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Which bite harder: new or old EU fiscal rules? Backcasting Croatian episode under the EDP

Frane Banić, Milan Deskar-Škrbić and Maroje Lang

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Author(s)

Frane Banić
Croatian National Bank
frane.banic@hnb.hr

Milan Deskar-Škrbić
Croatian National Bank
milan.deskar-skrbic@hnb.hr

Maroje Lang
Croatian National Bank
maroje.lang@hnb.hr

Nova i stara fiskalna pravila EU-a – retrospektiva u svjetlu hrvatskoga iskustva u proceduri pri prekomjernome proračunskom manjku

Sažetak

Cilj je ovoga rada objasniti glavna obilježja najnovije reforme sustava ekonomskog upravljanja Europske unije te prikazati razlike između novih i starih fiskalnih pravila, koristeći se iskustvom Hrvatske tijekom procedure pri prekomjernom manjku, koja je aktivirana 2014. godine. Naši rezultati upućuju na to da nova pravila omogućuju veću fleksibilnost, dulje razdoblje fiskalne prilagodbe te ublažavaju potencijalno prociklično djelovanje fiskalne konsolidacije. Glavno ograničenje naše analize leži u teškoćama izgradnje hipotetskog scenarija koji bi u potpunosti obuhvatio politički, ekonomski i institucionalni kontekst koji bi uslijedio da procedura nije bio aktiviran u Hrvatskoj, kao i pretpostavke o ponašanju donositelja fiskalnih odluka u takvom scenariju. Unatoč tome, ovaj rad pridonosi aktualnoj raspravi o posljedicama reforme fiskalnih pravila EU-a, i na akademskoj razini i u kontekstu oblikovanja politika.

Ključne riječi: Fiskalna politika, fiskalna pravila, fiskalno upravljanje, analiza održivosti javnog duga, Hrvatska, EDP.

JEL: E62, F42, H60, H61, H62, H63

Which bite harder: new or old EU fiscal rules?
Backcasting Croatian episode under the EDP[1]

Frane Banić
Croatian National Bank
frane.banic@hnb.hr

Milan Deskar-Škrbić
Croatian National Bank
milan.deskar-skrbic@hnb.hr

Maroje Lang
Croatian National Bank
maroje.lang@hnb.hr

ABSTRACT

The aim of this paper is to explain the main features of the latest reform of the EU fiscal framework and to illustrate the differences between the new and old EU fiscal rules, using Croatia's experience during the Excessive Deficit Procedure (EDP) activated in 2014. Our results suggest that the new rules provide greater flexibility, allow for a longer fiscal adjustment, and mitigate the potential pro-cyclical nature of fiscal consolidation. The main limitation of our analysis are the difficulties related to the construction of a hypothetical scenario that would fully capture the political, economic, and institutional context surrounding the activation of the EDP in Croatia, or assumptions regarding the behaviour of fiscal policymakers in such a scenario. The paper nevertheless contributes to the ongoing debate on the implications of the reform of EU fiscal rules at both academic and policy levels.

JEL: E62, F42, H60, H61, H62, H63

Keywords: fiscal policy, fiscal rules, fiscal governance, debt sustainability analysis, Croatia, EDP

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1. Introduction

The European Union's (EU) fiscal framework underwent reform in 2024, primarily aimed at enhancing the enforcement of regulations, simplifying the rules, and reducing the pro-cyclicality of fiscal policies among EU member states. A central feature of the new rules is the introduction of a single operational target based on net expenditure growth and the inclusion of debt sustainability assessments (DSAs) focused on specific circumstances in each member state. Unlike the former framework, which imposed uniform adjustment targets on all member states with excessive deficits, the revised rules now allow for customised debt trajectories . The new framework also considers the specific economic circumstances and needs of each member state, representing a significant shift from a detailed rules-based system to the one more based on economic analysis.

This paper examines how these new rules impact small, moderately indebted economies facing excessive deficits, with Croatia's experience during EDP from 2014-17 serving as a case study. We first compare the necessary structural adjustment under the old and new EDP rules. For this, we contrast the historical recommendation adopted by the Council and based on the old EU fiscal rules and methodology with a counterfactual scenario that uses the same economic and fiscal assumptions but applies the new rules and methodology.[2] We then examine the impact of the alternative consolidation paths on key fiscal variables – net lending, structural balance and public debt – and economic activity. This approach allows us to compare the fiscal outcomes in different scenarios and determine which scenario might be more conducive to growth and less pro-cyclical, especially given Croatia's struggle with a severe recession at the time the EDP was activated.

This paper makes a key contribution by being the first to apply the EU's reformed fiscal rules to a real-world case of a country that underwent an Excessive Deficit Procedure (EDP). By conducting a counterfactual analysis, it demonstrates how the new rules would have altered Croatia's fiscal adjustment path during its 2014 EDP, offering empirical insights into their potential effects. The study provides evidence that the reformed framework, which allows for a more flexible and country-specific approach to debt sustainability, could mitigate the potential pro-cyclical effects of fiscal consolidation and support macroeconomic stability. This analysis not only enhances the understanding of how the new fiscal rules function in practice

[2] 2014/56/EU: Council Decision of 28 January 2014 on the existence of an excessive deficit in Croatia; available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014D0056

but also informs the broader debate on EU fiscal governance reforms by highlighting their implications for fiscal discipline and economic growth. Our analysis adds to the ongoing policy debate on EU fiscal rule design, highlighting the advantages of a flexible, country-specific framework, with member allowed to consider further changes in their national fiscal frameworks and rules.

The remainder of the paper is structured as follows: Section 2 briefly reviews EU fiscal rules, their evolution and importance for macroeconomic stability. Section 3 focuses on the recent EU governance reform, highlighting the role of debt sustainability analysis and net expenditure targets compared with the old rules. Section 4 outlines the analytical framework and methodology used to simulate a counterfactual scenario in order to explore alternative fiscal paths. Section 5 compares the effects on fiscal and economic variables under the old and new frameworks and points to main limitations of the analysis. Section 6 concludes.

2. Importance and evolution of EU fiscal surveillance framework

Although the focus of this paper is on the latest reform of EU fiscal rules, it is important to place it in a broader historical context. To fully understand the reasons behind the latest reform, one must first appreciate the role of fiscal rules within the EU's economic governance framework and their evolution over time.[3]

2.1. Importance of EU fiscal rules

The fiscal rules introduced in the Maastricht Treaty of 1992 were a cornerstone of the preparations for the common currency, designed to ensure economic stability and credibility of the monetary union. The rules required member states to limit government deficits to 3% of GDP and public debt to 60% of GDP, were critical in addressing the challenges posed by a common currency and the risks associated with divergent fiscal policies among member states.

