Advisory report

on the

reform of the European fiscal rules

addressed to the parliamentary Budget Committee

This report comprises the concluding audit findings issued by the Bundesrechnungshof in accordance with Article 96 (4) Federal Budget Code. It is published on the homepage of the Bundesrechnungshof (www.bundesrechnungshof.de).

Ref.: I 3 - 0000682 28 June 2023

EU fiscal rules: proposal for reform does not ensure sound public finances over the long term

The planned reform of the EU fiscal rules will not ensure the sustainability of public finances within the European Union. Binding requirements are lacking which would ensure the reduction of excessive debts in a quick and sustainable manner. The Federal Government needs to continue to advocate such requirements and limiting the scope of the European Commission's free interpretation and discretion.

What is it all about?

The Maastricht criteria enshrined in Union law are expected to ensure sustainable public finances in the Member States. This is in particular of importance to the euro area since financial difficulties of one Member State on the capital markets can spread to other Member States. The European Commission's proposal for reform, however, does not ensure that Member States comply with the Maastricht criteria. This bears the risk that Member States with high debts will not adequately reduce these debts or not at a satisfactory pace.

What needs to be done?

The Federal Government faces challenging negotiations at EU level. Therefore, the German Bundestag should strengthen the Federal Government's position by providing a statement specifying guiding principles for these negotiations. On the basis of such a resolution, the Federal Government could substantially increase its efforts to enshrine binding minimum requirements in the framework and to limit the scope of the European Commission's free interpretation and discretion.

What is the objective?

The EU fiscal rules are expected to contribute that Member States reduce their high debts within a reasonable period of time, thus improving the sustainability of public finances. In order to achieve this, the quantitative requirements in the reformed framework need to be adequately ambitious and binding. The Federal Government must be consistent in its effort to advocate such an approach in the negotiations at EU level. The Federal Government should not agree to a reform of the framework which does not ensure such an approach.

Contents

0	Summary	5
1	Preliminary remarks	8
2	Starting point and objective of the report	8
3	The proposals of the Commission	10
4	Compliance with Maastricht criteria not ensured	13
4.1	Debt-to-GDP ratio of 60 per cent is not achieved at a satisfactory pace or cannot be ensured	13
4.2	Economic fluctuations of the budget balance are not taken into account	15
4.3	Calculations show: proposal for reform undermines Maastricht criteria	17
5	Commission continues to have broad scope for discretion in the excessive deficit procedure	19
6	Summary of conclusions and recommendations	20
7	Comments made by the Federal Ministry of Finance	21
8	Final conclusions	22
Annex: Glossary		23

List of abbreviations

B

Budget Committee *Parliamentary Budget Committee*

C

Commission *European Commission*

E

Escape clause *Escape clause of the Stability and Growth Pact*

G

GDP *Gross domestic product*

M

Ministry *Federal Ministry of Finance*

T

TFEU *Treaty on the Functioning of the European Union*

0 Summary

In autumn 2021, the European Commission launched a consultation on the planned reform of the EU fiscal rules. Various Member State governments, including the Federal Government, contributed to the subsequent debate on the reform.

On 26 April 2023, the European Commission specified its proposals for reform in a legislative proposal. We reviewed this proposal. This report serves to inform the parliamentary Budget Committee of our findings and conclusions and to provide recommendations for further negotiations at EU level. We took into account the comments made by the Ministry of Finance on our draft report.

We developed the following findings:

0.1 By means of the Maastricht criteria, Union law specifies two reference values for deficit and debt level that are to ensure the sustainability of public finances in the Member States. The legislative proposal of the European Commission does not intend to change the Maastricht criteria enshrined in primary law. **However, the new framework does not ensure that the Member States will comply with the reference values in the medium to long term.**

On the one hand, quantitative minimum requirements are lacking. When drawing up the budget, this could result in fiscal targets for Member States being not ambitious enough to adequately reduce their debts.

On the other hand, fiscal policy does not take into account the impact of economically difficult years. As a consequence the reference value for the deficit might only be achieved in theory but not in practice.

Furthermore, the European Commission has broad scope for free interpretation and discretion in the excessive deficit procedure. Therefore, we cannot assume that the rules will be better enforced in the future. **Should the legislative proposal be implemented in this form, the Maastricht criteria and thus the principles and objectives of primary law could be undermined.**

0.2 We consider the following adjustments to be necessary which should be included in the reformed framework as binding requirements for technical trajectories and net expenditure paths:

- First, the primary balance is not an appropriate target figure to aim at sustainable public finances. Therefore, the structural balance should be used as a “fiscal anchor” – as it is already the case in the current framework.
- Second, the net expenditure paths should be ambitious enough to ensure that the reference value for the debt-to-GDP ratio can be achieved on the basis of reasonable assumptions.

- Third, the net expenditure paths should be set in such a way that the reference value for the debt-to-GDP ratio is achieved within a reasonable period of time, e.g. within one or two generations at the most.
- Fourth, a safety margin should be defined regarding economic fluctuations in the budget balance.

Furthermore, the scope for the European Commission's free interpretation and discretion should be limited.

0.3 With a view to the expected challenging negotiations at EU level, we consider it to be appropriate to strengthen the Federal Government's position, e.g. by a statement of the German Bundestag. Such a resolution would also equip the Federal Government with guiding principles which the Federal Government would have to take as a basis for the negotiations.

0.4 The Federal Ministry of Finance stated that the Federal Government felt confirmed in its general stance on the reform of the EU fiscal rules by our statements. In principle, the Federal Government concurred with our economic assessments with regard to content.

However, our claim of a maximum period of time within which the reference value for the debt-to-GDP ratio should be achieved poses a problem in their view. Such rigid deadlines for reducing the debts could be too long for Member States with a debt level above but close to the reference value and too ambitious for Member States with a (very) high debt level. This could affect the implementation and enforcement of the framework.

