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The implications of the European Union's new fiscal rules

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Executive summary

EUROPEAN UNION COUNTRIES are required by the EU Treaty to keep their budget deficits within 3 percent of GDP, and their public debt within 60 percent of GDP. A new framework to enforce these rules is based on country-specific debt sustainability analyses (DSA) and uses a single indicator, a measure of public expenditure, as the annual fiscal policy target. These changes are welcome. To assess the sustainability of public finances, it is much better to focus on the likely evolution of the debt path than to rely on simple numerical rules. Public expenditures net of changes to tax policy are a far better target for fiscal policy than the deficit, since they are under the control of the government and cannot give rise to pro-cyclical fiscal policy (excess spending in good times, fiscal cuts in bad times). These features could increase the framework's efficiency and improve compliance.

HOWEVER, THE NEW framework also contains numerical safeguards to ensure a minimum pace of debt and deficit reduction. These might overwrite the DSA-based requirements and could undermine the rationale for the new rules and the incentives for compliance. The safeguards could also introduce some pro-cyclicality and, more importantly, could hold back increases in public investment.

OUR CALCULATIONS SHOW that the new framework will require ambitious fiscal adjustments from high-debt countries, though less than would have been required by the previous framework. Numerical safeguards will not be a significant constraint in the first application of the framework in 2024, except for Finland. In the next application, in 2028, they imply for France and Italy greater fiscal adjustment than required by the DSA and the 3 percent benchmark.

THERE IS AMBIGUITY about the consistency of the new fiscal rules and the largely-unchanged excessive deficit procedure (EDP), and whether proposed reforms and investment will influence the DSA. This could interfere with the successful application of the framework.

WE RECOMMEND THAT the EDP should require the same adjustment as the DSA, a methodology should be developed to estimate the quantitative impact of proposed investments and reforms, and the DSA methodology should be revised. In case EU countries' investment plans on aggregate do not fill the green public-investment gap, we recommend a new EU facility to foster such investments.

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European Union fiscal rules set limits for the national budget deficits and public debts member countries can have, to ensure sound public finances. The rules constrain the excess of government spending over government revenues. The main rules were enshrined in the Maastricht Treaty in 1992, while detailed regulations were codified in the Stability and Growth Pact (SGP) in 1997[1]. The SGP was subsequently revised a number of times. Then, in the wake of the COVID-19 pandemic and the subsequent energy crisis, European fiscal rules were suspended for 2020-2023 and reactivated from 2024. The European Commission began a review of the rules in 2020, though this was interrupted by the pandemic. The review restarted in October 2021 and led to an updated set of fiscal rules, which entered into force at the end of April 2024. This was an important step. The new rules determine the fiscal consolidation requirements and thus the ability of national fiscal policies to address national and European challenges.

This Policy Brief summarises the main features of the new fiscal framework in comparison to the previous one[2], quantifies its fiscal adjustment implications based on the May 2024 European Commission forecasts (the latest at time of writing), and assesses briefly its merits and shortfalls. We also offer a few recommendations on how the Commission and the Council should address loose ends in the framework when it is first implemented later this year.

1 The main elements of the new framework

Like its predecessor, the new framework is built around Article 126 of the Treaty on the Functioning of the European Union (TFEU) and its Protocol No. 12[3]. These lay out a standard for good fiscal behaviour by EU governments, as well as an 'excessive deficit procedure' (EDP) for dealing with countries that fall short of that standard.

- EU countries are required to both maintain their budget deficits below 3 percent of GDP, unless the deviation is small and temporary, and to keep gross government debt below 60 percent of GDP, unless debt is "*sufficiently diminishing and approaching the reference value* [ie 60 percent] *at a satisfactory pace*" (Article 126 (2)).
- The EDP involves a process by which the European Commission declares a deficit to be excessive and proposes corrective fiscal adjustment. Once this is endorsed by EU countries in the Council, the country concerned is expected to undertake the adjustment. If not, the procedure can lead to escalation, possibly resulting in financial sanctions. Meaningful sanctions have never been imposed, but there is some evidence that the EDP has created incentives to keep deficits below 3 percent (Caselli and Wingender, 2021).

The main difference between the old SGP and the new framework is the criteria that establish whether debt that exceeds 60 percent is "*sufficiently diminishing and approaching the reference value at a satisfactory pace*". In both the old and new frameworks, this involves a medium-term target that is supposed to ensure that debt is *"sufficiently diminishing"*. It also involves criteria to determine whether a country is on track to meet that target. The way in which the old and new frameworks define the target and compliance with it is very different, however.

In the old SGP, the main target – called the medium term objective, or MTO, was set in terms of the overall structural balance (SB), which cleans the government budget balance

1 See https://eur-lex.europa.eu/EN/legal-content/glossary/stability-and-growth-pact.html.

2 For a much more detailed treatment, see Pench (2024b).

3 Available at https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX%3A12008E126 and https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX%3A12008M%2FPRO%2F12%3AEN%3AHTML.

from cyclical factors (such as temporarily low tax revenue in a recession) and one-time fiscal measures (such as bank rescue costs after the 2008 global crisis). In 2023, country-specific MTOs ranged between -1 percent and +0.75 percent. The MTO was calculated based on three criteria, of which two were based on formulas. While the inputs into the formulas made sense – for example, countries with higher debts and higher costs related to ageing populations were prescribed higher MTOs – the numerical parameters to calculate the impacts of these effects were rather *ad hoc*[4]. Apart from expected ageing costs, the expected drivers of the debt dynamics – such as real interest rates or real growth – played no role in the setting of the MTO.

