

European Fiscal Board

**Assessment of the
fiscal stance appropriate for the euro area in 2021**

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Composition of the European Fiscal Board

Niels THYGESEN

Chair

Professor Emeritus of International Economics at the University of Copenhagen and former adviser to governments and international institutions, Denmark

Roel BEETSMA

Member

Professor and Vice-Dean of the Faculty of Economics and Business at the University of Amsterdam, the Netherlands

Massimo BORDIGNON

Member

Professor and former Director of the Department of Economics and Finance at the Catholic University of Milan, Italy

Mateusz SZCZUREK

Member

Former Finance Minister, teacher at Warsaw University and EBRD Associate Director, Poland

More information about the European Fiscal Board is available at:

<https://ec.europa.eu/european-fiscal-board>

This report was written under the responsibility of the European Fiscal Board with the support of its secretariat. Comments on the report should be sent to:

Secretariat of the European Fiscal Board
European Commission
Rue de la Loi 200
Office BERL 2/353
B-1000 Brussels
Email: EFB-SECRETARIAT@ec.europa.eu

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FOREWORD



Prof. Niels Thygesen

Chair of the European Fiscal Board

The Covid-19 pandemic has been having a dramatic impact on the EU fiscal framework. The general escape clause, introduced almost a decade ago to offer flexibility in the event of a severe economic downturn, was activated at the end of March. The EFB supports this step. A rules-based framework shows its strength not only in normal times but also in its ability to allow for truly exceptional circumstances. Nevertheless, we are concerned that the clause does not contain a sunset provision. At a minimum, a review date should be set. We believe the date for the review could be spring 2021.

Our report reviews the current situation and outlook providing input to the draft budget plans for 2021. A return to pre-crisis patterns of spending by households and firms seems unlikely at this stage. National public finances will have to support demand. The overall size of the 2020 fiscal stimulus is significant, but so are the issues of *how* to spend the money. Finding a better balance between national and joint efforts and protecting growth-enhancing government expenditure have been major recommendations in earlier EFB reports, and these have become more relevant in the current situation. Even prudent national policies can be overwhelmed by large shocks, making the case for a central fiscal capacity more obvious. Moreover, the role of government investment is essential in laying the foundations for future growth.

We are encouraged to see advances on both issues in recent months, thanks to joint actions by the ECB, the Commission, the ESM and the EIB. The initiatives launched so far can be

labelled ‘timely, targeted and temporary’. They have prepared the ground for recovery, performing de facto the initial stabilising role that a central fiscal capacity would play.

Further steps with a longer, but in principle still limited, time horizon are now being negotiated under the European Recovery Instrument. This bold and highly significant initiative would overcome two limitations of the current EU economic governance framework. First, by envisaging some disbursements as grants rather than loans, it would ease fiscal constraints at national level, while leaving wider scope for EU influence on how the funds are spent. Second, the proposal emphasises structural, rather than cyclical, spending in areas where national government investment would bring value added for the whole EU, e.g. the green deal, digitalisation and joint infrastructure in transport and communication.

The emerging package would tackle the two main weaknesses in the EU fiscal framework: it would reinforce the joint element in EU fiscal policymaking and take a first step towards protecting the EU’s future growth potential. The first-best approach to achieving the latter is a central fiscal capacity. Hence, the EFB starts its review with the topic of protecting growth-enhancing government expenditure and examines how a more permanent central fiscal capacity could operate. We also outline, in order of diminishing ambition, three other approaches to protecting investment without a central fiscal capacity. They are not mutually exclusive but should be seen as complementing each other.

Progress towards a genuine central fiscal capacity focusing on the protection of growth-enhancing government expenditure makes the return to a rules-based EU framework for national fiscal policies a natural complement. The Commission’s review of European economic governance, currently on hold, could resume and examine the emerging prospect for reforming both the national and joint dimensions of fiscal policymaking in the EU.

KEY MESSAGES

- For 2021, the European Fiscal Board recommends providing further fiscal support. In 2020, containment measures to fight the Covid-19 pandemic have triggered an unprecedented recession in the euro area. Governments have adopted discretionary fiscal measures to support the economy, estimated at around 3¼ % of GDP, on top of automatic stabilisers of close to 5% of GDP. Recent announcements by Germany and France could push the discretionary stimulus of national governments in 2020 to 4% of euro area GDP or more.
- Most of the discretionary support measures are projected to be discontinued in 2021, leaving a considerable gap compared to the growth path expected in early 2020. This calls for an extension of discretionary fiscal support at the national level next year, underpinned or complemented by the initiatives launched at EU level.
- Activation of the so-called general escape clause of the Stability and Growth Pact in the event of a severe economic downturn was fully justified. For greater effectiveness and credibility, the activation should have provided indications on the timing of and conditions for exit or review. Clarifications should be offered in spring 2021 at the latest. In the current context it would not be advisable to use the growth rate of real GDP when considering the end of a severe economic downturn; using a pre-crisis level of real GDP of the euro area and the EU as a reference would make more sense.
- Budgetary plans for 2021 offer an opportunity to give a more dynamic orientation to fiscal support among euro area countries. Priority should be given to government investment and growth-enhancing government expenditure more generally. It should differentiate across countries, taking into account the underlying situation and making good use of existing as well as upcoming instruments at the EU or euro area level.
- The Covid-19 pandemic underscored once more the difficulties of managing large shocks with hardly any joint elements, most importantly without the EU having a central fiscal capacity allowing it to borrow a meaningful amount of funds on the market. Recent initiatives such as SURE and the Recovery Instrument go in the right direction when it comes to heading off the crisis, but should eventually be replaced by or morph into a permanent EU fiscal instrument so the EU can respond to severe shocks in a timely fashion.

1. GUIDANCE BASED ON CURRENT SITUATION AND OUTLOOK

The current crisis provides a perfect example of why the euro area fiscal stance matters. In normal times the aggregation of country-specific fiscal recommendations provides a good basis for evaluating an appropriate fiscal stance in the euro area as a whole. In very difficult times, however, simply following EU fiscal rules does not necessarily amount to a fiscal stance that ensures an appropriate balancing of sustainability and stability considerations for the euro area as a whole; this was clearly observed in the wake of the sovereign debt crisis and is also evident now. The prescriptions of the Stability and Growth Pact (SGP) for 2020 would at best have entailed

unchanged underlying fiscal positions across Member States, making the recession even worse, with the output gap widening by an additional 2 to 3 percentage points⁽¹⁾. The activation of the so-called general escape clause of the Stability and Growth Pact has provided

⁽¹⁾ According to the matrix of fiscal requirements of the preventive arm of the Stability and Growth Pact, 2020 being a year of negative growth, Member States would have benefited from the so-called waiver, which only requires the structural balance to remain unchanged compared to the previous year. This would not have allowed the fiscal support measures implemented by Member States.

additional flexibility. However, while some countries with fiscal space have tended to provide more fiscal support than other countries, the additional leeway has largely been used in an uncoordinated way; it has not sufficiently taken into account the underlying strengths or weaknesses of national public finances.

The Covid-19 pandemic has had a dramatic impact. The current crisis is unprecedented both by its nature as a health crisis and by the speed at which the pandemic has triggered the most severe recession since the Great Depression of the 1930s. It combines a supply shock, a demand shock and financial volatility. It operates through several channels. First, containment measures affect demand and prevent much of the population from going to work. The results are job losses, cash-flow issues and bankruptcies, which exacerbate the economic impact. In parallel, the disruption of supply chains affects trade; confidence drops and investment decisions are postponed, again affecting supply and demand ⁽²⁾. The dramatic consequences of placing half of the world population in lockdown are clearly visible in the numbers. In the first quarter of 2020, real GDP decreased by 3.6% in the euro area compared with the previous quarter; this was the sharpest decline since the beginning of the series in 1995. Looking forward, confidence indicators have plummeted at unprecedented speed to levels not observed since the Great Recession of 2008-2009, anticipating a further contraction (see Graph 1.2). Recent rebounds are very partial and uncertainty remains on the outlook.

The common exogenous shock is having a very different impact across the euro area. Some countries, and some regions within countries, have been more severely hit by the Covid-19 pandemic than others. This partly reflects the health situation and the response to it: while all Member States took emergency measures when the extent of the epidemic

became evident, they were first taken in a decentralised manner, with a different timing and different levels of constraints imposed on the population. Where the health crisis struck earlier and was more severe, lockdown measures were stricter and applied longer. Moreover, the fiscal leeway to react to the crisis without triggering tensions on financial markets differed depending on a country's initial position in terms of government deficit and debt. Finally, economies were hit to varying degrees, depending on structural factors that included sector specialisation, population density, degree of openness and the quality of digital infrastructure.

The economic policy response took place in three steps and involved many actors. There was a forceful policy response involving Member States and EU institutions (see Box 1 for an overview). The first step was to provide support to the health care sector. The emergency was to save lives, notably by providing the necessary financial and technical means, but also by imposing containment measures to prevent the overcrowding of hospitals and gain time to find a treatment. The second step was to throw a lifeline to households and firms in order to keep the social and economic costs as temporary and limited as possible. The bridging measures were aimed to mitigate job losses ⁽³⁾, maintain household income, ensure sufficient liquidity and avoid bankruptcies, notably by deferring tax payments and providing guarantees. As a third step, the authorities took discretionary measures to prop up aggregate demand beyond the effects of automatic stabilisers. Overall, the discretionary measures at the national level are estimated to amount to 3¼ % of GDP, on top of close to 5% of GDP linked to the operation of automatic stabilisers. Additional measures

⁽²⁾ <https://voxeu.org/article/how-should-we-think-about-containing-covid-19-economic-crisis>

⁽³⁾ As explained in Box 1, this is mainly through reductions in working time and the SURE initiative adopted on 19 May 2020. To make it operational, all Member States need to sign guarantee agreements with the Commission, which in many cases require the approval of national Parliaments.

announced by the German and French governments in June could bring the total discretionary stimulus of national government in 2020 to around 4% of GDP. Moreover, some measures are not included in the budget figures, namely tax deferrals (by statistical convention)⁽⁴⁾, and loans and guarantees. In view of the depth of the crisis, risks associated with guarantees must be considered significant.

The activation of the general escape clause of the SGP was fully justified; but it should have included indications on (and conditions for) exit or review. The general escape clause of the Stability and Growth Pact was activated on 23 March 2020. The clause offers badly needed additional flexibility under the commonly agreed rules, including temporary fiscal expansions (Box 2 provides details on the nature of the clause). All euro area countries have taken advantage of the clause to adopt outright fiscal stimulus packages to lean against the sharp economic downturn. However, while offering additional flexibility, the activation of the general escape clause was silent about how long it would be in operation and how it would be applied. There is obviously no reason for deactivating the clause at this stage. At the same time, without a common understanding on when and how the clause should be reviewed, the transition to the normal implementation of the Stability and Growth Pact is bound to lead to contentious discussions between the Commission and the Council and within the Council. Clarity should be offered in due course, ideally by spring 2021. One possibility would be to use a pre-crisis level of real GDP of the euro area and the EU as a reference. Focusing on the rate of real GDP growth would not be advisable in view of the likely rebound in 2020, a rebound that is mostly an automatic effect of the sharp deterioration of the economy, but that is in any case set to be partial. More generally, a review of

the provisions underpinning the general escape clause should be considered.

The lack of a central fiscal capacity weighs on the ability to generate support for the euro area, putting an excessive burden on the European Central Bank. The composition of fiscal support across countries departs from the requirements of stabilisation due to sustainability concerns and the absence of a genuine central fiscal capacity. Moreover, current arrangements imply lengthy discussions among Member States to arrive at a coordinated response, putting an excessive burden on monetary policy to stabilise the euro area⁽⁵⁾. In fact, while the European Central Bank has been very reactive, it has been prompted to move closer to a point that should be anathema in terms of the agreed division of responsibilities between the political and monetary authorities in Economic and Monetary Union. The establishment of a genuine and permanent central fiscal capacity with a focus on stabilisation would contribute to a more balanced policy mix.

Forecasters, for the most part, expect a significant yet incomplete rebound of economic activity in 2021. At the early stages of the Covid-19 pandemic, most observers anticipated a V-shaped and full recovery from the crisis. As the crisis deepened, the consensus view moved to a partial and less swift recovery in the second half of 2020 and in 2021, going into 2022 and possibly beyond. The strength of the recovery will crucially depend on how the pandemic unfolds and on the effectiveness of policy measures. Most EU and international institutions, notably the Commission, the European Central Bank and the International Monetary Fund, present a baseline scenario in which the spread of the virus is expected to remain under control after the strict lockdown

⁽⁴⁾ National accounts are accrual based. Hence, government revenues are recorded in the period they become due as opposed to when they are paid.

⁽⁵⁾ The challenge is finding the right policy mix. The idea of a euro area fiscal stance, although not new, gained prominence during the slow recovery in the wake of the euro area sovereign debt crisis, when the policy of the European Central Bank seemed to be reaching its limits.

measures are gradually lifted (no-resurgence scenario in the table below). This should give rise to a partial recovery in the second half of 2020, also thanks to the protective economic measures taken by national governments and EU institutions. In such a scenario, the loss of output in 2021 is estimated in the range of 4 to 6% compared to the growth path envisaged in projections made ahead of the pandemic in late 2019, early 2020. Thanks to short-time work schemes, the increase in the unemployment rate is expected to be currently limited to 2 percentage points in the euro area in 2020, taking the rate to about 9 ½ %, according to the Commission forecast. Although surrounded by uncertainty, economic slack is estimated to remain very significant in 2021.

Overview table: Scenarios in recent projections

	Date of projections	No-resurgence scenario		Resurgence scenario	
		GDP growth		Output loss in 2021*	Output loss in 2021*
		2020	2021		
IMF	April 2020	-7.5	4.7	6%	11%
Commission	May 2020	-7.7	6.3	4%	8%
ECB	June 2020	-8.7	5.2	6%	12%
OECD	June 2020	-9.1	6.5	5%	11%

* compared to the last projections published by each institution ahead of the covid-19 pandemic

Sources: International Monetary Fund, European Commission, European Central Bank, Organisation for Economic Co-operation and Development. The comparisons are against the IMF January 2020 World Economic Outlook, the Commission 2020 Winter forecast, the ECB March 2020 staff projections and the OECD November 2019 Economic Outlook.

Against the background of heightened uncertainty, the fiscal stance would turn very restrictive in 2021 in the absence of new measures. According to the Commission 2020 spring forecast, the structural primary balance of the euro area as a whole is estimated to deteriorate by 3.3% of GDP in 2020 before improving by 2.2% of GDP in 2021. If no new measures are taken, the magnitude of the fiscal contraction in 2021 is confirmed when looking at the fiscal stance through the lens of the expenditure benchmark, i.e. the difference between net government expenditure growth and medium-term potential output growth (Graph 1.14). The uncertainty surrounding the measurement of the fiscal stance in 2020 and 2021 is, however, particularly high and regards

both the size of discretionary fiscal measures and the estimates of potential output⁽⁶⁾. Moreover, in line with established practice, the forecast for 2021 uses a no-policy-change assumption: only the measures that have been adopted, presented to national parliaments or sufficiently specified are factored in. Since the lockdown imposed by the Covid-19 pandemic was expected to be temporary and short, most discretionary measures taken by national governments were announced as affecting only 2020 and are recorded as such in the Commission forecast.

