CAN Europe position:
The reform of the EU fiscal framework

Massive public and private investments in climate mitigation and adaptation are urgent to avoid runaway catastrophic climate scenarios. As noted by the European Central Bank (ECB), “there are clear benefits to acting early: the short-term costs of the transition pale in comparison to the costs of unfettered climate change in the medium to long term”. More frequent and severe natural disasters could lead to a decrease in European GDP, should policies to mitigate climate change not be introduced. But beyond the impact on GDP, the cost of inaction would be immense in terms of humanitarian needs to deal with climate-related disasters and increase in food prices, public health impacts, or additional annual welfare loss in Europe (175bn € under a 3°C global warming scenario, and 83bn € under a 2°C global warming scenario).

While estimates of the green investment gap vary and it is very complex to measure in some environmental policy areas, according to the European Commission, the additional investments needed to reach the EU’s 2030 climate and environmental policy goals are around €470bn per year. These estimates predate the increase in policy ambition to 55% GHG emission reductions by 2030, but they do not consider the possible effect of the removal of environmentally harmful subsidies and internalisation of external costs. The Commission more recently estimated the gap at 520 billion euros each year. In a nutshell: in order to deliver the objectives of the European Green Deal, important investments in climate and nature protection are needed right now.

Private finance is huge and invested properly, it could be a game changer for the just transformation of our economies and societies. However, so far the market failed to deliver the investments needed in climate action. The Polluter Pays Principle has not been properly applied and external costs have not been internalized. This has generated enormous price
distortions, which greatly contribute to the fact that economic activities harmful for the climate or the environment are often profitable. Proper carbon taxation could incentivize private investments in alternative cleaner models of production, with reduced GHG emissions.\textsuperscript{viii} Regulation of private finance, ending fossil fuels subsidies, putting in place environmental taxation as part of a broader tax reform are necessary as well to shift private finance towards climate action.

However, public spending also has a key role to play to drive the just transformation of our economies and societies. Some areas requiring massive investments are not attractive to private finance seeking a (quick) return, such as building renovation, or many adaptation measures.\textsuperscript{ix} According to McKinsey & Company, half the required €28 trillion necessary investments to be done in the EU before 2030 would not have a positive business case.\textsuperscript{x}

Public investments are necessary to ensure alternatives to high-carbon activities are available early enough, including for low-income people. Robust carbon price is also indispensable to steer and leverage private finance towards climate action. And effective measures are needed to reduce corruption and misuse of public money, which is still frequently financing climate-damaging and environmentally harmful activities.\textsuperscript{xii} We therefore need a reformed EU economic governance, an enabling monetary policy, and a fiscal framework able to incentivize genuinely green public investments. While current EU fiscal rules have contributed to a certain economic stability in the EU, they have failed on many other accounts and are not fit to help achieve the EU’s economic, social and environmental goals. Therefore, they need to be fundamentally changed. We need a fiscal framework which is a tool to respond to societal challenges while ensuring sustainable public finances.

The EU fiscal framework is a set of rules to coordinate and monitor Member States’ fiscal policies, in particular Eurozone members’ budgetary status, in order to avoid that economic difficulties facing one country (‘unsustainable’ debt) could affect the others. These rules notably include two major so-called numerical fiscal rules:

- The total debt of Member States should not exceed 60% of their Gross Domestic Product (GDP). If it is higher, it should decline annually at a certain pace.

- Member States’ annual budget deficit should not exceed 3% of their GDP.

These EU fiscal rules are enshrined in the Treaty on the Functioning of the European Union, while the specific reference values of 3% and 60% are set in Protocol 12 to the Maastricht Treaty, and further detailed in EU Regulations called the Stability and Growth Pact (SGP). They have been suspended (via the activation of the ‘general escape clause’) in the aftermath of the covid-19 pandemic to allow Member States to increase public spending to respond to the health, economic and social needs caused by the pandemic. These rules will be suspended till the end of 2022. By then, the European Commission wants “to build a consensus among Member States on the way forward well in time for 2023”\textsuperscript{xii} The Commission launched a public consultation on the review of the EU economic governance in October 2021.
Why do we need a reform?

- The EU fiscal framework contributed to constrain public spending and investments in a number of Member States before the pandemic, and will translate in austerity and cuts in public spending if applied again from 2023.\textsuperscript{xiii}

- The EU economic governance framework has not effectively encouraged Member States to invest sufficiently in the just transition so far, nor to end environmentally harmful subsidies. This is problematic as the quality of public spending is fundamental, i.e. public money must be used for genuine climate and environmental action and for providing high quality public services (education, health care, etc).

