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Here to Stay? The Return of Fiscal Policy and Challenges for the EU Governance

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Abstract: The reaction of European Union's (EU) policy makers to the Covid-19 shock was bold and timely; although they could not avoid a crisis whose dimensions made the 2007-2008 Global Financial Crisis pale by comparison, the governments' titanic effort managed, with the support of EU institutions, to mitigate its impact on incomes and employment. This came as a welcome change after the calamitous management of the sovereign debt crisis. But it is precisely the extraordinary dimension of the crisis that prompts the question of whether the activism of economic policy denoted a change in the mindset of EU governments and institutions, or simply was the only option available to policymakers to avoid the collapse of their economies. This paper tries to answer the question through an assessment of the debate on Eurozone reform, with a focus on the "New Kid in Town": fiscal policy.

JEL classification: E61, E63, E65, F45, H87, N14
Keywords: Fiscal policy, EMU, Stability and Growth Pact, Covid Crisis, Sovereign Debt Crisis, Fiscal Rules, Central Fiscal Capacity

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1 The Return of Fiscal Policy

Ever since the Global Financial Crisis of 2008 macroeconomic theory has been in a state of flux. The crisis challenged the central tenet of the consensus that dominated since the 1980s, namely that markets are capable of absorbing macroeconomic shocks and converge back to the natural equilibrium with little or no help from macroeconomic policy (for details see Saraceno, 2018). Rediscovering the old Keynesian recipes, the meltdown of the financial sector and the collapse of private aggregate demand were met by a timely and bold policy response, with central banks providing liquidity and governments stimulus plans to sustain demand and economic activity.

The success of the pragmatic policy response to the crisis inevitably triggered soul-searching among academics and policymakers. This "rethinking macroeconomics" (Blanchard, 2016) is ongoing and wide-ranging, from the reconsideration of the merits of capital controls to the reassessment of the timing and nature of structural reforms, the interaction of monetary and fiscal policy (especially at the zero lower bound), the relationship between cycle and trend, the impact of income distribution on economic performance, and more.

While a new paradigm has not yet emerged from this debate, we may safely assume that the cursor between markets and governments has swung back towards the centre and that macroeconomic policy will have a more important role than in the past.

Specifically, the pre-2008 consensus had side-lined fiscal policy: within a framework of limited impact of macroeconomic policy at large, monetary policy was to be preferred because it was less subject to biases (such as appropriation by vested interests and political cycles) and implementation lags. This consensus was the backdrop for the European fiscal framework, a Stability and Growth Pact strongly limiting discretionary fiscal policy. Determining the role of government expenditures and revenues, therefore, is pivotal in the current reassessment. Experience from the past decade has shown that fiscal policy strongly affects growth and convergence: for the better when in 2008 (and again in 2020) it kept the European Union (EU) economy afloat through widespread stimulus packages; and for the worse when, during the sovereign debt crisis, it turned procyclical deepening the woes of Eurozone's peripheral countries.

The reappraisal of fiscal policy happened in three stages. In the first one, following the 2008 crisis, the debate on fiscal policy effectiveness mostly dealt with the issue of how to use countercyclical fiscal policy to stabilise the economy during a financial crisis with features that were quite well known since the 1930s: the collapse of private sector demand that required Keynesian fiscal stimuli. This explains why the debate on the size of multipliers was particularly lively during that period (for a survey, see Gechert and Rannenberg, 2018).

