Towards a progressive EMU fiscal governance

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Nacho Álvarez, *et al.*

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Abstract

The fiscal governance of the EMU is in dire need of reform. Its current arrangements suffer from several shortcomings, most notably, the limitations they impose on national fiscal policies, steering them towards too restrictive or pro-cyclical stances; the absence of an unconditional lender of last resort for governments and the consequent doubts over the 'safe asset' status of national government bonds that this absence creates; the underdevelopment of an economic (policy) union, resulting in the dominance of public deficit and debt considerations over considerations of well-being, full employment and broader economic objectives in guiding the conduct of fiscal policies; and last but not least, the fact that, under the EMU institutional architecture, there are fewer opportunities for democratic participation and scrutiny of the conduct of fiscal policies. Starting from the view that the crises in the euro zone were basically triggered by financial markets and reinforced by a lack of instruments for effective economic policy at the EMU level, we contribute to the ongoing debate on how to reform the Eurozone. We propose a focus on general principles for fiscal governance reform aiming at a better economic, social and environmental performance on the part of EMU. As the main principles for progressive governance, we identify a need for:

- a much more active and prominent role for fiscal policy;
- 'safer' government bonds;
- more and better coordination between fiscal and other economic, social and environmental policies, as well as between member states, to foster sustainable well-being; and
- more democratic participation and scrutiny.

1. Introduction

The fiscal governance of the euro zone is in dire need of reform. Spurred by the crisis and its economic, social and political impact, the debate on the adequacy of the institutional architecture of Economic and Monetary Union (EMU) has regained momentum in recent years. This includes high policy-level documents, ranging from the Van Rompuy and the Five Presidents reports in 2012 and 2015, respectively, to the European Commission's Reflection Paper on Deepening the EMU in 2017. Steps have been taken to establish a Banking Union, although crucial elements are still lacking. To direct reforms more closely in line with the vision outlined in these documents, the European Commission set out a roadmap, including some legislative proposals, in December 2017, along with some concrete proposals for a euro-zone budget as part of the next EU Multi-annual Financial Framework in May 2018.

By mid-December 2019, the European Council had only agreed on a number of minor steps to change EMU's fiscal governance. The Commission proposal to establish an embryonic euro-zone budget within the EU Budget for stabilisation to asymmetric shocks has in the meantime degenerated into an agreement to establish a budgetary instrument for convergence and competitiveness (also known as 'BICC'), lacking any features of a stabilisation mechanism. The most likely further step seems to be a 'Capital Market Union', potentially with negative side effects (Gabor and Vestergaard 2018). Some announcements by the new Commission's president, such as a 'more growth-friendly fiscal stance in the euro area', a Green Deal or a focus on the Sustainable Development Goals within the European Semester (von der Leyen 2019) go in the right direction. What is missing is a more ambitious debate about EMU fiscal governance. This paper puts forward a set of progressive reforms of EMU fiscal governance, based on two points of departure: first, our view that inappropriate fiscal policy and accelerated divergence within the euro area have been the main drivers of the poor economic and social performance observed since 2010; second, we recently witnessed a shift in the academic economics debate, with a focus on too restrictive fiscal policy (at least when monetary policy is limited by the zero lower bound; see Blanchard 2019) and too low public investment (especially in Germany; see Bardt *et al*. 2019) rather than public debt. Given the above, we believe that further changes of fiscal governance should be at the top of the new Commission's agenda and we argue what these should be.

We suggest that reform should take a progressive path, bringing on board social actors and political players at the national and European levels. In this paper, we focus on general principles for fiscal governance reform aiming at a better economic, social and environmental performance in EMU. As the main principles for progressive governance, we identify a need for:

- a much more active and prominent role for fiscal policy;
- 'safer' government bonds;
- more and better coordination between fiscal and other economic, social and environmental policies, as well as between member states, to foster sustainable well-being; and
- more democratic participation and scrutiny.

2. Shortcomings of the current fiscal governance arrangements

The current fiscal governance arrangements suffer from various shortcomings, the most important of which are: the limitations they impose on national fiscal policies, with rules which often steer them towards too restrictive and pro-cyclical stances; the absence of an unconditional lender of last resort for governments and the consequent doubts over the 'safe asset' status of national government bonds that this absence creates; the underdevelopment of an economic (policy) union, resulting in the dominance of public deficit and debt considerations over considerations of well-being, full employment and broader economic objectives in guiding the conduct of fiscal policies; and last but not least, the fact that, under the EMU institutional architecture, there are fewer opportunities for democratic participation and scrutiny of the conduct of fiscal policies. In this section, we highlight these shortcomings in some detail, as they are the point of departure for our reform proposals.

In principle, fiscal policy – understood as the management of taxation and public expenditure – can serve various objectives in a market economy. It can promote social cohesion, macroeconomic and financial stability and affect the growth prospects of the economy through several functions, including the provision of public goods and services, short-run stabilisation after a shock (for example, helping the economy return to high employment levels after a fall in aggregate demand), industrial policy and the redistribution of income.

Governments cover expenditure for some of these functions by issuing debt in the form of government bonds. Government bonds play, additionally, an important role for the stability of the banking system, as they are normally considered to be 'safe' assets which banks keep in their balance sheets and use as collateral for borrowing. In nation states that issue their own currency, the 'safe' asset status of government bonds is underpinned by the national central bank acting as a lender of last resort for the government: the national central bank implicitly guarantees that there will always be a buyer for government bonds and this is usually sufficient for keeping the interest rates of government bonds relatively low. Last but not least, national governments are scrutinised for their conduct of fiscal policy by the national parliament, but also by the electorate.

