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## **From Loans to Grants - the EU Corona Recovery Fund and Temporary Debt-Sharing in Europe**

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# From Loans to Grants – the EU Corona Recovery Fund and Temporary Debt-Sharing in Europe



# Universiteit Leiden

Thesis Seminar International Organisations

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**Abstract** As reaction to the corona crisis, EU Member states agreed in July 2020 to implement a corona recovery fund, the Next Generation EU (NGEU) fund. Under its framework, the EU Commission started to take on joint debt on the financial markets and is transferring this money partly in form of grants to member states. Earlier attempts of debt-mutualization had failed due to the resistance of Northern member states. This thesis aims to answer the following research question: Given the long-standing record of opposition to debt-sharing, why did government leaders of EU member states agree to adopt the NGEU fund? The objective was to provide an explanation why it was agreed on debt-sharing in the NGEU fund. This thesis argues that the corona crisis can be considered a critical juncture that activated latent spillover effects. Explaining-outcome process-tracing methods were applied in a within-case, single outcome case study. The case of Germany was analysed representing the Northern EU member states, Italy the Southern ones. Furthermore, it was aimed at contributing to deepen the understanding of the drivers of fiscal integration in Europe by providing new insights into the application of combined European integration theories.

### **Abbreviations**

EMU system	Economic and Monetary Union
ESM	European Stability Mechanism
NGEU fund	Next Generation EU Recovery Fund

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## 1. Introduction

After the onset of the Corona pandemic, the heads of the member states of the European Union (EU) agreed on the creation of corona recovery funds on July 21<sup>st</sup> 2020. In consequence, the EU Commission launched a €750 billion stimulus package, the *Next Generation EU (NGEU) fund*, financed through joint EU debts and to be paid back by 2058 through the EU budget, the Multiannual Financial Framework (MFF) (European Parliamentary Research Service, 2020, p. 1). Each European country contributes to paying back the debt according to the respective contributions to the MFF. While €360 billion will be transferred to member states as loans, €390 billion will be provided as grants to member states (European Council, 2020, p. 3). What is fundamentally new about the NGEU fund is that EU member states agreed on sharing debt (Picek, 2020, p. 325; Fuest, 2021, p. 3).

The debate around debt-sharing in the EU evolves around two opposing models of fiscal union: centralised versus de-centralised (Heinemann, 2020, p. 103). The centralized model is traditionally put forward by the Commission and supranationalists, while especially Northern member states advocate the decentralized model. The de-centralised model resumes the fiscal framework established in the Maastricht Treaty (Heinemann, 2020, p. 104). At its core is the member states' financial self-responsibility, i.e., no-bailout-clause and prohibition of monetary state financing. In other words, the decentralized model builds on moral hazard-oriented fiscal policies derived from ordo-liberalism. The market is supposed to discipline public spending (Heinemann, 2020, p. 105). On the other hand, there is the centralised, federalist model of fiscal union. Proposals range from joint European debts and Euro Area budget to unemployment insurance. The idea is creating instruments to counterbalance macroeconomic shocks and enhance financial resilience through risk-sharing. Accordingly, the centralised model requires a substantial degree of financial solidarity (Heinemann, 2020, p. 104). The debt-sharing aspect of the NGEU fund belongs to the centralised model (Fuest, 2021, p. 5).

The idea of debt-sharing came up in the context of the creation of the Economic and Monetary Union (EMU) at the end of the 1990s (European Commission, 2000, p. 1). Yet the topic would become salient only during the euro crisis from 2008 onwards. Credit rating agencies such as Standard and Poors had downgraded credit standings of countries like Italy or Portugal. Consequently, they would have to pay higher risk premia on financial markets to re-finance their state budgets. This has ever since caused them major financial problems (Große Hüttmann, 2020, p. 1). It was in this context that the EU Commission published a Green Paper in which it

proposed joint European Bonds to relieve the financial distress of those countries (European Commission, 2011, p. 2). Instead, intergovernmental loans were provided to member states due to the resistance of Northern countries like Germany, the Netherlands and Finland against debt-sharing (Schimmelfennig, 2018a, p. 979). In 2012, Angela Merkel said she would not tolerate debt-sharing “as long as I live” (Spiegel, 2012). As a result, EU member states lent money to other member states through the creation of temporary instruments such as the European Financial Stability Facility, and by installing a permanent financial institution in 2012, the European Stability Mechanism (ESM, 2019, p. 24). In the years to come, the EU Commission has published several documents that include proposals to complete the EMU system by extending fiscal integration in Europe. What is most relevant in those documents in this context is the idea of extending the EU budget, and the idea of installing a European Finance and Economic Ministry (European Commission, 2017, p. 3). However, the EU has not picked up on those ideas due to disagreement on financial responsibility and financial solidarity between Northern and Southern member states (Große Hüttmann, 2020, p. 2).

Against this background, it is puzzling why European leaders agreed on sharing debts under the NGEU fund framework. The NGEU fund can be considered as “antechamber of a European fiscal federal solution” (Costa Cabral, 2021, p. 1) and seems to stand in stark contrast to the position of Germany and other Northern member states. Hence, the objective of this research was to explain why it was agreed on. The research question was: Given the long-standing record of opposition to debt-sharing, why did government leaders of EU member states agree to adopt the NGEU fund? This research conducted a within-case study and used explaining-outcome process-tracing to analyse qualitative data.

The argument to answer the research question is two-fold. Historical institutionalism and neo-functionalism were both looked at in this research. The corona crisis was considered a critical juncture that triggered fiscal integration. Yet, it is claimed that debt-sharing can only be explained in combination with spillover. This research argues that the corona crisis jeopardized the integrity of the EU’s joint market, leading to spillover to protect it. This research developed an explanation that both causal factors combined led to the agreement on debt-sharing, the NGEU fund.

