THE LONG-LASTING POST-COVID SYMPTOM: 
THE CASE FOR THE EU FISCAL RULES REFORM?

Abstract: The paper investigates compliance with the EU fiscal rules in the period 1992–2020. The EU fiscal rules are prescribed as guidelines and represent a typical example of the soft law approach. The negative impact of the soft law approach is more visible after the periods of economic crisis (2008–2009; 2020–2022). The non-compliance with the prescribed ceilings on the level of the budgetary deficit and public debt create instability and various adverse economic effects. In the paper it is shown that existing rules are not adequate for the job they were made for. It is shown that the design and enforcement of the rules are poor, and that actually the European Commission, the watchdog, is in fact a toothless dog. The goal of the paper is to present potential reform alternatives with the aim to contribute to the reestablishment of the sound fiscal framework in the EU. The paper is concluded with the proposal of a completely new approach for the fiscal rules reform – Growth-Enhancement Fiscal Policy Switch (GEFPS).

Key words: fiscal rules, fiscal policy, Maastricht criteria, reform, EU.

1. Introduction

The Treaty on European Union or the Maastricht Treaty was concluded in 1992 between twelve member states welcoming further European integration through European citizenship, common foreign and security policies and most notably, the introduction of a single currency (Economic and monetary union). In order to support the Economic and Monetary
Union, it was necessary to safeguard fiscal sustainability in the European Union (hereafter: EU). While the monetary union has been fully centralised at the EU level, fiscal policies were, and still are, conducted at the national level. It became clear that it was of essential importance to coordinate fiscal policies to preserve debt sustainability, mutual trust between Member States and confidence of EU citizens and markets in the Euro. These rules for coordinating fiscal policies were written down in the Maastricht Treaty. They are commonly known as Maastricht criteria or Euro convergence criteria.

Maastricht criteria were set to achieve price stability in the EU and ensure that the Community is not adversely affected by new Member States. The introduction of these restrictive fiscal rules was justified by potential negative effects of one Member State on the rest of the EU. Potential debt externalities, either through spill-overs of fiscal crises or through dominance of monetary policy, could lead to inflation if European Central Bank is forced to monetise. Additional reason for constraining fiscal policies was the existence of suspicion between Member States, especially the northern states, that some of the Member States are more debt risk prone and focused on short term periods with non-existent or inadequate constraints.

Therefore, the Treaty laid down the rule that the Member States shall regard their economic policies as a matter of common concern under multilateral surveillance. Most notably, the Maastricht Treaty gave power to the Council of EU to formulate broad guidelines for the Member States’ economic policies and of the Community. These guidelines introduced performance thresholds for Member States that should be abided by to progress toward the third stage of the European Economic and Monetary Union, i.e., adopting the new common Euro currency.

These criteria are 1) high degree of price stability through low inflation rate (state rate should not be more than 1.5 p.p. higher than the average rate of the three Member States with the lowest inflation level); 2) sustainability of the government financial position through government deficit that should not exceed 3% of gross domestic product (hereafter:


3 Art. 103 of Treaty of European Union (hereafter: TEU).
GDP) and public debt must not exceed 60% of GDP; 3) observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System through stable exchange rates; and 4) durability of convergence achieved by the Member State and of its participation in the Exchange Rate Mechanism of the European Monetary System through low interest rates (state rate should not be more than 2% higher than in the three Member States with the lowest inflation). Out of these criteria, the most important ones are the ones setting deficit and debt limits as they are introduced to ensure balanced budgets and avoid excessive budget deficits. Their purpose was to allow the use of countercyclical policies that would create fiscal space to be used in recessions.

It is essential to highlight that maintaining public debt to GDP ratio below 60% in the mid and long term requires a stable economic growth rate equal to or higher than the public debt growth rate. Therefore, the crucial pre-condition for compliance with the EU fiscal rules is the productive purpose of borrowed funds to generate new private investment and, consequently, sustainable economic growth and development.

