

# INVESTING IN OUR FUTURE

Seven EU economic governance reforms for a stronger, greener and more resilient Europe

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## Joint Policy Brief

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# INTRODUCTION

**Europe faces serious economic, environmental and social challenges that require reforms and investment.** Europe is coping with multiple compounding crises, particularly the cost of living crisis, the aftermath of the Covid-19 pandemic, the Russian invasion of Ukraine, the climate crisis and biodiversity loss. At the same time, Europe must tackle additional long-term challenges around economic, energy and digital sovereignty, decaying infrastructure, quality of work, inequality and ageing populations. Tackling these challenges will require transformative legislative reforms. Evidence also points to the need for more and better public investment to catalyse significant amounts of private capital towards these socially desirable goals<sup>1</sup> – as illustrated by existing funding gaps.<sup>2</sup>

**But actions remain constrained by the European economic governance framework.** Fiscal rules that aim at ensuring debt sustainability are a legitimate feature of a monetary union without fiscal union. However, their focus on arbitrary debt and deficit limits incentivises undifferentiated reduction of public spending without sufficient regard for EU objectives, euro area (EA) needs<sup>3</sup> and spending quality – with public investment as collateral damage. Moreover, their use of the debt-to-GDP ratio to gauge debt sustainability overlooks broader drivers of debt unsustainability.<sup>4</sup> These rules also fail to adapt to the changing macroeconomic environment.<sup>5</sup> The long-term solution should be to amend the EU Treaties, reforming arbitrary debt and deficit limits.<sup>6</sup> In the meantime, the European economic governance framework requires fundamental upgrades to effectively ensure sustainable public finances that also support EU objectives – such as environmental protection, sustainable economic development and convergence.<sup>7</sup>

**We keenly observed and reflected upon many elements of the European Commission's orientation paper, and view it as a good starting point for the review.** Whilst the return to country-specific debt pathways is the rational and responsible course of action, we support the use of debt sustainability analyses (DSA) as a basis for country-specific reference paths built around expenditure paths – a welcome move away from the unreliable structural deficit rule.<sup>8</sup> We welcome the proposed move towards national medium-term fiscal-structural plans connecting country-specific debt pathways and their duration, with commitments for reforms and investments that improve debt sustainability.<sup>9</sup> We see the importance of establishing a common EU assessment framework aiming to ensure investments and reforms in national plans support debt sustainability, EU environmental, social and economic priorities and country-specific challenges.

**But we need more to ensure that the EU economic governance supports, rather than undermines, the EU's goals.** Whilst improving the tax system has an important role to play in delivering sustainable public finances,<sup>10</sup> the European economic governance review is an opportunity to embed powerful incentives for Member States to trigger the public investments and reforms needed to tackle today and tomorrow's economic, social and environmental challenges while ensuring a just transition for all. Meanwhile, the Commission's proposal is vague on mechanisms to ensure the quality of public finances and reforms. Furthermore, it maintains arbitrary limits to debt-financed quality investments which make little sense in the absence of debt sustainability risks. It's particularly detrimental as Europe is facing serious challenges that call for an increase in quality investment and social support. We therefore put forward the following seven key demands:

## 1. QUALITY PLANS

### Ensure the quality of national medium-term fiscal-structural plans

The proposed “common assessment framework” needs improvement in order to fulfil its objective to ensure investments and reforms in national plans support debt sustainability, support EU environmental, social and economic priorities and address country-specific challenges.

- First, the **‘Do no significant harm’ principle** (DNSH) should become its cornerstone – no support should be given to investments and reforms that leave future generations worse off.
- Second, **objectives should be specific and measurable** (e.g. greenhouse gas emission reductions, employment and poverty reduction targets, gender equality) and annual progress assessed via granular key performance indicators whenever possible (e.g. growth in rail traffic, number of buildings insulated). The aim is not to impose an obligation of results but to inform, if necessary, on the need to adapt national plans to meet agreed EU objectives.
- Third, the **detailed assessment must be made public** to increase transparency, public scrutiny and ultimately, trust and buy-in.
- Lastly, **resilience-enhancing reforms and investments** should be recognised as increasing long-term debt sustainability as they lower fiscal risks. Considering the potential future costs for public budgets from failing to tackle challenges facing Europe, the most fiscally responsible course of action is to rethink the 3% limit as discussed below.

