#FocusFuture

The 7Ds for Sustainability

Debt EXTENDED

Decarbonisation
Defence
Democracy
Demography
De-risking globalisation
Digitalisation

Wilfried Martens Centre for European Studies

The 7Ds for Sustainability – Debt Extended

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December 2024

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The Wilfried Martens Centre for European Studies is the political foundation and think tank of the European People's Party, dedicated to the promotion of Christian Democrat, conservative and like-minded political values.

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Assistant Editors: Sara Pini, Senior Research Officer & Theo Larue, Editorial and Publications Officer
Cover design: Gëzim Lezha, Brand and Visual Communications Officer
External editing: Communicative English bv
Typesetting: Victoria Agency
Printed in Belgium by INNI Group

This publication receives funding from the European Parliament.

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BRRD	Bank Recovery and Resolution Directive
CMDI	Framework for Bank Crisis Management and National Deposit Guarantee Schemes
ECA	European Court of Auditors
ECB	European Central Bank
EFB	European Fiscal Board
EPBO	European Parliament Budget Office
EPP	European People's Party
ESM	European Stability Mechanism
ETS	Emissions Trading Scheme
GNI	Gross National Income
MFF	Multi-Annual Financial Framework
MS	Member State
NGEU	Next Generation EU
OECD	Organisation for Economic Cooperation and Development
PCCL	Precautionary Credit Line
SGP	Stability and Growth Pact
TPI	Transmission Protection Instrument
VAT	Value added Tax

Introduction

by Klaus Welle and Eoin Drea

Debt is a question of dose. Too much, and you lose your political independence and sovereignty. Too little, and you might miss out on the possibility and necessity of building infrastructure that facilitates future development.

Keynes taught us that there are situations in which price and interest signals do not work and, as a result, the state is the only actor able to step in temporarily and stabilise the economy—and with it, the political system. A hard lesson was learned in the 1930s. It inspired us during Covid, when the economy threatened to come to a standstill. But debt was put on the EU's balance sheet without corresponding own resources for the Union to finance and repay it. In addition, no proper parliamentary oversight of debt at the EU level was introduced.

Unfortunately, we have now entered a period of vulgar Keynesianism: increasing the debt-to-GDP ratio in crisis times and in good times as well. The consequence is a debt-to-GDP ratio of about 90% in the eurozone and around 100% in the UK and the US. If this trend continues, it will not be very long before a debt crisis reoccurs and the independence of our political decision-making is threatened, together with the cohesion of the EU.

China and Japan are no exception to this trend. Japan has already demonstrated how ageing societies, with correspondingly meagre growth, can enter into decades of exploding debt. China's debt is largely out of control, especially on the local and regional level, for which the central state will ultimately have to take responsibility. This accumulation of debt was partially driven by the end of a property building boom and significant over-capacity in many sectors of the economy. This has resulted in Chinese debt levels no longer being accompanied by a sustainable growth model.

The situation is further aggravated by the fact that public investments have become unavoidable in digital infrastructure, defence and decarbonisation, and to alleviate the financial burdens of unfavourable demographics. De-risking from China will add to the burden. The time of imported deflation that was the consequence of hundreds of millions of Chinese workers being integrated into the global market for the first time seems to be over.

During the eurozone crisis, we learned that cutting expenditure on its own is not the answer, because the potential reduction in debt can be largely offset by a significant reduction in GDP as well. Any successful strategy will therefore have to focus on growth and productivity-enhancing strategies at the same time.

Ensuring the Sustainability of Public Finances

by Jürgen Matthes

Summary

Current debt levels in the eurozone remain high. While future public spending requirements are large, economic growth will be slower in the medium term and interest rates are likely to remain higher for some time. Under these circumstances, public debt levels could increase further into dangerous territory if an overly lax fiscal policy were to be adopted. Therefore, ensuring public debt sustainability is a prerequisite for the continued success of the wider European integration process. A return of the euro debt crisis would endanger not only macroeconomic stability but also the EU's aims of prosperity, green transition and open strategic autonomy. We propose nine recommendations that aim to achieve a sound fiscal future in the EU by strengthening the incentives of the member states to implement a stability-oriented fiscal policy. Above all, when the EU institutions implement the reformed Stability and Growth Pact, they should prioritise debt sustainability. Moreover, the European Central Bank's continuous presence in the sovereign debt markets tends to reduce the willingness of member states to stick to a stability-oriented fiscal policy. Thus, a reformed European Stability Mechanism should be given a larger role in the EU's fiscal governance framework.

Keywords EU – Debt – Sustainability – NextGenerationEU – European Central Bank – European Stability Mechanism – Moral hazard

Introduction

The current economic challenges Europe is facing are immense. Ensuring growth, security, green transformation investments, strategic autonomy and—above all—public debt sustainability at the same time is like squaring a circle. However, as another euro debt crisis would be highly detrimental to the EU's economic and political future, safeguarding public debt sustainability needs to be prioritised. Only with the precondition of sound fiscal finances can the other objectives be targeted. Based on this premise, this study outlines the challenges the EU is facing and the opportunities it can take advantage of to ensure a prosperous future for the EU. It takes as its starting point the recently published *7Ds for Sustainability: Strategic Policy Initiatives for the European Centre-Right*,[1] and focuses on the issue of Debt to sketch an approach to maintaining public debt sustainability.

The outlook for public debt sustainability in Europe will worsen over the medium term due to several relevant economic trends (see Figure 1). Above all, the retirement of baby boomers will lead to significant decreases in employment and will thus dampen economic growth. The impact on growth of decarbonisation is also unlikely to be entirely positive and could even be negative. Furthermore, the impact of deglobalisation trends and the push for strategic autonomy on growth will also likely be negative. Many of these trends are likely to increase the need for expenditure; some will also impact real interest rates and thus the financing burden due to public debts.

[1] K. Welle, P. Hefele et al., *The 7Ds for Sustainability: Strategic Policy Initiatives for the European Centre–Right*, Martens Centre (Brussels, 30 April 2023). The 7Ds are defined as Defence, Digitalisation, Debt, Deglobalisation, Demography, Decarbonisation and Democracy. Moreover, the study draws on B. Kauder, J. Matthes and S. Sultan, *Reforming Economic and Monetary Union: Balancing Spending and Public Debt Sustainability*, Martens Centre (Brussels, 2023); J. Matthes, *Reforming Economic and Monetary Union: The ECB's Transmission Protection Instrument*, Konrad-Adenauer-Stiftung (2023); and J. Matthes, *Coming out of the Shadows: The European Stability Mechanism and Euro Area Governance*, Wilfried Martens Centre for European Studies (Brussels, 2024).

Figure 1 Effect of the four disruptive trends on debt sustainability

	Government expenditure	Growth	Real interest rate
Demography	Higher spending on pensions, health and care insurance	Shrinking work force and shortage of skilled labour	Higher savings for old-age pensions, but possible dissaving in old age
Decarbonisation	Government investment and subsidies	Structural transformation	Higher investment
Digitalisation	Government infrastructure investment	Higher productivity growth (but so far not observable)	Higher investment
Deglobalisation/ Strategic autonomy	Industrial subsidies	Lower productivity growth	Perhaps slightly higher inflation

Note: Qualitative colour rating scale: improvement in public debt sustainability = green, neutral impact = no colour, deterioration = orange. Lighter shade implies lower impact.

This paper has three sections, as three key elements of the EU's economic governance framework could prove insufficient to ensure public debt sustainability. First, the member states' incentive to implement a sound fiscal policy could be compromised by certain policy measures, such as the creation of common EU debt. Second, the reformed Stability and Governance Pact (SGP) could be implemented in an overly flexible manner that proves too lax. Third, the European Central Bank (ECB) has been pushed into a dangerous role as lender of last resort, which raises concerns about moral hazard.

Empowering good fiscal governance at the national level

The responsibility for ensuring the sustainability of fiscal policy rests with the member states. However, politicians in parliamentary democracies can lack incentives to follow sound fiscal policy. As fiscal austerity is often unpopular with voters, politicians tend to favour more generous fiscal policy stances than might be adequate to keep public debts sustainable. This well-known and infamous deficit bias[2] should be kept in mind when the adequacy of the European fiscal governance framework is being discussed. Thus, it is important to counter the deficit bias with measures that create more stability-oriented incentives for policymakers. Several elements of the euro governance framework aim to achieve this objective: financial market discipline, the no-bailout clause, the SGP and the existence of independent fiscal councils.

Recommendation 1: Ensure member states' responsibility for sound fiscal policy

In general, EU institutions should strengthen the national responsibility for fiscal soundness. Importantly, governments have to clearly discern the consequences of lax fiscal policies resulting in a loss of market confidence. In particular, the no-bailout clause is important in this respect.

[2] X. Debrun, *Democratic Accountability, Deficit Bias, and Independent Fiscal Agencies*, IMF Working Paper no. WP/11/173 (Washington, DC, 2011).

Recommendation 2: Allow joint EU borrowing only in exceptional circumstances

The setting up of the Next Generation EU programme (NGEU), which enabled the raising of a common EU debt by way of joint borrowing, is a deviation from the no-bailout clause. However, the NGEU was founded during the height of the Covid pandemic, that is, in very exceptional circumstances that were beyond the control of the member states. At that time, this step was reasonable to calm the financial markets and support national budgets, which were being severely strained by both the Covid crisis and the financing of the green and digital transitions.

However, as a result, new public debt was incurred and more leeway was given to the member states to increase public spending without establishing clear repayment commitments. Moreover, the debt-financed NGEU transfers are not accounted for in national fiscal budgets. As such, the nexus between higher public debts, market confidence and national responsibilities has been significantly weakened. Even now, it is still unclear how these common EU debts will be repaid in the long run.

For these reasons, common EU debts should be used only in very exceptional circumstances. Nevertheless, there have been calls to establish an NGEU 2.0 to tackle the impact of the energy crisis—again financed by joint borrowing. However, such a step would be questionable and could endanger public debt sustainability.

Moreover, there is no need for an NGEU 2.0 as there is still plenty of money available in the NGEU 1.0 fund. As of summer 2024, less than half of the funds of the Recovery and Resilience Facility, the key part of the NGEU, have been paid out. The Facility has a total €648 billion in funds, of which €357 billion can be paid as direct transfers and €291 billion can be made available through loans at relatively low interest rates. At this juncture, transfer payments to the member states amounting to more than €180 billion and nearly €200 billion in loans are still available until the end of 2026. Instead of asking for new money, the priority should lie in making the best of the remaining NGEU funds. This is all the more vital as it appears that the member states are having difficulties identifying suitable projects in which to invest both the NGEU funds and those from the Cohesion Fund. The absorption capacity of member states for both funds is obviously rather limited.

