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The public debt outlook in the EMU post Covid: A key challenge for the EU fiscal framework

Abstract

The Covid-19 pandemic triggered an unprecedented global economic and health crisis that will have a long-lasting impact on public finances. This paper takes stock of the emerging public finance landscape in the (post-)crisis environment. It explores 10-year scenarios for economic growth and public finances in several EU countries, and discusses their implications for fiscal sustainability. It takes up key challenges for the EU fiscal framework moving forward, especially the future of the so-called debt rule.

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Authors

This paper was prepared by an ad-hoc working group of the Network of the EU Independent Fiscal Institutions (IFIs) under the coordination of Nicolas Carnot (High Council of Public Finances). The group was composed by the High Council of Public Finances (France), the Estonian Fiscal Council (Estonia), the Hellenic Fiscal Council (Greece), Italy's Parliamentary Budget Office (Italy), the Portuguese Public Finance Council (Portugal), the Independent Authority for Fiscal Responsibility (Spain) and the Secretariat of the Network of EU IFIs.

Chapter 1: The public finances outlook post Covid: a simulation exercise

Lead Author: Vladimir Borgy (High Council of Public Finances, France)

Contributing authors: Christos Axioglou (Hellenic Fiscal Council, Greece), Esther Gordo (Independent Authority for Fiscal Responsibility, Spain), Inna Oliinyk (Secretariat of the Network of EU IFIs)

Chapter 2: Challenges of the public debt outlook for the EU fiscal framework

Lead Author: Nicolas Carnot (High Council of Public Finances, France)

Contributing authors: Panagiota Kolioussi (Hellenic Fiscal Council, Greece) and Ricardo Vicente (Estonian Fiscal Council, Estonia)

Other contributors to the paper: Eric Dubois (High Council of Public Finances, France), Yiorgos Ioannidis (Hellenic Fiscal Council), Flavio Padrini and Alexandre Lucas Cole (Italy's Parliamentary Budget Office), Carlos Marinheiro and Nazaré da Costa Cabral (Portuguese Public Finance Council), Lucia Rodriguez Muñoz and Guillermo Rehberger Bescos (Independent Authority for Fiscal Responsibility, Spain) and Willem Pieter de Groen (Secretariat of the Network of EU IFIs).

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Disclaimer

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Introduction and summary

The fiscal consequences of the Covid-19 pandemic are without precedent. Plunging tax revenues and unparalleled fiscal responses to manage the pandemic and its economic fallout have pushed public borrowing to levels rarely seen since wartime. In 2020, government bond emissions in the EU and the euro area easily broke the records set during the financial crisis of 2009. Even so, no fiscal crisis has arisen. On the contrary, as in other regions and following decisive action by the European Central Bank (ECB), interest rates on public bonds have also broken records, being at their lowest in decades. Interest payments on public debt have thus remained muted.

These fiscal developments will cast a long shadow. The ‘public debt push’ induced by the pandemic follows a decade of uneven progress in repairing fiscal balance sheets. Large differences in fiscal positions across the EU, which characterised the pre-Covid situation, will not emerge diminished post Covid. With interest rate/growth rate differentials expected at multi-decade lows, the sustainability of fiscal trajectories is not under immediate threat. Recent policy actions accordingly focus on fostering recovery, including via EU initiatives to speed up structural transformations and limit the extent of ‘scarring’. Yet, medium- to long-term fiscal risks have also risen. The extent to which public deficits will be eliminated thanks to the recovery remains to be seen. Moreover, with debt ratios certain to persist at higher levels, the sensitivity of fiscal accounts to financial conditions has increased permanently.

The EU rules-based fiscal framework is questioned head-on by the new fiscal prospects. The fiscal provisions enshrined in the Treaty and in the Stability and Growth Pact (SGP) aim at prudent fiscal positions in all member states. Several countries already struggled to comply with those provisions before the pandemic, including in the relatively good times of the late 2010s. In particular, compliance with the debt criterion and the so-called debt rule already featured as a sticking point in pre-crisis fiscal discussions. The outlook for the 2020s magnifies these challenges. Indeed, the future of the debt rule could well be the testing ground for the ability of EU partners to generate a renewed consensus over their fiscal rulebook, once the general escape clause consensually triggered to face Covid-19 is lifted.

This paper aims to shed light on these issues by analysing the fiscal outlook under several 10-year scenarios and its implications for the EU fiscal framework. The first contribution of the paper is to present illustrative projections of public deficits and debt trajectories up to 2030 for the euro area and six member states (Germany, France, Italy, Spain, the Netherlands and Greece). Given the uncertainty, the simulations draw on three stylised scenarios for GDP recovery (catch-up, limited loss and persistent weakness). They are not ‘forecasts’ and do not cover all possible outcomes, but provide a background for discussing policies. The results highlight a challenging fiscal outlook in all scenarios, albeit to differing degrees, in the absence of a credible plan for medium-term fiscal adjustment. In terms of the EU fiscal framework, compliance with the provisions of the SGP, particularly the debt rule, will clearly be at risk.

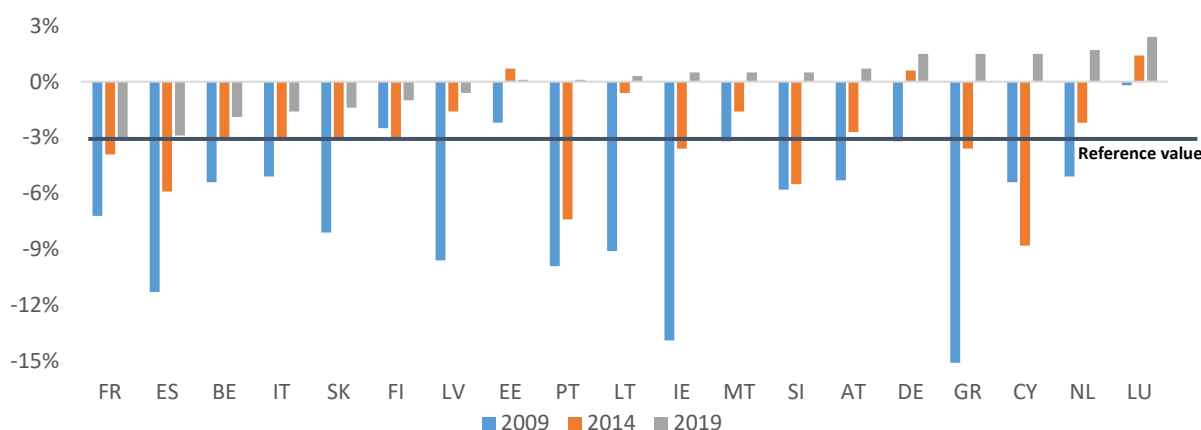
Accordingly, the second contribution of the paper is to examine the questions over the future implementation of the debt rule. We distinguish two questions that are often conflated. One is whether the debt rule provides a sensible long-run guideline for maintaining prudent fiscal positions. We do not provide a definite answer to this question, but discuss options for a possible ‘recalibration’ if this were to be pursued. The other question is whether having a specific debt rule is the most effective approach to serve the very objective of containing debt ratios in the EU, or whether, alternatively, it would be preferable to strengthen other rules of a more practical nature in a simplified system. There is a case for replying positively to this second question, making the link to the broader reform of EU fiscal rules.

The public finances outlook post Covid: a simulation exercise

Fiscal developments in the EU before the crisis

Public finances in the European Monetary Union (EMU) over the last decade gradually improved overall, with very substantial heterogeneity across member states. Against a background of modest average economic growth and low interest rates, budget balances recovered strongly in 2014, after the sovereign debt crisis across all countries. By 2019, all member states had fallen in line with the reference value of the Treaty (3% of GDP). Differences remained substantial, however.

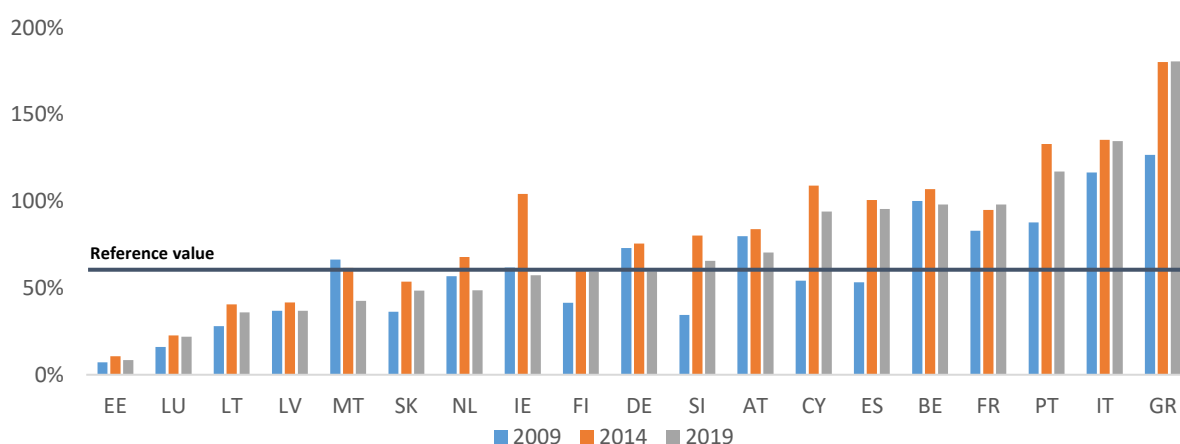
Figure 1. Government budget balance across EMU countries in 2009-19 (% of GDP)



Source: Eurostat.

Public debt generally increased as a share of GDP from 2009 to 2014, and then levelled off or declined in subsequent years. By 2019 nine EMU countries had debt above the Treaty reference value (60% of GDP).¹ Only a few countries had brought their debt back to below the 2009 level.

