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Revisiting the EU framework: Economic necessities and legal options

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1 Introduction

In response to crises, new challenges and enduring changes in the economic environment, the EU has embarked on a process of transformation to an extent unforeseen by its architects. Over the last decade, it has put in place assistance and resolution mechanisms to cope with sovereign refinancing woes; transferred to the Union level major responsibilities for banking supervision and – nominally at least – the resolution of banking crises; allowed monetary and fiscal policy to explore unchartered territories; come to terms with the need to review and possibly rethink its fiscal rules; and assigned to the Union's public finances the new role of supporting the rebound of Covid-hit economies with debt-financed grants and loans. It is also gathering support for an acceleration of the transition to a carbon-neutral economy, which is bound to trigger a major change in the structure of the European economy.

This transformation has so far taken place within the framework of largely unchanged EU primary law. While EU secondary legislation has been amended and two intergovernmental treaties have been added – the 2012 treaties on the European Stability Mechanism (TESM) and on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), covering mainly euro area members – the EU Treaty base itself has remained largely unchanged since the 1992 Maastricht Treaty. Major policy shifts, such as the assignment of financial stability responsibilities to the

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EU level, the creation of banking union, and most recently the NextGenerationEU (NGEU) initiative, have relied on sometimes complex and convoluted interpretations of existing Treaty provisions.

The EU, in other words, has embarked on an evolutionary transformation rather than the transformation by design undertaken with the Single European Act of 1986, the 1992 Maastricht Treaty and subsequent adaptations of the European primary law. The result is a legal architecture whereby policy is in some fields set in great details by the Treaties, while entire policy planks or even domains have been developed without being laid out in the Union's primary law.

This evolution has not gone unquestioned. Legal challenges have been raised, on the ground that some of the initiatives taken in response to events infringe certain provisions of the EU Treaties, exceed the competences granted to the EU or are contrary to the constitution of a Member State. Whilst so far these legal disputes have, for the most part, been resolved in a manner that allowed those iniatives to be preserved, their recurrence signals that the process of adapting the EU policy system within the framework of the existing Treaties may be close to reaching its limits.

A particular worry regards the multiplication of legal tensions between the European Court of Justice and the constitutional courts of certain Member States. These tensions arise from divergent interpretations given to EU law and its relationship with national constitutions. In particular, the scope of what EU law authorises EU institutions to do is increasingly being challenged under the constitutional law of some Member States. Such legal uncertainty entails economic costs, especially in crisis times. Furthermore, legal arguments take place against the background of political disagreements, which may impede both significant Treaty revisions and interpretative adaptation. There is, therefore, the risk of the EU being locked onto a dangerous path whereby political disagreement would prevent Treaty revisions and require that crucial policy amendments be done by stretching the legal limits of the existing Treaties. In turn, the latter could be challenged under national constitutions, questioning the authority of EU law itself and feeding more radical forms of political disagreement.

At the same time, the process of change has not reached its end-point. Reforms are in some cases incomplete, such as the resolution of banking crises, which remains the de facto responsibility of the Member States despite the creation of a Single Resolution Mechanism. The post-pandemic regime will come with new risks and challenges that may require further reforms and adaptation of the EU governance, which may potentially stretch further the limits of the Treaties. In some other cases, such as the prohibition of the monetary financing of governments, the principles of the Treaties remain sound but the exact meaning of corresponding provisions has become abstruse. In the case of the fiscal rules, key Treaty provisions remain valid but conditions have changed so much – before and as a consequence of the pandemic crisis – that numerical benchmarks that were already criticised before the shock have become irrelevant. And in the case of the post-pandemic NGEU initiative, a legal construct has been built to respond to a particular emergency, but without clarifying if, and under what sort of conditions, similar responses to exceptionally deteriorated conditions can be contemplated.

Neither economists nor jurists can address these issues alone. Their discussion requires combining two logics that are sometimes congruent and sometimes not. Yet such interdisciplinary discussions seldom take place in earnest. This is why a group of economists and lawyers specialised in EU matters gathered on 9-10 September 2021 at the European University Institute to analyse the state of the EU's economic policy system and to explore avenues for reform that meet both economic requirements and legal constraints. The present paper is the outcome of their discussions on macroeconomic governance. A companion paper will deal with banking union.

The paper examines three policy fields: the relationship between the monetary and the fiscal pillars; the fiscal rules; and the NGEU initiative and the potential for a common fiscal capacity. In each case, we provide a brief assessment of the state of the policy architecture and some thoughts on the direction of desirable reforms, followed by an assessment of the legal state of play and the changes that might be required to strengthen the policy system and support desirable reforms. A concluding section summarises the main lessons across the three areas.

2 The relationship between the monetary and the fiscal pillars[2]

STATE OF PLAY

Economic and Monetary Union centralised monetary policy while keeping the main responsibility for fiscal policy at the national level. In designing the institutions and rules governing these policies, the fathers of EMU (they were, actually, all men) gave priority to addressing two potential problems. The first was fiscal dominance over monetary policy, which would threaten price stability – an objective that was given the highest priority, both as a concession to Germany and in reaction to inflationary experiences in the 1970s and the 1980s. The second was moral hazard in the form of fiscal free-riding by one Member State on the others.

To neutralise these problems, the Maastricht Treaty took a belt-and-braces approach. The ECB was made independent, committed to price stability *and* prohibited from undertaking monetary financing. Both excessive deficits *and* bailouts of Member States were prohibited. As a result, the Maastricht system does not just seek 'monetary dominance', but separates monetary and fiscal policy much more strictly than is the case in other economies. Taking the common monetary policy as given, each Member State undertakes fiscal stabilisation policy, subject to a set of fiscal rules – the Stability and Growth Pact (SGP) – that was created to promote sound public finances and operationalise the prohibition of excessive deficits.

In addition to the ECB's independence and price stability mandate (Articles 130 and 127 TFEU, respectively), four Treaty-level provisions are relevant in this context:

- The *prohibition of monetary financing* (Article 123 TFEU) provides an extra bulwark against any pressures that might lead to public debt monetisation. The scope of this prohibition, however, was for a long time uncertain. Monetary interventions by the ECB initially did not include outright purchases of government securities, focusing instead on repurchase operations. This barrier was broken only in 2015, when the ECB saw no alternative but to embark on direct asset purchases (trailing the Federal Reserve and the Bank of England by several years). With the new ECB strategy review, outright purchases have now been made part of the 'normal' toolbox. This raises questions about the meaning and implications of the no monetary financing provision.

2 This section focuses on the possible unintended consequences of the Maastricht architecture for monetary policy and monetary-fiscal coordination. Its consequences for fiscal stabilisation and the reform of the fiscal rules are covered in the following section.

- The *no-bailout clause* (Art. 125 TFEU) prohibits the EU and its Member States from assuming liability for the debt of a Member State. The purpose is that of ensuring that Member States are subject to market discipline when they enter into debt, as this contributes to their budget discipline and, ultimately, to the financial stability of the EMU.[3] This does not, however, prohibit financial assistance so long as the latter is indispensable for the safeguarding of the financial stability of the euro area as a whole and subject to strict conditions aimed at preserving budget discipline.[4]
- *ECB financial independence*. The ECB statute provides for the ECB's financial arrangements to be kept separate from those of the EU. The ECB has its own budget. Its capital is subscribed and paid up by the euro area national central banks (NCBs). However, although it is understood that the NCBs must provide the ECB with adequate capital and national treasuries must capitalise the NCBs correspondingly, the rules on capitalisation, the distribution of seigniorage and risk sharing within the Eurosystem lack clarity.
- Finally, the *principle of proportionality* (Article 5 TFEU) requires that the content and form of policy intervention at euro area/EU level should not exceed what is necessary to achieve the objectives of the Treaties. For monetary policy, proportionality implies that the ECB's actions (1) must be suitable to address the identified risks to price stability; and (2) should not go beyond what is necessary to achieve those objectives. According to the Court of Justice, this requires that the ECB actions not be based on a manifest error of assessment or go manifestly beyond what is necessary to achieve that objective.[5]

The experience since 1999 has shown that important aspects of this policy framework have not passed the test of time.

First, while the strict disconnect between monetary and fiscal policy can work in a setting in which the ECB has sufficient policy space to reach its price stability objective, it creates a problem when inflation is persistently below target – a consequence of the decline of equilibrium real interest rates and the effective lower bound on short-term interest rates. In these circumstances, fiscal policy is particularly impactful on inflation and fiscal action may be needed not just for national-level stabilisation purposes but in support of monetary policy.

