rules. This flexibility was crucial in mitigating the immediate economic impacts of the pandemic but also led to a significant rise in public debt in many countries. For example, public debt in the euro area rose from 86% of GDP in 2019 to 98% in 2020. This increase poses long-term challenges for fiscal sustainability, as countries will need to manage higher debt levels in a context of uncertain economic growth.

In addition to increased spending, the pandemic also negatively affected tax revenues. Lockdown measures and the reduction in economic activity decreased revenues from income, consumption, and corporate taxes. The drop in tax revenues, combined with increased spending, exacerbated fiscal deficits. This imbalance between revenues and expenditures creates additional pressures on public finances, which could lead to the need for future fiscal consolidation measures, such as reducing public spending or increasing taxes, to restore fiscal sustainability.

The Covid-19 crisis also highlighted the importance of institutional quality in managing public finances. Countries with stronger fiscal institutions and more transparent governance systems were able to respond more effectively and efficiently to the crisis, implementing support measures without severely compromising long-term sustainability. In contrast, countries with weaker institutions faced greater challenges in managing the increase in spending and the decline in revenues, exacerbating pre-existing fiscal problems and complicating economic recovery.

In summary, the Covid-19 pandemic has profoundly impacted the sustainability of public finances, increasing debt and deficit levels in many countries. As the world recovers from the crisis, governments will face the challenge of balancing the need to continue supporting economic recovery with the need to restore fiscal sustainability. This balance will require prudent fiscal policies, structural reforms, and continuous improvement in institutional quality to ensure that public finances are sustainable in the long term.

The need for new fiscal rules

The need to implement new fiscal rules arises from the persistent non-compliance with previous fiscal rules and the financial problems that have accumulated in recent years. Since the introduction of the Stability and Growth Pact in 1997, several European countries have struggled to meet the established limits for fiscal deficits and public debt. This situation has led to a series of adjustments and reforms in the fiscal rules, but the compliance issues persist, underscoring the need for a new approach.

The recurrent non-compliance with fiscal rules has led to a loss of credibility in the European fiscal framework. Countries such as Greece, Italy, and Spain have faced significant difficulties in staying within the prescribed limits, resulting in debt crises and financial bailouts. These situations have not only affected the countries in question but have also had repercussions throughout the eurozone, highlighting the interconnectedness of European economies and the importance of responsible fiscal management.

The lack of compliance with fiscal rules has also highlighted weaknesses in the structure and enforcement of these rules. The existing rules have often been criticized for being too rigid and not taking into account the economic and structural differences between countries. This rigidity has led to situations where fiscal policies have been procyclical, exacerbating economic downturns instead of mitigating them.

Moreover, the previous fiscal rules did not always provide adequate incentives for compliance. Sanctions for non-compliance were often insufficient or inconsistently applied, weakening the motivation for countries to adhere to fiscal norms. The lack of clear and effective incentives for compliance has undermined the effectiveness of the fiscal framework.

Given this context, the new fiscal rules of 2024 aim to address these issues and improve fiscal sustainability in Europe. These rules are based on country-specific debt sustainability analyses and use a single indicator: government spending net of tax policy changes as the annual fiscal policy goal. This approach simplifies monitoring and implementation, making it more transparent and manageable.

The process for determining each country's net expenditure trajectory includes several steps. First, the European Commission will provide member states with debt above 60% of GDP or deficits above 3% of GDP with a "reference trajectory for net spending" covering a four-year adjustment period, with the possibility of extending it up to three additional years. Countries must then submit medium-term structural fiscal plans that align their fiscal reform and public investment commitments with this reference trajectory.

The new framework introduces several numerical safeguards to ensure a minimum pace of debt and deficit reduction. These safeguards include the prohibition of increasing the annual adjustment during the adjustment period, a minimum reduction in the debt ratio, and an annual improvement in the structural primary balance. These mechanisms aim to avoid procyclical fiscal adjustments and ensure sustained fiscal consolidation.

