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Policy priorities and initiatives for financing EU's growth model and withstanding global challenges?

Public Goods at EU/EA Level

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Policy priorities and initiatives for financing EU's growth model and withstanding global challenges?

Public Goods at EU/EA Level

Abstract

Becoming ever more exposed to global developments that transcend the powers of national governments, the European Union needs to widen the spectrum of strategic public goods it provides. To avoid fruitless conflicts over the '*juste retour*', this should be funded by new permanent EU fiscal resources, with an appropriate mix of taxation and debt issuance, and underpinned by proper democratic governance. Not only would this advance the Union's strategic goals but also yield benefits for economic stability, convergence and growth.

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LIST OF ABBREVIATIONS

CAP	Common Agricultural Policy
ECB	European Central Bank
EEA	European Economic Area
EFB	European Fiscal Board
ESM	European Stability Mechanism
GDP	Gross Domestic Product
GNI	Gross National Income
Greens/EFA	The Greens/European Free Alliance
IFI	Independent Fiscal Institutions
NATO	North Atlantic Treaty Organization
NGEU	New Generation EU
RRF	Recovery and Resilience Facility
SGP	Stability and Growth Pact

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EXECUTIVE SUMMARY

The European Union is increasingly exposed to events arising from global developments, such as migration, climate and health emergencies, threats to energy and cyber security, and armed conflict. The recent experience with the Covid-19 pandemic, and the acute energy shortages after the Russian invasion of Ukraine, have shown that such events easily transcend the ability of EU member states to be addressed on their own. As a result, a demand for a new strand of strategic public goods, to be provided at the EU level, is emerging.

Public goods provided by the EU to date have been largely of a regulatory or operational nature, pertaining to e.g. the single market and single currency and the conduct of common competition and trade policies. This is about to change, however, with the spectrum of public goods provided by the EU likely to widen towards investments in infrastructure, natural resources and human and digital capital. Such spending is likely to make a much larger call on EU fiscal resources.

The provision of public goods with EU-wide strategic importance risks to be undersupplied at the national level as their benefits are not sufficiently internalised. Moreover, even if large economies of scale of central provision can be reaped, conflicts about a '*juste retour*' are always around the corner, which may lead to undersupply also at the EU level. Therefore, ideally their funding should be assigned to the EU level as well, endowing it with its own, permanent, revenue sources, based on an appropriate mix of taxation and debt issuance.

The allocation of taxation powers to the EU should not a priori discriminate between member countries, while the tax should be relatively easy to implement and conducive to achieving (other) EU policy and goals, including to combat tax avoidance and evasion. Two such tax resources have entered the debate prominently: an EU corporate profit tax and an EU wealth tax. While the former can build on a history of harmonisation and coordination, the latter would break new ground, yet be worth considering in view of concerns about financial fragilities stemming from excessive inequality. Earmarking the proceeds from carbon tax and emission trading to repay EU debt incurred during the Covid-19 pandemic (under 'New Generation EU') could complement it.

The EU provision of public goods in the pursuit of the energy transition, climate mitigation and adaptation, and security, ultimately serves to protect the sustainability of economic growth and welfare. Endowing the EU with its own powers to tax and borrow would further the pursuit of this goal. Not only would it create an additional instrument for macroeconomic stabilisation, thus easing the burden on monetary and national fiscal policies, it would also present an opportunity to expand the pool of EU safe bonds, widely seen as necessary to deepen EU capital markets, promote the use of the euro as a global reserve currency, and – via a lower cost of financing – create additional fiscal space to finance public investment.

With the onset of the Covid-19 pandemic and the Russian invasion of Ukraine the popular support for the provision of public goods by the EU has grown. Translating this support into a strong political mandate for EU provision and funding of public goods requires the democratic processes of decision making and control to be assigned to the EU level as well. Adopting the European Parliament's call to allocate more powers to the EU on strategic issues would be a first step. While still a distant prospect now, reforming the electoral system, with European (as opposed to national) political parties competing on EU-centred platforms, could be a next step.

1. INTRODUCTION

The collapse of the communist bloc and the subsequent emergence of the Central and Eastern European economies in the 1990s triggered widespread optimism that liberal democracies had the day. With the geopolitical context thus reshaped, the European Union's strategic focus shifted from institution-building towards enlargement and international partnerships, while the internal agenda emphasised the pursuit of economic integration, liberalisation and convergence.

From the outset, the Union's institutional architecture was deemed to be incomplete – especially that pertaining to the European Economic and Monetary Union (EMU). Notably the absence of an automatic system for cross-country transfers to facilitate the absorption of adverse economic shocks hitting countries or regions, alongside the weakness of alternative adjustment mechanisms via capital markets and relative price adjustment, has been widely debated. These fragilities indeed surfaced soon after the global financial crisis.

The European sovereign debt crisis that ensued led to the creation of new tools to at least stem the risk of macroeconomic and financial breakdown, in particular the establishment of the European Stability Mechanism (ESM), the Bank Recovery and Resolution Mechanism and an expanded role for the European Central Bank (ECB) to use 'unconventional' tools, such as financial asset purchases. Even so, many gaps in the institutional architecture that lay behind the underlying fragilities largely remained.

A new strand of emergency tools was created when the Covid-19 pandemic hit in 2020. For the first time in history the European Union engaged in large scale bond issuance to finance fiscal solidarity support to member countries that were worst affected by the pandemic. Grants and loans provided under this programme – dubbed New Generation EU (NGEU) – were subject to strict conditions, *inter alia* to ensure they support EU strategic goals such as the digital and energy transitions, with its timing proving extremely fortunate in view of the Russian invasion of Ukraine.

New fragilities have become apparent in the areas of energy, cyber and health security, climate change and the EU's territorial integrity, however. Addressing these (again) transcends the remit of member states, and accordingly increasing calls are made on the EU to fill the gap. The EU is therefore likely to expand its role as a provider of 'public goods'. Aside from emergency mechanisms, the EU so far has been mostly providing public goods that are of a regulatory or operational nature. This may well change, however, with the emphasis shifting towards (infrastructure, human, digital) capital spending, entailing a larger call on EU fiscal resources.

Drawing on the ongoing debate and a burgeoning literature, this paper applies straightforward economic principles to examine the need for such public goods to be provided, and funded, by the EU. It also assesses how this could help to achieve other EU policy goals such as financial integration and economic convergence, growth and stability. The associated need to strengthen the EU's democratic legitimacy and governance is discussed as well.[1]

[1] As all, but one, EU member countries are formally committed to adopt the single currency if entry criteria are met, the paper makes no explicit distinction between EU public goods and public goods developed for the euro area (EA), nor makes it a distinction, if applicable, for other EU-related jurisdictions such as the Schengen area or the European Economic Area (EEA).

2. THE EU AS A PROVIDER OF PUBLIC GOODS

2.1. What are EU public goods?

The European Union has since long been a provider of regulatory public goods, most prominently regarding the single market, the handling of trade and competition policy, the single currency and the conduct of monetary policy and the surveillance of fiscal and financial stability. In the current environment, however, the emphasis is shifting towards a new strand of EU public goods, which unlike the EU's 'traditional' modes of provision, may require large investments in physical, human and digital capital.

While the amount and nature of public goods to be provided by the EU is far from being agreed politically, a broad consensus has emerged that this should include 'strategic' public goods pertaining to the energy transition, security, protection against health catastrophes and the development of human capital (see again Table 1). This assessment is shaped by recent developments such as the Covid-19 pandemic, the Russian invasion of Ukraine, recurrent climate calamities, acute shortages of oil and gas and the associated surge in prices, and the rapid growth in demand for 'strategic' natural resources necessary for the energy transition.

Table 1: Overview of 'strategic' EU public goods

	Examples
Energy transition, energy security and climate	Common purchase of critical raw materials, protection of national resources, mitigation of climate effects, energy infrastructure (e.g. green hydrogen), electrification, high-speed railway infrastructure
Defence and border protection	Handling of migration flows, protection of EU's common borders, common procurement of military equipment, European defence cooperation within NATO
Digital security	Digitalisation, development of 5G network, quantum communication infrastructure
Protection against health catastrophes	Procurement of vaccines, near-shoring of medical facilities, epidemic preparedness and response
Human capital	Common platform for skills acquisition and exchange, R&D

Source: Assessment by the author based on Allemand et al (2023), Buti and Papaconstantinou (2022), Buti et al (2023), European Commission (2021), Fuest and Pisani-Ferry (2019), and Thöne and Kreuter (2020).

Ideally the provision of public goods is informed by economic principles – see Box 1 for a discussion. Usually, a distinction is made between goods that can be efficiently provided by the market and goods for which public provision is more efficient. Whatever their specifics – all public goods have in common that individuals can 'free ride' on their provision, resulting in a shortage of supply (if supplied at all) if left to the market.

Box 1: Defining features of public goods

Economic theory makes a distinction between 'pure' and other forms of public goods. A pure public good is available to all users ('nonexcludable') and can be enjoyed without diminishing the benefits they deliver to other users ('nonrival'). These goods tend to be undersupplied by the market, if supplied at all, because individuals cannot be prevented from using them and thus cannot be charged for their use ('free-rider problem').

Broader definitions of public goods exist (see Table 2). For instance, using the atmosphere as a recipient for the emission of harmful substances is nonexcludable yet rival, as it would soon be exhausted without public intervention ('tragedy of the commons'). By contrast, 'club goods' can be effectively supplied by the market, because they are excludable (yet nonrival), such as for instance internet access. However, this usually requires licensing and regulation by a public authority.

In addition, there are several forms of 'quasi-public goods'. If the use of these goods delivers benefits or entail costs that emerge as 'external effects', public intervention helps to avoid welfare losses. Other examples of quasi-public goods are 'merit goods', where individuals underestimate benefits for themselves, or 'natural monopolies' where network effects are an obstacle to private provision, and hence public intervention is required.

Table 2: Stylised taxonomy of public goods

	Nonrival	Rival
Nonexludable	Pure Public Goods	Commons
Excludable	Club Goods	Quasi-Public Goods

Source: Based on Chin (2021).

In practice these distinctions are not as clear-cut as the stylised taxonomy in Table 2 suggests, as there may be overlaps and grey zones. Moreover, what may qualify as a pure public good from the perspective of an individual citizen (e.g. the single currency in Europe), may well qualify as a club good from the perspective of a national government in the EU (its use being nonrival yet excludable if certain criteria are not met).