- The EU fiscal framework is based on reference values (3% annual fiscal deficit to GDP ratio/60% debt to GDP ratio) that are 30-year old, not robustly evidenced and miss other important criteria (including climate risk for public budgets) which increasingly matter to ensure the trust of creditors, and thereby the sustainability of our public finances.

- Current rules are too complex and not flexible enough to accommodate national situations.

- Current procedures are not democratic enough, with little space for civic engagement and public debate, including in national and the European parliaments.

- Current rules have been implemented with negative social consequences in several member states, with differentiated gender impacts. This contributed to rising inequality and made our societies less resilient to shocks such as pandemics or climate havoc (cuts in social spending, public health, public services).\textsuperscript{xiv} Promoting the care economy through investments in gender-responsive public services (childcare, elderly care, dependency care, etc.)\textsuperscript{xv} is an indispensable ingredient for a just transition.

- Debt has been rising in all EU member States as a result of governments’ response to covid, with a majority of Eurozone members reaching 100% debt to GDP ratio; a return to the 60% debt to GDP ratio starting in January 2023 without fundamental reforms would inevitably entail austerity in these Member States. This in turn would risk exacerbating anti-EU feelings and votes and might generate a political and economic context profoundly unfavourable to ambitious climate action.

- Recommendations from the EC to member States regarding macroeconomic decisions are largely based on economic estimates that often prove to be wrong (e.g. expected potential growth), and these estimates risk to be even more inaccurate in a less predictable post-covid economy.

- The EU fiscal rules are not receptive to societal challenges, in particular climate change and social rights. We urgently need to fund the just transition/the transformation of our societies and economies, to protect all people, particularly the rights of young people and future generations.
CAN Europe urges a fundamental reform of EU fiscal rules and economic governance in order to ensure that any additional fiscal space will translate into targeted and effective climate action by Member States.

The experience of NGEU could be an important step in this direction, seeking to channel the fiscal stimulus on climate action to a certain extent. However, while EU countries seem to have performed better than other G20 economies in terms of the greenness of the fiscal stimulus in response to the pandemic, a number of recovery and resilience plans paid little attention to nature and biodiversity, and may harm nature.

Therefore, very strict common criteria will have to be agreed at EU level to avoid greenwashing, environmental harm, inefficient use and misuse of public money, and to make sure that any public spending escaping the debt and deficit rules will meet the highest quality standards regarding nature protection and climate. The permission for public spending to escape the debt and deficit rules should be tied to a requirement that national funding will not contradict the EU’s climate and environmental objectives (greening national budgets so that public money will never be used for projects and activities which increase CO2 emissions or harm nature and biodiversity); that fossil fuel subsidies will be terminated with a binding pathway; and that accompanying measures will be in place to mitigate the possible adverse social impacts. Last but not least, CSOs will have a crucial role to play to monitor whether those conditions are respected by governments.

Seven short term demands

1. No return to austerity

The general escape clause allows a temporary deviation from the 60% and 3% deficit rules in case the euro area or the Union as a whole faces a severe economic downturn. Since March 2020, the EU activated the general escape clause of the Stability and Growth Pact. As a result, the fiscal deficit and debt rules were suspended to allow Member States to respond with increased public spending to the health, economic and social needs caused by the pandemic. Unfortunately, public spending, including fiscal stimulus in response to the pandemic, has been providing too much support to fossil fuel (including in some EU Member States), and to environmentally harmful activities. Robust safeguards against corruption are also crucial. We therefore need particular attention to the quality of investments and other activities supported with public money.

The general escape clause will be applied through 2022 and de-activated in 2023.

CAN Europe considers that the EU should agree as soon as possible on new measures and rules, so that there will be no return to austerity when the escape clause will be de-activated in January 2023. However, we also believe that a longer term deeper reform of the EU fiscal framework and economic governance is needed, which may take more time.

Among the short term measures, the uniform 60% debt to GDP rule should be replaced with country-specific debt targets (for example over five years). A credible debt
reduction objective adapted to each country’s situation will allow a differentiation of the pace of convergence towards debt sustainability, without excessive pressure stifling public spending or increasing poverty and inequality. This will ensure sustainable public finances while allowing investments in climate action and social justice.

