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Reforming Economic and Monetary Union

Balancing Spending and Public Debt Sustainability

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Summary[1]

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Fiscal policy in the EU faces the dilemma of having to meet large spending needs despite the existence of elevated public debt ratios. Fiscal policy therefore needs to put the member states on a sustainable path to gradual debt reduction. The Stability and Growth Pact (SGP) is the decisive mechanism in the EU to ensure that this is the case. The European Commission's proposal to reform the SGP is, in theory, a step in the right direction. However, it has some major practical shortcomings: among others, it permits a long adjustment period and grants considerable political discretion to the European Commission. To seize the theoretical opportunities the reform offers, the proposal needs to be depoliticised. To this end, independent institutions should have a more important role. Moreover, common quantitative benchmarks should be introduced as safeguards to limit the political discretion allowed. With a basic public debt sustainability analysis, we find that even in the baseline scenario the public debt ratio is likely to increase in some big member states such as France. In our two more pessimistic scenarios most member states analysed would see their public indebtedness rise, with the notable exceptions of Greece and Portugal. In such a situation, a sovereign debt crisis could arise. In this case there would not be sufficient capacity to meet the transformative spending required in the years ahead. A sound reform of the SGP is therefore a vital building block when considering how to square the circle of high public expenditure needs with the existing high public debt ratios.

Keywords Fiscal policy – Euro governance – Stability and Growth Pact – Public debt sustainability

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Introduction

After the Covid-19 pandemic and in the midst of an energy crisis, the challenges for the EU are immense. Ensuring growth, competitiveness, transformative investment and—above all—public debt sustainability at the same time would appear to be attempting to square the circle. A fundamental conflict looms. On the one hand, there are large expenditure demands for important aims such as the green and digital transformation and the reduction of energy and supply-chain dependencies. On the other hand, high public debt ratios limit fiscal space and increase the risk that states will be overburdened with ever more tasks. This conflict has been further accentuated by the rise in interest rates in response to high and surprisingly persistent inflation.

The EU reacted forcefully to the effects of the Covid-19 pandemic, with several far-reaching anti-crisis measures. Most significant was the creation of the NextGenerationEU (NGEU) fund, which is based on the issuance of common debt by the EU and allows for sizeable transfers from the fiscally stronger member states to weaker EU countries. Nevertheless, additional problems have arisen since, mainly the energy crisis.

These challenges have led to demands to put even more money on the table at the EU level, be this through an NGEU 2.0 or a sovereignty fund, again possibly based on the issuance of common debt by the EU. Moreover, there are proposals to introduce (even) more flexibility to the Stability and Growth Pact (SGP) to tackle the aforementioned problems. On top of this, with the introduction of the Transmission Protection Instrument (TPI) in July 2022, the European Central Bank (ECB) has become the lender of last resort for highly indebted member states. Moreover, the European Stability Mechanism (ESM), an established anti-crisis instrument, has been sidelined. Going down the path that these changes indicate would weaken the governance framework of the euro area. Without a doubt, these challenges call for smart strategies and possibly also for measures that go beyond existing ones. But is there really a need for new instruments and procedures or are the existing ones sufficient? And while, in the short term, it might seem attractive to relax fiscal policy in view of these challenges, is this also the right strategy to ensure fiscal resilience in the longer run?

This brief will focus on fiscal policy issues and the reform of the SGP. After elaborating further on the above-mentioned challenges and conflicts in section two, section three will discuss the envisaged reform of the SGP. To put this debate into context, an analysis of public debt sustainability will be carried out to highlight what a less-stringent fiscal policy approach might imply in view of higher interest rates (section four). Section five offers some conclusions and policy recommendations.

The circle that needs to be squared

In view of the challenges mentioned above, the EU needs to focus on its key objectives, including dealing with the existing conflicts among these aims, and then prioritise the necessary and appropriate actions and approaches. The key objectives of the EU can be stated as follows:

- investing in the green and digital transformations,
- tackling the energy crisis and moving towards open strategic autonomy,
- promoting growth and competitiveness,
- maintaining public debt sustainability.

Investments in the green and digital transformation

Implementing the European Green Deal and financing the digital transformation are key objectives of the European Commission. The generous funds of the NGEU have been set up to ensure that, in the aftermath of the Covid-19 pandemic, there is sufficient financing, particularly for the economically weaker member states. But are the NGEU funds sufficient, given the additional costs that have arisen due to the energy crisis?

Tackling the energy crisis and moving towards open strategic autonomy

The invasion of Ukraine and the ensuing energy crisis have revealed the critical dependencies of the EU on Russia, particularly with regard to the supply of gas and raw materials. The EU is similarly dependent on China for raw materials, particularly rare earth elements, and various other goods. In times of rising geopolitical conflict, such dependence on autocracies implies vulnerability and the potential for blackmail. However, reducing these dependencies and increasing the EU's (open) strategic autonomy will not only take time, but also be costly.

State aid might be needed to build up production capacities for those goods that are deemed essential. Batteries for electric vehicles, semiconductors and hydrogen have been identified as such goods, and European state aid rules have been loosened to allow for industrial policy support in these fields through their listing as Important Projects of Common European Interest. Moreover, the US Inflation Reduction Act has added impetus to this matter regarding the fields of renewable energy and climate change–abatement technologies. It seems that a global subsidy race has started in several of these fields which might turn out to be costly. On top of all this comes the increased need for Europe to strengthen its defence and security architecture in view of its sizeable dependency on the US in this respect.

