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Fiscal Policy as a Tool for Stabilization in the European Union

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Introduction

The arrival of the Covid-19 pandemic has brought to the surface the weaknesses and inconsistencies of the Euro Area economic system but, at the same time, has also shown the potential for a stronger and bolder Union which may be indispensable to empower and support individual Member States. A "European fiscal capacity" is the central issue on which the future of our continent's Economic and Monetary Union will hinge, and it will be necessary to place at the center of the debate the methods for addressing this issue and making it a reality as soon as possible, before the arrival of a new symmetric shock.

This paper analyzes previous fiscal policy adopted in the European Union, and the impact of the Covid-19 pandemic on the latter, with a view to making hypotheses on the possibilities available in the future. The extraordinary situation we have been living in has required a firm and strong policy response which could be the answer to the fiscal disparities characterizing the EU. A new and expansionary monetary and fiscal policy mix with the possible addition of a central fiscal capacity has the potential for a newfound stability within the Euro Area.

The first chapter is centered on how European institutions have navigated through the many crisis scenarios of the past, analyzing the mistakes made and the opportunities missed. This breakdown of measures previously taken, along with their pros and cons, allows for a deeper understanding of the Euro Area's fiscal functioning and its general framework. The research would be incomplete without paying particular attention to the EU's main fiscal tool, the Stability and Growth Pact. By retracing the path of various reforms to the Pact and their implementation, it is possible to draw useful conclusions on the effectiveness of central fiscal constraints and debt-handling procedures.

In the second chapter, the focus moves to the impact of the pandemic on the EU economy and, particularly, the policy response constructed to deal with it. Through the description of the recovery plan, culminating in the "Next Generation EU" and its "Recovery and Resilience Facility", a new idea of fiscal policy comes to life, with the possibility of granting effective and sustainable support through expansionary and centralized crisis-management mechanisms. The novelty of this approach, as opposed to the usual tightening of constraints during a recession, opens the door to a series of opportunities for the future of the EU which cannot be underestimated. The goal in establishing an effective post-crisis framework through the rethinking of fiscal policy has to be stabilization without incurring in stagnation. All potential reforms must be made with a sustainable and growth-friendly approach, in order to reduce differences between Member States and promote economic convergence. The possibilities for doing so are numerous and often complementary, starting with a deep revision of existing treaties, the creation of a central fiscal capacity, and building up to the shift towards a federal-like system.

CHAPTER 1

The European Backdrop

1.1: European fiscal policy through the years

The International Financial Crisis (IFC), which reached its peak in September 2008, was a clear signal of several problems within European institutions. This event, before the pandemic considered the deepest recession of the last centuries, started a domino effect: in the attempt to recover from the crisis, many issues such as current account imbalances and the collapse of banking systems arose in European countries. The structure of the European Union and Euro Area economic governance at the time was based only on a few factors to ensure its efficient functioning: progress in the single market, national fiscal policies subject to centralized constraints, and a centralized monetary policy. In particular, the long-term solution to disequilibria was based on market discipline which, over time, led to a stalemate which determined an increase in political and institutional uncertainty and a lack of trust among Member States. The concept of market discipline promotes transparency and fiscal disclosure by market participants, creating a barrier to faulty fiscal policies and hence promoting fiscal discipline[1]. This type of approach allows for a framework in which national governments maintained their own fiscal authority, subject to centralized European constraints, which mainly consisted in imposing national debt and deficit maximum thresholds and, if the circumstances were to arise, strict rules to correct imbalances. According to European treaties, disequilibria in the balance sheet pertained solely to the involved country and had to be overcome through national fiscal policies, often leading policymakers to adopt measures of fiscal repression. Furthermore, the European Central Bank (ECB) could not intervene in national issues, but was to be fully independent, pursuing its monetary policy goals, as specified by its mission in the European Treaties, without being subject to other constraints[2]. This created a heavy reliance on monetary policy since it is impossible for other countries and European institutions to aid Member States in difficulty by purchasing their public bonds in the market through what is called a bailout procedure, meaning there should be no redistribution of public debts and no risk sharing.

This framework of economic governance presents a lack of any mechanism of crisis management which became evident after the outbreak of the International Financial Crisis. Whereas the United States, the country in which the IFC originated, managed to recover swiftly through government interventions, the crisis opened a gateway in the EU which, at the end of 2009, had to come to terms with the fact that there

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[1] Simone Manganelli and Guido Wolswijk, “Market Discipline, Financial Integration and Fiscal Rules: What Drives Spreads in the Euro Area Government Bond Market?” (European Central Bank, April 2007), https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp745.pdf.

[2] Isabel Schnabel, "The Shadow Of Fiscal Dominance: Misconceptions, Perceptions And Perspectives", Speech, Berlin, 2020.

were strong disequilibria between Member States, making the impact of the crisis much stronger than in the US. Europe's reaction initiatives were insufficient to ensure an adequate recovery mainly due to a lack of centralized coordination in national governments' programs. Between 2008 and 2009, the ECB reacted to the crisis by significantly lowering policy interest rates and, subsequently, adopting some "enhanced credit support" measures to meet banks' transitory increase in demand for liquidity and to maintain credit availability[3]. Following the ECB's actions, governments' main response was to implement aid programs and benefits to prevent national banks from going bankrupt, entailing a significant increase in public spending and public debt. On 12 October 2008, the European Action Plan was adopted by EA countries as the core for consistent national measures to be implemented. Though countries acted within the scope of the Plan, differences soon emerged regarding the implementation of the measures: some preferred a case-by-case intervention for specific banks, while other adopted a more universal approach[4]. This lack of coordination, along with preexisting asymmetries, generated profound disparities between Member States. The macroeconomic imbalances which had built up between core and peripheral countries generated a flight to quality: risk-averse core countries lost faith in the creditworthiness of peripheral countries and decided to withdraw their investments in favor of safer portfolios[5].

