European Economic and Social Committee

OPINION

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Reshaping the EU fiscal framework for a sustainable recovery and a just transition

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Reshaping the EU fiscal framework for a sustainable recovery and a just transition
(own-initiative opinion)

ECO/553

Rapporteur: **Dominika BIEGON**

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1. Conclusions and recommendations

1.1 The European fiscal rules need a revision: deficiencies were already obvious after the 2008/09 financial crisis and the COVID-19 pandemic poses even more serious challenges to the current fiscal framework. In past opinions, the EESC has welcomed the European Commission's economic governance review. In this opinion, the EESC reiterates its position on the need for reforms and calls on the Commission to swiftly continue the revision of the EU economic governance framework, which has currently come to a halt. Before the revised framework comes into force, the Commission should put forward guidelines for a transition period, during which time the excessive deficit procedure should not be triggered, and with the possibility to use the "unusual event clause" on a country-specific basis.

1.2 Any future fiscal framework needs to a) strengthen public investments, b) allow for more cyclical leeway and c) permit greater flexibility and country-specific differentiation as far as debt adjustment paths are concerned, while at the same time guaranteeing fiscal sustainability. A revision of the EU fiscal framework is not only necessary for the purpose of short- to medium- term stabilisation of the economy. It is also of vital importance in order to finance the socio-ecological transformation of our economy, guaranteeing full employment, high-quality jobs and just transitions.

1.3 More specifically, the EESC's main proposal for the revision of the fiscal framework is to introduce a golden rule for public investments, which the EESC has already put forward in past opinions, in combination with an expenditure rule. In addition to this, the EESC welcomes the proposal made by the European Fiscal Board (EFB) regarding the country-specific differentiation of fiscal adjustment paths.

1.4 Finally, the EESC points out that fiscal policy is the classic domain of parliamentary politics and its decisions affect the entire structure of state expenditure and revenue. Therefore, both national parliaments and the European Parliament need to be given a prominent role in the future EU economic governance framework.

1.5 In a similar vein, there is a need to involve civil society to a greater extent in the European Semester at both national and EU level. This way, a balanced economic policy can be established, where all interests are reconciled. This is particularly the case for the governance of the Recovery and Resilience Facility, where civil society involvement has not been satisfactory[1]. The partnership principle, which has long been a tradition in the governance of the European Structural and Investments funds, should serve as a blueprint for an effective mechanism of civil society involvement.

[1] EESC Resolution on the Involvement of organised civil society in the National Recovery and Resilience Plans – What works and what does not? (2021), OJ C 155, 30.4.2021, p. 1.

2. Background: new challenges after the COVID-19 pandemic

2.1 The European fiscal rules need a revision. Before the crisis, the European Fiscal Board's (2019)[2] assessment of the EU fiscal framework rightly pointed out two main problems: first, fiscal rules tend to be procyclical: following the 2008/2009 financial crisis, fiscal consolidation came too early because of overwhelming sustainability concerns, leading the European economy into a double-dip recession. Second, public investment in the EU has been the first target for spending cuts. Comparing the average government investment rate for 2015-2019 with the pre-crisis average (2005-2009), 20 out of 27 Member States saw their rates decline, for some by as much as 50%, to such an extent that the value of the stock of public capital, marked by negative net public investment figures, deteriorated between 2013 and 2017 in the euro area.

2.2 The COVID-19 pandemic poses even more serious challenges to the EU fiscal framework: the economic slump together with policy measures to mitigate the social and economic impact of the pandemic have led to massive increases in government deficit and debt to GDP levels in many Member States[3]. Estimations by the European Fiscal Board (2020)[4] show that if the EU fiscal rules were activated unchanged after lifting the general escape clause, the expected debt ratio reduction path would overburden some Member States, with significant negative economic, social and political consequences endangering the economic recovery in the EU.

