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THE RETURN OF FISCAL POLICY: EUROZONE MACROECONOMIC GOVERNANCE AFTER COVID

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ABSTRACT

The paper traces the developments of policies and institutions for the EMU in the past decades, linking them to evolutions of the consensus in macroeconomics. The EMU institutions were designed in the 1990s, when the consensus posited a very limited role for the government in business cycles regulation and in fostering growth. Accordingly, the burden of adjustment in the EMU in its current form is on market forces. The paper shows how the global financial crisis moved the cursor back towards an increased role for macroeconomic (most notably fiscal) policy; nevertheless, during the sovereign debt crisis Europe has been impervious to empirical and theoretical developments, remaining tangled in self-defeating austerity policies. The Covid crisis marked a turning point, with EU governments and institutions reacting boldly and quickly. The paper concludes investigating possible paths for reform, capable of adapting the European institutions to the newfound centrality of macroeconomic policies.

Keywords: EMU Reform, Global Financial Crisis, Surrogate Federalism, Debate in Macroeconomics.
JEL Codes: B22, E63, E65, F45, N1.

The swift reaction of European policy makers to the Covid-19 crisis surprised the many who had previously been critical of the timidity and mistakes in the management of the sovereign debt crisis. Both national governments and European institutions reacted promptly to the pandemic wave; although they could not avoid a crisis whose dimensions made the 2007-2008 global financial crisis pale by comparison, the governments' titanic effort managed to mitigate its impact on incomes and employment.

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But it is precisely the extraordinary dimension of the crisis that prompts the question of whether the activism of economic policy denoted a change in the mindset of European governments and institutions, or simply was the only option available to policymakers to avoid the collapse of the economy. This article attempts to answer this question and, based on the answer, tries to formulate hypotheses on the outcome of the many reform yards that have been opened in the recent past.

After analysing the theoretical foundations on which rests the European construction in its current form, I will point out that the 2008 crisis shook up this doctrinal framework, making possible an in-depth rethinking of the role of the State in the economy. A rethinking, however, that in Europe did not have an impact on the management of the sovereign debt crisis. The rethinking of macroeconomics has undermined the previous consensus, but a new one has not emerged yet (if ever it will). The Covid crisis thus comes at a time of theoretical uncertainty, when there is no dominant paradigm; and contrary to the early 2010s, this time the European debate is lively: the voices preaching a return to the pre-crisis status quo are today minoritarian, but certainly not powerless. Whether the changes in the policymakers' attitude and the discussions of the past months will eventually evolve into a more functional institutional architecture than the current one is an open question. The article concludes by reviewing the main areas of reform for the EU and particularly for the eurozone.

1. Ideas and institutions: From the end of Keynesian domination to the single currency

The institutions that were put in place with the Maastricht Treaty were not born in vacuum but were strongly influenced by the macroeconomic consensus that emerged from the struggle of ideas of the post Second World War period.[1] The three decades that followed the Second World War were dominated by the Keynesian theory. The publication of the *General Theory* in 1936 inaugurated a long phase during which economic policy was inspired by the idea that markets and public authorities, both imperfect institutions, interacted to determine growth, employment, and income distribution. Keynes rejected the main result of the pre-1929 neoclassical model, namely that markets could spontaneously attain the full employment equilibrium. The essence of economic policy was, according to the British economist, a continuous fine tuning to compensate, without claim-

[1] The interested reader can refer for details to Saraceno (2017a; 2018).

ing to replace them, for markets' inefficiencies and imperfections, to ensure macroeconomic stability and long-term viability. It is this insistence on the complementarity between the State and the market, and not the caricatural emphasis on public spending (which often unites partisans and detractors of the Cambridge economist), that constitutes the essence of the Keynesian theoretical system.

The State in Keynesian economic theory and policy had a dual role: short-term cyclical regulation, aimed at sustaining economic activity in periods of slowdown (or cooling it down in case of overheating) using fiscal and monetary policies; and more structurally, interventions aimed at increasing the 'resilience' of the economy, its ability to absorb macroeconomic shocks, and to achieve acceptable equilibria from the point of view of economic efficiency. In addition to social justice criteria, the very development and consolidation of welfare systems in the 1940s and 1950s also responded to this need: universal access to health and education, automatic stabilisers such as unemployment benefits, and (last but not least) equitable income distribution, all contributed to increasing the capacity for automatic stabilisation on the one hand, and on the other to increasing what economists clumsily call 'human capital' and therefore the economy's growth potential.