But CAN Europe considers that allowing investments in climate action is not enough: The future EU fiscal framework needs to encourage, incentivize such public investments, and discourage public investments that are harmful for the climate or the environment. In addition, efforts to avoid corruption and misuse of public funds, including funds from the EU budget, need being tightened.

2. Put climate, environmental and social objectives at the core of a reformed EU fiscal framework

The objectives of the EU fiscal framework, as enshrined in a reformed Stability and Growth Pact, should be adapted to be fit for the challenges of the 21st century.

The reference to indiscriminate GDP growth as an objective per se should be replaced with societal goals, including human rights (in particular economic and social rights), the rights of future generations, employment, climate neutrality and nature protection. Whether or not this generates overall GDP growth is secondary, as economic activities that are compliant with climate and environmental objectives must definitely grow, while sectors harmful for the environment should shrink.

The European Semester, the EU macro-economic and budgetary policy coordination system, should be based on improved indicators that capture the distributional impact of policies and measures’ inclusiveness; climate action and environmental protection indicators; and social indicators (which goes beyond job creation and encompasses fundamental rights such as health, education, food or housing and gender equality). For example, as per the indicators in the European Pillar of Social Rights and the Social Scoreboard.

The European Semester and Country Specific Recommendations (CSR) should integrate a much stronger focus on just transformation and the achievement of climate neutrality. Convergence in Member States’ performance should not be primarily economic, but should also include environmental, social and gender-equality performance. Recommendations should be about public spending and investments, as well as policy reforms with clear positive environmental impact, to achieve countries’ pathways compliant with the objectives of the Paris Agreement (‘Fit for 1.5°C’ and related National Energy and Climate Plans - NECPs). The implementation of Member States’ commitments to policy reforms as part of their Recovery and Resilience Plans will be monitored under the EU Semester. This offers a robust starting point for greater attention to climate action and the just transformation in the European Semester in the future.

3. Include a just & green investment rule in the Stability and Growth Pact

Public spending and investments aimed at delivering climate and environmental objectives through a just transformation should be excluded from the calculation of Member States annual fiscal deficit, up to a certain level (for example a proportion of the national budget
and/or until risks emerge regarding debt’s sustainability). However, governments should make sure they abide by the “polluter pays” principle, i.e. do not use public money to pay for damages that polluters should pay. This must be a precondition to excluding public spending and investments aimed at delivering climate and environmental objectives through a just transformation from the calculation of Member States annual fiscal deficit.

An uncompromised green taxonomy (“Taxonomy +” – genuinely science-based) could be used to define what is a green investment (covering both capital investments and current spending). Taxonomy-compliant economic activities have to contribute substantially to one or more of the environmental objectives listed in the Taxonomy Regulation, do no significant harm to the environment, and respect human and labour rights. Such public expenditure should also be compliant with new and ambitious National Energy and Climate Plans (NECPs).

The taxonomy should be the way to determine which investments and spending quality to escape the deficit rule, but this only to the extent that the final Delegated Acts on the taxonomy do not generate problematic loopholes (biomass, fossil gas, nuclear). Would that be the case, even if they are included in the taxonomy, investments in fossil gas, nuclear energy and unsustainable biomass should not be excluded from the calculation of Member States annual deficit. The same holds true with the Do No Significant Harm Principle: It should be interpreted in a more ambitious manner than has been the case under the Recovery and Resilience Facility so far.

The possibility to require reforms from Member States to meet their climate commitments in order for such investments and public spending to escape the deficit rule should also be considered, as part of the European Semester. As a strict minimum, Member States should timely implement EU climate and environmental legislation.

In addition, the two cumulative criteria included in the Regulation establishing the Just Transition Fund could be used to determine the eligibility of social public spending to elicit the fiscal deficit rule:

- The spending should aim at “enabling regions and people to address the social, employment, economic and environmental impacts of the transition towards the Union’s 2030 targets for energy and climate and a climate-neutral economy of the Union by 2050, based on the Paris Agreement” (Art. 2 of the Regulation).

- Only activities listed in Art. 8 of the Just Transition Fund Regulation would be eligible.

