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European Union’s Fiscal Rules and New Financial Instruments for 2021-2027: Bulgaria’s Case Study

Iana Paliova, PhD[1]

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Abstract

Fiscal policymaking of the Member States aims to follow fiscal rules through the economic cycle that ensure macroeconomic sustainability in the European Union (EU). After the 2008 global crisis, the Stability and Growth Pact introduced the enhanced supranational fiscal rules, setting additional boundaries to fiscal deficits and government debt. The new ceiling on the structural deficit in public finance laws of Member States has served to protect creditworthiness. The COVID-19 pandemic, which led to a temporary suspension of the fiscal rules, clearly indicates that the key challenges are to implement a countercyclical policy during upturns, building buffers for bad days. Under the Next Generation Europe’s initiative the European Commission (EC) will borrow up to €750 billion and distribute it over 2021-2024 to Member States (European Commission, 2020a). Raising funds in the EU budget and repayment of the EC debt may lead to amendments to the design and application of the EU fiscal rules. This paper lays out the objectives of the EU current fiscal framework and its main pillars, discusses how the EC new financial instruments for the period 2021-2027 will be accounted for in the Member States’ fiscal framework, and what are its possible changes and challenges after Covid-19 and Brexit.

Keywords: EU integration, fiscal rules, financial instruments
JEL: F34, H62, F36

Introduction

The creation of the Economic and Monetary Union (EMU) was not accompanied by the creation of a fiscal union, following the subsidiary principle of the EU Treaty. The application

[1] Senior Assistant Professor at the Economic Research Institute, Bulgarian Academy of Sciences. E-mail address: i.paliova@iki.bas.bg

of this principle concerning the conduct of economic and fiscal policy accordingly, however, put back on the agenda after the 2008 global economic and financial crisis. Functioning of monetary union without a fiscal union meant large direct and indirect secondary effects on the EU economy from the independent fiscal policies of member states.

For its part, Britain, with its choice not to join the Eurozone and with its exit from the EU on February 1, 2020, has shown that differences between the countries remain. After Brexit the questions are what will be the implication of Brexit on the EU budget and how the debt, which is envisaged to be issued by the European Commission during 2021-2024, will be repaid by member states[2]. The discussion is also underway on how substantial transfers from the Next Generation Europe (NGEU)[3] initiative for economic recovery will reflect the fiscal framework.

In this regard, this paper lays out the objectives of the EU current fiscal framework and its main pillars, discusses how the EC new financial instruments for 2021-2027 will be accounted for in the member states' fiscal framework, and what are its possible changes and challenges after Brexit.

The working of the EU fiscal framework

The structure of the *EU fiscal framework* consists of three segments, with only the EU budget being the instrument for implementing fiscal policy at supranational level. The other segments are a set of rules and commitments through which member states harmonize and coordinate fiscal policy. Thus, a specific form of fiscal federalism has been adopted as a result of political and constitutional constraints on the EU level. These specificities relate to the fiscal jurisdiction between member states and the EU as a supranational body regarding the conduct of fiscal policy, the EU budget, public expenditure and revenue policy, and the uniqueness in terms of resource targeting, allocation and stabilization objectives.

The EU fiscal framework is laid out in the Art. 126 of the EU Treaty, stating the Member States should avoid excessive government deficit. The corrective arm of the Stability and Growth Pact (SGP) had to ensure that Member States adopt an appropriate policy response to correct excessive deficits. The crisis of sovereign debt as a continuation of the 2008 global financial and economic crisis, however, exposed structural weaknesses and adverse debt-related externalities of some European economies, which gradually hampered competitiveness. The 3% deficit limit in nominal terms did not protect countries from spending surpluses during an economic upswing. Unlike Finland and Luxembourg, other Eurozone countries suffered from persistent failure to meet the objectives of the structural deficit even before the 2008 global crisis.

[2] To finance the necessary investments, the European Commission will issue bonds amounting to EUR 750 bil. on the financial markets on behalf of the EU over 4 years, backed by the EU budget (see https://ec.europa.eu/commission/presscorner/detail/en/IP_20_2073).

[3] For details about the NGEU see https://www.consilium.europa.eu/en/policies/eu-recovery-plan/.