The European situation was very imbalanced after the crisis and some countries were severely struggling with an alarming increase in deficit/GDP ratios due to a series of events. In Greece there were several disequilibria caused by a mismanagement of public balances: a new center-less government discovered the previous administration had falsified public accounts to record less debt. In Ireland the problem was caused by struggles in the banking sector; the Irish government introduced important fiscal advantages but created disequilibria in the country's balance sheet. Finally, in the beginning of 2011, Portugal also suffered from current account imbalances which the government was unable to reduce, bringing about a drastic economic depression. Spain and Italy were also struggling, the former having problems similar to Portugal, the latter carrying historical imbalances. This triggered the Sovereign Debt Crisis which, with no management mechanism in place, rapidly deteriorated. It became obvious that a centralized management method was necessary, but the Union's framework made it difficult to construct one. Instead, the EU Council and Member States launched the European Financial Stability Mechanism (EFSM) and the European Financial Stability Facility (EFSF) as temporary mechanisms, lasting three years, with the aim of supporting struggling Member States by allocating government debts on the financial market. In order to attain credibility, the two programs were respectively guaranteed by the European

[3] Jean-Claude Trichet, "The ECB Enhanced Credit Support" (Munich, July 13, 2009), https://www.ecb.europa.eu/press/key/date/2009/html/sp090713.en.html.

[4] Maria Grazia Attinasi, "Euro Area Fiscal Policies and the Crisis" (European Central Bank, April 2010), 12–16.

[5] Marcin Szczepanski, "A Decade On From The Crisis: Main Responses And Remaining Challenges", Briefing, 2019, https://www.europarl.europa.eu/RegData/etudes/BRIE/2019/642253/EPRS_BRI(2019)642253_EN.pdf.

multiannual budget and participating Member States[6]. This complex mechanism implied that each issuance of bonds by the EFSF is equivalent to a proportional increase in public debt for MS not benefitting from the aid program. However, these attempts at recovery were not sufficient and entailed several negative consequences, mainly because of their case-by-case approach and late timing. Indeed, European institutions did not act immediately, aggravating the economic and social costs of the crisis and imposing excessively rapid fiscal adjustments which can have adverse effects on the banking sectors, as in the Irish case[7]. At the end of 2010, the decision was made to create a permanent crisis management mechanism, stemming from the EFSM and EFSF, organized on a long-term basis, the European Stability Mechanism (ESM). As with the previous programs, the ESM set out to provide financial assistance to MS in difficulty depending on policy actions being implemented. The main differences were that the ESM had its own paid-in capital to issue bonds on the financial market and finance the aid interventions and that ESM loans have seniority over private loans. However, this attempt too was unable to solve the sovereign debt crisis and public debt ratios remained dangerously high: supporting the ESM's paid-in capital meant increasing public debt of non-user MS and its presence carried the risk of crowding out private demand for government bonds. The ESM's approach, based on conditionality, was too rigid and short-sighted, with little regard for structural improvements. Moreover, the adjustments required by the Troika (European Commission, European Central Bank, International Monetary Fund) to national governments were based on strong wage compressions with a consequent decrease in economic demand which set the stage for an even worse recession. It is important to note that the response to the sovereign debt crisis marked a change in the European mindset and its attempt at centralization created a deeper cooperation among MS, but its excessive harshness impeded a full recovery[8].

During the summer of 2011, the situation worsened when Italy and Spain became unable to adjust their increasing economic disequilibria, dragging the Euro Area into the so-called "doom loop" between a new illiquidity crisis and the still unsettled sovereign debt crisis. Initially, the EU demanded the countries made the necessary adjustments to their balance sheets but soon realized the situation was beyond control. The main reaction to the banking sector crisis was given by the ECB's purchase of Greek and Italian sovereign bonds in order to decrease spreads. In the fall, the situation was dramatic, and a new problem emerged: the European Banking Authority discovered great losses in fragile countries' banking groups which required significant recapitalization. European institutions were unable to react to the peak of the

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[6] Gian Luigi Tosato, "Notes On The Genesis Of The European Stability Mechanism" LUISS School of European Political Economy, Policy Brief, 2020, https://sep.luiss.it/sites/sep.luiss.it/files/%20Notes%20on%20the%20genesis%20of%20the%20European%20Stability%20Mechanism%20%20.pdf.
[7] Philip R. Lane, "The European Sovereign Debt Crisis", *Journal Of Economic Perspectives* 26, no. 3 (2012): 49-60, doi:10.1257/jep.26.2.1.

[8] Marcello Messori, *Recovery Pathways: The Difficult Italian Convergence In The Euro Area* [S.l.]: BOCCONI UNIV PR, 2021.

crisis, so the only reaction was to approve and launch new restrictive fiscal tools. Again, the more sensible long-run approach would have been to allow for expansionary national fiscal policies, but instead European institutions decided to further tighten centralized constraints through amendments to the Stability and Growth Pact. A temporary solution offered by the ECB consisted in the reduction of policy interest rates and the launch of Long-Term Refinancing Operations (LTRO) to prevent a breakdown of the EU banking sector. This response had great success in solving the risk of immediate insolvency but didn't tackle any structural problems or foster new solutions.

