ISSN 2443-8014 (online)

Quarterly Report on the Euro Area

Volume 21, No 4 (2022)

- **How to ensure debt sustainability in a growth-friendly manner?** by E. Orseau, H. Van Noten, P. Arevalo, A. Cepparulo, G. Mourre & S. Pamies
- **Enhancing the ability of fiscal policy to ensure macroeconomic stabilisation** by O. Galgau, P. Mohl, A. Monks, G. Mourre & D. Radu
- **The role of the fiscal framework to foster public investment, including in light of the green and digital transitions** by S. Langedijk, Å. Johannesson-Lindén, P. Brans, A. Cepparulo, H. Hernnäs, A. Ioannidis, C. McDonnell, P. Mohl & V. Ernesto Reitano
- **Improving compliance with the EU fiscal framework through stronger ownership and enforcement** by H. Van Noten, E. Bova, G. Mourre & Ch. Weise
- **Annex: The euro area chronicle** by J. Wtorek

INSTITUTIONAL PAPER 195 | FEBRUARY 2023

EUROPEAN ECONOMY

Economic and Financial Affairs

The **Quarterly Report on the Euro Area** is written by staff of the Directorate-General for Economic and Financial Affairs. It is intended to contribute to a better understanding of economic developments in the euro area and to improve the quality of the public debate surrounding the area's economic policy.

DISCLAIMER

The views expressed are the author's alone and do not necessarily correspond to those of the European Commission.

The Report is released every quarter of the year.

Editors: Lucio Pench, Eric Rusher and Matteo Salto
Coordination: Eric Meyermans
Statistical and layout assistance: Luisa Boa

Comments on the report would be gratefully received and should be sent to:

Unit C3 – Macroeconomics of the Euro Area, Monetary Policy and Euro Convergence
European Commission
Directorate-General for Economic and Financial Affairs
Directorate Macroeconomic Policy

Email: ECFIN-QUARTERLY-REPORT-EA@ec.europa.eu

LEGAL NOTICE

Neither the European Commission nor any person acting on behalf of the European Commission is responsible for the use that might be made of the information contained in this publication.

This paper exists in English only and can be downloaded from
https://economy-finance.ec.europa.eu/ecfin-publications_en.

Luxembourg: Publications Office of the European Union, 2023

PDF ISBN 978-92-76-61644-3 ISSN 2443-8014 doi:10.2765/72382 KC-BC-23-002-EN-N

© European Union, 2023
Reuse is authorised provided the source is acknowledged. The reuse policy of European Commission documents is regulated by Decision 2011/833/EU (OJ L 330, 14.12.2011, p. 39). For any use or reproduction of material that is not under the EU copyright, permission must be sought directly from the copyright holders.

CREDIT
Cover photography: © iStock.com/gwycech

European Commission
Directorate-General for Economic and Financial Affairs

Quarterly Report on the Euro Area

Volume 21, No 4 (2022)

EUROPEAN ECONOMY

Institutional Paper 195

Table of contents

Editorial 5

I. How to ensure debt sustainability in a growth-friendly manner? (By Eloïse Orseau, Henk Van Noten, Pedro Arevalo, Alessandra Cepparulo, Gilles Mourre and Stéphanie Pamies) 7

- I.1. Introduction 7
- I.2. Debt sustainability in the wake of the COVID-19 crisis 7
- I.3. How to calibrate a pace of debt reduction consistent with sustained and sustainable growth? 12
- I.4. How to make debt reduction strategies more realistic, sustained and growth-friendly? 15
- I.5. Conclusion 17

II. Enhancing the Ability of Fiscal Policy to Ensure Macroeconomic Stabilisation (By Olivia Galgau, Philipp Mohl, Allen Monks, Gilles Mourre and Diana Radu) 19

- II.1. Introduction 19
- II.2. Pro-cyclical fiscal policy remains pervasive despite the existence of fiscal rules 19
- II.3. Reducing pro-cyclicality in normal and exceptional circumstances 24
- II.4. Conclusions 28

III. The role of the fiscal framework to foster public investment, including in light of the green and digital transitions (By Sven Langedijk, Åsa Johannesson-Lindén, Paul Brans, Alessandra Cepparulo, Helena Hernnäs, Alexander Ioannidis, Clíona McDonnell, Philipp Mohl and Vito Ernesto Reitano) 29

- III.1. Introduction 29
- III.2. Conclusions 38

IV. Improving compliance with the EU fiscal framework through stronger ownership and enforcement (By Henk Van Noten, Elva Bova, Gilles Mourre and Christian Weise) 39

- IV.1. Introduction 39
- IV.2. Compliance with the EU fiscal framework: mixed records and reasons 39
- IV.3. Supporting national ownership 42
- IV.4. Enforcement instruments 44
- IV.5. Conclusion 46

Annex. The euro area chronicle 48

This special edition of the Quarterly Report on the Euro Area (QREA) focusses on technical topics that are at the core of the Commission's recent proposals for the reform of the EU economic governance framework. The economic governance framework is a key pillar of the architecture of the Economic and Monetary Union anchored in the Maastricht Treaty. It underpins the resilience of the euro by aiming to detect, monitor, prevent, and correct fiscal and economic imbalances that could undermine the stability and development of the union and the Member States. The two main elements of the framework are the set of fiscal rules of the Stability and Growth Pact and the Macroeconomic Imbalance Procedure. The latter was introduced in the wake of the global financial crisis to identify, prevent and address the emergence of macroeconomic issues, other than fiscal, that could have a negative impact on a Member State's economic stability. The economic governance framework has significantly evolved over time, most notably following the global financial crisis and the euro area sovereign debt crisis through a set of reforms aimed at strengthening the surveillance and coordination of macroeconomic policies across the EU and the euro area, the so-called Six-Pack -Pack and Two-Pack reform packages.

On 9 November 2022, the European Commission adopted a Communication on orientations for a reform of the EU economic governance framework. This followed an extensive preparatory process that was launched in February 2020, when the Commission published a review assessing the effectiveness of the framework. The review noted that the Stability and Growth Pact had become increasingly complex, did not sufficiently account for heterogeneous sustainability challenges across Member States, and had neither prevented a build-up of public debt, nor safeguarded important public investment in many Member States. The review process was put on hold in March 2020 as the policy focus turned to the response to the COVID-19 pandemic. In October 2021, the Commission relaunched the public debate with a Communication on the EU economy after COVID-19 and the implications for economic governance, inviting other EU institutions and all key stakeholders to engage. Through various fora, citizens, national governments, parliaments, social partners, academia and other EU institutions, contributed to the debate, expressing views on the key objectives of the governance framework, its functioning, and new challenges to be addressed.

The orientations for the reform aim to address the prevailing challenges and contribute to making Europe more resilient, by sustaining strategic investment and by reducing high public debt ratios in a realistic, gradual and sustained manner. Improving national ownership, simplifying the framework, and moving towards a greater medium-term focus, combined with stronger and more coherent enforcement, are key elements in the Commission's orientations. The reform should facilitate effective economic surveillance, anchored in a common framework that ensures effective equal treatment and multilateral policy coordination. The reformed framework should be robust to changing economic conditions and uncertainty, requiring a solid and predictable rule book and escape clauses for exceptional circumstances. It also pursues an integrated approach whereby surveillance tools complement each other, in the context of the European Semester. Effectively preventing and correcting macroeconomic imbalances will require better detection of emerging risks and maintenance of reform momentum, while placing more emphasis on EU and euro area developments, and on policy implementation.

Taking account of the inputs of the broad consultation, the Commission Communication acknowledges the very different public debt challenges that Member States face. The proposed reform of the framework aims at giving Member States a greater sense of ownership and will allow for simplification based on clear national commitments and a streamlining of indicators. National medium-term fiscal-structural plans will be the centrepiece of the reformed framework. Each national plan would set out a country-specific medium-term fiscal trajectory based on annual expenditure ceilings (netting out new revenue measures) and aimed at putting debt ratios on a plausible downward path or allowing them to stay at prudent levels. At the same time, deficit ratios should be maintained below the Treaty-reference value. The plans should also cover major reform and investment commitments. As the counterpart of giving Member States leeway to design their own fiscal trajectories, Member States' plans will commit their annual budgets on a cumulated-annual basis. To strengthen compliance, a new tool to ensure the implementation of reform and investment commitments would be introduced and the use of sanctions would be revised,

with the aim of facilitating their potential use when required.

This edition of the Quarterly Report on the Euro Area (QREA) features four analytical sections that present economic underpinnings of the proposals on the reform of the economic governance framework. It was used as background material for dedicated discussions in the Economic and Financial Committee. The first section examines how to ensure fiscal sustainability in a growth-friendly manner. During the COVID-19 crisis, public debt ratios strongly increased, adding in several cases to existing debt vulnerabilities. This situation calls for a gradual, sustained and growth-friendly reduction of debt ratios towards more prudent levels. The section discusses this challenge based on stylised facts, simulations, and further analytical insights.

The second section describes the role and scope of macroeconomic stabilisation in the EU fiscal rules, drawing on empirical evidence of the pro-cyclicality of national fiscal policies. It finds that fiscal loosening in good economic times and fiscal consolidation in bad times have driven procyclical fiscal policy, both at the stage of fiscal planning and implementation, the latter typically featuring slippages relative to plans. Successive innovations in the fiscal framework have sought to reduce pro-cyclicality by encouraging Member States to build buffers in good economic times so that automatic stabilisers could operate fully in bad economic times. At the same time, the complexity of the fiscal rules has not encouraged Member States' compliance with them. Increased complexity of the fiscal rules has reduced their predictability and contributed to the weak compliance in many Member States, which has limited their ability to conduct counter-cyclical fiscal policies.

The third section explores the role of fiscal frameworks in fostering public investment, including in light of the green and digital transitions. Public investment is critical for growth and helps putting debt on a sustainable path. Moreover, the green and digital transitions require a persistent increase in both private and public investment levels. Based on stylised facts and analytical insights, this section discusses the role that fiscal rules may play to facilitate or promote public investment.

And the fourth section provides an overview of recent compliance with the EU fiscal framework, looking at both the preventive and the corrective arms. It then discusses a few elements to strengthen the ownership of the EU fiscal rules, including an enhanced role of national fiscal frameworks, and examines various possible instruments to enforce fiscal rules.

I think that the insights from this selection of analytical topics can benefit the readers' understanding of the challenges and trade-offs in the ongoing technical and political discussions on the reform of the EU economic governance framework. On the basis of these discussions following its 9 November orientations, the Commission will consider tabling legislative proposals that would allow for clarification and simplification, with the involvement of the Council and the European Parliament. Swift agreement on revising the EU fiscal rules and other elements of the economic governance framework is a pressing priority at the current critical juncture for the European economy. Considering the mounting challenges that the EU is facing, there is a need for strong budgetary and structural policy coordination and effective economic and fiscal surveillance. This would also reassure financial markets on the institutional robustness of the euro area – which rests on sustainable public finances and on preventing and addressing macroeconomic imbalances in all Member States – and would facilitate the conduct of monetary policy.

I. How to ensure debt sustainability in a growth-friendly manner?

By Eloïse Orseau, Henk Van Noten, Pedro Arevalo, Alessandra Cepparulo, Gilles Mourre and Stéphanie Pamies

Abstract: *During the COVID-19 crisis, public debt ratios strongly increased, adding in several cases to existing debt vulnerabilities. This situation calls for a gradual, sustained and growth-friendly reduction of debt ratios towards more prudent levels, especially in the face of increasing costs of population ageing and tightening financing conditions. The section discusses the challenge of ensuring debt sustainability in a growth-friendly manner, based on stylised facts, simulations and further analytical insights. Current EU fiscal rules would impose in some cases an unrealistically demanding, frontloaded fiscal adjustment. Moreover, they are only loosely related to country-specific debt levels and sustainability challenges. The recent Commission orientations for a reform of the EU economic governance framework focus on debt sustainability and promoting sustainable growth. A revised EU framework would build around Member States' medium-term fiscal-structural plans. This would not only allow for greater differentiation among countries by taking into account their specific public debt challenges, but it would also provide tangible incentives for growth-friendly reforms and investment.*

I.1. Introduction

This section discusses the challenges of ensuring debt sustainability in the post-COVID-19 context in the framework of the EU's fiscal rules. Government debt has increased in the EU as a result of the COVID-19 crisis, reaching very high levels in some Member States. While the sizeable fiscal support provided to the economy was fully justified, and the activation of the general escape clause in March 2020 allowed Member States to depart from the budgetary requirements that would normally have applied, governments now need to bring debt back to more prudent levels. Rebuilding fiscal buffers is necessary, not only to be prepared to respond to future shocks, but also to face the upcoming costs of population ageing and considering the on-going tightening of financing conditions. Debt, however, should be reduced in a gradual, sustained and growth-friendly manner, and taking into account country-specific situations and challenges. This section therefore assesses to what extent the existing EU fiscal rules would be able to achieve this in the post-pandemic environment.

In addition to the pace of adjustment, a growth-friendly composition of the adjustment also matters for debt reduction to be sustainable and preserve growth, including in view of the twin transition. Fiscal adjustments could harm long-term growth if achieved through cuts in growth-enhancing expenditure or through a rise in distortive taxation ([1]).

This section is organised as follows. Subsection I.2. assesses fiscal sustainability in the EU in the wake of the COVID-19 crisis, paying attention to the context of higher inflation and tightening financing conditions. Subsection I.3. discusses, on the basis of illustrative simulations and stylised facts, the pace of fiscal adjustment and debt reduction that the existing EU fiscal rules would imply. Subsection I.4. puts forward principles for making debt reduction strategies more realistic, sustained and growth-friendly, and the last subsection concludes ([2]).

I.2. Debt sustainability in the wake of the COVID-19 crisis

I.2.1. Debt sustainability challenges have increased in most Member States

Public finances took a considerable hit as a result of the severe recession and the necessary policy response to the COVID-19 crisis**,** with a strong increase in deficits across the EU, which will

([1]) Blanchard, O. and Leigh, D. (2013) 'Growth forecast errors and fiscal multipliers', *IMF Working Paper 2013/1,* International Monetary Fund; Abiad, A., Furceri, D. and Topalova, P. (2016), 'The macroeconomic effects of public investment: evidence from advanced economies', *Journal of Macroeconomics,* 50:C, 224-240.

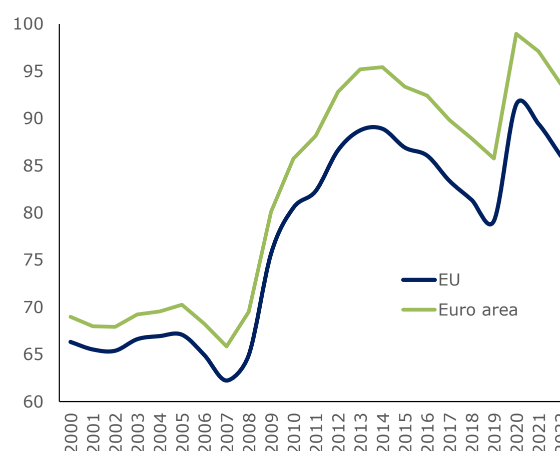
([2]) It should be clarified that the variable of interest of this section is the debt-to-GDP ratio and its dynamic (henceforth referred to as 'debt' to ease the reading).

unwind only gradually (3). After reaching historic lows in 2019 (at 0.5% and 0.6% of GDP respectively), the EU and euro area aggregate deficits soared to 6.7% and 7.0% of GDP in 2020. This massive increase in deficits was due to both the impact of automatic stabilisers – resulting from the strong contraction in GDP – and the sizeable measures taken to address the epidemiological and economic emergency posed by the outbreak of COVID-19. By protecting workers and businesses, public support has helped preserve production capacities and in turn potential growth.

Despite the fast recovery from the COVID-19 shock and the almost completed withdrawal of crisis-related temporary emergency measures (4), the aggregate deficit in 2022 remained substantially above pre-crisis levels (at 3.4% of GDP in the EU and at 3.5% in the euro area). The still strong real GDP growth, supported also by recovery measures, helped in reducing the deficit ratio. Energy price increases started in mid-2021 and significantly worsened in early 2022 with the Russian aggression against Ukraine, contributing to the surge in inflation. Overall, the phasing out of the residual pandemic-related measures was more than offset by the sizeable fiscal measures adopted to soften the impact of skyrocketing energy prices on households and firms. As a result, 15 Member States still had a deficit above 3% of GDP in 2022.

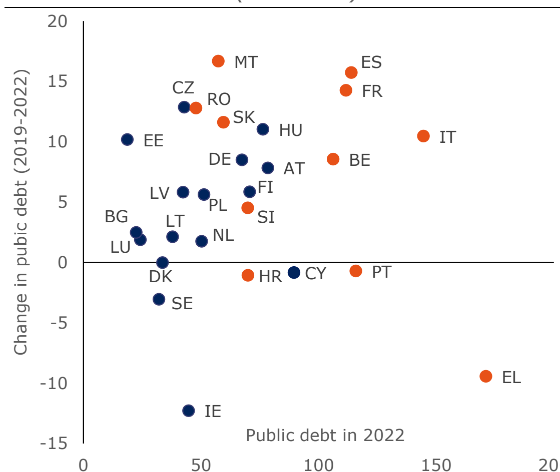
High deficits and the large fall in GDP led to a strong increase in debt-to-GDP ratios in 2020. After steadily declining in 2014-2019 amid favourable economic developments, debt increased by more than 10 pps. of GDP in 2020 in both the EU and the euro area as a whole (see Graph I.1). Afterwards, debt has started to decline on the back of the positive impact of the economic recovery and of surging inflation on the denominator of the debt-to-GDP ratio. These factors have been to some extent counterbalanced by the discretionary policy response to the energy crisis, as well as the economic slowdown and the rise in interest rates.

Graph I.1: **Aggregate public debt in the EU and the euro area, 2000-2022**
(% of GDP)



Source: European Commission.

Graph I.2: **Public debt and change in public debt, 2019-2022**
(% of GDP)



Note: The red circles denote Member States with high medium-term sustainability risks.
Source: European Commission.

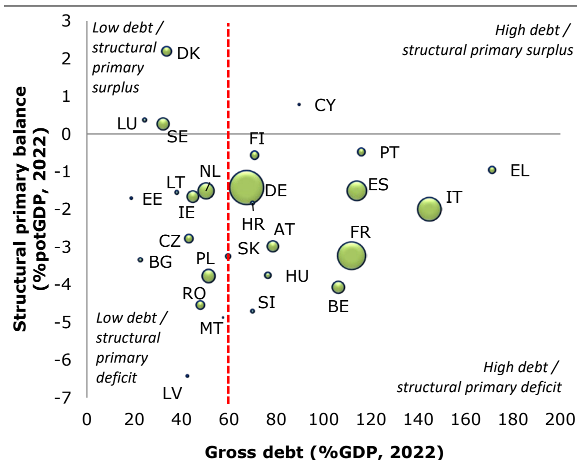
The pandemic has also increased the heterogeneity in Member States' debt positions (see Graph I.2). Thanks to the strong recovery, also supported by the implementation of investments and reforms under the Recovery and Resilience Plans, the output loss compared to the pre-crisis level was eliminated by end 2021. At the same time, those Member States that have the highest debt ratios are

(3) See Commission Communication of 19 October 2021, 'The EU economy after COVID-19: implications for economic governance', COM(2021) 662.

(4) Temporary emergency measures are fiscal measures introduced since March 2020 to support healthcare systems and compensate workers and firms for pandemic-induced income losses. These measures are designed to keep the economy afloat and limit economic scarring. They are by nature temporary, with an expiry date in 2023 or earlier, consistent with the expected normalisation of the public health and economic situation.

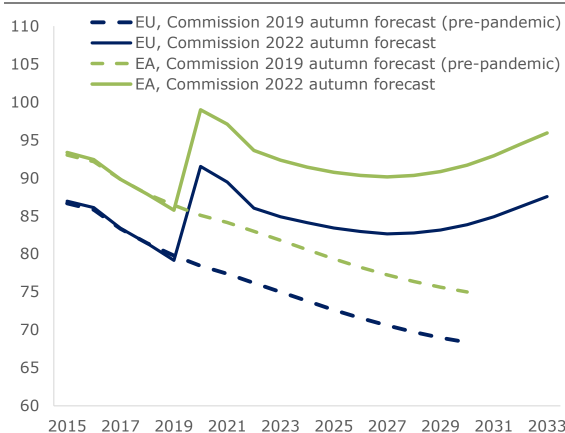
estimated to have had the highest structural deficits in 2022 for three reasons (see Graph I.3) (5). First,

Graph I.3: **Structural primary balance and debt in EU Member States**



Note: The size of the bubbles is proportional to GDP.
Source: European Commission.

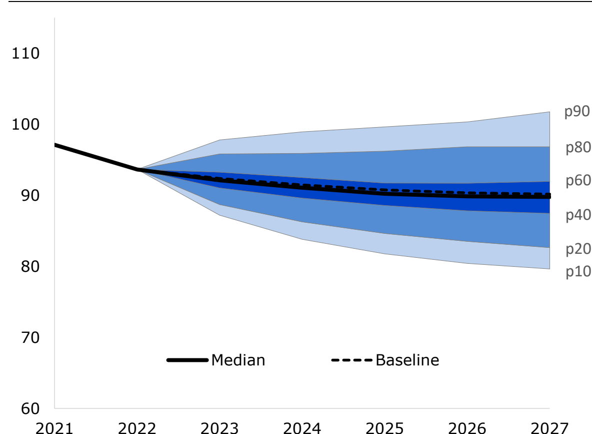
Graph I.4: **Government debt projections before and after the pandemic, EU and euro area**
(% of GDP)



Source: European Commission (based on the European Commission's Debt Sustainability Analysis – see Fiscal Sustainability Report 2021 for the methodology).