Promoting growth and competitiveness

When the severe crisis due to the Covid-19 pandemic receded, a strong rebound in economic growth was expected in 2022. However, the impact of the energy crisis and ongoing supply-chain bottlenecks dampened the economic recovery after the Russian invasion of Ukraine. Even though a recession did not materialise in the EU, the near term the outlook for economic growth remains subdued due to high inflation and rising interest rates. In addition, the enduring higher levels of energy prices are weighing on price competitiveness, particularly, but not only, for energy-intensive companies, for which the possibility of the significant relocation of investments and production has arisen. In addition, the US Inflation Reduction Act has raised concerns about the general competitiveness of the EU for climate change abatement–related production. As a result, the hope that the green transformation can significantly support economic growth has become more questionable.

In the medium term, important disruptive megatrends are also tending to weaken future growth prospects, as illustrated in Figure 1. These trends are as follows:

- Demographic developments. Many baby boomers will retire while fewer younger employees will enter the labour market. The lack of (particularly skilled) labour will significantly dampen potential economic growth in this and the next decade.
- Reshoring or nearshoring economic activities. Increasing supply-chain resilience to foster (open) strategic autonomy will reduce the efficiency of international labour sharing and thus total factor productivity as an important driver of growth. The same could become true for the above-mentioned rise in state aid.
- Decarbonisation. This change might not provide the hoped-for positive impulses for growth. Important growth factors such as the capital stock, labour inputs or growth-enhancing technical progress are unlikely to increase when existing production structures are only made climate friendly, instead of being augmented. It is true that more investment and economic activity will surface for climate-friendly production, but climate-unfriendly activities will decline at the same time, resulting in the overall balance being uncertain.

Table 1 Effect of the four disruptive trends on debt sustainability

	Government expenditure	Growth	Real interest rate
Demography	Higher spending on pensions, health and care insurance	Shrinking workforce and shortage of skilled labour	Higher savings among the young for old age, but lower savings among the elderly
Decarbonisation	Government investment and subsidies	Structural transformation	Higher investment
Digitalisation	Government infrastructure investment	Higher productivity growth (but so far not observable)	Higher investment
Deglobalisation / strategic autonomy	Industrial subsidies	Lower productivity growth	Perhaps slightly higher inflation

Source: J. Matthes (authors' translation).

Note: Qualitative colour rating scale: improvement in public debt sustainability = green, neutral impact = no colour, deterioration = orange. A lighter shade implies a lower impact.

Maintaining public debt sustainability

Public debt ratios have risen to problematic levels in several European countries due to the Covid-19 pandemic. The energy crisis is further burdening government budgets. Rising interest rates will, over time, also have a negative impact on public debt sustainability, as will the above-mentioned decreasing prospects of economic growth. In the medium term, the disruptive megatrends mentioned above will also tend to undermine public debt sustainability with regard to higher government expenditures and higher real interest rates (for details see Figure 1).

Priority: avoiding a sovereign debt crisis

In summary, the fiscal situation is tense and will remain so in the medium term. It is questionable how all the above-mentioned spending needs can be financed without endangering public debt sustainability, especially in highly indebted countries.

Should fiscal policy prove too lax to guarantee a sustainable fiscal outlook, a sovereign debt crisis could occur—and very likely an ensuing broader financial crisis also. Such a crisis would severely weaken the EU and would fundamentally undermine all the objectives mentioned in this section, including the strategic autonomy of the EU. Thus, avoiding a sovereign debt crisis must be the key priority of the EU. In other words, the above-mentioned objectives can only be achieved if public debt sustainability is not endangered. For this reason, the proper functioning of the SGP is a vital building block to square the circle.

Reform of the SGP

Preceding reform discussions and proposals

Discussion of the reform of the SGP started before the Covid-19 pandemic, but the higher public debt levels in many member states have added urgency to such discussions. The criticism of the SGP centres around its complexity, the lax interpretation of its rules and the fact that sanctions are not used. Moreover, critics argue that fiscal policy in the EU is too procyclical despite the SGP and that the calculation of the structural balance, which is currently the main operational indicator in the so-called preventive arm, is error-prone and often subject to revision.

There has been a lively academic debate about how to reform the SGP. While the proposals differ in important respects, there are also significant commonalities:

- It is commonly accepted that the SGP's debt reduction rule would overburden highly indebted member states as it would force them to consolidate very radically, jeopardising their economic growth.

