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Policy Paper

Shaping the EU's Financial Architecture for the Future

Impetus for the EU reform debate

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Foreword

The war in Europe, the worsening climate crisis, the pressure on liberal democracies and Europe's unresolved position in the global power structure – the European Union is facing historic challenges. In order to maintain its future viability, the EU must become more capable of taking action. The Russian war of aggression against Ukraine also shows us that the enlargement and neighbourhood policy is in urgent need of readjustment. However, the enlargement process makes the institutional reform of the EU, which is already needed to strengthen its ability to take action, even more pressing. There is currently no uniform position in the EU on the question of how broadly such a reform should be structured and how it should be implemented. Suggestions and ideas have been put forward, though reservations and concerns have also been expressed. An agreement can only be reached if all sides are listened to and taken seriously. As the largest Member State, Germany has a special responsibility in this regard.

Against this backdrop, the Heinrich Böll Foundation has invited experts from various policy areas to provide impetus for the EU reform debate. Common goals for sustainable policy-making and recommendations for institutional reforms have been formulated, based on the current challenges. In their entirety, they are intended to better equip the EU to take action, as well as become more democratic, ecological and socially just. In doing so, we have not limited ourselves to the interaction of the EU institutions in the narrower sense but have, rather, also looked at policy areas that are central to the future viability of the EU: European foreign and security policy as well as energy, agricultural, fiscal and enlargement policy. The result is a series of policy papers, some of which propose pragmatic approaches, others a change of direction. Many of the recommendations can be achieved without treaty amendments. What is needed above all is the political will to exploit the existing potential. All texts conclude with the question of how Germany can contribute to the success of the reform process. We hope this will provide impetus for the relevant debate.

This policy paper deals with European fiscal policy. We would like to thank the authors Dr. Philipp Heimberger and Dr. Margit Schratzenstaller and the members of the expert group – MEP Rasmus Andresen, Lydia Korinek and Member of the German Bundestag Jamila Schäfer – for their valuable contributions.

Berlin, Spring 2024

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Executive summary

Climate change is one of the greatest challenges facing the EU and requires a profound transformation of the European economy. At the same time, the EU finds itself in an increasingly complex global situation of an international subsidy race, technology competition and the dependence of a large number of Member States on fossil fuels. Considerable financial investment is required to achieve the EU climate targets, increase industrial competitiveness, secure sustainable jobs and safeguard public services of general interest. For the public sector, current estimates put this at €260 billion per year. However, the financial scope for action available is limited at both Member State and EU level. The situation is exacerbated by the fact that grants from the Recovery and Resilience Facility (RRF) will no longer be available after 2026 and the reform of the EU fiscal rules will hardly increase the scope for green public investment. As a result, the pressure to consolidate budgets is expected to increase considerably in the coming years. In addition, the EU Member States need to contend with highly unequal fiscal base lines at national level, which increases the risk of fragmentation in the EU.

A lot of the green investments needed to reduce CO_2 emissions in the energy and transport infrastructure are characterised by the fact that they are not only important within the borders of one country but must, rather, be considered at a pan-European level. Coordinated European financing instruments are needed for such infrastructure. Consequently, a central objective of fiscal policy at EU level should be to enable cross-border green investments with EU added value. A jointly coordinated and financed industrial policy strategy must ensure that future technologies can be produced in Europe and that existing sectors (e.g. energy grid expansion, transportation) are made fit for the future. The objective at Member State level should be to make green investments that contribute simultaneously to climate protection and social security in the socio-ecological transformation by promoting the development and expansion of a socio-ecological infrastructure. A sustainable European financial architecture based on three pillars is needed to finance the necessary additional green public investments at EU level. Whether the reform recommendations formulated here require treaty changes depends on their precise form of implementation.

In view of the many challenges, Germany should support a fiscal policy at European level that does not exacerbate existing economic and political problems but, rather, helps to solve them through an ambitious and targeted investment focus. This is not only due to the upcoming negotiations on the next Multiannual Financial Framework (MFF, 2028–2034) or Mario Draghi's report on European competitiveness, which is expected this year, but also to Germany's limited fiscal space resulting from the debt brake enshrined in the German Constitution. By helping to shape increased financial leeway at EU level in an ambitious way, Germany could also enable important expenditure to strengthen its own economic capacities.