Due to the fiscal tightening and absent long-term solutions, the EU entered a new recession from the end of 2011 to mid 2013. During this period market strains worsened and there was an impending need for reforms to promote growth and a steady recovery. The ECB intervened once again with a reduction in policy interest rates and President Draghi's statement that the ECB is ready to do "whatever it takes to save the euro" which effectively turned market expectations around and heavily decreased instability. The ECB then launched Outright Monetary Transactions (OMT) in September 2012, which granted it the possibility of buying public bonds on secondary markets and partially compensated for the excessively binding fiscal constraints. The main novelty was that the ECB could purchase these bonds for an unlimited amount, so it was able to pump an unlimited amount of liquidity into the economic system. This implied a proper bail-out, but only under the specific condition that MS had to be already receiving aid from the EU, necessary for the ECB not to overstep in its mandate. After the approval of the OMT European financial markets entered a period of stability, but several peripheral Member States were still characterized by difficulties in the path towards sustainable growth. Instead, fiscal policy continued to be set on tightening constraints as demonstrated by the introduction of the Six Pack, Two Pack, and Fiscal Compact which exacerbated the effects of the crisis rather than mitigating them.

The fall of 2014 was defined by important changes in economic variables which greatly improved the European situation: the European Commission launched a more flexible interpretation of the generalized fiscal rules and monetary policy took an expansionary path. The ECB adopted a series of unconventional measures aimed at increasing liquidity with the launch of quantitative easing (QE) and its extension through the Asset Purchase Programs (APPs). The programs were built in order to gradually reduce the intensity of quantitative easing: in December 2016 it was set to go on until the end of 2017, but in April 2017 the ECB started to decrease the quantity purchased. In October 2017, a few months before the expected end of the program, the ECB decided to extend the APP until September 2018, but further reducing the amount of the monthly purchase.

In the following years (2015-2018), the EU had somewhat recovered and entered a period of financial stability thanks to the monetary operations launched by the ECB, but these had only a short-term positive impact and were instead quite vulnerable to exogenous shocks. During the period of growth, fiscal policies did not take advantage of the expansion but remained neutral, causing a setback in the following

years. After new Greek and Italian crises, there was a newfound lack of trust between countries in the Euro Area. In the spring of 2015, the Greek government asked for the fourth restructuring of its public debt before signing a new European aid program. The European Commission maintained that the Greek governments had been unable to implement all the reforms included in the old aid program, hence the request made by the ECB was that any agreement would be signed only if the Greek government was able to complete the macro-adjustments and reforms detailed in the previous one. This led to radical disagreements which caused additional instability in the Greek economy and a flight to quality of national and external financial wealth and created an insolvency crisis in the Greek banking sector. In August a new compromise was reached with severe adjustment clauses, but not without producing distrust of other MS towards the Greek administration and of the latter towards European institutions. The Italian crisis on the other hand was set off by its banking sector being the worst performer in the ECB's Comprehensive Assessment of possible fallings in capital requirements. The crisis in four Italian banks shed light on structural problems in the Italian banking sector, particularly the excessive presence of non-performing loans (NPL). These events and the friction they produced between Member States led to a stalemate in governance strengthened by a concentration of elections in many European countries and a difficult political cycle. These factors combined created strong instability and ended the short-lived expansion period.

The important lesson to draw from the EU's history in crisis management is that the lack of coordination in fiscal policy has not only created a heavy reliance on monetary policy, but also prevented the Euro Area from achieving long-term stability. The common trend throughout the years has been on one hand a limited expansion during economic booms and, on the other, the application of excessive constraints as an attempt for damage control during the various crises[9].

1.2: The Reformed Stability and Growth Pact

The main reference for centralized fiscal constraints in the European Union and Euro Area is the Stability and Growth Pact (SGP). When it entered into force in 1999, it set very specific thresholds for public deficit and public debt to GDP ratios, respectively 3% and 60%. The flaws in the original Pact became evident early on in its implementation. The way the Pact was structured made it so that it was a set of strict rules rather than a procedure, which left no room for cooperation and gave it an *ex-post* approach. Instead of implementing mechanisms to promote growth and avoid exceeding the debt limits, the SGP prescribes recommendations and sanctions to countries who are already in an imbalanced situation. Hence, the preventive rules, outlined in Council Regulation (EC) No. 1466/97 "on the surveillance of budgetary

[9] Maria Demertzis and Nicola Viegi, "Policy Coordination Failures in the Euro Area: Not Just an Outcome, but by Design," Bruegel, December 20, 2021, https://www.bruegel.org/2021/12/policy-coordination-failures-in-the-euro-area-not-just-an-outcome-but-by-design/.

positions and economic policies”[10], served as mere guidelines and the focus was more on the corrective measures. These were centered on the “excessive deficit procedure” which consisted in making recommendations having strict deadlines to Member States concerned and the imposition of sanctions should the conditions not be met. This approach causes political instability and incurs the risk of prescribing the direction of Member States' national fiscal policies in its attempt to achieve economic convergence. Another issue was the disregard for underlying situations and economic cycles: the SGP considered any figure above the deficit and debt thresholds to be excessive, no matter the circumstances. This philosophy led to a restrictive state of mind which again left no room for structural improvement, but only for patching up extreme situations. The need for a reform of the Pact was indisputable.

