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Carrot and Stick

EU's way to a Common Ground for more Fiscal Sovereignty

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2022 is a decisive year for the EU Economic Governance. After years of fiscal rule escape clause due to the COVID-19 pandemic, on October 19th, 2021, the European Commission relaunched its February 2020 consultation on the Economic Governance Review: what should be done? How can debts be reduced while at the same time stimulating economic growth? Could these evolutions trigger more fiscal sovereignty at the EU level, i.e. the capacity of the EU to conduct real fiscal policies?

Based on an analysis of the macroeconomic context surrounding the reform and of relevant proposals, the cep Paris suggests a number of desirable features to trigger growth and debt-to-GDP ratio reduction in the fiscal domain. Ideally, the European fiscal strategic autonomy should be strengthened through a "carrot-and-stick" approach.

- The need for an EU Economic Governance reform is justified by (i) complex and non-credible fiscal rules that did not allow for debt-to-GDP ratio reduction at the EU level despite national structural reforms, (ii) fiscal space divergences in the EU leading to (iii) an increased risk of sovereign debt default of highly indebted European countries, especially Italy and Greece – which would create new tensions in the euro area – and to (iv) a new risk of ECB's intervention on sovereign markets to control spreads – perpetuating fiscal dominance with an inflationary effect expected. Moreover, (v) levels of public investments are declining, especially in highly indebted countries, which all call into question the economic sovereignty of the EU.
- Regarding the reform, fiscal rules should remain, despite the impossibility to design a "perfect set of rules", to both ensure fairness between Member States and avoid too frequent dragging-on political negotiations, which would undermine long-term credibility of the new setup.
- To support debt sustainability and reduce the risk of fiscal dominance, fiscal rules should be simpler. First, only potential output growth should be used as a forward-looking element to compute national expenditure ceilings and these could be calculated on a multi-annual basis to provide more fiscal predictability, enforceability and credibility, which would send a signal of mid-term fiscal discipline to markets. Furthermore, the assessment of fiscal situations and escape clauses should be entrusted to a network of national independent fiscal authorities coordinated by a supervising agency at the European level.
- Nevertheless, whatever the changes, the SGP will remain a "stick" focused on debt-to-GDP ratio reduction, given the macroeconomic context and the Tinbergen rule.
- The energy of policymakers should rather focus on a "carrot": a fiscal instrument, preferably a central fiscal capacity, which would foster growth and positively incentivise Member States to conduct further structural reforms.
- Discussions will take place during the Summit for a New European Growth Model on March 10th and 11th. An official proposal of the Commission is expected in June 2022 for an implementation in 2024.

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1 Introduction: A Call for Reform of The EU Economic Governance

By the end of 2022, the euro area's general government gross debt-to-GDP ratio is expected to reach 97.9%[1] of GDP while the EU level will reach 90%[2]. Therefore, after rapidly increasing debt-to-GDP ratios in 2020 and 2021 with the COVID-19 crisis, European public finances have entered a new era, characterised by a high level of indebtedness compared to the targets of the Stability and Growth Pact (public debt less than or equal to 60% of GDP, public deficit less than or equal to 3% of GDP)[3]. The SGP, which was integrally suspended in 2020[4], is expected to be reinstated in 2024[5], with Member States having to comply to the set of fiscal rules.

Many voices are calling for a change of the SGP in the EU. Among them, the European Fiscal Board[6] is pleading in favour of a modification of the fiscal rules, which are considered too complex and poorly adapted to national contexts and specificities[7]. The IMF, the World Bank[8] and the European Central Bank[9] also consider that it is necessary to revise the SGP's framework once again, after revisions that already took place in 2005, 2011, 2012 and 2015[10].

In this context, on October 19th, 2021,[11] the European Commission relaunched its February 2020 consultation on the Economic Governance Review. The strategy announced by the Commission entails wanting to provide an adapted response to both the structural challenges already present before the crisis (rapidly ageing population, expected reduced labour supply and growth potential in the EU, lagging digital transformation, climate change, economic inequalities) and the consequences of the crisis (aggravated pre-existing vulnerabilities, increased macroeconomic and public finance divergences in the EU).

It assumes that the "firepower" of €2 trillion from the 2021-2027 Multi-annual Financial Framework and the Next Generation EU recovery program (including the Recovery and Resilience Facility – RRF) are an opportunity for the Member States to address these challenges. It recognizes that the RRF provision of grants and loans to Members States until 2026 is a way to support fiscal sustainability in a high-debt environment.

It also assesses that the fiscal-monetary policy mix implemented during the COVID-19 crisis (ECB's Pandemic Emergency Purchase Program, suspension of SGP fiscal rules, fiscal coordination between

[1] European Commission, European Economic Forecast, 11.2021, p. 35. The major economies in the euro area whose debt-to-GDP ratio will exceed 100% in 2022 according to the Commission are Belgium (113.1%), France (113.7%), Spain (118.2%), Portugal (123.9%), Italy (151.4%) and Greece (196.9%).

[2] Ibid.

[3] European Commission, Stability and Growth Pact.

[4] Les Échos, Le Pacte de stabilité européen emporté par le coronavirus, 20.03.2020.

