PUT FORWARD FOR DISCUSSION: TWO DIFFERENT VIEWS ON THE APPLICATION AND REFORM OF EUROPEAN FISCAL RULES

92. In the following section, council members put forward for discussion two different approaches to the application and reform of the European fiscal rules.

2. European fiscal rules (Veronika Grimm and Volker Wieland)

Compliance with fiscal rules and safeguarding the economic recovery

93. Since their introduction, the fiscal rules of the EU have become increasingly broader and more complex. ↘ BOX 9 At this stage, they also allow a **high degree of flexibility** with regard to their application in practice. For one, there is the **general escape clause,** allowing Member States to deviate temporarily from the rules of the Stability and Growth Pact (SGP). Further to this, the rules contain **various exceptions and broad scope** that give the European Commission **plenty of flexibility** even without applying the escape clause. The European Commission has made use of this leeway in the past. For example, a breach of the 1/20 rule – i.e. the rule to reduce the gap between the debt-to-GDP ratio and the 60 % threshold by 1/20 each year – has not yet been a reason to open an excessive deficit procedure (EDP), as other factors have also been taken into consideration.

94. For the first time since the introduction of the SGP in 1997, the European Commission – with the support of the European Council – invoked the **general escape clause for 2020, 2021 and 2022** in response to the coronavirus crisis. ↘ BACKGROUND INFO 6

↘ BACKGROUND INFO 6

Escape clause under the European fiscal rules

The **decision to activate the general escape clause** under the European fiscal rules lies with the **European Commission.** The **European Council** must **approve** this **decision** before activation can take effect. The general escape clause allows Member States to adopt budget policies within the Stability and Growth Pact to address a deep economic downturn in the euro area or in the EU overall and to take action to counter a general crisis situation that this triggers in all Member States. The corrective arm in Article 3 (5) and Article 5 (2) specifies that in the event of a deep economic downturn in the euro area or in the EU the Council can decide, at the recommendation of the European Commission, to adopt a revised budgetary stance. The general escape clause does **not suspend** the **procedures of the Stability and Growth Pact.** It does, however, give the European Commission and the Council the **power** to **adopt coordination measures** within the framework of the Pact while deviating from the budgetary obligations that normally apply. In some Member States, the activation of the escape clause in national fiscal rules depends on the activation at European level. This is the case in France, Italy and Portugal, for example (EUIFIs, 2020; Gbohoui and Medas, 2020). In Portugal, the activation of the national escape clause is automatically linked

to activation at the European level. In France, the activation of the clause must be approved by the High Council for Public Finances, and by Parliament in the case of Italy.

95. In March 2021, the **European Commission** (2021b, p. 7) made the continued **application of the general escape clause for 2022** contingent upon the general economic situation in the EU and the euro area, to be assessed on the basis of the output gaps, growth rates, labour market indicators and the level of GDP **compared to the pre-crisis level** at the end of 2019. With regard to the first three of these criteria, the European Commission pointed out that the available data was subject to uncertainties and delays and therefore placed emphasis on the comparison with pre-crisis levels for the decision-making process. Given that the European Commission's Winter Forecast of February 2021 (European Commission, 2021c, p. 18) projects that GDP will reach its pre-crisis level in the EU by mid-2022, the European Commission saw this (2021b, p. 8) as a preliminary indicator that the general escape clause should be applied in 2022 but not in 2023.

96. In the European Commission's Spring Forecast (European Commission, 2021d, p. 25) of May 2021, **pre-crisis economic activity** was projected to be reached around the **fourth quarter of 2021** in the EU as a whole and only in the **first quarter of 2022** on average in the **euro area** Member States. At the level of the individual EU Member States, this forecast projects that some would already return to their pre-crisis level in 2021 and all would return by the end of 2022 at the latest. ↘ CHART 41 TOP On the basis of this forecast, in June the European Commission (2021e) deemed the aforementioned criteria to be met and declared that the general escape clause would continue to be applied in 2022 and was expected to be deactivated in 2023. The European Commission (2021f, S. 8) pointed out that the country-specific situations of the individual Member States will be considered following the deactivation of the escape clause and the application of the fiscal rules. In March 2021 it stated that all the flexibilities within the Stability and Growth Pact will be used for individual Member States that have not yet returned to the pre-crisis level of economic activity (European Commission, 2021b, p. 8). The European Commission has therefore a **substantial** degree of **flexibility** in the application of the SGP rules, which it has also made use of in the past. ↘ ITEM 116

