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The EU's Future Prosperity: What Role for the Fiscal Framework?

KEY MESSAGES

- **Public investment has been low in recent years, resulting in shortcomings in infrastructure and other public assets capable of underpinning economic growth and competitiveness**
- **Efforts at the EU level to establish a Sovereignty Fund intended to enhance competitiveness and to respond to the likes of the US Inflation Reduction Act have been watered down, as have plans to boost funding for the Strategic Technologies for Europe Platform**
- **Although golden rules have fallen out of favor in some jurisdictions, there is a case for a fresh look at how such rules, applied at both the EU and member state levels, could boost the quality of public finances and competitiveness**
- **Three principles for a revived approach to golden rules could be: a focused, but more open approach to eligible spending, as opposed to conventional national accounting definitions of investment; scrutiny of government plans by independent financial institutions or similar; and the adoption of a medium-term perspective**
- **Building on the analytic reviews by Mario Draghi on competitiveness and Enrico Letta on the single market, funding EU public goods by issuing debt should be furthered, rather than relying on the constrained resources of the EU budget**

In the aftermath of the coronavirus pandemic and cost of living crises, European countries are struggling to revive economic growth and to respond to policy initiatives in major competitor countries, not least China and the United States. Countering climate change, accelerating digitalization, and securing a prominent position in emerging technologies, ranging from artificial intelligence (AI) to life sciences, are all on the agenda and are being advanced by initiatives at both the national and EU levels.

Yet, as the strongly worded opening line of a study by the European Policy Analysis Group (EPAG) (Fuest et al. 2024) observes: "The EU is losing the global innovation race." The same can be said of the EU's immediate neighbors, not least the UK. There are many well-known reasons for this outcome, among which the EPAG highlights the relatively low level of private investment in research and development, the relative concentration of that investment in what the Group characterizes as "middle technology trap" sectors (above all automobiles, and thus not at the cutting edge of science-based "new" industries), and various governance shortcomings.

In addition, the EU approach to fiscal governance plays a key role. The new approach just adopted has dealt with some of the more egregious shortcomings, but at both the national and EU levels, fresh thinking on public investment is needed. The next section assesses the global competitive challenges and is followed by a discussion of the EU's unconvincing responses to them. In the subsequent sections, the effects of the fiscal framework are examined and the merits of reviving some forms of the golden rule are considered. Policy Conclusions complete the paper.

THE CHALLENGE FOR THE EU EMANATING FROM THE IRA IN THE US AND THE CHINA 2025 STRATEGY

The EU is under pressure from global competitors, not least the US and China. In the former, the Inflation Reduction Act (IRA) is a program that, according to the latest estimates, will pay out up to USD 1.2 trillion mainly in tax credits (Goldman Sachs 2023). The China 2025 strategy aims at enabling catch-up in industries where the EU has a competitive advantage (e.g., railways or aerospace). But it is also investing in future-oriented sectors such as robotics, creating a double challenge for the EU: new competitors in old industries and competition for new sectors (Wübbeke et al. 2016).

The dearth of European companies in the global league tables of technology is also striking. The Forbes global ranking[1] lists only three Europe-based companies in the top 20: Accenture based in Ireland (and even then, the company is not really "Irish") at 13, SAP (Germany) at 16, and ASML (Netherlands) at 18. American companies dominate the list, but it is worth noting that Taiwan has two companies ranked above the Europeans. Other Forbes lists, such as the top 50 AI companies (six from the EU and two from the UK) and Fintech companies (a solitary one from the Netherlands), are even more dominated by the US.[2]

The EU has not been short of initiatives aimed at boosting its competitiveness. The Lisbon strategy launched twenty-four years ago sought to transform the Union into the "most competitive and dynamic

[1] https://www.forbes.com/sites/jonathanponciano/2023/06/08/the-worlds-largest-technology-companies-in-2023-a-new-leader-emerges/.
[2] https://www.forbes.com/lists/ai50/; https://www.forbes.com/lists/fintech50/.

knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion” by 2010. Can anyone regard it as a success? The Europe 2020 strategy had the strapline “smart, sustainable, and inclusive” growth, but scarcely fared better. The strategic ambition is now encapsulated in the “Green Deal,” complemented by aspirations on accelerated digitalization.