One of the primary reasons for these rules was to enforce fiscal discipline across the union. Common view was that without fiscal rules member states might pursue unsustainable fiscal policies borrowing excessively and putting pressure on central bank(s) to support them. Such policies could destabilize the entire monetary union. Therefore, the adoption of fiscal rules reassured markets that the euro area was committed to sound fiscal management, helping to maintain the euro's credibility as a reliable currency on the global stage. This credibility was

[3] This section draws on Buti and Giudice (2017), Kamps and Leiner-Killinger (2019), and Bilbiie, Monacelli and Perotti, R. (2021).

essential not only for the functioning of the euro but also for fostering trust among the member states participating in the monetary union.

Similar arguments were used in the context of the prohibition of monetary financing, outlined in Article 123 of the Treaty on the Functioning of the European Union (TFEU). Prohibition of monetary financing prevents central banks, including the European Central Bank (ECB), from directly financing government deficits. The Maastricht fiscal rules encourage governments to maintain sustainable fiscal policies, reducing the risk of the so-called fiscal dominance in which case the central bank may be compelled to maintain low interest rates or purchase government debt to make it easier for the government to finance its deficits. On the other hand, the prohibition of monetary financing complements these rules by forcing governments to finance deficits through market mechanisms, which impose discipline via interest rates and investor scrutiny. In addition, the prohibition of monetary financing is one of the main foundations of the independence of the ECB and national central banks, which is crucial in the context of monetary financing, and fiscal rules support this independence by reducing the risk of fiscal crises that might pressure central banks to intervene

Fiscal rules also played a vital role in facilitating economic convergence. By requiring member states to meet similar fiscal and economic standards, the Maastricht criteria ensured that the euro area was built on a foundation of fiscal and economic stability. This convergence was necessary for the European Central Bank's single monetary policy to be effective across all member states, avoiding the risks of divergent economic conditions undermining the union's cohesion.

The importance of these rules for the euro cannot be overstated. They were instrumental in maintaining economic stability within the euro area by ensuring that fiscal behaviour in one member state did not jeopardise the stability of the euro. By promoting sound fiscal management, the rules have protected the euro's credibility in international markets, reducing the risk of speculative attacks or financial crises. They have also helped prevent fiscal fragmentation, promoting convergence among member states and reducing disparities in borrowing costs.

In summary, the fiscal rules introduced in Maastricht were a fundamental element of the euro area's architecture. They were designed to ensure fiscal discipline, prevent moral hazard, and support the stability and credibility of the euro.

2.2. Evolution of EU fiscal framework from 1992 until the adoption of the new reform

The EU fiscal framework evolved significantly from 1992 to 2024 reflecting the Union's continuous efforts to balance fiscal discipline with economic flexibility in response to changing circumstances and crises.

As mentioned above, the journey began in 1992 with the Treaty of Maastricht, which established the euro as a common currency and introduced strict fiscal rules. These rules required member states to limit government deficits to 3% of GDP and public debt to 60% of GDP, aiming to ensure fiscal stability across the Union.

Building on this foundation, the Stability and Growth Pact (SGP) was introduced in 1997 to enforce fiscal discipline. The SGP was divided into two components: the Preventive Arm (1998) which required member states to set medium-term budgetary objectives (MTOs) in order to prevent excessive deficits and the Corrective Arm (1999) which established the Excessive Deficit Procedure (EDP) to address situations where deficits exceeded the prescribed limits.

In 2005, the SGP underwent significant amendments to increase flexibility and strengthen compliance. The original SGP required member states to keep their budget deficits below 3% of GDP and public debt below 60% of GDP. However, by the early 2000s, the rules faced significant challenges. Germany and France breached the deficit limit due to economic slowdowns arguing that the rigid application of the rules was counterproductive during periods of weak economic growth. Smaller member states criticised unequal enforcement of the rules, claiming that larger member states were treated more leniently. These tensions culminated in 2003 when the European Commission recommended launching Excessive Deficit Procedures (EDPs) for Germany and France. The Council of Ministers, influenced by political considerations, chose not to act, undermining the SGP's credibility. This highlighted the need for reform, leading to reform in 2005 to enhance flexibility and economic relevance:

- Introduction of the Medium-Term Objective (MTO): member states set medium-term budget goals based on economic conditions, with stricter targets for highly indebted or low-growth economies.
- Greater flexibility: Temporary deviations were allowed during exceptional circumstances, focusing on structural performance rather than rigid targets.
- Emphasis on structural balance: Distinction was made between cyclical and structural factors to avoid pro-cyclical policies.

- Improved enforcement and peer pressure: The reform introduced a more rules-based approach to reduce political interference and increased peer pressure for compliance.
- Increased consideration of member state-specific circumstances: expenditures on public investment and pensions were incorporated into compliance assessment.
- Streamlined EDP: The procedure was made quicker and more effective, though sanctions remained politically sensitive.

The reforms of the European Union's fiscal rules in 2010s were driven by the eurozone sovereign debt crisis, which emerged in the aftermath of the global financial crisis. The crisis exposed weaknesses in the original Stability and Growth Pact (SGP), as many member states exceeded deficit and debt limits.

To address these issues, the EU introduced the Six-Pack in 2011, strengthening fiscal surveillance, requiring debt reduction, and introducing the Macroeconomic Imbalance Procedure (MIP) to detect and correct economic vulnerabilities. The Two-Pack in 2013 further enhanced oversight by requiring euro area countries to submit draft budgets for EU review. These reforms, alongside the European Semester for policy coordination, improved fiscal discipline and crisis prevention. However, they faced criticism for promoting austerity during downturns, increasing complexity, and inconsistent enforcement. Overall, while the reforms strengthened fiscal governance, they highlighted the need for greater flexibility in future frameworks.

The Six-Pack aimed to prevent excessive deficits, debt, and economic imbalances that could destabilise the euro area, while promoting greater fiscal discipline and economic convergence among EU member states.

While Six-Pack put requirements to all member states, additional requirements were set for the euro area members. In 2012 intergovernmental Treaty on Stability, Coordination, and Governance (TSCG) included additional requirements for the signatories including better coordination of economic policies, requirement to incorporate balanced budget rules into their national legislation, as well as stronger financial sanctions.

