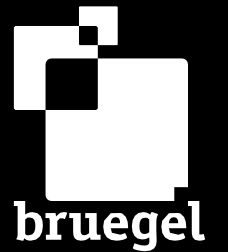
The European Union's new fiscal rules and their implications for Finland



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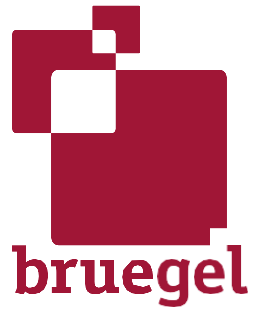
Based on joint works with Lennard Welslau and Jeromin Zettelmeyer

Guest lecture, The Finnish Centre for New Economic Analysis (UTAK), 18 September 2024, Helsinki

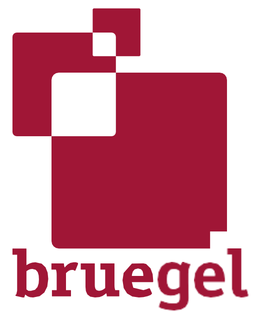
Motivation



- The EU’s new fiscal framework entered into force in April 2024 after a fundamental reform

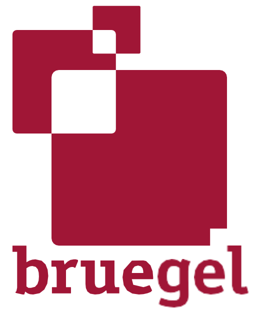
- What are the new features of new framework?
- What are the implications for EU countries, and in particular, for Finland?
- Will the new framework be conducive to public investment?

Outline



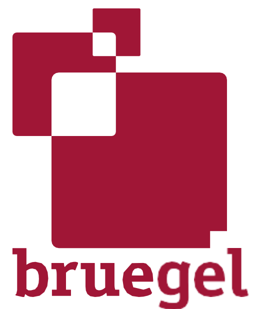
1. A brief history of EU fiscal rules
2. The new EU fiscal framework
3. Fiscal adjustment requirements under the new fiscal framework
4. The case of Finland
5. Incentives for reforms and investments in the new fiscal framework
6. The missed opportunity: fostering green investments with a fiscally sustainable public investment rule

1. A brief history of EU fiscal rules



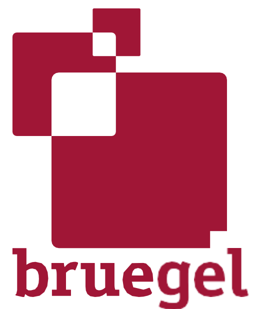
- Safeguarding fiscal sustainability in the euro area is crucial due to centralized monetary policy and decentralized fiscal policy
- Maastricht Treaty (1992): 3% deficit & 60% debt ratio benchmarks
- Stability and Growth Pact (1999): operationalised the rules, aimed for balanced budgets, poor enforcement
- Some reform waves in 2005-2015
- Problems: complexity, multiple objectives, some fiscal targets were set in an unobserved variable (the structural budget balance), the 1/20th debt rule (for high-debt countries, 1/20th of the gap to 60% had be reduced annually) was disregarded, lack of ownership, poor enforcement
- Suspended during the pandemic (general escape clause)

2.1 The new EU fiscal framework – timeline



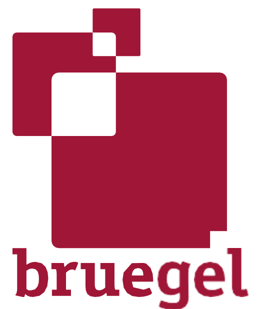
- February 2020: Launch of the Economic Governance Review
- November 2022: European Commission communication - reform ideas
- April 2023: European Commission legislative proposal
- December 2023: ECOFIN adopts its negotiating position
- January 2024: European Parliament adopts its negotiating position
- February 2024: Trilogue agreement between the European Parliament, the Council, and the Commission
- 30 April 2024: new regulations appear in the Official Journal of the EU
- Autumn 2024: EU countries must submit their fiscal policy plans subject to the new rules

