Introduction to the Issue on

Reform of the EU Economic Governance – Why and How?

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Rising cost-of-living, climate emergency and war are just some of the more pressing challenges Europe is now facing. How should the EU's economic governance framework be modified to make Europe stronger, more sustainable, and more resilient to meet these challenges? First, higher debt and deficits across Europe and the need for public investment to achieve the EU's long-term goals, such as building a digital and green economy, raise questions about the current shape of the Stability and Growth Pact (SGP). Second, the European Semester appears in need of adjustment to better accommodate the implementation and monitoring of national recovery and resilience plans. Third, the pandemic and war have highlighted not only the importance of public safety and security, but also that of high-quality social services to address inequalities and achieve better health outcomes. Social and strategic investments should therefore be properly reflected in the EU's economic framework.

In this context, the EU has revised its economic governance framework: in November 2022, the European Commission developed orientations for a reformed framework, a debate on which had been launched in 2020. These orientations aim primarily to make the framework simpler, more transparent, and more effective, strengthening national ownership and improving enforcement, while enabling strategic investments together with a realistic, gradual, and sustainable reduction of high public debt. In March 2023, the European Council agreed on a reform of the EU economic governance framework and endorsed these guidelines for reform. However, such economic policy coordination efforts at the EU level and the individual governance reform policy proposals open up new debates and create the additional need to assess to what extent they meet the real needs and interests of the EU as well as those of its member states, taking into account their country-specific economic, structural and social realities.

This issue of EconPol Forum contains eleven articles that highlight important aspects related to the reasons and opportunities for reforming the EU's economic governance. They examine the key challenges facing the EU and its member states and critically assess the EU's recent reform proposal. They also suggest policies and measures to make the public finances and economies of the EU and its member states healthier and more resilient.

According to *Clemens Fuest*, there is a tension between the idea of European fiscal supervision and the fact that national parliaments are ultimately responsible for fiscal policy. Market discipline is necessary to ensure that the costs of unsustainable fiscal policies are borne primarily by the countries pursuing such policies and by their creditors. However, this is hampered by, among other things, financial regulations that allow banks to hold large amounts of national government bonds. As long as this is the case, sovereign debt restructuring poses a threat to financial stability, undermines the credibility of the no-bailout clause and hinders the functioning of market discipline.

George Economides and *Apostolis Philippopoulos* suggest that a reliable analysis of fiscal sustainability requires debt-based rules in which fiscal instruments (such as public expenditure items and tax rates) respond systematically to the gap between inherited government debt and a policy target. This is consistent with the rhetoric of the new economic governance framework announced by the European Commission.

Iain Begg posits that the strong focus on the status quo in successive rounds of negotiations of the EU's Multiannual Financial Framework (MFF) and the lack of an overarching strategy in introducing new, extrabudgetary mechanisms are evidence of a certain caution in the search for durable solutions, but also contribute to a growing incoherence in the financial architecture. Ad hoc responses to crises, even if well-intentioned, leave a legacy of unresolved problems and unintended consequences that need to be addressed before they spiral out of control. Two of the most important problems he sees are the costs of funding, and legitimacy.

George Kopits highlights that EU member states that continuously respected the SGP's reference value for the budget deficit not only exhibited much lower volatility and higher growth rates than those that did not, but also recorded a significant decline in their government debt-to-GDP ratios. Compliance with the fiscal deficit and debt-to-GDP reference values, as proposed by the Commission for the reform of the EU fiscal framework, is therefore consistent with the overarching objectives of stability, growth and debt sustainability.

With regard to the difficulty of enforcing EU fiscal rules, reflecting actual experience with the implementation of the SGP, *Paul Dermine* and *Martin Larch* show that while several legal instruments exist to ensure enforcement, they are not being used, not least because EU governance arrangements have not been adapted to the changing political role of EU institutions. As integration in the EU grows deeper, the Commission has turned into a political actor whose interests do not necessarily coincide with those of its original role as "guardian of the treaties." This evolution must be taken into account, among other things, when assessing the enforceability of EU fiscal rules in the context of the ongoing reform of the SGP.

In order to effectively enforce compliance with the EU's fiscal rules, *Wolfram Richter* argues for shifting the responsibility for imposing sanctions in the event of noncompliant behavior by member states from the Community to the intergovernmental level. Rewarding compliance rather than punishing noncompliance makes the transition possible. Such a reform would bring the governance framework of the SGP closer to that of the European Stability Mechanism (ESM).

To restore debt discipline in the EU, *Vesa Kanniainen* calls for the introduction of a tax on subsequent borrowing ("Tobin tax") when it exceeds a critical level. This solution, comparable to balanced budget rules at the US state level, introduces a more radical type of political discipline than simply relying on market discipline, which usually comes too late.

Vivien A. Schmidt argues that the EU's fiscal rules must not be primarily aimed at debt reduction, but at investing in the future. The European Semester should be decentralized at the national level to ensure effective national ownership and legitimacy. In addition, EU economic governance should also be democratized through strategic dialogues focusing on macroeconomic and industrial policy.

According to *Torben M. Andersen*, the need for government investment is steadily increasing in the EU due to the green transition, energy disruption and digitalization, but does not require more complicated fiscal rules. Therefore, the policy focus on investment can be strengthened by continuous, in-depth monitoring of public investment and/or separate spending targets for public consumption and investment.

Sebastian Blesse, Florian Dorn and *Max Lay* propose a reform introducing a modified golden rule that promotes public investment while maintaining fiscal sustainability, i.e., debt-financed spending should be limited to net investment, while debt-financed investment is capped by a deficit rule. Other primary expenditures (excluding net investment) must be balanced. In addition, the investment categories relevant for the golden rule must be narrowly and clearly defined to avoid creative accounting tricks, while the narrow definition of investment should be limited to investment spending that can create new capital stock and stimulate sustainable economic growth.

Finally, *Anne-Laure Delatte* suggests linking government support for the business sector to carbon emissions, an area where EU policy guidance could be helpful. To be budgetarily efficient, government support to protect citizens from climate shocks should target low incomes rather than providing across-the-board income support. The ECB's corporate bond portfolio allocation is still largely biased toward carbon-intensive companies; therefore, the European Parliament should be given more control to actively promote the rebalancing of this portfolio toward low-carbon companies.

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