In 2013, the "Two-Pack" legislation added another layer of oversight for euro area member states. This reform was designed to complement the "Six-Pack" by further strengthening economic governance within the euro area. It focused on improving the coordination and monitoring of national fiscal policies and enhancing the financial stability of the euro area.

- Draft budgetary plans: euro area member states had to submit their budgetary plans to the Commission for review before adoption, ensuring alignment with EU fiscal rules.
- Enhanced surveillance: Stricter reporting for member states experiencing financial difficulties and under financial assistance programs to monitor adherence to agreed measures.

By 2015, the EU introduced greater flexibility in the application of SGP rules, linking structural reforms and investment with fiscal responsibility. This approach aimed to support growth while maintaining fiscal discipline.

In response to the COVID-19 crisis, the EU activated the General Escape Clause thus affecting the implementation[4] of the SGP in 2020 and enabling member states to activate necessary fiscal measures to address the unprecedented economic challenges posed by the pandemic. This clause allows member states to deviate temporarily from fiscal requirements during severe economic downturn affecting the euro area or the EU as a whole. The activation of the General Escape Clause allowed member states the flexibility to implement large-scale fiscal measures without fear of breaching the usual fiscal rules. This meant governments could increase spending on healthcare, unemployment benefits, business support schemes, and economic recovery packages. member states were also allowed to run higher deficits and accumulate more debt to mitigate the immediate effects of the crisis and prevent long-term economic scarring. The European Commission also refrained from initiating of corrective EDP's based on the identified excessive deficits.

3. A brief summary and discussion on the new EU fiscal framework

The reforms of the EU fiscal framework in 2024 were driven by the need to address challenges in debt sustainability, promote inclusive growth, and enhance the resilience of EU economies. These reforms were the most comprehensive overhaul of the EU's economic governance rules since the aftermath of the global financial crisis. They aimed to correct shortcomings in the previous framework, which often led to pro-cyclical fiscal policies—stimulating economies during good times and imposing austerity during downturns.

[4] Activation of the General Escape Clause is often interpreted as the suspension of SGP, i.e., fiscal rules. The rules were never actually suspended; only the quantitative targets describing the pace for making preventive MTO and corrective 3% deficit were relaxed and the Commission refrained from initiating EDPs. However, both the Commission and member states implicitly considered the existence of the General Escape Clause as permission to run high deficits and disregard the fiscal rules.

One key reason for the reforms was to strengthen the sustainability of Member States' public debt while promoting sustainable and inclusive growth. The new framework introduces medium-term fiscal structural plans, requiring Member States to outline fiscal targets, priority reforms, and investments. These plans focus on achieving debt reduction through a balanced combination of fiscal adjustments, reforms, and investments within a defined adjustment period.

The reforms also addressed the need for simpler, risk-based fiscal rules tailored to individual Member States' situations. The new system introduces safeguards, including the debt sustainability safeguard to ensure debt follows a downward path and the deficit resilience safeguard to maintain a safety margin below the 3% of GDP deficit reference. This approach prevents pro-cyclical adjustments that could harm economies during downturns.

Promoting reforms and investment was another crucial driver of the reforms. The EU recognized the importance of facilitating the green and digital transitions, strengthening social and economic resilience, and enhancing security capacity. The framework encourages Member States to align their fiscal plans with these long-term priorities.

Finally, the reforms aimed to enhance enforcement. While Member States now have more flexibility in designing their plans, they are subject to stricter oversight. Annual progress reports ensure accountability, with the European Commission assessing implementation and ensuring commitments are met.

Overall, the 2024 reforms reflect a shift towards a more flexible yet disciplined approach to fiscal governance, promoting sustainable growth while ensuring resilience against future economic shocks.

3.1 Similarities and differences between old and new EU fiscal rules

The EU economic governance framework, including the new fiscal rules, remains grounded in Articles 120 and 121, which require member states to conduct their economic policies with a view to contributing to the achievement of the objectives of the Union and regard them as a matter of common concern. Thus, single monetary policy in incomplete fiscal union means that fiscal sustainability of every member state is a matter of common concern. As the Treaty has not changed, the new fiscal rules remain based on Article 126 of the Treaty and its Protocol No. 123 that define the key elements of fiscal discipline and the criteria for the activation of the EDP for member states that breach the Treaty provisions. In this sense, under new rules EU member states are still required to maintain their budget deficits below 3% of GDP and to keep gross government debt below 60% of GDP, or reduce it at a satisfactory pace.

The second similarity refers to a minimum required fiscal adjustment during the EDP: member states are still required to adjust their structural primary balance by at least 0.5 percentage points of GDP per year as in the previous framework.

However, there are several important differences between the old and the new set of rules.

The first difference refers to the abolishment of the concept of the medium-term objective (MTO), a key fiscal benchmark for assessing fiscal sustainability that served as the cornerstone of the preventive arm of SGP. The MTOs were calculated based on three different criteria, the formula was complex and depended on unobservable variables, and the process involved a relatively high degree of arbitrariness on the part of the EC. Unless structural balance was already at or above the MTO, member states had to correct structural deficit by at least 0.5% of GDP per year as a baseline,[5] and real spending growth had to be lower than potential growth.

The second major difference relates to the definition of public debt trajectory. The old rules required all member states with public debt above 60% of GDP to reduce their debts by at least 1/20th of the gap between the actual debt level and the reference value per year. Failure to meet this rule could lead to the 'debt-based EDP'. This proved to be too strong a requirement for heavily indebted member states faced with anaemic growth and was the main reason for the reform. The Council and the Commission had to define numerous exclusions from this rule, which in the end proved to be intractable. On the other hand, the new rules on the public debt trajectory are based on debt sustainability analysis (DSA) for each member state. They require member states to put the debt-to-GDP ratio on a plausibly downward path to keep it at prudent levels below 60% of GDP over the medium-term. A plausible downward path implies that there is at least 70% probability that debt will decline after the end of the adjustment period, even in case of the pre-defined adverse assumptions about interest rates, GDP growth and primary fiscal balance. Whether the downward path is plausible is assessed using stochastic and deterministic DSA.

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[5] However, the system allowed an annual deviation of 1/2 percent from this requirement, or 1/4 percent during two consecutive years. The deviation was not supposed to be corrected in the following years, which means that the annual requirement was only ¼ of percentage points. Moreover, the required adjustment was further modified for the cyclical position, according to a matrix that was first announced by the Commission and later verified by the Council. The matrix effectively watered down the requirement. In addition, there were investment and reform clauses unrelated to any actual costs, and which allowed for additional relaxation of the targeted adjustment. Finally there was a „margin of appreciation“, which further diluted the requirement.

