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A proposal to reform the EU's fiscal rules

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Executive summary

- The EU's fiscal framework must be reformed. The current rules are asymmetric and pro-cyclically biased, and they lack transparency and political ownership in member states.
- The fiscal impact of the COVID crisis makes the reform unavoidable. The current macroeconomic scenario, with debt levels exceeding 100% of GDP, adds up to the already existing problems and deficiencies of the Stability and Growth Pact.
- Not reforming is not an option. It would require the Commission to strictly apply the existing rules, which could derail economic recovery, or to ignore them altogether, undermining the authority and reputation of EU institutions.
- The Commission should make a bold reform proposal and force a thorough debate at the Council in order to bring about substantial changes in the fiscal framework. We believe that there are politically acceptable reform options to improve the current framework, including the mechanisms and institutions created over the past decade, which would prevent fiscal profligacy, stimulate economic growth through reforms and ensure ownership of the process at the national level, while increasing risk sharing and control. The Commission's proposal should be considered a top priority, avoiding unnecessary delays.
- The overarching element of the reform would be a permanent central fiscal capacity, consolidating and institutionalising the Next Generation EU instrument, transformed into a new pan-European investment mechanism. It would finance EU public goods (especially green and digital investments, with considerable external effects) and would also ease the path of adjustment of member states towards a solid and sustainable fiscal position, no longer defined by arbitrary reference values (such as the 60% debt rule), but as the result of a process of analysis and permanent interaction with EU institutions.
- The aim must be to return to balanced fiscal positions. Once this is achieved, the preventive arm would be based on a simple and observable primary expenditure rule (complemented with a safeguard for highly indebted countries) which would replace other indicators such as the structural balance or the expenditure benchmark.
- The reform of the preventive arm would be complemented with a strengthening of the accountability of national Stability and Convergence Programmes and Draft Budgetary Plans, as well as with an enhancement of member states' fiscal policy assessments through a newly created European System of Independent Fiscal Institutions.
- On the corrective arm, we propose suppressing the 1/20th debt reduction rule and reforming the Excessive Deficit Procedure so that it can only be triggered by a simultaneous consideration of both debt and deficit indicators. Recommendations should concentrate on fiscal structural factors behind excessive deficits, and would not be required if the excessive deficit derives from asymmetric downturns.
- Finally, this debate should tackle other aspects of the Eurozone governance, including additional EU own resources and debt issuance. Democratic accountability must be reinforced by strengthening the European Parliament's oversight over fiscal policy and taxation, reverting the intergovernmental tide. The European Stability Mechanism and other intergovernmental bodies must be fully included into the EU treaties, institutionalising and merging the figure of a Euro Finance Minister/Vice-president of the Commission, permanent President of the Eurogroup/Ecofin, and single representative of the Euro in international forums.

Introduction

The COVID-19 pandemic unleashed an unprecedented economic crisis. Member states and EU institutions reacted swiftly to guarantee an economic safety net for citizens under confinement. The European Commission activated the escape clause of the Stability and Growth Pact (SGP, henceforth the Pact), formally allowing member states to deviate from their path towards balanced fiscal positions by enabling automatic stabilisers to operate fully while undertaking discretionary expansionary measures. The European Council provided loans to member states for employment-support schemes in the form of an instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE). The European Central Bank launched a Pandemic Emergency Purchase Programme that appeased the markets, and the Council and the Parliament approved the historic Next Generation EU (NGEU) recovery plan. The EU seems to have learnt from the mistakes made after the 2008 financial crisis, when austerity weakened social cohesion, inflicted needless economic damage and delivered lasting political volatility.

The current policy reaction to the COVID-19 outbreak, however, is not just an attempt to avoid previous mistakes. The macroeconomic scenario is radically different: if the 1990s were the years of the Great Moderation –characterised by low inflation, moderate interest rates, sustained economic growth and macroeconomic stability– the decade following the Great Recession stands out by deflationary risks, very low or even negative interest rates, and stagnant growth –so-called 'secular stagnation'–.[1] Whereas under the first scenario it was relatively easy to keep debt and deficit levels in line with the Maastricht criteria, a low-growth context makes it much more difficult to conduct budgetary policies under a one-size-fits-all fiscal framework.