The crisis of Keynesian economics in the 1970s opened a new phase. The monetarist critique, and shortly thereafter the rational expectations revolution (associated with the names of Milton Friedman and Robert Lucas respectively) refocused the analysis on the existence of a natural equilibrium, to which the economy tends if unhampered. Rational agents react to macroeconomic policy shocks (be it monetary of fiscal) in order to attain the natural equilibrium as quickly as possible, thus making government intervention irrelevant if not harmful in the medium run (and in the case of rational expectations and of Real Business Cycle models also over shorter time horizons). From the 1980s onwards, the mainstream consensus evolves towards a less extreme framework in which nevertheless the notion of natural equilibrium remains central. True, the existence of rigidities can lead to deviations from the natural equilibrium that nevertheless cannot be persistent as they will eventually exert pressure on prices that will bring the economy back to its attractor.

For the new consensus, therefore, the State has a limited role. As in the old pre-Keynesian model, structural reforms are the main policy tool: curbing monopolies (both in goods and in labour markets), reducing the weight of the State in the economy, avoiding informational asymmetries, eliminating price and wage rigidities, should make it possible to remove the frictions that on the one hand hinder potential growth, and on the other hand amplify the magnitude of cyclical fluctuations. In this context, discretionary macroeconomic policies are not particularly appropriate; on the contrary, governments should follow clear and predictable policy rules, to reduce uncertainty and allow markets to converge more quickly to their natural equilibrium. It is therefore clear that the new consensus is in fact close to the pre-Keynesian neoclassical theory: macroeconomic policy is only effective in the short run, and only if it remains predictable thus not disturbing the normal functioning of markets whose efficiency is the main pillar of the theory. The persistent deficiencies in aggregate demand that were central to Keynes' analysis are marginal in the mainstream that emerged in the 1990s and dominated the policy landscape until at least the global financial crisis of 2008.

It was in this context that the Maastricht Treaty of 1992 laid down the rules of the game for the eurozone, from the criteria for adopting the single currency to the statute of the European Central Bank (ECB). In 1997, the Treaty of Amsterdam completed the institutional framework with the Stability and Growth Pact, which laid down the rules of conduct for the euro area member countries' fiscal policy. In accordance with the consensus, the main objective of the Stability Pact is to limit fiscal policy to the operation of automatic stabilisers. The structural (i.e., independent of cyclical factors) budget must be balanced. The Fiscal Compact, hastily approved in 2012 during the Greek debt crisis, adds to this rule the constraint of reducing public debt whenever this is above the 60% level set by the Maastricht Treaty.

Monetary policy is also consistent with the consensus' conceptual framework, as the ECB is only given a price stability mandate, which it can pursue with considerable independence. The difference with the US Federal Reserve is striking: the statute of the latter, which dates to the 1970s (when Keynesian economics still dominated the policy landscape) gives it a 'dual mandate' of pursuing price stability and full employment.

Last, but not least, the Single Act of 1986 brought to completion what had been a pillar of the European Union since the Treaty of Rome in 1957, competition policy, aimed at curbing all forms of market power, and in so doing eliminating rigidities that prevent markets from converging towards the optimal equilibrium. The interpretation that the European Commission and the European authorities have given to competition policy, and the rather rigid definition of "state aids" (forbidden by the Treaties as they hamper competition), have in fact prevented Member States from implementing coherent industrial policies and long-term economic planning.

It is therefore no coincidence that even before the 2008 crisis, the constant emphasis on reducing public deficits and debt as a precondition for 'market-driven' growth was accompanied by a much timider monetary policy than that of the United States, continued emphasis on the need to reform the economies of the old continent and the total absence of long-term planning and industrial policies.

The Consensus was not a European peculiarity, but the pressure to reduce the role of the State in the economy was particularly strong in the EU. The perimeter of the welfare state has over time been slowly but pervasively reduced, the role of automatic stabilisers undermined (somewhat inconsistently with the Stability Pact emphasis on their importance in absorbing business cycle fluctuations), and the cyclical regulation of the economy through macroeconomic policies sacrificed on the altar of 'market flexibility'. The elimination of fiscal policy from the policy makers' toolbox has particularly affected public investment, an expenditure item politically less sensitive than other items of public expenditure that is as crucial for long-term growth as it is 'invisible' to the public.[2]