Unless its structural balance was already at or above the MTO, a country needed to satisfy several criteria to be considered compliant. Its structural balance was supposed to increase by 0.5 percent of GDP per year as a baseline, and real government expenditure growth had to be lower than potential growth. Furthermore, countries with public debt above 60 percent of GDP were expected to reduce their debts by at least 1/20th of the gap between the actual debt level and the 60 percent reference value per year. Failure to meet this 1/20th debt reduction rule could lead to the opening of a 'debt-based EDP' (in fact, this never occurred, even though the 1/20th rule was violated repeatedly; see Pench, 2024a).

The MTO-based framework was criticised heavily – for its complexity, its reliance on unobserved and poorly estimated variables (the output gap and the structural budget balance), and the arbitrariness of some of its numerical parameters (Claeys *et al*, 2016; Darvas *et al*, 2018; Blanchard *et al*, 2021; Arnold *et al*, 2022). More importantly, the main goals of the framework were not achieved. Compliance was poor, leading to public debt ratios increasing well above the 60 percent benchmark in about half of the EU countries. The framework was also accused of encouraging – and certainly has not been able to prevent – procyclical fiscal policy (fiscal tightening in weak economic conditions and insufficient consolidation in good times), and of being insufficiently protective of public investment (which declined, particularly in the years following the euro crisis).

In the new framework[5], there is only a single operational target in the form of a net expenditure path over a four-to-seven year adjustment period[6]. This is set to ensure that "*by the end of the adjustment period, assuming that there are no further budgetary measures, the projected general government debt ratio is put or remains on a plausibly downward path, or stays at prudent levels below 60 percent of GDP over the medium-term*" (Regulation (EU) 2024/1263). 'Plausibly downward' means that there is at least a 70 percent probability that debt will decline, based on a stochastic debt sustainability analysis (DSA), and also that this can be expected to happen even under pre-defined adverse assumptions about interest rates,

4 The formula for the debt requirement was: $MTO = Balance_{debt\text{-}stabilizing(60\%ofGDP)} + \alpha * AgeingCosts + Effort_{(debt\text{-}reduction)}$, where the first right-hand term represents the budgetary balance that would stabilise the debt ratio at 60 percent of GDP, the second *"represents the budgetary adjustment that would cover a fraction of the present value of the projected increase in age-related expenditure, where α=33% and the ageing cost corresponds to the discounted value of the increase in the cost of ageing, calculated to an infinite horizon"*, and the third *"represents a supplementary debt-reduction effort, specific to Member States with general government gross debt above 60% of GDP. It follows a continuous linear function:* $Effort_{debt\text{-}reduction} = 0.024*debt - 1.24$ *which ensures a supplementary effort of 0.2% of GDP when debt reaches 60%, while requiring a supplementary effort of 1.4% of GDP when the debt ratio attains 110% of GDP"* (European Commission, 2019, page 12). Another formula was based on the standard deviation of output gaps to ensure a sufficient safety margin relative to the 3 percent of GDP deficit benchmark. The third requirement was a minimum threshold for euro-area and Exchange Rate Mechanism participating countries: -1 percent for countries with debt ratios below 60 percent of GDP and -0.5 percent for countries with higher debt ratios.

5 The new framework consists of two regulations, Regulation (EU) 2024/1263 (https://eur-lex.europa.eu/eli/reg/2024/1263/oj) replacing the 'preventive arm' of the old system and Regulation 2024/1264 (https://eur-lex.europa.eu/eli/reg/2024/1264/oj) amending the excessive deficit procedure, and Directive 2024/1265 (https://eur-lex.europa.eu/eli/dir/2024/1265/oj), which sets out requirements for member states' budgetary frameworks.

6 Net expenditure is defined as "government expenditure net of interest expenditure, discretionary revenue measures, expenditure on programmes of the Union fully matched by revenue from Union funds, national expenditure on co-financing of programmes funded by the Union, cyclical elements of unemployment benefit expenditure, and one-offs and other temporary measures".

GDP and the primary fiscal balance[7]. We refer to these conditions as the 'DSA requirements'. In addition, the net expenditure path must ensure that whenever the budget deficit is larger than the 3 percent of GDP benchmark, it is reduced below 3 percent by the end of the adjustment period (the 'deficit requirement').

The new framework also requires the net expenditure path to meet some additional conditions ('safeguards') for countries with either public debt in excess of 60 percent of GDP or a deficit of more than 3 percent of GDP:

- No backloading: the annual fiscal adjustment cannot increase during the adjustment period;
- Debt sustainability safeguard: at least one percentage point of GDP per year decline in the debt ratio for countries with a debt ratio greater than 90 percent of GDP; and half a percentage point of GDP per year for countries with a debt ratio between 60 percent and 90 percent of GDP), from either the beginning of the adjustment period or from the correction of an excessive deficit (whichever is later) by the end of the adjustment period;
- Deficit resilience safeguard: for countries with a structural overall budget deficit greater than 1.5 percent of GDP, an annual improvement in the structural primary balance of at least 0.4 percent of GDP when the adjustment period lasts for four years, and at least 0.25 percent of GDP when it lasts for seven years.

Finally, the new framework inherits a requirement from the current **'deficit based' EDP**: countries with deficits of more than 3 percent of GDP (unless the deviation is small and temporary) are required to adjust by at least 0.5 percent of GDP per year, measured in terms of the structural primary balance in 2025-2027 (that is, excluding interest payments) and in terms of the overall structural balance from 2028 on.