0.5 By demanding a reasonable – i.e. finite and clear – period of time, we do not seek to ensure that all Member States reduce their debts within a single, harmonised deadline to the reference value. On the contrary, we voice our support for specifying a target for the structural deficit, depending on the respective baseline situation, and to set the net expenditure paths in such a way that this target can be achieved. The structural deficit would thus become a "fiscal anchor" and the Member States would achieve the reference value for the debt-to-GDP ratio within different periods of time – depending on the baseline situation.

The wording "reasonable period of time" is thus not meant as a rigid requirement but as a safeguard to avoid that the reduction of debts to the reference value reaches too far into the future and, as a matter of fact, burdens the generation after next.

We reiterate our claim that binding requirements should be included in the reformed EU fiscal rules. This also and in particular applies to determining a reasonable period of time for reducing the debts. The maximum length of such a period of time should be a political decision.

We have serious doubts, however, that a period of 60 years or more would be reasonable. **A framework which allows such a long period to reduce the debts would send the signal that the European Union has actually departed from the Maastricht criterion for the debt level and thus also from long-term sustainable public finances in the Member States.**

1 Preliminary remarks

The EU fiscal rules should ensure the sustainability of public finances in each individual Member State of the European Union. This is in particular of importance to the euro area. Should one Member State have difficulties to obtain funding on the capital markets, this could spread to other Member States (spill-over effects). The so-called euro crisis from 2010 to 2012 showed that liability risks in the range of several billion euros could arise for national budgets caused by sovereign debt crises.

The outbreak of the COVID-19 pandemic in 2020 led to a sharp decline in economic activity in the European Union. In March 2020, the European Commission (Commission) then activated the general escape clause of the Stability and Growth Pact (escape clause) to enable the Member States to cope with the economic impact of the pandemic in fiscal terms. The escape clause enables the Member States to temporarily deviate from the target values of the EU fiscal rules. Because of this clause, the public debt and the budget deficit significantly increased in almost all EU Member States. In May 2022, the Commission decided not to deactivate the escape clause until the end of 2023 because of the economic impact of the Russian war of aggression against Ukraine.

We expect that the Commission will deactivate the escape clause for 2024. The applicable EU fiscal rules would then oblige many Member States to consolidate their public budgets. After four years with an activated escape clause, returning to the reference values of the EU fiscal rules could involve very ambitious fiscal adjustment efforts for some Member States because of high budget deficits and increased debt-to-GDP ratios. In some cases, it might actually be impossible to return to the reference values.

2 Starting point and objective of the report

The reform of the EU fiscal rules has already been discussed at EU level for some years. A reform process initiated by the Commission in February 2020 was suspended because of the outbreak of the COVID-19 pandemic. In autumn 2021, the Commission resumed the reform process and launched the consultation with national governments and parliaments and a broad range of stakeholders.[1]

In August 2022, the Federal Government actively contributed to the reform process and presented a paper of principles.[2] This paper informed the parliamentary Budget Committee (Budget Committee) of the Federal Government's proposals on how to shape the EU fiscal

[1] cf. COM (2021) 662 final of 19 October 2021, Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions, The EU economy after COVID-19: implications for economic governance.

[2] Proposed principles to guide the German government in deliberations on the reform of EU fiscal rules, information provided to the Budget Committee by the Federal Ministry of Finance of 4 August 2022.

rules in the future. In November 2022, the Commission outlined its proposals on the reform of the framework in a communication.[3] On 5 April 2023, the Federal Government submitted a non-paper to the Commission. In doing so, the Federal Government again contributed to the debate on the reform on selected aspects.[4] On 26 April 2023, the Commission provided a legislative package of two regulations and one directive containing specific proposals on the reform of the economic governance framework.[5]

Against this backdrop, we advise the Budget Committee and the Federal Government with regard to further negotiations at EU level.

In Article 126(2) of the Treaty on the Functioning of the European Union (TFEU), Union law specifies two reference values, known as Maastricht criteria, which are expected to ensure the sustainability of public finances:[6]

- **Deficit criterion:** Budget deficit of a maximum of 3 per cent of gross domestic product (GDP),
- **Debt criterion:** Debt level of a maximum of 60 per cent of GDP.

If the debt-to-GDP ratio exceeds the reference value, the ratio has to be on a firm downward path and approach the reference value at a satisfactory pace.

The present report explores whether and to what extent the provisions the Commission outlined in the proposal for the reform manage to guide in such a way that the reference values for deficit and debt level are achieved or fall below within a reasonable period of time to thus ensure sustainable public finances in the Member States.

We took into account the comments made by the Federal Ministry of Finance (Ministry) on our draft report.

---

3 COM (2022) 583 final of 9 November 2022, Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, Communication on orientations for a reform of the EU economic governance framework.

4 German technical non-paper following up on selected issues identified by the ECOFIN conclusions.

5 The legislative package of 26 April 2023 encompasses proposals for three legal acts: For a regulation on the new orientation of the preventive arm of the Stability and Growth Pact (footnote 7), for a regulation on the change of the excessive deficit procedure (footnote 22) and for a Council Directive amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States (COM (2023) 242 final).

6 cf. Article 126(2) TFEU in conjunction with Article 1 of the protocol (No 12) on the excessive deficit procedure.

3 The proposals of the Commission

The Commission intends a fundamental new orientation of the preventive arm of the Stability and Growth Pact by means of the proposal for a regulation on the effective coordination of economic policies and multilateral budgetary surveillance[7]. The requirements on the structural balance (country-specific medium-term budgetary objectives) and on the consolidation paths[8] defined in advance should be abolished. These figures have so far been determined according to uniform rules.

Instead, the Commission intends to bilaterally negotiate with those Member States which do not comply with one of the two reference values on a country-specific net expenditure path every four years.[9] The net expenditure path defines an annual upper limit for the nationally financed net primary expenditure[10] (hereinafter: net expenditure) over an adjustment period. In contrast to the current framework, the requirements specified for national fiscal policy should only be made via the net expenditure path. The net expenditure path will thus become the only operational indicator. The adjustment period covers four years. This period, however, can be extended by up to three years by means of investment and reform commitments on the part of the Member States[11].