Moreover, the crisis showed that countries need to create stable fiscal buffers to ensure macroeconomic stability during a crisis and not to spread the adverse debt-related externalities as well as the negative effects of the financial system and international trade across member states. Therefore, the focus on nominal rather than structural targets, and the weak implementation of fiscal buffer initiatives, was revised in 2011 with the introduction of medium-term targets in structural terms for fiscal buffer building. This led to stricter supranational budgetary and macroeconomic surveillance and a more effective rescue mechanism for reforms aimed at debt sustainability, growth and competitiveness.

The reform included the adoption of a special directive Fiscal Pact (COUNCIL DIRECTIVE 2011/85/EU) and five regulations ("six packs") (COUNCIL REGULATION/EU/No 1177/2011), four of which deal with fiscal issues, including a reform of the preventive and corrective parts of the SGP. The other two regulations are for identifying and overcoming macroeconomic imbalances.

More detailed changes established second generation fiscal rules (2011), which provide flexibility to respond to economic shocks, avoiding clauses in severe recessions and new cyclical-corrective fiscal indicators, which should presumably support economic growth and also saving on excess income in strong growth to create buffers for rainy days. The stricter budget rules require member states to develop their national budgetary frameworks and legislation for the provision of budgetary discipline in support of macroeconomic and financial stability. In 2012 a Treaty on Stability, Coordination and Governance of the EMU was has been signed by 25 member states.

The contract introduced the Fiscal Pact for the strengthening of budgetary discipline and for enhancing economic governance through establishing fiscal councils based on the budgetary rules adopted in the EU in 2011[4]. The procedure of macroeconomic imbalances (2011) aims at monitoring imbalances in the private and public sector, going beyond their fiscal metrics. It includes monitoring of ten key indicators for potential sources of microeconomic imbalances, including private debt, current account of payment balance and the net investment position, which is an incentive for governments to conduct fiscal policy in support of growth through national programs for reforms and convergence programs. The "investment clause" (EU Regulation 473/2013, Article 16.2) in the context of the SGP allowed the EU member states that had fallen into a deep recession, though with a deficit below the designated pact level of 3% to benefit from it for implementation through investments in structural reforms in order to achieve employment and growth.

Thus, countries can deviate temporarily from the budgetary medium-term objectives (MTOs) or adjust the path to their achievement under the following conditions:

- Economic growth is negative or GDP remains well below its potential (i.e. the "output gap" is negative and greater than 1.5%);
- Deviation does not lead to a breach of the 3% limit for deficits and rule for 60% level of government debt;

4 In Bulgaria the Fiscal Council was established by law in 2015 (see https://www.fiscalcouncil.bg/bg/publikacii).

- Investment levels significantly increase the result;
- Deviation from the MTOs is associated with public spending on projects co-funded by the EU funds, including on the initiative for youth employment, trans-European system, and the financial instrument Connected Europe and the European Fund for Strategic Investments created for realization of the Europe's Investment Plan, called "Juncker Plan".

Member states need to compensate deviations from the MTOs in a four-year period of their current Convergence Program. In case of breaching the approved parameters, through the subsequent review, the EC and the European Council can propose new recommendations, including a fine of 0.2% of GDP for the Eurozone countries (Regulation (EU) No 1173/2011). For the Central and Eastern European countries, which are not members of the Eurozone, the failure to comply with the recommendations may lead to a delay in providing EU funds.

Medium-term budgetary objectives

Medium-term budgetary objectives for Member States (see MTOs) are at the heart of the preventive measure of the SGP. The legal basis is Art.2a of Regulation №1175/2011, which defines the way in which MTO is to be determined, while other articles regulate their roles. MTOs are determined in structural terms, which means that the budgetary position is structurally adjusted without one-off and other temporary measures.

The regulation specifies that the MTOs should be pursued to achieve a structural fiscal deficit of at least 1% of GDP for countries in the Eurozone and in the Exchange Rate Mechanism II (ERM II). Member countries that are signatories to the Treaty on Stability, Coordination and Governance in the EMU have an even more ambitious commitment to achieve at least 0.5% structural fiscal deficit. The lower limit can be determined at a 1% of GDP if their general government debt is significantly below 60% of GDP and risks regarding the long-term sustainability of public finances are low. Conceptually, the primary reason for concerns about the structural deficit is that the latter is projected to grow faster than the economy. We deem that the level of 1% is a limit for structural deficit, which is considered appropriate in the short run but should be adjusted to zero in the long term.

