ANALYSIS

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European Union fiscal rules: it's already time to reform the reform

The EU should tweak its recent fiscal rule reform, capitalising on new realities to make improvements

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The European Union's fiscal framework – a set of rules intended to ensure countries keep their debts manageable – was most recently reformed in April 2024[1]. The reform followed an unprecedented spell of *de-facto* suspension of the fiscal rules starting in 2020, when countries were given virtually unlimited fiscal leeway to respond to the coronavirus pandemic and subsequently to the energy crisis triggered by the war in Ukraine.

Now, little more than one year on from the reform, the fiscal framework is at risk of unravelling in the face of the heightened geopolitical tensions since Russia's invasion of Ukraine. To prevent progressive erosion of the framework, the European Commission and EU countries should consider a focused 'reform of the reform' to realign it with its original goal: ensuring public debt sustainability based on a risk-based methodology with a limited role for rigid numerical targets.

Risks to the April 2024 reform have arisen in particular for two reasons:

First, activation has been permitted of the 'national escape clause' of the Stability and Growth Pact (SGP – the collective term for the EU fiscal framework legislation)[2]. The activation of the national escape clause, which temporarily eases the fiscal rules, is to allow countries to incur extra defence-related deficit spending (European Commission, 2025). Countries already submitted plans in the autumn of 2024 showing how they would put their spending into sustainable territory over four or seven years; the national escape clause allows them to spend up to 1.5 percent of GDP more for a maximum of four years.

However, activating an escape clause almost as soon as the new fiscal rules begin to apply raises the understandable concern that the rules might not be enforced at all in the next few years. In particular, there are reasons to expect that no new excessive deficit procedures (EDP – a corrective procedure overseen by the European Commission for countries spending beyond the agreed limits) will be opened[3] or that existing procedures[4] will be escalated (Pench, 2024, 2025). Remarkably, some of the countries with the highest debts, which are the main intended beneficiaries of the escape clause, have so far declined to take advantage of it – in particular France, Italy and Spain. This presumably reflects the perceived risk of falling into a 'debt trap' triggered by market reactions, irrespective of whether the rules allow temporary extra borrowing for rearmament.

The second risk factor for the reformed EU fiscal rules is that Germany in March 2025 agreed at record speed a reform of its constitutional 'debt brake' fiscal rule, to permanently remove borrowing constraints for defence expenditure (above a 1 percent of GDP floor) and to allow for a one-off €500 billion extra budgetary fund for 'additional' infrastructure investment. The new German fiscal posture has been largely welcomed as boosting the economy and addressing neglected spending priorities, at both national and European level[5], without risking adverse market reactions.

Although the German move was dictated exclusively by domestic considerations, the Commission can also present it as a vindication of sorts of the national escape clause (Germany has a debt slightly in excess of the maximum of 60 percent of GDP required under the SGP). However, under plausible assumptions, implementing the new German fiscal rule would still run up against the EU fiscal rules, potentially, given Germany's weight, with repercussions for the whole framework. In particular, extra deficit spending on defence would become problematic beyond the time limit set for the national escape clause. Even in the short term, the EU fiscal rules, which do not permit exemptions for spending on investment programmes, may obstruct deployment of Germany's infrastructure fund (Steinbach and Zettelmeyer, 2025).

Agreeing on the April 2024 reform of the EU fiscal framework was difficult and it is understandable that the Commission may wish to dismiss concerns about the future of the framework raised by these developments[6]. In particular, it may be tempted to accommodate the new German posture on fiscal policy – in other words, papering over possible violations of the EU fiscal rules. Allowing Germany to fudge the EU rules to achieve domestic objectives is unlikely to raise strong objections in the rest of the EU, given that an expansionary German fiscal stance would help lift growth across the continent. However, this would compound the doubts on the working of the new fiscal framework raised by the early activation of the national escape clause. In particular, it would rekindle long-standing preoccupations with 'equal treatment', bearing in mind that Germany reformed its fiscal rules without any consultation with the EU.

Going back to make it better

Rather than contemplating an early withering of the new EU fiscal framework, the Commission could respond proactively by proposing a surgical 'reform of the reform'. It could even bring the framework closer to the Commission's original design (European Commission, 2022a), which was partially overturned in the legislative process because of concern that the consensus necessary for its adoption would not be reached. That worry reflected the traditional German fixation on strict numerical deficit and debt targets. Germany's own fiscal overhaul thus offers an unexpected opportunity to refocus the EU fiscal framework reform on its original aim, allowing in the process the use of fiscal space where it is available and the elimination of rules devoid of economic justification.

The EU reform's original aim can be described as the de-risking of national debts, ie the eventual removal of situations in which a country's public debt poses a high sustainability risk. Rather than requiring debt to hit a target by a certain time or to diminish by a certain amount, the concept of sustainability was long operationalised by the Commission through the development of a specific methodology for assessing medium-term sustainability risk (European Commission, 2023). This combines countries' projected debt levels with their projected trajectories, suitably stress-tested, to reach an overall conclusion on whether debt presents a high sustainability risk.

With some approximation, the criteria can be described as follows: for countries with debt projected to stay at very high levels – in excess of 90 percent of GDP – the projected debt trajectory should be declining continuously, with a high probability that debt will not rise. For countries with debt projected to stay between 60 percent and 90 percent of GDP, the debt trajectory may rise temporarily, provided that there is a high probability debt will be trending downwards before the end of the projection period. Meanwhile, countries with debt projected to stay below 60 percent of GDP are not deemed high sustainability risks.