- Many experts propose the introduction of an expenditure rule as the single operational indicator, in order to reduce the complexity and enhance the operability of the SGP, and to reduce procyclicality.[2]

- To enhance compliance with the rules, it is often suggested that independent institutions are more closely involved.[3]

Other notable reform proposals are more controversial or less widespread:

- Some experts propose a 'golden rule' for public investment, which in principle would allow deficit-financing of public investment.[4] Recently, similar exceptions have been suggested for green public investments.[5]

- A number of reform proposals argue in favour of moving away from general rules to *country-specific rules* for debt reduction.[6]

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[2] M. Andrle et al., *Reforming Fiscal Governance in the European Union*, IMF Staff Discussion Note 15/09 (Washington, DC, 2015); A. Bénassy-Quéré et al., *Reconciling Risk Sharing With Market Discipline: A Constructive Approach to Euro Area Reform*, Centre for Economic Policy Research, Policy Insight 91 (London, 2018); D. Christofzik et al., *Uniting European Fiscal Rules: How to Strengthen the Fiscal Framework*, German Council of Economic Experts, Working Paper 04/2018 (Wiesbaden, 2018); Z. Darvas, P. Martin and X. Ragot, *European Fiscal Rules Require a Major Overhaul*, French Council of Economic Analysis, Note no. 47 (Paris, 2018); Deutsche Bundesbank, *Europäischer Stabilitäts- und Wachstumspakt: zu einzelnen Reformoptionen*, Monthly Report (Frankfurt am Main, 2019); EFB, *Annual Report 2019* (Brussels, 2019); B. Busch and B. Kauder, *Der Stabilitäts- und Wachstumspakt. Bestandsaufnahme und Vorschläge für mehr fiskalpolitische Disziplin in Europa*, IW Analysis no. 142 (Cologne, 2021); J. Matthes, *Stabilität statt staatlicher Überforderung. Empfehlungen für eine Reform des Stabilitäts- und Wachstumspaktes*, IW, Policy Paper no. 1 (Cologne, 2022).

[3] Bénassy-Quéré et al., *Reconciling Risk Sharing With Market Discipline*; Christofzik et al., *Uniting European Fiscal Rules*; Deutsche Bundesbank, *Europäischer Stabilitäts- und Wachstumspakt*; EFB, *Annual Report 2020* (Brussels, 2020); Busch and Kauder, *Der Stabilitäts- und Wachstumspakt*.

[4] J.-P. Fitoussi and J. Creel, *How to Reform the European Central Bank*, Centre for European Reform (London, 2002); F. Barbiero and Z. Darvas, *In Sickness and in Health: Protecting and Supporting Public Investment in Europe*, Bruegel, Policy Contribution 2014/02 (Brussels, 2014); A. Truger, Implementing the Golden Rule for Public Investment in Europe, AK Wien, Materialien zu Wirtschaft und Gesellschaft Working Paper no. 138 (Vienna, 2015); EFB, *Annual Report 2020*.

[5] A. Pekanov and M. Schratzenstaller, *The Role of Fiscal Rules in Relation With the Green Economy – Study Requested by the ECON Committee*, Austrian Institute of Economic Research, Study no. 66442 (Vienna, 2020); Z. Darvas and G. Wolff, *A Green Fiscal Pact: Climate Investment in Times of Budget Consolidation*, Bruegel, Policy Contribution 18/21 (Brussels, 2021).

[6] EFB, *Annual Report 2020*; P. Martin, J. Pisani-Ferry and X. Ragot, *Reforming the European Fiscal Framework*, French Council of Economic Analysis, Note 63 (Paris, 2021).

- A more far-reaching suggestion is to replace the current fiscal rules with *qualitative standards* and to give more room for economic judgement based on the standard tool of a debt sustainability analysis (DSA) of public debt.[7]

The European Commission's proposal

Against the backdrop of the ongoing reform discussion, the European Commission presented its proposal for reform of the SGP in November 2022[8] and a legislative proposal in April 2023.[9] One of its main elements is that the Maastricht Treaty reference values of a government budget deficit of 3% of GDP and a 60% debt-to-GDP ratio remain, in principle, unchanged. Moreover, the focus is on achieving a credible debt-reduction path towards a debt-to-GDP ratio of 60% that is sufficiently conducive to economic growth. The single operational indicator to ensure debt sustainability would be net primary expenditure, which would replace the structural balance and the debt-reduction benchmark, the so-called 1/20th rule.[10]

The central change would be the introduction of country-specific medium-term fiscal-structural plans. These would be bilaterally negotiated between the respective member state and the European Commission, usually cover a period of four years and have a net expenditure path as the single fiscal indicator. The European Commission would set up reference net expenditure paths:

- For highly indebted countries (those with a debt-to-GDP ratio above 90%), by the end of the 4-year adjustment period debt reduction would have to be sustainable and on a downwards trend for the next 10 years; moreover the budget deficit of 3% of GDP would have to be respected

[7] C. Wyplosz, *Fiscal Discipline in the Eurozone: Don't Fix It, Change It*, Ifo, DICE Report II/2019 vol.17 (Munich, 2019); O. Blanchard, A. Leandro and J. Zettelmeyer, *Redesigning EU Fiscal Rules: From Rules to Standards*, Peterson Institute for International Economics, Working Paper 21–1 (Washington, DC, 2021).

[8] European Commission, *Communication on Orientations for a Reform of the EU Economic Governance Framework*, COM(2022) 583 final (9 November 2022).

[9] European Commission, *Proposal for a regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) no. 1466/97, 2023/0138 (COD)*; European Commission, *Proposal for a Council Regulation amending regulation (EC) no. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, 2023/0137 (CNS)*.

[10] Net primary expenditure is defined as expenditure net of discretionary revenue measures and excluding interest expenditure as well as cyclical unemployment expenditure.

for the next 10 years.

