E3G

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PUBLIC CONSULTATION RESPONSE
REVIEW OF EU ECONOMIC GOVERNANCE FRAMEWORK

About E3G

E3G is an independent climate change think tank with offices in Brussels, London, Berlin and Washington D.C. E3G's mission is to accelerate the transition to a climate-safe world. E3G works closely with like-minded partners in government, politics, business, civil society, science, the media, public interest foundations and elsewhere.

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Introduction

E3G welcomes the Commission's initiative to relaunch the public debate on the review of the EU's economic governance framework[1]. The Covid-19 crisis represents an unprecedented economic shock and has exposed a number of key challenges for the future of the European economy. The circumstances of the pandemic economy, increased levels of public debt and the necessity for increased public investment to achieve our climate goals provoke important questions around the understanding of fiscal sustainability. These changed circumstances warrant that policy makers embed a new understanding of sound public financial management into our shared economic governance framework.

Political leaders across Europe have already demonstrated a willingness to address this issue with President Macron signalling that a *"rethink"* of the EU's fiscal rules will be one of the top priorities of the upcoming French Presidency of the Council[2]. The incoming German government has agreed to a *"further development"* of the fiscal rules oriented towards the goals of growth, debt sustainability and climate

[1] **https://ec.europa.eu/commission/presscorner/detail/en/ip_21_5321**

[2] **https://www.france24.com/en/europe/20211209-live-emmanuel-macron-presents-france-s-priorities-for-europe**

friendly investment[3]. Italian Prime Minister Draghi has stated that a reform of the rules is *"inevitable"* both because of the pandemic and the future challenges the European economy faces[4].

The economic urgency of the reform is clear. The General Escape Clause (GEC) activated in March of 2020 proved timely and appropriate in facing the Covid-19 crisis but now the changed circumstances of significantly higher levels of public debt create an urgent need for fundamental reform. The absence of such a reform would require a number of countries to begin implementing severe contractionary fiscal policies as of 2023[5]. Such a policy turn risks stoking existing political risks and tensions, including anti-European and populist sentiments. As Commissioner Dombrovskis has pointed out the crisis has *"made some challenges more visible such as higher deficits and debt, wider divergences and inequalities and a need for more investment"*[6].

The environmental urgency is also clear. The physical and transition risks associated with climate change can and will have major impact on economic stability, fiscal sustainability and our shared prosperity going forward. For example, the increased frequency of extreme weather events will require higher levels of public expenditure for relief and reconstruction and may lead to negative impacts on the tax base[7]. As well as the direct costs of mitigation and adaptation measures, increased public spending is necessary to address the social costs of climate change and to ensure a just transition for all. Public spending should be aligned with the objectives of the European Green Deal. In the words of Commissioner Gentiloni, we need *"to ensure that our future growth is both sustained and sustainable"*[8].

In this context, E3G argues for a **future-fit fiscal framework with an expanded understanding of fiscal sustainability**. The current understanding focusses too heavily on backward-looking variables such as historic deficit and debt figures. A future-fit fiscal framework should have a **forward-looking perspective which considers resilience to future climate shocks as well as future growth and interest rates as a core part of its definition of fiscal sustainability.** Inspired by

[3] https://www.spd.de/fileadmin/Dokumente/Koalitionsvertrag/Koalitionsvertrag_2021-2025.pdf

[4] https://www.ft.com/content/f3377da4-2ec6-4edb-b9b8-6a5af22bc2a2

[5] https://www.europarl.europa.eu/RegData/etudes/STUD/2021/689445/IPOL_STU(2021)689445_EN.pdf; https://voxeu.org/article/reforming-eu-fiscal-framework-now-time

[6] https://ec.europa.eu/commission/presscorner/detail/en/ip_21_5321

[7] https://www.oecd.org/gov/budgeting/scoping-paper-on-fiscal-sustainability-and-climate-change.pdf

[8] https://ec.europa.eu/commission/presscorner/detail/en/ip_21_5321

the lessons of the Recovery and Resilience Facility (RRF), the framework should move away from a rigid one-size-fits-all rules-based approach **to a tailored country-specific approach.** Critical climate investments should be encouraged but tightly monitored and independently assessed while taking into consideration different circumstances in different member states. The economic governance framework be couched in the **principles of transparency, fairness, solidarity, and the level-playing field**. These principles are essential for ensuring legitimacy and acceptance of the governance framework and can also help address macroeconomic imbalances.

E3G has explored the Stability and Growth Pact, its limitations and how climate change might offer an avenue for reform in our briefing "**Climate Action & Europe's Fiscal Debate**". Below we address the specific questions posed by the Commission in the context of the public consultation.

