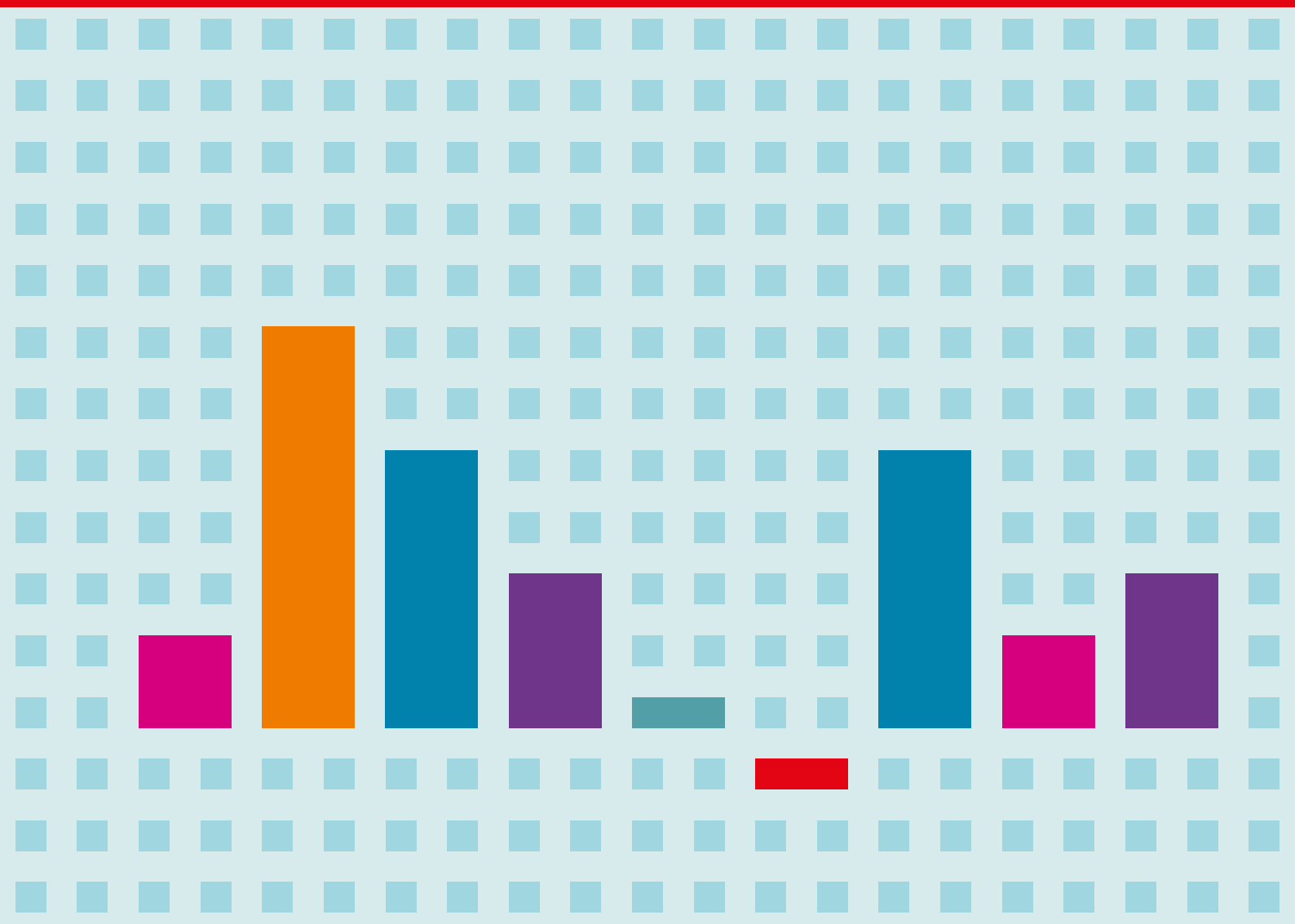


POLICY BRIEF

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THE NEW FISCAL RULES: ANOTHER ROUND OF AUSTERITY FOR EUROPE?

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Summary

This policy brief presents the new EU fiscal rules with a focus on its core element, the so-called debt-sustainability-analysis (DSA). Our results suggest first that the new rules will lead to substantial fiscal consolidation in the next years albeit less severe than the austerity measures during the euro crisis, second that the new rules are far less beneficial for public investment than previously thought, and third that relatively minor changes to the DSA assumptions on ageing costs and interest rates can have important consequences for fiscal adjustment needs. However, even if some of the assumptions underlying the DSA methodology were to be changed, the additional fiscal space would still fall drastically short of the massive public investment needs of the EU's green transition. We conclude by making the case for an EU-wide debt-financed investment fund.

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1 The new EU fiscal framework – another round of austerity ahead?

The new EU fiscal framework, which was finally accepted by the European Parliament on 23 April 2024, will have important consequences for member states' fiscal policies and public investment programs. After the first analytical reports by Bruegel (Darvas, Welslau und Zettelmeyer 2023, 2024) and others came out (Feigl 2024; Schubert 2024), many observers who previously hoped for more investment-friendly reform outcomes now fear the required fiscal consolidation in the coming years will prevent governments from undertaking the necessary public investments needed for the green transition (Lamberts 2024; Fiscal Matters Coalition 2024; Moller-Nielsen 2024). Against this background, this policy brief aims to clarify major parts of the new rules and evaluate their impact on the future fiscal stances of EU countries with a focus on France, Germany, Italy and Spain.

This section provides an overview of the new fiscal framework and discusses the required fiscal consolidation efforts in historical comparison. The second section then deals in more detail with the so-called debt-sustainability-analysis (DSA) which is at the heart of the new framework. We discuss the role of ageing costs and the interest-growth rate differential in the DSA and show how sensitive the results are to the assumptions made about them. Finally, we draw some preliminary conclusions as to how the new rules will most likely impact the prospective fiscal stances of EU member states and why we believe an EU-wide debt-financed investment fund will be necessary to support the massive investment needs arising from the green transition.

