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Position Paper

SGI Europe contribution to the review of the EU economic governance

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Improving the framework

In the light of experience, effective delivery on the objectives of ensuring sustainable public finance positions and avoiding macroeconomic imbalances is key. Effective economic coordination and surveillance is a cornerstone for ensuring resilience in the EU and the Economic and Monetary Union in view of potential negative spillovers resulting from the building up of unsustainable positions. While there has been progress overall in terms of debt sustainability and correction of macroeconomic imbalances, that progress has not always been sufficient, with large differences across Member States. Therefore, an effective framework needs to ensure the sustainability of public debt, including where it is most necessary, and the prevention and correction of macroeconomic imbalances.

Question: How can the framework be improved to ensure sustainable public finances in all Member States and to help eliminate existing macroeconomic imbalances and avoid new ones arising?

First of all, we would like to thank the European Commission for this inclusive debate. We agree with the European Commission that a high degree of consensus and trust amongst all key stakeholders is crucial for achieving a meaningful and sound economic governance review.
The new framework should be informed by the lessons learnt from the pandemic. In particular, the crisis revealed that existing rules are not fit-for-purpose, and that fiscal policy has a crucial role in economic policymaking and growth-oriented policy choices.
Secondly, adapting to the post-pandemic economic reality would also be of paramount importance. Current high debt levels and low interest rates should lead to a rethinking of how to reconcile the objectives of debt reduction and fiscal consolidation while fostering the investments needed for the twin transition.
The objective should be to design a better functioning fiscal regulatory framework and simplify the rules, evolve from a one-size-fits-all to a more targeted approach, find a balance between investments and sustainability of public finances, and reform its governance in line with the best practices of the Recovery and Resilience Facility (RRF).

Safeguarding sustainability and stabilisation

Fiscal policy guidance supports Member States in ensuring the long-term sustainability of public finances and in pursuing counter-cyclical fiscal policies to contribute to a better macroeconomic stabilisation in both good and bad times. While an effective framework should aim to be counter-cyclical in good and bad times, it has often not been achieved in practice. An appropriate fiscal effort and debt reduction in good economic times helps to create the space to use fiscal policy in bad times. Appropriate medium-term policy planning, both regarding fiscal targets and structural reforms to promote productivity and investment, and an appropriate policy anchor help in that regard.

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

In the short term, the key priority should be to prevent a tightening of fiscal support at a too early a stage and allow Member States to fully benefit, in the context of the post-pandemic recovery, from the growth potentials of productive investments oriented towards the EU green and digital goals.
To prevent crushing the recovery and ensure consolidation of public finances, it would be counterproductive to envisage reinstating the current 1/20th adjustment with countries edging towards an average debt-to-GDP ratio of around 96% in 2022. A too early and excessive fiscal tightening would hinder growth potentials, thus making the debt reduction path impossible.

Cutting public sector investment spending or increasing taxes and fiscal charges would be counterproductive and likely to jeopardise the economic recovery at a time of great uncertainty and volatility. Public sector spending on investment has a particularly significant bearing on the recovery process: measures oriented towards dynamic expenditure must be boosted rather than curtailed.

All efforts should now be focused on strengthening growth in Europe. Under the "outgrowing debt" strategy, the sum of debt in the numerator needs to grow more slowly than nominal GDP in the denominator. Under this scenario, the debt ratio will decline yearly, with the process expected to accelerate at higher inflation rates.
On the contrary, by constraining the space for public sector productive investment and governments' measures to promote private ones, Europe would likely face production cuts and layoffs as medium-term consequences. A stagnation of the economic recovery would indeed lower tax revenues with additional higher social spending needed to cushion adverse effects.

However, with the RRF coming to an end in 2026, it is paramount to ensure and assess that Member States will be on the right path towards achieving feasible rates of public finances consolidation and debt reduction in the long term. A sustainable debt reduction and the promotion of a better composition of public finances are crucial elements that will allow Member States to be financially sustainable and build up buffers for future crises. Yet, as stated already, those objectives can only be achieved by a sustained and long-lasting post-recovery growth strategy.