In the run-up to the bilateral negotiations, the Commission plans to specify a technical trajectory for the trend in net expenditure. The Commission intends to derive the technical trajectory using several criteria on the basis of a debt sustainability analysis. These criteria are in particular the following:[12]

- At the latest by the end of the adjustment period, the debt-to-GDP ratio projected for the following ten-year period is on a “plausibly downward path” without further fiscal measures.
- The budget deficit is brought and maintained below the 3 per cent of GDP reference value.

---

[7] COM (2023) 240 final of 26 April 2023, Proposal for a Regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97.

[8] The annual fiscal adjustment measures required in the currently applicable framework up to the medium-term budgetary objective of a Member State arise from an adjustment matrix and depend on the GDP growth rate and on the current economic situation. See also Deutsche Bundesbank, Design and implementation of the European fiscal rules, Monthly Report June 2017, p. 34.

[9] cf. COM (2023) 240 final of 26 April 2023, Article 5. Member States which comply with the two reference values do not have to provide a country-specific net expenditure path. cf. ibid., Article 7(2). The usual cycle of four years stems from Article 7(3) of the draft regulation.

[10] Net primary expenditure is government expenditure net of interest expenditure, cyclical unemployment expenditure and discretionary revenue measures. Furthermore, the net expenditure path should not take into account Union programmes fully matched by revenue from Union funds. cf. ibid., recital (12).

[11] The reform and investment commitments in particular have to be growth enhancing, support fiscal sustainability and address country-specific recommendations. Investments have to meet the characteristic of additionality. cf. ibid., Article 13.

[12] cf. ibid., Article 6 and Annex 1.

- Backloading of the fiscal adjustment effort is not allowed.
- The debt-to-GDP ratio at the end of the adjustment period[13] is below the ratio in the year before its start.
- Net expenditure growth is on average below medium-term growth of potential output.[14]

The technical trajectory corresponds to a structural primary balance which the respective Member State needs to achieve at the end of the adjustment period.[15]

The technical trajectory is expected to ensure that the debt-to-GDP ratio is put on a ten-year downward path after the end of the adjustment period. In order to set the trajectory, the Commission therefore needs to project the trend in the debt-to-GDP ratio for this ten-year period. The projection depends on the trend in real GDP, inflation, average interest on government bonds, demographic costs and the primary balance.[16] In its calculations, the Commission needs to rely on assumptions for these macroeconomic indicators.

Overall, a period of 14 to 17 years is considered for deriving the technical trajectories for individual Member States. Figure 1 illustrates the individual time periods.

---

[13] The Commission uses the term “planning horizon” for this target criterion without defining the term. cf. ibid., Article 6(d). Our comments are based on the assumption that the adjustment period is meant.

[14] Potential output is a measure of macroeconomic production capacities. These capacities determine the growth potential of a country’s economy over the medium and long term.

[15] cf. ibid., Article 7(1)(c).

[16] The primary balance corresponds to the budget balance without interest payments.

Figure 1

Technical trajectories cover a long period under review

In order to set the technical trajectory of a Member State, the Commission considers the period of the next 14 to 17 years. The four-year adjustment period at the beginning may be extended to up to seven years by means of reform and investment commitments. For the following ten years, the Commission intends to project the debt-to-GDP ratio in a sustainability analysis.

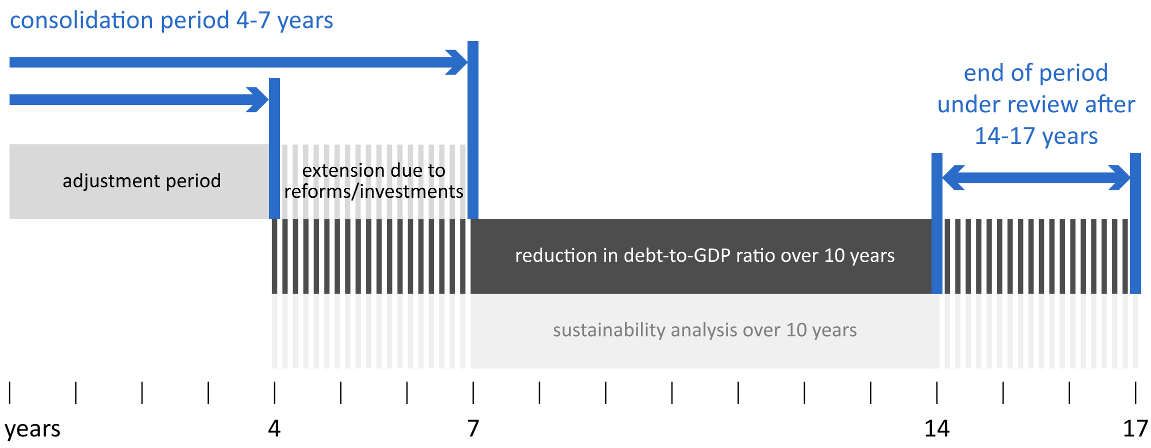


Figure: Bundesrechnungshof.

After the technical trajectories have been published, the Member States hold bilateral discussions with the Commission. Following these discussions, they present their fiscal-structural plans. These plans cover a term of four years and describe the net expenditure path, the assumptions made and the fiscal measures planned. The net expenditure paths may deviate from the respective technical trajectory. A justification is to be provided for "upward" deviations – which means higher net expenditure.[17]

After the Commission has positively assessed the medium-term fiscal-structural plans, they are presented to the ECOFIN Council[18] for endorsement.[19] The draft regulation stipulates the comply or explain rule for proposals and recommendations of the Commission to the ECOFIN Council. This means: The Council is expected to, as a rule, follow the recommendations and proposals of the Commission or explain its position publicly.[20]

The Commission annually monitors the implementation of the plans and in particular the trend in net expenditure paths. For this purpose, the Commission sets up a control account

17 cf. ibid., Article 11. Pursuant to the current wording of the regulation, the formal final net expenditure path requirements mentioned in Article 12 fall short of the technical trajectory criteria (Article 6 and Annex 1). Formally, only the first two target criteria would also apply to the final net expenditure path. In the negotiations of expert committees, the Ministry seeks to ensure that the higher requirements are also formally transferred to the net expenditure path.

