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The new proposed European economic governance reform

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Abstract

If governments were angels, we would not need rules. However, in an imperfect world even rules cannot be perfect. In this policy brief, we will deliver a first-hand assessment of the European economic governance reform as presented by the European Council on December 20, 2023. In the first part, we will highlight what we deem to be a conceptual flaw, consisting in the new governance framework's exclusive focus on national fiscal policies. In the second part, we will describe how the new framework works, highlighting its two main components (coordination and safeguard clauses). Finally, we will look at the potential contradiction between the two components when the reform exits the transitory period. Focusing on the case of Italy's fiscal adjustment efforts, we stress the role of the Recovery and Resilience funds in alleviating Italy's pursuit of the fiscal targets prescribed by the new governance, making the targets easily achievable in the first years. However, we notice a contradiction in the successive years, and we share the interpretation according to which the adjustment efforts commanded by the new governance are so severe for Italy as to endanger people's consensus for Europe.

The main flaw in the concept of the new governance

If governments were angels, we would not need rules. However, in an imperfect world even rules cannot be perfect. The proposed reform of the rule-based economic governance of the European Union is far from perfect. In fact, it is conceptually incoherent and politically risky. However, it increases the degree of interaction between the Member States and the European institutions and their agenda. The new rules can still build a basis for tighter integration on the inherent dynamics of stronger economic coordination.

In this brief we first present an analysis of the conceptual flaws of the new regime. Then, we try to assess which of the two systems of governance (coordination and safeguard-clauses) will prevail. Finally, we will offer some thoughts on the consequences on Italy as an exemplary case for the functioning of the new regime.

On December 20, 2023, the Ecofin Council delivered a Regulation[1] on the effective coordination of economic policies and multilateral budgetary surveillance, amending the procedure of the preventive arm of the Stability and Growth Pact. In the second Regulation,[2] the Council detailed how the fiscal corrective policies will be amended, interpreted, and implemented. The documents were the product of a long process - started in 2019, suspended during the health crisis, and relaunched in 2022 - intended to improve the economic governance framework of the European Union and specifically the effectiveness of the Stability and Growth Pact.

The proposed regulation may be gauged in at least two different ways: the first questions whether the new framework represents a comprehensive and effective form of economic governance; the second focuses on the fiscal nature of the proposal and considers whether the regulation is suited to tackle at least the fiscal issues of the Union.

Concerning the first issue, it is fairly easy to observe that, rather than providing a comprehensive framework for economic policy coordination and governance, the Regulation intends to provide a reform – prevalently, if not exclusively - of the *fiscal* governance framework of the European Union. The fiscal framework is only one part of the European Semester. It is the exercise of ongoing economic coordination, comprising the coordination and surveillance of broader economic and employment policies of the Member States, aiming to ensure that the European economies are based on stable prices, sound public finances and monetary conditions and a sustainable balance of payments. However, the coordination inherent in the fiscal component of the European Semester comes short of representing a system of comprehensive governance.

The conceptual bedrock of the fiscal component of the governance has stuck to its original design, consisting in the assumption that sustainable and stable government finances are preconditions for price stability, which is essential to a monetary union. In the neo-Keynesian models prevalent when the Stability and Growth Pact was adopted, the stabilization of inflation expectations was directly connected with the stabilization of the output gap. Once fiscal policy was stable, monetary and financial stability were expected to support credit provision, fostering economic growth.

[1] https://data.consilium.europa.eu/doc/document/ST-15874-2023-REV-4/en/pdf
[2] https://data.consilium.europa.eu/doc/document/ST-15876-2023-REV-4/en/pdf

In the course of time, however, the European economic framework has been severely tested. In the first decade after the adoption of the Stability and Growth Pact, a coincidentally strong increase in banking and financial flows caused economic and productivity divergences among the Member States. The different fiscal and productive conditions of each Member State caused asymmetric vulnerabilities in the financial shocks that jeopardized the euro area as a whole. Relying too much only on fiscal stabilization proved less than optimal to recreate convergence among the Member States. Restoring fiscal stability after the crisis of 2010-2013 was often achieved by cutting public investments, and thus undermining future growth. Sometimes, fiscal discipline also proved pro-cyclical, deepening the recessions, or failing to reduce public debts in the more favorable years.