Five years after setting down the rules and signing the Maastricht Treaty, in 1997, Member States signed the Stability and Growth Pact (hereafter: SGP) when they agreed to strengthen the monitoring and coordination of national fiscal and economic policies in order to enforce the deficit and debt limits established by the Maastricht Treaty. The essence of the rules remained the same; Member States were still obliged to comply with the reference values provided in the Maastricht Treaty, but some additional obligations were introduced. Now they had to submit periodic stability (for Member States that adopted Euro) and convergence programmes (for Member States that did not adopt Euro) where they would explain how they plan to comply with the criteria.

The selection of the criteria and their values was made as an approximate indicator of economic policies for developed economies at that time,

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almost thirty years ago. However, in the years that followed, we witnessed high public debt levels across Member States, procyclical instead of counter cyclical fiscal policy, overly complex fiscal rules, poor enforceability, and scarcity of public investments. Today, especially after the Covid-19 pandemic crisis, it has become clear that these rules are obsolete and that reform is imminent. For that reason, in this paper, we will argue that the need to change the criteria is evident due to the poor design of the rules and the lack of effective enforcement. We will further support existing ideas for the reform of the rules.

2. THE NEED TO CHANGE THE CRITERIA

2.1. POOR DESIGN OF THE RULES

There were two main concerns when designing the rules that would shape European fiscal policy. On the one side, it was of essential importance that these criteria are simple and uniform for the Member States to be willing to follow them. If the rules are simple, everyone will be able to comply with them. Otherwise, in case of extreme complexity, the application could be endangered, affecting the effectiveness of the rules. Furthermore, if the rules are uniform and there is no differentiation on any basis between the Member States, it would help the credibility of the rules. Without credibility, there is no trust in the rules and no reason why Member States should comply. On the other side, it was agreed that some flexibility should be provided to make the application of the rules easier for Member States.

When the rules were first introduced, a compromise was made that considered these two concerns. As mentioned in the TFEU, Member States will conduct their economic policies in a way that would contribute to the achievement of the objectives of the Union (defined in Article 3 of the Treaty on European Union) and in the context of the broad guidelines of the economic policies of the Member States and of the Union defined in the Treaty on the Functioning of the European Union (hereafter: TFEU). Namely, the European Commission and European Council were awarded the task of defining and recommending broad guidelines of the economic policies of the Member States and of the Union to the European Parliament. Consequently, four main rules – the criteria, have been formulated in the annexed protocol to the Treaty of the European Union as the Treaty itself defines them as broad guidelines.

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7 Art. 120 TFEU.
8 Art. 121(2) TFEU.
When we talk about EU law, there are many possibilities for EU institutions to choose when setting up a common rule or policy. When it came to setting up the economic policy, a form of soft law – guidelines were chosen. As defined by the TFEU, guidelines are a form of soft law that have no binding force in itself.9 TFEU confirms this view by stating that these guidelines should be broad, i.e., that Member states should still preserve their authority regarding economic policy. Economic policies, especially fiscal policies, are still in the hands of national governments, and governments are not willing to let go of their sovereignty and give power to EU institutions in this area. Consequently, by choosing this type of enactment, it could be concluded or at least argued that Member States understood that they should only be broadly in line with the setup policy, not fully.

Time has shown that these rules were not enough for countries going through difficult times. Difficult times proved that the rules were too rigid, which led to their violations and, consequently, the need for their amendments. Several amendments were introduced starting in 2005. Created as simple rules, the later amendments turned these rules into a very complex set of rules and sub-rules.10 As mentioned in the literature, these modifications were seen more as repairs than a coherent set of rules that were not easily applied.11 A side effect of these complex rules was that not many understood them. Modifications were not only complex, but they also softened the criteria through many elements of discretion that were concerned more with political dimensions rather than economic aspect of these rules.12

Aside from their complex nature, one must question the effectiveness of these rules. The 2008 economic crisis pointed out one of their main negative aspects. What these criteria failed to do, which proved to be of vital importance for surviving difficult times, is that they did not make Member States prepare for “bad times” when they had a chance. When

