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Reforming the European fiscal governance. Beyond new rules

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Abstract

As of March 2020, at the outbreak of the Covid-19 pandemic, the fiscal rules of the European Economic and Monetary Union were suspended until 2023. Should their reactivation be accompanied by some kind of reform? Disagreement, especially at political level, looms large. We argue that the existing fiscal regulation of the EMU is the product of the cultural and political climate that prevailed in the 1980s and 1990s, when confidence in the self-regulative capacity of markets was unlimited, the need for, and effectiveness of, active fiscal policies was deemed limited if not harmful, and monetary policy was seen as a universal panacea for (residual) stabilisation purposes. The subsequent three decades have been characterised by a sequence of global-scale crises with profound economic, social and political consequences that have subverted those beliefs. Any reform of the regulatory system of public finance in the EMU must take account of the changed circumstances. We also argue that the reform should go beyond the technical restyling of fiscal rules. Renewed fiscal rules should rest on renewed political-economic pillars. The first is the transition from "horizontal" to "vertical" co-ordination. The second is a clear separation of tasks and roles between technical evaluation and political responsibilities. Relying on these pillars, we subscribe to two new rules aimed at granting sustainable public finances of member countries. One shifts the focus from annual budgets to medium-long-term debt sustainability. The other introduces primary spending controls, with macro-stabilisation and public investment safeguards.

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1. The European Economic and Monetary Union's fiscal rules are thirty years old

Why does a monetary union need fiscal rules? In short, to safeguard member states against the externalities generated by the fiscal policies of other member states in the absence of such protective barriers as flexible exchange rates and limited capital mobility. This is even more the case for the European Economic and Monetary Union (EMU), which lacks a federal government, with fiscal sovereignty thus remaining with member state governments (Gros 2021). This fundamental principle was enshrined in the Maastricht Treaty, which came into force in 1992 and was then structured into a series of rules set down in the 1997 Stability and Growth Pact (SGP), which is still today the fiscal cornerstone of the EMU. although significant changes took place over time, culminating in the 2012 Treaty on Stability, Coordination and Governance in the EMU, referred to as the Fiscal Compact**.**

1.1 The wrong design

The existing fiscal regulation is the product of the cultural and political climate prevailing in the 1980s and 90s, when confidence in the self-regulative capacity of markets was unlimited, the need for, and effectiveness of, active fiscal policies was deemed limited, and monetary policy was seen as a universal panacea for (residual) stabilisation purposes.[1]

The subsequent three decades have been characterised by profound economic, social and political changes related to the three global-scale crises: the 2001 attack on the Twin Towers in New York, the global financial crisis and the 2008–9 Great Recession, and the 2020 Covid-19 pandemic. The debate over the EMU's "fiscal constitution" is ongoing, and both its successes and its failings are singled out (for example, Regling 2021). However, analyses of the European crisis and stagnation in the last decade, and the exceptional challenge brought by the pandemic, have shifted the judgement pendulum in the direction of a growing anachronism of the existing fiscal rules and the unfeasibility of the restoration of the pre-pandemic status quo.

In the EMU's conception, the stabilisation policy was, in principle, entirely a matter for the central bank despite it being common knowledge that the latter is not fully up to the task in a monetary union when shocks are asymmetric, i.e. hitting the various member states to different extents and/or in different directions (Bofinger and Mayer, 2007). The argument that the fiscal space granted by the 3% deficit ceiling would be enough to accommodate country-specific asymmetric shocks was based on evidence dating back a few decades (e.g. Buti and Sapir, 1998). As a matter of fact, the first serious stress test for the EMU was the huge *symmetric shock* produced by the 2007-08 global financial crash and the subsequent deep recession, when the whole world discovered that monetary policy alone was impotent. With interest rates close to (or even below) zero, and the economy showing symptoms of "secular stagnation," fiscal policy has been reassessed as a necessary and indeed powerful tool to trigger recovery

[1] The non-Keynesian-effects of fiscal policy "theory" (Giavazzi, Pagano, 1990) supported the view that prolonged fiscal consolidations might have expansionary effects. Many doubts are now cast on such a view, while standard Keynesian multipliers are estimated to be high in deep recessions, even in countries with high debt and limited "fiscal space" (Boitani, Perdichizzi, Punzo, 2022, for a recent assessment).

and ensure it is stable and sustainable over time (Blanchard, 2009; Blanchard et al., 2010).