In a second phase, attention shifted to fiscal policy for the long-term. On the one hand, it became evident that short run policies, through their impact

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on the depth and duration of the cycle, could have a strong impact on long term potential growth through the destruction of human and physical capital (Blanchard et al., 2015; Fatás and Summers, 2018). On the other hand, public investment and industrial policy took centre stage as tools to foster potential growth (and, incidentally, contribute to the sustainability of public finances). Decades of subdued public capital accumulation, low levels of interest rates (IMF, 2014) and the complementarity of public and private investments (Durand et al., 2021) all called for a public investment push.[1]

With the COVID-19 pandemic, we entered a third phase of the debate on fiscal and industrial policy: starting from the spring of 2020, policymakers increasingly focused on fiscal policy as a means for providing not only physical and human capital, but also global public goods such as health care and education. Meanwhile, the pandemics acted as a powerful reminder that the efforts for economic recovery needed to be framed within the broader long-term goals of ecological and digital transitions (and the not-emphasised-enough social transition). The pandemics proved that, for most of these public goods, the appropriate scale for an efficient provision and cost-effective financing is the European one. This was the justification for the flagship programme Next Generation EU, probably the most innovative instrument introduced by the EU in decades.

Since the EU lacks a central fiscal policy, Next Generation EU is coordinating the national recovery plans by means of strict conditionalities on the scope and timing of public investments and reforms (European Commission, 2020). This was done to ensure the attainment of common goals of recovery from the pandemic, cohesion, and investment in strategic sectors to ensure a green and digital transition.

2 The Need for a Significant Fiscal Capacity in the EU

The pre-2007 consensus shaped the EU institutions that were put in place with the Maastricht Treaty in the early 1990s. The Treaty centred European economic governance on the rejection of active macroeconomic policies. Embracing the monetarist credo, the European Central Bank was given a mandate only for price stability, furthermore with considerable autonomy in pursuing it (Saraceno, 2016). Furthermore, the Stability and Growth Pact (SGP) required countries to balance their budget over the cycle (i.e., making sure that surpluses in good times compensate for deficits in crisis periods),

[1] The European Public Investment Outlooks that I co-edit with Floriana Cerniglia (Cerniglia and Saraceno, 2020; 2022; Cerniglia et al., 2021) took stock of this new awareness, drew a gloomy picture of the state of public capital in all of the EU countries, including the most successful ones, and emphasised the need to adopt a broad definition of capital, comprising both tangible and intangible assets to boost human capital (such as social capital).

forcing countries to rely solely on automatic stabilizers to cushion economic fluctuations.

Last, but not least, the EU gave the Commission a strong saying in competition policies, with the objective of favouring structural reforms and removing obstacles to the efficient working of markets.

The minimal State consensus was not a European peculiarity, but the pressure to reduce the role of the state in the economy was particularly strong in the EU. The perimeter of the welfare state has over time been slowly but pervasively reduced[2], the role of automatic stabilisers undermined (somewhat inconsistently with the Stability Pact emphasis on their importance in absorbing business cycle fluctuations), and the cyclical regulation of the economy through macroeconomic policies sacrificed on the altar of "market flexibility".

In fact, for a long time, Europe was quite impervious to the debate on rethinking macroeconomics. On the contrary, since 2010 the eurozone crisis has been interpreted as an "apologue of fiscal sinners", a crisis due to the indiscipline and inefficiency of the governments of some Mediterranean countries (Saraceno, 2020; Tooze, 2018). The austerity season of the early 2010s was a by-product of this narrative. The institutional reforms that between 2011 and 2014 followed the sovereign debt crisis (The Fiscal Compact, the Six-Pack and Two-pack sets of regulations, the European Stability Mechanism, the banking union) were also consistent with the apologue of fiscal sinners: taken together, those innovations in governance reinforced EU institutions' control over national fiscal policies and perpetuated the idea that structural reforms and market flexibility at the country level ("risk reduction") are in fact the main driver of convergence. To be fair, many, starting with the then European Central Bank President Mario Draghi, have since 2014 called for more activism in fiscal policies and for a revival of public investment and domestic demand (Draghi, 2014). However, these calls were carefully framed to emphasize the priority to be given to fiscal discipline (only countries with "fiscal space", defined at the time as the respect of the Stability Pact, were supposed to implement expansionary policies). In addition, these voices remained largely unheard.