Reversing the fiscal stance rapidly is not advisable given the way in which the crisis is expected to evolve. The assumed withdrawal of discretionary fiscal support measures explains the swift reversal of budgetary positions in 2021. However, a larger and longer fiscal support will be needed also in 2021. The easing of lockdown measures is going to be slower than initially expected, and consumers are likely to build up precautionary savings. Even in the most benign scenario, the recovery in 2021 will only be partial. Therefore, an extension of some discretionary fiscal support measures launched in 2020 is desirable. When private households and firms, both domestic and foreign, cut spending on the back of a temporary negative shock, government spending, alongside monetary accommodation, is the only way to sustain demand.

Fiscal support in 2021 should include a strong component of government investment and growth-enhancing expenditure. Beyond its size, the composition of fiscal support is crucial. In view of the sizeable government investment gap in the euro area, fiscal support in 2021 should include a strong investment component. Any initiative, including at the EU level, aimed at pushing

⁽⁶⁾ In April 2020, the Commission introduced three temporary adjustments to the commonly agreed methodology to estimate potential output. The aim was to keep estimates as stable as possible by assuming that the Covid-19 crisis would only have a short-term effect on potential output.

government investment already in the short term, would be a crucial step towards achieving three objectives: stimulating aggregate demand, boosting future growth, and improving the long-term sustainability of fiscal policy. Section 2 outlines ideas of how this could be achieved.

The recent fiscal initiatives launched at EU level clearly point to the right direction. On top of the decisive measures taken by the European Central Bank, the European Investment Bank and the European Stability Mechanism, the EU has recently launched two additional fiscal initiatives: a European re-insurance scheme for national short-time work schemes or similar ones – dubbed SURE – and a funding instrument to support the recovery of the European economy – named Next Generation EU or European Recovery Instrument (7). SURE was adopted by the Council on 19 May and involves concessional loans of up to €100 billion. The Commission’s proposal for a recovery instrument is being discussed by the co-legislators; it combines grants and concessional loans for a total of €750 billion (see Box 1 for details).

Risks to the growth outlook in 2021 are clearly on the downside and warrant contingency considerations. The earlier the containment measures can be lifted, the swifter the rebound is likely to be. The main risks are threefold: (i) households and firms may exhibit a higher than previously assumed degree of caution after the lockdown measures are lifted; (ii) the protective measures taken by governments may not fully prevent longer-lasting damage to the economy; and (iii) lifting the lockdown measures without having comprehensive testing facilities or a vaccine may spark a second wave of infections, requiring a new lockdown and leading to more permanent

(7) Based on the Commission proposal, the loans under SURE will be granted in line with the provisions of Article 220(5) of Regulation (EU, Euratom) 1046/2018, which states that the beneficiary Member State shall bear all costs incurred by the Union that relate to this financial assistance. No other fees are envisaged.

economic and social damage. New local outbreaks would have a more limited direct impact but would affect confidence on a broader scale. Other risks include an increasing divergence among countries, especially if the coordinated policy response is limited; this might feed stress on financial markets. Some of the risks associated with government loans or guarantees for fragile companies may also materialise. Externally, the global rebound could be weaker than expected if the pandemic keeps spreading outside Europe or if further protectionist measures are taken.

Member States need to stand ready to take further coordinated action to organise and finance additional policy responses, if necessary. The alternative scenarios of main forecasters illustrate how protracted containment measures in 2020 and a second outbreak in late 2020 or 2021 could affect economic activity. The cost of a strict lockdown is estimated at 2 to 3% of GDP per month in the euro area; lighter containment comes at a lower cost but still impedes the recovery. The projections of the Commission, the International Monetary Fund, the European Central Bank and the Organisation for Economic Co-operation and Development assume that in case tight containment measures need to be extended or renewed, the output loss compared to the pre-pandemic path could reach 8 to 12% in 2021, and part of this loss could remain permanent (see the overview table above) (8). Such negative developments would require much more ambitious coordinated action.

(8) The Commission’s ‘second wave’ scenario assumes a new outbreak in the second half of 2020 requiring six additional weeks of lockdown. The International Monetary Fund’s ‘new outbreak’ scenario assumes that a second outbreak will take place in 2021 and be milder than the first outbreak. The European Central Bank’s ‘severe’ scenario assumes that a strong resurgence of the virus will require stringent containment measures to remain in place until mid-2021. The Organisation for Economic Co-operation and Development’s ‘double hit’ scenario assumes a second, but less intensive, virus outbreak in October/November 2020.

Box 1: Economic policy response to the Covid-19 crisis

The moment the extent of the Covid-19 crisis became evident, **EU Member States** started taking economic support measures at the national level as a complement to public health decisions introducing restriction and containment, and they have stepped up the support measures over time. On aggregate, the discretionary fiscal measures taken by national governments currently approach 3 ¼ % of EU and euro area GDP on top of the impact of automatic fiscal stabilisers of close to 5% of GDP. The fiscal measures include three broad categories: (i) support to the healthcare sector and medical R&D; (ii) support to households (in particular by subsidising part-time unemployment and short-term work schemes to preserve jobs and by extending social benefits to support income); and (iii) support to businesses (in particular through direct financial assistance). In addition, Member States have committed to providing liquidity support amounting to 22% of GDP in the form of public loan guarantee schemes and deferred tax payments, in support of firms facing disruptions and liquidity shortages. At this stage, numerical estimates of both the impact of measures and the level of GDP are surrounded by a high degree of uncertainty. In late March 2020, the Network of EU Independent Fiscal Institutions published an overview of measures in a special update of the European Fiscal Monitor ⁽¹⁾. Moreover, several websites, including those of the Organisation for Economic Co-operation and Development (OECD), the European Bank for Reconstruction and Development (EBRD) and the International Monetary Fund (IMF) keep track of the policy responses in all countries in real time ⁽²⁾.

A series of important initiatives were taken or launched **at EU level**.

- **The European Central Bank** has taken several sizeable monetary policy support measures. On 12 March 2020, it announced temporary measures to address liquidity risks, preserve the provision of credit to the economy and contain financial instability. This included: (i) lower interest rates for existing targeted long-term refinancing operations; (ii) additional longer-term refinancing operations; and (iii) additional asset purchases of €120 billion combined with the existing asset purchase programme. On 18 March, the European Central Bank announced a much larger €750 billion pandemic emergency purchase programme (PEPP) to purchase private and government sector securities until at least the end of 2020. It also relaxed collateral standards to give easier access to liquidity. On 7 April, the European Central Bank adopted further collateral-easing measures. On 30 April, the European Central Bank announced further support, including flexible continuation of the new Pandemic Emergency Purchase Programme until the crisis phase is over and the creation of a series of non-targeted pandemic emergency longer-term refinancing operations (PELTROs) providing a liquidity backstop. On 4 June, the European Central Bank increased the envelope for the PEPP by €600 billion to a total of €1,350 billion and extended the horizon for net purchases under the PEPP to at least the end of June 2021.
- On 13 March 2020, **the Commission** announced a first series of measures, among which: (i) liquidity measures to help SMEs; (ii) a revision of State aid rules; (iii) the creation of a €65 billion Coronavirus Response Investment Initiative (in force since 1 April) to make flexible use of the EU budget and structural funds; and (iv) the use of existing flexibility within EU fiscal rules ⁽³⁾ ⁽⁴⁾. On 20 March, the Commission issued its assessment of the activation of the general escape clause of the Stability and Growth Pact subsequently endorsed by the Council (see Box 2). On 2 April, the Commission made a second series of proposals ⁽⁵⁾. In particular, it proposed a Coronavirus Response Investment Initiative Plus for greater flexibility in using cohesion funds, and it launched the Support mitigating Unemployment Risks in Emergency (SURE). SURE is designed as a second line of defence to national short-term work schemes and related measures, providing loans at favourable rates, with a maximum capacity set at €100 billion (0.7% of 2019 EU-27 GDP) that is backed by a €25 billion guarantee from Member States. The Council adopted the legislative act underpinning the instrument on 19 May 2020. The instrument will become operational once Member States have signed bilateral guarantee agreements with the Commission. The respective national procedures differ across countries and can take some time. SURE will be available until end 2022, with an option to renew it for another six months.

Following a mandate by the European Council, the Commission adopted a new package on 28 May 2020, which includes the temporary funding instrument Next Generation EU or the European Recovery Instrument. Using an increase in the headroom of the EU budget to raise money on the financial markets, the proposal for the new instrument offers €750 billion in extra funding up until 2024 in the form of €500 billion in grants and some guarantees and €250 billion in loans. According to the Commission proposal, between 2028 and 2058 Member States will use the EU budget to pay back the debt issued under the new instrument. The Commission also announced future proposals for new own resources such as the carbon border adjustment mechanism, a tax on non-recycled plastics, a common corporate tax or a digital tax, or a revenue share of the EU emissions trading scheme. Three quarters (€560 billion) of the resources from the Recovery Instrument will be used to source the Recovery and Resilience Facility, a new spending

programme of the EU budget to support investment and reform projects of EU Member States linked to the EU's priorities such as the green deal and digitalisation. In the Commission proposal, the facility combines grants of up to €310 billion and loans of up to €250 billion. The distribution key of the facility takes into account the population of the Member States, the inverse of per-capita GDP and the average unemployment rate over the past five years. The remaining €190 billion of the Recovery Instrument are to be distributed across an array of additional instruments, either new or reinforced.

- On 16 April, the **European Investment Bank** created a pan-European guarantee fund backed by Member State guarantees, which can support up to €200 billion in financing for companies throughout the EU.
- On 15 May, the **European Stability Mechanism** established the Pandemic Crisis Support instrument to provide credit lines of up to 2% of GDP to each participating Member State (€240 billion in total for the euro area). The new instrument is built around the existing enhanced conditions credit line (ECCL), with some adaptations, especially as regards the conditionality: the only requirement is to use the credit line to finance direct and indirect healthcare, cure and prevention-related costs due to the Covid-19 crisis.

- (1) <https://www.euifis.eu/eng/fiscal/277/march-2020-update-of-the-european-fiscal-monitor-on-the-fiscal-measure>
- (2) <http://www.oecd.org/coronavirus/en/#policy-responses>, <https://www.ebrd.com/what-we-do/coronavirus> and <https://www.imf.org/en/Topics/imf-and-Covid19/Policy-Responses-to-Covid-19>.
- (3) https://ec.europa.eu/commission/presscorner/detail/en/IP_20_459
- (4) The Commission describes its full economic response as it evolves at https://ec.europa.eu/info/live-work-travel-eu/health/coronavirus-response/economy_en.
- (5) https://ec.europa.eu/info/sites/info/files/using_every_available_euro.pdf
- (6) https://ec.europa.eu/info/sites/info/files/communication_-_a_european_roadmap_to_lifting_coronavirus_containment_measures_0.pdf
- (7) <https://www.consilium.europa.eu/en/press/press-releases/2020/04/09/report-on-the-comprehensive-economic-policy-response-to-the-Covid-19-pandemic/>

Box 2: Activation and implementation of the general escape clause

The general escape clause 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 for the euro area or the EU as a whole. The clause was activated for the first time on 23 March 2020 further to an assessment by the Commission that was subsequently endorsed by the Council ⁽¹⁾ ⁽²⁾.

In the public debate, some observers have interpreted activation of the general escape clause as effectively suspending the Stability and Growth Pact. However, the Commission Communication of 20 March 2020 clarified that: *the general escape clause does not suspend the procedures of the Stability and Growth Pact. It will allow the Commission and the Council to undertake the necessary policy coordination measures within the framework of the Pact, while departing from the budgetary requirements that would normally apply.* The Council backed this interpretation in its Report of 4 April 2020 on the comprehensive economic policy response to the Covid-19 pandemic, which states that the clause *offers the flexibility necessary to the national budgets to support the economy and to respond in a coordinated manner to the impact of the Covid-19 pandemic. Overall fiscal guidance will be provided within this framework and as part of a streamlined European Semester exercise.* ⁽³⁾

The relevant legal provisions of the general escape clause are:

- (a) Regulation 1466/97 (the preventive arm of the Stability and Growth Pact):
 - With reference to the ex ante definition of the adjustment path towards the medium-term objective, Articles 5(1) and 9(1) of Regulation (EC) 1466/97 state that *in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term.*
 - With reference to the final assessment of the adjustment path to the medium-term objective, Articles 6(3) and 10(3) state that *the deviation [from the adjustment path] may be left out of consideration (...) in case of severe economic downturn for the euro area or the Union as a whole, provided that this does not endanger fiscal sustainability in the medium-term.*

(b) Regulation 1467/97 (the corrective arm of the Stability and Growth Pact):

- Article 2(1) states that a deficit above 3% of GDP *shall be considered exceptional, (...) when (...) resulting from a severe economic downturn. In addition, the excess over the reference value shall be considered temporary if budgetary forecasts as provided by the Commission indicate that the deficit will fall below the reference value following the end of (...) the severe economic downturn.*
- With regard to the assessment of and decision on the existence of an excessive deficit in accordance with Article 126(3) to (6) of the Treaty on the Functioning of the EU, Article 2(2) states that *the Commission and the Council may consider an excess over the reference value resulting from a severe economic downturn as exceptional (...) if the excess over the reference value results from a negative annual GDP volume growth rate or from an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential.*
 - With regard to the assessment of whether effective action has been taken, Articles 3(5) and 5(2) of Regulation (EC) 1467/97 stipulate that in the case of a severe economic downturn in the euro area or in the Union as a whole, the Council may also decide, on a recommendation from the Commission, to adopt a revised fiscal trajectory.

The provisions listed above show that while activation of the general escape clause is triggered by an economic downturn hitting the euro area or the EU as a whole, the requirements of the Stability and Growth Pact are defined and applied on a country-by-country basis. As a result, the flexibility of the general escape clause should also, in principle, be applied to each country individually, taking into account the specific features of the case.

In normal times, fiscal requirements in the preventive arm of the Stability and Growth Pact are set for each country on the basis of a ‘matrix of adjustment’. The matrix modulates the benchmark annual adjustment of 0.5% of GDP depending on cyclical conditions, economic growth, and the government debt-to-GDP ratio. No adjustment is needed in exceptionally bad times, defined as real GDP growth between 0 and -4 % of GDP. Since the current crisis is characterised by real growth rates projected well below -4 % of GDP in 2020, the general escape clause offers leeway for expansionary measures before the adjustment towards the medium-term objective resumes. Should an excessive deficit procedure be launched, the flexibility of the general escape clause can also be used to modulate the correction of the excessive deficit by extending the adjustment period.

While activation of the general escape clause created the conditions for the Member States to formulate an adequate fiscal response to the economic impact of the health crisis, the clause’s actual implementation is likely to give rise to discussions. Most importantly, while the Commission and the Council clarified that the general escape clause does not suspend the Stability and Growth Pact - but offers additional flexibility within the rules - one key issue in the general escape clause’s implementation has been left open, namely for how long does it apply. In principle, the clause should be deactivated as soon as the severe economic downturn in the EU and the euro area comes to an end. However, there is no commonly accepted or agreed definition of a severe economic downturn. The Commission and the Council may hold different views. Also within the Council views may diverge considerably, especially if the economic impact of the Covid-19 crisis differs across countries: some may soon embark on an upturn, others may experience negative growth for longer.

Activation of the general escape clause should have included a sunset clause or, at least, a review clause, i.e. indications of when and how to reassess the situation. Without such clarifications, the clause’s implementation will mostly depend on how the Commission and the Council effectively interpret the relevant provisions of the Stability and Growth Pact. In particular, once the health crisis is sufficiently contained for more normal activity to resume, it would be time to agree on the principles of how the flexibility under the general escape clause is to be applied⁽⁴⁾. These principles should cover the extent of the flexibility and how they affect the adjustment path. They should be embedded in the country-specific adjustment paths towards the medium-term objective or towards the correction of an excessive deficit.