Incentivising reforms and investments

The framework should be consistent with today and tomorrow's challenges. It needs to be discussed what the appropriate role of the EU surveillance framework is in helping to promote a growth-friendly composition of public finances and for Member States to sustain adequate levels of investment. In particular, significant investment will be required to meet the broader ambition of the European Green Deal. This raises the question of the extent to which the fiscal framework can support the investments needed for the transition to a climate-neutral, resource-efficient, and competitive economy, in a manner that leaves no one behind. This includes reassessing the appropriateness of the current flexibility clauses in terms of their scope and eligibility, in order to facilitate the right type and level of investment while preserving debt sustainability. In addition, thought should be given to the role of the fiscal framework in greening national budgets.

Question: What is the appropriate role for the EU surveillance framework in incentivising Member States to undertake key reforms and investments needed to help tackle today and tomorrow's economic, social, and environmental challenges while preserving safeguards against risks to debt sustainability?

We would like to remind that the whole issue goes back to when the EU took a series of measures to strengthen its economic governance and surveillance framework to respond to the vulnerabilities exposed by the economic and financial crisis in 2008-2009. The six-pack and two-pack were introduced to enhance economic policy coordination and promote sustained convergence of economic performance through strengthening budgetary surveillance under the Stability and Growth Pact (SGP).

A decade later, on the 5 February 2020, and one month before the outbreak of the COVID-19 pandemic, the European Commission presented a review of the effectiveness of the economic surveillance framework and launched a public debate on its future. That review stated that the EU framework for economic surveillance had guided Member States in achieving their economic and fiscal policy objectives. The review found that the surveillance framework has supported the correction of existing macroeconomic imbalances and the reduction

of public debt. This, in turn, has helped to create the conditions for sustainable growth, strengthened resilience and reduced vulnerabilities to economic shocks. It has also promoted sustained convergence of Member States' economic performances and closer coordination of fiscal policies within the euro area. Moreover, according to the review, the EU faced an economic context that significantly changed since the rules were established. However, the report identified some vulnerabilities, such as the increasingly complex framework of the fiscal rules. Climate change was also one of the most critical issues flagged in the communication.
Two years later, we now have to think of a framework that should be consistent with today's challenge linked to the uncertainty of a prolonged health emergency with negative economic and social spillovers and tomorrow's challenges that need investments now. Concerning the medium and long term, could the reinstatement of the SGP "as it is" hamper the implementation in the medium and long term of the EU Green Deal? The answer is probably yes.

Since its inception in 1997, the rules underpinning the SGP have been continuously adjusted according to contingent challenges. However, the post-pandemic reality has significantly altered the economic environment based on which the reference values were calibrated.
The policy objective of reconciling government budgets consolidation with the emergence of necessary massive public investment to reach Europe's climate targets requires more than simply adjusting the current rules. In particular, to reach the green and digital transition objectives, the Commission estimated that Member States will indeed need to mobilise - on top of the NRRPs - around 650 billion euros of public and private investments each year until 2030.A possible solution would be the introduction of a 'Golden Rule of Green Investment', stating that net public investments (such as the increase of the public or social capital stock providing future environmental benefits) should be financed by debt and, consequently, be excluded from balanced-budget rules. By distinguishing between growth-enhancing, productive and unproductive investments, a better composition of public finances could be achieved. The latter would also allow long-term growth prospects for Europe while setting a sustainable path towards debt consolidation. A better assessment of the output gap estimations would also likely support fiscal consolidation through growth.