Exceptional measures to fight the pandemic and mitigate its economic impact have made public deficit and debt levels soar. In the first quarter of 2021 the Euro area public debt exceeded 100% of GDP for the first time in its history (14 percentage points more than the previous year). This has stirred up the need for an overhaul of the EU's fiscal architecture, understood both as the capacity for fiscal coordination at the European level and as a set of rules and guidelines.[2] A return to the current Pact does not seem realistic. However, if no agreement is reached for the reform of the existing fiscal architecture, from 2023 onwards the EU will face a self-defeating dilemma: either re-impose austerity to comply with the existing rules and derail economic recovery, or ignore them altogether, thus undermining EU institutions, including the rule of law.

Resolving this impasse will dominate policy discussions between EU Finance Ministers throughout 2022. While we join an ongoing conversation, we seek to reinvigorate this debate, especially in Spain, and to participate in the public consultation recently launched

1 On this subject, see B. Bernanke (2004), 'The Great Moderation', Remarks at the meeting of the Eastern Economic Association; R. Lukasz & L. Summers (2019), 'On secular stagnation in the industrialised world', Brooking Papers on Economic Activity, The Brookings Institution.

2 F. Steinberg (2021), 'La nueva realidad de la política fiscal y sus implicaciones para España', ARI, Real Instituto Elcano.

by the European Commission.[3] To this end, we propose a series of reforms of the EU's fiscal rules, which include:

- Deploying a permanent EU fiscal capacity by consolidating and institutionalising NGEU (as a discretionary investment tool) to help member states reach a sound fiscal position that would be defined not by specific and arbitrary measures of deficit and debt, but by a permanent discussion with EU institutions.
- A preventive arm based on a clear and observable primary expenditure rule, which should be the objective and the permanent benchmark once the fiscal balanced position of a Member State has been reached. This rule could be complemented with a safeguard for highly indebted countries and would replace other indicators such as the structural balance or the expenditure benchmark.
- A reinforcement of the accountability of annual Draft Budgetary Plans and Stability and Convergence Programmes, enhancing the dialogue between national authorities and the Commission.
- The creation of a European System of Independent Fiscal Institutions, composed by the Commission, the European Stability Mechanism and independent fiscal institutions to help assess member states' fiscal policies.
- A reform of the Excessive Deficit Procedure so it can only be triggered by simultaneous consideration of both debt and deficit indicators, suppressing the 1/20th debt reduction rule.
- Recommendations to correct excessive deficits by concentrating on fiscal structural factors –especially permanent components of the budget– but not required in the case of excessive deficits resulting from asymmetric downturns (as the common fiscal capacity should help member states to regain sound fiscal positions).
- A governance and ownership framework based on a simple idea: democratic fiscal oversight and control needs to occur at the level decisions are taken. At the national level, national parliaments need to make sure that the government adheres to the simple expenditure rule. At the European level, the European Parliament needs to control that the central fiscal capacity obtains the necessary own resources and that the central money covers the public investment gaps and fosters the needed reforms in member states.

3 For previous proposals, see O. Blanchard *et al.* (2021), 'Redesigning EU fiscal rules: from rules to standards', Working Paper, nr 21/1, Peterson Institute for International Economics; M. Buti & M. Messori (2021), 'The search for a congruent Euro area policy mix: vertical coordination matters', VoxEU.org; P. De Grauwe (2021), 'Euro Area fiscal policies and capacity in post-pandemic times', European Parliament; European Fiscal Board (2021), 'Annual Report'; O. Francová *et al.* (2021), "EU fiscal rules: reform considerations', Discussion Paper Series, nr 1/7, European Stability Mechanism; Á. Ubide (2021), 'An all-weather economic policy framework for the Euro area', VoxEU.org.

1 The need for a permanent fiscal capacity

Although there is broad consensus that the Pact has become too complex and lacks transparency and predictability, member states at the Council are divided when it comes to specific options of reform and the trade-offs they entail (see Box 1). While any reform should be based on a broad and balanced agreement, there must be a wide consensus that a no-reform scenario is too risky.

