NEW EU FISCAL RULES IN LIGHT OF CONTRACT THEORY: IMPROVEMENTS AND UNSOLVED PROBLEMS

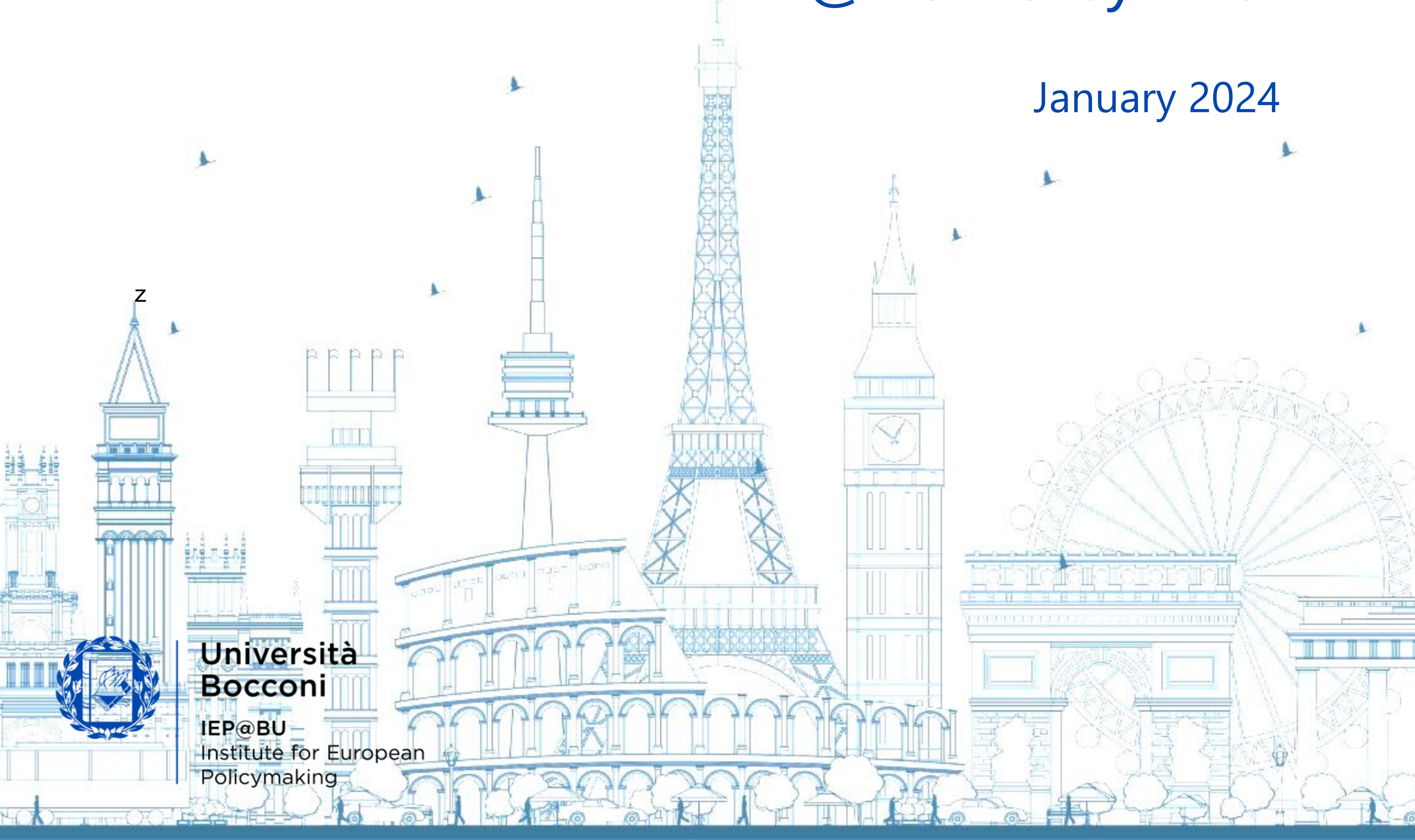
MARCELLO MESSORI

Schuman Center, European University Institute (EUI);

and Institute for European Policymaking (IEP), Bocconi University

IEP@BU Policy Brief

January 2024



Università Bocconi

IEP@BU
Institute for European Policymaking

Abstract

The revision of the old Stability and Growth Pact (SGP), elaborated in the period 2005-2013 and subject to a general escape clause during the years 2020-2023, triggered a long debate in 2021 and 2022. The European Commission tried to synthesize this debate by elaborating a Communication in November 2022, followed by a normative scheme in April 2023. Finally, the Council of the European Union (EU Council) agreed on a provisional set of new fiscal rules in its meeting on December 20, 2023, that introduces significant changes to the Commission's proposals. A part of these new rules must still be submitted to the co-decision of the European Parliament; another part will involve the Parliament in a mere consultancy role. In both cases, it is unlikely that the related trialogue, with the involvement of the Commission, can determine substantial changes to the results achieved by the EU Council.

There were two main innovations in the Commission's approach to the SGP. The first was the national ownership of the adjustments aimed at making the public balance sheet of each member state sustainable and compatible with economic growth in the medium-long term. The second innovation was the required compliance of these adjustments with a small number of quantitative indicators and the related elimination of that set of complex quantitative constraints which were included in the old fiscal rules (mainly since 2011) but which were poorly enforced.

The compromise reached a few days before the end of 2023 weakens the latter innovation because it reintroduces many quantitative constraints that partially bring the new fiscal rules back into the methodological context of the old SGP. The crucial and unresolved issue is the possible impact of these additional constraints on the national incentives to manage public debt sustainability through a well-balanced combination of fiscal adjustments and efficient investments and reforms for growth.

To compare the different steps in the evolution of the EU fiscal rules, this paper refers to a specific theoretical key: the 2005-2013 SGP, the Commission's proposal, and the new fiscal rules are analyzed in terms of the principal-agent literature focusing on mechanism designs. The thesis is that: (i) the design of the SGP is based on several quantitative indicators that do not include any binding incentive constraint so that the principal (i.e., the European Commission) imposes a set of fiscal rules on the agents but is unable to induce each of these agents (a member state, specifically with significant fiscal disequilibria) to be *ex-post* compliant with the commitment imposed *ex ante*; (ii) the Commission's proposals define few quantitative indicators that are compatible with a binding incentive constraint because member states exercise the national ownership in defining their specific fiscal plans and in selecting the most appropriate national combination between public debt sustainability and economic growth; (iii) the new fiscal rules add quantitative safeguards to the Commission's scheme that can become too demanding for EU countries with significant fiscal disequilibria and that can, thus, interfere with the binding incentive constraints.

These three points show that, compared to the old SGP, the adoption of the new fiscal rules would decrease the risk of causing systematic *ex-post* withdrawals of the member states from their ex-*ante* commitments. However, the opposite holds for the Commission's proposal of April 2023. In this latter case, the new fiscal rules weaken the effectiveness of the binding incentive constraints introduced by the Commission. This conclusion justifies the statement that the fiscal reform marks progress but is, at the same time, a lost opportunity.

This paper is a contribution to a research project carried out in cooperation with Marco Buti at the EUI's Economic and Monetary Union Laboratory (EMU Lab). It has greatly benefited from the comments and criticisms that Fabrizio Balassone, Marco Buti, Stefano Feltri, Daniel Gros, and Gian Luigi Tosato made of a previous draft. In the current version, I have been unable to incorporate or discuss all their advice, which is why responsibility for the following interpretation and the possible mistakes should be attributed solely to the author

Introduction

This paper aims to assess the impact of the compromise that was reached by the Economic and Financial Affairs Council (ECOFIN) in its extraordinary meeting on December 20, 2023, concerning the EU's fiscal governance.