Member States entered the crisis with very different fiscal positions. Second, some high-debt Member States were particularly hard hit by the pandemic due to the severity of the health crisis or the structure of their economies, including sizeable cross-border tourism sectors. Lastly, expenditure is on an increasing trend in some of these countries, in part owing to permanent deficit-increasing measures taken during the crisis, which will make it more difficult to put debt on a declining path in the absence of compensatory measures. More recently, some Member States also took sizeable deficit-increasing measures to offset the impact of higher energy prices on households and businesses.

Graph I.5: **Stochastic debt projections, euro area**
(% of GDP)



Source: European Commission (based on the European Commission's Debt Sustainability Analysis – see Fiscal Sustainability Report 2021 for the methodology).

Without policy action and based on simulations shown in more detail in Subsection I.3.2, high public debt ratios are set to be on an increasing path over the medium term in the EU and the euro area as a whole. At unchanged policy (6), the aggregate public debt ratio is expected to decline slightly until the late 2020s. As of 2027, the rising cost of ageing and a gradually less favourable snowball effect (7) would reverse the trend, reflecting much less supportive financing conditions for rolled-over debt (Graph I.4).Some highly indebted countries (notably Belgium, France

(5) Structural (primary) balance estimates are, however, currently less reliable than in normal times due to larger-than-usual uncertainty surrounding output gap estimates at the current juncture.

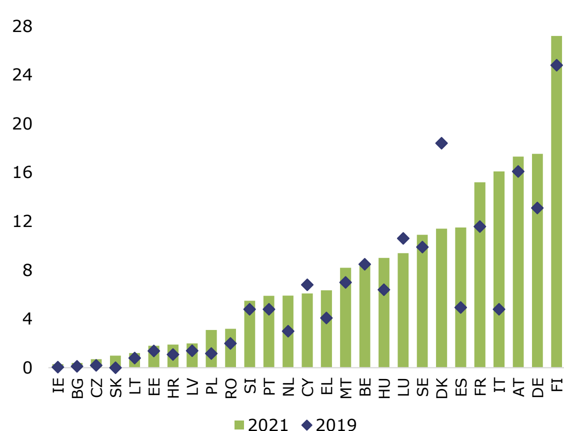
(6) These projections are based on the Commission's standard Debt Sustainability Analysis (DSA) risk framework. They rely on a standard 'no-fiscal-policy-change' assumption implying that, as from 2024, no new measures are taken into account and the structural primary balance is only affected by projected changes in the cost of ageing. Ageing cost projections come from the 2021 Ageing Report, jointly prepared by the Commission and Member States within the Ageing Working Group of the Economic Policy Committee (https://ec.europa.eu/info/sites/default/files/economy-finance/ip148_en.pdf). Inflation and interest rates are assumed to gradually converge to market-based expectations. Moreover, GDP growth over 10 years is projected in line with the EU commonly agreed methodology and incorporates to a large extent the expected favourable impact of NextGenerationEU.

(7) The snowball effect, which is closely related to the interest-growth rate differential, represents the combined impact of interest expenditure, inflation and real GDP growth on debt dynamics.

and Italy) would follow an increasing debt path as from the mid-2020s in the absence of corrective policy action.

The vulnerability to adverse macroeconomic and financial shocks is more acute now due to higher debt levels. Stochastic projections ([8]), featuring the uncertainty surrounding baseline projections, suggest a 33% probability that 2027 debt in the euro area as a whole will be higher than in 2022 (see Graph I.5).

Graph I.6: **Stock of guarantees in 2021**
(% of GDP)



Note: For Germany, Greece and the Netherlands, data refer to 2020.
Source: European Commission.

Moreover, contingent liabilities risks have also increased as a result of the COVID-19 crisis, notably due to sizeable public guarantees granted to the private sector (see Graph I.6) ([9]).

I.2.2. Less favourable debt dynamics in a context of higher inflation and tightening financing conditions

While most of the EU has benefited from favourable financing conditions so far, this is fast evolving as the recent surge in inflation has prompted a tightening of monetary policy. Despite elevated debt ratios, interest payments decreased over the 2010s, reflecting very favourable financing conditions. The interest-growth rate differential also diminished, turning negative before the COVID-19 crisis on average in the EU and for many countries. During the crisis, monetary policy created additional space for undertaking the necessary national fiscal policies, in particular thanks to the ECB's purchases of public sector bonds (the Public Sector Purchase Programme and the Pandemic Emergency Purchase Programme) for the euro area. As a result of a sequence of major adverse disruptions, particularly the energy crisis fuelled by Russia's war against Ukraine, however, HICP inflation rose steeply during the second half of 2021 and in 2022, peaking at 10.6% in the euro area as a whole in October 2022. This has triggered the end of quantitative easing and a series of hikes in interest rates, with the ECB raising its monetary rates by a total of 250 basis points in 2022 and expecting to raise them significantly further, 'because inflation remains far too high and is projected to stay above the [2% medium-term] target for too long' ([10]).

The deterioration in financing conditions is likely to weigh on interest payments and – if not counterbalanced by output growth – on the debt dynamic, although this will happen relatively slowly. The increase in market interest rates will gradually pass through to the implicit interest rate, as maturing debt progressively needs to be rolled over (Graph I.7). This will be spread over time, especially as, in many Member States, a gradual extension of debt maturity has taken place in recent years, lengthening the average maturity in the EU from 5.5 years in 2009 to over 8 years currently (Graph I.8). Overall, gradually increasing implicit interest rates, along with gradually declining potential growth ([11]), are projected to make the

([8]) The stochastic projections show the impact on debt dynamics of 2000 shocks affecting governments' budgetary positions, economic growth, interest rates and exchange rates compared to the baseline. The methodology is presented in Annex A7 of European Commission (2021), 'Fiscal Sustainability Report 2021', *European Economy – Institutional Paper*, No. 171, and in Berti, K. (2013), 'Stochastic public debt projections using the historical variance-covariance matrix approach for EU countries', *European Economy – Economic Paper*, No. 480.

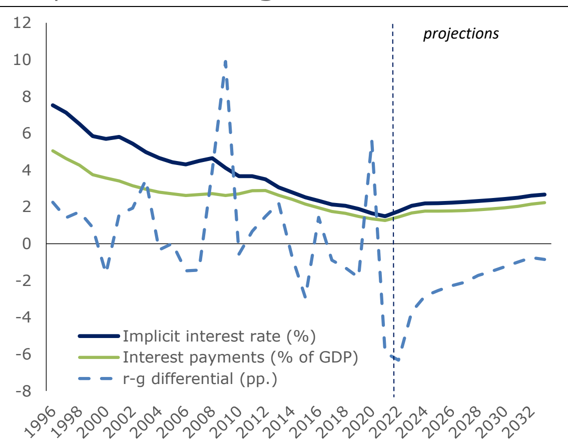
([9]) Risks related to contingent liabilities are only captured in the stochastic projections insofar as they are based on the historical volatility of underlying macroeconomic variables, including the primary balance, whose past developments reflect to some extent the materialisation of contingent liabilities (e.g., during the last financial crisis).

([10]) ECB Press release on monetary policy decisions, 15 December 2022.

([11]) The Commission's estimates of medium-term potential growth do not include the full positive impact of reforms that are part of the Recovery and Resilience Plan and that can boost potential growth.

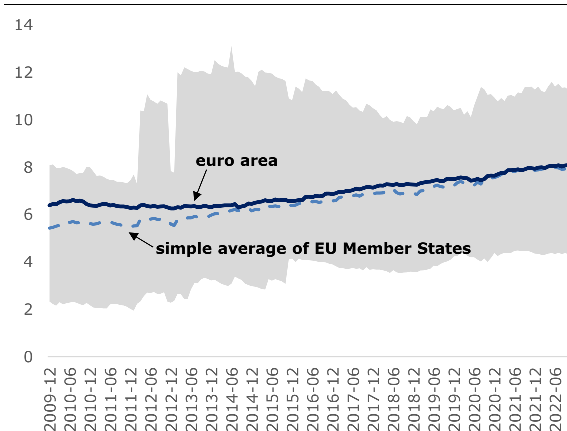
interest-growth rate differential less favourable over the next decade, turning positive in some countries. This will weigh on public debt dynamics, especially where debt levels are already high.

Graph I.7: **Financing conditions in the EU**



Notes: These projections are based on the European Commission's 2022 autumn forecast.
Source: European Commission (based on the European Commission's Debt Sustainability Analysis – see Fiscal Sustainability Report 2021).

Graph I.8: **Average residual sovereign debt maturity in the EU**
(years)



Notes: The graph shows the range and simple average of residual maturities of general government debt securities in EU Member States and the euro area as a whole. As debt is also financed by loans, the overall maturity of total general government debt may differ. In particular, the maturity of total general government debt in Greece is estimated at 22 years as of end-2022.
Source: ECB, European Commission.

Ensuring prudent fiscal policies remains necessary in this context. Higher inflation may have a positive impact on the debt ratio in the short term, in particular via the denominator effect. Still, this impact will be only temporary and is likely to be reversed if inflation increases the cost of debt servicing and possibly weighs on economic growth.

Moreover, some factors make certain countries more vulnerable to less favourable financing conditions, such as a shorter debt maturity or a higher or increasing debt level. For all these reasons, prudent fiscal policies are warranted in order to put debt on downward paths towards safer levels (see Section II).

I.2.3. Importance of assessing country-specific debt sustainability risks

Given the high and increasing debt levels in some Member States over the medium term (under unchanged policies), there is a need to correct the dynamics and ensure downward debt trajectories that are gradual, sustained and growth-friendly. Highly indebted Member States will need to gradually reduce primary deficits and generate primary surpluses. This will determine how well they can respond to possible future shocks. It will also help to maintain favourable financing conditions.

Debt reduction paths will need to take into account country-specific situations, in particular the degree of sustainability challenges, as well as growth considerations, notably in view of the twin transition. The Commission's debt sustainability analysis takes into account the growth dimension of fiscal strategies, as higher growth improves the debt dynamics and facilitates fiscal consolidation. In particular, the analysis takes into account to a large extent the expected favourable impact of NextGenerationEU ([12]), as well as the interactions between fiscal consolidation and growth. Debt sustainability analysis therefore provides a useful tool to illustrate how different debt reduction strategies affect debt sustainability risks. At the same time, like in any projection exercise, debt simulations depend on assumptions, which are subject to uncertainty.

The assessment of debt sustainability goes beyond the simple consideration of debt projections at unchanged policy. According to the state-of-the-art

([12]) See footnote (6). The expect impact of structural reforms is reflected – both in the short-term forecast and its T+10 extension through persistence effects – insofar as these reforms have already been legislated or are certain and known in sufficient detail. At the same time, the T+10 commonly agreed methodology does not explicitly account for all of the channels by which structural reforms could affect growth. Additional reforms planned under the RRF could contribute to further support growth and debt sustainability and are considered as a mitigating factor in the debt sustainability analysis.

definition used by the European Commission, the ECB and the IMF, assessing debt sustainability (risks) requires a multidimensional approach, encompassing additional mitigating and aggravating factors such as the structure of debt, public assets and the net external position. Importantly, conclusions on debt sustainability risks should not be interpreted as a binary statement on whether debt is sustainable or not, which is also closely conditioned to institutional factors. Concluding that a country is at high risk or – in other words – has substantial public debt challenges only means that it needs to take measures to avoid its (high) debt being on an increasing path.

I.3. How to calibrate a pace of debt reduction consistent with sustained and sustainable growth?

I.3.1. While there is a clear need to reduce high debt there are different approaches on the pace of reduction

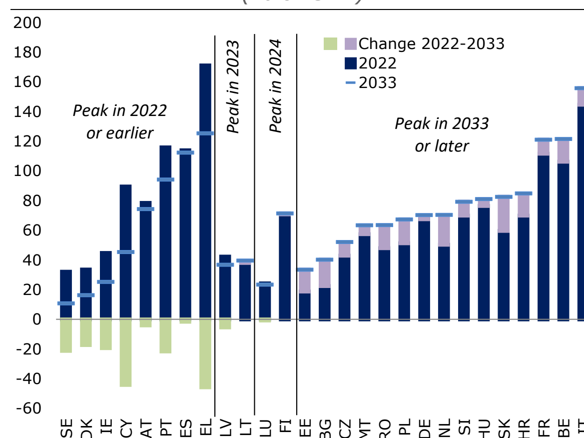
Ensuring debt sustainability requires reducing debt when the economy is doing well enough, since crises often entail a surge in debt. Economic crises are rare events – although they have recently happened more frequently than in the past – but they tend to have a sizeable adverse impact: debt increases more quickly during crisis periods than it decreases during economic booms ([13]). For this reason, it is widely accepted that stabilising or gradually reducing debt-to-GDP ratios in the long run requires a credible commitment to reducing debt in times of positive economic developments, to rebuild buffers in preparation for future shocks.

However, there are different approaches on the optimal speed of debt reduction. On the one hand, delaying the adjustment keeps debt at persistently high levels for longer, which tends to crowd out investment, weighing on growth and in turn hampering fiscal sustainability ([14]). On the other hand, tightening fiscal policy too sharply can be counter-productive, especially if this happens suddenly, during a slowdown or before the recovery has taken hold (see also Subsection I.3.3).

I.3.2. Debt on the rise or remaining high in most Member States without policy action

In a situation of high primary deficits coupled with the projected rise in ageing costs and less favourable financing conditions, fiscal policy measures are needed just to prevent a further increase in already high public debt ratios. At unchanged policy, debt-to-GDP ratios will remain on an increasing path over the medium term in a majority of Member States, including three high-debt countries: Belgium, France and Italy (Graph I.9).

Graph I.9: **Debt in 2033 vs. 2022 under a no-fiscal-policy-change assumption, EU Member States**
(% of GDP)



Note: Debt projections based on the standard approach used in the Commission's Debt Sustainability Analysis.
Source: European Commission.

I.3.3. Simulating the impact of current EU fiscal rules

The Stability and Growth Pact (SGP) includes two elements that are meant to correct the debt trajectory and ensure sound public finances: the debt reduction benchmark and the preventive arm ([15]). The debt reduction benchmark is meant to ensure that, if a Member State's debt ratio exceeds the Treaty reference value of 60% of GDP, debt sufficiently diminishes and approaches the threshold at a satisfactory pace. In operational terms, the pace is considered satisfactory if debt is

([13]) Gaspar, V., and Escolano, J. (2016), 'Optimal debt policy under asymmetric risk', *IMF Working Papers 2016/178*, International Monetary Fund.

([14]) Huang, Y., Panizza, U., and Varghese, R., (2018) 'Does public debt crowd out corporate investment? International evidence', *CEPR Discussion Paper* 12931, Center for Economic Policy Research.

([15]) This section does not look into deficit-based excessive deficit procedures, as these explicitly focus on the deficit criterion. For a precise definition see European Commission (2019), 'The Vade Mecum on the Stability & Growth Pact', avalable at Vade Mecum on the Stability and Growth Pact – 2019 Edition (europa.eu).

reduced each year, on average over three years, by 1/20th of the gap to 60% of GDP ([16]). As for the preventive arm, it requires a country's structural balance to converge towards a country-specific medium-term budgetary objective (MTO). The MTO is computed to ensure sound public finances, by creating a safety margin with respect to the 3% of GDP reference value for the nominal deficit, reducing debt and pre-financing part of the projected ageing costs.

The debt reduction benchmark implies a demanding frontloaded fiscal effort. The debt reduction benchmark applies, by definition, to three-year averages. If it were mechanically applied beyond the horizon of the Commission 2022 autumn forecast, i.e., as from 2025, the debt reduction benchmark would therefore require all Member States with debt above 60% of GDP to put their debt on a 'sufficiently diminishing' path as early as in the first three years of adjustment. As some countries would start from a large primary deficit and a very high level of debt, this would impose a very demanding and unrealistic frontloaded fiscal effort, especially compared to the adjustment recorded by Member States in the past (see Table I.1) ([17]). Without the positive impact on growth of the investments and structural reforms under NextGenerationEU, and with inflation at lower levels than currently projected, the required effort would be even more demanding.

The effort required by the debt reduction benchmark risks jeopardising growth and being pro-cyclical. Such rapid fiscal consolidation exercises a negative drag on GDP growth through fiscal multiplier effects, which would deteriorate the budget balance and, in turn, weaken the debt reduction ([18]). To achieve the intended debt reduction, an even larger fiscal tightening could therefore be needed, highlighting the pro-cyclical nature of the effort. Too large and sharp adjustments can in fact turn self-defeating if the fiscal multiplier is high and the adjustment weakens potential growth, for instance if it involves cuts in public investment or increases in distortionary taxes.

Table I.1: **Fiscal requirements under the debt reduction benchmark over 2025-2027, selected countries**

Country	Cumulated adjustment 2025-2027 *(pps. of GDP)*	SPB 2027 *(% of GDP)*	Percentile rank of 2027 SPB
BE	6.4	3.8	29%
EL	0	-	-
ES	6.4	5.3	0%
FR	8.7	6.7	0%
IT	13.6	13.2	0%
PT	0	-	-

Notes: This table reports countries in which debt is expected to exceed 90% of GDP in 2024. The first column shows the cumulative adjustment in the structural primary balance that would be needed over the period 2025-2027 to bring debt in line with the debt reduction benchmark, i.e. to ensure that it declines at a sufficient pace over these three years. In Greece and Portugal, no adjustment is needed as debt is already projected to be sufficiently diminishing at unchanged policies. The second column shows the SPB implied by the required adjustment, and the last column shows how this level compares with the past distribution of SPBs in each country. For instance, 29% of the SPBs recorded by Belgium over the past decades were surpluses of 3.8% of GDP or above. The percentile ranks lower than 25% are highlighted in blue.
Source: European Commission.

Moreover, complying with the debt reduction benchmark is particularly challenging in periods of low nominal growth, as observed in recent years. Already before the COVID-19 crisis, many high-debt Member States did not meet the debt reduction benchmark. The Commission considered (broad) compliance with the preventive arm requirements as a key relevant factor for not opening excessive deficit procedures based on the debt criterion (see discussion in Section II). While this approach avoided imposing an overly demanding fiscal effort, it contributed to the general complexity of the fiscal framework.

By comparison with the debt reduction benchmark, the requirements under the preventive arm allow for a more gradual and less pro-cyclical adjustment. The matrix of requirements provides for some degree of differentiation based on the economic cycle and the debt level (see Table I.2). The required structural adjustment for high-debt countries, of 0.6 pp of GDP per year in normal economic times, allows in principle those countries starting with a high structural deficit to gradually put their debt on a downward path. In addition, the increased focus on the expenditure

([16]) The concepts of "sufficiently diminishing" and "satisfactory pace" are defined in Regulation (EC) 1467/97, and the debt reduction benchmark is set out in the Code of Conduct on the SGP endorsed by the Council.

([17]) See in particular, in Table I.1, the low percentile ranks associated with the SPBs that Spain, France and Italy would need to reach by 2027 to meet the debt reduction benchmark. Percentile ranks of 0% indicate that these countries never recorded such high structural primary surpluses in the past decades.

([18]) In the simulations presented in this section, a fiscal multiplier of 0.75 is applied, as in the Commission's debt sustainability analysis framework. Moreover, compared with a 'no-fiscal-policy-change' scenario, fiscal consolidation reduces actual GDP growth and increases the output gap, while potential GDP growth is assumed to remain unchanged.

benchmark ([19]) as the operational indicator makes the assessment of compliance rely more on elements that are under the control of government and makes the fiscal adjustment requirements more countercyclical ([20]).

Table I.2: **Matrix of structural adjustment requirements under the preventive arm of the SGP**

Condition		Required annual fiscal adjustment (pp of GDP): Debt ≤ 60% and low/medium sustainability risks	Debt > 60% or high sustainability risks
Exceptionally bad times	Real growth < 0 or output gap < -4	No adjustment needed	
Very bad times	-4 ≤ output gap <-3	0	0.25
Bad times	-3 ≤ output gap <-1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1.5 ≤ output gap < 1.5	0.5	> 0.5
Good times	Output gap ≥1.5	>0.5 if growth below potential, ≥0.75 if growth above potential	≥0.75 if growth below potential, ≥1 if growth above potential

Source: European Commission.

However, simulations illustrate four weaknesses of the preventive arm requirements:

- First, they are not sufficiently country-specific and, in practice, only loosely related to debt levels and sustainability risks. The same speed of annual adjustment is required for all countries with debt ratios above 60%, irrespective of the degree of debt sustainability risks (see Table I.2). Moreover, all euro area and ERM2 countries are subject to a uniform lower limit of -1% of GDP for the MTO, irrespective of each country's public debt challenges. For the signatories to the Fiscal Compact, the lower limit is set at -0.5% of GDP, or -1% if debt is significantly below 60% of GDP and long-term fiscal sustainability risks are low.

Table I.3: **Structural primary surpluses associated with the MTOs, selected countries**

Country	SPB associated with MTO (% of potential GDP)	Percentile rank
IT	4.5	7%
EL	3.8	19%
BE	2.9	50%
HU	2.9	7%
ES	2.8	0%
PT	2.4	13%
FR	2.2	0%
PL	2.1	0%
SI	2.0	10%

Notes: This table reports the countries for which the MTO corresponds to a structural primary surplus of at least 2% of GDP. The percentiles ranks highlighted in blue are lower than 25%, indicating that such surpluses have rarely been achieved in the past based on historical data starting at the earliest in the 1980s (for instance, only 7% of the SPBs recorded by Italy over the past decades were surpluses of 4.5% of GDP or above).
Source: European Commission.

- Second, in some cases, remaining at the MTO is particularly demanding over very long periods. Some countries' MTOs, if translated in terms of structural primary balance, correspond to large surpluses that these countries have rarely achieved in the past (see Table I.3). Furthermore, remaining at the MTO over an extended period may put some countries' debt on an ever-decreasing path, going beyond the need to converge to 60% of GDP or to keep debt sustainable (see Table I.4). This is the case, for instance, for highly volatile economies, as their MTO includes a large safety margin in order to keep their headline deficit below the 3% of GDP threshold in downturns ([21]).