Reform objectives

- Close the green public **investment gap** at European level
- Build a common European **fiscal capacity**
- Finance green investments in **projects with European added value** to make existing sectors fit for the future (energy grid expansion, transport infrastructure)
- Secure future-proof **jobs**
- Increase industrial **competitiveness**
- Mobilise **private investment**
- Provide funds to strengthen public **services of general interest**
- Drive forward the development and expansion of a **socio-ecological infrastructure** in order to contribute to **climate protection** and **social security** in the transformation process

Proposal 1 | Adjust the expenditure structure of **the Multiannual Financial Framework**

- Strengthen spending on green investments
- Make cohesion and agricultural policy more climate-friendly
- Raise the 30% target, according to which at least 30% of MFF expenditure is to be used to support climate targets
- Replace 2% expenditure deflator with actual inflation rate

Proposal 2 | Establish a permanent **EU investment**

- Financed through borrowing by the European Commission on financial markets
- Focus on financing public goods with European added value
- Co-financing of national green investment projects possible in the form of grants
- Democratic control through the central role of the EU Parliament in terms of establishment and supervision
- New EU investment supervision to coordinate public and private green investments with regular reporting to the European Parliament

Proposal 3 | Introduce new sustainability-oriented **EU own resources**

- Priority is given to green own resources
- Accelerate implementation of the European Commission's proposals for revenue from EU Emission Trading Scheme and the Carbon Border Adjustment Mechanism (CBAM)
- Taxes on international air and shipping traffic or cryptocurrencies
- Introduction of a progressive wealth tax
- EU-wide coordinated taxation of financial transactions

1 Challenges

Climate change is one of the biggest challenges facing the EU in the coming decades and will require a profound transformation of the European economy. At the same time, Europe is facing an international subsidy race fuelled by industrial policy interventions in the USA and China. Competition for the technologies and industries of the future is in full swing, while the dependence of many EU Member States on fossil fuels, some of which are imported from autocratic states, remains a key risk for the European economy and the EU internal market.

This multitude of economic and political challenges requires an ambitious strategy to future-proof the European financial architecture. However, the financial scope for action available for this is limited both at Member State and EU level. The expected financial requirements go far beyond the possibilities of the EU's existing budget planning. In addition, EU Member States need to contend with highly unequal fiscal base lines at national level. This entails the risk of political and economic fault lines emerging and social divergences between Member States being exacerbated. Especially, if some Member States can undertake significantly more public spending for the socio-ecological transformation than others.

The question of how to cover the financial requirements for the necessary socio-ecological transformation and a functioning security order is central to the future of the EU, but is often treated as a secondary issue. Current estimates show that the additional green investment required to achieve the EU's climate targets in the coming decades will be considerable: an additional €10,000 billion needs to be invested by 2050 to decarbonise the EU economy. This equates to additional investment of 2.3% of EU economic output per year, which will be even higher for the public sector if these investments are postponed.[1] Companies and private investors will only be able to partially close this green investment gap. The amount is simply too large for this. At the same time, these investments are often associated with high risk, low profit prospects and an excessively long planning horizon. The public sector therefore has an important role to play in closing the green investment gap.[2] The share of additional public green investment required is estimated at €260 billion (1.6% of the EU's economic output) annually, though this figure may vary by a factor of up to 2.5 upwards or downwards for some Member States. The financing

1 See Institut Rousseau: Road to Net Zero. Bridging the Green investment gap, January 2024.

2 See e.g. Pekanov, A., Schratzenstaller, M.: Making green public investment a reality in the EU fiscal framework and the EU budget, in: Cerniglia, F., Saraceno, F., Watt, A. (ed.): Financing investment in times of high public debt, Open Book Publishers 2023, pp. 137–156.

requirements vary considerably depending on activity regarding emissions and current investment.[3]

Many of the green investments needed to reduce CO_2 emissions in the energy and transport infrastructure are characterised by the fact that they are not only important within the borders of one country but must, rather, be considered at a pan-European level. This infrastructure therefore also requires coordinated European instruments. Initiatives by individual states would be insufficiently funded for significant green investments in cross-border projects and would be difficult to implement due to a lack of coordination. In other areas, individual national approaches could jeopardise the integrity of the internal market and thus lead to inefficient transformation paths. This raises the question of EU level funding instruments to cover the additional financing requirements.