1.1 Overview of the new fiscal framework

Whilst the new EU fiscal framework retained the familiar Maastricht Treaty reference values for government budget deficits and debt of 3% and 60% of GDP, respectively, several changes to the criteria and operating principles how members states are to form their fiscal policies in the future were introduced. The new single operational target is public net primary expenditure growth, replacing the focus on the annual improvement of the structural deficit towards the medium-term objective (MTO) in the old rulebook. For each member state with a deficit or debt ratio above the threshold of 3% or 60% of GDP respectively, the European Commission (EC) first calculates a multi-annual net expenditure growth path for a four- and seven-year adjustment program. In each program, this so-called *reference trajectory* in terms of net primary expenditures must fulfill various criteria deriving from debt sustainability analysis as well as three safeguards and benchmarks setting annual minimum requirements.³ At the heart of the new fiscal rules is therefore the European Commission's DSA, which replaces the existing framework with a more risk-based and country-specific framework that includes both deterministic stress tests and a stochastic debt analysis. Based on the reference trajectories calculated by the European Commission member states must then provide so-called "*medium-term fiscal structural plans*" (MTFSP). The first national MTFSP must be submitted by 20 September 2024, afterwards each April of the year in which the next MTFSP is due.

³ At the request of the respective member state, the EC may provide so-called technical information on upcoming fiscal dynamics for countries not exceeding the government deficit or debt reference values.

Now we will go into the different procedural steps of the new rules in somewhat more detail. Whilst the 2-pillar model with the preventive and corrective arm remains in place, major changes were made to the preventive arm (Regulation (EU) 2024/1263, European Union 2024). The reform introduces a single operational instrument that limits the growth of net primary expenditure (excluding interest payments, discretionary revenue measures, cyclical unemployment benefits, one-off measures, and expenditure funded with Union finance). Importantly, different to the proposal made by the IMK during the reform process (Dullien et al. 2020), the expenditure target does not obey the principle of the golden rule of public investment. Hence, public investment is not pre-empted from net expenditures, but continues to count as part of net expenditures. The single operational target replaces the complex set of existing rules and indicators and aims for simplicity and transparency. The reform thus shifts focus from the medium-term-objectives (MTO) in terms of structural balances to a net primary expenditure rule, which is simpler to measure, less prone to manipulation and less sensitive to data revisions.

The process starts with the European Commission calculating a reference trajectory based on the DSA and the agreed minimum annual adjustment requirements, the so-called safeguards and benchmarks. Reference trajectories are calculated for those EU Member States in which either the general government debt-to-GDP ratio is expected to exceed the reference value of 60% of GDP or in which the deficit is expected to exceed the reference value of 3% of GDP in the year prior to the start of the adjustment period. These trajectories will determine the expected pace and extent of deficit reduction required for each member state, reflecting their unique economic realities and challenges.

The information on the reference paths is then sent to the member states, which draw up the MTFSP on this basis. In the MTFSP member states must set net primary expenditure paths over a four- or seven-year time horizon. Accordingly, the reform also marks a move away from the very short-term orientation of the past, where the MTO was recalculated and revised every year, and which had made the planning of the fiscal policy stance much more difficult. The countries are granted the extension of their adjustment period to seven years if they submit public investment programs and structural reform plans. Key criteria are that the reform plans promote long-term potential growth and structurally improve government finances. In principle, the proposed expenditure path may deviate from the reference trajectory by the EC. However, it must meet the same DSA requirements as well as all safeguards and benchmarks. Finally, member states present the MTFSPs to the European Council, who ultimately must approve the net expenditure growth path for the next four or seven years, respectively.

1.2 The central role of the Debt-Sustainability-Analysis (DSA)

At the core of the new EU fiscal framework is the European Commission's Debt-Sustainability Analysis (DSA) which so far has been used repeatedly in its Debt Sustainability Monitors. The method is now applied to assess the criterion in Article 126 of the Treaty on the Functioning of the European Union (TFEU) as to whether a debt level above 60% of GDP is "sufficiently diminishing and approaching the reference value at a satisfactory pace" (European Union 2008). It allows for a more differentiated and country-specific assessment of the sustainability of public finances, accounting for the specific economic conditions and debt level of each country.

The DSA requirements derive from Regulation 2024/1263 which states that net expenditure growth must be set in a way that *“by the end of the adjustment period, assuming that there are no further budgetary measures, the projected general government debt ratio is put or remains on a plausibly downward path, or stays at prudent levels below 60 percent of GDP over the medium-term.”* (European Union 2024, Article 6a)

To fulfill the requirements in the previous clause, three criteria must be met (European Commission 2024b):

1. *“By the end of the adjustment period at the latest, and over the 10 following years, debt declines or stays below 60% of GDP both in the adjustment scenario and under all three deterministic stress tests.*
2. *In the 5 years following the adjustment period, debt declines with a sufficiently high probability, i.e. at least 70%, in line with the threshold used in the Commission’s standard DSA.*
3. *The deficit is brought and remains below 3% of GDP over the medium term.”*

The first criterion concerns the 10-year period after the end of the 4 or 7-year adjustment period, so that the DSA is effectively carried out over a period of 14 or 17 years. In addition to the adjustment scenario, in which the fiscal stance during the adjustment period is chosen such that the debt level falls or remains below 60% of GDP over the following 10 years assuming no further fiscal policy changes, the EC methodology contains three deterministic stress tests that are applied around that adjustment scenario to account for uncertainty. The idea is that the debt and deficit requirements should also hold under adverse macroeconomic conditions. These adverse conditions include, first, a scenario where the primary structural balance is reduced by 0.5 percentage points after the adjustment period to account for fiscal uncertainty (“lower SPB scenario”). In a second scenario, the r-g interest-growth rate differential is assumed to be permanently 1 percentage point higher than in the adjustment scenario (“adverse r-g scenario”). Third, and quite similar to the adverse r-g scenario, market interest rates are temporarily increased in the “financial stress scenario”.

The second criterion addresses the stochastic component in DSA. Here, stochastic scenarios are simulated around the baseline to control more thoroughly for uncertainty around the budgetary and macroeconomic assumptions. The shocks for each country are derived from historical data.

Finally, the DSA should also ensure that the actual budget deficit is brought below the 3% of GDP reference value.