This thesis is structured as follows. First, debt-sharing in Europe is briefly discussed by assessing and comparing the body of literature on it. A more detailed discussion of European integration theories on is then outlined, justifying the combination of theories and concepts of this thesis. At last, the research design and methods, the case selection and the

operationalization are outlined and justified. The analysis follows subsequently and is subdivided into two parts: firstly, evidence to show that the corona crisis was a critical juncture is set out, and secondly, an analysis if spillover took place. The last chapter consists of the conclusions of this research.

## 2. Literature Review

This chapter firstly gives a brief outline of what is known about fiscal integration in Europe, and especially debt mutualisation. Thereafter, this chapter elaborates on research gaps, before finally explaining the value of this research project.

Haas defines integration as “delegation of sovereignty to a new supranational authority” (Haas, 1958: 16). Fiscal integration can refer to both coordinated supervision of fiscal deficits, or supranational budgetary integration (Drèze and Durré 2014, p. 7).

Due to the recent nature of the NGEU fund, research papers are still in the writing process. Thus far, debates on fiscal integration turn around responses to the euro crisis. On the one hand, concrete measures were taken, such as the creation of the European Stability Mechanism (ESM) as permanent bail-out institution for member states in need, such as Greece in the euro crisis (Ioannou, Leblond and Niemann, 2015, p. 159). Additionally, three rather small, yet concrete steps towards a fiscal union were taken: the Six-Pack to reinforce the Stability and Growth Pact (SGP), the Two-Pack, and the Fiscal Compact (TSCG). Those measures aimed at strengthening financial supervision and at creating more converging and coordinated fiscal policies. The objective is to create more financial and economic stability to prevent or prepare for future crises (Ioannou, Leblond and Niemann, 2015, p. 161). On the other hand, there is the ongoing debate on *Eurobonds*, which the next section explains.

### 2.1 The debate on debt-sharing in the EU

The NGEU fund represents the first instance of joint borrowing in the EU (Picek, 2020, p. 325; Fuest, 2021, p. 3). Yet the topic of debt-sharing has been discussed intensely since the Euro Crisis in 2008 in the context of Eurobonds (Jones, 2012, p. 1). The concept is that the EU takes on shared debt on financial markets. The debate evolves around the issue whether debt-sharing would indeed increase stability or rather incentivise Southern European countries to further conduct unsustainable fiscal policies (Jones, 2012, p. 3). Linked to this, it is disputed whether

debt-sharing should be temporary or permanent<sup>1</sup>. The objective of Eurobonds is to solve the problem of over-indebtedness of some euro area member states, and linked, financial and economic instability in the euro area (Jones, 2012, p. 2). All proposals agree that this goal can be achieved by reducing the overall borrowing costs that euro area countries pay on financial markets (Holoubek, 2016, p. 42).

The centre of the debate was the *Blue Bond Proposal* from Delpla and Weizsäcker (Holoubek, 2016, p. 43). The concept behind this proposal was to establish a supranational and a national government bond, entailing a distinction between responsible and irresponsible debts. The idea was to pool debts of all euro area members up to 60% of respective GDPs of member states (Delpla and Weizsäcker, 2010, p. 2). Joint liability for those debts guarantees high credit ratings. Hence, euro area members would collectively pay lower interest rates, potentially even Germany (Delpla and Weizsäcker, 2010, p. 7). A country could still yield national government bonds if it wanted to take on debt for more than the foreseen maximum. Yet, the costs for those national government bonds would be prohibitively high. Consequently, there would be a market incentive for high debt countries to reduce national debt (Delpla and Weizsäcker, 2010, p. 4). The trick was that for instance a Greek insolvency could be unwound and would no longer endanger the stability of the euro area as a whole<sup>2</sup> (Delpla and Weizsäcker, 2010, p. 3).

## 2.2 Theoretical discussions on debt-sharing and fiscal integration in Europe

The question about the drivers of fiscal integration and debt-sharing has been widely debated in the literature since the creation of the EMU system in the 1990s. There have been several main positions on this issue, each focussing on a certain aspect of integration.

One strand, *liberal intergovernmentalism*, explains fiscal integration with national interest (Moravcsik, 2018). For instance, Northern EU member states like Germany, the Netherlands, Sweden, Denmark, and Finland have opposed debt-sharing out of fear of having to pay monetary transfers to the South (Jones, 2012, p. 14). States transmit the preferences of domestic actors to the international level and act accordingly. Negotiations between states, as well as the

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<sup>1</sup> The majority of proposals are of permanent nature. Compare Delpla & Weizsäcker (2010): [https://www.bruegel.org/wp-content/uploads/imported/publications/1005-PB-Blue\\_Bonds.pdf](https://www.bruegel.org/wp-content/uploads/imported/publications/1005-PB-Blue_Bonds.pdf), Suarez (2011): <https://voxeu.org/article/three-pillar-solution-eurozone-crisis>, Greenpaper of the Barroso Commission (2011): <https://op.europa.eu/en/publication-detail/-/publication/4980ec30-b10a-4e8b-85cf-6eadfacb5769/language-en>. Some proposals have been of temporary nature. The German Council of Economic Experts suggested a 25 years long Eurobond (2011): <https://voxeu.org/article/european-redemption-pact> The European League for Economic Cooperation ELEC suggested a four year bond: [https://ec.europa.eu/economy\\_finance/articles/governance/pdf/elec.pdf](https://ec.europa.eu/economy_finance/articles/governance/pdf/elec.pdf)

<sup>2</sup> This model has been quantitatively confirmed by Baglioni and Cherubini (2016): Eurobonds - A Quantitative Approach.

institutional setting in which those take place, play a crucial role (Moravcsik, 2018). Liberal intergovernmentalism stresses the importance of power and distributional conflicts between member states in the integration process (Moravcsik and Schimmelfennig, 2018). In that sense, the creation of the ESM can be explained by the interests of the most powerful member states (Biermann, Guérin, Jagdhuber, Rittberger, and Weiss, 2019). Compared to other theories, liberal intergovernmentalism's explanatory power is highest when it comes to explaining initial steps of integration, based on national preferences and interstate negotiations (Schimmelfennig, 2018a).