Eventually, though, the mistakes made in managing the Sovereign Debt Crisis[3], and (on the contrary) the bold and successful management of the pandemics, have put on the table the issue of having European Institutions (specifically those that manage fiscal policy) able to protect the newly reassessed role of government intervention, both for short term Keynesian

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[2] Causa and Hermansen (2017) show that in most OECD countries, the insurance role of the welfare state (through, for example, unemployment benefits) has over time been reduced, leading to an increase of inequality after taxes and transfers. In some countries, assistance to the most disadvantaged categories increased, but this was not enough to reverse the trend.

[3] See Saraceno (2020) for a detailed account of the bias built in the single currency construction and of the eurozone "lost decade" following the sovereign debt crisis.

macroeconomic stabilization and for long-term support to growth, innovation, and the transformation of the economy.

In fact, the first twenty years of the single currency and the sovereign debt crisis showed that markets cannot be relied upon for absorbing macroeconomic shocks and ensure long term convergence. On the contrary, they sometimes row in the wrong direction. That was evident during the Eurozone crisis, when destabilising capital flows deepened the structural differences among the members of the eurozone, increasing asymmetry of shocks. But it should have been understood also during the first decade of the single currency, when excessive capital flows from the core to the periphery of the Eurozone, and misallocation of expenditure in the latter, contributed to large current account imbalances and the build-up of net foreign liabilities. Far from being benign, as some at the time argued (Blanchard and Giavazzi, 2002), these imbalances eventually led to capital flights out of peripheral Economic and Monetary Union countries and to the sovereign debt crisis. Therefore, no matter how hard individual countries may push their reform efforts, exclusive reliance on markets will necessarily be unwarranted: part of the burden of adjustment following whatever exogenous shock may hit the economy must necessarily fall on the shoulders of public policies. In fact, Farhi and Werning (2017) show how the presence of externalities makes it impossible a full stabilization through market forces, even when capital markets are complete. In this case, the existence of a fiscal stabilization mechanism can lead to greater international diversification of portfolios, and thus to "internalize" the benefits of risk sharing through markets. Market and government risk sharing therefore would be complementary. Considering this theoretical result, the empirical findings by Alcidi et al. (2017) are not surprising[4]: even in the United States, a monetary union characterized by strong flexibility and high factors' mobility, macroeconomic policies (in particular risk sharing operating through the federal budget) play a central role not only during crises but also in normal times.

The coronavirus crisis makes it even more evident that only real mutual insurance mechanisms, typical of a federal budget, could make it possible to guarantee stability and growth by operating alongside (and sometimes in place of) market adjustments. Of course, the federal budget cannot exist without a federal state, and it is obvious that the United States of Europe is today little more than a chimera. Yet, the existence of an ideal solution, however utopian, serves as a benchmark against which to assess the desirability of the many reform proposals that are discussed: any institutional change that acts as a surrogate for a properly federal structure must be encouraged as a means to ensure convergence.

It is important that the new EU governance recognize the newfound centrality of fiscal policies, especially when it comes to investment in global

[4] Dullien (2019) recently argued that this stream of literature likely underestimate the role of Government risk sharing; therefore, the results by Alcidi et al. (2017) should be seen as a lower bound.

public goods such as ecological transition or social protection. Yet, the European budget represents a tiny fraction of EU GDP, and mostly serves (with a mixed track record) the objective of catching up of lagging regions. No central capacity for short term countercyclical stabilization exists in the EU, nor in the Eurozone. At the same time, the existing EU fiscal rule strongly constrain member states, that need to balance the structural budget and de facto can only let automatic stabilizers play. Even if the European fiscal rules never yielded actual sanctions in spite of the numerous infringements, for the first twenty years of existence of the single currency their very existence was capable of constraining governments' action through peer pressure and a general reprobation attached to fiscal policy activism (Fitoussi and Saraceno, 2008).

