SUSTAINABLE FINANCE LAB

INPUT FOR THE PUBLIC CONSULTATION OF THE EUROPEAN COMMISSION

On the review of the EU economic governance

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POLICY PAPER

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The Sustainable Finance Lab (SFL) is an academic think tank whose members are mostly professors from different universities in the Netherlands. The aim of the SFL is a stable and robust financial sector that contributes to an economy that serves humanity without depleting its environment. To this end the SFL develops ideas and provides a platform to discuss them, thus bridging science and practice.

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Policy Paper

Sustainable Finance Lab publishes different types of publications.
This is a Policy Paper. Policy papers are reports produced by SFL members or employees that contain specific proposals and recommendations for the financial sector or policy makers.

1. IMPROVING THE FRAMEWORK

Question: 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?

The broken promise of convergence

At the start of the European Monetary Union it was acknowledged that a monetary union between such different economies requires both a form of fiscal union as well as an economic convergence between the Member States. The 1992 Maastricht Treaty therefore starts by expressing the resolve of its signatories to achieve the strengthening and the convergence of their economies. Unfortunately, we now have to conclude that the EU has not delivered on this promise of convergence and that a sufficient common fiscal capacity is still lacking. This has become clear since the euro crisis erupted in 2010. Especially Southern European countries still suffer from the austerity approach during the euro crisis when the pro-cyclical rules of the Stability and Growth Pact (SGP) exacerbated the structural imbalances between the eurozone countries and led to a strong decline in investments. Whereas the SGP-norms have often not been lived up to in full, also before 2010, they nevertheless resulted in a much less expansionary fiscal stance than in for instance the US in the same period.

Economic governance reform

The reform of the economic governance should seek to repair the broken promises of the Maastricht Treaty. To this end it should effectively promote convergence within the EU and eurozone by enabling sufficient space for productive (green) public investments and a socially just post-pandemic recovery. Financially sustainable public finances also require ecologically and socially sustainable societies. This should be reflected in both the SGP and the macroeconomic imbalance procedure (MIP). The SGP and MIP should support a fiscal stance aimed at maintaining effective demand by supporting wage growth and decreasing unemployment throughout the whole EU while keeping financial imbalances, both private and public, from building up. It should also be acknowledged that debt burdens in several member states have become so high that they will need to be resolved. We therefore propose to:

Enable green and productive investments

Debt sustainability deteriorates when productive public investments are not undertaken. Therefore, the SGP should leave room for productive investments like those in education and other growth enhancing investments. In particular, room needs to be given for the necessary investments for the Green Deal. To enable sufficient public investments and spending, one could think of a (green) golden rule (GGR) as well as broadening the MIP to also include ecological elements, including the dismantling of ecologically unsound government spending and subsidies.

Increase the symmetry between SGP and MIP

Currently there is an imbalance between the SGP with its corrective arm, including sanctions, and the MIP that lacks such measures. This while financial sanctions are of limited use in disciplining fiscal imbalances, as they will only add to the problem, while member states running persistent trade surpluses do have the financial means to pay fines. To that end, the MIP could be made more forceful and include sanctions for countries that do not reduce their macroeconomic imbalances to below the limits set. Most urgently, this should focus on the current account imbalances as well as private sector credit flows and private debt that played such a large role in creating the euro crisis.

Adjust debt reduction pathways and look at debt cancellation

Whereas SGP and MIP seek to prevent unsustainable situations, it needs to be acknowledged that there are public debt problems in several euro countries for which solutions need to be found. Country specific debt reduction and debt sustainability pathways are needed that depart from the current debt reduction rule that would require a reduction of the debt with 1/20th of the distance to the 60%-debt norm. More realistic, hence lower, country specific debt reductions need to be specified and made possible, if necessary, with the help of less indebted Member States. Also, recent calls to set aside the corona debt growth that is now on central banks' balance sheets and effectively write it off should be considered.

Strengthen the common fiscal capacity

We welcome the Recovery and Resilience Facility (RRF) as it is commonly funded, and its means distributed to the places where it is needed most, thus helping countries with already high debt levels to finance productive investments and undertake necessary reforms. Financial instruments such as the RRF can absorb shocks, tackle divergence in the EU, improve debt sustainability as well as foster climate mitigation and adaptation. As such they provide a basis for a “Grand Deal” where European financial support is given in exchange of a reform plan presented by the country receiving support itself, as also proposed by the European Shadow Financial Regulatory Committee[1].

