Finance Watch

Breaking The Stalemate

Upgrading EU economic governance for the challenges ahead

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Stalemate; noun.:

A disagreement or a situation in a competition in which neither side is able to win or make any progress;

(In chess) a situation in which a player cannot successfully move any of their pieces and the game ends without a winner.

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Introduction

Europe faces serious economic, environmental, and social challenges. Climate change, biodiversity loss, the health crisis, and the related economic crisis have rightly grabbed headlines over the past three years. At the same time, Europe is wrestling with concerns over economic and digital sovereignty, decaying infrastructure, unemployment, and social inequality in an ageing population.

Addressing these challenges calls for reform and significant public and private investment. Estimates of what is needed to bridge funding gaps are daunting: *€520 billion* a year until 2030 to meet EU environmental objectives, *€142 billion* a year for social infrastructure such as hospitals and schools, along with *€190 billion* a year to stabilise the stock of public capital – such as publicly-owned roads, buildings, bridges and ports.[1]

Many calls have been made over the past decade for private finance to fill these gaps, as the world bathes in abundant liquidity and private capital. Although these calls appear logical, funding gaps remain precisely because the private sector has little appetite to finance these investments, which are marked by low profitability or high risk. Another factor contributing to the funding gap falls closer to home, as financing is often needed for projects managed by financially-constrained public authorities or households.

Europe needs to update its view of the role played by the public sector and move beyond the 90s vision of economic governance. To tackle the challenges facing Europe better regulation is needed. But evidence also points to the need for better economic and fiscal policies to shape (new) markets, change incentives, and catalyse significant amounts of private capital towards EU's objectives and global commitments such as the sustainable development goals. As it stands EU governments remain constrained by the European economic governance framework – *a maze of rules* built over 30 years on *questionable assumptions* about public debt and the role of the state.

This economic governance framework earns its fair share of criticism. The core of this three-pillar system[2], the *European fiscal framework*, has been criticised along four main lines. First, focus on arbitrary numerical fiscal limits overshadows country-specific drivers of debt unsustainability. Second, one-size-fits-all debt reduction rules incentivise undifferentiated reductions in public spending without sufficient regard for the euro area needs and fiscal stance[3], or spending quality – with public investment as collateral damage.[4] Third, the desire to codify every situation possible made the framework grow increasingly complex. Lastly, overreliance on *unobservable variables* leads to pro-cyclical policies and reduces the credibility of the framework.

European economic governance was created for a completely different macroeconomic environment. In the 1990s debt servicing costs were a significant part of Member States budgets, accounting for 3,5-11% of GDP, as governments struggled with high inflation and high long-term sovereign interest rates (7-25%).[5] In this context, creating binding numerical fiscal limits was per-

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

2 The three pillars are: fiscal surveillance (Pillar I), macroeconomic surveillance (Pillar II) and socio-economic coordination (Pillar III).

3 Abiding by this rule would require the euro area to maintain an annual fiscal surplus of 1.1% of GDP over 20 years – a level that would halt the recovery and lower many countries' GDPs over the long run, therefore increasing their debt-to-GDP ratio.

4 In 2019, net public investment was negative in Spain, Italy, Portugal, Greece and Cyprus, whilst it remained very low in core member states – Germany, France, Belgium, the Netherlands.

5 Source: *AMECO*

ceived as a necessity to ensure that Member States could continue to service their debt – therefore limiting contagion risks inside the euro area – without assistance or bailout by other members or by the European Central Bank.[6]

The time has come for Europe to upgrade its economic governance framework. Thirty years after Maastricht rules first came into force, the same European countries have experienced a prolonged period of deflation risks – only recently eclipsed by temporary supply-induced inflation peaks[7] – and a continuous fall in long-term interest rates to a historically low level of 0-3%.[8] This has resulted in debt servicing costs as low as 0-3% of GDP[9] despite higher stocks of public debt. In other words: servicing public debt has never cost so little to European governments. With negative interest-growth differentials expected to last for the foreseeable future[10], most governments are able to sustain a much higher level of debt-to-GDP. Many calls have therefore been made to allow more leeway for qualitative public expenditures aimed at tackling Europe's challenges.

After a first attempt was interrupted by the Covid crisis, in October 2021 the European Commission relaunched its *public debate on the review of the European economic governance* framework. Meanwhile, EU Member States remain divided on the need for reform and on which road to follow. The Finance Watch answer to the Commission's consultation outlines 13 reform proposals to move beyond this stalemate and upgrade the framework to make it fit for our time.

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6 In addition to the EU fiscal rules, policymakers originally engineered market discipline as a force for fiscal prudence in the euro area. This was achieved by barring the way to a lender of last resort for sovereign issuers in the European Treaties – the monetary financing prohibition (art 123 TFEU) and the 'no bailout clause' (art 125 TFEU). The financial and recent health crises have shown that a different approach is needed. The first step towards this was the institutionalisation of the European Stability Mechanism (ESM) as a limited and conditional lender of last resort to sovereigns: the euro debt crisis crudely illustrated that the absence of such a lender creates higher risks of sovereign default. The second step was the progressive transformation of the ECB into a guardian of "favourable financing conditions" for sovereigns as sharp increases in yield spreads at the onset of the Covid crisis reinforced the case for more flexible and decisive actions.

7 On the temporary nature of current inflation, see: SUTTOR-SOREL, L., "*Fiscal Mythology Unmasked*", Finance Watch, July 2021, p.9-10; ODENDAHL, C., "*Europe shouldn't worry about inflation*", CER, July 2021, 11p.

8 Risk premia have decreased sharply thanks to the establishment of the European Stability Mechanism as a (limited and conditional) lender of last resort for sovereigns, and of the European Central Bank's 'Outright Monetary Transactions' (OMT) program. But the lasting fall in sovereign interest rates in advanced economies is not only conjunctural or related to accomodative monetary policy, it also has structural roots, among which: (i) economic growth lower than during previous periods, (ii) increased savings due to an ageing population, (iii) income growth in emerging economies, and (iv) an unmet uptick in demand for safe assets such as sovereign bonds due to a surge in risk aversion in the aftermath of the global financial crisis. All these structural and long-term factors play an important role in explaining why the multi-decade decline in sovereign interest rates should not be expected to be easily reversed. More in: SUTTOR-SOREL, L., "*Fiscal Mythology Unmasked*", Finance Watch, July 2021

9 Source: *AMECO*

10 See: BLANCHARD, O., "*Public debt and low interest rates*", American economic review, Vol.109, n°4, April 2019; BUCHNER, M., "*Fiscal policy in an age of secular stagnation*", Comparative Economic Studies, 2020, 62: 398-429; EUROPEAN COMMISSION, "*Debt Sustainability Monitor 2020*", Institutional Paper 143, February 2021, p.38.

Key proposals

A. Debt rules upgraded for the 21st century

Fiscal rules aimed at ensuring debt sustainability are a legitimate feature of a monetary union. However, focusing on non-evidence based debt-to-GDP thresholds to gauge debt sustainability overlooks broader country-specific drivers of debt unsustainability and emerging fiscal risks. Furthermore, current debt-reduction rules are unrealistic. Abiding by these rules would require the euro area to maintain an annual fiscal surplus of 1.1% of GDP over 20 years – a level that would halt the recovery and lower many countries' GDPs over the long run therefore increasing their debt-to-GDP ratio.

