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Financing for a future-fit Europe

Feasible and impactful proposals for a reform of the EU fiscal framework

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Introduction

With the European Green Deal, the EU has set itself an ambitious agenda to transform its economy. Over the course of the next 30 years the EU wants to transition to a green economy that respects planetary boundaries and provides decent jobs and wellbeing for its citizens.

Public funding has an essential role to play in achieving these goals and bridge massive financing gaps[1]. According to estimates by the European Commission, additional investments of €470 billion per year are needed to meet the EU's climate and environmental targets alone[2]. And yet, this does not include investment that is needed to address other social and economic challenges. In May 2020, the European Commission estimated the digital transformation investment gap at €125 annually[3]. The funding provided by the Recovery and Resilience Facility (RRF) for digital goals is only a fraction of what is needed to build the necessary infrastructure and skills for the digital decade[4]. However, the current EU fiscal rules limit governments to close financing gaps, so that achieving green, digital, and social targets seems unlikely without changing the architecture of those rules.

When the cornerstones of the current framework, the Maastricht treaty and the Stability and Growth Pact (SGP), were designed in the 1990s, today's challenges like climate change and the COVID-19 pandemic had not been foreseen. With the financial crisis and the pandemic, economic circumstances have changed and current fiscal rules that are centred around automatic adjustments in tax revenues and spending for stabilisation[5] are no longer fit for purpose. Today, the fiscal rules not only limit Member States to provide sufficient investment for closing financing gaps[6], but they also hinder Member States to react properly to economic crises due to their procyclical nature[7]. Furthermore, the current fiscal rules are not flexible enough to react to changes in interest rates, as the level of interest rates is not considered in any of the fiscal rules. Thus, a reform of the current EU economic governance framework that refocuses fiscal rules on the primary goal of public finances is necessary. Namely, fiscal policy needs to ensure stability for the sustainable prosperity of our economies.

There is not much time to find a solution before the deactivation of the general escape clause in 2023, which obliges Member States to rapidly find a consensus for a comprehensive reform of the economic governance framework that is responsive to current challenges.

In this policy brief, we describe three complementary reform proposals that have a high political feasibility while granting all Member States as much necessary fiscal flexibility as possible:

- An exemption of the rules for investment for a green and just transition,
- An expenditure rule, and
- The establishment of a permanent centralised fiscal capacity

In the next chapter we set out why these three proposals complement each other and why they are most likely to be politically feasible[i]. Building on this, we will explain how each of the proposed reforms will improve the current EU governance framework and enable Member States to address the urgent challenges of today and tomorrow, while ensuring stability.

A reform for a governance framework tailored to the circumstances and challenges of the times

A key finding of our recent analysis assessing the feasibility and impact of fiscal policy reform proposals was that reforms addressing only the preventive arm of the SGP have a higher political and legal feasibility. These reforms only need an Ordinary Legislative Procedure, which only requires a qualified majority in the ECOFIN Council and a simple majority in the European Parliament. However, this does not sufficiently support those countries that are in the corrective arm[8] with debt levels above the 60% threshold. Ambitious debt-reduction pathways (1/20 rule[ii]) in the corrective arm do not only require unrealistically high surpluses per year, but also significant spending cuts if public investment is allowed otherwise. In the past, austerity measures have exacerbated inequalities[9] and contributed to concerning anti-EU sentiments[10]. This must now be avoided. A reform of only the preventive arm is therefore not sufficient. What is needed is a profound reform of both the preventive and the corrective arm of the SGP so that Member States with debt levels above 60 % of GDP have enough fiscal flexibility to close funding gaps and ensure a just transition. Such reform cannot be introduced through an Ordinary Legislative Procedure but requires either a Special Legislative Procedure or even an amendment of the Treaty on the Functioning of the European Union (TFEU). While both procedures need unanimity among the EU Member States, an ordinary revision to amend the treaties additionally needs a so-called *convention*, which is an intergovernmental conference, followed by national ratification according to Member States' own constitutional procedures. The political feasibility of reforms that require a Special Legislative Procedure is therefore much higher than that of reforms that require a treaty change. Thus, we consider reform proposals that require a Special Legislative Procedure but no treaty change.

