

New European fiscal rules

Calculating the constraints imposed on national budgets

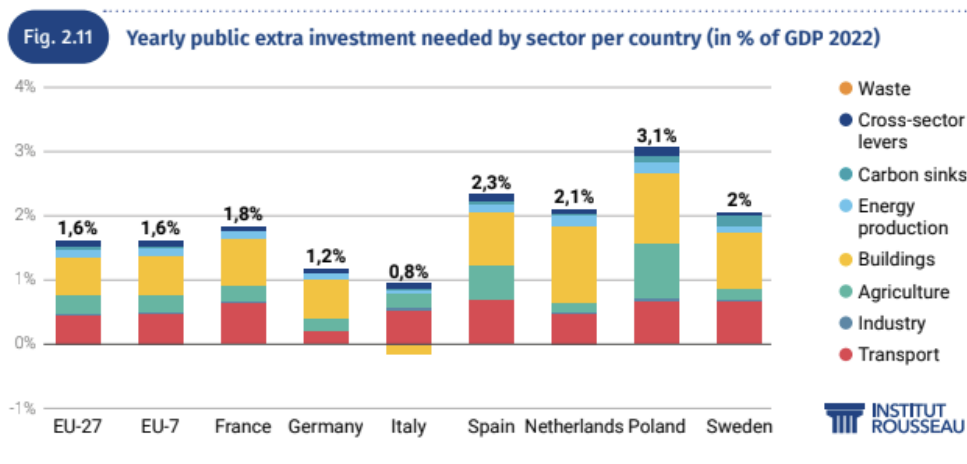
A critical examination

- 1. Rules that do not speed up investment in the transition 1
- 2. The logic of the regulations and their final objectives: 3
- 3. The implementation in question 4
- 4. Problematic calculations 4
- 4.1. Three critical hypotheses 4
- 4.2. Taking uncertainty into account 8
- 5. Conclusions..... 9
- Appendix: Estimation, projection and significance of potential GDP and its growth 12

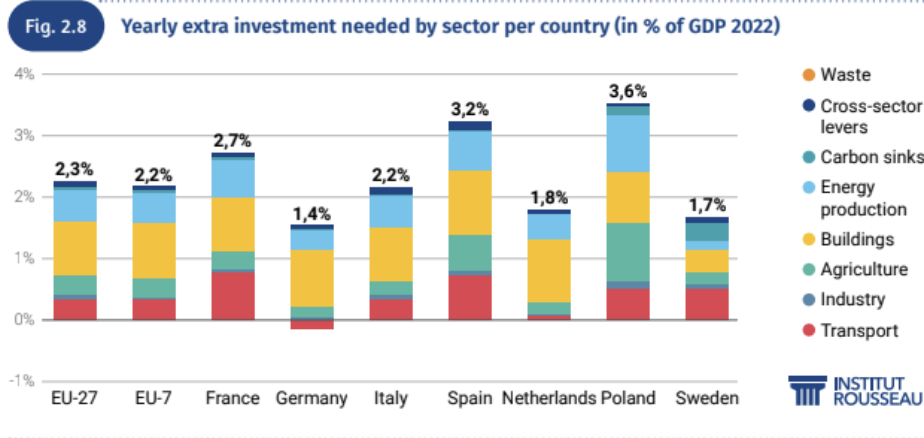
1. Rules that do not speed up investment in the transition

The new European fiscal rules were promulgated in the Official Journal of the European Union on 30 April 2024 ([regulation on multilateral budgetary surveillance](#) ("preventive regulation" - RegP), [Regulation on the correction of excessive deficits](#) ("corrective regulation"), [directive on the budgetary frameworks](#)).

Before 30 April, in cooperation with [the Fiscal matters coalition](#) of civil society organisations and trade unions, [we warned of the constraints](#) that these new rules would impose on national public spending.



GREENTERVENTION



Will these rules be able to cover the need for investment in decarbonisation, health, education or housing, which has now been widely documented (see, for example, [the report by the Rousseau Institute](#) and the graphs below, [the joint report by two German research institutes](#), which estimates the need for additional investment in Germany at 600 billion over 10 years, or 1.4% of GDP per year, or the [joint report by the European Trade Union Confederation and the New Economic Foundation](#))?

The European Commission's [spring economic forecasts](#) provide the empirical answer: public and private investment are stagnating (see chart below).