In a context of historically low debt servicing costs, high investment needs, and growing fiscal risks, Finance Watch calls for the following key upgrades to the EU economic governance framework:

1. ARBITRARY DEBT ANCHOR

Move the **arbitrary debt limit from 60 to 100% debt-to-GDP**[1], and **reform its scope of application** to cover only the share of the debt stock exposed to market scrutiny – i.e. the debt stock net of debt held by the Eurosystem and the European Stability Mechanism. Additionally, this arbitrary limit should become **a long-term debt anchor** that can be reached at different paces.

2. DEBT REDUCTION RULES

Replace impracticable one-size-fits-all debt reduction rules with **country-specific debt pathways** built on **country-specific debt sustainability analyses**. Moving beyond arbitrary debt-to-GDP ratio to gauge debt sustainability, these analyses would account for **country-specific drivers of debt unsustainability**. These drivers include the evolution of interest payment-to-GDP ratios, interest-growth differentials, share of short-term debt and foreign-held debt in the total debt stock, its average maturity, and the building up of fiscal risks.

3. ENHANCED GOVERNANCE

Improve the mandate and expand the tasks of **Independent Fiscal Institutions (IFIs)**. A particular emphasis should be put on producing **country-specific debt sustainability analyses, fiscal risks analyses**, and **monitoring spending quality** – e.g. green budgeting. Crucially, IFI governance arrangements must ensure a **balanced composition** and account for **minority views**.

4. EMERGING FISCAL RISKS

Better understand and monitor **climate-related fiscal risks** – i.e. the impact that underinvesting in climate change mitigation and adaptation will have on public budgets. IFIs of the United Kingdom and Ireland have started to estimate these fiscal risks.[2]

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1 Whilst the macroeconomic environment has changed in 30 years, pragmatic calls have been made to move to a 90% or 100% debt-to-GDP reference value. Meanwhile, reforming this reference value might prove difficult as it requires unanimity in the Council. See: ESM, "*EU fiscal rules: reform considerations*", 2021; DULLIEN, S., et al, "*Proposals for a reform of the EU's fiscal rules and economic governance*", 2020; DULLIEN, S., et al. "*Between high ambition and pragmatism: Proposals for a reform of fiscal rules without treaty change*", EESC, 2021, 48p.

2 The Office for Budget Responsibility recently estimated that climate change could add between 21 and 45 per cent of GDP to the UK's public debt by 2050 (i.e. climate-related fiscal risks). In: Office for Budget Responsibility,"*Fiscal risks report*", July 2021, 242p.

B. Future-oriented framework

The European fiscal framework's focus on numerical limits incents undifferentiated reduction of public spending with insufficient regard for context, euro area needs and fiscal stance, and spending quality – with public investment as collateral damage. This proves problematic in the presence of growing economic, environmental and societal challenges and daunting funding gaps. Failing to address these challenges via adequate reforms and investments could leave future generations worse off and negatively impact long-term debt sustainability. Therefore, we recommend to:

5. MULTIANNUAL NATIONAL PLANS

Merge economic reforms and fiscal plans that the Member States submit as part of the European Semester[3] into multiannual **National Reform and Investment Plans (NRIPs)** that have to align with **EU priorities, country-specific debt pathways and recommendations (CSRs)**. The latters should be formulated in a way that allows to measure progress towards targeted EU objectives.

6. OPERATIONAL RULE

Move from two deficit rules to **a unique expenditure rule** that caps expenditures net of interest, one-off and cyclical expenditures, **net investment** (up to a certain threshold), and certain categories of **future-oriented expenditures**. To address concerns that any mechanism of exclusion of some categories of spending could create negative incentives to circumvent the rules, we suggest the following:

7. FUTURE-ORIENTED

Allow newly-formed governments to submit, as part of their NRIPs, **a list of future-oriented expenditures[1] to be excluded** from their expenditure ceilings. The decision to exclude some spending from a Member State's expenditure ceiling should be part of a broader process of **technical assessment** by the Commission (e.g. respect of the do-no-significant-harm principle, quality, EU objectives, conditionality) and **political validation** by the Council.

8. SPENDING QUALITY

Require Member States, supported by their IFIs, to **assess and disclose spending quality**[2] as part of their NRIPs. 'Greening' national budgets being an important part of the transition to a sustainable economy, such disclosure should assess the **impact of public expenditure on the six environmental objectives** as laid down in the European Taxonomy.

Fix bias against public investment by **aligning public accounting with corporate standards**: create separate accounts for current and for capital expenditures and **spread investment cost** over the investment lifetime.

9. EU FISCAL CAPACITY

Create an **EU fiscal stabilisation capacity** activated alongside the general escape clause and a **EU permanent investment facility** for important projects of common European interest. This would reinforce the **international role of the euro** and reduce the **global shortage of safe assets**.[4]

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1 Future-oriented expenditures cover categories such as public investment, green expenditures, and productive social expenditures such as spending on education (i.e. investment in human capital) and healthcare – both associated with a positive impact on GDP growth.

2 Understood as the effective contribution of an expenditure item to a policy goal - e.g. the European Green Deal, EUropean industrial policy.

3 i.e. respectively National Reform Plans and Stability or Convergence Programmes.

4 A shortage of safe assets as collateral constrains firms' borrowing capacity and, therefore, has significant implications for economic development.

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Question 1 | Improving the framework

How can the framework be improved to ensure sustainable public finances in all Member States and to help eliminate existing macroeconomic imbalances and avoid new ones arising?

Public finance can become unsustainable because of excess decrease in public revenue or excess increase in public spending, and/or negative debt dynamics. Whilst changes in key macroeconomic variables – such as interest, inflation, and growth rates – can directly impact the debt dynamics by creating negative snowball effects, most large budget deficits are the result of financial, economic, or environmental crises that increase spending needs whilst often lowering public revenues.[11]

Considering this complex reality and a new macroeconomic environment of historically low interest rates and negative interest-growth differential, ensuring sustainable public finance and macroeconomic stability calls for a number of changes:

- **Reform 1 Move the arbitrary debt anchor from 60 to 90 or 100% debt-to-GDP, and reform its scope of application.** Whilst the 'debt-to-GDP' ratio **lacks economic sense** and suffers from **important conceptual flaws**[12], there is additionally a large consensus that the limit of 60% debt-to-GDP value defined 30 years ago is **arbitrary** and **not adapted** to current macroeconomic realities.[13]

  As a second best approach that will give breathing space to fiscal policy, Finance Watch supports the pragmatic calls that have been made to **move to a 90% or 100% debt-to-GDP** reference value[14] and to make it **a long term debt anchor**.

  Simultaneously, this arbitrary debt-to-GDP value should see its scope of application reformed to **only cover the share of the debt stock exposed to market scrutiny** – i.e. the debt stock net of debt held by the Eurosystem (ECB) and the European Stability Mechanism.

