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One year since the outbreak of COVID-19: fiscal policy response

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1. Introduction

The outbreak of the COVID-19 pandemic caused an unprecedented global public health crisis, which entailed a severe decline in economic activity. Member States have faced the double need of addressing the public-health emergency and supporting the economy. The forceful policy response at the national and EU level has cushioned the impact of the crisis on Europe's economic and social fabric. The economic downturn and emergency fiscal support have resulted in a sharp increase in government deficits and public debt.

This Communication sets out the Commission's considerations on how to coordinate at EU level the conduct of fiscal policy, taking to the next phase the concerted approach of addressing the pandemic, sustaining the economy, supporting a sustainable recovery and maintaining fiscal sustainability in the medium-term. Member States are currently implementing their 2021 budgets, tailoring timely, temporary and targeted policy measures to their country-specific circumstances. In April, Member States will submit their Stability and Convergence Programmes, setting out their medium-term fiscal policies. In the coming months, following the entry into force of the Regulation on the Recovery and Resilience Facility (RRF), Member States will submit their Recovery and Resilience Plans, the implementation of which will entail in many cases a sizeable fiscal impulse financed by the EU. For these reasons, this Communication provides Member States with broad orientations for the conduct of fiscal policies in the period ahead.

The current situation is still highly uncertain, but some of the challenges that our economies will face as they emerge from the pandemic are clear. To successfully tackle those challenges, a coordinated and consistent policy response will be needed, involving credible medium-term fiscal policy strategies in order to support the recovery, while ensuring fiscal sustainability.

The activation of the general escape clause of the Stability and Growth Pact in response to the onset of the COVID-19 pandemic has allowed Member States to depart from the budgetary requirements that would normally apply. As the clause does not suspend the procedures of the Pact, the European Commission continues to operate the annual cycle of fiscal surveillance. This Communication provides policy orientations to facilitate the coordination of fiscal policies and the preparation of Member States' Stability and Convergence Programmes. It discusses the proper design and quality of fiscal measures, looking at their effectiveness, their gradual adjustment from emergency to more targeted measures, and their eventual phasing out. It also sets out the Commission's considerations regarding the deactivation or continued activation of the general escape clause. Finally, the Communication provides general indications on the overall fiscal policy for the medium term, including the implications of the RRF for fiscal policy.

These considerations provide input to the ECOFIN Council and Eurogroup discussions and will be further detailed in the fiscal policy guidance that will be proposed as part of the Commission's spring European Semester package in late May 2021.

2. Economic situation and outlook

Europe is still firmly in the grip of the pandemic, a year after the COVID-19 pandemic hit the EU and the global economy. The resurgence of infections in autumn 2020 and the emergence of more contagious variants have aggravated the epidemiological situation and forced Member States to reintroduce or tighten containment measures that affect economic activity.

At the same time, recent months have brought light at the end of the tunnel. The breakthrough development of vaccines last autumn and the start of mass vaccination campaigns in all Member States have brightened the outlook beyond the near term and raised hopes for a return to a new normality. Furthermore, agreement was reached on the Multiannual Financial Framework and Next Generation EU. The RRF has entered into force, which will help Member States on the way to a sustainable recovery.

The European economy is expected to have ended 2020 and started the new year on a weak footing, but the Commission 2021 winter forecast projects European growth to resume this spring and gather momentum in the summer. Economic activity contracted in the fourth quarter of 2020 and survey indicators point to depressed economic activity at the start of the year. Progress in the vaccination of vulnerable populations is, however, assumed to facilitate an unfreezing of economic activity. External demand is set to support the recovery on the back of an improved outlook for the global economy. All in all, growth is forecast to rebound to about 3¾% in 2021 in the EU and the euro area, after contracting by around 6½% in 2020. As the recovery takes hold, the 2022 annual growth rate should settle at around 4% in the EU and 3¾% in the euro area. Real GDP is now expected to reach pre-crisis levels in the second quarter of 2022 on average in the EU and the euro area. However, output is not projected to return to its pre-crisis trend by the end of 2022 (Appendix Graph 1).[1]

The recovery is set to be uneven across countries. The expected speed of the recovery reflects differences in the severity of the pandemic, the stringency and duration of containment measures, the relative importance of tourism and leisure activities, the economy's resilience and fundamentals, and the size and timeliness of policy responses. Some Member States are expected to see the distance to their pre-crisis output levels close by the end of 2021 while some others are not even expected to reach those levels by the end of 2022.

These projections are subject to significant uncertainty and elevated risks, predominately linked to the evolution of the pandemic and the success of vaccination campaigns (Appendix Graph 2)**.** On the upside, the vaccination process could lead to a faster easing of containment measures and therefore an earlier and stronger recovery. Moreover, the strength of the rebound could surprise on the upside. A burst of post-crisis optimism could unleash stronger pent-up demand and investment projects, thanks to historically high household savings, low financing costs, and supportive policies. On the downside, the pandemic could prove more persistent or turn out to be more severe in the near term. There is

[1] Trend output as forecast in the Commission 2020 winter forecast, i.e. before the COVID-19 outbreak in the EU.

the risk, amongst others, that new and more contagious variants of the coronavirus could delay the lifting of containment measures. This would delay the expected recovery, which would risk leaving deeper scars in the fabric of the European economy and society inflicted by the protracted crisis, through bankruptcies, rising long-term unemployment and higher inequalities. It is a risk that premature withdrawal of fiscal support could hold back the recovery and exacerbate scarring across the EU. Finally, widening cross-country divergences could deepen, disrupting the functioning of the internal market, causing efficiency losses and ultimately becoming self-reinforcing.

