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Article

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Reflections on the Euro Area Fiscal Stance

The first considerations on the fiscal stance for the euro area as a whole date back to the late 1980s, when the foundations for the Economic and Monetary Union (EMU) were laid. For example, in a background study for the Delors report, Alexandre Lamfalussy, later to become the first president of the European Monetary Institute, highlighted that fiscal policy coordination was a “vital component of a European EMU”.¹ In his view, such coordination had the joint objectives of determining “a global fiscal policy” and avoiding “tensions from excessive differences between the public sector borrowing requirements of individual Member States”.² In another background paper to the Delors report, the former president of the German Bundesbank Karl Otto Pöhl stressed that “it is of outstanding importance for the success of monetary integration [...] to be accompanied by sufficient progress in the integration of economic and fiscal policy”.³ To this end, “broad agreement [needed] to be reached on the policy mix”, which would “provide a basic guideline for each country’s fiscal policy”.⁴

* The views expressed in this paper are those of the authors and do not necessarily reflect those of the European Central Bank. We would like to thank Hans-Joachim Klöckers, Marien Ferdinandusse, Maximilian Freier, Stephan Haroutunian and David Pichler for their input and comments. We also thank Paul de Grauwe and participants of the Intereconomics/CEPS conference “A Fiscal Stabilisation Function for the Eurozone” in Brussels on 20 April 2017 for valuable discussions.

1 A. Lamfalussy: Macro-Coordination of Fiscal Policies in an Economic and Monetary Union in Europe, in: Collection of papers submitted to the Committee for the Study of European and Monetary Union, Luxembourg 1989, Office for Official Publications of the European Communities.

2 Ibid.

3 K.O. Pöhl: The further development of the European Monetary System, in: Collection of papers submitted to the Committee for the Study of European and Monetary Union, Luxembourg 1989, Office for Official Publications of the European Communities.

4 Ibid.

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The subsequent Delors report put forward a comprehensive vision for an appropriate fiscal and economic governance framework for the EU,⁵ many elements of which were indeed implemented - not all at once but eventually. For example, the report’s recommendations regarding upper limits on deficits, price stability as the prime objective of monetary policy as well as the monetary financing prohibition all found their way into the Maastricht Treaty of 1992.⁶ Moreover, the report’s call for rules and procedures for budgetary and macroeconomic coordination to be binding is reflected in the Stability and Growth Pact (SGP) of 1997 and the many reforms thereof (in 2005, 2011 and 2013). It is also reflected in the Fiscal Compact of 2012 and the Macroeconomic Imbalance Procedure, introduced in 2011. The report’s recommendation to create a European Commission fiscal assistance instrument to help countries in temporary difficulties can be seen to have been followed up by the establishment of the European Financial Stabilisation Mechanism and the European Financial Stability Facility in 2010 and the European Stability Mechanism in 2011.

Interestingly, the Delors report also contained a call for coordinating budgetary and macroeconomic policies in order to define an aggregate EMU fiscal policy stance and ensure the coherent conduct of national economic policies. This was followed up only in the latest comprehensive amendment to the EU’s fiscal framework.⁷ In 2013 the Two-Pack Regulation No 473/2013 introduced a legal basis for the assessment of the euro area aggregate fiscal stance.⁸ In 2014 ECB President Mario Draghi underlined the usefulness of discussing the overall fiscal stance of the euro area and the benefits that could arise from stronger coordination among the different national fiscal stances.⁹

Specifically, according to the Two-Pack regulation:

5 Committee for the Study of Economic and Monetary Union: Report on Economic and Monetary Union in the European Community (The Delors Report), Luxembourg 1989, Office for Official Publications of the European Communities.

6 Note that the Delors report contains no mention of binding rules on debt or of the no-bailout clause.

7 For a survey of what the Delors report recommended and how this was reflected later in EMU governance, see H. Enderlein, E. Rubio: 25 years after the Delors report: Which lessons for Economic and Monetary Union?, Policy Paper No. 109, Notre Europe and Jacques Delors Institute, 2014.