2.2 The new EU fiscal framework – the main feature



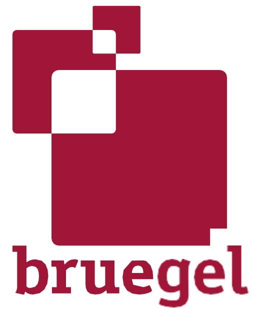
- Risk-based, country-specific fiscal adjustment requirements, based on a debt sustainability analysis (DSA) and the 3% of GDP treaty-based benchmark for budget deficit – **great new feature**
- DSA: Debt ratio projections based on countries' current debt and forecasts for GDP growth, inflation, interest rates, and ageing costs
- 4 to 7-year comprehensive medium-term fiscal-structural plans (MTFSPs) to reach a budget position that ensures:
  - Debt to GDP ratio falls over the 10-year period after the end of the adjustment period, even under adverse scenarios for growth, interest rates and budget balance (deterministic stress scenarios) and with high probability (stochastic simulation)
  - Deficit remains below 3%

2.3 The new EU fiscal framework – operational target



- An intermediate indicator, the Structural Primary Balance (SPB – budget balance net of interest, cyclical component and one-off/temporary measures) is calculated
- The SPB is poorly measured ex post (i.e. first estimates are often revised later) and thus the SPB is not a proper operational target for fiscal policy, but its clear economic concept is useful for ex ante planning
- To get a reliable operational target, the forward looking SPB path is translated into a public expenditure growth indicator (so-called "net expenditure") – **great new feature**, since public expenditures are under the control of the government

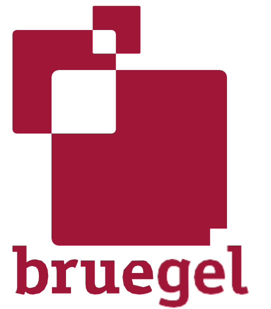
2.4.1 The new EU fiscal framework – additional safeguards for countries with debt > 60%



- **Debt sustainability safeguard**: at least one percentage point of GDP per year decline in the debt ratio for countries with a larger than 90% of GDP debt ratio, and half a percentage point of GDP per year for countries with a debt ratio between 60% and 90% of GDP), from either the beginning of the adjustment period or from the correction of excessive deficit (whichever is later) by the end of the adjustment period.

➢ **Ad hoc requirement**; Finland is the only victim of this safeguard

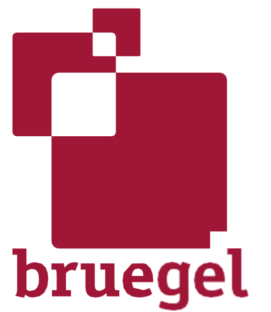
2.4.2 The new EU fiscal framework – additional safeguards for countries with debt > 60% or deficit > 3%



- **Deficit resilience safeguard:** the structural overall budget deficit should not be higher than 1.5% of GDP, and when it is higher, the annual improvement in the structural primary balance should be 0.4% of GDP when the adjustment period lasts for four years and 0.25% of GDP when the adjustment period lasts for seven years.

➢ **Ad hoc requirement**; minor impacts in the first adjustment period (2025-2028 or 2025-2031), but sizeable impact for France and Italy later

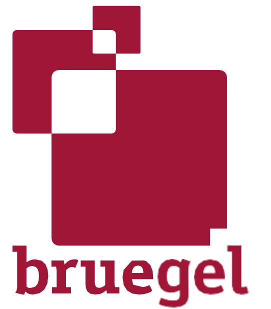
2.4.3 The new EU fiscal framework – additional safeguards for countries with deficit > 3%



- **Minimum annual adjustment under the deficit-based excessive deficit procedure:** 0.5% of GDP annual adjustment, which is measured in terms of the structural primary balance in 2025-2027 and in terms of the overall structural balance from 2028

