Presidency Issues Note for the Informal ECOFIN Working Session III

Resilient recovery and fiscal adjustment scenarios: is there enough space for investments for the future?

Ministers are invited to discuss what will be the appropriate timeframe of balancing the budgets and how to safeguard investments once the general escape clause is deactivated, and fiscal rules kick-in. The basis for this issue note is a background document prepared by Bruegel: A Green Fiscal Pact for a resilient recovery: increasing green investment while consolidating budgets.

Past experience shows that that consolidation requirements after crisis should not be too demanding and that public investment is normally the first victim of fiscal consolidations[1]. As the background document is highlighting, the challenge in coming years will be to consolidate deficits while increasing green investments to achieve the ambitious targets of the EU to cut emissions or any other investments intended to transform the economy.

Fiscal policy in the Covid-19 setting

From the start of the pandemic, the general escape clause was activated that allowed for a fast and decisive response of the governments to deal with the public-health emergency and support the economy. The general escape clause is expected to be deactivated as of 2023 when the economic activity in the EU and euro area is forecast to surpass the pre-crisis levels (end 2019). As a result, the public deficits increased substantially in 2020 and will continue to be elevated this year and in 2022. Similarly, public debt increased throughout the EU.

Fiscal policy after the deactivation of the general escape clause

Under current rules and procedures of the Stability and Growth Pact (SGP), deficits would first need to be reduced to more sustainable levels, while structural balance will be the ultimate goal. The timeframe of eliminating the excessive deficits and achieving structural balance will need to be carefully considered as it is extremely important that fiscal constraints do not hamper growth. At the same time, the aim of the EU is to seize the opportunity to use the post-pandemic recovery to achieve genuine green and digital

[1] Page 4 in the background document: "In the current 27 EU members, the structural budget balance as a share of GDP increased by 0.8 percentage points in 2011, 1.5 percentage points in 2012 and 0.8 percentage points in 2013. This rapid fiscal consolidation was a major driver of the recession of 2012."… "Gross public investment fell by about 0.8 percentage points of GDP during 2009-13 in the EU as a whole."

transformation. Even if we only consider the former (that is highlighted in the background document and can be considered as the most illustrative example), the EU has set itself ambitious goals that will require substantial financing in the coming decades (according to the background document additional public investments will have to amount to between 0,5 % and 1 % of GDP annually). But we also need to take into account other investment areas.

Fiscal simulations

The simulations in the background document under specific assumptions[2] present the possible nominal and structural balance scenarios under existing fiscal rules (without the application of the 1/20th deficit reduction rule) and the impact of RRF. In the corrective arm of the SGP, the historical scenario is assuming a 3-year deadline for correcting the excessive deficits that would result in the reduction of the structural deficit to 2,5 % GDP while in the flexible scenario 0,5 % of GDP structural fiscal effort is assumed per year (the minimum adjustment set by the SGP). In 2023 (first year of the activation of fiscal rules) the RRF grants and loans will offset the needed consolidation to certain extent. However, the impact decreases with years and the required fiscal effort increases. In the preventive arm, the historical scenario takes into account the SGP matrix so that the MTO is reached in maximum four years, while the flexible scenario assumes that MS also make use of the flexibility clause due to structural reforms. Overall, the simulations show that the existing fiscal rules allow for longer consolidation paths on average than in previous crisis, but the flexible application is not automatic and is subject to agreement. However, even when flexibility is applied, this may still require substantial fiscal effort in nominal terms (especially when the output gaps turn positive that is not considered in the simulations) what could be politically difficult to achieve even without taking into account any additional investment needs.

Consolidation needs and investments

Experience from the period after the global financial crisis shows that during the periods of fiscal consolidations the level of public investments drops substantially. In this regard, the policymakers will be faced with a challenge of how to respect the requirements from the fiscal rules while at the same time increasing the productive investments. The background document considers several options that would allow for higher spending for investments for the future.

Questions for discussion:

1. Is there sufficient flexibility under SGP to allow for a sufficient adjustment time to support growth?
2. Is the flexible use of current fiscal framework enough to allow the fiscal policy to support the recovery and restructuring of our economies and societies? As the possible legal changes of fiscal rules require time for consensus building to find efficient solutions, do we need to find intermediate solution to safeguard investments?
3. Do you consider any of the options of addressing the trade-off between fiscal consolidation and the need for increasing public investments for the future as appropriate? Are there any alternative possibilities that could be considered?

[2] See p. 19 of the background document.