1 https://sustainablefinancelab.nl/wp-content/uploads/sites/334/2021/09/ESFRC-Statement-on-Fragilities-in-the-Eurozone.pdf

2.
SAFEGUARDING SUSTAINABILITY AND STABILISATION

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

Fiscal rules are needed given the interdependencies between Member States with regard to their fiscal decisions. However, the euro crisis has shown that there are not only negative externalities of too broad fiscal policies. Fiscal policy can also be too timid, as it has been in the North during the euro crisis years.
The euro crisis also showed that austerity does not necessarily improve debt-to-GDP ratios. Through austerity economies can actually shrink more than the government's expenditures. Resulting in not only hardship and deteriorating economic potential, but also higher debt to GDP burdens.

The European fiscal framework should therefore allow for short-term stabilisation policies to deal with the challenges that Member States face. These can be cyclically, recovering from an economic shock such as the consequences of the pandemic. These can also be transitory, like climate change and digitalization. Maintaining effective demand by supporting wage growth and decreasing unemployment contributes to long-term economic development and better social outcomes. Safeguarding long-term sustainability implies both dealing with the afore-mentioned challenges and enabling sustained economic development. Fiscal standards (qualitative prescriptions that leave room for flexibility) instead of rules would enable more country specific fiscal policy and therefore increase the chances of meeting the set targets. This does require strong national ownership of the overall objectives of the EU's economic and budgetary policy, and of their relationship with national policy decisions. It also calls for strong Independent Fiscal Institutions (IFI's) that are seen as trustworthy on the national level as well as by other Member States and the European Commission. Overall, stronger ownership and stronger IFI's could improve compliance by the Member States.

During the corona crisis we saw an acknowledgement of the differing possibilities of Member States to withstand the shock. This has resulted in the creation of the Recovery and Resilience Facility (RRF) and the activation of the general escape clause of the SGP and a broad monetary policy of the ECB. This has enabled Member States to make the necessary investments and expenditures to support their crisis-stricken economies, while prioritising investments that contribute to the green energy transition and digitalisation.

However, long-term sustainability can only be achieved if Member States can continue to steer their economies towards a socially just green energy transition. Post-pandemic austerity could lead to destabilisation of European economies, especially in the South. Instead, inequality within and between countries should be tackled and con-vergence fostered, in line with the goals of the Maastricht Treaty[2]

[2] “The Community shall have as its task [...] to promote throughout the Community [...] a high degree of convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States.” https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A11992M%2FTXT

3. INCENTIVISING REFORMS AND INVESTMENTS

Question: 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?

The current framework does not focus on tackling the ecological imbalances (climate and biodiversity) that also threaten to undermine the long-term financial sustainability of public finance, next to the wellbeing of citizens in the EU and globally. To prevent this from happening, both the SGP and the MIP need to include green provisions.

A green golden rule in the SGP

To enable sufficient public investments and spending, one could think of a (green) golden rule (GGR). The European Fiscal Board already supported the idea of a golden rule in 2019[3]. This suggestion could be developed further for policy areas that are in line with the European Green Deal and the RRF, including education, as recently promoted by Bruegel.[4]

The introduction of a GGR should not lead to "greenwashing", i.e., pushing the boundaries of what can be classified as a green investment. To prevent this use can be made of the EU green taxonomy, which provides clear criteria for defining green economic activities. In this respect, a "brown" taxonomy would be complementary to define undesirable investments that harm climate, nature, and the environment.

[3] https://ec.europa.eu/info/sites/default/files/2019-09-10-assessment-of-eu-fiscal-rules_en.pdf
4 Https://Www.Bruegel.Org/2021/09/A-Green-Fiscal-Pact-Climate-Investment-In-Times-Of-Budget-Consolidation/

Whereas a GGR creates financial space, it also implies that public debt will still rise. This does not have to be a problem however if these investments stabilize economies so that private investor's trust in sovereign debt is maintained. What is arguably worse, as we have seen during the euro crisis, is when through austerity economies actually shrink more than the government's expenditures, resulting in not only hardship and deteriorating eco-nomic potential, but also higher debt to GDP burdens. In this particular case, a lack of climate mitigation and adaptation expenditures could lead to large costs in the future, further threatening the sustainability of public finances in especially Southern countries.[5] A GGR may also correct for the fact that investments, whose benefits materialize in an uncertain future, in current budgetary considerations often lose out to expenditures that provide more immediate benefits.

