EU's Fiscal Framework - identified shortcomings and proposed remedies

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Tiivistelmä

Finanssipolitiikan säännöt pyrkivät rajoittamaan hallitusten taipumusta alijäämiin, ja ohjaamaan finanssipolitiikkaa pitkällä aikavälillä kestävään suuntaan. Valuuttaunionissa yhden maan velkaantumisella voi olla haitallisia vaikutuksia muihin jäsenmaihin. Siksi EU:n finanssipolitiikan säännöillä pyritään viime kädessä turvaamaan jäsenmaiden velkakestävyys.

Käytännössä on vaikea laatia sääntöjä, jotka rajoittavat riittävästi, mutta jättävät tarvittavaa finanssipoliittista liikkumavaraa. Ajan myötä EU:n sääntökehikosta on tullut monimutkainen ja heikosti jäsenmaita ohjaava. Sääntökehikon uudistamiseksi on ehdotettu velkakestävyyden korostamista numeeristen raja-arvojen sijaan, maakohtaisuutta, velkaantumisen vähentämistä nousukausien vastasyklisellä finanssipolitiikalla, havaittaviin muuttujiin perustuvaa operationaalista tavoitetta sekä suurempaa roolia kansallisille finanssipolitiikan valvojille.

Näiden elementtien lisäksi komission marraskuussa 2022 julkaisemat suuntaviivat muuttaisivat sääntelyyn liittyvää prosessia. Kukin jäsenmaa neuvottelisi oman nelivuotisen rakenne- ja finanssipoliittisen suunnitelmansa komission kanssa, ja sitoutuisi sen toimeenpanoon tiukemman ohjauksen ja uudenlaisten sanktioiden uhalla. Maakohtaisuuden lisääminen ehdotetusti johtaisi hajautuneempaan finanssipolitiikkaan, ja olisi askel säännöistä kohti finanssipolitiikan standardeja EU:ssa. Ehdotus yksinkertaistaisi EU:n finanssipolitiikan kehikkoa monilta osin. Kansalliseen finanssipolitiikan kehikkoon vaikuttaisi erityisesti muutos prosessissa, jossa jäsenmaalla on oltava neuvotteluvalmius komission kanssa ja näkemys siitä, millaiseen finanssi- ja rakennepolitiikkaan sitoutua neljäksi vuodeksi.

Abstract

Fiscal rules seek to limit the tendency of governments to run deficits, to steer them towards countercyclical and sustainable long-term fiscal policy. In a monetary union, a sovereign debt crisis caused by over-indebtedness of a member state can cause negative externalities to other member states. EU fiscal rules aim at containing these debt-related externalities by ensuring debt sustainability in each member country.

The creation of effective but contingent common fiscal rules in Europe has proved to be a difficult task. The result is a complex framework that does not guide Member State's fiscal policy as intended. Experts supporting reform emphasize debt sustainability instead of thresholds to be reached within a certain time frame, country-specificity, expenditure ceilings, that rely on an observable indicator, as the main operational rule and a greater role for national independent fiscal institutions.

In addition to these improvements, the Commission's orientations of November 2022 outline a new process, where each Member State would negotiate its own 4-year fiscal-structural plan with the Commission. New

sanctions and stricter enforcement are foreseen to improve political commitment. While the framework would be simpler, the increasing country specificity would lead to more fragmented fiscal policy in Europe and would be a move away from fiscal rules towards standards. An important implication for the national framework is related to the bilateral negotiations, which would require a clear vision of the fiscal and structural policies the Government would be committing to for the following four years.

Introduction

Fiscal rules seek to limit the tendency of governments to run deficits, to steer them towards effective countercyclical measures and, essentially, towards sustainable long-term fiscal policy (von Hagen, 2002; Fatás & Mihov, 2003; Beetsma & Larch, 2019). In a monetary union, a sovereign debt crisis caused by over-indebtedness of a member state can cause negative external effects to other member states and even systemic shocks. The over-indebtedness of a Member State is also a risk to the independence of the European Central Bank (ECB), as the need to avoid a financial crisis may make it impossible for the ECB to refrain from going against its mandate and taking action to rescue the over-indebted state (Eichengreen & Wyplosz, 1998; Beetsma & Larch, 2019, European Commission, 2020). Containing these debt-related externalities in a monetary union therefore implies ensuring debt sustainability in each member country. Against this background, the design of supranational rules like the EU's fiscal rules differs from the design of national fiscal rules (Blanchard et al. 2021).

The creation of effective common fiscal rules in a Europe comprised of sovereign nation states has proved to be a difficult task. This background report for Finland's Economic Policy Council first presents the main challenges identified in the EU's fiscal framework, and then summarizes the relevant proposals made recently to address the identified challenges, emphasizing the implications for the national fiscal framework.

The European Commission reviewed the EU's Economic governance framework in 2020, just before the pandemic, and updated its review in 2021. Commission's main findings are in line with the views presented by many others and, therefore, a consensus among experts on the main revision needs of the EU's fiscal framework seems to have emerged. The rules have been repeatedly violated because they are not sufficiently contingent and are hard to enforce, which has led to even more complexity and to a lack of ownership by Member States (Blanchard et al. 2021). The revision of the framework will be undertaken by the EU's Member States.

What the proposals broadly have in common is a return to the basics as intended in the Treaty - avoiding gross policy errors. Experts supporting reform agree on the need to aim at declining debt ratios by avoiding pro-cyclicality in good times. Debt sustainability is emphasized instead of thresholds to be reached within a certain time frame, and there is support for tailoring the framework to country-specific circumstances. Many suggest expenditure ceilings, that rely on an observable indicator, as the main operational rule. Finally, a greater role for the Member States' independent fiscal institutions (IFIs) in the monitoring and implementation of national fiscal frameworks is often envisaged. In many proposals some sort of a macroeconomic stabilization tool for the EU is also recommended to create fiscal space and to support monetary policy.

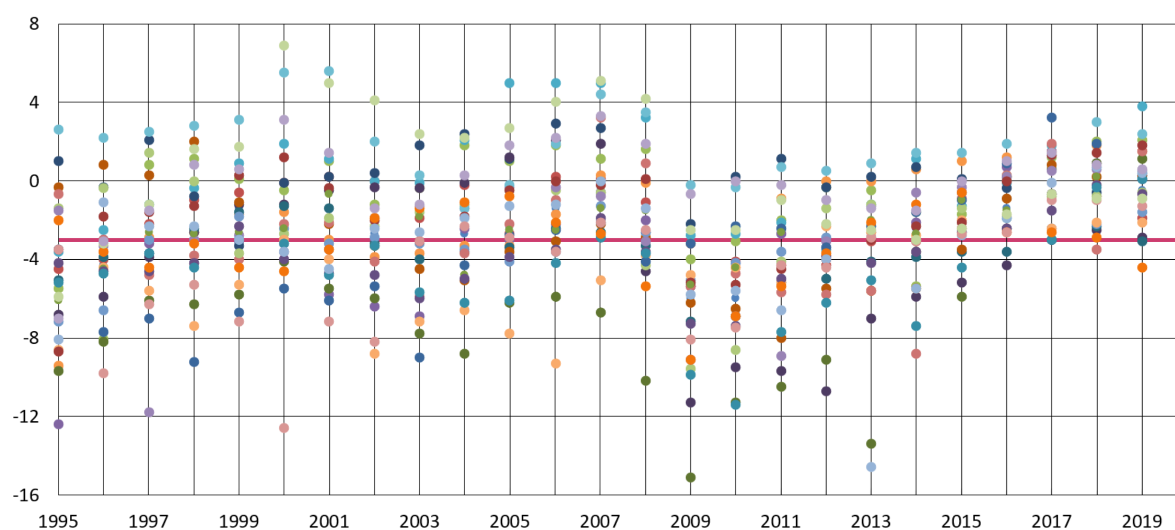
Commission released a communication on orientations for a reform and hence on the possible direction for compromise in November 2022 (European Commission 2022b). The orientations are heavily influenced by the recent experience with the Recovery and Resilience Facility (RFF) of the Next Generation EU (NGEU), and of the national Recovery and Resilience Planning (RRPs) process. Aligning the fiscal framework with the governance structure of the RRF has already gained support from Spain and the Netherlands - two Member States that in the past have often had diverging views on issues relating to fiscal policy. While Member States would gain more freedom in designing their medium-term fiscal

