SUSTAINABLE FINANCE LAB

A SUSTAINABLE FISCAL PACT FOR EUROPE

In this paper

The EU is currently not able to deliver on its objectives: raising the standard of living throughout the Union while respecting the environment.

Without a new economic governance this fragile Union risks falling prey to a new debt crisis that destabilises the monetary union and increases tensions between and within Member States.

We formulate recommendations for a new Sustainable Fiscal Pact for Europe that enables all Member States to reform and invest in an inclusive way in the productivity and sustainability of their economy.

Sustainable Finance Lab

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POSITION 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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Position Paper

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This is a Position Paper. Position papers are reports in which SFL as a whole advises the sector or policy makers. They are often set up because of a special occasion. The content of these reports is based on plenary discussions within SFL. Not all views, recommendations and conclusions expressed in this publication are necessarily coherent with the views of every individual SFL member.

CONCLUSIONS AND RECOMMENDATIONS

The EU has weathered the storms of the 2008 banking crisis, the 2010-euro crisis and most recently the Covid crisis. Yet, the Union is in a fragile state, not able to live up to its promise to raise the standard of living throughout the Union while respecting the environment. As the ECB reaches the limits of its monetary mandate, fiscal solutions are needed.

To that end the European Union urgently needs to reform its so-called economic governance: the fiscal framework (e.g., Stability and Growth Pact), Macroeconomic Imbalances Procedure and European Semester. Additionally, the set of common fiscal instruments should be expanded.

This economic governance should enable all Member States to make the necessary investments in the productivity and sustainability of their economies.

Failure to do so could put the Green Deal objective of a fair transition to a sustainable economy out of reach. This in turn can discourage other parts of the world in taking action against climate change and biodiversity loss — effectively making them unavoidable.

Failure to do so also creates a risk of the Union falling prey to a new debt crisis, destabilizing the monetary union, and increasing tensions between and within Member States. Additionally, the geopolitical situation requires unity now more than ever before.

There is a unique opportunity this fall, as the European Commission will present its proposals for changing the fiscal framework of the European Union. Neither a return to the old rules nor a leap towards 'US-style' fiscal integration seem politically or economically feasible. However, smaller more pragmatic steps will make it possible to ensure that all EU Member States are able to make the necessary reforms and investments.

There are five elements that need to be part of this new Sustainable Fiscal Pact for Europe:

1. **Increasing the debt limit.** The general 60% debt limit in the Protocol to the Maastricht Treaty is no longer tenable and should be increased. This is possible without a formal Treaty change.

2. **Country specific expenditure rules based on national reform and investment plans.** Instead of the structural deficit rule, an anticyclical and country specific expenditure rule should be used to control spending over the economic cycle. Green and productive investments should be stimulated by being treated differently from other expenditures.

3. **Greening the Macroeconomic Imbalances Procedure.** Climate and biodiversity have large macroeconomic impacts. The European framework should pay more attention to such risks and integrate them across the board. The MIP should incorporate indicators that target climate and other environmentally related risks.

4. **EU transition funds.** Temporary EU transition funds enable all Member States to make the necessary investments. To that end, the model of the Recovery and Resilience Facility can be repeated: commonly financed temporary funds to stimulate and finance targeted green and productive reforms and investments.

5. **Strengthening governance and democratic accountability.** Better adherence to the rules and guidelines of the economic governance is a prerequisite for trust between Member States and hence for further integration steps. Independent Fiscal Institutions can contribute to this. These should also take social and environmental factors into account.

SUMMARY

The broken promise of Maastricht

The European Union in its current state is not able to do 'what it takes'. The EU is not able to deliver on the objectives to which it is bound by the Treaty: raising the standard of living throughout the Union while respecting the environment.

This report discusses how the current 'economic governance', the fiscal rules and the subsequent coordinating institutions within the EU, has proved to be unfit for purpose. The report contains several recommendations for its upcoming reform to equip the Union for fulfilling the promise of the Maastricht Treaty.

A Union not fit for purpose

Even before the start of the monetary union economists warned that a monetary union requires a common fiscal capacity to absorb economic shocks and drive convergence, accelerating economic development in the less wealthy and less dynamic parts of the Union. This is especially true for a relatively fragmented monetary union such as the eurozone. Despite the lack of a common fiscal capacity, the first ten years of the euro saw convergence of GDP within the EU. A trend driven primarily by Eastern Member States catching up.

In the South, convergence was driven by increased borrowing from the North. When these credit flows ended in 2010 and austerity set in, the economic situation in the South worsened severely and economies diverged again from the North. Painful reforms and budget cuts did not turn the tide. On the contrary, government debt to GDP ratios increased due to a procyclical fiscal stance throughout the whole EU. It was only after the ECB promised to do 'whatever it takes' that the euro crisis subsided. Since then, the economic governance has been reformed, adding amongst others a process for the identification and mitigation of macroeconomic imbalances.

However, these reforms have not been able to halt divergence between North and South. Meanwhile, particularly in the South, government debts and unemployment remain high. This leaves the Union in a fragile state.

When the covid pandemic hit, the EU quickly recognised that the existing economic governance was not fit for purpose. Fiscal rules were suspended, and new conditional common fiscal instruments created. As these instruments are temporary, the need for permanent reforms remains. A need that is illustrated by the fact that even the strongest Member States are effectively budgeting out of line with the current fiscal framework.

A change of fiscal policies is needed as the ECB may have reached the limits of what monetary policy can contribute. With high inflation levels, the ECB's Transmission Protection Instrument may seem less credible than the Outright Monetary Transactions programme did in 2012.

This fragile Union needs to confront large and expensive challenges in the years to come. Most acute is the fallout due to the Russian invasion of Ukraine, increasing the need to support low-income households. Strongly rising energy prices strengthen the case for an acceleration of the energy transition, already needed to comply with the global Paris agreement. Other pressing ecological issues also require investments, such as the need to realize a circular economy that halts the current biodiversity loss. Geopolitical tensions underscore the need to make the EU more economically independent, adding to the need to invest in economic productivity. Meanwhile, the EU is ageing, quickly increasing the burden of pensions and health care.

With the current fiscal framework, it seems the Southern and Eastern Member States will not be able to meet the challenges. Investment needs clash with current debt levels and deficits. Within the rules many countries have no space for such investments. Even if the fiscal rules would permit it, it is questionable whether market conditions would allow them to raise the necessary funds.

No definitive solution in sight

In the discussion on the future economic governance of the EU, two 'definitive' solutions have been tabled. These can be placed at the ends of a spectrum. On the one hand, a scenario calls for reinstalling the old rules and market discipline. Each Member State is on its own. At the other extreme, Member States share their fiscal budgets to a much larger extent in a full-fledged European integration scenario.

The problem with the first solution is that even its proponents admit it can only be considered after the current high debt levels in the South have been reduced to sustainable levels. There does not, however, seem to be any political willingness to perform such a debt restructuring. More fundamentally, in this scenario there is an apparent lack of forces for convergence. And in the run-up to the euro crisis, financial markets have not proven to be effective disciplining mechanisms.

The full-fledged integration scenario could work economically, but the political feasibility at this stage seems to be small. Especially in the North, there is broad resistance to more common budgets or the issuance of common debt.

Ways forward

Several smaller steps forward have been put on the table and seem to have more political support. Firstly, to allow Member States to make better use of the fiscal space they have. A widely supported measure is replacing the structural deficit target by an expenditure rule. This caps the growth of government expenditure at a level related to the potential growth of GDP. This could ignore cyclical expenditure such as unemployment benefits.

The expenditure rule can consider country specific characteristics relevant for long-term debt sustainability. A distinction can be made between "consumptive" government spending (e.g., on salaries or social welfare) and investments in e.g., green energy projects, infrastructure, or education. The expenditure rule can also consider the reform agenda of a Member State.

Such an expenditure rule can also replace the current rule of reducing government debt annually at a pace of 1/20th of the distance to the 60%-debt limit. The 60% norm can be updated as well. With levels between 90% and 100%, current average government debt in the EU is substantially lower than it is for instance in the US and Japan. The 60% debt limit can be changed through a unanimous vote in Council in a special procedure.

These reforms of the fiscal rules, however, will not help Member States whose debt levels have reached such heights that financial markets will only lend to them against (prohibitively) high risk premiums. Therefore, additional fiscal burden sharing is needed. This can take two forms: debt relief or common investment programmes. Since debt relief is met with a lot of political resistance, a more targeted, temporary, and conditional approach may be more realistic. A fund of a sufficient size could significantly support all Member States in making the necessary investments.

The macroeconomic impact of ecological imbalances could also be reflected in the economic governance. One way to achieve this is through the introduction of a green golden rule that stimulates green investments. While greenwashing is a real concern here, the EU taxonomy does provide a framework to prevent this. Green indicators such as the sustainable investment gap, environmentally harmful subsidies and the use of green taxes can be added to the Macroeconomic Imbalances Procedure.

Finally, enforcement of rules and guidelines of economic governance has been limited. Proposals have been tabled to strengthen governance and democratic accountability. One example is the proposal to design sanctions that prevent enlarging budgetary problems and which settle the balance between the fiscal and macroeconomic norms by setting the same sanctions for each.

To increase ownership of reforms, a more inclusive approach could help, bringing civil society and national parliaments into the discussion. National Independent Fiscal Institutions can improve national surveillance and thus trust between Member States. Given the strong interdependencies between traditional financial and economic developments and social and environmental factors, IFIs will need to make an integral analysis, including long term social and environmental effects.

A Sustainable Fiscal Pact for Europe

The Stability and Growth Pact has brought the EU insufficient stability and growth, especially since the euro crisis. Since the rules of the European Monetary Union were written in 1992, new challenges have presented themselves. The most urgent challenge is the need to realise an inclusive and ecologically sustainable economy. To that end it is imperative that the economic governance rules are rewritten. Effective solutions are needed that enable all Member States to invest in strengthening their economies sustainably.

A Grand Deal needs to be struck, starting from the common interest of all EU Member States in kickstarting their economies and transitioning to a sustainable and equitable economic model. Failing to do so risks the Union falling prey to a new debt crisis, destabilising the monetary union, and increasing tensions between and within Member States on an unprecedented scale. Therefore, the recommendations for a new economic governance that embodies a Sustainable Fiscal Pact for Europe are:

1. **Increase the debt limit.** The general 60% debt limit in the Protocol to the Maastricht Treaty is no longer tenable and should be increased. This is possible without a formal Treaty change.

2. **Use country-specific expenditure rules based on national reform and investment plans.** Instead of the structural deficit rule, an anticyclical and country specific expenditure rule should be used to control spending over the economic cycle. Green and productive investments should be stimulated by being treated differently from other expenditures.

3. **Green the Macroeconomic Imbalances Procedure.** Climate and biodiversity have large macroeconomic impacts. The European framework should pay more attention to such risks and integrate

them across the board. The MIP should incorporate indicators that target climate and other environmentally related risks.

4. **Introduce EU transition funds.** Temporary EU transition funds enable all Member States to make the necessary investments. To that end, the model of the Recovery and Resilience Facility can be repeated: commonly financed temporary funds to stimulate and finance targeted green and productive reforms and investments.

5. **Strengthen governance and democratic accountability.** Better adherence to the rules and guidelines of the economic governance is a prerequisite for trust between Member States and hence for further integration steps. Independent Fiscal Institutions can contribute to this. These should also take social and environmental factors into account.

CONTENT

LIST OF ABBREVIATIONS

ASGS	Annual Sustainable Growth Strategy
CBAM	Carbon Border Adjustment Mechanism
CMU	Capital Markets Union
CPB	Bureau for Economic Policy Analysis
DGS	(European) Deposit Guarantee Scheme
DNB	Dutch central bank
ECB	European Central Bank
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilization Mechanism
EMU	Economic and Monetary Union (of the European Union)
EPC	European Policy Centre
EPSAS	European Public Sector Accounting Standards
ESM	European Stability Mechanism
ETS	Emission Trading Scheme
EU	European Union
GDP	Gross Domestic Product
GGR	Green Golden Rule
IFI's	Independent Fiscal Institutions
IMF	International Monetary Fund
MIP	Macroeconomic Imbalances Procedure
MTO	Mid Term Objective
NRIPs	National Reform and Investment Plans
OMT	Outright Monetary Transactions
RRF	Recovery and Resilience Facility
SGP	Stability and Growth Pact
SURE	Support to Mitigate Unemployment Risks in an Emergency
US	United States (of America)

1. INTRODUCTION

“The Community shall have as its task, by establishing a common market and an economic and monetary union [...] to promote throughout the Community a harmonious and balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, 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” (European Union, 1992).

“We are in a climate and environmental emergency. The European Green Deal is an opportunity to improve the health and well-being of our people by transforming our economic model [...] Our responsibility is to make sure that this transition is a just transition, and that nobody is left behind as we deliver the European Green Deal” (Timmermans, 2019).

