

II. Fiscal Policy

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The EU first established common fiscal rules in 1993, with the entry into force of the Maastricht Treaty. The operational details of these rules were subsequently formalised in 1997 with the adoption of the Stability and Growth Pact. Since then, the rules have evolved along a number of dimensions, not least with the adoption of the Six-pack and Two-pack reforms in the early years of the current decade. More recently, innovations have mainly come about through the interpretation of underlying legal texts, with the Commission placing an emphasis on making use of available flexibility in the rules. In the context of these changes, this section looks at fiscal developments in the EU over the last twenty years, with a focus on the most recent developments and the current fiscal positions of Member States. Some lessons are drawn from the experience of implementing the fiscal rules.

II.1. Introduction

This section provides an overview of fiscal policy and fiscal surveillance in the EU over the last 20 years. It aims to assess the performance of EU fiscal rules, with a particular focus on the period that followed the crisis. The first sub-section describes the development of the EU fiscal framework, in particular the Stability and Growth Pact. The second sub-section gives an overview of fiscal developments during this period and looks at the current fiscal situation in the EU. Recent experience and challenges with implementing the EU's fiscal framework are discussed in a third sub-section. A final sub-section draws some conclusions.

II.2. An evolving fiscal framework

This sub-section presents the Stability and Growth Pact as it has evolved, with an emphasis on the economic reasoning behind the need for fiscal rules in the EU. The legal development and evolution of the Pact is first presented, followed by a description of how interpretation of the underlying legal texts has led to recent changes in how these fiscal rules are implemented.

II.2.1. Development of the Stability and Growth Pact

The benefits of fiscal rules in ensuring sound fiscal outcomes are well established. A wide literature in this area documents a correlation between the introduction of fiscal rules and improved fiscal outcomes.⁽⁷⁵⁾ In particular, well-

designed fiscal rules can offset the deficit bias of governments.⁽⁷⁶⁾ Before the economic and monetary union (EMU) was created, it was feared (as reflected in the 1989 Delors report) that it would exacerbate this bias and that lax fiscal policy in some Member States – facilitated by weaker financial market scrutiny because of the common currency – would undermine price stability. This could result in an unbalanced mix between monetary and fiscal policy in the euro area.

EU fiscal rules were first set out in the Maastricht Treaty, which was signed in 1992.

This Treaty laid out the framework that would govern the EMU and sought to reconcile a common monetary policy with national fiscal policies. It included a provision that 'Member States shall avoid excessive deficits' (Article 104c) and empowered the Commission to 'monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors'. Requirements for Member States to keep their headline deficits below 3% of GDP and their debt below 60% of GDP (or diminish their debt towards that threshold at a satisfactory pace) were included in a protocol annexed to the Treaty. The operational details of the EU's fiscal rules were subsequently developed in the Stability and Growth Pact adopted in 1997.⁽⁷⁷⁾

The primary goal of the Stability and Growth Pact (the Pact) is to ensure that public debt is sustainable. The Pact aims to prevent and, where

⁽⁷⁴⁾ This section represents the authors' views and not necessarily those of the European Commission.

⁽⁷⁵⁾ See an overview in, for example, IMF (2009), 'Fiscal Rules – Anchoring Expectations for Sustainable Public Finances', IMF Policy Paper.

⁽⁷⁶⁾ The existence of this bias is well established in the relevant economic literature. See, for example, Alesina, A. and Perotti, R. (1996), 'Income Distribution, Political Instability, and Investment', European Economic Review, Vol. 40 Issue 6.

⁽⁷⁷⁾ A summary of the challenges associated with designing supranational fiscal rules can be found in Yared, P. (2019), 'Rising Government Debt: Causes and Solutions for a Decades-Old Trend', Journal of Economic Perspectives, Vol 33 No 2.

necessary, correct excessive deficits as a means of keeping debt at sustainable levels. What is known as the ‘preventive arm’ of the Pact operationalises the first element, while the ‘corrective arm’ implements the excessive deficit procedure (EDP). Without prejudice to the sustainability objective, the rules of the Pact are also meant to allow for fiscal macroeconomic stabilisation. Differences in national preferences on the appropriate pace of debt reduction makes reconciling the sustainability and stabilisation objectives challenging.⁽⁷⁸⁾ Since the euro-area crisis, the focus has shifted to risks and spillovers arising from unsustainable levels of public debt and risks from possible debt crises, including contagion, possible monetary bailouts and even redenomination risks. The existence of such spillovers, together with the fact that markets tend to (over)react too late, provide an essential rationale for provisions on fiscal discipline to make national public debts safe in the EMU.

The Pact has developed considerably since its creation, largely in response to weaknesses that became apparent during crisis episodes.

The conceptual underpinning of the framework has been gradually developed and its scope broadened to make the rules ‘smarter’, i.e. better adapted to changing economic conditions. Successive reforms have made the preventive arm of the Pact more central, based on the observation that Member States fail to make the necessary fiscal adjustments when economic times are good.

The first reform of the Pact in 2005 aimed to better take into account the economic cycle and better consider specific features of individual countries. In the preventive arm, the medium-term budgetary objective (MTO) was redefined: the requirement that all countries have to achieve a budgetary position of close to balance or surplus in nominal terms was replaced by country-specific objectives set in structural terms (i.e. net of cyclically-driven expenditure and revenue and of one-off measures). Those objectives take account of Member States’ gross government debt levels and the magnitude of the fiscal challenges posed by population ageing. In the corrective arm, the possibility of extending the deadline for EDPs was introduced for Member States that had taken effective action but were

faced with unexpected adverse economic circumstances that were having a significant impact on their public finances. For both arms, the legislation indicated a benchmark annual adjustment for the size of the correction to be made for Member States. Furthermore, in order to enhance the growth-oriented dimension of the Pact, the adjustment path towards the MTO could take into account the implementation of major structural reforms, provided these reforms have a verifiable positive impact on the long-term sustainability of public finances. These impacts could be either direct (such as for pension reforms) or indirect via a related increase in growth potential (which would lower the level of public debt as a percentage of GDP).

Following the economic and financial crisis in 2008, and drawing on the experience of implementing fiscal surveillance, the Six-pack reform of 2011 amended the Pact for a second time.

The Six-pack introduced a greater emphasis on aggregate expenditure developments and revenue-increasing (or decreasing) policy measures, which are more directly under government control than other fiscal indicators. In addition, the reform sought to refocus fiscal surveillance on debt developments by making the Treaty’s debt criterion operational, notably by introducing a debt reduction benchmark that requires public debt to diminish (per year) by 1/20th of the gap to the reference value of 60% of GDP. The system of sanctions was made more automatic by applying reverse qualified majority voting (also introduced for other surveillance decisions) for Council decisions on Commission proposals in this area. These decisions are also now taken at an earlier stage of the non-compliance procedures. Finally, reflecting the experience of the Great Recession, a collective ‘escape clause’ was introduced, effectively allowing (but not prescribing) the rules to be suspended in case of ‘a severe economic downturn’ in the EU or the euro area as a whole.

The Two-pack reform of 2013 strengthened the surveillance framework for euro-area Member States.

This reflected the potential of stronger spillovers within monetary union. In order to achieve closer budgetary coordination, the reform obliged euro-area Member States to submit their draft budgetary plans to the European Commission and the Council before national parliaments adopted them. The reform also brought in the procedure of assessing the aggregate euro-area

⁽⁷⁸⁾ At the same time, safe levels of debt should allow automatic stabilisers to operate without leading to fiscal or financial market stress.

fiscal stance and stepped up surveillance for euro-area Member States under the EDP.

As the Pact has evolved, the EU has introduced requirements for national fiscal frameworks that have become increasingly precise. Protocol 12 of the Maastricht Treaty includes a broad requirement that national budgetary frameworks must enable Member States to meet EU fiscal rules. While the Pact's focus has been on supranational fiscal rules, there has been a growing recognition (in particular since the crisis) of the importance of national fiscal arrangements as a means of ensuring compliance with EU fiscal rules. In this respect, national frameworks are perceived as serving two goals: first, to provide the necessary setting for implementing fiscal policy in compliance with EU rules; and second, as a means of strengthening national 'ownership' of EU rules. Member States agreed a number of requirements for their fiscal frameworks to improve their quality and effectiveness and, therefore, support fiscal discipline in the EU context. Some of these requirements took the form of EU law, while more intrusive requirements were established in the intergovernmental Treaty on Stability, Coordination and Governance in the EMU. This Treaty, which included the 'Fiscal Compact', enshrined Member States' MTO into national law (preferably at constitutional level), with a stricter lower limit for the structural deficit.