[i] For the assessment of the political feasibility of the reform proposals we draw on the methodology used in our recent publication on Fiscal Policy Reform Proposals. Political feasibility takes into account the support or rejection of the reform proposal by the relevant decisionmakers, mainly in the Member States. The assessment is a result of discussions with key stakeholders and experts, as well as the monitoring of the statements and positioning of key actors over a period of months.
[ii] The 1/20 rule requires Member States with a debt-to-GDP ratio of above 60% to reduce the part of its debt-to-GDP ratio that exceeds 60% by 1/20 per year.

We put forward 3 complementary proposals that have, according to our study, a high political feasibility and together reform the current fiscal framework sufficiently to provide all Member States with as much needed fiscal flexibility as possible while ensuring stability:

- Granting Member States exemptions of green investments from the fiscal rules. This generates the required fiscal flexibility for the urgently-needed investments for financing the green and just transition.

- An expenditure rule that limits government expenditure growth to medium-term nominal output growth. This simplifies the current framework and ensures flexibility for spending to bounce forward after (economic) crises while safeguarding stability and the sustainability of public finances.

- A permanent central fiscal capacity with a component on loans and grants, following the example of the RRF. The grants component shall serve to finance large-scale cross-border projects and foster collaboration between Member States. The loans component would help Member States access capital for investments with favourable conditions. The creation of euro safe assets would also strengthen the international role of the euro.

In the presented form, all three proposals correspond to the provisions of the TFEU. Hence, these are measures that effectively provide Member States with the means to enable a fair and sustainable transformation of our economy without having to change the treaties to do so.

Reform proposals

This chapter will explain for each of the proposed reforms (a) how they contribute to providing short-term stability and sustainability of public finances, (b) how they simplify the current framework and (c) enhance transparency, (d) in which ways they incentivise reforms and investment to help set Europe on track for transitioning towards a digitalised, carbon-neutral and just economy in 2050, (e) how they draw on lessons from the RRF, (f) how they effectively enforce the rules, and (g) how they consider the euro area dimension and the agenda towards deepening the Economic and Monetary Union[iii].

Exemptions for green investments

The investment needs for tackling the pressing economic, social, and environmental challenges are huge. The additional annual investment needs just to meet the EU's current climate and environmental targets for 2030 are estimated to be around €470 billion[11].

Private investments will be crucial to close these financing gaps. The World Inequality Report shows that the net wealth of governments has fallen sharply over the last 40 years, while the share of net wealth in private hands has strongly risen worldwide[12]. However, investments in key areas, such as

[iii] In case we could not identify any benefits to the listed aspects (a) - (g) in the proposals, we leave the corresponding aspect unmentioned in the description of the proposal.

green and social infrastructure, are often characterised by low profitability and high risk. The private sector has little incentive to finance these investments. A recent McKinsey study has estimated that 60% of the required investments in the EU do not have a business case (e.g., last mile digital infrastructure)[13]. Public funding plays a pivotal role in de-risking investment and raising the appetite for private investment in key areas for building resilience. Thus, a significant portion of the required investments will need to come from the public sector to bridge these funding gaps.

Thus, the EU economic governance framework should incentivise Member States to undertake key reforms and investments needed to help tackle the economic, social, and environmental challenges of today and of the future. To do so, Member States shall be granted exemptions for public investments that are essential for the green and just transition. These investments would not be considered in any of the fiscal rules of the EU economic governance framework. This would give Member States the required fiscal flexibility for providing the public investments that are needed for closing the investment gap.

While this reform would certainly allow for sufficient public investment, it must ensure debt sustainability at the same time. It is therefore crucial that the decision of which type of public investments can be excluded from the fiscal rules is subject to democratic oversight. This can be ensured using a robust and universally binding framework that sets out the exact conditions for the exemptions. To unleash the full potential of green investments, it is important to broaden the definition of public investment and include key support expenditures in this classification. These are public expenditures needed to enable a green and just transition, such as retraining of workers in emissions-intense industries, affordable prices for the usage of trains or subsidies for refurbishments for buildings. One option[14] for implementing such a process entails the following steps:

1) Member States submit National Reform and Investment Plans (NRIP) that integrate the European Semester's economic reforms and fiscal plans. The NRIPs set out how Member States align with country-specific debt pathways, challenges, and priorities. They list the investments to be excluded from the fiscal rules. To ensure that the plan outlines significant reforms while taking debt sustainability analyses and macroeconomic forecasts into account, national stakeholders, specifically Independent Fiscal Institutions, shall be consulted.