A different, principal explanation for debt-sharing and fiscal integration in Europe is *neo-functionalism*. The core assumption of this theory regarding the drivers of integration are spillovers (Schimmelfennig, 2016). It is argued that integration in one sector overflows into another sector for which integration was not originally intended. For instance, it can be argued that Eurobonds are needed to counterbalance the integrative discrepancy between monetary and fiscal integration in the euro area (Baglioni and Cherubini, 2016, p. 507). In other words, the integration process develops its own dynamic and forces states to gradually hand over sovereignty to the supranational level (Rosamond, 2005). In that sense, the main difference to liberal intergovernmentalism is that neo-functionalism does not consider states to be in complete control of the integration process. The theoretical thrust of neo-functionalism, spillover effects, can be divided into subtypes. *Functional spillover* occurs due to functional or economic problems of integration, while *political spillover* emphasizes socialisation between governmental decision-makers due to high frequency of interaction between member state officials and supranational actors (Niemann, Lefkofridi and Schmitter, 2019, p. 48). By contrast to liberal intergovernmentalism, the creation of the ESM can be explained as technocratic necessity due to the integrative discrepancy between monetary and fiscal integration (Schimmelfennig, 2014).

Historical institutionalist approaches contend that the drivers of fiscal integration are path dependence and lock-in effects (Verdun, 2015). Therefore, historical institutionalists emphasize the flaws and inefficient construction of integration. For instance, the creation of the Euro allowed Greece, Portugal and other Southern member states to take on more debt than the government bond markets with separated currencies would have allowed (Becker and Fuest, 2017, p. 43). This fragile institutional design of integration partly caused and worsened the euro crisis, which then led to further fiscal integrational steps. Crises are considered to be historical moments, or *critical junctures*, that allow for more integration, due to exceptional circumstances (Gocaj and Meunier, 2013).

Conversely, scholars from various theoretical backgrounds have recently suggested that European integration is too multi-faceted to be fully explained by one single theory (Jones, Kelemen and Meunier, 2016, p. 1015; Pollack, 2019, p. 125; Schimmelfennig, 2018b, p. 159). To develop a more comprehensive theoretical grip on European integration, hence, it seems plausible to construct what Beach and Pedersen (2013, p. 64) call “eclectic theorization”. For example, the euro crisis has been explained by joint approaches of liberal intergovernmentalism and neo-functionalism (Jones, Kelemen and Meunier, 2016) or of neo-functionalism and historical institutionalism (Schimmelfennig, 2014). Last-mentioned combination has also been applied to provide an explanation for the creation of the banking union (Schimmelfennig, 2016). Both theories are suitable for combination owing to overlaps, such as path dependence and spillover (Schimmelfennig, 2014, p. 321). This research is situated in the camp of scholars that combine theories of European integration.

This research project contributes to scholarship in several ways. First, it contributes to understanding eclectic theorization of European integration theories. Concretely, to the understanding of merging critical juncture and spillover in the context of fiscal integration. Second, debt-sharing is a new phenomenon on EU level, as outlined. At the time of writing, only incredibly few articles have been published that research the reasons behind the adoption of the NGEU fund. This research aims at filling this gap and at adding to the build-up of a new body of literature within fiscal integration scholarship.

### 3. Theoretical Framework

The explanatory power of this research is based on a causal chain reaction, consisting of two elements: critical juncture and spillover. Both concepts have been picked because they directly relate to and build on instances of shocks or crisis, as this chapter will explain.

#### 3.1 Critical junctures

The theory of critical juncture originates from historical institutionalism. This theory regime is an analysis of how “temporal processes and events influence the origin and transformation of institutions that govern political and economic relations” (Falletti, Fioretos and Sheingate, 2016, p. 3). Supranational institutions produce positive feedback effects that make actors stick with them. The core idea is to explain the evolvement of institutions as path-dependent. This is where the concept of critical juncture comes into play (Pollack, 2019, p. 111).

Critical junctures are short time periods in which decisions are taken that have a substantial impact on the future institutional development (Capoccia, 2015, p. 148). They can be defined as “a situation in which the structural (that is, economic, cultural, ideological, organizational) influences on political action are significantly relaxed for a relatively short period” (Capoccia and Kelemen, 2007, p. 43). That opens up new alternative choices to political decision-takers and the impact of their decisions are highly far-reaching. Junctures are critical because they set pathways for future institutional development, which are then complicated to change in the future (Pierson, 2004, p. 135). The unit of analysis is, consequently, an institutional setting. For instance, it can be argued that the key critical juncture for the EU countries to save Greece from going bankrupt and leaving the Eurozone was the creation of the EMU system in the 1990s (Verdun, 2015, p. 224). A more recent critical juncture for fiscal integration in Europe was the euro crisis (Verdun, 2015, p. 231).

### 3.2 Spillover effects

This research used a neo-functionalist argument to build up the second part of the causal chain of the explanation of the NGEU fund. The neo-functionalist paradigm assumes international relations are considered a positive-sum game, that means cooperation has a better pay-off than non-cooperation (Rosamond, 2005, p. 242). A core assumption is interdependence between countries and economies. In that sense, not all policy problems can be resolved by member states alone, but more cooperation is needed. This is why the concept of spillover is relevant (Rosamond, 2005, p. 244).