Moreover, views on the effectiveness of active fiscal policy have changed. In particular, it is now understood that in response to large supply shocks such as pandemics, or climate emergencies, fiscal policy is a better instrument than monetary policy for dealing with trade-offs between price stability and output stabilisation since it can be more targeted. Fiscal policy may also attenuate the trade-off between price stability and the financial stability risks caused by sustained very low nominal interest rates and flat yield curves.

Second, increased risks have revealed inadequate protection of the ECB's financial independence. The increase in the size of the balance sheet of the Eurosystem has been accompanied by a maturity mismatch between its assets and liabilities. In this situation, changes in the slope of the yield curve create fluctuations in the net income of the central banks of the euro area. Inevitably, this will lead to periods when they may make losses. On some (rare) occasions when there is a sharp unexpected movement in inflation and in the stance of monetary policy, these losses could be large and

3 Case C-370/12, Pringle v Ireland, para. 135.
4 Ibid., para. 136.
5 See, notably, Case C-493/17, Weiss, paras. 71 ff (citing further case law).

exceed previous provisions. Market anticipation of these losses and/or uncertainty about the implications of one national central bank finding itself with negative capital could harm the credibility of ECB monetary policy and lead to instability. The Treaty says that the national central banks should be adequately capitalised, but it does not specify a process for ensuring that they are (Reichlin et al. 2021).

Third, an excessively narrow interpretation of the prohibition of monetary financing and the principle of proportionality could limit the scope of ECB action, with negative economic consequences:

- To ensure its compliance with the prohibition of monetary financing, the ECB has employed 'safeguards' including buying bonds only in the secondary rather than in primary markets and purchasing securities issued by all members states roughly in proportion to the ECB capital key and within certain quantitative limits. These are meant to address concerns that the purchase of government bonds could lift market pressure on governments, in contravention of the purpose of Article 123 TFEU to maintain incentives for Member States to conduct sound budgetary policies. The trouble is that the associated constraints tend to become binding over time, forcing the ECB to choose between limiting a policy instrument that may be essential to reach its price stability objective and modifying the previously advertised safeguards.[6]
- Non-standard monetary policies, such as special loans to banks, asset purchases and negative interest rates, have potential distributional effects (for example, by favouring asset holders). These have been used to argue that some ECB policies could run afoul of the proportionality principle. But many of these policies have been, and may in the future be, essential to achieve the ECB's price stability objective.

REFORM DIRECTIONS

In response first to the euro crisis, then to a persistent undershooting of the ECB's inflation target and finally to the Covid shock, the scope of monetary policy initiatives has significantly expanded. Which of the new instruments and procedures have acquired a permanent character, however, remains uncertain, as does the question of which additional measures should be made part of an enlarged policy toolbox.

In what follows, we consider four possible reform areas.

1) Strengthening the fiscal support to monetary objectives

In the Maastricht architecture, the structural fiscal stance is assumed to be neutral or geared towards sustainability. Individual fiscal policies can deviate from this assignment if a Member State has been hit by an idiosyncratic shock that cannot be tackled by the common monetary policy, but fiscal policy is not expected to substitute or complement monetary policy. The experience of the last few years has shown, however, that situations can arise where the effectiveness of monetary policy is persistently hampered by the effective lower bound on interest rates. In such a case, joint fiscal action is desirable to help escape from a low-inflation trap.

The EMU toolbox does not include an effective mechanism for coordinating fiscal support. The general escape clause of the SGP is a very rough instrument that can only be activated in situations of acute stress. The provisions of the European Semester are

6 This is currently the case for the 2020 Pandemic Emergency Purchase Programmes, in which the ECB allows itself greater flexibility than under the original 2015 Public Sector Purchase Programme.

geared towards the surveillance of individual Member States, and recommendations for the euro area as a whole have little traction. The Macroeconomic Imbalances Procedure has been largely ineffective.

What would be required to cope with this type of situation is a two-regime set-up in which fiscal policy prescriptions would differ depending on whether monetary policy is facing limitations to its effectiveness. This could happen through a modification of the fiscal rules. For example, Lane (2021) proposes making the required pace of fiscal consolidation dependent on whether the euro area inflation rate undershoots or exceeds the 2% target, while Blanchard et al. (2021) similarly argue that the pace of adjustment should depend on whether the ECB is constrained by the effective lower bound on interest rates. Another approach would be to create a central fiscal instrument. These ideas are explored in greater depth in the next two sections.

2) Making room for monetary-fiscal coordination

In the face of persistent and severe adverse conditions, monetary expansion may prove ineffective while expansionary fiscal policy may fail to succeed if its impact is offset by higher private savings and/or higher interest rates. This situation may require that the fiscal authorities undertake fiscal transfers while the central bank intervenes in the market on the scale required to prevent additional sovereign risk premia. This, in a nutshell, is what has been done informally in response to the pandemic shock. It would be desirable to design a framework to facilitate monetary-fiscal coordination when this is required for effective stabilisation policy (see the discussion in Bartsch et al. 2020).

Any coordination that would constrain the ECB's decision-making power would violate its independence. So long as coordination does not violate the principle of monetary dominance, however, it remains consistent with that independence. As put forward in a recent proposal, for example, this would apply to the establishment of a new consultative board comprising representatives of both the fiscal and monetary authorities, which would be asked to provide analysis and non-binding recommendations.[7]

A more radical solution to the monetary-fiscal policy coordination problem would be to allow the central bank to undertake direct fiscal transfers ('helicopter money'). In addition to raising operational problems, however, this options creates legal and political risks (described in Box 1).

3) Strengthening the financial independence of the Eurosystem by equipping it with callable capital

The individual level of capitalisation of the NCBs, and the rules for their recapitalisation and dividend distribution, determine the collective fiscal support of the Eurosystem (Reichlin et al. 2021). In case of unexpected large losses arising from the conduct of monetary policy, both the ECB and the NCBs should be given the right to require recapitalisation by the national treasuries. This would be implemented under a set of rules that ensure the ECB behaves prudently in managing its portfolio risk, and that exclude sovereign default as a trigger. For example, one could envision the creation of a fund through which the Eurosystem would manage sovereign purchases. The amount

7 The proposal of a board for facilitating monetary-fiscal coordination has been put forward by Reichlin et al. (2021).

and distribution of purchases would be determined in relation to the monetary policy objective. Profits and losses would be distributed to the NCBs in proportion to the capital key and capital would be callable for risk management purposes.[8,9]

4) Discarding 'safeguards' that stand in the way of effective monetary policy

In order to remove ambiguity and strengthen legal certainty, Article 123 TFEU should be interpreted in a way that focuses on the *objective* of the central bank's policy actions and the preservation of incentives to budget discipline rather than implementation of the specific modalities applied in previous cases such as the level or share of purchases of bonds in relation to the capital key. Bond purchases should not be considered monetary financing so long as (1) the ECB can provide a clear rationale for why they are essential in the pursuit of its price stability mandate; and (2) the bond purchases do not lift the pressure on Member States to pursue sound budgetary policies (Steinbach 2017).

A similar approach could be used to ascertain whether the *principle of proportionality* is respected.[10] Distributional effects of monetary policy should not constitute a breach of this principle when policy actions appear to be necessary to meet the ECB's price stability objective. The responsibility for explaining why this is the case would rest with the ECB.

LEGAL ASSESSMENT

1) Non-binding monetary-fiscal coordination

Any provision on fiscal-monetary coordination must preserve the ECB's independence (Article 130 TFEU). Independence not only means not taking, or being subject to, instructions from any institution, government or other body, but also prevents the ECB from entering any binding commitment vis-à-vis other policy players. Any binding coordination in the form of coordinated monetisation must therefore be ruled out.

One might argue that independence should not be a concern as long as the coordination remains consistent with the inflation target. However, besides the substantive obligation to price stability, independence requires the ECB to remain free of obligations vis-à-vis other stakeholders or policy actors. For example, it cannot commit to supporting fiscal action by national governments, even if it regards this action as desirable. In other words, the risk of being deprived of ECB support must be borne by governments.

There are, however, no legal concerns for formats of exchange that do not imply binding commitments by the ECB. Soft coordination arrangements involving dialogue, exchange of views, the creation of a common analytical basis with other policy institutions and possibly even joint statements with fiscal policymakers are legally acceptable as long as they are analytical in nature and do not, explicitly or implicitely, commit the ECB. Institutionally, such exchanges could take place through a dedicated board, a permanent forum or the European Semester process.

8 The proposal of callable capital has been put forward by Reichlin et al. (2021).

9 The United Kingdom provides an example of such a mechanism. The portfolio of government bonds bought by the Bank of England sits in a subsidiary which the central bank manages, but which is indemnified by HM Treasury. In such a system, all profits made by the central bank are regularly transferred to the treasury, and any losses trigger a payment under the indemnity. Therefore, any losses or gains in the portfolio of the central bank are automatically losses and gains of the treasury, and so are automatically consolidated.

