REFORMING EU MACROECONOMIC GOVERNANCE

GREENS/EFA POSITION PAPER

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THE GREENS/EFA
in the European Parliament

CONTENTS

NOTE: The scope of this paper covers the main dimensions of the review of the macroeconomic governance framework and completion of the EMU. State aid framework, bank exposures to covid related risks, sustainable finance and CMU are not addressed.

Executive Summary

The recent history of Europe is one of recurring crises. The global financial and euro crisis a decade ago have exposed stark divisions in Europe while bringing about some reforms to the Eurozone' institutional architecture, without solving the underlying lack of risk-sharing mechanisms to address economic shocks.

More recent economic crises have further exposed that **Europe does not have the right fiscal rules, institutions, or economic coordination mechanisms.** The Covid-19 pandemic has required a suspension of Europe's fiscal rules, and the creation of Next Generation EU, a far-reaching yet temporary instrument based on joint EU debt. In the current juncture, the Russian war of aggression and weaponisation of energy led to divergent measures among member states, pointing to the need for a coordinated EU response providing a targeted social safety net whilst laying down the foundations of a truly energy independent Europe.

This **sense of perma-crisis is set to continue** amid a succession of record-breaking heat waves, forest fires, and droughts. The climate emergency is a long-term challenge that will require more than the slow adoption of ad hoc emergency responses seen up until now.

Instead of lurching from crisis to crisis, **Europe has to become more resilient,** with a macroeconomic governance that allows it to absorb economic shocks, finance the just transition to a decarbonised future, and protect social investment to ensure no one is left behind.

An ambitious reform of the currently suspended Stability and Growth Pact (SGP) is urgent. The current fiscal rules are widely discredited: counterproductive, pro-cyclical, promoting short-termism, indifferent to spending quality, asymmetric, unenforceable, based on unobservable variables subject to massive revisions, and ultimately aiming for arbitrary numerical reference values (the 3 and 60 percent of GDP deficit and debt levels) that were agreed under vastly different circumstances 30 years lacking any economic rationale.

Moving away from a **narrow vision of EU economic governance based on mistrust** means that we view rules at EU level not as a constraint but as an enabling condition to orient national budgets towards the pursuit of commonly identified EU policy objectives, including social and territorial cohesion and environmental sustainability. We need a framework that does not focus only **on the quantity of spending and borrowing** from a narrow accounting perspective, **but instead assesses its quality.**

To achieve this, we refocus the fiscal rules away from **annual deficits**, and towards the more relevant metric of the sustainability of public debt from a long-term perspective. Under this rule, **country-specific debt adjustment paths** are agreed with each Member State, with debt sustainability assessments **incorporating the fiscal consequences of climate inaction,** which may require increases of targeted green expenditure. To properly account for any debts incurred in order to accelerate the just transition, we introduce **amortisation** as the accounting method for investments recognised as sustainable under a green golden rule, i.e. green (renewables, energy efficiency, grids) and social (housing, education, healthcare infrastructure, national co-financing of cohesion funds) investments. Amortisation spreads the cost of net public investment over the life-cycle of an investment (e.g. 20 years or more), instead of fully accounting for it upfront. This allows the frontloading of urgent climate investments, flattening the emissions reductions curve in line with the Paris Climate Agreement-aligned scenarios.

To speed up the green transition and ensure Member States can and do invest also where debt levels are high or the political inclination to address the climate emergency is limited, we need a follow-up instrument to the recovery and resilience fund (RRF). Based on Article 122 to address the climate and energy price emergencies, the **EU Energy Transition Facility would be funded via joint EU debt-issuance**, and address the surge in energy prices with grants for energy efficiency and renewable energy.

The **governance** of the SGP is overhauled, moving to **multi-year National Investment and Reform Programmes (NIRPs).** These programmes are co-created between incoming national governments and the European Commission **at the beginning of each legislature**, and validated by the Council and the European Parliament. The latter shall have a binding say if national programmes are rejected, and in the disbursement of Energy Transition Facility funds. Investments funded via this new facility as well as expenditures receiving a preferential treatment under the green golden rule are made conditional on compliance with the new set of fiscal rules and are aligned with the country-specific reforms and investment priorities set out in the NIRPs. These serve as additional incentive to implement the commonly agreed programmes. Independent fiscal institutions at national level, operating under commonly developed methodologies and minimum standards for governance and accountability, serve as additional checks on the new framework.

This position paper embeds these changes in **broader reforms of the EU macroeconomic governance framework**, including a completion of Banking Union notably through a European Deposit Insurance Scheme providing private stabilisation via the banking sector, as well as making the European Stability Mechanism the EU's debt agency under the European Commission.

A section focusing on **Treaty change** includes the introduction of majority voting on **tax matters** and governance of **EU own resources** under the ordinary legislative procedure, a permanent fiscal capacity at EU level, and changes to the deficit and debt limits of 3 and 60 percent of GDP. Finally, the Green Group in the European Parliament proposes a clarification of the **European Central Bank's** mandate and accountability, notably introducing dual interest rates to boost private investment in the green transition.

EU economic governance in an era of crises

Over the past 15 years, Europe has been emerging from recurring crises. The global financial crisis that hit the European Union, especially the euro area, triggered excessive fiscal austerity in Member states, such as Greece, with lasting scars on their societies and economies, exacerbating existing disparities and ultimately dividing the Union.

Almost ten years after, the COVID-19 pandemic has led to a tragic loss of human life with a devastating impact on health, jobs, poverty and collective wellbeing. This time the EU policy response was not punitive, and entailed measures unthinkable before the pandemic, namely the suspension of the fiscal rules under the Stability and Growth Pact and the creation of Next Generation EU, enabling the Union to issue up to 800bn of debt to jointly finance the Recovery and Resilience Facility and other crisis fighting tools, successfully containing the economic downturn. However, these are temporary and exceptional instruments not addressing the long-term effects of the crisis and structural shortcomings of the currency union.

Today, the implications of the war in Ukraine for the European economy are becoming painfully manifest. The impact of drastically increased energy prices (in particular for oil, gas and electricity) and food prices is significant,[1] leading to unprecedented levels of inflation, eroding people's income, and ultimately tipping Europe into recession.

And while Europe is still struggling to overcome these crises, another underlying emergency cannot be forgotten in the midst of yet another record-breaking summer of recurring heat waves, widespread droughts and forest fires: Climate change continues to accelerate, leading to catastrophic risks of climate disruption, extreme weather events and environmental degradation linked to biodiversity loss, with planetary boundaries being crossed. Fighting these challenges will require decisive action also through fiscal policy tools, notably extensive public investment in the green transition.

Currently, the fiscal rules are suspended from the onset of the pandemic until the end of 2023. Reinstating the old framework would trigger significant cuts in public spending for many Member States, impeding the recovery, eroding social rights and preventing the Union from realising its green and geopolitical ambitions. Against this background, the European Commission relaunched in 2021 the Economic Governance Review with the purpose of responding to the COVID-19 crisis and climate emergency, in addition to addressing previously identified weaknesses. However, the public consultation carried out by the Commission hints at a limited revision with incremental changes focusing on simplification and enforcement of the rules. Yet the EU economic governance framework requires a major overhaul. "Tinkering around the edges" cannot be a credible response to the needs of the wider economy, society and the planet.

In this regard, a "first generation of crises" (Eurozone crisis, Covid-19 pandemic) highlights the need for sufficient fiscal flexibility to enable the **macroeconomic stabilisation** required **in recessions**. This effectively means fiscal policy has to be **designed counter-cyclically**, i.e., allowing for higher government spending and lower government revenues in recessions and compensating this with lower spending and higher revenues in the upside of the economic cycle. Without countercyclical fiscal policy, there is a threat that a crisis or a recession will trigger **fiscal consolidation in the government's budget,** which could lead to austerity[2].