This research focused on the concept of spillover because it matches the technicalities of economic, monetary and fiscal policy integration, according to Niemann, Lefkofridi and Schmitter (2019, p. 47). Spillover is defined as the dynamic when “integration of one sector leads to technical pressures that push member states to integrate other sectors” (Niemann, Lefkofridi and Schmitter, 2019, p. 48). In other words, spillover effects are a consequence of incremental integrative steps that create a discrepancy between sectors that are under supranational or national authority (Schimmelfennig, 2016, p. 486). This discrepancy decreases the efficiency of both supranational and national policy-making and can jeopardize the original objectives of the integration process if no additional integrative steps are taken (Ioannou, Leblond and Niemann, 2015, p. 198). The creation of the ESM in 2012 to save the euro area is an illustrative example for this.

The thrust of this research is that it is argued that neither critical juncture nor spillover alone can explain why the NGEU fund was adopted. Critical junctures were used to explain why

government leaders of EU member states started to consider debt-sharing for the NGEU fund in 2020. Yet, it is argued that the concept of critical juncture cannot explain why debt-sharing was needed without using the concept of spillover. On the other hand, there were no significant changes in terms of European integration most recently (Costa Cabral, 2021, p. 11). Hence, spillover alone cannot explain why the NGEU fund was adopted in 2020 either (and not earlier). What spillover can explain, however, is the rationale behind debt-sharing. Accordingly, the hypothesis for this research is formulated as follows: *A chain reaction of critical juncture and spillover effects caused government leaders of EU member states to agree on debt-sharing to adopt the NGEU fund.*

The hypothesis implies that the two concepts did not co-occur, but relate to each other in a specific order. First, the corona crisis was the critical juncture to initiate a momentum for integration. Then, spillover effects took place as intrinsic causal force of fiscal integration. That has implications for the above-described expectations. If the expectations can be observed, but not in exactly this timely order, the hypothesis must be rejected. Concretely, if there is no unambiguous evidence that the corona crisis started before German public opinion shifted in favour of debt-sharing and before the German government took advantage of this increased amount of possible decisions, the hypothesis must also be rejected.

## 4. Methodology

### 4.1 Research design

This research conducted a longitudinal, case-centric case study. A theory is a useful heuristic instrument to understand an outcome (Beach and Pedersen, 2013, p. 13). The ambition of this research thesis is to test the above-mentioned theory. More concretely, this thesis conducted a single outcome study. To increase internal validity, Gerring suggests to construct “comparable observations within the case of primary interest” (Gerring, 2006, p. 711). The corona and the euro crisis were used as within-case comparable observations.

This research deployed process-tracing methods. Those are best suited for several reasons. First, process-tracing methods can systematically trace causal mechanisms and allow for strong causal inference (Beach and Pedersen, 2013, p. 2; Mahoney, 2010, p. 124). These methods enabled the carrying out of the hypothesized causal chain that delivered an explanation of the adoption of the NGEU fund in a within-case empirical analysis. Second, process-tracing methods allow for a meticulous analysis of the evolving of events and stand up to the multiplicity of

involved actors and factors (Collier, 2011, p. 829). This is particularly advantageous for examinations of new research objects (Beach and Pedersen, 2013, p. 15).

It is vital to determine clearly which type of process-tracing is applied to hold out against methodological rigour (Beach and Pedersen, 2013, p. 10). This research conducted explaining-outcome process-tracing. The objective of an explaining-outcome process tracing is to develop a minimally sufficient explanation by combining causal mechanisms to explain the outcome, also called “eclectic theorization” (Beach and Pedersen, 2013, p. 64). Accordingly, the logic of this problem-oriented research strategy corresponds to the logic of case-centric case studies.

#### 4.2 Case selection

The case of the NGEU fund was chosen because it is a least-likely case for fiscal integration, as outlined above. Comparable observations help to determine the sufficiency of the explanation (Beach and Pedersen, 2013, p. 92). To understand why the NGEU fund was adopted, it is vital to examine the Northern member states that opposed debt-sharing, as well as the Southern ones that demanded it. For the purpose and scope of this research, Germany was examined as representative country for the Northern countries. There are two reasons for this. First, Germany was the largest net-contributor to the 2014-2020 EU’s multi-annual budget and will be to the 2021-2027 budget (Darvas, 2019, p. 31). Second, Germany is the biggest and most critical player of the Northern countries (Maris and Sklias, 2016, p. 3). Accordingly, this research assumed that the German shift in attitude towards debt-sharing caused the other Northern countries to shift as well.

Italy is chosen as proxy for the Southern European Countries. Firstly, Italian governments have distinguished themselves as most pronounced proponent of Eurobonds during the corona crisis; a role that France played during the euro crisis (Becker and Fuest, 2017, p. 63). In that sense, Italy represents the Southern opposition to the North. Second, Italy is the third biggest net-contributor to the EU budget. The sheer size of its economy can stimulate substantial growth in Europe (Darvas, 2019, p. 6). Third, Italy is chosen due to the steep raise of Euroscepticism in recent years. While there are many other countries with high levels of Euroscepticism such as Hungary, none has run through a comparable sharp shift from being a Europhile to being a Eurosceptic country (Brunazzo and Mascitelli, 2020, p. 23).

#### 4.3 Operationalization

Collier suggests constructing several tests to enhance soundness of process-tracing (Collier, 2011). Those tests are “straw-in-the-wind, hoop, smoking-gun, or doubly decisive” (Collier, 2011, p. 825). Doubly decisive tests are complicated to construct, but the combination of hoop

and a smoking-gun tests can demonstrate necessary and sufficient condition (Collier, 2011, p. 827). This research applied smoking-gun tests to show that the corona crisis was a critical juncture. For the spillover effects, no smoking-gun evidence could be found. Hence, straw-in-the-wind tests were applied.