The **process for arriving at each country's net expenditure path** involves several steps.

First, the European Commission will provide to member states with debt of more than 60 percent of GDP or deficits of more than 3 percent of GDP budget *"a reference trajectory for the net expenditure covering an adjustment period of four years and its possible extension by up to three years"* (Article 5 of Regulation (EU) 2024/1263) that meets all requirements (other countries will receive *"technical information"*). This is normally supposed to happen by 15 January in the year in which the net expenditure paths are negotiated, but this year (2024) it will be provided by 21 June.

Next, all EU members must present medium-term fiscal structural plans (MTFSPs, replacing the earlier national reform, stability and convergence programmes). These should explain countries' fiscal, reform and public investment commitments over the next four or five years. In 2024, countries can submit these plans in September or even somewhat later, while in the next round, these plans must be submitted by April. Countries can request extensions of the adjustment period from four to seven years if they propose, in their MTFSPs, reforms and investments that *"as a general rule, taken altogether"* are growth-enhancing and that support fiscal sustainability, address common EU priorities, address relevant European Semester country-specific recommendations and result in an increase in nationally financed investments. While the net expenditure path in an MTFSP can differ from the Commission's reference path, it is expected to comply with the same criteria (debt sustainability, deficit requirement and safeguards). Furthermore, *"sound and data-driven economic arguments"* must be provided if the fiscal adjustment proposed by the member state is less than that of the reference path.

Once agreed with the Council, the net expenditure path is supposed to be enforced through the **debt-based EDP**. The latter would in principle be triggered if the cumulative

7 For the first application of the framework this year, the DSA methodology described in European Commission (2024a) will be used. A new working group was established to review the methodology, which might result in some changes in the next application.

deviation from the approved path exceeds 0.3 percent of GDP annually or 0.6 percent cumulatively, but there is no automaticity for a debt-based EDP when the deviation exceeds these values.

2 Expected implications for fiscal adjustment

We use the DSA methodology of the European Commission (2024a) (see Darvas *et al*, 2023) to compute the fiscal adjustment requirements on the first application of the new fiscal framework in 2024, based on May 2024 European Commission forecasts, market expectations for interest rates and inflation rates averaged for May 2024, and ageing cost projections published in April 2024 (European Commission, 2024b).

While the new framework will set net expenditure growth trajectories, these are derived using an interim variable, a structural primary balance (SPB – which excludes interest payments from the structural balance) target at the end of the four or seven year adjustment period. Table 1 reports our results for these SPBs, organised in a way that makes it clear which of the new framework's criteria drive fiscal adjustment for each country. Columns (1)-(3) show the most recent Commission forecasts for 2024 debt, fiscal balance and the structural primary balance (SPB). Columns (4)-(11) show the structural primary balance at the end of the four- or seven-year adjustment period required by the various criteria, with the binding requirement highlighted by shading (for readability, columns (8)-(11) contain values only if the safeguards are binding). Columns (12) and (13) show the SPB at the end of the adjustment period that meets all criteria. Columns (14) and (15) show the corresponding average *annual* fiscal adjustment requirement.

For eight of the twelve countries with debt above 60 percent of GDP, the DSA requirements determine fiscal adjustment over both four-year and seven-year adjustment periods (Austria, Belgium, Germany, Greece, Hungary, Portugal, Slovenia and Spain; light green shading in Table 1). For the four-year adjustment period, the DSA requirements would also be binding for France and Italy. For Italy (only the seven-year case), the requirement to reduce the budget deficit below 3 percent by the end of the adjustment period is binding (light blue shading), albeit by just a tenth of a percentile. Cyprus is expected to have a 2.9 percent of GDP budget surplus in 2024 – this country can do a fiscal stimulus (ie reduce its budget surplus) in the coming years according to the new fiscal rules, which stimulus is constrained by the requirement of keeping the deficit below 3 percent.

The numerical safeguards will mostly not be binding during the adjustment period (except for the no-backloading condition, which is assumed to apply throughout). The main exceptions are Finland and France. For Finland, the debt sustainability safeguard binds in the four-year and the seven-year cases (yellow shading), primarily because of updated stock-flow adjustments related to public pension funds. These funds register surpluses, which are part of the general government headline balance, but this surplus is used for building up pension fund assets and not for reducing debt (see European Commission, 2024a)[8]. In France, the deficit resilience safeguard determines the adjustment need for the seven-year case, if only

8 Moreover, Finland, with a 3.4 percent of GDP deficit forecast for 2024, would have been better off with an EDP for one year, because in that case, the debt sustainability safeguard would have required an average annual decline in the debt ratio of 0.5 percent of GDP starting from 2025, the year of exiting the EDP. In this case, this safeguard would have required an SPB target of 2.8 percent of GDP by 2028 in case of a four-year adjustment, not the extraordinarily high 4.3 percent reported in Table 1. In the seven-year case, the target for 2031 would have been 2.6 percent instead of 3.3 percent.

marginally – 0.81 percent for deficit resilience (dark orange shading) versus 0.80 percent for DSA[9]. Malta and Estonia, both of which have debt ratios below 60 percent, are also projected to face a binding deficit resilience safeguard, until their deficits are reduced below 3 percent.