Grants from the Recovery and Resilience Facility (RRF), which helped EU Member States to carry out green investments after the Covid-19 pandemic, will no longer be available after 2026. At the same time, the EU budget in its existing structure only makes a limited contribution to strengthening green investments at EU level. A new Multiannual Financial Framework, which could be geared more towards green investments, will not be available until 2028. These financial restrictions call the necessary expansion of green public investment in the EU into question. However, the additional structural investment requirements outlined above necessitate long-term financing solutions for the coming decades. Consequently, it is necessary to think beyond existing programmes.

Even at national level, the recently adopted reform of the EU fiscal rules[4] will not significantly improve the scope for green public investment. The reform shifts the focus of the analysis from the annual trajectory of public finances to a medium-term perspective. In addition, the individual EU Member States can commit to a series of investments and reforms in order to extend the fiscal adjustment path for up to seven years – provided the European Commission agrees that the investments are compatible with debt sustainability. However, considerable parts of the necessary green expenditure will not be taken into account as they do not reduce the debt-to-GDP ratio.

The pressure on national governments to consolidate their budgets – especially those with high public debt ratios – will increase in the coming years to such an extent that it will become significantly harder or even impossible to expand sustainable investments. If the pressure to consolidate the budget increases, public investments are more likely to be cut or

3 See Institut Rousseau (2024), op. cit.

4 European council: Economic governance review: Council and Parliament strike deal on reform of EU fiscal rules, press release on 10.2. 2024, *https://cepr.org/voxeu/columns/how-reconcile-increased-green-public-investment-needs-fiscal-consolidation*. [last accessed on 8.3. 2024]

postponed than other government spending components.[5] Such a development would hugely jeopardise the socio-ecological transformation as well as the maintenance and necessary strengthening of public services of general interest.

5 See Jacques, O.: Austerity and the path of least resistance: how fiscal consolidations crowd out long-term investments, Journal of European Public Policy, 28(4), 2021, pp. 551–570.

2 Political objectives

In view of the challenges described above in an increasingly complex global mix of geopolitics, industrial and climate policy and, at the same time, severely restricted budgets, the aim of EU fiscal policy must be to provide funds to strengthen public services of general interest as well as enable investment in industry and other sectors of the economy. This promotes a sustainable and socially inclusive economic system in which additional economic capacities are created that secure future-proof jobs thanks to increased competitiveness. EU-wide policy approaches are needed to link climate policy with geostrategic and socio-political requirements. In the context of the global subsidy race, national solo efforts threaten to damage the EU's internal market and the EU project by making it more difficult for all member states to find solutions that are based on solidarity and beneficial to economic policy in the long term. At the same time, the necessary transformation must be socially balanced in order to avoid social upheaval and ensure broad social acceptance for the green transformation of the economy and society.

A central objective of EU fiscal policy at EU level should be to enable cross-border green investments with EU added value, which would otherwise not be made, or only to an insufficient extent, without cross-border coordination and financing. Such investments strengthen cohesion between the EU Member States. A jointly coordinated and financed industrial policy strategy must ensure that future technologies can be produced in Europe. Joint European projects can also help to make existing sectors fit for the future: The realisation of an integrated electricity grid for the transmission of renewable energies and support for complementary battery and green hydrogen projects could be financed in the energy sector.[6] A common European high-speed train system has the potential to significantly reduce emissions in the transport sector.[7] Such public green investment projects would attract further private green investments and thus ensure the competitiveness of the national and European economy.[8] A soundly financed, long-term public investment programme also contributes to the competitiveness of the European economy through greater planning security and improved local conditions (e.g. by investing in infrastructure and strengthening the labour market) help to mobilise private green investments.[9]

6 See Creel, J., Holzner, M., Saraceno, F., Watt, A., Wittwer, J.: How to spend it: a proposal for a European Covid-19 recovery programme, wiiw Policy Report No. 2020.