8 See Regulation (EU) No. 473/2013 on common provisions for monitoring and assessing draft budgetary plans, Article 7.

9 M. Draghi: Unemployment in the euro area, Speech by the President of the ECB at the annual central bank symposium, Jackson Hole, 22 August 2014.

the Commission shall make an overall assessment of the budgetary situation and prospects in the euro area as a whole, on the basis of the national budgetary prospects and their interaction across the area [...] [The overall assessment] shall also, as appropriate, outline measures to reinforce the coordination of budgetary and macroeconomic policy at the euro area level.¹⁰

To this end, the Commission regularly puts forward its assessment of the appropriate euro area aggregate fiscal stance for the next year. This is done in November of each year in the context of the review of governments' draft budgetary plans for the following year. In line with the regulation, on the basis of the Commission assessment, the Eurogroup discusses the budgetary situation and prospects in the euro area as a whole. Since the inception of this surveillance exercise in 2013, the Commission has released four assessments of the appropriateness of the euro area aggregate fiscal stance for the subsequent year. For each of the years 2014-16, the Commission assessed a broadly neutral fiscal stance to be appropriate as balancing the euro area aggregate's sustainability and stabilisation needs, an assessment shared by the Eurogroup. For 2017 the Commission and the Eurogroup concluded in mid-2016 that a broadly neutral fiscal stance was appropriate. In November 2016, the European Commission revised its assessments towards the need for a fiscal expansion of 0.5% of GDP, while the Eurogroup reiterated its initial assessment.¹¹

Discretionary fiscal policies versus automatic stabilisers

There is broad consensus that discretionary fiscal policy tends to be ill-suited to deal with normal cyclical fluctuations.¹² Discretionary fiscal policy can even reinforce unwanted economic fluctuations if fiscal interventions

are ill-timed, for example due to implementation lags or measurement uncertainty of macroeconomic variables.¹³ Instead, automatic fiscal stabilisers – which are still thought to be relatively large in most European countries – are generally seen as the more effective tool to stabilise economic fluctuations. They therefore should be the main instrument to smooth temporary and small shocks.

In the recent economic environment, characterised by prolonged weak growth and monetary policy at the zero lower bound, it has been argued that there could be a stronger role for discretionary fiscal policy as an economic stabilisation tool, provided risk-to-debt sustainability remains contained.¹⁴ Generally, related literature indicates that the effectiveness of fiscal stimulus depends very much on the soundness of the underlying fiscal position.¹⁵ Fiscal stimulus is unlikely to be effective and possibly even counterproductive in countries that have high risk-to-debt sustainability. At the same time, some literature stresses that with monetary policy at the effective lower bound on nominal interest rates, the effectiveness of discretionary fiscal stimulus may have risen and fiscal multipliers increased.¹⁶ It has to be recognised that monetary policy is not ineffective at the lower bound. Recent experience of major central banks with non-standard monetary policy measures, notably large scale asset-purchase programmes, and forward guidance suggests that monetary policy can still provide stimulus at the lower bound.¹⁷

The EU's fiscal framework, set out in the SGP, broadly reflects the consensus view that automatic stabilisers

10 Regulation (EU) No. 473/2013 of the European Parliament and of the Council: on common provisions for monitoring and assessing draft budgetary plans and ensuring the corrections of excessive deficit of the Member States in the euro area, Brussels 2013, Article 7.4.

11 See European Commission: Towards a positive euro area fiscal stance, Commission Communication, Brussels 2016; and Eurogroup: Eurogroup statement on the draft budgetary plans for 2017, Brussels 2016.

12 See J.B. Taylor: Reassessing Discretionary Fiscal Policy, in: *Journal of Economic Perspectives*, Vol. 14, No. 3, 2000, pp. 21-36, who states that "recent changes in policy research and in policy-making call for a reassessment of fiscal policy. Such a reassessment indicates that countercyclical fiscal policy should focus on the automatic stabilisers rather than discretionary actions. [...] A discretionary fiscal policy could make monetary policy-making more difficult. Rather fiscal policy should focus on long run issues, such as tax reform and social security reform. [...] Other examples might include stating explicitly how fiscal policy would be used in unusual situations, such as when nominal interest rates hit the lower zero bound. Such rules for fiscal policy are more difficult to specify and enforce in practice than parallel rules for monetary policy."