The European Commission proposed a general framework of new centralized fiscal rules in November 2022, and it turned its proposal into a normative scheme in April 2023. The latter should have replaced the version of the Stability and Growth Pact (SGS) elaborated in the period 2005-2013 and subject to a general escape clause during the years 2020-2023. There were two main innovations in the Commission's approach. The first was the national ownership of the adjustments aimed at making the public balance sheet of each member state sustainable and compatible with the national economic growth in the medium-long term. The second innovation was the required compliance of these adjustments with a small number of quantitative indicators and the related elimination of that set of complex quantitative constraints which were included in the old fiscal rules (mainly since 2011) but which were poorly enforced.

The compromise reached a few days before the end of 2023 weakens the latter innovation because it reintroduces many quantitative constraints that partially bring the new fiscal rules back into the methodological context of the old SGP. The crucial and unresolved issue is the possible impact of these additional constraints on the national incentives to manage public debt sustainability through a well-balanced combination of fiscal adjustments, efficient investments and reforms for growth.

This paper starts by comparing the old SGP and the fiscal rules proposed by the Commission (Section 2.) This comparison stresses that had if been implemented, the Commission's framework would have offered a stronger degree of enforcement (Section 3.) The 2005-2019 SGP's constraints were usually incorporated in the yearly budget laws of the EU member states but were systematically violated *ex post*. The Commission's proposal aimed at overcoming this inconsistency through a more effective harmonization of the preventive and corrective arms.

The new compromise marks progress with respect to the old SGP. However, it again risks making it convenient for member states with high disequilibria in their balance sheets to non-comply *ex-post* with fiscal rules (Sections 4 and 5). There are at least two reasons that justify this statement. First, the new fiscal rules reintroduce a set of quantitative safeguards whose implementation through the net primary expenditure ceilings can become too demanding in terms of balance adjustments; second, these rules provide a phase of flexibility that legitimizes the short-termism of national policymakers. In the Conclusion of this paper, I emphasize that the latter element is particularly dangerous because short-termism downplays the medium-term results and is, thus, in contrast to the method that was introduced by the Next Generation–EU and that was at the core of the Commission's design. This amounts to stating that the new fiscal compromise reached by ECOFIN offers insufficient support to the strengthening of that central fiscal capacity which is crucial to improving the EU's economic model and its competitiveness at the international level.

The improvements in the Commission's framework

The proposal designed by the European Commission in its Communication of November 9, 2022, and translated into the normative framework of April 27, 2023, was centered on a specific methodological principle: the adjustments of the national fiscal disequilibria are decided by each member state through a multiannual plan that should consider the national trajectory outlined by the European Commission (see European Commission, 2022; Buti *et al.*, 2023). Every fiscal plan has a long-term attractor (a 'focal point' in game theory parlance: see Myerson, 1991, p. 372): the original 60% as the threshold to which the higher public debt to GDP ratios should plausibly tend. Moreover, there is another traditional and maximum threshold: a 3% nominal public deficit to GDP ratio that should be met in the medium term.

If an EU country has a public deficit to GDP ratio higher than 3% or public debt to GDP ratio higher than 60%, its plan should include fiscal adjustments; conversely, the member states compliant with these two maximum thresholds should just reproduce their pre-existing national fiscal equilibrium over the years. In any case, each member state is called to elaborate a four-year plan that can be extended to seven years if a specific country in fiscal disequilibrium focuses on crucial reforms and investments that take more time to have positive effects. Each of these plans should be discussed with the Commission while it is under elaboration,[1] and finally, it must be assessed by the Commission itself and submitted to the EU Council for approval.

The aimed result of the Commission's proposal was an effective combination of debt sustainability and national ownership. The Commission's technical trajectories are determined by a Debt Sustainability Analysis (DSA) applied to the macroeconomic dynamics and to each country's balance sheet.[2] These trajectories offer a non-compulsory, even if significant, reference to the process of fiscal adjustment decided by the national government of each of the member states affected by a high incidence of public debt or of public deficit in the sense just specified.

It is important to stress that the reference to the technical trajectories is "non-compulsory" for, at least, two reasons (Pench, 2023). First, even if the Commission defines a specific trajectory for each country, its DSA methodology will be based on standard assumptions and parameters that respond to the principle "one size fits all"; hence, the national ownership featuring the new fiscal rules justifies a country's departure. Second, DSA calculates the national potential outputs without considering the expected impact of specific investments and reforms that could be included in the national plans and that should have positive *ex-post* effects on the fiscal ratios at the country level; conversely, each country in fiscal disequilibrium founds part of its adjustments on the impact of forecasted investments and reforms. The conclusion is that, unlike commonly believed, in the Commission's proposal there was a low probability that the DSA's quantitative trajectories and the adjustments selected by a member state with fiscal disequilibria and included in its multiannual plan were coincident.

In the April normative framework, the Commission modified its previous Communication by introducing additional quantitative indicators besides the 60% and 3% thresholds (see European Commission, 2023b and 2023c). Countries with an excessive stock of public debt should gradually adjust this fiscal disequilibrium by keeping the growth rate of their net primary expenditure below the growth rate of their GDP,[3] by setting the public debt to GDP ratio below the initial value within the

---

[1] These preventive interactions are crucial for countries with severe fiscal disequilibria.

[2] The DSA is a methodology usually utilized by the European Commission for its periodical macroeconomic assessment of the EU countries and by various international institutions such as the International Monetary Fund (IMF). See for instance: IMF (2011), Darvas and Hüttl (2014), Corsetti (2018), and European Commission (2023a). A critical comparison of the different variances of this methodology is offered by Alcidi and Gros (2018).

[3] The net primary expenditure is the only general and quantitative tool utilized in the new fiscal setting. Hence, this tool has the function of a unit of measure. This means that the other quantitative indicators must be expressed in terms of net expenditure. In this paper I do

four-year horizon (even in the case of an extension to a seven-year plan),[4] and by spreading the adjustments of this last ratio throughout all the years and not just in the final year of the plan. Moreover, EU countries with an excessive public deficit (but not yet under the excessive deficit procedure) should yearly decrease this deficit by, at least, 0.5% of their GDP.

As discussed in various Eurogroup meetings (see European Fiscal Board, 2023; Eurogroup, 2023), the rationale behind these changes was the search for compatibility between the positions of those member states which assimilated national ownership with excessive flexibility and asked for additional rule-based (quantitative) constraints, and the opposite positions of those member states which were worried by the severity of the DSA trajectories (see Darvas *et al.*, 2023; see also: Reichlin, 2023). Some of these additional quantitative constraints (and others here omitted) were redundant and could have been replaced with simpler institutional constraints. Moreover, the related policy adjustments ran significant risks of being pro-cyclical. Nevertheless, these quantitative indicators are explainable by some basics of economic theory or by some features of the European institutional setting. Hence, their introduction would not have undermined the balance between fiscal sustainability and national ownership, compromising the latter without improving the former (for a different view: Pench, 2023).

The quantitative constraints that relate to public debt can be conceived as protection against opportunistic behavior characterizing the models of dynamic inconsistency (see Kydland and Prescott, 1977). Fiscal policymakers could exploit their national ownership by systematically postponing the most significant (and politically costly) adjustments at the end of the multiannual plans whenever this end comes after significant elections or the expected conclusion of the government's term. However, it is redundant to combine a four-year decreasing trend in the incidence of public debt and the requirement of its linear adjustment. It would have sufficed to introduce the latter constraint.

Conversely, the explicit introduction of a minimum quantitative threshold in the yearly reduction rate of the public deficit can be justified by the EU's previous governance. 0.5% of GDP is the minimum adjustment imposed by the excessive deficit procedure that is not affected by changes in fiscal rules (see Section 3 below). Hence, the new quantitative constraint introduced by the Commission in its April normative proposal has two possible implications. On the one hand, a 0.5% minimum adjustment is required without necessarily putting the country involved under a European procedure. On the other hand, this same adjustment becomes compulsory in a stage preceding that activated by the traditional procedure. In any case, analogously to the public debt maximum threshold, the 3% public deficit to GDP ratio can be interpreted as a medium-term attractor (a 'focal point').

