BRIEFING

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Thematic Digest on EU Economic Governance Review

This document presents the summaries of some papers in the area of EU economic governance, recently published by the European Parliament upon a request of the Economic and Monetary Committee (ECON).

The thematic papers presented in this digest provides hopefully information and suggestions which will be useful for the on-going debate among policy makers, namely on the review of the EU legal framework for economic governance. They are written by external experts and supervised by the Economic Governance Support Unit.

The papers deal with following subjects:

- The **role of 'green public investment' in the EU fiscal rules**. Papers written by the following authors: *C. Cottarelli*; *A. Pekanov and M. Schratzenstaller*; and *P. van den Noord*.
- The **review of the Stability and Growth Pact**, notably the role of expenditure benchmarks and public investments. Papers written by the following authors: *D. Gros and M. Jahn*; *W. H. Reuter*; and *Z. Darvas and J. Anderson*.
- The **review of the Macroeconomic Imbalances Procedure**, notably lessons learned of its application. Papers written by the following authors: *A. Bénassy-Quéré and G. Wolff, L. Codogno;* and *A. Kriwoluzky and M. Rieth*.

The hyperlink on the PE number of the papers listed in this document takes to the published version. All papers are also available on the ECON homepage.

The *Economic Governance Support Unit* provides expertise in view of supporting the European Parliament and its relevant committees and bodies, notably in their scrutiny-related activities on economic governance and banking union. EGOV is part of the Directorate-General for Internal Policies of the Union (DG IPOL).

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PE 651.364

The role of fiscal rules in relation with the green economy

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This paper discusses the analytical basis for facilitating green public investment under the SGP. It concludes that additional public debt created by deficit-financed green public investment is likely to increase fiscal sustainability risks. However, such additional risks could be justified to avoid the economic damages (which would also have long run consequences for public finances) arising in the absence of sufficient green public investment. The trade off could be improved if green public investment were financed through EU debt.

The paper discusses the analytical basis for facilitating green public investment under the Stability and Growth Pact (SGP) fiscal rules. As a starting point, the author defines *green public investment* as public investment in the areas considered to be "green" in the "taxonomy" included in the final report of the EU Technical Expert Group on Sustainable Finance where *investment* includes other forms of public spending that have favorable environmental effects (including some current spending).

The author addresses green public investment from the perspective of whether the SGP rules should be relaxed to allow deficit-financed green public investment. He argues that while the theoretical case could be allow to exclude green public investment from the SGP ceilings, there is no evidence that green public investment that is financed by issuing public debt involves lower costs in terms of roll over risks and of potential growth rates with respect to other priority forms of public spending. As such, the rationale for a "preferential treatment" of green public investiment is to be found elsewhere. The author points to the "newness" of the global warming challenge, where the costs arising from global warming are an additional factor that may justify accepting a higher degree of risk arising from public debt and fiscal deficits.

The author then focuses on the possible options allowing a different treatment of green public investment under the SGP rules. He suggests consideration of:

(a) relaxing the overall fiscal deficit ceilings;

(b) introducing a specific flexibility clause allowing more green public investment, up to a certain level;

(c) tightening existing ceilings, while allowing them to be exceeded as a result of green public investment;

(d) the possibility of a temporary flexibility clause allowing additional deficit and debt for a limited number of years, so as to allow a "green public capital stock" to be built; and

(e) financing and approving more green public investment at the European Union budget level (in line with the Next Generation EU).

A number of additional considerations relating to needed adjustments in the Medium Term Objectives (MTOs), and the pace of convergence towards the MTos, the expenditure benchmark and the public debt ceiling, are discussed as well. The author advises involving external experts in decisions excluding certain investment projects from the fiscal ceilings, namely by the Expert Group that prepared the taxonomy.

PE 614.524

The role of fiscal rules in relation with the green economy

Authors: Atanas Pekanov and Margit Schratzenstaller

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This study argues that to achieve the necessary green transition in the EU, additional public investment by Member States will need to be mobilised throughout the next decade. In light of the macroeconomic environment of very low interest rates, this calls for a reform of the EU fiscal framework. The paper discusses three approaches for a reform of the fiscal rules to better reflect the need for higher (debt-financed) green public investment: (1) an exemption clause for green public investment; (2) the implementation of a green golden rule; (3) a country-specific benchmark share of government expenditures dedicated to green public investment recommended by the European Commission.

