Where does the European Union stand?

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Speech at the "European Political Economy and European Democracy" seminar on June 23, 2023, at Sciences Po Paris, as part of the 'Théorie et Economie Politique de l'Europe' seminar, organized by Cevipof and OFCE.

The aim of the first study day of the Theory and Political Economy of Europe seminar is to collectively engage in a work of overall theoretical reflection, following on from the thematic sessions of 2022, by continuing the multidisciplinary spirit of the seminar. The aim is to begin outlining the contours of the two major blocks of European political economy and European democracy and to identify the points of articulation between them. And to prepare for multidisciplinary writing with several hands.

An apparent paradox

During the various and rich interventions pointing out the shortcomings, dilemmas, and contradictions that characterize the processes of European integration, a central question seems to emerge:

"How has a politico-economic regime in permanent disequilibrium, which has become very complex, been able, until now, to overcome a large number of crises, some of which threatened its very existence?"

A brief review of the current situation is enlightening and makes it more necessary to seek out the factors likely to explain this resilience, which never ceases to surprise researchers and specialists, foremost among them many economists. In the face of a succession and accumulation of poly-crises and rising uncertainties, is it reasonable to anticipate that the European Union (EU) will continue its current course, protected by the mobilization of the processes that have ensured its survival, not least thanks to the responsiveness demonstrated by both the European Central Bank (ECB) and the European Commission since 2011?

Baroque architecture full of inconsistencies

The various speakers highlighted many of them:

- The European Parliament is a curiosity: it is an assembly with no fiscal powers. Would giving it this power be enough to restore the image of democracy on a European scale?
- The EU issues a common debt even though it has no direct power of taxation: isn’t this a call for an embryonic federal state? Is there a political consensus on this path?
- This debt corresponds to the financing of the Next Generation EU plan, which recognizes the need for solidarity with the most fragile countries, in response to a common “shock” that does not lend itself to the moral hazard so feared by the frugal countries of the North. Yet it is the result of an ambiguous compromise, with two opposing interpretations: an exception that must not be repeated for the North, and a founding, Hamiltonian moment for the South.
- It is not very functional or democratic for the European Parliament to vote on Community expenditure, but for national parliaments to vote on revenue.
- Does it make sense to have a multiannual program adopted by an outgoing assembly of the European Parliament, which will then be binding on the next one?

- The ceiling set for the European budget limits the financing of European public goods, which should compensate for and go beyond the limitation on the supply of national public goods in the application of the criteria governing national public deficits and debts.
- At the European level, the quest for more democracy tends to focus on the question of political control over the Commission and the ECB, whereas social democracy has in the past been a critical component in the legitimacy of governments at the national level.
- The same applies to the question of corporate governance in Europe, a forgotten issue on the European agenda that is regaining a certain interest in the face of the transformations brought about by digital technology and the environment.
- Competition policy is often perceived by economists as one of the Commission's key instruments since it is an integral part of the construction of the single market. Yet legal analysis shows that competition is not a categorical imperative, defined finally, but a functional concept that evolves over time. So much so, that the Commission can declare that today it is at the service of the environment.
- The Commission is usually criticized for its role as a defender of the acquis, its taste for excessive regulation, its technocratic approach, and its inertia. And yet, since 2011, it has continued to innovate in response to successive crises, to the point of having relaunched European integration.
- The ECB was founded as the embodiment of an independent, typically conservative central bank, with a monetarist conception of inflation. And yet, without changing European treaties, the ECB has been able to innovate and effectively defend the Euro.
- The EU Court of Justice and national constitutional courts do not have the same interests and legal

conceptions, but so far, no head-on conflict has produced a blockage in European integration. Is this sustainable?
- Is the distribution of competencies, fixed by the treaties and de facto adjusted as problems and crises arise, satisfactory and up to the challenges of the industry, the environment, public health, and solidarity in a dangerous and uncertain international environment?
- The “European Constitution” is not a constitution, because integration has proceeded via a series of international treaties. How can we explain the fact that these treaties have been imposed when member countries could have coordinated through the OECD, EFTA, the IMF, or ad hoc agreements (European Space Agency, Airbus, Schengen) with no overall architecture?

Reasons for surprising resilience

We need to identify the factors that can account for the perseverance that lies at the heart of continental integration and ask ourselves whether they are sufficiently powerful to overcome the current multi-crises.

- From the outset, the project was a political one, aimed at halting Europe’s decline in the wake of the two world wars. But in the absence of political agreement on a common defense, the coordination of economic reconstruction was seen as a means to this end. In this respect, Russia’s invasion of Ukraine has strengthened ties between governments, even if it means inverting the hierarchy between geopolitics and economics and bringing back to the forefront the possibility of Europe as a power.
- Conflicts of interest between nation-states are at the root of a succession of crises, which are overcome by ad hoc compromises that never cease to create further imbalances and inconsistencies, which in turn lead to another crisis. In a way, the perception of incoherence

and incompleteness is a recurring feature of European construction. However, the configuration can become so complex and difficult to understand that it can overwhelm the inventiveness of the collectives that are the various EU entities and their ability to coordinate. By way of example, a genuine EU macroeconomic theory has yet to be invented, and this is a major obstacle to the progress of integration.

- European time is not homogeneous. Periods when new procedures are put in place after a breakthrough give the impression of bureaucratic, technocratic management at a distance from what citizens are experiencing. By contrast, open crises forbid the status quo, as the very existence of institutional construction is at stake, with the stratification of a large number of projects and their incorporation into European law. This experience of trial and error is the breeding ground that enables the Commission, for example, to devise solutions to emerging problems. As a result, the equivalent of an organic intellectual seems to have emerged from this collective learning over an extended period. This is one interpretation of the paradoxes mentioned above.
- European Councils, the Court of Justice, the ECB, and the European Parliament all play their part in this movement, but it is undoubtedly the European Commission that in a sense represents the European, if not the general, interest. The fact that it has the power to initiate regulations and manage procedures gives it an advantage over other bodies. Indeed, many governments would be satisfied with inter-state negotiations, with no common ground to build on, and would go it alone. Failure to find a compromise solution would mean the simple disappearance of the EU. Similarly, without the “whatever it takes” approach, the ECB would have disappeared with the Euro. The major crises offer a strong incentive to move beyond dogmatic posturing in

favor of a re-hierarchization of objectives and the invention of new instruments.

- Finally, there are two sides to the proliferation of regulations, procedures, and European agencies attached to the Commission. On the one hand, they give rise to the diagnosis of poorly controlled management and the harsh judgments of defenders of national sovereignty. On the other hand, they are also factors in the reduction of uncertainty and the creation of regularities that coordinate expectations in a context where financial logic generates bubbles and macroeconomic instability.

  In a way, a certain redundancy in a myriad of interventions is a guarantee of resilience. The European Stability Mechanism (ESM), for example, was a way of circumventing the ECB’s delay in recognizing the need for vigorous intervention. So the complexity of the EU can also mean redundancy and resilience.
- Political power plays a crucial role in the development of European institutions. It intervenes in the framework of councils and summits. So far, in the national political arena, governments favoring further integration have prevailed: this is sometimes one of the only markers of their policy that survives the various periods. As a result, a collapse of the EU could mean the loss of their credibility. It would be dramatic for a government to be held responsible for the failure of a project that has been built up over decades. This is perhaps a hidden source of the permanence of European institutions. What is more, “Brexit” far from marking the end of the EU has rather closed ranks, especially as the expected benefits for the UK have not manifested themselves. Beware, however, that the polarization and division of societies between the winners and losers of trans nationalization has favored the breakthrough of parties defending strong national sovereignty, i.e. a countertrend that forbids prolonging the hypothesis of a lasting hegemony of pro-European parties.

- Finally, the succession of financial crises, the return of pandemics, the harshness of the confrontation – not only economic – between the United States and China, the growing awareness of the environmental emergency, and the installation of a new inflation generated by recurring scarcities, which risks being aggravated by the transition to a war economy, are all factors in a dual awareness. On the one hand, common interests tend to outweigh disagreements between member countries. On the other hand, each of them carries little weight in the confrontation with the United States, which has become openly protectionist, and China, with its dynamism in emerging productive paradigms. The EU needs to be a geo-economic and political player in its own right. This explains the Commission's activism since Covid-19. Citizens have benefited from this new impetus, with a common strategy on vaccines, for example. For their part, the governments of the most fragile economies have benefited from European solidarity, which has counterbalanced the principle of regional competition.

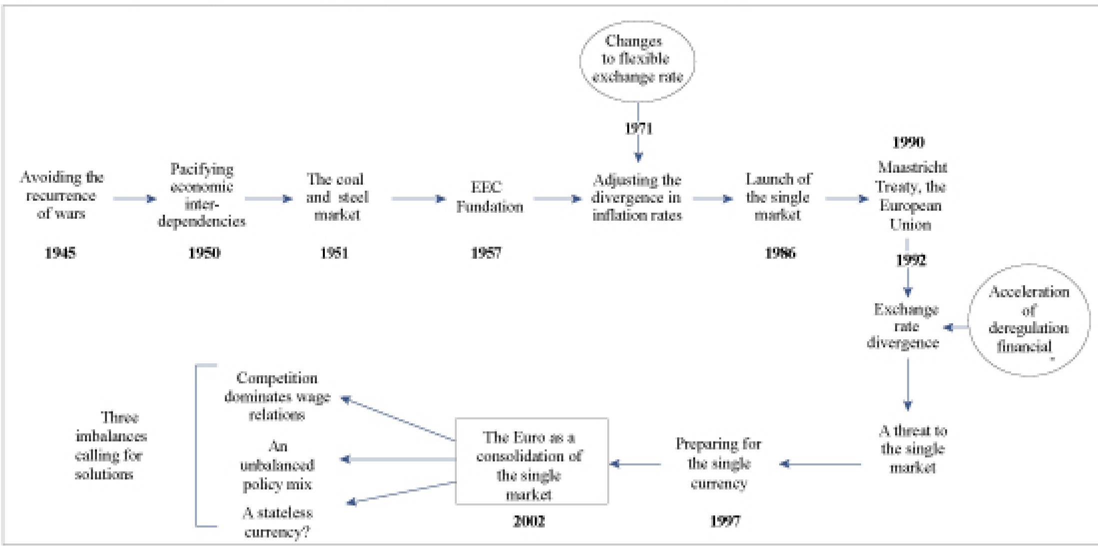
Historical bifurcation, polycentric governance, or nationalist withdrawal?