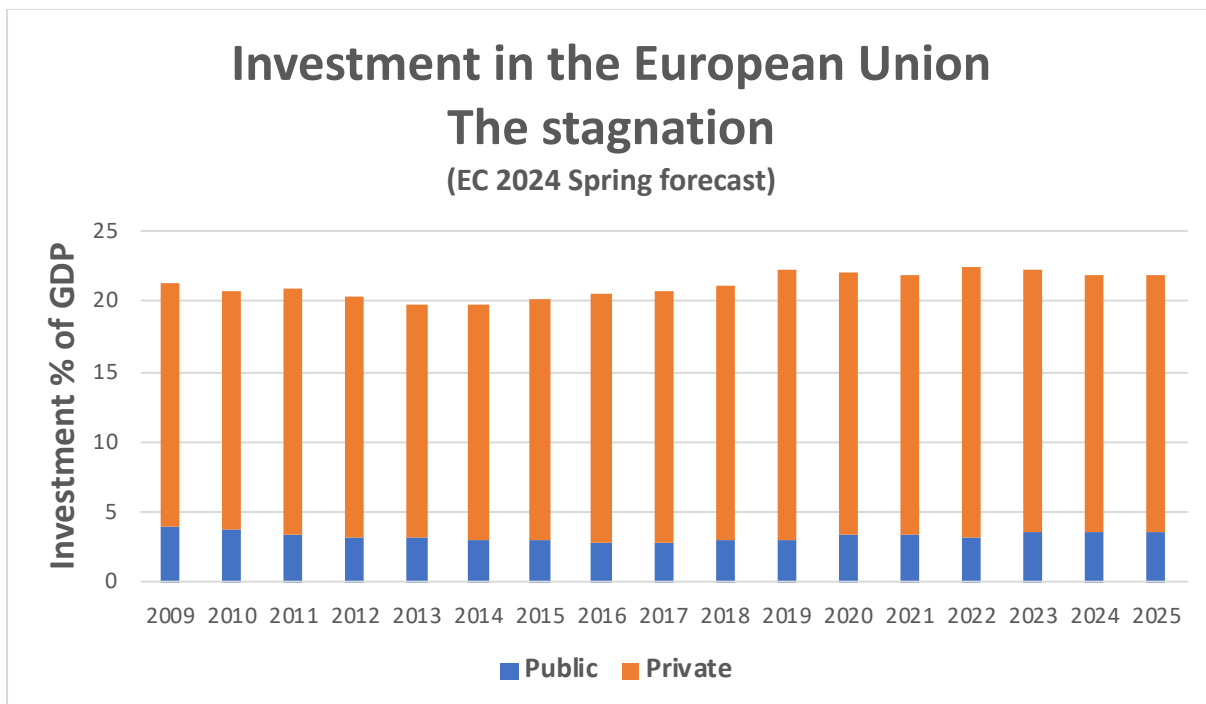
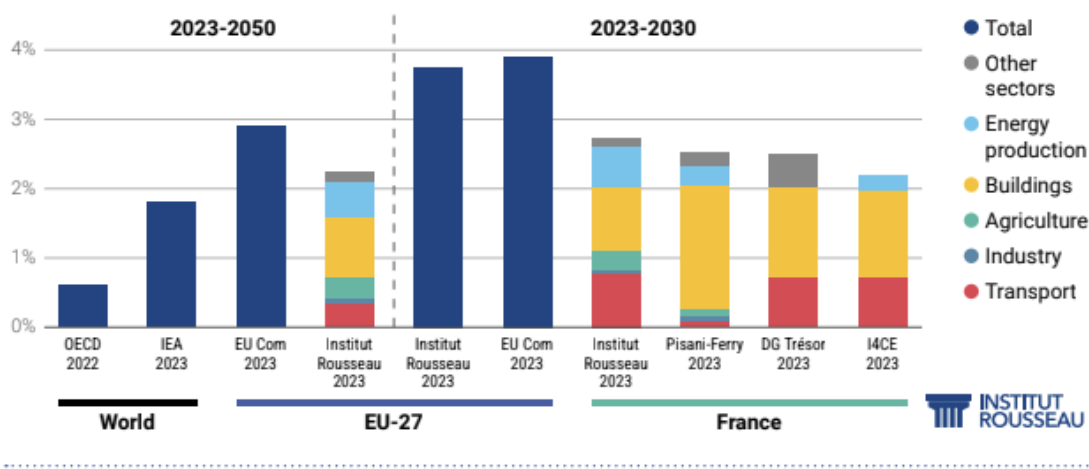


Fig. 2.9 Comparing average yearly transition investment and extra investment as a percentage of GDP⁷, according to various studies for the world, EU-27 and the illustration of France



2. The logic of the regulations and their final objectives:

The postulate has prevailed that the sustainability of the debt and the budget deficit depends on these two aggregates remaining below the reference values enshrined since 1992 in the Treaty on the Functioning of the European Union (60% and 3% of GDP respectively). The Regulations prescribe a medium/long-term trajectory for these two aggregates towards these reference values.

The "future" is divided into two periods: an adjustment period of 4 years in principle and the following decade. At the end of the adjustment period, assuming there are no further budgetary measures:

- "the projected public debt ratio must be placed or remain on a plausible downward trajectory or remain at prudent levels below 60% of GDP over the "medium term", i.e. during the decade following the end of the adjustment period, and
- "the planned government deficit must have been brought below 3% of GDP during the adjustment period and maintained below this reference value in the "medium term".