2. Rethinking macroeconomics after the 2008 crisis

The global financial crisis of 2008 shook the certainties that fed the consensus. The persistence of the recession showed the inconsistency of the claim that markets can quickly return to natural equilibrium following a shock. In 2008 and 2009, in adherence to the old Keynesian theory, monetary policy and then fiscal policy were called to the rescue of an economy that seemed unable to recover on its own. It is true that the Keynesian experiment was short-lived and that, especially in Europe, there was a rapid return to the fiscal discipline advocated by the new consensus. Nevertheless, economists and policy makers began to question the old recipes and in general the solidity of the foundations of the new consensus itself. After more than thirty years of emphasis on the supremacy of markets in guaranteeing the optimal allocation of resources and fostering innovation and growth, a wide-ranging debate has begun, and still goes on, on the need to re-assess the role of the government in managing business cycles, in regulating markets and in correcting their inefficiencies. The discussion spares no dogma of the consensus, from industrial policy to income distribution, from capital controls to trade barriers, from taxation to the role and nature of structural reforms, from monetary policy in a framework of secular stagnation and low rates to the link between cyclical fluctuations and long term growth. For the debate on European macroeconomic gov-

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[2] See the essays collected in Cerniglia and Saraceno (2020) and Cerniglia *et al.* (2021).

ernance it seems particularly relevant the reassessment of fiscal policy, that was previously relegated to a marginal role but in the past decade turned out to be pivotal for macroeconomic stabilisation, among other things because monetary policy has been constrained by the zero lower bound, limiting the central bank's capacity to stimulate economic growth.[3] In this context, empirical research on public investment and its impact on growth and employment in the short and long term was lively for a decade and became pervasive with the Covid pandemic. The academic literature so far has just taken stock of the overwhelming empirical evidence against the "natural equilibrium consensus"; this evidence has helped policy makers embrace pragmatism and experiment with different recipes (not everywhere! See the next session) but, as were to be expected, has not yet triggered the emergence of a new consensus: the construction of a new theoretical framework necessarily needs longer horizons than the urgency of policy responses to the crisis.

To sum up, after the years of 'market fundamentalism', the profession now seems to have returned, albeit in a confused and non-systematic way, to a broadly Keynesian conception of economic policy: an adaptive process in which, instead of delegating to supposedly efficient markets the task of converging to the best of all possible worlds, policy makers must attempt to guarantee the macroeconomic stability which facilitates investment and accumulation of knowledge and human capital, and thus stable long-term growth.

3. The eurozone impervious to change: The sovereign debt crisis

For a long time, the rethinking macroeconomics debate had little echo in the European policy arena. On the contrary, since 2010 the eurozone crisis has been interpreted as an "apologue of fiscal sinners", a crisis due to the indiscipline and inefficiency of the governments of some Mediterranean countries.[4] The austerity season of the early 2010s was a by-product of this narrative. The institutional reforms that between 2011 and 2014 followed the sovereign debt crisis (the Fiscal Compact, the Six-Pack and Two-Pack sets of regulations, the ESM, the banking union) are also con-

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[3] In 2013, the IMF issued a *mea culpa* on the size of multipliers. The crisis had shown that their value was much higher than estimated by the pre-crisis models used as a justification for European austerity programmes (Blanchard and Leigh 2013). On the policy mix see the recent report published by CEPR (Bartsch et al. 2020).

[4] The interested reader can refer to Saraceno (2020), which traces the history of the single currency and the unfortunate season of austerity.

sistent with the apologue of fiscal sinners: taken together, these reforms reinforce control over national fiscal policies and perpetuate the idea that structural reforms and market flexibility at the country level ('risk reduction') are in fact the main driver of convergence. To be fair, many, starting with the then ECB President Mario Draghi, have since 2014 called for more activism in fiscal policies and for a revival of public investment and domestic demand. However, these calls were carefully framed to emphasize the priority to be given to fiscal discipline (only countries with 'fiscal space', defined as the respect of the Stability Pact, were supposed to implement expansionary policies); in addition, these voices remained largely unheard. One of the cornerstones of the new consensus, the separation between the natural equilibrium, determined by structural, supply-side factors, and the short-term fluctuations around it, was the last line of defence of austerity: sure, it was argued, the adjustment imposed on the eurozone periphery had prolonged the recession, further increasing unemployment and poverty, and deepening the gap between the rich and the poor; but this was just a bitter (but necessary) medicine to be taken in the short run in order to boost growth in the long run. The empirical literature inspired by the EMU crisis has shown the fallacy of this argument: prolonged recessions lead to a deterioration of the economy's (physical and human) capital, and thus of its ability to grow in the long run (hysteresis).[5] An increasing number of macroeconomists believes today that it is better to err on the "too much" side in supporting the economy during a downturn, than to let it slide in a long period of subdued growth that permanently hampers the growth potential.

