European Fiscal Board

Annual Report

2021

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ABBREVIATIONS

Member States

BE	Belgium
AT	Austria
BG	Bulgaria
CY	Cyprus
CZ	Czechia
DE	Germany
DK	Denmark
EE	Estonia
EL	Greece
ES	Spain
FI	Finland
FR	France
HR	Croatia
HU	Hungary
IE	Ireland
IT	Italy
LT	Lithuania
LU	Luxembourg
LV	Latvia
MT	Malta
NL	Netherlands
PL	Poland
PT	Portugal
RO	Romania
SE	Sweden
SI	Slovenia
SK	Slovakia
EA	Euro area
EU	European Union
EU-27	European Union, 27 Member States
EA-19	euro area, 19 Member States

Other

AEA	American Economic Association
AIReF	Independent authority of fiscal responsibility - Spain
CAPB	Cyclically adjusted primary balance
CP	Convergence programme
CSR	Country-specific recommendation
CUBS	Capacity utilization indicators
DBP	Draft budgetary plan
DG ECFIN	European Commission's Directorate-General for Economic and Financial Affairs
DSA	Debt sustainability analysis
DSM	Debt Sustainability Monitor
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EDP	Excessive deficit procedure
EERP	European economic recovery plan
EFB	European Fiscal Board

EFC	Economic and Financial Committee
EFC-A	Alternates of the Economic and Financial Committee
EMU	Economic and monetary union
EPC	Economic Policy Committee
ERM II	European exchange rate mechanism
ESM	European Stability Mechanism
FAC	Fiscal Advisory Council - Austria
GDC	Government Debt Committee - Austria
GDP	Gross domestic product
GFCF	Gross fixed capital formation
HCF	High Council of Finance - Belgium
HCPF	High Council of Public Finance - France
IFIs	Independent fiscal institutions
IMAD	Institute of Macroeconomic Analysis and Development - Slovenia
IMF	International Monetary Fund
MFF	Multiannual financial framework
MIP	Macroeconomic imbalance procedure
MTBF	Medium-term budgetary framework
MTO	Medium-term budgetary objective
NAWRU	Non-accelerating wage rate of unemployment
NGEU	Next Generation EU
OECD	Organisation for Economic Co-operation and Development
OeNB	National Central Bank - Austria
OGWG	Output Gap Working Group
PBO	Parliamentary Budget Office - Italy
RQMV	Reverse qualified majority voting
RRF	Recovery and resilience facility
RRP	Resilience and recovery plan
SB	Structural balance
SCPs	Stability and convergence programmes
SDP	Significant deviation procedure
SGP	Stability and Growth Pact
SIFI	Scope index of fiscal institutions
SP	Stability programme
SPB	Structural primary balance
SURE	Support to mitigate Unemployment Risks in an Emergency
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance
WIFO	Institute of Economic Research - Austria

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FOREWORD

Prof. Niels Thygesen

Chair of the European Fiscal Board (EFB)

In this annual report – the fifth in the short history of the EFB – our aim is, as usual, to assess the implementation of the EU rules-based fiscal governance framework. We also propose improvements in the light of experience.

What is unusual this year is the speed of events over the two years from start to end of the latest complete surveillance cycle, which relates to 2020. Starting from the policy recommendations formulated in 2019, through the fiscal policy decisions of 2020, the dramatic year of the Covid-19 pandemic and the response to it, to the *ex post* evaluation of a period when EU fiscal rules were *de facto* suspended, the environment changed radically. We have been writing this report in the phase when the recovery has gained in strength and coverage throughout the EU. Aggregate EU income is now expected to move beyond its 2019-level before the end of this year – earlier than was anticipated, making it virtually certain that the severe economic downturn clause will be deactivated with effect from 2023. That raises with some urgency a major issue for the Commission and the Council: what should be the basis for the fiscal guidelines to be formulated in the context of the European Semester in a post-pandemic environment?

Our report moves through three quite different regimes for economic, and, in particular, fiscal policy which have come in rapid succession over the last two years: (1) the pre-pandemic one of steady growth and marked by a growing degree of complacency, illustrated by backloading of adjustments and weakening compliance with policy recommendations; (2) the swift deployment of massive measures in national fiscal policy, supplemented by significant joint EU efforts, to contain the economic impact of the pandemic by sustaining employment and incomes; and (3) the future environment when the recovery becomes more complete and both the policy objectives and the means of moving towards them must be updated.

This multi-faceted sequence of regimes offers a sharp contrast to the, in retrospect, deceptively stable environment, which formed the background to the EFB's efforts to meet our mandate in earlier reports. This contrast and the lessons of the first two regimes must lead to sharper future recommendations. More impatience than in February 2020, when the Commission started the economic governance review, seems to us justified at this point. The complacency of the pre-pandemic regime with its reluctance to address even modest reforms of implementation is outdated. And the dramatic challenges which the EU faced – and tackled with considerable effect – need to be reviewed; the lessons from the emergency measures, though adopted as one-off initiatives, should be used in the design of governance and of complementary national and joint efforts.

The EFB has made several proposals for improving fiscal governance in reports over 2017-20. Our core ideas for simplifying and updating the framework have, in our view, become even more relevant since then. We note that they are supported by some official EU institutions, including the ECB and the European Parliament, and by a number of independent economists. The future focus should be on one primary objective, a long-run anchor for public debt, with one main operational rule - an expenditure benchmark - to target a gradual reduction of the debt ratio towards the anchor at a pace tailored to country circumstances. A single escape clause to be applied under well-specified conditions and backed by independent economic analysis, would complete the system. It would mark a major simplification by rolling back complications developed in the corrective and, particularly, in the preventive arm of the SGP.

We do not dispute either the general argument that prevention is better than cure, or the good intentions embodied in the practice. But the indicators relied upon can be estimated only with a

low degree of reliability limiting their suitability for policy recommendations. Furthermore, the latter have developed an excessively annual rather than a medium-term approach. Compliance has been limited throughout the life of the SGP; recommendations are often criticised for being too intrusive. More focus on gross errors in a medium-term perspective, as originally foreseen in the Treaty, would be desirable.

Updating fiscal governance in the way outlined in previous EFB reports would go some distance towards what we see as the reforms required for a post-pandemic regime. But the positive bold response to the recent crisis could create momentum to aim for more ambitious reforms to extend the constructive interaction of national and joint fiscal efforts beyond 2026 when the joint efforts in the Recovery and Resilience Facility (RRF) are set to fade out.

The RRF has temporarily addressed important omissions in the EU governance framework that look even more pressing today in view of the experience of the EU over several decades of slowly decelerating potential growth and economic shocks of apparently increasing amplitude. In our analysis of 2020, we expose the recent crisis as the latest dramatic evidence in this longer perspective on the challenges for the EU. Fortunately, the policy response of 2020 provided some assurance that the EU will not, in the recovery from the pandemic and beyond, see an extension of the very low past levels of growth-enhancing public expenditures; it has done so by ring-fencing RRF-related outlays from the reach of the rules, and by transferring resources to Member States with heavier legacies from the pandemic and a lesser ability to sustain the needed fiscal support. The size is sufficiently important – together with the SURE mechanism to help most EU countries in financing their domestic efforts to sustain employment and economic activity – to see the RRF also as an experiment with a central fiscal capacity for stabilisation purposes.

Attempting to rely again only on implementing rules for national fiscal performance with a series of flexibility clauses, when some allowance for other objectives than the primary one of assuring sustainability must be made, would seem an inferior strategy to finding a way of continuing some of the joint policy experiments of 2020.

Why has the EFB urged reforming the fiscal framework before the severe economic downturn clause is deactivated? Many policy makers consider such speed infeasible; it will take longer to define a 'common landing area' for the diverse proposals of different groups of national policy makers. However, the latest substantial reform of fiscal governance a decade ago was agreed in the course of about six months, admittedly at a time when the fear of financial instability was stronger than today. We welcome that the Commission has relaunched the economic governance review.

Our main argument in favour of seeking clarity on the main points in future fiscal governance in the EU at the time the severe economic downturn clause is deactivated, is simple: we believe the Commission would otherwise face a near-impossible task in being asked to implement rules that are known to be unrealistic in a post-pandemic world. The outcome is likely to be a drift into more generalised discretion, which could hardly satisfy either the countries that primarily wish for a return to familiar rules, firmly implemented, or the countries that are the supposed beneficiaries of discretion, as the uncertainty surrounding their fiscal policies will rise and could become costly.

The approach of the EFB to these future challenges may seem overly radical. We see it as radical mainly in the sense of returning to the roots of why the EU needs a fiscal framework. Such a focus would allow most of the elaborate superstructure of fiscal micromanagement erected around the Treaty provisions over the past decades to be downplayed in the future. That should reduce the risk of frustrated ambitions, which overstep what can be achieved in an EU fiscal governance framework.

EXECUTIVE SUMMARY

Budgetary plans for 2020 confirmed an unfortunate pattern in fiscal policymaking. Amid a still ongoing economic recovery in 2019, few Member States sought to improve budgetary positions in their plans for 2020. The 2019 stability and convergence programmes (SCPs) implied a deficit of 0.5% of GDP for the euro area, down from a 0.3% surplus a year earlier in spite of largely unchanged growth forecasts. Especially high debt countries revised their ambitions downwards, and the draft budgetary plans tabled in autumn 2019 envisaged even lower headline targets. These successive revisions underscore once again the unfortunate pattern highlighted by the EFB in earlier reports: The credibility of medium-term plans is undermined by an important group of Member States consistently back loading planned fiscal adjustment and not taking advantage of economic good times to build fiscal buffers.

The EU assessment of fiscal plans for 2020 identified clear issues, but advice was not heeded. The Commission's assessment of the 2019 SCPs concluded that the budgetary plans of ten Member States deviated significantly from the requirements under the preventive arm of the SGP. Two, Romania and Hungary, received their third and second warnings respectively under the SGP significant deviation procedure. Half the Member States received specific fiscal recommendations for 2020, with requirements for quantitative adjustment towards their medium-term budgetary objective (MTO). Nevertheless, in autumn 2019, the draft budgetary plans of eight euro area Member States were still found to be at risk of non-compliance.

The Covid-19 pandemic triggered the deepest economic recession since World War II invalidating earlier policy plans. Real economic activity posted a dramatic drop in the first half of 2020 in both the euro area and the EU as a whole, followed by a partial rebound and further contraction later in the year. Real euro area and EU GDP nosedived by over 6% on the previous year, the sharpest and deepest contraction since WWII. The pandemic ended an economic recovery of almost seven years of (average annual) growth. In spring 2019, when Member States presented their SCPs for the years ahead, the euro area and the EU were still expected to post a solid economic expansion, in line with prevailing estimates of potential GDP growth.

The swift activation of the severe economic downturn clause gave rise to a radical shift in EU fiscal policy guidance. In early 2020, national governments enacted tight lockdown measures amid surging Covid-19 infections and growing casualties linked to the virus. The Commission and the Member States swiftly agreed to activate the SGP's severe economic downturn clause, to give Member States fiscal flexibility. Announced in March 2020, the activation of the clause was formalised with the country-specific recommendations (CSRs) in July. For the first time in the history of the SGP, the fiscal recommendations were virtually the same for all countries and contained only qualitative guidance for 2020 and 2021. The Member States were asked to take measures to address the pandemic and support the recovery, while preserving fiscal sustainability in the medium term.

The timely response to the pandemic also involved the activation of national escape clauses. Driven by the economic governance reforms of 2011-13, most domestic numerical rules in the EU were complemented by suspension clauses to provide for exceptional circumstances. In the large majority of Member States, such clauses were activated for the first time in reaction to the Covid-19 crisis, either as an automatic consequence of the SGP's severe economic downturn clause, or, more typically, as a result of national decisions. The involvement of national independent fiscal institutions (IFIs) ranged from actively initiating the legal procedures to providing non-binding opinions. In few cases, IFIs and national governments had different views on how to interpret or implement national clauses.

A strong policy response succeeded in mitigating the economic impact of the Covid-19 crisis. Automatic fiscal stabilisers, which support aggregate demand without specific policy action on the part of lawmakers, were the first line of defence. Although these are comparatively strong in most EU countries, the scale and depth of the crisis also triggered a massive discretionary policy response. The activation of the severe economic downturn clause gave Member States the

leeway to implement measures to protect households and firms. Available indicators signal a highly expansionary fiscal impulse from discretionary measures of 2.5% to 4% of GDP in the euro area and the EU as a whole. In addition, national governments adopted guarantee scheme with an overall envelope of 18% of GDP.

The magnitude of the crisis underscored notorious measurement issues. Sharp economic disruptions, accompanied by major policy responses complicate the assessment of conventional fiscal indicators. As the economic crisis caused by the pandemic was taken to be temporary, the relevant Council committees agreed to make *ad-hoc* adjustments to the commonly agreed method for estimating potential output and the output gap. As a result, the structural budget balance showed a more limited discretionary fiscal expansion attributing the lion's share to automatic stabilisers. In contrast, the expenditure benchmark and purely judgment-based assessments point to a much more significant share of discretionary measures. The Commission argued that temporary emergency measures, which are estimated to account for the bulk of the discretionary support in 2020 and 2021, do not have a significant impact on aggregate demand and, by extension, should not be included in conventional indicators gauging the fiscal impulse.

EU institutions' initiatives created room for manoeuvre in countries with limited fiscal space. In previous years, not all Member States had taken advantage of the protracted recovery from the global economic and financial crisis to improve public finances. A significant number of euro area Member States entered the pandemic with a debt-to-GDP ratio well above pre-2007 levels and had limited budgetary leeway for responding to another major economic shock. In light of the truly exogenous nature of the pandemic, the EU adopted the Next Generation EU (NGEU) initiative, which involves substantial cross-country transfers. In addition, the European Central Bank (ECB) launched the pandemic emergency purchase programme (PEPP) to mitigate early signs of stress on certain euro area sovereigns and stabilise yields at low levels.

Supranational initiatives mitigated, but did not eliminate, national constraints. Right from the start, national governments deployed fiscal packages of an unprecedented size, especially by increasing expenditure. Government expenditure in 2020 grew well above the medium-term rate of potential output growth in both the EU and the euro area, even excluding health-related and job retention measures. Despite decisive ECB intervention in sovereign debt markets and fiscal transfers under the NGEU initiative, government expenditure grew significantly less in countries with very high debt and/or high sustainability risks. Conversely, countries with low government debt were able to make more aggressive use of their fiscal space.

Containing the pandemic had a conspicuous impact on public finances, with significant cross-country differences. In spring 2019, well before the Covid-19 virus started spreading, the Commission had projected a general government deficit in the euro area and the EU of around 1% of GDP in 2020, broadly unchanged on the previous year. Thanks to the still positive growth-outlook, government debt was expected to continue its downward trend towards less than 85% of GDP in the euro area and below 80% of GDP in the EU. Only two years later, national accounts data for 2020 showed a completely different outcome. Euro area and EU government expenditures exceeded revenues by around 7% of GDP and gross government debt posted an increase of close to 15 % of GDP on 2019. Although ubiquitous and exogenous in nature, the pandemic had markedly different impacts across Member States. Countries with a comparatively large tourism sector and a lower degree of digitalisation (e.g. France, Italy, Spain, Portugal, Croatia, Malta and Greece) experienced a drop in real GDP of 7 ½ % or more on the previous year and a heavy deterioration of public finances. Others such as Bulgaria, Denmark, Sweden, the Netherlands and Luxembourg saw a comparatively contained economic contraction combined with a limited impact on government finances.

The extra flexibility of the SGP's severe economic downturn clause was interpreted as a general waiver. The Commission's and the Council's swift agreement to resort to the extra flexibility that the EU's fiscal rules provide for in the event of a severe economic downturn was warranted. However, the way decisions were taken highlights important issues in the design and application of a rules-based system.

- Introduced in 2011, the severe economic downturn clause is embedded in a set of rules that, by design and established practice have

consistently been applied country-by-country taking into account the specifics and severity of each case. In response to the Covid-19 pandemic, however, the clause has been interpreted, communicated and applied indiscriminately, as a 'general escape clause'.

- A whatever-it-takes fiscal guidance was issued to all Member States in spring 2020 on the back of the dramatic impact of the first wave the pandemic. The Commission tried to complement fiscal guidance in letters to finance ministers in the autumn, after in-year monitoring had shown that some countries had taken measures leading to a permanent increase in spending without indications of budgetary coverage.

- When activating the clause, the Commission and the Council did not address the timing or conditions for its deactivation. The definition of a severe economic downturn set out in the SGP was considered too restrictive. The Commission and the Council concurred they could apply discretion. A subsequent Commission communication in spring 2021 offered some pointers but left considerable room for manoeuvre for judgement. The lack of clear indications as to when and how to exit the clause has further weakened the forward guidance that should be embedded in the application of EU fiscal rules.

- Official Commission documents rightly insisted that the activation of the clause did not mean the suspension of the SGP. However, the Commission and the Council agreed not to launch any procedural follow-up in clear cases of non-compliance. This approach was based on political considerations rather than established practice or precedents. In the past, excessive deficit procedure (EDPs) were opened, as a rule, when, based on actual data, the Commission's assessment pointed to a breach of the deficit or debt criterion. Especially in the wake of past recessions, EDP recommendations typically served as guidance for the medium term rather than an instrument of frontloaded fiscal adjustment.

The extensive interpretation of the severe economic downturn clause is a particularly visible symptom of the underlying challenge in the current arrangements of multilateral surveillance in the EU: Within the limits imposed by the Treaty, discretion (when backed by the necessary majority in the Council) trumps rules. An overhaul of the SGP's flexibility clauses seems warranted.

The extensive interpretation of the severe economic downturn clause affected the activities of national IFIs. One key task of IFIs is to assess budgetary developments against numerical benchmarks or reference values laid down in EU or national fiscal rules. However, the *de facto* suspension of the SGP and national rules rendered this task obsolete. As a result, most IFIs diverted resources to other activities beyond their formal mandates. All IFIs started assessing and costing emergency measures while some also engaged in more elaborate sustainability analysis. Their planning and actual work were complicated by the extensive interpretation of the severe economic downturn clause and the lack of clarity concerning the de-activation process.

The pandemic postponed the review of EU economic governance; it was re-launched in October 2021. In March 2020, less than six weeks after its launch, the Commission decided to put the EU economic governance review on hold. Faced with the sharpest and deepest economic downturn since WWII, decision makers rightly focused on coming up with the right policy response. In the course of 2020, the Commission clarified that the review would resume as and when the economic recovery takes hold. It was re-launched on 19 October 2021. The objective of the review is to reflect and hopefully agree on how to make the EU's fiscal framework more effective taking into account the fallout of the Covid-19 pandemic. While many experts, including the EFB, concur that experience with the SGP has been mixed at best, views as to how and when to improve it radically diverge among Member States.

National correction mechanisms agreed under the Fiscal Compact were meant to strengthen ownership and compliance. One longstanding difficulty with implementing the SGP is the lack of compliance with EU fiscal rules in a number of countries. In 2012, to address the issue, 22 Member States signed the Fiscal Compact, an intergovernmental agreement whereby they undertook to put in place national institutions and processes consistent with the EU fiscal rules. In particular, they undertook to adopt binding, permanent mechanisms involving an automatic trigger to correct deviations from a prudent

medium-term budgetary objective or from the adjustment path towards it.

The design of national correction mechanisms differs significantly across countries. To ensure credibility, essential features of the correction mechanisms are detailed in common principles that emphasise four key elements: (i) legal status; (ii) the circumstances for triggering the mechanism; (iii) the size and timeline of the fiscal adjustment; and (iv) role of national IFIs. Nevertheless, a dedicated survey involving the monitoring institutions in the Fiscal Compact countries shows that governments retained considerable discretion in designing the mechanisms. In particular, national correction mechanisms and related procedures varied, most notably, in terms of their legal status, forward-looking nature, automaticity and clarity.

Linking the automatic trigger to decisions at EU level impairs the effectiveness of national correction mechanisms. When the Fiscal Compact was established, the effectiveness of the national correction mechanisms was predicated on automatic triggers in the event of significant deviations. The rationale was that automaticity would override politically motivated discretion. However, in most of the countries the transposition of the Fiscal Compact stipulates that the assessment of EU institutions in the context of the supranational surveillance cycle triggers the national correction mechanism, not that of an independent assessor such as an IFI. As EU decisions often involve considerable forbearance, the original purpose of national correction mechanisms is defeated.

The EFB's successive reform proposals to simplify EU fiscal governance have gained greater relevance post Covid. The Commission recently re-launched its review of EU economic governance, the central vehicle for stakeholder consultations on SGP-related policy challenges, both those identified already before, and those emerging from the Covid-19 crisis. Starting from 2017, the EFB has developed a reform concept, arguing essentially that an SGP reform should be organised around three central elements: i) a medium-term debt anchor; ii) a single operational rule that caps the growth rate of net primary expenditures; and iii) a single escape clause. These elements also feature prominently in the debate among fiscal economists, and in particular pro-reform experts. In fact, the new generation of reform plans are similar to the EFB's in a number of important aspects, such as shifting the focus of EU surveillance on observable variables and on a medium-term perspective.

Clear and recognisable numerical goalposts, such as the SGP's 3% of GDP reference value for the deficit, play an important role in any solid fiscal framework. There are other, admittedly more radical, ideas on how to reform the SGP, notably to do away with all numerical benchmarks. The EFB is a strong advocate of maintaining reference values as they provide tangible focal points for public debates in the fiscal domain and a basis for decision-makers' accountability. In fact, there are both economic and political economy arguments to keep the Treaty-based and well-established 3% of GDP reference value for headline balances even in a revised SGP framework.

A revised EU fiscal framework should be complemented by additional policy levers enhancing its resilience and robustness. Beyond the update of EU fiscal rules, there are other long overdue governance reforms in the EU, most notably, the creation of a central fiscal capacity. The recently established NGEU facility consists partly of budgetary transfers, with strings attached as to how they can be spent, also with a view to reverse the trend of declining government investment and to improve the quality of public finances. The jury is still out whether this initiative remains a one-off or it will lead to permanent institutional changes.

Given the investment needs to manage the green and digital transitions, a scheme to promote government investment is warranted. To this end, the EFB already proposed to augment the EU budget by dedicated national envelopes for providing EU common goods, such as green public investment and transnational infrastructure projects. This mechanism could constitute a safeguards against possible future cuts in public investments, perhaps in a more manageable manner than a potentially substitute golden rule-type arrangement.

A simple reinstatement of the status quo ante after the de-activation of the severe economic downturn clause is not viable. The EFB is convinced that a genuine reform of the fiscal framework is better than a possible alternative of discretionary and hard-to-predict tweaks in the implementation of the existing rule book. In a

scenario of no major changes to the SGP, EU institutions should spell out transparently how the necessary flexibility and constrained discretion vis-à-vis the 'Maastricht numbers' will be applied in the coming period.

While greater reliance on country-specific expertise has merits, the EFB sees limits to a significant decentralisation of surveillance. National independent fiscal institutions have become an important and integral part of the EU's fiscal framework. At the same time, absent a major effort to ensure minimum standards, they remain too heterogeneous to consistently shape the conduct of fiscal policy. Their enhanced involvement in EU surveillance procedures would be premature before a systematic harmonisation of their resources and functions. Thus, the Commission's and the Council's role in monitoring compliance and formulating recommendations at the central level remains essential.

1. MAIN MACROECONOMIC AND FISCAL DEVELOPMENTS IN 2020

Highlights

- The Covid-19 pandemic led to the deepest economic recession in the euro area and the EU since WWII. On the back of severe lockdown measures, real GDP posted a dramatic drop in the first half of 2020, followed by a partial rebound and a further contraction later in the year. The average annual decline of real GDP exceeded 6%.

- The policy reaction to the pandemic was robust. The total amount of budgetary measures - discretionary and automatic - offered by all Member States combined exceeded 6.5% of GDP and was complemented by liquidity support amounting to around 18% of GDP.

- The scale and composition of budgetary support varied markedly across EU countries, reflecting how hard they were hit by the crisis and fiscal space accumulated ahead of the pandemic.

- The activation of the severe economic downturn clause of the Stability and Growth Pact (SGP), plus assertive action by the ECB, provided the necessary room for fiscal manoeuvre and prevented tensions in sovereign bond markets.

- On top of measures taken by national governments, the EU launched unprecedented and innovative fiscal initiatives; notably the Next Generation EU (NGEU) and the Support to mitigate unemployment risks in an emergency (SURE).

- Thanks to the bold policy decisions, the decline in employment was contained and the level of bankruptcies low. Unemployment rates rose by only around a quarter of a percentage point in the euro area and the EU.

- The budgetary impact of the crisis was more marked than after past major economic shocks, with the deficits exceeding 9% of GDP in several Member States. The annual increase in government debt was equally unprecedented.

- Much of the sharp rise in budget deficits can be attributed to the operation of automatic stabilisers. While different indicators yield different breakdowns between discretionary and automatic components of the fiscal response, the comparatively strong role of government in many Member States played an important role in stabilising output. Government revenues remained broadly unchanged as a share of GDP.

- On top of automatic stabilisers, discretionary measures led to the strongest year-on-year increase in government expenditure on record. Subsidies to firms played a much more prominent role than in previous crisis episodes.

- The robust fiscal response and the sharp drop in economic activity added more than 13 percentage points to the general government debt-to-GDP ratio in the euro area and EU as a whole; the ratio reached respectively 100% and more than 90%. Member States with the highest debt before the crisis recorded the biggest increases.

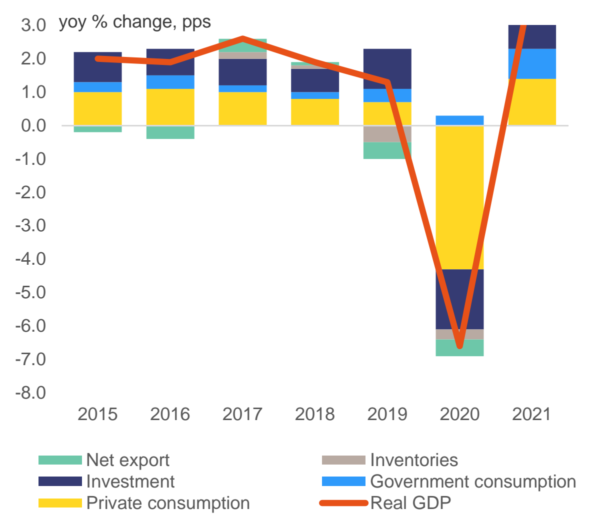
- To date, the increase in government debt has been significantly sharper than in other major recessions in Europe since WWII, but broadly comparable in size.

1.1. MAIN MACROECONOMIC DEVELOPMENTS

In 2020, the Covid-19 pandemic triggered a dramatic fall in economic activity in Europe and globally. Real GDP contracted by 6.6% in the euro area and 6.1% in the EU as a whole. The drop was significantly larger than during the global financial crisis in 2009 when real GDP fell by 4.5%.

In the EU, the depth of the recession varied between countries, from -0.9% in Lithuania to to -10.8% in Spain. Ireland was the only country that recorded positive growth in 2020. Several factors drove these divergences, including: (i) the intensity and duration of the shock and Member States' containment measures; (ii) the relative size and economic importance of contact-intensive sectors (e.g. tourism, travel and hospitality); and (iii) differences in available fiscal space.

Graph 1.1: **Real GDP growth and its components, euro area**

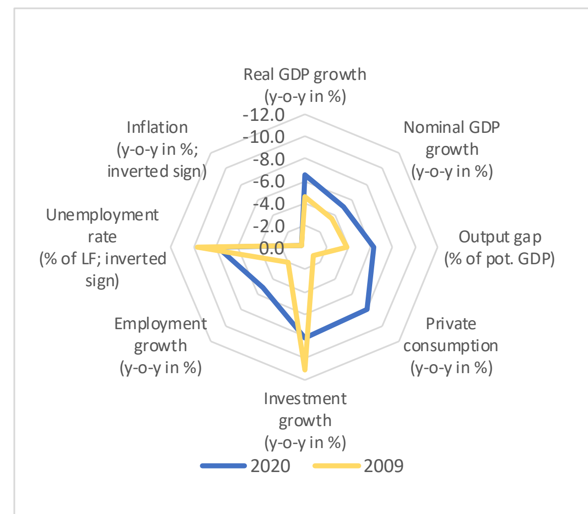


Source: European Commission

Reflecting the nature of the crisis, domestic demand was the biggest contributor to the sharp fall in real GDP. The spring 2020 lockdowns and social distancing triggered a collapse in private consumption, in particular on services In addition, persistent pandemic-related uncertainty weighed heavily on private investment, as firms revisited or postponed projects.

The sharp drop in private demand was partly compensated by a sharp expansion of government consumption, both as a percentage of GDP and in absolute terms: public employment was preserved, while the acquisition of intermediate goods (e.g. medical supplies) and transfers to firms and households increased.

Graph 1.2: **Comparison of main macroeconomic indicators in 2020 with 2009, euro area**



Source: European Commission

The impact of the crisis on the labour market was comparatively muted. The decline in employment was much more contained than one may have expected in the light of the sharp drop in economic activity, thanks partly to bold policy decisions (Section 1.2).). Headcount employment decreased by 5.3% from 2019 in the euro area and by 4.5% in the EU as a whole. Targeted policy support, notably short-time work schemes, prevented mass lay-offs and large income losses. The impact of these measures is best reflected in the difference between the change in the number of persons employed and the change in the number of hours worked. While the former decreased by 1.6% in the euro area and 1.5% in the EU as a whole, the latter fell by 6.4% and 5.3%, respectively. The effect was also visible in unemployment rates, which rose only marginally (by 0.3 percentage point) to 7.8% and 7.1%.

Headline inflation in the euro area decreased year on year by 0.9 percentage point to 0.3%, mainly due to significantly lower energy price inflation and policy measures, including temporary VAT cuts in Germany. Despite upward pressure on prices from supply-side disruptions, downward pressures (such as weak demand, labour market slack and the appreciation of the euro) prevailed and kept core inflation at 0.9% in the euro area. The GDP deflator posted a larger increase of 1.5%, on account of improved terms of trade due to the sharp drop in oil prices and the euro's appreciation.

1.2. THE POLICY RESPONSE TO THE CRISIS

The EU policy response was exceptionally strong and swift. Complementary monetary and fiscal policy measures were very effective in mitigating the impact of the crisis ([1]) and hopefully preventing long-term scars. Monetary policy supported the flow of credit and reduced financial market stress, governments deployed large fiscal packages to support vulnerable households and firms, and the EU agreed on new, albeit temporary, tools to enhance stabilisation and growth.

Monetary policy

Monetary policy remained highly accommodative in the euro area, and the ECB announced additional monetary stimulus measures in March 2020. The new pandemic emergency purchase programme (PEPP) helped contain sovereign spreads and ease the monetary policy stance. Also, the ECB offered 'targeted longer-term refinancing operations' (TLTROs) at very favourable conditions, supporting bank lending to firms and households. Overall, between March and December 2020, the ECB expanded its balance sheet by more than 15% of euro area GDP in comparison to 2009 when its balance sheet remained almost unchanged.

Fiscal policy

National and supranational fiscal support had a significant impact on economic activity and budgetary developments in the EU. At the onset of the crisis, national governments deployed fiscal packages of an unprecedented size to accompany the automatic fiscal stabilisers. Budgetary and non-budgetary fiscal measures provided immediate financial support for health systems, protecting jobs, workers and firms. In view of the exceptional nature of the crisis, the EU activated the severe economic downturn clause of the Stability and Growth Pact (SGP), offering Member States flexibility to expand their budgets (Section 2.5).

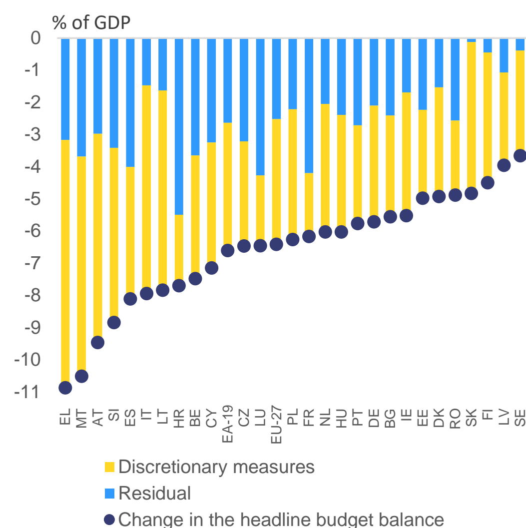
The Member States implemented a broad range of measures as a first line of defence, (i) with direct budgetary impact, e.g. emergency measures that addressed immediate health and economic problems; and (ii) with indirect impact, e.g. liquidity measures to support firms.

([1]) According to the IMF, without fiscal stimulus, economic activity might have been an additional 3-4 pp of GDP lower in 2020 (IMF, 2020).

Overall fiscal support, budgetary and non-budgetary, in 2020 is estimated at around 22-25% of GDP (€2.6 trillion in the euro area; €3.0 trillion in the EU).

The total budgetary impulse, measured as the deterioration in the headline balance between 2019 and 2020, was 6.6% of GDP in the euro area and 6.4% in the EU as a whole (Graph 1.3) ([2]). Estimates of the structural part of the budgetary impulse differ depending on the method used. The change in the structural budget balance accounts for two fifths of the change in the headline balance (2.6% of GDP), (Graph 1.3) while direct or so-called bottom-up calculations point to three fifths (or 4% of GDP).

Graph 1.3: **Total budgetary impulse in 2020**

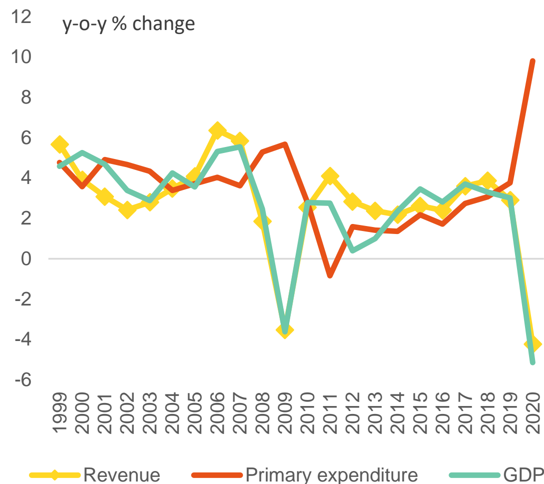


(1) The total budgetary impulse is measured as the y-o-y % change in the headline budget balance compared to 2019. (2) Discretionary measures represent the incremental budgetary impact of adopted or credibly announced measures, as compared to a 'no policy change' forecast' estimated based on judgment (bottom-up approach). Automatic stabilisers are measured as a residual.
Source: European Commission

The strong, immediate budgetary response to the pandemic is evidenced in the biggest ever year-on-year increase in government expenditures, by over 9% in both the euro area and the EU (Graph 1.4). The drop in revenues mostly followed the decline in output and was therefore more pronounced than in 2009; revenues remained broadly stable as a percentage of GDP (Graph 1.5).

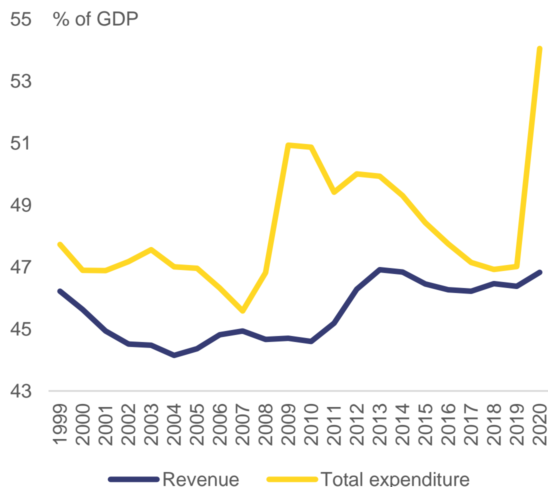
([2]) This report uses government data reported in the April 2021 EDP notifications. While the October EDP notifications published on 21 October 2021 show large 2020 data revisions for some countries, those do not materially change analysis of this report.

Graph 1.4: **Expenditure, revenues and GDP, euro area (current prices)**



Source: European Commission

Graph 1.5: **Expenditure and revenue-to-GDP ratio, euro area, (current prices)**

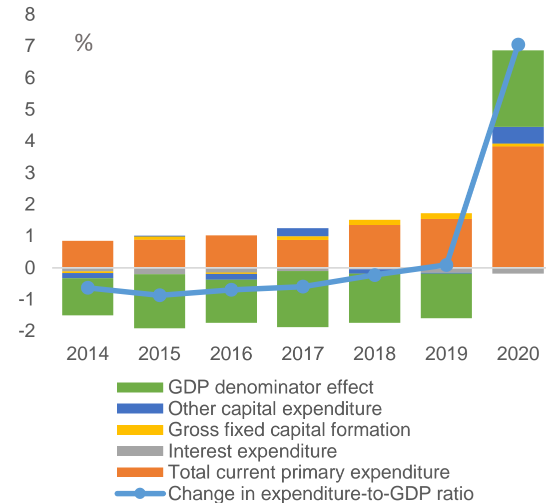


Source: European Commission

The role of government expenditure, and in particular primary current expenditure, in stemming the economic impact of the Covid-19 pandemic is heightened when looking at GDP ratios (Graph 1.6). Around one third of the reported increase is the pure denominator effect, i.e. the inertia of expenditure in the face of lower GDP. On top of that comes the exceptional expansion of expenditure levels mentioned above.

In addition to measures with a direct budgetary impact, countries also gave businesses sizeable support in the form of state guarantees, direct equity injections and loans. The estimated average scale of the liquidity support is around 18 % of GDP for the euro area and the EU as a whole. So far, the actual uptake of government guarantees has been relatively low compared to the total envelopes made available by governments (Section 2.7).

Graph 1.6: **Drivers of the expenditure-to-GDP ratio, euro area**



(1) The denominator effect shows a deterioration (improvement) due to the slowdown (acceleration) of nominal GDP growth. (2) Other capital expenditures include capital transfers payable (i.e. capital taxes, investment grants and other capital transfers), change in inventories and acquisitions (e.g. finished goods) less disposals of valuables (e.g. precious metals) and acquisitions less disposals of non-financial, non-produced assets (e.g. land and other tangible non-produced assets).
Source: European Commission

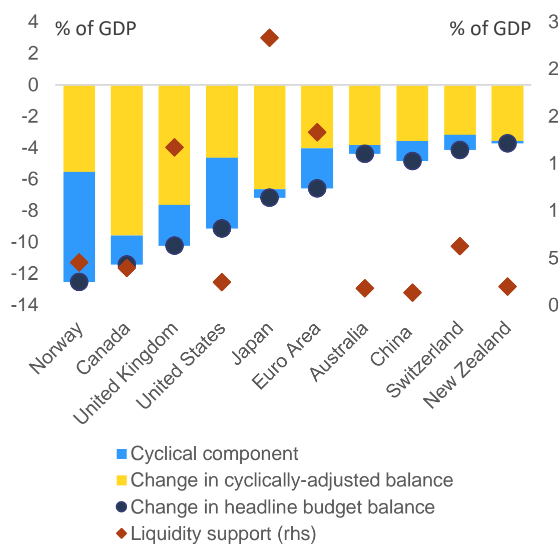
The size and composition of budgetary support varied greatly across countries, reflecting in part how hard they were hit by the crisis. Since the economic shock hit all countries largely through the same channels, their fiscal responses in the earlier stages used similar instruments. Over the course of 2020, however, countries announced additional fiscal packages that reflected their changing priorities. While some concentrated on emergency measures, others focused more on recovery and longer-term developments.

The overall impact of the Covid-19 pandemic on the Member States' budget balances ranges from -11% of GDP in Greece to -4% in Sweden (Graph 1.3). In terms of discretionary support measures alone, Greece, Malta, Austria, Italy and Lithuania provided most support as a percentage of GDP. However, as indicated above, there are several challenges in quantifying and comparing discretionary fiscal measures across countries. For a start, there is no consistent track record — using the same methodology — of national measures Also, despite Eurostat's guidance, the statistical

recording of measures differs across countries (3). Furthermore, due to the divergences in the reporting of measures, the Commission's calculations differed from those of national authorities or other international institutions (4).

When it comes to comparing fiscal support packages at a more global level, the diverse structure of some economies and social security systems also complicate matters. Countries with wide social safety nets expanded existing measures and their policy response tended to rely more on automatic stabilisers. In contrast, countries with more limited social safety nets adopted larger discretionary fiscal measures (Graph 1.7).

Graph 1.7: **Fiscal impulse in 2020 in selected countries**



(1) The fiscal impulse is measured as the y-o-y % change in the headline budget balance compared to 2019.
Source: IMF Fiscal Monitor Database, European Commission.

As an example, the composition of the United States' fiscal plans are quite different from those in the euro area. According to IMF estimates, in 2020 the USA adopted budgetary measures on a scale of close to 10% of GDP and liquidity support at 2.4% of GDP, whereas the numbers for the euro area are close to 7% and around 18%. Due to its smaller safety net, the USA relied more on discretionary fiscal measures, such as direct payments to individuals, while the euro area relied more on automatic stabilisers. The EU-wide fiscal response also involved more loans and guarantees. However, the starting point of fiscal policy was larger as the size of government in the EU than in the USA at the onset of the pandemic.

The EU responded with a number of significant, bold supranational initiatives offering financial assistance that supported national fiscal responses:

(i) The 'support to mitigate unemployment risks in an emergency' (SURE) initiative, under which loans for up to €100 billion are granted to the Member States. In 2020, the Council approved a total of €90.3 billion in financial support to 18 Member States.

(ii) The European Investment Bank's pan-European guarantee fund (EGF), which provides up to €25 billion of guarantees backing €200 billion of additional financing for companies. In 2020, guarantees for €2.7 billion were approved, mobilising investment of €27.8 billion (5).

(iii) Pandemic crisis support from the European Stability Mechanism, which provides precautionary financial assistance. To date, no Member State has requested support from this line of financing;

(iv) In July 2020, the European Council adopted the Next Generation EU (NGEU) initiative (6). The NGEU's investment stimulus is a unique coordinated fiscal expansion across the EU. Financed by issuing debt at EU level, backed by the Member States, it is worth up to €750 billion (in 2018 prices, 5.4% of EU GDP in 2019). Although none of this was disbursed in 2020, the instrument had important implications for countries' borrowing, by preventing yields on government debt from increasing. This temporary recovery instrument represents an important improvement in the fundamental functioning of EMU. The coordinated fiscal response to the economic fallout from the pandemic has also increased confidence in this form of cooperation between the Member States.

Despite its gradual and targeted implementation, NGEU is expected to generate positive effects on growth and productivity over the medium term. According to Commission model simulations (7),

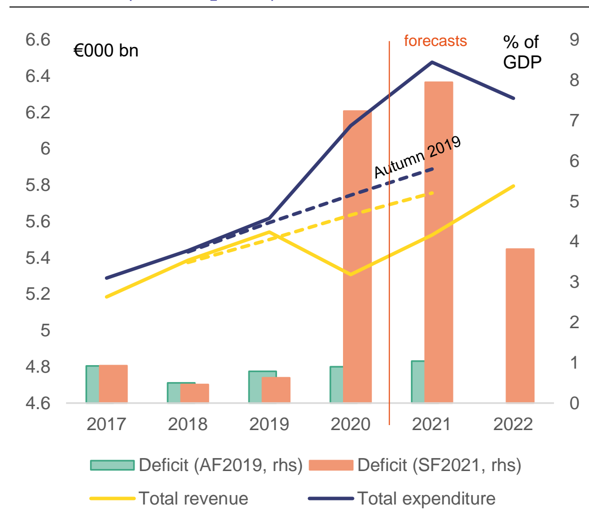
(3) For example, Member States reported tax deferrals as part of the total costs of fiscal packages, even though they should not affect the budget balance
(4) The ECB and the IMF estimated the size of the euro area discretionary measures for 2020 at 4.25% and 3.8% of GDP respectively (ECB 2021; IMF Fiscal monitor database).
(5) EIB (2021).
(6) For a detailed description, see *EFB 2020 annual report* (Section 5.2).
(7) Autumn 2020 Commission Economic Forecast. The Commission's model estimates of the economic impact of the NGEU are based on a calibrated theoretical (QUEST III) model.

real GDP in the EU could be up to 2% higher in the years of active NGEU operation compared to a no-policy change' baseline. More specifically, based on the available national plans (4% of GDP) and taking into account also both direct and spill-over effects, Pfeiffer *et al.* (2021) find that the level of real GDP in the EU could be around 1.5% higher in 2024 than in a 'no policy change' scenario. In addition, public investment can lead to lasting productivity improvements.

1.3. MAIN BUDGETARY DEVELOPMENTS

Due to the unexpected shock of the pandemic and the decisive policy response, the budgetary situation deteriorated markedly across the EU. The general government deficit in the euro area and the EU amounted to 7.2% and 6.9% of GDP respectively, up from less than 1% the year before.

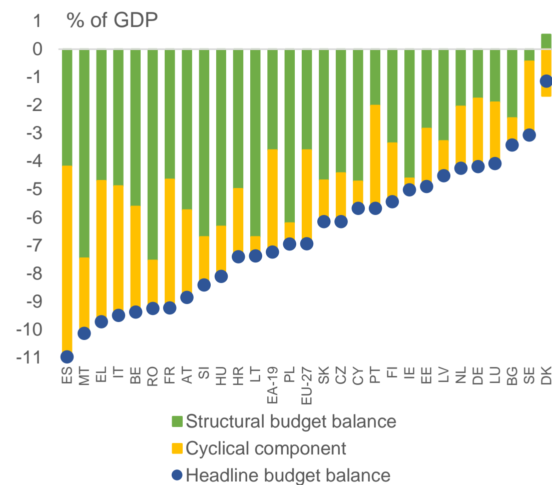
Graph 1.8: **Drivers of the headline deficit, euro area (current prices)**



(1) AF2019 represents Autumn 2019 Commission Economic Forecast; (2) SF2021 represents Spring 2021 Commission Economic Forecast.
Source: European Commission

As regards national headline balances, all EU countries recorded a shortfall of revenues over expenditure, but the level differed substantially (Graph 1.9). The general government deficit ranged from 11% of GDP in Spain to 1.1% in Denmark, which was the only country in 2020 not to breach the 3% of GDP deficit threshold.

Graph 1.9: **Government budget balance by country**



Note: Estimates of the structural budget balance are surrounded by uncertainty as they involve forecasts. They are likely to be revised when new data are become available.
Source: European Commission

After falling for five consecutive years in a row, gross government debt increased significantly. The government debt-to-GDP ratio reached 100% of GDP in the euro area and 92.4% in the EU as a whole. The increase reflects the combined effects of a deterioration of the primary balance and the contraction in GDP, which resulted in a significant snowball effect (Graph 1.10).

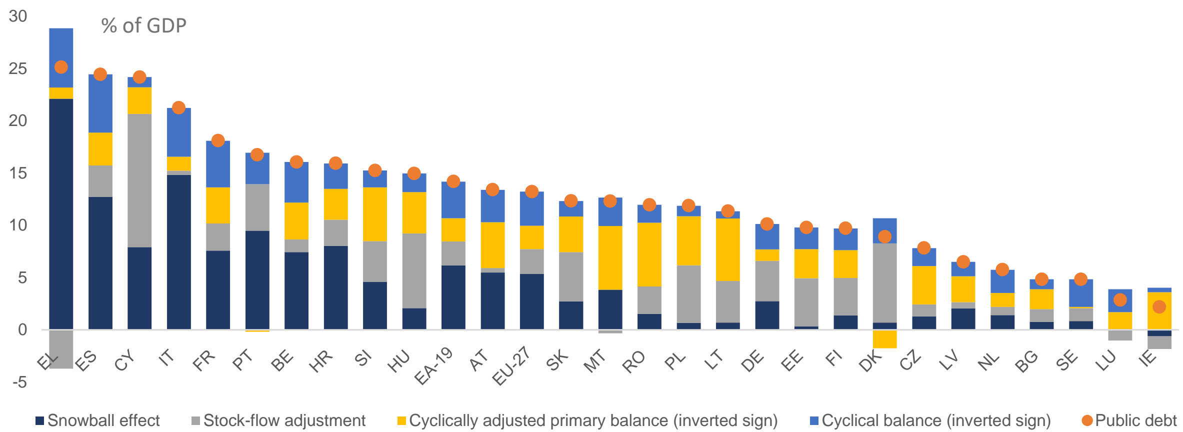
Public debt grew substantially in all EU countries, but the size of the increase varied considerably. The largest (around 25% of GDP) was recorded in Greece and, the smallest in Luxembourg (2.2%). Seven Member States reached a debt ratio of over 110% – Greece and Italy over 150% and Portugal 130%; the other being Spain, Belgium, France and Cyprus. Another seven (Croatia, Austria, Slovenia, Hungary, Germany, Finland and Slovakia) breached the 60% limit.

Sustainability risks have increased compared with last year's Commission assessment especially in the short term ([8]), owing to the severity and impact of the crisis (Table 1.1). For the medium term, the risk classification worsened for seven countries (Croatia, Cyprus, Hungary, Netherlands, Austria, Slovenia and Slovakia). For the long term, six were deemed to face more acute risks (Bulgaria, Croatia, Cyprus, Slovenia, Slovakia and Sweden), while Italy was reclassified from high to medium risk.

Revisions reflect worse forward-looking debt sustainability analyses for Slovenia, Croatia and

([8]) European Commission (2021a).

Graph 1.10: **Drivers of the increase in government debt-to-GDP ratios, 2020**



(1) The snowball effect is the debt impact of the differential between the interest rate and GDP growth. (2) Stock-flow adjustments are changes in gross debt which are unrelated to changes in the budget deficit.
Source: European Commission

Cyprus, changes in the initial budgetary position in Bulgaria and Sweden and a revision of projected ageing costs in Slovakia. In the case of Italy, the long-term risk category improved from high to medium due to the downward revision of interest rates lowering expected interest payments. Going forward, debt dynamics are expected to benefit from an assumed gradual correction of the primary balance and from negative interest-growth differentials.

Table 1.1: **Fiscal sustainability risk classification by EU Member States**

	short-term	medium-term	long-term		short-term	medium-term	long-term
	S0	**S1**	**S2**		**S0**	**S1**	**S2**
BE	HIGH (LOW)	HIGH	HIGH	**LT**	LOW	LOW	LOW
BG	LOW	LOW	MEDIUM (LOW)	**LU**	LOW	LOW	HIGH
CZ	LOW	LOW	MEDIUM	**HU**	LOW	MEDIUM (LOW)	MEDIUM
DK	LOW	LOW	LOW	**MT**	LOW	LOW	MEDIUM
DE	LOW	LOW	MEDIUM	**NL**	LOW	MEDIUM (LOW)	MEDIUM
EE	LOW	LOW	LOW	**AT**	LOW	MEDIUM (LOW)	MEDIUM
IE	LOW	LOW	MEDIUM	**PL**	LOW	LOW	LOW
ES	HIGH (LOW)	HIGH	MEDIUM	**PT**	HIGH (LOW)	HIGH	MEDIUM
FR	HIGH (LOW)	HIGH	MEDIUM	**RO**	HIGH (LOW)	HIGH	HIGH
HR	HIGH (LOW)	MEDIUM (LOW)	MEDIUM (LOW)	**SI**	LOW	HIGH (LOW)	HIGH (MEDIUM)
IT	HIGH (LOW)	HIGH	MEDIUM (HIGH)	**SK**	HIGH (LOW)	HIGH (LOW)	HIGH (MEDIUM)
CY	HIGH (LOW)	MEDIUM (LOW)	MEDIUM (LOW)	**FI**	HIGH (LOW)	MEDIUM	MEDIUM
LV	HIGH (LOW)	LOW	LOW	**SE**	LOW	LOW	MEDIUM (LOW)

(1) In brackets, risk classification in the Debt Sustainability Monitor 2019 whenever the risk classification has changed.
Source: European Commission (2021a)

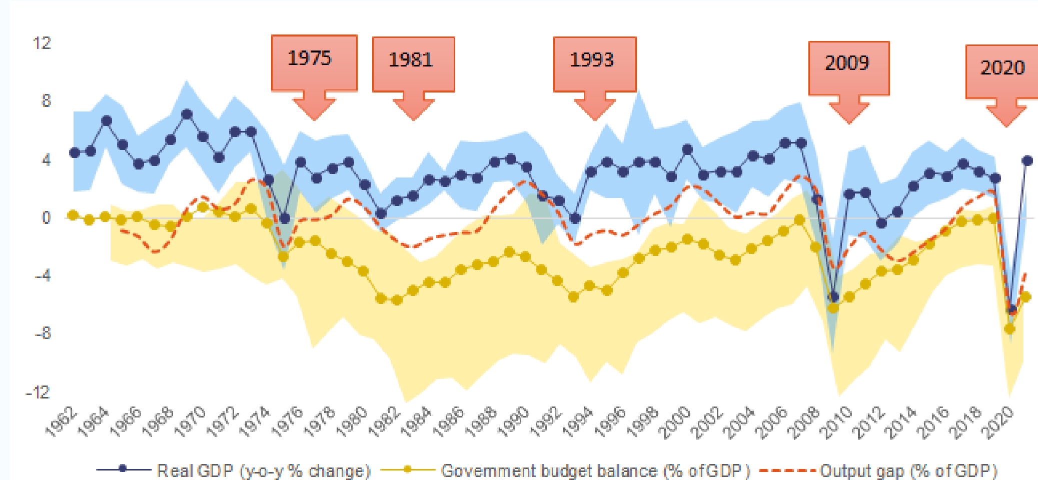
Box 1.1: Fiscal developments in times of crisis

The Covid-19 pandemic had a severe impact on public finances due to both the working of automatic stabilisers and substantial discretionary fiscal measures put in place by national governments to protect households and firms. This box aims at comparing the fiscal impact of the pandemic with previous major crisis episodes, looking at possible regularities, but also differences.