Figure 2. Public debt across EMU countries in 2009-19 (% of GDP)

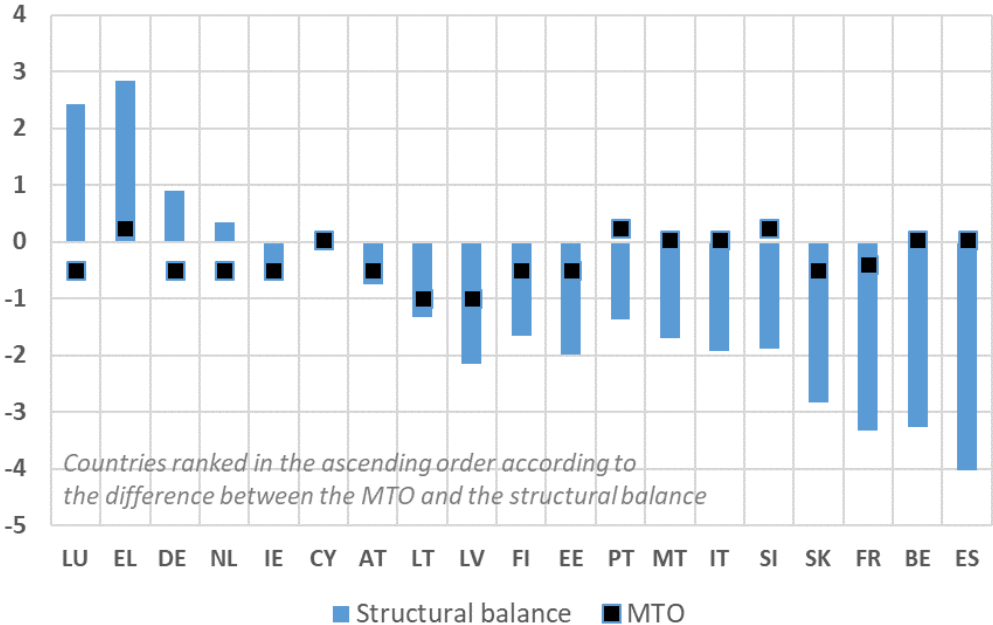


Source: Eurostat.

¹ Exceeding the debt threshold does not automatically imply SGP debt rule violation, as a country can remain compliant if the pace of debt reduction is sufficient (1/20th rule, see hereinafter).

Cross-country differences in structural balance positions were also visible before Covid-19. In the euro area, six countries met or exceeded their medium-term objectives (MTOs) in 2019. Five countries had a gap between their structural balance and their MTO of less than 1.5 points of GDP. As a result of limited structural adjustment in the past and/or unfavourable starting positions after the 2009 crisis, other countries remained further from their MTOs.

Figure 3. Structural balance in 2019 and medium-term objective



Note: output gaps in 2019 have been revised since the Covid-19 crisis but the picture has not been fundamentally modified in qualitative terms.
Sources: European Commission and Ameco (Autumn 2020 forecast).

The underlying drivers of these developments have been analysed elsewhere (see for instance EFB, 2020). In general, large consolidation in the early 2010s was followed by some relaxation in the latter part of the decade. In recent years, the improvement was primarily due to favourable economic conditions and low interest rates. In this context, in their assessment of national fiscal outlooks, the European Independent Fiscal Institutions (IFIs) generally identified a lack of prudence in fiscal approaches, risks of pro-cyclicality, and insufficient attention to medium-term implications of fiscal measures.

Compliance with fiscal rules appears to have been mixed overall. According to EFB (2019), the average rate of compliance with rules increased mildly over the 2010s (63%) relative to the 2000s (57%). Differences between countries, time periods and rules are important. Published in early 2020, the European Commission review found several areas of concern for the EU fiscal framework (besides being complex), including procyclicality of fiscal policies and low effectiveness at reducing high public debt and enhancing the quality of public finances.

The Covid-19 pandemic has had a major impact on economies and EU public finances. Health restrictions to curb the pandemic curtailed activity and led to a sharp economic contraction. According to IMF estimates, global activity declined by over 4% in 2020, more than during the 2009 financial crisis (-2%). The recession was particularly severe in many EU countries. The year 2021 should mark a significant rebound, globally and in Europe, with significant uncertainties revolving notably around the

speed of vaccination. Although those economies that were struck more severely in 2020 could also rebound faster, differences may persist between them in terms of the speed at which they reach their pre-pandemic output levels.

The emerging legacy of the crisis: illustrative projections

The Covid-19 crisis will have significant consequences for public finances in EU member states in the medium term. Given the uncertainties related to the potential impact of the crisis on economic activity in the different countries, we present simulations of public deficits and debt trajectories over the medium to longer run according to different macroeconomic scenarios.

Three stylised scenarios are presented in this section. The scenarios are built for six European countries: Germany, France, Italy, Spain, the Netherlands and Greece. To initialise the projections on a standardised basis, the starting points (2021-22) of the scenarios are based on the European Commission's Autumn 2020 forecasts. The pre-crisis potential growth estimates serve to define a "no crisis benchmark", using estimates published in January 2020 in the *Debt Sustainability Monitor 2019*.

These scenarios are not supposed to cover all the possible outcomes. They do not correspond to forecasts. However, they illustrate a range of paths out of the crisis and their implications for public finances. Hence, they provide a broad picture to reflect on public finance strategies in the face of current uncertainties.² Another qualification is the difficulty to disentangle temporary from permanent measures taken in the context of the Covid-19 crisis.

Main assumptions and key features of the macroeconomic scenarios

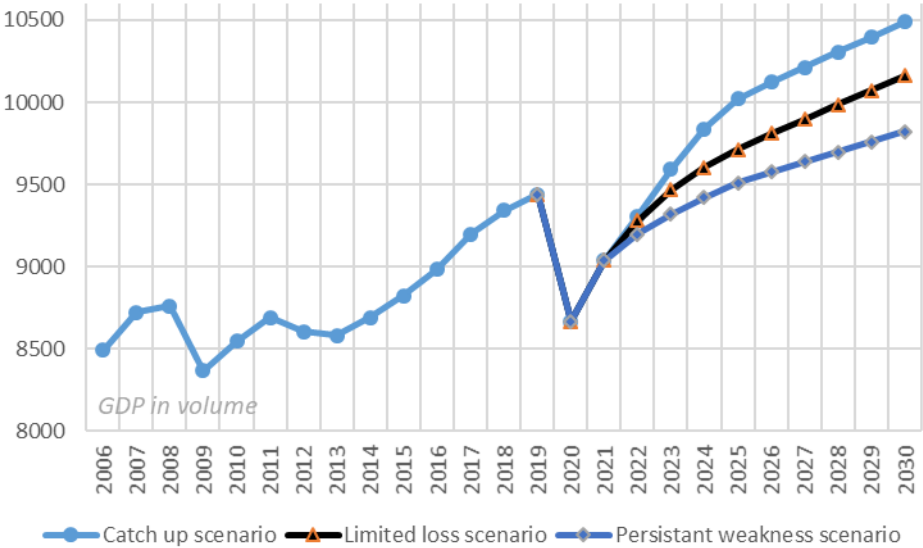
The following scenarios are considered:

- a 'catch-up' scenario in which GDP returns to its pre-crisis path after a few years (see Figure 4);
- a 'limited loss' scenario, in which GDP does not fully recover the ground lost during the crisis, but follows the same growth trend as before the crisis;
- a 'persistent weakness' scenario, in which not only the level but also the growth rate of GDP is persistently weaker compared to pre-crisis levels.

The simulations are presented first for an aggregate that we denote with "*euro countries*", which is based on the six countries included in our analysis, representing over 80% of the euro area's GDP. Results for the individual countries are presented next and in the appendix.

² Hence, the projections presented in this paper are constructed on the basis of similar features for the different countries and do not correspond to forecasts released by members of the EUIFI network. The scenarios build on analytical work recently conducted on France (Cour des Comptes, 2020). They bear similarities with recovery scenarios presented elsewhere, e.g. by the European Central Bank (2020).

Figure 4. Euro countries aggregate: GDP scenarios



Note: the catch-up scenario assumes a convergence of GDP level towards pre-crisis potential GDP, based on the Debt Sustainability Monitor, January 2020. In the limited loss scenario, GDP would return to the pre-crisis growth rate after a permanent level loss of 3 GDP points. In the persistent weakness scenario, GDP levels would deviate over time from the path followed in the other scenarios, as the GDP growth rate would be persistently lower than in the two other scenarios.

Sources: authors’ calculations based on European Commission data.

In the **catch-up scenario** (or ‘back to normal’, ‘no scar’ scenario), the functioning of the economy is only temporarily impaired and production capacities emerge undamaged from the crisis. Such a scenario assumes that potential GDP is unaffected by the shock and thus maintained at its pre-crisis value. For this reason, actual GDP reverts over time to the ‘no crisis trend’. EU recovery initiatives that are successful in driving structural transformations would increase the odds of such a scenario. Still, even if the health crisis is of a very particular nature (an ‘exogenous’ shock induced by the temporary nature of lockdown measures), the scale of the recession is such that it could leave long-lasting consequences and affect the potential GDP of the European economies. In this perspective, two other illustrative scenarios are envisaged.

The **limited loss scenario** is built on the assumption of a somewhat less pronounced rebound in activity in the short term. It assumes that GDP would eventually return to the same growth rate as before the crisis, but that the losses would not be recovered completely. Thus, business bankruptcies resulting from the crisis and the postponement of certain investment projects would reduce production capacity. The level of GDP would then remain durably lower than the one that would have prevailed in the absence of the crisis (by a little more than 3 points, e.g., around two and a half years of GDP growth lost on average for euro area countries as a result of the crisis). As in the catch-up scenario, potential growth after the crisis would be identical to that prevailing before the crisis.

The **scenario of persistent weakness** assumes an even more moderate rebound in activity as the economy emerges from the crisis, since the growth rate would continue to decline. In such a scenario, investments would be affected in the long term, due to financing constraints or the costs of reallocating means of production as a result of the crisis. As a consequence, the economy’s growth potential would be perpetually reduced (by ¼ percentage point here for the different countries). In such a scenario, GDP levels would deviate over time from the path followed in the other scenarios.

Assumptions for inflation and interest rates

Inflation and interest rate assumptions are calibrated with the long-term forecasts released by the Consensus Forecasts.³ In all three scenarios, inflation rises gradually from 2021 onwards to reach values close to 2.0% in 2030 (see Table 1). Conventionally, the interest rate assumptions correspond to the average expectations of 10-year bond issuance rates from Consensus Forecasts. These interest rate assumptions are the same in the different scenarios and are consistent with the inflation assumptions, as both are taken from the Consensus Forecasts expectations.⁴ They include a rise in rates over the projection period together with the expected modest rise in inflation. Changes in rates at issuance gradually pass through to implicit interest rates as the maturing securities are renewed. For simplicity, the fraction of debt that is annually rolled over is set at 1/8th for all countries, in line with average maturities over the zone. We return later to these assumptions and their implications.