There are also additional conditions on the minimum rate of reduction of the budget deficit or the debt ratio during the adjustment period.

The adjustment period can be extended up to 7 years if the Member State "commits to implementing a relevant set of reforms and investments" (article 14 RegP). Among other things, this package must contribute to "an improvement in the potential growth and resilience potential of the economy of the Member State concerned in a sustainable manner". It must also ensure that the level of investment does not decline and "respond to the common priorities of the Union", namely a just ecological and digital transition, including climate objectives, social and economic resilience, including the core of fundamental social rights, energy security and the strengthening of defence capabilities.



GREENTERVENTION

Countries that do not respect one or other of the fiscal limits in the Treaty will receive from the European Commission before 20 June a sheet setting out the medium-term trajectory for the budget balance and public spending. This "technical trajectory" is also sent to the [Economic and Financial Committee](#) (articles 5 and 36 of the RegP). After a phase of dialogue with the Commission, each Member State must submit a National Medium-Term fiscal-structural Plan (NMTFSP) by 20 September 2024. The trajectory of the NMTFSP of a country that does not respect one or other of the deficit or debt limits can only differ from the "technical trajectory" calculated by the Commission on the basis of "sound economic arguments based on data". The technical trajectory prevails in the event of disagreement between the Commission or the Council and the Member State concerned.

3. The implementation in question

Even if we assume that the limits imposed on the fiscal balance and the debt/GDP ratio by the Treaty are relevant as medium/long-term objectives, their implementation comes up against a practical problem, which is simple to formulate but which has not found, and indeed cannot really find, a lasting satisfactory solution.

Neither the trajectory of the total fiscal balance nor that of the debt-to-GDP ratio are under the direct control of the budgetary authorities. Both aggregates depend on GDP and interest rates, which determine the unavoidable cost of debt. These two variables are subject to the vagaries of the economic cycle and external events, to major trends in the economy and to economic, social and monetary policy choices. Projecting them is an exercise in which the outcome is necessarily uncertain. Like any economic forecasting exercise, it involves a degree of arbitrariness.

The regulations, both the past and the new ones, attempt to solve the problem by identifying variables which are, on the one hand, under the control of the budgetary authorities and, on the other, linked to the final objectives by a sufficiently regular relationship. To this end, the regulations use the concept of the structural balance, i.e. the cyclically-adjusted balance net of one-off and other temporary measures. They also use the concept of the primary structural balance, i.e. the structural balance net of interest charges. But, probably for the sake of simplicity, readability and communicability, the control variable in the new regulation is the growth in net public expenditure, adjusted to correspond to the change in the structural balance. The correction relates in particular to cyclical expenditure, temporary or one-off measures and expenditure financed by a European Union budget.

4. Problematic calculations

4.1. Three critical hypotheses

Net expenditure is both the control variable and the yardstick against which compliance with the regulations is formally measured. However, the regulations themselves do not detail the method for calculating the trajectory of the structural balance, and therefore of net expenditure, which would comply with the final objectives of the debt-to-GDP ratio and the budget balance. For this, they refer to the method described in the Commission's document,



GREENTERVENTION

"Debt sustainability monitor [Debt sustainability monitor 2023](#)" ("DSM2023", see in particular chapters I.2 and II.1 and for the arithmetic Annex 3, P. 131).

The diagram below provides a simplified description of the interaction between the regulations and the calculation method. In the rectangular bubbles, the diagram shows the requirements set out in the regulations themselves. These prescriptions concern the debt-to-GDP ratio and budget balances as a % of GDP (total and structural). The oval bubbles indicate the variables for which it is necessary to make an estimate and/or a long-term projection, and for which the method of calculation is described in the document "[Debt sustainability monitor 2023](#)".

- Potential GDP is the denominator of the targets. Positive GDP growth "automatically" reduces the debt and budget balance/GDP ratios. Potential GDP also defines the standard for eliminating cyclical or cyclical variations in budget variables and therefore the structural balance and expenditure, the variables that are supposed to be controlled by the authorities. Finally, GDP is used as an approximation of the tax base.
- The interest rate determines compulsory interest expenditure and "automatically" increases the numerator of the debt and balance ratio as a percentage of GDP.
- The fiscal multiplier, i.e. the impact of a change in the budget balance on short- and long-term growth.