Applying the critical juncture in an EU integration context during the corona crisis would generate certain expectations. The corona crisis forced European countries to lockdown public life. Curfews were repeatedly imposed for several weeks in many southern European countries. The 2020 GDP of the EU shrank by 7,6% compared to 2019 (Statista, 2021). If the corona crisis was indeed a critical juncture, it would be expected that two things happened. First, decision-makers would have more freedom of policy choice. Concretely, that would be that in Northern European countries, rejection of debt-sharing is re-considered by the public, allowing for integrative steps that were unthinkable beforehand. This would be considered a necessary condition for a critical juncture, also called “permissive condition” (Soifer, 2012, p. 1576). Smoking-gun evidence would be that the German government did not lose popularity after opting for debt-sharing. Second, a causal force would be needed that makes a critical juncture out of the historic moment. Hence, a sufficient condition, also called “productive condition” (Soifer, 2012, p. 1577). In this research, that would be an actor or a group of actors that actually takes initiative and uses the historic moment to push debt-sharing forward by coming up with new, concrete proposals for debt-sharing. Concrete initiatives from the German government would be smoking-gun evidence.

For expecting spillover to take place, it is first important to state from which sector it originates, and towards which sector it is directed. It will be assumed that the spillover effects originated from the EMU system, set up in the early 1990s (Picek, 2021, p. 325). This research assumed that spillover effects headed from market integration to fiscal integration. It was further assumed that – in order to save the integrity of the Common Market – a stimulus package was needed. The Common Market eliminated most trade barriers between its member states, increased trade substantially and is the world’s biggest single market (Große Hüttmann, 2020). Its integrity was violated after the UK left the EU.

This research collected straw-in-the-wind evidence to show that the Italian dislike towards the EU and accordingly, the potential, yet subliminal risk of Italy opting to leave the EU, motivated Northern EU member states to take action. This is considered political spillover. Further straw-in-the-wind evidence was collected to illustrate the economic pressures. The risk of a collapse

of the Italian economy and its implications for the whole EU economy created functional spillover to prevent this.

#### 4.4 Data

For this research, newspaper articles, public opinion polls, press conferences and speeches of government leaders in Germany and Italy, ministerial working papers, protocols of parliamentary debates, the coalition agreement between Christian and social democrats and election manifestos in Germany were used. Additionally, EU Commission, Council, and European Parliament documents were analysed as primary sources. To help interpret diagnostic evidence and justify interpretations, pertinent scholar articles were consulted.

### 5. Analysis

The analysis consists of two stages. First, it is analysed if there is evidence that proves that the corona crisis was a critical juncture for temporary debt-sharing. The second stage is to test whether it was spillover that led to the adoption of the NGEU fund. As mentioned above, critical junctures consist of permissive and productive conditions. The analysis is subdivided accordingly.

#### 5.1 Permissive conditions in Germany

##### 5.1.1 Germans support more financial means for the EU

The origin of German's opposition to debt-sharing derives from the fear of importing financial instability from other European countries and has been particularly pronounced since the introduction of the euro (Karlsson and Schoeller, 2021, p. 201). By contrast, an opinion poll conducted by Infratest Dimap end June 2020 showed that 59% of Germans approved of the EU taking on joint debts (WDR, 2020, p. 1). A Covid-19 online survey conducted by the European Parliament Research Service in June 2020 indicated that half of the interviewed Germans favoured the EU to have more financial means to combat the Covid-19 pandemic (European Parliament EP, 2020, p. 1). Additionally, the high popularity of the Merkel IV administration, due to its handling of the pandemic, allowed for additional leeway (Oltermann and Rankin, 2020). While both public opinion and states elites opposed debt-sharing during and after the euro crisis, both agreed to debt-sharing in the corona crisis (Freudlsperger and Jachtenfuchs, 2021, p. 119).

It is unclear whether a German sense of European solidarity caused this temporal shift of preferences, or Italian Prime Minister Giuseppe Conte's countless efforts to persuade the German public, or both. Germans feel a historic duty and debt for Europe that often helps overcome a leap of faith and come up with a solution (Wendler, 2019, p. 605). Conte tried ceaselessly to

persuade the German public. In interviews in the public leading news channel *ARD*, the national newspaper *Sueddeutsche Zeitung* (Meiler, 2020), and in an article published in the influential *Die Zeit*, he asked Germans for solidarity (Conte, 2020).

## 5.2 Productive conditions in Germany

What makes a historical opportunity a critical juncture with a concrete outcome is the existence of a productive condition, that is, an actor who initiates change (Soifer, 2012, p. 1577). It is assumed that the fact that there is a Franco-German proposal for fiscal integration is such a condition; the proposal was adopted with minor changes and, according to the ordinary legislative procedure, proposed by the European Commission (European Council, 2020, p. 3). This chapter aims at explaining the existence of the Franco-German proposal and at explaining how it came into place.

### 5.2.1 Social democrats as agents of change

Social democrats played a crucial role in using the corona crisis for pushing debt-mutualization due to their federalist conviction. Already their election manifesto from 2017 stated that “each investment in our neighbouring countries is at the same time an investment in our own future” (Social Democratic Party of Germany SPD, 2017, p. 96). The German Minister of Finance Olaf Scholz and the Minister of Foreign Affairs Heiko Maas, both social democrats, demanded unconditional financial aid for EU member states in need and explicitly rejected the idea of austerity policies (Maas and Scholz, 2020, p. 2). European solidarity was crucial for them to help the European economy recover and should be taken into account when discussing the MFF 2021-2026. Particularly Olaf Scholz has shown a clearly federalist orientation when he labelled the NGEU fund as “Europe’s Hamiltonian Moment” (Bundesministerium der Finanzen, 2021, p. 3), referring to the state-building momentum in US history. This attitude is a stark contrast to Olaf Scholz’ predecessor, Wolfgang Schäuble (Greive and Hildebrand, 2020). The conservative politician was an unparalleled advocate for fiscal discipline nationally and internationally. Under his rigorously strict fiscal policy regime, Germany achieved in 2014 its first budget without taking on new debts since 1969 (Marschall, 2016). Wolfgang Schäuble is arguably one of the reasons why the Greeks during the euro crisis did not receive unconditional financial aid, but only loans that were strictly linked to conditionality and reforms (Zimmermann, 2015, p. 370).