By contrast, for EMU member states (MSs) fiscal space remained constrained, not only in countries under financial distress. The fiscal rules in force until March 2020 envisaged only one type of externality, namely excess debt and/or deficit by one or more member MS), jeopardising the Union's financial stability and generating debt monetisation pressure on the ECB or transfers between states to save one or the other from default. This view substantially ignores the macroeconomic externalities of the unilateral restrictions in the fiscal policy implemented by a single country (especially a large one) in a continent where trade is intense and value chains are increasingly integrated. Moreover, rules applied rigidly on a national level in an un-coordinated way can potentially exacerbate the macroeconomic externalities, culminating in an overall euro area fiscal stance which is too restrictive more frequently than it is too expansionary. Rather than generating stability, the rules actually generated instability, including by destabilising expectations.[2]

An example relevant to the future is of use in illustrating this point. Germany plans to reduce its net debt from 240 billion euro in 2021 (forecast 6.95% of GDP) to 80 billion euro in 2022 (forecast 2.22% of GDP) and rapidly return to the balanced budget *(Schuldenbremse)* enshrined in its Fundamental Law, apparently without taking account of the impact this will have on other Eurozone countries, just as it has done from 2011 onwards. Such an economic package is fully in line with the old European fiscal rules and the quintessence of fiscal orthodoxy. But is this ultimately compatible with a monetary union characterised by wide-ranging and profound macroeconomic externalities?[3] What might be the impact of such a drastic reduction in quantities of "safe" financial assets (such as German Bunds) on the ECB's monetary policy choices?

1.2 Technical bugs

The fiscal rules also displayed technical bugs which made them procyclical, whatever the intended contrary effects (Darvas, 2019). With the 2005 reform of the SGP the key tool in public budget control became the structural budget balance to GDP ratio, i.e. the government budgetary balance (in relation to GDP) net of the business cycle effects (the balance tends to improve with expansion and worsen with contraction) and of one-off and temporary measures. This was intended to eliminate the obvious procyclical nature of calculating the deficit-GDP relationship alone.[4]

A key role in calculating the structural balance is played by what is referred to as the output gap. The more negative this is (i.e. the deeper the recession), the less the structural deficit with a given effective (or "nominal", in jargon) balance. The problem is that the output gap – as the difference between real and potential GDP – is not an observable variable and potential GDP is, in turn, not observable but rather estimated on the basis of past data (Heimberger and Kapeller, 2017). Output gap values were thus

[2] On "excess" or "self-defeating austerity" see De Grauwe and Ji (2013), Nuti (2013), Tamborini (2013).
[3] Buhl, Cohen-Setton and Vallée (2021) have estimated that the negative fiscal impact on the euro area of this German package would be in the region of 0.6% of its GDP.
[4] When GDP shrinks in recession, the deficit/GDP ratio increases even if the deficit remains constant. The ratio grows even more because, in a recession, tax revenue declines and spending on social welfare increases.

reviewed on the basis of past GDP trends which were used for fresh potential GDP forecasts.[5] Thus, after a period of prolonged recession, potential GDP forecasts were adjusted downwards in such a way as to narrow the gap between real and potential GDP (i.e. a reduction in the output gap), with the result of worsening the structural balance for a given nominal balance. Frequent forecast reviews generated significant uncertainties and errors in the definition of a country's cyclical position and consequently in the budgetary policies enacted in accordance with the constraints set by the SGP. Consequently, restrictive policies were advised and, on some occasions, implemented in economies in full recession solely on the grounds that the forecasts showed a reduced potential GDP and thus an increased structural deficit.