([19]) The use of the structural balance to assess fiscal effort is well known and widely used among experts. However, it suffers from some weaknesses, mainly related to its endogenous relation with GDP, which in turn may distort the estimations of governments' fiscal actions. In other words, the structural balance may be, and frequently is, affected by non-policy effects. The 2011 six-pack reform and subsequent application of the fiscal surveillance framework have sought to address the shortcomings of the structural balance approach by introducing a further indicator: the expenditure benchmark, which sets an upper limit for the growth rate of primary government expenditure net of discretionary revenue measures. The assessment of compliance with the expenditure benchmark is based on observable figures rather than on estimates of underlying positions. Moreover, in contrast to the structural balance, it is not affected by factors that lie outside government control, including abnormal responses of revenues to economic activity. Overall, it is a more stable, more transparent and, by extension, more effective indicator than the structural balance. See also Section IV.2.2 for a broader overview of the strengths of expenditure rules.

([20]) European Commission (2019), 'Performance of spending rules at the EU and Member States' level', in 'Report on Public Finances in EMU 2019', *European Economy – Institutional Paper*, No. 133.

([21]) According to Regulation (EC) 1466/97, the MTOs should be set to (i) provide a safety margin with respect to the 3% of GDP deficit limit. For each Member State, the safety margin is estimated in the form of a minimum benchmark which takes past output volatility and budgetary sensitivity to output fluctuations into account; (ii) ensure sustainability or rapid progress towards sustainability. That criterion is assessed against the need to ensure the convergence of debt ratios towards prudent levels, with due consideration to the economic and budgetary impact of ageing populations; (iii) in compliance with (i) and (ii), allow room for

- Third, they do not take into account the composition of the adjustment. As seen in the past, it can be more expedient for Member States to deliver adjustments by cutting growth-friendly expenditure, undermining potential growth and ultimately fiscal sustainability.

Table I.4: **Projected debt levels under preventive arm requirements, selected low-debt countries**

Country	Debt level 2022 (% of GDP)	Debt level 2033 (% of GDP)	Change 2022-2033
IE	44.7	24.5	-45%
SE	32.1	24.0	-25%
LU	24.3	18.3	-25%
DK	33.7	26.6	-21%
LV	42.4	33.9	-20%
RO	47.9	38.8	-19%
MT	57.4	47.9	-17%
CZ	42.9	37.5	-13%
SK	59.6	54.1	-9%
LT	38.0	34.7	-9%
PL	51.3	49.8	-3%
NL	50.3	48.9	-3%

Note: This table reports the countries for which debt in 2022 was below 60% of GDP and would decline over the medium term in case of compliance with the current preventive arm requirements.
Source: European Commission.

- Finally, they are complex and lack transparency. While the high degree of sophistication (see also Subsection IV.1.2) of the preventive arm, linked in particular to the simultaneous use of the structural balance and the expenditure benchmark, and the various flexibility mechanisms were meant to make the framework more adaptable to changing economic and country-specific conditions, it has also increased its complexity and reduced its transparency.

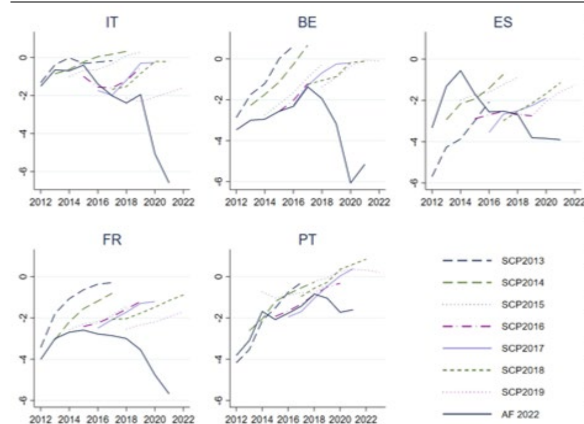
Overall, the provisions under the existing EU fiscal rules may lead to difficult policy choices. To preserve growth-enhancing spending and meet the green and digital investment needs while delivering the required adjustment, some Member States may need to resort to substantial cuts in other expenditure items or significant increases in government revenues. The RRF offers an opportunity to improve underlying fiscal positions while improving the composition and quality of public finances. Better understanding the reasons for past slippages is also crucial to achieve more realistic debt reduction strategies over the medium term.

I.4. How to make debt reduction strategies more realistic, sustained and growth-friendly?

I.4.1. The poor track record of current soft medium-term targets and the need to address the tendency to back-load efforts

Ex post analysis shows poor performance for the achievement of medium-term budgetary targets. Graph I.10 confirms that in the pre-pandemic period, Member States (especially those with high debt) systematically missed the structural balance targets put forward in their consecutive stability programmes.

Graph I.10: **Member States' medium-term plans in consecutive stability programmes**
(structural balance, % of potential GDP)



Source: European Commission, Stability programmes.

Policy decisions largely explain these systematic delays in fiscal adjustments. While a small part of the worse-than-planned outcomes can be attributed to revisions of potential output or negative inflation surprises, it seems that governments have reacted to budgetary shortfalls or slippages by postponing their budgetary targets. By contrast, governments have often used positive growth surprises and budgetary windfalls to increase current expenditure or to cut taxes, rather than to accelerate debt reduction (see Subsection II.1.1). This points to a so-called nominal strategy, i.e., a focus on nominal fiscal targets in periods of strong growth, despite the preventive arm's emphasis on the underlying fiscal

budgetary manoeuvre, in particular taking into account the needs for public investment.

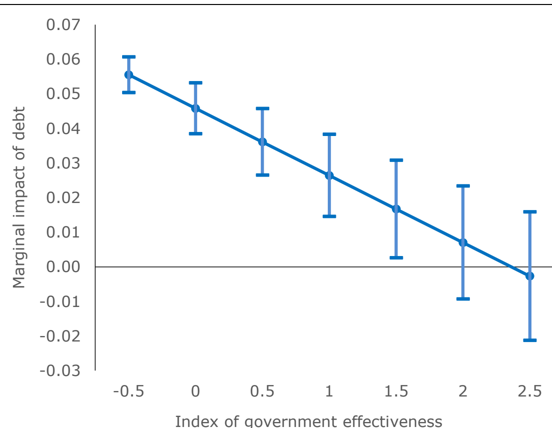
efforts, with a focus on the expenditure benchmark.

A more stringent implementation of the budget and more binding medium-term budgetary targets might contribute to enhance the credibility of national plans. Medium-term targets, at least if understood in terms of limits on the growth of (primary) expenditure (net of discretionary revenue measures), would be robust to normal fluctuations in the business cycle. The application of the general escape clause would cater for large shocks. At the same time, coherent enforcement mechanisms should ensure that Member States stick to their medium-term plans.

I.4.2. Quality of public finances and the institutional setup

Credible debt reduction strategies would need to be consistent and coherent with policies to promote sustained economic growth. Growth improves debt dynamics and facilitates fiscal consolidation. Conversely, not embarking on a credible and growth-friendly debt reduction path could hamper economic growth through risk premium shocks, lower public investment and higher tax rates. Successful debt reduction strategies should therefore not only focus on fiscal consolidation but also on the quality and composition of fiscal measures, in order to preserve growth-friendly expenditure, notably investment to support the twin transition. Moreover, debt reduction strategies should take into account the impact of reforms and investments as they both contribute to potential growth and therefore reinforce the sustainability of public finances in the medium and long term. In the coming years (up to 2026), the support from the Recovery and Resilience Facility will continue to help in this respect. Overall, the objectives of fiscal sustainability, macroeconomic stabilisation, sustainable growth and the quality of public finances need to be jointly and coherently addressed at the planning stage.

Graph I.11: **Marginal impact of government debt on spreads for different levels of government effectiveness**



Notes: The graph reports the total marginal impact of government debt on spreads conditional to a given level of government effectiveness. Bars represent the confidence interval of the estimated coefficients. It shows that for countries with the strongest national institutions, financial markets are less sensitive to a given (higher) level of public debt.
Source: European Commission.

A country's institutional setup could play an important role for debt sustainability. Sound national fiscal frameworks enhance the quality of budgetary implementation, the credibility of medium-term budgetary plans, and fiscal discipline ([22]) (see also Subsection II.4). Strong national institutions, including independent fiscal institutions, reduce the cost of servicing high public debt. Commission analysis ([23]) shows that financial markets care about the strength of national institutions and in particular the effectiveness of governance (see Graph I.11). Indeed, structural factors, including the strength of national institutions, can largely mitigate the impact of higher public debt on prevailing spreads between euro area sovereign debts. Hence, policies that reinforce government institutions and thereby effectiveness can be expected to improve investors' perception of sovereign risk and their forbearance of higher debt.

([22]) See also IMF Fiscal Monitor, October 2021, 'Chapter 2: Strengthening the Credibility of Public Finances', https://www.imf.org/en/Publications/FM/Issues/2021/10/13/fiscal-monitor-october-2021.

([23]) See Pamies, S., Carnot, N., and Patarau, A (2021), 'Do Fundamentals Explain Differences between Euro Area Sovereign Interest Rates?', *European Economy – Discussion Paper*, No. 141.

I.4.3. The role of debt structure

Lastly, further enhancing debt management and the structure of public debt could help reduce the vulnerability to shocks in particular for highly indebted countries. This would further reduce governments' exposure to rollover risk. For example, the use of long-term bonds indexed to GDP would increase the resilience of debt to future shocks ([24]).

I.5. Conclusion

This section gave an overview of recent debt developments and debt sustainability risks in the EU and euro area after the COVID-19 crisis. To this end, it presented some stylised facts and illustrative simulations on future debt trajectories, assuming either no policy action or the application of current fiscal rules.

It highlighted some of the challenges faced by public finances: the consequences of the COVID-19 crisis in terms of debt legacy; a less favourable interest-growth rate differential, notably driven by the energy crisis and the surge in inflation; the budgetary cost of population ageing; and the need to finance the green and digital transitions. To assess the impact of the SGP requirements on fiscal adjustment and debt dynamics, this section looked into two of its main elements, namely the debt reduction benchmark and the preventive arm requirement of meeting a sound structural balance (i.e., the MTO). It showed that, for high-debt countries starting from very weak budgetary positions, the debt reduction benchmark would require an overly abrupt, sizeable, frontloaded fiscal effort. Moreover, the debt reduction benchmark works in a pro-cyclical manner, requiring tighter adjustments in periods of lower nominal growth. Regarding the preventive arm, its requirement of reaching the MTO entails a more realistic pace of adjustment than the debt reduction benchmark but is only crudely related to debt levels and sustainability challenges, and not sufficiently country-specific, especially since the MTO should be set above a uniform minimum level and could not, thus, vary much. In some Member States, the requirement to meet the MTOs is associated with large primary surpluses rarely achieved in the past. Meeting and remaining at the MTO may also lead to reducing debt well below 60% of GDP. Finally, it does not take into account the composition of the adjustment, while the higher degree of sophistication has increased complexity.

Binding medium-term budgetary targets and a stringent implementation of the budget, supported by a stricter EU enforcement, could enhance the credibility of debt reduction strategies. Importantly, they would need to be consistent and coherent with policies to promote sustained economic growth. Overall, the objectives of fiscal sustainability, macroeconomic stabilisation, sustainable growth and the quality of public finances need to be jointly and coherently addressed at the planning stage. Sound national fiscal frameworks could help improve the credibility of medium-term budgetary plans and contribute to fiscal discipline.

The recent Commission orientations for a reform of the EU economic governance framework ([25]) propose to move to a more risk-based framework that puts debt sustainability at its core. This would allow for differentiating more between countries by taking into account their public-debt challenges, while adhering to a transparent and common EU framework consistent with the 3% of GDP and 60% of GDP reference values of the Treaty. This would also strengthen the medium-term dimension of fiscal policy, by putting Member States' medium-term fiscal-structural plans at the core of the revised EU framework. Lastly, it would provide concrete incentives for growth-friendly reform and investment. In this way, national medium-term plans, coupled with better enforcement, would ensure sustainable debt reduction paths through both gradual consolidation and reforms and investments.

([24]) See Carnot, N. and Pamies, S. (2017), 'GDP-linked bonds: some simulations on EU countries', *European Economy – Discussion Paper*, No. 073.

([25]) Commission Communication of 9 November 2021, "Orientations for a reform of the EU economic governance framework", COM(2022) 538.

II. Enhancing the Ability of Fiscal Policy to Ensure Macroeconomic Stabilisation

By Olivia Galgau, Philipp Mohl, Allen Monks, Gilles Mourre and Diana Radu

Abstract: *The section examines the scope of macroeconomic stabilisation in the EU fiscal rules, drawing on empirical evidence of the pro-cyclicality of national fiscal policies. It focuses on the period following the adoption of the Six- and Two-Pack reforms (2011-2013). The findings show that fiscal loosening in good economic times and fiscal prudence in bad times have driven pro-cyclical fiscal policy, both at the stage of fiscal planning and ex post with subsequent slippages. Successive innovations in the EU fiscal framework have sought to reduce this observed pro-cyclicality by encouraging Member States to build buffers in good economic times so that automatic stabilisers can operate fully in bad economic times. At the same time and despite their counter-cyclical design, the increased complexity of the EU fiscal rules has reduced predictability and contributed to weak compliance in many Member States, which has limited their ability to conduct counter-cyclical fiscal policies. Based on these findings and the economic literature, the section highlights some elements that could enhance counter-cyclicality in the EU fiscal rules in both normal and exceptional circumstances.*

II.1. Introduction

This section examines the scope of macroeconomic stabilisation in the EU fiscal rules, drawing on empirical evidence of the pro-cyclicality of national fiscal policies. It focuses on the period following the Six- and Two-Pack reforms (2011-2013), which sought to encourage Member States to build fiscal buffers in good economic times so that automatic stabilisers can operate in full in bad economic times ([26]). After a period of (moderate) monetary dominance during the euro area's first decade (1999-2007) and a short episode of coordinated expansionary policies at the outset of the global financial crisis, *sui generis* fiscal dominance prevailed during and after the sovereign debt crisis (2011-2019) ([27]). A first sub-period of that crisis (2011-2014) was dominated by the sovereign debt crisis with restrictive fiscal policies. A second sub-period (2015–2019) was characterised by a broadly neutral fiscal stance at the euro area level, attained through an inappropriate distribution of national fiscal positions in light of Member States' specific sustainability and stabilisation needs ([28]). In practice, fiscal policy in the EU remained largely pro-cyclical throughout the economic cycle, with a failure by high-debt Member States to build sufficient fiscal buffers in good times driving pro-cyclical fiscal tightening in bad times, thus going beyond the adjustment requirements of the Stability and Growth Pact. At the same time, Member States with overall strong fiscal positions and large external surpluses did not undertake counter-cyclical fiscal policies, especially in the immediate aftermath of the great financial crisis, thus contributing to persistent inflation undershooting and not addressing the EU priority of achieving a sustained upward trend in investment.

The section is structured as follows. Sub-section II.1 presents stylised facts on the extent of pro-cyclicality of fiscal policy and the actual impact of fiscal rules. Looking forward, Sub-section II.2 focuses on ways to reduce pro-cyclicality. Sub-section II.3 concludes.

II.2. Pro-cyclical fiscal policy remains pervasive despite the existence of fiscal rules

Pro-cyclicality of fiscal policy in EU Member States has occurred both for those with low deficits (i.e., under the preventive arm of the Stability and Growth Pact (SGP)) and countries with high deficits (i.e., under the corrective arm of the SGP) ([29]) ([30]). A root cause of the problem is the

([26]) The issue of the optimal design of automatic stabilisers, while pertinent to a debate on the macroeconomic stabilisation properties of fiscal policy, remains in the EU an issue of national preference related to the quality of public finances and is thus not discussed in this section.

([27]) Buti, M. and Messori, M. (2021): "Euro area policy mix: from horizontal to vertical coordination", CEPR Policy Insight, no.113, October.

([28]) Fiscal adjustment first stalled and then reversed in high-debt Member States.

([29]) The *preventive arm* of the SGP aims to ensure sound budgetary policies over the medium-term by setting parameters for Member States' fiscal planning and policies during normal economic times. The corrective arm ensures that Member States adopt appropriate policy responses to correct excessive deficits (and/or debts) by implementing the Excessive Deficit Procedure. See also Section I.

insufficient restraint of government expenditure growth in good economic times, especially for Member States in need of fiscal buffers, which has resulted in pro-cyclical fiscal tightening in bad times. The fact that the EU legal framework only allows "proscribing" and not "prescribing" certain fiscal policies has contributed to such pro-cyclicality. However, the pro-cyclical bias is not specific to EU Member States: empirical evidence shows that it is a common feature of fiscal policy throughout the world, which is only partly mitigated by the presence of fiscal rules ([31]).

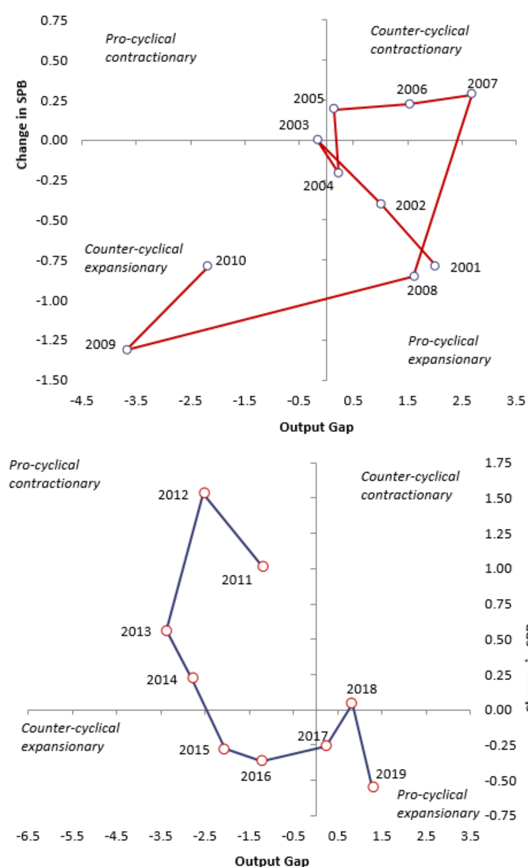
II.2.1. Overall evidence on the pro-cyclicality of fiscal policy

Fiscal loosening in good economic times and fiscal prudence in bad times had driven pro-cyclical fiscal policy

Fiscal policy has on average been pro-cyclical in the EU (Graph II.1). Empirical evidence indicates that discretionary fiscal policies (i.e., the fiscal effort) have been pro-cyclical in both good and bad economic times on average in the EU ([32]), irrespective of whether the economic cycle is measured in real time or on the basis of *ex-post* data ([33]) ([34]).

One key driver of pro-cyclicality is fiscal loosening in good economic times preventing the build-up of fiscal buffers (Graph II.2) ([35]). As a result, Member States have had to implement fiscal tightening in bad economic times, thus counteracting (at least partly) the operation of automatic stabilisers ([36]).

Graph II.1: **Euro area fiscal stance 2001-2019, change in the structural primary balance**



(1) The fiscal stance up to 2011 is represented by the change in the cyclically-adjusted primary balance. It is represented as the structural primary balance for the rest of the period.
Source: European Commission 2022 Autumn Forecast.

Governments' asymmetric fiscal reaction to unpredictable fiscal developments has also aggravated this pro-cyclical bias. There is evidence that positive shocks to the structural budget balance (i.e., the structural balance turns out to be higher than expected) have given rise to fiscal loosening by Member States, while negative shocks have not resulted in a corresponding adjustment of budgetary policies ([37]) ([38]). There are different

([30]) As discussed below, it is in any case inherently difficult to avoid pro-cyclicality in the corrective arm. As a rule, Member States are required to correct a breach of the deficit criterion by the year following its identification, irrespective of cyclical conditions. Of greater concern is the use of the so-called 'nominal strategy' by some Member States to achieve nominal EDP targets during good economic times.

([31]) See for example: Manasse, P. (2006), "Procyclical Fiscal Policy: Shocks, Rules, and Institutions—A View From MARS", IMF Working Paper 06/27.

([32]) The fiscal effort is a quantification of the impact of government fiscal policy actions. It is obtained by looking at the change in a budgetary aggregate, typically the structural balance.

([33]) There is some evidence that pro-cyclicality in good times is slightly higher if the position in the economic cycle is measured using ex-post data. This could point to an underestimation of cyclical conditions in good times.

([34]) See for example: Alesina A.,Tabellini G. and Campante F. (2008): "Why is fiscal policy often procyclical?", Journal of the European Economic Association vol.6, no.5; Balassone F. and Kumar M. (2007): "Cyclicality of fiscal policy" in Kumar M. and Ter-Minassian (eds.) "Promoting fiscal discipline", IMF, 2007; Aldama, P. and Creel, J. (2021), "Real-time fiscal policy responses in the OECD from 1997 to 2018: procyclical but sustainable?", European Journal of Political Economy (forthcoming).

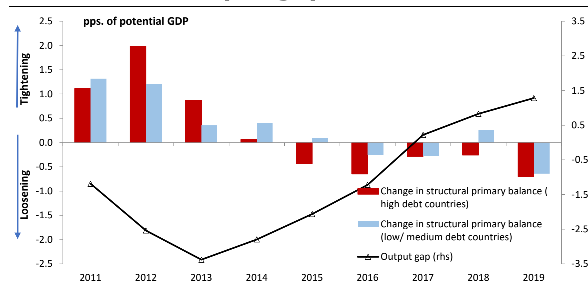
([35]) European Commission (2020), "Report on Public Finances in EMU 2019", EU Commission (DG ECFIN) Institutional Paper no.133, July 2020.

([36]) During the euro area sovereign debt crisis, domestic bailouts of the banking system also led to large increases in debt and increased market pressure to undertake significant, pro-cyclical fiscal consolidation. At the same time, financial market regulation, macroprudential as well as other policies can help limit the need for public intervention in such cases.