The processes described above can recombine to form a wide variety of trajectories. Prediction is not possible, as it is the strategic interactions between collective actors that will determine how to overcome the EU's various crises. It is possible to imagine three more or less coherent scenarios.

- *Towards an original federalism disguised by a myriad of technical coordination procedures*

This first scenario is based on three central assumptions. Firstly, it marks the end of reliance on neo-functionalism, whereby governments must be the servants of the necessities imposed by economic interdependence between nation-states (figure 1). The sphere of politics pursues its objectives, even if governments must contend with economic logic. Secondly, it draws the consequences of technological, geopolitical, health, and environmental transformations that threaten the stability of societies and the viability of their socio-economic regimes. Pooling resources increases the chances of success for all participants in European programs. Finally, this first scenario extends the trends already observed since the outbreak of the pandemic.

Figure 1: **Building the European market step by step: the virtues and limits of the functionalist approach 1945-2002**



As far as the word federalism has a repulsive effect on public opinion, which is influenced by populist nationalism, the practice of enhanced cooperation does not have to be accompanied by an appeal to the federalist ideal. Instead, skillful rhetoric must convince citizens that the EU ensures their protection and opens new common goods. These advances in no way subtract from the social, economic, and political rights guaranteed at the national level. Charismatic politicians must be able to resist anti-EU rhetoric that feeds on the relative powerlessness of national authorities overwhelmed by transnational forces beyond their control.

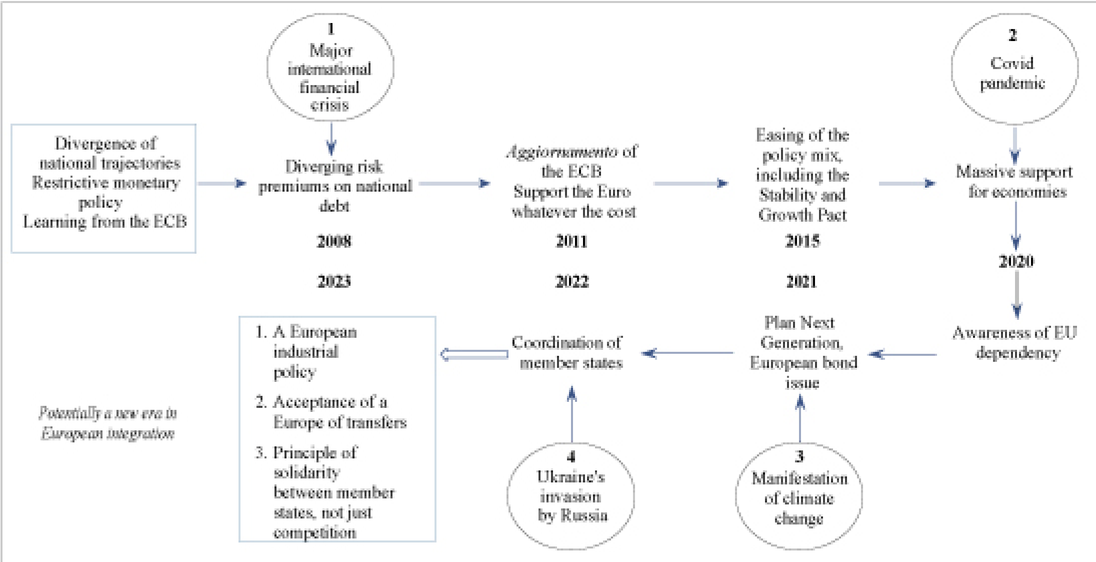
- *Adapting polycentric governance at the margins, far from a Europe of power*

This second scenario, on the other hand, assumes that the current period will be one of continuity with the long-term trajectory of European integration. The polycentrism of EU entities is a vector of pragmatic adaptability to emerging issues, without the need to centralize power in Brussels, as suggested by the diversity of European agency locations. Trial and error, the multiplication of ad hoc procedures, and the possible use of enhanced cooperation on issues involving a fraction of member countries are all sources of adaptation in the face of the repetition of events potentially unfavorable to the EU.

This considers the fact that negotiating new European treaties seems a perilous mission, that public opinion judges the EU on the basis of its contribution to the well-being of its populations rather than the transparency and coherence of its governance, and that an imperial conception is illusory. One might be tempted to invoke a form of catallaxy applied not to the economy and the market, but to the political sphere: the interaction of highly varied processes, without central authority, eventually leads to a roughly and provisionally viable configuration. The English expression “muddling through” aptly captures this pragmatism, marked by the renunciation by public decision-makers of the need to spell out an objective and a goal, if only to persevere in being.

Success is not guaranteed. Firstly, past successes are no guarantee of their continuation into the future. Secondly, there is no guarantee that a pragmatic solution will be found in the face of an avalanche of unfavorable events since the affirmation of an objective may prove to be a necessary condition for lifting the prevailing uncertainty as to the outcome of both institutional and economic crises. Last but not least, how can we politically legitimize an order whose logic and nature elude decision-makers? Isn’t this powerlessness the breeding ground for populist voluntarism?

Figure 2. **Transformations in the global economy affect all countries and stimulate unprecedented institutional advances (2008-2023)**



- *National and European elections: a nationalist majority redesigns a different Europe*

This third scenario is based on an analysis of changes in the objectives of government following recent elections in Europe. Both in the South (Italy) and in the Scandinavian countries (Finland, Sweden, Denmark), coalitions have come to power dominated by parties opposed to immigration, defenders of national identity, and, in short, reluctant to delegate new powers to the EU. In this, they join the authoritarian, nationalist governments of Central Europe (Hungary, Poland). In the European Parliament elections of 2024, could this movement result in the loss of a majority in favor of the EU’s current policies, to the benefit of a new majority bringing together nationalist parties that are very diverse, but share the same obsession: to block the extension of EU competences and repatriate as many of them as possible to the national level?

Russia’s war against Ukraine has brought the imperative of defense to the fore, an area in which the EU has made little progress. Does not this mean that NATO is becoming central to the political organization of the old continent, to the detriment of the economic objectives pursued by European integration?

These hypotheses, derived from the 23 June 2023 CEVIPOF and OFCE meeting? call for a follow-up, as the questions to be clarified are so many and quite difficult indeed. Cross-disciplinary analysis is more necessary than ever.

Why – and how – to make Next Generation EU (NGEU) sustainable

Frédéric Allemand, **Jérôme Creel**, **Nicolas Leron**, **Sandrine Levasseur** and **Francesco Saraceno**

The Next Generation EU (NGEU) instrument was created during the pandemic to finance the recovery and, above all, to ensure the resilience of the European Union (EU). Since then, with the war in Ukraine and its various consequences, the shocks hitting the EU continue to accumulate, in a context where it is also necessary to accelerate the ecological transition and the digitalization of the economy. Russia's invasion of Ukraine has put defence matters back on the front burner, while inflation is giving rise to heterogeneous reactions from member states, which is not conducive to economic convergence, not to mention the monetary tightening that is destabilizing some banks. The Biden administration's subsidies to US industry have all the hallmarks of a new episode in the trade war, to which the European Commission has responded by temporarily relaxing the rules on state aid. In this uncertain environment, where one shock is following another, the idea of making the NGEU instrument permanent instead of temporary has gained ground. European Commissioner P. Gentiloni, for example, mentioned the idea as early as 2021; it was raised at a conference of the Official Monetary and Financial Institutions Forum in 2022; it appeared at the conclusion of an article by Schramm and de Witte, published in the *Journal of Common Market Studies* in 2022; and it was mentioned publicly by Christine Lagarde in 2022. There is, however, little consensus on this issue, especially in Germany, where, after the Constitutional Court's decision in favour of the NGEU on 6 December 2022, the Minister of Finance, Christian Lindner, reminded us that the issuance of common debt (at the heart of the NGEU) must remain an "exception". As the debate remains open, in a recent study for the Foundation for European Progressive Studies (FEPS), we assessed the economic and political relevance that the implementation of a permanent NGEU-type instrument would entail, as well as the technical and legal difficulties involved.

The implementation of the NGEU has already raised delicate questions of coordination between member states regarding the allocation of funds to the Commission's various structural priorities (how much to the ecological transition? how much to digitalization?) and between the countries themselves, since the question of a "fair return" never fails to resurface in the course of negotiations. Adding to these coordination difficulties, the first part of our study raises the question of the *democratic legitimacy* of EU policies when supranational priorities limit the autonomy of national parliaments, starting with fiscal policy, the "material heart" of democracy. The problem of democratic accountability is not new if one considers that supranational rules, such as the Stability and Growth Pact, impose limits on the power of parliaments to "tax and spend". In fact, the intrinsic logic of coordination is to force political power to conform to functional (macroeconomic) imperatives, which inevitably leads to a form of depoliticization of fiscal and budget policy. The perpetuation of the NGEU must therefore be seen as an opportunity to remedy the depoliticization of EU policies and to move towards a “political Europe” by establishing a supranational level for the implementation of a European fiscal policy.

This part of the study also reminds us that while the implementation of the NGEU has been of paramount importance in stimulating a post-pandemic recovery, the economic results are still uncertain since the funds were allocated only relatively recently[1]. It also reveals a change in the mindset of EU policymakers. For the first time, joint borrowing and some risk-sharing have become features of a European fiscal plan. It would be wrong, however, at this stage to see the NGEU as a “Hamiltonian” moment or as the founding act of a federal Europe: the NGEU is limited in scope and duration; it does not take over the past debts of the member states; and it has not created a common spending (investment) capacity. And this is perhaps both its main weakness and its main area for improvement. The pandemic and the strong economic response to it by European states have indicated that they can share common, crucial goals: recovery, resilience, the ecological transition and digitalization. What is missing, however, is a central fiscal capacity to better link the long-term challenges with an instrument adapted to this kind of horizon. Hence the idea of making the NGEU permanent.