2. The EMU Trilemma

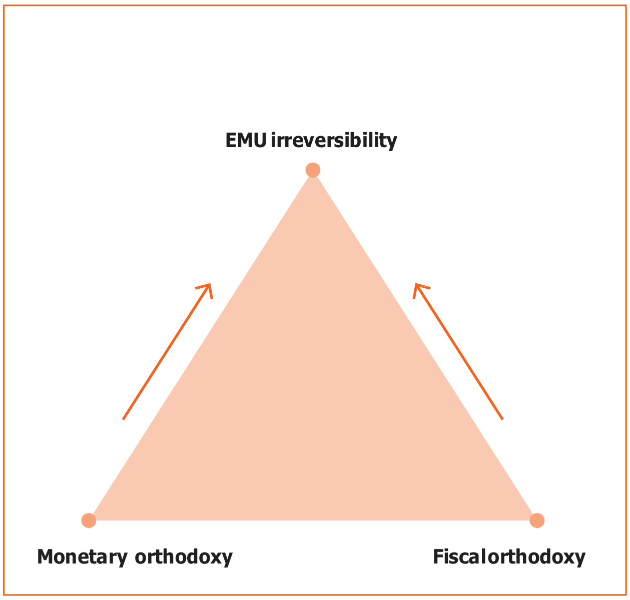
The lasting legacy of the second decade of the 21st century goes well beyond the role of fiscal rules. It is a situation which Della Posta and Tamborini (2021) referred to as the **EMU Trilemma** (see figure 1). Both following the "Europeanisation" of the 2008–09 global crisis and the outbreak of the pandemic, we have seen that when significant **systemic shocks** hit the EMU only two of its three pillars can be salvaged: 1) the **integrity** of the Monetary Union; 2) **monetary orthodoxy** (the price stability priority and the ban on the monetising of public debt); 3) **fiscal orthodoxy** (national fiscal sovereignty subject solely to deficit and debt constraints with the addition of debt market discipline).

During both systemic shocks, the initial defence of the twin orthodoxies led the euro to the brink of collapse or, putting it mildly, to the break of the single currency **irreversibility** principle. In the acute phase of sovereign debt crises the temptations of "exiting" gained ground, and European governments and institutions struggled to combat them (and in some cases initially shored them up). The financial and currency markets began to price the risk of redenomination, i.e. the risk of a nation's exiting the euro zone and reverting to its national currency (Di Cesare et al., 2012, De Santis, 2015). The EMU was saved only by the ECB's financial stabilisation programmes announced in the summer of 2012 (Wyplosz, 2014). These programmes could be seen as a deviation from the EMU's monetary orthodoxy (the arrow to the left of the triangle in figure 1),[6] although they were perfectly aligned with the functions of a central bank as generally understood in the rest of the world.

On the fiscal front, on the other hand, the budgetary rules and fiscal consolidation plans were tightened up and not only in the nations with the highest risk of entering a debt crisis. The result was a contradictory mix of economic policies which contributed to the protracted stagnation of the 2010s, a decline in confidence in the EMU and the strengthening of sovereigntist and anti-euro movements.

[5] The same was true of a further important variable for the Stability Pact: the rate of unemployment compatible with non-accelerating inflation (NAIRU).
[6] And, in fact, as is well known, the announcement of these programmes led to appeals to the German Constitutional Court and a dispute between the latter, the ECB and the European Court of Justice.

Figure 1. The EMU Trilemma



Source: Della Posta and Tamborini (2021)

The disastrous economic consequences in Europe of the Covid-19 pandemic in early 2020 were initially taken on (once again) by the ECB alone with an extraordinary quantitative easing plan (*Pandemic Emergency Purchasing Programme,* PEPP). The EU fiscal response was hesitant. National governments and the Commission decided to temporarily suspend budgetary rules, as is provided for by the treaties in the presence of exceptionally adverse events, and it became increasingly clear that leaving the capacity for a health, economic and social response to each single state's "fiscal space" would rapidly increase the risk of collective catastrophe. Lengthy and tense intergovernmental negotiations followed, until July 2020, designed to draw up a large-scale EU fiscal plan whose purpose was to supplement monetary policy (*Next Generation EU,* NGEU) encompassing significant "heterodox" elements such as raising financial resources via the issue of euro bonds (the arrow along the right-hand-side of the triangle in figure 1).

The lesson for the future of the EMU is that not only do the fiscal rules need to be amended if undesirable consequences are to be avoided, but the new rules must also be complemented by a system of safeguards designed to protect the EMU's integrity in the event of systemic shocks.

"*For extreme adverse events, excessive emphasis on individual liability is counterproductive; in such circumstances the solidarity principle should dominate. The European community thus needs a discussion of the extent to which it is willing to assume tails risks for its members. A commonly acceptable cut-off needs to be identified, agreed upon, clearly communicated, and enforced in future crises*" (Brunnermeier et al. 2016, p. 117).

