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Rethinking EU economic governance: The foundation for an inclusive, green and digital transition

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Visuals created by Jon Wainwright.

List of abbreviations

CSR	country-specific recommendation
DBP	draft budgetary plan
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EFB	European Fiscal Board
EMU	Economic and Monetary Union
EPC	European Policy Centre
EPSR	European Pillar of Social Rights
GEC	general escape clause
IFI	independent fiscal institution
MIP	Macroeconomic Imbalances Procedure
NRIP	'National Reform and Investment Plan'
NRP	National Reform Programme
NRRP	National Recovery and Resilience Plan
RRF	Recovery and Resilience Facility
SCP	Stability and Convergence Programme
SGP	Stability and Growth Pact
SURE	temporary Support to mitigate Unemployment Risks in an Emergency programme
TTF	'Twin Transition Facility'

Executive summary

The European Union is undertaking a comprehensive review of its economic governance framework, to address longstanding criticisms, respond to the impact of COVID-19, and prepare for the challenges posed by the twin green and digital transitions.

This Discussion Paper represents the final instalment of an EPC Task Force series that examined the current approach and proposes 10 concrete policy recommendations to make EU economic governance stronger, greener and fairer:

1. Establish a central investment capacity for green and digital investments (including associated social investments) or, alternatively, a golden rule modelled on the governance of the Recovery and Resilience Facility.

2. Introduce a single net expenditure rule with a country-specific debt target based on nationally designed expenditure and debt plans to enhance political ownership.

3. Shift to a multiannual supervision and assessment framework and introduce fixed medium-term budgetary plans, with a control account tracking deviations.

4. Reform the sanctions regime to increase proportionality, perceived fairness and political enforceability.

5. Differentiate country-specific supervision based on a clear risk threshold.

6. Introduce 'National Reform and Investment Plans' modelled on the National Recovery and Resilience Plans, using a commitments-based approach to operationalise social, fiscal, macroeconomic and structural country-specific recommendations. The plans' components with strong links to fiscal sustainability should govern the use of Stability and Growth Pact (SGP) flexibilities.

7. Reform the Stability and Convergence Programmes (SCPs) to focus more on the investment composition of national fiscal plans and their link to broader policy objectives.

8. Introduce an opinion on the individual and joint impact of the SCPs on imbalances into the Macroeconomic Imbalances Procedure to strengthen its link with the SGP.

9. Introduce new processes into the European Semester to assess non-macroeconomic structural risks, such as climate and environmental risks.

10. Build on the success of the temporary Support to mitigate Unemployment Risks in an Emergency (SURE) programme to create insurance-based mechanisms to support national fiscal policy during downturns.

The European Commission aims to table its proposals in the second half of 2022, which will need to carefully balance an array of competing priorities, member state preferences and political obstacles. To address these challenges, the EPC established the Rethinking EU Economic Governance Task Force in Spring 2021. The EPC Task Force investigated the main challenges and reform options in three fields: (i) the Stability and Growth Pact; (ii) the European Semester and the Recovery and Resilience Facility; and (iii) social investment. These discussions informed three Policy Briefs written by the authors.

Introduction

The European Union's economic governance framework has long been one of its most contentious structures. It bears the unenviable task of managing the tension between a highly integrated Economic and Monetary Union (EMU) and decentralised national fiscal and economic policy.

Given the magnitude of this challenge, the framework has evolved into a complex edifice of detailed rules and exemptions. This edifice has come in for substantial criticism from both sides of the EU's divisive fiscal policy debates. It is accused of failing to reduce high-debt burdens and of enforcing austerity; of opaque and excessively flexible enforcement and of stifling investment. These debates have often featured appeals for greater solidarity between member states that are pitched against calls for responsible fiscal behaviour. Furthermore, as the Union has evolved, it has been called upon to coordinate a widening range of economic policy priorities, from the twin digital and green transitions to social investment.

The EU economic governance framework has evolved into a complex edifice of detailed rules and exemptions. This edifice has come in for substantial criticism from both sides of the EU's divisive fiscal policy debates.

To address the criticisms levelled at the framework and reshape it to meet upcoming challenges, particularly the twin transitions, the European Commission launched a review of the EU economic governance in February 2020. A month later, the 'general escape clause' (GEC) was activated to allow member states to support their economies in the face of the unprecedented COVID-19 pandemic. The review was consequentially put on ice.

On 19 October 2021, the review restarted in a drastically different environment. EU debt levels have surged, and regional, economic and social divides have been exacerbated. European policymakers face inflationary pressures for the first time in decades, and the Recovery and Resilience Facility (RRF) and accompanying EU-level bond issuance fundamentally changed the EU's economic architecture. In parallel, there is a widespread acknowledgement that the climate crisis and the rise in technological competition between world powers require a steep increase in public investment, particularly in member states that lag behind the European average.

Against this backdrop, the European Policy Centre (EPC) established the Rethinking EU Economic Governance Task Force in Spring 2021. This EPC Task Force convened high-level academics, experts, and current and former policymakers for a series of six closed-door roundtables to debate possible reforms to EU economic governance. The authors draw deeply on the insights from these discussions to formulate their own proposals for reforming the framework.

The EPC Task Force investigated the main challenges and reform options in three fields: (i) the Stability and Growth Pact (SGP); (ii) the European Semester and the RRF; and (iii) social investment. First, the SGP needs reform to ensure realistic yet sustainable fiscal behaviour. Second, the European Semester must strengthen pan-European economic policy coordination, drawing on the lessons of the RRF. Third, the pandemic highlights the need for high-quality public and social services to improve economic resilience in the face of structural change. The Task Force discussions informed three Policy Briefs written by the authors.[1]

The EPC's work has been particularly focused on the design of institutional and governance structures. There have been many valuable contributions over the years concerning the technical design and macroeconomic underpinnings of the fiscal rules.[2] However, lack of trust between member states and concerns over governance remain key obstacles to effective reform. Regardless of their merits on paper, calls for reform are often treated with suspicion amongst so-called hawks who are wary that flexibility will be misused. This ultimately leaves the hawks on the hook for the behaviour of high-debt member states. Without addressing this lack of trust, no substantial reform is possible. Therefore, our proposals have sought to create an integrated set of institutional mechanisms to ensure strong governance and enforceability.

1. The purpose of the EU economic governance framework

Economic coordination is key in a tightly integrated entity like the EMU, particularly for euro area members that share a single monetary policy yet have heterogenous economic structures and decentralised fiscal policy. This logic underpins the Treaty's requirement that member states should coordinate their economic policies and consider them a matter of "common concern" (Article 121 TFEU).

Initially, economic coordination was primarily focused on securing sustainable fiscal policies, in line with TFEU Article 126. This was seen as essential to prevent negative spillovers to other member states in the monetary union, in the forms of either inflation or excessive debt leading to fiscal crises and bailouts.[3] Sound public finances were therefore considered a prerequisite for economic growth as they guarantee a stable economic environment.

In 1997, the SGP operationalised the Maastricht criteria and its well-known reference values of 60% debt-to-GDP and 3% deficit-to-GDP ratios on this basis.[4] Over time, however, the SGP underwent substantial reforms. These reforms attempted to advance stricter enforcement and simultaneously balance this with greater responsiveness to macroeconomic conditions. The end result is a complex assemblage of rules and exemptions, detailed supervisory scrutiny, and a broad margin of discretion in assessing compliance.[5]

Economic convergence between member states, sustainable and social development; addressing macroeconomic risks; and European public goods provision are increasingly recognised as important objectives for the EMU's effective functioning.

As the Union has evolved, broader economic policy coordination, beyond fiscal policy, has also gained greater prominence within the EU's framework. Economic convergence between member states, sustainable and social development; addressing macroeconomic risks; and European public goods provision are increasingly recognised as important objectives for the EMU's effective functioning. Going forward, the green and digital transitions (including rising geopolitical tech competition) have emerged as the lodestars guiding EU policy across a number of fields, requiring their incorporation into the economic governance framework.

1.1. THE STABILITY AND GROWTH PACT[6]

European fiscal rules are operationalised in Regulations 1466/97 and 1467/97, collectively known as the SGP. It was first reformed in 2005 to introduce greater flexibility following the dot-com bubble burst as some countries – notably France and Germany – struggled to keep their deficit-to-GDP ratio below the Maastricht thresholds. The second set of reforms in 2011 and 2013, the so-called six-pack and two-pack, during the height of the eurozone crisis, aimed to both strengthen enforcement and introduce greater flexibility to respond to macroeconomic conditions. These legislative reforms were further supplemented by extensive interpretative guidance by the European Commission and Council, which constitute a key determinant of how the rules are applied in practice.