An initial analysis of estimates of potential GDP and its medium-term growth, interest rates and the short- and medium/long-term impact of fiscal consolidation policies highlights the following points:

- The use of unobservable variables, the level and growth of potential GDP and its derivatives, the output gap and the cyclically adjusted balance, is critical because it concerns variables which have a strong influence on budgetary requirements and whose calculation is subject to a high degree of uncertainty (see the appendix for more details). This uncertainty is such that the Regulation authorises Member States to deviate from the method of estimating potential agreed long ago between the Finance Ministries (art. 36f RegP). In itself, the estimated order of magnitude of potential growth does not seem to pose any problems (generally between 1% and 2%, see the table in the annex). However, the sensitivity of the prescription to this estimate is high (see appendix).
- In addition, the estimated gap at the start of the period between actual GDP and potential GDP determines the proportion of the balance due to cyclical variation. This proportion is considered to be "automatically" absorbed by a self-sustained return of GDP to its medium-term path. It therefore does not require an adjustment in expenditure. Prior to the suspension in 2020 of the old fiscal rules because of COVID and the war, the estimation of the output gap and therefore of the cyclically-adjusted balance was the subject of [debate between officials from the European Commission's Directorate General for Economic and Financial Affairs](#) and [academic economists](#). These debates should be relaunched and conducted at the level of each country.