➢ **Ad hoc requirement**; luckily it has just some minor impacts

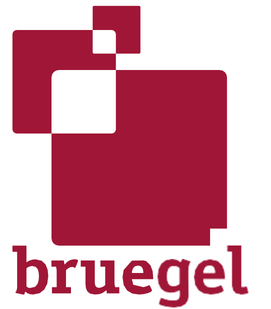
2.4.4 The new EU fiscal framework – additional safeguards for countries with debt > 60% or deficit > 3%



- **No backloading safeguard:** the annual fiscal adjustment cannot increase during the adjustment period

➢ **This is sensible**: governments should not leave most of fiscal adjustment to the next government

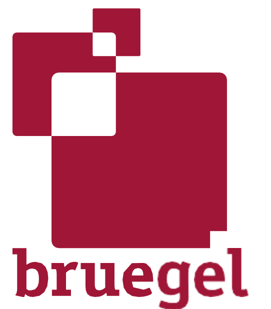
3. Fiscal adjustment requirements by 2028 or 2031 (SPB %GDP)



	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	4-year adj.	7-year adj.	4-year adj.	7-year adj.	4-year adj.	7-year adj.	4-year adj.	7-year adj.	4-year adj.	7-year adj.	4-year adj.	7-year adj.
	(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	154	-1.2	1.7	1.9	2.2	1.7	2.1	...	...	...	...	1.9	2.2	0.05	0.07
Italy	139	-4.4	-1.1	3.4	3.2	3.2	3.2	...	...	...	...	3.4	3.2	1.12	0.60
France	112	-5.3	-3.0	0.9	1.0	0.9	1.0	...	...	...	...	0.9	0.9	0.98	0.56
Spain	106	-3.0	-0.8	2.8	2.9	2.2	2.3	...	...	...	...	2.8	2.9	0.92	0.53
Belgium	105	-4.4	-1.9	1.2	1.2	0.9	1.0	...	...	...	...	1.2	1.2	0.77	0.44
Portugal	96	0.4	2.2	2.6	2.3	1.6	1.4	...	...	...	...	2.6	2.3	0.09	0.01
Finland	80	-3.4	-0.5	1.5	1.1	-0.4	-0.6	5.6	4.2	...	...	5.6	4.2	1.53	0.67
Austria	78	-3.1	-1.1	0.8	0.8	-0.1	-0.3	...	...	...	...	0.77	0.8	0.48	0.27
Hungary	74	-5.4	0.0	3.2	3.5	2.5	3.0	...	...	...	...	3.2	3.4	0.79	0.49
Cyprus	71	2.9	3.5	0.2	-0.3	0.6	0.2	...	...	...	...	0.6	0.2	-0.72	-0.47
Slovenia	68	-2.8	-1.2	0.6	0.6	0.4	0.5	...	...	...	...	0.6	0.6	0.47	0.27
Germany	63	-1.6	0.0	0.5	0.2	-0.5	-0.7	...	...	...	...	0.5	0.2	0.12	0.03

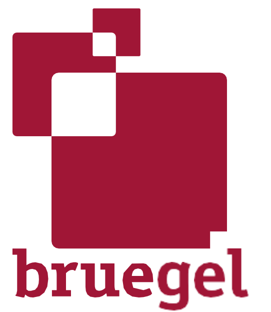
Legend colour	Meaning
Green	Binding DSA criterion
Blue	Binding 3% deficit cap
Yellow	Binding debt sustainability safeguard