Question 1: *How can the framework be improved to **ensure sustainable public finances** in all Member States and to **help eliminate existing macroeconomic imbalances** and avoid new ones arising?*

Ensuring sustainable public finances requires **safeguarding healthy sustainable growth**. The existing fiscal framework locks in a deflationary bias by setting an upper ceiling for deficits and debt but does not no minimum floor for spending to ensure for example full employment or minimum replacement of public capital stock. Reforms to the economic governance framework should aim to **eliminate deflationary biases**.

Inspired by the lessons of the Recovery and Resilience Facility (RRF), the framework should **move away from a rigid one-size-fits-all rules-based approach to a tailored country-specific approach**. Rather than automatically ruling in or out different types of expenditure, individual public investment expenditures aligned with long term strategic and climate goals and respectful of fiscal risks should be assessed and approved individually. This would not function like an automatic golden investment rule proposal but rather face tight oversight and monitoring requirements with technical assessment by the Commission and political approval by the Council. A tailored approach would also be better able to take into account different country circumstances and facilitate measures such as country-specific debt reduction pathways.

Debt ceilings and the pace of debt reduction

The existing 60% debt-to-GDP ceiling for the stock of public debt is particularly problematic. We would emphasise that there is no empirical or theoretical basis for a hard public debt-to-GDP ceiling limit. Indeed, recent research suggests that the average linear effect of public debt levels on growth is zero[9]. It should be noted that the 60% limit was arbitrarily derived based on a simple 5-year average preceding the negotiations of the Maastricht treaty[10]. The 60% ceiling laid down in protocol 12 of the Treaty on the Functioning of the European Union no longer reflects the current fiscal situation of most member states. Considering the changed circumstances, the European Stability Mechanism has expressed support for moving to a debt-to-GDP limit of 100%[11].

Even more troubling however is the pace of debt reduction. The six-pack[12] regulations introduced a uniform debt reduction pathway of 1/20th of the debt exceeding 60% per year until convergence at said level. A reinstatement of these rules without reform would require a number of countries to implement severe contractionary fiscal policies in 2023[13]. Members of the German Council of Economic Experts have labelled the 1/20th debt reduction rule as *"very problematic"*[14], while the European Fiscal Board has said that the 60% target looks *"unattainable even over a longer time span"* for highly indebted member states[15]. Attempts to hold to such a rule under current circumstances risks pushing member states into recession which would lead to further deterioration of their fiscal stance. Thus the 60% target coupled with the 1/20th debt reduction pathway endangers the sustainability of public finances in some member states. In addition, a political risk exists that member states may simply choose to ignore the rules. Enforcing the rules on larger member states could be politically challenging and a failure to do so effectively would provoke serious questions of credibility.

In the light of this, E3G supports **moving from a one-size-fits-all 1/20th debt reduction rule to tailored country-specific debt reduction pathways**. This would not compromise a general desire to reduce public debt levels in the long run but would prevent a return to harsh contractionary fiscal policies and allow for the

[9] https://wiiw.ac.at/do-higher-public-debt-levels-reduce-economic-growth-dlp-5976.pdf

[10] https://voxeu.org/article/maastricht-values

[11] https://www.esm.europa.eu/sites/default/files/document/2021-10/DP17.pdf

[12] https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF

[13] https://voxeu.org/article/reforming-eu-fiscal-framework-now-time

[14] https://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/gutachten/jg202122/JG202122_Gesamtausgabe.pdf

[15] https://ec.europa.eu/info/sites/default/files/efb_annual_report_2020_en_1.pdf

consideration of country specific circumstances. We also consider this to be a solution that is both technically and politically feasible in the short run as the uniform debt reduction of 1/20th is anchored in secondary legislation rather than in the European treaties.

Quality and Nature of Public Debt

The 60% debt-to-GDP ceiling has traditionally applied to *all* public debt without distinction as to the holder of the debt. It may be more appropriate to apply a debt ceiling only to the portion of the debt stock which is exposed to market scrutiny. At the beginning of 2021 ca. 3 trillion Euro (or 30% of total) outstanding sovereign debt in the Euro area was held by the European Central Bank with further sums held by the European Stability Mechanism[16]. It should be noted that this is not an anomaly but rather recalls an earlier period of subordinated monetary financing that existing in the 1950s and 1960s[17] and compares to a present day figure of almost 50% in Japan[18]. Debt owed by member states to the European Central Bank is, in some sense, one branch of government owing money to another branch of government. This cannot be taken to be of the same qualitative nature as debt owed to private investors and is not subject to the same market risks. In light of this, E3G supports **interpreting the debt-to-GDP ceiling such that it only applies to the portion of debt which is held by the market**.

In the long-run, E3G has a preference for a more fundamental change in approach to move away from a hard 60% debt-to-GDP ceiling. In line with economic research, we are sceptical of the anchoring of any hard public debt-to-GDP ceiling in primary legislation.