An ambitious and swift implementation of the Next Generation EU programme, including its RRF, would provide a strong boost to the EU economy. Following the political agreement reached on the RRF in December 2020, the preparation of national Recovery and Resilience Plans has intensified in all Member States. So far, most draft plans have not been incorporated in the Commission forecast. When the measures of the forthcoming Recovery and Resilience Plans are implemented, the economic recovery in 2021 and 2022 could turn out stronger than currently projected. In parallel with the development of their Recovery and Resilience Plans, Member States should also accelerate the programming of their 2021-2027 cohesion policy funds so that all instruments are coherent in their support for a sustainable, green and digital recovery.

The deterioration of the health and economic situation in the last quarter of 2020 and beginning of 2021 led Member States to extend emergency measures or provide additional fiscal support. At the same time, sovereign debt risk premia remained low, in part due to a combination of decisive EU and Member State actions. The latter include the close coordination of policy responses and the strongly supportive policy stance on both the fiscal and monetary sides. A premature withdrawal of fiscal support, in the EU and in other large economies (Box 1), or a departure from the commitment to preserve fiscal sustainability in the medium term could change financial markets' perceptions.

Box 1: Fiscal policies in the rest of the world

The global fiscal response to the COVID-19 pandemic amounted to around EUR 6 trillion of direct budgetary support in 2020 (close to 7½% of world GDP), with most support coming from the G20 countries.[2] This is more than double the amount provided in response to the global financial crisis in 2008-2010. The fiscal support has mitigated the effects of the pandemic on consumption and output,[3] while leading to a rise in public deficits and debt. Global public debt is estimated to have reached 98% of world GDP at the end of 2020,[4] compared with 84% of GDP for the same year based on projections made just before the outbreak of the pandemic. Additional health sector spending amounted to EUR 800 billion, while direct fiscal support to households and firms reached almost EUR 5 trillion.

On top of direct fiscal stimulus, governments provided around EUR 5 trillion (around 6% of

[2] IMF Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic (January 2021). https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19
[3] International Monetary Fund – IMF (2021), World Economic Outlook, January 2021 Update.
[4] International Monetary Fund – IMF (2021), Fiscal Monitor, January 2021 Update.

world GDP) of liquidity support measures to companies and households, such as equity injections, loans, asset purchases or debt assumptions, and guarantees. Any possible future impact of these contingent liabilities on public debt and deficit depends on the extent to which these guarantees are taken up by the private sector and the extent to which they will be called upon or activated.

Access to affordable financing, the size of the welfare state and available policy space influenced country-specific fiscal responses. Countries with wider safety nets expanded existing measures and their policy response relied relatively more on automatic stabilisers. In contrast, countries with more limited safety nets had to adopt larger discretionary fiscal measures. For example, in 2020 the US adopted budgetary measures of close to 17% of GDP and liquidity support for 2.4% of GDP, while a new USD 1.9 trillion package (around 10% of GDP) is under discussion in the US Congress. Another bill is expected to be presented later this year and to focus on measures to create jobs, improve infrastructure, combat climate change and address racial equity.

In a context of constrained monetary policy, Japan employed a relatively large fiscal stimulus, amounting to around 15½% of GDP of direct fiscal support and more than 28% of GDP of liquidity support. China provided budgetary support of around 4½% of GDP and liquidity support of more than 1% of GDP. In the UK, budgetary measures and liquidity measures amounted each to over 16% of GDP. Finally, the share of measures targeting the health sector reflected the epidemiological situation and pre-existing conditions in the health sector, with total public spending on health ranging from 0.1% of GDP in China to more than 5% of GDP in the UK.

Generally, advanced economies were able to borrow more cheaply than other countries and were thus able to finance larger packages. Whilst on average advanced economies deployed about 24% of GDP in fiscal measures, this stood in stark contrast with 6% in emerging markets and less than 2% in low-income countries.[5] Support from the international community through grants, concessional finance, and debt relief is essential to facilitate the policy response of EU partner countries.

3. The national fiscal policy response: addressing the pandemic, sustaining the economy and supporting a sustainable recovery

Member States undertook an unprecedentedly strong and rapid fiscal policy response, with fiscal and liquidity measures estimated to have cushioned the contraction in GDP in 2020 by around 4.5 percentage points.[6] This response was facilitated by the early activation of the general escape clause of the Stability and Growth Pact in March 2020 and the use of the full flexibility foreseen under EU State Aid rules, in particular by means of a Temporary Framework also adopted in March 2020. In total, fiscal support in the EU – automatic stabilisers and discretionary measures – in 2020 is estimated at about 8% of GDP,

[5] https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19

[6] See: Updated Commission estimates based on the simulation analysis presented in Pfeiffer, P., Roeger W. and in 't Veld, J. (2020), 'The COVID-19 pandemic in the EU: Macroeconomic transmission and economic policy response', ECFIN Discussion Paper 127, July 2020.

considerably more than the fiscal support provided in 2008-2009. Member States took crisis-related discretionary fiscal measures amounting to close to 4% of GDP in 2020 (Appendix Table 1) on top of already sizeable automatic stabilisers estimated at around 4% of GDP. The bulk of discretionary measures consisted of additional spending (3.3% of GDP). This included emergency spending on health care (0.6% of GDP), for example to increase the capacity of health systems, to provide protective equipment or to set up testing and tracing systems. Expenditure measures in other areas (2.7% of GDP) consisted of compensations to specific sectors for income losses, as well as short-time work schemes and other items. Tax relief measures accounted for an additional 0.4% of GDP. Member States also provided sizable liquidity support (around 19% of GDP), mostly in the form of public guarantees. Around a quarter of available guarantees has been taken up so far. In many cases, these guarantee schemes have required State aid assessment and approval by the Commission, which was swiftly granted in line with EU State aid rules.