Recommendation 3: Give a greater role to the European Stability Mechanism in the fiscal governance framework

The European Stability Mechanism (ESM) is an important building block of the Economic and Monetary Union architecture. As the newly founded lender of last resort during the euro debt crisis, the ESM was relatively successful. However, it has been sidelined in recent years because of problematic allegations that it interfered unduly with national sovereignty, even though unpopular reforms were inevitable during the euro debt crisis. In general, the ESM is indispensable in times of crises and should thus be brought back onto the EU stage.

As the ESM was mainly designed for countries with unsound economic policies, it rightly entails reform conditions as a precondition for financial support. However, the ESM lacks viable instruments to support countries with relatively sound economic policy fundamentals. An already well-advanced reform of the ESM would change this. It introduces a new instrument, a change to the so-called precautionary credit line (PCCL), that would provide general access to an ESM loan without the respective country necessarily drawing on it. Such a precaution would be intended to calm the financial markets should they begin to doubt the debt sustainability of a country. The new PCCL would not entail reform prescriptions as in other ESM programmes, but would require existing sound economic policy fundamentals and the clearly stated intention to ensure the continuation of these as a precondition. Choosing the ESM as a crisis support mechanism would be a better way to tackle the current challenges than relying on the ECB with its overly lax Transmission Protection Instrument (TPI, see below).[3] Thus, the ESM reform, which has been ratified by all but one ESM member state, should now be fully ratified.

Implementing the reformed SGP in a sound manner

The SGP is the key instrument in the EU to ensure that member states' fiscal policies remain on a resilient and sustainable path. The SGP has recently been reformed.[4] The reform is, in principle, a step in the right direction, but it has its pros and cons:[5]

- On the positive side, the reformed SGP puts a stronger focus on medium-term fiscal sustainability, as proposed, for example, by Blanchard et al.[6] As ageing costs will become an increasing burden for the budgets of many member states in the medium term, it is important to take precautions and to build fiscal buffers now for the future. Moreover, the reform introduces a fiscal expenditure rule that should make the operation and monitoring of the SGP's recommendations easier and more straightforward.[7]
- On the negative side, there are certain challenges with regard to implementing the reformed SGP. In particular, the reform grants considerable discretion to the European Commission, which is often subject to significant political pressure and could thus potentially allow overly lax fiscal policies.

Recommendation 4: Depoliticise EU-level economic governance

Too often, the euro area's fiscal governance has been influenced by political instead of economic considerations. Thus depoliticising the SGP is of major importance. To this end, more power should be given to independent institutions such as national fiscal councils and the European Fiscal Board (EFB).[8] Moreover, the EFB needs to become a truly independent organisation and should no longer be institutionally attached to the European Commission.

Recommendation 5: Ensure sound fiscal governance by the Commission

The reformed SGP needs to be soundly managed by the European Commission. It is true that the Commission's leeway has been somewhat limited in the final version of the reform compared to the original proposal through the introduction of several numerical safeguards to ensure minimum levels of fiscal consolidation. Nevertheless, it still has considerable discretion.

- The reformed SGP allows the possibility for countries to be granted longer fiscal adjustment periods, of up to seven instead of four years, if certain important reforms or investments are implemented. This time horizon is rather long and should be used only rarely. Fiscal consolidation efforts should not be unduly postponed into the future, otherwise public debt sustainability might not be guaranteed for countries with already high public debt levels.

[3] J. Matthes, *Coming out of the Shadows*.

[4] European Commission, 'New Economic Governance Framework'.

[5] C. Wyplosz, 'Reform of the Stability and Growth Pact: The Commission's Proposal Could Be a Missed Opportunity', *VoxEU*, 17 November 2022; Kauder, Matthes and Sultan, *Reforming Economic and Monetary Union*; Z. Darvas, L. Welslau and J. Zettelmeyer, *The Implications of the European Union's New Fiscal Rule*, Bruegel Policy Brief 10/24 (June 2024).

[6] O. Blanchard, A. Leandro and J. Zettelmeyer, *Redesigning EU Fiscal Rules: From Rules to Standards*, Peterson Institute for International Economics, Working Paper 21–1 (Washington, DC, 2021).

[7] A. Bénassy-Quéré et al., *Reconciling Risk Sharing With Market Discipline: A Constructive Approach to Euro Area Reform*, Centre for Economic Policy Research, Policy Insight 91 (London, 2018); Darvas, Welslau and Zettelmeyer, *The Implications of the European Union's New Fiscal Rule*; B. Busch and B. Kauder, *Der Stabilitäts- und Wachstumspakt. Bestandsaufnahme und Vorschläge für mehr fiskalpolitische Disziplin in Europa*, IW-Analysen no. 142 (Cologne, 2021).

[8] Bénassy-Quéré et al., *Reconciling Risk Sharing With Market Discipline*; EFB, Annual Report 2020 (Brussels, 2020); Busch and Kauder, *Der Stabilitäts- und Wachstumspakt*.

- Moreover, when the Commission conducts public debt sustainability analyses for the medium term, the influence of assumptions is large. It is therefore important that the Commission is fully transparent about the data and assumptions used in its debt sustainability analyses, so that researchers can cross-check the results.

Recommendation 6: Build fiscal buffers in good times

Governments often fail to build fiscal buffers in good times. In bad times, they therefore often have to cut public spending, and particularly public investment, which tends to deepen the economic slowdown. This procyclicality has plagued fiscal policy for decades and relates to the above-mentioned deficit bias.

The new fiscal expenditure ceilings in the reformed SGP could mitigate procyclicality. The ceilings are derived from medium-term growth forecasts of the economy instead of short-term growth performance. In good times, with high economic growth, fiscal expenditures would thus grow slower than GDP, and in bad times they would grow faster, stabilising the economy in an anticyclical way. It will still be challenging to determine the correct level of medium-term growth rate—especially as European economies have recently been plagued by several crises and thus exceptional downs and ups. Nevertheless, these expenditure ceilings should be heeded by national governments so that fiscal buffers can build up in good times.

Defending an independent eurozone monetary policy

The ECB has an important role in the European governance framework. As an independent institution, it is tasked with achieving and maintaining price stability by administering an appropriate monetary policy.

Fiscal and monetary policy interact in important ways. If fiscal policy is too lax, the economy can heat up and inflation may rise. Should this happen, monetary policy will have to interfere through the implementation of higher interest rates to dampen demand. Higher interest rates, however, increase the debt servicing burden of national governments. In countries with high public debt ratios, a situation known as fiscal dominance may occur.[9] This arises when higher interest rates cause public debt servicing to become unsustainable. Therefore, fiscal policy needs to be constrained to enable the ECB to remain truly independent.

Recommendation 7: Maintain the independence of the ECB from fiscal policy

The ECB's independence is key for guaranteeing price stability. If inflation increases, interest rates have to rise accordingly, no matter how this affects the debt sustainability of highly indebted member states. The ECB's decisions must not be concerned with fiscal implications, regardless of the political pressure applied to it.[10]

Recommendation 8: Ensure the conditionality of the ECB's support to governments

In times of high economic uncertainty, financial markets can trigger a severe sovereign debt crisis. This situation can occur, particularly in countries with elevated debt levels, if interest rates rise continuously, creating unsustainable public debts.[11] In order to prevent interest rates from spiralling out of control in an unwarranted way, the ECB is able to use its immense market power to intervene in sovereign debt markets in order to stabilise market expectations.

[9] T. J. Sargent and N. Wallace, 'Some Unpleasant Monetarist Arithmetic', *Federal Reserve Bank of Minneapolis Quarterly Review* 5/3 (1981).
[10] F. Heinemann, 'Fiskalische Dominanz als Gefahr für die Europäische Zentralbank – Analysen und Empfehlungen', *Integration – Vierteljahresze-itschrift des Instituts für Europäische Politik* 45/4 (2022).
[11] P. De Grauwe and Y. Ji, 'Mispricing of Sovereign Risk and Multiple Equilibria in the Eurozone', *Journal of Common Market Studies* 50/6 (2012).

However, caution is warranted with regard to ECB actions intended to protect governments from a loss of market confidence. In cases where unsound national fiscal policies have contributed to this loss of confidence, the ECB should only be able to intervene if the respective country agrees to an ESM programme with reform conditions.[12] Otherwise, the prospect of ECB interventions could undermine member states' incentives for sound fiscal finances.

Recommendation 9: Reform the ECB's TPI

For euro states with sound economic policies, the TPI of the ECB allows sovereign bond purchases as a way to contain unwarranted interest rate hikes. The TPI was hastily introduced after the Russian invasion of Ukraine, which led to rapidly rising energy prices and significantly higher inflation, as there was the fear of a loss of market confidence. While this innovation in the European fiscal governance framework is justified in principle, the design of the TPI is problematic.[13] The current arrangement tends to lower the incentives of member states to follow a sound fiscal policy, as the ECB has a lot of leeway and could potentially also protect countries with unsound fiscal policies. Moreover, the significant amount of discretion the ECB has regarding decisions about the eligibility of countries for TPI interventions raises serious concerns about legality, democratic legitimacy and, ultimately, fiscal dominance, which could endanger the ECB's independence.

A better solution would be to involve the ESM. In contrast to the ECB, the ESM is governed by elected politicians. As the above-mentioned envisaged ESM reform introduces a new PCCL that has very similar conditions to the TPI for countries with sound economic policies, the use of the TPI should only be permitted if a country in need adopts an ESM programme. In this way, the ECB's intervention power would be connected to the democratically legitimised ESM.

Conclusion

As public debt sustainability could be endangered in highly indebted countries under the expected economic conditions in the near future, fiscal policy needs to prioritise stability to avoid a detrimental sovereign debt crisis. Other spending objectives, even though highly important in themselves, can only be realised if public debt sustainability remains guaranteed.

The European People's Party (EPP) should therefore make one of its priorities strengthening the incentives for member states to ensure fiscal prudence. As common EU debts tend to be problematic in this respect, the option of joint borrowing should be reserved only for very exceptional circumstances. Moreover, a clear redemption path for the debts incurred as a result of the NGEU should be defined soon. To bring the ESM back onto the EU stage, the EPP should try to ensure that the ESM reform is finally ratified so that the new PCCL can enter into force—giving the ESM a more benign face. In terms of controlling the use of the reformed SGP, the EPP needs to ensure that the significant amount of discretion given to the Commission is not misused. Finally, the introduction of the TPI has overburdened the ECB. Therefore, the EPP should work towards giving the ESM a larger role in combating any financial crises that arise that affect countries with sound economic policies.

