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REFORM PERSPECTIVES FOR EUROPEAN FISCAL POLICY

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This is a translated version of the original German-language chapter "Reform-perspektiven für die europäische Fiskalpolitik", which is the sole authoritative text. Please cite the original German-language chapter if any reference is made to this text.

KEY MESSAGES

↘ The Coronavirus pandemic and the Russian war against Ukraine put pressure on national public budgets and exacerbate the tension between debt sustainability and public task fulfilment.

↘ A binding expenditure rule could make the EU fiscal rules more verifiable, limit risks for debt sustainability, have a stabilising effect on the economy and expand the scope for investment.

↘ Reforms should go beyond the design of fiscal rules to enable possible financing of joint European projects and a stable financial market.

EXECUTIVE SUMMARY

The fiscal measures to cushion the economic consequences of the coronavirus pandemic have put a **strain on public budgets across Europe**. With the **Russian war** against Ukraine, which also accelerated inflation, **major additional fiscal challenges** were posed to European countries. Thus, further **fiscal measures** became necessary to support households and firms as well as to secure energy supplies and improve defence capabilities. EU-level fiscal rules, including the general escape clause, basically provide the necessary leeway for appropriate responses during such crises. However, ensuring debt sustainability is a challenge for some EU member states due to high debt-to-GDP ratios and rising interest rates. In view of the **tension between debt sustainability and the fulfilment of government tasks,** government spending must be prioritised, conditions for private capital formation must be improved and the long-standing debate on reforms of the economic and monetary union must be brought to a conclusion.

The **reform proposals** currently discussed **for the economic and monetary union** focus on **three aspects:** First, there are proposals to reform the **EU fiscal rules**. So far, the main objective of these rules, to ensure sustainable public finances, has only been achieved to a very limited extent. Moreover, the EU fiscal rules repeatedly failed to enable fiscal policy to stabilise the economy. In the past, fiscal policy was therefore often pro-cyclical and also had too little incentive and scope for forward-looking spending. Secondly, there are proposals to establish a European **fiscal capacity.** These aim at more effective solutions for the absorption of asymmetric shocks or a joint financing of tasks that are in the European interest. Thirdly, reform steps are proposed to strengthen the resilience of the **financial market** so that in crises, national budgets are not additionally burdened.

A reform of the economic and monetary union should both **ensure debt sustainability and guarantee** the **fulfilment of government tasks**. A comprehensible and binding expenditure rule can contribute to this, at the same time reducing the problem of pro-cyclical effects. The establishment of a permanent fiscal capacity would be associated with difficulties in terms of political economy. Additional funds at the European level, for example through higher national contributions or own EU revenues, could however be used for tasks with a European added value. Financial markets could contribute to a more resilient monetary union if the banking and monetary union were completed.

I. INTRODUCTION

199. Since 2020, fiscal policy has launched **unusually extensive support measures** for companies and private households across Europe. The aim of these fiscal measures has been to cushion the economic impact of the coronavirus pandemic and the recent sharp rise in energy prices. The fiscal policy of the member states of the European Union (EU) was flanked by the expansionary monetary policy of the European Central Bank (ECB) and the temporary recovery fund NextGenerationEU (NGEU).

200. To finance these short-term fiscal measures, the EU member states have significantly increased their new borrowing. To make this possible, the **exception clauses** in the respective **fiscal rules were invoked** at European and national levels. For 2023, the exception clause in the EU fiscal rules will continue to be applied with reference to the worsened economic outlook following the outbreak of war in Ukraine (Gentiloni, 2022). A key challenge for the coming years will be to return to the application of the EU fiscal rules. On the one hand, a quick return is desirable to ensure the medium-term sustainability of public debt in view of sharply increased debt levels and rising interest rates. On the other hand, accelerated fiscal consolidation could be difficult for some countries, as the effects of the current energy crisis are likely to continue for longer and affect economic recovery. In addition, the energy crisis is putting additional strain on **national general governments**. The urgent transformation of the energy supply will now have to get by without energy supplies from Russia, and defence spending will increase.

201. The challenges must not be reduced to a problem of public budgets. Rather, it is of key importance to create market-based incentives for **private investment** and behavioural change through **regulatory frameworks** – such as a consistent pricing of carbon emissions. Many financing needs will have to be covered for the most part by the private sector. Regulatory barriers must be limited and planning and approval procedures simplified. Where government spending is required, the necessary scope should also be generated by prioritising expenditure.

202. European fiscal policy is caught between sustainability risks and increased demands on the fulfilment of government tasks. The institutional architecture should therefore be designed in such a way that the member states have an incentive and the ability to make their public finances sustainable and, at the same time, tackle essential public tasks for the future. Against this backdrop, and in view of the European Commission's forthcoming proposal to reform the EU fiscal rules, **the discussion on reforms of the economic and monetary union** is of considerable importance.

203. The **fiscal rules** are at the centre of the reform debate. Their purpose is to **prevent excessive debt** to ensure medium-term sustainability. At the same time, they should have a **counter-cyclical effect** to stabilise the economy and **provide financial leeway** for future-oriented spending. ↘ ITEMS 226 FF. The rules in their current form and application have been criticised for some time in view of

the very high levels of public debt in some member states, the often pro-cyclical effects of the rules and the very limited financial leeway of some EU states. Furthermore, there is criticism of the rules' considerable complexity and lack of transparency, their lack of acceptance (ownership) in the member states, and the weak enforcement of the rules. ↘ ITEMS 232 FF.

204. However, **focusing exclusively on reforming the fiscal rules is not sufficient** to ensure a resilient and growth-oriented economic and monetary union. Because of the single monetary policy in the monetary union, there are increased demands on member states' national fiscal policies when it comes to stabilising asymmetric shocks. This increases the likelihood that they will reach the limits of their fiscal space. ↘ ITEM 245 With the European Stability Mechanism (ESM), an institution exists that can provide support with loans in such cases. Some reform proposals aim to set up a **European fiscal capacity** ↘ GLOSSARY that provides additional funds for certain tasks at the European level. For example, it could automatically support member states with transfers for stabilisation following asymmetric or asymmetrically acting shocks. However, this kind of risk sharing is problematic because of possible false incentives. ↘ ITEMS 247 FF.

A European fiscal capacity is furthermore associated with the financing of tasks that could be located at the European level – because of efficiency and cost advantages – and thus generate **European added value**. ↘ ITEMS 254 F. The EU budget already offers various possibilities for this. Some reform proposals envisage expanding these possibilities and making them more efficient. Some of the proposals for a fiscal capacity also make a distinction between a permanent and temporary design or between credit- or contribution-based financing. ↘ ITEM 252

205. Another part of the reform debate looks at a **stronger European integration of the financial markets**. Payment difficulties in the financial markets, especially at banks, have in the past prompted EU member states to help out with state funding so as not to jeopardise the financing of companies and households. At the same time, sovereign payment difficulties can lead to high losses for banks. ↘ ITEMS 256 FF. Reducing the interlinkages between states and domestic banks (**sovereign-bank nexus**) and completing the Banking and Capital Markets Union can make the European financial market more attractive and crisis-resistant, making the need for government support for banks less likely. ↘ ITEM 260

206. Possible reforms can be legally embedded in different ways. The most far-reaching would be an amendment of the European Treaties in order to **bundle** all the **reform areas** mentioned and to **enshrine them institutionally** in primary law. While the European Commission has the right of initiative for the upcoming fiscal rule reform proposal, such a change in the treaty would have to be decided unanimously by the European Council (Treaty on the Functioning of the European Union, Article 126(14)) and adopted by all member states in accordance with their constitutions (Treaty on European Union, Article 48(6)). This seems unlikely at present because there is little agreement among EU member states on how market discipline and risk sharing should be prioritised (Bénassy-Quéré et al., 2018).

Alternatively, **reform proposals** can also **be initiated within the existing treaties**. In particular, the interpretation of some rules of the preventive arm of the Stability and Growth Pact ↘ BOX 12 could be changed by a simple majority in the European Parliament and a qualified majority in the European Council (Nguyen, 2022). Depending on the design, however, unanimity may be required if changes in interpretation necessitate adjustments to secondary legislation (Dullien et al., 2022). However, further modifications of the already complex regulatory framework entail the risk that any changes will not lead to the desired aim of simplification and greater transparency.

II. INITIAL POSITION AND PROSPECTS IN FISCAL POLICY

1. Consequences of the coronavirus pandemic

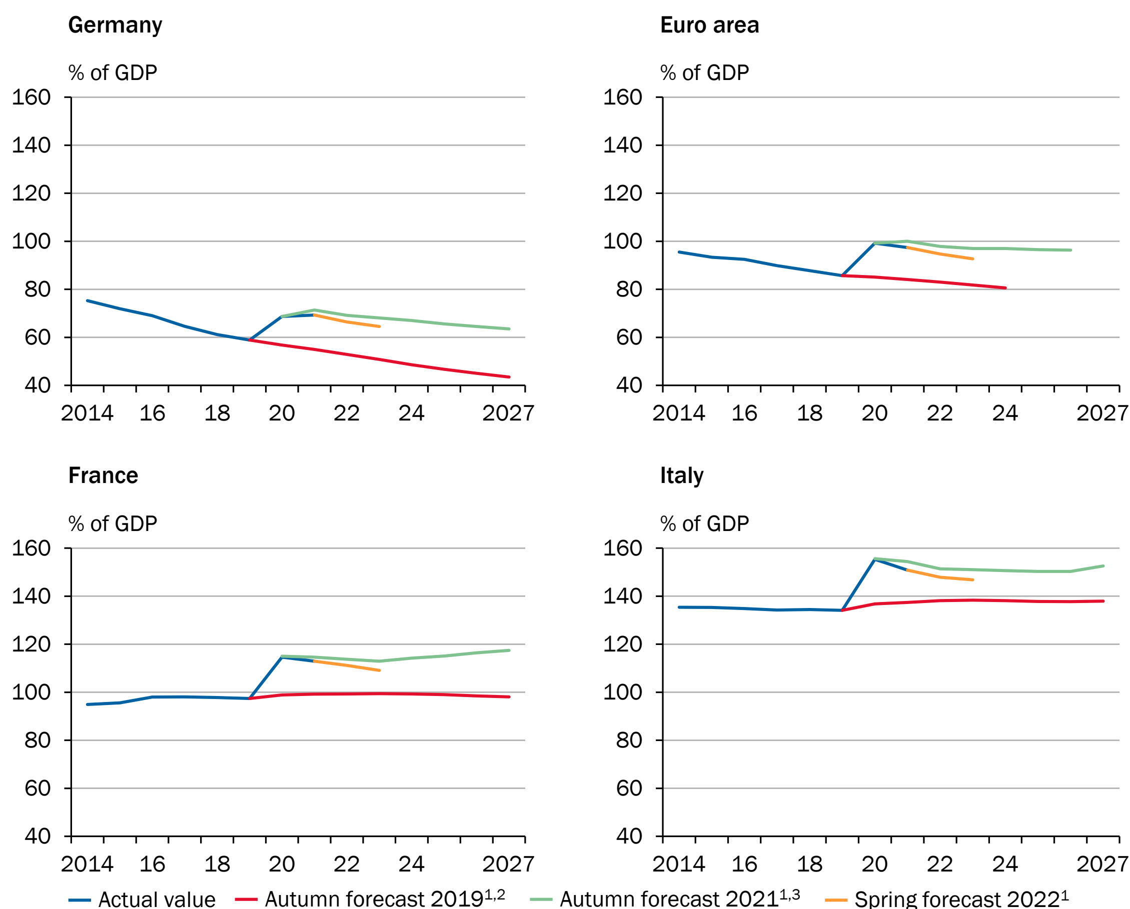
207. Countries worldwide have taken **extensive fiscal measures** to cushion the economic consequences of the coronavirus pandemic (GCEE Economic Outlook 2021 item 6). In combination with far-reaching monetary-policy measures, these measures limited the economic slump and supported the recovery process. In addition to national measures, the EU member states have also backed **joint fiscal support measures**. These include temporary loans for national short-time work schemes (SURE), facilitated access to ESM programmes and additional loans via the European Investment Bank, EIB (GCEE Annual Report 2020 items 260 ff.). The most significant fiscal measure is the €750bn NGEU recovery fund, the main element of which is a recovery and resilience facility with loans and grants to member states (GCEE Annual Report 2021 items 190 ff.). The resources made available for the reconstruction fund are raised by the European Commission on the capital market using its own bonds with joint liability.

208. The discretionary fiscal policies, together with the automatic stabilisers, have led to a significant increase in government debt in the euro area. The **debt-to-GDP ratios** projected by the European Commission in autumn 2021 for the period up to 2027 were 10 to 20 percentage points higher than the projections made in the autumn of the pre-crisis year 2019. ↘ CHART 49 For Germany, the European Commission continues to expect a decline in the debt-to-GDP ratio. According to the Commission's projection, the debt-to-GDP ratios for the euro area as a whole and Italy will decline in the short term and then remain roughly constant. For France, however, the projections indicate a slight increase. ↘ CHART 49 The European Commission's most recent full short-term projection published in spring 2022 points to a slightly more favourable development over the next two years in which debt-to-GDP ratios will decline a little more than was expected in autumn 2021.

209. The debt-to-GDP ratios do not include **debt at the EU level**, for example via the NGEU, or the associated payment obligations of the member states. In order to increase transparency about possible future payment obligations and to ensure

↘ CHART 49

Impact and management of the coronavirus pandemic suggest permanently elevated paths of debt-to-GDP ratios for euro area member states



1 – European Commission projections. 2 – Projection in Debt Sustainability Monitor 2019 based on Autumn 2019 forecast. 3 – Projection in Fiscal Sustainability Report 2021 based on Autumn 2021 forecast.