The regional scope of public goods can indeed be local, national, supranational, or even global, which has important ramifications as well. Specifically, would-be providers of supranational public goods, such as the European Union, may lack the legal authority to supply them at will, or to raise tax to finance them. That may occur because supranational providers deal with national governments (as opposed to individual citizens) that prove reluctant to transfer 'sovereignty' to the supranational level.

Source: Based on Buti et al (2023), Collignon (2017), and Chin (2021).

At what administrative level (regional, national, supranational) public goods are best provided depends on basic economic principles as well. EU-provision of public goods may be justified if they help achieve EU strategic goals, or the 'European Public Good' (Walker 2023). However, it would be misleading to take the pursuit of EU strategic goals as the sole leading principle for deciding on the level of provision. In some cases it may be more efficient to supply public goods nationally even if they serve the 'European Public Good'.

Whether or not the EU provision of public goods is efficient depends on the 'European value added' derived from EU-provision. Three factors determine the size of this value added (Fuest and Pisani-Ferry 2019, Thone and Kreuter 2023):

- *Spillover effects*, when sizeable cross-border positive externalities leadi to under-supply of public goods at the national level;
- *Economics of scale*, when the cost of supply falls with the volume of provision due to efficiency gains from standardisation or sunk cost; and
- *Preference heterogeneity*, when EU provision leads to welfare losses due to differing preferences among member countries.

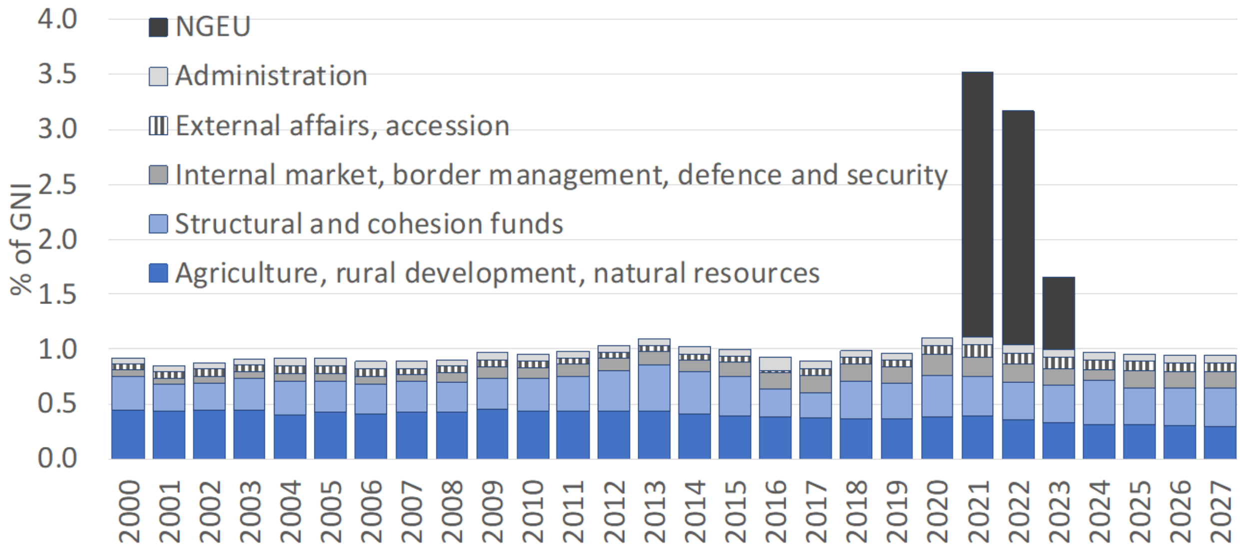
Spillover effects and economies of scale tend to raise the net welfare benefit derived from EU-provision whereas preference heterogeneity subtracts from it. It is not always straightforward to assess the net benefit of EU-provision for each and every public good. Even so, its share in the EU-budget has clearly remained modest to date, not least in view of the emerging strategic goals.

2.2. The EU budget

Since the 1980s the size of the EU budget has hovered around 1% of Gross National Income (GNI), which is considerably less than the typical levels of 20% or more found in federal budgets across the world. This reflects the predominance of the 'subsidiarity principle' guiding the mandates allocated to the EU, as enshrined in the treaties. However, it also reflects the nature of the public goods supplied by the EU which, as noted, are primarily of a regulatory or operational nature and therefore do not involve large sums of public investment spending (Begg 2021).

In fact, the largest spending items on the EU budget concern programmes that are of a redistributive nature, with grants and subsidies allocated to member countries based on pre-set formulas or ad hoc commitments. The bulk of this expenditure is taken up by transfers to support agriculture and economic convergence in member countries via the Common Agriculture Policy (CAP) and the Cohesion and Structural Funds. While the relative weight of these programmes gradually diminished over time, these still cover over 70 per cent of the total (see Figure 1). Accordingly, the EU budget is sometimes labelled as a 'historic relic' (Schout et al 2023). Even if in the latest seven-year EU-Budget for the period 2021-2027 more transfers have been earmarked for research and innovation, migration and border control, the energy transition and digitalization, these are still negligible as a share of GNI (European Commission 2021).

Figure 1: Evolution of the EU budget over time



Source: European Commission; grouping of spending categories by the author. NGEU refers to budget allocations; actual spending may take place in later years.

Against this backdrop, the launch of 'Next Generation EU' (NGEU) in 2020, in response to the Covid-19 pandemic, may be seen as a 'game changer' (Bisciari et al 2021), boosting the EU envelope available for expenditure to over 3½% GNI in 2021 and to over 3% of GNI in 2022 (see Figure 1). Under NGEU, grants and loans are allocated to national governments, subject to approval of countries' 'National Recovery and Resilience Plans'. Since NGEU covers several emergency programmes, of which the Recovery and Resilience Facility (RRF) is by far the largest, these outlays are formally outside the EU budget. Moreover, the disbursement of these funds to the national governments is more spread out over time, averaging ¾ % of GNI per annum until the end of 2026 (Darvas 2020). Even so, this implies a virtual doubling of EU outlays relative to the regular EU budget for the period 2021-2026.

Apart from its size, the main novelty of NGEU is that it is financed, not by contributions by the member countries, but by common debt issued by the European Commission on behalf of the EU. To be able to do so at favourable terms, the Commission has made use of the so-called 'headroom' built in the EU budget (resources the Commission can tap as judged necessary in case of emergencies) as a guarantee. Although the approved National Recovery and Resilience Plans should advance the 'twin' EU goals of green and digital transition, the loans and grants accorded still involve a large element of redistribution, given that the formula applied privileges 'poorer' over 'richer' member countries, albeit with stronger conditions attached than for the regular EU budget.

Although NGEU could be seen as a first step towards a permanent EU budget for public goods (Allemand et al 2023), an important aspect of NGEU that may not be easily replicable pertains to its bottom-up nature. Specifically, the approach adopted in NGEU is to invite member countries to draw up their own plans for co-funding from the EU. This approach is susceptible to risks common to EU policy initiatives that rely on countries submitting their own plans (even when subject to vetting by the European Commission) in general. Such risks include the use of EU funds to finance projects that would have been undertaken anyway, the temptation to launch pet infrastructure projects that have a purely electoral motivation and the spreading of funds too thinly over small projects (Beetsma et al 2020, Buti and Papaconstantinou 2022, Codogno and Van den Noord 2022).

Some programmes financed over the regular EU budget and NGEU do qualify as EU 'public goods' even if they are still relatively limited in size. For instance, the flagship programme RePower-EU adopted in 2022, to replace Russian gas by LNG and other energy sources such as green hydrogen, biogas and energy efficiency and electrification, is a case in point. While strategically important, it amounts to roughly € 300 bn until 2030, or 0.2% of GNI per annum (Brasili et al 2022). Other examples are the Connecting Europe Facility to develop trans-European networks in the areas of transport, energy, digital and telecommunication and a range of programmes for technology and innovation, such as InvestEU and Horizon Europe (Buti et al 2023). According to the European Commission (2021) such 'new and reinforced priorities' taken together are projected to comprise about one-third of the EU Budget (NGEU included) over the 2021-2027 period or just over ½ per cent of GNI per annum.[2] This envelope may well turn out to be too small to address emerging strategic issues over the longer haul.

2.3. The quest for 'strategic autonomy'

While the provision of genuine public goods over the EU-budget remains small, this has not always been the case. At the outset attempts to create the European Defence Community (rejected in 1954) and the pursuit of food self-sufficiency and energy autonomy via the Common Agricultural Policy (CAP) and the Euratom Treaty in 1957 were predominant. The provision of public goods by the European Communities at the time was motivated by concerns over Europe's 'strategic autonomy' (Fuest and Pisani-Ferry 2019, Papaconstantinou 2021), but this orientation of policies gradually eroded – see Figure 2 for a stylized illustration.

Over time, 'strategic autonomy' has been overtaken by goals of economic integration and convergence as the prominent European 'Public Good', as reflected in the creation of the structural and cohesion funds, the single market and the single currency.[3] While many of these programmes are found to have achieved their goals (Campos et al 2018), attempts to lift sensitive political functions – such as defence and foreign policy – to the supranational level remained firmly in the hands of the member countries (Spolaore 2015).

