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# Poland, Slovakia, Hungary, and Romania under the excessive deficit procedure

**After the pandemic-related loosening of fiscal rules – in the new framework following the reform – the EU's excessive deficit procedure is returning. On 26 July 2024, the Council of the European Union decided to initiate it against seven member states, including three from Central Europe: Poland, Slovakia, and Hungary. This is the result of failing to meet the deficit criterion for the general government sector. At the same time, three other countries from this region also failed to meet it: the Czech Republic, Estonia, and Slovenia, but this was considered exceptional or temporary, and it was decided not to subject them to this procedure. In the case of Romania, which has been subject to this since 2020, a lack of effective action to reduce the deficit was found.**

**New fiscal framework.** The need to change the architecture of public finances has been discussed in the European Union for years. However, this debate was interrupted by the COVID-19 pandemic. At that time, in the face of sudden, huge expenditures to mitigate the effects of the crisis ("IEŚ Commentaries", No. 273), it was decided to temporarily suspend the existing fiscal rules. Over time, however, work on their reform was resumed ("IEŚ Commentaries", No. 1076), with the main goal being to ensure the long-term financial stability of member states while avoiding slowing down economic growth and planned investments in strategic areas. Eventually, the reform came into force on 30 April 2024.

The reform did not change the basic fiscal rules – i.e., maintaining the threshold of 3% of GDP for the deficit and 60% of GDP for the debt of the general government sector. However, the ways of achieving and maintaining them below these thresholds were modified by introducing the obligation for member states to develop national medium-term fiscal-structural plans. These plans are to include – in line with the main goal of the reform – not only assumptions regarding maintaining public finance discipline but also planned structural reforms and investments supporting sustainable economic growth. In principle, the plans are to cover a period of four years, but there is a possibility to extend them to a maximum of seven years.

Some changes were also introduced in the excessive deficit procedure. The first step in the process of its potential opening is now the publication by the European Commission of a report covering member states that do not meet (or are at risk of not meeting) the indicated fiscal rules. The report includes an assessment in this regard, which – and worth emphasizing as a novelty – considers various "relevant factors" that could (or may) have an impact on the public finance situation of individual countries. Increasing public investment in defence was explicitly recognized as such a factor. The regulation on this procedure states: "Acknowledging the rising geopolitical tensions and security challenges, and the corresponding need for Member States to build-up their capabilities, the increase of government investment in defence, where applicable, should be considered as a relevant factor when assessing the existence of an excessive deficit". This – which is also worth emphasizing – is particularly important from the point of view of Central European countries as for many of them, these investments have become a priority in the face of growing security threats.

The next step is the decision of the Council of the European Union regarding the opening of the excessive deficit procedure. Countries covered by it are obliged to take effective action to correct their deficit, considering the recommendations of EU institutions – the so-called reference trajectories for net expenditure, which should be reflected in national medium-term fiscal-structural plans. If a country does not take effective action, the Council may impose a fine (maximum 0.05% of GDP from the previous year for a period of six months, payable every six months until effective action is taken).

**New countries covered by the excessive deficit procedure.** The aforementioned report was published by the European Commission – for the first time after the reform – on June 19, 2024. Exceptionally, it only assessed the deficit criterion, as the new fiscal framework significantly changed the way the debt criterion is assessed. It is to be based on member states' compliance with the indicated reference trajectories. These have not yet been defined, as member states are to submit their first national medium-term budgetary-structural plans only in autumn 2024.

The report thus included countries where the deficit in relation to GDP in the previous year or the deficit planned for the current year exceeded 3%. Among Central European countries in 2023, these were Hungary – 6.7%, Poland – 5.1%, Slovakia – 4.9%, Czech Republic – 3.7%, and Estonia – 3.4%. In the case of the last two countries, after taking into account "relevant factors", these exceedances were considered temporary (in the Czech Republic, the deficit planned for the next year does not exceed the threshold) or exceptional (in Estonia, it was due to a significant economic slowdown). Slovenia's planned exceedance of the deficit criterion in 2024 was also considered temporary (it was indicated that this is the result of reconstruction expenditures in the face of a natural disaster). However, with regard to the remaining three countries – Hungary, Poland, and Slovakia – the European Commission recommended initiating the excessive deficit procedure. It was also emphasized that these countries plan to exceed the deficit threshold in 2024 as well. Ultimately, by the decision of the Council of the European Union on 26 July 2024, this procedure was initiated against them (as well as Belgium, France, Italy, and Malta).

In the case of Romania, which was not included in the report due to being subject to this procedure since 2020, a lack of effective action in terms of deficit reduction was found. It was noted that this country recorded an exceedance of the threshold in relation to GDP in 2023 – 6.6%, and according to the plan, it will also be exceeded in 2024 – 4.9%.

**Conclusions and perspectives**

- The main goal of the excessive deficit procedure is to correct excessive indebtedness in EU member states and restore public finance stability. The new fiscal framework, while maintaining this goal, tries to find a balance between financial discipline and the need for structural reforms and necessary investments, which is particularly important for the catching-up economies of Central Europe. The introduction of national medium-term fiscal-structural plans may give countries subject to this procedure greater flexibility in conducting economic policy, primarily due to the possibility of spreading fiscal adjustments over a longer period. However, the inclusion of Hungary, Poland, and Slovakia in the excessive deficit procedure and its maintenance in the case of Romania may have significant consequences for their economic policies. These countries will be obliged to take into account EU reference trajectories, which will require a more restrictive fiscal policy including cuts in planned expenditures and/or tax increases. This, in turn, may affect the pace of economic growth and the competitiveness of these countries. In the case of Romania, this may be exacerbated by potential fines, which are an element of the excessive deficit procedure for member states that have not taken effective action to correct their fiscal policy.
- Moreover, this procedure may affect the implementation of planned public investments in strategic areas in these countries. This is particularly important in the context of investment in defence in the face of the ongoing war in Ukraine. According to the reform assumptions, these investments were to be considered when assessing the existence of an excessive deficit. However, it is worth noting two significant limitations; firstly, only investments are taken into account, not total defence expenditures, and secondly, considering this data is difficult due to delayed reporting. Thus, in the Commission's report, data on defence investments for 2022 was the basis for assessing deficits in 2023-2024. In relation to GDP, these investments amounted to 0.3% in Poland and Hungary and 0.2% in Slovakia. Only in the case of Poland were estimates for 2023 presented, according to which they were to increase to 0.7% of GDP. Consequently, the actual impact of these investments on the assessment of the fiscal situation may be less than assumed. Moreover, in the long term, the excessive deficit procedure may

prompt these countries to revise their plans for modernizing the armed forces to some extent, which may have consequences for regional security.

- At the same time, the fact that the Czech Republic, Estonia, and Slovenia avoided the excessive deficit procedure despite exceeding the 3% GDP threshold in 2023 or planning to exceed it in 2024 shows that EU institutions are willing to consider significant factors when deciding on implementing this procedure. However, it seems that this is only the case when the exceedance does not significantly deviate from the assumed threshold.