The European Union has set high on its policy agenda the goal of transforming the EU economy in an environmentally sustainable way. In light of the substantial resources required to finance the necessary green transition, private investments need to be re-directed accordingly, and additional public investments by Member States will need to be mobilised throughout the next decade. The current fiscal framework of the European Union, the Stability and Growth Pact (SGP), does not provide enough flexibility for Member States to react adequately to these challenges by increasing debt-financed green public investment (GPI). Public investments are often very pro-cyclical – they are reduced during economic downturns, and are therefore susceptible to short-run fluctuations, making it difficult to bind them to long-term goals such as combating climate change.

The study comes up with the following key recommendations:

1. Additional green public investment at the Member State level, at least partially debt-financed, will be needed to address the climate emergency as a central priority for the current EU political cycle. The fiscal framework will need to be reformed to better accommodate green public investment to achieve this goal.

2. Three different approaches to amend the current fiscal framework to better address climate challenges and ensure the necessary green public investment offer themselves:

• expansion of the investment clause in the Stability and Growth Pact to include green public investment

• introduction of a “green golden investment rule”

• a benchmark for green public investment amounting to a pre-determined share of the government expenditures.

3. At least one of these approaches should be followed through to enable the flexibility of national budgets to ensure a level of green public investment which – together with private resources – is sufficient to close the existing green investment gaps.

4. Implementation could be top down via the European Semester or bottom up within Member States’ Resilience and Recovery Programs prepared to receive funds from the COVID-19 EU Recovery Instrument. A balanced approach between the two implementation strategies should be pursued.

5. A green taxonomy specifying areas and projects for green public investment should be elaborated as the basis for such a coordinated approach.

PE 651.382

The role of fiscal rules in relation with the green economy - A new start after the outbreak

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According to this study the fiscal framework in principle provides sufficient flexibility to accommodate the call on government budgets from the European Green Deal – even in the very challenging fiscal landscape that is currently unfolding. However, it also observes that for this to hold in practice a number of conditions must be met, including a strong design of policies, a careful assessment of their budgetary impact and the integration of the relevant governance processes.

Against the backdrop of the European Green Deal (which calls for reviewing the EU Fiscal governance rules) and the dramatic fiscal impacts of the COVID crisis, the study examines how the fiscal framework could facilitate the ambitious plans for green investment stemming from the European Green Deal while securing sustainable public finances. It looks into three strands of practical issues:

- The repercussions of green investment for government budgets, deficits and debt;
- The flexibility in the fiscal rules available to accommodate these repercussions; and
- The implications for fiscal governance – including coordination, surveillance and enforcement.

The authors' overarching conclusion is that, in principle, sufficient flexibility is available in the current fiscal framework to accommodate the call on government budgets from the European Green Deal – even in the very challenging fiscal landscape currently unfolding. However, to that end, the following conditions must be met:

- The emphasis of fiscal action should be as much as possible on loans, equity injections and guarantees, as opposed to grants and subsidies;
- The "leverage" of the amount and quality of green investment triggered by government support required to achieve the climate goals needs to be maximised to keep the need for a socially costly tax increase and spending cuts as small as possible;
- The plans developed under the European Green Deal as laid down in the National Energy and Climate Plans (NECPs) should specify to what extent programmes are vetted for EU co-funding, indicate what part of the plans would be funded by the national governments and where these would appear in the general government account. Such NECPs should be better reconciled with the Stability and Convergence Programmes;
- These repercussions ultimately should feed into the country-specific Medium-Term Budgetary Objectives (MTOs), consistent with the requirement of sustainable debt and the clauses allowing temporary deviations from (the adjustment path towards the) MTO to finance investment should be invoked to frontload green public investment.

The author argues that since sustainable public finances can never be achieved when climate risks undermine economic activity these need not be conflicting objectives. However, fiscal resources to green the economy unavoidably compete for scarce resources with other legitimate policy goals, now and in the future, and therefore should be employed cautiously. Insofar as the planned green investment effort pursuant to the European Green Deal involves government budgets, the EU fiscal framework is more relevant than ever.

PE 614.523	***Benefits and drawbacks of an "expenditure rule", as well as of a "golden rule", in the EU fiscal framework*** **Authors: Daniel Gros and Marvin Jahn** **Contact persons in European Parliament:** **Jost Angerer and Alice Zoppè (EGOV)**
	In the current crisis, all fiscal rules have been suspended. When the economy recovers, both expenditure and structural balance rules will be more difficult to apply, as both the level and growth of potential output will become even more uncertain. Focussing on reducing high debt levels might at that point be more appropriate. *The economic argument for a golden rule is that debt can be used to finance the creation of public capital. But this implies that any golden rule should only exempt net investment, which is much lower than the gross investment.*

Literature shows that uncertainty about both the level and growth of potential output constitutes the Achille's heel of structural deficit rules and the expenditure rules, respectively.

