



# How Europe is kicking the debt habit

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A liberal path

**Authors:**  
**Lukas Sustala**  
**Günther Oswald**



Graphic design: Andreas Pohancenik

Publisher:  
European Liberal Forum EUPF  
Rue d'Idalie 11-13, boîte 6, 1050 Ixelles, Brussels (BE)  
[info@liberalforum.eu](mailto:info@liberalforum.eu)  
[www.liberalforum.eu](http://www.liberalforum.eu)

NEOS Lab  
Neubaugasse 64–66, 1070 Vienna (AUT)  
[lab@neos.eu](mailto:lab@neos.eu)  
[lab.neos.eu](http://lab.neos.eu)

Published by the European Liberal Forum in cooperation with NEOS Lab. Co-funded by the European Parliament. The views expressed herein are those of the author(s) alone. These views do not necessarily reflect those of the European Parliament and/or the European Liberal Forum.

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Printed by Printpool, Austria 2022

ISBN: 978-2-39067-042-1

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## A liberal path

### Abstract

European countries have accumulated a mountain of debt. The sovereign debt ratio has risen to new record highs in the Covid pandemic, and sharply rising interest rates threaten to exacerbate the financial situation in many eurozone countries. This book shows ways to eliminate high debt in the long term employing optimal liberal approaches. This requires modernisation of fiscal rules and a greater focus on the future of budgetary policy.

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**Lukas Sustala**  
Author



**Günther Oswald**  
Author

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# Introduction

**European countries' deficits and debts have risen sharply in the coronavirus pandemic. According to data from the European Commission, total debt in Europe has risen from around 86 percent of GDP in 2019 to over 100 percent in 2020, and the recent energy crisis will push debt up even further.**

The debt situation varies widely between Member States. Countries that have followed a comparatively steady path through the pandemic have returned to pre-pandemic levels of economic output faster and have already partially reduced their debt ratio. Other eurozone countries are reporting record levels of debt.

But tight margins for public budgets are a problem. In order to finance the adjustment of European economies toward green energy sources or in the face of demographic change, money must be spent on education or infrastructure. Countries that are still burdened by past crises and have no scope for new investments are at a competitive disadvantage here.

Ways to kick the debt habit in the long term and to increase public budget margins are therefore needed. And these should also be liberal in order to strengthen economic locations and increase prosperity in Europe. This paper shows what these liberal paths could look like. In order to improve the financial situation structurally, new rules for debt in the eurozone are also needed.



## Chapter 1

# Rules that are constantly being broken

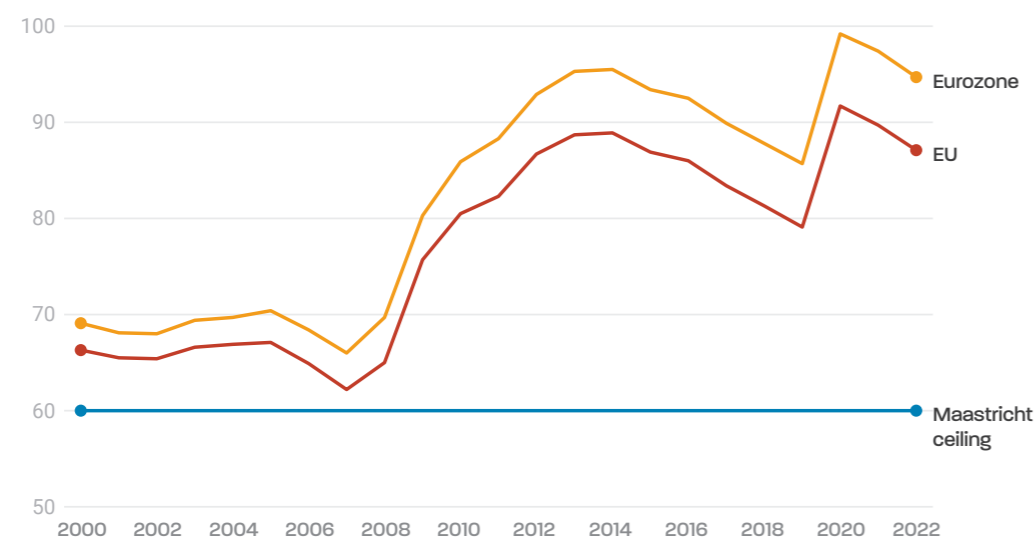
**The European debt problem is as old as the discussion about monetary union. If, over the last 30 years, the Heads of State or Government or national parliaments had adhered to the provisions laid down of the Maastricht Treaty (1992), there would be no need to constantly debate possible improved fiscal rules and the European Union as a whole would be much more resistant to crises.**

In terms of realpolitik, however, the Maastricht criteria were far too often not taken seriously, meaning Europe has had to deal with its mountain of debt over and over again. Although the debt ratio, which rose massively after the 2008 global financial crisis, declined somewhat in the 2010s, in the pre-pandemic year 2019, the debt of all EU countries was 79.1 percent of gross domestic product (GDP), but only slightly below the level of 2010 (80.5 percent). In the eurozone, the debt ratio in 2019 was more or less exactly at 2010 levels (85.7 percent versus 85.9 percent).

Figure 1

### Development of the sovereign debt ratio

as a percentage of GDP (economic output)



Source: Ameco, NEOS Lab

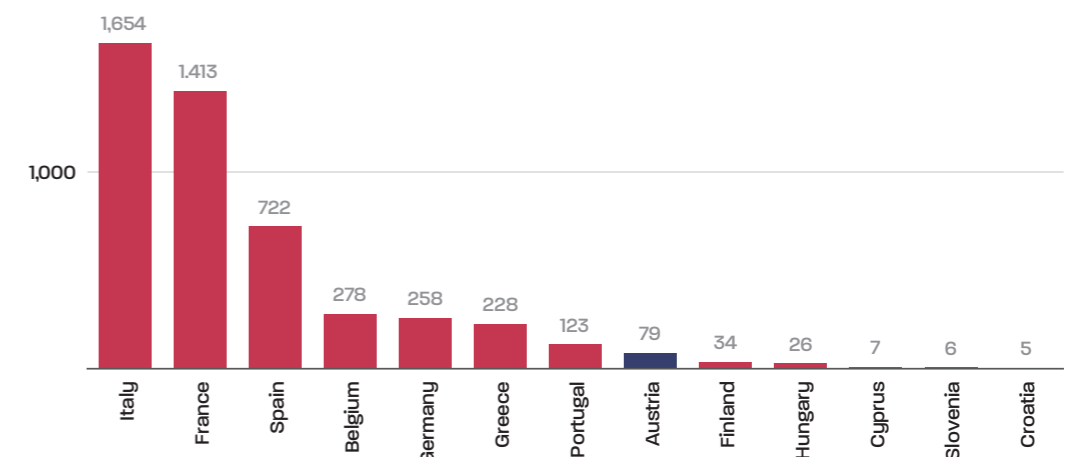
Before the outbreak of the global coronavirus pandemic, therefore, progress in debt reduction was slow. Coronavirus-specific expenditure, which has been substantial and poorly targeted in many countries, has pushed sovereign debt ratios even higher, to almost 100 percent in the eurozone in 2020 and 91.7 percent in the EU as a whole, with a subsequent slight decline in 2021 and 2022.

What appears a small increase in percentage points makes a huge difference in absolute amounts. According to data from the European Commission's summer forecast, in 2022, 14 of the 27 EU countries will have a debt ratio above the Maastricht target of 60 percent. If all countries had adhered to this ostensibly binding ceiling, these 14 countries would cumulatively have to repay 4.75 trillion euros less in debt.

Figure 2

### The debt should actually be this much lower

If the debt level were at a maximum of 60 percent of GDP, countries would have billions of euros less debt in 2023.



Source: Ameco, NEOS Lab

Now, even before a sustainable consolidation policy can be put in place, Europe is already facing its next major crisis. The Russian war of aggression in Ukraine has led to severe dislocations in the energy markets and has fuelled inflation massively. The huge economic stimulus and rescue programmes during the pandemic, as well as the expansion of transfer payments, have had an additional inflationary impact. In addition, supply chains are still disrupted and/or there are still supply shortages, the result of China's zero-covid policy and a general trend towards deglobalisation, which is likely to be further exacerbated by the war in Ukraine.

Finally, developments in recent years have also led to shifts in labour markets. Lockdowns and other constraints on economic activity have caused some workers to seek new jobs in entirely different industries and precipitated other trends, such as the home office and a stronger focus on work-life balance. The result is a shortage of skilled workers in almost all industries and almost all European countries.

## Convergent shocks

This combination of several severe shocks, which were naturally not part of any medium- or long-term plans by economists or economic policy-makers, has turned out to a surprise and unwelcome guest at the party and has brought a rapid end to the European Central Bank's (ECB) zero-interest-rate policy.

In mid-2021, the general market expectation was that interest rates would remain negative for at least five years (Claeys & Guetta-Jeanrenaud, 2021). A year later, there is no mention of this. At the beginning of September 2022, the ECB responded to rampant inflation with the largest interest-rate hike in its history. The monetary guard-dogs around Christine Lagarde raised the base interest rate by 0.75 percentage points to 1.25 percent. Previously, the ECB had already initiated the interest-rate turnaround in July. Further interest rate steps are expected, only their extent remains unclear.

In other words: Interest rates are back, and so are some of the problems that have almost been forgotten in the past decade. Interest rates are the price of lending money and are therefore an indicator of the sustainability of countries' economic activity. This in itself banal statement has not been valid since "whatever it takes" has been undermined by the massive interventions of the ECB in the context of its bond purchases.

However, if interest rates are once again set more by the market and not in the offices of the ECB, this inevitably leads to (variably) rising interest rates in the EU states. Governments are facing new challenges. In the end, the central bank bought them time to reform, time which was, however, not used everywhere.

## Chapter 2

# Wide variability

**The starting position within the common economic area is widely divergent. Those countries that have already emerged from the financial crisis with a debt ratio of more than 100 percent of GDP (in 2010 this was Greece, Italy, Portugal and Belgium), still currently have a debt ratio of (in some cases far in excess of) 100 percent.**

In addition, Spain and France are currently joining the "100+" club of countries (forecast values for 2022). At the other end of the scale, there are five countries whose debt ratios will be below 40 percent of GDP this year – Denmark, Sweden, Bulgaria, Luxembourg and Estonia.

The long-term development of three countries is shown as an example: Austria, Sweden and Italy. In the course of this Policy Brief, we will make repeated comparisons of these countries.

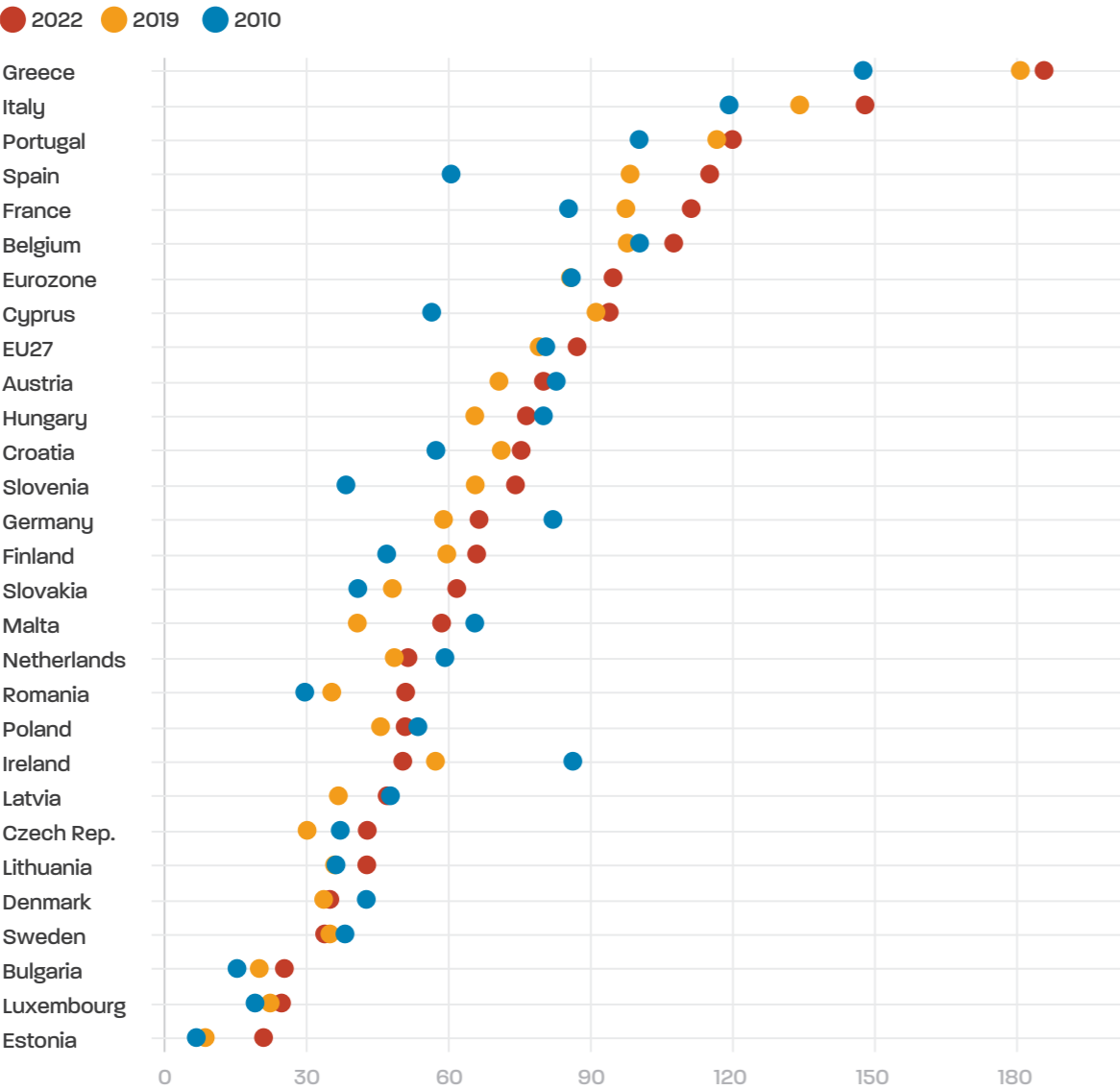
Austria and Sweden, which had a similar high Maastricht debt in the mid-90s, are now almost 50 percentage points apart. While in Sweden, following a severe sovereign debt crisis at the beginning of the 90s (see own chapter), a decision was taken to divorce politics as far as possible from the financial markets and to refrain from debt-financed policies on a permanent basis, in Austria the long-term trend showed a slight but steady rise in the debt ratio.