The implementation of these EU requirements has seen national budgetary frameworks develop significantly in recent years. The progress is most noticeable in Member States that had no (or only rudimentary) domestic frameworks before the crisis. For those Member States, the EU requirements have served as a basis to construct a modern fiscal framework. In particular, national numerical fiscal rules have been growing in number and quality, dominated by the structural balanced budget rules required by the Fiscal Compact. Independent institutions have also been set up (or strengthened) in virtually all Member States with a mandate to monitor and assess public finances and (in particular) national fiscal rules. The scope of annual budgeting and medium-term fiscal planning has been widened, and the process has become more transparent. New streams of fiscal statistics have also been created, most notably on the contingent liabilities of Member States. This has helped to raise the attention of policy-makers and the general public to this issue. Requirements that macroeconomic forecasts have to be prepared or

endorsed by independent fiscal institutions appear to have led to slightly more prudent forecasting.⁽⁷⁹⁾

II.2.2. Recent innovations by way of interpretation

In the aftermath of the Great Recession, tensions arose between the need for a return to sustainable public finances and the need for economic stabilisation. Very strong market pressure between 2010 and 2012 forced some Member States to implement large fiscal adjustments, sometimes going beyond the requirements of the Pact (see below). This gave rise to fiscal fatigue in several highly-indebted Member States. Moreover, economic conditions after the Great Recession turned out to be worse than anticipated, with the euro area experiencing a second recession in 2012-2013. This was followed by a protracted period of low growth relative to the pre-crisis period and unprecedentedly low inflation, with monetary policy facing the zero lower bound and the European Central Bank introducing a number of non-standard monetary policy measures in an effort to foster the economic recovery.

In this context, the Commission put emphasis on a flexible interpretation of the EU's fiscal rules. At the beginning of 2015, the Commission described in a Communication how it intended to use the flexibility embedded in the EU's fiscal framework.⁽⁸⁰⁾ This approach took into account the need to foster the economic recovery, as well as the need for some high-debt Member States to implement reforms in labour and product markets. The flexible implementation also reflected a political economy reality: namely, that the Six- and Two-pack reforms had increased the Commission's decision-making responsibilities, such as the decision to impose sanctions, that could have far-reaching political implications in the Member States.

This approach allowed for flexibility for three elements: cyclical conditions, structural reforms and public investment. Since 2015,

⁽⁷⁹⁾ See Jankovics, L. and Sherwood, M. (2017), 'Independent Fiscal Institutions in the EU Member States: The Early Years.' European Economy Discussion Papers No. 67, European Commission.

⁽⁸⁰⁾ See European Commission (2015), 'Making the best use of the flexibility within the existing rules of the Stability and Growth Pact', COM(2015)12 of 13 January 2015.

flexibility has taken two main forms.⁽⁸¹⁾ Firstly, the adoption of the so-called ‘matrix of requirements’ in the preventive arm allowed the required annual structural adjustment to the MTO to be modulated according to a Member State’s position in the economic cycle. Secondly, the Commission allowed temporary deviations from required annual fiscal adjustments for Member States undertaking major structural reforms or public investment, provided they fulfilled certain eligibility criteria. Such ‘flexibility clauses’ built upon existing provision for temporary deviations from preventive arm requirements due to ‘unusual events’.

II.3. Fiscal performance in the euro area

This sub-section presents the performance of the EU’s fiscal rules, with a particular focus on the period since 2011. Performance is measured by comparing fiscal outcomes with the ultimate objectives and numerical thresholds set out in the Pact. This constitutes both unenforced compliance as well as actions taken by the Commission and Council to force Member States to comply with the rules.⁽⁸²⁾

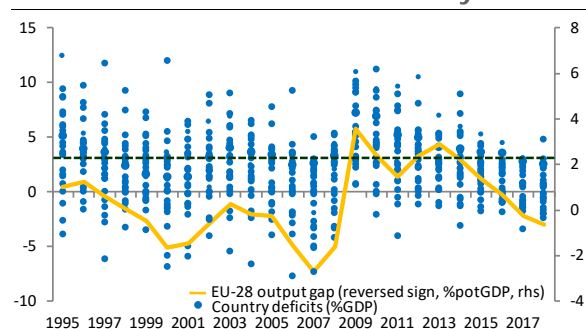
II.3.1. Have Member States avoided or corrected gross policy errors?

EU Member States are required to avoid gross policy errors. As discussed above, EU Member States must keep their headline deficits below 3% of GDP and their debt below 60% of GDP (or diminish their debt towards that threshold at a satisfactory pace). As long as a Member State fulfils the deficit and debt criteria, it remains in the preventive arm of the Pact. If it breaches one (or both) of the criteria, it is placed in EDP. While this gives rise to the possibility of sanctions being imposed, that has not been done since the adoption of the Six-pack and Two-pack reforms (see II.4.2.). Until the debt criterion became operational in 2011, EU surveillance mainly focused on the deficit criterion.

Developments in headline deficits

While there have frequently been breaches of the Pact’s deficit threshold of 3% of GDP since the euro’s creation, the Great Recession resulted in an exceptional situation in which almost all Member States breached this threshold. The 2008-2009 economic and financial crisis had a massive impact on Member States’ deficits, which in some cases reached double digit levels (see Graph II.1). Due to the depth of the recession and bank recapitalisation needs in some Member States, the deficit at the aggregate EU level exceeded 6% of GDP in 2009-2010. As a consequence, 24 out of the then 27 Member States entered the EDP for breaching the Treaty’s deficit criterion.⁽⁸³⁾

Graph II.1: Distribution of headline deficits and slack in the economy



Source: Eurostat, European Commission

The situation has gradually improved and all Member States had corrected their excessive deficits by 2018. All Member States have brought their headline deficits below the threshold of 3% of GDP and have become subject to the Pact’s preventive arm (see Graph II.2).⁽⁸⁴⁾ Since 2015, however, excessive deficits have mainly been corrected by improving macroeconomic conditions, which help to lower nominal deficits thanks to the reversal of automatic stabilisers (i.e. generating additional revenues and lowering unemployment expenditure). This has allowed some Member States to correct their excessive deficits without making any significant (or any) structural fiscal adjustments (the ‘nominal strategy’). Member States that lack a sufficient

⁽⁸¹⁾ Further details on the implementation of this flexible interpretation can be found in the Commission’s 2018 ‘Communication on the review of the flexibility under the Stability and Growth Pact’ and the European Fiscal Board’s 2018 annual report.

⁽⁸²⁾ Enforcement involves a clear act by the enforcer which (may) lead to a changed performance. However, the distinction between unenforced compliance and compliance through enforcement is often difficult to make, in the absence of a counterfactual.

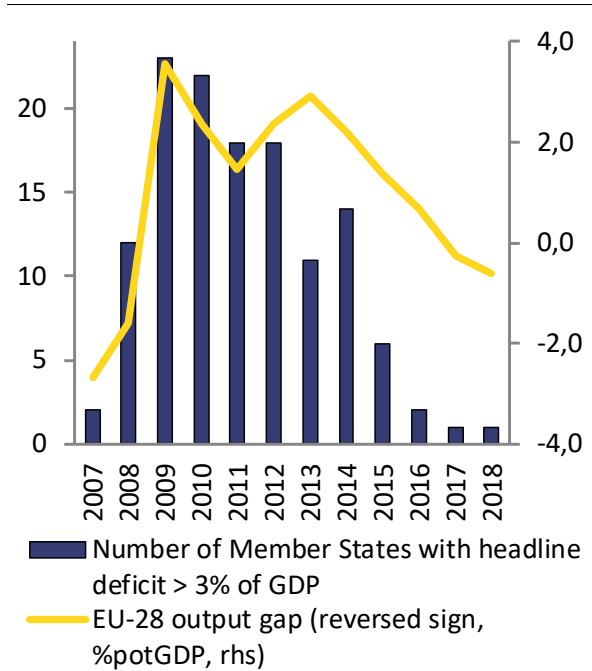
⁽⁸³⁾ Finland was put in EDP for a planned breach, although the deficit eventually stayed below 3%.

⁽⁸⁴⁾ With the exception of Cyprus, where there was a temporary peak in the deficit in 2018 (at 4.4% of GDP), due to the one-off support measures related to the sale of the Cyprus Cooperative Bank.

safety margin to the 3% of GDP threshold will have insufficient buffers if an economic downturn occurs (see below). Furthermore, maintaining a nominal deficit close to 3% of GDP may not be sufficient to avert unsustainable debt.

The reduction of headline deficits been broad-based and, in general, variation between countries has somewhat narrowed over time (see Graph II.1). In the pre-crisis period, Member States’ fiscal positions ranged from sizeable budget surpluses to equally sizeable deficits. Such differences subsisted throughout the crisis, with the range narrowing only in recent years.