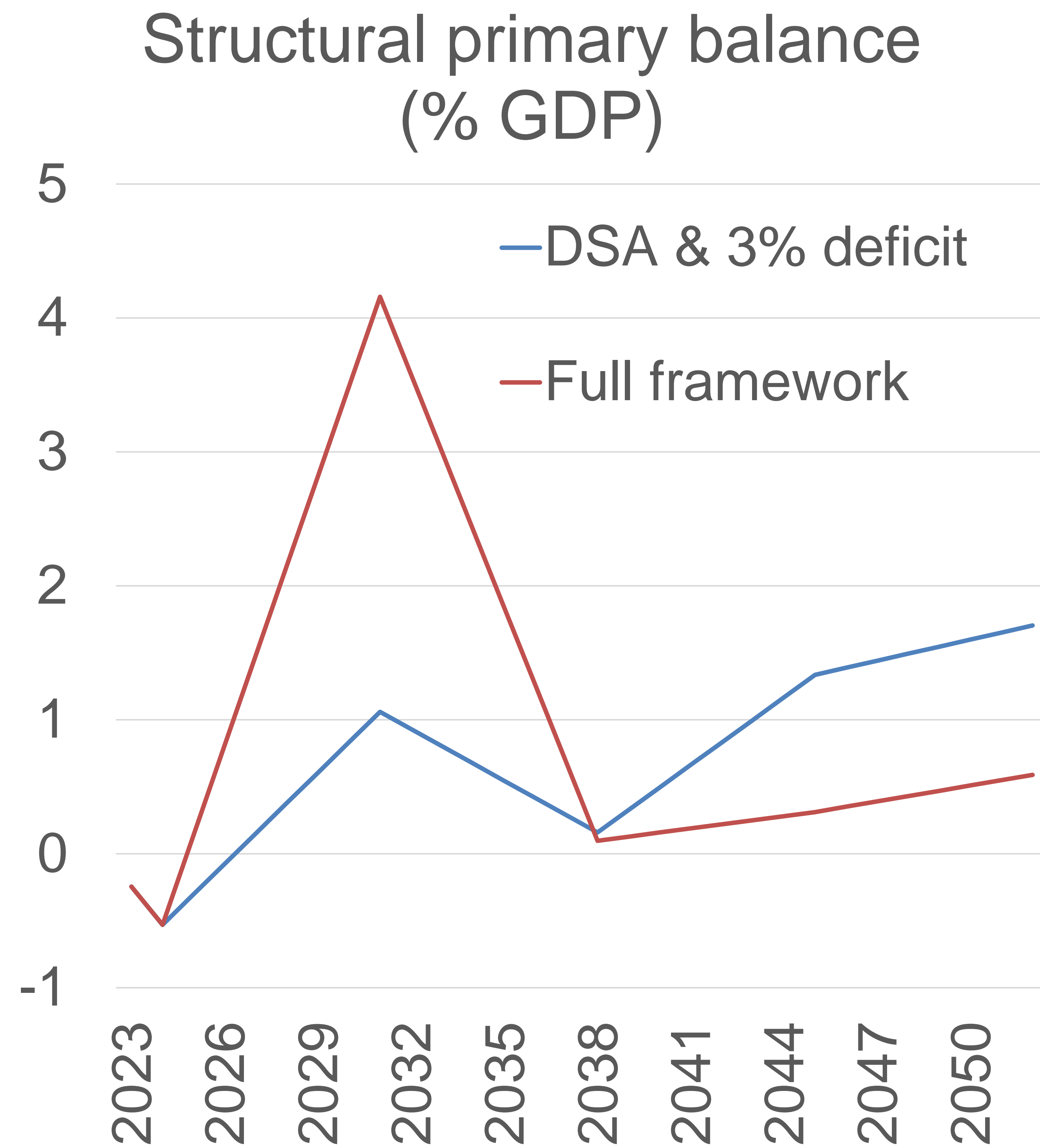
4.1 The case of Finland – the main reasons