Macroeconomic imbalances

The emergence of macroeconomic imbalances has undermined the stability of the monetary union and has contributed to the Eurozone crisis. By targeting deficits and debt, the economic governance framework may focus overly on the symptoms of the problem at the expense of tackling the underlying causes. The roots of the Eurozone crisis lay, in part, in growing current account imbalances between member states which produced a rapid build-up of private and public debt[19].

[16] https://www.ceps.eu/wp-content/uploads/2021/03/PI2021-04_Selling-sovereigns-held-by-the-ECB-to-the-ESM.pdf

[17] https://transformative-responses.org/wp-content/uploads/2021/01/TR_Report_Gabor_FINAL.pdf

[18] https://www.statista.com/statistics/756192/japanese-government-bonds-by-type-of-holders/

[19] https://www.ipe-berlin.org/fileadmin/institut-ipe/Dokumente/Working_Papers/ipe_working_paper_145.pdf

As part of the European Semester, the Macroeconomic Imbalance Scorecard was introduced in 2011 to provide an "alert mechanism for the early detection of emerging macroeconomic imbalances"[20]. However, the alert mechanism has an asymmetric focus on reducing deficits at the expense of steps to reduce large surpluses. For example, the threshold values for current account balances are 4% for deficits and 6% for surpluses, promoting a deflationary bias within the European economy[21]. Furthermore, there appears to be an asymmetry in the application of the rules. Despite consistent violations of the current account surplus thresholds by some member states, the Excessive Imbalance Procedure and related sanctions foreseen in the regulation have never been applied.

E3G supports reforming the current account balance thresholds to be symmetrical to reduce deflationary bias. Furthermore, the Commission should pursue a stronger line in the implementation of country specific recommendations relating to member states which violate surplus indicators on the scorecard. In the case of consistent violations over time, the Excessive Imbalance Procedure should be activated and if necessary, the Commission could withhold tranches of funding from various EU facilities including the RRF as a penalty.

Question 2: *How can the framework ensure responsible fiscal policies that* ***safeguard long-term sustainability, while allowing for short-term macroeconomic stabilisation****?*

Safeguarding long-term sustainability requires that we **broaden our understanding of fiscal sustainability**. Several factors affect public debt sustainability including future government revenues, future economic growth, the cost and maturity of debt, future interest rates and fiscal risks (e.g. climate-related and other shocks) as well as market and investor perception and confidence and the type of bond holders. **A broader understanding of fiscal sustainability can also help address issues of intergenerational justice**. As the recent German constitutional court ruling argued, the less climate action taken by society today, the less freedom the citizens of tomorrow will enjoy as more drastic restrictions will then be required in the future[22]. When assessing our public expenditures, we

[20] https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0025:0032:en:PDF#:~:text=Regulation%20%28EU%29%20No%201176%2F2011%20of%20the%20European%20Parliament,on%20the%20prevention%20and%20correction%20of%20macroeconomic%20imbalances

[21] https://www.karlwhelan.com/Papers/Whelan-April-2012.pdf

[22] https://www.whitecase.com/publications/alert/reshaping-climate-change-law

should therefore balance today's climate investments against the "climate debt" that we risk passing on to future generations

Climate Risk and Public Finances

E3G supports a future-fit fiscal framework. The current framework focusses disproportionately on historical variables such as historic deficits and debt levels anchored in the reference values of 3% deficit-to-GDP and 60% debt-to-GDP in protocol 12 of the TFEU. A broader understanding of fiscal sustainability and its drivers is needed. As Dezernat Zukunft have argued[23], the fiscal framework should be forward-looking and goal oriented, taking into account future variables such as economic growth, future interest rates and climate related risks.

The **physical and transition effects associated with climate change pose significant new fiscal risks for government**. The European Commission itself has identified a significant green funding gap of ca. 470 billion EUR per year in order meet the EU's 2030 climate and environmental goals as well as a public investment gap of ca. 100 billion EUR per year until 2030 just to maintain existing capital stock[24]. The UK's Office of Budget Responsibility estimates for example an increase in public sector net debt of 20% of GDP in an 'early action scenario' which rises to 45% in a 'late action scenario' by 2050 due to the costs of climate change mitigation and adaptation for the UK. It is important to note that these figures are net and include receipts from carbon taxes as well as expenses associated with climate change[25]. Beyond this, important investments in resilience will be needed to adapt to the effects of climate change and ensure that areas more exposed to climate risks are not left behind. Given the uncertainty around the effects of climate change it is not possible to generate comprehensive estimates of adaptation costs, rendering the above figures conservative benchmarks.

