Informal ECOFIN, 9 and 10 September 2022 in Prague, working session II

Presidency issues note

Sound fiscal policy for the future

Twenty years of implementing the economic governance framework have revealed its limits. In 1997, the EU agreed on the Stability and Growth Pact (SGP), a set of rules designed to ensure that Member States pursue sound public finances and coordinate their economic policies, thus enhancing the stability and prosperity of the economic and monetary union. Since its introduction, the EU fiscal framework, together with its implementation, has reached its limits. A substantial increase in public debt in the EU over the last 20 years is one of the most alarming signs. Other significant issues include pro-cyclicality, excessive complexity, a low level of national ownership, insufficient compliance and enforceability, and reliance on variables that are not directly observable and are frequently revised.

Multi-year fiscal adjustment, combined with investment and reforms to sustain growth potential, is needed to curb debt dynamics. Ensuring sustainable public finances through a gradual reduction of high public debt is of utmost importance. Failing to reduce the debts of high-debt countries in the medium term would negatively impact growth prospects and deepen divergences between countries. Successful debt reduction strategies should focus on fiscal consolidation, the quality and composition of public finances and promoting growth-friendly reforms and investments. Postponing necessary fiscal adjustments to later years increases implementation risks and often leads to difficulties in achieving medium-term budgetary targets. In addition, it often means that fiscal buffers are not rebuilt when economic conditions allow. Potentially unsustainable government debt levels reduce the ability to withstand shocks, can result in substantial negative cross-border spillovers and may complicate the achievement of the objectives set out in the Treaty.

The EU economy was already facing several long-term structural challenges before the COVID-19 crisis. First, a rapidly ageing population threatened to reduce labour supply and thus EU growth potential. Second, weak productivity growth acted as a drag on economic growth. Third, the substantial socio-economic costs of climate change were manifesting themselves with increasing clarity and urgency. Fourth, rising income and wealth inequality, territorial disparities within and among Member States, and unequal access to education and skills, were holding back economic growth and creating a strain on the EU's social fabric. Recovery from the economic and financial crisis of 2007–2013 has been protracted; the growth potential of many Member States has not yet returned to pre-crisis levels and interest rates have remained persistently low. The COVID-19 crisis and the impact of Russia's aggression against Ukraine have increased pre-existing economic, social and territorial divergences and made these challenges even more visible and more urgent. As the economic and financial crisis showed, market sentiments can change abruptly and may lead to sudden shifts in interest rates, which could increase fiscal burden, particularly for high-debt countries.

Public finances took a considerable hit as a result of the recession during the financial crisis and the pandemic. Deficits and debt ratios have risen in all Member States, albeit to varying degrees, with the EU headline deficit increasing to about 7 % of GDP in 2020 from 0.6 % of GDP in 2019, and the aggregate debt ratio jumping by 13 percentage points to 92 % of GDP at the end of 2020. Divergent debt dynamics across Member States reflect large differences, especially in the pace of fiscal consolidation and economic growth. In 2020, public debt levels were below 60 % of GDP in around half the Member States, but remained around or (well) above 100 % of GDP in others.

Faced with severe public health and economic crises, Member States quickly adopted wide-ranging fiscal support measures facilitated by the activation of the general escape clause. The clause does not suspend the Stability and Growth Pact but allows for a temporary departure from the normal budgetary requirements provided that this does not endanger fiscal sustainability in the medium term. In its 2022 Spring Package, the Commission noted that the EU economy had not returned to more normal conditions and that the continued activation of the general escape clause in 2023 would provide the space for national fiscal policy to react promptly when needed. Policy measures at national level are supported by the EU response, in particular with the help of the Recovery and Resilience Facility (RRF), which promotes an investment-rich recovery and growth-enhancing reforms which are expected to increase potential growth and mitigate fiscal challenges.

The Member States are currently confronted with several challenges simultaneously. These include debt sustainability issues, the asymmetrical financial consequences of Russia's aggression against Ukraine, including unprecedented energy price hikes, continued supply chain disturbances as well as substantial investment needs, especially with respect to the twin transition.

The Commission first launched the economic governance review and presented its communication on this subject in February 2020. The debate was put on hold shortly afterwards due to the need to focus on the immediate challenges posed by the outbreak of COVID-19. The Commission relaunched the public debate in October 2021 with the aim of building consensus on the way forward.

Debates at expert level have taken place mainly in the Economic and Financial Committee, but also at ministerial level in the ECOFIN Council and among euro area members in the Eurogroup for specific euro area aspects. Discussions were organised around several key topics. These included the sustainability of public debt and growth-friendly debt reduction; the protection of public investment; a digital and resilient EU economy; reflections on the lessons learned from the COVID-19 crisis response; counter-cyclical fiscal policies and creating room for short-term stabilisation; and last but not least, how to simplify fiscal frameworks, achieve stronger national ownership and better enforcement.

While views are converging on the reform of the SGP in general after almost two years of discussions, divergent opinions remain on numerous aspects. While Member States agree on the main goals of the framework in general, such as the long-term sustainability of public finance and a simplification of the rules, when it comes to specific proposals, no structured compromise seems to be emerging yet. In its 2022 Spring Package, the Commission promised to provide its orientations on possible changes to the economic governance framework. These orientations are to be published in the coming weeks.

Against this background, the Presidency invites Ministers to exchange views on the most important aspects of the future economic governance framework and on the way forward.

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Questions for discussion:

- *What, in the Ministers' opinion, is the reason for the substantial increase in public debt levels in the EU over the last 20 years? How can we ensure that elevated public debt levels do not create risks for debt sustainability in the medium and long term?*
- *Which elements of the current EU fiscal framework do the Ministers consider the most useful? What set-up would most likely lead to the best outcome of the fiscal framework in terms of enforcement, fiscal convergence and sustainability?*
- *What, in the Ministers opinion, is the most important feature of the future rules to be included in an envisaged compromise (e.g. simplification, national ownership or better enforcement)?*