EU's revised fiscal rules would cut public investment

Revised fiscal framework is unlikely to increase compliance or address high investment needs

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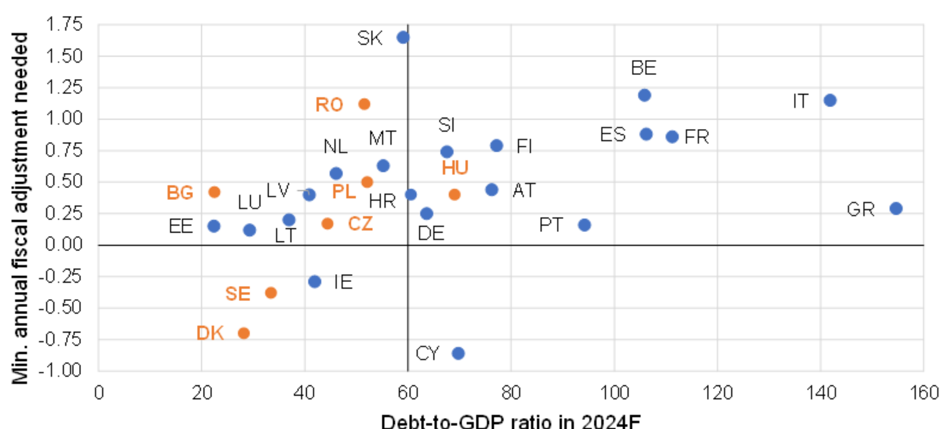
The EU's revised fiscal rules, while better in certain areas and looser in others, remain inadequate with respect to Europe's high green, digital and defence investment needs. If fully enforced, the rules would reduce public investment over coming years.

Adhering to the EU's updated fiscal rules would result in significant fiscal adjustments at a time when Europe's medium-term economic growth outlook is already weak, at around 1.4%.

Based on Bruegel Institute estimates, compliance with the rules would result in annual average fiscal consolidation of around 0.8%-1.2% of GDP over a four-year period for highly indebted countries such as Belgium (rated AA-/Negative Outlook; 1.19% average annual adjustment), Italy (BBB+/Stable; 1.15%), Spain (A-/Stable; 0.88%) and France (AA/Negative; 0.86%).

Among less indebted countries, the required fiscal adjustment to comply with the revised rules is highest for Slovakia (A/Stable; 1.61%) – the highest of all EU member states – and Romania (BBB-Stable; 1.12%).

Figure 1: Significant fiscal adjustments needed to comply with EU's revised fiscal rules



Source: Bruegel Institute estimates, Scope Ratings debt projections. Average annual fiscal adjustments over four-year consolidation plans

The rules continue to focus on countries' individual fiscal positions. They thus remain incomplete as a truly European fiscal framework and should consider the creation of a permanent fiscal capacity to provide EU-wide public goods.

The fiscal rules remain highly complex but while there may be more flexibility for member states' fiscal consolidation paths, the additional flexibility is unlikely to result in greater compliance with the rules. However, continued eligibility for the ECB's Transmission Protection Instrument (TPI) could provide an important incentive for fiscal rule compliance.

Overall, we expect EU member states' fiscal consolidation paths to continue to be informed by investor and rating agency assessments of their credibility rather than relying solely on compliance with the EU's revised fiscal rules.

A missed opportunity to effectively address the EU's investment needs and strategic challenges

3% fiscal deficit and 60% debt level remain the key anchors of the rules

Credible fiscal rules are an important institutional anchor and inform our sovereign rating decisions. Our analysis considers fiscal policy credibility together with projected public-debt dynamics so complying with credible fiscal rules is credit positive. The EU's revised fiscal rules maintain the same overall objective as before the Covid-19 crisis: that member states take fiscal paths that must lead to a deficit below 3% of GDP and public debt below 60% of GDP.

Fiscal adjustments now country specific with safeguards and exemptions

If either of the two targets (deficit or debt) is not met, the European Commission proposes a gradual fiscal adjustment plan over four years, which can be extended to seven years if certain reforms or investments are implemented. Critically, the fiscal adjustment path will now be country specific and each country's progress towards achieving it will be evaluated by growth in net primary expenditure[1].

The Excessive Deficit Procedure (EDP) will be triggered by both excessive deficit and excessive debt. Several safeguards[2] have been implemented to ensure fiscal adjustment. However, several exemptions apply, including spending on climate and digital transition, energy security and defence, as well as co-financing of EU-funded programmes. This leaves room for interpretation and negotiation.

Permanent financing capacity at EU level still missing

In the EU's context, a credible fiscal framework will not only focus on individual fiscal positions and sustainable adjustment paths but would also include the creation of permanent financing capacity to credibly address the EU's long-term green, digital and defence investment needs. Acknowledging the political compromise this would entail, the revised framework remains a missed opportunity in the current geopolitical environment, not least since the outcomes of the US election and Russia-Ukraine war present considerable risk.