Italy, on the other hand, which at 120 percent of GDP already had a debt almost twice as high as Austria and Sweden in the mid-1990s, has only managed a slight improvement in the past 30 years and in the more recent past has reached new all-time highs.

This still does not take into account the implicit debt of countries arising from future commitments, in particular pension system commitments, which would once again significantly increase official debt ratios.

Figure 3  
Development of debt ratio by country

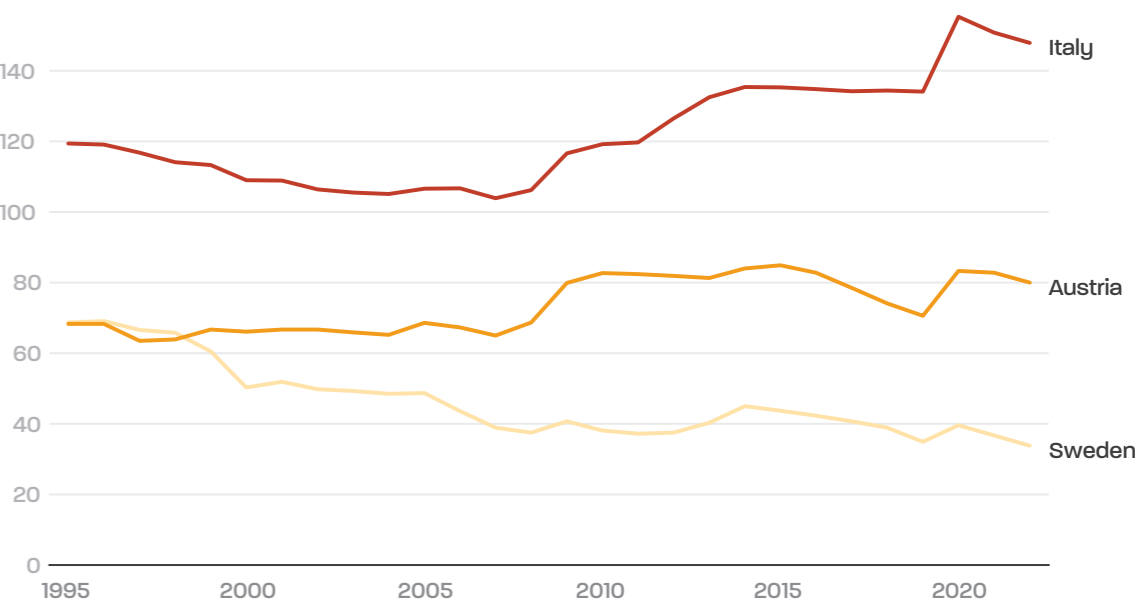
As a percentage of GDP, ranked by values for 2022



Source: Ameco, NEOS Lab

Figure 4  
Italy, Austria and Sweden in comparison

Development of debt ratio as a percentage of GDP



Source: Ameco, NEOS Lab

### Deficits in good times and in bad

In the Maastricht treaties, the second central criterion, alongside the debt ratio, was an annual budget deficit of no more than 3 percent of GDP. The original idea was that, in economically bad years, it should be possible to exhaust this limit in order to counteract a downturn in an anti-cyclical way. In fact, however, the limit has instead had a rather magnetic effect and is often also targeted in economically good years.

In any case, the overall picture since 1995 is that there has not been a single year in which the EU or the eurozone has generated a budget surplus. Deficits are therefore not only produced in an anti-cyclical manner, but also in a pro-cyclical manner.

Analysis of the fiscal data of all 27 EU countries illustrates the following: Only a few countries regularly meet both the criterion of total debt of a maximum of 60 percent of GDP and the criterion of a deficit of a maximum of 3 percent of GDP.

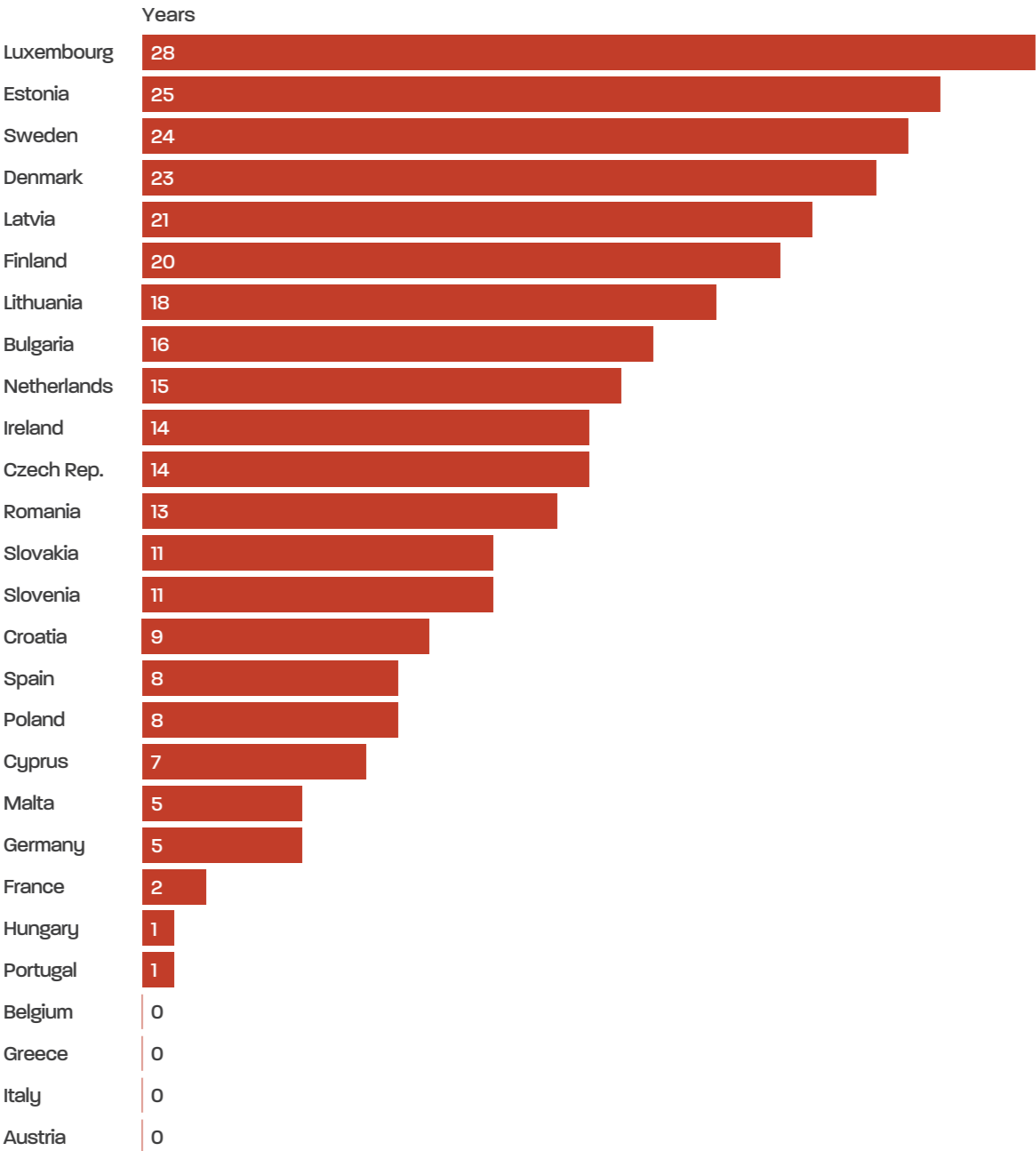
In the 29 years since 1995, for which comparable time series can be found in the EU Commission's Ameco database (including forecasts for 2022 and 2023), only six countries (Luxembourg, Estonia, Sweden, Denmark, Latvia, Finland) in 20 or more years have met both Maastricht criteria. It should be stressed in this evaluation that not all current 27 EU Member States have been members for the entire period.

The majority of countries did not meet the criteria even in half of the years. Four countries (Austria, Italy, Greece and Belgium) have not had a single year since 1995 when both the debt level and deficit were below the Maastricht targets. Even the major European economic powers, Germany and France, only met the Maastricht criteria in exceptional cases.

Figure 5

How often the Maastricht criteria have been met

The number of years since 1995 when the debt level was not above 60 percent of GDP and the annual budget deficit was not above 3 percent of GDP.



Including the Commission's forecast for 2023

Source: Ameco, NEOS Lab

Summary

Although economists have repeatedly pointed out that the Maastricht criteria are not upper limits that can be clearly derived from economic evidence and that even higher debt ratios can still be manageable (Reinhart & Rogoff, 2010), the insouciance with which elected politicians throughout Europe take it for granted that binding agreements will not be honoured is nevertheless remarkable.

## Chapter 3

# What the reforms so far have achieved

**The European fiscal rules have been repeatedly reformed not least because of the problems described and the frequent non-compliance. The last major changes took place after the 2010 sovereign debt crisis and resulted in the Sixpack and the Twopack respectively, and the European Fiscal Pact (Suttor-Sorel, 2021).**

This was intended to allow for greater differentiation between countries due to macroeconomic disparities. However, the original targets (60 percent debt ratio and 3 percent deficit) were not abandoned; rather, a new, extensive and complex set of rules was drawn up in addition to achieve these same targets.

The regulations of the Stability and Growth Pact are set out in detail in the EU Commission's 108-page "Vade Mecum on the Stability & Growth Pact" (2019 edition).

## Focus on structural deficit

At its core, there is now a preventive arm and a corrective arm. The aim of the preventative approach is to avoid any major deviations from the budget targets. According to this, the structural deficit may not exceed 0.5 percent of GDP. Only those countries whose debt ratio is less than 60 percent are allowed to register a structural deficit of up to one percent. If members fail to meet their medium-term fiscal targets, the structural deficit must be reduced by 0.5 percent per year.

The structural deficit was chosen as a benchmark because it was assumed that it would be better able to cushion pro-cyclical policies. In the case of the structural deficit, the effects of cyclical fluctuations and one-off effects are excluded. It should therefore make visible that part of the deficit which results from a general imbalance between incomings and outgoings and which can only be eliminated by means of consolidation measures.

In addition, an expenditure benchmark is also provided. In the medium term, government spending should not rise more than growth. Those countries that have not yet met their medium-term targets must be below the benchmark.

## Difficult to estimate

However, the difficulty in practice is to make assumptions in advance about the development of the structural deficit. Statistically this cannot be precisely recorded, as is the case with other variables, but is estimated by the Commission in a technically very complex procedure.

To calculate the economic effect, the so-called potential output is first determined. This is the level of economic output achieved by the average capacity of input factors (capital, labour and technical progress). The difference between actual production (current GDP) and the hypothetical value of potential output (potential GDP) corresponds to the "output gap" (Parliamentary Budget Service Austria 2014). The output gap calculated in this way is then multiplied by the "budget sensitivity". This value indicates the extent to which revenue and expenditure in the budget respond to cyclical fluctuations.

In part, the structural deficit values change significantly with new economic forecasts. Due to data revisions, significant corrections can also be made retrospectively, which is why this indicator is viewed critically in science.

## Possible sanctions

Ultimately, the corrective arm of the new rules clarified the course of the deficit procedure. An "Excessive Deficit Procedure" can be initiated whenever a country deviates from the convergence criteria.

Once such a procedure is in place, on the one hand, the structural deficit must be reduced by at least 0.5 percent per year, and on the other, it is specified what the path should be toward a return to a debt ratio of 60 percent. According to this, all countries would have to reduce the debt to 60 percent within 20 years. Therefore one twentieth of the difference between the current debt ratio and the 60 percent mark would have to be reduced annually.

The sanction mechanism has also been tightened up. If countries that are in a deficit procedure do not adhere to promised reform plans, fines of up to 0.2 to 0.5 percent of the GDP of the affected country can be imposed. In addition, funds from the European Structural and Investment Funds may be suspended. The possibilities of preventing sanctions at a political level have not been eliminated, but they have been made somewhat more difficult. The reverse majority principle now applies. This means that a fine is deemed to have been accepted unless the Council rejects it by a qualified majority.

In addition, an early warning system for excessive macroeconomic imbalances was established in the course of the six-pack legislative act. The Commission's experts try to determine the extent of imbalances on the basis of various indicators and derive recommendations to the Member States. 14 indicators are observed, which,

on the one hand, focus on external economic imbalances and competitiveness (e.g. current account balance, change in export market shares, unit labour costs), and on the other, record domestic economic imbalances (e.g. private sector debt, real estate price developments, unemployment rate).

### Rules suspended

As pointed out at the beginning, before the coronavirus pandemic these tougher rules only partially reduced the debt mountain. Since 2020, fiscal rules have been suspended anyway. In March 2020, the general escape clause was activated for the first time. It stipulates that a temporary deviation from the fiscal targets may be possible in the event of a severe economic downturn in the euro-currency zone or the Union as a whole.

In view of the major economic uncertainties arising from the war in Ukraine, the Commission has already proposed extending the suspension of the Stability Pact until the end of 2023. For the time being, therefore, fiscal rules are not only not respected by reform-weary governments, but may also be officially ignored.

### Pro-cyclical action continues

Even in the years 2010 to 2019, EU countries only partially managed to get away from pro-cyclical policies. As an analysis of Ameco data shows, there was no year in this period where the structural deficit in the entire EU economic area or the euro area was below 0.5 percent, when positive economic growth was achieved at the same time.

Apart from Luxembourg, only Germany, Sweden, Denmark and Estonia managed to meet the new structural deficit target in at least seven out of ten years, when there was economic growth at the same time. Greece, which was the particular focus of the last debt crisis, managed to generate structural surpluses in the years leading up to the pandemic, even if the economy has not always grown in real terms.

The other countries whose debt ratio exceeds 100 percent of GDP have hardly managed to push the structural deficit below the desired target of 0.5 percent, let alone generate structural surpluses.