[5] Reuters, Deal on New EU fiscal rules unlikely before end-2023, 04.02.2022.
Politico, Good news for France and Italy as Brussels looks to keep debt rules on ice in 2023, 09.02.2022.

[6] The European Fiscal Board was created following the publication of the 2015 Five Presidents' Report, with the aim of strengthening the current fiscal governance framework. It is tasked with assessing the implementation of the Union's fiscal framework and the appropriateness of the fiscal stance at the euro area and national levels, making suggestions on the future evolution of the EU fiscal framework, assessing the future fiscal stance, cooperating with independent national budgetary councils and providing ad hoc advice to the Commission President.

[7] Euractiv, European Budget Committee supports suspension of Stability and Growth Pact for 2022, 17.06.2021.

[8] Source for IMF and World Bank: Financial Times, EU urged to consider far-reaching fiscal reforms as debt soars, 26.02.2021.

[9] La Tribune, Après les dépenses des Etats, Christine Lagarde n'exclut pas une réforme du pacte de stabilité, 22.06.2021.

[10] Fipéco, the Maastricht Treaty and the Stability and Growth Pact.

[11] European Commission, COM(2021) 662: The EU economy after COVID-19, implications for economic governance, 19.10.2021.

Member States) helped Member States recover much faster than after the 2008-2009 Great Financial Crisis (GFC).

Therefore, the goal of revising the Economic Governance framework should focus on “reducing high and divergent public debt ratios in a sustainable, growth-friendly manner”.[12] Is the approach of the Commission well-suited? How should the revision operate, in order to simultaneously support debt reduction and economic growth in the EU? Is seeking more EU – or at least euro area - fiscal sovereignty the right approach?

To answer these questions, this cep**Input** first reviews the academic and macroeconomic context underlying reform proposals for clues about the potential direction of the reform (Section 2). Then, the economic debate is described, focussing first on the SGP reform and then the Central Fiscal Capacity reform (Section 3) before providing a general assessment of the direction of the reform and pointing out the desirable “carrot-and-stick” approach the Commission should adopt in its proposal (Section 4). In conclusion, the cep**Input** comes back on salient facts and details the schedule of next months and years related to the Economic Governance Review (Section 5).

2 Scientific, Macroeconomic and Political Contexts Underlying Reform Proposals

Many elements concur to justify the timing of the reform. First, there is an emerging consensus in the economic profession in favour of a reform of the EU Economic Governance Framework (Section 2.1). Moreover, the macroeconomic situation of the EU highly emphasises the need for a reform (Section 2.2) and the political will in the EU is strong to conduct reformist policies, at least in Germany, France and Italy (Section 2.3).

2.1 The Scientific Consensus for a Reform of the EU Economic Governance Framework

Economists strongly support a call reform, with 98% of those questioned in the June 2021 CfM-CEPR survey asserting that the existing EU Economic Governance framework requires revisions (see Figure 1).[13] To improve this framework, they envision solutions ranging from total renationalisation of fiscal discipline (18%, weighted by experts’ self-assessed confidence levels) to the expansion of EU level fiscal capacity for expanded mutual insurance (24%). The solution that convinces most of them is the one seeking more flexible, countercyclical, expenditure-based fiscal rules (30%),[14] while some economists also emphasise the need for fiscal councils and fiscal standards (26%).

Hence, even if the flexibility of the SGP has shown its adequacy in difficult macroeconomic periods – thanks to its general escape clause introduced in 2015,[15] it does not mean that SGP rules in normal

[12] Ibid., p. 10.

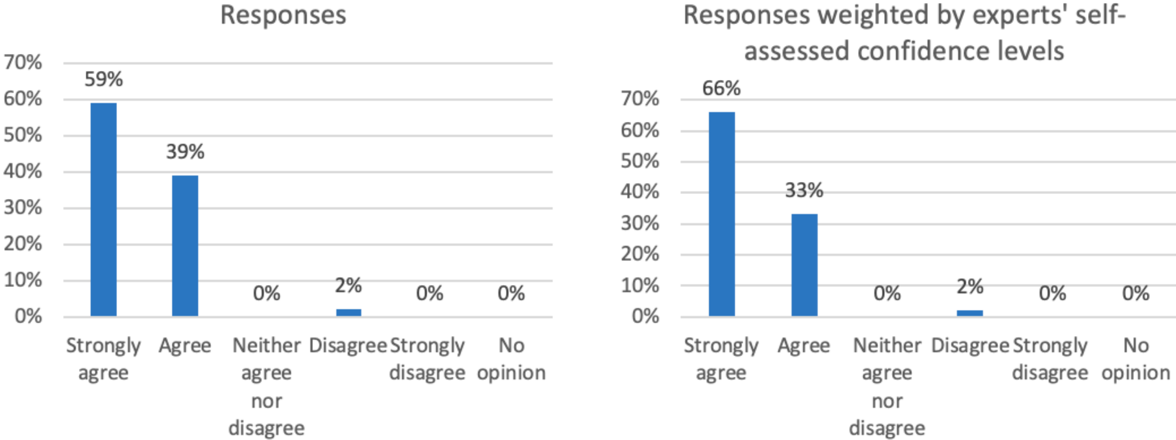
[13] Voxeu/CEPR, Fiscal rules in the European Monetary Union, 10.06.2021.