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the 2008 economic crisis emerged, it was clear that Member States were not prepared, *i.e.*, they failed to build buffers in good times.\(^{13}\) By failing to make reserves in good times that would allow automatic stabilisers to diminish the impact of the decline in aggregate demand, Member States had to resort to procyclical consolidation measures and were faced with unwanted budgetary contractions.\(^{14}\) Furthermore, expenditures were used for current spending, not for investments that could help the countries in the medium and long run.\(^{15}\)

These outcomes were bad for each Member State that had to deal with them, but what made it worse in the EU was the fact that these negative impacts in one Member State spread to others, endangering the whole Union. If country-specific shocks are not cushioned, the shock is spread throughout the EU which also prolongs the time needed to recover from it.\(^{16}\)

The story repeated itself when the Covid-19 pandemic started in 2020. Not long after the world recovered from the 2008 economic crisis, the coronavirus crisis led once again to a sharp increase in public debt ratios and a decline in GDP. As the crisis was prolonged, the severe economic downturn clause from the SGP that provided for departure from the criteria had been activated.\(^{17}\)

The need for conforming to the criteria was put aside. Countries reverted to a wide range of measures to help businesses and people, including short-time work schemes and public guarantees, which all led to high expenditures.\(^{18}\) Effects of the crisis can easily be noted in the debt ratios of some Member States, which are well above the criteria threshold, 60%, and even higher than 100% of GDP.\(^{19}\) Figure 1 illustrates the changes in the levels of general government gross debt from 2000 to 2011, and finally 2020.\(^{20}\) Figure 2 highlights the Member States departing from the 60%


\(^{14}\) Beetsma, R., Larch, M., 2018; Deroose, S. *et al.*, 2018.

\(^{15}\) Beetsma, R., 2022, p. 11.


\(^{20}\) Data for 2021 are still preliminary, however, some are published in Eurostat quarterly data (GOV_10Q_GGDEBT). It does not seem that this debt today is significantly different in comparison to 2020.
criterion – quite obviously, the North-South division is starting to dwindle. In addition, the usual suspects in the EU’s East seem to abide by the rules much more than those in the West.

Figure 1. Levels of General government gross debt across the EU-27 in 2000, 2011 and 2020 as % of GDP (green = 0%, red = 200%+).21

Figure 2. Levels of General government gross debt across the EU-27 in 2020 as % of GDP, with Member States in breach of the Maastricht criterion related to debt (>60% of GDP) highlighted in shades of red (darker shade denotes higher debt).22

21 Authors’ own work. Data used to create the figures has been taken from the Eurostat database (data code: SDG_17_40), (https://ec.europa.eu/eurostat/databrowser/product/page/SDG_17_40, 10. 5. 2022).

22 Authors’ own work. Data used to create the figures has been taken from the Eurostat database (data code: SDG_17_40), (https://ec.europa.eu/eurostat/databrowser/product/page/SDG_17_40, 10. 5. 2022).
2.2. WHAT HAPPENED TO THE ENFORCEMENT OF THE CRITERIA?

Any rule to be effective, especially fiscal rules that coordinate fiscal policies of Member States, must be accompanied by clear and efficient enforcement rules. If there is no efficient enforcement of the rules, the functioning of fiscal coordination policy will be inefficient and it might trigger moral hazards between states.23 Interestingly enough, enforcement of the criteria has been viewed as the Achilles’ heel of European monetary union.24 Even though there was a mutual understanding that rules should be flexible, the fact that the flexibility was introduced through the enforcement process characterised the rules by political compromises.25 Enforcement proved to be dependent more on political decisions than a straightforward application of the rules.26

![General government gross debt, EU–27 average](image)