An initial reform was implemented in 2005 in favor of a stronger preventive arm and a more flexible corrective arm. The introduction of country-specific medium-term budgetary objectives (MTO) allowed for tailored paths towards stability and convergence, considering the individual needs of Member States. These targets were to be updated every three years, or sooner if a country has sustained significant fiscal reforms, with the goal of achieving feasible debt levels. As a baseline, countries not yet having reached their MTOs, should aim for a yearly adjustment of 0.5% of GDP, taking into account the economic situation the country is in. Furthermore, MS are allowed slight deviations from their MTOs or the adjustment paths towards them if the reason behind said deviations is a structural reform which entails a stronger positive impact in the long term. Concerning the corrective measures, the 2005 Reform acknowledges the possibility of extending deadlines for excessive deficit correction with regard to special circumstances and adverse events[11]. There was also greater attention to public debt trends in countries struggling to meet requirements, signaling a broader consideration of all determining factors as opposed to a myopic method. These modifications rectified many aspects of the original document, turning the pact into more of a procedure than a rule and giving it an *ex-ante* approach: the focus switched to monitoring changes and possible issues as they happen rather than correcting excesses.

Following the dramatic events of the sovereign debt crisis and the subsequent banking sector crisis, there was an urgent need for additional tools to monitor and strengthen countries’ fiscal positions. With this in mind, in October of 2011, the Stability and Growth Pact was further tightened through the Six Pack, consisting of six pieces of legislation with the aim of strengthening national budget legislation and surveilling macroeconomic imbalances. The package includes EU Regulations 1173/2011, 1174/2011, 1175/2011, 1176/2011, 1177/2011 and Directive 2011/85/EU. The main innovations of the reform introduced:

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[10] Council of the European Union, “Council Regulation (EC) No 1466/97 of 7 July 1997 on the Strengthening of the Surveillance of Budgetary Positions and the Surveillance and Coordination of Economic Policies,” July 7, 1997, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31997R1466&from=EN.

[11] R. Morris, H. Ongena and L. Schuknecht, "The Reform And Implementation Of The Stability And Growth Pact", Occasional Paper Series European Central Bank, 2006, https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp47.pdf.

- the obligation for countries whose public debt exceeds 60% of GDP to adopt measures to reduce it at a satisfactory rate, to the extent of at least 1/20th of the excess over the 60% threshold calculated over the last three years;
- a semi-automatic procedure for the imposition on countries that violate the rules of the Pact of sanctions, which are recommended by the Commission and submitted for approval to the Council.

The procedure outlined in the Six Pack defines a stringent system for giving effect to the parameters of the SGP with respect to the economic policies pursued in member countries. In fact, the new procedures are not limited to setting objectives that must be pursued by EU Member States within the established timeframe but introduce a mechanism of coordination of economic and financial policies based on an extremely precise timeframe that follows state action. The joint presentation of the National Convergence and Stability Plans and the National Reform Plans before they are implemented in the individual states is intended to provide European economic governance with an integrated overall vision of national finances, in which public finance objectives are directly linked to the measures intended to implement structural reforms. On the basis of these elements, European institutions should be better able to formulate in greater detail the indications for the economic convergence of each country.

Just a month later, the European Commission proposed two additional regulations, the Two Pack, with the aim of reinforcing the Six Pack by extending the European Union's power of control, allowing it to sanction countries that do not respect European parameters or need financial aid. The most important change in the new regulations is the introduction of a yearly presentation of national fiscal budgets to the European Commission in order to better monitor and assess budgetary plans with an *ex-ante* approach.

As a result of the European Council of March 1-2, 2012, Member States of the European Union (except for the United Kingdom and the Czech Republic) signed a new treaty on "stability, coordination and governance in the Economic and Monetary Union", better known as the Fiscal Compact. By organizing and systematizing in a single document some of the public finance rules and procedures for the coordination of economic policies already in force or in the process of being introduced, the treaty represents an important source of the new European economic governance. The Fiscal Compact goes back to prescribing national "golden rules" stating that countries' budget positions must remain balanced or in surplus and those in an excessive deficit situation can achieve this goal through the 1/20 rule, building on the changes made in the Six Pack. In a period of crisis, this treaty was designed to tighten budgetary discipline and improve economic policy coordination. The Fiscal Compact was inspired by the idea that stronger national laws and institutions might strengthen EU fiscal regulations and so play a key role in encouraging effective fiscal policies and creating a stronger fiscal system overall[12].

[12] "The Fiscal Compact – Taking Stock" (European Commission, February 21, 2017), https://ec.europa.eu/info/publications/fiscal-compact-taking-stock_en.

1.3: The limits of the European Commission's proposals

The Six Pack was the first reform of the Stability and Growth Pact to go beyond fiscal policy and include new economic surveillance mechanisms with the introduction of the Macroeconomic Imbalances Procedure (MIP). This feature was particularly useful in moving towards an *ex-ante* approach since it calls for a screening of potential imbalances, which are then analyzed in their severity and cause, and finally a recommendation is made to address the issue and mitigate its effects. On paper, the reforms presented in the Six Pack had great potential, but they turned out to be quite contradictory. For example, the MIP follows a country-by-country approach with the intention of better accommodating specific circumstances, but this has resulted in lower implementation and growth: the country-specific recommendations have often been deemed as unclear or lacking in consistency[13]. In general, since European institutions found themselves in a position in which they were unable to strengthen aid programs, the decision was made to approve and launch new restrictive tools which had the effect of worsening the crisis rather than handling it. The decision to increase flexibility in national fiscal policy prevented the adoption of an expansionary fiscal stance which would have created a more sustainable mechanism. The Six Pack finds justification in the critical context in which it was introduced but was deemed inadequate in hindsight.