Most of the existing literature on expenditure rules assumes either explicitly or implicitly that demand shocks constitute the dominant source of uncertainty about output, implying that the medium-term growth rate of potential output is rather stable. But this might not be the case in reality. The estimates for medium term potential GDP growth of the Commission are also subject to substantial revisions, much as estimates of the structural balance. The advantages for expenditure rules over structural balance rules might thus have been limited, even before the start of the current crisis.

Since the outbreak of COVID-19, all EU and national fiscal rules have been suspended for the time being. The debate about expenditure rules and cyclically adjusted balance rules will need to be reassessed once the full impact of the current crisis is known. What can be anticipated with confidence is that the post-crisis environment will imply higher both public debt and expenditure generally, not only in the health sector. Existing expenditure rules start from a baseline under which expenditure is allowed to grow along with potential GDP (thus keeping the ratio of expenditure to GDP constant). This baseline is then adjusted downward for the need to reduce debt levels. In a post–COVID-19 environment, one might have to introduce another adjustment for an unusually high starting level of expenditure, thus complicating the application of an expenditure rule. Rules based on cyclically adjusted deficits might also become more difficult to apply, because the usual methods to measure the output gap will be affected by the current crisis as well. But expenditure rules might face a similar problem in estimating the post–COVID-19 potential growth rate.

Golden rules relating to investment usually stipulate that governments should only borrow to finance investment, not expenditure in general. The economic argument for such a rule is that the creation of public capital can be financed by debt since this capital should yield a return that can support debt service. The returns from public capital do not have to come in the form of direct revenues, such as user charges, but can also come from higher growth, which increases tax revenues. The argument that capital creation can be financed by debt is often read as implying that all investment spending should be exempted from the computation of the deficit. But, from an economic point of view, this is a misunderstanding because public capital creation, i.e. the increase of the public capital stock, must take into account the wear and tear that reduces the value of capital. This depreciation of the public capital stock is taken into account in the "net capital formation" indicator, not in the indicator of "gross fixed capital formation". For most Member States, gross fixed capital formation of general government is typically in the range of 2.5% - 3% of GDP; meanwhile, net capital formation is usually in the range of +/-0.5% of GDP. Any golden rule should thus be based on net (not gross) investment spending. The use of this indicator in the "golden rule" would provide a strong incentive for a government to undertake - at least - the maintenance expenditure needed to keep the capital stock intact. In practice, this could be achieved by deducting negative net investment from the allowable deficit.

PE 645.732

Benefits and drawbacks of an "expenditure rule", as well as of a "golden rule", in the EU fiscal framework

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Focusing the EU fiscal framework on an expenditure rule could help to increase transparency, compliance and ownership. In various other respects, like estimation errors or counter-cyclicality of prescribed fiscal policy, an expenditure rule is similar to a structural balance rule. If the EU decides to go beyond the current focus on fiscal aggregates, a two-rules system aimed at safeguarding specific expenditures could be placed at the centre of the EU fiscal framework. The key challenge is to define and measure the protected expenditures.

This paper discusses two possible avenues for reforming the EU fiscal framework: focusing the framework on an expenditure rule to reduce complexity, and introducing a golden rule to safeguard specific public expenditures. An overarching challenge when reforming the EU fiscal framework is to increase compliance with its fiscal rules: even the best-designed rules are no good if they are not complied with, or if the leeway granted by these rules is not used where it would be advisable. A more transparent, more predictable and less complex fiscal framework could make a significant contribution to enhancing compliance and the role of fiscal rules. The most important lever is to increase national governments' ownership, as well as the visibility of rules for politicians, the general public and the media. The benefits of expenditure rules are often discussed in comparison to observed fiscal policy, but not in relation to other possible rules or rule designs. As fiscal policy is often chosen not purely in line with the limits set by fiscal rules, however, analysing observed fiscal policy to evaluate the current fiscal framework might be misleading. For example, both expenditure and structural balance rules *per se* would have prescribed a more counter-cyclical fiscal policy in the EU over the past few decades. Expenditure rules are similar to structural balance rules in various respects. Like structural balance rules, they are associated with significant challenges when forecasting and estimating the variables necessary for their operationalisation. These errors are substantial and biased in the case of variables required to operationalise structural balance rules. They are smaller, although still significant, and less biased, in the case of expenditures. However, the operationalisation of expenditure rules also requires other variables, such as the measure of discretionary revenue, which involve cumbersome estimates and are associated with a high degree of uncertainty. The main advantages of expenditure rules are that the constrained variable is more directly controlled by governments, it is more transparent and the ceiling set by the rule for fiscal policy is less volatile.