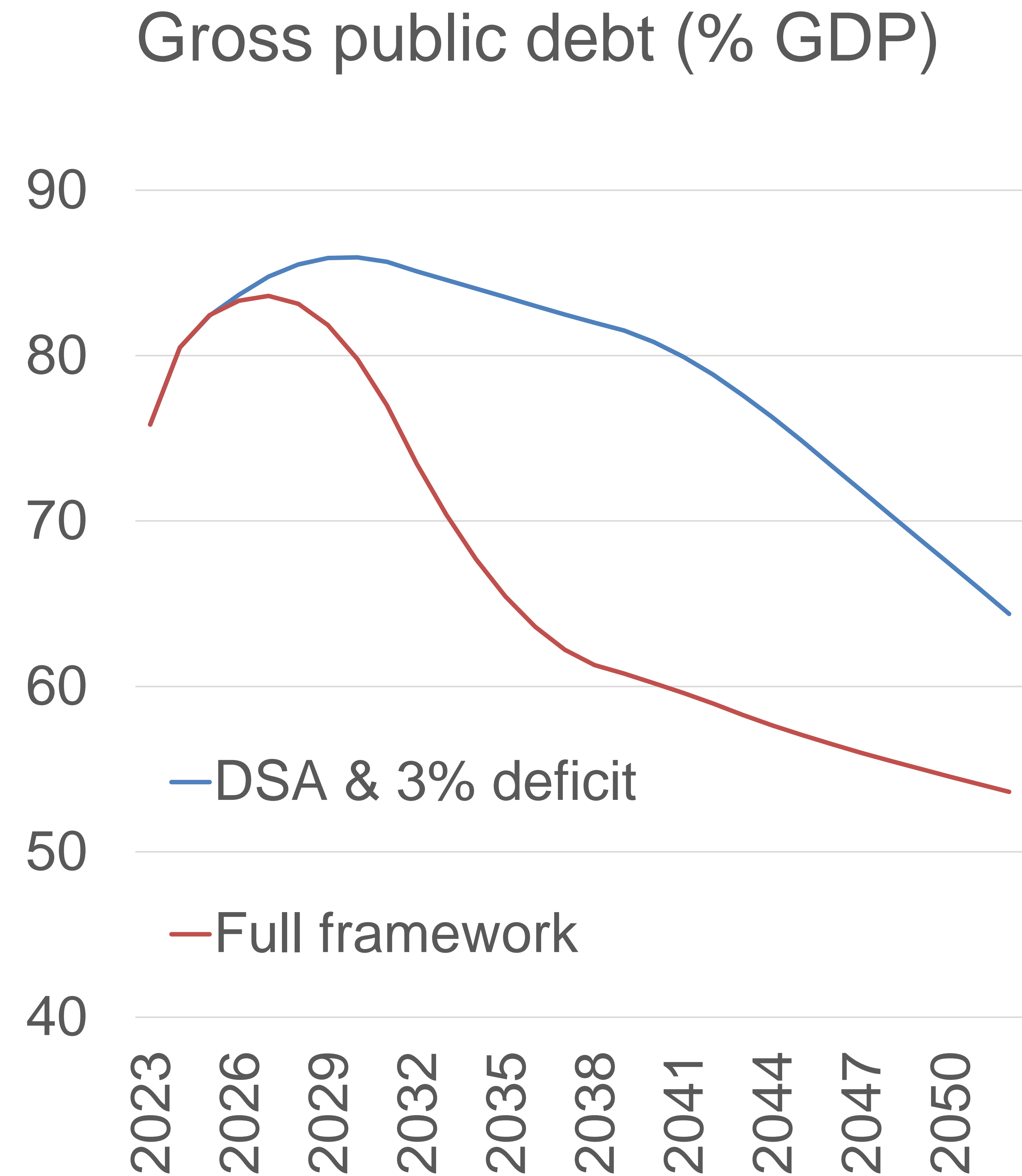


- **Finnish prudence**: public pension funds register surpluses, which are part of the general government headline balance, but this surplus is used for building up pension fund assets and not for reducing debt
- If there were no safeguards, the 2031 SPB target would be 1.1% of GDP, which is not particularly high
- **The absurdity of the debt sustainability safeguard**: it requires the Finnish public debt ratio to decline from 2024 to 2031. The corresponding 2031 SPB target is far the highest among EU countries at 4.2% of GDP