([37]) The structural balance is the headline budget balance net of the cyclical component and one-off measures. One-off measures are

possible explanations for this pattern such as: (i) the governance of budgetary planning and budgetary revisions; and (ii) the trend increase in difficult-to-compress expenditure items (in particular, age-related spending) in the absence of fiscal-structural reforms. The EU fiscal framework has not been able to adequately tackle this, neither before nor after the Six- and Two-Pack reform.

Graph II.2: **Change in structural balance and output gap 2011-2019**



(1) High and medium/low debt countries are those with high and medium/low debt sustainability risks, respectively, based on the S1 indicator. The graph is based on ex-post data.
Source: European Commission 2022 Autumn Forecast.

In the opposite direction, bad economic times, in particular during the great financial crisis and the euro area sovereign debt crisis, were also characterised by pro-cyclical fiscal policies. The onset of the Great Financial Crisis gave rise to a short period of coordinated expansionary fiscal policy in the EU. However, the ensuing increase of fiscal deficits was rapidly followed by a generalised movement toward fiscal consolidation in the short-lived period of rebound, with a sharp consolidation, well beyond the adjustment requirements of the Pact, triggered in some countries by market pressure ([39]). At the same time, fiscal consolidation also started in Member States with fiscal deficits but overall strong fiscal positions, not exposed to financial market pressure (some in fact benefitted from flight-to-safety flows in their sovereign bond markets) and with large external surpluses. This was in line with the EU fiscal rules, which required these Member States to return to their medium-term objectives (MTOs) (Graph II.2) ([40]). Overall, pro-cyclical fiscal policies at that time undermined a smooth adjustment within the euro area and contributed to persistent inflation undershooting and decline in trend growth. Under these circumstances, it also proved more expedient for governments to reduce investment rather than other types of expenditure, which conflicts with the need to support economic growth in the medium term ([41]). The situation also gave rise to increasing calls for a more supportive aggregate fiscal stance at the level of the euro area ([42]).

In the years following the euro area debt crisis, there was an inappropriate distribution of the fiscal stance across Member States in the aftermath of the euro area debt crisis. Fiscal consolidation came to a halt as of 2014, at a moment when the output gap in the euro area was still negative. Monetary policy continued to provide substantial support with policy interest rates approaching the effective lower bound. The aggregate fiscal stance in the euro area continued to be broadly neutral even though the euro area's output gap had turned positive by 2017. This resulted from a more flexible interpretation of the EU fiscal rules, which gave rise to criticism, including (in retrospect) as a lost opportunity for building fiscal buffers ([43]). The neutrality was attained via an inappropriate distribution of national fiscal stances in light of specific sustainability and stabilisation needs. For instance, in some high-debt Member States, fiscal adjustments first stalled and then were reversed. Thus, despite the reinforced preventive arm, many Member States with high public debt did not make use of the more benign economic times to build up counter-cyclical fiscal buffers.

The pro-cyclicality of the aggregate fiscal stance is partly driven by the asymmetric functioning of the EU rule-based fiscal framework. The SGP 'proscribes' excessive government deficits and requires Member States to achieve their MTOs, but it does not 'prescribe' supportive polices by countries with fiscal space. This, combined with the absence of a centralised fiscal capacity and the

government transactions that have a transitory budgetary effect and do not lead to a permanent change in the budget balance.

([38]) See Mohl, P. and Mourre, G. (2021), "Fiscal policy reactions to the uncertainty of fiscal outcomes", Quarterly Report on the Euro Area, vol. 20, no.1, Commission (DG ECFIN) Institutional Paper no.146, February 2021.

([39]) This was driven by failure to build sufficient fiscal buffers in good times as well as by an incomplete EMU architecture.

([40]) For a definition see Section I.3.3.

([41]) It should be noted that some of the low- and medium-risk Member States were in EDPs during this period, which explains part of the fiscal consolidation that they undertook.

([42]) See, for example: 'Unemployment in the euro area', speech by Mario Draghi at the Annual central bank symposium in Jackson Hole, 22 August 2014; and 'Improving macroeconomic stabilisation in the euro area', speech by Luis de Guindos, 3 October 2019.

([43]) See, for example, 2021 Annual Report of the European Fiscal Board.

incomplete EMU architecture more generally, including as regards the banking union, limits the ability at the EU level to steer the aggregate fiscal stance. It highlights the embedded pro-cyclicality as long as the medium-term budgetary objective is not attained.

Two-stages of pro-cyclicality: pro-cyclical fiscal planning and subsequent slippages

More than half of the observed pro-cyclicality comes from slippages in budgetary execution. These slippages, defined as the difference between the actual and planned fiscal effort, have been strong in bad but also in good economic times (particularly when the fiscal effort is measured *ex post*) ([44]) ([45]). On average across the cycle, Member States underestimated their expenditures. Those Member States that were compliant with the fiscal rules also underestimated their budget revenues, which helped them to achieve compliance. In contrast, those that were not compliant overestimated their budget revenues.

As an aggravating factor, *ex-ante* fiscal planning has also been pro-cyclical, even in real time. Evidence over the 2001-2019 period shows that Member States on average planned fiscal tightening in bad economic times and fiscal loosening in good economic times, irrespective of whether the fiscal effort (and the cyclical position) is measured *ex ante* based on forecast data or *ex post* based on outturn data.

Pro-cyclicality in the preventive arm

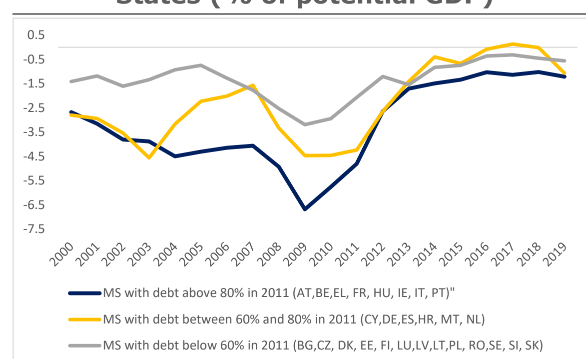
National fiscal policies remained largely pro-cyclical in the preventive arm in part because national fiscal stances were not appropriately differentiated across Member States (Graph II.3):

First, high-debt Member States remained close to the 3% of GDP deficit limit and far from their MTOs, despite favourable macroeconomic conditions (therefore not sufficiently building buffers when economic times were conducive to do so).

Second, Member States with low or medium debt and not yet at their MTOs continued to consolidate in the immediate aftermath of the great financial crisis and during the euro area sovereign debt crisis, as per the rules of the SGP, while this was not necessary from a fiscal sustainability point of view.

Third, Member States that rebuilt fiscal buffers and reached or exceeded the MTO made limited progress in implementing fiscal and structural policies to increase investment (see Section III).

Graph II.3: **Structural balances in Member States (% of potential GDP)**



(1) due to data availability, the figures up to 2009 refer to the cyclically-adjusted balance (i.e. including one-offs).
Source: European Commission 2022 Autumn Forecast.

A series of factors may have contributed to the insufficient differentiation across Member States including the failure to build buffers in good times. The simultaneous fiscal adjustment of all Member States in the euro area at the start of the 2010s depressed economic growth and made it more difficult for high-debt Member States to comply with the rules. Moreover, the strong focus on compliance with annual requirements in the Six- and Two-Pack reform generally weakened the focus on medium-term budgetary planning, contributing to many Member States postponing the achievement of their medium-term budgetary objectives.

Pro-cyclicality in the corrective arm

The pro-cyclicality of fiscal policy is to some extent embedded in the corrective arm. Member States in an EDP are required, as a rule, to correct the excessive deficit by the year following its identification, even if (as is likely) the breach of the deficit criterion has occurred in the context of adverse cyclical conditions. In order to mitigate the pro-cyclical impact of an EDP, the Council has, in

([44]) In the case of slippages in bad times, the actual fiscal effort was found to be higher than the planned effort. This can be the result of various factors (e.g., lower spending, differences in the measurement of the fiscal effort, etc.).
([45]) European Commission (2020) "Performance of spending rules at EU level" in Report on Public Finances in EMU 2019.

all relevant cases since the Six- and Two-Pack reform, decided to grant a longer, multi-year adjustment path on the basis of a Commission proposal. The EDP also requires Member States to deliver an annual adjustment of at least 0.5% of GDP as a benchmark, with some flexibility to deviate from this benchmark in view of, for example, prevailing economic conditions.

A worrying trend has been the continuous use of the so-called 'nominal strategy' by some Member States in the corrective arm, which only works in good economic times. Under this strategy, Member States achieve the nominal fiscal targets set out in the EDP adjustment path without meeting the structural or expenditure targets, thus preventing them from building fiscal buffers ([46]). The use of the 'nominal strategy' conveys the wrong idea in the national debate, i.e., that only the 3% of GDP nominal reference rate matters, disregarding the need for underlying fiscal adjustment.

II.2.2. The increased complexity of the EU fiscal rules has contributed to pro-cyclicality

Successive innovations in the fiscal framework have sought to reduce pro-cyclicality. These innovations include: (i) the introduction of the structural balance concept in order to "correct" the headline balance for the budgetary impact of the economic cycle (2005 reform); (ii) the fine-tuning of fiscal requirements to country-specific cyclical positions in the preventive arm through the introduction of the matrix of adjustment requirements (2015 Communication) and the margin of discretion (for 2018 as a one-off); and (iii) allowing temporary deviations from fiscal requirements (i.e. the concept of "broad compliance") and the introduction of a general escape clause (Six-Pack legislation) ([47]).

Table II.1: **The impact of EU fiscal rules on the pro-cyclicality of fiscal policy**

Preventive arm	
• Structural balance adjustment met	++
• Expenditure benchmark met	++
Corrective arm	
• Government gross debt	
< 60% of GDP	+++
> 60% of GDP	-
> 80% of GDP	--
> 100% of GDP	---
Debt benchmark met	+++
Other factors	
• EDP	-
• EDP & good economic times	-
• EU/IMF assistance programme	-

(1) (+/- refers to a decreasing/increasing impact on pro-cyclicality)
(2) The table summarises findings from panel regressions for a sample of Member States and shows the sign and degree of significance of the impact of the variables on the pro-cyclicality of fiscal policy. The impact gets stronger with the number of +/- which correspond to the level of statistical significance of the regression results. Hence +++/--- corresponds to a level of significance at the 1% confidence level, ++/-- corresponds to a level of significance at the 5% confidence level and +/- corresponds to the level of significance at the 10% confidence level. It should also be stressed that while some of these variables reduce the pro-cyclicality of fiscal policy, they do not necessarily give rise to counter-cyclical fiscal policy.
Source: European Commission (2019), Report on Public Finances in EMU 2018.

The consequent increased complexity of the fiscal rules has reduced predictability and made enforcement and compliance more challenging ([48]). In particular, the reliance on unobservable variables has hampered transparency and predictability, not least due to the volatility that frequent revisions to the estimates of these variables give rise to. This has contributed to the weak compliance on the part of some Member States, which has limited their ability to conduct counter-cyclical fiscal policies.

([46]) For legal reasons, a deficit-based EDP cannot be "stepped up" if the Member State achieves its intermediate headline deficit target, even when the recommended change in the structural balance is not achieved.
([47]) The structural balance corrects for the economic cycle. The adjustment matrix allows modulating the fiscal effort based on the position of the country in the economic cycle. It requires a stronger fiscal effort in good economic times and a smaller fiscal effort in bad economic times. The margin of discretion seeks to balance the stabilisation and sustainability objectives by reducing the fiscal effort required by the adjustment matrix if it is found to be at odds with the stabilisation needs of the country. The aim of temporary deviations from the fiscal requirements or the suspension of the requirements is to avoid pro-cyclical fiscal contractions. Flexibility clauses such as the unusual events clause, the structural reforms and public investment clauses aim to reduce adjustment requirements to enable governments to face additional costs outside their control and to foster growth-enhancing policies.
([48]) The 2018 Communication on the evaluation of the 2015 Communication on flexibility provides some highlights on the extent to which the implementation of SGP flexibility since 2015 contributed to a pro-cyclical (or counter-cyclical) pattern of fiscal policy in some Member States.

Empirical evidence shows that compliance with the EU fiscal rules reduces pro-cyclicality, while lack of compliance aggravates it (Table II.1) ([49]):

Member States that met the requirements of the preventive arm have a lower degree of pro-cyclicality than those that did not;

The presence of low headline deficits is associated with lower pro-cyclicality;

Member States with debt below the 60% of GDP threshold have shown a lower degree of pro-cyclicality, while those with high deficit and debt ratios have tended to have a higher degree of pro-cyclicality;

Member States that comply with the debt reduction benchmark have a less pro-cyclical pattern (albeit not a counter-cyclical one), although the adjustment imposed by the debt reduction benchmark in order to achieve such compliance is itself pro-cyclical ([50]).

II.3. Reducing pro-cyclicality in normal and exceptional circumstances

While the EU fiscal rules can seek to limit the pro-cyclicality of national fiscal policies, they will never be able to fully eliminate it. Without a strong commitment from Member States themselves, ensuring counter-cyclical fiscal consolidation in good economic times will always be difficult, in particular when the deficit remains below the Treaty requirement of 3% of GDP (i.e., when Member States are in the preventive arm). Similarly, so long as not all Member States enjoy favourable fiscal positions, ensuring a counter-cyclical fiscal response in bad economic times will remain difficult in light of the asymmetry of the current rules in line with their objective to prevent so-called “gross errors” in the conduct of fiscal policy, as these can have negative spillovers to other Member States and to the monetary union as a whole.

This sub-section focuses on possible ways of reducing the pro-cyclicality of fiscal policy in the EU. The first two elements (reinforcing the medium-term focus and placing a greater emphasis on an expenditure rule) are complementary and seek to reduce pro-cyclicality under normal conditions. Drawing lessons from the COVID-19 and energy crises, the general escape clause could continue to serve in such circumstances, although reflection on its scope and its relationship to country-specific shocks is necessary.

II.3.1. A medium-term approach to fiscal planning and surveillance

Recent innovations designed to reduce pro-cyclicality have increased the focus on the annual budgetary cycle in EU fiscal surveillance. The Six- and Two-Pack reforms led to a strong focus on the assessment of annual fiscal targets, arguably to the detriment of a medium-term assessment, for a number of reasons: (i) the Significant Deviation Procedure is based on the *ex post* assessment of deviations over one and two years ([51]); (ii) the outer years of the annual Stability and Convergence Programmes (SCPs) presenting Member States’ medium-term fiscal plans are not assessed in detail (the focus is on the assessment of the previous, current and next year); (iii) the incorporation of medium-term investment and reform initiatives in the medium-term fiscal projections has in practice not been a central element of the SCPs and of the Commission’s assessment, although it is a formal requirement of the SCPs (this is also reflected in the separate preparation and assessment of SCPs and National Reform Programmes); and (iv) for euro area Member States, the focus has been on the budget of the following year through the evaluation of the Draft Budgetary Plans (DBPs) ([52]).

Member States have mostly failed to achieve their medium-term plans, by engaging in a back-loading of fiscal adjustment, and by continuously delaying the achievement of their fiscal targets. The Six- and Two-Pack reforms, including the associated enforcement procedures ([53]), have generally not

([49]) European Commission (2019), “Report on Public Finances in EMU 2018”, European Commission (DG ECFIN) Institutional Paper no. 095, January 2019.

([50]) Compliance with the debt reduction benchmark implies that Member States have more fiscal space that could be used in bad economic times to stabilise the economy, hence its effect on decreasing pro-cyclicality.

([51]) The Significant Deviation Procedure aims to give Member States the opportunity to correct a deviation from their MTO or the adjustment path towards it in order to avoid the opening of an Excessive Deficit Procedure.

([52]) Each year, euro area Member States submit DBPs to the European Commission. The Commission assesses the DBPs to ensure that economic policy among the countries sharing the euro is coordinated and that they all respect the EU’s economic governance rules.

([53]) For example, the Six-Pack reform introduced the Significant Deviation Procedure in the preventive arm, while the Two-Pack

resulted in Member States (especially those with high debt) complying with the structural balance targets put forward in their SCPs. While a small part of those worse-than-planned outcomes can be attributed to revisions to potential output or negative inflation surprises, they are largely due to a progressive postponement of budgetary targets by governments (for example in reaction to budgetary slippages). By contrast, governments have not used positive growth surprises or budgetary windfalls, including savings on interest payments, to accelerate debt reduction ([54]). These experiences demonstrate that ownership of the fiscal framework has been insufficient, which is also related to the difficulty of communicating, monitoring and enforcing complex requirements that rely on non-observable variables.

Observers have suggested that focussing fiscal planning and EU surveillance on the medium term could help ([55]). The adoption of fiscal targets for the medium-term in the form of annual (primary) expenditure (net of discretionary revenue measures) ceilings would better capture medium-term expenditure developments and the contribution of revenue decisions to fiscal outcomes. It would also allow reforms and spending priorities with an impact on the medium-term budgetary trajectory to be taken into account. Medium-term fiscal targets would also be able to cater for normal cyclical fluctuations. In the event of large shocks that demand a reset of targets, including the need for material short-term discretionary policy measures beyond automatic stabilisers, in line with the relevant literature ([56]), the fiscal path could be adapted through recourse to an escape clause.

reform gave the Commission the power to invite a Member States to resubmit its DBP.

([54]) See Mohl, P. and Mourre, G. (2021), "Fiscal policy reactions to the uncertainty of fiscal outcomes", Quarterly Report on the Euro Area, vol. 20, no.1, Commission (DG ECFIN) Institutional Paper no.146, February 2021.

([55]) Martin, Pisani-Ferry and Ragot (2021) : "Pour une refonte du cadre budgétaire européen", Note du Conseil d'Analyse Economique, no.63, April 2021; Darvas and Anderson (2020): "New life for an old framework: redesigning the European Union's expenditure and golden fiscal rules", Bruegel Paper prepared for European Parliament's ECON Committee; Kamps and Leiner-Killinger (2019): "Taking Stock of the Functioning of the EU Fiscal Rules and Options for Reform", ECB Occasional Paper Series; Network of EU IFIs: "EU Fiscal and Economic Governance Review", Contribution to the EFB Annual Conference, February 2021.

([56]) See, for example, Kopits, G. and Symansky, S. (1998): "Fiscal Policy Rules", IMF Occasional Papers, July 1998. In its various contributions to the debate, the European Fiscal Board has also highlighted the need for an escape clause, e.g., EFB Annual Report 2019.

The medium-term approach would facilitate a needed integrated approach to macroeconomic surveillance. In particular, consideration of the effectiveness of macroeconomic stabilisation policies beyond the working of fiscal rules is also needed. The transmission of fiscal policy decisions to the real economy (and thus the effectiveness of stabilisation) is largely dependent on the composition of public finances and the adaptability of our economies, not least in terms of the time lags associated with the impact of fiscal policy actions. Policies that ensure well-functioning labour, capital and product markets can make our economies more adaptable and resilient to shocks. This calls for an integrated approach to fiscal and macroeconomic surveillance. Increasing the effectiveness of macroeconomic stabilisation cannot be viewed in isolation from the broader aims of improving the quality of public finances, promoting the investment and reforms that enhance resilience and adaptability, and accelerating the growth of our economies.

A medium-term focus would require a strengthening of national budgetary frameworks (see also Section IV). In light of the weak achievement of medium-term budgetary targets, a refocussing of fiscal planning on the medium term together with more stringent implementation of national budgets, budgetary correction mechanisms and more binding targets would enhance the credibility of Member States' SCPs ([57]). This raises the question of the extent to which enforcement mechanisms, including sanctions (for example of a reputational nature), might prevent departures from those plans. The national institutional setup will play an important role. Sound national fiscal frameworks enhance the quality of budgetary implementation, the credibility of medium-term budgetary plans, and fiscal discipline more broadly. Strong national institutions, including independent fiscal institutions, also reduce the cost of servicing (high) public debt by providing signals to international financial markets regarding the credibility of fiscal plans ([58]).

([57]) Belu Manescu C. and Bova E. (2020): "National Expenditure Rules in the EU: An Analysis of Effectiveness and Compliance", European Economy Discussion Paper No.124, April 2020.

([58]) Cangiano, M. et al. (2013), "Public Financial Management and its emerging architecture", Section 4.5.2, p. 167-168; Jalles, J.T. (2019), "How do macroeconomic fundamentals affect sovereign bond yields? New evidence from European forecasts", CESIfo Economic Studies, vol. 65, issue 1, March 2019; Iara, A. and Guntram W.B. (2010), "Rules and risk in the euro area: does

II.3.2. A greater emphasis on expenditure rules

A better performance in reducing pro-cyclicality

The use of an expenditure rule as an operational indicator can help reduce the pro-cyclicality of fiscal policy ([59]). First, expenditure rules are not affected by windfall revenues, which can distort the reading of structural or nominal fiscal balances. The impact of windfall revenues on the structural balance can lead to an overly benign interpretation of budgetary developments in good times and an underestimation of consolidation needs. Second, an expenditure rule can be based on an estimate of medium-term growth (such as a ten-year average of potential output), which means that it is not affected by significant swings in annual estimates of potential GDP, as is the case for the structural balance. Overall, compliance with an expenditure rule is measurable *ex post* and the indicator is less affected by factors that lie outside government control. It would thus appear to be a robust operational target in medium-term budgetary planning and to help in the monitoring of in-year budgetary execution ([60]).

The superior performance of spending rules in reducing pro-cyclicality is supported by empirical evidence ([61]). Spending rules are generally more demanding in good economic times and less demanding in bad economic times, compared to the structural balance rule (Graph II.4) ([62]). The more counter-cyclical requirements implied by spending rules hold irrespective of the measure of the output gap used (*real-time* vs *ex-post* estimates).

The general case for expenditure rules does not exclude that the use of structural balance rules may be preferred at a national level. While national spending rules generally display better stabilisation properties, some Member States with national structural balance rules have shown a good track record in SGP compliance, which in turn reduces the pro-cyclicality of fiscal policies, largely due to acceptance of these rules by policy makers and/or a high visibility among the public. The benefit of moving to a spending rule may be limited for those Member States' national frameworks.