The launch of the single currency and the underlying philosophy of its institutional architecture changed fiscal governance. Although fiscal policies remained mainly in the hands of national governments, rules for the conduct of

national fiscal policies, known as the Stability and Growth Pact (SGP), were put into place: they did not address 'what matters for the country as a whole going forward[,which] is the nation's balance sheet' (Stiglitz *et al*. 2018: 48), but set an upper limit for public deficits of 3 per cent of GDP and for public debts of 60 per cent of GDP, later extended by a limit of just 0.5 per cent of potential GDP for structural deficits. A 'no bail-out' clause was also adopted in the Treaty. The assumption underlying these rules was that only 'sound' fiscal policies, operationalised by the limits of the rules, could guarantee low market interest rates for government borrowing and therefore prevent negative spillovers across member states. These rules were further tightened after 2011, most notably by making operational the public debt limit, with the adoption of the six-pack, the two-pack and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (the so-called 'Fiscal Compact'). In 2015, the European Commission attempted to introduce some flexibility in implementing these rules.

In their current form, these rules have become too complex (Pisani-Ferry 2018), so their interpretation is in itself a discretionary – and very opaque – decision. An illustrative example is the case of Italy, with which the Commission reopened an Excessive Deficit Procedure in autumn 2018, based on the already completed evaluation of the budgetary outcome of the former government in 2017 to address the new government's expansionary budgetary plan for 2019, with letters, negotiations and threats, but ultimately no further steps towards serious consequences. But more important, fiscal rules have several adverse consequences:

First of all, the unnecessarily restrictive target values impede full utilisation of fiscal policy's potential for sustainable well-being. At least assuming that the public value of wealth and goods can be higher than that achieved by highly concentrated private wealth, and that it is worth spending money on objectives such as full employment and sustainability. However, EMU economic and fiscal governance seems to be guided by the idea that private solutions always maximise well-being, so national fiscal policies were to be restrained, while prioritising supply-side, liberalising structural reforms that emphasise market deregulation and competitiveness policies (intrinsically uncooperative policies). Intrinsically cooperative active demand-management policies, aimed at full employment, ceased to be a priority objective for economic policies (Rothschild 2009). Powerful 'watchdog' institutions rating parliamentary decisions such as fiscal boards or the proposed competitiveness boards (which in the end were recast as the less biased and voluntary national productivity boards) are intended to guarantee these political priorities. A clear break from this strategy is a prerequisite for improving the economic framework in Europe.

Second, they have proven to lead to pro-cyclical policies either by construction or through the inherent flaws of almost any calculation method based on cyclical adjustment (for example, Heimberger 2019). These shortcomings, while already identified and debated prior to the crisis, came into stark relief during the Great Recession years, when most member states were subjected to

the 'corrective arm' of the SGP. The coordinated fiscal consolidation that followed from implementing the fiscal rules resulted in an excessively restrictive aggregate fiscal stance in the area. Moreover, member states in which annual output contracted by 2 per cent or more were exempted from pursuing fiscal consolidation for the year in which they experienced that level of recession, but had to start reducing their budget deficits as soon as output was no longer contracting so much, even if their output was not growing. The combination of these aggregate and individual member-state policy stances resulted in pro-cyclical effects, which were counterproductive for improving the sustainability of public finances across Europe. The more flexible implementation of the rules introduced in 2015 and the stronger focus on an expenditure rule since 2017 have not been sufficient as they only apply to those countries whose deficit is already under the 3 per cent limit and – as proven recently by Italy – comply with the potentially more restrictive debt rule.

The current rules make member state governments responsible for the evolution of economic variables that are not in fact under their control. They also disregard the crucial role of public assets, including investment in infrastructure and human capital, for stimulating productivity growth, employment creation and well-being. In addition, they neglect the crucial role of discretionary fiscal policy in stabilising member countries' economies, especially in the absence of national monetary and exchange rate policies. These rules go against the principles of the 'functional finance' approach, formulated by Abba Lerner (1943), according to which economic policy should permit fiscal policy to support aggregate demand. So, when an economy suffers a negative shock and GDP decreases, fiscal policy should step in to compensate. With strict fiscal rules, however, the goal of full employment must be neglected, along with other detrimental – in terms of well-being – economic and social results. This is the case within the euro zone, where the 'rules contributed to excessive fiscal austerity during the crisis' (Darvas *et al*. 2018: 1). Finally, they have become increasingly complex and opaque. The targets included in the rules have been controversial, with no evidence that they are optimal for allowing enough space for fiscal policies to achieve their purposes (see, for example, Buiter and Grafe 2004) or that they can be sustainable in the long run.

Thus, one of the main characteristics of the current euro-zone economic policy framework is that the scope for adequate utilisation of fiscal policy has been strongly constrained at the national level, even though countries need to run more active fiscal policies because they have lost control over their interest rates and exchange rates. These constraints have been even more binding in the absence of a significant fiscal capacity at the European level.

Thirdly, the launch of the euro meant that individual member states lost their lender of last resort, as the ECB was the central bank of the euro area as a whole. Member states and the interest rates at which they could borrow became more vulnerable to financial market perceptions about the sustainability of their public debt and the 'safety' of their government bonds. Although, as experience has shown, financial market perceptions are often not rational, they can pose severe constraints and unnecessary limitations on the fiscal

space for primary expenditure of member states in distress. During the crisis, there was thus a divergence between the security of government bonds and their interest rates among member states.

A single currency, in principle, is not compatible with disparate national interest rates as this makes the transmission of monetary policy difficult. Although the ECB's quantitative easing policy has spurred interest rate convergence again and brought them down in practice, a durable solution would require that public debts, like bank deposits, become safe assets again. Nevertheless, several countries reject the most effective way of avoiding such disparities, which is an unlimited guarantee to counterparties. In particular, the German Constitutional Court forbids any guarantee not explicitly agreed by the German Parliament. A reliable unlimited guarantee is a prerequisite for the single currency, however.