In the last 60 years, output growth in EU economies has been gradually trending down. The first oil shock of 1973-1974 ended a period of strong economic growth, resulting in the first recession in the EU since the end of World War II. The following economic shocks of 1981, 1993, 2009 and 2020 have been of growing intensity (Graph 1). The first oil shock also created a 'breaking point' in the conduct of fiscal policy. Large and persistent government deficits became the norm after years of balanced budgets. One of the reasons for this was that real GDP did not move back to pre-crisis trends in spite of significant fiscal expansions. The correction of fiscal imbalances following each shock has been sluggish, although adjustments appear to have been slightly more sustained prior to the introduction of the euro.

In spring 2020, the Covid-19 outbreak led to a uniquely severe economic crisis. Governments were forced to take drastic measures to contain the spread of the virus. In the first half of the year, real GDP fell at double-digit rates in both the euro area and the EU. The strong policy response also had a substantial impact on public finances. In 2020, the budget deficit exceeded 9% of GDP in several Member States.

Graph 1: **Real GDP growth and government budget balance (1960-2020)**



Notes: (1) Shadowed areas represent the standard deviation of the distribution of real GDP growth rates (light blue) and budget balances (yellow) across Member States for a given year. (2) Real GDP growth and government budget balance (dotted lines) are averaged across EU Member States. (3) The sample includes an increasing number of countries over time in line with the subsequent waves of EU enlargement.
Source: European Commission, own calculations.

Slowing economic growth alone cannot explain the perpetuation of budgetary deficits after economic downturns, leading to the accumulation of government debt. Budgetary behaviour at different stages of the economic cycle shows the notorious asymmetry of fiscal policy, which supports the economy when the output gap is negative but fails to correct imbalances when the output gap is positive, thereby not seizing the opportunity good times provide to reduce imbalances (Graph 2). Compared to earlier decades ([1]), in the years 1995-2000 the conduct of fiscal policy did not significantly change, with a persisting structural deficit also in times of a higher positive output gap, but lower actual and structural deficit levels on average over the cycle. In that respect, it seems that the introduction of the SGP had only a very limited effect in reverting this fiscal misbehaviour. By the same token, and contrary to popular belief, the introduction of the SGP did not prevent the provision of substantial fiscal support in times of both moderate and large negative output gaps, while in the earlier period there was a tendency to moderate fiscal support

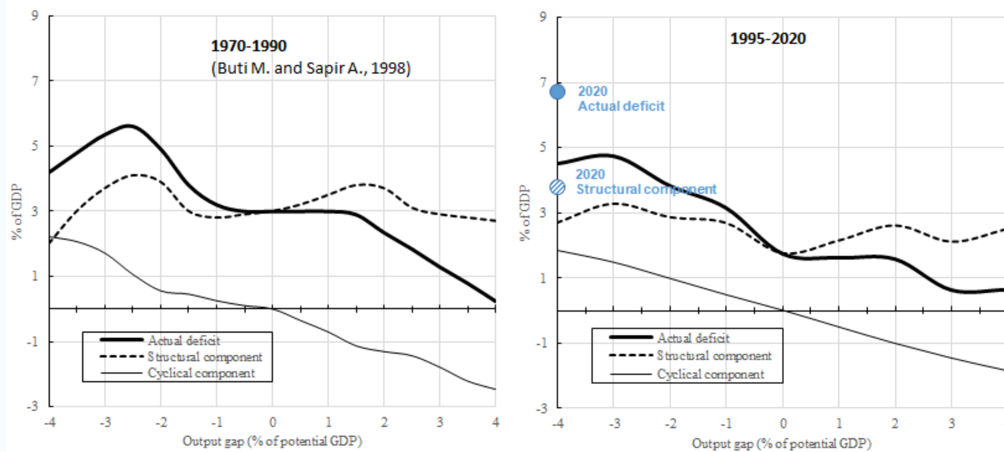
([1]) Graph 2 extends analysis by Buti and Sapir (1998) for the years 1970-90 and 1995-2020.

(Continued on the next page)

Box (continued)

when the output gap was very negative. The year 2020 is significant: the actual and structural deficits are well above the averages recorded for the lowest interval of negative output gaps.

Graph 2: **Output gap and budget balance at different stages of the economic cycle in EU countries**



Notes: (1) The graph shows the output gaps of EU countries against their actual (headline) budget balance, and its structural and cyclical component. (2) Output gaps are divided into ranges of 1% of potential GDP. At the extreme ends, intervals are open. (3) Values in the vertical axis are the simple averages within output gap ranges. (4) The output gap in 2020 was estimated at around -6 ½% of GDP.
Source: European Commission, Buti and Sapir (1998), own calculations

Relatively speaking, i.e. in terms of the deficit increase for a given change in the degree of economic slack, the budgetary impact of the Covid-19 crisis was more decisive than in previous economic shocks. Graph 3 shows that the budgetary impact in 2020, relative to the deterioration of the output gap, was greater than in the 2008-2009 global financial crisis and in previous crisis episodes since World War II. The budgetary impact of the 2011-2013 sovereign debt crisis is an outlier, as growing market pressure, the absence of a central fiscal capacity and less accommodative monetary policy forced some governments to reduce headline deficits. Compared to past episodes, one main difference in the Covid-19 crisis is, however, a more homogeneous response to the shock across countries. The reason for this could certainly be the greater symmetry of the initial shock. Closer coordination between Member States, the early activation of the severe economic downturn clause of the SGP, and the forceful intervention of the ECB in sovereign bond markets have also played a role.

Looking at the composition of budgetary developments in times of crisis, the Covid-19 pandemic has been unique in size and nature. Graph 3 shows, for 12 euro area countries, the changes in the main budgetary items in 1975, 1981, 2009 and 2020. In 2020, the change in total primary expenditure, expressed as a proportion of the previous year's GDP, was unprecedented, at 5.2% of GDP, 1½ percentage points higher than in the first oil shock and almost 3 percentage points above what it was in the 2009 financial crisis.

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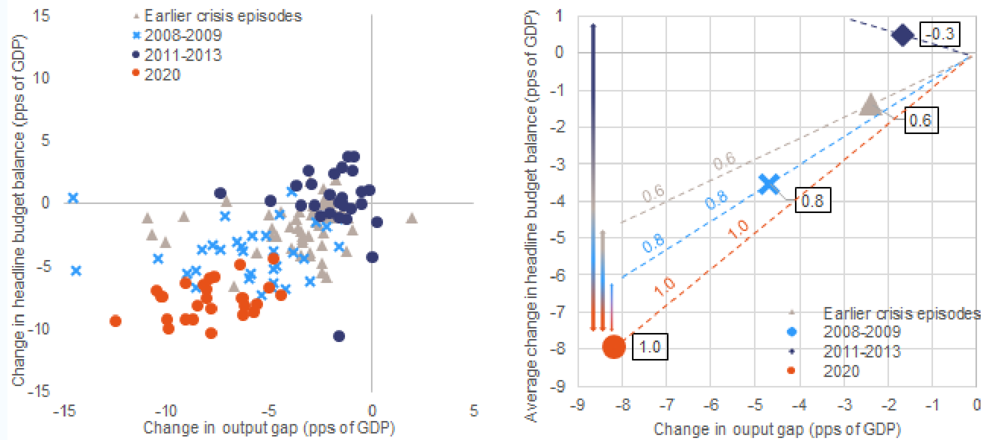
Box (continued)

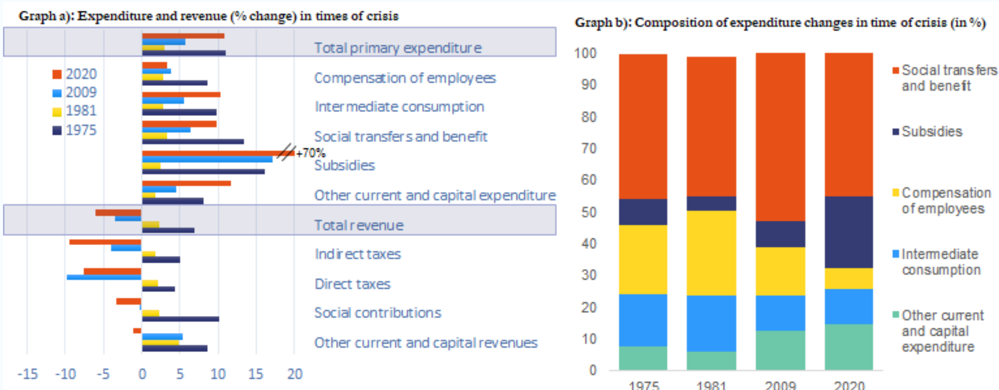
Graph 3: **Budgetary impact of crisis episodes (1965-2020)**



Notes: (1) Crisis episodes are defined as years with negative real GDP growth. (2) Earlier crisis episodes refer to the country/year with negative real GDP growth between 1965 and 2008. (3) Values on the right-hand side of the charts are GDP-weighted averages.
Source: European Commission, own calculations

The most striking difference with respect to previous crisis episodes is the strong increase in subsidies, both in absolute terms (Graph 4.a) and in proportion to the overall expenditure change (Graph 4.b). This reflects the sizeable financial support governments provided to firms. Social transfers and benefits also rose significantly in 2020, although the increase was comparable to what it had been in the past. In line with the initial guidance from Eurostat (2), most of the job-retention measures, in the form of new or existing short-time work schemes, could have been recorded as production subsidies or current transfers (both as social assistance or other current transfers), thereby partly falling under 'other current expenditure'.

Graph 4: **Changes in government expenditure and revenue in times of crisis (12 euro area countries)**



Notes: (1) While data for 2009 and 2020 are based on the 2010 European system of accounts (ESA2010), data for 1975 and 1981 are based on former statistical definitions. (2) Data for 1975 and 1981 include only West Germany. (3) Percentage changes for 1975 and 1981 in Graph (a) are net of price increases (i.e. in real terms, using a GDP deflator) in euro amounts.
Source: European Commission, own calculations

On the revenue side, the first year of the two oil shocks (Graph 1), were not associated with a drop in government revenues, which continued to rise, albeit more slowly than in previous years. Conversely, government revenues fell in the 2009 financial crisis and, even more significantly, the Covid-19 crisis. Compared to 2009, the most marked difference in 2020 is the drop in indirect taxes, due to the 'freeze' in private consumption, and in social security contributions, as a consequence of the reduction in hours worked and short-time working arrangements. Conversely, and probably due to income support measures, direct taxes fell proportionally less than in 2009. The drop in government revenues, especially if associated with a narrowing of the tax base, should be carefully monitored. This

(2) https://ec.europa.eu/eurostat/documents/10186/10693286/GFS_draft_note.pdf

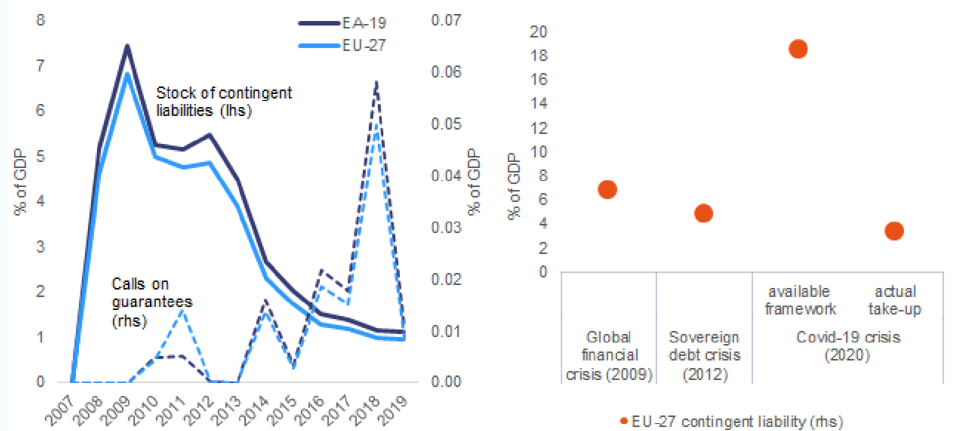
(Continued on the next page)

Box (continued)

is because the repayment of sovereign debt and the risk associated with the large government guarantees provided to the economic system, would require a stable and broad flow of government revenues.

Budgetary measures were not the only responses to the Covid-19 crisis. In order to mitigate the sudden drying up of liquidity, allow businesses to continue paying suppliers and employees and avoid having solvency issues, most Member States launched substantial loan guarantee programmes (Section 2.7). In some countries, such as Belgium, Germany, Spain, France and Italy, these programmes represented more than two thirds of all fiscal measures. Although a comparison with previous crisis episodes is difficult, it is worth considering the level of contingent liabilities after the 2008-2009 global financial crisis ([3]).

Graph 5: **Government contingent liabilities in time of crisis**



Notes: (1) The chart on the left shows the total amount of government contingent liabilities, as a percentage of GDP, between 2007 and 2019, in the form of government interventions to support financial institutions. (2) The chart on the right compares the aggregate EU-27 total amount of contingent liability (as a percentage of EU GDP) across crisis episodes (i.e. red dot on the right). Note: lhs, right rhs of Graph 1
Source: European Commission, our own calculations.

In the aftermath of the 2008-2009 crisis, contingent liabilities increased significantly in both the euro area and the EU as a whole, peaking at 7.4% and 6.8% of GDP, respectively (Graph 5, left hand panel). These contingent liabilities mainly took the form of guarantees granted on the assets and/or liabilities of financial institutions. There was a significant time lag between actual use of guarantees and the time they were issued. Although the number of guarantees used was rather limited, amounting to roughly 2% of total outstanding guarantees, the figures might be somewhat misleading. This is because part of the decrease in government guarantees can be attributed to restructuring operations, with sovereigns purchasing impaired assets previously guaranteed ([4]).

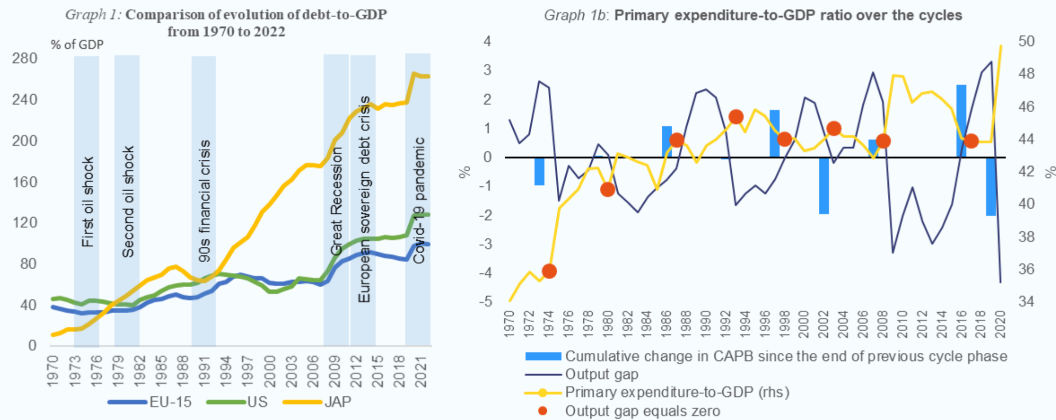
So far, the overall uptake of government liquidity support issued in response to the Covid-19 crisis has been greater than in the most recent crisis episode ([5]). The most striking difference is the range of beneficiaries. In the 2007-2019 period, government guarantees were issued to support financial institutions. However, in the Covid-19 pandemic, they offered support to a wider range of beneficiaries, mainly small and medium-sized enterprises (SMEs) and self-employed people. As a result, there has been a sizeable increase in bank lending of small amounts with medium and long-term maturity, typically backed by guarantees.

([3]) https://ec.europa.eu/eurostat/web/government-finance-statistics/excessive-deficit/supplemtary-tables-financial-crisis
([4]) ECB (2015). https://www.ecb.europa.eu/pub/pdf/other/eb201506_article02.en.pdf
([5]) Under the Temporary Framework, Member States can grant liquidity support in the form of State guarantees and subsidised loans with up to 6 years' maturity. The Framework, set to expire on 31 December 2021 (likely to be extended by 30 June 2022), provides Member States with various options to support the economy with public guarantee schemes even beyond its expiry date.

Box 1.2: Comparison of debt increase in 2020 with past crisis episodes

This box examines the evolution of the government debt of EU-15 ([1]) countries in past crisis episodes and analyses differences compared to the current pandemic. Since 1970, EU countries have experienced six major economic crises resulting in significant debt increases (Graph 1a). Over this period, debt rose on the back of successive increases in primary expenditure compared to GDP only partially matched by discretionary increases in revenues (Graph 1b). During the pandemic, which started in early 2020, the increase in aggregate debt of the 15 EU countries in our sample has been much faster and more broad-based than in any previous crisis.

Graph 1: **Evolution of debt-to-GDP and primary expenditure-to-GDP over time**



Note for Graph 1b: (1) The graph shows the primary expenditure-to-GDP ratios (yellow line) and the output gap (dark blue line) for the aggregate available EU Member States. (2) The red dots represent primary expenditure, as a percentage of GDP, in years where the output gap is close to zero. (3) The light blue bars show, on the right-end scale, the cumulative change in the cyclically adjusted budget balance since the beginning of the previous phase of the cycle, i.e. when GDP was close to its potential.
Source: European Commission, own calculations.

All EU countries significantly increased debt levels in the first year (Graph 2a). This can be attributed to two main factors: (i) the large and sharp drop in real GDP ensuing from tight lockdowns, limited demand and recurring business interruptions; and (ii) the nature of the crisis, which called for immediate financial support to assuage the health-related and economic consequences of the shock (Graph 2b). In previous crises, an increase in debt ratios of a similar magnitude only occurred at a steadier pace over a longer period of time.

Graph 2: **Evolution of debt-to-GDP and real GDP over the crisis periods**

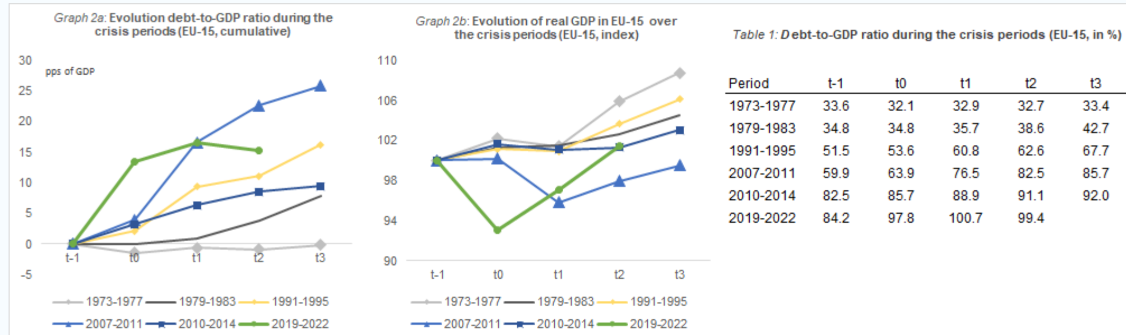


Table 1: Debt-to-GDP ratio during the crisis periods (EU-15, in %)

Period	t-1	t0	t1	t2	t3
1973-1977	33.6	32.1	32.9	32.7	33.4
1979-1983	34.8	34.8	35.7	38.6	42.7
1991-1995	51.5	53.6	60.8	62.6	67.7
2007-2011	59.9	63.9	76.5	82.5	85.7
2010-2014	82.5	85.7	88.9	91.1	92.0
2019-2022	84.2	97.8	100.7	99.4	

Notes: Data from 2020 on represents the Commission Spring 2021 Forecast.
Source: European Commission, IMF, Historical Public Debt Database; own calculations

([1]) Belgium, Denmark, Germany, Ireland, Greece, Spain, France, Italy, Luxembourg, Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom.

(Continued on the next page)

Box (continued)

Compared to other episodes of large debt increases, the pandemic hit EU countries at significantly higher debt-to-GDP ratios (Table 1). At the same time, the expected magnitude of the debt increase 2019-2022 is not unprecedented. The sharp drop of economic activity in 2020 is followed by a comparably sharp recovery in 2021 and 2022 capping the increase of the debt ratio at well below the one observed after the post-2007 financial crisis. According to the Commission 2019 spring forecast, the increase in the debt-to-GDP ratio between 2019 and 2022 should equal 15 percentage points on average in the EU-15, a figure in line with some past crises (Graph 2a).

In some respect, the current situation resembles that of the financial crisis in the early 1990s and the economic and financial crisis in 2007-2011, with a pre-crisis period of a stable or only slightly declining debt ratio due to the favourable economic conditions. There appears to be a ratchet effect in the sense that government debt tends to start from higher levels each time a crisis occurs ([2]), for two reasons: (i) permanents shifts in GDP level and (ii) incomplete consolidation.

To identify the drivers of the debt increase periods, i.e. the factors that influenced the way the government debt ratio evolved and to what extent, we break down changes in the debt-to-GDP ratio with a debt dynamics analysis using the following equation (Escolano 2010, Eichengreen et al. 2019) ([3]):

$$b_T - b_0 = \sum_{t=1}^{T} pb_t + \sum_{t=1}^{T} \frac{i_t - \gamma_t}{1+\gamma_t} * b_{t-1} + \sum_{t=1}^{T} sfa_t$$

The equation states that the total change in the debt-to GDP-ratio ($b_T - b_0$) over the course of a crisis is the sum of three components, each cumulated over the crisis years: (i) the primary deficit (pb_t); (ii) the products of the lagged debt ratio and the differential between the effective interest rate on debt (i_t) and the nominal GDP growth rate (γ_t), known as the snowball effect; and (iii) a stock-flow adjustment (sfa_t).

According to this analysis, the driving force behind the debt increase during the Covid-19 crisis has been the contribution of the primary balance (Graph 3a). We can see that the reason for 90 percent of the increase in the EU-15 debt ratio is the (cumulative) increase in the primary deficit (Table 2). Compared to previous crises, this contribution of fiscal action was much higher and primarily reflects expenditure increases instead of revenue losses. This novelty corresponds to the nature of the policy response that was more decisive, substantial and timely than in past crises. In absolute terms, this was the largest countercyclical fiscal action in the EU's history, with significant implications for the debt ratio. This strong fiscal response prevented higher employment losses, which in turn prevented a bigger decline in revenues and output (Section 1.3).

Graph 3: **Drivers of govrnenment debt**

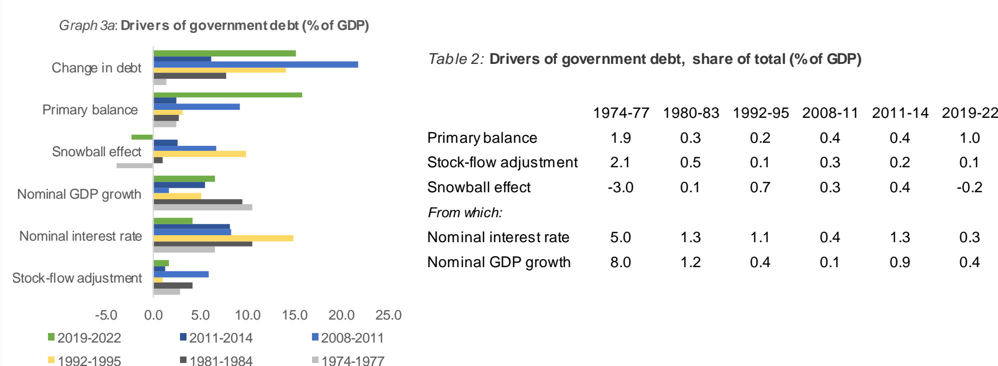


Table 2: **Drivers of government debt, share of total (% of GDP)**

	1974-77	1980-83	1992-95	2008-11	2011-14	2019-22
Primary balance	1.9	0.3	0.2	0.4	0.4	1.0
Stock-flow adjustment	2.1	0.5	0.1	0.3	0.2	0.1
Snowball effect	-3.0	0.1	0.7	0.3	0.4	-0.2
From which:						
Nominal interest rate	5.0	1.3	1.1	0.4	1.3	0.3
Nominal GDP growth	8.0	1.2	0.4	0.1	0.9	0.4

Notes: (1) Data from 2020 on represents the Commission Spring 2021 Forecast. (2) The snowball effect is the debt impact of the differential between the interest rate and GDP growth. (3) Stock-flow adjustments are changes in gross debt which are unrelated to changes in the budget deficit.
Source: European Commission; IMF, Historical Public Debt Database; own calculations

([2]) See Losoncs and Tóth (2020), Abbas et al. (2011), Eichengreen et al. (2019).
([3]) To ensure the comparability of data, the crisis periods covered are those with the largest increases in debt since 1970 in the 15 oldest Member States. Member States that joined the EU in 2004, 2007 and 2013 have been excluded from the analysis because in the 1990s most of them were experiencing the consequences of the transition to the market economy.

(Continued on the next page)

Box (continued)

In contrast to fiscal policy, the snowball effect has made a negative contribution to the increase in the debt ratio during the Covid-19 crisis. Before the 1980s, the average growth of nominal GDP in the EU-15 was substantially above the nominal interest rate. This resulted in its making a negative contribution. Until the end of the 1990s, nominal interest rates continued to increase, surpassing nominal growth rates, with the result that the snowball effect made a positive contribution to debt increase. Over the last two decades, both variables have followed a downward trend in general, but the nominal interest rate more so than the nominal GDP growth rate. Nevertheless, during the crisis periods, nominal interest rates increased due to the heightened risk perceived by financial markets. For example, in the previous crisis (2007-2012), some countries even lost access to the markets. During the current crisis, an immediate and significant monetary response made it possible to avert large rises in government yields.

The contribution of the stock-flow adjustment (SFA) ([4]) to debt dynamics is somewhat smaller compared to the previous crisis. During the pandemic, support for the financial sector has been provided by the central bank or in the form of government guarantees not reported as an increase in government spending, government financing or debt. In the previous crisis, the SFA reflected extensive financial sector support and loans to support the housing sector. However, because of data quality and gaps, the SFA's contributions to past debt increases remain largely unexplained ([5]).

([4]) The SFA is the difference between the change in government debt and the government deficit/surplus for a given period. Several factors contribute to the difference: loans granted by government or equity injections into corporations; privatisation and bank recapitalisation costs; debt restructuring or default; timing effects (deficits are measures in accrual terms while debt is a cash concept); valuation effects on foreign currency debt; statistical discrepancies (Eurostat (2020), Eichengreen et al. (2019)).

([5]) According to Abbas, A. et al. (2011) and Jaramilo et al. (2016), the impact of the SFA was significantly higher during debt surges than in pre- or post-crisis periods. Governments have used creative accounting during debt spike episodes in order to report narrower deficits.

2. EX-POST EVALUATION OF THE IMPLEMENTATION OF THE EU FISCAL FRAMEWORK

Highlights

- Budgetary plans for 2020 underscored a recurring issue in the implementation of the SGP: on the back of a projected recovery, most Member States eased budgetary targets in their stability and convergence programmes (SCPs). Draft budgetary plans tabled in autumn 2019 featured further easing, despite an almost unchanged growth outlook.
- The Covid-19 pandemic completely derailed fiscal plans for 2020. By the end of the year, government expenditures in the euro area and the EU as a whole exceeded revenues by around 7% of GDP against a deficit target of only 0.5% in the SCPs of spring 2019.
- The response to the pandemic was robust. On top of automatic stabilisers (which are quite substantial in most EU countries) authorities enacted sizeable discretionary measures. Governments also undertook to extend liquidity support to firms and households worth 18% of GDP, which in part may turn into actual liabilities.
- The EU swiftly agreed to activate SGP provisions that give Member States extra flexibility in the event of a severe economic downturn in the euro area or in the EU as a whole. The 2020 country-specific recommendations (CSRs) encouraged all Member States to take measures to address the pandemic and support the recovery.
- While the size and exogenous nature of the shock justified the activation of the severe economic downturn clause, its implementation gave rise to diverging interpretations. Some argued that EU fiscal rules had been suspended, while others pointed to the SGP provisions themselves. Also, communication on the criteria for deactivating the clause involved a considerable degree of discretion.
- Designed to be applied country by country, in effect the severe economic downturn clause was interpreted as a general waiver: the normal implementation of the rules was put on hold.
- On the back of the robust fiscal response, government expenditure grew well above medium-term potential growth in the euro area and the EU as a whole, even without taking account of health-related and job retention measures.
- The above also applied to countries with sustainability risks. However, a combination of low potential output growth and the absence of fiscal headroom limited their fiscal response. Conversely, countries with low debt made aggressive use of their fiscal space, providing a stronger shelter for businesses and households.
- The lack of fiscal headroom in some countries resulted, to a great extent, from failure to address fiscal imbalances during the 2014-2019 economic recovery. In particular, high debt countries failed to keep their net expenditure growth in line with, let alone below, medium-term growth prospects.
- EU guidance issued in 2020 called on Member States to respond to the crisis with timely, temporary measures. Commission analysis included in the 2021 spring package showed that most of the fiscal measures were indeed temporary, but some countries took on significant permanent expenditure increases without budgetary coverage.
- In 2020, a total of 23 Member States failed to meet the SGP deficit criterion, and 13 the debt criterion. On the grounds of high uncertainty, the Commission and the Council agreed not to open excessive deficit procedures (EDPs). This decision was based on political considerations rather than SGP provisions and precedent.

The outbreak of the pandemic and the activation of the SGP's severe economic downturn clause had a dramatic impact on the implementation of the EU fiscal framework in 2020. This chapter has been adapted to reflect the unprecedented circumstances. As in previous years, it gives a full overview of the annual EU fiscal surveillance cycle. However, as the discussion on the activation of the clause took centre stage in March 2020, here we describe in detail events preceding and following the decision.

Because of the activation of the clause, the Commission did not perform the conventional assessment of compliance with the previsions of the Stability and Growth Pact (SGP), but focused instead on fiscal support measures. Nonetheless, this chapter looks at fiscal developments across EU Member States in 2020 with a view to characterising fiscal performance relative to economic as opposed to formal benchmarks. It closes with a focus on governments' contingent liabilities.

Following the United Kingdom's withdrawal from the EU on 31 January 2020 and in line with similar Commission economic reports, this chapter will not cover the UK. For the same reason, references to the Member States and aggregate values for the EU as a whole no longer include the UK.

2.1. INNOVATIONS IN SURVEILLANCE METHODS AND PRACTICE

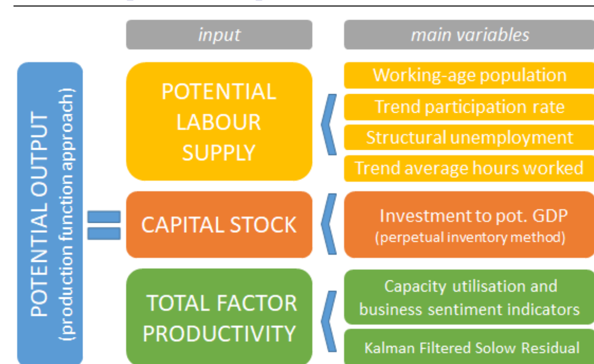
The 2020 fiscal surveillance cycle was characterised by some methodological and interpretative innovations in the EU fiscal framework, in particular:

- the commonly agreed method for estimating the output gap, which plays a crucial role in the current framework;
- the implementation of the SGP's severe economic downturn clause.

The first is discussed here; the second in Section 2.5.

The unprecedented economic shock caused by the pandemic heightened the challenge of estimating potential output, a crucial concept in EU fiscal surveillance (Table 2.1). As a result, in spring 2020 the Output Gap Working Group (OGWG) of the Council's Economic Policy Committee (EPC) reviewed and adjusted the commonly agreed method for estimating potential output and the output gap. In particular, the Member States endorsed three temporary modifications, primarily aimed at keeping potential output estimates as stable as possible relative to the autumn 2019 baseline. The Commission applied the modified method for the first time in the 2020 spring forecast round and then for the spring surveillance package published in May 2020.

Table 2.1: **Commonly agreed method for estimating potential output for EU fiscal surveillance**



The Solow residual represents a part of an economy's output growth that cannot be attributed to the accumulation of capital and labour. The Total Factor Productivity (TFP) trend is estimated from the Solow residual by using a bivariate Kalman filter method that exploits the link between the TFP cycle and capacity utilization.
Source: European Fiscal BoardCommission

The modifications focused on dampening the impact of massive labour hoarding (i.e. the labour input not fully utilised in the production process), further to job retention schemes activated by Member States ([9]). More specifically:

- average hours worked: the 2020 average was replaced by a linear interpolation of the 2019 and 2021 values before applying a smoothing procedure;
- structural unemployment: 'labour hoarding' dummy variables were added for 2020 (and 2021) in the estimation of the unemployment rate consistent with stable wage growth (i.e. NAWRU) for Member States where the relationship between the unemployment gap

([9]) Uncertainty around the impact of labour hoarding on potential output also related to possible measurement issues regarding the correct distinction between 'actual hours worked' and 'hours paid'. While hours paid but not worked should in principle be excluded from the national accounts' official hours worked series, in practice national statistical offices encountered difficulties and differences emerged across Member States, in part due to the different short-time working schemes involved.

and labour cost indicators would have otherwise collapsed ([10]); and

– capacity utilisation indicators (i.e. CUBS) reflected the sudden impact of the pandemic with a lag and the Commission's 2020 spring forecast used proxy values based on experience at the onset of the financial crisis (2008-2009);

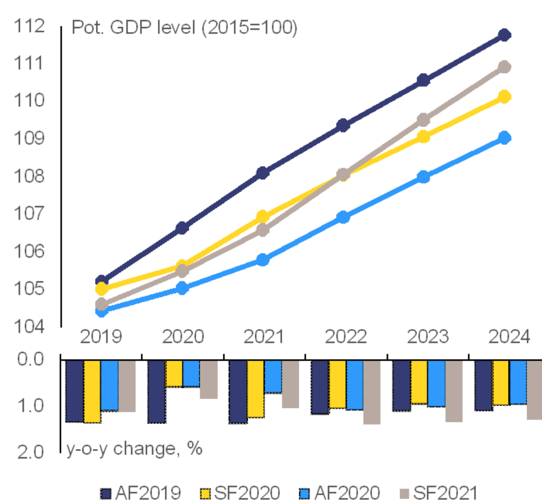
In autumn 2020 and spring 2021, the OGWG and the Commission agreed to retain the *ad hoc* modifications that limited the impact of labour hoarding. The only exception were the capacity utilisation indicators, for which monthly data for 2020 were available from the Commission's business and consumer surveys ([11]).

The *ad hoc* modifications to the commonly agreed method were intended to address measurement uncertainties, given the difficulty of collecting data in times of crisis (e.g. actual hours worked vs paid hours). Going forward, it is reasonable to expect national accounts and labour force statistics to reflect changes to hours worked due to short-time work schemes more accurately, as the production of statistics comes into line with Eurostat guidance ([12]).

Minimising backward and forward revisions of potential output in the face of a crisis has significant implications for the assessment of the underlying fiscal position: It yields a larger estimate of the negative output gap and, for a given headline deficit, a lower estimate of the structural deficit. In short, a given deterioration of the headline deficit is interpreted mainly as cyclical, while the structural position (the main reference for fiscal surveillance and an important input to the Commission's sustainability analysis) is less affected. As indicated in Chapter 1, this effect is evident in the data. The estimated change of the structural budget balance of the euro area and the EU is around - 2.5% of GDP. More direct measures of discretionary fiscal policy measures (such as the expenditure benchmark) point to around -4% of GDP or more (see also Chapter 1).

Although designed to stabilise the potential output estimates as compared to the pre-crisis baseline, the *ad hoc* modifications did not completely neutralise the impact of the pandemic. Compared to the Commission's 2019 autumn forecast, more recent estimates show significant revisions of the level and the growth rate of potential output (see Graph 2.1) ([13]). However, the estimates in the 2021 spring forecast show a rebound in potential growth over the forecast period, based on a better global activity and trade outlook. This is also aided by incorporating the impact of the Recovery and Resilience Facility (RRF) ([14]).

Graph 2.1: **Potential output – level and growth in euro area, different Commission forecasts**



Source: European Commission

While the most recent forecasts expect the pandemic to have a limited impact on potential output in the long term, uncertainty remains

([10]) Estimation of the NAWRU is particularly sensitive to labour hoarding due to its knock-on effect on productivity and unit labour costs. Under certain short-time work schemes, both the benefits to workers and social security payments are initially paid by employers, and refunded only later. Labour cost statistics that do not correctly reflect this phenomenon, could distort estimates, showing a sharp drop in labour productivity (i.e. output per hours worked/paid) and thus a sudden rise in unit labour costs.

([11]) https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/business-and-consumer-surveys_en

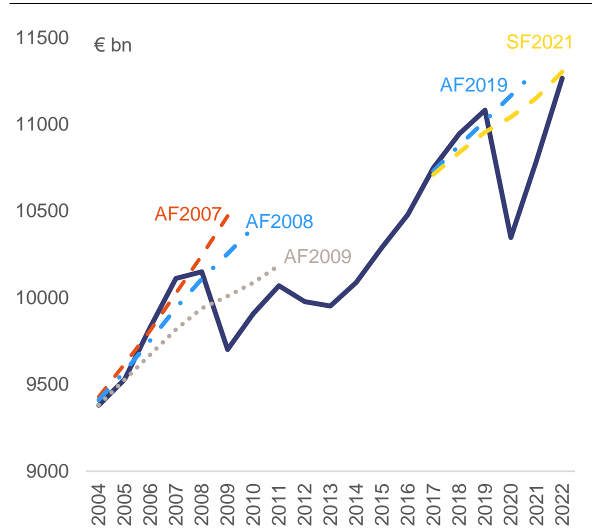
([12]) Since the outbreak of the pandemic, Eurostat has provided guidance on how to apply existing accounting rules in the context of the crisis. Of particular relevance here is the guidance on: i) government measures mitigating the impact of Covid-19; ii) the implications of Covid-19 measures for public partnership programmes and concessions; iii) government guarantees to the SURE instrument; and iv) the future EIB Pan-European Guarantee Fund. For all Eurostat's statistical guidance relating to the pandemic, see: https://ec.europa.eu/eurostat/data/metadata/covid-19-support-for-statisticians

([13]) Due to the use of various filtering methods in the estimation of potential output, which involve lags and leads of relevant variables, new forecasts also affect past values of potential output.

([14]) The Commission's spring 2021 forecast covered the budgetary and economic impact of all Member States' resilience and recovery plans (RRPs). The autumn 2020 and winter 2021 forecasts covered only RRP measures adopted or credibly announced/specified by a few Member States, in line with the 'no policy change' assumption.

high (15). Judging from past recessions, including the global financial crisis, large economic shocks typically produce lasting effects that surface only gradually (see Graph 2.2).

Graph 2.2: **Real GDP level and revisions of potential output across forecast vintages (EA-12)**



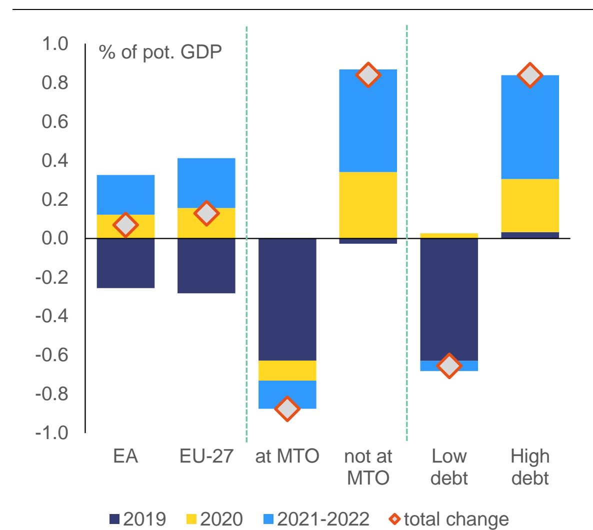
(1) Real GDP level (i.e. dark blue line) is based on the latest Commission forecast.
(2) Dotted and dashed lines represent real potential GDP estimates from different rounds of Commission autumn forecasts (AF) and the 2021 spring forecast (SF).
(3) 'EU-12' stands for the first 12 Member States, which adopted the euro as their common currency.
Source: European Commission, own calculations

In addition to the above modifications, there was also one country-specific adjustment to the commonly agreed method. In October 2020, the Commission agreed to a request from Estonia to align the starting year for the capacity utilisation indicator (CUBS) — a key measure of slack in the commonly agreed method — with that used for the other two Baltic countries. The Commission introduced the change in the autumn 2020 forecast; as yet, there is insufficient data to disentangle its effect from the other changes. However, based on the 2019 autumn forecast, shortening the CUBS series (i.e. starting in 2002 rather than in 1995) appears to produce worse output gaps for Estonia, turning them from positive in negative in both 2020 and 2021.

2.2. MEDIUM-TERM BUDGETARY PLANS

Countries' budgetary plans in the spring 2019 SCPs involved a cut in the EU aggregate budget deficit from 0.8% of GDP in 2019 to 0.4% in 2020. For the euro area, the planned improvement was similar, from a deficit of 0.9% of GDP in 2019 to 0.5% in 2020. The programmes assumed sustained economic growth in 2020, slightly above potential. Member States' plans targeted a marginal improvement of the structural balance in 2020, by around 0.1% of GDP for the euro area and 0.2% for the EU as a whole (see Graph 2.3) (16).

Graph 2.3: **Planned changes in structural balance, 2019 SCPs**



(1) The graph shows changes from the previous year in the structural balance for 2019, 2020 and cumulated over 2021-2022 according to the 2019 SCPs, as recalculated by the Commission according to the commonly agreed methodology.
(2) Countries close to or above and below their respective MTOs in 2018 according to Commission 2019 spring forecasts.
(3) Low- or high-debt countries (i.e. those with debt, below or over 60% of GDP) in 2018.
(4) Groups' aggregate values are calculated as weighted averages by countries' shares in each group's GDP.
Source: European Commission

At the same time, and following a pattern that is as unfortunate as it is familiar, the 2019 SCPs involved a significant revision of the fiscal targets set in the plans submitted a year earlier. For 2019, the euro area and EU structural budget balance was planned to improve by 0.3% of GDP, while the 2019 SCPs pointed to a deterioration of around 0.3% (17). Similarly, the adjustment targeted in 2020

(15) Skills mismatches and worker discouragement could prolong labour market scars (hysteresis effect), restricting the participation rate. The stock of capital could take longer to return to pre-crisis level after the huge drop in investment, which risks aggravating the situation for many companies if their liquidity difficulties turn into solvency problems. In addition, the freeze of certain activities might have accelerated the depreciation of certain assets (e.g. aircraft).

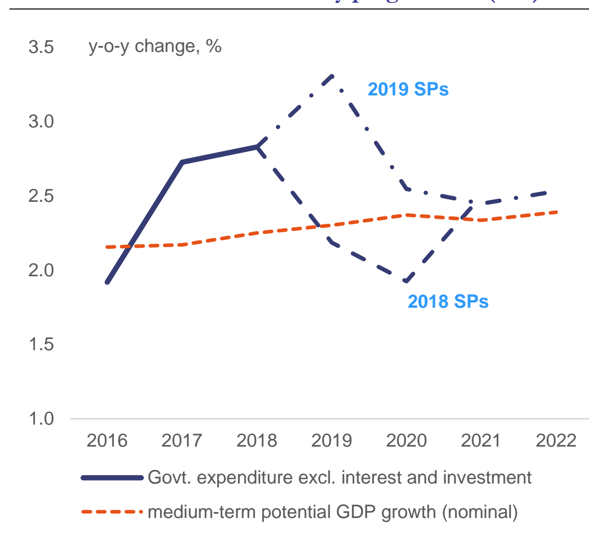
(16) The structural budget balances are those recalculated by the Commission on the basis of information provided in the programmes according to the commonly agreed methodology.

(17) As noted in last year's EFB annual report (Section 2.2), the downward revision of fiscal effort was greater for countries not yet at their MTOs. The reduction was particularly large in Italy

slipped from their earlier targets (by some 0.2 percentage point of GDP in both the euro area and the EU.

The planned improvement in the aggregate headline balance in 2020 relied on expenditure restraint, a quarter of which was from savings in interest payments on government debt. In this context, it is worth looking at planned expenditure growth and its revisions. Graph 2.4 shows, for the euro area, yearly growth in government spending net of debt interest and gross fixed capital formation, which can be considered expenditure outside governments' control (i.e. interest on existing debt) or repayable by induced future growth (i.e. investment). The deceleration of government expenditure in 2020, as envisaged in the 2018 stability programmes, vanished in the spring 2019 plans, with current primary expenditure expected to grow above medium-term potential output until the end of the forecast period.

Graph 2.4: **Planned government expenditure growth in 2018 and 2019 stability programmes (SPs)**



The medium-term potential GDP is in nominal terms. It is calculated as the 10-year average of real potential output growth rates plus the estimated GDP deflator.
Source: European Commission

As amply documented in previous EFB reports, the back-loading and delaying of fiscal adjustments to subsequent SCP updates are a recurring phenomenon in the EU fiscal framework. Successive reforms of the SGP, in particular the 2011 six-pack reform, have sought to strengthen the link between medium-term fiscal plans and the national budgetary process, but failed to do so, mainly because the SCPs have come to play a weaker role in EU fiscal surveillance [18].

On the basis of the information in the spring 2019 SCPs, the Commission concluded that the medium-term budgetary plans of ten Member States (Belgium, Estonia, Spain, France, Italy, Hungary, Poland, Portugal, Romania and Slovakia) pointed to a risk of significant deviation in 2020 from the requirements of the preventive arm of the SGP [19]. For Romania and Hungary, this coincided with the third and second warnings, respectively, under the significant deviation procedure (SDP). However, these assessments did not feature prominently in the press materials issued by the Commission [20], so received little to no public attention.

2.3. POLICY GUIDANCE – DEFINING FISCAL REQUIREMENTS

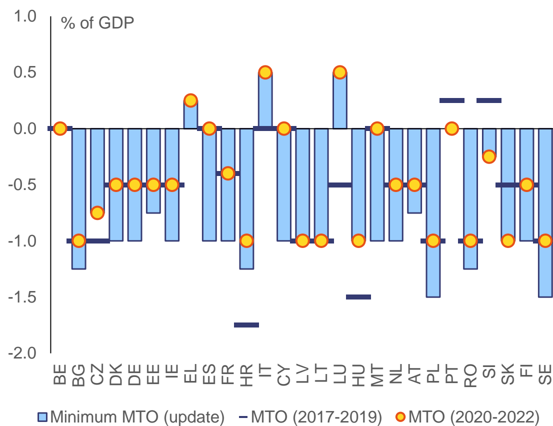
In their 2019 SCPs, Member States set out their new medium-term budgetary objectives (MTOs) for 2020-2022, on the basis of updated minimum MTOs calculated by the Commission [21]. Eight Member States changed their MTO for 2020-2022, seven in a response to the update. Czechia, Croatia, Italy, Luxembourg and Hungary set stricter MTOs (i.e. corresponding to a higher structural surplus or lower structural deficit) due to the upward revision of the minimum MTOs [22]. Slovenia and Portugal opted for a lower (i.e. less demanding) target, taking advantage of the downward revision of their minimum MTOs. Slovakia reduced the MTO to the minimum allowed, despite an unchanged minimum MTO. Over half the countries [23] chose

(from +0.7% to -0.2% of GDP), Spain (from +0.4% to -0.1%) and Poland (from +0.6% to -1.3%).

[18] See European Fiscal Board (2019).
[19] https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/stability-and-convergence-programmes/assessment-programmes-2019_en
[20] i.e. press releases, *chapeau* communications, memos, etc.
[21] These represent a lower bound for the MTO, which Member States have to respect in order to be considered SGP-compliant. Under Regulation (EC) No 1466/97, the minimum MTO should be revised every 3 years, after the publication of the 'ageing report', which provides up-to-date data on the ageing challenge facing Member States. For more details, see EFB *2019 annual report* (Section 2.2.1), pp. 17-18.
[22] Croatia did so partly to meet the entry conditions for the exchange rate mechanism (ERM II), which it joined in July 2020. Compliance with the -1% lower bound for euro area and ERM II Member States is the third of the three bounds determining the minimum MTO (see Glossary). This also explains how Croatia (and Hungary, which has not joined ERM II) was able to set its MTO below -1% of GDP for 2017-2019.
[23] Bulgaria, Denmark, Germany, Estonia, Ireland, Spain, France, Croatia, Cyprus, Malta, the Netherlands, Austria, Poland, Romania, Finland and Sweden.

a more stringent MTO than the minimum, with an average distance of 0.3 percentage point of GDP.

Graph 2.5: **Medium-term budgetary objectives (update, 2020-2022)**



Greece's minimum MTO for 2020-2022 is the first since it exited the ESM macroeconomic adjustment programme. It adopted an MTO for the first time in its 2019 stability programme.
Source: European Commission

On 9 July 2019, based on the information in the 2019 SCPs, the Council addressed CSRs to the Member States. It called on half of the Member States to achieve their MTOs, or issued specific guidance is this respect in the form of quantitative fiscal adjustment requirements, i.e. in terms of maximum nominal growth rate of net primary government expenditure and the corresponding adjustment in the structural balance (see Table A1). Member States with high debt-to-GDP ratios were recommended to use windfall gains to accelerate the reduction of the general government debt ratio.

The Council also adopted CSRs for Greece, for the first time since its exit from its macroeconomic adjustment programme in August 2018 ([24]). While it issued no specific fiscal guidance (Greece's structural balance was estimated to be above its MTO of 0.25% of GDP), it recommended that Greece continues abiding by the 22 June 2018 commitments agreed with the Eurogroup ([25]), in particular a primary surplus of 3.5% of GDP until 2022 ([26]).

The fiscal requirements in the CSRs for 2020 were based on the matrix of adjustments ([27]) except for three countries. For Spain, the Commission considered the output gap estimate from the commonly agreed methodology (2.0% of GDP) to be subject to a high degree of uncertainty. It therefore recommended that the Council lower the requirement for 2020 from 1% of GDP (i.e. the matrix-based adjustment requirement in 'good times') to 0.65% (i.e. close to the requirement in 'normal times') ([28]). Unlike in the previous surveillance cycle, the decision was based on the result of the plausibility tool and a correct application of the constrained judgement ([29]). For Hungary and Romania, the required adjustment for 2020 (0.75% of GDP in both cases) was based on the Council's recommendations of 14 June 2019 under the Significant Deviation Procedure (SDP).

2.4. ASSESSING DRAFT BUDGETARY PLANS FOR 2020

In autumn 2019, all euro area countries presented draft budgetary plans (DBPs) for 2020. Four submitted such plans without including policy plans, due either to national elections (Austria, Portugal and Spain) or being in the process of forming a new government (Belgium). Compared to the stability programmes of spring 2019, the DBPs set less ambitious fiscal targets despite an almost unchanged growth outlook. A mix of additional spending (two thirds of which consisted of investment) and discretionary tax cuts explained deficits that were higher than initially planned (Graph 2.6).

The aggregate picture masks marked differences across countries. Those for which the Council

([24]) Member States subject to a macroeconomic adjustment programme are exempt from some requirements of normal fiscal surveillance (Article 12 of Regulation (EU) No 472/2013).

([25]) https://www.consilium.europa.eu/media/35749/z-councils-council-configurations-ecofin-eurogroup-2018-180621-specific-commitments-to-ensure-the-continuity-and-completion-of-reforms-adopted-under-the-esm-programme_2.pdf

([26]) See EFB *2020 annual report* (Box 2.1).