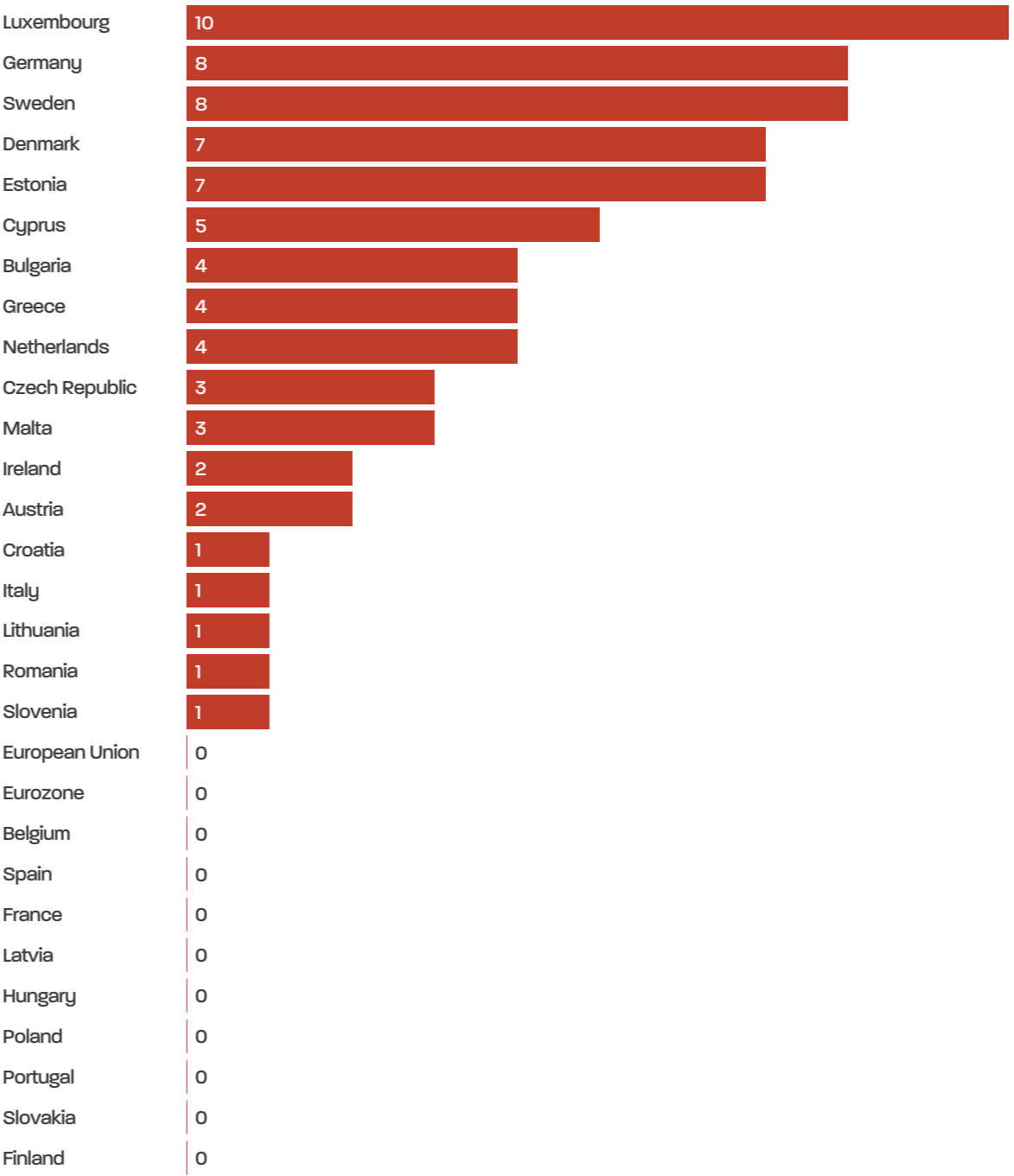
In the years leading up to the pandemic, which were characterised by solid growth rates throughout, the structural deficits of Spain and France averaged almost 3 per cent, Belgium also averaged over 2 per cent, and Italy and Portugal recorded structural deficits that were on average three times as high as actually planned.

Financial sanctions, which could now theoretically be more easily imposed, have not yet been imposed. So this seems to be a blunt weapon.

Figure 6

### Deficits despite GDP growth

Number of years between 2010 and 2019 when the structural deficit was below 0.5 percent, with positive economic growth achieved at the same time.

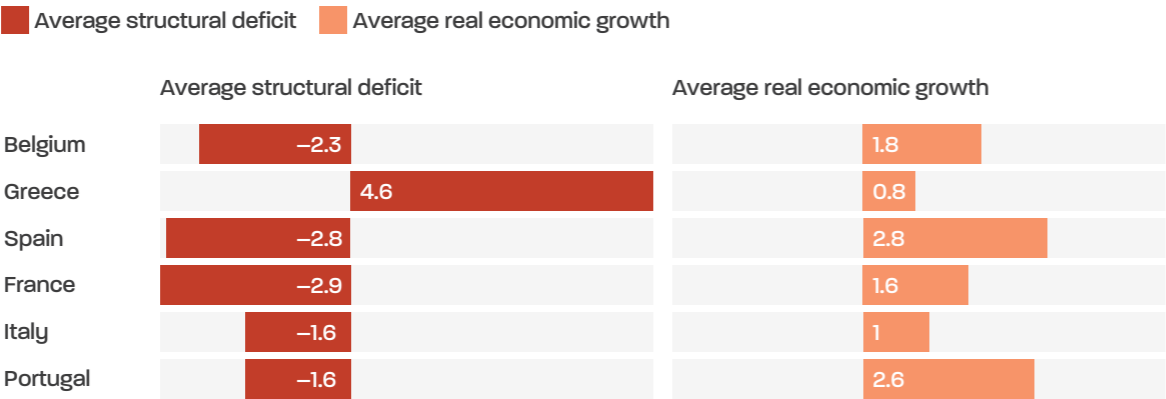


Source: Ameco, NEOS Lab

Figure 7

Structural deficit and growth

Average values for the years 2015 to 2019



Source: Ameco, NEOS Lab

According to this study, Member States have implemented only 26 percent of country-specific recommendations “substantially” or “fully” between 2011 and 2018. At least 44 percent had made “some progress,” but at least 30 percent had made “limited progress” or “no progress”. This is not least why the Court of Auditors recommended that the Commission monitor the implementation of the recommendations more closely and link the granting of EU funds more closely to the country-specific recommendations.

Criticism of instruments

Experience to date with the recommendations of the EU Commission on macro-economic imbalances also reveals clear room for improvement. In a 2018 report, the European Court of Auditors stated that the Brussels recommendations were implemented by Member States “only to a limited extent”.

There are also several weaknesses in the Commission’s design: “There is no systematic link between the specific imbalances identified in the in-depth review and the proposed recommendations.” This makes it difficult for Member States to take appropriate corrective action. Moreover, the country-specific recommendations do not take sufficient account of the fiscal policies of the Member States.

The European Court of Auditors has expressed its doubts about the enforcement of this instrument as follows: “It is worth noting that the Commission has never recommended the initiation of an Excessive Imbalance Procedure, despite the fact that several Member States have been found to have excessive imbalances for extended periods of time since the launch of the MIP in 2012.”

Recommendations are often not implemented

In a second report in 2020, the Court of Auditors devoted itself to the country reports of the Commission, which document the annual economic progress of the Member States and make concrete recommendations for important structural reforms.

Summary

It becomes apparent that: The European debt problem remains unresolved. The rules of the game are now enormously complicated, but the results leave much to be desired. In the face of a looming recession, there are legitimate concerns about a new sovereign debt crisis in Europe, which in reality has never been overcome.

Member States have not yet managed to act in a sufficiently anti-cyclical manner and adequately to reduce debt ratios in good economic times. As before, there is still a tendency to kick the can of reforms or budget adjustments down the road.

## Chapter 4

## The ECB's tightrope walk

Before we go into more detail about the possible financial consequences of the interest rate turnaround, we should recall the most important stages of ECB intervention. After the financial crisis from 2007, the European Central Bank began to design securities purchase programmes. The first covered bond purchase programme started in July 2009, and another covered bond purchase programme started in October 2011 (Deutsche Bundesbank overview, 2022).

The ECB began buying government bonds in May 2010. Within the framework of the so-called Securities Markets Programme (SMP), bonds of Greece, Portugal and Italy, which were in the crosshairs of the financial markets at the time, were acquired on the secondary market until September 2012. The volume in the course of two years already amounted to a considerable 210 billion euros, but compared to the programmes that followed later, these orders of magnitude sound almost modest today.

The ECB's purchase programmes then went through the roof in 2015, when central bankers decided to expand the asset purchase programme. Up to 80 billion euros of securities were purchased every month. The declared aim was to lower long-term interest rates and provide additional liquidity to boost inflation, which was then very low, and avoid deflation. The Public Sector Purchase Programme (PSPP) already had a volume of more than 2 trillion euros at the beginning of the pandemic in early 2020.

Following the outbreak of the coronavirus pandemic, the ECB launched another programme – the Pandemic Purchase Programme (PEPP), which initially totalled 750 billion but subsequently increased several times.

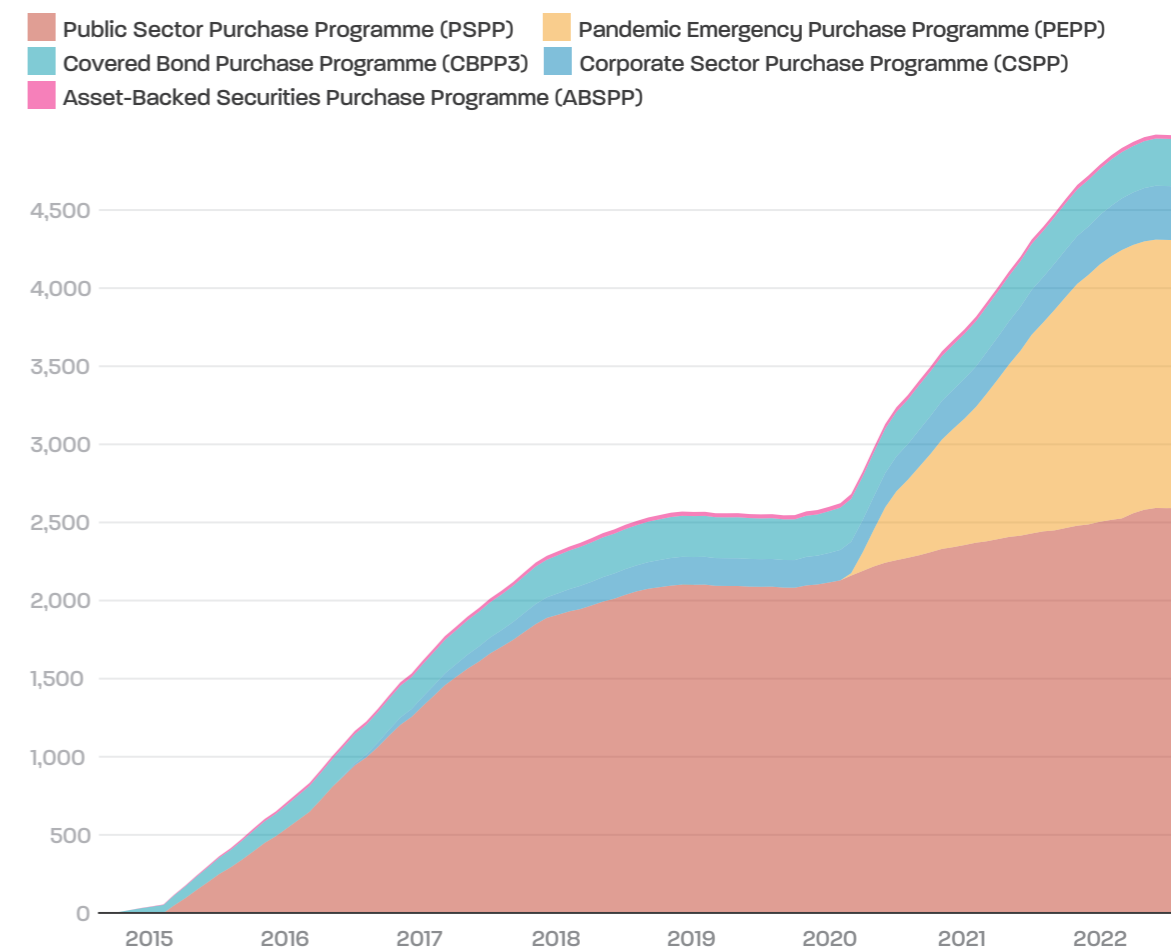
The result after a seven-year shopping spree: In August 2022, the ECB had just under 5 trillion euros in securities on its books, almost 2.6 trillion euros is spent on government bond purchases under the Public Sector Purchase Programme, and another 1,700 billion on government bonds under the pandemic programme.

In order to protect themselves formally against the accusation of government financing, the secondary markets not only buy government bonds from highly indebted EU countries, but bonds across the bank. Consequently, in absolute amounts, German bonds were mostly bought (almost a trillion), followed by France, Italy and Spain.