- For moderately indebted countries (with a debt-to-GDP ratio of 60%–90%), these requirements would apply after an additional adjustment period of three years (i.e. seven years).
- Member states could request an extension of three years to the time horizon of the plans for special reforms and investments.

To assess the plausibility of the fiscal-structural plans, the European Commission would use DSAs. Once the fiscal-structural plans had been agreed with the Commission, they would need to be approved by the Council. Should a highly indebted country not be able to comply with its plan, an Excessive Deficit Procedure (EDP) would be opened by default.

Further elements of the European Commission's reform proposal are the introduction of member state–specific general escape clauses, which could be activated in case of an unforeseen macroeconomic downturn in the country. Moreover, the Commission suggests the introduction of milder sanctions, in the form of lesser financial sanctions or reputational sanctions, such as the requirement to present measures to comply with the EDP recommendations in the European Parliament.

The European Commission's legislative proposal,[11] presented in April 2023, is very similar to the proposal from November 2022.[12] However, there are two main differences:

- The public debt ratio must be lower at the end of the period covered by the fiscal-structural plans than at the start.
- As long as the government deficit remains above 3% of GDP, there needs to be a minimum fiscal adjustment of 0.5% of GDP per year.

[11] European Commission, *Proposal for a regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance*; European Commission, *Proposal for a Council Regulation amending regulation (EC) No 1467/97*.

[12] J. Zettelmeyer, 'How Will Member States React to the European Commission's Proposal for Fiscal Governance Reform?', *The Why Axis*, 27 April 2023.

Evaluation of the European Commission's reform proposal

The Commission's proposal has been met with a mixed response. Blanchard et al. generally approve of its core elements, such as the medium-term fiscal adjustment plans based on DSAs and using net expenditure as the operational target. At the same time, they criticise the outsized role of the Commission and the vagueness of important requirements, and suggest adding clarity to the proposal by establishing a clearer framework for both the adjustment path and the DSA. Moreover, they are in favour of stronger involvement from the independent national fiscal institutions (IFIs) and the European Fiscal Board (EFB), as this would help reduce the leeway available to the European Commission.[13] This view is shared by Wyplosz.[14] A stronger role for the EFB is also advocated by Heinemann.[15] Lorenzoni et al. similarly suggest giving more space to IFIs and the European Parliament in the evaluation and approval of the fiscal-structural plans.[16]

Wyplosz generally welcomes the medium-term perspective and the differentiation among member states, but has objections to DSAs, as they are highly sensitive to the underlying assumptions, which would be decided upon and judged by the European Commission.[17] Additionally, he argues that the four-year horizon for the fiscal-structural plans is too short. Heinemann, in contrast, views the time horizon as too long. He also criticises the general acceptance of debt-financed investment, arguing that this should be restricted to types of investment that have been proven to enhance growth.[18]

The positive aspects and the shortcomings of the main elements of the Commission's reform proposal, from the point of view of the authors of this brief, are summarised in Table 2. Overall, in theory, the reform proposal could be a step towards ensuring fiscal sustainability. This is particularly true with regard to the

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13 O. Blanchard, A. Sapir and J. Zettelmeyer, 'The European Commission's Fiscal Rules Proposal: A Bold Plan With Flaws That Can Be Fixed', *Bruegel*, 30 November 2022.

14 C. Wyplosz, 'Reform of the Stability and Growth Pact: The Commission's Proposal Could Be a Missed Opportunity', *VoxEU*, 17 November 2022.

15 F. Heinemann, 'Der Schulden-Plan für Europa geht genau in die falsche Richtung', *Welt.de*, 17 February 2023.

16 G. Lorenzoni et al., 'New EU Fiscal Rules and Governance Challenges', *VoxEU*, 2 January 2023.

17 Wyplosz, 'Reform of the Stability and Growth Pact'.

18 Heinemann, 'Der Schulden-Plan für Europa geht genau in die falsche Richtung'.

medium-term focus of the fiscal-structural plans, as they provide more room for country-specific circumstances and focus on the debt-reduction path by using the established method of DSAs.

However, while in theory the proposal has important merits, there are two main problems which will become relevant to its practical application:

- The discretion in the hands of the European Commission is too extensive and could be misused politically. As a remedy, independent institutions, such as the EFB or the IFIs, should have a stronger role, for example, in conducting the DSAs and in monitoring the implementation of the fiscal-structural plans.
- Moreover, medium-term DSAs are highly sensitive to assumptions, which again implies a large scope for discretion. Thus, the European Commission has to keep its promise to communicate very openly about the methodology and the underlying assumptions made in the DSAs.

In addition, a quantitative safeguard should be introduced to limit the significant discretion granted to the European Commission. With net expenditure as the single operational indicator in the fiscal-structural plans, it would make most sense to apply a benchmark to this indicator, for instance by setting a limit to the growth of net expenditure with regard to potential GDP growth.[19] This would add credibility and transparency to the process, while maintaining the necessary flexibility.

[19] J. Matthes and S. Sultan, 'Reform der EU-Fiskalregeln: Lindners Ideen haben Berechtigung', IW, Short Report no. 29 (Cologne, 2023).