These considerations imply that the new EU fiscal governance proposed by the European Commission in its November 2022 Communication and April 2023 normative framework was centered on risk-based principles. Each member state kept national ownership of its fiscal adjustments: it was entitled to choose a multiannual re-balancing path compatible with a small number of quantitative indicators. Hence, EU countries were fully committed to debt sustainability and to the execution of the adjustments included in their multiannual plans once approved by the EU Council. On its part, the Commission had a triple duty: (i) to indicate a standard adjustment path using the DSA in case of EU countries with fiscal disequilibria, (ii) to reach an *ex-ante* agreement with each member state under the condition that the national fiscal adjustments are compliant with few European fiscal indicators, and (iii) to enforce the full execution of the agreed national adjustments in terms of the net primary expenditure.

not discuss the other more substantial functions that could be attributed to the net primary expenditure (see for example: Fuest and Gros, 2019.)

[4] The initial public debt to GDP ratio coincides with the value reached in the year preceding the national adjustment plan.

From an analytical point of view, the risk-based relationships between the Commission and each member state can be depicted as a contract with incomplete information.

The old SGP, as defined in the years 2005-2013, did not adopt this 'risk-based' method (see Buti, 2021). As a general principle, the original SGP assumed that "one size fits all" in the sense that the same top-down and quantitative fiscal indicators apply to each of the member states in the various possible contingencies. The European Commission has the function of monitoring and enforcing the compliance of the national fiscal initiatives with a centralized set of rules. Hence, at least in its original formulation based on simple nominal and pro-cyclical rules (typically, the public debt to GDP ratio, at most, equal to 60%, and the public deficit to GDP ratio, at most, equal to 3%),[5] the old SGP can be represented as a unique contract that applies to each EU member state and that has a single expected outcome (the medium-term compliance with the fiscal rules) in a world of perfect information.

The main features of the real world do not fit this type of contract. A large part of the variables at stake is influenced by future contingencies that cannot be put by the member states under control during the execution and cannot be easily checked by the Commission during its monitoring and enforcement activity. Hence, the relationships between the Commission and each EU member state are affected by incomplete information on both sides.

The literature on contract theory showed a long time ago (see for instance: Myerson, 1983; and Laffont and Tirole, 1988) that incomplete information hinders the execution and enforcement of fixed rules and – hence – shatters their effectiveness in the absence of a binding incentive design. Moreover, the consequent contract is often an incomplete one, that is, it cannot include *ex ante* all the possible *ex-post* contingencies (see Hart, 1995).

These aspects apply to the European fiscal rules. From 2005 to 2013, European institutions redefined the original SGP by introducing structural but overly complex indicators: output gap, structural deficit, Medium-Term Objectives (MTOs), and so on (see European Commission, 2016.) Moreover, they strengthened the corrective arm of the SGP by making the Excessive Deficit Procedures (EDPs) and their consequences more severe. The aim was to reduce the pro-cyclicality of the fiscal rules and to improve their execution. The results were the introduction of additional quantitative indicators unobservable even *ex-post*, new quantitative constraints unachievable for most of the EU countries with significant fiscal disequilibria (typically, the 1/20 yearly reduction of the difference between the actual public debt to GDP ratio and the 60% threshold), and a systematic inability to apply the main consequences of the EDPs. In terms of contract theory, these changes and consequences highlighted the inadequacy of the original SGP and its modifications to determine an efficient mechanism design.

The framework of the original SGP was, thus, characterized by a lack of national ownership and was based on fully centralized and ineffective enforcement. The 2005-2013 evolution of the SGP can be interpreted as a series of unsuccessful attempts to adapt this "one size fits all" principle to the definition of an optimal mechanism design in a world of incomplete information. The same drawbacks apply to the later introduction of some flexibility in the old SGP (European Commission, 2015.) By mid-January 2015, the EU member states compliant with basic EU fiscal rules and affected by a rate of growth that was negative or largely below the potential were allowed to rule out specific public expenditures from the calculation of their public deficits in a limited period. The reference was to

[5] For the sake of simplicity, I neglect that the old SGP allowed the member states to temporarily have excessive public debts and public deficits without activating a European procedure. To avoid the procedure, a member state with excessive public debt must diminish the relative ratio at a sufficient pace; and a member state with a public deficit to GDP ratio above 3% has to keep the temporary excess either within 50 basis points or justify a larger excess by referring to exceptional events.

those investments and reforms able to overcompensate their costs through a positive impact on the national rate of growth.

Apart from the fact that the flexibility of the SGP was largely utilized by countries with excessive public debt to increase their current expenditures, all these changes in the old fiscal rules shared a structural weakness: the lack of efficient incentives for the member states with fiscal disequilibria. Acting on behalf of the EU, the Commission tried to directly impose compliance with a set of quantitative indicators on these member states independently of their objectives; moreover, a growing part of these indicators became unobservable or disputable.

The enforcement of the fiscal rules

The previous section has shown that also the normative framework elaborated by the Commission in April 2023 utilized future or unobservable variables. The reference to these variables is unavoidable to address the issues of expected economic growth and public debt sustainability in the medium-long term. However, the relationships between the Commission and each member state and the related incentive design were largely improved relative to the old SGP. Instead of multiplying recourse to complex indicators, the few quantitative variables were referred to a single unit of measure (the net primary expenditure: cf. above, n. 3) and were reduced to two benchmarks (the original ratios relating to public deficit and public debt) with few ancillary constraints.[6] Moreover, even the member states with significant disequilibria were incentivized to be compliant with this simplified set of fiscal rules that aimed at combining debt sustainability and medium- to long-term economic growth.

To better justify my previous statements, it can be useful to re-read the old 2005-2019 SGP as well as the fiscal framework proposed by the European Commission in terms of mechanism design. My thesis is that the old rules wrongly reduced the design to a set of top-down quantitative indicators with a poor degree of enforceability; on the contrary, the Commission's proposal aimed to address the enforcement problem by reaching cooperative outcomes starting with non-cooperative interaction.[7]

A reference to a few basics of contract theory will provide some interesting insights on the point. Let me assume that the mechanism design can be reduced to a standard problem of moral hazard, where the interaction of a principal with an agent is mainly characterized by two aspects: (i) by pursuing its own interest (maximization of its utility), the agent undertakes actions that affect the outcomes obtained by the principal; and (ii) the principal is unable to perfectly monitor the agent's actions because these actions can be neither directly observed when implemented nor checked *ex post* through the achieved results that depend on a set of undetectable contingencies (see Kreps 1990, ch. 16).

---

[6] As already stated, in game theory parlance, the two benchmarks act as 'focal points' since they were conceived as medium-term (deficit) and long-term (debt) reference indicators.

[7] This well-known puzzle has an intuitive and convincing analytical solution in repeated games with observable actions: the non-cooperative parties find an *ex-post* cooperation convenient for minimizing the probability of triggering 'tit-for-tat' strategies. It is harder to reach analogous results in repeated games with incomplete information and – *a fortiori* – in dynamic games of incomplete information. See for instance: Fudenberg and Tirole, 1991; Başar and Zaccour, 2018. In this paper I can leave these analytical problems in the background and assume that cooperative outcomes can generally be reached in non-cooperative games. My simplification is partly justified by an institutional aspect. As it will become clearer in what follows, in the EU, the *ex-ante* relationships of the Commission with member states are also based on trust so that they can be – at least partially – cooperative. I do not go into detail on this aspect because it would require the reference to a widespread strand of economic theory: the neo-institutional literature (see for instance: Williamson, 1975) and its modeling in terms of contract theory (see Hart, 1988; Tirole, 1999).