1.3 Benchmarks and numerical Safeguards

A group of countries, led by Germany, have used the reform process to strongly advocate for the inclusion of safeguards and benchmarks, some of which were finally included in the new set of rules. These safeguards and benchmarks can be regarded as annual minimum requirements for the member states, as was previously the case in the old rules. Three hard-wired numerical requirements need to be fulfilled by the reference trajectory in addition to the DSA-based criteria (European Commission 2024b):

1. *Deficit benchmark*: The structural balance needs to increase by at least 0.5 percentage points of GDP if the headline deficit exceeds 3% of GDP in the previous year.⁴
2. *Debt sustainability safeguard*: The debt ratio needs to decline by a minimum of at least 1 percentage point of GDP per year over the adjustment period if debt exceeds 90% and 0.5 percentage points of GDP if the debt ratio ranges between 60% and 90%.
3. *Deficit resilience safeguard*: The primary structural balance needs to be increased by at least 0.4 percentage points of GDP until the structural balance is brought under -1.5% of GDP (0.25percentage points of GDP in the 7-year extension case).

Additionally, the so-called no-backloading clause requires that the fiscal effort must be gradual and evenly spread over the adjustment period and is not allowed to be concentrated on the last years.

The provision that countries with excessive deficits, i.e. deficits above 3% of GDP which are deemed to be non-temporary, must reduce their deficits discretionally by at least 0.5% of GDP remained as the deficit benchmark in the new rules. Following this, the European Commission has recently reacted to the currently still high deficits in some member states and initiated excessive deficit procedures, including France and Italy in particular (European Commission 2024d).

The new debt sustainability safeguard mimics the old 1/20th debt reduction rule of the old rules. However, it is significantly less strict than before and takes greater account of the respective fiscal position.

Lastly, the deficit resilience safeguard once again introduces a rule regarding the structural primary deficit. However, the target has been significantly softened compared to the old MTO and the reference value is now -1.5% of GDP. This rule is intended to create a safety margin to the maximum 3% of GDP headline deficit limit.

We should add at this point that even if reference trajectories are in terms of net expenditure growth, the structural primary balance has not completely disappeared from the framework. Instead, reference trajectories are computed based on changes of the SPB and are then converted into a net primary expenditure path. This is, first, because the deficit resilience safeguard as well as the deficit benchmark are set in terms of that indicator, and second, the DSA method is based on the structural primary balance and uses this indicator to determine fiscal requirements as well. The permitted growth rate of net primary expenditure is then only derived retrospectively.

1.4 Required fiscal consolidation: Austerity ahead despite massive public investment needs?

Table 1, taken from Bruegel (Darvas, Welslau und Zettelmeyer 2024), presents the predicted fiscal consolidation needs under the new rules for the four largest economies of the EU, Italy, France, Spain, and Germany. The total fiscal consolidation needs range from above 4% of GDP in the case of Italy to as little as 0.1% in the case of Germany. These values correspond to average annual fiscal consolidation needs between 1.1% of GDP and almost zero. The last column indicates that in most cases it is in fact the DSA that is the binding criterion. Only in the cases of

⁴ In the years 2025-2027 the deficit benchmark is measured in terms of adjustment of the primary structural balance. From 2208 onwards in terms of the overall structural balance.

Italy and France for the 7-year adjustment period, it is the deficit benchmark and the deficit resilience safeguard, respectively, that are the binding criteria.

Table 1: Fiscal consolidation under the new EU fiscal rules, in % of GDP

	EC forecasts for 2024			Minimum SPB satisfying all criteria		Total fiscal consolidation needs		Average annual fiscal consolidation needs		Binding criterion	
	Debt	Fiscal balance	SPB	4-year	7-year	4-year	7-year	4-year	7-year	4-year	7-year
Italy	138.6	-4.4	-1.1	3.3	3.1	4.4	4.2	1.1	0.6	DSA	Deficit benchmark
France	112.4	-5.3	-3.0	0.8	0.8	3.8	3.8	0.9	0.5	DSA	Deficit resilience safeguard
Spain	105.5	-3.0	-0.8	2.7	2.8	3.5	3.6	0.9	0.5	DSA	DSA
Germany	62.9	-1.6	0.0	0.4	0.1	0.4	0.1	0.1	0.0	DSA	DSA

Source: Darvas, Welslau und Zettelmeyer (2024).