However, currently the pendulum is shifting back to the concept of 'strategic autonomy' as the predominant Public Good, driven by a confluence of geopolitical developments (Brasili et al 2022, Buti et al 2023, Casolari 2023, Fuest and Pisani-Ferry 2019, Gstrein 2023, Lokenberg et al 2023), including:

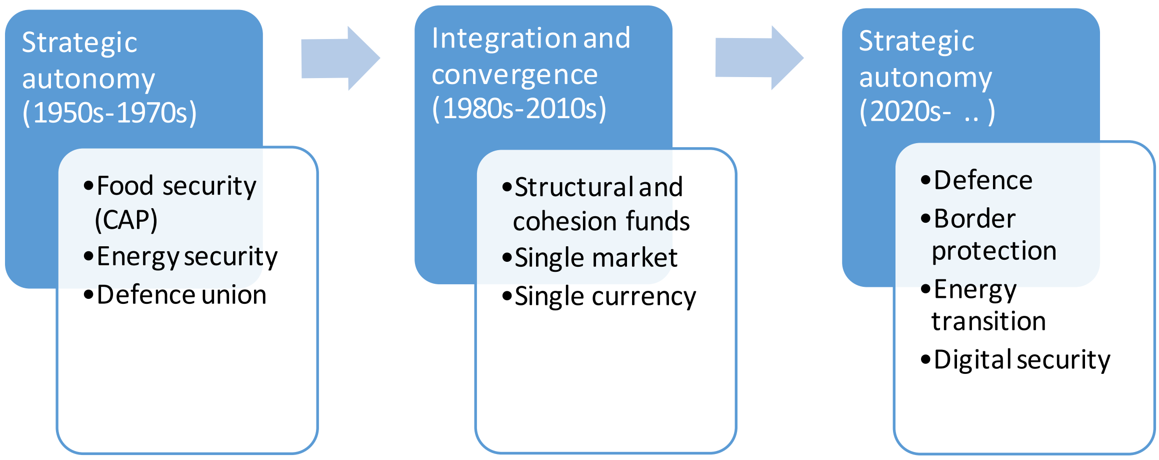
- The Russian invasion of Ukraine exposing the extent and risks of fossil energy dependency. Tapping new sources of renewable energy should help to address this issue further, but also brings new dependencies, namely on critical raw materials whose value chains are often in the hands of autocratic regimes;
- Individual member countries grappling with threats to their (cyber)security, with powerful corporations owning essential cloud infrastructure and state actors across the globe denying the importance of democracy and human rights attempting to exploit weaknesses;
- The role of the United States as the dominant military power of the North Atlantic Treaty Organization (NATO) becoming more questionable with post-cold war US priorities less and less centred on Europe, prompting an interest of EU nations to take joint defence initiatives;

2 The largest of these programmes are Horizon Europe with a budget for the 2021-2027 period of € 86 bn, Neighbourhood and Development Cooperation with a budget of € 79 bn, Erasmus+ for student exchanges (€ 25 bn) and the Connecting Europe Facility (€ 21 bn) – European Commission (2021).

3 While public goods are material or legal devices, the Public Good is about the goal of the provision and use of such devices (see Walker 2023).

- The refugee crisis of 2015 demonstrating the need for a proper EU regime of border control to screen would-be immigrants, decide on their eligibility to asylum and organize settlement; and
- The need for a strategic multilateral approach in the field of health protection after the outbreak of Covid-19, with the common procurement of Covid-19 vaccines seen as a successful harbinger for the development of more permanent tools.

Figure 2: Strategic orientation of the EU over time



Source: Based on Collignon (2017).

As noted earlier, most of these challenges have already led to the creation of new EU programmes to address them, but the EU budget is still struggling to keep up with the new realities (Schout et al 2023). However, rapid shifts in the geopolitical landscape may lead to stronger calls on the EU as a provider of public goods on a case-by-case basis, with potentially important ramifications for the funding of the EU as well as the performance of the EU economy, as discussed below.

3. THE EU AS A FUNDER OF PUBLIC GOODS

3.1. Current modes of funding

The EU budget derives its redistributive thrust from using national contributions that are largely proportional to the size of the national economies to finance transfers that are directed towards 'poorer' member states. However, at an estimated 0.2% of EU's GDP, the redistributive impact of the EU budget is quite small (Deutsche Bundesbank 2020, Riso and Pasimeni 2017). Even so, negotiations over the budget with member countries tend to be intense, reflecting concerns over a '*juste retour*' (fair return) on their contributions, which are strongly politicised.

Specifically, around 70 per cent of the regular EU budget is financed by direct payments from the national budgets (based on countries' shares in EU gross national income, or GNI), with the remainder consisting of custom duties (13 per cent of the budget) and a 0.3 per cent take from the value added tax (VAT) collected by the member countries (12 per cent of the budget). The European Commission does retain some 'own resources', consisting of the budget 'headroom' – the flexibility margins built in the EU budget for unforeseen circumstances. However, these resources still rely on contributions from the member countries. The creation of genuine 'own resources' is being considered, but so far only a levy based on volumes of non-recycled plastic – expected to yield ½ per cent of the budget (European Commission 2021) – has been introduced as of 1 January 2021.

Such a redistributive thrust is present also in the case of NGEU. As noted, the main novelty of NGEU is that it is financed via bond issuance at the center, using the EU budget 'headroom' as a guarantee. This means that the cost of redistribution is not immediately felt by member countries while the benefits are immediate. Eventually, however, NGEU debt must be repaid (by 2058) and, depending on how this is shaped, this is likely to involve some redistribution. It is yet to be decided whether repayment will be based on contributions from national budgets or by empowering the EU executive with new 'own resources'. In the former case, member countries will certainly turn out to be net contributors or recipients, although this need not be a 'zero sum' if the anticipated impact of NGEU spending (mostly of an investment nature and with EU funding subject to structural reform efforts) on economic growth is realised (Bańkowski et al 2022).

Some observers have argued that NGEU, which is intended to be temporary, should be converted into a permanent instrument for the financing and provision of EU public goods (Allemande et al 2023). However, even if that were possible within the existing legal framework, the validity of this assessment strongly depends on how NGEU is repaid. A major drawback of financing the EU provision of public goods via national contributions (directly or indirectly via the repayment of EU-debt) is that the concerns over a *juste retour* distracts the attention from the unique 'European value added' derived from such public goods (Fuest and Pisani-Ferry 2020). Ideally, therefore, the funding of EU public goods should be assigned to the level of government where decisionmakers, users and taxpayers coincide – known as the 'fiscal equivalence' principle (Thöne and Kreuter 2022). This would require a more ambitious approach to raising revenues at the EU-level.

3.2. The need for 'own resources'

In principle the provision of EU public goods can be: (i) left to member countries while possibly adjusting the fiscal framework to create the necessary fiscal room to finance it at the national level; (ii) left to the member countries but financed by supranational resources (akin to the set-up of the Recovery and resilience Facility under NGEU financed by EU debt); (iii) provided at the supranational level but financed by 'externally assigned' country contributions to bypass the EU budget (e.g. national contribution of euro area countries to the capital of the ESM); or (iv) provided at the supranational level and financed by EU own fiscal resources. All four models coexist in the increasingly complex 'European budget galaxy' (Crowe 2017, Saraceno 2021, Buti and Papaconstantinou 2022) – see Table 3.

Table 3: Modes of funding and provision

Provision / Funding	Supranational	National
Supranational	Health Emergency Preparedness and Response (HERA)	Recovery and Resilience Facility (RRF)
National	European Stability Mechanism (ESM)	Important Project of Common European Interest (IPCEI) on batteries

Source: Author's assessment, based on Buti and Papaconstantinou (2022) and Crowe (2017).

When goods are truly public, the 'fiscal equivalence' criterion (see the previous section) basically rules out the second and third options as the principal approach to provide and fund EU public goods, as this could lead to political fights over the '*juste retour*' and an associated undersupply (unless national contributions and supranational provision are underpinned by a solid legal framework such as in the case of the ESM), or (in the case of national provision) would require elaborate top-down vetting and surveillance procedures. Therefore, a combination of the first and fourth options, balancing the advantages and disadvantages of central and national provision (see Section 2.1), looks more promising. This would also be in line with survey outcomes suggesting that the European public considers national and EU provision as complements rather than substitutes and that they prefer EU provision to be funded at that level as well (see Annex).

The revision of the fiscal framework agreed by the Council in December 2023 and now awaiting approval by the European Parliament – with more realistic and better enforceable adjustment paths for national public debt, while 'protecting' strategic areas such as digital, green, social or defence – is consistent with this 'mixed' approach combining funding and provision at both the national and EU levels. Specifically, a strong call on the EU to lead the provision and financing of public goods, renders it easier for fiscal policy at the national level to focus on debt sustainability (Ubide 2023). On the other hand, to the extent a significant share of new EU public goods provision and financing is left to the member countries, the escape clause regarding the strategic areas embedded in the fiscal framework offers the necessary room for manoeuvre.

An important choice that lays ahead is what kind of own resources the EU should be endowed with to finance public goods provision at that level. Fuest and Pisani-Ferry (2020) propose four criteria to guide this choice:

- *Whether the base can be attributed to a particular member state*. Ideally this would not be the case since the benefits of EU public goods do not accrue exclusively to individual member states either;
- *Whether the revenues can be raised without requiring coordination between member states*. This would be case if the definition of the tax base is identical or at least harmonised across member countries;
- *Whether it can help reduce tax distortion*s. Reducing the incentives for tax competition between member states for a specific revenue source by raising a tax at the EU-level might be welfare enhancing; and
- *Whether the resource is related to other EU policies.* The EU should focus on revenue sources that influence economic behaviour in a direction that supports the achievement of EU policy goals such as climate mitigation or macroeconomic stability.

Fuest and Pisani-Ferry (2020) argue that allocating the proceeds from the European carbon Emission Trading System (ETS) would fit all four criteria and could therefore be used (and would be largely sufficient) to repay the NGEU debt of around € 800 bn, not least since the timeframe of NGEU debt repayment broadly corresponds to that of the trajectory towards carbon neutrality by 2050. A similar argument could probably be made for the proceeds of an EU carbon tax. However, if the spectrum of EU public goods is to be widened significantly, additional revenue sources would need to be considered as well. Two such potential sources have entered the debate prominently: an EU corporate tax and an EU wealth tax.

An EU corporate tax could build on the European Commission's proposal for a common corporate tax base BEFIT (Buti et al 2023) and was proposed earlier by the High-Level Group on Own Resources (2016). The average corporate tax take in the EU amounts to roughly 3 % of GDP and a theoretical possibility is to transfer part of this tax take to the EU-budget, or to levy a surtax for that purpose, earmarked for the provision of EU public goods. Owing to the BEFIT proposal a common tax base is virtually being established and a common tax rate relatively easy to implement. Moreover, as the combination of a common tax base and rate could help combat distortions stemming from e.g. transfer pricing and undue tax competition, it would be consistent with stated EU policy goals. How much common corporate tax should be levied by the EU is far from settled, but by way of illustration a starting point could be to assume that provisionally up to one-third of the corporate tax take (about 1% of GDP) could be earmarked for the EU.