Table 1. Comparison of the key elements of the new and old EU fiscal framework

	Old SGP	New framework
Main target	Medium-Term Objective (MTO) based on structural balance (SB), adjusted for cyclical and one-off factors.	Net expenditure path over 4–7 years, ensuring debt sustainability and prudent debt levels (<60% of GDP).
Debt reduction rule	Reduce debt exceeding 60% of GDP by at least 1/20th of the gap annually (often violated).	Decline of 1% of GDP annually for debt >90% of GDP, 0.5% for debt between 60-90%, during the adjustment period.
Operational indicator	Structural balance and real government expenditure growth relative to potential growth.	Single indicator: net expenditure path calibrated to debt sustainability and deficit reduction needs.
Complexity	Relied on unobservable variables (e.g., output gap) and arbitrary numerical parameters.	Simplified with clearer criteria, and fewer indicators.
Procyclicality	Failed to reduce the level of the procyclicality of fiscal policies in member states.	Contributes to the reduction of the level of the procyclicality of fiscal policies in member states with countercyclical fiscal paths and automatic stabilisers fully operational.
Deficit requirement	Deficit above 3% of GDP required adjustment by 0.5% annually; structural measures emphasised post-2028.	Deficit >3% of GDP requires reduction below this level by end of adjustment period, with annual improvement safeguards.
Safeguards for high debt	No additional specific annual adjustment safeguards for high debt, except for the "1/20 rule".	Debt sustainability and deficit resilience safeguards ensure consistent and front-loaded adjustments.
Investment protection	Limited focus on protecting public investment.	Incentives for growth-enhancing reforms and investments, excluding national EU co-financing from net expenditure calculations.
Enforcement	Poor compliance; violations of debt rules often unpunished; weak enforcement of debt-based EDP.	Aims to improve and strengthen the enforcement via annual progress reports, control accounts, and clear criteria for EDP activation.
Flexibility	Limited flexibility for member state-specific circumstances; uniform rules applied broadly.	Greater flexibility with differentiated fiscal paths based on member state-specific debt sustainability challenges.
Adjustment period	No explicit adjustment period length tied to reforms or investments.	4-to-7 year adjustment periods based on reform and investment commitments, promoting gradual fiscal alignment.
Escape clauses	General escape clause for EU-wide crises; no formal mechanism for member state-specific circumstances.	General and member state-specific escape clauses for extraordinary situations outside government control.
Performance	Failed to ensure debt sustainability or compliance with 60% debt threshold; criticised for poor results.	Aims to improve debt sustainability and compliance with stricter, clearer rules and enhanced flexibility.

Note: the table presents only the key features of the old and new rules without explanation of potential deviations, adjustments etc.
Source: authors based on Darvas, Welslau and Zettelmayer (2024) and official EC documents[6]

[6] Regulation (EU) 2024/1263 of the European Parliament and of the Council of 29 April 2024 on the effective coordination of economic policies and on multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97; Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.

The third difference is the introduction of the single operational target that replaces MTOs in the form of a net expenditure path over a period of four to seven years.[7] The rationale for this change is to ensure that the projected general government debt ratio is put on a plausibly downward path, and that whenever the budget deficit is larger than 3% of GDP, it is reduced below this reference value by the end of the adjustment period.

The new framework also requires the net expenditure path to meet three additional conditions ("safeguards") if public debt or deficit breach the reference values:

i) *No backloading*: annual fiscal adjustment cannot increase during the adjustment period;

ii) *Debt sustainability*: at least 1 percentage point of GDP per year decline in the debt ratio for member states with a debt ratio greater than 90% of GDP; and ½ a percentage point of GDP per year for member states with a debt ratio between 60 and 90% of GDP, from either the beginning of the adjustment period or from the correction of an excessive deficit (whichever is later) by the end of the adjustment period;

iii) *Deficit resilience*: for member states with a structural overall budget deficit greater than 1.5% of GDP, an annual improvement in the structural primary balance of at least 0.4% of GDP when the adjustment period lasts four years, and at least 0.25% of GDP when it lasts seven years.

The net expenditure path in the EU's new fiscal framework is a collaborative process between the European Commission, EU institutions, and national authorities to ensure fiscal sustainability while allowing national flexibility.

Each member state develops a Medium-Term Fiscal-Structural Plan (MTFSP) outlining fiscal targets and expenditure paths over four to seven years. The European Commission evaluates these plans for compliance with EU fiscal rules, particularly regarding debt and deficit levels. For high-debt countries, the Commission may propose a reference net expenditure path. A structured dialogue allows adjustments before the Council of the EU reviews and endorses the plan, making it binding.

[7] Net expenditure is defined as government expenditure net of interest expenditure, discretionary revenue measures, expenditure on programmes of the Union fully matched by revenue from Union funds, national expenditure on co-financing of programmes funded by the Union, cyclical elements of unemployment benefit expenditure, and one-offs and other temporary measures.

To ensure compliance, Annual Progress Reports track adherence, while a Control Account Mechanism monitors deviations, allowing timely corrections. Independent Fiscal Institutions (IFIs) provide national oversight, while an EU-wide network enhances fiscal governance.

If a country significantly deviates, the Excessive Deficit Procedure (EDP) can be triggered, requiring corrective measures and potential sanctions. This system ensures that member states maintain fiscal discipline while balancing investment needs and economic stability within a unified EU strategy.

For high-debt countries, deviating from the adjustment path can trigger the opening of the EDP. The EDP serves as a corrective mechanism within the Stability and Growth Pact (SGP), aiming to ensure that EU member states maintain fiscal discipline by addressing excessive deficits and debt levels. While traditionally part of the corrective arm, the EDP can also function as an enforcement tool within the preventive framework, compelling countries to adhere to fiscal targets and adjustment paths. This dual role underscores the EDP's significance in both preventing and correcting fiscal imbalances. Member states with debt below 60% of GDP and no plans to exceed it are unaffected by the new rules, unless they breach the 3% deficit threshold.[8]

Additional "sound and data-driven economic arguments" will have to be provided if the fiscal adjustment proposed by the member state is smaller than the Commission's reference path. In the old fiscal framework, Commission's recommendations for actions to end the excessive deficit were binding, and deviations from these recommendations were treated as non-compliance with potential consequences.