trajectories, this would come at a cost of stricter monitoring and stronger enforcement by the Commission. In addition to containing those elements on which there is agreement among experts, the orientations imply a move away from rules towards standards and have a debt sustainability analysis as a starting point, as suggested by Blanchard et al. (2021), among others.

1. Main shortcomings of the EU's fiscal framework

This section presents an overview of the main challenges of the EU's fiscal framework to gain a thorough understanding of its shortcomings[1]. Some of the issues are related to the design of the rules themselves, while others stem from the way the framework is implemented, and compliance with the rules is assessed. The need for revision therefore goes beyond the EU's numerical fiscal rules.

Figure 1. Budgetary positions of EU countries 1995-2020, % of GDP (excl. Ireland's large deviation in 2010)



The dots depict the budgetary positions of EU countries in different years. **The red line** marks the 3% deficit level contained in the rules.
Source: AMECO database.

To summarize, the experience of recent decades shows that there are significant differences between European countries in terms of both their preferred fiscal policy and also the policy they implement in practice. Differences in economic conditions and structures but also in political preferences are all reflected in the large range of budgetary positions seen across the EU (Figure 1). Although efforts have been made for many years to guide the fiscal policy of Member States through common fiscal rules, public indebtedness within the EU has not, on average, fallen during economic upturns, nor have sufficient economic buffers been created for downturns[2]. Since non-compliance with the EU fiscal rules is common (Larch & Santacroce 2020, Eyraud et al. 2017, Gaspar & Amoglobeli 2019), the procyclicality of fiscal policy seems to stem more from the failure of the rules to steer fiscal policy rather than from the procyclicality of the rules themselves (Larch et al. 2021, Gootjes and de Haan 2022, Arnold et al. 2022).

[1] Sections 1.2 and 1.4 are based on Kuusi and Puonti (2021).

[2] On the pro-cyclicality of fiscal policy in the European Union countries, see for example Eyraud et al. (2018), European Commission (2020), Larch and Santacroce (2020), Larch et al. (2021), Gootjes and de Haan (2022).

1.1. Overview of the current fiscal framework

The Maastricht Treaty laid the foundations of the single currency area in 1992. To protect price stability and central bank independence from excessive public indebtedness, the Treaty requires Member States to avoid government deficits exceeding 3 % of GDP and to keep public debt levels below 60 % of GDP. Since then, the Union has developed a very comprehensive and detailed framework of fiscal surveillance laid down in secondary legislation and other documents (European Commission 2020) [3].

In 1997 the Stability and Growth Pact (SGP) was established to strengthen the monitoring and coordination of national fiscal and economic policies. The *corrective arm* of the SGP takes appropriate measures to correct excessive deficits or debt levels, while the *preventive arm* of the SGP aims at avoiding the build-up of excessive deficits. At the heart of the preventive arm is the medium-term objective (MTO), which is expressed as a target level for the structural balance over a three-year interval.

In 2005 the SGP was reformed to take account for the impact of economic cycle and country-specific features on government finances. After the economic and financial crisis in 2007, the economic governance framework was further strengthened with legislative packages known as the Six-Pack (in 2011) and Two-Pack (in 2013). The review recently undertaken by the Commission focusses specifically on these two legislation packages[4].

In brief, the Six Pack reform strengthened both the preventive and corrective arms of the SGP. To create fiscal space in Member States during good economic times, it introduced the concept of a significant deviation from the medium-term budgetary objective or from the adjustment path towards it and established the Significant Deviation Procedure to correct such a deviation. Expenditure benchmark was introduced to complement the structural balance. In the corrective arm, the reform operationalized the Treaty's debt criterion, which requires Member States to approach the 60% debt-to-GDP-ratio at a satisfactory pace, by introducing the debt reduction benchmark. The monitoring of both budgetary and economic policies was organized under the European Semester, and minimum requirements for national budgetary frameworks were introduced.

The Two Pack reform further strengthened budgetary coordination among euro-area Member States by requiring submission of budgetary plans to the Commission for opinion and multilateral assessment before adoption by national parliaments[5].

In addition to the EU level legislation, Finland is bound by the Treaty on Stability, Coordination, and Governance of 2012 (TCSG), an intergovernmental Treaty with which countries agreed to take the structural balance objective into their national legislation. In case of a significant deviation from the fiscal path leading to the MTO[6], the national legislation also requires the activation of a correction mechanism, whereby the Government is required to correct the deviation.

Another relevant element of the national fiscal framework is the requirement for an annual Government Fiscal Plan[7], where the government sets multiannual targets for public expenditure, revenue and debt ratio as well as sets the medium-term objective (MTO) for the structural balance. The main operational tool is the Finnish expenditure ceiling for budgetary expenditure, also reported in the Government Fiscal

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[3] These documents include the Code of Conduct of the Stability and Growth Pact and the Code of Conduct of the Two-Pack, Vade Mecum on the Stability and Growth Pact and the Compendium on the Macroeconomic Imbalance Procedure.

[4] For the full history and details of the Stability and Growth Pack, see e.g. https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/history-stability-and-growth-pact_en

[5] In addition to strengthening fiscal surveillance, the Six-Pack reform introduced the Macroeconomic Imbalance Procedure (MIP) and the Two Pack established a framework for dealing with Member States with financial stability issues.

[6] Significant deviation as defined in the EU-legislation.

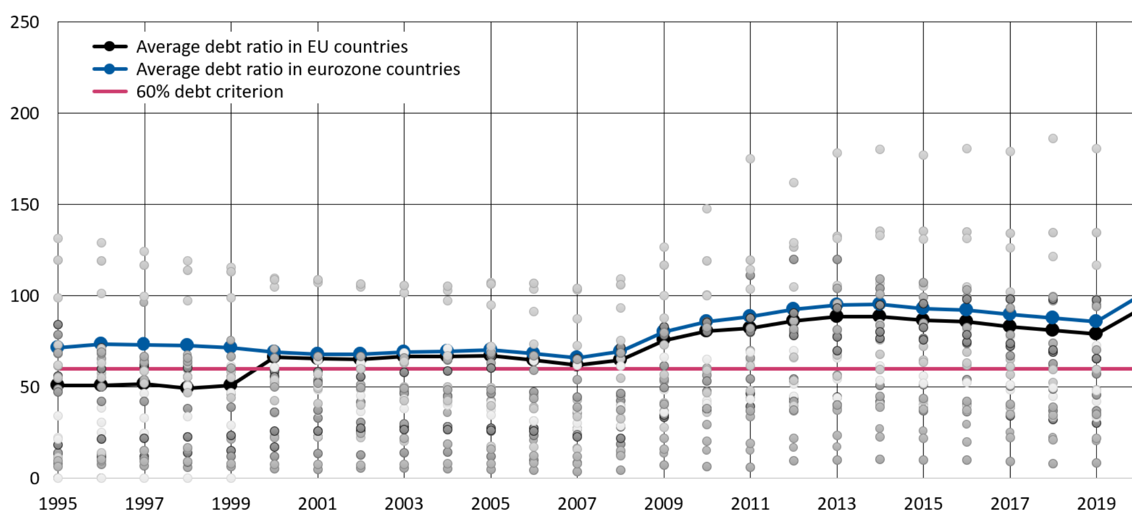
[7] Valtioneuvoston asetus julkisen talouden suunnittelusta, 120/2014.