Adding ecological indicators to the MIP scoreboard

The Commission's initiative to integrate the European Green Deal and RRF objectives into the European Semester, as exemplified amongst others by publishing a renewed Annual Sustainable Growth Survey, is a welcome step. However, currently, the 14 indicators of the scoreboard of the MIP focus exclusively on trade, finance, and employment. Green indicators should be added. For instance, on government expenditures and subsidies that harm climate and biodiversity, such as tax exemptions for fossil fuels and subsidies to intensive farming. Also, indicators can be made for green taxes on activities that harm the climate and biodiversity or have other negative external effects. Such budgetary shifts would also relief the tax burden on labour. Member States that continue to excessively subsidise their fossil economy should face sanctions.

Also, climate adaptation and the exposure to the physical risks of climate change should be factored in as this can be an important driver of worsening public finances in the (near) future. It is estimated that in the EU the largest socio-economic impacts are expected on countries with already high levels of debt, hence exacerbating existing macroeconomic and fiscal divergences among Member States.[6]

Incentivising reforms and investments

[5] https://www.espon.eu/sites/default/files/attachments/Final%20Report%20Main%20Report.pdf

[6] Joint Research Center, Projection of Economic Impacts of climate change in sectors of the EU based on bottom-up analysis, https://ec.europa.eu/jrc/en/peseta-iv

4. SIMPLIFICATION AND MORE TRANSPARENT IMPLEMENTATION

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

The expenditure rule

The structural deficit that currently is central to the SGP is widely considered to be too complex and procyclical due to the concept of the output gap on which it depends. An expenditure rule is considered to replace the structural deficit rule. Expenditure rules have the benefit of targeting an observable indicator, namely governmental ex-penditures. They also have an anticyclical character if allowing for higher expenditures if the economic situation requires (extra) governmental investments (automatic stabilizers). Additionally, a study by DG ECFIN has found that expenditure rules "are associated with lower expenditure volatility and higher public investment efficiency." However, it should be remarked that as with the structural deficit, assumptions need to be made to arrive at the allowed level of expenditures. In calculating the potential growth one runs the risk over over- or underestimation which can have pro-cyclical effects.

Keep flexibility

Whereas simplification in itself is good, this should not mean that the EU framework would allow for less flexibility. Flexibility that will be needed as long as especially the arbitrary debt level of 60% is maintained. Despite the broad consensus that the 3% and 60% targets are outdated and arbitrary norms they are enshrined in the Treaty and as such it is important that the SGP leaves enough flexibility to work around this if needed. In the long-run these tar-gets should be removed from the Treaties.

5. FOCUS ON PRESSING POLICY CHALLENGES

Question: How can surveillance focus on the Member States with more pressing policy challenges and ensure quality dialogue and engagement?

Creating ownership, public and political support

Realizing the desired reforms requires ownership. This starts with ensuring democratic and political processes where reforms are proposed on behalf of countries in a bottom-up way, instead of being perceived as being imposed by international institutions. The European Commission should start by inquiring at the Member States what the most pressing challenges are, analysing these and reporting on this. This creates commitment of and within Member States. Taking such an approach allows the Commission to identify additional challenges and the independent bodies, including IFI's, involved in surveillance to identify and follow up on challenges identified earlier while keeping Member States to their own promises and prioritizations. Also, civil society organizations, trade unions and national parliaments should be engaged actively in dialogues with the European Commission in the development of country specific recommendations and the surveillance framework. This also applies to investment plans and reforms that are part of the European semester or other EU arrangements.

6. LESSONS FROM THE RRF

Question: 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?

Overall, it seems that the RRF plans that were submitted are generally ambitious and well substantiated. The lesson being that the more bottom-up approach of the Commission (i.e., plans that have been developed by the Member States themselves instead of being prescribed by the Commission) could be successful by creating more democratic support from the Member States and a sense of ownership. The disbursement in tranches embedded in the RRF framework and all the checks and balances that it involves stimulates sufficient and complete implementation of the RRF agreements. Also, does it prevent a lack of action by the Member States after receiving funding.