2) Using a commonly-agreed methodology and the Do No Significant Harm (DNSH) principle, the European Commission assesses the compliance of the NRIPs with country-specific challenges identified in the context of the European Semester.

3) Following a recommendation from the Commission, the Council endorses or rejects the NRIP and the related exclusion.

- *How this proposal ensures long-term sustainability of public finances while allowing for short-term stabilisation*

In the short term, increased levels of investment will help stabilise the economy, for example by providing employment. In the medium- to long-term, the reform will accelerate the green and just transition while building resilient economies and societies. The application of the DNSH principle in the assessment of the NRIPs particularly guarantees the sustainability of public finances. This is because the DNSH principle addresses climate-related fiscal risks and helps protect public finance from facing structural pressures due to extreme weather events and other consequences of climate change.

- *How it simplifies the EU economic governance framework*

This reform proposal contributes to the simplification of the surveillance and coordination of holistic policy goals under the European Semester. Member States shall submit NRIPs to get confirmation for exemptions for green and social investments. To achieve a significant simplification of the current process, the NRIPs shall integrate and streamline other reform and fiscal plans, such as the National Reform Plans, Stability and Convergence Programmes and Draft Budgetary Plans as well as the report on the implementation progress of the NRRPs that EU governments need to submit in the Semester process.

- *How the transparency of the implementation of the economic governance framework is improved*

This reform proposal increases the transparency of the implementation of the EU economic governance framework since the NRIPs would be created in collaboration with national stakeholders (e.g., Independent Fiscal Institutions and Civil Society Organisations) and publishing would be made mandatory. Transparency will also be ensured during the assessment process of the Commission as well as during the endorsement process of the Council.

- *How this proposal incentivises Member States to undertake important reforms and investments*

By excluding investments and important complementary spending from the fiscal rules, this reform proposal would strongly incentivise the Member States to undertake key reforms and investments needed to help tackle the environmental, social, and economic challenges of today and tomorrow.

- *How this proposal draws on lessons from the RRF*

Since the concept of NRIPs and their assessment and approval by the Commission and the Council resembles the RRF process, many lessons learned from the RRF apply to this proposal. Both the taxonomy regulation and the DNSH principle can be used for assessing the NRIPs and deciding about the exclusion of public investments from the fiscal rules. While there is room for improvement for the taxonomy and the DNSH principle[15], the RRF provides a solid foundation to build upon. The RRF process has demonstrated that consistency in economic and fiscal policy increases, national ownership is strengthened, and a comprehensive involvement of the national Parliaments and stakeholders is possible[16].

- *How it ensures effective enforcement of the EU fiscal rules*

This reform proposal would give the Commission a huge lever in terms of effective enforcement because the approval of NRIPs could be made dependent on compliance with the fiscal rules. This would allow effective enforcement of any rule within the EU economic governance framework. For example, Member States that do not comply with the expenditure rule could be sanctioned with the rejection of their NRIPs.

Given all these benefits, the discussed exemptions for green public investments from the fiscal rules are an essential element of a feasible and impactful reform of the EU economic governance framework. Although it allows much-needed fiscal flexibility for a green and just transition of the EU, it does not require a treaty change but only a Special Legislative Procedure.

Expenditure rule

A reform of the fiscal rules must not only give Member States room for investments to close funding gaps, but also ensure that Member States have sufficient flexibility for important spending. The COVID-19 pandemic has revealed the consequences of underfunded health care systems due to massive cuts in social spending in some EU countries after the financial crisis[17]. It is thus essential to learn the lessons from the past for a healthy, inclusive, and sustainable recovery from the pandemic by allowing for sufficient spending for building resilience and ensuring the wellbeing of people. An expenditure rule would serve this purpose while ensuring stability and financial sustainability by limiting nominal public expenditure to country-specific fiscal targets. These fiscal targets should be set on the basis of the Member States' respective potential estimates of output growth.