Plan. In addition to these, the Government sets its own fiscal targets in the Government Program, such as the general government fiscal balance target in the initial Antti Rinne/Sanna Marin's Government Program, later substituted by the target to bring the public debt ratio on a downward path by mid-2020s.

1.2. The old deficit and debt rules are weak and inconsistent

At the time of the Maastricht Treaty, the EU's average nominal economic growth was 5%, so a deficit of less than 3% was sufficient to stabilize the debt ratio at 60%, the average debt ratio at the time. The debt criterion was therefore irrelevant in practice: compliance with the deficit rule was sufficient to comply with the Stability and Growth Pact (Larch & Santacroce, 2020). Between 2010 and 2019, economic growth in EU countries averaged only 2.7%. In the context of low economic growth and inflation, a deficit of 3% stabilizes the debt at a much higher level of around 100% (Kamps & Leiner-Killinger, 2019). This means that under the conditions of slow economic growth and low inflation that prevailed for long, the deficit and debt limits set in the Maastricht Treaty are no longer consistent.

Figure 2. Debt ratios in the EU countries 1995-2020, % of GDP



The dots depict the debt-to-GDP ratio of EU countries in different years.
Source: AMECO database.

The slowdown in average nominal economic growth was also one of the reasons why the debt criterion was supplemented with the debt reduction benchmark[8] to keep debt ratios on a downward trajectory (Larch & Santacroce, 2020).

Figure 2 shows that although many countries' debt ratios have declined, very high debt ratios have been rather persistent, making rather slow progress towards the 60% mark. Nonetheless, countries have not been subjected to the Excessive Deficit Procedure (EDP) in particularly large numbers for breach of the debt criterion after 2013–2016.

The reasons behind this are the many forms of flexibility in the rules and the Commission's discretionary powers in the interpretation of the debt criterion. In the wake of the financial crisis, the flexibility of the rules was increased through the introduction of the Six Pack and Two Pack regulations. Within the preventive arm, for example, flexibility was enhanced with the addition of the investment and restructuring

[8] Member States are required to reduce the difference between the debt-to-GDP ratio and the 60% threshold at an average rate of one-twentieth per year over a three-year period.

clauses, which have also been utilized by Finland[9]. In practice, fulfilment of the 3% of GDP deficit criterion and compliance with the less demanding preventive arm of the Stability and Growth Pact, i.e. the adjustment of the structural balance, have been sufficient for countries to avoid facing an Excessive Deficit Procedure (Kamps & Leiner-Killinger, 2019).

Due to the discretionary decisions countries have not been subject to the EDP, and they are bound in practice only by the structural deficit rule of the preventive arm. According to this rule, a country that has achieved its country-specific structural balance objective should remain at this level. If the objective has not been achieved, the country must make progress towards it by adjusting its structural balance at a pace that depends on both the stage of the business cycle and the country's debt ratio.

1.3. The pace of debt reduction required by current rules is seen as unrealistic for some Member States

The government debt-to-GDP ratios in the European Union's member states increased from 79,1 % at the end of 2019 to 89,7 % at the end of 2021. As a result of the COVID-19 -pandemic, the average debt ratio of the EU countries peaked at its historically highest level (Figure 3). While in many countries the debt ratio remained below the 60 % threshold, in others public debt has been accumulating faster than the GDP for long. The European Commission expects public debt ratios to remain above 100% of GDP in six Member States in 2023, while staying below 60% of GDP in about half of the Member States (European Commission 2022a).

Simulations by Hauptmeier et al. (2022) imply that fiscal consolidation in line with the EU's current fiscal rules as enshrined in the Stability and Growth pact would mean achieving the debt reference level of 60 % of GDP within twenty years. At the same time, governments' reactions to the war in Ukraine, increasing consumer prices, climate change and the ensuing green transition as well as demographic change will put further pressure on public finances, and hence on the debt ratios. Altogether this means that it will be very challenging for countries to bring debt ratios significantly down in the near future. Accepting higher debt levels – either permanently or for long – therefore seems inevitable.

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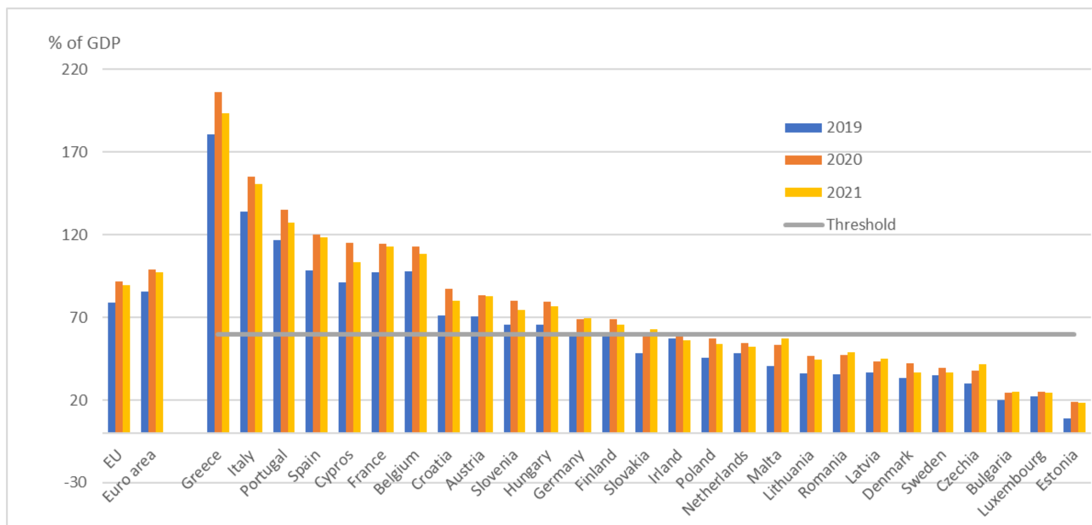
[9] See, for example, https://www.consilium.europa.eu/en/policies/stability-growth-pact-flexibility/

Figure 3. Government debt as a share of GDP in EU Member States in 2019, 2020 and 2021. Source: AMECO Database



Even before the COVID-19 crisis, the European Commission (2020) acknowledged that enforcing the debt reduction benchmark when growth is weak, and inflation low has proven politically and economically difficult. Especially in some of the highly indebted countries, imposing the debt reduction benchmark would have required such high fiscal efforts that it would have been counterproductive (Arnold et al. 2022).

Therefore, as foreseen by the Six-Pack legislation, the Commission's assessment of compliance with the debt criterion has taken into account all relevant factors, including low inflation and weak growth as well as compliance with the preventive arm of the SGP (European Commission 2020). Weak enforcement of the debt rule and of the debt reduction benchmark has led to a growing importance of the less demanding preventive arm of the SGP and, hence, of the structural balance[10].