“We need fiscal rules that allow for strategic investment, while safeguarding fiscal sustainability. Rules that are fit for the challenges of this decade. (..) Let us rediscover the Maastricht spirit – stability and growth can only go hand in hand” (Von der Leyen, 2022).

A shining Europe

The European Union has high ambitions. And for good reasons: its current standard of living is high and, in many respects, historically and internationally exceptional. Southern and Eastern European countries have experienced a remarkable economic development since joining the Union. The EU ranks high for the wellbeing of its people (Ahrendt et al., 2018). Compared to the US, the EU has relatively low-income inequality (Bubbico & Freytag, 2018) and a high life expectancy (OECD, 2022a). Civic values, such as social trust and active civic participation remain strong (Andriukaitis, 2017). Through its Green Deal Europe is leading the global fight against climate change with the world's most ambitious and detailed plan to decarbonize the economy. The EU has important economic advantages over the US, with a lower government debt (OECD, 2022c), lower fiscal deficits (OECD, 2022d), and a more balanced trade account (OECD, 2022b).

Great challenges

But not all is well in the Union. Many Europeans are not able to shoulder the burden of the current high inflation. High fossil fuel prices confront the Union with its large dependency on fossil fuels. Governments, especially in the South, emerging damaged by the euro crisis and Covid pandemic have limited room to shield their citizens against the effects of these price hikes. The promise of the Maastricht Treaty for “convergence of economic performance” has been reversed by the austerity of the euro crisis, eroding the foundation of a successful economic and monetary union.

A window of opportunity: economic governance under review

The fiscal rules of the economic and monetary union have been stretched and breached since their inception. As a result of the Covid crisis the Stability and Growth Pact has been suspended altogether. Reintroducing these economic governance rules now would most likely seriously damage the EU economy. The latter not only gives extra weight to the planned revision of the economic governance but may also bring about the political majority needed to adapt the rules. This fall the European Commission presents its proposals for a review of the economic governance; the EU fiscal framework consisting of the Stability and Growth Pact (SGP), the Macroeconomic Imbalances Procedure (MIP) and the European Semester (see annex for a more detailed description).

Political winds of change

Important lessons from the euro crisis appear to have been learned. There is consensus that severe austerity can increase debt levels further. The Covid pandemic revealed how governments can prevent a temporary crisis from resulting in permanent damage. The attitude of government leaders towards the role of fiscal policy in society has changed. Several European leaders acknowledge the necessity of reforming the fiscal framework.[1]

[1] For example, Italian prime minister Draghi and French president Macron made a common pledge for reform in the FT at the end of 2021, stating that Member States need to have more room for manoeuvre and enough key spending for the future and to ensure our sovereignty” and arguing to favour debt raised to finance such investments by the fiscal rules, see (Draghi & Macron, 2021).

We see a broad consensus that European fiscal rules should not undermine post-pandemic recovery nor the buildup of resilience. Sigrid Kaag, the new Dutch minister of finance, for instance, called the recovery fund “one of the building blocks” to tackle “the major transnational challenges of this time – climate change, security and digitalisation” (Kaag, 2022).

The former leader of the frugal countries (most notably Austria, The Netherlands, Denmark and Sweden) recently stressed the importance of sufficient public investments, arguing in favour of country specific medium-term fiscal plans together with Spain (Spain and The Netherlands, 2022).

Structure of the report

The next chapter answers the question whether the current economic governance of the EU is fit for purpose. It starts with a description of the first years of the European Monetary Union leading to the current situation. It describes the different threats to the well-being of Europeans and the stability and sustainability of European economies. Chapters three and four discuss the feasibility and desirability of different options to improve the fiscal framework. Chapter three discusses two far reaching solutions on opposite sides of the spectrum: a market-driven approach and a federalist approach. In chapter four, a range of more incremental policy reforms currently under debate on fiscal rules, governance, ecological sustainability, and debt reduction follows. This publication closes with conclusions and recommendations.

2. THE STATE OF THE UNION: THE NEED FOR CHANGE

Through an analysis of the economic state of the European Union, this chapter discusses whether the Union's economic governance is fit for purpose. This analysis starts at the origin of the monetary union in 2000. There are different threats to the well-being of Europeans and the stability and sustainability of European economies. The current fiscal framework does not allow all member states to effectively address these threats. This means that the very existence of the euro and (therefore) that of the EU itself is threatened.

The first 20 years of the Monetary Union

The first years of the euro were in some respects successful, with some Southern (albeit slowly) and especially Eastern members catching up economically. The euro crisis changed this picture dramatically. Reforms to economic governance have been made but have not fundamentally solved the problem of a monetary union without sufficient common fiscal capability. The austerity of the euro crisis years retarded social and economic development and led to further divergence.

A 'one legged' monetary union

From the beginning, it was clear that the Eurozone is less of, what economists call, an 'optimal currency area' than most other monetary unions. Compared to for example the United States and Canada, real exchange rates, as well as real securities prices, are considerably more variable in Europe while labour mobility and the speed of labour market adjustment are lower (Eichengreen, 1991). Shock absorption through private financial channels in the euro area is one-fifth of the US (Heijdra et al., 2018).

As the economy has become less unified, and slower to adapt, there is a larger need for fiscal transfers to cushion the effects of economic shocks, at least temporarily. With an EU budget of around 1% of GDP (compared to 30% of GDP in the US) the EU has limited common fiscal shock absorbers (FiscalData.treasury.gov, 2022). The lack of this 'fiscal pillar' of the European monetary Union has been the subject of criticism from the start (Reuten et al., 1998).

This also explains the ambition for economic convergence — not only as an ideal of European integration with prosperity for all, but also as a precondition to make a success of common monetary union. Cyclical convergence, where economic cycles between countries move more in tandem, reduces the problem that one interest rate for the whole Union can be too high for one part and too low for another. This also reduces the need for the central bank to prevent fragmentation of the monetary union through unconventional and often controversial policies. Currently however, the economic governance framework does allow for convergence sufficiently.

While the EMU introduced a single currency and European monetary policy conducted by the ECB, a fiscal pillar has always been lacking. Common fiscal mechanisms could help achieve economic stability in the event of economic shocks. Countries could then apply a more accommodative fiscal stance in times of crisis, especially in a suboptimal monetary union, such as the EMU. Common fiscal mechanisms can also compensate for the divergency trends increased by the euro has, such as the strengthened export position of the North (due to a relatively cheap euro) and the weakened export position of the South (which had to deal with relatively higher exchange rates).

The failed Dutch attempt to establish a political Union

Why was a strong fiscal pillar or a fiscal union never introduced, especially in an era (beginning of the 1990's) when there was much support for a political union (Bart Stol, n.d.)?

Ironically, it was the Dutch, known for their frugal mentality today, who tried to establish a political union shortly before the Maastricht Treaty was signed – and failed. This historical occasion is better known as "Black Monday". The Netherlands assumed the EU presidency from Luxembourg in 1992. Luxembourg had tabled a modest proposal for more intergovernmental cooperation including economic and monetary policy, eschewing too great a transfer of powers in a growing EU.

When the Dutch took over, they pleaded for a stronger Community approach (attributing more competences to the EU) for a political union, including terrains such as foreign policy, defence, and legal affairs. The main proponent of the plan was Piet Dankert, state secretary of European Affairs and a euro federalist (with background support of then prime minister Ruud Lubbers). Due to lack of agreement between the Dutch government leaders involved in

> the proposal and other Dutch officials and diplomats, as well as disagreement between countries, the proposal was rejected.[2] In the end, a proposal was pitched that resembled the Luxembourg proposal, and the establishment of a political union was off the table.

The first ten years: low-income economies catching up

The first ten years after the euro came into existence, some lower income countries did catch up. These were mainly the Eastern European countries and Greece, with Italy and Portugal falling further behind, as displayed in Figure 1 EU convergence 2000-2009 (North – South/East).

EU convergence 2000-2009 (North – South/East)

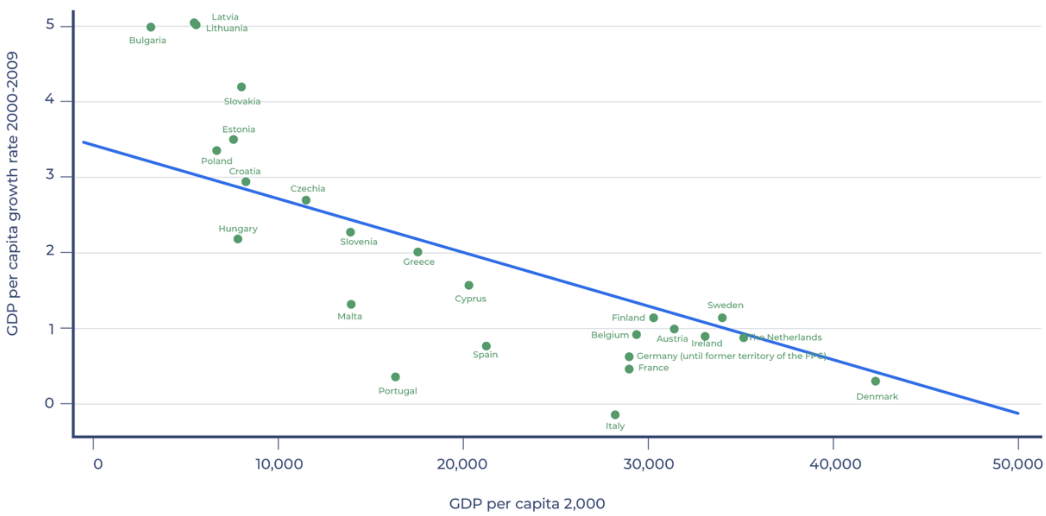

Figure 1. Source: authors' own, based on Eurostat data: https://ec.europa.eu/eurostat/data/database

Before introduction of the euro, interest rates in the euro member states did converge, with the rates falling sharply in the South, as visible in Figure 2 EU interest rate convergence.

The resulting lower borrowing costs fuelled increases in both investments and consumption. As a result, the current account surpluses of the North increased sharply while the South experienced increasing current account deficits. Between 1992 and 1997 the current accounts of the South on average were -0.7% of GDP. In the period 1999-2007 this was -6.8% of GDP. In the same period the surplus of the North increased from 0.9% to 4.6% of GDP (Holinski et al., 2012).

[2] There were signs that the proposal could not count on support, not only uttered by Dutch diplomates themselves, but also by countries such as Italy, see (Kuijk, 2012)

Southern countries therefore had to borrow from the North to finance their imports and again to finance the servicing of these debts (Holinski et al., 2012).

EU interest rate convergence

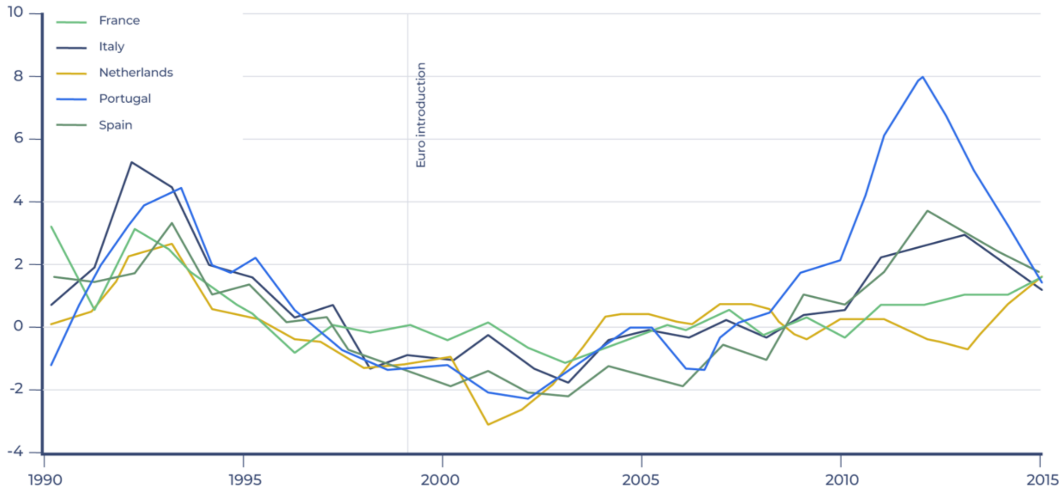

Figure 2. Source: IMF (Franks et al., 2018)

The borrowing need increased further as money transfers from North to South, through EU social and cohesion funds, were rechannelled towards the East. While the South received on average 3% of GDP from the EU during the '90s, this amount was reduced to 0.3% at the start of the euro (van Tilburg & Simić, 2020).