Fourthly, the decision-making process for fiscal policy has shifted. De jure, fiscal and more generally economic policy in EMU is decided by the European Council. De facto, however, the Eurogroup is decisive. It is an informal meeting of national representatives with rather weak legitimacy to decide on European issues, with no formally binding obligation to make decisions and discussions public, and no possibility to hold single participants accountable. In a recent report on the workings of the Eurogroup, Transparency International EU concluded: 'even while operating as a de-facto gouvernement économique, the Eurogroup as such is not accountable to anyone' (Braun and Hübner 2019). The Eurogroup Working Group (EWG) prepares the decisions. The EWG consists of senior officials from national administrations of euro area member states, the Commission and the European Central Bank. Its work is entirely opaque; the only information available on its website concerns its President. Neither the current agenda nor decisions are available, and there is no parliamentary involvement.

In such an institutional arrangement, there is no possibility for European citizens to influence the outcomes or at least to vote for other representatives to shape the future at European level. The problem is especially pressing in cases such as Troika programmes, where the ESM board – which effectively consists of the members of the Eurogroup – can use their greater bargaining power to force a democratically much more strongly legitimised national government to accept nearly every condition they impose, regardless of whether it is in line with European legislation or not (see Fischer-Lescano 2014). Although the Eurogroup members themselves have the same national legitimacy, these processes usually hardly allow for decisions to be contested in detail by their national parliaments.

3. A critical review of current reform proposals

The shortcomings of EMU fiscal governance that the crisis laid bare triggered a still ongoing debate and several reforms and proposals. Views on lessons learned varied. One of the key differences underlying the different views on the causes of the crisis and the way forward concerns the role of the state and of financial markets. At one end of the spectrum, the crises in the euro zone were basically triggered by financial markets and reinforced by a lack of instruments for effective economic policy at the EMU level. At the other end of the spectrum, the roots of the crises lay with uncontrolled discretionary expansive fiscal policy and other forms of 'irresponsible' national economic policy interventions. The six-pack, two-pack and Fiscal Compact reforms were clearly informed by views about 'irresponsible' fiscal policies.

Beyond these, the European Commission put the main legislative proposals for fiscal governance reform on the table in December 2017 (European Commission 2017a) following the 'Five Presidents' Report' (Juncker *et al*. 2015) and the European Commission's Reflection Papers on Deepening the EMU and the Future of Europe (European Commission 2017b and 2017c). These were followed by suggestions made by economists (Bénassy-Quéré *et al*. 2018, Andor *et al*. 2018, Darvas *et al*. 2018), trade unions (DGB 2018 and ETUC 2018) and governments (especially the Meseberg declaration, see Bundesregierung 2018), most of them from Germany and France, two economies accounting for half the euro zone's GDP. The European Commission also tabled a proposal for establishing an embryonic euro-zone fiscal capacity for stabilising investment against asymmetric shocks within the next Multi-annual Financial Framework (that is, the EU Budget) for 2021–27 in May 2018. These proposals sought to address some of the shortcomings of fiscal governance identified in the previous section.

Official proposals acknowledged the need for a stronger role for fiscal policy and a more effective counter-cyclical design, focused on the establishment of a fiscal capacity or a euro-zone budget. If they were implemented sensibly, such reforms would support national fiscal policies, increase the counter-cyclicality of fiscal policy at both the national and the euro-area level and strengthen public investment. Such proposals also carry risks, however, insofar as they are usually linked to further restrictions on national fiscal policies as a precondition of their implementation. Even if a progressively interpreted fiscal capacity were successfully developed at the euro-zone level, the EU current fiscal rules would still need fundamental reform because they focus on arbitrary tar-

get values for the headline deficit and the debt-to-GDP level. Some economists (for example, EFB 2019) have also been suggesting further reinforcement of the existing fiscal rules by allowing the Commission to deprive non-compliant member states of access to structural funds and of their voting rights at the Council. It is not evident, however, that rules ought to be strengthened given the lack of economic justification.

Bénassy-Quéré *et al*. (2018) claimed to have put forward a pragmatic compromise between risk sharing – through better policy coordination and the pooling of common resources – and risk mitigation (through tougher rules and more market discipline). It is unlikely, however, that further reforms will go beyond a minimal consensus and move the EMU forward. The expected result of this is to end up with the status quo, characterised by 'an ineffective combination of complex rules, erratic market discipline and loose inter-governmental cooperation arrangements' (Andor *et al*. 2018).

One of the most dangerous reform ideas is to increase the ability of financial market actors to control member states, for example by treating government bonds as risky assets in banks' balance sheets (Andritzky *et al*. 2016). The possibility of a member state defaulting on its public debt or exiting from the euro zone would be thus explicitly introduced. This of course would further weaken member states' public finances and encourage speculation, posing the question of whether and if so, how desirable it is that financial market actors should be in charge of evaluating national fiscal policies.

Another problematic idea for fiscal governance reform concerns the introduction of a euro-area ministry of economy and finance (European Commission 2017b), which would have the power to oblige member states to modify their budget plans. Although it might improve coordination, within the current framework of fiscal policymaking, based as it is on restrictive numerical targets and contested structural reform proposals, it is more likely that it would demand inadequate economic policies for each member state analysed in isolation instead of coordinating them to maximise material well-being and full employment. Furthermore, without a broader change in the governance structure, the power to shape economic policy will remain within the ECOFIN/Eurogroup. In the current setup, transferring more power to European institutions could be dangerous, as it might weaken democratic participation possibilities and restrict national policies even further without compensation in the form of tools to enhance economic and social performance at the European level.