The German council presidency had to rewrite its plans after the onset of Corona in March 2020, according to the head of the Department for European Affairs in the finance ministry

(Bundesministerium der Finanzen, 2020, p. 13). This can be considered as smoking-gun evidence for the fact that the corona crisis was a critical juncture that led to the launching of NGEU fund. This is clear evidence for the fact that Germany was a crucial causal force for making debt-sharing happen.

### 5.3 Political Spillover

In the following subchapter, it is explained why the social democrats in the Merkel IV cabinet were able to push the NGEU fund through, given they were the smaller coalition partner (Freudlsperger and Jachtenfuchs, 2021, p. 124)

#### 5.3.1 Eurosceptics on the rise

Italy's government in 2020 under the leadership of Conte consisted of the anti-establishment and Eurosceptic 5-Star-Movement (MS5) and the centric Partito Democratico. Yet, from 2018 to 2019, it consisted of the M5S and Matteo Salvini's Lega Nord, representing the first populist government in a founding EU member state (Kirchgaessner, 2018). The overall results of the Populist parties in the 2018 elections, including Fratelli d'Italia, amounted for over 50% (Politico Research, 2018). So did the results of the EP election in 2019 (Brunazzo and Mascitelli, 2020, p. 17). Both elections clearly mirror the rise of Euroscepticism in Italy (Brunazzo and Mascitelli, 2020, p. 18). ~~48~~ The Eurobarometers since 1973 reveal that until 2006, more than half the Italians believed that their EU membership was beneficial, a value that has never been achieved since 2007 (Brunazzo and Mascitelli, 2020, p. 21). Since 2011, only under 40% shared that view (Brunazzo and Mascitelli, 2020, p. 21). This development culminated in September 2018 in a survey with 1000 interviewees conducted by Tecné: 42% of Italians indicated they would leave the EU (Vergine, 2020).

#### 5.3.2 Populists demonising Europe – us against them narrative

This change of mind can be explained by the shift of the dominant narrative in Italy from Europhile to Eurosceptic (Brunazzo and Mascitelli, 2020, p. 21). Many Italians do not see the EU as saviour any more, but as opponent (Begg and Featherstone, 2018, p. 1). The EU was long seen as constructive, external constraint: Italian governments reduced their budgetary spending, without taking the blame for it (“constructive hypocrisy”) (Begg and Featherstone, 2018, p. 2). Yet, the EU is rather seen as external enemy. Eurosceptic parties have long tried to capitalise on fiscal disputes and found Italy on unprecedented levels of Euroscepticism in mid-2020.

Serious Euroscepticism is a trend in Europe: Varoufakis and Tsipras in Greece during austerity policies in the early 2010s, Poland and Hungary over judicial disputes and refugee quotas, and Italy over budget deficits (Begg and Featherstone, 2018, p. 3). Yet, the budgetary dispute

between Rome and Brussels was not new. Since the adoption of the Two Pack in 2013, Italy submits its draft budgetary plan to the EU Commission before it is ratified by the Italian Parliament (European Commission, 2021). In 2018, the EU Commission had rejected the Italian budget plan for 2019 for their intention to increase public spending and end austerity policies. After the Italian government had in return stated it would not accept the rejection of its budgetary plan, but rather stick to it, consensus was eventually found (Cardiff EDC, 2018). This is another example of the us-against-them narrative of Italian governments. They try to appear strong against the demon in Brussels before their domestic voters.

### 5.3.3 Italy during the Covid-19 pandemic

Italy was the country in Europe that was hit the earliest by the covid-19 pandemic. Already in early March 2020, the number of infections was the highest in Europe and among the highest worldwide (Villa, 2020, p. 2). Italy was in lockdown from March 8<sup>th</sup> until May 4<sup>th</sup> (Vergine, 2020). The economically strong North was hit especially hard (Brunazzo and Mascitelli, 2020, p. 28). At the same time, in some parts of Southern Italy, people had hardly enough to eat (Vergine, 2020). The Italian GDP was expected to decrease by 8% in 2020 and public debt to raise to 155% of GDP (Vergine, 2020). In the second quarter of 2020, the Italian GDP shrank by 17,3%, the debt-GDP ratio was expected to climb up to 166,1%, unemployment amounted for 8,3% and youth employment at 31% (Hänsel, 2020, p. 24).

### 5.3.4 The EU falling apart over Italy?

Against the backdrop of social and economic hardship in a highly Eurosceptic political landscape, Conte stated in April 2020 that “the risk of failure is real” (Vergine, 2020) if no new impulse was given to the EU. This view was shared by the German finance minister Olaf Scholz who contended that the economic divergence, caused by the corona crisis, would have ultimately led to a political split-up (Bundesministerium der Finanzen, 2021, p. 3). Both saw the adoption of the NGEU fund as the only way to protect the integrity of the Single Market and the Euro (Hänsel, 2020, p. 22). Indeed, Italy is expected to receive around 28% of the NGEU fund’s money until 2026 (Hänsel, 2020, p. 22).

On top of this, European countries failed to help Italy and show solidarity at the beginning of the Covid-19 pandemic (Kanter, Bohnet, Galetti and Hofmeister, 2020, p. 2). For instance, a substantial mask delivery got stuck in Germany owing to closed borders. Czech Republic and Romania blocked medical supplies to use them themselves (Makarychev and Terry, 2021, p. 5). Those are instances of Europe failing to help that fuelled Italian disappointment of the EU.

During the onset of the Covid-19 pandemic, there was a “real sense of betrayal” (Brunazzo and Mascitelli, 2020, p. 24) that made many Italians rethink the worth of being an EU member state.