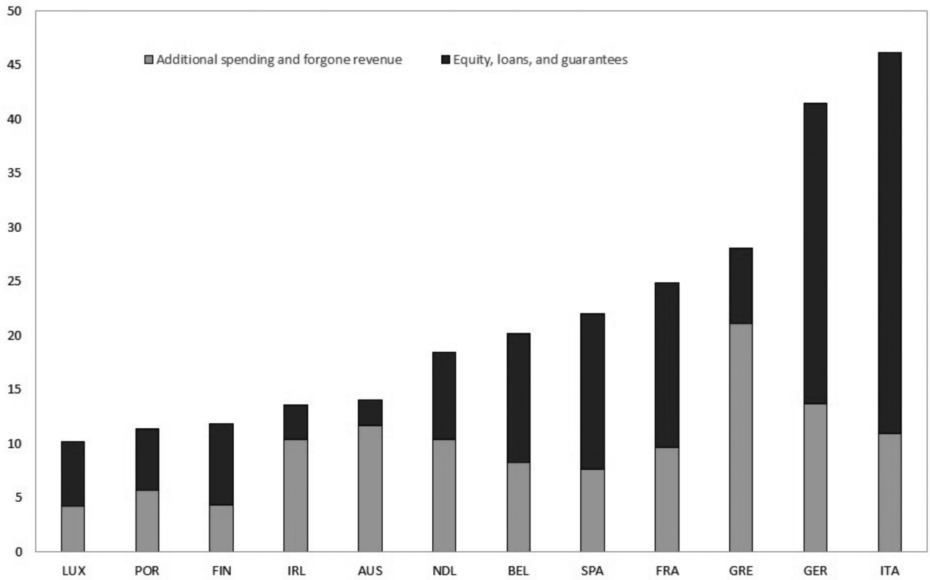
4. The Covid storm

The spring of 2020 has come to reshuffle the cards. The mistakes of previous years seem to have prompted European policymakers to act quickly and well. The first dam against the pandemic wave has been erected by the governments of the member countries, which was inevitable in the absence of a European federal government. In addition, to cope with the health emergency, Member States have injected resources into the economy to support businesses' liquidity, to limit the fall in labour income, and to provide guarantees aimed at keeping credit flowing to the productive sector (Fig. 1) In almost all European countries, the measures were extended and renewed as the economic effects of the pandemic unfolded; they are

[5] See, for example, Fatás and Summers (2018).

being withdrawn as we write (November 2021). The effect of these measures on public finances was immediate; debt and deficits exploded, and in most EU countries they will continue to rise in 2021. This colossal effort by European governments has borne fruit, however, and everywhere incomes and employment have fallen significantly less than GDP.

Fig. 1. *Discretionary Fiscal Response, EMU 12 Countries (% of GDP).*



Source: IMF Database of Fiscal Measures in response to Covid-19 (July 2021).

During the first response phase European institutions acted as guarantors of the member countries' efforts. The ECB opened a protective umbrella by launching a vast programme of government bond purchases (the *Pandemic emergency purchase programme*, PEPP), which in December 2020 was extended until the spring of 2022. This helped to reduce interest rates (already low due to the huge amount of savings available following the lockdowns and the drop of consumption and investment), making debt more sustainable. The European institutions also made loans available to Member States for the most urgent expenses, on health and the contrast to the pandemics as well as for the support to labour market. Whether it was the adaptation of an existing mechanism like the €240 billion ESM pandemic line, or a newly created instrument, like the €100 billion *European instrument for temporary Support to mitigate Unemployment Risks in an Emer-*

gency (SURE), the principle was the same: Europe borrows at favourable rates and transfers the funds to member countries, which can therefore save on interest expenses. If the ESM pandemic line did not take off, SURE was highly demanded and in autumn 2020 it started lending, reaching €90 billion to 19 countries by the summer 2021. The Commission further signalled its intention to support member countries' efforts by activating the suspension clause of the Stability Pact (it will not be reinstated until 2023) and easing state aid rules so as not to hamper countries' efforts to support the sectors most affected by the pandemic. Table 1 resumes the emergency response to the pandemics.