Table 1. Assumptions on GDP inflation, interest rates and nominal GDP growth

| | GDP deflator inflation | | 10-year interest rates | | Implicit interest rates | | Nominal GDP growth* |
|-------------|------------------------|------|------------------------|------|-------------------------|------|---------------------|
| | 2025 | 2030 | 2025 | 2030 | 2025 | 2030 | 2030 |
| Germany | 1.8% | 1.8% | 0.8% | 1.4% | 0.7% | 1.0% | 2.7% |
| France | 1.6% | 1.8% | 1.0% | 1.6% | 1.0% | 1.2% | 3.0% |
| Italy | 1.5% | 1.8% | 2.9% | 3.5% | 2.2% | 2.7% | 2.0% |
| Spain | 1.4% | 2.0% | 1.9% | 2.5% | 1.8% | 2.0% | 2.9% |
| Netherlands | 1.6% | 2.0% | 0.9% | 2.2% | 0.9% | 1.4% | 2.8% |
| Greece | 1.3% | 1.8% | - | - | 1.1% | 1.5% | 2.8% |

Sources: authors' calculations based on data from the Consensus Forecasts and European Commission.

* The nominal GDP growth rates displayed in this table are taken from the catch-up and limited loss scenarios. They are lowered by 0.3% in the persistent weakness scenario for each country. The Consensus Forecasts do not provide long-term projections for Greece. For this country, we took information about GDP growth and interest expenditure from the European Commission Debt Sustainability Monitor in order to compute the series needed to build our scenarios.

Public finance trajectories

The public finance trajectories build on these economic scenarios and the conventional 'no policy change' assumption of a constant primary structural balance once temporary crisis measures have been lifted. The primary balance is taken from the EC forecast up to 2022. It includes a structural improvement over 2023-24 to reflect the phasing out of crisis support measures, which is calibrated at 1% of GDP.⁵ From 2024 onwards, the no policy change convention assumes that real primary public expenditure grows in line with potential growth, and that there are no new tax and social security measures. In the first two scenarios, the structural primary balance is therefore constant in the post-

³ In this paper, we used the long-term projections of the October 2020 Consensus Forecasts.

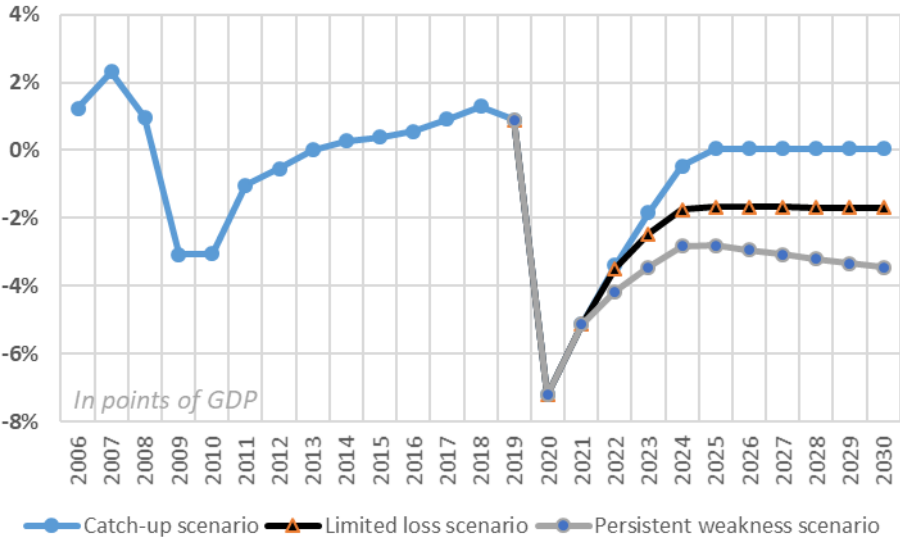
⁴ Current market expectations of rates are lower. Growth expectations in the Consensus are broadly similar to those used in the catch-up scenario, although in Italy Consensus growth forecasts appear slightly more favourable. Thus, at least for that scenario, the interest rate assumptions are consistent overall with growth paths. In other scenarios with lower GDP growth, policy rates could arguably be lower, but risk premia may also rise. The assumptions presented here cannot cover all possible combinations, but give a general idea of possible outcomes.

⁵ This is to some extent a conventional assumption that neglects possible heterogeneities between countries. However, it seems impossible to disentangle permanent from temporary measures clearly at this stage.

crisis period, i.e. from 2024 onwards.⁶ However, the level of this primary structural balance differs between the different scenarios, due to lasting differences in potential GDP level.

The headline primary deficit falls in all scenarios until the mid-2020s, in connection with the rebound of the economy and the closing of the output gap: this pattern holds for each country individually and is therefore captured in the public balance of the euro countries aggregate (see Figure 4). However, the speed and magnitude of this decline varies across the different scenarios: in the catch-up scenario, the primary deficit would fall back quickly to a level close to 0%; in the limited loss scenario, the rebalancing is a little slower and would be at a deficit level of around 2% for the euro countries aggregate. Finally, in the persistent weakness scenario, the evolution would be even more worrying, as the primary deficit would remain persistently high after the crisis, barely falling back below 3% in the mid-2020s. The evolution of the headline balance itself is reported in the appendix.

Figure 5. Euro countries aggregate: primary balance



Sources: authors’ calculations based on European Commission and Consensus Forecasts data.

Public debt-to-GDP ratio at the euro countries aggregate level:

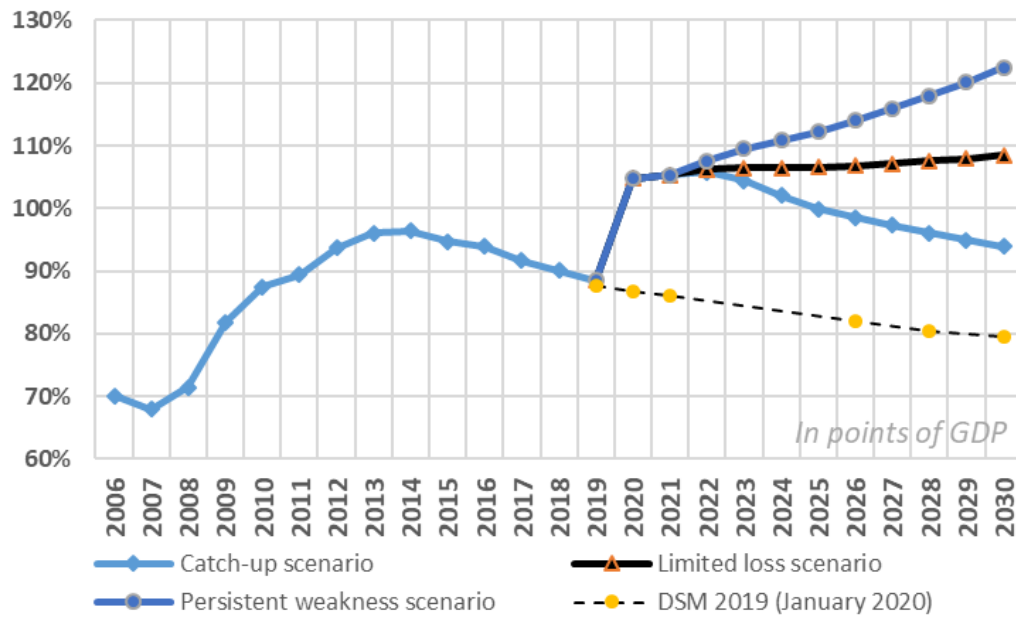
- In the catch-up scenario, after a few years of quasi-stabilisation, this ratio falls as a share of GDP in the following years: the ratio decreases by 10 points of GDP between 2023 and 2030.⁷ However, 10 years after the crisis, the debt ratio would still remain above its pre-crisis level. It would also be above the level that could be derived for the euro countries aggregate in the pre-crisis *Debt Sustainability Monitor* by around 13 points of GDP.⁸ Even in this favourable scenario, the ratio would still be above the pre-crisis level and well above what could have been expected in the absence of the crisis (under a no policy change scenario).

⁶ It should be noted that in these scenarios, countries do not consolidate further to catch up the crisis damage. In the persistent weakness scenario, the structural primary balance slightly deteriorates as primary public expenditure grows in volume terms at a higher rate than potential growth.

⁷ The average pace of decrease in the public debt ratio in this scenario is close to the one observed for the period 2014-2019 (around -1.5% per year on average).

⁸ The comparison is done with the ‘Baseline no policy change scenario’ presented for each country in the January 2020 edition of the *Debt Sustainability Monitor*.

Figure 6. Euro countries aggregate: public debt



Note: the Debt Sustainability Monitor (DSM) denotes the weighted sum of public debt ratios for the countries included in the euro aggregate sample. The circles denote the dates for which the forecasts are presented in the report.

Sources: authors' calculations based on European Commission and Consensus Forecasts data.

- In the limited loss scenario, the partial reduction of the deficit at the euro countries aggregate level (which reaches a level close to 3 points of GDP and remains close to this value), together with the rebound in activity, would the public debt ratio to increase slightly over the decade (to reach 108 points of GDP in 2030, 5 points higher than the 2020 level).
- Finally, in the scenario of persistent weakness, the public debt ratio would rise continuously, reaching 122 points of GDP at the end of the period (even without a major new shock).

Country simulations

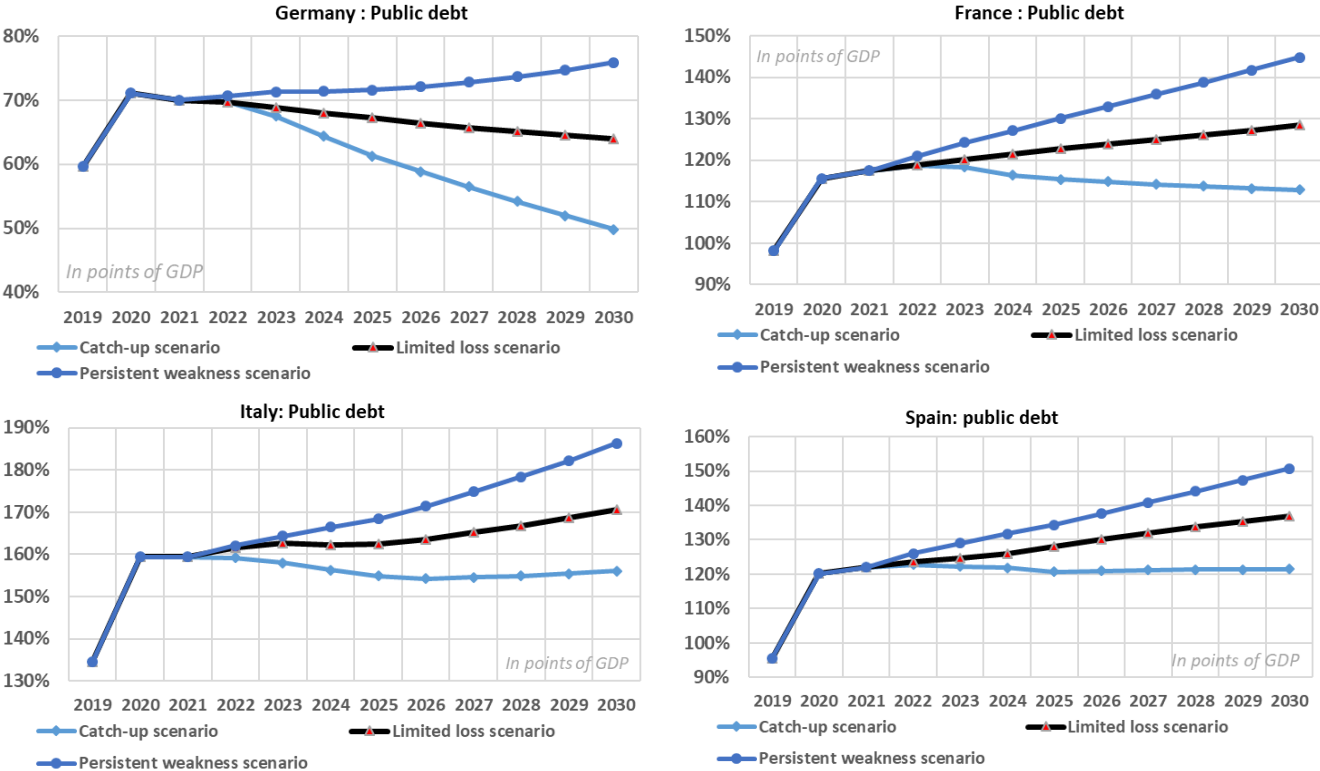
The analysis based on aggregate data masks very different public debt trajectories at individual country level. These differences stem notably from the different fiscal situations of the countries before entering the 2020 crisis (see section on 'Fiscal developments in the EU before the crisis':