If the old SGP is reinterpreted in terms of this standard problem of contract theory, it will follow that the member states under examination act as agents, and the European Commission on behalf of the EU acts as a principal. The crucial point is that the principal (in our case, the Commission) offers a pre-determined rule-based contract to the agent (in our case, a member state of the EU) instead of addressing point (ii) and satisfying the agent's incentive constraint. The missed reference to the incentive constraints could be justified by assuming that each member state is always forced to select the action preferred by the European Commission. However, this only applies to a world with perfect information. In case of incomplete information, the effective solution of the contract requires that the Commission make it convenient for a utility-maximizing member state to select that (or those) action(s) which is (are) relatively preferred by the Commission itself. Otherwise, any EU country able to pursue actions in its own interest without complete monitoring by the Commission and without binding incentive constraints has a dominant strategy: to make *ex ante* the commitment of selecting the actions preferred by the principal and to defeat *ex post* the actions selected to maximize its convenience.

My first conclusion is that despite the robust forty-year-old results obtained by the principal-agents' models, in the period 2005-2013 European institutions reformed the SGP by assuming that it would have been possible to turn the lack of monitoring of the agent's actions into perfect enforcement of these same actions by adding general quantitative indicators and by strengthening the EDPs, but by further neglecting the introduction of binding incentive constraints. Hence, the Commission behaved as an odd principal: it gave up any possibility of setting an effective mechanism design and supplied a pre-determined and rule-based contract.

The obvious consequence was that the EU member states with significant fiscal disequilibria adopted yearly national budget laws that were characterized by two aspects: (a) the *ex-ante* planned fiscal adjustments were so severe as to make the public balance sheets fully compliant with the enriched set of quantitative constraints (in particular, the national MTOs), and (b) the *ex-post* actual adjustments were a fraction of those planned so that the countries under examination did not converge towards their MTOs. Moreover, the European Commission had difficulties in managing point (b) by repeatedly activating the EDPs and – mainly – by applying the related punishment to the countries under procedure. Consequently, there was a systematic failure in the implementation of the old fiscal rules.

Some descriptive empirical evidence supports the last statement. Several EU member states with significant fiscal disequilibria but not under European aid programs[8] were not compliant with the SGP. This situation did not just characterize the second dip in the euro area (from 2011 to mid-2013) and the following years of weak economic recovery (from the second half of 2013 to the end of 2015). It was also a recurrent problem during the years of flexible implementation of the SGP and of higher economic growth (2016-2017) as well as during the following years threatened by new stagnation in the EU before the pandemic shock. Hence, the incompatibility between commitments and outcomes applied to different macroeconomic phases.

The empirical evidence signals that the main weaknesses of the old SGP were not due to a cyclical lack of *ex-post* enforcement tools. Combining this result with the ineffective mechanism design discussed above, it follows that the recurrent failures of the enforcement in the different economic phases are the effect of structural deficiencies that do not only belong to weaknesses in the *ex-post* monitoring but are also due to the structure of a contract that lacks binding incentive constraints. The implication is straightforward: contrary to a widespread claim in the northern part of the EU (see for

[8] An analysis of these programs is offered by Tumpel-Gugerell (2017). It is worth noting that this analysis originated from an initiative of the European Stability Mechanism to have the assessment of an independent evaluator. Hence, the reference to Tumpel-Gugerell (2017) does not cover the rich and critical debate on a crucial aspect of the EU's economic governance. However, this aspect is not at the core of the present paper.

example: Kirchsteiger and Larch, 2023), it is unrealistic to believe that the main problems of the old fiscal rules could be solved by simply strengthening the enforcement phase. These problems mainly depend on inadequacy in the design of the old fiscal rules: the non-alignment of interests between the principal (the Commission) and the agents (the member states).[9]

This conclusion matters for a comparison with the fiscal rules proposed by the Commission, and then for an assessment of the new fiscal rules approved a few days before the end of 2023. The November 2022 Communication and the April 2003 normative framework aimed at improving the enforcement tools by determining more credible pecuniary fees and by introducing reputational punishment on member states that fall into an EDP and do not comply with the related compulsory adjustments (see European Commission, 2023c). However, the European Commission did not redefine the main features of the old EDPs. According to some commentators (see for instance: Dermine and Larch, 2023), this was the weakness of the Commission's proposal. Conversely, if my criticism of the failures in the incentive design of the old SGP were correct, it would follow that any assessment of the EDP and enforcement tools in the Commission's fiscal rules should consider the effectiveness of the contract structure between the Commission and the member states.

In this last respect, each EU country was in the condition to determine its fiscal adjustments (national ownership) under the constraints of debt sustainability (as agreed with the Commission). The effective combination of these two components can greatly contribute to overcoming the distortionary convenience for the EU member states to systematically withdraw from their commitments. In the Commission's proposal, the national ownership in the definition of the country-specific fiscal adjustments guaranteed that each EU member state can define a multiannual plan compatible with its adequate economic growth and its political-institutional stability under the constraint of its debt sustainability. Hence, even if the contracts that found the multiannual fiscal plans are characterized by incomplete information and incompleteness, there would be shared interest for the contractors to obtain cooperative outcomes.

The first implication is that the fiscal rules proposed by the Commission did not require significant changes in the EDP. However, from a theoretical perspective, the second implication could be even more procrustean: these fiscal rules did not need strong enforcement tools because *ex-post* defections by member states would be inconvenient in repeated and dynamic interaction with the Commission. However, several factors in real life can interfere with this theoretical implication (see n.7 and 9 above). For instance, a given member state could adopt a myopic horizon to meet some short-term and over-assessed political constraints that are incompatible with its multiannual plan agreed with the Commission. In other cases, this same member state could realize that the actual macroeconomic scenario does not fit its expectations. Hence, solid enforcement tools would have been required even in the Commission's proposal. The difficulty in assessing the effectiveness of these possible tools depends on their adaptability to the huge set of specific factors that can explain the *ex-post* withdrawal by a member state from its *ex-ante* commitments.

These observations lead to a general conclusion relative to the effective redesign of the corrective arm in the Commission's proposal. If a member state withdrew *ex post* from the commitments set by its *ex-ante* national ownership, it should assume the full responsibility of justifying its behavior by referring to objective exceptional events of a general or idiosyncratic nature. Otherwise, this member

[9] My last statement does not mean that the enforcement phase is irrelevant, but that an efficient management of this phase requires the preliminary design of an effective contract. To clarify my point of view, let me assume that some version of the EU fiscal rules leads to the definition of contracts with binding incentive constraints. Despite this achievement, it is a well-known result that the outcomes of the contract are usually unable to satisfy the "first-best" solution (see Kreps, 1990, ch. 16-18). To hinder the first best, it suffices that the signaling or the incentivization are costly, or even that the contract is incomplete. In the last case, the principal could not design *ex ante* all the *ex-post* contingencies and therefore it would not be in the condition to enforce the agents to behave in its own interest or to accept a punishment under the missed contingencies (see Hart, 1988). A similar situation applies *a fortiori* to the EU fiscal rules. Despite the *ex-ante* setting of an efficient mechanism design, member states hold sovereignty on fiscal matters. Hence, centralized enforcement remains important and difficult to implement.

state should be aware of the consequences: its automatic fall into a very severe EDP. Hence, in principle, my analysis would have been compatible with the strengthening of the enforcement phase in the Commission's proposal. However, it would be pointless to further elaborate this possible result. It suffices to restate that my position on the enforcement of rules directly depends on the incentive constraints designed in the contract. As will be shown in the next session, the new fiscal rules approved by the EU Council in its meeting on December 20, 2023, have redefined the incentive mechanism that was at the core of the Commission's proposal. Hence, it is worthwhile to assess the more appropriate enforcement tools after examining their preventive arm included in the new fiscal rules.