Source: European Commission
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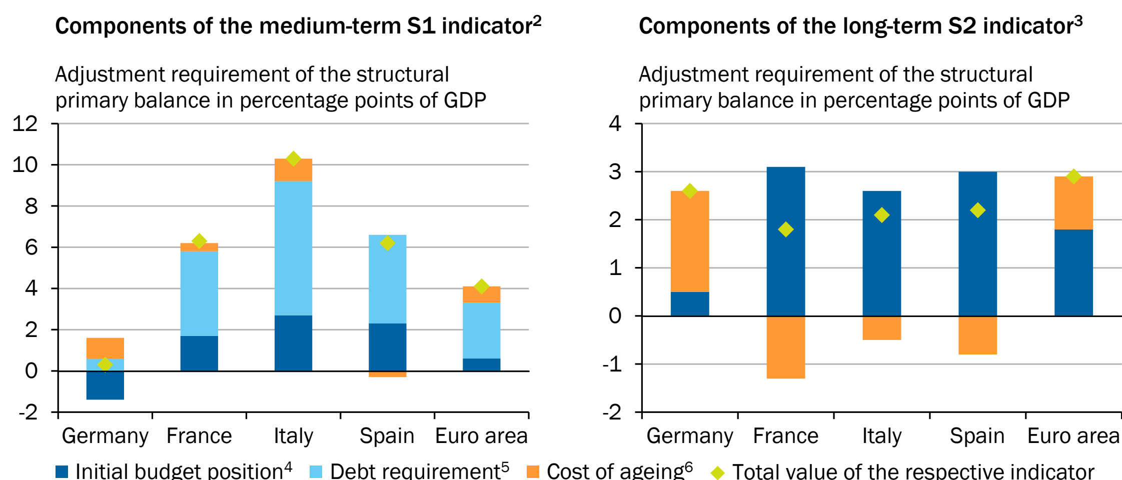
sustainability, the EU's debt could be added proportionately to the national debt levels according to the level of the countries' gross national income (Deutsche Bundesbank, 2022a, p. 79). Future payment obligations, e.g. due to pension and retirement entitlements, are also not taken into account. However, the latter are included in **sustainability calculations**, for example in the S1 and S2 indicators of the European Commission (European Commission, 2022a). ↘ CHART 50 The differences in the need for adjustment to ensure long-term sustainability (S2 indicator) are much smaller between the four largest states of the EU and the euro area than in the case of the need for adjustment to ensure medium-term sustainability (S1 indicator) or in the debt-to-GDP ratios (GCEE Annual Report 2021 item 101). While in Germany there is a considerable need for adjustment of the structural primary balance in the long term, mainly due to the high costs of ageing, in the other three countries the current high level of debt is the determining factor for the S2 indicator. In these states, at least according to current legislation, the costs of ageing are declining relative to GDP, which makes a positive contribution to sustainability.

↘ CHART 50

Sustainability indicators of the EU Commission show smaller differences in long-term than in medium-term adjustment needs[1]



1 – European Commission estimates for 2021. 2 – The S1 indicator quantifies the cumulative adjustment required in the structural primary balance over five years to reach a debt-to-GDP ratio of 60 % within 15 years. 3 – The S2 indicator quantifies the cumulative adjustment to the structural primary balance that is required to stabilize the debt ratio over an infinite horizon. 4 – Corresponds to the difference between the prevailing structural primary balance and the target value for the balance that would stabilise the debt ratio in the long term. 5 – Corresponds to the necessary adjustment to the structural primary balance that is required to reach the target debt ratio of 60 % of GDP within a prespecified time of 15 years. 6 – Corresponds to the necessary adjustment of the structural primary balance to cover the costs of ageing. This includes the costs of pensions, health care, long-term care and education. For details see European Commission (2021).

Source: European Commission (2022a)

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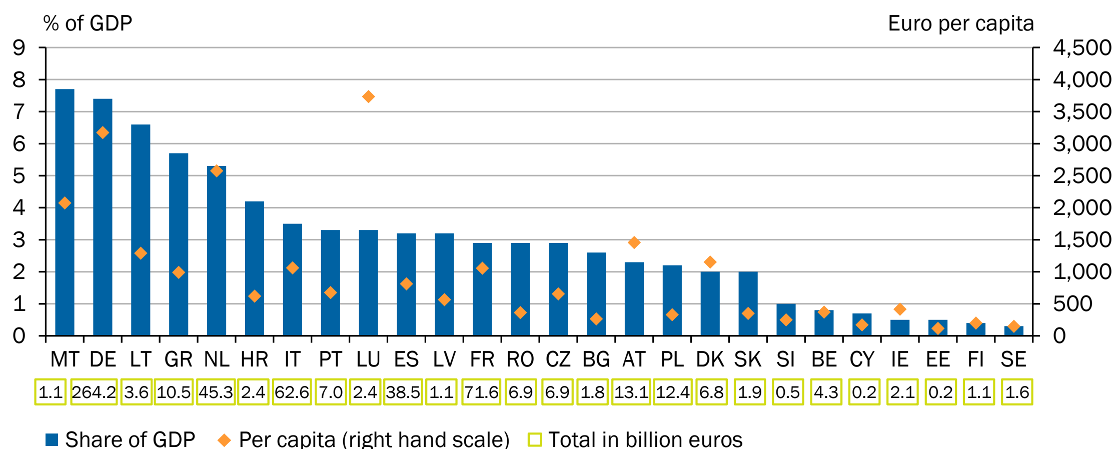
2. Effects of the war

210. The **war in Ukraine**, high energy prices and ongoing supply-chain disruptions are creating a lot of uncertainty and many downside risks. In view of this, the European Commission decided in May 2022 to continue **applying the general exception clause of the Stability and Growth Pact in 2023** (European Commission, 2022b). The exception clause has thus applied continuously since 2020, allowing EU member states within the Stability and Growth Pact to take budgetary measures in the event of a severe economic downturn in the euro area or the EU (GCEE Annual Report 2021 item 117).

211. In order to cushion the **impact of the Russian war of aggression** against Ukraine and the resulting accelerated price rises, especially for energy carriers, ↘ ITEM 8 the EU member states have announced – or already implemented – **comprehensive fiscal policy measures.** Relative to GDP, the measures are most extensive in Malta and Germany at over 7 % as of 20 October 2022. In absolute terms, the measures in Germany are by far the largest to date. ↘ CHART 51 Transfers to needy population groups, reductions in energy and sales taxes and support payments to companies are mainly used for providing short-term relief. ↘ ITEM 151 In addition, there is higher spending on defence and the conversion of the energy supply, which is likely to extend over a longer period of time (Blanchard and Pisani-Ferry, 2022).

↘ CHART 51

EU member states respond with fiscal measures to the burden of energy price increases on households and businesses[1]



1 – For the period September 2021 to October 2022. As of 20 October 2022. The compilation includes fiscal measures at the national level to protect households and companies from the burdens of high energy prices: Reduced energy taxes and/or sales taxes, regulations on retail and wholesale prices, transfers for vulnerable groups, mandates to state-owned companies, taxes on windfall profits/regulations, support measures for companies. MT-Malta, DE-Germany, LT-Lithuania, GR-Greece, NL-Netherlands, HR-Croatia, IT-Italy, PT-Portugal, LU-Luxembourg, ES-Spain, LV-Latvia, FR-France, RO-Romania, CZ-Czechia, BG-Bulgaria, AT-Austria, PL-Poland, DK-Denmark, SK-Slovakia, SI-Slovenia, BE-Belgium, CY-Cyprus, IE-Ireland, EE-Estonia, FI-Finland, SE-Sweden. No meaningful data for Hungary.

Sources: Eurostat, Updated version of Sgaravatti et al. (2021), own calculations
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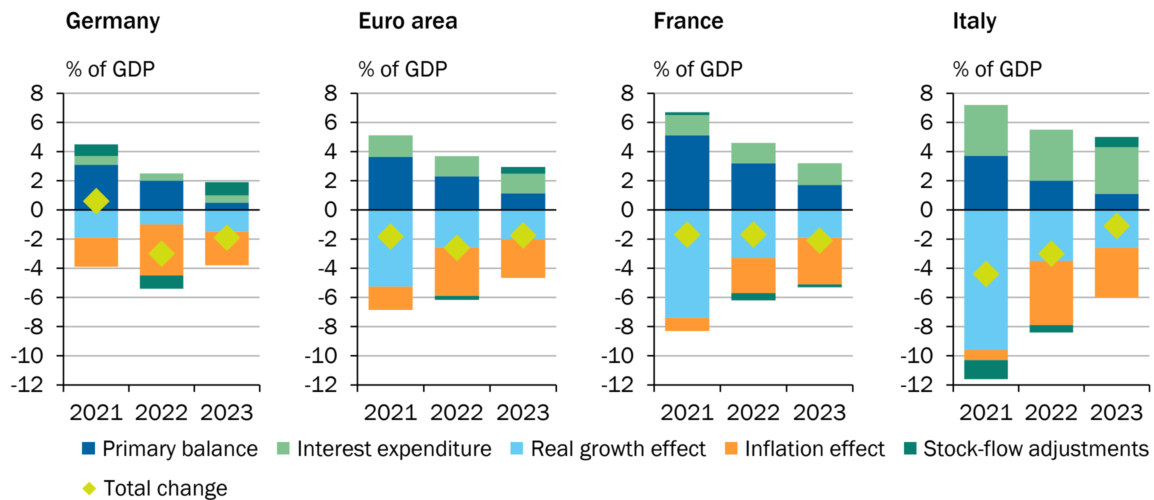
Short- and long-term effects of inflation on fiscal policy

212. The European Commission's spring forecast on changes in the **debt-to-GDP ratios** up to 2023 shows **inflation as a major influencing factor**. ↘ CHART 52 The primary balances (balance minus interest expenditure) ↘ GLOSSARY have a decreasing, interest expenditure an increasing effect on the debt-to-GDP ratios. Real economic growth, especially in 2021, and **inflation** from 2022 onwards have led to a **significant decline**. Overall, the negative effects on the debt-to-GDP ratios dominate, so that in the European Commission's forecast for Germany, France and Italy, as well as for the euro area as a whole, the debt-to-GDP ratios will fall in 2022 and 2023. It should be noted, however, that inflation is likely to increase interest expenditure, which should reduce the overall inflation effect. The mathematical breakdown of the effects in the European Commission's forecast does not allow a causal interpretation in this respect. Moreover, it is not possible to **unequivocally determine the medium- to long-term effect of high inflation** on the debt-to-GDP ratio. ↘ BOX 10

↘ CHART 52

Components that reduce debt ratios predominate into next year[1]



1 – Spring Forecast 2022 by the European Commission.

Sources: European Commission, own calculations

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↘ BOX 10

Effect of inflation on the public debt burden

High inflation is often seen as beneficial for indebted states, as it lowers the real value of the nominal outstanding debt. In addition to this clear effect on the value of the respective debt level, inflation increases both government revenues and expenditures, with a net balance effect that cannot be clearly determined a priori (Deutsche Bundesbank, 2022b). On the one hand, nominal tax revenue rises in the short term, especially from value-added tax. On the other hand, nominal consumption, investment expenditure and transfer payments increase. Compared to a demand shock, a supply shock increases the probability that the overall effect will be negative, as higher inflation is accompanied by lower growth (Mosk and Welz, 2022).

Added to this is a **possible increase in key policy rates by central banks** in response to rising inflation. This leads to an increase in the government's interest expenditure, which is all the greater the more heavily the government has indebted itself with short-term or inflation-indexed government bonds. ↘ BACKGROUND INFO 10 Rising nominal interest rates are primarily intended to **dampen demand** and thus **slow down price increases** (Mosk and Welz, 2022). However, knock-on effects such as lower growth can lead to declining government revenues. In addition, expenditure could rise as a result of higher unemployment figures.

If inflation is due to a **negative supply shock**, economic growth will be lower than in the case of demand-driven price increases. If the central bank reacts to a supply shock by taking restrictive measures, the government therefore has to deal with greater problems due to rising costs and lower growth. In this case, the interest rate-growth differential develops less favourably than in the case of demand-induced inflation, as interest rates rise, but growth is lower. This could lead to problems for highly indebted countries, particularly in terms of their debt sustainability (GCEE Annual Report 2021 items 102 ff.).

In the short term, **high inflation leads to the** already mentioned **mechanically reducing (one-off-) effect on debt-to-GDP ratios**, as nominal economic output serves as the reference value. Fukunaga et al. (2022) assume an average reduction in debt-to-GDP ratios of 0.7 percentage

points in the following year in the case of inflation that is 1 percentage point higher – assuming that the credibility of the central bank and the monetary policy framework remain unchanged.

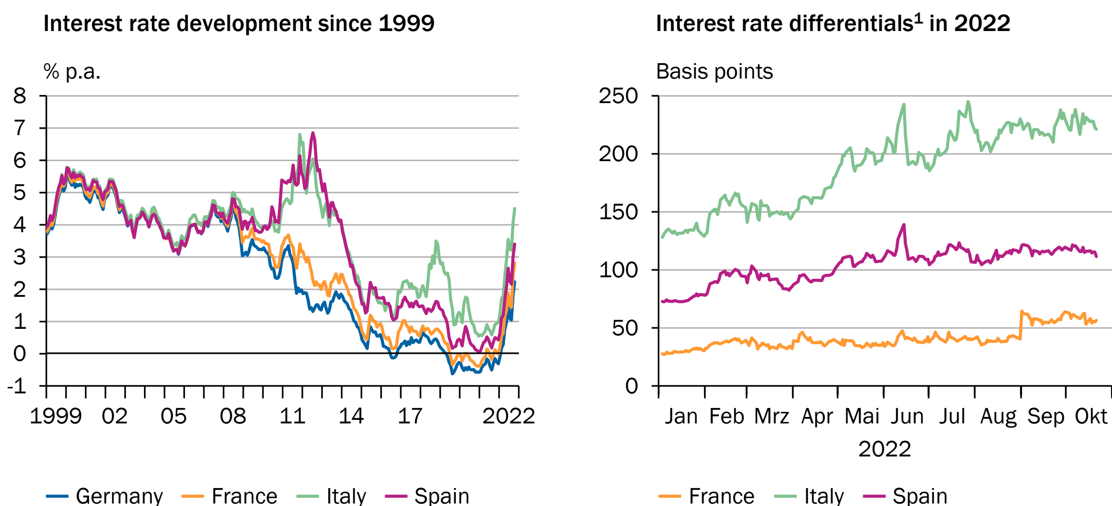
Unexpectedly high inflation should thus initially lower debt-to-GDP ratios. However, this effect could **lose significance the longer inflation and the expectations of inflation remain high.** A central bank that is focused on price stability should then react with corresponding interest-rate hikes to dampen demand and thus dampen growth. Rising interest rates would then lead more quickly to higher interest expenditure and cause the interest rate-growth differential to rise.

Effects on interest expenditure

213. Although inflation began to rise as early as 2021, it increased further when the Russian war of aggression began. The subsequent and expected interest-rate hikes by central banks ↘ ITEM 12 led to a marked rise in government bond interest rates. ↘ CHART 53 The danger this poses to the sustainability of government debt is reflected in the **projections for interest expenditure** in relation to GDP. With interest rates rising by three percentage points, the current baseline scenario is within the range of the most pessimistic scenario from last year's GCEE Annual Report (GCEE Annual Report 2021 items 107 ff.). ↘ CHART 54

214. Even the current **level of interest rates** is likely to result in rising interest expenditure ratios for the countries in the euro area in the coming years. ↘ CHART 54 Scenarios in which interest rates for all maturities (parallel shift in the interest-rate curve) rise by only one percentage point, i.e. roughly to the level of the early 2000s, would lead to higher interest expenditure ratios in France, Italy and Spain than at the time of the European sovereign debt crisis. However, since average

↘ CHART 53
Rising interest rates burden public finances
10-year government bonds of selected euro area member states



1 – Difference between the interest rate on 10-year government bonds of the respective state and the interest rate on 10-year government bonds of Germany.