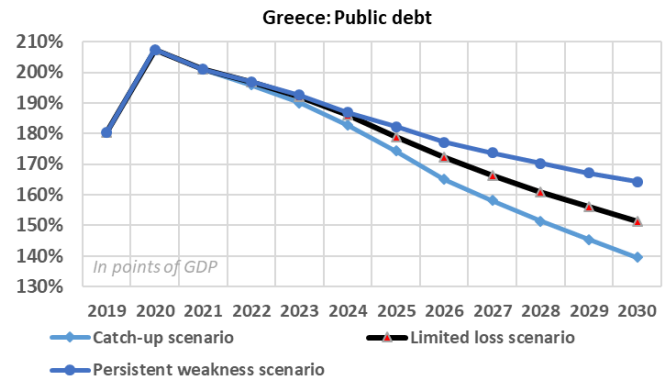
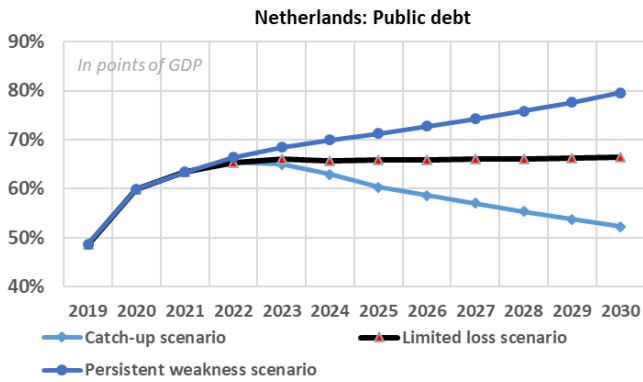
- For Germany and the Netherlands, the public debt-to-GDP ratio path is clearly oriented towards a decrease in the more favourable scenario. The public balance level that is reached (a surplus of around 1 point of GDP in Germany and a slightly positive balance in the Netherlands) allows a sustained decrease in the public debt ratio. In the limited loss scenario, public debt would be stabilised in the Netherlands and would still be on a decreasing trend in Germany, albeit at a slower pace than in the catch-up scenario. In the persistent weakness scenario, debt would be on an upward trend in the Netherlands, increasing by 10 points of GDP between 2023 and 2030. In Germany, the partial reduction of the deficit, together with the more limited rebound in activity, would initially make it possible to maintain the public debt ratio at just over 70 points of GDP, before starting to rise slightly again.

The public debt outlook in the EMU post Covid: a key challenge for the EU fiscal framework

- Starting from a high level in 2020 (over 200% of GDP), the debt-to-GDP ratio would decrease in the three scenarios considered for Greece, although at different paces. Indeed, the primary balance reaches a level that is above the debt-stabilising threshold in a context where the increase in interest payments remains limited.
- The outlook is different for countries like Italy, Spain and France. In the catch-up scenario, public debt would decrease in France but to a much lesser extent than in Germany and the Netherlands. In Italy, under the more favourable macroeconomic scenario, public debt would initially decrease slightly before rising again, though at a very limited pace. In Spain, it would almost stabilise over the decade. Note that for Italy, the Consensus GDP growth forecast appears to be higher than that of the Commission, especially in the medium term. By performing a sensitivity analysis using the Consensus Forecast in the catch-up scenario, the projected path of Italy’s debt-to-GDP ratio appears to decrease slightly, though starting from a high level. In the limited loss scenario, the partial reduction of the deficit, together with the recovery in activity, would not prevent the rise of the public debt ratio in France and Spain. In Italy, it would allow the public debt ratio to be maintained at just over 160 points of GDP during the first years, before starting to rise again.
- Finally, in the scenario of persistent weakness, the public debt ratio would rise almost continuously, increasing by more than 25 points of GDP during the decade in each of the three countries.

Figure 7. Public debt-to-GDP ratio





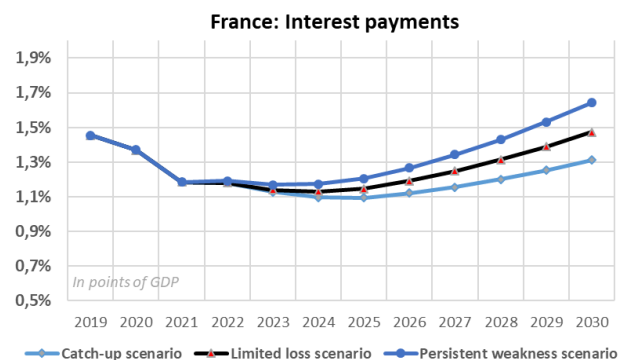
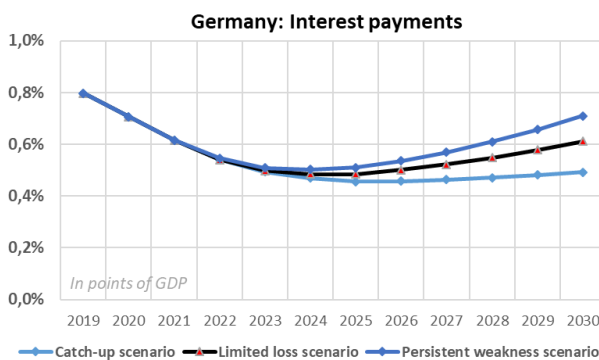
Sources: authors' calculations

Interest payments

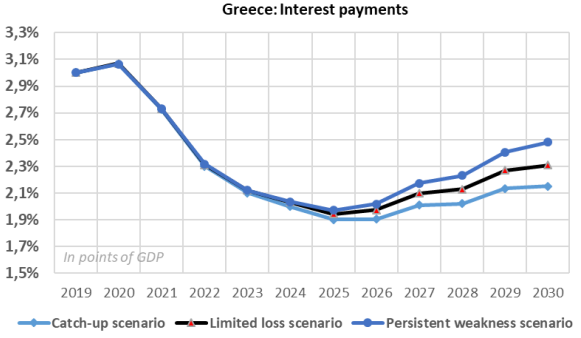
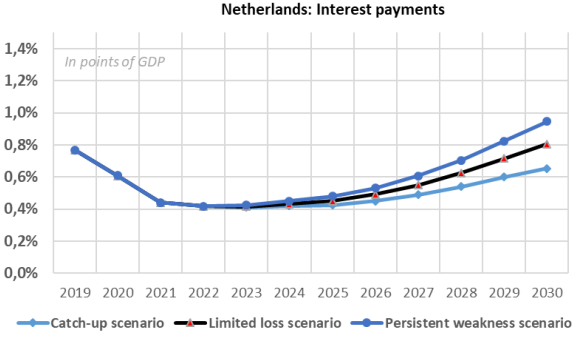
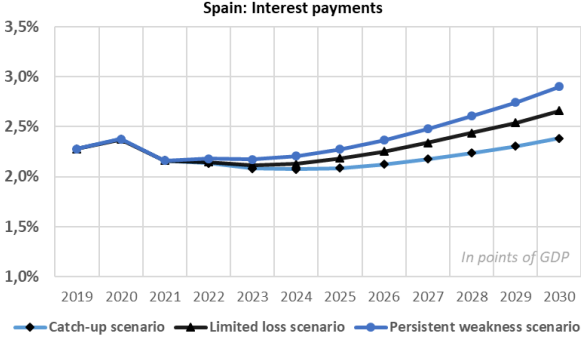
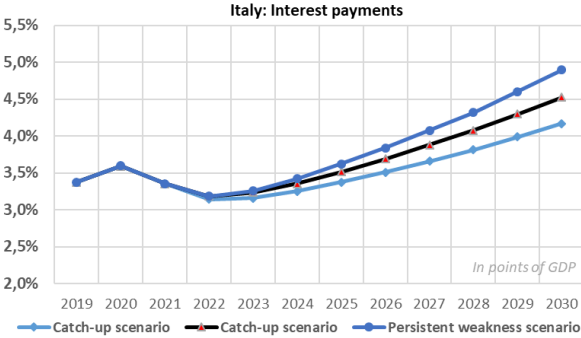
The three reference scenarios are, as mentioned before, constructed for each country on the basis of the same assumptions of interest rates at issuance. The interest rate at issuance would remain lower than the GDP growth rate in value over the whole period for all the countries with the exception of Italy, where the difference between the two variables appears low in any case by historical standards (see table 1). The macro-financial conditions therefore remain very favourable in this sense. Moreover, given that the rise in the rate at issuance is only transmitted as the maturing securities are renewed, the implicit interest rate would only be gradually affected by the rise in the former. With the exception of Italy, the interest rate/growth rate differential would therefore remain negative throughout the period. In the case of Italy, the interest rate/growth rate differential will be positive only at the end of the period, reflecting the impact of the increase in the interest rate at issuance on the implicit interest rate in a context of limited real GDP growth. In the period 2026-2030, the differential in Italy would be +0.5% on average, against -1.4% on average in the period 2022-2025 in the catch-up and limited loss scenarios.