Table 2 Pros and cons of the main elements of the European Commission's proposal to reform the Stability and Growth Pact

Reform element	Pro	Con
Maintaining Maastricht criteria of 3% GDP budget deficit and 60% debt-to-GDP ratio	These criteria have well-known visibility and important signalling effects in the public debate	
	Debt-to-GDP criterion de facto attainable for many member states (no need to increase it as sometimes suggested)	
Abolition of 1/20 debt reduction rule	Abolition of 1/20 rule reduces pressure to have to consolidate too fast	
Introduction of medium-term fiscal-structural plans with a time horizon of a minimum of four years	More focus on the medium-term as fiscal policy tends to be too short-sighted in practice	Long regular adjustment period could delay necessary debt reduction
	Increases 'ownership' of member states as they set up the plans, which could increase compliance	Medium-term focus renders forecasts more dependent on underlying assumptions and opens up greater potential for error
		Medium-term fiscal-structural plans may conflict with election cycles, which might make revisions to the plans necessary or else risk legitimacy problems
Introduction of country-specific DSAs to assess the plausibility of the fiscal-structural plans	Complicated thicket of rules is replaced by a risk-based DSA that is more attuned to individual circumstances than general rules	Increases discretion of the European Commission, which could also be used politically
	Commission will use a common DSA framework and promises to be very transparent about method and results	DSA hinges on the underlying assumptions which increases the discretion of the European Commission, which conducts and monitors this analysis

Reform element	Pro	Con
		Unclear under which minimum probability the public debt ratio has to decline in DSA
		Using DSA to construct the reference expenditure path is risky, as DSA is better suited to calculating debt risks under different assumptions.
Member state and the European Commission negotiate fiscal-structural plans bilaterally	Allows for the consideration of country-specific circumstances	Grants unduly large opportunity for discretion to European Commission
In case of investments and reforms, the adjustment period can be prolonged by three years	Gives member states room to make investments and implement reforms, which is particularly important for the green and digital transition	Definition of which reforms and investments justify extension of adjustment period is too vague, granting too much discretion to the Commission
		Grants a lot of discretion to the member states
		Unclear how to ensure that reforms and investments are growth-enhancing and strengthen debt sustainability
Net primary expenditure as main operational indicator for medium-term fiscal-structural plans to ensure that debt is on a downward path	This indicator would replace the structural balance as operational indicator in the preventive arm, which is error-prone and can only to a limited extent be controlled by the government	The focus of the plans is on the debt-reduction paths, while the actual debt ratios become less relevant
		Estimating suitable expenditure paths based on potential growth estimate could also be error-prone
No golden rule for public investment	Not all public investment is growth-enhancing and thus basically self-financing	Possibility to prolong adjustment period in case of suitable investments could de facto amount to a kind of golden rule
Introduction of milder sanctions	Increases probability that sanctions are actually used	

Reform element	Pro	Con
Fiscal-structural plans should address CSRs priorities and refer to RRPs	Need to consider both CSRs and the RRPs makes policy consistency more likely	
Introduction of country-specific general escape clauses	More flexibility to react to country-specific crises	More discretion to justify reduced consolidation efforts
For member states with 'substantial' public debt challenges, default activation of debt-based EDP in case of deviation from the plan.	Reduces the political discretion in its activation and increases enforcement	
For member states with a 'moderate' public debt challenge, the European Commission has the discretion to open a debt-based EDP	Suited to the more limited debt challenge of these member states in comparison to member states with 'substantial' public debt challenges	Political risks related to unequal treatment of member states

DSAs for public debts

Public debt sustainability could become endangered if the reform of the SGP led to an unduly lax fiscal policy stance, particularly as financial markets could demand higher interest rate risk premiums as a result. In view of this, a basic DSA of public debts is carried out in this section. It shows that the margins for a lax fiscal policy stance are small, particularly for highly indebted countries.

The DSA uses various assumptions about the fiscal policy stance in the near future and, therefore, focuses on the development of public debt ratios. The short- and medium-term factors mentioned in section two affect fiscal policy and public debt sustainability. Several additional aspects will also have an impact:

- The NGEU loans taken out by the member states are not accounted for in the fiscal deficit statistics but do de facto increase public debts. This accounting trick tends to negatively influence the public debt dynamics.
- After 2027, when the NGEU programme ends, member states will no longer be supported by the respective funds, which could imply higher fiscal deficits.
- Moreover, the loans taken out by the EU to finance the NGEU must be repaid in the three decades after 2027 using financial means that will effectively be taken from EU economies—regardless of whether the member states decide to increase their EU budget contributions or new own resources for the EU are agreed.

Framework and scenarios

In the following, public debt sustainability is examined for seven EU member countries: France, Germany, Greece, Italy, Poland, Portugal and Spain. This list includes the five largest EU member states as their fiscal policy is also decisive for the rest of the continent. The time horizon is 2030.

The simulations are carried out for three scenarios: a baseline scenario, an intermediate scenario and a pessimistic scenario. The scenarios differ in their assumptions about the development of (primary) fiscal balances and of the average interest rates on public debts (for more details, see the Technical Appendix).

The pessimistic scenario assumes a considerably laxer fiscal policy and, as a result, also higher interest rates compared to the baseline scenario, which relies to a large extent on projections by the International Monetary Fund (IMF). The intermediate scenario lies between the baseline and the pessimistic scenario regarding the fiscal policy stance.