House prices North and South

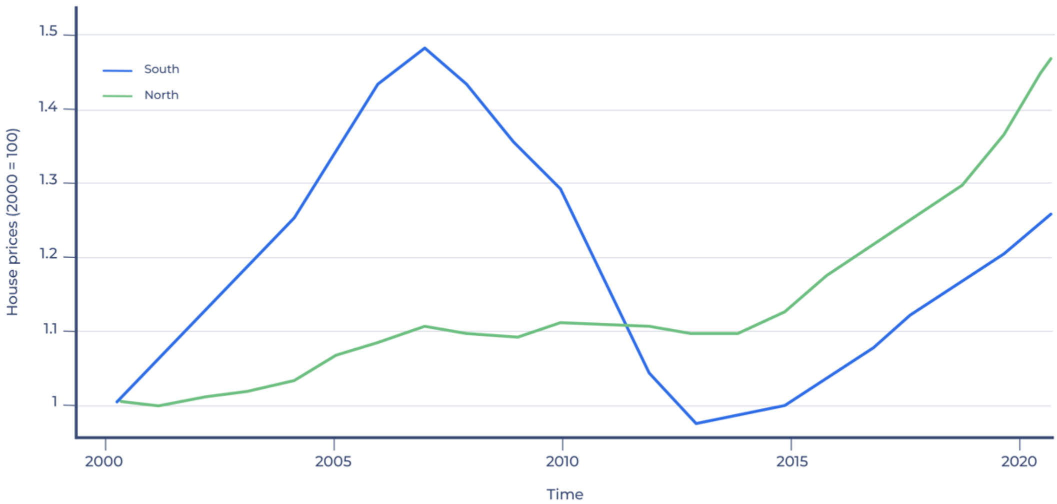

Figure 3. Source: Authors' own, based on Eurostat data: https://ec.europa.eu/eurostat/data/database

In the first ten years of the euro, Southern debt to the North lend increased by 340% (Baldwin et al., 2015). Debt accumulated in the periphery (Portugal, Ireland, Italy, Greece, and Spain) and was owned by creditors in the core (Germany, France, Austria, Belgium, and the Netherlands) creating bank-solvency risks in the latter countries.

The increase of credit to the non-financial sector in Southern countries was substantial after the euro was introduced, as illustrated in Figure 4. Many of the investments in the periphery went to non-traded sectors and the housing market. This led to increased house prices in the South, as shown in Figure 3.

Credit to the non-financial sector North and South

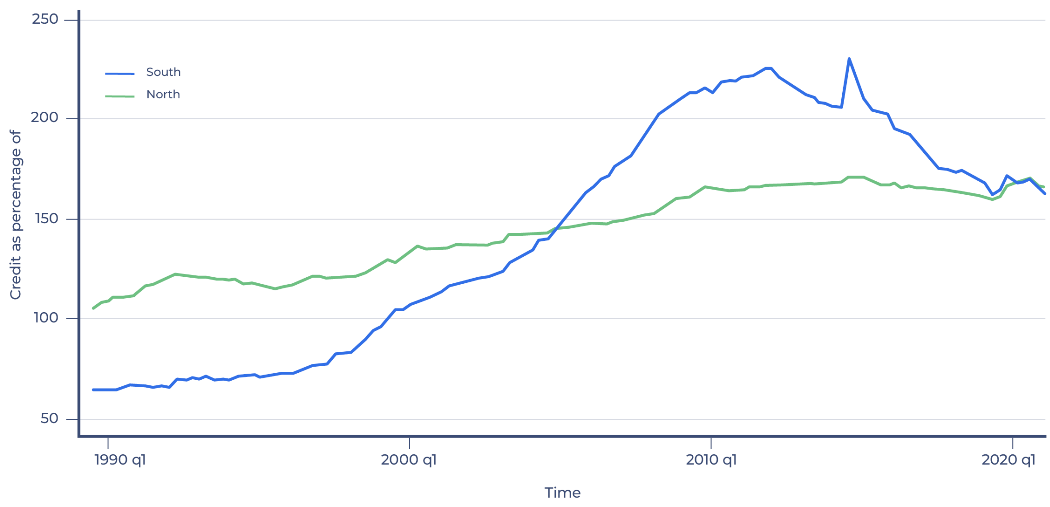

Figure 4. Source: Authors' own, based on Bank for International Settlements Statistics: https://www.bis.org/statistics/index.htm?m=6

As a result, wages and costs rose in such a way that they harmed the competitiveness and thus current accounts of Southern countries (Baldwin et al., 2015), visible in Figure 5.

Despite a relatively good economic climate, the fiscal rules of the Stability and Growth Pact have been broken numerous times. Between 1999 and 2007, the 3% budget deficit rule was breached 34 times, including by France and Germany (Baldwin et al., 2015). As a result, the government debt stayed above the prescribed 60% level for several countries. These trends led to an unsustainable financial situation that eventually culminated in the euro crisis.

The euro crisis years

Initially the eurozone seemed to withstand the 'US originated' 2008 financial crisis relatively well. However, in 2010 things changed dramatically when it was revealed that the actual government budget deficit of Greece was much higher than previously reported.

When the crisis in the eurozone took hold, governments and European institutions faced several fundamental limitations. Several countries lacked the fiscal space to absorb the economic shock on their own. Because of the monetary union, countries could not devalue their currency. The only way out was an ‘internal’ devaluation lowering wages and austerity.

Relative Unit Labour Cost

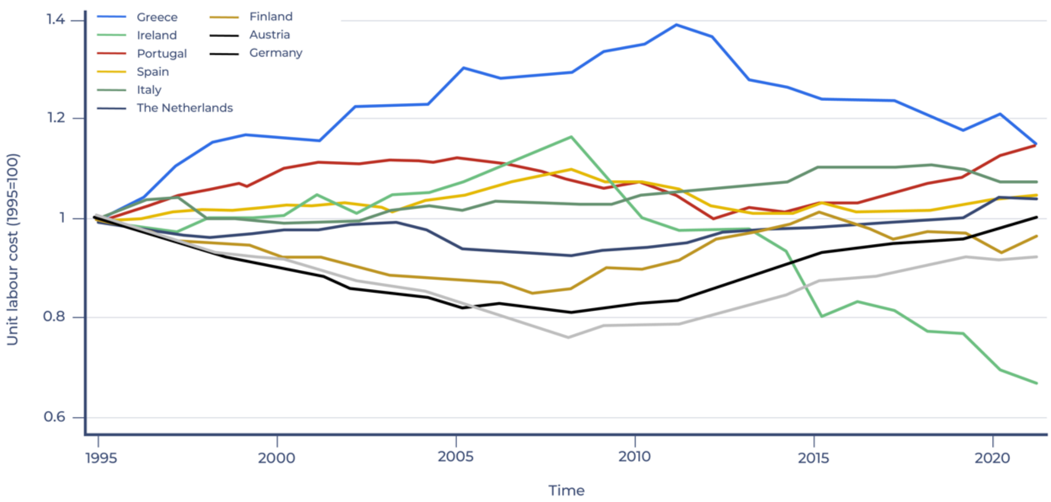

Figure 5. Source: Authors’ own, based on Eurostat data: https://ec.europa.eu/eurostat/data/database

Due to the prohibition on monetary financing and the no bailout clause, support from the countries with larger buffers or those less hit by the shock, came late. The absence of common fiscal shock absorbers, combined with procyclical fiscal rules, proved disastrous, pushing the eurozone into an ever-deeper recession that could only be halted through extraordinary action by the European Central Bank (ECB) in 2012.

The tightening fiscal stance throughout the eurozone led to a prolongation of the crisis. Fiscal tightening took place in the periphery countries that were forced to take austerity measures prescribed by support packages, but also in the North. Germany accounted for 32% of overall fiscal tightening in the eurozone (Baldwin et al., 2015). Consequently, GDP per capita in the eurozone dropped and unemployment rates soared, especially in the South. In the absence of any typical Balance of Payment adjustment mechanisms, such as devaluation and interest rate adjustment, internal devaluation had to take place in already deflationary environments at near zero interest rates. Still today unemployment is high relative to the North, as visible in Figure 6.

By contrast, in the US, where the fiscal stance was much more supportive, the economy rebounded much sooner. The US government had a deficit of 3.6% on average from 2009 to 2018, while the euro area had a surplus of 0.5% (Draghi, 2019).

Unemployment rate North and South

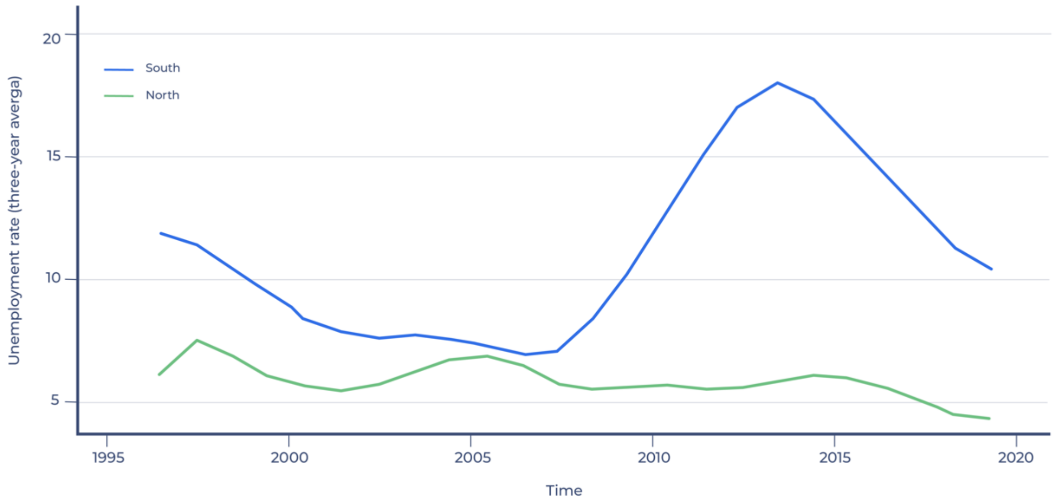

Figure 6. Source: Authors' own, based on Eurostat data: https://ec.europa.eu/eurostat/data/database

As a result, the euro area economies, especially those in the South, have experienced a much weaker economic recovery (compared to the US) after the 2008 financial crisis, as can be seen in Figure 7 GDP US and Euro area 2008-2020.

GDP US and Euro area 2008-2016

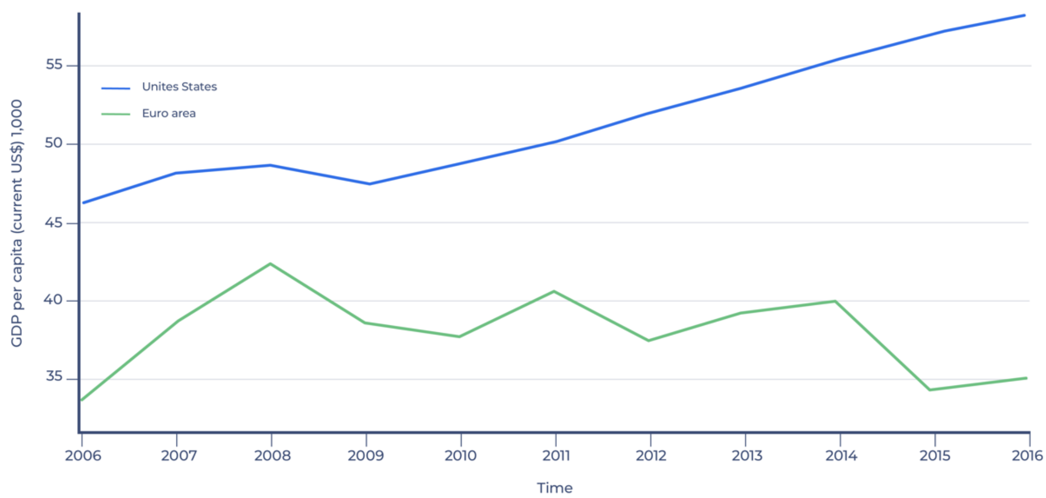

Figure 7. Source: OECD

This financial turbulence came to a halt only after fiscal support measures were implemented under very strict conditions by the Troika (consisting of the European Commission, IMF, and ECB). The Troika developed economic adjustment programs backed by the European Financial Stability Facility (EFSF), the European Financial Stabilisation Mechanism (EFSM) and the European Stability Mechanism (ESM). In the end, the crisis was tamed by the ECB's president Mario Draghi announcing that "the ECB is ready to do whatever it takes to preserve the euro" (Draghi, 2012). The Outright Monetary Transactions (OMT) instrument was designed to "safeguard an appropriate monetary policy transmission and the singleness of the monetary policy" through potentially limitless interventions on condition of an EFSF/ESM programme (ECB, 2012). The instrument has never been used.