4.2 The case of Finland – SPB and debt dynamics

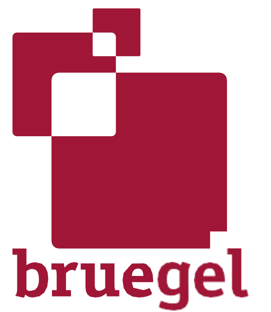






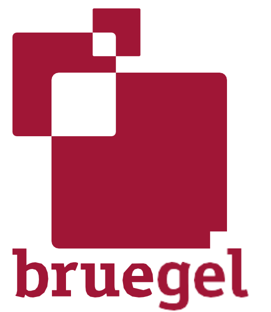
- The debt safeguard requires a massive fiscal adjustment in 2025-2031 to achieve a debt ratio reduction from 2024 by 2031
- Finland would have been better off with an excessive deficit procedure in 2024

5.1 Incentives for reforms and investments in the new fiscal framework



- Main incentive: the possibility of extending the four-year-long adjustment period to seven years, thereby lowering the annual fiscal adjustment requirement (see the chart on the next slide)
- Various requirements, including no decline in public investments compared to the average realised over the period covered by the Recovery and Resilience Plan
- However, to increase public investment at a time of fiscal consolidation, EU countries would need to undertake more fiscal consolidation in non-investment components of the budget to make room for extra investment – yet political economy tends to favour current spending over investment spending

5.2 Annual average fiscal adjustment requirements under the new fiscal framework



2
1.5
1
0.5
0
-0.5
-1
-1.5

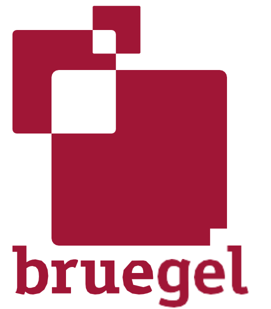
Finland Slovakia Romania Italy France Spain Poland Hungary Belgium Croatia Austria Malta Slovenia Netherlands Czechia Latvia Germany Portugal Greece Bulgaria Lithuania Luxembourg Estonia Sweden Cyprus Ireland Denmark

4-year adjustment 7-year adjustment difference

- For Finland, the 7-year adjustment period requires 0.9% of GDP less average annual adjustment than the 4-year adjustment period
- For some other countries, this gap is about 0.5% of GDP

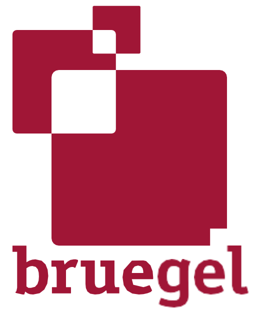
Source: Bruegel. Note: Methodology based on European Commission (2024) and adjusted with the new requirements of the approved fiscal framework.
Data: May 2024 Commission forecast for macro variables, August 2024 market expectations for interest rate and inflation.

5.3.1 Two provisions related to the national co-financing of EU funds – not helpful



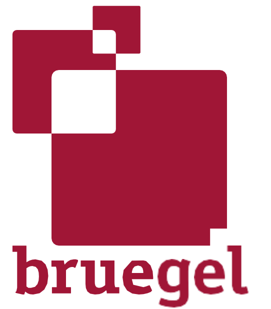
- Article 2 (Definitions): “*(2) ‘net expenditure’ means government expenditure net of interest expenditure, discretionary revenue measures, expenditure on programmes of the Union fully matched by Union funds revenue, national expenditure on co-financing of programmes funded by the Union, cyclical elements of unemployment benefit expenditure, and one-offs and other temporary measures;*”
- However, the net expenditure indicator is the operational target in the new fiscal framework, but it does not influence any of the fiscal adjustment requirements
- If during implementation, national co-financing increases relative to the initial plan – it will not trigger an excessive deficit procedure (minor help)