13 See, for example, J. Címadomo: Fiscal Policy in Real Time, in: *Scandinavian Journal of Economics*, Vol. 114, No. 2, 2012, pp. 440-465.

14 For more discussion on the concept of an appropriate euro area aggregate fiscal stance, including measurement and operationalisation issues, see e.g. European Central Bank: The euro area fiscal stance, ECB Economic Bulletin, No. 4, 2016; European Commission: Report on Public Finances in EMU 2016, Institutional Paper 45, 2016; and K. Bańkowski, M. Ferdinandusse: Euro area fiscal stance, ECB Occasional Paper No. 182, European Central Bank, 2017.

15 For example, see M. Kirchner, J. Címadomo, S. Hauptmeier: Transmission of government spending shocks in the euro area: Time variation and driving forces, Working Paper Series No. 1219, European Central Bank, 2010; and G. Corsetti, A. Meier, G. Müller: What Determines Government Spending Multipliers?, in: *Economic Policy*, Vol. 27, No. 72, 2012, pp. 521-565. They find that short-term multipliers tend to be lower the higher the public debt ratio. For a review of the literature on state-dependent multipliers, see T. Warmedinger, C. Checherita-Westphal, P. Hernández de Cos: Fiscal multipliers and beyond, Occasional Paper No. 162, European Central Bank, 2015.

16 See for example L. Christiano, M. Eichenbaum, S. Rebelo: When Is the Government Spending Multiplier Large?, in: *Journal of Political Economy*, Vol. 119, No. 1, 2011, pp. 78-121.

17 For example, according to ECB staff analysis, about half of the extra GDP growth achieved during the recovery that started in 2014 can be attributed to ECB policy. See M. Draghi: Monetary policy and the economic recovery in the euro area, Speech by the President of the ECB at the ECB and Its Watchers XVIII Conference, Frankfurt, 6 April 2017.

are best suited to stabilise cyclical fluctuations in normal times. Its lynchpin is the medium-term budgetary objective (MTO), which is country-specific and defined in structural terms. It is set such that, inter alia, compliance with the MTO ensures that countries' automatic stabilisers can work freely in normal cyclical conditions without breaching the three per cent of GDP deficit reference value in downturns. For countries that have not yet achieved their MTOs, automatic stabilisers can operate around an agreed adjustment path towards it. To this end, the SGP incorporates structural effort requirements that are intended to balance stabilisation and sustainability objectives for countries that have not achieved "sustainable" fiscal positions, as operationalised by their MTO. The structural effort recommendations shall reflect that countries should adjust "more in good times and less in bad times". Specifically, the trade-off between countries' sustainability and stabilisation needs was operationalised in a matrix under the preventive arm of the SGP in the Commission's communication on SGP flexibility in 2015.¹⁸ For countries under the SGP's corrective arm, the excessive deficit procedure (EDP) operationalises the adjustment needs for countries with excessive deficits. These adjustment needs should in principle be larger than for countries under the preventive arm of the SGP. The SGP does not, however, prescribe a fiscal policy stance for countries that have fiscal space in the sense of having overachieved their MTOs. Consequently, within the current framework of fiscal rules, a range of fiscal stances for the euro area aggregate could be deemed "appropriate", depending on whether or not the use of fiscal space is deemed desirable. It should be noted that with frequent reforms to the SGP over time, the resulting rules-based appropriate euro area aggregate fiscal stance has also changed over time.