7 See Angers, E., Arsenev, A., Holzner, M.: The emissions reduction potential for freight transport on a high-speed rail line along the ‹European Silk Road›, wiiw Research Report No. 472, 2023.

8 See e.g. Mazzucato, M.: Mission-oriented innovation policies: challenges and opportunities, Industrial and Corporate Change, 27(5), 2018, pp. 803–815.

9 See e.g. Darvas, Z., Wolff, G.: How to reconcile increased public investment needs with fiscal consolidation, VoxEU, 7.3. 2022, *https://cepr.org/voxeu/columns/how-reconcile-increased-green-public-investment-needs-fiscal-consolidation* [last accessed on 7.3. 2024]

The objective at Member State level should be to make green investments that simultaneously contribute to climate protection and social security in the socio-ecological transformation by promoting the development and expansion of a socio-ecological infrastructure («universal basic services»[10]). Such infrastructure offers universal and affordable access to a range of public services of general interest that enable climate-friendly living. Public transport infrastructure, for example, is a core component of a just-transition strategy that avoids the social hardships of an ambitious climate policy and thus ensures acceptance of the necessary socio-ecological transformation.

10 Cf. in principle Gough, I.: Universal basic services: A theoretical and moral framework. The Political Quarterly, 90(3), 2019, pp. 534–543; Bohnenberger, K.: Money, Vouchers, Public Infrastructures? A Framework for Sustainable Welfare Benefits, Sustainability, 12(2), 2020, pp. 596.

3 Reform proposals to create a sustainable financial architecture for the EU

The financing of the necessary additional public green investments at EU level should be based on several pillars. Existing potential for reallocating expenditure within the EU budget should be used. However, as a future-oriented expenditure structure of the EU budget can only partially cover the necessary financing requirements, part of the public green investment gap should be financed through borrowing. The expansion of green own resources should make a further financial contribution. This section sets out economic proposals for a reform of the financial architecture. A legal assessment with regard to their compatibility with the current EU treaties is still pending – also because this has to be done in a very specific way depending on the practical design and on the basis of particular political decisions.

Adjusting the expenditure structure of the Multiannual Financial Framework

Spending on green investments should be strengthened within the Multiannual Financial Framework.[11] This requires a shift in spending towards European green research and innovation programmes and European climate-friendly transport and electricity networks, which currently account for only a small proportion of total EU spending.[12] The climate-friendliness of cohesion and agricultural policy must also be enhanced. Against this backdrop, it is a matter of discussion, for example, to restructure the first pillar of the Common Agricultural Policy in such a way that direct payments per hectare are abandoned and the available funds are invested in the climate-productive expansion of regional socio-ecological infrastructure to strengthen services of general interest. The same applies to cohesion spending, which should also flow to a significant extent into projects to build a socio-ecological infrastructure.

It is also necessary to increase the current target of 30% of EU spending to support the achievement of climate targets. These targets should be implemented much more strictly, particularly in agricultural and cohesion policy.

11 See Pekanov, A., Schratzenstaller, M.: Making green public investment a reality in the EU fiscal framework and the EU budget, op. cit., p. 137–156.

12 Expenditure on research and innovation accounts for around 7% of the total EU budget, and just under 2% for cross-border infrastructure.

It is also necessary to observe the do-no-significant-harm principle, according to which climate-counterproductive EU expenditure must be avoided in a more consistent way.[13] Last but not least, the annual inflation adjustment of total EU expenditure, which is currently limited to 2%, must be replaced by a valorisation of expenditure with the actual inflation rate, as the current regulation severely impairs the already limited scope for green investments in phases of high inflation.[14] Overall, EU expenditure can be used much more efficiently through such a restructuring of the Multiannual Financial Framework and, in this way, the added value of the EU budget for the EU can be significantly increased.