[12] Matthes, *Reforming Economic and Monetary Union*.
[13] K. Bernoth et al., *The ECB's Transmission Protection Instrument: A Legal & Economic Analysis*, ECON Committee of the European Parliament, Monetary Dialogue Papers (Brussels, September 2022); L. Feld et al., 'The ECB's Toxic Bond-Purchase Program', *IFO Viewpoints*, 12 August 2022; I. Angeloni and D. Gros, 'ECB Transmission Protection Instrument Needs a "User Manual"', *Official Monetary and Financial Institutions Forum*, 17 August 2022; Matthes, *Reforming Economic and Monetary Union*.

	Programme 1	Programme 2	Programme 3
	Empowering good fiscal governance at national level	**Defending an independent eurozone monetary policy**	**Simplifying and depoliticising EU-level economic governance**
Project 1	Responsibility for keeping fiscal policy sustainable rests with member states. EU institutions should not interfere with these national responsibilities to enable governments to clearly discern how lax fiscal policies can result in a loss of market confidence.	Raise interest rates accordingly if inflation increases, no matter how this affects the debt sustainability of highly indebted member states. The ECB's decisions must not be concerned with fiscal implications regardless of the political pressure. Its independence is key to guaranteeing price stability.	Depoliticise and simplify the SGP, for example by giving more power to independent institutions such as national fiscal councils or the EFB. Too often the euro area's fiscal governance has been influenced by political instead of economic considerations.
Project 2	Joint borrowing by the EU interferes with the connection between national fiscal policies and market confidence. Raise EU debts only in exceptional circumstances. There is no need for an NGEU 2.0 or other common funds financed by EU debts on a regular basis. Prioritise making the best of the NGEU funds, which are still plentifully available.	Exercise caution in ECB actions to protect governments from a loss of market confidence. In cases where unsound national policies contribute to a loss of market confidence, the ECB should only intervene if the respective country agrees to an ESM programme with reform conditions (as is provided for by the Outright Monetary Transaction programme).	The SGP reform renders public debt sustainability more central to fiscal policy guidance. The European Commission should manage the SGP soundly and not make decisions influenced by political pressures.
Project 3	As lender of last resort, the ESM has been sidelined in recent years because of allegations that it interfered unduly with national sovereignty. A pending ESM reform would change this and introduce an ESM programme without any reform conditions for countries with sound economic policies. All member states should ratify this reform. The new ESM programme could also be the key condition for the use of the TPI.	Use the democratically legitimised ESM to decide on the soundness of a member state's economic policies and thus its eligibility for the TPI. For euro states with sound economic policies, the ECB's TPI allows sovereign bond purchases in order to contain unwarranted interest rate hikes.	The SGP reform aims to change the pattern of governments often failing to build fiscal buffers in good times to avoid excessive spending cuts in bad times. New expenditure ceilings will be introduced that are derived from medium-term instead of short-term growth performance. National governments should heed these ceilings so that fiscal buffers can grow in good times.

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Ensuring Financial Stability

by Fredrik N. G. Andersson and Lars Jonung

Summary

The financial system is a cornerstone of the modern economy, acting as a bridge between savers and investors. It facilitates the allocation of capital, supports the trading of stocks and other financial products, and helps with pricing risks. When functioning well, the financial system is a powerful engine for economic growth. However, it can also be a source of instability. Financial disruptions and imbalances have historically led to some of the most severe economic crises. A stark example is the global financial crisis of 2008–9, which triggered the European debt crisis and dealt a significant and long-lasting blow to the EU's economy. Despite institutional reforms since 2008, significant weaknesses persist within the European framework for financial stability, particularly in terms of both crisis prevention and crisis resolution. While the measures taken have undoubtedly strengthened the system, challenges remain that could undermine the EU's ability to effectively prevent future crises and manage them when they occur. We highlight important issues related to crisis avoidance, crisis preparedness and the digitalisation of the financial system.

Keywords EU – Debt – Crisis avoidance – Crisis preparedness – Digitalisation

Introduction

The current EU framework for safeguarding financial stability is built upon two main pillars: the evaluation of macroeconomic risks and the enactment of macroprudential stabilisation policies, coupled with enhanced oversight and assessment of micro-level risks and of the conduct of individual financial institutions. At the institutional level, the European Systemic Risk Board was founded in 2010, and the European Central Bank has assumed a considerable role in fostering financial stability. A number of other institutions have been set up to improve financial supervision and stability, such as the European System of Financial Supervision, which is centred around the European Central Bank. The establishment of the Banking Union in 2012 is also part of the strengthening of financial stability within the EU. Furthermore, the Capital Markets Union, launched in 2015, is another attempt to foster an efficient financial system in the EU.

Our three programmes are summarised in the table below. For each programme, three specific projects are proposed which seek to improve the overall financial stability of the EU.

Programme 1: Avoiding crises

Avoiding a crisis is, of course, essential. The table outlines three key projects proposed to limit the risk of a future financial crisis. First, with today's technological advancements and the growth of the fintech sector, lawmakers must ensure that regulation and supervision are adequate to manage the new landscape. The principle of 'same activity, same risk, same rules' must be applied to all EU regulatory and supervisory actions in these areas.

The focus of the current EU financial stability framework on regulating the aggregate amount of credit and the risks undertaken by individual households and financial institutions is well-founded, judging from studies indicating that significant credit expansions often precede financial crises.[1] However, research also highlights

[1] A. Sufi and A. M. Taylor, 'Financial Crises: A Survey', in G. Gopinath, E. Helpman and K. Rogoff (eds.), *Handbook in International Economics* (vol. 6) (North Holland: Elsevier, 2022).

that a volatile and fragile macroeconomic backdrop can precipitate a financial crisis, particularly as banks face challenges in maintaining profitability amid uncertain and low returns.[2] The risk of households, firms and governments failing to repay their loans increases as GDP growth declines.

Between 1999 and 2022, growth in the euro area averaged 1.4% annually, in contrast to the 2.2% annual growth rate in the US. The euro area also experienced greater macroeconomic volatility. This was especially evident during and after the Covid-19 pandemic. This tepid and volatile economic growth not only prolonged the recovery from the global financial crisis but also contributed to the subsequent European debt crisis, which in turn further lowered the level of growth. Europe risks being stuck in a vicious circle of low growth and recurring crises.

To avert future financial crises, it is crucial not only to regulate the financial system and control the level of credit available, but also to place greater emphasis on fostering economic growth in the EU, aligning it with the performance of high-growth economies.

Regulating the volume of credit and other financial variables cannot by itself limit all aggregate macroeconomic financial risks. Thus, our second proposed project relates to strengthening economic growth through structural reforms, including by completing the single market for services and deepening the capital market. In particular, the consolidation of the EU's stock exchanges, clearing houses and national securities laws must be advanced to unlock deeper and more liquid pools of capital. Naturally, the Banking Union must also ensure that banks are robust and able to withstand any future financial crises. This is an example of how growth-enhancing reforms should be combined with micro-level regulation of the financial system.

The third project relates to avoiding a rerun of the European debt crisis that prolonged the economic misery of the global financial crisis. We suggest that all EU legislative proposals should be fully costed by an independent, non-partisan European Parliament Budget Office (EPBO). The EPBO would produce a cost estimate for every bill that is approved by a full committee of the European Parliament. This tool would allow policymakers to better avoid future budgetary crises.

Programme 2: Preparing for crises

Although strengthening economic growth may reduce the probability of a financial crisis occurring, it is still essential to stay prepared to deal with any future crisis. As outlined in the table, there are some features of the present system that need further improvement. Both the first and second projects of this programme relate to public finances.

The global financial crisis exposed notable vulnerabilities in the euro area's crisis preparedness, particularly the absence of coordinating mechanisms for fiscal policy and the sharing of fiscal costs. The Five Presidents' Report[3] of 2015 initiated steps to address this deficiency, with tangible progress observed during the pandemic. However, on their own, the coordination and sharing of fiscal responsibilities are inadequate to prevent a future sovereign debt crisis from causing financial turmoil.

Crucially, maintaining a low debt burden prior to a crisis is vital, as this allows governments during and immediately after any crisis to substantially increase public debt to support the financial system and the real economy. Researchers including Laven and Valencia[4] and Andersson and Jonung[5] estimate that the public-debt-to-GDP

[2] A. Demirgüc-Kunt and E. Detragiache, 'The Determinants of Banking Crises in Developing and Developed Countries', *IMF Staff Papers* 45/1 (1998); IMF, 'Chapter 1: Financial Stability Challenges in a Low-Growth, Low-Rate Era', in IMF, *Global Financial Stability Report* (October 2016).

[3] J.-C. Juncker et al., *Completing Europe's Economic and Monetary Union* (2015).

[4] L. Laven and F. Valencia, *Systemic Banking Crises Revisited*, IMF Working Paper 46232 (2018).

[5] F. Andersson and L. Jonung, 'Preparing for the Next Crisis: Lessons From the Successful Swedish Fiscal Framework', in B. W. Poulson, J. Merrifield and S. Hanke (eds.), *Public Debt Sustainability: International Perspectives* (Lexington Books, 2021).

ratio typically surges by 30–40 percentage points in such situations. This indicates that EU member countries should have fiscal headroom of at least that much to avoid being forced to cut government expenditure, raise taxes and hike interest rates in ways detrimental to economic performance.

To ensure effective crisis preparedness, it is necessary to reduce the public-debt-to-GDP ratios in euro area member states in the near future to levels that can accommodate significant increases in public debt in response to a financial crisis, without triggering a fiscal crisis. The Maastricht budget criteria should remain the relevant guidelines in this regard. Furthermore, within a monetary and banking union, the fiscal power of individual countries to deal with the costs of a financial crisis should be distributed more evenly. To make the risks and costs more evenly spread, member states should try to fulfil the Maastricht budget criteria. The fiscal framework for bank crisis management and national deposit guarantee schemes (the Bank Crisis Management and Deposit Insurance framework) could then be implemented more successfully.

Finally, it is essential that the current regulatory frameworks for crisis management, such as the Bank Recovery and Resolution Directive, keep up with the changes to the financial system brought about by technological advancements. The digitalisation of the financial system is creating new financial products and introducing new actors into the financial system. This creates new risks concerning the prevention and resolution of financial crises. The frameworks and institutions set up after the global financial crisis run the risk of becoming obsolete if they are not brought up to date.