Under the SGP's **preventive arm**, member states must converge towards their medium-term budgetary objective, defined in structural terms[7] at a rate set by their debt levels and prevailing economic conditions. In addition, net expenditure cannot grow above the potential economic growth rate. Under the **corrective arm**, if countries run a deficit or debt above the two Maastricht thresholds, the Commission and Council may trigger an Excessive Deficit Procedure (EDP). In theory, this can impose fiscal consolidation measures on the member state in question. On the debt criterion, member states with a debt-to-GDP ratio above 60% must converge to the reference value at a 'satisfactory pace'. This was indicated in the 2011 six-pack reform as a yearly reduction of one-twentieth of the debt exceeding 60%. Euro area countries not complying with the SGP can face fines, although this is yet to occur.

The six- and two-pack reforms also introduced measures to strengthen national fiscal frameworks, including increasing the role of independent fiscal institutions (IFIs) to assess national fiscal behaviour. However, both the mandate and resources given to different IFIs vary significantly across member states. In addition, although not formally EU law, the Treaty on Stability, Coordination and Governance, signed by most EU member states during the eurozone crisis, reinforces SGP clauses by enshrining broadly similar requirements into domestic legal systems.[8]

Several exemptions and interpretative flexibility allow the Commission and Council to exercise a broad margin of discretion when assessing compliance, permitting flexibility and temporary derogations from the headline rules.

1.2. THE MACROECONOMIC IMBALANCES PROCEDURE

The Macroeconomic Imbalances Procedure (MIP) was introduced in 2011 in response to the eurozone crisis, which revealed how macroeconomic imbalances could lead to economic and fiscal crises.[9] The MIP serves as an early warning mechanism for macroeconomic risks like high private debt, potentially damaging asset price dynamics and balance of payments imbalances. Sanctions are foreseen when member states fail to correct excessive imbalances, although they are yet to be applied.

1.3. THE EUROPEAN SEMESTER[10]

The European Semester is the yearly integrated cycle of economic surveillance which embeds the MIP and SGP alongside broader economic and structural policy coordination.

Under the Semester framework, the Commission gives an overview of recent developments on economic growth with its Annual Sustainable Growth Survey and issues an Alert Mechanism Report on macroeconomic imbalances. A Joint Employment Report analyses the EU's employment and social situation, related challenges and member states' policy responses. Member states submit documents covering their three-year fiscal plans – Stability and Convergence Programmes (SCPs) – and structural policies – National Reform Programmes (NRPs) – in the medium term. The Commission assesses these programmes and proposes country-specific recommendations (CSRs), which the Council then endorses. The Commission's country reports analyse the respective economic and social developments and progress in implementing the respective CSRs. Specific procedures are in place for euro area countries, which must submit draft budgetary plans (DBPs) every October.

The binding force of the European Semester's different components varies drastically. The SGP created a set of prescriptive and theoretically enforceable obligations, but otherwise, EU bodies do not have substantive powers to guide national economic policy.

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2. The pre-COVID-19 performance of EU economic governance

The performance of the economic governance framework has undoubtedly been mixed. There are a dozen common concerns over how the SGP operates:[11]

- Many high-debt countries have not successfully reduced their debt ratios following the 2011-13 eurozone crisis, despite their compliance with deficit and expenditure criteria improving substantially. (However, these improvements had started to reverse somewhat in the immediate pre-COVID-19 years.)
- SGP rules have led to procyclical dynamics. Many member states failed to build up fiscal buffers during relatively good economic times (i.e. 2003-07, and between the post-eurozone crisis and COVID-19 outbreak),[12] while the EU as a whole conducted highly procyclical consolidation during the eurozone crisis.
- Non-compliance has been as common as compliance and is concentrated in high-debt countries. Nevertheless, the rules have changed behaviour, with the deficit and expenditure objectives acting as an anchor around which member states' fiscal outcomes cluster.[13]
- The reference values are not grounded in economic criteria but rather reflect the average macroeconomic conditions of the 1990s.[14]
- The SGP rules' complexity undermines their credibility and transparency and contributes to weak enforcement. Following the 2005 and 2011 reforms, the SGP became a complex system of overlapping indicators, with several derogations in place justifying the exercise of ad hoc flexibility. For example, in practice, compliance with the preventative arm has been considered sufficient to ensure compliance with the debt criterion. Therefore, EDPs have not been opened despite debt ratios not reducing at the one-twentieth pace.[15] The structural balance rule is particularly criticised for its practical complexity and reliance on the estimated output gap, a non-observable indicator subject to major uncertainty and revision. The expenditure rule increases complexity further, as the two indicators are often at odds when assessing compliance. In practice, before COVID-19, the European Commission was already starting to de-emphasise the structural balance and focus more on net expenditure when assessing compliance.[16]

The SGP rules' complexity undermines their credibility and transparency and contributes to weak enforcement.

- The European Commission's exercise of flexibility when assessing compliance has further aggravated the issues of complexity and transparency. This undermines the legitimacy of the rules-based framework. However, the flexibility is widely acknowledged as resulting from the need to address procyclicality concerns and respond to wider macroeconomic conditions and is grounded in legal provisions, highlighting the challenge of operating the rules-based framework under variable economic circumstances.
- The surveillance framework places particular focus on detailed annual assessments, to the point of "getting

bogged down in the 'decimals'."[17] There have been continual slippages over the medium term, however. The rolling three-year fiscal plans in the SCPs have become moving targets. This is partly due to variable economic conditions, the challenges of assessing certain metrics over a single year, and member states' exploitation of the annual thresholds. Most of these slippages have gone to current expenditure rather than investment.[18]

- There is a substantial disconnect between the fiscal framework and the actual budgetary process of member states. The fiscal aggregates used, particularly the output gap, are not easily translated into budgetary terms, complicating enforcement further. Countries with weaker budgetary frameworks are particularly prone to fiscal slippages.[19]

- To date, sanctions have never been used and are widely considered too politically toxic to be implemented.

- Given the lack of a central fiscal capacity coupled with a centralised monetary policy, euro area countries with higher debt burdens may not have the fiscal space to respond to country-specific shocks.

- Fiscal policy coordination has tended to lack effectiveness. Although the rules are intended to curb excessive deficits and debt, they cannot control the EU's aggregate fiscal stance. For example, if countries in a strong fiscal position consolidate during a downturn, procyclicality can spill over to the rest of the EMU, as was the case between 2011 and 2013.[20]