While the deficit resilience safeguard does not make a material difference for any country with debt above 60 percent during the four or seven-year adjustment period, it could make a difference for Belgium, France and Italy after this period. For France, the structural balance would continue to exceed 1.5 percent of GDP after both the four-year and seven-year adjustment periods; for Belgium and Italy it would be only for the seven-year period (though for Belgium, the excess is just 0.1 percent of GDP) – see columns 4 and 5 of Table 2. The deficit resilience safeguard therefore obliges these countries to continue their adjustments[10]. Belgium would face a binding deficit resilience safeguard for just one year following the end of the first adjustment period, which would not affect its overall SPB target in the next adjustment period. For France, the additional adjustment requirement (beyond the SPB targets reported in columns 12 and 13 of Table 1) would be dictated by the deficit resilience safeguard, which exceeds DSA requirements by 1 percent of GDP. For Italy, the deficit resilience safeguard would require an SPB target of 4 percent of GDP in a second adjustment period, 1.4 percentage points above what would be required by other criteria.

Columns (14) and (15) show that the average fiscal adjustment requirements implied by the new rules would be substantial for several high-debt countries:

- Italy: 1.08 percent per year with a four-year adjustment and 0.59 per year with a seven-year adjustment;
- France: 0.94 percent in the four-year case and 0.54 percent in the seven -year case;
- Spain: 0.89 percent and 0.52 percent;
- Finland: 1.21 percent and 0.55 percent;
- Hungary: 0.75 percent and 0.47 percent;
- Belgium: 0.74 percent in the four-year case and 0.43 percent in the seven-year case.

In contrast, adjustment requirements for Greece and Portugal are small, notwithstanding their high debt levels, because these countries already have sizeable primary surpluses (column 3). The reverse is true for Slovakia, Poland and Romania, where the new rules prescribe large adjustments to reduce currently high deficits, although debt for these countries is below 60 percent. For Cyprus, the current structural primary surplus is higher than the medium-term requirement, implying a negative adjustment requirement.

9 For France, the debt sustainability safeguard is not binding because France is expected to exit the EDP only by the last year of the adjustment period. Thus, the requirement of this safeguard to reduce the debt ratio from the year of exiting the EDP to the last year of the adjustment period cannot be interpreted, because the two years are the same. For example, in the case of the four-year adjustment period, France would exit the EDP in 2028 and the last year of the adjustment period is also 2028. Thus, a reduction of the debt ratio from 2028 to 2028 cannot be interpreted.

10 Finland would face a binding deficit resilience safeguard in its third plan, but not in the first two plans for which the debt sustainability requirement determines the adjustment.

Table 1: Fiscal adjustment requirements under the new EU fiscal framework (in percent of GDP)

	European Commission forecasts for 2024			Min. SPB required by DSA criteria		Min. SPB required by 3% deficit cap		Min. SPB required by EDP and the debt safeguard		Min. SPB required by EDP, debt safeguard and the deficit resilience safeguard		Minimum SPB satisfying all criteria		Average annual fiscal adjustment need	
	Debt	Fiscal balance	SPB	Adjustment period (four or seven years)											
				4	7	4	7	4	7	4	7	4	7	4	7
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)=max (4,6,8,10)	(13)=max (5,7,9,11)	(14)= {(12)-(3)}/4	(15)= {(13)-(3)}/7
Greece	153.9	-1.2	1.7	1.9	2.1	1.7	2.1	...	...	...	...	1.9	2.1	0.03	0.05
Italy	138.6	-4.4	-1.1	3.3	3.0	3.2	3.1	...	...	...	...	3.3	3.1	1.08	0.59
France	112.4	-5.3	-3.0	0.8	0.8	0.7	0.8	...	...	...	0.8	0.8	0.8	0.94	0.54
Spain	105.5	-3.0	-0.8	2.7	2.8	2.2	2.3	...	...	...	...	2.7	2.8	0.89	0.52
Belgium	105.0	-4.4	-1.9	1.1	1.1	0.8	0.9	...	...	...	...	1.1	1.1	0.74	0.43
Portugal	95.6	0.4	2.2	2.6	2.3	1.7	1.5	...	...	...	...	2.6	2.3	0.09	0.01
Finland	80.5	-3.4	-0.5	1.4	1.0	-0.4	-0.6	4.3	3.3	...	...	4.3	3.3	1.21	0.55
Austria	77.7	-3.1	-1.1	0.8	0.7	-0.1	-0.2	...	...	...	...	0.8	0.7	0.48	0.26
Hungary	74.3	-5.4	0.0	3.0	3.3	2.3	2.8	...	...	...	...	3.0	3.3	0.75	0.47
Cyprus	70.6	2.9	3.5	0.4	-0.2	0.7	0.3	...	...	...	...	0.7	0.3	-0.70	-0.46
Slovenia	68.1	-2.8	-1.2	0.5	0.5	0.4	0.4	...	...	...	...	0.5	0.5	0.44	0.25
Germany	62.9	-1.6	-0.0	0.4	0.1	-0.5	-0.7	...	...	...	...	0.4	0.1	0.11	0.02
Croatia	59.5	-2.6	-2.0	0.3	0.5	-1.0	-0.9	...	...	...	...	0.3	0.5	0.58	0.36
Slovakia	58.5	-5.9	-4.3	0.8	1.1	0.4	0.6	...	...	...	...	0.8	1.1	1.27	0.77
Poland	53.7	-5.4	-2.6	0.6	0.8	0.5	0.5	...	...	...	0.9	0.6	0.9	0.80	0.50
Malta	52.0	-4.3	-2.9	-1.9	-1.3	-1.3	-1.0	...	...	-1.0	...	-1.0	-1.0	0.48	0.26
Romania	50.9	-6.9	-4.4	0.0	0.9	0.1	0.4	...	...	...	...	0.1	0.9	1.13	0.75
Netherlands	47.1	-2.0	-0.6	-0.6	-0.6	-0.3	-0.4	...	...	...	...	-0.3	-0.4	0.09	0.04
Czechia	45.2	-2.4	-0.1	-0.2	-0.1	0.3	0.6	...	...	...	...	0.3	0.6	0.11	0.10
Latvia	44.5	-2.8	-1.4	-1.0	-0.7	-1.2	-1.2	...	...	...	...	-1.0	-0.7	0.10	0.10
Ireland	42.5	1.3	2.5	-2.0	-2.0	-0.6	-0.6	...	...	...	...	-0.6	-0.6	-0.79	-0.45
Lithuania	38.9	-1.8	-0.0	-0.8	-0.8	0.0	-0.2	...	...	...	...	0.0	-0.2	0.01	-0.02
Sweden	32.0	-1.4	0.7	-2.3	-2.4	-1.0	-1.7	...	...	...	...	-1.0	-1.7	-0.44	-0.34
Luxembourg	27.1	-1.7	0.1	-3.1	-3.0	-0.7	-0.9	...	...	...	...	-0.7	-0.9	-0.21	-0.13
Denmark	26.5	2.4	2.9	-2.9	-3.1	-1.2	-1.6	...	...	...	...	-1.2	-1.6	-1.03	-0.64
Bulgaria	24.8	-2.8	-2.3	-3.0	-2.3	-2.2	-1.8	...	...	...	...	-2.2	-1.8	0.03	0.08
Estonia	21.4	-3.4	-0.3	-3.1	-2.8	-2.1	-1.9	...	...	...	...	-2.1	-1.9	-0.44	-0.23
Memorandum items															
EU	83	-3.0	-0.9	0.7	0.6	0.5	0.5	...	...	...	...	0.9	0.9	0.47	0.25
Euro area	90	-3.0	-0.9	1.0	0.9	0.7	0.6	...	...	...	...	1.1	1.0	0.51	0.28