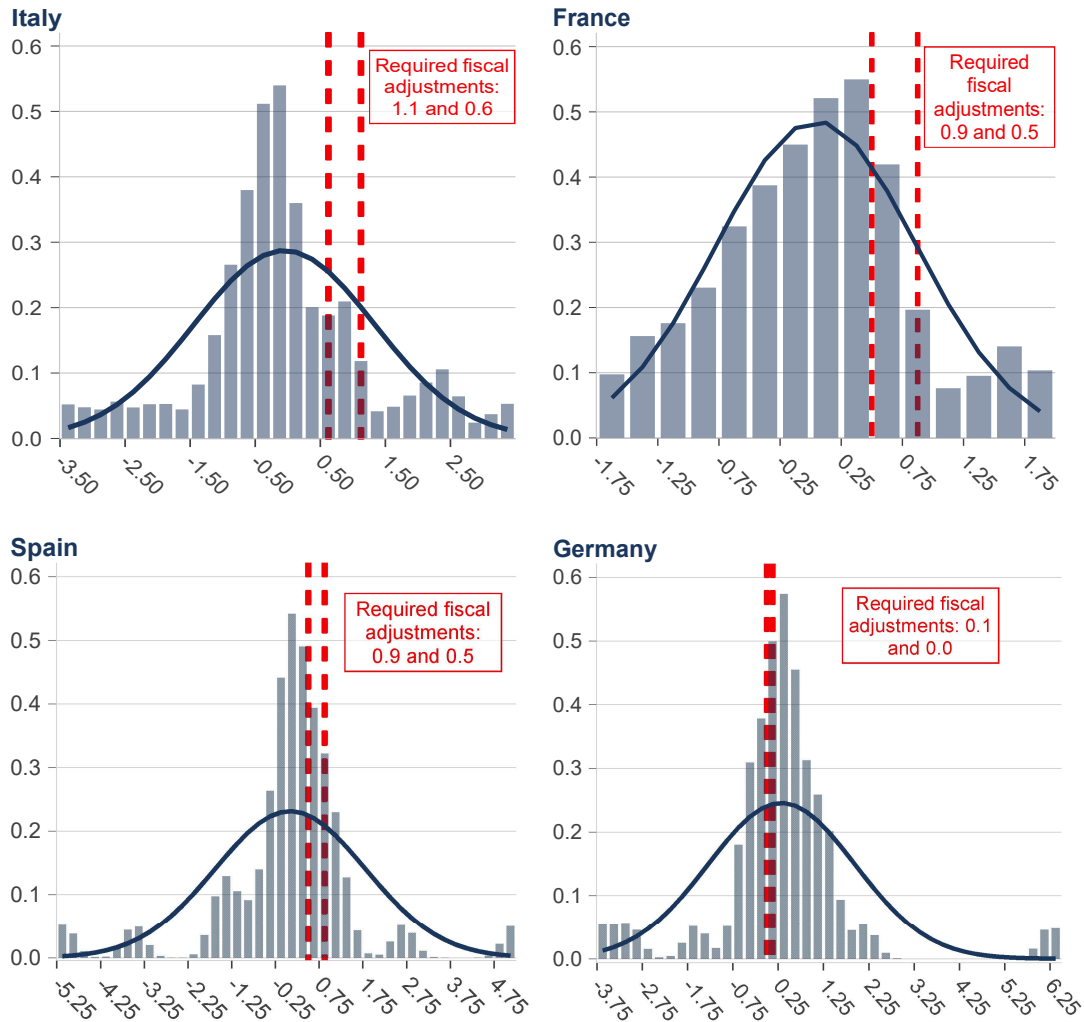
Obviously, such fiscal consolidation efforts over the next years will stand in the way of the large-scale public investment programmes urgently needed in the EU which are conservatively estimated at around 1% of GDP (European Central Bank 2024b; Koch et al. 2024) and which will have to be – at least to some extent – financed via debt. However, apart from the problem of how to finance the additional investment needs, we first analyse how severe the expected implementation of the new rules will be in historical comparison.

Figure 1 shows histograms and corresponding kernel densities for each of the four countries with changes in the cyclically-adjusted primary balance against their respective frequencies for the period 1995 to 2025. Changes in the cyclically-adjusted primary balance can be regarded as yearly fiscal consolidation efforts of the past. We use the cyclically-adjusted primary balance instead of the closely related structural primary balance because of longer data availability. As can be seen in the figure, for Italy and France the size of the required fiscal consolidation effort is far to the right of the density's mode, in particular for the 4-year adjustment period. To a somewhat lesser degree this is also the case for Spain. Only for Germany is the required fiscal effort slightly to the left of the mode.

What the figure shows is that although the required fiscal consolidations by Italy and France are not nearly as extreme as those of the austerity years during the euro crisis when the primary balance of each of the two countries increased by above 2% of GDP in some years, they are nevertheless quite demanding, particularly under the 4-year adjustment program. Historically, at least, there were not that many times when the change in the primary balance was larger than what is being required under the new rules. This is less the case for Spain and not so for Germany where the required fiscal consolidation is only 0.1 of GDP or zero. For all countries, of course, the

consolidation effort required under the 7-year adjustment programs is somewhat less severe than under the 4-year program.

Figure 1: Histograms and kernel densities of changes in the cyclically-adjusted primary balance in percent of GDP, 1995-2025



Sources: Ameco, Macrobond, IMK calculations.



2 Remarks on the European Commission's DSA

A debt-sustainability-analysis is now at the heart of the European Commission's new fiscal framework. This section first discusses the basics and particularities of the EC's DSA methodology, and then moves on to highlight the role of its crucial assumptions on ageing costs and the interest-growth rate differential, before analysing in depth the DSA's sensitivity to changes in those assumptions.

2.1 Basics of the EC's DSA methodology

Any debt sustainability analysis starts from the well-known government debt accumulation equation:

$$d_{t+1} = (1 + r_{t+1} - g_{t+1})d_t - s_{t+1}, \quad (1)$$

where d_t is the government debt ratio, r_t the rate of interest, g_t the growth rate of the economy, and s_t the primary surplus, i.e. tax revenues less government expenditures and excluding interest payments. In the case of the EC's use in its new fiscal framework the DSA is best understood if the equation is solved forward T years to read:

$$d_{t+T} = d_t \prod_{s=1}^T (1 + r_{t+s} - g_{t+s}) - \sum_{s=1}^T \left[\prod_{i=s}^T (1 + r_{t+i} - g_{t+i}) \right] s_{t+s}. \quad (2)$$

This equation shows that the debt ratio in the future increases with higher future primary deficits (negative surpluses). It also shows that the interest-growth rate differential matters as it magnifies or dampens the effect of a higher deficit on the debt ratio. In practice, the European Commission then uses its own forecasts of interest rates and growth rates together with the required primary surpluses over the 4 or 7-year adjustment period and assumes constant primary surpluses under the subsequent no-fiscal-policy-change period to project member states' government debt ratios. Changes in the primary surplus affect the real growth rate of the economy with a constant multiplier of 0.75.

To give an example, in the case of Spain and its fiscal consolidation need of 0.9% of GDP for the 4-year adjustment program (see Table 1), this corresponds to a primary surplus of 0.1% of GDP in 2025, the first year of the adjustment program. The primary surplus is then increased each subsequent year by 0.9% of GDP until it reaches 2.7%⁵ of GDP in 2028, the last year of the adjustment program. The primary surplus is then being held constant at 2.7% of GDP under the so-called no-fiscal-policy-change assumption for the 10 years after the end of the adjustment period over which the debt ratio path is evaluated.⁶

2.2 A closer look at ageing costs and their role in the DSA

Importantly, however, and in some ways counter-intuitive, increases in ageing costs (as a percentage share of GDP) are then subtracted from the primary surplus during the entire 10-year no-fiscal-policy-change period, whilst revenue from the ageing side's insurance contributions or tax systems is kept constant (again as a percentage share of GDP). Formally, equation (2) is adopted by the inclusion of ageing costs a_t as follows:

$$d_{t+T} = d_t \prod_{s=1}^T (1 + r_{t+s} - g_{t+s}) - \sum_{s=1}^T \left[\prod_{i=s}^T (1 + r_{t+i} - g_{t+i}) \right] (s_{t+s} - a_{t+s}). \quad (3)$$

where a_t is set to zero during the adjustment period and equals the ageing costs increase vis-à-vis the last year of the adjustment period for the subsequent 10-year no-fiscal-policy-change period. In the case of Spain this leads to substantial reductions of up to 2.0% of GDP from the primary balance with the result that its debt ratio will correspondingly decline far less. Because it

⁵ Slight numerical discrepancies arise from rounding errors.