Supply side policies, essentially structural reforms intended to facilitate the flexible response of markets to economic shocks, failed to induce the expected improvement in productivity in the lagging countries, probably because of the suboptimal quality of investments and technology. The compression of aggregate demand in fiscally unstable countries also hampered growth and capital building.

Other projects intended to address coordination problems not directly related to fiscal policies – primarily the banking union and the capital markets union – failed to reduce the level of fragmentation of the European economies. To meet both the heterogeneity of the objectives and the divergent positions of the Member States, fiscal and governance rules have become more and more complicated.[3]

Eventually, the objectives of the policies inherent in the common economic governance have gone well beyond those directly related to limiting fiscal instability and its impact on a common monetary policy, as well as to contrasting the temptation of some governments to accumulate debt to the detriment of other Member States. Year after year, the common governance has had to respond to more numerous and heterogeneous questions: how to prevent a new financial crisis in the euro area; how to favor investments and reforms, rather than low-productivity public consumptions; how to coordinate the economic cycles (and public spending) of twenty states with a single monetary policy; how to find and put together the financial resources needed to provide common answers to the problems shared by all EU Member States in a transformational age.

A change of strategy occurred after the Covid-19 pandemic. The strong policy response to the health crisis proved highly effective in mitigating its economic and social consequences. The EU's post-Covid response was also innovative, introducing a stronger link between common policies, shared financial resources, and national economic policies. This was possible because financial resources were collected through mutual debt and

[3] Before the currently proposed reform, the fiscal framework relied on:

- the Treaty on the Functioning of the EU, which set thresholds that require government deficits to remain below 3% of gross domestic product (GDP) and public debt levels below 60% of GDP
- the stability and growth pact: a set of rules and procedures to strengthen the coordination of national fiscal and economic policies in the EU, adopted in 1997
- the European Semester: an annual cycle of economic, fiscal, employment and social policy coordination within the EU, introduced in 2011
- the six-pack and two-pack legislative reforms: additional rules and procedures to strengthen the stability and growth pact, adopted in 2011 and 2013

conditioned by strong intertwinement of national economic sovereignty and European orientation and surveillance.

However, the Council's regulation mentions a significant increase in public- and private-sector debt ratios as the main result of the post-Covid strategy: "underscoring the importance of reducing debt ratios and deficits to prudent levels in a gradual, realistic, sustained and growth-friendly manner ensuring leeway for counter-cyclical policies and addressing macroeconomic imbalances, while paying due attention to employment and social objectives."

Three years after the common and solidaristic response to the pandemic crisis, the idea that European challenges can be responded to jointly, and thus strengthening European integration, has rapidly withered. On the contrary, the exceptional challenges of the time – "achieving a fair digital and green transition, including the Climate Law, ensuring energy security, supporting open strategic autonomy, addressing demographic change, strengthening social and economic resilience and sustained convergence, and implementing the strategic compass for security and defense" – have been reconducted to minor adjustments of the Union's standard economic governance framework, mainly making room in national budgets for the sustained high levels of future investment required by those challenges.

The main objective of the reform of the economic governance framework, as quoted in the Regulation approved by Ecofin on December 20, is "to ensure sound and sustainable public finances, while promoting sustainable and inclusive growth and job creation in all Member States through reforms and investment." The Council agreed on the framework's overall objective of reducing debt ratios and deficits in a gradual, realistic, sustained and growth-friendly manner while protecting reforms and investment in strategic areas such as digital, green, social or defense. At the same time the framework will provide appropriate room for counter-cyclical policies and address macroeconomic imbalances.

The revised fiscal rules should "contribute to achieving common medium and long-term policy objectives such as a digital and green transition, ensuring energy security, supporting open strategic autonomy, addressing demographic change, strengthening social and economic resilience and sustained convergence, and implementing the strategic compass for security and defence" by ensuring that enough fiscal space is allowed for in the national budgets.