[14] Ibid.

[15] « In 2015, the Commission responded to claims of excessive rigidity of these rules in a low-growth, low-inflation environment with a communication spelling out in more detail the provision regarding the way cyclical positions, differences in debt levels and risks for sustainability are taken account of. It also specified how provisions are operationalised that increase fiscal flexibility in the case of growth enhancing structural reforms or public investments (European Commission 2015). Subsequently the Council published a commonly agreed position on the communication (Council, 2015), which was endorsed in 2016 and used as the basis for an update of the 'Code of Conduct' on the implementation of the SGP (Council, 2016). » European Parliament, When and how to Deactivate the SGP General Escape Clause?, 12.2020.

times are well-suited to fulfil the conditions needed for their effectiveness nor to address the challenges the EU is going to face. These conditions and challenges must be more closely identified.

Figure 1: Results of The Economists' Survey on The Need for A Reform of The EU Economic Governance Framework

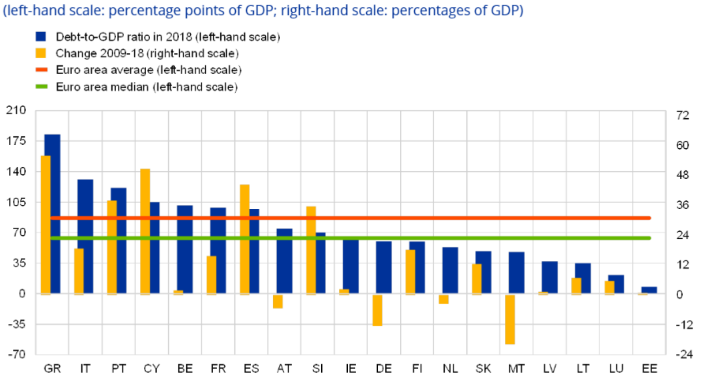


Source: Ethan Ilzetzki, London School of Economics.[16]

2.2 The Macroeconomic Situation underlying a Reform of the EU Economic Governance Framework

Regarding conditions for fiscal rules to be effective, it is important to highlight that the current ones did not lead to debt-to-GDP ratios in many euro area Member States after the GFC. In fact, between 2009 and 2018, only Malta (about -20 percentage points), Germany (-12 perc. points), Austria (-5 perc. points) and the Netherlands (-3 perc. points), succeeded in reducing their ratio, while many other countries were only able to stabilise it at best, resulting in an overall increase over the period (see Figure 2).[17]

Figure 2: Developments in Government Debts in The Euro Area Between 2009 And 2018



Source: ECB.[18]

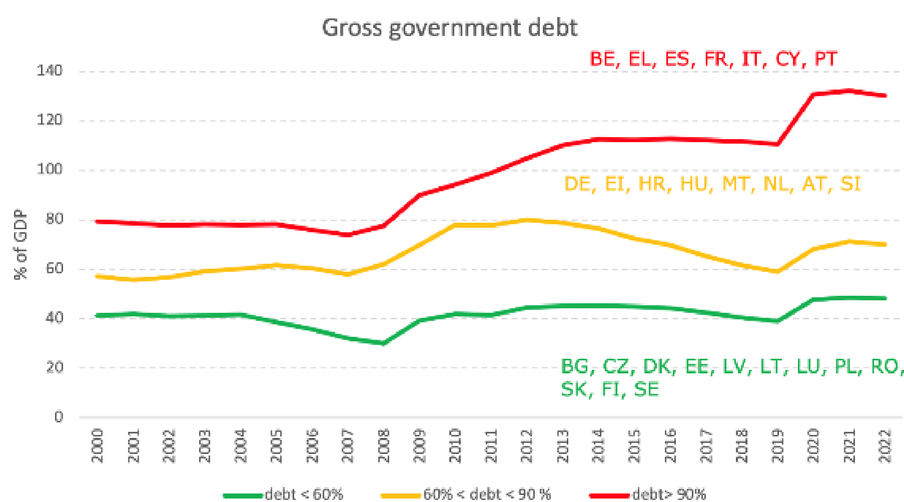
[16] Ibid.

[17] ECB, Fiscal rules in the euro area and lessons from other monetary unions, Chart 5, 2019.

[18] Ibid, Chart 5.

This divergence in debt-to-GDP ratio paths led to the appearance of three distinct groups of EU countries since 2009 (see Figure 3): the highly indebted countries (Belgium, Spain, Greece, France, Italy and Portugal) with debt-to-GDP ratios currently all exceeding 110% of national GDP,[19] the moderately indebted countries (Germany, Ireland, Hungary, Croatia, Malta, the Netherlands, Austria and Slovenia) with debt-to-GDP ratios ranging between 60% and 90% of national GDP, and the lowly indebted countries (the Eastern bloc and Scandinavian countries), with debt-to-GDP ratios below 60%.[20]

Figure 3: The Appearance Since 2009 of Three Distinct Groups of Countries in the EU, in Terms of Debt-To-GDP Ratios