4. Changing the way public investments are accounted for in national budgets or “Special purpose vehicle fund”

An option discussed by some Member States would be to exclude certain public investments from budget constraints. For example, Austria and Germany set up state-owned companies (ASFINAG and Autobahn GmbH respectively) to build and maintain motorways. These companies can borrow huge amounts on capital markets. The company’s state-guaranteed borrowing is not counted as public debt, because it is serviced by a significant percentage of dedicated revenue streams, from truck tolls and an annual user fee for cars. The same holds true for national development banks such as KfW in Germany, which function on the basis of
a public guarantee, but their balance sheet is separate from the government’s balance sheet. This allows avoiding EU debt limits if it’s considered part of the private sector - not the government. Some argue that a similar approach could be followed by Member States to fund investment in climate action such as smart energy grids and solar parks.\textsuperscript{xxiv} The conditions for such special funds to escape from the Stability and Growth Pact rules are quite stringent though.

While this option could be part of the picture if some Member States decide to set up such vehicles, we consider that to escape the EU fiscal rules, such funds would have to be strictly tied with climate and environmental conditions. In addition, it should not replace a reform of the EU fiscal framework for the following reasons:

- It can be useful to fund asset purchases via loans/debt, but many climate-related expenditures require subsidies and not loans (for building renovation, adaptation, reskilling, etc).

- It would enable green public investments, but not necessarily encourage them, including because of the uncertainty around what could exactly escape from the deficit calculation and be compatible with the state aid rules.

- There may be a risk of privatisation of public services if private companies run the assets purchased (public transportation, energy grids, etc), with possible adverse impacts in terms of social justice/equal access to infrastructures and assets purchased.

- Robust European rules and criteria regarding socially just green investments would support more transparent domestic budgeting, which would not be the case of creative accounting and use of state financial institutions to finance investments outside of regular budgeting and common debt rules.

- Cohesion may be eroded among Member States as their capacity to establish such special vehicle funds and get advantageous interest rates will differ, thereby deepening inequality between them in terms of their capacity to finance the just transition.

5. \textbf{Strict assessment and monitoring to avoid corruption}

An indispensable precondition to ease the fiscal rules (as well as the continuation of EU funding) for Member States must be the full implementation of the anti-corruption recommendations of the European Commission (especially in the Country-Specific Recommendations and the Rule of Law Report), GRECO\textsuperscript{xxv}, OECD, and the United Nations. The recommendations of CSOs fighting against fraud, corruption and tax evasion should also be taken into account. Hungarian CSOs have made numerous concrete proposals for such preconditions, which need serious consideration.\textsuperscript{xxvi}

Any public green spending escaping the EU fiscal rules must show measurable contribution to national or/and EU objectives on energy and climate, biodiversity, waste and water quality or pollution. Specific indicators that show measurable contributions to the objectives should be used.
Additional funding and resources to the European Public Prosecutor’s office, and a reinforcement of national public prosecutor’s office are needed, as well as increased transparency.

6. Democratic ownership of the reforms

We are calling for the EU and Member States to dedicate specific efforts and resources to make sure there are public debates about the EU fiscal policy reform. Democratic ownership of the reform is crucial to have an EU fiscal framework fit for the coming decade, and for taxpayers to adhere to our common fiscal rules.

Whatever option will be retained to reform the EU economic governance, national parliaments and the European Parliament need to play a central role in the future architecture, transparency ensured and social partners and CSOs involved.

7. Beyond public debt: The role of progressive taxation

Taxation has a crucial role to play to increase governments’ income – which in turn can help reducing fiscal deficit and the level of debt. Taxation needs to be more efficient, address resource consumption and pollution, be gender-sensitive and play a redistributive role. The wealthiest have become even richer during the pandemic, further exacerbating a trend of rising inequality. The recent agreement in the OECD on a global minimum corporate tax rate lacks ambition. This should not prevent European countries from progressing at a faster pace, and with much higher ambitions. Environmental taxes, progressive income taxes, wealth taxes (on property, capital gain, etc.), financial transaction taxes, the closing of tax havens and ending tax avoidance within Europe and at global level, are part of the solution.

Environmentally harmful subsidies (including fossil fuel subsidies which often take the form of tax breaks) should be mapped, their social impact assessed and addressed through carefully designed flanking measures, and they should be removed. This, together with environmental taxation, should be addressed under the European Semester.

Two longer term reforms

1. Establish a permanent borrowing capacity for the EU, making Next Generation EU a permanent feature

CAN Europe considers that a permanent capacity for EU borrowing for socially and gender-just climate and environmental action should only be supported if lessons learned from the Recovery and Resilience Facility (which ends in 2024) show that it allowed to boost climate action and the just transition. The advantage would be that the EU would access cheaper loans on the capital market than most Member States, thereby interests to be served would be lower.