Despite political constraints, it is also important to acknowledge that the macroeconomic scenario after the pandemic and the broader geopolitical framework have opened up a window of opportunity for reform. The NGEU mechanism will be a good test case to analyse whether fiscal support from the EU is accompanied by the necessary structural reforms. Moreover, the consensus on debt sustainability and the role of fiscal and monetary policies has dramatically changed in the last decade, together with the need to fight climate change, promote digitalisation and achieve strategic autonomy.

Box 1. Trade-offs in the reform of the EU's fiscal rules

- Simple vs fair rules. Simple rules may lead to unfair treatment, but fair treatment may result in high complexity. Flexibility clauses, for instance, wanted to take into account country-specific situations, but derived in far too complex compliance assessments.

- Flexible rules vs equal treatment. Flexibility may cause rules to be implemented in an inconsistent manner (or to apply different rules to member states in a similar situation). Equal treatment, on the other hand, may lead to one-size-fits-all solutions with inconsistent effects.

- Stabilisation vs sustainability. If a Member State's fiscal accounts are unbalanced, its sustainability may require fiscal consolidation. But this might jeopardise the stabilising role of fiscal policy.

- National vs Eurozone fiscal stances. A fiscal stance for the Eurozone (or for a few member states) may not be consistent with rules for specific members. At the same time, a Eurozone fiscal stance is key for macroeconomic stability.

- Fiscal discipline vs political cycle. Times are rarely good enough to make fiscal consolidation to build fiscal buffers politically acceptable.

- Solidarity vs responsibility. Some member states consider that structural reforms can only be acceptable with accompanying financing. Others, in turn, consider that structural reforms are good for the country and therefore should be carried out regardless of the availability of common funds.

- Risk sharing vs risk reduction. On the one hand, the fear of risk sharing deriving into a union of transfers discourages fiscal integration. On the other hand, without an adequate system of risk sharing, contagion risks increase.

- National vs suprational democratic oversight. In the absence of a European demos, some believe that democratic budgetary control needs to be execised by national parliaments. Others consider that an intergovernmental arrangement is problematic.

Although the pandemic has caused a global shock, its economic effects have been asymmetric, revealing the need not only to coordinate fiscal and monetary policies, but also to go beyond the horizontal fiscal coordination represented by the Pact. Some member states were caught in the middle of necessary but painful fiscal consolidation processes and entered the pandemic-induced downturn in a vulnerable fiscal position.

There is a need for a central fiscal capacity that allows countries to cope with severe economic downturns, support national public investment during the adjustment towards sound fiscal positions, and ensure the appropriate fiscal stance for the Euro area and efficient coordination with monetary policy when needed. The consolidation of the NGEU mechanism would make sure that public investment (key for the energy and digital transition, long-term growth and therefore debt sustainability) is no longer the main victim of fiscal adjustment. Moreover, the consolidation of the SURE mechanism could also be considered to provide an adequate automatic stabiliser for the Eurozone. While the NGEU should focus on productive investment, SURE would help finance unemployment benefits in bad times –provided that structural reforms are implemented to reduce long-term unemployment, enhance human capital and promote flexicurity in labour markets–.

Although creating a permanent fiscal capacity seems at first sight difficult to agree upon at the political level, we believe that agreeing on European public goods and levels of conditionality can eventually become easier than defining a complex taxonomy of 'green' and 'digital' investments to be included in a 'golden rule'.[4] If EU fiscal rules must be simple and not arbitrary, a golden rule based on the purpose of expenditure will hardly meet these requirements. The problems of defining 'structural deficit' would be replaced by the inconvenience of defining 'green' and 'digital' in another cumbersome vademecum. Therefore, not only would a permanent fiscal capacity be advisable from a theoretical point of view, but it could also be more practical.

The permanent fiscal capacity of the Euro area at the institutional level would be subject to strict budgetary conditionality, providing the right incentives for vulnerable countries to undertake structural reforms and reduce the gap between permanent expenditures and revenues, which are hardly politically sustainable otherwise. Financial support might be one of the best ways to enhance ownership of such reforms. Conditionality would be designed and decided by both the Commission and member states and ratified by the Parliament and the Council with the additional aim of providing the right incentives for vulnerable countries to undertake structural reforms. Co-decision making and financial support will contribute to enhance ownership of the reform process. This central fiscal capacity should be part of

4 For a discussion on the introduction of a 'Green Golden Rule' see Z. Darvas & G.B. Wolff (2021), 'A green fiscal pact: climate investment in times of budget consolidation', Policy Contribution, Bruegel.

the Multiannual Financial Framework from 2027 onwards so that the Parliament has co-decision powers.