3 A Comprehensive Approach to Eurozone Fiscal Governance Reform

Different paths for reform exist. Fiscal capacity could be created at the central level, providing the EU bodies with a significant and permanent tax and spend capacity; if that were the case, fiscal rules could remain as restrictive as they are today. Alternatively, if one had to consider (as some legitimately do) that the creation of a significant central fiscal capacity, in a system that remains non-federal, is problematic and cumbersome, room would have to be given to fiscal policies at the country level, with rules more permissive than the Stability Pact. In short, what the "optimal" fiscal rule is will depend on the direction that the debate on a European fiscal capacity will take.

3.1 A Central Fiscal Capacity

Looking at the experience of the United States, the most effective way to endow the eurozone with the capacity to implement fiscal policy would be to create a fiscal capacity at the central level. Next Generation EU could be a first step towards such a European fiscal capacity. Hopefully European countries will be able to use the Recovery Facility to revive the economy, channel the resources efficiently into a green and digital transition that can no longer be postponed and transform the Union into a dynamic knowledge-based economy. The success of the Next Generation EU package could pave the way for a discussion on the next step, the creation of a permanent fiscal capacity. It would not be the first time that temporary instruments have acted as icebreakers and led to innovations in European governance. The Recovery Facility possesses (albeit at an embryonic stage) the characteristics of a federal-type ministry of finance: its own borrowing capacity, a (prospective) ability to finance itself from its own resources, an allocation of resources that combines the needs of individual countries with the pursuit of common goals such as the ecological transition and digitalisation. Speculative attacks on sovereign debt, and the risk of free riding by national governments, so feared by the "frugal" countries, would

be greatly reduced if the eurozone were to equip itself with such an instrument.

While it would be a first best in terms of efficacy (for example in dampening asymmetric shocks or in absorbing supply side shocks like the current inflationary one, see Buti and Messori, 2022), a central fiscal capacity would be quite difficult to put in place, even abstracting from the scepticism of some Member States worried by the possibility of free riding and moral hazard.

The creation of a European capacity to tax and spend would require finding a solution to several interconnected problems: how to ensure the accountability in front of voters (in accordance with the principle of no taxation without representation), the coexistence of "federal" instances with local ones, division of tasks and determination of accountability across various levels of decision-making. These are all difficulties that could be swept away by the creation of a truly federal fiscal policy body, an option that nevertheless will most likely remain non-viable for the foreseeable future. In the absence of a political union, the creation of a central tax-and-spend capacity will need to be thoroughly weighed and framed in the appropriate legal framework.

3.2 Reforming Fiscal Rules

The discussion on the creation of a fiscal central capacity, or at least of a joint stabilization mechanism, rages among academics and policymakers; nevertheless, it is still quite far from becoming a priority in the European political agenda. On the contrary, the year 2023 will see a heated debate on the reform of the Stability and Growth Pact. It would be simplistic to say that European fiscal rules forced the season of austerity after 2010. This was the result of a vision that traced financial instability and the debt crisis back to the profligacy of southern Eurozone countries, whereby, with or without the existing fiscal rules, European countries would have walked that path anyway. Still, the institutions for European macroeconomic governance were consistent with that turn to austerity and, as demonstrated by the management of the Greek crisis, provided the appropriate instruments to pressure even the most recalcitrant governments.

The activation of the suspension clauses of the Stability Pact in March 2020 was motivated by the pandemic that was just starting; however, the Commission had already, just a few weeks earlier, opened a consultation process on the reform of the rules; an assessment which was based on a surprisingly severe assessment of the existing framework (European Commission, 2020b).

The Commission finally took on board the criticisms that had been unanimously voiced by independent economists (but also by the European Fiscal Board, 2019) for several years:

(a) the current framework is overly complex, arbitrary, and difficult to enforce;

(b) the rules allow to control deficits, but much less debt, which is the true threat to public finances' sustainability;

(c) public investment, which is generally easier to reduce than current spending, has been penalised at least since the Global Financial Crisis;
(d) finally, the Commission acknowledged for the first time that in the recent past the current framework pushed many governments to implement procyclical fiscal policies, reducing spending when the economy was slowing down (particularly between 2010 and 2013).