Beyond this, with the reforms to the SGP in 2011, an "escape clause" was introduced into the fiscal framework, which in principle would have direct consequences for the euro area fiscal stance. Specifically, in periods of "severe economic downturn" for the euro area as a whole, member states under the SGP's preventive arm may be allowed to temporarily deviate from their adjustment path towards the MTO. Under the corrective arm, EDP deadlines may be extended. Importantly, the "escape clause" may only be triggered provided this does not endanger fiscal sustainability in the medium term. The "escape clause" has so far neither been operationalised nor applied – although

it de facto reflects the logic used at the time of the 2009 European Economic Recovery Plan, which proposed a coordinated fiscal stimulus worth 1.5% of the EU's GDP.¹⁹ However, the definition of a "severe economic downturn" has not yet been clearly spelled out. Article 2(2) of the SGP's corrective arm regulation stipulates that a "severe economic downturn" relates to "a negative annual GDP volume growth rate or [...] an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential".²⁰ The Code of Conduct to the SGP further states that the indicator for assessing accumulated losses of output is the output gap.²¹

Against this background, several questions regarding how the SGP may affect the euro area aggregate fiscal stance appear still open. For example, what would be the trigger point of the SGP's "escape clause" in terms of real growth and/or the level of the output gap? Is there any role for the lower bound on nominal interest rates and/or low inflation? In fact, the SGP was not originally designed to cope with long periods of low inflation. This is now partly being addressed when implementing the SGP; notably, account is taken of low inflation by acknowledging that it is a relevant factor that impedes countries' ability to comply with the pace of debt reduction as foreseen under the debt rule.²² A further open question is, in case the escape clause is triggered, what would be the appropriate euro area aggregate fiscal stance under such conditions?

18 Communication From the Commission to the European Parliament, the Council, the European Central Bank, the Economic and Social Committee, the Committee of the Regions and the European Investment Bank: Making the Best Use of the Flexibility Within the Existing Rules of the Stability and Growth Pact, European Commission, 2016, available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0012&from=ES>.

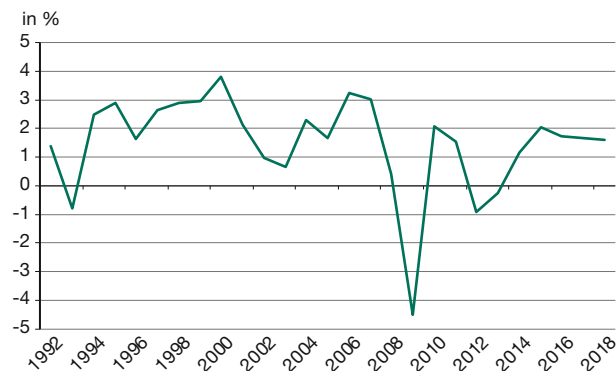
19 Ibid: "Since 2011, the Pact has provided, in cases of a severe economic downturn in the euro area or the Union as a whole, for the pace of fiscal consolidation to be adapted for all Member States, as long as this does not endanger fiscal sustainability in the medium-term. This provision has so far never been applied – although it de facto reflects the logic used at the time of the 2008 financial crisis when the adjustment paths were re-designed for several Member States. The activation of this provision would not mean putting on hold the fiscal adjustment, but rather re-designing the adjustment path on a country-specific basis, both in terms of the adjustment effort and the deadlines to achieve the targets, to take into account the exceptional circumstances of the severe economic downturn in the euro area or the Union as a whole. The use of this provision should remain limited to exceptional, carefully circumscribed situations to minimise the risk of moral hazard."

20 Article 2(2) of the SGP's corrective arm regulation.

21 SGP Code of Conduct.

22 Specifically, the Commission gauges the impact of inflation surprises on countries' ability to comply with the debt rule. Negative inflation surprises tend to make compliance with the requirements of the SGP's debt rule more demanding in the short term. Government revenues tend to adjust faster to price changes than primary expenditure. Fiscal balances therefore tend to be adversely affected by unanticipated declines in inflation. At the same time, to the extent that interest payments are sensitive to short-term inflation developments, e.g. in the case of inflation-indexed bonds or variable rate debt, a negative inflation surprise may drive down interest spending, counteracting the adverse impact on the primary balance. Beyond this, and more importantly, unanticipated declines in inflation accelerate the accumulation of government debt through a denominator effect, thereby making compliance with the debt reduction benchmark more demanding. See for details European Central Bank: Government debt reduction strategies in the euro area, ECB Economic Bulletin, No. 3, 2016.

Figure 1
Real GDP growth in the euro area, 1992-2018



Source: IMF.