On 20 July 2020, the Council recommended Member States to take all necessary measures to effectively address the pandemic, sustain the economy and support the recovery. Looking ahead, it also recommended that Member States pursue, when economic conditions allow, fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment.

Measures adopted by Member States are proving effective at protecting jobs. National short-time employment support initiatives protected around 20% of employment in the EU. Member States are making ample use of financial support in the form of favourable loans under Support to mitigate Unemployment Risks in an Emergency (SURE) to finance short-time work schemes and similar measures to protect employees and the self-employed.[7] Measures included a large variety of programmes, including making existing schemes more flexible to support job transitions, skills upgrading, and extraordinary vocational trainings as an alternative to reduced working time. These state-sponsored schemes are reducing labour costs for businesses while offering better replacement incomes for workers, compared to the usual unemployment benefits. They are also helping safeguard jobs and mitigate further drops in the number of jobs, households disposable income and domestic demand. These schemes are proving very effective: the EU unemployment rate increased only marginally in 2020, despite the large drop in economic activity. This increase was much lower than that implied by the historical relationship between unemployment and GDP growth (Appendix Graph 3). Furthermore, the EU unemployment rate fluctuated markedly less than in the US (Appendix Graph 4). Employment support schemes are most effective in countries with well-established national schemes. Countries that introduced such schemes during the pandemic may have witnessed a somewhat smaller mitigating effect on unemployment.

Vital liquidity support prevented liquidity shortages from turning into solvency problems. The corporate sector suffered during the crisis and many financially healthy firms with viable business models were pushed into financial distress. The impact differed across industries, exerting particular pressure on firms in the service sector that rely more directly on

[7] Council Regulation (EU) 2020/672 on the establishment of a European instrument for temporary support to mitigate unemployment risks in an emergency (SURE) following the COVID-19 outbreak; EUR 100 billion of financial assistance in the form of loans to be provided to the Member States requesting it.

social contact. Measures included equity injections, opening of credit lines, provision of public loan guarantees, postponing of interest payments, postponing or cancelling of certain taxes and social contributions and insolvency-related measures[8]. Commission estimates suggest that without government support measures (beyond short-time work schemes) or new borrowing, a quarter of EU companies would have experienced liquidity distress by the end of 2020 after exhausting their capital buffers. Government credit guarantees and loan repayment moratoria have so far prevented a rise in loan defaults. Administrative delays, loan repayment moratoria and the temporary relaxation of bankruptcy regulations led to fewer companies going bankrupt in 2020 than in the year before.

Discretionary fiscal policy support is projected to gradually decline, due to the withdrawal or expiry of emergency measures. Recently, many Member States have reconsidered the pace of discontinuation of emergency measures due to the evolution of the pandemic and continued restrictions on social contact, confirming the need for national fiscal responses to remain agile. Overall, the impact of COVID-19 related measures is currently expected to amount to around 2.6% of GDP in 2021 and around 0.6% of GDP in 2022. In addition, automatic stabilisers will continue to provide further support to the economy.

Member States' 2021 Draft Budgetary Plans were overall in line with the fiscal policy recommendation. In autumn 2020, the Commission assessed euro area Member States' Draft Budgetary Plans for 2021, based on a qualitative assessment of fiscal measures, including their targeted and temporary nature. Most of the measures in the Draft Budgetary Plans support economic activity against the background of considerable uncertainty. In most Member States, the presented measures were mostly temporary. However, some measures set out in the Draft Budgetary Plans of a few Member States did not appear to be temporary or matched by offsetting measures. Since the assessment of the 2021 Draft Budgetary Plans, Member States have taken measures with an additional direct budgetary impact of 1.0% of EU GDP in 2021, almost all on the expenditure side. Additional healthcare spending and expenditures on short-time working schemes are estimated at 0.2% of GDP each. The additional spending also includes various support schemes for companies affected by the crisis, including subsidies to particularly affected sectors.

4. The EU policy response: making best use of the general escape clause and Next Generation EU

In March 2020, the EU activated the general escape clause of the Stability and Growth Pact, allowing for a temporary departure from the normal operation of fiscal rules in a situation of a severe economic downturn in the EU. The Commission proposed to activate the general escape clause for the EU to continue to respond quickly, forcefully and in a coordinated manner to the fast-evolving crisis. Specific provisions in the EU's fiscal rules allow for a coordinated and orderly temporary deviation from the normal requirements for all

[8] Including such measures as suspension of the duty (for debtors) and the possibility (for creditors) to file for insolvency or moratoria on the enforcement of claims or the termination of contracts and interruption of court proceedings. Overview of insolvency measures taken by the Member States is available at https://e-justice.europa.eu/content_impact_of_covid19_on_the_justice_field-37147-en.do

Member States in a situation of generalised crisis. Specifically, for the preventive arm of the Pact, Regulation (EC)1466/97, Articles 5(1) and 9(1) state that *"in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term"*. The Commission found that the general escape clause does not suspend the procedures of the Pact, but its activation would allow the Commission and the Council to undertake the necessary policy coordination measures within the framework of the Pact, while departing from the budgetary requirements that would normally apply.