1.4. The preventive arm of the SGP has failed to guide fiscal policy sufficiently

The Six Pack and Two Pack legislations emphasize the importance of avoiding pro-cyclical fiscal policy. They aim to ensure that Member States build fiscal buffers in economic good times and allow automatic stabilizers to provide fiscal stimulus in bad times, and to increase investment. In practice this is achieved by requiring Member States to adjust their budgetary position in structural terms so that the required adjustment depends on the Member States' position in the economic cycle and the debt ratio.

Nonetheless, fiscal policies have remained largely pro-cyclical and many Member States did not build fiscal buffers during economic good times (European Commission 2020, Larch and Santacroce 2020, Larch et al. 2021 Gootjes & de Haan 2022.) In the years preceding the pandemic, in both high-debt countries (Spain, France, Portugal, Italy) and in Finland, the adjustment has remained below that required by the rules so that public finances have not strengthened enough to result in an overall reduction of the debt ratio (European Commission 2020, Kuusi and Puonti 2021, Arnold et al. 2022).

The insufficient structural adjustment is partly due to the fact that the measurement of the structural deficit at the key transition points in the business cycle has proved to be very difficult, leading to different

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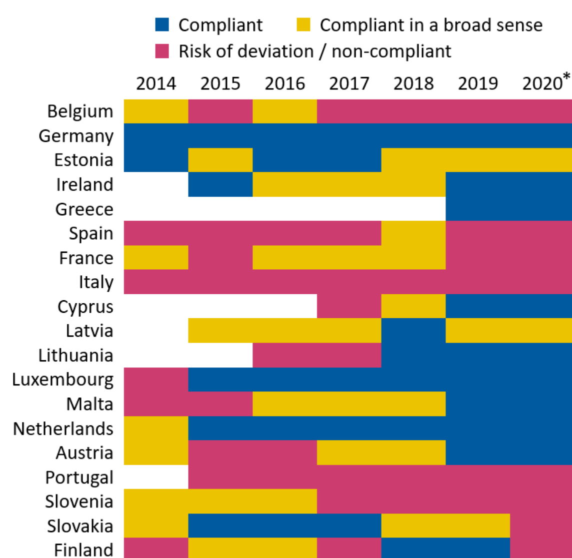
[10] Larch and Mazubris (2022) have recently questioned the focus on the structural balance at the expense of the debt rule by showing that the major difference in the consolidation effort required by the debt rule compared to the structural balance lies in the time frame. While the debt rule requires a larger initial adjustment than the structural balance, the opposite happens in the long term. Their simulations show that the overall adjustment is broadly the same, so that what matters, is compliance over time.

fiscal policy recommendations in real-time and ex-post. In addition, the indicator requires numerous technical assumptions that make its use politically difficult, as it is hard for politicians to explain their fiscal policy to supporters if its objectives are not understandable. As a result, the concept of structural balance is beyond the reach of policy makers[11] (Kuusi and Puonti 2021.) It can therefore rightly be said that the structural balance has not anchored its position in fiscal policy in the same way as, for example, national spending limits procedures[12].

This is reflected in the fact that Member States do not always even make advance plans for fiscal policy that would meet the criteria of the Stability and Growth Pact. The European Commission assesses ex-ante Member States' draft budgetary plans in the autumn of each year. Figure 4 shows that, between 2014 and 2020 (prior to the pandemic), many euro countries submitted to the Commission a budget (a draft budgetary plan covering the entire public sector) that did not comply with the EU's structural balance rules. This was particularly the case for heavily indebted countries but is also true for Finland[13]. According to the Commission, the annual surveillance and assessment of compliance has weakened the medium-term perspective and led many Member States to repeatedly postpone the achievement of the medium-term budgetary objective (European Commission 2020).

Figure 4. Many countries of the euro area, year after year, submit a draft budgetary plan to the commission that is not in line with the preventive arm of the Stability and Growth Pact



1.5. Inability to promote the quality of public expenditure

The EU's fiscal framework underlines the importance of public investment in supporting sustainable public finances, and the framework contains provisions to protect public investment and to incentivize the implementation of structural reforms (European Commission 2020.) Nonetheless, the framework has

[11] This was recently confirmed by the National Audit Office of Finland, which interviewed the Finnish public administration and found, that the multiple rules and criteria used for assessing compliance, reduce ownership of and commitment to the EU's fiscal rules (Valtiontalouden tarkastusvirasto, 2021)

[12] Raudla and Douglas (2020) provide research evidence for Ireland, Austria and Portugal.

[13] Countries were then asked to change their fiscal plans to comply with the SGP, and when assessed ex-post by the Commission in the spring of the next year, only one country was identified at significant deviation or at non-compliance. This partly reflects the fact that "numerical compliance" does not necessarily correspond to "legal compliance" assessed by the Commission using its discretionary judgement (Feld & Reuter 2022).

not been able to prevent a decline in public investment, nor has it made public finances more growth friendly (European Fiscal Board 2019).

The SGP's investment clause has been of limited use because it protects investments in a deep downturn, not investments in general, while the success of the structural reform clause in promoting reforms has been rather limited. The COVID-19 crisis has only underlined the importance of reducing high and divergent public debt ratios in a sustainable, growth-friendly manner (European Commission 2021, Arnold et al. 2022).

1.6. Inability to steer the euro area fiscal stance

Although the SGP has procedures to correct high public deficit and debt levels, it cannot force Member States to support economic activity and does not allow the Union institutions to enforce the appropriate fiscal stance for the euro area as a whole (European Commission 2020). In practice the SGP requires Member States to progress towards their MTO, thereby contributing to an overall restrictive fiscal stance, while countries at their MTO cannot be requested to use their fiscal space to support the economy (Kamps & Leiner-Killinger 2019).

Arnold et al. (2022), European Commission (2020), Benassy-Quéré et al. (2016), among others, have argued that the inability to steer the euro area fiscal stance limits the scope of fiscal policy to stabilize the macroeconomy in the event of non-policy induced large shocks even though fiscal policies may be more effective in stabilizing the economy in a severe downturn. This leaves the euro area overly reliant on monetary policy for macroeconomic stabilization, in addition to national economic policies (Arnold et al. 2022Kamps & Leiner-Killinger 2019). From the point of view of the ECB, the EU's fiscal framework is more focused on fostering sound fiscal policies to avoid inflationary pressures than supporting the ECB's price stability objective in periods of low inflation (Kamps & Leiner-Killinger 2019, Maduro et al. 2021). Arnold et al. (2022) even see the lack of EU-wide fiscal stabilization having contributed to the persistent undershooting of the ECB's inflation target.

2. Proposed remedies

This part summarizes the relevant proposals made recently to address the identified challenges. Although there seems to be a consensus view among economists on how to simplify the rules and make them more transparent, there is less agreement on what way large shocks are accounted for (with escape clauses or with a central fiscal capacity), whether and how to account for large expenditure needs and how to improve the compliance and governance aspect of the framework.

The main shortcomings of the EU's fiscal framework, proposed remedies and implications for the national framework are collected in Table 1.

Table 1. Summary of the main shortcomings and proposed remedies of the EU's fiscal framework.