18 The Economic and Financial Affairs Council (ECOFIN Council) is a configuration of the Council of the European Union. The ECOFIN Council consists of the economics and finance ministers of all Member States.

19 As a rule, the plans shall be endorsed within four weeks. cf. ibid., Article 16.

20 cf. ibid., Article 27.

and keeps track of cumulative deviations of a Member State's actual net expenditures from the agreed net expenditure path.[21]

The Commission also proposes changes (in the corrective arm) for not complying with the Maastricht criteria.[22] The changes primarily concern the excessive deficit procedure as a result of not complying with the debt criterion ("debt-based excessive deficit procedure"). So far, the requirement stipulated under Article 126(2) TFEU specifying that a debt-to-GDP ratio exceeding the reference value needs to be sufficiently diminishing and approaching the reference value at a satisfactory pace has been operationalised by means of the 1/20th rule.[23] The latter rule should be replaced by a Member State's compliance with the net expenditure path.[24]

The main features of the "deficit-based excessive deficit procedure" will remain unchanged and will be linked to the new preventive arm: As long as the deficit criterion is not met, the net expenditure path needs to ensure an annual adjustment of a minimum of 0.5 per cent of GDP.[25]

4 Compliance with Maastricht criteria not ensured

4.1 Debt-to-GDP ratio of 60 per cent is not achieved at a satisfactory pace or cannot be ensured

In Member States which exceed one of the two reference values, the net expenditure path in conjunction with the target for the structural primary balance needs to adequately ensure at the end of the adjustment period that the debt-to-GDP ratio is on a "plausibly downward path" without further fiscal measures over a longer period of time.[26] This qualitative requirement, however, is not refined by quantitative requirements specified in advance. The present quantitative targets of the preventive arm on the structural balance should be abolished.

---

21 cf. ibid., Article 21.

22 COM (2023) 241 final of 26 April 2023, Proposal for a Council Regulation amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

23 Pursuant to the 1/20th rule, the difference between the actual debt-to-GDP ratio to the limit of 60 per cent has to be reduced by an annual amount of at least one twentieth over a three-year average.

24 Article 2(1a) as amended by the proposal for a regulation COM (2023) 241 final of 26 April 2023.

25 The draft regulation does not specify a basis (e.g. budget deficit or structural deficit) for the minimum adjustment. cf. Article 3(4) as amended by the proposal for a regulation COM (2023) 241 final of 26 April 2023. The minimum annual adjustment will then become an additional target criterion of the technical trajectory. cf. COM (2023) 240 final of 26 April 2023, Annex 1(c). The Ministry urged the Commission to make the wording more specific.

26 cf. COM (2023) 240 final of 26 April 2023, Article 12(a).

The structural primary balance alone, however, does not allow to make any statements whether Member States comply with the Maastricht criteria or not. The primary balance does not indicate how much a government's debt increases or decreases because interest expenditure is not considered. But the latter also has to be paid from the national budget. In the case of a primary balance in equilibrium, interest expenditure thus leads to higher government debt. Accordingly, two Member States with the same primary balance but different interest expenditure can have completely different budget balances.[27]

For projections of the debt-to-GDP ratio, information on the primary balance is therefore not enough. In fact, additional assumptions on the trend in interest expenditure and nominal GDP growth have to be made. The higher the difference between interest on the government debt and the growth rate of the nominal GDP (interest-growth differential), the higher the primary balance has to be in order to reduce the debt-to-GDP ratio.

The structural balance takes into account the trend in interest expenditure. Therefore, the structural balance is the more relevant and more appropriate indicator to verify compliance with the Maastricht criteria. This is the reason why our analyses are based on the structural balance.

Our calculations show that only adequately ambitious values for the structural balance ensure that the debt-to-GDP ratio no longer exceeds 60 per cent.

We assumed a GDP growth of 2.5 per cent for our calculations.[28] In this case, the critical level for the structural deficit is slightly lower than 1.5 per cent of GDP. This means: In the case of a structural deficit of 1.5 per cent of GDP and more, a debt-to-GDP ratio of 60 per cent will not be achieved.

In a projection for a hypothetical Member State with an initial debt-to-GDP ratio of 120 per cent, a nominal GDP growth of 2.5 per cent and a structural deficit of 0.5 per cent of GDP, it would take 38 years alone to achieve the reference value of 60 per cent of GDP again. It would even take 49 years for an initial debt-to-GDP ratio of 150 per cent. If this Member State was permitted a higher budget deficit of 1.5 per cent of GDP, the reference value would never be achieved. The following figure illustrates this case.

