Research Institute – Europe Inside and Out

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#EU / #Monthly / #Fiscal Policy

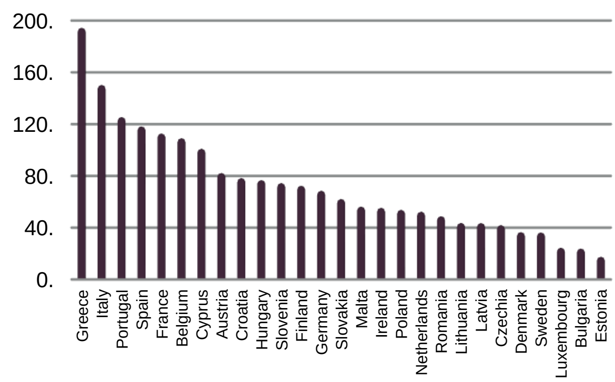
All change: the EU plans major fiscal reform in 2023

Covid, Ukraine, and growing protectionism are pushing the European Commission to respond by increasing fiscal flexibility and creating conditions for greater state involvement in industrial strategy.

Key Takeaways

- The European Commission's proposed fiscal rules would introduce a more flexible and credible fiscal framework, focused on bespoke debt reduction pathways. If passed, this would limit the risk of conflict with member states over fiscal policy.
- However, while most "frugal" member states are satisfied with the proposals, Germany is not yet on board. Timescales are tight for the new framework to replace the (currently suspended) rules from 2024.
- The European response to the US Inflation Reduction Act will initially focus on relaxing state aid rules and repurposing existing funds to protect the level playing field. It's unlikely, although still a risk, that an escalating US-EU 'subsidy war' gets underway.
- Over time the EU will move to more active industrial policy by member states, benefitting green technologies.

Figure 1: Debt/GDP ratios increased sharply in 2021



Source: Eurostat, February 2023

Fiscal rule proposals would allow member states greater flexibility

All EU member states agree that the rules of the Stability and Growth Pact should be reformed before they are reintroduced.

Under current rules, a member state's government deficit may not exceed 3% of its gross domestic product (GDP), while its debt may not exceed 60% of GDP. Where there is an overshoot of debt-to-GDP, the gap is meant to close by 1/20th each year.

Fifteen member states are violating the deficit rule, while fourteen are violating the debt rule.

The Commission's new proposals aim is to create a more realistic debt reduction path with political buy-in from member states, while enhancing enforcement. The proposals have three main components:

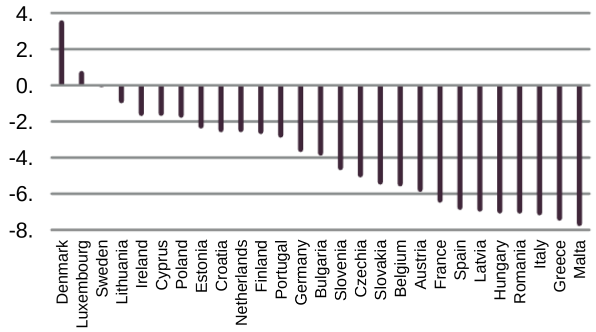
1. **National ownership of debt reduction plans**. Member states propose a four-year fiscal plan. This must put debt and the deficit on a credible downward path to below the 60% and 3% targets. Annual budget levels would be set for the period of the fiscal plan. All plans must be approved by the Commission and the Council before implementation.
2. **Simplification of fiscal rules**. Primary expenditure – net of interest, cyclical unemployment spending and discretionary spending – would be the sole fiscal indicator. Net expenditure paths would be moderated depending on the scale of the debt challenge.
3. **Enhanced enforcement.** Member states would submit annual progress reports, with sanctions for states

deviating from the agreed path. Structural funds may be withheld from states that refuse to comply.

Time running out for new rules to be in place for the 2024 budget process

The European Council will debate the proposals at its meeting on 23-24 March, though final agreement is likely to take longer. Hopes that the new rules can be implemented for the 2024 budget process may now be too optimistic, given German objections. A further suspension of the existing rules, with the new rules coming into force in 2025, is possible.

Figure 2: Fifteen states broke the 3% deficit rule in 2021



Source: Eurostat, February 2023

The Southern states have won significant concessions on slower debt reduction plans, as well as bespoke reduction targets, and will support the proposals. Northern states are likely to seek stricter enforcement mechanisms, and potentially the addition of more fiscal rules, but have not voiced significant opposition to the principle of the reforms.

However, Germany objects to the principle of bespoke debt reduction paths. It's opposition to a key principle of the Commission's vision will slow progress substantially unless a compromise can be found.

The US Inflation Reduction Act risks lower demand for EU products

The Inflation Reduction Act (IRA) passed by the US in 2022 has been a source of controversy in the EU. The introduction of protectionist measures by the US to shore up its domestic manufacturing base, combined with a failure to communicate with EU member states during drafting, has been a source of tension.

