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When and How to Deactivate the SGP General Escape Clause?

Fiscal Surveillance after the Break

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Abstract

Based on a brief assessment of the current EU fiscal framework, the paper discusses when and how fiscal surveillance should be enacted again, and investigates possible options for reform. The general escape clause should be lifted as soon as epidemiological conditions allow for economic activity to normalise, probably by 2022. We propose a transitory arrangement if the discussion on a broader reform of the fiscal framework remains inconclusive while the general escape clause is in force.

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CONTENTS

LIST OF ABBREVIATIONS

EFC	European Fiscal Compact
EMU	Economic and Monetary Union
EU	European Union
GDP	Gross Domestic Product
MTO	Medium-term objective
SCP	Stability and Convergence Programmes
SGP	Stability and Growth Pact
TSCG	Treaty on Stability, Coordination and Governance

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EXECUTIVE SUMMARY

- **The EU fiscal rules have become increasingly complex over the years.** The rules rely strongly on unobservable variables such as potential output or the output gap, which are prone to revisions over time. Several clauses and exceptions increase the flexibility, but weaken transparency.
- **The fiscal rules have arguably failed to deliver.** The record of compliance with the rules is mixed at best. The outcome is insufficient consolidation where it was needed most, elevated debt and a consequent lack of fiscal buffers in a number of countries. As a result, the ECB was again pushed into purchases of government bonds in order to stem escalating risk premia for high-debt countries in the covid-19 crisis.
- **Activating the general escape clause enabled a sizeable fiscal response to the covid-19 crisis**. Automatic stabilisers worked unrestricted and all Member States were able to launch counter-cyclical fiscal policies, although to a differing degree. The resulting strong increase of government debt, often from already elevated levels, implies considerable fiscal adjustment needs once the general escape clause will be lifted.
- **The general escape clause should be lifted as soon as epidemiological conditions allow for a sustained normalisation of economic activity.** This could be the case in 2022, if vaccines are made available to a sufficiently large share of the population in 2021.
- **Under the current framework, we propose a transitory arrangement following the de-activation of the general escape clause in which all Member States remain under the preventive arm of the SGP.** Reflecting increased uncertainty about the long-run effects of the crisis on the economy, the corrective arm would remain idle for another two years and the Commission would consider pre-crisis estimates of potential output as a benchmark to determine fiscal adjustment needs.
- **The period under the general escape clause could be used to redesign the fiscal framework, but it is difficult to see a consensus emerge.** Criticism of the current rules has led to numerous reform proposals, albeit with quite different approaches. Changing the fiscal rules to allow for higher debt ratios or structural deficits amid the current low-interest rate, low-inflation environment will keep high-debt countries vulnerable to changes in perceptions of financial markets and a possible increase in interest rates. Focusing on expenditure rules would not eliminate the need for cyclical adjustment and has its own problems. An alternative approach that aims at re-establishing the no-bailout rule laid down in the Maastricht treaty would eventually allow to dispose of fiscal surveillance entirely. This would require fundamental reforms to disentangle the bank-sovereign doom loop and to allow for orderly restructuring of public debt. A way forward could be a transitory regime in which refinancing costs of Member States are subsidised in the case of excessive yield spreads by transfers out of a fund that is financed by all Member States. .

1. INTRODUCTION

Fiscal rules are suspended at least until the end of 2021 due to the covid-19 crisis. In spring 2020, the pandemic led to an unprecedented contraction of economic activity. The Stability and Growth Pact (SGP) allows Member States of the European Union to temporarily disregard the budgetary requirements that would otherwise apply under the SGP in case of a severe economic downturn in the euro area or the Union as a whole. On March 23, the Council agreed to enforce this provision, known as the general escape clause, in order to give governments more flexibility to undertake the fiscal effort necessary to protect European citizens and support the economy in view of the pandemic, a decision welcomed by the EU leaders on March 27. In light of the outlook for an incomplete recovery and increased downside risks for growth and fiscal outcomes amid a resurgence of the virus in autumn, the general escape clause will remain in force in 2021. In spring 2021, the European Commission will reassess the situation, taking account of updated forecasts, and evaluate the application of the general escape clause.[1]

A review of the current fiscal framework is ongoing. The fiscal rules laid down in the SGP aim at preserving fiscal sustainability while allowing fiscal automatic stabilisers to work. This fiscal framework has come increasingly under attack in recent years from different angles. In February 2020, a review of the six- and two-packs was initiated by the European Commission in order to discuss strengths and weaknesses of the increasingly complex fiscal surveillance framework, with the aim to come to conclusions by the end of the year. Due to the pandemic, this review has been put on hold, but will likely be back on the agenda in 2021. The period of suspension of the fiscal rules could be used to discuss and refurbish the fiscal framework. As a result, Member States could start with a reformed set of rules when the general escape clause is eventually lifted.

Based on an assessment of the EU fiscal framework in its present state, this paper discusses when and how to re-impose fiscal surveillance again and outlines possible options for reform. A brief description of the current fiscal framework (Section 2) is followed by an analysis of compliance with the different fiscal rules by Member States (Section 3). Section 4 briefly outlines the fiscal response to the covid-19 crisis according to the autumn 2020 Commission forecast. Against this backdrop, we discuss when and under which conditions the general escape clause should be lifted and propose a transitory arrangement to avoid premature fiscal tightening in the aftermath of the crisis (Section 5). Section 6 describes different directions of reform of the EU fiscal framework, including relaxation of current fiscal rules, a possible shift of the SGP focus away from targeting structural budget balances to expenditure rules, and the idea to build a framework under which fiscal surveillance could be removed altogether and fiscal self-responsibility would be re-established. Section 7 concludes.

[1] See European Commission, Communication on the 2021 Draft Budgetary Plans: Overall Assessment. 18 November 2020. https://ec.europa.eu/info/sites/info/files/economy-finance/dbps_overall_assessment.pdf

2. THE CURRENT FISCAL FRAMEWORK

The fiscal framework has been introduced with the Treaty of Maastricht (1992) and the Stability and Growth Pact (1997), in the context of establishing the European Monetary Union. The Treaty of Maastricht aimed at deepening the political and economic integration of the European Community, including the establishment of a single currency as part of the Economic and Monetary Union (EMU). In order to safeguard stability of the European currency, convergence criteria were defined to qualify for participation in the common currency. The fiscal criterion referred to two fiscal variables defining thresholds for the general government deficit and gross public debt. Specifically, it was stipulated that the budget deficit must not exceed 3% of GDP and gross public debt should be below 60% of GDP (or declining to that level at sufficient speed). These reference values were kept when surveillance and coordination of fiscal policies were strengthened with the introduction of the Stability and Growth Pact (SGP) in 1997. The SGP consists of a surveillance procedure (the preventive arm) and an excessive deficit procedure in case of violation of the rules (the corrective arm). The preventive arm includes the annual submission of stability programmes by each country (convergence programmes for non-euro area Member States) outlining their expectations for fiscal developments over the next years, and their evaluation by the Commission and the ECOFIN Council. The corrective arm provides that penalties can be imposed if a country does not sufficiently respond to repeated requests to correct its fiscal position.

The original rules laid out in the SGP were soon criticised as being overly rigid and unenforceable, which prepared the ground for a major reform in 2005. This reform introduced three important changes. It (1) strengthened the focus on the cyclically-adjusted budget balance in order to allow for a better consideration of the business cycle. By requiring an improvement of the budgetary position in "good times", and allowing automatic stabilisers to work in "bad times", the approach aims to prevent pro-cyclical fiscal policies as a result of the application of the rules. The reform (2) introduced a country-specific medium-term objective (MTO) to be reviewed every four years and stipulated that a minimum annual budgetary effort be undertaken in case of deviation from it. The revised fiscal framework (3) allows to temporarily deviate from the MTO if this is a result of short-term budgetary costs of structural reforms that will improve fiscal sustainability in the longer term and in case of various other relevant factors, which can be regarded as an effective loosening of the pact (Sabic, 2006).

The European sovereign debt crisis in 2010-12 that followed on the global financial crisis of 2008 triggered another set of changes to the European fiscal framework. The reform aimed at strengthening fiscal and economic policy surveillance with the so-called "six-pack" set of legal acts (5 regulations and 1 directive). Among other things, the "six-pack" introduced the Macroeconomic Imbalances Procedure as part of the European Semester to coordinate economic policy. The reforms were reflected in the Treaty on Stability, Coordination and Governance (TSCG), also known as the "Fiscal compact", which came into force in 2013. The TSCG entails a balanced budget rule, a correction mechanism in the case of deviation from this rule, and a debt brake rule requiring additional efforts from countries with gross debt above 60%, and it requires signature countries to integrate these rules in national law. Specifically, the TSCG contains the 1/20 rule introduced in the "six-pack" regulations, which defines the speed of adjustment that is sufficient in the case that countries have a debt-to-GDP ratio of more than 60%. This rule requires an annual reduction of the debt ratio by 1/20 of the difference between the actual debt-to-GDP ratio and the 60% threshold. The rule is applied over a three-year-average. In 2015, the Commission responded to claims of excessive rigidity of these rules in a low-growth, low-inflation environment with a communication spelling out in more detail the provisions regarding the way cyclical positions, differences in debt levels and risks for sustainability are taken account of. It also specified how provisions are operationalised that increase fiscal flexibility in the case of growth enhancing structural reforms or public investments (European Commission 2015). Subsequently the Council published a commonly agreed position on the communication (Council, 2015), which was endorsed in 2016 and used as the basis for an update of the 'Code of Conduct' on the implementation of the SGP (Council, 2016).

