European Economic and Social Committee
Employers' Group

Position Paper of the EESC Employers' Group on the reform of the Stability and Growth Pact

Reforming the fiscal framework in the EU

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Key points

- The COVID-19 pandemic and Russia's invasion of Ukraine are exerting pressure on public finances. The fiscal framework will have to be revised. Irrespective of the fiscal framework, however, public debt will have to be financed and this will shrink the space for public investment and consumption in the coming years. The extent of this shrinkage will depend on the growth rate of the economy and the level of interest rates. With low interest rates, at least for some time, a debt level above 60% of GDP is sustainable.

- The Employers' group acknowledges Member States' ambition to review the existing framework in the EU. It is, however, important to maintain reference values, as the European Fiscal Board points out, since clear and recognisable numerical goalposts play an important role in any solid fiscal framework. The subjective classification of expenditure items may lead to unwarranted debt levels and distortions. Therefore, "golden rules" are not a panacea. Any use of golden rules must not jeopardise medium-term fiscal sustainability or the value of the euro. The reclassification of investments as "green investments" should also be prevented. Any temporary rules should be strictly limited in time and a transition path to permanent rules should be followed.

- The fiscal framework should be enforceable, should be enforced and should encourage the consolidation of public finances in good time, so that deficits can be sustained during a crisis. Public investment needs to form a larger share of government spending. Deficits and public debt will typically lead to higher taxes, other things being equal, which will often burden investments and create uncertainty and instability. Given the high tax burden in many Member States, fiscal consolidation should be through expenditure control, rather than through tax increases. Controlling deficits and public debt is therefore in the interest of both employers and wage earners. Sound public finances are important for growth and the well-being of citizens – in particular those with low incomes and insecure jobs.

Introduction and background

A reform of the EU rules for a fiscal framework is on the agenda. The pandemic, with all the debt that it has generated, has highlighted the importance of the framework and its need for revision.

In 2020, the **government deficit** (net borrowing of the consolidated general government sector, as a share of GDP) of **both the EU and the euro area** (EA) increased sharply to become the **highest deficit recorded** in the time series. Increases in the general government debt-to-GDP ratios of both areas exceeded the very sharp increases in the deficit, resulting in a record high level.

Following a notable expansion by 5.3% in 2021, the **EU economy is expected to grow by 2.7% in 2022 and 1.5% in 2023**[1]. However, the economic sanctions issued as a consequence of Russia's invasion of Ukraine are predicted to have a negative impact on those expected growth levels and on the EU's economies. This further underscores the importance of fiscal policies in Member States being able to respond quickly if economic growth deteriorates.

There is also an ongoing debate about **transferring funds from national budgets to the EU budget, i.e. own resources**. The implementation of the **Recovery and Resilience Facility** and the lessons learnt will be decisive in the years to come for reinforcing the **European integration process**, particularly the **Economic and Monetary Union**, while pushing for relevant investments and reforms. Such a transfer can either be made outright from national budgets or by handing over a share of tax revenues. Custom duties and VAT revenues are examples of direct funding of the EU budget, while transfers from national budgets represent the bulk of own resources for the EU budget. There is now a discussion on **surrendering tax revenues** from the Carbon Border Adjustment Mechanism (CBAM), as well as from other sources e.g. the future tax revenues from Pillar 1 in the global tax agreement. Surrendering tax revenues has implications for national public finances.

1 Summer 2022 Economic Forecast (europa.eu)

Government finance statistics contain crucial indicators for determining the health of the economies of the EU's Member States. Under the terms of the **EU Stability and Growth Pact (SGP)**, Member States pledged to keep their deficits and debt below certain limits: a Member State's **government deficit may not exceed 3% of its gross domestic product (GDP), while its debt may not exceed 60% of GDP**. If a Member State does not keep to these limits, the so-called **excessive deficit procedure (EDP)** is triggered. This entails several steps — including the possibility of **sanctions** — to encourage the Member State concerned to take appropriate measures to rectify the situation. The same deficit and debt limits are also criteria for economic and monetary union (EMU) and hence for joining the euro. Furthermore, the latest revision of the integrated economic and employment guidelines (revised as part of the Europe 2020 strategy for smart, sustainable and inclusive growth) includes a guideline to ensure the quality and the sustainability of public finances.

General government surplus/deficit and debt[2]

The **EU's government deficit-to-GDP ratio** increased from -0.5% in 2019 to -6.9% in 2020, while this ratio in the euro area increased from -0.6% to -7.2%. Both increases are the **result of the measures undertaken in response to the COVID-19 pandemic**. The economic downturn caused by the virus, as evidenced by a drop in nominal GDP (-4.3% in the EU and -4.8% for the euro area), as well as the expenditure measures to contain the economic and social impact of the COVID-19 pandemic, had a strong impact on the deficit and debt ratios.