Given the urgency of the climate challenge, the new German[26] and Dutch[27] governments envisage creating special purpose funds which will redirect untapped fiscal space toward climate transition investments. These options are of

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[23] **https://www.dezernatzukunft.de/wp-content/uploads/2021/07/A-new-fiscal-policy-for-Germany.pdf**

[24] **https://ec.europa.eu/info/sites/default/files/economy-finance/assessment_of_economic_and_investment_needs.pdf**

[25] **https://obr.uk/docs/dlm_uploads/Fiscal_risks_report_July_2021.pdf**

[26] **https://www.euractiv.com/section/energy-environment/news/german-cabinet-passes-climate-fund-booster-with-e60-billion-extra-budget/**

[27] **https://www.ft.com/content/126f589c-9fff-41d0-bdd0-1cdf082bff86?accessToken=zwAAAX3DyQVYkc8Sb1icn_9B0NO90BzfCCv_hg.MEYCIQChlqoMXfzVtiH2gI0BzgcrHLU2rPJtsvj5rpsxkl2uXwIhAI9jpqyYs4XzWWiSM96kBn0W_4s2jaXtGkc6mU_hZJr2&sharetype=gift?token=f652307d-6cff-4e18-8d51-1dc99e856159**

course not possible for member states with higher levels of debt but do allow some member states to circumvent, in some sense, the existing debt rules. It should be noted that the pursuit of such solutions suggests that existing debt rules are too restrictive to allow for the necessary investments, even for member states with a track record of fiscal rectitude.

Therefore, E3G supports **exempting climate change related expenditure from the deficit rules.** Inspired by the success of the Next Generation EU and Recovery and Resilience Facility (RRF), governments could submit proposals for green public spending that could be excluded from expenditure ceilings. This type of exemption would not function like an automatic golden investment rule proposal but rather face **tight oversight and monitoring requirements**. Requests for exemption of certain public expenditures would have to align with EU priorities on climate change mitigation and adaptation and would include disclosure of quality of spending and be subject to performance-based monitoring. The approval of such exemptions would be **subject to technical assessment by the European Commission and political validation by the Council of Ministers**. This type of reform would allow member states to ensure sustainability by pre-empting fiscal risks associated with climate change while also maintaining a responsible fiscal policy with the help of independent oversight.

Furthermore, **climate risks should be included in debt sustainability analyses** as part of the macroeconomic surveillance in the Macroeconomic Imbalances Procedure and the European Semester. It should be noted that some member states such as Ireland already include climate related risks in their fiscal assessment reports[28]

Short-term macroeconomic stabilisation

A future-fit fiscal framework should also provide sufficient flexibility to allow for short-term macroeconomic stabilisation. This could be achieved by moving from a deficit rule to an expenditure rule. An expenditure rule would focus on limiting nominal expenditures such that they do not grow faster than long-term nominal income[29]. When coupled with a country-specific deficit reduction pathway, this approach would allow for a better balance between budgetary discipline and counter-cyclical stabilisation, allowing for deficits in recessions and limiting expenditures in booms[30].

[28] https://www.fiscalcouncil.ie/wp-content/uploads/2021/05/Fiscal-Assessment-Report-May-2021-1.pdf

[29] https://voxeu.org/article/economic-case-expenditure-rule-europe

[30] https://zoe-institut.de/en/publication/an-analysis-of-the-feasibility-and-impact-of-proposals-for-reforming-fiscal-policy-in-the-eu/

A particular weakness in the current fiscal framework is the calculation of the output gap. The larger the output gap or difference between full potential output and actual output the greater the fiscal space allowed to stimulate the economy toward full output under the rules[31]. The estimation of the output gap is a theoretical exercise and research[32] suggests that pro-cyclical biases in the underlying economic modelling lead to underestimations of the output gap. As a result, a small number of technical assumptions can produce strong effects in policy recommendations.

In light of this, E3G supports Dezernat Zukunft's proposal to **adjust the calculation of the potential output upwards based on the full utilisation of the labour rather than historical trends**[33]. This approach envisages fiscal policy as forward-looking, goal-oriented tool. This proposal has garnered particular attention in Germany and has even been alluded to in the incoming government's coalition agreement[34].

Question 3: *How can the framework* ***incentivise Member States to undertake the key reforms and investments needed to deliver on the Green Deal*** *and help tackle today's and tomorrow's economic, social, and environmental challenges such as the twin transition while preserving safeguards against risks to debt sustainability?*

The European Union, as it emerges from the COVID-19 pandemic, faces twin environmental and social crises: crises which increase public scrutiny on fiscal policy at EU-level, and demand that governments have the fiscal space in order to adequately respond.