For most countries in our sample, the debt burden would remain contained in the different scenarios, albeit upward sloping by period-end. In the case of Germany, in 2030 the interest payments would reach a level in points of GDP below the value observed for 2019 in the different scenarios (see Figure 8). In France and the Netherlands, the value reached for interest payments (in points of GDP) would be below the 2019 level in the catch-up and limited loss scenarios. In the persistent weakness scenario, the level would only be slightly higher than the 2019 level for these two countries. The increase in interest payments (in points of GDP) should be higher in Italy's case, given the notably higher interest rates at issuance.

Figure 8. Interest payments



The public debt outlook in the EMU post Covid: a key challenge for the EU fiscal framework



Sources: authors' calculations

Higher debt burdens could therefore materialise even with the persistence of favourable financing conditions overall. To be sure, interest rates could well remain lower than assumed now by Consensus expectations. However, since this would likely happen together with lower nominal growth, the debt picture and the eventual risks for debt service once inflation eventually rises may not be so altered. Even with higher nominal growth, spreads could also remain contained if successful EU initiatives were furthered and the ECB maintained accommodative policies. However, interest rates could also turn out higher than those included in the long-term projections of the Consensus Forecasts, particularly in debt-exposed member states in the event of shocks. In general, the sensitivity of the interest expense to interest rate shifts increases as a result of higher debt and higher deficit levels: gross financing needs and rollover of public debt will remain significantly higher than before the crisis, especially in the worst-case scenario presented here. It should be noted that interest payments as they appear in the scenarios at the projection horizon remain quite moderate from a historical perspective, yet the upward sloping nature of the curve is also to be borne in mind.

The role of public finance assumptions in the simulations should be noted. The various scenarios are based on the conventional assumption of a constant increase in the volume of public spending⁹ and assume no tax cuts. However, public spending is also expected to be subject to upward pressures in the coming years, e.g. related to health, ageing populations and climate change policies. To improve fiscal positions structurally, public expenditure growth needs to be kept well below potential growth by limiting or cutting less productive spending, while taking these needs into account. Otherwise, tax and social security contributions would have to be increased or productive spending reduced, with the risk that growth would be hampered.

⁹ The 'no policy change' / 'constant structural primary balance' scenario implies that public expenditure (net of interest payments) should evolve at the same rate of growth as potential output in the first two scenarios. In the persistent weakness scenario, the growth rate of potential GDP is lowered and the growth rate of primary expenditure is unchanged.

Implications of high debt levels for fiscal sustainability

The simulations highlight that the public finance outlook will remain challenging. The deficit and debt trajectories depend largely on potential output assumptions. Views over the likelihood of scenarios may differ. Based on the experience of past recessions, catch-up type scenarios would not be the most likely. Policies aimed at mitigating the crisis impact and fostering reforms nevertheless raise the odds of such an outcome. A stronger growth path, including as boosted by EU recovery initiatives,¹⁰ would facilitate the stabilisation of public finances considerably and require fewer budgetary efforts to contain sustainability risks. In other scenarios, where potential output stays significantly below pre-crisis expectations, the situation of public finances remains lastingly deteriorated in several countries under study. In the absence of medium-term fiscal adjustments (in line with the ‘no policy change’ assumption), deficits and debts would not stay safely in check, creating a vulnerable situation should interest rates eventually rise.

Fiscal sustainability is not only related to public debt levels – the traditional focus of analysis – but reflects a broader range of variables including the ‘r-g’ differential. In general, fiscal sustainability depends on many other characteristics than public debt such as, to name only a few, the level of private savings, the strength of institutions and the composition of debt. One key factor is r-g, the differential between the interest rate and economic growth. A positive r-g contributes to debt accumulation through the so-called snowball effect. Conversely, a negative r-g contributes to reducing the debt ratio. The sustainability of a debt trajectory therefore depends on the dynamic nexus between the debt level itself, the primary balance and the differential r-g. This being said, fiscal sustainability requires at a minimum that the debt to GDP ratio does not follow an ever-ascending path.

The r-g differential had declined and turned negative in a number of countries before the Covid-19 crisis. Traditional economic models assume a positive value of the differential, usually associated with a dynamic efficient economy. Yet the empirical evidence regarding the value of r-g is mixed: at first order, r-g appears negative roughly as frequently as positive in past data of advanced economies, with major dependence on the time period and policy regime being examined.¹¹ Moreover, the recent period has seen a widespread fall in interest rates as well as, to a somewhat lesser extent, in r-g.

Looking forward, the prospects for interest rates remain uncertain. Factors such as ageing populations, structurally high saving and low investment or declining productivity may continue to weigh on long-term growth and contribute to a permanent decline in the real equilibrium interest rate (Rachel and Summers, 2019). At the same time, it cannot be taken for granted that current financial conditions will continue indefinitely. The r-g has fluctuated largely in the past, and there is no guarantee that it will remain negative (Mehrotra and Sergeyev, 2019). In addition, some authors suggest that r-g is endogenous to the level and dynamics of public debt (Wyplosz, 2019). In this vein, Lian et al. (2020), using a large sample of advanced and emerging economies, find that high public debts can lead to adverse future r-g dynamics.¹² A related possibility is multiple equilibria (Rogoff, 2020): future shocks

¹⁰ While favourable to growth and therefore indirectly conducive to lower debt in the national accounts, the EU recovery initiatives increase EU-level debt. Moreover, as the distribution of funds differs from relative country weights, some member states are beneficiaries in net intertemporal terms, while others are net contributors.

¹¹ See notably Blanchard (2019). Mauro and Zhou (2020), using a large historical database on average effective government borrowing costs for 55 countries over up to 200 years, document that negative differentials have occurred more often than positive ones.

¹² Specifically, countries with higher initial public debt are found to experience (i) negative r-g episodes that are shorter and have a higher probability of reversal, (ii) higher average r-g, and (iii) a more right-skewed r-g distribution, implying higher downside risks, particularly when public debt is denominated in foreign currencies.

could push $r-g$ upwards, increasing the risk of a bad equilibrium and heightening the tension between stabilising the economy and the debt sustainability risks.

A period of negative or very low $r-g$ facilitates the unwinding of debt, but failure to take advantage of it raises risks associated with an eventual reversal. With a lastingly negative $r-g$, countries can grow their way out of debt without generating primary surpluses. Besides, in theory an economy could then even sustain a constant primary deficit of any size: in such a situation indeed, assuming that $r-g$ remains negative at a constant value, the debt ratio eventually stabilises. This may, however, occur at a very high level and be stable only in theory, as financing crises could fast emerge following any shock. Moreover, once high values of debt have been reached, a country becomes highly vulnerable to future changes in interest rates even if there is no outright crisis:¹³ as soon as $r-g$ moves to positive territory, the primary surplus needed to keep the debt ratio stable increases with that ratio.

The interaction between monetary and fiscal policy becomes richer in this context, calling for both to play their part. The new environment may call for a reconsideration of the role that monetary and fiscal policies can play to stabilise the economy (Blanchard and Ubide, 2019). Moreover, the central bank can act as a backstop for providing liquidity. Yet, fiscal activism could also lead to ‘fiscal dominance’, compromising the ability of monetary policy to pursue its objective independently. In the specific institutional setting of the EMU, the ECB statutory independence may shield it against fiscal dominance (Schnabel, 2020). At the same time, the EMU institutional setting assumes that national sovereign bonds are “*made safe* through sound fiscal policies” (Coeuré, 2016). The actions of the central bank presume a strong commitment from governments to preserve fiscal sustainability.

Overall, also in the post-Covid environment, the case for viable rules aimed at preserving the sustainability of public finances by controlling the dynamics of public debt ratios remains strong in the EU and especially in the euro area. Medium-term fiscal challenges, including ageing populations and climate change, require the preservation of substantial fiscal space. Favourable financial conditions may well facilitate the containment of public debt trajectories in the post-Covid recovery, but they cannot substitute for prudent fiscal policy. The period of negative or low $r-g$ offers a window of opportunity to repair public balance sheets in an orderly manner, including without hampering growth prospects.

¹³ During the European sovereign debt crisis, several countries saw their market access compromised and resorted to assistance programmes. This led to the creation of new institutions and arrangements, including the European Stability Mechanism.

Challenges of the public debt outlook for the EU fiscal framework

The post-Covid debt outlook of the EU member states raises a major challenge for the common fiscal framework, particularly for the so-called debt rule. The very purpose of this framework, as embodied in the Treaty on the Functioning of the European Union and the ensuing secondary legislation of the SGP, is to ensure prudent fiscal positions throughout the Union. “Gross errors” in fiscal policy are defined in the Treaty (Article 126) with reference to the ratios of public balance and government gross debt. Specifically, on the latter, a key plank of the six-pack reform adopted in 2011 is the “operationalisation” of the public debt criterion via the introduction of a debt reduction benchmark. When the debt to GDP ratio exceeds the reference value of 60%, the benchmark requires a reduction of the excess at an average pace of 1/20th (5%) per year.¹⁴

Given the deteriorated debt positions of most member states (see part I), the implementation of these provisions is set to be a major sticking point in forthcoming fiscal discussions. Under the no policy change assumption adopted in previous scenarios, the pace of debt reduction over the 2020s would hardly match that required by the debt reduction benchmark for the euro area as a whole, even in a growth catch-up scenario. For the most indebted countries, it would be far from being met. And in less optimistic growth scenarios, the debt path would not even be declining. It is worth noting that as the current legal texts stand, the debt reduction benchmark will be applicable once the general escape clause triggered by the Covid-19 crisis is lifted without a transition period of the kind that was in place in the early 2010s.

When discussing the challenges that are likely to occur in the future implementation of the debt rule, it is useful to ask two separate questions:

- (1) Taken as a long-run objective, do the debt criterion and the debt reduction benchmark together provide a sensible guideline for maintaining prudent fiscal positions for EU countries? Or are they ‘over demanding’, either in the sense of being undesirable economically or infeasible politically? Even assuming that it provides a sensible long-run benchmark, is it a reasonable one for the next few years, given the deteriorated fiscal positions that most member states will start from?
- (2) Is a debt rule – in the specific sense of a numerical rule that is monitored on a yearly basis and triggers strong procedural consequences in the event of non-compliance – an effective approach for surveillance? This asks whether the objective of containing debt ratios as per the Treaty is best served by the existence of a dedicated operational rule as per the six-pack reform. An alternative would be to strengthen other rules of more practical nature, which are eventually conducive to preserving prudent debt trajectories.