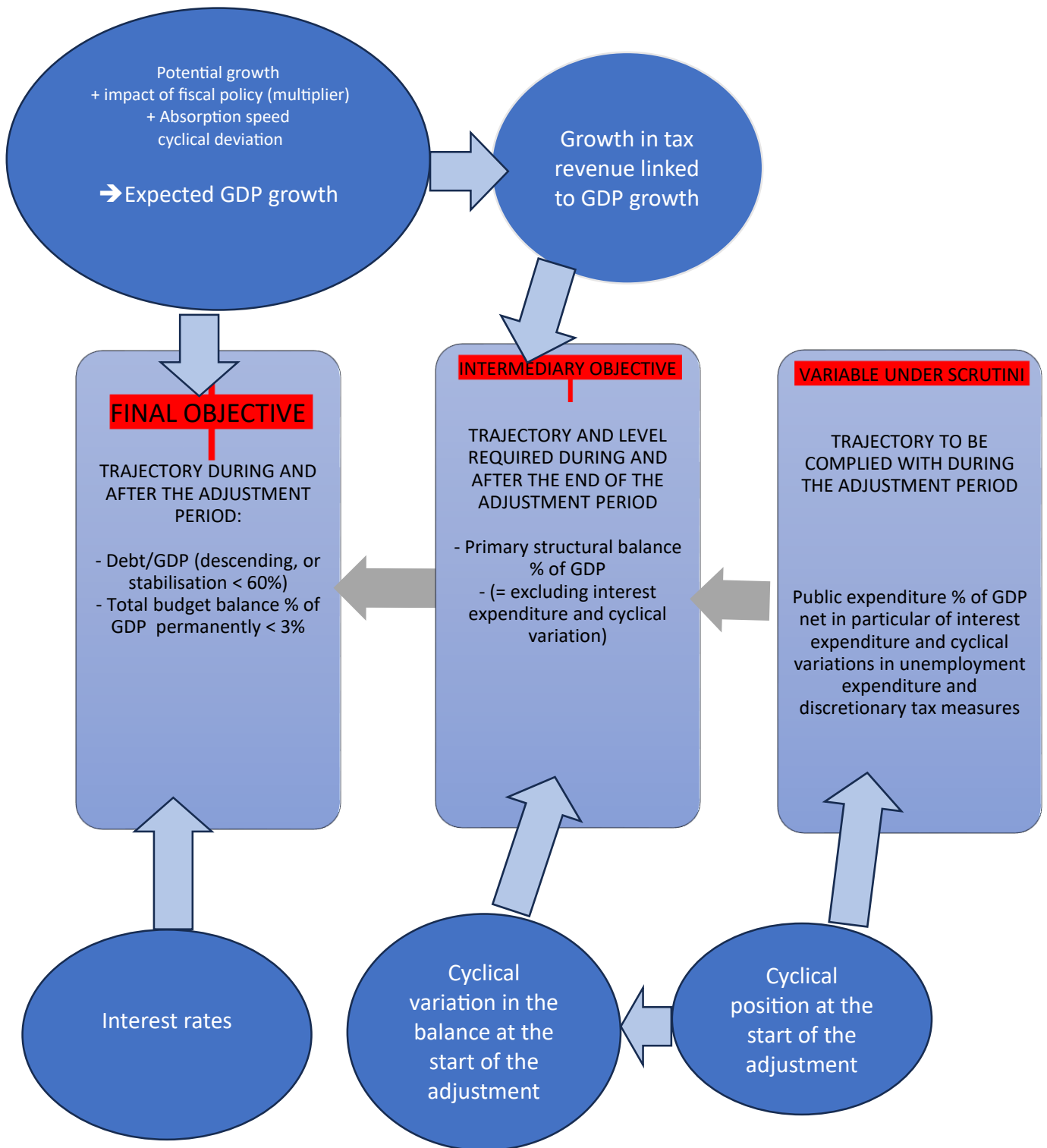


GREENTERVENTION

- The assumption is that nominal interest rates on the debt of all countries converge towards 4%, i.e. after deducting inflation, a real rate of 2% (the assumption for the medium-term inflation rate is compliance with the 2% target). Interest rates would therefore tend to exceed the rate of GDP growth in the medium term, often significantly so in virtually all countries. Under this assumption, the simple stabilisation of the debt/GDP ratio requires the sustainable achievement of primary budget surpluses. However, this assumption for real interest rates runs counter to the downward trend observed in recent years and many recent analyses, including those of the IMF (see for example: [IMF, April 2023, World Economic Outlook, Chapter 2](#)). It must be called into question.
- The hypothesis concerning the short- and long-term impact of fiscal policy on economic activity and investment is succinct and uniform for all countries. The "Keynesian" fiscal multiplier, the impact of a change in the structural deficit on GDP, is estimated at 0.75, regardless of the country, the fiscal instrument used (taxes, investment, public consumption), or the position in the cycle. Similarly, the assumption regarding the speed with which actual GDP returns to the path of potential GDP is identical for all countries, i.e. 3 years. These assumptions run counter to numerous studies, including recent ones by the IMF ([IMF, 2023, Fiscal consolidation - Taking stock of success factor](#)) and ([IMF, 2023, Getting into the Nitty-Gritty of Fiscal Multipliers: Small Details, Big Impacts](#)).



GREENTERVENTION



4.2. Taking uncertainty into account

To take account of macroeconomic uncertainty and ensure that debt declines plausibly even under more unfavourable assumptions, three stress tests are applied around the adjustment scenario (see [Debt sustainability monitor 2023](#) , P. 111-12).

- Lower structural balance excluding interest" scenario: the structural balance is assumed to be reduced by 0.5 percentage points of GDP in total, with a reduction of 0.25 percentage points each year for the first two years, and to remain at this level thereafter.

- "Interest rate minus growth rate" unfavourable scenario: the spread between interest rates and growth rates is assumed to increase permanently by 1 percentage point of GDP over the projection horizon, i.e. for ten years after the end of the 4- or 7-year adjustment period;

- "Financial stress scenario": market interest rates are assumed to rise temporarily for one year by 1 percentage point, plus a risk premium for the most heavily indebted countries.

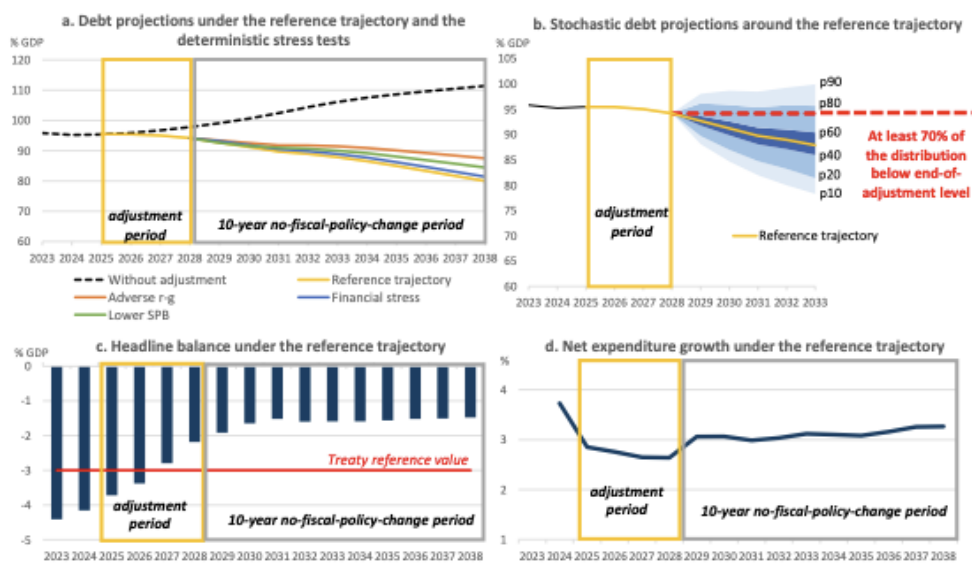
The last two scenarios are all the more pernicious in that the spread between interest rates and growth rates is already largely positive for most countries in the central scenario.

In addition, stochastic simulations are applied for the decade after the adjustment period in order to take account of large uncertainty. The 10,000 shocks affecting government budget positions, economic growth, interest rates and exchange rates are generated on the basis of the historical distribution of shocks for each country. The benchmark for the debt to GDP ratio is that at least 70% of the distribution is below the level required at the end of the adjustment period.

The following graphs taken from [Debt sustainability monitor 2023](#) illustrate these calculations for a fictitious country:



Graph II.1.1: DSA-based criteria in the reference trajectory: an illustrative example



Source: Commission services.