A new form of divine coincidence[4] should grant that the available fiscal space in some countries be actually used for the intended common purposes. Moreover, focusing on fiscal discipline does not grant that the Member States enjoying stronger fiscal positions actually pursue the common policies, investing their savings to their full capacity at all, thus supporting also the aggregate demand in the Union. In fact, not much consideration is assigned to the aggregate fiscal stance of the euro area, although a mention is made describing the consultative role of the European Fiscal Board (art 22bis (3)). Finally, the idea of designing ad hoc adjustment processes for each country, taking into account the different starting positions, is contradicted by the common rules applied to the adjustments and by the only distinction in the adjustment rates that separates countries whose debt-to-GDP ratio is below or above the reference value of 90%. Countries like Italy,

[4] The reference is to the "divine coincidence" of neo-Keynesian models as labelled by Blanchard and others.

with a much higher debt-to-GDP ratio, are not reserved any specific consideration. This is relevant because no clear indication of the plausibility of the conditions required for the sustainability of public debt under the new regime is produced.

In terms of political economy, the conceptual framework of the new regulation consists in a displacement of resources from the current items of public expenditure to certain kinds of public and private investments. The amount of investments for the green transition is estimated around 620 billion euro until 2030.[5] A significant part of it will be carved out from national budgets, constrained by the fiscal rules, in the form of tax increases or transfer cuts. Rather than financing the outstanding common exceptional challenges with European debt, the funding for policies like the digital or environmental transition, are expected to be covered by savings within the national budgets. While paying lip service to social "resilience" in an age of great transformations and wobbly consensus for democracies, the new economic governance might imply a reduction in welfare expenditure and, consequently, problems of acceptance among the citizenry.

A recent experience in Germany, where the government charged households with the costs of its environmental agenda (through new norms imposing the purchase of heat pumps for domestic purposes), has shown how easy consensus may shift from the traditional parties sponsoring the European agenda to the new anti-European, anti-environmental policy and pro-Russian formations.

The privatization of the public agenda (requesting households to finance public policies through cuts in the transfers they received from the state) is complemented by the choice not to integrate the public agenda, inherent in fiscal policy, with the private channels of resource allocation through the banking and the capital markets unions. In fact, the focus on fiscal regulation, if the rules are less than perfect, may contribute to deepening the fragmentation of capital markets. Thus, separating fiscal policy from the rest of the governance is probably the main flaw in the conceptual framework advanced by the proposed regulation.

How it works

In this section we describe how the system is expected to function, considering the potential contradiction between the coordination exercise and the numerical references of the safeguard clauses.

After a technical dialogue with the Commission, to ensure compliance with the provisions of the new Regulation, each Member State will prepare a **medium-term fiscal-structural plan**, spanning over four or five years, whereby they commit to a fiscal trajectory as well as public investments and reforms that together ensure sustained and gradual debt reduction and sustainable and inclusive growth. Each Member State shall submit by April 30 their national medium-term fiscal-structural plans to the Council and the Commission. Those plans will be the cornerstone of the Union's economic governance framework, bringing together the fiscal policy, structural reforms, and investments of each Member State, aimed to ensuring "**sustained and gradual debt reduction** and sustainable and inclusive growth, while avoiding a pro-cyclical fiscal policy." To

[5] https://www.repubblica.it/economia/2023/12/29/news/i_25_anni_delleuro_il_valore_dellunita_in_un_mondo_in_trasformazione-421777923/

ensure a more gradual debt reduction, the adjustment period can be extended by a maximum of 3 years "if the Member State underpins its medium-term fiscal-structural plan with a set of verifiable and time-bound reforms and investments that, taken altogether, are growth-enhancing; supports fiscal sustainability; addresses the common priorities of the Union; addresses relevant country-specific recommendations addressed to the Member State under the European Semester, including, where applicable, recommendations issued under the Macroeconomic Imbalances Procedure, as well as the country-specific investment priorities without leading to a reduction in the level of nationally financed public investment over the period of the plan, compared to the medium-term level before the start of the plan."

