

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

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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.

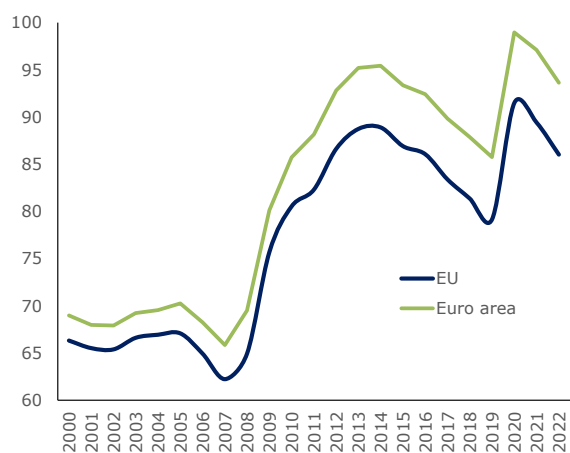
Despite the fast recovery from the COVID-19 shock and the almost completed withdrawal of crisis-related temporary emergency measures ⁽⁴⁾, the aggregate deficit in 2022 remained substantially above pre-crisis levels (at 3.4% of GDP in the EU and at 3.5% in the euro area). The still strong real GDP growth, 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.

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

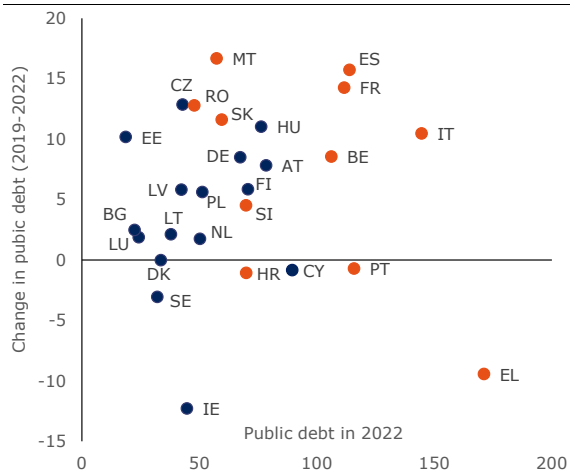
⁽⁴⁾ Temporary emergency measures are fiscal measures introduced since March 2020 to support healthcare systems and compensate workers and firms for pandemic-induced income losses. These measures are designed to keep the economy afloat and limit economic scarring. They are by nature temporary, with an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

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)



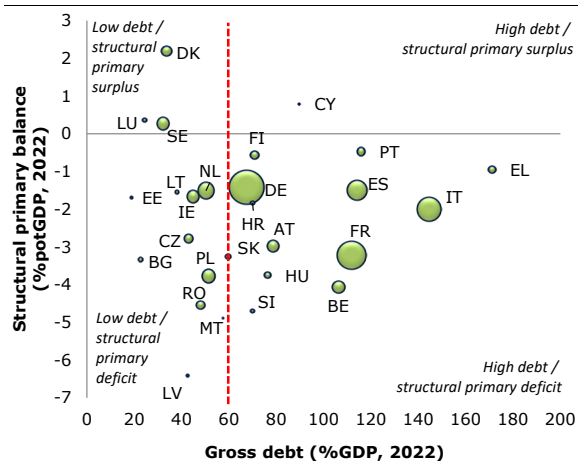
Note: The red circles denote Member States with high medium-term sustainability risks.