## 2. FUTURE GENERATIONS

### Free future-oriented spending from arbitrary constraint

The scope of public investment required to support the EU in the fight against compounding crises is significant. To ensure sufficient fiscal leeway to bridge related funding gaps, Member States should be allowed to submit, as part of their national medium-term fiscal-structural plans, a list of **future-oriented spending**<sup>11</sup> to be excluded from

deficit and expenditure limits. Indeed, in the absence of debt sustainability risks, there is little rationale for applying arbitrary limits to debt-financed quality investments and productive spending that benefit future generations.

To address concerns that any mechanism automatically excluding some categories of spending could create negative incentives to circumvent the rules, the decision to exclude such spending should be part of the broader process of **ex-ante technical assessment** by the European Commission (e.g. the debt sustainability analysis, respect of the do-no-significant-harm principle, EU objectives and country-specific recommendations), and **political validation** by the Council – as suggested by *Finance Watch*.

## 3. DEBT SUSTAINABILITY

### Improve the monitoring of debt sustainability

By monitoring most factors that impact a country’s debt sustainability as well as their interaction, **debt sustainability analyses (DSA)** are more granular and far superior to proxy indicators such as debt-to-GDP ratios.<sup>12</sup> However, **DSA design choices are not neutral**.<sup>13</sup> Considering the importance DSAs should take in the new EU economic governance, we suggest two changes.

- First, the **DSA’s assumptions** should be derived from the objectives of the EU Treaties, especially sustainable economic development and convergence, and be agreed upon in a political process.
- Second, the DSA methodology should be developed, and regularly revised, by a **dedicated working group**.<sup>14</sup> This working group should be inclusive enough to ensure both state-of-the-art knowledge and diversity of views. It is particularly important that DSAs properly account for the fiscal multiplier of public investment<sup>15</sup>, as well as monitor the build-up of fiscal risks such as **climate-related fiscal risks**<sup>16</sup> – i.e. the fiscal impacts of failing to do the precautionary investment and reforms required to mitigate and adapt to climate change. Output gap calculation methods used in DSA will also need to be reformed.<sup>17</sup>



#### 4. CO-ORDINATING SUCCESS

##### Reform the European Semester to deliver on EU environmental, economic and social objectives

Whilst the monitoring function of the Semester has improved over the years<sup>18</sup>, changes are needed to improve its ability to steer Member States towards the achievement of agreed EU objectives and/or national targets<sup>19</sup> and conducive to European upward convergence.

- First, **country-specific recommendations** (CSRs) should better account for EU objectives and EMU dimensions (e.g. euro area fiscal stance, spillovers, externalities), be associated with specific indicators, be tailored according to the country distance to the related target, and formulated in a way that makes progress measurable.
- Second, economic governance should be better connected to **energy and climate governance** – for example, steering the phasing out of environmentally harmful subsidies to improve the quality of public finance and free up fiscal space for the just transition.<sup>20</sup>
- Third, a **Social Imbalances Procedure (SIP)**<sup>21</sup> integrated into the European Semester process complementing and improving existing monitoring frameworks and indicators, would help detect and address social imbalances early before they turn into prolonged crises.
- Finally, to facilitate future evolutions, the European Semester should be separated from the Stability and Growth Pact and have its **own dedicated regulation**.

#### 5. MONITORING RISKS

##### Broaden and deepen the Macroeconomic Imbalance Procedure

As the Macroeconomic Imbalance Procedure (MIP) is expected to lead to commitments in national plans and to their potential reopening, it is important to ensure the MIP captures all relevant macroeconomic risks and emerging imbalances, both in national and European dimensions.