3. Rules *versus* discretion once again?

The fiscal rules were also shaped by a series of "neoliberal" doctrinal arguments – widely accepted in the academic community in the late 1970s and 1980s – in favour of tying governments' hands by means of strict rules of conduct designed to avoid erratic and discretionary action, underlining that such action was by definition harmful to economic stability and people's well-being (Kydland and Prescott, 1977; Barro and Gordon, 1984). Until recently, arguments highlighting the shortcomings of this doctrine were not very influential. Yet, as Lohman (1992) argued, when the contingencies faced by governments and other worldwide policy institutions are uncertain in nature, the ability to marshal an optimal response requires **flexibility,** i.e. a range of options rather than a single predetermined action.

As Mario Draghi noted in his Bologna University honorary degree lecture (2019), an entirely rules-based approach is ineffective first and foremost because the rules are static, i.e. "*they cannot be updated quickly when unforeseen circumstances arise, whereas institutions can be dynamic and employ flexibility in their approaches* " when economic conditions change suddenly. Furthermore, rules lose credibility if applied in a discretionary manner or with a frequently opaque flexibility. "*This is why there are always tensions when it comes to economic policies that follow the rules-based approach*." Moreover, entirely trusting (even the best-designed) rules goes against the grain of the fact that even those in government and those drawing up the rules have limited knowledge of future economic developments and all potential scenarios are replete with utmost uncertainty (and not simply probabilistic risk). In Keynes's words (1937), in the majority of significant economic and social situations "we simply do not know." On this point contemporary neo-liberals, distrustful of (what they see as) the "traps "inherent in Keynesian thought might consider the remarks of such an arch-liberal as Friedrich von Hayek in his Nobel Prize lecture:

If man is not to do more harm than good in his efforts to improve the social order, he will have to learn that in this, as in all other fields where essential complexity of an organized kind prevails, he cannot acquire the full knowledge which would make mastery of the events possible" ("The Pretence of Knowledge", Nobel Memorial Prize Lecture, reprinted in *American Economic Review,* 1989, vol. 79, p. 7).

Hayek underlines the inevitable incompleteness of any "contract" between sovereign nations. Drawing up rules capable of taking account of all potential future events is thus impossible and even simply increasing the number of contingencies quickly leads to highly complex rules which are difficult to apply and easier to manipulate and even circumvent (Blanchard et al., 2021). It is no coincidence that democratic constitutions are systems of general and abstract principles rather than specific rules and translating principles into rules of contingent conduct is a legal process which in turn follows applicative rules and measures which necessarily leave a controlled discretionary margin. This discretionary element, or **institutional discretionality** (Amato et al., 2022), might be said to be a necessary evil in incomplete contracts, and the purpose of constitutions is to regulate, not remove it.[7]

The difficulties referred to are exacerbated in a two-level (central and national) framework such as that of the EMU. Cyclical stabilisation policies in the US and budget (and debt) constraints and such a rigidity are justified and made credible precisely by the fact that macroeconomic shocks are tackled primarily by using federal rather than state funds. On paper, the SGP imposed rules on MSs but neither the Commission nor the Council had the budgetary tools needed to prevent individual MSs from increasing their deficits and national public debts when facing a recession.

[7] Regulated institutional discretionality is not to be confused with adding some "flexibility" to formally "rigid" rules.

A progressively weaker defence of the rules and denial of discretion has simply pushed discretion behind the curtains of opaque and arbitrary bargaining, in which politics, inevitably but justly so, returns to the fore. It should not be forgotten that in democratic countries it is the electoral mandate which legitimises the government to exercise its powers. Voters want governments to govern, to take the necessary and appropriate decisions in each condition, although they are un-specified and not provided for in their (incomplete) constitutional contracts. Democracy falters in both situations of *dictatorship of the majority* and *impotence of the majority*. In this way, the doctrine which ties governments' hands, alongside the overweening power of the global markets, acts to undermine elected governments, both effectively and in popular perceptions, and with them democracy's most tangible expression of voters' will. These are phenomena which now seem, perhaps not by chance, to be fuel to the sovereigntist fire.

