Policy Paper

New Fiscal Rules: The EU Beyond Covid and the War

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In Brief

In the last two years, the global economy – and the EU's in particular – has been shaken by **two "black swans" in a row**: Covid-19 and the war in Ukraine. In 2020, the Covid-19 pandemic had a heavy impact on the economy of the European Union Member States, (with a 6.1% GDP loss), triggering an **unprecedented policy response**: extended monetary expansion (through the introduction of the Pandemic Emergency Purchase Programme – PEPP) by the ECB; the suspension of the fiscal rules of the Stability and Growth Pact (SGP), which allowed for a massive increase in public spending that resulted into skyrocketing public deficits and debts (well beyond 100% of GDP) in several Member States; and the launch of "Next Generation EU" (NGEU), a €800bn plan to boost economic recovery through a EU-wide common debt. After the impressive economic rebound in 2021, Russia's invasion of Ukraine in February 2022 is casting shadows on the strength and resilience of the EU's recovery: the war has already taken its economic toll, with growth forecasts for 2022 and 2023 already revised downwards and inflation reaching 30-year record levels mostly due to increasingly higher prices of energy and other commodities.

The **EU had started to discuss how to reform its fiscal rules before these two unprecedented shocks occurred**. Despite a number of attempts made in order to strengthen and update the SGP rules by enhancing monitoring and surveillance of fiscal policies in the EU Member States, this proved not to be enough: for instance, the EU Fiscal Compact approved in 2012 succeeded in avoiding new debt crises after the one in 2011, but GDP growth remained somehow slow in many countries. This could also be explained by the "fiscal straitjacket" imposed by the SGP criteria and functioning: the rules are too complex, obscure and not transparent; current levels of public investment are too low compared to those of current expenditure; in today's economic context, it is almost impossible to respect the rules (such as the 3% deficit/GDP and 60% debt/GDP thresholds).

In view of the reintroduction of the SGP rules scheduled for 2023, Member States had been invited to submit reform proposals to the European Commission by mid-2022. But the Ukraine war and deteriorating economic prospects made the reform of European fiscal governance less of a priority. **However, underestimating existing problems would be very risky**: high debt stocks remain a crucial issue to deal with should the ECB further reduce its broad support by ending its asset purchase programme and raise interest rates. Sweeping those problems under the carpet would be a major mistake and a serious risk to the future of European economic governance and integration. That is why reforming EU fiscal rules should be kept high on the agenda of EU leaders, despite Covid and the war (or indeed because of them) and in light of the energy and digital transitions that require huge financial resources in order to be swiftly carried forward.

So, **it is key for the EU to urgently address three issues**: 1) reforming fiscal governance without harming Member States' growth potential; 2) managing carefully the forthcoming normalisation of monetary policy in the current context of rising inflation and slowing growth; 3) assessing whether a permanent "EU common debt" is an option at hand, from both a political and an economic point of view.

A **number of proposals for SGP reform have already been put on the table** by some Member States and experts, such as the introduction of a "golden rule" to exempt "green" investments from deficit/debt calculation, the adoption of country-specific debt targets, or the progressive mutualisation of EU-wide common debt to finance the provision of "EU public goods" in sectors such as health, education, environment, security and defence.

It is worth noting that the all main policy proposals advanced so far go in the same direction aimed at adopting **simpler, clearer and more flexible strategies**. Our take for a potentially effective landing point among these proposals could be based on the following key points:

1) **We still need "some sort of" SGP:** if we want to escape the fate of a new debt crisis in the eurozone, it is not just about whether (and to what extent) to reintroduce fiscal discipline, but it is a matter of deeply reforming the public finance framework in the eurozone;
2) **One-size-fits-all strategies don't work:** a common framework consisting of a limited number of rules and allowing for country-specific strategies would be ideal to combine fiscal discipline with growth-friendly policies;
3) **A forward-looking approach to anticipate risks and avoid crises:** detailed medium-term budgetary plans (possibly with a three-year horizon) should be adopted by Member States under the common umbrella of the European Fiscal Board (or a similar body);
4) **Further explore debt mutualisation to boost the transitions:** NGEU might be considered as a preliminary "experiment" to increase the EU's fiscal capacity and raise capital to support the supply of "European public goods" (including security and defence).

This paper is divided into two parts: the first – **"What's at stake"** – analyses current and future economic risks if EU fiscal rules are not reformed after Covid and the Ukraine war. The second part – **"Exploring options"** – offers a broad overview of key reform proposals by leading experts and our take on them.

New Fiscal Rules: Why they are needed

What's at Stake

€8.5tn

Euro-denominated securities held by the ECB

AFTER COVID AND THE WAR, A FINANCIAL BLACK SWAN?

The Covid-19 pandemic had a heavy impact on the economy of the European Union Member States, (6.1% GDP loss at the EU level - and an even higher – 6.5% in the eurozone),[1] triggering an unprecedented policy response which bore consequences in at least three areas:

- Firstly, from a monetary point of view, the European Central Bank played its part in maintaining an **expansionary stance**, keeping interest rates at zero and launching a temporary asset purchase programme of private and public sector securities for a total of €1,850bn (Pandemic Emergency Purchase Programme, PEPP) on top of its asset purchase programme launched in late 2014. This means that today the ECB is holding an unprecedented 8.5 € tn. in euro-denominated securities;[3]
- Secondly, in 2020 the European Commission decided to suspend the rules of **the Stability and Growth Pact**, thus allowing Member States to escape the 3% deficit/GDP threshold and to diverge from the long-term target aimed at containing the debt-to-GDP ratio below 60%; The broader fiscal space made available by the massive fiscal stimulus was turned into cross-cutting social benefits and national short-term unemployment benefit schemes, thus alleviating the worst consequences of the economic crisis, particularly in terms of disposable income, on poverty rates and inequality.[4] In parallel with that, EU Member States took the historic decision to boost post-Covid recovery by launching the EU-wide common debt "Next Generation EU": €806.9bn on top of the EU 2021-27 Budget (€1824.3bn in total).
- And last but definitely not least, such fiscal expansion produced a massive side-effect on **public debt**, which overall at EU level rose from 77.2% of GDP in 2019 to 90.1% in 2020.[5] For some Eurozone countries (Greece, Italy, Portugal and Spain) this was even more serious since their debt/GDP ratio was already beyond 100%, while for some (Belgium, France and Cyprus) it was close to 100% and this threshold was hit in 2020.