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

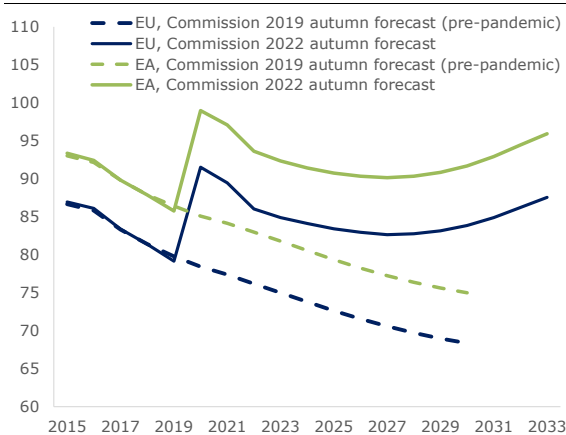
estimated to have had the highest structural deficits in 2022 for three reasons (see Graph I.3) ⁽⁵⁾. First,

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)**



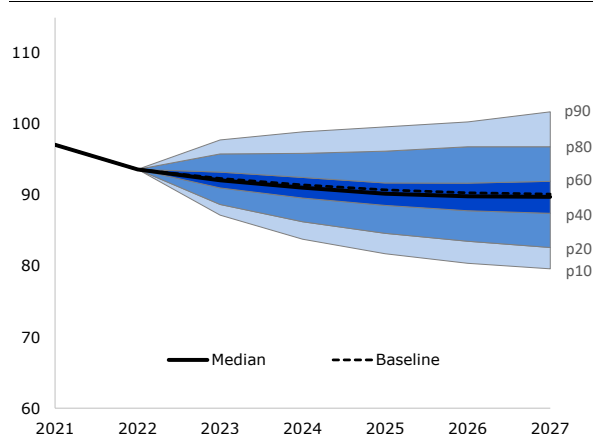
Source: European Commission (based on the European Commission's Debt Sustainability Analysis – see Fiscal Sustainability Report 2021 for the methodology).

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,

⁽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.

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

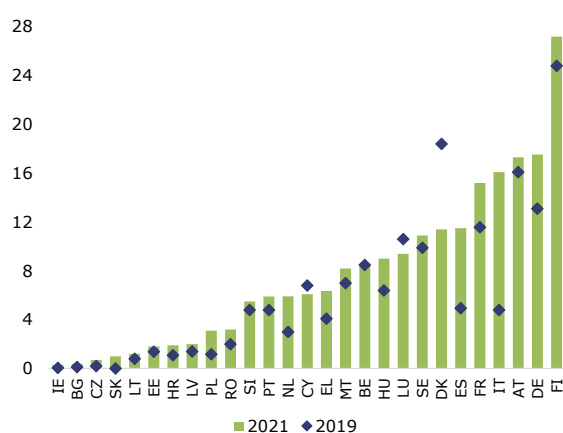
⁽⁶⁾ These projections are based on the Commission's standard Debt Sustainability Analysis (DSA) risk framework. They rely on a standard 'no-fiscal-policy-change' assumption implying that, as from 2024, no new measures are taken into account and the structural primary balance is only affected by projected 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.

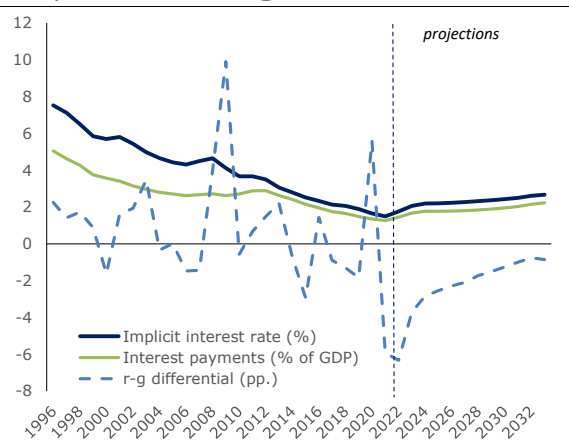
⁽⁹⁾ Risks related to contingent liabilities are only captured in the stochastic projections insofar as they are based on the historical volatility of underlying macroeconomic variables, including the primary balance, whose past developments reflect to some extent the materialisation of contingent liabilities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