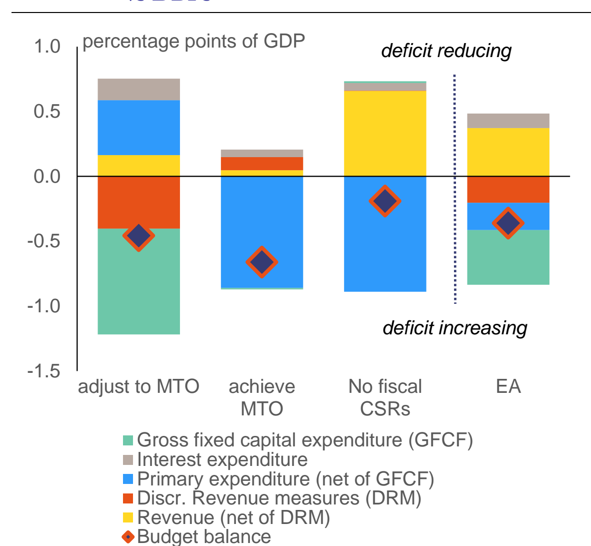
([27]) Fiscal requirements in the preventive arm of the SGP are set on the basis of a matrix that modulates the benchmark annual adjustment of 0.5% of GDP according to cyclical conditions, economic growth and the government debt-to-GDP ratio. It follows the principle that high government debt warrants larger fiscal adjustments in favourable economic times.

([28]) Based on the Commission 2019 spring forecast, the plausibility tool suggested that in five Member States (Cyprus, Lithuania, Luxembourg, Slovenia and Spain), the output gaps estimated according to the commonly agreed methodology were subject to a high degree of uncertainty. However, only in the case of Spain did it have an impact on the requirements for 2020.

([29]) The plausibility tool and constrained judgment are meant to assess the plausibility of output gap estimates from the commonly agreed methodology by using past errors — and if necessary to propose alternative values. If the estimate falls outside the range suggested by the plausibility tool, the Commission can use judgment in choosing an estimate for the purposes of fiscal surveillance. The degree of judgment is constrained by the above range. For more detail, see EFB *2018 annual report* (Section 2.2.1).

recommended adjustments towards the MTO (Belgium, Estonia, Spain, France, Italy, Latvia and Finland) changed their plans in favour of an even larger fiscal stimulus through additional investment and deficit-increasing revenue measures, while planning savings in current expenditure. On the other hand, countries required to achieve their MTOs in 2020 (Ireland, Portugal, Slovenia and Slovakia) changed policy orientation from a surplus to a deficit, mostly through additional spending. Lastly, countries that did not receive fiscal recommendations (being at or above their MTOs) changed their initial plans so as to target a slightly lower surplus in 2020 via spending increases only partially financed by higher revenues.

Graph 2.6: **Revisions of budgetary targets for 2020 – SCPs vs DBPs**



(1) The graph shows the change in the 2020 headline budget balance between the DBPs (draft budgetary plans) (autumn 2019) and the SCPs (stability and convergence programmes) (spring 2019), its main drivers for the euro area as a whole and countries grouped according to the fiscal guidance issued by the Council.
(2) Expenditure items (i.e. primary expenditure, interest and GFCF) are shown with inverted sign.
Source: European Commission, own calculations

While no DBP was found to be in particularly serious non-compliance ([30]), the Commission sent letters to Belgium, Spain, France, Italy, Portugal and Finland, whose plans appeared not to be in line with SGP requirements ([31]). The letters asked for additional information including on the precise composition of the structural balance changes and expenditure developments. Most of the Member States concerned provided additional information ([32]). The Italian authorities argued that their own output gap estimates indicated that the economy was experiencing 'bad times', justifying a lower adjustment. No plans were revised after the exchange of letters.

Table 2.2: **Draft budgetary plans – assessment of compliance with preventive arm of SGP**

	2014	2015	2016	2017	2018	2019	2020	Ex-ante average deviation (% of pot. GDP) SB	EB
BE								-0.4	-0.6
DE								0.9	0.7
EE								-0.1	-0.1
IE								0.1	-0.1
EL								1.5	2.2
ES								-0.7	-1.2
FR								-0.6	-0.7
IT								-0.8	-0.8
CY								0.2	-0.1
LV								-0.1	-0.7
LT								0.4	-0.3
LU								0.4	0.4
MT								0.1	-0.4
NL								0.1	0.4
AT								-0.2	-0.2
PT								-0.5	-1.0
SI								-0.7	-0.7
SK								-0.3	-0.2
FI								-0.3	-0.3

(1) Green, yellow and red correspond to an assessment of 'compliance', 'broad compliance' and 'risk of non-compliance', respectively, with the preventive arm of the SGP (years in EDP not reported).
(2) The assessment of compliance following the Commission's 'overall assessment' includes deviations over 2 years and the possible application of the SGP flexibility clauses.
(3) SB refers to the structural balance; EB to the expenditure benchmark. Deviations from the medium term budgetary objective (MTO), or from the annual adjustment requirements for both the SB and the EB are expressed as a percentage of potential GDP and averaged over the years.
(4) For countries above the MTO, requirements consider the use of fiscal space: if a country's structural balance is estimated at 1% of GDP above its MTO, the requirement considers the possibility of a deterioration of its underlying fiscal position of up to 1% of GDP. Hence, if the structural balance worsens by 0.5% of GDP, the table still shows a positive deviation from the requirement of 0.5% of GDP.
(5) Only euro area countries submit DBPs.
Source: European Commission

On 20 November 2019, the Commission issued its opinions on the DBPs of the euro area countries. Eight countries (Belgium, Spain, France, Italy, Portugal, Slovenia, Slovakia and Finland) were found to be 'at risk of non-compliance' with the preventive arm of the SGP, as their plans were assessed as resulting in a significant deviation from the adjustment path towards their respective MTOs. For Belgium, Spain, France and Italy, the risks of non-compliance also related to insufficient reduction of the high level of public debt under the corrective arm of the SGP. Nine plans were found to be in compliance with the SGP requirements, while two might have resulted in some deviation from the MTOs (see Table 2.2).

([30]) In line with the procedure in the 'two-pack' code of conduct, the Commission first assesses whether, on the basis of the DBPs, a country is intentionally planning to deviate significantly from the MTO or the adjustment path towards it, or to breach the deficit ceiling or the debt rule.
([31]) The letters for Belgium, Spain and Portugal also underlined the importance of submitting updated DBPs.
([32]) Replies from Belgium, Spain and Portugal are not available.

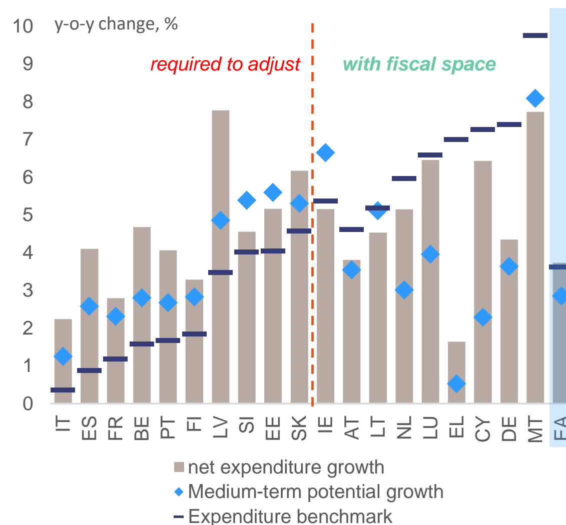
On 4 December 2019, the Eurogroup issued a statement underlining the very different budgetary situations across euro area members and the need for those still far from their MTOs to rebuild fiscal buffers while reducing high debt levels at a sufficient pace ([33]). In line with Commission opinions, the Eurogroup invited Member States with fiscal space, notably Germany and the Netherlands, to undertake additional expenditure and boost investment.

Graph 2.7 shows expected primary expenditure growth in 2020 (net of discretionary revenue measures and one-offs) against the expenditure growth ceilings set in Council recommendations. According to the Commission's 2019 autumn forecast, all euro area countries required to adjust towards, or achieve, their respective MTOs (with the exception of Ireland) were expected to exceed those ceilings. Most of them were also projected to exceed their medium-term potential GDP growth rate (defined as the 10-year average of real potential GDP growth plus the estimated GDP deflator), without considering the additional spending brake, which allows the structural balance to adjust towards the MTO (reflected in the expenditure benchmark) ([34]). Countries overachieving their MTOs were not expected to make full use of their fiscal space.

([33]) https://www.consilium.europa.eu/fr/press/press-releases/2019/12/04/eurogroup-statement-on-the-draft-budgetary-plans-for-2020/

([34]) If an adjustment is required, the convergence margin reduces the maximum allowed growth of expenditure compared to medium-term potential GDP growth.

Graph 2.7: **Expected expenditure growth and expenditure benchmark in 2020**



(1) Expected net expenditure growth for 2020 is based on the 2019 autumn forecast and calculated according to the expenditure benchmark (EB) methodology (i.e. net of discretionary revenue measures, corrected for one-offs and by smoothing investment).
(2) Medium-term potential growth (i.e. the 10-year average of potential GDP growth estimates) and the EB are expressed in nominal terms by using the GDP deflator.
(3) Unlike medium-term potential growth, the EB takes into account the convergence margin, which ensures that countries below MTO adjust towards it, and the fiscal space available for countries above MTO.
Source: European Commission

The events of autumn 2019 confirm past experience. The formal assessment of the DBPs introduced with the two-pack reform has fostered detailed discussion of national budgetary plans at EU level before their final approval by national parliaments. Although this did not happen in 2019, there are examples of Member States adjusting (the implementation of) plans after such discussions. More importantly, however, experience also shows that some Member States have persisted in their non-compliance with fiscal rules even after it has been pointed out by the Commission. Moreover, the targets in the DBPs typically represent the end-point in a series of downward revisions across successive SCPs, even (and in particular) when economic developments are favourable ([35]).

2.5. PROVISIONS FOR SEVERE ECONOMIC DOWNTURNS

On 20 March 2020, in view of the fast-evolving crisis and the rapid worsening of the economic outlook, the Commission proposed to the Council that use be made of the SGP provisions allowing for extra flexibility in the event of a severe

([35]) See, for example, EFB (2020b) (Section 2.2) and EFB (2019) (Section 3.3).

economic downturn for the euro area or the EU as a whole ([36]). In public debate, this has become known as the 'general escape clause' ([37]). At the time, Italy (11 March), Spain (14 March) and France (17 March) had already entered nationwide lockdowns, closing all but essential shops.

The 10 days leading up to the activation of the severe economic downturn clause

A week earlier, on 13 March, the Commission had presented a set of immediate actions in its Communication on a *Coordinated economic response to the Covid-19 outbreak* ([38]). In order to allow Member States to deliver an appropriate response to the emergency, the Communication, among other initiatives ([39]), also outlined ways to make use of various contingency provisions in the SGP that allow for the modulation or relaxation of the constraints imposed on national fiscal policies by the EU fiscal rules ([40]). In addition, the Commission signalled its readiness to activate the clause introduced with the 2011 SGP reform that provided for extra flexibility in the event of a severe economic downturn in the EU and the euro area as a whole, so as to accommodate a more forceful fiscal policy response to the crisis ([41]).

The Commission's willingness to consider the activation of the severe economic downturn clause largely reflected discussions in the Council committees preparing the ECOFIN meetings. Already then, many Member States were calling for a broad interpretation of the SGP provisions, so that the activation of the clause would not only allow for more flexibility in the canonical country-by-country application of the surveillance procedures, but effectively suspend the SGP across the board. The Commission tried to clarify the specific nature and possible limits of the provisions, but a more extensive interpretation prevailed.

On 16 March, the Eurogroup welcomed the set of measures taken by the Commission ([42]). The euro area finance ministers agreed with the Commission that 'the budgetary effects of temporary fiscal measures taken in response to Covid-19' should be excluded when assessing compliance with EU fiscal rules. They also agreed that the 'flexibility to cater for unusual events', as provided in the preventive and corrective arms of the SGP ([43]), should apply. They considered that 'automatic revenue shortfalls and unemployment benefit increases resulting from the drop in economic activity' should not affect the assessment of compliance with fiscal requirements ([44]). Lastly, they welcomed the Commission's readiness to activate the severe economic downturn clause, 'allowing for further discretionary stimulus, while preserving medium-term sustainability'.

On 17 March, in a video conference with members of the European Council, the President of the Commission announced the Commission's intention to table a proposal to the Council in the coming days to activate the severe economic downturn clause ([45]).

([36]) COM(2020) 113 final

([37]) The SGP severe economic downturn clause allows for additional, temporary flexibility in respect of the normal requirements of the preventive and corrective arm of the SGP in the event of a severe economic downturn for the euro area or the EU as a whole. For a detailed presentation, see EFB (2020a) (Box 2).

([38]) COM(2020) 112 final.

([39]) The Commission announced a series of measures, including: (i) liquidity measures to help SMEs; (ii) a revision of State aid rules; and (iii) a €65 billion Coronavirus Response Investment Initiative (in force since 1 April) to make flexible use of the EU budget and structural funds.

([40]) The Communication indicated three possible sources of flexibility in the EU fiscal framework to allow an 'unconstrained' fiscal response to the pandemic: (i) classifying all crisis-related measures as one-offs; (ii) applying the flexibility provided under the unusual event clause of the preventive arm of the SGP; and (iii) revising the required fiscal efforts in the light of the worsening of the economic outlook.

([41]) As explained in EFB (2020) (Box 2), the clause encompasses a series of SGP provisions that allow for more flexibility in the application of the rules in the event of a severe economic downturn in the euro area or the EU as a whole.

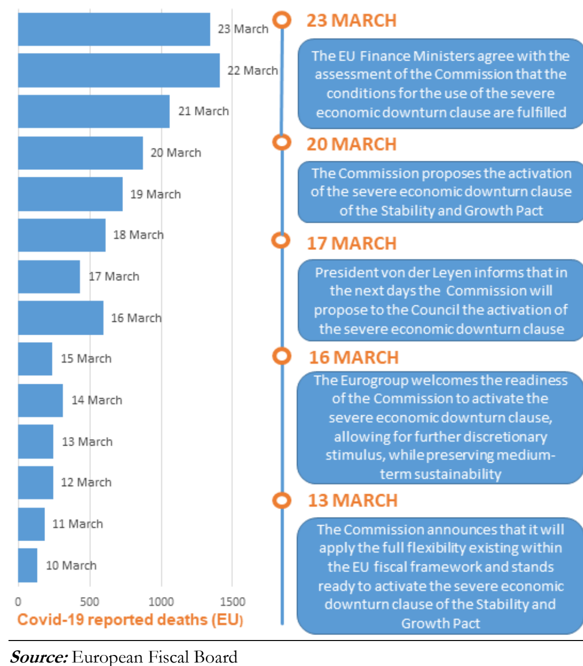
([42]) Statement on COVID-19 economic policy response.

([43]) Regulation (EC) No 1466/97 (Articles 5(1), 6(3), 9(1) and 10(3)) and Regulation (EC) No 1467/97 (Articles 3(5) and 5(2)).

([44]) Neither revenue shortfalls nor unemployment benefits should be considered as one-offs or qualified for the unusual event clause according to standard practice and principles (see Box 2.1).

([45]) Statement by President von der Leyen at the joint press conference with President Michel, following the EU Leaders' videoconference on COVID-19.

Graph 2.8: **The 10 days leading up to the activation of the severe economic downturn clause**



Source: European Fiscal Board

On 20 March, the Commission issued a Communication to that effect ([46]), justifying the approach mainly on the basis of the need for 'more far-reaching flexibility' under the SGP in the light of the scale of fiscal effort needed to protect people and businesses, and 'to support the economy following the pandemic'. However, the Communication did not (and could not) provide formal updated guidance for Member States on the conduct of fiscal policy. It referred to the forthcoming proposals for CSRs to be issued in May.

The Commission Communication referred to the relevant flexibility provisions in the SGP, which by design and practice are to be applied country by country in the event of a severe economic downturn. It called on the Council to endorse the Commission's conclusion, with a view to providing clarity for the Member States, and stated that the clause did not suspend SGP procedures.

On 23 March, the ECOFIN council issued a statement agreeing with the Commission's assessment of the conditions for the use of the clause ([47]). It clarified that the additional flexibility should be used to support emergency measures and protect EU economies, including through further discretionary stimulus 'designed, as appropriate, to be timely, temporary and targeted'.

Follow-up to the decision to activate the clause

On 20 May, the Commission issued proposals for CSRs, which the Council adopted on 20 July. For the first time ever, and with a view to the formal activation of the severe economic downturn clause, the CSRs (i) were virtually the same for all countries and (ii) contained only qualitative guidance for the conduct of fiscal policy in 2020 and 2021. The CSRs encouraged Member States to take the necessary measures to address the pandemic, keep the economy afloat and support recovery. They also envisaged a return to more prudent fiscal policies when economic conditions would allow, with the aim of establishing appropriate medium-term fiscal positions and ensuring debt sustainability, while enhancing investment.

In letters dated 19 September ([48]), the Commission informed finance ministers that the clause would remain active in 2021 in the light of the continuing uncertainty as to the economic consequences of the pandemic. It called on Member States to continue to provide 'targeted and temporary fiscal support in 2021', while ensuring fiscal sustainability in the medium term. It also called for a gradual shift from emergency responses to more structural measures to facilitate the recovery and improve economic resilience to future crises. The letters reiterated that the activation of the clause did not suspend SGP procedures. Unlike the activation of the clause, its extension was not formally endorsed in an official Council document ([49]).

On 3 March 2021, the Commission presented a new Communication updating the fiscal policy response to the pandemic ([50]). This included views on the possible deactivation of the clause, including new quantitative criteria, such as the level of economic activity in the EU or euro area compared to pre-crisis (end-2019) levels ([51]). The Commission spring package (2 June 2021) reaffirmed this approach, while a return to

([46]) Communication from the Commission to the Council of 20 March 2020.
([47]) Statement of EU ministers of finance on the Stability and Growth Pact in light of the COVID-19 crisis.
([48]) Letters on fiscal policy orientations for 2021.
([49]) With few explicit exceptions and following a general principle of Treaty-based Community method, all decisions under the SGP are taken by the Council on a proposal from the Commission.
([50]) One year since the outbreak of COVID-19: fiscal policy response (COM(2021) 105 final).
([51]) The Communication clarified that the Commission would assess the deactivation of the clause on the basis of the 2021 spring forecast, following dialogue with the Council.

pre-pandemic activity levels was projected somewhat earlier in terms of quarterly data.

Contrasting interpretations of the clause

The Commission and the Council concurred that the exceptional crisis and its extraordinary macroeconomic and fiscal impact warranted a clear and immediate break in the conduct of fiscal surveillance. However, unlike other forms of flexibility under the SGP (e.g. the unusual event clause, which formally follows the same logic as the severe economic downturn clause), activation of the severe economic downturn clause was uncharted territory. As a result, the implementation of the clause has given rise to diverging views and new interpretations.

Competing narratives

In public debate, including in the media, the prevailing view was that the activation of the clause had suspended the SGP. Official pronouncements by the Commission consistently clarified that this was not the case, but that activation 'allowed the Commission and the Council to undertake the necessary policy coordination measures within the framework of the Pact, while departing from the budgetary requirements that would normally apply' ([52]). Formally, the EU finance ministers concurred, stating that they 'remain fully committed to the respect of the Stability and Growth Pact'. The same line was taken in the spring 2020 CSRs ([53]).

However, it is clear from the implementation of the clause that the SGP was *de facto* suspended. First, in spring 2020, when the assessment of Member States' fiscal performance in 2019 detected episodes of clear non-compliance, this was not followed up. The Commission and the Council considered that, given the unprecedented economic shock resulting from the pandemic and the need to maintain a supportive stance, it was not appropriate to launch significant deviation procedures (SDPs) under the preventive arm of the Pact in response to budgetary outcomes in 2019 ([54]).

Second, in the light of the expected sharp deterioration of national budgets in 2020, the Commission prepared reports under Article 126(3) TFEU for all Member States except Romania, which was already in the corrective arm of the Pact. Although all reports, except that for Bulgaria, concluded that the deficit criterion in 2020 was not fulfilled, the Commission considered that no decisions should be taken to place Member States under an EDP. This approach was motivated by the exceptional uncertainty created by the pandemic, which according to the Commission would have made it difficult *inter alia* to plot a credible path for fiscal policy ([55]).

Therefore, the actual impact of the clause on the EU fiscal framework has been greater than suggested by the repeated assurances in official communications from the Commission and the Council. The adjustments to the implementation of the rules have gone beyond what was formally provided for. This also applies to the very concept of 'severe economic downturn'. The Commission and the Council concurred that they would not feel bound by any previously agreed definition ([56]).

Process and governance

The EU fiscal framework provides for the SGP requirements to be determined and applied country by country. The severe economic downturn clause (like other elements of flexibility under the SGP) is meant to be applied to individual countries via legal acts as part of specific surveillance procedures.

In contrast, the communicated 'activation' of the clause followed a novel procedure: the Commission issued a Communication in early March (a non-binding act), followed by a statement from the EU finance ministers (another non-legislative act). Only later, in July, did the Council's adoption of the CSRs replace the previous fiscal

([52]) The 20 March Communication clarified the statement in the 13 March Communication that the clause would 'suspend the fiscal adjustment recommended by the Council'.

([53]) e.g. paragraph 5 of the Council recommendations for Belgium: 'The severe economic downturn clause does not suspend the procedures of the Stability and Growth Pact. It allows Member States to depart from the budgetary requirements that would normally apply while enabling the Commission and the Council to undertake the necessary policy coordination measures within the framework of the Pact' (COM(2020) 501 final).

([54]) As pointed out in the EFB 2020 *annual report*, the number of EU countries significantly deviating from their requirements in 2019 was the highest since the six and two-pack legislative reforms of 2011-2013.

([55]) 2020 European Semester: country-specific recommendations..

([56]) In the Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes (agreed between the Commission and the Council), a severe economic downturn is defined as 'negative annual GDP volume growth rate' or 'an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential'.

guidance and, thus, formally implement for each country the flexibility allowed by the clause. However, as indicated above, the guidance was qualitative in nature and virtually identical across the board, despite significant differences in terms of countries' fiscal and economic conditions.

This created uncertainty, especially among independent fiscal institutions (IFIs), which lacked a clear reference for assessing the conduct of national fiscal policies (see Chapter 3).

Scope and boundaries

A third source of divergence in the interpretation of the clause relates to its scope and possible limitations as to the types of measure it is intended to cover. While the unusual event clause (for example) caters for the budgetary impact of measures in direct response to an unexpected event outside a government's control, such as a natural disaster, the severe economic downturn clause is subject *a priori* to no clear limitation, as long as the medium-term sustainability of public finances is preserved.

The 20 March 2020 Commission Communication suggested that the clause had to be activated to accommodate the substantial fiscal effort necessary to 'protect European citizens and businesses from the consequences of this crisis, and to support the economy following the pandemic'. The finance ministers' statement of 23 March 2020 was more detailed, specifying that the extra flexibility should support 'our health and civil protection systems and (...) protect our economies, including through further discretionary stimulus'. Such measures should be 'designed, as appropriate, to be timely, temporary and targeted'. While these 'three Ts' were less prominent in the CSRs, they reappeared in the Commission's policy orientations for the DBPs for 2021 (57) and in the euro area recommendation (58).

Temporary vs non-temporary measures

The SGP requires any departures from the adjustment path, under the severe economic downturn clause, to be temporary and not undermine medium-term fiscal sustainability. In its assessment of budgetary developments following the activation of the clause, the Commission therefore started to look at the distinction between temporary and non-temporary policy measures. In its assessment of the DBPs for 2021, it noted that, while in 2020 the majority of policy measures were assessed as temporary or mostly temporary, for several Member States a substantial share of fiscal measures in 2021 did not appear to be temporary or matched by offsetting measures (59).

Permanent and temporary policy measures also have to be distinguished in the light of two earlier decisions by the Commission and the Council that affect the assessment of fiscal performance, in particular the underlying fiscal position:

- not to treat any crisis-related measure as a one-off; and
- to adjust the commonly agreed methodology for estimating potential output to minimise the expected impact of the crisis on the structural budget balance.

The first decision was based on the fact that expenditure classified as one-off and that covered by the clause are mutually exclusive (60). All else being equal, not classifying a large part of deficit-increasing measures as one-off produces a worse underlying fiscal position, as measured by the structural budget balance. As diagnosed in Section 2.1, the second decision influenced the estimation of the output gap, increasing the part of the deficit attributed to the cycle and reducing that considered to be permanent or structural. Both decisions affected the diagnostic accuracy of the structural budget balance (i.e. the budget balance net of the cyclical component and one-off and other temporary measures) the reputation of which had already suffered before the pandemic.

(57) Commission guidance to euro area Member States on fiscal policy orientations for 2021, in the form of letters to finance ministers dated 19 September 2020.

(58) The text agreed by the Eurogroup on 16 December 2020 (COM (2020)746 final).

(59) France, Italy, Lithuania, and Slovakia presented permanent measures above 0.5% of GDP that were not compensated by other offsetting measures. Notable examples were increases in public wages (e.g. Lithuania, France) and social benefits (e.g. Italy, Lithuania) or cuts to social security contributions (Italy).

(60) One-off measures are automatically excluded from the calculation of the structural budget balance, so do not need further flexibility *vis-à-vis* the required fiscal effort.

Box 2.1: **Towards a genuine general escape clause**

The current system of EU fiscal rules is a complex one, with flexibility and exceptions applied with a growing degree of discretion or increasingly broad interpretations of EU law. Over the years, this has undermined the rules-based nature of the commonly agreed EU fiscal framework. Recent experience with the severe economic downturn clause was the latest, and a particularly telling, example.

The activation of the severe economic downturn clause was justified in response to the Covid-19 pandemic. However, its implementation revealed shortcomings that are representative of the more general design and governance shortcomings of the Stability and Growth Pact (SGP). As detailed in Chapter 2, the legal provisions of the clause were interpreted with a degree of latitude that went well beyond some of the Pact's fundamental principles. On the one hand, official communication consistently and rightly clarified that the activation of the clause had not suspended the SGP. On the other hand, the implementation of the rules was *de facto* deferred or suspended across the board regardless of significant and persistent differences across countries. Despite clear cases of non-compliance, and in contrast to past practice, the Commission and the Council decided not to launch any formal surveillance procedure.

The *de facto* suspension of the SGP is also reflected in the purely qualitative fiscal guidance issued in spring 2020, essentially asking Member States to do whatever it takes to stem the crisis. Later in the year, the Commission modified this type of recommendation in a letter to finance ministers asking Member States to take targeted and, most importantly, temporary measures.

Finally, the supremacy of discretion has also become apparent in the way the clause was extended in spring 2021. Although the SGP includes a fairly clear definition of a severe economic downturn (Section 2.5), the Commission and the Council agreed they enjoyed a wide margin of discretion in specifying relevant criteria. In fact, while clarifying to some extent the economic circumstances that may mark the end of the economic crisis caused by the pandemic, justifying the deactivation of the serve economic downturn clause, the Commission and the Council both left a back door open by referring to an overall assessment.

The wide margins of discretion in the application of the severe economic downturn clause have caused uncertainty and given rise to concern on two counts, both of which affect the medium-term outlook for public finances in some EU countries: (i) lawmakers, independent fiscal institutions and financial markets do not know when and how the EU will again apply the rules as they were originally intended to be applied; and (ii) some countries have taken many permanent measures in response to the crisis, but not indicated the necessary budgetary coverage.

Overall, the way the severe economic downturn clause has been applied shows it is necessary to revisit the design and governance of provisions dealing with major unforeseen events. This is not to say that escape clauses should be abolished. On the contrary, any rules-based system needs to be flexible. Trying to codify all kinds of contingencies from the outset is impracticable and eventually leads to the excessive complexity that characterises the SGP. At the same time, a genuine escape clause should not be synonymous with pure (political) discretion. A few key aspects need to be clarified in advance. The proposals in this section follow up on ideas presented in previous EFB reports ([1]) and take into account additional insights gained during the Covid-19 pandemic.

As a general principle, the current system of waivers and exceptions should be replaced with one genuine escape clause, to be used sparingly and on the basis of well-defined principles or rules. The following questions are crucial: (i) When should the clause be activated?, (ii) How and by whom should it be activated?, (iii) What are the specific implications of the clause for the application or suspension of the rules?, and (iv) How and when should it be deactivated?

What does the above mean in practice? Escape clauses should satisfy a number of conditions. First, they should be limited to truly exceptional circumstances when automatic stabilisers are no longer considered sufficient to cushion an economic downturn. Second, they should define clearly who is responsible for activating the clause and monitoring its implementation. Third, they should link the decision to activate a clause to an assessment carried out

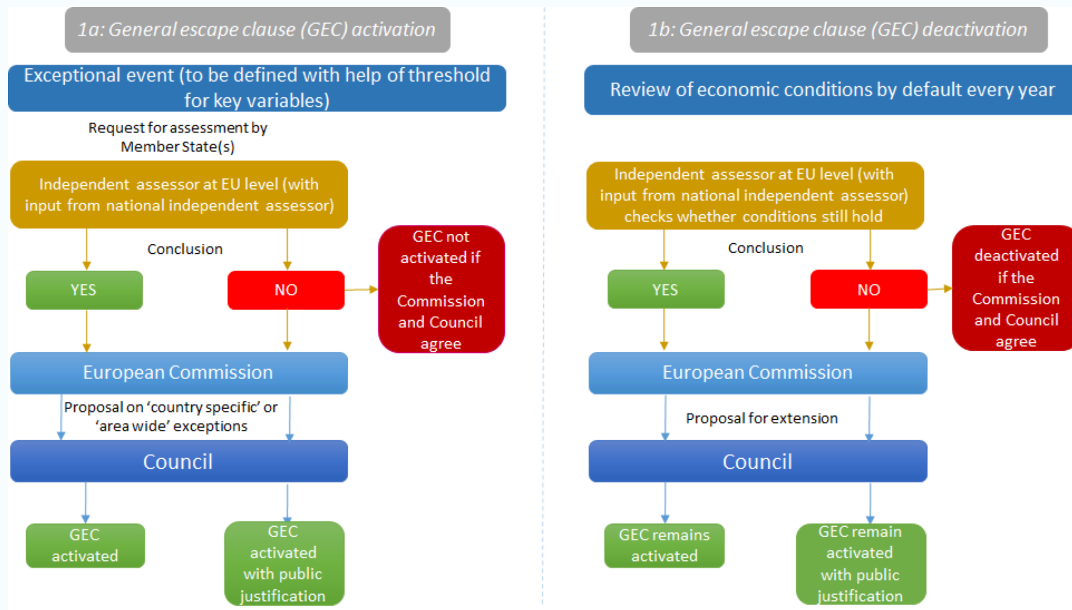
([1]) The EFB laid out its first proposal for a (general) escape clause in the 2018 EFB annual report (Section 6.4.5) and advanced the proposal further over the years (see Assessment of the fiscal stance appropriate for the euro area in 2021). The EFB proposal for a (general) escape clause differs from the general escape that is applied now, because it can be invoked for an individual country on the basis of independent analysis and advice.

(Continued on the next page)

Box (continued)

by an independent entity. Fourth, they should detail the length of the period of their application, including a regular review. Fifth, they should clarify their implications for the application of the rules. Sixth, they should define the process for returning to the originally intended application of the rules.

Graph 1: Procedure for the activation and deactivation of a genuine general escape clause



With this in mind, Graph 1 illustrates the procedure for the activation and deactivation of a possible future genuine general escape clause. In particular, such a clause should only be activated in exceptional circumstances, when one or more Member State(s) are experiencing a shock beyond the government's control with a major budgetary impact. A predefined and complete taxonomy of shocks on the basis of which to activate the clause would not be advisable or practicable. However, there should be thresholds for key macroeconomic and fiscal variables. Breaching these would trigger a careful and comprehensive assessment of the need to activate the clause. The thresholds should be sufficiently low or high, as the case may be. Normal cyclical fluctuations are to be addressed by automatic stabilisers in line with national preferences. Reliance on a well-defined expenditure benchmark, as suggested in previous EFB reports, would guarantee the necessary counter-cyclical stance without discretionary interventions.

To prevent opportunistic use of a genuine escape clause, the assessment following the breach of pre-defined thresholds should be carried out by independent national and EU bodies. Following a negative conclusion, the clause could be activated only subject to a public justification by the Commission and Council. The Commission and Council would have leeway in defining the modified fiscal requirements while the clause is active, keeping in mind the medium-term sustainability of the public finances of the Member States concerned. Ideally, the derogations entailed by the activation of the escape clause should be country- and crisis- specific. The Covid-19 pandemic has clearly shown that even in the event of common exogenous shocks, the impact and policy response can and should be very different.

Any escape clause should be temporary: the process for deactivating it should be as clearly defined as the one for activating it, as the left-hand side of Graph 1 outlines. In many cases, it will be difficult to determine the precise impact and duration of a major economic shock. Therefore, and unless a pre-defined duration seems appropriate, the activation of a general escape clause should include regular review dates, say after one year as a minimum. The review would again involve the assessment of key economic variables by independent national and EU bodies, leading either to the extension or deactivation of the clause. In both cases, and to give economic agents, including those in the financial markets, sufficient guidance, the Commission and Council should clarify the specific nature of the derogations.

The Commission's efforts in autumn 2020 to distinguish between permanent and temporary policy measures should be seen as a necessary attempt to recover an essential objective of any

fiscal surveillance exercise, i.e. to assess a Member State's underlying fiscal position. The practical downside of the Commission's approach is that it relies on bottom-up, purely judgment-based estimates of fiscal measures, with limited comparability across countries, which may be difficult to defend in the context of multilateral surveillance [61].

In conclusion, the way the severe economic downturn clause was interpreted and implemented highlights some important issues with the current set of rules. First, the scale and nature of the Covid-19 shock went far beyond what legislators had imagined when the clause was designed. Secondly, events in 2020 underscored once more the governance challenges that stem from the multilateral nature of EU fiscal surveillance where clear majorities in the Council can support very broad interpretations of the rules. While formally espousing compliance with the SGP rules, actual implementation involved their effective suspension. In effect, the clause was interpreted as a 'general escape clause' rather than one allowing for temporary deviations from country-specific adjustment paths in the event of a severe economic downturn.

Since the activation of the clause was justified overall, such considerations could be seen as purely formalistic. At the same time, they highlight a clear tension between applying the rules to the letter and using discretion, and the question of where to draw the line. Such tensions will never be resolved fully, especially when it comes to handling unexpected shocks. Nevertheless, they call for a careful review of how escape clauses should be formulated and (de)activated in a rules-based system, including the role of independent assessments (see Box 2.1 and Section 5.4)

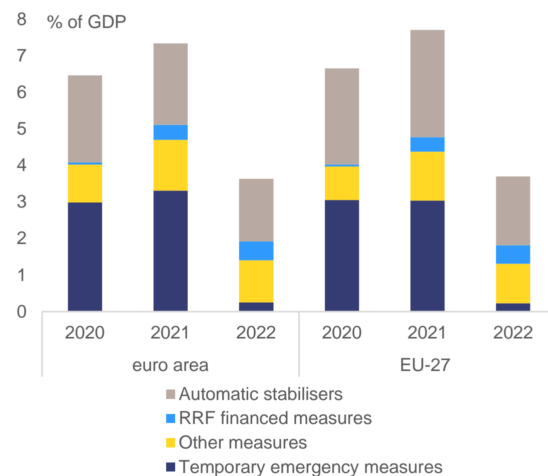
2.6. ASSESSING FISCAL DEVELOPMENTS BEYOND THE SGP PROVISIONS

Ex post assessment of 2020

The Commission's 2021 spring surveillance package concluded for all Member States that 'the measures taken in 2020 and 2021 have been in line with the Council Recommendation of 20 July 2020'. This summary assessment reflected the purely qualitative nature of fiscal policy guidance, that was essentially the same for all countries. There was little country-specific analysis, except Member States were differentiated by the size of their non-temporary measures exceeding 0.5% of GDP beyond 2022 (the Commission's forecast horizon).

The Commission did not produce the country reports that usually underpin policy guidance [62]. Neither did it prepare the usual internal analysis of the implications of its forecast for budgetary surveillance. The analytical overview of the 2021 SCPs focused mainly on EU and euro area aggregates and forward-looking policy plans, omitting more granular country analysis [63]. Only the assessments of the DBPs in autumn 2020 reviewed specific measures for 2020 and 2021 for each euro area Member State. Those assessments, mandated by law, were accompanied by an analytical overview note [64]. However, many measures and estimates for 2020 changed towards the end of the year, making earlier assessments only partly informative.

Graph 2.9: **Breakdown of EU fiscal deficits**



(1) 'Automatic stabilisers' are estimated as a residual between nationally financed discretionary measures and the change in the general government balances.
(2) 'RRF-financed measures' represent RRF grants financed by EU borrowing.
(3) 'Temporary emergency measures' and 'Other measures' represent nationally financed discretionary fiscal measures adopted since March 2020.
Source: European Commission (spring 2021 package), own calculations

Based on the Commission's assessment in spring 2021, discretionary fiscal measures in response to the crisis amounted to some 4% of GDP in 2020 in the EU as a whole, with automatic stabilisers

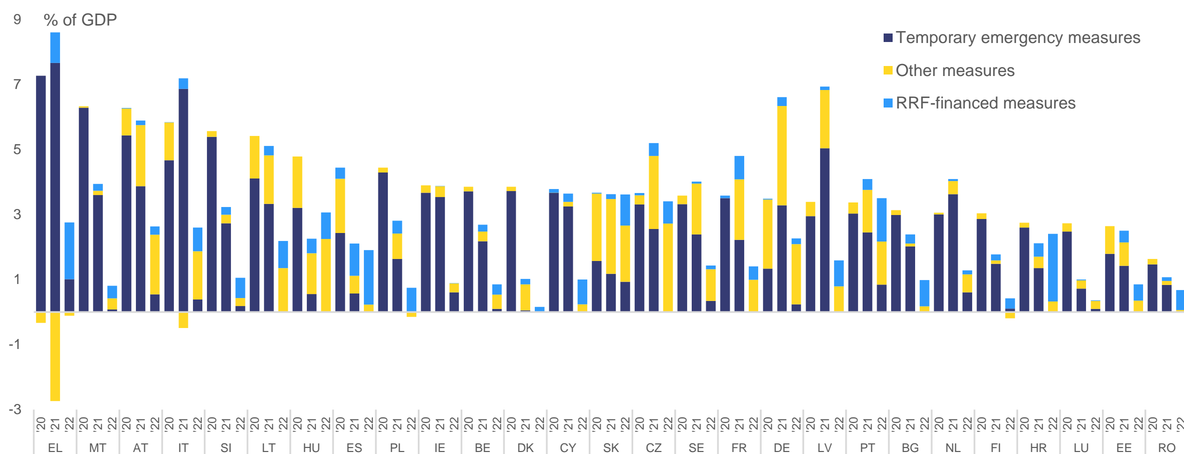
[61] The fiscal measures are measured against revenue and expenditure trends under the no-policy-change assumption.

[62] This was because the RRF was being implemented. In effect, the Commission's assessments of the national RRPs replaced the country reports.

[63] The 2021 Stability & Convergence Programmes: an Overview, with an Assessment of the Euro Area Fiscal Stance

[64] The draft budgetary plans for 2021 and their assessments.

Graph 2.10: **Discretionary fiscal measures adopted since March 2020, based on Commission 2021 spring forecast**



(1) 'Temporary emergency measures' support health systems and compensate workers and firms for pandemic-induced income losses; they are set to expire in 2023 or earlier.
(2) 'Other measures' include other crisis-related measures, either temporary or permanent.
(3) 'RRF-financed measures' contribute to aggregate demand, but do not affect national government balances.
Source: European Commission, own calculations

estimated at 2½% (Graph 2.9). Within the overall budgetary response, the Commission identified 'temporary emergency measures', which mainly consist of pandemic-related support for the health sector, and furlough and business loss compensation schemes. According to its calculations, such measures accounted for the bulk of the discretionary effort in 2020 and 2021. However, while 'other measures' also provide fiscal support in the context of the crisis, they are partly non-temporary and thus likely to weigh on public finances after 2022 unless complemented with new revenue measures.

At country level, the size and timing of discretionary measures (as assessed in the Commission's 2021 spring package) vary considerably (Graph 2.10). Differences may be linked to the severity of the pandemic and to political and institutional factors. Most Member States spent more on fiscal emergency and other support measures in 2020, when the economic shock was first felt. However, for some large Member States (Germany, France, Italy and the Netherlands), estimates of overall fiscal support are markedly larger in 2021, thus making the EU-wide fiscal response stronger this year, with the economy projected to rebound. This suggests some delays in mobilising the fiscal policy response. However, the effectiveness of any additional fiscal stimulus in 2020 would have been limited by the strict lockdown measures.

As part of the 2021 spring package and in line with established practice, the Commission also assessed the existence of excessive deficits and debt in all Member States, except for Romania, which had been put in EDP in early 2020 (on the basis of the government's planned deficit for 2019). This time, the Commission report under Article 126(3) TFEU grouped country assessments in a single 'omnibus' report. The analysis largely maintained the standardised approach taken in spring 2020, while more clearly identifying common fiscal challenges due to the pandemic and country-specific elements as part of the assessment of 'relevant factors' (Table 2.3). In particular, countries were differentiated by level of debt sustainability risk, macroeconomic imbalances and the scale of non-temporary measures after 2022. The assessment of non-temporary measures is a new analytical element, introduced with the Commission's assessment of the DBPs for 2021. It is meant to highlight the possible risk of exiting the pandemic with permanent expenditure rises that lack the necessary budgetary coverage.

The omnibus EDP report confirmed excessive deficit and debt levels in many Member States [65], but did not mention possible procedural steps. In

[65] Belgium, Czechia, Germany, Estonia, Ireland, Greece, Spain, France, Croatia, Italy, Cyprus, Latvia, Lithuania, Luxembourg, Hungary, Malta, the Netherlands, Austria, Poland, Portugal, Slovenia, Slovakia and Finland failed to meet the deficit criterion. Belgium, Germany, Greece, Spain, France, Croatia, Italy, Cyprus, Hungary, Austria, Portugal, Slovenia and Finland failed to meet the debt criterion.

its *chapeau* Communication, the Commission suggested postponing any decision on excessive deficit procedures in view of the high uncertainty and the difficulty of plotting fiscal adjustment paths. The Council concurred.

Table 2.3: **Overview of excessive deficit assessments**

	Deficit criterion	Debt criterion	Relevant factors		
			Non-temporary measures	Debt sustainability risks	Macroeconomic imbalances
BE	red	red	green	red	green
BG	green	green	green	green	green
CZ	red	green	red	yellow	green
DK	green	green	green	green	green
DE	red	red	red	green	yellow
EE	red	green	red	green	green
IE	red	green	green	green	yellow
EL	red	red	green	red	red
ES	red	red	green	red	yellow
FR	red	red	red	red	yellow
HR	red	red	green	yellow	yellow
IT	red	red	red	red	red
CY	red	red	green	yellow	red
LV	red	green	red	green	green
LT	red	green	red	yellow	green
LU	red	green	green	green	green
HU	red	red	red	yellow	green
MT	red	green	green	yellow	green
NL	red	green	red	green	yellow
AT	red	red	red	yellow	green
PL	red	green	green	green	green
PT	red	red	red	red	yellow
SI	red	red	green	yellow	green
SK	red	green	red	yellow	green
FI	red	red	green	green	green
SE	green	green	red	green	yellow
RO*	red	green	green	red	yellow

(1) The table presents the main elements of the 'omnibus' report under Article 126(3) TFEU.
(2) * Romania received a revised Council Recommendation under Article 126(7) TFEU, but is included in the table for comparison.
(3) For the deficit and debt criteria: 'red' = non-compliance; 'green' = compliance. For non-temporary measures, 'red' = excess over 0.5% of GDP in 2023; 'green' = size of measures below 0.5% of GDP. For debt sustainability risks, 'red' = high sustainability risk; 'yellow' = medium risk; 'green' = low risk. For macroeconomic imbalances, 'red' = 'excessive imbalances'; 'yellow' = 'imbalances'; 'green' = no in-depth review under the Macroeconomic Imbalances Procedure.
Source: European Commission

This decision not to propose any new steps under the EDP, except in the case of Romania, was based mainly on political considerations rather than the letter or spirit of the SGP. In fact, there are many precedents where the Council, on a proposal from the Commission, has opened EDPs for Member States in the wake of major shocks. In particular, between spring 2009 and 2010, it opened EDPs for 22 countries, many of which featured fairly distant deadlines for the correction of the excessive deficit and the option of backloading fiscal adjustment. In many cases, the deadline was subsequently extended and the adjustment path modified after unexpected adverse economic events.

Romania, which was placed under the EDP in early 2020, received a revised EDP recommendation with the correction deadline extended from 2022 to 2024. The revised adjustment path was set in line with the deficit targets in its 2021 convergence programme. While Romania stands out procedurally and faces major fiscal challenges, some other Member States also show a number of fiscal warning signs.

In the past and by design, EDPs typically aim at anchoring expectations for governments incurring significant fiscal imbalances, as defined by the Treaty. Leaving aside the fiscal adjustment requirements, which (following the 2005 reform of the SGP) are typically adjusted in the light of unexpected adverse economic events, EDPs primarily entail stricter reporting and monitoring at EU level, which are appropriate in the EMU context.

Underlying fiscal developments in 2020

In line with the severe economic downturn clause and the very general, qualitative guidance received in spring 2020, Member States were allowed to deviate from the requirements of the preventive arm of the SGP in 2020 and 2021. Therefore, in spring 2021, at the end of the 2020 surveillance cycle, the Commission and Council did not (and could not) produce a quantitative assessment of compliance. Nonetheless, it might be useful to take a closer look at fiscal developments and to identify patterns and trends beyond the specific provisions of the SGP.

Such an exercise entails a number of challenges and making a number of assumptions. The first challenge relates to the difficulty of estimating the output gap and, in turn, the structural budget balance in the wake of a very large shock. The *ad hoc* adjustments to the commonly agreed methodology for estimating potential output (Section 2.1) and the question of how to classify crisis-related measures (Section 2.5) reflect this difficulty.

The obvious alternative to the structural budget balance is the expenditure benchmark, which by design is much less affected by revisions of snapshot estimates of potential output and the output gap. It is built around the medium-term rate of potential growth, defined as the 10-year back- and forward-looking moving average of potential growth estimates for a given Member State. As long as government expenditures do not outpace this medium-term rate of growth, the debt ratio should not increase in the medium term. In normal times, the SGP expenditure benchmark imposes a lower speed limit on government expenditures in

countries that have yet to achieve their MTO. In contrast, the spending limit is higher in countries that have exceeded their MTO. For our analysis, we use the medium-term rate of potential output growth as the main reference and ignore the specific adjustment requirements that the SGP provides for in normal times.

The second challenge relates to the crucial distinction between temporary and permanent expenditure increases. An increase is generally considered less of a problem for the sustainability of public finances if it comes with a sunset clause and/or is strictly linked to a temporary feature of a major shock. One way to address this in our assessment exercise is to look also at expenditure growth net of pandemic-related health measures and short-time work schemes ([66]).

The results of our analyses of fiscal performance in 2020 are summarised in Graph 2.11. The cluster compares alternative metrics for net expenditure growth in 2020 with medium-term rates of potential output growth, for different aggregates and partially overlapping country groups. The medium-term rate of potential output growth can be interpreted as the rate of increase of a country's revenue base over the cycle.

The first point to note (Graph 2.11(a)) is that net expenditure increased in 2020 close to three times faster than the underlying tax base in the euro area and the EU as a whole. When health-related and job-retention measures are removed, the growth rate (i.e. the dark blue dots) declines, but is still double the medium-term rate of potential output growth.

By initial fiscal position, growth rates are quite similar across groups except for Member States with a very high debt-to-GDP ratio (i.e. above 90% of GDP), notably Belgium, Greece, Spain, France, Italy, Cyprus and Portugal. In this group of countries, net expenditure grew significantly less. However, the same countries show the largest deviation from the medium-term reference rate, pointing to a more significant deterioration of the respective underlying fiscal positions (Table (b)).

As evidenced in last year's annual report and in this section, very high levels of government debt appear to have weighed on countries' capacity to respond to the crisis in 2020 ([67]). In comparison, countries with lower government debt (i.e. 60-90% of GDP) were able to increase expenditure more significantly, targeting healthcare and labour market pressures (see the difference between the light blue triangles and the dark blue dots in Graph 2.11(a)). Possible sustainability constraints were temporarily eased in the course of 2020 and beyond, thanks to the ECB's Pandemic Emergency Purchase Programme (PEPP) and the agreement on the Recovery and Resilience Facility (RRF). The additional fiscal expansion in 2021, including in countries with high debt, testifies to this.

An overview of net expenditure growth rates by different types and degrees of fiscal sustainability risks, as measured in the Commission's debt sustainability monitor (Graph 2.11(c)), supports this observation. In particular, net expenditure growth is significantly lower in countries considered to be at risk of fiscal stress in the short term than in low-risk countries ([68]). The same holds for countries facing high fiscal sustainability risks in the medium term ([69]). At the same time, due to their (on average) lower medium-term rate of potential output growth and lack of fiscal space, the weaker expansion of expenditure amounts to a more pronounced deterioration of the underlying budgetary position.

([66]) Net expenditure growth refers to the growth rate of primary expenditures at current prices, net of discretionary revenue measures and cyclical unemployment benefits, in line with the definition of expenditure benchmark.

([67]) The classification of countries by debt level is arbitrary (low, high, very high). It was first used in European Fiscal Board (2019b).

([68]) The Commission uses a composite indicator to evaluate short-term fiscal risks. This is based on a set of 25 fiscal and financial competitiveness variables proven to perform well in detecting fiscal stress in the past. For more details, see European Commission (2021a).

([69]) The medium-term fiscal sustainability risk assessment is based on: (i) a debt sustainability analysis (DSA), which identifies fiscal risks associated, essentially, with EU countries' debt ratio level and trajectory; complemented by (ii) estimates of the fiscal sustainability gap, i.e. the additional adjustment, in terms of change in the structural primary balance, required over 5 years to bring the general government debt-to-GDP ratio to 60% in 15 years, including any future additional expenditure due to population ageing.