With the launch of the Green Deal, the passing of Europe's climate law and the debut of the Fit-for-55 package, the EU is on the way to achieving its ambition of being the world's first climate neutral continent by 2050. Such a transition will be driven in large part by investments in the private sector funded by private capital, however, according to the EIB[35], public funding will play a significant role in mobilising and facilitating this private financing. As per the Commission's own

[31] https://zoe-institut.de/en/publication/an-analysis-of-the-feasibility-and-impact-of-proposals-for-reforming-fiscal-policy-in-the-eu/

[32] https://wiiw.ac.at/keynes-the-output-gap-and-the-eu-s-fiscal-rules-n-487.html

[33] https://www.dezernatzukunft.de/wp-content/uploads/2021/07/A-new-fiscal-policy-for-Germany.pdf

[34] https://www.spd.de/fileadmin/Dokumente/Koalitionsvertrag/Koalitionsvertrag_2021-2025.pdf

[35] https://www.eib.org/en/publications/investment-report-2020

impact assessment[36], the additional investment required amounts to 2 percentage points of GDP annually, of which the additional public investment need will be between 0.5-1% GDP annually[37].

This public investment will support the clean transition in the private sector, expand and improve domestic infrastructure, and adequately protect citizens from the social impacts of decarbonisation. Governments need the fiscal space necessary to start meeting these investment needs as soon as possible.

Beyond the needs of the transition to a clean economy, Member State fiscal policy will need to be similarly supportive of social investments in the coming years, either in improved public services, mechanisms which support a just transition as Europe decarbonises, or human capital investment which strengthens the skills and capacities of European citizens so that they can fully participate in the green and digital transition[38].

The fiscal framework, as it stands, is not ready to support these crucial public investments. By focusing almost exclusively on aggregate macroeconomic indicators in its assessment of government spending, the framework fails to adequately consider the quality and impact of said spending, or how it contributes to achieving the EU's wider environmental and social goals. Non-compliant member states may be investing in improved infrastructure and an ambitious climate transition, while compliant member states may have large, inefficient civil bureaucracies, threadbare public services and ailing infrastructure and be lagging in its decarbonisation efforts – yet the framework as designed does little to recognise the qualitative difference.

Furthermore, the existing framework has in the past encouraged fiscal consolidation in member states emerging from crisis, which in turn has limited public investments: over the past decade, gross government investment in the euro area has declined, with its ratio to GDP falling from 3.6% in 2009 to 2.8% in 2019[39]. **A return to such a fiscal environment in 2023 would severely limit the ability of governments to invest in the EU's environmental and social goals, while simultaneously slowing the recovery from the COVID-19 pandemic.**

[36] https://eur-lex.europa.eu/resource.html?uri=cellar:749e04bb-f8c5-11ea-991b-01aa75ed71a1.0001.02/DOC_1&format=PDF

[37] https://www.bruegel.org/wp-content/uploads/2021/09/PC-2021-18-0909.pdf

[38] https://epc.eu/content/PDF/2021/EU_economic_Governance_Social_investment_PB.pdf

[39] https://epc.eu/content/PDF/2021/EU_economic_Governance_Social_investment_PB.pdf

Any reform of the fiscal framework should, therefore, be one that allows governments to make these crucial public investments in the years and decades to come. **E3G supports a framework which exempts investment in the green and digital transitions, as well as investment in social services, infrastructure and human capital, from the deficit rules.** This type of exemption would serve to preserve against risks to debt sustainability through **tight oversight and monitoring requirements,** with the European Commission assessing whether planned investments align with Europe's decarbonisation, digitalisation and social goals.

An alternative proposal would be the **reform of the investment clause**. In this reform, the **interpretation of "major structural reforms" would be expanded to include investments which are judged to support Europe's decarbonisation, digitalisation and social goals. The conditionality of the clause could be relaxed**, so that not only member states with negative or underperforming GDP growth could use it to support necessary investments. This could be achieved by mirroring the Recovery and Resilience Facility (RRF) process, with 5-year national investment plans proposed by member states and an assessment and approval by the European Commission and the Council. All investment and spending related to the approved national plan would then have special treatment in the fiscal rules.

Question 4: *How can one **simplify** the EU framework and **improve the transparency** of its implementation?*

Simplification

Simplification of the fiscal framework could contribute to increased ownership, transparency and acceptance by member states. Simplicity allows for better communication and would also lower the burden of implementation, enforcement and compliance. However, **it should be noted that simplification can come at the cost of necessary flexibility and a degree of country-specific tailoring of recommendations**. Simplification should not mean to the adoption of uniform one-size-fits-all rules as country-specific circumstances should be taken into consideration. A future-fit fiscal framework should aim to strike this delicate balance.

