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

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

II.1. Introduction

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

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

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

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

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

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

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

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

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

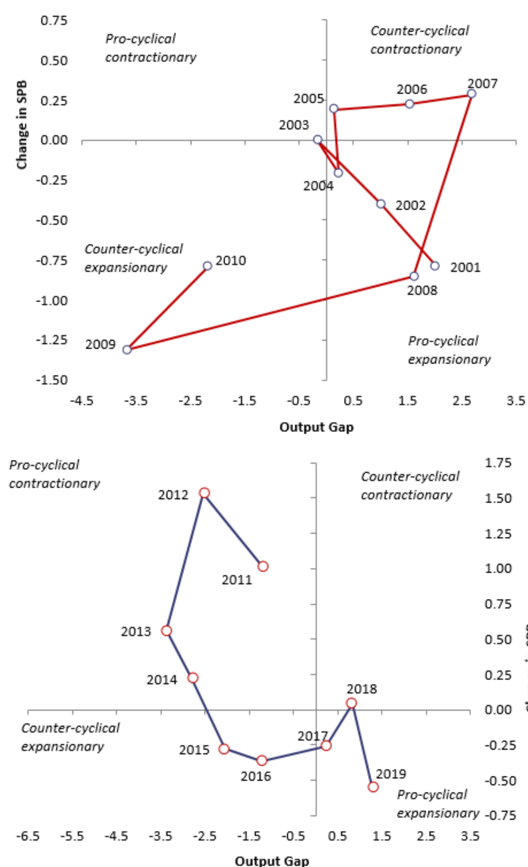
II.2.1. Overall evidence on the pro-cyclicality of fiscal policy

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

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

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

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



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

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

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

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

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

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

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

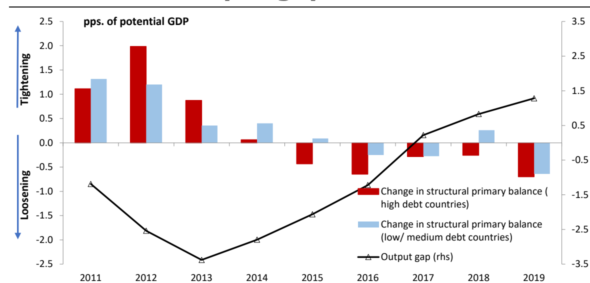
(35) European Commission (2020), "Report on Public Finances in EMU 2019", EU Commission (DG ECFIN) Institutional Paper no.133, July 2020.

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Pro-cyclicality in the preventive arm

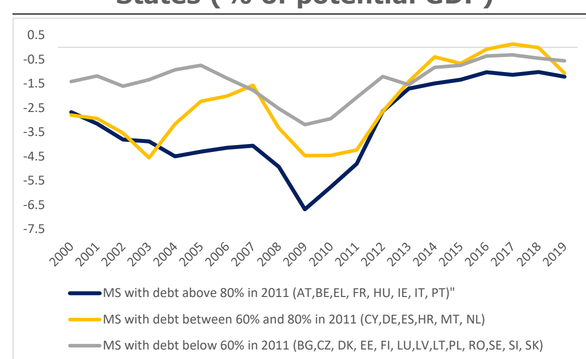
National fiscal policies remained largely pro-cyclical in the preventive arm in part because national fiscal stances were not appropriately differentiated across Member States (Graph II.3):

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

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

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

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



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

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

Pro-cyclicality in the corrective arm

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

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

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

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

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

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

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

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

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

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

([46]) For legal reasons, a deficit-based EDP cannot be "stepped up" if the Member State achieves its intermediate headline deficit target, even when the recommended change in the structural balance is not achieved.

([47]) The structural balance corrects for the economic cycle. The adjustment matrix allows modulating the fiscal effort based on the position of the country in the economic cycle. It requires a stronger fiscal effort in good economic times and a smaller fiscal effort in bad economic times. The margin of discretion seeks to balance the stabilisation and sustainability objectives by reducing the fiscal effort required by the adjustment matrix if it is found to be at odds with the stabilisation needs of the country. The aim of temporary deviations from the fiscal requirements or the suspension of the requirements is to avoid pro-cyclical fiscal contractions. Flexibility clauses such as the unusual events clause, the structural reforms and public investment clauses aim to reduce adjustment requirements to enable governments to face additional costs outside their control and to foster growth-enhancing policies.

([48]) The 2018 Communication on the evaluation of the 2015 Communication on flexibility provides some highlights on the extent to which the implementation of SGP flexibility since 2015 contributed to a pro-cyclical (or counter-cyclical) pattern of fiscal policy in some Member States.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

II.3.2. A greater emphasis on expenditure rules

A better performance in reducing pro-cyclicality

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

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

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

Reduced reliance on unobservable variables

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

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

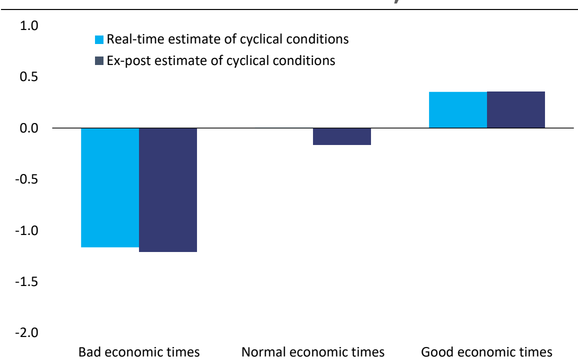
([59]) European Commission (2019), "Fiscal outcomes in the EU in a rules-based framework – new evidence", Report on Public Finances in EMU 2018, Institutional Paper 095, pages 105-156.

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

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

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

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



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

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

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

Role of fiscal policy in the event of strong shocks

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

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

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

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

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

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

II.4. Conclusions

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

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

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

([64]) Exceptional events can be defined according to EU law (Article 6 of Regulation 1476/97).
([65]) For a discussion on the fiscal dimension of disaster risk management, see Radu, D. (2021), “Disaster risk financing. Main concepts and evidence from EU Member States”, Discussion Paper, 2021, and Radu, D. (2022), “Disaster risk financing: limiting the fiscal cost of climate-related disasters”.