The permanent fiscal capacity, which would issue debt and obtain revenues from the EU's own resources, would play a countercyclical role in bad times for the Euro area as a whole. It would complement national automatic stabilisers and support investment in highly indebted member states. Following the example of Next Generation EU, priority should be given to green and digital investments, due to their important external effects and key roles for the future of the EU as a whole.

2 Reforming the preventive arm

Member states should keep sound budgetary positions for three main reasons: (a) to preserve the stabilisation role of fiscal policy so that it operates automatically in normal times and has a discretionary margin in extraordinary times; (b) to avoid fiscal dominance (therefore preserving the independence of the European Central Bank);[5] and (c) to ensure sustainability, a necessary condition for stabilisation. By reducing vulnerabilities, addressing fiscal structural weaknesses and applying basic preventive rules, member states can have room to finance automatic stabilisers and maintain investment levels during normal recessions.

In the preventive arm of the Pact, a balanced fiscal position is currently defined at the Member-State level by the Medium-Term Budgetary Objectives (MTOs), which are set in terms of the structural balance and are country-specific. The structural balance excludes the cyclical component and one-off policy measures. For countries with structural balances below their target, an adjustment path is set on the basis of the annual improvement in the structural deficit.[6] These reference values are supplemented by an expenditure rule that also depends on potential output and the MTO.[7] Moreover, a series of flexibility rules modulate the adjustment paths according to possible structural reforms, investment needs and economic conditions. The Commission has a margin of discretion when assessing compliance with the recommended annual structural adjustment. Furthermore, the aforementioned structural components are not directly observable. They are based on estimates of the potential output as well as on elasticities measuring the sensitivity of the budget to the cycle, which are based on assumptions that might be technically questioned.[8] The multiplicity of indicators, flexibility rules and margin of discretion result in a very complex and opaque fiscal framework.

The EU requires countries to submit Stability Programmes (Convergence Programmes in the case of non-Eurozone members), which set the medium-term objective for each country and the adjustment path towards it, as well as draft budgetary plans, which spell out the measures and targets for the following year's budget before it is approved by the national parliament. An external assessment of member states' fiscal policies is carried out by independent fiscal institutions, which monitor compliance with fiscal rules, produce or endorse macroeconomic forecasts for the budget, and can advise governments on fiscal policy matters. However, the mandate, composition and resources of the independent fiscal

5 Fiscal dominance occurs when a country's high levels of public debt and deficit force the central bank to avoid the government's bankruptcy instead of concentrating on its traditional monetary policy targets such as inflation.

6 According to the structural balance rule, a country is considered compliant if the general government's structural balance is at or above the medium-term objective or if the annual improvement of the structural balance is equal or higher than 0.5% of GDP.

7 The current expenditure rule establishes a maximum net growth rate of government spending modulated by two factors: its medium-term potential economic growth rate and the deviation from its medium-term objectives. According to this rule, a country is considered compliant if the annual rate of growth of primary government expenditure, net of discretionary revenue measures and one-offs, is at or below the 10-year average of nominal potential growth rate minus the convergence margin necessary to ensure an adjustment of the structural balance consistent with the structural balance rule. Therefore, both rules are closely interlinked.

8 The cyclical component depends on the output gap, ie, the difference between actual and potential GDP, and the sensitivity of the budget balance to changes in this output gap.

institutions vary across countries, and their recommendations are not necessarily followed by the authorities.

The deficiencies of the current system call for a simplification of the rules and a restructuring of the framework. Regarding the simplification of the rules, most proposals go in the direction of keeping a single expenditure rule and a sustainability rule in the form of a long-term debt anchor. We make the following reform proposals:

(a) The 60% of GDP debt level should stop being an absolute reference value for sustainability. There are no magic figures and, in the case of debt, neither the threshold of 60% nor that of 100% guarantee sustainability. The sustainability analysis should be carried out through a mechanism of permanent dialogue between the EU institutions and member states. Hence, we endorse the European Fiscal Board's recommendation to develop country-specific paths for debt reduction.[9]

(b) The path of adjustment of member states towards a sound fiscal position should be backed by the permanent fiscal capacity, which would provide support for public investment during the process. It could also ensure an adequate fiscal stance for the Euro area as a whole.