Sources: Refinitiv Datastream, own calculations

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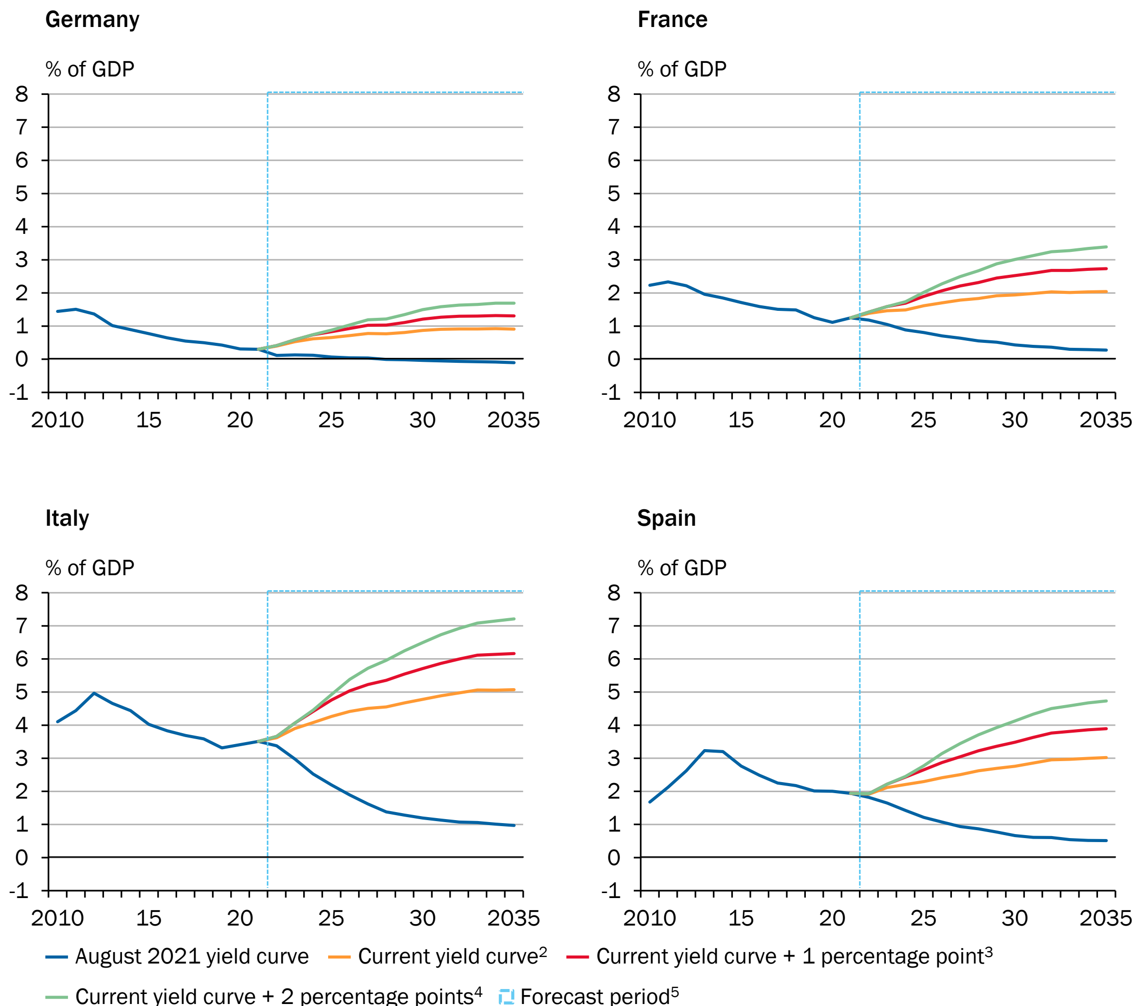
↘ CHART 54
Scenarios for central government interest expenditure[1]



1 – Assuming that the debt ratio from 2021 remains constant in all subsequent years. 2 – Yield curve of 7 October 2022. 3 – Assuming that the current yield curve increases in 0.5 percentage point steps yearly from 2022 until 2023. 4 – Assuming that the current yield curve increases in 0.5 percentage point steps yearly from 2022 until 2025. 5 – Scenario calculations are based on the outstanding bonds of the central government. From 2022 on, new issuances follow the maturity structure of the year 2019. For GDP, the IMF October 2022 forecast is used.

Sources: Agence France Trésor, Deutsche Finanzagentur, Eurostat, IMF, Ministry of Finance Italy, Ministry of Finance Spain, Refinitiv Datastream, own calculations
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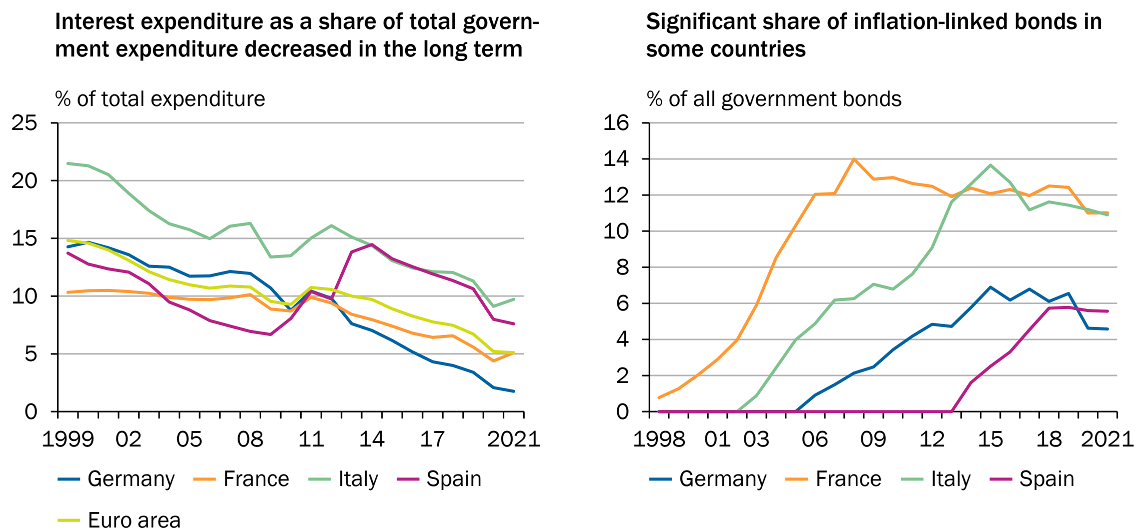
maturities have increased in recent years, the very sharp increase in the interest expenditure ratio would only occur with a certain time lag (Grimm et al., 2022). In any case, the development that has already occurred points to the **end of the phase of** falling interest expenditure for **the time being**. ↘ CHART 53 LEFT

215. Purchases of government bonds by central banks have had a strongly dampening effect on government bond interest rates in recent years. The rise in interest rates and the end of net purchases of government bonds were accompanied by sharply rising **spreads on bonds of highly indebted euro states** compared to German bonds. ↘ CHART 53 LEFT With the justification of securing monetary policy transmission in the euro area, the ECB launched the **Transmission Protection Instrument (TPI)**. ↘ ITEM 146 Under this instrument, purchases of a theoretically

↘ CHART 55
Interest expenditure ratios and indexed government bonds[1]



1 – Related to the Central Government.

Sources: Eurostat, National Debt Management Agencies, own calculations
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unlimited number of government bonds are possible. Inasmuch as this instrument continues to have a dampening effect on interest rates, a sharp rise in interest expenditure ratios in the countries concerned could possibly be avoided.

216. In the case of **inflation-indexed bonds**, an increase in inflation automatically leads to an increase in the government's interest expenditure. Inflation-indexed bonds account for about 5 % of outstanding central government bonds in Germany and Spain, but about 11 % in France and Italy. ↘ CHART 55 RIGHT The observed increase in interest expenditure relative to total government expenditure in France in 2021 was due to the increase in inflation. ↘ BACKGROUND INFO 10 The increase in Italy was also probably partly due to inflation-indexed bonds. Inflation-indexed bonds could accelerate the possible turnaround in interest expenditure ratios.

↘ BACKGROUND INFO 10

Interest expenditure in the case of inflation-indexed bonds

For 2021, the French National Institute of Statistics and Economic Studies (Insee) reported an **increase** of €8.8bn **in interest expenditure on inflation-indexed bonds** for France (Insee, 2022a). This more than offsets the further decline in interest expenditure on fixed-rate bonds in 2021, resulting in an overall increase in interest expenditure (Insee, 2022b). In 2022, interest expenditure on inflation-indexed bonds is expected to increase further because of higher inflation. In the case of inflation-indexed bonds, a large proportion of the interest expenditure caused by higher inflation rates is not incurred until maturity. In order to avoid special burdens as a result of very high final payments, provision is made for this in a special fund in Germany every year. In April of this year, this special fund – called “Provision for Final Payments for Inflation-Indexed German Government Securities” – was topped up by €4.4bn (BMF, 2022a). At the end of July 2022, there was €9bn in the special fund (BMF, 2022b).

217. In addition to the effects on government spending, rising interest rates are currently also having an impact on government revenue. **The central banks** will not be making any **pay-outs** for the time being, for example in Germany (Deutsche Bundesbank, 2022b). Until the coronavirus pandemic, these pay-outs to the federal budget amounted to about €2.5bn per annum. In the context of quantitative easing, central banks have bought large amounts of long-term, low-interest bonds in recent years. They financed the bond purchases with variable-rate central bank money (Deutsche Bundesbank, 2021a; The Economist, 2022). The rise in interest rates thus leads to a faster increase in interest expenses compared to interest income, which weighs on central bank profits.

III. THE REFORM DISCUSSION IN THE ECONOMIC AND MONETARY UNION

1. Between debt sustainability and the fulfilment of government tasks

218. The fiscal effects of the coronavirus pandemic and the Russian war of aggression have increased the **tensions between sustainability risks and the fulfilment of government tasks**. This has intensified the discussion on reforms of the economic and monetary union. Both crises have been accompanied by high unplanned short-term expenditure on crisis management. In the coronavirus pandemic, many EU member states saw a significant increase in public debt, which in some cases was already high. ↘ ITEM 208 Deteriorating growth prospects as a result of the Russian war of aggression ↘ ITEM 2 and fiscal measures to cushion high energy prices ↘ ITEM 211 are now likely to make it more difficult to ensure fiscal sustainability. Moreover, the two crises have highlighted long-term financing needs, e.g. in the health, energy and defence sectors.

To enable EU member states to be prepared for future crises, on the one hand, the **sustainability of public finances must be ensured**. On the other hand, this should not hinder **adequate government task fulfilment** at the national level. Fiscal policy must be in a position to perform its macroeconomic stabilisation function and at the same time contribute to the financing of essential tasks for the future, such as coping with the upcoming **transformation processes**, especially in climate policy and digitalisation.

219. On the one hand, government borrowing for various purposes is well justifiable from an economic perspective. ↘ BOX 11 On the other hand, sustainability risks can set limits to the fulfilment of these purposes. The **sustainability** of government finances is an **essential prerequisite** for the stability of the **monetary union** (Woodford, 1998; Deutsche Bundesbank, 2017; Leiner-Killinger and Nerlich, 2019; GCEE Annual Report 2021 items 99 ff.). Financing problems caused by excessive borrowing by individual states can jeopardise the independence of the joint central bank and limit the effectiveness of monetary policy. Moreover, a high

debt burden restricts future fiscal leeway if interest expenditure accounts for an ever-increasing share of the national budget. In extreme cases, lenders may lose confidence in a state's solvency, so that refinancing is no longer possible. In addition, government borrowing can become excessive for political-economic reasons. ↘ BOX 11 Fiscal rules can contribute to **borrowing being used** in such a way that the fiscal space increases growth and promotes prosperity, **while at the same time limiting it** so that it does not adversely affect sustainability.

↘ BOX 11

Government borrowing: economic rationale and political-economic risks

Excessive government borrowing can affect the sustainability of public finances. **On the one hand,** there are various mainly **political-economic reasons** that explain the long-term increase in government debt in many countries (GCEE Annual Report 2019 items 433 f.). These include, for example, the **tendency** of politicians **to run deficits.** Especially before elections, politicians have an incentive to finance spending programmes through loans instead of raising taxes or cutting spending (Alesina and Passalacqua, 2016). The aim of financing public benefits with loans and satisfying interest groups may be to increase the likelihood of (re)election (Wyplosz, 2013). In addition, excessive borrowing may be a consequence of **short-sighted budgeting**, as debt repayment is not given the required degree of consideration (Krogstrup and Wyplosz, 2010). Moreover, a pronounced degree of **political fragmentation** can lead to higher government spending and deficits (Persson et al., 2003; Mody and Fabrizio, 2006).

On the other hand, there are various **economic reasons** that speak in favour of financing public expenditure by borrowing. First, the government can use credit financing to help **smooth taxes.** Government spending can fluctuate with the business cycle or due to unplanned events such as a pandemic or a war. Covering these fluctuating expenditures by making frequent tax adjustments creates a lot of administrative work and additional burdens (Barro, 1979; Angeletos, 2002). In principle, however, the concept of tax smoothing envisages credit financing that is not permanent, but rather varies with the business cycle.

Second, credit financing can have a **burden-shifting function** and follow the **pay-as-you-use principle** (Musgrave, 1959). Government expenditure that benefits future generations in particular should be co-financed by them. In the spirit of such intertemporal intergenerational equity, investment expenditure on infrastructure as well as spending on research and development should not be financed exclusively by today's government revenues. It is difficult to quantify the respective benefits to current and future generations and to determine the preferences of future generations.

Third, the state has the option of financing **expenditure with loans whose** future **benefits exceed the costs of** loan financing (Musgrave, 1939, 1959). In the context of fiscal rules, exceptions for investment are therefore discussed within the framework of a golden rule. Investment financing by borrowing is controversial because of the need for the government to identify and define worthwhile expenditures (GCEE Annual Report 2019 items 532 and 572; GCEE Annual Report 2021 items 214 ff. and 230 ff.) and because of a possible risk of crowding out private investment (GCEE Annual Report 2019 items 490 and 565).

Fourth, government borrowing fulfils **important functions for the financial markets**. **Safe assets** issued by states considered to be particularly solvent serve for the financial markets as a benchmark for a risk-free interest rate that is needed to price various financial products (Gourinchas and Jeanne, 2012). In addition, institutional investors need government bonds to fulfil their regulatory obligations, such as investing part of the funds they manage in assets that are considered safe (Gorton, 2017).

The above-mentioned reasons for government borrowing **exist independently of the discussion as to whether the level of government debt affects the sustainability of government finances.** Scenarios are conceivable in which an expansion of government debt actually appears to be sensible, but would not be appropriate due to already existing sustainability problems. Similarly, a low level of public debt should not be a reason to take out loans for economically unjustifiable reasons.

