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Making EU Economic Governance Fit for Purpose: Investing in the Future and Reforming the Fiscal Rules While Decentralizing and Democratizing

KEY MESSAGES

- **The EU needs a permanent EU debt facility to address its many existential challenges, including climate change, energy, inequality, and security related to the Ukraine crisis**
- **The EU's fiscal rules need to be fit for purpose, meaning that rather than primarily targeting debt-reduction they need to be focused on investment to meet the EU's many challenges**
- **Germany is the elephant in the room when it comes to obstacles to fit-for-purpose fiscal rules and EU level investment capacity**
- **The European Semester should be decentralized and democratized at the national level to ensure effective national "ownership" and legitimacy. The EU's economic governance should also be democratized through strategic dialogues focused on macroeconomic policy and industrial policy**
- **The dangers of populist extremism can be addressed only by developing common solutions that recognize the interdependence of the EU's economies and the need to address the EU's many existential challenges through EU solidarity, including EU leveldebt and fit-for-purpose fiscal rules**

In the past few years, the EU has been confronted with multiple crises that have led to a major rethinking of its economic governance. The decade of the 2010s was defined by the response to the eurozone crisis, focused on deficit and debt reduction. The "governing by rules and ruling by numbers" of the Stability and Growth Pact was first reinforced through belt-tightening austerity and structural reforms that didn't work and were slowly reversed over time as EU institutional actors recognized the need for growth in 2012, flexibility as of 2014, investment beginning in 2015, and social rights in 2017 (Schmidt 2020a).

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When the Covid-19 crisis hit in 2020, Eurozone economic governance was transformed. Member-states engaged in expansive measures to shore up their economies and protect peoples' lives and livelihoods; the Commission suspended the fiscal rules along with state aid rules and created SURE to support employment; and the Council agreed to Next Generation EU and the 800bn euro Resilience and Recovery Fund (RRF) focused on the green transition, the digital transformation, and addressing social inequalities. In the meantime, the Commission had also revamped the European Semester, changing it from top-down negative conditionality to bottom-up positive conditionality, with more carrots and fewer (but better) sticks (Schmidt 2020b; Vanhercke and Verdun 2022).[1]

These measures all contributed to the largely successful management of the potentially disastrous economic fallout from the pandemic (Schmidt 2022). This was followed, however, by the inevitable inflationary pressures linked to restarting economies with broken supply chains, leading to the cost-of-living crisis. Then came the security crisis resulting from the Ukraine war, and the concomitant energy crisis which only added to the inflationary pressures. Last but certainly not least has been the on-going existential crisis related to climate change, with the uncalculatable human and environmental costs linked to increasingly hot summers, intense forest fires, cataclysmic storms, and rising seas.

How the EU responds to the on-going challenges driven by these crises will determine its future. The question confronting the EU today is: will it go back to the status quo ante of the fiscal rules or will it reform the rules significantly? Will it leave the temporary RRF as a one-shot emergency investment or will it add new EU level debt vehicles that would enable it to address its many crises while taking the necessary steps towards a more sustainable, equitable and just transition? The EU's answer will not only determine its future economic trajectory but also its political one. A return to the failed governance of the Eurozone, with austerity and without the investment vehicles necessary to confront the EU's many challenges, will also produce the negative spill-overs that fuelled the

[1] Negative conditionality required rapid fiscal consolidation to meet the deficit and debt criteria of the Stability and Growth Pact along with structural reforms focused on deregulating labour and cutting the welfare state or face enhanced surveillance procedures by the Commission and the threat of sanctions. Positive conditionality involves RRF grants (carrots) for green, digital, and social projects proposed by countries in exchange for structural reforms focused on addressing national economic and administrative problems, as well as social inequalities.

rise of populist anti-system politics, and will make EU level coordination to resolve its many crises increasingly difficult.