A first assessment of the new fiscal rules

The fiscal rules approved by the EU Council in its meeting of December 20, 2023 (hereinafter: the new fiscal rules),[10] are a compromise between the risk-based approach adopted in the Commission's proposal and the rule-based quantitative approach inspiring the old SGP.

The new fiscal rules recognize that the adjustments of the excessive disequilibria in the national balance sheets should be based on country-specific processes because the legacy of Covid-19, the related supply bottlenecks, and the energy crisis have increased the heterogeneity of the national imbalances and, at the same time, have strengthened the need for national reforms and investment for the implementation of the 'green' and digital transitions. Hence, it is crucial that each member state have the ownership of its multiannual adjustment plan compatible with the sustainability of its public debt as well as with an adequate path of economic growth. As shown in the previous sections, the Commission's proposal followed this same risk-based approach by minimizing the recourse to quantitative constraints, and by pursuing cooperative equilibria through contracts between each member state and the Commission that include binding incentive constraints. Conversely, the new fiscal rules re-introduce various quantitative indicators (safeguards) to minimize the probability that the determination of the fiscal adjustments is downgraded into a political bargain between each country and the Commission employing too discretionary medium-term national fiscal plans.

As a result, the new fiscal rules incorporate quantitative indicators that mimic the pivotal constraints of the old SGP (such as the MTOs for the structural public deficit and the 1/20 rule for the public debt), even if at lower quantitative values. Consequently, a rule-based approach is superimposed onto the risk-based one.

This description of the new fiscal rules should allow for an assessment based on a single question: is the overlapping between risk-based and rule-based approaches compatible with an incentive design able to effectively influence the country-specific fiscal adjustment processes? Unfortunately, the answer to this question is made more complex by the agreement that was reached by Germany and France, and that led both countries to recommend the approval of the new fiscal rules. Germany has obtained the introduction of binding quantitative fiscal safeguards under the normal regime; however, France has obtained the postponement of the implementation of this normal regime. Hence, in their first phase (that is, from their start in 2025 to 2027), the new fiscal rules will be subject to a temporary regime characterized by weaker adjustment constraints. This bilateral compromise

[10] The Regulation relating to the preventive arm of the new fiscal rules is labeled as "proposal" because it must still be submitted to the co-decision of the European Parliament (see EU Council, 2023b). However, it would be unlikely that the related trialogue, with the involvement of the Commission, can determine substantial changes to the current formulation. This applies even more so to the other Regulation (relating to the corrective arm) and the Directive, which will involve the European Parliament in a mere consultancy role (see EU Council, 2023c and 2023a, respectively).

implied that, at the EU Council meeting of December 20, 2023, the new fiscal rules were adopted with a unanimous vote.

Independently of its rationale,[11] the French-German compromise as reflected in the EU Council agreement runs at least three risks that can make the overlapping between risk-based and rule-based approaches distortionary. First, the temporary regime will have the effect of shortening the horizon of policymakers in the countries with significant fiscal disequilibria and, thus, of strengthening their propensity to postpone significant adjustments.[12] Consequently, *ceteris paribus*, the implementation of the rules in the normal regime will require stronger multiannual adjustments in these same countries to be compliant with the new binding quantitative safeguards. Finally, it will become more difficult to design an effective contract between the Commission and each EU country with important fiscal disequilibria; the increased severity of the national adjustments will hinder cooperative interaction or – at least – the implementation of cooperative outcomes in the normal regime.

To specify these three risks, it is necessary to provide some details of the new fiscal rules and to stress their differences from the Commission's proposal. In so doing, I will mainly focus on the preventive arm of the new fiscal rules that includes the most important changes.[13]

The proposal of April 2023 emphasized that member states with a public deficit to GDP ratio of over 3% should implement a structural yearly adjustment of at least 0.5% of GDP. This quantitative adjustment coincided with that required of the countries under European procedure for excessive public deficit in the old SGP. That aspect of the corrective arm had not been redefined by the Commission's proposal. Hence, a possible and logical explanation of the new emphasis put on the 0.5% minimum threshold is that the fiscal rules had a strengthened chance to impose this structural adjustment without opening a formal procedure.

Conversely, the new fiscal rules limit the possibility of exceptional events that are triggered by macroeconomic or idiosyncratic shocks beyond the control of the national governments. In these cases, temporary "escape clauses" become operative.[14] This does not mean that, in the new fiscal rules, a public deficit to GDP ratio higher than 3% automatically leads to the opening of a European procedure. It is explicitly underlined that the Commission should consider, as mitigating factors, that part of public expenditures due to defense and the implementation of reforms and investment also relating to the national Recovery and Resilience Plans, as well as a high rate of potential growth and low rates of private debt; conversely the Commission should consider, as an aggravating factor, an excessive public debt to GDP ratio.

As I just recalled (see n.12 above), there is a very low probability that these relevant factors can avoid the opening of a European procedure towards France, Italy, and other EU member states in

---

[11] The French Presidential elections will be held in 2027. Hence, the French government has a strong short-term interest in postponing severe fiscal adjustments after that date to avoid the political cost of a recessionary fiscal policy. A similar situation characterizes the political cycle of other member states with strong excessive imbalances (for example, Italy). Hence, the temporary regime of the new fiscal rules is the result of a political bargain. These rules meet the German long-term objectives but offer short- to medium-term flexibility to fragile EU member states.

[12] As I will specify below, this impact is subject to two limits. First, the weakening of the short-term fiscal adjustments is decided by each country within binding quantitative constraints determined by the new fiscal rules even in the temporary regime. Second, there is a very high probability that member states that are more interested in the short-term flexibility will enter a European procedure for excessive public deficit before the launch of the new fiscal rules; hence, these countries will be entitled to utilize the temporary regime under the Commission's strict surveillance.

[13] The reference to the corrective arm will be limited to a few aspects. A more detailed analysis of the consequences that the incentive constraints designed by the *ex-ante* contracts of the new fiscal rules can have in terms of enforcement will be the subject of a future paper (see n.9 above).

[14] Differently from the Commission's proposal, the new fiscal rules make an explicit distinction between an "escape clause" that applies to major general shocks and a "country-specific escape clause" that applies to unpredictable negative events affecting a given member state. This distinction is useful as it represents an improvement offered by the new fiscal rules; however, it could have easily been included in the Commission's proposal.

2024. The public deficit to GDP ratio of these countries largely exceeds 3%. Moreover, their public debt to GDP ratio is largely above 90%, and there is a high risk that their net public expenditures will record deviations higher than those allowed by the new fiscal rules: yearly deviations above 0.3% of GDP and cumulative deviations above 0.6% of GDP. In principle, these countries could thus be submitted to a procedure for excessive deficit or excessive debt; and the latter procedure would be more binding because it requires that the member states involved be able to return to their original adjustment trajectory at a sufficient pace (cf. n. 5 above) and before a pre-determined deadline. However, in 2024 the new fiscal rules will not be operative, and the opening of a procedure for excessive deficit makes the activation of a procedure for excessive debt unlikely.

Here, it is important to stress that the impact of an excessive deficit procedure on the member states could be moderate in terms of fiscal adjustments for the years 2025-2027. With the temporary regime being operative, these countries will be allowed to adjust their public deficit by excluding their additional financial burden due to the increases in the interest rates on their public debt. Consequently, within this limit, their yearly adjustments could be lower than 0.5% of GDP by a few decimal points (perhaps 20 basis points).