More democratic participation and control is addressed in the Five Presidents' Report (Juncker *et al*. 2015: 17): 'Greater responsibility and integration at EU and euro area level should go hand in hand with greater democratic accountability, legitimacy and institutional strengthening. This is both a condition for success and a natural consequence of the increasing interdependence within EMU.' The report, however, fails to address the central question of democracy, namely how citizens can shape decisions. In representative democracies, politicians representing a majority can take decisions. If they fail to address

the changes requested by majorities, they can be voted out of office. At the European level, such a mechanism is missing for economic policy-making. The problem, as stated by Begg (2018: 30), is to 'reconcile the desire for collective discipline, portrayed as being in the common interest, with national autonomy and democratic choice'. Although it is not clear whether there is a good answer, it is obvious that the current reform proposals would not change much. The Five Presidents' Report itself contains only proposals to strengthen the dialogue between institutions, for example between the Council and the Parliament, inter-parliamentary meetings and visits to national parliaments. Without further involvement in the decision-making process, however, dialogues tend to amount to little more than listening to the statements of the other party, but not taking into account their interests and concerns in decision-making. The fact that the new Commission's president recognises the 'need to move towards full co-decision power for the European Parliament' (von der Leyen 2019: 20), is at least a promising announcement.

At the time of writing, the timely completion of the Banking Union seems to have stalled, whereas the European Commission's proposal for a euro-zone stabilisation mechanism (a fiscal capacity) have been reduced to a Budgetary Instrument for Convergence and Competitiveness, which is far smaller than necessary to the point of being largely symbolic, without any stabilisation features (Eurogroup 2019). This will probably not be enough for the euro area to survive a new economic crisis or to create sufficient political support to resist populist political attacks arising from the lack of economic and social progress linked to the European integration project.

4. A progressive way forward

4.1 Principle 1: a much more active and prominent role for fiscal policy

As national fiscal policies are quantitatively still much more important than European ones, a principal objective of reform is to enable them to perform their role. A European fiscal capacity to finance public investment and more generally European common goods (such as fighting climate change), financed by common resources (such as a carbon tax and a financial transaction tax), and by issuing euro-bonds, can be supportive – as long as it is not linked to additional constraints on national public budgets.

One fundamental and economically justified reform would be to replace the SGP altogether. Policymakers should replace it with a comprehensive approach to macroeconomic policy coordination involving monetary policy, fiscal policy as well as macroprudential, income and exchange rate policies where applicable, at both the national and the EMU-wide level (see Principle 3, as well as Mathieu and Sterdyniak 2013; Hein and Truger 2017). In this case, member states would be disciplined only if their policies are detrimental to their partners. Such an approach is politically highly ambitious and therefore difficult to implement in the short run.

The scope for a much more active and prominent role for fiscal policy is threefold: (i) there should be more leeway to strengthen economic and social stabilisation, especially in times of crisis; (ii) public investment should be given preference; and (iii) structural policies should be implemented to tackle country-specific shocks.

4.1.1 More leeway to strengthen economic and social stabilisation

As the ambitious approach of replacing the SDP is not likely to be adopted in the short term, but more leeway is nevertheless needed, in this section we propose less ambitious fiscal policy reforms, drawing on proposals from Truger (2015b) and in the iAGS 2017 (Timbeau *et al*. 2016) to use the interpretational leeway of the current framework. None of these options is a sufficient solution on its own or a game changer, but all of them are potentially available and could help to increase to fiscal leeway.

Table 1 **Short-term options for more fiscal leeway in the EMU**

Goal	Measures
Cyclical stabilisation (*ex ante*)	(1) implement better methods of cyclical adjustment
	(2) use a realistic fiscal multiplier in budgetary analysis *ex ante*, especially for public investment
Cyclical stabilisation (*ex post* in crisis)	(3) increase flexibility for cyclical conditions
	(4) use exceptional powers for severe (EU-wide) downturn
	(5) use balanced-budget-multiplier
	(6) create a euro area stabilisation instrument
Strengthening public investment	(7) allow for temporary investment programmes (similar to EFSI)
	(8) interpret certain temporary investment programmes as 'structural reforms'

Source: Authors' table based on Truger (2015b).

To improve cyclical stabilisation ex ante – that is, before a crisis or excessive capacity utilisation is under way – the EU Commission's method of cyclical adjustment must be reconsidered. This would help to stabilise potential output estimates, thus enabling automatic stabilisers to work fully when the fiscal rules are applied (Mathieu and Sterdyniak 2015; Truger 2015b). Methods to achieve that (point [1] in Table 1) could include averaging several potential output estimates or calculating potential output in such a way that the decrease of investment during a recession does not have an impact on it, for example by calculating the equilibrium unemployment rate so that increases in the actual unemployment rate do not affect it in the short run. Considering the recent debate about 'nonsense output gaps' (Brooks and Basile 2019; Heimberger 2019; Tooze 2019), we should add that in general, the estimated output gap should not be seen as a reliable parameter for policy recommendations. The alternative of once again prioritising rules based on nominal gross debt or the headline deficit (for example, 'black zero' in Germany) is worse, however, so in a second-best world of too strict fiscal rules it is still better to use potential output estimates in favour of a more anticyclical fiscal policy.

In addition, by using adequate fiscal multipliers in the budgetary analysis ex ante (point [2]) we can help to develop a better estimate of the real budgetary effect of fiscal measures – doing so will help prevent growth-reducing expenditure cuts during slowdowns.

If an economy is already in recession, reference to adverse cyclical conditions might help to increase leeway even further (point [3]), although this could create the danger of a stop/go policy if cyclical conditions improve, as can be expected under a stimulus programme. Probably the most convincing way to increase member states' fiscal space in the short run would be to use the provision concerning a severe downturn in the euro area or the EU as a whole (point [4]) to justify an expansionary fiscal policy, thus allowing for a substantial European Investment Programme. The Commission has explicitly made a comparison with the 2008 European Economic Recovery Plan (European Commission 2008) to give an example of the potential use of this provision (European Commission 2015: 17). As a condition for use it 'should remain lim-

ited to exceptional, carefully circumscribed situations to minimise the risk of moral hazard' (European Commission 2015: 17).

Finally, at the national level (point [5]), if fiscal leeway is exhausted, a (partially) tax financed expenditure stimulus may kick-start the economy by exploiting the balanced-budget multiplier (Haavelmo 1945). However, another idea is to activate a euro area stabilisation instrument (point [6]) in such a case (see Buti and Carnot 2018). This could provide additional financial resources to a member state that has experienced a particularly severe shock but should probably only be for certain expenditure categories, such as investment or for spending related to unemployment.