As a result of the successive reforms, refinements and amendments, the European fiscal framework has become increasingly complex. The 2019 Vade Mecum on the Stability & Growth Pact (European Commission, 2019), which is published in order to enhance the clarity of the fiscal governance toolbox and improve transparency about the way the Commission and the Council apply the rules, comprises 95 pages. The rules are also incoherent as a result of the numerous adjustments and political constraints.[2]

Compliance with the preventive arm of the SGP is based on a two-pillar approach, including the assessment of the structural budget balance and of the growth rate of expenditures. In order to ensure prudent fiscal policies, the preventive arm of the SGP requires Member States to attain a country-specific MTO for their budgetary position. The MTO is a structural balance proposed by the Member States in their respective Stability or Convergence Programmes (SCP) in line with commonly agreed principles. In accordance with Regulation (EC) 1466/97, MTOs should provide a safety margin with respect to the 3% of GDP deficit limit, ensure fiscal sustainability and allow room for manoeuvre for fiscal policy, especially with respect to public investment. Numerically, the structural deficit set as MTO must not exceed 0.5% (except for countries outside the TSCG), or 1% if the debt ratio is below 60% and long-term risks to sustainability are low. Member States not at their MTO need to define and follow an appropriate adjustment path. A second approach to assess fiscal policy is a comparison of expenditure growth with a benchmark. In accordance with this rule, government expenditure (net of interest expenditure, cyclical expenditure on unemployment, expenditure on EU programmes, and with investment expenditure smoothed over four years) over the medium term must not grow faster than potential GDP. Any excess growth of expenditure must be covered by discretionary revenue enhancing measures. An overall assessment of compliance is launched if one of the two criteria signals deviation, and a Significant Deviation Procedure may follow if one of the criteria breaches a threshold of significance.

The required adjustment towards the MTO takes account of the cyclical position and of sustainability risks. If the estimated structural balance is below the MTO, corrective measures are necessary. Originally, an adjustment of the structural balance of 0.5% of GDP per annum was called for as a benchmark, which should be higher in Member States with debt in excess of 60% and could be reduced in bad economic times. These provisions are spelled out in the so-called "matrix of requirements" (Figure 1), which relates adjustment requirements to the cyclical position (output gap and actual growth relative to potential growth) and debt levels.

[2] There is, for example, a tension between the debt rule, which aims to lower debt to 60% of GDP, and the MTO, which would lead to far lower debt levels (Kamps and Leiner-Killinger, 2019).

Figure 1: Required annual fiscal adjustment when the structural balance falls short of the MTO

	Condition	Debt <60% and no sustainability risk	Debt > 60% or sustainability risk
Exceptionally bad times	Real growth < 0 or output gap < -4%	0 (No adjustment needed)	
Very bad times	-4 <output gap < -3	0	0.25
Bad times	-3 <output gap < -1,5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1,5 <output gap < 1,5	0.5	>0.5
Good times	output gap > 1,5	>0.5 if growth below potential, >0.75 if growth above potential	>0.75 if growth below potential, > 1 if growth above potential

Source: Council (2016); own representation.

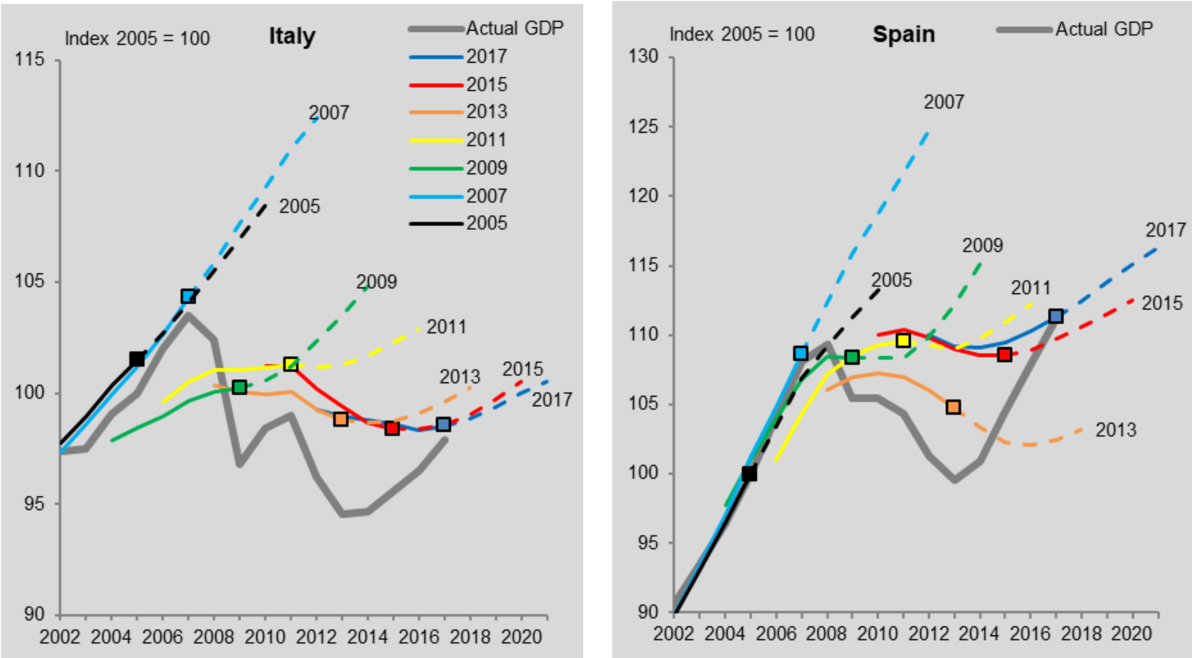
Several clauses and exceptions increase the flexibility of the SGP rules. A number of provisions allow for a temporary deviation from the MTO or the adjustment path towards it. These include the general escape clause introduced into the framework after the global financial crisis. Adjustments may also be temporarily suspended in the case of an unusual events outside the control of the Member State concerned, as the budgetary impact of the measures taken in response would be excluded in the assessment of compliance with the SGP. Another exemption relates to the budgetary effects of structural reforms in general and pension reforms in particular, in order not to discourage policies designed to raise growth and improve the fiscal position in the medium term. Also, investments co-financed by EU institutions with positive, direct and verifiable long-term effects on growth may justify a temporary deviation from the MTO.

The fiscal rules rely strongly on unobservable variables such as potential output or the output gap, which are prone to revisions over time. The MTO is defined in terms of the structural budget balance, i.e. the cyclically adjusted balance net of one-off and other temporary measures. The minimum adjustment requirement in case of a deviation from the MTO takes account of the cyclical position measured by the output gap, and the benchmark for expenditure growth is medium-term potential GDP growth in nominal terms.[3] All of these variables ultimately rely on the concept of potential output (the level of output that can be sustained over the medium term with stable inflation). Potential output is not observable and thus needs to be estimated. To this end, the Commission draws on a production function approach (European Commission, 2014). Estimates of potential output and output gaps – which are calculated as the difference between actual output (GDP) and potential output in percent of potential output – are heavily revised over time, as the examples of Italy and Spain illustrate. While potential output for Italy was consistently revised downwards over time (Figure 2 left), implying that the estimated structural balance appeared more favourable in real time than in retrospect, in the case of Spain revisions were in both directions (Figure 2 right). Incorrect identification of underlying fiscal

[3] Calculated as the average over ten years consisting of the current year plus five years history and four years forecast.

positions in real time as a consequence of errors in the estimate of the output gap is a serious issue, potentially leading to significant policy mistakes (Kamps et al., 2014).

Figure 2: Potential output estimates in real-time for Italy and Spain, 2005-2017



Source: Ademmer et al. (2019).

Note: Data taken from the European Commission autumn forecasts of selected years between 2007 and 2017. Squares indicate the year of the respective estimate.

Misjudgement of the output gap in real time is a problem, particularly in the latter part of the expansionary phase of the business cycle. Recessions are almost never forecast, and thus the estimation method in an expansionary period attributes too large a share of the output growth to the structural component (potential output) and too small a share to the cyclical component (the output gap). Consequently, revisions of the output gap are especially large for years preceding a recession, and they are always in the direction of an upward correction of the cyclical component. Occasionally this even leads to a retrospective change in the sign of the output gap. By contrast, forecasts at the trough of the cycle usually correctly anticipate a recovery, and errors are only made with respect to the strength of the rebound of activity. Therefore, revisions of output gaps in this phase of the cycle tend to be smaller and go in both directions (Ademmer et al., 2019). For example, the 2007 real-time estimate of potential output in Spain implied a slightly negative output gap, suggesting ample fiscal space in the presence of substantial budget surpluses between 2005 and 2007. However, this episode was later interpreted as a boom period with a positive output gap of 3.5% in 2007, according to the autumn 2020 Commission forecast (European Commission, 2020a). In the case of Italy, the negative output gap for 2007 estimated in real-time has been revised to a positive output gap of 3.1%.

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3. COMPLIANCE WITH FISCAL RULES IN THE PAST

Countries in excess of the 60% threshold for the debt-to-GDP ratio can be expected to violate this upper limit year by year. High levels of public debt became a major concern after the global financial crisis and the associated vulnerabilities became evident during the sovereign debt crisis that followed (Figure 3, for euro area countries). In recent years, the ultra-low interest rate environment was generally not utilised to reduce debt levels substantially. Many countries entered the covid-19 crisis with elevated debt levels, in some cases of about 100% or more. Debt levels are set to increase strongly in the wake of this crisis, to about 200% in Greece, 160% in Italy, and 120-130% in France, Spain, Belgium and Portugal, according to the latest Commission forecast. On the other end of the spectrum, the Baltic countries and Luxembourg continue to keep some distance to the 60% threshold.