10 The German Constitutional Court has developed a stricter interprepation of the principle of proportionality than that of the European Court of Justice (see Box 1).

BOX 1 WOULD HELICOPTER MONEY BE COMPATIBLE WITH EU LAW?

From a strictly legal standpoint (and disregarding implementation issues), direct transfers by the ECB to non-government agents in the euro area would be acceptable provided that this initiative observed (1) the ECB's independence, (2) the prohibition of monetary financing (Art. 123 TFEU) and (3) proportionality.

1) To satisfy the first condition, the ECB could not receive directives from another policy sphere on how to conduct direct transfers, nor could it limit its monetary policy spaces through reciprocal agreement. However, since fiscal policy is not legally constrained in its coordination activities, an arrangement requiring fiscal policy to react to monetary policy to achieve an objective should not be problematic. Specifically, monetary policy could announce a certain monetary policy programme and call on fiscal policymakers to act in a certain way in order to ensure the effectiveness of this measure.

2) Helicopter money would have to be an adequate tool from a monetary policy perspective (i.e. to achieve the price stability objective) and be exclusively motivated by the need to reach that objective, as opposed to another (fiscal) motivation. This is relevant for the design of helicopter money, as the ECB should not assume any (old or new) functions that are traditionally allocated to the government. Although direct central bank transfers to households would not finance the government directly, they would arguably substitute for government transfers. As a result, it could be argued that helicopter money constitutes indirect government financing. However, the ECJ already found that a monetary policy measure cannot be treated as equivalent to an economic policy measure just because it may have indirect effects that can also be sought in the context of economic policy.[11] Hence, if helicopter money is exclusively motivated by monetary policy objectives, it may still fall under the ambit of monetary policy despite potential side-effects of an economic or fiscal policy nature.

3) Proportionality has become a more important review mechanism since the judgement of the *Bundesverfassungsgericht* (BVerfG) in *Weiss*. In that judgement, the German Federal Constitutional Court considered the (distributive) side-effects of monetary policy and found that the ECB's proportionality analysis took insufficient account of these effects. As developed by the BVerfG, the proportionality review, among others, requires the monetary policy measure to be necessary – i.e. that no equally effective alternative exists with fewer side-effects on Member States' economic policy. Therefore, in order for helicopter money to be proportionate (i.e. suitable, necessary and proportional), the ECB ought to be able to demonstrate that no alternative means exist to maintain price stability and that the benefits of monetary policy exceed the non-monetary policy side-effects. However, in the same Weiss case, the ECJ adopted a much less strict form of proportionality review by looking only for manifest errors of assessment by the ECB or for instances where it had manifestly gone beyond what was necessary to pursue its objectives. In highly technical issues such as these, the more deferential approach adopted by the ECJ tends to be the standard (Steinbach 2013). Courts generally do not substitute their own technical opinion and do not require independent competent institutions to carry out extensive (third-level) cost-benefit analyses in very technical areas.

Beside the observations in (1), (2) and (3), to observe the ban on monetary financing, helicopter money must remain compatible with the conditions set out by the ECJ in the judgements in *Gauweiler* (on OMT) and *Weiss* (on PSPP).[12] In these judgements, the core concern associated with the purchase of government bonds was that market pressure would be lifted on governments, as they could rely on the ECB's bond purchases. In other words, the ECB must not set incentives for Member States to conduct unsound budgetary policies – they must remain subject to the 'logic of the markets'. Helicopter money would have to observe these safeguards – and it well might, as its impact on government bond markets would be less direct and less significant than that of direct asset purchases.

11 *Weiss*, para. 61; *Gauweiler*, para. 52.

12 The prohibition of monetary financing refers to (1) direct buying on the primary market, (2) acting on the secondary market in a way that affects price formation on the primary market, and (3) activities that remove incentives for Member States to follow a sound fiscal policy. According to the ECJ, the prohibition protects the financial stability of the Union rather than monetary policy.

The consistency of helicopter money with the Treaties is less straightforward. As argued in Box 1, a case can be made that it is consistent with the Treaties if appropriately designed. But there is a risk is that helicopter money may be viewed as indirect provision of monetary financing if it amounts to transfers to entities that would normally receive support from the government, and hence loosens fiscal constraints.

2) Financial independence of the Eurosystem

The financial independence of the Eurosystem depends on the adequate capitalisation of NCBs and on capitalisation of the ECB. An automatic rule for recapitalising the NCBs would be problematic, since if Germany (or another country) had an obligation to recapitalise the ECB and in so doing exhaust the federal budget, the parliament would be deprived of its budgetary autonomy.

The compatibility with EU law of a fund that held assets acquired under monetary policy programmes and distributed losses and profits to the NCBs according to the capital key would depend on its specific design. If the fund were designed similarly to the ESM but for use by the ECB for monetary policy purposes, there would be a problem because the ECB must not delegate its core functions to another organ or institution. The normative reason for this requirement is that the institutions foreseen in the EU Treaties must not pass on their tasks to institutions not foreseen in the Treaties. However, if the fund were not authorised to take decisions on its own, but rather remains under the direction and control of the ECB, there would not be any legal problem.

It could also be argued that a government-backed fund could dilute the Treaty-based separation between fiscal and monetary policies, because fiscal policy would somehow 'contribute' to monetary policy. This would be regarded as in conflict with the separation of Member States' competence for fiscal/economic policies on the one hand, and the ECB's competence for monetary policy on the other. However, not only have courts (including the ECJ and the BVerfG) recognised that there is no strict separation of fiscal and monetary policies, but it can also be – and has been – reasonably argued that rules on capital are needed to guarantee fiscal backing, which in turn is a condition for the credibility of central bank action and, ultimately, its independence.

3) The prohibition of monetary financing and the principle of proportionality

The ban on state financing by the ECB does not draw a distinction between solvent states and insolvent states. Its rationale is rather that states must be, and remain, subject to market pressure. This is a general intention that does not distinguish between solvent and insolvent states.

No Treaty changes are necessary to make asset purchases part of the normal operational toolbox at the ECB. The ECJ has accepted sovereign bond purchases under two conditions, namely, that (1) they serve the pursuit of monetary policy goals, and (2) they do not lift the pressure on Member States to follow a sound budgetary policy. While specific safeguards (in particular, the limitation of bond purchases, allocation based on a capital key, purchase limits per identification number) have been applied in previous cases, the legal requirement lies in demonstrating that budgetary pressure on Member States is upheld. In this regard, the ECJ assesses each ECB bond purchase programme individually, taking into account the relevant circumstances at the time the programme was launched.

To date, neither the ECJ nor any national constitutional court has found any purchase programme to be incompatible with EU law or a national constitution. Going forward, issues could be raised if purchases were made in a flexible way on a regular basis (the interpretation could be that safeguards are not respected).

Proportionality is an established principle under EU and national laws (for example, in Germany and France). The ECJ found that the ECB conducted its monetary policy in line with the proportionality principle. Given this well-established ECJ jurisprudence, there is no need to further specify the principle through EU legislation.

3 The fiscal rules

STATE OF PLAY

EU fiscal rules seek to reconcile two objectives: (1) to mitigate the risk of debt crises and fiscal dominance over monetary policy (to prevent excessive debt and deficits, in Treaty parlance); and (2) to give the Member States sufficient flexibility to conduct counter-cyclical fiscal policies. Membership of the euro area exacerbates the importance of *both* objectives: debt crises have larger negative externalities, in part because they could, *in extremis*, force euro area members to exit; at the same time, fiscal policy is the only tool for macroeconomic stabilisation at the Member State level and, as developed in the previous section, reliance on it may also be needed at euro area level.