Regarding strengthening public investment, additional net investment could be justified if it came in the form of a temporary investment programme, similar to the way the Commission interprets contributions to the EFSI (point [7]). The current exception for 'structural reforms' lacks a clear definition and the assumption that they always raise potential output and therefore public revenue in the long run is problematic. It may be possible, however, to treat an investment programme as a structural reform that temporarily allows for additional leeway of up to 0.5 per cent of GDP (point (8)). The conditionalities and limits set by the Commission and the Council in their current interpretation – co-financing of EU projects, limit of 0.5 per cent of GDP, mostly for countries in the preventive arm – certainly prevents a substantial and sustained fiscal stimulus. Even so, at least the provisions may be used for some stimulus, and political pressure may be built up to push for a more generous interpretation in application or for a more generous official reinterpretation.

If the next cyclical downturn or even crisis comes before the more comprehensive fiscal reform proposals advocated in this paper have been implemented, it will be crucial for prosperity and the survival of the euro that pragmatic steps like those presented in Table 1 are taken.

4.1.2 Safeguard public investment

As a pragmatic way to deal with public investment quite compatible with the current SGP framework, we propose a Golden Rule for public investment (see, for example, Truger 2015a) combined with a specific type of spending rule approach (see Principle 2 for our more ambitious proposal). The proposal aims at implementing the traditional public finance concept of the golden rule within the framework of the SGP, that is, excluding net public investment from both the calculation of the headline and the structural deficit, so that net public investment can be financed via deficits. Formulated as an expenditure rule, it allows us to abandon the concept of structural deficit within the SGP. The limits for nominal expenditure growth should be determined by the medium-term growth rate of real potential output plus the ECB target inflation rate of 2 per cent. Increases in permanent nominal expenditure growth above this limit – which will be necessary to tackle social and ecological challenges – are then allowed if revenues are increased simultaneously. In case of general tax cuts

– which are not recommended – however, expenditure growth rates should incorporate these withdrawals of resources, with a likely overall detrimental effect on well-being. Using medium-term potential growth rates and the target inflation rate stabilises expenditure growth over the cycle. In any case, public investment should be favoured by separating current and investment budgets, just as in the golden rule proposal.

Privileging public investment makes sense from an economic point of view. The true golden rule strives for an intertemporal realisation of the pay-as-you-use principle in the case that present government spending provides future benefits. It allows financing of such spending (net public investment) by government deficits thus promoting intergenerational equity. Net public investment increases the public and/or social capital stock and provides benefits for future generations. Therefore, it is justified that future generations contribute to financing those investments via debt servicing. Future generations inherit the burden of public debt, but in exchange, they receive a corresponding public and/or social capital stock. Failure to allow for debt financing of future generations' benefits will lead to a disproportionate burden for the present generation through higher taxes or lower spending, creating incentives for the under-provision of public investment to the detriment of future generations. Germany is an example of a country with strong fiscal rules and also underinvestment. This general incentive problem is exacerbated in times of fiscal consolidation when cutting public investment may seem politically expedient as the easiest way of reducing the budget deficit. Recent experience with 'austerity' policies shows that this danger is real. The German case and developments in countries such as Spain raise awareness about investment and appropriate fiscal rules (for example, EFB 2019).

The natural starting point for the analysis is the debate about the growth effects of public investment, as classified in the national accounts, as it has received the most attention in the literature. Bom and Ligthart (2014) conducted meta-regressions for the public capital–growth nexus. According to their results, the implied marginal returns are in the range between 10 per cent (short run, national, all public capital) to 34.6 per cent (long run, regional, core infrastructure). One may safely assume that traditional public investment has markedly positive growth effects.

In addition to the longer-run supply-side effects, we must address the short-run demand-side effects of public investment. As to the question of the relative size of the public investment multiplier, the pre-crisis literature as a rule of thumb found it to be (slightly) above 1 and therefore slightly larger than for other spending categories. The implication is that public investment, in addition to its long-term economic advantages, could be seen as the most effective short-run fiscal policy instrument (see, for example, Gechert and Rannenberg 2014).

4.1.3 Foster reforms of regional economic structures

Fiscal policy is not only a short-run stabilisation tool; in fact, when aimed at maintaining sufficient levels of demand in the economy, it has stable and lasting effects in the long term, increasing potential output. Sufficient levels of aggregate demand lead to increasing economies of scale, as well as greater private investment. This new investment – particularly in capital equipment – boosts productivity increases in the long term.

A renewed fiscal policy must serve to transform economic growth. European countries need growth-inducing investment in the social and ecological infrastructure that are not possible in the current context, focused exclusively on budget consolidation. Such investments are needed to foster productive convergence inside the euro zone among the different regions, but also to confront the challenges of digitalisation, energy transition and climate change or gender equality, to name some of the main examples. Increasing spending on active labour market policy may be a minimum consensus, as training tends not to be contested by any economist or serious politician, is relatively cheap and obviously needed, but hard to increase sufficiently in times of tight budgets and high unemployment. The announced Green Deal, including a Just Transition Fund (von der Leyen 2019), might go in the right direction, although it seems that it will fall short as regards spending power.

The EMU needs more financial resources at the central level in order to drive upward convergence between regions. Several questions need addressing, however. First, should this be a euro-zone or an EU budget? Second, given the obvious lack of consensus among member states, which areas should receive money as a priority? Thirdly, how much money is required? Fourthly, how can we finance this budget? A bolder EU budget financed by (fractions of) new harmonized taxes (especially on high income to counter inequality) spent on common goods (Trans-European Networks, research projects, Europe 2030 or other targets) might be a solution, which has to be developed further. The new Budgetary Instrument for Convergence and Competitiveness (Eurogroup 2019), with an envisaged cumulated amount of around 0.015 per cent of GDP each year, is obviously not.

