Public hearing on New Economic Governance Rules fit for the Future
ECON Committee of the European Parliament, 20-09-2023

Introductory Statement
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Thanks for inviting me. I will organise my remarks around three points. First: what should be the aim of the Economic Governance Review? Second, to what extent do the European Commission's legislative proposals meet these aims? Third, how should these proposals be amended to make the review a success?

The aim

In my view, the current framework suffers from two main problems.

- First, fiscal adjustment prescriptions are insufficiently sensitive to economic circumstances that vary across countries and over time. This means that the present system is not very good at reconciling the objectives of keeping fiscal risk low and allowing room for public investment and output stabilization.
- Second, low compliance. As a result, debt levels are far higher today than they would be if the system had worked as intended.

The framework proposed by the European Commission seeks to address both problems.

- To establish how much each member state needs to adjust, it proposes a tailored approach, based mainly on debt sustainability analysis. The question answered by debt sustainability analysis is whether the debt ratio is likely to remain stable or fall, given expected growth, borrowing costs, aging costs, the structure of the debt stock as well as possible shocks. Most of these are country-specific factors.
- To increase compliance, the Commission has a few ideas for more effective enforcement, but the main idea is to increase national ownership.

These two elements are related and make a lot of sense. Article 126 of the Treaty explicitly rules out the normal judicial channel in the EU – the treaty infringement procedure – to enforce the prohibition of excessive deficits. In light of this, enforcement of the rules has always been and will remain weak, relying on symbolic fines and peer pressure. Our main hope for raising compliance is therefore to make the rules more reasonable and more mindful of country-specific circumstances, so that countries are more ready to follow them.

The legislative proposal

When the Commission first published its ideas last November, I liked the logic of the proposal, but also had two concerns. First, the wording of the debt sustainability requirement left me with doubts as to whether it would require sufficiently ambitious fiscal adjustment. Second, the Commission seemed to be giving itself a lot of discretion to decide how much adjustment was right. I felt that this ran counter to the aim of increasing national ownership.

Some member states had similar concerns. In its April proposal, the Commission tried to address these by providing more detail on how it intended to check debt sustainability—and by adding a set of "safeguards" that would need to be met in addition to the debt sustainability requirement and the requirement to bring deficits below 3% during the adjustment period. These safeguards cap net expenditure increases, and require a debt ratio reduction during the first four years after the framework is approved. They also require minimum deficit reductions for countries with excessive deficits. This raises a fresh concern: do these safeguards go too far in interfering with the country-specific nature of the DSA-based system, consequently undermining the objective of raising country ownership?

The problems

To answer these questions, my colleagues Zsolt Darvas, Lennard Welslau and I have replicated the Commission's debt sustainability analysis and applied the requirements of the proposed regulation, with the following results.

First, the proposed framework would require ambitious fiscal adjustment: on average, more than 2 percent of GDP over the medium term, in addition to the adjustment that is already predicted for 2023-24. This addresses one of my original concerns.

Second, fiscal adjustment under the proposed system would be somewhat less demanding than under the current system. This is not surprising: one of the motivations for revising the current system was that, given high deficits and debts after Covid and energy price shocks, it would have required unrealistically high fiscal adjustments in the short and medium term, including because high debt is penalised in an ad-hoc way. The proposed system, in contrast, is less concerned about the level of debt *per se*, but rather about ensuring that debt above 60% is on a robustly downward path.

Third, we found that for most countries with debt above 60% of GDP, the adjustment requirements are driven by the DSA rather than the safeguards, but with significant exceptions. The main exception is France, for which the debt safeguard imposes substantially higher fiscal adjustment than the DSA. If the adjustment period were to be extended from four to seven years (as is possible under the framework for countries that submit growth-enhancing reform and investment plans), the safeguards would also be binding for several other countries. Hence, the fear that the safeguards could interfere with the main aims of the proposal is indeed justified.

Finally, the proposal continues to give the European Commission significant discretion. It would have full control over the debt sustainability methodology that it uses to assess member state plans. It would also have delegated powers to change that methodology. At the same time, member states would be allowed to use their own methodologies. This may be a concession, but we fear that it sets up the Commission and member states for disagreements attributable to methodology that will be resolved through political negotiation. Furthermore, the fact that the Commission does not allow member states into its methodology kitchen will continue to fan suspicions that its DSA might be subject to political abuse, and hence demands for economically nonsensical safeguards.

Recommendations

Based on this analysis, we offer nine main recommendations on how to modify the legislative proposal. Let me summarise them in just two points:

1. Drop or modify most of the safeguards, including the debt safeguard. This includes revising the so-called no-backloading safeguard, which is supposed to prevent member states from putting off adjustment until the last minute but is so poorly drafted that is would not achieve that aim. Once this safeguard is fixed, the remaining safeguards could be safely removed.
2. Develop a common DSA methodology, which both the Commission and member states use to justify and assess the member states' medium-term plans.

Developing a common DSA methodology does not need to delay the legislative process. The new methodology could be based on the Commission's current methodology, which is largely sound, but requires some revision. This could be delegated to an independent expert group—in consultation with technical level experts from the Commission, member states, the ECB, ESM and European Fiscal Board—and codified in a revised version of the Code of Conduct of the Stability and Growth Pact. The review could take place during 2024, after the approval of the new framework, but before its first full application, with 2024 constituting a transition year.