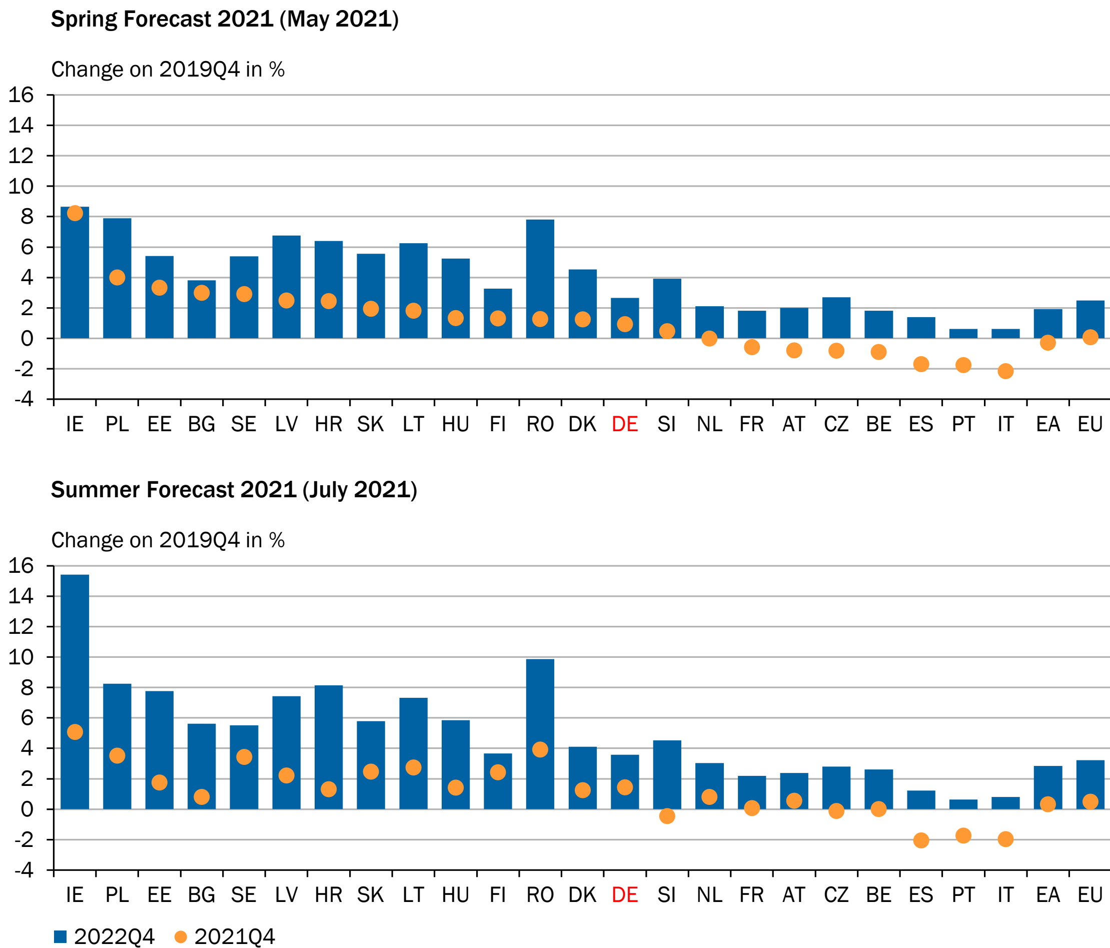
The **criteria** determining **when the general escape clause is applied and when country-specific flexibilities** are used remain **vague, however**. Clear criteria would be helpful considering that the European Commission's forecast indicates that the EU Member States will, on average, have returned to the pre-crisis level by the end of 2021 but the general escape clause – and not country-specific flexibilities – are still to be applied for 2022. In the European Commission's Summer Forecast of July 2021, the outlook had improved somewhat further, with the European Commission (2021g) expecting the pre-crisis level to be reached for the euro area by the end of 2021. ↘ CHART 41 BOTTOM The GCEE is expecting this for the fourth quarter of 2021.

97. As soon as the general escape clause no longer applies, the rules of the **preventive and corrective arm of the SGP** that are currently valid – like those for

↘ CHART 1

Pre-crisis level reached in the EU on average by the end of 2021 according to the Spring and Summer Forecast

European Commission GDP projections for EU member states



1 – IE-Ireland, LT-Lithuania, PL-Poland, SE-Sweden, EE-Estonia, HR-Croatia, FI-Finland, LV-Latvia, BG-Bulgaria, SI-Slovenia, DK-Denmark, SK-Slovakia, RO-Romania, HU-Hungary, DE-Germany, FR-France, NL-Netherlands, CZ-Czech Republic, PT-Portugal, BE-Belgium, AT-Austria, ES-Spain, IT-Italy, EA-euro area, EU-European Union. No quarterly GDP forecasts available for Cyprus, Greece, Luxembourg and Malta.

Sources: European Commission, Eurostat, own calculations

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the general government deficit, the structural deficit, the debt ratio and expenditure growth – become relevant once again.