**Figure 3.** Level of General government gross debt in EU-27 (mean value) 2000–2020 as % of GDP.27

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27 Authors’ own work. Data used to create the figures has been taken from the Eurostat database (data code: SDG_17_40), (https://ec.europa.eu/eurostat/databrowser/product/page/SDG_17_40, 10. 5. 2022).
Consequently, Member States were never too worried about being fully compliant with the criteria.\footnote{EFB, 2021, \textit{Annual Report 2021}, p. 49.} Without teeth in good times that would make sure all Member States are compliant with the criteria and flexibility in bad times, these rules proved to have been highly ineffective since their adoption and throughout their evolution.\footnote{Bénassy-Quéré, A. \textit{et al.}, 2018, Reconciling risk sharing with market discipline: A constructive approach to euro area reform, \textit{Policy Insight}, No. 91, CEPR, p. 3.} In fact, ever since the introduction of the criteria and the Euro, the average public debt in the EU-27 has never fallen under 60%, even though at times majority of Member States were indeed below the threshold.

The European Commission and the European Central Bank (hereafter: ECB) publish every two years (usually) a convergence compliance report. The first compliance report was published in 1996 when it was noted that only three Member States were compliant with Maastricht criteria.\footnote{Commission of the European Communities, \textit{Report on convergence in the European Union in 1996} (COM.96 560 final), (https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:1996:0560:FIN:EN:PDF, 29. 3. 2022).} As a result, the introduction of the Euro was postponed for two years, when 11 out of 12 Member States were found compliant, with the exception of Greece.\footnote{European Commission, Directorate General for Economic and Financial Affairs, \textit{European Economy}, 1998, No. 65, (https://ec.europa.eu/economy_finance/publications/pages/publication8013_en.pdf, 29. 3. 2022).} In the years that followed the introduction of the Euro, it became clear that in difficult times it was difficult for Member States to remain compliant. Between 1995 and 2015, research shows that European countries complied only half of the time with national rules, while in the EU, Member States have been under Excessive Deficit Procedures around half of the time as well.\footnote{Eyraud, L. \textit{et al.}, 2018, Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability, IMF Staff Discussion Notes, p. 11; Larch, M., Santacroce, S., 2020, Tracking Compliance with EU Fiscal Rules: A New Database of the Secretariat of the European Fiscal Board, \textit{VoxEU}, (https://voxeu.org/article/tracking-compliance-eu-fiscal-rules, 29. 3. 2022).} In 2019, the EFB found that since the SGP entered into force, the average compliance rate was 57\%.\footnote{EFB, 2019, \textit{Assessment of EU fiscal rules with a focus on the six and two-pack legislation}, p. 31.} In 2020, the EFB found that ten Member States were not compliant with the criteria, the highest number since 2011 reforms.\footnote{Belgium, Estonia, Spain, France, Hungary, Poland, Portugal, Slovenia, Slovakia and the United Kingdom. EFB, 2020, \textit{Annual Report 2020}, pp. 30–31.}

Interestingly enough, Maastricht criteria are followed by the “no-bailout” provision providing that no Member State or EU will come to the...
rescue of a fellow Member State facing serious financial threats.\textsuperscript{35} The rule was intended to discourage risky behaviour, \textit{i.e.}, make countries more accountable for their fiscal policies. The rule was supposed to be strengthened by multilateral surveillance, \textit{i.e.}, peer pressure. However, in 2003 when Commission wanted to move Germany and France further down towards the excessive deficit procedure, other Member States supported them, and Council decided not to go through with Commission’s recommendation.\textsuperscript{36} Another example of giving support to the non-complying countries, despite the rules, was in 2010 and 2011, when Greece, Portugal and Ireland were awarded financial packages for overcoming serious financial crises. In the end, it seems fair to conclude that these decisions were more political decisions that made the criteria pointless.

\textbf{2.3. IS THE WATCHDOG ACTUALLY A TOOTHLESS DOG?}

In the case where it is established that the economic policies of a Member State are not consistent with the criteria, not much power has been given to the European Commission, which was supposed to be the watchdog. European Commission can only issue a warning to the Member State concerned.\textsuperscript{37} However, the recommendation as to how to remedy the situation and become compliant with the criteria that is sent to the Member State concerned is provided only if adopted by the Council.\textsuperscript{38} In the case where European Commission concludes that there is excessive deficit in a Member State, or that it might occur, it can issue a recommendation. However, again, in order for that recommendation to reach the Member State in question, it has to be adopted in the European Council. A good example of this happened in 2004 when the European Court of Justice issued a ruling by which it allowed Member States (through European Council) to postpone the implementation of recommended measures to reduce excessive deficits.\textsuperscript{39}