In May 2020, the Commission adopted reports under Article 126(3) of the Treaty on the Functioning of the EU for all Member States except Romania, which was already under an excessive deficit procedure. These reports assessed Member States' compliance with the deficit criterion in 2020, based on their plans or on the Commission's 2020 spring forecast. For some Member States, they also assessed compliance with the debt criterion in 2019. As a consequence of their policy response to the COVID-19 crisis, Member States' planned deficits for 2020 were generally above the 3% of GDP threshold. The Commission reached the conclusion that, at that juncture, a decision on whether to place Member States under an excessive deficit procedure should not be taken. This was justified by the exceptional uncertainty created by the macroeconomic and fiscal impact of the COVID-19 outbreak, including for designing a credible path for fiscal policy.

In the view of the Commission, the decision on the deactivation or continued application of the general escape clause should be taken as an overall assessment of the state of the economy based on quantitative criteria. The economic outlook remains highly uncertain and does not allow for a firm anticipation of the end of the severe economic downturn in the EU or the euro area. The deactivation of the clause should be conditional upon the state of the EU and euro area economy, recognising that it will take time for the economy to return to more normal conditions. Various indicators could be considered, but also have limitations:

- Estimates of the gap between actual and potential output are a common feature of the EU fiscal rules but are subject to particularly large uncertainty at the current juncture due to the severity of the economic shock and its unique features.
- Quarterly or even yearly economic growth rates only provide a partial reading of the state of the economy, with strong economic growth rates in 2021-2022 confounding the strength of the recovery given the unprecedented decline in GDP in 2020 and the ensuing deep scarring.
- Labour market indicators, such as the recorded unemployment rate, might misrepresent economic conditions due to the massive use of short-time work schemes, involuntary part-time work and the fact that labour market indicators react with a lag to economic developments.
- The *level* of economic activity in the EU or euro area compared to pre-crisis levels is a more suitable indicator to gauge the state of the recovery.[9]

[9] The European Fiscal Board also suggested such an approach. See: European Fiscal Board (2020), 'Assessment of the fiscal stance appropriate for the euro area in 2021', July 2020. https://ec.europa.eu/info/sites/info/files/2020_06_25_efb_assessment_of_euro_area_fiscal_stance_en.pdf

The level of economic activity in the EU or euro area compared to pre-crisis levels (end-2019) would therefore be the key quantitative criterion for the Commission in making its overall assessment of the deactivation or continued application of the general escape clause. Based on the Commission 2021 winter forecast, EU GDP is projected to reach its 2019 level towards the middle of 2022. Therefore, current preliminary indications would suggest to continue applying the general escape clause in 2022 and to de-activate it as of 2023. The Commission will assess the deactivation or continued application of the general escape clause as part of its spring European Semester package, on the basis of the Commission 2021 spring forecast. Country-specific situations will continue to be taken into account after the deactivation of the general escape clause. In case a Member State has not recovered to the pre-crisis level of economic activity, all the flexibilities within the Stability and Growth Pact will be fully used, in particular when proposing fiscal policy guidance.

Unprecedented EU actions have supported and complemented national fiscal policy responses. The SURE instrument is providing cheap loans to Member States to help them to support workers. In 2020, the Council approved a total of EUR 90 billion in SURE support to 18 Member States, with another Member State applying in February 2021. The European Investment Bank has set up a safety net for businesses, while the European Stability Mechanism's Pandemic Crisis Support Instrument extends a safety net to Member States to support financing of healthcare, as well as cure- and prevention-related costs arising from the COVID-19 pandemic. Next Generation EU, including the RRF, will ensure a sustainable, even, inclusive and fair recovery. Finally, cohesion policy funds were redirected where most needed through the Coronavirus Response Investment Initiative Plus.[10] The EU's policy response also included the adoption a Temporary Framework to enable Member States to use the full flexibility foreseen under State Aid rules to support the economy in the context of the COVID-19 outbreak. It was later amended to increase possibilities for public support to research, testing and production of products relevant to fight the pandemic, to protect jobs and to further support the economy. Later, it was extended to enable recapitalisation and subordinated debt measures, to further support small companies and to incentivise private investments. More recently, the Temporary Framework was prolonged until end 2021, certain aid ceilings were increased and the conversion of certain repayable instruments into direct grants was allowed. In response to the economic fallout caused by the pandemic, the ECB took a broad set of monetary policy measures, most notably launching the pandemic emergency purchase programme (PEPP) and providing additional liquidity through targeted longer-term refinancing operations. These measures contribute to preserve favourable financing conditions over the pandemic period for all sectors of the economy, thereby underpinning economic activity and safeguarding medium-term price stability.

The RRF will support Member States' efforts to increase growth potential through structural reforms and investments while contributing to the green and digital transitions. The facility will provide EUR 312.5 billion of non-repayable support and up to EUR 360 billion of loans to Member States and is oriented towards the economies worst affected by the economic fallout of the pandemic. The facility will help mitigate the risk of divergences in both economic and social conditions within the euro area and the EU. The

[10] OJ L 99, 31.3.2020, p. 5–8.

overall scale of the facility is made possible by an unprecedented recourse to EU debt issuance. Maintaining the benefit of advantageous financing of Next Generation EU will equally depend on the quality of the spending and EU Member States' ability to implement their plans in practice, including by putting in place effective structures to absorb large and front-loaded EU funding. Consistency between Member States' medium-term fiscal planning and their investments and reforms under the RRF is also an important prerequisite for the successful use of EU support under Next Generation EU.