In greater detail, the national medium-term fiscal-structural plan shall:

1) present a multi-annual net expenditure path, as well as the underlying macroeconomic assumptions and the planned fiscal-structural measures;
2) include the technical trajectory or the technical information transmitted by the Commission (...). Where the national-medium-term fiscal-structural plan includes a higher net expenditure path than in the technical trajectory issued by the Commission pursuant to Article 5, the Member State shall provide in its plan sound and data-driven economic arguments explaining the difference;
3) explain how it will ensure the delivery of investment and reforms responding to the main challenges identified within the European Semester, in particular in the country-specific recommendations, and to the common priorities of the Union including achieving a fair green and digital transition, ensuring energy security, strengthening social and economic resilience and, where necessary, the build-up of defence capabilities;
4) describe the action of the Member State concerned to address the country-specific recommendations that are relevant for the Macroeconomic Imbalances Procedure, and the warnings by the Commission, where applicable, or the recommendations by the Council, where applicable, made pursuant to Article 121(4) TFEU;
5) if applicable, explain how it will ensure the delivery of a relevant set of reforms and investments referred to in Article 13, underpinning an extension of the Member State's adjustment period by 3 years at most;
6) include the impact of investments and reforms already implemented, paying particular attention to the impact on fiscal sustainability through future public revenues, expenditures and potential growth, based on sound and data-driven economic evidence;
7) contain information related to the main macroeconomic and budgetary assumptions, implicit and contingent liabilities, expected impact of reforms and investments underpinning the extension of the adjustment period, forecasted level of nationally-financed public investment throughout the planning horizon of the national medium-term fiscal-structural plan and information on the consultations of national parliaments and other relevant stakeholders.

Plans should also include broader reforms and investments, including in relation to common EU priorities, namely the green transition, part of which consists in the European Green Deal and the transition to climate neutrality by 2050; the digital transition, including the Digital Decade Policy Programme 2030; social and economic resilience and the implementation of the European Pillar of Social Rights, including the related targets on employment, skills and poverty reduction by 2030; and the build-up of defence capabilities where

applicable, including the Strategic Compass for Security and Defence. During the lifetime of the Recovery and Resilience Facility, commitments undertaken in the national Recovery and Resilience Plans should be duly taken into account. In order to ensure the implementation of the medium-term fiscal-structural plans, the Commission and the Council should monitor the reforms and investments made in these plans under the European Semester, based on the annual progress reports submitted by the Member States.

However, allegedly in order to simplify the fiscal framework, a single operational indicator anchored in debt sustainability should serve as a basis for setting the fiscal path and carrying out annual fiscal surveillance for each Member State. That single operational indicator should be based on nationally financed **net primary expenditure** (expenditure net of discretionary revenue measures and excluding interest expenditure, cyclical unemployment expenditure as well as expenditure on Union programs fully matched by revenue from Union funds). This indicator, which is not affected by the operation of automatic stabilizers and other expenditure fluctuations outside the direct control of the government, provides leeway for counter-cyclical macro-economic stabilization. The adoption by the Commission of that single indicator in its interaction with the Member States is also meant to allow for a transparent interaction between the common Union framework and national budgetary frameworks. Based on a recommendation from the Commission, the Council should adopt a recommendation setting the net expenditure path and, as appropriate, endorse the reforms and investments underpinning the possible extension of the adjustment period.

The National medium-term fiscal-structural plans should allow for the adoption of a differentiated approach towards each Member State to take account of the heterogeneity of fiscal positions, public debt and economic challenges across the EU. Thus, the new framework will allow multi-annual country-specific **fiscal trajectories for each Member State** while ensuring effective multilateral surveillance and respecting the principle of equal treatment.

The net-expenditure indicator is derived from the **technical trajectory** that the Commission will transmit to Member States whose debt exceeds the 60% of GDP reference value or where the government deficit exceeds the 3% of GDP reference value. This multiannual net expenditure trajectory is risk-based and differentiated and would ensure that:[6]

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[6] In Annex I of the proposal advanced by the European Commission in April 2023, the technical trajectory was to comply with six criteria. "For Member States having public debt above the 60% of GDP reference value or government deficit above the 3% of GDP reference value, the technical trajectory shall ensure that:

1. *by the end of the adjustment period, at the latest, the 10-year debt trajectory in the absence of further budgetary measures is on a plausibly downward path or stays at prudent levels.*
2. *the government deficit is brought and maintained below the 3% of GDP reference value in the absence of further budgetary measures over the same 10-year period.*
3. *for the years that the Member State concerned is expected to have a deficit above the 3% of GDP reference value, and the excess is not close and temporary, the technical trajectory is also consistent with the benchmark referred to under Article 3 of Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure as amended by Regulation [X].*
4. *The adjustment effort is not postponed towards the final years of the adjustment period, that is to say the fiscal adjustment effort over the period of the national medium-term fiscal-structural plan is at least proportional to the total effort over the entire adjustment period.*

1) by the end of a fiscal adjustment period of four years, at the latest, assuming there are no further budgetary measures, the projected general government debt ratio is put or remains on a plausibly downward path or stays at prudent levels below the 60% GDP Treaty reference value over the medium-term;
2) the projected general government deficit is brought below the 3% of GDP Treaty reference value over the adjustment period and maintained below such reference value over the medium-term assuming there are no further budgetary measures;
3) the fiscal adjustment effort over the period of the national medium-term fiscal-structural plan is linear as a rule and at least proportional to the total effort over the entire adjustment period.

The technical trajectory should comply ex-ante with a **debt sustainability safeguard**. This safeguard should ensure in the design phase of the medium-term fiscal-structural plans that the projected government debt ratio decrease by a minimum annual average. This debt sustainability safeguard would act as a floor to the effort underlying the technical trajectory and the net expenditure path.

Risk-based requirements for the technical trajectory are expected to bring deficit levels below the 3% Treaty reference value. However, in order to make the framework more robust to uncertain developments of macro-fiscal variables, the technical trajectory should also provide for a common resilience margin relative to the 3% of GDP deficit Treaty reference value or convergence towards it. This **common resilience safeguard** should ensure the build-up of fiscal buffers for adverse circumstances and shocks, thereby facilitating the conduct of counter-cyclical policies in the Union's fiscal framework.

The safeguards

As previously described, the new process consists in the definition of a technical trajectory, based on a state-specific analysis of debt sustainability, and aimed at respecting two safeguards (debt sustainability and deficit resilience). The technical trajectory is expressed in terms of one single indicator, which is the net expenditure. Ostensibly, the adjustment path is conditioned by the respect of the two clauses. We briefly describe here the two safeguards that the Regulation adopts to limit the discretion in the assessment of fiscal adjustment.

The first is a **debt sustainability** safeguard, according to which, the technical trajectory shall ensure that the projected general government debt-to-GDP ratio decreases by a minimum annual average amount of:

a) 1 percentage point of GDP as long as the general government debt-to-GDP ratio exceeds 90%.
b) 0,5 percentage point of GDP as long as the general government debt-to-GDP ratio remains between 60% and 90%.

5. *the public debt ratio at the end of the planning horizon is below the public debt ratio in the year before the start of the technical trajectory*
6. *national net expenditure growth remains below medium-term output growth, on average, as a rule over the horizon of the plan."*

The average decrease shall be computed from the year before the start of the technical trajectory or the year in which the excessive deficit procedure is projected to be abrogated under Council Regulation (EC) No 1467/97, whichever occurs last, until the end of the adjustment period.

The second safeguard concerns **deficit resilience** and prescribes that the Commission technical trajectory shall ensure that fiscal adjustment continues until the Member State reaches a deficit level that provides a common resilience margin in structural terms of 1,5% of GDP relative to the 3% of GDP deficit Treaty reference value.

The **annual improvement in the structural primary balance** to achieve the required margin shall be of 0,4% of GDP, which shall be reduced to 0,25% of GDP in case of an extension of the adjustment period. The extension is subject to a set of requisites, detailed in art. 13 of the Regulation.

A Member State may also request to submit a revised national medium-term fiscal-structural plan to the Commission before the end of the period if there are objective circumstances preventing its implementation. A newly appointed government of a Member State may submit a revised national medium-term fiscal-structural plan covering a new period of 4 years or 5 years depending on the regular length of the national legislature.