Graph II.2: Number of Member States breaching the 3% of GDP limit and slack in the economy



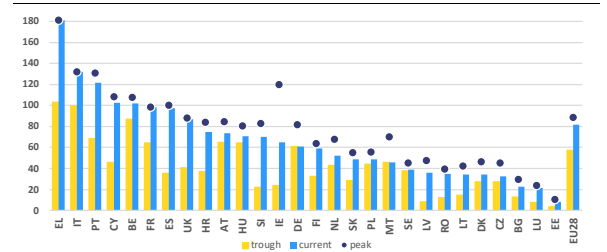
Source: Eurostat, European Commission

Developments in debt ratios

While the aggregate EU debt ratio remained around 60% of GDP in the pre-crisis period, it increased to almost 90% between 2009 and 2014, before starting to decline. Until 2008, the aggregate debt of the EU Member States remained relatively constant at around 60% of GDP. The economic and financial crisis led to higher cyclical and structural deficits, pushing debt ratios substantially upwards. This was further amplified by the impact of low economic growth on the ratio (through the ‘denominator effect’) and by direct intervention by some Member States in the

financial sector. The increase in debt levels was particularly high in Ireland, Greece, Spain, Cyprus, Portugal and Slovenia.

Graph II.3: Debt dynamics: 2018 debt levels versus pre-crisis low point and post-crisis peak



Source: Eurostat

Debt dynamics across Member States have been quite divergent. As shown in Graph II.3, there is little relationship between Member States’ debt-to-GDP ratios before the euro-area sovereign debt crisis and the subsequent change in those ratios in the years following the crisis. This reflects large differences between countries in the pace of fiscal consolidation, in the impact of the ‘snowball’ (or ‘r-g’) effect ⁽⁸⁵⁾ and in the idiosyncratic fiscal costs related to support measures for the banking sector. Of note, most Member States have benefited from a negative snowball effect since 2014, with the impact of low nominal growth (which delays the reduction in the ratio) offset by historically low interest rates on sovereign debt. This, of course, reflects the weak post-crisis recovery and the fact that euro-area inflation has remained low. Had economic dynamics after 2014 returned to the situation prevailing before the financial market crisis (proxied here as the average r-g during the period 1999-2007), debt ratios would have now been even higher in those highly-indebted Member States (see Graph II.4). ⁽⁸⁶⁾

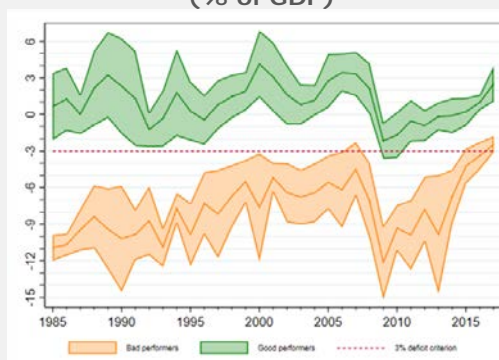
⁽⁸⁵⁾ The snowball effect is the impact on debt dynamics of the difference between the average interest rate charged on government debt and the nominal GDP growth rate multiplied by the debt-to-GDP ratio in the previous period. It is therefore often referred to as the ‘r-g’ effect.

⁽⁸⁶⁾ Only in Spain is the ‘r-g’ effect still less favourable than in the pre-crisis period. However, one could question whether the growth of the Spanish economy in the early and mid-2000s was sustainable.

Box II.1: Has the headline deficit ceiling of 3% of GDP improved fiscal outcomes in the EU?

Member States that had large headline deficits just before the Pact's launch have reduced their deficits significantly, although this was not the case during the Great Recession. In Graph A.1, the orange area shows the range of the deficits for the quarter of Member States with the highest deficits ('bad performers') for each year since 1985. Before the Pact's launch in 1998, several Member States had deficits exceeding 5% of GDP. The deficits then decreased slowly until the start of the Great Recession, so that only three Member States displayed deficits exceeding 3% of GDP in 2007. In the aftermath of the crisis, Member States' deficits rose significantly, with 24 out of the then 27 Member States having deficits above 3% of GDP and entering the EDP. Since then, all Member States have corrected their excessive deficits. Overall, these developments suggest that the deficit criterion of 3% of GDP has contributed to better fiscal outcomes, particularly in Member States with high public deficits before the launch of the Pact. At the same time, the deficit criterion seems to have acted as a target rather than a ceiling, since several Member States with a record of high deficits still have public deficits close to 3% of GDP, despite the current favourable macroeconomic conditions. By contrast, there seems to be no clear-cut impact of the 3% deficit criterion on Member States that had headline surpluses or low deficits before the Pact was introduced. The green area in Graph A.1 depicts, for each year, the range of the budget balances for the quarter of Member States with the lowest deficits or highest surpluses in that year ('good performers'). While the composition of the group varied, there have always been Member States recording, on average, surpluses since the launch of the Pact in 1998, with the exception of the years following the Great Recession. This suggests that there has been no downward convergence of the good performers towards the 3% of GDP deficit criterion, as has recently been argued in policy papers ⁽¹⁾.

Headline balances in EU Member States
(% of GDP)

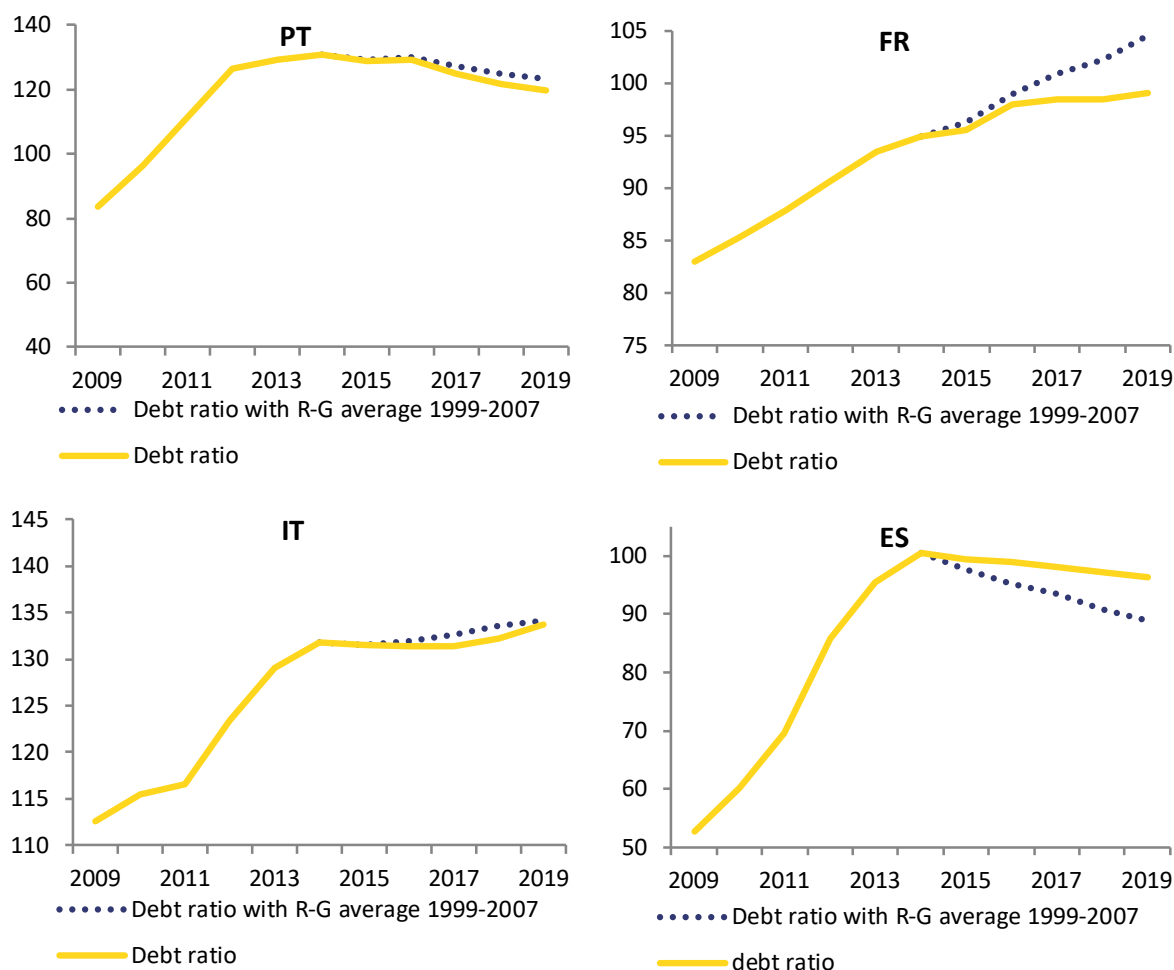


Note: Headline balance figures from 1995 are based on ESA 2010 while previous figures are back-casted according to the observed change in the ratio as from the series based on ESA 1995. As a consequence of the variable composition of the groups of 'bad performers' and 'good performers', some of the fluctuations could be the result of composition effects (i.e. Member States shifting categories).