The calculation of the country-specific MTOs and their ceilings, which ensure compliance with the requirements of the SGP, is carried out according to the following methodology:

- To maintain the fiscal deficit cap of 3% of GDP. For each member state, a minimum value of the MTOs that provides a reserve for compliance with the limit shall be assessed, taking into account the accumulated volatility of production in the past period and the budgetary sensitivity to its fluctuations. In this way, the minimum reference value is calculated. A country with greater past volatility and greater budgetary sensitivity to its fluctuations will need stricter MTOs to ensure that the 3% limit is not violated during normal period of the economic cycle. The effect of the automatic fiscal stabilizers is ensured by including in the MTOs a sufficient reserve in terms of reaching the 3% limit.

- To provide sustainability or rapid progress towards sustainability. For each country in question a minimum value for the MTOs is calculated, which provides stability or rapid progress towards sustainability, taking into account contingent liabilities and debt. This minimum value ensures that the debt-to-GDP ratio approaches reasonable levels with due regard to the economic and financial assessment of the impact of population aging, and is a sum of three components.

MTOs = Fiscal balance (1) – expenses in the aging of the population (2) + efforts (3)

(1) denotes the budget balance, which will stabilize the debt-to-GDP ratio to 60%. It This is expected to be achieved by using the forecast for average nominal economic growth for the period 2010-2060 as calculated by the Working Group on Aging.

(2) represents the budgetary adjustment to cover part of the present value of the expected increase in age-related expenditure at $\alpha = 33\%$.

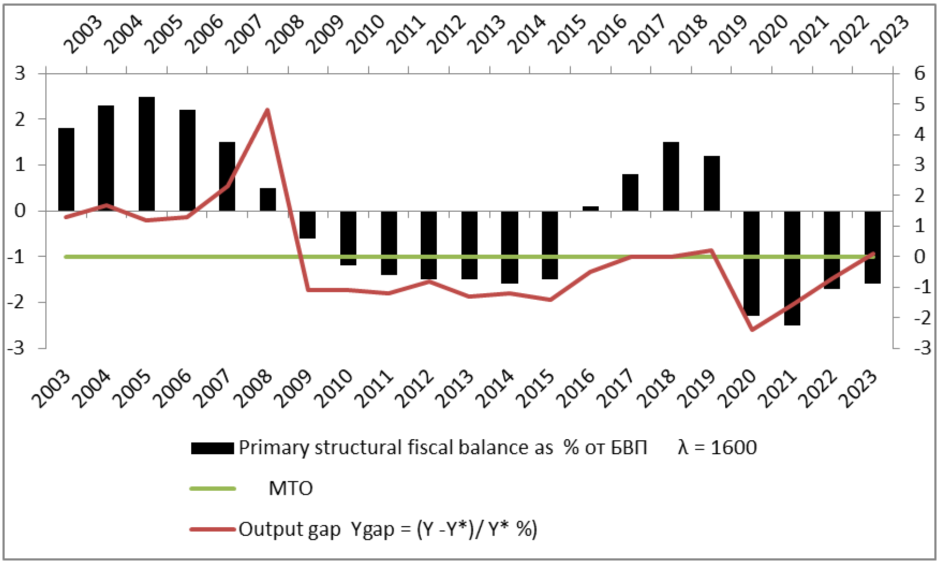
(3) represents an additional debt reduction effort specific to countries with gross government debt above 60% of GDP. It should be a continuous linear function that provides an additional effort of 0.2% of GDP while debt is seen to reach 60%. Additional effort of 1.4% of GDP is required when the ratio of debt to GDP is 110%.

The rationale for the EU fiscal policy rules is macroeconomic stability; however, each country should apply it according to its economic development and national circumstances.

The case of Bulgaria

Bulgaria has built a strong track record of prudent fiscal policy after introduction of the currency board introduced in 1997. Since then, the country is running sizable surpluses prior to 2008, reducing its public debt stock and accumulated sizable fiscal savings. The parliament introduced a rule in the organic low and in 2014 in the public finance law which limits the structural deficit up to 1 percent of GDP and caps expenditure at 40 percent of GDP as an appropriate level to preserve from "crowding out effects".

