Finance Watch

Policy Primer

Navigating The Maze

A Finance Watch guide on how to reform European economic governance

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Key points

- **Europe faces serious environmental, economic and social challenges** that require a rethink on public intervention. But European governments' are not free to do as they wish. Fiscal and socio-economic policies they devise are constrained by a self-imposed maze of rules that comprise European economic governance.
- **European economic governance is a multilateral and three-pillar system** aimed at (i) enforcing fiscal surveillance, (ii) ensuring macroeconomic surveillance and (iii) facilitating socio-economic coordination. These pillars are grounded in primary legislation (i.e. articles of the EU treaties), developed in secondary legislation (i.e. regulation, directive) and refined via extra-legislative interpretive documents (e.g. code of conduct, commonly agreed positions).
- **To allow Member States to respond to the Covid-19 pandemic, the European Union has put on ice for 2020 and 2021 its fiscal rulebook** via the activation of the general escape clause of the Stability and Growth Pact (SGP). At the time of writing, a debate takes place on the appropriate timing to reactivate EU fiscal rules and on whether they should be reformed first – and to what extent as different legislative procedures could apply.
- A thorough understanding of the policy maze is the first step to any meaningful effort to reform it. To grasp its complexity, Finance Watch provides in this primer the **key elements of the European economic governance as well as the main procedures to reform its prominent fiscal pillar.** Reform measures needed now are:

1 **Tweaking the Stability and Growth Pact Code of Conduct:** the low-hanging fruit that would clarify escape clauses and ease existing flexibilities, but would fail to address fiscal rules' main flaws.

2 **Transforming both arms of the Stability and Growth Pact via the Ordinary Legislative Procedure** to improve flexibility for sustainable public investment, as well as better account for public spending quality and reduce ill-timed debt-reduction pressures, among others.

3 **Rewriting the European treaties via the ordinary or simplified revision procedures:** needed if we are to scrap or relax the core numerical fiscal rules – maximum 3% deficit-to-GDP ratio and 60% debt-to-GDP ratio – and integrate the sustainability imperative at the heart of the fiscal and socio-economic pillars.

Introduction

Europe faces serious economic, environmental and social challenges. While climate change, biodiversity loss and economic crisis rightly have made the headlines during the past three years, concern over economic and digital sovereignty, decaying infrastructure, rising unemployment and social inequality in an ageing Europe present additional long-term trends that must be tackled.

While the Covid-19 pandemic has only made these challenges more acute for many European countries, it also shed a crude light on how decades of cuts and underfunding in healthcare led to insufficient preparedness and resilience. The result: much greater human suffering and financial cost than if policy had addressed those gaps prior to the Covid crisis.

Similar outcomes could happen for other environmental, social and economic challenges if policymakers fail to ensure funding gaps are bridged. The projected gaps are daunting[1]: €470 billion a year until 2030 to meet EU environmental objectives[2]; €142 billion a year for social infrastructure such as hospitals or schools[3], along with €190 billion a year to stabilise the stock of public capital.[4]

As the world bathes in abundant liquidity[5] and private capital, many calls have been made in the past decade for private finance to fill these gaps. Although these calls appear logical, **funding gaps remain precisely because the private sector has little appetite to finance these investments,** marked by low profitability, and high risk. Another factor contributing to the funding gap falls closer to home, **as financing oftentimes must be made for projects managed by financially-constrained local authorities or households.**[6]

The current situation shows the need to embrace a more balanced view of the role played by the public sector than the one prevailing since the 1990s. While tackling these challenges facing Europe calls for better regulation, evidence also points to the need for more and better public investment to catalyse significant amounts of private capital towards these socially desirable goals. Long overdue is a shift of the pendulum from an inefficient and reactive role by governments as market failure "fixers" towards a far more efficient and active role of market shapers.[7]

Meanwhile, European Member States remain constrained by European economic governance – a maze of rules impacting their fiscal and socio-economic policies. Highly intertwined with an annual cycle of coordination known as the European Semester, this "three pillars" governance system aims to enforce fiscal discipline, ensure macroeconomic surveillance, and facilitate socio-economic coordination.

What are these rules and are they fit for the task? If not, what elements form their legal foundation and how can Europe best reform them? Leaving aside the legitimate question on effectiveness of rules[8], this Finance Watch publication focuses on the latter, helping the reader better understand European economic governance by:

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1 While estimating aggregate financing needs remains challenging and the result therefore debatable, they can be taken as a reference to estimate the order of magnitude.

2 European Commission, "SWD(2020) 98 final - Identifying Europe's recovery needs", 27.5.2020, p.14-16

3 This estimation only cover health and long-term care (EUR 70 billion), education and life-long learnings (EUR 15 billion) and affordable housing (EUR 57 billion). Source: FRANSEN, L., BUFALO, G., REVIGLIO, E., "Boosting Investment in Social Infrastructure in Europe - Report of the High-Level Task Force on Financing Social Infrastructure in Europe", 2018, 116p.

4 European Commission, "SWD(2020) 98 final - Identifying Europe's recovery needs", 27.5.2020, p. 18-20

5 As illustration, excess liquidity (i.e. holdings of central bank reserves in excess of minimum reserve requirements and holdings of equivalent central bank deposits) exceeded €1 900 billion or 17 percent of euro-area GDP, in September 2018. Source: DARVAS, Z., PICHLER, D., "Excess Liquidity and Bank Lending Risks in the Euro Area - Monetary Dialogue September 2018", Septembre 2018, p.44.

6 Residential energy efficiency represents € 115 billion of the estimated green funding gap. In: EC, Op cit., p.14-16

7 MAZZUCATO, M., RYAN-COLLINS, J., "Putting value creation back into 'public value': From market-fixing to market-shaping", UCL Institute for Innovation and Public Purpose, Working Paper Series (IIPP WP 2019-05), 2019.