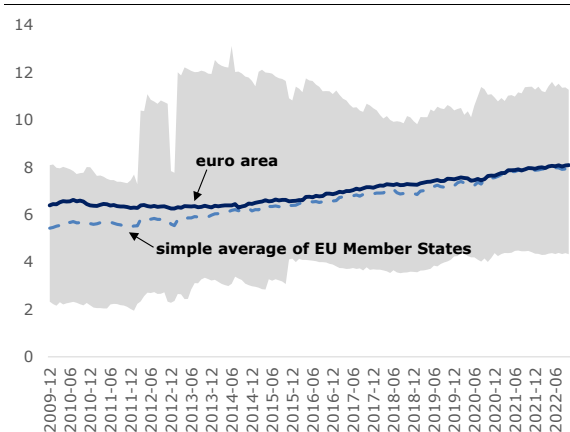
Graph I.7: **Financing conditions in the EU**



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 expected 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).

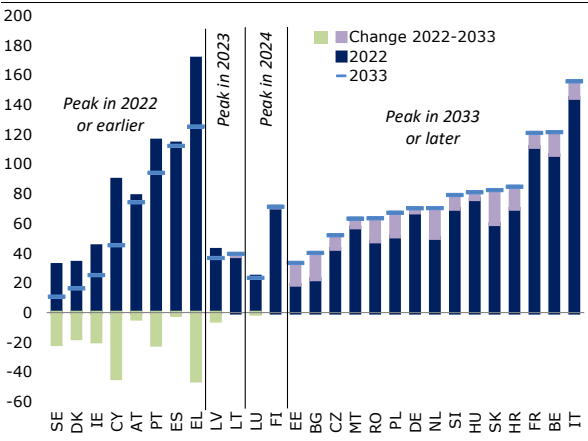
⁽¹³⁾ Gaspar, V., and Escolano, J. (2016), ‘Optimal debt policy under asymmetric risk’, *IMF Working Papers 2016/178*, International Monetary Fund.

⁽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.

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

⁽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’, available at [Vade Mecum on the Stability and Growth Pact – 2019 Edition \(europa.eu\)](https://ec.europa.eu/economy_finance/vade-mecum-on-the-stability-and-growth-pact-2019-edition).

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%,

⁽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.

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⁾.

⁽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

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

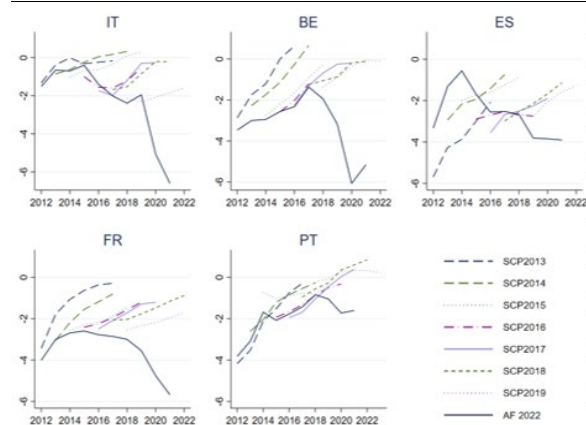
realistic debt reduction strategies over the medium term.

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

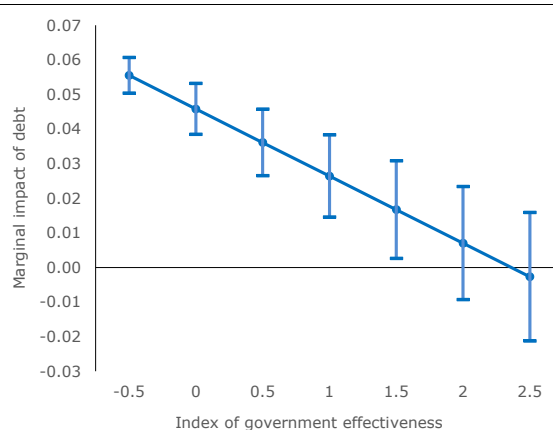
efforts, with a focus on the expenditure benchmark.

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.