In the preventive arm, i.e. for Member States not in an EDP, the rule is that the Member States' structural deficit must be more or less equivalent to the country-specific medium term objective (MTO) or must undertake adjustment towards this objective with sufficient speed (European Commission, 2019, p. 15). The latter depends on the national economic situation and is likely to be met by most Member States by **pursuing a structural deficit reduction in steps** of 0.5 % of GDP per year. If the structural deficit of a Member State is not brought down as planned, the European Commission still has **leeway in the assessment of whether the preventive arm of the SGP is breached**. For example, structural reforms can be considered a positive element. An EDP is opened as soon as

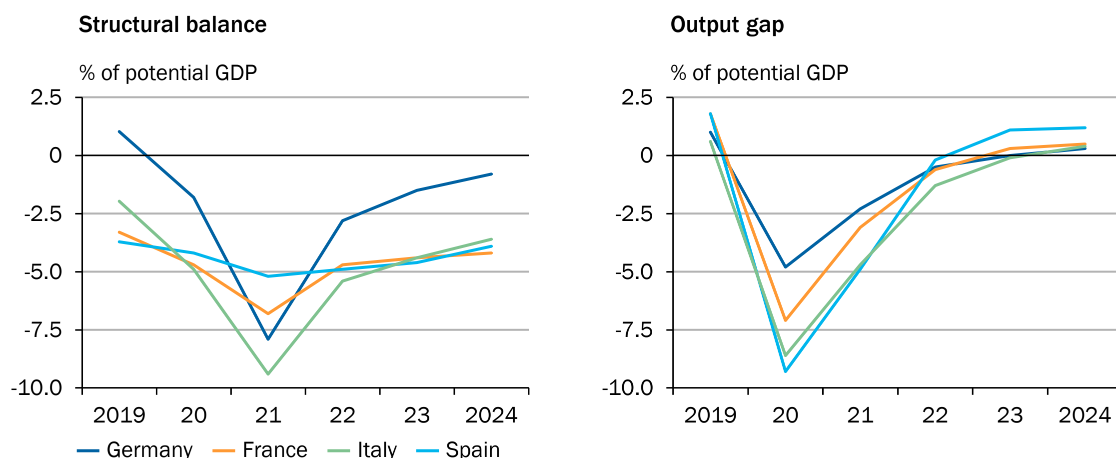
the general government deficit of a Member State exceeds 3 % or a deficit of this magnitude is planned. While in theory an infringement of the rule to limit public debt can also trigger the opening of an EDP, the interpretation is less strict in practice. **In the corrective arm of the SGP** – in which the Member State would then be – more detailed supervision rules and requirements with regard to planned national fiscal measures apply. The European Commission and the European Council also have a **wide margin for implementation here**.

98. The **forecasts presented by the EU Member States** in their stability reports show that most plan to gradually **pare down their structural deficits to a sufficient degree** in the coming years. The phase-out of pandemic-related support measures will play a particular role in achieving the necessary reduction. Spain is an exception in 2022 and 2023, as is France in 2023, as their structural deficit reductions are slightly lower than needed considering their forecast economic recovery. ↘ CHART 42 LEFT

In Spain, the output gap will be almost closed again in 2022, however, and both countries expect slightly positive output gaps in 2023 and 2024 according to their stability reports. ↘ CHART 42 RIGHT While the European fiscal rules require an improvement of over 0.5 % of GDP in this context, the forecast for Spain falls short of this requirement by 0.3 percentage points and that for France by 0.2 percentage points. In their **simulations** for the next few years, Darvas and Wolff (2021) also demonstrate that given the scope of the European Commission to flexibly apply the rules, **only a minor fiscal adjustment** would be necessary in just a few states in **order to comply with the rules,** based on the deficits projected by the European Commission. Funds from the Recovery and Resilience Facility can additionally reduce the required adjustments in this context.

99. The **fiscal policy of most** euro area **Member States** is **therefore not** significantly **limited by EU fiscal rules in the coming years**. Consequently, the application of the general escape clause is not a necessary precondition in most Member States to be able to comply with the fiscal rules from 2022 onwards. In

↘ CHART 2
Structural balance and output gap



Sources: European Commission, Stability programmes of EU member states, own calculations
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mid-2021, the **independent Advisory Board to the German Stability Council** (2021) saw no need to apply the general escape clause for 2022 on the basis of the forecasts. Nor was there any need, according to the **Deutsche Bundesbank** (2021d, p. 10), to decide as early as June 2021 on the application of the general escape clause in 2022. It called for a later decision to be made on the application of the general escape clause depending on the economic recovery. In addition, there was also the option of using country-specific flexibilities where necessary instead of applying the general escape clause. **In future,** any debate on the **application of the general escape clause should be conditional on an independent analysis and review,** as suggested by the European Fiscal Board, for instance (European Fiscal Board, EFB; 2018, p. 81).