Figure 3: Gross public debt (% of GDP)

	99	00	01	02	03	04	05	06	07	08	09	10	11	12	13	14	15	16	17	18	19	20	21	22
DE	60	59	58	60	63	65	67	67	64	66	73	82	80	81	79	76	72	69	65	62	60	71	70	69
FR	60	59	58	60	64	66	67	65	65	69	83	85	88	91	93	95	96	98	98	98	98	116	118	119
IT	113	109	109	106	105	105	107	107	104	106	117	119	120	126	132	135	135	135	134	134	135	160	160	159
ES	61	58	54	51	48	45	42	39	36	40	53	61	70	86	96	101	99	99	99	97	96	120	122	124
NL	59	52	49	49	50	50	50	45	43	55	57	59	62	66	68	68	65	62	57	52	49	60	63	66
BE	115	110	108	105	102	97	95	91	87	93	100	100	103	105	105	107	105	105	102	100	98	118	118	119
AT	67	66	67	67	66	65	69	67	65	69	80	83	82	82	81	84	85	83	78	74	71	84	85	85
IE	47	36	33	31	30	28	26	24	24	42	62	86	111	120	120	104	77	74	67	63	57	63	66	66
FI	44	42	41	40	43	43	40	38	34	33	42	47	48	54	56	60	64	63	61	60	59	70	72	73
PT	55	54	57	60	64	67	72	74	73	76	88	100	114	129	131	133	131	132	126	121	117	135	130	127
EL	99	105	107	105	101	103	107	104	103	109	127	147	175	162	178	180	177	181	179	186	181	207	201	195
SK	47	50	51	45	43	42	35	31	30	29	36	41	43	52	55	53	52	52	52	50	48	63	66	68
LU	8	7	8	7	7	8	8	8	8	15	16	20	19	22	24	23	22	20	22	21	22	25	27	29
SI	24	26	26	27	27	27	26	26	23	22	35	38	46	54	70	80	83	79	74	70	66	82	80	80
LT	23	24	23	22	20	19	18	17	16	15	28	36	37	40	39	41	43	40	39	34	36	47	51	49
LV	12	12	14	13	14	15	12	10	8	19	37	48	44	42	40	42	37	40	39	37	37	48	46	46
EE	6	5	5	6	6	5	5	5	4	5	7	7	6	10	10	11	10	10	9	8	8	17	23	26
CY	56	56	57	61	64	65	63	59	54	46	54	56	66	80	104	109	107	103	94	99	94	113	108	103
MT	62	61	65	63	69	71	70	64	62	62	66	65	69	66	66	62	56	54	49	45	43	55	60	59
EA	71	69	68	68	69	70	70	68	66	70	80	86	88	93	95	95	93	92	90	88	86	102	102	103

Data source: European Commission (2020), autumn forecast.

Note: Colours indicate the degree of compliance with an upper limit of debt of 60% (white). Green indicates debt levels below 60%, while red indicates debt levels above this threshold. Values of 140% or higher are highlighted in the same dark red colour.

Before 2019, the budget deficit limit of 3% was violated in 35% of all possible cases in the euro area. Between 1999 and 2019, there have been 113 (out of 319 possible) cases in which the fiscal deficit of a euro area country exceeded the Maastricht limit of 3% in relation to GDP (excluding countries that joined the currency union at a later stage). From 2017 to 2019, however, violations of the deficit criterion have been rare, as a result of favourable refinancing conditions and a sustained period of uninterrupted growth. In 2020, all euro area Member States will run excessive deficits again, in some cases these deficits will reach two-digit values. Most countries will probably not reduce deficits below the SGP's limit by 2022 (Figure 4).

Figure 4: Government net lending (% of GDP)

	99	00	01	02	03	04	05	06	07	08	09	10	11	12	13	14	15	16	17	18	19	20	21	22
DE	-1,7	-1,6	-3,0	-3,9	-3,7	-3,3	-3,3	-1,7	0,3	-0,1	-3,2	-4,4	-0,9	0,0	0,0	0,6	1,0	1,2	1,4	1,8	1,5	-6,0	-4,0	-2,5
FR	-1,6	-1,3	-1,4	-3,2	-4,0	-3,6	-3,4	-2,4	-2,6	-3,3	-7,2	-6,9	-5,2	-5,0	-4,1	-3,9	-3,6	-3,6	-3,0	-2,3	-3,0	-10,5	-8,3	-6,1
IT	-1,8	-2,4	-3,2	-2,9	-3,2	-3,5	-4,1	-3,6	-1,3	-2,6	-5,1	-4,2	-3,6	-2,9	-2,9	-3,0	-2,6	-2,4	-2,4	-2,2	-1,6	-10,8	-7,8	-6,0
ES	-1,2	-1,2	-0,5	-0,3	-0,4	-0,1	1,2	2,1	1,9	-4,6	-11	-9,5	-9,7	-11	-7,0	-5,9	-5,2	-4,3	-3,0	-2,5	-2,9	-12,2	-9,6	-8,6
NL	0,3	1,2	-0,5	-2,1	-3,1	-1,8	-0,4	0,1	-0,1	0,2	-5,1	-5,2	-4,4	-3,9	-2,9	-2,2	-2,0	0,0	1,3	1,4	1,7	-7,2	-5,7	-3,8
BE	-0,6	-0,1	0,2	0,0	-1,9	-0,2	-2,7	0,2	0,1	-1,1	-5,4	-4,1	-4,3	-4,3	-3,1	-3,1	-2,4	-2,4	-0,7	-0,8	-1,9	-11,2	-7,1	-6,3
AT	-2,6	-2,4	-0,7	-1,4	-1,8	-4,8	-2,5	-2,5	-1,4	-1,5	-5,3	-4,4	-2,6	-2,2	-2,0	-2,7	-1,0	-1,5	-0,8	0,2	0,7	-9,6	-6,4	-3,7
IE	3,5	4,9	1,0	-0,5	0,3	1,3	1,6	2,8	0,3	-7,0	-14	-32	-13	-8,1	-6,2	-3,6	-2,0	-0,7	-0,3	0,1	0,5	-6,8	-5,8	-2,5
FI	1,7	6,9	5,0	4,1	2,4	2,2	2,7	4,0	5,1	4,2	-2,5	-2,5	-1,0	-2,2	-2,5	-3,0	-2,4	-1,7	-0,7	-0,9	-1,0	-7,6	-4,8	-3,4
PT	-3,0	-3,2	-4,8	-3,3	-5,7	-6,2	-6,1	-4,2	-2,9	-3,7	-9,9	-11	-7,7	-6,2	-5,1	-7,4	-4,4	-1,9	-3,0	-0,3	0,1	-7,3	-4,5	-3,0
EL	-5,8	-4,1	-5,5	-6,0	-7,8	-8,8	-6,2	-5,9	-6,7	-10	-15	-11	-10	-9,0	-13	-3,6	-5,7	0,5	0,7	1,0	1,5	-6,9	-6,3	-3,4
SK	-7,2	-13	-7,2	-8,2	-3,1	-2,3	-2,9	-3,6	-2,1	-2,5	-8,1	-7,5	-4,3	-4,4	-2,9	-3,1	-2,7	-2,6	-0,9	-1,0	-1,4	-9,6	-7,9	-6,0
LU	3,1	5,5	5,6	2,0	0,3	-1,4	-0,2	1,9	4,4	3,5	-0,2	-0,3	0,7	0,5	0,9	1,4	1,3	1,9	1,3	3,1	2,4	-5,1	-1,3	-1,1
SI	-3,0	-3,6	-4,5	-2,4	-2,6	-1,9	-1,3	-1,2	0,0	-1,4	-5,8	-5,6	-6,6	-4,0	-15	-5,5	-2,8	-1,9	-0,1	0,7	0,5	-8,7	-6,4	-5,1
LT	0,0	0,0	0,0	0,0	0,0	-1,4	-0,3	-0,3	-0,8	-3,1	-9,1	-6,9	-8,9	-3,1	-2,6	-0,6	-0,3	0,2	0,5	0,6	0,3	-8,4	-6,0	-2,8
LV	-3,7	-2,7	-1,9	-2,3	-1,6	-1,2	-0,5	-0,5	-0,6	-4,3	-9,6	-8,6	-4,1	-1,4	-1,2	-1,6	-1,4	0,2	-0,8	-0,8	-0,6	-7,4	-3,5	-3,3
EE	-3,3	-0,1	0,2	0,4	1,8	2,4	1,1	2,9	2,7	-2,6	-2,2	0,2	1,1	-0,3	0,2	0,7	0,1	-0,4	-0,7	-0,5	0,1	-5,9	-5,9	-5,1
CY	-4,0	-2,2	-2,1	-4,1	-5,9	-3,7	-2,2	-1,0	3,2	0,9	-5,4	-4,7	-5,7	-5,8	-5,6	-8,8	-0,9	0,3	1,9	-3,5	1,5	-6,1	-2,3	-2,3
MT	-6,7	-5,5	-6,1	-5,4	-9,0	-4,3	-2,8	-2,5	-2,1	-4,1	-3,2	-2,3	-2,4	-3,4	-2,3	-1,6	-1,0	0,9	3,2	2,0	0,5	-9,4	-6,3	-3,9
EA	-1,5	-1,3	-2,0	-2,7	-3,1	-2,9	-2,6	-1,5	-0,6	-2,2	-6,2	-6,3	-4,2	-3,7	-3,0	-2,5	-2,0	-1,5	-0,9	-0,5	-0,6	-8,8	-6,4	-4,7

Data source: European Commission (2020), autumn forecast.

Note: Colours indicate the degree of compliance with an upper limit of the budget deficit of 3% (white). Green indicates higher budget balances, while red indicates excessive deficits. Deficits of 6% or higher are highlighted in the same dark red colour.