220. Expenditure to increase **long-term growth potential** makes a significant contribution to ensuring long-term sustainability. There are different estimates of the size of such future-oriented financial requirements (GCEE Annual Report 2021 item 206). However, there is broad agreement on a considerable need for funding in the areas of climate protection and energy supply, digitalisation, education and, in addition, for defence. It is difficult to determine both the scale of what is needed and how expenditure should be divided between the private and public sectors.

The provision of public goods – such as education and defence, research and development, and infrastructure – requires government spending. Under certain conditions such as positive externalities, start-up financing and credit support for private investment can be added. This is likely to require **considerable budgetary resources.** Against the backdrop of limited resources overall, however, the state must prioritise its spending. A large proportion of growth-enhancing expenditure must come from the private sector. To achieve this, the state must ensure the necessary **framework conditions for private investment**. To this end, regulatory hurdles must be limited, planning and approval procedures simplified (GCEE Annual Report 2021 items 200 ff.), ↘ ITEM 338 and other barriers addressed – such as shortages of skilled workers in certain occupations. ↘ ITEM 355 The EU could help reduce existing regulatory differences in the member states and create uniform market-based structures, for example in the energy market.

221. According to the subsidiarity principle, tasks should be carried out at the European level when joint action offers efficiency and cost advantages, i.e. in the case of **European public goods** (Fuest and Pisani-Ferry, 2019) or a **European added value** (Alesina et al., 2005; Feld, 2005; Bassford et al., 2013; Heinemann, 2018; GCEE Annual Report 2020 items 253 f.). The current EU Multiannual Financial Framework, which sets out EU areas of expenditure for the years 2021 to 2027, is explicitly based on European added-value considerations (European Commission, 2018a). In areas such as the internal market, foreign trade, competition policy, climate protection, as well as the financial and capital markets, key policy areas have already been partially shifted to the European level.

European funding for future tasks has already been put in place via parts of the existing EU budget, e.g. via Horizon Europe. Furthermore, there is the temporary recovery fund NGEU (GCEE Annual Report 2021 items 190 ff.). European funding implies that individual states become net recipients. ↘ ITEM 255

222. The same applies to dealing with **asymmetric shocks**, which can confront an individual state in a monetary union with hardly manageable financial challenges.

Financial transfers by the other member states within the framework of a European fiscal capacity could have a stabilising effect both for the member state and for the euro area. However, this **risk-sharing function is impaired by incentive problems**. For example, there could be incentives to refrain from reforms that would reduce the disbursement of European funds in the event of a crisis. Moreover, a fiscal capacity could reduce the need to pursue a viable fiscal policy in advance. ↘ ITEM 247

2. Dimensions of a reform of the economic and monetary union: an overview

223. Against the background of these areas of tension, various **reform proposals for the economic and monetary union** are being discussed. The most recent reform proposals focus on **three main aspects**: fiscal rules, fiscal capacities and

↘ CHART 56

Discussed elements of a reform of the European Economic and Monetary Union

Fiscal rules

Operational rule to limit the deficit
- ▪ Commitment and transparency
- ▪ Counter-cyclical effect
- ⇨ Central expenditure rule

Debt ceiling
- ▪ Ensure debt sustainability
- ⇨ Central or country-specific debt ceiling
- ⇨ Realistic debt reduction path

Future-oriented expenditure
- ▪ Sustainable growth
- ⇨ Extended investment clause
- ⇨ Golden Rule

Fiscal capacity

Fiscal capacity for shock absorption
- ▪ Automatic macroeconomic stabilisation of the euro area
- ▪ Incentive-compatible design
- ⇨ Common financial resources

Additional funds for the European level
- ▪ European added value through efficiency and cost advantages
- ▪ Contribution to growth and transformation
- ⇨ Common financial resources

Financial market architecture

Completion of the banking union
- ▪ Resilience of the banking system
- ⇨ Joint deposit guarantee
- ⇨ Strengthening of joint bank resolution

States-Banks Nexus
- ▪ Decoupling from risk transfer
- ⇨ Capital requirements for government bonds

Financial market integration
- ▪ Capital mobility
- ⇨ Capital Markets Union
- ⇨ Cross-border bank mergers

Source: own representation
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the financial market architecture. ↘ CHART 56 Reform proposals on **European fiscal rules** aim, on the one hand, to make the rules more binding to ensure sustainability ↘ ITEMS 229 FF. and, on the other hand, to strengthen fiscal policy that has a counter-cyclical effect. ↘ ITEMS 239 F. In bad economic times, there should be enough leeway for sustainable reforms, while, in good times, fiscal rules should encourage discipline to prioritise future-oriented spending. To this end, various proposals focus on reducing complexity and opacity through a stronger focus on an expenditure rule. ↘ ITEM 236 This should be combined, where appropriate, with an adjustment of the debt ceiling or with a privileging of public investment, e.g. through a golden rule. ↘ ITEMS 241 FF.

224. Proposals to establish new **European fiscal capacities** can essentially be distinguished according to their objectives of absorbing asymmetric shocks ↘ ITEM 245 or redistributing fiscal resources across EU member states, for instance to finance tasks with a European added value. ↘ ITEM 254 Furthermore, the proposals differ in terms of the temporary or permanent nature of the fiscal capacity, and in whether they are financed through contributions from EU member states, the EU's own revenues or joint borrowing.

225. Some reform proposals underline the importance of the **financial market architecture** and the possible risks it may pose to government budgets. The proposals refer in particular to reducing the risks of government bonds on bank balance sheets, for example through stricter regulatory capital requirements. ↘ ITEM 260 Other proposals urge the completion of the banking union to strengthen the resilience of the banking sector. ↘ ITEM 257 A common deposit insurance scheme, in particular, is under discussion for completion. ↘ ITEM 259

3. Fiscal rules

226. Fiscal rules impose **long-term numerical limits on government budget sizes**. The fiscal rules in the Stability and Growth Pact (SGP) of the European Economic and Monetary Union are divided into a preventive arm and a corrective arm (European Commission, 2019). ↘ BOX 12 The rules in the preventive arm limit the structural balance and the growth of government expenditure. In the corrective arm, the two rules already laid down in the Maastricht Treaty limit the general government deficit to 3 % of GDP and the debt-to-GDP ratio to 60 % of GDP. In addition, the corrective arm includes the 1/20 rule, which provides for a reduction of debt that exceeds 60 % of GDP by one twentieth per year. These rules are complemented by procedural rules on budget planning and its implementation (European Commission, 2010; Eyraud et al., 2018).

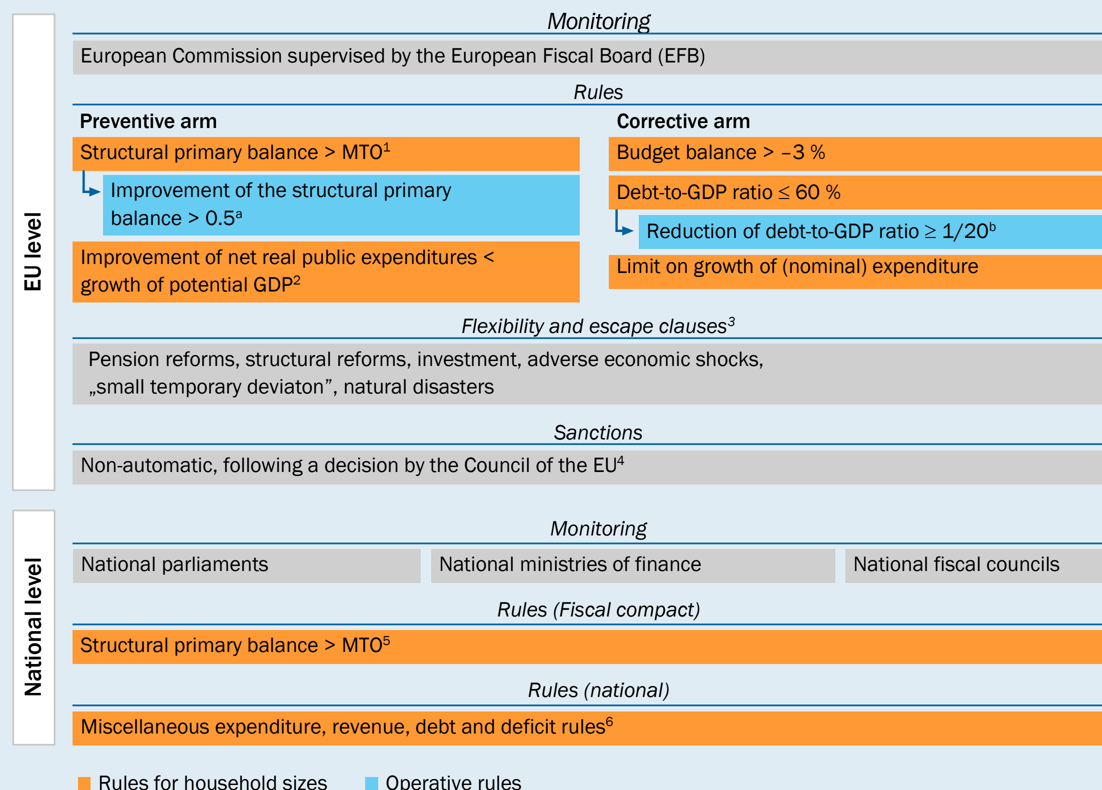
↘ BOX 12

The European fiscal rules currently in force

The **foundation of the European fiscal rules** is the **Maastricht Treaty** of 1992, in which the EU member states laid down uniform limits for the deficit ratio and the debt-to-GDP ratio. The fiscal rules have been continuously expanded and supplemented since then (EFB, 2019; European

Commission, 2022c). The complexity of the European fiscal rules has steadily increased due to initial adjustments in 2005, the extensive “six-pack” reforms of 2011, the European Fiscal Compact in 2013, and an adjusted interpretation in 2015. All these reforms aimed to improve the effectiveness of the fiscal rules, but they also reduced their transparency (GCEE Annual Report 2017 item 95).

↘ CHART 57
Schematic representation of the fiscal rule framework of the euro area



1 – Country-specific Medium Term Objectives (MTO), structural primary deficit maximum 1 % of GDP. 2 – Net public expenditures calculated by netting out interest expenditures, cyclical elements of unemployment spending, spending on programmes funded by the EU and taking into account the four-year average value of investment expenditure as well as individual and special cases. 3 – For details see European Commission (2019). 4 – Sanctions up to 0.2 % of GDP. Sanctions up to 0.5 % of GDP in the context of the Excessive Deficit Procedure. Other types of sanctions may involve the suspension of commitments or payments under the European Structural and Investment Funds. 5 – Country-specific Medium Term Objectives (MTO), structural primary deficit maximum 0.5 % of GDP. 6 – Various national fiscal rules for general and central government. a – Adjustment path may depend on the current debt-to-GDP ratio and the output gap. b – Assessment of compliance based on past and projected debt ratios.

Sources: European Commission (2019), own representation
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On the one hand, the European fiscal rules define **limits for specific budget sizes**; on the other, they specify operational rules if the size of the budget exceeds the target limit (European Commission, 2019). The limits on specific budget sizes include, in the preventive arm, a limit on the structural fiscal balance according to the country-specific Medium-Term Objectives (MTOs), which allow general government structural deficits of up to 0.5 % or 1 % of GDP, and on expenditure growth depending on potential output growth. In the corrective arm, they include public debt ceilings of 60 % of GDP and general government deficits of 3 % of GDP. Operational rules if the size of the budget exceeds the target limit include adjustment paths such as improv-

ing the structural balance by 0.5 % of GDP in the preventive arm and the 1/20 rule in the corrective arm. The rules are monitored by the European Commission in the context of the European Semester and by the European Fiscal Board (EFB). At the national level, monitoring is the responsibility of the national fiscal councils. ↘ CHART 57

Numerous exceptions, e.g. for structural reforms and narrowly defined forms of investment, allow for temporary overruns of the various limits (European Commission, 2019). The European Commission assesses whether a deviation is justified. In the event of an excessive deficit or a lack of debt reduction, the European Commission may propose the initiation of the Excessive Deficit Procedure (EDP). This also requires the consent of the European Council. In practice, the Council has so far approved every proposal by the European Commission to open an EDP (Vespermann and Zuber, 2021).

227. **Fiscal rules** limit the scope for fiscal policy decisions. Their primary aim is to **help avoid excessive deficits** and, as a consequence, enable sustainable public finances. ↘ ITEM 219 ↘ BOX 11 In addition, fiscal rules should fulfil two further requirements (IMF, 2009; European Commission, 2010; Deutsche Bundesbank, 2017; GCEE Annual Report 2020 item 297). First, they should **make it possible to stabilise the economy** and not restrict the effect of automatic stabilisers. To ensure that fiscal policy measures have the necessary leeway in a recession, fiscal buffers must be built up during recovery phases. On the other hand, fiscal rules should **enable** adequate long-term **economic growth**. They can contribute to this by prioritising forward-looking spending and capital formation that has a positive impact on potential output.

228. These requirements provide guidelines for the **design of fiscal rules**. First and foremost, the limits should be chosen in such a way that they are neither too strict nor offer too much leeway that would be inconsistent with fiscal sustainability. ↘ BOX 13 Fiscal rules should have a **counter-cyclical effect** in order to stabilise economic activity. ↘ ITEMS 239 F. This is important above all for economic reasons, since in times of crisis revenues fall at the same time as the need for spending to combat the crisis rises, so that the room for manoeuvre should be more generous. Conversely, deficits must be reduced or surpluses achieved in times of recovery, i.e. the leeway must be correspondingly restricted. In this respect, counter-cyclical fiscal rules are more **credible and enforceable**. ↘ ITEM 233 They also make it possible to plan the budget in the **long term**. Enforceable **sanction mechanisms** and **independent control** also increase credibility and are therefore essential components of the design. ↘ ITEM 234 In turn, **transparent** rules and **comprehensible** formulations are an important prerequisite for effective control by parliaments, the public or independent monitoring bodies. ↘ ITEM 235

Ensure sustainability

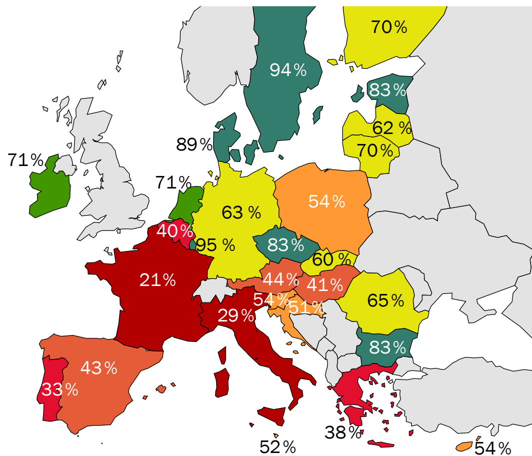
229. EU fiscal rules are designed to **prevent excessive deficits and continuously rising debt-to-GDP ratios**. Nevertheless, debt-to-GDP ratios have been rising in some euro area member states over the long term (GCEE Annual Report 2021 item 100). One reason for this could be the fact that the current fiscal rules are

de-facto not very binding. ↘ ITEMS 231 FF. The EFB's compliance tracker documents compliance with the limits for the deficit rule and debt rule in the corrective arm and for the structural balance and the expenditure rules in the preventive arm (Larch and Santacroce, 2020). Between 2002 and 2019, the average compliance rate across all countries and all four rules was only 60 %. ↘ CHART 58 TOP LEFT Germany is actually just above this with a compliance rate of 63 %.