As a preamble to a possible long-term establishment of the NGEU, another part of the study raises the issue of determining the main task of a permanent central budgetary instrument. One obvious answer is the provision and financing of European public goods (broadly defined to include the areas of security and environmental protection) that member states may not provide in sufficient quantity, due to a lack of resources and/or externalities. Regarding the provision of public goods, it should be recalled that the preferences of EU citizens are fairly homogeneous within the Union, and that there is a growing demand for some needs to be met at the EU level. For example, 86% of EU citizens are in favour of making investments in renewable energy *at the EU level*. Even the production of military equipment by the EU is increasingly supported by citizens, with 69% "agreeing or strongly agreeing". The provision of public goods at the EU rather than the national level would also allow for very tangible economies of scale, for example in the field of infrastructure. Last but not least, this would be justified by the instrument's capacity to "make Europe" through concrete actions and strengthen the feeling of being European. Any debate on a central budgetary capacity would of course have to be conducted in parallel with that on the reform of the Stability and Growth Pact in order to guarantee the creation of a fiscal space (or additional margins of manoeuvre) in the EU.

The study then points out that there are few options for creating a central budgetary capacity within the current institutional framework. The treaties define a budgetary framework (centred on the multi-annual financial framework, the MFF) for the EU that ties spending to the ability to raise funds, thus severely limiting the ability to raise debt in normal times. The creation of special financial instruments and the decision to spend beyond the MFF ceilings are explicitly linked to exceptional circumstances and cannot be a solution for the recurrent provision of public goods. The 0.6 percentage point increase in the own resources ceiling to 2 percent of GNI **[2]** ensured that the unprecedented level of borrowing respected the constitutional principle of a balanced budget.

However, this increase was approved only because of its exceptional and temporary nature, as the ceiling on own resources for payments is to be reduced to 1.40 percent of GNI once the funds are repaid and the commitments cease to exist. Even if permanent funding were to be allocated to the NGEU instrument, its capacity to intervene would remain limited. In accordance with its legal basis (Article 122 TFEU), the NGEU is a tool for crisis management whose activation is linked to the occurrence or risk of exceptional circumstances. As a matter of principle, European legislation prohibits the EU from using funds borrowed on the capital markets to finance operational expenditure.

The study examines other legal arrangements that could contribute to the financing of public goods, but whatever legal basis is chosen, (a) the EU does not have a general multi-purpose financial instrument that it could activate, in addition to the general budget, to finance actions and projects over the long term; and (b) the EU cannot grant funds to finance actions outside its area of competence, i.e., it cannot substitute itself for member states in areas where the latter retain competence for their policies. Therefore, if a central budgetary capacity is to be created, it would be necessary to revise the treaties or establish new intergovernmental arrangements (along the lines of the European Stability Mechanism).

Based on the second option, the study proposes that a European public investment agency be created as a first step towards the creation of a central budgetary capacity. This agency would have the function of planning and implementing investment projects, in cooperation with the member states. Under EU legislation, the agency would not have full control over policy choices but would act mainly within the limits set by the roadmaps of the EU institutions. Nevertheless, it would have the administrative capacity to design public investment projects that the Commission currently lacks, and it could be given control over allocating grants, developing technical guidelines, monitoring cross-compliance, etc.

The last part of the study reminds us, nonetheless, that even substantial progress in developing a central budget capacity should not obscure the need for national budget policies to be implemented as well, and that close coordination between them is needed. While increasing powers are being transferred to the European level in the area of public goods, as can be seen for example with the European Green Pact and with the targeting of NGEU spending towards greening and digitalization, there is still a need to coordinate national governments' policies with each other and with the policies implemented at the central level. Policy coordination, which necessarily limits the autonomy of national parliaments, raises the question of the democratic legitimacy of EU policies and may lead to a form of depoliticization of fiscal policy. This would become even more problematic if the EU were to transfer to the supranational level some of the decisions about which public goods to provide and from whom to finance them. To avoid delinking the strengthening of European macroeconomic policy on public goods with the democratic dimension of this orientation, nothing less than a quantum leap in the creation of a political Europe, with two democratic levels, is probably needed, with genuine *European democracy* –- because it would be based on a real European parliamentary fiscal power, which would in turn be linked to the preferences of the European electorate –- but fully *articulated with the national democracies* with their recovered fiscal margins.

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[1] The inconsistency between the need to revive the European economy after the pandemic and a very gradual disbursement of funds is discussed by Creel (2020).

[2] GNI: Gross national income, defined as GDP plus net income received from abroad for the compensation of employees, property, and net taxes and subsidies on production.

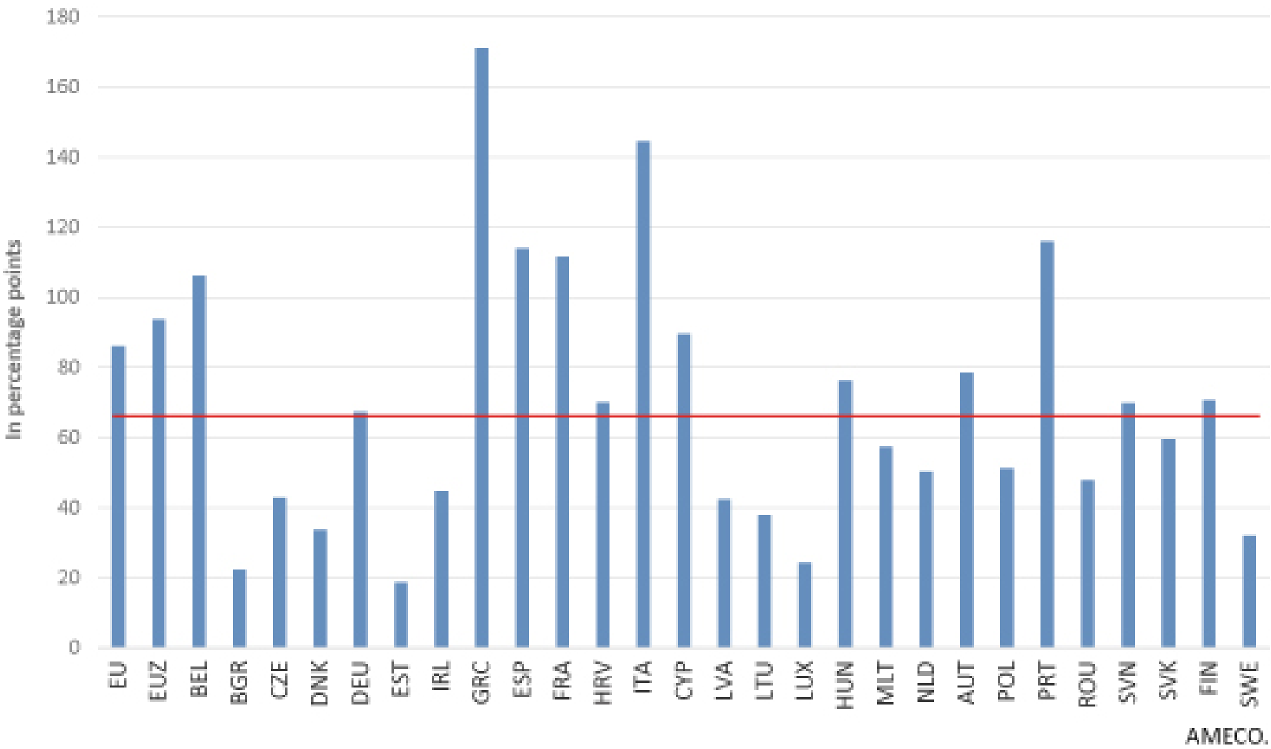
Reforming the Growth and Stability Pact: The Commission has fallen on the debt

By [Jérôme Creel]

In its communication of 9 November 2022, the European Commission outlined the contours of the new European fiscal framework that should, in its words, be simplified and adapted to Member States' specific needs in order to ensure that they remain solvent and to allow for necessary reforms and investments. The new framework should also take better account of economic imbalances, including those relating to trade, and, finally, it should be better applied. A vast programme!

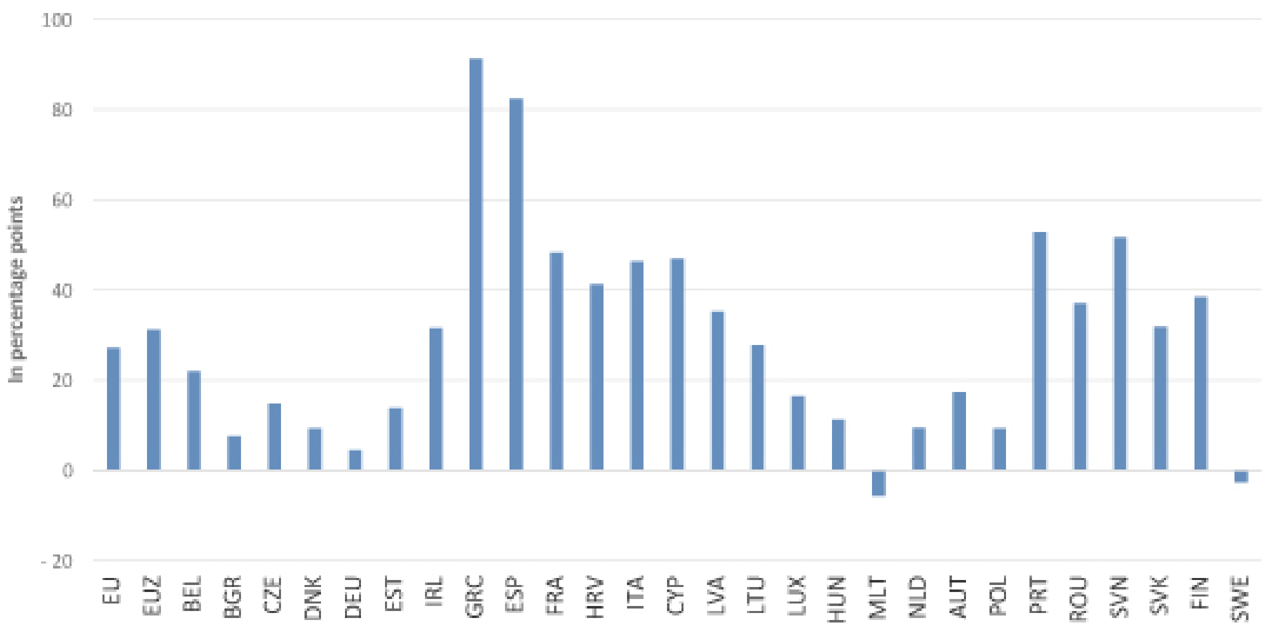
The goal of ensuring the Member States' solvency, which is reiterated by the Commission, reflects that a significant number of Member States have excessively high public debt-to-GDP ratios within the current European fiscal framework: 12 Member States out of the 27 will have a public debt-to-GDP ratio that exceeds the 60% threshold at end 2022 (Figure 1).