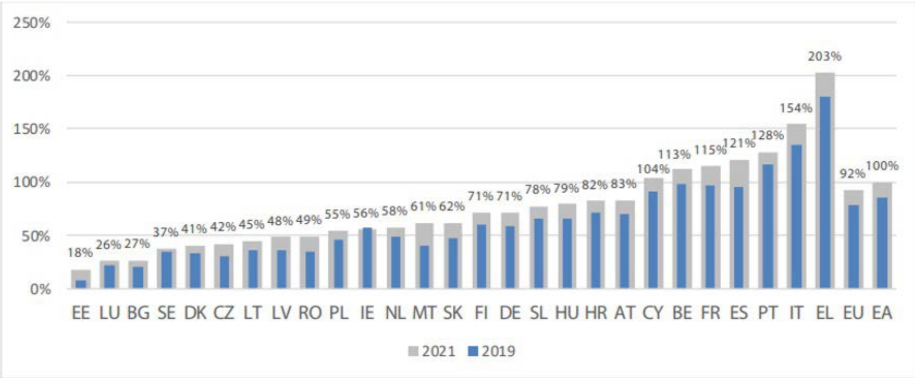
In 2020, all Member States reported a deficit. The highest deficits were recorded in Spain (-11.0%), Malta (-10.1%), Greece (-9.7%), Italy (-9.5%), Belgium (-9.4%), France and Romania (both -9.2%), Austria (-8.9%), Slovenia (-8.4%), Hungary (-8.1%), Croatia and Lithuania (both -7.4%) and Poland (-7.0%). All Member States, except Denmark (-1.1%), had deficits higher than 3% of GDP.

As a comparison, in the first quarter of 2022, the seasonally adjusted general government deficit to GDP ratio stood at 2.3% in the euro area and 2.2% in the EU. We can thus observe decreases in the deficit but they remain at a high level compared to the pre-pandemic period.

In the EU, the government debt-to-GDP ratio increased from 77.2% at the end of 2019 to 90.1% at the end of 2020, the highest in the time series. According to the Eurostat, this ratio has then decreased at 88.1% in 2021 and at 87.8% in the first quarter of 2022. See the table below indicating the magnitudes of the debt level increases between 2019 and 2021.

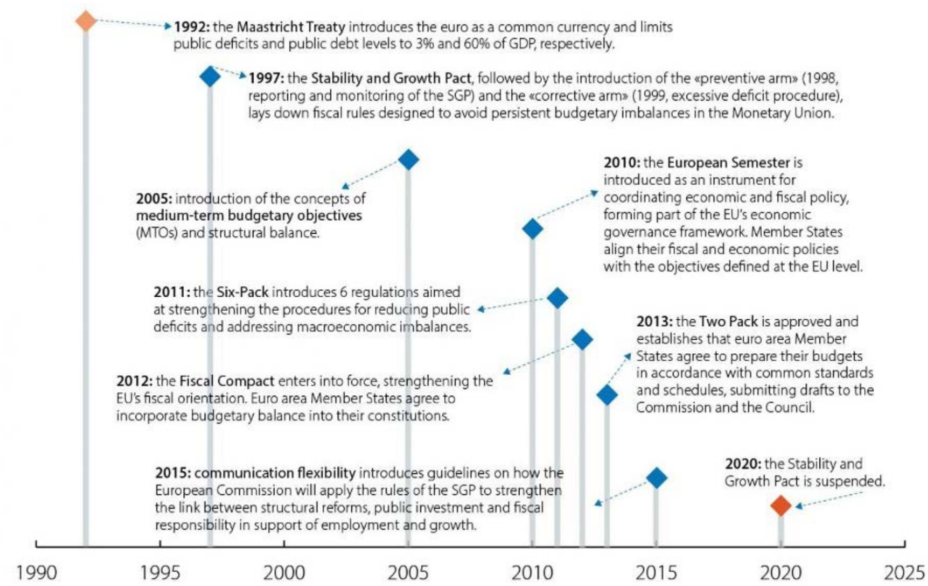
2 Eurostat deficit and debt data of 2020
Eurostat - euroindicators- first quarter of 2022 - July 2022
Eurostat - Government finance statistics - April 2022

Government debt (as % GDP) in EU Member States in 2019 and 2021



Source: *[Commission Autumn 2021 Economic Forecast]*
Note: The displayed numbers related to the forecast debt level for 2021.

The evolution of the EU fiscal rules framework



Source: *CaixaBank Research.*

It should remain the main trigger point for assessing the opportunity to initiate corrective actions in a revised framework[3].

The EESC has expressed its views in a number of opinions, most notably in an own-initiative opinion entitled *Reshaping the EU fiscal framework for a sustainable recovery and a just transition* (an own-initiative opinion from Gr. II), for which the rapporteur was Dominika Biegon, ECO/553. The opinion states that the EESC recommends[4] "**a fundamental revision of the 'investment clause'**". Firstly, the EESC suggests that the 'investment clause' in the Stability and Growth Pact should be interpreted more flexibly. So far, it has rarely been invoked, primarily because of its **restrictive eligibility criteria**. These eligibility criteria should be loosened: in principle, public investments should justify a temporary deviation from the adjustment paths, independently of the position of the Member State in the economic cycle and even if these investments lead to an excess over the 3% of GDP deficit reference value."