EU-LEVEL INVESTMENT CAPACITY TO ADDRESS EUROPE'S MANY CHALLENGES

Europe needs permanent EU level fiscal capacity for investment and redistributive purposes to address the risks with regard to sustainability, social issues, and security. The sustainability risks are largely focused on ensuring the greening of the economy and the digitalizing of society, already targets of the temporary Resilience and Recovery Fund. But much more than the RRF would be necessary here, given the need for vast public expenditure on the green transition alone to fund the transformations of energy, transport systems, and buildings as well as to spur private sector investment in these areas. Such funding is required to ensure that all European member states, and not just the richer ones, can invest in all the ways necessary. With the reapplication of the SGP fiscal rules and in the absence of any EU level investment fund, only a handful of member states would be able to meet the EU's green investment targets, were they so inclined (Mang and Caddick 2023).[2] And without any such funds, it is equally doubtful that countries with less inclination to meet the targets would even try, in particular Central and Eastern European countries that face particular challenges with regard to decarbonization, given their reliance on coal-powered plants and in some cases their political inclinations. The lack of significant investment might not be felt immediately. But once the RRF runs out in 2026, the national spending gap for green investment will in subsequent years become much more problematic for highly indebted countries in view of the fiscal rules, however they are reformed (Tordoir 2023).

The United States, with its massive investment initiatives such as the CHIPS Act for semi-conductors and the $369bn Inflation Reduction Act (IRA) for energy security and climate change, is banking on the multiplier effects of public targeted investment to spur private sector investment. Initially, the EU did little in response other than to complain about the unfair competition and about European companies relocating to take advantage of US subsidies. Most recently, though, the European Commission proposed the Green Deal Industrial Plan, with production targets for green manufacturing, temporarily relaxing state aid rules, and promoting skills development, along with "STEP" (Strategic Technologies for Europe Platform), which repurposes existing funds and won't have the capacity to support the necessary industrial transformation in the EU.[3] As currently configured, then, the Green Deal Industrial Plan will not be able to match the US in terms of the money or the multiplier effects (given the lack of a Capital Markets Union to galvanize venture capital).[4] Moreover, the EU proposals lack the kind of social conditionality tied to the US IRA, linked to such things as collective bargaining, good wages, job creation, investment in training and apprenticeships, taxation on excess corporate profits, bans on corporate stock buy-outs and excessive share-holder dividends.

Equally importantly, although the loosening of the rules on state aid through the "Temporary Crisis and Transition Framework" is key to unleashing more investment, in the absence of a major EU level funding vehicle it risks unbalancing the "fair playing field" which is so important to the Single Market. Easing state aid rules on its own leaves the way open to uneven investment, as richer member states with the fiscal space (as per the fiscal rules) will invest but member states which are poorer and/or lack the fiscal space won't and/or can't (Mang and Caddick 2023).[5] For the moment, in short, the EU still lacks the major resources or the instruments to combat the twin challenges of decarbonization and digitalization in an effective manner, despite lots of "blah, blah, blah" (as Greta Thunberg would say).

Even before the impetus coming from the current US initiative, many had called for permanent EU level debt that could provide investment funds for all member states on a regular basis, even if this required treaty change (Cornago and Springford 2021; De Angelis et al. 2022; Schwarzer and Vallée 2020). Think of a permanent EU level debt facility as an EU wealth fund, akin to national sovereign wealth funds, which issues debt on the global markets to use to invest through grants to the member states in education, training, and income support; in greening the economy and digitally connecting society; as well as in big physical infrastructure projects (Lonergan and Blyth 2018; De Angelis et al. 2022). Another way to think of such funds, given continued resistance to EU level debt by some member states would be as "temporary just transition funds" targeting green and productive reforms and investments (Sustainable Finance Lab 2022) or as a permanent EU Climate and Energy Investment Fund (Heimberger and Lichtenberger 2023).

Such an EU level debt facility could also be used for solidarity purposes through a range of innovative EU funds targeting the EU's socio-economic needs. Examples include a long called-for common European unemployment reinsurance scheme (Enderlein

[2] Mang and Caddick (2023) estimate that only four countries representing only 10 percent of EU GDP would have sufficient fiscal space within their projected deficit and debt limits to meet the 1.5 degree aligned climate targets whereas eight countries representing 50 percent of EU GDP would not be able meet the targets without breaching the 3 percent deficit limit, and the rest would have difficulty meeting them.

[3] See the critique by Climate Action Network Europe (CAN), https://caneurope.org/the-step-proposal-recovery-funds.