An interesting innovation has been introduced through the option of activating a **national escape clause**. Following a request from a Member State and based on a recommendation by the Commission, the Council may adopt within four weeks a recommendation allowing a Member State to deviate from its net expenditure path where exceptional circumstances outside the control of the Member State led to a major impact on the public finances of the Member State concerned, provided it does not endanger fiscal sustainability in the medium term. The Council shall specify a time-limit for such a deviation.

The excessive deficit procedure

The excessive deficit procedure (EDP) for breaches of the deficit reference value of 3% of gross domestic product (GDP) (‘deficit-based EDP’), referred to in Article 126(2) TFEU[7] and Protocol N. 12, is a well-established element of the Union's fiscal surveillance framework that has been effective in influencing fiscal policy in the Member States. To strengthen the EDP for breaches of the debt criterion of 60% of GDP (‘debt-based EDP), the focus should be on departures from the net expenditure path. The Regulation allows for exceptional circumstances that need to be taken into account before assessing a violation of the excessive deficit. However, while considering all relevant factors, substantial public debt challenges in the Member State concerned should be considered a key aggravating factor. A special attenuating consideration will be devoted instead to acknowledging the rising geopolitical tensions and security challenges and the corresponding need for Member States to build-up their capabilities, the increase of government investment in defence, where applicable, should be considered as a relevant factor when assessing the existence of an excessive deficit in accordance with Article 126(3) TFEU.

[7] https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E126

The Commission, when preparing a report under Article 126(3) TFEU, shall take into account all relevant factors as indicated in that Article, in so far as they significantly affect the assessment of compliance with the deficit and debt criteria by the Member State concerned.

The report shall reflect, as appropriate:

1) the degree of public debt challenges based on the methodology referred to in Article 8 of Regulation [on the preventive arm], 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, including any implicit liabilities related to ageing and private debt;
2. the developments in the medium-term budgetary positions, including, in particular, the size of the actual deviation from the net expenditure path, in annual and cumulative terms as measured by the control account;
3. the developments in the medium-term economic position, including potential growth, inflation developments and cyclical developments compared to the assumptions underlying the net expenditure path;
4. the progress in the implementation of reforms and investments, including in particular policies to prevent and correct macroeconomic imbalances and policies to implement the common growth and employment strategy of the Union, including those supported by NextGeneration-EU, and the overall quality of public finances, in particular the effectiveness of national budgetary frameworks;
5. the increase of government investment in defence, where applicable, considering also the time of recording of military equipment expenditure.

The budgetary position shall be considered **close to balance** if the headline deficit does not exceed 0,5 percentage points of GDP. **The corrective net expenditure path under the EDP is activated when the general government deficit needs to be brought below the reference value of 3% of GDP**. The corrective net expenditure path under the EDP would in principle be the one originally set by the Council while taking into account the **need to ensure a minimum structural adjustment of 0.5% of GDP** in case of a breach of the deficit criterion or the need to correct the deviation from that path as a rule in case of a breach of the debt criterion. In case the original path is no longer feasible, due to objective circumstances, the Council should be able to set a different path under the EDP.

For Member States under an EDP, the Council, on a recommendation from the Commission, should continue to be able to extend the deadline for the correction of the excessive deficit where it establishes the existence of a severe economic downturn in the euro area or in the Union as a whole in accordance with Article 24 of Regulation (EU) [on the preventive arm], or in the case of exceptional circumstances outside the control of the government with a major impact on the public finances of an individual Member State in accordance with Article 25 of Regulation (EU) [on the preventive arm], and provided that it does not endanger fiscal sustainability in the medium term.

Where the excessive deficit procedure was opened on the basis of the deficit criterion, for the years when the general government deficit is expected to exceed the reference value, **the corrective net expenditure path shall be consistent with a minimum annual structural adjustment of at least 0,5% of GDP as a benchmark.**

Where the excessive deficit procedure was opened on the basis of the debt criterion, the corrective net expenditure path shall be at least as demanding as the net expenditure path adopted by the Council in accordance with Article 16 of Regulation (EU) [on the preventive arm] and correct as a rule the cumulated deviations of the control account by the deadline set by the Council.