Transparency

Approaches could also be applied to improve transparency of implementation of the economic governance framework. E3G supports a stronger involvement of civil society organisations (CSOs) in the European Semester process. **CSOs can provide crucial input in relation especially to social and environmental aspects**

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of the European Semester. Indeed, the European Semester aims to consider the UNs Sustainable Development Goals (SDGs) but has thus far has not sufficiently mainstreamed the SDGs into its framework[40]. CSOs can also help hold member states to account in relation to alignment of macroeconomic policy with stated long-term goals and commitments such as the pathway to net zero. **The Green Recovery Tracker developed by E3G and the Wuppertal Institute** provides an example of civil society scrutiny of the public investment plans under the RRF[41].

E3G supports CAN Europe's call[42] for member states to fully implement the anti-corruption recommendations of the European Commission, GRECO, OECD and the United Nations. Hungarian CSOs for example have made numerous concrete proposals for such measures to be preconditions for easing of fiscal rules[43].

Question 5: *How can surveillance **focus on the Member States with more pressing policy challenges** and ensure quality dialogue and engagement?*

Surveillance should take into consideration that different member states find themselves at different starting points due to differences in socio-economic structures, historical circumstances and differentiated exposure to externalities and risks such as climate change. Convergence to a level-playing field necessitates common but differentiated responsibilities such as country-specific debt reduction pathways **(see response to questions 1 and 8)**. It is important however for reasons of transparency and acceptance that surveillance applies to all member states and that perceptions of special treatment are avoided.

[40] **https://www.socialplatform.org/wp-content/uploads/2020/11/Social-Platform-2020-Semester-process-analysis-final-1.pdf**

[41] **https://www.greenrecoverytracker.org/**

[42] **https://caneurope.org/content/uploads/2021/11/CAN-Fiscal-Framework-Position.pdf**

[43] **https://www.levego.hu/egyeb/ngo-proposals-for-the-partnership-agreement-on-eu-funds-and-the-national-recovery-and-resilience-plan/**

Question 6: *In what respects can the* ***design, governance and operation of the RRF provide useful insights in terms of economic governance*** *through improved ownership, mutual trust, enforcement and interplay between the economic, employment and fiscal dimensions?*

Creditworthiness

The operation of the Recovery and Resilience Fund (RRF) provides a number of instructive lessons and useful insights for the future of economic governance in Europe. The RRF demonstrates the fiscal strength and economic health of the European Union. The issuance of the first tranches of common European debt by the Commission both with shorter- and longer-term maturities were more than **eleven times oversubscribed, providing very favourable financing conditions**[44]. This signals a tremendous appetite from global capital markets for common European sovereign debt and indicates that **common European debt is a safe sovereign asset that enjoys much market confidence**.

Design and Governance

The governance structure of the RRF demonstrates a bottom-up approach to public investment with member states designing their own investment plans based on individual country specific circumstances, socioeconomic contexts and national priorities. The design and operation of the RRF embeds ownership of the investment plans with the member states. This **increases mutual trust as well as transparency** and when coupled with oversight can address moral hazard concerns often associated with mutualisation of debt or fiscal liability.

The **performance-based design of the RFF also improves the quality of public investment.** The recovery and resilience plans set out milestones and targets which are agreed with the Commission. The disbursement of each tranche of funding is conditioned on the fulfilment of the agreed upon targets. This approach incentivises performance-based investment and fulfilment of the submitted recovery and resilience plans. A similar approach should be applied generally to green investments to allow for exemption from the fiscal rules. The EU has an opportunity to lead internationally in this area but should ensure that its approach is aligned with international standards such as the IMF's Public Investment Management Assessment (PIMA) framework[45], the UNDP's Climate Public

[44] **https://ec.europa.eu/commission/presscorner/detail/en/IP_21_3287**

[45] **https://infrastructuregovern.imf.org/content/PIMA/Home/PimaTool/What-is-PIMA.html**

Expenditure and Institutional Review (CPEIR)[46], and the Public Expenditure and Financial Accountability programme (PEFA)[47].

The RRF approach also incentivises **long-term economic planning and an active industrial policy**. The resilience and recovery plans are based on a five-year cycle which requires member states embed investment decisions into a long-term planning framework. The milestone contingent disbursement of these funds ensures that member states stick to the initial plans.

Generally, the economic governance framework should embrace moving from a rigid rules based-based approach to a tailored country-specific approach. Rather than automatically ruling in or out different types of expenditure, public investment expenditures aligned with long term strategic and climate goals respectful of fiscal risks should be assessed and approved individually. This type of approach should involve **tight oversight and monitoring requirements**. The approval of such exemptions would be **subject to technical assessment by the European Commission and political validation by the Council of Ministers**.