↘ CHART 58

Differences in compliance with EU fiscal rules

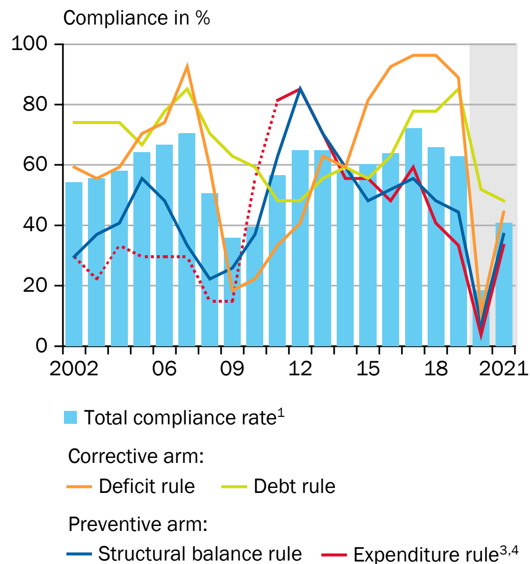
By country



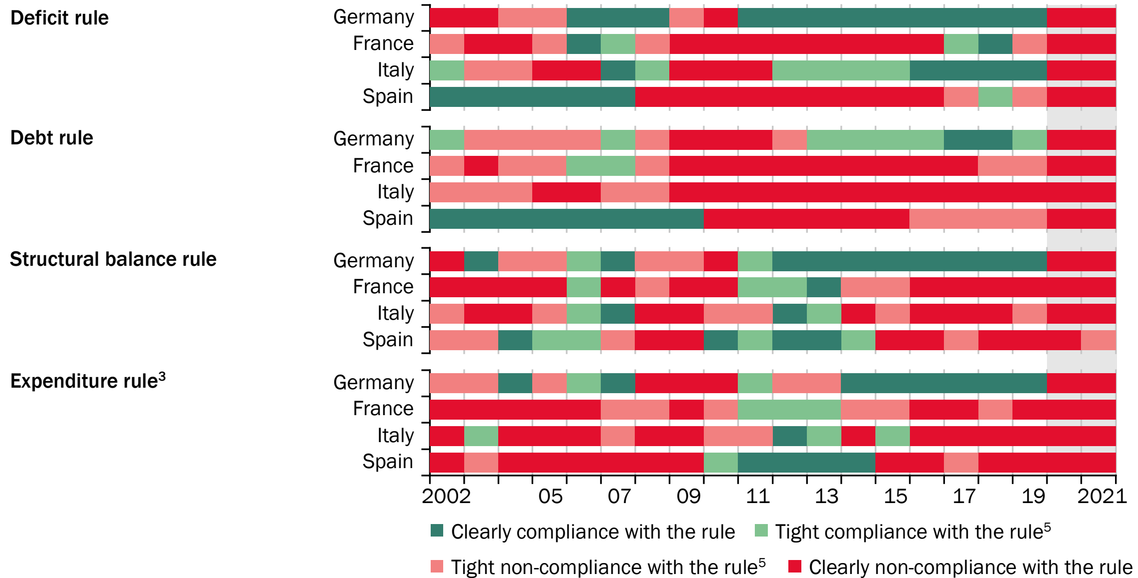
Average compliance rate[1] in the years 2002 to 2019:

- ≤ 30 %
- > 30 % to ≤ 40 %
- > 40 % to ≤ 50 %
- > 50 % to ≤ 60 %
- > 60 % to ≤ 70 %
- > 70 % to ≤ 80 %
- > 80 %
- No values available

About time[2]



By rules[2]



1 – The index takes into account compliance with the debt, deficit and structural balance rules up to and including 2010. From 2011 onwards, it also takes into account compliance with the expenditure rule. 2 – In 2020 and 2021, the exception clause applied. 3 – The expenditure rule became mandatory only in 2011. 4 – The hypothetical compliance with the expenditure rule before 2011 is shown with the dashed line. 5 – Tight (non-)compliance corresponds to a maximum deviation of +/- 0.5 percentage points from the rule limit for the deficit, structural balance and expenditure rule and a maximum deviation of +/- 5 percentage points from the rule limit for the debt rule.

Sources: EuroGeographics for the administrative boundaries, European Fiscal Board, Larch and Santacroce (2020), own calculations

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230. **Compliance with** the fiscal rules is highly **dependent on the economic situation**. ↘ CHART 58 TOP RIGHT Thus, the compliance rate was particularly low in the joint crisis years of 2009 and 2010, as well as in 2020 and 2021. From 2020 onwards, the rule limits were suspended anyway due to the application of the general exception clause.

Even **in economically favourable times, the rules have not been consistently complied with.** ↘ CHARTS 58 BOTTOM AND 65 APPENDIX While national budget compliance with the deficit and debt rule improved after the financial crisis – only Cyprus failed to comply with the deficit rule in 2018 – compliance with the structural balance rule and the expenditure rule has declined since 2011. The reforms in 2011 and the associated introduction of the expenditure rule have thus not led to a sustained improvement in compliance with the EU fiscal rules. This development could be attributed to the fact that the binding force of the rules in the preventive arm is lower than in the corrective arm, or that an increase in complexity in connection with additional exceptions to the rules generally reduces their binding force. The European sovereign debt crisis and its consequences may have made compliance with the rules even more difficult in some states.

231. The **effectiveness of the fiscal rules** in place has been **low** in the past. Despite the strict rule limits and the 1/20 debt-reduction path, EU member states have not reduced their debt-to-GDP ratios sufficiently. The debt-to-GDP ratio for the 15 EU member states to which the rules have applied since the Maastricht Treaty has risen from an average of 71 % in 1995 to 88 % in 2021. Of the nine member states that did not comply with the debt rule in 1995, only four were able to reduce their debt-to-GDP ratio. In the other five member states, the debt-to-GDP ratios have increased, in some cases substantially. While the debt-to-GDP ratios for these five member states exceeded the ceiling by only 22 percentage points on average in 1995, the deviation amounted to around 75 percentage points in 2021.

232. Due to high structural deficits and increased debt-to-GDP ratios, it could be **difficult for some countries to return to the limits** of the fiscal rules after three years of the exception clause. ↘ ITEM 208 For this to happen, their structural balance would have to be above the country-specific medium-term target, and the debt-to-GDP ratio would have to be reduced in accordance with the 1/20 rule if the 60 % limit is exceeded. According to a scenario calculation based on the European Commission's spring forecast, many EU member states would comply with the structural balance rule and the 1/20 rule in 2023. ↘ BOX 13 However, some other EU member states would have to take extremely drastic consolidation measures to achieve the primary surplus necessary to comply with the 1/20 rule.

↘ BOX 13

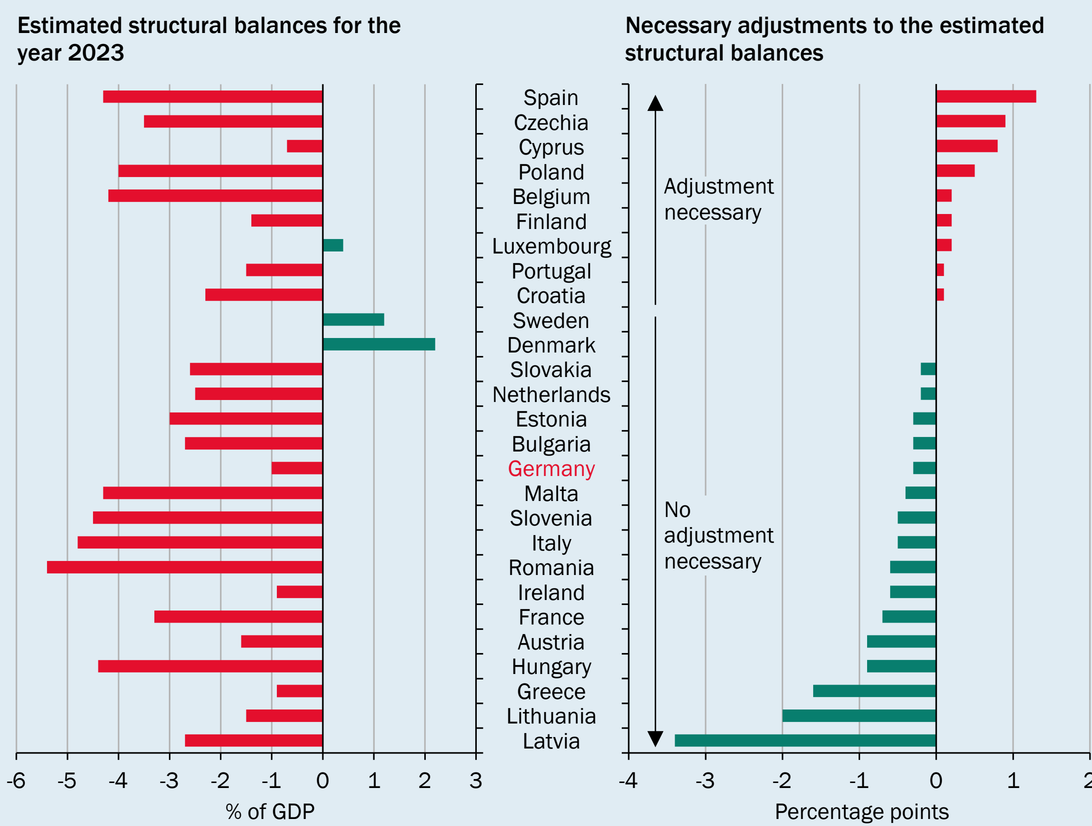
Scenario analysis on compliance with the structural balance and debt rule in 2023

Compliance with the 1/20 rule could mean exceptional fiscal adjustments in times of crisis for states with a high debt-to-GDP ratio (Francová et al., 2021). After the application of the exception clause, **returning to the limits** without a transitional arrangement could therefore be **next**

to impossible for some states. The following section examines, on the basis of the European Commission's spring forecast, whether the EU member states would hypothetically comply with the structural balance and debt rule in 2023 and, if not, what fiscal adjustments would be necessary in order for them to comply.

↘ CHART 59

Estimated structural balances and necessary adjustments[1]



1 – According to the spring forecast of the European Commission.

Sources: European Commission, own calculations
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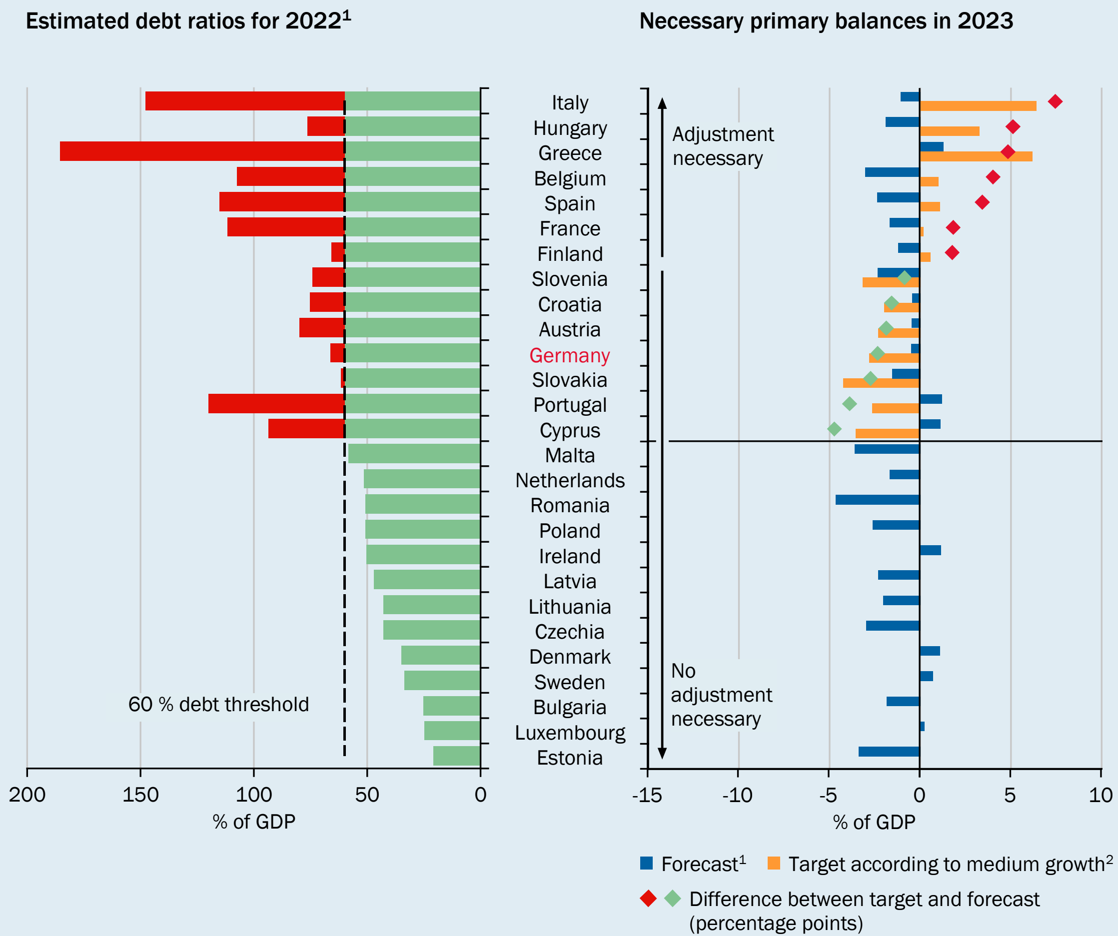
In the spring forecast, the European Commission predicts a structural fiscal deficit for 21 EU member states in 2023 that exceeds the upper limit of the country-specific medium-term objective (MTO) ↘ BOX 12 in each case. ↘ CHART 59 LEFT The estimated structural balances of these 21 member states can nevertheless be in line with the rules if they sufficiently reduce last year's structural balance (European Commission, 2019). The size of the necessary reduction depends on the debt-to-GDP ratio, the sustainability indicators and the economic situation. For most member states, the target is a reduction in the structural balance of at least 0.5 percentage points. **Nine out of 27 EU member states will not meet this reduction target** in 2023 **according to the scenario calculation** and would have to reduce their structural balance by more than has been planned up to now. ↘ CHART 59 RIGHT

Compliance with the debt and 1/20 rule can also be checked on the basis of the spring forecast. **In 2022, 14 countries are likely to exceed the debt ceiling of 60 % of GDP.** ↘ CHART 60 LEFT Their debt-to-GDP ratios could still be considered compliant if they are reduced under the 1/20 rule. For many countries, the projected primary balance is higher than the primary balance needed to comply with the 1/20 rule. ↘ CHART 60 RIGHT However, the projected primary balances of seven member states are below target, so more significant consolidation efforts would be needed to comply with the 1/20 rule.