Graph 2.11: **Benchmarking net expenditure growth in 2020, alternative approaches and country groups**

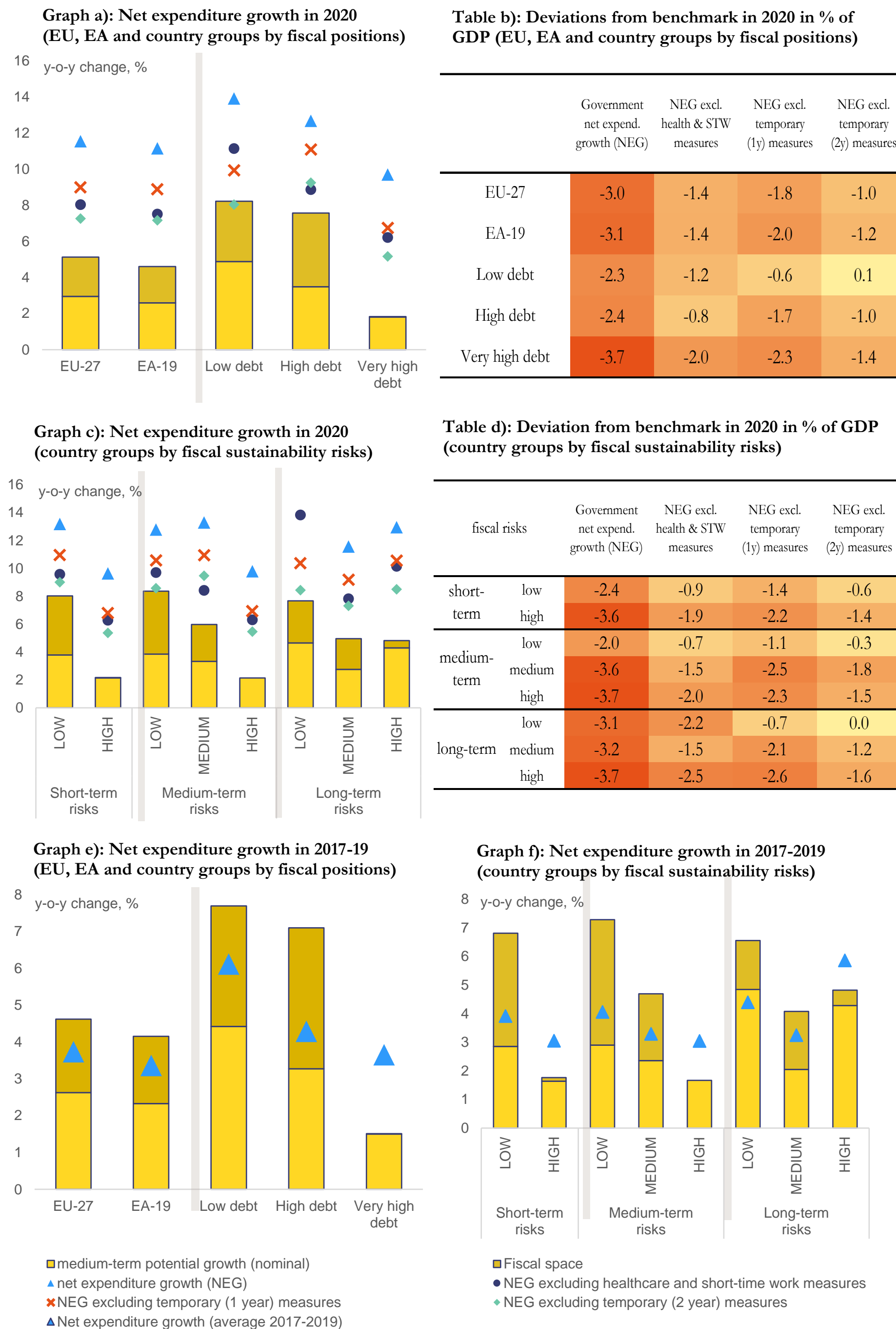


Table b): Deviations from benchmark in 2020 in % of GDP (EU, EA and country groups by fiscal positions)

	Government net expend. growth (NEG)	NEG excl. health & STW measures	NEG excl. temporary (1y) measures	NEG excl. temporary (2y) measures
EU-27	-3.0	-1.4	-1.8	-1.0
EA-19	-3.1	-1.4	-2.0	-1.2
Low debt	-2.3	-1.2	-0.6	0.1
High debt	-2.4	-0.8	-1.7	-1.0
Very high debt	-3.7	-2.0	-2.3	-1.4

Table d): Deviation from benchmark in 2020 in % of GDP (country groups by fiscal sustainability risks)

fiscal risks		Government net expend. growth (NEG)	NEG excl. health & STW measures	NEG excl. temporary (1y) measures	NEG excl. temporary (2y) measures
short-term	low	-2.4	-0.9	-1.4	-0.6
	high	-3.6	-1.9	-2.2	-1.4
medium-term	low	-2.0	-0.7	-1.1	-0.3
	medium	-3.6	-1.5	-2.5	-1.8
	high	-3.7	-2.0	-2.3	-1.5
long-term	low	-3.1	-2.2	-0.7	0.0
	medium	-3.2	-1.5	-2.1	-1.2
	high	-3.7	-2.5	-2.6	-1.6

(1) The medium-term rate of potential GDP growth is in nominal terms. It is the 10-year average of (a) real potential output growth and (b) the year-on-year rate of change of the GDP deflator.
(2) For countries above the MTO, our benchmark takes into account fiscal space (i.e. the difference between the estimated structural balance at the beginning of the surveillance cycle and the MTO).
(3) The fiscal space for Greece is set to zero, although this is above its MTO, due to fiscal commitments taken at the end of the economic programme.
(4) Net expenditure growth refers to the growth rate of government expenditure, excluding some items (interest expenditure, expenditure on EU programmes fully matched by EU funds revenue, and the cyclical part of unemployment benefit expenditure) and is net of discretionary revenue measures and one-offs. Investment expenditures are averaged over 4 years.
(5) Temporary measures refer to the part of additional expenditure measures taken in 2020 which, according to governments' plans, are phased out in 2021 or, alternatively, over 2021-2022.
(6) The classification of short-term, medium-term and long-term sustainability risks is based on the Commission's latest Debt Sustainability Monitor (February 2021). For the definition of each indicator, refer to the glossary.
(7) Low debt countries = EE, LU, BG, CZ, SE, DK, RO, LT, LV, MT, PL; high debt countries = NL, IE, SK, FI, DE, HU, SI, AT, HR; very high debt countries = CY, FR, BE, ES, PT, IT, EL.
Source: European Commission, own calculations

Net expenditure growth rates in 2020 are considerably lower if one removes all temporary policy measures (on healthcare, job retention, etc.). Under the most benign option of excluding

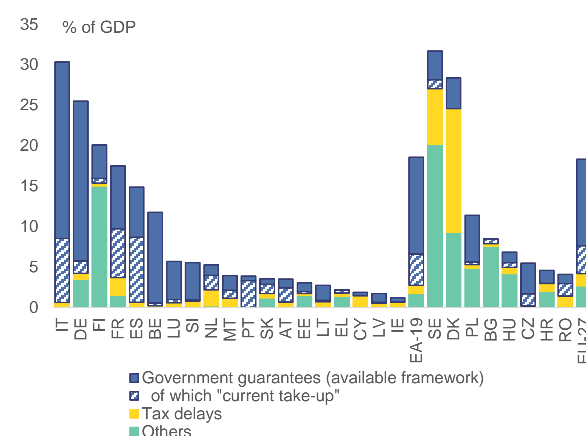
measures that are expected to be phased out in 2 years' time, the deviation from the reference rate comes somewhat closer to the 'significant deviation' threshold (0.5% of GDP) for countries with low debt or facing low short- and medium-term fiscal risks. However, the gap is still significant for countries with very high debt and high fiscal risks (Graph 2.11(d)) due to a lower medium-term rate of potential growth and the absence of fiscal headroom.

A closer look at average net expenditure growth in the pre-crisis years, 2017-2019 (Graph 2.11(e)), highlights the notorious issue affecting the EU fiscal framework that has been documented in successive EFB annual reports, namely the failure on the part of some Member States to take advantage of good times. Through years of positive and sustained economic growth, several countries, especially those with a very high debt-to-GDP ratio, fell short of their fiscal requirements, spending in excess of the recommended limits. As a result, although government expenditure in highly indebted countries grew at a significantly lower rate, economic and fiscal imbalances widened. The same applies when countries are classified by fiscal sustainability risks (Graph 2.11(f)), with those currently facing higher risks deviating the most. The countries facing long-term fiscal sustainability risks had the highest net expenditure growth.

2.7. GOVERNMENT GUARANTEES AS LIQUIDITY SUPPORT

In addition to the massive measures with a direct budgetary impact, Member States also committed to provide ample liquidity support to counter the economic consequences of the Covid-19 crisis. Such measures amounted to 18½% of euro area and EU GDP [70]. The most common vehicle for liquidity support were government-guaranteed credit schemes, with available envelopes of around 14% of GDP in the EU as a whole. Deferred tax payments, another form of liquidity support, amounted to 1.5% of GDP (Graph 2.12). Member States also issued guarantees to support the financing of the new EU-level instruments, in particular the temporary Support to mitigate Unemployment Risks in an Emergency (SURE) initiative and the EIB's Pan-European Guarantee Fund.

Graph 2.12: **Government liquidity measures in 2020 without a direct budgetary impact**



Source: European Commission

Credit-support schemes transfer some of the credit risk and potential credit losses from banks to governments, thereby mitigating the costs to firms and banks. Government guarantees have no direct impact on the government budget balance or debt. They are *contingent* liabilities, i.e. governments' deficit and debt are increased only when a guarantee is called.

Eurostat started collecting official data on Member States' contingent liabilities, including government guarantees, on the back of reinforced EU economic surveillance following the 2011 'six-pack' reform of the SGP [71]. However, as data are collected with a 1-year lag to the reporting period [72], the current analysis is based on information that Member States voluntarily provided in their 2021 SCPs. This includes the maximum size of guarantee frameworks and their take-up, i.e. the actual amount of signed loan contracts between private entities and governments [73].

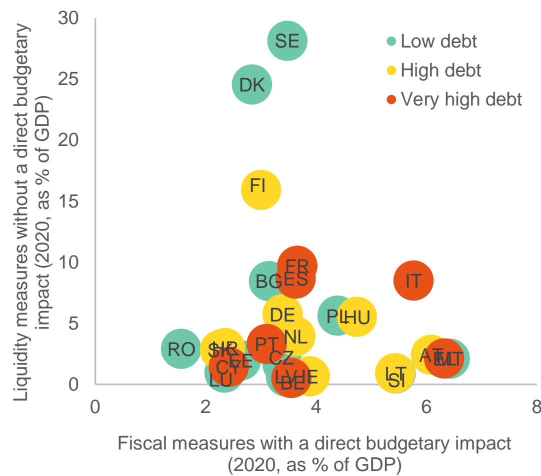
[70] According to the ECB's bank lending survey, around 70% of banks reported an increase in firms' demand for loans and credit lines in the second quarter of 2020. This was driven mainly by the growing difficulty of businesses to finance their ongoing costs via operating cash flows, due to the sudden fall in their revenues during lockdowns: https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/ecb.blssurvey2020q4~e89c77d212.en.html

[71] In particular, Council Directive 2011/85/EU, which is aimed at improving the completeness and reliability of national public accounts. Eurostat added a supplementary table on government contingent liabilities to the regular EDP questionnaire on general government statistics.

[72] National statistical authorities report data on contingent liabilities to Eurostat before 31 December of the following year (T+12 months).

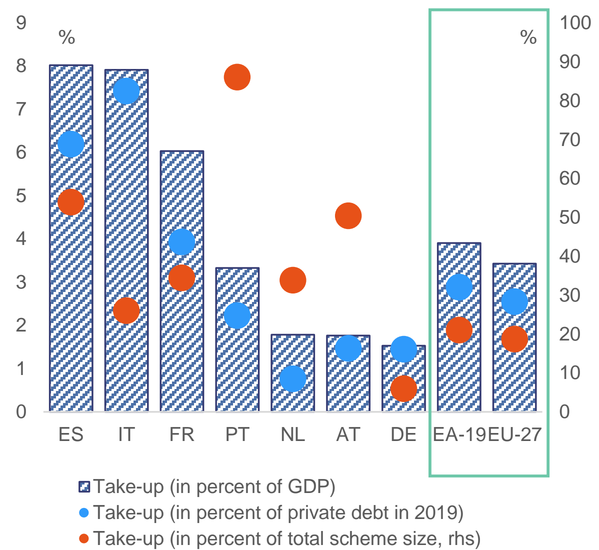
[73] Only actual take-ups (currently, a fifth of the announced total programme envelopes) become contingent liabilities in economic and statistical terms.

Graph 2.13: **Liquidity measures without a direct budgetary impact vs measures with a direct budgetary impact, by debt level**



(1) Liquidity measures include only actual take-up (i.e. the actual amount of signed loan contracts between private entities and governments) of total amount of programme envelopes.
(2) Low debt countries = EE, LU, BG, CZ, SE, DK, RO, LT, LV, MT, PL; high debt countries = NL, IE, SK, FI, DE, HU, SI, AT, HR; very high debt countries = CY, FR, BE, ES, PT, IT, EL.
Source: European Commission, own calculations

Graph 2.14: **Take-up of government guarantees (spring 2021)**



(1) The private sector debt is the stock of liabilities (at the end of 2019) held by non-financial corporations, households and non-profit institutions in the form of debt securities and loans.
(2) 'Actual take-up' represents the actual amount of signed loan contracts between private entities and governments.
Source: European Commission

Since March 2020, various observers have expressed concern that the more highly indebted EU countries, with a perceived narrower fiscal margin of manoeuvre, may face constraints in providing enough support for businesses, thus creating competitive distortion in the single market. However, Graph 2.13, in which liquidity measures include only the actual take-up of government guarantees, does not at this stage show any visible correlation between liquidity support measures and (lack of) fiscal space, as measured by the level of sovereign debt (74). Neither does it confirm any substitution effect between measures with and without budgetary impact.

Nonetheless, the use of government guarantee schemes has been heterogeneous across countries (Graph 2.14). Actual take-up (as a percentage of GDP and total private indebtedness) was highest in Italy, followed by Spain and France, the countries most severely hit by the first wave of Covid-19 infections and the first to decree nationwide lockdowns. Portugal, Germany and Austria were the other countries to make substantial use of government guarantees (i.e. above 1% of GDP).

At the same time, there seems to be no direct correlation between the initially announced size of the guarantee programme and actual take-up. Take-up compared to initial announcements was highest in Portugal, Austria and Spain, and lower in Germany and, to a certain extent, Italy. The lack of correlation could simply reflect the fact that initial announcements were intended to reassure markets, rather than respond to actual increases in demand for loans. However, country-specific conditions and scheme characteristics might have played a role in incentivising (or discouraging) take-up.

While government guarantee schemes must comply with Commission guidelines (75), their characteristics, including the maximum amount per borrower, the proportion of the principal loan guaranteed and eligibility conditions, varied across

(74) See also Anderson *et al.* (2021), who analyse credit-support programmes in the EU's four largest economies (Germany, France, Spain and Italy) plus the UK.

(75) As an exemption from the general prohibition on State aid, Article 107(3)(b) TFEU allows for large government interventions in the event of 'serious disturbance' in the economy of a Member State. In March 2020, the Commission stated that Covid-19 qualified as such a 'serious disturbance', first for Italy, then for the entire EU. It adopted a temporary framework to support the smooth processing of notifications under this provision (see Section 3.2 of the Communication on a *Temporary framework for State aid measures to support the economy in the current Covid-19 outbreak*). In this context, loan guarantee programmes must have certain characteristics, in terms of minimum premia (starting at 25 basis points for 1-year and increasing with loan duration), the duration of the guarantee (up to 6 years), usage and coverage. Loss absorption is generally subject to a maximum of 90% of the loan principal, although in a few countries a limited amount of credit is available with a 100% guarantee.

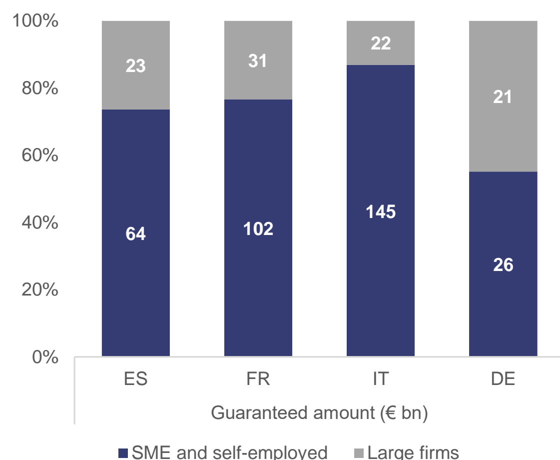
Member States ([76]). In some countries, beneficiary firms were subject to further conditions, such as a prohibition on distributing dividends, limits on the remuneration of managers or a commitment to retain employees.

In addition, detailed arrangements under the schemes differed significantly. Some governments directly guaranteed loans issued by banks to households and firms. Others relied on national promotional institutions to implement liquidity support programmes ([77]), which themselves varied considerably in term of structure and dependency on central government. In such context, the national public financial institution (which is classified, for statistical purposes, outside the general government) assesses whether a public guarantee can be granted on a loan request received by a bank. If the loan qualifies, the guarantee becomes a liability for the institution, whose balance sheet the government supports in turn ('counter-guarantee').

According to preliminary ECB analysis ([78]), the greater recourse to loan guarantees in Spain can be partly explained by the absence of alternative fiscal relief measures for companies, such as debt moratoria or government subsidies. In France, the higher take-up of guaranteed loans may reflect the very favourable pricing conditions, especially in the 1st year. Conversely, in Germany, the relatively limited use of government guarantee schemes, both in absolute terms and as a percentage of the total envelope, may be due to their more prudent design (i.e. tighter conditions) to avoid excessive risk-taking. In the case of Italy, operational constraints, amplified by pre-existing inefficiencies in the banking system and public administration, could explain the low recourse to guaranteed loans, especially in the first months of operation ([79]).

A more focused examination of government guarantee programmes in the four largest Member States shows that small and medium enterprises (SMEs) and the self-employed have been by far the main beneficiaries of guaranteed loans (Graph 2.15). The proportion of take up accounted for by SMEs is largest (i.e. close to 90%) in Italy and lowest in Germany.

Graph 2.15: **Take-up of government guarantees by firm size (as a share of guaranteed amounts in selected countries)**

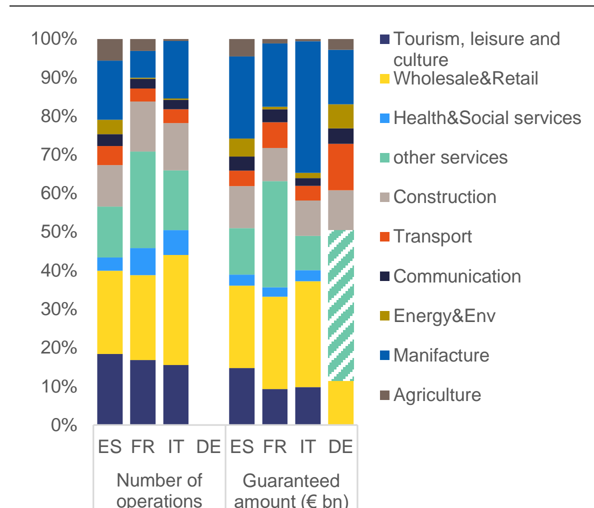


(1) Data refer to information available as of March 2021.
(2) Distinction between small and medium enterprises (SMEs) and large firms as in original sources.
(3) 'Take-up of government guarantees' represents the actual amount of signed loan contracts between private entities and governments.
Source: Kreditanstalt für Wiederaufbau (KfW) for Germany; Instituto de Crédito oficial (ICO) for Spain; Ministère de l'Économie et des Finances for France, Fondo di Garanzia and SACE for Italy, own calculations.

SMEs' greater use of government guarantees reflects their higher dependency on bank financing and potentially more limited access to collateral, coupled with softer conditions for smaller guaranteed loans. Unsurprisingly, the demand for guaranteed loans is concentrated in sectors most affected by the pandemic, notably services that require face-to-face contact and that were directly affected by lockdown measures (Graph 2.16). Take-up was higher – both in terms of number of operations and total amount of guarantees – in wholesale and retail, and tourism, leisure and culture (which includes accommodation and food supply services).

([76]) For a summary of the characteristics, see European Central Bank (2020b), Box 4.
([77]) e.g. KfW in Germany, KredEx in Estonia, the Hellenic Development Bank, BPI France, CDP in Italy, Altum in Latvia, INVEGA in Lithuania, the Malta Development Bank, and Finnvera in Finland (see Box 1 in COM(2020) 750 final).
([78]) European Central Bank (2020a).
([79]) In an inquiry report presented to the Italian Parliament on 11 June 2020, the Bank of Italy identified four main causes of slow disbursement: (i) operational difficulties due to high demand and bank branches' slow transition to remote working; (ii) operational difficulties experienced by the public administrator (*Fondo Centrale di Garanzia*); (iii) robust legal credit-assessment requirements not sufficiently relaxed; and (iv) recurring legal reviews of the regulatory framework.

Graph 2.16: **Take-up of government guarantees, by sector**



(1) Data refer to information available as of March 2021.
(2) For France, number of operations = number of beneficiaries.
(3) For Germany, the composition of all new bank loans between December 2019 and December 2020 was used as proxy. 'Other services' (patterned green bar) includes tourism, leisure and culture, and health and social services.
(4) 'Take-up of government guarantees' represents the actual amount of signed loan contracts between private entities and governments.
Source: Bundesbank for Germany; Instituto de Crédito oficial (ICO) for Spain; Ministère de l'Économie et des Finances for France, Fondo di Garanzia for Italy, own calculations.

It is instructive to look more closely at the activities of Italy's *Fondo di Garanzia*, a public guarantee scheme set up in 2000, particularly for SMEs. Since the outbreak of the pandemic, the number of new, approved requests has reached 2.5 million, for a total guaranteed loan amount of around € 200 billion ([80]). This corresponds to the total amount of guaranteed loans financed and twice the number of operations approved in the 20 years preceding the Covid-19 crisis ([81]).

While government guarantee schemes were crucial in supporting firms and providing them with the necessary liquidity, especially in the early months of the outbreak, concerns have emerged with regards to firms' excessive indebtedness and long-term viability. The current perception is that, in the initial rush to provide a lifeline, the objective of quickly reaching as many firms as possible took precedence over the stability of the financial system. Although the nature of the two crisis and the support instruments are not directly comparable, during the global financial crisis of 2008-2009 government contingent liabilities peaked at 6.8% of EU GDP (7.4% for the euro area), which is a third of the level of Covid-related guarantee programmes that have been announced to date ([82]).

The risks of insolvencies and closures should be monitored carefully, notably for the impact on already strained government finances. Assuming a final 50% take-up of the initially announced programmes and 30% losses on the loans, with consequent calls on government guarantees, debt would increase by around 3% of GDP in both the euro area and the EU as a whole, with the highest rise in Italy (5%).

So far, budgetary measures and monetary support have continued to cushion the shock and keep businesses afloat. The rate of insolvencies has been remarkably stable or even lower in the course of the crisis ([83]). However, these developments might be harbingers of an acceleration of insolvencies in the coming months, as support measures are phased out ([84]).

Moving forward, government guarantee schemes should be wound down gradually, without unwarranted interruptions in the credit flow. At the same time, their design should be calibrated to avoid allocative inefficiencies by artificially keeping afloat firms that are no longer viable. Striking the right balance between these two objectives is challenging, given the still-high uncertainty in the economic outlook and the permanent sectoral and behavioural changes that the pandemic may have brought to our economic landscape.

([80]) https://www.fondidigaranzia.it/numeri-del-fondo/
([81]) Almost two thirds of the requests related to loans of up to € 30 000, with 100% coverage, for a financed amount of around € 21.5 billion, which can be disbursed without waiting for final assessment by the fund manager.
([82]) https://ec.europa.eu/eurostat/web/government-finance-statistics/excessive-deficit/supplemtary-tables-financial-crisis
([83]) For 2020 Q2, Eurostat registered 35% fewer bankruptcies declared than for 2019 Q2. Although 2020 Q3 showed an increase, the level remained well below that for 2019 Q3.
([84]) For an analysis of expected insolvencies, see, for example, Giacomelli *et al.* (2021), *Fallimenti di impresa in epoca Covid.*

3. INDEPENDENT FISCAL INSTITUTIONS AND NATIONAL FRAMEWORKS

Highlights

- Escape clauses have become crucial ingredients of rules-based fiscal systems at both the EU and national levels. The Covid-19 crisis gave them to their first full-scale test.
- In most Member States, independent fiscal institutions (IFIs) are involved in triggering national clauses, typically via non-binding opinions. In some cases, the EU's severe economic downturn clause applies. Without questioning the merits of triggering national clauses, IFIs pointed to a number of uncertainties, especially around the conditions for deactivation.
- National mechanisms to correct deviations towards a medium term budgetary objective are at the core of the Fiscal Compact. EU Member States retained a considerable degree of freedom in designing their mechanisms. They vary, most notably, in terms of their legal status, forward-looking nature, degree of automaticity, and clarity.
- A better-designed correction mechanism is not necessarily associated with a stronger compliance record with fiscal rules. The visibility of fiscal policy issues (especially the role of IFIs) in the public debate, and sustained economic growth seem to compensate for more lenient design choices.
- The effectiveness of national correction mechanisms had been predicated on automatic triggers so as to decouple surveillance decisions from political considerations. However, in very few countries does the assessment of a national IFI trigger the mechanism. In most cases, activation is directly linked to EU surveillance decisions, which are characterised by a considerable degree of forbearance and discretion. As a result, the original purpose of national mechanisms is defeated.
- Stronger enforcement may involve a shift to automatic triggers for national corrective action transparently operated by domestic independent bodies.
- This chapter also reviews two national IFIs: those in Austria and Italy. The aim is to identify best practice. IFIs in both countries enjoy appropriate independence safeguards and are tasked with a comprehensive mandate. The main findings are:
  - On the back of a long tradition of fiscal advisory bodies, Austria has two IFIs. Their combined mandate is among the widest in the EU. The Austrian Institute of Economic Research (WIFO) is conventionally responsible for producing the official macroeconomic forecast, while the Fiscal Advisory Council (FAC) acts as a fiscal watchdog, monitoring compliance with numerical rules. Its set-up reflects a stakeholder approach rooted in Austria's social partnership.
  - The FAC's risk assessments and recommendations have played an influential role in the domestic policy debate, in particular as regards the clarification of institutional roles in the national correction mechanism, simplification of the domestic rules and the quality of public finances.
  - Italy's Parliamentary Budget Office (PBO) is one of the largest IFIs in the EU, reflecting its wide mandate. It provides independent assessments of economic and budgetary developments and monitors the government's compliance with fiscal rules.
  - The PBO established an elaborate way to assess the government's macroeconomic projections. Aided by its own forecasts, it first examines the government's no-policy-change (trend) scenario, and then its policy scenario. This approach constitutes an analytically robust basis for sensitive fiscal decisions and can serve as a good example. Nonetheless, although improvements have been observed in recent years, official Italian macro forecasts still turn out to be on the optimistic side.

This chapter includes three main sections: (i) a discussion of national escape clauses as part of the design of numerical rules, and the role of national IFIs in triggering them, complemented by an updated snapshot of how IFIs responded to the pandemic in 2020; (ii) a survey-based analysis of how enforcement of national rules has been influenced by the correction mechanisms of the Fiscal Compact; and (iii) portraits of IFIs in Austria and Italy, i.e. two countries where independent institutions have a comparatively wide mandate. The idea is to draw possible lessons for other EU IFIs and to share best practices.

3.1. NATIONAL ESCAPE CLAUSES AND THE ROLE OF IFIS

Well-defined escape clauses are increasingly perceived as a key feature of sound rules-based policy frameworks. Acknowledging the practical impossibility of designing rules covering all possible contingencies, the economic literature has long argued for inserting some flexibility in the rules to cope with unexpected shocks and events outside the government's control (see Drazen, 2000). At the same time, *ex ante* legislated safeguards should be in place to limit the possibility of abuse, specifying in general terms the contingencies that would justify departures from the rules (typically, natural disasters or severe economic recessions). Precise escape clauses in terms of decision-making competences and procedures to be followed can reinforce credibility, while vague provisions may render a rule ineffective.

In the wake of the global financial crisis, European supranational and intergovernmental legislation acknowledged the importance of well-defined clauses [85]. First, the 2011 reform of the Stability and Growth Pact (SGP) added a dedicated clause allowing for extra flexibility in the event of a severe economic downturn (see Chapter 2 for an assessment of its implementation in 2020). Secondly, the Budgetary Frameworks Directive [86], while not obliging Member States to stipulate escape clauses for their numerical rules, set some requirements as to the specification of any such clauses that do exist. Specifically, the application of escape clauses must be limited to certain specific circumstances and subject to stringent procedures.

Subsequently, the intergovernmental Fiscal Compact [87] contained more detailed provisions for the transposition of the compulsory structural budget balance rule, including escape clauses. In particular, it stipulated that escape clauses must adhere to the notion of exceptional circumstances as agreed in the SGP, i.e. an unusual event with a major budgetary impact outside the control of the government or periods of severe economic downturn [88]. Importantly, it gave IFIs a formal role for in the application of escape clauses, requiring that they must always provide a public assessment *'over the occurrence of circumstances for triggering, extending and exiting escape clauses'*. Furthermore, it enhanced this role by adding a comply-or-explain requirement to such assessments, whereby the concerned national authorities '*shall be obliged to comply with, or alternatively explain publicly why they are not following*' their IFI's opinion on this matter [89].

Currently existing escape clauses in the EU Member States broadly reflect EU legislation, and were used very rarely before the Covid-19 crisis. According to the latest vintage of the Commission's Fiscal Governance Database [90], in total 114 numerical rules were in force in 2019 in the Member States. Typically defined for the general government level, around half have escape clauses [91]. Around three quarters of them refer directly to exceptional circumstances as defined in the SGP. [92] In the years leading up to the pandemic, the use of escape clauses was scarce [93].

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[85] Empirical analysis by the IMF (2018) found an improving trend in the design features of escape clauses at global level, too. Even if they existed a decade ago, most of these waivers were not clear enough.They have recently been used more widely as the list of events they cover has become broader and more specific.

[86] Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States – OJ L306, 23.11.2011, p. 41

[87] The Fiscal Compact is Title III of the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), signed in March 2012. It requires euro area countries to introduce in the national legislation a balanced budget rule in structural terms and with pre-defined characteristics. Three non-EA countries, Bulgaria, Denmark and Romania, are also bound by the same requirements on a voluntary basis.

[88] See also principle 6 of the 2012 Commission's Communication on 'common principles'.

[89] Idem, principle 7.

[90] The dataset is available at: Fiscal Governance in the EU Member States: Numerical Fiscal Rules.

[91] The classic examples are in fact the structural budget balance rules in the 22 Fiscal Compact countries.

[92] Exceptional circumstances cover both unusual events and severe economic downturns.

[93] There were a few such episodes in Ireland and Lithuania over the recent years, see European Commission (2020a).

The sharp economic downturn resulting from the pandemic led to a mass triggering of national escape clauses in 2020. Based on an EFB survey answered by 21 monitoring institutions in the Member States bound by the Fiscal Compact, two distinct groups emerged (see Table 3.1) following the activation of the EU's severe economic downturn clause (see detailed discussion in Section 2.5). In the first group, national legislation provided for numerical rules to be suspended automatically as a function of the EU-level decision, i.e. the national clause takes effect once the corresponding SGP clause on exceptional circumstances is activated. In the second group, the nationally defined escape clauses were triggered independently of EU procedures, in some cases even earlier than the ECOFIN statement of 23 March 2020. It is important to recall that the national escape clauses in the second group had been assessed to be fully consistent with the Fiscal Compact, too ([94]), but Member States have added further specifications to the notion of exceptional circumstances or laid down a distinct legal activation procedures.

Table 3.1: **Types of national escape clauses**

Automaticity: suspension of domestic rules linked to SGP clause	Austria, Cyprus, Denmark, Estonia, Finland, Luxembourg, Malta, Portugal
National procedures laid down to suspend domestic rules	Parliamentary approval: Bulgaria, Germany, Italy, Latvia, Spain Governmental approval: Belgium, France, Ireland, Lithuania, Romania, Slovakia, Slovenia
Special cases	Greece: derogation under enhanced surveillance [(1)] agreed separately with creditors. the Netherlands: no system of national rules, fiscal policy follows EU provisions

(1) The enhanced surveillance framework (introduced by the two-pack regulation for euro area Member States with financial stability issues) facilitates support for the completion of reforms to which the Greek authorities are already committed to under the financial assistance programme.
Source: EFB survey, national IFI webpages

There are some special cases. In the Netherlands, the relevant legislation does not contain any reference to escape clauses, but the general legal principle whereby Dutch fiscal policy should be conducted in line with Union law implies that the SGP definition of escape clauses applies to the national provisions. In Greece, the binding constraint for fiscal policy is the primary surplus target of the ongoing enhanced surveillance process, the suspension of which was agreed with the EU institutions ([95]).

The involvement of IFIs in the management of national escape clauses varies across countries (see also Box 3.1). In most of the 22 countries surveyed, IFIs have some role in the process, usually by issuing a non-binding opinion on the existence of exceptional circumstances, normally under the comply-or-explain principle. Following the outbreak of the pandemic in spring 2020, some IFIs formally proposed the activation of the national escape clause (those in Bulgaria, Slovenia, Lithuania; in the latter case, it was binding for the government). In several countries of the second group, decision-making competences are assigned to the national governments; it is somewhat less common for the legislative bodies to have the final say (see Table 3.1). In a few countries (typically where EU surveillance decisions are directly applicable), IFIs have no formal role in the activation process.

Also linked to the pioneering nature of their activation, in their responses to the EFB questionnaire national IFIs signalled some issues for clarification as to the regulation of escape clauses. As regards the substance of the clauses, around a quarter of the IFIs surveyed stated that all procedural and policy constraints in relation to the operation of national rules are suspended in their countries. About half of them indicated that reporting obligations for the national institutions remain, but numerical rules do not apply. The remaining quarter reported that the clauses provide for additional flexibility mostly in the final assessment of compliance.

While the economic case for applying the flexibility allowed by the escape clauses in 2020-2021 has not been contested at all, several IFIs pointed to some shortcomings in national provisions (see also the discussion on the future of the supranational escape clause in Box 2.1). A number of IFIs found the national definition for triggering the clause insufficiently operational, and even more pointed to the lack of guidelines, thresholds, or more generally, review conditions for deactivating it. These deficiencies could create tensions when IFIs will need to take a position on when to exit from the national clause, as it may not be necessarily aligned with the corresponding SGP decisions. In some countries, the procedure was not clear for the parties concerned, e.g. the Spanish and Slovenian fiscal councils signalled that there were no deadlines for action in case the national IFIs propose the triggering of the clause.

([94]) European Commission (2017).
([95]) European Commission (2020c).

Box 3.1: The IFIs' response to the Covid-19 crisis

The pandemic-related economic uncertainty and the budget flexibility given to Member States by the activation of EU and national escape clauses have significantly affected the role and functioning of national independent fiscal institutions (IFIs). The requirement to base fiscal planning on independently produced or endorsed macroeconomic forecasts in the euro area was upheld in 2020, even amidst an exceptional degree of economic uncertainty. As a result, IFIs' contribution to forecasting prudency was less meaningful than in normal times. Their assessment of compliance with numerical fiscal rules – the other mandate of EU IFIs stemming from EU law – was also rendered essentially redundant by the widespread activation of EU and national escape clauses for 2020-2021. Even so, IFIs duly published *ex post* compliance assessments for the 2019 fiscal year in accordance with legal provisions, pointing out that the timing for any potential follow-up action, such as the activation of correction mechanisms, was not appropriate. In sum, IFIs' standard publication schedule was in general maintained with some inevitable adjustments to the timing and themes. Most IFIs also felt compelled to react to the crisis with new types of analytical activities.

In order to capture these first institutional responses, a dedicated EFB survey was conducted in spring 2020, covering 27 IFIs operating in 26 Member States and the UK Office of Budget Responsibility to gather information on the activities of IFIs during the first wave of the pandemic, as well as the degree of cooperation with national governments. Similar initiatives had also been undertaken by other institutions such as the OECD Network of Parliamentary Budget Offices and Independent Fiscal Institutions ([1]) and by the Network of EU IFIs ([2]). Results are broadly consistent across surveys.

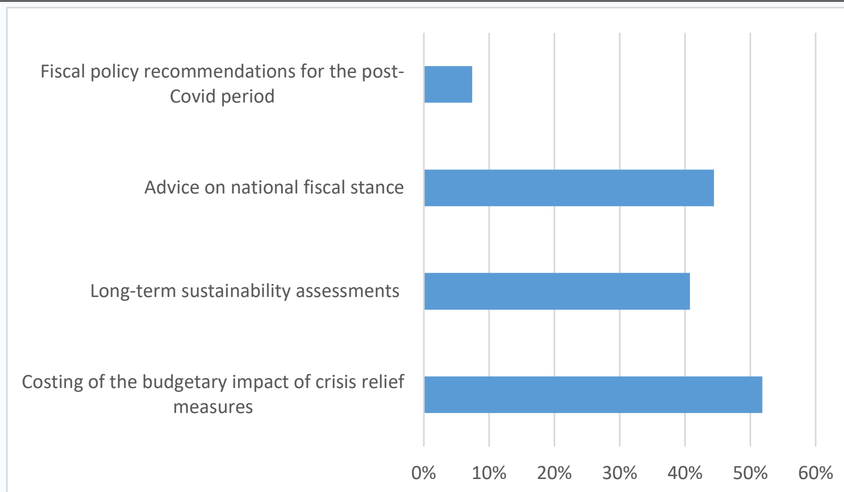
The IFIs reacted swiftly to the pandemic, at times being the first national budget institutions to shed light on its economic and budgetary impact. The EFB questionnaire enquired whether IFIs carried out at least one of the following activities, typically going beyond their traditional mandate: i) costing the budgetary impact of government measures; ii) providing advice on the national fiscal stance; iii) assessing the impact of the crisis on the long-term sustainability of public finances; and iv) issuing fiscal policy recommendations for a time when the health crisis will be sufficiently contained. The large majority of respondents carried out one or more of these tasks in 2020. Given the rapidly unfolding adverse economic impacts and the speed with which national authorities put together stimulus packages, activities focused first on providing fiscal policy guidance and the costings of the crisis-fighting measures; but then subsequently turned to assessing the implications for long-term sustainability (see Graph 1). It should be emphasised that in many cases, and in particular as regards the costings of measures, these analyses were not embodied into dedicated publications, but rather the pandemic led to ad hoc assessments or the IFIs' regular reports contained the related discussions.

([1]) See OECD (2020).
([2]) In fact, the Network repeated its pandemic-related survey on a quarterly basis to underpin its flagship publication, the European Fiscal Monitor. See the most recent edition reporting overall about IFI-related developments in 2020: Network of EU IFIs (2021).

(Continued on the next page)

Box (continued)

Graph 1: **IFIs' activities in 2020 during the Covid-19 crisis (shares of surveyed entities)**



Source: EFB survey

According to the OECD survey, IFIs were also faced with many challenges while undertaking these activities, on top of managing a general shift towards teleworking. The main challenges were capacity constraints, delays in budgetary processes due to the crisis and difficulties obtaining information from government counterparts, in particular information on the parameters and details of crisis relief measures. In addition, the Network of EU IFIs survey pointed to the analytical challenges stemming from the unprecedented uncertainty in the economic outlook, which called for new methodological tools (e.g. scenario analysis, fan charts, adjusted models). Respondents to the EFB questionnaire confirmed the challenging environment faced by IFIs especially with regard to cooperation with national governments.

3.2. ENFORCEMENT OF FISCAL RULES: LESSONS FROM THE FISCAL COMPACT

3.2.1. Legal and institutional landscape for enforcement in the EU

Past EFB reports and supporting analysis showed that in the two decades of SGP history there was no overall trend towards better compliance in spite of successive reforms aimed at making the rules more effective. [96] There seem to be entrenched patterns of (non-)compliance across time and countries. Therefore, any new attempt to revise the supranational surveillance framework will have to pay particular attention to the issue of enforcement and incentives in the fiscal framework, which has so far suffered from various shortcomings. Besides recent EFB reports, the reluctance to impose sanctions (or difficulties in doing so) was highlighted by the European Court of Auditors (2016) in its analysis of SGP implementation, and has been acknowledged by the European Commission (2020b). More specifically, any form of financial sanction has increasingly been perceived as a 'nuclear bomb without real deterrent effect' not least due to the inherent time-inconsistency: sanctions typically apply when the Member States concerned find themselves in economic and budgetary difficulties, and the political opportunity and willingness to 'punish' is weak.

The importance of enforcement was acknowledged in the EU economic governance reform process of 2011-2013 in relation to national numerical rules as well. One component of the so-called six-pack, the Budgetary Frameworks Directive set minimum standards for domestic fiscal frameworks. As part of the design requirements for national fiscal rules, it asked Member States to set out consequences in the event of non-compliance with each of their numerical rules. Admittedly, many of these consequences took the form of reputational costs, e.g. simply requiring the publication of IFI

(96) See EFB (2019) and Larch and Santacroce (2020).

monitoring reports or government documents on the breach of the rule. ([97])

The intergovernmental Fiscal Compact ([98]), as agreed in early 2012, followed the same objective as the 2011 Budgetary Frameworks Directive, namely to strengthen enforcement and compliance with EU fiscal rules by asking Member States to put in place at the national level institutions and procedures consistent with the latter. The Fiscal Compact obliged its contracting parties to enshrine national correction mechanisms of binding force and permanent character alongside their compulsory structural budget balance rules (for which a general lower bound of a 0.5% deficit was laid down ([99])).

The core objective of these national correction mechanisms is to avoid lasting deviations from the country-specific MTO or the adjustment path towards it, as agreed in the EU surveillance framework in structural terms. The correction mechanisms were meant to enact, through an automatic trigger, budgetary measures to put an end to any significant deviation from the country-specific objectives or the adjustment towards them. In addition, the Fiscal Compact contained a requirement to establish a pre-defined timeline for the implementation of the budgetary adjustment measures. As the domestic structural budget balance rules had to be formulated in a consistent manner with the EU rules, such an arrangement was expected to foster national ownership of the supranational surveillance framework.

The essential features of the correction mechanisms are detailed in the above mentioned Commission's communication on 'common principles', which, *inter alia*, emphasises four key elements:

(i) higher legal status than the budget law;

(ii) well-defined circumstances for triggering the mechanism;

(iii) pre-determined rules to frame the size and timeline of the fiscal adjustment; and

(iv) role of national IFIs in monitoring all relevant aspects of the mechanism, and in particular its triggering, progress and extension, all under the aegis of the comply-or-explain principle.

To ensure the credibility of the national monitoring process, the principles laid down a number of minimum standards for IFIs to safeguard their independence, most notably, in terms of statutory regime, freedom from interference, appointments, adequacy of resources and of access to information.

It is worth clarifying that the Fiscal Compact did not go as far as to demand the introduction of a control account as pioneered in the EU by Germany, Austria and Latvia. This enhanced type of correction mechanism is used for recording all *ex post* deviations from the targets. If these deviations reach a pre-defined threshold (e.g. 1% of GDP), the national authorities must offset them within a given time-frame through symmetrical overachievement of the targets, thereby tackling the 'ratchet effect' of periods with looser public finances.

In its February 2017 report, which exclusively focused on the legal transposition of the Fiscal Compact, the Commission found the compliance of national legislations with the supranational provisions to be generally satisfactory. ([100])

3.2.2. EFB survey on national correction mechanisms

Despite the jointly agreed common principles, there are significant differences of design between correction mechanisms across the 22 countries that signed the Fiscal Compact. This heterogeneity can be exploited to identify elements of best practice,

([97]) Nonetheless, there are several examples of more stringent enforcement mechanisms: for debt rules (e.g. Poland and Slovakia have legislated links between numerical thresholds of debt-to-GDP ratios in the proximity of their debt anchors and certain budgetary steps), and for sub-national rules (e.g. in Estonia, Germany, and Lithuania, breaches of the rules trigger well-specified corrective action, often allowing for central authorities to override non-compliant local budgets). See European Commission (2020a) for a survey of existing arrangements.

([98]) The Fiscal Compact requires its 22 contracting parties to introduce in their national legislation a structural balanced budget rule equipped with a correction mechanism; the essential features were specified in an accompanying Commission Communication on common principles.

([99]) For countries with a government debt-to-GDP ratio significantly below 60% and with low risks for the long-term sustainability of public finances, the lower limit could reach a structural deficit of at most 1% of GDP.

([100]) European Commission (2017). In the few cases, in which the Commission's report concluded on conditional compliance (reflecting a public commitment for remedial actions by the respective authorities), the countries in question subsequently took supplementary measures. These were, for instance, the operationalisation of the Slovenian Fiscal Council in spring 2017, or the Spanish decree amendment in March 2018, which removed a provision restricting access to information for the Independent Authority for Fiscal Responsibility.

especially as regards the enforcement of fiscal rules. To this end, the EFB organised a dedicated survey with the independent monitoring institutions in the 22 Fiscal Compact countries on the design and application of the mechanisms.

The answers confirmed that since the Fiscal Compact provisions were transposed in 2012-2013, there have been only four cases of IFIs seeking to trigger the correction mechanism *ex post*, i.e. based on an observed significant deviation at general government level. In two episodes (France 2014, Slovakia 2016), their call was unheeded, while in two more recent cases in late 2019 (Estonia and Slovakia), the mechanisms were activated, but the Covid-19 crisis suspended the enforcement process in the two countries at a relatively early stage.

According to the EFB secretariat's compliance tracker ([101]), in the 22 countries, numerical compliance with the EU structural balance requirements in the period under review was only around 50%. ([102]) At first sight, therefore, the enhanced national frameworks, and in particular, the correction mechanism seem to have had a limited effect in terms of promoting adherence with the EU fiscal rules. Given the rarity of the mechanisms being implemented so far, the following analysis focuses mainly on identifying design elements that could be associated with more fiscal discipline/compliance.

The structure of the EFB survey followed the logic of the common principles to capture the key characteristics of correction mechanisms across Member States (see the list of main building blocks mentioned above). Some three fifths of the questions covered, in a factual manner, the various design features adopted by the national authorities, while the remaining two fifths asked about the IFI's own assessments and their perceptions as to the consistency, clarity and effectiveness of the arrangements. Answers to the first set of questions were compared to the findings of the Commission's 2017 transposition report and a selection of national legal documents cited therein.

The responses by the independent monitoring institutions confirmed that, within the boundaries of the common principles and essential standards, Member States have retained a considerable degree of freedom in terms of designing their own national correction mechanism and the set-up and mandate of their national IFIs. As several countries already had structural budget balance rules and national IFIs before the TSCG was adopted, and given the diversity of national administrative settings and legal traditions, the Fiscal Compact refrained from imposing a one-size-fits-all model.

Overall, the EFB analysis identified four crucial dimensions of the correction mechanisms, which could be directly linked to their perceived deterrent effect and where strong patterns emerged (see also Graph 3.2 for a distribution of countries):

(i) legal status, i.e. whether national provisions were adopted as an ordinary law or at a higher legal level (the latter combines constitutional amendments, cardinal laws with qualified majority quorums and special legal arrangements in federal states, such as internal stability pacts). ([103])

(ii) orientation, i.e. whether the mechanism can also be activated ex ante based on a high risk of a significant deviation or only ex post;

(iii) automaticity, i.e. whether the mechanism is triggered fully automatically or is constrained in some ways; and

(iv) clarity of the national provisions, i.e. a summary IFI assessment as to how well the triggering conditions and the subsequent procedural steps are defined (clearly; mostly well; vaguely).

Other potential design features were also considered (most notably, specific timelines for adopting/implementing corrective measures, pre-determined nature of corrective measures, and the role of various institutions (government, IFIs, parliaments). However, these were not included in the quantitative analysis on account of either too diverse national solutions, or unclear assignments. The latter is probably due to the fact that in the overwhelming majority of countries the mechanism

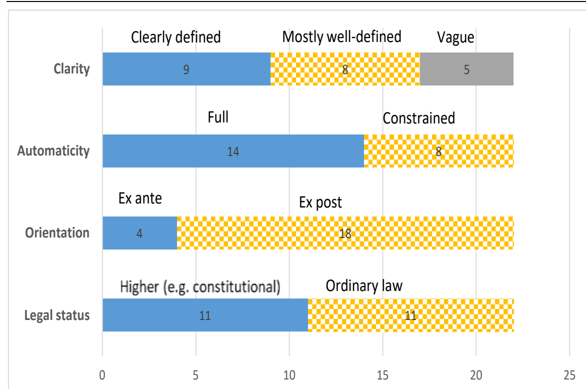
([101]) This database measures numerical compliance with all the quantitative constraints on budgetary and fiscal aggregates under the EU fiscal framework, including the structural budget balance. See Larch and Santacroce (2020) for details.

([102]) The overall rate of compliance computed with all four SGP rules is around 60%.

([103]) While some fundamental provisions (e.g. the stipulation of the structural balanced budget rule) were adopted in a legal instrument with a higher status than ordinary law, the detailed implementing arrangements (e.g. steps and procedures for the correction mechanism or the governance arrangements for the monitoring institution) were set out in associated ordinary legislation. The countries concerned were still assigned to the 'constitutional' group as the binding force of the structural balance rule equipped with a correction mechanism is better captured by the legal status of its core element(s).

has never been activated, so many practical and procedural aspects have yet to be clarified.

Graph 3.1: **Design features of national correction mechanisms along four dimensions**



Source: EFB survey

Of the four dimensions listed above, legal status is the one that has traditionally been scrutinised to capture its relevance for the effectiveness of fiscal frameworks. In this context, it is worth recalling that the IMF's and the European Commission's Fiscal Rule strength indices both assign a higher score for rules with a higher statutory basis, which in principle would make them more difficult to amend. However, the empirical literature is not decisive on this issue, for instance, Debrun et al. (2008) found some positive, but statistically insignificant association between the statutory basis of fiscal rules and fiscal outcomes.

To find similarities and differences across the Fiscal Compact countries, we carried out a cluster analysis. On top of the four dimensions of the national correction mechanism presented above, a number of additional variables of interest, described in Table 3.2, were added.

Table 3.2: **Additional institutional and economic variables used in the cluster analysis**

Variable (abbreviation)	Scale	Source	Comment
World Governance Indicator (WGI)	Values range from approximately -2.5 (weak) to 2.5 (strong) performance.	World Bank	The three most relevant WGI dimensions for fiscal outcomes (i.e. control over corruption, government effectiveness and quality of regulations) are averaged over the 2013-2019 period.
Political Stability and Absence of Violence/ Terrorism (PS)	Values range from approximately -2.5 (weak) to 2.5 (strong) performance.	World Bank	Averaged over the 2013-2019 period
Media visibility of national IFIs (Media)	0%-100%	Europe Media Monitor (as taken from European Commission (2021b))	Share of mentions relative to total number of articles. Calculated over the 2004-2019 period.
Compliance score for the structural balance rule (SBB)	0-100%	EFB compliance tracker	Averaged over the 2013-2019 period
Public debt-to-GDP ratio (Debt)	% of GDP	Eurostat	Averaged over the 2013-2019 period
Average growth rate of real GDP (Growth)	year-on-year%	Eurostat	Averaged over the 2013-2019 period

Source: World Bank WGI database, Europe Media Monitor, EFB Secretariat's compliance tracker, Eurostat

The clearest pattern was achieved by a four-clusters setting ([104]). The average scores for each variable across clusters are reported in Table 3.3. Clusters are ordered by average compliance with the structural budget balance rule, which is at the heart of the Fiscal Compact, as measured by the EFB secretariat's compliance tracker. Numerical compliance is taken as a proxy for enforcement and/or ownership, two key objectives of the Fiscal Compact.

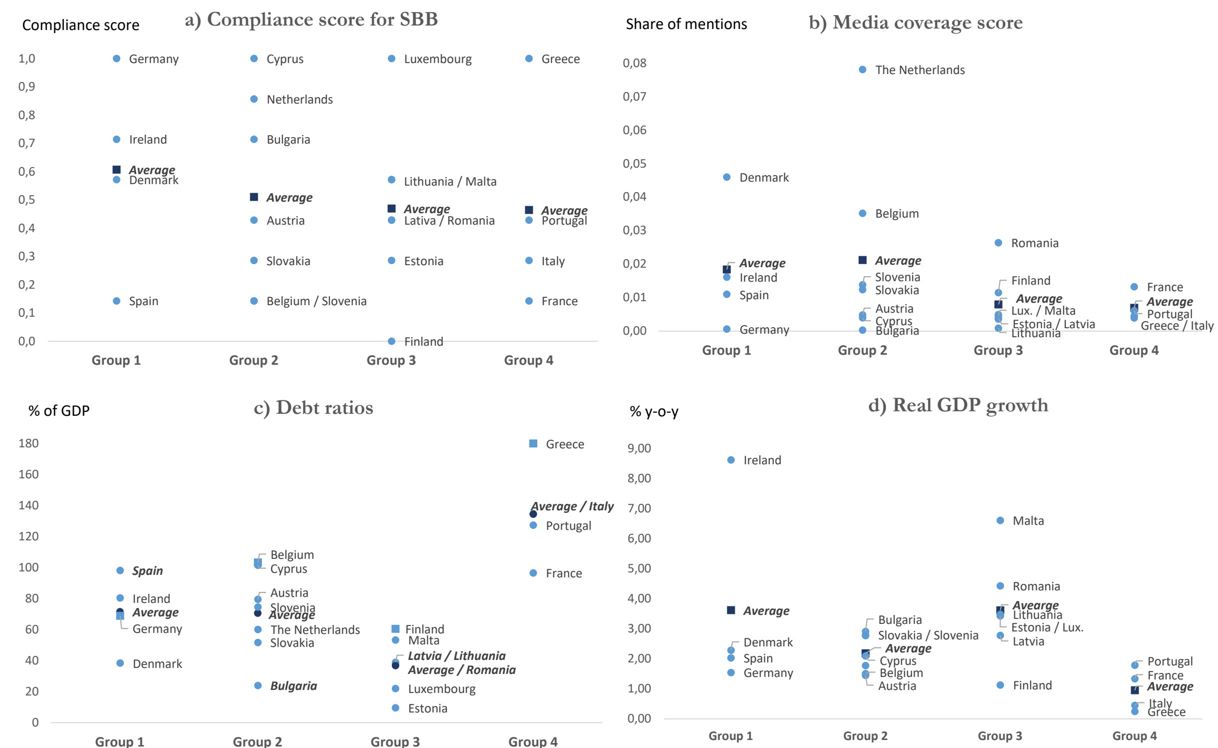
([104]) We applied a Ward-type cluster analysis (minimum variance method) given the large number of variables and difference in scales. In line with common practice, the data was standardised in advance.