Bulgaria's fiscal policy for the period 2003-2023 was assessed, measuring the change in the primary structural fiscal balance against potential GDP (Graph 1). The calculated indicator Ygap (output gap), which represents the direction of deviation of actual GDP from potential GDP and characterizes the phase of the business cycle in which the economy is located, is calculated by the formula: Ygap = (Y - Y*) / Y*), where Y is the actual GDP and Y * is the potential GDP. Potential (trend) GDP Y* is defined as the actual GDP is cyclically adjusted with the Hodrick-Prescott filter (HP filter) at a smoothing parameter $\lambda = 1600$, which is standardly used in quarterly data and corresponds to the business cycle. The change in the structural (cyclically adjusted) fiscal balance was defined as the difference between cyclically adjusted budget revenues and fixed expenditures. Structural components of budget parameters were applied by clearing the cyclical elements of net budget revenues and expenditures at constant prices (Paliova, 2021).



Graph 1. Bulgaria's Primary structural fiscal balance (PSFB) and output gap (Ygap)

Source: Own calculations Paliova (2021), Ministry of Finance (2020)

After the 2008 global economic crisis during recession the output gap and structural fiscal balance of Bulgaria moved in parallel until 2016, and the structural fiscal balance was below the target of 1% of GDP. The assessment shows that since the early 2000s the fiscal policy of Bulgaria has been countercyclical, achieving fiscal consolidation aligned with the output gap movement (Paliova, 2021). During the period 2016-2019 when the output gap was positive, the country created stable buffers, keeping structural balance positive and higher than the MTOs target of 1% of GDP. During the COVID-19 pandemic the country's fiscal balance in structural terms has worsened, following the negative output gap. However, the projections showed a gradual improvement by 2023 (European Commission 2020/a).

Financial instruments of the EU budget for the 2021-2027 cycle

During COVID-19 outbreak the EU relaxed the temporarily effective rules for fiscal balance and government debt to accommodate increasing fiscal deficits and to provide support to households and firms, but fiscal balance and debt are expected to return gradually to their targets after 2021. Furthermore, the new macroeconomic situation of the Member States may require amendments to the quantitative fiscal rules or at least to the speed for their return to targets. The discussion about the fiscal rules' amendments was launched for several reasons.

First, the EU long-term budget for the 2021–2027 cycle of €1.8 trillion envisages the €1,074 billion budget together with a €750 billion Recovery Plan– Next Generation Europe (NGEU) as a response to the COVID-19 outbreak and €5billion for supporting the EU member states and economic sectors that are worst affected by Brexit. Under the NGEU for the first time the EC will borrow up to €750 billion and distribute it over 2021-2024 to all EU countries. Most of the resources amounting to €390 billion will be distributed among Member States as grants, while up to €360 billion could be distributed as loans. The EC debt will be repaid, starting 2027 and running to 2058, and the question is how Member States will contribute to it and what the consequences will be for their fiscal stance.

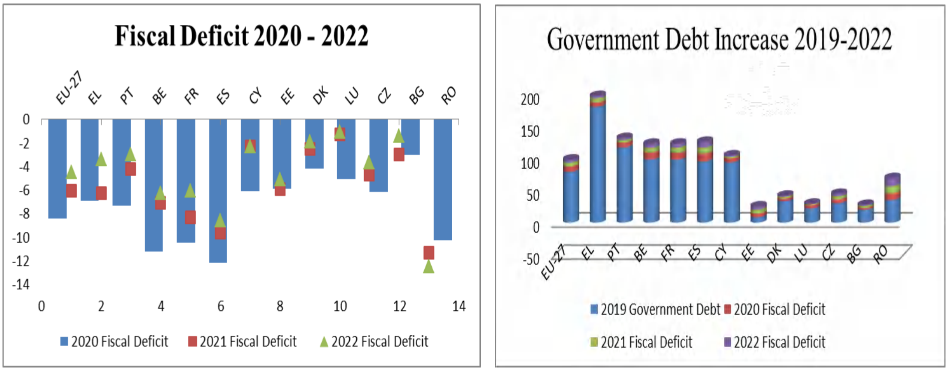
Second, the resources provided as loans to Member States will further increase their government debt when these resources are received through national budgets. Some of the resources might be absorbed by state-owned enterprises and the private sector for the purposes of transition to a low-carbon economy, which may create further fiscal risk.