Tab. 1. *Emergency Response to the Covid-19 Shock*

Member countries	Fiscal Stimulus: spending foregone revenues, equity, loans guarantees		
Europe	ECB	PEPP (€1850bn) – until March 2022	
	European Commission	SGP suspension clause – until December 2022	
		State Aid rules softened	
		Financial Assistance	SURE (€100 bn)
			ESM Pandemic Line (up to 2% of GDP)
			Emergency support (€37 bn)
	EIB	European Guarantee Fund for SMEs (up to €200 bn)	

If Europe's role in the short term could only be limited to support member countries (as was done quite effectively), things change if we look beyond the emergency. As we are putting the crisis behind us, we must tackle the challenges that the pandemic will inevitably leave behind. This means providing the 'global public goods' that are essential for a strong recovery in the long term, such as the transition to sustainable growth, the revival of public investment, digitalisation, and the rethinking of our welfare systems. Not even the largest European countries can hope to meet these challenges alone: the greater effectiveness of coordinated investment, economies of scale, and externalities are all factors that militate in favour of policies conducted, or at least financed and coordinated, at a common level.

The global challenges have inspired the *Next Generation EU* (NGEU) program, which supplements the €1 trillion 2021-2028 European budget with the *Recovery and Resilience Facility* (RRF) and other extraordinary mechanisms, for a total of €750 billion (Tab. 2). There has been much discussion about the innovative aspects of the instrument: it is the first time that the Commission issues debt for such significant amounts, to finance a vast investment programme that should reconcile the exit from the Covid crisis with the Union's long-term programmes (green growth, digitalisation, social cohesion). In addition, resources are allocated to Member States not according to the usual keys, but according to the needs linked to the costs of the pandemic and to the severity of the crisis; this creates some sort of transfer among countries (risk sharing) that had so far been fiercely opposed by Germany and other so-called 'frugal' countries. Debt will be repaid starting in 2028 (until 2058), hopefully with European resources such as a Carbon border tax. If no progress is made on this side, each country's contribution to the EU budget will have to increase (of quite a modest amount). It has been pointed out by many that Italy, usually a net contributor to the budget, will be a net beneficiary of the Recovery and Resilience Facility.

Tab. 2. *Next Generation EU Breakdown*

Recovery and Resilience Facility (RRF)	673
of which, loans	*359*
of which, grants	*314*
ReactEU	47
Horizon Europe	5
InvestEU	6
Rural Development	8
Just Transition Funds (JTF)	10
RescEU	2
TOTAL	750

There is little doubt, therefore, that we are in the presence of a radical change: for the first time in its history, the Union is making a joint effort to boost recovery and growth, and the principle of an albeit temporary debt mutualisation has been accepted. What makes the agreement even more significant is the position of Germany, which has never agreed to introduce elements of risk sharing and which, this time, has put its full weight behind the Commission's initiative from the outset. Nevertheless, the enthusiasm of those who speak of a Hamiltonian moment, of a founding act for a federal Europe, is not entirely justified, as we are still very far from a genuine federal fiscal capacity. Meanwhile, Germany's historic green light was conditioned by the one-off nature of the NGEU, which does not take over existing debts (contrary to what the US Treasury did with Alexander Hamilton, for the debt of the American states after the War of Independence). Moreover, only the plastic tax is now a reality; for all the other 'federal' taxes that would make it possible to avoid an increase in the contributions of the Member States to the European budget, the consensus is still far from being achieved. Finally, the Facility operates by transferring resources for investment programmes that will nevertheless remain national, as the Union does not currently have a spending capacity comparable to that of a federal State. Therefore, a truly European investment program is very far from being reality yet. On the contrary, during the negotiations for the Next Generation EU, the so-called 'frugal' countries erected barricades against common policies and eventually gave in only in exchange for significant financial concessions. Even more problematic was the demand to reduce funding for genuinely European public goods such as education, the *Invest Europe* programme and health. For example, the proposal for an embryonic health union (the *EU4Health* programme was saved, albeit with a major downsizing, thanks to early intervention by Parliament) has borne the brunt of struggles between States concerned about paying as little as possible.[6] Beyond the quantitative aspects, the message that emerges is that of a downsizing of the Union's commitment to the provision of the few genuinely European public goods. In a sort of institutional schizophrenia, while with the NGEU the EU launched an ambitious programme to meet the challenges of the 21st century, an opportunity was missed to direct the EU's ordinary instruments towards the same goals. Lastly, the question of conditionality is not yet resolved. It was legitimate, indeed necessary, for there to be constraints on the allocation of funds, precisely because of the principle that NGEU is a joint effort aimed at common goals. Member countries had to prepare Recovery and Resilience programs that were approved by the Council; funding will be granted after the Commission has verified respect of the milestones and compliance with the requirements, which will ensure that the overall consistency of national plans is attained. Nevertheless, because of the insistence of the 'frugals', the agreement includes the need to verify the conformity of the plans with the annual recommendations that the Commission addresses to Member States (the country-specific recommendations). These recommendations are often very specific about the economic policy of European countries, containing calls for controversial structural reforms. In this way the economic policy