(1) <https://ec.europa.eu/transparency/regdoc/rep/1/2020/EN/COM-2020-123-F1-EN-MAIN-PART-1.PDF>

(2) <https://www.consilium.europa.eu/en/press/press-releases/2020/03/23/statement-of-eu-ministers-of-finance-on-the-stability-and-growth-pact-in-light-of-the-covid-19-crisis/>

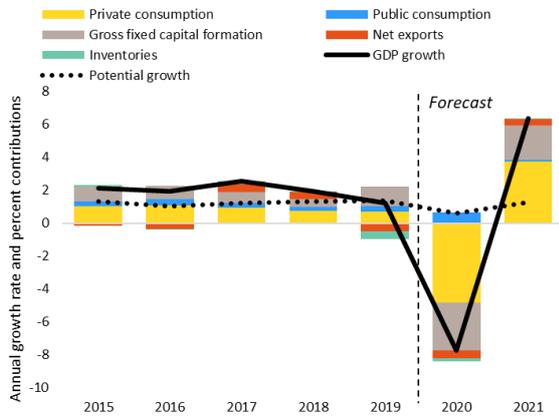
(3) <https://www.consilium.europa.eu/en/press/press-releases/2020/04/09/report-on-the-comprehensive-economic-policy-response-to-the-covid-19-pandemic/>

(4) See the European Fiscal Board’s statement on Covid-19 issued on 23 March 2020: https://ec.europa.eu/info/publications/statement-european-fiscal-board-covid-19_en.

THE MACROECONOMIC OUTLOOK

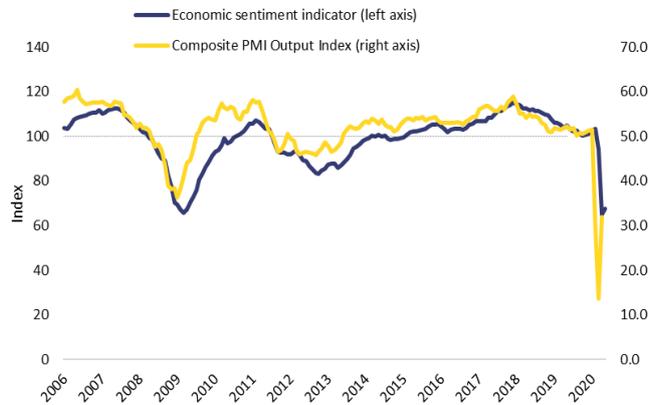
The macroeconomic outlook for 2021 is shrouded in uncertainty. However, after the deep recession of 2020 it is expected that 2021 will witness a strong but partial recovery. Unemployment levels will remain elevated.

Graph 1.1: GDP growth and contributions, euro area



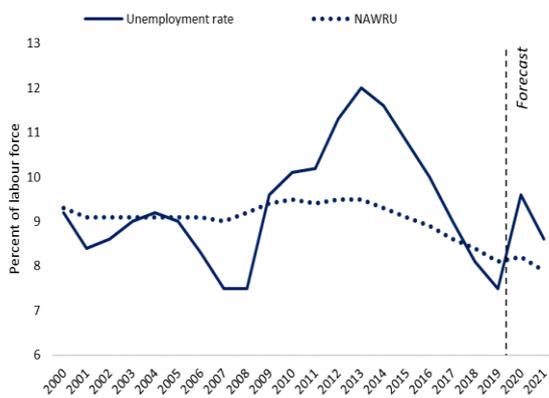
Source: European Commission.

Graph 1.2: Economic survey indicators, euro area



Source: European Commission, Macrobond.

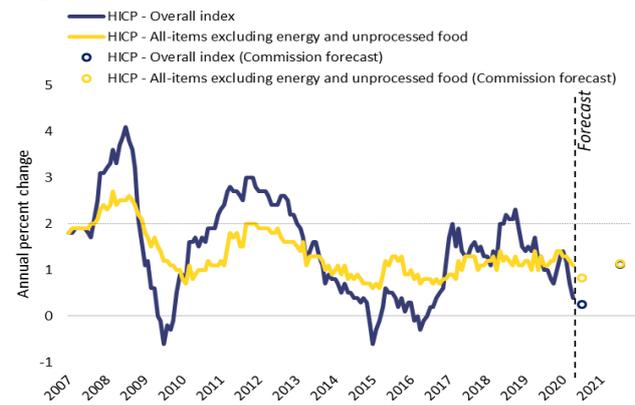
Graph 1.3: Unemployment rate, euro area



Source: European Commission.

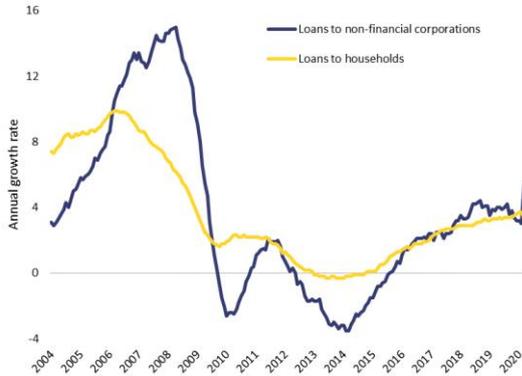
Note: NAWRU refers to the non-accelerating wage rate of unemployment.

Graph 1.4: Inflation rate, euro area



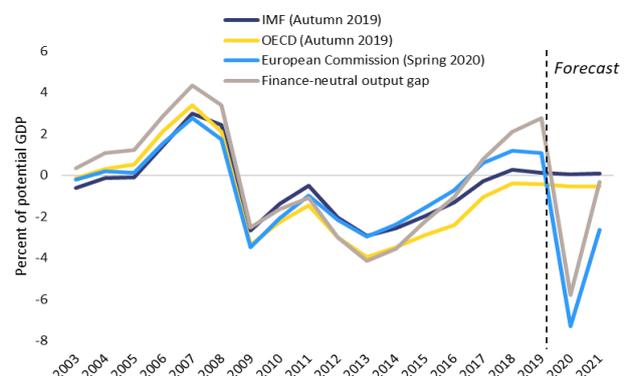
Source: European Central Bank and European Commission.

Graph 1.5: Lending growth, euro area



Source: European Central Bank.

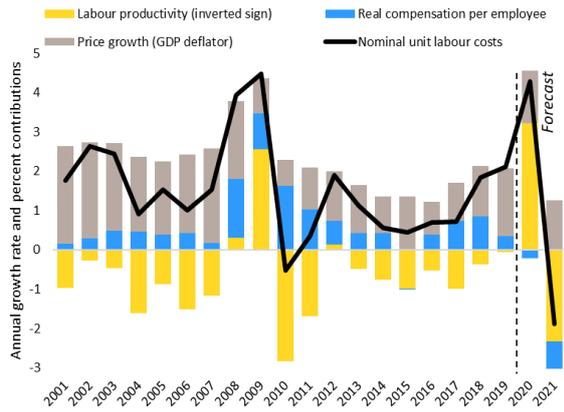
Graph 1.6: Output gap, euro area



Source: European Commission, OECD, IMF.

Note: (1) The IMF's spring 2020 forecast and OECD's spring 2020 Interim Report did not entail output gap estimates. (2) The finance-neutral output gap is derived from an extended HP filter that takes into account short-term real interest rates, credit growth and house price inflation.

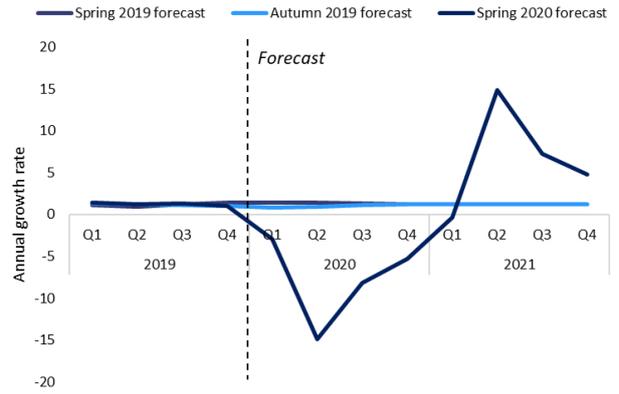
Graph 1.7: Unit labour costs, euro area



Source: European Commission.

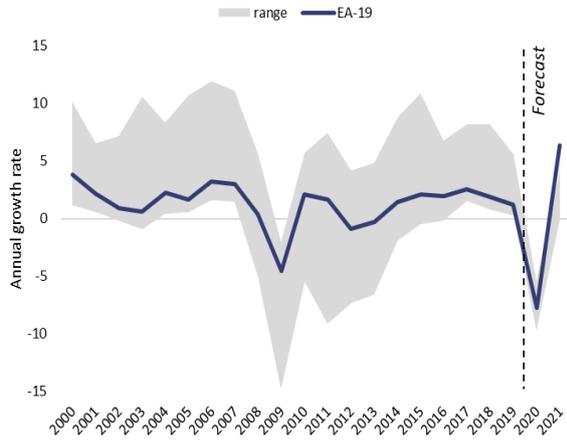
Note: Nominal unit labour costs are the ratio between nominal compensation per employee and output per employee; nominal compensation is the product of real compensation and the GDP deflator.

Graph 1.8: Real GDP growth projections by quarter



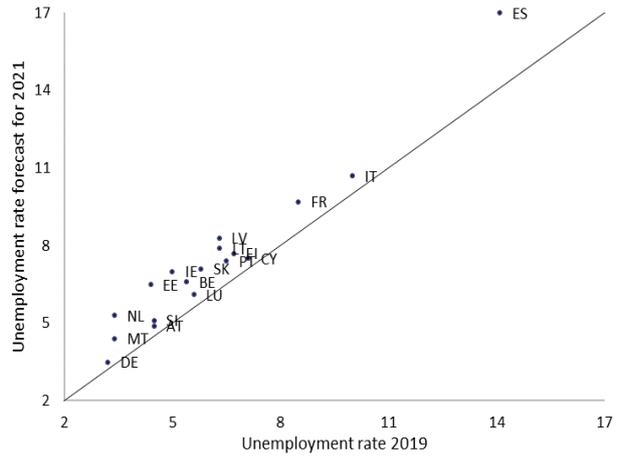
Source: European Commission.

Graph 1.9: Growth dispersion in the euro area



Source: European Commission, European Fiscal Board calculations.

Graph 1.10: Unemployment across Member States

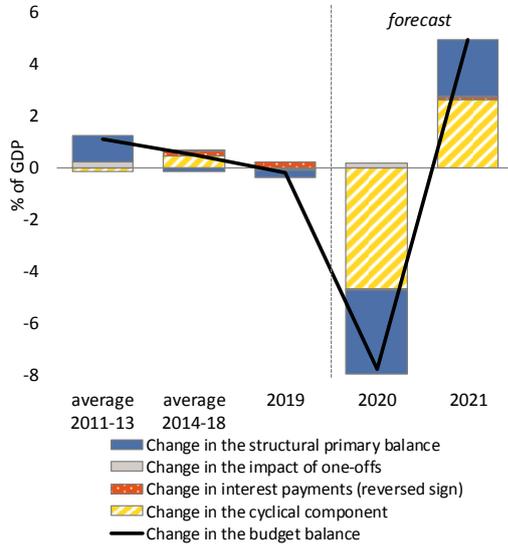


Source: European Commission.

FISCAL POLICY DEVELOPMENTS

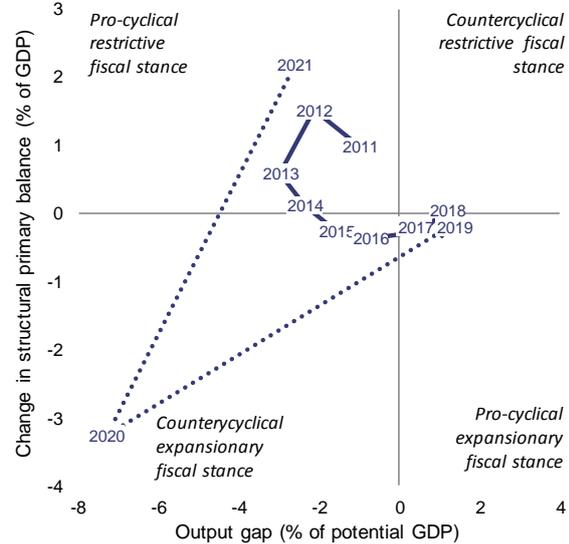
Budget deficits and government debt are forecast to increase sharply in 2020 followed by an improvement in 2021 as a result of both a rebound in economic activity and an assumed discontinuation of discretionary fiscal support.

Graph 1.11: Drivers of the change in the general government budget balance; euro area aggregate



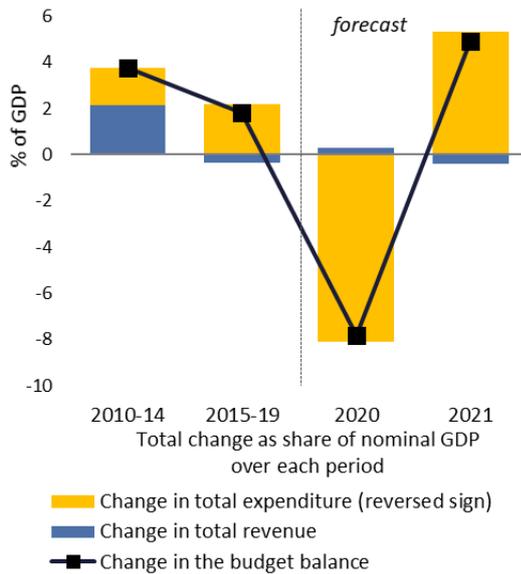
Source: European Commission, European Fiscal Board calculations.
Notes: (1) The forecast does not yet include the draft budgetary plans of euro area Member States for 2021 nor recently announced stimulus measures in DE and FR. (2) A decrease in interest payments is shown as an improvement in the headline balance.

Graph 1.12: Fiscal stance as measured by the change in the structural primary balance; euro area aggregate



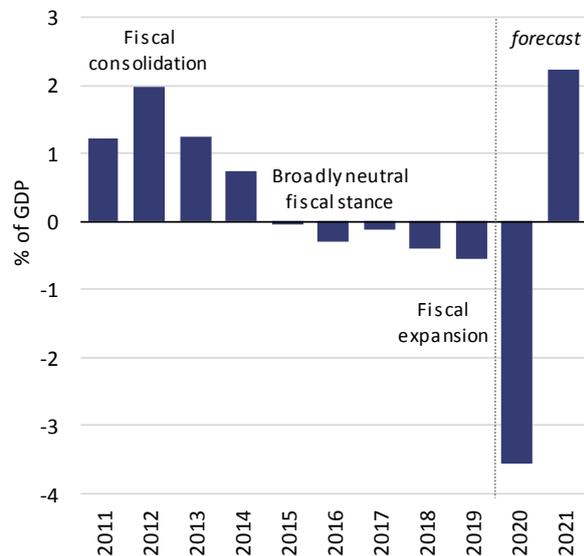
Source: European Commission, European Fiscal Board calculations.
Note: The forecast does not yet include the draft budgetary plans of euro area Member States for 2021 nor recently announced stimulus measures in DE and FR.