100. In light of the forecast economic growth, the **escape clause invoked due to the coronavirus crisis should cease to apply in 2023 at the very latest** so that Member States remain within the normal limits of the fiscal rules once again. The application of the general escape clause in 2022, which has already been decided by the European Commission, allows Member States to once again incur extensive budget deficits and a sharp rise in debt. From 2023, Member States would then be required to bring their structural deficit into line with the country-specific MTO by gradually reducing it by 0.5 % of GDP each year. **According to** the **forecasts** currently **available** for the development of economic output and public finances, **there are no indications that the application of currently valid fiscal rules from 2023 onwards would put the continued economic recovery at risk**.

101. According to the European Commission forecast (2021d, p. 39), **14 Member States** will exceed a **debt ratio of 60 %** in 2021. The Spring Forecast projects that the euro area is likely to have a debt ratio of at least 102 % of GDP in 2021 and of roughly 101 % of GDP in 2022. The average for the EU overall is roughly 95 % in both years. The European Commission emphasises the considerable degree of uncertainty due to the coronavirus pandemic from a macroeconomic perspective and, consequently, for fiscal policy. Either way, the European Commission has a **high degree of flexibility within the fiscal rules that currently apply to safeguard** the continued **economic recovery**. It has drawn on this flexibility in the past, for example when countries have breached the 1/20 rule associated with bringing the debt-to-GDP level down to the 60 % threshold.

Reforming fiscal rules in order to strengthen resilience in good economic times

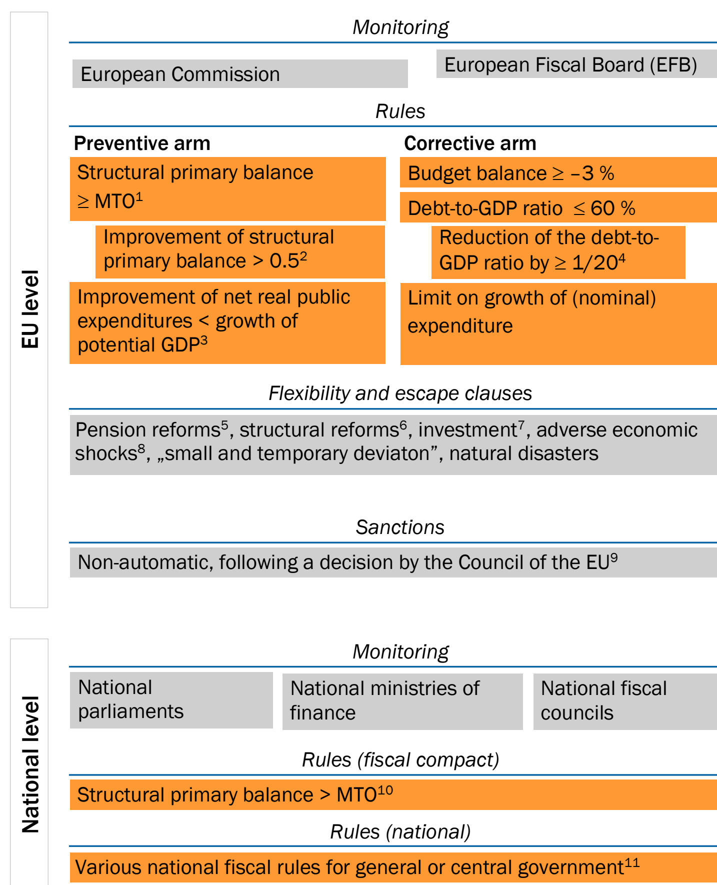
102. An **evaluation of the EU's fiscal framework** was already underway before the coronavirus pandemic struck and is now being relaunched (European Commission, 2021h). A number of **proposals for reform** are being discussed in this context. ↘ BOX 10 The proposals differ particularly as to whether the intention is to relax the fiscal rules in general, or to more effectively ensure that budgets are consolidated in times of good economic growth in order to improve resilience for future crises. It would make sense to reduce the complexity of the fiscal rules framework, increase transparency of compliance and implementation, and avoid procyclicality ↘ GLOSSARY of the rules (GCEE Annual Report 2020 items 297 ff.). The

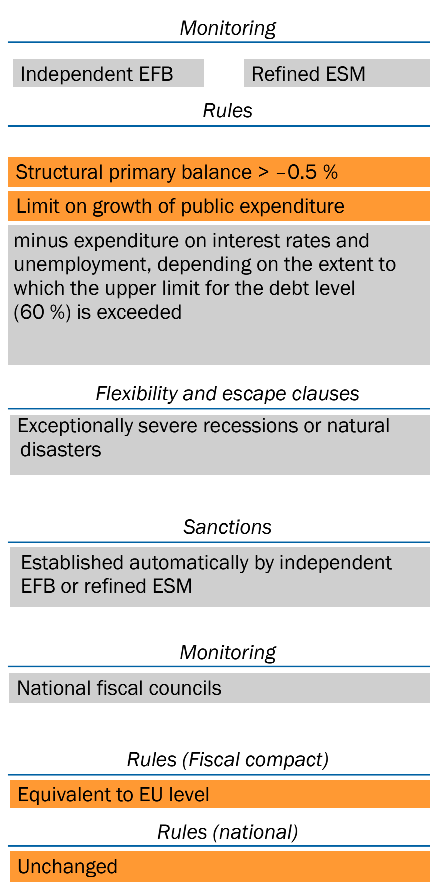
German Council of Economic Experts developed a proposal back in 2017 that achieves these objectives (GCEE Annual Report 2017 items 98 ff.; GCEE Annual Report 2018 items 61 ff.). ↘ CHART 43