Model-based simulations highlight the significant growth impact of Next Generation EU. EU GDP is estimated to be almost 2% higher in the short and medium term and 1% in the long term, under the assumption that all grants and half of the loans are used to increase productive public investment.[11] Higher investment is expected to boost short-term demand and medium-term potential growth. With interest rates at the effective lower bound, the risk of the fiscal stimulus crowding out private investment is limited. Higher GDP will also have a favourable impact on debt-to-GDP ratios, especially in high-debt Member States, with the consequent decline in risk premia stimulating private consumption and investment. Finally, the coordinated nature of the fiscal stimulus generates positive growth spillovers on account of increased intra-EU export opportunities.

The rollout of the RRF has important implications for national fiscal policies. Expenditure financed by the facility will provide a substantial fiscal impulse in the coming years. The expenditure financed by the RRF with non-repayable support will make it possible to fund high-quality investment projects and cover costs of productivity-enhancing reforms without giving rise to higher deficits and debt. RRF financing will thus contribute to Member States supporting the economic recovery, fostering higher potential growth and gradually improving their underlying fiscal positions. This opportunity is particularly important for Member States with less fiscal space or high levels of public debt, who should maintain prudent fiscal policies. Provided the absorption of RRF funds is successful, the additional expenditure financed by RRF will provide a significant fiscal impulse in the coming years, which will abate after the first years of frontloading RRF investments. In designing their medium-term fiscal strategies, Member States should take into account this interplay between the RRF and nationally-financed spending to make use of the window of opportunity (see also section 5). The approval of the Own Resources Decision is a prerequisite to finance the RRF via Next Generation EU. Member States should take all necessary steps to ensure a swiftapproval, in line with their national requirements.

The RRF is meant to spur Member States to improve the growth-friendliness of public expenditure and revenue. For this to happen, public investment funded by RRF non-repayable support should come on top of existing levels of investment. Only if that RRF support finances additional productive and high quality investment, will it contribute to the recovery and lift potential growth, in particular when combined with structural reforms. If, on the contrary, the RRF support does not result in an increase in investment, it will only temporarily reduce deficits and debt ratios, with no positive effect on potential growth in the

[11] See: Commission Economic Forecast, Autumn 2020. https://ec.europa.eu/info/sites/info/files/economy-finance/ip136_en_2.pdf Update of the initial model simulations presented in European Commission (2020), `Identifying Europe's recovery needs', SWD (2020) 98 final.

medium to long term and risking to result in a worse composition of public spending. Moreover, the additional fiscal space provided by the RRF is temporary and hence not intended to finance additional recurrent expenditures. Instead, new permanent measures should be matched by national funding sources that can be maintained over time.

Member States should ensure that their Recovery and Resilience Plans include reforms and investments that sustain the recovery and strengthen economic and social resilience. In line with the Regulation agreed with the European Parliament and Council, Member States should effectively address all or a significant subset of challenges identified in the relevant country-specific recommendations, including those that contribute to sustainable public finance positions over the medium term.[12] Implementing the country-specific recommendations would also support the recovery and enhance resilience. On the revenue side, this could include measures to strengthen tax collection and enforcement, to widen tax bases and to undertake growth-friendly tax shifts, which *inter alia* reduce the burden on labour and support environmental and climate objectives. On the expenditure side, this could include measures to strengthen public financial management and to undertake expenditure reviews, which lead to a meaningful redirection of spending towards more productive uses. It could also involve measures to ensure the sustainability of social welfare systems, for example by reforms that increase employment rates and reducing the risk that the COVID-19 crisis leads to higher long-term unemployment or a decline in labour market participation, also in view of an ageing population. Finally, measures that remove unnecessary impediments to investment and doing business are important to preserve sound public finances through higher economic growth, while often not entailing budgetary costs.

5. Orientations for coordinated fiscal policies

Coordination of national fiscal policies is crucial to underpin the recovery in an uncertain environment with constrained monetary policy. In the context of the Recommendation on the economic policy of the euro area, the Council agreed that fiscal policies should remain supportive in all euro area Member States throughout 2021.[13] Policy measures should be tailored to country-specific circumstances and be timely, temporary and targeted. Member States should continue coordinating actions to effectively address the pandemic, sustain the economy and support a sustainable recovery. When epidemiological and economic conditions allow, emergency measures should be phased out, while combatting the social and labour market impacts of the crisis. Moreover, the Council Conclusions on the Alert Mechanism Report, adopted in January 2021, called for further targeted and temporary measures to support the recovery, taking into account existing and emerging risks to macroeconomic stability. This coordinated orientation for the conduct of fiscal policy at Member State and EU level remains fully valid.

Against this background, the conduct of fiscal policies in the period ahead should rely on a number of key considerations. First, coordination of budgetary policies remains essential

[12] OJ L 57, 18.2.2021, p. 17–75

[13] (forthcoming) Council Recommendation on the economic policy of the euro area. Agreed text available on: https://data.consilium.europa.eu/doc/document/ST-14356-2020-INIT/en/pdf

in the context of Member States' submission of Stability and Convergence Programmes and Recovery and Resilience Plans. Second, fiscal policy should remain agile and adjust to the evolving situation as warranted. Third, a premature withdrawal of fiscal support should be avoided. Fiscal policy is an effective tool, especially in an uncertain environment. Risks of an early withdrawal are higher than the risks associated with keeping support measures in place for too long. Moreover, premature withdrawal would lead to an unbalanced overall policy mix in a situation where monetary policy is likely to operate at or close to the effective lower bound for some time to come. Fourth, once health risks diminish, fiscal measures should gradually pivot to more targeted measures that promote a resilient and sustainable recovery. Fifth, fiscal policies should take into account the impact of the RRF. Finally, fiscal policies should take into account the strength of the recovery and fiscal sustainability considerations. Member States should as part of a well-sequenced and gradual withdrawal of policy support and, at the appropriate moment, pursue fiscal policies aimed at achieving prudent medium-term fiscal positions, while enhancing investment.