Source: Bruegel based on European Commission May 2024 forecasts, the April 2024 Ageing report (European Commission, 2024b), Bloomberg, and ECB. Note: methodology based on European Commission (2023) and adjusted with the new requirements of the approved fiscal framework. Light green shading marks cases where the DSA criteria (4,5) are binding. Light blue shading marks cases where the SPB required by the 3 percent deficit cap (6,7) exceeds the SPB required by the DSA criteria. Yellow shading marks cases where the SPB required by the debt sustainability safeguard (8,9) exceeds the DSA criteria and the 3 percent deficit cap. Dark orange shading marks cases where SPB required by the deficit resilience safeguard exceeds the SPB required by the DSA criteria, the deficit cap, and the debt safeguard. EU and euro area rows are calculated as GDP-weighted averages of respective country scenarios.

Table 2: Comparison of adjustment requirements based on the medium-term objective (MTO) of the previous framework and those of the new framework (in percent of GDP)

	European Commission forecasts for 2024		Medium term targets, in structural balance terms			Adjustment requirements, in structural balance terms			Difference in adj. requirements, new vs old	
	Debt	Structural balance	Previous (MTO)	New 4-year	New 7-year	Previous	New 4-year	New 7-year	4-year	7-year
	(1)	(2)	(3)	(4)	(5)	(6)=(3)-(2)	(7)=(4)-(2)	(8)=(5)-(2)	(9)=(4)-(3)	(10)=(5)-(3)
Greece	154	-1.7	0.5	-1.3	-1.1	2.2	0.4	0.6	-1.8	-1.6
Italy	139	-5.0	0.3	-1.5	-2.2	5.3	3.5	2.8	-1.8	-2.5
France	112	-5.0	-0.4	-2.0	-2.4	4.6	3.0	2.6	-1.6	-2.0
Spain	106	-3.4	0.0	-0.1	-0.2	3.4	3.3	3.2	-0.1	-0.2
Belgium	105	-4.0	0.8	-1.4	-1.6	4.8	2.6	2.4	-2.2	-2.4
Portugal	96	0.0	-0.5	0.5	0.2	-0.5	0.4	0.2	1.0	0.7
Finland	80	-1.8	-0.5	2.7	1.6	1.3	4.4	3.3	3.2	2.1
Austria	78	-2.5	-0.5	-1.0	-1.2	2.0	1.5	1.3	-0.5	-0.7
Hungary	74	-4.9	-1.0	-1.2	-0.8	3.9	3.7	4.1	-0.2	0.2
Cyprus	71	2.1	0.0	-0.9	-1.6	-2.1	-3.0	-3.7	-0.9	-1.6
Slovenia	68	-2.7	0.8	-0.9	-1.0	3.4	1.7	1.6	-1.7	-1.8
Germany	63	-0.9	-0.5	-0.7	-1.1	0.4	0.2	-0.2	-0.2	-0.6
Croatia	60	-3.6	-1.0	-1.4	-1.3	2.6	2.2	2.3	-0.4	-0.3
Slovakia	58	-5.6	0.3	-1.0	-0.9	5.8	4.6	4.7	-1.2	-1.1
Poland	54	-4.8	-1.0	-2.3	-2.2	3.8	2.5	2.6	-1.3	-1.2
Malta	52	-4.2	0.0	-2.4	-2.5	4.2	1.7	1.7	-2.4	-2.5
Romania	51	-6.4	-1.0	-2.5	-2.1	5.4	4.0	4.3	-1.5	-1.1
Netherlands	47	-1.3	-0.8	-1.1	-1.3	0.6	0.2	0.0	-0.4	-0.6
Czechia	45	-1.5	-0.8	-1.2	-1.0	0.8	0.3	0.5	-0.5	-0.2
Latvia	45	-2.4	-1.0	-2.4	-2.3	1.4	0.0	0.1	-1.4	-1.3
Ireland	42	1.8	-0.5	-1.3	-1.3	-2.3	-3.1	-3.1	-0.8	-0.8
Lithuania	39	-0.8	-1.0	-1.0	-1.3	-0.2	-0.3	-0.5	-0.0	-0.3
Sweden	32	-0.0	-1.0	-3.2	-3.3	-1.0	-3.2	-3.2	-2.2	-2.3
Luxembourg	27	-0.3	0.5	-1.2	-1.2	0.8	-0.9	-1.0	-1.7	-1.7
Denmark	27	2.4	-0.5	-1.6	-1.9	-2.9	-4.0	-4.3	-1.1	-1.4
Bulgaria	25	-2.8	-1.0	-3.0	-2.9	1.8	-0.1	-0.0	-2.0	-1.9
Estonia	21	-0.7	-0.5	-2.8	-2.7	0.2	-2.1	-2.0	-2.3	-2.2
Memorandum items										
EU	83	-2.3	-0.4	-1.3	-1.5	2.0	1.1	0.8	-0.9	-1.1
Euro area	90	-2.6	-0.3	-1.1	-1.4	2.4	1.6	1.3	-0.8	-1.1