+5.2%

EU GDP growth in 2021

It was clear that the combined effect of the fiscal and monetary "bazookas" was needed to avoid a cliff-edge scenario. And the EU's interventions were effective in helping bring EU countries back on a positive growth path, with a +5.2% growth in 2021.[6]

With the prospect of substantial GDP growth in 2022 – and despite increasing concerns about inflation – the EU had set the objective of reintroducing the SGP (and/or to reform it) by the end of 2022. The **war in Ukraine** – the second "black swan" in three years – broke out within this framework, casting shadows on the strength and resilience of the EU's economic recovery. It became immediately clear that **the list of priorities was radically changed**: discussion on SGP reform was supposed to begin in March, but the issue was only addressed on the surface and was barely mentioned at the Informal European Council hosted by French President Macron on 17-18 March at the Versailles Palace. However, EU Commissioner for Economy Paolo Gentiloni confirmed that a detailed reform proposal will be submitted by mid-2022. The rationale behind it is clear: in view of a most likely economic slowdown and inflation on the rise again (+5.8% in January and +7.5% in February on an annual basis, the highest inflation ever in the history of the euro), a scenario of low growth and high prices (stagflation) might turn into reality[7] and a new financial crisis could be around the corner. High debt stocks remain a crucial issue to deal with should the ECB further

90.1%

Debt/GDP level in the eurozone in 2020 (+13% from 2019)

1992

Signature of the Treaty of Maastricht

reduce its broad support (and should the Federal Reserve confirm the rise in interest rates): financial markets could start getting nervous and express concerns about some countries' ability to repay their creditors. Rising spreads could act as a litmus test for those economies with the highest debt/GDP ratios, putting an end to a **period of financial stability**. Sweeping those problems under the carpet would be a major mistake and a serious risk to the future of European economic governance and integration. That is why reforming EU fiscal rules should be kept high on the agenda of EU leaders, despite Covid and the war (or indeed because of them).

THE SGP IN CONTEXT: WHERE ARE WE NOW?

This is a 30-year long story. The SGP originates from the Treaty of Maastricht, signed in 1992 as the cornerstone for the creation of the euro area. The Treaty – which limits government deficits to 3% of GDP and public debt levels to 60% as basic conditions to ensure progressive macroeconomic convergence and the stability of the monetary union – offered the framework for subsequent European rules (most of them in the aftermath of the Eurozone crisis): the "Six Pack" and "Two Pack" regulations, and the Fiscal Compact.

Let us start from the SGP, which was agreed in 1997 and entered into force between 1998 and 1999.[8] The SGP is based on two pillars. The first is the preventive "arm", aimed at ensuring sound budgetary policies over the medium term through the adoption of Medium-Term Budgetary Objectives (MTOs),[9] a public expenditure benchmark based on the medium-term economic growth potential, and stability and convergence programmes to pursue macroeconomic alignment with other Member States.[10] The second pillar is the corrective "arm" (also called "Excessive Deficit Procedure"), aimed at allowing Member States to avoid deviating from their MTOs through the adoption of concrete policy responses to correct excessive deficits (and/or debts) and surpluses.

Such rules were progressively fine-tuned, amended and updated over the years. In 2011, in response to the debt crisis originating from some Eurozone Members States at the end of 2009, the preventive "arm" was strengthened through the adoption of the so-called "Six Pack" regulations, which introduced reinforced surveillance mechanisms (such as the "European Semester"[11]) to support countries at risk of financial instability.[12] These regulations lay at the basis of the Macroeconomic Imbalances Procedure (MIP), which aims to identify, prevent and address the emergence of potentially harmful imbalances that could hamper economic stability in a particular Member State, the euro area, or ultimately the EU as a whole.[13] In a nutshell: these rules were conceived in order to set up a "scorecard" aimed at assessing a country's economic stability.

Unfortunately, this was not enough. Between 2011 and 2012 the worsening of the sovereign debt crisis triggered a double-dip recession (after the one in 2009) in the eurozone and brought some countries such as Greece, Ireland, Italy, Portugal and Spain (the so-called PIIGS) to the brink of financial default, clearly showing that existing rules were not sufficient to keep all Member States on the same track towards fiscal discipline. This is why Member States agreed to further strengthen their economic governance: the EU Fiscal Compact, approved in 2012 and enforced in 2013, introduced the commitment by the Member States to run a balanced budget, and to reduce debt in excess by an annual rate of 1/20 of the debt beyond the 60% threshold.[14] Moreover, in 2012 it was decided to provide countries at risk of financial distress with a sort of "shield": the European Stability Mechanism with a €500bn lending capacity. Finally, in 2013 the "six-pack" regulations were further strengthened by the so-called "two-pack", which increased the EU's fiscal surveillance by allowing the Commission to assess the Member States' draft budgetary plans.[15]

€500bn

The lending capacity of the European Stability Mechanism

Undoubtedly, the Fiscal Compact succeeded in avoiding new debt crises, although this effect should be considered in strong connection with the bold actions undertaken by the ECB: Mario Draghi's historic "whatever it takes" speech (a financial "weapon of last resort" that has never been used so far) and the programme of massive expansionary interventions launched in 2014 (and about to expire in the second half of 2022). These measures played a decisive role in ring-fencing the most fragile eurozone economies, thus allowing for financial stabilisation. However, GDP growth in the eurozone has remained somehow slow in many countries: **was this because of the "fiscal straitjacket" imposed by the SGP criteria and functioning?**