Figure 5: Structural balance (% of potential GDP)

	10	11	12	13	14	15	16	17	18	19	20	21	22
DE	-2,1	-1,2	-0,1	0,4	0,9	1,1	0,9	0,7	1,1	0,9	-3,4	-2,7	-1,9
FR	-5,7	-5,0	-4,3	-3,4	-3,0	-2,9	-3,0	-3,1	-3,1	-3,3	-5,1	-5,7	-4,8
IT	-3,6	-3,5	-1,5	-0,6	-0,5	-0,5	-1,5	-2,2	-2,6	-1,9	-5,8	-5,0	-4,3
ES	-6,9	-6,1	-2,8	-1,1	-0,9	-2,1	-3,0	-2,9	-3,0	-4,0	-6,0	-6,0	-7,2
NL	-3,9	-3,7	-2,3	-1,6	-0,7	-1,0	0,2	0,3	0,3	0,3	-4,6	-3,9	-2,7
BE	-3,8	-4,0	-3,6	-3,1	-3,1	-2,7	-2,5	-1,6	-2,1	-3,3	-6,8	-4,6	-5,3
AT	-3,1	-2,5	-1,7	-1,0	-0,6	0,1	-1,1	-1,2	-1,0	-0,8	-6,6	-5,2	-3,4
IE	-9,4	-8,0	-7,0	-5,2	-4,9	-3,6	-1,9	-1,5	-0,8	-0,5	-5,4	-4,8	-1,5
FI	-1,1	-0,9	-1,1	-0,9	-1,2	-0,7	-1,0	-1,1	-1,4	-1,7	-5,3	-3,5	-2,7
PT	-8,7	-6,9	-3,9	-3,1	-1,8	-2,3	-2,1	-1,8	-1,3	-1,4	-3,3	-3,3	-2,6
EL	-9,0	-4,4	1,9	3,8	3,6	3,5	5,8	5,2	5,2	2,8	-0,1	-2,6	-1,1
SK	-7,0	-4,0	-3,5	-1,5	-2,3	-2,4	-2,5	-1,4	-2,3	-2,8	-7,8	-7,3	-6,4
LU	0,6	1,5	2,7	2,6	2,5	1,5	1,6	1,5	2,9	2,4	-2,2	0,8	0,9
SI	-4,5	-5,5	-1,4	-11,3	-1,6	-0,9	-0,9	-0,7	-1,0	-1,9	-6,9	-6,2	-5,6
LT	-3,1	-3,3	-2,2	-1,8	-1,2	-0,6	-0,5	-0,8	-1,0	-1,3	-7,7	-5,0	-1,5
LV	-2,2	-1,8	-0,5	-1,0	-0,9	-1,8	-0,6	-1,7	-2,3	-2,1	-5,7	-2,8	-3,1
EE	0,5	0,0	0,2	0,1	0,2	0,1	-0,9	-2,3	-2,3	-2,0	-4,1	-4,1	-3,6
CY	-4,9	-5,1	-4,0	-0,7	4,4	2,7	0,7	1,0	2,1	0,0	-4,8	-1,9	-2,5
MT	-3,4	-1,6	-2,8	-2,2	-3,0	-3,4	-0,2	1,1	-0,3	-1,7	-6,9	-3,7	-2,6
EA	-4,3	-3,5	-2,0	-1,2	-0,8	-0,9	-1,1	-1,2	-1,1	-1,3	-4,8	-4,3	-3,7

Data source: European Commission (2020), autumn forecast.

Note: Colours indicate the degree of compliance with the criterion of a structural balance of at most -0.5% (white) in relation to GDP applicable as medium term objective to countries with excess debt. Green indicates structural balances higher than that, while red indicates excessive structural deficits. Structural deficits of 6% or higher are highlighted in the same dark red colour.

The structural deficit was excessive in many euro area countries before the corona crisis unfolded. In 2019, only 6 out of 19 Member States had a structural balance in line with the medium-term objective or higher (Figure 5). In fact, since 2012 when the fiscal compact was adopted, a structural deficit of 0.5% was exceeded in about 70% of the cases across euro area Member States. Uncertainty around estimates of the structural balance is hardly responsible for widespread non-compliance, as the MTO was missed by a large margin in many countries, including France, Spain or Belgium. Looking ahead, the Commission expects structural deficits in 2022 to remain elevated in most countries. The aggregate structural deficit for the euro area is forecast at 3.7% in 2022, implying considerable adjustment requirements in subsequent years.

Countries usually failed to implement the required fiscal adjustment. The gap between the actual structural balance and the MTO shows the required medium-term fiscal consolidation for euro area countries (Figure 6). However, countries that failed to meet the MTO by a large margin did generally not successfully close this gap in subsequent years. Therefore, the requirement of the fiscal framework to incrementally improve the structural state of public finances towards the MTO has rarely been complied with, particularly in recent years and in high-debt countries (Thygesen et al., 2020). Looking ahead, the required fiscal adjustment in 2022 for France, Italy, Spain, Belgium and others will be considerable, and it will take several years to meet the MTOs if fiscal adjustments are implemented slowly and incrementally.

Figure 6: MTO and fiscal adjustment needs to meet MTO

(a) MTO Deficit Limit

	12	13	14	15	16	17	18	19	20	21	22
DE	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-1	-0,5	-0,5	-0,5
FR	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5
IT	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5
ES	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5
NL	-0,5	-0,5	-0,5	-0,5	-0,5	-1	-1	-1	-1	-0,5	-0,5
BE	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5
AT	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5
IE	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-1	-0,5	-0,5	-0,5
FI	-1	-1	-1	-0,5	-0,5	-0,5	-1	-1	-0,5	-0,5	-0,5
PT	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5
EL	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5
SK	-1	-1	-1	-1	-1	-1	-1	-1	-0,5	-0,5	-0,5
LU	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1
SI	-1	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5
LT	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1
LV	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1
EE	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1
CY	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5
MT	-0,5	-0,5	-0,5	-1	-1	-1	-1	-1	-1	-0,5	-1
EA	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5	-0,5

(b) Distance to MTO Limit

	12	13	14	15	16	17	18	19	20	21	22
DE	0,4	0,9	1,4	1,6	1,4	1,2	1,6	1,9	-2,9	-2,2	-1,4
FR	-3,8	-2,9	-2,5	-2,4	-2,5	-2,6	-2,6	-2,8	-4,6	-5,2	-4,3
IT	-1,0	-0,1	0,0	0,0	-1,0	-1,7	-2,1	-1,4	-5,3	-4,5	-3,8
ES	-2,3	-0,6	-0,4	-1,6	-2,5	-2,4	-2,5	-3,5	-5,5	-5,5	-6,7
NL	-1,8	-1,1	-0,2	-0,5	0,7	1,3	1,3	1,3	-3,6	-3,4	-2,2
BE	-3,1	-2,6	-2,6	-2,2	-2,0	-1,1	-1,6	-2,8	-6,3	-4,1	-4,8
AT	-1,2	-0,5	-0,1	0,6	-0,6	-0,7	-0,5	-0,3	-6,1	-4,7	-2,9
IE	-6,5	-4,7	-4,4	-3,1	-1,4	-1,0	-0,3	0,5	-4,9	-4,3	-1,0
FI	-0,1	0,1	-0,2	-0,2	-0,5	-0,6	-0,4	-0,7	-4,8	-3,0	-2,2
PT	-3,4	-2,6	-1,3	-1,8	-1,6	-1,3	-0,8	-0,9	-2,8	-2,8	-2,1
EL	2,4	4,3	4,1	4,0	6,3	5,7	5,7	3,3	0,4	-2,1	-0,6
SK	-2,5	-0,5	-1,3	-1,4	-1,5	-0,4	-1,3	-1,8	-7,3	-6,8	-5,9
LU	3,7	3,6	3,5	2,5	2,6	2,5	3,9	3,4	-1,2	1,8	1,9
SI	-0,4	-10,8	-1,1	-0,4	-0,4	-0,2	-0,5	-1,4	-6,4	-5,7	-5,1
LT	-1,2	-0,8	-0,2	0,4	0,5	0,2	0,0	-0,3	-6,7	-4,0	-0,5
LV	0,5	0,0	0,1	-0,8	0,4	-0,7	-1,3	-1,1	-4,7	-1,8	-2,1
EE	1,2	1,1	1,2	1,1	0,1	-1,3	-1,3	-1,0	-3,1	-3,1	-2,6
CY	-3,5	-0,2	4,9	3,2	1,2	1,5	2,6	0,5	-4,3	-1,4	-2,0
MT	-2,3	-1,7	-2,5	-2,4	0,8	2,1	0,7	-0,7	-5,9	-3,2	-1,6
EA	-1,5	-0,7	-0,3	-0,4	-0,6	-0,7	-0,6	-0,8	-4,3	-3,8	-3,2

Data source: European Commission (2020), autumn forecast.

Note: (a): The MTO for the structural deficit is at most 0.5% (1%) for countries with debt ratios beyond (below) 60%. (b): Consolidation requirement to reach MTO as indicated by table (a). White indicates a structural balance at the MTO. Green indicates that fiscal space is available (structural balances above MTO), while red indicates that consolidation is required. Values of -5% or lower are highlighted in the same dark red colour.

