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Beware what lies beneath: Pragmatic policies for reconciling debt and growth

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Abstract
The EU has a plethora of investment needs. However, the scale of the required investments will not be reached if the EU's financial stability is called into question. This article calls for a set of pragmatic policies which can generate significant economic growth and raise living standards. This growth will be a key ingredient in increasing employment, improving competitiveness and strengthening budgetary sustainability. The associated fiscal space will also contribute significantly to narrowing the investment gap in the next decade and beyond. The article sets out three pillars—stability and governance, growth and fairness, and budgetary accountability—as the key drivers in building a pragmatic economic programme which bridges the gap between fiscal conservatism and future expenditure. It further identifies the need to refocus on the single market as a key economic driver. It also calls for any discussion on further joint EU borrowing programmes to be postponed until funding sources for the existing Recovery Fund are agreed and its overall economic effectiveness can be analysed.

Keywords
EU, Debt, NextGenerationEU, Budget, Multiannual Financial Framework, Sustainability, Own resources

Introduction

On the 21 July 2020—in the midst of the initial wave of the pandemic—the European Council reached agreement on budgetary and Recovery Fund frameworks for the EU

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totalling €1,034 and €750 billion respectively. To be financed by the borrowings of the European Commission on the capital markets, the Recovery Fund was simultaneously hailed as a critical step forward in the creation of deeper European integration and a symbol of solidarity in a time of unprecedented crisis.

At that time the opposition of several member states—Austria, Denmark, Finland, the Netherlands and Sweden—to the non-refundable grant element of the Recovery Fund was viewed as being out of step with the public mood (Dennison and Zerka 2020). However, the events of the past three years have shown how a changed economic and geopolitical landscape—arising primarily, but not wholly, from Russia's invasion of Ukraine—can rapidly alter underlying financial conditions, unexpectedly increase future spending commitments and challenge the fundamentals of existing budgetary frameworks.

In this context, the Recovery Fund symbolises the seemingly irreconcilable tension between the demands for increased government spending on one side and the need to ensure budgetary sustainability on the other (Matthes et al. 2023). Politically, the debate over the nature of the Recovery Fund highlighted that for some on the left of the political spectrum this 'solidarity' was viewed as just the starting point for establishing the principle of leveraged financial instruments at EU level (Stanishev 2020).

This article takes as its starting point the recently published *7Ds for Sustainability: Strategic Policy Initiatives for the European Centre–Right* (Hefele, Welle et al. 2023).[1] The article focuses on the issue of 'debt', sketching an approach to achieving a pragmatic political consensus that balances debt sustainability concerns with the requirements of increasing employment and modernising public services.

The basis for the work of Hefele, Welle et al. is formed by the core beliefs of Christian Democratic and conservative people's parties—a focus on pragmatic solutions, not immovable ideologies, and the desire to be a reconciling and moderating force between both political extremes (Hefele, Welle et al. 2023). These objectives are at the very core of the Martens Centre's longstanding commitment to the middle of society, or the 'middle classes' in European societies (e.g. Siegmann et al. 2018; Drea 2018).

This article is structured as follows. First, taking the events of July 2020 as a starting point, it provides a brief analysis of how the Recovery Fund (and subsequent geopolitical events) has had unintended consequences for the debates about financial sustainability in the EU. The implications of these consequences for the political process in Brussels are also briefly highlighted. Second, three pillars are proposed which have the potential to act as consensus builders in forming a stability-orientated and growth-focused approach to economic policy. These pillars would serve to bridge the gap between fiscal conservatism and increased future expenditures—thus they would be pragmatic policies for reconciling debt and growth. The last section offers some reflections on the potential future path.

Joint debt: beware what lies beneath

Although the soaring (European) political rhetoric surrounding the establishment of the Recovery Fund—'We did it. Europe is strong . . . Europe is united' (Michel 2020)—was reflective of the public health uncertainty at that time, it also represented a belief that Europe had reached a transformative moment of deepening integration (Kaletsky 2020). Even more-detached observers viewed the establishment of a joint European debt instrument as a 'baby step' on the path to a unified eurozone debt market (Calhoun 2020).

However, the events of the three years that have passed since the agreement of July 2020 have highlighted the economic and political risks associated with using an unexpected (public health) crisis to deepen the economic integration of the EU. The outbreak of war in Ukraine in early 2022 (and the associated rise in inflation levels) quickly overshadowed the longer-term implications of the development of joint EU borrowing.

So, while the EU, quite understandably, has been focusing on the conflict in Ukraine and its myriad geopolitical consequences, the impact of the Recovery Fund on the EU's budgetary sustainability is only now coming into focus. And this focus is becoming even more important given the EU's increasing dependence on borrowing to finance its activities. From the ongoing financial support to Ukraine—€18 billion with another €50 billion proposed up to 2028 (European Commission 2023a)—to the increasingly ambitious environmental targets which require at least €1 trillion in investment over the next decade (European Commission 2020), the EU is spending like never before.