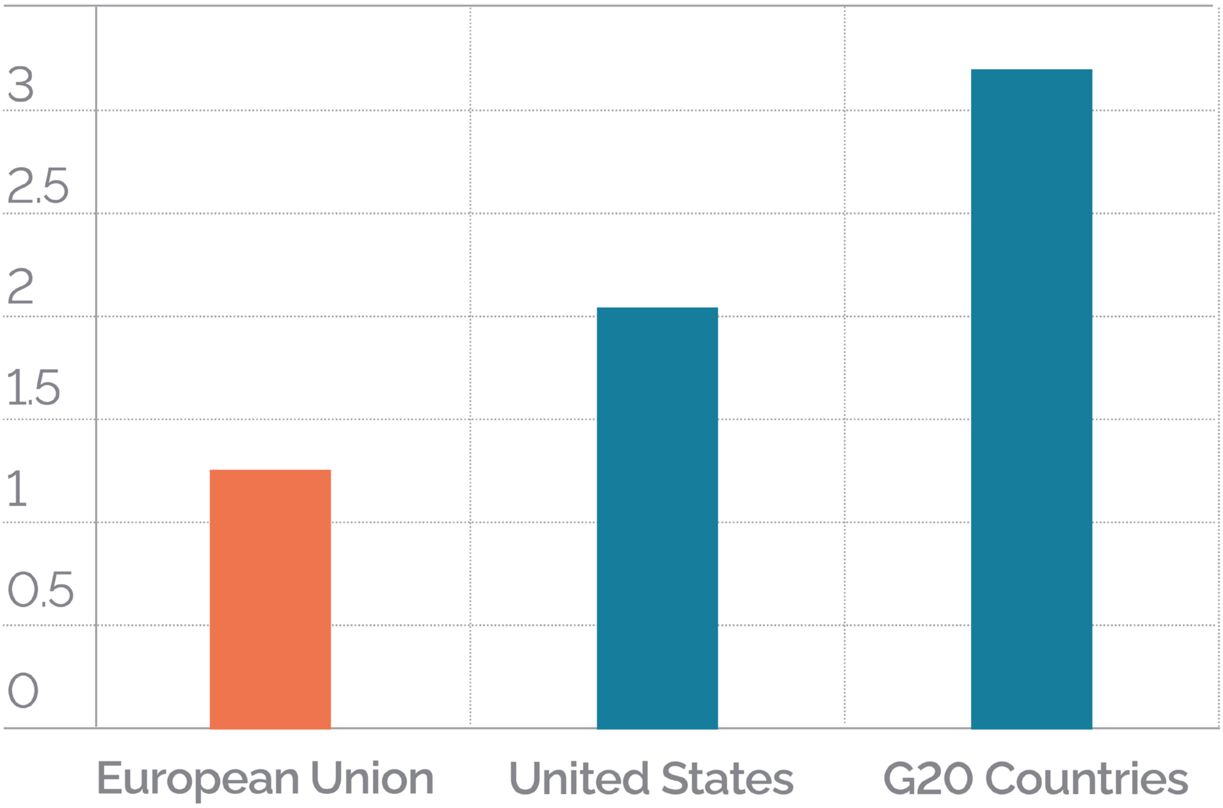
A PACT IN NEED FOR REFORM

The SGP was key to allow EU countries to pursue a satisfactory degree of convergence, at least in its first years of implementation. However, after the double-dip recession in 2009 and 2011, the Pact did not prove fit to support a more sustained recovery path in the EU *vis-à-vis* other key global economies. During the last decade, GDP growth has been slower than in the US and the rest of the G20 countries (Figure 1). Moreover, in 2021 only 13 countries out of 27 were compliant with the Maastricht criteria (Figure 2). The rules of the SGP were criticised well before the two "black swans" heavily disrupted the world and the European economies. Here is a summary of these complaints:

1) **Public debts on the rise**: in terms of sustainability of public finances, the rules aimed at reducing debts remained inapplicable. Despite all the new rules and "packs", some Member States' debt/GDP ratios have continued to rise or, at best, have stabilised;[16]

European Union: slower than the rest

Average GDP growth, 2010-21



Source: OECD

2.7%

Public Investment/EU GDP

2) **Rules are too complex, obscure and not transparent**: the computation of the "output gap", a key variable used to cap public expenditure and avoid excessive deficits, proved to be particularly unreliable, biased and obscure.[17] This reduced the effectiveness of procedures included in the "preventive arm", which led Member States to keep spending both in good times (instead of saving) and in bad times;[18]

3) **Low public investment, high current expenditure**: the fiscal rules were not able to prevent a decline in public investment, nor did they make public finances more growth-friendly (with public investment dropping from 3.7% of EU GDP in 2009 to 2.7% in 2017); in a nutshell, governments prioritised pensions, tax cuts and other expenditures with a strong impact (and political return) in the short run, instead of investing in their own future;

4) **The rules cannot be respected (and everybody knows it):** some Member States' public debts are so high that no one really believes that, after Covid and the war in Ukraine, debt/GDP ratios can be brought back to below 60% in 20 years. For instance, at current debt levels, Italy would need an annual €80bn fiscal adjustment to meet the target.

Therefore, a debate around the need for a reform of the Pact had already started before the Covid-19 outbreak in 2020. In February 2020, the Communication of the European Commission to the European Parliament acknowledged the positive role of the SGP in reducing imbalances and avoiding excessive deficits; however, it advocated for a more flexible surveillance framework, fit for tackling "today and tomorrow's pressing economic, demographic, and environmental challenges".[19]

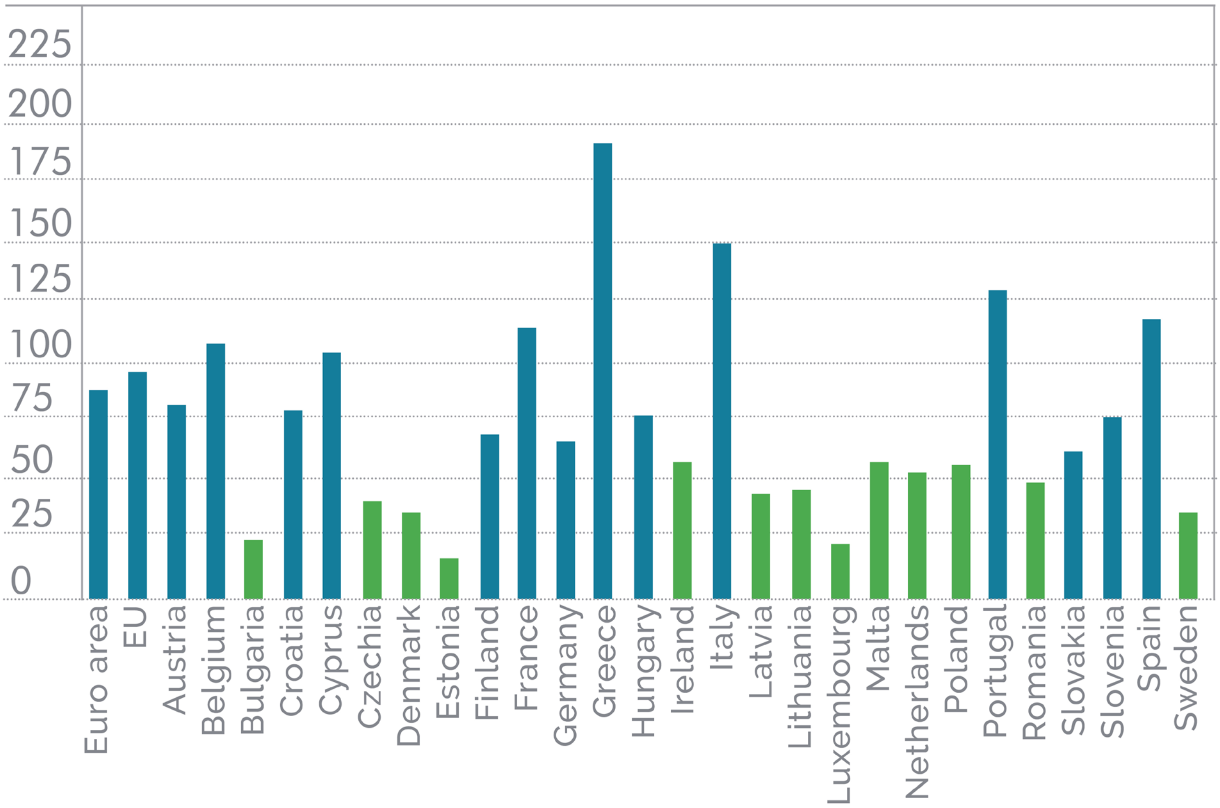
€650bn

The annual additional investment needs to finance the Digital and Green transitions in the EU

The pandemic made these challenges even more pressing, with deficit and debt ratios soaring in all Member States, increasing investment needs to drive the digital and green transitions (estimated at an additional €650bn per year), and an alarming threat to social cohesion with the rise in poverty and economic inequalities. This sense of urgency was quickly perceived by the European Commission, which called for a public consultation with the objective of collecting proposals on how to reform the SGP and enabling them to take into account the post-Covid economic framework, potentially building on Next Generation EU to further enhance economic integration among EU Member States.[20]

Debt/GDP: who is complying with the rules?