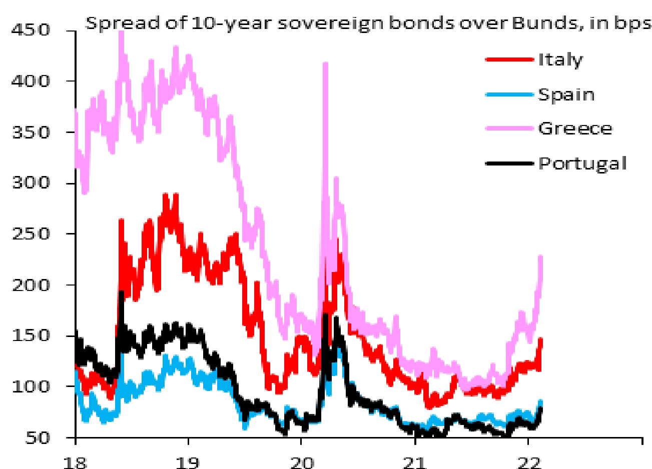


Source: Baarsma & Beetsma, 2022.[21]

This situation is prone to create new tensions in the Economic and Monetary Union, and especially in the euro area. Once the monetary policy of the ECB starts tightening by stopping its Pandemic Purchase Emergency Program in March 2022[22] and maybe even raising interest rates before the end of 2022, sovereign debt interest rates for the group of highly indebted countries (especially Italy and Greece) may rise sharply. This uptick is related to an increased private sector perception of a risk of insolvency after 2 years of ECB buyouts on secondary markets, even in the context of a low-interest environment.[23] In fact, interest rates have already started to increase for Italy and Greece after the ECB announced its new stance on February 3rd (see Figure 4).[24]

[19] See footnote 1.
[20] Voxeu/CEPR, Reducing public debt need not be a punishment, 18.01.2022.
[21] Voxeu/CEPR, Reducing public debt need not be a punishment, 18.01.2022.
[22] ECB, Monetary policy decisions, 03.02.2022.
[23] ECB, The future of the EU fiscal governance framework: a macroeconomic perspective, 12.10.2021, Chart 6.
[24] Financial Times, Christine Lagarde fuels investor bets on ECB interest rate rises with hawkish shift, 03.02.2022.

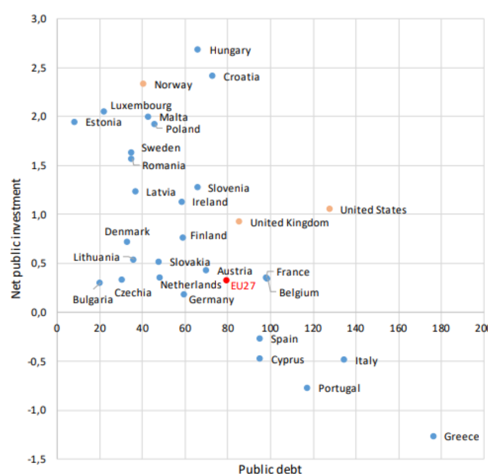
Figure 4: An End of Loose Monetary Policies May Trigger a New Surge of Sovereign Debt Interest Rates for Most Indebted Countries



Source: Robin Brooks, Institute for International Finance.[25]

Finally, the high level of debt may also infringe growth in the long-term as Member States tend to decrease their level of public investments (see Figure 5) when they need to adjust fiscally[26], i.e. to successfully reduce their primary balance (the difference between public revenues and expenditures)[27]. This tendency is detrimental to their growth potential and contributes to a slowdown of EU growth and to the EU's GDP relative decline compared to the US and China.[28]

Figure 5: Net Public Investment Declines as Public Debt Grows, Illustrating the Potentially Detrimental Choices Made by Politicians When They Need to Fiscally Adjust



Source: Bruegel.[29]

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[25] Robin Brooks, Europe needs a plan, 08.02.2022.

[26] Bruegel, New life for an old framework : redesigning the European Union's expenditure and golden fiscal rules, p. 28, 10.2020.

[27] To successfully reduce their primary balance, cuts in public expenditures are more appropriate than increases in taxes. Alesina, Ardagna (2013), the Design of Fiscal Adjustments, Tax Policy and the Economy : in Barclays, the future of the EU fiscal governance framework, p. 6, 12.11.2021.

[28] World Bank, GDP, in current USD, of the EU, the US and China between 2000 and 2020.

[29] Bruegel, New life for an old framework : redesigning the European Union's expenditure and golden fiscal rules, p. 28, 10.2020.

Hence, the need for an EU Economic Governance reform is justified by (i) complex and non-credible fiscal rules that did not allow for debt-to-GDP ratio reduction at the EU level - despite national structural reforms, (ii) fiscal space divergences in the EU leading to (iii) an increased risk of sovereign debt default of highly indebted European countries, especially Italy and Greece – which would create new tensions in the euro area – and to (iv) a new risk of ECB intervention on sovereign markets to control spreads – perpetuating fiscal dominance with inflationary effects expected. Besides (v) levels of public investments are declining, especially in highly indebted countries, which all call into question the economic sovereignty of the EU.

2.3 The Political Reformist Alignment in the EU

Furthermore, given the unprecedented political constellation in Europe, with governments promoting EU reforms at least in France, Italy and Germany,[30] 2022 may be a decisive year to achieve this reform, even if its implementation would probably have to be delayed to 2024.