Source: Bruegel based on May 2024 European Commission forecasts for (1) and (2); European Commission (2023) for the last MTO (3). Note: Columns (4) and (5) are computed by taking the SPB* estimates from Table 1 and subtracting projected interest payments as a share of GDP, conditional on baseline growth and interest rate assumptions. Green shading marks cases where the new rules imply lower adjustment needs, red shading marks cases where they imply higher adjustment needs.

Table 2 shows how the fiscal adjustment requirements would have differed if the old SGP had been reinstated. To compare the two systems, we express the SPB requirements of the new framework in SB terms[11]. Column (3) of Table 2 shows the most recent MTO of the old framework, while columns (4) and (5) show the corresponding structural balance targets under the new framework for the four and seven-year horizons[12]. Column (6) shows how much total adjustment would have to be made under the previous framework in four years, while columns (7) and (8) show the corresponding adjustment requirements under the new framework, over four and seven years, respectively. Finally, columns (9) and (10) show the differences between these 'MTO-equivalent' adjustment targets under the new framework, and the MTO-based adjustment under the previous framework. A negative sign means that the adjustment requirements under the new framework are less than under the old.

The main result is that for most countries, the old framework would have required greater fiscal adjustment than the new one. This remains true even if we take into account the additional fiscal adjustment requirements for Belgium and Italy triggered by the deficit resilience safeguard, which are outside the adjustment horizon of the first MTFSP. For Spain and Lithuania, the adjustment requirements are broadly the same in the old and new systems. The two countries for which the new framework requires significantly larger adjustment than the previous framework are Finland (3.2 percent of GDP in the four-year case and 2.1 percent in the seven-year case) and Portugal (1 percent and 0.7 percent, respectively)[13].

3 Appraisal

Is the new framework an improvement over the old one? The short answer is yes. However, it falls well short of the improvement that was within reach. This is partly a result of the dilution during the negotiation process with and among EU countries of the concept originally proposed by the European Commission (2022), and partly because the 'deficit-based' excessive deficit procedure has been maintained largely unchanged and is not well integrated with the new framework.

The Commission's November 2022 concept was based on the premise that by addressing widely criticised flaws of the old rules, the reform could achieve two objectives: to increase the efficiency of the system – in the sense of giving countries maximum flexibility to conduct fiscal policy while still ensuring debt sustainability –.and to improve compliance, as a more reasonable system is more likely to be respected. Article 126(10) of the Treaty on the Functioning of the European Union expressly takes judicial enforcement (the Treaty infringement procedure) off the table, and the last 25 years have shown that beyond the exercise of peer pressure, the Council was not willing (or able) to enforce the rules through fines, as envisaged by Article 126(11). The remaining route to compliance was hence to create a better system that member states would be more willing to accept.

11 The MTO is defined in terms of the (overall) structural balance (SB) while the new framework focuses on the net expenditure path, with the SPB as an intermediate/technical variable.

12 These are computed as the SPB requirements shown in columns (10) and (11) of Table 1, minus the interest payments projected conditional on reaching this SPB and baseline growth and interest rate projections.

13 For Finland, European Commission (2024a) now incorporates stock-flow adjustment for more than a decade ahead, which increases the Finnish debt ratio by 13 percentage points of GDP in ten years and about 17 percentage points in twenty years, compared to the previous assumptions. Without these new stock-flow adjustments, the Finnish adjustment need would have been lower in the new fiscal framework than in the old framework. Presumably, even in the previous fiscal framework, this new large stock-flow adjustment would have increased the Finnish MTO. Thus, our comparison of the adjustment needs based on the 2023 Finnish MTO and the 2024 new fiscal framework reported in Table 2 is misleading because of significantly different assumptions. For other EU countries, there were no such significant changes in assumptions from 2023 to 2024.

The concept sought to achieve this through three main changes to the old framework.