8 Discussed by Finance Watch in "One Framework to Rule them All" (2021) and "9 Myths on public debt and fiscal rules" (2021), and in a forthcoming report on the reform of the European economic governance.

- Clarifying the main elements within the legislative framework, provided in **Part 1 - The Maze.** It includes a presentation of the primary and secondary legislation as well as extra-legislative and interpretive documents that comprise the framework for fiscal surveillance *(Pillar I)*, macroeconomic surveillance *(Pillar II)* and socio-economic coordination *(Pillar III)*.
- Discussing procedures to reform its different components as contained in **Part 2 - The Navigation.** It includes a discussion on why fiscal rules need to remain frozen and what needs to be reformed in the short and long run.

Part I - The Maze

Pillar I. Fiscal surveillance

A set of numerical fiscal rules form the core of fiscal surveillance, limiting Member States' debt stock to 60% of their gross domestic product (GDP), budget deficit to 3% of GDP and structural budget deficit[9] to 0.5-1.0% of GDP. Completing these rules are a series of correction mechanisms aimed at tackling deviations from these limits[10], country-specific caps to public expenditure growth[11], and a complex system of flexibility arrangements.[12]

As part of the annual cycle of coordination and surveillance known as the "European Semester", **Member States must submit by April their fiscal plans to the European Commission,** named Stability or Convergence Programmes, and additional Draft budgetary Plans by mid-October for euro area countries. In these plans, Member States shall set country-specific medium-term budgetary objectives (MTO) and define the pathway towards reaching it.

The Commission then assesses compliance of these plans with the EU fiscal rules. In case of non-compliance by a Member State, **the Council can launch an Excessive Deficit Procedure (EDP) or a Significant Deviation Procedure (SDP) that can lead to a series of escalating measures** following recommendations from the European Commission.[13]

This architecture results from residue left by three decades of debates marked by tension between simplicity, adaptability and enforceability. This Finance Watch paper guides the reader through its most important elements.

I. The 1992 Maastricht treaty

PRIMARY LEGISLATION

The EU Fiscal Framework has its origins in the 1992 Maastricht Treaty and now appears in Article 126 of the Treaty on the Functioning of the European Union, or TFEU. It laid **the foundation for the Excessive Deficit Procedure** (EDP), a list of procedural steps aimed at correcting an excessive deficit, among which are:

- *Member States shall avoid excessive deficit*, defined as crossing reference values, which are further specified in an annexed protocol.
- *The Commission examines Member State's budget's compliance* with these deficit thresholds.
- In case of non-compliance, *the Commission prepares a report* and *makes recommendations* to the Council on further escalating measures. Annexed to the Treaty on European Union, Protocol No.12 further specified the two reference values of the Excessive Deficit Procedure referred to in Art. 126 TFEU: the 3% deficit-to-GDP and 60% debt-to-GDP ratios.

9 The structural deficit is that part of the deficit not related to the state of the economy and that would exist regardless of the economy being at full employment. A structural deficit target takes into consideration business cycle swings such as smaller tax revenues and larger unemployment benefit pay-outs in a recession. The target filters out the effects of one-off and other temporary measures such as bail-outs of banks. The Fiscal Compact sets a structural budget deficit rule for euro-area Member States at 0.5% of their GDP, with a possibility to run a structural deficit up to 1.0% of GDP for countries with a debt ratio significantly below 60%.

10 If the public debt-to-GDP ratio exceeds 60%, it must decline by at least one twentieth of the gap to the 60% target every year (the so-called 'debt-reduction benchmark'). In case of non compliance with the debt or deficit limits, the Member State will be required to achieve a minimum annual improvement in its structural balance of at least 0.5% of GDP per year.

11 Introduced in 2011 as part of the Six-Pack, the expenditure benchmark caps public expenditure growth to help countries meet their structural budget balance objectives, namely medium-term budgetary objectives (MTO).

12 There are, first, general exceptions in case of economic recession or extraordinary events and, second, a series of flexibility clauses aimed at promoting structural reform and investment, among other things. Lastly, some flexibility exists also for cyclical conditions which applies to the fiscal adjustment path (i.e. the so-called 'matrix of requirements').

13 Those include submission of a revised budget draft, non-public recommendations, public recommendations, and even financial sanctions.

II. Two arms of the 1997 Stability and Growth Pact (SGP)

EXTRA-LEGISLATIVE

Inspired by a memorandum written in 1995 by then German Finance Minister Theo Waigel, the Stability and Growth Pact (SGP) was agreed on in June 1997 as a way to clarify fiscal provisions outlined in the Maastricht Treaty. In Resolution 97/C 236/01, Member States agreed on a series of guidelines further specified in the two Council Regulations establishing the preventive and corrective arms of the Pact.

SECONDARY LEGISLATION

Regulation (EC) No 1466/97 established **the preventive arm of the SGP**, which concerns the setting and attainment of medium-term budgetary objectives via soft coordination procedures. Member States commit to:

- Respect a medium-term budgetary objective **(MTO)** to achieve a ***close-to-balance or in-surplus budget*** **(Art. 3, 2., (a))**.
- Submit annually a ***Stability (or Convergence) programme*** presenting their MTO, the adjustment path towards this MTO, and a series of other relevant information **(Art. 3 and 7)**.

Building on the article 126 TFEU, Regulation (EC) No 1467/97 established **the corrective arm of the Pact** by further codifying the Excessive Deficit Procedure. The Regulation:

- Provide the Excessive Deficit Procedure's timeline **(Art. 3-8)**.
- Clarify the originally imprecise provisions on ***sanctions*** for excessive deficit **(Art. 11-16)**.
- Further define under which condition a deficit shall be considered as exceptional[14] – the so-called "***unusual event clause***" **(Art. 2, 2.)**.