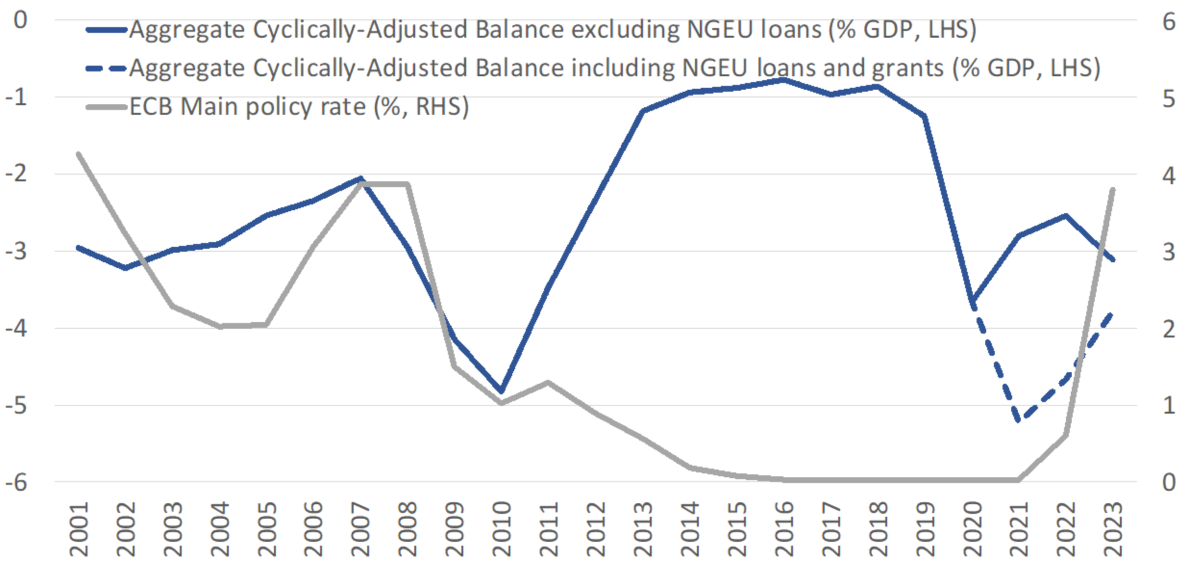
Several proposals have been floated recently for the introduction of an EU wealth tax (Kapeller et al 2021, Krenek and Schratzentaller 2022, Schwarscz 2021, The Greens/EFA 2023, European Commission 2023). Depending on how it is set up, such a new EU revenue source is tentatively estimated to yield an amount of roughly 1% of GDP. At this juncture EU wealth tax may be a remote prospect, but not devoid from an economic rationale. Since it is based on a relatively footloose tax base it cannot be attributed easily to individual member countries and would help to reduce tax avoidance and evasion. Moreover, there is evidence that growing inequality has led to excess saving, in turn fuelling credit bubbles that have resulted in financial fragility (Davoodi et al 2021). By helping to make the wealth distribution less unequal, a EU wealth tax may therefore have merits from a macroeconomic stabilisation perspective. However, this is not the only link between the provision and funding of EU public goods and macroeconomic stability, as discussed below.

3.3. The nexus with macroeconomic stability

Expanding the spectrum of public goods provided by the EU, financed by its own fiscal resources, would create to possibility for countercyclical fiscal policy via the EU budget. The case for such an active European fiscal policy to assist monetary policy has been made abundantly, including by (former) central bankers (Draghi 2023, Knot 2023).

In the absence of a fiscal policy instrument at the EU level, macroeconomic stabilisation policies necessarily rely on a combination of monetary and national fiscal policy tools. Figure 3 shows that prior to the onset of the sovereign debt crisis in 2010 the aggregate stance of EU fiscal policies and that of monetary policy moved broadly in concert, i.e. easing during the recession of the early-2000s, tightening in the subsequent upswing until 2007-2008 and again easing in the immediate aftermath of the financial crisis.

Figure 3: Evolution of the fiscal and monetary policy mix



Source: ECB, European Commission AMECO database, author's computations. ECB policy rate refers to the fixed-rate or variable-rate tenders of the Main Refinancing Operations; the cyclically adjusted balance refers to the aggregate for the 27 EU Member States.

However, when the financial crisis morphed into the sovereign crisis in 2010-2015 countries with high levels of debt were forced to strongly cut public expenditure, with public investment bearing the brunt of the adjustment (Van den Noord 2019). As a result, the fiscal and monetary policy stances strongly diverged, with an easing of monetary policy serving to offset a sharp tightening of fiscal policies (see again Figure 3). Eventually monetary policy hit the ''zero lower bound' and was forced to resort to 'unconventional' measures such as purchases of sovereign debt. With the room for fiscal policy so much constrained, ECB monetary policy was clearly overburdened.

It was only in 2020 when the EU economy was hit by another major shock – the Covid-19 pandemic – that fiscal policy resumed its stabilising role, facilitated by the suspension of the full application of the fiscal rules under the 'General Escape Clause' stipulated in the Stability and Growth Pact (SGP) in case of an 'unusual event outside the control of one or more Member States'. Specifically, as shown in Figure 3, the aggregate cyclically adjusted budget deficit jumped from 1.2% of GDP 2019 to 3.7 % of GDP in 2020 (a similar jump was recorded for the aggregate of the euro area from 1.4% in 2019 to 3.8 % in 2020 not shown in the chart) – representing the largest fiscal expansion since the launch of the single currency in 1999.

While the pandemic-related fiscal expansion in aggregate was partly reversed from 2021 onwards, some of this was offset by NGEU (though not in all countries as highlighted in EFB 2023), with the aggregate fiscal stance in the EU – now comprising both national fiscal policies and fiscal stimulus stemming from NGEU – significantly easing. Accordingly, as shown in Figure 3, the aggregate cyclically adjusted budget deficit (national and NGEU) rose to a record 5.2% of GDP in 2021. Without this fiscal impetus the economy would undoubtedly not have recovered from the 2020 downturn as briskly as it did. While some observers have argued that this fiscal expansion has been inflationary (Barro and Bianchi 2023), disruptions in supply chains and surging energy prices have probably plaid a larger role, and in any case inflationary pressure is currently receding.

Against the backdrop of the experience with NGEU it should be clear that establishing an EU budget for public goods would allow a more balanced policy mix to be a feature of the macroeconomic landscape of the European Union. The combination of discretionary public investment expenditure financed by cyclically-sensitive 'own resources' such as an EU corporate tax and/or wealth tax would be fit for this purpose. It is well-known that corporate profit tax proceeds move in a strongly procyclical fashion (Price et al 2005 and Van den Noord 2002). This is likely to be the case for a wealth tax as well since its tax base (financial assets and real estate prices for instance) is strongly correlated with the business cycle (Bricker et al 2022).

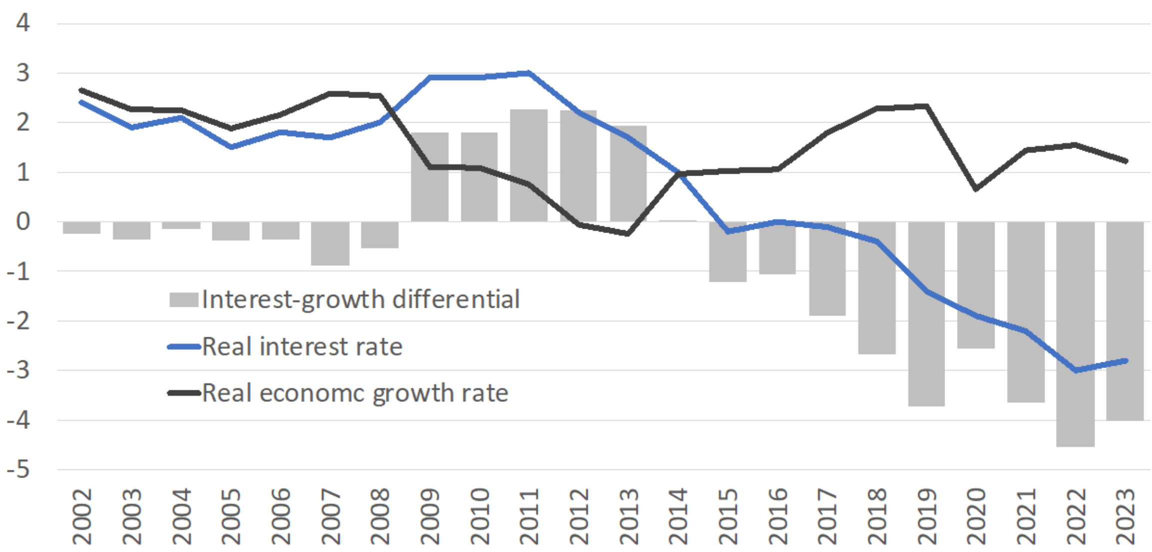
The impact of 'automatic stabilisation' at the centre, while worthwhile, would likely be limited – of the order of 0.1 percentage points of GDP for a 1% cyclical decline in output relative to potential, as compared to around 0.5 percentage point on average for developed countries' national budgets[4]. However, the discretionary nature of investment of EU public goods would allow the timing of expenditure to be adapted in case of major shocks, in lockstep with monetary policy (Bianchi et al 2023, Codogno and Van den Noord 2020), though attempts to fine-tune the business cycle should be avoided in view of the long lags of recognition and implementation.

4 The usual gauge for the automatic stabilisation effect, the semi-elasticity of the primary balance with respect to the output gap (ε), is estimated to be at best 0.1 percentage points, meaning that for every 1 percentage point increase in the output gap the primary balance would increase by at most 0.1% of GDP. This is computed as $\varepsilon = \Sigma_i w_i(\alpha_i - 1) - x(\beta - 1)$, where w_i is the GDP share of revenue source i, α_i is the elasticity with respect to the output gap of revenue source i, x is the public spending share in GDP and β the elasticity with regard to the output gap of public spending. If it is assumed that $\alpha_i = 2$ for EU corporate tax and wealth tax, and their relative GDP shares are fixed at respectively 1 % each while x=5% and $\beta = 0$, the computation yields $\varepsilon = 0.07$. See for details on the methodology Karras and Yang (2022), Price et al (2005) and Van den Noord (2002).