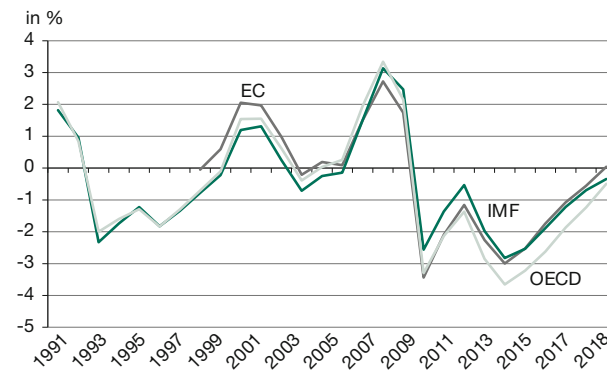
Importantly, how should the fiscal sustainability provision be captured under such circumstances?

In light of this, a further issue would be whether a fiscal rule could be designed that would work under both normal and exceptional times. Schmidt, for example, proposes a fiscal rule in which fiscal policy remains passive in “normal” times, such that only automatic stabilisers would be at work, while it would allow for stimulus in crisis times in order to avert an expectations-driven liquidity trap.²³ Generally, the implementation of such a rule would need to account for the EMU’s institutional set-up, in which fiscal policies remain decentralised. Overall, the operationalisation of the euro area aggregate fiscal stance is difficult, notably in the absence of a fiscal instrument at the central level. Such difficulties arise from, *inter alia*, situations in which domestic stabilisation needs conflict with those at the euro area level. Cyclical positions inside the euro area tend to differ. From a purely domestic perspective, countries with positive (negative) output gaps may have no incentive to enact more expansionary (contractionary) policies, even if this would contribute to a more desirable fiscal stance at the aggregate level. In the same vein, a fiscal stimulus in a country that actually has fiscal space under the SGP would be conducive to economic development in other countries, most notably in case fiscal spillovers across countries are large. For normal times, empirical estimates point to small, but not negligible, fiscal spillover effects.²⁴ They can be

23 S. Schmidt: Lack of confidence, the zero lower bound, and the virtue of fiscal rules, in: *Journal of Economic Dynamics and Control*, Vol. 70, No. C, 2016, pp. 36-53.

24 R. Beetsma, M. Giuliodori, F. Klaassen: Trade spill-overs of fiscal policy in the European Union: A Panel Analysis, in: *Economic Policy*, Vol. 21, No. 48, 2006, pp. 639-687.

Figure 2
Output gap estimates, 1991-2018



Sources: IMF; OECD; and AMECO.

larger when monetary policy is constrained at the (zero) lower bound and does not react to a fiscal expansion.²⁵

Identifying exceptional circumstances

As shown in Figure 1, when looking at the past 25 years, the year 2009 stands out as a year in which real GDP growth in the euro area was exceptionally negative, with a contraction of more than four per cent in a single year. 2009 was also exceptional in terms of the output gap, which was very large and negative (see Figure 2). According to this indicator, the years 2012-13 could also be seen as having been exceptional in terms of extraordinarily weak growth performance. Since then, economic times have gradually improved. In 2017, according to the European Commission’s 2017 winter economic forecast,²⁶ the euro area appears to be in “normal” times, with a small negative output gap that is expected to close next year.²⁷

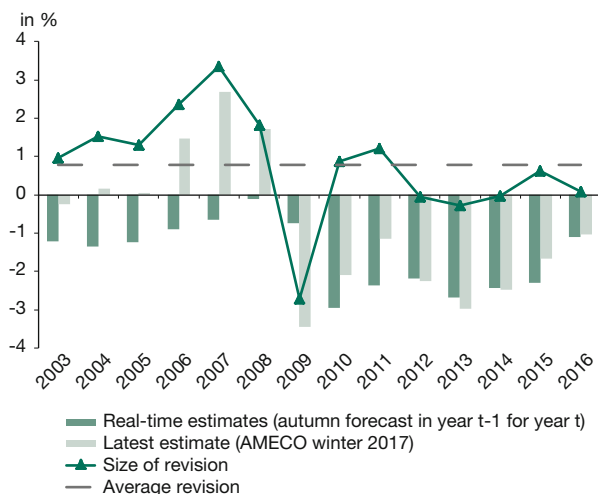
As is well known, identifying a country’s position within the business cycle is surrounded by a large degree of uncertainty. Notably, the output gap is an unobservable variable that has been subject to frequent and often sizeable *ex post* revisions in the past. To show the magnitude of such revisions and the implications for the real-time assessment of the fiscal stance, Figure 3 depicts real-time estimates of the