- **Reform 2 Increase the role of country-specific debt sustainability analyses.** The EU fiscal framework overly relies on one-size-fits-all arbitrary debt-to-GDP threshold[15] to gauge

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11 Over the period 1995-2021, the average change in debt observed over a five-year time horizon from the onset of an economic crisis is 20% debt-to-GDP for the Euro area, with a maximum recorded at 61% debt-to-GDP for Spain. In: ALLOZA, M., ANDRES, J., BURRIEL, P., et al., "*The reform of the European union's fiscal governance framework in a new macroeconomic environment*", Banco de Espana, Documentos Ocasionales n° 2121, 2021, 38p., p.23.; Financial crises have led to a maximum cost of 56,8% debt-to-GDP and environmental disaster 6% debt-to-GDP - expected to grow in the future as the climate situation worsens. In: BOVA, E., RUIZ-ARRANZ, M., et al., "*The fiscal costs of contingent liabilities: A new dataset*", IMF Working Paper, January 2016, 55p., p.13.

12 Such as non-commensurability and time-inconsistency. See more in: SUTTOR-SOREL, L., "*Fiscal Mythology Unmasked*", Finance Watch, 2021, p.22.

13 The quantitative limits of the Maastricht Treaty were defined taking into account, approximately, the average of the EU Member States debt levels and the average economic situation at the end of the 1990s. Assuming potential growth of 2% and an inflation target of 2%, a budget deficit limit of 3% of GDP would stabilise the ratio of government debt to GDP at 60%.

14 Whilst the macroeconomic environment has changed in 30 years, proposals have been made to apply similar methodology to today's parameters. For more details, see: ESM, "*EU fiscal rules: reform considerations*", 2021; DULLIEN, S., et al, "*Proposals for a reform of the EU's fiscal rules and economic governance*", 2020. Meanwhile, reforming this reference value might prove difficult as it requires unanimity in the Council. For an in-depth economic and legal analysis, see: DULLIEN, S., et al. "*Between high ambition and pragmatism: Proposals for a reform of fiscal rules without treaty change*", EESC, 2021, 48p.

15 The quantitative limits of the Maastricht Treaty were defined taking into account, approximately, the average economic situation at the end of the 1990s. Assuming potential growth of 2% and an inflation target of 2%, a budget deficit limit of 3% of GDP would stabilise the ratio of government debt to GDP at 60% - which was approximately the average debt-to-GDP ratio of the EU member states in 1990. "With the same procedure, a reference value of 70 per cent could be calculated for 2000, of 86 per cent for 2010 and 101 per cent for 2020." In: BOFINGER, P., "Easing the EU fiscal straitjacket", December 2020, Social Europe.

debt sustainability, **overlooking country-specific drivers of debt unsustainability**.[16] Those drivers include: the evolution of interest payment-to-GDP, gross financing need-to-GDP, interest-growth differential (r/g), share of short-term debt and foreign held debt on total debt stock, average maturity of the debt stock, and the building up of fiscal risks. Crucially, **climate-related fiscal risks** – i.e. the impact that climate change will have on public budgets – need to be better understood and monitored.[17]

Fixing this lack of relevance and detail commands to give a more prominent role to **country-specific debt sustainability analysis (DSA)**[18] in the European fiscal framework[19] – see question 7.

- **Reform 3** **Replace impracticable debt reduction rules with country-specific debt pathways.** Introduced in 2011, the **debt-reduction benchmark** requires countries to reach the 60% debt-to-GDP value over twenty years. To comply with this rule, the euro area would need to maintain an annual **fiscal surplus of 1.1% of GDP over 20 years** – a level that would break the recovery and lower many countries' GDPs over the long run therefore increasing their debt-to-GDP ratio.

  Acknowledging that the sustainable level of government debt hinges on each sovereign's macroeconomic fundamentals, **country-specific debt sustainability analyses** should become the basis of **country-specific debt pathways** that would feed into governments' fiscal plans. Crucially, these pathways are not only about reducing debt stock, but can be about extending stock maturity, reducing share of external debt, or expanding debt stock to fund growth-enhancing or risks-lowering expenditures.

- **Reform 4** **Improve the Macroeconomic Imbalances Procedure.** The MIP scoreboard should be improved by:

  (1) **Replacing the government debt indicator by a new "debt sustainability" section** covering the aforementioned indicators. This would allow **more granularity about drivers of debt unsustainability**.[20] Prudential thresholds that would trigger an in-depth review if exceeded can be deducted from the extensive literature discussing these dimensions and indicators.

  (2) **Adding indicators related to environmental pressures**. Whilst the European Semester should be used to steer and assess progress – see question 6 –, including environmental

16 For recent analysis of debt sustainability determinants refer to: e.g. SUTTOR-SOREL, L., "*Fiscal Mythology Unmasked. Debunking Eight tales about European public debt and fiscal rules*", Finance Watch, July 2021, p.7-8; BLANCHARD, O., LEANDRO, A. ZETTELMEYER, J., "*Redesigning the EU Fiscal Rules: From Rules to Standards*", October 2020; FURMAN, J, SUMMERS, L, "A Reconsideration of Fiscal Policy in the Era of Low Interest Rates", November 2020.

17 As an illustration, the Office for Budget Responsibility recently estimated that climate change could add between 21 and 45 per cent of GDP to the UK's public debt by 2050 (i.e. climate-related fiscal risks). In: Office for Budget Responsibility,"*Fiscal risks report*", July 2021, 242p.

18 Common practice of the International Monetary Fund (IMF), national Independent Fiscal Institutions (IFIs), and the European Commission, DSA take into account a larger set of debt unsustainability drivers. For more information, see: IMF, "*Review of the debt sustainability framework for market access countries*", IMF policy paper, January 2021, 124p.; GORDO, E., CASEY, E., et al., "*The role of the Independent Fiscal Institutions in assessing the sustainability of high public debt in the post-Covid era*", EU IFIs contribution to the EFB annual conference, February 2021, 27p.; The European Commission produces DSA for Member States requesting ESM financial assistance - Art.6, Regulation (EU) No 472/2013. The Commission also produces the annual *Debt Sustainability Monitor*.

19 The former IMF's chief economist, Olivier Blanchard, has also proposed to give to DSA a more prominent role in the fiscal framework: BLANCHARD, O., LEANDRO, A. ZETTELMEYER, J., "*Redesigning the EU Fiscal Rules: From Rules to Standards*", October 2020, Presented at the 72nd Economic Policy Panel Meeting, 27p.

20 As part of the Macroeconomic Imbalance Procedure (MIP), trends that could lead to macroeconomic imbalances are monitored via 14 headline indicators and 25 auxiliary indicators organised around three dimensions — external imbalances and competitiveness, internal imbalances, and labour market. If we accept, one the one hand, that debt unsustainability is a macroeconomic imbalance and, on the second hand, that it can be monitored via a broader set of indicators more relevant for debt sustainability than the debt-to-GDP ratio, there is a strong rationale to include a new "debt sustainability section" in the Macroeconomic Imbalances Procedure (MIP).

pressure indicators in the MIP would **level the legal playing fields** between economic, fiscal and environmental CSRs[21], and could **force a reflection on trade-offs** that could exist between these dimensions.

(3) **Increasing the focus on the euro area**. The MIP follows a country-by-country approach that pays too little attention to defining, and enforcing, an **appropriate overall fiscal stance for the euro area**.[22]

(4) **Reducing asymmetry** regarding the threshold for the scoreboard indicators.[23]

21 If CSRs related to fiscal and macroeconomic imbalances are more often complied with than social or environmental ones, it is because they have a stronger legal basis (i.e. SGP and MIP) and failing to comply could theoretically lead to sanction. Including environmental objectives and pressures in the MIP could give more legal teeth to related CSRs.