↘ CHART 60
Planned reduction paths of dept ratios and necessary primary balances



1 – Based on the spring forecast of the European Commission 2 – The target value is derived from the debt-to-GDP ratio of the previous year, the new debt taken on since the previous year, the medium-term nominal growth rate and the long-term interest rate. The calculation is based on the spring forecast of the European Commission and data of the ECB for the long-term interest rate.

Sources: ECB, European Commission, own calculations
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233. The European Commission's **considerable discretionary powers** when interpreting the fiscal rules contribute to a **contradictory perception of the rules**. The discretionary leeway when identifying rule violations and determining sanctions is a consequence, for example, of various exceptional circumstances. ↘ BOX 12 In most cases, the countries were not accused of violations or not accused of repeated violations because the fact that the reference values were exceeded was interpreted as justified on the basis of exception rules. In the cases of Portugal and Spain in 2016, where repeated breaches of the rules should technically have led to penalty payments, the European Commission suspended the penalty payments on the grounds that comprehensive structural reforms had been undertaken and a commitment had been made to reduce the deficit in the future (European Commission, 2016a, 2016b). On the one hand, such a de facto suspension of sanctions can make sense, since a penalty deposit payment places an additional

burden on the budget in a tight financial situation. On the other hand, the rulebook could lose credibility in this way, which is why less discretionary leeway could lead to **stricter enforcement and more binding force** of the rules (EFB, 2021; Bundesregierung, 2022). It might therefore be a good idea to initiate and carry out a rule violation procedure automatically without requiring the approval of the European Council, as it is currently the case. ↘ BOX 12

234. Some proposals additionally envisage **strengthening the institutional framework** by separating monitoring from policy enforcement (Asatryan et al., 2017; Bénassy-Quéré et al., 2018; Arnold et al., 2022; GCEE Annual Report 2017 item 101). According to the EU Treaties, both tasks currently fall to the European Commission. A change in the division of tasks would require an amendment to the EU Treaties (Bénassy-Quéré et al., 2018). According to Bénassy-Quéré et al. (2018), monitoring could be carried out by an independent institution such as the European Fiscal Committee or the ESM. Arnold et al. (2022) propose the establishment of a European Fiscal Council to coordinate the work of independent national fiscal councils and to develop standards.

235. **Less complex rules** could make them more **binding and transparent**. The Deutsche Bundesbank (2021b) argues that a rule that is easy to apply and understandable could result in higher political acceptance within the member states (national ownership). To strengthen ownership, Truger (2020) suggests democratising the EU fiscal rules in the form of formal participation by the European Parliament in the decision-making process on European fiscal-policy issues. Furthermore, acceptance by the member states could be increased by reducing the number of individual decisions made at EU level. Since the founding of the European monetary union, however, the complexity of the regulatory framework has increased continuously. ↘ BOX 12 The GCEE has pointed out in the past that the large number of rules existing in parallel and enforced to varying degrees, as well as the continuous addition of exceptions, make monitoring by policymakers and the public considerably more difficult (GCEE Annual Report 2017 item 96).

236. To make the regulatory framework more binding and credible while ensuring effectiveness, many reform proposals envisage reducing complexity by introducing a **central expenditure rule, combined with a medium- or long-term reference value**. An expenditure rule limits nominal or real expenditure growth depending on medium-term economic growth. ↘ BACKGROUND INFO 11 The proposed designs of the expenditure rule differ mainly in terms of the targets and time horizon considered. Some proposals include an expenditure rule for primary or total government expenditure growth combined with a long-term debt ceiling (Andrle et al., 2015; Claeys et al., 2016; Bénassy-Quéré et al., 2018; Darvas et al., 2018). A medium-term debt-reduction path could be added (Bénassy-Quéré et al., 2018; Darvas et al., 2018; Giavazzi et al., 2021). In the past, the GCEE has proposed an expenditure rule for annual primary expenditure growth, combined with a structural deficit rule as a medium-term target (Christofzik et al., 2018; GCEE Annual Report 2017 items 98 f.).

↘ BACKGROUND INFO 11

Expenditure rule

Expenditure rules are designed to limit the nominal or real **growth of government expenditure** (Cordes et al., 2015). Since 2011, the EU's fiscal rules have included an expenditure rule that limits the annual increase in public expenditure **depending on medium-term growth** (European Commission, 2011). Medium-term growth is determined by estimating the average growth rate of potential output for the past five years, the current year and the following four years (European Commission, 2019, p. 29). A focus on expenditure rules is considered beneficial because public expenditure is directly observable (Bénassy-Quéré et al., 2018; Eyraud et al., 2018) and primary expenditure is under the more direct control of governments than the structural deficit (Darvas et al., 2018; GCEE Annual Report 2017 item 99). Moreover, the expenditure side is considered much less cyclically sensitive than the revenue side – especially when public expenditure is adjusted for unemployment payments (Christofzik et al., 2018) – and easier to forecast over a short time horizon (GCEE Annual Report 2017 box 18). However, an expenditure rule cannot take long-term changes in revenues into account (Eyraud et al., 2018), which can lead to a persistent deficit or budget surplus (Eyraud et al., 2018). There is also the question of implementation in a federal state (Bundesregierung, 2022). Nationwide fiscal rules are a challenge in general due to the necessary distribution of the rules among the individual territorial authorities. However, this applies not only to an expenditure rule but also to the structural deficit.

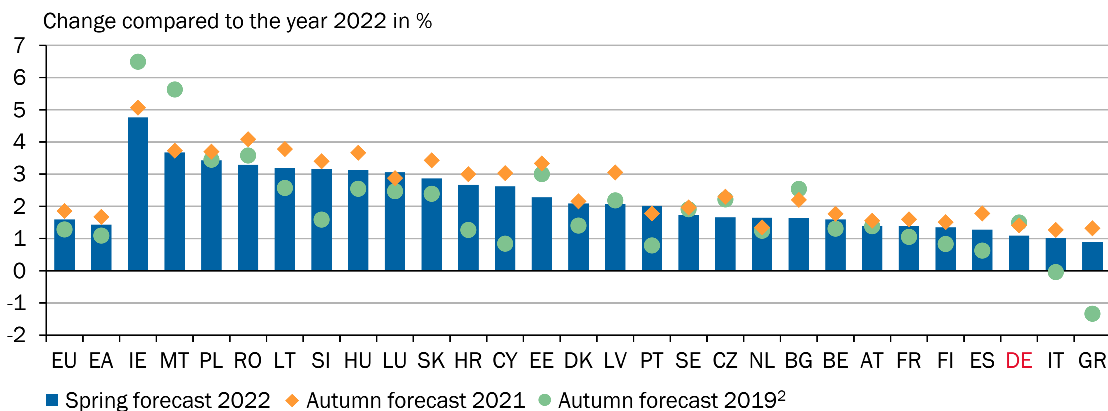
237. To ensure sustainability, it is often pointed out that a **firmly established long-term debt ceiling**, such as the current 60 % limit, is necessary as a complement to an expenditure rule (Bénassy-Quéré et al., 2018). Its aim is to ensure that interest payments can be serviced in the future. Reform proposals have addressed the level and generality of this limit in particular. Some proposals again envisage a **uniform EU-wide debt ceiling** (Bénassy-Quéré et al., 2018; Darvas et al., 2018; Deutsche Bundesbank, 2019; Arnold et al., 2022).

Other proposals advocate **country-specific caps on debt-to-GDP ratios**. Blanchard et al. (2021) advocate fiscal standards instead of fiscal rules. These aim to describe the goal of debt sustainability in qualitative terms and include a margin of discretion in the assessment of fiscal measures with regard to target achievement. The long-term real interest rate, potential growth and the government primary balance are crucial for fiscal stabilisation (GCEE Annual Report 2020 box 12). Higher potential growth rates or a lower long-term interest burden can make higher debt ceilings sustainable (Furman and Summers, 2020; Blanchard, 2022). Some proposals therefore envisage linking debt-to-GDP ratios variably to country-specific potential growth and the expected long-term interest rate (Martin et al., 2021; Priewe, 2021). However, potential growth differs significantly across EU member states and varies with the timing of the estimate. ↘ CHART 61 Especially for member states with high debt-to-GDP ratios, such as Greece and Italy, potential growth is particularly low.

238. If the debt ceiling is exceeded, a **credible debt-reduction path** must be set up that EU member states can adhere to. The European Commission decided in the

↘ CHART 61

Estimation of potential growth for the year 2023 at different estimation times[1]



1 – EU-European Union (27 Member States), EA-Euro area, IE-Ireland, MT-Malta, PL-Poland, RO-Romania, LT-Lithuania, SI-Slovenia, HU-Hungary, LU-Luxembourg, SK-Slovakia, HR-Croatia, CY-Cyprus, EE-Estonia, DK-Denmark, LV-Latvia, PT-Portugal, SE-Sweden, CZ-Czechia, NL-Netherlands, BG-Bulgaria, BE-Belgium, AT-Austria, FR-France, FI- Finland, ES-Spain, DE-Germany, IT-Italy, GR-Greece. 2 – Forecasts from the autumn 2019 forecast were extrapolated based on the average growth rate between 2012 and 2021.

Sources: European Commission, own calculations

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past that economic reasons justified non-compliance with most of the breaches of the currently applicable 1/20 rule (EFB, 2019). The Federal Government (Bundesregierung, 2022), similar to other institutions, proposes a relaxation of the rule, arguing that strict adherence to the rule could put a significant strain on public finances. ↘ BOX 13 The 1/20 rule could be relaxed by reducing the mandatory annual adjustment (EFB, 2020). Alternatively, the Federal Government (Bundesregierung, 2022) suggests that compliance with the preventive arm's requirements should be considered a sufficient condition for compliance with the 1/20 rule. Arnold et al. (2022) argue for country-specific adjustment paths that depend on the debt-to-GDP ratio and the sustainability analyses.

Stabilise the economy

239. In addition to ensuring the sustainability of public budgets, another **central objective** of fiscal rules is to **make possible a fiscal policy that stabilises the economy**. A pro-cyclical effect of the rules should be avoided; otherwise, deficits would be higher than optimal when economic conditions are favourable, and states would be forced to take consolidation measures when they are unfavourable. Against this background, the reform of the SGP in 2005 was to be welcomed, as was the focus on cyclically adjusted variables in the preventive arm. ↘ BOX 12 However, the cyclical adjustment needed for this relies on unobservable values that have to be estimated in real time and are prone to revisions. Various studies have shown that in the past, on average, an underutilisation of potential output has been revised downwards and an overutilisation has been revised upwards (Eyraud and Wu, 2015; Claeys et al., 2016; Reuter, 2020; GCEE Annual Report 2017 box 3). In this respect, the underlying idea is to be welcomed, but the practical implementation is highly inadequate. There would have to be a greater focus

on the measurability and observability of the underlying values for effective implementation.

240. The application of **an expenditure rule** could **counteract pro-cyclical fiscal policy**, as public expenditure is more observable and less cyclically sensitive than public revenue. ↘ BACKGROUND INFO 11 In addition, estimates of the growth rates of potential output are considered to be less prone to revisions than estimates of associated level values, especially if multi-year average rates are used (Andrle et al., 2015).

Prioritise transformative and growth-promoting expenditure

241. The **EU member states face considerable transformative tasks**. ↘ ITEM 218 It is questionable whether the fiscal rules currently in place are well targeted and provide the necessary room for manoeuvre. The investment clause, introduced in 2015, is designed to support EU member states in undertaking investment that has a direct, positive and sustainable impact on economic growth and budgetary positions (European Commission, 2019, p. 24). The investment clause temporarily allows minor deviations from the medium-term budgetary objective if the investment is co-financed by the EU, and there are negative growth prospects for the respective member state (European Commission, 2015).

242. Various **proposals** suggest increasing the fiscal space for public investment. It is crucial for gaining majority support and for successful implementation to find a clear definition of the areas of application and mechanisms for incentive-compatible implementation and financing. The practical implementation of such an **investment orientation** could be accomplished on different scales. First, investment could be prioritised on an extended scale under the investment clause. The Federal Government (Bundesregierung, 2022) proposes allowing the applicability of the investment clause outside of economic crises and extending it to other EU programmes. Alternatively, exceptions for public investment spending can be created within the fiscal rules. For example, the current expenditure rule provides for an exemption for public investments made within EU programmes and co-financed by European Structural and Investment Funds (ESI Funds) (European Commission, 2019, p. 32). ↘ CHART 57 Thirdly, public investments could, in principle, be exempted from the limitations of an expenditure rule in the sense of a golden rule.

243. The **various proposals for a golden rule** differ above all in the level of privileged public investment and in how it is defined. The Deutsche Bundesbank (2019) uses the existing medium-term target to determine the level and proposes capping deductible investment at 0.5 % of GDP. Truger (2015) recommends a limit on deductible public investment (excluding military expenditure) of 1 % to 1.5 % of GDP. In principle, such limits aim to prevent excessive use of exemptions and to reduce risks to sustainability. An alternative approach by Giavazzi et al. (2021) additionally provides for the debt-reduction path to exclude capital expenditure to a certain extent.

Pekanov and Schratzenstaller (2020) and Darvas and Wolff (2021) propose a "green golden rule" that only allows **deficit financing of public investment for climate protection and adaptation to climate change**. The Federal Government (Bundesregierung, 2022) rejects the general deduction of certain forms of investment because it is not consistent with debt sustainability and sound budgets. Other authors criticise the sole focus in a golden rule on public investment in the sense of national accounts (Christofzik et al., 2019; Feld et al., 2021; Martin et al., 2021; GCEE Annual Report 2019 item 532). For example, they do not regard expenditure on education or personnel expenses for teachers as public investments, even though they can have a considerable effect on potential output. Furthermore, there are concerns that an imprecise definition or delimitation creates scope for present-day expenditure, making it impossible to use all possible scope to strengthen investment activity (Feld et al., 2021).