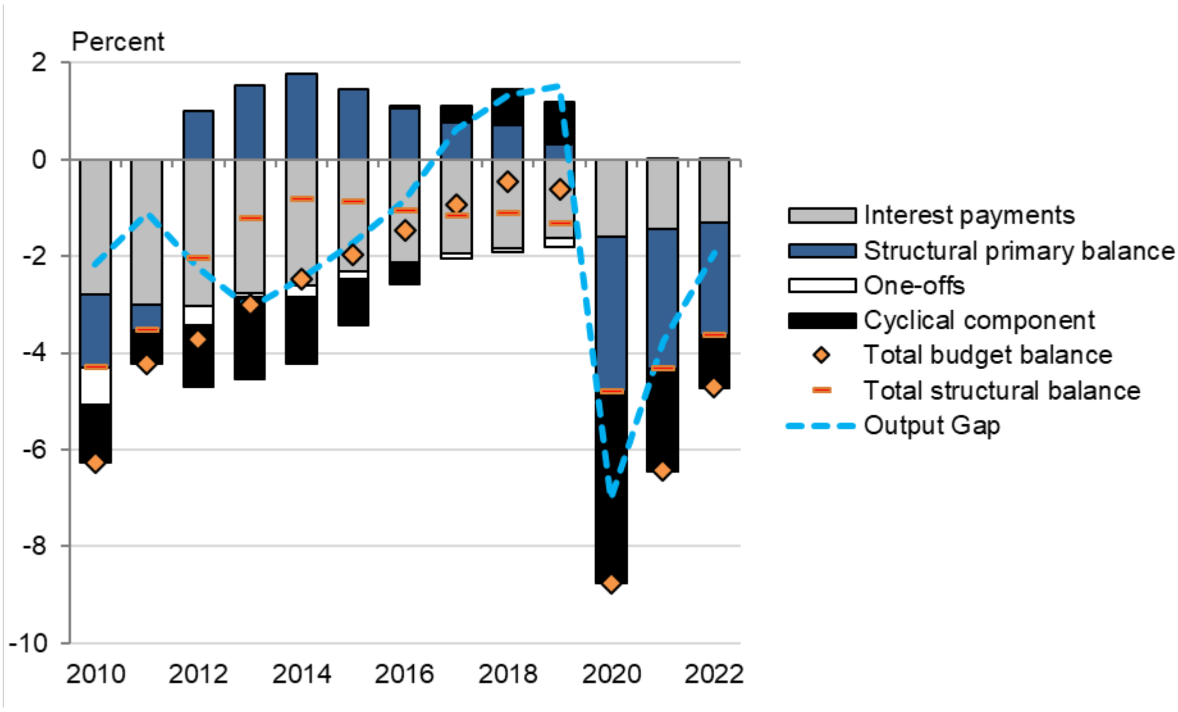
The overall picture of compliance with the current set of fiscal rules is mixed, at best. In sum, the current fiscal framework has generally not led Member States to build up substantial fiscal buffers, and the experience with respect to compliance was rather mixed.[4] The poor performance of the existing fiscal framework is especially striking, as over the most recent years governments have benefited massively from record-low refinancing costs.

[4] For a comprehensive account of the degree of compliance with the SGP framework, including the expenditure rule and non-euro area Member States, see Larch and Santacroce (2020a, 2020b).

4. THE FISCAL RESPONSE TO THE COVID-19 CRISIS

The fiscal response to the covid-19 crisis is sizeable. The fiscal stance can be measured by the change in the structural primary balance, which is the total fiscal balance less the impact of one-off or temporary measures (like a bank rescue), the cyclical component (which captures the budgetary effect of automatic stabilisers), and interest payments on public debt, which cannot be directly influenced by governments (Figure 7). The aggregate fiscal response to the corona crisis in the euro area is indeed considerable, with an estimated 3.5 percentage point reduction in the structural primary balance in 2020.[5] The Commission expects the deficit in the structural primary balance to gradually decline in 2021 and 2022. Notably, the surplus in the structural primary balance has been decreasing already in the preceding years, despite a strong economy (with a positive and rising output gap), indicating pro-cyclical expansionary fiscal policies in the years 2017–2019 in the euro area as a whole.

Figure 7: Components of the euro area fiscal balance, 2010-2022



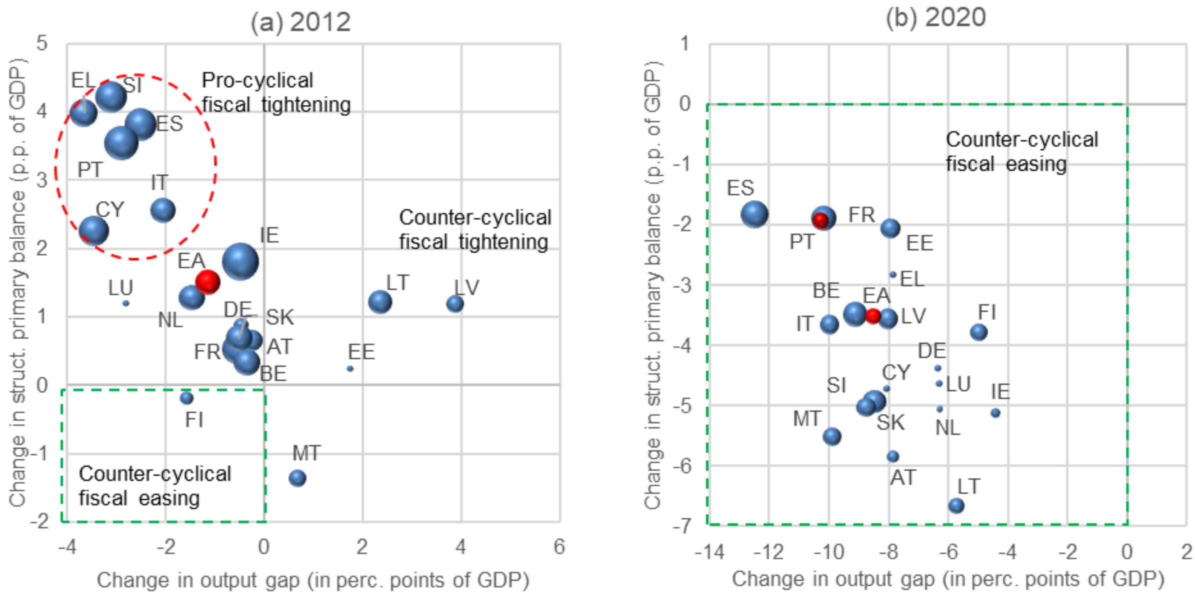
Source: European Commission (2020), autumn forecast, own calculations.

Note: For reasons of representation, the graph uses a mix of denominators at the cost of introducing a limited degree of imprecision. Output gap, "one-offs" and total structural balance: percent of potential GDP; Total budget balance and interest payments: percent of GDP. All data are taken from the Commission autumn forecast 2020. The structural primary balance is derived by deducting interest payments (% of GDP) from the structural balance (% of potential GDP). The cyclical component is derived by deducting the structural balance and one-offs (both as % of potential GDP) from the total budget balance (% of GDP). 'One-off and other temporary measures' are referred to as "one-offs", which is a usual practice by the Commission.

[5] It can be argued that temporary measures, which are a direct response to covid-19 and the economic repercussions of measures to contain the pandemic, should be treated as "one-off and other temporary measures" and not included in the structural budget balance (Danish Ministry of Finance, 2020). The Commission, by contrast, does not categorise the fiscal implications of such initiatives as one-offs, which remain insignificant in the decomposition of the Commission forecast for the euro area budget balance in 2020–22 (see Figure 7). The categorisation of covid-related fiscal measures is, however, not critical in the context of the fiscal surveillance at the current juncture as the general escape clause has been activated and will remain in force until the end of 2021. Expansionary fiscal measures that remain in place into 2022 and beyond should arguably not be regarded as one-offs.

While in 2012 several euro area Member States were forced to tighten fiscal policy despite a recession, in 2020 automatic stabilisers worked unrestricted and all Member States have launched counter-cyclical fiscal measures. During the sovereign debt crisis of 2010–12, debt sustainability of several Member States of the periphery was questioned in financial markets and rising risk premia on these countries' government bond yields forced them to implement substantial fiscal consolidation measures, reducing demand further in economies that were already in recession (Figure 8a). From a stabilisation policy point of view, the highly restrictive fiscal stance at a time of recession was clearly undesirable. However, with structural deficits in the range of 4.5% to 7% of potential GDP in the preceding year (indicated by the size of the bubbles in Figure 8) and already high levels of public debt to start with, the improvement of the structural balance in times of crisis ("austerity") seemed necessary to reassure financial markets. This time is indeed different, as the fiscal response to the pandemic is characterised by counter-cyclical measures in all Member States (Figure 8b).

Figure 8: The fiscal stance during crises: 2012 vs. 2020



Data source: European Commission (2020), autumn forecast.

Note: Bubble size represents the structural deficit in % of potential GDP in the preceding year (structural surpluses shown as dots).

Remarkably, there is a negative correlation between the fiscal response and the depth of the crisis. This implies that countries hit hardest (like Spain, Portugal, France) are to a lesser extent counter-cyclical in their fiscal policy measures than those with a relatively modest loss of output (like Ireland, Austria, the Netherlands, Germany). Again, the pre-crisis state of public finances is most likely responsible for the different extent of fiscal expansion to counter the crisis: while Germany, the Netherlands, Austria and Ireland had ample fiscal space (as measured by the structural balance of 2019) and relatively modest debt levels, Spain and France entered into the crisis with considerable structural deficits and already elevated debt levels. This evidence underlines the need to build up fiscal buffers in good economic times, in order to be able to implement appropriate fiscal responses in future crises.

5. LIFTING THE GENERAL ESCAPE CLAUSE

5.1. When and under what conditions?

As long as the pandemic substantially affects economic activity, the general escape clause should remain in force. We cannot expect economic activity to normalise as long as there is no large-scale medical solution available. Uncertainty and precautionary behaviour will likely remain, as will government restrictions to reduce social contacts. Governments will continue to need full leeway to mitigate the social and economic damage of the crisis, at least through 2021. Thus, continued activation of the general escape clause is appropriate in 2021. It may be necessary even in 2022 if the hopes that vaccination of a sufficiently large share of the population will be possible next year prove to be overly optimistic.

