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Draghi's message: sharing economic sovereignty is hard but possible

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A shared diagnosis

The significance of the report on the future of European competitiveness, drawn up by former Italian prime minister and European Central Bank governor Mario Draghi (Draghi, 2024), is that it offers a thorough diagnosis of the weaknesses and opportunities of the economic and institutional setting of the European Union. The report, published 9 September, rightly points out that, given the negative long-term demographic trends facing the EU and the lack of a common integrated policy on migration, the only driver of sustainable European growth is labour productivity, and mainly its elusive but crucial component represented by total factor productivity.

Draghi is also correct in stating that three conditions must be met to boost EU productivity: (i) the European economy must catch up technologically with the United States and China by implementing streams of innovation to feed both the digital and green transitions; (ii) the EU needs more start-ups, which will eventually scale-up and be able to attract the highly-qualified people who today are leaving Europe; (iii) meeting these objectives should be combined with the construction of a unified security and defence framework, which is not only a necessary response to the geopolitical conflicts at the EU borders but is also needed to protect value chains and guarantee the availability of technological inputs.

This diagnosis has two implications. First, the EU should make fundamental economic and institutional changes in order to radically redesign its production model [1]. Second, these changes are also required to safeguard the European social model that, despite a certain weakening, is still able to guarantee the world's highest level of social inclusion.

As Draghi notes, the current EU *per-capita* income growth rate would not be enough to make the resources available for the additional investments needed to implement

these transformations and safeguard the current level of social protection. According to Draghi (2024), combining the green and digital transitions would require around €800 billion annually in additional investment over the next decade. And the social impact of these economic changes would mean additional costs to improve education and to include the most vulnerable people (including migrants) in the new economy.

The EU must therefore improve its growth performance to free resources to finance additional investments, but it cannot boost growth without innovative and sustainable reforms and investment. Draghi puts forward a convincing set of policies to break out of this catch-22 situation, including ways to boost productivity growth.

In line with another report by a former Italian prime minister, Enrico Letta's April 'Much more than a market' report (Letta, 2024), Draghi stresses the importance of completing the single market in areas where pervasive national segmentation persists [2]. The best examples are high-tech services, such as telecommunications, and the financial sector. Overcoming market fragmentation would mean less duplication in national expenditures and would ensure that the necessary consolidation of firms to build companies at European scale does not hinder market competition. It would also allow the exploitation of economies of scale and scope and create greater opportunities for innovations and their diffusion.

A true single market in the financial sector would enable the mobilisation of the huge wealth held by European households and firms, and its allocation to the green and digital transitions. As is often repeated [3], the completion of EU capital markets union is crucial, as banks are unsuited to finance this type of investment, which is, so to say, long in ideas and short in collateral.

Draghi makes very granular recommendations on how to implement new sectoral and horizontal policies. His leitmotif is 'joined-up policy-making' [4] to achieve a greater degree of common planning that should be articulated at all levels of decision making. For this, it is necessary to overcome unanimity requirement that often paralyses the EU by giving countries effective vetoes. Similarly to Letta (2024), Draghi suggests recourse to a '28th regime' that would allow companies to opt out from national regulatory frameworks and follow rules valid everywhere in the EU.

Embracing European public goods

Draghi recognises that radical changes to the European production model to catch up with the technological frontier, succeed in the green transition and reduce dependence on external demand cannot be fully entrusted to market mechanisms and financed entirely via the mobilisation of private wealth. To deliver such a dramatic re-orientation in investment, public intervention and regulation are needed at both EU and national levels.

European policymakers face here a dilemma. The EU has agreed new fiscal rules that require the high public debts of EU countries to be put on a downward path to increase fiscal space (see Darvas *et al*, 2024). If policymakers apply these in a loose manner, they are unlikely to build the mutual trust necessary to step up interventions at EU level. But strict enforcement of the new fiscal framework would constrain the room for manoeuvre at national level. Overcoming the dilemma is difficult. The new fiscal rules allow more gradual fiscal adjustment but this requires commitments from governments to carry out reforms and investments, especially those in line with EU-wide priorities. Therefore, as a first step, the European Commission should implement this clause very seriously.

However, the main focus should be enabling a substantial increase in the EU budget and building a central fiscal capacity, as recommended by Buti *et al* (2024). On the demand side, a larger and refocussed multiannual EU budget could compensate for tighter national fiscal constraints in the short term imposed by the fiscal rules. On the supply side, a dramatically reformed EU budget would stimulate other investment and thus could be the linchpin of a new European industrial policy centred on the production of European public goods (EPGs) aimed at delivering the triple green, digital and social transition [5].

In our reading, Draghi's recommendations amount to a combination of a reformed EU budget establishing a central fiscal capacity with a new European industrial policy. This combination legitimises the recurrent statement, made in his report, that the green and innovative transitions should be made compatible and should even strengthen the European social model.

This would have an overarching implication: a new European production model should not be an attempt to copy the US economy. The EU needs capital markets union and the development of private equity; however, these financial breakthroughs, if they can

be achieved, must be regulated to support innovative and sustainable production and should avoid feeding market distortions.

The EU needs innovative and cross-border companies in services and manufacturing to reduce gaps relative to the US in digital activities and artificial intelligence. However, this does not imply creating excessively large companies that acquire too much power and end up threatening democracy. Therefore, while Draghi rightly criticises the excess of regulation in EU countries as a possible barrier to innovation, this should not be mistaken for advocacy of an across-the-board weakening of regulation or giving up on European regulation that is essential to combine a new production system with the EU social model.