III. Stability and Growth Pact reform in 2005

The launch in 2002 of excessive deficit procedures against Portugal, Germany and France, following crisis-related deficits, shed a crude light on Stability and Growth pact's inappropriateness and procyclicality. It sparked intense debate resulting in two main additions in both arms of the pact: a **structural deficit rule** and the move from an assessment based on fiscal outcomes towards an **assessment based on fiscal *efforts*.**

SECONDARY LEGISLATION

Regulation (EC) No 1055/2005 amending **the preventive arm** (Regulation (EC) No 1466/97):

- The MTO is made ***country-specific and cyclically adjusted*** (i.e. net of one-off and temporary measures), and has to range from -1.0% of GDP to a structural surplus **(New Art. 2a)**.
- In case of non-compliance with the MTO, the ***adjustment path*** must be an annual reduction of the structural deficit of at least 0.5% of GDP – with a higher effort given in good times **(New Art. 5, 1.)**.

Regulation (EC) No 1056/2005 amending **the corrective arm** (Regulation (EC) No 1467/97):

- Member States in excessive deficit situations will be requested to achieve a ***minimum annual budgetary effort*** corresponding to a structural deficit reduction of at least 0.5% of GDP. **(New Art. 5, 1.)**.
- The reformed "***unusual event clause***" allows the Council to grant to a Member State a one-year extension to correct an excessive deficit. **(New Art. 3, 5.)**.

14 "[...] consider an excess over the reference value resulting from a severe economic downturn to be exceptional only if there is an annual fall of real GDP of at least 2%."

SECONDARY LEGISLATION

- A new "***structural reform clause***" allows MS implementing major structural reforms to deviate from their MTO, or the adjustment path towards it **(New Art. 5, 1.)**.

- A less stringent definition of '***severe economic downturn***'[15] applied for the SGP's "unusual event clause". **(New Art. 2, 2.)**.

- Clarification of the ***other relevant factors*** which may be relevant to take into account when assessing.the existence of an excessive deficit. **(New Art. 2, 3.)**.

IV. Euro crisis, the 'Six-Pack', the TSCG and the 'Two-Pack' (2011-2013)

As the global financial crisis morphed in 2010 into the Euro crisis, structural imbalances in euro area Member States and failures in the design of the Economic and Monetary Union (EMU) became apparent.

As part of packages of new regulations negotiated between 2010 and 2013 – the so-called 'Six-Pack', 'Fiscal Compact' and 'Two-Pack' – both **arms of the SGP were tightened**, minimum requirements for **National Fiscal Framework** defined and **specific requirements for euro area Member States** added, among other things.

a. Stability and Growth Pact: Improving and tightening its two arms

SECONDARY LEGISLATION

Regulation (EU) No 1175/2011 tightened and improved the **preventive arm** (Regulation (EC) No 1466/97) by:

- Creating the ***European Semester*** to improve multilateral surveillance **(New Art. 2-a)**.

- Including respect of the MTO within the new "***national medium-term budgetary frameworks***"[16], and its revision every three years **(New Art. 2a)**.

- Improving ***Stability and Convergence programme*** content, reliability and presentation **(New Art. 3 and 7)**.

- Introducing the **significant deviation procedure** (SDP) which can lead to sanction in case of significant deviation from the planned adjustment path towards the MTO **(New Art. 6, 2. and 10, 2.)**.

Regulation (EU) 1177/2011 amending **the SGP's corrective arm** (Regulation (EC) No 1467/97):

- Under the new "***debt-reduction benchmark***", Member States with debt-to-GDP levels higher than 60% must reduce annually by 1/20 of the total level the gap between their debt level and this 60% reference **(New Art. 2, 1a.)**.

- ***The debt criterion*** is put on an equal footing with the deficit criterion **(New Art.1, 1.)**: failing to meet the debt-reduction benchmark can now also launch an Excessive Deficit Procedure.

- Equivalent of the unusual event clause but for severe economic downturn affecting the euro area or the Union as a whole, the "***general escape clause***" allows the Council to grant Member States a one-year extension to correct excessive deficits. **(New Art. 3, 5.)**

15 A 'severe economic downturn' occurs when there is "[...] a negative annual GDP volume growth rate or [...] an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential."

16 According to the Council Directive 2011/85/EU, EU Member States will now have to prepare and execute their budget according to a set of minimum requirements covering five key blocks, among which "medium-term budgetary frameworks".

SECONDARY LEGISLATION

- Creating a new ***expenditure benchmark***[17] as an additional indicator to assess compliance with the adjustment path towards the MTO **(New Art. 5, 1.)**.
- Allowing Member States to temporarily depart from the adjustment path towards their MTO in case of unusual event impacting a Member State's financial position, or in case of severe economic downturns affecting the euro area or the Union as a whole – respectively the reformed "***unusual event clause***" and the new "***general escape clause***" **(New Art. 5, 1.)**.
- Establishing an ***economic dialogue*** between the European Parliament and the other EU institutions involved in the economic governance in an attempt to improve transparency and accountability[18] **(New Art. 2-ab)**.
- Ensuring a ***permanent dialogue*** between the Commission and relevant national authorities and undertaking enhanced surveillance missions in case of significant deviation from the adjustment path, i.e. SDP **(New Art.-11)**.
- Further specifies the ***relevant factors*** that must be taken into account by the European Commission when assessing compliance with deficit and debt criteria. **(New Art. 2, 3-7)**

b. Creating national fiscal frameworks

According to the Council Directive 2011/85/EU, EU Member States will now have to prepare and execute their budget according to **a set of minimum requirements** covering:

SECONDARY LEGISLATION

- Accounting and statistic **(Chapter II)**
- Forecast **(Ch. III)**
- Numerical fiscal rules **(Ch. IV)**
- Medium-term budgetary frameworks **(Ch. V)**
- Transparency of general government finances and comprehensive scope of budgetary frameworks **(Ch. VI)**

It also sketches the role independent fiscal bodies play in monitoring Member State compliance with fiscal rules and providing economic and budgetary forecasts.