2.3 A reform of the EU fiscal rules is not only necessary for the purpose of a short- to medium-term stabilisation of the economy. It is also of vital importance in order to finance the socio-ecological transformation of our economy, guaranteeing full employment, high-quality jobs and just transitions. To achieve the EU climate targets, a profound modernisation of the capital stock is needed. A sustainable economy needs a massive expansion of public investments, otherwise European economies will be facing climate-related fiscal risks[5]. At the same time, fiscal sustainability needs to be ensured. In previous opinions, the EESC has already underlined the need to introduce a golden rule for public investment in the EU fiscal framework[6]. These demands remain valid: for Europe to meet its 2030 climate and environmental targets, the European Commission recently estimated the overall funding gap to be around EUR 470 billion a year until 2030[7]. As rightly emphasised "mobilising the necessary scale of finance will be a significant policy challenge", and clearly public investment will have a critical role to play, not least also in order to trigger private investment. The reform of the EU fiscal framework has to take these considerations into account.

2.4 The EESC underlines that Member States must face the challenge of reducing debt to GDP ratios after economic recovery takes hold to retain enough fiscal space to counter the next

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2 European Fiscal Board (2019): *Assessment of EU fiscal rules with a focus on the six and two-pack legislation*.

3 European Commission, *European Economic Forecast Spring 2021*.

4 European Fiscal Board (2020): *Annual Report 2020*.

5 Finance Watch (2021), *Fiscal Mythology Unmasked. Debunking eight tales about European public debt and fiscal rules*.

6 OJ C 353, 18.10.2019, p. 32; OJ C 123, 9.4.2021, p. 12 and OJ C 429, 11.12.2020, p. 227.

7 Commission Staff Working Document (2020), *Identifying Europe's recovery needs*, SWD(2020) 98 final.

economic crisis. The expenditure rule proposed in this opinion (see points 3.3.2. and 3.3.3.) would indeed ensure that Member States consolidate their public finances in good times.

2.5 The EESC underlines that a revision of the EU fiscal framework needs to take into account the current macroeconomic context. Both the IMF[8] and the European Commission[9] state that debt to GDP ratios should stabilise in the short to medium term thanks to low interest rates and increased growth rates. The sustainability of sovereign debt depends on the (real) GDP growth rate, annual primary balance and the (real) interest rates on outstanding sovereign debt. The EESC urges the European Commission to take these factors into consideration when assessing Member States' debt sustainability.

2.6 Moreover, the EESC stresses that sustainable public finances depend to a large extent on reliable public revenues and fair taxation, including, for example, the fight against tax fraud and aggressive tax planning. In addition, the announced new own resources should contribute to enhancing fair taxation, as well as to social and climate justice. Transparency of revenue and spending, open contracting and the constant involvement of civil society in the oversight of public financial management is also necessary to ensure sustainable public finances.

2.7 In past opinions, the EESC has welcomed the European Commission's economic governance review and highlighted the need for a revision[10]. The EESC has also proposed that the question of reforming EU economic governance should be debated at the Conference on the Future of Europe. Adapting the TFEU's economic governance provisions to the EU's current economic reality should not be taboo. The EESC reiterates this call, particularly in the face of the COVID-19 crisis. To prevent a return to the old fiscal rules and manage a shift towards a prosperity-focused economic governance, the EESC urges that the review process be resumed as soon as possible[11].

3. Specific comments

3.1 Rebalancing EU economic governance

3.1.1 Fiscal policy should be part of a broader multi-level and balanced governance framework. The EESC advocates a prosperity-focused economic governance, where people's social and economic wellbeing is prioritised so that no one is left behind, while ensuring public debt sustainability. Therefore, the Committee calls for a balanced economic policy that stresses the importance of and gives equal weight to a range of key policy objectives such as sustainable and inclusive growth, full employment, decent work and just transitions, a fair distribution of income and wealth, public health and quality of life, environmental sustainability, financial market stability, price stability, well-balanced trade relations, a competitive social market economy and sustainable public finances. These objectives are consistent with both the

8 *IMF Fiscal Monitor Reports*, April 2021.

9 *Debt Sustainability Monitor*, European Commission, February 2021.

10 [OJ C 429, 11.12.2020, p. 227](#).