Identified shortcoming	Proposed remedy	Implications for the national framework
Given very high debt ratios in some Member States, the current debt reduction benchmark would require fiscal consolidation regarded as too demanding and counterproductive for some Member States. With the increased flexibility in the interpretation of the debt criterion, this has led to a slow progress towards the 60 % mark.	Linking the medium-term obective directly to the debt target would simplify the framework by making the debt-reduction rule (and the deficit limit) irrelevant, while keeping debt ratios on a downward path.	A simpler framework with a sligthly slower speed of adjustment towards the 60 % debt target. The Government would present a fiscal trajectory in line with the new adjustment requirements in the Government Fiscal Plan, in the Stability Program and in the Draft Budgetary Plan.
Fiscal positions and sustainability challenges differ across Member States and over time. Designing rules contingent to all situations has turned out impossible.	Giving Member States more power in designing their medium term fiscal trajectories and national fiscal institutions a stronger role in their monitoring is expected to result in more effective fiscal policy guidance, increase national ownership and reputational costs of noncompliance.	There would be more freedom in defining the medium-term fiscal trajectory in the Government Fiscal Plan and more fluctuations within the planning horizon would be allowed. The Commission or a national fiscal institution would assess compliance with the path, not compliance with annual debt reduction or fiscal adjustment required by a common rule book.
Regardless of the increased importance of the preventive arm of the Stability and Growth Pact, its structural balance objective does not sufficiently guide Member States' fiscal policies due to technical and political challenges.	Replace the structural balance with an expenditure benchmark.	The two indicators are related. Although Finland's Medium Term Objective (MTO) is defined as a structural balance target, the Commission already assesses progress towards the MTO in terms of the expenditure benchmark as well.
Although the framework contains provisions to support public investment and structural reforms, it has failed to make public finances more growth friendly.	Protect public investment in Member States but not necessarily by excluding them from the EU fiscal rules.	No clear implications. Even if green or other investment were to be excluded from the EU rules to incentivize them, they could still be included in the national budgetary ceilings for national reasons such as sustainability concerns.
Member States haven been reluctant to impose financial sanctions on each other in case of non-compliance.	An alternative way to incentivize compliance is to replace/supplement financial sanctions with financial rewards, or with political costs.	Political costs of non-compliance could imply strengthening the role of national fiscal institutions in monitoring and assessing compliance.

2.1. Replace the structural balance with an expenditure benchmark

The method agreed between the Member States and the European Commission for assessing the output gap, a measure that describes cyclical conditions, has proved to be very unreliable and subject to revisions (see for example Tereanu et al. 2014, Kuusi 2017, Huovari et al. 2017). This reduces the credibility of the structural balance.

Many have proposed reducing reliance on structural balance/output gap estimates by substituting structural balance with an expenditure rule (European Commission 2021, EFB 2020, Larch & Santacroce, 2020, Kamps & Leiner-Killinger 2019, Christofzik et al. 2018, Eyraud et al. 2018) like the one introduced by the Six Pack reform. Shifting focus on the expenditure benchmark has been politically difficult, as the signatories of the Fiscal Compact have enshrined it in national primary law, resulting in an unwillingness to amend the preventive arm of the SGP (Kamps & Leiner-Killinger 2019).

2.2. Link the medium-term objective directly to the debt target

Many have proposed linking the medium-term objective directly to the debt target (Arnold et al. 2022, Martin et al. 2021, European Fiscal Board 2020, Costâncio 2020, Kamps & Leiner-Killinger 2019, Beetsma et al. 2018, Christofzik et al. 2018) as it would simplify the framework. Kamps and Leiner-Killinger (2019) suggest allowing more variation in the MTO based on countries' debt ratio to ensure convergence to 60 % of GDP at a feasible pace, while Beetsma et al. (2018) suggest setting the expenditure benchmark so that a debt ratio of 60 % would be reached after 15 years.

Other proposals range from a rule that sets a ceiling on the growth rate of primary spending derived from a medium-term debt target with different debt reduction rates by type of debt (Gavazzi et al. 2022), to a 'two-tier' system linking an inflation-adjusted expenditure growth-rule to the debt anchor (Hauptmeier et al. 2022), or to determining the speed and magnitude of fiscal adjustment based on a debt sustainability analysis (DSA) using a common methodology (Arnold et al. 2022, Blanchard et al. 2021).

Linking the expenditure benchmark or other medium-term objective directly to the debt level raises the question of the role of the 3 % reference value for the headline deficit. The European Fiscal Board (2021) addresses the question and outlines alternatives. In essence, there might be a political desire to avoid any legislative change that is not strictly necessary, providing an argument for not modifying the relevant Protocol 12 of the Treaty and, hence, for leaving the deficit limit in place.

2.3. Protect public investment – but not necessarily with a golden rule

According to the European Commission (2022), the EU Fiscal Framework should also incentivize public investment and reforms. In the proposition put forth by Giavazzi et al. (2022), debt accumulated for public investment would have a smaller effect on the medium-term expenditure rule than debt accumulated for other reasons. Like a 'green golden rule', whereby net green investment is excluded from the fiscal indicators, this might distort governments' incentives to reclassify current spending as investment.

Although the most promising way to protect green investment during consolidation, Darvas and Wolff (2021) do not regard a 'green golden rule' necessary in the next few years. Instead, private green investment can be incentivized with better regulatory policy and a higher price on emissions, which would contemporaneously reduce public costs. Their simulations show that budget consolidation at a moderate pace in the presence of additional climate investment is feasible in line with the EU rules, if the rules are interpreted flexibly[14].

Excluding investment or green expenditures from the rules has also been questioned on the grounds of debt sustainability, and of weak evidence that well designed rules reduce investment (Feld & Reuters 2022, Basdevant et al. 2020). According to Basdevant et al. (2020), strengthening infrastructure governance can help countries address fiscal sustainability concerns while protecting public investment. Feld and Reuters (2022) also see inconsistency in a supranational requirement on the composition of public finances with fiscal policy belonging to national competence.

2.4. More leeway to Member States in designing their fiscal trajectories

Given the impossible task of designing quantitative rules for all possible contingencies, one alternative is to replace numerical rules with general fiscal policy guidelines, and to give a greater role to national fiscal councils in assessing compliance (Debrun et al., 2019; Blanchard et al., 2021; De Grauwe, 2021). In practice that means focusing on gross policy errors as set out in the Treaty (European Commission 2021), rather than micromanaging Member States' annual performance (European Fiscal Board 2021).

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[14] The authors have estimates that the EU's climate goals require additional public investment worth 0,5-1 % of GDP annually during this decade.

Since each country is different and prospects vary over time, numerical rules could be replaced with stochastic debt sustainability models (Blanchard et al. 2021) so that the speed and magnitude of fiscal adjustment would be based on a debt sustainability analysis for each country (Arnold et al. 2022), or with binding formula-based benchmarks defined and assessed by national fiscal councils to magnify reputational costs (Debrun and Jonung 2019). As numerical benchmarks also serve as tangible guideposts for the general public, and the supranational aspect supplements the national frameworks (European Fiscal Board 2022), another way to increase the country-specificity of the rules would be replacing common debt target with country-specific targets (Martin et al. 2021).

Since the rationale for EU-level rules is containing adverse debt-related externalities across members, Blanchard et al. (2021) claim that their only purpose should be ensuring debt sustainability, which is fundamentally a probabilistic statement. Instead of building additional contingencies in the form of escape clauses, Blanchard et al. (2021) suggest moving away from fiscal rules to standards accompanied by criteria, procedures, and methods that describe how to apply them[15].