These considerations have implications for the conduct of fiscal policy in the near future, specifically regarding the design of measures, the overall fiscal impulse, and the need to consider differing situations across Member States. They will be further detailed as part of the guidance in the forthcoming European Semester spring package.

Design of fiscal support measures

Support measures should be timely, temporary and targeted Fiscal measures should maximise support to the recovery without pre-empting future fiscal trajectories. Therefore, measures should avoid creating a permanent burden on public finances. When Member States introduce permanent measures, they should properly fund them to ensure budgetary neutrality in the medium term.

Once health risks diminish, support measures should pivot from emergency relief to more targeted measures that promote a resilient and sustainable recovery. It is crucial that measures preserve their efficacy over time and that their withdrawal is gradual. The quality of measures will be very important to efficiently support the economy with limited fiscal resources. As containment measures are lifted and economic activity normalises, continued fiscal support should pivot towards minimising long-term economic scarring and ensuring a swift reallocation of resources. At the same time, governments will have to start addressing the legacies of the crisis, including elevated public and private debt levels and the social and labour market impacts.

As the economy and individual sectors move into the recovery phase, authorities should step-up employment incentives for workers. Policies should shift from protecting existing employee-firm relationships to increasing job opportunities for unemployed and inactive persons, and supporting transitions from crisis-induced unemployment or short-time work schemes towards other employment opportunities in future-proof sectors. Measures that reduce the risk of higher structural unemployment include government programmes for education, up- and reskilling and targeted extensions of short-time work schemes to support job transitions, as well as well-designed, temporary hiring incentives.

Targeted support measures should help viable but still-vulnerable firms to reopen and adjust their business models. Liquidity support should be withdrawn gradually to ensure that accumulated liabilities do not result in solvency problems. For solvent but liquidity-constrained firms that are expected to suffer a temporary impact from the COVID-19 crisis maintaining support is essential to prevent insolvency problems. Targeted and temporary corporate tax cuts or wage subsidies could continue to be justified in specific cases. Financing for viable firms should become more diversified towards equity and other capital (hybrid solutions). Incentivising the provision of capital by the private sector (e.g. tax deductions for strengthening capital of viable companies with solvency problems) or blending of private and public solvency support could be considered.

As the recovery takes hold, fiscal policy should prioritise higher public and private investment, supporting the transition towards a green and digital economy. These investments should be wisely selected and coupled with reforms in order to maximise their impact. Significant additional investments should address strategic policy objectives, namely to strengthen productivity, help meet the new 2030 climate target and the objectives of the European Green Deal, upgrade digital capacities, and other investments where strong positive spillovers exist. A successful recovery strategy will also incorporate investment that promotes social and gender inclusion, in particular through education and skilling, as well as regional cohesion. Funds received through the RRF for the implementation of reforms and investment will also contribute to these objectives.

Considering the total fiscal impulse

The overall fiscal impulse, stemming from national budgets and the RRF, needs to remain supportive in 2021 and 2022. The extent of the fiscal impulse provided by the RRF needs to be explicitly taken into account in national budgetary planning as it is not captured by the usual metrics for evaluating the fiscal stance. With the RRF coming on stream, the usual indicators normally used in fiscal surveillance will underestimate the fiscal impulse being provided to the economy. Expenditure financed by grants from the RRF represents a fiscal impulse that will not translate into a higher deficit or debt. This additional fiscal impulse will be particularly important for those Member States where funding provided by the RFF is the largest in comparison with the level of GDP or total public investment.

The RRF is a unique window of opportunity to improve the underlying fiscal position without choking off growth. The fiscal impulse and higher potential growth resulting from RRF measures are mutually beneficial. As health risks abate and emergency measures are phased out, the rollout of the RRF investments and reforms provides an opportunity for Member States to improve their underlying fiscal positions in the medium term while still supporting growth and job creation. It is, therefore, essential that Member States take an integrated view of national spending and revenue-raising decisions by embedding the RRF in their medium-term budgetary strategies.

Taking into account different situations across Member States

In the perspective of economic activity gradually normalising in the second half of 2021, Member States' fiscal policies should become more differentiated in 2022. Member

States' fiscal policies should take into account the state of the recovery, fiscal sustainability risks and the need to reduce economic, social and territorial divergences:

- Increased differentiation in fiscal guidance to Member States should go hand-in-hand with an overall supportive fiscal stance in 2022, avoiding a premature withdrawal of fiscal support. Premature withdrawal would be a policy mistake with adverse effects on economic activity (both domestically and in other Member States) and confidence. It would risk scarring the social and economic fabric and make it more difficult to implement those reform priorities that will help to enhance the EU's economic and social resilience and regional cohesion. Given the need to support a sustainable recovery in the EU, Member States with low sustainability risks should gear their budgets towards maintaining a supportive fiscal policy in 2022, taking into account the impact of the RRF.
- Sustainability risks have increased due to the severe impact of the crisis. The much higher levels of debt-to-GDP ratios and the negative impact on trend growth as a result of the crisis are likely to lead to less favourable trajectories over the medium-term.[14] Low interest rates provide benign financing conditions for all Member States to undertake spending that can boost potential growth and avoid a low-growth high-debt trap. Credible medium-term fiscal strategies are needed to anchor expectations. On balance, Member States with high debt levels should pursue prudent fiscal policies, while preserving nationally-financed investment and using RRF grants to fund additional high-quality investment projects.
- All Member States should focus on the composition and the quality of public finances, both on the revenue and expenditure side of the budget. They should also give priority to fiscal structural reforms that will help provide financing for public policy priorities and contribute to the long-term sustainability of public finances.