Simplification and more transparent implementation

Whereas the current fiscal surveillance framework has included elements of flexibility and discretion through a complex set of provisions adopted against a background of lack of trust amongst key stakeholders, an effective application of economic judgement within a rules-based framework needs to be done in an objective and transparent manner. This includes, for example, considering whether a clear focus on gross policy errors as set out in the Treaty, based on clearly defined objectives and operational policy targets, could contribute to an effective implementation of the surveillance framework. A simpler framework and implementation could contribute to increased ownership, better communication, and lower political costs for enforcement and compliance.

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

The rules should be simplified to increase transparency and build credibility, including better observable indicators. Therefore, an improved scoreboard considering social and economic indicators beyond the mere deficit and debt indicators - in line with the ongoing "Beyond GDP" debate - would be advisable. This scoreboard could help assess the economic condition of any given Member States more thoroughly.
As already indicated in the previous question, a different assessment and calculation of output gaps would likely support more robust growth rates, making debt consolidation less challenging.

Focus on pressing policy challenges

Surveillance should be commensurate to the gravity of the situation, with a stronger focus on the most pressing cases and less-intrusive procedures where overall risks are low. Therefore, it is to be considered whether the surveillance framework, in order to be effective, should focus more on 'identifying gross errors' [i.e. on Member States whose policy Cf. Article 126(2) of the Treaty on the Functioning of the European Union.] strategy puts public debt on a potentially unsustainable trajectory or leads to other macroeconomic imbalances. Moreover, a strong policy dialogue with Member States and stakeholders is key, especially in a multilateral setting, but also bilaterally with the Commission.

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

SGI Europe believes that, within the European economic governance, the European Semester has become a reliable tool for encouraging timely and meaningful reforms targeting the most pressing policy challenges. SGI Europe welcomes the clear focus of the European Semester on environmental sustainability and the green transition, productivity and digital transition, fairness and macroeconomic stability. These pillars should remain the guiding principles in monitoring the implementation of the national recovery and resilience plans (NRRPs) as well as designing and implementing necessary reforms. The European Semester's design has continually evolved to become more streamlined, more focused on key challenges and more transparent. It offers tools for multilateral surveillance and dedicated space of exchanges between individual Member States and the European Commission.
The European Semester should remain a key tool to ensure continuity and commitment to the required reforms. The role of DG REFORM in this respect is essential. Increased long-term growth and employment in the EU will depend on the proper implementation of many structural reforms. The EU institutions must ensure the NRRPs are sufficiently linked to the implementation of structural country-specific reforms, as designated under the European Semester. More efforts must be made to improve the consultations of social partners at the national level to identify the most appropriate reforms and investments.

Lessons from the RRF

The RRF's commitment-based approach to policy coordination, with strong national ownership of policy design and outcomes, is expected to support implementation of agreed reforms and investments. This approach takes into account the complexities that arise from the simultaneous pursuit of various national and EU objectives, in a context of differences in socioeconomic structures and national preferences. It underpins ownership and trust. Rapidly-evolving developments since the start of the pandemic (and even before it) have illustrated the difficulty of designing comprehensive rules that are able to cater for all possible circumstances. Taking into account the lessons from the RRF, the economic governance review should consider how national ownership, mutual trust, the effective delivery of the framework on its key objectives, and the interplay between economic and fiscal dimensions can be best ensured.

Question: In what respects can the design, governance and operation of the RRF provide useful insights in terms of economic governance through improved ownership, mutual trust, enforcement and interplay between the economic and fiscal dimensions?

Two valuable lessons on governance from the RRF can be replicated. The first one concerns the role of the European Parliament: it has a substantial role in the RRF's governance, with regular structured dialogues enabling it to invite the Commission to discuss the implementation of the RRF.