25 Spillover effects across most model-based analyses appear to go in the same direction, i.e. roughly amounting to 0.1 in normal times and to around 0.3 with a constrained monetary policy. See, for example, J. in’t Veld: Fiscal consolidations and spillovers in the Euro area periphery and core, *European Economy, Economic Papers* 506, European Commission, 2013.

26 European Commission: *European Economic Forecast – Winter 2017*, 2017.

27 According to the so-called preventive arm matrix, as first outlined in the Commission’s communication on flexibility within the SGP, normal times are defined to capture output gaps within the range of -1.5 and +1.5% of potential output.

Figure 3
Euro area output gap: real-time estimates and revisions, 2003-2016



Source: ECB staff calculations based on AMECO data.

euro area aggregate output gap as well as their revisions. It shows that the real-time output gap clearly failed to identify the pre-crisis boom, with real-time output gaps being negative over a prolonged period. As a consequence, when adjusting for the much more favourable economic conditions as identified *ex post*, countries' cyclically adjusted primary balances were also much smaller than assumed at the time (see Figure 4).²⁸ These substantial problems with measuring the output gap in real time show that discretionary policies can be effective only if the position in the cycle can be identified with sufficient certainty.²⁹ However, this tends to be the case only in periods of extraordinarily large and prolonged upswings and downturns – and even then with a possible delay.

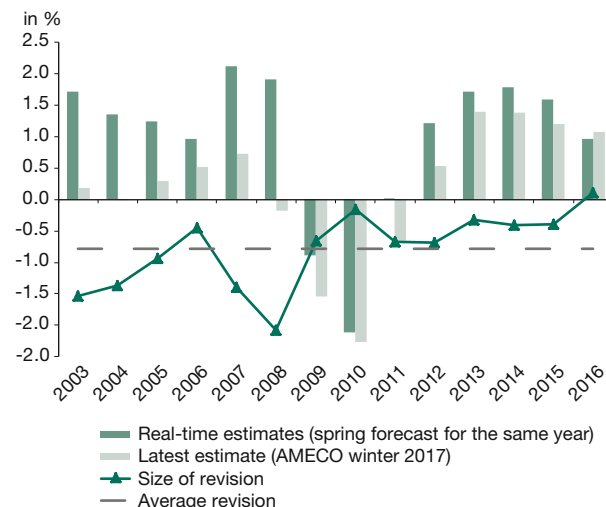
The appropriate euro area aggregate fiscal stance at the current juncture

In light of the considerations above, within the current macroeconomic situation in the euro area characterised by a firming recovery, there does not seem to be a case for discretionary fiscal stimulus at present. Instead, as the economy continues to improve, it will be important for euro area countries to progress towards their MTOs in line with

28 See further analysis in C. Kamps, R. De Stefani, N. Leiner-Killinger, R. Ruffer, D. Sondermann: The identification of fiscal and macroeconomic imbalances – unexploited synergies under the strengthened EU governance framework, ECB Occasional Paper No. 157, 2014, European Central Bank.

29 See P. Lane: Monetary-Fiscal Policy Interaction in an Uncertain World: Lessons for European Policy Makers, in: M. Buti (ed.): Monetary and Fiscal policy in EMU: Interactions and Coordination, Cambridge 2003, Cambridge University Press.