Challenges in meeting the debt rule

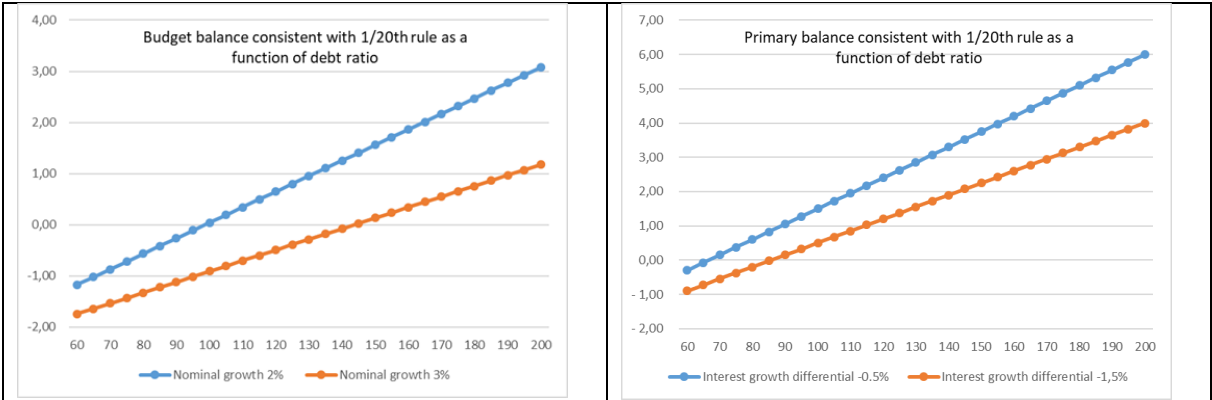
There is no established value in the economic literature for safe public debt ratios, even though risks of fiscal stress are comparatively higher when debt is elevated and/or rising fast. The initial choice of 60%

¹⁴ The existence of the debt criterion is part of the Treaty, and the specification of the numerical value of 60% belongs to Protocol n°12 on excessive deficits. The debt-reduction benchmark, sometimes loosely referred to as the debt rule, is set within Regulation (EC) No 1467/97 as amended by the six-pack reform. The intergovernmental Treaty on Stability, Coordination and Governance of 2012 reasserted the commitment to the debt rule. As per the Regulation, the precise examination of the debt reduction benchmark involves a calculation over three years, an adjustment for the cycle, and backward and forward-looking specifications.

as the reference value for the debt ratio has always been acknowledged as partly conventional. At the time of the Maastricht Treaty, it was close to observed values for several countries and seen as a reasonable guideline. Concerning the 5% pace encapsulated in the debt reduction benchmark, it would be an exaggeration to state that it was agreed without controversy just a decade ago. Yet, in a context that was marked by the financial crisis of the late 2000s and a relative consensus on the importance of fiscal discipline, it was adopted without too many difficulties. Even then, criticisms over its design were soon formulated (e.g. Barnes et al., 2012) and the implementation of this benchmark ran into problems almost as soon as it became binding in the 2010s. In an environment of persistently low inflation, highly indebted countries found it hard to sustain the pace of adjustment required by adherence to the numerical benchmark, despite low interest rates compared to the past.¹⁵

In the emerging post-crisis environment, meeting the parameterisation of the debt rule will be very challenging in high-debt countries. For high-debt countries, returning to 60% at a pace of 1/20th per year implies very low deficits or very high public surpluses (see charts for illustrations). It also implies significant primary surpluses, even assuming benign values for the differential between interest rates and growth rates. For instance, a country with 150% of GDP debt facing trend nominal growth of around 2% and a mildly negative differential (-0.5%) – a set of assumptions that provide a ballpark scenario for countries like Italy – must deliver a budget surplus of 1½% of GDP and a primary surplus of 3¾% of GDP for many years. When trend nominal growth is at 2%, an increase of 20 percentage points of the debt ratio implies an increase of 0.6 p.p. of GDP of the budget balance consistent with the debt reduction benchmark (3% nominal growth would require a balance improvement of 0.4 p.p. of GDP).

Figure 9. Budget balance and primary budget balance consistent with the debt reduction benchmark (% of GDP)



Note: the chart on the left shows the budget balance consistent with the debt reduction benchmark for two illustrative values of nominal growth. The chart on the right shows the primary budget balance consistent with the debt reduction benchmark for two illustrative values of the differential between the interest rate and the growth rate.

Source: authors.

¹⁵ See European Commission (2020), which notes that enforcing the debt reduction benchmark during periods of weak real growth and very low inflation has proven politically and economically difficult. In effect, the debt rule was put aside by accepting broad compliance with the preventive arm of the SGP as a sufficient condition for not opening excessive deficit procedures.

Whether these objectives are ‘excessively’ demanding is a controversial topic. The arguments seem to be as follows:

- As a matter of principle and argued above, it remains essential to control public debt, including – where it has most increased – by demonstrating the capacity to reduce it significantly outside of any crises. Successful episodes of budgetary consolidation in the past, such as in Belgium over the 1990s, did imply sustained primary balances, while lower differentials between interest rates and growth rates relative to the past actually reduce the necessary surpluses under the debt rule. In addition, the required level of surpluses falls as the debt to GDP ratio declines. Finally, in some countries, net transfers from the EU, either from the traditional EU budget or under Next Generation EU, reduce the primary balance effectively sustained by national taxpayers.
- The desirability of reverting from present-day debt ratios in some countries *all the way* to below 60% of GDP appears doubtful. As has been argued (Ostry et al., 2015), even if it is *ex ante* optimal to avoid large debt ratios, it may be *ex post* preferable to “live with (moderate) debt” once it has been accrued, so as to limit the costs of consolidation policies, as long as sustainability risks remain contained. With interest rates at a lower level for some time, a slower pace of debt reduction might be considered sufficient to restore fiscal credibility. In addition, previous experience highlights phenomena of fiscal fatigue following strong fiscal adjustments. In practice, the fiscal contractions that would be required in a short period of time to reach the required levels of (primary) balances could be very high in some countries, putting sustained growth in the recovery period in jeopardy.

Overall, both the feasibility and desirability of the fiscal adjustments implied by adherence to the present debt reduction benchmark may at least be questioned. As a minimum, a smoother transition path than would result from a mechanical application of current provisions of the debt rule may be necessary in the short term, once exiting the general escape clause.

A revision in the calibration?

A change in the calibration of the debt rule, if it is pursued,¹⁶ could in principle follow several avenues.

One first option would be a recalibration of the rule’s parameters. There are two basic parameters, the reference value and the pace of reduction:

- Some authors have evoked raising the reference value itself, for instance moving from 60% to a higher value such as 80% or 90% (Trueger, 2020). This would be loosely justified by a ‘reality principle’, together with an acknowledgement that ‘safe values’ of debt ratios, even though impossible to capture precisely, may be higher in the present environment than in the past.¹⁷ Nevertheless, while improving consistency with the deficit reference value, such a change would have a rather an ad hoc nature.¹⁸

¹⁶ As argued thereafter, this may not be needed if the long-run objective of containing debt, including possibly in line with the current benchmark in the long run, is pursued through adherence with other operational rules.

¹⁷ The change could also be justified as enhancing the consistency with the 3% deficit ceiling. As [Marinheiro \(2020\)](#) recalls, the 3% deficit ceiling is consistent with the 60% debt ceiling if nominal GDP growth is 5%, figures which were plausible at the time of the Maastricht Treaty. With lower inflation and real growth, a given deficit ratio is consistent with a higher debt ratio. Vice versa, one could argue that the reference value for the deficit ratio could be reduced, while keeping unchanged the reference value for the debt ratio.

¹⁸ Procedurally, it requires an amendment to the EDP Protocol, a procedure that requires unanimity of the Council, but is not as heavy as a full Treaty change.

- The pace of the debt reduction (1/20th) could also be modified. This involves an amendment of the secondary legislation that defines the “satisfactory pace” notion of the Treaty. However, such a change could again seem makeshift. Indeed, it is difficult to see which alternative number could credibly be picked based on purely objective considerations, as the choice involves a certain amount of judgement.¹⁹

A more principled option would be to modify the notion of debt to move to a concept of net debt, instead of gross debt. In this option, the parameters could stay unchanged or be modified as well. Such a conceptual change would have differentiated effects on member states, but these would receive substantial justification. It would be imperative to use a well-defined concept that does not put overwhelming pressure on the statistical apparatus:

- In this respect, a relatively straightforward possibility would be removing from gross debt only the most liquid assets, which gives a ‘net debt’ indicator already published by Eurostat. The justification would be that these liquid assets are relatively easy to mobilise in a funding crisis.
- A somewhat more ambitious option would take into account the build-up of public capital, to the extent that it is the counterpart of increased debt. This would also be a way of taking into account public investment in the framework.

The pros of such an avenue would be that the *de facto* relaxation of the rule would come with a stronger economic content. But this could also make agreement complicated. In any event, it would be a major change politically and procedurally, requiring an amendment to at least the Excessive Deficit Procedure (EDP) Protocol.

Another avenue may be to explore a differentiation of the required pace of debt reduction, in place of a one-size-fits-all parameter. Two possibilities have been notably suggested and may even be combined (EFB, 2020):

- One possibility is to differentiate the required pace of debt reduction with the initial levels of indebtedness, with the intention to smooth out the expected time-paths of primary balances and/or the growth of net expenditures. While this effectively alleviates the fiscal objectives for highly indebted member states, it may be difficult to justify, from a fiscal prudence perspective, that the expected pace of debt reduction is getting *lower* as the debt level is getting *higher* (even though the required level of primary deficit would still increase with the debt level).
- Differentiating with respect to other circumstances, particularly the interest rate/growth rate differential, has also been suggested. In the EFB proposal, the required debt reduction pace would be lowered when the differential increases. However, a problem with this idea is that two arguments conflict: a higher differential raises the level of primary balances needed for a given pace of debt reduction, suggesting that for feasibility reasons the pace of debt reduction might indeed be lowered when the differential increases. On the other hand, a higher differential increases the urgency of reducing debt, which would militate for increasing the pace of debt reduction when the differential increases.

On balance, trying to fully pre-specify the way in which the differentiation would apply may lead to complicated formulations that in any case would not cover all possible circumstances and arguments. Such a ‘technical’ approach may also run against the willingness to strengthen the political commitment to the rule. The experience with the cyclical “matrix”, which was introduced as part of flexibility

¹⁹ Hauptmeier and Kamps (2020) suggests a speed of 3% in order to avoid that fiscal adjustment becomes self-defeating, together with a ‘nominal’ cyclical correction which adjusts for fluctuations of nominal GDP growth around a country’s real potential growth and the ECB’s price stability objective.

provisions in the 2010s and was well intended, provides a cautionary tale (Hauptmeier and Leiner-Killinger, 2020): the pre-defined granularity did not prevent a degree of procyclicality in practice, given observability issues of output gaps, and also as member states proved reluctant to consolidate in good times.