The second point is the scoreboard. A scoreboard will be established and made publicly available to provide information on progress in implementing the RRF and the NRRPs. It will display the progress of the implementation of recovery and resilience plans in each of the six pillars of the RRF. This scoreboard should be operational by December 2021 and should be updated by the Commission on a biannual basis.
This scoreboard is interesting because it creates a sort of peer pressure among Member States and identifies the national specificities. This method could be used to define the new SGP, and this scoreboard should include all indicators discussed in the debate on "Beyond the GDP". Social and economic indicators are impacted by fiscal and growth policies beyond the deficit and debt indicators. This scoreboard could help assess more thoroughly the economic condition of a Member States.
Likewise, the RRF country-specific targets (for green and digital projects/expenditures) could also enhance ownership to national, regional and local authorities. Doing so also builds an effective buffer against populism and resistance to long-term enabling reforms. However, from the RRF, it is still unclear how the interplay between economic and fiscal dimensions can be best ensured.

National fiscal frameworks

It has to be considered whether a stronger role for national fiscal frameworks, in particular independent fiscal institutions, would contribute to better compliance with EU fiscal rules and improve ownership of the framework at the same time. Moreover, given that high quality statistics are key for a transparent fiscal framework, it has to be assessed what further improvements in data quality would be needed.

Question: Is there scope to strengthen national fiscal frameworks and improve their interaction with the EU fiscal framework?
It is possible to strengthen national fiscal frameworks and their interactions with the EU fiscal framework.
Ideally, national frameworks have the potentials to enhance policy ownership at the domestic level whereas also creating the conditions for improving trust and transparency among Member States via a sort of peer-pressure system. Independent fiscal institutions (IFIs) could therefore play a greater role in the EU surveillance process, particularly outside the corrective arm. However, in the absence of both clear objectives for a common fiscal stance/policy of Eurozone Members and an effort to harmonise roles and functions of IFIs, the benefits of decentralisation can be limited.

Effective enforcement

The appropriate balance between pecuniary sanctions and tools incentivising macroeconomic stability and sustainable growth, such as a Budgetary Instrument for Convergence and Competitiveness or the Convergence and Reform Instrument, has to be carefully considered as an element to ensure an effective implementation of the framework.

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

The introduction of a "Green Golden Rule" would raise some political issues: Who would have the economic surveillance on this rule? Who would be responsible for the debt generated by the green bonds? How would these investments impact long-term debt sustainability? This raises the issue of the effective enforcement of macroeconomic stability, along with sustainable and environmentally friendly growth.
The role of potential pecuniary sanctions and reputational costs seems not to be working adequately. There is a need for positive incentives and substantial improvements to the current instruments. A possible tool would

be for an enhanced Budgetary Instrument for Convergence and Competitiveness (BICC) to promote additional investments that reinforce public infrastructures, support the digital and green transition and create quality jobs reinforcing the European Social Model.
This Enhanced BICC (EBICC) would have a relevant percentage of the co-financing to be subtracted from the calculation of the deficit and debt rule under the SGP. A broader involvement of social partners and a stricter accountability of the European Parliament on this instrument could be also desirable.

Interplay between the SGP and MIP

Multiple surveillance streams partially overlap but the links have not always been fully exploited. While the integration of the MIP and the SGP within the framework of the European Semester has helped to strengthen the interaction between those surveillance strands, there is further scope to make them work better together while avoiding overlaps between them when addressing at the same time macroeconomic imbalances, potential growth challenges and risks to public fiscal sustainability. MIP surveillance may also have so far insufficiently taken account of interactions between new emerging economic challenges, notably related to climate change and other environmental pressures.

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

The European Semester was implemented in 2011 to strengthen EU economic governance. It is an annual governance cycle that coordinates socioeconomic policies belonging to different policy domains, including social, employment, economic and financial policies. The interplay between the SGP and the Macroeconomic Imbalance Procedure (MIP) is crucial within the framework of the European Semester.
However, these surveillance strands overlap and seem to be outdated considering the new challenges arising from the stress put on the social and public infrastructure by the health crisis. The European Semester, after a decade, should be reorganised and incorporate the lessons learned from the current crisis, for instance, on the temporary state aid framework for essential facilities. We have to be ready to face another similar crisis without the delays and hiccups in the second quarter of 2020.
Furthermore, the deactivation of the general escape clause should only take place after (1) the health crisis is under complete control, (2) the EU has returned to its pre-crisis level in terms of GDP per capita and employment and (3) when a reform of the SGP has been agreed.