Indeed, on December 9th, 2021,[31] when French president Emmanuel Macron introduced his program for the French presidency of the EU Council, he emphasised his will to set in motion a European reform in favour of a "new European growth model" representing a revision of the EU's economic governance. He initiated the Summit on the new European growth model in March 2022, in the context of the French presidency. He was joined by the Italian prime minister Mario Draghi – with whom he signed the Quirinal treaty[32] on November 26th to strengthen the ties between France and Italy – in line with his reformist efforts. Together they formulated a proposal of reforms of EU fiscal rules on December 23rd.[33] In parallel, the German government announced in its "Koalitionsvertrag" its commitment to reforming the EU,[34] and the country's Finance Minister, Christian Lindner, who is in charge of negotiating the new economic governance framework on behalf of Germany, confirmed that he had a "friendly" approach and wanted to be "part of the solution, and not part of the problem".[35]

In this context, a summary of the current economic debate is needed to see where this reform of the Economic Governance of the EU, starting with the SGP, is headed.

3 The Economic Debate Around the Reform of The EU's Economic Governance Framework

According to Tinbergen's rule,[36] one tool is not well-suited to simultaneously handle debt-to-GDP ratio reduction and growth enhancement, which both concur to public debt sustainability and improve the functioning of the EU Economic Governance. Hence, if the SGP is dedicated to debt-to-GDP ratio reduction (Section 3.1), the governance framework could be completed by a new instrument fostering growth in the EU, which could for instance be based on the current NGEU framework (Section 3.2).

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[30] For more details on this political alignment, please refer to our Adhoc on the « Club of the Willing » from December 2021.
[31] Élysée, Présentation de la Présidence française du Conseil de l'Union européenne, 09.12.2021.
[32] Élysée, Traité entre la République française et la République italienne pour une coopération bilatérale renforcée, 26.11.2021.
[33] Italian Government, Revising the European Fiscal Framework, 23.12.2021.
[34] Koalitionsvertrag, Mehr Fortschritt wagen, 24.11.2021, p. 131.
[35] Bloomberg TV, Lindner's interview, 18.01.2022.
[36] The rule states that, for each public policy goal, a dedicated policy tool must be used. Jan Tinbergen.

3.1 The Stability and Growth Pact Reform

3.1.1 The Rationale and Description of the Stability and Growth Pact

Introduced in 1997, the SGP was meant to incentivise Member States to avoid large public deficits in order to guarantee the fiscal space required for stabilising their economy in difficult periods without the need for a bail-out from the European Central Bank, which is forbidden by the EU treaties.[37] Hence, the goal of the Pact was to allow for the Monetary Union to survive and thrive whilst preserving national ownership over fiscal policies without central fiscal capacity nor a lender-of-last-resort clause, which is usual in "monetary federations". This situation avoids the case of "fiscal dominance"[38] where governments have the upper hand over their central bank and try to monetise their debt to reach macroeconomic objectives, usually with large inflationary effects that devalue their currency.

The SGP is comprised of two arms[39]:

- Its preventive arm where: (1) Member States have a public deficit under 3% of GDP, (2) they must comply with a medium-term objective (MTO) to define their fiscal stance[40], (3) if they don't, they must improve their structural balance by 0.5% of GDP per year as a benchmark, (4) their debt-to-GDP ratio level should not exceed 60% of GDP, and if it does not, they must decrease by 5% (1/20th) each year the margin between their current level and 60%, (5) the growth of public expenditure must not exceed the medium-term potential GDP growth.
- Its corrective arm where: (1) Member States have either a deficit exceeding 3% or a pace of debt-to-GDP ratio reduction below the annual 5% of the margin between their current level and 60% or both, (2) they must achieve annual fiscal adjustments defined by European authorities in order to correct the excessive deficit within a defined period, (3) they are given a deadline of six months (or three for a serious breach) to comply with recommendations that provide them with a concrete path for correcting their excessive deficit within a set timeframe, (4) they are subject to financial sanctions if they don't comply and belong to the euro area.

3.1.2 The Possible Features of a Reform of the Stability and Growth Pact

In recent years, the technical debate in Europe[41] has led to the emergence of proposals, among which one is supported by many: the 60% debt-to-GDP ratio and 3% deficit targets would be preserved – since changing these key targets would amount to modifying the EU Treaties which would require a ratification of the changes by the 27 Member States, a long and arduous process – but the main metric of interest would become the expenditure rule that would limit annual growth in public expenditure by capping the potential growth rate of the domestic economy. This solution is also supported by the cep.[42]

Many other proposals[43] have been formulated during the last years, especially since the relaunch of the Commission's consultation in October 2021. To determine Member States obligations, almost all

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37 Isabel Schnabel, The shadow of fiscal dominance: Misconceptions, perceptions and perspectives, 11.09.2020.
38 Voxeu/CEPR, Large public debts need not imply fiscal dominance, 13.11.2021.
39 For a longer description, please refer to the cepInput 14/2020.
40 The MTO corresponds to a fiscal balance in « structural » terms, i.e., excluding cyclical components and one-off measures. It should be close to zero, or positive. It is revised every three years.
41 Among others: Philippe Martin, Xavier Ragot, Zsolt Darvas, The economic case for an expenditure rule in Europe, 12.09.2018.
Agnès Benassi-Quéré et al, How to reconcile risk sharing and market discipline in the euro area, 17.01.2018.
42 For a description of the solution, please refer to the cepInput 14/2020.
43 All the investigated proposals are listed in the Reference Section.