Continued complexity and somewhat more flexibility…

Some improvement regarding transparency of the rules

Moreover, the new rules only partially meet the objectives of creating a simple, flexible and credible framework representing an improvement over the existing framework. Regarding simplicity, replacing the "structural deficit" as a control variable with net primary expenditure is positive as it will reduce controversies around the unobservable "structural deficit" and the "output gap". Similarly, the fact that the European Commission's debt sustainability analysis must be approved by the EU Council, published and replicable, increases transparency.

As the main operational target, net primary expenditure is less likely to be pro-cyclical. However, structural variables are still present in debt sustainability analysis, calculation of cyclical unemployment expenditure, minimum deficit reduction and deficit resilience safeguards. The safeguards unnecessarily increase the control variables, reducing simplicity.

[1] Defined as observable expenditure, net of discretionary revenue measures (i.e. one-off revenues) and excluding interest payments, spending on national co-financing with EU-funded expenditure, and cyclical unemployment expenditure.

[2] First, a minimum annual structural deficit reduction rate of 0.4%, which may be limited to 0.25% if the country is undertaking reforms and investments within a seven-year plan. This minimum reduction will be 0.5% if the member state is subject to an EDP. Second, the so-called deficit resilience safeguard forces all countries to reduce their structural deficit even after the 3% deficit rule is met, down to a structural deficit of 1.5%, to create a fiscal cushion for times of difficulty. Third, the "debt sustainability safeguard", which concerns the pace of public debt reduction, requires that debt at the end of the adjustment period should represent, as a percentage of GDP, an average annual reduction of 0.5% for countries with debt between 60% and 90% of GDP and 1% for countries with debt above 90%, although it will only apply when the deficit has fallen below 3%. Finally, in the case of countries subject to an EDP, an additional safeguard is included to ensure that actual net primary expenditure in each year cannot deviate by more than 0.3% of GDP from the annual target, nor by more than 0.6% cumulatively over the total adjustment period.

As for flexibility, individual adjustment plans and their possible extension present uncertain outcomes. While they may incentivise growth-enhancing reforms and investments – which support sovereign ratings – they also give member states enhanced flexibility to postpone and deviate from necessary fiscal adjustments, which may prove credit negative. The multi-year plans may also collide with the electoral cycle, possibly resulting in delays and re-negotiations in cases of government changes.

More flexibility for fiscal consolidation; multi-year plans may collide with electoral cycle

...but compliance unlikely to improve

Credibility and effective compliance are unlikely to improve and might even weaken. This is due to the mere advisory role of national independent fiscal councils, which places the burden of compliance on the European Commission and the Council. This was already the case under the previous rules but without much success. Compliance may also be undermined by the added complexity of the rule changes. Although EU fiscal rules have allowed deviations by member states – particularly concerning the 60% debt rule – the 3% deficit rule has proven to be much more of an anchor, precisely because it is simple.

National fiscal councils only have an advisory role

The new rules are comparatively looser than before their suspension at the time of the 2020 crisis. Adjustments of a minimum 1pp when debt is greater than 90% and 0.5pps when debt sits between 60% and 90% represents a less-demanding adjustment path than the previous debt brake, particularly for more highly indebted member states. While a less stringent adjustment path may increase credibility because it is more feasible to achieve, it will ultimately only be more credible if it is enforced.

Looser consolidation paths for highly-indebted countries

In case of non-compliance, half-yearly fines will be imposed amounting to 0.05% of GDP until the country reacts (with no limits on cumulative fines). Fines continue to be pro-cyclical, potentially further damaging the member state's fiscal position and undermining the credibility of the rules. To date, no fines have ever been applied.

Fines remain pro-cyclical and are unlikely to be applied

However, an important incentive for countries to respect the new rules is linked to potential support under the ECB's Transmission Protection Instrument (TPI). The eligibility criteria include compliance with the EU fiscal framework, an absence of severe macroeconomic imbalances and evidence of fiscal sustainability. However, even if a country is facing an excessive deficit procedure, its bonds will remain TPI-eligible as long as effective action in response to an EU Council recommendation is being taken.

TPI could provide an important incentive to comply with the rules

The ECB has stated that the criteria for TPI eligibility are an input into the Governing Council's decision-making, which is also driven by risks and market conditions faced at the time. This flexibility, while needed, may weaken incentives to comply with the fiscal rules to ensure TPI-eligibility, which remains untested.

Interest payments are excluded until 2027 in the calculation to identify countries subject to an annual minimum fiscal adjustment of 0.5% of GDP. While this eases pressure on current governments to consolidate their public finances, it may weaken pressure to achieve budgetary sustainability and make it even more difficult for future governments to comply with the rules.

Pressure for consolidation likely to be higher for next governments

For these reasons, EU member states' fiscal consolidation paths are likely to continue to be informed by investor and rating agency assessments of their respective credibility rather than solely compliance with the EU's revised fiscal rules.

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