The hard lessons: Destabilising private flows and austerity driving increases in debt

Hard lessons were learned. The "sudden stop" of credit and the austerity that hit the South further shrank the economy resulting in rising deficits and debts (Baldwin et al., 2015). A doom-loop emerged where governments were forced to save their national banks, and with increased debt levels and sovereign risks that fuelled further losses for national commercial banks.

The effect of budget cuts, the fiscal multipliers, were much larger than anticipated (O. Blanchard & Leigh, 2013). Fiscal contraction had a much bigger negative effect on the economy than expected. As a result, fiscal contraction negatively impacted debt sustainability. The debt to GDP ratio increases if economic growth is reduced more than expenditures due to austerity.

The euro crisis demonstrated that negative spill overs in a monetary union are not solely caused by government budgets. Also, the unrestrained flow of private capital can be destructive for economies (and even the EMU as a whole) if it finances unproductive or destabilizing investments. The 60% norm for government debt did not prevent these private imbalances from accumulating. Several periphery countries did not have high government debt burdens when the euro crisis started. For example, Ireland and Spain had debt ratios under of respectively 24% and 34% of GDP in 2007 (Baldwin et al., 2015). Italy meanwhile was running primary surpluses between 1995 and 2006 (Bastasin et al., 2019). Even in the past ten years, Italy is a positive outlier: between 2012 and 2021, Italy only ran primary deficits in 2020 and 2021, being severely struck by the Covid crisis (ECB, 2021).

Reform of the economic governance: no definitive solution

During the euro crisis, the Stability and Growth Pact (SGP) went through several reforms.[3] Most importantly, it was expanded with the so-called six-pack and two-

[3] For a summary of the economic governance framework (including the SGP), see Annex I

pack in respectively 2011 and 2013. These measures were meant to strengthen fiscal discipline and enforce debt reduction, thus demanding a frugal stance. The Macroeconomic Imbalances Procedure (MIP) procedure, introduced in 2011, was added to prevent and correct macroeconomic imbalances that threaten economic stability, such as the private debts and current account imbalances that played such an important role in the euro crisis. The European Semester (2011) established an integrated surveillance and coordination policy framework for the Member States. In 2015, the European Commission published a guidance on how to make best use of flexibility within the SGP.

For the objectives of providing shock absorbers and driving convergence these reforms of the SGP are somewhat of a mixed bag. On the one hand, more fiscal coordination can be beneficial while the prevention of macroeconomic imbalances is important for the economic stability of the EU. While the flexibility provided by the SGP when in difficult economic circumstances is desirable the reforms did not lead to more convergence[4]. The fiscal discipline imposed by the six-pack and two-pack limited the fiscal space that governments have and often triggered austerity that harmed the economic strength. Ultimately these rules contributed to fiscal contraction and a much bigger impact of the euro crisis on individual countries.

The European Semester was meant — amongst other objectives — to stimulate structural reforms within Member States. It did not prove very successful in this respect. At the height of the euro crisis, when emergency loans were made conditional on implementing reforms, there was an acceleration of reforms in targeted countries. However, this uptake of economic reforms has subsequently declined (Wolff et al., 2018).

The European Commission's assessment of progress of structural reforms of 2020 signalled that the EU faces challenges with regard to insufficient investments, digitalization, education, pockets of vulnerabilities in the financial sector and more (European Commission, 2020a).

Other macroeconomic and financial EU policy has been partially implemented. The European banking union remains unfinished without a European Deposit Guarantee Scheme (DGS). The Single Resolution Mechanism has not been able to prevent new bank rescues in both Germany and Italy. Southern countries' banks still hold large chunks of their own governments' debts on their balance sheet. In Italy this even increased from around 10% to 12% of the total balance sheet of its banks between 2010 and 2020 — compared to less than 4% for the euro area on average (ECB, 2020). The bank-sovereign doom-loop has not been broken yet.

[4] Convergence is also explicitly mentioned in the two-pack, for example: "A gradually enhanced monitoring procedure should contribute to better budgetary and economic outcomes, macrofinancial soundness and economic convergence, to the benefit of all Member States whose currency is the euro" (European Parliament & Council, 2013).

The establishment of the Capital Markets Union (CMU) is progressing only slowly. Originally launched in 2014, a range of (legislative) proposals were adopted. However, the progress on CMU stalled during the subsequent years.

Pandemic response: unprecedented yet temporary steps

That the economic governance did not allow the EU to withstand a big shock was quickly obvious when in early 2020, after seven years of relative stability and moderate economic growth, the Covid virus pushed the European economies into lockdown. This triggered the escape clause of the Stability and Growth Pact, effectively suspending the fiscal rules. To allow all governments to borrow, the ECB introduced a new instrument, the Pandemic Emergency Purchase Programme, allowing it to buy more government debt from distressed eurozone members.

Important steps were taken to set up temporary, but significant, common fiscal shock absorbers. The first was 100 billion euro for the temporary Support to Mitigate Unemployment Risks in an Emergency (SURE) instrument. SURE is designed to support countries in tackling the socioeconomic consequences of the pandemic. The loans are meant to address increases in public expenditures to preserve employment (European Commission, n.d.a). The instrument is financed by social bonds (targeted at social objectives) issued by the European Commission.

After that a new, and until then deemed politically impossible, new instrument was launched: the NextGenerationEU plan, with its Recovery and Resilience Facility (RRF) of 723.8 billion euro. It consists both of loans (385.8 billion) and grants (338 billion) and is distributed where the need is the largest, on condition of reforms. Positive assessments have been made on the reforms proposed in the Recovery and Resilience Facility, for example in the case of Italy (Corti & Núñez Ferrer, 2021).[5] The RRF is financed with bonds issued by the European Commission on behalf of the Member States. The EU will develop new own resources in the coming years to repay the RRF loans, such as an Emission Trading Scheme (ETS) own resource, Carbon Border Adjustment Mechanism (CBAM) and a profit tax (European Commission, n.d.b).

Frugals tweaking the budget rules

That the current fiscal framework, if reinstalled, may still be too tight is illustrated by the fact that even the Member States with the strongest economic performance and government finances do not bring their budgets

[5] Mainly because of the austerity programmes of the past decade, Italy's public administration has come to suffer from increasing inefficiency and ineffectiveness due to three problems: a reduced workforce, which is also relatively old, and due to a lack of training misses the skills needed for the challenges of today (digital, ecological, etc). Similar problems exist in the notoriously slow judicial system. Italy's reform plan addresses all these problems by investing in new jobs, and employee skills and training.

in line with the fiscal framework. The recent coalition agreements in Germany and the Netherlands are both out of line with the structural deficit rules and others.

In the Netherlands, funds have been established to tackle problems related to climate and nitrogen of respectively 35 and 25 billion euro. In their coalition agreement, the Dutch write that they accept a temporary higher debt level and structural deficit of 1,5% (VVD D66 CDA & ChristenUnie, 2021). The CPB Netherlands Bureau for Economic Policy Analysis has calculated that the coalition agreement may lead to a structural deficit of 3.1%, resulting in a rise of government debt from just above 50% today (CPB, 2022) to more than 90% in 2060, if current levels of taxes, transfers and public services remain unchanged (CPB, 2022).

The new coalition in Germany has committed to reinstalling in 2023 the Schuldenbremse, the debt brake which caps the structural deficit at 0.35% of GDP and is enshrined in the German constitution, after its suspension in 2020 due to the Covid crisis (Bundesfinanzministerium, n.d.). But in contrast to the official narrowing of the German deficit, the off-budget spending on defence and the climate transition will strongly increase in the next years. Around 200 billion is reserved to be spent between 2022 and 2026 on the climate transition (DBRS Morningstar, 2022) through the off-budget Climate and Transformation Fund. This was filled with unused debt (60 billion) in December 2021 (Euractiv with Reuters, 2021). By modifying the accounting rules, government ensured that only the year in which money is channelled to the fund (2021) is relevant for the deficit; not the year of spending (Schäfers, 2022). Additionally, the German government committed to a 100 billion defence fund in response to the war in Ukraine, omitting the debt brake by changing the constitution (Reuters, 2022).

Where we are now: a fragile Union

So where do all these developments leave the EU? Unemployment remains high in the South. This is especially true for youth unemployment, which stands at over 30% in Spain and 26.8% in Italy, compared to 7.8% for the Netherlands and 6,1% for Germany (Eurostat, 2022a). Also, government finances are substantially worse in the South. Towards the end of 2021, the debt levels of many Member States were much higher than the 60% threshold, e.g., Greece (193.3%), Italy (150.8%), Portugal (127.4%), Spain (118.4%) and France (112.9%) (Eurostat, 2022b).

While the MIP now seeks to improve economic governance in potentially destabilising developments in the private sector, some imbalances such as current account deficits in the South have shrunk. At the same time countries such as the

Netherlands and Germany continue excessive current account surpluses. In case of the Netherlands, there is also the pressing issue of high private debts due to the large amount of (large) mortgages, which exposes households and the economy as a whole to financial risks (DNB, n.d.).

Convergence absolute income North and East

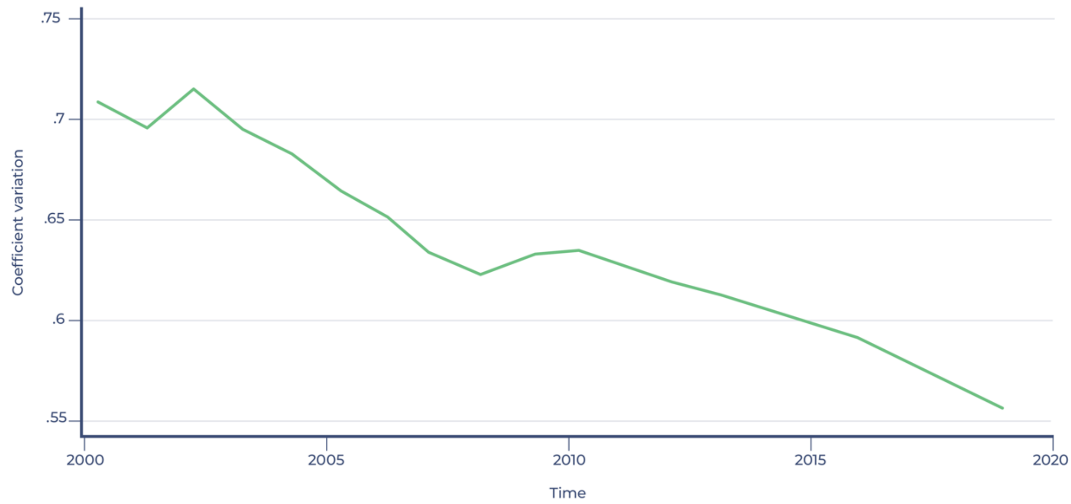

Figure 8. Source: Authors' own, based on Eurostat data: https://ec.europa.eu/eurostat/data/database

Most worrisome however may be the dynamics of the EU economies. Since the euro crisis, the South continues to fall behind. In the years before the pandemic the eurozone experienced relative calm and a moderate economic growth. The divergence trend (the South falling behind), however, has not been changed.

Figure 8 Convergence absolute income North and East and Figure 9 Divergence absolute income North and South show how the absolute income levels of the North and the East have converged steadily in the past two decades, while Southern countries experienced almost no real convergence before 2009 and clear divergence since the euro crisis.

These trends are the more worrisome given that the ECB, having played a crucial role ending the euro crisis, may be running out of options to keep the eurozone together. Before inflation started to increase the ECB had already exhausted many of its instruments to stimulate the economy, bringing interest rates into negative territory and reaching the (self-imposed) limits of government debt on its balance sheet.

These limits that were raised during the pandemic. However, with inflation currently above its target rate, interest rates are increasing. The ECB has stressed that it will act when it sees 'fragmentation' in the eurozone, i.e., when the difference between the interest rates paid by North and South become excessive.

Divergence absolute income North and South

Figure 9. Source: Authors' own, based on Eurostat data: https://ec.europa.eu/eurostat/data/database

However, doubts remain about the effectiveness and political and legal acceptance of its anti-fragmentation tool, the so-called Transmission Protection Instrument. Should another crisis occur the Outright Monetary Transactions (OMT) instrument, conditional upon an ESM programme, may still be needed.

The challenges ahead for the Union

The previous paragraph describes how convergence in the EU has stalled since the euro crisis. This leaves already burdened Member States vulnerable, especially as no permanent instruments to counter new shocks have been created. While new economic shocks are highly unpredictable, as the Covid virus has shown, many challenges can be identified.

The cost-of-living crisis

Even before the inflation increase, many Europeans struggled to make ends meet (Eurostat, 2022c). One in six EU workers earns a low wage, while in-work poverty (i.e., workers living in poverty) is increasing. In 2019 almost 40% of disposable income within the EU went to the top 20% of the population by income, while the bottom 20% received around 8%. Income inequality is highest in the Southern and Baltic States (Eurostat, 2022c).