Graph 1.13: Government revenue and expenditure; euro area aggregate



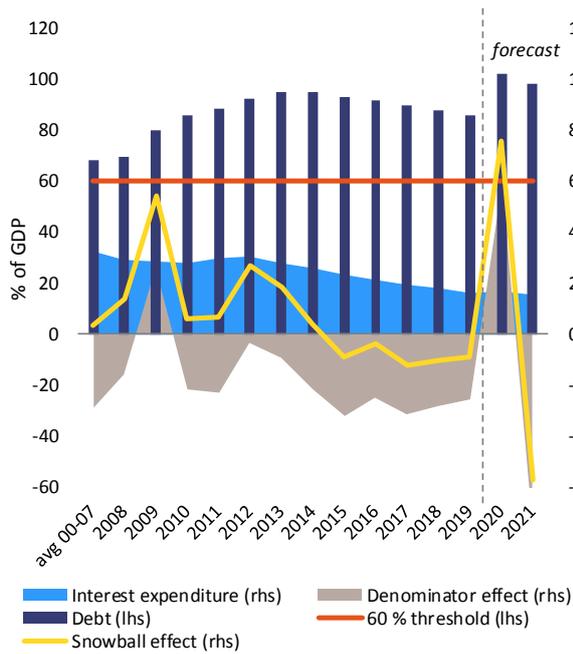
Source: European Commission, European Fiscal Board calculations.
Note: (1) By statistical convention, national accounts are accrual based, i.e. government revenues are recorded in the period they become due as opposed to when they are paid; the tax deferrals of 2020 are therefore not visible in the revenue numbers. (2) The forecast does not yet include the draft budgetary plans of euro area Member States for 2021 nor recently announced stimulus measures in DE and FR.

Graph 1.14: Fiscal stance as measured by net government expenditure growth relative to medium-term potential growth; euro area aggregate



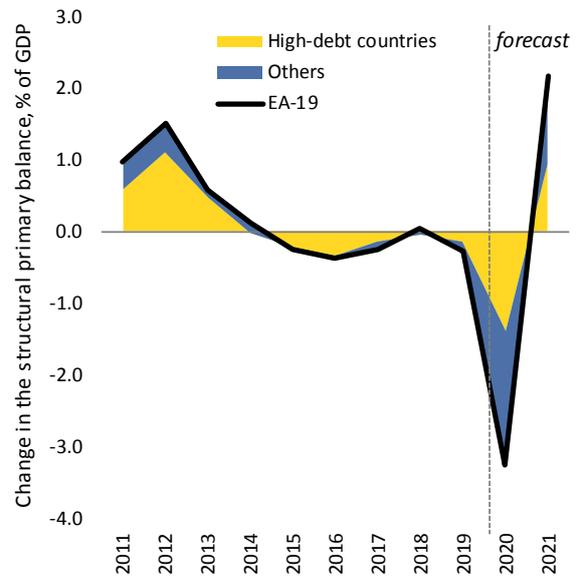
Source: European Commission, European Fiscal Board calculations.
Note: (1) The graph shows the difference between medium-term potential growth and net expenditure growth (as defined in the glossary); it is multiplied by the share of expenditure in nominal GDP to be expressed in % of GDP. If net expenditure growth exceeds medium-term potential growth, the fiscal stance is considered to be expansionary. (2) The forecast does not yet include the draft budgetary plans of euro area Member States for 2021 nor recently announced stimulus measures in DE and FR.

Graph 1.15: Government debt developments; euro area aggregate



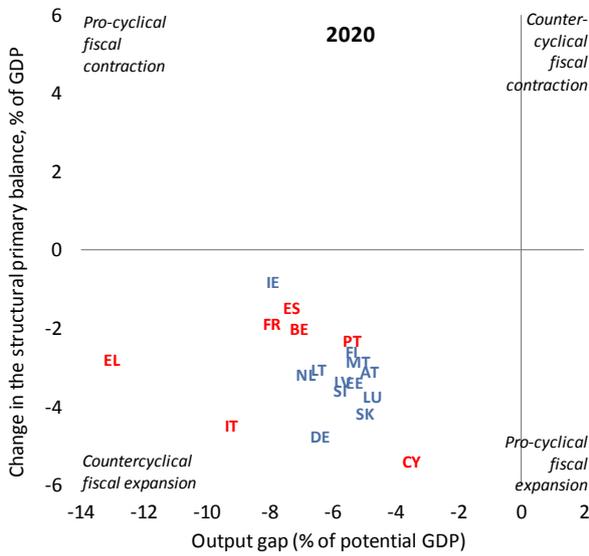
Source: European Commission, European Fiscal Board calculations.
Notes: (1) The forecast does not yet include the draft budgetary plans of euro area Member States for 2021 nor recently announced stimulus measures in DE and FR. (2) The snowball effect combines the impact of interest expenditure (blue area) and of nominal GDP growth (denominator effect, grey area) on the debt-to-GDP ratio: if GDP does not grow sufficiently fast to offset the cost of servicing debt, the debt ratio increases.

Graph 1.16: Contributions of countries to the aggregate fiscal stance



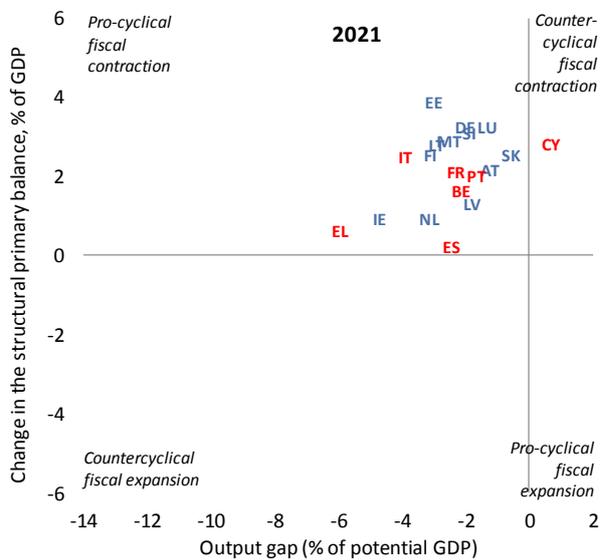
Source: European Commission, European Fiscal Board calculations.
Notes: (1) The group of high-debt countries includes the euro area countries with a debt-to-GDP ratio above 90% in 2019: Belgium, Greece, Spain, France, Italy, Cyprus and Portugal. Others: the remaining countries of the euro area. (2) The forecast does not yet include the draft budgetary plans of euro area Member States for 2021 nor recently announced stimulus measures in DE and FR.

Graph 1.17: Fiscal stance, cyclical conditions and sustainability in euro area Member States in 2020



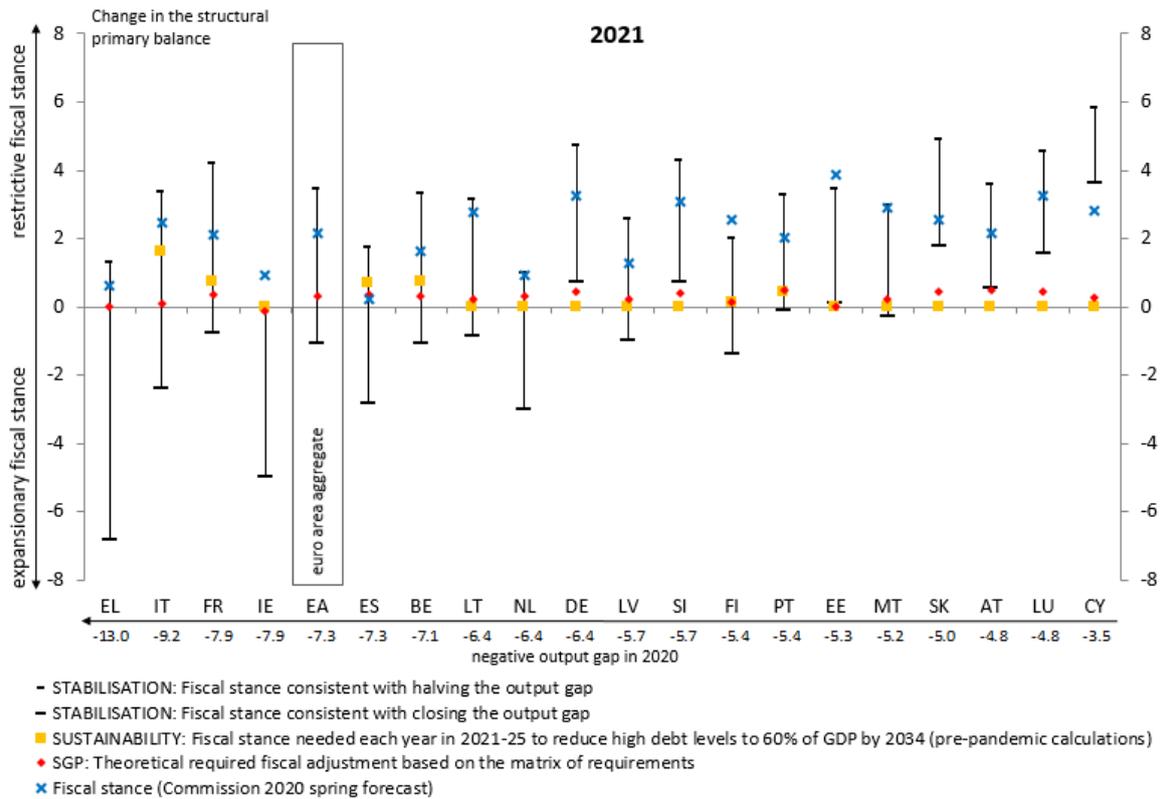
Source: European Commission, European Fiscal Board calculations.
Notes: (1) Red labels indicate countries with a debt-to-GDP ratio above 90% in 2019: Belgium, Greece, Spain, France, Italy, Cyprus and Portugal. (2) The forecast does not yet recently announced stimulus measures in DE and FR.

Graph 1.18: Fiscal stance, cyclical conditions and sustainability across euro area Member States in 2021



Source: European Commission, European Fiscal Board calculations.
Notes: (1) Red labels indicate countries with a debt-to-GDP ratio above 90% in 2019: Belgium, Greece, Spain, France, Italy, Cyprus and Portugal. (2) The forecast does not yet include the draft budgetary plans of euro area Member States for 2021 nor recently announced stimulus measures in DE and FR.

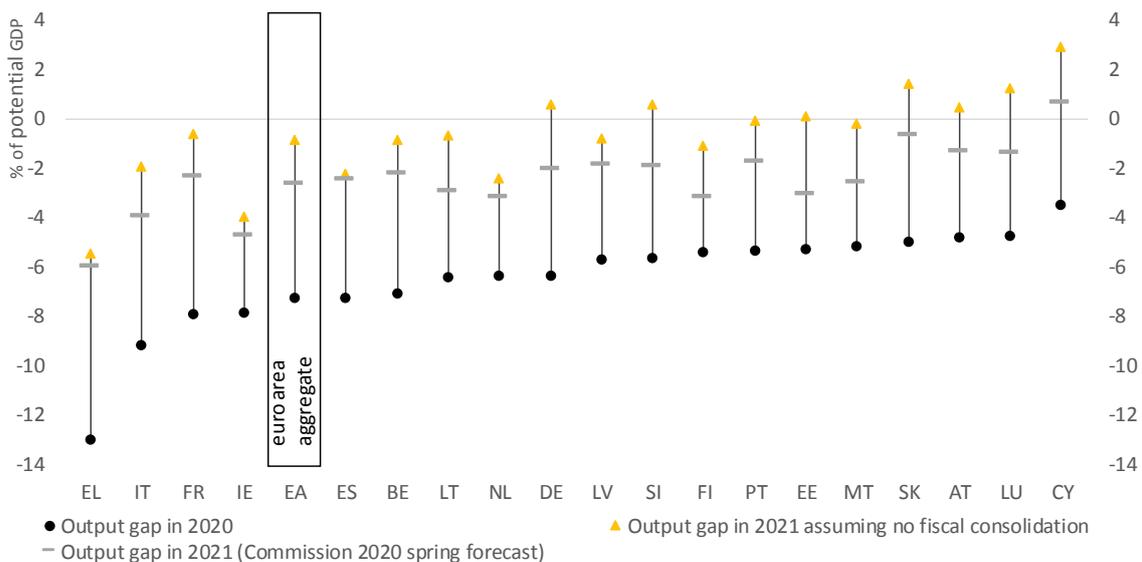
Graph 1.19: Overview: expected national and aggregate fiscal stances, fiscal requirements, stabilisation and sustainability



Source: European Commission, European Fiscal Board calculations.

Notes: (1) Countries are ordered by increasing level of output gap in 2020. (2) Stabilisation: the vertical bars show the range for a fiscal stance consistent with a reduction of the output gap by 50% to 100% compared to its 2020 level, using a uniform fiscal multiplier of 0.8. (3) Sustainability needs are assessed using the Commission's S1 indicator. S1 measures the total cumulative adjustment needed in 2021-2025 to bring the debt-to-GDP ratio to 60% by 2034. For countries where 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 per year in 2021-2025. (4) In countries where S1 is negative, debt is already below 60% of GDP or expected to decline below it by 2034, therefore no additional consolidation is needed. (5) The graph uses S1 based on the Commission 2019 autumn forecast, as the Commission has not recalculated S1 based on its 2020 spring forecast. (6) The theoretical country-specific fiscal requirements for 2021 (diamonds) show the adjustment requirements in case the general escape clause had not been activated and all countries remained under the preventive arm. These requirements are derived from the matrix of requirements under the preventive arm of the Stability and Growth Pact. They depend on each country's debt level, sustainability risks, output gap, and real and potential growth. (7) For consistency, the fiscal requirements are recalculated in terms of change in the structural primary balance, while in official documents they are formulated in terms of change in the structural balance. (8) The forecast does not yet include the draft budgetary plans of euro area Member States for 2021 nor recently announced stimulus measures in DE and FR.

Graph 1.20: Change in the output gap in 2021



Source: European Commission, European Fiscal Board calculations.

Notes: (1) Countries are ordered by increasing level of output gap in 2020. (2) The calculations are based on the Commission 2020 spring forecast, which expects on average a closure of the output gap by two thirds in 2021 (grey lines) despite a very restrictive fiscal stance. We calculate the additional change in the output gap obtained in a neutral fiscal stance scenario by removing the impact of the projected fiscal consolidation on the output gap, using a standard fiscal multiplier of 0.8. (3) The forecast does not yet include the draft budgetary plans of euro area Member States for 2021 nor recently announced stimulus measures in DE and FR.

2. PROTECTING GROWTH-ENHANCING GOVERNMENT EXPENDITURE

The tendency to cut government investment when public finances come under pressure needs to be tackled. Most governments have a tendency to disproportionately cut investment expenditure in order to address a deteriorating fiscal position. The global financial crisis of 2008-2009 and the subsequent European sovereign debt crisis were the latest and particularly evident example of government investment bearing the brunt of fiscal consolidation efforts. The hit to government investment was largest for the countries with the highest government debt. The economic and fiscal repercussions of the Covid-19 pandemic seem likely to threaten the already historically low levels of government investment. This backdrop strengthens the call for national as well as joint EU efforts to protect growth-enhancing government expenditure better than in the past.

At the current juncture, protecting government investment has both short-term and long-term benefits. Stimulating government investment would not only enhance the long-term growth potential. As indicated in Section 1, it should also be part of the fiscal stimulus aimed to sustain aggregate demand in the short term; the multiplier effect of government investment should be larger than that of other government expenditure ⁽⁹⁾.