Programme 3: Digitalising the financial system and the emergence of new actors—Big Tech and fintech

The existing system of financial regulation reflects a reactive approach, primarily aiming to prevent a recurrence of past crises similar to the global financial crisis. The focus is on the existing financial system, in particular on the commercial banking sector. In the near future, however, the financial system is poised for significant transformation driven by new digital technologies including artificial intelligence.[6]

This evolution will introduce innovative methods for assessing risks and investment opportunities, as well as new financial products. Actors including Big Tech companies and new fintech companies will enter and transform the financial system to an extent unknown today. Overall, this process is likely to provide benefits to consumers, companies and society, fostering financial inclusion. However, new risks will emerge that require vigilant monitoring by financial regulators.

Within this programme there are three essential projects. The first is to ensure the robust implementation of existing supervisory mechanisms, including the Basel Accords, which set international standards for bank capital adequacy, stress testing and liquidity requirements. There is a danger that, along with new actors, a shadow banking system could emerge that may increase the level of systemic risk unless it is fully monitored and regulated.

The second project addresses the fact that applying the existing rules is not enough. These must also be adjusted to the changes to the financial system brought about by digitalisation. It will be necessary to develop new EU-wide mechanisms to manage the new types of risk presented by a financial system that relies on peer-to-peer and peer-to-business lending, where new as well as old financial institutions will function as intermediaries.

The third project focuses on the need for international cooperation with regard to new financial regulations.

6 K. Petralia et al., *Banking Disrupted? Financial Intermediation in an Era of Transformational Technology*, International Center for Monetary and Banking Studies (Geneva, 2019); S. Cevik, *Is Schumpeter Right? Fintech and Economic Growth*, IMF Working Paper 24/20 (2024).

It is particularly important that EU and US regulation is coordinated to create a level playing field and similar frameworks for competition and control. The remit of the EU–US Trade and Technology Council should be expanded to include the digitalisation of the financial system.

Conclusions

Preserving the stability of the European financial system requires more than just enforcing existing regulations or concentrating solely on the actions of the current financial institutions. Ensuring future stability demands a proactive approach that considers the ongoing evolution of the financial landscape, particularly in light of the digitalisation of finance. As technological advancements continue to introduce new financial products and bring new players to the market, it is crucial that the financial stability framework evolves in parallel. Adapting to these changes is essential to safeguard the system against emerging risks and ensure its resilience in the face of future challenges.

Often overlooked in discussions on financial stability are the critical roles of macroeconomic growth and public-sector debt. Low economic growth frequently contributes to financial crises, while high public indebtedness prior to a crisis can hinder effective crisis mitigation and exacerbate the situation by leading to a debt crisis.

To prevent future financial crises and ensure robust crisis preparedness, it is essential that the EU implements structural growth reforms. These reforms should aim to align Europe's economic performance with that of the world's high-performing economies. Key to this effort is the strengthening of the single market, which will enhance economic integration, boost growth and increase resilience across the EU.

Furthermore, it is crucial that public debt levels are reduced to create the fiscal space needed for effective crisis management. Strict adherence to the Maastricht budget rules is essential in this regard. The experience of Europe's most successful economies demonstrates that it is possible to combine structural growth reforms with budget discipline. This approach offers a far more promising path than the current trajectory of high debt and low growth. By committing to these principles, Europe can strengthen its economic foundation and enhance its resilience against future financial crises.

	Programme 1	Programme 2	Programme 3
	Avoiding crises	**Preparing for crises**	**Digitalising the financial system**
Project 1	Lawmakers must ensure that regulation and supervision are adequate to handle the new landscape, which includes today's technological advancements and the growth of the fintech sector. The principle of 'same activity, same risk, same rules' must be applied to all EU regulatory and supervisory actions in these areas.	Ensure that current regulatory frameworks for crisis management, such as the Bank Recovery and Resolution Directive, keep up with the changes to the financial system brought about by technological advancements.	Ensure robust implementation of existing supervisory mechanisms including the Basel Accords, which set international standards for bank capital adequacy, stress testing and liquidity requirements.
Project 2	Further deepen the EU's single market for capital. Reforms that spur future growth are an essential, indirect measure to prevent future financial crises. In particular, progress the consolidation of the EU's stock exchanges, clearing houses and national securities laws to unlock deeper, more liquid pools of capital.	Reduce current debt levels in the euro area to create sufficient fiscal space to successfully cope with a future financial crisis. The Maastricht budget criteria should remain the relevant guidelines in this regard.	Develop new EU-level mechanisms for managing risks in a financial system that will be increasingly reliant on peer-to-peer and peer-to-business lending, where new as well as old financial institutions will function as intermediaries.
Project 3	Establish an independent, non-partisan EPBO to fully cost all EU legislative proposals. The EPBO should produce a cost estimate for every bill that is approved by a full committee of the European Parliament. This tool will allow policymakers to better avoid future budgetary crises.	Complete the Banking Union to ensure that banks are robust and able to withstand any future financial crises. The Bank Crisis Management and Deposit Insurance framework should be implemented.	Financial regulation requires international cooperation. Coordinate EU and US regulation to create a level playing field and similar frameworks for competition and control. The remit of the EU–US Trade and Technology Council should be expanded to include the digitalisation of the financial system.

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The Middle Way: Three Ways to Balance Growth and Fairness

by Eoin Drea

Summary

Vast swathes of the established middle classes have lost the belief in their ability to achieve a higher standard of living and offer better opportunities for their children. Although Europe's well-developed welfare states have traditionally mitigated the worst effects of income inequality, it is clear that a perception now exists which emphasises inequality of opportunity and lack of social mobility. Amplified by the recent pandemic, social mobility across Europe is also struggling against the meta trends of increasing automation and rapid technological change. This paper sets out a three-point plan that balances the objective of increasing economic growth with that of ensuring higher social mobility. The three points set out the priorities. First, a focus on the single market as the most important wealth generator in the EU and the potential source of the revenues needed to support increased investment in the future. Second, greater priority for middle-class families, to allow them to better deal with the economic realities they are faced with on a day-to-day basis. This aims to put a sense of control back into the middle-class lexicon. Third, an evolved social market economic model based on the inclusivity of compassion, focusing on mental health, rural areas and affordable housing.

Keywords Middle class – Single market – Social market economy – Intergenerational inequality – Mental health – Affordable housing

Introduction

Writing in 1938, the future British Prime Minister Harold Macmillan noted that the ongoing crisis in 'international political relationships followed hard upon the crisis in domestic and in world economic affairs. This was not an accidental occurrence; the two things are closely related'.[1] In linking internal societal cohesion with broader global unrest, MacMillan was prescient in acknowledging the importance of improving socio-economic conditions as part of soothing larger global conflicts. In his view, this could be best achieved by liberating 'men from want and the unfolding of new possibilities of a more satisfactory and abundant life'.[2]

Although writing nearly a century ago, MacMillan's identification of the centrality of social mobility to societal cohesion remains highly relevant today. In the aftermath of the global financial crisis, the ability of many young Europeans to improve their economic prospects began to decline.[3] Europe's education system—contrary to public perception—has failed to close the attainment gap between children from richer and poorer backgrounds.[4] Amplified by the recent pandemic, social mobility across Europe is also struggling against the meta trends of increasing automation and income inequality.[5]

[1] H. MacMillan, *The Middle Way: A Study of the Problem of Economic and Social Progress in a Free and Democratic Society* (London: MacMillan, 1938), 10.
[2] MacMillan, *The Middle Way*, 12.
[3] *Eurofound*, 'Diverging Trends Across Europe Highlight Stagnation and Decline in Social Mobility' (19 April 2017).
[4] C. Bodewig and L. Gortazar, 'Education's Hollow Promise of Social Mobility in Europe', *Brookings*, 7 December 2016.
[5] M. Giordano and M. C. Padberg, 'Why Europe's Employers Can – and Should – Do More to Improve Social Mobility', *World Economic Forum*, 27 March 2024.

In the broader context, vast swathes of the established middle classes have lost the belief in their ability to achieve a higher standard of living and offer better opportunities for their children. Although Europe's well-developed welfare states have traditionally mitigated the worst effects of income inequality,[6] it is clear that a perception now exists which emphasises inequality of opportunity and lack of social mobility. This self-perception is based on the understanding that 'while on average the economic conditions of the middle class are not worse than they used to be, comparison with the previous generation creates an illusion of great poverty'.[7]

This paper sets out a three-point plan to balance the objective of increasing economic growth with that of ensuring a higher level of fairness and social mobility. These priorities, akin to MacMillan's 'more satisfactory and abundant life' have always been the mainstays of the social market economic model. Yet, these principles now require updating and reinforcing in light of the succession of crises evident in Europe over the past two decades. These crises, accompanied by rapid technological and social change, have made the need for a modernised social market economic model more urgent than ever.

The EU's growth is the mother of all investment

The social market economic model is not just about growth statistics, debt levels and employment figures. At its heart it is about people. However, a growing economy is essential to accrue the financial resources necessary to ensure that social mobility and societal fairness can be revitalised in this post-Covid age. The situation is further aggravated by the fact that significant public investments in digital infrastructure, defence and decarbonisation, and to alleviate the financial burdens of unfavourable demographics, have become unavoidable. De-risking from China will add to the burden.[8]

Politically, the crises of the past two decades—underscored by the ongoing war in Ukraine—have resulted in a focus on policies designed to combat immediate problems. And while this approach is understandable, it has unintentionally resulted in economic growth being overlooked as the essential starting point for public investment. Unfortunately, rather than focus on growth as a prerequisite for further spending, joint borrowing is emerging as a favoured option at the EU level, particularly among those on the left of the political spectrum.[9]

This political focus on the potential of joint borrowing has resulted in the EU's historical source of wealth generation—the single market—being overlooked as the obvious driver of the required financial resources for the decade to come. However, the incoming European Commission still has the opportunity to ensure that further deepening of the single market is repositioned as the most pressing economic objective over the course of its mandate.

It is impossible to overstate the importance (and still unrealised potential) of the EU's single market. Data from before the Covid pandemic highlighted that each year, the EU's GDP was 1.7% higher as a result of integration, which amounted to €250 billion per year.[10] The removal of obstacles has led to a significant increase in trade within the EU. While exports of goods to other EU countries amounted to €671 billion in 1993, this had risen to more than €3.4 trillion in 2021.[11] Even without a dedicated free-trade agreement,

6 G. Fisher and S. Filauro, 'Income Inequality in the EU: General Trends and Policy Implications', *VoxEU*, 17 April 2021.