The Fiscal Compact is the most criticized provision due to its return to being more of a set of stringent rules as an attempt to regulate and contain the excessive imbalances. This was required by the context the EU was in: after the sovereign debt crisis, countries found themselves in the condition of having to substantially increase public expenditure and, inevitably, public debt. However, the extreme rigidity characterizing this treaty and the SGP reforms created an imbalance in EU policies: with fiscal policy being so constrained, too much reliance fell on the ECB, making monetary policy the "only game in town".

Another criticism moved towards the SGP has been directed at its excessive complexity: the various reforms have contributed to this aspect since, prior to the resolution of issues pertaining to existing provisions, new features were implemented often in contrast with those already established. The reforms of 2011/2012 were overall too shortsighted. The main problem derives from the extreme weight given to stabilization and immediate correcting interventions instead of addressing structural needs. This has been the cause of stagnation in the EA with periods of expansion being short-lived and growth prospects looking grim. The idea of achieving a horizontal fiscal coordination solely based on surveillance of national policies has not led to an appropriate fiscal stance, highlighting the need for a central fiscal capacity[14]. The combination of these issues has brought about a compelling need for a change in perspective for what

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[13] Agnès Bénassy-Quéré and Guntram Wolff, "How Has the Macroeconomic Imbalances Procedure Worked in Practice to Improve the Resilience of the Euro Area?" (European Parliament Committee on Economic and Monetary Affairs, March 2020), https://www.bruegel.org/wp-content/uploads/2020/03/IPOL_STU2020645710_EN.pdf.

[14] Marco Buti, "A Tale of Two Crises: Lessons from the Financial Crisis to Prevent the Great Fragmentation," VoxEU.Org, July 13, 2020, accessed May 31, 2022, https://voxeu.org/article/lessons-financial-crisis-prevent-great-fragmentation.

concerns fiscal policy, with greater attention to structural improvements, growth, and coordination between Member States.

CHAPTER 2

Towards A New European Fiscal Framework

2.1: Response to the pandemic: an expansionary and centralized fiscal policy

Between the end of 2019 and the beginning of 2020, the outbreak of the Coronavirus triggered a healthcare, economic, and social crisis which came to be the deepest EU economic depression in times of peace of the last two centuries. The most important factor which differentiates this crisis from the previous ones is its symmetric nature: the Covid-19 pandemic was an exogenous shock which hit the entire Euro Area, albeit with asymmetric effects. Countries suffered the consequences unevenly since the shock hit some sectors more than others; countries with larger tourism and services sectors, such as Greece, Italy, and Spain, suffered greatly from the lockdown and various safety protocols, whereas those relying more on the industrial sectors, like Germany, likely have a quicker recovery timeframe. The asymmetric outcomes are also the result of the situation countries were in before the crisis hit: Member States with preexisting fragilities and particularly high public debt levels (i.e., Greece, Italy, Spain) were still recovering from previous financial crises and had little fiscal space to effectively respond to the crisis[15]. For this reason, a unified response at the EU level was necessary.

For the first time in the EU's history, there was a homogeneous interaction between monetary policy, fiscal policy, and a new centralized fiscal policy. This allowed for a new policy mix in which monetary policy is no longer burdened with supporting national fiscal policy and the latter is vertically coordinated with a new EU central fiscal capacity. The economic emergency required strong increases in public expenditure in all MS which caused a dramatic increase in public debt to GDP ratio, worsened by the fall in GDP. Expansionary fiscal policies at the national level were largely made possible, even in countries without fiscal capacity, thanks to the EU's suspension of centralized fiscal rules. As a matter of fact, the first policy to be implemented at the European level at the beginning of the pandemic was the suspension of the Stability and Growth Pact. By activating the general escape clause (GEC) present in the SGP, budgetary requirements that would normally apply are put on hold in order to give MS the fiscal space needed to sustain the post-crisis recovery[16]. The expansionary fiscal policies at the national level were accompanied by new initiatives at the European level introducing a central fiscal response and swift actions

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[15] Ibid.

[16] Luisa Lambertini, "When and How to Deactivate the SGP General Escape Clause?" (European Parliament's Committee on Economic and Monetary Affairs, December 2020), https://www.europarl.europa.eu/RegData/etudes/IDAN/2020/651381/IPOL_IDA(2020)651381_EN.pdf.

by the ECB aimed at increasing the liquidity pumped into the economy[17]. In order to give a comprehensive strategy to respond to the pandemic, the European Commission, the European Investment Bank, and the ESM all guaranteed programs to immediately aid Member States in recovery, the most important ones being the SURE, the European Guarantee Fund, and the Pandemic Crisis Support respectively aimed at mitigating unemployment, supporting the private sector and small medium enterprises, and covering healthcare costs.

The true innovation with respect to the International Financial Crisis response came with the Next Generation EU (NGEU): a program of direct support guaranteed by the EU multiannual budget. European institutions' response to the pandemic has been radically different from that following the Great Recession thanks to the implementation of rapid expansionary policies rather than falling back on fiscal prudence and debt stabilization. The Covid-19 crisis is significantly worse than the financial crisis, with a decline that is more than twice as large as the one that followed the financial crash, and the initial forecast signaled a partial and much delayed return to pre-crisis growth levels[18]. Today we are witnessing a turning point in European economic recovery thanks to a response which was not only different in size, but in substance[19]. It comprised both short-term support to immediately tackle countries' rise in public spending and forward-looking interventions aimed at opening the door for structural reforms and greater collaboration between Member States. This was also made possible by the symmetric nature of the Covid crisis which called for a prompt and united response, whereas the narrative behind the financial crisis was not as explicit and opened moral hazard arguments. In fact, one of the primary causes of the EU's slow recovery after the financial crisis was capital misallocation along with little focus on productivity growth. European politicians eventually reacted by launching a significant wave of regulatory and governance innovation at the EU level. However, each of these steps was implemented with significant delay, prolonging the European crisis unnecessarily and creating friction among Member States and between struggling countries and European institutions. Furthermore, most of the provisions taken were only partial answers, and Member States often chose intergovernmental action over proceeding through EU institutions. In many cases, the cumulative effect was too little, too late[20].