- First, replacing multiple operational targets with a single indicator: net expenditure growth over the medium term. Unlike its predecessor – the structural balance – this is observable in real time. It also cannot give rise to procyclical policy by construction (expenditure is not adjusted in response to either weak or strong cyclical conditions, and cyclical expenditure items are excluded from net expenditure).
- Second, setting the medium-term net expenditure path only with debt sustainability in mind, as well as compliance with the treaty requirement of reducing (or maintaining) the fiscal deficits below the 3 percent reference value.
- Third, allowing a more gradual fiscal adjustment path to countries undertaking public investment and reforms that were likely to strengthen fiscal solvency. This was expected to both create incentives for public investment and some room to finance it without making drastic cuts in other areas.

The Commission's November 2022 concept also had one significant weakness: the required fiscal adjustment was determined by a DSA methodology that only the Commission fully understood and that EU countries and outside observers were not able to replicate. In the eyes of some member states, this gave the Commission too much power and made the results politically manipulable. The Commission exacerbated these worries by showing little willingness to share its code. Whether or not an offer to 'socialise' the DSA methodology would have made a difference is hard to say: some countries, including Germany, disliked the DSA approach *per se*, in addition to the Commission's control of it.

In any event, Germany, supported by other fiscally conservative member states, insisted on the numerical safeguards that would ensure a minimum pace of debt and deficit reduction, no matter what the DSA indicated. To accommodate these countries, the Commission included two ill-designed safeguards, a 'debt safeguard' and an 'expenditure growth safeguard', in its April 2023 legislative proposal (Darvas *et al*, 2023). In the final Council compromise in December 2023, the debt safeguard was improved and the expenditure growth safeguard was dropped. However, a new safeguard was included: the 'debt resilience safeguard', which introduced a new long-term deficit ceiling at 1.5 percent of GDP. In addition, the existing 'deficit-based' EDP was maintained largely unchanged even in the finally adopted regulation, including a requirement that countries with deficits greater than the 3 percent benchmark must lower their deficits by a minimum of 0.5 percent per year[14].

An alternative approach to address the mistrust in the DSA would have been to transform the Commission's methodology into a common methodology, after review by member states (Blanchard and Zettelmeyer, 2023; Darvas *et al*, 2023). This idea was taken up in part in the final regulation, which envisages the involvement of member states in a working group reviewing the methodology (after its first application based on the Commission's DSA, which has become more transparent after we replicated and published it in Darvas *et al*, 2023), though there is no formal requirement to get consent from member states' representatives or the Council.

The net result of the negotiation process was to re-import some of the weaknesses of the old system that the Commission had set out to remove:

14 The only difference is that in the old framework, the adjustment pace was measured in terms of the overall structural balance, while in the new framework, the structural primary balance is applied in 2025-2027. From 2028, the measure of adjustment reverts to the overall structural balance. This rather odd arrangement reflects a compromise between France, which would have preferred using the structural primary balance throughout, and Germany, which preferred no change at all. In practical terms, the use of the structural primary balance as an adjustment measures makes a difference particularly in 2025-2027, since this is when interest payments (which are excluded from the structural primary balance) rise sharply in several EU countries, reflecting the impact of higher interest rates on a rising share of the debt stock. Hence, using the structural primary balance in this period generally lowers the adjustment requirement from what it would have been if the EDP had been kept unchanged.

- The possibility that numerical 'safeguards' override the DSA contradicts the main principle that was intended to raise compliance with the new system: that member states would be required to undertake fiscal adjustment if and only if their debt sustainability or the 3 percent of GDP Treaty-based deficit benchmark required it. The worst offender, in this regard, is the deficit resilience safeguard: unlike the other safeguards, this might not just impact the speed of adjustment, but the medium-term consolidation target (requiring a more ambitious target than the DSA)[15].
- The minimum adjustment requirement for countries breaching the 3 percent deficit benchmark add a potentially procyclical element to the rules: a country that is hit by an output shock that results in an excessive deficit may be forced to undertake additional fiscal adjustment even if it was, and remains, fully compliant with the agreed net expenditure path[16].
- Finally, the no-backloading condition and the presence of minimum adjustment requirements through the deficit-based EDP and the deficit resilience safeguards make it tough to raise investment. While many countries continue to have strong incentives to propose investment and reform that will entitle them to a three-year extension of the adjustment period, the new system will generally force them to offset increases in investment spending one-for-one through higher taxes or lower non-investment spending, as they would otherwise violate one of the minimum adjustment requirements and/or the no-backloading safeguard[17] [18].

The last problem could have been avoided by incorporating a fiscally responsible public investment rule in the new framework, which would have exempted Council-endorsed investment from all safeguards and minimum adjustment requirements, while continuing to require the resulting net expenditure paths to meet both the DSA requirements and the requirement to lower the deficit below 3 percent by the end of the adjustment period. In the Annex[19], we show that even for high-debt countries, this rule would have not endangered public debt sustainability, while it would have allowed a meaningful increase in public investment.

A further risk is that the fiscal adjustment required by the EDP will turn out to be *lower* than what is required by the DSA and deficit requirements for the MTFSP-based net expenditure paths (Pench, 2024a). This could happen if:

- The corrective paths prescribe fiscal adjustment of 0.5 percent of GDP per year even when the DSA requirements and the deficit requirement would require higher adjustment

15 It is straightforward to construct examples in which the medium-term deficit consistent with a 'plausibly downward' debt trajectory in the meaning of the regulation is higher than 1.5 percent of GDP. For a given debt level above 60 percent of GDP, this would be the case for countries in which ageing costs are expected to fall or rise relatively slowly, or for which growth is expected to be relatively high. At present, this is the case for France and Italy (in the latter case, for the seven-year adjustment case only). See Table 2, columns (4) and (5).