22 See: DULLIEN, S, et al., 2021, Op.cit., p.12; EUROPEAN COMMISSION, “Economic governance revi. Communication”, 2020; etc.

23 For instance, the choice of a -4% of GDP floor for current account deficits but a +6% ceiling for surpluses, or the fact that there is only an upper limit on nominal unit labour cost increases.

Question 2 | Safeguarding sustainability and stabilisation

How to ensure responsible and sustainable fiscal policies that safeguard long-term sustainability, while allowing for short-term stabilisation?

The **first generation of EU fiscal rules** (1992-2005), with its 60% debt-to-GDP limit and the 3% budget deficit cap, was heavily criticised for being procyclical and unable to account for the economic cycle. In theory, the **second generation of EU fiscal rules** (2005, 2011, 2013), with country-specific structural deficit targets, flexibilities, and escape clauses, was supposed to fix this bias and allow for short-term stabilisation. In practice, the new structural deficit rule came on top of the general deficit rule of 3% – not instead of – making the fiscal framework even tighter while bringing a raft of measurement issues.[24] Ensuring sustainable fiscal policies while accounting for new macroeconomic environment (i.e. historically low real interest rates; negative r/g differential) and allowing for better stabilisations in time of crisis calls of **a third generation of EU fiscal rules in an enhanced European fiscal architecture:**

- **Reform 5** **Move from deficit rules to a unique expenditure rule.** Enhanced version of the existing expenditure benchmark[25], the new expenditure rule[26] would aim at **reaching country-specific fiscal targets by capping the growth rate of nominal public expenditure** – net of interest expenditures, cyclical expenditure[27], net public investments (i.e. golden rule – see question 3), and discretionary revenues measures.[28] Building on private accounting best practices, **investment costs will be spread over the investment lifetime**.

  Submitted to the European Commission by each Member State, this expenditure ceiling would revolve around **the medium-term growth of nominal potential GDP** (i.e. the sum of medium-term potential output growth[29] and ECB's inflation target[30]), corrected to attain **a rolling medium-term country-specific debt target** – see questions 6 and 7.

  Expenditure rules promote a better balance between budgetary discipline and macroeconomic stabilisation objectives than deficit rules. Whilst **automatic stabilisers can operate freely** under an expenditure rule, recent evidence shows that such rules are generally associated with

24 The structural deficit is an unobservable variable, of which calculation depends on contested hypotheses. See for example: HEIMBERGER, P., KAPELLER, J., "*Output Gap Nonsense' and the EU's Fiscal Rules*", January 2020; Acknowledging measurement issues, the Commission introduced in 2016 "plausibility tool" allowing for an element of judgement in the application of the fiscal surveillance framework (as pointed by: BUTI, M., CARNOT, N. et al., "*Potential output and EU fiscal surveillance*", September 2019).

25 In 2011, an expenditure benchmark rule was introduced in the preventive arm of the Stability and Growth Pact to complement existing rules.

26 See e.g.: CLAEYS, G., et al, *2016*; BENASSY-QUERE, A., et al., *2018*; EFB *2019*, *2020*, *2021*; DULLIEN, et al., Op.cit, 2020; etc.

27 I.e. exceptional one-off expenditures (such as the repair of public infrastructure after environmental disasters or bank bail-out) and unemployment-related expenditures. We subscribe to the view of CLAEYS et al 2016 that "Excluding all unemployment-related expenditures would not lead to major moral hazard issues, because it is unlikely that a government will adopt measures to increase unemployment just to be able to spend more on unemployment benefits". In: CLAEYS, G, DARVAS, Z., LEANDRO, A., "*A proposal to revive the European Fiscal Framework*", Brugel, Issue 2016/07, 20p.

28 Which means that expenditures above the ceiling would only be allowed for net investments (i.e. golden rule for public investment) or when public revenues are increased.

29 The calculation of the potential output should be improved, notably by being calibrated to target full employment instead of NAIRU. For more development, see the work done by the German think tank Dezernat Zukunft: SCHUSTER, F., KRAHE, M., SIGL-GLÖCKNER, P., LEUSDER, D., "*The cyclical component of the debt brake: analysis and a reform proposal*", 2021, 50p.

30 First proposed by the think tank Bruegel in 2016 (cf. CLAYES, G, DARVAS, Z., LEANDRO, A., "*A proposal to revive the European Fiscal Framework*", 2016, 20p.) the idea to include the 2% inflation target in nominal expenditure rules has been endorsed in November 2021 by Philip R. Lane, Member of the Executive Board of the ECB, in its speech "*The future of the EU fiscal governance framework: a macroeconomic perspective*".

lower pro-cyclicality, lower expenditure volatility, and higher investment efficiency than other fiscal rules.[31] At the same time, they tend to be more transparent and easier to monitor – expenditure and its growth rate are directly observable and are mostly directly controlled by governments.[32] Furthermore, **errors in forecasting potential output growth are marginal** in comparison to errors in output gap estimates needed for the structural deficit rule.[33] That being said, there is **room for improving the calculation of the potential output** – notably by calibrating it to target full employment instead of obscur and contested[34] 'non-accelerating wage rate of unemployment' (NAWRU).[35] In any case, forecasts should be taken with caution as their calculation is by nature uncertain.

- **Reform 6** **Clarify escape clauses' procedures, timing, and conditionality.** Whilst the two existing escape clauses[36] could be merged into a unique escape clause, the review of the rules should bring clarity on **procedure, responsibility, timing, and conditions for (de) activating an escape clause** as well as on the necessity to have **transitional arrangements in place when deactivating the clause**.

- **Reform 7** **Create permanent fiscal capacity at EU level.** Taking stock of what has been achieved with the Recovery and Resilience Facility, **a permanent EU fiscal stabilisation capacity[37] could help avoid mismatches between euro area needs in periods of crises and the fiscal policy of its Member States**. Whilst the possibility to trigger escape clauses in time of crisis theoretically allows Member States to implement countercyclical fiscal policies, some countries can lack the risk-absorbing capacity to implement them whilst others countries with more fiscal room can lack the willingness to compensate by engaging into more countercyclical policy. The activation of the general escape clause could serve as a criterion to call up this countercyclical fiscal capacity – see question 10.

Moving to an expenditure rule, clarifying escape clauses and creating a permanent fiscal stabilisation capacity at the EU level would do a lot to **ensure sustainable fiscal policies that allow for short-term stabilisation**.

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31 "Empirical estimates over the 1999-2016 period confirm that while fiscal policy is indeed procyclical in the EU, the magnitude of the pro-cyclical bias is lower in presence of expenditure rules." in: BELLU MANESCU, C., BOVA, E., "National expenditure rules in the EU. An analysis of effectiveness and compliance", European Commission, DG ECFIN, Discussion Paper 124, 2020, 40p.

32 REUTER, W-H, "*Benefits and drawbacks of an "expenditure rule", as well as of a "golden rule", in the EU fiscal framework*", IPOL, Study requested by the ECON committee, September 2020, 47p., p.11.