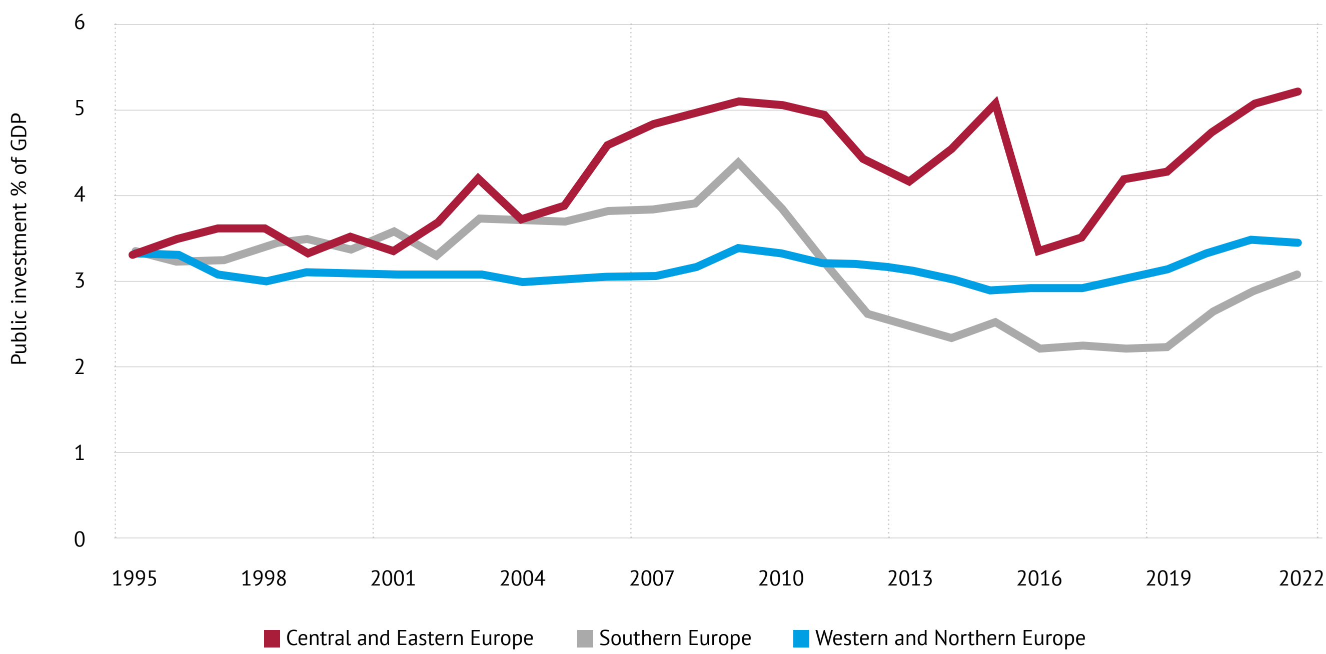
- The composition of public expenditure has suffered from the lower political cost of cutting public investment during consolidations. Public investments have been cut since the 2011 eurozone crisis, especially in Southern Europe (see Figure 1). Despite the strong potential of high-quality social services and social infrastructure to generate economic returns, reduce inequality and increase social cohesion, cuts have also targeted social investments.[21]

  Furthermore, as the European Fiscal Board (EFB) outlines,[22] the use of flexibility and discretion did not incentivise member states to improve the composition of public finances (i.e. deviations from the rules were used to finance current expenditures). Overall, the SGP's implementation has had an anti-investment bias.

More generally, in sharp contrast to the prevailing situation in the 1990s, the 2010's persistently lower interest rates made higher debt levels more sustainable. Combined with low growth and (pre-COVID-19) low inflation, this rendered fiscal policy a necessary complement to monetary policy at the zero lower bound.[23] One of the overarching criticisms of the SGP framework has been its consistent unresponsiveness to these changes in the macroeconomic environment. Attempts to introduce greater flexibility and discretion into the framework have not deterred this, as they tended to focus on temporary annual deviations rather than structural objectives.

Fig. 1

PUBLIC INVESTMENT AS GROSS FIXED CAPITAL FORMATION (1995-2022)



Source: Brasili *et al.* (2021)[24]

There is considerable debate over the durability of this macroeconomic environment, particularly given the recent rise in inflation and the macroeconomic consequences of the green transition (see section 5).[25] It is also worth noting that a significant component of the fiscal space gained in the low-interest-rate environment is tied to the European Central Bank's (ECB) purchases of government bonds as part of its mandate, which was also a critical component of the response to the eurozone crisis.[26] This highlights the importance of the interaction between the fiscal and monetary frameworks when considering economic governance reform.

Turning to the European Semester, it secured a predictable and structured framework for economic coordination among EU member states. However, as raised during the EPC Task Force meetings, the yearly economic monitoring framework has not boosted convergence between member states nor incentivised reform. The implementation rates of CSRs have been low due to their broad and cross-cutting nature.[27] One of the CSRs' key objectives is also to improve the quality of economic policy dialogue, provide a stronger base for economic policy coordination at the European level, and strengthen the link between EU strategic objectives and national policy. On this criterion, the Semester has failed to impact national debates. The annual framework is also seen as unfit for the long-term reforms it seeks to encourage.

Overall, the Semester's top-down process is considered to have failed to engender strong national political ownership of fiscal and economic objectives. Policy experts view this flaw as particularly critical, as the European Commission's economic surveillance tools cannot substitute political commitment. In its absence, evasion and weak compliance predominate.[28]

The European Semester's top-down process is considered to have failed to engender strong national political ownership of fiscal and economic objectives.

The MIP is widely viewed as lacking effectiveness. MIP CSRs have also seen low implementation rates and have been criticised for remaining a country-by-country exercise rather than a holistic assessment of EU-wide imbalances. Correcting imbalances is not within the straightforward control of policymakers, but the MIP has also seen low engagement even among policy experts.[29]

3. The economic impact of and response to COVID-19

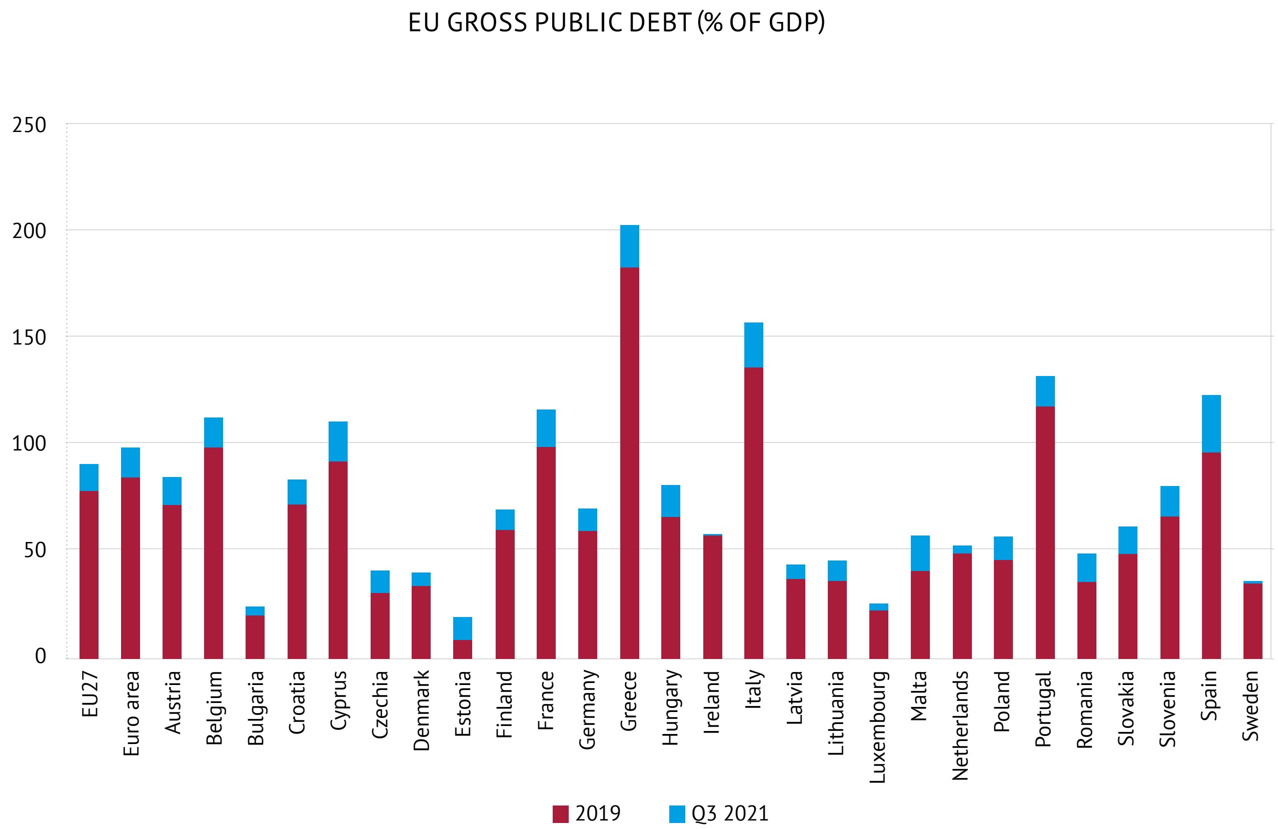
The EU reacted decisively to manage the economic impact of COVID-19. In March 2020, the European Commission activated the GEC, allowing member states to respond to the unprecedented health and economic crisis.[30] When countries with higher debt burdens saw a jump in borrowing costs, the ECB responded forcefully via its Pandemic Emergency Purchase Programme, creating the necessary fiscal space to act. The level of fiscal coordination and complementarity between fiscal and monetary policy is in sharp contrast to the events of the 2011 eurozone crisis.