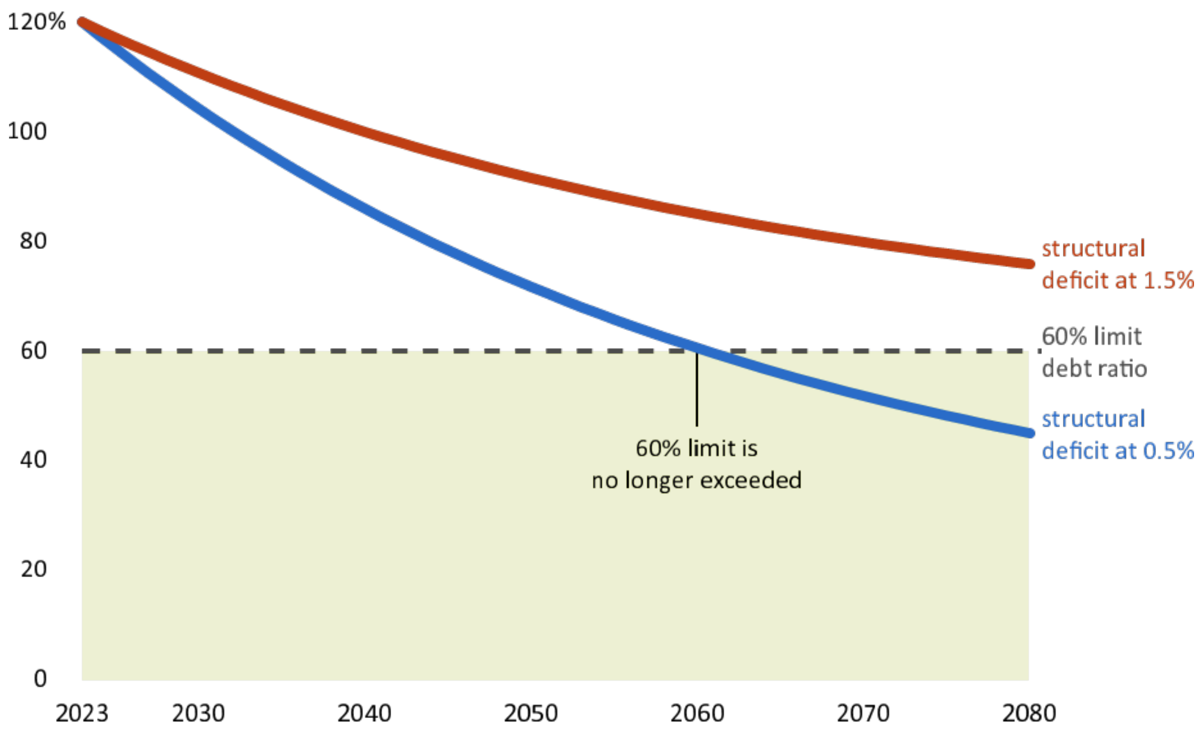
[27] In 2022, the range of interest expenditure was between 0.1 per cent and 4.4 per cent of GDP among the Member States.

[28] In the period between 2000 and 2019, the average annual nominal GDP growth for Germany totalled 2.7 per cent. For the euro area, the growth rate amounted to 2.9 per cent. A large EU economy could only report an average GDP growth of 2.0 per cent in the same period. We used the historical growth rates of the Commission's AMECO database.

Figure 2

Reduction of debt-to-GDP ratio to 60 per cent not always ensured

A structural deficit of 0.5 per cent of GDP ensures that the debt-to-GDP ratio complies with the limit of 60 per cent within a reasonable period of time. A less ambitious structural balance would not always ensure that this limit is complied with.



Explanatory note: The calculations are based on an annual nominal GDP growth rate of 2.5 per cent.

Figure: Bundesrechnungshof.

In its non-paper, the Federal Government stated that the debt sustainability analysis is not appropriate as a key tool to set the expenditure paths. Since the net expenditure paths alone did not always ensure an adequate reduction of debts, quantitative minimum requirements for the structural deficit would be required. In tangible terms, the Federal Government holds that specifying a medium-term structural deficit in a range of 0.5 per cent to a maximum of 1 per cent of GDP would be an appropriate option for all Member States.

In doing so, the Federal Government actually confirms the results of this projection.

4.2 Economic fluctuations of the budget balance are not taken into account

Pursuant to the Commission’s proposal, the deficit criterion will remain unchanged. The proposal stipulates that the budget balance must not exceed 3 per cent of GDP. The technical trajectories and the net expenditure paths should be set in such a way that this is ensured on a sustainable basis over the medium term.[29] The budget balance is subject to economic fluctuations. These fluctuations are deducted when determining the structural balance. In times of economic downturn (recession), the budget balance is therefore in some cases significantly lower than the structural balance.

A structural balance of only slightly below 3 per cent of GDP most likely leads to non-compliance with the 3 per cent deficit criterion in times of weaker economic activity. The Commission does not explain whether and to what extent the Commission intends to take into account economic fluctuations of the budget balance (cyclical component) in the bilateral negotiations, and whether a safety margin against breaching the 3 per cent deficit criterion is envisaged to be included.

The Commission provides estimates for the cyclical component.[30] According to the estimates, the cyclical component for the budget balance of the European Union as a whole was at approximately 1.5 per cent of GDP in the boom year of 2007 and -3 per cent of GDP in the recession year of 2020. In the years from 2012 to 2015, which were subject to weaker economic activity, the cyclical component achieved values of up to -1.8 per cent of GDP. If this period was used, the structural deficit should be at no more than 1.2 per cent of GDP to most likely comply with the deficit criterion.

In the current framework of the Stability and Growth Pact, the Commission takes into account the cyclical component in the preventive arm when determining the medium-term budgetary objectives. According to these estimates, the structural deficit should not be at more than 1 per cent of GDP for the majority of the Member States to ensure compliance with the deficit criterion even in times of weak economic activity.[31]

Figure 3 illustrates the cyclical component for the European Union and underlines the importance of a safety margin for the structural deficit in order to comply with the deficit criterion.

---

[29] cf. COM (2023) 240 final of 26 April 2023, Article 6(b) and Article 12(a).