As early as 2014 Nobel laureate Michael Spence said that "power games hinging on unrealistic parameters fixed when the situation was very different no longer make sense." This is even truer today because these parameters are now even more unrealistic (think first of all of the 60% debt/GDP ratio when the eurozone average is around 100%) and because such power games have been shown to be a dead end. If we are to avoid falling into the stupidity trap once again, fiscal rules must be radically overhauled to take account of both the changed economic and political context and of the new theoretical and empirical knowledge which has since emerged. There is now widespread scholarly agreement on this.[8] But we also need to set up channels, which are currently absent, for an appropriate relationship between the "technical" rules and the legitimate economic policy discretionary decision-making spaces (inherent to parliamentary democracy) within a multilevel framework such as the EMU.

4. Looking ahead

In addition to the historical modifications of the economic and doctrinal context recalled above, any reform of the regulatory system of public finance in the EMU must also take into account the changed circumstances.

First, interest rates are much lower than they were in the 1990s when the old rules were drawn up, to such an extent that the euro area's spending on interest payments is a much smaller percentage of its GDP than it was in the 1990s, despite debt being significantly higher. This means that the sustainability threshold has been raised and will probably remain high for some time, given the persistence of excess savings worldwide, which exerts downward pressure on real interest rates.

Second, with Covid the debts of all EMU MSs have grown considerably relative to GDP, making the 60% threshold enshrined in the old SGP entirely out of the reach for many nations (in Southern Europe but also in France, Belgium and Austria), except at the cost of a demand squeeze capable of throwing the continent back into recession (Francovà et al., 2021). The primary surplus needed to satisfy the one-twentieth rule set out in the 2012 Fiscal Compact would be extraordinarily high. For example, by complying with the one-twentieth rule, an MS with a debt/GDP ratio of 160% (100 percentage points above the 60% threshold) would have to reduce its debt/GDP ratio by 5% in the first year and to a gradually diminishing extent in subsequent years. This would still leave it with a debt/GDP ratio of

[8] For a summary see the recent European Stability Mechanism paper by Francová, Hitaj et al. (2021).

around 75% in 2060. Even if nominal interest rates were the same as nominal growth rates and remained so at length, the application of the rule enshrined in the Fiscal Compact would require a primary surplus of 5% of GDP in the first year and this would need to remain over 3% until 2031. These are values which would increase considerably with a nominal interest rate higher than the growth rate. It is a truly non-credible trajectory, in any case.

Third, the 3% total deficit/GDP limit – capable of stabilising the debt/GDP ratio at 60% in a *hypothetical economy growing at a nominal 5% rate* – is now lacking any logical underpinning, both because the euro area's average debt/GDP ratio is around 100%, and because a 5% nominal growth rate (with inflation at 2%) is totally out of reach, perhaps except the immediate post-pandemic years. But the 3% deficit is compatible with a 100% debt/GDP ratio in the more realistic hypothesis of a 3% nominal growth rate (1% real growth and 2% inflation).

Fourth, the debt/GDP ratio is exactly that, a ratio. Its rate of change over time is obtained by subtracting the rate of change in the denominator from the rate of change in the numerator. Thus, recession increases the ratio even when the numerator (i.e. the debt) does not increase. Expecting the ratio to always go down and for a long period of time is thus entirely illogical. Whilst it is true that the old SGP allowed the rules to be suspended in the event of very widespread aggregate shocks (such as the 2008 financial crisis or Covid) the macroeconomic impact over time can be profoundly asymmetrical (as in the 2011–14 period) and this makes the application of a uniform rule calibrated to a ratio in which the denominator varies considerably between member states vulnerable and practically unworkable.

Fifth, the fact that interest rates have been close to zero for some time means that monetary policy's effectiveness has waned throughout the world and that it is of limited use in tackling widespread negative shocks, including those of a symmetrical nature. A greater use of fiscal policy for the purpose of stabilisation and related macroeconomic externalities must be carefully considered. In the wake of the pandemic, it has become clear that the future economic sustainability of European nations is bound up with an extraordinary (and anything but temporary) budgetary effort. Until 2026 there is the NGEU. And then?

Delving into the often highly technical details of the many reform proposals on the table is not within the scope of this paper. We think that reform should go beyond the technical restyling of fiscal rules. The whole of the considerations set out herein shows that the direction of profound change is essentially political rather than technical.[9] **Renewed fiscal rules should rest on renewed political-economic pillars**.