As a result of Covid-related global supply chain problems and Russian invasion of the Ukraine, inflation has reached unprecedented levels in the Union. High prices have eroded the purchasing power of many Europeans. Governments now struggle to find ways to help their citizens and businesses to weather this storm.

Energy transition

High energy prices reiterate the need to accelerate energy transition. They come on top of the increasing impact of climate change, visible in Europe in floods and droughts that cause wildfires. Climate change poses serious economic and financial risks for all Member States. The 'liveability' of many regions is under threat. Both transition risks and physical risks of climate change are set to impact EU member states in very different ways. Those countries with high levels of debt will most likely experience the biggest socioeconomic impacts of climate change (Joint Research Centre, n.d.), thus further threatening the sustainability of public finances in especially Southern countries (ESPON, 2011). This is visible in Share of firms exposed to physical versus transition risk by country.

Share of firms exposed to physical versus transition risk by country

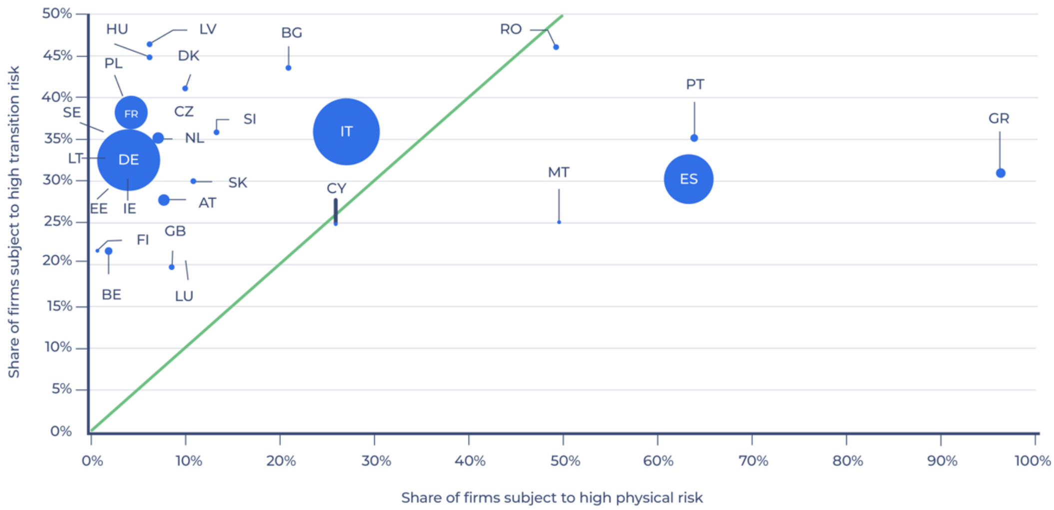

Figure 10. Source: ECB (Alogoskoufis et al., 2021).

The European Union has committed to ambitious programmes for energy transition as enshrined in the Green Deal. However, the so called 'green funding gap' was estimated at 520 billion euro annually last year (European Commission, 2021). With REPowerEU, the European Commission has added ambitious plans to accelerate ending the EU's dependency on Russian fossil fuels, by way of energy savings, diversification of energy supplies and accelerated rollout of renewable energy. The REPowerEU goals require an additional investment of 210 billion euro until 2027 (European Commission, 2022c).

Circular economy

Our current economic model of 'take, make, waste' is unsustainable because of its material needs and waste production. In addition to the energy transition a circular transition is needed, an economic model that centres around 'reduce, reuse, recycle'. The EU has set itself a target to become fully circular in 2050 (European Commission, n.d.c.). A global binding agreement on biodiversity is expected this year under the Global Biodiversity Framework of the Convention on Biological Diversity. For the Netherlands for example, the financing gap for circular economy projects was estimated at between 360 million and 1.7 billion euros in 2019 for the next five years, or 60% of the total financing need of circular economy projects (European Investment Advisory Hub, 2019).

Economic independence

The trade disputes with the US under the Trump presidency, the broken supply chains during the pandemic and the increasing geopolitical tensions have all led to calls in Europe to become more self-sufficient economically. Stronger economic independence is part of the EU's quest for strategic autonomy. However, while there was much support for "reshoring" of various sectors at the start of the pandemic, the enthusiasm for these kinds of operations faded when their costs and complexity became apparent (EPRS, 2022). Instead, reshoring efforts have been limited to critical sectors. Nevertheless, the EU has set itself several goals for more strategic autonomy and economic independence, such as in the field of cloud computing, batteries and more.

Lagging productivity

The EU's productivity growth continues to slow with considerable differences across Member States and regions (European Commission, 2020a). Since the euro crisis, there is a clear pattern of divergence in productivity between the North and the South, as Multifactor productivity North and South demonstrates.

While the whole world is experiencing low productivity growth, in the EU investments levels are particularly low. The US invests more in R&D than almost all Western European countries (UNESCO Institute for Statistics, n.d.), while R&D investment levels in Central and Eastern Europe remain persistently low, compared to regions such as South and West Asia and Latin America and the Caribbean (UNESCO Institute for Statistics, 2020).

More recently, in 2020, investments in R&D by EU companies fell by 2.2% due to the pandemic, while companies in the US and China increased their investments with respectively 9.1% and 18.1% (Zubașcu, 2021).

Multifactor productivity North and South

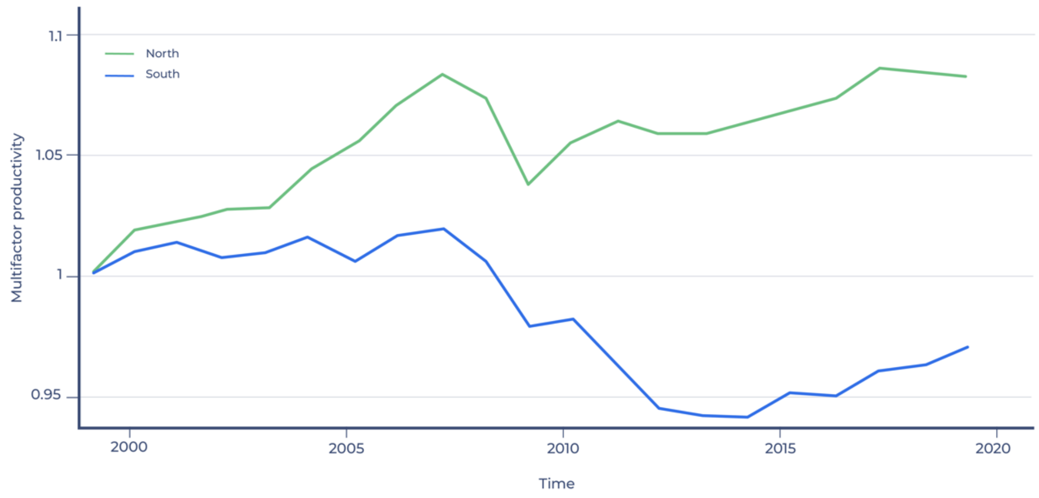

Figure 11. Source: Authors' own

EU companies and societies lag behind the US in adopting digital technologies (EIB, 2020). The investment gap in digital transition is estimated to be 125 billion per year (European Commission, 2022b). The European Commission's assessment of progress of structural reforms of 2020 clearly signalled that the EU faces challenges concerning insufficient investments, digitalisation, and education (European Commission, 2020a).

Ageing

As in many other parts of the world, the EU is ageing. In the next decades, the demographic share of elderly people (65 or above) will increase (Eurostat, 2020). The EU's old-age dependency ratio (i.e., the ratio between people aged 65 years and over and those aged 20-64) is projected to increase from 34% in 2019 to 59% in 2070, i.e., a shift from three to one working-age people for every person aged 65 years and over to below two in 2070 (DG ECFIN, 2020). This will lead to increasing pressure on government budgets for health care and pension expenditures. Simultaneously, labour supply will decline (Commissie Europese economie, 2021). The costs of ageing (such as pensions and health care) will increase. While the total cost of ageing stood at 24% of GDP in 2019, it is projected to rise by 1.9 percentage point of GDP in 2070 (DG ECFIN, 2021).

Education

Government spending on education has declined in the EU since the financial crisis of 2008-9. From a high of 5.5% of GDP in 2009 it decreased to a low of 4.6% of GDP in 2018. There has been some recovery since, to 5% in 2020, but the gap with pre-crisis levels remains large. The differences between Member States remain stark, with no sign of convergence.[6]

These cuts in education spending across the EU happened as a result of SGP-inspired austerity in the wake of the financial crisis but are in fact paradoxical. An appropriate level of public expenditure on education in training is necessary to achieve the economic and employment improvements that are necessary for growth and social returns.

Defence

The Russian invasion of Ukraine has increased the readiness of EU Member States to live up to their NATO agreement on defence spending of 2% of GDP. With average defence spending in the EU now at 1,3% (Eurostat, 2022d), spending levels vary considerably again between Member States, with highs for Greece (2.91%) and Estonia (2.35%) and lows for Belgium (1.02%) and Luxemburg (0.58%).[7] Closing the gap between 1.3 and 2.0% would require an annual extra investment of 94 billion Euros.[8]

A Union that cannot do what it takes

Is the EU able to deliver on the objectives that it has set itself? Is its economic governance, including the fiscal framework, fit for purpose? The European Monetary Union lacked a solid fiscal foundation from the start to absorb shocks and drive real convergence, and the fiscal rules have regularly been broken. The euro crisis left several EU Member States in a highly vulnerable position with high debts, high unemployment and increased economic divergence.

During the Covid pandemic government leaders did show an unprecedented resolve to act together, using their common fiscal muscle. However, the main instruments for the pandemic are set to expire by 2022 (SURE) and 2026 (RRF). These instruments help EU Member States to confront the challenges of the post-pandemic recovery, including energy and digital transition but have been insufficient to remedy fragile macroeconomic development and public finances. This is the more worrisome given the large challenges that need to be confronted in the decades ahead. The EU is in dire need of more productive public investments, if it wants to honour its commitment to the Paris Agreement, increase the circularity of the economy, improve productivity through investments in human capital and R&D, and most urgently: tackle the current cost of living crisis.

[6] Lifelong Learning Platform, Public investment on education and training in the EU: Trends, challenges and future prospects, 2022, https://lllplatform.eu/lll/wp-content/uploads/2022/04/Invest-in-ET-Study.pdf
[7] NATO, Defence Expenditures of NATO Countries (2014-2022), 2022, https://www.nato.int/cps/en/natohq/news_197050.htm
[8] Considering EU GDP was 13 450 460 million euros in 2020 (data from Eurostat extracted 5-10-2022).

In the current fiscal framework and without support it does not seem realistic particularly for the Southern and Eastern Member States to be able to meet these challenges.

These investment needs clash with current debt levels and deficits. Within the rules of the current fiscal framework, many countries have no room for such investments. But even if the fiscal rules would allow them, it is questionable whether market conditions will make it possible to raise the necessary funds at sustainable interest levels.

The Netherlands and Germany have the luxury that they can borrow at low cost to fund such investments, but this may not be the case for other European Member States. Especially now that the ECB has changed its course and has started to tighten its monetary stance.

While the financial and economic situation is worrisome in many EU Member States, a global perspective shows that as a whole the EU — with an average government debt of 96% of GDP for the euro area as a whole (Eurostat, 2022b) — still in a relatively good position compared to 151% in the US and even 259% in Japan (OECD, 2022d).

To achieve the targets enshrined in the EU Treaty large investments are needed. If all EU member states are to be allowed to make the necessary investments new European rules and/or instruments will be necessary. The next chapter discusses them.

3. GOING ALONE OR FULL INTEGRATION?

So what solutions are available to reform EU economic governance in such a way as to enable all its members to tackle the challenges ahead and to realize the objectives the EU has set itself in the Treaty? This chapter discusses two options for a definitive solution to make the economic governance sustainable and coherent from an economic and financial point of view. They can be placed at the extreme ends of a spectrum. On the one hand each Member State is on its own (and only the market is for all), while on the other Member States share their fiscal budgets to a much larger extent (full-fledged European integration). The chapter discusses both the economic and political feasibility.

Going alone: reinstalling the old rules and market discipline

The minimalist approach to reform of the economic governance starts with the observation that even the original rules have never been upheld. This approach therefore proposes to start by enforcing the original rules, the 3% maximum budget deficit and 60% debt and principles such as the ‘no bail out’ clause. The enforcement mechanisms have either been lacking or have not been used. Therefore, the market should be reinstalled as a disciplining force. Advocates of such a “Maastricht 2.0” approach argue against further “premature” integration (Feld et al., 2016). This approached was echoed by eight frugal Member States in 2021, who argued that they “do not consider the fiscal rules as an obstacle to efficient fiscal policy” (Blümel et al., 2021).

