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Policy Brief

How to change what?

A Reformer's Guide to the legal bases of the EU fiscal framework

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#FiscalRules
#ExcessiveDeficit
#StabilityAndGrowthPact

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Between the deleterious effect of the Covid pandemic on public finances and the financial investments required to stem the growing climate emergency, the debate on reforming the EU fiscal framework has become ever more urgent. At the same time, there is no consensus on what reforms are needed even among those calling for them. A variety of proposals exists but it often remains unclear what legal changes they imply. This question is key for their implementation, however. In this Policy Brief, Thu Nguyen provides an overview of the legal bases of the current EU fiscal framework to help inform the reform debate.

Introduction[1]

In early 2020, the European Commission launched a public debate on reforming the EU's economic governance framework, including the fiscal framework. In the two years since then, in particular the discussion on the fiscal rules has become ever more urgent. The deleterious effect of the Covid pandemic on public finances in member states, the huge but as yet unknown costs related to the war in Ukraine and the financial investments required to meet the growing climate emergency have all raised questions about whether the EU fiscal framework can remain and be applied as is, or whether they need to be changed because applying them to the letter would cause massive macroeconomic damage in the member states.

[1] Many thanks to Marijn van der Sluis and Andreas Eisl for their valuable comments and feedback.

There may well be a push for reforming the fiscal framework but no consensus on what reforms are needed even among those calling for it. A variety of proposals exists, ranging from introducing greater flexibility by redrafting the existing rules via a looser application of the current rules to a stricter application of the rules even. At the same time, it often remains unclear what legal changes the proposals imply. But this question is key for their implementation.

This policy brief will not add to the list of proposals or evaluate specific ideas. But rather, it provides an overview of the legal bases of the current EU fiscal framework to help inform the reform debate.

EU fiscal rules: What are they about?

One part of the confusion about the EU fiscal framework is related to its purpose: what role do they serve? Whereas originally the fiscal rules were often discussed in light of the need to create economic convergence, now the focus has shifted to preventing unsustainable public finances and hence to avoid triggering bail-outs. The rules on fiscal and economic policy making thus originate in the Treaty of Maastricht (1993) and are now enshrined across EU Treaties, secondary legislation and an intergovernmental treaty. They should be read in light of the guiding principles in article 119 TFEU: stable prices, sound public finances and monetary conditions and a sustainable balance of payments. A vade mecum of the Commission on the Stability and Growth Pact (SGP) furthermore gives guidance on implementation, as well as several political declarations and soft law instruments.

The Treaty on the Functioning of the European Union (TFEU) sets out the general EU fiscal rules, including the budget deficit and public debt criteria. The Stability and Growth Pact complements and specifies the rules. Cast as two regulations in 1997, it is based on articles 121 and 126 TFEU. It consists of a preventive arm, aimed at monitoring member states' budgetary situations and ensuring that they avoid excessive deficits, and a corrective arm, which aims to ensure that member states correct their excessive deficits. The SGP was amended through secondary legislation in 2005, in 2011 (by the so-called 'six-pack') and again in 2013 (by the so-called 'two-pack'). It was also complemented in 2013 by an intergovernmental treaty, namely the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), commonly referred to as the Fiscal Compact. In 2009, the Lisbon Treaty furthermore introduced the possibility to adopt economic governance measures specifically for Euro area member states. This legal basis was used to tighten the rules on how sanctions could be imposed in different parts of the preventive and corrective arms.

Today, the EU fiscal framework is characterized by a myriad of different prescriptions and exemptions. However, four key pillars are in the middle of the current reform debate:

- A **budget deficit criterion of 3% of GDP** and a **public debt criterion of 60% of GDP**, including an obligation to reduce debt where it exceeds that value
- A requirement for the structural budget balance of member states to meet the country-specific **medium-term objective (MTO)** or to be moving towards it
- An **Excessive Deficit Procedure (EDP)** for member states that breach the 3% or 60% criteria
- A **general escape clause** that allows member states to deviate from the fiscal criteria in specific circumstances.

A key characteristic of these rules is that they place significant discretion in the hands of the Commission and the Council in making (economic) assessments and in deciding what constitutes an excessive deficit in specific circumstances.