of them include the abandonment of output gaps and structural deficits, which are too sensitive to national methodologies[44] to determine fiscal rule parameters, and they instead only rely on potential output growth as a forward-looking element. The expenditure rule is sometimes associated with a primary balance target, or just to the 3% deficit-rule to avoid tax cuts that are too strong. Most proposals also tend to entrust debt sustainability monitoring and assessment, as well as escape clause implementation, to Independent Fiscal Institutions (IFIs) that would work in a network, supervised by a European IFI that could either be derived from the current European Fiscal Board or completely new (a "European Fiscal Agency"). Most of them also want to adapt the pace of debt-to-GDP ratio reduction to each country's capacity to foster growth: each country would determine in accordance with European institutions its middle-term "debt anchor", which would replace the 5%-rule that has hardly been respected in the past.

Nonetheless, influent economists[45] also point out that the establishment of any rule incorporating potential growth forecasts, which are necessarily debatable, would not make it possible to define a level of expenditure that is truly consistent with the sustainability of public debts. Moreover, their sustainability is a function of a continuously changing macroeconomic environment, such that no "perfect rule" can be implemented. These economists argue in favour of introducing national sustainability "standards"[46] calculated ex-post[47] by a national and/or European IFI(s), placing the trajectory of each national public debt in one of three categories: sustainable with high probability, sustainable with low probability, unsustainable. As soon as a trajectory falls into the low probability category, the European Commission would require the State concerned to take measures to restore the situation. This solution would give more responsibility to the Member States themselves in maintaining sustainable debt trajectories and further internalising fiscal discipline constraints. On the other hand, it would imply the establishment of a dispute settlement mechanism between the European Commission and Member States, which could take the form of an ad-hoc chamber or be established at the EU Court of Justice. This chamber would be responsible for overturning or confirming possible sanctions by the Commission. This vision is shared with other proposals that emphasise better fiscal coordination between Member States as a key factor for a well-functioning European Economic Governance framework.[48]

Among all the other proposals, one in particular, was introduced in December 2021[49] by Emmanuel Macron and Mari Draghi. It includes an expenditure rule but also has a second section that proposes a Debt Assumption Plan, consisting in transferring all COVID-19 and even GFC public debt to a European Debt Management Agency, which would receive contributions from national governments to cover future interest payments. Debt would not be eliminated but replaced by new debt at low cost to the

[44] For a long time, national methodologies were not even made public. For instance, the German BMWK released a document detailing its output gap and output potential method only on January 18th. BMWK, Ergänzende Unterlagen zu den Berechnungsgrundlagen für die Bestimmung des gesamtwirtschaftlichen Produktionspotenzials, 18.01.2022.

[45] Peterson Institute for International Economics, Redesigning EU fiscal rules: From rules to standards, 02.2021. The influent economists are Blanchard, Leandro & Zettelmeyer.

[46] According to Blanchard, Leandro and Zettelmeyer, the sustainability of trajectories depends on many factors: the level of debt relative to GDP, the ability of the primary balance (government revenue minus government expenditure) to vary following macroeconomic shocks, the level of the primary balance, the interest-growth differential, and institutional factors (tax raising capacity, type of government, credibility of the government, ability to improve the primary balance).

[47] Blanchard, Leandro and Zettelmeyer argue for a "constant reassessment" of the sustainability of debt trajectories based on established macroeconomic data.

[48] OFCE, Vers une réforme des règles budgétaires dans la zone euro ?, 2021.
EUI, Adapting the EU Fiscal Governance to New Macroeconomcs and Political Realities, 2020.

[49] Italian Government, Revising the European Fiscal Framework, 23.12.2021.

European guarantee weighing on it. This would help lower the debt burden that most indebted countries face.

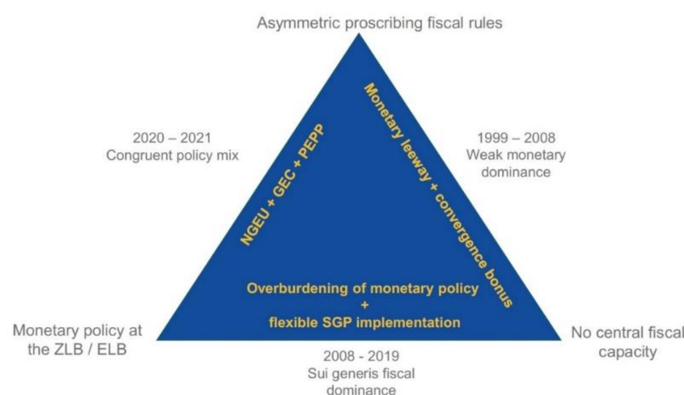
3.2 The Central Fiscal Capacity Reform

3.2.1 Rationale and Description for the Recovery and Resilience Facility

On top of the SGP reform, many discussions also focus on how to give more fiscal space to foster growth and assist in the ecological transition and digitisation of Member States economies while also complying with a debt-to-GDP ratio reduction framework to ensure the sustainability of debt-to-GDP ratio trajectories. For certain countries, this increase of national fiscal space is not possible without a real central fiscal capacity. "Standard" monetary federations, like the US and Switzerland, do have this sort of central fiscal capacity, which allows them to stabilise any Federated State in case of external shocks, to redistribute, to conduct various public policies and to borrow at lowest cost.[50]