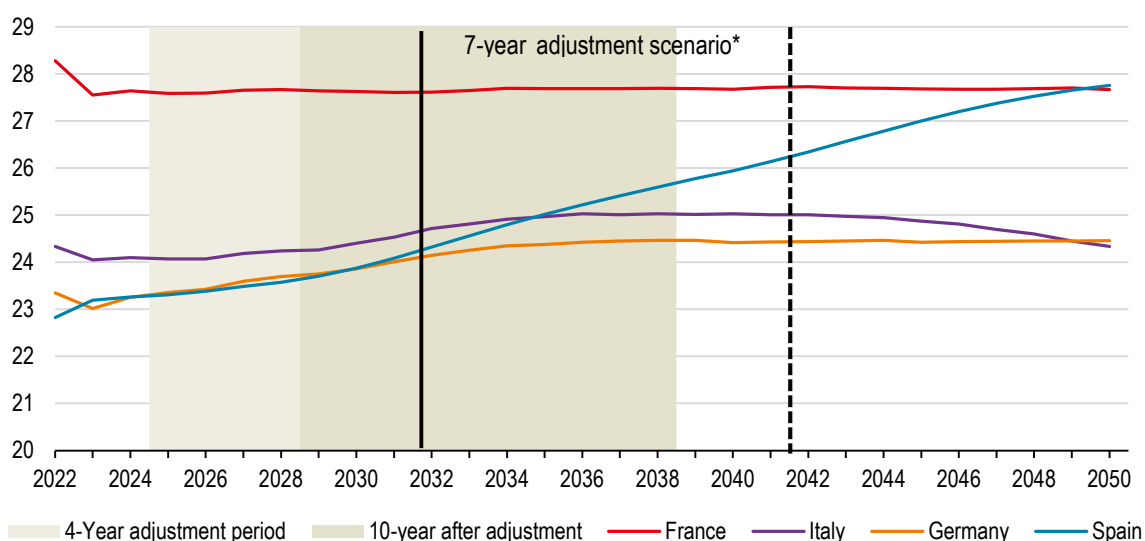
⁶ For expositional purposes the primary balances given in this example are in fact structural primary balances. We abstract from cyclical-effects here.

does have an important effect on debt dynamics and therefore on the fiscal consolidation requirements, we next take a closer look at what precisely ageing costs are and why they are included in the EC's DSA.

Broadly speaking the EC uses the concept of total costs of ageing to capture the fiscal burden of an ageing population. Total ageing costs include pension, health care, long-term care and education expenditure (European Commission 2024a). All those expenditure items move closely with the demographic development of an economy. The EC uses a standardized methodology to forecast total ageing costs and its four components for each EU member state until 2070. Roughly speaking, total ageing costs varied between 20% and 30% of GDP for most member states of the EU in 2022 and are projected to increase by around 1-2% of GDP for the EU overall until 2070. The largest part of total ageing costs is typically made up of pensions (11.4% of GDP for the EU), followed by health care (6.9%), education (4.4%), and long-term care (1.7%). The increase in total ageing costs until 2070 largely stems from increases in pensions, followed by increased spending on long-term care and then health care, whilst education expenditures is projected to decline somewhat (European Commission 2024a).

What matters for the EC's use of the concept in its DSA is, however, limited to what is happening to a country's total ageing costs in the 10-year period after the initial 4 or 7-year adjustment period. To be precise, what matters is the extent of the increase in a country's total ageing costs during those 10 years. Figure 2 presents total ageing costs, net of taxes on pensions, as it is used by the EC in its DSA, for France, Spain, Italy, and Germany, together with shaded areas and lines indicating the adjustment as well as the subsequent 10-year no-fiscal-policy-change period for 4 and 7-year adjustments, respectively. Whilst total ageing costs are highest for France, the country with the strongest increase is in fact Spain, which coincidentally is the country with the lowest costs in 2022. The large increase in total ageing costs in Spain is mainly due to recently adopted legislation that partly reversed the 2011 and 2013 pension reforms (European Central Bank 2024a).

Figure 2: Total ageing costs (net of taxes on pensions)
in % of GDP



*The vertical lines indicate the end of the 7-year adjustment period (solid line) and the end of the corresponding 10-year no-policy-change period after adjustment (dashed line).

These observations on the concept of total ageing costs and the way the EC uses it in its DSA deserve some more critical remarks: Certainly, for the pension part of total ageing costs which is by far the largest part of it, it seems somewhat dubious that the revenue side, particularly the projected increase in revenues, is not accounted for in the methodology under the no-fiscal-policy-change assumption. In many countries, Germany and Spain for example, additional pension expenditures in the future are by law paid for by increases in contribution rates. Those pension systems are therefore largely self-financed with only a certain share of government funds being granted in addition to the contributions of employers and employees. If the no-fiscal-policy-change assumption was in fact taken seriously, there should be zero additional fiscal costs at least from the pension part of the ageing costs for a country like Germany or Spain.

Whilst the EC's method of only accounting for additional pensions expenditure and ignoring additional contributions makes perfect sense from a stress-test or risk-scenario perspective, its use is misplaced in the baseline DSA projections which aim at best and most precisely forecasting the true fiscal costs and revenues arising from an ageing population to set the appropriate fiscal policy stance in terms of primary balance over the next 4 or 7 years. In general, it seems odd to make projections under a no-policy-change assumption and at the same time include increased ageing costs as if they were an exogenous shock the government does not typically react to.