Past deficiencies of fiscal rules to protect government investment can be overcome. Two potential caveats to fiscal rules aimed to protect government investment have been raised in the past. First, such rules intrude into the expenditure allocations of national governments by aiming beyond aggregate deficits and debt. Second, the implementation of such rules is

challenging to monitor. Both problems could be mitigated, if the rules were anchored at the European level and designed to focus on commonly agreed investment priorities. Transparency and an effective monitoring regime conducted by the European Commission and supported by national independent fiscal institutions could then help to ensure that investments are carefully targeted and implemented while maintaining a sustainable medium-term fiscal position.

The current state of government investment

Government investment has not fully recovered since the global financial crisis. Gross government investment has been in decline throughout most of Europe. In 2019, six years into recovery, it stood at 2.8% of GDP in the euro area, below its already modest pre-global financial crisis average of 3.2% ⁽¹⁰⁾. For comparison, in 2019 in the US and Japan, the government invested around 3.4% and 3.7% of GDP respectively, but investment has also been in decline in these economies ⁽¹¹⁾. Of note, these investment figures are in gross terms. In other words part of investment serves to replace or maintain the depreciating existing capital stock. In fact, net investment has been negligible; nearly all gross investment has been replacement investment (Graphic 2.1). In this context, the composition of government investment plays an important role. For example, part of gross investment targets digitalisation which does not replace existing infrastructure. Investment to maintain the existing capital stock may be deteriorating, hiding under the aggregate investment rate.

⁽⁹⁾ <https://www.oecd.org/economy/reconciling-fiscal-consolidation-with-growth-and-equity.pdf>

⁽¹⁰⁾ Average of 1995-2005.

⁽¹¹⁾ Reflecting, among other factors, an above average decrease in prices of investment.

Although prevalent, the extent of the investment shortfall varies across countries.

The aggregate figure masks stark differences across Member States. The majority saw their government investment level decrease compared to the pre-crisis average, in most cases in the context of protracted fiscal adjustment efforts. Most of those who exhibited rising government investment - typically the countries of the 2004 and 2007 enlargements - had started from a low investment level by European comparison and were catching up with the more advanced economies. This process was supported by EU accession, notably by access to EU cohesion funding (Graph 2.2). Member States under a financial adjustment programme saw the strongest decline in their government investment ratios, which underlines the tendency of governments to particularly target investments when budgetary cuts are required. In some cases, corrections took place after excessive investment in non-tradeable sectors such as construction, or the agreed fiscal correction protected social expenditure.

Consolidation tends to affect investment, but fiscal space does not seem to spur investment either. Member States with ample fiscal space also exhibit low investment rates. Fiscal rules or adjustment programmes are not the only constraining factors for government investment expenditure. This point is reinforced by the fact that during the last economic recovery positive revenue surprises across many Member States were rarely used to increase government investment expenditure - while substantial upward revisions in other primary expenditure were observed (see Graph 2.3).

Other government expenditure items supporting economic growth are being cut too. Investment rates do not tell the full story. Some government expenditure not classified as 'investment' nonetheless raises the growth potential of the economy⁽¹²⁾. Examples are

⁽¹²⁾ European Fiscal Board (2019), 'Assessment of EU fiscal rules with a focus on the six and two-pack legislation',

expenditure on education or investment in health care that affect labour productivity and labour supply. Growth-enhancing expenditure may be more difficult to delineate than government investment but can be equally important for a country's growth potential.

The changed economic environment

Low levels of government investment and other growth-enhancing government expenditure weigh on economic growth.

Given the current low level of government investment and simultaneously shrinking working-age population, as well as weak productivity growth, it is not surprising that real GDP growth has, in recent years, been reduced to historically low rates. In fact, trend growth for the euro area has not recovered to pre-crisis levels, but has remained below 1.5% per year.

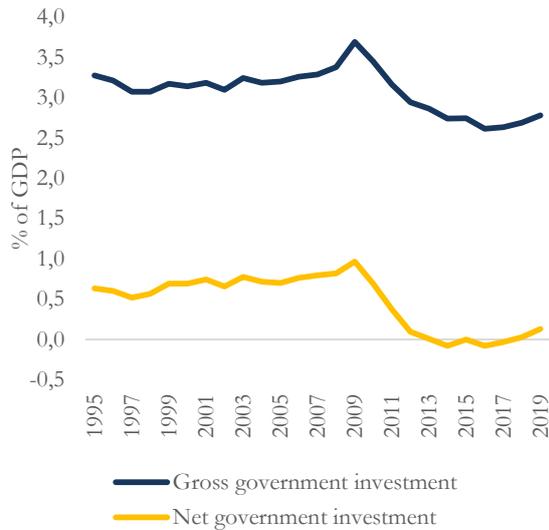
Government investment is likely to have a higher impact at the current juncture. After a period of fiscal restraint and government underinvestment, both multipliers of and returns⁽¹³⁾ on new investment can be assumed to be higher at the margin than they used to be. The elevated returns and multiplier effects render government investments more desirable and may even enhance the sustainability of public finances due to the combined effects on short-term demand and medium-term supply⁽¹⁴⁾.

https://ec.europa.eu/info/publications/assessment-eu-fiscal-rules-focus-six-and-two-pack-legislation_en

⁽¹³⁾ The rate of return will also be driven by the scale of the existing capital stock.

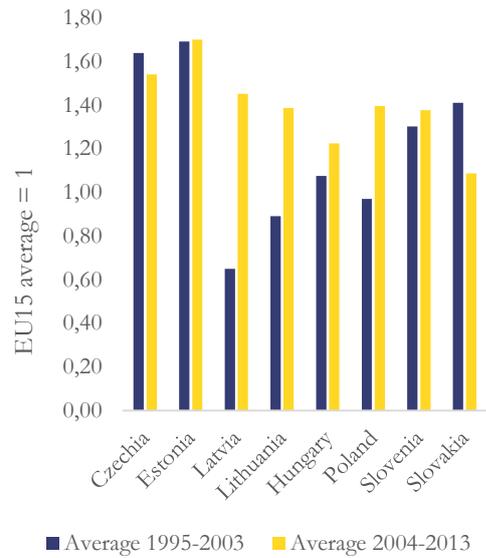
⁽¹⁴⁾ <https://www.imf.org/en/Publications/WEO/Issues/2016/12/31/World-Economic-Outlook-October-2014-Legacies-Clouds-Uncertainties-41632>

Graph 2.1: Gross and net investment dynamics in the euro area



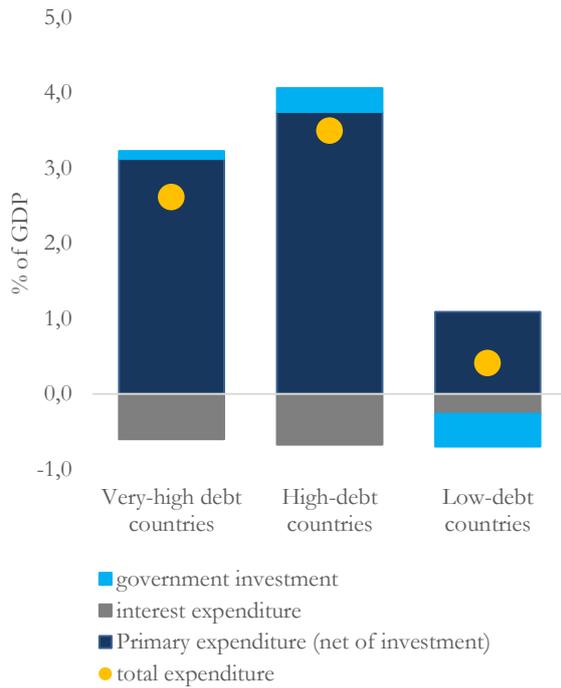
Source: European Commission, European Fiscal Board calculations.

Graph 2.2: Government investment rate relative to EU15



Notes: EU15 = BE, DE, DK, IE, EL, ES, FR, IT, LU, NL, PT, AT, DE, SE, UK.
Source: European Commission, European Fiscal Board calculations.

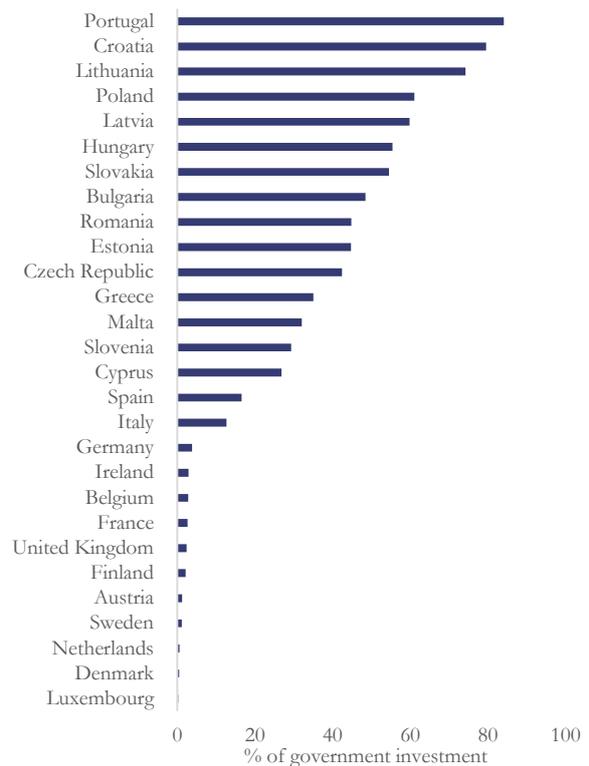
Graph 2.3: Revisions of government spending plans by government debt level (cumulative, 2016-2019)



Notes: (1) The graph shows the cumulative difference between government expenditure outturns and spending plans in the stability and convergence programmes in 2016-2019 in % of GDP (2) The classification of countries by government debt is based on the average debt-to-GDP ratio in 2011-2018. Very high-debt countries = above 90% of GDP (i.e. BE, IE, EL, ES, FR, IT, CY, PT); High-debt countries = between 60% and 90% (i.e. DE, HR, HU, MT, NL, AT, SI, UK); Low-debt countries = below 60% (i.e. BG, CZ, DK, EE, LV, LT, LU, PL, RO, SK, FI, SE).

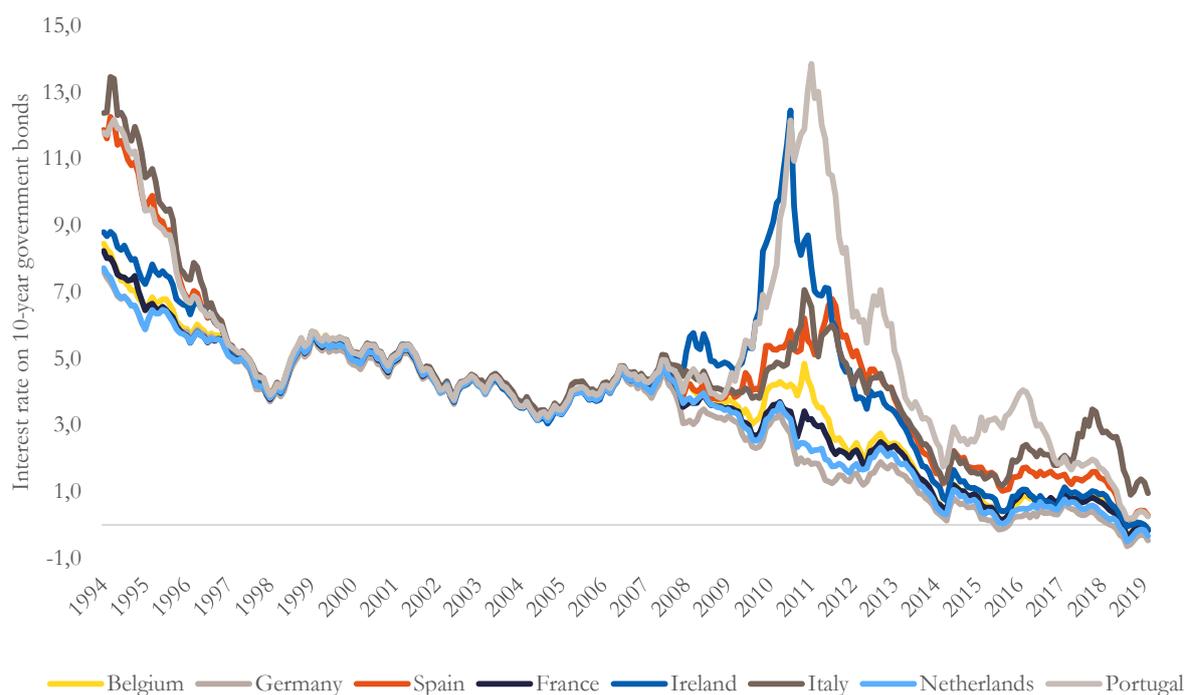
Source: European Commission, European Fiscal Board calculations.

Graph 2.4: Cohesion policy funding as an estimated share of government investment, 2015-2017



Source: European Commission, <https://cohesiondata.ec.europa.eu/Other/-of-cohesion-policy-funding-in-public-investment-p/7bw6-2dw3>

Graph 2.5: Historical yield on ten-year government bonds



Source: European Central Bank.

In addition, very low interest rates offer a unique opportunity for governments to invest in the future. The second reason why fostering growth-enhancing government expenditure has gained urgency is the fundamentally changed economic environment. The persistence of low interest rates enables governments to borrow at historically low rates (Graph 2.5). With government bond yields close to zero in many countries, investment only entails an almost negligible debt-servicing burden, especially if interest rates remain low (or can be locked in through borrowing at long maturities) and investment projects are carefully chosen. Consequently, debt-financed investment would have only a minor impact on future current government expenditure. Direct returns on investment and tax receipts owing to higher growth rates could then be used to pay off the principal over time. The precondition is that borrowing countries retain sufficient fiscal space to seize these opportunities ⁽¹⁵⁾.

⁽¹⁵⁾ Fiscally constrained countries pay a considerable premium on new debt.

National experiences with rules aimed to protect growth-enhancing expenditure

So-called golden rules have been tried in a number of countries. Policies aiming to combine debt sustainability and government investment protection are not new. In the past, arrangements to protect growth-enhancing government expenditure often relied on an investment rule with explicitly defined parameters. These so-called golden rules have been tried in several countries ⁽¹⁶⁾. A golden rule aims to constrain government borrowing to resources needed for government investment. Debt financing in that case is considered to be justified since investments are expected to benefit future generations by raising long-term growth. The time horizon for compliance with the rule is sometimes chosen over the economic cycle to avoid pro-cyclical policies.

⁽¹⁶⁾ Notably, Argentina, Costa Rica, Germany, India, Japan, Malaysia, New Zealand, Pakistan and the United Kingdom.

Recent experience with golden rules in the EU at the national level can be found in the United Kingdom and Germany. In 1997-2008 and 2010-2015 the fiscal framework of the United Kingdom included a golden rule. In Germany a golden rule was in place for 40 years from 1969 to 2009. In both cases the rule was eventually abandoned in the wake of the financial crisis and new debt dynamics (see Box 3). Both episodes can be instructive, as they highlight practical challenges (definition of growth-enhancing expenditure, creative accounting, and effective monitoring of implementation) and political challenges (back-loading, enabling character of the rule⁽¹⁷⁾ and absence of a sustainable adjustment path). These caveats would need to be addressed by any new arrangement at the European level to protect growth-enhancing expenditure, but that appears feasible. Past deficiencies should not disqualify golden rules more generally.