↘ CHART 3

Simplification of the EU fiscal framework as proposed by the German Council of Economic Experts

Existing rules | **GCEE proposal**





1 – Country-specific Medium Term Objectives (MTO), structural primary balance maximum –1 % of GDP. 2 – Adjustment path may depend on debt-to-GDP ratio and the output gap. 3 – Net public expenditures calculated by netting out interest expenditures, cyclical elements of unemployment spending, spending on programmes funded by the European Union, four year average of investment expenditures as well as one-off measures. 4 – Assessment of compliance based on the average adjustment over the past three years. 5 – Deviation from the MTO or adjustment path in event of reforms to strengthen the sustainability of national pension systems (fully financed multi-pillar system). 6 – According to the definition of the European Commission, qualified reforms must be substantial, long-term, promise positive budgetary effects, and be implemented in a binding legal form. The initial deviation from the MTO must not exceed 1.5 % of GDP. The annual deviation must not exceed 0.5 % of GDP. Cumulative deviation must not exceed 0.75 % of GDP. The exception may only be used once in the context of the adjustment path to the MTO. 7 – By their very nature and impact of action, qualified investments must be similar to structural reforms and hold the prospect of a positive effect on potential growth. Investments must qualify for co-funding through the European Regional and Cohesion Fund. The current growth in the member state concerned must be negative, as must be the output gap. The maximum annual deviation must not exceed 0.5 % of GDP. The cumulative deviation must be less than 0.75 % of GDP. The deficit limit of 3 % of GDP may not be exceeded during the entire period. The exception may only be used once in the context of the adjustment path to the MTO. 8 – Includes severe recessions in the euro area and the European Union. 9 – Must be determined by the European Commission and followed by a subsequent request by the European Council for a decision to be made. Voting in the European Council by qualified majority. Sanctions can be up to 0.2 % of GDP (up to 0.5 % of GDP in the EDP). Other types of sanctions may involve the suspension of commitments or payments under the European Structural and Investment Funds. 10 – Country-specific Medium Term Objectives (MTO), structural primary balance maximum –0.5 % of GDP. 11 – Rules valid in 2017 and beyond.

Source: European Commission, own representation

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103. Some experts currently **argue** that the renewed application of the **fiscal rules following the coronavirus crisis would be unrealistic** because the path back to a debt target of 60 % is too long for some Member States with very high debt ratios and therefore the application of the 1/20 rule would require savings to be made too quickly (Martin et al., 2021). Considering the experience since the financial crisis, it is indeed **questionable whether** it is **still even realistic to expect** that the application of the fiscal rules will **bring down the debt ratios**. It obviously made sense to allow high deficits and increased debt ratios during the financial crisis and the coronavirus pandemic in order to cushion the impact of the crises. However, only a few Member States – including Germany, the Netherlands and Ireland – managed to significantly bring down their debt ratio again during the recovery following the financial crisis.

In contrast, other Member States have barely made a dent in their debt ratios despite an environment with extremely low interest rates on government bonds. Some **Member States even increased their debt ratio further in the growth phase** before the coronavirus crisis. One example in this context is France whose debt ratio rose from 65 % of GDP before the financial crisis to just below 90 % after the financial crisis. During the recovery and growth phase that followed, the debt ratio rose again to just under 100 %. The coronavirus crisis has pushed it up further to 115 %.

104. Contrasting with these developments, the priority is to **make use of times of economic expansion to reduce high debt ratios**. To achieve this goal, it would make sense to reform the fiscal rules as proposed by the German Council of Economic Experts in 2017, as compliance with fiscal rules can contribute to a more countercyclical fiscal policy (European Commission, 2020a; Larch et al., 2021). The proposed reform reduces the complex set of rules to **two central rules** and **an independent monitoring system**: an expenditure rule as an annual operational target and a structural deficit rule as a medium-term objective.