Figure 1. **Ratio of public debt / GDP forecast for end 2022**



These high levels of public debt are the consequence of the series of economic, financial and geopolitical crises that have hit Europe since 2007. Between end 2007 and end 2021, public debt rose by almost 30 percentage points of GDP on average, with a dispersion of around 23 points. As Figure 2 shows, some EU Member States (recall that the Stability and Growth Pact that the Commission is planning to reform applies to all of them, not just those in the euro zone) have experienced debt increases of almost 50 points (France, Italy, Cyprus, Portugal) or even much higher (Greece, Spain). Others, like Germany, have seen their debts increase only slightly, or even decrease (Malta, Sweden). In this context, it would be difficult if not impossible to apply fiscal rules in a homogeneous or undifferentiated way, as this would require major efforts from Member States that are gradually emerging from the pandemic and are continuing to suffer from the energy crisis that is severely hurting public finances[1].

Figure 2. Variation in the ratio of public debt / GDP between end 2007 and end 2021



AMECO, Author's calculations.

The Stability and Growth Pact, which has been in force since the creation of the euro zone in 1999, aims to ensure fiscal discipline among EU countries by preventing excessive government deficits and debts or by correcting them through fiscal policies that limit spending and boost tax revenues. As the Pact is not applied mechanically, its application depends on how the States and the Commission interpret what is meant by the "excessive" nature of deficits and debts. Although numerical criteria have been appended in a Protocol to the Treaty on the Functioning of the European Union – the well-known criteria of 3% of GDP for the deficit and 60% of GDP for the debt – there are exceptional circumstances that allow for temporary exemptions. So when a serious crisis occurs, as was the case in 2020 with the pandemic, the derogation clause relating to the suspension of the preventive arm of the Pact can be activated. As a result, the Pact will have been put on hold from 2020 to the end of 2023. In the Commission's view, what should happen after that?

The Pact's two numerical criteria would be retained, but the main tool for meeting the criteria would be changed. Fiscal sustainability[2], i.e. the reduction of public debt, would now be assessed on the basis of a single indicator: primary expenditure, i.e. public spending net of discretionary income, excluding interest charges on the debt and expenditure on unemployment benefits. The reference in the current fiscal framework to the annual reduction in the debt (one-twentieth of the difference between the current debt and the 60% of GDP target) would be dropped, as would the reference to a minimum reduction in the cyclically adjusted government deficit. The one new indicator would replace two, and hence in the Commission’s view constitute a simplification.

The primary expenditure target should ensure a plausible path for reducing the public debt towards the 60% of GDP target over 10 years. This does not imply that the debt will necessarily have reached its target after 10 years, but rather that it will be on a trend towards that at a pace deemed satisfactory.

Member States are to present the Commission with a “national medium-term fiscal and structural plan” consistent with their commitment to fiscal discipline. The primary expenditure target established in close coordination between the Member State and the Commission should therefore be consistent with the expenditure deemed necessary by both parties to ensure structural reforms and investments. The precise nature of these is not specified. The primary expenditure target could therefore differ from one country to another, in accordance with likely differences in their needs for reform and investment.

Primary expenditure in line with this fiscal discipline would be planned over a period of 3 to 4 years, engaging the State’s responsibility during this period. If unforeseen economic circumstances prevented the public debt from falling at the desired pace (the State’s commitment is accompanied by a growth scenario over the same horizon) or if the reforms and investments fail to produce the anticipated results, mainly economic growth, the adjustment in primary expenditure could be extended by up to 3 more years: the State would then have a maximum of 7 years to reduce its public debt towards the 60% of GDP target at a satisfactory pace. This would tend to greatly expand the notion of the medium term in the current version of the Stability and Growth Pact.

Since 2011, the European Union has equipped itself with instruments for monitoring macroeconomic imbalances (the overheating of wages, trade imbalances, excessive private debt, etc.), which have so far not been connected to the European fiscal framework. The Commission is proposing to integrate these into the framework. By better monitoring these imbalances, the Commission would adjust its recommendations for reforms and investments to ensure that the Member States enjoy sustainable growth and gradually reduce their debt.

Finally, the Commission is giving serious emphasis to the need for Member States to respect their commitments – the application of the Stability and Growth Pact has not always been very scrupulous – and for national bodies to more closely control these (in France, the High Council for Public Finances, the HCFP). These bodies would be responsible for organising a national debate on the relevance of the multiannual public finance assumptions made by governments.

So this is the reform project. What do we think of it?

First of all, the reform project, if adopted, would give the States greater manoeuvring room than in the current rules: reducing the debt more slowly, maintaining spending on unemployment benefits, and taking investments into account. There would be no immediate fiscal austerity.

However, adjusting primary expenditure over several years to ensure debt sustainability while taking account of the reforms and investments deemed necessary does not really seem much different from the situation prevailing today. Flexibility would be enshrined in the new draft whereas it is more a matter of improvisation in the current framework. But in practice how much does this really change? The States are by now used to modifying their fiscal policies to finance reforms and investments while ensuring their solvency. The hearings before France’s High Council on Public Finance are already supposed to stimulate the national debate on the short and medium-term orientation of public finances. On this point, too, it is rather difficult to see how the Commission’s proposal is innovative.

The *a priori* coherence between a potentially more flexible target for primary expenditure and the continuing need to meet the public deficit criterion is not self-evident. How much manoeuvring room will States with deficits in excess of 3% of GDP really have? They will definitely need to find new resources to reduce their deficit and maintain their primary expenditure capacity in order to finance reforms and investments. This is a major challenge, especially if macroeconomic conditionality is applied for the availability of EU funds (cohesion policy, funds from the Recovery and Resilience Facility of the Next Generation EU programme) when the public deficit is deemed excessive: the granting of EU funds may be suspended.

The major role played by the Commission in the proposed fiscal process is another significant factor. The Commission imposes the path for adjusting expenditure, and if the States fail to implement their fiscal plans and reforms on time, it may magnanimously grant them a little extra time to do so. And, in what is considered an intelligent proposal for sanctions[3], it plans to systematically require the finance ministers of countries that have not met their commitments to explain this before the European Parliament. In this fiscal process, should the role of Europe’s only democratic assembly really be limited to systematically humiliating those at fault? This provision does of course already exist, but it is not applied systematically. There are undoubtedly other ways of involving the European Parliament in the new fiscal framework.[4] But it is true that the Commission has a strong penchant for technocratic bodies, such as fiscal committees or high councils for public finance.

As for better integrating the tools for monitoring macroeconomic imbalances, the intention to ensure the overall coherence of the Commission's recommendations is laudable. It remains to be seen however whether countries that exceed the maximum threshold for their trade surplus – which is likely to happen again once energy costs have fallen – will actually implement the recommendations. Germany's governments have thus far never taken these into account.

Finally, there is something very mechanical in the vision of fiscal policy that this reform project conveys. Over a three- to four-year horizon, ministry officials will continue to do what they have been doing since the Stability and Growth Pact was first put into place, i.e. to calculate expenditure trajectories compatible with reducing the public debt. And, contrary to what the proposal tries to imply, the controversial notion of the output gap, i.e. the gap between unmeasurable potential GDP and actual GDP, has not disappeared from the European fiscal framework. It will remain crucial to separate the cyclically-adjusted deficit from the cyclical deficit, and the primary structural balance (the cyclically-adjusted government balance excluding interest charges) remains the benchmark for analysing debt sustainability.[5] Given the series of economic crises that we have been going through for the last 15 years and the rising debt they have generated, it is not clear that these exercises have been very useful.

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[1] See the forecast for the world economy [in French] recently conducted by the OFCE's Analysis and Forecasting Department.

[2] On the sustainability of the debt, see the special issue of the *Revue d'économie financière* from last month.

[3] The characterization as intelligent appears in column 3 of Figure 2 of the Commission Communication.

[4] This is the subject of my contribution to the aforementioned special issue of the *Revue d'économie financière*.

[5] See pp. 11-12 and p. 22 of the Commission Communication.

Europe/US: How has fiscal policy supported income?

By Christophe Blot, Magali Dauvin and Raul Sampognaro

The sharp fall in activity and its brutal social consequences have led governments and central banks to enact ambitious support measures to cushion the shock, which resulted in an unprecedented global recession in the first half of 2020, as discussed in Policy Brief 78 . Faced with a health crisis that is unprecedented in contemporary history, requiring forced shutdowns to curb the spread of the virus, governments have taken urgent measures to prevent the onset of an uncontrolled crisis that could permanently alter the economic trajectory. Three main types of measures have been taken: some aim to maintain consumer purchasing power in the face of the shutdowns; others seek to preserve the production system by targeting business; and some are specific to the health sector. The quarterly national accounts, available at the end of the first half of the year, provide an update on the extent to which the disposable income of private agents has been preserved by fiscal policy at this stage of the Covid-19 crisis [2].