With respect to mitigating scars to the economy, governments should preserve production structures for a post-crisis recovery. During the crisis, sales volumes in some industries decline heavily, while their fixed costs remain largely unchanged. This continuously weakens the equity position of many companies and may finally cause numerous bankruptcies. As most of the affected industries are likely to meet sufficient demand after the crisis, governments have good reasons to preserve the most of the production structures for a post-covid-19 recovery. The best instruments to achieve this are targeted transfers to those economic agents who lose income due to the pandemic. By contrast, aggregate demand management is not appropriate in the current crisis. Fiscal stimulus remains ineffective – particularly in a sectoral recession – when business models are primarily hampered by production restrictions due to measures to control the pandemic (Gros, 2020). General stimulus will not substantially mitigate the damage in the sectors affected directly by the pandemic, but will stimulate spending in sectors that are not restricted or even benefiting from the crisis, e.g. durable consumer goods and internet-based trade.

Once restrictions on economic activity aimed to contain the pandemic will not be necessary anymore, the general escape clause should be lifted, which could be the case in 2022. Recent reports suggest that an effective vaccine against the Coronavirus can probably be rolled out in Europe in the course of 2021, and experience from the current year suggests that infection numbers will likely decline in spring. Therefore, direct restrictions of social interactions can be expected to cease weighing on economic activity in 2022. In that case, it appears warranted to carefully switch on fiscal surveillance again. Given the large scale of additional public debt accumulated during the crisis, often starting from already high levels, fiscal sustainability considerations should assume a more prominent role again as soon as possible.

The period under the general escape clause could be used to redesign the fiscal framework. The current fiscal framework is accused of being overly restrictive and limiting the potential for growth, lacking compliance, being overly complex, and relying on shaky foundations with respect to methodology and legitimacy. Some of the weaknesses are acknowledged by the Commission in its recent Economic Governance Review (European Commission, 2020b). The Commission has invited a public debate on how to improve the fiscal framework (1) in terms of effectiveness of delivering fiscal sustainability in the long-term while allowing for sufficient room for macroeconomic stabilisation in the short-term, (2) in the way it can be effectively enforced, (3) in its transparency in implementation, and (4) in the way it is interacting with the national fiscal frameworks, as well as with the general approach of economic policy coordination in the European Union (European Commission, 2020c). Against this backdrop, the time until the deactivation of the general escape clause could be used to establish consensus on the direction of reform and to adjust the fiscal rules accordingly, before the exemption from the current rules is terminated.

A timely agreement on a major reform may be difficult to achieve though. If the general escape clause were to be lifted in 2022, a new fiscal framework would have to be established by the end of 2021. This appears difficult to achieve, given the apparent differences in policy approaches across countries and political families. It is also not clear whether it would be wise to design a new fiscal framework under the impression of an imminent crisis. A new fiscal framework could be designed to cater the needs of those Member States that are under particular fiscal pressure directly after the crisis. Designing a rule to fit to extreme situations could result in inappropriate provisions for "normal" times.

In the absence of a new consensus, the current rules would have to be phased in. Exiting the general escape clause does, however, does not necessarily imply that strict adherence to the entire set of fiscal rules will be required immediately. Instead, during the process of post-crisis recovery – when cyclical deficits decline and temporary fiscal measures expire, leading to a reduction of the structural deficit – the Commission may make use of the large degree of flexibility that the existing fiscal framework allows. Typically, the Commission aims for a gradual process of fiscal consolidation.

5.2. A possible transition period

We propose a transitory arrangement following the deactivation of the general escape clause in which no new excessive deficit procedure is launched, and the preventive arm of the SGP is applied giving due consideration to the exceptional uncertainty at this stage. The fiscal framework does not require the Commission to launch excessive deficit procedures for Member States with significant deviations from fiscal objectives as long as such a step is deemed inappropriate. Keeping the corrective arm largely paralysed for – say – two additional years would preclude strict enforcement of consolidation requirements.[6] Instead, the Commission should negotiate a reasonable path of consolidation. This arrangement would reflect the uncertainty over the longer-term effects of the crisis on the productive capacity of the economy that will persist for some time during the recovery.

Consolidation requirements derived from the estimate of potential output should be interpreted with particular care in the aftermath of the crisis. Potential output can be expected to be revised downward significantly, reflecting the steep drop in output, as the estimation methodology interprets a sustained reduction of GDP partly as being structural. In a typical business cycle, this procedure is appropriate, as a recession is often a response to the development of unsustainable imbalances in the previous boom – such as in the case of the 2008 financial crisis, which involved an unwinding of excess leverage in the financial sector, a correction of housing bubbles and a reduction of unsustainable external deficits and fiscal positions in some countries. The current crisis, however, results from a temporary disruption of economic activity due to the pandemic, and it is an open question whether and to what extent the production structures will have to adjust in the longer term. Thus, uncertainty about the level of potential output will be particularly high in the years ahead. As a consequence, ambitious consolidation requirements derived from a downward revision of potential output in real time and the implied output gaps should be treated with reservation, at least until the post-covid-19 recovery is largely completed.

[6] Romania, for which an excessive deficit procedure was launched in spring 2020, would remain under the corrective arm. While the assessment of the fiscal position will need to take due account of the impact of fiscal efforts taken in response to covid-19 and the high uncertainty around its medium-term impact on output, adjustment in policies decided before the pandemic, namely major pension increases which have led to the decision to launch an excessive deficit procedure, could be monitored.

Pre-crisis estimates of potential output may temporarily serve as a benchmark. While the covid-19-induced losses of production capacity are unclear, the pandemic did certainly not increase the level of potential output. Thus, for the time being, the Commission could consider the most recent pre-crisis estimates of potential output (from the autumn forecast of 2019) as a benchmark and conceptual upper limit for production capacity in their assessment of output gaps. Such a generous interpretation of potential output would respond to concerns that application of the fiscal framework could lead to premature fiscal consolidation. This approach would imply the least strict fiscal adjustment in line with the matrix of requirements (see Figure 1). For example, as long as the output gap based on the pre-crisis output trend (as estimated in autumn 2019) is below -4%, no consolidation effort would be required. With an output gap of -3.5% (in 2022) in a country with a debt ratio in excess of 60%, the required adjustment of the structural balance amounts to no more than 0.25 percentage points in the subsequent year, and with an output gap of -3%, the required fiscal adjustment would be 0.5pp. It is difficult to argue that fiscal adjustment of this magnitude would be excessive in an environment of economic recovery. In the near term, the expiration of temporary fiscal measures to help the economy through the covid-19 crisis will automatically reduce structural deficits. Probably, this will be more than sufficient to fulfil the requirements for fiscal adjustment so that no additional fiscal tightening would be necessary.

Nevertheless, the risk of permanent economic scars is real. Experience with the global financial crisis and the sovereign debt crisis suggests that there can be huge and persistent shifts in potential output (see Figure 2). Despite the exceptional nature of the current crisis, the fiscal framework should not exclude the possibility that significant changes to economic structures will prevail, with potentially negative implications for the level of potential output in the longer term and, hence, consequences for the sustainability of public finances. While the recovery proceeds, evidence on the longer-term impact of the corona crisis on the level of potential output will progressively emerge. Once the dust settles, and once EU economies are well advanced in their recovery, uncertainty around output gap calculations derived from contemporary estimations of potential output will normalise. Consequently, these estimates could assume a more prominent role in the assessment of the structural position of public finances again – at least unless a consensus emerges among Member States to reform the fiscal framework.

6. REFORM PROPOSALS FOR THE FISCAL FRAMEWORK

The possibility of "self-fulfilling debt crises" underscores the need for sound public finances. The European institutional architecture is specific in that it combines a common monetary policy with fiscal policies decided and implemented at the national level. Moreover, Member States of the euro area are indebted in a quasi-foreign currency – they are unable to print money indefinitely to ensure repayment of national debt. Consequently, under this arrangement there exists default risk, which brings about the possibility of multiple interest rate equilibria. Multiple interest rate equilibria can occur when a debt level may be sustainable at a given (low) interest rate, but becomes unsustainable at a somewhat higher interest rate. If financial markets perceive an increase of the default risk and demand a higher risk premium – which drives up interest rates – the perception of increasing default risk can become self-fulfilling (Cohen and Portes, 2006). The development of such "self-fulfilling debt crises" can be prevented either by a lender of last resort – the central bank or fellow governments that offer financial assistance if need be – or by keeping government finances in a condition where multiple interest rate equilibria are unlikely to emerge, i.e. with debt sufficiently low that even a substantial (but temporary) fiscal deterioration as a result of a negative economic shock will not lead to doubts over fiscal sustainability.

The EU fiscal rules have arguably failed to deliver. The economic rationale for the introduction of the SGP was to ensure sound fiscal policies and convergence to low and stable public debt in order to shield the ECB from fiscal dominance and protect its independence (Schnabel, 2020). However, the record of achievement of the fiscal framework is insufficient consolidation where it was needed most, elevated debt and a consequent lack of fiscal buffers in a number of countries, and a central bank being pushed into purchases of government bonds in order to stem escalating risk premia on government bonds of high-debt countries. While expansionary monetary policies – amid the corona crisis – are appropriate given downward pressure on inflation at already subdued levels, there are indications that these policies ultimately amount to monetary financing, and fiscal dominance is increasingly becoming a valid concern (Fiedler et al., 2020).

The EU fiscal framework has nevertheless not been without effect. It can be noted that since the reforms of the fiscal framework in 2011/2012 there has been convergence of headline deficits and finally all but one Member States had exited the Excessive Deficit Procedure by 2019 (Deroose et al., 2018). At the same time, the euro area has performed relatively well with respect to the size of general government deficits and the development of the debt ratio by international comparison. Empirical evidence suggests that fiscal policies are constrained by fiscal rules even if they are imperfect and compliance is incomplete (Debrun et al., 2018). Still, there have been constant complaints over the EU fiscal framework in recent years, accompanied by numerous proposals for reform.