Two important innovations in the EU's economic governance architecture matched these national and ECB efforts. The RRF, funded by central EU borrowing, directs investment into the Union's worst-impacted regions to propel their recovery following national stabilisation measures. Meanwhile, the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE) provides low-cost loans to national unemployment schemes.[31]

These measures helped member states' economies in critical times, and the EU is virtually back to pre-pandemic output levels, with recoveries in highly impacted countries like Italy better than expected. Furthermore, nationally financed investment has been preserved[32] and, with RRF funds, will rise significantly in many member states over the next few years. For example, in Southern Europe, it will grow from an average of 2.2% (2016-19) to 3.0%-3.1% of GDP (2021-23); in Central and Eastern Europe, from 3.8% to 5.7%.[33] However, overall investment levels remain below their pre-crisis level, in sharp contrast to the US.[34]

The extraordinary fiscal measures caused a surge in public deficit and debt. Countries with already high debt burdens were impacted disproportionally, further cementing divergences between member states. According to the latest data, in the third quarter of 2021, the EU27 deficit-to-GDP ratio was -3.3%, whereas the overall debt attained 90.1% of GDP (97.7% in the euro area) (see Figure 2, page 10). The EPC Task Force broadly agreed that should the fiscal rules be reactivated (expected in 2023) without amendments (or without very flexible interpretations), they would likely be politically,

Fig. 2



Source: Authors, based on *Eurostat*[35]

socially and economically untenable in countries with high debt levels. Given the rise in debt burdens in the most impacted countries, a one-size-fits-all approach to debt reduction is increasingly unrealistic. COVID-19 may also produce long-term impacts that further exacerbate macroeconomic imbalances between member states.

The pandemic also highlighted the continuing vulnerability of countries with high debt levels to shocks, despite the overall low-interest-rate environment, and their continuing reliance on the ECB to create the necessary fiscal space.[36]

4. The Recovery and Resilience Facility's early success[37]

The RRF is one of the most significant economic outcomes of the EU's response to COVID-19 and holds important implications for the economic governance reform debate. To summarise its structure, the funds borrowed at the EU level will be distributed to member states to implement their National Recovery and Resilience Plans (NRRPs). These plans cover both investments and reforms and contain multiple targets and milestones to meet in order to receive funds. Member states designed these plans, thereby reflecting national priorities and political objectives. However, they must also address their pre-existing CSRs, follow the European Commission's overarching guidance and engage with it closely.

The European Semester has been amended to integrate the NRRPs. Member states will report on their milestones twice a year, alongside the NRPs and DBPs, with the reports incorporated into the respective NRPs. The Commission will update an implementation scoreboard in parallel and present an annual report to the European Parliament and Council in July.

The assessment of the RRF by observers and policymakers to date has been extremely positive. In contrast to the Semester's top-down, 'teacher to student' process, the NRRPs' bottom-up nature has been praised. It is judged to have increased national ownership and allowed for country-specific prioritisation between competing objectives.[38] Likewise, its concrete, multiannual plans and milestones are viewed as shifting the focus from annual processes to actionable long-term outcomes.

Of course, the large sums of funding attached are a key reason for the levels of national engagement. Whether its implementation will be a success also remains to be seen. In particular, the credibility and legitimacy of the new instrument are linked to the ability of the largest beneficiaries (e.g. Italy, Spain) to meet targets and deliver reforms. Nevertheless, the RRF appears to hold important lessons for revamping the Semester process more widely.

One area of criticism has been the lack of participation by social partners, the European and national parliaments, and other stakeholders. Cross-border, pan-European projects were also limited.[39] Although excusable due to the extraordinary circumstances of the pandemic and the short timeframe to set up a new instrument, the RRF framework should address these concerns going forward.

5. The twin transitions and the social challenge[40]

Any assessment of the economic governance framework must also consider the Union's strategic challenges and its leaders' political priorities. On this basis, the framework clearly must adapt.

The most pressing challenges are the twin green and digital transitions and the social transition that must underpin them.[41] Europe also faces rising geopolitical competition defined by the contest over the control and development of key technologies.[42] Europe has lagged in these areas considerably over the past two decades and is engaging in a series of industrial policy initiatives to reverse its ailing position.[43]

The twin green and digital transitions will require around €650 billion a year in public and private investment until 2030. €520 billion of that would be for the green transition alone.

The twin transitions will require around €650 billion a year in public and private investment until 2030. €520 billion of that would be for the green transition alone.[44] Although the amount of additional public investment this will require is debated, it will likely be at least €100 billion a year for the green transition.[45] Beyond the level of public investment, the required economic structural change is epoch-defining. Annual global emissions will have to fall by 7.8% every year. For context, they fell by 5.8% during the pandemic-induced economic shutdown of 2020.[46] There is already substantial EU policy coordination through the Fit for 55 package and numerous industrial policy initiatives, but the economic governance framework should be an essential tool in the twin transitions. For example, it could play a valuable role in incentivising the 'greening' of government budgets, promoting private investment, and tackling subsidies for carbon-intensive activities.

The green transition will also have a significant macroeconomic impact that will have to be managed. Severe disruptions to the climate will likely create greater inflationary pressures and negative supply shocks that disrupt labour and product markets significantly.[47]

A further serious and related challenge is the social dimension of European governance. The COVID-19 impact has been heavily asymmetric. Certain regions, economic sectors and social groups (i.e. students, youths, low-skilled workers) have been hit harder than others. This has and will continue to impact Europe's poverty levels, territorial cohesion and inequalities. In addition, the pandemic has revealed some member states' deficiencies in social service provision, primarily healthcare and long-term care.[48] Member states which had, for instance, better-equipped hospitals, long-term care facilities and schools have tended to perform better in the face of the pandemic.[49]

Investments in social services (e.g. education and training, childcare, active labour market policies) and social infrastructure (e.g. healthcare and long-term care facilities, educational facilities, social housing) make key contributions to the EU's key political objectives. Neglecting them will have severe negative long-term impacts.[50] The European Commission's estimate of the additional investment needs in social infrastructure alone is €192 billion per year, with healthcare and long-term care accounting for 62%.[51]

Investments in social services and social infrastructure make key contributions to the EU's key political objectives. Neglecting them will have severe negative long-term impacts.

The structural changes accompanying the green and digital transitions will radically reshape our society, economy and everyday lives. Fear surrounding these dramatic transformations is high, especially in those regions and sectors where the adjustments will be felt most keenly. Unless these valid fears are heard and assuaged, long-term public support for the transitions cannot be assumed.[52] Public spending will be fundamental in managing the transitions; through social investment in the upskilling and reskilling of workers, and repairing and enhancing social safety nets. While the transitions offer a path to a more sustainable future, they also have the potential to create significant social and political unrest if not managed well. If insufficient attention is given to the social impact of these transformations, they will not succeed. With so much now depending on the successful delivery of the twin transitions, this failure would be a very serious blow to the EU's credibility.

Through the European Pillar of Social Rights (EPSR) and events like the 2021 Porto Social Summit, European leaders have emphasised the importance of social commitments at the European level and that the economic governance framework must reflect them. The European Semester is already growing to incorporate social policy concerns by integrating the EPSR and the UN Sustainable Development Goals. This should be continued and reinforced going forward.

6. The objectives and principles of reform

The challenges to EU economic governance outlined in the preceding sections can be broken down into five broad categories:

1. The **design** of the current rules, in terms of their complexity, procyclicality, enforceability and anti-investment bias.

2. The **COVID-19 impact** on public finances and macroeconomic imbalances. Rising debt ratios in countries already highly indebted have rendered the current benchmark for debt consolidation increasingly unrealistic. Although the impact on imbalances is still unclear, the pandemic is likely to have had, and potentially will continue to have, a significant effect.

3. The growing number of sources of **imbalances and risks**, such as climate change.

4. The **demands of the green and digital transitions**, which require a long-term surge in public investment. Many member states will struggle to achieve this within the SGP's current strictures.

5. Preserving and enhancing the **social dimension** of EU economic governance.

These five overlapping challenges, combined with certain political changes in several member states, have generated a fresh momentum for reform. To address these challenges effectively while drawing lessons from the past two decades of EU economic governance, the reform proposals should reflect the following key principles:

- **National political ownership of commitments**, whether of fiscal trajectories or investments and structural reforms, **is critical**. The rules' technical design is important, but experience has shown that sticking to commitments also requires strong national political ownership and buy-in.