Debt/GDP ratios, EU Member States, Q4 2021 (green = below debt 60% of GDP)



Source:
Eurostat

2021

The year of EU Common Debt

LEGACY OF COVID-19 AND THE WAR IN UKRAINE

Are there any lessons learnt from the Covid-induced economic crisis? The answer is: definitely, yes. And, despite the negative consequences produced by this unforeseeable shock, the response of the EU was quite bold and ambitious. The adoption of Next Generation EU – and in particular of its most powerful "weapon", the Recovery and Resilience Facility – represent a remarkable step ahead, not only in economic terms but also from a political point of view. This is because of the forward-looking rationale underlying this package of measures, and also because of the mechanism identified to collect the financial resources needed for this plan to work: the issuance of common debt, which used to be considered taboo by many Member States, in particular those with a lower level of debt and a sound macroeconomic framework.[21] In a nutshell, it is a U-turn for the EU: instead of focusing mostly on debt reduction, the spotlight was shifted to sustainable investment and growth.

However, the crisis also left many EU countries with a heavy burden in terms of increased public debt. This happened, among other things, because the Pact was not reformed earlier. In fact, the adoption of more flexible criteria (avoiding "one-size-fits-all" rules but taking into account country-specific situations), combined with more cautious fiscal policies in periods of growth (aimed at building fiscal buffers to prepare for future crises),[22] would have favoured better coordination and convergence among Member States. Today the economic consequences of the conflict in Ukraine should make clear that kicking the can down the road is not the right answer: the EU may further delay the reform of its fiscal rules, but it should at least identify the key criteria of what comes next. This is the right time to act. Such a reform should be far-reaching and ambitious; it might also include a "European fiscal capacity" (see BOX 1), that is a permanent common debt.

So, despite today's pressing issues the EU has to deal with (the war in Ukraine and the related energy crisis), there are some key questions about the future of European economic integration and governance that should no longer be by-passed:

- **How can fiscal governance be reformed without harming EU countries' growth potential?** In other words, the issue here is to strike a balance between the need to avoid future debt crises and the importance of providing and channelling adequate financial resources to keep the digital and energy transitions going; not to mention the need for a strengthened EU defence. In a nutshell: how can the EU scale up strategic investments?

- **What should the ECB do with the financial assets it holds?** While the ECB is preparing to hit the brakes of its bond-buying programme, normalisation of monetary policy should be managed carefully in the current context of rising inflation and slowing growth, which makes acting on the interest rate leverage extremely difficult;
- **And last, but definitely not least: is a "EU common debt" at hand?** It is time to go beyond today's one-off "Next Generation EU" and move towards permanent common debt. How can we go beyond one-off initiatives with a narrow scope and move towards a real common debt to finance the provision of EU public goods, including in the defence and military spheres?

In the second part of this Policy Paper we will present the state of play in the debate on these policy issues and try to identify a series of actionable measures.

BOX 1

AFTER NEXT GENERATION EU, IS IT ABOUT TIME FOR A EUROPEAN COMMON DEBT?

Marcello Messori

Since **spring 2020** the **European Union** (EU) and **euro area** (EA) economies have enjoyed a 'policy mix', based on strengthened and ultra-expansionary **unconventional monetary policy and on innovative 'vertical coordination'** between expansionary national fiscal policies and a central (even if temporary) fiscal capacity.[1] This new 'policy mix' allowed a strong rebound from the economic depression triggered by the pandemic shock in 2021. From 2022, the main components of central fiscal capacity – that is, the **Next Generation-EU and its most important programme (the Recovery and Resilience Facility: RRF)** – should be used by EU Member States to transform their rebound into **a recovery and then sustainable long-term development**. However, at the end of February 2022, the **invasion of Ukraine by Russia** started creating a dramatic **exogenous shock** that could lead the EU and EA economies to stagflation (that is, to the coexistence of economic stagnation/recession and a high inflation rate).

In this scenario, **it is difficult to design an effective stance for monetary policy**. Given its objective (price stability) and target (an inflation rate at 2%), the **European Central Bank (ECB) should gradually implement the restrictive stance** (end of unconventional programmes, and then moderate increases in the policy interest rates) outlined at the beginning of last February, leaving the task of countering the new risks of recession to expansionary fiscal policies. However, as shown at the peak of the pandemic shock, in the EA the most fragile countries have a **high public debt/GDP ratio** so they can only activate national expansionary fiscal policies if the ECB's purchase programmes absorb a huge amount of their public debt in the secondary segments of the financial markets. This contradiction leads to, at least, two consequences. First, **to overcome the impact of the war, a growing and long-term role for central fiscal capacity becomes crucial in the EU**. Second, the extension of **this central capacity in relation to national fiscal policies via 'vertical coordination' takes time**; hence, the ECB's policy should find that tricky balance between the control of inflation rates, the management of the term-structure of market interest rates affected by the restrictive initiatives of the US central bank, and the temporary support for national fiscal policies.

The latter considerations imply that the efficient implementation of the RRF, mainly in the major beneficiary countries, and **the creation of strong links between RRF processes and the new European fiscal rules are the pivotal components of EU economic governance in the post-pandemic world**. Amato et al. (2021) maintains that the new 'Stability and Growth Pact' (SGP) should borrow a few **methodological principles** from the RRF:[2] the definition of simple general rules (in the SGP's case, the two nominal thresholds in terms of public deficit/GDP and public debt/GDP embedded in the original European Treaties); country-specific adjustments, based on formal agreements between EU institutions and each Member State; a kind of **'golden rule' to finance**, at European level instead of at national level, a part of the private investments and other public expenditures required to achieve **the 'green' transition**, **digital transformation** and the related **restructuring of the production systems** and labour markets, even beyond the end of the RRF; the extension of this **'golden rule' to the production of crucial European public and common goods** such as, respectively, centralised infrastructures in network services and centralised purchases of energy products and security systems.