3.1. Academic and policy discussion on the new EU fiscal framework

The academic and policy discourse on the new EU fiscal rules revolves around their flexibility, enforcement mechanisms, and potential unintended consequences. While scholars generally acknowledge that the reforms are an improvement over previous frameworks, concerns persist regarding the impact of quantitative safeguards, compliance risks, and the need for further alignment between fiscal rules and investment priorities. The debate suggests that the success of the new framework will depend on its implementation, the balance between fiscal discipline

[8] The deficit safeguard resembles the old preventive arm with limit for structural deficit set at 1.5% of GDP instead of 1% or less.

and economic growth, and the EU's ability to support public investment in the face of fiscal constraints.

Some authors emphasize that one of the primary advantages of the reformed framework is its differentiation of fiscal paths based on individual country situations, as highlighted by Darvas, Welslau, and Zettelmeyer (2023, 2024). This risk-based approach offers high-debt countries, such as France and Italy, a less stringent adjustment process compared to previous rules. However, the requirement for annual deficit reductions of at least 0.5% of GDP for countries exceeding the 3% threshold remains a limiting factor, potentially forcing fiscal tightening during economic downturns. This concern is echoed by Paez and Watzka (2024), who emphasize that even slight changes in DSA assumptions could significantly alter fiscal requirements, making medium-term planning uncertain and exposing public investment to risk.

The tension between fiscal consolidation and investment priorities is a recurring theme. Both Paez and Watzka (2024), along with Haimberger et al. (2024), argue that while the new rules are less restrictive than those applied during the euro crisis, they still risk undermining public investment, particularly in critical areas like green and digital transitions. To counterbalance this, they propose the establishment of an EU-level debt-financed green investment fund. Such an initiative would not only safeguard long-term growth but also ensure that fiscal adjustments do not come at the expense of sustainable development goals.

However, not all scholars view the increased flexibility positively. Pench (2024) raises concerns that the revised Excessive Deficit Procedure (EDP) could allow high-debt countries to delay necessary fiscal adjustments. He warns that some member states might meet the 3% deficit limit without addressing underlying debt challenges, thus weakening overall fiscal discipline. To address this, he calls for tighter alignment between the EDP and the preventive fiscal framework, ensuring that both deficit and debt criteria are met for exiting the EDP. Darvas, Welslau, and Zettelmeyer (2024) also highlight this misalignment, suggesting that without an independent review of DSAs and adjustments to debt safeguards, the framework could lead to inconsistent enforcement and increased pro-cyclicality.

Historical perspectives further highlight the complexities of the new framework. Mesorri (2024) compares the current reforms to the 2005–2013 Stability and Growth Pact, noting that while the new approach introduces binding incentives and greater flexibility, the continued reliance on strict numerical safeguards could still pose compliance challenges. He argues that without further reforms, including clearer enforcement mechanisms and greater consistency between fiscal rules and economic realities, the framework's effectiveness remains uncertain.

4. Analytical framework

This section presents the key elements of the analytical framework used in the paper.

Our analysis examines the impact of the new EU fiscal rules on small, moderately indebted economies facing excessive deficits, using Croatia's experience during the 2014–2017 Excessive Deficit Procedure (EDP) as a case study. It begins by comparing the required structural adjustments under the old and new EDP frameworks. This involves contrasting the historical recommendations adopted by the Council, based on the previous EU fiscal rules and methodology, with a counterfactual scenario applying the new rules while maintaining the same economic and fiscal assumptions.

The analysis then evaluates how the alternative consolidation paths affect key fiscal variables, including net lending, the structural balance, public debt, and overall economic activity. This comparative approach highlights the fiscal outcomes under different scenarios, providing insights into which framework may better support growth and minimize pro-cyclicality, particularly in the context of Croatia's struggle with a severe recession when the EDP was first activated.

4.1. Basic fiscal arithmetic

The key indicator in EU fiscal analysis is the structural primary balance, which is the indicator of fiscal policy stance.[9] The primary balance, pb_t, is calculated as the sum of general government balance, ggb_t, and interest payments, it_t:

$$pb_t = ggb_t + it_t \tag{1}$$

The general government balance is defined as the sum of structural balance, sb_t, and a cyclical component (cyc_t):

$$ggb_t = sb_t + cyc_t \tag{2}$$

Structural primary balance (spb_t) is defined as sum of structural balance (sb_t) and interest payments (it_t):

[9] No change, improvement or deterioration of structural primary balance correspond to neutral, tightening or loosening fiscal policy.

$$spb_t = sb_t + it_t \tag{3}$$

Change in the debt to GDP ratio is given by conventional debt dynamics equation:

$$\Delta dt_t = \frac{i_t - (\pi_t + g_t)}{(1+\pi_t)(1+g_t)} * dt_{t-1} - pbt_{t-1} + dda_t \tag{4}$$

where i_t is the interest rate, π_t is GDP deflator, g_t is real growth rate, and dda_t are deficit-debt adjustments. For the first two years of the consolidation horizon, interest payments are based on EC's vintage forecast; afterwards, they are projected using a simple ARMA forecast based on market interest rate and debt duration. The deficit-debt adjustments beyond the EC forecast horizon of two years are set to zero.

The reference trajectory in terms of net primary expenditure is calculated as:

$$nex_t = \hat{g}_t + \pi_t - fe_t, \tag{5}$$

where nex_t is net primary expenditure growth, calculated as a sum of potential GDP growth $\hat{g}_t$ and GDP deflator π_t, fe_t is the expected fiscal effort, i.e., the required change in the ratio of structural primary balance to primary expenditure over GDP. Net primary expenditure is the operating variable that should ensure debt stabilisation in the medium-term.