This approach could also be applied to the further development of temporary common European mechanisms (like funds) for the sustainability and other transitions or for common economic shock absorption. Of added value would be to not only focus on national investments and reforms, but rather also look at European global goods such as transport- and energy networks that cross the borders of different Member States.

Additionally, the role of national civil society organizations, trade unions, IFI's and parliaments could be strengthened, both in terms of the establishment of plans as well as their implementation. Also, a public evaluation of the RRF plans in all participating Member states would be of added value to increase civic engagement in European integration, leading to more European solidarity.

7. NATIONAL FISCAL FRAMEWORKS

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

An EU fiscal framework that allows for more country specific policy goals will likely increase the involvement of independent fiscal institutions, think tanks, civil society organisations, trade unions, politics, and EU citizens. Also, a more democratic European semester that gives more space for these actors to engage will lead to plans and recommendations that can count on more democratic support and national ownership.

The EU should strengthen transparency and information sharing between the Member States regarding their national fiscal frameworks. Comparability of Member State data may help EU citizens, national parliaments, civil society organizations and trade unions to hold their governments accountable.

A larger role for independent IFI's

Several experts plead for more involvement of Independent Fiscal Institutions. This is understandable and worth considering, since IFI's often have specific knowledge of a country and can provide guidance in public investment leeway and other policy related issues.

In countries where there are no proper IFI's yet, EU support and technical assistance (also from Member States, as peer to peers) should be provided to set them up. IFI's can improve fiscal policy in Member States as well as compliance with the common fiscal policy norms. Therefore, in the long run, supporting the establishment of proper IFI's in all Member States will benefit the EU fiscal framework as a whole and strengthen trust between Member States. Additionally, IFI's can relieve the pressure off the Commission to be held responsible for many different tasks, such as surveillance.

As their main task, IFI's should be preoccupied with the quality of expenditures and investments. They should make an integral analysis of not only the budgetary impact of investments, but also its wider economic implications, including the long term social and environmental ones, thus contributing to assessing the progress made regarding European policy agreements, such as national climate plans and the European Green Deal.

Based on a clear mandate

However, a larger role for IFI's does not imply that technocratic institutions take over the role of national states or democratic political institutions. Developing national fiscal frameworks are primarily the responsibility of the governments and parliaments, and political decisions should primarily be left to the political realm. IFI's should control and report, thus informing the political process. Also, given the need for an integrated approach, it is important that IFI's consist of a diversity of experts stemming from different disciplines (financial, economic, but also social and ecological). Accordingly, they should function in a democratic and transparent way.

8. EFFECTIVE ENFORCEMENT

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

To increase the compliance with the EU fiscal rules the single most important requirement is that these are seen to make sense. The current 60% public debt rule no longer does, as a recent survey amongst Dutch economist showed, where only a small minority thought this to be the case. Also, the deficit rules have come under criticism of economists due to their pro-cyclicality during the eurocrisis and sometimes ineffectiveness to contribute to the goal of debt sustainability by increasing debt to GDP ratios through the harm done by austerity to the economy. Hence, it is senseless to talk about enforcement of such rules without first repairing the rules themselves so that they are accepted, and a majority of Member States feels an intrinsic urge to comply.

Nevertheless, also before 2008 SGP-norms were often not upheld because of which many Member States entered the euro crisis with elevated levels of public debt.

Incentivizing Member States...

At present and in the past, pecuniary sanctions are not being enforced. Whether sanctions work at all is question-able, while they can also have counterproductive effects. First, we advise to work on ownership of the fiscal and macroeconomic imbalances rules through involving civil society organizations, trade unions, IFI's and national parliaments in the process. Also, positive incentives, such as the RRF subsidies and loans or conditional EU funds, can enhance ownership of reforms and ensure proper implementations of agreements. With budgetary problems pecuniary sanctions will only aggravate the problem, while access to common funding will directly alleviate the budgetary squeeze and hence provide political space, also for reforms. So, to complement the surveillance framework a supporting framework is needed as well.

…while fighting corruption

In order to gain trust and public support it is also important to combat corruption by fully implementing the anti-corruption recommendations in the Commission's Country Specific Recommendations and Rule of Law report. The implementation of anti-corruption measures and recommendations should be supported by a credible sanction mechanism. This means amongst others that the Commission shows preparedness to use her powers to withhold subsidies both in the context of the RRF (e.g., by not approving national recovery plans) and by applying the new rule of law mechanism with respect to decisions on the allocation of EU budget spending. Cases of suspected fraud or corruption should be handed to the European Public Prosecutor's Office, the independence, and legal competences of which should be strengthened.