1. Fiscal support and monetary vigilance: economic policy implications of the Russia-Ukraine war for the European Union, Olivier Blanchard and Jean Pisani-Ferry, Policy Contribution Issue n°06/22 | April 2022
2. Updating the EU's fiscal rules , How improving the EU's potential output methodology can mitigate the risk of deepening recessions, Zoe institute, Lukas Bertram, Feridun Temory, Jakob Hafele

However, the challenges posed by the climate emergency require a broader paradigm shift. A review of the fiscal framework should not only focus on what we have learned over the past 20 years on countercyclical spending and the existence of fiscal space. Current challenges, especially those linked to the overarching objective of achieving the just transition leaving no one behind require a sustained level of targeted public investments to a certain extent independently of the economic cycle. At the same time, any proposed change to the framework should carefully account for the **quality of public spending**, and be **embedded in a broader framework of economic and budgetary policy coordination** where fiscal rules serve as the **means to the achievement of common EU policy objectives** so that **spending priorities do not contradict each other.**

The purpose of this paper is to outline a Greens/EFA position on the reform of the EU economic governance framework with the aim to promote long-term sustainability and addressing poverty and inequalities, while safeguarding short-term economic stabilisation. Part 2 and 3 focus on the shortcomings of the current fiscal rules and on proposals for their revision, respectively. Part 4 proposes the creation of an EU fiscal capacity, reforming the European Stability Mechanism and the completion of the Banking Union. All reform proposals take into consideration the significant legal constraints set by the EU Treaties. The last section advocates for a Treaty change and makes broader policy recommendations.

A framework unfit for purpose

The EU's fiscal rules have been prone to controversy since their inception in the 1990s and subject to several waves of reform. The 60 percent debt limit and the 3 percent deficit cap, introduced in Maastricht, are enshrined in the Treaty on the Functioning of the European Union (TFEU), but lack any sound economic justifications[3]. They are based on the assumption of nominal GDP growth averaging 5% (3% real growth and 2% inflation). These assumptions may have seemed 'realistically ambitious' during the early 1990s but are definitely out of reach in the current context.

The two figures remain, however, cornerstones of a highly complex fiscal policy framework laid down in EU secondary law. This framework introduces a debt reduction path, albeit very difficult if not impossible for several Member States to achieve[4] and a structural budget balance threshold[5] interwoven with additional rules and various exceptions and derogations. The structural balance, based on methodologies to calculate the output gap of economies, was introduced to enable countercyclical policy in spite of the rigidity of the Treaty-based thresholds. However, it is widely discredited due to recourse to unobservable variables and its propensity for major, pro-cyclical revisions especially during times of crisis.[6] Ex-post revisions of the estimated output gap by the European Commission are routinely of the same order of magnitude as the estimated output gap itself.

Overall, the main shortcoming of the EU fiscal rules framework can be summarised as follows:

Unresponsive to the economic cycle It is generally acknowledged that the EU fiscal rules framework has failed to provide countercyclical stabilisation. It has led to insufficient debt reduction in many countries in good times, while it contributed to excessive fiscal austerity during and after the financial and Eurozone crisis. The latter amplified economic and social problems, led to a hasty reduction of public deficits with a strong negative impacts on economic growth and employment, and actually ended up increasing debt to GDP ratios[7].

Promoting short-termism and indifferent to spending quality Overall, the excessive focus on numerical limits prompts undifferentiated reductions of government spending without regard for its quality. As it is politically easier in times of crisis to abstain from investing than to cut regular consumption, public investment has been one of the major victims of the past decade. Also, by forcing cuts regardless of Member States' and regions' socio-economic needs, the framework ignores the build up of long-term fiscal risks such as those arising from environmental crises.

Asymmetric While the EU fiscal framework constrains deficits, it lacks the necessary tools to require spending increases in countries with excessive current account surpluses. The consequences of such an asymmetry can be a downward spiral which reduces aggregate demand, creates deflationary pressure, and cements macroeconomic imbalances in the currency union.

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3. See above (60% debt/GDP is the asymptotic ratio towards which an economy converges assuming a deficit of 3% and a nominal GDP growth of 5% (3% real growth + 2% inflation).
4. If public debt is higher than 60 percent of GDP, it must decline annually by at least 1/20th of the gap between the actual debt level and the 60 percent reference value.
5. The budget balance which excludes the impact of the economic cycle and one-off fiscal measures must be higher than the country- specific medium-term objective (MTO), which, in the case of euro-area countries, has to be chosen at or above -0.5 percent of GDP, or -1 percent for countries with a debt-to-GDP ratio below 60 percent.
6. "Why structural balances should be scrapped from EU fiscal rules" (2019), "Fiscal rules require a major overhaul" (2018)
7. Pro- cyclical fiscal tightening in a recession implies that long-term public debt sustainability is achieved in an ineffective way, because undue fiscal consolidation in a recession can prolong economic weaknesses and keep the debt ratio higher by shrinking GDP, triggering further fiscal consolidation.

Complex and unenforceable The EU fiscal framework is a remarkable legal maze composed of a dozen regulations, directives, Treaty articles and Annexed protocols, as well as a "vade-mecum" and code of conduct as interpretational guidance notes by the European Commission.[8] Reliance on such opaque rules to enforce policy measures with far-reaching distributional impacts puts into question the framework's legitimacy. The weak economic rationale underpinning the rules has harmed the Commission's and Member states' willingness and ability to enforce them. The result of the last attempt at reforming the Maastricht rules can be summarised as bad enforcement of bad rules.

Table 1: Overview of the existing EU fiscal rules

Rule	Description	Legislative reference
Debt rule	National debt cannot be more than 60% of GDP	TFEU (121, 126), Protocol 12
Debt reduction rule	Gap between a country's debt level and 60% reference value to be reduced by one 20th yearly	Secondary legislation- SGP corrective arm
Deficit rule	Budget deficit cannot exceed 3% of GDP	TFEU (121, 126), Protocol 12
Structural balance rule	MTO at or above -0.5% of GDP for countries with debt-to-GDP ratio below 60% If structural balance lower than MTO, must increase by 0.5% of GDP per year as baseline	Secondary legislation- SGP preventive arm
Expenditure rule	***If MS is at its MTO or higher:*** Real gov expenditures cannot grow faster than the medium-term potential economic growth ***If MS has not yet reached its MTO:*** Expenditure growth must be lower than potential growth to ensure adjustment towards the MTO.	Secondary legislation- SGP preventive arm
Unusual Events Clause	Allows deviation from parts of the preventive or the corrective arm of the SGP, because an unusual event outside the control of one or more Member States has a major impact on the financial position of the general government.	Secondary legislation- SGP
General Escape Clause	Allows deviation from parts of the preventive or the corrective arm of the SGP, because the euro area or the Union as a whole faces a severe economic downturn.	Secondary legislation- SGP

Source: CEPS 2022, A comparative approach to possible treatments of green and social expenditures in a revised fiscal framework

8. https://www.consilium.europa.eu/en/policies/stability-growth-pact-flexibility/

Revising the Stability and Growth Pact

Any proposal to reform the EU fiscal rules should start with the fundamental question of why we need a rules based framework at EU level in the first place.

The mainstream reply to that question is that fiscal rules set **permanent constraints** on fiscal policy and help **overcome** the tendency of governments to allow deficit and debt levels to increase over time (known as the "**deficit bias**"), thus ensuring sound fiscal policies. According to the same narrative, fiscal policies of individual EU member states are a common concern for the entire EU as an expansionary fiscal stance in one country may push up the country's public debt and magnifies solvency risk, which may **spill over to other member states** and force them to come to the financial rescue. By the same token, EU fiscal rules are the indispensable **"quid pro quo" for any solidarity-based mechanism** at EU level, such as NGEU.

Moving away from such a narrow vision of EU economic governance based on mistrust means that we view rules at EU level **not as a blanket constraint but as an enabling condition** to **orient national budgets towards the pursuit of commonly identified EU policy objectives**, including social and territorial cohesion and environmental sustainability.