5. Conclusions

The note revealed the hidden face of the new fiscal rules. The regulations define precise targets for the budget balance and public spending. However, the precise intermediary calculations are not included in the legislation and are referred to a [technical document](#). The prescriptions for national fiscal policies are basically determined by projections over the next 14 to 17 years of four parameters: the level and growth of potential GDP, the interest rate and the impact of fiscal policies on economic activity and investment via the Keynesian fiscal multiplier.

The public discussions that preceded the adoption of the new Stability Pact regulations focused little or not at all on these aspects. However, an informed debate on fiscal policies cannot do without a discussion of these assumptions and, on a case-by-case basis, verification of their relevance to the country concerned.

There are several angles to the discussions that should take place at national level.

- The first is the use of an unobservable variable, the construction of which can and must once again be subject to open criticism, as was the case before the suspension of the old rules, and cannot be left in the hands of the [Potential Output Working Group](#), a group of ad hoc technicians dependent on the Ministries of Finance.
- The second is the assumption that interest rates will rise to a level above the expectations of many analysts, including the IMF. The assumed permanently positive gap between the interest rate and the growth rate has the arithmetical consequence of imposing a structural budget surplus target simply to stabilise the debt/GDP ratio. The prescriptions are all the more restrictive in that the central scenario is supplemented by two restrictive stress scenarios defined by an increase in this gap.
- The third is the theoretical and empirical weakness with which the impact of budgetary policies on activities and investments in the short, medium and long term via demand



GREENTERVENTION

is considered: the same and unique budgetary multiplier for each country and an "automatic" return to a potential growth path that does not depend on the past realizations. Any possibility of hysteresis, which is widely recognised in economic literature, is eliminated.

- The fourth is - despite a long-term horizon - the use of arithmetic that ignores the feedback loop between the capacity to preserve the viability and productivity of the economic and social system on the one hand and, on the other, social and environmental investments, particularly in biodiversity, in the energy transition and in adaptation to climate change. The fact that these themes are included in the narrative of the regulations does not mean that they are part of the equations in the strict sense of the term.

It is envisaged that the calculation method may be adjusted before the first plans are finalised by a group of experts from the Member States and the Commission. According to the regulation, Parliament will at least have the opportunity to request that the European Commission make a presentation.

Member States have a certain amount of leeway when it comes to implementation. They can propose extending the adjustment period from 4 to 7 years, provided they commit to an ambitious programme of investment and reform. During the economic dialogue that will take place between the sending of the "technical trajectory" by the Commission (in June) and the submission of the national medium-term fiscal-structural plan (in September), they may also convince the Commission that the assumptions underlying the technical trajectory are unfounded, including in view of the measures they intend to take. For countries subject to the excessive deficit procedure, there is some room for negotiation insofar as they can put forward any relevant factors they deem useful.

If they stick only to the prescribed method of calculation, the ability of national budgetary authorities to loosen the stranglehold of the rules depends essentially on their ability to show that the reforms and investments they commit to will improve "potential" growth understood in a narrow sense, i.e. increasing labour supply, employment flexibility and factor productivity without regard to distributional or environmental consequences. Of course, other economic policy objectives, in particular social objectives and the potential for resilience in the face of climate risks and the digital transition, are present in the narrative of the regulations. But they are not in the hard core that determines the permitted growth in public spending. The assumption of high interest rates will further reinforce the tendency to prioritise high-return investments that significantly improve productivity and potential growth.

The debates that should precede the adoption of national medium-term plans could be a first opportunity to go beyond a strictly accounting vision. It is about shifting the paradigm on the determinants of debt sustainability in an economy whose resilience is undermined by under-investment in the fight against precariousness, the prevention of natural risks, adaptation to climate change, environmental protection and the reduction of greenhouse gas emissions.

Fiscal rules having been suspended because of COVID and then the war in Ukraine, budgetary policies over the last four years have no longer been guided by accounting rules but by deliberation and a consensus on needs. The results have been rather convincing. A dogmatic



GREENTERVENTION

implementation of the new regulations that adheres strictly to the calculation methods agreed at this stage would be a dangerous step backwards.



GREENTERVENTION

Appendix: Estimation, projection and significance of potential GDP and its growth

Estimated potential GDP

Potential GDP and its growth are unobservable variables. Estimating and projecting them requires the use of macroeconomic models and empirical assumptions. The model used by the Commission is essentially based on demographic assumptions, labour market participation, 'technical progress' and a 'non-inflationary' unemployment rate (see [Ageing population report 2024, Underlying assumptions & projection methodologies](#), P. 63 and [EC, 2021, Output gap estimation using the commonly agreed method](#)).

Such projections are always questionable and uncertain. They require assumptions to be made on demography, including on migration flows, on labour market participation of different groups (men/women, by age), on the impact of technological advances on productivity, on the reaction of wages to the unemployment rate, among others.

It is also a sign of methodological weakness that estimates of the gap between potential and real GDP can differ significantly between two institutions such as the Commission and the IMF. This difference is far from insignificant, since it is also reflected in differences in the estimate of the cyclically-adjusted balance, one of the strategic variables in the regulation (see graphs below).