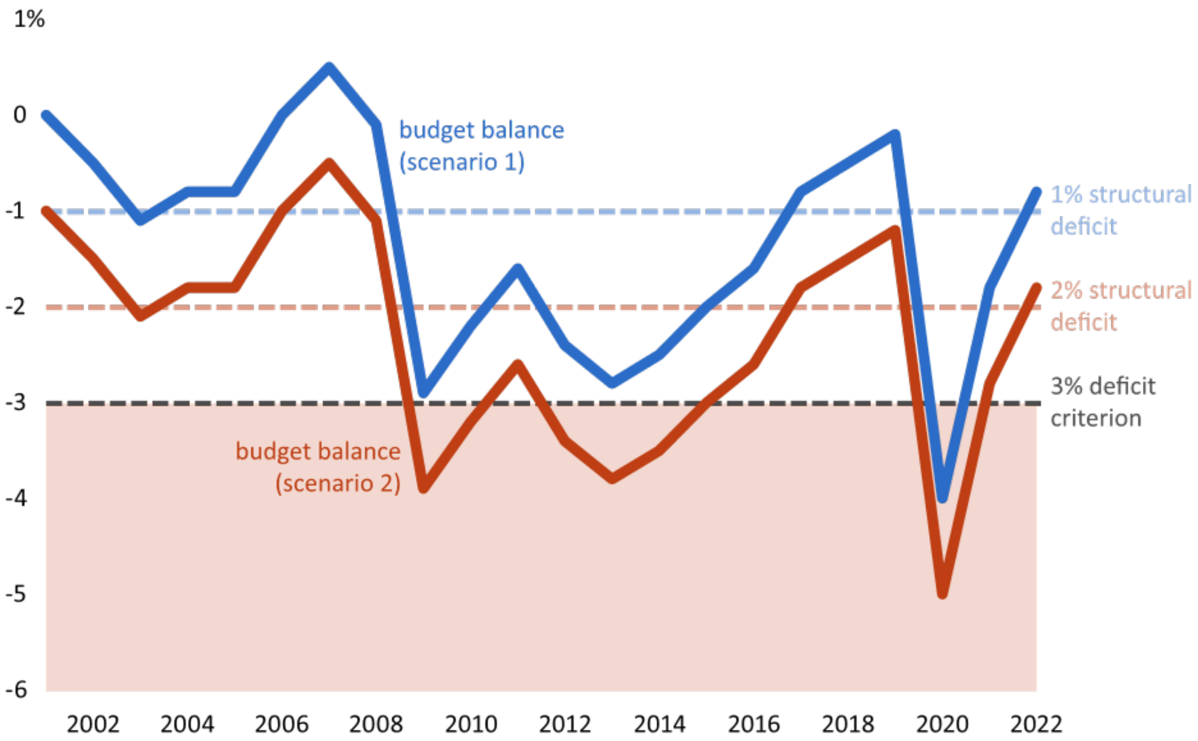
[30] The estimates can be found on the website of AMECO Online; please see: https://dashboard.tech.ec.europa.eu/qs_digit_dashboard_mt/public/sense/app/667e9fba-eea7-4d17-abf0-ef20f6994336/sheet/2f9f3ab7-09e9-4665-92d1-de9ead91fac7/state/analysis.

[31] The Commission publishes these estimates using the term "minimum benchmarks". They can be found in a handbook in which the Commission provides a comprehensive description of the provisions of the Stability and Growth Pact. cf. European Commission, Vade mecum on the Stability & Growth Pact, 2019 Edition, Institutional Paper 101, April 2019, page 91. For the calculation of the "minimum benchmarks", cf. ibid., page 10 et seq.

Figure 3

Safety margin to 3 per cent deficit criterion required

If the structural deficit is too high, the deficit criterion may not be complied with in times of economic downturns. Therefore, an adequate safety margin to the 3 per cent deficit criterion is required.



Explanatory note: In order to derive the budget balances from the structural balances for the two scenarios, we relied on the cyclical component of the European Union.

Figure: Bundesrechnungshof.

4.3 Calculations show: proposal for reform undermines Maastricht criteria

Commission staff prepared first calculations for the sustainability analyses of the Member States. These are preliminary calculations which the Commission has neither adopted nor confirmed. However, they meet the target criteria on setting the technical trajectories (cf. chapter 3).

The calculations show various projections for individual Member States, namely for the (structural) primary balance and budget balance, GDP, inflation and debt-to-GDP ratio after a successful adjustment period.

We reviewed these calculations and the associated impact on the basis of the following questions:

- Can an economic downturn at the end of the four-year or seven-year adjustment period (2028 or 2031) lead to non-compliance with the deficit criterion?
- Do the technical trajectories ensure that a structural balance is achieved at the end of the adjustment period that, as a rule, ensures a full return to the debt-to-GDP ratio of 60 per cent?
- Will the amount of the structural balance at the end of the adjustment period be enough to ensure a full return to the debt-to-GDP ratio of 60 per cent in no later than 50 years (2074)?

We found the following:

- In the case of some Member States, the Commission made overly bullish assumptions with regard to economic growth (cf. figure 4).[32] This has a significant impact on the projection of the debt-to-GDP ratio and the technical trajectories since the target criterion of a debt-to-GDP ratio which is on a downward path in the projection period can this way be more easily achieved in mathematical terms. The calculated need for consolidation in the adjustment period is therefore lower.[33]
- In the case of weaker economic activity, some Member States will breach the 3 per cent deficit criterion even if they comply with the technical trajectory.
- In the case of one Member State, the calculation shows that the technical trajectory at the end of the adjustment period leads to a structural balance with which this Member State can never ever achieve a debt-to-GDP ratio below 60 per cent – and thus the reference value.[34]
- In the case of individual Member States with a current debt-to-GDP ratio of considerably more than 60 per cent, it is possible that they cannot achieve a debt-to-GDP ratio below 60 per cent until the years after 2074.

---

[32] The GDP growth rates assumed in the projection period are significantly above the historical values of the years from 2000 to 2019.