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17 The expenditure benchmark places a cap on the annual growth of public expenditure according to a medium-term rate of growth. It does not constrain the level of public expenditure per se, but rather ensure that expenditure plans are adequately resourced by equivalent permanent revenues.

18 One of the points won by the European Parliament during the negotiation of the Six-pack.

c. Adding special requirements for euro area Member States

SECONDARY LEGISLATION

The Regulation (EU) No 1173/2011 adds sanctions concerning the manipulation of statistics and a gradual **system of (semi-automatic) sanction** for euro area Member States: most sanctions under the Excessive Deficit Procedure are now taken by ***Reverse Qualified Majority Voting*** (RQMV).[19]

INTERGOVERNMENTAL TREATY

One year later in March 2012, the intergovernmental Treaty on Stability, Convergence and Governance (Title III. Fiscal compact) added **a series of commitments for euro area Member States** to integrate to their national legal framework (preferably constitutional):

- A ***tightened structural deficit rule*** introducing a lower limit of 0.5% of GDP, and 1.0% for Member States with a debt-to-GDP ratio below 60% **(Art. 3, 1., (b) and (d))**.
- A ***correction mechanism***[20] that shall be automatically triggered in case of significant deviation **(Art 3, 1., (e))**.

SECONDARY LEGISLATION

The two regulations known as the "Two-Pack" only apply to euro area countries. The first regulation, the Regulation (EU) No 473/2013, **enhances the monitoring of budgetary policies** by further defining:

- A ***common budgetary timeline*** to complement the EU Semester. By 15 October, euro area Member States have to submit a Draft Budgetary Plans. The final budget must be adopted for the 31 Dec **(Art.4)**.
- ***Draft Budgetary Plans*** (DBPs) should be consistent with Member States' Stability/Convergence Programme, the euro area Broad Economic Policy Guidelines (BEPG), and must be submitted to the EC and the Eurogroup **(Art. 6)**.
- As part of its ***assessment***, the Commission can request a revised draft budgetary plan. Based on Draft Budgetary Plans, , the Commission also assesses that euro area fiscal stance that will then be explored in the Eurogroup **(Art.7)**.
- Euro area Member States under an Excessive Deficit Procedure shall present an ***economic partnership programme*** which includes details of fiscal and structural reforms they intend to carry out (for example, on pension systems, taxation or public healthcare) to correct their deficits (Art.9). These Member States shall also assess financial and fiscal risks, and report regularly on budget execution, impact, targets and measures. **(Art 10.)**
- Euro area Member States should have in place a ***National Fiscal Board*** acting as an independent fiscal surveillance institution.

19 With RQMV, the Council needs a qualified majority to block a decision by the Commission to impose a fine.

20 The Commission has further specified Common principles that should apply to national fiscal correction mechanisms.

SECONDARY LEGISLATION

The second regulation of the "Two-pack", the Regulation (EU) No 472/2013 **strengthened the surveillance of Member States in the euro area** experiencing, or threatened with, serious financial stability issues. More precisely:

- Member States experiencing financial difficulties or under precautionary assistance programmes from the European Stability Mechanism, or ESM[21], are subject to "***enhanced surveillance***" **(Art.2)**, involving regular review missions by the European Commission **(Art. 3, 5.)**.
- ***Macroeconomic adjustment programme*** (MAP) shall be submitted by Member States requesting financial assistance **(Art.7)**, or when there is both significant contagion risks and a decision of the Council voting by qualified majority, or QMV **(Art. 3,5.)**. The MAP shall include annual budgetary targets and has to be approved by the Council at QMV. Regular adjustment to the MAP is examined by the Member State and the 'troika' – Commission, European Central Bank and potentially International Monetary Fund **(Art.7)**.
- The European Commission produces in-depth ***Debt Sustainability Analysis*** of Member States requesting ESM financial assistance **(Art.6)**.

V. Non-legislative interpretative documents

EXTRA-LEGISLATIVE

The Code of Conduct of the SGP (2017) provides guidelines on the format and content of the stability and convergence programmes. More crucially, the Code **specifies some important aspects of the implementation of the Stability and Growth Pact, among which the commonly agreed position on flexibility** that clarifies the so-called "*investment clause*", "*structural reform clause*" and cyclical flexibilities – including the matrix of requirements. A similar Code of Conduct of the Two-Pack provides guidelines on the format and content of Draft Budgetary Plans, Economic partnership programmes, among others, and specifies elements of the reform of 2013.

Flexibility embedded in the SGP was clarified earlier by the Communication (2015) 12 final. The Vade Mecum on the Stability and Growth Pact is a manual prepared by the European Commission (DG ECFIN) that presents the procedures and methodologies for its implementation.

21 Created in October 2012 via an intergovernmental treaty, the ESM is currently the sole and permanent instrument for financial assistance to euro area Member States. It has an effective lending capacity of €500 billion. Loans are financed by ESM borrowings on financial markets and are guaranteed by the euro area Member States.

Pillar II. Macroeconomic surveillance

As the 2010 euro crisis ensued following the global financial crisis, a series of macroeconomic imbalances became apparent. As part of reform measures taken in December 2011 on European economic governance, known as the "Six-Pack", Member States decided to task the European Commission with **monitoring the build up of macroeconomic imbalances** and to make it a pillar of the European Semester.