If the currently proposed method was in fact implemented, it could have serious negative effects: First, both old and young generations would be burdened unnecessarily: Both would have to pay for higher taxes and endure cuts to government spending today, and the young would additionally have to pay higher contributions in the future as projected by the EC's Ageing Report. Second, the need to increase the primary surplus unnecessarily much today will most likely increase the distortions in tax systems. Third, given the enormous uncertainties around those ageing costs projections policy failures are bound to occur.⁷

The EC should therefore reconsider its use of ageing costs in its DSA. It might either abandon their inclusion entirely arguing that if ageing costs are being accounted for under current policies, they will also be accounted for in the future under the no-fiscal-policy-change assumption. Or else it should in greater detail forecast total ageing costs and revenues and include the difference as additional fiscal costs of ageing in the DSA.

2.3 A closer look at the assumptions on interest and growth rates

The interest-growth rate differential is of crucial importance for government debt dynamics (Blanchard 2019). As seen in equation (2) it magnifies or dampens the effect of a higher primary deficit on the debt ratio. Importantly, however, and less easily seen from the equations above, the differential determines whether the debt ratio will potentially be explosive in a long-run steady-state sense or not. In fact, if it is negative, i.e. if the interest rate is less than the growth rate of the economy – either both in nominal or real terms – government debt dynamics will never be explosive as there will always be a primary surplus (or deficit) that will ensure the debt ratio is being

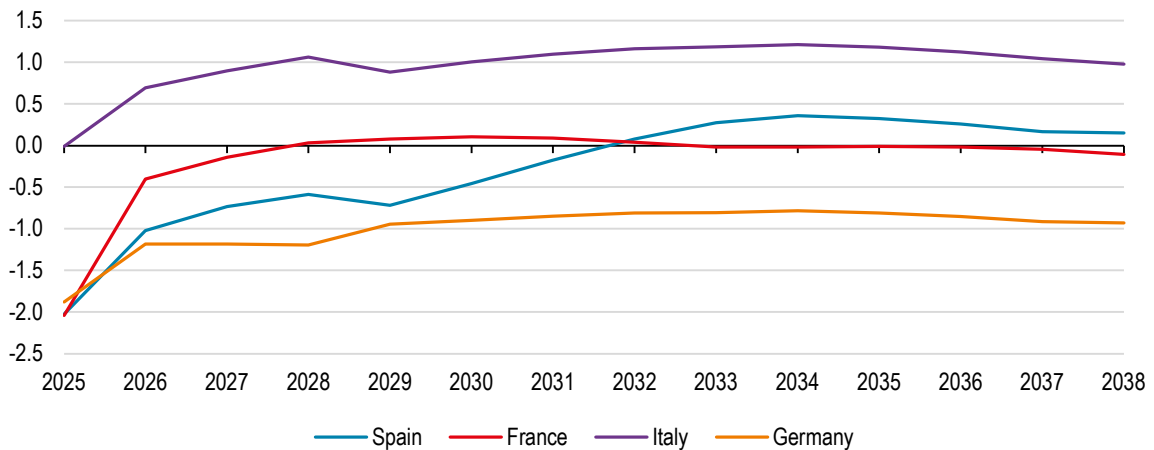
⁷ Figure A1 in the Appendix shows changes in total ageing costs between 2030 and 2040, the relevant period for the upcoming adjustment period, for different vintages of Ageing Reports. The high variation in some countries will correspondingly have enormous consequences for their fiscal spaces under the new fiscal rules.

held constant in the long-run.⁸ It is only for the case where the differential is positive, i.e. the interest rate exceeds the growth rate, that debt will become explosive if the primary deficit exceeds a certain threshold which is in the long-run steady-state given by:

$$s = (r - g)d, \quad (4)$$

where s , r , g , and d are the constant long-run steady state values of the respective variables.

Figure 3: Interest-growth rate differential (r-g), with r the implicit nominal interest rate and with g the nominal growth rate of the economy.



Source: Data from Darvas, Welslau und Zettelmeyer (2024), IMK calculations.



The implication for the practical purpose of the DSA is that purely from an analytical perspective, there is no need to be concerned about debt sustainability for countries in which the interest-growth rate differential is forecasted to be negative into the distant future. Figure 3 shows that this differential is in fact forecasted to be always negative for Germany and negative in most years for France. In the case of France, it is, however, almost zero for most of the forecast horizon. Spain is forecasted to have a negative differential until the early 2030s, after which it turns positive. Only in the case of Italy is it positive throughout the forecast horizon disregarding the single year 2025.

Carrying-out a DSA might, however, still be sensible even for countries like Germany and France. Of course, it is controversial how much confidence one should have in any long-term forecast, particularly a long-term forecasted negative interest-growth rate differential which will respond almost certainly to changes in the fiscal stance or other economic changes. Finally, the analysis of the r-g-differential focused entirely on government solvency requirements from a highly abstract and analytical perspective. It abstracted from liquidity requirements and important risk considerations of financial markets. Thus, the argument that debt sustainability is not an issue for countries like Germany or France should not be taken at face value but needs to be qualified. However, the fact that public debt is indeed less of an issue in the case of a negative interest-growth rate differential should be kept in mind when the DSA is carried-out for those countries.

⁸ Nevertheless, even in the case of a negative (r-g)-differential, high deficits and correspondingly high steady-state debt ratios might be problematic as well.

2.4 Sensitivity of DSA to major assumptions

In this section we present quantitative results for the sensitivity of the DSA-related fiscal consolidation needs to the assumptions on interest rates, ageing costs, and stress tests for the four big EU countries Germany, France, Italy, and Spain. We compare our findings to the baseline DSA reference trajectory calculated by Bruegel (Darvas, Welslau und Zettelmeyer 2024), which in turn are based on the European Commission 2024 spring forecast and the 2024 Ageing Report (European Commission 2024c, 2024a). We follow Bruegel and show results for the required reference trajectories in terms of the change in the primary structural balance and not in terms of net primary expenditure growth.