Figure 8

## Development of the ECB's asset purchase programmes

Cumulative net purchases, in billions of euros



Source: EZB, NEOS Lab

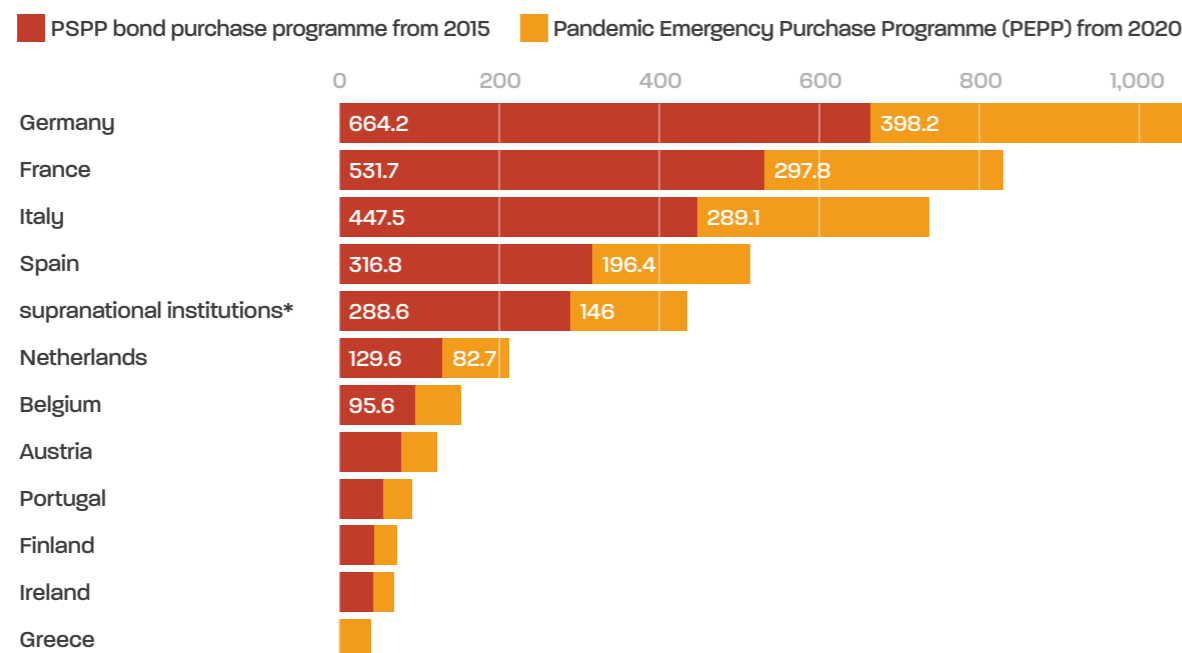
In the case of Italy, Spain and Portugal, the government bonds held by the central banks correspond to almost 40 percent of the gross domestic product of 2022. Whether or not such huge market interventions violate the existing prohibition of government financing (Article 123 of the Treaty on the Functioning of the European Union) has been a matter of great debate among experts for years. And even at the highest court level, the issue is raising eyebrows.

The European Court of Justice (ECJ) declared the PSPP bond purchase programme compatible with EU law in 2018. The Luxembourg judges saw no violation of the ban on monetary financing. PSPP would have neither the same effect as buying bonds in the primary markets, nor would it remove the incentive for sound fiscal policy.

Figure 9

**Government bonds held by central banks**

in billions of euros, as of August 2022



\* e.g. European Stability Mechanism (ESM), European Financial Stability Facility (EFSF), European Investment Bank (EIB)

Source: ECB, NEOS Lab

In May 2020, the German Federal Constitutional Court ruled that the ECB was acting "in breach of competence" with PSPP. More than that: The German Court of Justice said that the ECJ also acted outside its powers ("ultra vires") with its decision, so that it was not binding on Germany.

In any case, this remarkable match in terms of justice policy, which has also led to massive irritation between the EU Commission and Germany (in the end, the Republic formally pledged to recognise the primacy of EU law), shows how far the ECB has moved away from the original spirit of the EU Treaty. It is only possible to legitimise further market interventions with legal artifacts.

**New programme since summer 2022**

Now the next intervention chapter is already being opened. Following the announced exit from the zero-interest-rate phase, the ECB has already announced a new programme that can be activated to, as the central bankers announced in July 2022, "counteract unwarranted, disorderly market developments, insofar as they pose a serious threat to the uniform transmission of monetary policy in the

euro area." In such a case, securities from individual countries could be bought up again in order to prevent a deterioration in financing conditions, provided that these are not justified by "country-specific fundamentals".

For several reasons, this programme could become an even more precarious balancing act. For example, central bankers now have to define when interest-rate surcharges are "unwarranted" or when they can no longer be justified by "country-specific fundamentals". The ECB therefore becomes even more of a political actor and decides which government deserves monetary support and which does not. Since TPI is to be used only in ailing countries, it is also becoming increasingly difficult to argue that it is not government funding.

**Summary**

The ECB is sitting on more than 4 trillion euros in government bonds. Prohibited government financing can only be denied by employing legal legerdemain. In any case, it is clear that the original spirit of the EU treaties is being violated. In the current period of high inflation, the economic policy dilemma is becoming ever more obvious. Interest rates must rise rapidly to prevent inflation from becoming entrenched. This threatens to overwhelm the heavily indebted countries, which is why the ECB is forced to make further interventions.

So the vortex continues to whirl: The real signal of interest rates, namely to give a price to the risk of default, is to be further artificially eliminated or at least distorted by the ECB. Pressure on individual countries to consolidate their budgets is being reduced; at least TPI is not tied to political reforms. The subversion of directly legitimate parliaments in the event of such serious interventions will certainly lead to renewed fundamental legal debate.

## Chapter 5

# What additional costs could be incurred by EU countries

## 5.1 Simulations NEOS Lab

The extent to which TPI is being used and how much it can influence interest rate development is currently unclear, as are the subsequent political discussions that will be triggered. In any case, interest rates on government bonds have already soared significantly in the second half of 2022. While countries such as Germany, Austria, Denmark or the Netherlands recorded negative interest rates on ten-year government bonds in the previous year (i.e. they made money by borrowing debt), these countries had to pay around 2 percent or even slightly more at the beginning of September. Spain already stood at around 3 percent for ten-year bonds, while Italy must offer investors 4 percent in return.

For public budgets, this means: After years of falling financing costs (interest rate expenditure as a proportion of GDP in the euro area fell from 2.8 percent in 2010 to only 1.5 percent in 2021), things are now heading in the other direction. Investors want to be compensated for record-level inflation rates and they can also assume with a probability bordering on certainty that the ECB will take further interest rate steps.

### Medium-term risks

In order to get a sense of the dimensions that countries could face, several scenarios were simulated for this Policy Brief. The intention is to show that: The risks, especially for the highly indebted countries, are considerable in the medium to long term if appropriate reform measures are not taken.

First, an overview of interest rate development. The values for 2020 and 2021 are taken from the OECD interest rate database, the values for "early September 2022", with which the following simulations were carried out, are current market values as of 8 September. Market dynamism, however, is currently high. By the end of September, the yields of most countries were already significantly higher again. In Italy, they climbed to 4.7 percent after the parliamentary election on 25 September, in which the right-wing alliance under the leadership of the Fratelli d'Italia emerged as the winner.

Table 1

### Interest rate development; ten-year government bonds

	2020 average	2021 average	Beginning of September 2022
Austria	-0.22	-0.09	2.184
Belgium	-0.15	-0.01	2.200
Bulgaria	0.25	0.19	2.618
Czech Republic	1.13	1.90	4.629
Denmark	-0.36	-0.06	1.931
Finland	-0.22	-0.10	2.026
France	-0.15	0.01	2.148
Germany	-0.51	-0.37	1.579
Greece	1.27	0.88	4.142
Hungary	2.23	3.06	9.130
Ireland	-0.06	0.06	2.171
Italy	1.17	0.81	3.848
Latvia	-0.06	0.00	3.250
Lithuania	0.22	0.16	2.999
Luxembourg	-0.41	-0.36	1.850
Netherlands	-0.38	-0.33	1.884
Poland	1.50	1.94	6.077
Portugal	0.42	0.29	2.615
Romania	3.89	3.63	8.060
Slovakia	-0.04	-0.08	2.640
Slovenia	0.08	0.07	2.598
Spain	0.38	0.35	2.720
Sweden	-0.04	0.27	1.936

The macroeconomic basis for the calculations is the EU Commission's summer forecast, which includes the debt levels of the 27 EU Member States and the expected budget deficits for 2022 and 2023. The extent to which individual countries are affected by rising interest rates depends on several factors.

- **Residual maturity:** The longer the maturity of government bonds, the slower interest rate hikes will be. Conversely, the shorter the maturity, the faster rising interest rates will be felt. There has been a trend toward longer-term debt in the past decade. However, there are significant differences in the average residual maturity of bonds. Austria and Slovenia are above ten years, according to data from the EU's Economic and Financial Committee (Risk Metrics database). In Greece, where the last crisis led to a major rescheduling, the residual maturity is currently over 20 years. At the other end of the scale are Sweden and Poland, whose bonds have an average maturity of less than five years, but Hungary also has comparatively short maturities at just under six years. Italy is slightly below the euro area average at seven years.

Again, the examples of Italy, Austria and Sweden are used to show the differences resulting from the investment strategies. Sweden has short maturities, but since the debt is relatively small, only about 9 billion euros need to be refinanced annually. Austria, which has significantly longer average maturities, will have to refinance around 37 billion euros of expiring bonds per year due to its much higher debt ratio. In the case of Italy, the large debt level of almost 2,800 billion euros results in an annual refinancing requirement of around 200 billion euros.

- **Variable rate bonds:** Countries are also more likely to feel rising interest rates if they have a larger share of variable-rate government bonds (inflation- or interest-indexed bonds). Similar to the residual maturities, there are major differences between the individual countries. According to the Risk Metrics database, Estonia, whose debt level is the lowest in the EU, had more than 40 percent of variable-rate bonds in the first quarter of 2022. In Cyprus, Poland, Finland and Hungary, it was more than 20 percent. But Italy, too, had a comparatively high share of variable-rate bonds, at 14.5 percent. In Austria, on the other hand, this instrument is hardly used at all (0.69 percent of bonds have variable interest rates).

These data were used to determine the financing needs of each country for 2023 and to estimate the associated costs in three different scenarios.

- **Scenario before interest rate turnaround:** The first scenario simulates how costs would have developed if there had been no inflation shock and no end to zero-interest-rate policy. The cost of new debt in 2023 is shown as if average interest rates were still as low as in 2021.
- **“Current Market Value” Scenario:** The second scenario is based on the interest rates of 8 September 2022 and assumes that they will continue to correspond to the average yield of the individual countries in the coming year.
- **Scenario +1:** In the third scenario, it is assumed that interest rates will rise by one percentage point in the coming year compared to the beginning of September 2022.
- **Scenario +2:** The fourth scenario assumes interest rates that are 2 percentage points above September values.

It must be stressed that this approach can only approximate costs. If you want to have exact values, you would have to evaluate the specific bond structure for all countries, i.e. take into account in which month which bond matures with which maturity.

There are also uncertainties in variable bonds. The EU Risk Metrics database only shows what percentage of a country's total bonds are variable-rate bonds. However, it is not possible to derive from this exactly to which indices individual bonds are linked and in what volume. For the simulation, a link to the Euribor interest rate with a maturity of three months was assumed. The calculation was based on the rate at the beginning of September, which was 0.712 percent and thus a good 1.2 percentage points above the average value for 2021. But here too, there has been a great deal of dynamism since the ECB's rate hike. At the end of September, the 3-month Euribor was already around 1.2 percent. This method of calculation estimates the costs rather conservatively. Bonds linked to the current very high inflation inevitably incur significantly higher costs.

Finally, for future scenarios (i.e. scenario +1 and scenario +2), it was assumed that the premiums on current interest rates would be the same for all countries. However, higher premiums for countries with high debt and lower creditworthiness are more realistic.

The results

The simulations however are highly suitable for assessing the extent of the interest rate problem for the individual countries or the EU area. The calculations show that massive additional burdens can occur even in the short term. With the interest rates of early September alone, the 19 countries of the Eurozone will have to reckon with slightly more than 45 billion euros in interest costs in 2023 for the refinancing of old debts as well as for the financing of the budgeted deficit. The costs for all 27 EU members amount to almost 55 billion euros.

If all EU countries could still finance themselves as cheaply as they did before the rate turnaround, the cost of interest would be less than 6 billion euros. Even if interest rates next year stabilise at the level of early September 2022, there will be additional burdens of around 50 billion euros.

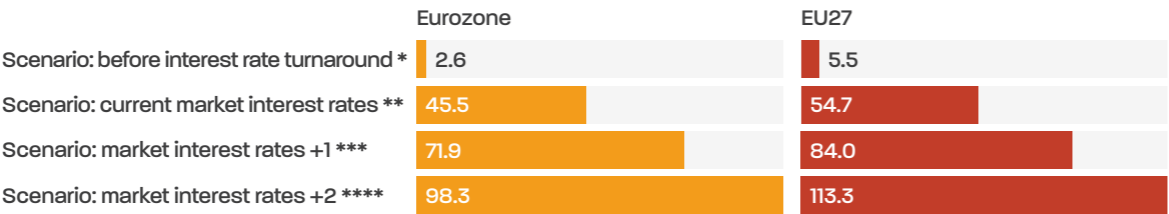
As mentioned, this scenario could already be outdated. Yields at the end of September were already well above the beginning of the month, so they were more in line with the "scenario +1". In this case, next year the 27 EU countries would have to expect interest costs of 84 billion euros (72 billion for the euro countries).

Even if yields were to rise by even two percentage points compared to the values of early September 2022, after further interest rate steps by the ECB, the interest costs to the EU countries would still amount to 113 billion euros.

Figure 10

Supposedly small interest rate hikes can tear big holes in national budgets

Cost of 2023 new debt, in billions of euros



\* Cost of new debt in 2023 if the phase of zero or negative interest rates were to continue \*\* Cost of new debt in 2023 if interest rates remain at the level of September 2022 \*\*\* Cost of new debt in 2023 if the interest rates of all EU states are one percentage point above the level of September 2022 \*\*\*\* Cost of new debt in 2023 if the interest rates of all EU states are two percentage points above the level of September 2022

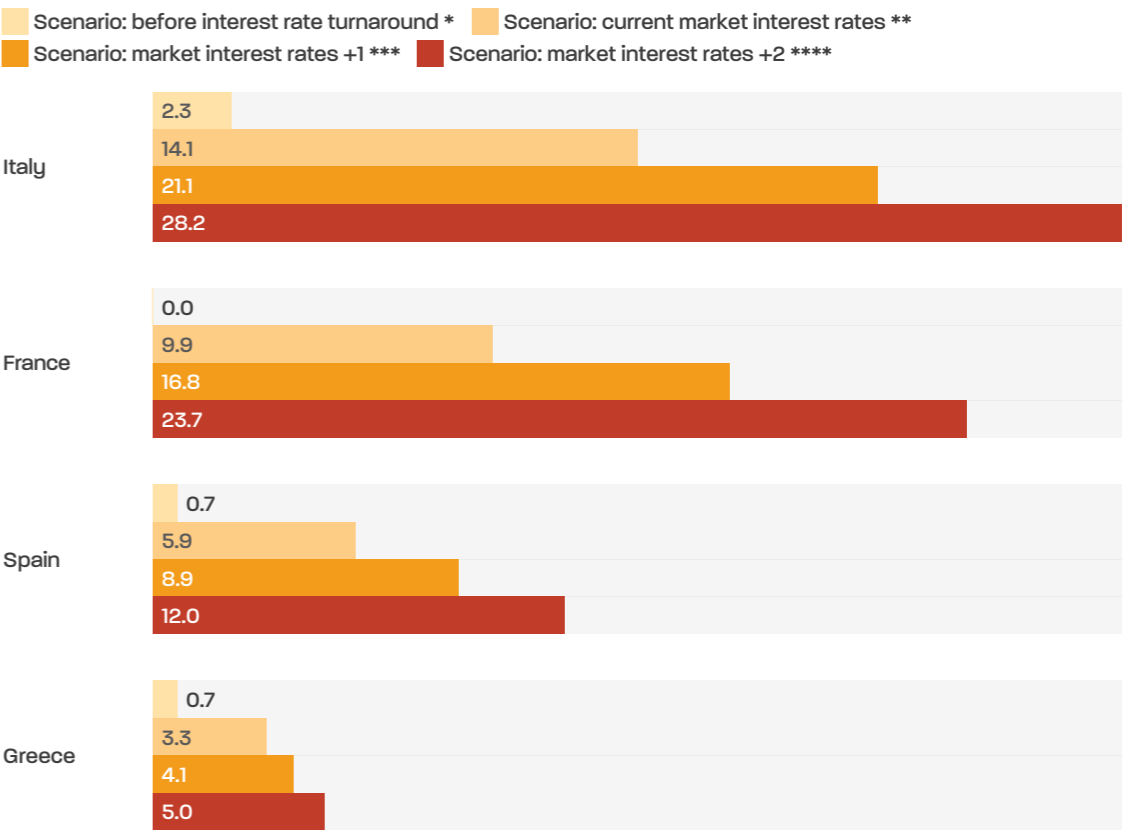
Source: NEOS Lab

The following chart shows the budgetary impact for selected countries. In "scenario +1", Italy would have to reckon with around 20 billion euros in additional costs. If interest rates were to deteriorate further to "scenario +2", it would be almost 30 billion euros. France, too, would have to expect additional costs of more than 20 billion euros, while in Spain it would be 9 to 12 billion euros.