Simulation results

France

The fiscal situation of France gives cause for concern. Figure 1 shows that the debt-to-GDP ratio of France increases in all three scenarios. Having started at 112.6% in 2021 according to the IMF, the debt ratio is expected to increase to 129.4% even in the baseline scenario, which is largely based on IMF assumptions until 2027.[20] This is the sharpest increase in the first scenario among all the countries considered here. Underlying this is an average interest rate of 3% on public debts and a primary fiscal deficit of 3.1% in 2030 (see Figures A1 and A2). While the average interest rate in this scenario is among the lowest in the countries considered, the primary deficit is the largest, corroborating the fact that France's poor fiscal performance results mainly from its high budget deficit.

The two other scenarios feature an increase in the debt ratio to 139.3% or even 147.4%, respectively, based on average interest rates of 4%–5% and primary deficits of 4.8%–6%. France's public debt ratio is hence expected to increase above the level of that of Portugal and Spain in all three scenarios. Having below-average growth prospects (nominal 3.4% in 2030) contributes to the poor outlook.

[20] *IMF*, 'World Economic Outlook Database' (October 2022).

Germany

Starting from a debt ratio of 69.6% in 2021, in the baseline scenario Germany's debt ratio is expected to fall to 58.8%. The underlying assumption is a primary surplus of 0.2% and an average interest rate of 2.7% in 2030. In this case, Germany would show the lowest debt ratio in 2030 among the countries considered.

In the intermediate and the pessimistic scenarios, Germany's debt ratios are expected to increase to 66.3% and 72.3% respectively in 2030. The average interest rates in these scenarios would be 3.7% and 4.7% in 2030. In both scenarios, a primary deficit is expected (1.4% and 2.6% respectively). Nevertheless, Germany has the best fiscal prospects (after Poland) among the countries considered. While the growth prospects (an increase in nominal GDP of 3.7% in 2030) and the fiscal balance are mediocre, Germany benefits from having the lowest average interest rates.

Greece

The starting point for Greece is the worst in the set of countries considered. The public debt ratio in 2021 amounted to 199.4%. Its prospects are, however, the most positive. In the baseline scenario, the public debt ratio is expected to decrease by about 50 percentage points to 148.9% in 2030. The underlying assumption is a primary surplus of 2% in 2030, the largest among all the countries studied. The average interest rate is expected to increase to 3.7% by 2030 in this scenario.

In the two other scenarios, the debt ratios are also expected to decrease substantially, to 159.7% and 169.1%, respectively. The underlying average interest rates are 4.7% and 5.7%, with primary balances of 0.4% and -0.9%, respectively. Given that the average interest rate is expected to increase to relatively high levels, it is undoubtedly the primary balance that explains the good fiscal prospects for Greece, despite having quite poor expected GDP growth rates (nominal 3.3% in 2030).

Italy

With a starting public debt ratio of 150.9% in 2021, Italy is another country giving cause for concern. It has the second-highest debt ratio in the group of countries considered. Even in the baseline scenario, Italy's debt level is expected to remain nearly constant (150.4% in 2030)—with just a small decline heading towards the middle of the decade and a similar increase afterwards. The reason for this is the poor expected nominal GDP growth rate of 2.9% and a relatively high average interest rate of 3.9% in 2030. The primary balance is slightly positive at 0.1% in 2030, which makes Italy one of the better performers in this respect.

In the two other scenarios, Italy's debt ratio is expected to increase to 159.0% and 168.2% respectively. The average interest rates in these two less-optimistic scenarios amount to 4.9% and 5.9% respectively, while the primary balances turn negative, to -1.1% and -2.4%. Italy's fiscal problems are primarily caused by having the worst nominal GDP growth rates among the countries under consideration.

Poland

As the only country from Central and Eastern Europe in this study, Poland is remarkably different. The public debt ratio in 2021 was 53.8%, which is the lowest value among the countries considered. In 2022, the ratio even fell below 50%. In all three scenarios, however, Poland's debt ratio is expected to increase. In the baseline scenario, the debt level increases to 59.7% by 2030. The underlying average interest rate is assumed to be 6.2%, and the underlying primary deficit 5.2%. While its 2030 deficit is the largest after France's, Poland's forecast average interest rate is by far the highest in the sample.

The other two scenarios show increases in the debt ratio to 66.7% and 72.4% respectively. The underlying assumptions for these scenarios are average interest rates of 7.2% and 8.2% and primary deficits of 3.9% and 5.2% respectively in 2030. The negative effects of high interest rates and primary deficits dominate the positive effect of having the highest growth rates for nominal GDP among the countries analysed (6.5% in 2030).

Portugal

After Greece, Portugal is the only country among those considered with decreasing public debt ratios in all three scenarios. Having started with a debt ratio of 127.4% in 2021, it is expected to decrease to 92.5% in the baseline scenario. This is due to both a moderate average interest rate (3.1% in 2030) and a primary surplus (0.9% in 2030). An expected high growth rate of nominal GDP of 4.3% in 2030 (the second highest value in the sample) contributes to this positive outlook.

Furthermore, the intermediate and the pessimistic scenarios also forecast a declining debt ratio in Portugal, with values of 99.9% and 107.0% respectively in 2030. The underlying average interest rates amount to 4.1% and 5.1%, and the primary balances to -0.4% and -1.7%, respectively. Overall, Portugal benefits from relatively good growth and a strong fiscal position, which is also reflected in the fact that its formerly high interest rates have moderated.