33 In the case of the estimation of the potential output growth, "only the growth rates are included in the calculations and not the level of estimated potential output (which is far likely to be revised)." in: DULLIEN, et al., "*Proposals for a reform of the EU's fiscal rules and economic governance*", 2020, IMK Report, 159e., p.11; This can explain why "The revisions of the real-time estimates of the medium-term average potential growth rate (which is used for the expenditure rule) were smaller than the revisions of the change in the structural balance estimates." CLAEYS, G, DARVAS, Z., LEANDRO, A., "*A proposal to revive the European Fiscal Framework*", Brugel, Issue 2016/07, March 2016, 20p.; Experts seems to converge in their opinion that the commonly agreed potential output methodology run by the Commission could be significantly improved (e.g. DARVAS, Z., SIMON, A., "*Filling the gap: open economy considerations for more reliable potential output estimates*", Bruegel Working Paper 2015/11, October 2015.)

34 Illustrating the disaffection for this concept, the Federal Reserve (FED) decided in 2020 to stop relying on the (highly similar) NAIRU as a central indicator and to instead pursue the goal of 'maximum employment'.

35 For more development, see the work done by the German think tank Dezernat Zukunft: SCHUSTER, F., KRAHE, M., SIGL-GLÖCKNER, P., LEUSDER, D., "*The cyclical component of the debt brake: analysis and a reform proposal*", 2021, 50p.

36 The Stability and Growth Pact (SGP) contains two escape clauses allowing Member States to deviate from some provisions of the European fiscal rules in the face of exceptional circumstances: the 'unusual events clause' and the 'general escape clause'. These clauses allow deviation either because an unusual event outside the control of one or more Member States has a major impact on the financial position of the general government, or because the euro area or the Union as a whole faces a severe economic downturn. The general escape clause was activated in March 2020 to allow Member States to respond to the Covid-19 pandemic. Meanwhile, the timing or conditions for its deactivation remained unclear and fostered intense political and technical debate.

37 The *European Fiscal Board*, the *European Central Bank*, and the *International Monetary Fund* and many other institutions, have been arguing for a central fiscal capacity approach to covering a gap in the EU fiscal framework.

Meanwhile, **it will not be sufficient to ensure long-term sustainable public finance if we fail to tackle today and tomorrow's economic, social, and environmental challenges**. As discussed, unresolved challenges can give rise to crises that are the largest sources of budget deficit.

The EU fiscal frameworks should incentivise appropriate precautionary actions by granting to related expenditure and investment a preferential treatment in expenditure rule, and by conditioning this preferential treatment to the fulfillment of commonly agreed targets and related reforms (see question 3).

Question 3 | Incentivising reforms and investments

What is the appropriate role for the EU surveillance framework in incentivising Member States to undertake key reforms and investments needed to help tackle today and tomorrow's economic, social, and environmental challenges while preserving safeguards against risks to debt sustainability?

Europe faces serious economic, environmental and social challenges, and consequences could be important if policymakers fail to ensure funding gaps are bridged. And the projected gaps are daunting: €470 billion a year until 2030 to meet EU environmental objectives[38]; €142 billion a year for social infrastructure such as hospitals or schools[39], along with €190 billion a year to stabilise the stock of public capital.[40]

As the world bathes in abundant liquidity 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.

Considering the need for public finance to step in to bridge these important funding gaps while ensuring debt sustainability, there is therefore a question on how to best **incentivise investment, spending and reform that helps tackle today's and tomorrow's economic, social, and environmental challenges**. Building on previous answer, there is a need to:

- **Reform 8** **Move to unique National Reform and Investment Plans (NRIP).** These plans would integrate and streamline economic reform and fiscal plans that Member States submit as part of the European Semester – i.e. respectively *National Reform Plans and Stability or Convergence Programmes*. These NRIP would have to align with **country-specific debt pathways, challenges and priorities**. This could improve the interplay between economic and fiscal policies while simplifying the European Semester – see question 6.

- **Reform 9** **Incentivise appropriate spending, investment and reform by granting them preferential treatment.** Whilst moving to unique NRIPs could facilitate consistency between expenditures and reforms, **excluding some of the related expenditures from the expenditure ceiling could act as a powerful incentive to actually conduct** these spending, investment, and reforms needed to tackle today and tomorrow's economic, social, and environmental challenges.

  Considering the potential future costs for public budgets from failing to tackle these challenges, **excluding related-spending** would entail a positive impact on long-term debt sustainability and would therefore be **the most fiscally responsible course of action**.

  To address concerns that such a mechanism could create negative incentives to circumvent the rule even further, **the decision to exclude some spending from a Member State's expenditure ceiling could be part of a broader process of technical assessment and political validation** – see reform 11.

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

39 This estimation only covers 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.

40 European Commission, "SWD(2020) 98 final - Identifying Europe's recovery needs", 27.5.2020

- **Reform 10 Improve spending quality by incentivising public investment and improving spending quality disclosures.** The focus on numerical limits incents undifferentiated reduction of government spending without regard for its quality. This lack of differentiation proves problematic. **First, public investment in Europe has significantly declined since the financial crisis** as it is often politically easier to abstain from investing than to cut regular spending – such as for civil servant salaries and social services. Meanwhile, cuts in public investment have a particularly negative impact on economic growth and employment as its multiplier effect is particularly high. **Second, bridging the green funding gap calls for more qualitative green public expenditures**, whatever their growth impact or their classification as investment or expenditure.

  To improve the quality of public spending:

  (1) **Remove existing biases against public investment**. This can be achieved by aligning public accounting with corporate standards: First, create **separate accounts** for current and for capital expenditures (i.e. OpEx and CapEx) and, second, **spread investment cost** over the investment lifetime as part of the expenditure rule (see reform 5).

  (2) **Introduce the golden rule for net public investment**. Considering their positive impact on an economy's growth potential, **net public investment should be automatically excluded from the calculation of the expenditure ceiling**. To strike a right balance between discretion and political concerns that such a mechanism could create negative incentives to circumvent the rules, this golden rule could be limited to a certain percentage of a country's GDP. **Net investment above this threshold would require political validation** by the Council as part of a country's NRIP – see reform 9 and question 6.

  (3) **Require Member States to disclose spending quality** as part of their NRIP. Acknowledging that 'greening' national budgets is an important part of the green transition[41] and building on best practices[42], such disclosure should at least assess the **impact of public expenditure[43] on the six environmental objectives** as laid down in the European Taxonomy.[44]

41 As expressed in the European Commission's Green Deal Communication, "a greater use of green budgeting tools will help to redirect public investment, consumption and taxation to green priorities and away from harmful subsidies"in; European Commission, "*The European Commission Green Deal Communication*", 2019, p.17.

42 For an analysis of recent methodologies, see: BOVA, E., "Green budgeting practices in the EU: a first review", DG ECFIN, Discussion Paper 140, May 2021.

43 There are three approaches to green budgeting: (1) identifying expenditure that has an environmental objective, regardless of its actual impact, and estimating its share of the budget; (2) identifying expenditure that can be expected to contribute positively (or negatively) to the achievement of an environmental objective, but does not measure this contribution, and estimating its share of the budget; (3) assess the actual impact of the expenditure in terms of achieving the environmental objectives. The two first approaches seem insufficient to properly assess quality of spending.

44 These are: climate change mitigation, adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention control, and protection and restoration of biodiversity and ecosystems.