4. Fiscal capacity

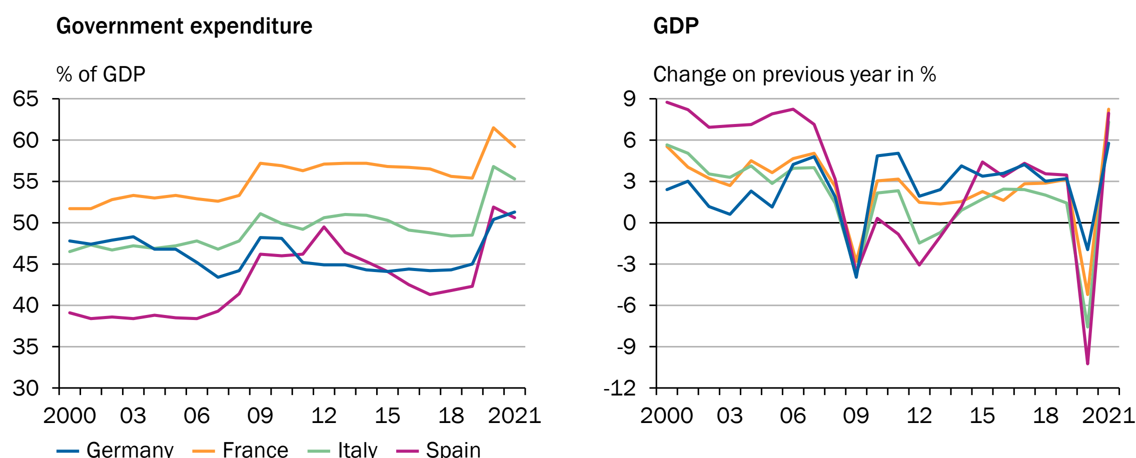
244. **Fiscal policy** in the EU is predominantly a **national responsibility**. Since there are no signs of a common EU fiscal policy in the foreseeable future, there are various proposals to **overcome** the **problems arising from** this **distribution of powers**. They include reform proposals on European fiscal capacities. These aim at more effective solutions for absorbing asymmetric shocks, or at creating European added value; some are temporary, others permanent, and can be financed by loans or contributions.

245. Apart from monetary-policy instruments, **several channels** continue to **operate** in the member states **to absorb** possible **asymmetric or asymmetrically acting shocks**. In the context of national fiscal policy, asymmetric shocks are initially absorbed via the automatic stabilisers, e.g. short-time working. Moreover, in a monetary union, because there is no devaluation option, absorption increasingly takes place by means of an adjustment of factor payments or via factor mobility. In addition to the automatic stabilisers, discretionary fiscal policy measures may become necessary if current shocks have an exceptionally strong impact on the overall economy. However, **fiscal space** may be **limited** by the rules to ensure the **sustainability of public debt**. ↘ CHART 62

246. The ESM was created in 2012 to expand the fiscal space of highly indebted states in emergency situations. Subject to economic-policy reform requirements, it grants loans to member states on significantly more favourable terms than the usual market conditions. The euro area member states agreed in 2021 to expand the ESM's **set of instruments** (ESM, 2021). This includes strengthening surveillance and monitoring, **crisis preparedness** and the **backstop** for the Single Bank Resolution Fund. ↘ ITEM 258

247. Proponents of an expansion of the institutional framework point to the fact that the European currency area is **not an optimal currency area** (van Rompuy, 2012), e.g. due to existing wage rigidities and limited labour mobility within Europe. The potentially **adverse incentive effect** of intergovernmental transfers and the possible **loss of national fiscal sovereignty** must be seen critically. It

↘ CHART 62
Government expenditure and GDP in the euro area



— Germany — France — Italy — Spain

Source: Eurostat
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should also be borne in mind that the limits of the European community of solidarity must be negotiated in the political decision-making process.

248. In order to improve intergovernmental risk diversification by means of fiscal policy as well as to internalise possible spillover effects of national fiscal policy in the euro area (Farhi and Werning, 2017), there are numerous **proposals** to establish further European **fiscal capacity**, i.e. a jointly financed budget at the **European level**, which could complement national capacities to smooth large macroeconomic or financial shocks. Various proposals differ mainly in the financing model (contribution-financed or debt-financed), the financial capacity, the disbursement mechanism, and the avoidance of moral hazard (GCEE Annual Report 2018 item 431).

249. Calculations hypothetically applying the respective assumptions to ex-post data in some cases reveal **substantial net transfer payments** (GCEE Annual Report 2018 items 433 ff.). Several **variations in design** have been proposed to avoid such transfers – e.g. in the form of payment surcharges as a result of capacity utilisation (e.g. Bénassy-Quéré et al., 2018), a "co-payment" (e.g. Bénassy-Quéré et al., 2018), a cap on transfers above a previously defined threshold (e.g. Arnold et al., 2018) or the precondition that European fiscal rules are respected (e.g. European Commission, 2018b). However, a look at the period from 1970 to 2020 for the Euro-12 countries shows that these variations do not solve the fundamental problem of net transfers (Weiske and Yeter, 2022).

250. One problem with most proposals for a fiscal capacity is **differentiating the asymmetric shock** from the self-caused economic pressure that triggers an event covered by insurance. For example, macroeconomic variables, such as the change in unemployment, do not allow for a convincing differentiation between institutionally induced changes and the shock effect.

251. Furthermore, it is important to consider incentives when designing transfer mechanisms. Studies show that **institutional differences in labour markets**

are correlated with the occurrence of net transfers, and that net transfers can sometimes be **very persistent**. This could result in political-economic disincentives, since, for example, labour-market policy decisions can have an ex-ante effect on the probability of a transfer reference (Persson and Tabellini, 1996; Bucovetsky, 1997; Lockwood, 1999; Beetsma and Bovenberg, 2001; Goodspeed and Haughwout, 2012; Fernández-Villaverde et al., 2013; Baskaran et al., 2017; Beetsma et al., 2021).

252. From a theoretical perspective, a fiscal capacity aiming at incentive-compatible risk diversification should only provide **temporary intergovernmental transfers** that do **not** generate **net transfers** between member states in the medium to long run (Hagen and Hammond, 1998). Moreover, no member state of the common currency area should expect to receive a transfer reference due to self-inflicted economic tensions (Beetsma et al., 2018). At the same time, however, a fiscal capacity should provide transfer payments that ensure a sufficiently rapid and strong stabilisation effect (Arnold et al., 2018).

253. In order to evaluate the proposals for an additional fiscal capacity, it must be examined whether, and to what extent, they meet the above-mentioned criteria regarding the persistence and anticipation of transfer payments, to what extent **new tasks** are taken on that are not (or cannot be) fulfilled by established facilities, and whether there are **trade-offs** with existing European institutions. The **relationship to the ESM** in particular would have to be **clarified** before a European fiscal capacity for shock absorption can be created. Some proposals for the design of new European fiscal capacities envisage transfer payments via lending, which would involve a particular need for demarcation from the ESM. Instead of a new institution, Misch and Rey (2022) advocate a stability fund managed by the ESM, which would contribute to financial stability when the euro area or individual member states are affected by external shocks.

254. In addition to absorbing asymmetric shocks, a fiscal capacity could be used in the sense of the **subsidiarity principle** to take over various national tasks, the fulfilment of which can be expected to add value at the **European** level. In the economic and monetary union, these include, for example, the ESM, the NGEU programme, the Regional and Cohesion Funds or the European Investment Bank.

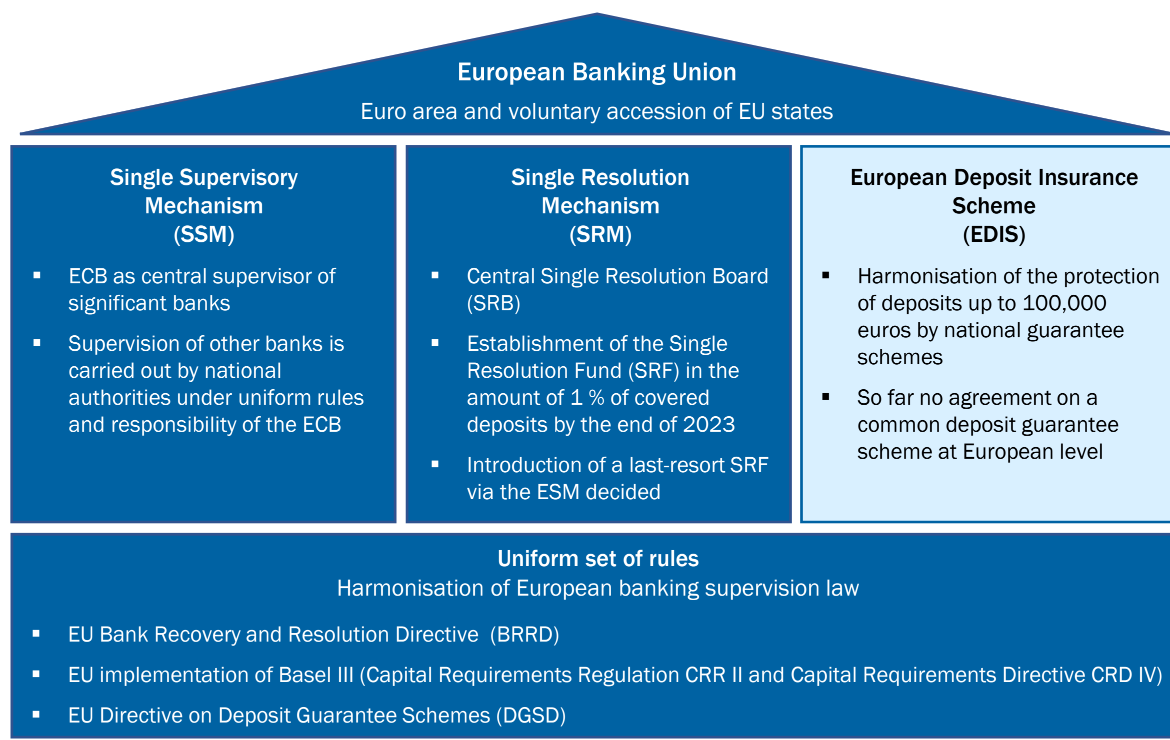
255. Arnold et al. (2022) advocate a combination of objectives for a fiscal capacity so that it can also support transformative projects beyond shock absorption, for example in the field of energy. EU-funded tasks have a long tradition in Europe. Instruments such as the promotion of research (**HorizonEurope**) or business (**InvestEU**) serve this purpose. The capacity proposed by Arnold et al. (2022) would be partly loan-funded and partly tax-funded. However, an incentive-compatible design of joint borrowing could require comprehensive changes to the European Treaties and a deepening of the European community of solidarity.

5. Financial market architecture

256. **Reforms** in the economic and monetary union **must take into account** the interdependence between sovereign debt sustainability and the **stability of the financial system** – the sovereign-bank nexus. On the one hand, a financial crisis with extensive bailout programmes for financial institutions, as in 2009, could cause sovereigns problems despite sustainable public finances. Banks are often backed by implicit and explicit sovereign guarantees, which are a burden on public finances. In addition, there are indirect links through the domestic real economy (GCEE Annual Report 2018 item 481). On the other hand, a fiscal imbalance could have a direct impact on bank default risk through losses in the value of financial assets held by banks vis-à-vis sovereigns.

257. With the establishment of the **banking union**, significant steps have already been taken since the financial and sovereign debt crisis to unbundle the sovereign-bank nexus and to **strengthen the resilience of the financial system**. Up to now, the banking union consists of two pillars, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM); it is based on uniform European rules on capital requirements (CRR II/CRD IV), recovery and resolution (BRRD) and deposit guarantee schemes (DGSD). ↘ CHART 63 Despite efforts to promote financial market integration via the single framework, European financial market integration remains below pre-financial crisis levels. ↘ CHART 64 RIGHT Moreover, risks in the banking systems of euro area member states continue to vary. Further reforms are therefore necessary to deepen financial market integration in the euro area and effectively limit the sovereign-bank nexus. In addition to the

↘ CHART 63
The three pillars of the banking union



Source: own represention
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completion of the Banking and Capital Markets Union, these include further centralising supervision and resolution processes at the European level and strengthening the above-mentioned supervisory institutions.

258. The **uniform set of rules for bank resolution is intended to enable failing banks to exit the market** without negative effects on financial stability. Instead of the implicit guarantee that systemically important banks will be rescued with state funds (bail-out), the SRM allows for resolution with the involvement of creditors (bail-in), and can thus contribute to maintaining market discipline and limiting the sovereign-bank nexus. The Single Resolution Board (SRB) makes it possible for resolution decisions to be initiated centrally at the European level. Up to now, however, the SRM's powers have been limited to significant banks. ↘ GLOSSARY Moreover, the current decision-making process provides for the involvement of national actors, making it possible for resolution decisions of European interest to be influenced and averted by national interests (Tröger and Kotovskaia, 2022). In order to sustainably strengthen the credibility of the resolution regime, it should be ensured that all resolutions of public interest take place via the SRM. To this end, **further centralisation and harmonisation at the European level and** a **strengthening of the role of the SRB** could be helpful and limit national influence (for example, Bénassy-Quéré et al., 2018; HLWG on EDIS, 2019).