Following the new excessive imbalance procedure (EIP) put in place in 2011, the Council may **adopt a recommendation establishing the existence of an excessive imbalance and recommending corrective action.** Failing to correct the imbalances can lead to escalating measures and sanctions.[22]

SECONDARY LEGISLATION

Regulation (EU) No 1176/2011 introduces the main element on the prevention and correction of macroeconomic imbalances, the new **Macroeconomic Imbalances Procedure (MIP):**

- ➜ An ***alert mechanism report*** (AMR) prepared by the Commission and based on a scoreboard of 14 headline indicators covering the most relevant areas of macroeconomic imbalances. **(Art. 3, 4)**.
- ➜ Countries whose situation requires deeper analysis are subject to an ***in-depth review*** (IDR). **(Art. 5)**.
- ➜ According to a new ***Excessive Imbalance Procedure***, Member States experiencing excessive imbalances receive preventive recommendations and must submit ***corrective action plans*** **(Chapter III)**.
- ➜ The Council, on a recommendation from the Commission, can adopt ***Country-Specific Recommendations (CSRs)*** **(Art. 6, 7, 8, 10)**.

SECONDARY LEGISLATION

To enforce the correction of macroeconomic imbalances, Regulation (EU) No 1174/2011 further defines **sanctions and enforcement mechanisms**.

22 Decisions are deemed adopted by the Council unless a qualified majority of Member States reject the recommendation, called Reverse Qualified Majority Voting (RQMV).

Pillar III. Socioeconomic coordination

As part of a yearly policy coordination cycle named "the European Semester", **Member States coordinate fiscal, employment and economic policies.**

The process starts in November with the Commission publishing **policy priorities covering economic, budgetary and labour policies** to be adopted by the Council – i.e. the Annual Sustainable Growth Strategy[23], the recommendation for the euro area, and the Joint Employment Report. The Commission also publishes country-specific analysis, such as alert mechanism reports in November and country reports in February.

Taking into account these priorities, analysis and prior recommendations, **Member States present in April of each year their economic and fiscal plans** – i.e. respectively their National Reform Programmes and their Stability or Convergence Programmes. Euro area Member States additionally submit by mid-October Draft budgetary Plans. The cycle ends in July with the adoption of country-specific recommendations by the ECOFIN Council.[24]

a. Coordinating economic policies

PRIMARY LEGISLATION

While Articles 2, 5 and 119 of the Treaty on the Functioning of the European Union (TFEU) require Member States to view their economic policies as a matter of common concern and to coordinate them closely, **the areas and forms of coordination** are specified in Article 121 TFEU:

- ➜ Member States shall coordinate their economic policies within the Council **(Art 121, 1.)**.
- ➜ European Commission and Council shall formulate the ***broad guidelines of the economic policies*** of the Member States and the European Union **(Art 121, 2.)**.
- ➜ Commission produces ***Country Reports*** (CRs) **(Art 121, 3.)**, and the Council can address ***Country-Specific Recommendations*** (CSRs) following EU Commission recommendations **(Art 121, 4.)**.

b. Coordinating employment policies

PRIMARY LEGISLATION

The European employment strategy (EES) is a soft law mechanism designed to coordinate the employment policies of EU Member States. While the objectives, priorities and targets are agreed at EU level, national governments are fully responsible for formulating and implementing the necessary policies. First institutionalised in 1997 by the Treaty of Amsterdam and now embedded in Article 148 TFEU, the strategy specifies that:

- ➜ ***Employment guidelines*** are common priorities and targets for employment policies proposed by the Commission, agreed by national governments and adopted by the EU Council **(Art 148, 2.)**.
- ➜ The Council and the Commission produce annually a J***oint Employment Report (JER)*** based on the assessment of the employment situation in Europe, the implementation of the Employment Guidelines and, since 2018, on an assessment of a scoreboard of key employment and social indicators – the so-called Social Scoreboard[25] **(Art 148, 5.)**.

23 Formerly known as the "Annual Growth Survey", this is "the Commission's main tool for setting out the general economic and social priorities for the EU for the following year."

24 See Annex 1 for more details on the European Semester timeline.

25 In 2018 the Joint Employment Report (JER) presents for the first time the Social Scoreboard that monitors Member States' performance in relation to the European Pillar of Social Rights.

- The Council can address ***country-specific recommendations*** (CSRs) following EU Commission recommendations **(Art 148, 4.)**.

c. Integrating fiscal surveillance and socio-economic coordination

SECONDARY LEGISLATION

Regulation (EU) No 1175/2011 further institutionalised **the European Semester** in the Stability and Growth Pact preventive arm **(New Art. 2-a)**. The Semester brings under an integrated umbrella fiscal and macroeconomic surveillance and socio-economic coordination (see annex 1).

- At the beginning of each annual cycle, the Commission and Council formulate the ***Broad Economic Policy Guidelines (BEPG) and the Employment Guidelines (EG)*** of the Union – both respectively based on Articles 121 and 148 of the TFEU **(New Art. 2-a, 2. (a) and (b))**.
- In addition to submitting ***Stability or Convergence Programmes (SCPs)*** that shall be aligned with EU fiscal rules, Member States submit ***National Reform Programmes (NRPs)*** expected to be aligned with the Union's strategy, the Broad Economic Policy Guidelines (BEPG) and Employment Guidelines (EG). SCPs and NRPs are assessed by the Commission later in the cycle **(New Art. 2-a, 2.)**.
- The European Commission is tasked also to ***prevent and correct macroeconomic imbalances*** under Regulation (EU) No 1176/2011.
- The European Commission proposes **country-specific recommendations (CSRs)**[26] to be adopted by the Council **(New Art. 2-a, 3.)**. Failure to take CSRs into account can result in the Member State receiving more recommendations and sanctions under the SGP or the macroeconomic imbalance procedure (MIP) **(New Art. 2-a, 3.)**.
- The European Parliament shall be involved in the European Semester by means of ***economic dialogue***. Other stakeholders, among which social partners, shall also be involved where appropriate **(New Art. 2-a, 4.)**.