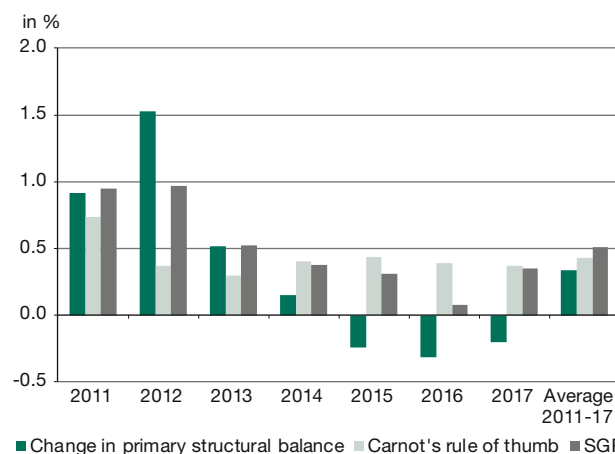
Figure 4
Euro area cyclically adjusted primary balance: real-time estimates and revisions, 2003-2016



Source: ECB staff calculations based on AMECO data.

SGP requirements, reduce high government debt and thus rebuild fiscal buffers. As Figure 5 shows, there is also currently no conflict between what the SGP foresees as an appropriate pace towards sustainable positions and rules

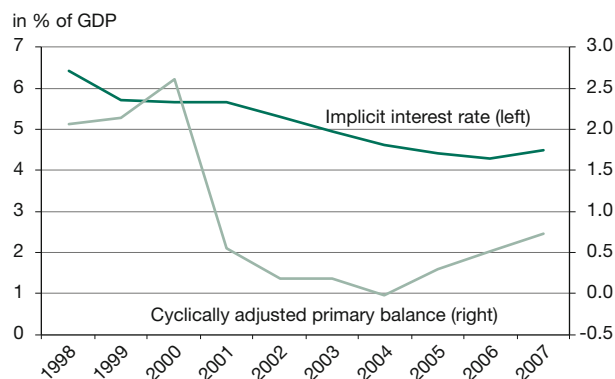
Figure 5
Euro area fiscal stance: actual vs normative benchmarks, 2011-2017



Note: "SGP" refers to aggregated structural effort requirements, not adjusted for changes in interest payments. If the latter were accounted for, "SGP" requirements would be slightly larger in 2011-12 and slightly lower in 2013-2017, and lower by 0.1 pp on average over 2011-17. The light green bars operationalise a so-called "rule of thumb" for setting the aggregate fiscal stance as put forward by Carnot. See N. Carnot: Evaluating Fiscal Policy: A Rule of Thumb, European Economy, Economic Papers No. 526, European Commission, 2014. It is derived by explicit consideration of a measure to contain debt at "moderate" levels and "views" on the business cycle.

Sources: AMECO; authors' calculations.

Figure 6
Implicit interest rate and cyclically adjusted primary balance for the euro area, 1998-2007

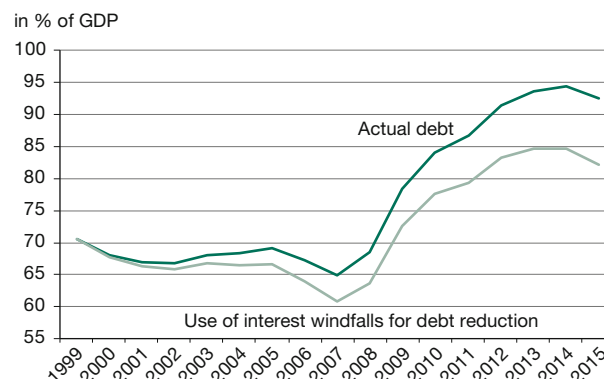


Source: ECB staff calculations based on AMECO data.

that aim to explicitly reflect the trade-off between sustainability and stabilisation objectives for the euro area as a whole.³⁰