CAN Europe considers that in case such borrowing capacity would become permanent, it should only be for climate and nature protection and related social justice measures (i.e. same scope as the just & green investment rule mentioned above).
2. **Replace the numerical fiscal rules of 3% and 60% with broader sustainability criteria**

In the longer term, the Treaty on the Functioning of the EU (TFEU) should be amended in order to replace the reference values (fixed at 3% and 60% by Protocol 12) with standards, i.e. general objectives such as “keeping debt at a sustainable level” and “avoiding excessive fiscal deficit”.

Under current EU rules, a debt to GDP ratio above 60% is considered unsustainable. Markets’ confidence (and thereby the interest rate) is not dependent on a particular debt-to-GDP ratio, as many other factors play a role, such as the existence of a lender of last resort. For the moment, interest rates on public debt are very low, despite the increase in debt volume.

CAN Europe considers that whether a debt is sustainable should be assessed based on a set of criteria that would be applied to each Member State taking into account the specific national context (expected GDP, future interest rates, future trust of investors in the capacity of governments to honour their debt, climate change systemic risks for the public budget and financial sector, etc.). In particular, the systemic risk generated by climate and environmental shocks to the economy/public budget should be integrated into fiscal decision-making. Pending a revision of the EU Treaties, this should immediately be taken into account in the framework of the assessment of Member States’ budgetary situation and macro-economic imbalances in the EU Semester.

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* “In the industry sector, 95 percent of pathway capital expenditures lack positive business cases; in
buildings, it’s 85 percent; in power 46 percent; in transportation 36 percent; and in agriculture 11
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budgetary surplus of 5 percent to comply with a reduction of 1/20thper year above the 60 percent
reference value. The Commission forecasts a ten-year average nominal potential growth rate of 2
percent (before RRF reforms) for Italy. Spain would need to run a surplus of about 3 percent, due to
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xv European Economic and Social Committee, The Impact of “Anti-Crisis” Measures and the Social
and Employment Situation, Portugal, 2013,
https://www.eesc.europa.eu/sites/default/files/resources/docs/qa-31-12-351-en-c.pdf; Study of the
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xviv Care work is performed for pay by care workers (nurses, teachers, doctors, domestic workers). But
the majority of the care work worldwide is undertaken by unpaid carers, mostly women and girls.
Unpaid care work is a key factor in determining both whether women enter into and stay in
employment and the quality of jobs they perform.[ILO, Care work and care jobs for the future of
of unpaid care work. However, these unpaid working hours are not valued, not included in economic
statistics, and never taken into account in macroeconomic policy, they are just taken for granted.
[https://www.cidse.org/2020/06/04/how-to-move-toward-care-economy/]. Investing in the care sectors
has the potential to generate massive employment opportunities for women and men. [ITUC,
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the future in the form of a better educated and healthier population. It should be seen as an
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Alternatives_Vol-1.pdf. See also on informal care during COVID: https://eige.europa.eu/covid-19-and-
gender-equality/unpaid-care-and-housework; as well as a provisional gender impact assessment of
NGEU in 2020 and the social & economic benefits of investing in care (see pp 29-30 for example):
https://alexandrageese.eu/wp-content/uploads/2020/07/Gender-Impact-Assessment-
NextGenerationEU_Klatzer_Rinaldi_2020.pdf
xvi https://www.energypolicytracker.org/region/g20/; On progress on phasing out fossil fuel subsidies in
G20 EU countries from 2015 to 2019, see BloombergNEF, Climate Policy
Factbook, July 2021, https://assets.bubble.io/professional/sites/24/BNEF-Climate-Policy-
Factbook_FINAL.pdf
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major economies in relation to climate action and biodiversity goals, July 2021, https://a1be08a4-d8fb-
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Since 2010, Eurozone countries have been in severe financial distress. The establishment of the European Stability Mechanism (ESM), an institution that can provide loans to Eurozone member states, was completed in 2013. This was followed by the establishment of the European Central Bank's (ECB) Outright Monetary Transactions (OMT) programme, which allowed the ECB to purchase sovereign bonds of Eurozone member states. The ECB was able to purchase a large volume of bonds, which helped to stabilize the Eurozone and prevent a eurozone default crisis.

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