E3G supports improving the quality of investment further with the application of stringent conditions and criteria regarding green and climate related expenditure to avoid the facilitation of greenwashing. The **Green Recovery Tracker developed by E3G and the Wuppertal Institute** for example points to a number of countries falling short of the desired 37% of spending going toward the green transition[48]. **Ideally an uncompromised science-based taxonomy should be used as a basis for aligning public investment expenditure with an ambitious pathway toward net zero.**

Fiscal capacity

In the context of the RRF, we note that **fiscal capacity at the member state level and at the European level should not be viewed as independent of one another but rather as complementary tools in the overall macroeconomic policy framework** of the European Union. Reduced fiscal space at the member state level can be compensated by European fiscal capacity. While increased fiscal space and flexibility at the member state level reduces the necessity for a European fiscal capacity. Additional fiscal space at the European level can also be used to

[46] https://www.asia-pacific.undp.org/content/rbap/en/home/library/democratic_governance/CPEIR-lessons-learnt.html

[47] https://www.pefa.org/sites/pefa/files/resources/downloads/PEFA%20Climate%20Framework%20from%20August%204%202020%20Final.pdf

[48] https://www.greenrecoverytracker.org/

compensate current account imbalances between member states thus reducing the potential for public and private debt build ups.

In the long-run, **E3G would prefer a permanent expenditure capacity at the European level.** The experience of the RRF has demonstrated that it may be more feasible technically and politically to exercise control and oversight and hence ensure quality public expenditure in the context of a European fiscal capacity. In addition, commonly issued European debt allows all member states to benefit from pooled creditworthiness and hence favourable market conditions and low interest rates. Maintaining a permanent fiscal European fiscal capacity in addition to national fiscal capacities would help avoid mismatches between the euro area's needs in times of crisis and the long-term fiscal policies of the individual member states. Indeed, the ECB has also recently suggested that a permanent central fiscal capacity could *"play a role in enhancing macroeconomic stabilisation and convergence in the euro area in the longer run"*[49]. In any case, E3G urges that reform of fiscal rules for member states take into consideration the possibility and extent of any future permanent European fiscal capacity.

Question 7: *Is there scope to **strengthen national fiscal frameworks** and improve their interaction with the EU fiscal framework?*

National fiscal frameworks should be aligned with the EU fiscal framework while allowing for different national preferences and circumstances **(see response to question 1)**. It should also be noted that fiscal capacity at the member state level and at the European level should not be viewed as independent of one another but rather as complementary. Both national and European fiscal frameworks should take this into consideration in their design **(see response to question 6).**

Question 8: *How can the framework **ensure effective enforcement**? What should be the role of financial sanctions, reputational costs and positive incentives?*

Consistent and effective enforcement of conditionalities and rules for all member states is essential for the achievement of fiscal objectives. In addition, effective enforcement is important in ensuring legitimacy, trust and acceptance of the framework by member states.

[49] **https://www.ecb.europa.eu/pub/pdf/other/eurosystem_reply_commission_eu_economy_after_covid_implications_economic_governance211202~d2eeec68dc.en.pdf**

E3G supports strict conditionality to ensure effective enforcement of the framework. However, such conditionality should take into account a broader understanding of fiscal sustainability which includes climate related risks. A future-fit fiscal framework should require member states to align national budgets with climate objectives including elimination of environmentally harmful subsidies. Budgetary spending should seek to comply with the *"Do No Significant Harm"* principle and **an uncompromised science-based taxonomy should be used as a basis for aligning public investment expenditure with an ambitious pathway toward net zero.**

Positive Conditionality

The framework already foresees financial sanctions for breaches of the Stability and Growth Pact. Historically however, such fines have never been applied which has provoked questions of trust, legitimacy and credibility. In some cases, they have not been applied by the Council for political reasons[50] while in others they have not been recommended by the Commission due to challenging economic circumstances[51]. The non-application of fines poses two challenges: (i) firstly how to avoid political capture by larger member states and (ii) how maintain credibility and effectiveness of the rules in cases of violation.

In light of this E3G, favours a **principle of 'positive conditionality**' with regard to the fiscal framework. Rather than imposing fines in the case of a breach the Commission should withhold further tranches of funding under the RRF or other facilities. In addition, any requests for exemptions from the fiscal rules for green or climate aligned expenditure should not be approved by the Commission if the member state in question has a track record of non-compliance.

Different Starting Points

Borrowing from the UNFCCC and in the spirit of solidarity, Europe's economic governance framework should recognise a **principle of common but differentiated responsibilities.** Due to differences in socio-economic structures, trade patterns, tax policies, historical circumstances and differentiated exposure to externalities and risks such as climate change, member states find themselves at different starting points. In order to converge to a level-playing field country-specific debt reduction pathways are both the most equitable and realistic means to achieve and maintain healthy public finances.