d. Improving the European Semester

Following its revamping in 2015, the proclamation of the European Pillar of Social Rights in 2017 and of the European Green Deal in 2019, the European Semester has been improved in four notable areas:

- ***Country reports (CRs)*** analysing the economic policies of EU Member States and the euro area as a whole are released three months earlier in the process, in late February. They also include an evaluation of progress made by Member States in addressing prior year country-specific recommendations (CSRs), and in-depth reviews for all EU Member States identified as experiencing excessive macroeconomic imbalances.
- Fewer and more targeted ***country-specific recommendations (CSRs)***. Their focus is further in line with the priorities set out in the Annual Sustainable Growth Strategy.

26 Country-Specific Recommendations (CSRs) have different legal bases that make each of them more or less binding. They can be based on Article 126, (8), (9), (11) and (12) of the TFEU (fiscal policy), Article 121, (4) of the TFEU (economic policy), Article 148, (4) of the TFEU (employment policy) or Article 6, 7, 8 and 10 of Regulation (EU) No 1176/2011 (macroeconomic imbalances).

- There is now ***a monitoring of social trends***[27] ***and of the Sustainable Development Goals (SDGs)*** across the EU which feeds into the European Commission's Country Reports (CRs) and Country-Specific Recommendations (CSRs). Instead of the usual Annual Growth Survey, an Annual Sustainable Growth Strategy (ASGS) giving a greater role to sustainability and social inclusion was published in 2020.

- ***Improved European Parliament involvement.*** Among others, a plenary debate discussed the key EU economic priorities ahead of the adoption of the Annual Sustainable Growth Strategy (ex-Annual Growth Survey).

27 The European Pillar of Social Rights is accompanied by a 'social scoreboard' which monitors the implementation of the Pillar by tracking trends and performances across EU countries in 12 areas and feeds into the European Semester.

Part II - The navigation

I. Keep EU fiscal rules frozen

To respond to the Covid-19 pandemic, **the European Commission** proposed **in March 2020 to activate the general escape clause** to allow temporary departures from the budgetary constraints that normally apply under the European fiscal framework.[28] The economics and finance ministers of the EU Member States (ECOFIN) accepted on 23 March to activate the clause.

Under this clause, Member States are allowed to **temporarily deviate from the adjustment path towards their medium-term budgetary objective** – provided that this does not endanger fiscal sustainability in the medium term (Articles 5 and 6.3 of Regulation (EC) 1466/97).

Meanwhile, **the activation of the general escape clause does not mean that a Member State cannot be subject to an excessive deficit procedure (EDP)** (see box 1) – as illustrated by the Romanian case.[29] The clause states that the Commission may recommend to the Council to grant an extension for the correction of the excessive deficit to Member States concerned by an excessive deficit procedure (Article 3.5 of Regulation (EC) 1467/97), but it has no obligation to do so.

At the time of writing, a debate has started taking place on when to deactivate the escape clause. While a supportive fiscal stance will likely still be needed in 2022, Member States need clarity to prepare their draft budgetary plans for 2022.[30] The European Commission has indicated that it will **reassess the situation in spring 2021**, taking account of updated forecasts, and evaluate the application of the general escape clause.[31] Similarly to March 2020, the Commission will likely seek endorsement of finance ministers.

Considering current debt and deficit levels – an estimated aggregate government deficit of 6.4% of GDP in 2021 and 4.7% in 2022 – **an early reactivation of the rules could lead to the launch of a wave of Excessive Deficit Procedures** among Member States and lead to unrealistically high cuts in spending that could break the recovery because of an excessive debt-reduction benchmark.

- ➜ At the least, the European Commission and the Economic and Financial Affairs Council (ECOFIN) should delay the reactivation of these rules until **the EU has returned to its pre-crisis level** measured by GDP per capita or employment. In case of early reactivation, then both the Commission and ECOFIN should seek to maintain Member States under the preventive arm of the Stability and Growth Pact.

- ➜ Considering their flaws, a reactivation of the rules should only take place when agreement occurs on a meaningful reform of the European Economic Governance.[32]

28 The Stability and Growth ˙Pact (SGP) contains two escape clauses allowing Member States to deviate from the european fiscal rules in the face of exceptional circumstances: the 'unusual events clause' and the 'general escape clause'. They are embedded in Articles 5.1, 6.3, 9.1 and 10.3 of Regulation (EC) 1466/97 and Articles 3.5 and 5.2 of Regulation (EC) 1467/97 – the SGP's respective preventive and corrective arms.

29 The Commission and the Council decided to open an EDP against Romania in March 2020 considering that the excessive deficit was structural and anterior to the Covide-19 pandemic. Source: " The Commission, [...], is of the opinion that an excessive deficit exists in Romania due to non-compliance with the deficit criterion.", Commission opinion 4 March 2020; "Romania should put an end to the present excessive deficit situation by 2022 at the latest.", Council recommendation of 3 April 2020; "The Excessive Deficit Procedure (EDP) is based on the breach [...] caused by expansionary measures enacted in recent years. Even before the impact of the Covid-19 pandemic, the deficit was projected to further increase significantly in 2020…" Letter to Romania, 6 April 2020.

30 Member States have to prepare their draft budgetary plans for 2022, to be submitted by mid-October 2021 to the Commission and Council.