Question 4 | Simplification and more transparent implementation

How can one simplify the EU framework and improve the transparency of its implementation?

First, complexity could be addressed by reducing the number of rules and by simplifying their interpretation. As outlined in question 2, the first proposal is to move from two deficit rules to a unique expenditure rule. The second complementary proposal is to move from an unrealistic and difficult to enforce one-size-fits-all debt-reduction benchmark[45] (and additional flexibilities) to country-specific debt pathways suggested by governments – see questions 1 and 7.

Second, simplifying the European Semester process. As outlined in questions 3 and 6, this could be achieved by streamlining the several economic and fiscal plans in a unique integrated National Reform and Investment Plan (NRIP). To facilitate future evolutions, the European Semester should be disembedded from the Stability of and Growth Pact and have its own regulation.

Lastly, transparency of implementation could be improved by increasing national ownership of compliance with the rules. As discussed in questions 7 and 8, giving a more prominent role to Independent Fiscal Institutions (IFIs) could participate to increase national ownership.

45 Under this “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.

Question 6 | Lessons from the RRF

In what respects can the design, governance and operation of the RRF provide useful insights in terms of economic governance through improved ownership, mutual trust, enforcement and interplay between the economic and fiscal dimensions?

Four lessons can be drawn from the Recovery and Resilience Facility (RRF) experience. First, **integrating spending and reforms in a unique plan increases consistency** between economic and fiscal policy. Second, national ownership and enforcement are reinforced by a system of governance where **Member States submit integrated plans** and interact with the European Commission to improve these plans. Third, Member States accept such a demanding process when it is **linked to an access to more fiscal capacity (i.e. positive incentive)**. Fourth, the legitimacy of these integrated plans is reinforced by the **involvement of national parliament and stakeholders in the planning process**.

Building on these key lessons:

- **Reform 11** **Improve and simplify the European Semester.** Whilst the European Semester should be disembedded from the Stability and Growth Pact and **have its own dedicated regulation** to facilitate future evolutions, we believe that this mechanism of coordination should be reformed along the following lines:

  (1) **Improve Member States coordination towards achieving EU's objectives** (e.g. European Green Deal, EU pillars of social rights, EU industrial policy), global commitments such as the **UN 2030 Agenda for Sustainable Development** as well as overarching goals given by the treaties (e.g. convergence within the EU and well-being of its peoples). Significant economic and fiscal involvement being a prerequisite for success, the European Semester should be used to assess progress towards the achievement of targets by each Member State and to **tailor CSRs according to the distance to the target**.[46]

  (2) **Improve country-specific recommendations (CSRs)**. Fiscal and macroeconomic surveillance frameworks have been built to monitor and control externalities that can exist in a monetary union – such as contagion risks, lack of aggregate demand, and environmental externalities.[47] As part of the European Semester, the European Commission issues **country-specific recommendations (CSRs) aimed at steering Member States economic and budgetary plans in order to reduce these externalities and attain EU objectives** – arguably with limited success.[48]

  To improve relevance and compliance, CSRs should (i) better account for **EU objectives and EMU dimensions** (e.g. euro area fiscal stance, spillovers, externalities), (ii) be associated with **specific indicators**, (iii) formulated in a way that makes progress

46 CHARVERIAT, C., BODIN, E., "*Delivering the Green Deal. The role of a reformed European Semester within a new sustainable economy strategy*", IEEP, 2021, 26p., p.21.

47 The main ones are contagion risks (i.e. collateral damage of a Member State's insolvency upon other members), aggregate demand (e.g. overly restrictive fiscal policy result in a suboptimal level of economic activity in partners' economy; inadequate wages leading to excessive trade imbalances), and environmental externalities (i.e. a lack of action in one Member State can impact the environment of other members).

48 While most of these recommendations are politically but not legally binding, they appear to be only followed when they fit the agenda of the Member State's ruling party. A very clear explanation is that country-specific recommendations (CSRs) are underpinned by various surveillance and coordination instruments with different legal bases: the Stability and Growth Pact (SGP), the Macroeconomic Imbalance Procedure (MIP) and the employment policy coordination. While the CSRs related to the SGP and the MIP are more often followed by Member States as failure to comply could theoretically lead to sanctions, it is less the case for recommendations related to employment, social or environmental concerns.

measurable, and (iv) **prioritised** according to their significance. Crucially, the sum of fiscal-related CSRs should reflect the fiscal stance recommended for the area as a whole.

(3) **Require governments to present integrated National Reform and Investment Plans (NRIP)** at the start of a new national legislature. These medium-term plans would integrate and streamline economic reform and fiscal plans that Member States submit annually as part of the European Semester – i.e. respectively *National Reform Plans and Stability* or Convergence Programmes. **These NRIP would have to align with country-specific debt pathways, challenges, and EU priorities**.

(4) **Allow governments to submit a list of future-oriented expenditures to be excluded from their expenditure ceilings**. Whilst the proposed expenditure rule allow for exceptional one-off expenditures and net public investment up to a certain threshold (see reform 5 and 10), **additional future-oriented expenditures[49] would have to be presented in the NRIP as part of a coherent package** of spending, investment, and reforms aligned with CSRs and commonly agreed EU priorities – e.g. the six pillars of the RRF.[50] **Such exclusion could be made conditional to compliance with the new set of fiscal rules and with CSRs** – see question 8.

(5) **These plans would have to be constructed in consultation with national stakeholders** (e.g. social partners, IFIs, NPBs). In particular, Independent Fiscal Institutions would be tasked to prepare **country-specific debt sustainability analysis and macroeconomic forecasts** (e.g. potential output growth, r/g differential). On this basis, governments would determine **country-specific debt pathways** and **expenditure ceilings**. Considering the broad range of debt unsustainability drivers, these pathways should not only be about reducing debt stock, but can be about extending debt stock maturity, reducing share of external debt, or expanding debt stock to fund growth-enhancing and/or risks-lowering expenditures.

(6) **The European Commission would then assess compliance of these NRIP** with **country-specific challenges** identified in the context of the European Semester (cf. CSRs), a specific set of predefined **assessment criteria** (e.g. respect of the do-no-significant-harm principle), as well as their contribution to **European objectives** (e.g. the green and digital transitions).

(7) **The Council would then endorse or reject the NRIP and the related exclusion** on the basis of a recommendation from the Commission. Allowing **political validation** would address concerns that such a mechanism could create negative incentives to circumvent the rules.

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49 Future-oriented expenditures cover categories such as public investment, green expenditures, and productive social expenditure such as education (i.e. investment in human capital) and healthcare – both associated with a positive impact on GDP growth.

50 As part of the Recovery and Resilience Facility, Member States' National Recovery and Resilience Plans (NRRPs) were expected to contribute directly to the following six pillars: (1) green transition, (2) digital transformation, (3) smart, sustainable and inclusive growth, (4) social and territorial cohesion, (5) health, economic, social and institutional resilience, and (6) policies for the next generation.

Question 7 | National fiscal frameworks

Is there scope to strengthen national fiscal frameworks and improve their interaction with the EU fiscal framework?

According to the Council Directive 2011/85/EU that institutes **national fiscal frameworks**, EU Member States have to prepare and execute their budget according to a set of minimum requirements.[51] This directive also outlines the role **Independent Fiscal Institutions (IFIs)** play in monitoring Member States compliance with fiscal rules and providing economic and budgetary forecasts.