105. Primary expenditure is under the direct and discretionary control of the government, particularly if expenditure on unemployment insurance – which is sensitive to the economic cycle – is excluded. The maximum permissible change in primary expenditure under the **expenditure rule** would need to remain below average growth of potential GDP. In this context, the maximum permissible difference between expenditure growth and growth of potential GDP could be set as dependent on the gap to the 60 % debt limit, which is enshrined in the Maastricht Treaty. The expenditure rule alone, however, cannot guarantee fiscal sustainability given its focus on one side of the public budget. Fiscal sustainability could be ensured through the Fiscal Compact's **structural deficit rule,** however. The structural deficit rule is more suitable as a medium-term objective rather than as an operational rule – as currently the case – because measurement errors are associated with the use of structural variables. In addition, it would be necessary to have the **set of rules monitored** by independent fiscal councils, which would need to have sufficient resources.

106. **If Member States actually commit to an effective expenditure rule** to this effect through a reform of the rules and abolish the many exceptions to the

rules, it would be reasonable to assume that expenditure growth would be slower than economic growth in good economic times and that the debt ratio would decline considerably. With this reformed set of rules, it would be **conceivable to extend the time** for highly indebted Member States **to approach the reference value of 60 % to a period of over twenty years** if substantial and continuous progress is made. The 60 % threshold set down in the SGP should not be abandoned, however.

↘ BOX 10

Proposed reforms for European fiscal rules

The German Council of Economic Experts (GCEE) has stated that a reform of the fiscal framework could allow fiscal rules to create more fiscal scope in better economic times and counteract procyclical policies (GCEE Annual Report 2020 item 301). For this, it is desirable for the rules to rely on variables, where possible, that are under the direct control of policy makers and are associated with smaller revisions of real time estimates. This applies to a larger extent to public expenditure than to the structural deficit, which currently plays a prominent role in the set of fiscal rules. For this reason, as far back as 2017 the GCEE put forward a proposal to simplify the complex set of rules and to refocus them on two central rules and independent monitoring, wherein the operational rule would be an **expenditure rule** (GCEE Annual Report 2017 item 98). A broad range of academics and institutions also put forward a proposal for an expenditure rule of this kind (Andrle et al., 2015; Bénassy-Quéré et al., 2018; Christofzik et al., 2018; Darvas et al., 2018; Deutsche Bundesbank, 2019; EFB, 2019). Common to all is the principle that growth in public expenditure (minus interest expenditure and unemployment support) may not outpace growth of potential output while the difference between the two growth rates must be bigger the higher the debt ratio.

The GCEE's 2017 proposal, however, also retains the Fiscal Compact's structural deficit rule as a medium-term objective, as the expenditure rule alone cannot guarantee fiscal sustainability. Supporting their proposal, Feld et al. (2018) argue that the fiscal rules have so far not been sufficiently effective to limit the deficit bias of governments and guarantee the sustainability of public finances. They also want to **strengthen independent fiscal councils**, such as the EFB or the independent Advisory Board to the Stability Council in Germany. Other proposed reforms also want to **improve compliance with fiscal rules** by involving independent institutions as monitoring watchdogs (Bénassy-Quéré et al., 2018; Deutsche Bundesbank, 2019; EFB, 2020) or to enforce market discipline through various types of bonds (Bénassy-Quéré et al., 2018).

A second line of reform proposals focuses on giving **special status to public investment** (Fitoussi and Creel, 2002; Barbiero and Darvas, 2014; Truger, 2015; Deutsche Bundesbank, 2019; EFB, 2020). Depending on the proposed reform a '**golden rule**' is combined with other fiscal rules (Reuter, 2020). For example, within the framework of an expenditure rule the EFB (2020) puts forward exceptions for additional public investments, to be identified based on a comparison with the average country-specific level of public investment under the European System of Accounts (ESA) of the past few years. Another option would be a golden rule combined with a structural budget balance rule (Fitoussi and Creel, 2002; Barbiero and Darvas, 2014; Truger, 2015; Deutsche Bundesbank, 2019). The proposals differ primarily with regard to the amount of deductible investments and how these are defined. The Deutsche Bundesbank (2019), for example, is in favour of a cap at 0.5 % of GDP. Truger (2015), who believes that fiscal policy is too tightly constrained with the Fiscal Compact, recommends 1 % to 1.5 % of GDP. With regard to the definition, the Deutsche Bundesbank (2019) bases its definition on

public investments according to the national accounts, while Truger (2015) takes this as the basis with exceptions (e.g. minus military spending).

Pekanov and Schratzenstaller (2020) as well as Darvas and Wolff (2021) discuss **exceptions only with regard to green public investments.** Darvas and Wolff (2021) recommend the introduction of a "green golden rule", which would allow deficit funding of green public investments. They propose the goal of greenhouse gas emission reduction as a guideline for defining such investments. Pekanov and Schratzenstaller (2020) discuss two additional approaches. For one, an exception clause for green public investment could be added to the SGP. Secondly, the European Commission and the European Council could define country-specific targets for the share of green public investment in government spending. This type of expenditure by Member States should then not be subject to the limits set by the deficit rules of the SGP. Pekanov and Schratzenstaller (2020) recommend basing the definition of green investment on the corresponding taxonomy of the EU.