Establishment of a permanent EU investment fund

A new EU investment fund with green requirements needs to be set up to finance the level of investment in public goods required for the EU and drive forward the achievement of climate targets. Following the example of the Recovery and Resilience Facility (RRF), the European Commission would issue (green) EU bonds to raise funds for investments from financial markets.[15]

The money financed by the EU investment fund should be targeted towards projects with European added value, particularly for the conversion of energy and transportation systems. The focus on investments in public goods of a cross-border nature can promote the legal compatibility of the EU Investment Fund with EU law. A further portion of the financial resources raised via EU bonds could flow to the individual Member States in the form of grants, e.g. for EU co-financing of national green investment projects, particularly with a focus on socio-ecological infrastructure, in order to contribute to a just transition in the EU. This also holds the potential for a positive leverage effect to mobilise additional public spending in the Member States. This is because national expenditure within the scope of co-financing can be excluded from the assessment of government expenditure by the European Commission when checking compliance with the reformed EU fiscal rules. Thus, grants from the EU investment funds could in turn increase the scope for aligning national public spending with EU policy priorities.

13 See European Court of Auditors: Common agricultural policy and climate – half of EU climate spending but farm emissions are not decreasing. Special Report, 16, 2021; European Court of Auditors: Climate spending in the 2014-2020 EU budget – not as high as reported. Special Report, 9, 2022.

14 See Schratzenstaller, M., Scheiblecker, M., Pekanov, A., Kubeková, V.: The Impacts of Recent Inflation Developments on the EU Finances, study commissioned by the BUDG Committee of the European Parliament (November 2023).

15 See Heimberger, P., Lichtenberger, A.: A Permanent EU Investment Fund in the Context of the Energy Crisis, Climate Change and EU Fiscal Rules, wiiw Research Report no. 23, 2022.

In order to make the political processes democratic, the European Parliament should play an important role in establishing and supervising the EU Investment Fund. The tasks of the European Parliament should include the approval of funds, oversight and a right to information vis-à-vis the European Commission and the Member States.

A newly established EU investment supervisory authority could promote the coordination of public and private green investments. The European Commission, the European Council, and the European Investment Bank could each appoint representatives to the EU investment supervisory body. To this end, a pool of experts from science and business can be nominated to contribute to analyses against the background of existing policy objectives. The EU investment supervisory body would report to the European Parliament, which would exercise democratic control through regular hearings. However, the possibilities for shaping the role of the European Parliament in the context of the EU Investment Fund must be examined in advance from a legal perspective - especially if the EU Investment Fund, like the RRF, is to be placed outside the Multiannual Financial Framework.

While debt taken on by individual Member States for green investments increases the national debt ratio and thus conflicts with EU fiscal rules, investments financed via EU bonds would be considered grants. These grants do not have to be repaid by the individual Member States. The EU bonds for the investment fund are to be serviced by new sustainability-oriented EU own resources.[16]

Introduction of new sustainability-oriented EU own resources

Currently, the EU budget is primarily financed by national contributions from the Member States. New sustainability-oriented own resources, on the other hand, would not only have a financing function, but could – unlike the EU's existing financing system – support the EU's strategic objectives. This would strengthen the coherence between EU expenditure and revenue. Strengthening the revenue base through new EU own resources could also increase the EU's creditworthiness and thus encourage investors to pay lower interest rate premiums for EU bonds. Furthermore, if the servicing of the debt incurred for the Next-GenerationEU reconstruction programme is paid from new EU own resources, other EU expenditure does not have to be reduced.

16 Another option is to not (fully) service the EU bonds issued with EU own funds and allow the build-up of EU debt.

Given the urgency of the climate crisis, green equity should be a priority.[17] This would shift the burden of financing from all taxpayers to the perpetrators of environmental problems. The revenues from EU emissions trading and the carbon border adjustment mechanism (CBAM) proposed by the European Commission should be implemented, given that they are particularly suitable as green own resources and are based on EU policies that would not exist without EU-wide coordination. Other possible sources of funding for the EU budget are taxes on international air and shipping traffic[18] or cryptocurrencies, which are associated with negative climate impacts.[19] An EU-wide coordinated introduction of a progressive wealth tax on high levels of wealth could reduce evasive reactions and generate considerable revenue for the EU budget.[20] It would counteract the decreasing progressiveness of many tax systems and strengthen the «polluter pays» principle, as high wealth contributes disproportionately to greenhouse gas emissions.[21] Finally, an EU-wide coordinated taxation of financial transactions with low tax rates could generate substantial revenue and reduce speculative movements on the financial markets.[22]