But EU IFIs differ in terms of the extent of their independence. Whilst well-designed mandate with strict operational independence from politics are key to IFIs' efficiency[52] – particularly as their analysis will not always please the ruling government –, EU IFIs are often not well equipped and subject to decisions that limit their functional autonomy.[53]

Furthermore, EU IFIs differ in terms of tasks they are entrusted with. Whilst some of them are responsible for preparing key pieces of analysis in the budgetary process (e.g. macroeconomic and fiscal costing forecasts), many see their role confined to issuing their official opinion on budget plans.

- **Reform 12 Improve the mandate and expand the tasks of Independent Fiscal Institutions (IFIs).** The effective functioning of IFIs should be supported by **enhanced minimum national framework standards in EU Member States**. Building on best practices, these minimum standards should ensure (i) functional autonomy (e.g. adequate and stable own resources; flexibility to manage their resources), (ii) access to information, (iii) safeguards from political pressures (e.g. strict rules for conflict of interest), and (iv) an effective implementation of the "Comply or Explain" principle.[54]

  Crucially, these standards should **ensure governance arrangements that shield IFIs from being captured** by any school of thoughts. In addition to expertise requirements, important avenues are: (i) board members should be proposed by the parliament, social partners and civil society; (ii) individual board members should benefit from dedicated staff – in addition to general staff; (iii) minority and divergent opinions should be allowed to be reported in official reports as they would be instructive for the political debate.

  These standards should also ensure a specific and recurrent **monitoring process at EU level** to verify periodically that Member States are effectively complying with these minimum requirements – i.e. second-order control.[55]

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51 These cover accounting and statistics, forecast, numerical fiscal rules, medium-term budgetary frameworks, transparency of general government finances and comprehensive scope of budgetary frameworks.

52 Four key characteristics really matters for IFIs to have a positive impact on budgetary performance: (i) independence or functional autonomy (i.e. a strict operational independence from politics); (ii) a mandate to assess compliance with fiscal rules; (iii) an explicit input role in the budgetary process; (iv) high media impact. More in: DEBRUN, X., KINDA, T., et al., "*The functions and impact of fiscal councils*", International Monetary Fund, 16 July 2013, 62p.

53 Including decisions on budgets, hiring restrictions, location decisions, impediments to information flows or decisions concerning leadership appointments. In: EU IFIs, "*Network statement on the need to reinforce and protect EU IFIs*", 22 January 2019.

54 We subscribe to the call made by IFIs: EU IFIs, "*Network statement on the need to reinforce and protect EU IFIs*", 22 January 2019.

55 "In the EU, first-order control is generally the competence of national institutions. Member states implement and enforce policies ('direct control'). Second-order control lies with the EU Commission and entails controlling the controller ('indirect control'). Although second-order control lies in the hands of the EU Commission, it can be organised on the basis of teams of national experts to ensure maximum involvement of member states, to support mutual exchange and to arrive at a shared professional culture (upward convergence)." in: SCHOUT, A., "*Economic Governance :from Rules to Management. How to strengthen member states*", Clingendael, December 2020.

The new macroeconomic environment of low nominal interest rates coupled with complex implications of challenges such as climate change or demographic changes **suggest a need to strengthen public expertise in public finances**. The role of IFIs could be made commensurate with these challenges by granting them (at least) the following tasks:

(1) **Conduct country-specific debt sustainability analysis (DSA)**. The EU fiscal framework overly relies on one-size-fits-all arbitrary 60% debt-to-GDP threshold[56] to gauge debt sustainability, overlooking many **drivers of debt unsustainability**. Drivers include the evolution of interest-payment-to-GDP, gross financing need-to-GDP, r/g differential, share of short-term debt on total debt stock, average maturity of debt stock, share of foreign held debt on total debt stock as well as the building up of fiscal risks.[57] Giving a more prominent role to country-specific Debt Sustainability Analysis (DSA)[58] in the European fiscal framework would help fix this lack of granularity.

Already produced by many IFIs, these DSA should be enhanced to cover the emergence of ***climate-related fiscal risks*** (i.e. the impact that climate change will have on public budgets) and ***resilience-related fiscal risks*** (i.e. the impact that a lack of resilience in different sectors, e.g. the health sector, have on public budgets). Methodology should be further developed by the European Fiscal Board and the EU IFIs in dedicated working groups.

Acknowledging that the sustainable level of government debt hinges on each sovereign's macroeconomic fundamentals, **the production of these country-specific DSA would feed into country-specific debt pathways and expenditure ceiling proposed by the government** in its NRIP (see questions 3 and 6). Fiscal policy being at the core of democratic sovereignty, these latter two should be determined via democratic processes, not technocratic ones.

(2) **Forecast key macroeconomic variables** (e.g. the medium-term potential growth, r/g differential). This would feed into government fiscal and economic plans (i.e. expenditure ceiling submitted as part of a NRIP – see question 6), ensuring their quality and reliability.

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56 The quantitative limits of the Maastricht Treaty were defined taking into account, approximately, the average economic situation at the end of the 1990s. Assuming potential growth of 2% and an inflation target of 2%, a budget deficit limit of 3% of GDP would stabilise the ratio of government debt to GDP at 60% - which was approximately the average debt-to-GDP ratio of the EU member states in 1990. "With the same procedure, a reference value of 70 per cent could be calculated for 2000, of 86 per cent for 2010 and 101 per cent for 2020." In: BOFINGER, P., "Easing the EU fiscal straitjacket", December 2020, Social Europe; In a context where Japan has no issue to service a stock of debt of 256% of its GDP, the pertinence to rely on debt-to-GDP ratio as a proxy indicators of debt sustainability can arguably be challenged.

57 For recent analysis of debt sustainability determinants refer to: e.g. SUTTOR-SOREL, L., "*Fiscal Mythology Unmasked. Debunking Eight tales about European public debt and fiscal rules*", Finance Watch, July 2021, p.7-8; BLANCHARD, O., LEANDRO, A. ZETTELMEYER, J., "*Redesigning the EU Fiscal Rules: From Rules to Standards*", October 2020; FURMAN, J, SUMMERS, L, "A Reconsideration of Fiscal Policy in the Era of Low Interest Rates", November 2020.

58 Common practice of the International Monetary Fund (IMF), national Independent Fiscal Institutions (IFIs), and the European Commission, DSA take into account a larger set of debt unsustainability drivers. For more information, see: IMF, "*Review of the debt sustainability framework for market access countries*", IMF policy paper, January 2021, 124p.; GORDO, E., CASEY, E., et al., "*The role of the Independent Fiscal Institutions in assessing the sustainability of high public debt in the post-Covid era*", EU IFIs contribution to the EFB annual conference, February 2021, 27p.; The European Commission produces DSA for Member States requesting ESM financial assistance - Art.6, Regulation (EU) No 472/2013. The Commission also produces the annual *Debt Sustainability Monitor*.

(3) **Monitor public investment**. By holding governments to account for the value and quality of assets created by public investments, IFIs could ensure that Member States do not make too few investments or of insufficient quality. Crucially, IFIs could **assess rationale for – and quality of – one-off expenditures and investment** proposed to be excluded from expenditure ceilings.[59]

(4) **Forecast costing of fiscal policy measures** (e.g. the impact of tax changes on government revenues).