Practical issues designing an investment rule

Identifying eligible expenditure requires a common agreement on the objective. Are the government expenditure items to be supported those that yield the highest return on investment or that are considered to be most growth-enhancing in the long-term or those with a specific societal or environmental goal? Should the focus lie on expenditure items that have a clear EU value-added and hence could qualify as an EU public good⁽¹⁸⁾? Should sustainability feature as a criterion that considers the cost-reducing effect of eligible investment on government expenditure in the future, such as climate-change mitigation or measures enhancing government efficiency? What weight can be put on significant fiscal spillovers? The most straightforward approach is to focus on items covered under the statistical concept of

gross fixed capital formation. The methodology is already employed by Member States, but this approach may exclude other desirable growth-enhancing expenditure items. A broader approach could rely on a functional differentiation of expenditure items⁽¹⁹⁾ and enable Member States to jointly agree on a more targeted group of eligible expenditure. For example, R&D and education expenditure can be expected to have a significant impact on a country's growth potential.

Current economic, social and environmental priorities in the EU have identified new investment in healthcare, climate neutrality and digital transformation. First, the digital transformation is a key determinant of the competitiveness of the single market. Ensuring Europe is ready for the digital age necessitates vast investments with a crucial role to be played by the public sector. Second, in order to make the objective of climate neutrality by 2050 attainable, the European Commission is aiming to combine EU funds with national co-financing to crowd in private sector financing worth 1 trillion euro over the next decade. Climate action can generate tangible returns on investment while reducing the indirect costs of climate change, although the latter are difficult to estimate accurately. The exact demarcation of targeted investment will need to be developed carefully and transparently. In the current state of the Covid-19 pandemic, healthcare spending merits a special status.

Clear eligibility criteria can be oriented along the investment priorities under the EU budget. The EU budget already identifies investment priorities that have clear EU value-added, providing well delineated categories of investment. Vague eligibility criteria have to be avoided, since they would open the door to reclassification of expenditure and creative accounting that jeopardise fiscal sustainability ex

⁽¹⁷⁾ It is not mandatory to use the fiscal leeway provided by the rule.

⁽¹⁸⁾ Referring to a good that is non-rival and non-excludable, i.e. everyone in society enjoys access to them without direct prior contribution.

⁽¹⁹⁾ See, for example, the classification of the functions of government where government functions are broken down into different divisions, groups and classes.

post and undermine the acceptability of arrangements. Similar to funding under the European Structural and Investment Funds, thematic objectives could be developed. Regular audits (conducted or commissioned by the Commission) would assess if expenditure items listed under eligible investment match objectives and demarcated investment areas.

Investment protection rules are best operationalised based on *net* investment figures. Most golden rules have in fact focused on net investments rather than gross investment. In view of inter-generational equity, additions to the capital stock is the appropriate approach.

However, quantifying net government investment is challenging from a practical standpoint. This statistical difficulty is even more severe if one considers net growth-enhancing government expenditure. Measuring the value of the existing capital stock and estimating a depreciation rate may prove particularly demanding, especially for items such as education ⁽²⁰⁾. Alternatively, a pre-determined percentage share of gross investment or more generally growth-enhancing expenditure could be taken as a proxy for net investments. However, this approach is somewhat arbitrary and would not necessarily enable Member States to expand or stabilise their capital stock.

The enabling character of fiscal rules

Rules aimed to protect growth-enhancing government expenditure are typically of an enabling nature.

The effectiveness of a fiscal rule that aims to protect growth-enhancing government expenditure depends not only on how the rule provides more fiscal space for investment, but also on whether policymakers actually make use of this space. As indicated above, during the recent recovery phase (2016-2019) additional spending overwhelmingly took the form of current government expenditure; less than one tenth was in investments (Graph 2.3).

Fiscal rules are not the only constraining factor on government investment. Other impediments relate to political economy considerations, i.e. political incentives that lead lawmakers to favour current expenditure over investment ⁽²⁰⁾ ⁽²¹⁾. Further obstacles stem from allocating resources at different levels of government and lacking the capacity to absorb available funds (i.e. lacking human resources to use them, e.g. through public procurement). Another impediment is shortages of private sector suppliers due to cyclical bottlenecks; and an increasingly stringent set of regulations make it difficult to raise government investment rapidly for cyclical purposes. These difficulties make it more desirable to protect and design investment for the medium term.

Mechanisms could be introduced to go beyond the enabling nature of the rule. Some of the arrangements presented later entail mechanisms to strengthen the incentives for governments to make use of the extra spending allowed under the rule. Negative incentives in the form of sanctions for non-compliance have proven in the past to be difficult to implement; positive incentives should work better.

⁽²⁰⁾ The depreciation rate for education investment is particularly high, thus limiting the added scope by including education (https://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Expertisen/Staatsverschuldung_wirksam_begrenzen.pdf)

Box 3: Experiences with the golden rule

The golden rule allows governments to only incur deficits to finance (net) government investment and otherwise mandates that current expenditure be balanced by revenues. Golden rules in practice often entail a cyclical perspective and an escape clause for (severe) downturns. The concept has been well established ⁽¹⁾ and several countries have or had introduced a golden rule with varying degrees of success.

The International Monetary Fund ⁽²⁾ identified nine countries that had a genuine golden rule in place since 1985 (Brazil, Costa Rica, Germany, Japan, Kosovo, Liberia, Malaysia, Pakistan and United Kingdom) while some countries had adopted variants of the golden rule or significant elements of it (e.g. Argentina, India, New Zealand, Mexico and others). Many used the net investment rate as the primary target (e.g. the United Kingdom and New Zealand) while a few others (e.g. Germany) employed a gross investment rule.

The German golden rule

The German golden rule was introduced in 1969 and was anchored in the Constitution (Articles 109 and 115). The rule was comparatively simple, as it allowed deficits as long as they did not surpass the level of *gross* government investment, ex ante in the budget plans. Both articles in the Constitution also refer to an escape clause that could be triggered in case of ‘a disturbance to the macroeconomic equilibrium’. However, the Constitution remained silent on what constitutes such a disturbance.

During its existence from 1969 to 2010, the golden rule does not seem to have achieved its goals ⁽³⁾. The debt ratio rose from 18% in 1970 to 64% of GDP prior to the financial crisis of 2008/2009. At the same time, gross government investments shrank from nearly 5% to 2% of GDP from the inception of the golden rule to its abandonment. In the end, despite the rising debt levels, government assets decreased over time ⁽⁴⁾.

Overall, the golden rule suffered from several shortcomings: (1) There was no definition in the German Constitution on which investments ⁽⁵⁾ were to be considered under the rule. This left room for interpretation to suit the political needs of the time. (2) Gross investment was chosen instead of net investment, thus enabling higher deficits. (3) Deviations from the budget plans and a liberal use of the escape clause, paired with a lack of a mechanism to incentivise governments to use windfall revenues for consolidation, were key deficiencies of the framework.

The Organisation for Economic Co-operation and Development (OECD) ⁽⁶⁾ found a lack of ex post compliance despite budgetary plans being in order. Between 1991 and 2005, the rule was violated in seven years ex post. There is also evidence showing ⁽⁷⁾ that over the entire period, in 19 out of 44 years, deficits exceeded gross fixed capital formation, though in 13 of these years the output gap was negative ⁽⁸⁾. As the Constitution did not define what constitutes a ‘disturbance to the macroeconomic equilibrium’, the escape clause could be invoked liberally based on ad hoc political judgement.

Despite rising debt, investment barely increased with the introduction of the golden rule, indicating that the rule was unable to overcome the political preferences for current expenditure/tax breaks over government investment. The low rate of investment had, of course, many causes. One explanation is structural shifts, such as lower population growth and an ageing society. Another is the level of government responsible for spending. Municipalities accounted for around half of total government investment, and they experienced a stark decline in net investment rates (particularly in buildings). The golden rule only applied to the states and the federal level, but not to municipalities. However, the latter have limited scope to borrow and depend on current and capital transfers from the states, which in the early 2000s had embarked upon a consolidation path; the golden rule did not prevent a cutback in investment grants for municipalities. Municipalities also tended to have insufficient capacities (e.g. available trained staff) to develop investment projects, while some municipalities simply lacked fiscal space due to high indebtedness ⁽⁹⁾. Despite the shortcomings of the German golden rule, a modified ⁽¹⁰⁾ golden rule was still considered as an option ⁽¹¹⁾ to replace the former one, though the current debt brake ended up being implemented instead, not least because of the difficulties in delineating eligible net investments ⁽¹²⁾.

⁽²¹⁾ The electorate directly benefits from current expenditure, while part of the gains from investment rest with future generations. The demographic trend of an ageing society may amplify this effect.

⁽²²⁾ In some Member States public procurement may entail legal risks for decision-makers and officials of being accused of corruption, making it less costly to cut current spending than investment.

The golden rule in the United Kingdom

The United Kingdom adopted a golden rule in the Code of Fiscal Stability in 1998, which stipulated that the government could only borrow to finance net investments. In practical terms the rule required that the current budget balance excluding net investment would be at least in balance over the ‘business-cycle’. The linked ‘sustainable investment rule’ demanded that the net government debt was not to breach 40% of GDP and was also evaluated over the cycle.

Gross government investment increased strongly after the introduction of the golden rule from 1.6% in 1997 to 2.9% in 2008 ⁽¹³⁾ and net government investment showed a similar dynamic ⁽¹⁴⁾. This upward trend has been linked to the golden rule’s implementation ⁽¹⁵⁾. At the same time, the government debt level initially fell, but it started to rise again in the early 2000s. Budget plans began to turn out to be overly optimistic, which led to what is viewed in retrospect as a manipulation of the rule.

The economic cycle had originally been determined to start in 1999/2000, and until 2005 the current budget excluding investment had on average been slightly in surplus and fulfilled the golden rule ⁽¹⁶⁾. However, as the budget of 2005 was predicted to overshoot the plan and threaten a breach of the rule, the government opted to correct the starting point ⁽¹⁷⁾ of the economic cycle to 1997/1998 ⁽¹⁸⁾. This reclassification enabled the government to fulfil the ‘balanced-over-the-cycle’ rule without having to take corrective fiscal measures. While the ‘over-the-cycle-balance’ rule is economically sound, it is open to political manipulation, as clearly shown by this case. A strong independent fiscal institution tasked to monitor the implementation of the rule would have been valuable at the time.

In this context, the Institute for Fiscal Studies’ Green Budget 2006 ⁽¹⁹⁾ proposed a more forward-looking fiscal rule. And indeed, after doing away with the golden rule between 2008 and 2010, a new fiscal rule was established lasting from 2010 to 2015. The rule introduced the ‘fiscal mandate’ to achieve a balanced cyclically-adjusted current balance over a rolling window of 5 years ⁽²⁰⁾. Since then the fiscal rules have been adapted to target cyclically-adjusted government sector net borrowing without a derogation for investment. An independent fiscal council, the Office for Budget Responsibility, was set up in 2010.

Other experiences around the world

Golden rules have been established in several set-ups, with governments complying with these rules to a varying degree. New Zealand and Japan are among those countries that are following a golden rule to this day.

The Japanese golden rule has been enshrined in Article 4 of the Public Finance Law and been in place since 1947 ⁽²¹⁾. It allows the government to use ‘construction bonds’ to finance investments, which are not subject to their deficit rules. This special allowance for government investment has effectively encouraged a government investment rate, which is comparatively high with an average of around 4% of GDP over the past two decades. Since 1975, the current balance had been in surplus, with the exception of the short-lived waiver used in 1990-1993 ⁽²²⁾.

Golden rules are also commonplace at the subnational level in several countries – for example Canada, Germany, Switzerland and, notably, the United States ⁽²³⁾. In fact, all US states have a variant of a budget balance rule with the exception of Vermont. Not all are statutory and their strictness varies ⁽²⁴⁾. These debt brakes usually only apply to the operational budget (the general fund), while the capital budget is not constrained by the rule, thus they effectively constitute golden rules.

These golden rules have been comparatively successful in keeping state and local government debt in check ⁽²⁵⁾, in particular in states that forbid carrying over deficits ⁽²⁶⁾. State governments can rely on sizable federal grants and reimbursements that are earmarked for specific expenditure items. This federal transfer system serves as a powerful stabilisation function for states during economic downturns. During the Great Recession, local and state investment did not plummet but actually increased slightly in aggregate ⁽²⁷⁾. In short, the golden rules combined with the beefed-up financial support from the federal level (i.e. the American Recovery and Reinvestment Act) enabled local and state governments to effectively protect government investment, at least until recently.

(1) <https://www.imf.org/external/datamapper/fiscalrules/Fiscal%20Rules%20at%20a%20Glance%20-%20Background%20Paper.pdf> or Musgrave (1939), ‘The nature of budgetary balance and the case for a capital-budget’.

(2) <https://www.imf.org/en/Publications/WEO/Issues/2016/12/31/World-Economic-Outlook-October-2014-Legacies-Clouds-Uncertainties-41632>

(3) <https://www.oecd-ilibrary.org/economics/oecd-economic-surveys-germany-2008> eco_surveys-deu-2008-en or Sachverständigenrat (2007), <https://www.sachverstaendigenrat->

- wirtschaft.de/fileadmin/dateiablage/Expertisen/Staatsverschuldung_wirksam_begrenzen.pdf
- (4) <https://www.bundesbank.de/resource/blob/692644/c96fc26ed9d40067b8d0ba6ff4d6340a/mL/2007-10-haushaltsrechtsreform-data.pdf>
- (5) The Constitutional court questioned the application of the rule with regard to the delineation of investments.
- (6) https://www.oecd-ilibrary.org/economics/oecd-economic-surveys-germany-2008_eco_surveys-deu-2008-en
- (7) <https://www.eesc.europa.eu/resources/docs/achim-truger---implementing-the-golden-rule-for-public-investment-in-europe.pdf>
- (8) He also asserts that 5 out of the remaining 6 years had factors present that could justify a deviation.
- (9) <https://www.wirtschaftsdienst.eu/archiv/jahr/2019/heft/5.html>
- (10) Notably moving towards a net investment rule and clearly defining ‘investment’ under the rule.
- (11) https://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Expertisen/Staatsverschuldung_wirksam_begrenzen.pdf
- (12) https://www.bundesrat.de/SharedDocs/downloads/DE/sonstiges/Abschlussbericht-Foeko-II.pdf?__blob=publicationFile&v=1
- (13) The investment rate is still below the level of 1970/1980 due to structural shifts, privatisation of utilities and lower (social) housing investment (<https://www.ifs.org.uk/budgets/gb2006/06chap2.pdf>).
- (14) AMECO and https://obr.uk/docs/dlm_uploads/GOLDEN-RULE-IN-THE-UK-290915.pdf
- (15) The investment rate is still below the level of 1970/1980 due to structural shifts, privatisation of utilities and lower (social) housing investment (<https://www.ifs.org.uk/budgets/gb2006/06chap2.pdf>).
- (16) <https://www.ifs.org.uk/budgets/gb2006/06chap2.pdf>
- (17) While there is evidence to support this view, the reclassification under these circumstances was problematic.
- (18) <https://www.imf.org/en/Publications/Fiscal-Affairs-Department-How-To-Notes/Issues/2018/03/15/How-to-Select-Fiscal-Rules-A-Primer-45552>
- (19) <https://www.ifs.org.uk/budgets/gb2006/06chap2.pdf>
- (20) <https://www.oecd.org/gov/budgeting/UnitedKingdom.pdf>
- (21) <http://www.nicmr.com/nicmr/english/report/repo/2013/2013spr03.pdf>
- (22) <https://www.imf.org/external/datamapper/fiscalrules/Fiscal%20Rules%20at%20a%20Glance%20-%20Background%20Paper.pdf>
- (23) See e.g. <https://www.imf.org/external/np/pp/eng/2009/121609.pdf> and <http://www.oecd.org/economy/public-finance/Fiscalrulesforsub-centralgovernments2011updateoftheOECDindicator.pdf>
- (24) <https://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf>
- (25) Differences across states are large, with debt ranging from 5-25% of gross state product. https://www.usgovernmentspending.com/state_debt_rank
- (26) <https://www.nber.org/papers/w5533.pdf>
- (27) http://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_251-300/WP259.pdf

Approaches to protect growth-enhancing government expenditure

The Covid-19 crisis will have important implications for the EU fiscal framework. The economic ramifications of the Covid-19 epidemic and the resulting sky-rocketing debt levels will as a minimum require a recalibration of the fiscal framework and revive the discussion on how to deepen and complete the Economic and Monetary Union. In particular, pressure to adapt or reform the rules is likely to increase compared to the time the Commission published its economic governance review in February 2020.