259. One hitherto missing **element of the banking union** that would limit the burden on general governments in the event of bank failures is a **common European Deposit Insurance Scheme** (EDIS). ↘ CHART 63 Deposit insurance at the national level is vulnerable to asymmetric shocks and reinforces the sovereign-bank nexus, as it implicitly assumes the state will provide a backstop. A harmonised deposit insurance scheme at the European level could help relax the ties within this risk group. As long as national leeway exists in dealing with risks in the banking system, a **more incentive-compatible design of the deposit insurance scheme**, for example by moving to a European deposit insurance scheme via joint **reinsurance**, is of key importance (GCEE Annual Report 2018 items 519 f.). Losses are initially borne by the national deposit insurance scheme. Only in severe systemic crises will additional recourse be made to common funds. Furthermore, risks in the national banking sector can be taken into account in the contributions to reinsurance, and inclusion in the EDIS can be made dependent on the fulfilment of risk-mitigation targets (Adam et al., 2020). A current proposal for an EDIS with a gradual transition to a common deposit insurance scheme is being blocked by Germany in particular. ↘ BACKGROUND INFO 12

↘ BACKGROUND INFO 12

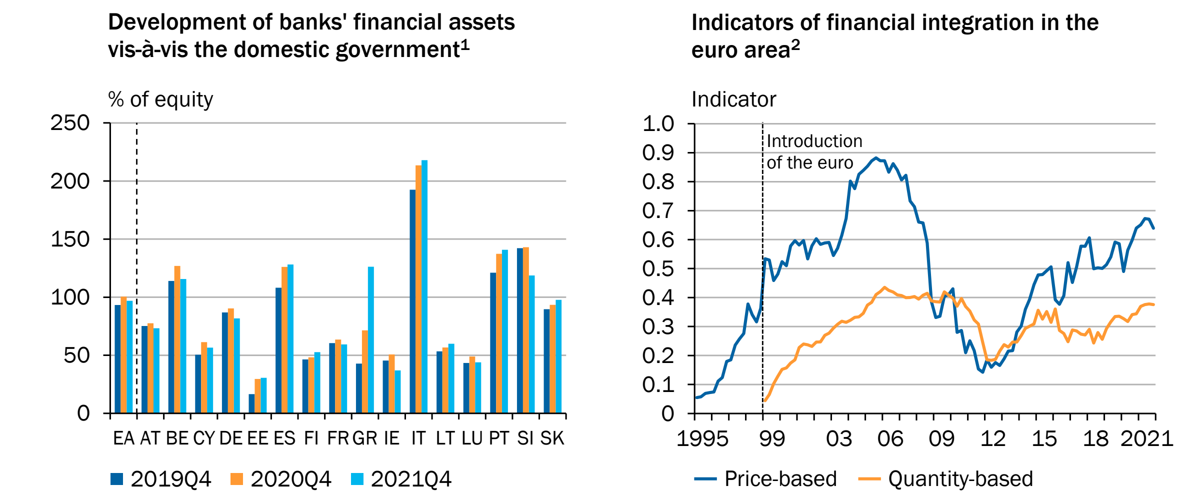
Current status of negotiations on the joint deposit insurance scheme (EDIS)

The current proposal for the European integration of national deposit insurance schemes is based in the **first phase on a hybrid model** in which the national deposit insurance schemes and a common fund, as a reinsurance scheme, would coexist. **Subsequently**, a **gradual transition to a common deposit insurance scheme** should take place. This gradual transition would be accompanied by corresponding risk reductions in the banking systems (HLWG on EDIS, 2019). The EDIS is to be

financed by risk-based contributions from the banking sector. For example, banks with a higher concentration of individual sovereign government bonds on their balance sheets might have to make correspondingly higher contributions (HLWG Chair, 2019; HLWG on EDIS, 2019). Some member states, including Germany, have long blocked a common European deposit insurance scheme (Clemens et al., 2020). The Federal Government prefers only a form of reinsurance that maintains the institutional guarantee schemes (SPD, Bündnis 90/Die Grünen and FDP, 2021, p. 133). This is specifically in the interest of the German savings banks and co-operative banks (DSGV, 2018). The proposal to include government bonds as a risk factor in bank balance sheets, on the other hand, has met with resistance in Italy (Strupczewski, 2019; Greive et al., 2022).

260. The successes achieved so far in reducing banks' default risks and strengthening the resolution regime contribute to reducing sovereign contagion risk in the case of failing banks. However, banks and sovereigns remain closely intertwined through the claims that banks hold against sovereigns. This interdependence is particularly strong if banks hold a **high share of government bonds of their own country of domicile (home bias)** (Schnabel and Schüwer, 2016). In the euro area, it can be seen that the level of claims against the country of domicile is heterogeneous in relation to equity, and has increased in the wake of the coronavirus pandemic, especially in the southern European states. ↘ CHART 64 LEFT Domestic banks are considered safe buyers of government bonds and can have a stabilising effect on government financing, as they reduce dependence on international investors and show a higher propensity to hold on to bonds in the event of a crisis

↘ CHART 64
Current developments in the financial and banking system of the euro area



1 – EA-Euro area, AT-Austria, BE-Belgium, CY-Cyprus, DE-Germany, EE-Estonia, ES-Spain, FI-Finland, FR-France, GR-Greece, IE-Ireland, IT-Italy, LT-Lithuania, LU-Luxembourg, PT-Portugal, SI-Slovenia, SK-Slovakia. No data available for Latvia, Malta and the Netherlands. 2 – As at end of each quarter. The price-based indicator aggregates ten raw indicators of financial markets, such as the cross-country standard deviation of unsecured interbank overnight interest rates and two- and ten-year government bond yields. The quantity-based indicator aggregates five raw indicators, including the share of cross-border lending among euro area Monetary Financial Institutions (MFIs) and the cross-border holdings by MFIs and investment funds of shares issued by euro area residents. For a detailed definition of the price- and quantity-based indicators of financial integration, see also ECB (2022).

Sources: ECB, own calculations
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(Saka, 2020). It has been shown that more highly indebted countries can refinance themselves more cheaply if domestic banks hold higher financial assets vis-à-vis their own government than foreign banks, i.e. there is a stronger home bias (Asonuma et al., 2015).

However, if a sovereign's debt sustainability deteriorates, the home bias can have a destabilising effect on banks and their lending (Gennaioli et al., 2014; Altavilla et al., 2017). Up to now, unlike other assets, the holding of government bonds has not been restricted by the application of large exposure limits. Moreover, a 0 % risk weight can be applied to EU government bonds regardless of the countries' credit standing (BCBS, 2017). In order to bring about risk-commensurate capital adequacy and incentives for greater diversification of the government bond portfolio, various proposals for a **reform of the regulation of government bonds** have been discussed in recent years (GCEE Annual Report 2018 items 488 ff.). It should be noted that these reforms could lead to a deterioration in financing conditions for sovereigns in the euro area, which could have a negative impact on debt sustainability. Therefore, possible adjustments in regulation would at least have to be linked to transition periods.

IV. CONCLUSIONS FOR ECONOMIC POLICY

261. Various far-reaching reform proposals have been put forward to strengthen the economic and monetary union. A **comprehensive overall package would be desirable** in this context. In addition to fiscal rules, it should also cover the areas of fiscal capacity and financial market architecture. However, in view of the need to amend the EU Treaties, this would require a suitable reform package that covers the different interests and economic-policy ideas within and between the member states. This is likely to be politically difficult. Reform steps that provide for **amendments to secondary law** or in the **interpretation of the existing treaties** therefore seem **more likely as a compromise**. However, like treaty amendments, some amendments to secondary law might require unanimity. Despite this, changes in the framework of the economic and monetary union, whether they concern the treaties or merely their interpretation, should, however, follow certain principles. The **central goal** should be a **stable monetary union** that can cope with crises.

This requires **fiscal rules** that **ensure the sustainability** of public finances, **can have a cyclical and counter-cyclical effect** and ensure incentives and scope for financing **future-oriented expenditure.** In this context, a forward-looking fiscal policy can make a decisive contribution to sustainability, but this is not guaranteed if the pressure for consolidation impairs the economic sustainability of a member state. Against this background, and in view of the de-facto lack of binding force, it is understandable that Germany's Federal Government proposes that the corrective 1/20 rule be considered to have been complied with if there is compliance with the rules of the preventive arm (Bundesregierung, 2022).

262. **Linking the debt-to-GDP ratio to interest rates and potential growth** poses operational difficulties and **considerable risks** in the event of unexpected changes such as the current interest-rate hikes. Furthermore, country-specific ceilings could mean there is little or no incentive to reduce debt in a low-interest-rate environment or when country-specific potential growth is high. Country-specific ceilings may also undermine the objective of equal treatment of all member states. Moreover, fiscal rules and approaches with fiscal standards are problematic if they replace a debt ceiling with qualitative criteria for measuring sustainability. ↘ ITEM 237 Such an approach would hardly be operationalisable and strongly dependent on political influence. Bilateral negotiations between the European Commission and the member states are unlikely to contribute to the clarity and binding nature of the rules and should be kept within narrow limits. Overall, therefore, a **general debt ceiling** currently looks like the **better choice**.

263. The thresholds of the **current fiscal rules are aimed at** securing medium-term **sustainability**. Even so, the operational rules limiting the deficit and the structural balance have not been able to prevent debt-to-GDP ratios in some member states from rising well above the limits in the past. In the coming years, an environment of higher interest rates could therefore pose a significant sustainability risk. The fact that the current regulatory framework is so **opaque and complex** complicates both political acceptance in the respective member states and effective public surveillance.

264. Changes to the fiscal rules should aim at a transparent and understandable set of rules that are verifiable and do not involve a lot of exceptions. For this reason, many proposals envisage a uniform **expenditure rule**. ↘ ITEM 236 This would reduce the complexity of the rules and make them **more understandable and binding**. In addition, the member states would have more control over compliance with the rule. There are still open questions relating to concrete implementation, for example regarding application in a federal state and medium-term target. However, these questions appear solvable, as similar questions have also arisen for the structural deficit. ↘ ITEM 236

265. The current fiscal rules, despite comparatively strict limits, have in many cases been unable to prevent debt-to-GDP ratios from rising – even when economic conditions have been favourable. Against this background, far-sighted reforms that ensure long-term reliability would be desirable. Reforms must strike a balance between the sustainability of public finances and the necessary scope for future tasks. **Enforcement** could be improved, for example by automating processes for initiating rule-breaking procedures. **Understandable and transparent rules** can contribute to higher domestic acceptance and better monitoring. Monitoring can be strengthened by assigning the task to an independent institution. Reducing the rules to these essential aspects could serve as a guideline for finding compromises. A uniform expenditure rule is advantageous in this context because primary expenditure is easily observable and less cyclical than government revenue.

266. Joint budgets at the European level serve primarily to **finance** tasks that have **European added value**, e.g. in the field of **research or business promotion**. At the EU budget level, it must be continually examined whether tasks can actually be fulfilled better and more efficiently at the European level. However, in some areas, such as grid expansion for an integrated European energy market, the EU could contribute more to funding and coordination than it has so far. To provide the funds for the EU, its own revenues or national contributions to the EU budget could be increased.

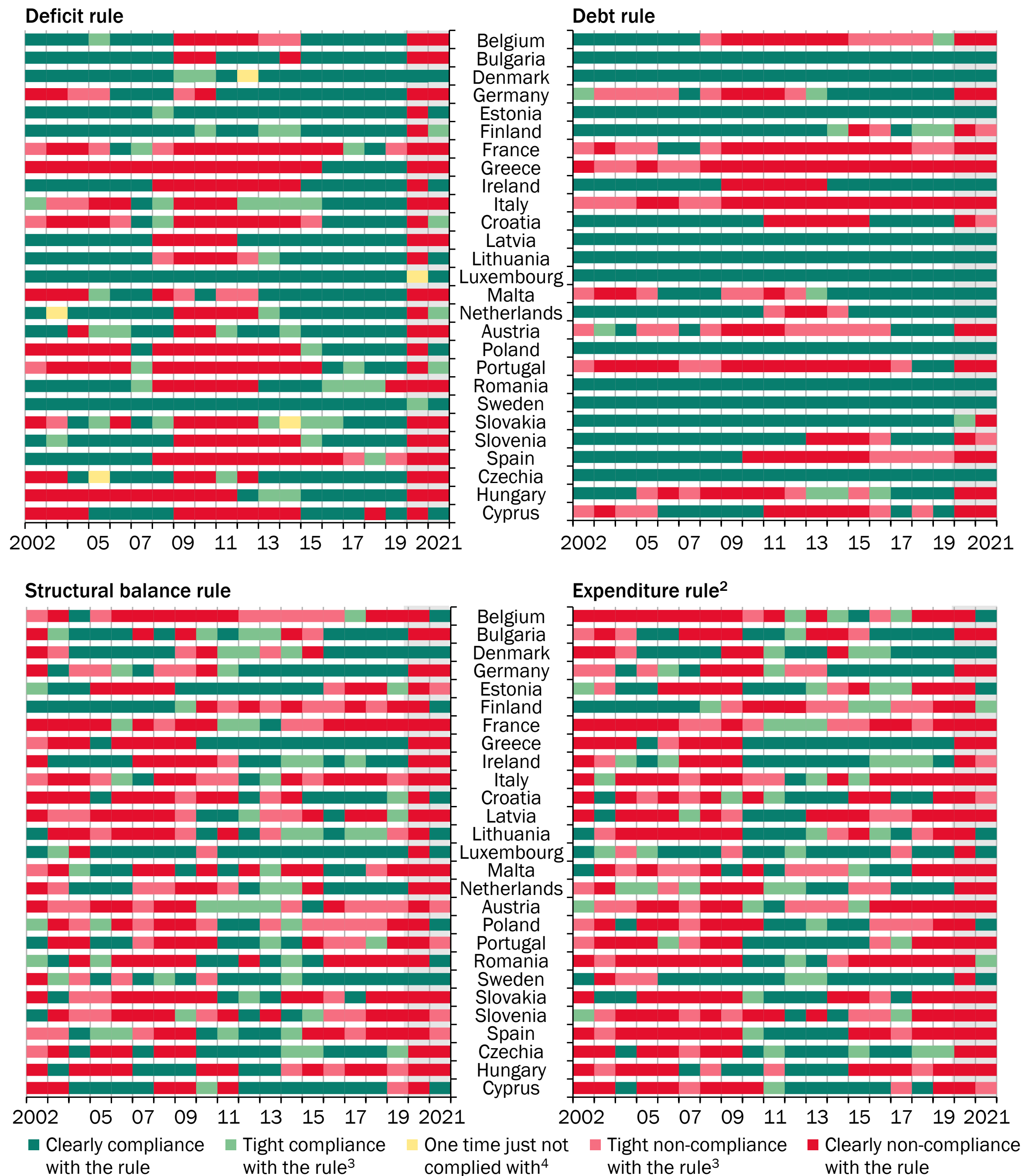
A **permanent fiscal capacity to absorb shocks** could be helpful in terms of stabilisation policy, but it is **fraught with difficulties** from a political-economic perspective. On the one hand, a crisis mechanism already exists in the form of the ESM. On the other hand, a fiscal capacity would have to be designed in an incentive-compatible way, so that there is no inducement to use it permanently. At present, there are no convincing proposals for such a design.

267. A number of reforms have already been implemented to **protect the economic and monetary union** from the effects of another **financial crisis.** As a result, the European financial system is much more robust today than it was a few years ago. Nevertheless, further steps towards a **complete banking and capital market union** are necessary. Not least because of the lack of **an incentive-compatible reform proposal** and the resulting blockade by Germany, the third pillar of the banking union is still missing: a jointly coordinated deposit insurance scheme. In addition, bank resolution could be further harmonised. A limit on government bonds held by domestic banks is advisable to unbundle the sovereign-bank nexus. However, this could lead to a further increase in interest rates on government bonds, which have risen recently. Therefore, corresponding reforms would at least require sufficient transitional periods or alternative backstop mechanisms.

APPENDIX

↘ CHART 65

Compliance with EU fiscal rules[1]



1 – In 2020 and 2021, the exception clause applied. 2 – The expenditure rule became mandatory only in 2011. 3 – Tight (non-)compliance corresponds to a maximum deviation of +/- 0.5 percentage points from the rule limit for the deficit, structural balance and expenditure rule and a maximum deviation of +/- 5 percentage points from the rule limit for the debt rule. 4 – The deviation from the limit of the deficit rule ranges between -0.5 and 0 percentage points and is limited to one year.

Sources: European Fiscal Board, Larch and Santacroce (2020), own calculations

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