If we recognise that **emissions know no borders** and that a political and economic union should aim at an **upwards social convergence** among its members, then the size of green public investment and social spending or conversely the expenditure in environmentally harmful activities in one country produces **spill-over effects to the rest of the member states**.

Therefore, we need an **economic governance framework at the European level that** does not **focus exclusively on the *quantity* of spending and borrowing** from a narrow accounting perspective **but instead assesses its *quality***. Both increasing spending in unproductive, polluting sectors driven by short-term political motivations as well as refraining from expenditure that addresses the social and environmental challenges of our day will leave future generations worse-off and negatively impact long-term debt sustainability.

A revised framework must **actively encourage spending that supports the achievement of social and environmental targets** and **prevent spending that runs counter to these objectives. Without ignoring the economic cycle,** public expenditure must be seen **from a long-term perspective**, taking into consideration the **future direct and indirect returns, not simply the short-term fiscal flows**. Moreover, based on the multilevel governance principle, **the central government and the devolved authorities within a given member state should fairly cooperate and coordinate their positions in order to ensure a better ownership of the long-term perspective.**

How a reformed EU framework can deliver on the above, especially taking into account the existing numerical constraints laid down in the Treaties is the subject of the next sections.

A. European Semester

• Green and gender budgeting

A framework that focuses on the quality rather than the quantity of spending pre-supposes an alignment of national budgetary processes with environmental and social goals by redirecting public investment, consumption and taxation to green and social priorities away from harmful subsidies.

Such a process starts with the application of **green budgeting tools** on **both public expenditure and revenues.** Such tools would assess, given the regulatory and administrative context, the impact of budgetary items against specific indicators based on the six environmental objectives of the European Taxonomy. Synergies with social objectives can be explored by measuring employment in the circular economy or tracking the use of just transition funding in Member States at all levels of governance. Notably, going beyond individual budgetary items, a holistic indicator/ assessment criterion **that measures the discrepancy of Member States' annual budgets from a Paris-aligned scenario used as a benchmark** needs to be introduced.

Further to that, building on the Commission's efforts to develop a methodology to include gender budgeting in the EU budget, gender budgeting principles need to be mainstreamed into the assessments of draft budgets, in order to ensure that national budgets contribute to advancing gender equality, rather than reinforcing existing inequalities. Budgets are not gender neutral, but too often gender ignorant. Without accounting for gender, an optimal budgetary distribution cannot be assured, as investment and expenditure associated with some sectors and work may be systematically undervalued or put at a disadvantage - most often predominantly female activities.[9]

The ultimate purpose is to **identify public and private investment gaps** as well as **budgetary items that run counter to policy objectives** such as subsidies for fossil fuels or other activities that breach the "Do no significant harm" criteria or austerity measures with disproportionate effect on single mothers. **Common methodologies on green and gender budgeting** should be developed through an EU Directive and monitored by the European Commission.

• National Investment and Reform Plans

This process should become an integral part of a new "European Semester" that proactively improves Member States coordination towards achieving the EU's objectives (e.g. European Green Deal, EU pillar of social rights, global commitments such as the UN 2030 Agenda for Sustainable Development), moving beyond the "taking into account" approach.

To allow for meaningful analysis and implementation, and to increase the democratic legitimacy of the exercise, the Semester must be transformed into a more long-term **European Strategic Cycle for policy coordination,** based on **national plans** addressing **Country Specific Recommendations, Macroeconomic Imbalances and EU-wide priorities.** These plans would be drawn up by national governments, upon a transparent process of consultation with regions, social partners and civil society, at the beginning of each national legislative term, in cooperation with the European Commission, and validated by the Council. Thus, changes in political majorities would open a new cycle of reform for the duration of the mandate, bolstering ownership and democratic legitimacy of National Investment and Reform Plans. This bottom-up approach, in line with that chosen for the RRF reform programmes, will improve buy-in from Member States, leading to better implementation.

Governments will be required to submit multi-annual **'National Investment and Reform Plans'** (NIRPs) inspired by the National Recovery and Resilience Plans introduced with the pandemic recovery fund. The plans, addressing the identified needs via the application of green budgeting tools, would point to investments expenditure that would subsequently qualify for a preferential budgetary treatment (see below). Such treatment as well as additional EU funding under a follow-up instrument to the RRF (see below) should be made conditional on compliance with the **new set of fiscal rules, anchored in country specific debt adjustment paths, CSRs and MIP recommendations**.

9. www.economist.com/finance-and-economics/2017/02/23/why-national-budgets-need-to-take-gender-into-account

A new set of CSRs **would not focus on means but rather outcomes** and assess performance based on the **distance from predefined targets** preventing reforms being prescriptive on precise policy measures**.**

Beyond fiscal issues, CSRs should establish measurable and **binding targets on environmental objectives - such as the elimination of fossil fuel subsidies** - as well as **social objectives, aiming at the reduction of inequalities and social-economic exclusion in line with the Pillar of Social Rights and Sustainable Development Goals.**

• Macroeconomic Imbalance Procedure

In order to ensure that all the components of EU economic governance are given appropriate weight, **the supervision of macroeconomic imbalances should be decisively strengthened**[10]. CSRs should integrate binding MIP recommendations with a clear effect on imbalances[11]. Further to that, the **MIP framework should be profoundly revised eliminating** by order of priority **existing asymmetries,** eg. a -4% of GDP floor for current account deficits but a +6% ceiling for surpluses, or the fact that there is only an upper limit on nominal unit labour cost increases[12]. Importantly, the MIP would focus **more on the euro area as a whole rather than following a country-by-country approach.**

While imbalances deriving from the financial sector should be more thoroughly examined by integrating better the MIP and the macro-prudential process, the extension of the MIP scope seems warranted. **Additional indicators** should be introduced on **households' disposable income, poverty, capital unit costs, as well as measuring progress towards investment in environmental sustainability and innovation,** with respective **alert thresholds signalling the build-up of imbalances. Inefficiencies in energy and resource usage** should be targeted in particular as they may significantly deteriorate competitiveness and the current account balance.

B. Country specific debt adjustment paths

A new less complex fiscal framework should be anchored in a **single operational rule focusing on the sustainability of public debt** viewed **from a long-term perspective**, decisively integrating sustainability fiscal risks deriving from climate change and the crossing of planetary boundaries.

This should translate into debt adjustment paths that are **country specific** and **require, where appropriate, increases of targeted green debt financed expenditure.**

• Country-specific pathways

The Protocol to the Treaties spells out a target of 60% debt/GDP to which gross public debt should converge. While the change of such a target requires unanimity in the Council, the time-frame for adjustment that sets the speed at which government debt should converge towards the Treaty-based 60% of GDP target is set in secondary legislation (6-pack).

10. The MIP serves as an early warning mechanism for macroeconomic risks like high private debt, potentially damaging asset price dynamics and balance of payments imbalances..The MIP is widely viewed as lacking effectiveness. MIP CSRs have also seen low implementation rates and have been criticised for remaining for an asymmetric approach on account deficits VS surpluses as well as being a country-by-country exercise rather than a holistic assessment of EU-wide imbalances. Correcting imbalances is not within the straightforward control of policymakers, but the MIP has also seen low engagement even among policy experts
11. ECA report 2018
12. As pointed out in "*How has the MIP worked in practice to improve the resilience of the euro area?*" this feature could lead to a "race-to-the bottom" in the euro area, each country trying to reduce its ULCs (or limit their increase), which would keep inflation at a low level without any gain in terms of price competitiveness.

Therefore, to avoid a "one size fits all" solution and unrealistic adjustment efforts such as those posed by the current debt reduction rule, **different speeds of adjustment for each member state should be defined**. Such an approach will effectively render the **60% debt/GDP a long-term term target** without formally changing the reference value.

The country specific debt adjustment paths should be based on key **economic variables** such as **interest rate/growth differentials, initial debt level, composition of public debt stock** (eg. considering the probability of default by looking at the share held by the ECB/ESM vs the share held by private domestic/foreign investors). In order to account for the broader context of country specific needs and the quality of spending, the modulation of the adjustment paths should also take into consideration other dimensions such as the costs related to the projected **increase in health and pension expenditure** due to an ageing population.

