Comments on
"Redesigning EU Fiscal Rules: From Rules to Standards"
by O. Blanchard, A. Leandro and J. Zettelmeyer

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As a consequence of the current COVID crisis, many member countries of the European Union (EU) are likely to have debt/GDP ratio in excess of 100 percent, a level that is well above the limit of 60 percent imposed by current EU fiscal rules. These rules have been suspended, and it is now time to think about which rules should be adopted afterwards.

The EU fiscal rules have been widely criticized, even before COVID, for being "too stringent", "too complex" and "hard to enforce". The strict 60 percent debt and 3 percent deficit limits initially established by Stability and Growth Pact (1997) were recurrently violated, and were modified by a stratification of reforms, each allowing for new contingency clauses and procedures, resulting in an extraordinary complex structure ---using the authors' words "like the Cathedral of Seville where [...] the many additions make it hard to see the consistency of the whole".

The open question is what kind of reform could be realistically undertaken. It is often emphasized that abandoning the 60 percent and 3 percent debt and deficit limit does not seem feasible from a political viewpoint, as it would require changing the Treaties. For this reason, most existing proposals argue to replace the abundant escape clauses and procedures with simpler expenditure rules, where the speed of adjustments to the long-run targets may vary depending on the cyclical conditions, and for instance allow member countries to implement countercyclical stimulus packages.

This paper proposes a different approach. The main premise is that introducing new rules, while an improvement, won't be enough. From a practical viewpoint, it seems unfeasible to codify all the possible future economic conditions into a rule. Thus, any fiscal rule that specifies ex-ante some formulas or quantitative criteria, is likely to be inadequate ex-post: it would be "too strict" in some cases, and "too loose" in others.

The authors' proposal is to adopt a different legal framework, and namely to move from "rules" to "standards". For instance, the "rules" imposing the current debt and deficit limits could be replaced (or supplemented) with the "standard" that "Member states shall ensure that their public debts remain sustainable with high probability". Whether debt is sustainable or sufficiently "safe" will be determined ex-post through a

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quantitative framework (e.g., the stochastic-debt-sustainability-analysis). The paper also discusses some options to guarantee the enforcement of the fiscal standards, such as which institutions should be responsible for initial surveillance (e.g., the European Commission), and who would serve as final adjudicator of potential disputes (e.g., the European Council or the European Court of Justice).

This proposal deserves to be taken into serious consideration. The key question is whether adopting fiscal standards would constitute an improvement relative to the status quo. My discussion focuses on two main questions. First, would the introduction of "standards" affect the credibility/enforceability of fiscal regulations? Second, would the proposed standards provide more flexibility to implement countercyclical polices, relatively to the status quo?

Regarding the first question, the conventional wisdom is that replacing the existing debt and deficit limits with more loosely defined standards ("debt sustainable with high probability") may severely undermine credibility. It is not obvious this would be the case. Are the existing rules more or less credible that the proposed standards? The typical criteria to assess the credibility of fiscal policies is to look at the expectations that an announced policy will be carried out, or the probability that governments will honor their debt obligations. According to these criteria, the current rules are not very credible. The prescribed debt and deficit limits were repeatedly violated, and (almost) no sanctions were imposed. Also, and due to their complexity, the application of the rules is subject to a high degree of discretion, and it is very difficult to foresee what the limits are in practice. Finally, what happened during the last decade demonstrated that the existing EU regulation is not adequate to avoid turbulence in sovereign debt markets and default episodes.

In contrast to the conventional wisdom, the adoption of standards may actually enhance credibility. One reason is that, almost by definition, it is more difficult to violate a standard than a strict rule. For instance, in the current circumstances with low (or even negative) interest rates, most EU countries are violating the 60 percent debt limit, but would not violate the standard to maintain a "sustainable debt with high probability". Another reason is that the proposed standard is better suited to prevent default episodes. Fiscal policies would be evaluated according to a debt-sustainability analysis, to keep the probability of default below a certain threshold. Now, consider a situation with high interest rates (r) and low growth prospects (g), i.e. where $r>g$. As is well known, in this case debt is not sustainable, regardless of whether the country complies with current the 60 percent debt and the 3 percent deficit limits. The proposed standard would then trigger a corrective action, but current rules would not.

As recognized by the authors, a crucial aspect for the implementation of standards is related to the transparency of the evaluation criteria, and to the procedures to resolve the disputes. This would be a complex and delicate aspect of any EU fiscal reform, and of the outmost practical relevance. But it there is no obvious advantage or disadvantage of standards vs rules along this dimension, at least considering a status-quo where the application of the rules is subject to a high degree of arbitrariness.