Reduced reliance on unobservable variables

Components of the current EU fiscal rules that are designed to reduce pro-cyclicality are heavily reliant on unobservable variables. These components pertain to: (i) a fiscal adjustment measured in structural terms; and (ii) a stable fiscal position around which automatic stabilisers can fully operate (i.e., the MTO), also defined in structural terms. The use of structural balance and output gap estimates, which are unobservable and subject to frequent revisions, makes these components difficult to monitor on a real-time basis and adds a detrimental element of volatility to fiscal surveillance. The output gap, while an informative economic indicator, does not appear robust enough in terms of measurability to be a cornerstone of fiscal surveillance. There have been instances when *ex-ante* forecasts of the output gap have been negative, while *ex-post* estimates (based on outturn data) have been positive. Such discrepancies have contributed to fiscal slippages on the part of Member States and increased the pro-cyclicality of fiscal policy.

rules-based national fiscal governance contain sovereign bond spreads?", European Economy Economic Papers no.433, December 2010; Manescu, C. and Bova, E, "National Expenditure Rules in the EU: An Analysis of Effectiveness and Compliance, European Economy Discussion Papers 2015, No 124.

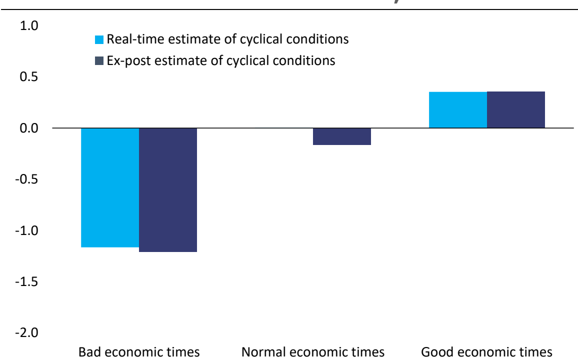
([59]) European Commission (2019), "Fiscal outcomes in the EU in a rules-based framework – new evidence", Report on Public Finances in EMU 2018, Institutional Paper 095, pages 105-156.

([60]) Bénassy-Quéré et al. (2018) : "Reconciling risk sharing with market discipline: A constructive approach to euro area reform", CEPR; Darvas, Martin and Ragot (2018): "The economic case for an expenditure rule in Europe", VoxEU; OECD (2018): "Euro area", OECD Economic Surveys; EFB (2018): "Annual Report 2018"; Cottarelli (2018): "How could the SGP be simplified?", Paper prepared for the European Parliament's ECON Committee; Reuter (2018): "Benefits and drawbacks of an "expenditure rule", as well as of a "golden rule" in the EU fiscal framework", Paper prepared for the European Parliament's ECON Committee.

([61]) European Commission (2019), 'Performance of spending rules at EU level', in Report on Public Finances in EMU 2019. See also Mohl, P. and G. Mourre (2020): "Performance of the EU spending rule: a quantitative assessment of sustainability, stabilisation and predictability", Paper presented at the joint conference of European Fiscal Board, Amsterdam Centre for Economic Studies and CEPR on Rethinking the European.

([62]) Analysis shows that the pro-cyclicality of the current expenditure benchmark could be further reduced by two adjustments to the indicator: (i) replacing the GDP deflator with the ECB's medium-term inflation target of 2%; and (ii) replacing the current average 10-year potential growth rate (average 4-years ahead, …, 5-years back) with an average that is less dependent on future estimates and more backward looking (e.g. average 8-years back, …, 1-year ahead). For further information, see European Commission (2019), 'Performance of spending rules at EU level', in Report on Public Finances in EMU 2019.

Graph II.4: **Additional fiscal effort required by the expenditure benchmark compared with the structural balance, 2000-2018**



(1) The additional fiscal effort required by the expenditure benchmark is the difference between the fiscal effort measured by the variation of the structural balance and the fiscal effort measured by the expenditure benchmark, expressed as a difference between benchmark and net expenditure growth in percentage of GDP. Bad economic times: output gap of 1.5% of less (N=148 in real time, 140 ex post); normal economic times: output gap between -1.5% and 1.5% (N=286 in real time, 216 ex post); good economic times: output gap of 1.5% or more (N=32 in real time, 110 ex post). 80% of real-time bad economic times episodes took place in the aftermath of the global financial crisis and the EU sovereign debt crisis (2009-2015), and 50% of good economic times took place in 2018 and 2019. The years preceding the global financial crisis (2003-2007) were considered normal economic times in most Member States in real-time, but are estimated to have been good economic times ex post. "Real-time" refers to the Commission autumn forecast vintages over the 2000 to 2019 period; "ex-post" refers to the Commission 2019 spring forecast.
Source: European Commission (2019), 'Performance of spending rules at EU level' in Report on Public Finances in EMU 2019.

Expenditure rules are more stable, more predictable and less subject to revisions. While the calculation of an expenditure rule includes unobservable variables (in the form of medium-term potential output), the use of a medium-term average (as opposed to the annual estimates used in the structural balance) makes such rules more stable. Discretionary revenue measures, which are deducted from the expenditure aggregate, are also not fully observable. However, they are a "real" element of the national budgetary process (as opposed to the output gap, which is not directly used in the national budgetary process) and are currently subject to a regular transparency review between Member States and the Commission.

II.3.3. A general escape clause to respond to strong economic shocks

Role of fiscal policy in the event of strong shocks

The general escape clause was one of the main post-financial-crisis innovations in the EU fiscal rules. The general escape clause aims to facilitate a strong and coordinated fiscal policy response in the event of a severe economic downturn in the euro area or EU as a whole. While it does not give Member States *carte blanche*, it allows them to temporarily depart from the adjustment path towards the MTO, provided that this does not endanger fiscal sustainability in the medium term. As such, it seeks to prevent a large EU or euro area recession from becoming entrenched as a result of contractionary fiscal policies in some (or most) Member States, which could give rise to negative trade and confidence spillovers for other Member States. At the same time, it is solely permissive in nature due to the asymmetric nature of the Pact: it allows Member States to temporarily depart from the adjustment paths towards their MTO but cannot enforce a supportive area-wide fiscal stance by obliging Member States to undertake fiscal expansions.

Reflection on medium targets raises the question of country-specific flexibility

Country-specific flexibility would allow Member States to deal with large country-specific shocks and unpredictable/unusual exogenous events that could not have been prevented and that require counter-cyclical fiscal measures. Such measures may lead to departures from the established medium-term path. The pairing of well-defined *ex-post* country-specific flexibility with *ex-ante* disaster risk financing would ensure that SGP flexibility is limited to truly unusual and exceptional events of a sizeable nature. High-frequency events known to occur with a certain probability would be addressed through liability management and budgetary buffers.

The EU fiscal surveillance framework foresees a different treatment of costs related to unusual, exogenous events [63]. However, as the relevant EU provisions have been detailed over time, they are complex.

[63] For instance, on the one hand, short-term emergency costs in response to natural disasters with a clear, direct and immediate link to it can be treated as one-off measures and thus be excluded from the EU fiscal compliance assessment indicators. On the other hand, Member States can request flexibility for additional investment made in relation to an unusual event outside the control of the government, provided this does not endanger debt sustainability. The unusual event clause is covered by the Vade Mecum on the SGP 2019 edition, pages 25-26.

Moreover, national escape clauses allow for a temporary deviation from compliance with national fiscal rules. A third of the 120 national fiscal rules in force in EU Member States have escape clauses for exceptional circumstances such as disasters, either defined by reference to the SGP, ([64]) to the Treaty on Stability, Coordination and Governance (in 19 cases) or via a specific reference (in 12 cases). The fiscal impact of disasters can quickly overwhelm the buffers built in regular budgets ([65]). Greater focus on a medium-term approach to fiscal planning and surveillance (see Subsection II.2.1) would contribute to the management of temporary shocks.

II.4. Conclusions

In practice, fiscal policy in the EU has remained largely pro-cyclical throughout the economic cycle. High-debt Member States did not build sufficient fiscal buffers in good economic times and had to implement pro-cyclical fiscal tightening in bad economic times, under market pressure and beyond the adjustment requirements of the Pact. At the same time, Member States with overall strong fiscal positions and large external surpluses did not undertake counter-cyclical fiscal policies, especially in the immediate aftermath of the great financial crisis, thus contributing to persistent inflation undershooting and not addressing the EU priority of achieving a sustained upward trend in investment. This was always among the stated objectives of the reforms of the Stability and Growth Pact (SGP), with the introduction of a fiscal objective in cyclically-adjusted terms in 2005. This was also the explicit justification of some innovations subsequent to the 2011 reforms (e.g., the introduction of the matrix of adjustment requirements in the preventive arm in 2015). However, these successive reforms have rendered the rules increasingly complex and difficult to implement, and thus unable to achieve a strengthening of counter-cyclicality.

On the basis of these observations and drawing from the literature, the section has examined certain elements that could increase the counter-cyclicality of the EU fiscal framework. These include: (i) a greater focus on a medium-term approach; (ii) greater ownership of fiscal adjustment paths; (iii) a simplified framework and (iv) greater emphasis on spending rules. In the exceptional circumstances of a severe economic downturn in the EU or euro area as a whole, the activation of the general escape clause has been found to be an essential tool.

An integrated approach to macroeconomic surveillance is critical. Increasing the effectiveness of macroeconomic stabilisation cannot be viewed in isolation from the broader aim of improving the quality of public finances and promoting the investment and reforms necessary to enhance economic resilience and foster growth.

([64]) Exceptional events can be defined according to EU law (Article 6 of Regulation 1476/97).

([65]) For a discussion on the fiscal dimension of disaster risk management, see Radu, D. (2021), "Disaster risk financing. Main concepts and evidence from EU Member States", Discussion Paper, 2021, and Radu, D. (2022), "Disaster risk financing: limiting the fiscal cost of climate-related disasters".

III. The role of the fiscal framework to foster public investment, including in light of the green and digital transitions

By Sven Langedijk, Åsa Johannesson-Lindén, Paul Brans, Alessandra Cepparulo, Helena Hernnäs, Alexander Ioannidis, Cliona McDonnell, Philipp Mohl and Vito Ernesto Reitano.

Abstract: *This section discusses the role that the EU fiscal framework may play to promote public investment. It examines public investment developments in the EU since the mid-1990s and provides estimates of additional public and private investment needs up to 2030 for the green and digital transitions. The findings of a review of theoretical and empirical literature suggest that Member States public investment appears to have been adversely affected more by concerns on debt sustainability and related market pressures than by the EU fiscal rules. Still, the fiscal framework may provide stronger incentives to increase and sustain public investment, also during periods of fiscal consolidation. Considering the large additional investment needs to facilitate the green and digital transitions towards a resilient EU economy the section considers some elements that would strengthen the role of the fiscal framework in promoting public and private investment spending.*

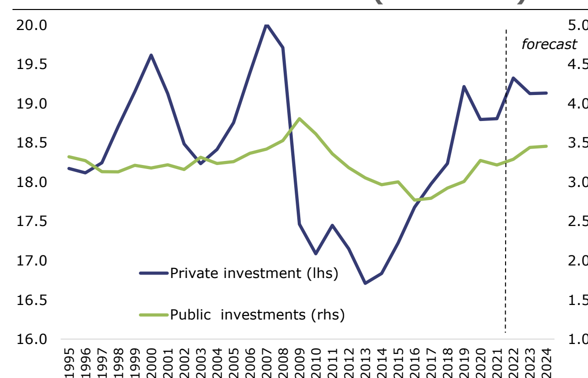
.

III.1. Introduction

The reform of the economic governance framework aims to contribute to making Europe more resilient by sustaining strategic investment and by reducing high public debt ratios in a realistic, gradual and sustained manner. Together with prudent fiscal strategies and structural reform, public investment contributes to sustainable growth which is key to ensuring fiscal sustainability. Public and private investment increase are also needed to enable the green and digital transition towards a resilient economy.

This section discusses the role that fiscal rules may play in facilitating or promoting investment. When examining investment developments over the past decades it focuses on national account concepts of investment, gross and net fixed capital formation (GFCF and NFCF). Moving beyond the national account definition of investment raises difficulties of defining what exactly constitutes 'investment' with positive future returns. The focus is on *public* investment ([66]). While public investment represents only a small share of total investment and the private sector is responsible for the bulk of EU investment, the public sector plays an important role.

Graph III.1: **Public and private sector investment in the EU (% of GDP)**



Source: European Commission 2022 autumn forecast.

The private corporate and household sectors' investment amounted to around 19% of GDP in 2019 (Graph III.1) compared to the public sector's 3%. Still, the government's role in total investment extends beyond the limited share of public investment including by creating the conditions under which the private investments decisions are taken. Private investment benefits from essential public investments in infrastructure and the macroeconomic conditions (crowding-in) ([67]). Crowding-in effects occur as long as increases in

([66]) For data comparability considerations, the focus is on government investment excluding investment carried out by public enterprises that are not classified in the government sector (e.g., in transportation and communication and energy). Public investment refers here to gross or net fixed capital formation of general government as defined in national accounts, which may include some public corporations when they are considered non-market and hence classified inside the general government sector.

([67]) See ECB (2018), 'Business investment in EU countries', *Occasional Paper Series*, No. 215

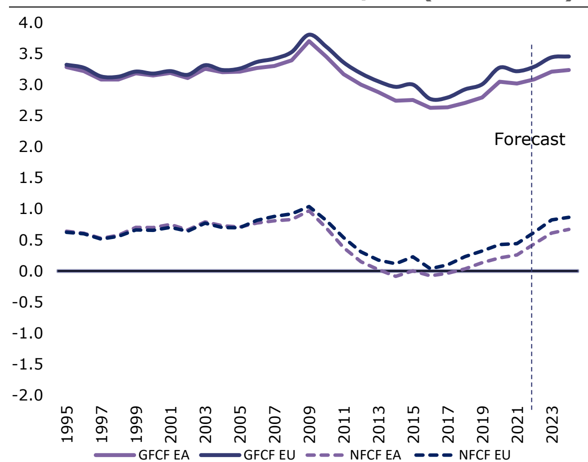
public debt do not trigger high risk premia and increase the cost of financing.

The first section focuses on investment developments and prospects in the EU and Member States since the mid-1990s, including the contribution from the Recovery and Resilience Facility (RRF). The second section presents the private and public investment needs of the twin transition and discusses the role and nature of public funding. The last section discusses how fiscal rules may affect investment.

III.2. Pre-COVID public investment levels did not contribute to raising the capital stock

In the aftermath of the Great Financial Crisis, the EU experienced a widespread and prolonged decline of public investment. Investment could scarcely keep up with depreciation levels, reflected in net investment close to zero on aggregate in the period 2010-2019 (Graph III.2).

Graph III.2: **General government: gross and net investment in the EU/EA (% of GDP)**

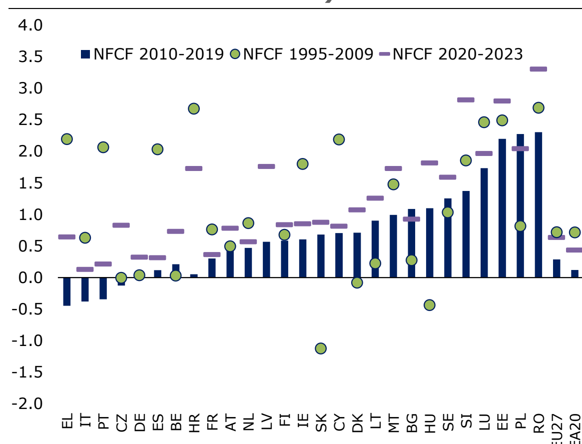


Source: European Commission 2022 autumn forecast.

If sustained, these low public investment levels would result in a gradual but substantial reduction of the public capital stock as a share of GDP in a number of Member States and in the EU/EA on aggregate.

Public investment levels were very uneven across Member States before the COVID crisis. High-debt countries often had very low or negative net investment levels in the period 2010-2019 (Graph III.3). This includes countries that needed to engage in substantial fiscal consolidation in the aftermath of the Great Financial Crisis and sovereign debt crisis under market pressure (Greece, Italy, Portugal and Spain) [68]. Net investment levels in most of these Member States had been amongst the highest in the EU before the Great Financial Crisis. Empirical research suggests that such investment-based fiscal consolidation is not conducive to fiscal sustainability as public investment and supply-side, productivity-enhancing reforms are critical for medium-term growth and essential for debt reduction strategies [69].

Graph III.3: **General government: gross and net investment in Member States (% of GDP)**



Source: European Commission 2022 autumn forecast.

Divergence across Member States is also reflected in the degree to which debt accumulation has resulted in the building up of public capital. In principle, an increase in government debt that leads to a corresponding increase in the capital stock is neutral for the net asset value of the government sector. In most low- and medium-debt Member States, the accumulation of (net) debt is largely reflected in the accumulation of public capital, although in few Member States (e.g., in FI and LU) it also reflects debt raised due to the accumulation of financial assets of non-debt nature (e.g., equity and investment fund shares). In most high-debt Member States, however, the accumulation of public debt has not been reflected in a higher capital stock indicating that deficit spending has

(68) Some other Member States, including low-debt countries such as Czechia and Germany, have had persistently low net investment levels (also before the Great Financial Crisis).

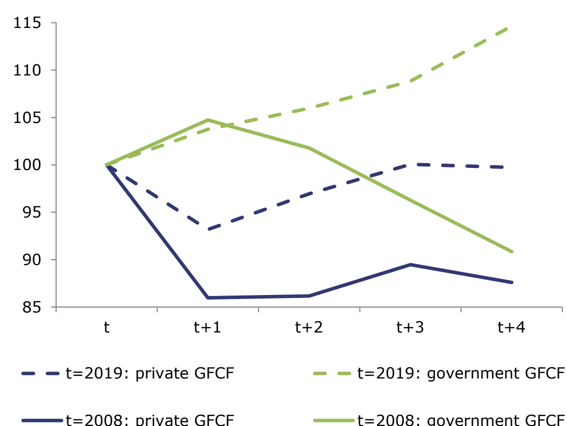
(69) See Baldacci, E., Gupta, S., and C. Mulas-Granados (2013), 'Debt Reduction, Fiscal Adjustment, and Growth in Credit-Constrained Economies', IMF Working paper, WP/13/238.

not been channeled towards capital expenditure but financed consumption.

III.2.1. An investment boost in response to the COVID-19 crisis

The COVID-19 crisis has not structurally weighed on either private or public investment. Because of the substantial monetary and fiscal policy support, and the explicit recommendation to preserve nationally financed investment. The positive investment developments after the COVID-19 crisis should facilitate a swift and sustained recovery with better medium-term prospects (Graph III.4).

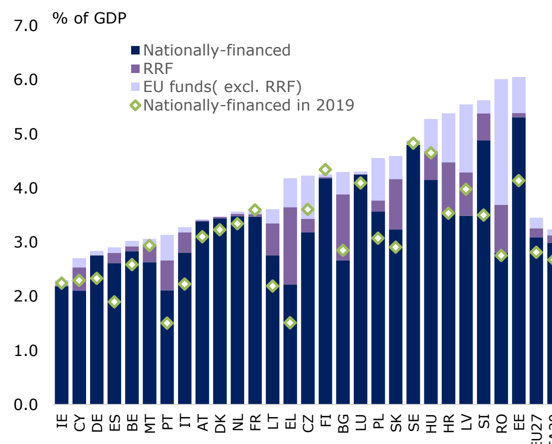
Graph III.4: **Real private and public investment in the EU in the aftermath of the great financial crisis and the COVID-19 crisis (index, t=100)**



Source: European Commission 2022 autumn forecast.

The RRF supports investment in particular in high-debt Member States and central and eastern European Member States. The EU economy experienced a strong recovery after the COVID-crisis, thanks to policy support at both EU and national level. To the extent that the investment is productive and high-quality and comes on top of sustained nationally financed investment, the RFF raises potential growth. In 2022, most Member States preserved nationally financed public investment underpinning a pick-up in overall public investment (Graph III.5). In future years, as fiscal consolidation will be needed to ensure sustainable fiscal positions, sustaining nationally financed investment will require clear prioritisation of expenditures and efforts to improve the composition and quality of public finances. Potential growth should be further supported by consistent implementation of reforms, including those that Member States have committed to in the Recovery and Resilience Plans (RRPs). However, the RRF is a temporary support instrument (up to 2026), while the investment needs of the twin transition will remain substantial in the longer term.

Graph III.5: **Public investments in the EU/EA and Member States and source of financing (2022, %of GDP)**



Source: European Commission 2022 autumn forecast.

III.3. Investment needs to meet the objectives of the twin transitions

The EU's commitment to the twin green and digital transitions, enshrined in the EU Green Deal [70] and the EU digital strategy, will require immediate and sustained increased investment levels. Both private and public sector financing will be needed to accommodate these needs [71].

[70] The Green Deal constitutes a comprehensive policy framework supported by EU-level funding. The EU has set strong energy and climate ambitions under the Green Deal, with the headline commitment to achieve climate neutrality by 2050. The Climate Law enshrined this long-term commitment and also updated the intermediate 2030 target, increasing it from a 40% to a 55% reduction in greenhouse gas emissions compared to 1990 levels. The 'Delivering the Green Deal package' is the set of legislative proposals to update the EU climate and energy framework to reach the new targets.

[71] The investment needs referred to in this section were estimated and published in the context of the Fit-for-55 Package (in SWD (2021) 621 final) for climate, and NextGenerationEU (in SWD(2020) 98 final) for other environmental objectives and digital, respectively. They do not include investments needed for policy developments since then.

III.3.1. Investment needs for climate and energy

Compared to the average of green investments as share of GDP for the period 2011-2020, the annual additional investments needed in this decade correspond to an increase of green investments as share of GDP of approximately 2.9 percentage points. Of this, additional climate and energy investments represent 2.1 percentage points and additional other environmental investments represent around 0.8 percentage points ([72]).