Proposals for a for-reaching reform of the EU fiscal rules want to **abandon rules in favour of qualitative standards** (Wyplosz, 2019; Blanchard et al., 2021), including standards with a margin of discretion for an acceptable fiscal position. This would require independent institutions that make discretionary decisions within the standards' framework and monitor and guarantee the implementation of the standards.

Within the existing set of rules, the EFB (2020) advocates the introduction of **country-specific adjustment paths** in order to comply with the general debt limit instead of the general rule for a reduction of the debt ratio by at least 1/20. The paths would either depend on macroeconomic variables defined ex ante or be defined on a case-specific basis. The proposal by Martin et al. (2021) goes even further with the introduction of country-specific debt limits. The proposed reform by Francová et al. (2021) also envisages adjustments to the debt rule under the SGP. In addition to raising the limit for the debt ratio to 100 % of GDP, the proposed reform argues in favour of maintaining the 3 % deficit rule. An expenditure rule would help anchor the pace of convergence towards the debt target, calibrated to be reached within a period of 20 years.

3. European fiscal rules (Monika Schnitzer and Achim Truger)

107. In the wake of the coronavirus crisis, the European Commission, with the approval of the European Council, **activated** the **general escape clause** for the years 2020, 2021 and 2022 for the first time since the introduction of the European Stability and Growth Pact (SGP) in 1997. ↘ BACKGROUND INFO 6 As soon as this clause is **no longer** applied, the rules of the preventive and corrective arm of the SGP that currently apply – such as those for the general government budget deficit, the structural deficit, the debt ratio and expenditure growth – become relevant once again.

Under the preventive arm of the SGP, i.e. for Member States that are not under an EDP, the rule applies that a country's structural deficit must be more or less in line with the country-specific medium-term objective (MTO) or on a path towards it at an appropriate pace (European Commission, 2019, p. 15). The necessary pace of adjustment depends on the national economic situation and normally requires a **reduction in the structural deficit in steps of** 0.5 % of GDP

per annum. Under the corrective arm of the SGP, an EDP is opened as soon as the general government deficit of a Member State exceeds 3 % or a deficit of this magnitude is planned. While a violation of the rule to limit public debt can also trigger the opening of an EDP, so far the interpretation has been more flexible in practice. **In the corrective arm of the SGP,** more detailed monitoring rules and requirements with regard to planned national fiscal measures apply.

108. It is **an undisputed fact** that **fiscal rules** are **needed** in light of **political economy considerations** to contain the **deficit bias**, and also for the purpose of fiscal and monetary policy coordination within a monetary union. More recent deliberations on fiscal policy in times of low interest rates (Blanchard, 2019; von Weizsäcker and Krämer, 2021) make little difference to this. Rather, analyses concerning sustainability and interest rate risks ↘ ITEMS 100 FF. demonstrate the continued need to limit debt ratios in the euro area and that the notion of perennially low interest rates, and therefore of self-financing deficits, is anything but convincing.

109. However, it does not therefore ensue that the fiscal rules in the euro area would need to remain unchanged after the crisis and that fiscal policy should pursue an intensified course of consolidation. Rather, the broad range of economic and financial impacts that continue to be felt in many Member States as a result of the coronavirus crisis, coupled with the high degree of economic uncertainty, are arguments in favour of a **cautious fiscal exit strategy that does not jeopardise the economic upturn** and growth prospects.

110. As the euro crisis demonstrated, **substantial fiscal multipliers** and therefore markedly **negative macroeconomic consequences** can be expected from **consolidation policy** (Blanchard and Leigh, 2013; Gechert, 2015; Gechert and Rannenberg, 2018). The acute euro crisis in the countries on the European periphery could only be overcome from 2015 onwards when the European Commission significantly relaxed its interpretation of the fiscal rules and adopted a much less restrictive fiscal policy stance. Only then were the crisis-struck countries able to transition to a more or less neutral fiscal policy which, together with bond purchases by the ECB, lead to a gradual upturn driven by domestic demand and whose outcome, nevertheless, was a significant budget consolidation and an end to the crisis-related rise in the government debt ratios (Truger, 2020).

If some countries were to face another crisis due to an **excessively restrictive fiscal policy** following the coronavirus crisis, quite apart from the economic and social costs this would also drive up the debt ratios and would therefore be **counterproductive from a consolidation policy perspective**. On the other hand, **prudent consolidation efforts** would not jeopardise the expected strong recovery and would also make it easier for the ECB to **normalise monetary policy**. ↘ ITEMS 181 FF.