Third, the money for the repayment of debt issued by the EC under the EU budget for 2021-2027 and used as grants by Member States is supposed to be raised from the Member States' contributions to the EU budget, including the newly created own resource of the EU budget, such as the unrecycled plastics tax, and from the GNI-based own resource of the EU budget as a "balancing" resource to cover expenditures in excess of the amount financed by the traditional own resources. Before Brexit the United Kingdom (UK) was reimbursed by 66% of the difference between its contribution to the EU budget and what the country receives back from the budget. The cost of the UK rebate was divided among all Member States in proportion to their share to the EU GNI. Since 2002 the normal financing share for Germany, the Netherlands, Austria and Sweden was also limited to 25% (European Commission, 2021). Consequently, after Brexit the remaining 34% of the former UK contribution to the EU budget should be compensated by all Member States. The latter changes in the contributions of Member States to the EU budget may further limit the fiscal space for expenditures under national budgets.

Fourth, under the NGEU initiative the EC aims to transform the EU economy towards green transition, which will require mobilization of public investments by member states and private investments. The implementation of the EU climate change and environmental objectives through the NGEU financial instruments for the period 2021-2027 can expose additional problematic areas for public finances' sustainability of Member States. Currently, the "investment clause" (2013) under the SGP allows EU member states in deep recession but with a deficit below the SGP's level of 3% to take advantage of it and implement structural reforms through investments in order to achieve employment and growth. Is this clause enough to reach or maintain sustainable fiscal and debt levels, including contingent liabilities, for the purposes of the implementation of the European Green Pact's objectives?

Thus, raising funds for the EU budget through borrowing at international financial markets will ensure funds to Member States during the period of the next program cycle for economic recovery and the green and digital transformation of the economy, but may also increase the levels of the government debt of Member States, and it will be more difficult to return to the 60% levels under the current fiscal framework. The current status of the government debt of many Member States is much above the 60% target limit and another series of lockdowns could worsen the debt levels, given that more budget resources will be needed to support households and firms.

The projected increases in general government deficits are expected to be much higher than those registered during the 2008 global financial crisis. Many Member States will suffer from fiscal deficit above the 3% target over the period 2020-2022. Some counties like Bulgaria, Lithuania, Denmark, and the Eurozone countries Cyprus and Portugal are expected to adjust to or below the target. Taking into account the EC projections for fiscal deficit of the Member States, government debt of some of them is expected to deteriorate further over the period 2021-2022 (Graph 2).



Graph 2: Fiscal Deficit and Government Debt Increase of Bulgaria and selected EU countries (% of GDP)

Source: Own calculations, European Commission (2020/b)

Note: The government debt increase reflects the projected fiscal deficit for the respective year.

Fiscal framework critics

Some researches criticize the current quantitative fiscal rules as complicated, not transparent and difficult for implementation (Claeys et al, 2016; Darvas et al., 2018). One of the major criticisms is that structural budget balance estimates and budget forecasts are subject to large revisions, partly due to the uncertain estimates of the output gap, which lead to erroneous policy recommendations (Darvas et al., 2018). They also do not always fit the diversity of macroeconomic situation of Member States and uncertainty of debt forecasts about the size of future off-budget liabilities, about economic shocks, future interest rates and future growth rates (Blanchard et al., 2021).

One of the alternatives is to simplify the current rules and/or to develop EU fiscal standards (Blanchard et al., 2021). Some researchers suggest that a system based on a rule more suitable to the two core objectives – debt sustainability and fiscal stabilization – should be established (Clayes et al., 2016). Other studies propose “expenditure rule” as more appropriate (Darvas et al., 2018) or the expansion of the investment clause in the SGP to include green investments aligned with the EU Green Pact’s objectives (Pekanov and Schratzenstaller, 2020).

The author's view is that fiscal standards that would introduce principles and a more prominent role of "expenditure rule" for public finances (e.g. capping expenditure as percent of GDP at a certain level) would be more efficient and help countries stabilize their economies in downturns and move towards green and digital economy in a sustainable manner. Thus, during the downturns countries would be pushed to implement structural reform measures instead of adjusting fiscal deficit through the reduction of capital spending.

Conclusion

As a result of the high level of fiscal deficits of the EU countries during the coronavirus pandemic, in most of the member states the budget deficit has significantly increased, going well beyond the 3% target and so has government debt that exceeded the 60% cap. The implementation of the EU's new legislative initiatives and financial instruments of the EU budget for 2021-2027 to recover the EU economy in response to the coronavirus pandemic may require a redesign of the EU fiscal framework, which will have an impact on national fiscal policies and public finance laws.

A central fiscal capacity at the EU level to develop fiscal standards and assign a more prominent role to the expenditure rule for public finances would strengthen the ability to deploy fiscal policy, complementing monetary policy, in the event of a significant EU area-wide downside dynamics.

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