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6 On the need for the EU to be more ambitious on health, see Creel, Saraceno and Wittwer (2021).

of the Member States could be heavily influenced. It would be unreasonable to link access to funding to macroeconomic adjustment programs that would have no justification other than to perpetuate a concept of "permanent austerity" that still has too many partisans in Europe, despite the disastrous handling of the sovereign debt crisis.

However, highlighting the grey areas of the Next Generation EU should not lead to neglect its innovative aspect, nor to forget that Europe has been effective in the face of the pandemic, supporting member countries in their emergency effort and launching a common programme to govern recovery in the medium term.

5. The reforms wards: Towards a surrogate federalism

Following the global financial crisis, the slider between the State and the market has shifted back towards the centre: many economists today have no problem recognising a role in macroeconomic stabilization for monetary and (especially) fiscal policies. In fact, the first twenty years of the single currency and the sovereign debt crisis have shown that markets cannot be relied upon for absorbing macroeconomic shocks and ensure long-term convergence. On the contrary, they sometimes row in the wrong direction: destabilising capital flows, deepening structural differences among the members of the eurozone, increasing asymmetry of shocks. Therefore, no matter how hard individual countries may push the reform effort, exclusive reliance on markets will necessarily be unwarranted: part of the burden of adjustment following whatever exogenous shock may hit the economy must necessarily fall on the shoulders of public policies. Even in the United States, a monetary union characterized by strong flexibility and factors' mobility, macroeconomic policies play a central role not only during crises but also in normal times.[7] The coronavirus crisis makes it even more evident that only real mutual insurance mechanisms, typical of a federal budget, could make it possible to guarantee stability and growth by operating alongside (and sometimes in place of) market adjustments. Of course, the federal budget cannot exist without a federal State, and it is obvious that the United States of Europe is today little more than a chimera. Yet, the existence of an ideal solution, however utopian is useful to find one's bearings in the thicket of concrete and politically feasible measures and reform proposals under discussion today. Any institutional change that acts as a surrogate for a properly federal structure must, in my opinion, be encouraged.

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[7] See Alcidi, D'Imperio and Thirion (2017).

At least three reform axes can be identified, against which European ambitions will be measured in the coming years: the first one is to provide the eurozone with some kind of automatic risk-sharing instruments. In other words, if we are too far from a real common fiscal capacity, we should design mechanisms able to replicate the business cycle-related transfers between regions that allow convergence in a federal State. The second axis of reform should make it possible to strengthen the capacity of markets to absorb asymmetric shocks. Lastly, the third area of reform should involve revising fiscal rules so that the member countries, which are deprived of an autonomous monetary policy, can at least use fiscal policy to counter economic fluctuations and support growth in the long term. In short, it is a question of supporting the only 'federal' institution, the ECB, with renewed national and common fiscal instruments, relieving it of some of the burden it has so far had to carry alone.

The Next Generation EU programme could be an embryo of a European fiscal capacity. Hopefully European countries will be able to use the Recovery and Resilience Facility to revive the economy, channel the resources efficiently into a green transition that can no longer be postponed and transform the Union into the most dynamic knowledge-based economy in the world (one of the objectives of the Lisbon Treaty that so far remained unattained). Only the success of the NGEU package could pave the way for a discussion on the next step, the creation of a permanent fiscal capacity. It would not be the first time that temporary instruments have acted as icebreakers and led to innovations in European governance. The Recovery Mechanism possesses (albeit at an embryonic stage) the characteristics of a federal-type ministry of finance: its own borrowing capacity, a (prospective) ability to finance itself from its own resources, an allocation of funding that combines the needs of individual countries with the pursuit of common goals such as ecological transition and digitalisation. Speculative attacks on sovereign debt, and the risk of free riding by national governments, so feared by the 'frugals', would be greatly reduced if the EU were to equip itself with such an instrument.