“Green” and “digital” are also central to the Recovery and Resilience Facility (RRF), the large fund established in 2020 in response to the pandemic (albeit not a more conventional fiscal stimulus like those implemented by both the Trump and Biden administrations). In addition, there has been much talk in Brussels about establishing a Sovereignty Fund, intended partly as a retort to the US IRA, but also as a means of reinvigorating European industry. In her 2019 political guidelines for the incoming European Commission, Ursula von der Leyen asserted that it was “not too late to achieve technological sovereignty in some critical technology areas” (von der Leyen 2019). In her 2022 State of the Union address, she went further by promising to “push to create a new European Sovereignty Fund. Let’s make sure that the future of industry is made in Europe” (von der Leyen 2022).

According to Isabel Schnabel (2024), a shortfall in public investment has been damaging for the EU relative to the US. She emphasizes the complementarities between public and private investment, and expresses concern about the overly tight timetable for investment funded by the RRF and the associated administrative burdens. The EIB also points to a gap in productive investment of 1.5 to 2 percentage points of GDP between the EU and the United States.

THE COHERENCE (OR ITS ABSENCE) OF THE EU RESPONSE AS THE AMBITIONS OF THE SOVEREIGNTY FUND HAVE BEEN WATERED DOWN

Despite calls for a substantial Sovereignty Fund, the ambition behind it has been watered down because of disputes among the member states about its purpose and which investments it should prioritize. While there are various EU programs, the landscape for promoting competitiveness is very opaque and heterogeneous. This complexity detracts from the EU’s response to challenges such as the IRA.[3] In addition, EU programs tend to be more upstream than the IRA’s investment and production subsidies and are specifically aimed at promoting certain industries. Indicators such as the quantity and quality of different publications illustrate the point: even though the quality of research in Europe is in many ways comparable to that of the US and China, it does not translate into downstream funding of innovation.

[3] https://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Publikationen/FGCEE/CAE-SVG_Joint_statement_IRA_2309.pdf.

As so often, the question of funding is critical. Making room within the EU budget for a Sovereignty Fund is bound to be contentious, with opposition likely from current recipients of EU spending on the one hand and, on the other, from net contributors reluctant to see the overall size of the budget increase. Yet the appetite for additional debt to finance such a fund is also limited.

Consequently, instead of an ambitious retort to programs like the IRA, today there is only a minimal response in the form of the Strategic Technologies for Europe Platform (STEP). Although announced with great fanfare, it has a budget of just EUR 72 billion; its financial resources are thus relatively meager and unlikely to change significantly in the future.

THE FISCAL FRAMEWORK IN FOSTERING COMPETITIVENESS

Fiscal frameworks in EU member states comprise both national- and EU-level obligations, with the latter especially binding on euro area members. The EU level’s own finances can also be conceived of as being set within a fiscal framework, albeit far from systematic at present (Begg et al. 2023). This framework comprises the EU budget, the various off-budget and associated lending mechanisms, and governance provisions.

The European Commission has long pushed for a sharper focus on the “quality” of public finances. The communication that launched the review of economic governance in 2020 (European Commission 2020) dwelt on this notion, noting that it is multi-faceted. The proposition is beguilingly simple: the “right” kind of public spending will enhance economic growth and, thus, act on the denominator (GDP) of the ratios (debt and deficits) used to monitor fiscal sustainability. The Treaty requires the Commission “to take into account government investment spending when considering whether a Member State has an excessive deficit.” The communication also recalls that the Stability and Growth Pact “recognizes the need to consider the overall quality of public finances in terms of the growth-friendliness of the taxation system and public expenditure.”

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Of the responses to a consultation launched in February 2020 by the European Commission, 60 percent "highlight the green and digital transitions as key challenges in the years to come. One-half of these respondents call for a permanent exemption of investment expenditure from fiscal surveillance indicators, as a way to tackle the twin transition, for example through a so-called green golden rule. On the other hand, nearly three out of ten respondents caution against giving preferential treatment to investment expenditure in fiscal surveillance" (European Commission 2022).