11 [OJ C 123, 9.4.2021, p. 12](#).

objectives set out in Article 3 of the Treaty on European Union and the current UN Sustainable Development Goals[12].

3.1.2 In order to support Member States on their way to a sustainable and inclusive economy it is not only necessary to allow for more fiscal leeway under certain conditions. In addition to this, incentives for reforms must be promoted. The current EU economic governance framework consists of three pillars a) fiscal surveillance b) macroeconomic surveillance and c) social and employment policy coordination. Thus, it already has a strong focus on reforms. A variety of empirical studies emphasise that despite reforms, the bulk of past country-specific recommendations have focused on boosting competitiveness and consolidating public budgets[13]. The EESC urges the EU institutions to be more balanced in future country-specific recommendations: fiscal benchmarks, as well as EU climate goals and the European Pillar of Social Rights should serve equally as important reference points for country-specific recommendations. Special focus should be put on reforms that support the transition towards a green and digital economy (such as active labour market policies and lifelong learning schemes, including programmes to reskill and offer career change support) and on reforms that guarantee that EU funds are absorbed effectively (such as building up technical capacities in public administrations to manage investment projects, effective and open public procurement systems and reforms to remove other non-monetary barriers to an effective investment policy).

3.2 Strengthening public investment

3.2.1 The EESC underlines that the EU fiscal framework needs to be reformed in a way that better protects public investments[14]. The multiplier effect of public investment is particularly high, and cuts in public investment therefore have a particularly negative impact on economic growth and employment. Cuts in public investment in particular, and in government spending more generally, are particularly damaging in times of economic slumps and recessions[15]. In addition, many studies also identify public investment as a growth booster in the long term[16]. A long-term increase in public investments also provides a more secure basis for private-sector planning[17].

3.2.2 These facts justify an approach that treats public investments preferentially as far as the assessment of Member States' compliance with EU fiscal rules is concerned. The EESC advocates a "golden rule" for public investments[18], to safeguard productivity and the social and

12 OJ C 429, 11.12.2020, p. 227.

13 Crespy, Amandine and Vanheuverzwijn, Pierre (2019), "What Brussels means by structural reforms: empty signifier or constructive ambiguity?", in: *Comparative European Politics, Vol. 17, Iss. 1, pp. 92-111*; Hacker, Björn (2019): *A European Social Semester? The European Pillar of Social Rights in Practice*. Brussels, ETUI.

14 See also *European Fiscal Board* (2019).

15 European Commission (2016), *Report on Public Finances in EMU 2016*, Institutional Paper No 045; J-M Fournier (2016), *The positive effect of public investment on potential growth*, OECD Economics Department, Working Paper No 1347.

16 IMF Fiscal Monitor (2020), *Policies for the Recovery*.

17 H. Bardt, S. Dullien, M. Hüther and K. Rietzler (2020), *For a sound fiscal policy. Enabling public investments*, IW policy paper No 6/2020, Institut der deutschen Wirtschaft (IW), Köln.

18 OJ C 429, 11.12.2020, p. 227.

ecological base for the wellbeing of future generations, while at the same time ensuring fiscal sustainability. In general, the EESC suggests implementing the traditional public finance concept of the golden rule within the revised fiscal framework[19]. This means that net public investments need to be excluded from the calculation of the headline deficits. If an expenditure rule is implemented as called for by the EESC (see points 3.3.2 and 3.3.3) net public investments should also be excluded from the public expenditure ceiling, while investment costs would be distributed over the entire service life, instead of a four-year period, as is currently the case. Net public investment increases the public and/or social capital stock and provides benefits for future generations[20]. Future generations inherit the servicing of the public debt, but in exchange, they receive a corresponding and increased public capital stock.

3.2.3 The EESC underlines that the golden rule leads to preferential treatment of public investments under the EU fiscal framework. It does not release governments from the obligation to justify and win majorities for relevant investment projects. Transparency and parliamentary accountability must, in any case, be retained, also to ensure that only those public investments that serve the common good are made.