The major lesson to draw from the pre-crisis times for fiscal policies is undoubtedly that good economic times need to be used to build fiscal buffers to ensure that countries become more resilient in the face of adverse shocks. There was a sizeable EMU dividend over the period 1998-2007 in terms of interest savings (see Figure 6).³¹ Over this period, the implicit interest rate for the euro area as a whole declined from a level of close to 6.5% in 1998 to 4.5% in 2007. During the same period, the cyclically adjusted primary balance declined significantly, indicating governments did not use their interest savings for government debt reduction. As counterfactual simulations in Figure 7 show,³² had euro area countries used the interest savings over 1998-2007 for faster debt reduction, euro area aggregate government debt would have stood at around 60% of GDP in 2007, shortly before the crisis hit, i.e. about five percentage points lower than actually observed. Such faster debt reduction would have increased the resilience of euro area countries in the face of the fi-

Figure 7
Euro area debt developments since start of EMU – actual versus counterfactual, 1999-2015



Source: ECB staff calculations based on AMECO data.

nancial crisis that hit in 2008. This effect would have been particularly pronounced for countries with high government debt. In the same vein, such faster debt reduction during the pre-crisis good times would have reduced the need for pro-cyclical fiscal tightening during the sovereign debt crisis.

Conclusion

The methodological concept of the euro area fiscal stance, as introduced to the fiscal governance framework for the euro area with the Two-Pack regulations in 2013, is useful. It also provides useful information in the context of the conduct of the single monetary policy. While there may be no need to target a specific euro area fiscal stance in normal times, during which automatic stabilisers appear to be sufficient, there may be a need for more discretionary fiscal action in times of deep and protracted swings in the cycle that can be unequivocally identified as such in real time.

We have seen during the crisis and from the experience with the European Economic Recovery Programme in 2009 that the scope for member states with high debt sustainability risks to provide fiscal stimulus is very limited and often non-existent. At the same time, concentrating any fiscal stimulus to countries that have fiscal space can likely not substitute for a euro area-wide fiscal capacity unless fiscal spillovers are very large. Such a fiscal instrument – in line with the principles mentioned in the June 2015 Five Presidents' Report – would have to be designed in a way that prevents permanent transfers and does not undermine countries' incentives for sound fiscal and

30 N. Carnot: Evaluating Fiscal Policy: A Rule of Thumb, European Economy, Economic Papers No. 526, European Commission, 2014.

31 Changes in implicit interest rates – computed as the ratio of interest spending to the previous year's total government debt – between 1999 and 2007 are treated as "EMU dividend". On average, the implicit interest rate declined by around two percentage points from 6.4% in 1998 to 4.5% in 2007 in the euro area.

32 The simulations assume that interest windfalls increase cyclically adjusted primary balances and therefore are used to reduce government debt. Changes in the fiscal path vis-à-vis the baseline are assumed to affect real GDP via state dependent fiscal multipliers amounting to 0.5 in good times (output gap > 1.5), 1.5 in bad times (output gap < -1.5) and 0.8 in normal times.

economic policies.³³ In particular, the establishment of a euro area fiscal capacity would require the restoration of trust in the EU's fiscal governance framework and the full and consistent implementation of the EU fiscal rules. Currently, it appears that SGP ownership has declined (despite the Fiscal Compact), in part because the rules have become very complex. Moreover, enforcement is weak due to the lost credibility of the SGP's sanction mechanism.

Given limited and unevenly distributed fiscal space, as well as limitations within the existing governance framework, fiscal policies can support economic growth and progress towards the MTO by improving the growth-friendliness of public finances. Such policies have medi-

um-to-long-term benefits in terms of higher growth and improved sustainability of public finances. Unfortunately, the changes in budgetary composition observed since 2010, the year when consolidation started in many countries, indicate that the largest reductions in expenditure were registered in the two most growth-friendly categories, namely education and infrastructure investment. On the revenue front, despite greater reliance on property and consumption taxation, labour taxation, which is one of the more distortionary taxes, has registered the most significant increases.

As the economy improves, it is time that euro area countries progress towards their MTOs, reduce high government debt and thus rebuild fiscal buffers. Avoiding the mistakes of the past, when the good times were not used to build buffers, will be crucial to avoid countries again being forced to engage in a pro-cyclical fiscal tightening in the next downturn.

³³ J.-C. Juncker, D. Tusk, J. Dijsselbloem, M. Draghi, M. Schulz: Completing Europe's Economic and Monetary Union, Five Presidents' Report, European Commission, 2015.