EU and national fiscal and regulatory policy responses

As soon as governments across Europe started imposing measures to stem the spread of the virus, they also began announcing parallel actions to protect people, firms and the productive capacity of their national economies from the short-term impact of suspending large parts of economic activity. Governments stepped in to subsidise wage replacement for short-time work and job retention (furlough) schemes. They extended unemployment and sickness benefits, and expanded the eligibility criteria, to support the income of workers who had to go into quarantine (including support for categories of workers that would not have been previously covered).

Households and companies were granted the possibility to defer their tax and social security contributions and rent payments to the public sector. Public guarantees were granted to firms against their bank loans, and regulations were established to protect firms against creditors' claims. Governments also extended funding to expand the capacity of their national healthcare sector to cope with the demands from the pandemic. The objective has not just been to alleviate hardship but also to protect the production capacity of economies (in terms of both physical and human capital) in the face of what is being considered a temporary (albeit lasting longer than originally thought) shock, and thus to allow for a speedier recovery.

Policymakers at the EU level initially unsuccessfully tried to coordinate early national policy responses, while Member States instead attempted to secure sufficient stocks of health protection equipment for themselves and unilaterally close borders (see also Chapter 7 in this volume). They thus swiftly proceeded to temporarily suspend or ease regulatory restrictions – notably concerning state aid rules, fiscal rules and bank lending rules – that would have otherwise constrained national policy and financial initiatives to support workers, businesses and the economy. They also provided, among other funds, a total of €540 billion to finance three safety nets: the 'Support to mitigate unemployment risks in an emergency' (SURE) programme (up to €100 billion), a pan-European guarantee fund for loans to companies (up to €200 billion through the European Investment Bank), and the Pandemic Crisis Support credit line for Member States (a precautionary credit line of up to €240 billion provided via the European Stability Mechanism for the euro area Member States).

In May, following a European Commission proposal, the Council approved a regulation for the launch of the SURE programme, which would provide up to €100 billion in loans to Member States to support them, as a second line of defence, in meeting any suddenly and severely increased financing needs for short-time work and job retention schemes. This scheme aims at supporting firms in rescuing jobs and at protecting employees and the self-employed against the risk of unemployment and income loss (European Commission 2020b) (see also Chapter 2). It will also help Member States by ensuring that they face more advantageous interest rates when borrowing to finance their short-time work or job retention schemes. It is therefore more relevant for those Member States which, due to their fiscal positions, might face higher borrowing costs than the EU.

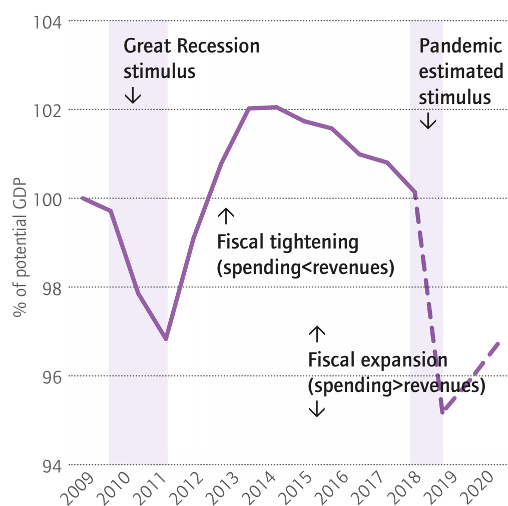
The SURE loans have been backed by €25 billion of guarantees provided on a voluntary basis by the Member States to the EU budget, with national contributions depending on a Member State's share of total EU gross national income. By mid-November 2020, €90.3 billion worth of support had been approved for and/or requested by a total of 18 Member States after three rounds of bond issuance. The response of investors was very encouraging, with demand in each round of issuance being 10-13 times higher than the amount that the EU set out to borrow.

While the SURE scheme provides loans and not grants, is activated on an ad hoc basis rather than automatically, and focuses specifically on short-time work/job retention schemes, it could nevertheless be a first step in establishing a more permanent unemployment reinsurance scheme at the EU level, which could help Member States, especially those of the euro area, stabilise their economies in the face of shocks, which are hitting some countries harder than others. Moreover, SURE could entice even Member States without pre-existing short-time work schemes to set them up systematically (Claeys 2020). The benefits of these schemes have been well established during situations of temporary negative shocks in an economy (see for example Hijzen and Martin 2013). Still, given the relatively limited size of the funds available under SURE compared to the support need, its impact in lightening the fiscal burden for Member States of paying interest rates when borrowing to support short-time work/job retention is likely to be rather small (Claeys op.cit.). This is also because even Member States with higher public debt/GDP ratios, which, other things being equal, might face higher interest rates for borrowing, have not in fact been facing this problem, thanks to the interventions of the ECB in the financial markets (see next section).