- **Complete contracts are neither possible nor desirable.** In the attempt to retain a comprehensive set of rules, the SGP evolved from simple benchmark indicators to a complex edifice of detailed rules and exemptions. This has been driven by the need to accommodate the tension between fiscal sustainability and short-term stabilisation and to reflect complex and changing economic environments.[53] Discretion has been exercised through continuous interpretation of the rules, creating greater opacity, political mistrust and lack of accountability for decision-making. It would be preferable instead to allow clear room for discretion within the governance framework, to respond to variable economic circumstances. The focus should be on creating governance processes which ensure that discretion is exercised in a transparent, accountable and politically legitimate fashion.

Governance processes which ensure that discretion is exercised in a transparent, accountable and politically legitimate fashion should be created.

- Given the heterogeneity in country debt burdens and economic structures, **a one-size-fits-all approach is increasingly recognised as untenable**. Greater country specificity, in terms of both objectives (e.g. debt reduction targets) and supervision, would be preferred. However, any differentiation in supervision should be justified through objective criteria and must ensure that all the components of EU economic governance are given appropriate weight. For example, the supervision of macroeconomic imbalances should not be neglected because a member state has low public debt.

- **The relationships between the SGP and the rest of the EU economic governance framework must be balanced.** Although fiscal sustainability is critical, economic policy coordination and tackling macroeconomic and structural imbalances are ever more vital. The SGP may have the strongest legal force at the EU level, but the political commitments by Europe's leaders to overarching European goals, like the twin transitions and the full implementation of the EPSR, are clear. The framework cannot, therefore, neglect these aspects.

- In the same vein, as a key determinant of fiscal space for member states and one of the Commission's strongest economic policy tools, many reform proposals involve utilising the SGP's flexibilities to pursue broader goals. While certain reforms and investments are critical for long-term fiscal sustainability, **the SGP should not be overburdened with multiple policy objectives that would be better addressed by other components of the economic governance framework**. Proposals must be carefully balanced with the SGP's primary objective of fiscal sustainability.

- There is an increasing acknowledgement that the rules must address the composition of public finances.[54] Unlike between 2011 and 2013, any fiscal consolidation must preserve growth and public investment, and Europe will have growing investment needs over the medium and long terms. However, there is considerable doubt among some member states whether greater flexibility will automatically result in their neighbours pursuing growth-promoting investments or other desirable policy goals. This concern is borne, to an extent, out of historical experience. **A reformed framework will need governance mechanisms that can address this lack of trust.** Nevertheless, greater oversight of the composition of public spending creates clear tension with member state sovereignty and democratic accountability, which must be addressed.

- The current framework focuses on member states' annual budget cycles, but this has not prevented a continual slippage in medium-term fiscal paths. **Reforms must** address this flaw to **ensure that fiscal sustainability is actually achieved over the medium term**.

- **A reformed economic governance framework must be robust enough to withstand different macroeconomic environments.** Until the onset of the pandemic, the EU struggled with low growth and low interest rates that not only increased the sustainability of public debt but also reduced the effectiveness of macroeconomic policy. At the moment, COVID-19-induced disruptions, supply chain tensions and the macroeconomic impact of the twin transitions threaten to create long-term inflationary pressures. These could ultimately lead to the ECB tapering its purchases of government bonds, thereby increasing yields for high-debt member states. No matter the eventual prevailing macroeconomic circumstances, the EU must be able to preserve debt sustainability, undertake effective macroeconomic policy, and make the required investments in the twin transitions and related social measures.

7. Reform proposals

7.1. GREEN, DIGITAL AND SOCIAL INVESTMENT

To undertake the necessary investments in the green and digital transitions, we support the creation of a **central investment facility – a 'Twin Transition Facility' (TTF) – that is modelled on the RRF and funded through EU-level borrowing**. Funds could in turn be disbursed through a combination of direct grants and loans (e.g. RRF). Such investment support would be tied to relevant reform commitments to ensure that money is well spent and is part of a holistic and growth-enhancing economic strategy. Some proportion of these investments should also be directed towards social investments necessary to support the twin transitions. For example, workers made redundant by structural changes could be retrained, or energy efficiency renovations for poorer households subsidised. We acknowledge that the political consensus over the need to finance the green transition is strongest and that the proposed facility may have to be limited to green investments only.

A central investment facility – a 'Twin Transition Facility' – that is modelled on the RRF and funded through EU-level borrowing should be created.

In contrast to the RRF, however, such a facility should not be structured to be *a priori* redistributive. This would create too many political obstacles and raise fears of a permanent 'transfer union'. In order to move the debate forward, it must be reframed away from the 'North/South' and 'creditor/debtor' dichotomies of the eurozone crisis and towards the EU's joint challenges. Allocations from the TTF should be based on GDP shares or measures of investment needs, which are much more evenly distributed across the Union. Furthermore, a proportion of centrally raised funds should be allocated to EU-level and cross-border programmes, such as industrial policy initiatives. The TTF could require co-financing from national budgets to ensure additionality in investments.

In the long term, the TTF would require greater own resources or national contributions. The options for achieving this are not covered in this Discussion Paper, and the 'own resources' discussion related to the RRF remains ongoing. However, finding sufficient own resources is fundamentally a matter of political will: where there is political agreement on the necessity of such an investment facility, the necessary own resources will be found.

Should there be insufficient political consensus for greater EU-level borrowing, our alternative proposal would be to **adopt a green and digital golden rule modelled on RRF governance**. Exemptions from the SGP's borrowing limits would fund nationally designed reform and investment plans approved at the EU level. This option has challenges related to the governance of the funds raised. Due to the time inconsistency between granting the flexibility to raise funds and plan milestones and because member states maintain control over funds once raised, there are fewer mechanisms to enforce adherence to plans. Therefore, it could be supplemented by creating national envelopes at the EU level that would hold the funds raised by member states so that the European Commission could withhold funding if milestones are not met.

This additional level of control by the Commission is legitimate since raising funds outside SGP strictures still impacts fiscal sustainability, with potential spillovers to other member states. This therefore necessitates additional governance guarantees to ensure that funds are spent effectively.

In our view, the alternative golden rule design based on accountancy methods (i.e. determining *ex ante* what qualifies by automatically designating some types of investments as green or digital) would be too challenging to implement and give rise to legitimate 'greenwashing' and governance concerns.

Many green and digital investments are public goods with spillovers to other member states. This may mean that they will be under-provisioned unless funded centrally.

Although it would represent a welcome improvement to the economic governance framework, this second option is less desirable than the first, TTF proposal. Many green and digital investments are public goods with spillovers to other member states. This may mean that they will be under-provisioned unless funded centrally. Furthermore, many member states have fragile balance sheets and will be dependent on benign macroeconomic conditions and central bank support to increase investment significantly. Financial markets are primarily concerned with gross debt and the overall health of countries' balance sheets, not with their treatment under the SGP. Given that such conditions are not guaranteed, necessary investments may not be undertaken, even if SGP strictures are removed.

Central capacity for short-term macroeconomic stabilisation would also be beneficial.[55] However, this remains a politically contentious idea. Given the positive experience to date of the RRF and the growing political consensus over the investment (as opposed to stabilisation) challenges faced by the EU, we believe that political capital and energy should not be expended proposing central fiscal capacity for short-term stabilisation. Instead, **the successful SURE programme should be built upon** to create insurance-based support for national automatic stabilisers during downturns.

7.2. THE STABILITY AND GROWTH PACT AND THE EUROPEAN SEMESTER

There is no reason to depart from the widespread expert consensus that the current rules should be replaced with some variation of a single net expenditure rule (excluding automatic stabilisers) and a single country-specific debt anchor, shifting the focus of the economic governance framework towards debt rather than deficit control. The net expenditure rule is widely considered a more stable operational target, directly under the control of policymakers without the substantial variation, sensitivity to economic cycles, and retrospective revisions seen with output gap estimates. In practice, expenditure rules have also been found to be more countercyclical than the structural balance rule.[56]

It is unnecessary to amend the Treaty reference values as part of the EU economic governance reform. Instead, country-specific debt anchors should be seen as intermediate operational targets.