3.2.4 As a very first step, the EESC recommends a fundamental revision of the "investment clause". Firstly, the EESC suggests that the "investment clause" in the Stability and Growth Pact should be interpreted more flexibly. So far, it has been rarely invoked primarily because of its restrictive eligibility criteria[21]. These eligibility criteria should be loosened: in principle, public investments should justify a temporary deviation from the adjustment paths, independently of the position of the Member State in the economic cycle and even if these investments lead to an excess over the 3% of GDP deficit reference value.

3.2.5 Currently, deviations from the medium-term budgetary objective (MTO) or the adjustment path towards it are only allowed if they are linked to national expenditure on projects co-funded by the EU[22]. The EESC suggests a broader definition of investments. At the same time, the definition of investments needs to be clear and practicable to prevent "creative accounting". The European Commission's guidance to Member States in the context of the Recovery and Resilience Facility and the definition of investments therein constitutes a good starting point[23], as it includes investments in tangible assets but also investments in health, social protection, education and training, and investments aimed at the green and digital transition.

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19 A. Truger (2020), *Reforming EU Fiscal Rules: More Leeway, Investment Orientation and Democratic Coordination*, Intereconomics, 55(5).

20 See also P. Bom and J. Ligthart (2014), *What have we learned from three decades of research on the productivity of public capital?*, Journal of Economic Surveys, 28(5), 889-916.

21 J. Valero (2019), *New investment clause fails to win EU member state support*, Euractiv. See European Commission (2015), *Making the best use of the flexibility within the existing rules of the stability and growth pact*, COM(2015) 012 final.

22 European Commission (2015).

23 European Commission (2021), *Guidance to Member States. Recovery and resilience plans*, SWD(2021) 12 final, part 2/2.

3.2.6 The EESC welcomes the taxonomy for sustainable activities. It establishes in a clear-cut manner what qualifies as an "environmentally sustainable economic activity", which in turn makes it possible to define "environmentally sustainable investments"[24]. Therefore, the EESC recommends taking the well-developed EU Taxonomy for sustainable activities as a basis for an evaluation of the sustainability of public investments, in a combination with a golden rule. Moreover, the EESC awaits with interest the Commission's proposals on green budgeting.

3.3 More cyclical leeway for fiscal policy

Reforming cyclical adjustment methods or introducing an expenditure rule

3.3.1 The EESC underlines that the European Commission's method for cyclical adjustment is opaque, and a source of procyclicality. The European Commission's method determining the structural balance has proven to be problematic because the calculated potential output is strongly influenced by the current economic situation. In phases of economic downturn, for example, potential output is quickly and sharply revised downwards, although this does not have to reflect real conditions[25]. The downward revision of potential output has severe consequences for the calculated structural deficit and the consolidation efforts identified correspondingly. Making the calculation of the potential output less sensitive to cyclical fluctuations can open up considerable fiscal room for Member States for countercyclical economic policies. This reform proposal could be implemented easily and should be taken into consideration merely as a minimum requirement for making the EU fiscal rules more fit to deal with cyclical fluctuations. However, even if reformed, the structural deficit will remain an extremely complex concept and its calculation is nearly impossible to explain to citizens and stakeholders. Because of the technical problems and the opaqueness of the concept, alternative options should be considered.

3.3.2 An alternative reform option is to abandon the contested concept of structural deficit altogether and, instead, to implement a public expenditure rule in a revised fiscal framework[26]. Unlike the cyclically adjusted deficit, public expenditure is observable in real time and are directly controlled by the government. Public investment should be favoured by separating current and investment budgets, subjecting only the current budget to limits for nominal expenditure growth. This way, the golden rule approach could be combined with an expenditure rule[27].

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24 OJ C 62, 15.2.2019, p. 103.

25 A. Truger (2015), *Austerity, cyclical adjustment and the remaining leeway for expansionary fiscal policies within the current EU fiscal framework*, Journal for a Progressive Economy, 6, 32-37.