Since their inception in the 1990s, the fiscal rules – also known as the Stability and Growth Pact (SGP) – have been augmented and amended several times. The resulting complexity has been widely criticised and there is a growing consensus that the aim of avoiding 'gross errors' has been lost in the process. But this should not hide that rules have continuously relied on the same basic architecture to balance the same two fundamental goals. This architecture, which emerged as a political compromise during the negotiations preceding the Maastricht Treaty, comprises three elements:[13]

1. According to Article 1 of Protocol 12, the "reference values" referred to in Article 126 (2) TFEU are 60% and 3% of GDP, respectively, for deficit and debt.
2. Article 126 TFEU lists the state-contingent procedures and rules governing fiscal adjustment toward those reference values or within the constraints determined by them (the corrective and preventive arm of the SGP).
3. The enforcement system relies on graduated peer pressure backed by the possibility of financial penalties, and not on the Treaty infringement procedure. It gives the institutions charged with enforcement – the European Commission, which proposes or recommends, and the Council, which decides – considerable discretion.[14]

The establishment of "reference values" is foreseen in the Treaty itself (Article 126 (2)), but it is Protocol 12 that lays out these reference values at 3% and 60 % of GDP. Elements (2) and (3) above are based both on the Treaty and EU secondary law (a set of regulations and directives).[15]

There has been periodic dissatisfaction with the SGP for both constraining fiscal policy when it should not – with insufficient scope to increase deficits in downturns – and failing to constrain it when it should have (allowing pro-cyclical fiscal expansions and lacking rigorous enforcement). In response, the rules were twice amended, in 2005 and 2011, and were supplemented by an intergovernmental treaty (the TSCG, also known as the Fiscal Compact) in 2012.[16] These changes attempted to deal with the weaknesses of the SGP by making rules and procedures more state-contingent:

13 Bini-Smaghi et al. (1994: 27-31).
14 In particular, this allows the European Commission to "take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State" (Article 126 (3) TFEU) and gives the power of decision as well as the ultimate enforcement authority to the Council rather than the ECJ (Article 126 (13) TFEU).
15 This legislation can be found on the European Commission web page dedicated to the SGP.
16 See Boxes 0.1 and 1.3 in European Commission (2018) and Box 2.3 in EFB (2019a).

in 2005, especially through the introduction of cyclically-adjusted variables; in 2011, by making enforcement somewhat less discretionary; and in 2012, by overlaying the Fiscal Compact as an additional commitment device.

Common to all of these amendments and additions is that they did not challenge the principle of uniform debt and deficit reference values (nor their level). Rather, they constituted attempts to fine-tune elements (2) and (3) of the Maastricht compromise, while leaving element (1), and the basic architecture, unchanged.

The essential difference between the ongoing debate on the reform of the SGP and previous debates is that challenging both the principle and level of common debt and deficit reference values has become part of the mainstream critique of the SGP.[17] There is now a majority view (though not a consensus) among economists that, in view of the prevailing heterogeneity across Member States, country- and time-invariant reference values – particularly at their current levels – are hard to justify and likely counter-productive, for three reasons:

- First, country- and time-invariant debt and deficit reference values miss a large amount of information that is relevant to whether a country's debt is sustainable. This includes expected fiscal balances, interest rates and long-term growth; implicit and contingent liabilities; the level of taxes; the country's fiscal track record; its ability to record significant primary balances; and, ultimately, national politics and institutions.
- Second, any attempt to take this additional information into consideration through element (2) of the SGP's architecture – state-contingent procedures and rules governing fiscal adjustment toward those reference values – is doomed to fail. This is because such reforms would require making these procedures much more complex than is currently the case. Moreover, these procedures require estimation of structural budget balances, which are subject to instability and errors, leading to significant policy mistakes and persistent negative impacts.[18]
- Third, in the post-pandemic environment in which both average debt levels and differences in debt levels across EU members have risen sharply, while ECB monetary policy risks remain constrained by the effective lower bound on interest rates, maintaining and enforcing uniform debt reference values while avoiding adjustment rules of unmanageable complexity could put the EU into a fiscal straitjacket, prevent adequate stabilisation and risk leading to economic stagnation over a protracted period of time (see Section 3).

The third of these problems could arguably be addressed by increasing across the board the levels of the current debt and deficit reference values while maintaining the principle that the same reference values should apply for all EU members and remain unchanged over time after the initial adjustment. Addressing the first and second problems, however, requires much deeper reform. Ideas under discussion can be put into three categories.

17 See Section 5.2 of EFB (2021) for a summary of the common elements of recent fiscal rules reform proposals. A notable recent proposal that falls outside this description because it does not discuss EU fiscal rule revision in general is Darvas and Wolff's (2021) idea to adopt a 'green golden rule' that would exclude green investment from the deficit and debt calculations of the EU fiscal rules. See also Section 4, where we discuss whether an NGEU-type mechanism could promote such investments.

18 See Claeys et al. (2019) and Fatas (2019).

DIRECTIONS FOR REFORM

Arguably the most radical idea is to give up on numerical fiscal rules altogether (Blanchard et al. 2021). Instead, the Treaty provision on the avoidance of excessive deficits would be interpreted as requiring that EU members undertake fiscal adjustment when their debts are no longer sustainable with high probability. Whether this is the case – and if not, whether the government's fiscal adjustment plans are adequate – would be regularly assessed by independent national fiscal institutions (IFIs) and/or the European Commission. Non-compliance with the recommendations of the Commission could be enforced either through a variant of the current excessive deficit procedure (potentially leading to fines imposed by the Council) or by replacing the latter with the Treaty infringement procedure (i.e. judicial enforcement, which is currently ruled out by Article 126 (10) TFEU). The authors of that proposal argue for the latter, on the grounds that the flexibility inherent in standards requires an independent jurisprudence, both to develop what the standard can accommodate and to credibly enforce it.

An alternative, less radical approach would be to maintain debt (and possibly deficit) reference values, as well as a fiscal rule governing adjustment toward those values, but to give up the principle that they must be the same for all countries and at all times (Martin et al. 2021). Specifically, debt sustainability would inform the choice by each government of a country-specific medium-term debt target, the appropriateness of which would be first assessed by the domestic IFI on the basis of a common methodology, and subsequently by the Commission, before being endorsed (or rejected) by the Council. Once debt targets have been set, they would serve as anchors for expenditure rules governing the path for primary nominal expenditure net of new discretionary tax measures (and excluding automatic stabilisers on the expenditure side). Enforcement would take place through the excessive deficit procedure and be triggered by a manifest violation of the country-specific expenditure rule.

The third variant, which includes proposals by the European Fiscal Board (EFB),[19] would be to maintain the existing debt and deficit reference values on the ground that they provide "tangible focal points for public debates in the fiscal domain and a basis for decision-makers' accountability" (to quote from the EFB's latest report), but to allow more flexibility along the path of convergence towards these objectives through one or more of the following mechanisms:[20]

- First, by setting country-specific speeds of adjustment toward the debt reference value and regularly revising this speed. One way to do this would be to follow the procedure proposed by Martin et al. (2021) except that rather than deriving medium-term country-specific debt targets, a medium-term country-specific average speed of adjustment would be derived.[21] Once the average speed of adjustment is set, an expenditure rule would guide fiscal policy so as to achieve that adjustment.
- Second, by giving debt sustainability analysis a central role in deciding whether deficits are to be considered 'excessive', that is, whether the members comply with budgetary discipline although the debt and deficit reference values of 60% and 3% of GDP, respectively, have been breached. In addition,

19 See the EFB's 2018, 2020 and 2021 Annual Reports, as well as the EFB's 2019 assessment of EU fiscal rules (EFB 2019b, pp. 91-92).
20 Providing more time for the amortisation of the debt incurred as a consequence of the Covid crisis could also be named in this list. However, other than providing for a one-time exception, it would not change the rules, and it can be questioned on the grounds that the historical origin of the debt has no bearing on its sustainability.
21 This is equivalent to the 'second option' described in EFB (2020, p. 89).

debt sustainability analysis could play a bigger role in determining the required adjustment and speed of adjustment once countries have been found to have excessive deficits.

- Third, by broadening and providing more structure to the 'general escape clause' that was introduced as part of the 2011 reform of the SGP and was activated by the European Commission in March 2020. The present clause allows for a "coordinated and orderly temporary deviation from the normal requirements for all Member States in a situation of generalised crisis caused by a severe economic downturn of the euro area or the EU as a whole" (European Commission 2020). This could be replaced the following alternatives:
  - An escape clause allowing for a temporary deviation from the normal requirements for a *single* member triggered on the basis of independent judgement in the case of adverse economic events (but not necessarily a severe downturn for the EU as a whole; see EFB 2018, p. 81).
  - An escape clause that can be activated at the discretion of a member, but deactivated also by an independent fiscal institution and/or the European Commission, under specified conditions. This approach could be used to nest Blanchard et al.'s (2021) 'fiscal standards' idea within the present (or a reformed) set of fiscal rules. Governments would in effect be allowed to temporarily 'opt out' of the fiscal rules, provided they submit to surveillance by an independent body that would periodically check whether debt remains sustainable, and cancel the temporary opt-out if this is not the case.

All these sets of reform ideas would require changes in the EU secondary legislation underpinning the current SGP. They might also require a change in the TSCG, which, along with various EU regulations, enshrines the rule that the excess of actual debt to the 60% reference value must be reduced at "an average rate of one twentieth per year as a benchmark", as well as national legislation introduced in compliance with the TSCG.[22] The question, explored in the next section, is whether they would also require Treaty change.