The Commission's sustainability-risk assessment methodology continues to provide the main foundation of the new EU fiscal rules, specifically the requirement for countries' medium-term adjustment plans to show that debt is on a *"plausibly downward"* trajectory or will stay *"at prudent levels"* (Pench, 2023). However, the translation of the methodology into legal requirements accentuated existing rigidities and missed opportunities for clarification. In particular, the April 2024 reform inherited a cumbersome approach to stress testing the baseline debt trajectory; it effectively obliterated any difference between countries with debts projected to stay above 90 percent of GDP and those in the 60 percent to 90 percent range; and it did not factor in the possibility that the debt trajectory may be affected temporarily by time-limited spending programmes, eg on infrastructure.

The reform also introduced unrelated numerical debt and deficit requirements: the so-called 'debt sustainability safeguard' and the 'deficit resilience safeguard'. The latter, requiring countries to eventually reach an arbitrarily set deficit level, results in an unrealistic tightening of the adjustment requirement for countries with very high debts. The former, requiring a minimum pace of debt reduction already during the adjustment period, while the debt exceeds 60 percent of GDP, paradoxically turns out to be potentially penalising not for the countries with very high debts, but for those in the middle range.

'Surgical' reform

A targeted revision of the reform to address critical weaknesses would be relatively easy.

First, the risk-based requirements should be reviewed to make them less rigid for countries projected to stay in the middle range of debt (60-90 percent of GDP). For those countries, the requirement could be that debt stabilisation should occur with high probability before the end of the sustainability assessment horizon (ie the period including the four to seven-year medium-term adjustment plan and the subsequent 10-year 'unchanged policy' projection)[7]. In turn, the definition of 'unchanged policy' should be tweaked to allow for self-reverting spending programmes, such as the German infrastructure fund, with opportune safeguards against their extension.

Second, the debt sustainability safeguard and the deficit resilience safeguard should be abolished to restore the reform's underlying sustainability-risk-centred approach.

Eliminating the numerical safeguards would be necessary to allow for limited increases in the debt ratios of countries in the middle range, and would avoid disproportionate penalisation of countries with very high debts.

This solution would be preferable to simply raising the Treaty-based debt threshold from 60 percent of GDP to 90 percent (as suggested by eg Steinbach and Zettelmeyer, 2025). Besides the symbolic value attached to the 60 percent threshold, simply replacing it with 90 percent after Germany announced plans to increase its debt would risk creating the impression that the target is being shifted to please the EU's dominant player.

Impact on Germany

Admittedly, such a surgical reform of the reform would fall short of allowing Germany to exploit all the room for increasing debt implied by its new domestic rules (as estimated by Zettelmeyer, 2025). Germany would still be required to stabilise its debt below 90 percent of GDP and eventually bring it further down towards 60 percent (barring new expenditure programmes). This, however, would confirm the logic of the proposed new reform as not simply accommodating shifting German priorities. It would also reinforce the message that borrowing to finance an expenditure increase, such as for defence, which is expected to be permanent, while politically expedient, is not an economically desirable policy.

The unwillingness shown by the highest-debt countries to profit from the national escape clause suggests that these countries should not be hostile to greater differentiation within the group of countries with debts above 60 percent of GDP. As to the elimination of the two safeguards, the apparent dismissal of these in the application of the national escape clause by the Commission suggests that they are already implicitly recognised as a source of unnecessary and damaging complexity.

The surgical reform could be done through an amendment to Regulation (EU) 2024/1263 of April 2024 (the regulation traditionally referred to as the 'preventive arm' of the SGP). This, unlike replacement of the 60 percent of GDP debt threshold, would not need unanimity of EU countries.

Further specification of the risk-based requirements should be done by reference to the Commission methodology (under the control of an *ad-hoc* working group of EU countries, Commission and European Central Bank representatives), as it is already the case with the current rules.

The methodology should be reviewed to ensure full consistency with the proposed definition of the risk-based requirements and, more generally, to deal with critical issues that the April 2024 reform left unaddressed. In particular, the specifications for the construction of the 'fan chart', illustrating the range of possible outcomes around the central adjustment scenario and their probabilities, could be reviewed including in terms of statistical technique, period covered and the operationalisation of the requirement for debt stabilisation with high probability (Darvas *et al*, 2025).

References

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Endnotes

1 See European Commission, 'New economic governance framework', https://economy-finance.ec.europa.eu/economic-and-fiscal-governance/eu-assessment-and-monitoring-national-economic-policies/evolution-eu-economic-governance/new-economic-governance-framework_en.

2 See Council of the EU press release of 30 April 2025, 'Coordinated activation of the National Escape Clause', https://www.consilium.europa.eu/en/press/press-releases/2025/04/30/coordinated-activation-of-the-national-escape-clause/.

3 Specifically, for failure to respect the SGP's 60 percent of GDP debt criterion.

4 These have been opened based on breaches of the SGP's 3 percent deficit threshold.

5 Jeromin Zettelmeyer, 'What does German debt brake reform mean for Europe?' The Why Axis, 31 March 2025, Bruegel, https://www.bruegel.org/newsletter/what-does-german-debt-brake-reform-mean-europe.

6 See for example, 'Opening Statement by Commissioner Dombrovskis at the European Parliament Committee on Economic and Monetary Affairs on the activation of the national escape clause', 31 March 2025, https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_25_935.

7 Specifically, the stochastic stress test should exclude with high probability (70 percent) continued increase in the debt over the five years after the mid-point of the 'unchanged policy' projection. This definition mirrors closely that of the European Commission's (2022b) debt sustainability analysis (DSA) risk classification, with the important qualification that increases in debt should be probabilistically excluded over the second half of the projection period (and not the first half, which would effectively negate the possibility of the baseline projection showing debt increasing in the first half). Alternative measures of stabilisation could be considered in the context of a review of the DSA methodology.

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