Since the EU adopted the Next Generation EU recovery plan – which includes a sketch of central fiscal capacity –, it could escape the "Trilemma of ill-designed monetary unions" (see Figure 6), by using both its monetary and fiscal arms – at the EU level and nationally – and taking Member States out of the covid-19-related recession. This crisis proved that a congruent policy mix was successful for the Union and could be used again during the next crisis. In the meantime, to avoid "sui generis fiscal dominance" due to unsustainable public debt-to-GDP ratio trajectories, like what happened between 2008 and 2019, the EU should reflect on a permanent central fiscal capacity to continue escaping the trilemma.

Figure 6: The Evolution over Time of the Solution to the "Trilemma of Ill-Designed Monetary Unions" in the Euro Area



Source: Marco Buti & Marcello Messori.[51]

The Next Generation EU recovery plan and its instruments could be used as a basis for a future permanent central fiscal capacity, especially its Recovery and Resilience Facility[52]. This European central capacity includes €312.5 billion in grants, and €360 billion in loans. Funds are distributed according to the impact of the COVID-19 in the Member States. Italy and Spain were the most served,

[50] ECB, Fiscal rules in the euro area and lessons from other monetary unions, 2019. « Generally, as the experiences in the United States and Switzerland have shown, once government debt ratios are relatively low and less divergent, countries might be able to afford to set their fiscal rules more autonomously. Experience in other monetary unions suggests that market discipline can reinforce the ownership of sub-federal fiscal rules ».

[51] Voxeu/CEPR, The search for a congruent euro area policy mix : Vertical coordination matters, 13.10.2021.

[52] European Commission, Recovery and Resilience Facility.

receiving respectively about €180 billion and €140 billion.[53] A conditionality has been added to the disbursement of the RRF: Member States must implement structural reforms detailed in a National Reform Plan – already a yearly requirement of the European Semester– before they are granted or lent any funds.

3.2.2 The Possible Features of a Central Fiscal Capacity Reform

Many proposals detailing an SGP reform also include a central capacity requirement and/or a "golden rule" aimed at excluding certain investments from a national deficit calculation. Nevertheless, a golden rule excluding public growth-enhancing investments from the calculation of public deficits would face difficulties in classifying different sorts of expenditures as public or not. For instance, education is growth-enhancing but usually is not accounted as a public investment.[54] Furthermore, certain public "green" investments could be greenwashing – on top of being non-growth-enhancing – investments, if the European surveillance system is not sufficiently performant. In the context of the ecological transition, a European centralisation for the management of green and growth-enhancing investment could alleviate this adverse effect.

Hence, many proposals introduce a central investment capacity, inspired by the RRF or focused on supplying either stabilisation of asymmetric shocks to Member States or European public goods (ecological transition), or both. Conditionality usually is a key feature to incentivise Member States to conduct structural reforms to obtain further European funds. Proposals also avoid adding a cross-border redistributive instrument, like currently in the RRF. This helps short-circuit debate about a "Redistribution Union" to which frugal countries do not want to commit.

According to the different proposals, a central fiscal capacity could be financed by transfers from Member States, debt emitted by the EU, and new EU fiscal resources like the Carbon Border Tax or the new Carbon Rights for the Emissions Trading System extension. An example of a central capacity proposal is the European Climate Investment Facility (ECIF) recently introduced by Marco Buti, which would provide grants and loans to fight climate change until 2050, with an average of €57 billion each year.[55]

4 Assessment: A "Carrot-and-Stick" Approach for More Fiscal Sovereignty in the EU

Launching a serious debt-to-GDP ratio reduction program requires maintaining fiscal rules instead of fiscal standards associated to national fiscal coordination. Hence, the idea of only relying on standards is not well-suited, as common rules ensure "fairness" between Member States. The latter may face varying macroeconomic situations, they all belong to the same Union, which implies they must follow the same set of rules to guarantee a Union between equals instead of the untenable position of a Union between privileged and less privileged. Also, the revision cannot aim at designing "perfect rules" but it can implement the "best fiscal rules", providing average best debt reduction and output growth paths for varying macroeconomic constraints.

[53] Barclays, the future of the EU fiscal governance framework, 12.11.2021, p. 4.
[54] Fipeco, L'investissement public et les règles budgétaires européennes, 13.01.2022.
[55] Voxeu/CEPR, Combining environmental and fiscal sustainability: a new climate facility, an expenditure rule, and an independent fiscal agency, 14.01.2022.