At the highest level could be the current EU fiscal standard "Member States shall avoid excessive government deficits" (Art. 126 TFEU) or a requirement for Member States to ensure that public debts remain sustainable with high probability. The main tool to assess compliance with the standard would be stochastic debt sustainability analysis (DSA) by the European Commission and/or the European Fiscal Board. Violation of the fiscal standard would not be an indication of unsustainable debt but would imply that fiscal adjustment is required for debt sustainability with high probability. DSA methods have been developed by many institutions (including the European Commission), and notwithstanding their failings, Blanchard et al. (2021) deem them vastly superior to the simple debt and deficit limits as predictors of debt distress. The authors admit that retaining the current reference values for deficit and debt could be consistent with the stochastic DSA approach they propose if the requirements for a deficit ratio "close" to the reference value and for the debt ratio to be "sufficiently diminishing and approaching the reference value at a satisfactory pace" were assessed with their proposed methods.

2.5. Financial rewards or political costs instead of sanctions to improve enforcement

Acknowledging that the incentives for Member States to enforce fiscal adjustments or impose sanctions against each other are very low, Feld and Reuter (2022) suggest increasing compliance through higher political costs of non-compliance in front of the national electorate. Strong and independent fiscal institutions can increase transparency and media attention (Beetsma and Debrun 2018, Burret and Feld 2018, Eyraud et al. 2018), and so increase the political costs of non-compliance.

In practice, however, national fiscal institutions are different in terms of resources, mandates, and competence, and not all of them enjoy sufficient political backing and public recognition required to have a significant impact on fiscal performance (European Fiscal Board 2021). It is therefore not clear that assigning a greater role to national institutions in the monitoring and implementation of the rules is, in practice, feasible. An alternative way to incentivize compliance is to replace sanctions with rewards – a multi-annual period of complying with the rules would lead to financial rewards from the EU (Kamps & Leiner-Killinger 2019).

2.6. Create fiscal space and support monetary policy with a common fiscal capacity or EU debt

In a monetary union, a sovereign debt crisis caused by over-indebtedness of a member state can cause negative external effects to other member states and even systemic shocks. The over-indebtedness of a Member State is also a risk to the independence of the European Central Bank (ECB), as the need to avoid a financial crisis may make it impossible for the ECB to refrain from going against its mandate

[15] Blanchard et al. (2021) explain how rules and standards are just "alternative ways of writing down legal norms that regulate behavior" and refer to the legal literature on the subject matter.

and using monetary policy to rescue the over-indebted state. With monetary financing of budget deficits, the central bank would then run the risk of creating excessive inflation (Eichengreen & Wyplosz, 1998; Beetsma & Larch, 2019, European Commission 2020).

The EU's fiscal framework was established to ensure the sustainability of Member States' public finances and so to prevent these outcomes (European Commission 2020, Feld & Reuter 2022). In doing so, the system separates monetary and fiscal policy in a way that, according to Maduro et al. (2021) is stricter than in other economies because of the absence of an aggregate stabilization tool. An alternative way to ensure the sustainability of public finances, and so to prevent a sovereign debt crisis, and to protect central bank independence, would be the creation of a central fiscal capacity (Feld & Reuter 2022).

The EU does not have a significant central fiscal authority, but some proposals also include an establishment of a permanent fiscal capacity or common EU debt (Kamps & Leiner-Killinger 2019, Giavazzi et al. 2021, Maduro et al. 2021, European Fiscal Board 2021). The European Commission (2020) also sees that a fiscal stabilization capacity for the euro area would complement national fiscal policies, and allow monetary policy to become more effective, while reducing its side effects. In Kamps and Leiner-Killinger's (2019) view, such an instrument would clarify the roles of national fiscal policies and of the aggregate euro area fiscal stance, which could be steered with the instrument in exceptional times for the euro area.

In the EFB's proposal, a permanent central fiscal capacity (CFC) would provide fiscal space necessary for macroeconomic stabilization of the EU economy in case of a major shock, especially when monetary policy is constrained. The CFC would also work as an insurance mechanism in case of idiosyncratic shocks or common shocks with asymmetric effects. To mitigate the moral hazard problem inherent in all insurance mechanisms, the EFB suggests linking access for funds to compliance with the EU fiscal rules, or to create a mechanism similar to the SURE (the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency), so that the EU rases funds collectively, while individual Member States remain liable for the debt so that the expenditures would raise deficits. Since the EU has no taxing powers, proposals for a CFC rely either on building up rainy-day funds or creating a borrowing capacity for the EU (Maduro et al. 2021, Arnold et al. 2018).

Aarden et al. (2018) argue that in light of a high degree of convergence of euro area business cycles, the disadvantages through moral hazard and permanent transfers across Member States outweigh the advantages of a CFC. The stability of the EMU can be strengthened through stronger financial market risk sharing and more effective use of automatic stabilizers at the national level, while the ESM already acts as a lender of last resort (Aarden et al. 2018).

A related proposal from Giavazzi et al. (2021) is to gradually transfer a portion of national public debts to a European Debt Management Agency, say the European Stability Mechanism (ESM). This would help contain risks in countries that entered the pandemic with already high debt levels and benefit from the operations of the European Central Bank. In practice, as the ECB scales back its bond purchases, the Agency would be able to continue its debt acquisitions (Giavazzi et al. 2021).

NGEU as a prototype of a central fiscal capacity with a new way of operating

Because of its lending capacity, the Recovery and Resilience Facility (RRF) of the Next Generation EU (NGEU) program has been seen as a prototype of a fiscal capacity (European Fiscal Board 2021, Maduro et al. 2021), although its size (2% of GDP) is modest for macroeconomic stabilization and the use of funds remains essentially in the hands of national parliaments (Feld & Reuter 2022).

NGEU consists of debt-financed fiscal support to Member States. Maduro et al. (2022) describe the NGEU as having "*unlocked a long-frozen debate about the creation of common fiscal capacity and the future of the EU policy system more broadly*". Although of a relatively limited addition to the Member States' own pandemic support programs, it "*amounts to a significant debt-financed redistribution to the benefit of least-developed and struggling Member States*" (Maduro et al. 2021).

Although the purpose of NGEU is not short-term stabilization, in EFB's view, NGEU showed that it is possible to agree on a central fiscal transfer mechanism in a relatively short period of time, and not unreasonable to assume such mechanisms could be deployed again (European Fiscal Board 2021)[16].

A proposal for a macroeconomic stabilization instrument, or a fiscal capacity, was put forth in the Five Presidents' Report already in 2015. The European Commission proposed such a capacity, called the European Investment Stabilization Function, in 2018, but it was rejected by the Member States. At the same time the Commission proposed a Reform Support Program aimed at providing financial and technical support to EU Member States implementing reforms. The purpose was to reward policy actions reinforcing EU economic policy coordination, and so to support competitiveness and convergence (Freier et al. 2022). Although Member States at the time rejected Commission's initiative, in June 2019 the Eurogroup agreed on a similar instrument for the euro area called the Budgetary instrument for Convergence and Competitiveness (BICC)[17]. NGEU builds on these previous attempts to establish policy instruments incentivizing the implementation of necessary national structural reforms (Freier et al. 2022), and the creation of BICC has now been dropped (D'Alfonso 2020).

Maduro et al. (2021) see NGEU as a major innovation, as it contrasts with the political rejection of a 'transfer union' and consists of financing exceptional expenditures with EU debt. However, they note that the effectiveness of the program depends on the domestic reforms that the grants are dependent on. The conditionality is still much milder than under the European Stability Mechanism programs, and unlike with the EU's Structural Funds, Member States themselves allocate the funds to specific projects. The release of the funds is, nonetheless, subject to meeting milestones and targets agreed with the Commission, as laid down in each country's Recovery and Resilience Plan (RPP).