Current reform debates touch upon all of these elements. However, the legal hoops required to change them vary immensely. Each will be explained in more detail below, including their legal bases and the procedures that must be followed to amend them. A table with an overview of the key elements of the EU fiscal framework, their legal bases and revision procedures will be provided at the end.

The budget deficit and public debt criteria

Article 126 TFEU requires member states to avoid excessive government deficits and tasks the Commission with monitoring the budgetary situation and government debt levels in individual countries by referring to reference values. The Council is then tasked with making the final decisions. The Court of Justice of the EU is excluded from making certain assessments under the Treaties.

These reference values are not set in the Treaties themselves but specified in the annexed Protocol No° 12 on the EDP: 3% for the ratio of the planned or actual government deficit to GDP and 60% for the ratio of government debt to GDP. Critically, these values are not binding limits as they are not decisive to determine whether an excessive deficit exists (see section on EDP).

Revision procedure

The fact that the existence of debt and deficit criteria is established by the Treaties and that their values specified in a Protocol establishes high hurdles for change. Generally, both the Treaties and the Protocols annexed to them are amended through a lengthy Treaty revision procedure:

- Under the ordinary Treaty revision procedure (arts. 48(2) to (5) of the Treaty on European Union (TEU)), a Convention – composed of representatives of national parliaments, of the heads of state or governments, of the European Parliament and of the Commission – is called to propose amendments. Where such amendments are not extensive, the European Council can, with Parliament‘s consent, make the proposals itself. Proposals are then submitted to an intergovernmental conference (ICG), composed of the member states' representatives, which must adopt them by unanimity.
- Under the simplified Treaty revision procedure (art. 48(6) TEU), which applies to Part Three of the TFEU, including EU economic and monetary policies, no Convention is needed: the European Council can adopt the amendments by unanimity, after consulting the Parliament and the Commission. In both cases and in any event, amendments must in the end be ratified by all 27 member states. This means, for the majority of countries, ratification by parliament but might also entail referenda.

For Protocol No° 12 the Treaties foresee a special revision procedure. Article 126(14) TFEU thus allows the Council to replace the Protocol by unanimity under a special legislative procedure and after consulting the European Parliament and the European Central Bank. This means that no Treaty revision procedure would be required to amend the 3% deficit and 60% debt criteria, if, for example, the debt criterion were raised to 100% as has been suggested, amongst others, by the European Stability Mechanism (ESM). But this would still require all member states to reach consensus on any new reference values.

The preventive arm: Ensuring sustainable fiscal paths

While the Treaties set these reference values as well as some ground rules on member state compliance with them, the precise rules against breaking them are found in secondary legislation.

Article 121(1) TFEU requires member states to coordinate their economic policies on the basis of broad economic policy guidelines. They must do so with a view to contributing to the achievement of the objectives of the Union, as defined in article 3 TEU, while complying with the principles set out in Article 119 TFEU, mentioned above (art. 120 TFEU). Articles 121(3) and (4) TFEU establish a multilateral surveillance procedure to ensure such coordination. But detailed rules are laid down in the SGP's preventive arm, which aims at ensuring that member states comply with the deficit and debt criteria.

The preventive arm was adopted as Council Regulation (EC) 1466/97, amended by Council Regulation (EC) 1055/2005 and Regulation (EU) 1175/2011, to ensure sustainable public finances in member states. It is based on article 121(6) TFEU, which gives Parliament and Council the competence to adopt detailed rules for the multilateral surveillance procedure in accordance with the ordinary legislative procedure (OLP).

Medium-term objective (MTO)

Critically, the preventive arm aims at putting member states on 'a sustainable path' by requiring national budgets to adhere to the so-called medium-term objective (MTO). The MTO defines the upper target limit for government deficits and, since 2005, is a country-specific value between -1% of GDP and balance or surplus. This is supposed to allow for sufficient safety room against breaching the 3% deficit criterion (art. 2a Regulation 1466/97). For contracting parties to the Fiscal Compact the limit is -0.5% of GDP (art. 3(1) TSCG). In countries with low debt levels, the deficit can reach 1% of GDP. The TSCG also requires member states to introduce these criteria at the national level. Crucially, the MTO is set in structural terms. This means that government deficits are not treated as nominal values but are adjusted for cyclical economic trends net of any one-off and other temporary measures.