A first step to move forward in the development of a fiscal capacity for the euro area – instead of arguing about the size that this budget must have – can be to discuss the type of public goods that we should finance for all Europeans. We must take advantage of the fiscal debate to promote what is perhaps the public investment that Europe needs most at this moment in order to transform economic growth: a Green New Deal. By developing an egalitarian clean energy investment programme for the EU, with an investment of 1.5 to 2.0 per cent of the EU's GDP each year over a full 10-year investment cycle, we will be able us to tackle several goals simultaneously. These goals include a rapid raise in energy efficiency standards, an expansion of the EU's supply of renewable sources, a reduction in carbon emissions and an increase in new green jobs.

4.2 Principle 2: : 'safer' government bonds

The member states of the euro area should be able again to issue safe sovereign bonds, at an interest rate below the rate of growth to reduce the weight of the public debt controlled by the ECB, and to tackle the 'inherent instability of the sovereign bond markets' (De Grauwe and Ji 2018). They should be able to run public deficits in line with their macroeconomic stabilisation needs, taking into account their growth model. Public debt mutually guaranteed by the ECB or by Eurobonds should therefore be restricted to countries agreeing to submit their economic policies to a coordination process (see Principle 3). Economic governance reforms implemented since 2010 should be reviewed and their aims should be modified in this respect. It must be guaranteed that this process does not ending up with 'coordination' dominated again by an arbitrary fiscal rule (like the 60 per cent of GDP debt ceiling, as proposed for example by Bini Smaghi and Marcussen 2018). The process should always reach an agreement on coordinated but differentiated strategies.

Public deficits resulting from this coordination process should be financed through debt issuance guaranteed by all euro area countries and by the ECB. Only where a country pursues a too expansionary fiscal policy, for which there is evidence of adverse effects on its partners, may its new securities not be collectively guaranteed. If the debt increase comes from new economic shocks, however, securities issued by the country must be guaranteed. The Treaty needs to maintain an effective process in the event there is no agreement. In that case, the new debt issued by countries outside the agreement would not be guaranteed, but such a case should never occur in practice.

The fact that public debts are currently not guaranteed is a factor of fragility for the banking sector, which cannot be solved by compelling banks to consider their national public debt assets as risky. Large deposit banks should be entirely warranted by the Single Resolution Fund, smaller ones by their state; in return, their activities should be controlled and limited to prevent financial bubbles and they should focus on productive activities (especially re-industrialisation and environmental transition). They should be forbidden to engage in speculative activation and to finance speculators, such as hedge funds.

We are aware that it would be difficult, if not impossible, to reach such an agreement, based on intelligent and precise cooperation rather than an uncoordinated decentralised process with rigid limits provided by numerical rules. It would require negotiations with uncertain outcomes, more confidence between member states and changing the European Treaty. Nevertheless, this is the best way for a currency area to work properly.

In the meantime, pragmatic steps to guarantee a minimum safety net should be implemented and prolonged. The ECB's OMT programme and the ESM allowed for some ex ante stabilisation. The conditionality of harsh austerity programmes, which dampen aggregate demand and add to macroeconomic fragility, however, means that the measures are double-edged. Furthermore, unconventional monetary policy helped a lot, so the effective stabilisation

power of OMT and ESM will become clear only in the next economic downturn. A backstop is needed for the single resolution fund in order to avoid the transformation of a national banking crisis into sovereign funding problems.

The ECB itself must be reformed in order to expand its objectives and strengthen its democratic control. The new objectives of the ECB must include employment and financial stability, alongside price stability and on an equal footing. This must also involve formal coordination of monetary policy with the rest of economic policy. The role of lender of last resort should ultimately be guaranteed not only for banks, but also for national treasuries. In fact, the ECB has implicitly played this role throughout the crisis, mainly through the OMT programme. This has been presented as an exceptional and discretionary action by the ECB, however, justified by an inflation rate that is too low. It cannot be taken for granted that this unconventional monetary policy will be repeated on other occasions and therefore it must be formalised on the basis of formal statutes.

4.3 Principle 2: more and better coordination between fiscal and other economic, social and environmental policies, as well as between member states to foster sustainable well-being

Good fiscal policy should be part of a broader multi-level governance framework aiming for example at the 'well-being of its peoples' or sustainable 'economic and social progress'. Both principles are also expressed in the European Treaties (see Feigl 2017), in the overall global UN priorities provided by the Agenda for Sustainable Development (UN 2015) and by Stiglitz *et al*. (2018) in their new report on measuring what really counts as regards economic and social performance. With the recent adoption of Council Conclusions on 'the Economy of Wellbeing' (Council of the European Union 2019) and Ursula von der Leyen's announcement that she will 'refocus the European Semester into an instrument that integrates the United Nations Sustainable Development Goals' (von der Leyen 2019: 9), the issue has already gained momentum in the European institutions.

To achieve sustainable and upward-convergent well-being, EMU needs policy coordination well beyond numerical fiscal targets. This needs to be organised between the member states. Coordination should target material well-being, full employment, quality of life, ecological and economic sustainability. Countries should follow an economic policy strategy that allows them to meet commonly agreed economic, social and environmental targets (see Mersch 2018).

In the euro zone's current economic policy framework, wages are seen mainly as a mechanism for adjusting competitiveness as national governments compete with each other to promote their exports. One consequence of this has been downward wage competition, weakening of aggregate domestic demand in the euro zone and rising inequality (see, for example, Timbeau *et al*. 2017).

It is important to abandon this approach and to recognise the need to coordinate wage policies in order to guarantee wage growth in all countries, making it possible to close the gap that has been growing for years between wages and productivity (see, for example, Theodoropoulou 2019). A common reference for wage growth – a 'golden rule' – should be developed and coordinated among social partners and countries to prevent the race to bottom: in the medium term, nominal wages should grow in line with average labour productivity growth and the inflation target. Coordination should be extended beyond a golden rule. Adjustment processes should be implemented by countries in which wages have risen too rapidly or insufficiently in recent years. This adjustment process could be facilitated by social contribution increases to finance more generous social benefits in surplus countries, or by social contribution cuts (offset by higher taxation on capital gains or on wealth) in deficit member states.