One of the likely consequences of the temporary regime is that the member states under procedure will be unable to reduce their public deficit to GDP ratio below 3% before the end of 2027. After that date, it will be necessary to implement a yearly full adjustment to be compliant with the permanent (i.e. normal) regime. However, the slower adjustments of the 2025-2027 period imply that compliance with the 3% rule will be met in a longer horizon and – *ceteris paribus* – with a higher public debt to GDP ratio. To appreciate the importance of the latter implication, it is necessary to recall that every country exiting the procedure should define its multiannual fiscal adjustment plan by considering the specific DSA elaborated by the Commission and by establishing a "technical dialogue" with the Commission based on several variables (besides the incidence of the public debt and public deficit, forecasts on interest spending, private savings, age-based expenditures, and so on.) A comparable but probably easier multiannual plan should be elaborated starting in 2025 by those member states with a public deficit below 3% of GDP but with a public debt above 60% of GDP.

As stated above, each national plan lasts four years and can be extended to seven years by including reforms and investments that suit the European programs and the European Semester's country-specific recommendations, and that need a longer horizon for obtaining the forecasted positive results. The consequent net expenditure path, which is the only unit of measure of the fiscal adjustments (see n.3 above) and which must be specified by each country in its fiscal plan, will be assessed by the Commission. Given this assessment and the advisory opinion of the European Fiscal Board, the EU Council will take its decision on the approval of each fiscal plan. It is obvious that the severity of the national adjustment processes, which is required to obtain the approval of a given plan, will be directly correlated with the starting incidence of the national public debt and with the appreciation of the other relevant variables mentioned above. Hence, *ceteris paribus*, the temporary regime can worsen the severity of the adjustments required for countries with fiscal disequilibria during the normal regimes.

This framework reaffirms each country's ownership of its specific process of fiscal adjustments as well as its possible cooperative interaction with the Commission in the definition of a medium- to long-term equilibrium. However, in the new fiscal rules, this interaction is burdened by the introduction of quantitative safeguards and various constraints. As shown in the following section, these new quantitative indicators have different operating areas and do not apply to member states under the European procedure for excessive deficit or debt. In any case, they make the correlation between the severity of the national adjustment processes and the national public debt even more binding. Hence, they worsen the distortionary interaction between temporary and normal regimes.

The impact of the quantitative safeguards

The first quantitative safeguard is represented by the request to keep the maximum structural deficit of each country at 1.5% of GDP, independently of the incidence of its public debt.[15] Moreover, the new fiscal rules fix the minimum rates of adjustment that the national plans should include to reach this structural deficit in case of original non-compliance: a yearly increase in the primary surplus of, at least, 0.4% of GDP in the four-year plans; and a correspondent increase of 0.25% in the seven-year plans. These new indicators are less binding than the maximum thresholds of structural deficits fixed by the Fiscal Compact: 0.5% for countries with a public debt-to-GDP ratio above 60%, and 1% for the remaining member states. They are also less severe than the constraints imposed by the MTOs in the old SGP.[16] However, the new safeguard of 1.5% follows the same logic of the components of the old fiscal rules; and, differently from the structural equilibrium of the Fiscal Compact and the MTOs, it restates the "one size fits all" principle which is in contradiction with the national ownership and threatens the feasibility of *ex-post* cooperation between the country and the Commission.

Another quantitative safeguard is determined by the request for a minimum yearly decrease in the public debt-to-GDP ratios that are above the threshold of 60%. This minimum rate is fixed at 1% of GDP for member states with an incidence of public debt exceeding 90%, and at 0.5% of GDP for member states with an incidence of this debt between 60% and 90%. The new quantitative indicator is less severe than the old SGP's 1/20 debt rule; however, also in this case, it reproduces the approach of the old fiscal rules, which is in contradiction with the country-specific fiscal adjustments. Moreover, this new safeguard tends to disincentivize the pursuit of the objective that was at the core of the Commission's proposal: a non-confrontational combination of national public debt sustainability and implementation of an adequate economic growth rate. Finally, it could become systematically non-binding for those member states that have exploited the temporary regime of the new fiscal rules and, in so doing, have worsened their public debt-to-GDP ratios and thus need severe fiscal adjustments in the normal regime.

These three features of the quantitative indicator under examination show that its introduction is either distortionary or useless. Hence, in my view, this indicator is a safeguard that weakens the coherence of the new fiscal rules relative to the Commission's proposal of April 2023. This criticism contrasts with the comparative analysis offered by Zettelmeyer (2023), who maintains that the request for a yearly minimum decrease in the public-debt-to-GDP ratio is less intrusive than the quantitative indicators included in the normative scheme proposed by the Commission.

As I mentioned above (see Section 2), the Commission elaborated three constraints to avoid opportunistic postponements of the fiscal adjustments at the conclusion of the national fiscal plans. It required countries to keep the dynamics of their net primary expenditures below the medium-term growth rate of their GDP, to reduce the public debt to GDP ratio in a horizon of four years even in the case of seven-year plans, and to implement 'proportional' fiscal adjustments over time. The shared criticism is that these three constraints are redundant. Zettelmeyer (2023) adds that specifically the second constraint could impose premature and overly severe debt adjustments on EU member states ready to implement reforms and investments with positive effects in the medium to long term. Conversely, I interpret the second indicator in the light of the third one, in the sense

[15] The extension to all countries that are not under the European procedure for excessive deficit implies that this quantitative provision pursues a stabilization objective that goes beyond the sustainability of national public debts.

[16] The medium-term budgetary objectives (MTOs) of the EU countries were introduced in the 2005 reform of the SGP and aim at ensuring public debt sustainability. In particular, the national determination of the MTO must include a safety margin to manage shocks and temporary non-compliance with the EU's fiscal rules. Member states deviating from their MTO should implement a yearly structural adjustment of their balance disequilibria at a rate equal – at least – to 0.5% of GDP.

that the binding constraints should be put by the latter.[17] Hence, differently from the safeguards introduced by the new fiscal rules, the overlapping of these two indicators is coherent with the core of the Commission's proposal: the national ownership of the fiscal adjustment processes and the *ex-post* cooperation between each member state and the Commission.

In support of my interpretation, it should be noted that also the new fiscal rules emphasize the third constraint that was proposed by the Commission and that tends to incorporate the second one. Article 6 of the preventive arm maintains that "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" (EU Council, 2023b).

Let's assume that my previous reading of the Commission's proposal is fully shared. Yet, my criticism of the two quantitative safeguards introduced by the new fiscal rules could be subject to a serious remark: it apparently neglects an important mitigating factor of the possible negative impacts of these two safeguards.

According to the text of the European Regulation on the preventive arm, the constraint of a maximum structural deficit at 1.5% of GDP, as well as that of a minimum decrease (1% of GDP) in the yearly incidence of the public debt, are directly included in the technical trajectories determined by the Commission's DSA, not in the national fiscal plans. The distinction is important because, as I specified above with respect to the Commission's proposal (see Section 2), the technical trajectories should offer an important but non-compulsory reference to the process of fiscal adjustment decided by the national government of each member state affected by a high public debt or a high public deficit. This point is partially confirmed by the new fiscal rules: a member state can change the assumptions of the DSA in its medium-term fiscal adjustment process, but this choice must be explained and "duly" justified (see EU Council, 2023b). To consider all these factors, I qualified the introduction of the two safeguards in terms of a "request". However, it is true that my following criticism did not take into account the possible non-compulsory nature of these safeguards; and this factor would limit the binding and distortionary impacts of the two related constraints.

My possible oversight has an explanation. In the new fiscal rules, the introduction of the quantitative safeguards through the Commission's technical trajectories must be combined with two important changes in the definition of the DSA's role, which is implicit in the statement of the EU Council (2023b) just referred to. The first change is that the methodology adopted by the Commission to specify the national technical trajectories is not only subject to transparency and reproducibility criteria but it is also submitted to the formal approval of the EU Council. The second change is that the EU Council can suggest improvements to the DSA methodology to the Commission by making recourse to the advice offered by an "Economic and Financial Committee" composed of national experts, the Commission, and the European Central Bank.[18]

It looks quite odd that a tool such as the technical trajectories, to be utilized as a mere reference in the definition of the national fiscal plans, be burdened with a superstructure so complex as to involve several European institutions as well as experts of the member states. Moreover, in the past, the DSA's methodology adopted by the Commission was shared with the member states through various technical committees. Hence, these changes could be justified only if they pursued the aim of redefining the role of the DSA in the contract between the Commission and each member state. In this perspective, the technical trajectory attributed to a given EU country would become the general compulsory constraint to be met by the corresponding national fiscal plan. Consequently, the two safeguards under examination (a structural public deficit below 1.5% of GDP and a yearly rate of decrease in the public debt to GDP ratio of at least 1% of GDP) would become quantitative

[17] In Section 2, I had already suggested to focus on the third constraint and to skip the second one.