While conducting an active fiscal policy via an EU budget for public goods may be useful though subject to limitations, more important stabilisation effects may be expected to emerge also from the creation of a European 'safe asset' in the form of EU bonds. One purpose of such a 'safe asset' is to create a security that banks could buy to serve as collateral for interbank loans and ECB funding, instead of national sovereign bonds. Its advantage is that it would reduce the risk of the 'banks-sovereign doom loop' whereby fiscal stress and banking stress feed onto each other in a vicious circle. NGEU borrowing potentially represents a first step towards such a European safe asset. For it to succeed, however, EU borrowing would have to be made a permanent feature, and its volume larger (Christie et al 2021). This would require the EU budget to run a permanent primary deficit.

How large this EU structural primary deficit should be, in part depends on the long-term outlook for the real interest rate, economic growth and the targeted size of EU debt. The higher the latter, and the smaller the differential between the real interest and economic growth rates, the higher this primary deficit should be. For instance, assuming a long-run target for EU debt of 30% of GDP (in line with estimates by Alogskoufis et al 2020), and assuming that the real interest-growth differential would be sustained at its -2% average for the past ten years (see Figure 4), the structural primary deficit would need to be slightly over 0.5% of GDP.[5]

Figure 4: Evolution of the interest-growth differential



Source: ECB, European Commission AMECO database, author's computations. Real interest rate refers to the 10-year benchmark rate deflated by the rate of change of the GDP deflator bit averaged for the 27 EU Member States; economic growth refers to the five-year average rate of growth of real GDP for the 27 EU Member States.

This estimate of a sustainable EU primary deficit requires that real interest rates stay close to their recent lows. While obviously subject to uncertainty, a benign outlook for the interest-growth differential is supported by a recent assessment by the IMF (2023) which suggests that nominal rates are likely to reverse to close to the zero lower bound once the impact of the inflation shock has waned. If, moreover, the yields on EU debt prove to be lower than the EU average of national sovereign debt (see Section 3.4 below), even more fiscal space – allowing a primary deficit of close to 1% of GDP – could be

[5] The steady state debt to GDP ratio is defined as $d = p/(r - g)$, where d is the ratio of public debt to GDP, p is the primary balance as a per cent of GDP and $r - g$ is the differential between the real interest rate r and the real rate of economic growth g. Assuming g- r = 2.1% and $d = 0.30$ then $p = -0.6\%$

available.[6] The upshot is that part of the expanding EU role in the provision of public goods could indeed be debt financed.

3.4. The nexus with economic growth and convergence

Expanding the spectrum of EU public goods is generally expected to have a positive impact on the sustainability of economic growth via higher energy efficiency, impetus to innovation more generally, enhanced fiscal space via a lower cost of procurement, and better resilience to the risk of major (and therefore a lower cost of) climate events (Ferrari and Meliciani 2022, Hazna et al 2023). However, in the EU the financial channel – via the creation of a European safe asset of which there is a structural shortage especially in the euro area 'periphery' countries – looks relevant as well.

The EU's economic growth model has so far relied largely on the convergence of 'weaker' member countries towards the best performers ('catch-up' growth), alongside efforts to 'push the frontier' of the best performers. The creation of the single currency was hoped to provide the necessary impetus to this convergence process via *inter alia* the international trade channel and the associated pressure on weaker performers to increase their competitiveness, underpinned by a reallocation of capital across the Union. Unfortunately, the experience in the euro area as a trigger of convergence has been disappointing.

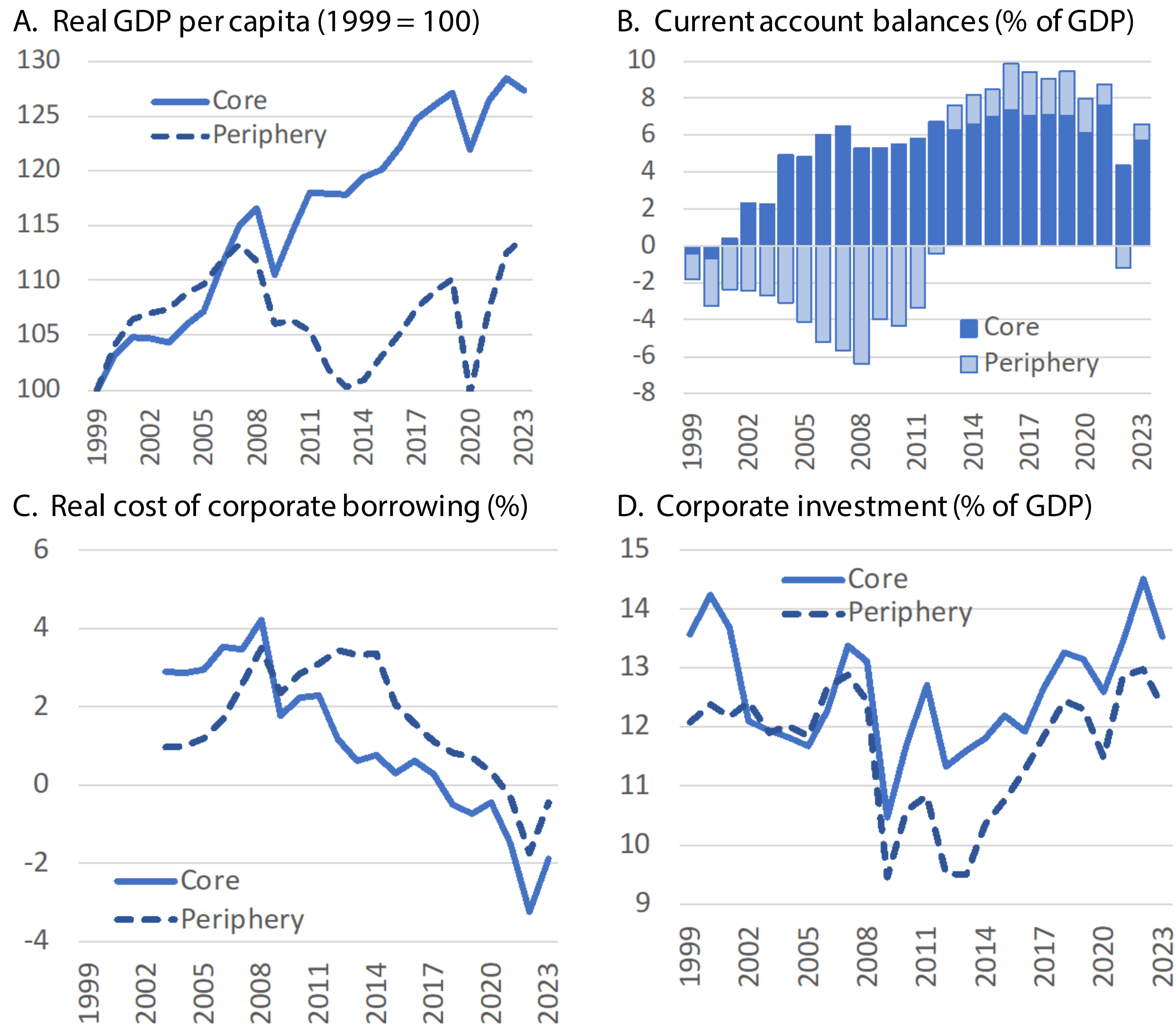
As shown in Figure 5 (Panel A), there has been significant divergence – not convergence – of per capita GDP in the euro area, notably in the aftermath of the Global Financial Crisis. The convergence that did occur in the first decade of the European Economic and Monetary Union (EMU) was driven largely by a real estate boom in the 'periphery' financed by external debt, as reflected in their large current account deficits (Figure 5 Panel B). Fast growth in the 'periphery' in the first decade of EMU proved unsustainable: when the financial crisis hit, capital flows reversed and underlying weaknesses in the periphery were exposed. The economic slump that resulted fed into potentially explosive public debt dynamics, requiring fiscal restraint (see above), in turn further depressing economic growth.

It is widely acknowledged that convergence has been held back not only by obstacles to the integration of product markets but also by underperformance of EU capital markets, with savers, portfolio investors and businesses too dependent on national banking systems and markets remaining fragmented along national lines (Orlowski 2020). This has resulted in corporate investment in the periphery persistently lagging and the cost of corporate credit exceeding, that in the core (Figure 5, Panels C and D). Owing to greater risk sharing and an ensuing reduction in volatility a more integrated capital market would offer protection against asymmetric shocks – vital in a monetary union because monetary policy is unable to mitigate the impact of asymmetric shocks. A more integrated capital market, moreover, is expected to allow firms in the periphery to tap into a broader investor base, lowering funding costs and improving access to capital (Bhatia et al 2019).

In the wake of the financial crisis EU policy initiatives have been launched to address this issue, notably the Capital Market Union initiative in September 2015. However, what remains sorely missing in the capital market architecture is the development of a 'safe asset', which so far has proved problematic (Alogskoufis et al 2020, Demertzis et al 2019, Frey et al 2020, Janse 2023).

[6] For instance, if $r = -3.1\%$ while leaving the other assumptions unchanged, then $p = -0.9\%$.

Figure 5: Evolving divergences in the euro area



Source: ECB, European Commission AMECO database, author's computations. 'Core' includes Austria, Germany, the Netherlands, Finland; 'Periphery' includes Greece, Italy, Portugal, Spain.

The hallmark of a safe asset is its ability to retain value in the event of market turmoil and its almost perfect liquidity. Its real yield (nominal yield less the expected rate of inflation) carries no risk premia other than a small term premium (which solely depends on the maturity of the security) and hence – on average over the business cycle – reflects the true 'rate of time preference' (the valuation of a quantity of real income now relative to the same quantity one year ahead) or the 'natural rate of interest'. As such it serves not only as a refuge in times of market turbulence, but also as the reference for the pricing of other financial securities. It would facilitate the diversification and de-risking of bank portfolios. It performs multiple additional functions as well, including the development of a proper term structure. Moreover, by fostering the international role of the euro (Ilzetzki et al 2020) yields could fall and new fiscal space created (Bogołębska 2019, Subacchi and Van den Noord 2023).