LEGAL ASSESSMENT

The Treaty basis for the current EU fiscal rules are Article 121, Article 126 TFEU and Protocol No. 12 on the Excessive Deficit Procedure. Article 121 lays out the possibility of multilateral surveillance of the Union over Member States' economic policies. It forms the basis for the preventive arm of the SGP, but does not restrict its substance (which is laid out in secondary legislation and the TSCG). As such, the remainder of this note focuses on Article 126 TFEU and Protocol No 12 (see Annex).

Article 126 TFEU boils down to four legal principles:

- First, a broad standard that lays out the purpose of the Article: "Member States shall avoid excessive government deficits" (para. 1).

22 The TSGC required the contracting members to translate key element of the SGP into national law (European Commission 2018, Box 1.3). Amending national laws and the TSGC (as an international treaty) would require consent by national parliaments and in this sense could be almost as difficult as amending the Treaties themselves. However, violations of the 'one twentieth rule' do not seem to have been enforced either at the national level or by the European Commission, because of the flexibility embedded in the rule (Darvas and Wolff 2021).

- Second, the separation of the roles of the Commission and the Council of the EU (represented by the Economic Financial Committee), with the former tasked with monitoring and reporting a risk of an excessive deficit and recommending remedial measures to the Council (paras. 2-3, 5, 7), and the latter with assessing whether an excessive deficit exists (paras. 4, 6), recommending remedial measures to the Member State based on a Commission recommendation (para. 7), and enforcing the measures, again based on Commission recommendations (paras. 8-9, 11-13).[23]
- Third, the use of a deficit and debt reference value as a criteria that informs the Commission's examination of Member States' compliance with the prohibition of excessive deficits (para. 2).
- Fourth, the exclusion of the prohibition of excessive deficit in the form of legal action against a Member State on the part of either the Commission or another Member State (para. 10).

Hence, Article 126 TFEU can accommodate any EU fiscal framework as long as this is consistent with the objective of avoiding excessive deficits, includes a reference value for both the deficit and the debt, respects the division of labour between Commission as the provider of economic analysis and recommendations and the Council as the decision maker and enforcer, and does not envisage judicial enforcement. This implies a great deal of flexibility, because Article 126 TFEU:

- allows the Commission to base its recommendations not just on the comparison of actual debt and deficits with their respective reference values (para. 2), but also on "whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State" (para. 3); and
- does not prescribe the reference values. In particular, it does not state that these need to be time- or country-invariant. Instead, the present reference values – which are indeed time- and country-invariant – namely, the famous 3% and 60%, respectively, are laid out in Protocol 12, which can be replaced by provisions laid out in EU secondary law using a "special legislative procedure" following a unanimous Council decision according to Article 126 (14) TFEU, i.e. without following the procedure of TEU article 48 on treaty change.[24]

On this basis, the EU-level legal constraints of the proposals outlined above can be summarised as follows. Compared to the previous section, the order of discussion of proposals is reversed, so as to start with ideas which would require no change in primary EU law and end with those that would require Treaty change.

23 Specifically, the Commission "shall examine compliance with budgetary discipline" on the basis of criteria laid out in para. 2 as well as "whether the government deficit exceeds government investment expenditure" and "all other relevant factors, including the medium-term economic and budgetary position of the Member State". If it concludes that there is a risk of an excessive deficit in a Member State, it must report this to the Council (para. 3) and the Member State concerned (para. 5) and recommend remedial measures to the Council (para. 7). The Economic and Financial Committee "shall formulate an opinion on the report of the Commission" (para. 4) and, on a proposal by the Commission, "decide after an overall assessment whether an excessive deficit exists" (para. 6), "[address] recommendations to the Member State concerned with a view to bringing that situation to an end within a given period" (para. 7), and take various measures to make the recommendations public (para. 8), to "give notice to the Member State to take, within a specified time limit, measures ... to remedy the situation" (para. 9), and if the Member State still does not comply, to require it to disclose its debt risks before issuing bonds and securities, invite the European Investment Bank to reconsider its lending policy towards the Member State, impose non-interest bearing deposits and impose fines (para. 11). All these Council decisions or recommendations (save the decision on the existence of an excessive deficit, which is taken on the basis of a proposal of the Commission) are to be based on a recommendation of the Commission (paras. 6, 7, 13).

24 Note that Article 126 itself can be amended using the simplified Treaty change procedure laid out in Article 48(6) TEU, namely without requiring to convene a Convention and then a Conference of Representatives of the Governments of the Member States, so long as the amendment does not increase the competences of the Union and that the ECB would be consulted in case of "institutional changes in the monetary area". This would require a decision at the level of heads of state or government (the European Council). However, that decision, taken after consulting the European Parliament and the Commission, "shall not enter into force until it is approved by the Member States in accordance with their respective constitutional requirements". The special legislative procedure provided in Article 126 TFEU to amend Protocol 12 is thus much lighter.

1. So long as compliance with the reference values continues to be considered as relevant information in its own right, neither the Treaties nor Protocol 12 would prevent the European Commission from paying greater attention to debt sustainability analysis in its monitoring of excessive deficits, or even making debt sustainability analysis the main instrument for assessing the risk of an excessive deficit.
2. Similarly, a greater or more structured use of escape clauses could be consistent with the Treaty. The use of escape clauses is currently governed by EU Regulation No 1175/2011; this already includes a 'specific' escape clause in addition to the 'general' escape clause activated in March 2020.[25] The conditions under which the clause is activated could be modified by amending the regulation.
3. So long as they respect other aspects of the Article (in particular, the distinct roles of the Commission and the Council), proposals to create country-specific speeds of adjustment to the current debt reference value of 60% – and hence, medium-term debt reference values that are *de facto* country-specific – could be consistent with both the Treaty and Protocol 12. The limit to this approach is that the procedure used set the country-specific speeds of adjustment cannot go so far as to render the reference to the 60% debt ratio meaningless, even in the long term. If it did, it could be said to be a legal circumvention of the debt reference value, possibly making it vulnerable to legal challenge.[26]
4. In the main provisions of the Treaty, Article 126 TFEU refers to the "reference values" without further specification of the values. In particular, it does not explicitly require the uniform application of reference values to all Member States. However, Protocol 12 specifies the reference values and does not offer leeway for a variable application of these values. Martin et al.'s (2021) approach aiming at country-specific reference values would therefore require replacing the present provisions of the Protocol to substitute the current numerical definition with a generic definition of the reference values through the special legislative procedure outlined in Article 126(14) TFEU, but would not require Treaty change.
5. Likewise, Blanchard et al.'s (2021) proposal may only require replacing the Protocol, as foreseen in Article 126(14) TFEU, so long as the current enforcement mechanism and the relative roles of the Commission and the Council remain in place. This would be consistent with giving national independent fiscal councils a greater role that could complement the Commission's role (but not with replacing the Commission's role). In order to avoid Treaty change, debt and deficit reference values would need to be maintained, but these could be country-specific and could be periodically revised using the DSA-based approach advocated by these authors.[27]
6. In the full-blown version of Blanchard et al.'s (2021), proposal, both the elimination of reference values and the replacement of the current enforcement approach with judicial enforcement would require Treaty change.

25 Currently, the conditions allow for activation in the case of "an unusual event outside the control of the Member State concerned, which has a major impact on the financial position of the general government or in periods of severe economic downturn for the euro area or the Union as a whole" (Regulation (EU) No 1175/2011).

26 This interpretation would, however, be contestable in view of the common meaning of the word 'reference' and the current economic landscape.

27 Since Martin et al.'s proposal also envisages the use of DSAs to determine the debt reference value, the main remaining difference between their proposal and a Treaty-consistent version of Blanchard et al.'s proposal would consist in how this value is used. Martin et al. would use it to anchor a medium-term expenditure rule. Blanchard et al. might use it not to create a new rule, but as a rolling three- to five-year-ahead benchmark. Each fall, the Commission would need to answer the question whether Member States' draft budget plans are consistent with reaching this benchmark, and if not, whether the deviation is so large as to threaten debt sustainability.

CEPR

4 The NGEU initiative and the potential for a common fiscal instrument

STATE OF PLAY

As argued in the previous sections, the choice to not equip the euro with a common fiscal capacity has significant implications for the functioning of macroeconomic policy and even, indirectly, for the monetary policy of the ECB.[28] The issue has been a matter for discussion since the early days of the euro and even before (see the MacDougall report of 1977 (European Commission 1977) and the Delors report of 1989 (European Council 1989)). It was explicitely considered as such by the ECB, at least since Mario Draghi's 2014 Jackson Hole speech (Draghi 2014).