Euro area dimension

There are a number of concrete links between the economic governance framework and the broader agenda to complete the Economic and Monetary Union. First, both the SGP and the MIP focus exclusively on national policies, in particular on the prevention and correction of high public debt levels and current account deficits. In such a context and in the absence of a central fiscal capacity with stabilisation features, the ability to steer the fiscal stance for the euro area as a whole remains constrained. The introduction of a stabilisation capacity of appropriate size would allow fiscal policy to contribute more to macroeconomic stabilisation at the level of the euro area as a whole. Second, the completion of the financial union (Banking Union and Capital Markets Union), the introduction of a common safe asset and the review of the regulatory treatment of bank sovereign exposures, could – depending on the specific design – facilitate market discipline and allow further simplification of the design of an effective fiscal surveillance framework. Third, a vibrant and resilient Economic *and Monetary Union, resting on solid foundations, is the best means to increase financial stability in Europe. It is a prerequisite to strengthening the international role of the euro, which in turn is a tool to enhance Europe's clout in the world and on global markets, thereby helping protect European firms, consumers and governments from unfavourable external developments.*

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

The framework should consider all parts of economic policy, monetary, fiscal, and financial market. The capital market union and banking union are two important reforms which will contribute to reduce financial risks in specific member states and increase access to capital for enterprises in all parts of the EA. It has proven to be hard to have an economic and monetary union without a common fiscal policy which can work as a complement to monetary policy.

Member States in the EA have not synchronised business cycles which implies that different fiscal policies run in parallel, making monetary policy hard to adapt to all different policy needs. The different business cycles and different structural challenges in the economies should imply different policy measures, therefore a national fiscal policy might be a good tool to meet these needs. The introduction of the six and two pack and the MIP were intended as tools to stimulate single Member States – in specific circumstances - to recover and/or make structural changes to improve the economy in a longer run. However, in a single currency area it can also create suspicion of moral hazards if some member states are in trouble more than others and are considered not doing enough to improve the macroeconomic balance and economic structures. This can be a political challenge at the EU level and result in different penalties which can worsen the economic situation and increase distrust between Member States.

Lastly, in the absence of a common fiscal policy, national fiscal policies which are structured to meet common standards and objectives through transparent and regulated frameworks can be used in times of crises.

New challenges due to the COVID-19 crisis

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

One specific challenge has been somewhat overlooked since the launch of the Next Generation EU and the RRF.

The COVID-19 crisis has clearly exposed the consequences of years of underinvestment in the European social and physical infrastructures, which are indispensable for long-term competitiveness, employment and growth. Furthermore, the pandemic also exhibited the essential role of SGIs to the well-being of citizens, the economic and social resilience of the EU, as well as their vulnerabilities across several Member States.

Against this backdrop, and if properly implemented at the national, regional and local levels, the Recovery and Resilience Facility (RRF) represents a unique opportunity to boost productive investments in high-quality and accessible SGIs and foster upward convergence within and across EU Member States. It could also be a central instrument to support peripherical regions, suburban and rural areas which have been particularly hit by the pandemic.

However, without a strong focus on access to high-quality SGIs and strengthening cohesion and social policy, the post-pandemic recovery risks becoming a great divergence process both across and within Members States.

Additional economic and social marginalisation, especially amongst the left-behind in disadvantaged suburban and rural areas, would inevitably broach public confidence in the post-pandemic transition, with another wave of populism likely to propel further disintegration processes of the EU.

One challenge for member states will be to turn the use of the very expansive fiscal policy used to meet the challenges of the pandemic such as increased demand for health care, support to enterprises and labour markets, to investments in future growth, including green and digital investments. The RRF is a good start but more will be needed both to invest in physical capital as well as in human capital.