In a first step, we assume short- and long-run future interest rates are reduced by 1 percentage point for each country. Second, we test how much the required fiscal effort depends on the additional costs of ageing by setting them to zero. Finally, we check how the results for the required fiscal effort changes if we disregard the deterministic stress test scenarios in the DSA.

Table 2 shows our results for the annual consolidation needs of the 4- and 7-year adjustment programs obtained from the DSA analysis under each of those assumptions.⁹

Table 2: Annual fiscal consolidation requirements (in percent of GDP) from DSA under alternative assumptions¹⁰

	Bruegel DSA reference trajectory		Minus 1pp interest rate assumption*		Assuming zero additional costs of ageing		Disregarding all stress tests	
	4-year	7-year	4-year	7-year	4-year	7-year	4-year	7-year
Italy	1.08	0.58	0.89	0.46	0.92	0.52	0.88	0.55
France	0.94	0.54	0.81	0.44	0.93	0.53	0.87	0.51
Spain	0.89	0.52	0.76	0.43	0.46	0.26	0.72	0.42
Germany	0.11	0.02	0.04	-0.02	0.03	-0.01	0.09	0.02

* The short- and long-term interest rates for T+10 and T+30 are each set 1 percentage point lower than in the baseline scenario.

Source: Darvas, Welslau und Zettelmeyer (2024), IMK calculations.



Lower interest rate scenario: If future interest rates are reduced by 1 percentage point compared to the baseline assumptions on interest rates, the required annual fiscal effort in most cases is lowered by around 0.1% of GDP. For Italy, the annual fiscal consolidation in the 4-year adjustment case even decreases by around 0.2% of GDP. The already low need for adjustment in the case of Germany will become negligible in the 4-year scenario. Our results therefore indicate that a

⁹ Note that in this analysis we disregard the safeguards and benchmarks and focus solely on the DSA requirements.

¹⁰ We want to thank Lennard Welslau and his co-authors Zsolt Darvas and Jeromin Zettelmeyer for sharing the full python code for replication of the EC's DSA method and the new fiscal rules on <https://github.com/lennardwelslau/eu-debt-sustainability-analysis/>. The analysis in this Section was fully carried out using his program.

reduction of future interest rates by 1 percentage point would reduce annual fiscal consolidation needs by between 0.1% and 0.2% of GDP for the four countries studied.

Alternatively, we could have also analysed changing the T+10 forward interest rate assumptions in the DSA so that they are set to a common value for all countries. If, for example, the T+10 rates were set to 3.0% for all countries, the effects would be even more favourable in terms of creating additional fiscal space, particularly for Italy and Spain, for which comparatively high interest rates are currently forecasted.

Zero additional costs of ageing scenario: As shown in section 2.2, Spain and to some extent Italy have larger additional costs of ageing in the current Ageing Report 2024 for the upcoming years than the other two countries. Hence, assuming zero additional costs of ageing has the largest effects for these two countries. This assumption would almost halve the annual consolidation requirements for Spain, from 0.9% to 0.5% of GDP and from 0.5% to 0.3% of GDP, for the 4- and 7-year case, respectively. Again, this assumption would eliminate entirely Germany's need for consolidation.

Disregarding all stress tests: Focusing exclusively on the adjustment scenario in the DSA and disregarding all stress tests will also lower consolidation requirements. The effect is strongest under the 4-year adjustment program with fiscal efforts being reduced by up to 0.2% of GDP for Spain and Italy. For the 7-year case, the changes are only marginal for all countries. In line with the important role of the r-g differential described above, the "adverse r-g scenario" is the binding DSA requirement for all countries in the baseline scenario, and a weakening of this assumption would thus provide countries with some additional fiscal space.

Our results show that small changes in the critical assumptions of the DSA can have noticeable effects on the resulting fiscal requirements. We find the greatest scope for Spain, where the assumed additional ageing costs in the coming years are particularly high and the stress tests particularly demanding. The fiscal pressure would decrease even more in most cases if individual changes of assumptions were combined.

Summing up, whilst the differences may appear marginal at a first glance, it should be borne in mind that the figures in Table 2 indicate the average *annual* adjustment requirement over 4 or 7 years. If one adds up the annual requirements over the adjustment period and examines the differences in the total fiscal consolidation needs, the changes are considerable in many cases (Table 3). With lower assumed interest rates, the range spreads from 0.3% of GDP for Germany (4 and 7-year adjustment) to 0.8% of GDP for Italy (4- and 7-years adjustment). Hence, by only assuming 1 percentage point lower short- and long-term future interest rates in the DSA, Italy's consolidation needs over the next 4 to 7 years would decrease by around 17 bn. Euro. Assuming zero additional costs of ageing, the reduced fiscal consolidation ranges even up to 1.8% of GDP or around 27 bn. Euro in the case of Spain. This amounts to just under half of the total adjustment requirements if ageing costs are being treated as proposed by the EC. Disregarding all stress tests the range goes to 0.8% of GDP or 17.6 bn. Euro in the case of a 4-year adjustment program for Italy. Needless to say, the lower total consolidation requirements shown in Table 3 would lead to higher fiscal spaces for member states, which could be used for additional public investment in the years after the adjustment programs.

Table 3: Reductions of total fiscal consolidation needs from Bruegel DSA reference trajectory under alternative assumptions
in percent of GDP and in bn. 2024 Euro

	Minus 1pp interest rate assumption*				Assuming zero additional costs of ageing				Disregarding all stress tests			
	4-year		7-year		4-year		7-year		4-year		7-year	
	% of GDP	bn. €	% of GDP	bn. €	% of GDP	bn. €	% of GDP	bn. €	% of GDP	bn. €	% of GDP	bn. €
Italy	0.8	16.6	0.8	17.5	0.7	14.1	0.4	8.6	0.8	17.6	0.2	5.0
France	0.5	14.8	0.7	19.2	0.0	0.6	0.1	2.3	0.3	8.4	0.2	6.3
Spain	0.5	8.3	0.6	9.3	1.7	26.9	1.8	27.4	0.7	10.5	0.7	10.4
Germany	0.3	11.4	0.3	14.1	0.3	14.3	0.2	9.7	0.1	3.6	0.0	1.6

Source: Darvas, Welslau und Zettelmeyer (2024), IMK calculations.