• Possibility to require increases of targeted green debt financed expenditure

The study commissioned by the group[13] reaches important conclusions on the impact of climate change on debt sustainability. By applying the analytical model[14] to a highly indebted EU member state, like Italy, the study investigates the trade-off between increasing the deficit today with the aim of a fast reduction in climate damage and a strategy which tends to be more conservative on fiscal balance today but delays adaptation to climate change.

Even on the conservative assumption that the impact of climate change on GDP as well as on public expenditures is limited, the impact in terms of deficit and debt-to-GDP ratio is larger because of loss of revenues (e.g., reduction in value added and corporate income taxes). According to the applied model, **frontloading adaptation/climate investments under a fast climate adaptation scenario is able to offset most of the negative effects, while a slow climate adaptation strategy is less effective. The considerable increase in the public deficit under the fast adaptation scenario, for the first years (2021-2024), does not prevent debt sustainability; rather, it avoids increasing debt dynamics close to the end of the simulation period (2050).**

The results consider the possibility that a country less indebted may find different trade-offs and that the impact of climate change is expected to be very different among European countries and has to be tested based on available data. However, the study does support that tight fiscal rules for highly indebted economies **may prevent these countries from taking the necessary actions to improve debt stability in the coming decades,** with the paradoxical result of undermining the debt sustainability the rules are intended to achieve. Conversely, **decisively increasing targeted green public expenditure is a factor for rendering public debt sustainable in the long-term.**

Therefore, a **new Debt Sustainability Analysis (DSA)**, laid down in EU legislation with common minimum standards, should adopt a long-term horizon and consider sustainability fiscal risks deriving from climate change. Consequently, country specific debt adjustment paths **should not merely translate into downward adjustment of debt/GDP ratio but may also require increases of targeted green expenditure,** identified in the process of the European Semester (see above), to offset sustainability fiscal risks and render the debt sustainable in the long term.

13. Climate Risks and Debt Sustainability, May 2022, University of Pisa
14. Eurogreen model

• Debt adjustment paths as the main operational rule

The overall goal is to make such debt adjustment paths the main operational rule, replacing the current focus on annual deficits. The 3% of GDP deficit limit, enshrined in the EU treaties (Article 126 TFEU, as well as its Protocol No. 12) can be construed in such a way as to reduce the difference between the preventive and the corrective arm of the SGP to a nominal one. This would make a country's placement in one category or the other less relevant, with merely procedural differences such as enhanced monitoring. More concrete consequences for a violation of the fiscal rules would rather be triggered by deviating from the debt adjustment path, which thereby becomes the main operational rule.

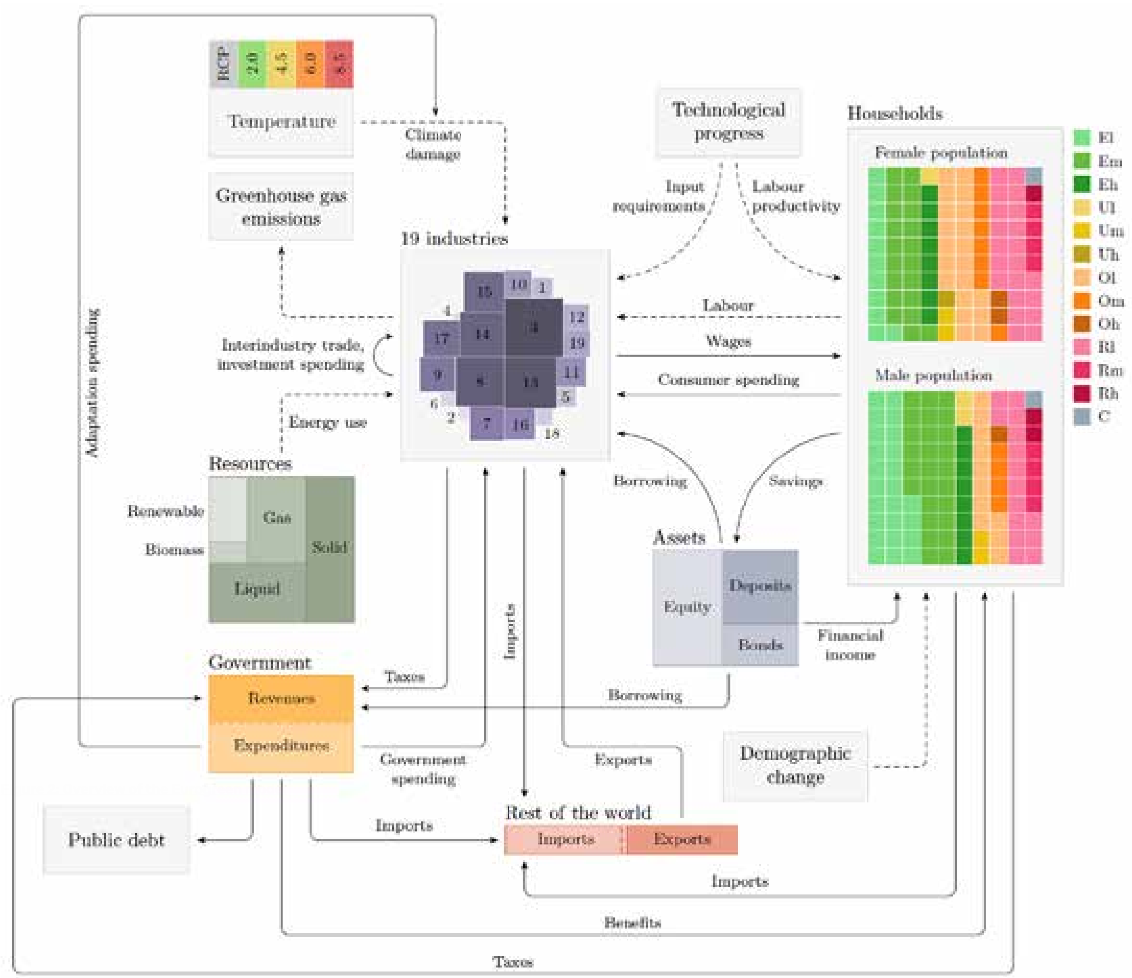
Figure 1: A baseline formulation of country specific debt adjustment paths without considering other parameters such as sustainability fiscal risks

		initial debt level		
	$1/n$	$60<d_{t-1}<100$	$100<d_{t-1}<150$	$d_{t-1}>150$
interest rate-growth differential	i-y<0	0.06	0.05	0.04
	0<i-y<1	0.05	0.03	0.03
	i-y>1	0.04	0.03	0.02

Note: The table shows possible speed of debt-reduction adjustment (i.e. 1/n) for different initial debt levels (i.e. dt-1) and interest-growth differentials (i.e. i-y).
Source: European Fiscal Board

Source: EFB annual report 2020.
1/n = speed of adjustment
d t-1= debt-to-GDP ratio in year t-1
i-y= the average interest rate that governments pay on their debt and the nominal growth rate of the economy

Figure 2: Overview of the Eurogreen model



The solid and dashed arrows represent monetary and nonmonetary flows, respectively. The Households, Industries, Resources, Assets, Government, and Rest of the world boxes summarily represent first-period simulation results. The dashed lines in the Government and Rest of the world boxes are drawn for reference and cut the area of the rectangles in half. Abbreviations in the Households box describe the following groups: E = employed; U = unemployed; O = out of labour force; R = retired; l = low-skilled; m = middle-skilled; h = high skilled; C = capitalists. List of industries: 1 = Agriculture, forestry and fishing; 2 = Mining and quarrying; 3 = Manufacturing; 4 = Coke and refined petroleum products; 5 = Electricity, gas and steam; 6 = Water supply; 7 = Construction; 8 = Wholesale and retail trade; 9 = Transportation and storage; 10 = Accommodation and food service activities; 11 = Information and communication;12 = Financial and insurance activities; 13 = Real estate activities; 14 = Professional, scientific, technical, administrative and support service activities; 15 = Public administration and defence; 16 = Education; 17 = Human health and social work activities; 18 = Arts, entertainment and recreation; 19 = Other

HOW TO PROTECT AND PROMOTE
SOCIAL EXPENDITURE IN A REVISED FRAMEWORK?