It is important to emphasise that **for this new European economic governance it is necessary for the central fiscal capacity to become a long-term ingredient of the European 'policy mix'.** The Next Generation-EU's architecture highlights that building **central fiscal capacity,** based on the **issuance of long-term EU debt and on an uneven transfer of resources to different countries**, is in compliance with the European Treaties only in extraordinary situations that go beyond the control of the single Member States; and a similar constraint is usually identified with the temporary feature of this fiscal capacity. However, as stated by Tosato, extraordinary situations are not necessarily isolated 'black swans' but are conceivable as long-term chains of related events.[3] An example of this different perspective is offered by the European 'green' and digital transitions, whose horizons go well beyond the end of RRF; and the dramatic impact of the Ukraine war on the European geopolitical and economic situation confirms that the **EU will have to handle a swarm of exogenous shocks in the near future**.

Swarm (of innovations) is used by Schumpeter[4] to maintain that the normal for our systems is **economic development and not a 'stationary state'.** The EU should learn the Schumpeterian lesson by adopting economic governance, centred on growing central fiscal capacity, able to manage adverse and positive breaks.

Marcello MESSORI, Professor at the LUISS University (Rome), and Director of the LUISS School of European Political Economy.

1. See Buti, M. and Messori, M. (2021), *Euro area policy mix: From horizontal to vertical coordination*, CEPR Policy Insight, no. 113, October.
2. Amato, G., Bassanini, F., Messori, M. and G.L. Tosato (2021), *The new European fiscal framework: how to harmonise rules and discretion. A contribution to the Commission Review of the EU Economic Governance Framework*, Astrid Paper, no. 81, December.
3. Tosato, G.L. (2021), *Sulla fattibilità giuridica di una capacità fiscale dell'Unione europea a trattati costanti*, Astrid Rassegna, no. 344, October.
4. Schumpeter, J.A. (2012), *Theorie der wirtschaftlichen Entwicklung*, München und Leipzig, Duncker & Humblot, 1926, 2d ed.; Engl.ed. *The theory of economic development*, New York: Oxford University Press, 1934.

Exploring Options

-2%

Expected GDP growth loss in the Eurozone in 2022

TOWARDS A NEW PACT: THE POLITICAL DEBATE IN TIMES OF WAR

It is not yet clear when the SGP will be reintroduced. The economic consequences of the war in Ukraine could be heavy and damage the recovery in the EU: preliminary estimates by the ECB reveal that growth prospects in the eurozone for 2022 could be halved (should the conflict continue), down to 2.2% from 4.2% initially forecasted.[23] This may even lead to another recession and increases the need for massive fiscal responses. Is this still feasible with the original plan to reform the SGP and reintroduce fiscal discipline in 2023? Obviously, much will depend on the scale of the impact of the conflict (and related sanctions) on the EU's economy, but also on the Member States' political will and tactical convenience. So far, the European Commission's approach has been cautious. Commissioner Gentiloni highlighted that the EU's stance is currently guided by four principles: 1) striking a balance between debt sustainability and sustainable growth; 2) paying more attention to medium term fiscal surveillance; 3) drawing lessons from the experience of NGEU in order to design future initiatives; and 4) simplifying rules and increasing national ownership of reform processes.[24] The forthcoming Spring Forecast (due in mid-May) will help the EC assess whether the Pact's suspension should continue also in 2023; meanwhile, proposals on how to reform fiscal rules should be submitted by mid-2022. But a clear-cut roadmap on how the entire process will work has not been announced yet.

How are Member States positioned in this respect? So far, a couple of initiatives have emerged, signalling that views within the eurozone look potentially more similar and compatible than they did only a few years ago:

- **Italy's Prime Minister Mario Draghi and French President Emmanuel Macron** jointly signed an op-ed on the *Financial Times* in which they advocated the need for simplifying fiscal rules with the exclusion of investments (so-called "golden rule"), in the context of a progressive reduction of public debt and introduction of structural reforms.[25] BOX 2 presents a proposal which includes a "golden rule";

- More recently, **the governments of Spain and the Netherlands issued a joint non-paper** confirming the urgent need to reach a consensus in 2022 on a new fiscal framework that takes into account the massive investment needs to finance the green and digital transitions. They propose to empower Member States through the adoption of country-specific medium-term fiscal plans, building on the NGEU's experience in order to create a virtuous circle between national ownership and enforcement;[26]
- Meanwhile, another key EU economy like **Germany hasn't come up with a detailed position yet**. The government coalition agreement refers to the reform of fiscal rules with a slightly more cautious tone: while acknowledging the need for simpler and clearer provisions, it says that "the SGP has shown its flexibility".[27] More recently, Chancellor Scholz's economic adviser was wary of the potential opening of a "Pandora's box", should too many exemptions to current fiscal rules be granted (particularly with respect to the adoption of a "golden rule" on green investments).[28]

All in all, it seems that some degree of convergence has been achieved among Member States on the need to reform fiscal rules by enhancing their flexibility and adopting a "tailor-made" approach. This could facilitate a smooth reform process, although the discussion on technical details has not advanced enough at this stage. Meanwhile, debate at the academic level has come up with a number of detailed, full-fledged proposals. What do they consist of?

WHAT'S ON THE TABLE? KEY REFORM PROPOSALS

Several experts have already taken part in the discussion aimed at proposing reforms of the SGP. While the specifics of each proposal are different, the rationale underlying them is quite similar in trying to achieve a simpler and more flexible and growth-friendly Pact. Here are the key features at its core:

- **A "golden rule" to finance the green transition:** to support and strengthen growth in the medium-to-long term, EU countries need to fill an investment gap. Moreover, the EU has set the goal to achieve carbon neutrality by 2050: this means that investments to finance the green transition need to expand immediately at least up to 2% of EU GDP. Such investments would be excluded from the deficit and debt calculation under current EU fiscal rules.

Public Debt

Country-specific targets?

The latter would not change but they would be applied with the highest possible degree of flexibility.[29]

- **Country-specific debt targets:** past experience has shown that applying the same rules to all Member States makes little sense. So, each government should set a medium-term debt target to be assessed by a domestic independent fiscal institution on the basis of a common methodology, monitored by the European Fiscal Board (or similar body). Once debt targets have been set, they should serve as anchors to contain public spending. The deficit and debt thresholds should be removed and replaced by a mechanism that would trigger the Excessive Deficit Procedure after a manifest violation of the country-specific spending rule.[30]
- **A spending rule to facilitate the provision of "EU public goods":** this plan would consist of two parallel actions. On one hand, debt would be kept under control and progressively mutualised by transferring a portion of national public debts to a European Debt Management Agency (based on the existing European Stability Mechanism or created from scratch). On the other hand, the appropriate flexibility in public spending would be ensured so to leave countries with the space needed to increase public investment and facilitate the provision of "European public goods", i.e., in sectors such as education, environment, health, peace and security (see BOX 2); a similar proposal suggests setting country-specific benchmarks for public spending, so that it does not exceed the longer-term GDP growth trend, thus aiming for cautious expansionary, investment-friendly policies (see BOX 3).
- **EU common debt to finance the transitions:** going back to the SGP's original requirements would simply be unsustainable for highly indebted EU countries. How can financial stability in Europe be preserved without constraining the investments needed for the green and digital transitions? Creating additional European funds through EU common debt could offer a suitable solution. Such a programme would build on the successful experience of NGEU and seek for larger resources to be raised in capital markets (see BOX 4).