2.5 The role of the safeguards and benchmarks

For the four EU countries analysed in this policy brief, France, Italy, Germany and Spain, the baseline trajectories are mainly determined by the DSA criteria (see Table 1). In those cases where the safeguards and benchmarks are binding, the reference path hardly differs from what the DSA would require (differences occur only in the second to third decimal point, compare Table 1 and 2). Above we show that small modifications to the DSA can lead to noticeable reductions in the required fiscal consolidation. Unsurprisingly, if the safeguards and benchmarks become binding, the additional leeway resulting from the changed assumptions in the DSA cannot be fully utilized.

If we assume 1 percentage point lower interest rates, the deficit reduction benchmark becomes binding for Italy and France in the first six years of the 7-year adjustment scenario; for both countries the last adjustment year will be determined by the deficit resilience safeguard. For France, the deficit benchmark requires more adjustment than the DSA also in the 4-year adjustment scenario (0.87 instead of 0.81).

Under the assumption of no additional ageing costs, the deficit benchmark and resilience safeguard become binding for Italy in the 7-year adjustment program. Of course, as described above Spain is the country most affected by this change in assumptions; under the DSA, the consolidation needs decrease most significantly compared to the baseline, as the additional ageing costs are highest here. However, in the case of Spain the debt safeguard applies due to the relatively high level of debt but low deficit. The debt safeguard would require an annual fiscal consolidation of 0.51 and 0.33 compared to the DSA requirements of 0.46 and 0.26 for the 4- and 7-year adjustment period respectively.

If we disregard all stress tests in the DSA, benchmarks and safeguards would become binding in all countries and adjustment horizons apart from Germany. In France the deficit benchmark would require an average annual adjustment over a 4-years program of 0.91. The 7-year scenario would consist of six years of binding deficit benchmark and the last year would be determined by

the deficit resilience safeguard, totalling an average annual adjustment need of 0.54. Italy would be constrained by the deficit criterium in the 4-year case (1.06 percentage points annually) and the 7-year adjustment scenario (0.59 percentage points). Finally, the deficit benchmark would also be binding for Spain for both adjustment periods (0.76 percentage points and 0.45 percentage points respectively), assuming that stress tests are disregarded in the DSA.

Summing up, although the additional possible leeway from changes to assumptions in the DSA cannot be fully exploited due to the safeguards, the differences are, however, only marginal in most cases, thus changing the DSA methodology would still provide additional fiscal space.

3 Preliminary conclusions

This policy brief outlined the new EU fiscal rules with a particular focus on its debt-sustainability-analysis. Our analysis suggests that the new rules require significant fiscal consolidation in the next years in some major EU countries like France and Italy. As such, they stand in the way of the much-needed public investment programs to modernise and green our European economies. However, whilst the fiscal consolidation in the years to come will be significant for some countries, it is not comparable to the harsh austerity period of the euro crisis. Nevertheless, it is safe to follow Bakker, Beetsma und Buti (2024) and conclude that the massive public investment needs of around 1% of GDP will need to be addressed by other means, possibly through an EU-wide debt-financed investment fund.

Our analysis of the European Commission's DSA also found that some of its assumptions should be reconsidered, in particular how ageing costs are treated and how assumptions about the future interest-growth rate differential are best being made for European economies in which the hike of inflation is fading, and growth remains subdued. We argued in previous work that great care must be taken to specify an expenditure rule, such that fiscal consolidation is achieved in a growth-friendly way (Paetz und Watzka 2023).

Whilst we generally acknowledge the right direction of the reform and its specific use of a DSA, we believe the precise method should be more openly discussed and then receive more critical appraisal by academia and the general public before it is being implemented. Focusing on ageing costs and the interest-growth rate differential, our results show that the fiscal consolidation requirements can be significantly reduced by minor modifications of some of the DSA assumptions, so that the large EU countries are spared a period of severe austerity in the upcoming years.

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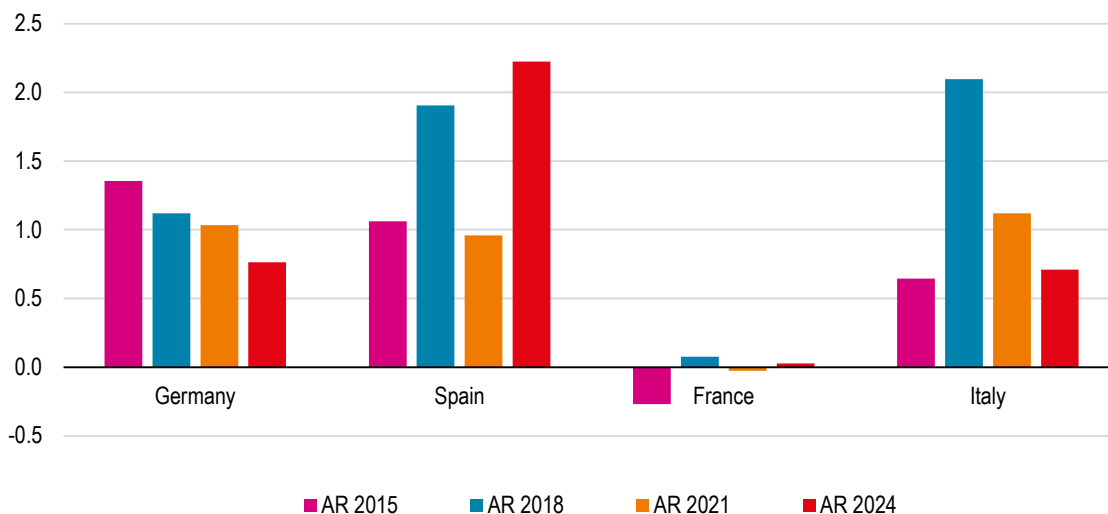
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Appendix

Figure A1: Change of Total Ageing Costs (net of taxes on pensions) between 2030 and 2040 in percentage points for different Ageing Report Vintages



Source: European Commission Ageing Reports 2015, 2018, 2021, and 2024.



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