26 OJ C 429, 11.12.2020, p. 227.

27 OJ C 429, 11.12.2020, p. 227.

3.3.3 Nominal public expenditure would be calculated net of interest payments and net of cyclical government expenditure. The limits could be determined by the medium-term growth rate of real potential output plus the European Central Bank (ECB) target inflation rate of 2%. If cyclical factors cause tax revenue to decline (in a recession) or rise (in a boom), the rule promotes stability by ensuring that government expenditure only increases within the stipulated limits. Expenditure in excess of the established limit should only be allowed if it is budget-neutral, i.e. if spending is cut by the same amount elsewhere or if tax revenue increases. In the case of general tax cuts, expenditure growth rates would have to incorporate these withdrawals of resources. The proposed combination of an expenditure rule and a golden rule for public investment could constitute an effective tool for limiting public spending to sustainable levels, while at the same time allowing the automatic stabilisers to operate and enabling governments to take discretionary measures.

Flexible and country-specific debt adjustment paths

3.3.4 The EESC supports the proposal made by the European Fiscal Board (2020)[28] to introduce country-specific elements in a simplified fiscal framework. In particular, the EESC welcomes the suggestion regarding the differentiation of the fiscal adjustment in the Member States, while maintaining debt sustainability. A country-differentiation of debt to GDP reduction strategies should be based on a comprehensive economic analysis taking into account factors such as the initial level of debt and its composition, the interest rate-growth differentials as a matter of sustainability, inflation perspectives, the projected costs of ageing and environmental challenges, unemployment and poverty levels, income and wealth distribution, internal and external imbalances and, primarily, whether the fiscal adjustment (e.g. the required primary budget surplus) is realistic[29].

3.3.5 The EESC recalls that the fiscal reference values are not defined in Article 126 TFEU itself but by Protocol No 12 in the Annex to the Treaty. Therefore, these values can be changed by unanimous vote in the Council without a formal Treaty change procedure. The EESC encourages the EU institutions to consider raising the 60% debt ceiling while taking into account the current macroeconomic context and ensuring fiscal sustainability.

3.3.6 Finally, it is worth adding in this context, that relying solely on national automatic stabilisers in recessions is not fully in line with the idea of countercyclical policy. Fiscal deficits caused by reduced output and employment do not fully compensate cyclical losses and are not enough to fully counter a cyclical downturn. They are only passive and partial countercyclical responses and need to be supplemented by active discretionary temporary responses to cyclical downfalls to be reversed in upswings. In the past, a range of Member States have decided to continue decreasing debt to GDP ratios with negative economic consequences while fiscal stimuluses would have been more appropriate. In a future fiscal framework, provided that a favourable interest rate environment continues, larger primary deficits should be allowed, while keeping debt to GDP ratios constant or decreasing and ensuring debt sustainability. This is why

28 European Fiscal Board (2020).

29 European Fiscal Board (2020).

exceptional clauses must remain a cornerstone of any future EU fiscal framework and should be adapted accordingly.

Deactivation of escape clause

3.3.7 The EESC welcomes the activation of the fiscal framework's general escape clause and warns against "returning to normal" too quickly as this might cause a contractive impulse, leading Member States to cut spending in order to reach MTOs, as was the case after 2010 causing a double-dip recession. This would counteract the aim of the Next Generation EU programme and could trigger a new recession.

3.3.8 The EESC supports the European Commission's decision to continue applying the general escape clause in 2022 and to deactivate the clause in 2023, provided that the level of economic activity reaches the pre-crisis level[30]. What is more, the EESC supports the European Commission's assertion that "country-specific situations will continue to be taken into account after the deactivation of the general escape clause"[31]. Finally, the Commission should put forward guidelines for a transition period until the new fiscal framework is in place, during which time no excessive deficit procedure should be activated, and with the possibility to use the "unusual event clause" on a country-specific basis. Moreover, the EESC calls on the Commission to swiftly continue the revision of the EU economic governance framework, which has come to a halt. Instead of a "return", the EESC recommends a "turn" towards a revised economic governance framework as indicated below[32].