The fiscal rules, which are currently not applied due to the general escape clause, carry the considerable **risk of an overly restrictive fiscal policy** in some Member States if they are applied without any modifications following the coronavirus crisis. The regulations for the structural deficit in the preventive arm and the deficit criterion in the corrective arm of the SGP would be less problematic

initially, even though this could indeed require additional consolidation efforts on the part of some countries. For example, Spain would need to step up consolidation efforts somewhat more in both 2022 and 2023, and France in 2023, than currently planned in their stability programmes. ↘ CHART 42 LEFT

111. In contrast, the **1/20 rule to reduce the debt ratio** towards the limit of 60 % of GDP **extremely challenging** for some Member States. The debt ratio for the euro area average is expected to rise from 85.8 % in 2019 to 102.4 % this year due to the coronavirus crisis. Even higher increases are expected for a number of economic heavyweights in the euro area whose debt ratios were above average even before the coronavirus crisis: in France, Spain and Italy, the ratio is expected to increase by around 20 percentage points and more to 117.4 %, 119.6 % and 159.8 % respectively (European Commission, 2021d, p. 39).

112. Referring to the need for strong consolidation efforts in countries with high debt levels, in its 2020 Annual Report (EFB, 2020) the independent European Fiscal Board (EFB) **expressed doubts** as to whether it is **at all realistic** for these countries to **comply** with the **current 1/20 rule** governing the debt ratio. In simulations for Italy, the EFB shows that Italy would need to reduce its structural primary balance by around four percentage points in just three years in order to comply with the rule. Active discretionary consolidation on this scale would risk derailing the economic recovery and tip Italy back into a recession.

113. In light of these problems, **the EFB points out** that a **continued implementation of the current rules** once the coronavirus crisis is behind us would ultimately **only be possible at the cost of a relaxation of the rules in practice – in the form of constant exemption decisions and new interpretations –** to the further detriment of transparency: "Compliance with the debt reduction benchmark, [...] is especially going to become a growing challenge for a sizeable group of countries, creating stronger tensions within the current system of rules. Deviations from the debt benchmark and a de facto differentiation of the speed of debt reduction are already being implemented under the current rules by way of new interpretations and by extending elements of discretion and judgement. Unless current rules are given an even wider interpretation, to the detriment of transparency [...] a one-size-fits-all prescription for debt reduction may no longer be tenable." (EFB, 2020, p. 85). The Deutsche Bundesbank (2021d, p. 80), while itself in favour of the swift reapplication of the fiscal rules without modification, supports this assessment given that in its reasoning it points out that the debt rule has ultimately not been adhered to in the past.

114. For the reasons explained above, the EFB strongly advocates **country-specific differentiation** of (intermediate) **debt ratio targets** or the **speed of adjustment** towards a given reference value. In a recent interview with news magazine *Der Spiegel* Klaus Regling, the Chief Executive Officer of the European Stability Mechanism (ESM) and one of the negotiators of the SGP, states that compliance with the debt rule was not feasible for the likes of Italy, for example, and feared that sticking steadfastly to rules that had proven to be economically counterproductive could **result in a loss of credibility** (Regling, 2021). Regling obviously based his argument on an ESM discussion paper in which Francová et al. (2021, S. 15) conclude that compliance with the 1/20 rule for the debt ratio is unrealistic

and therefore keeping the rule would undermine fiscal framework credibility. They propose raising the current reference value of 60 % of GDP for the debt ratio for all Member States.

115. **Another problem** with the current fiscal rules that most of the reform proposals discussed have touched upon ↘ BOX 10 is the **lack of investment focus**. Public investment, as an expenditure category discretionally adjustable in the short term, has faced drastic cuts particularly in periods of crisis and consolidation (Barbiero and Darvas, 2014). Furthermore, there are **good economic arguments for debt financing of public net investments** (Musgrave, 1959; Truger, 2015; Expertise 2007). For this reason, many proposals for reform make provisions for the preferential treatment of public investment spending. While this does pose a problem with regard to the definition and classification of public investment spending and could present a sustainability risk if overused, it should be possible to resolve the problems of classification (EFB, 2019b, p. 77; Expertise 2007) ↘ ITEM 218 and sustainability issues could also be limited by putting caps on preferential status expenditure (Truger, 2020).

116. Against this backdrop, there are strong arguments for a **reform of the fiscal rules** that links **country-specific targets** for the debt level or pace of adjustment with the **preferential treatment of public investment spending**. This could be combined with the advantages of an expenditure rule (EFB, 2020, p. 92 f.). ↘ BOX 10 The slightly slower pace of consolidation and the somewhat higher debt ratio compared to the current set of rules that this implies is unlikely to be a problem in light of the current low interest environment. The analyses conducted also demonstrate that even a relatively sharp interest rate increase in the short-term would not overburden fiscal policy. ↘ ITEM 109 Ultimately, a reform of this kind should be **legally feasible without EU Treaty changes** and therefore **politically realistic** (Repasi, 2013, 2021).