4.1 First pillar: From "horizontal" to "vertical" co-ordination

It should, by now, be clear that delegating fiscal policy entirely to individual MSs constrained only by a set of rules which ignore macroeconomic externalities is no longer possible (Blanchard et al., 2021; Buti and Messori, 2021). The era of "do your homework alone" is over. Individual state budgetary policies must be more effectively controlled and, at the same time, co-ordinated and harmonised to maintain a balanced euro area fiscal stance in order to minimise negative spillovers from individual budgetary policies onto other member states.

[9] We have already attempted to outline this in Boitani and Tamborini (2021).

It should also be clear that there is a trade-off between the rigours and rigidities of individual state budgetary policies, on the one hand, and the existence of a common fiscal facility, on the other, namely an adequate federal budget to be used for the recessionary episodes which may strike the EU symmetrically or individual member states asymmetrically. If NGEU and, in particular, SURE (the shared funding tool for cyclical unemployment benefits) were to become permanent EU tools, national budgetary constraints might immediately gain political ownership and be easier to control because a significant part of the macroeconomic stabilisation task would be entrusted to the common budget which would be mainly funded by states' own resources. If the will for this is not there, we will need to accept that the "rules" should be very flexible and subject to constant political renegotiation.

4.2 Second pillar: Technical evaluation and political responsibility

We have argued that we should resist substituting political discretion with automatic algorithms. Replacing the whole rules-based framework with one based on standards, as suggested by Blanchard et al. (2021), would seem to be an appropriate one, however unlikely its implementation may appear in the current European Treaty framework. Yet, we do not agree with their suggestion that judgements (and sanctions) regarding failure to abide by the standards should be referred to the European Court of Justice after these standards have been drawn up by a (strengthened) European Fiscal Board (EFB). This would be moving in the opposite direction from the one set out in this paper, whose objective is a clear distinction between technical assessment and political responsibility.

Whenever technical evaluations on the state of public finances in the various MSs and the EMU as a whole must be translated into political decisions, competence should be assigned to politically responsible institutions (also Amato et al., 2022). In the EMU, political responsibility remains with member state governments. However, national governments must agree to share sovereignty with a higher order institution capable of guaranteeing the EU's collective interests. In our view, such an institution can only be the European Commission. For sure the latter must make use of independent technical structures such as the EFB and the national parliamentary budget offices for technical analysis and the formulation of guidelines for the implementation of standards.

4.3 From annual budgets to debt sustainability

With regard to fiscal rules, several proposals are converging on the recommendation that the focus should be shifted from annual budgets to medium-term public debt sustainability assessment (DSA) (Blanchard et al., 2021; Giavazzi et al., 2021; Martin et al., 2021). First, as a minimal remark, the two variables are related, hence targeting both is logically inconsistent (one of the two is redundant, given the other). Second, there may or not be a debt target level, but in any case DSA is a more comprehensive framework within which the current state of public finance and future evolution are determined. Third, the DSA is the appropriate framework in which short-term stabilisation contingencies should be evaluated.

What we deem really important is that DSA should be country-specific. This would eliminate any reference to fixed targets valid for all without distinction. It should be performed on individual MSs periodically and designed to assess the future evolution of debt, taking account of the specific features of each country with reference to growth, population dynamics, interest rate trends, but also current budgetary policies and those planned for the future.

"Stochastic analysis enables the uncertainty surrounding deterministic debt trajectories to be captured ... it has become part of the fiscal policy assessments of numerous international institutions"(Martin et al., 2021, p. 6). This type of analysis is by no means straightforward and should thus be entrusted to a strengthened EFB in conjunction with national institutions.[10]

On the basis of the DSA (on EFB proposal), the Commission would have to agree on a multi-year debt stability plan with the country concerned. While conducted at the single MS level, the DSA also needs to pay attention to the cross-country spillovers and the resulting aggregate fiscal stance of the Union as a whole, requiring that "debt sustainability risks be balanced against the costs of adjustment in terms of production"(Blanchard et al., 2021, p. 21), with the explicit goal of averting a debt crisis for the individual country concerned and the EMU as a whole.

4.4. Primary spending controls with stabilisation and public investment safeguards

In 2019 the EFB suggested that, if a debt reduction programme is needed, a primary spending ceiling could be implemented. This proposal, too, seems to encounter widespread agreement. One of its main merits is that using the primary spending path as a control instrument will make it possible to **accommodate ex-ante** some desirable allowances (rather than picking them up in ex-post negotiations).