Member states are required to reach their MTO. If they do not, they must be moving towards it at a rate of 0.5% of GDP per year as a benchmark, with higher adjustment efforts expected in economic good times and more limited adjustment efforts in bad times (art. 5(1) Regulation 1466/97). Here stricter rules apply to Eurozone member states. Regulation 1173/2011, which is based on article 136 TFEU, allows for sanctions to be imposed on Eurozone member states already under the preventive arm of the SGP: Where there is a significant observed deviation from the adjustment path to their MTO and the Council finds that they have taken no effective action (art. 6(2) Regulation 1466/97), Eurozone member states may be sanctioned by the Council under reverse qualified majority voting (art. 4 Regulation 1173/2011). Reverse QMV means that a proposal for sanctions by the Commission is deemed adopted, unless the Council rejects it with qualified majority.

Flexibility clauses

The preventive arm furthermore entails two flexibility clauses, which allow member states to deviate from their MTO or, if they are not at their MTO, from the adjustment path towards it:

- The structural reforms clause allows for deviations if governments are implementing major structural reforms, as long as these have a verifiable impact on the long-term sustainability of public finances. However, member states still have to keep an appropriate safety margin to the 3% criterion (art. 5(1) Regulation 1466/97).
- The flexible investment clause under which some investments are considered equivalent to major structural reforms. The conditions for the investment clause to apply are very strict, however: First, GDP growth must be negative or well below its potential. Second, the deviation from the MTO or adjustment path should not lead to a breach of the 3% deficit criterion. Third, the deviation is linked to national expenditure on projects co-funded by the EU, which have direct long-term positive and verifiable budgetary effects. Fourth, the co-financed expenditure should not replace nationally financed investments, so that total public investments do not go down. Fifth, member states must compensate for any temporary deviations and reach their MTO within four years.

Revision procedure

The preventive arm of the SGP can be revised in accordance with the ordinary legislative procedure (OLP) (art. 121(6) TFEU). Under the OLP, the European Parliament and the Council adopt legislation jointly on a proposal of the Commission (art. 294 TFEU). The procedure entails as usual up to three readings until Parliament and Council agree on a final text. For the legislation to be adopted, a simple majority in Parliament (i.e. majority of votes cast) and qualified majority in Council suffices. Amending the Fiscal Compact, however, is trickier as changing an intergovernmental treaty would require, in the end, the ratification of all contracting parties.

In general, it should be noted that the SGP leaves the Commission some limited discretion on how to calculate the MTO, with the current calculation method to be found in the vade mecum on the SGP. Some reform proposals thus intervene here by suggesting a different method of calculating output gap within the EU's current legislative fiscal framework.

The corrective arm: Excessive deficit procedure

If the preventive arm of the SGP cannot prevent member states from breaching either the deficit or debt criterion, its corrective arm comes into play. The legal principle is the same as above: The Treaties establish an Excessive deficit procedure under article 126 TFEU. But the detailed rules on its implementation are again being found in secondary legislation, namely the corrective arm. It was adopted as Council Regulation (EC) 1467/97, amended by Council Regulation (EC) 1056/2005 and Council Regulation (EU) 1177/2011, and is based on article 126 TFEU. Together they set out the steps taken under the EDP.

Decision on existence of excessive deficit

The Council on proposal of the Commission makes the decision of whether member states have an excessive deficit. The basic steps are set down in article 126 TFEU. In the first instance, the Commission is responsible for examining whether member states comply with the 3% deficit and 60% debt criteria. If they do not meet one or both criteria, the Commission draws up a report (art. 126(3) TFEU), on which the Economic and Financial Committee formulates an opinion (art. 126(4) TFEU). If the Commission finds that an excessive deficit exists, or may occur, it sends an opinion to the member state concerned and informs the Council (art. 126(5) TFEU). It is then, ultimately, for the Council to decide, on proposal from the Commission, whether an excessive deficit exists (art. 126(6) TFEU). Regulation 1467/97 gives more detailed rules on the implementation of these steps.