While the EU has not institutionalised a safe asset, a pool of securities that are sometimes labelled as European safe assets exists in the form of bonds issued by European supranational institutions such as the European Investment Bank (EIB), the European Stability Mechanism (ESM), and more recently the bonds issued by the European Union to finance NGEU. However, the volumes remain modest by international comparison and their yields exceed that of the safest sovereign bonds by a significant margin due to their limited liquidity and the temporary nature of the schemes financed by them (in particular in the case of NGEU bonds), see Mallušková 2023 and Bletzinger, et al 2022).

The EU has spent significant time debating technical solutions such as the creation of 'synthetic' safe assets involving mutualisation of national public debt (European Commission 2017). A concern with regard to these safe assets is that their safety ultimately rests on financial engineering while the underlying risk (of sovereign default) does not change (Codogno and Van den Noord 2020, Constancio et al 2019, Leandro and Zettelmeyer 2019). These ideas are also generally rejected by financial market participants and by debt management agencies because they lack a sovereign issuer with taxing power. Promoting national debt to perform the role of safe assets through fiscal consolidation (as suggested by Papadi and Temprano Arroyo 2022), while welcome in itself, would not resolve the issue of financial fragmentation.

The creation of EU public goods underpinned by EU taxing powers and partly funded with bond issuance of significant size would be a first step towards the creation of a genuine European safe asset. Depending on its design it should achieve a volume in the order of 15% to 30% of euro area GDP (Alogskoufis et al 2020), hence roughly of the order of up to five times the volume of outstanding pan-European securities. To play its role properly, EU bonds should be shielded from sovereign risk of national debt. Therefore, the recently adopted reform of the fiscal framework, which commits each member state to put public debt on a downward trajectory towards (or stay at levels below) 60% of GDP and the government deficit below 3% of GDP, is particularly welcome. However, this reform needs to be followed up by further changes in EU governance if the Union is to play a greater role in the provision and funding of public goods.

4. DEMOCRATIC LEGITIMACY AND GOVERNANCE

4.1. Popular support

Although sudden changes in attitude cannot be ruled out, the current political landscape does not look to be receptive to calls for expanding the spectrum of EU public goods financed by EU tax and debt. This has led the European Fiscal Board (2023), for instance, to assert in its latest Annual Report that "a more centralised approach to the provision of EU public goods seems (…) politically unrealistic in the nearer term" even if "the absence of a scheme capable of supplying selected strategic EU public goods through joint efforts is still an omission in the policy architecture".

European publics indeed tend to be more euro-sceptic than EU policymakers, as illustrated by outcomes of referendums on the Constitutional Treaty, and the gap may be widening. National politics and the (social) media play a pivotal role in shaping public opinions on European integration. As argued by Hobolt and De Vries (2016), 'Europe' being too complex, and too remote from their everyday lives, most citizens largely need to rely on the information obtained through these channels. Euro-sceptic political parties are vocal and have been gaining strength in most countries since the onset of the financial crisis, with those on the left mobilising anti-austerity concerns and those on the right emphasising national identity issues. Worse, whatever popular support there may be for European integration is not properly expressed in European elections, as these tend to serve as 'midterm national contests' or are used by voters to protest to domestic policies.

While the political support for a major EU public goods initiative thus looks questionable, recent studies do suggest that this may be changing due to the Covid-19 pandemic and the geopolitical backdrop. There is evidence of an increase in positive views on European integration in the areas of health after the Covid-19 pandemic (Alsamara and Brand 2023) and likewise on security and defence after the Russian invasion of Ukraine (Fernandez et al 2023). This is broadly supported by the most recent 'flash' Eurobarometer survey (see Annex), indicating strong public backing for EU provision of energy security and military cooperation. Importantly, a recent study by Beetsma et al (2023) shows strong support for the creation of a EU fiscal capacity provided this is not biased towards redistribution and strictly monitored – which points to the need for solid governance.

4.2. Need for institutional reform

If indeed a majority of citizens are in favour of EU provision of strategic public goods, it would seem important that these preferences be reflected in political representation in support of actual policy. This requires the widely critiqued EU 'democratic deficit' to be tackled. Specifically, an appropriate framework for governance and democratic control should be developed, with its design in line with the principle of 'fiscal equivalence' discussed earlier. This means that the provision of public goods should be assigned to the government level where decisionmakers, users and taxpayers meet. Hence the democratic process of decision-making and control should be assigned to the supranational level as well (Diaz 2021), lest distributional (*juste retour*) considerations continue to prevail.

The European Parliament (2023) has recently made a call to amend the Treaties accordingly. Specifically, it proposes to allocate more powers to the EU on environmental issues, as well as shared EU powers in the areas currently within the member states' exclusive remit: public health (especially cross-border health threats and including sexual and reproductive health and rights), civil protection, industry, and education. Moreover, existing shared powers would need to be developed further in the areas of energy, foreign affairs, external security and defence, external border policy, and cross-border-infrastructure. These proposals have been espoused by the Spanish Presidency during the second semester of 2023, but it is yet unclear to what extent the Council is ready to adopt it and funding issues (EU-own resource) will be settled at the same time.

Some (Casolari 2023) hold a benign view that such a change in mandates is in the cards, arguing that a new unitary (as opposed to an intergovernmental) approach has emerged, building on The Strategic Autonomy Doctrine (SAD) introduced in 2013 in the wake of conflicts in Libya and Syria. Perhaps some hope can indeed be derived also from the 2022 Versailles Declaration adopted by the European Council two weeks after Russia's military aggression, deciding "to take more responsibility for [...] security and take further decisive steps towards building [... the] European sovereignty, reducing [...] dependencies and designing a new growth and investment model for 2030."

Treaty change nevertheless still being remote, a stepwise establishment of new intergovernmental arrangements (akin to the ESM) would probably be needed (Spolaore 2015). One example is the proposal for a 'European Public Investment Agency' mandated to plan investment projects and implement them in cooperation with the Member States (Allemand et al 2023). In a similar vein Bakker and Beetsma (2023) propose a supranational fund for European Public Goods for projects initiated by (groups of) countries and grants subject to adherence to the (new) fiscal rules. Similarly, the Commission has suggested the creation of a 'European Sovereignty Fund', expected to finance multi-country projects of European importance for the green transition (Buti et al 2023). This idea came up in response to the US Inflation Reduction Act (IRA), a $400-billion subsidy and tax-break package the US government put together to finance the green transition.

Gradually assigning more tasks to the central level along the above lines – provided this is accompanied by the parallel development of a proper system of democratic control and accountability – could help to build trust among member states on a centralised approach (see the next section for a more elaborate discussion). The ultimate goals should be the establishment of a central fiscal capacity, endorsed by voters in the form of Treaty change. The starting point of any such future Treaty change must be the acknowledgment of the increasing number of shared goals and the need to finance them together (Draghi 2023), which in turn necessitates a different form of representation and centralized decision-making.

A reform also of the election system might be helpful in this regard, with European (as opposed to national) political parties competing on platforms that focus on European-wide issues. As Fuest and Pisani-Ferry (2019) put it: "the willingness to shift more public goods provision to the European level will (…) depend not just on convergence or divergence in preferences but also on the political decision-making process at the European level, and the extent to which it is perceived as legitimate and effective."

5. A ROADMAP FOR THE FUTURE

5.1. Direction and goal of reform

The key tenet of this paper is that the spectrum of public goods the EU needs to provide inevitably will shift from regulatory to physical (including human and digital) public capital, resulting in a larger call on fiscal resources at the EU level than thus far. Arguably, how much fiscal resources will be needed, and how these must be financed, should be informed by generally accepted economic principles, specifically:

- The provision of public goods at the EU level is justified if this is needed to address under-provision at the national level (where spillover effects are not sufficiently internalised) and large economies of scale can be reaped, and if these benefits are large enough to compensate for heterogeneity of country preferences; and

- To avoid fruitless conflicts about a '*juste retour*' along national lines resulting in under-provision of public goods at the EU level, their funding should be assigned to the EU level as well, hence endowing it with its own revenue sources and hence taxation powers, underpinned by democratic governance and control.

What type of tax bases the EU could tap should be based on economic principles as well, including that the associated tax revenues (i) not be obviously attributable to a particular member country or set of member countries, (ii) be defined according to harmonised and uniformly applied accounting principles, (iii) be relatively mobile and hence susceptible to distortions (tax avoidance or evasion), and (iv) be conducive to achieving (other) EU policy goals.

Proposals by the European Commission to use part of the proceeds from the European carbon Emission Trading System (ETS) and the European Carbon Adjustment Mechanism CBAM) as 'own' revenue sources to finance the repayment of common debt issued under NGEU would fit these criteria. Moreover, depending on the allocation key of the proceeds to be adopted, these would broadly fit the bill of around €800bn while the time frame would also be appropriate given that all NGEU debt is scheduled to have matured by 2058 when the EU economy would be carbon neutral and the proceeds from carbon emissions have been exhausted. However, if the spectrum of public goods provided by the EU is to be widened considerably, additional – permanent – revenue sources would need to be created as well.

Two such new own revenue sources have entered the debate prominently: an EU corporate profit tax and an EU wealth tax. The former has been debated for several decades, culminating in a proposal by a high-level working group headed by Mario Monti in 2016 to adopt an EU corporate tax, though this was shelved at the time. Meanwhile, owing to the European Commission's BEFIT proposal in 2023, a common base for corporate tax is virtually being established. The introduction of an EU corporate tax should also be facilitated by earlier efforts to establish a common minimum threshold rate to avoid harmful tax competition. The creation of an EU wealth tax would break entirely new ground, but its mobile tax base makes it suitable for the EU, not least since it could address concerns about wealth inequalities that act as a source of financial fragilities. As an offset national tax rates may need to be cut to some extent but would not necessarily lead to revenue losses on a one-for-one basis if a reduction in tax avoidance and evasion is achieved.

A novelty introduced by NGEU has been its financing by debt (of around 5% of EU GNI), underpinned by a guarantee in the form of the 'headroom' built in the EU budget (resources the EU executive can tap if judged necessary in case of emergencies). This set-up proved highly beneficial in several respects. First, it served to mitigate conflicts about the *juste retour*, with even the most 'frugal' member countries eventually crossing the line when the adopted 'conditionality' was judged to be sufficient. Second, it entailed substantial fiscal stimulus, helping to boost the EU economy out of the Covid-19 slump. Finally, NGEU bond issuance has contributed to the pool of European 'safe assets', offering banks and other investors a much-needed refuge in times of financial turbulence as well as collateral for credit.