1. Amortise social investments and the national co-financing of cohesion funds *in deficit and debt calculations to address the* ***social investment gap and territorial cohesion.***

2. *Introduce a debt rule where* ***the adjustment path addresses country specific***
socio-economic needs, *e.g. health and pension spending.*

3. Reconfigure the notion of reforms *as part of a revised European Semester, leaving the choice of means to Member States and setting* ***binding targets in line with the Pillar of Social Rights and SDGs with a focus on tackling poverty and reducing inequalities.***

C. Green golden rule

The introduction of a "golden rule" on public investments is vividly discussed in academic and policy circles. The underlying rationale is that future-oriented investments contribute to the productive capacity of the economy and provide benefits to future generations. Therefore, their treatment in the debt and deficit calculations should be favourable given that they bear long-term advantages in contrast to other forms of deficit spending.

From a green perspective, shifting away from a productivist, carbon intensive growth model implies that not all investments, but primarily "**sustainable"** ones should benefit from a favourable treatment in the EU fiscal rules framework. **A Green Golden rule would, therefore, amortise green and social *investments* including the national co-financing of investments under the EU cohesion policy funds that do not deviate from the Paris Agreement's objectives. The definition of identification criteria,** the **investment needs for each Member state** and **the ex-post verification** that projects comply **with the predefined criteria** should take place **in the framework of a revised EU Semester** and be an **integral part of 'National Investment and Reform Plans' and their validation process** .

This position is consistent with what has been developed above on country-specific debt adjustment paths. These paths would require increases in green debt financed expenditure in order to ensure long-term debt sustainability**. However, such an approach is mutually exclusive to carving-out green investments from deficit and debt calculations**. Therefore**, a green golden rule** should be translated into **allowing the cost of net green public investment to be spread over the life cycle of the investment** instead of **fully accounting for it in the year in which the expenditure is incurred**. Identifying such investments could rely on the technical screening criteria under the six environmental objectives of the EU taxonomy[15] and be subject to a politically agreed exclusion list similar to the one adopted in the Just Transition Fund or InvestEU regulations.

Applying a similar treatment on **social expenditure** is confronted with a certain number of conceptual difficulties. What emerges from the study*, A comparative*

15. This entails the obligation to make a significant positive impact in at least one of the objectives and cause no significant harm as regards all the other objectives.

approach to possible treatments of green and social expenditures in a revised fiscal framework commissioned by the group is that *traditionally* only a minor part of social expenditure is devoted to what is understood as "public investment", while the largest part comprises current expenditure (eg. salaries, social transfers, medical expenses, pensions etc). However, granting social expenditure a preferential treatment in fiscal rules effectively means that governments are encouraged to engage in deficit spending in order to pursue social policies. **Borrowing from the financial markets to enable social welfare is not a redistributive stance, as this spending should primarily derive from tax revenues, meaning transfers, not loans, from the wealthy.**

However, the rationale for the scope of a Golden rule should not be framed by the **composition of past national budgets but in terms of future-oriented needs**. The report published in 2018 by the High-Level Task Force of the European Commission on *Investing in Social Infrastructure in Europe*,[16] which attempted for the first time to **quantify social investment needs**[17]**,** paying due attention to regional disparities, identified the **minimum gap in social infrastructure** investment at around **EUR 142 billion per year at EU level**, and around **EUR 1.5 trillion over the period 2018 to 2030**, that is all but a marginal figure.

Table 2: Minimum estimate of the gap in social investment infrastructure

Sector	Annual minimum gap per sector (EUR billion)	Additional items (EUR billion per year)	Annual investment gap (EUR billion)
Education & lifelong learning (0.43 % of GDP)	15	-	15
Health & long-term care (0.5 % of GDP)	20	50 (for long-term care)	70 (20+50)
Affordable housing (0.4 % of GDP)	7	50 (to address energy poverty)	57
Totals	**42**	**100**	**142**

Source: EC Discussion Paper 074 (2018)

Therefore, a Green Golden rule would aim to amortise tangible and intangible social investments **in areas of education and life-long learning, health and long-term care as well as social housing, without covering current spending**[18] **(see table below for a precise definition).** The precise criteria for identifying such social public investments are to be defined in the framework of a revised EU Semester. Further to this, and in light of the difficulties of Member states to meet the co-financing requirements in order to carry out projects in the framework of Cohesion Policy, **the national co-financing of the investments funded by the ERDF**[19]**, JTF**[20]**, ESF+**[21]**, INTERREG, that does not deviate from the Paris Agreement's objectives,** shall also be amortised in the debt and deficit calculations (overall estimated amount around 110 bn EUR for 2021-2027).

16. Discussion paper 074 | 01/2018 Boosting Investment in Social Infrastructure in Europe, Report of the High-Level Task Force on Investing in Social Infrastructure in Europe, Lieve Fransen, Gino del Bufalo and Edoardo Reviglio
17. On what qualifies/ excluded as social infrastructure see pages 28-29 of the report
https://ec.europa.eu/info/sites/default/files/economy-finance/dp074_en.pdf
18. This would be also counter-intuitive as amortisation cannot by definition apply on current expenditure.
19. European Regional Development Fund
20. Just Transition Fund
21. European Social Fund

Table 3: Possible coverage of Social investments

Sector	Tangible	Direct Intangible	Excluded
Education Life-long learning	Kindergartens Childcare Schools Vocational colleges Universities Laboratories ICT equipment & Related cloud infrastructure Student accommodation Adjacent supporting infrastructure	Facility maintenance Energy efficiency Student lending R&D programmes Education software development	Salaries Utilities Materials
Health Long-term care Social Care	Hospitals Clinics Inc. community Diagnostic facilities Imaging facilities Medical equipment ICT equipment Private & Public research labs Long-term care facilities Short-term care facilities Nursing accommodation Adjacent supporting infrastructure	Facility maintenance Energy efficiency/ low carbon programmes Health programmes Public sector R&D and Cloud Infrastructure Private sector R&D (pharma, medical equipment) Health software development Education & training programmes	Salaries Utilities Materials
Affordable housing	Residential buildings in keeping with Housing Continuum Semi-residential buildings Adjacent supporting infrastructure Premises dedicated to community/ local services	Energy efficiency/ low carbon programmes Programmes for housing refurbishment/ renovation Provision of care & support services for social housing residents	Salaries Utilities

Source: EC Discussion Paper 074 (2018)

Table 4: Expenditure on housing and community amenities by function in selected Member States (average 2014-2018)

	Value (EUR million)				Share of capital and current expenditure (%)			
	Capital expenditure	Current expenditure	Of which: Intermediate consumption	Of which: Compensation of employees	Capital expenditure	Current expenditure	Of which: Intermediate consumption	Of which: Compensation of employees
BE	296.0	968.4	423.3	334.0	23%	77%	44%	34%
DK	202.9	685.0	56.6	47.7	23%	77%	8%	7%
DE	1 928.0	8 597.6	3 184.6	4 456.0	18%	82%	37%	52%
ES	1 115.2	3 596.8	2 160.4	1 140.2	24%	76%	60%	32%
FR	5 195.2	13 725.8	4 806.2	6 378.6	27%	73%	35%	46%
IT	1 942.6	4 241.2	2 841.0	1 207.6	31%	69%	67%	28%
NL	874.0	2 673.6	1 273.4	1 389.8	25%	75%	48%	52%
PL	486.8	3 398.3	1 874.5	471.4	13%	87%	55%	14%
PT	191.3	1 152.6	325.2	234.5	14%	86%	28%	20%
FI	110.0	511.6	237.0	385.8	18%	82%	46%	75%
SE	1 194.7	1 350.3	795.9	557.5	47%	53%	59%	41%