BOX 2

PROPOSALS BY THE EUROPEAN FISCAL BOARD FOR EU ECONOMIC GOVERNANCE

Niels Thygesen, Massimo Bordignon

The **European Fiscal Board** (EFB) welcomed the Commission's relaunch of the review of economic governance, interrupted by the pandemic since early 2020, as well as the declared ambition to "build consensus well in time for 2023". The uncertainties linked to war in Ukraine may have made that ambition unrealistic, leaving room for only more qualitative guidelines for fiscal policies next year. Yet, **reforms should not be long delayed**. They are important both for Member States keen to avoid further erosion of rules-based governance and for those willing to exploit the discretionary flexibility available to the Commission, as these countries would otherwise find that **less predictable fiscal policies make a repricing of risks in financial markets** more likely.

Risks to **debt sustainability** may seem remote as long as servicing costs remain historically low. But the recent inflationary experience already suggests that the extension of the present regime is not assured; and the **Ukraine crisis may further exacerbate inflationary expectations**. In this context, the 6 countries with very high debt, well above 100% of GDP, need to formulate strategies for reducing debt at a "satisfactory pace". They also need to have these strategies validated by EU institutions, with the aim of preserving both their ability to respond to future crises and to protect themselves and their EU-partners against potentially existential risks of financial spill-overs.

FISCAL RULES

Concretely, the EFB agenda for a major update and simplification of **European fiscal rules** is shaped by the pre-pandemic experience of an excessively intrusive, short-term focus and of an excessive reliance on multiple, partly unobservable, policy indicators, leading generally to poor compliance and pro-cyclical fiscal policy. However well-intentioned, the many discretionary exemptions which have been introduced in the past have gradually made the system overly complex and not transparent. While we do not dispute that the rules, although imperfect, might have somewhat strengthened the sustainability of public finances in the past, there remains extensive room for improvement.

The main EFB reform proposal is to aim for a **moderate and differentiated pace of debt reduction** in high-debt countries, implemented through a single, observable indicator: a public expenditure benchmark set below the longer-term trend of growth of the economy. To avoid misunderstandings, it should be recalled that the **expenditure benchmark** – already used by the Commission in combination with the structural budget to assess a country's adherence to the rules in the preventive arm — is computed net of **discretionary tax decisions** and net of those components of expenditure most affected by the economic cycle, including interest payments. The use of the expenditure benchmark therefore does not impose any restrictions on the size of the **public sector**, which remains an autonomous decision of each single Member Country. And like the structural budget, the expenditure benchmark is an indicator that is not affected by the cycle, with the advantage however that it is much easier to compute in real time and to communicate to politicians and public opinion. An escape clause, to be applied parsimoniously and on the basis of independent technical advice, should further reduce cases of pro-cyclical policies. We also propose to maintain the **3% of GDP reference value for the headline deficit** as a backstop to contain debt dynamics and as a trigger for the EDP. In short, we do not see discarding the Treaty reference values or restating them as essential to improving performance; but secondary legislation would require revisions.

ECONOMIC GOVERNANCE

Economic governance is, however, a broader concept than rules-based fiscal policy. **Two important gaps** would remain even after the implementation of the above revision of the rules: joint **EU support** for the provision of common goods; and scope for an **EU fiscal capacity** to conduct macroeconomic stabilisation. The EU initiatives of 2020 – respectively, the **Recovery and Resilience Facility (RRF)** with its emphasis on green and digital transitions, and the **SURE** (Support to mitigate Unemployment Risks in an Emergency) **mechanism**, which helped Member States finance employment-preserving policies in the downturn – can be seen as temporarily filling both gaps. But efforts to seek agreement on what is to replace the RRF from 2027 should begin soon.

The challenges of providing EU common goods and of supplementing what national budgets and a strained joint monetary policy can provide in terms of stabilisation, are clearly larger and have more dimensions than could have been foreseen – as the war in Ukraine is just reminding Europe once more.

Observing the **very low levels of public investment** that affected most countries after the financial crisis, many proposals, including from the EFB, converged on so-called **Golden Rules** – provisions to protect selected expenditures through exemptions from fiscal rules. However, given the centrality of these expenditure areas in providing EU common goods, the EFB believes that a preferable approach would be **inclusion in the central EU budget**, possibly enlarged by dedicated national envelopes. The key challenge of balancing national ownership of expenditure plans with EU perspectives might be met better in this way than through a more decentralised process of national allowances. In this context, the experience of **designing and monitoring national investment plans** under the RRF will have to be evaluated carefully. This experience is relevant even for deciding whether the observed **high cooperation** could survive into a post-RRF era without the direct transfers and the significant redistribution between Member States that have been key features of the 2020 initiatives.

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BOX 3

TOWARDS A NEW EUROPEAN FISCAL FRAMEWORK: A TWO-PRONGED REFORM EFFORT

Francesco Giavazzi, Veronica Guerrieri, Guido Lorenzoni, Charles-Henri Weymuller, Leonardo D'Amico

Returning to a strict implementation of the pre-pandemic European fiscal framework in 2023 would require excessive fiscal adjustments, especially for countries with high legacy debt, and would allow limited space for spending on desirable public investment projects and on expenses that contribute to European public goods. A **revision of the European fiscal framework should take into consideration three developments.**

First, the global macroeconomic environment is substantially different from the one prevailing in the years when the existing fiscal rules were initially conceived. The current environment is characterised by low natural interest rates and high global demand for safe assets. In this environment, monetary policy is more often constrained in its ability to achieve macroeconomic stabilisation by the effective lower bound on nominal interest rates. This creates a greater need for coordination between fiscal and monetary policy. Lower interest rates also reduce the cost of servicing debt, freeing up fiscal space. **A new framework should aim to make good use of this fiscal space**, designing robust rules that allow the use of fiscal policy to fight recessions, move the economy away from the effective lower bound, and help normalise monetary policy, while, at the same time, guiding countries to rebuild fiscal space during expansions.

The second development is the launch of the Next Generation EU (NGEU) programme. On the governance side, the experience with the national recovery and resilience plans so far makes us optimistic about the capacity of the EU to mobilise resources for growth friendly public investments. In particular, it points to (1) the ability to achieve fruitful cooperation and oversight in the relations between national governments and European institutions; (2) the potential of successfully exploiting the complementarity between investment and pro-growth reforms; (3) the definition of common objectives of EU policy to determine areas of intervention (for example, the green and digital transition). On the market side, the experience with Next Generation EU debt issuances confirms the existence of strong demand for safe European debt instruments.