For the period beyond 2022, fiscal policies should continue to take into account the strength of the recovery, the degree of economic uncertainty and fiscal sustainability considerations. A refocusing of fiscal policies towards achieving prudent medium-term fiscal positions, at the appropriate moment, including by phasing out support measures, will contribute to ensuring fiscal sustainability in the medium term. This should be done in a way that mitigates the social and labour market impact of the crisis and contributes to social sustainability.

6. Conclusions and next steps

Member States are expected to submit Stability and Convergence Programmes that take into account the 2020 country-specific recommendations, the Annual Sustainable Growth Strategy, the Council Recommendation on the Economic policy of the euro area and the policy orientations included in this Communication. Member States' Recovery and Resilience Plans should be fully consistent with those policy orientations.

As the general escape clause does not suspend the procedures of the Stability and Growth Pact, the Commission will assess the Stability and Convergence Programmes and propose

[14] See: European Commission (2020), 'Debt Sustainability Monitor 2020', February 2021. https://ec.europa.eu/info/publications/debt-sustainability-monitor-2020_en

country-specific fiscal policy guidance as part of the European Semester spring package. The proposed fiscal guidance will respect the Stability and Growth Pact, while using the full flexibility within it to ensure that the coordination of fiscal policy addresses the exceptional situation that the pandemic has given rise to. Based on the considerations outlined above, the Commission's proposals for fiscal policy guidance will remain predominantly qualitative and include some differentiated quantified element as part of the medium-term guidance. The fiscal impulse from the RRF, an improvement of the underlying fiscal position, and the implementation of reforms and investments to boost potential growth are mutually beneficial. This will be taken into account in the proposed policy guidance.

In May 2020, the Commission reached the conclusion that, at that juncture, a decision on whether to place Member States under an excessive deficit procedure should not be taken. As in spring 2020, the Commission intends to prepare reports under article 126(3). In this context, the Commission intends to take into account the high uncertainty, the agreed fiscal policy response to the COVID-19 crisis and the Council recommendations for 2021. The Commission approach will be confirmed in the spring European Semester package, based on the outturn data for 2020 and Member States' Stability and Convergence Programmes.

As part of the European Semester spring package, and following a dialogue between the Council and the Commission, the Commission will also assess the deactivation or continued application of the general escape clause of the Stability and Growth Pact. In the view of the Commission, the decision on whether to deactivate the general escape clause or continue it for 2022 should be taken as an overall assessment of the state of the economy based on quantitative criteria. The level of output in the EU or euro area compared to pre-crisis levels would be the key quantitative criterion. Current preliminary indications would suggest to continue applying the general escape clause in 2022 and to de-activate it as of 2023.

When the recovery takes hold, the Commission intends to relaunch the public debate on the economic governance framework. The Commission's review of February 2020 identified well-recognised challenges with the fiscal framework and its implementation.[15] While overall deficit and debt levels decreased, very high public debt had persisted in some Member States prior to the current crisis. The fiscal stance at Member-State level had frequently been pro-cyclical, both in good and in bad times, respectively by not building sufficient buffers in some periods or not making sufficient use of fiscal space in others. The composition of public finances had also not become more growth- and investment-friendly. In the event of large economic shocks, the ability to steer the fiscal stance for the euro area had been hampered by a lack of prudent policies in good times and remained constrained as long as it rested exclusively on coordination of national fiscal policies, in the absence of a central fiscal stabilisation capacity. Moreover, the framework has grown increasingly complex.

The pandemic has significantly changed the context of the public debate, with higher levels of debt and deficit and significant output losses, increased investment needs and the related introduction of new policy tools at EU level. Moreover, the general escape clause was used

[15] See: European Commission (2020), 'Economic governance review', February 2020. https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/economic-governance-review_en

for the first time in the implementation of the fiscal surveillance. Therefore, the crisis has highlighted the relevance and importance of many of the challenges that the Commission sought to discuss and address in the public debate. Relaunching the public consultation on the economic governance framework will allow the Commission to reflect on these challenges and draw lessons. However, in light of the COVID-crisis and the need to focus on the RRF and the immediate policy response, its relaunch has been put on hold.

Appendix

Table 1: overview of national fiscal measures in response to the COVID-19 pandemic

EU-27	2020		2020-2021		2020-2022	
	bln EUR	% of GDP	bln EUR	% of GDP	bln EUR	% of GDP
Initiatives by the Member States[1]						
A. Measures with a direct budgetary impact[2]	**497.8**	**3.8**	**364.7**	**2.6**	**83.1**	**0.6**
1. Expenditure	**438.5**	**3.3**	**322.2**	**2.3**	**65.9**	**0.4**
1. a) Health care	80.8	0.6	58.9	0.4	14.9	0.1
1. b) Other	363.0	2.7	264.5	1.9	52.3	0.4
2. Revenue	**59.3**	**0.4**	**42.5**	**0.3**	**14.1**	**0.1**
B. Automatic stabilisers[3]		**± 4**				
C. Liquidity measures without a direct budgetary impact	**2505.9**	**18.9**				
1. Tax deferrals	206.5	1.6				
2. Public guarantees (available framework)[4]	1877.0	14.2				
of which current take-up (actual contingent liability)	456.0	3.4				
3. Others	422.4	3.2				

[1] The amounts included cover the impact of nationally-financed measures, net of funding provided e.g. by EU initiatives

[2] The impact of the measures is given in increments compared to 2019 in accrual terms (ESA2010). GDP projections are based on the Commission 2021 winter forecast.