Crucially, the 3% deficit and 60% debt criteria are not binding when it comes to the question of whether an excessive deficit exists. For one, the Council retains an important discretion under the EDP: excessive deficits do not exist until it has, in fact, so decided, after making an 'overall assessment'. The factors it must consider in doing so are specified in Regulation 1467/97.

Secondly, the criteria are qualified in article 126(2) TFEU itself. Hence, the 3% criterion is not considered to be crossed when either the ratio has declined substantially and continuously and reached a level that comes close to 3%, or, alternatively, if the excess is only exceptional and temporary while remaining close to 3%. What is considered 'exceptional and temporary' is then further defined in art. 2(1) of Regulation 1467/97: it is exceptional if 'resulting from an unusual event outside the control of the member state concerned and with a major impact on the financial position of the general government, or when resulting from a severe economic downturn'. It is considered temporary if the deficit is forecast to fall below 3% following the unusual event or severe economic downturn.

Equally, the debt criteria is not triggered when the ratio is sufficiently diminishing and approaching 60% of GDP at a satisfactory pace. Article 2(1a) of Regulation 1467/97 then further defines what this means: the debt ratio is considered to be on track if it is reduced by 1/20th of the deviation to the 60% each year as a benchmark.

So while the general exceptions for compliance with the deficit criteria are written in the Treaties and can only be amended by Treaty amendment, the exact definition of how the exceptions are to be understood are laid down in secondary legislation, which is significant easier to change (see below).

Measures to be taken to correct an excessive deficit

Once the decision has been taken that an excessive deficit exists in a member state, the next steps are concerned with how to correct it. Again, article 126 TFEU sets out the basic steps, starting with recommendations by the Council, on proposal of the Commission, to the member state on how to correct its excessive deficit (art. 126(7) TFEU). If the member state persists in failing to put into practice the recommendation, as established under article 126(8) TFEU, the Council can ultimately request it to take specific measures within a specific time limit to reduce its deficit (art. 126(9) TFEU). Article 5(1) of Regulation 1467/97 specifies that the Council shall ask the member state to achieve annual budgetary targets with a minimum annual improvement of at least 0.5 % of GDP as a benchmark.

Should member states continue to fail to implement these measures, the Council can impose sanctions (art. 126(11) TFEU), ranging from an obligation to publish more information, or asking the European Investment Bank to reconsider its lending policy, via requiring member states to lodge a non-interest bearing deposit with the EU to the imposition of fines. As with the preventive arm, more stringent rules apply for Euro area member states. So where it is established that one such has failed to take corrective action to correct its excessive deficit under article 126(8) TFEU, article 6 of Regulation 1173/2011 requires the Commission to recommend to the Council it impose a fine of 0.2% of GDP on the member state within 20 days. This penalty is deemed adopted unless the Council rejects it by qualified majority. In addition, if a Eurozone member state persistently fails to comply with the recommendations, article 11 of Regulation 1467/97, as amended by Regulation 1177/2011, requires the Council to impose a fine on the member state – for non-Eurozone member states, the other options listed under article 126(11) TFEU and mentioned above continue to apply.

It is also for the Council to decide to abrogate any sanctions once it finds that the member state has corrected its excessive deficit (art. 126(12) TFEU). A curiosity of the Treaties is that the Treaties here do not protect to the same extent the discretion of the Council in each particular instance to determine what an excessive deficit is. As a result, the Council has less discretion in abrogating the Excessive deficit procedure than in finding whether an excessive deficit exists in the first place.

Revision procedure

The corrective arm of the SGP can be amended by the same special legislative procedure that is applicable to Protocol No° 12. Regulation 1467/97 specifically refers to the second sub-paragraph of article 126(14) TFEU. Thus, to revise it, the Council must reach consensus, after consulting the EP and the ECB. This means that to introduce more flexibility into the EDP, for example, by replacing the debt adjustment path of 1/20th of the deviation to the 60% each year with a country-specific one would require unanimity in Council.