59 This would fix one of the major issues that led to the abandonment of golden rule by the UK and Germany. Cf. "The abandonment of formerly existing Golden Rules for public investment in Germany and the UK cannot disprove the case for the proposed Golden Rule for Europe. (...) From a standard sound public finance perspective both the German and the UK rule – unlike the EU fiscal framework – suffered from a lack of independent surveillance, bindingness and enforcement." in: TRUGER, A., op.cit., 2015

Question 8 | Effective enforcement

How can the framework ensure effective enforcement? What should be the role of pecuniary sanctions, reputational costs and positive incentives?

European economic governance rules face a low level of enforcement. Member States' budgetary policies have been compliant with EU fiscal rules in just over half of the cases, with large differences across countries. [60] Country-Specific Recommendations (CSRs) are generally not implemented, with large differences across time, countries, and policy areas.[61]

Whilst a legitimate debate occurs on how to ensure enforcement of democratically defined rules, **lack of compliance also signals flaws of the current rules**. Whilst the most important step will be to ensure a meaningful reform of EU rules, a discussion must be held on the appropriateness to rely on some mechanisms to enforce compliance across sovereign states.

That discussion starts with **pecuniary sanctions** that are already part of the EU fiscal and macroeconomic surveillance frameworks (i.e. SGP and MIP) and are proven to be politically impracticable. It then goes on with , **reputational cost**, which often links to the idea of **"market discipline"**, and has proven to be too inefficient a mechanism to rely on.[62] Increasing **political cost** from failing to abide by the rules would be far more efficient if situated in the national democratic debate.

In our view, the only legitimate ways to improve enforcement are, first, via **positive incentives** and, second, via **increased national ownership** of the debate and compliance with the rules:

- **Reform 13** **Condition access to additional fiscal capacity to compliance with the new set of fiscal rules and the CSRs.** As developed earlier, the fiscally responsible course of action is to **exclude from the new expenditure ceiling** future-oriented spending that entails a positive impact on long-term debt sustainability – see reforms 9 and 11. In question 10, we outline the need for **a new permanent investment facility dedicated to important projects of common European interest** aiming at reaching EU objectives.

  Increased enforcement of the rules could be achieved by **conditioning both the exclusion of some spending from the expenditure ceiling and the access to the new investment facility** to an enforcement of the new set of EU fiscal rules and compliance with CSRs.

- **Reform 12** **Improve the mandate and expand the tasks of Independent Fiscal Institutions.** Greater level of compliance with fiscal rules seems to go hand in hand with a longer tradition of strong and well-established Independent Fiscal Institutions (IFIs).[63] As outlined in question 7, the effective functioning of IFIs should be supported by **enhanced minimum national framework standards** in EU Member States. These minimum standards would

60 LARCH, M., SANTACROCE, S., "*Numerical compliance with EU fiscal rules: The compliance database of the Secretariat of the European Fiscal Board*", May 2020.

61 EFSTATHIOU, K., WOLFF, G., "*What drives national implementation of EU policy recommendations?*", Bruegel, Working paper, April 2019,

62 In complement to the EU fiscal rules, policymakers originally engineered market discipline as a force for fiscal prudence in the euro area. This was achieved by barring the way to a lender of last resort for sovereign issuers in the European Treaties. But crises showed the necessity to have a different approach. The first step in that direction was the institutionalisation of the European Stability Mechanism (ESM) as a limited and conditional lender of last resort for sovereigns: the euro debt crisis crudely illustrated that the absence of such a lender creates higher risks of sovereign default. The second step was the progressive transformation of the ECB into a guardian of sovereign "favourable financing conditions" as sharp increases in yield spreads at the onset of the Covid crisis reinforced the case for more flexible and decisive actions. With crises repeatedly showing the limits of relying on market discipline as a force of fiscal prudence, policymakers should once and for all reject this logic.

63 BEETSMA, R., DEBRUN, X., et al., "*Independent Fiscal Councils: recent trends and performance*", IMF working paper, March 2018.

have to cover an effective implementation of the **"Comply or Explain" principle**.[64] Under this principle, all public administrations under the scope of the IFI would be required to follow IFI's advice or explain publicly why it departed from it. Coupled with stronger and well staffed IFIs, this could **increase national ownership of the debate** (as opposed to the current debate opposing Brussels to Member States) and lead to **increased government public accountability over their fiscal decision**, entailing therefore increased reputational cost.

Crucially, governance of the IFIs should be carefully built to **shield them from being captured** by any school of thoughts.

64 We fully subscribe to the call made by IFIs in that sense: EU IFIs, "*Network statement on the need to reinforce and protect EU IFIs*", 22 January 2019.

Question 10 | Euro area dimension - *How should the framework take into consideration the euro area dimension and the agenda towards deepening the Economic and Monetary Union?*

Financial markets need safe assets to function properly and are craving for more of them. The important novelty is therefore **the (long-overdue) creation of a European-wide common safe asset that strengthens the international role of the euro**. For a long time, such absence highlights the fragmented nature of national government bond markets. Ending a decades-long saga about whether or not to jointly issue debt (i.e. debates on Eurobonds, blue bonds, ESBies), the progressive issuance of up to around €750 billion of EU-denominated bonds to be reimbursed over an extensive time period (2038-2058) will create **a market and a yield curve for all maturities of EU debt** — 92 bn of bonds with a maturity between 3 months and 30 years have been issued so far.[65] Supported by the highest possible credit rating of the EU and ECB's bond purchases, these EU-denominated bond issuances have so far been a success with large oversubscription — mostly bought by Europeans investors, among which fund managers, banks and central banks represent roughly 80%.

The success of the bonds launched to fund NGEU should pave the way for future EU bonds issuance to fund **two permanent EU fiscal capacities:**

- **Reform 7** **Create permanent fiscal capacity at EU level.** First, and taking stock of what has been achieved with the Recovery and Resilience Facility, **a permanent fiscal stabilisation capacity**[66] could help avoid mismatches between the euro area's needs in periods of crises (i.e. the euro area fiscal stance) and the fiscal policy of its Member States. Whilst the possibility to trigger escape clauses in time of crisis theoretically allows Member States to implement countercyclical fiscal policies, some countries can lack the risk-absorbing capacity to implement them whilst others countries with better fiscal capacity could lack the willingness to compensate by engaging for more countercyclical policy. The activation of the **general escape clause** could serve as a criterion to call up this countercyclical fiscal capacity.

  Second, **a new permanent investment facility dedicated to important projects of common European interest** aiming at reaching EU objectives. Expanding investment at EU level would prove particularly important in case of absence of majority for an exemption of future-oriented expenditures and/or net investment from the expenditure rule – see reforms 5 and 10.

Lastly, whilst some improvements have already been made, the European Semester should see its focus on the euro area dimension (e.g. euro area fiscal stance, spillovers, externalities) further improved, especially in the country-specific part. In particular, the sum of **the country-specific recommendations related to fiscal policy should correspond to the fiscal stance recommended for the area as a whole**.

65 See: "*NGEU tracker*"

66 The *European Fiscal Board*, the *European Central Bank*, and the *International Monetary Fund* and many other institutions, have been arguing for a central fiscal capacity approach to covering a gap in the EU fiscal framework.

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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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