7 A. Siegmann and M. Schafer (eds.), *No Robots: The Position of Middle-Class Households in Nine European Countries*, Wilfried Martens Centre for European Studies, CDA-WI Research Institute and Konrad-Adenauer-Stiftung (Brussels, 2017), 7.

8 K. Welle and E. Drea (eds.), *The 7Ds – Debt in Depth*, Wilfried Martens Centre for European Studies (Brussels, 2024).

9 Party of European Socialists, *Manifesto for the 2024 European Elections* (2024).

10 P. Muller et al., *The EU Single Market: Impact on Member States*, LE Europe (February 2017).

11 *European Parliament*, '30 Years of EU Single Market: Benefits and Challenges' (2024).

trade between the EU and the US alone is estimated to support around 9.4 million direct jobs.[12]

Yet, the economics of the single market remain dependent on political will, particularly in the areas of services and capital. It requires significant leadership to reduce cross-border obstacles to trade, often in the midst of tenacious, entrenched domestic opposition to liberalisation. The sad reality is that we do not need another report on competitiveness or fostering economic growth. What the EU requires is an unequivocal political commitment to creating jobs and growth.

In this context, it is important for the incoming Commission to clearly signal its rediscovered commitment to further developing the single market as the key driver of growth and jobs in the EU over the next five years. This paper proposes that:

1. The portfolios of the European commissioners for the internal market and for trade be merged, and this role be reclassified as first vice-president of the Commission. This would send a very clear political message to the member states as to the importance of the single market for the incoming administration.
2. Every new EU legal act, policy programme or strategy should undergo a comprehensive competitiveness check to ensure its contribution to boosting the EU's economic efficiency. It is imperative that such a check be conducted in an impartial and independent manner.
3. Every new legislative initiative should be accompanied by a detailed regulatory impact assessment, verified by the Regulatory Scrutiny Board. This assessment must be updated (as required) across all EU institutions.

Real policies for real people

The period since the 1950s has been characterised by fundamental change, wrought by technology and changing social norms. Yet, the basic structure of much socio-economic policy remains firmly based on the models of the past. Social security and pension systems, taxation and even education all are predicated on a system of life-long, continuous employment with a defined retirement date.

However, it is clear that the challenges facing younger generations today are fundamentally different to those faced during the golden age of European economic recovery in the post-war decades. As previously noted, it is also clear that declining social mobility, perceived income stagnation and a pervasive sense of precariousness have fundamentally altered the political landscape of the middle class.

Now topics such as globalisation, free trade, immigration and even stable political systems are viewed as tools of the 'elite', designed to prevent progress for working- and middle-class families. This is the 'politics of fear' which has found fertile ground over the past decade in a Europe largely characterised by an increasing generational divide between younger citizens and those approaching or enjoying retirement.

In this context, many people are understandably desirous of protecting their position, rather than risking aspiring to even greater social mobility. This situation is compounded by the static socio-economic policies, which are often viewed by younger workers as tools to protect the now unaffordable privileges granted to earlier generations.

[12] *European Commission*, 'EU Trade Relations With the United States' (May).

Therefore, it is essential that a higher priority is given to allowing middle-class families to better meet the actual economic realities that they face on a day-to-day basis. This, in effect, means real policies for real people. It aims to put a sense of control back into the middle-class vocabulary. At the heart of this approach is understanding the difficulties of building up wealth and asset accumulation, including saving for retirement. This is a situation which many middle-class families view as having been easier for their parents and grandparents. It is also necessary to directly address the underlying sense of grievance regarding income inequality, and how the fair and transparent distribution of taxation across all sectors of the economy is essential to fostering a broader sense of social cohesion.

While acknowledging that most socio-economic issues fall outside EU competences, it is clear that Brussels can still play an important role in issues such as tax fairness, tackling intergenerational inequality and providing the analytical frameworks for further reform. In particular, this paper proposes that:

1. The impact of reducing the burden of national income taxes on economic growth, employment and financial security should be clearly identified for each member state. Europe's middle-income workers are overwhelmingly pessimistic about their future economic prospects. Reducing income taxes is important to allow them greater control over their financial well-being. *Further expansion of the EU budget must not result in higher taxes on workers' income*s.

2. Childcare is often a huge logistical and financial burden for families, particularly for those with small children and working parents. The EU should support national childcare models to give every type of European family the widest range of work–life balance options. The socio-economic benefits of affordable and accessible models of childcare are well established. They are drivers of social mobility, gender equality, economic growth and social inclusion, particularly in disadvantaged areas.[13]

3. The EU—in conjunction with its member states—should continue to lead the development of a business tax system in Europe which ensures every company contributes its fair share, regardless of size or domicile. This is essential for social fairness. The EU must also support and expedite the ongoing OECD process in this area on a global level.

The compassion of inclusivity

Technology and labour mobility are shaping Europe like never before. The opening up of opportunities to work in different countries has transformed how many people live. Successful urban centres have become magnets for jobs, people and investment. Simultaneously, however, much of rural and small-town Europe is facing a declining population (particularly among the young) and limited employment opportunities.

Yet, the EU's rural and exurban areas account for over 80% of its total area and are home to over 30% of its population. Across Europe these communities feel disconnected and detached from an increasingly remote political process—one which, they believe, gives precedence to the priorities of urban decision-makers rather than to the needs of smaller, less-vocal communities. In many sectors, particularly in agriculture, people believe that their way of life is threatened by an unending deluge of European and national-level regulations. Many feel abandoned by traditional political parties and disorientated by the rapid pace of economic and social change.[14]

[13] H. Penn, *Putting Childcare at the Heart of the Social Market Economy*, Wilfried Martens Centre for European Studies (Brussels, 2019).

[14] E. Drea and J. Daul, *Rural Europe: Our Contract With Rural Europe – A Five-Point Plan for Europe's Heartlands*, Wilfried Martens Centre for European Studies (Brussels, 2023).

In addition, the increasing prevalence of technology has had a host of unintended consequences, particularly among the young. This is a trend that was exacerbated by the recent pandemic. A growing body of evidence links a rise in depression in children to social media use.[15] As it becomes clear that technology—driven by mobile social media access—is building 'an anxious generation' of children, the necessity of public intervention in growing.[16]

To complete the societal challenges facing younger generations today, access to affordable, secure, long-term housing has re-emerged as a key dividing line, often both geographically and generationally. The social consequences of this trend for this group include, but are not limited to, delayed independent living and family formation, declining mental health and a diminishing belief in their ability to match the living standards of their parents. Increasingly vulnerable and insecure, many young people now link the issue of housing with inward migration. Left unresolved, this issue will further polarise (and radicalise) the political choices of younger generations in the years ahead.

The traditional social market economic model needs to be developed based on the compassion of inclusivity. It must be understood that the politics of the middle ground will only prosper if the majority of the population feel that their concerns are addressed in a meaningful way. The following priorities are identified.

1. Develop a more ambitious EU strategy on mental health which specifically sets out cross-border measures to provide support, advice and treatment for citizens of all ages. This has become particularly pressing because digitalisation and the Covid-19 pandemic have brought about a huge increase in the number of Europeans suffering from mental health issues. A key focus should be on developing consistent strategies which address the role of smartphone usage among children and teenagers. Policies should be developed for reducing smartphone access in schools and limiting exposure to social media for children and young teens.

2. Establish an EU health and education corps to place professionals such as family doctors, teachers and community nurses in underserved rural areas. Such postings would be for a fixed period and in return for financial support for training. Rural areas are Europe's heartlands. Yet, many of them are suffering from a shortage of basic public services, including health and education professionals.

3. The lack of access to affordable, secure, long-term housing is worsening divisions in society, reducing social mobility and widening the wealth gap between generations. It is also a key factor fuelling young people's disenchantment with politics. While housing policy must remain a national competence and does not require a European commissioner, the European Investment Bank should significantly expand its existing social and affordable housing financing programmes. In addition, EU state aid rules should be clarified (if required) to facilitate national-level spending on social and affordable housing.

4. If policymakers are serious about confronting the generational wealth gap, they will need to confront the basic inequalities at the heart of Europe's current taxation models. This step poses a significant challenge, particularly for centre–right political parties, which draw substantial support from property owners. However, such is the scale of the social and political challenges outlined in this paper that the greater taxation of existing wealth—primarily housing—will be essential to ensuring increased social mobility, fewer taxes on income for working families and more sustainable social security models in the decades to come.

[15] J. Smyth and H. Murphy, 'The Teen Mental Health Crisis: A Reckoning for Big Tech', *Financial Times*, 26 March 2023.
[16] J. Haidt, *The Anxious Generation: How the Great Rewiring of Childhood Is Causing an Epidemic of Mental Illness* (London: Penguin Random House, 2024).

Conclusion

Vast swathes of the established middle classes have lost the belief in their ability to achieve a higher standard of living and offer better opportunities for their children. Although Europe's well-developed welfare states have traditionally mitigated the worst effects of income inequality, it is clear that a perception now exists which emphasises inequality of opportunity and lack of social mobility. Amplified by the recent pandemic, social mobility across Europe is also struggling against the meta trends of increasing automation and income inequality. This article has identified three priority areas for political action based on the day-to-day socio-economic challenges facing middle-class families today.

	Programme 1	Programme 2	Programme 3
	Reinvigorating the single market, which drives jobs and growth	**Making work pay**	**Developing an inclusive social market economic model**
Project 1	Merge the portfolios of the European commissioners for the internal market and for trade, and reclassify this role as first vice-president of the Commission. This enlarged portfolio should be supported by a designated directorate-general for the single market, as this is the basis of the EU's global prominence.	Reduce the burden of national income taxes (by increasing the levels at which higher income tax rates apply). Europe's middle-income workers are pessimistic about their future economic prospects. Reducing income taxes is important to allow them greater control over their financial well-being. Further expansion of the EU budget must not result in higher taxes on workers' incomes.	Develop a more ambitious EU strategy on mental health which specifically sets out cross-border measures to provide support, advice and treatment for citizens of all ages. This has become particularly pressing because digitalisation and the Covid-19 pandemic have brought about a huge increase in the number of Europeans suffering mental health issues.
Project 2	Restore competitiveness to ensure the future of the single market. Every new EU legal act, policy programme or strategy should undergo a comprehensive competitiveness check under the direction of the first vice-president for the single market and trade. This check must be carried out free from all political considerations.	Support national childcare models to give every type of European family the widest range of work–life balance options. The socio-economic benefits of affordable and accessible models of childcare are well established. They are drivers of social mobility, gender equality, economic growth and social inclusion, particularly in disadvantaged areas.	Establish an EU health and education corps to place professionals such as family doctors, teachers and community nurses in underserved rural areas. Such postings would be for a fixed period and in return for financial support for training. Rural areas are Europe's heartlands. Yet, many of them are suffering a shortage of basic public services, including health and education professionals.