Reinstalling the old SGP rules and enforcing strict compliance, however, can only be done after current unsustainable debts have been reduced as it is unrealistic that countries like Greece, Italy, Portugal, Spain, and France could comply with the SGP debt rules any time soon. Greece for example would have to produce a budget surplus of almost 7% for twenty years in a row to comply with the debt reduction rule (van Tilburg, & Beun, 2022). This would most likely cause severe economic damage and unprecedented austerity. For comparison: if the Netherlands were to produce such a surplus the entire budgets for education, science, culture, police, justice, infrastructure, and water management would have to be sacrificed (van Tilburg & Beun, 2022). The euro crisis has demonstrated how austerity hurts the economy requiring more budget cuts and further austerity in a vicious circle.

In its assessment of the market scenario, the Dutch government's European Economy Expert Group concludes that Maastricht 2.0 implies an initial debt reset of highly indebted European member states (Commissie Europese economie, 2021). Thus, paradoxically, to arrive at a situation where the no bail out clause becomes credible, some sort of bail out is needed first.

Even after resetting debts this market scenario brings substantial political and economic risks. It relies strongly on the efficiency of markets and the belief that market discipline supports sound (public) finances. However, both the 2008 global financial crisis and the euro crisis proved that markets are not inherently efficient. Financial markets tend to underestimate risks during booms (while accumulating debt on their balance sheets) and overreact in times of recession or crisis, with great repercussions for society (de Grauwe & Ji, 2018). Or as SFL member Prof. Arnoud Boot put it: “Financial markets are either asleep or panicking.”

The Macroeconomic Imbalances Procedure (MIP) now also monitors potential destabilising developments in the private sector and some imbalances such as current account deficits in the South have shrunk. Still, as with the SGP, the rules are not respected, and the enforcement mechanisms for MIP are much weaker than those for SGP. This explains why countries like the Netherlands and Germany keep running excessive current account surpluses.

What this scenario does not address is the existing differences between the economic development of Member States. Even after debt levels have been reduced to sustainable levels, it is still questionable whether, given their different growth potential, all Member States will be able to make the necessary investments to increase the productivity and sustainability of their economies or to withstand an economic shock. Without more European coordination, mechanisms and means to foster convergence and implement the Green Deal, divergence is only likely to increase.

Both the financial crisis and the euro crisis have in recent years proved that markets are not inherently efficient. This strongly indicates that this scenario is not feasible – from either an economic or a political perspective.

Full-fledged integration: whatever it takes

The other extreme is full-fledged integration. This implies adding a fiscal leg to the monetary union, including completing the banking union with a common deposit guarantee scheme. A larger common budget can help fund the necessary investments and absorb shocks. European social security schemes, such as the temporary SURE program, and the establishment of a fully integrated European labour market could also be part of this scenario. The allocation and disbursement of the common budget would be based on the principles of a European welfare state and European Industrial Policy, including the need for sustainability. Member States most in need of funding would receive the biggest amounts. To get a sense of the scale: In the US the richest States annually contribute up to 10% GDP more to the federal budget than they receive (The Economist, 2011).

This scenario would imply the establishment of a European stabilization function to absorb economic and financial shocks. This mechanism could be integrated into the EU budget, provided the budget is large enough. A stabilization function could take the form of disbursements or cheap loans.

To fund the bigger European budget (European Commission, 2022a), either the national contributions of Member States should be increased, or new own resources for the EU can be created, such as an EU VAT, a Carbon Border Adjustment Mechanism (CBAM), a digital tax, a revision of the ETS or a financial transaction tax (General Secretariat of the Council, 2020). Common bond issuance such as in the ESM and RFF can be extended, thus creating Eurobonds. A common safeguard can diminish the financing costs of existing debts (Commissie Europese economie, 2021).

This scenario would answer the criticisms of economists from the outset of the EMU: an incomplete monetary union missing a fiscal leg. However, despite the measures along these lines that were taken during Covid, the political feasibility at this stage seems to be small. Especially in the North, there is a broad resistance to more common budgets and, in particular, more issuance of common debt.[9] In the Netherlands, for example, two resolutions were adopted in March 2022, which respectively call upon the Dutch government not to agree to common debt issuance for new European funds and projects (Omtzigt, 2022) nor to eurobonds or other forms of debt mutualization (Ephraim & van Haga, 2022). Similar resistance exists in other Northern Member States. It therefore seems unlikely that this scenario will be realized in the short term.

[9] In the light of the Ukraine war, this issue has once again come to the fore again with France and Italy embracing new jointly issued EU debt to tackle the consequences of the war. However, some countries, such as Germany and the Netherlands, oppose this plan (Euractiv, 2022).

4. OTHER PROPOSALS ON THE TABLE

Far-reaching reforms, providing ‘definitive’ solutions, do not seem to be politically feasible, and in the case of the ‘going alone’ scenario also not economically effective. This however does not alter the unsustainability of current economic governance in social, ecological, and financial terms.

So what remedies are on the table that could find a wider political support? This chapters presents and reflects upon specific proposals that have been tabled to improve EU economic governance. The proposals are grouped into four categories: reforming the fiscal rules, sharing the fiscal burden, greening economic governance, and strengthening governance.

Reforming the fiscal rules

This first set of proposals focuses on changes in the fiscal rules to allow Member States to make better use of the fiscal space they have. It means putting greater emphasis on an expenditure rule and the idea of a golden investment rule, country-specific fiscal limits, and national investment plans.

An expenditure rule

The current preventive arm of the SGP is widely considered to be too complicated (Darvas et al., 2018).[10] It consists of a Mid Term Objective (MTO) for the structural deficit, which is based on the output gap between a country’s current economic output and its potential output, as well as an expenditure rule for the net growth rate of government spending, which is based on potential economic growth and on how much the country deviates from its MTO. This intricate combination of rules is further complicated by the fact that potential output, which is needed for the output gap, is notoriously difficult to estimate. Calculations are based partly on historical output data, either extrapolated or included in the parameters of an

[10] A position shared even by a frugal country like the Netherlands, with respect to both the complexity of the set of rules and the calculation of potential output. See (Dutch Ministry of Finance, 2021).

economic production model. The risk here is that such calculations underestimate potential output during an economic downturn, which results in unnecessary and procyclical fiscal tightening. Developments in the business cycle and as new data becomes available, also leads to frequent and sizable adjustments of potential output estimates for a specific year (Darvas et al., 2018; European Commission, 2020b; Heimberger, 2020).

A broadly supported suggestion (for example advocated for in the Dutch-Spanish joint paper, (Spain and The Netherlands, 2022)) to remedy this is to replace the structural deficit target by an expenditure rule that caps the growth of government expenditure at a level related to the predicted medium-term potential growth of GDP or by putting more emphasis on such a rule. This has several benefits, the most important of which is that it reduces day-to-day monitoring to a single, easily observable variable that is under direct control of the government, namely expenditure, instead of being dependent on additional economic output data of varying quality.[11]

Most proponents agree that the spending cap under an expenditure rule should ignore cyclical expenditure on e.g., unemployment benefits, as the moral hazard related to this (a government wanting to increase spending by raising unemployment) seems minimal (Suttor-Sorel, 2022). Allowing automatic stabilisers do their work when government income decreases during a crisis also makes sure that the rule does not have a procyclical effect.

A study by DG ECFIN, referring to an analysis that compares 33 expenditure rules in 29 advanced and developing countries, concludes that expenditure rules "are associated with lower expenditure volatility and higher public investment efficiency" (Manescu & Bova, 2020). An expenditure rule can also take into account the government debt level. This way the 1/20 debt reduction mark of the current SGP can be replaced by including a country-specific debt reduction target in the expenditure cap, as suggested by the European Fiscal Board (European Fiscal Board, 2018).

The exact design of the expenditure rule, in the sense of which expenditures are included and which are not, is of great importance for its success. If this is not done right the rule may still end up too tight, causing a recession or preventing necessary investments. An expenditure rule also requires reliable estimates of the variables needed for its operationalisation, including government revenues which are not needed for MTO calculations, and which may be difficult to estimate (Reuter, 2020). However, estimation errors for growth rates tend to be smaller than

[11] Although calculating potential growth does not come without difficulties either.

for structural deficits, and expenditure is more readily observable and its growth therefore easier to control than structural deficits.

Treating investment differently from expenditures (golden investment rule)

In calculating allowed government expenditures, a distinction can be made between "consumptive" government spending (e.g., on salaries or social welfare) on the one hand, and investments in e.g., green energy projects, infrastructure, or education on the other. Unlike consumptive expenditure, investment spending is not "gone" when the year is over but continues to provide benefits to society. Investments therefore have a different impact on government debt in the long run, and on future generations and their earning capacity.

The European Fiscal Board previously supported the idea of a golden rule in 2019 (European Fiscal Board, 2019). 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 (Wolff & Darvas, 2021).

From the viewpoint of the soundness of government finances a golden rule makes sense. It allows governments to undertake investments that in the future can increase their income. This is the case if the investments lead to a more productive and competitive economy, or diminish expenditures, for example those needed to remedy the negative effects of climate change. A great variety of golden rules has been proposed (Reuter, 2020). Some, for instance, would allow for the deduction of net investments – subtracting the value of assets created (O. J. Blanchard & Giavazzi, 2004), whereas others opt only for public investments in the form of national co-financing of EU projects (EFB, 2019), or for green investments such as those included in the EU's "Green Taxonomy" for sustainable finance that is currently under negotiation (Claeys, 2019). Some proposals include a maximum for deductible investments, e.g., 0.5% of GDP (Deutsche Bundesbank, 2019) or a maximum for the size of the country's green investment gap as determined by the European Commission (O. J. Blanchard & Giavazzi, 2004). Others require that conditions are met, such as low long-term interest rates and the country not being in a precarious financial situation (Pisani-Ferry, 2019). The variety of options shows that it may be a political challenge to decide which investments are to be included in a golden rule and which not.[12]

To this end the EU could speed up the work of Eurostat on the development and implementation of harmonized European Public Sector Accounting Standards (EPSAS). The fact that these are based on accrual rather than cash accounting, allows the attribution of the costs and revenues of public investments to their

[12] As is illustrated by the heated discussions on the Green Taxonomy proposals.

entire lifetime, and creating an overview (balance sheet) of actual public assets and liabilities. Accrual accounting, which is the commonly used form of accounting in business, provides a more accurate and complete picture of the financial weaknesses and strengths of each Member State. The use of harmonized standards also makes it easier to compare public accounts between Member States.

Most Nordic and new member states of the EU have used accrual accounting for many years, whereas some older member states (Germany and the Netherlands) have made only limited progress transitioning from a cash-based to an accrual system (IDW, 2021). However, a reliable, transparent, and complete picture of each Member State's financial situation is of the utmost importance for the transparency of the debate on the budgetary reform that is needed.

Changing the fiscal limits and making them country specific

Returning to the fiscal limit of 60% debt currently makes no sense. The debt levels of many Member States are so high that bringing them down at the prescribed speed would cause a recession, which might trigger another euro crisis and subsequently further increase the government debt. With the relatively low interest rates of the last decade the current debt servicing costs of even the countries with high debt are relatively low. For instance, while the government debt of Italy has increased since 1995 from 119% of GDP to 151% of GDP now (ECB - Statistical Data Warehouse, n.d.a.), its debt servicing costs have decreased from 11% of GDP to 3.5% of GDP (ECB - Statistical Data Warehouse, n.d.b.). As a result, the arbitrary fiscal limits are contested by economists. A survey in the Netherlands among more than 350 economists showed that only one out of five economists support the strict Maastricht criteria. Most of these economists support a limit of 90% of GDP. The 60% limit for government debt could be expanded and made more country specific. The sustainability of any debt is dependent on the strength of an economy. Hence, a country with an ambitious reform agenda and/or track record could be allowed higher public debt (Spain and The Netherlands, 2022). However, the question is what this pathway should be, and in case of highly indebted Member States, whether such a sustainable path exists at all. This would give countries more fiscal space and avoid the most harmful public cuts. Another option is the introduction of a medium-term debt anchor that allows debt formed in response to crises and to finance so-called "spending for the future"[13] to be paid back at a slower pace, i.e., "two-speed rule" (Giavazzi et al., 2021).

In contradiction of what is usually assumed, this can be done without changing the Treaty itself. The 3% deficit and 60% debt (relative to GDP) limits are laid down in a protocol[14] to the Maastricht Treaty. Abolishing those limits altogether requires

[13] These are defined as expenditures that contribute to European public goods that benefit future generations.
[14] Protocol No. 12 on the Excessive Deficit Procedure.

change of the Treaty itself, which is a highly complicated procedure usually undertaken only in the context of much broader Treaty change. The protocol however can be changed by a special legislative procedure that (only) requires a unanimous vote in Council after consultation of the ECB and the European Parliament (EECS, 2021; Raad van State, 2022).[15] This means that the deficit and debt limits could be increased to levels that are better in line with the current economic circumstances and spending rules, or differentiated per country, as long as the Treaty's general prescription to avoid "excessive" deficits and debts (as defined in the protocol) is respected. A formal Treaty change can therefore be avoided. While it is always hard, if not impossible, to assess an "optimal" debt limit, a threshold of between 90% and 100% seems reasonable.