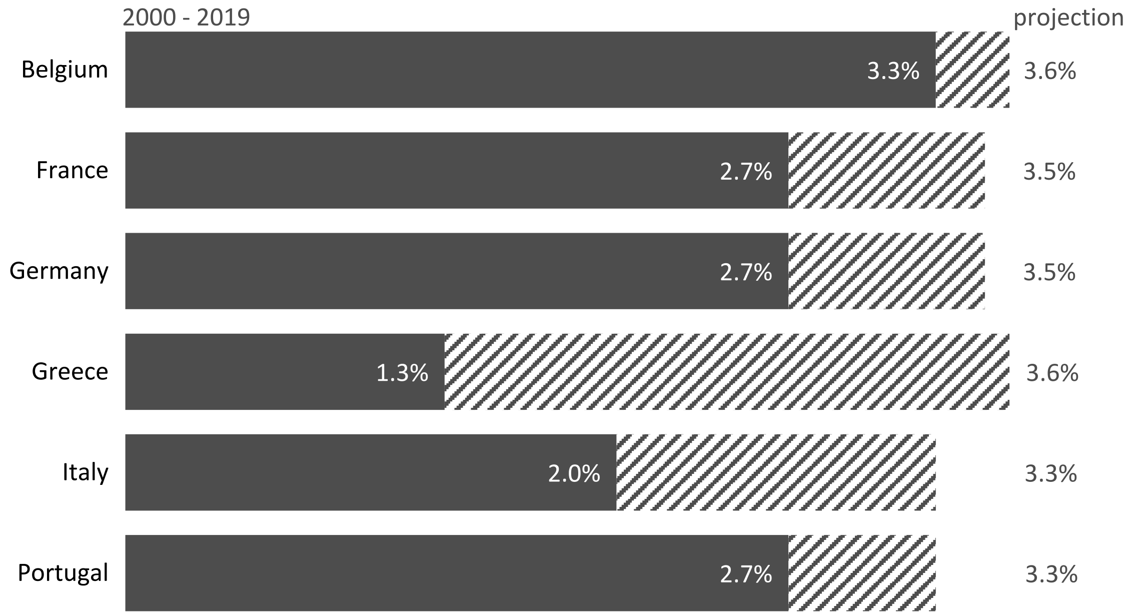
[33] In order to keep a debt-to-GDP ratio steadily at 100 per cent, the budget balance can be approximately one percentage point lower in the case of a higher GDP growth of one percentage point. The Deutsche Bundesbank also refers to the risks of overestimated values for GDP growth. cf. Deutsche Bundesbank, The reform of the EU's fiscal rules, Monthly Report May 2023, page 72.

[34] To that end, we determine for a given GDP growth figure the hypothetical minimum value of the structural balance that must be reached to achieve a debt-to-GDP ratio of 60 per cent. This value is then compared with the structural balance of the last year of the adjustment period. For the algebra of government debt, see German Council of Economic Experts, Effectively limit government debt ("Staatsverschuldung wirksam begrenzen"), expert report 2007, page 17, box 2 (in German only).

Figure 4

Overly bullish assumptions when setting trajectories

A higher growth rate of the GDP allows a faster reduction in the debt-to-GDP ratio. For the projection period from 2028 to 2038, Commission staff assumed growth rates for some Member States that are significantly higher than historical averages (2000 to 2019).



Explanatory note: The period for the realised GDP growth rates ends in 2019 and thus excludes the economic collapse caused by the COVID-19 pandemic.

Figure: Bundesrechnungshof.

Source: AMECO database of the Commission.

5 Commission continues to have broad scope for discretion in the excessive deficit procedure

In the “debt-based excessive deficit procedure”, a Member State’s compliance with the net expenditure path is to replace the present 1/20th rule.[35] Exceeding the net expenditure path, however, will also in the future not automatically lead to an excessive deficit procedure. In its report pursuant to Article 126(3) TFEU, the Commission takes into account the “relevant factors” to assess whether there is an excessive deficit from its perspective.

35 Article 2(1a) as amended by the proposal for a regulation COM (2023) 241 final of 26 April 2023.

The size of the annual and cumulative deviation from the agreed net expenditure path – which is recorded on the control account – is one of the "relevant factors".[36] In its draft regulation, however, the Commission has not provided any quantitative information regarding a critical threshold for the balance of the control account.

In the future, the Commission intends to take into account a Member State's debt sustainability risk as a "key" relevant factor. In the case of a significant sustainability risk, an excessive deficit procedure should be opened "as a rule".[37] However, the Deutsche Bundesbank holds that the draft regulation does not include any clear definition for a significant sustainability risk.[38] Furthermore, the Commission may take into account other relevant factors in its assessment.[39]

Therefore, the Commission continues to have broad scope for discretion when making assessments. Not until after the recommendation of the Commission and after an overall assessment, the ECOFIN Council shall decide pursuant to Article 126(6) TFEU whether an excessive deficit exists and whether an excessive deficit procedure is opened.

In its paper of principles, the Federal Government demanded "a better enforcement of the rules, including a rule-based opening and implementation of excessive deficit procedures".[40] **We hold that this key demand is not met by the Commission's proposal for reform.**

6 Summary of conclusions and recommendations

The present legislative proposal of the Commission does not intend to change the Maastricht criteria enshrined in primary law. Nevertheless, the proposal has a significant impact on whether the reference values are complied with in the medium to long term. In the future, the "new framework" defines legally binding fiscal targets which could make it virtually impossible to achieve the reference values despite compliance with the rules as

[36] cf. Article 2(3), sentence 4(b) as amended by the proposal for a regulation COM (2023) 241 final of 26 April 2023.

[37] cf. Article 2(3), first subparagraph, as amended by the proposal for a regulation COM (2023) 241 final of 26 April 2023.

[38] The wording of the draft regulation refers to the debt challenges "according to the most recent Debt Sustainability Monitor" of the Commission. The Deutsche Bundesbank pointed out that the Commission did not publish aggregated risk values but risk values for the short, medium and long term for the individual Member States that, in some cases, varied very widely. It was unclear what risk value the Commission intended to consider. cf. Deutsche Bundesbank, Monthly Report May 2023, page 71.

[39] cf. Article 2(3), second subparagraph et seq., as amended by the proposal for a regulation COM (2023) 241 final of 26 April 2023. Other relevant factors include, but are not limited to, "the evolution of the government debt position and its financing, and the related risk factors, in particular the maturity structure, the currency denomination of the debt and contingent liabilities".

[40] cf. Proposed principles to guide the German government in deliberations on the reform of EU fiscal rules, information provided to the Budget Committee by the Federal Ministry of Finance of 4 August 2022, page 2.

they are lacking in ambition. Should the legislative proposal be implemented in its current form, this could lead to the fact that the Maastricht criteria and thus the principles and objectives of primary law are undermined. The two papers of the Federal Government also address this risk in essence.