(c) Once the fiscal balanced position is achieved, the preventive arm would be based on a clear and simple expenditure rule (a directly observable variable). A Euro-for-Euro rule would make sure that any permanent increase in primary current expenditures (or permanent decrease in current revenues) should be matched by an equivalent permanent increase in current revenues (and/or a permanent reduction in primary current expenditures). It would allow national automatic stabilisers to operate fully in normal downturns, and the rule could be put on hold during extraordinary economic crisis. Therefore, indicators such as the structural deficit or the expenditure benchmark would no longer be needed.[10] A safeguard could be added to reinforce sustainability, especially in highly indebted member states, to make sure that revenues cover the debt burden. This safeguard (country-specific) would require that any increase in interest payments beyond a threshold should be matched by an additional adjustment of current expenditures and/or revenues while public investment is covered by the central fiscal capacity.

(d) A reinforcement of the accountability of the stability programmes at the state level. The programmes should spell out measures ensuring public finances sustainability in the medium term. These goals should be endorsed by national parliaments and independently assessed by member states' independent fiscal institutions, then by the Commission (whose role would be reinforced for this purpose) and ultimately by the Council. Part of this assessment process should be based on an intense dialogue between the national authorities and the Commission. Countries should be accountable for

9 European Fiscal Board (2021), 'Annual Report 2021', Brussels.

10 Estimates of potential GDP (and therefore structural deficit) would still be used internally, on a national level. The difference is that their accuracy or consistency would no longer be assessed or questioned at the EU level.

the content of their adjustment plans through peer review, transparency and financial incentives linked to reforms, in line with the conditionality and resources offered by the central fiscal capacity and with the necessary oversight of the European Parliament. The combination of an investment-support mechanism and the assessment of the medium-term budgetary plans based on judgement and dialogue would make controversial golden rules redundant.

(e) The monitoring of sustainability should be strengthened by a new European System of Independent Fiscal Institutions, composed by the Commission, the independent fiscal institutions of member states and the European Stability Mechanism (once it becomes a community institution). The latter would provide necessary information and contribute to shape the discussion, but it would be ultimately up to the Commission to reach a decision.

Box 2. The preventive and corrective arms of the SGP

A basic preventive arm normally includes the following elements:

- A set of indicators of fiscal sustainability under a common definition.
- A margin of discretion to consider a non-compliant indicator as compliant under certain circumstances.
- Medium-term objectives for one or more of these indicators.
- Short-term follow-up reports that establish the path and actions required to meet the objectives.
- An external assessment by an independent institution.
- Common automatic stabilisers and a common discretionary fiscal capacity.

A basic corrective arm normally includes the following elements:

- A regulated procedure to trigger the correction mechanism.
- The starting point and rhythm of correction.
- Penalties or sanctions in case the correction is not properly carried out.

3 Reforming the corrective arm

The procedure to correct excessive deficits (set out in the secondary legislation) is adopted by the Council and includes recommendations to ensure that the correction takes place as soon as economic conditions allow. Sanctions are currently contemplated in the regulations, but they have never been applied (even after the introduction of a gradual system of sanctions in the Six Pack). They lack credibility and, consequently, have not provided the right incentives to stick to the fiscal rules.

The experience of two decades of the Pact proves two things. First, that regardless of whether recommendations for adjustment are expressed in nominal or structural terms, any excessive deficit is considered corrected –and the deficit procedure therefore abrogated– when the nominal deficit goes below the 3% reference value.[11] As a result, highly-indebted countries have usually followed 'nominalist' strategies (ie, taking advantage of the effect of automatic stabilisers on the headline deficit during the expansive phases of the cycle, without fully tackling its underlying structural causes).