It is unnecessary to amend the Treaty reference values as part of the reform. Instead, country-specific debt anchors should be seen as intermediate operational targets. **Member states selecting realistic debt targets**

and designing their debt pathways will enhance political ownership and enforceability. One of the EPC Task Force's key concerns is that unrealistic targets inevitably lead to evasion, ultimately undermining the entire governance framework. Regarding the governance of these reformed rules, we support the proposals by economists Philippe Martin, Jean Pisani-Ferry and Xavier Ragot that member states submit multiannual expenditure and debt pathway plans. They would incorporate an assessment of maximum primary balance and the risks to the interest rate–growth differential, be verified by national IFIs and be accepted by the European Commission and Council.[57] To guard against overly optimistic forecasts – a perennial problem –,[58] the economic governance framework should require national IFIs to produce the macroeconomic forecast used as the basis of the plans.

The assessments of the country-specific plans should be complemented by Commission and EFB opinions on the euro area's fiscal stance as a whole, which should be used as a basis for fiscal coordination discussions and the overall assessment of expenditure and debt plans.

We further propose that **supervision be strengthened via fixed, multiannual budgetary plans**, in addition to the current fiscal SCPs – at least for euro area member states. The current DBPs would then be assessed against these multiannual commitments. Introducing a single expenditure rule as a clear operational target should make monitoring and enforcement easier, but medium-term budgetary plans would go a step further in operationalising fiscal commitments. Strong medium-term budgetary frameworks are an important determinant of improved fiscal outcomes.[59] The plans would be fixed to guard against the tendency of 'moving targets' from one year to the next. However, to maintain political ownership, newly formed governments should not be bound by their predecessors' plans and be able to submit new plans.

Strong medium-term budgetary frameworks are an important determinant of improved fiscal outcomes.

We do not believe that the Commission and Council should have the power to reject these budgetary plans,[60] as that would imply too great an interference into national autonomy and legislative processes. The current system of issuing an opinion should be maintained and extended to include an assessment of their compliance with medium-term budgeting framework best practices.

Expenditure deviations from the plans should be monitored, and, when over a certain threshold, the member states should commit to making up for overspending with underspending. This would mirror the control account in some member states' national frameworks, with *ex post* deviations recorded over a significant period (e.g. five years) to avoid keeping yearly repeated deviations just under the threshold. While these correction mechanisms have had limited success at the national level, bringing them into the EU framework will increase their political salience. Combined with a stronger political commitment to country-specific fiscal targets and improved medium-term budgetary planning, this would lead to better outcomes. Should new governments inherit substantial overspending in these control accounts, it would be the Council's discretion to determine how much would have to be made up for in their new fiscal plans.

The escape clause for severe economic downturns should remain, and the Commission should, in addition, retain some discretion to assess whether other economic conditions justify not making up for accumulated deviations. However, it should assess these deviations (i.e. those not incurred due to the escape clause) over the medium term and not on an annual basis. Should it consider that some proportion of the accumulated deviations in the control account need *not* be made up for, it should submit a proposal to the Council to that effect. The EFB should issue an independent assessment of the proposal in parallel. Political authorities would retain the ability to exercise discretion while increasing transparency.

Beyond the SGP, we also propose that **multiannual 'National Reform and Investment Plans'** (NRIPs) modelled on the NRRPs **replace the NRPs**. The NRRPs have two critical features that should be emulated:

- concrete, long-term investment and reform plans to address CSRs and pan-European priorities (i.e. clear milestones and targets for a transparent and structured assessment of national measures to tackle complex economic policy challenges); and
- national administrations lead the design of their plans (with appropriate guidance and earmarking from the European Commission), creating stronger national and political ownership and allowing greater country-specificity.

'National Reform and Investment Plans' have the potential to improve broader economic policy coordination significantly by requiring member states to be explicit about how they plan to operationalise their CSRs, with milestones and targets to which they can be held accountable.

NRIPs have the potential to improve broader economic policy coordination significantly by requiring member states to be explicit about how they plan to operationalise their CSRs, with milestones and targets to which they can be held accountable. These plans also encourage addressing fiscal, macroeconomic, social and structural issues (i.e. green and digital transitions) as a comprehensive package.

Expectations on the improvement of implementation without positive funding incentives should be realistic. However, this approach would still be better than the status quo. Explicit milestones would increase high-level political ownership and facilitate engagement by social partners, civil society and national parliaments. This could bolster the European Semester's salience and impact national economic policy debates, thereby creating a stronger basis for economic coordination and dialogue than the current Semester outputs. Given the decentralised nature of EU economic policy, it is through such dialogue that we see broader economic and social policy goals being operationalised and coordination improved.

Furthermore, **those measures in NRIPs that have a strong link to long-term fiscal sustainability could be used to justify slower national debt reduction paths**. This would essentially replace some of the current governance of the SGP's flexibilities by tying the exercise of flexibility to transparent multiannual milestones and targets. Failing to meet agreed milestones could be treated like overspending and accounted for under the correction mechanism.

We assume that creating a coherent package of fiscal plans coupled with investment and reform commitments and governed using clear targets and milestones will create the strong governance framework necessary to promote high-quality, growth-enhancing expenditure and assuage concerns that fiscal flexibility will be misused.

For investments and reforms that promote a pan-European objective but do not clearly link to long-term fiscal sustainability, this approach is also an option for when states do not have sufficient fiscal space under the rules. This is the essence of the green and digital golden rule proposal above. However, this would risk overburdening the SGP and implicitly increase fiscal spillover risks to other member states. It would be preferable to use central funding for such objectives and to provide positive incentives for difficult reforms rather than rely on fragile national balance sheets. An exception could be made, nonetheless, in cases where faster consolidation could incite social unrest that undermines the green and digital transitions.

We also propose that **the SCPs' three-year fiscal plans and the assessment of budgetary plans be reformed** to place a greater emphasis on the share of public investment, particularly related to categories that are recognised as important for pan-European objectives. They should include categories of social investment. The objective is to encourage policymakers to consider the investment impact of fiscal plans more holistically. This should be explicitly linked to the investment commitments made in the NRIPs and help assess whether flexibility and central funding lead to investment additionality. An assessment of how climate and environmental risks may impact the fiscal position should also be incorporated.

The Stability and Convergence Programmes' three-year fiscal plans should include categories of social investment.

Under these proposals, member states would retain the flexibility to increase debt ratios to fund investment programmes, subject to the agreement of the Council. Even when the objective is not debt reduction, this governance framework would aim to ensure that debt increases are undertaken in a sustainable and controlled manner, with appropriate attention to the quality of debt-financed expenditure.

EU policy goals like the green and digital transitions have been promulgated through the EU's political institutions and by the executives of member states. Nevertheless, there remains a tension between greater EU supervisory focus on the composition of public spending and democratic legitimacy. Therefore, we support giving the European and national parliaments a greater role in vetting and validating national commitments and plans.

7.3. THE MACROECONOMIC IMBALANCES PROCEDURE AND STRUCTURAL RISKS

Given the decentralised nature of EU economic governance, the nature of the risks covered by the MIP makes them extremely challenging to address. Tackling them requires bringing a wide range of policy tools to bear, often with high domestic political costs. Furthermore, there is often fundamental political disagreement over what constitutes an imbalance – particularly regarding the current account.[61]

The proposal to operationalise CSRs through NRIPs (see section 8.2.) may aid somewhat to address MIP CSRs, but this is fundamentally unlikely to have an impact without strong political ownership. In view of this, the focus should be on **raising the level of policy debate to generate a political consensus** over these issues, which would then support national political ownership of the necessary measures to tackle them. This could be taken a step further by integrating into the MIP an examination of whether EU-level tools, such as regulatory initiatives and macroprudential policy, can be used to combat certain imbalances while respecting subsidiarity.

The link between the MIP and SGP could, however, **be strengthened** by having an opinion on the impact of the SCPs – both individually and combined – added to the MIP process.

When it comes to other structural risks that should be addressed through the EU's economic governance framework, such as climate-related and environmental risks or demographic risks, **separate procedures should be introduced to identify relevant vulnerabilities**. During its public consultation, the European Commission raised the possibility of incorporating climate-related and environmental risks into the MIP. In our view, this would overburden the MIP and render its objectives unclear. For example, the physical, material impacts of climate-related and environmental risks are qualitatively different from those of macroeconomic imbalances. While the former may aggravate the latter, the impacts are likely to manifest across multiple economic and social areas.