9. INTERPLAY BETWEEN THE SGP AND MIP

Question: In light of the wide-ranging impact of the COVID-19 crisis and the new temporary policy tools that have been launched in response to it, how can the framework – including the Stability and Growth Pact, the Macroeconomic Imbalances Procedure and, more broadly, the European Semester – best ensure an adequate and coordinated policy response at the EU and national levels?

SGP and MIP are strongly related and equally important

The SGP and MIP cannot be seen in isolation. Not living up to the MIP can make attaining the SGP goals impossible. This became evident during the euro crisis, where austerity in the South was not matched by investments coming from the North, despite countries like Germany and the Netherlands grossly overshooting the balance of payments limits. For this reason, the current asymmetry needs to be diminished, where the SGP has a stronger sanction regime than the MIP does.

Focus on climate risks and common goods

The European framework, both SGP and MIP, should pay more attention to climate risks and integrate them across the board. Both transition risks and physical risks of climate change are set to impact EU member states in very different ways. Thus, adding to already existing divergences, as the South is impacted much stronger than the North. Thus, further undermining the common currency of the euro with its single monetary policy. To this end the MIP could monitor the development of these risks. This means that the MIP should incorporate indicators that target climate related risks, environmental protection etc. The SGP rules can make exceptions for green investments (GGR).

The economic governance can counter economic divergence in the EU and eurozone by taking on common challenges such as tackling the consequences of the covid crisis and fostering the green energy transition. European public goods can provide guidance for policy choices within all the different dimensions of the EU economic governance framework.

10. EURO AREA DIMENSION

Question: How should the framework take into consideration the euro area dimension and the agenda towards deepening the Economic and Monetary Union?

Broken promises

The promise of the euro of economic convergence has not been fulfilled. Since the euro crisis there is actually divergence. This is caused by a lack of economic reform and a lack of fiscal integration and European solidarity in the form of transfers. Also, the functioning of the euro itself contributed to the divergence in the eurozone, by creating trade flows from the North to the South, while capital was flowing the other way around. The austerity measures that followed the euro crisis have impacted countries in the South adversely also reducing their economic potential. Until today, the countries in the South are not resilient enough to grapple with the consequences of the corona-crisis.

While the euro has supported further integration of the internal market, the Nordic countries profited disproportionately from a (for them) cheap euro, strengthening their export position. Conversely, Southern euro members had to deal with a higher exchange rate compared to the situation without the euro, hurting their exports.

To tackle divergence within the eurozone, these macroeconomic imbalances should be eliminated. Furthermore, EU funding is needed to finance the green transitions in all EU Member States. An EU fiscal capacity is needed of a sufficient size for stabilization purposes. An EU investment agenda focused on the establishment and protection of European public goods could serve as a guidance for the deployment of such fiscal stimulation.

Last but not least, the completion of the Banking Union should be a priority with respect to financial stability within the eurozone, including improved climate risks assessments. However, given the conditions put forward by for instance Germany and the Netherlands a common deposit guarantee system is not to be expected in the short run. Likewise, the development of an integrated Capital Markets Union is progressing slowly at best. This enhances the need for a fiscal stabilization capacity of appropriate size.

A euro zone integration based on needs

Given the situation, it is unrealistic to expect from certain countries (most evidently amongst the larger countries Italy) that they will be able to comply with the SGP after the discontinuation of the general escape clause. If the euro area is to become a more stable monetary union, it should provide the eurozone members with enough possibilities and means to tackle the consequences of the corona-crisis, climate change and other challenges they face such as the corona-crisis and to tackle poverty and inequality.

For a new EU fiscal framework to be effective, the high debt problems of the Member States should be resolved. Special attention should be paid to the situation of the Southern countries, where public debts are soaring, and the general social and economic outlook is bleak. The recent calls to set aside the corona debt growth that is now on central banks' balance sheets and effectively write it off should be looked into.

11. NEW CHALLENGES DUE TO THE COVID-19 CRISIS

Question: Considering how the COVID-19 crisis has reshaped our economies, are there any other challenges that the economic governance framework should factor in beyond those identified so far?

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