In short, between the lines the Commission acknowledged that European rules had made fiscal policy a factor of instability rather than stabilisation. The proposition recently tabled by the Commission (European Commission, 2022) introduces two important principles.

The first is that it makes no sense to impose annual constraints, a multiannual perspective being more suited to an intrinsically intertemporal concept such as debt sustainability.

The second is that debt reduction towards the levels required by the treaties (which do not change, remaining at 60%) must take place at rates that are specific to each country. In addition, the proposal partly endorses the "Next Generation EU method", with countries being responsible and autonomous in programming their debt reduction paths, within the framework of guidelines given by the Commission and of numerical targets agreed together. Country ownership has emerged following the disastrous management of the Greek crisis as an unavoidable feature of any new governance framework.

Operationally, the new rule, if it is approved by member countries, stipulates that the Commission gives an assessment of debt sustainability over a medium-long horizon (ten years). On the basis of this assessment, the country shall submit a four-year debt reduction plan that is compatible with the objectives. To monitor adherence to the plan, the Commission considers the evolution of government spending netted from components that are difficult for the government to control (such as unemployment benefits, typically linked to fluctuations in the economy) and interest expenditure. If the country engages in public investment programs and reforms that make growth more robust, it can lengthen the adjustment period to seven years.

The proposal is a significant step forward compared to the existing framework, for at least three reasons: firstly, with the multiannual perspective and endorsing country ownership, it abandons these short-term and the one-size-fits-all features which, independently of all other problems, constitute the original sin of the Stability Pact. Then, the proposal drops the targets based on structural deficits, a concept as theoretically attractive as it is practically unsuitable, because of the arbitrariness of the assumptions necessary to calculate it (Darvas, 2019). Monitoring the medium-term trajectory of net expenditure should allow flexibility in the short term to respond to stabilisation needs, without giving rise to exhausting negotiations between the Commission and Member States on the cyclical position of the economy. Finally, the Commission proposes to

revive the Macroeconomic Imbalance Procedure[5], that was introduced following the Greek crisis but has been largely ignored ever since. It is very good news that the Commission intends to give it the importance it deserves, recognizing that public finances are not the only potential source of instability.

In the face of these improvements, however, the proposal still has several weaknesses, which risk making it fall short. First, there is still room for arbitrariness, for example in assessing debt sustainability. This can be used to allow flexibility, but also to impose draconian and not necessarily warranted fiscal adjustments the day the tide turns, and austerity comes back into fashion. Second, if the multiannual framework is an important qualitative improvement, the four-year horizon seems to be far too short to ensure that countries can plan long-term policies (e.g., in the framework of the ecological transition). Last, there is the problem of sanctions, which, as in today's Pact, risk being inapplicable and therefore not credible.

3.3 The Need to Protect Public Investment

There is nevertheless a more structural problems with the Commission reform proposal, which gives the most cause for concern: public investment is not sufficiently protected. Considering the revival of public investment in the academic and in the policy agenda, it is not surprising that many recent proposals (for a few examples, see Dullien et al., 2020; Darvas and Wolff, 2021 and Giavazzi et al., 2021) revolve around one form or another of a Golden Rule of public finances similar to the one introduced in the UK by the Chancellor of the Exchequer Gordon Brown in the 1990s, and applied until 2009 (for details, see Creel et al., 2009).

The key idea is to constrain current expenditure (either by balancing it with current revenues or by an expenditure rule linking it to GDP growth), while financing public capital accumulation with debt (the increase in liabilities would be in fact matched by an increase in assets). Investment expenditure, in other words, would be excluded from deficit calculation, a principle that is timidly applied already in the "flexible approach" adopted by the Commission since 2015 (European Commission, 2015). Such a rule would stabilize the ratio of debt to GDP, it would focus efforts of public consolidation on less productive items of public spending and would ensure intergenerational equity (future generations would be called to partially finance the stock of public capital bequeathed to them). Last, but not least, especially in the current situation, putting in place such a rule would not require treaty changes.