Source: European Commission, Report on Public Finances in EMU 2018, based on the Commission's spring 2018 forecast.

(1) See Caselli, F. and Wingender, M. (2018), 'Bunching at 3 Percent: The Maastricht Fiscal Criterion and Government Deficits', IMF Working Paper 18/182.

Graph II.4: Debt: the r-g effect



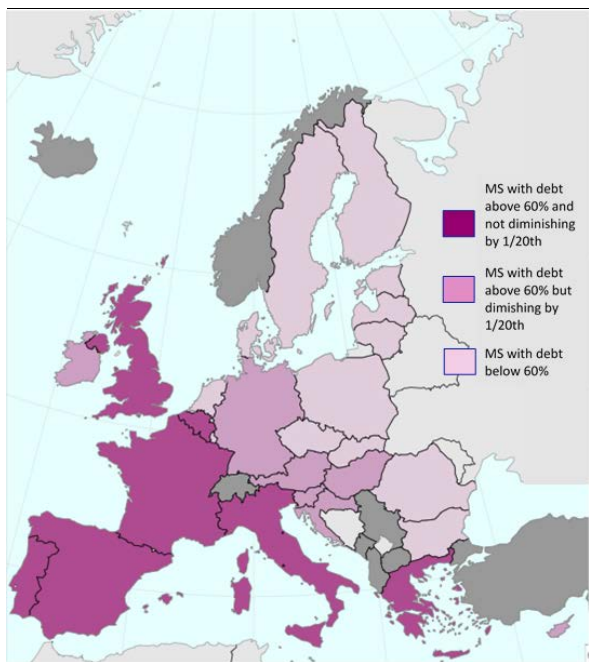
Source: Eurostat, European Commission

Despite recent improvements, all Member States (apart from Germany, Malta and Sweden) now have higher debt-to-GDP ratios than before the crisis. Around half of the Member States now have debt levels below 60% of GDP (see Graph II.5). Another group of Member States are above the threshold of 60% of GDP but their debt levels are diminishing by more than 1/20th of the gap to this threshold per year, in accordance with the debt reduction benchmark. Lastly, there is a group of Member States for which debt levels have hardly stabilised (Italy, Greece, France) or are not yet diminishing at a sufficient pace (Belgium and Spain). Compared to 2008, almost all Member States now have higher debt levels, especially some bigger Member States like Italy, France and Spain (See Graph II.6).

Graph II.7 shows the current situation with both the deficit and debt criteria. Over half of the Member States have brought their deficits

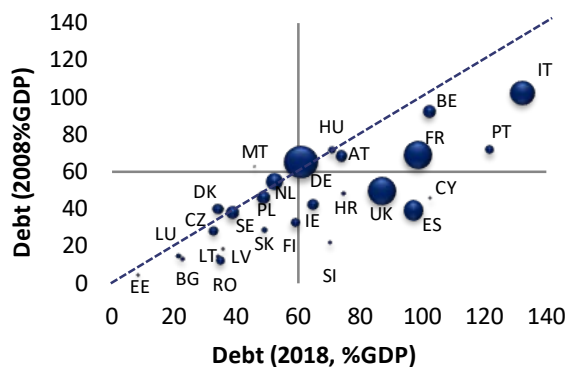
safely below the 3% limit and display debt ratios below 60% of GDP. Some of these countries now have budget surpluses. By contrast, other Member States, including some of the largest, still have sizeable deficits despite relatively favourable economic conditions in recent years. Debt in those Member States remains high, and in some cases very high. Those countries account for half of the EU's GDP.

Graph II.5: **Situation with the Treaty debt criterion in 2018**



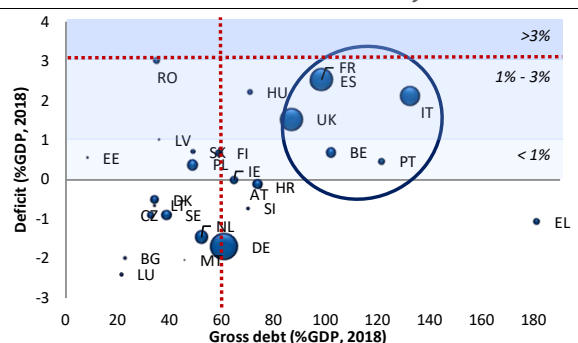
Source: European Commission

Graph II.6: **Comparison of debt levels in 2018 and 1999 (Size of bubbles is proportional to country shares in total EU-28 GDP)**



Source: Eurostat, European Commission

Graph II.7: **Where do Member States stand in relation to the Treaty criteria? (Size of bubbles is proportional to country shares in total EU-28 GDP)**

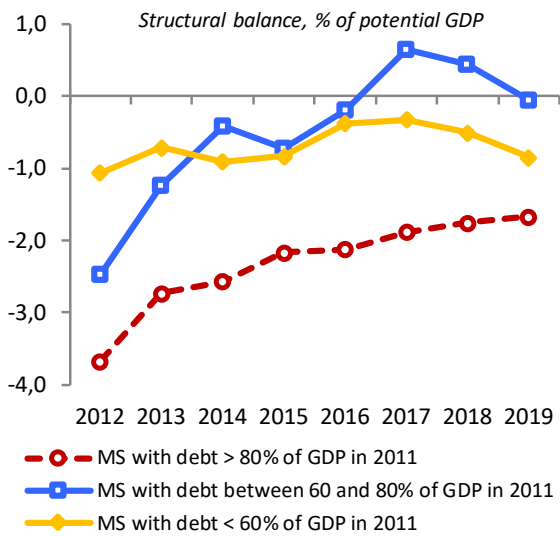


Source: Eurostat, European Commission

II.3.2. Have Member States ensured sound public finances?

All Member States have now moved to the preventive arm of the Pact and are required to make progress towards their MTOs. Graph II.8 shows developments in the structural balances of Member States, divided into three groups based on their debt ratio in 2011. The biggest structural adjustments took place between 2011 and 2013, when most Member States were still under the EDP. This partly reflected intense financial market pressure on some Member States during this period. Since 2014, the average fiscal effort of the Member States with the highest initial debt levels (Italy, Portugal, Ireland, Belgium, France, Austria, the UK and Hungary) has slowed down. This is partly explained by the fact that improvements in headline balances in some Member States have been achieved by relying on better cyclical conditions, thus allowing those Member States in the corrective arm to achieve their required adjustments without making a structural fiscal effort. It also shows that the preventive arm has had little traction on a number of Member States, despite the relatively high debt ratios of the Member States in this group. On the other hand, Member States with lower debt have continued to adjust, even when a structurally balanced budget or even a surplus was reached.

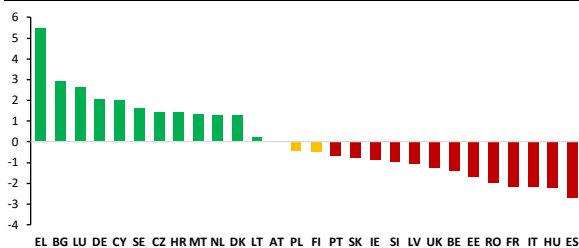
Graph II.8: Have Member States ensured sound public finances?



The composition of the three groups is fixed based on their debt levels in 2011:
 - MS with debt > 80% of GDP in 2011: IT, PT, IE, BE, FR, AT, UK, HU.
 - MS with debt between 60% and 80% of GDP in 2011: DE, MT, ES, CY, HR, NL.
 - MS with debt < 60% of GDP in 2011: PL, FI, SI, DK, SK, LV, CZ, SE, LT, RO, LU, BG, EE.
Source: European Commission, based on the European Commission's spring 2019 forecast.

As a result of uneven structural adjustments, Member States' current fiscal positions in relation to their MTOs vary widely. Graph II.9 shows the large differences between Member States. Around half of them have reached their MTOs, with some accumulating high surpluses that go beyond the requirements of the preventive arm. A few Member States are close to their MTOs. Lastly, a group of Member States remains far away from their MTOs and have not yet built sufficient buffers for the next downturn.

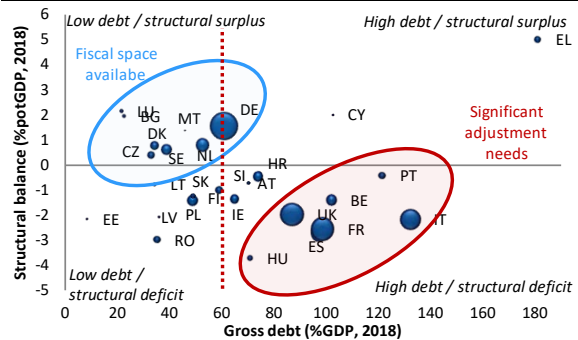
Graph II.9: How far were Member States from their MTOs in 2018?