6.1. Relaxation of rules

Low interest rates raise questions for the fiscal framework. Real interest rates have declined significantly since the inception of the SGP and are now lower than the growth rate of potential output. From the yield curve (or forward swaps) it can be inferred that investors expect interest rates to remain low over the next ten years. With low interest rates, much higher debt-to-GDP ratios are sustainable compared to a situation with higher levels of interest rates, like those that prevailed before the global financial crisis and that are implicitly built into the European fiscal rules. The actual cost of servicing debt has decreased or remained constant in relation to GDP since then, even in countries with significant increases in the debt-to-GDP ratio such as Italy or France. In a low interest rate environment, primary government deficits are feasible without jeopardising fiscal sustainability (Blanchard et al., 2020). From this perspective, the reference value for the level of public debt set in the Maastricht Treaty (60%) may appear outdated and the implied consolidation needs may appear too ambitious.

Interest rates may not stay low forever and fiscal policy should prepare for a turn of the tide. We need to take account of the fact that interest rates have been pushed down by extraordinary monetary expansion, which cannot be expected to last forever. When central banks stop asset purchases eventually, or even start unwinding bond holdings to drain liquidity in the case of rising inflation, strong upward pressure on interest rates could result. Given demographic ageing in increasing parts of the world, there are sound arguments to expect upward pressure on interest rates from declining savings in the not too distant future. A substantial rise in interest rates would immediately put into question the solvency of highly indebted governments and raise the spectre of bad interest rate equilibria. The covid-19 crisis, as well as the previous crises a decade ago, underscore the necessity to keep ample fiscal space available in order to be able to mitigate negative shocks of substantial proportions. Thus, the current era of low interest rates should not lead to complacency but rather be used as a window of opportunity to gradually reduce the legacy of fiscal profligacy in the past.

"Next-Generation EU" grants effectively relax fiscal rules during the post-crisis years. The process of consolidation will be alleviated by substantial grants from the "Next-Generation EU" programme, initiated in response to the corona crisis and financed by joint EU-level debt. The programme will generate additional financial resources averaging approximately 0.5% of GDP in the years 2022 through 2026, accumulating to about 2.7% (Darvas, 2020). As a result, for at least five post-crisis years, the budget constraints are effectively relaxed by about half a percentage point on average, and by even more for many periphery and eastern European countries.

The proposal to encourage public investment by implementing the golden rule has its appeal but also its drawbacks. Experience suggests that fiscal consolidation tends to disproportionately weigh on public investment, with negative effects on potential output and on the sustainability of public debt in the longer term. To avoid this, it has been proposed to introduce a golden rule, which would exclude net public investment from the calculation of the budget deficit (Blanchard and Giavazzi, 2004; Truger, 2016). However, debt accumulated to finance public investment also needs to be served and rolled over in capital markets and can therefore not be excluded from the perspective of the goal of achieving a level of public debt sufficiently low to make multiple interest equilibria unlikely. Importantly, a golden rule would only allow deficit financing of net investment (gross investment net of depreciation), which in mature economies is often small as a share of GDP or even negative (Gros and Jahn, 2020). The economic rationale for excluding net investment from the calculation of the deficit rests on the assumption that public investment is productive in the sense that it increases potential output of the economy and generates additional tax income in the future. It is, however, not clear that this is always the case, as frequent examples of underutilized regional airports, empty motorways, or bridges to nowhere illustrate, and the productivity of investment in defence structures and equipment, such as tanks or battleships, may also be subject to debate. On the other hand, there is expenditure, for example for education, which is clearly productive, but categorised as consumption expenditure. To some extent the current interpretation of the SGP already takes account of the problem of investment in that investment expenditure in the expenditure rule is smoothed over four years and investment expenditure related to European projects can justify a temporary deviation from the MTO, although these provisions relate to gross investment rather than net investment.

Switching from fiscal rules to fiscal standards addresses changing economic environments, but the challenge of multiple equilibria remains. Blanchard et al. (2020) argue that the fiscal rules in the EU do not sufficiently reflect changing circumstances such as lower interest rates and the need to give more leeway to national stabilisation policy. Adequately taking account of them would, however, lead to ever more complexity and is conceptually even impossible. Consequently, they propose to substitute the fiscal rules. The rules give clear guidelines for fiscal policy in advance of application (ex ante), while fiscal standards define abstract principles of fiscal policies and are brought to life in the concrete circumstances of application. The fiscal framework of New Zealand gives an example for such a standard: "*achieve and maintain prudent public debt levels*". The assessment whether the standard is met would be made against the backdrop of the concrete economic situation, including the cyclical position, the level of interest rates, an assessment of sustainability risks given observed trends in productivity or demography, etc. One question with this concept is whether it can be credibly enforced. Blanchard et al. (2020: 24-25) argue that, given the greater flexibility of a standard compared to a rule, the enforcement mechanism could be tougher. They suggest an independent adjudicator, such as the European Court of Justice or the European Fiscal Board, to decide whether a country has complied with the standard – rather than the Council that is in this position in the current enforcement procedure. From an economic point of view, it remains an open question whether standards will eventually lead to debt levels sufficiently low to eliminate the risk of multiple interest rate equilibria. If this was not the case, and an efficient fiscal backstop not available, the ECB would continue to be left with the job of preserving financial stability and cohesion in the monetary union in case of adverse economic shocks by keeping the level of interest rates and yield spreads low. This could lead to delicate trade-offs if inflation threatened to exceed the target, and the determination of the ECB to achieve its main goal of maintaining price stability would be tested (Fiedler et al., 2020).

6.2. Expenditure rules

Shifting focus towards an expenditure rule targeting a long-term level of debt is at the centre of many proposals for reform. The main idea underlying an expenditure rule is that nominal expenditure growth of the government in the medium term should not exceed expected growth of nominal income, and it should be lower than income growth in countries with debt levels above a pre-defined threshold, in order to reduce the debt level over time. The long-term target (or threshold) for debt serves as an anchor, and an expenditure-based policy rule is designed to approach that anchor. An expenditure rule is already part of the current fiscal framework, but it is dominated by the structural balance rule. Eliminating the structural balance as a benchmark and focusing on the expenditure rule is expected to help reducing the complexity and the procyclical properties of the current fiscal framework, while at the same time strengthening the scope for enforcement (Benassy-Quere et al., 2018; German Council of Economic Experts, 2018; Darvas et al., 2018; European Fiscal Board, 2020; Feld et al., 2020). The concept is also supported by analysis from the IMF (Debrun et al., 2018) and the ECB (Kamps and Leiner-Killinger, 2019).

An expenditure rule is easier to abide by governments and arguably less affected by revisions of potential output estimates than a structural balance rule. Government expenditures can be directly influenced by governments, and to the extent that they are in part indeed cyclical (like unemployment benefits or social assistance) the respective expenditures would be subtracted. The effect of the business cycle on expenditures is less pronounced than in the case of government revenues, and forecast errors for government expenditures are relatively smaller than for government revenues (Christofzik et al., 2018). Interest payments, which are not under the direct control of the government, could also be exempted from the expenditure rule. The estimated impact of changes in tax rates and tax bases would also be deducted, so that they would have to be compensated by offsetting expenditure measures to keep the expenditure rule unaffected. This would prevent a deterioration of the underlying budget balance due to measures on the revenue side, while it would remain possible to make fiscal policy choices that result in different long-term levels of both expenditures and taxes.

Revisions to estimates of potential output remain a problem for expenditure rules. An important assumption underlying the analysis of many proponents of expenditure rules is that potential output is rather stable, as shocks to GDP are mainly demand driven and do not affect potential output in the medium-term. However, the level of medium-term potential output as estimated by the Commission is also subject to substantial revisions (Gros and Jahn, 2020). A study evaluating compliance with expenditure rules on a national level finds that targets have generally been met in the past decade when judged against targets based on real-time information, whereas targets re-calculated based on latest information would have frequently been missed (Belu Manescu and Bova, 2020). This raises the question what to do when medium-term potential output turns out to have been lower (or higher) than estimated when the expenditure target for a given year was formulated. Should the expenditure target in the following year be adjusted accordingly, i.e. should the level of expenditures be brought in line with the revised benchmark level, possibly implying significant additional changes to the target growth rate of expenditures? Some proposals include such an adjustment mechanism to account for estimation errors (as well as deviations from plans in the process of budget execution).

A critical element is the speed of adjustment towards the debt anchor. Most EU countries carry public debt above the current ceiling of 60% in relation to GDP, and in some cases the difference is substantial. Moreover, debt ratios will rise dramatically amid the covid-19 crisis. This year and next year gross public debt will exceed 100% of GDP in the euro area as a whole, according to the most recent Commission forecast. In a number of countries, debt levels will be significantly higher: in France, Belgium, and Spain the debt ratio is expected to approach 120%, in Portugal 135%, in Italy 160%, and in Greece it will exceed 200%. A linear adjustment like the one imposed by the current 1/20 rule of the SGP implies very ambitious – in some cases even unrealistically strong – fiscal efforts in the high-debt countries if a common debt anchor in the neighbourhood of 60% of GDP was maintained. Therefore, it is proposed to adopt a more flexible approach that would require a debt reduction target on a country-by-country basis over a medium-term horizon (e.g. 5 years) in a co-operative effort of governments with the national fiscal council, the European Fiscal Board, and the Commission, while taking account of the actual debt-to-GDP ratio, a broader assessment of fiscal sustainability, and the general economic environment (Darvas et al., 2018). Reducing the speed of adjustment would allow for a smoother adjustment, but it would also mean that high-debt countries remain vulnerable to adverse shocks for a longer period of time (Kamps and Leiner-Killinger, 2019). Insufficient ambitions in reducing the debt stock in the current very low interest environment may lead to even more challenging fiscal adjustment requirements, should the interest-growth differential increase again in the future.