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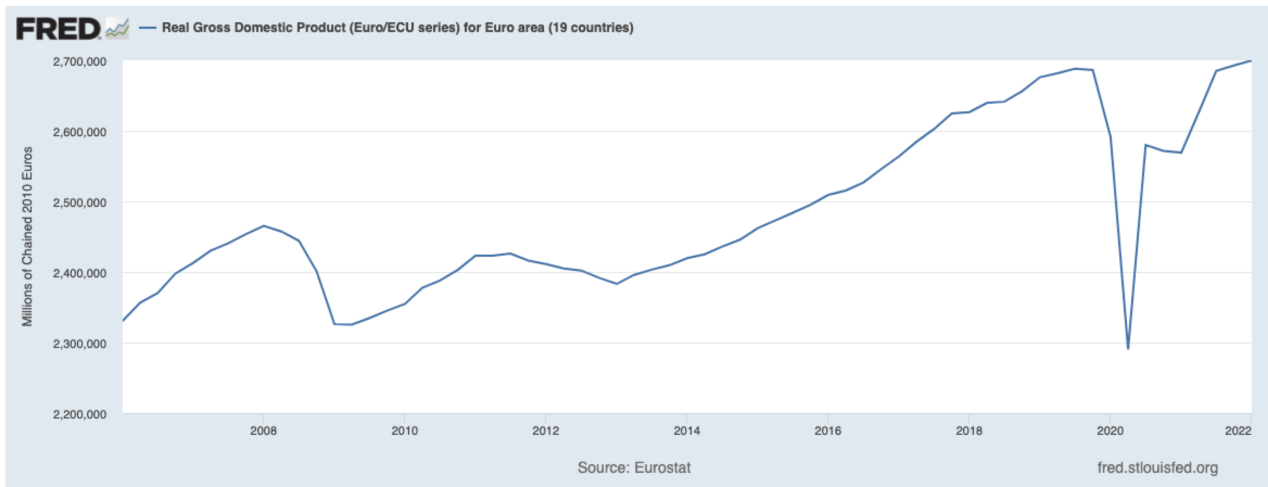
[17] Marco Buti and Marcello Messori, "Euro Area Policy Mix: From Horizontal to Vertical Coordination" (The Centre for Economic Policy Research, October 2021), https://cepr.org/content/new-cepr-policy-insight-euro-area-policy-mix-horizontal-vertical-coordination.

[18] Marco Buti, "A Tale of Two Crises: Lessons from the Financial Crisis to Prevent the Great Fragmentation," VoxEU.Org, July 13, 2020, accessed May 31, 2022, https://voxeu.org/article/lessons-financial-crisis-prevent-great-fragmentation.

[19] Carlos Cuerpo, "Economic Recovery in the Age of COVID-19," Intereconomics 2022, no. 1 (2022): 5–7, https://www.intereconomics.eu/contents/year/2022/number/1/article/economic-recovery-in-the-age-of--covid-19.html.

[20] European Commission. Directorate General for Economic and Financial Affairs., A New Era for Europe: How the European Union Can Make the Most of Its Pandemic Recovery, Pursue Sustainable Growth, and Promote Global Stability. (LU: Publications Office, 2022), https://data.europa.eu/doi/10.2765/11297.

Graph 1: *Real GDP for Euro Area (in millions of Euros)*



The conclusion can be made that even though the recession triggered by the Covid-19 outbreak has been much deeper and more severe, European institutions' firm and timely response has allowed real GDP to return to its pre-pandemic level in the final quarter of 2021. The new policy mix and the presence of a central fiscal capacity in the form of the NGEU has supplied an effective central reaction under distress, allowing for the attainment of a balanced fiscal-monetary policy mix unlike anything before in the history of the European Union.

2.2: Next Generation EU and the Recovery and Resilience Facility

On the 27 May 2020, the European Commission presented a proposal worth 500 billion euros in the form of transfers and grants and 250 billion euros in the form of loans to MS under the name of "Next Generation EU". The allocation of such funds is based on GDP levels, the asymmetric impact the pandemic has had on different countries, and any preexisting fragilities. The financing for this proposal comes from the issuance of bonds on financial markets by the Commission on behalf of the EU. As previously stated, part of the resources then goes towards loans to Member States, which will have to be repaid by 2058, while the majority are given out as grants which will not be repaid. In order to cover such a monetary outlay, the Commission has had to increase its own resources ceiling by 0.6 percentage points of the EU's Gross National Income (GNI)[21]. This ceiling is the maximum number of resources that the Commission can request from Member States and, if placed high enough, it gives the Union the room to meet all its financial obligations. This ensures that the EU will be able to fulfill its debts regardless of the circumstances. As a result, the EU may continue to profit from its excellent credit rating and borrow cash at favorable market rates[22]. To achieve this goal, the Commission has adopted a diversified funding strategy combining an

[21] "NextGenerationEU," Text, European Commission - European Commission, https://ec.europa.eu/info/strategy/eu-budget/eu-borrower-investor-relations/nextgenerationeu_en.