	Programme 1	Programme 2	Programme 3
Project 3	Ensure that every new legislative initiative is accompanied by a detailed regulatory impact assessment, verified by the Regulatory Scrutiny Board. This assessment must be updated (as required) across all EU institutions.	Lead the development of a business tax system in Europe which ensures every company contributes its fair share, regardless of size or domicile. This is essential for social fairness. Support and expedite the ongoing OECD process in this area on a global level.	Housing policy must remain a national competence and does not require a European commissioner due to the unique characteristics of national housing markets. However, the European Investment Bank should significantly expand its existing social and affordable housing financing programmes. In addition, EU state aid rules should be clarified (if required) to facilitate additional national-level spending on social and affordable housing. National incentives to stimulate private-sector-led activity in the 'homes for sale' market should also be utilised where necessary. To combat declining social mobility and increasing intergenerational inequalities, the taxation of existing wealth—primarily housing—must become an even more important source of government revenue in the decades ahead.

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The EU's Own Resources

by Alain Lamassoure

Summary

For the last 30 years, the EU has ignored the issue of how to properly fund its policies. Despite enlargements, new treaties and multiple crises, a consensus in the European Council managed to cap the EU's common budget at 1% of its gross national income. A murky assortment of various intergovernmental funds was expected to make up for the obvious shortfalls.

However, the consequences of global warming, the pandemic, the war in Ukraine and relentless migration pressures have made the current approach unsustainable. Therefore, the time has come for a complete overhaul of both how the EU is funded and the wider system of the EU's own resources. The basis for this should be simple, clear and democratic guidelines: democratic consistency, subsidiarity and fiscal constancy. The transfer of competences to a European level should not result in an increase in overall spending or overall taxation for taxpayers: all other things being equal, Europe must be built at constant costs. New own resources must support the more efficient operation of the single market, the common currency and wider EU priorities.

Keywords Own resources – Single market – Subsidiarity – EU budget – Fiscal constancy – Democratic consistency

Introduction

The discrepancy between the responsibilities conferred upon the EU and its financial means has been the black hole of the European debate for too long. Treaty after treaty, crisis after crisis, the EU has grown into a formidable normative power. Worried by this development, experts from other continents have lamented the 'Brussels effect', whereby Europe's competitors are forced to adopt the same standards, thus making the European model contagious.

And still, inexplicably, this giant has not only feet made of clay, but tiny ones: like a sky-high sequoia with bonsai roots. For the last 30 years the EU common budget has been stuck at 1% of EU gross national income (GNI). Therefore, the global ambitions of the European Council have long been murkily funded by a mishmash of various intergovernmental funds that have escaped parliamentary control, or have been resounding commitments deprived of specific timetables.

In 2020 the great disruption of the virus-driven crisis was a game-changer. A European Recovery Programme, with funds five times higher than the annual budget, was established through European borrowing, guaranteed by fresh EU own resources that were to be specified at a later date. This programme was announced as a one-time operation, meant to save national budgets from a once-a-century crisis, not to fund EU policies. Then, a short while later came the war in Ukraine and the prospect of a further enlargement of the EU. Throughout, global warming has been getting worse. As a result, the gap between the sum of European commitments and the EU budget has become wider and increasingly unaffordable. Any way out of this quagmire requires the creation of new EU own resources.

State of play

A unique feature which makes the EU stand out among international organisations is its capacity to raise public revenues. From day one the basic treaty specified: 'The Union shall provide itself with the means necessary to attain its objectives and carry through its policies. . . . The budget shall be financed from own resources' (art. 311, Treaty on the Functioning of the European Union).

In the early days, the customs duties levied on imports from third countries were sufficient to fund the budget, which was mostly dedicated to agriculture. But over time, EU policies and members have multiplied, while global trade agreements have reduced the income from duties. National contributions to fill the gap were introduced in the late 1980s, intended to be temporary and complementary. Today, they account for two-thirds of the EU's total revenue. This GNI-based resource is supplemented by two other national contributions which are based on value-added tax (VAT) and the levy on plastic packaging waste. Together, these national monies bring in almost 80% of the EU budget: €136 billion out of €142 billion in 2024. Moreover, these national contributions are not fair. A legacy of British membership is that the contributions of the richest countries are capped, meaning that the poorest ones pay relatively more.

On top of this, the EU budget as such is embedded in a seven-year framework. This Multiannual Financial Framework (MFF) sets annual spending ceilings for the seven categories of EU policies. It is adopted by unanimity by the Council, with Parliament only being allowed to give or withhold its consent.

Such a procedure ensures that the last word belongs to the stingiest or the least keen member of the club: every national leader is bound to compare their contribution with the direct return for their country. It is small wonder that the current MFF is set at less than 1% of GNI, at €1,065 billion for the term 2021–7. The original priorities of the 1990s, agriculture and regional policies, still absorb two-thirds of the budget. Thus new requirements, such as competitiveness, research, green energy, digital technologies and defence are left with a paltry amount, well below the necessary critical mass. Europe literally pays itself with words.

During the last term of office, in return for its consent for a frustrating MFF, Parliament called for a schedule for the tabling of new own resources proposals by the Commission. However, the latter kept postponing the agreed deadlines and put forward a blend of half-serious and half-unrealistic schemes, while the Council sometimes did not even vouchsafe to put them on its agenda.

In 2020 an elephant entered the room: owing to the consequences of the pandemic, the sleight of hand of the European Recovery Plan brought in a further €800 billion, entirely borrowed by the EU on the financial markets. This can be viewed either as a splurge on European common priorities or as a salve for national finances. But the facility is not designed to last for ever: this spending spree will be over after 2026 and we will be back to square one.

Policy recommendations

More money for Europe through new European taxes: it is difficult to imagine a battle less likely to be won. That is, that would be the case if we do not change the perspective or build on solid foundations. Therefore, the time has come for a complete overhaul of the system in order to build it on simple, clear and democratic principles, in line with the European People's Party's philosophy.

The principles

The first principle is that of democratic consistency. European decisions democratically taken must be democratically funded by elected European decision-makers wielding European own resources. From this principle flow the following:

- The timespan of the MFF should overlap with the terms of office of the Parliament and the Commission. Thus, the election campaign should include the proposed funding for the respective platforms, giving the new team in charge the means needed for their tenure.
- The MFF should be passed by a super-qualified majority in the Council, and amended by a qualified majority in the Parliament. Without this change, the stingiest or the grumpiest of the member states would still be able to stall the whole process.
- The same procedure should apply to the creation of new own resources. This would not need a transfer of tax sovereignty. If a member state refused to levy a new European resource, a penalty could apply to its returns from the EU budget.

The second principle is that of subsidiarity. Subsidiarity means that every public task must be entrusted at the most relevant level, not at the lowest or the highest. In budget matters, subsidiarity translates into the principle of constancy. Whatever the choices in the distribution of roles, in no case should the transfer of competences and means to another level result in an increase in overall spending or taxation for taxpayers: all other things being equal, Europe must be built at constant costs.

We can even expect the pooling of resources and talents to sometimes guarantee more efficiency for less money. Thus devised, the EU budget must not be a burden on national finances but rather offer a more efficient replacement of national tasks and costs at the EU level. For instance, if we mean business in transforming Frontex into a fully fledged European agency, the 10,000 or so border guards employed at the EU level will no longer be needed at the national level.

These considerations give rise to the following recommendations:

- *Ex ante* measurements should be taken of the net savings possible at the national level in return for new EU action. No European agency or administration should be created without comparing the advantages and costs of action at the national and European levels.
- Likewise, national staff and financial means should be transferred in line with new transferred competences.
- Every tax rise or creation at the EU level should be compensated for by a fall in another tax or at another level.

The whole system should be monitored by national and European parliaments. To make the approach credible, an overview should be provided by a competent and independent judge. The best plan would be to network the European Court of Auditors and the national equivalents. These bodies could evaluate, for instance, the savings made possible at the national levels by the transfer of competences to the EU level. The guarantee that savings would be made at a national level would be an absolute condition, necessary to placate the foreseeable concerns from ordinary citizens and national parliamentarians.

Proposals

Once this overarching precondition has been assured, several avenues are worth exploring for the creation of new EU own resources. Technical and political realism recommends close linkages with the single market and EU competences.

The simplest idea, which has never been considered, is to utilise VAT. There is a misunderstanding about VAT and EU own resources. As early as the 1980s, VAT was utilised as an additional financial resource to complement the income from customs duties. However, VAT has so far only been used to assess the respective wealth of member states, in parallel to GNI. Even if the methods chosen for this first attempt were flawed, let us not forget that VAT offers several merits as a common reference point:

- It is the most efficient of all taxes: it brings in half of total revenue at the national level.
- For 40 years it has been the only harmonised European tax. Thus, our administrations are completely familiar with the technical specificities, which are the same in all the member states.
- The arrangements necessary to devise a common European supplement to national VAT rates would be relatively simple to work out, and likewise simple to agree upon at the political level.
- The proceeds of VAT are entirely proportionate to economic growth, and are closely linked to the development of the single market. An extra mini-rate added to each national base rate could easily appear on invoices, enabling the consumer/taxpayer to realise that they are financing the EU budget.

An alternative would be to levy a corporation tax. As early as 2020, the European Parliament, the Council and the Commission jointly agreed that an own resource linked to the corporate sector should be proposed. Similarly to VAT, there are wrong and right approaches. The wrong one refers to a vague global agreement obtained in the OECD's *Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*: this agreement is subject to implementation by all OECD members, including the US.[1] The right approach would build on a very concrete and purely European project, the Common Consolidated Corporate Tax Base, as proposed by the European Commission in 2016. A further merit of this scheme would be to settle the issue of taxing multinational technology companies. Hailed and supported by an overwhelming majority in the European Parliament six years ago, this proposal was set aside by the Council in favour of the OECD mirage.[2] It needs to be revisited, both to improve fair competition inside the Union and to offer a base of one or two extra percentage points of funding for EU policies.