This paper discusses also options of golden rule, which would allow debt issuance to finance specific expenditure categories. There is a concern that needs to be addressed first, namely that such a rule would go beyond the current focus of the EU fiscal framework on fiscal aggregates and would distinguishes between different expenditures in Member States. The main challenge when introducing a golden rule is to clearly and narrowly define the deductible expenditures. Ideally, each spending decision involves a cost-benefit analysis and a subsequent decision to engage, irrespective of the category it belongs to. One proposed workaround is to identify expenditure categories which on average exhibit certain growth effects or future benefits. This identification, however, can be very difficult in practice. Furthermore, governments need to be prevented from using 'creative accounting' to shift other expenditures into the defined deductible categories. Addressing the bias of politicians towards too low investment expenditures does not remove the bias towards excessively high deficits in general. Furthermore, long-term fiscal sustainability still implies that there is a limit to the amount of annual debt issuance, which, however, might be higher with a golden rule. This suggests that a cap should be set on the amount of expenditures that is deductible, which would result in a system of two rules: one setting a limit on total expenditures (deductible and non-deductible) and a second one setting a lower limit on the non-deductible portion of expenditures.

PE 645.733

New life for an old framework: redesigning the European Union's expenditure and golden fiscal rules

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In the context of the review of the EU economic governance framework, this study recommends a multi-year ahead expenditure rule, anchored on an appropriate public debt target, augmented with an asymmetric golden rule that provides extra fiscal space only in times of a recession. An improved governance framework should strengthen national fiscal councils and include a European fiscal council, while financial sanctions should be replaced with instruments related to surveillance, positive incentives, market discipline and increased political cost of non-compliance.

The paper presents the following findings:

- In accordance with EU law, the expenditure benchmark (EB) is subordinate to the structural balance (SB). The EB matters only when a country's SB is lower than its medium-term objective (MTO). We find that in practice the SB is always preferred over the EB.
- The Commission adopted a generally lenient approach in cases of conflict between the EB and SB criteria, in the preventive arm of the Stability and Growth Pact.
- Estimates of the structural budget balance are subject to enormous uncertainty, while uncertainty is minor in the estimates of medium-term potential growth.
- Even in 2019, EU general governments' net investment (gross investment minus the depreciation of capital stock) was just a fraction of investment in the USA and in the UK. (as a share of GDP). Some countries with low public debts invest little, which seems to be a political choice not related to fiscal rules. It is an open question whether fiscal rules or market pressure influence public investment in high-debt countries in times of fiscal consolidation.
- The usefulness of the current EU investment clause is questionable.
- The institutional framework for overseeing the rules is as important as the rules themselves.

The authors propose changing the EU fiscal framework to include the following main elements:

- Anchor: five-year ahead or seven-year ahead debt ratio change objective, to be set by a joint effort of the government of the country concerned, the national fiscal council, the European Fiscal Council and the European Commission, and be approved by the Council;
- Operational target: multi-year ahead ceilings for public expenditure corrected for discretionary unemployment expenditure, interest expenditure and discretionary revenue changes;
- Public investment: an asymmetric golden rule that excludes net public investment from the considered expenditure aggregate only in bad times, in a way to create extra fiscal space. This extra fiscal space would be gradually eliminated as the recovery strengthens.
- Current and investment budgets should be separated, and investment costs would be distributed over the entire service-life. Activation of the asymmetric golden rule should not be based on unreliable estimates of the output gap, but on the contraction of economic output, and the opinion of national and European fiscal councils and the European Commission;
- The ceiling for the operational target should be compatible with the debt ratio objective;
- Institutional framework: strengthened independent national fiscal councils with increased minimum standards and establishment of a European Fiscal Council with a structure similar to the European Central Bank's Governing Council, while the Commission remains the institution that proposes recommendations to the Council of Ministers for adoption;

Financial sanctions: to be replaced with various instruments related to surveillance, positive incentives, market discipline and increased political cost of non-compliance; and

A general escape clause: instead of the current general escape clause and the additional complex web of exceptions, a single general escape clause (possibly applied to each member state separately) could be triggered by the Council of Ministers, based on the recommendation of the Commission, which will take into account the opinions of the independent national fiscal council and the European Fiscal Council.

PE 645.725

How has the macro-economic imbalances procedure worked in practice to improve the resilience of the euro area?