However, for the Next Generation EU to become a Hamiltonian moment, a founding moment for the creation of a federal fiscal capacity, much remains to be done. First of all, a political consensus needs to be found on the creation of own financial resources. As we write (November 2021), the only one on which agreement has been reached is the plastic tax, while there is no agreement on the taxation of multinationals[8] and the border

[8] In July 2021 OECD countries reached an agreement on a minimum corporate tax rate that represents an important step forward. Nevertheless, the agreement is the result of a com-

carbon tax. Secondly, the member countries should in future agree on the revival of investment in genuinely European public goods.[9] Last, but not least, the challenge for Europe and Italy will be to manage to channel resources into effective projects, according to a coherent project and, above all, by increasing spending capacity to respect the timeline given by the Commission. If the funds are used efficiently, if common resources and investment projects are worked on, if investments and reforms are made in those intangible resources (reorganisation of the public administration, justice, regulation) that currently slow down rather than stimulate growth, it will be possible at that point, and only at that point, to legitimately put on the European tables the project to transform the Recovery and Resilience Facility into a common fiscal capacity.

While waiting for the possible success of Next Generation EU to open political space for a common fiscal capacity, there is an urgent need to reorganise the Union's financial assistance functions, which over time have become increasingly 'blurred' and often confused. A recent Delors institute policy brief starts from the observation that the Covid crisis has created a political demand for solidarity and stabilisation mechanisms; it proposes to repatriate the ESM (now a sovereign bank governed by an intergovernmental treaty among eurozone countries) within the EU perimeter and consolidate it with the plethora of other existing assistance instruments: the SURE, the loan quota of the Recovery and Resilience Facility, the Bank Resolution Fund, the Balance of Payments Support Fund. These would all converge into a single facility capable of offering credit lines differentiated by purpose and access conditions. The ESM itself could then evolve into a debt agency to coordinate, and in the case of common projects such as the Next Generation EU, mutualise national debts. Among other things, it could become the issuer of the safe assets that would enable better management of European debt.[10]

In addition to reorganising financial assistance, the Union should equip itself with instruments that function as automatic stabilisers in the event of asymmetric shocks. One of the many possible tools is the European unemployment benefit, which has been discussed since the 1990s at least.[11] The unemployment benefit could be designed in different ways. The idea that is common to all proposals (among which one by the European Com-

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promise and is largely insufficient for a significant reduction of tax elusion. Furthermore, it does not seem to pave the way for a harmonization at the EU level that would be needed as a first step in order to have a common (possibly federal) corporate tax.

[9] See Creel *et al*. (2020).

[10] See Guttenberg (2020) and, on a EU safe asset, Amato *et al*. (2021) and Amato and Saraceno (forthcoming).

[11] See, among the many works devoted to the proposal, Andor (2016).

mission, in 2013) is that the European subsidy would be additional to the national ones in case of large deviations of the unemployment rate from a country-specific reference value. Therefore, it would be a contingent scheme, which would intervene only in the event of significant shocks and would be additional to, and not a substitute for, national benefits. This feature is obviously crucial in a non-federal system because it would leave to the social contract of each country the choice of how much and how long to protect workers from unemployment. No country would be able to take advantage of the scheme to abolish or reduce the level of its benefits and replace them with the European one. Attempts to simulate the stabilisation capacity of such a mechanism reach two conclusions: first, the effect in terms of GDP stabilisation at the European level would be limited, which is not surprising since the mechanism is specifically designed to absorb asymmetric shocks; second, as it should be, the stabilisation capacity increases with the severity of the shock. The European unemployment benefit could be designed in such a way that it does not lead to permanent transfers. The contingent scheme, designed to absorb asymmetric shocks, could then be complemented by a permanent version of SURE, allowing the Commission to borrow to finance the European benefit in case of common shocks.

The second area of reform, in the spirit of complementarity of market and government-based risk sharing, concerns strengthening the capacity of markets to stabilise asymmetric shocks, by completing the capital market union and the banking union. These are subjects on which the divisions between member countries are less marked than for centralised fiscal capacity or fiscal rules. The only exception is the common deposit insurance, proposed by the Commission as a complement to the banking union but, so far, vetoed by some countries, including Germany. However, even before the pandemic, it was Germany itself that had timidly opened a window of opportunity, which could now be further extended.