Spain

The expected development of the public debt ratio in Spain shows little dynamism. Starting from a debt ratio of 118.6% in 2021, the baseline scenario assumes a reduction to 113.2% by 2030. The average interest rate is expected to be moderate at 3.3% in 2030 in this scenario, while the primary budget deficit is expected to amount to 2%. The improvement in the debt level in the baseline scenario is supported by a relatively high growth rate of nominal GDP of 4.2% in 2030.

The other two scenarios show a moderate increase in the debt ratios to 120.2% and 127.8%, respectively. In these scenarios, the expected average interest rates in 2030 are 4.3% and 5.3% respectively, with the expected primary deficits at 3.2% and 4.4%. Taken together, Spain is in an intermediate position in the set of countries considered, with the growth rate of nominal GDP being one position above and the primary surplus one position below the median.

Figure 1 Simulated effect of different scenarios on public debt ratios (% of GDP)

France

Germany

Greece

Italy

Poland

Portugal

Spain

Baseline Intern. Pessim.

Source: European Commission, IMF, IW.

Note: The assumptions underlying the three different scenarios are outlined above and more detail is given in the Technical Appendix. The time frame for the simulation is 2023–30.

Conclusion and policy recommendations

Overall, the results of our DSA show that for countries in a fiscally weaker position, relaxing consolidation efforts and raising further public debt to finance investments that are unlikely to be growth enhancing could set the public debt ratio on an upward sloping path. This risks being regarded as fiscally unsustainable by the financial markets.

Meanwhile, the examples of Portugal and Greece show that in formerly vulnerable countries it is possible to combine a strong fiscal position with relatively good growth—as both countries continue to benefit from the encompassing reforms enacted during the euro debt crisis.

This highlights how decisive fiscal policy is in shaping the EU's outlook. In the face of growing geopolitical tensions, it is vital to maintain fiscal sustainability, as a sovereign debt crisis would endanger the green and digital transformation. This should be the guiding principle when reforming the SGP and leads us to offer the following conclusions and policy recommendations:

- While the proposed reform of the SGP by the European Commission is theoretically a step in the right direction towards a more integrated and long-term approach to fiscal sustainability, there are some major practical shortcomings to the proposal.
- In particular, the originally proposed adjustment period of up to seven years, in which debt would not have to decline, even for highly indebted countries, is far too long. The requirement in the Commission's legislative proposal of late April 2023 that the public debt ratio must decrease during the period covered by the fiscal-structural plans is therefore a step in the right direction.
- The proposal would grant a large amount of discretion to the European Commission, which understands itself as a political institution and is thus subject to significant political pressures. The aim should therefore be to depoliticise the implementation of the reformed SGP.
- This could be attained by giving independent institutions an important role with regard to the key elements of the new SGP procedures, such as the DSAs or the evaluation of fiscal-structural plans. This pertains to the EFB with the support of the IFIs.
- Moreover, a common quantitative benchmark is required, such as, for

instance, a fixed cap on the growth of public expenditure for member states facing a public debt challenge.[21] This would function as a safeguard to ensure that an excessive deficit and the debt-to-GDP ratio actually decline. In this regard, the requirement in the legislative proposal of a minimum fiscal adjustment of 0.5% of GDP per year for as long as the 3% deficit target is not attained, is a step in the right direction.

Technical appendix

DSA of public debts

A DSA is a simulation of a possible development of the public debt-to-GDP ratio, based on the following equation: The debt-to-GDP ratio in year t—that is, public debt in year t relative to nominal GDP in year t—is determined by formula (1), that is, by the average nominal interest rate on public debt (i), the growth rate of nominal GDP (g), the debt-to-GDP ratio in year t-1 and the primary fiscal surplus as a share of GDP (PS) in year t.[22]

$$Debt_to_GDP\ ratio_t = \left(\frac{1+i}{1+g}\right) Debt_to_GDP\ ratio_{t-1} - PS_t$$

How the individual variables influence the debt-to-GDP ratio can be illustrated as follows:

- If the interest rate equals the growth rate of nominal GDP, the debt-to-GDP ratio in year t is the difference between the debt-to-GDP ratio in year t-1 and the primary surplus in year t. The difference in debt-to-GDP ratios is thus the primary surplus. Should the primary surplus be zero, the debt-to-GDP ratio remains constant.

- If the interest rate exceeds the growth rate of nominal GDP, the debt-to-GDP ratio in year t exceeds the one in year t-1—at least it will in cases where the primary surplus is less than or equal to zero.If the growth rate of nominal GDP exceeds the interest rate, the debt-to-GDP ratio in year

21 Matthes and Sultan, 'Reform der EU-Fiskalregeln'.

22 Gottschalk, 2014; Matthes, 2015, 2017; Kauder, 2021

t is smaller than in year t-1—at least it will be in cases where the primary surplus is larger than or equal to zero.