All in all, none of the recalibration options seem devoid of limitations. The very principle of loosening the debt rule may be contested, especially if not matched by a strengthening of the framework in other respects. At the same time, for reasons exposed above, maintaining the debt rule in its present form – which was already *de facto* discarded before the Covid-19 crisis – may well be problematic.

These considerations suggest that a better ‘solution’ to the debt rule quandary may lie in a more systemic approach than recalibration, which requires taking up the issue of the debt rule in connection with the broader discussion on fiscal rules.

From debt rule to debt anchor?

The EU fiscal framework involves complexity and redundancies across rules, including the debt rule. The current system of rules is unanimously perceived as too complex. The complexity starts with the sheer multiplicity of rules: the six-pack reform added two main rules – including the debt reduction benchmark, the other one being the expenditure benchmark – to the headline balance and structural balance rules. At the same time, it created issues of internal consistency between those rules:²⁰ for instance, a close to balance structural budget implies, if followed effectively, a reduction of the debt ratio far below 60% of GDP (hence going somewhat beyond the debt criterion). At the same time, the values of MTOs for highly indebted member states may well fall short of what is required under the debt reduction benchmark.

Since the debt to GDP ratio is quite sensitive to shocks in the short term, the very idea of a yearly debt rule may be bound to run into implementation problems. The dynamics of the public debt ratio are very sensitive to both growth and inflation shocks, as these directly affect the denominator of the ratio, together with their possible impact on the deficit. An adjustment factor was introduced in the debt reduction benchmark to take into account the cycle, but this came at the expense of added complexity without tackling inflation surprises or avoiding repeated issues in implementation in the 2010s (Hauptmeier and Kamps, 2020). While more refined adjustments could be developed, they increase complexity and are unlikely to prove robust across all circumstances.²¹

Moreover, the debt ratio can hardly be taken as a suitable fiscal objective in the short term. Indeed, the response of the debt ratio to fiscal policy changes is typically non-linear (see e.g. European Commission, 2012, Codogno and Galli, 2017, and De Jong et al., 2017): in the short run, a discretionary fiscal contraction typically *raises* the debt ratio, as the denominator effect of lower GDP more than offsets the lower deficit. Only over time – and this can take several years depending on the circumstances – does it usually lead to a lower debt ratio. This is a crucial consideration: even if the preservation of a moderate public debt to GDP ratio is taken as the central objective of the EU fiscal framework, its attainment needs to be considered over the medium to long run. The fiscal soundness of the annual budget must be evaluated on metrics for which policy makers can be more accountable, even though the requirements for setting those metrics must be guided by the long-run effects on public debt.

²⁰ See e.g. Kamps and Leiner-Killinger (2019).

²¹ For instance, stock-flow adjustments can be sizable enough to create an unexpected material difference between the change in debt and the government deficit/surplus.

Against this background, the proposals for marrying a ‘debt anchor’ with a single operational rule within a simplified system present advantages. A major simplification of the SGP could follow the *debt anchor cum net expenditure target* approach increasingly advocated before the Covid-19 crisis.²² In this approach, the allowed growth of net public expenditure, relative to a sufficiently smooth measure of trend growth, must be set at a pace consistent with putting the debt trajectory on a path deemed consistent with sustainability over a suitably long horizon. Public debt is indeed best regarded as the final, long-run objective (debt anchor), while a ‘net’ expenditure indicator is the most convincing operational target for assessing annual budgets. Indeed, the growth of public spending and the decisions on new tax measures are more controllable and more easily measured in the short run than the (change in the) structural balance, and this approach allows fuller playout of automatic stabilisers (European Commission, 2020). The operational indicator does not need to equate precisely with the current expenditure benchmark.²³

This ‘systemic’ debt anchor approach to the future of the debt rule can come with or without a re-parametrisation. In the debt anchor approach, the equivalent of the debt reduction benchmark is not directly binding as a rule, but sets the level of ambition of the operational target. The current debt reduction benchmark may still be judged as overly ambitious in this respect, at least when it comes to the near future for highly indebted member states. It could, however, be preserved in a longer-run perspective. Alternatively, it could be amended along the lines evoked above.

A complementary idea, however, could be to strengthen the national appropriation of the debt reduction objective. Several ideas have also been suggested in this respect.²⁴ Accordingly, one idea is to grant a greater role to national medium-term budget plans laying out country-specific paths of debt reduction over a reasonably long period, especially when formulated at the beginning of the legislature. For instance, the Irish Fiscal Council suggested that the government introduce its own debt target with a five-year horizon (Irish Fiscal Advisory Council, 2019). As a necessary check, the assumptions of such plans would need to be fully vetted or prepared by independent fiscal institutions. The plans would be subject to common principles ensuring their adequacy and equal treatment, and would need to be endorsed by the EU institutions.

The connected simplification leaves open the interaction of the ‘debt anchor cum operational target’ with the headline deficit criterion. In practice, a deficit of 3% is significantly greater than what is required to reduce the debt ratio under a relatively broad range of parameters for both nominal growth and the pace of reduction of the debt to GDP ratio (see above). In this sense, the 3% criterion is not really the binding constraint in the set of EU fiscal rules, even taking into account lower growth than thought at the time of Maastricht and revisiting the required pace of debt reduction under the debt criterion. At the same time, the 3% is conceived as a ceiling and not a target, so not amending this criterion assumes

²² Among others, a single rule using net expenditure as the operational indicator and debt as the final objective was suggested by Debrun et al. (2008), Carnot (2014), Andrieu et al. (2015), Claeys et al. (2016), Heinemann (2018), Bénassy Quéré et al. (2018), Darvas et al. (2018) and Christofzick et al. (2018). The European Fiscal Board (2018, 2019, 2020) put it at the centre of its suggestions for an improved fiscal framework.

²³ In fact, some technical refinements included in the latter may need to be revisited and simplified, including to take into account the concerns of IFIs regarding transparency of calculation (Marinheiro, 2020b). Concerning the evaluation of tax measures, which is frequently mentioned as an important issue in such an approach, any concerns can be alleviated by strengthening independent evaluations of the measures, including by well-staffed IFIs.

²⁴ With some variants, this idea was put forward by Darvas et al. (2018), EFB (2019) and in more detail in EFB (2020). The proposal put forward in December 2017 by the European Commission for a directive incorporating the Fiscal Compact into EU law also went in the direction of a partial decentralisation of the EU fiscal framework in order to foster national appropriation.

that under revised rules member states would still need to run deficits in normal times below 3% of GDP with a security margin.

A provision for public investment?

Finally, a revision of the framework along the above lines might also consider more extended provisions for public investment. Calls for a more growth-friendly fiscal stance, with special attention to public investment, have strengthened, reviving the discussion on favourable treatment of public investment. This has been partially acknowledged in the EU fiscal framework with the so-called investment clause. Recourse to this clause has, however, only been modest so far, as reported by the European Commission in its review of the rules (European Commission, 2020). The relative stringency of the eligibility criteria may be one factor explaining the narrow use. In addition, the space provided by the clause is limited (to 0.5% of GDP), which may be constraining for large-scale projects especially in small member states.

In the literature there are arguments both for and against proposals for a specific treatment of investment in fiscal rules (see e.g. Darvas and Anderson, 2020):

- Advocates argue that: (a) inter-generational fairness requires that the cost of public investment be borne by future generations who will benefit from it; (b) in the presence of deficit limits, socially desirable public investment projects may not be undertaken leading to underinvestment; (c) efficient investments increase potential growth and may to some extent be ‘self-financing’ by raising future tax income; (d) public investment adds to government assets, therefore debt-financed public investment only increases gross, not net, public debt; and (e) in corporate accounting the cost of investment is not charged to a single year but distributed across the years of its use, so this principle should also apply to public investment.
- Sceptics note that: (a) the adoption of such legislation could maintain high public deficits for long periods; (b) the legislation may create distortions with favoured investments preferred to other forms of capital or current spending; (c) it may create incentives to record current expenditure as capital spending; (d) public investment is not a suitable instrument for counter-cyclical policy because it takes a long time to be implemented; and (e) it is difficult to apply due to problems in the determination of net investment.

Against this background, an extension of the current investment clause should be carefully designed.

The arguments supporting forms of ‘golden rule’ are substantial, particularly taking into account the post-crisis aspirations to sustained growth, low interest rates and the green transition. Risks and practical limitations are also important; thus, emphasis should be given to avoid abusive interpretations, allocative distortions or moral hazard. In design, it would be useful to consider only investment net of depreciation, clearly delineate the notion of investment, and maintain a cap on the amounts. This would allow increasing investment where it is currently particularly low, without allowing a relaxation of the fiscal stance for current spending. If such proposals are not taken up, there is a case for other policies with an equivalent functional outcome, perhaps building on the recovery and resilience facility, to support the enhancement of public investment and maximise its positive outcomes.

Moreover, it should be recognised that the quality of public investment is highly variable.²⁵ Quality can be seen from the perspective of a high social rate of return or a high net present social value of public

²⁵ For example, de Jong et al. (2017) report that the frequency distribution of output elasticities of public capital taken from published research papers ranges from -1.7 to 2.04, the average being 0.106. Also, the productivity of public capital may decrease the more capital is accumulated. Furthermore, there is evidence that cost overruns and delays are worse during periods of public investment scaling-up (IMF, 2020).

investment projects. It also means that projects are deployed with no significant delays and cost overruns, and that they are free from corruption. This points to the need for careful evaluation and selection of projects, and good management during project execution.

Concluding remarks

The public finance outlook of EU member states, particularly the high levels reached by the debt-to-GDP ratios in most countries, will return as a central question as post-pandemic recovery hopefully gains traction. Fiscal prospects, economic growth and the evolution of interest rates are all uncertain and intertwined. In this paper, we do not attempt to fully examine this nexus (which would be a nice but quite challenging extension). Instead, we show that even under favourable assumptions for GDP growth, the public debt trajectories will remain somewhat more elevated than expected before the Covid-19 crisis, in the absence of a credible medium-term fiscal adjustment plan.

Against this background, the policy mix in the EU faces a narrow path. Ongoing efforts focus on ensuring a strong recovery. The EU recovery initiatives offer an opportunity to support growth and carry out structural transformations without directly weighing on national debt, while easy monetary and financial conditions open a potentially long window of time to sort out fiscal imbalances in an orderly fashion. But credible plans at the national level to put debt trajectories in check remain necessary, especially in the most indebted member states. As has been noted, it is “all in the mix” (Bartsch et al., 2020). It requires the dual commitments of the monetary authority to its price stability objective and of the budgetary authority to fiscal sustainability.