Secondly, the debt criterion has never been used –perhaps rightly so–. The Commission has *de facto* considered that complying with the adjustment towards a balanced fiscal position (a flow variable) was equivalent to complying with the debt rule (a stock variable), so there was no need to open a deficit procedure on the basis of the debt rule even when the debt was not declining at a satisfactory pace –ie, when the gap between the current debt ratio and the 60% reference value is reduced by 1/20th per year–. Barring below-the-line operations and golden rules, the dynamics of the stock of debt mirrors the developments on the corresponding flow, the government balance, so that any debt-reduction path mirrors a deficit-adjustment path (in particular, a primary deficit adjustment path). In addition, debt rules are pro-cyclical in bad times (in good times, debt ratios are passively reduced by the increasing nominal GDP, while debt consolidation requires fiscal tightening in times of low growth). These two observations lead to the following reform proposals:

(a) The debt adjustment rule of 1/20th should be dropped by amending the secondary legislation that enshrines it. The excessive deficit procedure has been applied for more than two decades without the need for an unambiguous definition of when the debt ratio is approaching the reference value at a satisfactory pace.

(b) The excessive deficit procedure should be triggered only by simultaneous consideration of both debt and deficit indicators. Thus, the procedure should be opened (under *prima facie* evidence) when both the deficit and debt ratio are above their respective reference values and the latter is increasing. The procedure should be abrogated when the deficit is below the reference value and the debt ratio is decreasing. In other words,

11 The adjustment path in terms of the structural balance has been used to assess the extent to which the EDP has not been corrected in due time because the government has not taken effective action in accordance to the recommendation, in which case the procedure is stepped up and the possibility of imposing sanctions is triggered, but whatever the adjustment actually implemented the EDP is abrogated if the nominal balance is brought below the 3% reference value.

it should remain open until the government balance reaches a value consistent with a decline of the debt ratio –a value valid only for a certain country on a particular moment–.

(c) The recommendations to correct excessive deficits should concentrate on the factors behind them, especially their permanent components, which should be specifically addressed by member states in their adjustment plans. The Commission, when launching deficit procedures, should focus on possible factors resulting in permanent differences between permanent primary current expenditures and permanent current revenues. Countries should present credible measures to close possible structural gaps within a period consistent with growth conditions.

(d) No recommendation should be required if the main cause of the excessive deficit is an asymmetric economic downturn, regardless of its proportions, as the deficit should decline passively once economic conditions allow. In the meantime, the corresponding member states should allow automatic stabilisers to operate fully and adopt additional temporary measures to help stabilise its economy. The stabilisation function of the EU's fiscal capacity (see Section 2) should be triggered if adverse financial conditions do not allow member states to fund their fiscal expansion in debt markets. In any event, the deficit procedure recommendation should request the member states to revert possible temporary, anti-cyclical measures as soon as economic conditions allow.

From a legal point of view, it is worth noting that the reform of Protocol 12 (establishing the reference values of 3% and 60% of GDP for deficit and debt, respectively) does not require ratification by member states, but unanimity at the Council. This might be difficult to reach, but markedly less so than a full parliamentary ratification. Additionally, a long-lasting reform of the Protocol would probably require moving from common to country-specific and revisable reference values, something which does not seem to bode well with a Protocol in a Treaty. Therefore, unless Article 126 of the Treaty on the Functioning of the European Union (TFUE) is amended to drop the references to Protocol 12 and secondary legislation is allowed to define such reference values, it might be better to avoid the discussion on Protocol 12 and focus on the reform of the excessive deficit procedure as such.

As for sanctions, the experience of the financial assistance programmes implemented during the financial crisis and the current NGEU suggest that financial support creates much better incentives to encourage sound economic policies. Therefore, only in order to avoid a reform of the Treaty, the remit of sanctions should be left circumscribed to the spirit of paragraph 11 of Article 126 of the TFEU.[12]

12 We believe that the benefits of the permanent central fiscal capacity, available at all moments (not only on the way to a balanced position) for member states respecting the rules, together with the peer pressure and the sanctions of Article 126 TFEU, should be enough as last-resort mechanisms. Adding further sanctions –unlikely to be applied– could be counterproductive. Art. 126.11 of the TFEU states that 'As long as a Member State fails to comply with a decision taken in accordance with paragraph 9, the Council may decide to apply or, as the case may be, intensify one or more of the following measures:
- to require the Member State concerned to publish additional information, to be specified by the Council, before issuing bonds and securities,
- to invite the European Investment Bank to reconsider its lending policy towards the Member State concerned,
- to require the Member State concerned to make a non-interest-bearing deposit of an appropriate size with the Union until the excessive deficit has, in the view of the Council, been corrected,
- to impose fines of an appropriate size'.