The opinion continues by stating that the EESC[5] "**supports the European Commission's decision to continue applying the general escape clause in 2022 and to deactivate the clause in 2023, provided that the level of economic activity reaches the pre-crisis level**. What is more, the EESC supports the European Commission's assertion that "country-specific situations will continue to be taken into account after the deactivation of the general escape clause". Finally, the Commission should put forward **guidelines for a transition period** until the new fiscal framework is in place, during which time no excessive deficit procedure should be activated, and with the option of using the "unusual event clause" on a country-specific basis. Moreover,

Some views already expressed

The European Fiscal Board (EFB) is a supporter of a **reform of the fiscal framework**, but also a strong advocate of **maintaining reference values**, as **clear and recognisable numerical goalposts** play an important role in any **solid fiscal framework**. The EFB provides tangible focal points for public debates and a basis for decision-makers' accountability in the fiscal domain. To be specific, **the 3% of GDP deficit threshold remains a useful backstop against unsustainable debt dynamics**. The headline deficit is observable, easy to interpret, and uniformly applicable to all EU countries.

3 https://voxeu.org/article/eu-fiscal-framework-case-reform
4 ECO/553 *Reshaping the EU fiscal framework for a sustainable recovery and a just transition* (own-initiative opinion – Gr II), Rapporteur Dominika Biegon.
5 ECO/553

the EESC calls on the Commission to continue without delay the revision of the EU economic governance framework, which has come to a halt. Instead of a "return", the EESC recommends a "turn" towards a **revised economic governance framework**".

In its Communication of 2 March 2022[6], the European Commission explored avenues for reviewing the economic governance framework, with the idea of achieving consensus before 2023: **debt sustainability should be ensured through gradual and high-quality fiscal adjustment and economic sustainable growth should be promoted through investment and reforms**. Member States should also have more scope to implement their fiscal adjustment plan in the medium term but, at the same time, stricter rules should be enforced in the event of non-compliance.

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The views of the Employers' Group

Since **spending and deficits typically lead to higher taxes and increased uncertainty** for decisions on investments, the **business sector will be negatively impacted by a deterioration of public finances**. It is important that years with **positive growth performance be associated with considerable fiscal consolidation**, taking into account specific national situations so that debt levels are reduced and room for fiscal manoeuvre is created, to be used in a cyclical downturn. Given the high tax burden in many Member States, **fiscal consolidation should be through expenditure control, rather than through tax increases**.

Excluding certain investment expenses, either in general, by referring to a **'golden rule'** or a **'green golden rule'**, entails the **risk of distortions and unwanted uncertainty**. The Employers' group has often argued that the use of a golden rule approach would only be acceptable if it does not jeopardise medium-term fiscal sustainability or the value of the euro. The capital stock needs to be maintained, of course, and improved to ensure economic resilience. Thus, **high-quality public investments, combined with actual structural reforms, are preferable to public consumption and outright subsidies or transfers**.

High debt levels increase the risk of a debt spiral if falling growth and automatic stabilisers increase deficits. It is important to let the automatic stabilisers work. In situations of pandemic or other profound downturns in economies, additional spending is required. The limitation is the financial burden on future generations, in particular if there is also environmental debt. **It is important that spending is used effectively to secure a fast and solid rebound of the economy as soon as the negative externality (shock) is reduced**.

Given the development of debt levels and the likely prevailing interest rate levels, a return to the objective of 60 per cent debt level seems remote. With a primary balance in public finances, the deficit level of 3 per cent would be possible to achieve, provided the interest rate level for government borrowing is not above 5 percent.

The European Semester should play a larger role in order to achieve an increase in public spending quality and the introduction of growth-enhancing reforms at national level, while pursuing a credible fiscal consolidation pathway after the pandemic. This comes at a time when many countries are feeling the need to increase defence and security spending, making it even more important to prioritise among spending items.

Strong and independent economic policy analysis and monitoring functions should be further developed at EU level. The analysis should be regular and sufficiently broad, not limited to deficit and debt figures but should also review underlying factors. The EU-level analysis function would need to work in close cooperation with national experts.

The business climate is key to the successful handling of public finances. Tax bases should be broad and distortive taxation should be reduced. The composition of taxes may change over time. **Taxes on consumption are often preferable to income taxes on capital and wages**. The overall tax burden should not increase. To have an impact on incentives for a greener and digitalised economy, environmental taxes will play a role. Such taxes will collect revenues until households and firms have adjusted their behaviours. During that period, other taxes, in particular those on investments, should be reduced. At the same time, **reduced distortive government spending and subsidies may be the most effective tool to promote a competitive economy that ensures long-term sustainability and growth**.

The Employers' group acknowledges Member States' ambition to review the existing framework in the EU. It is important to maintain reference values, as the European Fiscal Board points out, since clear and recognisable numerical goalposts play an important role in any solid fiscal framework. The subjective classification of expenditure items may lead to unwarranted debt levels. Rules relating to the management of public finances must be clear. Therefore, golden rules are not a panacea. Any temporary rules should be strictly limited in time and a transition path to permanent rules should be followed. Sound public finances are important for growth and for the well-being of citizens – in particular for those with low incomes and insecure jobs.

6 Commission Fiscal Policy Guidance 2023 (europa.eu)

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