Introducing National Reform and Investment Plans

Another comprehensive way of giving more importance to and space for country specific fiscal policy, is by introducing National Reform and Investment Plans (NRIPs), as proposed by Finance Watch and CAN Europe (Suttor-Sorel & Brachet, 2022). The idea is that these plans are submitted by Member States as part of the European Semester, integrating and streamlining their National Reform Plans and Stability or Convergence Programmes. As part of these NRIPs, Member States need to table investment and reform plans aligned with EU priorities (first and foremost, commitments made under the Green Deal); country-specific debt pathways; and a list of qualitative future-oriented spending that could be excluded from the calculation of their deficits and expenditure ceilings. The latter implies that certain investments get a preferential treatment, embedded in a set of principles focused on a green and just transition (Suttor-Sorel & Brachet, 2022). Accordingly, a governance and compliance system would have to be developed to assess these investments. A similar proposal has been tabled by the chief economist of the French Treasury, who argues in favour of green investments and reforms to safeguard investment (Bénassy-Quéré, 2022).

Intermediate conclusion on reform of fiscal rules

All the proposals discussed here have the potential to better use the fiscal capacity of individual Member States. They are also complementary and thus can be introduced together. For all three there are good reasons to implement them. Whether these reforms allow Member States to make full use of their fiscal capacity depends on the calibration. An expenditure rule can still be too tight, as can country-specific debt limits or the definition of investments.
NRIPs which allow for preferential treatment of certain investments can help to foster the green energy transition and strengthen national ownership of fiscal policy and plans. It is important that Member States ending up in an Excessive Deficit Procedure are given enough time to correct their excessive deficits.

[15] As specified in article 126 sub 14 TFEU.

However, these reforms of the fiscal rules will not help the Member States whose debt levels have reached such heights that financial markets will only lend to them against (prohibitively) high risk premiums. To help such Member States more is needed, like sharing the fiscal burden.

Sharing the fiscal burden

Increasing the fiscal room for individual member states is one thing. However, not all member states will be able to make use of that space that as the market, reflecting worries about debt sustainability, may limit their borrowing capabilities. Some form of fiscal burden sharing is then needed. This can take two forms: debt relief or common investment programmes.

Reducing the debt burden

Since the euro crisis proved that high government debt can be a burden, several proposals have been tabled aimed at reducing this debt.

During the pandemic, there was a broadly supported call to cancel the Covid debt that is now on central banks' balance sheets in exchange for social and ecological recovery plans (Andor, L., Magnette, P., Piketty, T. et al, 2021).[16] The initiators of the plan argue that the ECB can operate with negative capital without difficulty or print money to compensate for its losses. While the Maastricht Treaty does not prohibit debt cancelation, it seems unlikely that this proposal will at present receive enough political support.

Economist Paul de Grauwe has argued that there is no need to explicitly cancel the debt (de Grauwe, 2021). Instead, he argues that the effect of debt cancelation takes place when a central bank buys government bonds because the seigniorage is transferred from the central bank back to national governments. Canceling the debt therefore does not make a substantial difference for governments. De Grauwe argues for governments to issue perpetual bonds with a zero interest rate, which are financed by banks and then bought from them by the ECB (Vandaele, 2020). Here too the question is whether this kind of monetary financing that is explicitly forbidden by the EU Treaty.

More pragmatic solutions have been tabled to transform (part) of the debt of national governments to common debt (von Weizsäcker, 2011; Boonstra, 2016). Most recently, an academic collective from Italy and France proposed a European Debt Management Agency, acting together with the ECB. This Agency (the ESM, or a new institute) could gradually assume a part of Member States' public debts, starting with the Covid debts. Initially, this is done through a transaction between the Agency and Member States' Central Banks where existing sovereign bonds are

[16] This call was supported by more than 100 economists, politicians and campaigners, including Thomas Piketty, Laszlo Andor and Paul Magnette.

exchanged for (newly issued) EU bonds. In return, the Agency receives contributions from Member States to cover interest payments. As the authors explain, the crux of the plan is that the Agency exploits the difference in returns between sovereign bonds and EU bonds. This means that Southern Member States will pay less interest on their EU bonds. In the case of Italy for example, the authors estimate that the fiscal contributions to the Agency would be more or less 38% of what Italy currently pays in interest on the same stock of debt. The ECB will have fewer sovereign bonds on its balance sheet because of the swap with EU bonds, which functions as an additional debt instrument. The ECB will face less concerns about the consequences of scaling back its purchasing programs for specific Member States, strengthening its monetary operations.

Common fiscal capacity

Whereas a 'US-style' fiscal capacity for the EU does not seem to be politically feasible, smaller, temporary and/or more targeted steps towards a stronger common fiscal capacity have proven to be possible and could of added value to the national fiscal capacities.

The German chancellor Scholz has signalled that the SURE programme was a successful crisis response initiative, stressing that SURE has resulted in "a more robust labour market and healthier businesses throughout Europe (Scholz, 2022)."

High officials from both the EU and the IMF recently displayed support for a green investment fund as an additional instrument to achieve the EU's climate goals (Politico Pro, 2022). The Structural and Investment Funds could also be enlarged or, if needed, new funds could be developed.

An important condition of such funds is their temporary nature, linking them to specific transitory issues such as shock absorption as with SURE or specific transitions, like climate and digitalisation as with the RRF.

Access to such common fiscal capacities could be made conditional on reforms that support the long-term sustainability of both the economy and the government finances. One elaboration of this idea has been the proposal for a "Grand Deal" between the North and the South (European Shadow Financial Regulatory Committee, 2020). This Grand Deal proposal was originally aimed at Italy due to its "too big to fail" status but could also be applied to other countries that are highly indebted or lack the means to make proper investments. The crux of the proposal is that the reform plans should be prepared and presented by countries themselves, strengthening ownership. The idea is that reforms can foster the economic performance and resilience of the EU and increase the wellbeing of its citizens.

The Grand Deal should be aimed at reforms that boost productivity, strengthen labour markets, create stronger institutions, and enable green and productive investments. Importantly, a Grand Deal will prevent debt levels to increase even further and will as such also put a brake on the looming doom loop. It would also take the pressure of the ECB by contributing to more stable and thriving economies in the European regions that lag.

Intermediate conclusion on sharing the fiscal burden

Given where several EU Member States are with their government finances, some fiscal burden sharing seems inevitable to allow all of them to make the necessary investments. Failure to do so will most likely push these countries, and eventually the whole euro zone, into even larger problems. In some (large) economies central banks play an important role in keeping the government debt tolerable, as in Japan. However, this is not permitted to the ECB. Therefore, some form of Eurobonds would be interesting to capitalise on the sound financial position of the EU as a whole. In the North strong political reservations exist against this proposal. A more targeted, temporary, and conditional approach may therefore be more realistic. A fund of a sufficient size could significantly support all Member States to make the necessary investments.

Greening the economic governance

With current exceptionally high energy prices, greening the European economies has become an even more prominent goal. Wildfires, floods, and droughts already make the macroeconomic impact of climate change large. The consequences of climate change are likely to increase much more in the coming years. Today however, the economic governance framework does not contribute to greener European economies. There are several proposals to green the economic governance, namely a green golden rule to stimulate green investments and adding green indicators to the Macroeconomic Imbalances Procedure.

A green golden rule

The first paragraph of this chapter discusses the golden rule. More recently, a more targeted proposal has been tabled: a green golden rule. With this proposal, the same logic applies, namely the deterioration of debt sustainability when productive public investments are not made. This includes investments in climate adaptation that reduce the impact of climate change, or investments in climate mitigation that reduce climate change altogether.

Several countries as well as the European Commission (Allenbach-Ammann, 2021) have tabled the option of a green golden rule. A GGR may also correct for investments, whose benefits materialize in an uncertain future, often losing out in current budgetary considerations to expenditures that provide more immediate benefits.

Critics of the GGR warn of the risk of "greenwashing" (for example, Commissie Europese economie, 2021), i.e., pushing the boundaries of what can be classified as a green investment in the wrong direction. The EU taxonomy does however provide a framework to be used. Green investments could also be tied to European public goods[17] or so-called "spending for the future" (Giavazzi et al., 2021).

Greening the macroeconomic imbalances procedure

Climate change and biodiversity loss pose an important macroeconomic threat to the EU economies. However, the 14 indicators of the scoreboard of the MIP currently focus exclusively on trade, finance, and employment. The introduction of green indicators is needed to factor in the consequences of climate policy or the lack thereof for macroeconomic stability. Possible indicators are:

- The sustainable investment gap (the difference between sustainable investment needs and actual investments).

- The amount of public money spent on environmentally harmful subsidies and investment support, as proposed by the German think tank Climate & Company (Climate & Company, 2022).

- Climate adaptation expenditures and the exposure to the physical risks of climate change.

- Green taxes. While the current fiscal framework is mainly aimed at limiting public deficits and debts, and therefore limited spending, budgetary policy also has a revenue side. Currently, there is no system of sufficient green taxes, either at the national or the European level (European Commission, 2020a). Green taxes can include taxes on energy, transport, pollution and resources (European Commission, n.d.d.) and imply the pricing of "dirty" activities. Green taxation aims to reduce environmental damage, generates income for states and stimulates sustainable activities. Such budgetary shifts would also relieve the tax burden on labour, hence increasing productivity.

By putting green indicators in the MIP it becomes linked to, and enhances, several ongoing EU policy developments. Examples are:

- The green budgeting project (European Commission, n.d.e.) of the European Commission. Green budgeting implies the assessment of environmental contributions of budgetary items and policies. Currently, the project is still at a modest scale; at best, only 9% of a Member States

[17] Such as the climate, air quality or sustainable energy infrastructure.

budgeting relates to green budgeting (France is the best practice). A much broader assessment of how Member States budgets affect the climate and biodiversity should be undertaken.

- The European Commission's effort in greening the European Semester. The European Commission has undertaken greening the European Semester. In 2020, it published an Annual Sustainable Growth Strategy (ASGS) instead of an Annual Growth Strategy, calling it "a paradigm shift in EU economic policy".

- Other proposals for European green taxes already mentioned, such as a Carbon Border Adjustment Mechanism (CBAM) and a revised ETS tradable permit system. Member States should include green taxes in their policy mix, such as a green tax rule (Delgado et al., 2022). A study commissioned by the European Commission explores ten different kinds of green taxes or other economic instruments that Member States could introduce in the field of air pollution, water pollution, water scarcity, waste, and biodiversity (Mottershead et al., 2021).

- The European Energy Taxation Directive, which is currently being reviewed by the European Commission. The Directive was updated in 2003 for the last time and is no longer in line with the EU's own climate objectives. The review includes a revision of the minimum rates for fuels and reconsidering the tax exemptions (de facto subsidies) for certain fossil fuels and economic sectors (European Commission, n.d.d.).

Intermediate conclusions on greening the economic governance

The transition to more sustainable economies, or the lack thereof, has ever greater macroeconomic impacts. It is important to account for this in the economic governance. A GGR could create the financial capacity to diminish these macroeconomic risks. Nevertheless, as with the golden rule, this is only an outcome for Member States that have sufficient fiscal capacity of their own.

Therefore, transition funds would be a necessary complementary solution. Enriching the MIP with green indicators will help to do what the MIP is supposed to do: signal imbalances that threaten the macroeconomic instability and thus put an agenda on the table as to address them.

Strengthening governance and democratic accountability

Enforcement of rules and guidelines of the economic governance has been limited, whether budgetary limits — the thresholds in the MIP — or the country specific recommendations. There are proposals for improvement: the use of sanctions, a more inclusive governance, and Independent Fiscal Institutions.

Sanctions

Despite many breaches of the fiscal rules, and despite the pecuniary sanction of 0,5% of GDP, no financial penalties have until now ever been implemented. The reason could be that Member States do not want to set a precedent that could in the future turn on them. Financial penalties for a country running too high a deficit only makes the problem worse. The European Policy Centre (EPC) has tabled a proposal to tie the sanctions levied to deviations from national expenditure plans. According to EPC, the link with national policy plans might make sanctions fairer and more proportional for Member States. The revenues should be put into a special account and reimbursed once compliance is restored, for the sole purpose of repaying public debt (de Angelis et al., 2022). Such a reform of sanctions could also be considered in a similar reform of the MIP.

More inclusive governance

In countries that were strongly impacted by the euro crisis, reforms were imposed "from outside", which often led to aversion to the EU from both political leaders and the people — and limited ownership of the reforms. However, much has improved in the establishment of RRF plans, where countries submitted reforms themselves in close coordination with the European Commission.