[4] See comments by Shahin Vallée, Euractiv June 6, 2023, https://www.euractiv.com/section/economy-jobs/news/european-sovereignty-fund-commissions-best-chance-or-empty-shell/.

[5] As it is, by the latest figures, Germany has announced over half of approved state aid (50 percent), followed by France (23 percent) then Italy (7.8 percent). *Euractiv* June 19, 2023.

et al. 2012), possibly modeled on the example of the temporary SURE (short-term employment schemes) social bonds, issued during the pandemic with great success;[6] a refugee integration fund for municipalities (Schwan 2020); beefing up support for the Asylum, Migration and Integration Fund to focus on the extra costs for social services, integration, resettlement, and retraining needs (as opposed to financing returns),[7] in particular in light of the Ukraine crisis and the uptick in migration via the Mediterranean; an EU fund for "just mobility" focused on brain drain (Hasselbach 2019); a fund for early childhood investment (Hemerijck 2023); or even a guaranteed (basic) minimum annual income (Lonergan and Blyth 2018).[8] But beyond these funds for socio-economic purposes, also needed is a common EU level investment fund to address security risks more generally, beyond (or as part of) the 2 percent pledged by NATO members, while Ukraine needs a fund all of its own to help it rebuild, modeled along the lines of the Marshall Plan, in which the EU would be a major donor among others (Eisen et al. 2023).

THE REFORM OF THE FISCAL RULES

Beyond this, the reform of the fiscal rules is of the essence, given the problems that would come from reinstating the unreformed rules (Jurgeleit et al. 2022). The rules of the Stability and Growth pact, as reinforced between 2010 and 2012 through the six-pack, the two-pack, and the Fiscal Compact, inflicted significant damage on the Eurozone's growth prospects as a result of their procyclical nature, and in particular for member states most affected by the excessive debt procedures—not to mention those in conditionality programs (Schmidt 2020a). But although by the latter half of the 2010s the economic situation across Europe had improved while more was done to "socialize" the European Semester, to make it better adapted to member states' different needs (Zeitlin and Vanhercke 2018), the austerity budgeting baked into the rules nevertheless entailed that those without the fiscal space could not invest (see Southern Europe) while those with the fiscal space did not invest (Northern Europe) (Schmidt 2022).

In response to the Covid-19 crisis, the Commission's mission was transformed. It largely left behind its roles of enforcer and then moderator in the Eurozone crisis to become promoter of the new industrial strategy initiatives through the National Resilience and Recovery Plans (NRRPs), in which grants (and loans) from the RRF were to be disbursed to eligible member states in exchange for meeting certain conditions. The European Semester is now a much more bottom-up exercise emphasizing member-state buy-in through greater "national ownership" of the plans, at the same time that the Commission still exercises oversight via conditionality—such as determining whether certain pre-agreed "milestones" in terms of economic reform are met before disbursing the next tranche of funding. This "conditionality" is a far cry from what it was during the early phase of the Eurozone crisis, however, when structural reform meant largely cutting welfare states and deregulating labor markets. It is focused on attacking national economic vulnerabilities and administrative hindrances as well as social "fairness" by addressing inequalities of opportunities as well as of outcomes. On the whole, NRRPs have worked effectively, although they have worked best in those countries that have taken ownership of the process, for the most part countries that were beneficiaries of RRF grants (Zeitlin et al. 2023).[9]

The main question for now is what will happen with the reform of the fiscal rules, in particular with the end of the temporary RRF, especially if no permanent EU level fiscal capacity is forthcoming. Will this mean a return to the "sticks" without any "carrots"? And if so, would the European Semester still be able to succeed in its efforts to redirect member-states toward the green and digital transitions as well as addressing social concerns?

In the past few years, many policy analysts had called for the rules to be permanently suspended, to be replaced, say, by a set of "fiscal standards" to assess sustainability in context (Blanchard et al. 2021); or by a "Golden Rule" in which public investments beyond those that are part of NGEU should not be counted toward deficits or debt when deemed to benefit the next generation (e.g., investments in education and training, greening the economy, digitalizing society, and improving the physical infrastructure) (Bofinger 2020; van den Noord 2023). Others have proposed eliminating the debt brake embedded in national constitutional legislation (that demands that investment by Eurozone countries be funded by current tax revenues rather than bond issues), to

[6] SURE raised €6.55 billion through a 15-year social bond, with total funding coming to €98.4 billion out of a maximum funding envelope of €100 billion, making the Commission by its own account one of the world's most significant environmental, social, and governance (ESG)-label issuers, accounting for 16 percent of global social bond issuance in 2021, https://commission.europa.eu/strategy-and-policy/eu-budget/eu-borrower-investor-relations/sure_en.