31 European Commission, "Communication on the 2021 Draft Budgetary Plans: Overall Assessment", 18 November 2020, p.4

32 MARTIN, P., RAGOT, X., "When and how to deactivate the SGP general escape clause?", IPOL, In-depth analysis requested by the ECON committee, January 2021.

Box 1 - The Excessive Deficit Procedure (EDP)

The Excessive Deficit Procedure (EDP) is launched when a Member State either breaches – or is at risk of breaching – the 3% deficit-to-GDP threshold, or violates the debt rule by having a government debt level above 60% of GDP that fails to diminish at a satisfactory pace.[33] Countries subject to the procedure are given a deadline of three to six months to comply with recommendations.

Since the 2011 reforms, the imposition of most sanctions under the EDP are semi-automatic as they are done under the reverse qualified majority voting (RQMV) – whereby a qualified majority of Member States is needed to reject a Commission proposal for a Council decision.

II. Reforming fiscal rules

The question is how best reform this web of complex rules. Finance Watch argues there are three main ways to address these questions:

a. Tweaking Stability and Growth Pact interpretative guidance

The Code of Conduct of the Stability and Growth Pact (2017) specifies some aspects of pact implementation such as **the commonly agreed position on flexibility**. It provides, for example, guidance on the application of the investment clause (as set out in Articles 5.1 and 9.1 of Regulation (EC) 1466/97), but also on the structural reform clause and cyclical flexibilities. Among others, some tweaks to this Code of Conduct could allow to improve:

- **The investment clause** (2011) which suffered unnecessarily restrictive conditions that, if lifted, could provide for more flexibility for public investment.[34]
- **The escape clauses' procedures** that could be further clarified.

Meantime, the Code only provides guidance on existing legislation. There is a pressing need to fix the main flaws in the EU fiscal framework if the European Union is to be able to face its 21st century challenges. **This will require at least a reform of the Stability and Growth Pact, and ideally a reform of EU treaties** as outlined below.

b. Short-term action: Reforming the Stability and Growth Pact

Similarly to what was done in 2005 and 2011, fixing flaws will require amending both arms of the Stability and Growth Pact – the Regulation (EC) No 1466/97 and Regulation (EC) No 1467/97. According to Article 121.6 TFEU[35], **the Ordinary Legislative Procedure** is the rule-making process applying to multilateral fiscal surveillance (see box 2).

In theory, the European Parliament could request the European Commission to submit a proposal to reform the EU fiscal framework, as stated under Article 225 TFEU. In reality, reforms historically have followed crises, long debates

33 According to the debt reduction benchmark, the gap between a country's debt level and the 60% reference needs to be reduced by 1/20th annually (on average over three years).

34 "The condition that a Member State must be experiencing bad economic times to benefit from the investment clause limited its use significantly. The need to respect the safety margin vis-à-vis the 3% deficit ceiling for three years has also proven constraining for some Member States." in: EC, "Communication on the review of the flexibility under the Stability and Growth Pact", 23 May 2018, p. 3.

35 Art 121(6): "The European Parliament and the Council, acting by means of regulations in accordance with the ordinary legislative procedure, may adopt detailed rules for the multilateral surveillance procedure referred to in paragraphs 3 and 4."

and a **high-level political agreement** among Member States prior to any legislative proposal by the Commission.[36]

The European Commission has launched a **public consultation on** ***the review of the EU economic governance***, which covers the fiscal framework, macroeconomic framework and socio-economic coordination and was foreseen to run from February to June 2020.[37] Meanwhile, with the change of debate parameters brought by the Covid crisis, **the process has been put on hold until further notice.**

Considering the high debt levels, rock-bottom interest rates and little inflationary pressures for core goods and services, many components of the fiscal framework could be reformed to allow for a stronger and more sustainable European Union, among which:

- **The debt-reduction benchmark** (2011) that requires Member States with debt levels beyond 60% of GDP to reduce annually 1/20 of that excess value. It should be reformed to avoid thwarting the recovery.[38]
- **The investment clause** (2011) that could be further improved by relaxing the conditionality, and be turned into a 'sustainable investment clause' by favoring necessary sustainable and strategic growth enhancing public investment.
- **The stability and convergence programme** (1997, 2005, 2011) **and** ***draft budgetary plans*** (2011) that could be required to include a tracking of the quality of public spending, allowing for more transparency, comparability and public accountability on the sustainability of public spending. It could open the door for minimum standards for the quality of public spending.
- **The European Semester** (2011) that could be reformed to not only monitor the SDGs, but prioritise related investment and reforms.
- **The expenditure benchmark** (2011) that could take the central role in the assessment of medium-term budgetary objectives (MTO).
- **Economic partnership programme** (2013) that could be required to be better balanced towards growth-enhancing sustainable investment.

Finance Watch will release its own proposal in a forthcoming report.

36 As illustration, the Six-Pack (2011) was largely pre-cooked by the Task force on economic governance composed of the European Commission, the Member States and the European Central Bank, before being submitted to the European Parliamentto be negotiated under the ordinary legislative procedure.

37 Its legal basis stems from the planned one-off review of the suitability of the Directive 2011/85 establishing minimum requirements for national fiscal frameworks. While the European Commission is also entitled to periodically assess the Six-Pack and Two-Pack, it has used this opportunity to expand the discussion on the suitability of the entire EU economic governance framework

38 "For Italy currently, that would imply bringing debt levels down by an unrealistic and hard-to-enforce three percentage points of GDP per year.» in: WIESER, T., "The post-coronavirus fiscal policy questions Europe must answer", Bruegel Blog, 3 February 2021

Box 2 - Ordinary Legislative Procedure

Under the Treaty of Lisbon, codecision officially became the "Ordinary Legislative Procedure" (OLP) and the general rule for passing legislation at EU level, now covering the vast majority of areas of Union action. While the European Parliament (EP) was initially only consulted for matters related to the European Economic Governance, the Lisbon treaty strengthened the European Parliament's position by making the OLP the decision-making rule for **multilateral surveillance procedures** (Article 121.6 TFEU) and to adopt **specific measures for the euro area members** (Article 136 TFEU).

