

EU fiscal rules: where to from here?

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The Ideas Exchange from Brussels



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As part of a BlackRock event series exploring big ideas and questions facing society today, the most recent Ideas Exchange from Brussels focused on what future for EU fiscal rules. As the European economy recovers from the pandemic, the role of public spending underpinning economic resilience may be forever changed. Equally, as Europe moves to reshape its economy to meet its net-zero and digitalisation aims, Europe looks to secure huge public and private investment. Do EU fiscal rules need to evolve to reflect these new realities and if so how?

Panelists from the public and private sector came together to discuss these main themes as follows:

The Covid-19 pandemic: a fiscal reform booster

Europe's fiscal rule book has long been the subject of criticism across Europe for both economic and political reasons. A lack of solid theoretical grounding and its increasingly complex and opaque nature are concerns frequently cited.

The Covid-19 pandemic has prompted new reflections on the suitability of current fiscal rules to a new reality of much higher sovereign debts across the euro area, along with much lower interest rates than when the initial rules were adopted. Christian Odendahl, Chief economist at Centre for European Reform emphasised this aspect: "*The pandemic*

“ Before the pandemic, there was an entrenched equilibrium against reviewing the rules: this has now changed”

Isabel Mateos y Lago, Global Head of BlackRock's Official Institutions Group

“ In real times of crisis, Europe has shown itself to be reactive and pragmatic (...) I am optimistic that by 2023 we can get some compromise [on SGP review]”

Michael Krautzberger
Head of Fundamental Fixed Income in EMEA at BlackRock

acted as a reform booster (...) these fiscal rules cannot be applied as they are anymore, yet it is unclear what the reform will mean”.

While the direction of travel on the reform of fiscal rules remains uncertain, the pandemic has created new momentum to revert to this divisive debate. The temporary 'suspension' of the SGP, euro area debt ratios reaching roughly 100% of the GDP, as well as the new model of temporary fiscal cooperation under the Recovery and Resilience Facility (RRF) have forced reflection and laid fertile ground for this debate.

Europe's pragmatism in the face of crisis

According to Christian Odendahl, the pandemic also played a crucial role in testing whether the ECB would effectively do 'whatever it takes' in times of crisis and whether an ad hoc insurance mechanism could exist in the euro area. The creation of RRF, which resulted in a preliminary form of fiscal capacity and mutualisation, contributed to boosting market participants' confidence in EU crisis management.

Michael Krautzberger, BlackRock's Head of Fundamental Fixed Income in EMEA, brought a markets perspective to the discussion, praising the new approach adopted by the EU, which factored in lessons learnt from

past crises. This is underpinned by recent openness to reform by both the German and French governments.

Despite a widespread awareness that the rules today are unrealistic and need more credibility, the EU has demonstrated its capacity to rise to the occasion in the crisis, showing its ability to use mutualisation if needed, in order to calm market sentiment. Even if the review failed to provide immediate solutions to the eurozone challenges, a market sell-off is not on the horizon.

The three core moving parts of the debate on SGP reform

In spite of the confidence in the EU and the role of the pandemic as a catalyst for reform, revolutionary reform should not be expected, given the entrenchment of opposing camps in the fiscal reform debate. Member States are more likely to agree on enhancing transparency in the application of the framework and ensuring the rules are more binding in their own right.

The forthcoming debate will therefore need to address key questions on the appropriate parameters for current debt levels, the reduction of procyclicality in the implementation of the rules, and the treatment of investment – especially green investment – under this framework.

The discussion also emphasised the lack of consensus on key elements such as the 60% debt ceiling. While some were generally in favour of raising it to 100%, Xavier Debrun, Board Member of the European Fiscal Board (EFB), reiterated the need to refocus the SGP on debt sustainability through a specific debt anchor. He noted that *“nobody knows what the exact debt limit should be [60%, 100%] as debt sustainability is a directional concept”*, underlining his preference for country-specific debt paths. Suggesting the introduction of expenditure ceilings and a single general escape clause to embed a stronger countercyclical component, Debrun raised the question of how to ensure investments can coexist with the broader goal of debt sustainability.

Going green – the role of fiscal policy in the climate transition

The question of how to treat investments under the SGP led to an animated discussion on whether green investments really need incentives through fiscal rules.

Christian Odendahl emphasised that under current rules the investment needed for a green transition in some countries would require spending cuts that are not realistic from a political point of view. Moreover, the new momentum behind the green agenda offers a major opening in the debate on SGP reform.

Xavier Debrun indicated that green investment is a matter of political choice and does not need an exemption from debt rules as, at the end of the day, it is still debt. Following

this logic, politicians will have to prioritise public spending and define the adequate allocation of the debt burden in the transition rather than rely on green fiscal rules. *“I do not want to have to tell my children that the best we can do is to leave them with either a climate debt or a financial debt”*.

Michael Krautzberger didn't think markets would react negatively to a more flexible application of the rules relative to green investment, but also noted that debt sustainability remains key and needs to be safeguarded. For high debt countries this would mean at least stabilizing debt to GDP ratio in the near term and reducing it over the longer term. He also pointed to the optimal solution for this debate, *“a permanent fiscal capacity for green investment would be a brilliant idea”*.

“ Climate change is the mother of all public goods, and requires primacy over the objective of debt sustainability.”

Christian Odendahl
Chief Economist at Centre for European Reform.

What way forward for fiscal reform?

All panelists indicated the need to promote the credibility of the framework and enforcement. While the rules rely on centralised enforcement within a consensus political model, it has been fundamentally challenged by the need for national ownership of the framework. The framework has revealed its shortcomings in terms of ‘carrots and sticks’, showing its limits in the enforceability of incentives and penalties. A possible solution, according to Debrun, could be further decentralisation of enforcement of the fiscal rules at national level. This would leave Member States the choice of how to adapt their national rules to guarantee enforcement and compliance.

The general agreement emerging from the debate points to a simplification of the rules, as the complex fiscal rulebook in place has become impossible to implement in practice. While unconstrained flexibility is not a feasible alternative, the overall view reached by the panelists is that some rules are necessary to define the direction of travel, even whilst maintaining a degree of flexibility, to lay the building blocks for political progress. Moreover, the panelists agreed that a central fiscal capacity would help ameliorate a lot of the tradeoffs present.

“ One key theme here is ownership. Centralised enforcement is challenging. We should be able to rely more on national fiscal frameworks.”

Xavier Debrun, Advisor National Bank of Belgium & Member of the European Fiscal Board