An expenditure rule does not eliminate the need to balance revenues and expenditures over the cycle. Ultimately, the development of government debt will depend on public borrowing requirements. Focusing exclusively on expenditures may not be sufficient to achieve a budget balance consistent with the targeted reduction of debt if revenues do not develop as assumed. While the proposed rules generally require that expenditures must be adjusted for the effects of discretionary changes of tax rules on revenues, these effects are notoriously difficult to forecast. Also, tax expenditures may provide a way to ease fiscal restraints. These are difficult to measure and tend to be increased upon the introduction of an expenditure rule (OECD, 2010). Structural trends that lead to declining revenues without discretionary changes to tax rates or tax bases (e.g. due to changing demand patterns) further complicate the framework of expenditure rules.[7] Finally, a substantial and permanent downward shift in the level of output – see Figure 2 again – would cut government revenue

[7] An illustrative example would be a decline in gasoline consumption due to the aspired switch from the combustion engine to electro mobility, which could reduce mineral oil tax revenues substantially over the medium term.

permanently, thereby shifting the budget balance downward and implying consolidation needs on the expenditure side.

The problem of enforcement remains. The current fiscal framework consists of a corrective arm which is ultimately based on the threat of fines. Apparently, this mechanism has not been effective as, despite frequent and often persistent violations of the rules, so far no fine has ever been imposed. An expenditure rule also needs an enforcement mechanism in case of non-compliance. As the imposition of fines on a country which is already in a weak fiscal position does not make economic sense and is thus not a credible threat, an alternative strategy could be to work with rewards, such as preferred access to certain EU funds or ESM loans in case of compliance with the rule.

6.3. Re-establishing the no-bail-out rule

The current fiscal framework is prone to provoking discord and disharmony between Member States. The pressure to adhere to fiscal rules generates incentives for national governments to put the blame for certain budget constraints on Brussels, whenever they must explain their actions to the general public. Moreover, there are debt externalities, i.e. risks to financial stability or even breakup risks of the monetary union in the case of fiscal failure of a Member State. This externality creates the possibility to extort concessions from other Member States. Concessions can be thought of either as a relaxation of otherwise applicable fiscal rules, or even in terms of financial transfers once suitable instruments are put in place (like NGEU). Strict application of rules and their rigid surveillance risk are being perceived as interference into national sovereignty and could ultimately severely damage popular support for the EU project. Plus, policies such as fiscal consolidation or structural reforms of product and labour markets – aimed to increase potential growth – are typically more successful if there is ownership for these reforms among national decision makers and their voters.

Removing debt externalities is key to an EU without fiscal surveillance. The economic rationale of fiscal rules at the European level would vanish as soon as the fiscal failure of one Member State no longer caused substantial negative cross-border spillovers. To this end, a credible and applicable insolvency regime is required to orderly restructure debt, whenever a country's debt burden turns out to be unsustainable and financing conditions deteriorate dramatically (Andritzky et al., 2016). This brings the sovereign-bank-loop to the fore, which describes the interrelatedness of (un-)sustainable public finances and the (in-)stability of the domestic financial sector. To address this "doom loop" between sovereign defaults and national banking crises, banking regulation needs to incentivise the diversification of risk, in particular to reduce the home bias in banks' bond portfolios and to reduce the vulnerability of banks to their own sovereign (Benassy-Quéré et al., 2018). Moreover, the home government must not be responsible to stabilise the domestic financial sector, but there has to be a financial backstop on supranational level that prevents systemic crises from escalating, particularly if the respective government is in financial trouble itself. This is a role that could well be assumed by the ESM. Instead of giving support to financially distressed governments, it could fully concentrate on stabilizing the EMU financial system in times of financial stress. This would allow the ECB to step back from its current role of lender of last resort for governments and its de-facto obligation to close spreads sufficiently to prevent the EMU from breaking up.

A regime of fiscal self-responsibility would be a harsh environment in the presence of high legacy debt. It is an open question whether membership in a currency union were attractive to many Member States, when there were indeed no fiscal rules anymore, but also no lender of last resort that prevents refinancing costs of distressed countries from exploding. In any case, the political hurdles to install such a regime appear prohibitively high, in particular in the presence of high legacy debt, which makes it unattractive for many countries to unguardedly expose themselves and their public refinancing conditions to the assessment and moods of private investors. As long as governments face multiple interest equilibria, such a way forward would per se not be attractive.

For some countries, a haircut on public debt may be necessary to reduce debt to sufficiently low levels. With moderate debt levels, the risk of "self-fulfilling debt crisis" would become manageable. However, it appears difficult to phase in a debt restructuring mechanism that is explicitly designed to cut debt in the foreseeable future, when rollover of existing debt is an ongoing process that requires willing creditors and favourable financing conditions. Moreover, disentangling the bank-sovereign nexus has proven complicated, too. Preventing banks from holding too many domestic government bonds appears to be inconvenient to governments, as they would lose an important lender. Finally, a haircut on public debt may indeed relieve the affected government to some extent in the aftermath, but might create immediate negative spillovers to the financing conditions of fellow Member States, and the required loss absorption capacities for the holders of restructured public debt would create considerable financial and political repercussions.

A sufficiently long transition period in which refinancing costs of Member States are subsidised in the case of excessive widening of spreads facilitates the way to fiscal self-responsibility. The prospect of haircuts as a means to achieve the goal of hazard-free debt levels in some countries would most likely induce financial turmoil and put public finances in high-debt countries under severe pressure, due to rising interest payments (before the haircut) and due to a potential loss of access to capital markets (after the haircut). Additionally, contagion effects could set in and endanger fiscal stability of other Member States. To prevent such a scenario, a mechanism along the lines of Heinemann (2012) could pave the way for a regime of fiscal self-responsibility. The proposal suggests to provide subsidies for those governments whose interest burden increases substantially due to hiking risk premia. When a new bond is issued and the actual yield is above a certain threshold relative to a benchmark (e.g. the average yield for the same maturity in the euro area), the difference to the threshold is granted to the issuing government by a fund that is financed by all Member States. Countries with below-average refinancing costs would partly offset the disadvantage of Member States with above-average refinancing costs, thereby effectively levelling the existing spreads. This would shield a distressed government from excessively rising debt burdens for some time. In the timeframe of – say – 10 years, each country would have to undergo structural reforms necessary to reduce public debt to sufficiently low levels and to strengthen potential output. After that transitory period, there would be no common fiscal rule, but also no bail-out mechanism like the ESM available for fiscal assistance to governments and also no central bank to close interest rate spreads via monetary interventions. If overall debt-levels are sufficiently reduced by the end of this transition period, the risk of self-fulfilling insolvencies (bad interest rate equilibria) will be substantially reduced. While this transitory euro area wide safety net of risk sharing is in place, each Member State can decide on its own how to keep public debt under control. Some countries may adopt a national fiscal rule, others may not.

7. CONCLUSIONS

The general escape clause should be lifted as soon as recovery from the covid-19 crisis is clearly underway, fiscal rules should be phased in, and their application should consider the increased uncertainty concerning the longer-term impact of the pandemic. As long as the pandemic prevents a sustained normalisation of economic activity, the general escape clause should remain active. Governments will continue to need full leeway to mitigate the damage of the crisis to society and the economy at least through 2021. The general escape clause could be lifted in 2022, if effective vaccines are made available to a sufficiently large share of the population in the course of next year. The fiscal framework should be restarted gradually, with the corrective arm switched off for another two years and consolidation requirements based upon a cautious assessment of output gaps reflecting the particularly high degree of uncertainty with respect to estimates of potential output.

The crisis underscores the need to achieve sound public finances, which contain the risk of "self-fulfilling debt crises". It appears that Member States with high debt and high structural deficits before the crisis have implemented less extensive fiscal support measures than Member States with solid public finances. This underlines the need to build fiscal buffers in good economic times in order to be able to implement appropriate fiscal policies in a crisis**.** When the covid-19 crisis unfolded, the ECB was also pushed into purchases of government bonds in order to stem escalating risk premia on government bonds of high-debt countries. Given the large scale of additional public debt accumulated during the crisis, fiscal consolidation should thus become a policy priority in order to create sufficient fiscal space as soon as possible.

The period under the general escape clause could be used to redesign the fiscal framework – or implement reforms that lead to a situation in which fiscal rules become obsolete. The EU fiscal rules have arguably failed to deliver and are criticised on various grounds. The activation of the general escape clause provides an opportunity for reform and it would be straightforward to introduce a new and rectified fiscal framework once the general escape clause is lifted. However, there is no set of rules available that ensures the achievement of sufficiently low debt levels to prevent the risk of sovereign debt crises and that releases the ECB from its current role as a lender of last resort for national governments in the foreseeable future. A stronger focus on expenditure rules, in combination with provisions to reduce debt levels at sufficient speed, has some appeal, as problems of the current rules would partly be alleviated, but such a framework would introduce new complications. In any case, one important element of a reform should be a more effective enforcement mechanism, possibly focusing on positive incentives (such as preferred access to EU funds in the case of compliance) rather than penalties (fines in case of non-compliance). An alternative approach would be to credibly re-establish the no-bail out rule laid down in the treaty of Maastricht, which would eventually allow for abolishing fiscal rules altogether. This would require fundamental reforms to disentangle the bank-sovereign loop and to enable orderly restructuring of public debt, thereby mitigating the risk of negative spillovers from excessive public debt, and could be supported by a transitory regime effectively capping interest rate spreads.

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Based on a brief assessment of the current EU fiscal framework, the paper discusses when and how fiscal surveillance should be enacted again, and investigates possible options for reform. The general escape clause should be lifted as soon as epidemiological conditions allow for economic activity to normalise, probably by 2022. We propose a transitory arrangement if the discussion on a broader reform of the fiscal framework remains inconclusive while the general escape clause is in force.

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