Countries should aim for price stability with an inflation rate at around 2 per cent (and more for catching-up countries or for countries with high current account surpluses). Member states should also announce and negotiate their current account balance targets. It is necessary to put in place a bilateral mechanism that ensures control of the current account imbalances of the euro-zone countries. In this way, application to the euro zone of the principles of the so-called 'Keynes Plan' for reforming the international monetary system (originally mooted at Bretton Woods) would lay the foundations for more stable and balanced growth. Countries running high external surpluses should agree to (i) lower them or (ii) to finance explicitly new industrial projects in economies in danger of having external deficits or the European Investment Bank (EIB). This partial channelling of the surplus balances would favour new EU industrial policies and the social-ecological transformation.

Furthermore, no fiscal strategy should ignore the causes of the Great Recession, such as the long-term pressure on wages. To sustain demand growth, countries such as Germany have followed a neo-mercantilist export-led strategy, while Anglo-Saxon and Southern Europe countries have been credit-led, fuelling financial and real estate bubbles. The unwinding of these strategies forced several governments to expand public deficits to restore growth. To bring them down in a sustainable and socially accepted way requires a coordinated strategy based on a new growth model and higher public revenues via tax harmonisation and a fight against tax evasion by the richest people and multinational companies.

A new growth model should be based on a more equal income distribution and on a new industrial policy, with large investment programmes geared towards an environmentally sustainable economy. This requires a political turning point: Europe should have clear objectives of full employment, ecological transition and social model development. Similar to what is envisaged in the European Pillar of Social Rights, Europe should move forward on:

(i) upward convergence in minimum wages (60 per cent of the median wage);

(ii) social protection (with ambitious targets for the population and child poverty rates and minimum requirements for national unemployment insurance systems);
(iii) labour regulations (with more rights for employees to intervene in corporate governance); finally,
(iv) all trade treaties should include social and ecological commitments.

On the revenue side, Europe needs a strategy of tax harmonisation, to set minimum tax rates for firms and higher incomes, to tax higher wealth and to ensure that each country is able to tax its firms and its residents. Tax evasion, tax optimisation and tax competition must be confronted by policymakers. All mechanisms allowing tax optimisation or evasion should be eliminated. An extensive list should be drawn up of all tax or regulatory havens, including those located in Europe. EU countries should prohibit their banks, financial institutions and companies from locating their operations in these havens. Furthermore, carbon taxation should be reinforced. In particular, the coordination of corporation tax is key to avoiding tax dumping. Corporate taxation regimes differ considerably between countries and in many of them tax loopholes are used by companies to avoid part of the taxation, shifting their tax burden from one country to another. It is crucial to set a minimum European effective tax rate of – for example, 25 per cent – below which the various national systems cannot introduce further exemptions and lower taxation.

The euro zone's proper functioning depends on the European project becoming popular again, fostering social and economic progress, an objective of convergence and solidarity among member states, and a turn towards a development model taking ecological constraints fully into account. Institutional progress should concentrate on this framework.

A less ambitious proposal is to develop an integrated scoreboard of economic, social and environmental indicators, to monitor developments and draw attention to deviations, which should be addressed by coordinated policies. They should be analysed in an 'Annual Well-being and Convergence Survey (AWCS)' (Feigl 2017: 4) and broadly discussed at the beginning of the European Semester before drafting the priorities, at least within the European Parliament, the European Economic and Social Committee and the Macroeconomic Dialogue. European governance should incorporate the global Sustainable Development Goals (see also Mersch 2018). The AWCS could be written by a council of economic, social and environmental experts, for example nominated by the European Parliament, together with the European Economic and Social Committee. The European Commission should only draft recommendations for the Parliament and Council to adopt after various discussions with the relevant stakeholders. This new council of experts should identify developments in well-being, convergence and sustainability and qualitatively assess targets, indicators and the current situation. Because this new council would seek to strengthen coherence and incorporate the objectives of the existing fiscal council (such as fiscal coordination, a proper fiscal stance and fiscal stability), the latter should be replaced by the former.

4.4 Principle 4: more democratic participation and scrutiny

One requirement for more democratic European fiscal governance is a clause on 'democratic conditionality', according to which any change in the governance of the euro zone, or the creation of any new institution, must ensure parliamentary control in its election and accountability. A second requirement is for some kind of EMU parliament (for example, as a subgroup of the European Parliament) with the right of co-deciding on all aspects of euro-zone economic decision-making. Third, the positions of each minister within the Eurogroup should be made public, allowing for a qualified discussion at the national level. Fourth, social partners as representatives of organized economic agents have to be seriously involved at the European, as well as the national level and not only formally by establishing ex-post meetings with an opportunity to comment on decisions already made. Fifth, the predominant status of fiscal rules (and furthermore competitiveness and economic growth) should be downgraded to being only one element of an economic governance focused on sustainable and upward-convergent well-being, as the Union's overall aim (see Principle 3).

In the short run, the third proposal on increasing transparency is the easiest. Whether it will make a significant difference remains to be seen. Giving the predominance of conservative ministers within the Eurogroup, it could even have a contradictory effect, as the pressure not to accept compromises could increase, especially in northern countries. On the other hand, more transparency could lead to a more informed debate and force the Eurogroup to develop a better economic underpinning for their decisions. Making the EWG more transparent increases the possibility for parliamentary control of national positions in each member state and gives political players the possibility to raise public awareness of upcoming issues.