And those spending commitments are in addition to the €646 billion allocated by member states to shield consumers from rising energy prices (Sgaravatti et al. 2023) and the, as yet undefined, spending by both Brussels and the national capitals in response to President Biden's Inflation Reduction Act in the US.

The political pressure to further increase public spending remains high. The eurozone budget deficit remains over 3% in 2023, notwithstanding rising interest rates and debts of more than 100% of GDP in six member states.[2]

In this context, the Recovery Fund and all the EU spending commitments that have followed are already causing significant political tension in Brussels (Drea 2020). If left unresolved, these tensions will result in significant economic dislocation in the years ahead. The key elements in such disagreements will include, but not be limited to

a) *arguments about how to repay the Recovery Fund.* The continuing delay in introducing increased revenues for the EU (its 'own resources') is weakening the EU's credibility regarding future spending commitments. As of June 2023, only increased national contributions based on non-recycled plastic packaging waste had been implemented. A broader agreement is unlikely before 2026 (Dobreva 2023). Therefore, no significant EU revenue streams are yet in place for repaying the Recovery Fund.

b) *disputes concerning monetary policy*. Due to rising interest rates, the initial borrowings of the Recovery Fund have already become significantly more expensive than originally envisaged (Pop 2022). Debt servicing costs for EU borrowings in 2024 are estimated to be double the original estimates (Johnston 2023). Leaders from heavily indebted states are also openly criticising European Central Bank policy due to their own precarious fiscal positions (Kazmin and Arnold 2023).

c) *the negative impact on the EU budget.* The increase in borrowing costs for the EU is now so significant as to endanger longer-term EU budgetary planning. This in turn has resulted in the European Commission seeking 'top up' contributions from members states (*Reuters* 2023), despite slowing economic growth and a rise in support for Eurosceptic parties in many member states.

d) *the effectiveness of the Recovery Fund*. Despite its clear criteria for investment, the Recovery Fund's resources remain only partially disbursed. As of June 2023, only €106 billion of grants and €47 billion of loans had been disbursed (European Commission 2023b) or just over 20% of the planned investment package. The Recovery Fund has also been subject to warranted criticisms regarding the nature of the projects submitted by some member states. All these factors cast doubt on the ultimate economic effectiveness of the joint borrowing mechanism.

e) *widening internal EU divisions*. The Recovery Fund has moved to centre stage in two widening political divisions in the EU. First, it is now an integral financial pressure point in the ongoing battle over 'rule of law' concerns in both Poland and Hungary. Brussels' funding for these states via the joint borrowing mechanism remains suspended. Second, the Recovery Fund has gradually hardened attitudes in key EU contributor states—Finland, the Netherlands and Germany among them—in terms of finding solutions regarding the future governance of the eurozone area. Both these debates remain deadlocked despite the fact that this means that significant structural challenges remain unresolved.

Pragmatic policies for reconciling debt and growth

As sketched out in the preceding section, it is obvious that the EU has a plethora of investment needs in the coming decades. However, the scale of the required investments will be impossible to achieve in the longer term if the EU's financial stability is called into question. However, this does not preclude additional EU and state level investment in the years ahead. Nor does it imply a return to the 'austerity' ideology of a decade ago.

Rather, it calls for a set of pragmatic policies which can generate significant economic growth. This growth will be the key ingredient in increasing employment and improving budgetary sustainability. This increased fiscal space—coupled with targeted investments in key productivity drivers—will contribute significantly to narrowing the investment gaps in the next decade and beyond.

This section sets out three pillars on which a centrist methodology for reconciling debt and growth should be built. The policies proposed are neither radical nor new; rather they involve refocusing on traditional EU policy priorities which have, unfortunately, slipped from view in the years since 2019.

Pillar 1: financial stability through credible governance

The decade from 2008 illustrated clearly the devastating impacts of instability in the financial sector and its spillover effects on whole societies. The costs of this instability will need to be repaid for many years to come in countries such as Ireland, Greece and Spain. To ensure a sound foundation for future investment needs, a core principle of financial stability through credible governance is essential. This pillar comprises two key elements:

1. *Stability through the completion of critical single market initiatives*. The financial structure of the eurozone remains incomplete. The solutions that are required are well known: the Banking Union must be completed, and further work must be undertaken on deepening the Capital Markets Union and regulating/managing emerging assets such as crypto and central bank digital currencies. Although lacking the political visibility of physical infrastructure projects, reducing barriers to the flow of capital around member states is one of the most vital tools for strengthening financial stability across the EU. A more integrated market for capital will widen funding sources for businesses, reduce borrowing costs and increase cross-border investment. All that is required now is the political will to drive these projects forward.
2. *Depoliticised eurozone governance which empowers national capitals*. For over two decades, members of the eurozone have debated its flawed institutional structure and allowed politics to weaken the credibility of its governance structure. Ongoing debates on the current European Commission proposals seem, once again, to be far from resolution (Tamma 2023). A non-theoretical approach is required that is informed by both economic history and political realities. Independent institutions should be given a more important role at both EU and national level (e.g. through the European Fiscal Board and the national fiscal councils). The implementation and enforcement of the Stability and Growth Pact should be depoliticised and a simplified common quantitative benchmark (e.g. a cap on public spending growth if the budget deficit is more than 3%) applied (Matthes et al. 2023). This approach would simultaneously remove political pressures at EU level and make national parliaments assume more responsibility for the consequences of their economic policies. It would also ensure independent enforcement of the existing rules. Perhaps most importantly, it would allow significant public investment in the long run as it would be based on a simplified procedure which offers clearer accountability.

Pillar 2: without growth and fairness we are all dead

A key lesson from the decade of financial crises that started in 2008 is that necessary fiscal adjustments can be undertaken 'in a growth unfriendly and unsustainable way' (Thomsen 2019). Given the multiple negative impacts on societal well-being over the last years (the pandemic chief among them), it is imperative that growth and fairness form a central component in building more robust societies. The two key elements of this pillar are:

1. *Breaking down barriers to growth*. As in Pillar 1, the single market has the potential to create jobs, widen business opportunities, stimulate trade and increase living standards across the entire EU. In every economic sector, the deepening of Europe's internal market is necessary to build on the stalling achievements of recent decades. The single market is the economic engine of the EU's economy and it should once again be placed at the forefront of the EU's strategies to build a bigger and fairer European economic space. A truly competitive Europe is a Europe that has the single market at its core.
2. *Intergenerational fairness at the heart of a modernised social market economy*. Since 2008, inequalities between the younger and older generations in Europe have increased significantly (Wolff et al. 2015). The EU cannot afford to allow this trend to continue. At the heart of a modernised economic model must be policies designed to allow younger generations to achieve social mobility, gain secure jobs, buy or rent property at a reasonable price, and save for their retirement. Without these prerequisites, social unrest, and the drift to the political extremes, will increase. Younger generations must be given a chance—taxation, social security and education systems must be updated. Flexibility and the individualisation of public services must be introduced to reflect that the traditional model of education, 40 years of stable employment and then retirement is no longer the predominant one. Leadership must be shown by ensuring that fairer taxation systems are implemented, that is, taxation models which widen the tax base to ensure that the burden is not disproportionately placed on the income earned by working generations. Social security systems must be updated to reflect modern realities—more flexible and affordable childcare, better work–life balance initiatives and reduced taxation for middle-income earners. We have to give younger generations the socio-economic frameworks necessary to succeed and flourish today.

Pillar 3: playing the tune means paying the piper—budgetary accountability

As noted, the scale of the investments required in the EU in the coming decades is staggering. Therefore, a key component in ensuring that a high level of public funding is available is the efficient use of all available financing options. However, a significant proportion of the required spending will be carried out at a national level, either utilising

existing EU funding programmes or through private-sector support. Therefore the key things to consider in this pillar include, but are not limited to:

1. *The fact that discussion of future joint borrowing mechanisms is premature and unhelpful*. It is not appropriate for the EU to consider further joint borrowing programmes when the existing Recovery Fund process remains unfinished. Two immediate issues have precedence. First, agreement on the EU's own resources must be reached as soon as possible to ensure that the Recovery Fund can be repaid in a timely and sustainable manner. Failure to do this will jeopardise the EU's standing in the financial markets. Second, given the increased interest costs associated with the Recovery Fund and ongoing debates about its disbursement and impact, a detailed review of its economic effectiveness should be carried out prior to any decision being made on future EU joint borrowing programmes. This review should also include the process for the selection of projects by national capitals.
2. *That recent history shows the need for a more flexible and responsive EU budget*. The experiences of the pandemic and the war in Ukraine have illustrated the need for a more responsive EU budget to reflect unexpected external events and emerging priorities. In this context, there should be more regular reviews of the overall Multiannual Financial Framework and member states should be granted greater flexibility to transfer unused funding to other designated investment uses.

Charting a path forward

The severity of the socio-economic crises buffeting the EU over the last two decades represents an unprecedented challenge for the European integration process. This article has sketched out a three-pillar approach to building a pragmatic politics for an economics of the centre. These pillars should attempt to act as consensus builders, forming a stability-orientated and growth-focused approach to economic policy. At the core of this proposal is the need to find a balance between fiscal conservatism and increased future expenditures. It is a challenge that must be conquered if we are to avoid burdening future generations with the fruits of our inaction.

Notes

1. The 7Ds are defence, digitalisation, debt, deglobalisation, demography, decarbonisation and democracy.
2. Belgium, France, Spain, Portugal, Italy and Greece.

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