The creation of a significant EU budget for the provision of public goods, endowed with its own taxation and borrowing powers, would present a welcome opportunity to draw on these benefits on a permanent basis. This paper provisionally estimates the size of this budget at 2½ % of EU GNI, of which around ½ % could be structurally debt-financed to generate a pool of safe asset approaching 30% of GNI in the long run on a sustainable basis. A budget of this size could be used to conduct fiscal policy at the EU level, helping to ease the burden of national fiscal and monetary policies. Moreover, a (now permanent) pool of safe assets of the indicated size would help to deepen EU capital markets, promote the use of the euro as a global reserve currency, and – via lower cost of financing – create additional fiscal policy space, while supporting private capital formation especially in the euro area periphery, and hence economic growth and convergence.

5.2. Speed and sequencing of reform

As the well-known quote from Jean Monnet goes, "Europe will be forged in crises, and will be the sum of the solutions adopted for those crises". It does not require much imagination to conceive a list of possible crises that may occur in the foreseeable future:

- A change in presidency in the United States may result in a cutback of the US role in European security, exposing the EU's vulnerability in case of threats of military conflict;
- Major climate, health or cyber events could hit, necessitating joint EU-action and demonstrating the need for a permanent response and prevention capacity; and
- Another wave of inflows of refugees, possibly triggered by military conflict or climate events elsewhere, would test the EU's capacity to absorb such shocks.

A perhaps less well-known quote from Jean Monnet allegedly says that: "Cooperation between nations, however important it may be, does not solve anything. What one has to seek is a fusion of the interests of the European people, not merely to preserve a balance among those interests" (Groupe d'études géopolitiques 2021). While this quote may now be more relevant than ever, there is a tension with the former quote. Specifically, even if the direction and goal of reform may be clear for most observers, a major reform would likely occur only in response to crisis – as indeed has been the experience when the sovereign-debt and Covid-19 crises hit. Yet, this does not rule out the possibility to pursue gradual reform in a stepwise fashion, though with a clear view to achieving EU strategic goals.

Based on an extensive review of the literature, a useful framework to demonstrate this analytically is provided by Nsouli et al (2002). They indicate how the appropriate speed and sequencing of reforms depend on the following factors:

- At times of distress the conditions for major 'big-bang' reform are favourable as it is clear to policymakers that without reform the situation would quickly deteriorate and repair be extremely costly, whereas without distress gradualism is likely to be more successful;
- If 'low hanging fruit' can be reaped in the short run, a stepwise approach may help build trust in the direction and goal of reform, whereas a big bang reform that entails significant setbacks in the short run can undermine such trust;
- If a reform programme is complex and takes time to prepare and implement a gradual approach is better suited, whereas comparatively straightforward reforms can be implemented more quickly.

Clear examples of EU policy that has helped to support trust in a centralised approach are the common procurement of vaccines during the Covid-19 pandemic, the joint purchases of natural gas at the height of the energy crisis and the EU military assistance provided to Ukraine, as reflected in the survey outcomes discussed in the Annex. These policies are seen as successful because the situation threatened to run out of control while the measures were relatively straightforward and gave immediate results. By contrast, the (technically and politically) more complex reforms required to expand the EU provision of public goods and EU taxation powers take more time to implement, and the results obtained may be mixed in the short run while hurting special interests. Moreover, in the absence of acute crisis (even if its prospect is looming) there is not always a clear consensus on the urgency of EU-led reform.

The above framework suggests that the sequencing of reform – reaping 'low hanging fruit' first to build trust among member countries on a centralised approach and conducting more complex policies further down the road – would be the optimal approach. For instance, in view of the situation in Ukraine, enhancing the Union's defence coordination and capability should receive priority, as advocated by European Movement International (2022). Likewise, immediate benefits could be secured from optimising the design and operation of national electricity systems jointly, rather than individually (Zachmann et al 2024). Potentially the list of such possible joint initiatives is very long. It is key that these are pursued with priority and results are well publicised.

The democratic processes of decision-making and control at the level of the European Parliament should be strengthened in parallel to reinforce public trust. Adopting the Parliament's recent call to allocate more powers to the EU on strategic issues mentioned earlier would be helpful in this regard. Although still a remote prospect now, eventually a reform of the election of the European Parliament, with European (as opposed to national) political parties competing on platforms built on positions taken on European-wide strategic issues, may become feasible.

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ANNEX: THE LATEST EVIDENCE ON POPULAR SUPPORT

This Annex analyses results of the latest Flash 'Eurobarometer' survey "to explore EU citizens' perception of the EU on the global stage and to obtain input on attitudes toward the EU's response to the energy challenges and the war in Ukraine", initiated by the European Commission (European Commission 2023). This survey is a follow-up on two earlier Flash Eurobarometer surveys on this topic.

From the results emerges the impression of overwhelming popular support for joint action at the EU level in the fields in question:

1. *More than eight in ten respondents (85%) 'totally agree' or 'tend to agree' that Russia's invasion of Ukraine shows the EU needs to ensure its energy and economic security.*
2. *More than eight in ten respondents (85%) are of the opinion that the EU should boost the manufacturing of clean technologies within its Member States.*
3. *Russia's invasion of Ukraine shows the EU needs to increase military cooperation between Member States according to most respondents (75%).*
4. *When asked whether the EU should fund joint defence projects to develop strategic defence capabilities and technologies, 75% of respondents agree.*
5. *About seven in ten respondents (71%) agree that the EU should continue imposing economic sanctions against Russia.*

While these results suggest broad support for EU joint action in these areas, this does not necessarily mean that this support reflected at the political level which, in any case, require unanimity at the level of the Council of Ministers. Hence it may be useful to examine how the replies are distributed across Member States and if there are any noteworthy patterns.

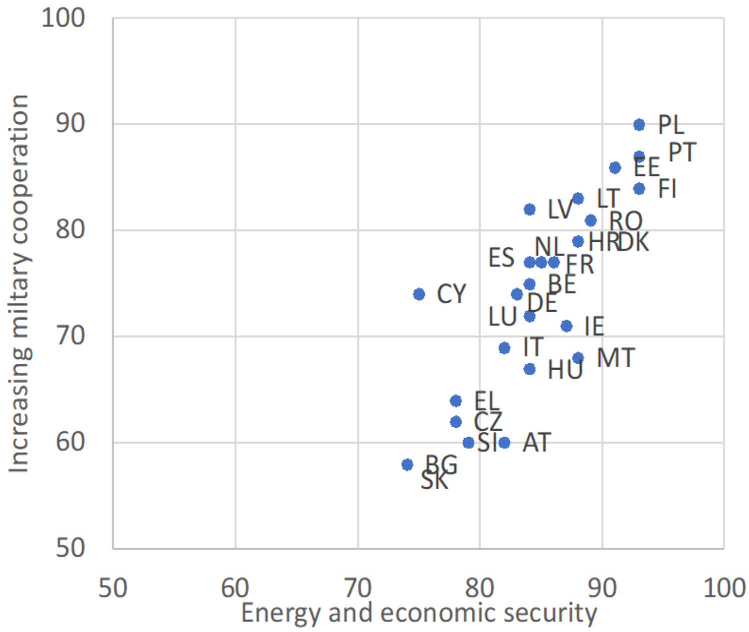
A general issue to be examined is whether the cross-country distributions of the public support for EU-action is similar for both areas. If so, it may tell something about countries' respective attitudes toward EU involvement in strategic issues more in general. Accordingly, Figure 6 compares the replies to the following two (sub-)questions:

> *How much do you agree or disagree with each of the following statements: Russia's invasion of Ukraine shows the EU needs to:*
>
> a. *Ensure its energy and economic security,*
>
> b. *Increase military cooperation between Member States.*

The figure indicates a strong correlation between the responses to both questions, suggesting that respondents see these sources of insecurity, and the need for a EU response thereupon, indeed as related. Note that in only six (small) Member States (EL, CZ, SI, AT, BG, SK) there is a less than two-thirds majority in favour of increasing military cooperation, and that support for EU-action on energy and economic security is also comparatively low. By contrast, Member States sharing a border with Russia, Belarus or Ukraine have comparatively large majorities of positive responses on both sub-questions (PL, EE, FI, LT, LV, RO, HR, except for SK), as may perhaps be expected.

Figure 6: Attitude to EU-action – military cooperation versus energy and economic security

Positive replies, % of respondents



Cross-country regression

Y = Positive replies on increasing military cooperation, %
X = Positive replies on ensuring energy and economic security, %

Y = 1.4*** · X - 44.1***

R^2 = 0.83

*, ** and *** indicate significance at the 10%, 5% or 1% level.

Source: European Commission, Flash Eurobarometer 2023, author's computations.