NGEU introduced a new way of operating for the EU, i.e. combining EU grants and loans with national initiatives, and conditioning access on the implementation of domestic reforms. It is this new way of operating that Maduro et al. (2021) suggest adding to the EU policy toolkit, in addition to permanent EU debt. Also, Arnold et al. (2022) from the International Monetary Fund (IMF) have very recently proposed to set up an EU fiscal capacity similar to the NGEU to help avoid cuts to growth-friendly spending during downturns.

2.7. Commission's orientations

In November 2022, European Commission released its orientations for a reform of the EU fiscal framework (European Commission 2022b) that aims to ensure public debt sustainability and would result in a simpler system of fiscal rules. The reference values of the Treaty (3% of GDP for public deficit and 60% of GDP for public debt) remain in place but the starting point for a Member State's fiscal planning would be a debt sustainability analysis conducted by the Commission.

[16] Already in December 2021 Mario Draghi and Emmanuel Macron published a letter in the Financial Times and called the NGEU program "*a success both in its assessment of public spending quality and in its mode of financing*" and, "*as such, it offers a useful blueprint for the way forward*". https://www.ft.com/content/ecbdd1ad-fcb0-4908-a29a-5a3e14185966

[17] https://www.consilium.europa.eu/en/policies/emu-deepening/bicc-faq/

The process would start with Commission conducting debt sustainability analysis (DSA) based on which Member States would be divided into three groups depending on their *public debt challenges*[18]. Each group would have a different schedule for reducing debt as well as different conditions for opening an Excessive Deficit Procedure. This is a major departure from the current set-up because the country specific plans would essentially lead to country-specific debt ratios.

Countries with *substantial public debt challenge* would need to ensure that the 10-year debt trajectory at unchanged policies is on a plausibly and continuously declining path by a 4-year planning horizon. Countries with *moderate* challenge would have 3 additional years to ensure the debt ratio is declining[19]. Commission would then prepare a reference adjustment path for each country that would form a basis for bilateral negotiations. The medium-term *fiscal structural plan* would be set in terms of *net primary expenditure*, which would be translated into corresponding annual spending ceilings. Countries with low public debt challenge would only be required to keep their deficit below 3%.

Using net primary expenditure as a single indicator for monitoring progress would simplify the framework. Commission defines it as expenditure net of discretionary revenue measures and excluding interest expenditure and cyclical unemployment expenditure[20]. Since it would allow automatic stabilizers to operate, deviations from the path due to cyclical conditions would not be allowed. Debt reduction benchmark, the requirement for structural balance adjustment and the related matrix as well as the significant deviation procedure would cease to exist.

Member States committing to structural reforms and growth boosting investments[21] could apply for a more gradual adjustment path with an extension of 3 years. Although monitoring of progress would still take place annually, the plans would be fixed for their whole duration, instead of being yearly updated as they currently are. This would improve the medium-term focus of the fiscal planning system. In practice the fiscal-structural plans would merge the current Stability and Convergence Programs with the National Reform Programs, and the plans would be implemented in annual budgets.

The process is inspired by the Recovery and Resilience Planning process so that the details of the plan would be negotiated by the Commission and the Member State. In this way the process would become more bilateral and the current multilateral approach, which has all Member States involved in the process, would be weakened.

The Commission also suggests novel enforcement mechanisms to better incentivize compliance. The rules for opening the Excessive Deficit Procedure (EDP) in case a country exceeds the Treaty's 3% deficit value would be maintained. In addition, the EDP would be opened *by default* if a country with a substantial public debt challenge deviates from the agreed adjustment plan. If a country with moderate public debt challenge deviates, the EDP could be opened if the Commission deemed the deviation as a "gross error".

Imposing financial sanctions is also made easier by lowering their amounts. The Commission also proposes so-called reputational sanctions, which could mean that Ministers of Members States in EDP would have to present the measures they intend to undertake to the European Parliament.

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[18] Details such as the definition of substantial or moderate public debt challenges were left unspecified in the Commission's orientations.

[19] There are also requirements to keep the deficit below the 3% of GDP reference value.

[20] No formula provided yet.

[21] No details on acceptable reforms and investments given at this stage.

Finally, independent fiscal institutions would be given new tasks. They would assess the assumptions and adequacy of the plans and monitor compliance. A bigger role for the national fiscal institutions is expected to lead to a greater debate at national level and hence a higher degree of political commitment.

A framework for steering general government finances – proposal by the Ministry of Finance

The Ministry of Finance published a report making suggestions on how to improve the steering of public finances in Finland in November 2022[22]. The report outlines a fiscal framework that aims at ensuring longer term debt sustainability. The main elements of the framework are not new, but the purpose is to strengthen the link between various fiscal targets at different levels of general government.

The framework consists of a "top-down" approach so that lower-level targets are consistently derived from the highest-level target. The process consists of the following main steps. First, the government determines a longer-term target for the public debt ratio to be reached over more than one government's term of office. Based on that, the government sets a target for the nominal general government financial position (as a percentage of GDP) and its subsectors at the end of its term in office. The targeted fiscal position is then compared to an independent forecast, and the difference between the two gives the monetary amount of fiscal consolidation needed to obtain the targeted fiscal position.

The Ministry of Finance suggests that the government makes a commitment to undertake measures leading to the targeted fiscal position, i.e. makes decisions on fiscal consolidation and structural reforms. The resulting general government fiscal trajectory is then taken as a basis for the government's tax policy during the term in office as well as for the budgetary expenditure ceilings. Monitoring of progress would take place annually and additional measures would be undertaken if needed to obtain the targeted general government financial position at the end of the planning horizon.

3. Implications for the national fiscal framework

The Six Pack reform introduced minimum requirements for national budgetary frameworks, while the Two Pack reform further strengthened budgetary coordination among euro-area Member States by requiring submission of budgetary plans to the Commission for opinion and multilateral assessment before adoption by national parliaments. The Finnish Government fulfills the requirement for a medium-term budgetary framework with the Government Fiscal Plan. As an attachment to the Government Fiscal Plan is Finland's Stability Programme, based on which the Commission assesses compliance with the EU fiscal rules[23].

Like other Member States, Finland defines its own medium-term objective and the fiscal path leading to it each year in the Government Fiscal Plan. According to the Commission, the current practice of annual monitoring has allowed Member States to postpone the achievement of the medium-term budgetary objective (European Commission 2021) as a sufficient change in the structural balance on average over two years has been enough for compliance for a country not at its MTO. This has eroded the medium-term perspective of the framework. To strengthen the multi-annual perspective, a procedural change outlined by the Commission (2022b) involves fixing a fiscal trajectory for the planning horizon and giving national fiscal institutions a role in monitoring progress. In practice Finland would negotiate its

[22] Developing the steering of general government finances, Publications of the Ministry of Finance 2022:71.
[23] In Autumn, the Members of the Euro area also submit their Draft Budgetary Plans to the Commission for monitoring of compliance.

own net expenditure path, that would reduce the debt ratio, with the Commission. The expenditure path translates into an expenditure ceiling for the general government.

The Commission and a national fiscal institution would then assess compliance with Finland's own targets and fiscal trajectories, not compliance with a pace of debt reduction or annual fiscal adjustment required by a common rule book. In this sense Member States would be given more leeway in defining their fiscal paths and more fluctuations within the planning horizon would be allowed. The Commission's assessment would be more focused on the outcome at the end of the planning horizon, but it would also keep track of small slippages on the way there.

