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Fiscal space, investment and inflation: towards a new policy architecture for the Eurozone

Editorial to the special forum

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Although national fiscal policies in the European Union (EU) and the euro area remain the responsibility of the member states, they have been coordinated since 1998 by the EU Stability and Growth Pact, which sets upper limits for both deficits and debt. Since its adoption, the pact has been reformed several times to address persistent violations of its rules. The member states were neither willing nor able to adhere to the fiscal rules due to the pact's underlying tendency to undermine economic growth. This became very clear after the Great Recession. The austerity measures implemented in line with the pact contributed to a prolonged recession and an increase in debt and unemployment in several member states. This obvious failure of the pact, together with the lessons learned from the COVID-19 crisis and the urgent need for a socio-ecological transition, has culminated in a reform of the pact in 2024/2025, which not only promises to reduce the debt-to-GDP ratios of the member states back to 60 per cent but also to flexibilise the fiscal straitjacket in order to make the pact more growth-friendly and enable more public investment. Is this already the new political architecture that is needed? The contributions to this special forum show that the European policy setting still lacks a coherent and comprehensive policy architecture with coordinated fiscal, monetary, income and industrial policies and that the Stability and Growth Pact does not promote the necessary investments in new technologies for ecological transition and the social flanking of structural change; rather, is likely to continue to hinder them in the future.

This Special Forum emerged from an EJEEP roundtable discussion on the same topic at the 2023 conference of the Forum for Macroeconomics and Macroeconomic Policies (FMM) in Berlin. The first contribution by *Jan Priewe* assesses the new policy architecture of the euro area, as reflected in the latest reform of the EU's Stability and Growth Pact. Calculating four scenarios, Priewe demonstrates that, despite some revisions, the new pact continues to favour austerity measures to achieve the 60 per cent debt-to-GDP target. He therefore concludes that the pact does not deliver on its promise of consolidation in a growth-friendly manner. This also implies that the scope for urgently needed investment in the EU is very limited. The proposal to establish a permanent EU investment fund by *Philipp Heimberger* and *Andreas Lichtenberger* offers a possible solution here. They argue that the green transition requires large-scale investment at the European level due to the restrictions imposed on the member states' national fiscal policies by the Stability and Growth Pact. They propose a new EU-wide fund for climate and energy investments, similar to the EU's Recovery and Resilience Facility adopted after the COVID-19 pandemic to promote economic recovery. They estimate that such a fund should cover at least 1 per cent of EU GDP per year. The consequences of not creating such fiscal space are highlighted by *Catherine Mathieu* and *Henri Sterdyniak*. Although the European Pillar of Social Rights aims at an increase in social spending, the restrictive Stability and Growth Pact does not allow this. Mathieu and Sterdyniak calculate the primary balance requirements and adjustment paths for several European countries that will be required by the new pact. The results are in stark contrast to the EU's social objectives and the implied social expenditures, as the authors empirically demonstrate for several areas of social spending. According to the authors, this calls for a new policy architecture consisting of active industrial policy, changes in taxation and an increase in spending.