The expenditure rule could be designed in a way that it complements our preceding proposal to exempt green public investments from the fiscal rules[18]. The expenditure rule serves as a main operational budgetary target which leads to a cyclically-adjusted medium-term public debt level target. Thus, nominal expenditures do not grow faster than medium-term nominal potential output and grow slower in countries with excessive debt levels to ensure debt sustainability. In other words, it limits the growth of non-investment government expenditures in line with potential output growth. By decoupling government expenditures from actual output (as in the 3% deficit rule) and coupling it to potential output, a procyclical fiscal policy design is prevented. Instead, its countercyclical design allows for higher deficits in times of recession (e.g., for automatic stabilisers) to prevent expenditure cuts which could lead to austerity. In times of high economic expansion on the other hand, it limits expenditures to a level below revenues, also to prevent possible inflationary pressures. Moreover, the expenditure rule replaces the debt reduction benchmark in the corrective arm of the SGP. This allows for longer and country-specific expenditure pathways and moves away from the one-size-fits-all approach of the current fiscal framework.

- *How this proposal ensures long-term sustainability of public finances while allowing for short-term stabilisation*

Due to its anti-cyclical nature, this expenditure rule allows for short-term stabilisation without the requirement of spending cuts during recessions. These have led in the past to a further downturn in economic activity and in some cases to higher debt levels in the long-term[19]. Regarding the replacement of the debt reduction benchmark, a recent study by the European Fiscal Board (EFB) has shown that there is no evidence that longer debt adjustment paths affect the medium- to long-term sustainability of public debt. The expenditure rule leaves the Excessive Deficit Procedure (EDP) in place. However, as long as the expenditure rule obliges Member States with debt levels above 60% of GDP to ensure a reasonable reduction of their current debt levels, this would not be triggered. This plays a crucial role not only for short-term stabilisation, but also ensures medium- to long-term debt sustainability and is in line with the provisions of the TFEU[20].

- *How it simplifies the EU economic governance framework*

The expenditure rule contributes to a significant simplification of the current framework, as it is only measured by one benchmark for structural expenditure development.

- *How the transparency of the implementation of the economic governance framework is improved*

Currently, public finances are assessed through structural deficits based on unobservable output gaps. These are often revised afterward due to developments in the business cycles and do not quite reflect the economic reality in many, especially economically struggling, Member States. The expenditure rule enhances transparency and makes the monitoring easier compared to the current rules on structural deficits because nominal government expenditures and their growth rates are observable and, in most cases, directly controlled by the government. Furthermore, it is less prone to errors because it is limited by medium-term potential growth rather than potential output, i.e., the oftentimes criticised output gaps[21].

- *How it ensures effective enforcement of the EU fiscal rules*

Effective enforcement would be ensured by leaving the EDP in place. This prevents countries from overshooting their intended expenditure path and thus running the risk of leaving their respective debt adjustment path. In this way, debt sustainability is guaranteed in the medium to long term. Effective enforcement can also be ensured by withdrawing the exemptions of green investment for Member States that do not comply with the expenditure rule.

Given its anti-cyclical nature, as well as its simplified approach to government expenditure compared to the assessment of structural deficits, this expenditure rule combined with additional exemptions of green public investments, secures both short-term stabilisation in times of crisis and long-term debt-sustainability.

Permanent central fiscal capacity

Building on the success of NextGenerationEU and the RRF, the two proposals presented above could be complemented by a permanent central fiscal capacity on the EU level. In this scenario, certain public investments of Member States are financed by the EU budget and common debt. The allocation of funds to the Member States is then based on the NRIPs, following the example of the RRF. The Member States submit NRIPs and after assessment and endorsement by the Commission and the Council, the approved public investments are divided into two parts: One part is funded through the permanent central fiscal capacity. The other part is financed by the individual Member States, making use of the exemption for key investments for the green and just transition from the fiscal rules. The establishment of such a permanent central fiscal capacity fills multiple gaps in the current framework.

Firstly, many of today's challenges, such as biodiversity loss or climate change, are cross-border problems that cannot be solved at a national level, or with a short-term solution. Therefore, joint action and thus also a centralisation of fiscal capacities with permanent funds is one of the most efficient solutions to address those challenges that affect Member States equally.