5.3.2 Two provisions related to the national co-financing of EU funds – not helpful



- Article 36 (Transitory provisions) "*(c) Projects related to Recovery and Resilience Facility loans as well as national co-financing of EU funds in 2025 and 2026 shall be taken into account whenever a Member State requests an exception to the no-backloading safeguard referred to in Article 6 point c, provided that this does not endanger fiscal sustainability in the medium term;*"
- However, when RRF-loan financed expenditures decline in 2026 = fiscal consolidation → excluding it would require more fiscal consolidation in other budget items
- Exclusion helps if such spending goes up in 2026 → incentive to delay such spending to 2026, or not to request an exception

6.1 The missed opportunity: fostering public investments with a fiscally sustainable public investment rule

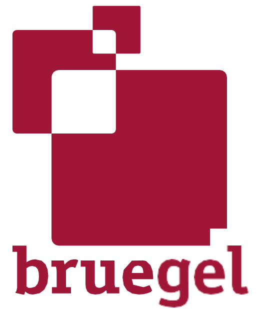


- From the perspective of fiscal sustainability, it is ok for public investment to result in a rise in the debt ratio if:

1. It pays for itself (by generating fees, or raising future output and taxes), or
2. Even if the investment does not pay for itself, if:
   - The investment programme is temporary (leading to a "level" increase in debt, rather than permanent increase in the deficit)
   - After the end of the investment programme, the primary balance is high enough to rule out explosive debt paths with high probability (which implies declining debt under baseline assumptions).

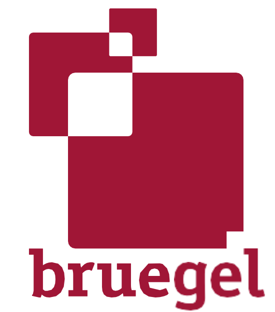
- Problems:
  - Not all green public investment satisfies (1), but even if they do, the current DSA practice does not incorporate the impact of planned measures, only adopted measures
  - The safeguards make strategy (2) impossible

6.2 The missed opportunity: fostering public investments with a fiscally sustainable public investment rule



- **Missed option 1** – a temporary green public investment programme:
  - For one year less than the length of the adjustment period (e.g. for 6 years if the adjustment lasts for 7 years)
  - Exempt the temporary investment programme from safeguards
  - While applying all safeguards to the rest of the budget
  - By the last year of the adjustment period, all conditions must hold
  - Only investments endorsed by the Council and monitored by the Commission can be excluded
- **Missed option 2** – a long-lasting green public investment programme
  - Same as above, except that the investment programme can last beyond the end of the adjustment period

6.3 Illustration of a temporary investment programme of 0.5% of GDP per year for 6 years



Austria | Belgium | Cyprus | Finland

France | Germany | Greece | Hungary

Italy | Portugal | Slovenia | Spain

- SPB (Baseline scenario)
- SPB (Investment scenario)
- Overall balance (Baseline scenario)
- Overall balance (Investment scenario)
- Adjustment period
- Investment period
- 10-year post adjustment
- Debt (Baseline scenario, RHS)
- Debt (Investment scenario, RHS)

- Little delay in debt decline
- Long-run structural primary balance (SPB) is hardly higher

- (note: for Finland, these calculations were made before the pension fund savings were incorporated)

Conclusions

- Welcome changes to EU fiscal rules: DSA and a single indicator (a measure of public expenditure) as the annual fiscal policy target – could increase the framework's efficiency and improve compliance
- However, numerical safeguards to ensure a minimum pace of debt and deficit reduction might overwrite the DSA-based requirements and undermine the rationale for the new rules and the incentives for compliance
- Finland is the main victim of the debt sustainability safeguard, partly due to its fiscal prudence of saving pension assets: instead of a 2031 SPB target of 1.1% of GDP, the target must be 4.2%, the highest among EU countries
- France and Italy will need to do more adjustment due to the deficit resilience safeguard after 2031
- Public investment might be at risk (except in countries with low debt ratios)
- Two important issues not discussed in the presentation: (a) consistency of the new fiscal rules and the excessive deficit procedure, (b) improvements to the DSA methodology

Thank you!

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