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Proposals for new fiscal rules in the EU: the perspective of Central European countries

The reform of public finance architecture in the European Union focuses on solutions that, on the one hand, will allow member states to ensure long-term financial stability, but on the other hand, will not stifle economic growth and the planned reforms and investments in strategic areas. Of particular importance from the point of view of Central European countries is the proposal that the new regulations provide space for necessary investments in defence, which has become a priority in the face of growing security threats.

Need for change. The EU's fiscal policy has its roots in the Maastricht Treaty, signed in 1992, which required all current and future member states to keep public debt below 60% of GDP and budget deficits below 3% of GDP. The Stability and Growth Pact, adopted in 1997, introduced additional procedures to monitor and enforce these requirements through two types of mechanisms: (1) preventive, mainly by requiring regular reporting on the state of public finances by member states, and (2) corrective, also referred to as repressive or deterrent, based on the excessive deficit procedure. Originally, the pact was based on a European Council resolution and two regulations. However, over time – in response to the challenges posed by the economic context – the EU's fiscal policy regulations have undergone significant reforms. Key changes were introduced in the wake of the global financial crisis and the eurozone debt crisis, including the adoption of a new treaty (the 2012 Treaty on Stability, Coordination and Governance, the so-called Fiscal Compact) and eight regulations (the 2011 six-pack and 2013 two-pack). As a result, the two main criteria – the size of the deficit and the debt-to-GDP ratio – were retained, while the correction mechanism associated with exceeding them was strengthened, primarily for eurozone countries.

Although the changes introduced were a significant step toward streamlining fiscal policy in member states, they did not end the discussion on the architecture of public finances in the EU. Public opinion was increasingly dominated by voices indicating that the complex network of rules and exceptions makes fiscal frameworks too complicated, inconsistent, and characterized by subjectivity and arbitrariness in terms of their enforcement. This was confirmed by the European Commission's economic governance review, which submitted a number of questions for public debate, including how the framework can be improved to ensure sustainable public finances in all member states[1]. However, this debate was interrupted by the COVID-19 pandemic, at which time the EC loosened budgetary requirements by triggering a special clause of the fiscal compact – general escape clause – to allow member states to increase spending to support economies weakened by pandemic austerity ("IES Commentaries", No. 273). The duration of the escape clause was extended after the outbreak of the energy crisis and the full-scale Russian invasion of Ukraine. At the end of 2023, the clause was deactivated, and the EU's existing fiscal rules took effect again.

Proposed changes. Reform of the EU's fiscal rules is once again at the centre of the discussion in the new post-pandemic realities, which have been further complicated by the challenges of growing security risks. On the one hand, arguments were made for increasing the flexibility of the fiscal rules so as not to restrict investment and risk further slowing down the – already relatively slow ("IES Commentaries" No. 1024) – economic growth, especially in the face of increased defence spending. On the other hand, however, arguments have been raised about the need to tighten fiscal rules, as the state of public finances has deteriorated significantly in many EU

[1] European Commission, *Economic governance review*, https://eur-lex.europa.eu/legal-content/en/TXT/?uri=celex%3A52020DC0055.

countries in the wake of the recent crises, with many exceeding the debt and deficit-to-GDP values enshrined in the Maastricht Treaty.

According to Eurostat data, as of the end of the third quarter of 2023, the public debt-to-GDP ratio exceeds the value of 60% in thirteen EU countries, including three central European countries: Hungary – 75%, Slovenia – 71.4%, and Croatia – 64.4% (the average value of this ratio for the whole EU is 82.6%). In addition, the European Commission forecasts that in 2024 the public deficit-to-GDP ratio will exceed the reference value of 3% in thirteen EU countries, including seven central European countries: Slovakia – 6.5%, Romania – 5.4%, Poland – 4.6%, Hungary – 4.3%, Slovenia – 3.3%, Latvia – 3.1%, and Bulgaria – 3.0% (EU-wide – 2.8%).

In this context, the preliminary agreement of the Council and the European Parliament, announced in February 2024, underscores the reform's objective of reducing debt ratios and deficits in a *gradual, realistic, sustained, and growth-friendly manner* while *protecting reforms and investment in strategic areas*. This is to be served by the national medium-term fiscal-structural plans (also known as reference trajectories), under which member states will present both fiscal paths ensuring the achievement of the debt and deficit ratios enshrined in the Maastricht Treaty and commitments to public investment and priority reforms. Among these, it points in particular to those related to green and digital transformation, the need to ensure energy security and social and economic resilience, and – of particular relevance in the context of Central European countries – the need to build defence capabilities. The agreement explicitly states that increasing public investment in defence should be considered as one of the relevant factors in assessing the existence of an excessive deficit. This is significant especially for Central European countries, which have noticeably increased defence spending in the face of the Russian invasion of Ukraine.

The reform is awaiting formal approval by the European Parliament and the Council of the European Union, with the new regulations expected to be adopted in 2024. The European Commission presented guidelines on 9 March 2024, for the conduct and coordination of fiscal policy until the new reform takes effect. In them, it recommended that some elements of the reform directions be incorporated into the fiscal surveillance cycle as early as 2024, including in particular those related to the preparation of plans in which member states determine their medium-term budget plans.

Conclusions. The reform of the public finance architecture in the European Union is focused on finding solutions that allow a more flexible approach to fiscal rules, without sacrificing the pursuit of long-term financial stability. The solution to reconciling these mutually exclusive goals (increased flexibility can make it difficult to maintain fiscal discipline) is medium-term fiscal-structural plans, which are designed to integrate fiscal commitments with ongoing reforms and strategic investments.

From the point of view of Central European countries – in light of the increase in security threats and the need for rapid adaptation to new geopolitical conditions – it is important that these plans take into account the need for increased defence spending. Indeed, it turns out that among the EU NATO member states, it is Poland, Finland, Hungary, Romania, Estonia, and Lithuania, in turn, that have increased their defence spending to the greatest extent since the outbreak of full-scale war in Ukraine (i.e., in 2022 and 2023)[2].

[2] NATO, *Defence Expenditures of NATO Countries*, https://www.nato.int/cps/en/natohq/news_216897.htm.