Fiscal policy has shot up Americans' household income and preserved Europeans' income

In the major advanced economies, the Covid-19 crisis generated losses in primary income (before cash transfers) ranging from 81 billion pounds in the United Kingdom to 458 billion dollars in the United States (Table 1). The initial income shock was thus larger in Spain and Italy – 6.5 and 6.7 GDP points respectively – and smaller in Germany (3.4 GDP points) and the United States (2.1 GDP points).

Table 1. Initial estimation of the fall during the first six months of 2020 of total primary income related to the Covid-19 crisis

	ITA	ESP	FRA	GBR	DEU	USA
In billions	-120 €	-81€	-114€	-81 £	-116 €	-458 $
In 2019 GDP pts	-6.7	-6.5	-4.7	-3.7	-3.4	-2.1

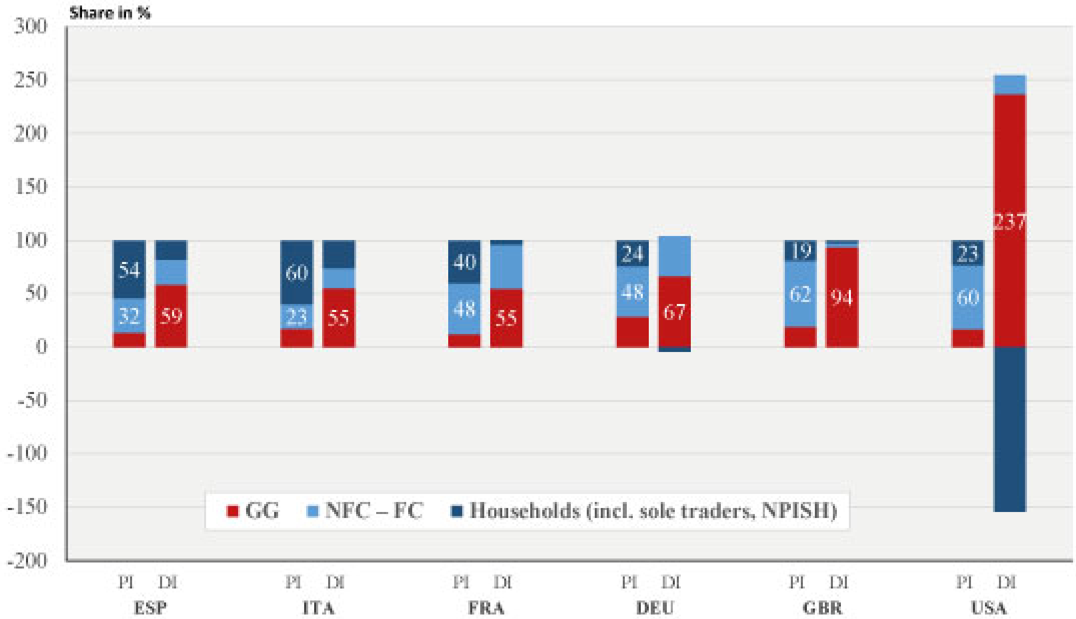
Note: At the end of the first six months of 2020, the Covid-19 crisis had led to a loss of 81 bn euros in primary income for the Spanish economy relative to the half-year 2019 average, corresponding to a loss of 6.5 GDP points.
Sources: National accounts, OFCE calculations.

Figure 1 breaks down the share of the primary income (PI) shock received by agents (first bar on the left for each country, labelled "PI"). In Spain and Italy, households suffered the majority of the losses, accounting for 54 percent and 60 percent, respectively, of the total income loss for the economy. In France and Germany, enterprises bore the lion's share of the income loss (48%). In the United Kingdom and the United States, enterprises incurred losses of £50 billion and $275 billion, respectively, accounting for 62% and 60% of the total loss for the economy. General government (GG) experienced a smaller shock in all the countries, which is explained by the spontaneous changes in some of the automatic stabilizers, and by a relatively lower value added due to the restrictions on activity during lockdowns.

Turning to the breakdown in losses in disposable income (DI), which takes into account cash transfers, social contributions, and income tax, the story is rather different. The implementation of emergency measures made it possible to absorb some of these losses, as illustrated by the bar labelled “DI” in Figure 1. The introduction of short-time working in European countries thus shifted the burden of wages from enterprises to the government, thus preserving household incomes and avoiding the termination of job contracts. Similarly, reductions in social contributions and tax on income and corporate profits have shifted the cost of the crisis from private agents to government. In the face of the unforeseeable shock, the State has thus played the role of insurer of last resort of private agent income, although to different extents in different countries. Thus, while Spain’s government absorbed 13.5 percent of the primary income shock, support measures raised this share to 59 percent, a higher level than that of Italy (55.3 percent) and France (54.3 percent) in terms of disposable income. In comparison, the measures taken by the German government absorbed a higher share of the shock, amounting to 67 percent of the loss of disposable income, compared with 28 percent of the fall in primary income.

In the United Kingdom, emergency measures absorbed the entirety of the shock. While business and households suffered primary income losses of £50 billion and £15 billion respectively, their disposable income fell by only £4 billion and £2 billion. As for disposable income, government absorbed 93.6 percent of the shock. The contrast is even more marked in Germany and the United States, where measures overcompensated the initial primary income shock, especially for households. The US figures are particularly impressive. Over the six-month period, primary income fell by $192 billion, while household disposable income rose by $576 billion, due in particular to the payment of a tax credit and an exceptional federal unemployment benefit of $600 per week that was paid to the unemployed, regardless of their initial income[3]. The various tax measures and subsidies to business reduced the loss by $210 billion. The US government thus absorbed 237 per cent of the shock, reflecting the magnitude of the support measures taken in March-April.

Figure 1. Share of the Covid-19 shock absorbed by each agent in the national accounts



PI : Primary Income; **DI** : Disposable Income.
Note: The share of losses in primary income resulting from the Covid-19 crisis in Italy suffered by private agents came to 83% (60% + 23%). Support from General Government, by compensating more than half of the losses in disposable income (55%) made it possible to ease the losses of households and business (100 – 55 = 45%).
Sources: National accounts, OFCE calculations.

Job losses and uncertainty about the future may hamper recovery across the Atlantic

As we have seen, fiscal policy has been mobilized massively across the Atlantic. Even if at this stage the macroeconomic shock has been weaker in the US than in the EU[4], the fiscal impulse is much larger. At the end of the first half-year, total transfers to households exceeded the immediate shock to their primary income. This has led to a 13% increase in the disposable income of US households, at the same time as their primary income fell by 4% in connection with job destruction. This situation is due in particular to a tax credit paid to households and an additional lump-sum allowance of $600 per week paid by the federal government to any person eligible for unemployment. Between Q4 of 2019 and Q2 of 2020, transfers to households leapt by 80%, now representing 31% of disposable income compared with 19% in 2019.

This difference in crisis management is undoubtedly explained by the weakness of the social safety net in the United States, which effectively reduces the role of automatic stabilizers while also limiting the ability of citizens with little or no health insurance coverage to meet health care expenses in the event of a fall in income. The use of counter-cyclical measures is thus of greater importance, which probably explains why the stimulus packages are more extensive than they were during the 2008-2009 crisis as well as why the measures provide direct, substantial support to household income. Moreover, in the US, the federal government is responsible for this stimulus, while in the EU, the bulk of the support plans come from the Member states.

The sharp rise in unemployment across the Atlantic – which peaked at 14.7% in April – contrasts with the situation in Europe, partly due to the differentiated strategy in economic policy. The United States carried out a positive, substantial transfer of income to households to offset the fall in wages resulting from job losses, which also helped to mitigate the shock on business margins. Conversely, in the main European economies, contractual employment relationships were maintained, but household incomes were not preserved quite as much – they actually fell slightly, except in Germany. In the main European economies, a decision was taken to use short-time working on a massive scale, while in the United States the response was to send cheques directly and immediately to households.

This situation, where income was propped up during a period when consumption was curtailed by the closure of non-essential shops, led to the accumulation of 76 billion euros in “Covid savings” in Germany (8 GDI points), 62 billion in France (9 GDI points) and 38 billion in Spain and Italy (10 and 6 GDI points respectively). In the United Kingdom and the United States, “Covid savings” were even greater: £89 billion in the UK (12 GDI points), while the sum reached $961 billion in the US (12 GDI points). How the epidemic develops and how these savings are used will be the two keys determining the extent of the rebound in activity starting in the second half of 2020.

This is precisely the moment when differences in approach can create divergences in economic trajectories. While it could be said that up to now household situations have been better preserved across the Atlantic, job contracts have been shredded. In this context, it may take some time to get the workforce back into employment, hindering the rapid redeployment of the production base. This could slow down the speed at which activity returns to normal, helping to keep job losses up and limiting the restoration of company balance sheets. Furthermore, negotiations between Democrats and Republicans in Congress have hit the wall of the approaching November 3 elections. If the measures taken during the crisis are not – at least partially – renewed, the situation of American households is likely to become more critical, since weak US social safety nets will not be able to mitigate what threatens to be a long-term shock. This may have second-round effects on primary income and investment [5]. Following the elections, further measures are likely to be taken, but the time lag could be long, especially if Joe Biden wins, as he will have to wait until he takes office in January 2021. Continued high uncertainty about the extent of the recovery – accentuated by political uncertainty – may encourage American households to avoid spending "Covid savings" in order to have "precautionary savings" to face a probable long-term health, economic and social crisis.

Glossary

Primary income (PI): Primary income includes revenue directly related to participation in the production process. The bulk of primary household income consists of wages, salaries and property income.

Gross disposable income (GDI): Income available to agents to consume or invest, after redistribution operations. This includes primary income plus social cash benefits and minus social contributions and taxes paid.

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[1] See "Evaluation de la pandémie de Covid-19 sur l'économie mondiale" [Evaluation of the Covid-19 pandemic on the world economy], *Revue de l'OFCE* no. 166 for an initial analysis of the various fiscal and monetary support measures implemented.