The third development is the urgent need for a significant amount of spending if EU countries are to reach the ambitious targets they are setting themselves in many areas. These include the fight against climate change, defence, industrial policy (including semiconductors), public health and international aid.

The suspension of the fiscal rules until the end of 2022 provides **a good window of opportunity to define a renewed European fiscal contract**

that addresses these challenges. The new rules should preserve a primary objective of debt sustainability, but, at the same time, allow for a stronger pro-growth stance, which, in the long term contributes to sustainability itself.

We propose a two-pronged reform effort based on two pillars:

1. **A debt assumption management plan**, that is, a plan to transfer a portion of national debt accumulated during the pandemic from the balance sheet of the European Central Bank to a European debt management agency. The pandemic was an extraordinary and exogenous shock to all, so there is no risk of moral hazard associated with this plan, while there are substantial benefits, both in terms of reduced funding costs for EU countries and in terms of normalising how monetary policy is conducted. A debt assumption The plan would consist of a gradual transfer of a portion of national public debts to a **European Debt Management Agency** (based on the existing European Stability Mechanism or created from scratch), which would receive contributions from national governments to cover future interest payments. Under the plan, the Agency would acquire a portion of the debt of each Member State, over a period of five years. In exchange for taking on this debt, each year the Agency will receive a stream of revenue from Member States that is sufficient to support the debt transferred. Under this plan, the Agency would have resources to purchase new issuances of countries' debt as old debt comes to maturity, so as to keep its holdings of national debt growing at the same rate as EU GDP. The plan would thus not cancel national debt, but it would replace it with an obligation to the EDA. We see it as having three main advantages: 1. it would create additional fiscal space by reducing the cost of debt; 2. it would complement and strengthen the role of the ECB and also remove country risk from NCB's balance sheets; 3. it would help clarify the fiscal and monetary dimensions of EU risk sharing.
2. **Second, a revision of the existing fiscal rules based on a medium-term debt anchor** with a speed of adjustment that depends on the share of spending for public investment, in order to contribute to European public goods, and to fight recessions. The target would be implemented through a spending rule, defined in a way that would give countries space to increase public investment.

Such reform would pursue **three objectives:** simplify rules and make them more transparent; have realistic rules where the debt reduction objectives are shared by member countries as contributing to European financial stability; give more room to national fiscal authorities for stabilisation purposes, for public investment, and for spending that contributes to European public goods, while still ensuring debt sustainability.

These two pieces, combined, can contribute to a coherent European strategy to foster durable growth by protecting desirable forms of spending, and sustainable public finances through gradual fiscal adjustment.

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BOX 4

THE EU'S GREEN AND DIGITAL TRANSITIONS REQUIRE PAN-EUROPEAN INVESTMENTS

Harald Benink

On March 28, 2022 the European Commission published a summary of responses on its online public consultation on the review of the EU governance framework. **The survey was launched in autumn 2021 and closed at the end of December 2021**.

Many respondents of the survey are of the view that the EU economic governance, including the fiscal rules, should become more growth-friendly, mindful of social issues, and support the policy priorities for the twin green and digital transition. Most respondents acknowledge the need for **the fiscal framework to support the resilience of EU economies** to shocks and that debt sustainability should remain a central objective of the EU fiscal rules. At the same time, they consider that the adjustment paths towards lower government debt should be realistic and gradual in order to avoid negative effects on the economy. Many respondents stress incentivising investment as a necessary feature of the economic governance framework.

The **past decade** saw an active debate on how investments from the EU level could be used to provide incentives to **EU Member States** to implement structural reforms of their national economies to enhance competitiveness and long-term growth, especially in their labour and services markets and pension systems.

The **European Shadow Financial Regulatory Committee**, a group of well known professors in the fields of economics, finance and law coming from 10 European countries, contributed to this discussion on a number of occasions.

In September 2016, a few months after the Brexit referendum, the ESFRC was concerned about Brexit's impact on the future direction of the **European integration process** after years of crisis in the southern Member States of the Eurozone, weakness in their banking systems and economic stagnation. The Committee issued a statement advocating for a **new public investment fund operating under the auspices of the European Investment Bank (EIB)** in order to finance new infrastructure projects in the EU countries for an amount of up to one trillion euros. As part of a grand deal, countries such as **France and Italy** would commit to a detailed agenda of implementing structural reforms of their economies. Also, the fund would be visibly effective and could contribute to changing political dynamics in terms of strengthening public support for the European project and the EU.

In February 2020, just before the outbreak of the **Covid-19 crisis,** the ESFRC issued a statement on Fragilities in the Eurozone: Pre-emptive Action to Save the Euro. In its statement the Committee advocated for the design of a longer-term financial policy action plan and structural economic reforms for Italy, where the lack of economic growth and increasing government debt ratio puts the country at risk of facing a financial sustainability crisis. This could have led in turn to huge losses for banks and other investors in its government debt, a **European banking crisis and the exit of Italy from the euro**, with unforeseeable consequences for the whole EU.

Because of the **Covid-19 crisis of 2020-2021,** governments in EU countries had to borrow substantial amounts of money in order to be able to support their economies, which were facing huge costs in terms of healthcare and providing income support to companies and families. Unfortunately, Italy was one of the countries most severely hit by Covid-19. In economic terms, this led to a further increase of **Italy's government debt ratio from around 135% before the crisis to around 160% now**. Countries such as France and Spain have also seen their government ratios rising up to near 120%.

The problem is that the EU's green and digital transition may experience difficulties if countries have to finance it primarily by increasing their national debt levels. For countries such as **Germany and the Netherlands**, currently having low government debt ratios, this may not be an issue. But for countries such as France, Italy and Spain this may become problematic, since it would jeopardise the sustainability of their government debt in an environment in which we can expect increases of interest rates as the ECB reduces the size of its QE program.

The **transition towards a green and digital European economy is a matter of great pan-European interest**. The ambitions will not be realised if countries such as Germany and the Netherlands can meet their targets but many other countries cannot due to issues of sustainability of national debt.

Therefore, there is a strong case to be made for European funding of these investments. In this respect, the **EU's Recovery and Resilience Facility**, which amounts to around 750 billion euros and was created to mitigate the economic and social impact of the coronavirus pandemic and make European economies and societies more sustainable, sets a good example, since the facility is financed by bonds issued by the European Commission. Because of this, the national debt of EU member countries is not increased.

But larger amounts are likely to be needed to finance the green and digital transition. **A way to organise this is to create additional dedicated European funds**. During a hearing of the Dutch Parliament on the future of the Stability and Growth Pact on November 24, 2021 I promoted this idea of creating new European funds. The point was well taken. Naturally, some political parties immediately responded positively while others had to reflect on this further. But the discussion has started in the Netherlands as well.

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In case readers are interested in receiving more information on the work of European Shadow Financial Regulatory Committee, please contact the author at H.A.Benink@tilburguniversity.edu.