Furthermore, keeping fiscal rules will avoid too frequent dragging-on political negotiations, which would undermine long-term credibility of the new setup. Besides, even if Member States do not comply to the SGP rules all the time, the latter do shift public deficits towards debt-to-GDP ratio reduction where market discipline is too unpredictable and volatile[56], and contribute to debt-to-GDP ratio reduction and fiscal sustainability. This "stick" is indispensable to the Economic Governance of the EU. The 2020 position of the cep on the topic is still valid[57]:

To support debt sustainability and reduce the risk of fiscal dominance, fiscal rules should be simpler, first by only relying on potential output growth as a forward-looking element to compute national expenditure ceilings, which could be multi-annual to provide more fiscal predictability, enforceability and credibility by sending a signal of mid-term fiscal discipline to markets. Furthermore, the assessment of fiscal situations and escape clauses should be entrusted to a network of national independent fiscal authorities coordinated by a supervising agency at the European level.

Nevertheless, whatever the changes, the SGP will remain a "stick" focused on debt-to-GDP ratio reduction, given the macroeconomic context and the Tinbergen rule.

Hence, policymakers should focus most of their energy on a "carrot": a perennial fiscal instrument, preferably a central fiscal capacity, which would help the EU transit to carbon-neutrality in 2050 – while the private sector still struggles to engage in this transition and needs public support for risky and not necessarily very profitable investments[58] –, and would incentivise Member States to conduct structural reforms due to the conditionality of the funds. If no increased central capacity is implemented, more fiscal leeway should be given to Member States, either through more growth-compliant fiscal rules or exclusion from the deficits of public investment. Finally, these public funds could leverage private investments like the current NGEU, or like the Juncker Plan did a few years ago.

However, a central fiscal capacity should not be so large to lead to US- or Switzerland-like fiscal federalism. An "Hamiltonian moment", when all EU Member States decide to mutualise their debts and fiscal resources, is still faraway, and not even desirable while national preferences remain very different from one country to another in the EU. A functional solution can be found between pure fiscal federalism and the current incomplete EU Economic Governance. The challenges lying ahead, starting with climate change, are the opportunities to build this new setup for the provision of more EU "public goods".

Therefore, an encompassing reform should combine: (a) a simplification of the SGP, where debt-to-GDP ratio reduction pace is nationalised, the main middle-term target is fixed by an expenditure rule and general escape clauses are examined by independent fiscal authorities, and (b) a non-redistributive Member-States-and-debt-financed central fiscal capacity, assessed as "long overdue" by the EFB, to help the EU transit to carbon-neutral economy.[59] This double solution sounds like a precondition for more fiscal sovereignty of the EU and needs a parallel deepening of the Banking Union and the Capital Market Union through the acceleration of cross-border consolidation.[60] The euro area ensures its sustainability under these conditions.

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[56] IMF, The Future Oft He EU Fiscal Governance Framework, 12.11.2021, p. 28.
[57] For a description of the solution, please refer to the cepInput 14/2020.
[58] The Guardian, 30.03.2021.
[59] Voxeu/CEPR, Reforming the EU fiscal framework : now is the time, 26.10.2020.
[60] IMF, The Future Of the EU Fiscal Governance Framework, 12.11.2021, p. 24.

5 Conclusion

The European Commission relaunched its February 2020 consultation on the Economic Governance Review on October 19th, 2021. The need for an EU Economic Governance reform is justified by (i) complex and non-credible fiscal rules that did not allow for debt-to-GDP ratio reduction at the EU level despite national structural reforms, (ii) fiscal space divergences in the EU leading to (iii) an increased risk of sovereign debt default of highly indebted European countries, especially Italy and Greece – which would create new tensions in the euro area – and to (iv) a new risk of ECB intervention on sovereign markets to control spreads – perpetuating fiscal dominance with inflationary effects expected. Besides (v) levels of public investments are declining, especially in highly indebted countries, which all call into question the economic sovereignty of the EU.

Regarding the reform, SGP fiscal rules should remain – despite the impossibility to design a "perfect set of rules" – to both ensure fairness between Member States and avoid too frequent dragging-on political negotiations, which would undermine long-term credibility of the new setup. Nevertheless, whatever the changes, the SGP will remain a "stick" focused on debt-to-GDP ratio reduction, given the macroeconomic context and the Tinbergen rule. Hence, policymakers should focus most of their energy on a "carrot": a perennial fiscal instrument, preferably a central fiscal capacity, which would help the EU transit to carbon-neutrality in 2050.

Recently, the French and German Finance Ministers, Bruno Le Maire and Christian Lindner, expressed their convergence regarding a reform which would primarily target the pace of reduction of debt-to-GDP ratios by country.[61] Nevertheless, no official statement has been made either regarding a perpetuation of the NGEU's Recovery and Resilience Facility as perennial investment capacity nor regarding the building-up of a brand-new instrument exclusively focused on the ecological transition. The "carrot-and-stick" approach still struggles to surface.

Important negotiations will occur during the New European Growth Model Summit on March 10th and 11th. An official Commission proposal resulting from these negotiations and the consultation is expected in June 2022 for an implementation in 2024. This process will show if indeed a reform is politically feasible.

It is likely that a "carrot-and-stick" strategy will participate to make it feasible for every side.

[61] Vie Publique, Declaration of M. Bruno Le Maire, French Finance and Economy Minister, 17.01.2022.

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