It is not so much the order of magnitude of the medium/long-term growth estimates (between 1% and 2% in the long term) that poses a problem, but the degree of arbitrariness and uncertainty that weighs on the construction of this non-observable variable, while the impact on the constraints imposed on budgetary spending is considerable.

Potential GDP and fiscal adjustment

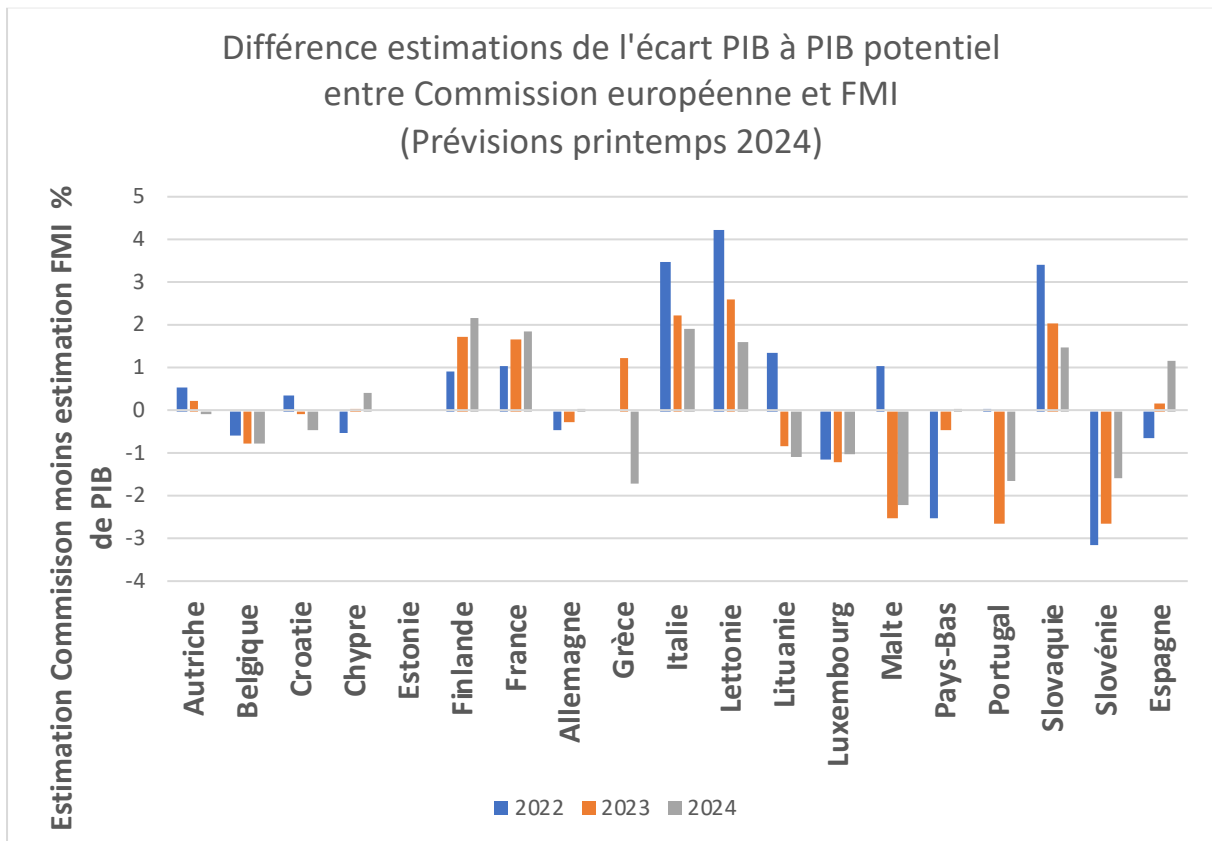
The estimate and forecast of potential GDP and its growth have a two-fold impact on the required trajectory of the public balance and public spending (see the exemplary graphs below, which show the budget surpluses required for an objective of a 1% annual reduction in the debt-to-GDP ratio under different growth assumptions).

- A faster projection of potential GDP growth has an impact on the denominator of the debt and deficit ratios as a percentage of GDP. It leads to an "automatic" reduction in these two variables more quickly and reduces the need for a structural budget surplus by the same amount (or increases the margin for a structural deficit by the same amount).
- Potential growth also has an impact on the numerator of the budget balance as a % of GDP. As the assumption is that tax revenues are correlated with GDP, a higher growth estimate "automatically" reduces the deficit in monetary terms, which - for a given target debt-to-GDP ratio - correspondingly relieves the constraint on spending (DSM2023, appendix A3 and chapter II.1.9).