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This paper assesses the effects of the implementation of the Macroeconomic Imbalance Procedure (MIP) on the macroeconomic performance of countries in the EU and the euro area, by analysing the indicators of the "MIP scoreboard" over time. The authors find that the introduction of the MIP led to a decline in current account imbalances and private sector debt and credit flows, but that the overall effects are limited. To strengthen the MIP, the authors support the introduction of the Budgetary Instrument for Convergence and Competitiveness, i.e. a fund that pays grants, conditional on the implementation progress of economic reforms.

The paper first presents the outcomes of an empirical analysis based on the 14 indicators of the MIP scoreboard. By applying a control/effect model, the authors find that the introduction of the MIP led to fewer breaches of those scoreboard thresholds that predict financial and economic crisis, namely the current account balance, and private sector debt and credit flow. As the economic literature shows that the deterioration of these indicators worsens a crisis, the authors infer that the improvement in these indicators put the countries in the EU and the euro area in better position to prevent a deep economic crisis.

Since the financial assistance during the financial and economic crisis provided to six member States was in three cases motivated by the need to recapitalise the banking sector, and in one case to assist in a balance of payment crisis, on the basis of our analysis the paper claims that parts of the financial assistance could have been avoided, should the MIP have been in place and enforced at the time.

Nevertheless, the introduction of the MIP did not lead to fewer breaches of the threshold for the majority of the headline scoreboard indicators. One reason for this can be poor compliance with the country-specific recommendations (CSRs) underpinned by the MIP.

Recently, in its "Economic Governance Review", the European Commission reported that the degree of CSR's implementation has declined in last years. In order to increase both the compliance with the CSRs and the impact of the MIP, the authors suggests that subsidies should be provided to Member States to this scope, and therefore support the introduction and the implementation of the Budgetary Instrument for Convergence and Competitiveness (BICC). The fund would pay grants to countries that meet the requirements of the country-specific recommendations, adopted by the Council. This fund would increase both the implementation and the importance of the MIP and would mitigate the potentially adverse consequences of structural reforms during the transition period.

Furthermore, the paper advocates to incorporate "green" environmental indicators into the MIP scoreboard.

PE 645.710	***How has the macro-economic imbalances procedure worked in practice to improve the resilience of the euro area?*** **Authors: A. Bénassy-Quéré and G. Wolff** **Contact persons in European Parliament:** **Alice Zoppè (EGOV)**
	This paper provides some suggestions on how the Macroeconomic Imbalances Procedure (MIP) could be streamlined and its underlying conceptual framework clarified. Implementation of the country-specific recommendations is low; their internal consistency is sometimes missing; despite past reforms, the MIP continues keeping mainly a country-by-country approach, thereby running the risk of aggravating the deflationary bias in the euro area. The authors recommend to streamline the MIP scoreboard around a few meaningful indicators, involve national macro-prudential and productivity boards, better connect the various recommendations, simplify the language and further involve the Commission into national policy discussions.

The Macroeconomic Imbalance Procedure (MIP) was introduced in 2011 as part of the 'six-pack' reform of economic governance. It aims to identify, prevent and address macroeconomic imbalances that could adversely affect economic stability in a EU country, in the euro area, or in the EU as a whole.

The empirical analysis provided in this paper shows that:

• The implementation rate of the country-specific recommendations (CSRs) has been declining over time; although imbalances have clearly receded in the euro area and in the EU over 2013-2018, there is no apparent link with the implementation of the CSRs;

• Despite past reforms, the MIP keeps still largely a country-by-country approach, thereby running the risk of contributing to a deflationary bias in the euro area;

• The MIP scoreboard could be simplified with little loss in terms of early-warning performance; some indicators need to be re-defined consistently with the objective of convergence within the euro area;

• The consistency among the CSRs and the recommendations made by the IMF and the OECD varies greatly across countries; the CSRs are less clear on the financial sector than the IMF is, and they are not always connected to the recommendations made by the ESRB;

• The CSRs sometimes lack internal consistency, especially for countries with high current accounts surplus and with respect to the connection with the recommendations to the euro area.

• National policy-makers and experts are often totally unaware of the entire European Semester process. Communication is often done in technical and administrative form – failing to trigger interest in national debates.

The authors suggest the following recommendations:

1. Streamline the scoreboard around a few meaningful indicators; check that they are geared towards intra-euro area imbalances rather than performance vis-à-vis the rest of the world.

2. In the recommendation to the euro area, include a section explaining the strategy to reduce imbalances, the contribution of each Member State being specified.

3. Focus MIP-CSRs on policy actions that can have direct impact on imbalances. Involve national macroprudential authorities and national productivity councils; coordinate the timetable of the European semester with that of ESRB's recommendations;

4. Simplify the language and further involve the Commission into national policy discussions.

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