Amendments to the criteria introduced through six-pack changes in SGP in 2011 provided more discretion to the European Commission and Council in their enforcement. New financial sanctions (interest and

\textsuperscript{35} Art. 125 of TFEU.  
\textsuperscript{37} Art. 121(4) TFEU.  
\textsuperscript{38} Ibid.  
non-interest bearing deposits and fines of up to 0.25% of GDP) were introduced for significant deviations from necessary adjustment requirements, which provided them with ample discretion in interpreting when a deviation can be considered significant. Furthermore, a possibility to start an excessive deficit procedure for non-compliance with the debt rule was provided through these changes. However, in defining the cases in which this procedure can be used, the substantial room has been left for interpreting the newly introduced non-quantifiable factors, which once again make the enforcement of the debt rule inefficient.\(^{40}\) As evidenced through a small number of cases when Commission invoked these sanctions, and there is not one case in which it used a financial sanction, it became clear that Commission prefers to avoid their enforcement. Rather, they resort to discretion in interpreting the rules and allowing exemptions.

In 2013 new regulation on European Regional and Developments Funds\(^{41}\) has been adopted which introduced another potential sanction for Member States that fail to make necessary adjustments under the excessive deficit procedure. The Commission is provided with the possibility to suspend all or part of commitments and/or payments under funds covered by the regulation for the non-compliant Member State.

The need to change the enforcement rules was clearly mentioned in the Five Presidents’ Report for completing the EU’s Economic and Monetary Union published in 2015.\(^{42}\) One of the mentioned steps was the establishment of the European Fiscal Board (hereafter: EFB) by the European Commission. The EFB was set up in 2016 and was awarded roles not commonly given to national fiscal boards, and it was set up as an advisory board to help the European Commission implement the European fiscal framework. More precisely, EFB focuses its work on making sure that surveillance is done on an equal footing, highlighting discriminatory treatment in cases of non-compliance with the criteria and proposing reforms to the rules. Namely, the work of EFB should lead to better compliance with the common fiscal rules, a more informed public debate, and stronger coordination of national fiscal policies.


\(^{42}\) Juncker, J-C. et al., 2015.
Inadequate sanctions, depicted in both their non-enforcement or sanctions mostly focused on penalisation through financial penalties, which makes them counterproductive, are also argued to have exacerbated political tensions in the EU.\footnote{Bénassy-Quéré, A. \textit{et al.}, 2018, p. 3.} Providing crisis loans to insolvent countries by conditioning them on strict fiscal adjustment has provoked anger in insolvent countries that helped the politically extreme tendencies.\footnote{Ibid.} On the other side, it also corroborated the lack of trust of northern countries in the fiscal policies of other Member States. Northern countries advocate for tougher enforcement of the criteria and more market discipline, as they believe that more risk-sharing (advocated for by France) can be counterproductive.


\section{Reform Ideas}

Many proposals have been made for the reform of fiscal policy. On the one side, there are the ones that propose the criteria to be loosened. One such proposition is to completely change existing rules with a cap on expenditures growth that would depend on potential output growth.\footnote{Bénassy-Quéré, A. \textit{et al.}, 2018.} Additionally, there is a proposal to replace current criteria with a more vague fiscal standards that would be interpreted and enforced by a new body set up just for that role.\footnote{Blanchard, O., Leandro, A., Zettelmeyer, J., 2021.} On the other side, there are those calling for stricter rules. One such proposal is to completely delate escape clauses.
as they provide for the unequal application of the criteria while adding a limit on nominal expenditure growth. Another proposal is to add a golden rule that would provide special treatment to public investments by not calculating them in the deficit benchmark.