4.2. GDP projections

Macroeconomic projections of the European Commission cover the period of T+2 years, while the new EU fiscal framework also requires longer-term projections. In our projections we assume that the GDP growth in the long run is determined by potential growth, persistence effects captured through an autoregressive process, and fiscal measures via the fiscal multiplier (Bouabdallah et al., 2017):[10]

$$y_t = \begin{cases} 0.5 * y_{t-1} + 1 * y_t^P - 0.75 * \Delta SPB_t - 0.2 * OG_{t-1}, if\ (y_t^P - y_{t-1}) * OG_{t-1} < 0 \\ 0 * y_{t-1} + 1 * y_t^P - 0.75 * \Delta SPB_t - 0.2 * OG_{t-1}, if\ (y_t^P - y_{t-1}) * OG_{t-1} > 0 \end{cases} \tag{6}$$

where y_t is GDP growth, y_t^P potential growth, ΔSPB_t change in structural primary balance, and OG_{t-1} output gap in the previous period, calculated as a deviation of real from potential GDP, which is not affected by fiscal consolidation. Equation (6) relies on the threshold multiplier, whereby the parameters which mostly affect the size of the multiplicative effect are

[10] We use long-term forecast for potential output from Ageing Report (2015), which is interpolated due to the lack of yearly forecast data, i.e. every fifth year is presented.

related to the pace of output gap closure (Warmedinger et al.,2015). Real GDP growth depends on the initial phase of business cycle (positive or negative output gap), the size of the fiscal multiplier, also taking into account the hysteresis effect, which is captured by the parameter related to the effects of GDP growth in the previous period on the growth rate in the current period. Additional consolidation would prolong the pace if the output gap deviates from zero at the beginning of adjustment. For instance, if the real GDP is below the potential GDP, consolidation effects could be self-defeating, resulting in the longer pace of output gap closure.

The corresponding fiscal multiplier is set at –0.75 on impact, in line with broadly accepted methodology (Debt Sustainability Monitor, 2024; Darvas et al., 2024; Carnot & De Castro, 2015). The elasticity with respect to the (lagged) output gap OG_{t-1} is set at 0.2, which suggests that the output gap would close in the medium run in the absence of additional structural adjustment, in line with the Debt Sustainability Monitor (2024). However, standard EC methodology is somewhat different regarding the multiplier equation (6). In the paper, we are following the threshold multiplier approach in line with Warmedinger et al. (2015), while EC's methodology does not take into account consolidation effects depending on the phase of business cycle. Nevertheless, they include also the assumption about the size of output gap, which is determined by fiscal consolidation. Annual growth rate of GDP deflator is assumed to converge gradually to 1.9%, in line with the ECB objective for price stability and DSA methodology proposed by Bouabdallah et al. (2017). Nominal GDP is calculated as the sum of real GDP and GDP deflator.

4.3. Deterministic debt sustainability analysis (DSA)

The adjustment scenario, based on the equations (3) and (6) in the new fiscal framework is appropriate if the reference trajectory of public debt calculated by equation (4) is below the following three stress scenarios from Debt Sustainability Monitor (2024) by the end of adjustment period at the latest and in the 10-year simulation horizon:

1. *Lower structural primary balance scenario* assumes that structural primary balance declines by a cumulative 0.5 percentage points over two years after the adjustment period (0.25 p.p. each year).
2. *Adverse r–g scenario* assumes increase in interest rate/growth rate differential by 1 percentage point over the simulation horizon after the adjustment period.

3. *Financial stress scenario* assumes a temporary increase of market interest rates for one year by 1 p.p. after the adjustment period, with additional risk premium for high-debt countries.

4.4. Stochastic debt sustainability analysis (DSA)

Stochastic DSA attemps to quantify macroeconomic and fiscal uncertainties around the adjustment scenario. It is based on a small macro-fiscal model, using annual data, that integrates a Vector Autoregressive (VAR) model (7), an ordinary least squares (OLS) equation of the fiscal reaction function (8) (proposed by Bohn (1998)), and an ARMA model for estimating the deficit-debt adjustments. Stochastic analysis for Croatia in our paper relies to the models for DSA from the paper (Banić, 2020).[11] This system of equations brings together stochastic forecasts for the key macroeconomic and fiscal variables of the debt accumulation process that determines the long-term debt to GDP trajectory.

In the first step we estimate a VAR model:

$$Y_t = \alpha + \phi Y_{t-1} + \varepsilon_t \tag{7}$$

where α is constant, Y_t is a vector of endogenous variables that includes nominal GDP growth and the first difference of implicit interest rate, and ε_t is the error term.[12]

In the second step we estimate the fiscal reaction function for primary balance:

$$pb_t = \alpha + \eta d_{t-1} + \theta pb_{t-1} + \hat{y}_t + \varepsilon_t \tag{8}$$

where *pb* is a function of lagged debt/GDP d_{t-1}, lagged primary balance, and output gap $\hat{y}_t$. Deficit/debt adjustments are calculated as a residual from equation (7) and estimated as an autoregressive moving average model.

5. Scenario analysis

Our analysis is based on the comparison of three scenarios: a baseline scenario of no policy change; the realised EDP scenario based on the Council's recommendation under the old fiscal rules; and a counterfactual scenario based on the new fiscal rules.

[11] For more details see Banić (2020). Our model is somewhat different comparing to the EC's stochastic DSA simulation.

[12] The model also includes a dummy variable that covers the period of the Great Financial Crisis (GFC).

5.1. Structural adjustment in different scenarios

a) Baseline scenario: no fiscal policy change

Baseline scenario assumes no consolidation efforts over the projection horizon. The structural primary balance in the first year is assumed to remain unchanged over the projection horizon. The overall structural balance is only affected by factors such as aging costs (pensions, health care, long term care), education, and unemployment benefits, in line with the methodology explained in Darvas et al. (2024). We use data from the Ageing Report (2015).

b) Alternative scenario I: structural adjustment under the old fiscal rules

This scenario is based on the actual Excessive Deficit Procedure (EDP) in Croatia, which was activated by the Council's decision in January 2014. The EDP was initiated due to deviations from the deficit and debt criteria. Lang (2023) highlighted that the European Commission demonstrated flexibility by delaying the activation of the Excessive Deficit Procedure (EDP) until January, considering the unfavorable macroeconomic outlook. The Commission also provided an evaluation of the expected fiscal effort, which was shaped by intensive dialogue with Croatian authorities.The European Commission's 2013 autumn forecast, released in November 2013, projected that the general government deficit would exceed 3% of GDP by a large margin and rise to over 6% through 2015 if no countervailing measures were taken. The Commission acknowledged that the deficit was due to severe economic downturn, but noted that it could not be considered temporary under the Stability and Growth Pact (SGP). Without policy changes, the general government debt was expected to exceed 60% in 2013 and remain elevated due to persistently high deficits and weak economic activity. To correct the excessive deficit, the Council recommended the fiscal effort (structural consolidation measures) of 2.3% of GDP in 2014 and 1% of GDP in both 2015 and 2016, which is consistent with an annual improvement in the structural balance of 0,5 % of GDP in 2014, 0,9 % of GDP in 2015 and 0,7 % of GDP in 2016.

c) Alternative scenario II: structural adjustment under the new fiscal rules

The new rules require that the reference trajectories and member states' plans need to meet three criteria:

1. By the end of the adjustment period at the latest, and over the following 10 years, debt declines or stays below 60% of GDP both in the adjustment scenario and under all three deterministic stress tests;

2. In the 5 years following the adjustment period, debt declines with a sufficiently high probability, i.e. at least 70%, in line with the threshold used in the Commission's standard DSA;
3. The deficit is brought and remains below 3% of GDP over the medium term.