Table 3.3: **Results of cluster analysis (mean scores)**

	Legal	Ex ante	Auto	Clarity	WGI	PS	Media	SBB	Debt	Growth	Countries	Characteristics
1.	0.50	1.00	1.00	2.00	1.52	0.72	0.018	0.61	71.4	3.62	Denmark, Germany, Ireland, Spain	Good design, high growth, strong compliance, good media coverage
2.	0.43	0.00	0.00	1.43	1.06	0.74	0.021	0.51	70.6	2.18	Austria, Belgium, Bulgaria, Cyprus, Netherlands, Slovakia, Slovenia	Mixed design, medium growth, medium compliance, good media coverage
3.	0.57	0.00	0.86	0.29	1.14	0.82	0.008	0.47	37.1	3.61	Estonia, Finland, Latvia, Lithuania, Luxembourg, Malta, Romania	Mixed design, high growth, low debt, weak compliance
4.	0.50	0.00	1.00	1.50	0.74	0.38	0.007	0.46	134.7	0.95	France, Greece, Italy, Portugal	Mixed design, weak growth, high debt, weak compliance, low governance indicator

(1) Dimensions of national correction mechanisms: Legal: higher status=1 vs lower status=0. Ex ante=1 vs ex post=0. Auto: fully automatic trigger=1 vs constraint=0. Clarity: clearly defined=2, mostly well-defined=1, vague=0. WGI: country-score of the World Governance Indicators, normalised units around 0. PS: World Bank political stability indicator; Media: media visibility index of IFIs: share of total number of articles. SBB: compliance score with the structural balance rule, 1 equal to full compliance. Debt: government debt in % of GDP; Growth: average real GDP growth rate, y-o-y % change. The reference period for all indicators is 2013-2019 with the exception of media visibility (2004-2019). The values in the table correspond to the mean of the cluster for each indicator.
Source: EFB survey, World Bank WGI database, Europe Media Monitor, EFB Secretariat's compliance tracker, Eurostat

Graph 3.2: **Distribution of sample across key dimensions**



(1) The reference period for all indicators is 2013-2019, with the exception of media visibility (2004-2019). SBB: EFB Secretariat's compliance score for the structural balance rule.
Source: EFB Secretariat's compliance tracker, Europe Media Monitor, Eurostat

The first cluster comprises four out of the universe of 22 Fiscal Compact countries that can activate their correction mechanism *ex ante*. The second and third groups each contain seven countries, while the last encompasses four high-debt countries with weak growth performance and meagre scores for institutional quality. There are significant differences within the four clusters, and differences across groups may not apply to each country individually to the same degree. That said, the cluster analysis still reveals some interesting profiles.

The first two clusters' comparatively high average compliance scores are associated either with a better-designed correction mechanism and/or a high media presence of IFIs (which seems to compensate for less convincing design). The third cluster underscores the importance of economic growth in containing the government debt-to-GDP ratio, even with a mediocre compliance score. This is further corroborated by the fourth group that performs similarly or only slightly worse than the third in terms of design and compliance, while higher debt levels go along with a relatively weak media presence of IFIs and low economic growth (see Graph 3.2 for the distribution of the four clusters along some key policy and economic dimensions).

Broadly similar results emerge when using the debt reduction benchmark instead of the structural budget balance rule to assess compliance. For the expenditure benchmark, a new breakdown emerges that contains Denmark and the Netherlands as single clusters, and is largely driven by strong media coverage and compliance in these countries. Otherwise, the broad grouping is maintained but less pronounced.

We ran various specifications to further test the robustness of our results. For example, in a three-group setting, the above distinctions are still present, but some nuances are lost, as some countries from the second cluster are dispersed. Extending the cluster analysis by an additional group does not reveal any further insights since it only isolates single countries, such as Greece, in stand-alone groups.

The above survey and related calculations indicate that the exact way of increasing local ownership of fiscal rules through national correction mechanisms was, on average, not necessarily conducive to

better compliance. This being said, the possibility of triggering the correction mechanism *ex ante*, on the basis of a risk assessment by an independent institution, appears to stand out as a desirable design feature. At the same time, higher-growth countries can potentially afford a more lenient design in their domestic fiscal frameworks while achieving a higher compliance score.

One explanation for these observations is that the overwhelming majority of countries in question decided to link the automatic trigger of their correction mechanism to a formal EU-level surveillance decision pointing to a significant deviation in the SGP framework. Although, in principle, this approach ensures consistency between the EU surveillance framework and national budgetary procedures, it does not appear to promote local ownership of EU rules, which was the primary objective of the Fiscal Compact.

As pointed out repeatedly in past EFB reports, the Commission and the Council have regularly shown forbearance *vis-à-vis* a number of countries when assessing compliance with fiscal requirements. A particularly clear, although not the only example is the introduction of the 'margin of discretion' in 2018, which allowed them to base their conclusions on an assessment that went well beyond developments of relevant budgetary variable *vis-à-vis* pre-defined SGP thresholds or reference values. ([105]) Other examples as regards the Commission's assessment in the final phase of the surveillance cycle include the generous treatment of the unusual event and flexibility clauses, for instance in the case of Italy (for a period of 2016-2018), *ad hoc* adjustments of the expenditure benchmark for Portugal and Slovenia (2017), and accepting France's and Spain's nominal strategies when they were under the SGP's corrective arm (2016-2017). Improved automatic correction mechanisms may not therefore be fully effective, because the trigger is subject to *ad hoc* interpretations or improvisations of EU provisions.

Only three countries (Belgium, Bulgaria and France) chose to make the activation of the correction mechanism automatic when the national IFI concludes on the existence of a significant deviation. However, exercising this strong power runs into difficulties in these countries. In Belgium, the High Council of Finance is able to carry out 'illustrative compliance assessments' ([106]) only, while in France the national IFI's attempt to trigger the procedure in 2014 was effectively circumvented by the government ([107]).

When IFIs were asked for an overall assessment of their national correction mechanism in the context of the EFB survey, a distinct group identified weak domestic transposition choices as the main culprit in the problematic enforcement of the Fiscal Compact. These IFIs called for more automaticity in the procedures and a reinforced role for themselves, so as to help depoliticise the necessary budgetary adjustments. At the same time, another set of IFIs argued that the effectiveness issues stem directly from poor design features embedded in the EU surveillance framework, most notably, a reliance on unobservable variables, and a conceptual disconnect between fiscal objectives and actual budgeting decisions.

Overall, to achieve the initial objective of the Fiscal Compact, a number of actions seem warranted. First, the automatic trigger of national correction mechanisms should ideally be linked to the assessments of independent national entities. Second, all decisions around establishing significant deviation and the concomitant activation of the correction mechanism should be subject to intense public scrutiny and discussion. Third, since economic growth fosters compliance, more attention should be given to growth-oriented policies, in particular structural reforms and government investment.

3.3. INDEPENDENT FISCAL INSTITUTIONS IN AUSTRIA AND ITALY

Case studies can provide useful insights to identify elements of good practices. They also illustrate the wide spectrum of IFIs within the EU. Institutional settings, task allocation and experience can differ

([105]) See EFB (2018) for a detailed discussion.

([106]) Despite the provision in the December 2013 Coordination Agreement, the Concertation Committee has yet to reach a decision in relation to the budgetary objectives apportioned to various levels of the federal government. Due to the lack of formally approved objectives, the High Council of Finance's annual compliance report has repeatedly concluded that it was not in a positon to verify whether one or more entities (i.e.: individual communities, regions and community commissions) had deviated significantly from their objectives.

([107]) The IFI's triggering of the French correction mechanism in May 2014 had eventually no effect. The budget bill for 2015, which would have been the vehicle for additional adjustment measures, set instead a new multi-year fiscal trajectory through a new programming law incorporating the past deviations with upwardly revised deficit targets.

greatly. The IFIs in Austria and Italy are examples of this diversity and display distinctive features. The following two subsections highlight such features and sketch the experience with them over the past years.

3.3.1. Austria

Austria is one of a handful of EU countries in which two entities perform the tasks of domestic IFIs, as prescribed by EU legislation (108). The Austrian Institute of Economic Research (WIFO) has been in charge of independently producing the official macroeconomic forecasts underpinning the government's budget for decades, while since 2013 the Austrian Fiscal Advisory Council (FAC) has monitored compliance with the domestic fiscal rules.

Austria has a rich history of economic advisory councils and fiscal advisory bodies. FAC's predecessor, the Government Debt Committee (GDC) started its operation in 1970 to advise to the government on public debt issues (109). The GDC was moved to the Austrian National Central Bank (OeNB) in 1997 and eventually transformed into the FAC in July 2013 (110), remaining organisationally attached to the OeNB. Its mandate was broadened in 2013 to align the institutional landscape with the new supranational legal requirements on tightening domestic fiscal surveillance (111).

Administratively, the FAC is set up as an independent unit attached to the OeNB. The federal law establishing the FAC forbids its members from taking instructions from the government or any other institution. Its financial and human resources are provided by the hosting institution, the OeNB. The FAC is among those IFIs whose board members are not employed full-time or remunerated; only their actual expenses are covered (112).

The FAC's board is one of the largest among EU IFIs, with 15 members. Its leadership and membership are carefully balanced on the basis of a 'stakeholder approach'. Its members are not selected by the appointing authorities collectively, but autonomously by each authority. This approach should be seen against the backdrop of the strong corporatist tradition and social partnership prevalent in Austria, which seeks inclusive structures of decision-making. The FAC thus offers an useful example of good practice in ensuring wider representation of social and economic interests on its board.

In practice, the government appoints six board members, while the Federal Chamber of Labour and the Federal Economic Chamber (in agreement with the Chamber of Agriculture) each appoint three. These 12 members are endowed with voting rights, while the remaining three members, who represent regional stakeholders (113), are not. Together, therefore the non-government appointed members can force a tied votes, in which case the President's vote decides. The President is always appointed by the government, whereas the two rotating (114) vice-presidents are selected by the chambers. Thus, the government-appointed members hold an implicit majority. However, members are formally barred from taking instructions from external actors, including the institution that appointed them. In this context it has to be noted that currently all of the government appointed members hail from the academic sphere and only some had prior employment in public administration (115). In practice, official FAC recommendations to the government and local authorities are often adopted by consensus. In some cases, specific policy advice has been subject of abstentions and dissent among members; for transparency, this is noted in the publications.

(108) There are two main pieces of supranational legislation in the EU with requirements for an IFI mandate. The intergovernmental TSCG (and its Fiscal Compact part, see references in the previous section) stipulates that a national independent body should be tasked with monitoring the mandatory structural budget balance rule. Subsequently, Regulation (EU) No 473/2013 (one element of the two-pack that only concerns euro area Member States) introduced a requirement for national medium-term fiscal plans and draft budgets to be based on IFI-produced/endorsed macroeconomic forecasts as well as gave IFIs a formal monitoring role for all numerical fiscal rules in force.

(109) Originally at federal level but expanded to other levels of government since 2002 (see presentation on the GDC).

(110) Federal law on the establishment of the FAC.

(111) For details, see the so-called Austrian Stability Pact.

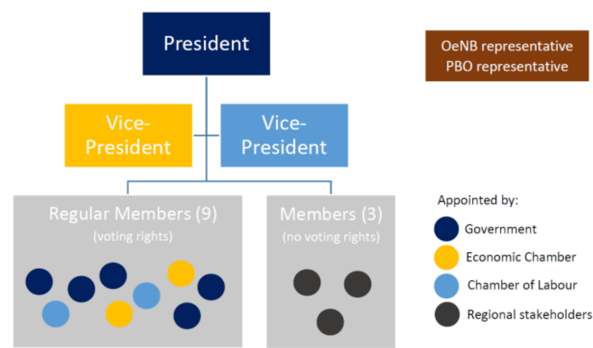
(112) OECD IFI database.

(113) Austrian Conference of Provincial Governors, Austrian Association of Municipalities and Austrian Association of Cities and Towns.

(114) Each vice-president presides for half of the year.

(115) FAC members may not simultaneously hold a position in (federal or local) government or parliament. Moreover, they must be Austrian nationals.

Graph 3.3: **Board Members by appointing authority**



Source: https://www.fiskalrat.at/Organisation.html

Several safeguards ensure the Board's business continuity. The members are appointed for six-year terms ([116]), which are renewable without limit. The median length of Board terms in EU IFIs is five years, but they usually range from three to seven year terms ([117]). Each member has an alternate who would take over in the event of their temporary absence. Moreover, the board remains operational as long as seven members are present (the fixed quorum threshold). Thus, only if e.g. all government-appointed members are absent, would the Board not be operational.

The succession of leadership has run comparatively smoothly. As appointments are decided by the individual stakeholder groups within their quota, they only have to reach an agreement among themselves (see Graph 3.3). Nevertheless, if the government is a coalition, this will involve the political parties on six common candidates. It is noteworthy that all FAC presidents have so far been Austrian university professors. The Parliament does not have a role in the appointment process. If a member resigns (either voluntarily or due to a conflict of interest ([118])), the official replacement serves for the remainder of the six-year term.

In 2020 and 2021, in quick succession, two FAC presidents stepped down early in their respective mandates, after being appointed as Deputy Governor of the OeNB and as Minister for Labour. ([119]) During the interim periods of seeking replacements, the serving vice-presidents took the role of acting president. Overall, the swift replacements of members and the shadow member system have so far safeguarded FAC's business continuity, thus serving as a good benchmark in this regard.

The Fiscal Council members are supported by the FAC's secretariat. It is staffed by OeNB personnel and the central bank fully covers their costs. In effect, this constitutes restricted recruitment choices in the hiring process, which highlights a degree of dependence on the OeNB. The secretariat is currently made up five economists and one research assistant. The team conducts analyses for the FAC, drafts its annual publications and organises workshops and outreach events. The FAC can also elicit inputs from external specialists for specific aspects of its research or to feed into its reports ([120]).

Inter-institutional dialogue is fostered by the inclusion of high-level representatives of other institutions to the Fiscal Council, most notably by the OeNB and the Parliamentary Budget Office (PBO). The latter is particularly important as it creates a permanent channel for exchange between the PBO and the FAC, both of which have key roles in the independent oversight of fiscal policy ([121]). Thus, information is shared prior to publication and informal discussions can influence and strengthen each institution. Lastly, the FAC's annual report is discussed in the Austrian Parliament.

Austria is one of a handful Member States in which an IFI produces the macroeconomic forecasts that underpin the Ministry of Finance's budgetary plans ([122]). The WIFO has the important task of providing unbiased estimates on economic growth, the output gap and other key variables that will significantly influence the government's budgetary policy choices. It is a research institute with a long history (founded in 1927) and excellent reputation. Following the entry into force in 2013 of the two-pack's requirement for the independence of macroeconomic forecasts, it was natural for the Austrian authorities to continue the existing practice. Delegating the production of official macroeconomic forecasts to an IFI is a clear

([116]) Longer than the parliamentary electoral cycle, but equal to the term of the President of the Austrian Republic.
([117]) Based on sample of IFIs covered by the OECD IFI database.
([118]) FAC members must resign if they are elected to one of the two chambers of the Austrian Parliament or to a regional assembly, or appointed to federal or regional government.
([119]) See the respective announcements in the press releases of the Institute of Advanced Studies, and the Federal Finance Ministry.
([120]) The contributing specialists are disclosed in the relevant reports.
([121]) The PBO was created in 2012 to support and advise the elected National Council members (i.e. the lower house of the Austrian Parliament) in monitoring the government's budgetary activities.
([122]) The use of WIFO macroeconomic estimates is a long-standing convention.

strength of the Austrian system, in that it ensures unbiased estimates.

In recent years, the WIFO and the FAC have already had an indirect link in that one of the government-appointed FAC members is a WIFO employee. This link has been further strengthened by the appointment of the outgoing WIFO Director as FAC's new President in May 2021. Furthermore, WIFO specialists are regularly invited to FAC meetings to exchange expertise and give presentations at FAC workshops ([123]). Nonetheless, unlike the OeNB and PBO, the WIFO does not have an *ex officio* representative on the FAC board. Stronger formal interconnectedness between the FAC and WIFO may be desirable.

The FAC performs eight main tasks under national law ([124]). It is charged with most IFI responsibilities stemming from the European legislation, in particular monitoring compliance with domestic fiscal rules. In its fiscal watchdog role, the FAC is responsible for making recommendations on compliance with both EU and national numerical rules (the Austrian fiscal rules are largely aligned with the SGP requirements and apportion the numerical constraints between central and sub-national levels).

Graph 3.4: **Tasks of the Fiscal Advisory Council (FAC)**

Source: Austrian Fiscal Council, https://www.fiskalrat.at/en/mandate.html

Compliance monitoring in a strongly federal system adds an additional layer of complexity for the FAC. Most of its tasks (see Graph 3.4) relate to public authorities at various levels of government, since fiscal rules and targets are applicable to all levels. The sub-national requirements were laid down in the Austrian Stability Pact adopted in 2012, a year before the FAC's mandate was upgraded. The Pact allocates the official task of monitoring compliance to the Austrian Court of Audit, which files sanctions if Statistics Austria detects a breach of the requirements ([125]). Despite the Court's role, the FAC obtained subsequently a similar mandate to monitor for significant deviations and submit recommendations that activate, extend or end corrective measures.

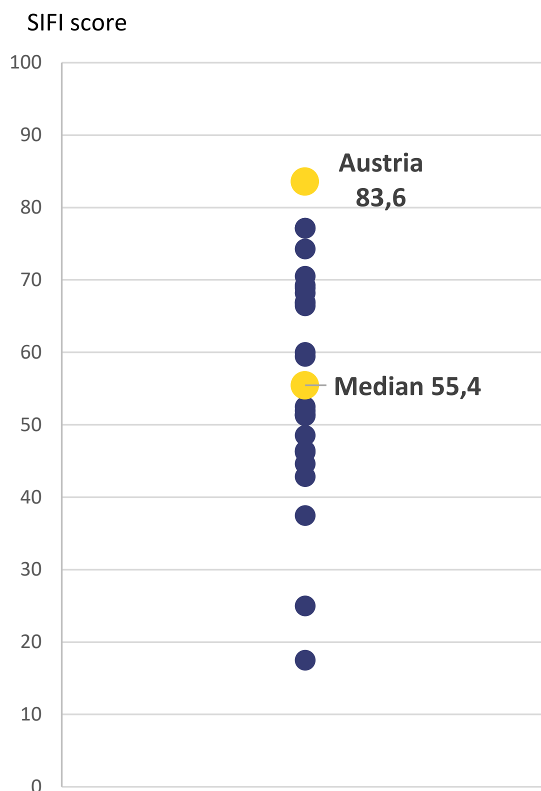
Obtaining timely regional government data is a challenge. The FAC has guaranteed access Statistics Austria digital data (including regional data) and public authorities are required to reply in a timely fashion to inquiries. However, the FAC noted in its 2018 recommendations that administrative budget data at the lower levels of government were not readily available in time. Another challenge is that the FAC does not have direct access to the reports that the national authorities are required to deliver to the Parliamentary Budget and Finance Committee under the Federal Budget Act (2013) ([126]). Access to the sub-national control account that records deviations from the structural budget balance requirements ([127]) is essential for the FAC to be able to recommend the activation of the correction mechanism ([128]). Following repeated calls for early access to budgetary estimates for the control accounts at all government levels, the situation has now been remedied ([129]). While the FAC is tasked to assess the activation of the correction mechanism, the Court of Audit is responsible – based on a first assessment by Statistics Austria – for establishing whether the threshold for triggering the correction mechanism has been breached. Nevertheless, the FAC has been vocal in pointing out where authorities at any level of government, in particular municipalities and regions, have exceeded or are expected to exceed the designated threshold of cumulated deviations from structural balance targets ([130]). The Austrian fiscal framework would benefit from a more exact delineation of national enforcement roles between the Fiscal Council, on the one hand,

([123]) See for example a WIFO press release about this arrangement.
([124]) Federal law on the establishment of the FAC.
([125]) Article 19 of the Austrian Stability Pact.
([126]) FAC July 2015 Recommendations.
([127]) As stipulated in the Austrian Stability Pact and linked legislation.
([128]) Outlined in article 3 of the Austrian Stability Pact and specifically references in the FAC mandate.
([129]) See e.g. FAC December 2018 Recommendations.
([130]) See e.g. FAC December 2019 Recommendations.

and Statistics Austria and the Court of Audit, on the other.

Overall, the range of tasks covered by the Austrian IFIs is widest in the EU. The European Commission's Scope Index of Fiscal Institutions (SIFI) measures the width of the mandate of IFIs carrying out EU-mandated tasks. The FAC has a relatively high ranking (8th out of 33), but from a country perspective Austria comes out on top, when WIFO is also taken into account (see Graph 3.5). It is noteworthy that the FAC has a relatively small support staff given its wide mandate and the additional complexity of applying fiscal rules at sub-national levels.

Graph 3.5: **Scope Index of Fiscal Institutions (SIFI) country scores, 2018**



(1) The SIFI index aggregates tasks performed by EU IFIs. The relevant scores are adjusted with a 'legal force coefficient' in order to capture the elements of the official mandates. The scores are then weighted so that tasks stemming from the EU legislation carry greater importance. Country scores combine the coverage of tasks by national IFIs. The score ranges from 0 to 100 (full coverage).
Source: European Commission's Fiscal governance database

Part of the FAC's mandate is to submit an annual report to the Ministry of Finance. In practice, the Fiscal Council publishes two flagship reports each year: the *Fiscal Rules Compliance Report* in May and the *Public Finance Report* in December. Both follow key dates in the European Semester: the stability programmes (SP) and the draft budgetary plans (DBP). They provide policy advice for the different levels of government and indicate risks of non-compliance with national and EU fiscal rules. While no explicit comply-or-explain principle is enshrined in the legislation, the Ministry of Finance has formally committed to issue public responses to the relevant FAC's assessments. The European Commission deemed the arrangement sufficient when it assessed the country's compliance with the requirements outlined in the Fiscal Compact ([131]).

The FAC's analysis and recommendations are widely discussed by the authorities and also disseminated to the public. Its reports are submitted to the Ministry of Finance and the Parliament, where they are discussed in the Budget Committee. The FAC issues press releases, short summaries and presentations on its flagship reports and staff working papers. It organises one or two workshops per year as another means of spreading its research findings and recommendations to relevant stakeholders. The FAC also holds regular meetings with representatives of public authorities to discuss their recommendations. This is particularly important given the strongly federal system in Austria and its budgetary implications.

FAC recommendations have played an influential role in the policy debate. They regularly contain warnings if the government is deemed not to fully comply with the fiscal rules and point out downward risks of over-optimistic fiscal projections. They are underpinned by the Council's own budgetary forecasts, which have been comparatively accurate in recent years ([132]).

The FAC regularly takes a critical position on the government's budgetary forecasts. This usually pertains to different expectations as regards public revenues and expenditures, or diverging assessment of the impact of newly budgeted fiscal measures. The FAC's annual reports present the underlying macroeconomic forecasts, as produced independently by the WIFO, but do not contest them. At the same time, the FAC is in charge of providing regular *ex post* accuracy evaluations of the macroeconomic forecasts as required by the

([131]) See the Commission's 2017 report on the Austrian transposition arrangements.

([132]) The FAC's budgetary forecasting accuracy has been good. For 2014-2017, it overestimated the deficit by 0.4% on average (t and t+1), which is of a size similar to the Ministry of Finance's and the European Commission's forecasting errors. For in-year budgetary forecasts, the FAC has outperformed the Ministry (see FAC press statement of September 2018))

Budgetary Frameworks Directive ([133]). WIFO forecasts tend to be very close to those of the other major forecasting institute, the Institute for Advanced Studies. In fact, the WIFO and the Institute present their projections at a joint press conference. ([134])

Recurring FAC policy recommendations have stimulated intensive debate on important issues. The proposals range from reforms to address the fiscal implications of an ageing society, boosting investment, and the quality of public finances to very specific shortcomings in legislation such as discrepancies between control account and SGP thresholds ([135]). More broadly, the FAC has issued recommendations to review the allocation of policy competences as well as revenue and expenditure among different levels of government. Recent reforms have gone in this direction ([136]), although important elements of these reforms have been dragged on and eventually interrupted by the snap elections of September 2019.

The FAC has long advocated simplification of the national fiscal rules. The application of the rules to regional and local authorities imposes a large burden on them, which could be reduced while preserving the spirit of the rules. The commonly agreed interpretation of the Stability Pact reached at the end of 2018 was viewed as a first step, but the Austrian fiscal framework remains highly complex ([137]).

These issues have certainly posed challenges in the exceptional year of 2020. The FAC voiced its support for the government's measures during the Covid-19 pandemic, which allowed automatic stabilisers to function without obstruction and introduced supplementary emergency fiscal measures. The FAC cautioned against pro-cyclical fiscal stances going forward and noted some potential obstacles to the expansionary fiscal measures to the extent needed ([138]). It was supportive of the activation of the severe economic downturn and national escape clauses. At the same time, the FAC doubled down on its recommendations for structural reforms to enhance growth potential and ensure fiscal sustainability over a longer time horizon. The significance of these issues was underscored by the release of the FAC's first Fiscal Sustainability Report in September 2021 ([139]) (scheduled to be updated every three years going forward).

3.3.2. Italy

Like many EU Member States, Italy has chosen to put a single IFI, the Parliamentary Budget Office (PBO), in charge of the EU-mandated IFI tasks. The PBO was established by constitutional legislation in 2012 ([140]) and it became operational in 2014. Its creation follows on the heels of the European economic governance reforms over 2011 and 2013, but debate was already ongoing on the need for an independent support body within the Parliament (across both chambers ([141])) to provide technical expertise and to act as a fiscal watchdog. The decision to assign the task of fiscal surveillance to the PBO is an effective method of ensuring democratic legitimacy through parliamentary oversight.

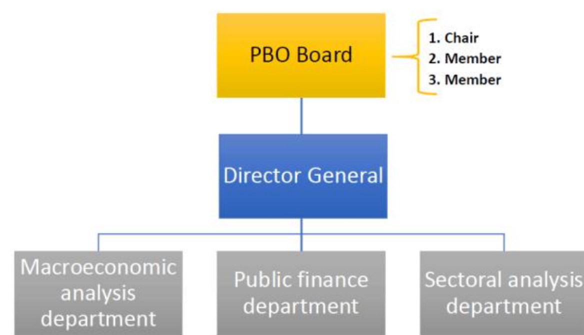
The PBO's independence is safeguarded in several ways. Firstly, Italy is one of the few EU countries where the IFI is not a fiscal council or national audit office, but instead hosted in the national Parliament. The PBO is thereby anchored into the framework of a bicameral parliament representing various political parties and interests. Secondly, the PBO's independent status is enshrined in constitutional law. Thirdly, in order to avoid a conflicts of interests, PBO's Board members are barred from taking up other professional posts in parallel. Lastly, the PBO is guaranteed by the establishing law ([142]) an annual budget of €6 million, financed equally by the two chambers of Parliament. The PBO's budget outstrips those of most other EU IFIs, which have median budget resources of close to €1 million a year ([143]).This is partly due to the fact that PBO board members are employed full-time. This is the case for only six out of 21 EU IFIs that are covered in the OECD

([133]) The first (and so far only) evaluation report was a commissioned study published in October 2018 (Schuster (2018)), which found that WIFO's GDP growth projections (both real and nominal) over 2005 and 2017 were not biased.
([134]) Of note, the previous President of the FAC, who served until early 2021, was also the Scientific Director of the Institute for Advanced Studies.
([135]) FAC September 2015 statement on the correction mechanism.
([136]) Fiscal sharing agreement (2017) and federalism reform linked to the *Österreichkonvent*.
([137]) FAC December 2018 Recommendations.
([138]) For example the interplay between the control accounts and the escape clause.
([139]) FAC's first Fiscal sustainability report.
([140]) Constitutional law no. 1, article 5.1 (f), amendment 20 April 2012.
([141]) Separately, the Chamber of Deputies and the Senate already benefited from specialised budgetary support units (the State Budget Department and the Senate Budget Service).
([142]) Law 243/2012 (Article 19).
([143]) Calculation based on OECD IFI database.

database, but follows one of the OECD recommendations for the ideal IFI design. ([144]).

The PBO is led by a small collegial governing board (see Graph 3.6), consisting of a President and two other members, who are all appointed for a six-year non-renewable term. This period is longer than the Italian electoral cycle, which functions as a further safeguard of independence.

Graph 3.6: **Organisation of the Parliamentary Budget Office (PBO)**



Source: PBO, https://en.upbilancio.it/organization-chart/

The Parliament is in charge of appointing the board members, but the process can be lengthy. The presidents of the Senate and the Chamber of Deputies appoint the Board members in agreement. They have to draw the members from a shortlist of ten candidates ([145]) approved by the parliamentary budget committees of the two chambers. Although this procedure was meant to reinforce PBO's independence, since it requires broad political consensus, the need to reach a qualified majority on a list of ten candidates can constitute a significant hurdle (depending on the composition of Parliament).

Given the administrative constraints faced by an interim board, the recent failure to appoint new members in a timely fashion has jeopardised business continuity. The first appointment process had already been lengthy ([146]). That first cycle started in April 2014 and should have come to an end in 2020. However, at the cut-off date of this report, the process of appointing replacements to the original board members has stalled. The outgoing board continues to fulfil its tasks, e.g. the President presented the usual reports to the Parliament during this interim period. The legislation does not lay down a timeframe by which new appointments must take place or provide explicit guidance on interim solutions as in the case of Austria. Political ploys or even a leadership vacuum could seriously undermine the effectiveness and ultimately the independence of the PBO.

In line with its budget, PBO's staff is among the largest of EU IFIs. Its establishing law provides for a staff of up to 40 employees ([147]), budget permitting. Competent staff can be recruited freely. However, its initial staff was largely seconded from public authorities (central bank, Ministry of Economy and Finance and national statistical office). To date, recruitment has been modest with a staff of only 25 rather than the potential 40, also linked to constraints with available office space. The secretariat is headed by a Director General and made up of along three departments (macroeconomic, public finances and sectoral analysis). As a consequence of the delayed appointment of new board members, the current Director General serves on an interim basis (since September 2020), together with several other senior managers, which poses formidable human resource management issues.

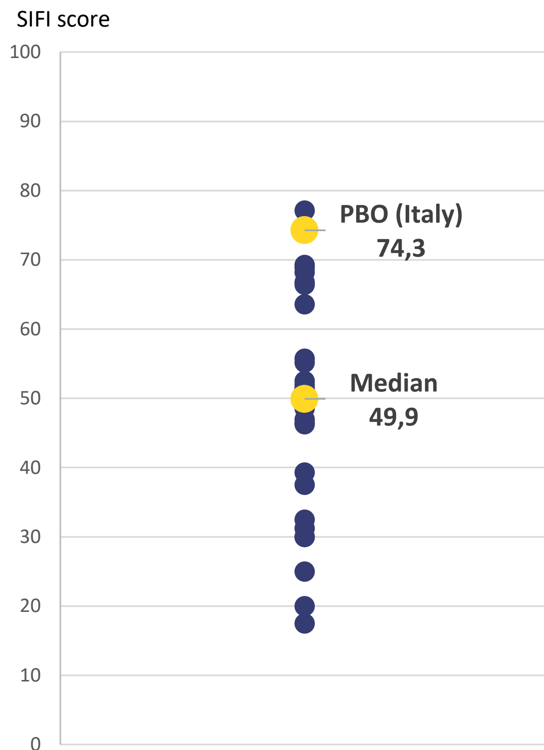
The PBO has legally guaranteed access to data and has regular exchanges with other relevant entities to obtain additional information. It cooperates with other institutions working on fiscal policy surveillance and public authorities to draw on their expertise and information. The establishing law grants the PBO in principle access to databases with relevant information on public finances and macroeconomic developments ([148]). Moreover, the PBO has concluded several cooperation agreements, most notably with the Ministry of Economy and Finance and the national statistical office to obtain timely macroeconomic and budgetary data and information on the underlying methodology ([149]). The combination of formalised and negotiated access to data conforms to the best practice in this field.

The PBO has a wide range of tasks that go beyond the minimum of the European legal requirements. In fact, the Commission's SIFI index ranks the PBO as the second-highest individual EU IFI in

([144]) Idem.
([145]) Members are supposed to have proven their independence and expertise in the relevant fields. Unlike in Austria, they do not have to be nationals, though so far with the appointment of the first leadership team, this has been the case.
([146]) OECD's (2015) case study on the PBO.
([147]) For the first three years the cap on staffing was set at 30.
([148]) Article 18(6) of law 243/2012.
([149]) The cooperation agreements concluded by PBO are all available at its website.

terms of the scope of its tasks (see Graph 3.7). These tasks include, most notably, monitoring compliance with national and EU rules and endorsing the official macroeconomic forecasts (see Graph 3.8 for a detailed list).

Graph 3.7: **SIFI institution-specific score, 2018**



See the explanatory note for Graph 3.3.
Source: European Commission's Fiscal governance database

The PBO is tasked to endorse the government's macroeconomic forecasts in the context of the SP and the DBP. In practice, the PBO sends a letter with its verdict, which is published on its website [150].The endorsement involves a formalised two-step approach: in the first step, the PBO separately validates the official no-policy change or trend macroeconomic trajectory. In the second step, the policy scenario, which includes the new policy measures and their impacts, is scrutinised for endorsement. In its analysis, the PBO uses its own macroeconomic projections based on a fully-fledged model; and as an additional safeguard, the assessment incorporates comparison with forecasts from four other research institutes, included in the PBO panel [151].

The Italian endorsement process could be regarded as an example of good practice, in particular its multi-step approach, whereby the official no-policy-change scenario is assessed first and only then the policy scenario. In case of differing views as to the country's growth prospects, this sequencing clarifies helps to clarify the source of disagreements, and to reconcile positions. In addition, the PBO's own macroeconomic projections serve as a pre-commitment device in buttressing the endorsement process, which also benefits from the expertise of other research bodies.

Graph 3.8: **Tasks of the Parliamentary Budget Office (PBO)**

Source: PBO, https://en.upbilancio.it/about-the-pbo/

The PBO has been outspoken in its criticism of the government's forecasts and budgetary impact assessments. There have been instances (both for the trend and the policy scenarios) in which following critical observations by the PBO on the optimistic figures, the government adjusted its projections before final submission. The PBO's vigilant approach has led to two formal non-endorsements. First, in autumn 2016, the PBO did not validate the first version of the macroeconomic projections underpinning the 2017 national budget bill. The government subsequently revised its macroeconomic projections before the submission of its DBP to the EU institutions. [152] Second, in October 2018, the PBO sent a negative validation letter to the government since the macroeconomic policy scenario underlying the 2019 DBP was

[150] For a detailed overview, see the description of the process on the PBO's website.
[151] Centro Europa Ricerche, Oxford Economics, Prometeia and REF.ricerche.

[152] See the PBO press statement about the lack of validation, and thereafter its endorsement letter on the revised scenario.

assessed to be falling outside the accepted range for plausibility ([153]). Subsequently, the Commission assessed Italy's budget plans as being in particularly serious non-compliance with SGP rules, and requested the national authorities to submit a revised DBP ([154]). In response to the Commission's rejection and mounting pressure from the markets, the Italian government adjusted its forecasts, which in turn was found to be endorseable by the PBO ([155]).

The PBO is the only IFI in the euro area that issued non-endorsements of official macroeconomic forecasts since the introduction of this requirement in 2013. This certainly had a real impact on the public debate and – in conjunction with the Commission's negative decision and growing market pressure in the 2018 episode – contributed to downward revisions. These cases exhibit a prime example of IFI's importance in the assessment of macroeconomic forecasts to counter excessive optimism in budgetary forecasting and, by extension, to avert deviations from budgetary targets. The analytical robustness of the PBO's endorsement procedure, including the production of its own forecast serving as a benchmark, could be seen as factors empowering a national IFI to take critical decisions. Nonetheless, it is worth noting that, in spite of the sound endorsement process at the PBO, the official macroeconomic forecasts underpinning the government's budget still display an optimistic bias ([156]).

The PBO produces an array of publications each year. The flagship reports are linked to the SP (spring) and DBP (autumn) in which the PBO validates the macroeconomic forecasts and assesses compliance with the fiscal framework. The PBO presents its findings to the budget committees of the Parliament and occasionally holds dedicated press briefings shortly afterwards to engage a wider audience and foster public discourse. The budget committees may also invite the President to other meetings to present the PBO's perspective and share its analysis. The PBO also publishes focus reports, working papers and reports on recent economic developments to draw attention to important policies and trends as part of their mandate. This analysis can be initiated by an inquiry from the Parliament or on its own initiative (see open-ended task 8 in Graph 3.8).

The PBO is in charge of assessing the need to activate the correction mechanism. However, its assessment does not legally bind the government, though it is subject to the comply-or-explain principle (see also below discussion) and creates public pressure given the PBO's excellent outreach. The PBO also issues its assessments as to the eligibility of the activation of the exceptional circumstances clause (pioneered in early 2020 linked to the Covid-19 crisis). The Italian clause on exceptional circumstances follows the notion established in context of the SGP of an unusual event outside of the control of the government or severe economic downturn, which allows for a temporary suspension of the correction mechanism ([157]).

The comply-or-explain principle is in place but could, in theory, face obstacles. If the government does not follow the PBO's assessment in relation to the monitoring of numerical rules, it has to publicly justify its position, if at least one-third of the budget committees have supported its application. Hence, the use of the principle is not automatic as it requires a sufficiently large political support in the chambers for launching the procedure. At the same time, the Commission positively noted that the authorities have committed to issue a public statement in case of differences in the assessment ([158]).

The PBO's other activities include conducting policy costings, that scrutinise and potentially counter with the government's expectations, thereby mitigating an optimistic bias in the projected costs and/or revenues ([159]). On a related note, the PBO has recently started to provide independent technical analyses of economic and financial aspects of specific legislation at the request of the Constitutional Court. ([160])

([153]) The PBO's letter on non-endorsement of October 2018.
([154]) Commission opinion of 23.10.2018 on the Draft Budgetary Plan of Italy and requesting Italy to submit a revised Draft Budgetary Plan (C(2018) 7510 final)
([155]) PBO's letter of endorsement of December 2018.
([156]) Simple calculations show that the optimistic bias of Italy's official one-year ahead GDP growth projections, as measured by the mean forecast error, survived the introduction of the independent endorsement process (-0.58 for 2014-2019), but its magnitude was decreased compared to a previous period (-0.82 in 2000-2007). See also European Fiscal Board (2020b) for an analysis of forecast errors in medium-term fiscal plans.
([157]) See the Commission's 2017 report on the Italian transposition.
([158]) Idem
([159]) OECD IFI database.
([160]) See PBO's press statement on the first such collaboration.

4. ASSESSMENT OF THE FISCAL STANCE IN 2020

Highlights

- Policy guidance for 2020, issued in 2019, was underpinned by an expectation of solid growth. The EFB, the Commission and the Council were largely in tune in calling for a neutral fiscal impulse. The EFB cautioned that Member States' budgetary plans would lead to a moderately pro-cyclical fiscal impulse and that Member States facing sustainability risks should rebuild fiscal buffers.

- The Covid-19 pandemic and ensuing restrictions on economic activity drastically changed the outlook for 2020 and rendered previous guidance obsolete. Real GDP in the euro area decreased by more than 6% on the previous year.

- With the activation of the severe economic downturn clause in spring 2020, governments received additional flexibility under the Stability and Growth Pact (SGP) to respond to the health and economic crisis as they saw fit, while letting automatic stabilisers take effect.

- The overall budget balance for the euro area as a whole deteriorated from a modest deficit of less than 1% of GDP in 2019 to a deficit of nearly 7% in 2020. A large part of the overall budgetary support can be attributed to automatic stabilisers.

- Governments also took major stabilisation measures that are not directly captured in the deficit, but still helped stabilise economic activity, such as government guarantees and equity injections.

- Assessment of the discretionary fiscal impulse is more complicated than usual. The economic shock caused by the pandemic was unusually large and very specific in nature, thereby increasing the notorious uncertainty surrounding the estimates of economic slack used to strip cyclical components off the headline balance. Differences across alternative indicators are unusually large.

- For 2020, the structural primary deficit of the euro area is estimated at 2.1% of GDP. Since the structural primary balance was broadly neutral in 2019, the estimated discretionary fiscal impulse amounts to 2.5% of GDP. In contrast, the aggregate discretionary fiscal impulse, as measured by the expenditure benchmark or purely judgment based methods, was around 4% of GDP.

- The structural budget balance signalled a much smaller effect of new budgetary initiatives in 2020, mainly due to *ad hoc* changes (agreed by the competent Council committee) to the commonly agreed method for estimating potential output and the output gap. The changes widened the cyclical component and, by extension, compressed the discretionary part.

- From a stabilisation perspective, a large-scale fiscal expansion was justified in 2020. Given the deep recession, the high degree of economic slack and the pronounced uncertainty of the epidemiological and economic outlook, the euro area fiscal impulse was appropriate.

- A stark differentiation of Member States' contributions to the fiscal stance was less pertinent, since all countries were severely affected by the crisis. Nevertheless, the fiscal response varied across countries, reflecting the severity of the crisis, the sectoral composition of economies and availability of fiscal space going into the crisis.

- Sustainability concerns in some Member States were mitigated by prompt EU policy responses, in particular the ECB's latest asset purchase programme and swift agreement on a common fiscal response at EU level via the SURE and NGEU initiatives.

This chapter provides a backward-looking assessment of the euro area fiscal stance in 2020. The first section summarises and compares the Commission, Council and EFB guidance for the fiscal stance, on the basis of information available in 2019 and early 2020. The second section uses the latest information to discuss whether the observed fiscal stance was in line with the guidance and what would have been appropriate.

The EFB's assessment of the fiscal stance considers the need for fiscal stabilisation subject to sustainability constraints on public finances. A clear distinction has to be made between *fiscal stance* and *fiscal impulse* (see EFB (2021)). The discretionary fiscal stance is defined as the structural primary balance (SPB) in a given year and signifies the overall level of fiscal support provided by governments on top of automatic stabilisers. The annual change in the fiscal stance is referred to as the fiscal impulse; the discretionary component can also be measured by the expenditure benchmark (EB). The difference between the two notions is particularly important for clear messaging in times of crisis. For instance, a neutral fiscal impulse might nonetheless maintain a highly supportive fiscal environment, as a large part of the fiscal support introduced in previous years is carried over ([161]). In the following, the fiscal stance and fiscal impulse are analysed in the context of the extent and dynamic of economic slack in the economy.

4.1. GUIDANCE IN 2019 AND EARLY 2020

Guidance given in 2019 was underpinned by an expectation of solid economic growth for 2020. In fact, 2020 was predicted to be the 7th year of an unusually long economic upswing. While growth had slowed down slightly in 2019, the consensus view in spring 2019 was that it would rise again in 2020, to 1.5%. During the course of 2019 growth prospects turned somewhat less favourable due to rising global trade tensions and concerns over the impact of Brexit. The growth forecast for the euro area was revised down slightly to 1.2% (see Graph 4.1). The weakening of external demand weighed on industrial production and the view emerged that the impact would persist over the following years. In October 2019, in light of the updated growth outlook, the Eurogroup reiterated its determination to provide counter-cyclical fiscal support if further downside risks materialised. At the same time, major forecasters still estimated that the euro area economy would be operating above although close to capacity in 2020. The output gap was revised only marginally between spring and autumn, from +0.5% to +0.4% above potential.

In spring 2019, the EFB called for an aggregate neutral fiscal impulse for 2020 and warned that projections indicated the potential need for a mildly pro-cyclical fiscal impulse. The Commission's 2020 spring forecast estimated the euro area aggregate discretionary fiscal impulse at close to a third of a percentage point of GDP. This deterioration in the SPB was based on a 'no policy change' scenario. As available estimates pointed to no economic slack in the economy, the Commission also recommended a broadly neutral fiscal impulse, to be achieved by following the country-specific recommendations issued at that time.

In autumn 2019, the draft budgetary plans (DBPs) and the Commission forecast pointed to a deterioration of the SPB by around 0.5%, thereby consolidating the expectation of an impulse that, based on the information available at the time, would have been inappropriately expansionary ([162]).

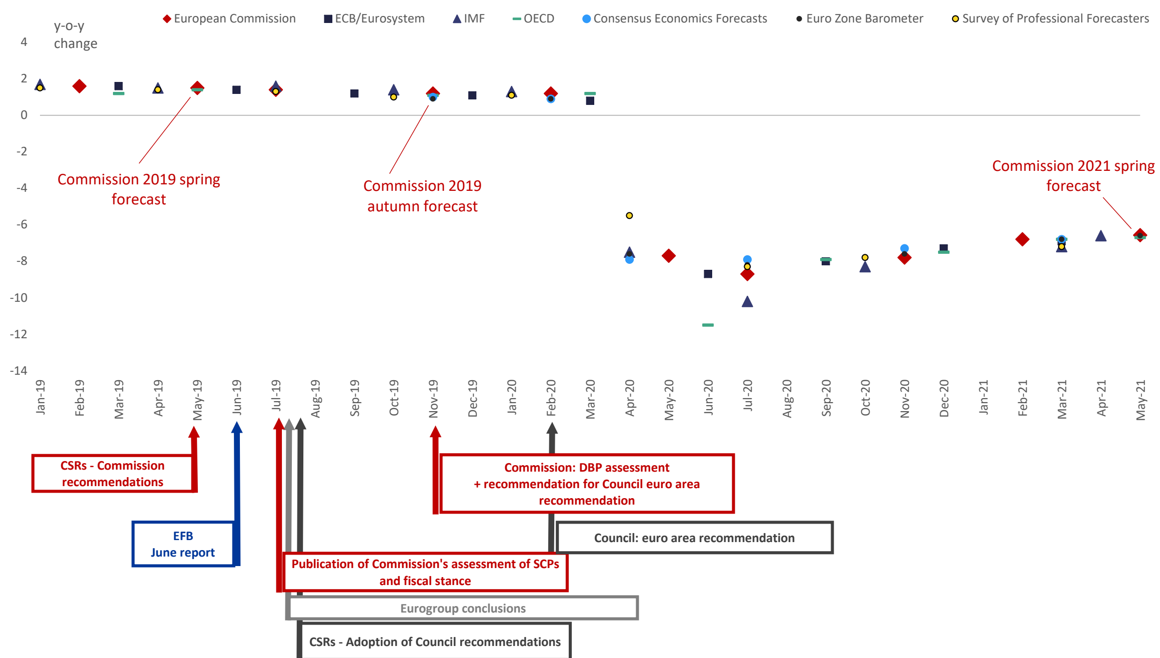
Like the Commission, the EFB (in its 2019 annual report) reiterated a point made in previous years, namely the need for Member States facing sustainability concerns to build fiscal buffers, while countries with fiscal space should use it to enhance their growth potential. The stability and convergence programmes (SCPs) indicated that Member States with fiscal space were in fact boosting investment, though some only used part of their fiscal space. However, countries below their medium-term budgetary objective (MTO), planned to make insufficient or no adjustment progress. More worryingly, some high debt countries were actually in danger of moving in the opposite direction, with a worsening of the underlying budgetary position. However, the Commission did not signal any case of serious non-compliance with the Stability and Growth Pact (SGP).

Overall, there was no major disagreement across institutions in 2019 as regards guidance for the euro area for 2020. Recommendations were for a

([161]) For a more detailed discussion, see the EFB's report on the assessment of the euro area fiscal stance (2021), Box 1.

([162]) Austria, Belgium, Portugal and Spain submitted plans based a 'no policy change' scenario, due to elections and an ongoing government formation process.

Graph 4.1: **Real GDP growth projections and guidance on the fiscal stance for the euro area in 2020**



(1) The ECB/Eurosystem and the OECD both report working-day adjusted growth rates, while the Commission and the IMF report unadjusted numbers. The other sources do not say whether they adjust growth rates for working days.
Source: European Commission, ECB, IMF, OECD, Consensus Economics, MJEconomics.

neutral aggregate fiscal impulse and better country differentiation. However, any advice was completely overtaken by the economic impact of the Covid-19 pandemic as of early 2020. A Commission Communication on 13 March encouraged Member States to do what was necessary to contain the crisis and limit the socio-economic effects ([163]). The Commission called for a series of relief measures and coordination at EU level (see Chapter 1). The activation of the SGP's severe economic downturn clause provided the necessary flexibility.

4.2. EX POST ASSESSMENT

The remainder of this chapter discusses whether, with hindsight, the fiscal stance was appropriate given the deep economic recession of 2020. Guidance will be addressed only briefly, since it became obsolete in the new circumstances.

Given the information available to EU institutions at the time, policy guidance was broadly appropriate, while the DBPs in autumn 2019 suggested some marginal deviation from guidance issued. However, due to the Covid-19 crisis, real economic growth in 2020 turned out close to 8 percentage points lower than expected in 2019 (Graph 4.1), thus requiring a fiscal impulse very different from that recommended previously.

The contingency recommendations for action in the event of downside risks had called for the use of discretionary fiscal policy to provide counter-cyclical support. Member States and the EU made good on that promise, though on a far larger scale than could have been anticipated.

The situation in 2020 was clear-cut. Euro area real economic output had contracted sharply. The pandemic-induced lockdowns and other restrictions affected economic activity and consumption. While the crisis heightened the notorious uncertainty around point estimates of real-time output gaps, there was no doubt that the level of economic activity in the euro area and the vast majority of its Member States fell well below the level of output consistent with stable inflation. As a result, a large-scale fiscal impulse was warranted to contain the crisis and stabilise the economy.

([163]) https://ec.europa.eu/info/sites/default/files/communication-coordinated-economic-response-covid19-march-2020_en.pdf

Box 4.1: **Guidance issued by the Commission, the Council and the EFB**

- **5 June 2019: Commission Communication on country-specific recommendations (excerpts)**

'It is crucial to raise potential growth and reinforce the fiscal space to counter future negative economic shocks. (…) Government debt is declining, but progress is uneven among Member States. Some have insufficiently taken advantage of the favourable cyclical conditions and low interest rates in recent years to rebuild fiscal buffers. (…) Member States with still high levels of public debt should continue to rebuild fiscal buffers. (…) Member States with adequate scope are also recommended to use fiscal and structural policies within the rules of the Stability and Growth Pact to increase public investment to support growth and facilitate economic rebalancing.'

- **1 July 2019: EFB June 2019 report (excerpts)**

'Based on announced policies, in 2020 the euro area fiscal stance ([1]) is expected to be on the expansionary side. (…) [T]he structural primary balance is expected to deteriorate by 1/3 of a percent of GDP on aggregate. (…) In an economy expected to operate at or above capacity, such a stance could turn out mildly pro-cyclical. (…) For 2020, the European Fiscal Board recommends a neutral fiscal stance in the euro area, with appropriate country differentiation. (…) [C]ountries that have not yet achieved their medium-term budgetary objective (MTO) need to progress towards it as required by the Stability and Growth Pact and those with very high debt need to reduce their debt steadily. By contrast, core Member States with large available fiscal space are advised to use more of it.'

- **26 July 2019: Commission overview of the 2019 SCPs and assessment of the euro area fiscal stance for 2020 (excerpts)**

'[I]n 2020 economic growth is set to return marginally above potential growth in a context of a very accommodative monetary policy. As a result, no stabilisation needs seem to emerge for 2020. Hence, fiscal sustainability concerns should prevail in those Member States where sustainability risks are high and public debts are not on a safe downward trajectory. Reducing large structural deficits should be the priority for highly-indebted countries. (…) The 2019 Stability Programmes point[s] to a broadly neutral fiscal stance for the euro area in 2020. The Commission 2019 spring forecast points to an expansionary euro area fiscal stance in (…) 2020. (…) An appropriate differentiation of national fiscal policies consistent with the proposed Country-Specific Recommendations would lead to a broadly neutral fiscal stance for the euro area in 2020.'

- **8 July 2019: Eurogroup, remarks Mario Centeno (excerpts)**

'There is broad consensus that for member states with high debt levels, there is a need to rebuild fiscal buffers. At the same time, countries who have already built such buffers, can prioritise investments, boost potential growth and tackle long term challenges. For 2020, based on current forecasts, appropriate and differentiated fiscal policies at the national level will lead to a broadly neutral fiscal stance for the euro area as a whole.'