[2] These results should be taken with a grain of salt. While the quarterly national accounts are the most comprehensive, consistent framework available, with data collected by official statistics institutes, they are nevertheless provisional. These accounts are subject to significant revisions that may significantly alter the final results when they incorporate new data (company balance sheets, etc.); they are considered final within two years.

[3] This allowance is in addition to that paid by State-run unemployment insurance systems.

[4] The loss in 6-month GDP was 5% in the US, compared with 8.3% in the EU.

[5] F. Buera, R. Fattal-Jaef, H. Hopenhayn, A. Neumeyer, and J. Shin (2020), "The Economic Ripple Effects of COVID-19", *Working Paper*.

Europe’s recovery plan: Watch out for inconsistency!

by [Jérôme Creel] (OFCE & ESCP Business School) [1]

On 27 May, the European Commission proposed the creation of a new financial instrument, Next Generation EU, endowed with 750 billion euros. The plan rests on several pillars, and will notably be accompanied by a new scheme to promote the revival of activity in the countries hit hardest by the coronavirus crisis. It comes on top of the Pandemic Crisis Support adopted by the European Council in April 2020. A new programme called the Recovery and Resilience Facility will have firepower of 560 billion euros, roughly the same amount as the Pandemic Crisis Support. The Recovery and Resilience Facility stands out, however, for two reasons: first, by the fact that part of its budget will go to grants rather than loans; and second, by its much longer time horizon.

The Pandemic Crisis Support (and the complementary tools adopted at that time, see Creel, Ragot & Saraceno, 2020) consists exclusively of loans, and the net gains that the Member States could draw from them are by definition low: European loans

allow a reduction in interest charges for States subject to high interest rates
on the markets. The gain for Italy, which was hurt badly by the coronavirus
crisis, is in the range of 0.04 to 0.08% of its GDP (this is not a typo!).

Under the Recovery and Resilience Facility, the euro
zone Member States would share 193 billion euros in loans and 241 billion euros
in grants, or in total 78% of the amounts allocated (the rest will go to EU states
that are not euro zone members). The loans will generate small net gains for Member
States (savings on the infamous interest rate spreads), while the grants will lead
to larger gains, since they will not be subject to repayment, other than via higher
contributions between 2028 and 2058 to the European budget (if the EU's own funds
have not been created or increased by then). In the short term, in any case,
the grants received represent net gains for the beneficiaries: they will
neither need to issue debt nor pay interest charges on such debt.

Expressed as a percentage of 2019 GDP, the net
gains from grants are far from negligible (Table 1)[2]: 9 GDP points for Greece, 6 for Portugal, 5 for
Spain and 3.5 for Italy. This will be even more significant given the expected
fall in GDP in 2020. The determination of the Commission is therefore clear.

Despite all this, these grants are not intended to
be used in the short term. The European Commission purportedly wanted the

allocated amounts to be spent as quickly as possible, in 2021, 2022 and in any case before 2024. This is what it calls "front-loading": do not put off till the morrow what can be done today. Except that the key to the distribution of the grant expenditures over time is somewhat in contradiction with this principle (Table 2). The grant commitments would be concentrated in 2021 and 2022, but the actual disbursals are planned for later: less than a quarter by 2023, half in 2023 and 2024, and the remainder after that. This kind of gap is frequent: it takes a little time to design an investment project and to ensure that it complies with the European Commission's digital ambitions and low-carbon economy.

As a result, the grants to the Member States will take a little time to actually be disbursed (Table 3), and the countries facing the greatest difficulties will have to be resilient before receiving the stimulus and… resilience funds. This seems contradictory. It will take until 2022 in Greece and Portugal and 2023 in Spain and Italy to actually collect around 1 GDP point apiece. This corresponds to 3 billion euros for Greece, 2 billion for Portugal, and 14 for Spain and Italy, respectively. By way of comparison, Germany, France and the Netherlands will by then receive 5, 7 and 1 billion euros, respectively, i.e. between 0.2 and 0.3 percent of their GDPs.

One can imagine the cries of outrage from the representatives of the frugal countries (Austria, Denmark, the Netherlands, Sweden) that these immense outgoings reward countries that are not virtuous. They should be reassured: this is no boondoggle!

Table 1. **Net gains from various recent European programmes, expressed as a percent of 2019 GDP**

	Max gain from use of Pandemic Crisis Support, SURE and the BEI*	Max gain from use of the Recovery & Resilience Facility loans**	Max gain from use of Recovery & Resilence grants***
Belgium	0.02	0.00	1.02
Germany	0.00	0.00	0.63
Estonia	—	—	3.60
Ireland	0.02	0.00	0.35
Grece	0.08	0.16	9.45
Spain	0.05	0.04	4.96
France	0.02	0.00	1.33
Italy	0.08	0.06	3.57
Cypru	0.07	0.08	4.99
Latvia	—	—	7.14
Lithuania	—	—	5.75
Luxembourg	—	—	0.16
Malta	0.03	0.01	1.51
Netherlands	0.01	0.00	0.64
Austria	0.02	0.00	0.75
Portugal	0.04	0.06	6.12
Slovenia	0.04	0.03	3.53
Slovakia	0.03	0.04	6.46
Finland	0.01	0.00	0.91

Note: The order of the countries corresponds to that set by the European Commission.
**Source:* Creel, Ragot & Saraceno (2020).
** Calculation of the amount of loans per country by applying to the total amount of loans announced by the Recovery & Resilience Facility the distribution rule for transfers between countries as set out in the document COM(2020) 408 final/3 of 2 June 2020, page 2, then using spreads (the same as in Creel, Ragot & Saraceno, 2020) to deduce the net gain.
*** *Source:* COM(2020) 408 final/3 of 2 June 2020, page 2.

Table 2. **Temporal breakdown of loans and grants under the Recovery & Resilience Facility, expressed as a percent of their total respective amounts**

		2021	2022	2023	2024	2025	2026	2027	>2027
Loans	Signatures	49.5	50.5						
	Payments	14.8	27.5	25.0	22.5	10.1			
Grants	Commitments	39.3	40.1	10.2	10.4				
	Disbursal	5.9	15.8	23.4	26.0	17.7	7.7	3.1	0.5

Note: In 2021, 49.5% of loans will have been signed, versus 50.5% in 2022.
Source: COM(2020) 408 final 28 May 2020, Table p. 40.

Table 3. Schedule of disbursal of grants per country, expressed relative to the 2019 GDP of each country

	2021	2022	2023	2024	2025	2026	2027
Belgium	0.06	0.16	0.24	0.26	0.18	0.08	0.03
Germany	0.04	0.10	0.15	0.16	0.11	0.05	0.02
Estonia	0.21	0.57	0.84	0.94	0.64	0.28	0.11
Ireland	0.02	0.06	0.08	0.09	0.06	0.03	0.01
Grece	0.56	1.50	2.21	2.45	1.67	0.73	0.29
Spain	0.29	0.79	1.16	1.29	0.88	0.38	0.15
France	0.08	0.21	0.31	0.35	0.24	0.10	0.04
Italy	0.21	0.56	0.83	0.93	0.63	0.27	0.11
Cypru	0.29	0.79	1.16	1.30	0.88	0.38	0.15
Latvia	0.42	1.13	1.67	1.86	1.26	0.55	0.22
Lithuania	0.34	0.91	1.34	1.49	1.02	0.44	0.18
Luxembourg	0.01	0.03	0.04	0.04	0.03	0.01	0.00
Malta	0.09	0.24	0.35	0.39	0.27	0.12	0.05
Netherlands	0.04	0.10	0.15	0.17	0.11	0.05	0.02
Austria	0.04	0.12	0.18	0.20	0.13	0.06	0.02
Portugal	0.36	0.97	1.43	1.59	1.08	0.47	0.19
Slovenia	0.21	0.56	0.82	0.92	0.62	0.27	0.11
Slovakia	0.38	1.02	1.51	1.68	1.14	0.50	0.20
Finland	0.05	0.14	0.21	0.24	0.16	0.07	0.03

Note: The order of the countries corresponds to that set by the European Commission.
Sources: COM(2020) 408 final/3, 2 June 2020, p. 2; COM(2020) 408 final 28 May 2020, Table p. 40; author's calculations.

[1] This text appeared in the 23 May 2020 edition of Les Echos, without the tables.

[2] The rule for the distribution of transfers between countries appears in the document COM (2020) 408 final/3 of 2 June 2020. For each country it depends on the size of its population, on the inverse of GDP per capita compared to the EU-27 average, and on the difference between its 5-year unemployment rate and the EU-27 average. In order to avoid an excessive concentration of grants to a few countries, ad hoc limits are imposed based on these three criteria. Germany will for example receive 7% of

the transfers,
France 10%, and Spain and Italy 20%, respectively.

How to spend it: A proposal for a European Covid-19 recovery programme

Jérôme Creel, Mario Holzner, Francesco Saraceno, Andrew Watt and Jérôme Wittwer[1]

The Recovery Fund recently proposed by the EU Commission marks a sea-change in European integration. Yet it will not be enough to meet the challenges Europe faces. There has been much public debate about financing, but little about the sort of concrete projects that the EU should be putting public money into. We propose in Policy Brief n°72 a 10-year, €2tn investment programme focusing on public health, transport infrastructure and energy/decarbonisation.

The investment programme consists of two pillars. In a national pillar Member States – broadly as in the Commission proposal – would be allocated €500bn. Resources should be focused on the hardest-hit countries and front-loaded: we suggest over a three-year horizon.

The bulk of the money – €1.5tn – would be devoted to finance genuinely European projects, where there is an EU value added. We describe a series of flagship initiatives that the EU could launch in the fields of public health, transport infrastructure and energy/decarbonisation.

We call for a strengthened EU public health agency that invests in health-staff skills and then facilitates their flexible deployment in emergencies, and is tasked with ensuring supplies of vital medicines (Health4EU).