4 Governance and ownership

In a post-pandemic context where issues of political economy –such as the societal impact of commercial, industrial and energy policies; the distribution of economic growth and income in the aftermath of the COVID crisis; or the changing balance of power between member states– will gain increased salience, the ownership and governance of the EU's new economic framework will be more important than ever. The aim should be to increase the democratic legitimacy, accountability and scrutiny of the decision-making process. To achieve this, certain reforms are unavoidable. Decisions around budgets are at the heart of sovereignty and parliamentarianism and, as multiple majorities in the European Parliament have reminded in numerous occasions, it is important that democratic scrutiny and control is enforced at the same governance level where executive decisions take place.[13]

This means that fiscal rules cannot only focus on avoiding overspending. They need to facilitate the revenue collection as well. Greater efforts should be made in tackling tax fraud, tax avoidance and evasion, as well as money laundering, to avoid tax dumping and the erosion of the member states' tax bases. For this purpose, it would be necessary to adopt a comprehensive 'passerelle clause' package that can facilitate the switch from unanimity to qualified majority voting in the Council on issues related to taxation and own resources. An agreement on the latter is all the more warranted in the context of the joint issuance of debt through NGEU and the possibility of establishing a central fiscal capacity as proposed here.

A revamped European Semester, based on the experience gained during the approval of the Recovery and Resilience Plans, should be articulated around the Commission Country Reports and the National Reform Programmes. An intense dialogue between the Commission and each Member State should identify main vulnerabilities and agree on policy action plans over the medium term. These policy actions would be endorsed by the Council in the Country Specific Recommendations. The scoreboard of the current Macroeconomic Imbalance Procedure should guide the preparation of the Country Reports and the identification of vulnerabilities. In this revamped European Semester the macroeconomic imbalance procedure, with its preventive and corrective arms, appears redundant, especially if the structural reforms are integrated with possible fiscal adjustments supported by a central fiscal capacity.

If the European Semester continues to be the main economic policy coordination framework, including the preventive and corrective arms of the Commission, it is also important to increase its parliamentary and democratic oversight at the European level. As the Committee on Economic and Monetary Affairs of the European Parliament stresses, 'according to Articles 121 and 126 of the TFEU, the European Parliament can neither scrutinise nor amend the recommendations adopted by the Council within the framework of the European Semester'.[14] This is a democratic limitation that might require a revision of the treaty. In this

13 See Margarida Marques (2021), 'Report on the review of the macroecnomic leagislative framework for a better impact on Europe's real economy and improved transparency of decision-making and democratic accountability', Committee on Economic and Monetary Affairs, European Parliament.

14 *Ibid*.

regard, it would be convenient to include the European Semester framework and the central fiscal capacity within the framework of the next Multiannual Financial Framework (MFF) so that the Parliament has democratic oversight. If this were not to be the case, it would be absolutely necessary for the decision-makers at both the Commission and even the Council level to explain their recommendations and decisions in front of national parliaments in a systematic way.

If democratic oversight is not conducted at the European level (the preferred option), it needs to be reinforced at the national level. This would certainly be necessary in the extreme cases of denying central fiscal support due to non-compliance of a Member State with the conditionality requirements of the EU's fiscal capacity.

There are also several institutions or bodies that are currently either intergovernmental or informal –like the European Stability Mechanism, the Eurogroup and the Euro Summit– that should be incorporated in the TFEU and work under the Community method to ensure the appropriate transparency and democratic control. It would also be appropriate for the Eurogroup President to become the Commissioner for Economic and Monetary affairs, one of the Vice-presidents of the Commission (hence also the chair of Ecofin) as well as the single representative of the Eurozone in international forums. He/she will effectively become the Eurozone/EU's Finance Minister.[15] This would facilitate his or her visibility (and democratic legitimacy) and foster the appropriate social and macroeconomic dialogue on fiscal matters with the different stakeholders at the European and national level, which is ultimately key to enhancing the ownership of the economic framework.