[7] The EU AMIF fund program budget in a nutshell between 2014 and 2022 shows co-financing for 425,870 returnees as opposed to funding for 51,581 places in reception accommodation infrastructure, 89,969 trained in asylum-related topics, and 176,998 participations in pre-departure measures, https://commission.europa.eu/strategy-and-policy/eu-budget/performance-and-reporting/programme-performance-statements/asylum-migration-and-integration-fund-performance_en#programme-in-a-nutshell.

[8] Paid for, say, by the "digital dividend," by having digital platforms pay for our data (which means establishing our property rights on our data, licensing private corporations to use it)—Lonergan and Blyth (2018).

[9] Zeitlinet al. (2023) found in their study of the implementation of the NRRPs in eight countries that whereas Portugal, Spain, Croatia, and Slovakia used the RRF to the fullest, for ambitious plans with significant social policy components, while Italy was a only bit less ambitious, mainly on the social side. Belgium lacked ambition while Estonia and Latvia also lacked ownership, arguably because of lower grant allocations and higher expenditure commitments. In contrast, Northern European countries such as Germany, the Netherlands, and Austria had lower levels of ambition and of ownership, as well as little in the way of grant allocations.

encourage countries to invest in infrastructure or to develop a green economy (De Grauwe 2016). Research has shown that in Germany during the Eurozone crisis years, adherence to the debt brake (along with fetishism for the "schwarze null") ensured not only that federal spending did not keep up with an expanding economy, despite years of budgetary surpluses, but also that in Germany's federalized system—with the Länder responsible for university education, and local governments for local infrastructure—the rules limited new investment for the poorer (and therefore already more indebted) regions and localities, thereby increasing inequalities among sub-federal units while stunting growth potential (Roth and Wolf 2018; Schmidt 2020a). It is also worth noting that the OECD in its *2016 Economic Outlook* used the example of Germany to demonstrate that debt-financed public investment would have no long-term effect on debt-to-GDP ratio (OECD 2016).

The Commission's proposal for reform of the fiscal rules (floated in November 2022, revised at the end of April 2023) offers a modest revision of the numbers-based rules of the Stability and Growth Pact, focused on debt sustainability. It keeps the numerical targets, notably with regard to no more than 3 percent deficit and 60 percent debt (eliminating only the 1/20th a year rate at which excess debt above 60 percent would have to be reduced yearly), most likely because the Commission was cognizant that Treaty change would be difficult, since the rules and numbers of the SGP are written in so many different places in the Treaties and legislation (Jones 2020). This would mean that as of 2024, the 14 countries with budget deficits above 3 percent of GDP, representing 70 percent of GDP of the EU, would be pushed to reduce their deficits by 0.5 percent of GDP or even 0.7 percent for four countries (Greentervention 2023). This said, the Commission has recommended longer time periods for meeting the numerical targets and more country-specific sensitivity in the application of the rules. But it did not adopt the golden rule on investment on the grounds that it would be difficult to assess what might count. It did little to link rules-reform to the NGEU targets on green and digital, other than vaguely suggesting that countries would "benefit from a more gradual fiscal adjustment path" if they were to commit to implementing "important reform and investment measures."[10] And it made no related proposal for a permanent EU level debt facility, seeing little agreement coming from a divided Council itself as a missed opportunity.