The launch in spring 2020 of the NGEU programme was a pathbreaking initiative taken in response to an exceptionally severe economic downturn and an acute perception of the risks facing the EU and the euro. Coming less than ten years after the euro crisis, the pandemic shock could have been yet another factor of divergence between European countries. Its onset in Italy and Spain (and its initially milder character in Germany) suggested that it would aggravate the situation of countries that had already been weakened by the euro crisis and short of the necessary fiscal space to respond forcefully to its consequences.

By engineering direct debt-financed fiscal support to the Member States, the EU went beyond economists' hopes and broke political taboos that experts thought unbreakable.[29] Moreover, it unlocked a long-frozen debate about the creation of common fiscal capacity and the future of the EU policy system more broadly.

For the EU as a whole, NGEU is a relatively limited addition to the Member States' pandemic support programmes. The €390 billion in grants financed by joint borrowing amounts to 2.8% of 2019 GDP and its disbursement is to be spread over five years (2021–26). At their peak (in 2023–24), the payments will amount to 0.7% of GDP.[30] This is a small fraction of what Member States themselves will have spent with the support of the ECB, and an even smaller fraction of what the US federal government is set to spend. Macroeconomically, NGEU is not a game-changer.

NGEU grants are, however, significant for some Member States: at their peak, they are expected to exceed 3% of GDP annually for Croatia, 2.5% for Bulgaria and Greece, 1.5% for Latvia, Portugal, Romania and Spain and 1% for several other countries, including Italy. NGEU therefore amounts to a significant debt-financed redistribution to the benefit of least-developed and struggling Member States.

Moreover, some EU countries have leveraged NGEU grants by bundling them with EU loans (from NGEU and other sources, such as the SURE facility administered by the European Commission) and other sources of financing. The Italian recovery and resilience programme is a case in point: it envisions €235 billion (13% of 2019 GDP) in investment spending over a six-year period. Beyond grants and marginally cheaper loans, the value of NGEU is that it provides a framework for the Italian recovery initiative and a blessing for a large-scale investment and reforms plan.

28 The same observation applies to another domain, not addressed here: the lack of a fiscal backstop to potential swap lines has been a hindrance to the internationalisation of the euro.
29 See, for example, our own rather modest proposals (Bénassy-Quéré et al. 2020a, 2020b).
30 See Darvas (2020).

There are several reasons why NGEU constitutes a major innovation:

- First, it organises significant transfers to the benefit of the least-developed and the worst-affected Member States. This response contrasts with the political rejection of a 'transfer union' throughout the euro crisis.
- Second, it involves the financing of exceptional recovery expenditures by EU debt, something that had never happened before and was generally deemed impossible.
- Third, it has lifted the own-resources ceiling in order to raise the revenue needed to repay the debt in the future. This decision also represented a break with the prevailing European consensus.

While transfers already existed in the EU budget, the financing of expenditures through EU debt departs from a long-standing reading of the legal constraints, according to which there cannot be room for debt-financed expenditures because the EU budget must (a) include all revenue and expenditure items (*universality principle*), (b) be ex ante in balance, and (c) be determined by the Union's Multiannual Financial Framework (Art. 310 TFEU).

The most important of these departures is from the second constraint. Contrary to frequent perceptions, the EU has from the start been allowed to borrow, for example for the financing of balance-of-payments assistance to Member States or third countries (in the case of conditional lending alongside the Bretton Woods institutions). But it was not allowed to go into debt for the financing of what are de facto EU budgetary expenditures.

NGEU, however, is an exceptional and time-bound *off-budget*, debt-financed programme of investment grants and loans to Member States. Its establishment does not affect the EU annual budget as legally defined by the Treaty.

The legal edifice of the NGEU consists of three components:

- *A decision to exceptionally increase the ceiling of the resources of the EU*, in order to enable it to respond to the pandemic shock. This decision, taken on the legal base of Article 311 TFEU, required unanimous agreement and ratification by all Member States. It increased the ceiling of the EU resources in order for the Union to be able to repay the debt incurred for the financing of grants and loans to the Member States. It entered into force on 1 June 2021.
- *The allocation of corresponding funds to a new off-budget Recovery Instrument* in the spirit of solidarity on the basis of Article 122 TFEU and in account of the legal obligation of the EU to promote solidarity among Member States, as enshrined in Article 3(3) TEU. Interestingly, the newly created Recovery and Resilience Facility (RRF) is not a mere technical piece of financial plumbing but a fully-fledged financial instrument that spells out in significant detail the macroeconomic, fiscal and sectoral policy conditions for accessing it, as well as the process through which disbursement is made conditional on meeting agreed milestones and targets.[31]

31 Article 122 TFEU authorises the Council, on a proposal from the Commission, to take economic measures "in a spirit of solidarity between Member States", in particular in cases of severe difficulties "in the supply of certain products, notably in the area of energy" [122(1)], and to provide financial assistance to a Member State threatened with severe difficulties "caused by natural disasters or exceptional occurrences beyond its control" [122(2)].

- *The channelling of the corresponding transfers and loans to Member States through EU programmes* and in accordance with EU procedures, on the basis of Article 175 TFEU, which directs members to coordinate their economic policies to reduce regional disparities and provides the legal basis for the EU structural funds.

The EU resources necessary for the repayment of the NGEU debt will consist in yet-to-be-identified new genuine own resources (mention was made of revenues from a digital taxation, carbon border adjustment levies, sales of ETS allowances and a financial transaction tax) and, implicitely but necessarily, to the extent necessary, future GNI-based contributions by the Member States.

The implication of this decision is thus to create implicit and contingent liabilities for the Member States (in case own resources would not be enough). Unless new, genuine own resources are levied, the EU is ultimately guaranteed to be repaid by the Member States. Because of the political agreement to consider new genuine own resources, however, repayment obligations have not been allocated to the Member States, despite the fact that they have precise knowledge of the amounts they would have to pay in accordance with normal rules of contributions of the Own Resources Decision, in case new and genuine own resources are not created.

The effectiveness of the initiative will largely depend on the action it may or may not trigger on the part of Member State governments. EU-financed investments (aka grants) are bundled with supporting domestic reforms and conditional on compliance with principles of sound financial governance under the rule of law, EU 'country-specific recommendations' and the provisions of the Stability and Growth Pact. This coupling amounts to a form of conditionality, whereby access to grants is made dependent on measures that are expected to maximise the social return on investment spending.

Grants and loans brought to Member States within the framework of the NGEU initiative depart both from the traditional support provided by the Structural Funds of the EU budget and from the conditional financial assistance provided by the European Stability Mechanism. Unlike with the Structural Funds, Member States enjoy leeway in the allocation of funds to specific projects, but their release is subject to their meeting performance criteria with regards to both policies (milestones) and outcomes (targets). And instead of the broad, across-the board conditionality applied to countries under ESM programmes, a milder and more targeted form of conditionality is expected to operate through nudges rather than constraint. This *modus operandi* introduces matching grants into the EU toolbox and could thereby influence the EU policy system lastingly.

Whether this conditionality will be effective is an open issue. While the overall approach is promising, the monitoring of the detailed 'targets and milestones' that are part of the Recovery and Resilience Plans (RRPs) (totalling 129 in the German RRP) can easily turn into a bureaucratic box-ticking exercise. The effectiveness of such conditionality will also substantially depend on the type of metrics used for such 'targets and milestones' – notably if they will be output- or outcomes-oriented.

Finally, a downside of the NGEU is that very little money, if any, was set aside to finance European *public* goods such as research and vaccine development. Although federally financed, the programme is in fact devoted to financing spending at national level.

REFORM DIRECTIONS

Two parallel discussions on EU public finances existed before Covid. The first focused on the *creation of a budget or a 'fiscal capacity' for euro area stabilisation purposes*. This included both the potential stabilisation role of a common budget in response to country-specific shocks and the possibility of letting a common budget play an aggregate stabilisation role in response to common shocks.

The debate on the response to country-specific disturbances was prompted by the observation that in the US, the federal budget provides an automatic partial offset to state-specific shocks.[32] The debate on aggregate stabilisation arose from the observation that the combination of a common monetary policy and individual fiscal policies of the Member States does not necessarily provide an adequate policy mix at the euro area level, particularly when monetary policy is constrained by the effective lower bound on interest rates.[33] Either approach would face the obstacle that the EU has no genuine taxing powers, so there were discussions on building up rainy-day funds or a combination of such a fund and a borrowing capacity.