General escape clause

The Stability and Growth Pact also contains a general escape clause under which the application of the fiscal criteria may be suspended in cases of severe economic downturn in the euro area or the EU as a whole as long as fiscal sustainability is not endangered in the medium term. This clause gives the framework some limited flexibility as was recently shown when it was activated in 2020 by the Council and the Commission in response to the Covid-19 crisis. It is expected to be deactivated for 2023.

The clause is mirrored in both the preventive and corrective arms of the SGP. Under article 5(1) and 9(1) of Regulation 1466/97 – the preventive arm –, member states may temporarily deviate from the adjustment path towards their MTO in such cases or in cases of ‘an unusual event outside its control, which has a major impact on the financial position of the general government’. Under article 3(5) of Regulation 1467/97 – the corrective arm – the Council can decide to revise its recommendation adopted under article 126(7) TFEU in cases of severe economic downturn in the euro area or EU as a whole as long as this does not endanger fiscal sustainability in the medium term.

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Overview of key elements of the EU fiscal framework, their legal bases and how they can be amended

Deficit and debt criteria	Legal basis	Amendment procedure
Establishment of reference values	Art. 126 TFEU	Treaty revision procedure: unanimity in ICG + ratification by all MS
Setting referencing values at 3% and 60%	Protocol No° 12	Special amendment procedure: unanimity in Council + consultation of EP
Prohibition of excessive deficit	Art. 126 TFEU	Treaty revision procedure: Unanimity in ICG + ratification by all MS
Preventive arm	**Legal basis**	**Amendment procedure**
Obligation to coordinate economic policies	Art. 121 TFEU	Treaty revision procedure: Unanimity in ICG + ratification by all MS
Requirement to adhere to medium-term objectives	Reg. 1466/97, as amended by Regs. 1055/2005 and 1175/2011	Ordinary legislative procedure: Simple maj. in EP + QMV in Council, upon proposal of COM
Definition of medium-term objectives	Reg. 1466/97, as amended by Regs. 1055/2005 and 1175/2011 (+ TSCG)	Ordinary legislative procedure: Simple maj. in EP + QMV in Council, upon proposal of COM (+ ratification by contracting parties)
Corrective arm	**Legal basis**	**Amendment procedure**
Establishment of Excessive deficit procedure	Art. 126 TFEU	Treaty revision procedure: Unanimity in ICG + ratification by all MS
Criteria for decision on existence of excessive deficit	Art. 126 TFEU + Reg. 1467/97, as amended by Regs. 1056/2005 and 1177/2011	Treaty revision procedure: Unanimity in ICG + ratification by all MS + Special legislative procedure: QMV in Council + consultation of EP
Measures to be taken to correct an excessive deficit	Art. 126 TFEU + Reg. 1467/97, as amended by Regs. 1056/2005 and 1177/2011	Treaty revision procedure: Unanimity in ICG + ratification by all MS + Special legislative procedure: unanimity in Council + consultation of EP + ECB
General escape clause	**Legal basis**	**Amendment procedure**
Escape clause allowing for deviation from adjustment path towards medium-term objectives	Reg. 1466/97, as amended by Regs. 1055/2005 and 1175/2011	Ordinary legislative procedure: Simple maj. in EP + QMV in Council, upon proposal of COM
Escape clause allowing for revised Council recommendations under art. 126(6) TFEU	Reg. 1467/97, as amended by Regs. 1056/2005 and 1177/2011	Special legislative procedure: unanimity in Council + consultation of EP + ECB

Conclusion

The EU fiscal rules are characterized by a myriad of different prescriptions and exemptions, enshrined in a variety of legal documents at different levels. Any push for reforming the EU fiscal framework must therefore be based on a solid understanding of its legal bases as the question of what level of revision would be required for their implementation is a crucial one. While the specific revision procedure will depend on the type of reform to be implemented, it should be stressed the hurdles are not unsurmountable either. Not every reform will require a Treaty amendment. In fact, key elements of the current framework, including the controversial 3% and 60% criteria, could be changed by less burdensome legislative procedures – subject, of course, to a consensus among member states.

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