Source: CEPS 2022, A comparative approach to possible treatments of green and social expenditures in a revised fiscal framework

Table 5: Expenditure on healthcare by function in selected Member States (average 2014-2018)

	Value (EUR million)		Share of capital and current expenditure (%)							
	Capital expenditure	Current expenditure	Capital expenditure	Current expenditure	Of which: Curative care and rehabilitative care	Of which: Long term care	Of which: Ancillary services	Of which: Medical goods	Of which: Preventive care	Of which: Governance and health system
BE	4 232.8	46 008.2	8%	92%	54%	23%	4%	14%	2%	3%
DK	1 724.7	28 744.5	6%	94%	56%	25%	5%	10%	2%	2%
DE	33 925.2	353 387.8	9%	91%	50%	17%	5%	20%	3%	5%
ES	8 672.3	100 840.1	8%	92%	58%	9%	5%	23%	2%	3%
FR	13 064.5	256 166.4	5%	95%	53%	15%	5%	18%	2%	6%
IT	6 094.9	148 655.0	4%	96%	55%	11%	8%	20%	4%	2%
NL	6 465.8	73 475.4	8%	92%	51%	27%	2%	12%	3%	4%
PL	:	28 576.6	:	:	62%	6%	4%	23%	3%	2%
PT	1 319.7	17 595.7	7%	93%	64%	5%	8%	20%	2%	2%
FI	1 089.6	20 557.8	5%	95%	59%	18%	3%	14%	4%	1%
SE	2 561.5	50 225.0	5%	95%	51%	27%	4%	13%	3%	2%

Source: CEPS 2022, A comparative approach to possible treatments of green and social expenditures in a revised fiscal framework

Table 6: Expenditure on education by category in selected Member States

	Value (EUR million)				Share of capital and current expenditure (%)			
	Capital expenditure	Current expenditure	Of which: Personnel pay	Of which: Other current expenditure	Capital expenditure	Current expenditure	Of which: Personnel pay	Of which: Other current expenditure
BE	1 136.5	26 412.7	22 677.8	3 735.0	4%	96%	86%	14%
DK	1 251.6	16 391.6	13 169.9	3 221.8	7%	93%	80%	20%
DE	11 178.5	140 131.4	109 298.1	30 833.2	7%	93%	78%	22%
ES	2 783.7	51 311.6	40 339.6	10 972.0	5%	95%	79%	21%
FR	10 335.1	123 411.5	99 380.8	24 030.7	8%	92%	81%	19%
IT	2 796.3	71 680.0	53 215.2	18 464.8	4%	96%	74%	26%
NL	4 163.0	35 644.0	27 714.5	7 929.5	10%	90%	78%	22%
PL	1 972.1	21 690.6	16 100.0	5 590.6	8%	92%	74%	26%
PT	506.7	9 364.6	7 550.7	1 813.8	5%	95%	81%	19%
FI	1 078.6	12 646.1	7 871.1	4 775.1	8%	92%	62%	38%
SE	1 457.7	29 209.2	19 944.5	9 264.7	5%	95%	68%	32%

Source: CEPS 2022, A comparative approach to possible treatments of green and social expenditures in a revised fiscal framework.

D. Governance

A profound fiscal governance reform forces us to rethink its institutional framework. An emerging challenge is how to reconcile an EU fiscal framework with strengthening national policy dialogue and national ownership.

The role of national independent fiscal institutions (IFIs) deserves further consideration in this respect. As a first step, IFIs independence, accountability and expertise whose scope should be expanded needs to be strengthened through upgraded minimum standards on: (i) the selection of board members (proposed by the parliament, social partners and civil society) (ii) functional autonomy (adequate and stable own resources and flexibility to manage those) (iii) independence (such as strict rules for conflict of interest) (iv) access to information (v) operational modalities (minority and divergent opinions should be allowed to be reported in official reports as they would be instructive for the political debate)[22]. Such minimum standards would be laid down in EU legislation and periodically monitored at EU level.

IFIs would apply green budgeting tools, conduct forecast costing of fiscal policy measures, undertake macroeconomic scenarios and DSAs, as well as assess fiscal risks. Such national independent fiscal institutions could be organised as a network centred around an independent European Fiscal Council that would concentrate specific competences concerning the overall Euro area fiscal stance, notably developing and improving over time the common methodology on sustainability risks, making macroeconomic projections on the Euro area and EU as a whole and issuing regular

22. Reforming the EU Fiscal Framework Strengthening the Fiscal Rules and Institutions, IMF 2022.
Breaking the stalemate, Finance Watch 2022

reports assessing the operation of the fiscal framework. The European Commission would still endorse the debt sustainability analysis, monitor the green budgeting processes based on EU legislation laying down common standards as well as submit a proposal to the Council for endorsing National Investment and Reform plans.

Overall, fiscal policy usually relies on a mix of ex ante fiscal rules and a governance process that ensures checks & balances. An intelligent application of the rules, with sufficient flexibility to account for changing circumstances, therefore needs to be balanced with increased democratic control. When it comes to highly consequential decisions - for example the rejection of a country's National Investment and Reform Plan, or a requirement to adapt the national budget under the reformed fiscal rules - an additional layer of legitimacy may be required at the level at which the decision is taken. In such cases, the reformed rules should grant the European Parliament the right to hold a hearing and a vote requiring a high voting threshold. To that end, any progress reports will also have to be made available to the members of parliament simultaneously to the Council, so as to allow for parliamentary scrutiny including via dedicated hearings. This will ensure that the Commission has to convincingly justify, and make transparent, its methodology and choices in assessing fiscal policies, debt sustainability, and National Investment and Reform Plans, thereby deterring abuse of the Commission's discretion and ensuring democratic accountability.

The current setup only requires a vote in Council. Here, ministers are accountable to 27 separate national parliaments, a setup that leads to a focus on national interests rather than a holistic view. The Council's fragmented accountability has not to date led to the application of sound economic judgement and fallen far short in terms of democratic legitimacy of the ensuing decisions. The additional parliamentary scrutiny meanwhile would make Parliament the central venue of public debate on the implementation of macroeconomic governance, convening the various stakeholders. This increases the profile of Parliament and holds the promise of strengthening the salience of EU legislative elections.

OVERVIEW OF A GREEN POSITION ON EU FISCAL RULES REVISION
New European Semester • Green & gender budgeting • Multiannual investment and reform plans addressing CSRs • Binding MIP based on revised Scoreboard
Country-specific debt adjustment paths • Treaty based 60% debt/GDP long term target • Speed of adjustment defined by: economic variables (eg. interest rate/ growth differentials, composition of debt stock) & country specific socio-economic needs • Potential to increase, not only decreases debt financed expenditure to address sustainability fiscal risks, notably deriving from climate change
Green golden rule in debt & deficit calculations • Amortise green & social investments & national co-financing of cohesion funds compliant with Paris agreement (trade-off with increasing debt financed green expenditure under new debt rule)

Broader EU fiscal architecture

The Union lacks permanent solidarity mechanisms such as fiscal transfers and counter-cyclical investment. Critical steps such as NGEU, the unconventional policies implemented by the ECB, the establishment of the ESM and the building up of an incomplete banking union have so far kept the EU afloat during recurrent crises. However, the Union needs 'fit for purpose' risk sharing mechanism (both public and private) which would on the one hand avoid unnecessary costs for society while facilitating a genuine recovery in the aftermath of multiple crises, and on the other hand allow it to cope with future crises, notably the climate emergency.

Interlinkages of fiscal and monetary policy

After a decade of record-low interest rates, accompanied by unconventional accommodative monetary policy, gas delivery shortfalls, the war in Ukraine and the subsequent energy price shock stemming from imported fossil fuels, mostly gas and oil, has brought a historic jump in inflation rates and led to aggressive interest rate hikes by the European Central Bank. Fiscal and structural measures would be more apt to deal with such a temporary price shock, including but not limited to: investments in energy efficiency and renewable energies, resilience of supply chains to bottlenecks, competition policy to address market power abuses that made profits one of the drivers of inflation, taxation of windfall profits (not limited to energy companies), and targeted compensation to citizens in need, as the blanket energy subsidies implemented by Member States increase consumption of fossil fuels, are more costly than targeted measures, and add to inflationary pressure.