A third option would be to impose green taxes. A global key challenge, and a mainstay of EU policies since the Green Deal, is the economic desire to make the wasting of energy expensive: all are in favour of 'green' taxes, and allocating some to the Union also garners broad consensus among European states and political parties.

1 OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy* (Paris, 8 October 2021).

2 The timeline for the European Council's withdrawal of this proposal is set out in *European Parliament, Legislative Train Schedule*, 'Common Consolidated Corporate Tax Base (CCCTB)'.

The following points can be added:

- The tax on plastic packaging waste should be turned from a statistical curiosity into genuine taxation. Set up in 2021, it has provided a not insignificant sum to national contributions to the EU budget, unbeknownst to taxpayers and barely noticed by members of national parliaments.
- The proceeds of the European Trading System represent a blueprint for European own resources. The scheme affects 1,500 major industrial facilities in the Union, but so far the auctions of these 'rights to pollute' have fuelled national budgets and not the EU one. Still, the market is Europe wide, the legal basis of the scheme is European, it is managed by the Commission and its target showcases the EU's priorities (i.e. the Green Deal). There is no reason why a sizeable part, if not all, of this revenue should not accrue to the EU. This is all the more the case since member states are obliged to spend all of their revenues from the scheme on climate action: so far, it has operated as a reversed own resource!
- For smaller polluters, the Commission and the Parliament have been intent on establishing a carbon border adjustment mechanism. But its foundation is questionable: how can the carbon content of an imported product be measured? And how can such a protectionist customs duty (in all but name) be designed in such a way as to make it admissible by the WTO? Pending the relevant answers, its entry into force has been postponed until 2028. It would be simpler to add an extra European contribution to the excise duties on fossil fuels that exist in most member states.

Fourth, the proceeds of GNI could be treated as a genuine own resource. This would mean that all unexpected receipts could be made available to increase the volume of EU spending, if necessary. Fines imposed by the Commission or the Court of Justice on the grounds of breaching the competence rules often reach into the double digits of billions of euros. Currently, these are treated as national resources since they are deducted from national contributions. This is unfair and does not encourage the Commission to punish well-off trespassers.

Fifth, the 'seignorial duty', earned by the European Central Bank due to its monopoly on issuing money in the eurozone, is probably highly profitable (its value is a secret to all but central bankers and finance ministries). Its use would be well-suited to spending on policies implemented by eurozone members, safe in the knowledge that, in the long run, all EU members will have to join the eurozone.

However, the potential for developing larger own resources at the European level cannot be considered in isolation from the issue of further EU joint borrowing.

A fresh, relevant approach would be to link further EU borrowing with compliance with the Stability and Growth Pact (SGP). Those countries fulfilling their SGP commitments could qualify for relief on their own investment efforts via a European fund financed by further EU borrowing. Any project financed by European loans would be limited to eurozone members and guaranteed by existing taxes. Until these guarantees are established, every member state should incorporate its share of the common debt into its national debt. Only policies generating measurable financial, economic or environmental profits and duly specified in the MFF should qualify for EU borrowing.

Also, it would be helpful in many ways to launch the titanic work of harmonising the key concepts and rules of public accounting in the EU, in order to secure transparency and fairness between member states. The matter has always been deemed too technical to appeal to politicians, and civil servants are not eager to upset their traditional ways of working. But had we achieved this boring chore previously, a lot of misunderstandings and good or bad faith spats around the interpretation of the SGP could have been averted.

Conclusion

The prerequisite for tackling this thorny issue is that the ostriches pull their heads out of the sand. Fixing the EU budget and putting in place new own resources does not need a legal revolution: on the occasion of the agreement of the next MFF or the settlement of the European Recovery Programme, the signing of a new interinstitutional agreement could be enough, pending a possible treaty. After all, the MFF procedure had been smoothly applied for two decades before its introduction in the Lisbon Treaty.

	Programme 1	Programme 2	Programme 3
	Founding the EU's financial resources	**Introducing green taxes as an important additional contributor to own resources**	**Ensuring the right technical framework is in place**
Project 1	Compensate for every tax rise or creation at the EU level with a fall in another tax or at another level. An expanded EU budget must not be a burden for national finances but a more efficient replacement of national tasks and costs at EU level.	Turn the tax on plastic packaging waste from a statistical curiosity into genuine taxation.	Use the profits from 'seignorial duty' as part of the EU's expanded own resources to contribute to policies implemented by eurozone members. Seignorial duty is the difference between the value of money and the cost to produce and distribute it. It is probably highly profitable (its value is a secret to all but central bankers and finance ministries).
Project 2	Apply an extra mini-rate of VAT to each national base rate. This could easily appear on invoices, enabling the consumer/taxpayer to realise they are financing the EU budget. VAT is uniquely suited to underpinning the EU's financial resources. It is the most efficient of all taxes: it brings in half of total revenues at the national level. It also applies across all member states.	Use a sizeable part, if not all, of the proceeds of the European Trading System to fuel the EU budget instead of national ones.	Link any possible future joint borrowing at the EU level with compliance with the SGP. Any project financed by European loans should be reserved for eurozone members and guaranteed by existing taxes. Until these guarantees are established, every member state should incorporate its share of the common debt into its national debt. Only policies generating measurable financial, economic or environmental profits and duly specified in the MFF should qualify for EU borrowing.
Project 3	Create the basis for the EU's financial resources to be linked to the corporate sector. The Common Consolidated Corporate Tax Base—which was supported by an overwhelming majority in the European Parliament six years ago—would both improve fair competition inside the Union and increase the means of funding EU policies.	Add an extra European contribution to the excise duties on fossil fuels that exist in most member states.	Take the project of harmonising public accounting standards across the EU seriously and implement it as soon as possible.

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EU Debt and the Credibility of the EU Budget

by Adriaan Schout[1]

Summary

A credible EU budget is more important than its size. Rather than starting with negotiations on the size of the EU budget—a sensitive matter—it might be useful to first diagnose and improve its quality. Applying the EU principles of good governance could provide the structure for a much-needed discussion of the quality of EU spending. Good governance principles relate to evidence-based assessments of results, independent accounting, keeping EU regulation (also regarding EU funds) as light as possible and ensuring that member states have their own independent capacities for assessing the usefulness of this spending (subsidiarity). As it stands, little is known about the actual outcomes (effectiveness) of this spending. EU funds suffer from bureaucratisation that complicates project selection. Moreover, the need to invest in predetermined public goods, the trend towards adding conditionality and the list of requirements for funding complicate the selection of projects, transparency and the extent to which member states feel ownership.

Keywords Multiannual Financial Framework – Eurobonds – Good governance – EU public goods

Introduction: the credibility of the EU budget

As we move towards 75 years of European integration and cooperation, the question that needs to be addressed is, what level of common standards for member states can be set and supervised? Essential good governance standards include transparency, the independence of information gathering and monitoring, subsidiarity and proportionality. These requirements create national ownership of and public respect for (EU) policy. In 2026 it will be 25 years since the White Paper *European Governance* was published after the fall of the Santer Commission. This paper uses good governance principles to examine the quality of the EU budget. Put differently, the budget is a case study to reflect on the quality of EU governance.

With the ever more ambitious EU agenda, the debate over eurobonds will remain high on the agenda. How can this next step in the EU's finances be justified? The focus here is not on the size of the EU budget or on its priorities. The first requirement for the acceptance of EU debt will be the assurance that the Union's expenditures are credible.[2] Credibility of spending is partly determined by whether member states are able to select effective projects, manage these projects efficiently, avoid giving the impression that the absorption of funds is a goal in itself, and achieve the agreed objectives, such as convergence and sustainable development. Moreover, it has to be clear that programmes are well audited and duly evaluated so that the legality of EU spending is ensured and the public knows that the funds have delivered (effectiveness).

This 7Ds contribution is about the quality of the *ex ante* project selection and the *ex poste* accountability of EU spending. Given the widely shared criticism of the functioning of the EU budget, any discussion on its future has to be linked to quality guarantees to ensure that solidarity goes hand in hand with solidity.

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1 This contribution to the 7Ds project is based on two Clingendael publications: A. Schout, *Cohesion Policy: A Management Audit*, Clingendael, Policy Paper (2024) and A. Schout, *Maximizing Effectiveness and Efficiency of the EU Budget: EU Investment Programs and National Public Investment Capacities,* Clingendael, Policy Paper (2024).

2 The idea of 'credibility' overlaps with the broader term 'legitimacy'. Both relate to trust in quality and public support. Yet, legitimacy also touches on the role of parliaments. The assessment of credibility in this paper is, however, limited to *ex ante* and *ex post* quality-control systems.

Priorities now high on the EU agenda include industrial policy, defence, continued support for Ukraine, implementation of the Green Deal, managing migration and improving infrastructure (energy, digitalisation and transport). This list has resulted in considerable political pressure to continue with the debt-financed Next Generation EU (NGEU) programme, which almost doubled the EU's budget for the 2021-7 period. Moreover, the member states are already overburdened, with public debt levels of well over 80%. Given the difficulties in reforming the existing budget and its priorities, and as also indicated in the Draghi Report, a serious debate on funding is necessary. Although transfers from the EU budget are often seen as a form of necessary solidarity and as compensation from strong Northern countries for access to the internal market, this does not make debating the quality of the EU budget less important.

Enduring support for EU spending depends on the Union financing the right things. This demands proper investment planning and appropriate accounting. Both these aspects need to be reconsidered. Despite the political sensitivities surrounding the EU budget, its credibility has received little attention. Importantly, credibility highlights the unresolved issues in the debates on the EU budget: its effectiveness, the way in which funding priorities are defined, the extent to which member states actually take ownership of the objectives of EU funding and whether accountability is sufficiently transparent.

Unpacking 'credibility'

The Multiannual Financial Framework is often presented as a relic of the past. Despite many attempts, it has proven difficult to reform, and attempts by the Commission have stumbled over political sensitivities in the Council. Given the pressures to align the EU budget to the new geopolitical and policy priorities, reforms will be hard to postpone at this point. Rather than starting at the policy end, this paper proposes starting with a debate on the budget's credibility, defined as the legality and effectiveness of EU spending. The concepts of legality and effectiveness relate to rules and procedures, and this technocratic perspective might trigger fewer battles over vested interests and offer suggestions for long-term solutions.