Secondly, a permanent central fiscal capacity supports cohesion by aligning national fiscal policies with the needs of the entire euro area. Member States that lack the risk-absorbing capacities needed in crises are supported by other Member States to enable targeted support for Member States that have the highest and most urgent investment needs.

Next, it also increases efficiency for the EU fiscal policy as the reforms with the highest return on investments, not just in monetary terms but also in terms of other aspects like emissions reductions or generated employment, get immediate support. Since the majority of benefits from the reforms accrue not just on a national level, but at a European or global level (e.g., reduced greenhouse gas emissions), a permanent central fiscal capacity has benefits for all Member States.

We recommend that the permanent fiscal capacity is composed of a loans-and-grants component, as in the NextGenerationEU's RRF, which could form the basis for a such a long-term fund. Thanks to the EU's high credit rating, the Commission can borrow on advantageous conditions. As such, Member States with a lower credit rating would benefit from the loans that are financed through the European Commission's common borrowing.

The realisation of the fund would be enabled by the natural disaster clause, through which the Council "may grant Union financial assistance to the Member States concerned" as a response to "natural disasters or exceptional occurrences beyond the Member States' control" (see TFEU, Article 122).

- *How this proposal ensures long-term sustainability of public finances while allowing for short-term stabilisation*

A permanent fiscal capacity at the EU level helps to avoid a mismatch between the euro area's needs in times of crisis and the fiscal policies of Member States. The escape clauses make it possible to pursue a counter-cyclical fiscal policy in times of crisis. However, some countries lack the risk-absorbing capacity to implement them. A common fund is supportive in this respect. For countries with better fiscal capacity, the fund facilitates countercyclical policies. A rigorous application of the DNSH principle further strengthens sustainability.

- *How the transparency of the implementation of the economic governance framework is improved*

The Conference on the Future of Europe can serve as an occasion for the establishment of such a fund. Member States should be encouraged to develop concepts for cross-border projects that promote a just and green transition developed in a co-creative process with citizens and key stakeholders. Following the model of the RRF, implementation should then be monitored to enhance transparency throughout the process. The existing indicators for reporting on the implementation progress of the NRRPs can be used for this purpose.

- *How this proposal incentivises Member States to make important reforms and investments*

A common fiscal capacity drives precisely those much-needed investments that are central to the just and green transition where there is a lack of political interest or financial capability from individual Member States for implementation. This applies, for example, to biodiversity protection and the development of a high-speed rail network connecting the whole of Europe.

- *How it draws on lessons from the RRF*

The RRF process has shown that a common fiscal capacity is crucial, especially in times of crisis, to be able to act in solidarity. It is therefore not only a means of counteracting imbalances and divergences, but above all an important step towards solidarity-based European integration.

- *How it ensures effective enforcement of the EU fiscal rules*

Similar to the proposal for exempting green investments from the fiscal rules, a permanent central fiscal capacity would support effective enforcement of the EU fiscal rules by making the disbursement of grants and loans conditional on compliance with the fiscal rules and on the fulfilment of targets set out in the NRIPs.

- *How the euro area dimension is considered and how it accelerates the agenda towards deepening the Economic and Monetary Union*

Establishing a permanent central fiscal capacity means creating EU safe assets. Their high rating, the guarantees by Member States and purchases by the European Central Bank (ECB) strengthen the international role of the euro.

In general, a permanent central fiscal capacity marks not just an important step towards solidarity-based European integration, but also increases the efficiency of the EU fiscal policy by prioritising and enabling the most urgent investments.

Conclusion

To successfully implement the green and just transition in the EU, it is not sufficient to only reform the preventive arm of the SGP. An impactful reform must generate fiscal flexibility for investments and spending for countries in both the preventive and the corrective arm. This can be achieved without a treaty change by implementing three complementary reforms: an expenditure rule, exemptions for green investments, and a permanent central fiscal capacity. These reforms enable Member States to address the key challenges of the times while ensuring stability and the sustainability of public finances. Moreover, these reforms have the potential to unlock several benefits for the economic governance framework of the EU, such as a simplification of the current rules, enhanced transparency, effective enforcement and to provide incentives for reforms and investments for the long term.

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