We present costed proposals for two ambitious transport initiatives: a dedicated European high-speed rail network, the Ultra-Rapid-Train, with four-routes cutting travel times between EU capitals and regions, and, alternatively, an integrated European Silk Road initiative that combines transport modes on the Chinese model.

In the area of energy/decarbonisation we seek to "electrify" the Green Deal. We call for funding to accelerate the realisation of a smart and integrated electricity grid for 100%-renewable energy transmission (e-highway), support for complementary battery and green-hydrogen projects, and a programme, modelled on the SURE initiative, to co-finance member-state decarbonisation and Just Transition policies.

The crisis induced by the pandemic, coming as it does on top of the financial and euro crises, poses a huge challenge. The response needs to take account of the longer-run structural challenges, and above all that of climate change. The European Union should rise to these challenges in the reform of an ambitious medium-run recovery programme, appropriately financed. An outline of such a programme is set out here by way of illustration, but many permutations and options are available to policymakers.

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Europe’s fiscal rules — up for debate

By Pierre Aldama and Jérôme Creel

At the euro zone summit in December 2018, the heads of state and government hit the brakes hard on the reform of fiscal governance: among the objectives assigned to the euro zone's common budget that they are wishing for, the function of economic stabilization has disappeared. This is unfortunate, since this function is the weak point of the fiscal rules being pursued by the Member States.

In a recent article, we assessed how governments use the fiscal tools at their disposal to respond to information about trends in the public debt or the economic cycle that is at their disposal when they make their budgetary decisions. Thus, instead of evaluating the properties of fiscal rules using data that may well be revised retrospectively, we evaluated them "in real time".[1]

Three main results emerged from our study. On the one hand, European governments ensure that their public debts are sustainable by improving their fiscal balance when the public debt increases. On the other hand, we found a trend towards fiscal consolidation at the bottom of the cycle in the euro area: fiscal policy is then rather destabilizing. Finally, euro area Member states have adopted a behaviour that was not found in the non-European countries in our sample: the euro zone Member states, unlike the others, continued to stabilize their public debts at the bottom of the cycle and during the crisis years. Thus the fiscal policy in the euro zone countries appears rather clearly to be untimely and inappropriate.

The results obtained as a whole for the euro area argue for a reform of Europe's fiscal rules, but not necessarily in the sense most commonly accepted. The issue of stabilizing the public debt does not seem to be essential in so far as this is already being taken care of by the fiscal policies being implemented. Rather, what is needed is to rebalance these fiscal policies in favour of macroeconomic stabilization, especially if no common mechanism – such as a euro zone budget – has been set up for this purpose. European fiscal policies need to be more flexible and less prescriptive, with a focus on the dynamics of macroeconomic stabilization. Since no progress is envisaged at the European level, national automatic stabilizers need to be reinforced, increasing tax progressivity and the responsiveness of social spending to changes in economic activity in order to deal with the next cyclical downturn, both individually and collectively.

[1] One of if not the first article that focuses on evaluating fiscal policy using "real-time" data is by Golinelli and Momigliano (Journal of Policy Modeling, 2006). This literature is summarized in Cimadomo (Journal of Economic Surveys, 2016).

The euro-isation of Europe

By Guillaume Sacriste, Paris 1-Sorbonne and Antoine Vauchez, CNRS and Paris 1-Sorbonne

In the latest article in *La Revue de l'OFCE (no. 165, 2019), accessible here in French*, the authors analyze the emergence of a new European government, that of the euro, built to a great extent on the margins of the EU's existing framework. In noting this, the article takes stock of a process of the transformation of Europe (the European Union and Member States), which we call here the "Euro-isation of Europe", in three dimensions: 1) the creation at its core of a powerful pole of Treasuries, central banks and national and European financial bureaucracies; 2) the consolidation of a European system of surveillance of the economic policies of the Member States; 3) the gradual re-hierarchisation of the political priorities and public policies of the European Union and the

Member States around the priority given to financial stability, balanced budgets and structural reforms. The article thus makes it possible to redefine the nature of the "constraints" that the management of the single currency is imposing on the economies of the Member States, constraints that are less legal than socio-political, less external and overarching than pervasive and diffuse, and ultimately closely linked to the key position now occupied by the transnational network of financial bureaucracies in defining European issues and policies.

The imperative of sustainability economic, social, environmental

OFCE[1], ECLM[2], IMK[3], AKW[4]

It was during the climax of the so-called Eurozone sovereign debt crisis that we engaged into the independent Annual Growth Survey – the project was first discussed at the end of the year 2011 and the first report was published in November 2011. Our aim, in collaboration with the S&D group at the European Parliament, has been to challenge and question the European Commission contribution to the European Semester, and to push it toward a more realistic macroeconomic policy, that is to say less focused on the short term reduction of public debt and more aware of the social consequences of the crisis and the austerity bias. For 7 years, we argued against a brutal austerity failing to deliver public debt control, we warned against the catastrophic risk of deflation. We also alerted on the social consequences of the deadly combination of economic crisis, increased labor market flexibility and austerity on inequalities, especially at the lower part of the income distribution. We cannot claim to have changed alone the policies of the Union, but we acknowledge some influence, although insufficient and too late to prevent the scars let by the crisis.

Today, there is a need to take this initiative a major step forward. The adoption of the UNSDGs calls for a new approach to economic governance and to economic growth. The measurement of economic performance needs to evolve into the measurement of well-being on all three accounts of sustainable development – economic, social and environmental. A broad range of policies have to be mobilized coherently to this effect, which must move fiscal policy from a dominant to an enabling and supportive role. Moreover, those policies need to be anchored on a consistent and inclusive long-term strategy, and should be monitored closely to check that they deliver sustainability.

So far, the EU has not properly embraced this agenda, and the still prevailing European Semester process is an inadequate process to lead the EU towards achieving the UNSDGs. In the same way as the iAGS challenged the dominant orthodoxy in the macroeconomic field, the iASES 2019 – independent Annual Sustainable Economy Survey, the new name of the iAGS – is our contribution to support a strategy towards sustainability and show the way.

The iASES 2019 scrutinizes the general outlook of the EU economy. The coming slowdown largely results from the gradual attenuation of the post-Great Recession recovery momentum and the convergence of growth rates towards a lower potential growth path. The slowdown of growth coincides with a revival of political turmoil – *Brexit*, Italy's public finances, the trade war and turbulences in some emerging countries. The upturn will come to an end at some point, and the euro area is not yet prepared for that, as imbalances persist and the institutional framework remains incomplete[5]. The euro area has moved into a large trade surplus, which may not be sustainable. Nominal convergence remains an important issue that should be addressed by political willingness to coordinate wage development more actively, beginning with surplus countries. Moreover, the incomplete adoption of a Banking Union may be insufficient to ensure banking stability in case of adverse shocks. The ECB could have to come to the rescue with extended unconventional policies, complemented with automatic stabilisation measures working across borders within EMU.

The social situation has slightly improved in the EU since the worse of the crisis and, on average, the unemployment rates across European countries are back at their pre-crisis levels. However, differences across countries and sections of the population are still huge. Policy makers need to be aware of possible trade-offs and synergies between economic, social and environmental goals in general and the Sustainable Development Goals (SDGs) in particular[6]. In line with the SDGs and intended goals of the European Pillar of Social rights iASES aims at promoting policies – expanding social investments, pro-active industrial policies, reducing working time, increasing collective bargaining to limit primary formation of inequalities – that address these goals and overcome the direct and indirect negative consequences of unemployment.

Climate change is arguably the most serious challenge that we collectively face. Computing carbon budgets can be useful to warn policy-makers about the effort to be delivered in order to put society on the road to environmental sustainability. The iASES evaluates the "climate debt" which is the amount of money that will have to be invested or paid by countries for them not to exceed their carbon budget, leading to three key policy insights. There are few years left for major European countries before exhausting their carbon budget under the +2°C target. Consequently, the carbon debt should be considered as one of the major issues of the decades to come since in the baseline scenario it represents about 50% of the EU GDP to stay below +2°C[7]. Framing the climate question in the words of debt is deliberate as the concept of excessive deficit applies today totally to the procrastination we demonstrate there.

[1] Directed by Xavier Timbeau with Guillaume Allègre, Christophe Blot, Jérôme Creel, Magali Dauvin, Bruno Ducoudré, Adeline Gueret, Lorenzo Kaaks, Paul Malliet, Hélène Périvier, Raul Sampognaro, Aurélien Saussay, Xavier Timbeau.

[2] Jon Nielsen, Andreas Gorud Christiansen.

[3] Peter Hohlfeld, Andrew Watt.

[4] Michael Ertl, Georg Feigl, Pia Kranawetter, Markus Marterbauer, Sepp Zuckerstätter.

[5] See « Some Challenges Ahead for the EU », *OFCE Policy Brief*, n°49, February 5,2019.

[6] See « Social Sustainability: From SDGs to Policies », *OFCE Policy Brief*, n° 50, February 5, 2019.

[7] See “An explorative evaluation of climate debt”, *OFCE Policy Brief*, n° 45, December 11, 2018.

Brexit: the November 25th agreement

By Catherine Mathieu and Henri Sterdyniak

The United Kingdom will leave the European Union on 29 March 2019 at midnight, two years after the UK government officially announced its wish to leave the EU. Negotiations with the EU-27 officially started in April 2017.

On 8 December 2017, the negotiators for the European Commission and the British government signed a joint report on the three points of the withdrawal agreement that the Commission considered to be a priority[1]: the rights of citizens, a financial settlement for the separation, and the absence of a border between Ireland and Northern Ireland. The European Council meeting of 14-15 December had accepted the British request for a transitional period, with the end set for 31 December 2020 (so as to coincide with the end of the programming of the current European budget). Thus, from March 2019 to the end of 2020, the United Kingdom will have to respect all the obligations of the single market (including the four freedoms and the competence of the European Court of Justice – CJEU), while no longer having a voice in Brussels. This agreement opened the second phase of negotiations.