[18] The European Fiscal Board and the European Stability Mechanism should sit on this Committee as observers.

constraints of the national fiscal plans even if they were not directly included in these plans. To be more precise, it could be stated that these safeguards would become compulsory constraints for the national fiscal adjustments precisely because of their inclusion in the national technical trajectories.

This new role of the technical trajectories would have an important impact on the structure of the contract between the Commission and the member states. In the Commission's proposal, that contract allowed that *ex-ante* non-cooperative interaction to achieve *ex-post* cooperative outcomes. Conversely, in the new fiscal rules, the game structure could refer to the interactions between the EU Council and each member state with the Commission confined to the role of intermediary between the two main parties.

Two interrelated clues support my hypothetical interpretation of the DSA's role in the new fiscal rules. The first is the insistence of these rules on the following aspect: if a multiannual national fiscal plan was judged non-compliant with the Regulation, the EU Council should recommend that the original technical trajectory, previously specified by the Commission for this member state, become "its next expenditure path" (see EU Council, 2023b, art. 18). An analogous provision was included in the Commission's proposal. However, considering the possible change of the contract structure in the new fiscal rules, this provision could be interpreted as a credible threat pushing each member state to be *ex-ante* (even if not necessarily *ex-post*) compliant with its technical trajectory. In this new framework, the second clue depends on the modified role played by the Commission's technical trajectories. The statement according to which a member state "shall provide in its plan sound and data-driven economic arguments" justifying its possible choice of changing the assumptions of the DSA in its medium-term fiscal adjustment process, should be read as proof that any deviation of the national fiscal plans from their technical trajectories represents an exceptional case (see EU Council, 2023b, art. 11).

This conclusion does not only justify my previous analysis of the role played by the quantitative safeguards in the new fiscal rules. Its main consequence refers, instead, to the incentive design and to the enforcement that characterize these rules. In the above interpretation, the EU Council would be entitled to impose a specific technical trajectory on each member state with excessive fiscal disequilibria; consequently, the national ownership in the definition of the medium-term fiscal plans would be reduced to the modes and tools utilized to meet this imposed result.[19] As in the old SGP, the interaction between the EU Council and the member state with excessive disequilibria should be interpreted in terms of a principal-agent model with incomplete information whereby the principal (the Council) deludes itself by believing that its objective (the *ex-ante* and *ex-post* compliance with the national technical trajectories) can be successfully implemented without incentivizing the agent (the member state).

As I mentioned above (see Section 3), economic theory has proven a long time ago that this would not be the efficient and dominant strategy for the principal. An agent that can pursue actions in its own interest without complete monitoring by the principal and without binding incentive constraints would find it worthwhile to make the *ex-ante* commitment of selecting the actions preferred by the principal and to withdraw *ex post* to maximize its utility. Hence, if the new fiscal rules are interpreted in this way, they will reproduce the main drawbacks of the old SGP.

The last statement cannot be a clear-cut interpretation of these rules. On the one hand, referring again to article 11 of the Regulation on the preventive arm of the new fiscal rules (see EU Council, 2023b), it remains true that the DSAs exclude the reforms and investments characterizing each of

[19] I do not think that the Commission's proposal, as well as the new fiscal rule, imply direct interference of European institutions (either the Commission or the EU Council) in the tools and contents of the national fiscal policies. These rules only matter for the determination of the balance sheet. The same applies to the old SGP. The European Treaties state that the definition of national fiscal policies is responsibility of the national policymakers. Hence, the different types of fiscal rules can set quantitative constraints in the short- to the medium-long term, but they cannot interfere with the autonomous national tools utilized to comply with these constraints.

the four-year or seven-year national fiscal plans. On the other hand, it is well-known that effective reforms and efficient investments can positively affect the numerator and denominator of the fiscal ratios at the country level. It follows that the new fiscal rules are ambiguous on the management of fiscal disequilibria. Hence, the Directive and the two Regulations approved by the EU Council in the meeting of December 20, 2023, represent a compromise that hinders the full exploitation of a great opportunity to specify the mechanism design of the fiscal contract between European institutions and EU member states.

Conclusion

The previous examination of the new fiscal rules approved by the EU Council a few days before the end of 2023 has shown that these rules mark substantial progress to the SGP, as defined in the years 2005-2013. However, the agreement reached by the EU Council is a compromise that weakens many achievements characterizing the Commission's proposal as defined in April 2023, and mainly in November 2022.[20] In this perspective, it represents a missed opportunity to further improve European economic governance.

To compare the different steps in the evolution of the EU fiscal rules, this paper has utilized a specific theoretical key: the old SGP, the Commission's proposal, and the new fiscal rules have been analyzed in terms of the principal-agent literature focusing on mechanism designs. The main conclusions are: (i) the design of the SGP is based on several quantitative indicators that do not include any binding incentive constraint, so that the principal (i.e., the European Commission) imposes a set of fiscal rules on the agents but is unable to induce any of these agents (a member state, specifically with significant fiscal disequilibria) to be *ex-post* compliant with the commitment imposed *ex ante*; (ii) the Commission's proposal defines few quantitative indicators that are compatible with a binding incentive constraint because member states exercise their national ownership in defining their specific fiscal plans and in selecting the most appropriate national combination between public debt sustainability and economic growth; (iii) the EU Council's agreement adds quantitative safeguards to the Commission's scheme, and these new indicators can become too demanding for EU countries with significant fiscal disequilibria and can, thus, interfere with the binding incentive constraints.

As confirmed by the empirical evidence, point (i) emphasizes that the enforcement of the old SGP was extremely poor due to the inefficient structure of the contract. To simplify the matter, it could be stated that European institutions built an analytical scheme that works under the assumption of perfect information and consequent perfect monitoring. Unfortunately, this scheme was applied to a world of incomplete information where the principal is unable to perfectly check the actions of the agents. The improvements offered by the Commission's proposal help overcome this weakness. Each agent (an EU country) will hold the ownership of its fiscal plan even if it is subject to a few quantitative constraints and must take into serious account the technical trajectories and the advice elaborated by the Commission. Hence, as stated above in point (ii), EU countries retain full responsibility for their *ex-ante* commitments and implementation in terms of fiscal adjustments. In this scenario, the structure of the contract is centered on a binding incentive constraint: even the EU countries that need strong fiscal adjustments find it useful to meet *ex post* their commitments. Point (iii) maintains that the compromise reached by the new fiscal rules approved by the EU Council includes additional quantitative safeguards to the Commission's proposed framework. These

[20] In the following, I do not distinguish between the November Communication and the April normative text. For a more detailed analysis, see Sections 2 and 3.

safeguards respond to a methodology that is analogous to that characterizing the old fiscal rule. Consequently, these safeguards weaken the binding incentive constraints in the structure of the contract designed by the Commission's proposal so that they can make it convenient for the EU countries with significant fiscal disequilibria to withdraw from their *ex-ante* commitments.