Source: European Commission

There appears to be an inverse relationship between Member States' debt levels and budget balances. Some Member States that currently have structural (and headline) surpluses are also those with relatively low debt levels (Graph II.10). That is the case for bigger Member States like Germany and the Netherlands but also for Bulgaria, Czechia, Denmark, Luxembourg, Malta and Sweden. On the other hand, some of the most highly-indebted Member States still need to make significant adjustments (Belgium, Spain, France, Hungary, Italy and, to a lesser extent, Portugal). This has clear implications for the sustainability of those Member States' debt burdens.

Graph II.10: Structural balance and debt ratios across Member States with country sizes (Size of bubbles is proportional to country shares in total EU-28 GDP)

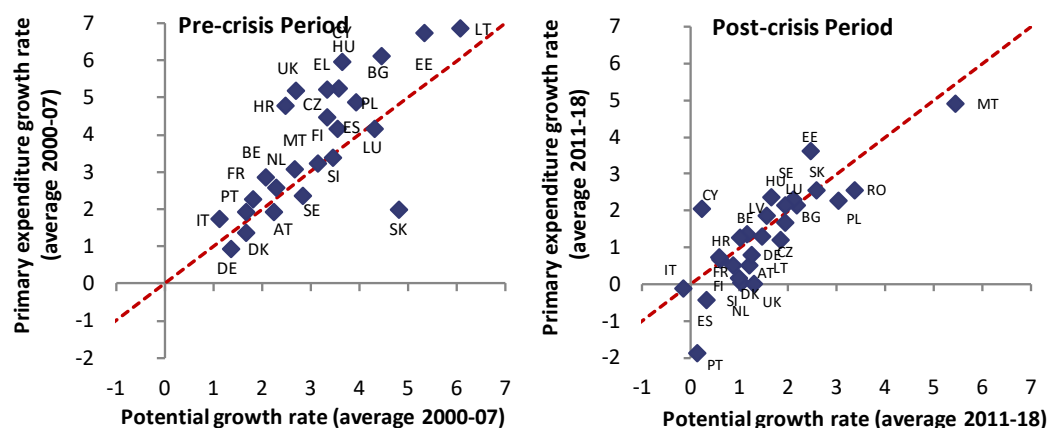


Source: Eurostat, European Commission

Expenditure dynamics now seem better controlled than before the crisis (Graph II.11). The pre-crisis period saw government primary expenditure in most Member States growing faster than potential output. Since the crisis, the growth rate of primary expenditure has slowed down in relation to potential output, with expenditure actually growing at or below the level of potential output in nearly all Member States. It is important to note that this assessment of expenditure dynamics does not take account of revenue measures, which on the whole have been revenue-increasing in the post-crisis period, thus partly neutralising the impact of expenditure increases on the deficit.⁽⁸⁷⁾ This contrasts with the pre-crisis period, which saw the majority of Member States cutting taxes. Expenditure dynamics net of revenue measures appear, therefore, even more contained in the post-crisis period compared with the pre-crisis period.

⁽⁸⁷⁾ Since 2016, the picture has been more mixed, with some Member States implementing new tax cuts.

Graph II.11: Controlling primary expenditure dynamics



Source: European Commission

The containment of expenditure growth in recent years is in line with the greater focus on expenditure developments in the preventive arm. As discussed in the first sub-section, the Six-pack reform led to a greater focus on aggregate expenditure developments. Indeed, since 2016, the Commission has given priority to the expenditure benchmark in its assessment of Member States compliance with the requirements of the preventive arm.⁽⁸⁸⁾ This is in line with the growing literature on the benefits of having binding ceilings on expenditure growth as a fiscal policy tool.⁽⁸⁹⁾ Research indicates that such rules can reduce the risk of excessive deficits and contribute to counter-cyclical fiscal policy. In contrast to rules based on estimates of the structural balance, they have the advantage of being easy to understand and therefore lead to greater transparency.

Despite recent innovations, the Pact has not improved the quality and composition of public finances. In principle, the Pact is neutral for the composition of public revenue and expenditure. However, in practice, it may be easier politically to raise certain taxes or to cut public investment rather than to cut current expenditure during a period of consolidation. For this reason, the Pact has often been used as a scapegoat for low levels of public investment in the EU. The negative impact of low public investment on potential

growth affects debt dynamics, which has led to criticism of the appropriateness of fiscal consolidation. The introduction of the investment clause in 2015 does not appear to have had a substantial positive impact on public investment. On the other hand, fiscal rules tend to reduce policy volatility, which is arguably also beneficial to long-term growth.⁽⁹⁰⁾

II.3.3. Fiscal stance and fiscal stabilisation

National fiscal stances have been largely pro-cyclical since 2011. Most Member States implemented sizeable fiscal adjustments (as measured by the change in the structural primary balance) in the period immediately following the crisis. This reflected a lack of fiscal buffers at the onset of the Great Recession, a need to correct excessive deficits and, in some cases, the need to restore market confidence. These fiscal adjustments took place in a context of very low or even negative economic growth in some Member States, which was most likely aggravated by a restrictive fiscal stance. In contrast, fiscal consolidation has ground to a halt since 2014 while economic growth has picked up. However, potential growth has declined substantially in most Member States compared to pre-crisis levels, which makes fiscal adjustments more demanding. Avoiding a pro-cyclical pattern of fiscal policy in good times has run counter to differing views among Member States about appropriate debt and

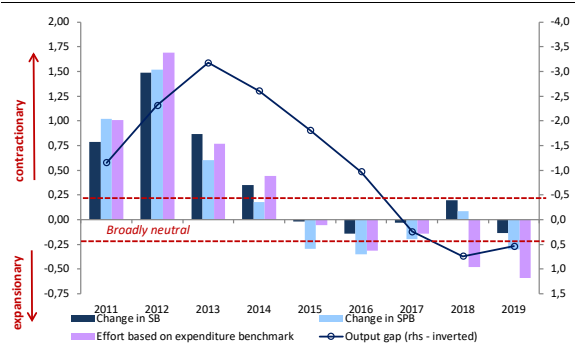
⁽⁸⁸⁾ See the Opinion of the Economic and Financial Committee of 29 November 2016 on 'Improving the predictability and transparency of the SGP: A stronger focus on the expenditure benchmark in the preventive arm'.

⁽⁸⁹⁾ For an overview of the recent literature in this area, see Bedogni, J. and Meaney, K. (2017), 'EU Fiscal Rules and International Expenditure Rules', Irish Government Economic & Evaluation Service.

⁽⁹⁰⁾ For a discussion of the interaction of fiscal rules and the composition of government expenditure, see Dahan, M. and Strawczynski, M. (2013), 'Fiscal Rules and the Composition of Government Expenditures in OECD Countries', Journal of Policy Analysis and Management.

deficit levels. For example, some Member States have remained just below the deficit limit of 3% of GDP in all but exceptionally bad times, instead of moving towards their MTOs. Empirical evidence suggests that compliance with the rules of the preventive arm would reduce pro-cyclicality, notably if debt is below 60% of GDP. Conversely, having high deficit and debt levels tends to amplify pro-cyclicality.⁽⁹¹⁾

Graph II.12: **Developments of key indicators for the fiscal stance in the euro area (% of potential GDP)**



Note: Several indicators are used in literature to assess the fiscal stance. The measures of the fiscal stance presented here are: the change in structural balance (SB), the change in structural primary balance (SPB) and a measure of the fiscal effort based on the expenditure benchmark methodology.

Source: European Commission 2019 autumn forecast.

The aggregate fiscal stance in the euro area was contractionary in 2011-2014, and broadly neutral overall in 2015-2018.⁽⁹²⁾ Graph II.12 presents the fiscal stance measured by: the change in the structural balance⁽⁹³⁾; the change in the structural primary balance; and the fiscal effort according to the expenditure benchmark methodology.⁽⁹⁴⁾ The change in the fiscal stance

has helped the economic recovery in the euro area since 2015, in a period when monetary policy has been constrained at the zero lower bound. However, as noted earlier, the fiscal stances of individual Member States were insufficiently differentiated and resulted in a situation where high-debt countries made limited or no fiscal adjustments while countries with fiscal space accumulated large surpluses. Since 2018, while the output gap in the euro area has been closed, the fiscal stance has become mildly expansionary, resulting in a pro-cyclical stance for the euro area as a whole.