Figure 11

Budgetary impacts of rising interest rates in selected EU countries

The costs of new debt in 2023 vary greatly depending on the scenario. Values in billions of euros



\* Cost of new debt in 2023 if the phase of zero or negative interest rates were to continue \*\* Cost of new debt in 2023 if interest rates remain at the level of September 2022 \*\*\* Cost of new debt in 2023 if the interest rates of all EU states are one percentage point above the level of September 2022 \*\*\*\* Cost of new debt in 2023 if the interest rates of all EU states are two percentage points above the level of September 2022

Source: NEOS Lab

The simulations also show that: It can also quickly become expensive again for countries such as Greece. Although the Greeks are now in very long-term debt, a significantly worse interest rate situation would increase the burden in scenarios +1 and +2 to 4 to 5 billion euros. Therefore, if the total amount of debt is simply

enormously high, long residual maturities provide only partial immunity against rising interest costs. Even a small percentage of debt that has to be refinanced annually then becomes a significant burden in absolute terms.

Conversely, it shows again that a country like Sweden would not really feel even a strongly rising interest-rate environment. Despite average short maturities, Sweden would have to expect only a few hundred million euros in additional costs, even in scenario +2. In contrast, in Austria, which is slightly smaller in terms of GDP, the costs would range from 1.4 (scenario +1) to 1.9 billion euros (scenario +2).

As outlined above, the current deficit forecasts according to the summer forecast of the EU Commission were taken into account for these calculations. However, these were created in the spring of 2022, so in many cases they do not yet contain all the aid measures announced by national governments in recent months to compensate for high inflation, especially in the energy sector. In Austria, for example, the deficit forecast for 2023 was raised from 1.5 to 2.9 percent of GDP in the autumn.

It is also questionable whether the growth forecasts made by countries can be maintained, as the economy has cooled significantly over the summer. The actual economic developments will therefore be significantly worse in 2023 than announced in Brussels in the spring.

Five-year forecast

The following scenarios were calculated:

- **“Current Market Value” Scenario:** This scenario is again based on the interest rates of 8 September 2022 and assumes that these correspond to the average yield of the individual countries for five years.
- **Scenario +1:** In this scenario, interest rates were assumed to rise by one percentage point from the September level and remain at that level for five years.
- **Scenario +2:** Finally, in scenario +2 it was assumed that yields over the next five years would be two percentage points above the level of early September 2022.

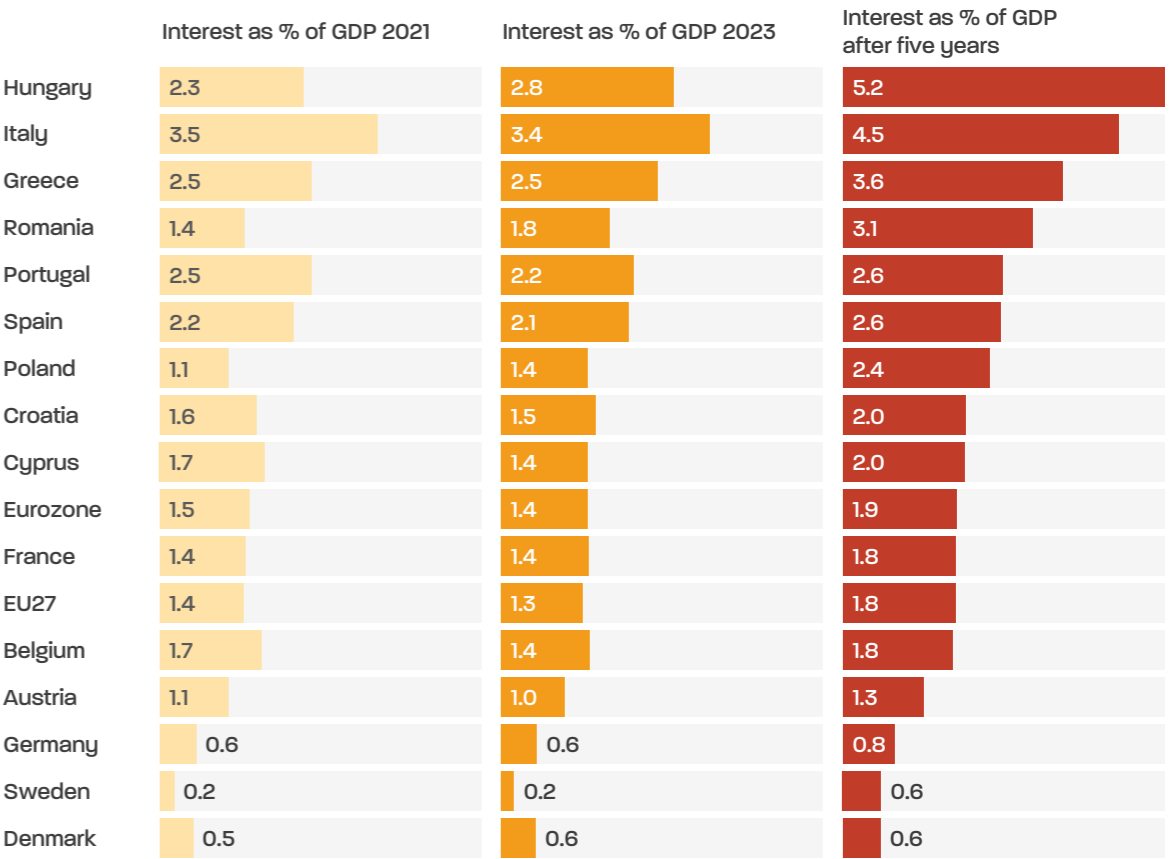
Here, too, certain assumptions had to be made for the calculations, which in reality may develop differently. For example, it was assumed that the average residual maturity of the bonds would remain at the level of the first quarter of 2022. The share of variable bonds was also left unchanged at the values of the first quarter of 2022. As an index for the variable bonds, the 3-month Euribor of September 2022 was raised by one and two percentage points respectively in the +1 and +2 scenarios.

It was also assumed that the debt-to-GDP ratio would remain broadly the same. The total debt was adjusted only by the rising costs of variable bonds and the increased costs of debt refinancing. However, no assumptions were made regarding development of the budget deficits. The calculations therefore only simulate how the costs of refinancing the existing mountain of debt as a percentage of GDP would develop within five years if there were no other changes in the framework conditions. They therefore do not take into account any further aid measures or possible structural reforms that could be introduced to reduce expenditure.

Figure 12

Status quo scenario: How debt servicing in EU states would develop

Assumption: Interest rates remain at the September 2022 level for five years



Source: NEOS Lab

In the status quo scenario (i.e. the continuation of the interest rate situation as of 8 September 2022), Italy’s debt servicing would increase from 3.2 percent of GDP to 4.5 percent after five years. In Hungary’s case, the rapid increase from

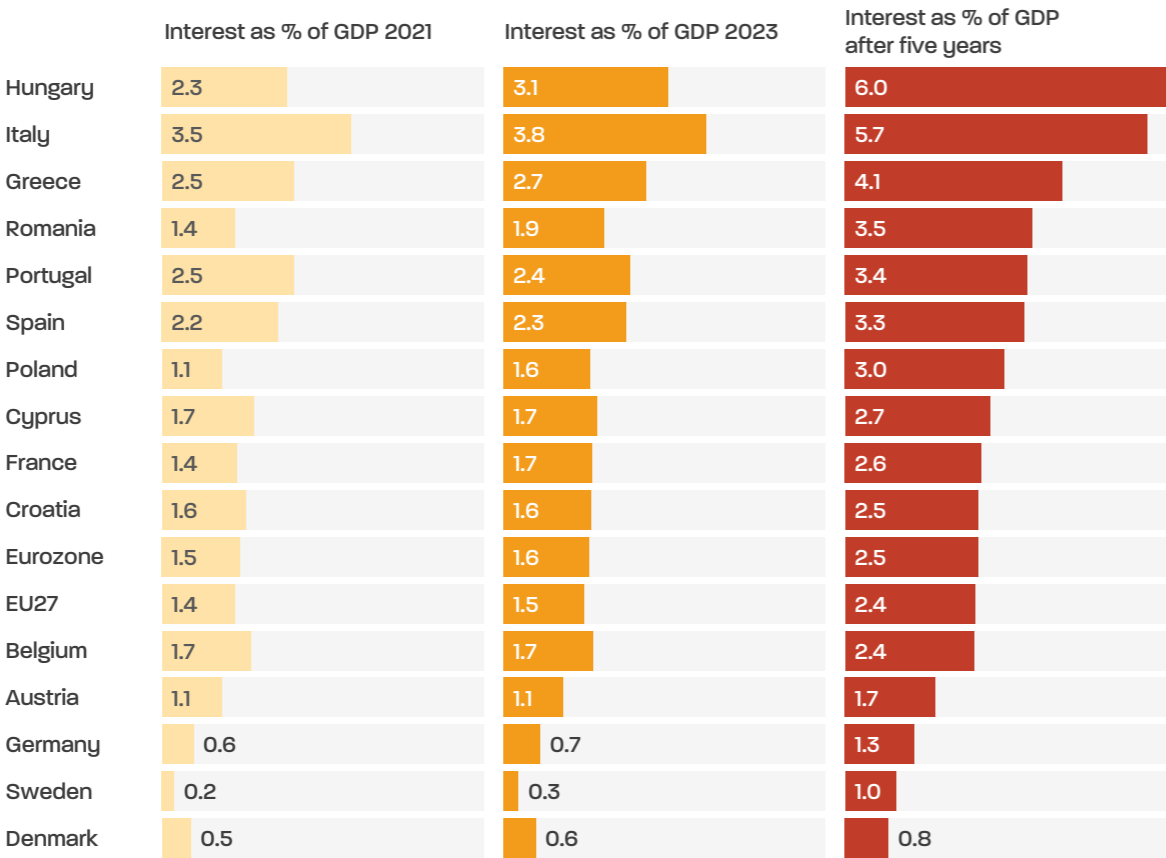
2.8 to 5.2 percent of GDP within five years is explained by the short average residual maturity of Hungarian bonds (5.97 years) and the high proportion of variable-rate bonds (20.78 percent). At the end of the period under review, almost the entire debt mountain would already be subject to the new, higher interest rates.

If EU countries’ interest rates rise by one percentage point compared to the beginning of September 2022, the cost of debt servicing would rise to 6 percent of GDP in Hungary and 5.7 percent in Italy. Even Greece would also be over 4 percent of GDP again.

Figure 13

Scenario interest rates +1: How debt servicing in EU states would develop

Assumption: The interest rates in all countries rise by one percentage point in 2023 compared to early September 2022, and then remain at this level for five years.



Source: NEOS Lab

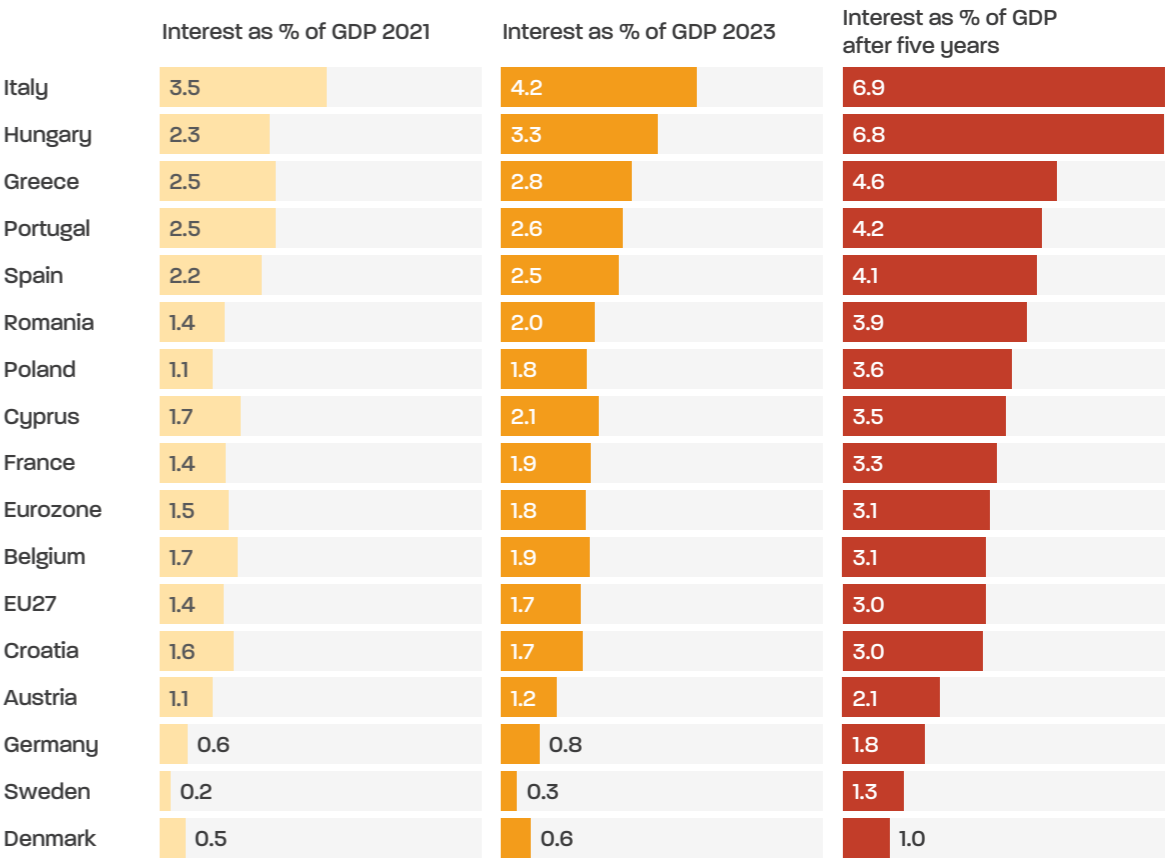
If yields on government bonds were to climb 2 percentage points from September 2022 levels and remain at that level for five years, Italy and Hungary would already be approaching the 7 percent mark. In addition to Greece, Portugal and Spain would also have to spend more than 4 percent of their GDP on debt servicing, but Romania, Poland, Cyprus, France and Belgium would also have to spend more than 3 percent.