Different approaches to support government investment and growth-enhancing government expenditure can be considered. Building on the ideas outlined in previous reports ⁽²³⁾, this section discusses four approaches to the protection of growth-enhancing government expenditure, while aiming to keep public finances on a sustainable path (see table below). These approaches are largely complementary in serving a double and complementary objective: address fiscal sustainability issues and establish arrangements conducive to protect growth-enhancing government expenditure beyond the shockwaves of the Covid-19 pandemic. The four approaches are presented in order of decreasing ambition.

Overview table: Four approaches to support government investment and growth-enhancing government expenditure

	Name	Feasible within current system?	Final/transition approach	Optional / prescriptive	Potential impact
Approach 1	Central fiscal capacity	No (legislative change)	Final	Prescriptive	Large
Approach 2	EU Investment Fund	Yes (adapt multiannual financial framework)	Final	Prescriptive	Large
Approach 3	Simplified Stability and Growth Pact	No (legislative change)	Final	Optional	Large
Approach 4	Flexibility in the Stability and Growth Pact	Yes	Transition	Optional	Moderate

Notes: (1) The third column indicates whether the approach would be feasible without legislative change. (2) The fourth column indicates whether the approach is envisaged as a transitory solution or as an ultimate cornerstone to protect growth-enhancing government expenditure. (3) The fifth column indicates whether the rule is of an enabling nature, i.e. it is up to the government to decide whether to make use of it or if it effectively compels governments to do so. (4) The last column indicates the expected impact of the approach in terms of its scale.

⁽²³⁾ European Fiscal Board (2019), ‘Assessment of EU fiscal rules with a focus on the six and two-pack legislation’, https://ec.europa.eu/info/publications/assessment-eu-fiscal-rules-focus-six-and-two-pack-legislation_en, and European Fiscal Board (2019) ‘2019 annual report of the European Fiscal Board’ https://ec.europa.eu/info/publications/2019-annual-report-european-fiscal-board_en

Approach 1: A central fiscal capacity

A complete Economic and Monetary Union requires a central fiscal capacity that can be deployed in a timely manner. In a genuine Economic and Monetary Union, coordinating national economic policies is complemented by a central fiscal capacity. A central fiscal capacity can be designed in an investment-friendly manner by tasking it to channel joint funds to Member States for specific areas of government expenditure. In the context of Economic and Monetary Union, the purpose of the central fiscal capacity has usually been understood to address common or country-specific shocks that are too large to be offset through the stabilising impact of joint monetary policy or automatic stabilisers in national budgets. But in the context of recovering from the current crisis, a central fiscal capacity would also have a major additional objective beyond stabilisation: to raise the growth potential of the economies of the Economic and Monetary Union.

There are different ways to finance a central fiscal capacity. Member States could contribute a share of their gross national product or empower the EU to collect designated taxes (such as those mentioned in the context of the Commission proposal of a Recovery Instrument (see Box 1) to provide the financial resources for the central fiscal capacity. The most efficient set-up endows the central fiscal capacity with the ability to borrow a meaningful amount on the markets to fund disbursements in the event of large shocks.

A central fiscal capacity should support growth-enhancing government expenditure. As the central fiscal capacity would be managed at EU/euro area level, it would indeed be well placed to provide the needed impetus to revitalise growth-enhancing government expenditure and strategically align investments in key areas such as climate mitigation and digital transformation. The central fiscal capacity would be an effective tool to foster transnational investment projects for investing in physical

infrastructure such as cross-border energy, communication, or transport networks.

Activation of the central fiscal capacity would be targeted. In order to ensure that central fiscal capacity funding is responsibly used for eligible expenditure, earmarking funds for designated investment objectives or sectors should apply and ex post monitoring should be enshrined in the respective legislation. One caveat to this solution could arise for the central fiscal capacity to fulfil its stabilisation mandate if an eligible investment project cannot be developed in time to provide the needed stimulus. If the central fiscal capacity is not solely investment-gearred, it could nonetheless entail a clause requiring Member States who draw financial support not to cut back on investment and to keep net investments rising at a predetermined rate or at least constant. Moreover, full access to the central fiscal capacity would be conditional on compliance with the Stability and Growth Pact, in turn eased by a central fiscal capacity to smooth government expenditure and alleviate budgetary pressures during a downturn when the risk of non-compliance is most acute.

Enforcement of punitive rules faces political obstacles. Implementation of such rules has proven difficult in past cases where they would have led to concrete sanctions (e.g. loss of access to the central fiscal capacity or an interest-bearing deposit). However, in the EU experience, this caveat has only been tested on transgression of upper bounds (e.g. deficits) rather than lower bounds (e.g. positive net investment). Moreover, gaining access to the central fiscal capacity should be viewed as an effective positive incentive.

In 2018, the Commission had already developed a proposal for a limited central fiscal capacity. The European Investment Stabilisation Function (EISF) proposal of spring 2018 was meant to operate under the EU budget and be able to borrow on the financial markets to provide funds in case of an asymmetric

shock. However, the proposal did not garner the necessary support; Member States were deeply divided over its stated primary stabilisation objective ⁽²⁴⁾. Prior to the Covid-19 pandemic, the next multiannual financial framework (2021-2027) was meant to contain a Budgetary Instrument for Convergence and Competitiveness (BICC) for the euro area. Rather than acting as a stabilisation tool, the Budgetary Instrument for Convergence and Competitiveness was supposed to support structural reforms and government investments in order to raise potential growth. The support would have taken the form of grants but was limited to €25 billion, i.e. around a quarter of a percent of euro area GDP over seven years.

The Covid-19 crisis has given rise to proposals for new EU fiscal instruments; one has features of a genuine central fiscal capacity. As mentioned above, in response to the Covid-19 crisis, the Commission has put forward two new proposals for fiscal support instruments at EU level. As an immediate initiative the Commission proposed the SURE instrument to provide support to national short-time work schemes and similar measures. Secondly, the Commission proposed the Recovery Instrument ⁽²⁵⁾ with the Recovery and Resilience Facility to support investment and reforms in the EU Member States at its core ⁽²⁶⁾. The Recovery Instrument has features of a genuine central fiscal capacity. It enables the EU to borrow a meaningful amount on financial markets at the central level. The grants and guarantee component under the Recovery Instrument amount to €500 billion, which, spread over four years, represent close to 0.9% of GDP per year. The EU's high credit rating

⁽²⁴⁾ Attention moved to the so-called Reform Support Programme with a focus on investment and reform rather than stabilisation.

⁽²⁵⁾ https://ec.europa.eu/info/sites/info/files/about_the_european_commission/eu_budget/com_2_020_441_en_act_part1_v13.pdf

⁽²⁶⁾ The Recovery and Resilience Facility builds on the earlier proposal for a much smaller Budgetary Instrument for Convergence and Competitiveness.

secures low interest rates. The funds are planned to be passed on to the Member States also in the form of grants, benefiting in particular those facing fiscal constraints. Moreover, the proposed allocation key includes factors ⁽²⁷⁾ that go beyond the immediate impact of the Covid-19 crisis in the Member States.

However, the new fiscal instruments are not meant to be permanent, and activation still takes time. Both proposals, SURE ⁽²⁸⁾ and the Recovery Instrument, will be fully operational with a considerable delay compared to the dynamics of the crisis. Moreover, both instruments are meant to be temporary: SURE would end in 2022, with the possibility to extend it once by six months, and the Recovery Instrument in 2024. Crisis support instruments are by definition meant to be deployed only in case of need. However, it would make sense to keep them 'alive' so they could be activated on the basis of a well-defined clause, in a timely manner in the event of future crises. From this point of view, SURE and the Recovery Instrument can be regarded as stepping stones towards a permanent and genuine central fiscal capacity. Experience gained through the two instruments, if successful, would provide a potential blue print for a central fiscal capacity Member States are already familiar with and whose impact has been tested.

Approach 2: A dedicated government investment protection fund

The EU budget could contain a dedicated fund that serves as a central fiscal capacity. This fund would be complementary to a central fiscal capacity to respond to an economic shock. It would provide constant support for growth-enhancing government expenditure irrespective of cyclical conditions. The main premise of this

⁽²⁷⁾ The allocation key includes population, the inverse of GDP per capita and the average unemployment rate over the past 5 years compared to the EU average (2015-2019).

⁽²⁸⁾ SURE has been officially adopted but the underlying Member State guarantees still need to be nationally approved.

approach is to reserve government funds at the EU level that are earmarked for growth-enhancing government expenditure. It could be operationalised within or alongside the EU budget under a separate fund for the next multiannual financial framework period (2021-2027). Each member's fixed contribution ⁽²⁹⁾ to the fund would be spent in the same Member State, so that the fund remains neutral in net terms, hence minimising the political controversy that inevitably surrounds net national contributions. The fund also serves the purpose of encouraging joint investment projects between Member States.

The dedicated expenditure would receive favourable treatment in the assessment of fiscal compliance. Two potential options could be employed to achieve this. The first option builds on existing flexibilities to provide fiscal leeway to Member States under the current Stability and Growth Pact. These would only be made available to Member States to the extent of the financial resources committed to the fund. As an example, contributions could be treated as a 'relevant factor' when assessing overall compliance (approach 4a below). In fact, the Commission has highlighted this principle for contributions to multilateral support between Member States with regard to the debt criterion ⁽³⁰⁾. Contributions to the European Stability Mechanism are a practical example of this application ⁽³¹⁾. The second option requires a reform of the Stability and Growth Pact in such a way that contributions to this fund ⁽³²⁾ are explicitly excluded from fiscal compliance metrics. Specifically, the headline targets, structural deficit or expenditure benchmark

⁽²⁹⁾ Minimum contributions could be set at a fixed share of GDP.

⁽³⁰⁾ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016DC0292&from=en>

⁽³¹⁾ https://ec.europa.eu/info/sites/info/files/economy-finance/ip101_en.pdf

⁽³²⁾ Annual contributions (fixed at a percentage of GDP frozen over the investment period/multiannual financial framework) would be deducted from deficits and the required fiscal effort.

could be corrected for contributions to the fund. These investments would thus be shielded from tightening during an economic downturn. The general principle would have to be enshrined in the relevant EU legislation, while scale and scope could be revised with each multiannual financial framework.

The European Structural and Investment Funds provide a good indication of the mechanism. European Structural and Investment Funds can be shown to have had a stabilising effect on government investment during the past decade ⁽³³⁾, effectively creating a floor. In fact, some Member States, such as Portugal or Lithuania, have moved quite close to this floor following the financial crisis and sovereign debt crisis (Graph 2.4) ⁽³⁴⁾.

The fund could also help steer investment into European priority areas. Eligible investment projects could be delineated by a set of transparent guidelines developed jointly and oriented along the EU budget. Green investments are a natural starting point ⁽³⁵⁾ as is digital infrastructure. The scope of eligible investments could be widened to other growth-enhancing government expenditure, with clear spillover effects and EU added-value such as transnational infrastructure projects. This arrangement would ensure that governments are setting aside sufficient resources for climate-change mitigation and upgrading EU infrastructure to maintain competitiveness and provide high quality public goods to the EU public. The fund would open the path towards a larger and more future-oriented EU budget.

The enabling character of most arrangements to protect growth-enhancing government expenditure could be effectively

⁽³³⁾ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014DC0473&from=en>

⁽³⁴⁾ <https://cohesiondata.ec.europa.eu/Other/-of-cohesion-policy-funding-in-public-investment-p/7bw6-2dw3>

⁽³⁵⁾ https://ec.europa.eu/info/publications/communication-european-green-deal_en

addressed. Financial resources that are distributed to each national investment budget would have to be used within a given timeframe (e.g. the period covered by the multiannual financial framework), otherwise they would be reallocated among those members ⁽³⁶⁾ that have exhausted their resources ⁽³⁷⁾ or revert to the EU budget as a whole.

Approach 3: Simplified Stability and Growth Pact with a provision to support investment

The Stability and Growth Pact could be markedly simplified while maintaining its core principles. In previous reports ⁽³⁸⁾, the European Fiscal Board has proposed a simplification of the Stability and Growth Pact that would rely on a simple medium-term debt anchor and an operational target in the form of an expenditure benchmark. The expenditure benchmark would impose a speed limit on government expenditure net of discretionary revenue measures, whereby the growth rate should not exceed the medium-term rate of GDP subject to an adjustment factor to ensure a declining path of debt to GDP towards the anchor within a given amount of years ⁽³⁹⁾.

The reformed Stability and Growth Pact should contain a stronger mechanism to encourage government investment. In practical terms, government investment or contributions to a fund, as outlined under

⁽³⁶⁾ According to a predetermined key based on population and GDP weights.

⁽³⁷⁾ EU budget items under the cohesion policy already work to that end.

⁽³⁸⁾ European Fiscal Board (2019), ‘Assessment of EU fiscal rules with a focus on the six and two-pack legislation’, https://ec.europa.eu/info/publications/assessment-eu-fiscal-rules-focus-six-and-two-pack-legislation_en, and European Fiscal Board (2019) ‘2019 annual report of the European Fiscal Board’ https://ec.europa.eu/info/publications/2019-annual-report-european-fiscal-board_en.

⁽³⁹⁾ The details of the proposal can be found in Chapter 5.3 of the 2019 annual report of the European Fiscal Board, https://ec.europa.eu/info/publications/2019-annual-report-european-fiscal-board_en

approach 2, could be excluded from the speed limit for government expenditure net of discretionary revenue measures ⁽⁴⁰⁾. Eligible expenditure could be further restricted to co-financing commitments of Member States for projects linked to the EU budget.

Approach 4: Flexibility in the current Stability and Growth Pact

The general escape clause gives a temporary fiscal breather. The Covid-19 pandemic and ensuing skyrocketing debt levels are dramatically changing the context for implementing the current EU fiscal rules. While the Stability and Growth Pact’s general escape clause provides temporary and necessary leeway during the severe economic downturn, returning to the commonly agreed rules will not be easy and will give rise to political controversies over how to adapt them. It is not clear whether a consensus on how to reform the rules will materialise in the short term, though moves towards a central fiscal capacity should facilitate agreement. In any case, it will take time before a reform is agreed.