The EU's ability to coordinate an appropriate fiscal stance for the euro area remains constrained. The Two-pack legislation requires the Commission to regularly assess the budgetary situation and prospects in the euro area as a whole. This allows the Commission to undertake a consistency check between individual Member States' policies and the appropriate policy stance for the euro area as a whole, with a view to balancing stabilisation and sustainability needs. However, there are strong limits in practice to achieving the appropriate aggregate fiscal stance based on the coordination of national budgets. Indeed, as a result of its prime focus on debt sustainability, the working of the Pact is asymmetric: it can *proscribe* high fiscal deficits but cannot *prescribe* lower fiscal surpluses. Therefore, the framework does not provide adequate tools to steer the aggregate fiscal stance in case the stances of individual Member States do not sum up to an appropriate aggregate fiscal stance.

A euro area fiscal stabilisation capacity would improve the EU's ability to coordinate an appropriate fiscal stance. Such an instrument would make it possible to supplement automatic stabilisers at national level in bad economic times. This would allow Member States to respond better to rapidly changing economic circumstances and stabilise their economies in the event of large economic shocks. In doing so, a fiscal stabilisation capacity would also contribute to the stability of the euro area, complementing other innovations in euro area institutional architecture that have been put in place since the financial crisis.

⁽⁹¹⁾ European Commission (2018), 'Fiscal outcomes in the EU in a Rules-Based Framework – New Evidence', Report on Public Finances in EMU 2018, 105-156.

⁽⁹²⁾ Given the uncertainty surrounding the measure of structural balance as an unobserved variable, an interval of the fiscal stance between -0.2% and 0.2% is considered to be broadly neutral.

⁽⁹³⁾ The change in the structural (primary) balance, although capturing the broad economic effects of fiscal policy, can be distorted by the following flaws: (i) swings in fiscal elasticities (i.e. tax windfalls or shortfalls); (ii) revisions in the estimations due to difficulties in measuring of the output gap in real time; and (iii) effects outside the control of governments (e.g. change in interest rates affecting the structural balance).

⁽⁹⁴⁾ The fiscal effort based on the expenditure methodology is based on the budgetary developments that are deemed to be under the control of governments. On the expenditure side, it looks at the increase in primary expenditure (net of one-offs, cyclical expenditures and EU-funded expenditure), relative to the 10-year average potential growth. On the revenue side, it only takes into

account discretionary revenue measures net of one-offs, as assessed in the Commission forecast.

II.4. Why has implementation of the Pact been insufficient in some cases?

As discussed above, the Pact appears to have been successful at correcting gross policy errors, in particular excessive fiscal deficits. At the same time, a number of highly-indebted Member States have undertaken little or no fiscal adjustment in recent years and remain far from their MTOs. Consequently, their debt ratios have continued to rise (or at best have stabilised), and they lack a sufficient safety margin to the deficit threshold of 3% of GDP, despite favourable economic conditions. These observations call into question the effectiveness of the preventive arm and the extent to which the reformed Pact has made a difference in those cases where fiscal discipline is most necessary. This sub-section offers some tentative explanations of why this has been the case, highlighting the idiosyncratic context of the post-crisis years.

II.4.1. A particular context: the sequence of austerity led by the debt crisis followed by an atypical recovery

Between 2010 and 2012, the need to restore market confidence forced some Member States to make large fiscal efforts in a difficult macro-economic context. Following the 2008-2009 crisis and the surge in headline deficits, a number of Member States were required to implement, over a period of 3 or 4 years, fiscal tightening of up to 6% of GDP, and even more in the cases of Ireland and Greece.⁽⁹⁵⁾ Market pressure forced some Member States to make even stronger adjustments than those set in the context of the Pact. That was the case of Spain and Portugal, and to some extent also of Italy. The large fiscal adjustment made at the height of the crisis was economically and politically difficult to sustain, and led those countries to significantly reduce, and even stop, adjusting afterwards, despite the persistent need to consolidate.

The modest pace of the recovery has also been given as a reason to slow down the pace of fiscal adjustment. In many Member States, economic growth remained subdued well after the peak of the crisis, and high unemployment rates

persisted. Inflation remained relatively low despite unprecedented monetary policy measures. Against that background and in order to prevent a lasting impact on employment, the Commission Communication ‘Towards a positive fiscal stance for the euro area’ of 16 November 2016 emphasised the need to strengthen domestic sources of growth, including through more supportive fiscal policy.⁽⁹⁶⁾ The Commission also considered the relatively low growth and inflation as a relevant factor for not opening debt-based EDPs for Italy and Belgium, despite non-compliance with the debt reduction benchmark in 2014, 2015 and 2016.⁽⁹⁷⁾ Lastly, the need to strike a balance between sustainability and stabilisation was taken into account when assessing Italy and Slovenia’s compliance with the preventive arm in 2018.

II.4.2. Reluctance to escalate surveillance procedures

The Commission and the Council have been reluctant to launch enforcement procedures envisaged by the Pact. As outlined above, the Commission has opted for a prudent and flexible approach in recent years, complemented by constant political dialogue with the Member States. In its 2017 annual report (and in IMF analysis), the European Fiscal Board confirmed that interpretation of the Commission’s approach, although in more critical terms. However, reluctance to fully exploit hard enforcement mechanisms provided by the legislation was already perceptible before 2014. For example, the two-year extension of the EDP granted to France in 2013 was at the time perceived and criticised as too soft a choice by some observers. Discussions on trade-offs between consolidation and reforms started in 2013-2014, with an investment clause introduced for the first time and a call by Member States, including those generally in favour of a strict interpretation of the EU fiscal rules, to consider structural reforms.

The draft budgetary plan process has proved useful for *ex ante* coordination and for fostering dialogue between euro area Member States and the EU. Before this process was

⁽⁹⁵⁾ For example, the Council on 2 December 2009 recommended that France, Spain and Portugal achieve average annual fiscal efforts of ‘above 1% of GDP’, ‘above 1.5% of GDP’ and ‘1¼% of GDP’ respectively over 2010-2013.

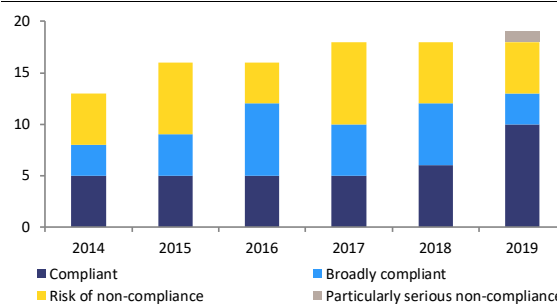
⁽⁹⁶⁾ European Commission(2016), ‘Towards a positive fiscal stance for the euro area’, COM(2016) 727.

⁽⁹⁷⁾ See subsequent Commission reports on Belgium and Italy prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union

introduced, the Commission would mainly assess whether budgetary outcomes complied with the EU's fiscal rules, i.e. the Commission would do an *ex post* assessment. Examining the medium-term budgetary plans presented in the stability and convergence programmes carried (and continues to carry) little traction, given that these plans are mere commitments without the backing of a budget law to implement them. The draft budgetary plan process has been designed to strengthen fiscal surveillance up front, i.e. allowing the Commission to give its view on whether the draft annual budget was likely to comply with the EU's fiscal rules. This is meant to alleviate the burden of surveillance carried out *ex post*, which was perceived as more punitive and less efficient as it came too late in the process and offered less scope for timely corrective action. In practice, the process has turned out to be useful for setting up a dialogue between the EU and euro-area Member States, as well as fostering awareness among national parliaments and the public of Member States' obligations under the Pact. However, the focus of the assessment on annual changes in the (unobservable) structural balance hampered this dialogue.

At the same time, the draft budgetary plan process has underlined the difficulty of influencing national fiscal policy. Only once the Commission has requested a Member State to submit a revised draft budgetary plan, in the case of the Italian 2019 draft budgetary plan, despite numerous plans that were at risk of non-compliance (see Graph II.13) and despite the absence of any form of sanctions associated with such a request. The Commission has instead sent 'follow-up letters' in all rounds since 2014. However, Member States have taken limited corrective actions. This is partly due to the fact that the Commission opinions come too late to influence the national budgetary process. Despite this seemingly limited impact, the mere existence of the draft budgetary plan process may have encouraged Member States to take the Pact's requirements into account when preparing their draft budgets. This mixed experience with the draft budgetary plan process raises the question of whether *ex ante* coordination can effectively ensure that Member States respect the EU fiscal rules.