Against this backdrop, we consider the following adjustments to be necessary which should be included in the reformed framework as binding requirements for technical trajectories and net expenditure paths:

- First, the primary balance is not an appropriate target figure to aim at sustainable public finances. Therefore, the structural balance should be used as a "fiscal anchor" – as it is already the case in the current framework.
- Second, the net expenditure paths should be ambitious enough to ensure that the reference value for the debt-to-GDP ratio can be achieved on the basis of reasonable assumptions.
- Third, the net expenditure paths should be set in such a way that the reference value for the debt-to-GDP ratio is achieved within a reasonable period of time, e.g. within one or two generations at the most.
- Fourth, a safety margin should be defined regarding economic fluctuations in the budget balance.

Furthermore, the scope for the European Commission's free interpretation and discretion should be limited. To that end, a clear, quantitative requirement should, in particular, be included in the regulation specifying the size of the annual and cumulative deviations from the agreed net expenditure path (balance of the control account) at which the Commission has to propose the opening of an excessive deficit procedure to the ECOFIN Council.

We expect challenging negotiations at EU level. With a view to the particular importance of this proposed reform for the sustainability of the Member States' public finances and thus for the future of the European Union, we consider it to be appropriate to strengthen the Federal Government's position, e.g. by a statement of the German Bundestag. Such a resolution would equip the Federal Government with guiding principles which the Federal Government would have to take as a basis for the negotiations.

7 Comments made by the Federal Ministry of Finance

The Federal Ministry of Finance stated that the Federal Government felt confirmed in its general stance on the reform of the EU fiscal rules by our statements made in this report. In principle, the Federal Government concurred with our economic assessments with regard to content.

However, our claim of a maximum period of time within which the reference value for the debt-to-GDP ratio should be achieved poses a problem in their view. Since such rigid requirements might have the disadvantage that they specify deadlines which are too long for Member States with a debt-to-GDP ratio close to the reference value. For Member States with higher debt-to-GDP ratios, however, the requirements could be too ambitious. This could affect the implementation and enforcement of the framework.

8 Final conclusions

By demanding a reasonable period of time, we expressly do not seek to ensure that all Member States reduce their government debts within a single, harmonised deadline to the reference value. On the contrary, we voice our support for specifying a target for the structural deficit, depending on the respective baseline situation, and to set the net expenditure paths in such a way that this target can be achieved. The structural deficit would thus become a "fiscal anchor". This target would ensure that the Member States with moderate debt levels would achieve the reference value for the debt-to-GDP ratio faster than Member States with higher debt levels. The wording "reasonable period of time" is thus not meant as a rigid requirement but as a safeguard to avoid that the reduction of debts to the reference value reaches too far into the future and, as a matter of fact, burdens "the generation after next".

In its non-paper, the Federal Government demanded that a quantitative minimum requirement for the annual reduction of debts must be included in the framework. The Federal Government proposed an annual reduction of 1 per cent of GDP for Member States with high debt levels. According to the Federal Government, this proposal also implies a maximum period within which the reference value of 60 per cent of GDP should be achieved. This period would take approximately 100 years for a Member State with an initial debt-to-GDP ratio of 160 per cent.

Therefore, we reiterate our demand that binding requirements for the technical trajectories and for the next expenditure paths should be included in the reformed EU fiscal rules. This applies, in particular, to determining a reasonable – i.e. finite and clear – period of time for reducing the debt-to-GDP ratio to the reference value. The maximum length of such a period of time should be a political decision. We have serious doubts, however, that a period of 60 years or more would be reasonable. **A framework which allows such a long period to reduce the debts would send the signal that the European Union has actually departed from the Maastricht criterion for the debt level and thus from long-term sustainable public finances in the Member States.**

Dr. Mähring Demir

Annex: Glossary

Budget balance	Difference between general government revenue (without net borrowing) and general government expenditure (federal, state and local governments, social security funds). The budget balance – like other fiscal indicators – is mostly considered in relation to the (nominal) gross domestic product to achieve comparability between the Member States.
Budget deficit (deficit)	Budget balance is less than zero, i.e. general government revenue (without borrowing) is less than general government expenditure. A budget deficit needs to be balanced by loans.
Cyclical component	Non-observable fiscal indicator which needs to be estimated with statistical methods. The cyclical component covers economic (business cycle) fluctuations of the budget balance or, to be more accurate, of the primary balance since no economic fluctuations are assumed for interest expenditure.
Discretionary revenue measures	Additional revenue of the public budgets that are attributed to targeted policy measures (e.g. increases in tax or contribution rates).
Economic cycle	In some years, a country's gross domestic product (GDP) can increase disproportionately (boom), and in other years, the GDP can decrease (recession). The multi-annual fluctuations of economic activity are referred to as economic cycle (business cycle).
Gross domestic product (GDP)	Key measure of economic activity of a country (e.g. German economy) or economic region during a specified period of time (e.g. within a year). To that end, all goods and services produced and valued at market prices within a country's geographical boundaries during a specified period are included provided that they are not used as intermediate consumption for the production of other goods and services.

Nationally financed net primary expenditure	Net primary expenditure net of expenditure on Union programmes fully matched by revenue from Union funds.
Net expenditure path	Multi-annual trajectory defining an upper limit for nationally financed net primary expenditure for every year.
Net primary expenditure	Net primary expenditure is government expenditure net of interest expenditure, cyclical unemployment expenditure and discretionary revenue measures.
Potential output	Potential output refers to the maximum amount of goods and services produced by a country (GDP) at normal utilisation of all production factors (no overtime, machines are in normal operation etc.).
Primary balance	Budget balance net of interest payments on debts. A positive primary balance means that revenue is enough to finance key government tasks and to cover some interest expenditure.
Structural balance	Budget balance adjusted by temporary effects (one-off measures) and economic effects in government revenue and expenditure (e.g. additional expenditure for unemployment caused by recessions). The economic (business cycle) effects are also referred to as cyclical component. It is a non-observable indicator which needs to be estimated with statistical methods.
Structural primary balance	Primary balance adjusted by economic (business cycle) effects in revenue and expenditure. These effects are also referred to as cyclical component. It is a non-observable indicator which needs to be estimated with statistical methods.