- First, **climate-related risk indicators**<sup>22</sup> must be in-

cluded in the MIP, given the ever-increasing impact of climate change on macroeconomic stability (physical and transition risks).<sup>23</sup> An indicator of exposure of private financial institutions to the sectors subject to particularly high climate-related risks, such as the fossil fuel sector, should be added to the list of auxiliary indicators. This would raise the importance of climate and environmental risks in economic policy<sup>24</sup> and financial regulation.<sup>25</sup>

- Second, **review the thresholds** of some MIP's scoreboard indicators to make them symmetric. In particular, the choice of stricter signalling thresholds for current account deficit than for surpluses<sup>26</sup>, misses that surpluses also cause imbalance.
- Lastly, the MIP follows a country-by-country approach that pays too little attention to defining and enforcing appropriate overall **EU/EA needs** (e.g. euro area fiscal stance). The proposed inclusion of EU/EA value for each indicator should facilitate the resolution of imbalances.

#### 6. DEMOCRATIC OWNERSHIP

##### Increase national and democratic ownership

Fiscal and economic policies sit at the heart of government policy and more democratic ownership will do much to improve the buy-in to government plans, as well as accountability and understanding of the choices made. This requires:

- First, reformed minimum standards for national fiscal framework should ensure the effective **involvement of parliaments, local authorities, trade unions and civil society** in the design of national medium-term fiscal-structural plans.<sup>27</sup>
- Second, a **newly formed government** should be able to make amendments to the national plans.
- Lastly, the mandate of the **Independent Fiscal Institutions (IFIs)** should be improved and their tasks expanded.<sup>28,29</sup> Particular emphasis should be put not only on producing macroeconomic forecasts, but

also fiscal and economic risks analyses (including transition risks), monitoring spending quality and assessing funding gaps. The network of EU Independent Fiscal Institutions (EUIFIs) should be part of the efforts to improve DSA methodologies. Crucially, IFIs governance arrangements must ensure a balanced composition and account for minority views.<sup>30</sup> This would shield IFIs from being captured by any one school of thought.

## 7. GROWING STRONGER

### Establish European fiscal capacities

Large funding gaps could continue to persist, even within the new framework proposed by the European Commission. Common EU borrowing would allow Member States to raise funds at a lower cost, as EU bills and bonds are viewed by financial markets as safe assets and have been in high demand. Establishing EU fiscal capacities could also help strengthen the international role of the euro<sup>31</sup> and euro area financial markets integration.

- First, **a permanent fiscal stabilisation capacity**<sup>32</sup> could help avoid mismatches between the euro area's needs in periods of crises (i.e. the euro area fiscal stance) and the fiscal policy of its Member States, while ensuring a level playing field.<sup>33</sup> The activation of the general escape clause could serve as a criterion to call up this countercyclical fiscal capacity.
- Second, **an EU fund for the just transformation** should be established and cover, among others, infrastructure needs as well as Important Projects of Common European Interest (IPCEIs).