Graph II.13: Overall compliance of the Draft Budgetary Plans with the Pact



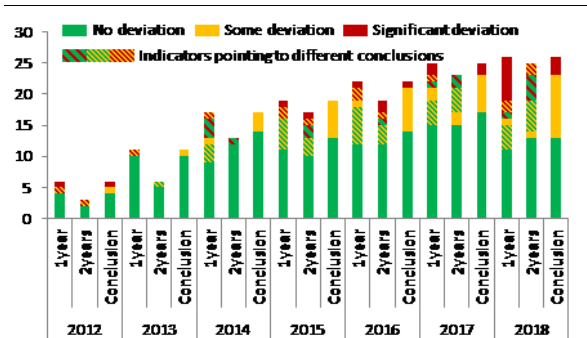
Note: This graph shows the number of Member States for which the draft budgetary plan (DBP) was found compliant, broadly compliant and at risk of non-compliance. '2014' refers to the assessment of the DBPs for 2014 carried out in autumn 2013. The number of countries submitting a DBP has increased over time, with Latvia and Lithuania joining the euro area in 2014 and 2015, respectively, and Ireland, Portugal, Cyprus and Greece gradually exiting the macroeconomic adjustment programmes. Portugal did not submit a DBP in autumn 2015.

Source: European Commission

While many Member States have achieved their MTOs, enforcing the preventive arm in some high debt countries has proven to be difficult. As shown in Section II.2.2, the pace of structural adjustment has been very uneven in the EU. The significant deviation procedure was introduced as part of the Six-pack as a means to enforce the Pacts' preventive arm. It aims to rectify significant deviations from the MTO or from the adjustment path towards that objective observed on an *ex post* basis. However, it has so far only been applied in the clear-cut cases of Romania and Hungary, with limited results. ⁽⁹⁸⁾ There have been a number of borderline cases but none of them has triggered a significant deviation procedure. In particular, in several instances the compliance indicators pointed to significant deviations from the adjustment requirements, while the overall assessments concluded that the deviations were not significant within the meaning of Regulation 1466/97 (see Graph II.14).

⁽⁹⁸⁾ Malta was found in significant deviation in 2012 but no significant deviation procedure was formally opened, as the country was also found to have breached the Treaty's deficit and debt criteria and was therefore put in EDP.

Graph II.14: Ex post assessment of compliance with the preventive arm of the Pact



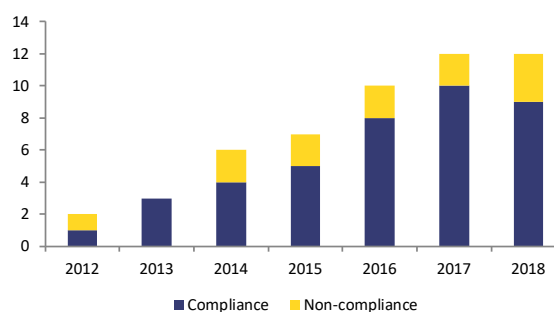
Note: This graph shows the number of Member States under the preventive arm where the compliance indicators pointed to no (green), some (yellow) or significant deviation (red) over 1 and 2 years, as well as cases where both indicators pointed to different conclusions. For each year, it also shows the conclusion of the overall assessment, for the Member States that were subject to the preventive arm in the concerned year. For example, in 2014, over 1 year, both indicators pointed to no deviation for 8 Member States, some deviation for 1 Member State, and different deviations for the remaining 8 Member States; over 2 years, both indicators pointed to no deviation for 10 Member States and different deviations for the remaining 3 Member States. Overall, no deviation was found for 14 Member States, some deviation was found for the remaining 3 Member States, while no Member State was found in significant deviation.

Source: European Commission

Enforcement is hampered by the fact that the framework relies heavily on unobservable and frequently revised variables. The output gap, which measures the amount of slack in the economy, is a key variable underpinning the Pact. It enters the Commission's assessments at different steps of the surveillance procedures and is a key element in calculating the structural balance. Since potential growth and output gaps are unobservable, they need to be estimated on the basis of economic data. This leads to unavoidable uncertainty and revisions of the estimates, for example between the ex ante policy guidance and the ex post assessment of compliance. This has allowed Member States to increasingly challenge the Commission's compliance assessments, especially when it comes to estimating Member States' precise structural balance position compared their MTOs. The use of a wider set of macroeconomic indicators to determine the cyclical position of a Member State and the use of the expenditure benchmark to assess compliance (introduced by the Six-pack) has had limited success in addressing Member States' concerns. Overall, the wide use of unobservable indicators has likely reduced ownership and political buy-in, especially in Member States subject to the preventive arm of the Pact.

Similarly, the operationalisation of the debt criterion did not lead to the opening of EDPs for insufficient debt reduction. The debt reduction benchmark was introduced in 2011 as an attempt to make the Treaty's debt criterion operational. However, so far no EDP has been opened on the basis of the debt criterion alone, despite breaches of the debt reduction benchmark (see Graph II.15).⁽⁹⁹⁾ The benchmark has proved challenging to implement as it is highly pro-cyclical and debt reduction is ultimately not directly in the hands of Member State governments. In this context, the Commission considers observance of the preventive arm requirements to be a key relevant factor when assessing compliance with the debt criterion, as it is supposed, under normal macro-economic circumstances, to ensure sustainability or rapid progress towards sustainability in the medium term. In turn, compliance with the preventive arm has been interpreted in an increasingly broad manner, notably because of the increased use of flexibility. Overall, successive breaches of the debt reduction benchmark by Belgium and Italy have not triggered the opening of 'debt-based' EDPs. While some have claimed that a relatively flexible interpretation of the rules has led to an insufficient reduction of debt, others have argued that the design of the debt rule is no longer fit for purpose in a context of protracted low nominal growth.

Graph II.15: Ex post compliance with the debt reduction benchmark including during the 3-year transition period



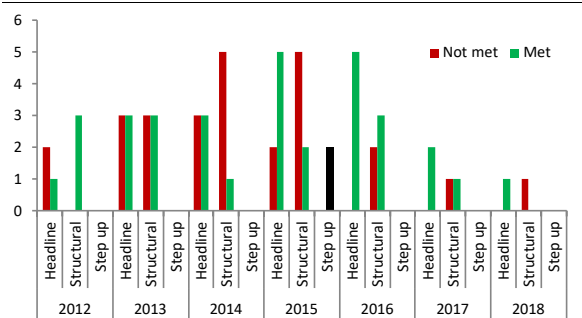
Source: European Commission

The implementation of the corrective arm also reveals some shortcomings. The 2011 reform aimed to address several weaknesses of the EDP. Introducing intermediate headline and structural

⁽⁹⁹⁾ The only debt-based EDPs so far were for Malta (2013) and Croatia (2014), but these were opened because they breached both the deficit and debt criteria.

balance targets was meant to prevent Member States back-loading fiscal consolidation and to make the assessment of effective action more transparent. Financial penalties kicking in earlier in the procedure and decisions on most sanctions being taken by reverse qualified majority voting were meant to ensure stricter compliance with the rules. In practice, the introduction of intermediate targets for both headline and structural balances has led to a situation where meeting the weakest of the two requirements *ex post* is sufficient to be considered compliant. At first, this meant that countries could miss headline targets while (just) meeting structural efforts and could benefit from deadline extensions. Then more recently, when economic conditions turned out more favourable than expected at the time of the EDP recommendations, the framework allowed instead for a nominal strategy, where Member States could meet their headline deficit targets without delivering (at all) the required improvements in the structural balance (Graph II.16). A direct and paradoxical consequence is that the actual fiscal adjustments implemented by EDP countries have in some cases turned out lower than those delivered by countries subject to the preventive arm of the Pact, thus affecting political ownership of the preventive arm (Graph II.17).⁽¹⁰⁰⁾

Graph II.16: Ex post compliance with headline and structural deficit targets under the EDP

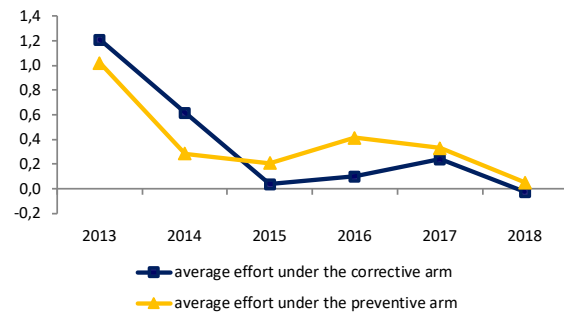


Note: Only post-Six-pack EDP recommendations and non-programme years are considered. The annual structural target is considered to have been met if at least one of the two compliance indicators (corrected change in the structural balance and bottom-up approach) was met. Decisions to step up the procedure refer to the year of non-compliance with the targets and not to the year when those decisions were formally taken.

Source: European Commission

⁽¹⁰⁰⁾ The Commission tabled a proposal to address that issue in 2016, in line with the commitment made in the Commission Communication of 21 October 2015 on ‘Steps towards completing Economic and Monetary Union’ (COM(2015) 600), but the Member States decided not to endorse the proposal.

Graph II.17: Observed Fiscal effort: corrective versus preventive arm



Note: “Preventive arm countries” in 201x comprises the countries that were in the preventive arm in 201x but not yet at their MTO at the start of 201x.