To keep track of actual deviations from the net expenditure path as set out in Article 21 of Regulation (EU) [on the preventive arm], the Commission will set up a **control account** for each Member State summing annual deviations over time. The information in the control account, the cumulated deviation, should be the basis of enforcement actions. The Commission shall prepare a report in accordance with Article 126(3) TFEU when the ratio of the government debt to GDP exceeds the reference value, the budgetary position is not close to balance or in surplus and when the deviations recorded in the control account of the Member State either exceed:

(a) 0,3 percentage points of GDP annually, or

(b) 0,6 percentage points of GDP cumulatively.

Transitory period

In art 24 of the new Regulation on the corrective arm of the governance, transitional provisions are included for Member States that are under an EDP when the reformed framework enters into force. Recommendations under Article 126(7) TFEU[8] and notices under Article 126(9) TFEU[9] that have been adopted prior to the entry into force of the amending Regulation need to be revised. This would allow the Council to set a corrective net expenditure path consistent with the new provisions for Member States that have taken action, without stepping up the excessive deficit procedure.

In a further specification, the Regulation adds that "whereas the rules of the deficit-based Excessive Deficit Procedure remain unchanged with a minimum annual structural improvement of at least 0,5% of GDP as a benchmark, against the backdrop of the significantly changed interest rate environment, the Commission may, for a **transitory period in 2025, 2026 and 2027** – in order not to compromise the positive effects of the Recovery and Resilience Facility – adjust the benchmark to take into account the increase in interest payments when setting the proposed corrective path relating to the first medium-term fiscal-structural plan for the years 2025, 2026 and 2027 within the Excessive Deficit Procedure, provided the Member State concerned fulfils the conditions laid out in Article 11 paragraph (c) of Regulation (EU) on the preventive arm (listed above on page

[8] Where the Council decides, in accordance with paragraph 6, that an excessive deficit exists, it shall adopt, without undue delay, on a recommendation from the Commission, recommendations addressed to the Member State concerned with a view to bringing that situation to an end within a given period. Subject to the provisions of paragraph 8, these recommendations shall not be made public.

[9] If a Member State persists in failing to put into practice the recommendations of the Council, the Council may decide to give notice to the Member State to take, within a specified time limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation. In such a case, the Council may request the Member State concerned to submit reports in accordance with a specific timetable in order to examine the adjustment efforts of that Member State.

5), consistent with the objective of achieving a green and digital transition and the build-up of defense capabilities.

Coordination or rules: which system will prevail?

An unusual degree of confusion surrounds the first evaluations of the efficacy of the new system. The uncertain impact of the new rules is due to the coexistence of two different methods of policy coordination. The first is dictated by the complex interaction between the European Commission and the Member State; the second consists in the application of the safeguard clauses. If we stick to the letter of the Regulations, there should be no doubt about which method will prevail: the technical trajectory should comply ex-ante with a debt sustainability safeguard. This safeguard should ensure in the design phase of the medium-term fiscal-structural plans that the projected government debt ratio decrease by a minimum annual average. This debt sustainability safeguard would act as a floor to the effort underlying the technical trajectory and the net expenditure path.

The reason why the new regime is generally considered less demanding in terms of fiscal adjustments required of Member States is due to the abolition of the pre-existing rule of the debt, which required a yearly cut of 5% of the debt-to-GDP ratio exceeding the reference value on average over three years. For Italy, that would have amounted to 4% of GDP, relative to the debt-safeguard requesting a yearly cut of only 1%. In fact, the debt-rule was never applied, it was unanimously deemed unrealistic, and its impracticality was the main reason for the effort to design a new framework.

The second reason is that the target of the adjustment is less challenging than the country-specific Medium-Term-Objective that has been, so far, the anchor of the structural balance, to be reached in at most four years. Again, for Italy, the MTO prescribed the achievement of a structural budget surplus of 0.25% of GDP, while with the current regulation the objective sets the targeted deficit-to-GDP at -1.5%. Although the DSA-based objective under the newly proposed system is similar to that pertaining to the MTO (*"ensure the convergence of the debt ratio towards prudent levels, with due consideration to the economic and budgetary impact of ageing populations"),* the latter was "calculated via a formula that ignores uncertainty and does not check the robustness of the convergence of the debt ratio to unfavorable events. At the same time, it penalizes countries with high debt levels using an *ad-hoc* parametrization."[10] In practice, this approach led to MTOs fluctuating within a relatively narrow range, from -1 to +0.75. In contrast, what matters under the proposed approach is less the level of debt than the fact that projected debt above 60 percent is on a falling trajectory with high probability and in a variety of stress scenarios.