Within this overall scenario of a proposed return to a modestly revised SGP with no permanent EU level debt facility, many analysts worry about the potentially negative effects on member state economic health as well as on investment for the twin green and digital transitions (Bertram et al. 2022; Hafele et al. 2023; Jurgeleit et al. 2022; Pekanov and Schratzenstaller 2023; Greentervention 2023). In response, some have called for revising the mathematical models and statistical instruments of the fiscal rules, such as by ensuring against potential procyclical effects by replacing the structural budget balance rule with an expenditure rule, and the output gap methodology used for the former with the potential output growth methodology used with the latter (Bertram et al. 2022; Jurgeleit et al. 2022). Others have proposed going beyond GDP for assessment of fiscal stability, such as by factoring in sustainability and well-being indicators (Hafele et al. 2023; Pekanov and Schratzenstaller 2023; Suttor-Sorel and Fiscal Matters 2023). One such suggestion would be for member states to commit to achieving climate targets (such as reducing greenhouse gas emissions) rather than committing to specific investments. This would have the added value of avoiding the onerous requirements of comprehensive and binding investment plans while benefiting from the flexibility of choosing the most efficient investments over time (Hafele et al. 2023). The experience of the NRRPs already suggests that performance-based financing risks emphasizing measurable output can lead to milestones and targets becoming goals in themselves, to the detriment of good policy outcomes (Bokhorst and Corti 2023; Zeitlin et al. 2023).

As it stands, despite the more user-friendly nature of the reform compared to the status quo ante, highly indebted countries are nevertheless likely to find themselves without the "fiscal space" or EU level funding to enable them to invest in the ways necessary to assure their EU sustainability and social investment obligations, and would arguably be subject to belt-tightening austerity were they not to meet their debt-reduction targets. At the same time, countries with the fiscal space would be able to invest as they see fit. But would they?

GERMANY AS THE ELEPHANT IN THE ROOM

Germany has a crucial role to play in enabling positive reform of the fiscal rules and the creation of an EU level fiscal capacity. But for the moment, all signs indicate that it is focused on pushing the EU to go back to the status quo ante, with support for the "frugal" position it took during the Eurozone crisis and in the early months of the pandemic, before the historic shift to temporary EU level debt.

The German Finance Minister Christian Lindner in particular has been calling for bringing back the full force of the Stability and Growth Pack rules and numbers in order to ensure that all member states tighten their belts to pay down deficits and debts, or suffer the consequences via the excessive debt procedure if they do not.[11] He has additionally opposed any perma-

[10] https://ec.europa.eu/commission/presscorner/detail/en/ip_23_2393 and https://economy-finance.ec.europa.eu/system/files/2023-04/COM_2023_240_1_EN.pdf.

[11] Letter to *New York Times* April 23, 2023, https://www.ft.com/content/8ec1d936-aabb-4f8a-b8db-ed45430888ab.

nent EU level fund, seeing it simply as "more debt" as opposed to investment in a more sustainable future.[12] And yet, while insisting on maintaining the German constitutional debt brake, the government got around its own rules by setting up enormous one-off, off-balance-sheet funds and relief packages to pay for the costs of the Ukraine war and for energy needs, not to mention its use of the state aid rules to invest heavily in its own industries, as noted earlier (in Footnote 5). And yet, at the same time, German governments have not only resisted any EU level permanent debt vehicle, they have more generally engaged in foot-dragging or downright blockage of many of the reforms needed to put the EU on an equal footing economically with the US in terms of meeting the challenges of the 21st century, such as completing banking union, establishing a Capital Markets Union, and finalizing a common European deposit insurance (Högenauer et al. 2023; Howarth and Quaglia 2021).

How do we explain the German government's obsession with debt, and in particular its seeming lack of policy learning with regard to the lessons of the Eurozone crisis, in which the turn to austerity through rapid deficit reduction meant anemic growth and the rise of the populist extremes? In other words, why has Germany not moved away from its pre-pandemic preference for fiscal restraint to "revaluation at home" (by boosting internal demand to rectify the Eurozone's structural imbalances) and/or to EU level fiscal redistribution via common debt? Possible explanations include ordo-liberal ideas and a "stability culture" that blind German policy makers to alternatives to fiscal consolidation; German companies' resistance to internal revaluation that might deprive them of their competitive advantage in EMU; and the assumed economic benefits of such a policy for Germany's export-oriented growth model (Schoeller and Heidebrecht 2023; Polyak 2022). But whatever the explanation, Germany's position fails to recognize the economic risks of a return to restrictive fiscal rules without any EU level investment facility, including the fact that Germany depends on flourishing neighbors for robust export markets (remember that China will soon have its own "Ch(m)recedes"). Moreover, Germany also ignores the political risks related to any return to austerity in the guise of fiscal stability, which is likely only to ignite further populist contestation.