First, in order to amend the anti-investment bias embedded in the previous regulation, allowance can be granted for a public investment quota, e.g. targeted to growth-friendly and EU priority public goods. Energy transition, and other EU priorities, will require huge and long-term investment which cannot realistically be done while simultaneously maintaining significant primary surpluses in all European nations, starting from Germany. It has been noted that post-pandemic resilience and recovery are based on "capital reconstitution and growth (especially human and social capital) which require increases – in a specific time frame – in spending which accounting systems classify as current expenditure but which can, on closer examination, be seen to be full-blown investment expenditure" (Boitani and Giovannini, 2021). Think of health and education spending. National accounting is a contract, but one which reflects and transmits a society's values.

Second, as for the problem of anticyclical stabilisation contingencies, allowance can also be made for expenditures related to automatic stabilisers (identified as those embedded in the existing legislation). This requirement would be greatly simplified and strengthened at the same time if SURE and similar devices were to become permanent Union tools. Tracking the trend growth path of primary expenditure *vis-à-vis* GDP also promises easier matching of the criteria of simplicity, observability, and communicability of policy variables and choices, overcoming the various deficiencies of the econometric mechanisms to extract from data the cyclical components put in place so far (see above, and EFB, 2019).

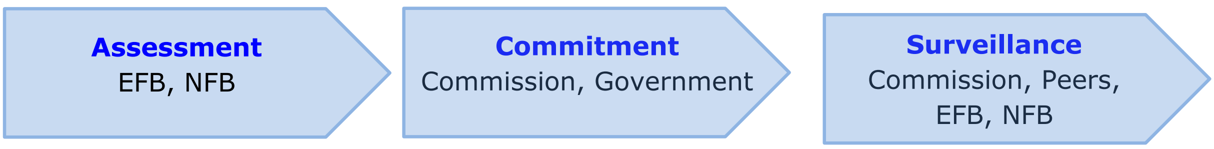
[10] The technical complexity of the indicators is tolerable if they do not automatically translate into political prescriptions, as they do in the existing framework, but constitute an assessment basis for agreed political decisions.

Reforms of the European fiscal rules and the introduction of the golden rule should be accompanied by a (at least experimental) modification of certain key spending classifications. The creation of common expenditure funds, such as NGEU and SURE, may also have the benefit of creating a common taxonomical and accounting framework. The usual objection that the list of exempted expenditures may be too lax and "elastic" should be weighed against the poor performance of the existing system based on ex-post econometric filters of governments' claims for "flexibility" in the application of seemingly unquestionable numeric rules.

5 Summary and recommendations

The backbone of our view of reform of the EMU fiscal rules is that the new rules should be grafted onto a new conception of the overall fiscal governance, the essence of which may be dubbed the "**Assessment, Commitment, Surveillance**" Model represented in Figure 2. This is a model in which the regulation system provides the framework for a policymaking process that combines technical assessment with political decisions in clear distinction of roles and responsibilities.

Figure 2. The Assessment, Commitment, Surveillance Model



In a nutshell, what should European policymakers be doing now?

1. Taking stock of the fact that, in the wake of Covid-19, reinstating an array of procyclical measures based on universally valid numerical parameters, in a sort of Maastricht 2.0, could jeopardise the stability, and perhaps even the very survival, of monetary union precisely at a time at which the ECB has limited room for manoeuvre. Taking swift action to create a "federal" permanent budget of a size that allows for cyclical stabilisation policies based on the EU's new fiscal capacity.

2. Making it unequivocally clear that policymakers will not abdicate their decision-making responsibilities. National government sovereignty can and must be shared with the Commission but not with the technocracy, which should appropriately be entrusted with technical assessment tasks even broader than those that currently exist.

3. Acknowledging that the rules must first and foremost deal with the externalities deriving from the unsustainable nature of public debt. Setting new fiscal "standards" in such a way as to ensure medium-term national public debt sustainability for each individual nation which do not penalise growth and employment. Acknowledging the central importance of macroeconomic externalities and accordingly defining an appropriate European fiscal stance.

4. Reforming (at least experimentally) national accounting agreements in such a way as to make national primary spending control credible and workable, net of investment spending, for the purposes of encompassing health and education spending as proper investment.

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