## ENDNOTES

- 1 Europeans' vulnerability to the skyrocketing cost of living and the climate crisis cannot be separated from EU rules restricting government investment in public goods. In: [Green European Journal \(2022\)](#).
- 2 The European Commission's services estimate funding gaps to amount to €520 billion a year until 2030 to meet EU environmental objectives, €142 billion a year for social infrastructure such as hospitals and schools, along with €190 billion a year to stabilise the stock of public capital – such as publicly-owned roads, buildings, bridges and ports.
- 3 Abiding by the current “1/20th” debt reduction rule would require the euro area to maintain an annual fiscal surplus of 1.1% of GDP over 20 years – a level that would lower many countries' GDPs over the long run, therefore increasing their debt-to-GDP ratio.
- 4 These drivers include the evolution of interest payment-to-GDP ratios, gross financing needs, cost of ageing, interest-growth differentials, share of short-term debt and foreign-held debt in the total debt stock, its average maturity, and the building up of fiscal risks. More in: Finance Watch ([2021a](#), [2022](#)).
- 5 In the 1990s, debt servicing costs were a significant part of Member States budgets, accounting for 3,5-11% of GDP, as governments struggled with high long-term sovereign interest rates (7-25%). Thirty years after Maastricht rules first came into force, the same European countries have experienced a continuous, and structural, fall in long-term interest rates to a historically low level of 0-3%. This, in addition to extended average debt maturity, has resulted in debt servicing costs as low as 0-4% of GDP despite higher stocks of public debt.
- 6 For more information see the [European Environmental Bureau's position paper](#).
- 7 A New Economics Foundation analysis showed that European citizens have been left just under €3,000 a year worse off in their household incomes and have seen €1,000 less spent on their public and social services since the global financial crisis. In: [NEF \(2022\)](#).
- 8 That being said, structural deficit plays a role in the current DSA methodology of the European Commission. It's therefore not a complete move away from it.
- 9 Several signatories of this position paper have suggested similar proposals earlier on. E.g. Finance Watch ([2021b](#), [2022](#)); [CAN Europe & Finance Watch \(2022\)](#).
- 10 According to [Oxfam](#), the richest 1 percent captured nearly two-thirds of all new wealth worth \$42 trillion created since 2020, almost twice as much money as the bottom 99 percent of the world's population. During the past decade, the richest 1 percent had captured around half of all new wealth. On top of closing international tax loopholes, the tax system should be made more progressive, with the dual aim of increasing public revenue and reducing unsustainable socio-economic inequalities and environmental externalities.
- 11 Future-oriented expenditures cover categories such as quality public investment, green expenditures and productive social expenditures, such as spending on education (i.e. investment in human capital) and healthcare – both associated with a positive impact on economic development.
- 12 The debt-to-GDP indicator can't explain why Japan's 250% debt-to-GDP and USA's 160% debt-to-GDP are sustainable, and why some countries default on 40% debt-to-GDP. A Debt Sustainability Analysis (DSA) can.
- 13 Whilst small changes in assumption can carry significant implications, there is not one correct DSA, but various fiscal stance/investment/growth combinations. More discussion in: [Dezernat Zukunft & Instituut voor Publieke Economie \(2022\)](#).
- 14 This working group would complement the work undertaken by two previous Economic Policy Committee working groups that are already developing some elements of the EC's current DSA: the [Working Group on Ageing Populations and Sustainability](#) (AWG) and the [Output Gaps Working Group](#) (OGWG). These working groups are composed of representatives of each finance ministry, the European Commission and the ECB.
- 15 Fiscal multipliers of public investment in most European countries are associated with permanent and positive impacts on the level of economic activity ([Gechert, S., 2015](#)), in particular public investment in infrastructure ([Espinoza, R., et al., \(IMF\) 2020](#)). This multiplier effect becomes considerably higher during recessions ([Gechert, S., Rannenberg, A., 2018](#)), when economic resources lay underutilised ([Delong, J.B., Summers, L., 2012](#)), as well as when interest rates are low ([Bonam, D., De Haan, J., Soederhuizen, B., 2020](#)). Some research also suggests that fiscal multipliers (in general) are country-specific (e.g. [OECD, 2012](#)).
- 16 The Office for Budget Responsibility recently estimated that climate change could add between 21 and 45 per cent of GDP to the UK's public debt by 2050 (i.e. climate-related fiscal risks). In: OBR (2021) "[Fiscal risks report](#)"; The Network of EU Independent Fiscal Institutions has also assessed the fiscal impact of the climate transition. In: [EUIFIs \(2022\)](#).
- 17 The European Commission current DSA methodology relies on problematic output gap estimation. The current method uses past data on the utilisation of economic potentials (including structural problems on the labour market), and presumes that these trends will continue in the future. Consequently, it does not incor-