The estimated required increase in investments as a share of GDP of 2.1 percentage points for climate and energy policy objectives covers the needs to decarbonise energy use across the economy as well as the expansion of the economy over the period ([73]). It refers to energy system related investments, including transport. Part of the increase is due to the expansion of the economy over the considered timeframe. This estimate does not factor in future climate adaptation needs ([74]) such as investments dedicated to making existing assets more resilient to climate change or increased costs due to more frequent extreme weather events. Possible compensatory measures are also not covered. On the energy supply side, investments cover mainly the power grid, power plants and new fuels (such as hydrogen and synthetic fuels that will replace fossil-based fuels). On the energy demand side, it concerns investments in energy efficiency and heating systems for buildings, as well as investments in industrial processes and transport. The full cost of new vehicles owned by households for private use (which make up a significant amount of the overall costs) are included, which would be considered as consumption of durable goods in national accounts.

Following Russia's invasion in Ukraine, the EU has taken action to enhance the security of its energy supply, which adds to these investment needs. The REPowerEU plan aims at phasing out the EU's fossil fuel dependence on Russia well before 2030, through diversifying supply and accelerating investments in energy efficiency and renewable energy. These investment needs are additional to the previous projections quoted above for the 2030 climate and energy targets and accelerate the implementation of clean and more efficient technologies. The REPowerEU also proposed to raise the ambition for the renewable and energy efficiency targets by 2030 ([75]).

The additional investment needs to deliver on the other environmental objectives of the green transition (beyond climate and energy) are estimated to require an increase in the share of investment to GDP by 0.8 percentage points ([76]). This figure includes investment gaps in a number of environmental policy areas, ranging from biodiversity to circular economy and resource efficiency, as well as wastewater management and pollution prevention and control.

The investment gap to deliver on a digital transformation in the EU is estimated to be 0.9% GDP per year ([77]). The figure includes investments in digital infrastructure, digital skills and advanced technologies, but leaves out other dimensions such as digital public services. The Digital Compass Communication and the related policy programme "Path to the Digital Decade", adopted in 2022, sets out a policy framework and targets for the digital transformation of the EU to be achieved by 2030 ([78]). An update of the investment needs in view of the new ambitions for the Digital Decade is on-going.

Part of the twin transition investment needs are addressed with EU funds. The EUR 2 trillion budget from the combined NextGenerationEU

([72]) In 2015 prices, the additional public and private investment needs for the green transition in the EU are estimated at around EUR 520 billion annually up to 2030. EUR 392 billion is for climate and energy investments (SWD(2021)621 final), EUR 130 billion is for other environmental investments (SWD(2020)98 final, table 1).

([73]) These estimates refers to the MIX scenario, reflecting a mix of carbon pricing and regulatory sectoral measures presented in SWD(2021)621. The carbon pricing includes the current emission trading system, including aviation, an extension to maritime transport, as well as a new emission trading system for road transport and buildings.

([74]) Investment needs for climate adaptation in the EU are estimated to range between EUR 35 billion and 500 billion annually, the large variation reflecting different underlying assumptions and methodological approaches. See Forster, D., Laan, J., Tippmann, R., et al. (2017), 'Climate mainstreaming in the EU budget: preparing for the next MFF', *Final report*, European Commission, Directorate-General for Climate Action,

([75]) COM(2022) 230final; SWD(2022)230 final.

([76]) See footnote (72).

([77]) See SWD(2020)98 final, table 2. Based on 2018 data, the investment gap has been estimated at EUR 125 billion and comprises investment gaps in communication networks, digital skills and advanced digital technologies and capacities (including high performance computing, cloud, artificial intelligence, blockchain, and cybersecurity, among others).

([78]) COM(2021) 118 final; COM(2021) 574 final.

Recovery Plan and the EU's seven-year budget are oriented towards a greener, more digital and resilient Europe. This corresponds to 1.98% of EU GDP on average per annum ([79]). The EU has increased the climate expenditure target from 20% in the 2014-2020 budget to 30% across the 2021-2027 seven-year budget and the NextGenerationEU. This EUR 2 trillion budget includes the Recovery and Resilience Facility that makes available EUR 723.8 billion in grants and loans. Its Regulation requires that 37% of funding is allocated to measures supporting climate action, and at least 20% to measures supporting the digital transformation. With these commitments, the combined NextGenerationEU Recovery Plan and the EU's seven-year budget contribute approximately 0.36% GDP and 0.14% GDP on average per year respectively to addressing the additional investment needs for the climate and the digital transitions ([80]). In May 2022, the Commission proposed to address the REPowerEU investment needs through the Recovery and Resilience Facility. The proposal adds security of supply to the objectives of the facility and provide further funding ([81]). Private funds will, however, be required to account for the major share of investments, with EU and national budgets providing important complementary funding to support policies and investments.

III.3.2. The different role of private and public funding for the digital and green transitions

Private investment finances most of the digital transformation, as economic returns can largely be attributable to the investors. Private and public investments are considered complementary. Public policy should focus on creating enabling conditions and correcting market failures. For communication networks, complete reliance on private funding can deprive rural populations of the equal access to high-speed connectivity as their urban counterparts, with related negative impact on job opportunities and access to services. Public funding is also crucial in closing the digital skills gaps, for the digitalisation of public services, as well as for cybersecurity for public services and critical infrastructures. When it comes to the development and deployment of advanced technologies, essential for the competitiveness and technological sovereignty of the European economy, public intervention should focus on removing any undue regulatory obstacles, avoid market fragmentation, enhance access to finance for credit constrained innovative SMEs, and provide R&D support. Public funding can play a role in addressing the funding gaps in the scale-up of innovative and strategic technologies. This includes capital-intense sectors with high barriers to entry, where the EU is lagging behind and is too dependent on other regions or on a limited number of companies.

In contrast, environmental and climate policy is based on the need to reduce and internalise negative (environmental) externalities of economic activities and to promote sustainable alternatives, to address market failures. As a result, the green transition is policy driven (rather than market driven), with a major role for the public sector acting as regulator, providing incentives, funding, and the enabling framework to drive investments towards clean technologies. Generally, public finances or policy have a role to fill when there is a lack of private funding, i.e., when the activity is not seen as generating sufficient private returns, or it is considered as too risky. This can be due to various market failures, e.g., asymmetric information, public goods etc. Due to the networks features in the provision of services such as transport, water, and energy, the public sector traditionally also plays a major role in infrastructure investment in these sectors, even if this differs across Member States and sectors. Public investment and public funding play a significant role when the market does not deliver the desired results. It can provide a strong signal and steer the private financing towards activities that support the policy objectives. Finally, it is worth stressing that private financing also plays an important role in the case of the green transition and covers a large share of the investment needs, although less than for the digital transformation.

III.3.3. Indications of the share of private and public funding based on historical investment shares

There are no estimates of the split between the need for private versus public funding for the

([79]) The estimate of 1.98% of EU GDP on average per annum is obtained by taking the combined NextGenerationEU Recovery Plan and the EU's seven-year budget in current prices (EUR 2,02 trillions) divided by EU 2021 GDP in current prices and by 7 years.

([80]) These are rough estimates based on the climate and digital targets,and are subject to underestimating factors as some additional spending in the MFF/NGEU is not covered, and potential overestimation as it assumes that all funding for loans under the RRF will be committed.

([81]) COM(2022)231final

green transition. The available estimate of the investment needs only provide overall figures ([82]). Over the period 2011-2020, the share of public investment in the total investment, was about 15% ([83]) with a high degree of heterogeneity across countries. Bruegel estimates the range between 20% and 25% ([84]) for the future investment needs for the energy and climate dimensions.

On this basis, and taking the total investment needs discussed above, public investment needs for the green transition could be roughly estimated to increase by an indicative 0.4% to 0.7% of GDP on average per year over the 2021-2030 period compared to 2011-2020. This number is to be considered as a rough order of magnitude, as it does not take account of several important dimensions. First, as mentioned above, the estimated total investment needs for the green transition do not only include investment in the strict statistical sense, i.e., GFCF spending, but also some spending that would statistically be classified as consumption, e.g., private cars and household appliances. The fact that the public sector would have a role to incentivise part of these investments through subsidies and tax expenditures are not accounted for. Second, investment or expenditures related to climate adaptation are not included, nor is any compensatory/social expenditure related to the transition ([85]). Overall, the estimated range is subject to a high degree of uncertainty.

The split between public and private investment needs would in practice differ across countries and depend on several factors, including:

- The choice of policy instrument - Policy instruments to achieve greenhouse gas reductions vary in nature, and in their impact on public finances. Their incentivising effect on private investment can also differ. For instance, a subsidy to trigger private investment in electric vehicles would help reduce greenhouse gas emissions in the transport sector through private investment. Similarly, Feed-in premiums (FIPs) can be used to support renewable energy producers and Member States can support energy efficient renovations through tax credits or various financial instruments, such as public guarantee schemes and loan facilities combined with subsidies targeting vulnerable groups. However, these types of measures would have an impact on public budgets either through foregone tax revenue or increased expenditure. On the other hand, taxation on combustion engine vehicles can ensure higher prices relative to clean mobility and therefore incentivises a shift towards clean mobility, and at the same time raises revenues for public budgets. Similarly, and even more cost-efficiently, using greenhouse gas emission trading, such as through the EU Emission Trading System, can incentivise the shift to clean technologies through an efficient price set by the market while producing public revenue through auctioning.

- Economic structure and role of the state in the economy - While this article primarily focusses on general government investment as defined in national accounts, the notion of public investment may also be seen in a broader sense, encompassing investments conducted by state-owned companies (SOEs) that in many instances are classified within the corporate sector in national accounts. The share of public ownership can vary across countries and will notably depend on the share and structure of SOEs. More generally, the ownership of natural monopolies holding network infrastructure, e.g., electricity grids, will vary as these have been privatised in some Member States but not in others. How residential investments are

([82]) The total additional (public and private) investment needs for the green transition in the EU are estimated at around EUR 520 billion annually up to 2030 as described in footnote 72. The Regulation on the Governance of the Energy Union and Climate Action contains a requirement for Member States to analyse additional public finance support or resources to fill identified gaps in the implementation of National Energy and climate Plans (NECP). However, the information provided in practice in the current NECPs are not detailed enough to provide a complete and robust overview of the needs for public funding.

([83]) At Member State level, this ratio varies between 5.9% to 28.5% in 2020, with an average of 14.9%.

([84]) Darvas, Z. and G. Wolff (2021) 'A green fiscal pact: climate investment in times of budget consolidation', *Policy Contribution* 18/2021, Bruegel

([85]) Reallocations of physical and human capital across sectors and regions will be needed and imply adjustment costs, while rising energy prices will have a regressive impact. Also carbon pricing may have regressive impacts if no corrections are in place, for instance related to the use of revenues. First, Member States can take measures to protect those most at risk of energy poverty or vulnerable transport users through direct support, tax reductions on energy bills, or allowances/subsidies for the purchase of clean vehicles or energy efficiency investments. Second, some measures can implicitly affect public finances through automatic stabilisers (i.e. higher unemployment benefits), and through higher costs of living due to higher energy prices and more expensive appliances. Regions and industries in transition could create further public finance needs due to support for the restructuring of the local economy.

classified will depend on the level of public housing. It is clear that the level of public investment in this broader sense will vary from country to country, but it will certainly be significant. Using Orbis data, a study by KPMG and Bocconi University [86] shows that in 2015 EU governments had stakes in around 37,000 companies, corresponding to more than EUR 5 trillion of assets (amounting to 40% of GDP of that year). Stakes reflect different degrees of public ownership, from full ownership to minority share holding.

Beyond the issue of the public versus private funding of the investment needs, the government sets the (regulatory) conditions that affect the transitions and the overall economic impact. This concerns in particular reforms that address absorption capacity constraints and facilitate the necessary shifts in the labour market as well as the entry of new businesses and competition in product markets to encourage the adoption of new technologies and a more efficient use of resources.

III.4. The effects of the fiscal framework on public investment

III.4.1. Theoretical and empirical literature on the effect of fiscal rules on public investment

There is a broad range of explanations for low public investment in the EU:

(i) Member States' public investment decisions appear to have been constrained by fiscal pressure and adverse macroeconomic conditions, in particular high public debt [87], poor economic conditions [88], and especially the global financial crisis [89];

(ii) Increased privatisation and the emergence of Public Private Partnerships (PPP) have weighed on public investment [90];

(iii) The impact of demographic changes appears not to be clear cut. On the one hand, a larger proportion of elderly people can depress public investment, since elderly people appear to discount future payoffs more heavily than younger people. Similarly, there is persuasive evidence in favour of the 'social dominance' hypothesis in the sense that social expenditure growth is a strong determinant of future negative growth in public investment [91] [92]. On the other hand, rising longevity could heighten the demand for long-lasting public goods, since more people live long enough to take advantage of the investments made [93] and investment is required to transform current savings for retirement into future (higher) consumption;

(iv) Structural factors behind lagging and sub-optimal investment reflect ineffective public investment management such as lack of investment pipelines, inadequate administrative capacity, poor governance and weak institutions.

At the same time, there has been a lively debate on the impact of fiscal rules on public investment. From a *theoretical* point of view, the relationship between fiscal rules and public investment is ambiguous. Some argue that fiscal rules have a negative impact on public investment, since they could (i) distort the relationship between investment and current expenditure [94] and thereby favour projects with higher short-term

[86] See European Commission (2018), 'Public Assets: What's at Stake? An Analysis of Public Assets and their Management in the European Union', European Economy Discussion paper 89.

[87] Bacchiocchi, E., E. Borghi and A. Missale (2011), Public investment under fiscal constraints, Fiscal Studies, 32(1), 11-42; Vuchelen, J. and S. Caekelbergh (2010), Explaining public investment in Western Europe, Applied Economics, 42(14), 1783-1796.

[88] Mehrotra, A. and T. Välilä (2006), 'Public investment in Europe: Evolution and determinants in perspective', *Fiscal Studies*, 27(4), 443-471.

[89] European Commission (2017), Report on Public Finances in EMU.

[90] See e.g. model by Easterly, W. (1999), When is fiscal adjustment an illusion? World Bank Policy Research Working Paper 2109, that suggest that this is not a purely statistical effect.

[91] Delgado-Téllez, Mar, et al. (2022), The decline in public investment: "social dominance"or too-rigid fiscal rules?, Applied Economics, 54.10: 1123-1136, analyse the determinants of social and public investment expenditure dynamics and the interrelation between them. Their results show strong support for the "social dominance hypothesis", in the sense that social expenditure growth is a strong determinant of future negative growth in public investment. They also find that the flexibility of the fiscal rules does not seem to have played a significant role, once other first-order determinants are taken on board.

[92] Jäger, P. and T. Schmidt (2016), 'The political economy of public investment when population is aging: A panel cointegration analysis', *European Journal of Political Economy*, 43, issue C, 145-158.

[93] Gonzalez-Eiras, M. and D. Niepelt (2012), 'Ageing, government budgets, retirement, and growth', *European Economic Review*, 56, 97-115.

[94] Buiter, W. (1984), Measuring aspects of fiscal and financial policy, NBER Working Paper 1332.

against long-term returns ([95]) or (ii) lead to asset decumulation, e.g., due to inefficient (and excessive) privatisation ([96]). Others argue that fiscal rules have a positive impact on public investment, since they may (i) mitigate the deficit bias and create fiscal space for sustainable investment in the long run ([97]) or (ii) reduce the overspending bias in ideological and less productive investment ([98]).

III.4.2. The impact of the current EU fiscal rules on public investment

Empirically, the current fiscal rules appear to have had neither an encouraging nor a discouraging direct impact on public investment. Evidence from the early years of EMU finds no meaningful effects of EU fiscal rules on public investment ([99]). However, the short sample period makes an assessment challenging. The few available studies show that Member States tend to have been constrained in their investment decisions by the need to ensure debt sustainability and market pressure rather than by the EU fiscal rules ([100]). In fact, as indicated in the Commission Communication of 5 February 2020, the essential role of public investment to deliver public goods and to support sustainable public finances is well recognised in the EU's fiscal framework. There are provisions in the fiscal framework that have sought to protect the level of public investment during downturns and to incentivise the implementation of structural reforms, which contribute to sustainable public finances, including by raising potential growth. Overall, however, evidence shows that the current fiscal framework did not prevent a decline in the level of public investment during periods of fiscal consolidation, nor did it make public finances more growth-friendly, reflecting deliberate policy choices in the Member States ([101]). The investment clause does not appear to have had a substantial positive impact on public investment (see Section III.4.3) and the structural reform clause has had a rather limited success in promoting reforms. During periods of fiscal consolidation, it has often been more expedient to cut public investment or increase taxes rather than rationalising other expenditure items. In the downturn that followed the 2008 economic and financial crisis, under market pressure, Member States pursued fiscal adjustment by cutting public investment, often having a pro-cyclical impact. At the same time, fiscal rules coexisted with a low level of investment and failed to bring the long-lasting decline of public investment to a halt.

III.4.3. Enhancing the role economic governance framework to promote investment

While the Stability and Growth Pact (SGP) is in principle neutral – not prescriptive – regarding the composition of public revenue and expenditure, it currently includes clauses for investment and structural reforms. These provisions are limited in scope and have been used only infrequently ([102]).

There is broad consensus on the need to strengthen provision in the governance framework to address the strong need to boost investment, both private and public, to make a success of the twin transition ([103]). Paying specific attention to

([95]) Based on this line of reasoning, voters seem to be rather insensitive to cuts in public investment in times of fiscal pressure, given its limited visibility and more diffuse character (Buiter, W. (1984), Measuring aspects of fiscal and financial policy, NBER Working Paper 1332.; Blanchard, O. and F. Giavazzi, 2004): Improving the SGP through a proper accounting of public investment, CEPR Discussion Paper, 4220, February).

([96]) Easterly, W. (1999), When is fiscal adjustment an illusion? World Bank Policy Research Working Paper 2109.

([97]) Turrini, A. (2004): Public investment and the EU fiscal framework, European Economy. Economic Papers, 2002, May.

([98]) Beetsma, R. and van der Ploeg, F. (2007): The political economy of public investment, CEPR Discussion Paper DP6090, February. Galí, J. and Perotti, R. (2003), Fiscal policy and monetary integration in Europe, Economic Policy 18, 533-572; Turrini, A. (2004): Public investment and the EU fiscal

([99]) Galí, J. and Perotti, R. (2003), Fiscal policy and monetary integration in Europe, Economic Policy 18, 533-572; Turrini, A. (2004): Public investment and the EU fiscal framework, European Economy. Economic Papers, 2002, May; Perée, E. and T. Välilä (2005): Fiscal rules and public investment, Economic and Financial Report, 2005/02; Heinemann, F. (2006): Factor mobility, government debt and the decline in public investment, IEEP, 3, 11-26. Mehrotra, A. and T. Välilä (2006): Public investment in Europe: Evolution and determinants in perspective, Fiscal Studies, 27(4), 443-471.

([100]) Bacchiocchi, E., E. Borghi and A. Missale (2011), Public investment under fiscal constraints, Fiscal Studies, 32(1), 11-42. Heinemann, F. (2006): Factor mobility, government debt and the decline in public investment, IEEP, 3, 11-26.

([101]) European Commission (2022), Do negative interest rate-growth differentials and fiscal rules matter for the quality of public finances? New evidence, Report on Public Finances in EMU 2021, Institutional Paper 181, July, 59-86.

([102]) For example, the investment clause focused on the specific situation of a deep downturn and has only been used twice, while the structural reform clause has been applied five times but with limited success in promoting reforms. For further info, see Commission Communication of 23 May 2018 on "the review of the flexibility under the Stability and Growth Pact", COM(2018) 335 and Commission Communication of 5 February 2020, 'Economic governance review: Report on the application of Regulations (EU) No 1173/2011, 1174/2011, 1175/2011, 1176/2011, 1177/2011, 472/2013 and 473/2013 and on the suitability of Council Directive 2011/85/EU1', COM(2020) 55.

([103]) Calls for strengthening public investment were also supported by the challenging economic conditions and low interest rate environment prior to the 2022 increase in rates. Blanchard, O.

how the economic governance framework can promote investment is also key in view of the positive effects of investment (and growth enhancing reforms) on debt sustainability.

Some argue for golden rule type provisions that allow for debt-financing of (net) public investment. Such provisions would give a clear incentive to prioritise investment over other expenditure categories, while the limited experience so far does not allow to draw robust conclusion on their effectiveness [104]. The scope could be different depending on whether social, economic and or environmental considerations prevail. For instance, one possibility would be to support (global) public goods, whose benefits extend largely across borders. The main example of such (global) public goods concerns investments that aim to reduce CO2 emission and address climate change. In the context, Darvas and Wolff (2021) call for a 'green' golden rule to be superimposed to the current adjustment provisions of the preventive arm of the SGP [105]. At the same time, they also create measurement challenges and make fiscal rules more complex. They also could incentivise creative accounting, which could pose challenges in terms of statistical validation in the context of budgetary surveillance. The proliferation of calls for specific 'golden rules', e.g., to cover military expenditure, tends to confirm the concerns about the viability of the golden rule approach. There may also be a need to consider trade-offs in terms of debt sustainability of additional debt financing for golden rules where those concerns are most pronounced.

A medium-term approach to economic governance based on comprehensive plans covering investment and reform commitments may help public investment planning. Specific incentives may further contribute to safeguarding and raising investment in the plans. Adequate enforcement provisions and strong national ownership of the plans including the investment commitments should contribute to full implementation and ensure that investment is not reduced to achieve necessary fiscal adjustment. Finally, by credibly strengthening debt sustainability and sustainable growth the revised governance framework should contribute to improving the conditions for private investment as well.