Broadly speaking, two phases can be distinguished in the management of any budget: the initiation of projects and the *ex post* approval of spending (see Table 1). When it comes to evaluations of the EU budget, most attention has traditionally been devoted to the legality of the spending at the end of a project and in the annual reports of the European Court of Auditors (ECA) (Box II, Table 1). The legality of the spending relates to whether money was spent according to the rules of the specific fund, of public procurement and of state aid. Legality is first audited by the member states and subsequently by the Commission's own internal auditors. Moreover, the European Court of Auditors checks the accounts and the spending of the European Commission and presents an annual report on the budget. In the Court's opinion, it is of key importance that irregular spending should not exceed 2% ('materiality threshold'). As a result of the additional NGEU budget, and the push to commit the funds on time (absorption), the margins of error reported by the ECA in 2023 for Cohesion Policy increased to 6.6% due to the need to spend more and the temporary 100% EU financing. Higher spending and the lack of co-financing therefore come with a risk to the credibility of the budget.

Aside from this percentage being too high, the auditing of Cohesion Policy funds highlights the politicised struggle that goes on behind the scenes when the legality of expenditures is audited. National authorities and the European Commission are the first to report on the margins of error. Yet, the member states tend to lack sufficient independent capacity to report the figures correctly. Subsequently, the Commission audits the figures provided by the member states and corrects irregularities in the reporting, but only to some extent. Hence, the error margins identified by the ECA end up being greater than those reported by the member states and the Commission. These discrepancies indicate that the accounting process lacks transparency and point to the well-intended but politicised involvement of the Commission in project management and project auditing. Ensuring legitimacy requires that the accounting and reporting methods should be revisited to align them with the principles of good governance.

With the focus being on the legality of spending, much less attention is devoted to the results—that is, to the effectiveness of these expenditures (Box IV, Table 1). The ECA has begun to write more Special Reports on the outcomes. However, given the number of projects across the EU and the need for a detailed knowledge of their impact, more insight into the effectiveness of spending will have to come from the member states and regions where the impact of EU spending is felt. Yet, the national audit authorities (supreme audit institutions) have, by and large, avoided examining the impact of EU spending. The European Commission does report on the results of EU funding programmes, but its central involvement and interests in absorption complicate its role as independent assessor. Experts tend to be critical of the Commission's 'marketing' reports on achievements (an expression that was used by an expert in a personal conversation). As things stand, Boxes I and II are more or less covered in current ways of working. But credibility is to a large extent based on the actual results for which Boxes III and IV are important and for which we see only limited attention.

Table 1 The credibility of the EU budget

	Project initiation	*Ex post* accountability
Legality	I Complying with both rules as defined in the Regulations for EU funds and public procurement rules to stimulate competition and avoid corruption	II Auditing of expenditure by the Commission and by the ECA (the current way of working for most EU financed programmes)
Effectiveness	III Project selection aimed at maximising added value for the EU and/or for the member states	IV Independent assessment of results

Reconsidering 'effectiveness'

Another aspect of the EU budget that has received relatively little attention is project management (project selection and the setting-up of project-management structures; see Box III) even though it is at this stage that the effectiveness of projects is determined. Within bodies such as the International Monetary Fund, the OECD and the EU, the challenges of setting up project-management systems aimed at delivering results are well known—but again with an emphasis on efficiency. For the EU the 'efficiency gap' is estimated to be between 15%–20% due to, among other factors, waste, corruption and lack of competition.[3] However, the variations are large, given the differences between advanced and less-advanced countries and regions, and between sectors. Infrastructure projects generally score better given their size, political salience and the related careful scrutiny of the Commission. The efficiency gap can be ameliorated through careful project selection and design of management systems, and the Commission offers ample assistance in project management and for capacity building. Yet the differences in efficiency in spending among the member states remain considerable.

[3] G. Schwartz et al. (eds.), *Well Spent: How Strong Infrastructure Governance Can End Waste in Public Investment*, International Monetary Fund (Washington, DC, 2020).

When it comes to effectiveness, a specific problem relates to a tendency to bureaucratise project management. The many objectives of the EU, from growth and greening to social inclusion, and the need to meet the reporting requirements of many indicators (e.g. measuring the contribution to sustainability and gender balance) dilute the focus of projects and steer their management towards a box-ticking exercise. One of the recurrent themes in the debates on reforming the budget is the reduction of bureaucracy to increase the efficiency and effectiveness of spending.

It is understandable to some extent that effectiveness has received less attention. Effectiveness should not be a problem in democratic societies where the political level decides on the objectives of the investments. It is the subsequent task of the administrative system to ensure value for money (efficiency). In a perfect democratic system, effectiveness is guaranteed, given that the political level decides on what is important. In reality, EU decisions on the objectives to be achieved through the provision of funding are compromises between the member states and the EU institutions.

These compromises create various kinds of problems. First, EU programmes define the areas for investment, but these EU priorities may not match the specific needs of countries and regions. Compromises can cause ‘target overload’. This can be seen in Cohesion Policy, for example, which covers a plethora of social, regional, gender and environmental objectives. The Resilience and Recovery Facility of the NGEU targets specific objectives (greening, digitalisation and competitiveness), as well as obligations to reform policies and institutions. The overload of objectives and requirements complicates the allocation of funds, hampers transparency on decisions as to whether spending is justified and gives the Commission ample room for manoeuvre to award funding as it can always be justified. This also explains why member states generally receive the funding. Hence, the focus has been on following procedures (the legality of spending), not on effectiveness.

This triggers a second problem, that of ownership. Member states receive earmarked funding and are keen to use it even though the subsidised projects may be politically and economically less relevant than projects on the national list of priorities. Moreover, even if ‘EU added value’ were to be defined at the EU level, this would not imply that this added value would be equally felt in the member states. Transport is an obvious example where EU preferences for long-distance cross border connections clash with the realities of national and regional interests. EU public goods may not be identified as being national public goods.

A third problem is the mismatch between funding needs and the funds that are available. Some member states have departments set up specifically to spend the sizeable EU funds. These departments operate quite independently from the national public investment agenda, for which money may be scarce. This gives rise to a situation in which, on the one hand, EU funds may be looking for projects—and even projects that the countries involved do not really want—while on the other hand, national projects that are needed may be suffering from underfunding. Italy is currently stopping projects funded by the Recovery and Resilience Facility, whereas in other countries the costs of projects are going up due to a lack of competition for the funds available.[4]

Conclusions and discussion

Debates on EU investments and EU debt will increase while prospects for budget reform look slim. Continued frustrations over the modernisation of the EU budget are quite likely. Instead of meeting the debates over the size and distribution of the EU budget head-on, it might be wise to start by mapping

[4] S. Cantarini, ‘MEP: Italy’s Post-RRF Spending Cuts Set Dangerous Precedent for EU Funding’, *Euractiv*, 3 June 2024.

and diagnosing the underlying problems concerning the legitimacy and effectiveness of EU spending. Political pressure to deliver a new budget will be high, so it might be productive to begin by defining the quality criteria for a credible EU budget.

To arrive at a more legitimate budget, auditing needs to be placed in the hands of independent and transparent bodies operating outside of the European Commission and the responsible national ministries. Neither the Commission nor the member states will be inclined to move in this direction. The current ways of working allow for almost continuous negotiations between member states and the Commission over changes to projects and, if necessary, over the scaling down of expectations. This helps to ensure flexibility in project management in the face of price increases and setbacks along the way, but it also raises the question of whether the Commission is too closely involved. Moreover, member states are more or less guaranteed to get their funding and audits approved. The system is focused on the absorption of funds and on preventing member states from ending up with unpaid bills.

Improving the management of the EU budget should be linked to the good governance principles of (network-based) subsidiarity, independent monitoring and accounting, and transparent reporting. To strengthen the EU's effectiveness, national audit institutions (independent agencies) should assess the legality and results of projects. So far the national supreme audit institutions have shown little interest in assessing the outcomes of EU spending.

Moreover, the question needs to be raised of at which level political decisions should be made regarding defining the objectives of funding programmes. Should the EU budget aim to achieve EU added value despite less national ownership or finance national added value in the hope that in the end everyone benefits? Should member states themselves decide on how to use the subsidies? This would allow the centralised rules and supervision to be slimmed down. Some countries may prefer to spend more on the green transition or education, while others might spend more on growth and defence. Such changes can only happen, however, if independent and transparent auditing of the outcomes of projects is guaranteed. National flexibility requires national credibility.

The introduction of eurobonds is likely to remain part of the debates on the EU's finances. Given the current state of play of the EU budget, there are good reasons to be critical of the use of common debt. So far little progress has been made to address the underlying weaknesses in assessing the effectiveness of spending. Addressing the issues that undermine the credibility of the EU budget could be a useful step out of the impasse and of the repetition of failed debates on budget reform. A credible budget is more important than its size.

	Programme 1	Programme 2	Programme 3
	Building on the EU level: good governance	**Ensuring multilevel interdependence**	**Establishing national-level preconditions**
Project 1	Use the EU budget as a case study to assess the quality of the core themes of good governance, including transparency, accountability and independent supervision. EU debt will, in part, depend on the quality of EU spending. In 2026 it will be 25 years since the White Paper *European Governance* was published after the fall of the Santer Commission.	Assess the themes highlighted in the 2001 White Paper *European Governance*. What is the state of transparency? Have independent agencies been accepted at the national level? The management of the EU budget indicates that major gaps persist both at the national level and in EU networks.	Using teams, assess the national investment systems—the quality of these varies considerably.
Project 2	Re-examine the level of harmonisation, with a view to allowing member states more flexibility in spending.	Examine the role of the budget in stimulating economic convergence. Some countries have had persistent problems with convergence; others have performed remarkably well. To what extent is convergence linked to the use of the budget? This could offer a basis for reconsidering the role of the EU budget.	The next Commission should assess the quality of the legislation of EU funds with a view to subsidiarity, proportionality and impact. The bureaucracy of EU funds hampers the effectiveness of its spending.
Project 3	Give priority to enforcement, the required networked-based institutions of checks and balances, and the separation of roles, which are currently in the hands of the Commission.	Examine the effects of the reports by the ECA that have highlighted the weaknesses in EU spending. This spending as a shared responsibility has been the object of 25 years of frustration.	Member states should reconsider the use of conditionality. Does conditionality complicate the effectiveness of EU spending? Does it hamper national ownership of the EU funds?

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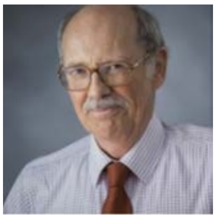

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