Ultimately, proper ownership requires that all member states accept that clear and credible fiscal rules are essential in the Eurozone, that ongoing structural fiscal deficits must end, and that structural reforms to increase economic growth and productivity are the best path towards debt sustainability. All member states must also accept that completing the monetary union requires more fiscal integration, and that the easiest way is to consolidate already-existing instruments (such as NGEU and SURE), and that the European Stability Mechanism should be ultimately integrated into the EU legal framework. Its functions should also be redefined in line with the completion of the banking, economic and political unions necessary for the survival of the Euro.

15 This new 'Finance Minister' would be to economic affairs of the EU what the High Representative is to Foreign and Security Policy. Therefore, the Finance Minister of the Member State holding the temporary presidency of the EU will no longer preside the Ecofin.

Annex 1. History of the preventive arm of the SGP

The origin of the preventive arm of the Stability and Growth Pact can be traced back to the Resolution of the European Council of Amsterdam on 17 June 1997, which considered that adherence to the objective of sound budgetary positions close to balance or in surplus would allow member states to deal with normal cyclical fluctuations without breaching the deficit reference value. At the time, the preventive arm consisted of Council Regulation No 1466/97 establishing the obligation to present adjustment plans which should set out the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards it.

A few years after its adoption, the adjustment plans became a procedural instrument. On many occasions they were backloaded and underachieved one year after the other. The reform of the pact in 2005 linked the medium-term objectives to public indebtedness, long-term ageing costs and major structural reforms, thus making them country specific. The medium-term objectives were defined in terms of the structural balance.

The 2011 reform introduced the expenditure benchmark as an indicator to assess compliance with the adjustment path towards the medium-term objectives, together with the change in the structural balance. The Six Pack also typified the role of independent fiscal institutions in monitoring compliance with domestic fiscal frameworks, among other things. The 2013 reform required Euro area member states to submit to the Commission and the Eurogroup adjustment plans before the adoption of the budget by national parliaments. It gave the Commission the possibility to issue a negative opinion on an adjustment plan, and to request a revision, in case of non-compliance with the Pact. In 2016, an agreement was reached between the Commission and the Council on a flexible interpretation of the Pact that would consider growth conditions, structural reforms and investments, together with debt, when setting up the annual adjustment towards the medium-term objective.

Annex 2. The Stability and Growth Pact and its corrective arm

The principle that member states shall avoid excessive government deficits is enshrined in article 126 of the TFEU. Avoiding excessive deficits is, therefore, a Treaty obligation and the Commission, as the guardian of the Treaties, must ensure compliance with article 126. According to the TFEU, such a task is carried out on the basis of two criteria: (a) whether the ratio of the deficit to GDP exceeds a reference value; and (b) whether the ratio of the debt to GDP exceeds a reference value. Such reference values were set in Protocol 12 of the TFEU at 3% of GDP for the deficit and 60% of GDP for debt.

The Pact adopted by the European Council in Amsterdam in June 1997 included Council Regulation No 1467/97, which operationalised Article 126 by defining a detailed procedure –the deficit procedure– to identify and correct excessive deficits. This regulation is the backbone of the so-called corrective arm of the Pact. Basically, once the existence of an excessive deficit had been identified in a member state, the Council had to address recommendations ensuring that the correction took place the year following its identification. In order to do that, the Council set up an adjustment path in terms of the ratio of the nominal deficit to the GDP (henceforth 'nominal deficit').

The corrective arm of the Pact has been amended on several occasions, in particular in 2005 and 2011. The first reform moved the focus from developments in nominal deficits to 'fiscal efforts', as measured by changes in structural balances, and introduced flexibility in the deadlines to correct the excessive deficits. Interestingly, the emphasis on fiscal efforts was introduced to take account of the impact of economic cycles on revenues and expenditures during the correction. The second important reform was adopted in 2011, within the framework of the Six Pack, and operationalised the debt rule by introducing a debt-reduction benchmark, according to which a debt ratio above 60% would be considered as diminishing at a satisfactory pace if the excess over the reference value was reduced by 1/20th per year.

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