Moreover, well-designed national rules and institutions may contribute to better quality of public finances with higher investment levels (see also Section IV). When. measured by the strength of national fiscal rules index or the World Bank's effectiveness of institutions' index well-designed national rules and institutions appear to reduce the negative impact of public debt on public investment [106]. Sound institutions contribute not only to the quantity of public investment, but also to its quality. In advanced economies, about a fifth of public investment spending is lost to inefficiencies, half of which results from poor public investment practices throughout the investment cycle [107]. Public investment management could be improved in a number of ways [108]:

(i) Better strategic planning, that is fiscally realistic and linked to the annual budgetary process, could provide much needed stability while avoiding rushed spending decisions [109]. By limiting underspending, targets on capital expenditure, for example, as part of a stable medium-term budgetary framework, offer a good way to both protect capital availability throughout the projects' lifetime while grounding spending decisions in the strategic plan.

(ii) Furthermore, independently reviewing project appraisals can reduce the optimism bias inherent in most projects appraisals. In terms of project implementation, good practice suggests, inter alia, the need to define responsibilities and accountabilities, need for standardised rules for

(2019), 'Public Debt and Low Interest Rates', *American Economic Review*, 109(4), 1197-1229.

(104) See Basdevant et al 2020.

(105) Darvas, Z. and G. Wolff (2021) 'A green fiscal pact: climate investment in times of budget consolidation', *Policy Contribution* 18/2021.

(106) European Commission (2017), *Report on Public Finances in EMU.*

(107) Baum A., Mogues T., and Verdier G., (2020), 'Getting the Most from Public Investment', Chapter 3 in Well Spent: How Strong Infrastructure Governance Can End Waste in Public Investment, Schwartz, G., Fouad, M., Hansen, T., and Verdier G. (eds.), International Monetary Fund, Washington, DC.

(108) See Belu Manescu C. (2022), 'New Evidence on the Quality of Public Investment Management in the EU', European Economy Discussion paper 177, European Commission.

(109) OECD (2017), 'Getting Infrastructure Right: a Framework for Better Governance', OECD Publishing, Paris; IMF (2018), 'Public Investment Management Assessment – Review and Update', International Monetary Fund, Washington, DC; Kim J.H., Fallov J. A., and Groom S, (2020), 'Public investment management reference guide', International Development in Practice. Washington, DC: World Bank. doi:10.1596/978-1-4648-1529-4. License: Creative Commons Attribution CC BY 3.0 IGO (eds.).

project adjustment and efficient procurement systems.

(iii) Finally, the entire system can benefit from regularly carrying out ex-post reviews of implemented projects, whose lessons could feedback into future rules for project design. While patchy, existing evidence in the EU suggests that room for improvement exists in most countries, to varying degrees, and that much can be learned from each other.

Complementing the EU governance framework and fiscal rules with strengthened national budgetary processes could in particular better incorporate the impact of climate change and climate policies. For example, green budgeting, mainstreaming and debt sustainability assessments would contribute to a better-informed decision-making. More generally, specific attention could be paid to the composition and quality of public finances, the adequacy and efficiency of investments to support the twin transition and public investment bottlenecks in the context of the broader economic governance framework. Such enhanced analysis and monitoring could strengthen incentives for reorienting spending towards climate investment.

III.2. Conclusions

While the economic literature does not suggest that EU fiscal rules have had an overall negative nor positive effect on public investment, there is broad consensus that the revision of the fiscal framework should contribute to strengthening investment spending. Golden rule type provisions may give incentives to prioritise investment over other expenditure categories, but in practice create measurement and definition challenges and make fiscal rules more complex and subject to creative accounting.

A medium-term approach to economic governance in which surveillance is based on comprehensive plans covering fiscal, reform and investment commitments may be a more effective way forward, especially when complemented with additional provisions and incentives for raising investment.

IV. Improving compliance with the EU fiscal framework through stronger ownership and enforcement

By Henk Van Noten, Elva Bova, Gilles Mourre and Christian Weise

Abstract*: This section examines compliance with the EU fiscal framework over the last decade. The corrective arm turned out to be an effective tool for reducing and maintaining government deficits below the 3% of GDP reference value of the Treaty. By contrast, fiscal performance under the preventive arm has been heterogeneous across Member States. The degree of compliance is linked to national ownership and to effective enforcement. The evidence also shows a weak compliance with national rules, pointing to a lack of ownership also vis-à-vis the national fiscal framework. The section also presents avenues for improvement. First, a stronger medium-term dimension could better meet national needs and capacities, with respect not only to fiscal adjustment but also to planned reforms and public investments. Second, simplification of the framework could improve compliance, for example, by relying on a single operational indicator rather than a complex set of rules. Third, a stronger involvement of national independent fiscal institutions can increase ownership. Finally, the use of a broader range of enforcement tools in the surveillance process, with a greater use of reputational sanctions and a strengthening of the debt-based EDP could improve enforcement.*

IV.1. Introduction

The six-pack legislative reform of the EU fiscal framework in 2011 strengthened the Stability and Growth Pact (SGP) in response to the vulnerabilities exposed by the economic and financial crisis ([110]). This included the introduction of a specific enforcement procedure for the preventive arm, the significant deviation procedure, coupled with a gradual system of financial sanctions for euro area Member States. It also included an attempt to operationalise the debt criterion of the Treaty (debt 'below 60%' or 'sufficiently diminishing' to that level) through the introduction of the debt reduction benchmark (for a reference see Section I).

However, compliance with the reinforced fiscal rules has been uneven. By and large, compliance can be seen as tightly related to national ownership, which implies the support and endorsement by national governments of the fiscal framework, and also to an effective enforcement. Against this background, this section discusses possible ways to increase national ownership, including a medium-term orientation for fiscal policy, an increased reliance on nationally-determined plans and stronger national frameworks. It also surveys various possible enforcement tools.

The section is structured as follows. Subsection IV.2 provides an assessment of recent compliance with the EU fiscal framework, looking at both the preventive and the corrective arms, offering some explanations for the lacklustre results. Subsection IV.3 assesses how to strengthen ownership of the EU fiscal rules, including the role of national fiscal frameworks, in order to improve compliance. Subsection IV.4 discusses different instruments to better enforce fiscal rules. Finally, Subsection IV.5 concludes.

IV.2. Compliance with the EU fiscal framework: mixed records and reasons

IV.2.1. A mixed record over the last decade: uneven between the corrective and preventive arms and across Member States

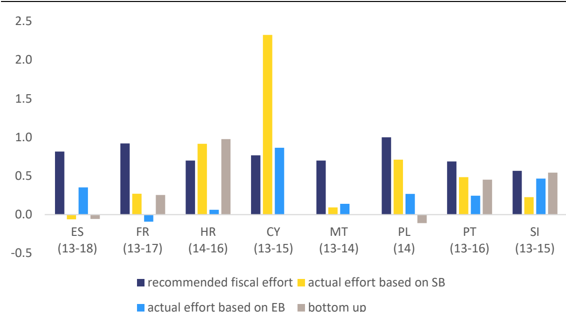
Since the six-pack reform of 2011, the corrective arm of the SGP ([111]) has been an effective tool for reducing and maintaining government deficits below the 3% of GDP reference value of the

([110]) The Maastricht Treaty focused initially mainly on the correction of 'gross errors', specifically through the excessive deficit procedure (EDP). In 2011, the six-pack reinforced the preventive arm, in particular by requiring the achievement of a differentiated MTO, with the aim of ensuring the sustainability of public finances or a rapid progress towards such sustainability while allowing room for budgetary manoeuvre, considering in particular the need for public investment. For more details, see Section I.

([111]) The corrective arm of the SGP ensures that Member States adopt appropriate policy responses to correct excessive deficits or debt levels by implementing the Excessive Deficit Procedure, which provides Member States with binding and operational recommendations on the fiscal adjustment needed to correct the excessive deficit situation within a given timeframe. See also Section II.

Treaty ([112]). However, after an initial period of strong consolidation (also reflecting market pressure), headline deficits were further reduced thanks to improving economic conditions rather than to discretionary fiscal efforts. As a consequence, the average fiscal effort in some Member States under the corrective arm remained far below the effort recommended by the Council (see Graph VI.1).

Graph IV.1: **Average fiscal effort under corrective arm by Member State since 2013 (% of potential GDP)**

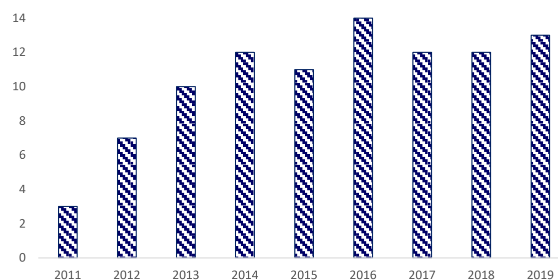


Note: *actual effort based on SB* refers to the annual change in the structural balance; *actual effort based on EB effort* refers to the fiscal effort as measured by the expenditure benchmark methodology; *bottom-up* refers to the (discretionary) changes in revenue and expenditure in comparison to the projections at the time of the EDP Recommendation.
Source: Commission staff calculations.

At the same time, no excessive deficit procedures have been opened on the basis of the debt criterion (so-called 'debt-based EDP'), despite its operationalisation in the 2011 reform. The dynamic of the general government debt has been uneven in the EU, with some Member States' debt ratios continuing to rise or, at best, stabilising (after the euro area debt crisis). Divergent debt dynamics across Member States reflected large differences in the pace of fiscal consolidation the impact of the economic growth-interest rate differential as well as in country-specific fiscal costs related to support measures for the banking sector. By 2019 around half of the Member States had debt levels below 60% of GDP while some others had their debt around or above 100% of GDP. While the decline in debt in some Member States fell short of the debt reduction benchmark, no EDPs have been initiated solely on the basis of the debt criterion, a decision in part justified by the unrealistically high effort imposed by the benchmark while these Member States broadly complied with the preventive arm requirements.

Since the six-pack reform of 2011, compliance with the preventive arm ([113]) has also been mixed, with a large heterogeneity between Member States. Between 2012 and 2016, most Member States corrected their excessive deficits and became subject to the (reinforced) preventive arm. They were required to gradually reduce their structural deficits until reaching their medium-term budgetary objective (MTO). On the one hand, around half of Member States had reached their MTO by 2016 (see Graph IV.2), sometimes helped by interest and revenue windfalls. Some of these Member States even exceeded their MTO substantially. After 2016, the number of Member States at their MTO did not further increase in spite of relatively favourable economic conditions.

Graph IV.2: **Number of Member States at MTO (2011-2019)**



Source: Commission staff calculations.

On the other hand, the other half of Member States did not reach their MTO or moved away from it after having reached it.

Among the Member States not complying with the average required net expenditure growth ceiling ([114]), some Member States, considered

([112]) See Box 1 in European Commission (2020), 'Staff Working Document on the Economic governance review', SWD (2020) 210 final.

([113]) The preventive arm of the SGP supports Member States in achieving their commitments on sound fiscal policies. It requires that Member States attain a country-specific budgetary objective over the medium-term, which takes into account the economic cycle, thus allowing for automatic stabilisation while it is conducive to sustainable public finances.

([114]) To better monitor how Member States implemented their budgetary commitments, the six-pack reform introduced an expenditure benchmark as a complement to the structural balance indicator. The expenditure benchmark provides more operational guidance to Member States in the conduct of prudent fiscal policies, by focussing surveillance on an indicator directly under the control of the government, notably the growth of primary expenditure net of discretionary revenue measures and cyclical unemployment spending ('net expenditure growth'). The allowed

broadly compliant with the SGP provisions, on the basis of the 'broad compliance margins' and flexibility provisions (e.g., unusual event clause) included in the legislation, despite a limited adjustment towards their MTO. Only Romania and Hungary were found to significantly deviate from the preventive arm requirements, resulting in the opening of significant deviation procedures in 2017 (for Romania), and in 2018 and 2019 (for both Member States).

IV.2.2. Reasons behind the uneven compliance

Deviations from the SGP requirements stem from various reasons.

- First, the assessment of compliance focused on annual figures rather than a medium-term orientation, allowing for an accumulation of deviations over time. While the SGP has in principle a strong medium-term focus, in practice, a strong emphasis is placed on an assessment of annual targets. The focus on medium-term performance (both backward- and forward-looking) has arguably further receded with recent reforms, including because of the link instituted between the assessment of compliance with the debt criterion of the EDP and that with the annual requirements of the preventive arm. Such emphasis on annual adjustments has made it more difficult to differentiate between Member States that have markedly different fiscal positions and sustainability risks ([115]).

- Second, the requirements associated with the debt reduction benchmark have proved not to be realistic. For example, enforcing the debt reduction benchmark during periods of weak real growth and very low inflation was politically and economically difficult ([116]). In some highly indebted countries, the debt reduction benchmark required particularly high fiscal efforts that could actually have aggravated the debt dynamics. Therefore, when assessing breaches of the debt reduction benchmark, the Commission's assessment and the subsequent opinions issued by the Economic and Financial Committee considered the debt criterion fulfilled on the basis that these Member States broadly compliant with the requirements of the preventive arm.

- Third, specific economic circumstances played a role. For example, in highly indebted Member States, the social scarring caused by contractionary fiscal policy in the wake of the global financial crisis and the sovereign debt crisis, prompted governments to slow the pace of adjustment after a very strong pro-cyclical consolidation in 2011-2013 which was primarily driven by market pressure. This implied that, under the corrective arm, the improving economic conditions as of 2014 helped Member States to reach the nominal targets of their EDP recommendations without implementing the structural adjustment targets ([117]). Then, once under the preventive arm, the abrogation of EDPs took away the pressure for fiscal consolidation, often against the backdrop of the complexity and difficulties to communicate to the public the requirements of the preventive arm. In some Member States, this also happened in a context of low potential output growth and fiscal fatigue. Against this background, the Commission and the Council did not trigger enforcement procedures.

- Fourth, national ownership has been insufficient in some Member States, where the preventive arm was not a reference for fiscal policy in the national debate. The Commission's caution in strictly enforcing the preventive arm might have reinforced this lack of national ownership. In many cases, weak compliance with the EU framework was mirrored by weak compliance with the national fiscal framework. Evidence shows that over the past two decades, Member States have complied on average only 60% of the time with EU fiscal rules and slightly less with national fiscal rules (see Graph IV.3). Also, empirical estimations show that, while the existence of national fiscal rules per se has no implications on compliance with EU rules, having a well-designed national rule

net expenditure growth is set at a rate consistent with medium-term potential growth, or at a lower rate for Member States that are not at their MTO in order to achieve the necessary structural improvement towards their MTO. See also Section II.

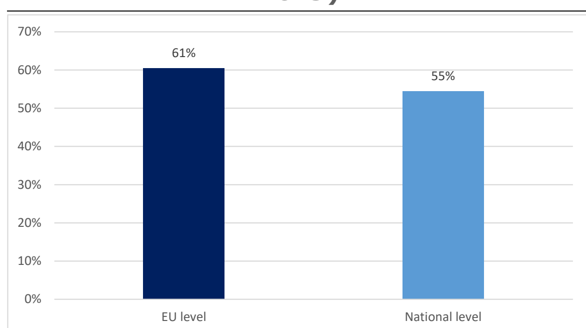
([115]) See European Commission (2020), 'Staff Working Document on the Economic governance review', SWD (2020) 210 final.

([116]) See Section I.

([117]) See: European Commission, 2018. 'Fiscal outcomes in the EU in a rules-based framework – new evidence', Report on Public Finances in EMU 2018, 105-156.

that is complied with supports compliance with EU fiscal rules ([118]).

Graph IV.3: **Average compliance rates with fiscal rules at EU and national level (1998-2019)**



(1) The numerical compliance rate refers to the average rate across four types of fiscal rules (structural balance, deficit, debt and expenditure rules), following the calculations in European Commission (2022). Compliance is measured as a dummy variable, where 1 refers to compliance and 0 to non-compliance.
Source: Commission staff calculations.

- Finally, the complexity of the overall fiscal framework and limited peer pressure further hindered compliance. Complexity, for example the reliance on multiple indicators including unobservable variables, hinders ownership and public communication. This makes it harder to get political traction, and easier to obscure a lack of compliance. A complex framework with many sub-rules provides incentives for Member States to follow the least constraining sub-rule, often in an inconsistent manner over time. Peer pressure might have been weak, as Member States tend to be reluctant to criticise each other's policy choices. In addition, serious peer surveillance requires a level of resources that goes well beyond what most Member States could make available.

IV.3.Supporting national ownership

Some features of a fiscal framework such as a strong medium-term orientation, simplification, and a strong national dimension can support ownership and compliance.

IV.3.1. A medium-term orientation

A medium-term approach helps reconciling different dimensions of fiscal policy, such as fiscal sustainability, macroeconomic stabilisation and the quality of public finances, in particular public investment. In addition, compared to annual targets, a medium-term approach might make it easier to take into account national priorities and needs, and can provide credibility and flexibility to the fiscal framework.

As most fiscal policy decisions have an impact that goes beyond the annual cycle, effective budget management requires medium-term planning. However, a medium-term dimension adds further challenges to the surveillance process, including changes in government and more uncertainty given the longer time horizon. Therefore, to be fully effective, such a medium-term orientation should rely on i) a binding commitment from the government, ii) regular, strong and independent monitoring, and iii) enforcement to limit frequent and discretionary revisions.

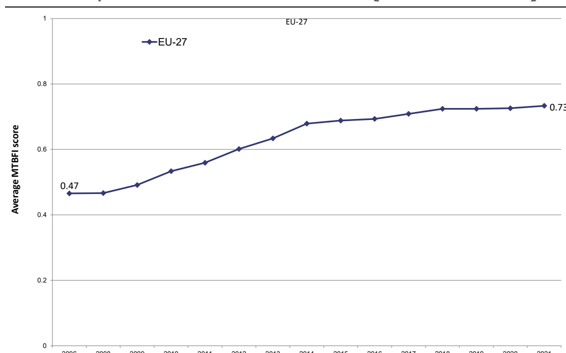
Spurred by the legislative momentum in the aftermath of the financial crisis, all Member States have developed medium-term budgetary frameworks (MTBFs), albeit to varying degrees. The Commission MTBF index points to a substantial improvement in the design and scope of MTBFs (Graph IV.4) ([119]). At the same time, empirical analysis shows MTBFs' positive contribution to fiscal outcomes ([120]).

([118]) European Commission (2022), "Do national fiscal rules support compliance with EU fiscal rules?". Part III, Report on Public Finances in EMU 2021.

([119]) The index compounds the following dimensions: coverage of the medium-term plans, link with the annual budget, involvement of national parliaments and IFIs and finally the level of details. All of these dimensions have improved over time.

([120]) See European Commission (2020) available here: https://economy-finance.ec.europa.eu/system/files/2020-02/swd_2020_211_en.pdf. The 2018 stakeholders' survey gathered evidence on the perceived effectiveness of Directive 2011/85 and was addressed to 73 national officials from Ministries of Finance, IFIs, and statistical offices.

Graph IV.4: **MTBF index (2006-2021)**



Source: European Commission Fiscal Governance Database

Despite these developments, there is room for improvement in various aspects. First, the binding nature of MTBFs remains unsatisfactory, as EU legal provisions do not prevent revisions of medium-term plans ([121]). In practice, annual updates to MTBFs are possible in many Member States; in most cases, conditions for updates are specified by national law ([122]).

Furthermore, EU legal provision do not require an explanation in case of revision, unless the revision is due to a change in government ([123]). In addition, unlike for national fiscal rules, there is no requirement on independent monitoring of compliance, nor for specifying consequences in the event of deviation from the medium-term targets. Finally, and reflecting the unsatisfactory binding nature of MTBF, consistency between annual budgets and multi-annual plans remains weak in many Member States ([124]).

IV.3.2. Simplification

Simplifying the current complex set of rules could contribute to better compliance. In this respect, focusing on one key anchor and one operational rule could facilitate the understanding of fiscal policy at the national level, thereby enhancing transparency and ownership.

As amply discussed in the relevant literature, among the various fiscal rules, expenditure rules seem to provide a better balance between budgetary discipline, as the aggregate is directly under the control of the policy makers, and macroeconomic stabilisation, as revenues would be allowed to fluctuate freely over the economic cycle ([125]). At the same time, they are transparent and easy to monitor, since the expenditure aggregate can be more easily translated into budgetary expenses. For this reason, an expenditure rule could serve as a good operational indicator.

In addition, an increased focus on gross errors could simplify the surveillance framework. This implies a focus of the EU framework on public debt sustainability and the actual risks associated to adverse dynamics over the medium term. This could become the anchor for fiscal policy, to be achieved by adhering to a single operational target, such as an expenditure rule. Such system would help improve the communication on the concrete economic risks associated to non-compliance and thus better reach out to national debates.

IV.3.3. A national dimension

Fiscal rules can be more credible and more owned by Member States if they take into account national preferences and policies, particularly reforms and investment programmes, which have implications for growth and debt sustainability. Therefore, the EU framework could give a larger role to national medium term budgetary plans, based on a technical dialogue between the EU and national governments, while maintaining a transparent common EU framework and multilateral surveillance.

At the same time, national independent fiscal institutions (IFIs) could also contribute to the surveillance process. IFIs are bodies that are structurally independent, or bodies endowed with functional autonomy vis-à-vis the budgetary authorities of the Member State, and which are

([121]) See Articles 9 to 11 in EU Council Directive 2011/85 on national budgetary frameworks.

([122]) In few cases, MTBFs are relatively stable over time (e.g. FR, IE, LT, NL).

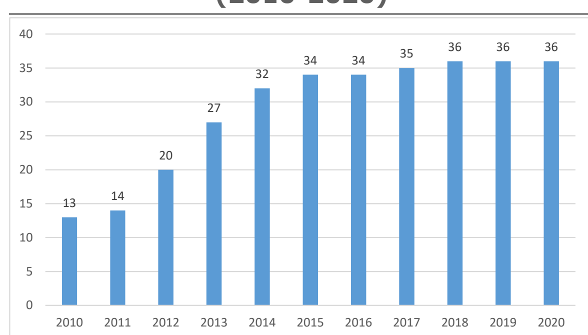
([123]) See European Commission (2020); and ECA 2019. Some of these points were also highlighted by ECA in its 2019 audit report on the EU budgetary framework provisions: namely, (1) a single process for preparing MTBF and annual budget and fully integrated documentation, (2) forward looking expenditure controls, (3) monitoring and accountability mechanisms, (4) indicative ceilings for out years and (5) spending estimates for out-years rolled over form one MTBF to the next.