The third reason is that the transitory period is particularly benevolent. As we have seen, the required debt reduction is lower than the normal in the first years. In particular, the fiscal adjustment between 2025 and 2027 takes into consideration both the costs inherent in the allegedly high-interest-rates environment and the need

[10] Darvas, Weislau and Zettelmeyer (2023) "A quantitative evaluation of the European Commission's Fiscal proposal". Working paper 16/2023 Bruegel - https://www.bruegel.org/sites/default/files/2023-09/WP%2016_3.pdf

not to squander the effort of implementing the National Recovery and Resilience Plans. In this regard, a factor is played by the accounting of fiscal transfers. Each year, Italy receives funds equivalent to 2.5% of its GDP. They are reflected in the GDP only once they become actual payments (investments) to the real economy. At that point, they produce revenues for the State that could be estimated between 40 and 50% of their amount. Since interest rates on those funds are not calculated, the deficit-to-GDP ratio benefits from a substantial increase in the revenues and from some increase in the GDP itself. This should make the transitory period a golden moment for the fiscal balance.

A different picture emerges from the simulations regarding the years after the transitory adjustment period, that is, after 2027. Given the lower fiscal adjustment in the first four years, 2024-2027, the following years are connotated by a significant challenge in respecting both the deficit and the debt safeguards. On the one hand, the regulation indicates that once countries have exited the EDP, and their deficit is below 3%, they are expected to pursue a deficit adjustment path with deficit declines of 0.4% in four years or 0.25% in seven years: leading in both cases the deficit-to-GDP below 1.5%. Since the latter requirement is equally valid for all Member States, however, it is not entirely obvious how this rule will impact the very differentiated levels of public debt connotating the different countries. Moreover, in this case the target for the primary budget (0,25% each year for seven years) is at loggerheads with the safeguard clause concerning debt sustainability, which prescribes an average decline of the debt-to-GDP ratio by 1% each year. This contradiction needs to be tackled by the debt-sustainability-analysis of the European Commission. The DSA needs to be transparent and consistent to design a reasonable "technical" trajectory for the reduction of the net expenditure. However, given the letter of the Regulations, there should be no doubt about the prevalence of the debt-rule over the deficit-rule.

Theoretically, at a stationary situation, if Italy pays yearly interests on its public debt of around 4-5% of its GDP, and must attain a deficit of 1.5%, it will need to have a stable level of primary surplus around 3% of GDP consistent with exiting the EDP. In Italy's case, however, it is very unlikely that a deficit of 1.5% is consistent with the debt-sustainability clause. Much depends on economic circumstances, which are impossible to fathom in advance. Yet, with a nominal growth around 3%, stable inflation (around 2%) and euro-area interest rates between 2 and 3%, the primary surplus should be around 4% to reduce the debt-to-GDP ratio by 1% each year. Similarly, an often-cited simulation by Bruegel[11] sees Italy with a required structural primary surplus of around 4.6% on a seven-year adjustment. Maintaining a structural primary surplus of that level for decades would prove daunting. No country has ever managed to sustain a similar fiscal effort for very long periods. Italy would need to keep it for 20 years only to bring its public debt closer to 120% of GDP. Such an endeavor should hold firm through different legislatures and political orientations. It is very likely that, given its starting position, with a debt-to-GDP ratio of around 140%, uncertainty over Italy's future public debt levels will still command interest rate premia on Italy's government bonds and a positive r-g differential, making it even more difficult to reduce the debt-to-GDP level.

The fact that the net expenditure is the main instrument for steering fiscal policy will make the cost of the fiscal adjustment very clear to the citizens. Given the amount of cuts in expenditure or increase in taxation, households may perceive the policies aimed at funding the common European projects, through further

[11] Darvas et alia, ibidem

welfare taxes or tax increases, as a vexation. This might endanger the people's consensus for the European project.