Finally, the third area is that of fiscal rules, which were tightened in 2012-2013 with the Fiscal Compact and the Two-Pack and Six-Pack regulations. It would be simplistic to say that European fiscal rules imposed the season of austerity after 2010. As we have seen, this was the result of a vision that traced financial instability and the debt crisis back to the profligacy of the governments of the so-called periphery. Therefore, with or without the existing fiscal rules, European countries would have walked that path anyway. However, the institutions for European macroeconomic governance were consistent with the turn to austerity and, as demonstrated by the management of the Greek crisis, provided the European institutions with the appropriate instruments of pressure to impose it on even the most recalcitrant governments.

The activation of the suspension clauses of the Stability Pact is obviously motivated by the pandemic; however, it came a few weeks after the opening of a consultation process on the rules, which in turn was based on a surprisingly severe assessment of the existing framework.[12] The Commission took on board the criticisms that had been unanimously voiced by independent economists for several years: *a*) the current framework is overly complex, arbitrary, and difficult to enforce; *b*) the rules allowed to control deficits, but much less debt, which is the true measure of public finances' sustainability; *c*) public investment, which is generally easier to reduce than current spending, has been penalised at least since the global financial crisis;[13] *d*) finally, the Commission acknowledged for the first time that the current framework pushed many governments to implement procyclical fiscal policies, reducing spending when the economy was slowing down (particularly between 2010 and 2013). In short, between the lines the Commission acknowledged that European rules in the recent past have made fiscal policy a factor of instability rather than of stabilisation.

The consultation process was suspended by the Covid emergency, but in the early Summer 2021 Commissioner Gentiloni relaunched it, while announcing that the Stability Pact suspension clause would remain activated at least until all 2022. It is therefore highly likely that the existing rules will be replaced before they come back into force. Among the many reform proposals, two stand out in my view. The first, which has been discussed since the 1990s, aims to preserve public investment by excluding it from the deficit calculation (the Golden Rule). The pandemics showed that investment is to be understood in the broadest sense as any expenditure (e.g., on health) capable of increasing tangible and intangible capital.[14] The second proposal suggests replacing numerical parameters with standards, principles of good public finance management based on an analysis of debt sustainability, compliance with which would ensure that no sanctions are imposed regardless of the contingent trends in debt and public deficit.[15] This radical proposal does not seem to have any political space, but the very fact that it is being discussed shows that the ground is now fertile for a wide-ranging debate.

The new fiscal rules may be inspired by one of these two proposals or by another that will emerge from the debate in the coming months. In any case, it is important that the new governance reconciles the objective

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[12] European Commission (2020); the communication takes on board the recommendations of the European Fiscal Board (2019).

[13] See chapter one of Cerniglia and Saraceno (2020).

[14] See the introduction of *ibid.*, and on the proposal of an "augmented Golden Rule" Saraceno (2017b).

[15] Blanchard, Leandro and Zettelmeyer (2021).

of sustainability of public finances with the newfound centrality of fiscal policies in the policymaker's toolbox. This may happen through increased fiscal capacity at the centre, and constraints on national policies that remain tight, or, conversely, by increasing the capacity of individual national governments to intervene. Either way, it is necessary for an effective management of the business cycle.

Conclusion

The Covid-19 crisis revolutionised the economic policy debate in Europe. Guiltily clinging to the old consensus, during and after the sovereign debt crisis, European policymakers had opened up as little as possible, often reluctantly, to the debate raging among economists on the instruments of economic policy and the best institutional set-up for the single currency. The pandemic has swept away timidity and hesitation. Within a few months the EU introduced instruments for common crisis management and for boosting the recovery that could, if successful, lead to an organisation of European public policies (especially macroeconomic policies) that is completely different from the one that showed so many shortcomings during the sovereign debt crisis. Interdependence and the need for risk-sharing mechanisms are now becoming obvious, even in Brussels and Berlin, in fields such as health, public investment, ecological transition and the management of asymmetric shocks. For the first time in thirty years, the outcome of the reform process of the European institutions is not a foregone conclusion. The risk of a return in the coming years to the status quo that proved so pernicious during the sovereign debt crisis is certainly not ruled out. However, two crises in little more than a decade have radically changed the intellectual framework; there is now scope, unimaginable until recently, for building European institutions that can ensure long-term sustainable growth and counteracting any tendencies towards divergence between Member States.

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