These negotiations culminated on 14 November 2018 in a withdrawal agreement[2] (nearly 600 pages) and a political declaration on future relations between the EU-27 and the United Kingdom, which was finalized on 22 November 22 [3] (36 pages). The two texts were approved on 25 November at a special meeting of the European Council [4] (all 27 attending), which adopted three declarations on that occasion[5]. The withdrawal agreement and the political declaration must now be subject to the agreement of the European Parliament, which should not be a problem and, what is much more difficult, the British Parliament.

The withdrawal agreement corresponds to Article 50 of the Treaty on the Functioning of the European Union (TFEU). It is a precise international agreement, which has legal value; it must be enforced by the UK courts, under the authority of the CJEU as far as EU laws are concerned. It takes up the points already settled by the negotiations in December 2017: the rights of British citizens in EU countries and the rights of EU citizens in the UK; and the financial settlement. It has three protocols concerning Ireland, Cyprus and Gibraltar. Any disagreements on the interpretation of the agreement will be managed by a joint committee and, if necessary, by an arbitration tribunal. The latter will have to consult the CJEU if this involves a question that one of the parties considers to be relevant to EU law. In July 2020, a decision could be reached to extend the transition period beyond 31 December 2020: this would require a financial contribution from the UK.

A safeguard clause will be applied to avoid the re-establishment of a physical border between Northern Ireland and the Republic of Ireland (the “backstop”): the United Kingdom will remain a member of the Customs Union if no other agreement has been concluded before the end of the transition period, and for an indefinite period, until such an agreement is reached. This agreement must be approved by the joint committee. The Customs Union will cover all goods except fisheries (and aquaculture) products. The United Kingdom will not have the right to apply a trade policy that differs from that of the Union. British products will enter the single market freely, but the UK will align with EU rules on state aid, competition, labour law, social protection, the environment, climate change and taxation. In addition, Northern Ireland will continue to align with single market rules on VAT, excise duties, health rules, etc. Controls could be put in place on products entering Northern Ireland from the rest of the United Kingdom (in particular for agricultural products), but these controls would be carried out by the UK authorities.

Thus, trapped by the issue of the Irish border, the United Kingdom must forgo for an indefinite period any independent trade policy. It will have to align itself with European regulations in many areas, subject to the threat of recourse to the CJEU.

The 22 November Joint Political Declaration outlines the possible future relations between the UK and the EU-27. On the one hand, it clearly corresponds to the goal of the close, specific and balanced relationship that the British have demanded. On the other hand, the UK is making a number of commitments that rule out any possible strategy of being a "tax and regulatory haven".

Article 2, for instance, states that the two parties intend to maintain high standards for the protection of worker and consumer rights and the environment. Article 4 affirms respect for the integrity of the single market and the four freedoms for the EU-27, and for the United Kingdom the right to conduct an independent trade policy and to put an end to the free movement of persons.

In general, the Declaration states that both parties will seek to cooperate, to discuss, and to take concerted action; that the United Kingdom will be able to participate in Union programmes in the fields of culture, education, science, innovation, space, defense, etc., under conditions to be negotiated.

Article 17 announces the establishment of an ambitious, wide-ranging, comprehensive and balanced free trade agreement. Articles 20 to 28 proclaim the desire to create a free trade area for goods, through in-depth cooperation on customs and regulatory matters and provisions that will put all participants on an equal footing for open and fair competition. Customs duties (as well as border checks on rules on origin) will be avoided. The United Kingdom will strive to align with European rules in the relevant areas[6]. This kind of cooperation on technical and health standards will allow British products to enter the single market freely. In this context, the Declaration recalls the intention of the EU-27 and the UK to replace the Irish backstop with another device that ensures the integrity of the single market and the absence of a physical border in Ireland.

In terms of services and investment, the two parties are considering broad and ambitious trade liberalization agreements. Regulatory autonomy will be maintained, but this must be "transparent, efficient, compatible to the extent possible". Cooperation and mutual recognition agreements will be signed on services, in particular telecommunications, transport, business services and internet commerce. The free movement of capital and payments will be guaranteed. In financial matters, equivalence agreements will be negotiated; cooperation will be established in the domain of regulation and supervision. Intellectual property rights will be protected, in particular as regards protected geographical indications. Agreements will be signed on air, sea, and land transport and on energy and public procurement. The parties pledge to cooperate in the fight against climate change and on sustainable development, financial stability, and the fight against trade protectionism. Travel for tourism or scientific, educational or business motives will not be affected. An agreement on fisheries must be signed before 1 July 2020.

Provisions will have to cover state aid and standards on competition, labour law, social protection, the environment, climate change and taxation in order to ensure open and fair competition on a level playing field.

The text provides for coordination bodies at the technical, ministerial and parliamentary levels. Every six months, a high-level conference will review the agreement.

Negotiations will continue on trade so as to ensure compatibility between the integrity of the single market and the Customs Union and the UK's development of an independent trade policy.

On the one hand, the text provides for a close and special partnership, as requested by the United Kingdom; on the other hand, the UK pays for this by its commitment to respect European rules; finally, problematic issues still need to be negotiated, including fishing rights, an independent British trade policy, and avoiding the Irish backstop. On 25 November, the European Council wanted to adopt two declarations. The first emphasizes the importance of reaching an agreement on fisheries before the end of the transitional period and making it possible to maintain the access of EU-27 fishermen to British maritime waters. It also links the extension of the transitional period to compliance by the United Kingdom with its obligations under the Irish protocol. It recalls the conditions that the EU-27 had set on 20 March 2018 for an agreement: "The divergence in external tariffs and internal rules, as well as the absence of common institutions and a common legal system, require checks and balances and controls to safeguard the integrity of the EU single market and the UK market. Unfortunately, this will have negative economic consequences, particularly in the United Kingdom … A free trade agreement cannot offer the same advantages as the status of a Member State." The second Declaration states that Gibraltar will not be included in the future trade agreement negotiated between the UK and the EU-27; a separate agreement will be necessary and subject to Spain's prior approval. These declarations will not make it easy for Theresa May to win the approval of the UK Parliament.

It is necessary to highlight two points that were barely mentioned in the negotiations. This privileged partnership could serve as a model for relations with other countries. The EU has signed many customs union agreements with its neighbors, the countries of the European Economic Area (Norway, Iceland, Lichtenstein), as well as Switzerland, Ukraine, Georgia and Moldova. Five countries are candidates for entry (Albania, Montenegro, Serbia, Kosovo and Northern Macedonia). Perhaps these partnerships could be formalized in a third circle around the EU?

Does not the commitment to fair competition impose some level of tax harmonization in the EU-27, particularly with respect to the rates and terms of corporation tax? Was the EU-27 right to support the Irish Republic without some quid pro quo? It is unclear how the EU-27 could accuse the UK of practicing unfair competition when it tolerates the practices of Ireland, the Netherlands and Luxembourg. Likewise, the insistence on arrangements that prevent the UK from engaging in unfair tax and social competition contrasts with the EU's laxity both in its relations with third countries and in the control of the internal devaluation policies of certain member countries (e.g. Germany).

On balance, the United Kingdom gets to regain its national sovereignty, to cease being subject to the CJEU, and to no longer need to respect the freedom of establishment of workers from EU countries. In return, it will have no voice in Brussels.

The business community has welcomed the proposal as it avoids the risks of No Deal and announces a free trade agreement between the UK and the EU that would impose few restrictions on trade.

To date, there is no certainty that the UK parliament will approve the deal proposed by Theresa May and the EU-27 negotiators. Theresa May must find a majority for a compromise deal. She will encounter opposition from Conservative hard Brexiteers who are prepared to leave without an agreement so that the United Kingdom can "regain control", engage in trade negotiations with third countries, get out from under European regulations, and begin a policy of deregulation that would make the UK a tax and regulatory haven. But the UK is already one of the countries where the regulation of the goods and labor markets is the most flexible. A sharp cut in taxes would imply further cuts in social spending, contrary to the promises of the Conservative Party. And leaving with no deal would erect barriers to the UK's access to the single market for its products and services. Theresa May will clash with the Irish Unionist Party (DUP), which is opposed to any differences in the treatment of Northern Ireland, as well as with Scottish nationalists, who want Scotland to remain in the EU. She will also have to confront the Remainers (Conservatives, Labour and Liberal Democrats) who, buoyed by some recent polls, are calling for a new referendum. While Jeremy Corbyn is not calling into question the result of the referendum, many Labour MPs could vote against the text, even if they are supporters of a soft Brexit, as the Treaty organizes. They hope to provoke early elections that could allow them to return to power. They claim they will resume negotiations after that, making every effort to obtain a better deal for the United Kingdom, which would allow it to enjoy "the same advantages as at present as members of the Customs Union and the Single Market" and to control migration. But the EU-27 has clearly refused any resumption of negotiations, and some Labour forces want a new referendum … Theresa May's hope is that fear of a No deal will be strong enough to win approval for her compromise.

If, initially, Brexit seemed to weaken the EU, by showing that it was possible for a country leave, the EU has demonstrated its unity in the negotiations. It became clear quickly that leaving the EU was painful and expensive. The EU is a cage, more or less gilded, which it is difficult, if not impossible, to escape.

[1] See: *Joint report from the negotiators of the EU and the*

UK government on progress during phase 1 of negotiations under Article 50 on the UK's orderly withdrawal from the EU, 8 December 2017. See Catherine Mathieu and Henri Sterdyniak, "Brexit: Pulling off a success", *OFCE blog*, 6 December 2017.

[2] https://ec.europa.eu/commission/sites/beta-political/files/draft_withdrawal_agreement_0.pdf

[3] https://www.consilium.europa.eu/media/37059/20181121-cover-political-declaration.pdf

[4] https://www.consilium.europa.eu/media/37114/25-special-euco-final-conclusions-fr.pdf et

[5] https://www.consilium.europa.eu/media/37137/25-special-euco-statement-fr.pdf

[6] The vagueness is in the text: "The United Kingdom will consider aligning with Union rules in relevant areas".