([124]) In some Member States (e.g., BG, LU, LV) the MTBF and annual budget are prepared at the same time, which ensures consistency at least for the first year of the MTBF.

([125]) See Ayuso-i-Casals (2012), "National Expenditure Rules – Why, How and When", European Economy Economic Papers No 473, European Commission, Brussels, and Belu Manescu and Bova (2022) "National Expenditure Rules in the EU: An Analysis of Effectiveness and Compliance", ECFIN Discussion Paper 124.

underpinned by national legal provisions ensuring a high degree of functional autonomy and accountability. IFIs have gone a long way since their establishment in the Member States in the aftermath of the global financial crisis. They gained an established role in forecasting and monitoring compliance with fiscal rules. As shown in Graph IV.5, the number of IFIs has rapidly increased over time, particularly after the entry into force of EU requirements. In addition, their scope in terms of tasks and activities performed has increased over time, as captured by the Scope Index of Fiscal Institutions (SIFIs- Graph IV.6), which compounds information on the monitoring of rule compliance, production or endorsement of macroeconomic and budgetary forecasts, debt sustainability analyses, promotion of transparency and issuance of recommendations.

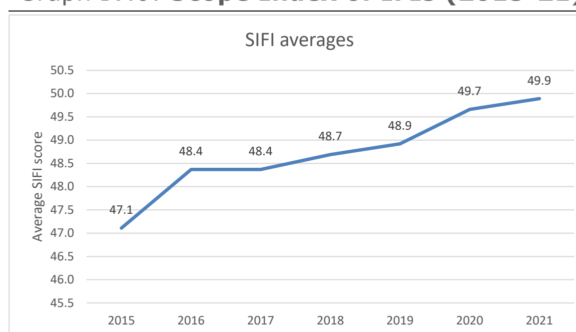
Graph IV.5: **IFIs in the Member States (2010-2020)**



Source: European Commission Fiscal Governance Database

The adoption of IFIs has been shown to increase accountability and improve fiscal performance, such as by enhancing the public debate on key fiscal policy decisions ([126]). For euro area Member States, IFIs also rely on rather strict independence requirements, such as i) not to take instructions from the budgetary authorities, ii) to have the capacity to communicate publicly, and iii) to have adequate and stable resources.

Graph IV.6: **Scope Index of IFIs (2015-21)**



Source: European Commission Fiscal Governance Database

Giving IFIs a role in the surveillance of the EU fiscal framework would require adequate safeguards for their independence and technical expertise. This could imply enhancing the competences and the resources of IFIs, while increasing their accountability by requiring regular external reviews of their activities, and/or, a 'comply or explain' principle to be applied to most IFI recommendations. The necessary distinction of roles between the national and the EU level in budgetary surveillance would also need to be preserved: while IFIs can provide inputs, enforcement of EU rules is the preserve of the Commission and the Council.

Strengthening national fiscal frameworks to support national ownership comprises more than MTBFs and IFIs. The production and publication of data on public finance as an indispensable base has improved in recent years, forecasts became more realistic and national fiscal rules are now better defined. Nevertheless, differences in accounting standards remain, budgeting is not as transparent as it could be, and rules are sometimes too complex.

IV.4. Enforcement instruments

In addition to more national ownership of fiscal requirements, a stronger enforcement could also contribute to better compliance. The EU fiscal framework contains a gradual system of financial sanctions that, however, have been used only to a very limited extent. For euro area Member States, the six-pack introduced a system of deposits and fines in the preventive arm and the EDP. The introduction of swifter sanctions and reverse qualified majority voting for Council decisions

([126]) See European Commission (2020), available here: https://economy-finance.ec.europa.eu/system/files/2020-02/swd_2020_211_en.pdf; Axiouglu and Grevesmuhl (forthcoming), Ecfin Discussion Paper Series and Beetsma et al. (2023) Beetsma, R. M. W. J., Debrun, X., & Sloof, R.. The political economy of fiscal transparency and independent fiscal councils. European Economic Review.

reinforced the role of the Commission ([127]). Outside the scope of the Stability and Growth Pact, EU funding can be suspended - even must in some circumstances - in case of non-compliance with the EU's fiscal framework under the macroeconomic conditionality of structural funds ([128]).

The Commission proposed the suspension of EU cohesion funds only for Hungary in 2012 due to a lack of effective action under the excessive deficit procedure. Subsequently, Hungary was deemed to have taken effective action well before the deadline, thus allowing the lifting of the suspension before it had taken effect. In 2016, Spain and Portugal were found not to have delivered effective action to correct their excessive deficit. However, the Commission recommended the cancellation of the fine that Regulation 1173/2011 would normally impose. Both countries were found to have taken effective action to the subsequent notice under TFEU Art. 126(9) by the time the required 'structured dialogue' with the European Parliament on the possible suspension of commitments or payments under European structural and investment funds had taken place, making the possible suspension outdated before it was proposed.

Financial sanctions risk to come too late and could aggravate fiscal challenges if they are of macroeconomic significance. However, the existence of such sanctions may still be useful as a deterrent for lack of compliance with the fiscal rules, and a last resort in case of serious non-compliance. An interesting experience concerns the application of financial sanctions in the field of public finance statistics, which were also introduced in the context of the Six-pack reform ([129]). These sanctions are based on a more detailed framework and carry mainly a reputational cost through adequate communication and small pecuniary costs (of no macroeconomic relevance) and therefore there seems to have been less reluctance to actively use them. For example, sanctions were imposed by the Council upon recommendation by the Commission on the Spanish region of Valencia in 2015, and on the Austrian state of Salzburg in 2018. Inspiration could also be taken from the case-law of the European Court of Justice, where financial sanctions linked to infringement of EU law are relatively modest but remain in place as long as the situation has not been addressed, providing an incentive for the government to rapidly correct the situation.

Even in the absence of financial sanctions, a credible threat of procedural steps in case of non-compliance could also act as a deterrent and therefore support compliance and enforcement. For example, since the two-pack reform, the reputational risk of seeing their budgetary plans being rejected by the Commission might have encouraged euro area Member States to better take into account the SGP's requirements when preparing their draft budgets ([130]). Similarly, the success of the 3% of GDP deficit limit illustrates governments' willingness to avoid the opening or stepping-up of the EDP, which comes with reputational costs and stricter surveillance. The debt reduction benchmark does not seem to have the same impact, as it is no longer considered as a realistic and credible requirement. In this respect, a clarification of the criteria for the opening - and abrogation – of the EDP for non-respect of the debt-based criterion (debt above 60% not sufficiently diminishing) could strengthen add a more credible enforcement step. Also, outside the EDP, reputational costs, as well as making use of early warnings, and targeted communication in case of serious non-compliance in the preventive arm, can contribute to better compliance.

The introduction of a notional control account - keeping track of deviations from the fiscal requirements - would also contribute to avoiding

([127]) The European Fiscal Board has argued that the introduction of reverse qualified majority voting has blurred the distinction between the analytical and (growing) political role of the Commission. It recommends a better separation between the economic analysis performed within the Commission and the policy decisions taken on the basis of that analysis. In addition, it proposes to remove the reverse qualified majority voting principle. See: European Fiscal Board (2019), "Assessment of the EU fiscal rules with a focus on the six- and two-pack legislation".

([128]) Macro-conditionality of EU funds has often been perceived as a sanction by extension. However, it needs stressing that its ostensible aim is not to ensure compliance with the SGP but to protect the financial interest of the European Union by ensuring proper functioning national institutions.

([129]) Regulation (EU) No 1173/2011 on the effective enforcement of budgetary surveillance in the euro area empowered the Commission to launch investigations if there are serious indications of manipulation of statistics, intentionally or due to serious negligence.

([130]) Since Regulation No 473/2013, euro-area Member States have been required to submit their budget plans for the coming year to the Commission and the Eurogroup. They are subsequently assessed by the Commission. The Commission can request a Member State to submit a revised plan in case of particulary serious non-compliance.

small annual deviations to give rise to a large cumulative deviation over the medium term, as was the case under the current preventive arm due to its annual focus. This information device would help retain memory to the system over the medium term, while increasing transparency and then the reputational costs of systematic deviations. Of course, deviations of different signs could also offset each other.

Reinforced and more targeted communication by the EU institutions in case of breaches, especially those endangering sustainability, could help reach out to the national policy debate, likely increasing the reputational costs of non-compliance. For example, some observers have stressed the outreach to national parliaments as a powerful step, in the spirit of national ownership.

As mentioned earlier, clarifying the conditions for the opening and abrogation of debt-based EDPs might be useful in this respect. A simpler framework could also make peer pressure more effective. Efficiency of reputational sanctions goes hand in hand with more national ownership and Member States having more scope to set and implement a fiscal adjustment plan. At the national level, communication by independent fiscal institutions could be strengthened by inserting 'comply or explain' obligations for governments with respect to IFIs' recommendations. National ownership will also increase the media coverage, which is in turn facilitating compliance through reputational effects ([131]).

Reputational costs might also contribute – to some extent – to better framing the disciplining effect of financial markets. Member States, in particular those with high debt, are under close scrutiny by financial market actors. Financial markets can react on assessments in the framework of EU (or national) fiscal surveillance, signalling to policy makers its appreciation of fiscal policy developments via the cost of credit. However, experience has shown that markets tend to react too late and too strongly, thereby amplifying rather than preventing shocks. In any cases, financial markets would likely be reassured - and thereby stabilised - by the effective implementation of credible fiscal rules.

([131]) See for instance European Commission (2021), "Does media visibility make EU fiscal rules more effective?". Report on Public Finances in EMU 2020.

Overall, none of the available enforcement tools can be seen as a panacea. Traditional financial sanctions – of macroeconomic significance - have proven their limits as the main enforcement tool. A greater use of reputational sanctions could be part of a stronger enforcement mechanism. Furthermore, they would need to be coupled with stronger ownership and a more medium-term approach. To be effective, different instruments would thus need to be combined. Reputational sanctions would need to be gradual, reflecting the gravity of the situation. Early warnings could be useful for Member States that risk entering an EDP. Ultimately, ownership and the willingness of Member States to comply with EU and national fiscal rules will remain a key condition for effective implementation of the fiscal framework.

IV.5. Conclusion

This section examined compliance with the EU fiscal framework over the last decade. Evidence shows that the corrective arm has been an effective tool for reducing and maintaining government deficits below the 3% of GDP reference value of the Treaty. As a caveat, compliance in the corrective arm was obtained mostly thanks to favourable macroeconomic circumstances in some Member States rather than by underlying fiscal adjustments, since the end target - staying or getting below 3% - is expressed in nominal terms. Evidence also indicates that fiscal performance under the preventive arm has been heterogeneous across Member States. Lacklustre and uneven compliance is linked to limited national ownership and weak enforcement. As regards enforcement, evidence illustrates that the EU had only used a narrow array of available tools. Lastly, evidence points to a weak compliance with national rules, suggesting a lack of ownership also vis-à-vis the national fiscal framework.

More ownership of fiscal requirements and better enforcement could improve compliance. As regards ownership, a stronger medium-term dimension, based on national medium-term plans, would be better calibrated to national needs and capacities, with respect to fiscal adjustment and reforms and investments. It would allow for a better planning of reforms and investments. This medium-term dimension could be underpinned by a single and simpler indicator based on net expenditure developments, which would help to simplify the current complex set-up of EU fiscal rules. A stronger national dimension would also

emerge from more involvement of national independent fiscal institutions in the process. As regards enforcement, using a broader range of tools in the surveillance process, with a greater use of reputational sanctions and strengthening the debt-based EDP, could improve effective implementation of and compliance with the fiscal rules.

Annex. The euro area chronicle

The Commission, the Economic and Financial Affairs Council and the Eurogroup regularly take decisions that affect how the Economic and Monetary Union (EMU) works. To keep track of the most relevant decisions, the QREA documents major legal and institutional developments, presented in chronological order with references. This issue covers developments between mid-September 2022 and mid-December 2022. Over the autumn, further Recovery and Resilience Facility (RRF) funds were disbursed while the Commission proposed to review macroeconomic surveillance rules in the euro area (and the EU) and adopted guidance to Member States for the conduct of their economic policy in 2023 ([132]).

Recovery fund disbursements to Italy and Cyprus. In the fourth quarter of 2022, the Commission continued to transfer funds under the Recovery and Resilience Facility (RRF). On 28 June 2022, Italy submitted to the Commission the second payment request based on the achievement of the 45 milestones and targets. They cover reforms in the areas of public employment (as part of a broader reform of public administration), public procurement, the teaching profession, tax administration and territorial healthcare. The payment request includes investments in key policy areas including ultra-broadband and 5G, research and innovation, tourism and culture, hydrogen, urban regeneration and the digitalisation of schools. This payment request also includes an investment to support the reform of the justice system and reduce the backlog of cases. On 27 September, the Commission adopted a positive preliminary assessment of Italy's request ([133]). Following the Economic and Financial Committee's opinion and agreement in the Economic and Financial Affairs Council, the Commission transferred EUR 21 billion to Italy, of which EUR 10 billion in grants and EUR 11 billion in loans. A similar process was followed with Cyprus. On 28 July 2022, Cyprus submitted its request for EUR 85 million in grants under the RRF. On 25 October, based on progress in reforms and investments in the electricity market, energy efficiency, circular economy, anti-corruption and transparency, measures in the financial sector, public administration, digital skills, as well as Cyprus' audit and control system for the implementation of the RRF, the Commission endorsed a positive preliminary assessment of the request ([134]).

Recovery fund disbursements to Greece and Portugal. A similar process was followed with Greece and Portugal. On 30 September 2022, Greece submitted to the Commission the second payment request based on the achievement of the 28 milestones and targets. They cover reforms and investments promoting the use of renewable energy, re-organising the railways sector, or opening up the public bus transportation market to improve services and to promote a greener bus fleet. They also support the digital transformation of small and medium-sized enterprises, interconnecting payment terminals with the tax administration, encouraging small companies to grow and export, enhancing the supervision of capital markets, creating new funding opportunities for research and encouraging new investments in the tourism, manufacturing and agriculture sectors. On 25 November, the Commission adopted a positive preliminary assessment of Greece's request ([135]). Following the Economic and Financial Committee's opinion and agreement in the Economic and Financial Affairs Council, the Commission transferred EUR 3.6 billion to Greece, of which EUR 1.7 billion in grants and EUR 1.9 billion in loans. Portugal also submitted its second request on 30 September 2022, and it was positively assessed by the Commission on 16 December ([136]). The request was based on the achievement of the 20 milestones and targets, which cover reforms in the areas of management of public hospitals and the digital transition in the private and public sectors. Several milestones and targets also concern major investments in the areas of health, forestry, water management, social protection, innovation, sustainable mobility, digital skills, culture, public finances and public administration. Following the Economic and Financial Committee's opinion and agreement in the Economic and Financial Affairs Council, the Commission transferred EUR 1.8 billion of grants and loans to Portugal.

([132]) Annex compiled by Jakub Wtorek. The cut-off date for this annex is 31 January 2023.
([133]) https://ec.europa.eu/commission/presscorner/detail/en/ip_22_5663.
([134]) https://ec.europa.eu/commission/presscorner/detail/en/IP_22_6333.
([135]) https://ec.europa.eu/commission/presscorner/detail/en/IP_22_7150.
([136]) https://ec.europa.eu/commission/presscorner/detail/da/ip_22_7710.

Review of macroeconomic surveillance rules. On 9 November 2022, the Commission presented its communication outlining the orientations for the reform of the economic governance framework ([137]). Improving national ownership, simplifying the framework, and moving towards a greater relevance of the medium-term focus, combined with stronger and more coherent enforcement, are key elements in the Commission's orientations. The communication aims to improve government debt sustainability and promote sustainable growth. The communication also proposes a more effective framework to detect and correct macroeconomic imbalances, as well as a more focused and streamlined post-programme surveillance that assesses the repayment capacity of Member States that have benefited from financial assistance programmes. The communication will feed into debate within the Council and with the European Parliament, with a view to reaching a broad consensus on the future design of the macroeconomic surveillance rules. While the framework is applied in the whole EU, it recognises the rationale for stronger rules within the monetary union, as euro area countries experience higher potential for spillovers due to, among other things, a common monetary policy.

Guidance for Member States on the economic policy. On 22 November, the European Commission adopted the so-called autumn package of the European Semester: a set of documents kicking off the annual cycle of economic policy coordination ([138]). The package includes: the Annual Sustainable Growth Survey, the Alert Mechanism Report, the Commission proposal for a Joint Employment Report, the proposal for a euro area recommendation as well as a set of country-specific documents related to fiscal policy guidance and to surveillance for euro area Member States that had exited financial programmes. The Annual Sustainable Growth Survey outlines the economic and employment policy priorities for the EU for the coming 12 to 18 months. The survey is articulated around four overarching policy objectives: environmental sustainability, productivity, fairness, and resilience. This year's survey put forward an agenda to coordinate EU policy responses to mitigate the negative impacts of energy shocks in the short term, and to continue increasing social and economic resilience and fostering sustainable and inclusive growth in the medium term. The Alert Mechanism Report assesses economic developments to identify Member States that may require the Commission to undertake in-depth reviews to detect if those Member States may be affected by macroeconomic imbalances. This year's report concludes that economic developments in thirteen euro area Member States require an in-depth review: Cyprus, France, Germany, Greece, Italy, the Netherlands, Portugal and Spain (which had all been subject to an in-depth review and found with imbalances or excessive imbalances in the previous annual cycle of Macroeconomic Imbalance Procedure surveillance), as well as Estonia, Latvia, Lithuania, Luxembourg and Slovakia (which were not subject to an in-depth review in 2021/2022).

A recommendation for actions to address key challenges in the single currency area. The recommendation for the euro area proposed by the European Commission presents tailored advice to euro area Member States on those topics that affect the functioning of the euro area as a whole. It recommends that euro area Member States take action over 2022-23, individually and collectively within the Eurogroup, to coordinate fiscal policy, which supports the timely return of inflation to the ECB's 2% medium-term target, and which targets fiscal measures to address the impact of high energy prices. Euro area Member States should sustain public investment for the green and digital transitions and energy security. The recommendation highlights the importance of fostering wage developments and social policies that limit the loss in purchasing power of wage-earners, while reflecting medium-term productivity developments and limiting second-round effects on inflation. The recommendation calls for supporting the business sector in the context of the energy crisis in a cost-effective, temporary, and targeted way, and for improving selected elements of business environment (e.g., insolvency frameworks), and preserving macro-financial stability.

Opinions on draft budgetary plans of euro area Member States. The European Commission also adopted 20 opinions assessing the compliance of draft budgetary plans for 2023 with the fiscal policy recommendations adopted by the Council in June 2022. Under the fiscal recommendations for 2023, low

([137]) COM (2022) 583 final, https://economy-finance.ec.europa.eu/system/files/2022-11/com_2022_583_1_en.pdf.
([138]) https://ec.europa.eu/commission/presscorner/detail/en/ip_22_7072.

and medium-debt Member States should ensure that the growth of nationally financed primary current expenditure is in line with an overall neutral policy stance. High-debt Member States were recommended to ensure prudent fiscal policy, in particular by limiting the growth of nationally financed primary current expenditure below medium-term potential output growth. For the first time, an opinion was also adopted on the Croatian budget considering Croatia's accession to the euro area in 2023.

Post-programme surveillance reports. The reports assess the repayment capacity of euro area Member States that have benefited from financial assistance programmes. The post-programme surveillance reports for Ireland, Greece, Spain, Cyprus and Portugal conclude that all five Member States retain the capacity to repay their debt. The report for Greece was the first one prepared for the country, following the end of the enhanced surveillance framework in August 2022. The report finds that Greece has taken the necessary actions to complete its specific commitments, despite the challenging circumstances due to Russia's war of aggression against Ukraine. This report could serve as a basis for the Eurogroup to decide on the release of a final tranche of policy-contingent debt measures agreed in June 2018.

EUROPEAN ECONOMY INSTITUTIONAL PAPERS SERIES

European Economy Institutional Papers series can be accessed and downloaded free of charge from the following address: Publications (europa.eu).

.

Titles published before July 2015 can be accessed and downloaded free of charge from:

- http://ec.europa.eu/economy_finance/publications/european_economy/index_en.htm
(the main reports, e.g. Economic Forecasts)

- http://ec.europa.eu/economy_finance/publications/occasional_paper/index_en.htm
(the Occasional Papers)

- http://ec.europa.eu/economy_finance/publications/qr_euro_area/index_en.htm
(the Quarterly Reports on the Euro Area)

GETTING IN TOUCH WITH THE EU

In person

All over the European Union there are hundreds of Europe Direct Information Centres. You can find the address of the centre nearest you at: http://europa.eu/contact.

On the phone or by e-mail

Europe Direct is a service that answers your questions about the European Union. You can contact this service:

- by freephone: 00 800 6 7 8 9 10 11 (certain operators may charge for these calls),
- at the following standard number: +32 22999696 or
- by electronic mail via: http://europa.eu/contact.

FINDING INFORMATION ABOUT THE EU

Online

Information about the European Union in all the official languages of the EU is available on the Europa website at: http://europa.eu.

EU Publications

You can download or order free and priced EU publications from EU Bookshop at: http://publications.europa.eu/bookshop. Multiple copies of free publications may be obtained by contacting Europe Direct or your local information centre (see http://europa.eu/contact).

EU law and related documents

For access to legal information from the EU, including all EU law since 1951 in all the official language versions, go to EUR-Lex at: http://eur-lex.europa.eu.

Open data from the EU

The EU Open Data Portal (http://data.europa.eu/euodp/en/data) provides access to datasets from the EU. Data can be downloaded and reused for free, both for commercial and non-commercial purposes.

Publications Office
of the European Union