[50] **https://www.theguardian.com/business/2003/nov/25/theeuro.politics**

[51] **https://www.politico.eu/article/no-fines-for-portugal-spain-over-budget-failures-european-commission-deficit/**

E3G supports moving away from the 60% debt-to-GDP and the associated uniform 1/20th debt reduction rule. These rules are no longer fit for purpose or appropriate to the current economic circumstances of the member states and their reimplementation would provoke dangerous destabilising deflationary policies in the short term. In this context, **effective enforcement and strict conditionality via the withholding of EU funding and reputational costs should be linked to country-specific debt reduction targets rather than the one-size-fits all 60% rule.**

Question 9: *In light of the wide-ranging* ***impact of the COVID-19*** *crisis and the new temporary policy tools that have been launched in response to it,* ***how can the framework*** *– including the Stability and Growth Pact, the Macroeconomic Imbalances Procedure and, more broadly, the European Semester –* ***best ensure an adequate and coordinated policy response at the EU and national levels****?*

The impact of Covid-19 as well as the challenges of the climate crisis underline the importance of coordination between the various policy tools and elements of the framework. The Stability and Growth pact should integrate resilience to future climate related risks into its definition of fiscal sustainability **(see response to question 2)**. The Macroeconomic Imbalances Procedure should take a sharper approach to tackling current account imbalances as they emerge **(see response to question 1)**. Enhanced use of the European Semester will be important as it allows for broad coordination of fiscal, employment and economic policies.

Question 10: *How should the framework take into consideration the euro area dimension and the* ***agenda towards deepening Economic and Monetary Union****?*

Since the establishment of the EMU, the fiscal rules, as enshrined in TFEU and the SGP, have played an important role, with the goal of promoting economic convergence between diverse economies[52]. These fiscal rules were backed by a 'no bailout' clause (Art 125 TFEU), which sought to impose market discipline on the euro zone and avoid contagion effects from unsustainable fiscal policy in one member State impacting the entire zone.

Yet it has been precisely this fiscal discipline element of the framework which has hampered efforts at encouraging economic convergence and deepening the EMU.

[52] **https://www.cae-eco.fr/staticfiles/pdf/cae-note063enV3.pdf**

The euro crisis of 2009-2010, with its "doom-loop" of mounting sovereign debt, is the prime example of this divergent dynamic. In response to the crisis, the EU took the necessary step of adopting various large-scale, ad-hoc financial support measures to support struggling member states. This support was, however, still furnished in the legal context of the 'no bail-out' clause – and was therefore provided under strict conditionalities which imposed damaging fiscal policies on the member states hit hardest by the crisis. This effect was further compounded by the strictures of the SGP, which mandated States to begin damaging fiscal consolidation at precisely the moment when they needed to invest in their recovery. In this way, the fiscal framework exacerbated inequalities between Eurozone economies: stronger economies were less impacted by the crisis and had the capacity to finance their recovery within the limits of the fiscal rules, while less-developed economies, who's economies had been further weakened by the crisis, could not adequately stimulate their domestic recoveries as government spending was constrained by the SGP.

In the wake of the COVID-19 pandemic, and as Europe and the Eurozone looks to invest in its economic recovery and transition to a clean economy, an unreformed fiscal rules risks creating the same, divergent dynamic between member states. member states with less-developed economies and higher debt levels risk being mandated to face public spending cuts, or a difficult choice between investing in the green transition or continuing to fund their domestic recovery. In either scenario, the Eurozone faces an uneven recovery or a green transition which progresses well in some member states but lags in others. Such a dynamic would weaken the European green transition as a whole and be detrimental to the economic convergence of the Eurozone.

To avoid this scenario and support a future deepening of the EMU, a revised fiscal framework should be one that seeks to close the gap between Eurozone member states, not widen them, while allowing them to collectively invest in a European clean transition. To facilitate this, any revised framework will have to account for the national conditions of member states, while ensuring they have adequate fiscal space to fund the transition to a clean economy, the latter of which could be achieved through a framework **which exempts investment in the green transition** or a **reform of the investment clause** to explicitly favour green investments.

In terms of Eurozone convergence specifically, any revision should be underpinned by a **principle of common but differentiated responsibilities,** in recognition that member states find themselves at different starting points due to diverse domestic economic conditions. With this principle established, **country-specific debt reduction pathways** are both the most equitable and realistic means to ensure that certain Eurozone member states have the fiscal space necessary to bring their macroeconomic conditions closer to the Eurozone average and therefore facilitate a deeper and more convergent Economic and Monetary Union.

Finally, the economic governance of the Eurozone should facilitate **coordinated interaction between fiscal and monetary policy**. Fiscal authorities should take the primarily role in macro-stabilisation. The European Central Bank should aim to facilitate the democratically legitimised fiscal policies of the member states via accommodative and subordinated monetary policy. As ECB President Christine Lagarde has stated the pandemic economy is supported on "crutches", one fiscal and one monetary[53].

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[53] **https://www.dw.com/en/eu-economy-on-crutches-warns-ecb-chief-christine-lagarde/a-57305248**