OUR TAKE: REFORMING THE PACT TODAY TO AVOID A NEW CRISIS TOMORROW

We are living in uncertain times: after the economic shock induced by the pandemic, the war in Ukraine will almost certainly slow the recovery, which was already hampered by a 30-year high inflation. Against such a troubled scenario, the easiest option would be to keep the SGP clauses on ice and further postpone its reform, thus allowing Member States to support their economies and contain the economic and social consequences of the war in Ukraine by continuing fiscal expansion. Although apparently tempting, this route would eventually present an expensive bill since it would certainly lead to even higher debt-to-GDP ratios in a context of tighter monetary policy, with QE coming to an end and interest rates potentially on the rise. Spreads in financially vulnerable countries could start rising again and pave the way for a new financial crisis.

7.4%

30-year high inflation (Eurozone, March 2022)

This means that SGP reform should not be postponed. All main policy proposals go in the same (and right) direction aimed at adopting simpler, clearer and more flexible strategies. In our view, a potentially effective landing point among these proposals could be based on the following key points:

1) **We still need "some sort of" SGP:** the current context characterised by successive economic shocks entails a real risk of not having a SGP at all. It is not just about whether (and to what extent) to reintroduce fiscal discipline, but it is a matter of deeply reforming the public finance framework in the eurozone. This is why rules are still needed: without them, countries with high levels of debt might be exposed to speculative attacks in the financial markets. In other words, we could be watching the replay of a film already seen in 2011-12, when rules were already there but very few were complying with them. From that experience, one lesson to be learnt is that better and up-to-date rules are needed, among other things, to create financial "firewalls" that could preserve more vulnerable countries. This is even more important because the only "shield" left – the ECB asset-purchase programme – is due to expire in the second half of 2022;
2) **One-size-fits-all strategies don't work:** the rigidities of the top-down architecture of the SGP has clearly shown that they are no longer appropriate to today's economic environment. The debt

EU public goods

through EU new debt?

reduction rule is unrealistic if compared to today's high levels of public debt in many Member States: its full application would imply massive fiscal restrictions (in the form of major spending cuts or tax increases) that would be simply unsustainable from both an economic and a socio-political point of view. A common framework consisting of a limited number of rules is needed, but a reformed SGP should allow for country-specific strategies focused on a two-track approach mixing fiscal consolidation, sustainable growth and reforms;

3) **A forward-looking approach to anticipate risks and avoid crises:** fiscal consolidation programmes could be strengthened by adopting more detailed medium-term budgetary plans (maybe with a three-year horizon) and further empowering the national independent budgetary institutions under the umbrella of the European Fiscal Board (or a similar body). This would ensure longer-term planning within a coherent European framework and help detect, and anticipate, potential risks of diverging from a safe financial path;

4) **Further exploring debt mutualisation to boost the transitions:** NGEU was a first – and limited – step in the issuance of EU common debt. However, much more needs to be done to allow EU countries to move fast along the green and the digital transition, that will define our future. So, NGEU should be considered as a preliminary "experiment" to increase the EU's fiscal capacity and raise capital to support the supply of "European public goods" in areas such as defence, security, development cooperation, research and development, climate change mitigation, and an adequate digital infrastructure.[31] Such a mechanism should be designed so that it does not provide a "bandwagoning" opportunity for heavily-indebted countries that do not intend to comply with the rules, and part of the spending undertaken by the EU budget is transferred from domestic budgets.

Notes

1. Eurostat.
2. ECB, "Pandemic emergency purchase programme", PEPP.
3. See "Annual consolidated balance sheet of the Eurosystem", European Central Bank, Eurosystem, 17 February 2022.
4. Eurostat, "Early estimates of income inequalities during the 2020 pandemic", June 2021.
5. Eurostat, "Government finance statistics", 20 October 2021.
6. Eurostat.
7. ISPI, "Europa: economia di guerra", DataLab, 18 March 2022.
8. European Commission, "History and Stability of the Growth Pact".
9. Medium-Term Budgetary Objectives (MTOs) are set on a country basis in order to reach balanced budgets in structural terms. MTOs are updated every 3 years, or more frequently in the case of a country that has undergone a structural reform which significantly impacted its public finances. All EU countries are expected to reach their medium-term budgetary objectives (MTOs), or to be heading towards them by adjusting their structural budgetary positions at a rate of 0.5% of GDP per year as a benchmark.
10. EUR-Lex, Council Regulation No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.
11. The European Semester is the main tool at European level to monitor national progress on economic and fiscal policies. Established in 2010 as a macroeconomic tool within the Europe 2020 strategy, it has become also the tool through which the Commission also makes recommendations for social policy reforms at national level. It is part of the European Union's economic governance framework which aims to detect, prevent and correct problematic economic trends such as excessive government deficits or public debt levels. Its focus is on the 6-month period from the beginning of each year, hence its named the 'semester'.
12. Parlamento Italiano, "Le modifiche al Patto di Stabilità: Six Pack e Two Pack".
13. European Commission, Macroeconomic Imbalances Procedure.
14. Camera dei Deputati, Temi dell'attività parlamentare XVII legislatura, "Trattato Fiscal Compact".
15. European Commission, "Economic governance rules after the financial and economic crisis – A review".
16. European Commission, "Economic Governance Review", Communication from the Commission to the European Parliament, 2020.
17. European Parliament, DG for Internal Policies of the Union, "How could the Stability and Growth Pact be simplified?", 2018.

18. In other words, government policies did not help to stabilize their economies (so-called "procyclicality").
19. Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee of the Regions, Economic governance review Report on the application of Regulations (EU) No 1173/2011, 1174/2011, 1175/2011, 1176/2011, 1177/2011, 472/2013 and 473/2013 and on the suitability of Council Directive 2011/85/EU COM/2020/55 final
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21. D. Tentori and A. Villafranca, "Recovery and Resilience Facility: una comparazione tra paesi chiave dell'Unione Europea", Osservatorio di Politica Internazionale, ISPI-IAI, 2021.
22. F. Bruni, "Guerra in Ucraina: nuovo cigno nero per l'economia UE?", *Global Watch*: Speciale Geoeconomia n. 96, ISPI, 25 March 2022.
23. European Central Bank (ECB), "ECB staff macroeconomic projections for the euro area", March 2022.
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25. M. Draghi and E. Macron, "The EU's fiscal rules must be reformed", *Financial Times*, 23 December, 2021.
26. Joint paper by Spain and The Netherlands on priority issues in 2022 on the EU's economic and financial policy agenda (2022).
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29. Z. Darvas and G. Wolff, *A green fiscal pact: climate investment in times of budget consolidation*, Policy contribution 18/21, Bruegel, September 2021.
30. P. Martin, J. Pisani-Ferry, and X. Ragot, "A new template for the European fiscal framework", VOXEU-CEPR, 26 May 2021.
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