[3] The impact of automatic stabilisers is estimated as the residual after subtracting the estimated impact of fiscal measures from the change in the primary balance

[4] Figures refer to the maximal public funds involved if all of the available guarantees were taken-up. Guarantees to EU and international level instruments are excluded. For Germany, the size of available guarantee schemes is included, while the overall guarantee framework is actually unlimited.

Euro Area	2020		2020-2021		2020-2022	
	bln EUR	% of GDP	bln EUR	% of GDP	bln EUR	% of GDP
Initiatives by the Member States[1]						
A. Measures with a direct budgetary impact[2]	**422.3**	**3.7**	**339.4**	**2.9**	**57.9**	**0.4**
1. Expenditure	**368.8**	**3.3**	**298.6**	**2.5**	**42.3**	**0.3**
1. a) Health care	74.0	0.7	51.8	0.4	7.8	0.1
1. b) Other	295.7	2.6	248.0	2.1	35.7	0.2
2. Revenue	**53.5**	**0.5**	**40.8**	**0.3**	**14.9**	**0.1**
B. Automatic stabilisers[3]		**± 4**				
C. Liquidity measures without a direct budgetary impact	**2164.8**	**19.2**				
1. Tax deferrals	112.3	1.0				
2. Public guarantees (available framework)[4]	1790.9	15.9				
of which current take-up (actual contingent liability)	448.4	4.0				
3. Others	261.5	2.3				

[1] The amounts included cover the impact of nationally-financed measures, net of funding provided e.g. by EU initiatives

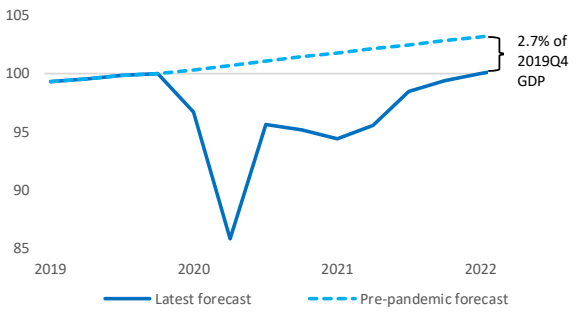
[2] The impact of the measures is given in increments compared to 2019 in accrual terms (ESA2010). GDP projections are based on the Commission 2021 winter forecast.

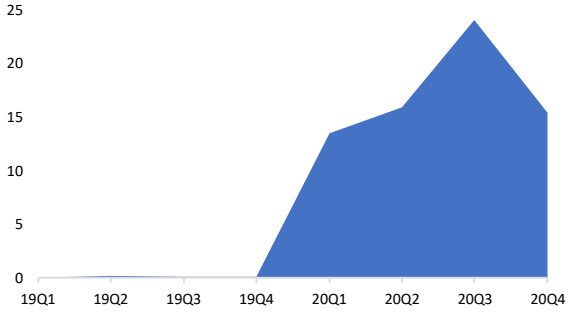
[3] The impact of automatic stabilisers is estimated as the residual after subtracting the estimated impact of fiscal measures from the change in the primary balance

[4] Figures refer to the maximal public funds involved if all of the available guarantees were taken-up. Guarantees to EU and international level instruments are excluded. For Germany, the size of available guarantee schemes is included, while the overall guarantee framework is actually unlimited.

Source: European Commission 2021 winter forecast

2020Q4

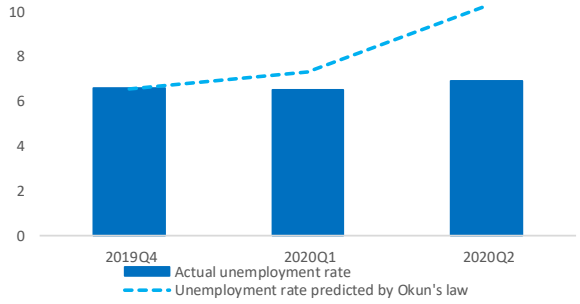




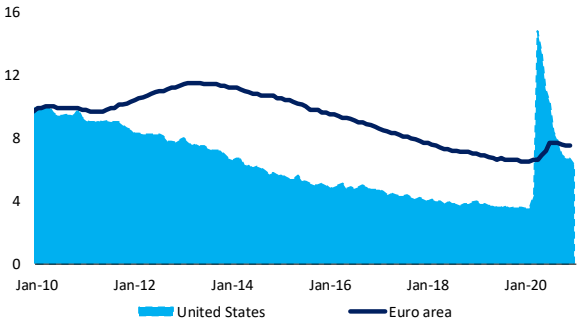
Note: Pre-pandemic forecast for 2022 is obtained by extrapolating 2021 quarterly growth rates.
Source: European Commission 2020 and 2021 winter forecasts.

Source: Ahir, Bloom and Furceri, "The World Uncertainty Index", mimeo.

Graph 3 **Actual unemployment rate and Okun's prediction in the EU, 2019Q4-2020Q2 (%)**



Graph 4 **Unemployment rate in the EU and the US, January 2010-December 2020 (%)**



Note: Okun's law is an empirically observed relationship between unemployment and real GDP growth.
Source: European Commission based on Eurostat's Labour Force Statistics and National Accounts.

Source: Eurostat.