The main characteristic of the Ordinary Legislative Procedure, as laid down in Article 294 TFEU, is the adoption of legislation jointly, and on an equal footing, by Parliament and Council. It starts with a legislative proposal from the Commission – a regulation, a directive or a decision – and consists of up to three readings, with the possibility for the co-legislators to agree on a joint text, and thereby conclude the procedure at any reading[39]. These agreements are reached through interinstitutional negotiations that generally take the form of tripartite meetings ('trilogues') between Parliament, Council and Commission.

c. Long-run: Reform the European Treaties

While many components of the European Economic Governance are in secondary legislation that can be amended via the Ordinary Legislative Procedure, fundamental features are embedded in the European Treaties and therefore require a reform of the treaty (see Box 2) to be modified or removed. This is, for instance, the case for:

- **The 3% deficit-to-GDP and 60% debt-to-GDP** reference values (Protocol No.12) that could be scrapped or relaxed as they lack economic rationale.
- **The foundation of the fiscal and socio-economic pillars** (Articles 121, 126 and 148 TFEU) that could better integrate the sustainability imperative.

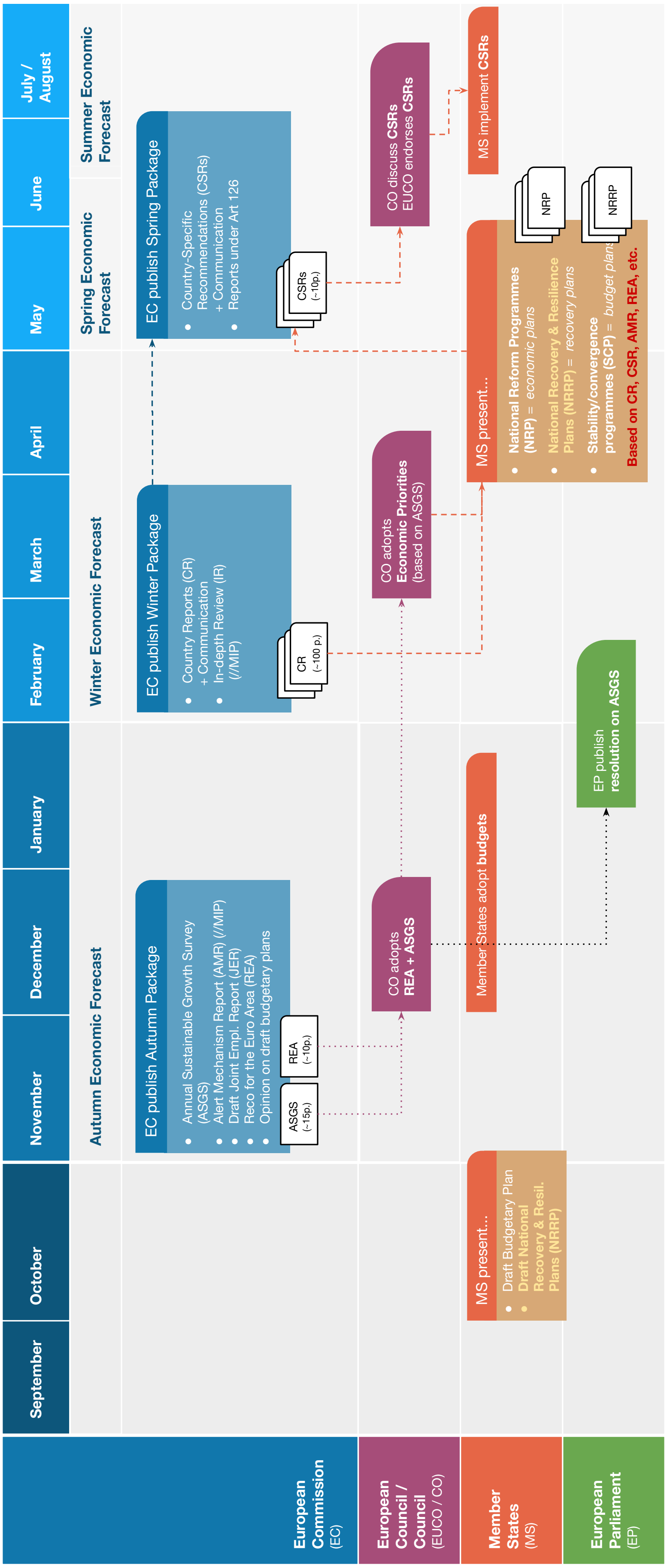
Aligned with the ordinary revision procedure (cf. box 3), the Conference on the Future of Europe could theoretically be a first step in the direction of a reform of the Treaties. However, some Member States have already stated that treaty reform fell outside the Conference scope.

Box 3 - Treaty reform

Treaty revision is governed by Article 48 of the Treaty on European Union (TEU), which provides for two main revision procedures: the ordinary and simplified. Whilst both procedures require a **unanimous agreement** among Heads of EU Member States or governments followed by **national approval**, the ordinary revision procedure requires **the organisation of an intergovernmental conference** – the so-called "Convention". In both cases, the initiative to amend the Treaties may come from the Commission, the Parliament or a Member State.

39 For more information: EP, "Overview of the Ordinary Legislative Procedure".

Annex 1 - The European Semester's timeline



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ANNEX 1

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About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org

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