- **9 October 2019: Eurogroup, remarks Mario Conteno (excerpts)**

'The Eurogroup (…) has been monitoring economic developments closely for several months and agreed to closely co-ordinate policies in case downside risks materialise. (…) [I]f there is a more marked downturn, we should not tighten our policies and make it worse. Where possible, our fiscal stance should be more accommodative.'

- **20 November 2019: Commission overall assessment of the 2020 DBPs (excerpts)**

'The European and world economies have weakened over the past year. (…) The aggregate euro area structural primary balance (…) continues to be in surplus but is projected to decrease by 0.4% of potential GDP in 2020, pointing to a slightly expansionary stance. Member States with fiscal space (…) have engaged in a more expansionary fiscal policy also conducive to investment. (…) At the same time, according to the Commission 2019 autumn forecast, some of their fiscal space will be left unused. Given the extent of their fiscal space, those euro-area Member States should stand ready to continue using it. By contrast, some of those euro-area Member States with no fiscal space plan either no meaningful fiscal adjustment or a fiscal expansion in 2020.'

([1]) In this box the term fiscal stance follows Commission language and refers to the change in the structural primary balance. This is in contrast to the rest of the report, where it refers to the level of the structural primary balance.

(Continued on the next page)

Box (continued)

- **17 December 2019: Commission recommendation for a Council Recommendation on the economic policy of the euro area (differences to Council text are in italics) (excerpts)**

Recitals: 'The euro area fiscal stance is expected to be broadly neutral to slightly expansionary in 2020 and 2021. At the same time, national fiscal policies remain insufficiently differentiated *in light of the available fiscal space in Member States. In case of a worsening outlook, achieving a supportive fiscal stance at the aggregate level that focuses on productive spending, while pursuing policies in full respect of the Stability and Growth Pact, taking into account country-specific circumstances and avoiding pro-cyclicality to the extent possible, is important to sustain growth in the short term.'*

Recommendation: 'In Member States with high debt levels, pursue prudent policies to put public debt credibly on a sustainable downward path. In Member States with a favourable fiscal position, use it to further boost high-quality investments. In case of a worsening outlook, deliver a supportive fiscal stance at the aggregate level, while pursuing policies in full respect of the Stability and Growth Pact, taking into account country-specific circumstances and avoiding pro-cyclicality to the extent possible, and stand ready to coordinate policies in the Eurogroup.'

- **17 December 2019: Accompanying Commission staff working document (excerpts)**

'The euro area fiscal stance is expected to remain broadly neutral to slightly expansionary in 2019 to 2021 but national fiscal policies are not expected to be appropriately differentiated. The change in the structural balance, points to a broadly neutral fiscal stance in 2019, 2020 and 2021 by around 0.1 or 0.2 percentage points each year in a no-policy change scenario. (…) While Member States with fiscal space are forecast to use part of it in 2020 to support economic growth prospects, broadly in line with the recommendations addressed to them, a number of highly-indebted Member States are not expected to reduce their structural deficits.'

- **18 February 2020: Council Recommendation on the economic policy of the euro area (differences to Commission text are in italics) (excerpts)**

'The euro area is continuing its expansion, but with interconnected risks to the outlook and uncertainty on the horizon. (…) The euro area fiscal stance is expected to be broadly neutral to slightly expansionary in 2020. At the same time, national fiscal policies remain insufficiently differentiated. (…) *If downside risks were to materialise, fiscal responses should be differentiated, aiming for a more supportive stance at the aggregate level, while ensuring full respect of the SGP. Country-specific circumstances should be taken into account and pro-cyclicality avoided, to the extent possible. Member States should stand ready to coordinate policies in the Eurogroup.*'

- **13 March 2020: Commission Communication on the coordinated economic response to the COVID-19 outbreak (excerpts)**

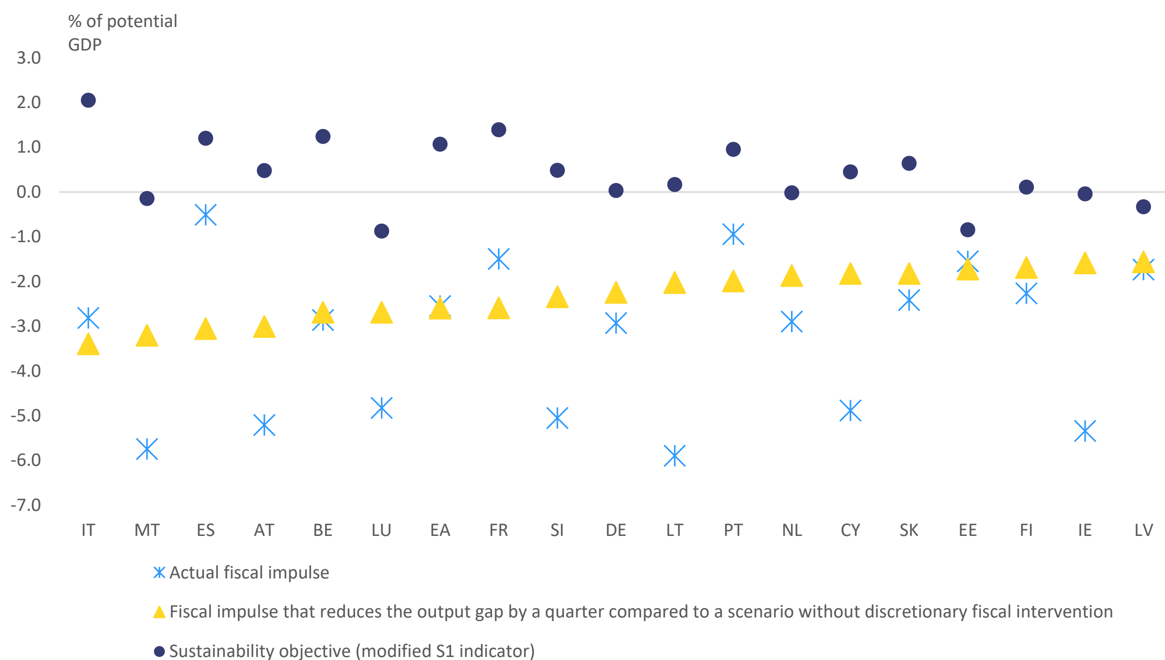
'In the face of the macro-economic and financial impact of COVID-19, the economic policy response should be taken boldly and in a coordinated manner. (…) The Commission will propose to the Council to apply the full flexibility existing within the EU fiscal framework, with a view to helping Member States to address the COVID-19 outbreak and deal with its fallout. (…) The Commission stands ready to propose to the Council that the Union institutions activate the general escape clause to accommodate a more general fiscal policy support.'

- **20 March 2020: Commission Communication on the activation of the general escape clause of the Stability and Growth Pact (2) (excerpts)**

'The EU must continue to respond quickly, forcefully and in a coordinated manner to this fast-evolving crisis. (…) [T]he President of the Commission announced the imminent activation of the so-called general escape clause. (…) The upcoming assessment of Member States' stability and convergence programmes, the spring forecast, and the subsequent Commission's proposal for country-specific recommendations by the Council will provide an opportunity to ensure such necessary coordination and to set the guidance to achieve an appropriate supportive fiscal stance at the national and aggregate level.'

(2) Although used in public discourse, the term 'general escape clause' is not mentioned in EU legislation underpinning the Stability and Growth Pact. It refers to a clause that makes allowance for extra flexibility on a country-specific basis in the event of a severe economic downturn in the euro area or the EU.

Graph 4.2: **Overview – National and aggregate discretionary fiscal impulse in 2020, stabilisation and sustainability**



(1) Countries are ordered by decreasing stabilisation needs.
(2) Stabilisation: A fiscal impulse of zero is considered to be appropriate when the output gap recently changed signs or is expected to narrow at a sufficient pace. If not, the stabilisation point shows the discretionary fiscal impulse that reduces the output gap by 25% compared to the output gap in a scenario without discretionary fiscal impulse, using a uniform fiscal multiplier of 0.8. Studies have shown that in normal times fiscal multipliers often range between 0.5 and 1.0, but that they can reach values above 1.5 during downturns (see e.g. Ramey 2019). In the Commission's Report on public finances in EMU 2019, the baseline scenario used a time-invariant multiplier of 0.7.
(3) Sustainability needs are assessed using the Commission's S1 indicator. S1 measures the total cumulative adjustment needed in 2020-2024, with the last SPB structural primary balance being maintained for another 10 years, to bring the debt-to-GDP ratio to 60% by 2034. For countries where the S1 is positive, we assume that sustainability needs are addressed by implementing S1 in a uniform manner over 5 years, i.e. one fifth of S1 is implemented in 2020.
(4) In countries where S1 is negative, debt is already below 60% of GDP or expected to fall below it by 2034, so no additional consolidation is needed.
(5) Greece is omitted, as the Commission has not published S1 for Greece in the latest Debt Sustainability Monitor (DSM).
(6) The sustainability estimate for the euro area is approximated by weighting countries by debt levels (in euro).
Source: European Commission, own calculation.

Graph 4.2 shows the discretionary fiscal impulse needed to reduce the slack in the economy by 25% compared to what it would have been without fiscal intervention (i.e. a neutral discretionary fiscal impulse). In normal times, narrowing the output gap by 25% may be considered a moderate effort, but the large output gap expected in 2020 meant that it was a considerable undertaking. For the euro area, it would have entailed a discretionary fiscal impulse of nearly 2.5% of GDP.

Overall, the sharp recession, large degree of economic slack and high level of uncertainty warranted a fiscal expansion of historic proportions.

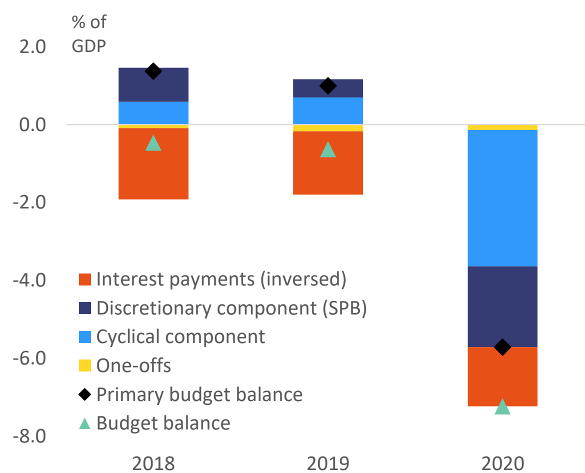
Was the actual aggregate fiscal stance appropriate?

Automatic stabilisers and monetary policy can cope with cyclical movements in normal times, but the scale of the crisis warranted an additional discretionary fiscal response. The activation of the severe economic downturn clause paired with accommodative monetary policy allowed governments to pursue a highly expansionary fiscal stance in response to the recession. In the course of 2020, the euro area headline deficit ratio rose from 0.6% to 7.2%. It was the largest fiscal expansion in the history of the euro area. On top of this direct support to aggregate demand, governments offered liquidity support to the economy, which is estimated in the double digits as a percentage of GDP (see Chapter 1).

Below we assess the discretionary fiscal stance and fiscal impulse, but it should be stressed that automatic stabilisers played a crucial role in limiting the fall in income, and by extension, aggregate demand. The deficit increase in 2020 stemmed in large part from automatic stabilisers (164) (Graph 4.3).

(164) Using a bottom-up approach to determine discretionary measure, the share of automatic stabilisers would increase to three fifths.

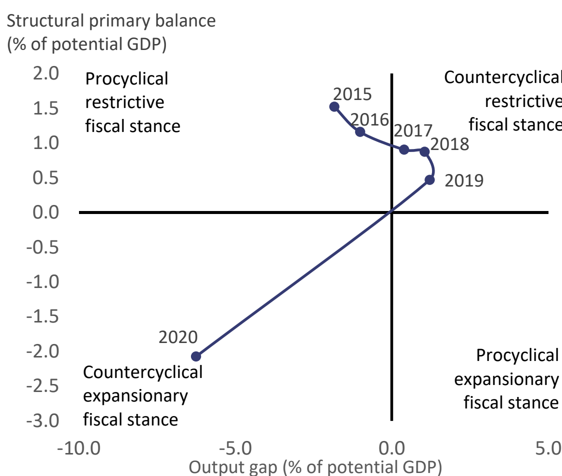
Graph 4.3: **Breakdown of euro area budget balance**



(1) SPB stands for structural primary balance.
Source: European Commission.

The euro area fiscal stance in 2020 was broadly appropriate and of a reasonable order of magnitude. The SPB deteriorated from a surplus of 0.5% of GDP in 2019 to a 2.1% deficit in 2020 (Graph 4.4). This expansionary fiscal impulse is consistent with the large increase in slack in the economy.

Graph 4.4: **Euro area fiscal stance**

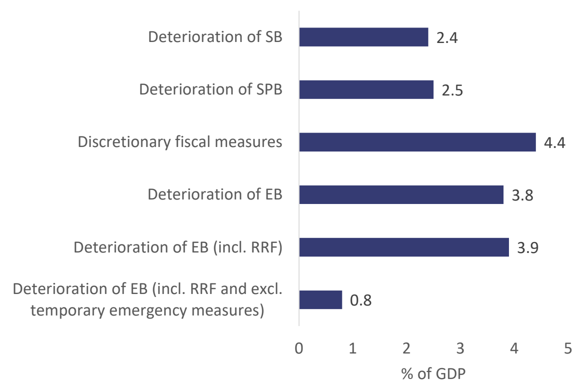


Source: European Commission.

An alternative metric to assess the discretionary fiscal stance or fiscal impulse is the expenditure benchmark (EB) approach. It measures observed expenditure growth relative to the medium-term potential economic growth rate and is netted of discretionary revenue measures (see glossary). For 2020, it returns a significantly more expansionary fiscal impulse of close to 4% of GDP (Graph 4.5). To a large extent, the difference *vis-à-vis* the SPB is explained by the *ad hoc* adjustments to the commonly agreed method for estimating potential output and the output gap (see Chapter 2). The *ad hoc* adjustment involved a much wider output gap in 2020 and hence a smaller structural component of the budget.

In its 2021 spring package, the Commission used a modified indicator to assess the discretionary fiscal impulse. During the pandemic, governments have taken a series of emergency fiscal support measures, which are largely temporary by design. The Commission has advocated excluding such measures, on the basis that they are considered to obfuscate the analysis and to have a negligible impact on aggregate demand. Their exclusion results in a slightly expansionary discretionary fiscal impulse in 2020 and indicates a more expansionary fiscal impulse in the following years.

Graph 4.5: **Euro area fiscal impulse in 2020 according to different metrics**



(1) SB stands for structural balance; SPB stands for structural primary balance; EB stands for expenditure benchmark; RRF stands for Recovery and Resilience Facility.
Source: European Commission, own calculation.

The EFB maintains its preference for unadjusted [165] SPB and EB indicators for at least two reasons:

- There is no perfect measure of the discretionary fiscal stance and fiscal impulse. Any measure offers only an approximation of the impact on aggregate demand stemming from deliberate measures adopted by governments. Expert judgment is needed to make a meaningful assessment of alternative indicators; and
- while the different emergency measures may have different multiplier effects, it seems unwarranted to assume they have no effect on aggregate demand in general.

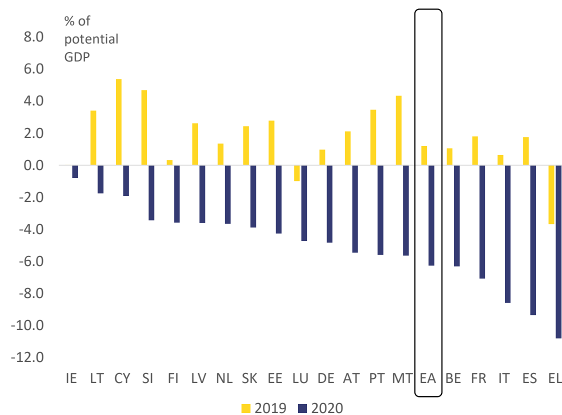
[165] I.e. not excluding crisis-related emergency measures.

- A plethora of indicators may be used to evaluate the appropriateness of the euro area discretionary fiscal stance, but they all point to a strong expansionary impulse in 2020.

Was the country differentiation appropriate?

The pandemic affected Member States with varying intensity and at different stages, though all except Ireland experienced a deep recession and all faced considerable downside risks. Output fell sharply below potential in all euro area countries. However, in Spain the negative output gap widened by 11.1% of GDP, while Ireland experienced a modest rise (0.8% of GDP) (Graph 4.6).

Graph 4.6: **Impact of crisis on slack in the economy**

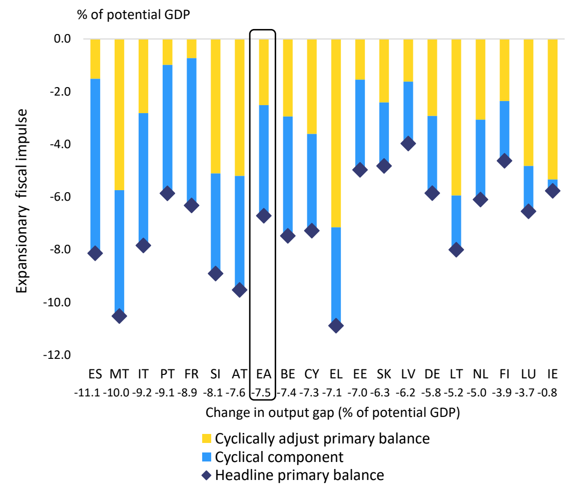


(1) Slack in the economy is estimated by the output gap as % of potential GDP.
Source: European Commission.

Covid-19 inflicted a common shock to the euro area and all governments reacted with a large fiscal expansion to contain the pandemic and support households and firms.

Member States most affected also provided the most extensive overall fiscal support, largely due to the effect of automatic stabilisers. The correlation is less clear for the discretionary fiscal impulse and the depth of the recession. The former was driven by the impact of the crisis, but also to some extent predicated on available fiscal space going into the crisis.

Graph 4.7: **Fiscal impulse and cyclical conditions in euro area Member States in 2020**



Source: European Commission.

In normal times, Member States with limited or no fiscal space are generally asked to run more prudent fiscal policies and to contribute less to the euro area fiscal stance. The pandemic shifted the focus for all governments towards stabilising their economies in the face of the health crisis and the impact of the lockdown measures. As a by-product of the ECB's measures, sovereign borrowing costs were kept historically low. This effectively reduced sustainability constraints, at least for the time being. Overall, governments pulled in the same direction and created positive fiscal spill-overs to the benefit of the euro area. Following recovery from the crisis, sustainability considerations and a more differentiated contribution of the euro fiscal stance are bound to become more pronounced again.

5. FUTURE EVOLUTION OF THE EU FISCAL FRAMEWORK

Highlights

- The EFB welcomes the relaunch of the economic governance review and the declared aim to build consensus in time for 2023. We believe reforms are needed.

- Reforming the fiscal framework remains a far better approach than discretionary and hard-to-predict tweaks in the implementation of the existing rule book.

- Reforming the framework in time would serve the interests of both: Member States keen to avoid a further erosion of the rules-based system, and those willing to exploit flexibility in a productive manner. A less predictable fiscal policy only makes sudden risk repricing by financial markets more likely.

- Our proposal revolves around one primary objective: a sustainable debt dynamics; one main policy instrument: an expenditure benchmark; and one escape clause to be invoked on the basis of independent economic analysis.

- While such a reform does not require Treaty change, revisions in secondary legislation or in implementation are needed. The 'satisfactory pace' in debt reduction should be country-specific while strengthening commitments by national authorities. Reliance on real-time output gaps should be reduced. Surveillance should be centred on gross policy errors, rather than on micromanaging annual performance.

- The scope for flexibility should be constrained. Routine channelling of the outcome of bilateral negotiations between the Commission and national governments through the Council should be replaced by a well-designed escape clause. Ideally, independent fiscal institutions should play a greater role in a process prone to counterproductive political bargaining.

- The 3% of GDP deficit ceiling is a useful backstop against unsustainable debt dynamics. The headline deficit is observable, well understood by the general public, and uniformly applicable to all EU countries. It should remain a vehicle for implementing the EDP.

- Three additional elements would be desirable to make the EU fiscal framework both leaner and better: a central fiscal stabilisation capacity; a safeguard against counterproductive spending cuts (i.e. public investment and the like); and a greater focus on macroeconomic imbalances

- When monetary policy is constrained, a joint fiscal capacity provides additional macroeconomic policy support. EU borrowing would facilitate such stabilisation. Conditioning funding to compliance with the fiscal rules could further encourage fiscal responsibility.

- Efforts to strengthen investment expenditure in the regular EU budget from 2027, possibly expanded through national envelopes as the EFB has proposed earlier, would seem preferable to blurring conventional fiscal indicators with exemptions for high-priority investments from national deficits.

- The Macroeconomic Imbalance Procedure (MIP) should fulfil its original promise to better integrate fiscal policy recommendations in the broader macroeconomic picture.

- While greater reliance on country-specific guidance by national fiscal councils can help, the latter remain currently too heterogeneous to consistently shape the conduct of fiscal policy. The Commission's and the Council's role in monitoring performance and formulating recommendations will remain essential.

- In the absence of a substantive reform of the EU fiscal rules, the Commission should clarify early on how it intends to implement current rules in the post-Covid context.

5.1. SOME PRELIMINARY CONSIDERATIONS ON REFORM VS CONTINUITY

The Covid-19 pandemic and the recovery from it should trigger a fundamental debate about the design and implementation of the EU rules-based fiscal framework prevailing when the severe economic downturn clause is deactivated. There is, in the light of the strength of the recovery, near certainty that this will happen with effect from 2023. In her State of the Union address to the European Parliament on 15 September the Commission President announced that the discussion on the economic governance review would be relaunched: that duly happened on 19 October. She also stressed that the aim was to build consensus well in time for 2023. The EFB welcomes the relaunch and ambitious timeline: we have long advocated both.

However, reluctance to engage in it remains widespread among Member States. Some regard an early return to the pre-pandemic framework, more rigorously complied with, as desirable; others find that framework outdated to such an extent that radical reform, including legislative steps, has become a prerequisite for a return to rules-based governance. This divergence of views is a deterrent to trying to build a convergence of perspectives; stalled negotiations would not only block reforms, but also further weaken any residual respect for the existing framework.

The EFB is mandated to monitor implementation of the existing fiscal rule book, and may propose ways of reforming the latter. Hence, we see a special responsibility to try to outline an intermediate position between the above views with their conflicting emphases on continuity and reform. The window of opportunity for trying to reach some common understanding among Member States on at least the principles of the future framework will remain open for only a limited period. Time is running short.

The main purpose of this chapter is not to outline in detail the design of the future fiscal framework; that would be premature. Nor do we advance proposals that require Treaty changes. We see our current task as one of providing an outline of how a balance might be found between reforms and continuity in the light of what we believe are current perspectives both on the role of fiscal policies and on what seems realistic in terms of the experience accumulated over three decades. That experience inspires a degree of humility in two dimensions: above all recognition of the limits to what a rules-based fiscal framework can achieve in a European Union that remains economically and politically very heterogeneous; but also the need to discard policy recommendations based on indicators too uncertain to rely on.

The EFB has in its reports over the past three years made a number of proposals to update and simplify EU fiscal governance. In the following sections we summarise them in the belief that several of them have, if anything, gained greater relevance and wider backing in the post-pandemic environment than could have been anticipated when they were first advanced in less turbulent times. But before turning to our proposed key principles of future fiscal governance, it may be helpful to recall the purposes that inspired the provisions in the Maastricht Treaty three decades ago - obviously from the perspective of how they look today.

The focus in 1991 was on the major institutional innovation of moving towards a single currency and a single central bank, but great attention was also devoted to the fiscal underpinnings for monetary unification. National governments were to retain, in respect of the principle of subsidiarity, sovereignty over the composition of expenditures and revenues, the core element in the domestic budgetary process. But aggregate outcomes were to be subject to guidelines (or ceilings) for budget deficits and a longer-term norm for public debt.

This, only mildly intrusive, strategy was chosen to minimise the risk of undesirable spill-overs from the accumulation of large public debt. It was seen as unlikely that the loss of exchange-rate changes as a policy instrument - or rather as the escape clause, which devaluations had provided in the past - would in itself provide sufficiently strong signals to governments that they would, from the start of monetary union, face a firmer long-term budget constraint. And it was accepted that financial market discipline could not be relied upon to operate in a gradualist way to support fiscal prudence; as the Delors Report put it: "The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive." [166] These deficiencies of foresight by policy makers and of financial market discipline

[166] Paragraph 30 of the Delors report: http://aei.pitt.edu/1007/1/monetary_delors.pdf

have been strongly confirmed by experience since 1991. This implies an important role for guidelines or norms to be agreed and monitored at the EU level; otherwise, negative spill-overs across borders from precarious public finances were likely to arise. This was – and remains – the core justification for a rules-based fiscal framework at the EU-level, even as the economic environment evolves and makes a reassessment of risks inevitable.

The upper guideline for deficits of 3% of GDP, respectively the norm for debt of 60%, approximated average performance of Member States at the end of the 1980s. In that sense these reference values were not as arbitrary as they appear; their purpose was simply to suggest to governments that it could be unsafe to go further into deficits and debt; risks of unsustainable public finances would then be likely to grow, triggering capital outflows and limiting access to external financing. The numbers were chosen to provide guidance for governments to react in time - not automatically, but with political judgment by the ECOFIN Council - and for financial markets to take notice of the indicators provided. Since two Member States carried in 1991 a legacy of debt ratios of more than twice the norm, flexible implementation was required; a 'satisfactory pace' of approaching the debt norm would have to be enough. The emphasis was on a long-term perspective on public finances as sustainable, and on the correction of 'gross errors' in the adjustment process, rather than on detailed, intrusive prescriptions for annual policy performance.

The risk of negative financial spill-overs between EU countries provided the basic argument for fiscal rules, but there was a second more national element at work in making agreement on them possible. Finance Ministers in 1991 broadly welcomed a reinforcement of their respective national roles through a mild external reminder - an 'anchor' – to bring into the national budgetary process a dampening of an apparently inexorable tendency for the growth of expenditures to outstrip that of revenues. National ownership was not absent in the early stage of EU fiscal governance after Maastricht, and it did not seem to be in conflict with constructive calls for prudence from the European level.

Prudence was seen in Member States with precarious public finances as an acceptable counterpart to monetary unification. The latter was expected to deliver lower and more stable inflation with more moderate, growth-friendly interest rates than several countries could hope to achieve on their own. In the transition to the start in 1999 of monetary union, this element of a trade-off became well-illustrated; the convergence of national debt servicing costs towards those in the strongest economies had expansionary effects that made major fiscal consolidation compatible with sustaining economic expansion. Perceptions changed after the adoption of the euro, as a number of countries relaxed their fiscal stance after 1999.

Persuasive as the two motivations – the core justification of minimising undesirable spill-overs and the potential support to finance ministers and central bankers from mild external anchors in supporting fiscal prudence – seemed three decades ago, they do look outdated in 2021. First, sustainability and the fiscal prudence it requires are less demanding at a time of historically low debt-servicing costs and of an ECB committed to keep policy rates low until inflation rises more durably. Assuring low debt servicing costs does not seem to require fiscal prudence in 2021, so the sense of a bargain has evaporated. Second, the pandemic has left a more ambitious perspective on government activity. Fiscal policy proved essential in overcoming a severe downturn, triggering also a more positive assessment of its role in normal times for counter-cyclical purposes. The spill-over effects of demand across borders which had been downplayed as of minor significance in the Treaty framework became visible in the fiscal consolidation process in most of Europe after the financial crisis and during the recovery when monetary policy was constrained by approaching the lower bound for policy interest rates. The two elements - low-for-longer costs of debt and a boost to the confidence of fiscal policy makers - have generated a very different background for the EU fiscal framework than what existed in 1991 or on those later occasions when the framework came up for review.

In earlier reports, notably EFB (2019a) we have analysed the stages of this evolution: the Stability and Growth Pact (SGP) in 1997, the refinements of 2005 following the Franco-German challenge to Commission recommendations, and the six and two-pack negotiated in the wake of the Euro and sovereign debt crises. Judging by the three desiderata for a fiscal framework - simplicity, flexibility and enforceability - emerging from the

debate, the original ambition to focus on simple and enforceable rules has faded, allowing for individual-country circumstances through flexible implementation, particularly through short-term stabilisation subject to long-term sustainability of public finances.

In this long process of increasingly bilateralised implementation, the rules have become steadily more complex and opaque without assuring better compliance. In the final pre-pandemic year (2019) more than half of the 19 participants in the Euro area were identified as being at risk of significant deviation from recommended adjustments. Deviations may have been modest in this and in any other particular year; however, the cumulative impact on public debt of non-compliance for some major Member States has been of the same order of magnitude as the sum of the two upward jumps in the debt ratios associated with the financial-cum-sovereign debt crises and the pandemic. And the relatively good years 2016-19, the later stages of the recovery between the two major crises, produced in several cases no political support for fiscal consolidation conducive to debt sustainability.

There is then a double challenge in finding agreement on a fiscal framework, to be implemented from 2023 onwards: (1) to take realistically account of the changes in the evaluation of sustainability; and (2) to reverse some of the many steps taken to base surveillance on short-term, partly unobservable policy indicators derived from estimates of the output gap rather than on observable performance over several years. In terms of the three desiderata for the framework, addressing the two challenges could improve simplicity and imbed flexibility by focusing on the medium term rather than through more improvised implementation.

Improving two dimensions of the rules-based framework must not imply that the third and most challenging dimension - enforceability - is sacrificed. Compliance in some countries needs to be strengthened in two ways: By linking eligibility criteria for joint facilities, both existing and future ones, and possibly by stronger decentralised features of surveillance in the shape of an enhanced role for the independent national fiscal councils (IFIs).

The following sections in this Chapter spell out these considerations in meeting the challenges. Section 5.2 reviews proposals made over the past years. We outline how to update the notion of sustainability without eroding it to the point when only qualitative policy guidelines become relevant. This section also contrasts the strong flow of relatively convergent reform proposals from international and EU institutions as well as from economic experts with the reluctance of most of the policy makers who would have to take the final decision to give priority to the debate.

Section 5.3 looks at the role the 3% of GDP reference value for the headline deficit and its future role in the EDP. Section 5.4 looks at elements to complement fiscal governance beyond the guidelines for national efforts and/or performance: a central fiscal stabilisation capacity, protection of growth-enhancing public expenditure, and proper, analytically-based and hence parsimonious use of a general escape clause, as well as at a possible link to more general macroeconomic considerations through the MIP. Section 5.5 reviews the "default option", viz. reliance on the current rules flexibly implemented in the absence of any agreement on significant reforms or even their direction. We argue that this option would be inferior to an agreement on the principles of the future fiscal framework along the lines proposed here. In particular, it could put the Commission in an untenable position by pushing it into recommending a degree of flexibility in implementation difficult to reconcile with its role as monitor of the EU fiscal framework.

5.2. TOWARDS A REFORM OF EU FISCAL GOVERNANCE: CONVERGING EXPERT VIEWS, NO POLITICAL CONSENSUS

The pandemic-related suspension of the official review of EU fiscal governance contrasts with the growing number of concrete reforms proposals from independent economists and international institutions, recently the European Parliament and ESM staff. Since 2018, EFB reports have contributed to spur the debate with proposals often echoed in recent analyses. The two past overhauls of the SGP (in 2005 and over 2010-13) were preceded by similar spikes in economists' interest in the issue. A natural question is thus whether today's active debate among experts signals imminent amendments to the framework. While the EFB certainly wishes so, it is fair to say that despite significant convergence in published policy advice, there is no consensus among

Member States, leaving the prospect for and the scope of potential improvements in doubt.

As outlined in Section 5.1, the EU fiscal framework was primarily conceived to prevent the kind of 'gross policy errors' likely to materially raise the risk of sovereign debt crisis. Indeed, in the absence of a fully-fledged fiscal union, unmanageable public debt developments in any Member State can directly threaten the integrity of the union through contagious sovereign debt stress. The lexicographic ordering of fiscal objectives underlying the framework is clear: debt sustainability dominates because it is existential. Without prejudice of this primary objective, other aims traditionally assigned to public finances can also shape policy.

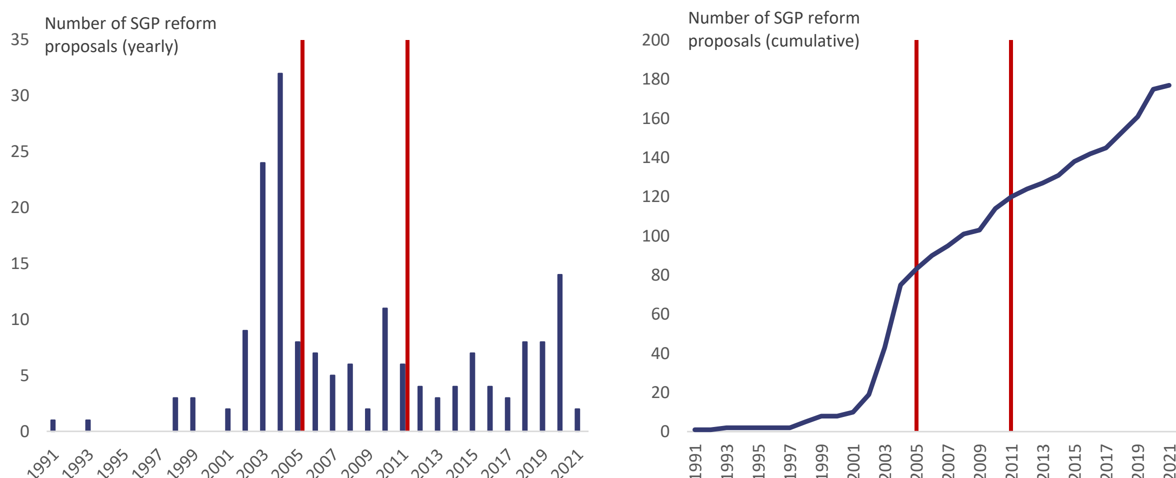
To promote debt sustainability in every corner of the union, the Maastricht Treaty established a rules-based system relying on given reference values for government debt and deficit. The rules were backed by an enforcement procedure imposing gradual pressure on non-compliant Member States to return within the Maastricht perimeter, or with respect to the debt norm to begin approaching it at a satisfactory pace.

Even before the Treaty came into force, the approach triggered great scepticism among economists who were quick to formulate what they saw as superior alternatives. While nobody disputed the importance to preserve sustainable public debts, both the role of fiscal policy in macroeconomic management and the nature of the institutional setup able to deliver sustainability were subject to an intense debate. Between 1991 and March 2005, Fischer et al. (2008) identified no less than 101 reform proposals. A more recent count by Debrun et al. (2021) puts the tally at about 80 proposals between 1991 and end-2005, with close to 100 additional proposals elaborated between 2006 and the time of writing (Graph 5.1). Without consensus on policy goals and effective institutions to achieve them, pre-2010 reform proposals formed a diverse bunch ranging from making the rules more flexible and more enforceable to scrapping them altogether (either in favour of market discipline or of independent fiscal watchdogs 'with teeth').

In the end, the two waves of SGP reforms attempted to plug a few consensual gaps "revealed" by analyses of fiscal performance under the Pact, such as pro-cyclicality in good times and weak enforcement in all times. Those reforms showed the great difficulty to design effective fiscal rules. Debrun and Jonung (2019) characterise the problem at hand as a trilemma between enforceability (i.e. an effective rule must entail consequences for those who do not comply with it), flexibility (i.e. the rule should not prescribe counterproductive policies, such as harsh austerity in the midst of a downturn) and simplicity (i.e. the rule must provide clear guidance on the future path of deficits and debts).

The reforms focused on ameliorating the trade-off between flexibility and enforceability, and simplicity was predictably sacrificed. Laudable efforts to create more agile, smarter rules forced the simultaneous adoption of safeguards against the risk that countries exploit the inevitable

Graph 5.1: **Proposals to reform the SGP: a growth industry**



(1) Based on web searches for papers in English or in French.
(2) Red bars identify years of actual reform of the SGP.
Source: Debrun et al. (2021)

loopholes created by new contingencies or new room for judgement. While most agree today that some of the added complexity was preventable (Deroose et al., 2018), the SGP is now an opaque machinery of overlapping, not always internally consistent and hence ambiguous provisions giving only loose guidance to policymakers and resulting in uneven performance and compliance across countries. Instead of constraining discretion with the sole purpose to prevent gross errors, implementing the current framework comes across as a questionable tool to micromanage national affairs, undermining its legitimacy.

In contrast to earlier debates about SGP reform, current conditions are more conducive to expert consensus on key properties of a revamped fiscal framework.

- First, there is much broader agreement among economists about the goals of fiscal policy. Hardly anyone would dispute the essential stabilisation function played by government budgets in the face of large shocks and limited monetary policy room. Fiscal policy is also key in mitigating income inequality and its adverse macroeconomic side effects or in promoting the transition to a greener economy, notably in which public investment is a key element.

- Second, a broad agreement also exists on the potential risks related to very high public debts, although current financial conditions complicate the estimation of critical thresholds beyond which debt could be considered out of control. Keeping debt dynamics in check is seen as essential to secure credible commitments to sustainability and for preserving fiscal fire power when the need arises. In exceptionally uncertain times, fiscal policy must indeed be nimble. As recent evidence in IMF (2021) shows, well-designed rules-based fiscal frameworks lend such credibility, preserving favourable funding conditions even after large public debt surges. There is also a consensus on the fact that debt sustainability is contingent on many factors (including monetary conditions) that change over time, which cautions against rigid adherence to specific numerical targets. Finally, persistently low interest rates and inflation have reinforced the view that deflationary policies such as persistent austerity might ultimately be counterproductive and that an organic debt reduction through higher nominal growth should be preferred to the extent feasible. As such, the lexicographic interpretation of fiscal objectives of the first period has given way to a smoother sustainability-stabilisation trade-off to be assessed considering country circumstances.

- Third, it is well understood that expenditure pressures - the old ones (aging) and the new ones (environmental transition, building more resilient health systems, plugging public investment gaps) - are the main source of stress on debt developments and must be addressed to preserve sustainability.

- Fourth, most agree on the importance of making the SGP more transparent and less ambiguous. This includes expressing rules and benchmarks in terms of observable indicators (e.g. expenditure growth) rather than estimated ones (e.g. the structural budget balance.) The emergence of independent fiscal institutions also offers opportunities to nurture enforceability and flexibility without necessarily sacrificing simplicity. For instance, specific IFI functions such as the validation or production of budgetary forecasts or the monitoring of compliance with national fiscal rules can plug loopholes inherent to certain contingencies without having to codify new rules or benchmarks.

- Finally, there is widespread realisation that the dramatic diversity of the current state of national public finances after the Covid-19 crisis undermines one-size-fits-all provisions, calling for greater tailoring to country circumstances. Uniform targets and benchmarks will not work.

Of course, consensus among pro-reform experts says nothing about the silent group (quite possibly a majority) who do not wish to change current arrangements. The elements of convergence nevertheless translate into a new generation of reform proposals that have in common some form of a return to the basics (i.e. avoiding gross errors):

- Declining debt trajectories when possible and desirable (that is by avoiding pro-cyclicality in good times). The emphasis is rightly placed on debt sustainability (which requires the debt-to-GDP ratio to be on a non-explosive path) rather than given thresholds to reach within a predetermined time frame.

- To provide short-to-medium term guidance tying annual budgets to the debt anchor, many analysts suggest expenditure ceilings as the core operational rule. That approach relies on an observable indicator (unlike other metrics relying on unobservable variables that can only be poorly estimated like the output gap), it provides short-term flexibility by letting automatic stabilisers play in real time and in a fully symmetric manner (allowing the organic regeneration of fiscal space during good times), and last but not least, it makes the operational rule visible through the annual budget law. Overall, greater simplicity is achieved without giving up flexibility and enforceability.

- A greater focus on debt must inevitably acknowledge the diversity of situations across countries and possibly different degrees of exposure to the realisation of contingent liabilities. Many recent proposals explicitly allow for tailoring the rules' implementation to country circumstances. Some also flag the potential role of national fiscal frameworks in delivering desirable debt trajectories.

- Finally, many proposals envisage a greater role for IFIs in the monitoring and implementation of fiscal rules. One sticking point, however, is that national IFIs remain highly heterogeneous in terms of institutional architecture, resources, and operations. Besides, not all IFIs enjoy a similar degree of political backing and public recognition, both of which are essential to their impact on fiscal performance. To avoid a multi-speed implementation of the framework through national IFIs, some harmonization guided by international best practice (codified in a Directive, for instance) would arguably be a pre-requisite.

The core EFB proposal (fleshed out initially in our 2018 annual report) belongs to a growing class of frameworks based on a single anchor (debt), a single operational rule (net expenditure growth) and a single escape clause. While the consistency between the desired debt path and medium-term spending caps is ensured by an error-correction mechanism, compliance monitoring involves an input from an institution independent from political pressures. Unjustified deviations can cut off access to central EU resources, including those from a permanent central fiscal capacity (also to be created as part of the proposal, see further discussion in Section 5.4). Refinements were introduced in subsequent reports, see EFB (2019b, 2020a,b) including a tailoring of debt targets to country conditions, concrete options to make compliance monitoring more independent, and technical provisions aimed at protecting growth-enhancing public outlays from unwarranted cuts.

Other plans are more radical but share the goal to refocus the framework on the prevention of gross policy errors likely to jeopardize debt sustainability. Given the difficulty to define adequately contingent yet simple and enforceable rules, some propose to replace numerical rules by non-binding formula-based benchmarks defined and assessed by IFIs to magnify the reputational costs of slippages (e.g. Debrun and Jonung, 2019) or by a mere commitment to stick to qualitative fiscal standards under the overarching principle that public debt remains sustainable with high probability (Blanchard et al., 2021). Because sustainability assessments (even if in the hands of independent bodies) are technically involved and subject to considerable judgement, the latter proposal suggests settling any dispute before the European Court of Justice which could then gradually build case law in that matter. Rooted in similar principles, the contribution by Martin et al. (2021) suggests replacing uniform debt and deficit caps by country-specific debt targets assessed by national IFIs based on a common methodology. Like the EFB, they suggest implementing the debt objective through medium-term expenditure ceilings whose material violation would trigger the excessive deficit procedure. Unlike Blanchard et al. (2021), this proposal preserves the institutional foundations of the existing fiscal framework. However, a significant and politically highly sensitive burden would fall on domestic IFIs, which would require more uniform capacities, institutional strength, and influence across the EU.

Overall, the EFB welcomes the emergence of several common elements in the debate on Europe's future fiscal framework. In particular, the renewed emphasis on debt sustainability as a common public good, the need to break the tendency for public expenditure to grow faster than revenues, deemphasising the lexicographic interpretation of the debt objective vs other fiscal targets, and the greater appreciation of country-specific situations should be considerations driving the reform process.

At the same time, we would strongly caution against needlessly radical or dogmatic shifts that

would risk alienating the support of some countries with no significant gain. A case in point would be the outright rejection of EU-wide numerical benchmarks for public debts and deficits. Labelled as arbitrary and baseless since at least Buiter (1992), Maastricht's 'numerology' has intrinsic value that cannot be ignored. Numbers are tangible guideposts for the general public. As such, they can act as 'magnets' for sound policies because of the reputational costs associated with large deviations. Simple numbers are key to cement broad societal ownership of rules-based fiscal policy particularly in countries with less developed institutional frameworks. In practice, there is often sufficient flexibility in real-world fiscal rules—and the SGP is no exception—to rule out the risk that numbers per se would ultimately cause gross errors that rules are precisely trying to prevent. This does not mean that numbers should be treated as untouchable relics worthy of adoration (see Box 5.1). A pragmatic compromise between the value of numerology and the recognition that ever changing economic and financial conditions affect the desirable deficit and debt ceilings could be the acceptance of regular reviews of the numerical aspects of the rules (see Eyraud et al, 2018).

Another manifestation of the lack of pragmatism underlying some proposals concerns the belief that strictly national fiscal frameworks (IFI or national fiscal rules) enjoy greater ownership than supranational arrangements. The fact that several EU countries have historically relied on external anchors to establish domestic policy credibility nuances the strength of that argument. Even if reliance on home-grown frameworks were to be emphasised, we see the preservation of a solid EU-wide pillar as essential to accommodate the full extent of institutional diversity in the Union.

All else equal, a stronger convergence in the analysis of the contours of a reformed fiscal framework should encourage an ambitious revamping of the SGP. However, in sharp contrast to 2004-5 and 2010-11, building the required consensus around an SGP reform is difficult. First, there is currently no perception of a looming existential crisis in the euro area. Fiscal fragmentation is not seen as a clear and present danger to the euro area integrity. Second, because the Covid-19 crisis was exogenous and demanded unprecedented macroeconomic policy support, the activation of the severe economic downturn clause for the whole of the EU was indisputably desirable and politically feasible. Hence, this time, the framework proved remarkably resilient to the shock. Third, supranational rules are not the only anchor of fiscal credibility anymore as Member States developed rules-based fiscal frameworks at the national level, following the prescription of the six-pack in 2011, reinforced in an intergovernmental Treaty (TSCS), Finally, the political capital available for structural and institutional reforms is itself constrained by growing political fragmentation and polarization both within and across countries, forcing political leadership to focus on a tighter agenda of measures seen as strictly essential.

Yet, if the Covid-19 crisis has not provided strong political incentives to reform the fiscal framework, the legacy of historically high public debt combined with the persistence of low borrowing costs and increased spending pressures (on public investment, healthcare, and other social spending) call for a bold rethinking of the institutional setup imagined more than 30 years ago. Relevant analytical work already exists and concrete advances could be made quickly.

5.3. THE ROLE OF THE 3% REFERENCE VALUE FOR THE HEADLINE DEFICIT IN A REFORMED FISCAL FRAMEWORK

A fiscal framework with the preservation of sustainable public finances as its primary, though not exclusive, purpose should have an approach to a longer-term debt norm as its main intermediate objective. Nevertheless, the Maastricht Treaty also set a reference value for the annual public sector deficit – a guideline or ceiling for the headline deficit of 3% of GDP – defined along with the norm for debt in a Protocol annexed to the Treaty. The main justification was that annual deficits account for a major part of changes in public debt, and hence the deficit is the main instrument for controlling the latter. The headline (or actual) deficit is at the same time well-known in domestic policy debates and, in accounting terms, a relatively unambiguous figure. An Excessive Deficit Procedure (EDP) was initially implemented solely on this indicator of actual performance, and the procedures around it became a centrepiece of the SGP a few years later. It has developed into the most – some would say the only – familiar indicator in the media and for the wider public.

The headline deficit may be easy to measure, but it remains difficult to interpret, since it is the

outcome of mixed impulses – discretionary decisions as well as cyclical fluctuations in the economy, with the latter producing automatic changes in both the revenue and expenditure sides of the budget balance. With the attempts to refine the policy indicators by focusing on the former of these two impulses, i.e. by moving from policy outcomes to policy input or intentions, analytical interest shifted in the direction of the cyclically-adjusted, or structural, deficit – the analytically relevant measure for implementing such a shift. Unfortunately, the structural deficit has proved to be very difficult to estimate with the accuracy required to provide reliable guidance on annual fiscal policy. Nevertheless, its role in the preventive arm of the SGP, and particularly as it evolved after the crises of a decade ago, has survived, or even become more prominent. The headline deficit became the easier indicator to meet as the recovery from 2014 on progressed, due to the gradual decline in debt-servicing costs, while considerable patience was shown by the Commission and the Council in taking no firm actions to contain transgressions of the 3%: the completion of getting all countries below the reference value extended to 2019.

If the fiscal framework is reformed in the direction the EFB – as well as many others – have proposed, the question needs to be raised whether there is still a place for the reference value for the headline deficit in the future system. The desire to avoid any change in the legislative framework that is not strictly necessary, obviously provides one solid argument for not trying to modify the relevant Protocol 12 of the Treaty. But other points must be considered in favour of retaining it, notably its familiarity to policy-makers, the media and the public. Efforts to remove it could create misinterpretations of excessive laxity in the thrust of reforms; and they would make agreement on an updated framework more difficult. These arguments do not make superfluous a careful consideration of what the 3% reference value can add to the framework proposed here and how it could best be implemented into a framework based primarily on a debt anchor and an expenditure benchmark to move towards it. We note that with the framework the EFB is proposing being designed for the high-debt countries, the reference value for the headline deficit would be the only indicator in surveillance applied to all participants. Containing deficits of also low debt countries remains relevant. Not imposing any restrictions could result in high deficits that are hard to reverse.

5.3.1. Some analytical considerations on the choice of deficit strategies

Within the overall constraints of debt sustainability, an ‘optimal deficit level’ depends on political preferences and, given these preferences, would differ across countries. For example, if the weight of welfare attributed to the elderly part of the population is raised, the deficit ceiling should be also be raised, so the burden in terms of higher future taxes is shifted more towards the young. Given the welfare weights attached to the different cohorts and the projected path of government expenditures, the appropriate deficit ceiling would be country-specific and solely a matter of national concern.

In contrast to the foregoing, there were no deep conceptual reasons to motivate the original choice of the 3% reference value. At the time the ceiling was chosen to be roughly equal the average of the actual deficits in the then Member States of the EU. A few countries had experimented with a deficit ceiling in consolidation efforts, notably France after 1983.

With the 60% debt norm becoming more remote and less relevant, the burden of identifying risk may shift towards the deficit ceiling as a more operational device. While it is difficult in practice to pin down what an unsustainable level of debt is, it is important that the deficit ceiling not be set at the border of the danger area where debt can spiral out of control, in order to maintain buffers sufficient to withstand further negative shocks.

The above exposition gives rise to the questions whether the 3% deficit ceiling is still appropriate and whether the deficit ceiling could also be made country-specific and contingent on the economic conditions. Box 5.1 addresses these questions. It also addresses the question under which circumstances the deficit ceiling is violated if a country adheres to the spending growth ceiling in the reformed Pact.

Box 5.1: **Analysis of a numerical deficit ceiling**

We have made the case that numerical rules are an essential part of an effective fiscal framework. Theory cannot pinpoint the exact numbers for those rules that are optimal from an economic perspective. However, what is important is that the numbers included in the rule indicate a relevant order of magnitude and, once they become a focal point in the public or political debate, violation of these numbers triggers action to correct the transgression. With the 60% of GDP debt reference value gone out of the sight of a number of countries, even more than before, the 3% deficit ceiling will remain a focal point of Commission monitoring and it will remain in the centre stage of the political interactions within countries, among governments and of governments with the Commission.

Analysis of potential reform of the SGP automatically implies the question whether a reformed SGP should contain a numerical deficit ceiling and, if so, whether a 3% ceiling is still appropriate. The answer to this question depends on whether adherence to the 3% ceiling could still lead to unstable debt dynamics under plausible circumstances. Recent experience suggests that may be the case. In 2019, the last year before the pandemic, none of the euro-area countries had deficit levels exceeding 3%. Still, in many EU countries public debt hardly came down. The macroeconomic situation before the Covid-19 crisis was characterised by low interest rates, low inflation rates and low GDP growth rates. Using the formula for the dynamics of the debt-to-GDP ratio, it is easy to demonstrate that a 3% deficit could still lead to an increasing debt ratio. The formula is:

$$\Delta d_t = pd_t + (i_t - g_t)d_t,$$

where d_t is the debt ratio of GDP, pd_t the primary deficit ratio, i_t the average nominal interest rate on the outstanding debt and g_t the nominal GDP growth rate. Take a plausible macroeconomic configuration with $d_t = 100\%$, $i_t = 1\%$ and $g_t = 2.5\%$ (e.g., 1.25% real growth and 1.25% inflation). Assume further that the average interest paid on the outstanding debt equals the current nominal interest rate of 1%, hence interest payments are 1% of GDP. A headline deficit of 3% would then amount to a primary deficit of 2%, which would dominate the $(i_t - g_t)d_t = -1.5\%$ term, and the debt ratio would continue to rise. With unchanged nominal interest rate, nominal GDP growth rate and headline deficit, the debt ratio would in this case stabilise at 120%. (1) However, financial markets require a higher interest rate i_t when the debt ratio rises, leading to a rise in the term $(i_t - g_t)d_t$ and a fall in pd_t for given headline deficit of 3%. Stabilisation of the debt ratio will take place at a higher level or the ratio may explode if the reduction in pd_t is no longer able to dominate the rise in $(i_t - g_t)d_t$.