While interest rate hikes are unable to deal with the supply shock represented by the energy price rises, they impact inflation in the medium term, when the energy price shock abates automatically through base effects and alternative supplies. In the short term, the increased rates tighten credit conditions across the euro area, increase the likelihood and depths of a recession, and worsen refinancing conditions for euro area sovereign bonds. This danger became clear in the form of rising spreads (interest rate differentials paid by Member States in comparison to the benchmark interest rate paid by Germany) and market volatility that followed the decision of the ECB in June 2022 to end net asset purchases ("quantitative easing"), necessitating the announcement of a new ECB programme, the Transmission Protection Instrument (TPI) to calm markets.

The TPI allows the ECB to buy up government bonds should their spread increase to a level where the financing conditions in that country no longer conform to the uniform monetary policy stance set by the ECB. In other words, to conserve the singleness of its monetary policy rate, the ECB can undertake market operations to an unlimited volume, buying up sovereign bonds while departing from the previously used capital key (i.e. no need to purchase bonds from all euro area Member States, as was already done with the pandemic emergency purchase programme PEPP). The programme is crucial to address an obvious danger that comes with rising interest rates, namely that highly-indebted countries will face increasing refinancing costs, which will at best impair their ability to invest in the green transition, and may at worst imperil the stability of the currency union. In the name of effective transmission of its monetary policy, it is not clear that the ECB should accept even small spreads: a risk of sovereign default calls into question the euro's sustainability and risk premia should therefore not be necessary.

The ECB Governing Council has full discretion on when and whether to trigger TPI, departing from previous programmes that made intervention contingent on a politically improbable ESM programme. At the same time, the ECB will take into account whether a Member State in need is in compliance with the fiscal rule framework, adding an additional incentive to reform the rules and render them less counterproductive.

The ECB does have a crucial role to play in accelerating the green transition, and has declared the greening of monetary policy a part of its primary objective, meaning it is necessary for the achievement of price stability. At the same time as increasing speed and ambition on the ECB's greening agenda, it should introduce a dual interest rate, charging lower for money going towards green investments that stand to reduce inflation by rendering us independent of fossil fuel imports. This would be a much more targeted way of addressing the energy price shock than the blunt interest rate change. In line with this approach, Green TLTROs (targeted long-term refinancing operations) or dual interest rates should become part of the standard monetary policy toolkit. Its action on standards in banking supervision, climate stress tests, and the greening of its collateral framework all remain crucial to further accelerate the accounting for climate risks in financial markets.

RRF 2.0: The EU Energy Transition Facility

While the debate continues over the necessary ingredients for a stable Economic and Monetary Union, the introduction of a **permanent fiscal capacity** has become a standing demand by progressive political forces. However, the concept is rather elusive in public debate. A fiscal capacity **is not** meant **as an enlarged EU budget.** It is effectively a mechanism that enables **deficit spending at EU level**. Member states receive **grants and loans financed through joint EU borrowing - that constitutes a form of safe assets/eurobonds** - allowing their economies to be stabilised in response to adverse macroeconomic shocks (macroeconomic stabilisation) while pursuing the delivery of common public goods.

However, **the Treaty puts narrow constraints on the possibility of establishing such a mechanism on a permanent basis within the remit of the EU budget.** The RRF was established by invoking exceptional circumstances under Article 122 TFEU[23], triggered by the Covid-19 crisis, and remains an "**off-budget" instrument, based on externally assigned revenue.** This is because issuing loans and especially grants backed by EU borrowing would contradict the Treaty based requirement that the annual EU budget needs to remain neutral while at the same time ensuring that the total revenue in the budget must cover the total expenditure (principle of universality).

Given these legal constraints, a fiscal capacity cannot currently be designed on a permanent basis. However, the spike in energy prices and the ongoing climate and environmental emergency represent exceptional circumstances similar to those leading to the establishment of NGEU and **a follow up instrument to the RRF** in the form of **EU Energy Transition Facility** should be envisaged on the same legal basis.[24] Such an instrument would address the high energy prices and the climate emergency by funding investments and reforms in energy efficiency, renovation, and

23. The financial foundation for the RRF, the European Union Recovery Instrument, is itself based on Article 122 of the TFEU

> 1. Without prejudice to any other procedures provided for in the Treaties, the Council, on a proposal from the Commission, may decide, in a spirit of solidarity between Member States, upon the measures appropriate to the economic situation, in particular if severe difficulties arise in the supply of certain products, notably in the area of energy.
>
> 2. Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken.

24. To be noted that The European Parliament has already formally declared a "climate emergency" in 2019. www.europarl.europa.eu/news/en/press-room/20191121IPR67110/the-european-parliament-declares-climate-emergency

renewables. It would be **based on grants financed by common EU borrowing with a size amounting to half of the identified public investment needs for the green transition** (eg. 1% of EU GDP).[25] Such an instrument at EU level would complement the introduction of a Golden rule on green public investment as it would ensure investments independently of Member states' individual borrowing costs and political predisposition towards addressing the green transition.

Establishing an instrument outside the remit of the EU budget forces us to pay due attention to its governance. Comprehensive consultation of local administrations, social partners and civil society, as well as targets on the territorial impacts of envisaged spending, should become binding requirements. Moreover, the additional investment funded through EU level debt issuance comes on top of national investment as defined in the National Investment and Reform Plans (NIRPs, see above) and should tie in with the investment priorities defined therein. Access to RRF 2.0 grants should be contingent on the implementation of the NIRP, providing new incentives to coordinate national economic policies at EU level. Additionally, this mechanism, and the provision of investments funded at EU level, will help ensure the delivery of the green transition.

To ensure that the RRF 2.0 delivers on its goals, additional governance safeguards will be needed, building on lessons learned from the current recovery fund. Indeed, the Commission and Council have not proved sufficiently steadfast in resisting pressure to agree national plans with countries under active Article 7 procedures due to shortcomings on the rule of law and democratic standards. The European Parliament should therefore have a vote on investment plans, in line with the procedure on adoption of NIRPs, as developed above.

In the long term, the EU Energy Transition Facility would require the creation of greater own resources to ensure debt service and enhance resilience of the EU budget. This is already the case with NGEU repayments, which are linked to the creation of the new own resources as stipulated in the own resources road map.[26] The options for achieving additional own resources that could be introduced in order to facilitate an RRF follow-up instrument are not covered in this paper bearing in mind the new own resource proposals expected for 2023 and the ongoing work to implement the proposals already on the table. However, sufficient own resources are fundamentally a matter of political will and we maintain that they could be based on EU environmental taxes such as kerosene tax and additional corporate related taxation revenue carrying the additional benefit of being a cyclical source of revenue.

Replacing the ESM with an EU debt agency

The ESM as it stands has lost its purpose, as it is too toxic for Member States to consider its loans, even when they are offered without any conditionality and at below-market rates. Nevertheless, Member States endowed the ESM with € 80 bn in paid-in capital, that should be put to better use as seed capital for the EU's many financial market borrowing activities. A starting point of its reform is to bring the ESM into the EU Treaties via secondary legislation as proposed by the Commission in 2018 and to transform it into the EU's debt agency, overhauling its governance and accountability under the Commissioner for economic affairs. This will enable decision-making by qualified majority and oversight by the European Parliament, rather than the unanimity requirement of the current intergovernmental model which in the past has led to harsh adjustment programmes and a manifest lack of democratic legitimacy. While negotiations and enforcement through the informal agents of the Eurogroup, the so-

25. A green fiscal pact: climate investment in times of budget consolidation, Bruegel 2021

26. It is to be noted that the first basket of the new own resources introducing the proposal for new own resources will not be sufficient in mobilising enough resources for the NGEU repayments and financing the Climate Social Fund. The revenue gap should be matched by an ambitious second basket of own resources to be published in 2023 which should include proposals for new own resources based on the Financial Transaction Tax, Common Corporate Tax Base/ BEFIT) and/or by a financial contribution linked to the corporate sector.

called Troika, should be abrogated, modified voting as well as an enhanced role for the Parliament (e.g. adoption of programmes by means of Delegated Acts) will change negotiating dynamics and thereby prevent a repetition of past mistakes.