3.4 The international role of the euro

3.4.1 Our common currency – the euro – enjoys a strong international reputation and has been recognised for its global significance as a reserve and trading currency. The euro's reputation as a stable and trusted currency is dependent on clear, comprehensible and enforceable fiscal rules that strengthen public investments to allow for the modernisation of the capital stock and generate more cyclical leeway in economic downturns, while at the same time ensuring debt sustainability. The EESC is therefore convinced that a revision of fiscal rules must not undermine the stability of the euro as the main "anchor" currency of the Union in any way. Particular emphasis should be given to the financial market's perception of the euro's long-term prospects as a globally important currency during the debate on the revision of the fiscal rules. In general, the Euro's reputation depends on economic, social and political stability.

30 European Commission (2021): *Economic policy coordination in 2021: overcoming COVID-19, supporting the recovery and modernising our economy*. COM(2021) 500 final.

31 European Commission (2021): *One year since the outbreak of COVID-19: fiscal policy response*, COM(2021) 105 final.

32 OJ C 429, 11.12.2020, p. 227.

3.5 Strengthening the role of parliaments and civil society in EU Economic Governance

3.5.1 The EESC points out that fiscal policy is the classic domain of parliamentary politics and its decisions affect the entire structure of state expenditure and revenue. Therefore, both national parliaments and the European Parliament need to be given a prominent role in the future EU economic governance framework. The role of the European Parliament should be strengthened in the European Semester through an interinstitutional agreement. At the same time, the principle of subsidiarity and the division of competences in the Treaties must be respected. National parliaments must hold governments accountable for the fiscal policies they pursue. Therefore, they need to be effectively involved in the European Semester and the implementation of national recovery plans.

3.5.2 In a similar vein, there is a need to involve civil society to a greater extent in the European Semester at both national and EU level. This way, a balanced economic policy can be established, where all interests are reconciled. This is particularly the case for the governance of the Recovery and Resilience Facility, where civil society involvement has not been satisfactory[33]. The partnership principle, which has long been a tradition in the governance of the European Structural and Investments Funds, should serve as a blueprint for an effective mechanism of civil society involvement.

3.5.3 In the event of significant deviations from indicators representing the economic policy objectives, negotiations between the EU institutions and the Member States should follow. The two sides should develop solutions together and on an equal footing. Instead of threatening the Member States concerned with financial sanctions, the introduction of positive incentives could ease the problem. The promotion of inclusive and sustainable growth must be the key criterion in recommendations[34].

3.5.4 The EESC criticises so-called "macroeconomic conditionalities" in the common provisions regulation applying to the European Structural and Investment Funds, in the regulation on the Recovery and Resilience Facility and in the intergovernmental treaty on the European Stability Mechanism which, generally speaking, allow the disbursement of EU funds to be stopped if Member States breach the EU fiscal rules or contribute to macroeconomic imbalances. After the deactivation of the escape clause, these macroeconomic conditionalities might cause a contractive impulse, leading Member States to cut spending in order to reach fiscal targets. This would counteract the political aim of territorial cohesion and the broader aims of the Next Generation EU Programme.

3.5.5 For a sustainable recovery, an accommodating monetary policy remains vital. The European Parliament could use its annual resolutions on the ECB and its quarterly "monetary dialogue" hearings with the ECB to vote on secondary objectives and to develop a process that is more democratic, with guidelines on macroeconomic and industrial policy. This would allow greater involvement of social partners and citizens, along with national parliaments. In this manner, the

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33 EESC Resolution on the Involvement of organised civil society in the National Recovery and Resilience Plans – What works and what does not? (2021), OJ C 155, 30.4.2021, p. 1.

34 OJ C 429, 11.12.2020, p. 227.

ECB would receive renewed legitimacy for an expanded set of goals. It could work efficiently, deploying its full toolkit to work towards a clear and politically defined set of policy objectives, guided by democratic institutions. The ECB is a public institution and can be enlisted to help Member States to fund themselves in times of rising interest rates, from either a price stability or an employment perspective, by targeting interest rates and spreads and through targeted monetary tools.

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Christa SCHWENG
The president of the European Economic and Social Committee