From the above expression we can infer possible paths for the debt dynamics in the aftermath of the Covid-19 crisis. The transitory high growth in response to the Covid-related overcapacity and private savings increase produces a period with $i_t - g_t < 0$, hence a negative snowball effect. With the shrinking output gap, growth slows down, thereby diminishing the negative snowball effect. Potentially higher inflation resulting from the current loose monetary policy may ameliorate the slowdown in growth. However, at some point higher inflation could be overtaken by a rise in the interest rate, which would gradually feed into higher interest payments on the entire outstanding stock of debt, potentially reversing the sign of the snowball.

The conclusion is that a ceiling to the headline deficit can serve as a backstop to help prevent the debt ratio from continuing to rise to truly alarming levels. However, a suitable fiscal framework should do more than merely preventing an explosion of the debt ratio, as higher debt ratios may have consequences in terms of intergenerational equity, economic growth and spill-overs between countries.

Ideally, from an economic perspective, the deficit ceiling would be made country-specific and contingent on the economic conditions, as suggested by the above numerical example. Making the deficit ceiling contingent on economic conditions would require defining the contingency. The above debt dynamics formula provides leads for this. The ceiling on the headline deficit could be set on the basis of the above formula such that, if the debt ratio exceeds its own ceiling, it is not allowed to rise further. The input variables for the formula are observable and established by Eurostat, so this should technically not be complicated. However, differentiating deficit ceilings across countries would be politically controversial, as countries could claim to be unfairly treated compared to their peers. An 'objective criterion' based on the debt dynamics formula might alleviate this objection.

In a reformed the SGP, the deficit ceiling will remain binding unless the Treaty Protocol is changed. The question is how relevant the ceiling will actually be. If the proposal of the EFB is followed with a long-run debt ceiling and an

(1) Stabilisation of the debt ratio means that $\Delta d_t = 0$. Hence, $0.03 - 0.01\, d_t + (0.01 - 0.025)d_t = 0$, hence, $d_t = 1.2$.

(Continued on the next page)

Box (continued)

intermediate ceiling of spending growth in line with potential output growth (with a correction to reduce the debt level if the debt level exceeds the long-run ceiling, and no correction otherwise), violation of the current deficit ceiling seems unlikely, but not entirely impossible. A violation could occur if (i) actual GDP growth is sufficiently far below potential growth, so that spending growth (in line with potential GDP growth) outpaces revenues growth (in line with actual GDP growth) by a margin sufficient to produce a deficit exceeding 3%; (ii) if intensive use is made of the compensation account. Such situations are likely to occur only sporadically and temporarily.

5.3.2. Operationalisation of the deficit ceiling in a reformed SGP

The focus on the 3% of GDP reference value may have contributed to countries treating the 3% as a target instead of a ceiling (see Caselli and Wingender (2021) for suggestive evidence). However, the observed strategy aimed at staying just below the 3% level is bound to produce instances in which countries end up at higher deficit ratios. An effective strategy to meet the medium-term objective would avoid most of such instances.

Enforceability has proven highly problematic throughout the history of the SGP, and there is no reason to believe that this will be different in the future without changes in the governance of the SGP, notably by strengthening the incentives of sovereigns to adhere to the rules. Threatening to impose sanctions on countries for excessive deficits has proved not to be credible as long as the Commission remains reluctant to make proposals to this extent, and finance ministers who have to vote in favour of such sanctions in Council meetings perceive to be threatened with reciprocal actions later. In fact, each minister has an incentive to freeride on the other ministers when it comes to disciplining a misbehaving country. So, how could enforcement be improved?

First, the Commission and the Council could focus on gross policy errors. Firm action against gross policy errors is easier to objectively justify and would as such become politically more acceptable. Moreover, the incidence of gross policy errors is less frequent than of that of minor transgressions. A situation with a large number of countries committing minor violations and one or two committing a major violation of the rules easily leads to a coalition in which all countries in conflict with the rules can form a blocking coalition so no one gets punished. Focussing coercion on one or two countries guilty of gross errors could prevent such coalition formation.

This still leaves a question: is a numerical ceiling relevant, if only gross policy errors are subject to enforcement? Much would depend on what constitutes such errors. For example, persistent minor transgressions of the deficit ceiling could count towards a gross error, so countries are still incentivised to keep their deficit below the ceiling. Second, domestic ownership of the SGP could be strengthened, for example by better aligning domestic fiscal rules with the EU fiscal rules and/or giving the national independent fiscal institutions a role in monitoring adherence to the EU rules, as discussed further in Section 5.5 below; and corrective action relating to violations of the deficit ceiling could be in embedded in domestic law. Third, one might limit the eligibility of countries for access to common facilities to those complying with the SGP rules. However, this is a tricky road to go, because the fight over the judgement whether the deficit ceiling has been broken will intensify.

5.4. ELEMENTS BEYOND THE RULES-BASED NATIONAL FRAMEWORK : A CENTRAL FISCAL CAPACITY FOR STABILISATION, ESCAPE CLAUSE, PROTECTION OF PUBLIC INVESTMENT

It has been recognised since at least the first plan for an Economic and Monetary Union, the Werner report of 1970, that an element of joint action and/or authority at the EU level would occasionally be required as a supplement to rules-based guidelines for national fiscal policies, which are appropriate for underpinning monetary unification in normal times. Attention focused in early years after the Maastricht Treaty on how to integrate an element of constrained discretion into the implementation of the rules-based system. Early efforts at giving numerical precision to such flexibility and to embodying them into pre-specified exceptions did not survive the first major challenge to the framework in 2003. Another conclusion from this challenge was that the

Council had to leave a more significant role for the Commission in order to make its recommendations for policy adjustment more difficult to overturn.

The financial and the euro area crises widened the agenda. The European Economic Recovery Programme (EERP) of 2009-10 was a bold experiment in encouraging Member States to expand in parallel and beyond what the fiscal framework foresaw. A safety net for governments was set up and developed into the major credit mechanism of the ESM for vulnerable economies, taking them temporarily out of the SGP into conditional adjustment programmes. But another development with lessons for the future was the recognition of powerful contractionary spill-over effects, as most Member States consolidated rapidly after the temporary stimulus of the EERP. The sum of national fiscal tightening recommendations in line with the rule book did not produce a satisfactory aggregate outcome in 2011-13 and in the early years of the recovery, leaving too much of the stabilisation effort to the ECB. With input from the EFB and the Commission, the Council discusses the issue of the appropriate fiscal stance for the euro area annually since then; but in the absence of instruments for reorientation through coordination of national policies or a central mechanism for stabilisation, this notion lingered on without any significant action.

Another lesson from the past decade has been that public investment bore a significant part of the brunt of fiscal consolidation, hence undermining future growth prospects in the EU. Efforts were made by the Commission and the Council to adjust the rules to make allowance for structural reforms and offer better protection for growth-enhancing expenditures, but the criteria appear to have been too restrictive to have any major impact (see EFB, 2019b, EFB 2020b).

It was no accident then, that the Commission President, when he asked in 2019 the EFB to provide a first assessment of how the most recent reforms of the framework a decade ago had worked, underlined three objectives for a rules-based system which further reforms could help to achieve: ensuring the long-term sustainability of public finances, stabilising economic activity and improving the quality of public finances. Are the main features of our proposals outlined in the previous sections sufficient for achieving the three objectives in the post-recovery EU? The EFB did not think so before the pandemic, and the experience in 2020-21 has reinforced the view that it will be important to look beyond reformed rules.

To summarise: a focus on gross policy errors in approaching nationally-differentiated debt anchors by means of expenditure benchmarks for the medium term, backstopped by a cap on headline deficits, would go some way towards achieving the above three goals. With a longer horizon for policy recommendations and by curtailing elements of short-term micro-management, realistic prospects for ensuring sustainability could be reconciled better than in the past with reducing pro-cyclicality of fiscal policies. Flexibility would be integrated more organically into the implementation of the framework.

However, the EFB still believes that additional elements enhancing the EU fiscal framework remain necessary: a central fiscal capacity (CFC) for stabilisation, protection and promotion of public investment purposes, and an escape clause for large exceptional - common or idiosyncratic – shocks.

5.4.1. A central fiscal capacity for stabilisation

The Covid-19 crisis provided a unique set of circumstances where monetary and fiscal policies became exceptionally well aligned, and the shock was sufficiently universal and truly exogenous to make the traditional debates on moral hazard moot. Agreement was reached not only to fund the NGEU through the EU budget, but even to make nearly half of the disbursements in the form of transfers, hence leaving EUR 390 billion of spending outside national debt and deficits over the 2020-26 budgetary period. NGEU showed that it is possible to agree on a centralised fiscal transfer mechanism in a relatively short period of time. However, its purpose is not short-term stabilisation but to support investment and reforms in the medium term. Moreover, it is designed to be a one-off initiative.

With the precedent set, and assuming the funds are efficiently used, it is not unreasonable to assume that such mechanisms could be mobilised again following a major shock. In fact, the EFB, along with the ECB, the IMF and many other institutions, has been arguing for a central fiscal capacity for stabilisation as the most direct approach to covering a gap in the EU fiscal framework. But the debates over 2016-19 at the official level showed that it may also be the most

controversial way of moving beyond the regular national framework.

A permanent central fiscal capacity (CFC) could support timely stabilisation of the EU economy in the case of a major shock to the entire EU, especially when monetary policy is constrained by the effective lower bound and the aggregate of national fiscal policy actions is suboptimal from the perspective of the Union. Constrained monetary policy makes the argument for concentrated fiscal action more powerful, both due to likely higher multipliers (In 't Veld, 2016) and to price stability arguments. In effect, a CFC would offer the fiscal space necessary to implement counter-cyclical policies in bad times.

A second argument for a CFC relates to idiosyncratic shocks or common shocks with asymmetric effects on the euro area economies and public finances. By supporting national finances in major downturns, a CFC would constitute an insurance mechanism.

As with all insurance mechanisms the risk of creating moral hazard needs to be addressed - and that could be helped with the EU fiscal rules; compliance with the latter would be a criterion for access to insurance. It is true that the lack of financial sanctions related to non-compliance with the EU fiscal rules does not make for a convincing case of a moral hazard reduction through reduced access to CFC funds. After all, there is little material difference between fines and non-payments under EU spending programmes. Both are equally politically difficult to implement. However, such a threat could still serve as an ultimate backstop function, preventing the most blatant cases of non-compliance.

Another option to deal with moral hazard is to build upon SURE-like mechanisms that contribute to evening out idiosyncratic shocks in the recent crisis. The EU could raise funds collectively, but individual Member States would be liable for the debt, and the expenditures would raise deficits. There would be no permanent transfers involved, expect for the fact that beneficiaries would not have to pay for guarantees and benefit from lower interest rates.

5.4.2. Protection or promotion of public investment

The NGEU, as well as the activation of the severe economic downturn clause and the ECB's extraordinarily expansionary steps, primarily its Pandemic Emergency Purchase Programme (PEPP), have created an important precedent in filling simultaneously several tasks: easier access to budget financing, especially for the Member States most affected by the pandemic and by structural weaknesses, health and employment support funds at low cost, and sizeable funds directed to the green and digital transition of the EU.

The provision of EU common goods, in particular relating to the green transition and to transnational infrastructure, is still not sufficiently addressed by the constrained EU budget, which is the natural place to target such spending. The success of the climate policies rests primarily on carbon pricing mechanisms rather than on public investment. The EU common good provision could therefore well include also social spending that facilitates credible implementation of environmental taxation or carbon adjustment mechanism.

Therefore, the EFB has proposed a mechanism for augmenting the EU budget through national envelopes for the EU common good, such as green public investment; see EFB (2020a). A mechanism through which Member States spend funds within their own borders on projects that are elements in an EU strategy for the transition may be useful both by helping to meet agreed climate targets and by weakening political reluctance towards EU spending. Such mechanism would provide a more manageable form of policy coordination than a modified golden rule the EFB had proposed (EFB (2019b)).

5.4.3. Limiting Macroeconomic Imbalances

Besides the role of the fiscal framework in shaping the opportunities for creating a stabilisation capacity and in protecting productive public spending, there is also a potential role of the framework in relation with the Macroeconomic Imbalance Procedure (MIP). In particular, can the fiscal framework be deployed in such a way as to incentivise countries to limit macroeconomic imbalances? The MIP was agreed in order to limit internal and external imbalances, hence potentially linking perspectives of fiscal policy to a broader assessment of macroeconomic conditions. External

imbalances can take the form of current account deficits or surpluses. Through policy adjustments those imbalances can only be limited in an indirect way, as they eventually originate in private sector decisions, but since fiscal policy affects the current account, a potential link can be established between the SGP and the MIP. The strength of this link varies across countries and over time. In general, we can expect a fiscal expansion in countries with fiscal space to reduce domestic saving and therefore their current account surpluses. This would benefit other countries in particular in periods of EU-wide recession when fiscal policy is particularly effective.

Whether the MIP should be used to push countries with space to expand fiscal policy is an open question. The answer depends on the strength of the positive cross-border spill-overs and the slack in surplus countries. There is evidence that normally spill-overs are quite limited. However, when slack is substantial or when monetary policy is at the effective lower bound a fiscal expansion is more effective in raising domestic activity, thereby producing larger positive spill-overs. Yet, foreign fiscal expansion would not be a long-term solution to economic divergences; these can only be durably addressed by domestic policy changes aimed at building fiscal buffers in good times. A complementary solution would be to rely on a CFC to support countries that find themselves in a severe cyclical downturn.

5.4.4. The residual need for a general escape clause

If the proposals made by the EFB in Sections 5.2 and 5.3 were to be complemented by the two extensions to the framework outlined in this section – a CFC for stabilisation in a revolving fund, access to which is based on well-defined criteria, and protection for growth-enhancing expenditures, currently provided through the national plans supported by the NGEU, ideally boosted by joint efforts through an enlarged EU budget – an escape clause could be limited to truly extraordinary situations approaching 2020 in severity in line with Art. 122 TFEU, which was invoked when the pandemic struck in justifying the NGEU and SURE mechanisms. The need for an escape clause would be reduced by the lengthening of the horizons over which compliance with the policy adjustments recommended is monitored, and by focusing on gross errors.

Besides promoting sustainability, a reformed EU fiscal framework should also aim at fostering macroeconomic stabilisation and productive public spending. Existing gaps in the current framework required flexibility through derogations to deal with contingencies. This largely explains the increasing complexity and opacity of a rulebook that had to be supplemented by a series of flexibility clauses.

The existence of a central fiscal capacity for stabilisation does not invalidate the case for an escape clause in all circumstances. What is more, delays in reforming the EU fiscal rulebook and in the introduction of CFC will strengthen the reliance on derogations to achieve the necessary flexibility of rules. This makes it even more important to constrain reliance on a general escape clause in line with the principles of the rules drafted in Box 2.1.

5.5. THE ‘DEFAULT OPTION’ OF NO SIGNIFICANT REFORMS

What are the likely implications for the EU economic governance of an absence of any agreement on reforms prior to the deactivation of the severe economic downturn clause? As mentioned in Section 5.1, some Member States would see that as basically returning to the familiar pre-pandemic set of rules. Both their interpretation of implementation in the pre-pandemic period as overly lax, and the joint steps taken during the crisis, notably the NGEU, will have reinforced the opinion of these countries that the main problem with the rules-based system lies not in its design, but in how it has been implemented in the past. On the other hand, other Member States will argue that the changes in the economic environment have been too profound to pretend that the past framework could be applied without major reforms; in the absence of such reforms a much more discretionary framework will, in their vision, have to emerge.

In the view of the EFB, these conflicting interpretations of the implications of not engaging in consultations to update and reform the framework would put the Commission in an increasingly untenable position in its role as the central monitor of fiscal policies with responsibility for making recommendations for adjustments. In announcing, on 2 June 2021, the continued activation of the severe economic downturn clause for the next year, the Commission assured that also

beyond 2022 the rules would be implemented with flexibility, taking into account national circumstances. Such assurances may seem superfluous. The issue is rather how far towards a discretionary implementation the Commission may be inclined to go and how much the Council would be willing to accept in the absence of an agreed reform.

Elements of discretion, based on economic judgement, can be positive. However, in the EU experience so far, the risk is that politically biased recommendations, based on discretion exercised bilaterally by the Commission and the Member State concerned, will tend to erode any rules-based framework. This erosion is strengthened by the fact that the reverse qualified voting in the Council supports automatic acceptance of individual country recommendations. In the past, such a process has left the public perception of conflict in the way fiscal rules are interpreted. ([167])

The result may seem an advantage for high-debt economies, as they might benefit from postponing adjustment. This is a mixed blessing, however, to the extent that the flexibility shown may blur market expectations that high debt ratios are set on a declining path, hence threatening perceptions of debt sustainability. Monetary policy is capable of dampening exaggerated and sudden perceptions in markets of the risks of unsustainability, but it could not undo the impact of a persistent application of fiscal flexibility.

Beyond financial markets, there is also a more general interest in a transparent fiscal framework in which discretion is constrained in scope and time and serves to limit the uncertainty related to future policies. Minimising the difficulties of assessing the evolution of the fiscal stance is also important for the private sector, for instance for employers planning future expansion of production and employment. This is not a plea for consolidation and austerity, but for predictability and transparency of important objectives of national economic policy.

These arguments in favour of engaging in reform discussions seem convincing for the EFB, but we are well aware that the likelihood of drifting into what may seem the familiar territory of the pre-2020 framework is high. Some comments on whether and how the Commission could in informal ways try to bridge the gap between divergent perceptions among Member States are then required. Could the risks we see in the 'default option' be reduced, once it becomes clear after extensive consultations that a 'common landing area' for reforms is not attainable in time? In order to protect the framework against the erosion that would likely be observed if the Commission and the Council were to spend most of their time confirming or extending exemptions from rules which it is, in principle, committed to implement, the Commission should outline how it intends to proceed with surveillance over the initial years after the recovery from the pandemic. Which parts of the framework should remain in focus, and which parts should be downplayed as overtaken by events or too difficult to interpret?

As discussed in some detail in Chapter 2, the Commission has reminded Member States that the activation of the severe economic downturn clause has not suspended the EDP, the corrective arm of the framework. Assuming the clause is deactivated in 2023, EDPs could again be applied, and may have to take on a more central role than in a reformed system provided it clearly reflects a multi-year rather than an annual correction mechanism as in the early years of its application.

Due to sharply increasing difficulty after the pandemic of estimating unobservable variables (in particular, the output gap and elasticities), the preventive arm will have to focus more on observable variables. The opportunity could be seized to move in a more decisive way towards the expenditure benchmark as the central indicator; the shift away from the structural budget deficit should accelerate, including other forms of reliance on the output gap in surveillance.

Unlike in the current implementation of the Pact, a country's deviation from the adjustment path towards the MTO based on the expenditure benchmark should consistently lead to the opening of a significant deviation procedure.

We have argued, see Section 5.4, that it would be naïve to believe flexibility will become superfluous. What is important, also in an unreformed framework, is to restrict the scope for flexibility in a way that makes its application more transparent, notably by requiring independent analytical input prior to decisions. On these criteria, the flexibility tentatively introduced unilaterally by the Commission in 2018 under the heading of 'the

([167]) The EFB is in favour of abolishing the RQMV introduced in 2011 (see EFB (2019b) for details).

margin of discretion' would seem to qualify more readily than more improvised and bilateral practices. This provision allowed recommendations for consolidation to be tempered in cases of 'fragility'. This initiative was quickly withdrawn, both because it remained undefined how fragility has to be evaluated, and because there was no shortage of other grounds for applying flexibility in the arsenal of the SGP. If these two conditions change, so that a margin of discretion could be exercised on the basis of independent economic analysis and judgement, while other elements of flexibility were taken out of use, the provision might become a useful element of the framework.

A final experience on which the Commission might build after 2022 in the absence of reforms is the informal qualitative guidance it has introduced in 2021 by distinguishing between temporary (or emergency) and permanent increases in public expenditures. Containing the latter is a crucial element in assuring sustainability; it remains to be seen whether the rather vague language used in qualitative guidance leaves any impact in the budgetary outcomes. The closer monitoring of the expenditure composition in national budgets which is key in the involvement by the Commission (and the Council) in approving the plans submitted for financing through the Recovery and Resilience Facility (RRF) will add substance to the potential of qualitative guidance.

If the Commission were to clarify the mix of continuity and innovation listed above, that would restore some of the role of the fiscal framework in providing 'forward guidance', in the sense of explaining how it interprets the framework, in analogy to what is seen as an important refinement and support for credibility in the area of monetary policy. The analogy is obviously imperfect; a central bank is more in command of its policy instruments than are national fiscal authorities - and even more so than the EU institutions that monitor the latter. Still, the potential for improving the transparency in fiscal policy making seems to us sufficiently important to warrant efforts in the direction suggested. By notifying the Council and Member States of any intentions of a systematic nature, the Commission may make its task as the arbiter of an unreformed framework less exposed than it would need to be. Notification would be useful in itself; more formal acceptance going beyond Council acquiescence, such as a change to the code of conduct, would be better, but no doubt difficult to obtain given divergent national positions.

Finally, could more decentralised surveillance procedures be deployed to ease some of the strains we see as inherent in the default option? Many experts see considerable potential in increasing reliance on contributions from national budgetary rules and from the national independent fiscal councils in improving compliance.

Some elements in the future EU fiscal framework do suggest that such reliance would be desirable. The efforts by IFIs to monitor and encourage realistic macroeconomic and budgetary forecasts of several governments have been helpful. The extension of EU monitoring to medium-term budgetary plans and, especially, to the risks of public finances becoming unsustainable over longer horizons, will increase the scope for input from the IFIs, regardless of whether the SGP is reformed or not. In the transition period after recovery from the pandemic, IFIs may have an informational advantage over the Commission as regards new legislation and data, enabling them to produce solid technical analysis of shorter-term issues. All these points support an expanded role for the IFIs in building up national ownership of the rules and of their implementation.

Nevertheless, as mentioned above, there are limits to what can be expected from decentralising surveillance via national IFIs. The role of the Commission and the Council at the centre of the process cannot be replaced, or even significantly reduced; it is needed to evaluate spill-over effects and, in particular, to build mutual trust in an EU fiscal framework which is a collective exercise; it is also needed for a horizontally equal treatment of cases of transgression of the rules.

Furthermore, as already discussed in previous parts of this report, national IFIs remain very different within the EU in terms of resources, mandates and competence. Putting strong emphasis on their role in monitoring compliance with fiscal rules, even national ones, would require central monitoring to step back from its main role today. The domestic political pressure on IFIs, were they to take on exclusively the highly sensitive task of monitoring compliance with the European rules, could pose threats to their independence. In the current framework of multilateral surveillance, the Commission is the arbiter of compliance, subject to final political decisions in the Council.

GLOSSARY

Automatic fiscal stabilisers: Features of the tax and spending regime of a government budget which react automatically to the economic cycle and reduce its fluctuations. As a result, the government budget balance in per cent of GDP tends to improve in years of high economic growth and deteriorate during economic slowdowns.

Budget semi-elasticity: The change in the *budget balance-to-GDP ratio* to a cyclical change in GDP. The estimates of budget semi-elasticity used for EU fiscal surveillance purposes are derived from an agreed methodology developed by the OECD. The average semi-elasticity for the EU as a whole is 0.5.

Constrained judgement: A two-step approach that allows the Commission, under specific circumstances, to depart from the *output gap* estimates of the commonly agreed method in its assessment of the cyclical position of a Member State. The plausibility of the commonly agreed method is first checked against the indications of an alternative tool. If the difference between the two exceeds a given threshold, the Commission may apply a constrained degree of discretion in choosing the appropriate output gap estimate for surveillance purposes.

Corrective arm of the Stability and Growth Pact: The part of the *Stability and Growth Pact* that deals with preventing the risk of and/or correcting an excessive budgetary imbalance. Under the SGP an excessive budgetary imbalance is (i) a government deficit exceeding 3% of GDP and (ii) government debt in excess of 60% of GDP that is not approaching 60% at a satisfactory pace (see also *debt reduction benchmark*).

Commonly agreed methodology for the estimation of potential output: Under the EU fiscal surveillance framework, the European Commission estimates potential output and the output gap with a commonly agreed methodology endorsed by the ECOFIN Council back in 2002. The commonly agreed method is based on a production function approach, which brings together the potential levels of labour, capital and total factor productivity. For more details, see Box 4.2 of the EFB annual report 2017.

Country-specific recommendations (CSRs): Policy guidance tailored to each EU Member State based on the provisions of the SGP and the MIP. The recommendations are put forward by the European Commission in May of each year, then discussed among Member States in the Council, endorsed by EU leaders at a summit in June, and formally adopted by the finance ministers in July.

Debt reduction benchmark: The reduction of a country's government debt above 60% of GDP by 1/20th per year on average. This is the criterion used to assess whether excessive government debt is sufficiently diminishing and approaching 60% of GDP at a satisfactory pace. The pace of reduction is assessed over both the past three years and the next three years, and after correcting for the cycle. Compliance in at least one of the three cases is sufficient to ensure compliance with the debt criterion (see *corrective arm of the SGP*).

Discretionary fiscal policy: A government decision that leads to a change in government spending or revenue above and beyond the effect of existing fiscal policies. Its effect is usually measured as the change in the budget balance net of the effect of *automatic fiscal stabilisers*, one-off measures and interest payments (see also *structural balance* and *structural primary balance*).

Draft budgetary plans (DBPs): Governments submit DBPs to the Commission and the Council to ensure the coordination of fiscal policies among Member States who have the euro as their currency and because the EU Treaty recognises economic policy as 'a matter of common concern'. They submit their DBPs for the following year between 1 and 15 October. The requirement was introduced in 2013 with the *two-pack* reform of the Stability and Growth Pact.

Economic partnership programme: since the two-pack reform of 2013, euro-area Member States entering an excessive deficit procedure (or receiving a new deadline for correction) must present such programmes, which contain detailed fiscal and structural reforms (for example, on pension systems, taxation or public healthcare) that will correct Member States' deficits in a lasting way.

Enhanced surveillance: tighter surveillance introduced by the two-pack reform for countries experiencing financial difficulties or under precautionary assistance programmes from the European Stability Mechanism. Under the enhanced surveillance, they are subject to regular review visits by the Commission and must provide additional data, for example on their financial sectors.

European economic recovery plan: a large coordinated stimulus package initiated by the European Commission and the euro-area Member States to tackle the negative effects of the 2008 global financial crisis. It aimed to boost demand and stimulate confidence. The plan called for a fiscal stimulus of €200 billion, equivalent to 1.5% of EU GDP. €170 billion would come from Member States' budgets, while the rest would take the form of EU funding.

European Semester: A framework for the coordination of economic policies across the European Union. It is organised around an annual timeline that allows EU countries to discuss their economic and budgetary plans and monitor progress at specific dates throughout the year.

Excessive deficit procedure (EDP): A procedure under the corrective arm of the SGP to correct an excessive deficit, i.e. a deficit that lastingly exceeds the 3% of GDP Treaty threshold by a margin, or a debt ratio that is not diminishing sufficiently.

Expenditure benchmark: One of the two pillars used to assess compliance with the *preventive arm of the Stability and Growth Pact*, along with the change in the *structural balance*. It specifies a maximum growth rate for public expenditure that (i) is corrected for certain non-discretionary items, such as interest expenditure, (ii) includes a smoothed measure of public investment, and (iii) is adjusted for discretionary revenue measures. The growth rate may not exceed *potential GDP* growth over the medium term and is further constrained for Member States that have not yet achieved their *medium-term budgetary objective*.

Fiscal Compact: The fiscal chapter of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (*TSCG*), which is an intergovernmental treaty aiming to reinforce fiscal discipline in the euro area. The *TSCG* was signed on 2 March 2012 by all Member States of the European Union except the Czechia, the United Kingdom and Croatia (which did not join the EU until 2013). Of the 25 contracting parties to the TSCG, 22 (the 19 euro-area Member States plus Bulgaria, Denmark and Romania on a voluntary basis) are formally bound by the Fiscal Compact. They are required to have enacted laws of binding character for their national budgets to be in balance or in surplus. These laws must also provide for a correction mechanism overseen by a national independent fiscal institution to avoid lasting deviations from a balanced budget position. The remaining three countries, Hungary, Poland and Sweden, has been exercising from the beginning their right of exemption from the Fiscal Compact provisions of the Treaty. In a similar vein, Croatia and Czechia, when recently became signatories to the TSCG, decided not to be bound by the Fiscal Compact.

Fiscal impulse: A measure of the thrust of *discretionary fiscal policy*. In this report, it is defined as the annual change in the structural primary budget balance or by the expenditure benchmark. It is thus the change in the fiscal stance (see also Fiscal Stance). A positive (negative) fiscal impulse has an expansionary (contractionary) effect on aggregate demand.

Fiscal stance: A measure of the overall support of *discretionary fiscal policy* to aggregate demand. In this report, it is measured by the *structural primary balance: a surplus* signal a restrictive stance, and deficit a supportive stance.

Five Presidents' Report: A report on 'Completing Europe's Economic and Monetary Union', prepared by the President of the European Commission in close cooperation with the President of the Euro Summit, the President of the Eurogroup, the President of the European Central Bank, and the President of the European Parliament. Published on 22 June 2015, the report sets out a roadmap towards the completion of the Economic and Monetary Union.

Flexibility clauses: Provisions under the preventive arm of the SGP allowing for a temporary and limited deviation from the *MTO*, or the adjustment path towards it. Flexibility clauses can be granted, subject to pre-defined eligibility conditions, to accommodate the budgetary impact of major structural reforms or government investment.

General escape clause: See *severe economic downturn clause*.

Margin of broad compliance: The margin of error the Commission applies in the assessment of compliance with the preventive arm of the SGP. A Member State is considered to be broadly compliant if the observed deviation from its MTO, or from the recommended adjustment towards it, does not exceed 0.5% of GDP in a single year, or cumulatively over two consecutive years. The margin of broad compliance is motivated by the measurement uncertainty surrounding real time estimates of the *structural budget balance*.

Matrix of adjustment requirements: A double-entry table detailing the structural adjustment required under the *preventive arm of the Stability and Growth Pact* since 2015. It modulates the benchmark annual adjustment of 0.5% of GDP depending on (i) cyclical conditions, as indicated by the level of the *output gap* and whether GDP growth is above or below potential, and (ii) the level of government debt and sustainability risks as measured by the *S1 indicator*.

Medium-term budgetary objective (MTO): the *Stability and Growth Pact* requires EU Member States to specify every three years a medium-term objective for their budgetary position in the *stability and convergence programmes*. The MTO is country-specific, in order to take account of the diversity of economic and budgetary developments and the diversity of fiscal risks to the sustainability of public finances. It is defined in structural terms (see *structural balance*). The MTO should not be lower than the *minimum MTO* calculated by the Commission (see below).

Minimum benchmark: The lowest value of the structural balance that provides a sufficient margin against the risk of breaching the Treaty deficit threshold of 3% of GDP during normal cyclical fluctuations. For each Member State, the Commission provides an annual update of the *minimum benchmark*, by taking into account past output volatility and the budgetary responses to output fluctuations. Since 2019, the volatility is measured as the simple average between the country-specific standard deviation of the cyclical component of the budget balance and the one based on all available observations for all Member States since 1985. A Member State with a greater output volatility and a larger budgetary semi-elasticity will need a more demanding structural balance in order to ensure compliance with the threshold of 3% of GDP.

Minimum MTO: the country-specific greatest lower bound for the MTO, which corresponds to the lowest MTO (i.e. the most demanding value) of the following three component: i) the *minimum benchmark* (see above); ii) the implicit liabilities and debt component, reflecting medium and long-term sustainability needs; iii) the -1% lower bound for euro-area and ERM II Member States. Member States are free to set a more ambitious MTO in their stability (and convergence) programmes.

Net expenditure growth: The growth rate of primary public expenditure corrected for certain items and net of discretionary revenue measures, in line with the *expenditure benchmark* definition. When net expenditure growth exceeds medium-term *potential GDP* growth, this signals an expansionary *fiscal stance*.

Output gap: The difference between actual output and estimated potential output at any particular point in time. A business cycle typically includes a period of positive output gaps and a period of negative output gaps. When the output gap is closed, the economy is in line with its potential level (see *potential GDP*). A standard business cycle usually lasts up to eight years, suggesting that the output gap is normally expected to close roughly every four years.

Overall assessment: The analysis of the information conveyed by the two indicators used to assess compliance with the *preventive arm of the SGP*, namely the change in the *structural balance* and the *expenditure benchmark*. An overall assessment is conducted whenever at least one of the two indicators does not point to compliance with the requirements. It is meant to clarify (i) whether and how specific factors may affect one or both indicators, and (ii) which indicator would provide a more accurate assessment in the given context if the two indicators do not support the same conclusions.

Potential GDP (or potential output): The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, constraints on capacity begin to show and inflationary pressures build. If output falls below potential, resources are lying idle and inflationary pressures abate (see also *production function approach* and *output gap*).

Preventive arm of the Stability and Growth Pact: The part of the *Stability and Growth Pact* that aims to prevent gross policy errors and excessive deficits. Under the preventive arm, Member States are required to progress towards their *medium-term budgetary objective* at a sufficient pace and maintain it after it is reached.

Production function approach: A method of estimating an economy's sustainable level of output, compatible with stable inflation based on available labour inputs, the capital stock and their level of efficiency. *Potential output* is used to estimate the *output gap*, a key input in estimating the *structural balance*.

Revenue windfalls and shortfalls: Changes in government revenue that are not explained by the standard elasticity of revenue to the economic cycle. Unusually buoyant revenue leads to revenue windfalls while unusually weak revenue leads to revenue shortfalls.

S0 indicator: A composite indicator published by the European Commission to evaluate the extent to which there might be a risk of fiscal stress in the short term, stemming from the fiscal, macro-financial or competitiveness sides of the economy. A set of 25 fiscal and financial-competitiveness variables proven to perform well in detecting fiscal stress in the past is used to construct the indicator.

S1 indicator: A medium-term sustainability indicator published by the European Commission. It indicates the additional adjustment, in terms of change in the *structural primary balance*, required over five years to bring the general government debt-to-GDP ratio to 60% in 15 years' time, including financing for any future additional expenditure arising from an ageing population.

S2 indicator: The European Commission's long-term sustainability indicator. It shows the upfront adjustment to the current *structural primary balance* required to stabilise the debt-to-GDP ratio over an infinite horizon, including financing for any additional expenditure arising from an ageing population.

Safety margin: The difference between the 3%-of-GDP deficit threshold and the *minimum benchmark*.

Severe economic downturn clause: In the public debate known as the general escape clause. It was introduced in 2011 as part of the six-pack reform of the Stability and Growth Pact. It allows for additional and temporary flexibility with the normal requirements of the preventive and corrective arm of the Pact in the event of a severe economic downturn in the euro area or the EU as a whole, provided that this does not endanger fiscal sustainability in the medium term.

Significant deviation procedure (SDP): A procedure under the preventive arm of the SGP to correct a significant deviation from the MTO or the adjustment path towards it.

Six-pack: A set of European legislative measures — five regulations and one directive — to reform the *Stability and Growth Pact*. The six-pack entered into force on 13 December 2011. It aims to strengthen the procedures for reducing public deficits and debts and to address macroeconomic imbalances.

Stabilisation: Economic policy intervention to bring actual output closer to *potential output*. In the Economic and Monetary Union, in normal economic times, this is expected to be achieved through the ECB's monetary policy (for common shocks) and national *automatic fiscal stabilisers* (for country-specific shocks). When this is not sufficient, *discretionary fiscal policy* can also play a role.

Stability and convergence programmes (SCPs): Every year in April, EU Member States are required to set out their fiscal plans for the next three years and to submit them for assessment to the European Commission and the Council. This exercise is based on the economic governance rules under the *Stability and Growth Pact*. Euro area countries submit stability programmes; non-euro area countries convergence programmes.

Stability and Growth Pact (SGP): A set of rules designed to ensure that countries in the European Union pursue sound public finances and coordinate their fiscal policies. The SGP is based on an agreement reached by the EU Member States in 1997 to enforce the deficit and debt limits established by the Maastricht Treaty.

Structural (budget) balance: The actual budget balance corrected for the impact of the economic cycle and net of one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance and of the overall orientation of fiscal policy (see also *fiscal stance*).

Structural primary (budget) balance: The *structural (budget) balance* net of interest payments (see also *fiscal stance*).

Sustainability of public finances: The ability of a government to service its debt. From a purely theoretical point of view, this basically assumes that the government debt level does not grow faster than the interest rate. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve. The European Commission uses three indicators of sustainability with different time horizons (*S0*, *S1* and *S2*). They are complemented by a debt sustainability analysis including sensitivity tests on government debt projections and alternative scenarios.

Two-pack: Two European regulations adopted in 2013 to introduce stronger fiscal surveillance including under the *Stability and Growth Pact*. The new mechanisms aim to increase the transparency of Member States' budgetary decisions, strengthen coordination in the euro area starting with the 2014 budgetary cycle, and recognise the special needs of euro area countries under severe financial pressure.

Unusual event clause: A provision under the preventive arm of the SGP allowing for a temporary deviation from the MTO or the adjustment towards it, in the case of an unusual event outside government control with a major impact on the financial position of the general government. To be granted, the deviation must not endanger fiscal sustainability in the medium term.

Zero lower bound (ZLB): When the short-term nominal interest rate is at or near zero, the central bank is limited in its capacity to stimulate economic growth by further lowering policy rates. To overcome the constraint imposed by the ZLB, alternative methods of stimulating demand, such as asset purchase programmes, are generally considered. The root cause of the ZLB is the issuance of paper currency, which effectively guarantees a zero nominal interest rate and acts as an interest-rate floor. Central banks cannot encourage spending by lowering interest rates, because people would choose to hold cash instead.

ANNEX A: OVERVIEW TABLES

Table A1: **Application of EU fiscal rules in the 2020 surveillance cycle - the preventive arm of the SGP (see Box A1 on how to read the table)**

	Spring 2019			Autumn 2019	2020	Spring 2021		
	Distance to MTO in 2019 % of GDP	Country-specific recommendation (CSRs) for 2020: Required adjustment: limit on spending growth under exp. benchmark, (EB); recomm. change in the structural balance (ΔSB) (y-o-y % ch. ; % of GDP)	Country-specific recommendation (CSRs) for 2020: Flexibility clauses (granted *ex ante*) % of GDP	Commission assessment of draft budgetary plan (DBP)	Updated country-specific recommendations under the severe economic downturn clause	Final Commission assessment: Observed fiscal performance in 2020 (% of GDP), 2020: ΔSB	Final Commission assessment: Observed fiscal performance in 2020 (% of GDP), 2020: NEG	Conclusion of the overall assessment and procedural steps after the reference period
BE	-1.4	(1.6 ; 0.6)	-	Risk of non-compliance	2020 CSR: take all necessary measures to effectively address the pandemic, sustain the economy and support the ensuing recovery	-2.4	-4.0	Motivated by the activation of the severe economic downturn clause the Commission did not provide the ususal assessment of compliance
						No assessment		
BG	1.7	-	-	-	idem	-3.8	-3.8	idem
						No assessment		
CZ	0.6	-	-	-	idem	-3.6	-4.1	idem
						No assessment		
DK	1.4	-	-	-	idem	-2.9	-2.5	idem
						No assessment		
DE	1.6	Use fiscal space	-	Compliant	idem	-2.8	-3.5	idem
						No assessment		
EE	-1.2	(4.1 ; 0.6)	-	Broadly compliant	idem	-1.6	-1.7	idem
						No assessment		
IE	-0.7	Achieve the MTO	-	Compliant	idem	-5.1	-3.4	idem
						No assessment		

(Continued on the next page)

Table (continued)

	Spring 2019			Autumn 2019	2020	Spring 2021			
		Country-specific recommendation (CSRs) for 2020				Final Commission assessment			
	Distance to MTO in 2019 % of GDP	Required adjustment: limit on spending growth under exp. benchmark, (EB); recomm. change in the structural balance (ΔSB) (y-o-y % ch. ; % of GDP)	Flexibility clauses (granted *ex ante*) % of GDP	Commission assessment of draft budgetary plan (DBP)	Updated country-specific recommendations under the severe economic downturn clause	Observed fiscal performance in 2020 (% of GDP) – 2020 ΔSB	Observed fiscal performance in 2020 (% of GDP) – 2020 NEG	Final Commission assessment	Conclusion of the overall assessment and procedural steps after the reference period
EL	-	Post-progr. commitments	-	Compliant	2020 CSR: take all necessary measures to effectively address the pandemic, sustain the economy and support the ensuing recovery	-6.7	-7.8	No assessment	Motivated by the activation of the severe economic downturn clause the Commission did not provide the ususal assessment of compliance
ES	-2.9	(0.9 ; 0.65)	-	Risk of non-compliance	idem	-0.5	-2.5	No assessment	idem
FR	-2.2	(1.2 ; 0.6)	-	Risk of non-compliance	idem	-1.3	-3.6	No assessment	idem
HR	0.2	-	-	-	idem	-3.5	-3.5	No assessment	idem
IT	-2.9	(0.1 ; 0.6)	-	Risk of non-compliance	idem	-2.7	-4.5	No assessment	idem
CY	1.1	-	-	Compliant	idem	-4.7	-4.7	No assessment	idem
LV	-0.6	(3.5 ; 0.5)	-	Broadly compliant	idem	-1.7	-2.9	No assessment	idem
LT	0.0	-	-	Compliant	idem	-5.7	-5.90	No assessment	idem
LU	0.4	-	-	Compliant	idem	-4.7	-3.8	No assessment	idem

(Continued on the next page)

Table (continued)

	Spring 2019			Autumn 2019	2020	Spring 2021		
		Country-specific recommendation (CSRs) for 2020				Final Commission assessment		
	Distance to MTO in 2019 % of GDP	Required adjustment: limit on spending growth under exp. benchmark, (EB); recomm. change in the structural balance (ΔSB) (y-o-y % ch. ; % of GDP)	Flexibility clauses (granted *ex ante*) % of GDP	Commission assessment of draft budgetary plan (DBP)	Updated country specific-recommendations under the severe economic downturn clause	Observed fiscal performance in 2020 (% of GDP)		Conclusion of the overall assessment and procedural steps after the reference period
						2020		
						ΔSB	NEG	
HU	-2.3	(4.7 ; 0.75)	-	-	2020 CSR: take all necessary measures to effectively address the pandemic, sustain the economy and support the ensuing recovery	-2.4	-3.8	Motivated by the activation of the severe economic downturn clause the Commission did not provide the ususal assessment of compliance
						No assessment		
MT	0.6	-	-	Compliant	idem	-5.7	-5.7	idem
						No assessment		
NL	1.2	Use fiscal space	-	Compliant	idem	-2.8	-4.6	idem
						No assessment		
AT	0.4	-	-	Compliant	idem	-5.1	-6.0	idem
						No assessment		
PL	-1.8	(4.4 ; 0.6)	-	-	idem	-3.6	-5.5	idem
						No assessment		
PT	-0.5	Achieve the MTO	(-0.04)	Risk of non-compliance	idem	-0.8	-2.8	idem
						No assessment		
RO	-2.6	(5.1 ; 0.75)	-	-	2020 CSR: Pursue fiscal policies in line with the Council's recommendation of 3 April 2020 , while taking all necessary measures to effectively address the pandemic, sustain the economy and support the ensuing recovery.	-2.8	-2.9	in EDP (see Table A3)

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Table (continued)

<table>
<tr><th rowspan="4"></th><th colspan="3">Spring 2019</th><th>Autumn 2019</th><th>2020</th><th colspan="3">Spring 2021</th></tr>
<tr><th rowspan="3">Distance to MTO in 2019 % of GDP</th><th colspan="2">Country-specific recommendation (CSRs) for 2020</th><th rowspan="3">Commission assessment of draft budgetary plan (DBP)</th><th rowspan="3">Updated country-specific recommendations under the severe economic downturn clause</th><th colspan="2">Final Commission assessment
Observed fiscal performance in 2020 (% of GDP)
2020</th><th rowspan="3">Conclusion of the overall assessment and procedural steps after the reference period</th></tr>
<tr><th rowspan="2">Required adjustment: limit on spending growth under exp. benchmark, (EB); recomm. change in the structural balance (ΔSB) (y-o-y % ch. ; % of GDP)</th><th rowspan="2">Flexibility clauses (granted ex ante) % of GDP</th><th>ΔSB</th><th>NEG</th></tr>
<tr></tr>
<tr><td rowspan="2">SI</td><td rowspan="2">-0.5</td><td rowspan="2">Achieve the MTO</td><td rowspan="2">-</td><td rowspan="2">Risk of non-compliance</td><td rowspan="2">2020 CSR: take all necessary measures to effectively address the pandemic, sustain the economy and support the ensuing recovery.</td><td>-5.0</td><td>-4.7</td><td rowspan="2">Motivated by the activation of the severe economic downturn clause the Commission did not provide the ususal assessment of compliance.</td></tr>
<tr><td colspan="2">No assessment</td></tr>
<tr><td rowspan="2">SK</td><td rowspan="2">-0.3</td><td rowspan="2">Achieve the MTO</td><td rowspan="2">-</td><td rowspan="2">Risk of non-compliance</td><td rowspan="2">idem</td><td>-2.4</td><td>-2.4</td><td rowspan="2">idem</td></tr>
<tr><td colspan="2">No assessment</td></tr>
<tr><td rowspan="2">FI</td><td rowspan="2">-0.5</td><td rowspan="2">(1.9 ; 0.5)</td><td rowspan="2">-</td><td rowspan="2">Risk of non-compliance</td><td rowspan="2">idem</td><td>-2.1</td><td>-1.6</td><td rowspan="2">idem</td></tr>
<tr><td colspan="2">No assessment</td></tr>
<tr><td rowspan="2">SE</td><td rowspan="2">1.5</td><td rowspan="2">-</td><td rowspan="2">-</td><td rowspan="2">-</td><td rowspan="2">idem</td><td>-1.1</td><td>-1.8</td><td rowspan="2">idem</td></tr>
<tr><td colspan="2">No assessment</td></tr>
</table>

Source: European Commission

Table A2: **Application of EU fiscal rules in the 2020 surveillance cycle - the corrective arm of the SGP; countries not in EDP (see Box A1 on how to read the table)**

	Autumn 2019		2020	Spring 2021		
	Commission assessment of draft budgetary plan (DBP)			Final assessment		
	Deficit Rule	Debt Rule (DR) / Transitional Arrangement (MLSA)	Procedural steps during the reference period	Deficit Rule	Debt Rule (DR) / Transitional Arrangement (MLSA)	Procedural steps after the reference period
BE	Compliant	At risk of non-compliance with the debt rule	**20.5.2020 –** The Commission prepared a report in accordance with Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that Belgium had not made sufficient progress towards compliance with the debt reduction benchmark in 2019. The Commission's assessment of relevant factors examined (i) the observed macroeconomic conditions; (ii) the implementation of growth-enhancing structural reforms in the past; and (iii) the significant deviation from the recommended adjustment path towards the medium term budgetary objective. **The report concluded that the debt criterion should be considered as not complied with. Given the exceptional uncertainty due to the Covid-19 pandemic, the Commission considered that at that juncture a decision on whether to place Member States under the excessive deficit procedure (EDP) should not be taken.** **20.11.2020 –** The Commission published its Opinion on Belgium's DBP. The Opinion did not include its assessment of Belgium's compliance with fiscal rules. It simply stated that the Belgium's DBP was, in line with the recommendation the Council adopted on 20 July 2020.	Non-compliant	Non-compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Belgium did not fulfil the deficit and debt criteria. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
CZ				Non-compliant	Compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Czechia did not fulfil the deficit criterion. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
DE				Non-compliant	Non-compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Germany did not fulfil the deficit and debt criteria. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
EE				Non-compliant	Compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Estonia did not fulfil the deficit criterion. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
IE				Non-compliant	Compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Ireland did not fulfil the deficit criterion. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
EL			**20.5.2020 –** The Commission prepared a report in accordance with Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that Greece had not made sufficient progress towards compliance with the debt reduction benchmark in 2019. The Commission's assessment of relevant factors examined (i) the observed macroeconomic conditions; (ii) some progress with the implementation of growth enhancing structural reforms in past years; and (iii) the compliance with Greece's fiscal targets in the context of enhanced surveillance. **The report concluded that the debt criterion should be considered as complied with.** **20.11.2019 –** The Commission published its Opinion on Greece's DBP. The Opinion did not include an assessment of compliance with fiscal rules. It simply stated that the Greece's DBP was, in line with the recommendation the Council adopted on 20 July 2020.	Non-compliant	Non-compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Greece did not fulfil the deficit and debt criteria. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.

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Table (continued)

ES	Compliant	At risk of non-compliance with the debt rule	**20.5.2020 –** The Commission prepared a report in accordance with Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that Spain had not made sufficient progress towards compliance with the debt reduction benchmark in 2019. The Commission's assessment of relevant factors examined (i) the observed macroeconomic conditions; (ii) the implementation of growth-enhancing structural reforms in the past; and (iii) the significant deviation from the recommended adjustment path towards the medium-term budgetary objective. **The report concluded that the debt criterion should be considered as not complied with. Given the exceptional uncertainty due to the Covid-19 pandemic, the Commission considered that at that juncture a decision on whether to place Member States under the EDP should not be taken.** **20.11.2019** - The Commission published its Opinion on Spain's DBP. The Opinion did not include an assessment of compliance with fiscal rules. It simply stated that Spain's DBP was, overall in line with the recommendation the Council adopted on 20 July 2020.	Non-compliant	Non-compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Spain did not fulfil the deficit and debt criteria. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
FR	Compliant	At risk of non-compliance with the debt rule	**20.5.2020 –** The Commission prepared a report in accordance with Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that France had *prima facie* not made sufficient progress towards compliance with the debt reduction benchmark in 2019. The Commission's assessment of relevant factors examined (i) the observed macroeconomic conditions; (ii) the implementation of growth-enhancing structural reforms in the past; and (iii) the significant deviation from the recommended adjustment path towards the medium-term budgetary objective. **The report concluded that the debt criterion should be considered as not complied with. Given the exceptional uncertainty due to the Covid-19 pandemic, the Commission considered that at that juncture a decision on whether to place Member States under the EDP should not be taken.** **20.11.2019** - The Commission published its Opinion on France's DBP. The Opinion did not include an assessment of compliance with fiscal rules. It simply stated that France's DBP was, overall in line with the recommendation the Council adopted on 20 July 2020.	Non-compliant	Non-compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that France did not fulfil the deficit and debt criteria. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
HR				Non-compliant	Non-compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Croatia did not fulfil the deficit and debt criteria. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
IT	Compliant	At risk of non-compliance with the debt rule	**20.5.2020 –** The Commission prepared a report in accordance with Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that Italy had *prima facie* not made sufficient progress towards compliance with the debt reduction benchmark in 2019. The Commission's assessment of relevant factors stressed (i) the observed macroeconomic conditions, whereby the slowdown recorded since 2018 can be argued to partly explain Italy's large gaps to compliance with the debt reduction benchmark; (ii) some progress with the implementation of growth enhancing structural reforms in past years; and (iii) the fact that there is no robust evidence of a significant deviation from the preventive arm in 2019 and over 2018 and 2019 taken together. **The report concluded that the debt criterion should be considered as not complied with. Given the exceptional uncertainty due to the Covid-19 pandemic, the Commission considered that at that juncture a decision on whether to place Member States under the EDP should not be taken.** **20.11.2019 –** The Commission published its Opinion on Italy's DBP. The Opinion did not include an assessment of compliance with fiscal rules. It simply stated that Italy's DBP was overall in line with the recommendation the Council adopted on 20 July 2020.	Non-compliant	Non-compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Italy did not fulfil the deficit and debt criteria. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.

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Table (continued)

CY	Non-compliant	Compliant	**20.5.2020 –** The Commission prepared a report in accordance with Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that Cyprus had not made sufficient progress towards compliance with the debt reduction benchmark in 2019. The Commission's assessment of relevant factors examined (i) the observed macroeconomic conditions; (ii) the limited progress with the implementation of growth-enhancing structural reforms over the past few years; and (iii) compliance with the medium term budgetary objective. **The report concluded that the debt criterion should be considered as complied with.** **20.11.2019** - The Commission published its Opinion on Cyprus's DBP. The Opinion did not include its assessment of Cyprus' compliance with fiscal rules. It simply stated that Cyprus' DBP was, overall in line with the recommendation the Council adopted on 20 July 2020.	Non-compliant	Non-compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Cyprus did not fulfil the deficit and debt criteria. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
LV				Non-compliant	Compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Latvia did not fulfil the deficit criterion. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
LT				Non-compliant	Compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Lithuania did not fulfil the deficit criterion. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
LUX				Non-compliant	Compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Luxembourg did not fulfil the deficit criterion. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
HU				Non-compliant	Non-compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Hungary did not fulfil the deficit and debt criteria. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
MT				Non-compliant	Compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Malta did not fulfil the deficit criterion. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
NL				Non-compliant	Compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that the Netherlands did not fulfil the deficit criterion. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
AT				Non-compliant	Non-compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Austria did not fulfil the deficit and debt criteria. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
PL				Non-compliant	Compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Poland did not fulfil the deficit criterion. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.