Flexibility in the Stability and Growth Pact can already be deployed to support growth-enhancing government expenditure. Reliance on the flexibility within the current framework is clearly a second-best to the three approaches outlined above, but it could still play a useful role in the transition towards a new and more apt arrangement. In normal times the Stability and Growth Pact offers three complementary provisions for flexibility that could be used to render the rules more targeted towards protecting investment.

a) Assessment of compliance

Based on recent practice, compliance with the preventive and corrective arm of the Stability and Growth Pact is determined by an overall

⁽⁴⁰⁾ Notably, if investment expenditure leads to higher debt, the adjustment factor mentioned above would increase. Thus long-term fiscal sustainability would be preserved even when the growth impulse and associated government revenues fall short of borrowing costs.

assessment which looks not only at whether a country's fiscal policy delivered the fiscal measures recommended by the Council but also other *factors* ⁽⁴¹⁾. These other factors might justify reducing the required scale of adjustment or stretching the adjustment period.

Since the list of applicable factors is non-exhaustive, it could be further supplemented, e.g. by taking into account the level of net investment expenditure in the respective year and budget plans. The Treaty already states that the *Commission shall also take into account whether the government deficit exceeds government investment expenditure [...] when assessing whether conditions for launching an excessive deficit procedure are met or not* ⁽⁴²⁾.

Economic judgment plays a decisive role in the application of both the preventive and the corrective arm ⁽⁴³⁾. A Commission communication could reorient the application of this practice to support growth-enhancing expenditure.

b) Broad compliance

The six-pack reform of the Stability and Growth Pact introduced a *margin of error* that is applied to the compliance evaluation under the preventive arm. If a Member State deviates from its medium-term objective or from the adjustment path towards it by less than 0.5% of GDP in a

single year or cumulatively over 2 years, the Commission will deem the fiscal stance 'broadly compliant' with the rules.

The application of the broad compliance concept could be adapted to support growth-enhancing government expenditure. A Member State would only be allowed to make full use of the margin of broad compliance – both *ex ante* and *ex post* – for increases in *net* growth-enhancing government expenditure budgeted for that year, subject to the established upper limit. It would thus constitute a departure from the current practice of basing broad compliance on unspecified factors but instead solely on net growth-enhancing investment efforts ⁽⁴⁴⁾. Deviations from the recommended adjustment due to increases in current expenditure would trigger the relevant procedures under the Pact.

c) Investment clause

The investment clause, as defined by the Commission Communication of January 2015 ⁽⁴⁵⁾, reduces the fiscal effort required from a Member State for three years by an amount equal to the national expenditure on projects co-funded by the EU under the European Structural and Investment Funds, Trans-European Networks, the Connecting Europe Facility, as well as to the national co-financing of eligible investment projects by the European Fund for Strategic Investment. The allowance is capped at 0.5% of GDP, and at 0.75% of GDP in total if combined with the structural reform clause. The clause can only be used once per period of adjustment towards the medium-term objective, and it has to maintain an appropriate safety margin to the deficit threshold of 3% of GDP.

Currently, in order to invoke this investment clause, one of the following two qualifying criteria has to be fulfilled: an output gap below -

⁽⁴¹⁾ The 2015 Commission communication on flexibility specifically added structural reforms undertaken and contributions to the European Fund for Strategic Investments in the context of the overall assessment (<https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1479128901339&uri=CELEX:52015DC0012>).

⁽⁴²⁾ Article 126 (3), Treaty on the Functioning of the European Union, <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E126>

⁽⁴³⁾ European Fiscal Board (2019), 'Assessment of EU fiscal rules with a focus on the six and two-pack legislation', https://ec.europa.eu/info/publications/assessment-eu-fiscal-rules-focus-six-and-two-pack-legislation_en

⁽⁴⁴⁾ It would therefore mirror the approach of the investment clause but without qualifying criteria and with a broader range of eligible investment.

⁽⁴⁵⁾ <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1479128901339&uri=CELEX:52015DC0012>

1.5% of GDP, or negative real GDP growth. In light of these restrictive prerequisites, the investment clause has only been activated twice - by Italy (2016) and by Finland (2017). In order to widen the scope for investment protection, the threshold on the output gap and GDP growth could be dropped or relaxed.

Eligible expenditure could be broadened to encompass the entirety of the planned *InvestEU* funds in the next multiannual financial framework and treat Member States' voluntary top-up in the same way – which have to be closely monitored (ex ante eligibility and ex post assessment).

Key indicators for the euro area

Output		LTA ⁽¹⁾	2016	2017	2018	2019	19Q1	19Q2	19Q3	19Q4	20Q1
Economic sentiment	<i>Indicator</i>	100.0	104.0	110.4	111.5	103.1	105.8	103.8	102.0	100.6	100.1
Gross domestic product	<i>% ch. on prev. period</i>						0.4	0.1	0.3	0.1	-3.6
	<i>% ch. on prev. year</i>	1.6	1.9	2.5	1.9	1.3	1.5	1.2	1.3	1.0	-3.1
Labour productivity	<i>% ch. on prev. period</i>						0.1	-0.2	0.2	-0.2	-3.4
	<i>% ch. on prev. year</i>	0.7	0.6	0.9	0.4	0.1	0.0	0.0	0.2	-0.1	-3.6
Private consumption		LTA⁽¹⁾	2016	2017	2018	2019	19Q1	19Q2	19Q3	19Q4	20Q1
Consumer confidence	<i>Balance⁽²⁾</i>	-10.7	-8.1	-5.4	-4.9	-7.1	-7.0	-7.0	-6.8	-7.6	-8.8
Retail confidence	<i>Balance⁽²⁾</i>	-8.5	0.6	2.3	1.3	-0.4	-1.0	-0.6	0.1	-0.1	-3.0
Private consumption	<i>% ch. on prev. period</i>						0.5	0.2	0.4	0.1	-4.7
	<i>% ch. on prev. year</i>	1.3	2.0	1.9	1.4	1.3	1.2	1.3	1.6	1.3	-3.9
Retail sales	<i>% ch. on prev. period</i>						0.7	0.5	0.5	0.3	-2.8
	<i>% ch. on prev. year</i>	0.9	1.6	2.5	1.6	2.3	2.4	2.1	2.7	2.0	-1.5
Investment		LTA⁽¹⁾	2016	2017	2018	2019	19Q1	19Q2	19Q3	19Q4	20Q1
Capacity utilisation	<i>Level (%)</i>	80.8	81.5	82.9	83.8	82.3	83.5	82.7	81.8	81.0	80.8
Production expectations (manufacturing)	<i>Balance⁽²⁾</i>	7.3	9.8	17.0	16.7	4.6	9.3	5.4	2.8	0.7	0.0
Gross fixed capital formation (3)	<i>% ch. on prev. period</i>						1.4	0.5	-0.1	0.2	-4.6
	<i>% ch. on prev. year</i>	1.6	2.6	3.9	3.3	3.1	4.0	3.3	3.1	2.1	-4.0
- equipment investment	<i>% ch. on prev. period</i>						0.8	0.0	-0.1	0.8	-10.8
	<i>% ch. on prev. year</i>		5.8	4.1	4.3	2.0	3.4	2.2	1.0	1.5	-10.2
- construction investment	<i>% ch. on prev. period</i>						1.2	-0.7	1.1	1.0	-5.5
	<i>% ch. on prev. year</i>		2.7	3.6	3.3	3.2	4.6	2.3	3.2	2.6	-4.2
Change in stocks	<i>Contrib. to GDP (pp)</i>	0.0	0.0	0.2	0.1	-0.5	-1.3	-0.1	-0.1	-0.3	0.3
Labour market		LTA⁽¹⁾	2016	2017	2018	2019	19Q1	19Q2	19Q3	19Q4	20Q1
Employment expectations (manufacturing)	<i>Balance⁽²⁾</i>	-6.2	0.0	7.7	9.4	-1.4	3.8	0.1	-3.4	-6.1	-7.6
Employment expectations (services)	<i>Balance⁽²⁾</i>	6.2	8.5	11.1	13.0	9.4	9.8	9.9	8.6	9.4	5.4
Employment	<i>% ch. on prev. period</i>						0.4	0.3	0.1	0.3	-0.2
	<i>% ch. on prev. year</i>	0.8	1.3	1.6	1.5	1.2	1.4	1.2	1.1	1.1	0.4
Employment (000)	<i>ch. on prev. period</i>		2003	2450	2357	1,919	879	400	216	424	-321
Compensation of employees (per head, nominal)	<i>% ch. on prev. period</i>						0.4	0.5	0.7	0.1	-1.0
	<i>% ch. on prev. year</i>	2.1	1.3	1.7	2.2	2.0	2.2	2.1	2.1	1.7	0.3
Unemployment rate	<i>% of lab. force</i>		10.0	9.0	8.2	7.6	7.8	7.6	7.5	7.4	7.2
Unemployment (000)	<i>ch. on prev. period</i>		-1139	-1587	-1384	-979	-425	-252	-106	-196	-274
International transactions		LTA⁽¹⁾	2016	2017	2018	2019	19Q1	19Q2	19Q3	19Q4	20Q1
World trade	<i>% ch. on prev. period</i>						-0.3	-0.6	0.7	-0.5	-2.5
	<i>% ch. on prev. year</i>		1.4	4.9	3.5	-0.3	0.6	-0.3	-0.7	-0.7	-2.9
Export order books	<i>Balance⁽²⁾</i>	-17.8	-10.9	-1.4	1.2	-13.4	-7.3	-11.4	-16.1	-18.6	-18.9
Trade balance (merchandise)	<i>Billion EUR</i>		263.7	236.3	191.4	222.6	52.7	50.3	54.8	64.8	67.7
Exports of goods and services	<i>% ch. on prev. period</i>						1.1	-0.1	0.7	0.1	-4.2
	<i>% ch. on prev. year</i>	4.8	2.9	5.5	3.3	2.5	3.3	2.3	2.7	1.8	-3.5
Imports of goods and services (3)	<i>% ch. on prev. period</i>						0.7	0.1	0.5	-0.5	-3.8
	<i>% ch. on prev. year</i>	4.4	3.3	5.2	3.1	2.1	2.5	2.3	2.2	0.8	-3.7
Prices		LTA⁽¹⁾	2016	2017	2018	2019	19Q1	19Q2	19Q3	19Q4	20Q1
Headline inflation (HICP)	<i>% ch. on prev. year</i>		0.2	1.5	1.8	1.2	1.4	1.4	1.0	1.0	1.1
Core inflation	<i>% ch. on prev. year</i>		0.8	1.1	1.2	1.2	1.1	1.2	1.1	1.3	1.3
Monetary and financial indicators		LTA⁽¹⁾	2016	2017	2018	2019	19Q1	19Q2	19Q3	19Q4	20Q1
Nominal interest rates (3-month)	<i>Level</i>		-0.26	-0.33	-0.32	-0.36	-0.31	-0.32	-0.40	-0.40	-0.41
Nominal interest rates (10-year)	<i>Level</i>		0.18	0.32	0.40	-0.21	0.13	-0.10	-0.52	-0.36	-0.41
ECB repo rate	<i>Level</i>		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bilateral exchange rate USD/EUR	<i>Level</i>		1.11	1.12	1.18	1.12	1.14	1.12	1.11	1.11	1.10
	<i>% ch. on prev. period</i>						-0.5	-1.1	-1.1	-0.4	-0.5
	<i>% ch. on prev. year</i>		1.6	5.1	4.6	-5.1	-7.5	-5.6	-4.4	-3.0	-3.0
Nominal effective exchange rate	<i>% ch. on prev. period</i>						-1.2	-0.1	0.4	-0.7	-0.3
	<i>% ch. on prev. year</i>		2.9	2.4	2.5	-1.6	-2.2	-1.2	-1.5	-1.6	-0.7

Sources: European Commission, ECB, CPB Netherlands Bureau for Economic Policy Analysis, Macrobond.

Notes: Data in the table have been taken from different sources available until 17 June 2020 and at different moments in time. (1) LTA = Long-term average. (2) Balance: the difference between positive and negative answers, in percentage points of total answers. (3) Data on gross fixed capital formation and on imports of goods and services do not include Ireland.

GLOSSARY

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

Discretionary fiscal policy: Change in the budget balance and in its components under the control of government. It is usually measured as the residual of the change in the budget balance after the budgetary impact of automatic stabilisers and interest payments has been excluded (see also Fiscal stance).

Expenditure benchmark: A mechanism applied under the preventive arm of the Stability and Growth Pact imposing an upper limit on the growth rate of government primary expenditure net of discretionary revenue measures. The objective of the benchmark is to ensure that a country stays at its MTO or on the adjustment path towards it (see also Net expenditure).

Fiscal space: Leeway to run an expansionary fiscal policy. While there is no generally accepted definition, in this document a country is considered to have fiscal space in year t if its structural balance in year $t-1$ is estimated above its MTO. Barring other considerations, the country may use this fiscal space, i.e. let its structural balance deteriorate at most until it is back at its MTO.

Fiscal stance: A measure of the direction and extent of discretionary fiscal policy. In this document, it is defined as the annual change in the structural primary budget balance. When the change is positive, the fiscal stance is said to be restrictive; when the change is negative, it is said to be expansionary.

General escape clause: Introduced in 2011, the clause allows for additional and temporary flexibility within the Stability and Growth Pact in the event of a severe economic downturn in the euro area or the EU as a whole.

Margin of discretion: A new interpretation of existing EU legislation of how to assess compliance with the requirements under the preventive arm of the Stability and Growth Pact. Under certain conditions, the European Commission may find that the fiscal adjustment in a Member State is adequate even if it falls short of the recommended adjustment.

The Commission indicated that it would apply the margin of discretion only in 2018.

Medium-term budgetary objective (MTO): According to the Stability and Growth Pact, stability programmes and convergence programmes present a medium-term objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary developments and fiscal risks to the sustainability of public finances. It is defined in structural terms (see Structural balance).

Net expenditure: Primary government expenditure net of certain items not directly under the control of government (expenditure backed by EU funds and the cyclical component of unemployment benefit expenditure) and using investment expenditure smoothed over 4 years. It is also net of discretionary revenue measures and revenues mandated by law, and corrected for the impact of one-offs (see also Expenditure benchmark).

Output gap: The difference between actual output and estimated potential output at a 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). Observations indicate that a standard business cycle usually lasts up to 8 years, suggesting that the output gap is normally expected to close roughly every 4 years.

Potential GDP: 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 bind 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).

Production function approach: A method to estimate the sustainable level of output of an economy 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 the estimation of the structural balance.

S0 indicator: A composite indicator published by the European Commission to evaluate the extent to which there might be a fiscal stress risk in the short term, stemming from the fiscal, macro-financial and 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: 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 5 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 long-term sustainability indicator of the European Commission. It shows the upfront adjustment to the current structural primary balance required to stabilise the debt-to-GDP ratio over the infinite horizon, including financing for any additional expenditure arising from an ageing population.

Stabilisation: Economic policy intervention to bring actual output closer to potential output. In the Economic and Monetary Union (EMU), this is expected to be achieved, in normal economic times, 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.

Structural balance: The headline 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.

Structural primary balance: The structural budget balance net of interest payments.

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 is using three indicators of sustainability with different time horizons (S0, S1 and S2) which are complemented by a debt sustainability analysis that includes sensitivity tests on government debt projections and alternative scenarios.

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 lowering policy rates further. To overcome the constraint imposed by the ZLB, alternative methods to stimulate demand are generally considered, such as asset purchase programmes. The root cause of the ZLB is the issuance of paper currency, effectively guaranteeing a zero nominal interest rate and acting as an interest rate floor. Central banks cannot encourage spending by lowering interest rates, because people would hold cash instead.