In other words, in many countries, especially those with high levels of debt, this would bring them back to the level we recently saw in the great debt crisis of a decade ago. Countries like Sweden, on the other hand, which have always paid attention to sound financial management in the past decades, do not have to fear any particular burdens even in such a scenario.

Figure 14

Scenario interest rates +2: How debt servicing in EU states would develop

Assumption: The interest rates in all countries rise by two percentage points in 2023 compared to early September 2022, and then remain at this level for five years.



Source: NEOS Lab

However, it should again be stressed that: This is a “no-policy-change” scenario that could be quickly overtaken by real world events. On the one hand, in the event of a recession that could affect large parts of Europe in early 2023, massive spending packages to stimulate the economy can be expected.

On the other hand, countries could also use the high inflation phase to “inflate” debt (see the chapter “[Strategies for kicking the debt habit](#)”). If debt is allowed to rise more slowly than GDP is growing, the vicious circle of debt could be broken. On the central bank side, those countries with their own currency (Hungary, Poland, Romania) have different options to those within the eurozone, where national leeway in monetary policy is limited. For example, the Hungarian central bank had already raised the base interest rate from 1.7 to 13 percent between September 2021 and September 2022.

## Summary

In all scenarios, the calculations show that: The prospects of heavily indebted countries can deteriorate relatively quickly. As the years before the pandemic were only used to a limited extent to reduce structural debt, the rapid interest rate turnaround has now come as a surprise. If interest rates continue to deteriorate, the additional annual costs in the EU area could quickly rise by 100 billion euros. In terms of GDP, debt servicing in some countries could return to threatening levels recently reached after the major financial crisis. While finance ministers could expect to benefit from low interest rates for a long time, which would have led to a further decline in interest payments, such a scenario in autumn 2022 can be described as mere wishful thinking. Clear strategies for sustainable budgets will be needed.

## 5.2 Eleven countries at “high risk”

**The “Fiscal Sustainability Report” of the EU Commission provides a different view of the current high risks in the EU area. The Brussels experts rated eleven of the 27 EU members as “high risk” in the medium term, eight countries as “medium risk” and another eight as “low risk”.**

The eleven countries with the highest fiscal vulnerability are: Belgium, Greece, Spain, France, Italy, Slovenia, Slovakia, Portugal, Croatia, Romania and Malta.

The last report was presented in April 2022. In its baseline scenario, it is now outdated, but the Commission’s experts have also simulated an adverse scenario that assumes a medium-term deterioration in the interest-rate environment. Specifically, it was assumed that the difference between the average interest rate that countries must pay for their debts, and GDP growth (interest-rate-growth differential) deteriorated by one percentage point.

This projection, which extends until 2032, also shows that the highly indebted countries will have to abandon an anticipated (baseline scenario) rapid decline in the debt ratio. In 2032, Italy would have the highest debt, with almost 175 percent, ahead of Greece, but Spain, France and Portugal would also have more than 130 percent.

A second analysis calculated how much consolidation would be needed to break the trend and attain the Maastricht debt-ratio target of 60 percent within 15 years. The values of this “S1 indicator” indicate the percentage of GDP by which the primary balance (budget balance less interest-rate expenditure) would have to improve within five years. Since short-term changes on a larger scale are difficult, this scenario assumes that they will be implemented by 2024.

For Italy, in the adverse scenario, there would be a need for consolidation of 11.7 percent of GDP. As GDP currently stands at around 2,000 billion euros, the need for consolidation would therefore be around 230 billion euros. But even the 9.4 percent in the case of Belgium would mean adjustments of more than 50 billion euros over five years in such a scenario.

These analyses by the EU Commission have the advantage that they not only focus on the interest-rate situation, but also take account of the structural reform needs of the countries by estimating the medium-term demographic costs of ageing societies (pensions, health, care).

Table 2

Debt-level development

Country	Baseline scenario	Adverse scenario
Italy	161.6	174.8
Greece	154.7	165.6
Belgium	133.6	143.0
Portugal	126.2	136.3
Spain	126.1	136.1
France	122.3	131.4
Slovenia	95.2	101.6
Croatia	76.7	82.6
Romania	76.9	82.0
Malta	73.2	78.4
Slovakia	72.2	76.4

Table 3

Required improvement of the primary balance over 5 years, as % of GDP

Italy	11.7
Belgium	9.4
Greece	8.0
Portugal	7.8
Spain	7.3
France	7.3
Slovenia	6.8
Romania	4.5
Slovakia	3.7
Malta	2.5
Croatia	2.3

Chapter 6

Strategies to kick the debt habit

6.1 What does actually work?

There are several ways to reduce public debt. Not all have traditionally the same prospects of success or the same political costs. However, before discussing which of these routes are politically compatible with a liberal rule of law and a liberal economic model, and which ones are best pursued, there are fundamentally five different ways to eliminate high public debt to examine:

- Real economic growth
- Inflation (Partial default payment)
- Illiquidity
- Financial repression
- Austerity

The option often preferred from a political perspective for eliminating a debt problem is **economic growth**. Because debt is often expressed in relation to economic output, a high level of real economic growth is one way to get out of a debt crisis. The problem is that in situations of high indebtedness, economic policy often fails to generate sustained high economic growth. If the fundamental framework conditions that have led to high indebtedness are not disabled, the prospect of high real growth is rather unlikely. Politically, it is the most popular answer to a debt problem. This is because higher economic growth is associated with a higher level of prosperity. And burgeoning fiscal revenues mean the country does not necessarily have to introduce painful spending cuts.

The second way to eliminate public debt is different: **High inflation**. In this case also, growth eliminates past debit; however not real, productive growth, but nominal growth. High inflation rather than real growth also leads to a shrinking debt relative to economic output. However, inflation is already associated with a lot of negative side effects. A high rate of inflation destabilises household finances, especially when a high proportion of private wealth is invested in nominal assets. Even rampant inflation will jeopardise the macroeconomic stability of an economy. Therefore, in developed, liberal democracies, this path is blocked by a clear mandate for price stability at central banks. The European Central Bank also has a clear mandate to keep inflation at close to two percent. Since 2021, however,

there has been an obvious failure on the part of the ECB to achieve this objective. Finance ministers in the European capitals are getting a tailwind for debt reduction as a result of much higher inflation in the euro area.

Financial repression describes measures to keep the demand for government debt artificially high and thus the cost of debt low.

**Austerity: Higher taxes and spending cuts.** Austerity policy is an important way to avoid a sovereign debt crisis. Spending less money and raising more money appears to be a key mix of measures to reduce public debt, and not only at first glance. In a monumental work, the Italian economist Alberto Alesina has compiled the experience of austerity episodes in economic policy and meticulously analysed when they were successful and when they were not. Economic history provides a number of outcomes in this regard: 1. Spending cuts are more successful than tax increases. When it comes to kicking the habit of high government debt, starting on the expenditure side is more likely to succeed. While tax increases often slow down economic development, spending cuts, combined with structural reforms, are more likely to be sustained and even boost economic dynamism in the medium term. 2. Austerity is not always successful. Although there are many historical episodes, many phases of austerity policy have failed. This was due to the fact that the phases of austerity were often accompanied by high political uncertainty and changes in government, which in turn led to measures being reversed.

One thing is clear from an economic standpoint: After high economic growth, well-designed austerity measures are probably the best way to reduce the debt ratio. Economic literature gives a lot of clues as to which measures have a particularly high chance of success. However, it should also be pointed out, especially in these very volatile times, that expansionary fiscal policy, that is, the creation of new debt, should only take place quickly, on a temporary basis and in a targeted manner. Measures to cushion, for example, the increased energy costs for households and businesses must not lead to a permanently rising level of expenditure, because this increases debt permanently and increases the likelihood of debt crises in the eurozone.

## 6.2 Sweden, the model student

Sweden can be described as a prime example of successful and, above all, sustainable fiscal consolidation. The following is therefore intended to describe the historical background of the major Swedish sovereign debt crises as well as the move towards a sustainable, sound budget policy.

After the Second World War, Sweden, like many other European countries, experienced a boom with high growth rates. Debt was not a real issue until well into the 1970s, with the Swedish government's debt ratio for a long time below 30 percent of GDP.

The first major sovereign debt crisis occurred in the late 1970s. Although it was possible to overcome this relatively quickly, major structural reforms initially failed to materialise. "Ultimately, the government debt of the first crisis in the 1980s was eliminated mainly by high inflation and not by hard cuts and austerity measures," Mehrtens (2014).

### Multiple crises

A sustainable cultural change only occurred with the second severe debt crisis at the beginning of the 1990s, in which a real estate and banking crisis combined with severe currency turmoil to cause a deep recession.

Within a few years, public finances turned from a surplus of 3.8 percent of GDP in 1990 to a deficit of 11.9 percent in 1993, giving Sweden the second highest deficit in the OECD after Greece (Brandner, 2003). The debt ratio doubled from around 45 percent to more than 80 percent of GDP between 1990 and 1994, reaching its historic peak of 84.4 percent of GDP in 1996 (Mehrtens, 2014).

The extent of the crisis can be illustrated by an interest-rate step taken by the Swedish Riksbank, which from today's point of view verged on the surreal. The central bank tried at all costs to prevent a devaluation of the Swedish krona in order to keep investments in kronor attractive. On September 17, 1992, in an unprecedented step taken to also curb speculation against the currency, it set the base interest rate at 500 percent.

## Interfactual consensus

Although the base interest rate remained at this level for only a few days (and ultimately the Riksbank had to release the exchange rate of the krona), there was a much stronger crisis awareness among the population as a result, and there was also rapid and massive political intervention. Just one day after this historic rate hike, the conservative prime minister Carl Bildt and the social democratic opposition leader Ingvar Carlsson announced cross-party and interfactional negotiations.

Observers see the willingness of the Social Democrats, in a severe crisis, to adopt tough and drastic structural reforms together with the conservative government as being decisive for the lasting success of the consolidation policy. There were, and still are, major differences in content between the parties in Sweden. However when push came to shove, it was possible to reach an agreement to ensure sound public finances in the long term. This principle has since been more or less upheld by all governments.

Bildt and Carlsson introduced substantial spending cuts within a short period of time. Neither conservatives nor social democrats were afraid to make cuts in many areas of the welfare state. After the change of government in 1994, further comprehensive austerity measures were adopted, at this time by a social democratic-led minority government.

As Mehrtens writes, under the social democratic government, savings were even more rigorous than under the conservative government, which is why he sees parallels to the “Nixon-goes-to-China thesis” according to which only a political hardliner like Nixon could visit Communist China without being suspected flying a false flag. In Sweden, this would mean that left-wing parties were more likely to be able to impose cuts in social policy, as they were basically not suspected of wanting to restrict the welfare state unnecessarily.

## Automatic balancing mechanism

Part of the austerity packages was a major pension reform implemented in several stages, which, on the one hand, created incentives to work longer and, on the other hand, provided flexibility in respect of the retirement age. A key element of the compromise was also an automatic balancing mechanism, which in principle no longer requires political decisions (Anderson, 2021).

Such automatic stabilisers, which are a red rag to other social democrats, should in any case ensure the financial viability of the system. The ratio between assets and liabilities is calculated annually. If it is skewed, the pension level is automatically adjusted, this process is called “automatic balancing” and is therefore nothing more than a spending brake.

Only the so-called guaranteed pension, which is a kind of basic security, is part of the national budget. The two other tracks of the Swedish pension system, the pay-as-you-go and earnings-related income pension and the premium pension based on privately funded pension funds, have to manage without government cross-financing. In this case, therefore, expenditure must not exceed revenue.

## Still a strong welfare state

The Swedish sovereign debt crisis can only really be described as over since the end of the 1990s. As a result, it was also possible for politicians to once more selectively expand social services. At the beginning of the 2000s, for example, the rate of compensation in health and unemployment insurance was increased from 75 to 80 percent.