Source: European Commission

Similarly, the introduction of swifter sanctions and reverse qualified majority voting for Council decisions has proved challenging to implement. These reforms have shifted more responsibilities to the Commission for difficult decisions that are inherently political in nature. So far, the Commission has refrained from imposing financial sanctions, including in 2016 when Spain and Portugal did not fulfil their commitments under the EDP⁽¹⁰¹⁾. Paradoxically, while sanctions are sometimes milder than the cost of market pressure (increased spreads), they are more controversial because they are perceived as limiting national sovereignty by a supranational body.⁽¹⁰²⁾ In its assessment of the EU fiscal rules⁽¹⁰³⁾, the European Fiscal Board highlights how the introduction of reverse qualified majority voting has blurred the distinction between the analytical and (growing) political role of the Commission. In order to more clearly demarcate economic analysis from political considerations, the Board recommends the abandonment of reverse qualified

⁽¹⁰¹⁾ The Commission’s proposal to cancel the fines in view of Spain’s and Portugal’s reasoned requests, endorsed by the Council on 8 August 2016, was based on a number of arguments, in particular the implementation of structural reforms and the commitment to adopt deficit-reducing measures. The ‘challenging economic environment’ (in the case of Spain) and ‘the fiscal adjustment undergone during the economic adjustment programme’ (in the case of Portugal) were also put forward as arguments. Many observers argued that also in the case of France in 2015, the EDP should have been stepped up, which in principle would have entailed penalties.

⁽¹⁰²⁾ A counter example in that respect is the decision to suspend structural funds in the case of Hungary in 2012 following a decision on non-effective action under the EDP. However, that decision was not formally based on the Six-pack provisions but on the macroeconomic conditionality provisions relative to the 2007-2013 financial framework.

⁽¹⁰³⁾ See European Fiscal Board (2019), ‘Assessment of EU fiscal rules with a focus on the six and Two-pack legislation’.

majority voting in this area. It further recommends the nomination of a full-time President of the Eurogroup.

II.4.3. A polarisation of views on the EU's fiscal rules

The challenges associated with enforcing the Pact should be seen in the context of a lack of consensus on the EU fiscal framework. In recent years, there has been a growing polarisation of views on the implementation of the EU's fiscal rules and, indeed, on the role that such supranational rules should play. Some Member States favour a strict interpretation of the rules. They criticise an alleged disregard for the debt reduction benchmark and the accumulation of flexibility devices, e.g. the lenient interpretation of the concept 'of 'broad compliance' with the requirements of the preventive arm, multiple flexibility clauses, ad-hoc changes to the fiscal requirements, and the non-application of sanctions. In their view, the flexible implementation of the rules has allowed a few high-debt Member States to avoid the significant deviation procedure and the debt-based EDP, despite little or no fiscal adjustment by these Member States. The stronger use of discretion is sometimes also perceived by smaller Member States as being unduly favourable to larger Member States, calling into question the principle of equal treatment. In contrast, Member States that have experienced slower recoveries from the Great Recession view flexibility as instrumental in supporting their economies and reducing unemployment. This polarisation of views has seriously eroded the consensus on the performance of the rules and the possible direction of future reforms.

Moreover, a lack of political ownership has also been aggravated by an emphasis on annual fiscal adjustments that has led to insufficient differentiation between Member States with markedly different fiscal positions and sustainability risks. In principle, the Pact has a strong medium-term focus, e.g. central role of Stability and Convergence Programmes, focus on a "close-to-balance or in surplus" budgetary position in the medium term, and multi-annual targets in the EDP. In practice, however, the framework mostly focuses on an annual assessment of annual targets, while the medium-term orientation of fiscal policy, including its multi-annual 'track record', receives less prominence.

While the secular decline in interest rates on government debt in recent decades suggests that countries might safely maintain higher levels of public debt, the heightened risks of debt market contagion within monetary union supports the need to aim for safe debt-to-GDP ratios. The design of the Pact is based on the view that high public debt is a drag on the economy and increases the risk of debt crises, in turn calling for primary surpluses that can be used for stabilising (or reducing) the debt-to-GDP ratio. This view has increasingly been called into question due to the observed decline of interest rates on government debt since the 1980s, with these rates falling below the growth rate of nominal GDP in several instances.⁽¹⁰⁴⁾ In such a situation, the public debt ratio can be stabilised (or even reduced) even if the government does not run a primary surplus, as nominal GDP growth will keep the debt ratio in check. It could, therefore, be argued that increasing debt-to-GDP ratios would be a desirable way to absorb private savings and boost the productive capacity of the economy, through higher public investment. These arguments ignore, however, the volatile and self-reinforcing nature of financial markets and the observation that unanticipated spikes in interest rates can lead to public debt spiralling to non-sustainable levels. This poses particular problems for countries in monetary union (particularly those with very high debt-to-GDP ratios) due to the specific institutional framework of the EMU, in which national public debt cannot be unconditionally backed by the central bank and where national public debt crises may threaten the EMU's overall integrity and stability. Furthermore, as the IMF argues in its April 2019 Fiscal Monitor, lower public debt ratios provide room for countercyclical fiscal policy during economic downturns.⁽¹⁰⁵⁾

II.5. Conclusion

The primary objective of EU fiscal rules is to ensure that Member States have a public debt that is sustainable. This is based on the rationale that unsustainable levels of public debt can give rise to debt crises that can spill over into other Member States' debt markets, thus threatening the very existence of the EMU. Successive reforms have given a central role to the preventive arm of

⁽¹⁰⁴⁾ See, for example, Blanchard, O. (2019), 'Public Debt and Low Interest Rates', *American Economic Review*, vol. 109 no. 4.

⁽¹⁰⁵⁾ IMF (2019), 'Fiscal Monitor: Curbing Corruption', 1 April.

the SGP, placed an emphasis on public debt in the corrective arm and tried to make the rules more adaptable to economic conditions. These innovations reflect several observations from the pre-crisis period, namely: market discipline was not sufficient to ensure sustainable fiscal policies; Member States failed to make necessary fiscal adjustments during good economic times; and debt levels can increase considerably during recessions and crisis periods.

In recent years, considerable progress has been made in reaching sound fiscal positions, although a number of highly-indebted Member States have made little or no fiscal adjustment. With all Member States meeting the 3% of GDP deficit criterion by 2018, the EDP has proven itself to be an effective tool for reducing excessive borrowing. More than half of the Member States have also reached (or are close to) their MTOs, thus providing them with fiscal buffers and proving the usefulness of the preventive arm. Underlying fiscal policies have not been appropriate in all Member States, however. For example, since the economic recovery in 2015, the correction of excessive deficits has mainly been driven by better-than-initially-expected macroeconomic conditions rather than structural fiscal adjustments. Furthermore, some highly-indebted Member States remain far from their medium-term objectives, which makes them vulnerable to breaching the (nominal) reference value of 3% of GDP if economic conditions were to deteriorate. Their debt ratios have also continued to rise or, at best, have stabilised. These observations raise the question of the extent to which the reformed SGP has made a material difference in the cases where fiscal discipline is most necessary.

Whereas successive reforms made the SGP more stringent, its implementation and enforcement have been characterised by an increasing use of flexibility and judgement. The Commission's approach to implementing the rules has been to strike a balance between the need for fiscal sustainability and the need for macroeconomic stabilisation. This has been done within the constraints of the framework and partly reflects the absence of a central fiscal capacity, as well as very large accumulated output losses during the Great Recession.

Despite successive reforms to make the framework more adaptable to economic

circumstances, the Pact continues to be implemented in a pro-cyclical manner, and the EU's ability to coordinate an appropriate fiscal stance for the euro area remains constrained. The fiscal adjustments made by a number of Member States in the immediate post-crisis period took place in a context of very low or even negative economic growth and were, therefore, clearly pro-cyclical. In contrast, fiscal consolidation has ground to a halt since 2014, while economic growth has picked up.

Moreover, in view of the asymmetry of the SGP because of its focus on debt sustainability at the Member State level, the surveillance framework does not contain the appropriate tools to steer the aggregate fiscal stance. This can be problematic when the appropriate aggregate stance is not consistent with the sum of the stances of the individual Member States. A euro area fiscal stabilisation capacity would improve the EU's ability to coordinate an appropriate fiscal stance.

The Six-pack and Two-pack legislation contain clauses requiring the European Commission to review the different pieces of legislation by the end of 2019. This will be an opportunity to reflect on the future of EU fiscal rules. In this context, the Commission has acknowledged the need to simplify the fiscal rules in the 2017 Reflection Paper on the deepening of the Economic and Monetary Union. ⁽¹⁰⁶⁾

⁽¹⁰⁶⁾ European Commission, 2017, 'Reflection Paper on the deepening of the Economic and Monetary Union', COM(2017) 291.