

## **Proposed principles to guide the German government in deliberations on the reform of EU fiscal rules**

Fiscal rules are necessary in a common currency area. If a member state has excessive debt levels and experiences difficulties in obtaining financing, this can lead to spill-overs to other member states and thereby threaten the stability of the entire currency union. For this reason, fiscal rules should focus on the core objectives of debt sustainability and sound public finances. At the same time, any necessary consolidation measures should be designed in a way that facilitates growth; this is crucial in order to avoid long-term adverse effects on public finances, to meet investment needs, and thus to encourage implementation of the fiscal rules by the affected member state. In addition, it is important to maintain space for counter-cyclical fiscal policies.

The European Union's fiscal framework has demonstrated a high level of flexibility – most recently during the pandemic. In key areas, the rules permit the specific circumstances of individual member states to be taken into account. Nevertheless, the framework needs to be further developed. For example, flexibility must go hand-in-hand with clearly defined limits and with improved mechanisms for enforcing the rules. For this reason, the further development of the fiscal framework should place a particular emphasis on the application of the rules.

We want to strengthen the framework's multilateral approach. In order to be effective, it is essential for the fiscal framework to ensure the equal treatment (both real and perceived) of member states and to use common benchmarks. Bilaterally negotiated individual arrangements for applying the rules are not the way forward when it comes to improving the common fiscal framework in a way that increases its transparency, gives it more binding force, and makes it more effective.

Against this background, we propose the following guiding principles:

- (1) The core objectives of the EU's fiscal rules are to ensure **debt sustainability** and **sound public finances**. A **debt reduction strategy** should be implemented that **ensures stability and facilitates growth** in the member states through the step-by-step reduction of budget deficits.
  - A country's capacity to take effective action depends on its public finances. In order to respond suitably to crises, governments have to reduce high levels of debt, and they have to build up financial buffers in times of good or normal economic conditions. Financial market participants must have confidence in the debt sustainability of each individual member state.
  - Therefore, ensuring resilient public finances and fiscal space will require a step-by-step, sufficient reduction of debt (the numerator in the debt ratio) in relation to GDP (the denominator in the debt ratio), particularly in member states with significantly elevated debt levels.

- However, strict compliance with the “1/20 rule” on debt reduction might require too much adjustment on the part of certain member states. Therefore, in order to avoid unrealistic adjustment paths but still reduce debt ratios in a way that ensures stability and facilitates growth, member states could explicitly agree that full compliance with the Stability and Growth Pact’s preventive arm is sufficient to qualify as compliance with the 1/20 rule.
  - Over the medium term, a combination of (a) consistent, step-by-step deficit reduction in the preventive arm with (b) pro-growth economic and fiscal policies will contribute to adequate levels of debt reduction.
  - This process of debt reduction must be backed up with improvements in the enforcement of fiscal rules, including the rules-based initiation and implementation of deficit procedures.
- (2) **Investment** to help the EU and its member states meet the challenges of the future and achieve sustainable economic growth
- Higher levels of public investment would have a long-term impact on growth and would facilitate the transformation towards climate-neutral economies. To this end, it is important to improve the quality of public finances.
  - For this reason, Germany is willing to support adjustments to the investment clause in several different ways:
    - Limited expansion of the investment clause, allowing it to be applied not only during periods of economic crisis
    - The overall limit for using the investment clause and the structural reform clause could be increased on a one-time, narrowly defined basis until the medium-term budgetary objective (MTO) is reached.
    - In addition, the investment clause could be expanded to apply to additional EU programmes that have so far not been covered by the clause and that have a substantial positive impact on potential growth and debt sustainability.
  - In contrast, factoring out specific items or categories of expenditure is not compatible with the core objectives of EU fiscal rules.
- (3) **Simplification** of the EU’s fiscal rules while continuing to apply **uniform and comparable parameters**. Continued use of the **structural balance** as the parameter for the MTO in the preventive arm.

- Keeping the MTO as the target makes it possible to obtain a full picture of fiscal trends and ensures compatibility with national fiscal rules and federally structured fiscal systems.
- Placing a stronger focus on the expenditure benchmark and thus on medium-term potential growth could reduce the influence of annual revisions of estimates of unobservable variables and could strengthen counter-cyclical fiscal policies. Focusing on the expenditure benchmark on the adjustment path towards the MTO would also reduce complexity. However, the use of an expenditure benchmark that is not based on the structural balance would not be appropriate.
- Keeping the MTO in structural terms means that it remains necessary for the Output Gap Working Group to conduct ongoing reviews of, and to further develop, estimates of potential output. Findings from the current evaluation of national cyclical adjustment methods could be integrated into deliberations at the European level.

(4) Establish clear criteria for the potential future use of the **general escape clause**

- If a severe economic downturn occurs in the euro area or EU, the general escape clause permits temporary deviations from the adjustment path towards the MTO.
- During the Covid-19 crisis, the general escape clause made it possible for member states to take the necessary fiscal measures. However, the clause is defined only vaguely in EU law.
- Specific criteria for invoking the general escape clause and clear procedures for (de)activating the clause would increase transparency and predictability for member states as well as market participants. However, it is important to emphasise that the activation of the general escape clause does not mean that the Stability and Growth Pact has been suspended.

(5) **European Fiscal Board (EFB)**

- Review the possibility of making the EFB institutionally and organisationally independent from the European Commission. This could facilitate more consistent implementation of the rules.