Less strict fiscal adjustment can be appropriate if the fiscal effort under the first two criteria is sufficient to ensure that debt is brought to or remains below 60% of GDP while the deficit remains below 3%. The rationale for these criteria is that when the debt to GDP ratio exceeds 60%, the size of fiscal adjustment should be sufficiently strong and credible to bring the debt ratio to a sustainable level under all three deterministic scenarios noted above.

We assume that Croatian policymakers would have opted for a four-year adjustment in 2014, and committed to fiscal effort of 1.3% of GDP in 2014, 1.2% in 2015, and 1% each in 2016 and 2017 to make it comparable to a three-year consolidation path planned under the EDP. For the remainder of the projection horizon we assume no policy change, i.e. we keep the primary structural balance at the 2017 level. This scenario would have leveraged greater flexibility of the new rules and an extended adjustment horizon, thereby aiming for a more gradual consolidation to satisfy the relevant adjustment criteria.

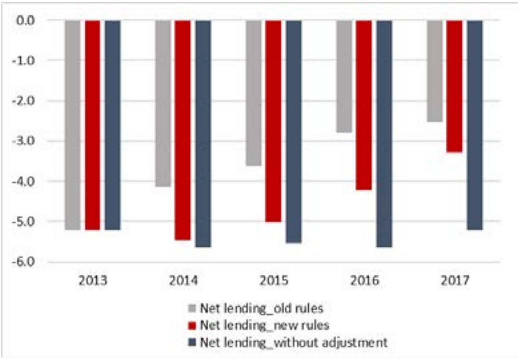
5.2. Fiscal and economic implications of the application of old and new EU fiscal rules on Croatia's experience under the EDP

Figure 1 shows that by the end of the adjustment period at the latest, and over the 10 following years, debt would have declined or stayed below 60% of GDP both in the adjustment scenario and under the three deterministic stress tests. In particular, five years following the adjustment period, debt would have declined with a probability of at least 70% and the deficit would have been brought to and remained below 3% of GDP over the medium term.

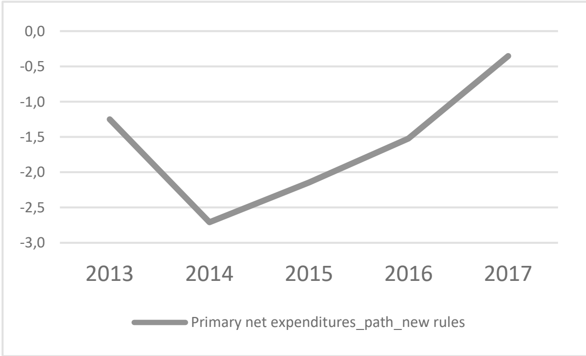
Figure 2 shows that at the end of 2016, i.e., consolidation horizon under the old rules, debt to GDP would have been around four percentage points higher under the new fiscal rules. At the same time, real GDP growth would be less exacerbated. This suggests that the new EU fiscal framework could provide more space for policymakers, allowing them to take a more gradual and growth-friendly fiscal adjustment. Deskar-Škrbić and Milutinović (2021) showed that fiscal consolidation implemented in Croatia during the EDP was not growth-friendly and was partially self-defeating. However, these conclusions should be taken with a grain of salt due to methodological and normative limitations described below.

Figure 1. DSA-based criteria in the reference trajectory

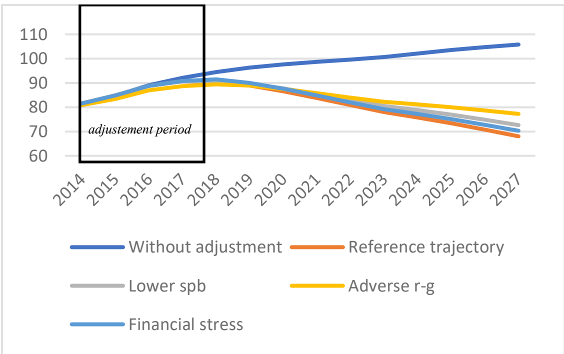
(a) Net lending/borrowing



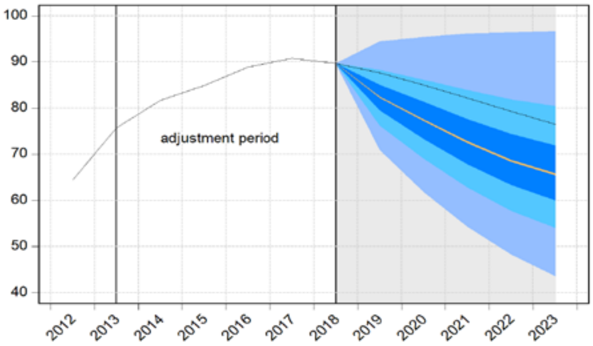
(b) Primary net expenditure trajectory



(c) Public debt / GDP (deterministic)



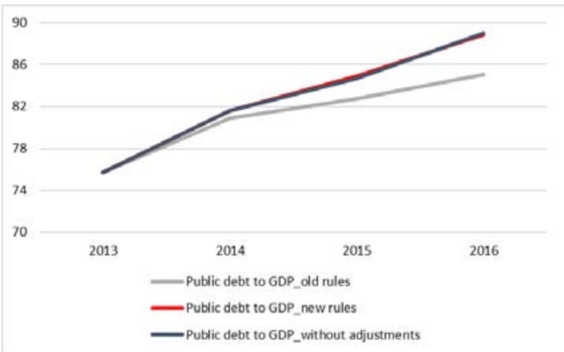
(d) Public debt / GDP (stochastic)



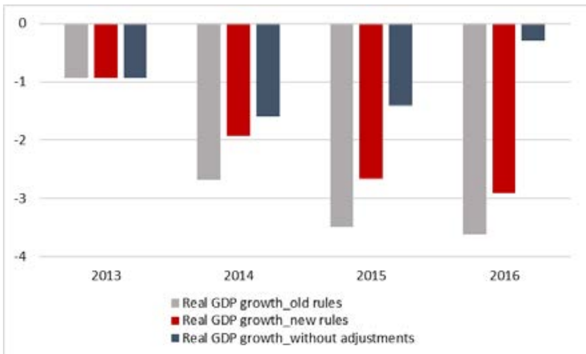
Source: Authors' calculations. For stochastic simulation (Figure d), black line represents debt trajectory after adjustment period, which is on a downward (plausible) path with 60% probability. Probability includes bands between 5th-95th percentiles, 20th-80th percentiles, 35th-65th percentiles, 45th-55th percentiles.