The second discussion was concerned with the *financing of EU-level public goods*. It was essentially of a public finance nature and took place within the constraints of the EU's balanced budget requirement. The issue was whether the distribution of public spending between the EU and the Member States met efficiency requirements and corresponded to the allocation of competences between the two levels of government. It involved a parallel discussion about the structure of EU resources and the possible creation of new own resources to compensate the dwindling of the traditional own resources, especially customs revenues.[34]

NGEU cuts across those two issues. Adding to the lack of consensus that prevented the establishment of a euro area budget, the (rational) choice of devising a response at EU rather at euro area level has probably settled the debate between advocates of an EU-level and a euro area budget in favour of the former. Already, the euro area-level Budgetary instrument for Convergence and Competitiveness (BICC), agreed by the Eurogroup in June 2019, is being subsumed into NGEU.

Crucially, however, NGEU is not a budget, but rather a one-off special emergency instrument. Transitioning to a proper budget financed by own resources, devoted to the financing of EU-level programmes and controlled by the European Parliament, would be legally much more controversial, leading to the establishment of a truly federal structure for the EU.

Three less ambitious, mutually compatible steps could be contemplated.

1) Rolling over NGEU debt

The first would simply be to roll over the NGEU debt. As things stand, repayment will not start before 2027 and the European Council has set end-2058 as the final date for extinguishing the NGEU debt. But this commitment could be revisited, especially if markets continue to exhibit appetite for the new EU-issued securities. EU supranational debt (EU debt raised to finance loans to third countries, EIB or

32 Discussions on this topic started with Sala-i-Martin and Sachs (1991). There has been a long series of follow-up empirical papers.
33 See Section 2 above. The origin of the idea goes back to the MacDougall report of 1977 (European Commission 1977).
34 See especially the Monti report on the EU own resources (European Commission 2016).

ESM debt) exists already and it is rather unlikely that EU Member States will decide to repay the debt in full if asset managers continue to regard it as an attractive investment vehicle.[35]

A rollover of the outstanding stock of NGEU debt would furthermore circumvent the need for new own resources. At its meeting on 17-21 July 2020, the European Council decided that the EU should work towards the introduction of new own resources, several of which are mentioned in the meeting's conclusions. The corresponding revenues are to be used, in a first step, to service the debt incurred for the EU Recovery Fund. Of these potential resources, however, only the ETS revenue is significant, and its Pigouvian nature implies that this revenue is by nature temporary. Moreover, even if it could be desirable, it may prove to be impossible for the EU to agree on a new own resource that is commensurate to the size of the future NGEU repayment.[36] It might settle on a symbolic addition to the existing common revenues. This would imply a corresponding increase in the contributions by the Member States – something that has proved politically difficult to agree on. The possibility of the NGEU debt being rolled over is therefore a real one.

2) Creating new mechanisms for coordination between EU and national levels

Turning to more structural initiatives, a second possibility would consist in building on the Recovery and Resilience logic to create new mechanisms for vertical policy coordination. Because it combines EU grants and loans with national initiatives and because it conditions access to the former on the implementation of domestic reforms, NGEU has the potential of adding a new *modus operandi* to the EU policy toolkit.

Conditional matching grants whereby the EU co-finances policy actions, subject to coherent initiatives on the part of national governments, could provide a new template for vertical cooperation between levels of government. Potential fields for implementation include for example the next vintage of Structural Funds, as well as the green and digital transitions.

A similar approach could be used for reforming the fiscal framework by granting preferential treatment to certain investments that contribute to meeting jointly defined goals. Subject to sustainability requirements, Member States could, for example, be authorised to borrow over and above standard limits for the financing of specified programmes of common European interest.

3) Creating a standing contingent facility

The key question, however, is if and how EU borrowing to finance grants to Member States (as with NGEU) or EU-level investments could be envisioned again in response to particularly adverse shocks or particularly pressing priorities. A third, complementary option would be to rely on the NGEU template to create a permanent contingent fiscal facility that would become part of the EU toolkit. Unlike a budget, this fiscal instrument would not provide funding for ongoing expenditures. It would rather be relied on if and when a new shock or a common challenge necessitates reliance on an EU-level debt-financed programme.

Economically, such an instrument would presumably not serve as a cyclical shock absorber. It could rather serve as a tool for financing investments and reforms in Member States experiencing severe trouble (because of natural disasters or geopolitical shocks). The conditional support instrument, the Recovery and Resilience Facility, has

35 What is likely is that ESM debt will eventually be brought under the umbrella of the EU. The outlook for this consolidation depends on the more general outlook for absorbing the ESM treaty into EU law.
36 See Fuest and Pisani-Ferry (2020).

already been established as a permanent mechanism. If justified by circumstances, it could be relied on to organise support on the condition that adequate resources are identified.

Similar mechanisms could also be used for the financing of non-recurrent joint endeavours of a structural nature (such as, for example, joint investment programmes for the green transition, an exceptional research and technology programme, or a joint security initiative). If justified by the nature of the programme and the existence of strong positive spillovers across countries (because action by any Member State contributes to common goals), investments in individual Member States could be financed through accessing a common fund that would borrow on the market and pass on corresponding resources to the Member States, with or without redistribution. The same technique could apply to investments carried out directly at EU level.

The facility could be activated in a predefined set of circumstances: macroeconomically, when sustained fiscal action is required in complement to monetary policy action, but Member States are unable or unwilling to contribute in a coordinated way; and structurally, when specific long-term programmes of common European interest have to be carried out at national or EU-level level. Triggers for activating the facility should be defined ex ante. They would presumably include economic conditions as well as decision-making rules.

Financing would ideally be pre-defined also. Own resources (if agreed upon) or Member States' contributions (if not) could be allocated to a fund or, alternatively, be called upon automatically after a decision to activate the facility has been made.

LEGAL ASSESSMENT

The EU currently does not have taxing powers (collection of taxes is the exclusive competence of the Member States).[37] This also restricts its capacity to issue debt (the collateral for which is the ability to raise taxes in the future). NGEU demonstrated, however, that provided there is unanimous agreement, a solution can be found under particular circumstances. At the same time, while it is a politically significant step, NGEU cannot be legally and functionally regarded as paving the way to a fundamental reform of the EU budget or the creation of a permanent EU 'fiscal capacity'. It does not grant the Union taxing powers, does not create permanent resources, does not modify the rules governing EU public finances, does not change the distribution of responsibilities between the Union and the Member States, and does not give additional powers to the European Parliament. It rests on an innovative, but largely circumstance-specific legal edifice.

Legally, NGEU combines temporary and permanent components. The grant allocation has by nature a temporary character. The political agreement within the European Council opens the way to the introduction of permanent new own resources, but it is far from certain that consensus will be found to create them. However, the Recovery and Resilience Facility, through which financial support is provided by the Union on the condition that Member States prioritise certain investments, meet certain targets and implement certain reforms, has a more permanent mechanism.

37 While the EU has no power to collect taxes, it does however has the competence to harmonise national taxes (including creating new harmonised taxes such as those under discussion with own resources). This includes the possibility for the EU to determine that newly harmonised taxes, while nationally collected, serve to fund the EU.

Despite its convoluted structure – a consequence of the need to respond to an exceptional situation, but also to fit legal as well as political constraints – NGEU appears to be secure under EU law. It is, however, being challenged in certain national jurisdictions as resulting from an *ultra vires* decision.[38]

If it proves successful – i.e. if it has measurable effects on the economic performance of the beneficiary countries – NGEU will be remembered as a demonstration of the capacity of the EU to respond creatively to testing conditions. It could then provide a basis recurring initiatives in response to crises or common imperatives.

1) Rolling over NGEU debt

A *decision to roll-over of the NGEU debt* beyond 2058 would require modifying the repayment date set by the own resources Council decision of 14 December 2020. This would be essentially a political decision, as it would demand the backing of both the governments and the national parliaments of all Member States. Whether or not it will be taken when the question arises will also depend on the degree of agreement there is on the identification of own resources and on market demand for EU debt securities.

2) Creating a new mechanism for coordination between EU and national levels

The establishment of *new mechanisms for coordination between EU and national initiatives* inspired by the operation of the RRF would not require any significant Treaty amendment. Specific conditionality is likely to make its way through the EU policy system on the occasion of the reform of the fiscal framework and/or in connection with the green transition.

3) Creating a standing contingent facility

Short of a fundamental reform, the question is if NGEU could be replicated in the future. At a minimum, the same type of instrument could be created if justified by circumstances. A further step would be the creation of a *state-contingent fiscal capacity* that could be activated in predetermined circumstances. This would require deciding what resources this facility would draw on. Reaching ex ante agreement on the role, functioning and means of a standing capacity would provide the additional safety of being able to activate it without having to obtain in an emergency unanimous agreement on the design of a new instrument. Assuming that resources could be identified and agreed upon (a non-trivial, but essentially political question), two additional issues would need to be addressed:

- The facility should be compatible with the universality principle of Article 310 TFEU. This would require it be established as a standing, but non-permanent mechanism, and to define a demanding enough activation trigger to ensure that reliance on it would be rare or specific enough to avoid an overlap with the traditional functions of the EU budget.
- Resources and activation triggers would need to be defined. The strongest option legally would be to set up a fund within the RFF and to secure corresponding resources. Activation would consist in the release of resources accumulated in the fund and the commitment of new resources to replenish it. Activation triggers, both substantive (the definition of the circumstances that would require it) and procedural (the majority threshold), should set the bar high enough to ensure that the facility would not serve as an off-budget device but rather have the character of an insurance mechanism.