The European Investment Bank group, following the endorsement of the European Council in late April, set up a Pan-European Guarantee Fund with €25 billion of capital to leverage support for SMEs and middle-capitalisation companies (also known as mid-caps) of up to €200 billion.

As a further measure to support governments, an agreement was reached at the Eurogroup in May to mobilise funds via the European Stability Mechanism (ESM) for a precautionary credit line, named

Figure 1.19 Fiscal effort EU, EA, 2020-2020 (forecast)



Source: AMECO.

Pandemic Crisis Support, to the euro area Member States (those that fund the ESM) which would need funds to face the crisis. The credit line is based on the Enhanced Conditions Credit Line instrument. A euro area country can thus borrow funds of up to 2% of its 2019 GDP at the rate at which the ESM borrows in the markets, plus some small administration fees, with the condition that it uses the funds to support domestic financing of direct and indirect healthcare costs and cure- and prevention-related costs due to the Covid-19 crisis. To date, no Member State has drawn on this facility, as, following the previous public debt and banking crisis, recourse to the ESM has been associated with stigma for governments and their capacity to keep on servicing their public debt.

In addition to these safety nets, additional funds to the tune of €9.3 billion were mobilised in amendments of the EU's 2020 budget – to be spent on, among other things, healthcare and testing supplies, transfers of payments and pre-ordering vaccine doses. Moreover, decisions were taken to redirect cohesion policy funds from the EU budget to help members tackle the pandemic, most notably, €37 billion under the Coronavirus Response Investment Initiative to support healthcare systems, SMEs and labour markets, and €800 million from the EU Solidarity Fund, whose scope was extended to public health crises so as to support those hit the hardest. Measures were also taken to provide for additional flexibility in using structural funds, also known as the Coronavirus Response Investment Initiative Plus.

Economic support costs weigh heavy on government budget balances and public debt

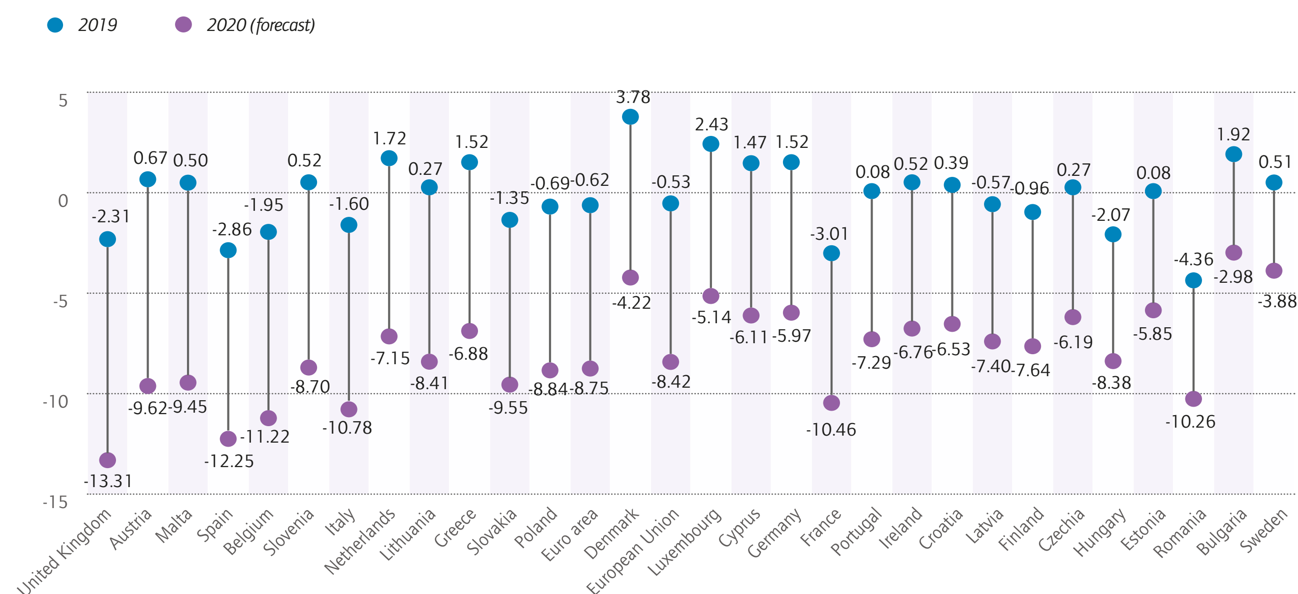
The EU safety nets notwithstanding, additional national spending and guarantee measures, along with the operation of automatic stabilisers, have pushed government budget deficits deeply into the red, while, inevitably, public debt as a share of GDP has been forecasted to expand everywhere. Governments have not faced difficulties in borrowing (i.e. too high interest rates or insufficient demand for their bonds) in the financial markets, as the ECB has intervened to buy securities, including sovereign bonds (see next section).