16 Whether this is the case depends on the initial fiscal adjustment path required by the MTFSP. The minimum 0.5 percent adjustment under the deficit-based EDP would not impact countries for which the MTFSP requires more than 0.5 percent annual adjustment. But when it envisages less than 0.5 percent annual adjustment, the EDP will require an acceleration of fiscal adjustment under weak economic conditions (unless an escape clause is activated).

17 Jeromin Zettelmeyer, 'Are the emerging EU fiscal rules green enough?' *First Glance*, 16 November 2023, Bruegel, https://www.bruegel.org/first-glance/are-emerging-eu-fiscal-rules-green-enough; Zsolt Darvas, Jean Pisani-Ferry and Jeromin Zettelmeyer, 'Bringing the reform of European Union fiscal rules to a successful close,' *First Glance*, Bruegel, https://www.bruegel.org/first-glance/bringing-reform-european-union-fiscal-rules-successful-close.

18 When only the deficit resilience safeguard is binding and an investment increase is linked to an extension of the adjustment period from four to seven years, the required offsetting fiscal adjustment in the year of the increase is lowered by 0.15 percent of GDP, reflecting the lower minimum adjustment in the event of an extension of the adjustment period (0.25 percent of GDP rather than 0.4 percent of GDP).

19 Available at https://www.bruegel.org/sites/default/files/2024-06/PB%2010%20Annexes.pdf.

(according to Table 1, this would be the case for Italy, Romania and Slovakia, even with a seven-year adjustment period, and for many more countries with a four-year adjustment period);

- Satisfactory progress during the EDP is measured based on changes in the 'nominal' (cyclically unadjusted) deficit rather than changes in net expenditure;
- Renegotiation of the corrective path in the EDP leads to a lower overall adjustment requirement than what would be required by the DSA requirements and the deficit requirement.

As argued by Pench (2024a), lenient treatment of excessive deficit countries would undermine the willingness of all others to respect the net expenditure paths agreed with the Council.

The initial application of the new rules could also be undermined by a lack of clarity on how proposed reforms and investments will impact the DSA, and consequently, the annual fiscal adjustment requirements. The Commission's practice is based on a no-policy-change assumption, under which the DSA is based only on reforms and investments that have already been implemented, but not on promised reforms and investments. Hence, countries would receive credit for high-quality reform and investment plans only through an extension of the adjustment period, not through a lower adjustment requirement relative to the Commission's seven-year reference trajectory due to faster growth. At the same time, the new rules both oblige member states to demonstrate the growth and fiscal sustainability impacts of proposed investments and reforms if they wish to receive an extension, and allow them to propose less-ambitious fiscal adjustment, provided this is backed by *"sound and data-driven economic arguments"* (Article 13(b) of Regulation (EU) 2024/1263) It is hard to imagine that countries whose arguments on the growth impact of planned reforms have been given a seal of approval in the form of an extension will not use these arguments to justify more optimistic projections and hence lower fiscal adjustment (Darvas *et al*, 2024).

How serious are these weaknesses and inconsistencies? As shown in Table 1, the risk that numerical safeguards would require much harsher fiscal adjustment than the DSA has not materialised so far, at least not during the initial four or seven-year adjustment period (as discussed above, it may require additional adjustment from Belgium and Italy after the adjustment period). This improves the chances that member states will accept the fiscal adjustment requirements implied by the new rules.

The remaining risks – procyclicality and the need to offset higher investment induced by minimum adjustment requirements, and lack of clarity on how deficit-based EDP's will be implemented and how MTFSPs will be negotiated – may well become an issue.

4 The steps ahead

While it is too late to fix the flaws in the new rules, member states, the Council and the Commission can make the best of them by taking the following steps in the months ahead.

1. The Commission and Council should agree on an EDP implementation plan that does not result in more lenient treatment under an EDP than without an EDP. This should involve: (1) corrective paths that do not require less adjustment than what is required by the DSA and deficit requirements; (2) disapplying the EDP only if *both* the deficit and debt criteria are satisfied.
2. The deficit-based EDP should be managed in a way that minimises procyclicality in line with the leeway allowed by Regulation 2024/1264 (see footnote 5). For countries with debt below 60 percent of GDP, an excessive deficit resulting from an adverse output

shock should not trigger an EDP. For countries with debt above 60 percent, the corrective expenditure path should remain the same as was approved in the MTFSP, even if it is somewhat lower than 0.5 percent.

3. The Commission should develop a methodology for deciding on the potential quantitative impact of proposed investments and reforms on the fiscal adjustment required under the new rules, and use this to judge the plausibility of any MTFSP that argues for higher net expenditure paths on the basis of such reforms. At the same time, the Council and the member state should agree on a lower net expenditure path that would come into effect if the reform does not materialise (see Darvas *et al*, 2024, for details).
4. Member states and the Commission should agree on a revised common DSA methodology following a thorough review of the current Commission methodology. Public commentary should be invited before the proposal is adopted. The computer code and data required to run the methodology should be made publicly available.

Unfortunately, none of these steps would address the main weakness of the new framework: that it will unduly constrain increases in investment to meet the EU's climate and other goals. Whether this risk materialises will become clearer when member states submit their MTFSPs, including their public investment plans, in autumn this year. If the risk does materialise, it will put the EU's 2030 and potentially 2040 European Green Deal targets in jeopardy, unless EU-level funding of public investment is increased substantially over the medium term.

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