#### 5.3.5 Merkel’s European conviction

Merkel’s European orientation shone through during the corona crisis. In a government statement on April 23<sup>th</sup> Merkel declared that the NGEU fund should be seen against the backdrop of the corona crisis being the hardest prove to cohesion and solidarity in Germany and Europe since World War II and that (Bundesregierung, 2020a, p. 11). As she stated, Germany could only fare well if Europe does (Bundesregierung, 2020a, p. 9). Consequently, she claimed that the German government needed to take action to fight the consequences of the corona crisis (Bundestag, 2020, p. 19707). Additionally, it can be argued that Merkel’s concern for the post-Brexit EU after her planned resignation in autumn 2021 made her agree on the NGEU fund, so she would bind up a European legacy for which to remember her (Hill, 2020).

Merkel governments since the euro crisis stand for “federalism by exception” (Enderlein and Guttenberg, 2020, p. 401). The adoption of the ESM in 2012 marked a watershed in German fiscal policy stance towards Europe. Keeping member states solvent through common funds introduced a new dimension of fiscal integration in the EU (Enderlein, Gnath and Haas, 2021, p. 254). Merkels European conviction could also be observed during the 2015 Euro Summit. Despite a majority among government leaders and within her own government to make Greece drop out of the euro area, Merkel agreed on remain (Becker and Fuest, 2017, p. 78). The fact that Italexit was ghosting through Italian media rather than being a reality was enough for Merkel to act. To sum up, Merkel is an example of political spillover. That is, national actors become agents of supranational integration.

#### 5.3.6 Europeanization of the German conservatives

Debt-mutualization in Europe was explicitly ruled out in the CDU election manifesto (CDU & CSU, 2017, p. 57). Yet, it was pushed over twice by the decision to loosen up the SGP fiscal rules on March 23<sup>rd</sup> 2020, as well as by the agreement on the NGEU fund on July 21<sup>st</sup>. This shift in attitude, again, could be explained by the Germans historically motivated responsibility for the European project (Wendler, 2019, p. 603). Already in the debate about bailing-out Greece in the euro crisis, Parliamentary debates in Germany were rather value-based than purely cost-benefit oriented (Wendler, 2019, p. 608). In that sense, also the CDU went through a process of political spillover. A favourable circumstance was that the social and economic hardship in the corona crisis, unlike during the euro crisis in Greece and elsewhere, was not a consequence of public mismanagement (Freudlsperger and Jachtenfuchs, 2021, p. 127). NGEU

fund money would not incentivise moral hazard considerably or hamper needed reforms from happening. In this respect, debt-sharing during the corona crisis did not openly contradict ordoliberal ideas (Fuest, 2021, p. 5).

## 5.4 Economic Spillover

This section sets out evidence for the economic rationale behind the adoption of the NGEU fund, contributing to explain the change of mind of the German government.

### 5.4.1 Design flaws of the EMU system and economic pressure

The EMU system has several design flaws, and Merkel was aware of them. First, the euro area is not an optimal currency area due to the stark divergence regarding economic and financial conditions between countries (Becker and Fuest, 2017, p. 25). Second, the past 30 years of monetary history in Europe have shown that it is crucial for countries to being able to de- and revalue their currencies to accommodate their economic welfare (Becker and Fuest, 2017, p. 31). Merkel stated during the parliamentary questioning in the German *Bundestag* on May 13<sup>th</sup> 2020 that only a monetary union without a political union was not enough (Bundestag, 2020, p. 19706). It was “completely evident” that the steps undertaken so far were not sufficient and treaty changes “must not be a taboo” (Bundestag, 2020, p. 19707). Finance minister Scholz described the NGEU fund as overdue reforms of the EMU system (Bundesministerium der Finanzen, 2021, p. 2).

### 5.4.2 Over-indebtedness in Southern Europe and the proposal of the Frugal Four

The third design flaw of EMU system, over-indebtedness, explains why loans might not have worked, even though suggested in the Frugal Four’s proposal. It suggested to provide only loans to member states to keep financial responsibility solely on the national level (Burchard and Heikkilä, 2020). The background of this is that the introduction of the Euro enabled Southern European countries to take on debt for significantly lower rates than before. For instance, Greece had to pay €200 million to receive €1 billion of additional credit in the 1990s, yet it had to pay only €60 million for it in 2001 (Becker and Fuest, 2017, p. 43). Lack of compliance and enforcement mechanisms of fiscal supervision did not hamper countries such as Italy or Greece from taking on too much debt. The problem is that once a country exceeds a certain threshold of GDP-debt ratio, taking on debts can cause a doom loop effect (Alcidi and Gros, 2019, p. 1). Investors would lose faith in the Italian government bonds and demand higher risk premia. The positive effect of the EU credits would have been neutralised by the higher risk premia (Alcidi and Gros, 2019, p. 2). It is estimated that the NGEU fund will increase the Italian GDP by 2,1%

per year (Picek, 2020, p. 325). That is a growth rate of 14,4% from 2021 until 2027. The economic rationale behind the adoption of the NGEU fund is that providing grants, instead of only loans, is cheaper than risking a collapse of the Italian economy with a potential domino effect (Picek, 2020, p. 331).

#### 5.4.3 Why it was reasonable to assume that the NGEU fund would reconcile Italians with Europe

The low approval of the EU in Italy in the 2010s was not only a result of influential Eurosceptics, but was also directly linked to concrete EU politics towards Italy. There is abundant evidence for this. This is a contrast to some Central European countries as Hungary, where the EU sending money is sometimes interpreted as weakness (Hargitai, 2020, p. 203). In Italy, approval of the EU increased by almost 10% as response to European financial help in the first years of the euro crisis from 2009 to 2011 (Brunazzo and Mascitelli, 2020, p. 21). After the implementation of the ESM in 2012 and ensuing austerity policies, approval of the EU in several Southern European countries fell immediately (Castelli Gattinara and Froio, 2014, p. 182). Italians do not see Europe as joint project they can help shape, but rather as an institution that they can demand things from and which has to deliver (Kanter, Bohnet, Galetti and Hofmeister 2020, p. 5). This sort of relationship between a state and its polity can be described as “Roman strategy” (van Middelaar, 2016, p. 407). The state provides the population with a concrete, beneficial output, such as social security or economic stability, and bases its legitimacy on it (van Middelaar, 2016, p. 408). In that sense, it was plausible to assume that the NGEU fund would increase approval of the EU in Italy.