EU-provision and EU-funding of military cooperation

Digging deeper into the attitudes towards military issues a question of interest is if a strong demand for military cooperation at the EU level is seen by the respondents as a complement *or a* substitute *of* national *defence expenditure. Figure 7 plots the responses to question b above against each country's military spending as a per cent of GDP. The correlation appears to be positive, suggesting that EU military cooperation is seen as providing 'value added' to national military spending. Only Greece is an outlier: its military spending is by far the highest in the EU while its demand for EU cooperation is not correspondingly strong.*

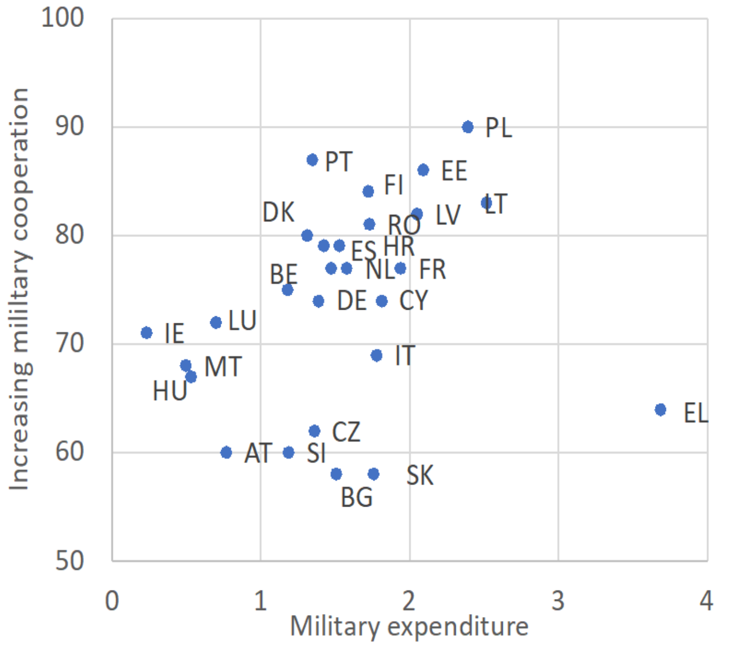
It is not a priori clear that a strong demand for EU cooperation would also imply a strong call on EU-funding (as opposed to defence expenditure remaining national responsibilities). Comparing the outcomes for the question on EU military cooperation with the following question may give an indication:

> *How much do you agree or disagree with each of the following statement:*
>
> *a. The EU should fund joint defence projects to develop strategic defence capabilities and technologies.*

As shown in Figure 8 there are majorities for EU funding of joint defence projects, except for Austria. Meanwhile, the figure suggests a positive correlation between the answers to both questions, although not a very strong one. However, Austria and Germany are outliers as their demand for EU funding of joint defence projects is lower than might be expected based on the statistical relationship. So, overall, there is strong demand for EU defence cooperation and EU funding of military efforts – but with Germany and Austria being the exception and Greece apparently in favour of maintaining a strong national military regardless of EU cooperation.

Figure 7: Attitude to EU-action – military cooperation versus national military expenditure

Positive replies, % of respondents; % of GDP



Cross-country regression

Y = Positive replies on increasing military cooperation, %
X = Military expenditure, % of GDP

D = Dummy EL

Y = 8.2*** · X - 28.5** · D + 62.3***

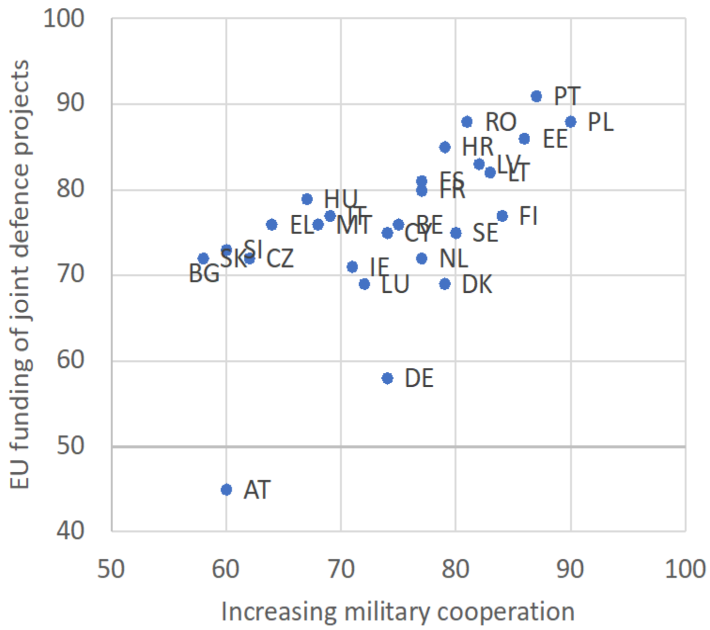
R^2 = 0.28

*, ** and *** indicate significance at the 10%, 5% or 1% level.

Source: European Commission, Flash Eurobarometer 2023, World Bank, author's computations.

Figure 8: Attitude to EU-action – military cooperation and EU financing of joint strategic defence capabilities and technologies

Positive replies, % of respondents



Cross-country regression

Y = Positive replies on joint EU funding of military projects, %

X = Positive replies on increasing military cooperation, %

D1 = Dummy AT

D2 = Dummy DE

Y = 0.5*** · X – 26.2*** · D1 – 19.6*** · D2 + 43.9***

R^2 = 0.77

*, ** and *** indicate significance at the 10%, 5% or 1% level.

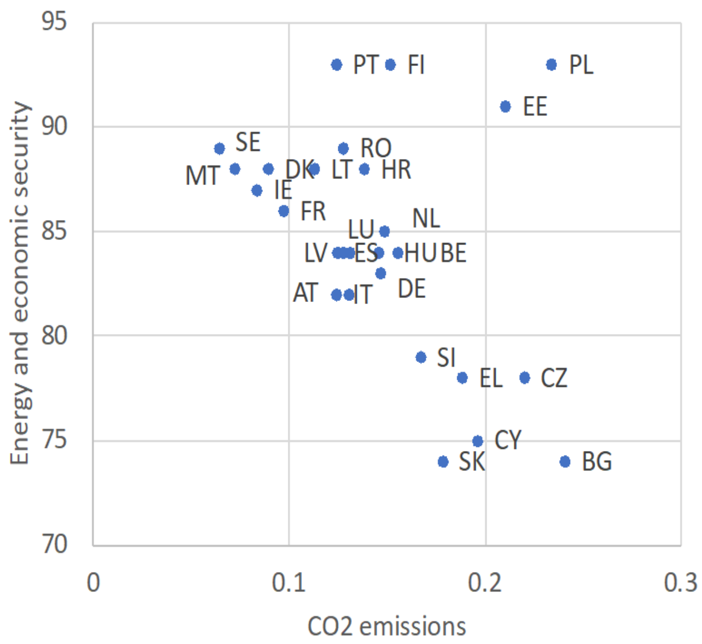
Source: European Commission, Flash Eurobarometer 2023, World Bank, author's computations.

EU-provision and EU-funding of energy security

A more than two-thirds majority of respondents is in favour of an EU-role in ensuring energy and economic security, but again the cross-country dispersion of the replies is large. An interesting question to address is if this dispersion is correlated with the countries fossil fuel dependency, gauged by their CO2 emissions per unit of GDP. As shown in Figure 9, the correlation is negative, suggesting that the lower a country's fossil fuel dependence, the stronger will be its the demand for EU-provision of energy security. This suggests that the move away from fossil fuels may be motivated by a country's concern over energy security, such as in the case France, where nuclear power is predominant for electricity generation. Poland and Estonia do not seem to conform to this pattern as they depend strongly on fossil fuels yet appear to make a call on the EU for energy security, which is probably related to their proximity to Russia.

Figure 9: Attitude to EU-action – energy versus economic security and carbon emissions

Positive replies, % of respondents; Tons per unit of GDP (PPP)



Cross-country regression

Y = Positive replies on ensuring energy and economic security, %

X = CO2 emissions per unit of GDP

D1 = Dummy PO

D2 = Dummy EE

Y = -91.2***· X +17.7***· D1 +13.5** · D2 + 96.7***

R^2 = 0.62

*, ** and *** indicate significance at the 10%, 5% or 1% level.

Source: European Commission, Flash Eurobarometer 2023, World Bank, author's computations.

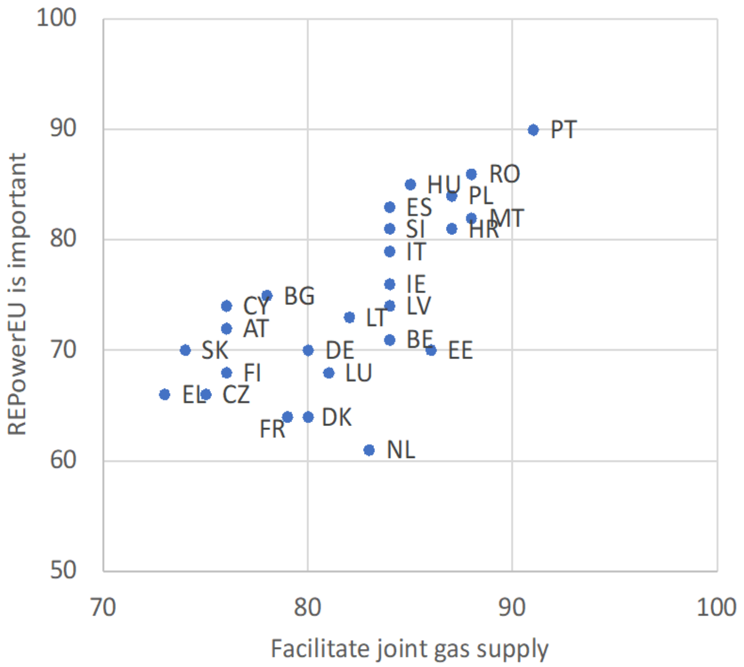
Does a strong demand for EU provisioning of energy security also imply a demand for EU financing of this policy? The Eurobarometer has a question on the importance of EU financing of accelerated investment in renewables via REPowerEU, and it has one on the need for EU joint purchase of gas. Specifically:

> *To what extent do you consider each of the following EU initiatives taken during the last year to be important?*
>
> *a. Providing financing to member states for accelerated investment in renewables via REPowerEU.*
>
> *b. Facilitate the joint purchases of gas by EU member States to ensure security of supply.*

REPowerEU is policy carried out by member states but financed by the EU and conversely for the joint gas purchases. As shown in Fiure 10, the correlation is high suggesting that countries in favour of coordination are also willing to commit EU financing. Only the Netherlands stands out as negatively predisposed to joint financing, presumably due to its redistributive features.

Figure 10: Attitude to EU-action – REPowerEU and joint gas purchases

Positive replies, % of respondents



Cross-country regression

Y = Positive replies on REPowerEU, %

X = Positive replies on joint gas purchases, %

D = Dummy variable NL

Y = 1.1*** · X – 15.3** · D + 14.3

R^2 = 0.80

*, ** and *** indicate significance at the 10%, 5% or 1% level.

Source: European Commission, Flash Eurobarometer 2023, World Bank, author's computations.

Becoming ever more exposed to global developments that transcend the powers of national governments, the European Union needs to widen the spectrum of strategic public goods it provides. To avoid fruitless conflicts over the '*juste retour*', this should be funded by new permanent EU fiscal resources, with an appropriate mix of taxation and debt issuance, and underpinned by proper democratic governance. Not only would this advance the Union's strategic goals but also yield benefits for economic stability, convergence and growth.
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