Reforming the EU production model is also key to harmonising the EU's domestic and international strategies. The EU can no longer benefit from purchases of cheap energy and raw materials, needed to produce goods that are mainly exported to China. European policymakers must recognise that a 'neo-mercantilist' growth model, relying on net exports, is incompatible with the EU's future prosperity and the new international order. This model has negative internal and external implications. Internally, persistent current-account surpluses are not an indicator of high competitiveness but represent the flipside of insufficient aggregate investment compared to aggregate savings. Externally, the export-led model makes the EU's economies vulnerable to the weaponisation of trade and currency by international competitors.

In short, to achieve a balance between efficiency, security and equity, and between fiscal, environmental and social sustainability, the EU must follow its own path without trying to imitate the US economic and social model.

Conditions for sharing economic sovereignty

In our reading of Draghi (2024), the centralised financing and production of EPGs would become the core of the new European model. But it is sure to be difficult to convince EU governments to pursue this opportunity [6] .

Finding a way forward should involve recognition of two factors (Buti and Messori, 2024). First, it should be acknowledged that the financing and production of EPGs require transfers of national sovereignty, with different costs for EU countries, depending on the relative strengths of their national states and intermediate

institutions: countries at the extreme ends of the spectrum (ie very strong and very weak countries) tend to have smaller costs than countries in between.

Second, there are different types of EPG. The simplest way to capture this is to distinguish between EPGs that would boost innovation (EPG-I) and EPGs that pursue greater solidarity (EPG-S) (Buti and Messori, 2024). The varying national appreciations of the net benefits of EPGs (the difference between their benefits and costs) arise because EU countries have different preferences in relation to the two EPG types: countries closer to the technology frontier prefer EPG-I while weaker countries prefer EPG-S.

This results in a diversified combination of national interests that will be difficult to reconcile. However, it can be done. Over and above the recommendations in Draghi (2024), the EU must ensure a balanced combination of EPG-Is and EPG-Ss. Closing the gap to the technological frontier is a priority and so it might be tempting to put all the political capital in the EPG-I basket. However, this would not forge the necessary consensus between EU countries and would be insufficient to safeguard the European social model.

Some concrete steps to ease the reconciliation of national interests (Buti and Messori, 2024) are:

1. EPGs must not lead to the 'transfers union' so greatly feared by northern EU countries. An example of a politically acceptable EPG-S is the SURE programme launched during the pandemic to shore up labour markets [7]. SURE could be reactivated, with an additional clause on minimum investments in education and the re-skilling of human resources (migrants included), specifically targeted at the green and digital transition.

2. To overcome the resistance of sceptical countries to transfers of sovereignty to the EU, the selection of both EPG-I and EPG-S must create tangible added value that generates sizeable net benefits, to compensate for the high costs of sharing sovereignty. An example could be the construction of a 'European Railway Silk Road', ensuring fast and efficient connections across the EU for freight transport.

3. Though the most fragile EU countries tend to prefer EPG-S, their preferences can shift and become more aligned with those of stronger countries if they can close their gaps to the technological frontier. Reaching this result is a joint responsibility:

weaker countries should effectively implement their post-pandemic National Recovery and Resilience Plans, while the EU should put in place an efficient system for diffusion of innovative outputs.

Meeting the ambitious goals set out Draghi (2024) requires the EU to change gear. Implementing Draghi's main proposals would amount to signing a new political and institutional contract between member states and EU institutions. Agreeing and implementing this contract will be difficult – but it's not impossible.

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Endnotes

1. See also Joaquin Almunia, Giuliano Amato, Laszlo Andor, Olivier Blanchard, Marco Buti, Elena Carletti ... Thomas Wieser, 'The European Union at the time of the New Cold War: A Manifesto', VoxEU, 4 October 2023, https://cepr.org/voxeu/columns/european-union-time-new-cold-war-manifesto.

2. Jeromin Zettelmeyer, 'The single market according to Enrico Letta - was the report worth the wait?' Bruegel Newsletter, 29 April 2024, https://www.bruegel.org/newsletter/single-market-according-enrico-letta-was-report-worth-wait.

3. See for example Nicolas Véron, 'European capital markets union: make it or break it', First Glance, 19 March 2024, Bruegel, https://www.bruegel.org/first-glance/european-capital-markets-union-make-it-or-break-it.

4. As noted by Martin Sandbu, 'Mario Draghi calls for joined-up thinking in Europe', Financial Times, 12 September 2024, https://www.ft.com/content/b0fafe09-dd57-46dc-8539-69577ea8969e.

5. On EPGs, see, for example Buti et al (2023) and Claeys and Steinbach (2024).

6. German finance minister Christian Lindner, for example, has already rejected Draghi's ideas on common EU borrowing and joint investment. Giovanna Faggionato and Hans von der Burchard, 'Germany's Lindner rejects Draghi's common borrowing proposal', Politico, 9 September 2024, https://www.politico.eu/article/germanys-lindner-rejects-draghis-common-borrowing-proposal/.

7. SURE (Support to mitigate Unemployment Risks in an Emergency) provided loans from the EU level to help countries with pandemic-related employment costs; see https://economy-finance.ec.europa.eu/eu-financial-assistance/sure_en.

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