DECENTRALIZE AND DEMOCRATIZE EU ECONOMIC GOVERNANCE

Whatever the outcomes of the reform of the fiscal rules and EU level debt initiatives, the increase in industrial policy and investment entails an enhanced role for "state" actors at the EU and national levels, with public entrepreneurs devising industrial strategies to revive economies and invest in the future (Mazzucato et al. 2021). NGEU and the RRF are clear examples of this. And in this context, the European Semester has had an important role to play, given its elaborate architecture for coordination. But it remains a technocratic exercise that is largely concentrated in the executive branches of national governments in coordination with the Commission, which discourages national ownership (De Angelis et al. 2022). Although the European Semester in the context of the NRRPs appears to have worked well, enhancing the Commission's steering capacity on reforms and investments while leaving member states largely in charge of their plans, it has reinforced centralizing tendencies between the Commission and national capitals. The European Parliament and national parliaments have had little input here, and the same goes for the social partners and civil society actors (Bokhorst and Corti 2023; Zeitlin et al. 2023; Vanhercke and Verdun 2021).

In view of the experience of the NRRPs so far, as well as in the eventuality of a more permanent EU level investment fund, most important is to ensure that the national planning processes (NRRPs) are not only democratized but also decentralized. Democratization means reinforcing the role of national parliaments in vetting national plans while ensuring participation by the social partners and civil society actors. Decentralization involves enhancing involvement of all the potential stakeholders at regional and local levels (industry, unions, and NGOs) not only to ensure that the industrial policy initiatives are appropriately targeted and work most effectively but also to guard against corruption and clientelism (Schmidt 2020a). Both together would serve to promote national ownership while helping to combat populist claims to be the only "democratic" alternative to EU-led technocratic rule.

But beyond encouraging the democratization and decentralization of national level dialogues in the context of the NPPRs, the Commission should also consider democratizing the EU planning process by opening up EU level dialogues with all stakeholders on its goals for industrial policy. We could call this the "Grand Industrial Strategy Dialogue," and task it with recommending overall targets and goals, say, for greener investing, more society-driven digitalization, and addressing social inequalities in addition to promoting the EU's "strategic autonomy" or economic "sovereignty". This could for example build on the existing Economic Dialogues and Monetary Dialogues regularly organized by the European Parliament with EU executive actors. But it would need to be more inclusive with regard to bringing in civil society actors as well as citizens—arguably on the model of the Conference for the Future of Europe—and more ambitious in terms of setting objectives for sustainable and equitable growth (Schmidt 2022).

More inclusive EU level dialogues accompanied by a more bottom-up approach to national planning in

[12] *Politico*, September 28, 2022 https://www.politico.eu/article/german-finance-minister-lindner-eu-debt-rules-energy-crisis-investment-climate/.

the European Semester, in particular if supported by permanent EU level investment, are likely not only to promote better economic performance but also build more political legitimacy. At the national level, they would help to counter the populist drift in many countries, which would certainly be fueled by any return to austerity policies. At the EU level, moreover, they would allow for more democratic deliberation about goals for sustainable and equitable development.

POLICY CONCLUSION

The EU is at a crossroads. Will it come up with a new unified EU level response to invest in the EU's future, including new industrial policy and investment vehicles to combat climate change and social inequality while responding to the security risks? Or will the EU and the member states at best muddle through, returning to a slightly modified version of the fiscal rules of the Eurozone crisis and leaving the member states to their own devices with regard to dealing with investment needs? This policy brief has argued that the only correct answer is the unified one that recognizes the interdependence of European economies and the need for solidarity, in particular in a political context of continuing populist contestation of EU liberal values and democracy. But beyond this, EU economic governance needs to be both democratized and decentralized, with enhanced roles for national parliaments and the European Parliament, given the redistributive function of EU level fiscal capacity, and with more bottom-up involvement of social partners and citizens at local, national, and EU levels. Beyond this, the EU would also do well to consider opening up on-going dialogues between EU institutional actors and all stakeholders on general industrial strategies as well as macroeconomic targets, so as to democratize and legitimize overall economic governance, as a replacement for the numbers-targeting rules.

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