38 In Germany, for example, to date only a preliminary ruling on *ultra vires* litigation against the EU Recovery Package has been rendered (*Bundesverfassungsgericht*, Order of 15 April 2021), while the principal proceedings and the final judgement are still pending.

An important question is whether the legal basis adopted for the NGEU initiative could also serve in different circumstances. The first paragraph of Article 122 TFEU refers to difficulties in the supply of certain products, which may restrict the range of eligible circumstances. The second paragraph speaks of difficulties, or the threat thereof, resulting from "exceptional occurrences" beyond the control of a Member State, which may or may not be understood as applying equally to a situation where several Member States find themselves in such a situation. The Council regulation of 14 December 2020 establishing the Recovery Instrument actually refers to Article 122 TFEU, without distinguishing between 122(1) and 122(2), and it justifies the creation of the instrument by "an exceptional situation [..] which is beyond the control of Member States" and calls for "a coherent and unified approach at Union level [..] in a spirit of Solidarity between Member States".

This choice is indicative of the direction that could be taken for creating a standing facility. Whereas demanding criteria and procedures should be relied on to ensure that recourse to such a facility would be limited to extraordinary occurrences, we consider that Article 122 TFEU could provide the legal basis for Union initiatives involving loans and grants to Member States as well as Union-level investments in response to specified and temporary challenges of exceptional severity.

5 Conclusions

Throughout the momentous sequence of crises over the last 15 years, the policy system of the euro area has proved remarkably adaptable. It survived the euro area crisis after coming perilously close to catastrophe. And although designed in a high-inflation, high-interest-rate context, it has proved able to respond to a low-inflation, low-interest-rate one. European policymakers and the Member States that made this adaptation possible must be praised for having learned from experience, including from their own mistakes.

Demonstrated flexibility should not serve as an excuse for complacency, however. In the three areas examined in this paper – the relationship between the monetary and the fiscal pillar, the fiscal rules themselves and the legacy of the Next Generation EU initiative – we have come to similar conclusions: the system has been stretched. Economically, policy innovations introduced in response to events have been effective but still distant from first-best strategies. New questions have arisen that call for a more fundamental retooling. Legally, room has been found to conduct policy actions whose need, in particularly demanding circumstances, had not been foreseen by the architects of the EMU. But this very flexibility raises questions as to the limits posed to such actions. Furthermore, challenges brought before national constitutional courts inevitably create a degree of legal uncertainty, which in turn creates unwelcome economic and political uncertainty.

This situation calls for more encompassing reforms than those introduced so far. In particular:

1. We propose interpreting two key legal provisions – the prohibition of monetary financing and the principle of proportionality – in such a way that gives the ECB maximum flexibility to pursue its price stability mandate (in particular, by discarding mechanical 'safeguards' that stand in the way of effective monetary policy as long as the ECB ensures that budgetary pressure on Member States is maintained).
2. We advocate building on experience to create a procedural venue for non-binding fiscal-monetary coordination and to equip the ECB with callable capital to protect its independence.

3. We argue for a reform of the fiscal rules to give higher priority to debt sustainability, create room for stabilisation and allow for differentiated medium-term debt anchors and risk-based debt reduction objectives.
4. We suggest building on the NGEU experience to develop new vertical coordination mechanisms between the Union and the Member States and to create a standing contingent fiscal capacity at EU level.

Most of the reforms we are advocating do not require amending the EU Treaties (though they would imply modifying secondary legislation, as well as the TSCG). As far as monetary policy and the national fiscal policies are concerned, clarifying amendments would in certain cases be useful, but not indispensable, as we regard the existing Treaty provisions as fundamentally sound. The scope for reforming the rules through existing Treaty procedures should, however, be made use of, as with the numerical debt and deficit reference values, which could be changed using a special legislative procedure in accordance with Article 126 (14) TFEU. Overall, significant improvement can be brought to the policy system while remaining within the confine of the existing primary law framework, if there is agreement for such reforms.

The one point where Treaty reform could in our view be contemplated is the creation of a common fiscal capacity. The EU and the euro area would be better able to tackle future challenges if equipped with a proper budget financed by genuine own resources and freed from the requirement of permanent balance. The reasons why it does not exist are ultimately political. Legal constraints are merely the result of a more fundamental reluctance by Member States to contemplate even a limited step towards fiscal federalism. It is because of this political constraint that we are not proposing a common fiscal capacity, but rather a standing contingent instrument that would be activated in specific circumstances and through ex ante determined mechanisms.

We are convinced that our limited set of proposals would provide the basis for a coming of age of the European macroeconomic policy system. Europe should stop placing bets on a return to normalcy. Rather, it should prepare for rougher times ahead: a world where the independence and credibility of the central bank remain essential but the range of policy initiatives it should be able to conduct has broadened considerably; where the threat of solvency crises has increased due to the high level of government debt, but macroeconomic stabilisation must regularly rely on fiscal support; and where tail risks of financial, health, climatic or geopolitical origin materialise more frequently and call for extraordinary responses.

Is now the right time to reform? Doubters object that there is significant flexibility in the policy system, as demonstrated by experience, and that it is much easier to find (possibly tacit) consensus on concrete initiatives than on modifying the rules of the game. To paraphrase Lampedusa, everything could change provided one pretends that nothing has changed.

We disagree. It is true that there is flexibility in the system, and it is also correct that in a zero nominal interest rate world, a 3% ceiling for the general government deficit is not a tight constraint. But the problem is not exclusively, not even mainly, a lack of flexibility. Rather, it is one of legal uncertainty and economic unpredictability. These generate a lack of clarity and credibility.

Adding to previous events, the Covid shock and the response to it have created the false impression that pragmatism and political will continue to reign supreme. To declare the window closed and go back to the old rules, without drawing the lessons from experience and without questioning what has proved questionable, would likely be ineffective. This stance would be met with the objection that rules that have proved inadequate have lost credibility, and it would risk undermining support for the very principles that have successfully passed the test of time.

We also disagree with the idea that the current context of economic uncertainty and inflation resurgence leaves no room for reform. The reforms we are advocating are not designed for a certain state of the world. Fiscal-monetary coordination, for example, is needed in a secular stagnation context, but also when facing an adverse supply shock. We are proposing all-weather reforms.

A more noteworthy objection regards the green transition, whose consequences are not explicitly taken on board in the analysis we have developed. We regard it as a transformation of major macroeconomic relevance that will significantly impact potential output, investment, growth, inflation and public finances in the years to come. Monetary policy will need to adapt to a different environment in line with the ECB's secondary mandate. Whether the public investments and the public cost of the corresponding reforms should be financed by current taxes or by debt is a first-order strategic issue. Choices will have to be made as regards the relative fiscal involvements of the Union and the Member States. It is hard to overestimate the significance of the climate challenge for macroeconomic policies.

The stability and adequacy of the monetary and fiscal frameworks of the euro area remain strong prerequisites for common prosperity. They will also provide the linchpin of further reforms and institution-building at EU level. In other words, the double crisis of health and climate change may require further institutions building at EU level, but this should not distract from the need to complete the European macroeconomic edifice.

To specify the reforms that we are advocating, gather consensus around them and proceed to the corresponding legislative programme, we envision a three-step approach.

- The first step would focus on building consensus on the macroeconomic policy lessons from the pandemic crisis and on a roadmap for reform. We would suggest initiating the corresponding dialogue without delay, immediately after the new German government has taken office and on the eve of the French presidency of the EU, with the aim of agreeing on a declaration of principles to be adopted by the European Council by early Spring 2022. The launch of this process would also coincide with the closure of the consultation process launched by the Commission.
- The second step would be to translate this broad political consensus into principles for reforming the fiscal framework. The Eurogroup should be tasked with this and aim at reaching agreement on key reform directions in time for these directions to be adopted well ahead of the de-activation of the General Escape Clause on 1 January 2023. Interim solutions for managing exit from the General Escape Clause could then be defined and implemented.
- The third step would consist in stipulating the corresponding legislative reforms. It would need to be completed by end-2023 or beginning 2024 at the latest, so that the process would be completed before the end of the term of the European Parliament.

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