A critical aspect of the new framework is its focus on flexibility. It allows for adjustments in fiscal trajectories in exchange for investments and reforms that enhance fiscal sustainability and economic growth. This flexibility aims to incentivize public investment and enable its financing without making drastic cuts in other areas, something the previous framework did not adequately achieve.

However, despite these improvements, the new framework is not without criticism. One issue is the incorporation of safeguards that increase complexity and limit flexibility, reintroducing requirements such as the reduction of the structural deficit by 0.4% annually. These safeguards can contradict the goal of simplification and increase the risk of arbitrary or politicized decisions by the Commission and the Council.

Another criticism is the persistence of rules such as the 3% deficit and 60% debt limits, which some consider obsolete in the current context. The lack of reinforcement of independent fiscal institutions and the low credibility of sanctions also undermine the effectiveness of the new framework. Without these elements, the new rules may face the same compliance issues as their predecessors.

In conclusion, the new fiscal rules of 2024 represent a significant effort to address the problems of fiscal sustainability and compliance that have plagued the European fiscal framework. While they offer improvements in terms of simplification and flexibility, their success will depend on effective implementation and the ability of countries to adapt to the new norms without sacrificing investment and economic growth. Continuous evaluation and adjustment of these rules will be crucial to ensure they can achieve their long-term objectives.

To sump up

The experience with the previous fiscal framework and the introduction of the new fiscal rules in 2024 highlight several important lessons about achieving fiscal sustainability. First and foremost, it has become clear that fiscal rules alone are insufficient if not accompanied by strong, independent institutions that can enforce these rules effectively. These institutions play a critical role in monitoring compliance, providing transparent oversight, and implementing corrective measures when necessary.

Independent fiscal institutions help ensure that fiscal policies are not influenced by short-term political considerations. By providing unbiased assessments and recommendations, these institutions can hold governments accountable and maintain fiscal discipline. The presence of such institutions has proven to be a significant factor in the successful implementation of fiscal rules in countries like Germany and Sweden, where compliance has been consistently high.

Moreover, the complexity of the formulas used in fiscal rules can often be counterproductive. The numerous adjustments, exceptions, and specific calculations can make the rules difficult to understand and implement, reducing their effectiveness. Simplifying these rules and focusing on clear, easily measurable targets can improve transparency and compliance, as well as public understanding and support.

Another critical lesson is the importance of building fiscal buffers during periods of economic growth. By generating savings in good times, governments can create reserves that can be used to cushion the impact of economic downturns. This countercyclical approach helps to avoid the need for harsh austerity measures during recessions, which can exacerbate economic problems and social unrest.

Avoiding procyclical fiscal policies is essential for maintaining economic stability. During economic booms, there is often a temptation to increase public spending and cut taxes, but such measures can lead to overheating and fiscal imbalances. Conversely, cutting spending and raising taxes during recessions can deepen economic contractions. Effective fiscal rules should encourage saving during booms and allow for increased spending during downturns to stabilize the economy.

The new fiscal framework of 2024 aims to address these issues by incorporating more flexible rules that can adapt to changing economic conditions. However, the success of this new framework will depend heavily on the ability of countries to establish and maintain strong, independent fiscal institutions. These institutions must be empowered to enforce rules and provide the necessary oversight to ensure that fiscal policies are sustainable.

Additionally, it is crucial that the new rules do not reintroduce the complexity that plagued the previous framework. Simplified, transparent rules, combined with robust institutional oversight, will be key to improving compliance and achieving long-term fiscal sustainability. By focusing on these elements, Europe can avoid the pitfalls of the past and build a more resilient fiscal system.

In conclusion, returning to a path of fiscal stability is essential for Europe to achieve sustainable growth. The lessons learned from the past two decades underscore the importance of independent institutions, simplified rules, and countercyclical fiscal policies. By adhering to these principles, Europe can avoid repeating past mistakes and create a stable economic environment that fosters long-term prosperity. Only through fiscal discipline and responsible management can Europe navigate future challenges and ensure a robust economic recovery.

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