As a bloc, the EU is likely to introduce state aid, funding, and regulatory reforms to increase its competitiveness as a manufacturing destination, particularly for green technologies.

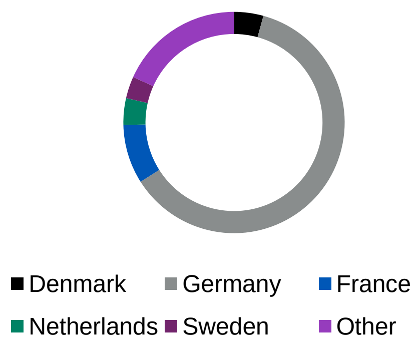
Individual member states, notably France and Germany, are also likely to continue publicly criticising the IRA. Their aim will be to use diplomatic engagement to persuade the US to reform the Act. Divisions between member states on the details of the response will likely result in a staggered series of reforms, delivered as market consequences of the IRA become apparent.

The first stage of the EU response will be a relaxation of state aid rules and regulatory changes

The EU Commission will present initial proposals to the European Council on 9-10 February, but substantive policy discussion is likely to take place at the next meeting on 23-24 March.

The eventual scale of the reform will hinge on the actual impact of the IRA on member states and the willingness of Northern states (likely the most affected) to grant concessions to Southern states concerned about the integrity of the level playing field. Broadly, the IRA will pressure member states into developing a more active industrial policy.

Figure 3: Germany received 62% of state aid for main EU objectives in 2020



Source: European Commission, February 2023

The default scenario is likely to be a limited response, focused on state aid and tax breaks. This has the advantage of rapid implementation, in line with the Commission's preference.

Key reforms may include an expansion of block exemptions, additional funding repurposed from the remaining EU Recovery Funds, and a Clean Tech Act to introduce new sustainability regulations.

These regulations aim to increase the barriers to non-EU products being imported by member states. The EU is also likely to take advantage of the ongoing fiscal reform to change how state aid is treated in debt reduction plans.

A more ambitious response would see Northern states, principally France and Germany, seek state aid reforms up to a matching of IRA initiatives, in exchange for providing greater funding to Southern states. There are substantial barriers to this scenario, notably the opposition of the Dutch and Scandinavians to providing additional funding and engaging in a 'subsidy war' with the US.

The likelihood of meaningful concessions from the US is slim. The IRA is popular domestically and the US is unwilling to water down the Act's deliberately protectionist intent. Additionally, political gridlock in Congress would make any legislative efforts extremely unlikely to pass.

Proposals boost the EU's macro policy framework and scope for activist industrial policy

If implemented, the fiscal reform process will likely result in fewer pro-cyclical fiscal contractions, lowering the risk of long recessions resulting from fiscal policy. This ought to lead to slightly higher equilibrium interest rates in time, by removing some of the disinflationary bias to Eurozone macroeconomic policy.

A more gradual, medium-term approach to debt reduction is also likely to reduce the risk of conflict between high-debt nations and EU institutions.

There is a risk, however, that the requirement to commit to budgetary limits over a minimum four-year period creates conflict with states that have a low government tenure, notably Italy.

The IRA response will likely incentivise greater state intervention in industrial policy, and investment in green transition industrials. Industrial strategies run the risk of state directed misallocation of capital, as resources are funnelled to inefficient national champions with political connections. The EU institutions will need to develop robust rules and process to limit this risk.

Our latest Eurozone and UK forecasts

- **Activity:** We now think the Eurozone can come through its winter challenges just stagnating rather than contracting. Lower energy prices have directly boosted activity and helped improve economic sentiment. In the UK, the economy seems to have avoided a technical recession in the second half of 2022. However, activity data remains weak and the economy is set to endure recession-like conditions for much of the year.
- **Inflation**: Lower energy prices will pull down headline inflation in the Eurozone. However, core inflation is proving more persistent, with underlying price pressure still elevated. The UK's extremely tight labour market is generating significant inflation risks despite the fact that headline inflation is set to drop rapidly this year.

  Monetary policy: Persistent core inflation in the Eurozone means we haved revised higher the European Central Bank (ECB) rate path. We expect the ECB to deliver a 50bps hike in February, before the depo rate eventually peaks at 3.25%. The Bank of England (BoE) looks set raise Bank Rate by 50bps in February to 4%. We expect Bank Rate to reach 4.5% by Q2 this year and then stay elevated for longer than previously expected given price pressures.

	2021	2022	2023	2024
Eurozone				
GDP (%)	5.3	3.5	-0.4	0.5
CPI (%)	2.6	8.4	5.4	1.9
Depo Rate (%)	-0.50	2.00	2.75	0.0
UK				
GDP (%)	7.4	4.1	-1.3	0.6
CPI (%)	2.6	9.0	6.2	2.4
Bank Rate (%)	0.25	3.75	2.50	0.1

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