#### 5.4.4 Setting the NGEU fund into motion

In March 2020, nine heads of Southern European member states, led by the Italian Prime Minister Conte, sent a letter to the president of the EU Council Charles Michel demanding joint EU debts (Böttger and Jopp, 2021, p. 5). The fact that France was among those countries who sent a letter to the president of the EU Council made Germany realise that, while some economies still had not fully recovered from the euro crisis, the corona crisis could make the EU fall apart. On May 8<sup>th</sup>, the French ministry of finance suggested additional, substantial means for the EU budget for the upcoming three years. This was a landmark for the adoption of the NGEU fund: Merkel contended in a statement in the German Bundestag that a currency union would “evidently” (Bundestag, 2020, p. 19707) require more integration. Only five days later, together with Macron, she suggested grants worth €500 billion. Owing to the resistance of the frugal four, the EU Commission cut it down to €390 billion in its proposal on May 18<sup>th</sup> (Bayer and Herszenhorn, 2021). This is the political rationale behind the adoption of the NGEU fund.

## 6. Conclusions

This research provided an empirical examination to answer the following research question: Given the long-standing record of opposition to debt-sharing, why did government leaders of EU member states agree to adopt the NGEU fund? By using explaining-outcome process-tracing methods, a longitudinal, case-centric research design was deployed for this research. To increase internal validity, tests to establish causal inference were applied, according to Collier (2011). The objective of this research was to develop a minimally sufficient explanation for the adoption of the NGEU fund by combining neo-functionalism and historical institutionalism. This objective was achieved.

The findings suggest that the combination of the concepts of critical juncture and spillover can sufficiently explain the adoption of the NGEU fund. First, it was clearly shown that German public opinion shifted towards a more favourable position regarding debt-sharing and that the German government took initiative only after the onset of the corona crisis. This suggests that the corona crisis was the critical juncture that caused this shift. The German Minister of Finance Scholz was the main actor to use this room for manoeuvre and to help the EU implement the NGEU fund. Second, evidence indicates that spillover effects took place. Political spillover effects were that Merkel and the CDU party, who used to oppose debt-sharing, suggested it in May 2020 with the Franco-German proposal. As shown, the Europeanization process of Merkel and the CDU had already begun in the aftermath of the euro crisis, when the ESM was adopted in 2012. This evidence is particularly compelling because first, Italy was far from factually voting to leave the EU, and second, because of the least-likely case selection. Evidence suggests further economic spillover effects. As shown, public debts in Italy were already at economically critical heights when the corona crisis started. A collapse of the Italian economy was looming, implying the risk of a domino effect. Financial aid was urgently needed to prevent it. This high level of public debt was partly caused by design flaws in the EMU system.

This research has engaged with literature in the following ways. First, it contributes to a rather new body of literature that combines European integration theories with each other, such as the works of Jones, Kelemen and Meunier (2016), or Pollack (2019). Concretely, this research linked the concepts of critical juncture and spillover effects. So doing, it elaborated further on Schimmelfennig's (2014; 2016) approach of combining neo-functionalism and historical institutionalism. Second, the NGEU fund is the first instance of debt-sharing in the EU (Picek, 2020,

p. 325; Fuest, 2021, p. 3). This research contributes to the build-up of a new sub-body of literature on fiscal integration, more concretely, on debt-sharing in the EU.

The combination of neo-functionalism and historical institutionalism has been applied in this research to explain European economic and political integration, such as in the works of Schimmelfennig (2014, 2016). It would be worthwhile for future research to test whether this combination of theories can be extrapolated to other fields of European integration. For instance, critical juncture and spillover effects could be applied to explain why it was the EU that negotiated the vaccine deals with pharma companies in the second half of 2020, instead of national governments. Moreover, the NGEU fund is still in an early stage of implementation, given that it was adopted in July 2020 and ratified only in December 2020 (Fuest, 2021, p. 1). In that sense, the findings of this research should be considered as sound signposts to the understanding of a research object that scholars have only recently started to examine. Many aspects are still to be studied, such as the factual economic benefits of the NGEU fund, or whether it indeed strengthens cohesion within the EU (Fuest, 2021, p. 8).

This research has the following caveats. First, the findings of single case studies can potentially not be generalised. Single case studies depend strongly on the case-specific circumstances (Bennett and George, 2005, p. 44). However, it cannot be ruled out that neo-functionalism and historical institutionalism can explain fiscal integration in other regions. This can be a subject of future research. Second, the analysis was simplified by focussing on Italy. A broader examination of the coalition of the Southern European countries seems to be promising. Especially the analysis of the Northern countries was simplified by assuming that they would follow Germany. This causal connection needs yet to be shown. Future research could examine what caused the leader of the Frugal Four, the Dutch government under the leadership of Mark Rutte, to agree on debt-sharing. The aspect of conditionality of financial transfers and rule of law seem to have played a vital role (Burchard and Heikkilä, 2020). Such research would enrich the understanding of the Northern opposition to debt-sharing. In turn, this could contribute to policy predictions regarding further fiscal integration. It will be highly interesting to observe whether Germany as proxy for the Northern EU countries was indeed a federalist “by exception” (Enderlein and Guttenberg, 2020, p. 401) or whether fiscal integration will be deepened in the future.

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