As such, an independent climate risk assessment procedure that takes the physical risks as its starting point and then assesses their manifold impacts on economic and social structures would be a more appropriate approach. The findings of these assessment procedures should be reflected in the assessment of the reformed SCPs and budgetary plans. There may be other categories of structural risks that are considered sufficiently broad-based and to have potentially high impacts on economic and social structures to merit more comprehensive assessment and integration into the economic governance framework. If so, they should also be reflected in distinct procedures suited to the nature of those risks.

7.4. SUPERVISION, ENFORCEMENT AND SANCTIONS

Supervision must balance the principle of equal application of the rules with prioritising high-risk cases that may create spillovers to the rest of the EU. **A clear and objective threshold should be established for the enhanced supervision of member state compliance with budgetary and fiscal commitments.** This threshold should be determined by debt sustainability, the biggest source of potential risks.

Having a clear, shared threshold that is easily communicable may have greater political salience and assuage concerns among hawkish stakeholders that the EU economic governance framework is moving too far away from shared standards.

It could be a clear and easily communicated numerical indicator like 100% debt-to-GDP, or a dynamic assessment of debt sustainability that better reflects country-specific circumstances. The latter would bring the framework closer to the 'standards' approach championed by Blanchard.[62] This assessment could be conducted by national IFIs and reviewed by the European Commission and EFB separately. However, the rest of the proposals in this Discussion Paper substantially move the framework towards a country-specific approach, and high-risk cases are all likely to be above 100% of GDP. As such, having a clear, shared threshold that is easily communicable may have greater political salience and assuage concerns among hawkish stakeholders that the framework is moving too far away from shared standards.

For those above the threshold, **deviations should be carefully tracked, accounted for under the correction mechanism, and acted upon to prevent medium-term slippage from targets**. The EDP should be triggered by accumulated slippages beyond a certain threshold over the medium term, not only single deviations. Deviations from the 3% Maastricht value as a metric for launching EDPs should be de-emphasised, with compliance to the expenditure commitments held as a mitigating factor – something that should be a possible interpretation of Treaty requirements.

There is a risk here that the anchoring effect of the 3% target could be lost, something also raised by Francová *et al*.[63] This would be problematic given that under the current macroeconomic projections, debt-to-GDP ratios would stabilise at around 100% with 3% deficits. Therefore, we would not go as far as Martin, Pisani-Ferry and Ragot to say that it should be *de facto* abandoned but instead de-emphasised so long as medium-term commitments remain on track.[64]

As part of this enhanced supervision, **the European Commission should engage strongly with different stakeholders in member states that influence the domestic fiscal process**. The Commission should consider stronger engagement in the public sphere, leveraging and amplifying similar efforts by national IFIs.

For those member states below the threshold, **supervision and enforcement should only focus on gross policy errors**, such as deviations of expenditure commitments beyond some relatively higher threshold.

Sanctions should remain focused on high-risk cases above a certain threshold. But the sanctions regime must evolve if it is to meaningfully contribute to enforcement.

Sanctions should also remain focused on high-risk cases above a certain threshold, but **the sanctions regime must evolve** if it is to meaningfully contribute to enforcement. Currently, sanctions are seen as too politically toxic to be implemented. However, a set of rules needs some ultimate enforcement mechanism or else could undermine politicians' perception of their binding nature. De-emphasising the reference values and their anchoring effect also requires strengthening the enforcement of country-specific commitments. As such, we propose the two following steps:

- The sanctions amount levied should be equal to the slippage from expenditure plans to create a clear link with national political commitments. This could increase the sanctions' perceived fairness and proportionality.
- The sanctions amount levied should be held in a special account and returned once compliance is restored, solely to pay down debt. By ensuring that the funds return to the respective member states, the political cost of sanctions would be reduced. Reserving these sanction funds for paying down debt would avoid any distorting incentives.

In addition, access to TTF funds should be conditional on complying with SGP commitments.

Regarding the supervision of the MIP, the current process already categorises member states according to their level of risk. The Commission should also consider more public and active engagement and communication on macroeconomic risks in high-risk member states. However, the Excessive Imbalance Procedure is unlikely to ever be politically tenable and should therefore be discontinued (quietly).

7.5. DISCRETION

In the proposals outlined above, **ultimate discretion remains in the hands of political authorities** at either the national or Council level. IFIs should also have a broad mandate and sufficient resources to analyse and validate the behaviour of fiscal authorities and produce independent forecasts. Given the variation in their powers and resources, there is a strong case for harmonisation across the EU.[65] However, political authorities, whether at the national or EU level, should retain ultimate control over fiscal policy decisions. Attempts to depoliticise supervision are unrealistic and would ultimately backfire by politicising other judicial and technical institutions.[66] Discretion should be exercised transparently through clear political decisions by the Commission and Council. This is what the proposals to have expenditure deviations automatically accounted for and requiring a positive decision to expunge them aims to achieve.

7.6. LEGAL CRITERIA FOR REFORM

In the preceding sections, little is said regarding the legal criteria for reform that may make some options more feasible than others, such as voting requirements, interaction with domestic constitutional requirements (e.g. the German debt brake) or the need for Treaty change. This Discussion Paper focuses on how the EU economic governance framework should be reformed from the first principles. Given the recent developments in the European political scene and the extraordinary advances made in response to COVID-19, it is far too early to say that some options are irrevocably closed off. We restrict ourselves to the plea that **any reform through the interpretative backdoors should be avoided**. Sustainable reform requires a broad-based consensus among all member states and relevant stakeholders. There should be clear consensus even where interpretation is used, and the interpretative change should be clearly set out and communicated.

Conclusion

In summary, this Discussion Paper puts forward the following 10 major reform proposals:

1. Establish a central investment capacity, a 'Twin Transition Facility', for green and digital investments (including associated social investments) or, alternatively, a golden rule modelled on the governance of the RRF.
2. Introduce a single net expenditure rule with a country-specific debt target based on nationally designed expenditure and debt plans to enhance political ownership.
3. Shift to a multiannual supervision and assessment framework and introduce fixed medium-term budgetary plans, with a control account tracking deviations.
4. Reform the sanctions regime to increase proportionality, perceived fairness and political enforceability.
5. Differentiate country-specific supervision based on a clear risk threshold.

6. Introduce NRIPs modelled on the NRRPs, using a commitments-based approach to operationalise social, fiscal, macroeconomic and structural CSRs. The plans' components with strong links to fiscal sustainability should govern the use of SGP flexibilities.

7. Reform the SCPs to focus more on the investment composition of national fiscal plans and their link to broader policy objectives.

8. Introduce an opinion on the individual and joint impact of the SCPs on imbalances into the MIP to strengthen its link with the SGP.

9. Introduce new processes into the European Semester to assess non-macroeconomic structural risks, such as climate and environmental risks.

10. Build on the success of the SURE programme to create insurance-based mechanisms to support national fiscal policy during downturns.

The EU economic governance framework must be adapted to ensure fiscal sustainability and macroeconomic stability while simultaneously promoting the Union's strategic objectives and respecting the balance of EU and national competences. In order to be effective, all reforms must balance flexibility with effective governance and enforceability to overcome any lack of trust from member states. The proposals in this Discussion Paper seek to balance these competing elements to create a coherent and interlinked governance architecture, combining more political discretion over national commitments with strong enforcement mechanisms. Furthermore, they seek to place the twin transitions at the heart of a reformed framework. Only by doing so can the economic governance framework be fit to tackle the pressing challenges faced by the Union.

[1] De Angelis, Francesco and Frederico Mollet (2021), "Rethinking EU economic governance: The Stability and Growth Pact", Brussels: European Policy Centre; Mollet, Frederico (2021a), "Rethinking EU Economic Governance: European Semester", Brussels: European Policy Centre; Rayner, Laura (2021), "Rethinking EU economic governance: Social investment", Brussels: European Policy Centre.

[2] See e.g. Francová, Olga; Ermal Hitaj; John Goossen; Robert Kraemer; Andreja Lenarčič; and Georgios Palaiodimos (2021), EU fiscal rules: reform considerations, Luxembourg: European Stability Mechanism.

[3] Harold, James (2012), *Making the European Monetary Union*, Cambridge MA: Harvard University Press.

[4] Initially, only the deficit criterion was operationalised in the Stability and Growth Pact. It was not until 2011 that the debt criterion was also made into an operational indicator.