Fabio Panetta (Governor of the Bank of Italy, formerly an executive board member of the ECB) pointed out in a speech in November 2022 that net public investment had slumped in the decade prior to the pandemic, a trend in need of urgent correction. His compatriots, Enrico Letta and Mario Draghi, charged with producing reports on, respectively, the future of the single market and on European competitiveness, both emphasize the need for a fresh approach to EU-level creation of public goods.

In a speech anticipating the findings of his review of EU competitiveness, Draghi (2024) highlights the need for the EU to be the provider of public goods to resolve the problem of underinvestment where a single member state cannot appropriate the benefits: "Where there are investments from which we all benefit, but no country can carry out alone, there is a powerful case for us to act together – otherwise we will underdeliver relative to our needs. We will underdeliver in climate and defense, for example, but in other sectors as well."

After lengthy negotiations, the Council of Economic and Finance ministers reached an agreement at the end of 2023 on a revised EU approach, emphasizing debt sustainability assessed country by country rather than with common rules. However, it is unclear whether it will lead to changes in how public investment is prioritized and how productive public investment can be stimulated.

A REVIVED GOLDEN RULE?

Over the years, many jurisdictions have made use of a golden rule to restrict borrowing to the funding of investment, while current public spending had to be balanced by revenue. Up to 2009, Germany was a leading example, yet it is instructive that when the German debt brake was introduced that year, the golden rule was abandoned. A similar rule in the UK was terminated at much the same time, but is likely to be revived by the Labour Party (Reeves 2024) if, as seems nearly certain, it wins the general election due to take place in 2024.

Anderson and Darvas (2020) summarize the advantages and drawbacks of a golden rule, but also mention a number of proposals designed to limit the negative effects, such as by specifying categories of public investments more likely to enhance growth or able to avoid distorting investment priorities. The principal objection to golden rules is that it becomes increasingly difficult to restrict the coverage of public investment when political leaders try to exempt new categories of spending from the current balance rule. In addition, unless the exempted categories of spending demonstrably increase future GDP, public debt ratios could rise.

Equally, proposals for exemptions have abounded. Keen to create momentum for the European Fund for Strategic Investment (EFSI, which evolved to become InvestEU), the European Commission issued (cautious) guidance in 2015 permitting Stability and Growth Pact rules to be eased for contributions to EFSI, as well as for action to accelerate structural reforms. A more subtle approach mentioned by Anderson and Darvas is to vary the golden rule according to the economic cycle, seeking to boost (or avoid cuts in) public investment in downturns, but being more stringent in boom times – they call this an "asymmetric golden rule."

There have also been calls for some form of "green golden rule" (for example, Pekanov and Schratzenstaller 2023). While the motivation is laudable, the risk of debt outpacing GDP growth remains. These authors also concede that adding a specific category of exemption would further complicate EU fiscal rules that are already criticized for being too complex. A solution proposed by van den Noord (2023) is for EU-level co-funding, making it more likely that fiscally constrained member states would be able to maintain public investment.

Could an independent board or agency be charged with assessing government proposals for investments subject to a new golden rule? In principle, independent fiscal institutions can play such a role, certainly at the national level by exercising a "watchdog" role, though over and above their primary mandate of scrutinizing the sustainability of public finances. An alternative model could be an independent infrastructure commission, as in New Zealand, where the mandate is to advise the government on planning and implementing major projects, including by combining public and private funding.[4] At the EU level, an extension of the role of the European Fiscal Board might be envisaged.

Another approach could be to allow exceptions where a certain future stream of income is equal to (or greater than) the cost of servicing and amortizing the investment. A similar, albeit not as far-reaching principle, exists in the German debt-brake exceptions if the government acquires specific types of assets. For example, an investment in rail infrastructure can be made if the money is later collected through fares. Such a concept may also be politically attractive if it allows expenditure usually classified as public consumption, but it rules out politicians' spending

[4] https://tewaihanga.govt.nz.

money on additional social welfare based on debt. The advantage of such an idea is that it is specific and contained (compared to some conceptually vaguer options). However, it could be criticized as being a bit bureaucratic and politically awkward, since each proposed budget line would have to be justified.

