How to accelerate EU investment within the revised framework of EU economic governance?

Zsolt Darvas
Based on a joint work with Lennard Welslau and Jeromin Zettelmeyer

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Outline

1. Incentives for reforms and investments in the new fiscal framework
2. Two provisions related to the national co-financing of EU funds – not really supporting investment
3. The current practice of incorporating reform and investment impacts in the debt sustainability analysis (DSA)
4. An approach for incorporating reforms and investments in the DSA
5. Conclusions
1. Incentives for reforms and investments in the new fiscal framework

• Main incentive: the possibility of extending the four-year-long adjustment period to seven years, thereby lowering the annual fiscal adjustment requirement (see next slide)
• Extension depends on various requirements, including no decline in nationally-funded public investments compared to the average realised over the period covered by the Recovery and Resilience Plan
• However, to increase public investment at a time of fiscal consolidation, EU countries would need to undertake more fiscal consolidation in non-investment components of the budget to make room for extra investment
Annual average fiscal adjustment requirements under the new fiscal framework

For some countries, the 7-year adjustment period requires about 0.5% of GDP less average annual adjustment.

Note: total adjustment over 7 years is typically slightly higher than total adjustment over 4 years.

Source: Bruegel. Note: Methodology based on European Commission (2023) and adjusted with the new requirements of the approved fiscal framework.

Data: November 2023 Commission forecast for macro variables, January-February 2024 market expectations for interest rate and inflation.
2.1 Two provisions related to the national co-financing of EU funds – not really supporting investment

• Article 2 (Definitions): “(2) ‘net expenditure’ means government expenditure net of interest expenditure, discretionary revenue measures, expenditure on programmes of the Union fully matched by Union funds revenue, national expenditure on co-financing of programmes funded by the Union, cyclical elements of unemployment benefit expenditure, and one-offs and other temporary measures;”

• However, the net expenditure indicator is the operational target in the new fiscal framework, but it does not influence any of the fiscal adjustment requirements
2.2 Two provisions related to the national co-financing of EU funds – not really supporting investment

- Article 38bis (Transitory provisions) “(c) Projects related to Recovery and Resilience Facility loans as well as national co-financing of EU funds in 2025 and 2026 shall be taken into account whenever a Member State requests an exception to the no-backloading safeguard referred to in Article 6 point c, provided that this does not endanger fiscal sustainability in the medium term;”

- However, when RRF-loan financed expenditures decline in 2026 = fiscal consolidation → excluding it would require more fiscal consolidation in other budget items

- Exclusion helps if such spending goes up in 2026 → incentive to delay such spending to 2026, or not to request an exception
3. The current practice of incorporating reform and investment impacts in the debt sustainability analysis (DSA)

- All projections (T+2 for near-term forecasts, and longer horizon projections for the NAWRU anchor, participation rate, and other ageing-cost related variables) are based on a no-policy change assumption and, therefore, take into account only policy measures and structural reforms which are legislated or otherwise credibly announced in sufficient detail at the cut-off date for the finalisation of the forecasts.
- This implies that the growth-enhancing impacts of reforms and investments proposed by EU countries in their medium-term fiscal structural plans (MTFSPs) will not be incorporated into the DSA.
- In fact, the EU lacks a methodology to quantify such impacts.
- Long-term TFP assumption is the same for all EU countries, and thus do not depend on structural factors.
4. An approach for incorporating reforms and investments in the DSA

- Countries planning reforms and investments in their medium-term fiscal-structural plans will likely argue that this will increase growth.
- Two main uncertainties:
  - **Implementation risk** (countries do not implement):
    1. Set benchmarks that would indicate if the reform is on track
    2. Set a ‘backup fiscal trajectory’, which comes into effect if the reform is not implemented
  - **Uncertain reform impact** (impact is lower than what models suggest):
    1. The Commission proposes a distribution around the estimated impact of the reform
    2. If the Council accepts the proposal, the required fiscal adjustment would be based on a conservative assumption about the growth impact of the reform – based, for example, on a 30th percentile estimate, rather than the median estimate of the impact
- Put this process into the ‘Code of conduct’ of the SGP
5. Conclusions

• New fiscal framework requires ambitious fiscal adjustments from high-debt countries
• Extending the adjustment period from 4 to 7 years reduces the annual average adjustment need by about 0.5% for some countries
• But the extension requires tough conditions
• Public investments and reforms can boost potential output, which would reduce fiscal adjustment needs
• There is a need for a new methodology to evaluate the impact of recently adopted and planned reforms and investments
• Reforms should be reflected in medium- and long-term TFP projections
• A new procedure is needed to address implementation risk and the uncertainty in reform impacts
Thank you!

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