GREENTERVENTION

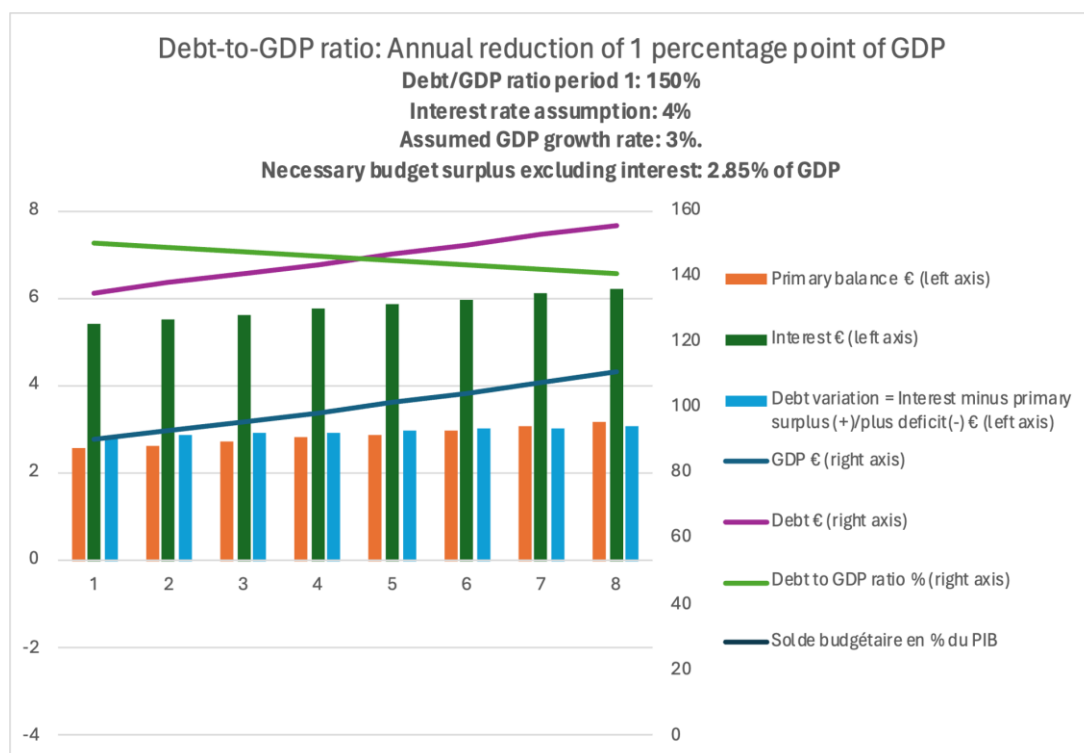
In addition, the output gap corresponds to the cyclical variation in GDP. It determines the proportion of the balance and expenditure due to this variation. The assumption is that in the medium term this cyclical component will disappear of its own accord. Its value at the start of the adjustment period therefore determines, by deduction, the structural adjustments needed to achieve the targets set for the end of the adjustment period.



GREENTERVENTION

Table I.3.1: **Potential GDP growth rate - period average (%)**

	2022-2030	2031-2040	2041-2050	2051-2060	2061-2070	2022-2070
BE	1.4	1.3	1.5	1.3	1.2	1.3
BG	2.0	1.5	1.3	1.2	1.2	1.4
CZ	1.4	1.4	1.6	1.5	1.5	1.5
DK	1.2	1.3	1.7	1.4	1.1	1.3
DE	0.8	1.1	1.4	1.1	1.2	1.1
EE	1.5	1.8	1.8	1.4	1.5	1.6
IE	5.2	1.9	1.3	1.3	1.1	2.1
EL	1.0	0.7	1.2	1.2	1.2	1.1
ES	1.2	1.1	1.4	1.3	1.1	1.2
FR	0.8	0.9	1.4	1.3	1.1	1.1
HR	2.3	1.5	1.5	1.2	0.9	1.5
IT	0.8	0.8	1.4	1.4	1.2	1.1
CY	2.3	1.7	1.7	1.2	1.2	1.6
LV	1.6	1.4	0.8	0.5	1.1	1.1
LT	2.3	1.4	0.9	0.3	0.6	1.1
LU	2.2	1.8	2.0	1.5	1.3	1.8
HU	2.4	1.8	1.7	1.5	1.3	1.7
MT	4.2	3.1	1.8	0.9	0.8	2.1
NL	1.3	1.1	1.7	1.4	1.1	1.3
AT	1.4	1.4	1.4	1.1	1.1	1.3
PL	2.6	2.0	1.0	0.9	1.0	1.5
PT	1.4	0.7	1.3	1.5	1.2	1.2
RO	2.6	1.9	1.3	1.4	1.2	1.7
SI	2.6	1.9	1.1	1.2	1.2	1.6
SK	1.7	1.6	1.4	1.2	1.3	1.4
FI	1.1	1.3	1.3	1.0	0.9	1.1
SE	1.6	1.8	1.8	1.6	1.4	1.6



GREENTERVENTION