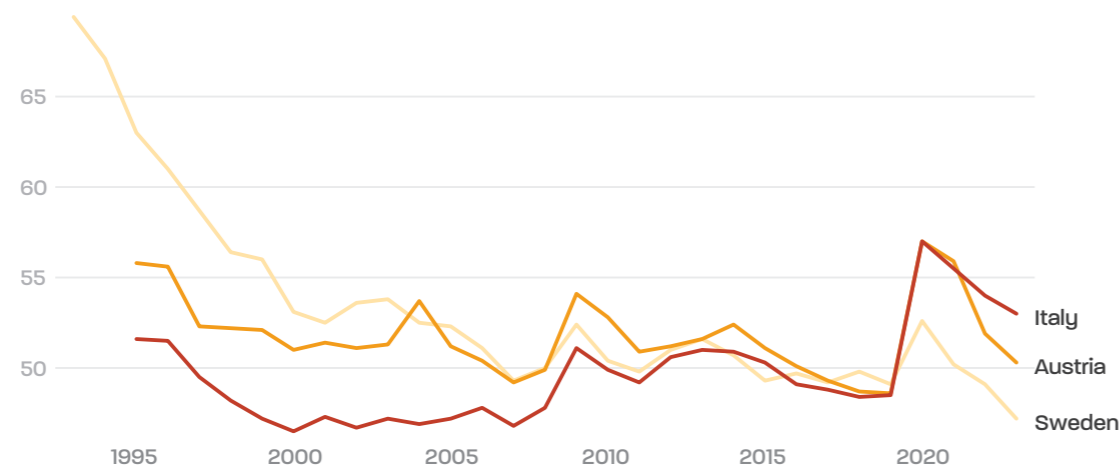
Overall, however, this major crisis was used to significantly flatten the government spending curve. The Swedish government spending ratio (i.e. total government expenditure as a percentage of GDP) fell from 69.4 percent in 1993 to below 50 percent in 2007. Since then, it has been below the 50 percent mark in most years. Nevertheless, Sweden still has a very well-developed welfare state with a functioning safety net.

But if we look again at the comparison with Italy and Austria, it becomes clear that these two countries today tend to have a higher state ratio than Sweden.

Figure 15

### How the government spending ratio has developed in Sweden, Italy and Austria

The government spending ratio is the ratio of government expenditure to gross domestic product. Values as a percentage of GDP.



For Austria and Italy, the Ameco database contains values from 1995 and for Sweden from 1993.

Source: Ameco, NEOS Lab

Part of the fundamental restructuring of the Swedish system was also the imposition of restrictive fiscal rules long before the Growth and Stability Pact was tightened at EU level (Molander & Holmquist, 2013). In this case, too, there was an extremely broad majority in parliament in favour of reform, which should have a positive effect on the real binding nature of the measures in the years and decades to come.

Since the financial year 1997, the Swedish Parliament has always set the nominal expenditure ceilings for three years in advance, both for total expenditure (less interest) and for all major expenditure areas, including social security and pensions.

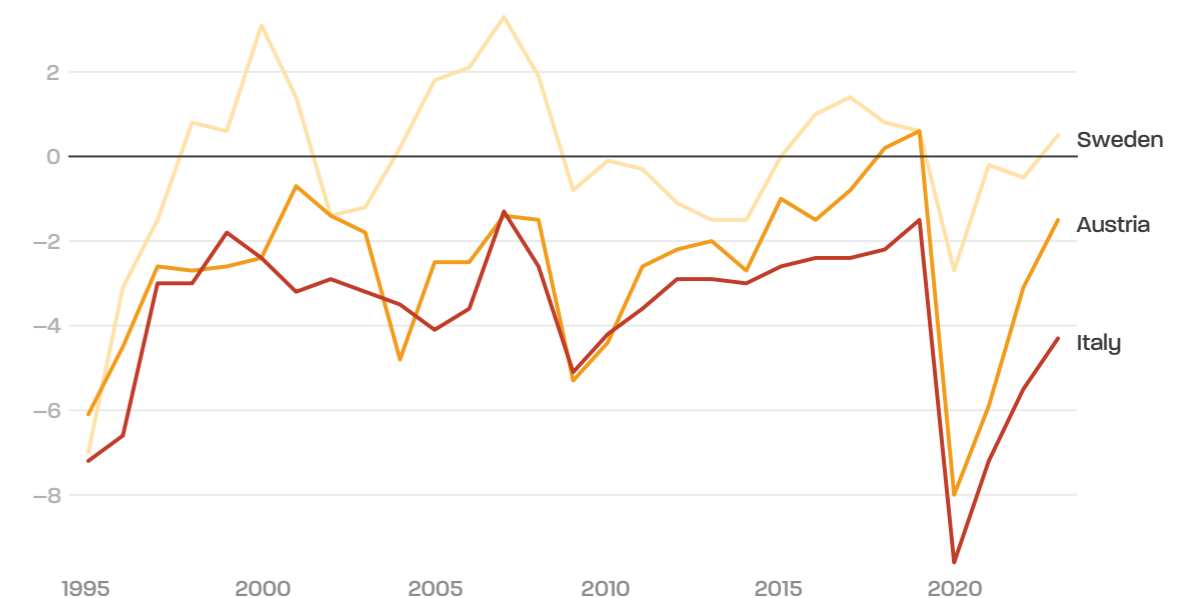
In 2000, a further tightening was introduced. Since then, Swedish budget rules have set a binding surplus target. Thus, a balanced budget is not only expected over the economic cycle, but a surplus is to be generated. At first, it was one percent of GDP, currently it is 0.33 percent of GDP (Swedish fiscal policy framework, 2021). Swedish municipalities and provinces are generally prohibited from indebtedness.

In contrast to other countries, Sweden also strictly complies with these requirements. A budget surplus has been generated eleven times since 2000, and six times this exceeded one percent of GDP. Conversely, the deficit was also above one percent of GDP in just six years since the beginning of the millennium. Only in the first pandemic year of 2020 was it higher than 2 percent (2.7 percent). But even in this extraordinary year, Sweden performed better than most EU countries, with only Denmark managing to have a smaller deficit in 2020 (0.2 percent).

Figure 16

### The Swedes manage to maintain regular budget surpluses

Maastricht deficits and surpluses respectively as a percentage of GDP



Source: Ameco, NEOS Lab

Italy, on the other hand, has not seen a surplus in any year since 2000, according to the Maastricht definition. Austria grew only slightly in 2018 and 2019 (0.2 and 0.6 percent, respectively).

## Restructuring of economic policy

In the mid-90s, the Swedes took a sovereign debt ratio, which is "normal" in the vast majority of EU countries today, as an opportunity to not only critically challenge their entire economic policy model, but also to restructure it. The previously common system of corporatist social partnership, which had led to economically unsustainable wage increases, was re-dimensioned. Economic policy priorities were no longer focused solely on full employment, but above all on combating inflation and on strict fiscal policies.

In parliament, broad alliances were forged that made it easier to take extraordinary measures that ultimately made Sweden a model fiscal student with the best credit rating. The about-turn was achieved not only with revenue increases, which mainly affected more affluent sections of the population, but also, above all, with broad-based spending cuts combined with structural reforms.

This includes, on the one hand, the difficult pension sector common to all ageing industrialised nations, but Sweden today is also a country with one of the least

burdensome regulatory frameworks for entrepreneurs. For example, the country is at the top of the OECD's occupational access index, which was first compiled in 2020 (OECD 2020). It achieved the best score in relation to access barriers to personal services and the third best score in relation to barriers to freelance services (Oswald, 2022).

## Summary

Despite the major upheavals, Sweden's welfare state has by no means lost touch internationally. Quite the contrary: The welfare state is still considered one of the best, societal inequality has not reached problematic proportions. The Gini coefficient, the most common indicator of inequality, has deteriorated somewhat since the mid-1990s, but still stood at 26.8 in 2021 (a value of 0 means absolute equality, a value of 100 means absolute inequality), according to Eurostat data. This means that Sweden is not only below the eurozone average, but also better than Denmark, Germany or Italy. The Gini index for Austria is pretty much at the Swedish level.

Even though political discussions are ongoing in Sweden, as in many other countries, about the priorities of the state, any international comparison reveals there can be no question of spending too little on future-oriented areas. According to Eurostat data, Sweden ranked third among the EU countries in terms of total public spending in 2020 in terms of education, research and the environment. Public investment was also at the forefront, with spending at 4.8 percent of GDP, well above the EU and Euro area average respectively.

In contrast to other countries, political upheavals following elections have so far changed little in the country's fundamental orientation. Whether this will remain the case after the victory of the conservative right-wing opposition in the parliamentary election in September 2022 remains to be seen. In any case, it is clear that: Sweden cannot be put under pressure by the financial markets in the foreseeable future. The situation is quite different in Italy, where the victory of Giorgia Meloni and the right-wing alliance led by Fratelli d'Italia caused interest rate fluctuations. In this case, it is worth recalling the legendary quote from former Swedish finance minister and prime minister Göran Persson: "Whoever has debt is not free."

## Chapter 7

# Expenditure is key

## 7.1 Focus on future spending

**In practice, clear spending ceilings, defined for several years in advance, such as those established by Sweden, are perhaps even more important than fiscal targets for deficit and debt levels. Ministers and government organisations who know that they can only exceed their spending under clearly defined circumstances (such as severe economic slumps) will plan differently from those who can expect to get an out-of-cycle budget increase at any time if they only intervene with the right political bodies.**

In the coming years and decades, significant green investments will be needed to achieve the climate targets that have been promised in international agreements. However, in order to be able to finance new priorities, it will be necessary to ensure that expenditure does not get out of control in other areas. Anyone who pledges new spending without paying attention to inefficiencies in existing spending will sooner or later face a financing problem.

## New future-ratio indicator

It is therefore important to sharpen focus on future-oriented spending. In science, there are various approaches to how this could be achieved. In 2021, the German economic research institute ZEW (Leibniz Centre for European Economic Research) developed its own indicator, the so-called future ratio (Heinemann et al., 2021). It indicates what percentage of the budget is directed towards long-term policy goals. It is thus a measure of future orientation and at the same time also makes transparent which portion of the budget mainly provides a benefit in the present or has any past orientation at all.

Of course, defining which budget pots are relevant for the future is not always easy. In its model, however, the ZEW has focused primarily on those policy areas where long-term benefits in economics are largely undisputed.

Firstly, these include measures to combat climate change. Expenditure is therefore assessed in terms of whether it contributes to the preservation or increase of natural capital. Second, there is a broad consensus in scientific literature that investment in early childhood education yields a major indirect return. Providing

quality care for the youngest children not only increases their chances in the labour market later on; a well-developed childcare system also allows parents to reconcile job and family. This is a decisive factor, especially with regard to equal career opportunities for women. Finally, research spending, especially for basic research, also belongs to the category where long-term benefits are undisputed. Economies that are well positioned in this area are or remain attractive as an economic location, produce competitive enterprises, and can thus improve their export opportunities.

On the basis of these key points, the ZEW has developed an evaluation algorithm. All budget items of the German federal budget were therefore evaluated according to various criteria. Expenditures that are primarily of benefit in the present and those that relate to the past (such as pension rights) are not included in the future ratio. All other items of expenditure are coded based on four primary and three secondary criteria.

The primary criteria are:

- Does an expenditure create technical knowledge?
- Will an expenditure enhance or create human capital?
- Is an expenditure used to build growth-relevant infrastructure?
- Does an expenditure contribute to the preservation of natural capital?

In addition, all expenditure items are evaluated on the following three secondary criteria:

- Will the benefit of an expenditure not be felt until far into the future?
- Is there any evidence of positive externalities in an expenditure?
- Is there any evidence in science of a particularly strong benefit of an expenditure?

At the end of this comprehensive coding process, the measure of future orientation can be determined, whereby the ZEW calculates two variants for the future ratio. A "wide variant" for which fewer criteria must be met, and a "narrow variant" for which more criteria must be met.

## Results

In its first evaluation for Germany in 2021, the ZEW calculated future ratios for the financial years 2019 and 2021 (the first pandemic year 2020 was omitted). In the "wide variant", which is preferred by the study authors, a future ratio of 18.34 percent was determined for 2019 and of 17.02 percent for 2021. In the narrow variant, for which more criteria had to be met, as mentioned above, the future ratio was just under 15 percent in 2019, compared to 14 percent in 2021.

## Future ratio for the Austrian budget

On the basis of the ZEW's conceptual considerations, the Neos Lab has also calculated a future ratio for the Austrian federal budget (Oswald 2022). The list of criteria (current or past orientation, primary and secondary criteria) were adopted by the ZEW as well as the evaluation algorithm; however, since each Ministry of Finance has its own budgeting rules and the function and grouping plans used by ZEW are not quite identical to the Austrian second-level detailed budgets, the results are also not comparable on a one-to-one basis.

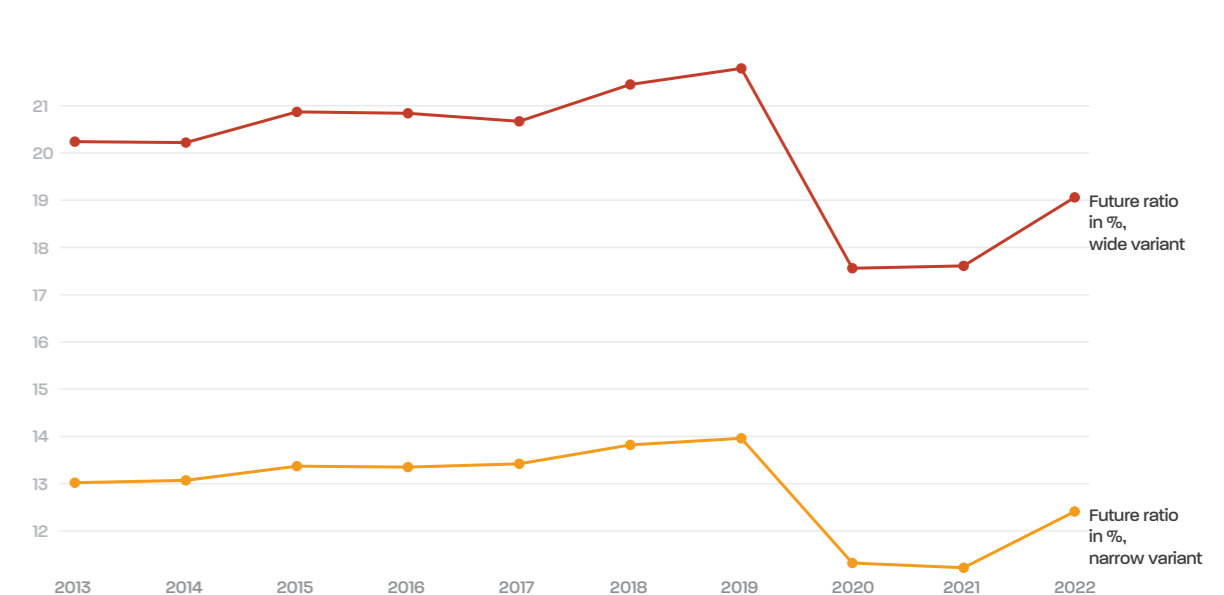
However, the general trend yields quite similar results. In the wide variant, the Austrian federal budget in 2022 showed a future ratio of around 19 percent, according to the calculations of the Neos Lab. Not even one in five euros of government spending is therefore spent on future-oriented policy areas such as environmental protection, elementary education or research. In the narrow variant, the future ratio was only 12.4 percent.