Important recommendations for reform of the criteria were made by the EFB in 2018. It was proposed that the focus should be on only one fiscal criterion – a debt ceiling at 60%, and the introduction of an expenditure benchmark that would impose a ceiling on primary expenditure growth. The idea behind these changes was to provide a built-in stabilising effect that the medium-term orientation would support. Furthermore, the EFB recommended a single (general) escape clause that would do away with all the existing discretionary clauses. The idea was to have an independent analysis based on economic facts rather than political, which would provide independent advice for national governments.

We propose three divergent paths for the needed reform process. While the first scenario is the most efficient from the fiscal policy perspective, it is also politically the least feasible one. The other two are more realistic from the political side, however, it is also worth noting that envisaged measures from the two could be combined into a new scenario.

The first reform endeavour towards the creation of fiscal union is completely not realistic due to the fact that this reform would fundamentally transform the essential pillars of the EU structure. It is by far the most ambitious prospect, highly unlikely to happen in the near future. With the Euro area currently facing shocks, waiting for such a development could prove detrimental for the stability of the European common currency and sustainability of the sovereign debts of its Member States.

The second option is to change and numerically adjust fiscal rules according to the prevailing levels of the budgetary deficit and public debt in the past 20 years. The enforcement of this option would require a complete change of the legal nature of fiscal rules and consequently is not politically acceptable for the EU Member States. This scenario also includes ideas from proposal already put forward by some authors, such as a cap on expenditures growth that would depend on potential output growth. This six-step approach includes coordinated introduction of common deposit insurance, followed by a simpler fiscal rule, which calls for replacing the current deficit criterion with a simpler rule, based on a long-term debt-reduction target.

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48 Feld, L. et al., 2018, Refocusing the European Fiscal Framework, VoxEU.
50 Beetsma, R. et al., 2018, Reforming the EU Fiscal Framework: A Proposal by the European Fiscal Board, VoxEU.
51 Bénassy-Quéré, A. et al., 2018.
Thus, debt planning in the long term takes precedence over the deficit rule, which might be broken due to exogenous (possibly asymmetric) shocks. New rules could include past debt levels, or only plan for the future ones.

The final option, a Growth-Enhancement Fiscal Policy Switch (GEFPS), is the only one connected with the economic policy management and is outside of the political sphere. Namely, the EU might introduce additional mechanisms to support and monitor the structure and impact of the budgetary deficits on the economic growth in the mid and long term. The enhanced impact of the budgetary deficits on the economic growth of the EU Member States would prevent further worsening of the public debt level or would even enable a stable decline of the public debt level and therefore guarantee the long-term fiscal stability. There are additional measures that could become part of this scenario, such as introduction of the incentives to diversify banks’ portfolios in order to make them less susceptible to external shocks. Also, current “no bailout” policy is working until there is a need for a bailout; a credible mechanism for restructuring of sovereign debts could make it possible for such clause to actually work in the future. Interest rates could be further lowered through novel collateral mechanisms. These could be either alternatives for the national Eurobonds in the form of bundled bonds from several or all Member States, or a special Euro fund that would serve the same purpose. Finally, introducing a new watchdog institution empowered to make executive decisions (or empowering any of the current ones) can introduce finality and predictability in the GEFSP.

4. Conclusion

Non-compliance with the EU fiscal rules has not created any serious political or adverse economic effects on any Member State. Therefore, the EU fiscal rules can be characterised as the lighthouse for sound economic policy in the mid and long term. The introduction of new fiscal rules with expanded public debt and budgetary deficit ceilings, which would respect the new reality caused by the world economic and the COVID-19 crisis, or stricter enforcement of existing ones are the most plausible policy options. Therefore, it can be anticipated that the EU fiscal rules will be revisited once the major economic concerns related to the lame economic growth and high inflation rates are finally solved.

The developed and elaborated GEFPS scenario represents an entirely novel approach for looming crises in fiscal stability of the Eurozone Member States and introduces simpler, yet more effective rules that Member States need to follow in order to keep the monetary union sustainable and successful in the future.
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DUGOTRAJNI POSTKOVID SIMPTOM: VREME ZA REFORMU FISKALNIH PRAVILA EU?
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