Figure 1.18 shows the evolution of fiscal effort in the EU since 2007. The fiscal effort shows how the balance between expenditure and revenues that are at the discretion of a government changes. It is measured by the government budget balance (i.e. revenues minus expenditures) adjusted for the business cycle, that is, taking out changes in expenditures and revenues due to higher/lower GDP (for example, higher expenditure in unemployment benefits thanks to the existing rules of the benefits system when unemployment increases) and excluding interest payments on existing public debt. An increase in the cyclically adjusted balance implies that expenditures are smaller than revenues and therefore the fiscal effort is tightening. When this happens while GDP growth is slowing or negative, then we have fiscal austerity. A fiscal expansion happens when the expenditure is greater than revenues.

We see that, according to the latest (autumn) European Commission forecasts (European Commission 2020d), in the EU, fiscal effort is forecast to expand in 2020 but then expected to tighten again in 2021 and 2022. The forecasts for 2021 and 2022 are still subject to much uncertainty though, regarding the evolution of output growth. What is interesting is that the fiscal stimulus of this recession seems to be sharper for this first year of the crisis than it was for the respective first year (2008-9) of the Great Recession.

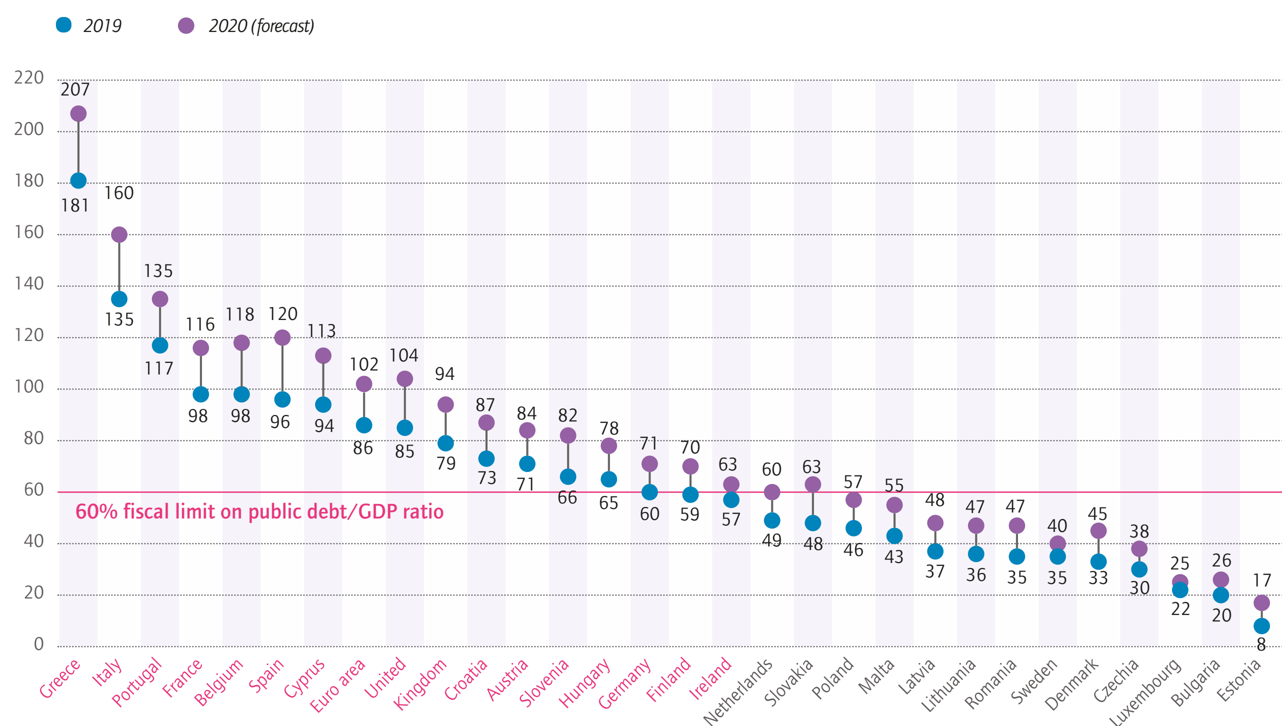
Figure 1.19 shows the general government budget balance for 2019 and the forecast for 2020. This budget balance is not adjusted for the effects of the business cycle, nor does it exclude interest payments as in the previous figure. What it does show is how government budget deficits which determine how much governments must borrow over a year is evolving. For 2020, the EU budget deficit is forecast to be 8.4% of GDP (8.7% for the euro area), down from 0.5% in 2019 (0.6% in the euro area). Bulgaria and Sweden are forecast to have the smallest budget deficits in 2020 at 3% and 3.9% of GDP respectively and also the smallest increases in budget deficits since 2019, by 4.9% and 4.3% percentage points respectively. The UK, Spain, Belgium, Italy, France, Romania, Austria, Slovakia, Malta, Poland and Slovenia are all forecast to have budget deficits larger than the EU average for 2020, between 13.3% of GDP in the UK, 12.2% in Spain, 10.8% in Italy, 10.4% in France and 8.7% in Slovenia.