The rules-based fiscal framework of the EU will inevitably be confronted with these new realities. In particular, the debt rule could crystallise the difficult discussions that will open as soon as the general escape clause that suspended SGP provisions is lifted. The debt to GDP ratio is one of the two basic criteria enshrined in the Treaty, and its importance for assessing fiscal sustainability remains central, notwithstanding other factors. For these reasons it is sensible to consider it as an ‘anchor’ of the common framework. Economic considerations may inform calibration choices, possibly along the lines evoked in this paper, but these will inevitably remain partly conventional. Greater simplicity in the overall design of rules and more certainty that they will be adhered to are imperative.

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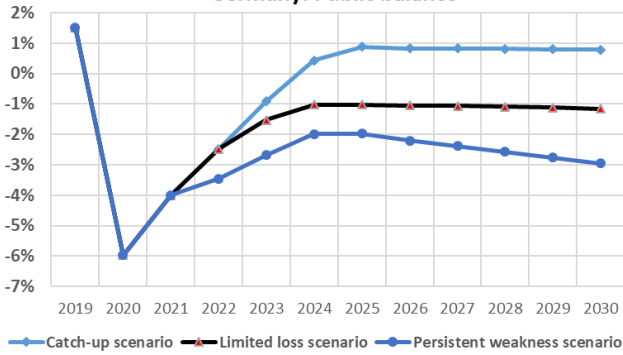
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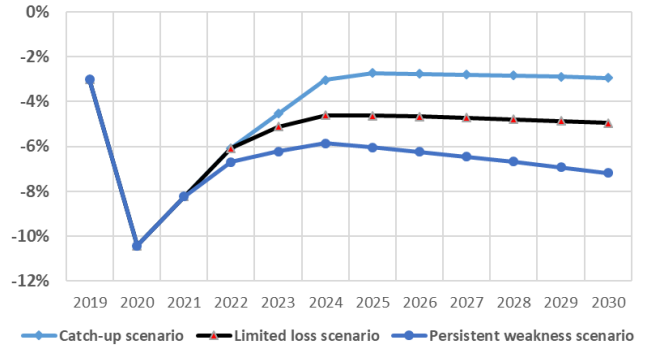
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Annex

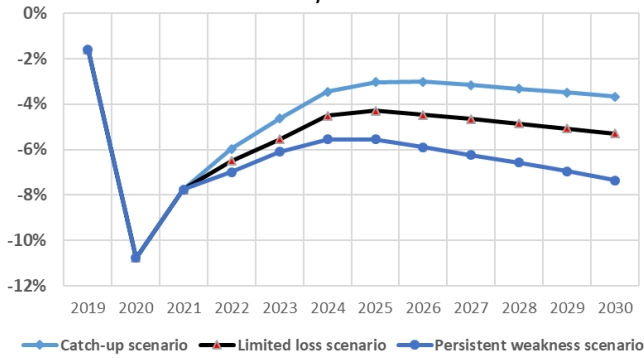
Germany: Public balance



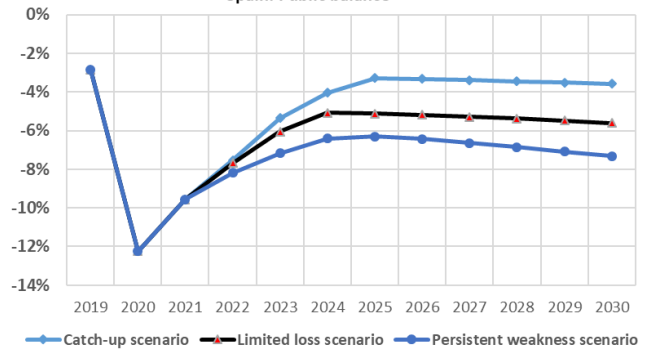
France: Public balance



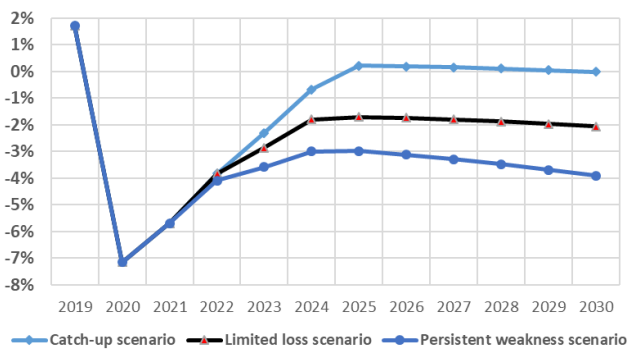
Italy: Public balance



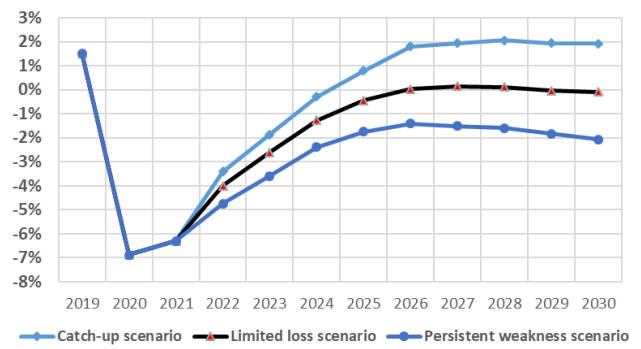
Spain: Public balance



Netherlands: Public balance

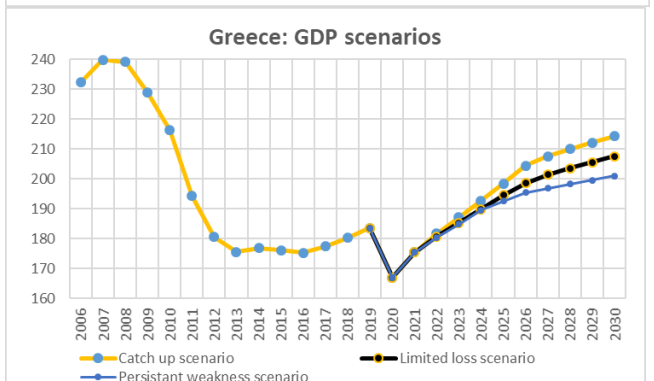
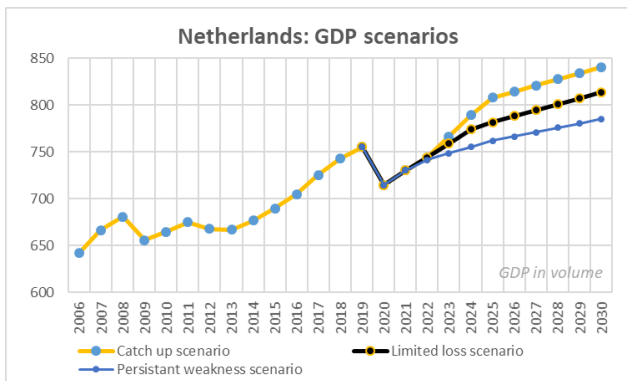
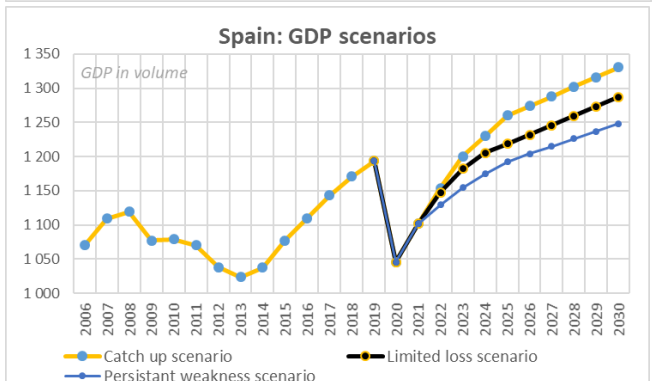
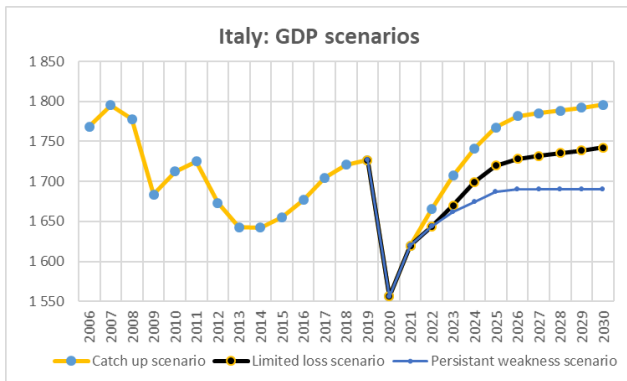
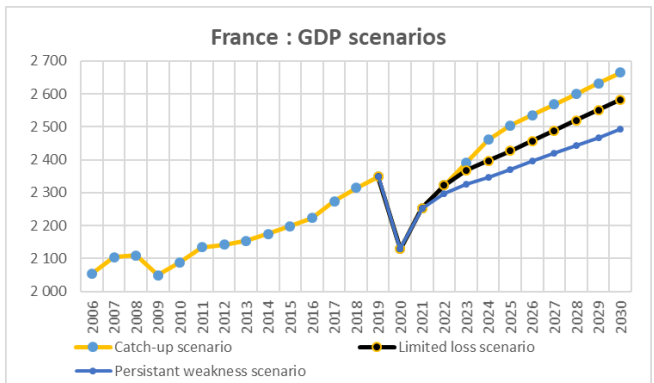
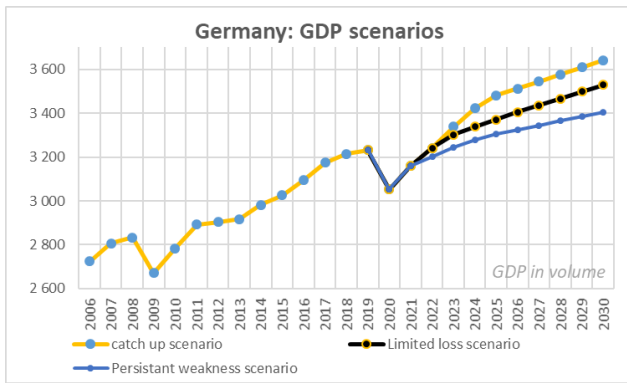


Greece: Public balance



Sources: authors' calculations

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Sources: authors' calculations

The Network of EU Independent Fiscal Institutions

The Network is composed of 30 Independent Fiscal Institutions representing 25 EU countries and the UK. It is a voluntary and inclusive institution, open to all independent fiscal oversight bodies operating in the EU. It provides a platform to exchange views, expertise and pool resources in areas of common concern. The Network supports the efforts to review and reinforce the EU fiscal framework, seeking to better exploit the synergies between rules and institutions, as well as between different levels of administration, whilst respecting the principle of subsidiarity and enhancing local ownership and accountability.

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