Advancing the development of a fiscal union with fewer rules and more coordination requirements (see Principle 1) will lead to the creation of new institutions and supranational responsibilities. These steps should not be taken until it is guaranteed that these new institutions are subject to parliamentary control, however. This 'democratic conditionality' clause must ensure that new institutions are not built up away from the democratic control of ordinary Europeans. In fact, some of the existing institutions must democratise urgently. That is the case with regard to the ECB. The ECB was conceived as an independent agency that could guarantee, using strictly 'technical' criteria, price stability throughout the monetary union. Today, however, it is evident that it has become an important political actor, with the capacity in many cases to influence the economic policies of national governments, with the added responsibility of banking supervision, and with a decisive influence on the euro zone's economic and financial stability. The ECB implements tasks that go far beyond its mandate to monitor inflation and therefore must be placed under greater democratic control. The procedure for appointing the President, Vice-President and the rest of the members of the Executive Board of the ECB, now characterised by secrecy and its intergovernmental nature, should be modi-

fied. Not only must the selection criteria be made transparent, but it must be carried out by a euro-zone Parliament together with a public discussion on the policy orientation of the institution.

The biggest advantage of a parliamentary formation for euro zone co-decision-making, not only on fiscal policy but on all aspects of economic policy, is the potential to shift the logic from the sum of national policies and different national interests to appropriate policies for EMU as a whole. Additionally, such a formation seems to be the only player able to enforce decisions in the European interest when there are no Pareto-solutions between member states. For example, in the case of the Greek memorandum of 2015, although it is likely that we would have seen austerity measures, they would have been more reasonable, less harmful, taken with more legitimacy and therefore more efficient with less conflict. Of course such a formation is no silver bullet, as power relations would be not entirely different from those in the Eurogroup. However, with the European elections 2019, the European level already seems to be more favourable for well-being oriented fiscal policy decisions than it was in the past, measured by declarations to 'make full use of the flexibility … [to] achieve a more growth-friendly fiscal stance in the euro area' (von der Leyen 2019: 9), as well as to 'refocus the European Semester into an instrument that integrates the United Nations Sustainable Development Goals' (ibid.), 'fair taxation' (ibid.), a 'European Green Deal' (ibid.) or the conclusions on the 'Economy of Wellbeing' (Council of the European Union 2019).

Furthermore, the prospect of alternative outcomes in future elections always favours political concessions in the here and now (although European election campaigns hitherto have generally not focussed on common European problems and political solutions). A parliamentary body for the euro zone could also alleviate the legitimacy problem of decisions taken within the framework of the European Semester. At present they are taken upon the economic expertise of the Commission with more (such as the European Fiscal Board) or less formally involved experts, mostly grounded in ideas that have been controversial within the economics profession, with asymmetric effects on different social groups. Finally, although importantly, a parliamentary body is a precondition for a significant euro-zone budget and increased accountability of executive bodies, such as the Commission and the Board of the European Central Bank.

Another important issue is broader economic policy coordination, of which fiscal policy is an important part. To achieve sustainable prosperity and upward-convergence, there should be true economic policy coordination by more decisive economic actors, such as the social partners, and not only member state finance ministers. By involving the most important social groups, political acceptance would increase, which is vital for more stable solutions.

Most of our proposals may not be feasible in the short term, but options are already available to improve matters. For example, the European Parliament could increase pressure in relation to economic issues decided by other institutions. The inclusion of social partners in the political process could be

increased immediately. Furthermore, the Eurogroup and the EWG could publish more data. In the past three years, we already have seen some progress in all three respects and it is likely that this has contributed to the development of a more reasonable fiscal policy compared with the previous strict focus on austerity.

Last but not least, nothing prevents the European Commission from publishing an integrated annual report on well-being, sustainable development and upward convergence, instead of the excessively narrow growth report, as the starting point for policy coordination within the European Semester (Mersch 2018). This new focus would be more in line with the fundamental economic policy principles stated in Article 3 of the TEU (well-being of its peoples, based on sustainable development, balanced economic growth, price stability, full employment and social progress, quality of the environment, cohesion and so on) and nurture public debate.

5. Summary and conclusions

While Economic and Monetary Union has undergone major changes in the past decade, several problems remain and should be addressed by a new fiscal governance reform. Although we have seen progress in crisis mitigation, if a new crisis occurred, problems such as the narrow fiscal space at national level due to misguided, in part pro-cyclical and asymmetrically focused fiscal rules, the absence of an explicit lender of last resort and pressure from financial market players would again become urgent. Furthermore, there are structural deficiencies, such as the end of convergence for all member states, low levels of public investment in the face of increasing social-ecological challenges, the focus of the European Semester on fiscal rules and competitiveness instead of on well-being and sustainable development, tax competition and a lack of democratic participation and control in the European Economic Governance.

To address these problems, we have formulated four principles for further reforms: (i) a much more active and prominent role for fiscal policy, (ii) 'safer' government bonds, (iii) more and better coordination between fiscal and other economic, social and environmental policies, as well as between member states to foster sustainable well-being and (iv) more democratic participation and scrutiny. Every further step to change fiscal governance should deliver progress on these principles. Concrete measures should be evaluated on this basis.

As there is no consensus on what else should be done, measures will be a compromise between different approaches and governments. Although we advocate ambitious measures, we also propose other less far-reaching ones that would be easier to implement and thus more difficult to reject. For example, concerning the first principle, we think that fiscal rules should be replaced by economic coordination that takes into consideration macroeconomic, social and environmental aspects. But we also propose economically more reasonable, but also more limited reforms in order to allow for more national fiscal space.

At the European level, fiscal capacities should be strengthened to deliver public value directly and to provide for cross-border stabilisation. Tools to keep financing costs low should accompany all proposals. Better coordination should mean having a more balanced overall economic policy to foster the well-being of the EU's peoples and expand fiscal space in the longer term by safeguarding tax revenues from transnational companies and the mobile

wealthy. Co-decision-making by the European (or EMU) Parliament should also be expanded with regard to fiscal policy, so that citizens could vote for certain policies and reject others.

Every step taken to strengthen our four principles would be welcome.

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