[22] Ibid.

annual borrowing decision, different types of issuing instruments, and transparent relationships with banks supporting the program[23]. This is a crucial decision by European Institutions since it requires a significant financial effort, made possible by the clause in Article 107 of the Treaty on the Functioning of the European Union (TFEU) which allows for granting aid to MS in the case of exceptional circumstances which are out of nations' control.

As for the content, the NGEU is based on three pillars: supporting Member States, supporting the private sector, and lessons from the crisis. The package's suggested distribution guarantees that money is directed to the member nations that are most in need and, by design, it ensures that the investment impulse is fully coordinated, enhancing its effectiveness[24]. The main goal of the first pillar, which finds its culmination in the Recovery and Resilience Facility (RRF), is to support MS in the implementation of the reforms necessary to recover from the crisis. The second pillar provides a new recapitalization mechanism for businesses in the pandemic's worst-affected countries through the Solvency Support Instrument, with the aim of strengthening key sector and technologies and financing efficient businesses which are lacking in capital. With the third pillar there is a greater attention towards the future in order to be more prepared for forthcoming crises and build stronger relationships with global partners.

The Recovery and Resilience Facility, which has a total value of €723.8 billion in current prices, is the core of Next Generation EU and the most significant element of the first pillar. It is an instrument that provides grants and loans to assist reforms and initiatives in the EU. Member States are to pursue bold changes and investments that will make their economies and society more sustainable, resilient, and ready for the green and digital transitions. The RRF strives to protect jobs, promote productivity and competitiveness, support research and innovation, improve the health system, facilitate financial sector evolution, and overall improve the social and economic environment. However, it is primarily designed to boost Member States' recovery efforts by supporting the reforms that are the foundation of national "Recovery and Resilience Plans" (NRRPs) that have been submitted to the European institutions for approval during the European Semester. The European Commission emphasized in its proposal that this financial support intends to create a strong relationship between the economic recovery of individual MS and the goals of digital and environmental innovation of the EU as a whole[25]. It is meaningful that the provision of financial support is not simply destined to patching up uneven balance sheets as we have witnessed in the past, rather it is placed in a broader perspective: the funds are to be used to make structural

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[23] "NextGenerationEU Diversified Funding Strategy," Text, European Commission - European Commission, https://ec.europa.eu/info/strategy/eu-budget/eu-borrower-investor-relations/nextgenerationeu-diversified-funding-strategy_en.

[24] Maarten Verwey, Sven Langedijk, and Robert Kuenzel, "Next Generation EU: A Recovery Plan for Europe," VoxEU.Org, June 9, 2020, https://voxeu.org/article/next-generation-eu-recovery-plan-europe.

[25] Marco Buti and Marcello Messori, "Next Generation EU: An Interpretative Guide" (Luiss School of European Political Economy, June 15, 2020), https://sep.luiss.it/sites/sep.luiss.it/files/Next%20Generation%20EU%20-%20English.pdf.

changes which will have great benefits in the long run, with a particular focus on the green transition, digitalization and innovation, and social inclusion.

As never before, the framework of the NGEU creates a vertical coordination between national fiscal policies and the European budget and represents a significant improvement in the coordination of EU policies. Firstly, the financing of European bonds implies a strengthening of the European budget because of the necessary increase in own resources. Furthermore, the considerable issuance of such bonds guaranteed by the Multiannual Financial Framework (MFF) implies a major redistribution of resources among Member States in order to strengthen the nations most impacted by the crisis. The main obstacle to risk sharing in the EU has always been the hesitance of core countries to take on the costs it implied by favoring unilateral aid to peripheral countries. The pandemic being an exogenous shock which hit all countries changed the scenario, thus warranting interventions like the RRF which can significantly reduce the gap between core and peripheral countries. This greater convergence can then open the path to risk reduction without causing a risk-sharing issue[26]. In fact, the NGEU is a tool with the power to aid even the most fragile countries. The convergence that could be reached through these reforms and a stronger European financial market would consolidate the single market, bolster the production of European common goods, and give way to a gradual process of fiscal union within the EU. Hence, the recovery plan represents a substantial and unexpected advance in the European Union's fiscal integration process because of the generation of a considerable stock of common debt for the first time in its history, which will be repaid by the collection of new common resources. Additionally, the mobilization of these funds will enable EU institutions to adopt some shared macroeconomic policy by assisting Member States in their economic recovery[27]. It follows that the measure implemented by European institutions in response to the crisis are unlike any enforced before, making the correct utilization of these funds even more crucial, especially in a long-term perspective. The NGEU is much more than a simple crisis response mechanism: it sets the goal of placing the EU, which is experiencing serious delays with respect to other important economic areas, on a path of sustainable development. The results of the reforms carried out today will determine and shape a new economic governance framework and set the stage for the next European generation.

2.3: The consequent new 'policy mix' and the potential for permanent fiscal coordination

Despite its extraordinary features, the NGEU is by construction a temporary solution since it is a centralization of public debt at the European level that cannot be fully included in the MFF which has to be constantly balanced. The fundamental question to ask now is how to build a strong new leg in the EU policy

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[26] Marcello Messori, *Recovery Pathways: The Difficult Italian Convergence In The Euro Area* [S.l.]: BOCCONI UNIV PR, 2021.