In contrast to the ZEW, the future ratio was calculated by the Neos Lab for the years 2013 onwards. The results for this time period are a good indicator that future-oriented spending has fallen significantly during the pandemic. This is, of course, not entirely unexpected. After all, the future ratio indicates a percentage of

Figure 17

### Future ratio is still below pre-crisis level

Percentage of the federal budget spent on future-oriented areas



Source: NEOS Lab

total expenditure, which has risen massively in the first pandemic year of 2020 due to government support measures. Nevertheless, 2022 still gives a lower value than the years before the pandemic. In total, only around one in five euros of public spending is spent on future-oriented projects. At any rate, this is a value that shows there is room for improvement.

The future ratio is undoubtedly not suitable as the sole indicator of budget valuation, especially because rising spending in certain areas does not in itself mean better output. Currently, high inflation in many areas will lead to higher public service pay without automatically increasing the quality of government services.

## Summary

Measurement figures such as the future rate however, can and should be used as an additional indicator. For example, a government could set itself targets for its legislative term or the next three years for how much of the budget should be spent on future-oriented projects. In the case of Austria or Germany, for example, this could be 25 percent. The impact-oriented impact assessment of laws, as has to be carried out in Austria and other countries, could focus even more on intergenerational equity or at least break down how legal measures affect different age cohorts.

## 7.2 Securing investments

**Perhaps the biggest challenge in the current environment is to reconcile environmental transformation that will require massive investment, with budget consolidation. If EU members are to come close to achieving the extremely ambitious target of reducing greenhouse gas emissions by 55 percent by 2030 compared to 1990 levels, and if net emissions are to fall to zero by 2050, more public investment will be needed, not less.**

In a rough estimate, Darvas and Wolff (2022) assume that public investment per year would have to rise by about 0.6 percent of EU GDP in order to achieve climate targets. At current prices, this would be about 100 billion euros per year.

In any case, the mistakes of the past should not be repeated. Following the financial crisis and the associated economic slumps, many countries experienced a significant decline in public investment. On the EU average, it was 0.7 percentage points lower in 2013 than in 2009 (3.1 versus 3.8 percent of GDP). In Greece, it fell from 5.7 percent to 3.5 percent, in Spain from 5.2 to 2.4 percent, and in Italy from 3.7 to 2.5 percent.

Although such major slumps have not been observed in the pandemic years, public investment is generally not particularly high in many countries. It is therefore noteworthy that EU countries have not generally used the years of extremely low interest rates for additional investment priorities. On average, EU public investment in the year before the pandemic (2019) was 3.0 percent and is projected to rise to 3.4 percent in 2022, according to the current forecast.

However, the war in Ukraine and the associated energy crisis have led to additional financing needs that must be taken into account in the budgets, but should not lead to the cancellation or postponement of necessary investments.

The debate on the reform of the fiscal rules has therefore been ongoing for several years; how, on the one hand, green investments could be facilitated without at the same time violating budget rules. In a study for the European Parliament's Committee on Economic and Monetary Affairs, Anderson and Darvas (2020) proposed an "asymmetric golden rule" whereby public investment would not have to be included in the budget targets in times of economic downturn. In a recession, these expenditures could therefore be deducted from the Maastricht deficit, while in growth phases they would increase the deficit.

In a recent proposal, Darvas and Wolff (2022) proposed a "green golden rule". According to this, green investments should be financed by deficits that would not have to be taken into account in the fiscal rules and would therefore also be excluded from the consolidation requirements. There would be no economic component in this case.

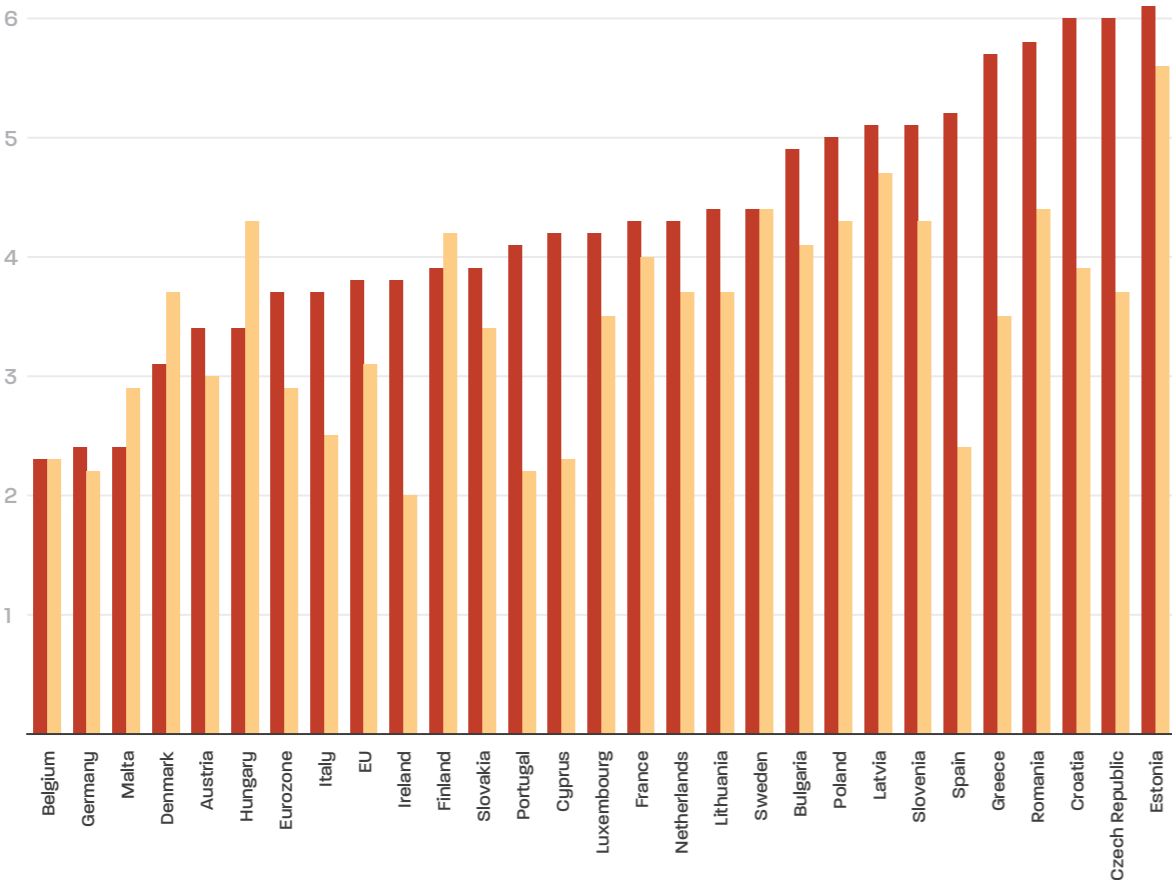
In order not to misuse the green golden rule for “greenwashing” (i.e. to re-label current expenditure or only alleged environmental projects as green expenditure), a narrow definition of green investments and appropriate control options by the EU Commission, the Court of Auditors or national independent fiscal institutions would be necessary.

Figure 18

Public investment after the financial crisis

Gross investment as % of GDP

2009 2013



Source: Ameco, NEOS Lab

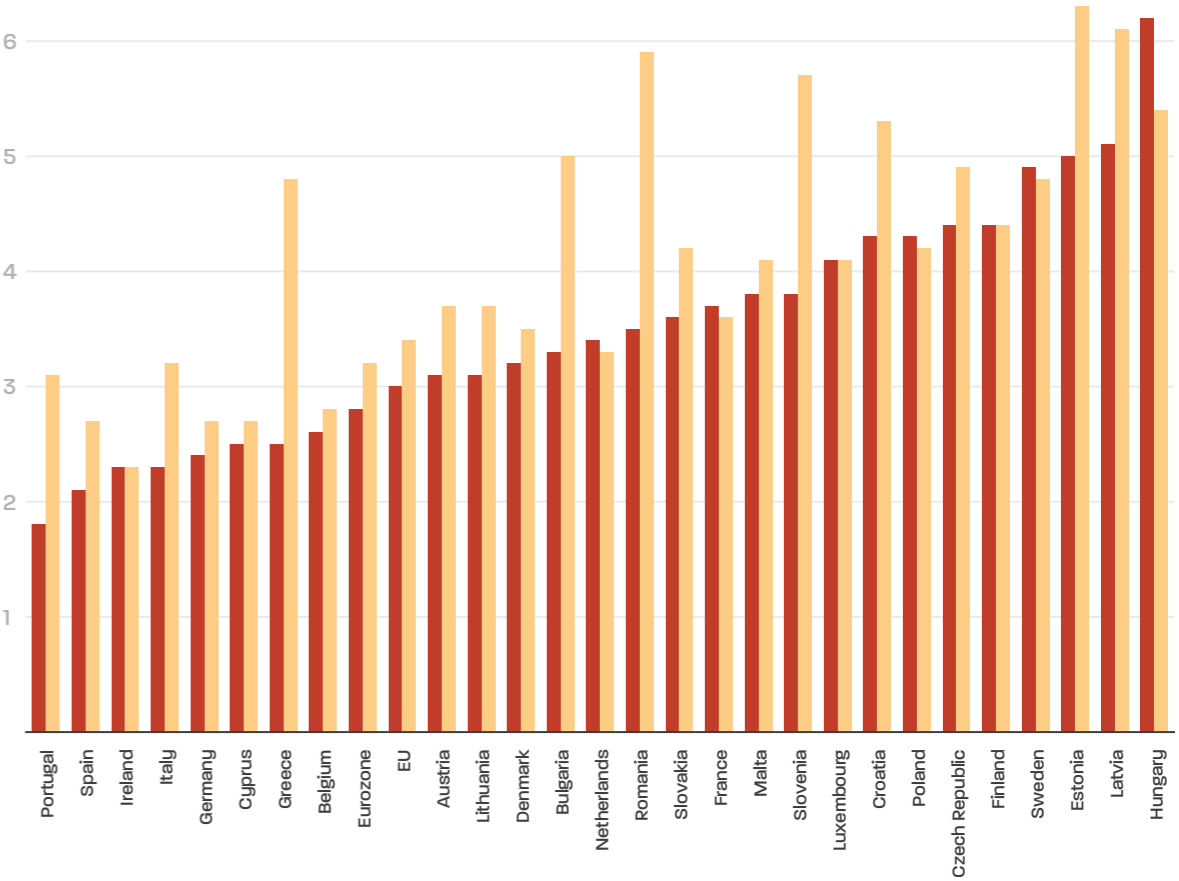
Although such derogations may, in principle, have a positive effect on investment, they raise some questions. Those countries whose financing conditions would not be immediately impaired if deficits were artificially reduced could benefit from this. Highly indebted countries, however, would need support so that their spreads are not pushed up even further. (De Angelis & Mollet, 2021). In any case, these problems would have to be resolved at a political level before a golden or green golden rule can be implemented.

Figure 19

Public investment after the pandemic

Gross investment as % of GDP

2019 2022



Source: Ameco, NEOS Lab

## Chapter 8

# Conclusions

- European fiscal rules have been continuously refined since the signing of the Maastricht Treaty at the beginning of 1992. Today, it is a comprehensive and complex body of legislation. The basic problem, however, is not the complexity, but the fact that holders of elected office and government representatives across the continent do not adhere either to the wording or, most importantly, the spirit of the European treaties.
- It is still not enough to pursue anti-cyclical budgetary policies. Good economic phases are not used to generate surpluses and thus reserves for downturns. Rather, there is a tendency to exploit the permitted deficit limits throughout the course of economic cycles. Another tendency is to kick the can of structural reform down the road.
- Fiscal rules should therefore be tightened more strongly than before in the direction of expenditure ceilings (Cabrillo & Albert, 2022). For this, Sweden can be taken as a model. Since a serious debt crisis in the 1990s, the Scandinavian country's fiscal law has required spending ceilings for the federal government and the pension system to be set three years in advance. Deviation from the ceilings is only allowed in clearly defined exceptional cases, such as an economic slump.
- As the existing mechanisms are not sufficient to avoid a pro-cyclical budgetary policy, not only defined deficit ceilings for downturn phases, but also lower surplus limits for periods of high economic activity should be set. In this way, balanced budgets can be secured over the economic cycle, and governments could not "forget" to budget positively in times of growth.
- In order to extend political support to the environmental and digital transformation as effectively as possible, a clear focus on future-oriented, growth-promoting investments (especially in the areas of education, research, sustainable economic system) is needed. New indicators, such as the future ratio described in the paper, could be taken into account when drawing up the budget. Another possibility would be a generational check for laws, i.e. an analysis of how measures would have a financial impact on different age cohorts.
- A green golden rule to accelerate environmental investment is only considered useful under certain conditions. Financial markets, in particular in highly indebted countries, would not distinguish between deficits that are excessive because of "normal" or "green" investments. One option would be to apply conditionality to a green golden rule, modelled on the European Stability Mechanism (ESM). Only countries with which clear reform agreements are concluded could therefore make use of this. In this case, however, the funds for the investments would also have to come from a European institution such as the ESM or a successor to the Recovery and Resilience Facility (RFF) created during the coronavirus pandemic. Countries with good creditworthiness can finance green investments without fiscal derogations.
- However, the role that broad political and social acceptance of sustainable financial management can play should not be underestimated. Small, intangible countermeasures cannot reduce mountains of debt within a few years. The mountains of debt can only be reduced permanently if the basic framework of an appropriate fiscal policy is maintained after elections. If there is not even a consensus that a competition-oriented, environmental market economy will continue to be the European economic system of the future, no lasting budget consolidation will succeed.

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AUTHOR

**Lukas Sustala** is director of the NEOS Lab, the political academy of the Liberal Party NEOS. The economics graduate previously worked for the liberal think tank Agenda Austria and is active on an ongoing basis as an economic policy commentator, especially in the media and the NZZ.

**Günther Oswald** works as an economic policy adviser in Vienna, primarily in the field of fiscal and financial policy. Previously, he worked as an economic policy journalist and chief of staff for the Standard newspaper.

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ISBN: 978-2-39067-042-1

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