The new EU debt agency will still offer precautionary and emergency loans to Member States, take over lending activities from Next Generation EU and the proposed EU Energy Transition Facility, double up as increased backstop for the Single Resolution Fund (SRF) as well as manage lending for the short-term work scheme SURE, which should be developed into a permanent unemployment reinsurance scheme to better distribute macroeconomic shocks via automatic stabilisers.

Completing the Banking Union

The creation of the **Banking Union in 2012 is the main risk-sharing pillar of EMU put in place to provide for effective private stabilisation via the banking sector**. It aimed to improve banking supervision via the establishment of supranational bodies (three EU agencies, the Single Supervisory Mechanism and the Single Resolution Board/Fund) to ensure the consistent and uniform application of the enhanced rulebook.

One of its most significant components is the **'bail-in' requirement**. In other words, the obligation to write-down banks' shares and debt in case of trouble, making the bank's owners and if needed creditors absorb losses before any potential involvement of taxpayers as a last resort. Introducing minimum requirements on liabilities and capital instruments that can be "bailed-in'' ensures that the banking system has, to the extent possible, sufficient loss-absorbing capacity to cushion even severe economic shocks without bail-outs from the public sector. Conversely, banks' creditworthiness would no longer be at the mercy of the public finances of their host country (and vice versa) resulting in the self-reinforcing doom loop between banks and sovereigns being broken or at least mitigated.

However, beyond the notable exceptions and loopholes in the 'bail-in' requirement, the Banking Union is incomplete as a vital element of its agreed roadmap is still missing: an **EU-wide mechanism for insuring guaranteed deposits (EDIS)**. Additionally, the Single Resolution Fund (SRF) remains potentially underfunded notably in a scenario where it would have to support the resolution of multiple large banks. In order to address such a situation euro area leaders agreed to create a **common backstop** by the European Stability Mechanism (ESM), providing loans as 'a last resort' support **to the SRF.** However, even though in principle agreed, the operational modalities of the ESM backstop as well as its overall size raise doubts over its effective implementation.

Overall, the aim of such instruments **is not to bail out banks by the backdoor, as required resources are intended to be refunded via risk-based contributions from the banking sector**. The objective is to provide common insurance with 'deeper pockets', guaranteeing that one euro deposited in one EU country is worth the same as one euro deposited in any other Member State, and delivering confidence that future troubles in the banking sector can be addressed without socialising the cost. Such insurance mechanisms would additionally deliver stabilising effects by anchoring expectations. Effectively, they constitute **private risk sharing mechanisms which, when working properly, can absorb a significant part of economic shocks, reducing the burden on the public.** Therefore, **completing the Banking Union through the creation of a European Deposit Insurance** and **the operationalisation of the backstop to the Single Resolution Fund** constitute integral parts of the reform of the EU macroeconomic governance framework.

Putting EU macroeconomic governance on a sustainable footing: The case for Treaty change

Since the Eurozone crisis until this day, EU economic policy has been based on **"governance by exception"** relying on ad hoc instruments and mechanisms. However, a Union that is frequently seen to operate at the boundaries of its powers risks eroding its legitimacy, and has to constantly contend with litigation risks. To rebuild trust among the European citizens and in the European project, a profound transformation of the EU macroeconomic framework and its institutional set-up is needed through Treaty change, enabling new tools and ensuring appropriate democratic legitimacy.

Once Treaty change is envisioned, the following aspects warrant further consideration:

The Fiscal Compact and the **numerical debt and deficit targets** introduced with the 1992 Maastricht Treaty (3% and 60%) **should be abrogated**. This would lead to the abandonment of fiscal rules in favour of fiscal standards, that is, qualitative prescriptions that leave room for judgement[27]

Abandoning the principle of budgetary neutrality would allow the creation of a **permanent European fiscal capacity** with allocation (efficient use of resources), distribution (equitable distribution of income) and stabilisation (high employment and price stability) functions, thus addressing all budgetary objectives and their interactions.[28]

As mentioned above, given the limitations of the EU architecture, there are no permanent adjustment mechanisms to address common or country-specific shocks that are too large to be offset through the stabilising impact of monetary policy or the automatic stabilisers in national budgets. Therefore, an EU fiscal capacity is needed with the possibility to borrow on financial markets, thus also increasing the range of available EU safe assets.

It shall notably entail a stabilisation function that would allow Member states to face such shocks without resorting to internal devaluation with adverse social consequences. Such a framework would encompass an EU wide unemployment insurance scheme and provision of funds allowing for counter- cyclical budgetary support. As part of the allocation and distribution functions, it would provide for the earmarking of government investments for a more efficient provision of European public goods such as environmental, social but also defence and immigration policies, beyond what is currently funded by the EU budget providing common solutions to problems shared by European citizens.

Finally, an EU fiscal capacity needs to be **embedded within the democratic remit of the EU budget**, have a meaningful size and diverse funding channels. It can be financed by an increased envelope of own resources based on transfers from the Member States, but also notably **by commonly raised EU taxes that would be enabled following Treaty change**. These should include carbon and pollutant taxes, an ambitious financial transactions tax (FTT), and a 'single market levy' from the minimum corporate tax base.

In this context, **the European Parliament, as one arm of the EU budgetary authority, should be placed on the same footing as the Council and acquire the right to co-decide on the EU new own resources**. Additionally, the **ordinary legislative procedure should be extended to tax policy**, ensuring the space for sustainable tax revenue in MS without harmful tax competition and further strengthening steerage on the revenue side of macroeconomic coordination.

27. Redesigning EU fiscal rules: From rules to standards, Olivier Blanchard, Alvaro Leandro, Jeromin Zettelmeyer
28. See EFB report 2020

The aforementioned fiscal capacity, forces us to rethink what kind of stabilisation EU fiscal rules are still required to offer. A "**division of labour**" would be needed for the various instruments. For instance, **reviewed and greener fiscal rules** would address **moderate macroeconomic shocks (normal business cycle), an EU fiscal capacity would be in place for severe shocks and emergencies affecting the EU as a whole** while **a new debt agency** would be **a crisis management instrument operating as a lender of last resort.**

The ECB should formally be given a dual mandate, balancing price stability with full employment, and become a lender of last resort for sovereigns to ward off speculation. The broader mandate would however require a reconfiguration of its independence doctrine and democratic accountability, as we cannot rely indefinitely on the ECB's willingness to fill the vacuum left by the politicians.

Absent a completion of the institutional architecture of our monetary union, the ECB's TPI programme may be the main factor in averting a renewed euro sovereign debt crisis. Yet a monetary union that can only be stabilised through accommodative policies of its central bank is not sustainable. A technocratic institution should not be the ultimate arbiter of democratic governments, and the ECB has sometimes been reluctant to play this role, or held back by litigation risks. Likewise, while the ECB is rediscovering its secondary targets, overburdening the independent central bank will strain its democratic accountability. This does not imply a reduction of its independence. On the contrary: A new interinstitutional agreement between the ECB and the Parliament and potentially the Eurogroup could stipulate mechanisms by which the ECB's prioritisation of its secondary targets receive political backing, better insulating its greening agenda and crisis fighting tools.

The ECB's accountability should be further strengthened by giving Parliament a right of veto over candidates for the ECB Executive Board, so as to better involve Parliament in the drawing up of shortlists for such appointments. The Monetary Dialogue should become a Treaty-based requirement, and be complemented by *in camera* meetings.

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