POLICY CONCLUSIONS

EU member states have consistently resisted providing the Union with the budgetary resources required to make a telling difference in stimulating competitiveness. In the mid-term review of the MFF, even the modest proposals for a bigger budget for STEP were salami-sliced. Proposed new funding was cut to EUR 1.5 billion and was accompanied by a cut of EUR 2.1 billion in the Horizon research budget. An article in Euractiv quotes Simone Tagliapietra of the Bruegel economic think tank as saying, "We were expected to get an EU fund to strategically invest in clean tech after the IRA, and what we get, basically, is a website."[5]

The EU public investment shortfall does not bode well for a revival of growth and higher system productivity. It is also likely to have a damaging effect on intergenerational fairness. Consequently, despite the reservations about golden rules, there is a sufficiently persuasive case for adopting such a rule both as a component of the revised fiscal framework in relation to national policy and for the EU level of public finances. The question then becomes how, so as to limit the negative effects. Here we suggest three principles.

First, public investment should be defined in such a way as to reflect economic priorities and not be unduly confined by national accounting conventions, notably the emphasis on physical capital. For example, maintenance of infrastructure may be more valuable than big, costly new projects. While there is bound to be a risk of opening Pandora's box, the guiding principle should be the potential contribution to sustainable growth. In Germany, for example, the Council of Economic Experts (2023) has clearly identified deficiencies in data infrastructure as a threat to growth.

Second, external scrutiny by the national IFI (or the New Zealand option of a dedicated body) or, for the EU level, a beefed-up European Fiscal Board can be used to validate public investment choices. There will be some risk of adding to administrative burdens, but these can be attenuated by a combination of suitable guidelines and transparency. In addition, performance indicators can serve a useful purpose in ensuring that qualitative milestones and quantitative targets are achieved. Indeed, as championed by the OECD (2023), an enhanced performance budgeting framework could be envisaged as a tool for effective delivery.

The third principle is to adopt a long enough medium-term perspective for public investment, linking it to creating public assets. For too long, the disciplinary character of fiscal rules has been at their core, but predominantly focused on the short term. Avoiding having too great a concentration of effort on one theme, such as "green," to the exclusions of others is also important.

[5] https://www.euractiv.com/section/energy-environment/news/eu-closes-deal-on-scaled-back-clean-tech-sovereignty-fund/.

Both Letta and Draghi identify fragmentation at the European level as an obstacle to technological advances and draw the conclusion that greater EU involvement in financing is required. However, the details will be crucial. Sentiment today has become negative about new EU funds based on borrowing (although the Ukraine Facility agreed on in February 2024 is a counter-example), while the experience of STEP is discouraging. Yet the concept of an EU-level Sovereignty Fund should not be abandoned too readily. As stressed by Draghi, EU public goods could be pivotal if they are under-provided by either private agents or by the public sector at the national level; he cites energy grids and super-computing as good examples of "chokepoints" that the EU level would be best placed to rectify.

Draghi clearly advocates EU borrowing as the answer but coupled with bringing in substantial amounts of private capital. Letta, too, mentions borrowing as the preferred mechanism for funding a new wave of EU public goods, also making the case for consolidating the many existing streams of EU borrowing. The obvious model here would be InvestEU, but with the difference that it would be based on EU borrowing, rather than funding from the EU budget. The reluctance evident in the mid-term review of the MFF to allocate funding to STEP testifies to member states' wariness about new money for the EU level. The modalities of servicing and repaying debt are also tricky: for NGEU, future EU budgets will bear the burden.

A predictable question is whether the EU level can be trusted to administer an investment strategy aimed at boosting the Union's competitiveness, especially in new strategic technologies, against a backdrop of member states' reluctance to increase budgetary resources. There are positive stories to be told: in batteries, the ECA (2023) renders a positive verdict. Yet there is a lingering suspicion among member states about making resources available to the EU level. A test here could be whether the monitoring and evaluation framework (perhaps following the "milestones and targets" approach of the RRF) can be made robust.

Nevertheless, if EU competitiveness is to be enhanced, it needs a supportive fiscal framework and imaginative solutions to complement measures to boost innovation.

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