- porate any incentives to extend economic potentials. To change that, make potential output conditional on current and planned policies that would extend utilisation of the potential. Such reform would ensure DSAs produce better values for the fiscal stance which are compatible with EU policy goals. For more discussion, see: [Schuster et al. \(2022\)](#).
- 18 With the addition of a social scoreboard that monitors implementation of the European Pillar of Social Rights, as well as a monitoring of the UN Sustainable Development Goals (SDGs).
  - 19 Member States submit national targets on employment, skills and poverty reduction as their national "contribution" to the EU headline targets.
  - 20 For more recommendations to align European fiscal policy with the imperatives of a just transition, and to develop the intergenerational aspect of green investment, see the European Youth Forum's [position paper](#).
  - 21 This was first proposed by the [Belgian and Spanish governments](#) and has since been supported by the European Commission as well as various member states. More information in [ETUI \(2022\)](#).
  - 22 McKinsey & company define seven characteristics of physical climate risks and show that they already have substantial risks that are likely to increase in a non-linear fashion. By 2030, climate impacts are likely to put millions of lives at risk, as well as trillions of dollars of economic activity and physical capital, and the world's stock of natural capital. In: [McKinsey & company \(2020\)](#).
  - 23 Whilst climate-related financial risks grow as the cost of fossil disengagement increases with each delay, climate-related fiscal risks grow as a consequence of the public costs stemming from (i) failing to mitigate and adapt to climate change (i.e. physical risks) and of (ii) the public costs stemming from the increasing risks of climate-related financial crisis. For more discussion, see NGFS "[Climate scenarios for Central banks and Supervisors](#)" (2022) and also the note by Greentervention [on the integration of climate risks into the economic governance](#).
  - 24 If country-specific recommendations (CSRs) related to fiscal and macroeconomic imbalances are more often complied with than social or environmental ones, it might be because they have a stronger legal basis (i.e. SGP and MIP) and failing to comply could theoretically lead to sanctions. Including environmental objectives and pressures in the MIP could give more legal teeth to related CSRs. This could also force a reflection on trade-offs that could exist between economic, environmental and social dimensions.
  - 25 For suggestions for strengthening financial regulation, see Chenet, H., Ryan-Collins, J., van Lerven, F. (2021), "[Finance, Climate change and radical uncertainty](#)", Ecological economics, 183(2021); Institut Veblen, et al., (2022), "[How banking regulation can serve the ecological transition](#)"; Finance Watch (2022), "[A safer transition for fossil banking](#)".
  - 26 Whilst the current thresholds are -4% of GDP floor for current account deficits but a +6% ceiling for surpluses, the European Commission originally proposed symmetric thresholds (-4% and +4%). For more discussion, see: [Bénassy-Quéré and Wolff \(2020\)](#).
  - 27 Member States should be required to detail how they involved stakeholders in a dedicated section of their plan.
  - 28 According to the Council Directive 2011/85/EU that institutes national fiscal frameworks, EU Member States have to prepare and execute their budget according to a set of minimum requirements. This directive also outlines the role Independent Fiscal Institutions (IFIs) play in monitoring Member States compliance with fiscal rules and providing economic and budgetary forecasts. In: "[Breaking the Stalemate](#)", Finance Watch (2022).
  - 29 Building on best practices, minimum standards should ensure (i) functional autonomy (e.g. adequate and stable own resources; flexibility to manage their resources), (ii) access to information, (iii) safeguards from political pressures (e.g. strict rules for conflict of interest), and (iv) an effective implementation of the "Comply or Explain" principle. See: EU IFIs, "[Network statement on the need to reinforce and protect EU IFIs](#)", 22 January 2019.
  - 30 In addition to expertise requirements and efforts towards gender equality, important avenues are: (i) board members should be proposed by the parliament, social partners and civil society; (ii) individual board members should benefit from dedicated staff – in addition to general staff; (iii) minority and divergent opinions should be allowed to be reported in official reports as they would be instructive for the political debate. In: "[Breaking the Stalemate](#)", Finance Watch (2022).
  - 31 "[...] the lack of an adequate supply of euro-denominated safe assets is a key constraint on [the Euro] international development." [Bruegel \(2022\)](#).
  - 32 The European Fiscal Board, the European Central Bank, and the International Monetary Fund and many other institutions, have been arguing for a central fiscal capacity approach to covering a gap in the EU fiscal framework.
  - 33 Whilst the possibility to trigger escape clauses in time of crisis theoretically allows Member States to implement countercyclical fiscal policies, some countries can lack the risk-absorbing capacity to implement them, whilst others countries with better fiscal capacity could lack the willingness to compensate by engaging for more countercyclical policy.



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## Members of the Fiscal Matters coalition



As academics, civil society, trade union leaders, activists and citizens, we are deeply concerned that the current fiscal framework prioritises debt reduction and balanced budgets over important human, economic and environmental outcomes. Accordingly, we work collaboratively to overhaul the current approach to fiscal policy and reshape our economies and tackle the unprecedented challenges facing the EU head on. For further information, see [www.fiscalmatters.eu](http://www.fiscalmatters.eu)

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