Figure 2: Illustrative trajectories of public debt / GDP and real GDP under new and old rules

(a) Public debt / GDP trajectory



(b) Real GDP (cumulative growth rate)



Note: Fiscal consolidation effects on real GDP are estimated using equation (6).

Source: Authors' calculations.

5.3. Key limitations of our approach

The counterfactual scenario using the new fiscal rules clearly cannot replicate conditions associated with investor sentiment after the euro area sovereign debt crisis, the Commission's policy nudges ahead of Croatia's EU accession in 2013, the quality of data and forecasts, and the composition of official and technical staff in the Commission and the Croatian administration.[13]

In addition, we cannot take into account the substantial changes in economic environment that came ad s positive surprise during the EDP period. More precisely, in 2015 and 2016, Croatia barely met the Excessive Deficit Procedure (EDP) recommendations. Yet, by the end of 2016, the EDP was abrogated on time due to significantly better-than-expected economic outcomes. In the period after 2016, Croatia recorded fiscal balances that were significantly more positive than both recommended and planned. During this time, the Convergence Programs generally projected balances very close to the Medium-Term Objective (MTO), while the recommendation was to remain at the MTO. Ultimately, Croatia substantially exceeded both targets. Considering that in the counterfactual scenario under new rules, the adjustment period would extend into this timeframe, it is reasonable to expect that Croatia would also have exceeded the reference trajectory in that scenario but we did not take this into account in order to avoid making the comparison even more complex.

So, once the recovery began and outcomes started to significantly exceed expectations on the positive side (well above forecasts) it is hard to imagine that the authorities would continue to follow the same recommendations based on 2013 forecasts. New framework would allow Croatian authorities to request a revised reference trajectory and submit a new plan with revised fiscal targets and structural effort.

Nevertheless, despite all the limitations, we believe that the assumed adjustment path is as close as possible to the fiscal effort the authorities would have undertaken if they could have opted for the new fiscal rules.

6. Conclusion

This study analysed and explained the main features of the latest reform of the EU fiscal framework and illustrated the differences between the new and old EU fiscal rules, using Croatia's experience during the Excessive Deficit Procedure (EDP) activated in 2014. Our

[13] For example, if Croatian authorities had opted for a more gradual consolidation path in 2013, risk premia on government debt would have probably been higher.

findings suggest that the reformed EU fiscal rules provide a more flexible, growth-friendlier approach to fiscal consolidation by allowing more customised debt sustainability assessments. By contrast, the old fiscal rules applied a uniform approach to deficit reduction, often resulting in weak growth. The greater flexibility under the new rules potentially mitigates potential pro-cyclical effects of fiscal adjustment and could thus help improve macroeconomic stability.

The application of old fiscal rules in Croatia required a swift and substantial deficit reduction at a time of a severe recession. The counterfactual scenario under the new rules suggests that a more gradual adjustment could have reduced the strain on the economy and resulted in a better growth trajectory. By allowing a more realistic debt reduction path while still fostering the EU's fiscal objectives, the new framework could be particularly beneficial for moderately indebted member states seeking to balance fiscal discipline and economic growth objectives.

The new fiscal rules are welcome because they shift the policy focus from a one-size-fits-all to a more nuanced, country-specific approach that puts fiscal sustainability in the context of economic realities. Looking back at a decade of weak growth after the GFC, such approach could support a better balance between fiscal consolidation and long-term growth. However, its benefits will depend crucially on the way the new rules are implemented and monitored.

The first challenge to the new framework may arise sooner than expected, as rising geopolitical tensions increase pressure for higher defence spending. While the system allows some flexibility – through rule interpretation or tools like the escape clause – balancing fiscal discipline with security needs remains complex. If pressures persist, further adjustments to the fiscal framework may be needed to maintain both stability and flexibility.

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Appendix 1: Key features of the new EU economic governance framework at glance

Medium-term fiscal-structural plans: Member States will draft 4-5 year plans combining fiscal, reform, and investment strategies under an EU framework. These plans aim to promote sustainable debt reduction, build a competitive, green, digital, and resilient economy, and align with national electoral cycles, enhancing ownership.

Single fiscal indicator for oversight: EU surveillance will focus on multi-year net expenditure paths tailored to each Member State, simplifying fiscal monitoring. These paths will ensure debt reduction, maintain deficits below 3% of GDP, and allow automatic stabilizers to function effectively.

Member State-specific fiscal adjustments with safeguards: Fiscal adjustments will account for each Member State's debt sustainability risks, including debt levels, deficits, and macroeconomic challenges. Safeguards like debt and deficit thresholds (60% and 3% of GDP) ensure minimum fiscal adjustments and prudent debt trajectories.

Extended adjustment period for reforms and investments: Member States committing to growth-oriented reforms and EU-aligned investments can extend fiscal adjustment periods from 4 to 7 years. Incentives include excluding EU program co-financing from fiscal indicators and considering commitments under the Recovery and Resilience Facility.

Escape clauses for extraordinary circumstances: A general escape clause will allow deviations during EU-wide economic downturns. Member State-specific clauses will address exceptional national situations, enabling flexibility while ensuring medium-term fiscal stability.

Enhanced enforcement mechanisms: Annual progress reports and control accounts will track deviations from fiscal paths. Persistent breaches, particularly with high debt levels, may trigger debt-based excessive deficit procedures. Non-compliance with reform commitments may shorten adjustment periods, while clearer fiscal rules will impose reputational costs for deviations.

Balanced governance framework: The reformed system ensures flexibility for Member States to design plans and adjust fiscal paths while emphasizing stricter enforcement. Simplified rules link net expenditure paths to debt, with periodic reviews and reinforced debt-based EDP's ensuring accountability and consistency.

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