The golden rule is not a new idea, and in the past, it has been criticized (see e.g., Balassone and Franco, 2000) on the ground that it introduces a bias in favour of physical capital and penalize certain expenses, for example education and health care, that - while classified as current - are crucial for future growth. This criticism, however, can be turned into a strength, by

[5] The procedure monitors other variables besides public finances, such as private debt, external deficits or surpluses.

making the choice as of whether a specific expenditure item is useful for future growth, a political one. The idea is to abandon the accounting definition of investment in favour of a functional one: investment should be whatever increases the material or immaterial public capital stock.

Dervis and Saraceno (2014) and Saraceno (2017) propose that at regular intervals, for example in connection with the European budget negotiations, the Commission, the Council and the Parliament could find an agreement on the future priorities of the Union, and make a list of areas or expenditure items (regardless of whether they are classified as current or capital) exempted from deficit calculation for the subsequent years. Joint programs across neighbouring countries could be encouraged by providing co-financing (for example, by the European Investment Bank).

This "augmented" Golden rule would in fact mark the return, on a European scale, to industrial policy, a political and democratic determination of the tools to mobilize for reaching the EU long-term growth objectives. The entrepreneurial State (Mazzucato, 2013), through public investment, could once again become the centrepiece of a large-scale European industrial policy, capable of implementing tangible as well as intangible investment. Waiting for a real federal budget, the bulk of investments would remain responsibility of national governments, in deference to the principle of subsidiarity. But the augmented Golden rule would coordinate and guide them towards the development and the well-being of the Union as a whole. The Commission's proposal is limited to a mild incentive for investment in terms of the timing of the debt reduction trajectory, and this is clearly not ambitious enough.

4 Conclusions

This short essay made the point that while the debate on rethinking macroeconomics is far from settled, a consensus is emerging on the fact that fiscal policy is back in town. Today, EU institutions do not provide room for it, thus being clearly at odds with the esprit du temps.

Guiltily clinging to the old consensus, during and after the sovereign debt crisis, European policymakers had neglected the debate raging among economists on the role of economic policy as an engine of macroeconomic stabilization and long-term growth. The pandemics swept away those hesitations.

In the Spring of 2020, in a matter of weeks, the EU introduced instruments for common crisis management and for boosting the recovery that could, if successful, pave the way for a reorganisation of European public policies (especially macroeconomic policies) quite different from the one that showed so many shortcomings during the sovereign debt crisis. Interdependence and the need for risk-sharing mechanisms are now becoming obvious, even in Brussels and Berlin, in fields such as health, public investment, the ecological and digital transition and the management of asymmetric macroeconomic shocks.

Nevertheless, the developments of the last several months, especially since the new German government took office and the Ukrainian war

started, have dashed the hope that the momentum gained with the response to the pandemics and with Next Generation EU could be maintained. The energy crisis, recent political developments in Italy and, above all, the German government's minimalist approach to the rewriting of the rules (contrary to what seemed to be the case during the pandemics, see Saraceno, 2021), have one side prevented the discussion on a central fiscal capacity to take off; on the other side, they yielded a proposal for reforming the fiscal rules that, while significantly improving on the current Stability and Growth Pact, clearly does not go far enough to protect public investment.

It is hard to see in today's debate the ambition that would be required by the newfound dignity of public spending. It is worrying that the urgent need for public goods and the colossal investments required by the ecological and digital transition remain marginal in the Commission's proposal and in general in the debate on EU governance reform. Unless EU policy makers embrace more ambitious goals, institutions risk remaining unfit to deal with todays' challenges.

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