Figure 1.20 General Government budget deficit (% of GDP) in EU, member states and the UK, 2019 and 2020 (forecast)



Source: AMECO UBLGE series.

Figure 1.21 General government gross debt (% of GDP)



Source: AMECO database, UDGG series.

Figure 1.20 shows the public debt/GDP ratio in 2019 and the European Commission's spring forecasts for 2020. We see that in 14 out of 27 Member States this ratio is forecast to be above the stipulated 60% of the fiscal rules, while the EU and euro area average public debt-to-GDP ratios are forecast to reach 94% and 102% of GDP. Greece, Italy, Portugal, Spain, France, Cyprus and Belgium are all forecast to have higher public debt-to-GDP ratios than the euro area average, with Greece reaching 207% in 2020, while even the frugal Germany, Austria and Finland, as well as the high-growth Ireland, are forecast to exceed the 60% limit. It is mostly central and eastern European and Baltic states who have had relatively low public debt-to-GDP ratios that are forecast to remain below the limit, as well as Luxembourg, Denmark and Sweden. Although the gross public debt/GDP ratio cannot alone illustrate the sustainability of public finances of Member States, it is one of the commonly used indicators thereof. The data on its forecasted levels for 2020 suggest that different Member States have very different degrees of fiscal space for rolling out support measures.

The suspension of the fiscal rules until the end of 2021 has meant that expenditures of Member States to deal with the impact of the pandemic will not be considered when budget deficits and public debts are assessed in 2020 and 2021 to evaluate whether Member States' public finances remain on sustainable paths. In recent public statements, Paolo Gentiloni, the EU Economics Commissioner, mentioned that the question of whether this suspension should be carried over to 2022 will be discussed in the coming months (Financial Times 2020b). While budget deficits should in principle start shrinking again once the pandemic and the extraordinary support

measures start being rolled back and economic activity resumes, there would be further concerns about how soon and how fast Member States would be required to start reducing their public debt at the rates stipulated by the rules.

Under the current rules, it is quite plausible that European economies with public debt/GDP ratios over 60% will be stuck with weak output growth but will nevertheless be required to tighten their fiscal policies to achieve the rate of reduction of public debt stipulated by the rules (one 20th of the difference between the actual public debt/GDP ratio and the 60% limit per year). Following losses in productive capacity and therefore a lower potential GDP, it is also very plausible under the current rules that structural budget balances will be ill-estimated for a while, resulting in recommendations for too tight fiscal policies. Under strong pressure to reduce deficits/expand surpluses too fast, public investment expenditure becomes more vulnerable to cuts, as the politically 'easier' option.

Prior to the current crisis, the European Commission had launched a process of assessing the EU economic governance framework, of which fiscal surveillance has been the most important pillar. Criticisms of the fiscal rules have been abundant, including opacity, over-reliance on metrics (most notably the potential output and the structural budget balance), which are neither observable in real time nor under the control of governments, outdated and arbitrary limits on the public debt/GDP ratio, too restrictive policy stances for safeguarding public investment, and an inability to steer national fiscal policies towards a suitable aggregate fiscal stance. The discussion about these reforms has apparently ground to a halt for the moment. However, its eventual conclusion will be a crucial factor for determining whether in the aftermath of the pandemic Europe will face another period of fiscal austerity and long-drawn-out recovery, as in the 2010s, or whether sufficient public investment will lead the way for the green and digital transitions.

Up until now, the advice of international organisations and prominent policymakers, such as the OECD, the IMF and Mario Draghi, has been unequivocal: governments should do whatever it takes to cushion the economic and social impact of the pandemic, by borrowing and spending and providing guarantees to households and firms until the shock is over. However, it is not clear whether the diversity in the states of different countries' public finances, as often made clear by the public debt/GDP ratio, is likely to restrain Member States (and some more than others) from being able to borrow enough to deal with the short- to medium-term economic and social impacts of the crisis.