A more inclusive form of governance, with more active engagement with civil society organizations, trade unions and national parliaments could further improve democratic support.

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

Independent Fiscal Institutions

Several experts and institutions advocate for an enhanced role of Independent Fiscal Institutions (IFI's). IFI's have an advisory function and are tasked to control and report, informing the political process. They assess the quality of public expenditures and investments, including challenges such as post-pandemic recovery and the green energy transition. IFI's have specific country knowledge and can provide guidance in for example making public investment choices. Research suggests that countries with IFI's show greater compliance with fiscal rules (Beetsma et al., 2019). Stronger IFI's could thus increase better national surveillance and trust between Member States.

The CPB Netherlands Bureau for Economic Policy Analysis, itself an IFI, suggests that the assessments of IFI's should be taken considered by the European Commission when assessing whether a country has good reasons to deviate from the fiscal rules (CPB, 2021). This proposal is also supported by the Dutch central bank (DNB, 2021). The European Commission and other European institutions (such as the European Court of Auditors) as well as the Member States could help countries that still lack proper IFI's to set them up.

While IFI's can play an important supportive role in policy making, developing national fiscal frameworks is primarily the responsibility of governments and parliaments. Parliaments are responsible for setting the exact mandate of IFI's.

Given the strong interdependencies between the traditional financial and economic developments and social and environmental factors, IFI's need to make an integral analysis, including long term social and environmental effects. As such, IFI's can help to assess the progress made on national climate plans and the European Green Deal. This is especially relevant for countries that do not have climate councils, i.e., most Member States. To perform this task well, IFIs should consist of, or work closely together with, experts from different disciplines (financial, economic, but also social and ecological).

Intermediate conclusions on strengthening governance and democratic accountability

Better adherence to the rules and guidelines of economic governance is a prerequisite for trust between Member States and hence for further steps towards common fiscal capacities. Independent Fiscal Institutions can contribute especially by taking social and environmental factors into account. This will also facilitate the ownership of policies by the larger public and their representative organisations increasing the quality of these policies through more diverse and knowledgeable contributions. With these developments there may be less need for sanctions.

As to sanctions, it may be sensible to reform them so as not to permanently do further harm to an already bleak fiscal outlook. This should then be balanced by the same sanctions for exceeding the thresholds set in the MIP.

5. CONCLUSIONS AND RECOMMENDATIONS

Conclusions: a union not able to do ‘what it takes’

EU governments have shown an unprecedented resolve to act together during the pandemic, using their common fiscal muscle. SURE and the RRF helped Member States to confront the challenges of the post-pandemic recovery, including the energy and digital transition.

Simultaneously, the European monetary union in its current state is not able to do ‘what it takes’. The EU is not able to deliver on the objectives to which it is bound by its Treaty: raising the standard of living and quality of life while respecting the environment and fostering convergence between Member States.

Immense challenges need to be confronted in the decades ahead, with a large and growing economic account if we fail. The EU is in dire need of more productive public investments if it is to honour its commitment to the Paris Agreement, increase the circularity of the economy, improve productivity through investments in human capital and R&D, and most urgent: tackle the current cost of living crisis.

These investment needs confront current debt levels and deficits. In the current fiscal framework, many countries have no space for such investments. But even if the fiscal rules would allow them, it is questionable whether market conditions will enable them to raise the necessary funds at sustainable levels of interest. The latter is all the more relevant since the ECB has changed its course and has started to tighten its monetary stance.

The new economic governance needs to address the ‘original sin’ of the euro of solely focusing on monetary integration. The European Monetary Union from the start lacked a solid fiscal foundation to absorb shocks and drive real convergence, improving the standard of living of all European citizens. Fiscal rules have therefore never been credible and have been breached dozens of times from the very start, including by the largest Member States such as Germany. The willingness of Member States to conduct the reforms prescribed by the European Commission is limited and decreasing. Meanwhile, the world has entered its decisive decade to halt global warming and make the leap towards a carbon-neutral economy. The climate emergency requires much bolder policy choices than the 30-year-old Treaty could envision. The current fiscal framework does not provide sufficient fiscal space for many Member States to make the necessary investments.

Recognition is needed for the current state of government finances and economic developments, especially in the South. The euro crisis left several EU Member States in a highly vulnerable position with high debts, high unemployment and increased economic divergence. At the very least temporary transfers are needed to counter this trend. Meanwhile, green, and productive reforms are needed everywhere, first and foremost in the South.

Reforming the fiscal framework is not only desirable but imperative. A Grand Deal needs to be struck, starting from the common interest that all EU Member States have in kickstarting their economies and transitioning these to a sustainable and equitable model. Failing to do so risks the Union falling prey to a new debt crisis, destabilizing the monetary union, and increasing tensions between and within Member States on an unprecedented scale. And that just when the geopolitical situation demands unity as never before.

Simply going back to the original rules (3% deficit and 60% government debt) and principles (no 'bail out') will not work. Even the proponents of such a course admit that this would require a restructuring of the government debt of the most heavily indebted countries — which seems politically unfeasible. Economically this scenario is problematic as well: it relies on a market discipline that has proven to be flawed at best and risks an increasing divergence that will put the monetary union and internal market under severe stress.

A 'definitive solution' at the other end of the scale is full-fledged European integration. While this scenario would remedy the incomplete monetary union by introducing a fiscal leg, and despite the success of Covid pandemic measures along these lines, the political feasibility at this stage seems also to be small. Especially in the North, there is a broad resistance to more common budgets and especially against issuing common debt.

A 'goldilocks' approach is needed of reforms that strike the right balance between the North, South and East of the Union. An approach that balances between being moderate and pragmatic enough to be politically acceptable, yet bold enough to enable all Member States to make the necessary structural economic reforms and productive investments to move the Union as a whole to a new equilibrium. The economic governance reform needs to strive for an equilibrium with diminished debt to GDP, reduced environmental risks and most importantly, improved quality of life.

Recommendations: a Sustainable Fiscal Pact for Europe

A Grand Deal needs to be struck between North, South and East of the Union, a Sustainable Fiscal Pact for Europe. To that end we recommend:

1. **Increase the debt limit.** The general 60% debt limit in the Protocol to the Maastricht Treaty is no longer tenable and should be increased. As explained in chapter 4, this is possible without a formal Treaty change procedure and leaves the Treaty's general prescription to avoid "excessive" deficits and debts untouched.

2. **Use country specific expenditure rules based on national reform and investment plans.** Instead of the structural deficit rule, a contracyclical and country specific expenditure rule should be used to control spending over the economic cycle. To stimulate green and productive investments, these should be treated different from other expenditures. This can be achieved either with a green golden rule, which could be tied to the concept of European public goods as investment guidance, or through National Reform and Investment Plans (NRIPs). NRIPs should allow for preferential treatment of certain investments, fostering the green energy transition and strengthening national ownership of fiscal policy and plans.

3. **Green the Macroeconomic Imbalances Procedure.** Climate and biodiversity have large macroeconomic impacts. The European framework, including the MIP, should pay more attention to such risks and integrate them across the board. The MIP should incorporate indicators that target climate and other environmentally related risks.

4. **Introduce EU transition funds.** All Member States should be able to implement the necessary investments and reforms needed to stabilize their economies and prepare them for the green transitions. However, several member states lack the fiscal room for this at their high debt levels. Temporary EU transition funds can help them overcome this limitation. To that end the model of the Recovery and Resilience Facility can be repeated: commonly financed temporary funds for targeted green and productive investments on condition of green and productive reforms.

5. **Strengthen governance and democratic accountability.** A better adherence to the rules and guidelines of the economic governance is a prerequisite for trust between Member States and hence for further steps

towards common fiscal capacities. Independent Fiscal Institutions can contribute to this. It is important that they do take social and environmental factors into account. The latter will also facilitate the ownership of policies by the larger public and their representative organisations. Connecting those to the discussion on appropriate policies will not only increase the ownership of those policies, but it will also most likely increase the quality of these policies if a more diverse and knowledgeable group of people can contribute to this. With these developments there may be less need for sanctions — and any sanctions should the same or like those for exceeding the thresholds set in the MIP.

ANNEX 1

The aim of European economic governance is to "monitor, prevent, and correct problematic economic trends that could weaken national economies or negatively affect other EU countries (European Commission, n.d.)." Its legal basis lies in the Maastricht Treaty, which aims to "achieve the strengthening and the convergence of their economies and to establish an economic and monetary union (European Union, 1992)." The three main pillars of economic governance are the Stability and Growth Pact, the Macroeconomic Imbalances Procedure (MIP) and the European Semester.

The Stability and Growth Pact

The Stability and Growth Pact (SGP) was introduced in 1997. The SGP forms a set of fiscal rules that prescribe how Member States should strive for sustainable public finances and coordinate their fiscal policy. Its legal basis lies in articles 121 and 126 of the Treaty on the Functioning of the European Union, which respectively deal with economic policy coordination and excessive deficits (European Union, 2012). Article 136 refers to the specific measures for the euro area. The secondary legislation of the SGP consists of a corrective arm and a preventive arm. These sets of rules aim to respectively reduce deficits to below 3% of GDP and bring structural budget balances in line with country-specific medium-term objectives. The Fiscal Compact (2012) added a rule for structural deficits, which are set at 0.5% (The Kingdom of Belgium et al., n.d.).

The SGP was amended during the euro crisis by the so-called six-pack and two-pack, with effect from respectively 2011 and 2013. These consist mainly of regulations to strengthen fiscal discipline and debt reduction in several ways. The six-pack included the excessive deficit procedure for countries with debts above 60% if they do not comply to the 1/20th debt reduction benchmark (even if deficits remain below 3%) and sanctions for countries in the procedure making insufficient progress (European Commission, 2011). The two-pack aimed to improve the coordination and surveillance of fiscal policy. It involves the monitoring and assessing of draft budgetary plans for all eurozone countries and enhances surveillance for countries in an unstable financial position or receiving EU support (European Commission, n.d.). As the Commission argued, the tightening of the SGP was meant to enforce more economic stability, prevent future crises, and increase fiscal coordination.

The SGP allows for a certain flexibility regarding Member States' fiscal policy. In 2015, the European Commission released a Communication with guidance for the best possible use of that flexibility without changing the rules (European Commission, 2015). Two clauses refer to special circumstances, namely the "unusual events clause" and the "general escape clause". The first refers to events out of control of governments, allowing for the exclusion of fiscal measures governments take to tackle the event in question when the Commission assesses their compliance with the SGP (European Commission, 2020e). The second clause is more far-reaching and prescribes that "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term (Council of the European Union, 1997)." The general escape clause allows, in addition, for a revised fiscal trajectory (European Commission, 2020c) and puts the SGP rules on hold. It has been activated by the European Commission in response to the corona-crisis and remains in effect until 2023 (European Commission, 2020d).

The Macroeconomic Imbalances Procedure

The Macroeconomic Imbalances Procedure (MIP) procedure was part of the secondary legislation that was added to the SGP in 2011, after the euro crisis. This surveillance mechanism aims to identify, prevent, and correct macroeconomic imbalances within the EU that form a threat for the economic stability within a Member State of the euro area or EU as a whole (European Commission, n.d.). It conducts so-called Alert Mechanism Reports and (if needed) In-Depth Reviews that identify (potential) macroeconomic imbalances within a country. The European Commission uses a scoreboard of 14 indicators, including deficits, international investment positions, (youth) unemployment, private debts, financial sector liabilities and changes in housing prices (European Commission, n.d.). In case of persistent excessive imbalances, the Commission may decide to start an Excessive Imbalances Procedure (EIP). This means that a country must submit a corrective action plan which describes how and in which time frame the macroeconomic imbalance is tackled (European Commission, n.d.). The monitoring of the implementation of the plan is executed by the Commission and Council, who also decide when to terminate the MIP.

The European Semester

The European Semester, which came into force in 2011, is the integrated surveillance and coordination framework of economic and social policies (European Commission, n.d.). Its structure requires Member states to discuss their economic, social, and budget plans in the first half of the year, resulting in national action plans in the second half. The basis consists of the European Commission's Annual Sustainable Growth Surveys (published in autumn), the Alert Mechanism Report, proposals for a Join Employment Report and recommendations of the euro Area (to be approved by Council) and finally the Commission's opinion on draft budgetary plans of the euro members.

The main "homework" of the Member States lies in the national reform programs and stability and convergence programs that they must present in April. These plans take account of the European fiscal rules, (the prevention of) macroeconomic imbalances, country-specific recommendations and policies aimed at boosting jobs and growth. Afterwards, in May, the Commission publishes country reports, which analyse the economic and social situation in Member States and make proposals for country-specific recommendations. Since the pandemic, the European semester is focused on an inclusive recovery and strong resilience and the monitoring of the implementation of the RRF plans (European Commission, n.d.).

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