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IMF STAFF CONTRIBUTION TO THE EUROPEAN COMMISSION REVIEW OF THE EU ECONOMIC GOVERNANCE FRAMEWORK[1]

IMF staff welcomes the relaunch of the European Commission's review of the EU's economic governance framework and the opportunity to contribute to the review. While this contribution focuses on potential reforms to the EU fiscal framework, the IMF continues to support the broader objectives of economic governance reform in the EU. This includes completing the banking and capital markets unions, which remains essential to strengthening the EU's resilience.

The unprecedented fiscal response to the pandemic, facilitated by the activation of the escape clause in the EU fiscal rules and new EU instruments to support member states, has helped dampen the economic impact of the shock and paved the way for a strong recovery. As a consequence, however, government debt levels have risen sharply, especially in those countries with already elevated debt ratios. Moreover, the heterogenous impact of the pandemic has resulted in uneven recoveries across sectors and countries, as well as new structural challenges. This comes at a time when European economies will need to adapt to deep environmental, technological, and demographic forces. In this context, there is a greater need than ever for an effective Stability and Growth Pact (SGP). At the same time, in light of the rise in debt ratios during the pandemic, the application of the current rules would require unrealistically large—and counterproductive—adjustments by high-debt countries.

The current fiscal framework has helped limit debt accumulation relative to a situation without rules, and fiscal councils have taken on a more important role. However, the rules are too complex, making them difficult to communicate, monitor, comply with, and enforce. Much of the complexity stems from reform efforts aimed to make the rules less procyclical and more flexible, but ultimately this has led to increasingly discretionary assessments of what qualifies as compliance with the rules. This increases pressure on the European Commission to internalize political considerations when assessing compliance, undermining trust in the even-handed application of the framework. It also weakens ownership, as the objectives of the rules and route to achieving them become less clear.

Moreover, the current framework focuses on a medium-term objective for the structural fiscal balance calculated using an estimate of the output gap, which is an unobservable variable subject to significant ex-post revisions. This raises the risk of policy errors made based on initial estimates of the output gap and structural fiscal balance that are later substantially revised.

[1] The views expressed in this contribution are those of IMF staff and do not necessarily reflect the views of the IMF, its Executive Board, or IMF management.

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The IMF has long called for a simplification of the fiscal rules to make them easier to communicate, monitor, comply with, and enforce. A 2015 Staff Discussion Note (SDN), laid out several options for simplifying the rules and strengthening the fiscal institutions supporting the framework. A main recommendation was to move to a *single fiscal anchor*—the gross government debt to GDP ratio—and a *single operational rule*—an expenditure growth rule. Moreover, an explicit debt correction mechanism—where expenditure growth is reduced when debt rises above the anchor—may be desirable. The SDN also argued for better coordination and cooperation on fiscal policy monitoring between national fiscal councils and the European Commission, in part to reduce the risk of conflicting assessments.

Building on the 2015 SDN and taking into account recent lessons and the current debate, IMF staff is working on an updated proposal to reform the fiscal framework, guided by the following principles:

First, the fundamental rationale for EU fiscal rules is to contain the risks and potential costs that unsustainable fiscal policies in one member state can impose on other members of the monetary union. Hence, the fiscal framework should maintain fiscal sustainability as a central objective. At the same time, the extent to which the EU imposes constraints on national fiscal policies should be commensurate with the risk those policies impose on other members.

Second, any reform needs to balance the objective of ensuring fiscal sustainability with that of allowing appropriate macroeconomic stabilization. Europe has suffered several serious shocks since 2008, requiring significant fiscal policy responses. This has been particularly true for the current pandemic, highlighting the importance of maintaining flexibility in the rules to respond to shocks, while also guiding policy toward a rebuilding of fiscal space when the shock fades. The rules should be designed to allow sufficient countercyclicality, including the use of well-defined escape clauses. A macroeconomic stabilization fund at the euro area level could further improve countries' ability to manage through the business cycle and help achieve an appropriate fiscal-monetary policy mix for the euro area, as argued by IMF staff in a 2018 SDN.

Third, there is still a strong case for numerical fiscal rules as a coordination device and commitment mechanism in the EU when there are differences in views on fiscal policy across countries. A debt anchor with a spending growth rule as the operational target remains IMF staff's preferred option. The calibration of the rules should factor in that, with the long-run decline in interest costs, the upper limit for a prudent level of debt could be higher than considered in the past. At the same time, some fiscal risks have increased, such as those associated with aging and climate change. Moreover, when fiscal adjustment is needed, the calibration should give weight to both the risks from elevated debt levels and the growth impact of adjustment.

Fourth, fiscal institutional reforms, including further strengthening of national fiscal councils and the European Fiscal Board, can play an important role in improving ownership and compliance with the rules, and fiscal policy making more generally. For instance, more independent fiscal councils could help enhance budget transparency by assessing the quantification of fiscal policy proposals and their underlying macroeconomic assumptions; provide long-term sustainability assessments, including on climate change risks to public finances; provide direct inputs to mitigate the inherent complexity of certain rules; and perform timely assessments of compliance.

Finally, a climate investment fund at the EU level could help countries meet their common climate goals. So-called “green golden rules” that exempt national public spending to address climate change would increase the complexity of the rules and run the risk of spending being “green washed” in order to be exempted from the rules. Instead, an EU climate investment fund could help finance the additional spending needed to mitigate and adapt to climate change, while also reflecting the fact that the benefits of reducing carbon emissions are felt across national borders. Such an EU fund would be well placed to prioritize those investments that will achieve the fastest carbon reduction at the lowest cost. An EU fund could also better identify and coordinate projects requiring cross-border investments.