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Table (continued)

PT				Non-compliant	Non-compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Portugal did not fulfil the deficit and debt criteria. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
SI				Non-compliant	Non-compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Slovenia did not fulfil the deficit and debt criteria. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
SK				Non-compliant	Compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Slovakia did not fulfil the deficit criterion. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.
FI				Non-compliant	Non-compliant	**2.6.2021 –** The Commission prepared an Omnibus report in accordance with Article 126(3) TFEU, confirming that Finland did not fulfil the deficit and debt criteria. The report did not contain conclusions on what steps to take next. In its chapeau communication the Commission suggested postponing any decision on EDPs in view of the high degree of uncertainty and the difficulty with defining fiscal adjustment paths.

Source: European Commission

Table A3: **Application of the EU fiscal rules in the 2020 surveillance cycle - the corrective arm of the SGP; countries in EDP (see Box A1 on how to read the table)**

	Spring 2019	Autumn 2019			2020	Spring 2021		
	EDP status (deadline)	Requirements % of GDP		Commission Assessment of draft budgetary plan (DBP)	Procedural steps during the reference period	Final assessment % of GDP		Procedural steps after the reference period
		Headline budget balance	Structural adjustment			Headline budget balance	Change in the structural budget balance	
RO				Not applicable	**14.2.2020 –** The Commission prepared a report in accordance with Article 126(3) TFEU after Romania had taken no effective action in response to the Council's recommendations. On 10 December 2019 the government adopted and sent to the Parliament its Fiscal Strategy for 2020-22, with an accrual deficit target of 3.8% of GDP in 2019. The Commission's assessment of relevant factors, based on its 2020 winter forecast, stressed that (i) the planned excess over the reference value was considered to be neither exceptional nor temporary (ii) general government gross debt remained well below 60% of the GDP reference value, and (iii) relevant factors did not provide mitigating elements. **The report concluded that after assessing all the relevant factors the deficit criterion should be considered as not complied with, and that the EDP was warranted.** **04.03.2020 –** The Commission issued a Recommendation for a Council Recommendation to end the excessive deficit situation. It concluded that Romania should put an end to the present excessive deficit situation by 2022 at the latest with an annual structural adjustment of 0.5% of GDP in 2020, 0.8% of GDP in 2021 and 0.8% of GDP in 2022. **8.4.2020** – The Council adopted a report accordance with Article 126(7) TFEU. The conclusions of its Recommendation coincided with those of the Commission's Recommendation. **18.11.2020 –** The Commission issued a Communication on the fiscal situation in Romania concluding that Romania was not in a position to be able to make adjustments that would be necessary to correct its excessive deficit in line with the latest Council Recommendation. It stated that due to the current high level of uncertainty, fiscal sustainability risks would be reassessed in spring 2021.	-9.2	-2.8	**2.6.2021** – The Commission issued a Recommendation in accordance with Article 126(7) TFEU for a Council Recommendation to bring an end to Romania's excessive government deficit. In its recommendations, the Commission took into account the country's changed fiscal situation, including budgetary developments in 2020 and the new budgetary strategy put in place by the Romanian government. It has concluded to extend the deadline for correcting the excessive deficit to 2024 and provided a new adjustment path for the rate of nominal growth in net primary government expenditure and an annual fiscal adjustment to the structural balance. It also stated that growth rates of net primary government expenditure would be the primary indicator used to assess Romania's fiscal effort if necessary. **18.6.2021** – The Council adopted a recommendation in accordance with the EDP for Romania.

Source: European Commission

Box A1: Reading the overview tables A1, A2 and A3

The tables in Annex A provide an overview of the various Stability and Growth Pact (SGP) procedures for all Member States in the reference period 2020. All tables are divided into columns covering the main steps of the annual cycle of EU fiscal surveillance.

Table A.1. Application of EU fiscal rules in the 2020 surveillance cycle: preventive arm

Distance to the medium-term budgetary objective (MTO): The difference between the country-specific MTO and the 2019 structural balance, on the basis of the Commission 2019 spring forecasts underpinning the July 2019 country-specific Council recommendations (CSRs).

Required adjustment: The annual adjustment requirement is expressed in terms of the two quantitative indicators of the SGP's preventive arm: (i) the expenditure benchmark (EB) and (ii) the change in the structural budget balance (ΔSB). The EB limits the year-on-year increase in government spending unless funded by new revenue measures. It is expressed using the annual growth rate of an expenditure aggregate, net of interest payments, spending on EU programmes paid for by EU funds and the cyclical component of unemployment benefits, while nationally financed government investment is smoothed over 4 years. The ΔSB is defined on the basis of a country's cyclical conditions, taking into account the sustainability needs of its public finances ([1]). The required structural adjustment is net of any flexibility clauses granted *ex ante*.

Flexibility clauses granted *ex ante*: An allowance for a reduction in the structural adjustment a country is required to make, determined for 2020 in the context of the assessment of its stability and convergence programmes in spring 2019, or determined in previous years and carried over for 3 years. Permitted deviations apply to the change or level of the structural balance, whichever entails the least stringent requirement. A deviation in terms of change affects the adjustment path towards the MTO and applies to countries that are still relatively far from achieving their MTO. By contrast, when the structural balance is close to the MTO, the permitted deviation refers directly to the distance from the MTO. A country can be granted flexibility for structural reforms, including the specific case of pension reform, for investments, or for the impact of adverse economic events outside its control, such as a severe economic downturn, natural disasters or a refugee crisis. For a comprehensive presentation of how flexibility is taken into account, see the Vade Mecum (2019 edition), Sections 1.3.3, 1.3.4, 1.3.5.

Commission overall assessment of the 2020 draft budgetary plan (DBP): In line with Regulation (EU) 473/2013, every year all euro area countries submit their DBPs by 15 October, except in the case of a macroeconomic adjustment programme. Plans are assessed for compliance with the SGP. The overall conclusion of the Commission can be: (i) compliant, (ii) risk of (some) deviation ([2]), or (ii) risk of significant deviation. If there is a risk of some deviation, the DBP is considered to be broadly compliant. However, if there is a risk of significant deviation, the DBP is considered non-compliant. For a comprehensive presentation of the assessment of compliance with the preventive arm of the SGP, see the Vade Mecum, Section 1.3.7.

Updated country-specific recommendations under the severe economic downturn clause: With the adoption of the country-specific recommendations in spring 2020, the Council, acting on a proposal from the Commission, updated its earlier fiscal guidance to allow extra leeway in the light of the economic impact of the Covid-19 pandemic.

Observed fiscal performance in 2020: Presents the underlying fiscal developments on the basis of two indicators: (i) the change in the structural balance (ΔSB) and (ii) excess net expenditure growth over the medium-term rate of potential GDP growth (i.e. NEG), both expressed in percent of GDP.

Conclusion of the overall assessment and procedural steps after the reference period: Records procedural or other steps taken following the spring 2021 assessment of fiscal performance in 2020, subsequent to the activation of the severe economic downturn clause.

([1]) The '*Required Structural Adjustment based on matrix*' is based on the matrix for specifying the annual adjustment required to achieve the MTO under the preventive arm of the SGP, as presented in the Commonly Agreed Position on Flexibility in the SGP endorsed by the ECOFIN Council of 12 February 2016: http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf

([2]) 'Some deviation' refers to any deviation that is not significant, namely below 0.5 – as stated by Articles 6(3) and 10(3) of Regulation 1466/97.

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Box (continued)

Table A.2. Application of EU fiscal rules in the 2020 surveillance cycle - the corrective arm: Countries not subject to the EDP

Deficit Rule: The Commission's assessment of a country's 2019 DBP's' ([3]) fulfilment of the 3% of GDP deficit criterion in autumn 2019.

Debt Rule (DR) / Transitional Arrangement (MLSA): Commission's assessment of a country's fulfilment of the debt criterion. A country is considered to fulfil the debt criterion if its general government consolidated gross debt is below 60% of GDP or sufficiently diminishing and approaching 60% of GDP at a satisfactory pace. For Member States subject to the EDP on the date the six-pack was adopted (8 November 2011), special provisions apply under a transitional arrangement for the 3 years following the correction of their excessive deficit. For a comprehensive presentation of both cases, see the *Vade Mecum,* Sections 2.2.1.2 and 2.2.1.3.

Procedural steps taken during the reference period: Records procedural or other steps under the corrective arm of the SGP taken between autumn 2018 and spring 2020. For 2018, this column presents reports written pursuant to Article 126 (3) TFEU, the first step in the EDP, analysing compliance with the Treaty's deficit and debt criteria.

Deficit Rule: see above.

Debt Rule (DR) / Transitional Arrangement (MLSA): see above.

Procedural steps after the reference period: see Table A.1.

Table A.3. Application of EU fiscal rules in the 2020 surveillance cycle - the corrective arm: Countries subject to the EDP

EDP status (deadline): Presents a country's status in the EDP procedure in July 2019; in brackets, the deadline set by the Council for correcting the excessive deficit.

Headline budget balance: The Council recommends to Member States subject to the EDP to reach annual headline deficit targets in order to ensure the correction of the excessive deficit by a set deadline. This column presents the required headline budget balance for 2020.

Structural adjustment: The required annual improvement in the structural balance consistent with the nominal target recommended by the Council and presented in column 1.

Commission assessment of 2019 DBP: see Table A.2.

Procedural steps taken during the reference period: Covers all steps taken under the corrective arm of the SGP between autumn 2019 and spring 2021. All articles referred to in this column are from the Treaty on the Functioning of the European Union.

Headline budget balance: Presents the headline budget balance outturn in 2020 or the information attesting the correction of the excessive deficit.

Structural adjustment: The estimated structural adjustment made in 2020, alongside the corrected figure for unanticipated revenue windfalls/shortfalls and changes in potential growth compared to the scenario underpinning the EDP recommendations. For the latter, see the *Vade Mecum* (2019 edition), Sections 2.3.2.1.

Procedural steps after the reference period: see Table A.2.

([3]) https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries/draft-budgetary-plans-2018_en

ANNEX B: STATISTICAL ANNEX

Table B1: **Gross domestic product at 2015 reference levels (annual percentage change, 2003-2022)**

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
BE	1.0	3.6	2.3	2.6	3.7	0.4	-2.0	2.9	1.7	0.7	0.5	1.6	2.0	1.3	1.6	1.8	1.8	-6.3	4.5	3.7
BG	5.2	6.4	7.2	6.8	6.6	6.1	-3.4	0.6	2.4	0.4	0.3	1.9	4.0	3.8	3.5	3.1	3.7	-4.2	3.5	4.7
CZ	3.6	4.8	6.6	6.8	5.6	2.7	-4.7	2.4	1.8	-0.8	0.0	2.3	5.4	2.5	5.2	3.2	2.3	-5.6	3.4	4.4
DK	0.4	2.7	2.3	3.9	0.9	-0.5	-4.9	1.9	1.3	0.2	0.9	1.6	2.3	3.2	2.8	2.2	2.8	-2.7	2.9	3.5
DE	-0.7	1.2	0.7	3.8	3.0	1.0	-5.7	4.2	3.9	0.4	0.4	2.2	1.5	2.2	2.6	1.3	0.6	-4.9	3.4	4.1
EE	7.6	6.8	9.5	9.7	7.6	-5.1	-14.4	2.7	7.4	3.1	1.3	3.0	1.8	3.2	5.5	4.4	5.0	-2.9	2.8	5.0
IE	3.0	6.8	5.7	5.0	5.3	-4.4	-5.1	1.8	0.6	0.1	1.2	8.6	25.2	2.0	9.1	8.5	5.6	3.4	4.6	5.0
EL	5.8	5.1	0.6	5.7	3.3	-0.3	-4.3	-5.5	-10.1	-7.1	-2.7	0.7	-0.4	-0.5	1.3	1.6	1.9	-8.2	4.1	6.0
ES	3.0	3.1	3.7	4.1	3.6	0.9	-3.8	0.2	-0.8	-3.0	-1.4	1.4	3.8	3.0	3.0	2.4	2.0	-10.8	5.9	6.8
FR	0.8	2.8	1.7	2.4	2.4	0.3	-2.9	1.9	2.2	0.3	0.6	1.0	1.1	1.1	2.3	1.8	1.5	-8.1	5.7	4.2
HR	5.6	4.2	4.3	5.0	5.1	1.9	-7.3	-1.3	-0.2	-2.4	-0.4	-0.3	2.4	3.5	3.4	2.8	2.9	-8.0	5.0	6.1
IT	0.1	1.4	0.8	1.8	1.5	-1.0	-5.3	1.7	0.7	-3.0	-1.8	0.0	0.8	1.3	1.7	0.9	0.3	-8.9	4.2	4.4
CY	2.6	5.0	4.9	4.7	5.1	3.6	-2.0	2.0	0.4	-3.4	-6.6	-1.8	3.2	6.4	5.2	5.2	3.1	-5.1	3.1	3.8
LV	8.4	8.5	10.7	12.0	10.0	-3.3	-14.3	-4.4	6.5	4.3	2.3	1.1	4.0	2.4	3.3	4.0	2.0	-3.6	3.5	6.0
LT	10.6	6.6	7.7	7.4	11.1	2.6	-14.8	1.7	6.0	3.8	3.6	3.5	2.0	2.5	4.3	3.9	4.3	-0.9	2.9	3.9
LU	1.6	3.6	3.2	5.2	8.4	-1.3	-4.4	4.9	2.5	-0.4	3.7	4.3	4.3	4.6	1.8	3.1	2.3	-1.3	4.5	3.3
HU	4.1	4.8	4.2	4.0	0.2	1.1	-6.7	1.1	1.9	-1.4	1.9	4.2	3.8	2.1	4.3	5.4	4.6	-5.0	5.0	5.5
MT	4.1	0.1	3.4	2.5	4.8	3.8	-1.1	5.5	0.5	4.1	5.5	7.6	9.6	3.8	8.6	5.2	5.5	-7.8	4.6	6.1
NL	0.2	2.0	2.1	3.5	3.8	2.2	-3.7	1.3	1.6	-1.0	-0.1	1.4	2.0	2.2	2.9	2.4	1.7	-3.7	2.3	3.6
AT	0.9	2.7	2.2	3.5	3.7	1.5	-3.8	1.8	2.9	0.7	0.0	0.7	1.0	2.0	2.4	2.6	1.4	-6.3	3.4	4.3
PL	3.5	5.0	3.5	6.1	7.1	4.2	2.8	3.7	4.8	1.3	1.1	3.4	4.2	3.1	4.8	5.4	4.7	-2.7	4.0	5.4
PT	-0.9	1.8	0.8	1.6	2.5	0.3	-3.1	1.7	-1.7	-4.1	-0.9	0.8	1.8	2.0	3.5	2.8	2.5	-7.6	3.9	5.1
RO	2.3	10.4	4.7	8.0	7.2	9.3	-5.5	-3.9	1.9	2.0	3.8	3.6	3.0	4.7	7.3	4.5	4.1	-3.9	5.1	4.9
SI	3.0	4.4	3.8	5.7	7.0	3.5	-7.5	1.3	0.9	-2.6	-1.0	2.8	2.2	3.2	4.8	4.4	3.2	-5.5	4.9	5.1
SK	5.5	5.3	6.6	8.5	10.8	5.6	-5.5	5.9	2.8	1.9	0.7	2.6	4.8	2.1	3.0	3.7	2.5	-4.8	4.8	5.2
FI	2.0	4.0	2.8	4.0	5.3	0.8	-8.1	3.2	2.5	-1.4	-0.9	-0.4	0.5	2.8	3.2	1.3	1.3	-2.8	2.7	2.8
SE	2.3	4.3	2.9	4.7	3.4	-0.5	-4.3	6.0	3.2	-0.6	1.2	2.7	4.5	2.1	2.6	2.0	2.0	-2.8	4.4	3.3
EA-19	0.6	2.3	1.7	3.2	3.0	0.4	-4.5	2.1	1.7	-0.9	-0.2	1.4	2.0	1.9	2.6	1.9	1.3	-6.6	4.3	4.4
EU-27	0.9	2.5	1.9	3.5	3.1	0.6	-4.3	2.2	1.8	-0.7	0.0	1.6	2.3	2.0	2.8	2.1	1.6	-6.1	4.2	4.4

Notes: (1) EA and EU aggregated figures are weighted in common currency.
Source: Commission spring 2021 forecast.

Table B2: **Harmonised index of consumer prices (percentage change on preceding year, 2003-2022)**

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
BE	1.5	1.9	2.5	2.3	1.8	4.5	0.0	2.3	3.4	2.6	1.2	0.5	0.6	1.8	2.2	2.3	1.2	0.4	1.8	1.5
BG	2.3	6.1	6.0	7.4	7.6	12.0	2.5	3.0	3.4	2.4	0.4	-1.6	-1.1	-1.3	1.2	2.6	2.5	1.2	1.6	2.0
CZ	-0.1	2.6	1.6	2.1	2.9	6.3	0.6	1.2	2.2	3.5	1.4	0.4	0.3	0.6	2.4	2.0	2.6	3.3	2.4	2.2
DK	2.0	0.9	1.7	1.8	1.7	3.6	1.0	2.2	2.7	2.4	0.5	0.4	0.2	0.0	1.1	0.7	0.7	0.3	1.3	1.3
DE	1.1	1.8	1.9	1.8	2.3	2.8	0.2	1.1	2.5	2.2	1.6	0.8	0.7	0.4	1.7	1.9	1.4	0.4	2.4	1.4
EE	1.4	3.0	4.1	4.4	6.7	10.6	0.2	2.7	5.1	4.2	3.2	0.5	0.1	0.8	3.7	3.4	2.3	-0.6	1.6	2.2
IE	4.0	2.3	2.2	2.7	2.9	3.1	-1.7	-1.6	1.2	1.9	0.5	0.3	0.0	-0.2	0.3	0.7	0.9	-0.5	0.9	1.3
EL	3.4	3.0	3.5	3.3	3.0	4.2	1.3	4.7	3.1	1.0	-0.9	-1.4	-1.1	0.0	1.1	0.8	0.5	-1.3	-0.2	0.6
ES	3.1	3.1	3.4	3.6	2.8	4.1	-0.2	2.0	3.0	2.4	1.5	-0.2	-0.6	-0.3	2.0	1.7	0.8	-0.3	1.4	1.1
FR	2.2	2.3	1.9	1.9	1.6	3.2	0.1	1.7	2.3	2.2	1.0	0.6	0.1	0.3	1.2	2.1	1.3	0.5	1.4	1.1
HR	2.4	2.1	3.0	3.3	2.7	5.8	2.2	1.1	2.2	3.4	2.3	0.2	-0.3	-0.6	1.3	1.6	0.8	0.0	1.3	1.3
IT	2.8	2.3	2.2	2.2	2.0	3.5	0.8	1.6	2.9	3.3	1.2	0.2	0.1	-0.1	1.3	1.2	0.6	-0.1	1.3	1.1
CY	4.0	1.9	2.0	2.2	2.2	4.4	0.2	2.6	3.5	3.1	0.4	-0.3	-1.5	-1.2	0.7	0.8	0.5	-1.1	1.7	1.1
LV	2.9	6.2	6.9	6.6	10.1	15.3	3.3	-1.2	4.2	2.3	0.0	0.7	0.2	0.1	2.9	2.6	2.7	0.1	1.7	2.0
LT	-1.1	1.2	2.7	3.8	5.8	11.1	4.2	1.2	4.1	3.2	1.2	0.2	-0.7	0.7	3.7	2.5	2.2	1.1	1.9	1.9
LU	2.5	3.2	3.8	3.0	2.7	4.1	0.0	2.8	3.7	2.9	1.7	0.7	0.1	0.0	2.1	2.0	1.6	0.0	2.1	1.6
HU	4.7	6.8	3.5	4.0	7.9	6.0	4.0	4.7	3.9	5.7	1.7	0.0	0.1	0.4	2.4	2.9	3.4	3.4	4.0	3.2
MT	1.9	2.7	2.5	2.6	0.7	4.7	1.8	2.0	2.5	3.2	1.0	0.8	1.2	0.9	1.3	1.7	1.5	0.8	1.2	1.5
NL	2.2	1.4	1.5	1.6	1.6	2.2	1.0	0.9	2.5	2.8	2.6	0.3	0.2	0.1	1.3	1.6	2.7	1.1	1.6	1.4
AT	1.3	2.0	2.1	1.7	2.2	3.2	0.4	1.7	3.6	2.6	2.1	1.5	0.8	1.0	2.2	2.1	1.5	1.4	1.8	1.6
PL	0.7	3.6	2.2	1.3	2.6	4.2	4.0	2.6	3.9	3.7	0.8	0.1	-0.7	-0.2	1.6	1.2	2.1	3.7	3.5	2.9
PT	3.2	2.5	2.1	3.0	2.4	2.7	-0.9	1.4	3.6	2.8	0.4	-0.2	0.5	0.6	1.6	1.2	0.3	-0.1	0.9	1.1
RO	15.3	11.9	9.1	6.6	4.9	7.9	5.6	6.1	5.8	3.4	3.2	1.4	-0.4	-1.1	1.1	4.1	3.9	2.3	2.9	2.7
SI	5.6	3.7	2.4	2.5	3.8	5.5	0.8	2.1	2.1	2.8	1.9	0.4	-0.8	-0.2	1.6	1.9	1.7	-0.3	0.8	1.7
SK	8.4	7.5	2.8	4.3	1.9	3.9	0.9	0.7	4.1	3.7	1.5	-0.1	-0.3	-0.5	1.4	2.5	2.8	2.0	1.5	1.9
FI	1.3	0.1	0.8	1.3	1.6	3.9	1.6	1.7	3.3	3.2	2.2	1.2	-0.2	0.4	0.8	1.2	1.1	0.4	1.2	1.2
SE	2.3	1.0	0.8	1.5	1.7	3.3	1.9	1.9	1.4	0.9	0.4	0.2	0.7	1.1	1.9	2.0	1.7	0.7	1.8	1.1
EA-19	2.1	2.2	2.2	2.2	2.2	3.3	0.3	1.6	2.7	2.5	1.3	0.4	0.2	0.2	1.5	1.8	1.2	0.3	1.7	1.3
EU-27	2.3	2.5	2.3	2.3	2.4	3.7	0.8	1.8	2.9	2.6	1.3	0.4	0.1	0.2	1.6	1.8	1.4	0.7	1.9	1.5

Notes: (1) National index if not available.
Source: Commission 2021 spring forecast.

Table B3: **Net lending (+) or net borrowing (-), general government (as a percentage of GDP, 2003-2022)**

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
BE	0.0	-1.9	-0.2	-2.7	0.2	0.1	-1.1	-5.4	-4.1	-4.3	-4.3	-3.1	-3.1	-2.4	-2.4	-0.7	-0.8	-1.9	-8.9	-4.2
BG	-1.2	-0.4	1.8	1.0	1.8	1.1	1.6	-4.0	-3.1	-2.0	-0.3	-0.4	-5.4	-1.7	0.1	1.1	2.0	2.1	-2.8	-1.8
CZ	-6.4	-6.9	-2.4	-3.0	-2.2	-0.7	-2.0	-5.5	-4.2	-2.7	-3.9	-1.2	-2.1	-0.6	0.7	1.5	0.9	0.3	-6.7	-4.0
DK	0.0	-0.1	2.1	5.0	5.0	5.0	3.2	-2.8	-2.7	-2.1	-3.5	-1.2	1.1	-1.3	0.1	1.8	0.7	3.7	-7.2	-2.3
DE	-3.9	-3.7	-3.3	-3.3	-1.7	0.3	-0.1	-3.2	-4.4	-0.9	0.0	0.0	0.6	0.9	1.2	1.2	1.9	1.4	-7.0	-1.5
EE	0.4	1.8	2.4	1.1	2.9	2.7	-2.6	-2.2	0.2	1.1	-0.3	0.2	0.7	0.1	-0.5	-0.8	-0.6	-0.3	-8.3	-3.4
IE	-0.5	0.3	1.3	1.6	2.8	0.3	-7.0	-13.8	-32.1	-12.8	-8.1	-6.2	-3.6	-2.0	-0.7	-0.3	0.1	0.4	-5.6	-2.9
EL	-6.0	-7.8	-8.8	-6.2	-5.9	-6.7	-10.2	-15.1	-11.2	-10.3	-8.9	-13.2	-3.6	-5.6	0.5	0.7	1.0	1.5	-6.4	-2.1
ES	-0.3	-0.4	-0.1	1.2	2.1	1.9	-4.6	-11.3	-9.5	-9.7	-10.7	-7.0	-5.9	-5.2	-4.3	-3.0	-2.5	-2.8	-10.1	-6.7
FR	-3.2	-4.0	-3.6	-3.4	-2.4	-2.6	-3.3	-7.2	-6.9	-5.2	-5.0	-4.1	-3.9	-3.6	-3.6	-2.9	-2.3	-3.0	-9.9	-4.0
HR	-3.3	-4.5	-5.0	-3.7	-3.1	-2.2	-2.8	-6.0	-6.5	-7.9	-5.4	-5.3	-5.3	-3.3	-1.0	0.8	0.2	0.4	-7.1	-2.2
IT	-2.9	-3.2	-3.5	-4.1	-3.6	-1.3	-2.6	-5.1	-4.2	-3.6	-2.9	-2.9	-3.0	-2.6	-2.4	-2.4	-2.2	-1.6	-11.1	-5.6
CY	-4.1	-5.9	-3.7	-2.2	-1.0	3.2	0.9	-5.4	-4.7	-5.7	-5.6	-5.8	-8.7	-1.0	0.3	2.0	-3.7	1.7	-7.0	-1.8
LV	-2.3	-1.6	-1.2	-0.5	-0.5	-0.6	-4.3	-9.6	-8.7	-4.3	-1.4	-1.2	-1.6	-1.4	0.2	-0.8	-0.8	-0.2	-7.3	-4.5
LT	-1.9	-1.3	-1.4	-0.3	-0.3	-0.8	-3.1	-9.1	-6.9	-9.0	-3.1	-2.6	-0.6	-0.3	0.2	0.5	0.6	0.3	-6.9	-2.7
LU	2.0	0.3	-1.4	-0.2	1.9	4.4	3.5	-0.2	-0.4	0.6	0.5	0.8	1.3	1.3	1.8	1.3	3.1	2.2	-4.8	0.1
HU	-8.8	-7.2	-6.6	-7.8	-9.3	-5.1	-3.8	-4.8	-4.5	-5.2	-2.3	-2.6	-2.8	-2.0	-1.8	-2.5	-2.1	-2.0	-5.2	-4.0
MT	-5.4	-9.0	-4.3	-2.6	-2.5	-2.1	-4.2	-3.2	-2.4	-2.4	-3.5	-2.4	-1.7	-1.0	1.0	3.3	1.9	0.5	-6.7	-2.5
NL	-2.1	-3.1	-1.8	-0.4	0.1	-0.1	0.2	-5.1	-5.2	-4.4	-3.9	-2.9	-2.2	-2.0	0.0	1.3	1.4	1.7	-6.3	-3.5
AT	-1.4	-1.8	-4.8	-2.5	-2.5	-1.4	-1.5	-5.3	-4.4	-2.6	-2.2	-2.0	-2.7	-1.0	-1.5	-0.8	0.2	0.7	-6.1	-1.9
PL	-4.8	-6.1	-5.0	-4.0	-3.6	-1.9	-3.6	-7.3	-7.4	-4.9	-3.7	-4.2	-3.6	-2.6	-2.4	-1.5	-0.2	-0.7	-9.5	-3.8
PT	-3.3	-5.7	-6.2	-6.1	-4.2	-2.9	-3.7	-9.9	-11.4	-7.7	-6.2	-5.1	-7.4	-4.4	-1.9	-3.0	-0.4	0.2	-6.5	-1.8
RO	-1.9	-1.4	-1.1	-0.8	-2.1	-2.7	-5.4	-9.1	-6.9	-5.4	-3.7	-2.1	-1.2	-0.6	-2.6	-2.6	-2.9	-4.3	-9.2	-11.4
SI	-2.4	-2.6	-1.9	-1.3	-1.2	0.0	-1.4	-5.8	-5.6	-6.6	-4.0	-14.6	-5.5	-2.8	-1.9	0.0	0.7	0.5	-7.2	-2.1
SK	-8.2	-3.1	-2.3	-2.9	-3.6	-2.1	-2.5	-8.1	-7.5	-4.5	-4.4	-2.9	-3.1	-2.7	-2.5	-1.0	-1.0	-1.3	-8.5	-4.2
FI	4.1	2.4	2.2	2.7	4.0	5.1	4.2	-2.5	-2.5	-1.0	-2.2	-2.5	-3.0	-2.4	-1.7	-0.7	-0.9	-1.1	-7.4	-3.4
SE	-1.4	-1.2	0.4	1.8	2.2	3.4	1.9	-0.7	0.0	-0.2	-1.0	-1.4	-1.5	0.0	1.0	1.4	0.8	0.5	-5.6	-2.2
UK	-1.9	-3.1	-3.1	-3.1	-2.8	-2.7	-5.1	-10.1	-9.3	-7.5	-8.2	-5.5	-5.6	-4.6	-3.3	-2.5	-2.2	-2.1	-10.5	-6.7
EA-19	-2.7	-3.1	-2.9	-2.6	-1.5	-0.6	-2.2	-6.2	-6.3	-4.2	-3.7	-3.0	-2.5	-2.0	-1.5	-1.0	-0.5	-0.6	-8.5	-3.5
EU-28	-2.6	-3.1	-2.8	-2.5	-1.6	-0.9	-2.5	-6.6	-6.4	-4.6	-4.3	-3.3	-2.9	-2.4	-1.7	-1.1	-0.7	-0.8	-8.6	-4.1

Source: Commission 2021 spring forecast.

Table B4: **Interest expenditure, general government (as a percentage of GDP, 2003-2022)**

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
BE	5.4	4.9	4.4	4.1	4.0	4.0	3.9	3.6	3.5	3.5	3.3	3.2	2.9	2.7	2.4	2.1	2.0	2.0	1.7	1.4
BG	2.2	1.8	1.6	1.3	1.1	0.8	0.7	0.7	0.7	0.8	0.7	0.9	0.9	0.9	0.8	0.7	0.6	0.6	0.6	0.6
CZ	1.0	1.1	1.1	1.0	1.1	1.0	1.2	1.3	1.3	1.4	1.3	1.3	1.1	0.9	0.7	0.7	0.7	0.8	0.8	0.7
DK	2.8	2.5	2.1	1.8	1.6	1.4	1.9	1.9	2.0	1.8	1.7	1.5	1.6	1.3	0.8	0.8	0.7	0.5	0.6	0.5
DE	2.9	2.8	2.8	2.7	2.7	2.7	2.6	2.5	2.5	2.3	1.8	1.6	1.4	1.2	1.0	0.9	0.8	0.7	0.6	0.5
EE	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1
IE	1.2	1.1	1.0	1.0	1.0	1.3	2.0	2.8	3.4	4.2	4.3	3.9	2.6	2.3	2.0	1.6	1.3	1.0	0.9	0.9
EL	4.9	4.8	4.7	4.4	4.5	4.8	5.0	6.1	7.7	5.3	4.1	4.0	3.6	3.2	3.1	3.4	3.0	3.0	2.7	2.6
ES	2.3	2.0	1.7	1.6	1.6	1.6	1.7	1.9	2.5	3.0	3.5	3.4	3.0	2.8	2.5	2.4	2.3	2.2	2.1	2.0
FR	2.8	2.8	2.7	2.6	2.7	2.9	2.5	2.5	2.7	2.6	2.3	2.2	2.0	1.8	1.7	1.7	1.4	1.3	1.2	1.1
HR	1.7	1.8	1.8	1.6	1.7	1.8	2.2	2.4	2.7	3.1	3.1	3.4	3.4	3.1	2.6	2.3	2.2	2.0	1.8	1.6
IT	5.0	4.6	4.5	4.4	4.7	4.9	4.4	4.3	4.6	5.2	4.8	4.6	4.1	3.9	3.8	3.6	3.4	3.5	3.3	2.9
CY	3.2	3.0	3.2	3.0	2.8	2.6	2.3	2.0	2.1	3.3	3.2	3.3	3.1	2.6	2.5	2.4	2.3	2.2	2.1	1.8
LV	0.8	0.7	0.5	0.5	0.4	0.6	1.6	1.8	1.8	1.7	1.5	1.3	1.2	1.0	0.9	0.7	0.7	0.7	0.6	0.6
LT	1.2	0.9	0.8	0.7	0.7	0.7	1.2	1.8	1.8	2.0	1.8	1.6	1.5	1.3	1.1	0.9	0.9	0.7	0.5	0.3
LU	0.2	0.2	0.2	0.2	0.3	0.4	0.4	0.4	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.3	0.2	0.2	0.2
HU	4.0	4.3	4.1	3.8	4.0	4.1	4.5	4.1	4.1	4.6	4.5	4.0	3.4	3.1	2.7	2.3	2.2	2.4	2.4	2.4
MT	3.5	3.7	3.8	3.7	3.5	3.3	3.2	3.0	3.1	2.9	2.8	2.7	2.3	2.1	1.8	1.5	1.3	1.3	1.4	1.4
NL	2.4	2.3	2.2	2.0	2.0	2.0	2.0	1.8	1.8	1.7	1.6	1.5	1.3	1.2	1.0	0.9	0.8	0.7	0.5	0.4
AT	3.2	3.0	3.2	3.1	3.1	2.9	3.1	2.9	2.8	2.7	2.6	2.4	2.3	2.1	1.8	1.6	1.4	1.3	1.2	1.1
PL	3.0	2.7	2.5	2.4	2.2	2.1	2.5	2.5	2.5	2.7	2.5	2.0	1.8	1.7	1.6	1.4	1.4	1.3	1.2	1.1
PT	2.7	2.6	2.6	2.8	3.0	3.1	3.0	2.9	4.3	4.9	4.8	4.9	4.6	4.1	3.8	3.4	3.0	2.9	2.6	2.4
RO	1.6	1.5	1.2	0.8	0.7	0.7	1.4	1.5	1.6	1.8	1.8	1.6	1.6	1.5	1.3	1.1	1.2	1.4	1.8	1.9
SI	1.9	1.7	1.5	1.4	1.2	1.1	1.3	1.6	1.9	2.0	2.5	3.2	3.2	3.0	2.5	2.0	1.7	1.6	1.5	1.3
SK	2.5	2.2	1.7	1.5	1.4	1.3	1.5	1.3	1.6	1.8	1.9	1.9	1.8	1.7	1.4	1.4	1.2	1.2	1.2	1.1
FI	1.8	1.7	1.6	1.5	1.4	1.4	1.3	1.3	1.4	1.4	1.3	1.2	1.2	1.1	1.0	0.9	0.8	0.7	0.5	0.4
SE	2.1	1.7	1.8	1.7	1.7	1.6	1.2	1.1	1.2	0.9	0.8	0.7	0.6	0.5	0.4	0.5	0.4	0.3	0.2	0.3
EA-19	3.2	3.0	2.9	2.8	2.9	3.0	2.8	2.8	3.0	3.0	2.8	2.6	2.3	2.1	1.9	1.8	1.6	1.5	1.4	1.3
EU-27	3.1	3.0	2.8	2.7	2.7	2.8	2.7	2.7	2.9	2.9	2.6	2.5	2.2	2.0	1.8	1.7	1.5	1.4	1.3	1.2

Source: Commission 2021 spring forecast.

Table B5: Structural budget balance, general government (as a percentage of GDP, 2011-2022)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
BE	-4.0	-3.5	-3.1	-3.0	-2.6	-2.4	-1.4	-1.8	-2.8	-5.6	-5.8	-4.4
BG	-1.9	-0.1	0.1	-1.6	-1.4	0.1	0.8	1.5	1.3	-2.5	-2.6	-2.0
CZ	-2.5	-1.3	0.0	-0.7	-0.7	0.8	0.6	-0.3	-0.8	-4.4	-7.5	-5.1
DK	-0.6	-0.2	-0.9	-0.4	-1.4	0.4	2.0	0.8	3.4	0.5	0.1	0.4
DE	-1.2	-0.1	0.4	0.9	1.1	1.0	0.8	1.2	1.0	-1.8	-6.2	-2.5
EE	0.7	0.9	0.7	0.8	0.7	-0.2	-1.6	-1.6	-1.3	-2.8	-4.2	-2.1
IE	-8.2	-7.2	-5.2	-4.5	-3.6	-1.7	-1.4	-0.4	0.5	-4.6	-4.7	-2.9
EL	-4.7	1.5	3.4	3.3	3.0	5.1	4.7	4.6	2.0	-4.7	-6.6	-2.2
ES	-6.0	-2.7	-1.0	-0.7	-1.9	-2.8	-2.7	-2.8	-3.7	-4.2	-4.9	-5.2
FR	-4.8	-4.1	-3.1	-2.8	-2.6	-2.8	-2.9	-3.0	-3.3	-4.6	-6.7	-4.7
HR	-7.3	-4.1	-3.7	-3.9	-2.5	-0.9	-0.1	-1.2	-1.4	-5.0	-3.2	-3.3
IT	-3.6	-1.5	-0.7	-0.5	-0.5	-1.5	-2.1	-2.5	-2.0	-4.9	-9.3	-5.1
CY	-5.1	-4.1	-0.8	4.3	2.7	0.7	0.9	2.0	0.0	-4.7	-4.7	-2.4
LV	-1.9	-0.7	-1.1	-1.0	-1.8	-0.6	-1.7	-2.2	-1.6	-3.3	-6.2	-1.9
LT	-3.3	-2.2	-1.9	-1.3	-0.6	-0.4	-0.7	-0.8	-1.0	-6.7	-7.0	-5.0
LU	1.4	2.6	2.5	2.4	1.6	1.7	1.7	3.2	2.8	-1.9	1.1	1.1
HU	-3.6	-1.0	-1.2	-2.2	-2.3	-2.1	-3.8	-3.9	-3.9	-6.3	-5.7	-4.3
MT	-1.7	-2.9	-2.3	-3.0	-3.3	-0.1	1.2	-0.1	-1.7	-7.5	-9.7	-4.5
NL	-3.8	-2.4	-1.7	-0.8	-1.1	0.3	0.6	0.6	0.8	-2.0	-3.4	-1.7
AT	-2.5	-1.8	-1.0	-0.6	0.1	-1.1	-1.1	-0.9	-0.6	-5.7	-5.8	-2.9
PL	-5.7	-3.6	-3.1	-2.5	-2.0	-2.0	-1.9	-1.5	-2.5	-6.2	-3.9	-2.9
PT	-6.9	-3.8	-3.0	-1.6	-2.0	-1.8	-1.5	-1.0	-1.2	-2.0	-3.2	-3.2
RO	-3.1	-3.1	-1.4	-0.8	-0.2	-1.8	-3.0	-3.2	-4.7	-7.5	-6.9	-6.4
SI	-5.6	-1.5	-11.3	-1.7	-1.0	-1.0	-0.8	-1.2	-1.7	-6.7	-7.7	-4.7
SK	-4.1	-3.7	-1.6	-2.4	-2.5	-2.5	-1.3	-1.9	-2.3	-4.7	-6.0	-4.4
FI	-0.9	-1.2	-1.0	-1.3	-0.7	-1.0	-1.0	-1.1	-1.2	-3.4	-3.3	-1.5
SE	-0.3	0.0	-0.1	-0.7	-0.4	0.7	1.0	0.5	0.7	-0.4	-1.9	0.2
EA-19	-3.5	-2.0	-1.2	-0.8	-0.8	-1.0	-1.0	-1.0	-1.2	-3.6	-6.2	-3.6
EU-27	-3.4	-2.0	-1.2	-0.8	-0.9	-0.9	-0.9	-0.9	-1.1	-3.6	-5.8	-3.4

Source: Commission 2021 spring forecast.

Table B6: **Gross debt, general government (as a percentage of GDP, 2003-2022)**

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
BE	101.7	97.2	95.1	91.5	87.3	93.2	100.2	100.3	103.5	104.8	105.5	107.0	105.2	105.0	102.0	99.8	98.1	114.1	115.3	115.5
BG	43.4	35.7	26.6	20.9	16.3	13.0	13.7	15.4	15.2	16.7	17.1	27.1	26.0	29.3	25.3	22.3	20.2	25.0	24.5	24.0
CZ	28.2	28.4	27.7	27.6	27.3	28.1	33.4	37.1	39.5	44.2	44.4	41.9	39.7	36.6	34.2	32.1	30.3	38.1	44.3	47.1
DK	46.2	44.2	37.4	31.5	27.3	33.3	40.2	42.6	46.1	44.9	44.0	44.3	39.8	37.2	35.9	34.0	33.3	42.2	40.2	38.8
DE	63.3	65.0	67.3	66.7	64.0	65.5	73.0	82.4	79.8	81.1	78.7	75.7	72.2	69.3	65.1	61.8	59.7	69.8	73.0	72.1
EE	5.6	5.1	4.7	4.6	3.8	4.5	7.2	6.6	6.1	9.8	10.2	10.6	10.0	9.9	9.1	8.2	8.4	18.2	21.3	24.0
IE	29.9	28.2	26.1	23.6	23.9	42.4	61.7	86.0	111.0	119.9	119.9	104.2	76.7	74.1	67.0	63.0	57.4	59.5	61.4	59.7
EL	101.5	102.9	107.4	103.6	103.1	109.4	126.7	147.5	175.2	161.9	178.4	180.2	177.0	180.8	179.2	186.2	180.5	205.6	208.8	201.5
ES	47.7	45.4	42.4	39.1	35.8	39.7	53.3	60.5	69.9	86.3	95.8	100.7	99.3	99.2	98.6	97.4	95.5	120.0	119.6	116.9
FR	64.4	65.9	67.4	64.6	64.5	68.8	83.0	85.3	87.8	90.6	93.4	94.9	95.6	98.0	98.3	98.0	97.6	115.7	117.4	116.4
HR	38.2	40.3	41.3	38.8	37.4	39.3	48.7	57.7	64.2	70.0	81.0	84.7	84.3	80.8	77.6	74.3	72.8	88.7	85.6	82.9
IT	105.5	105.1	106.6	106.7	103.9	106.2	116.6	119.2	119.7	126.5	132.5	135.4	135.3	134.8	134.1	134.4	134.6	155.8	159.8	156.6
CY	63.8	64.8	63.4	59.3	54.0	45.5	54.3	56.4	65.9	80.3	104.0	109.1	107.2	103.1	93.5	99.2	94.0	118.2	112.2	106.6
LV	14.1	14.6	11.9	10.0	8.5	18.6	36.8	47.9	43.7	42.2	40.0	41.6	37.1	40.4	39.0	37.1	37.0	43.5	47.3	46.4
LT	20.4	18.7	17.6	17.3	15.9	14.6	28.0	36.2	37.1	39.7	38.7	40.5	42.5	39.7	39.1	33.7	35.9	47.3	51.9	54.1
LU	7.5	7.9	8.0	8.3	8.2	15.4	16.1	20.2	19.0	22.0	23.7	22.7	22.0	20.1	22.3	21.0	22.0	24.9	27.0	26.8
HU	58.1	58.9	60.6	64.5	65.7	71.8	78.2	80.2	80.4	78.4	77.4	76.7	75.8	74.9	72.2	69.1	65.5	80.4	78.6	77.1
MT	68.6	71.3	69.9	64.3	61.9	61.8	66.3	65.3	69.3	65.9	65.8	61.6	55.9	54.2	48.5	44.8	42.0	54.3	64.7	65.5
NL	50.0	50.3	49.8	45.2	43.0	54.7	56.8	59.2	61.7	66.2	67.7	67.8	64.6	61.9	56.9	52.4	48.7	54.5	57.9	56.8
AT	65.9	65.2	68.6	67.3	65.0	68.7	79.9	82.7	82.4	81.9	81.3	84.0	84.9	82.8	78.5	74.0	70.5	83.9	87.2	85.0
PL	46.6	45.1	46.6	47.3	44.5	46.7	49.8	53.4	54.6	54.3	56.4	51.1	51.3	54.2	50.6	48.8	45.6	57.5	57.1	55.1
PT	63.9	67.1	72.2	73.7	72.7	75.6	87.8	100.2	114.4	129.0	131.4	132.9	131.2	131.5	126.1	121.5	116.8	133.6	127.2	122.3
RO	22.1	18.9	15.9	12.4	11.9	12.3	21.8	29.6	34.0	37.1	37.6	39.2	37.8	37.4	35.1	34.7	35.3	47.3	49.7	52.7
SI	26.8	26.9	26.4	26.1	22.8	21.8	34.5	38.3	46.5	53.6	70.0	80.3	82.6	78.5	74.1	70.3	65.6	80.8	79.0	76.7
SK	43.2	41.7	34.7	31.4	30.3	28.6	36.4	40.9	43.4	51.7	54.6	53.5	51.9	52.4	51.5	49.6	48.2	60.6	59.5	59.0
FI	42.7	42.6	39.9	38.1	33.9	32.6	41.5	46.9	48.3	53.6	56.2	59.8	63.6	63.2	61.2	59.7	59.5	69.2	71.0	70.1
SE	49.3	48.5	48.7	43.6	38.9	37.5	40.7	38.1	37.2	37.5	40.2	45.0	43.7	42.3	40.7	38.9	35.0	39.9	40.8	39.4
EA-19	69.3	69.6	70.3	68.3	65.9	69.6	80.2	86.0	88.4	92.7	94.9	95.2	93.1	92.2	89.7	87.7	85.8	100.0	102.4	100.7
EU-27	66.6	66.9	67.0	64.9	62.2	64.9	75.7	80.7	82.4	86.4	88.4	88.6	86.6	85.8	83.2	81.2	79.2	92.4	94.4	92.9

Source: Commission 2021 spring forecast.

Table B7: **Debt dynamic components (as a percentage of GDP)**

	Primary balance						Snow-ball effect (1)						Stock-flow adjustment (2)					
	average 2012-2017	2018	2019	2020	2021	2022	average 2012-2017	2018	2019	2020	2021	2022	average 2012-2017	2018	2019	2020	2021	2022
BE	0.3	1.3	0.1	-7.4	-5.9	-3.5	0.1	-1.3	-1.4	7.4	-5.0	-4.3	0.0	0.3	-0.3	1.2	0.3	1.0
BG	-0.3	2.7	2.7	-2.9	-2.6	-1.3	-0.2	-1.0	-1.3	0.8	-1.4	-1.1	1.6	0.7	2.0	1.2	-1.7	-0.6
CZ	0.2	1.7	1.0	-5.4	-7.8	-4.6	-0.4	-1.2	-1.2	1.3	-1.2	-2.0	-0.3	0.6	0.4	1.2	-0.3	0.2
DK	0.9	1.5	4.5	-0.6	-1.5	-0.9	0.2	-0.2	-0.4	0.7	-1.1	-1.5	-1.0	-0.2	4.3	7.6	-2.4	-0.8
DE	2.2	2.8	2.3	-3.5	-7.0	-2.0	-0.8	-0.9	-0.9	2.7	-2.9	-3.4	0.6	0.4	1.0	3.8	-0.9	0.5
EE	0.0	-0.5	0.1	-4.9	-5.5	-3.2	-0.5	-0.7	-0.6	0.3	-0.8	-1.4	1.0	-0.7	0.9	4.6	-1.7	1.0
IE	-0.3	1.7	1.7	-4.0	-4.1	-2.0	-5.4	-3.8	-3.9	-0.6	-2.6	-2.7	-2.2	1.5	0.0	-1.2	0.3	-0.9
EL	-1.3	4.3	4.1	-6.7	-7.3	-0.6	7.9	0.8	-0.7	22.1	-4.7	-10.5	-8.6	10.5	-0.8	-3.7	0.7	2.6
ES	-3.0	-0.1	-0.6	-8.7	-5.5	-3.2	1.4	-1.0	-0.9	12.7	-5.6	-6.8	0.3	-0.1	-1.6	3.0	-0.2	0.8
FR	-1.8	-0.6	-1.6	-7.9	-7.3	-3.6	0.4	-1.0	-1.5	7.6	-5.6	-4.8	-0.4	0.1	-0.4	2.6	0.0	0.2
HR	-0.2	2.5	2.5	-5.4	-2.8	-1.6	1.8	-1.3	-0.9	8.0	-3.8	-4.6	0.2	0.5	1.9	2.5	-2.1	0.3
IT	1.7	1.5	1.8	-6.0	-8.4	-2.8	3.2	1.0	1.9	14.8	-4.2	-5.6	0.9	0.7	0.1	0.4	-0.2	-0.5
CY	-0.1	-1.2	3.8	-3.5	-3.0	-0.2	2.4	-3.4	-1.5	7.9	-3.1	-3.6	2.1	7.9	0.1	12.7	-5.8	-2.3
LV	0.2	-0.1	0.1	-3.9	-6.7	-1.4	-0.6	-2.2	-0.9	2.0	-1.7	-3.0	0.0	0.2	0.9	0.6	-1.1	0.7
LT	0.6	1.5	1.3	-6.7	-7.7	-5.7	-0.4	-1.9	-1.4	0.7	-1.8	-2.6	1.3	-2.1	5.0	4.0	-1.3	-0.8
LU	1.7	3.4	2.7	-3.9	-0.2	0.1	-0.6	-0.9	-0.8	0.0	-1.4	-1.3	2.8	2.8	4.6	-1.0	3.4	1.2
HU	1.4	0.2	0.2	-5.7	-4.3	-2.1	-0.3	-4.5	-3.8	2.1	-4.1	-4.3	0.3	1.7	0.4	7.2	-2.1	0.8
MT	1.7	3.4	1.7	-8.8	-10.4	-4.1	-2.7	-1.9	-2.0	3.8	-1.8	-3.5	1.0	1.6	0.8	-0.3	1.8	0.2
NL	-0.3	2.3	2.5	-3.6	-4.5	-1.3	0.0	-1.7	-1.6	1.4	-1.7	-2.5	-1.1	-0.5	0.4	0.8	0.8	0.0
AT	0.6	1.8	2.0	-7.5	-6.3	-1.9	0.0	-1.6	-0.9	5.5	-2.6	-3.9	0.0	-1.0	-0.6	0.4	-0.5	-0.2
PL	-1.0	1.2	0.7	-5.7	-3.1	-1.2	-0.1	-1.7	-2.3	0.7	-2.6	-3.2	-1.6	1.1	-0.3	5.5	-0.8	-0.1
PT	-0.1	3.0	3.0	-2.8	-2.1	-1.0	2.1	-2.3	-2.0	9.5	-4.2	-5.6	-0.3	0.7	0.4	4.5	-4.3	-0.3
RO	-0.5	-1.8	-3.2	-7.8	-6.3	-5.2	-1.0	-2.3	-2.3	1.5	-1.9	-1.7	0.6	0.2	-0.3	2.6	-1.9	-0.6
SI	-2.1	2.7	2.1	-6.8	-7.0	-3.4	0.8	-2.6	-2.0	4.6	-3.2	-3.5	1.8	1.5	-0.6	3.9	-5.7	-2.2
SK	-1.0	0.3	-0.1	-4.9	-5.3	-3.0	0.3	-1.5	-1.1	2.7	-2.5	-3.1	0.0	-0.1	-0.4	4.7	-4.0	-0.3
FI	-0.9	0.0	-0.1	-4.8	-4.1	-1.7	-0.1	-1.0	-0.8	1.4	-2.5	-2.6	1.4	-0.4	0.4	3.6	0.3	0.0
SE	0.4	1.3	1.0	-2.8	-3.0	-0.3	-0.8	-1.3	-1.1	0.8	-2.1	-1.7	1.8	0.7	-1.8	1.2	0.0	0.0
EA-19	0.2	1.4	1.0	-5.7	-6.6	-2.6	0.4	-1.1	-1.0	6.2	-3.8	-4.4	0.0	0.4	0.1	2.3	-0.4	0.2
EU-27	0.2	1.3	1.0	-5.5	-6.1	-2.4	0.3	-1.1	-1.1	5.4	-3.6	-4.1	0.0	0.3	0.1	2.4	-0.5	0.2

Notes: (1) The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator); (2) The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.
Source: Commission 2021 spring forecast.

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