[5] European Fiscal Board (2019), Assessment of EU fiscal rules with a focus on the six and two-pack legislation, Brussels: European Commission.

[6] See De Angelis and Mollet (2021), *op.cit.*

[7] The structural balance does not include the cyclical component (i.e. change in revenues and expenditures during expansion and/or recession) nor one-off measures. The cyclical component is calculated by estimating the output gap between current and potential outputs.

[8] European Commission (2017), The Fiscal Compact: Taking Stock, C(2017) 1200 final, Brussels.

[9] The Spanish and Irish crises in the early 2010s were caused principally by macroeconomic imbalances. See Lane, Philip R. (2012), "The European Sovereign Debt Crisis", *Journal of Economic Perspectives*, Volume 26, Number 3, pp.49-68.

[10] See Mollet (2021a), *op.cit.*

[11] For a comprehensive overview of the operation of the Stability and Growth Pact following the six- and two-pack reforms, see European Fiscal Board (2019), *op.cit.*

[12] Schuknecht, Ludger; Philippe Moutot; Philipp Rother; and Jürgen Stark (2011), "The Stability and Growth Pact: Crisis and Reform", Frankfurt aM: European Central Bank. European Fiscal Board (2020), Annual Report 2020, Brussels: European Commission.

[13] Caselli, Francesca and Philippe Wingender (2018), "Bunching at 3 Percent: The Maastricht Fiscal Criterion and Government Deficits", International Monetary Fund, p.39.

[14] See Buti, Marco and Vitor Gaspar, "*Maastricht values*", *VoxEU*, 08 July 2021. Blanchard, Olivier; Álvaro Leandro; and Jeromin Zettelmeyer (2021), "Redesigning EU fiscal rules: From rules to standards", Washington DC: Peterson Institute for International Economics.

[15] European Fiscal Board (2019), *op.cit.*

[16] Buti, Marco; Nicolas Carnot; Atanas Hristov; Kieran Mc Morrow; Werner Roeger; and Valerie Vandermeulen, "Potential output and EU fiscal surveillance", *VoxEU*, 23 September 2019.

[17] Buti, Marco, "Lessons from a European journey through two crises", *VoxEU*, 18 November 2021.

[18] Thygesen, Niels; Roel Beetsma; Massimo Bordignon; Xavier Debrun; Mateusz Szczurek; Martin Larch; Matthias Busse; Mateja Gabrijelcic; Eloïse Orseau; and Stefano Santacroce, "Reforming the EU fiscal framework: Now is the time", *VoxEU*, 26 October 2020.

[19] Rodríguez, Lucía (2021), "The role of the Independent Fiscal Institutions in assessing the sustainability of high public debt in the post-Covid era", Brussels: The Network of Independent Fiscal Institutions.

[20] Buti, Marco and Nicolas Carnot, "The case for a central fiscal capacity in EMU", *VoxEU*, 07 December 2021. Buti, Marco; Gabriele Giudice; and José Leandro (2020, eds.), *Strengthening the Institutional Architecture of the Economic and Monetary Union*, London: Centre for Economic Policy Research. European Commission (2016), Towards a Positive Fiscal Stance for the Euro Area, COM (2016) 727 final, Brussels.

[21] Rayner (2021), *op.cit.*

[22] Thygesen *et al.* (2020), *op.cit.*

[23] The *zero lower bound* refers to the situation where interest rates are at or near zero, limiting the ability of central banks to lower interest rates further to stimulate growth and inflation. European Central Bank (2021), Monetary-fiscal policy interactions in the euro area, Frankfurt aM; Blanchard, Olivier (2019), "Public Debt and Low Interest Rates", *American Economic Review*, Volume 109, Number 4, pp.1197-1229; Furman, Jason, "The New View of Fiscal Policy and its Application", *VoxEU*, 02 November 2016.

[24] Brasili, Andrea; Atanas Kolev; Debora Revoltella; and Jochen Schanz (2021), "Public Investment in the Pandemic—Europe at a Glance" in Floriana Cerniglia, Francesco Saraceno and Andrew Watt (eds.), *The Great Reset: 2021 European Public Investment Outlook*, Cambridge: Open Book Publishers, Chapter 1, p.19. Central and Eastern Europe: Bulgaria, Croatia, Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia. Southern Europe: Cyprus, Greece, Italy, Malta, Portugal, Spain. Western and Northern Europe: Austria, Belgium, Denmark, Germany, Finland, France, Ireland, Luxembourg, the Netherlands, Sweden.

[25] Thygesen, Niels; Roel Beetsma; Massimo Bordignon; Xavier Debrun; Mateusz Szczurek; Martin Larch; Matthias Busse; Mateja Gabrijelcic; Laszlo Jankovics; and Stefano Santacroce, "High debt, low rates, and tail events: Rules-based fiscal frameworks under stress", *VoxEU*, 08 March 2021. Francová *et al.* (2021), *op.cit.*

[26] European Central Bank (2021), *op.cit.*

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[28] Mollet (2021a), *op.cit.*; Wieser, Thomas (2020), What Role for the European Semester in the recovery plan?, PE 651.368, Brussels: European Parliament.

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[33] Cerniglia, Floriana; Francesco Saraceno; and Andrew Watt (2021, eds.), *The Great Reset: 2021 European Public Investment Outlook*, Cambridge: Open Book Publishers.

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[35] Authors' calculations based on *Eurostat*, "General government gross debt – quarterly data [TEINA230]" (accessed 27 January 2022); *Eurostat*, "General government gross debt [SDG_17_40]" (accessed 27 January 2022).

[36] Francová *et al.* (2021), *op.cit.*

[37] See Mollet (2021a), *op.cit.*

[38] Pilati, Marta (2020), "National Recovery and Resilience Plans: Empowering the green and digital transitions?", Brussels: European Policy Centre/Konrad Adenauer-Stiftung.

[39] *Ibid.*

[40] See Rayner (2021), *op.cit.*

[41] Gentiloni, Paolo, Opening remarks by Commissioner Gentiloni at the press conference on the relaunch of the review of EU economic governance, European Commission, 19 October 2021.

[42] Mollet, Frederico (2021b), "China's grand industrial strategy and what it means for Europe", Brussels: European Policy Centre.

[43] Mollet, Frederico and Marta Pilati (2021), "Updating the European industrial strategy for the post-pandemic world", Brussels: European Policy Centre.

[44] Gentiloni, Paolo, Opening remarks by Commissioner Gentiloni at the press conference on the relaunch of the review of EU economic governance, European Commission, 19 October 2021.

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[47] Pisani-Ferry, Jean (2021), "Climate Policy is Macroeconomic Policy, and the Implications Will Be Significant", Washington DC: Peterson Institute for International Economics; Schnabel, Isabel, "Speech: Looking through higher energy prices? Monetary policy and the green transition", American Finance Association 2022 Virtual Annual Meeting, Frankfurt aM, 08 January 2022.

[48] European Commission (2021b), Annual Sustainable Growth Survey 2022, COM (2021) 740 final, Brussels.

[49] Rayner (2021), *op.cit.*

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The **European Policy Centre** is an independent, not-for-profit think tank dedicated to fostering European integration through analysis and debate, supporting and challenging European decision-makers at all levels to make informed decisions based on sound evidence and analysis, and providing a platform for engaging partners, stakeholders and citizens in EU policymaking and in the debate about the future of Europe.

The **Europe's Political Economy** (EPE) programme is dedicated to covering topics related to EU economic policy, in a context of increasing globalisation and rapid technological change. From an intra-EU point of view, the programme provides expertise on reforming and strengthening the Economic and Monetary Union and regional economies; ensuring a holistic approach to industrial policy; supporting the Single Market and digital policy; and optimising the use of the EU budget and its programmes. Within the international context, the programme focuses on trade policy and multilateral governance systems. The team is also informed on the process of Brexit and the long-term relationship between the EU and the UK.

The **Social Europe and Well-being** (SEWB) programme is structured around the following priorities:

(1) strengthening the social dimension of EU policies and governance for upward social convergence;

(2) moving towards a modern and inclusive labour market;

(3) making European welfare states and social protection systems 'future-fit' in the light of ongoing labour market transformation; and

(4) investing in human capital for greater well-being and less inequality, with a particular focus on health.

The activities under this programme are closely integrated with other EPC focus areas, especially those related to migration and the economy, with a view to providing more 'joined-up' policy solutions.

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