[27] Luca Lionello, "Next Generation EU: Has the Hamiltonian Moment Come for Europe?," Eurojus, 2020, http://rivista.eurojus.it/wp-content/uploads/pdf/lionello-nextgen.pdf.

mix towards central fiscal coordination starting from a temporary, and therefore weak, program like the NGEU. The latter has certainly shown how a more stable balance can be achieved through the enhancement of national fiscal policies by means of a central fiscal capacity. It is also crucial to maintain the framework of vertical coordination between national and central policies which would alleviate the pressure befalling monetary policy and the risk of the ECB going beyond its mandate. Part of what made the implementation of the NGEU possible is precisely its one-off nature; creating a more permanent version of it entails a change in the terms of both national and supranational economic governance, since the relative weights of a centralized monetary policy and national declinations but centralized directions of fiscal policies change as well. The first step in achieving this centralized capacity lies in the successful implementation of the RRF and the various NRRPs: having a successful precedent of the implementation of a *de facto* centralized capacity would determine an improvement in relationships between MS and a smoother path to convergence.

A conundrum emerges from the legal point of view: while the recovery fund's experience has shown that the Union can already take *ad hoc* emergency fiscal measures in times of crisis, conferring permanent fiscal competence would necessitate a significant change in the EU legal structure[28]. This is easier said than done since it is not always clear how to proceed with treaty reforms as previously established with the narrative of the SGP. In restoring the SGP for example, it is clear that strict centralized fiscal constraints in the hope of horizontal coordination are not a sufficient solution. As previously pointed out, fiscal rules have become excessively complex and require simplification. The proof is in the difficulty there has been at the European level in the implementation of sustainable national fiscal protocols. Central fiscal rules remain fundamental to maintain stability and equity between MS and to encourage countries in their reduction of excessive debt, but they cannot remain unchanged[29]. Another aspect to bear in mind is the sustainability of fiscal rules. In fact, it is vital to amend the treaties with the same mindset put into the construction of the recovery plan, gravitating towards growth and innovation to create a stronger foundation for the future.

Another hindering aspect could be the political one since a central capacity would pose the issue of moral hazard. National governments would have fewer incentives to build national fiscal space for maneuver in periods of robust growth if they expected the backing of a central fiscal instrument in the event of negative shocks or unfavorable cyclical phases. The problem could be avoided with adequate incentives and fair conditions, but it would still be difficult to overcome the political complications without an increase

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[28] Ibid.

[29] Giuliano Amato et al., "The New European Fiscal Framework: How to Harmonise Rules and Discretion" (Presented at the Commission Review of the EU Economic Governance Framework, Astrid, 2021), https://www.astrid-online.it/static/upload/protected/b9d2/b9d25d8630caa84c4f0cca3a9d6ee00b.pdf.

in trust between MS. This once again proves that the outcome and results of NRRPs are fundamental for success[30].

The key moving forward could be to find a way to adapt to the historical context we are witnessing around us. Instead of trying to force a permanent stability, the solution may lie in a new concept of normal characterized by a series of subsequent shocks. The EU has gone through one crisis after another, starting with the International Financial Crisis, followed by the sovereign debt and banking sector crises, the pandemic shock, and most recently the invasion of Ukraine. Rather than trying to create a universally applicable solution, a possible answer would be to use the NGEU framework to tackle the different challenges and create a sequence of temporary but persistent equilibria.

[30] Marco Buti and Marcello Messori, "Euro Area Policy Mix: From Horizontal to Vertical Coordination" (The Centre for Economic Policy Research, October 2021), https://cepr.org/content/new-cepr-policy-insight-euro-area-policy-mix-horizontal-vertical-coordination.

Conclusion

From the research and arguments proposed in the previous chapters, it is clear that the weakness of European interventions and the insufficiency of fiscal policies adopted in the past, both at the national and supranational level, have often aggravated the already fragile European framework. The Covid-19 pandemic has opened a path for greater fiscal integration and some form of central fiscal capacity, but a concrete and lasting result is still remote. As a matter of fact, in order to move forward a series of considerations have to be made regarding EU fiscal rules.

Firstly, as a result of the severe recession and the necessary policy responses, public finances have taken a hit, resulting in greater fiscal disparity between Member States. The most affected countries from the pandemic are the same ones which had high levels of public debt to begin with, so they have experienced incredibly steep increases. A fundamental post-crisis task will be to minimize these high and increasingly divergent public debt ratios in a gradual and sustainable manner, underscoring the necessity of a good composition and quality of public finances. It goes without saying that the fiscal adjustments which inevitably have to happen must be carried out with a growth-friendly perspective, avoiding excessively rapid reductions or strict rules which could lead to even higher social and economic costs.

Furthermore, the response to the crisis has proved how coordinated fiscal policy backed by a centralized fiscal capacity has had an unprecedented stabilizing effect. The expansionary approach taken during the recession has allowed for an effective response but, in order to replicate it, it is vital to create adequate fiscal space via the adoption of counter-cyclical policies and, possibly, the revision of the debt rule contained in the SGP to allow for more guided adjustments. Indeed, a general simplification of fiscal rules is crucial. As stated in the first chapter, the progressively complicated reforms to centralized fiscal rules have led to a lack of transparency and an increase in unpredictability. In reviewing the fiscal mechanisms in place, the main goals should of course be on effectiveness and efficiency, but these should be achieved through simplicity.

The necessary interventions recalled in this paper are but the first steps toward the creation of a truly solid and united European Union, capable of providing effective and timely responses in the face of emergency situations such as the one we are now facing. The fundamental condition for ensuring the stability and prosperity of Europe as we know it is the gradual move toward a federal-like fiscal system, with a common fiscal capacity that allows institutions to act when necessary to leave no country behind and to lead the EU to become the third player in the global economic, political and trade landscape.

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