17 See Schratzenstaller, M.: Elements of a European green fiscal policy. Intereconomics, 58(6), 2023, pp. 300–304.

18 See Chancel, L., Bothe, P., Voituriez, T.: Climate Inequality Report 2023, World Inequality Lab Study 2023/1.

19 See Baer, K., Mooij, R. D., Hebous, S., Keen, M.: Taxing cryptocurrencies, Oxford Review of Economic Policy, 39, 2023, pp. 478–497; Hebous, S., Vernon, N.: Cryptocarbon: how much is the corrective tax?, IMF Working Paper, No. 23/194, 2023.

20 See Krenek, A., Schratzenstaller, M.: A Harmonized Net Wealth Tax in the European Union, Journal of Economics and Statistics, 242 (5–6), 2022, pp. 629–668.

21 See Chancel, L., Bothe, P., Voituriez, T.: The potential of wealth taxation to address the triple climate inequality, Nature Climate Change, 14, 2024, pp. 5–7.

22 See Pekanov, A., Schratzenstaller, M.: A Global Financial Transaction Tax – theory, practice and potential revenues, WIFO Working Paper, 2019.

4 Potential for ambitious further development of the European financial architecture and the role of Germany

The negotiations on the reform of the EU fiscal rules have shown that ambitious reforms for a sustainable financial architecture often end in stalemates and inadequate compromises, which tend to exacerbate the pressure for budget consolidation. In addition to the acute climate, social and industrial policy challenges, there is also a risk of the erosion of democratic foundations. This is because austerity policies and the associated dismantling of state services of general interest undermine trust in democracy and strengthen extreme parties that cast doubt on the performance of liberal democracy.[23] Action is therefore urgently required.

The upcoming negotiations on the next Multiannual Financial Framework (2028–2034) offer an opportunity to rethink EU budgetary and financial policy and work towards the implementation of the above-mentioned proposals for restructuring the EU budget. Mario Draghi's report on European competitiveness, which is expected this year, also offers a window of opportunity to accelerate the political discussion on the EU's continued joint borrowing and an expansion of the EU's own resources.

Germany's limited fiscal leeway, which stems from the debt brake enshrined in the German constitution, also gives cause for a rethink. The ruling by the Federal Constitutional Court in November 2023, according to which the handling of emergency loans in the second supplementary budget for 2021 was unconstitutional, has considerably exacerbated the situation and significantly intensified the political discussions surrounding the debt brake in recent months. By helping to shape increased financial leeway at EU level in an ambitious way, Germany could enable important expenditure in order to strengthen its own economic capacities.

At the same time, Germany would be promoting European cohesion. This is because unequal fiscal burdens on the Member States as a result of the necessary green investments, coupled with widely differing fiscal space, harbour the risk of fragmenting the EU. This should be countered with strategic, joint EU spending. The deepening of European fault lines would have particularly negative consequences for Germany, given that the German export-oriented economic model is heavily interwoven with other EU Member States. Fragmentation would

23 See Gabriel, R., Klein, M., Pessoa, A.: The Political Costs of Austerity, 2022, *https://ssrn.com/abstract=4160971*.

increase the risk of Germany and Europe falling behind in economic policy terms in an international comparison with China, Russia and the USA. In this context, industrial policy means investing in the expansion of future-oriented sectors in the field of renewable energies, green infrastructures, and technologies in order to improve long-term competitiveness.

The German government should take up the outlined proposals for the further development of the European financial architecture from a political perspective in order to advance it in a socio-ecological and democratic direction. It should set a good example, given that Germany is the EU country which wields the greatest economic and political weight. Against the backdrop of increasing scepticism about the economic benefits of the EU and in view of the strengthening of right-wing forces, Germany's European policy has a special responsibility. At European level, Germany should therefore support a fiscal policy that does not exacerbate existing economic and political problems but, rather, helps to solve them through an ambitious investment focus. Germany has already shown in the past, for example with the introduction of the Recovery and Resilience Facility (RRF), that it can be successful here and deliver on its responsibilities.

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