The approach is inspired by the governance structure of the Recovery and Resilience Facility (RRF) and has already received support from Spain and the Netherlands, who issued a joint paper in April 2022[24]. According to these countries, a governance structure like the RRF's empowers national governments to propose country-specific medium term fiscal plans that reinforce fiscal sustainability in a growth-friendly manner, creating a virtuous cycle between national ownership – i.e. political commitment, and enforcement. Although the suggested approach would certainly streamline the EU fiscal framework, it is not clear whether being more involved in setting the targets would actually make governments more politically committed to them. To balance Member States' increased fiscal freedom, the Commission envisages stronger enforcement, meaning that noncompliance would more often lead to an opening of an Excessive Deficit Procedure (EDP) and to sanctions.

Although Finland's medium-term objective (MTO) is currently defined as a structural balance target, replacing the structural balance with an expenditure rule would not necessarily have implications for the national framework. According to the Commission (2022b), structural balance could be kept in the national legislation even if it was removed from the EU rules. Moreover, the two measures are related so that one can be expressed in terms of the other, and the Commission and the Council already give recommendations and assess progress towards the MTO in terms of the expenditure benchmark as well[25].

Currently the required annual adjustment of the structural balance depends on the country's debt ratio and cyclical conditions as commonly agreed[26], while a debt ratio exceeding 60 % should decline as prescribed by the debt reduction benchmark. Structural adjustment in line with the current SGP would make Finland's debt ratio to decline from approximately 71 % in 2022 to 60,8 % by 2031 (Hauptmeier et al. 2022) meaning that Finland would reach the 60% debt ratio in approximately 10 years. In its orientations, the Commission suggests that a country with moderate public debt challenge (the middle group) would present a fiscal plan with a *declining debt ratio at most 3 years after the 4-year planning horizon*.[27] While nothing is said about the amount of adjustment, the speed of adjustment seems slower than in the current framework. On the other hand, it seems to be in line with the schedule drafted in the Ministry of Finance's report, where fiscal consolidation would take place over two government terms of office, i.e. 8 years.

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[24] Joint paper by Spain and The Netherlands on priority issues in 2022 on the EU's economic and financial policy agenda, April 2022.

[25] For example, in 2019, the Commission's assessment of Finland's Stability Program stated that "In 2020, in view of Finland's projected output gap of 0.8%, *the nominal growth rate of net primary government expenditure should not exceed 1.9%*, in line with the structural adjustment of 0.5% of GDP stemming from the commonly agreed adjustment matrix of requirements under the Stability and Growth Pact".

[26] See the matrix of adjustment requirements in the SGP Code of Conduct.

[27] According to the orientations (Box 1), the Commission would use its DSA framework it has been using for its Fiscal Sustainability Reports, where it classifies Member States into low, medium and high-risk categories, so that a high risk category indicates substantial public debt challenges. In the 2021 Fiscal Sustainability Report, Finland was in the low-risk category.

Requiring a different pace of fiscal adjustment based on each country's "public debt challenges" and growth boosting measures makes the fiscal framework more country specific. The involvement of national independent fiscal institutions (IFIs, i.e. the National Audit Office in Finland) in assessing the assumptions and adequacy of the plans and in monitoring compliance would also increase their role and would likely require aligning the mandates of IFIs across the EU.

The increase in country-specificity, including the bilateral negotiations of country-specific fiscal-structural plans and the increasing role of national IFIs is likely to lead to more fragmented fiscal policy in Europe. It raises concerns about the equal treatment of countries, as Member States might differ in their bargaining power with the Commission. The Commission also retains the right to define the "gross errors" that lead to an opening of an EDP for countries with "moderate public debt challenges". However, these features are in line with the proposals to move away from rules to standards (see Section 2.4), put forth by Blanchard et al. (2021) and Arnold et al. (2022), including the increasing role of national fiscal institutions. In line with these proposals, the main purpose of the new framework is debt sustainability, with a stochastic debt sustainability analysis for each country as a starting point.

The framework outlined by the Commission is also well-aligned with the one proposed by the Ministry of Finance (MoF) in terms of both time horizons and the setting of targets. The EU framework would deliver an expenditure path for the general government – an expenditure ceiling, or a maximum amount of general government net expenditure for the 4-year period. This path already includes the impact of structural reforms, investments, and fiscal consolidation measures. Comparing this amount to a forecast at unchanged policies gives a monetary amount of measures the government is committed to. This is conceptually the same as the monetary amount of fiscal consolidation measures that the MoF derives starting from a target for the debt ratio and the general government fiscal balance.

The RRP-process of the Recovery and Resilience Facility involved long negotiations between Member States and the Commission. For the new EU fiscal framework to actually guide fiscal policy decisions, it will have to be integrated into the national political decision-making process, where the targets of the Government Programme currently seem to play a bigger role than the ones in the Government Fiscal Plan.

Conclusions

In the early years of the Maastricht Treaty, compliance with the deficit limit was enough to take debt ratios down, and the debt rule was close to irrelevant. The 60 % debt rule further lost significance with the increasingly discretionary assessment of compliance, especially for highly indebted countries where the debt reduction requirements by the rules were regarded as too high. Over time, focus shifted more towards the preventive arm of the Stability and Growth Pact (SGP), which requires annual structural adjustment so that Member States reach their structural balance objective over the medium term. This medium-term objective (MTO) has not sufficiently guided Member State's fiscal policy for technical and political reasons. Although higher compliance is associated with stronger debt reductions, in good economic times the rules do not seem to demand enough to significantly reduce debt ratios in all Member States.

The lack of numerical compliance with the EU fiscal rules does not, however, necessarily translate into a lack of legal compliance, which is based on an overall assessment by the European Commission. The Commission exhibits a high degree of flexibility, including exceptions, escape clauses, weighing of various rules, room for interpretation, and areas of discretionary judgement. The use of discretion together with an unstable structural balance indicator has reduced the transparency of the preventive arm of the SGP. For the Commission, the use of economic judgement is related to the lack of ownership by the Member States. The lack of political commitment manifests itself in that many Member States repeatedly

postpone the achievement of the medium-term budgetary objective, weakening the medium-term perspective of the framework.

The need for revision therefore goes beyond the design of the EU's numerical fiscal rules and concerns the whole governance aspect of the framework. Linking the medium-term objective directly to the debt target is seen as way to simplify the framework, while making sure that debt ratios are kept on a downward trajectory. To overcome the technical and political issues with the structural balance, it has been suggested to replace it by an expenditure benchmark. By giving Member States more power in designing their medium-term fiscal trajectories, both ownership and enforcement of the rules might be strengthened. These elements are included in the Commissions orientations for a reform of the EU fiscal framework. More broadly, the orientations imply a move away from rules towards standards as suggested by Blanchard et al. (2021), among others, with a debt sustainability analysis as a starting point.

In terms of the national fiscal framework this would imply that the Government sets a genuine debt reduction plan for the medium term, including a fiscal path and measures leading to it, in the Government Fiscal Plan. Like the national budgetary expenditure ceiling, the fiscal plan would translate into a binding 4-year expenditure ceiling for the general government. As the national independent fiscal institution, the National Audit Office of Finland would be given a bigger role in assessing the assumptions and the adequacy of the plan as well as in monitoring progress. Political commitment to the outlined EU framework is likely to depend not only on the planned novel sanctions but also on whether it will be fully integrated into the national political decision-making process.

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