In the new fiscal rules, the national ownership of the fiscal plans is reaffirmed because national policymakers could influence the extension of these plans (either four- or seven-year plans) as well as the effective combination of direct fiscal adjustments (the numerator of the fiscal ratios) and the support of the potential growth rate (the denominator of the fiscal ratios). In this sense, it is confirmed that the new fiscal rules mark progress with respect to the old SGP. Nevertheless, the reference to new and demanding quantitative safeguards underlines that these rules weaken the incentives in terms of *ex-post* compliance. The quantitative safeguards are too complex to be easily enforceable and tend to put the fragile relationships of member states with European institutions under stress.

This stress is increased by two additional elements. The first element is the ambiguous role played by the DSA. In the new fiscal rules, the technical trajectories defined by the Commission through the DSAs tend to be transformed into a binding minimum threshold for the national fiscal adjustments. The second element is the introduction of an initial phase of flexibility (2025-2027) that encourages the short-termism of national policymakers. The temporary regime of the new fiscal rules implies that many EU countries with significant fiscal disequilibria will enter the following normal regime (starting in 2028) and will define their related national fiscal plans with a public debt burden that, *ceteris paribus*, will be higher than the one they would have had in the absence of the temporary regime.

My conclusion is that, in the new fiscal rules, the risk of causing systematic *ex-post* withdrawals of member states from their ex-*ante* commitments is lower than in the old SGP but higher than in the Commission's proposal of April 2023. This conclusion justifies, *per se*, the statement that the fiscal reform marks progress but is, at the same time, a lost opportunity. However, there is a more general methodological reason that justifies the negative side of my statement.

The compromise reached by ECOFIN on December 20, 2023, weakens the approach introduced by the Next Generation-EU and the Recovery and Resilience Facility: to reward the member states that meet the commitments specified in their national Recovery and Resilience Plans in terms of targets and milestones. The strengthening of this approach would have been the preliminary but essential condition to put the central fiscal capacity (CFC) and the production of European public goods (EPGs) at the core of European economic governance. Moreover, the CFC and the production of EPGs are a crucial component of the European industrial policy that is a necessary tool to positively improve the EU's internal and external agenda (see Buti and Messori, 2022).

The European productive model is obsolete. Therefore, it is unrealistic to ground the future economic growth of the EU and – mainly – of the euro area on net exports as in the recent past. To improve the economic growth and convergence within the EU and to reproduce the European social model, it is necessary to implement a profound and widespread restructuring of the EU's economic activities. Moreover, this restructuring is made even more urgent by the increasing technological conflict between the United States and China and by the growing geopolitical tensions that are making the EU's international role marginal. Hence, dramatic changes in the EU's soft power (in terms of regulation and welfare state) and a reversal of the EU's widening lags in innovative activities are required. CFC and EPGs are crucial to upgrade the EU's economic model, to implement the 'green' and digital transitions, and to reaffirm the importance of the European social system. In brief, they are necessary to protect the EU's economic and social cohesion and competitiveness in a changing world.

As I just mentioned, the new fiscal rules do not put the CFC and the production of EPGs at the core of European economic governance. In this sense, they represent a missed opportunity to support the most effective evolution in European economic governance.

Bibliography

Alcidi, C. and D. Gros (2018), "Debt sustainability assessments: The state of the art", *The Economic Governance Support Unit of the European Parliament*, November, Brussels.

Başar,T. and G. Zaccour, (2018). *Handbook of dynamic game theory*, Springer, Berlin.

Buti, M. (2021), The man inside. A European journey through two crises, Milan: Bocconi University Press.

Buti, M., Friis, J.W. and R. Torre (2023), "The emerging criticisms of the Commission proposals on reforming the European fiscal framework: A response", *VoxEu*, 10 January.

Buti, M. and M. Messori (2022), "A central fiscal capacity in the EU policy mix," *CEPR Discussion Paper*, DP17577.

Corsetti, G. (2018), "Debt sustainability assessments: The state of the art", Study requested by the ECON committee of the European Parliament, November.

Darvas, Z. and P. Hüttl (2014), "The long haul: Debt sustainability analysis", Bruegel Working Paper, n. 06.

Darvas, Z., Welslau, L. and J. Zettelmeyer (2023), "A quantitative evaluation of the European Commission´s fiscal governance proposal', Bruegel Working Paper, n. 16.

Dermine, P. and M. Larch (2023), "Solving the enforcement dilemma of the EU fiscal rules, EconPol Forum, n.4, vol. 24, July, pp. 26-29.

Eurogroup (2023), "Eurogroup statement on the euro area fiscal stance for 2024", Brussels, 13 July.

EU Council (2023a), "Proposal for a Council Directive amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States", Brussels, 20 December

EU Council (2023b), "Proposal for a Regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation n° 1466/97, Brussels, 20 December.

EU Council (2023c), "Proposal for a Council Regulation amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure", Brussels, 20 December.

European Commission (2015), "Communication making the best use of the flexibility within the existing rules of the Stability and Growth Pact", Brussels, 13 January.

European Commission (2016): "Vade mecum on the Stability and Growth Pact – 2016 edition," European Economy - Institutional Paper, n. 021 (March), Directorate General Economic and Financial Affairs (DG ECFIN), Brussels.

European Commission (2022), "Communication on orientations for a reform of the EU economic governance framework", COM/2022/583 final, Brussels, 9 November.

European Commission (2023a), "Debt sustainability Monitor 2022", Institutional Paper, n.199, April, Brussels.

European Commission (2023b), "Proposal for a Regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97", COM/2023/241 final, Brussels, 26 April.

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

European Fiscal Board (2023), "Assessment of the fiscal stance appropriate for the euro area in 2024", Brussels, 28 June.

Fudenberg D. and J. Tirole (1991), Game theory, MIT Press, Cambridge Ma.

Fuest, C. and D. Gros (2019), "Applying nominal expenditure rules in the euro area", *EconPol Policy Brief*, vol. 3, March 15.

International Monetary Fund (2011), "Modernizing the framework for fiscal policy and public debt sustainability", IMF Policy Paper, August.

Hart, O. (1988), "Incomplete contracts and the theory of the firm", Journal of Law, Economics, and Organization, vol. 4, n.1, pp. 119-39.

Hart, O. (1995), Firms, contracts, and financial structure, Oxford University Press, Oxford.

Kirchsteiger, G and M Larch (2023), 'DP18304 The enforcement dilemma of EU fiscal rules', CEPR Discussion Paper No. 18304. CEPR Press, Paris & London. https://cepr.org/publications/dp18304

Kreps, D.M. (1990), A course in microeconomic theory, Princeton University Press, Princeton.

Kydland, F.E. and E.C. Prescott (1977), "Rules Rather than Discretion: The Inconsistency of Optimal Plans", Journal of Political Economy, vol. 85, n.3, pp. 473-92.

Laffont, J.J. and J. Tirole (1988), "The dynamics of incentive contracts", Econometrica, vol. 56, n.5, pp. 1153-75.

Myerson, R. B. (1983), "Mechanism design by an informed principal", Econometrica, vol. 51, n.6, pp. 1767-97.

Myerson, R. B. (1991), Game theory. Analysis of conflict, Harvard University Press, Cambridge Ma.

Pench, L. (2023), "Making sense of the European Commission's fiscal governance reform plan", Bruegel Policy Brief, n.17, September.

Reichlin, L. (2023) 'The Fight Over EU Fiscal Reform', Project Syndicate, 5 June, https://www.project-syndicate.org/commentary/european-commission-flawed-reform-of-stability-andgrowth-pact.

Tirole, J. (1999, "Incomplete contracts: Where do we stand?", Econometrica, vol. 67, n.4, July, pp.741-81.

Tumpel-Gugerell, G. (2017), "EFSF/ESM Financial Assistance Evaluation Report", European Stability Mechanism, Luxembourg.

Williamson, O. (1975), *Markets and hierarchies: Analysis and antitrust implications*, Free Press, New York.

Zettelmeyer, J. (2023), "Assessing the Ecofin compromise on fiscal rules reform", Bruegel Commentary, Brussels, 21 December.