- The data source for ex post data is the European Commission's AMECO database for the average nominal interest rate on public debts, that is, interest payments as a share of gross public debt, which is available until 2024.[23] For all other variables—public debt, the growth rate of nominal GDP and the primary fiscal surplus—we use the IMF's World Economic Outlook, which provides forecasts until 2027.[24]

Assumptions

The DSA requires assumptions to be made. In this study, three scenarios are investigated, which make different assumptions about the future development of the above-mentioned determinants of the public debt-to-GDP ratio until 2030. In all three scenarios, the IMF's projection for growth of nominal GDP is used until 2027. As of 2028, nominal GDP is assumed to grow at the average growth rate of nominal GDP between 2024 and 2027. The three scenarios differ in their assumptions about the development of the primary surplus and the average interest rate on public debts.

Scenario 1: baseline scenario

- For the primary surplus, the IMF's projection is used until 2027. It is assumed that the 2027 value persists until 2030.
- It is assumed that the average interest rate will follow the European Commission's predictions until 2024. At the end of our time horizon, in 2030, the average interest rate is assumed to be equal to the current five-year government bond yield on the market. Between 2024 and 2030, a linear increase in the average interest rate is assumed up to this level. The idea behind this approach is that the current market interest rates, which are only relevant for newly issued debts, are higher than the current average interest rates on public debt in several countries. Thus, average interest rates will rise over time. However, average interest rates

23 European Commission, 'AMECO Online'.

24 *IMF*, 'World Economic Outlook Database' (October 2022).

will rise only slowly due to the longer average maturities of public debts of about five to six years. Market interest rates will likely rise further before they fall again due to current inflation persistence and foreseeable ECB interest rate hikes. Taken together, the current market interest rate appears as a viable orientation for the average interest rate in 2030.

Scenario 2: intermediate scenario

This scenario is based on the assumption of a laxer fiscal policy.

- For the primary surplus, the IMF's projection is used until 2025. For the period 2026 to 2030, a continuous reduction of the primary surplus by a quarter of a percentage point per annum is assumed, due to the laxer fiscal policy.
- It is again assumed that the average interest rate will follow the European Commission's predictions until 2024. In 2030, the average interest rate is assumed to be equal to the current five-year government bond yield on the market, *plus one percentage point*. The higher level in 2030 is the result of somewhat higher assumed risk spreads due to the weaker fiscal performance of the primary surplus. Between 2024 and 2030, a linear increase of the average interest rate is again assumed.

Scenario 3: pessimistic scenario

This scenario is based on the assumption of a very lax fiscal policy.

- For the primary surplus, the IMF's projection is used until 2025. For the period 2026 to 2030, as a result of even laxer fiscal policy, a continuous reduction of the primary surplus by half a percentage point per annum is assumed. Moreover, higher interest rates due to higher risk spreads dampen the economy and reduce tax revenues, which also contributes to the reduction of the primary surplus.
- It is again assumed that the average interest rate will follow the European Commission's predictions until 2024. In 2030, the average interest rate is assumed to be equal to the current five-year government bond yield on the market, *plus two percentage points*. The significantly higher level in 2030 is the result of assumed considerably higher risk spreads

due to weaker fiscal performance and emerging fears about fiscal solvency. Between 2024 and 2030, a linear increase in the average interest rate is assumed.

The assumptions underlying the three scenarios are depicted in Figures A1 and A2 for each country and show that, both for the average interest rate and the primary surplus, our assumptions, even in the pessimistic scenario, are not unrealistic, as similar levels have been observed for both variables over the time horizon since 2000.

Figure A1 Assumptions for average interest rates on public debts (in %) in the three scenarios

Spain

10							
5							
0							
	2000	2005	2010	2015	2020	2025	2030

Baseline Intern. Pessim.

Portugal

10 / 5 / 0

2000 2005 2010 2015 2020 2025 2030

Baseline Intern. Pessim.

France

10 / 5 / 0

2000 2005 2010 2015 2020 2025 2030

Baseline Intern. Pessim.

Germany

10 / 5 / 0

2000 2005 2010 2015 2020 2025 2030

Baseline Intern. Pessim.

Greece

10 / 5 / 0

2000 2005 2010 2015 2020 2025 2030

Baseline Intern. Pessim.

Italy

10 / 5 / 0

2000 2005 2010 2015 2020 2025 2030

Baseline Intern. Pessim.

Poland

10 / 5 / 0

2000 2005 2010 2015 2020 2025 2030

Baseline Intern. Pessim.

Source: European Commission, 'AMECO Online'; IMF, 'World Economic Outlook Database'; assumptions by IW.

Figure A2 Assumptions for primary balances (in % of GDP) in the three scenarios

France

5
0
-5
-10
2000 2005 2010 2015 2020 2025 2030

Baseline Intern. Pessim.

Germany

5
0
-5
-10
2000 2005 2010 2015 2020 2025 2030

Baseline Intern. Pessim.

Greece

5
0
-5
-10
2000 2005 2010 2015 2020 2025 2030

Baseline Intern. Pessim.

Italy

5
0
-5
-10
2000 2005 2010 2015 2020 2025 2030

Baseline Intern. Pessim.

Poland

5
0
-5
-10
2000 2005 2010 2015 2020 2025 2030

Baseline Intern. Pessim.

Portugal

5
0
-5
-10
2000 2005 2010 2015 2020 2025 2030

Spain

5
0
-5
-10
2000 2005 2010 2015 2020 2025 2030

Baseline Intern. Pessim.

Source: European Commission, ‘AMECO Online’; IMF, ‘World Economic Outlook Database’; assumptions by IW.

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