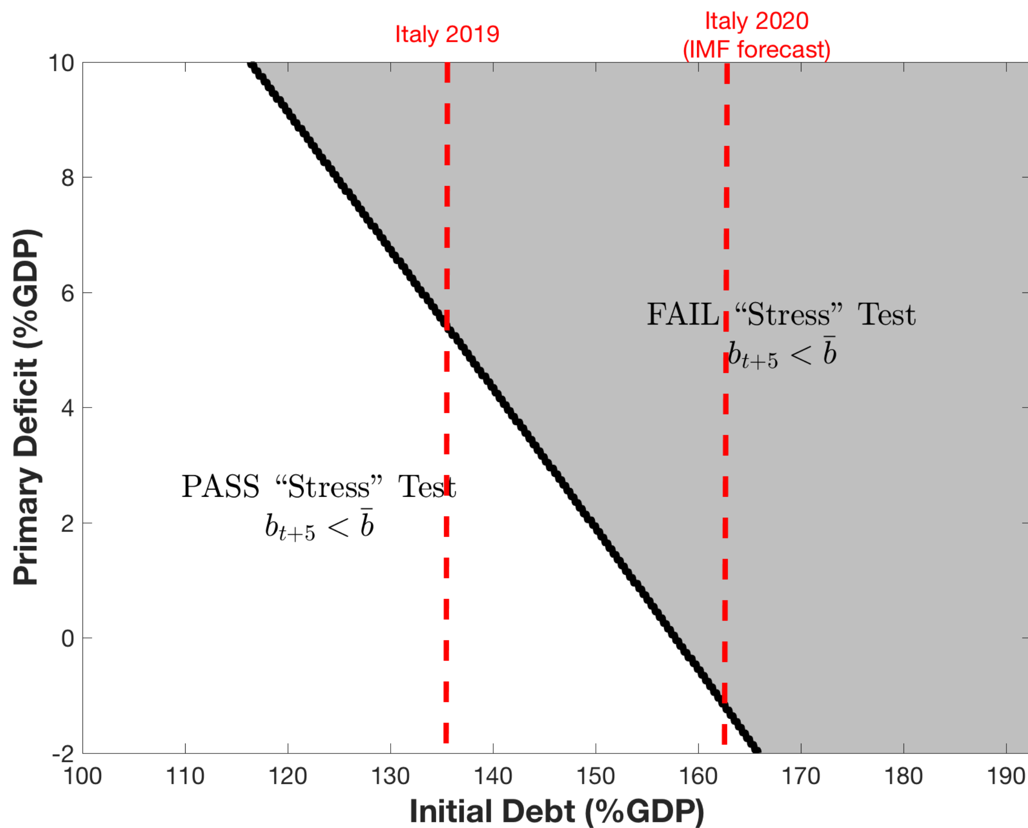
Let's now consider the issue of flexibility. Standards would lead to more flexibility than rules *de iure*. A separate question is what would happen *de facto*. For instance, it is not clear that the 60 percent debt "anchor" effectively constitutes a binding constraint. In most EU countries debt has been well above that limit for many years, and the expenditure rules prescribed a slow pace of adjustment, with many exceptions. Thus, removing the 60 percent debt limit may not make much of a difference (and would involve changing the Treaties). Things are different regarding expenditure limits. In this respect, it is worth remembering that, even if standards may provide more flexibility, they would not necessarily lead to looser fiscal policies than current rules. For instance, it is not clear that under the current economic circumstances, applying the proposed stochastic-debt-sustainability-analysis would allow countries to implement larger fiscal stimuli.[2]

Just to give a concrete example, and following authors' analysis, consider a country like Italy, with an initial level of debt (as of 2019) of about 135 percent of GDP. For simplicity, let's postulate that the growth rate of GDP is 1.2 percent per year (which corresponds to the Euro-Area average during the 1999-2019 period), that the maximum primary surplus that this country could implement is 2% per year, and that the real interest rate follows the process $r_t = -0.016 + 0.02b_t$. In this case, the maximum sustainable level of debt is 192%, clearly much higher than the current 60 percent limit. Let's now consider an adverse scenario (or a "stress test"), where interest rates increase by 350 basis points for 5 years ---as it happened during the 2011–2016 period--- and ask under which conditions debt would remain sustainable after 5 years. As illustrated in the Figure below, if the initial level is 135 percent of GDP, debt would remain sustainable as long as the deficit remains below 5 percent of GDP per year. However, if the initial level of debt increased above 160% (as predicted by the IMF for year 2020), debt would no longer be sustainable, even if it were running a primary surplus. It is hard to say what is the probability of such an adverse scenario, but the example clarifies that the outcome of the stochastic-debt-sustainability analysis may actually lead to more restrictions than the current rules (which had to be

[2] In fact, the stochastic-debt-sustainability analysis is already among the tools used by the European Commission (see e.g., 2020 Annual Report of the European Fiscal Board).

suspended).

To conclude, this paper contains a valuable proposal to re-design the EU fiscal rules. Adopting fiscal standards is not incompatible with the current Treaty (as abolishing the debt and deficit limit is not necessary) and may actually enhance the credibility of the EU regulations, conditionally on important implementation details. However, it remains unclear whether under the proposed reforms countries will be able to implement countercyclical fiscal policies, which are needed to respond to adverse economic shocks. In that case, there remains very few options, such as developing the fiscal union, improving financial integration and risk-sharing mechanism, and establishing a lender-of-last-resort. Without these reforms, the EU regulations would resemble the Basilica of the Sagrada Familia, a visionary project initiated more than a century ago (in 1882), but still incomplete.



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