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Rethinking the role of the *European Stability Mechanism* for local communities

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ABSTRACT
The Covid19-related emergency has changed our perspectives on individual and collective priorities. One of them is to invest on infrastructures at the level of local communities, where most social and economic relations take place. This note explores the possibility to use a fully fledged European Stability Mechanism for this purpose. This would provide a solution to the required transformation of the ESM from a temporary instrument for financial assistance into a growth-promoting fund.

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1. Introduction

The Covid19-related emergency has changed our perspectives on individual and collective priorities. Two aspects in particular will probably stand out for their impact on the way societies will change and adapt to the transformation required (and induced) by this shock.

The first is the need to rethink social, economic, political, and territorial planning in a way that allows a prompt, more efficient, decentralized – but also coordinated – response to exogenous shocks, that transcends current (State-centered) administrative and policy boundaries. This raises two related issues: the need to pay greater attention to the concept of the *smallest surviving unit*, that might sit astride existing juridical administrations; and a reflection on what kind of infrastructure is required to make such units more resilient and reactive.

The second issue is how to finance crucial local infrastructure that allow such local areas to effectively react to exogenous shocks and

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challenges; this implies competing on financial markets against the destabilizing (but often high-yield) component of market-induced instability due to short-termism (and the extremely variable demand for liquidity required to cover short-term obligations in times of crisis), redirecting resources towards long-term assets. As the public debate suggests both in the USA (World Urban Forum 2020) and the EU (Vallo *et al.* 2020), major cities are already pushing hard in this direction, calling for a reshaping of the role, functions and competences of local communities.

In this paper, we suggest that an instrument that should be more widely explored for this purpose is the *European Stability Mechanism* (ESM). This proposal might be conceived as an upscaling of the Eurogroup decision to use the ESM as a tool to provide liquidity for immediate emergency-related costs, conditional on their use to this end only.

In order to use it as an instrument for longer-term investment, its mission, nature and statute should be adapted, requiring some political and juridical steps. In the following sections we shall: outline the concept of *smallest surviving unit* as a basis for redesigning current (first immaterial, then also material) constitutions along a multilayered system of public choice (section one); briefly contextualize the birth and evolution of the ESM (section two); before turning to the way we suggest its re-design (section three).

2. Community design

The concept of *smallest surviving unit* as the minimum dimension of communities allowing for the survival of its members – once the *tribe*, later the *polis*, then the *nation-State*, and lately the *whole planet* – was profoundly shaken by the pandemic. In order to face a global problem, we re-discovered that the nation-State is the only juridical framework that can pass and enforce containment laws, and provide public goods that individuals require for their survival (*latu sensu*).

At the same time, we discovered that all nation-States, whatever their dimension, face similar domestic, sub-national issues concerning the optimum/most efficient degree of decentralization of some crucial activities, such as sanitary measures, social control, provision of assistance to those in need, etc. We also found that in the absence of a coordinated supra-national response to a supra-national issue, the most likely outcome is an increasing gap between individuals, regions, States, continents; a potentially disrupting perspective for the future.

The globalization and dematerialization of some economic activity in the last few decades has overshadowed the crucial role of *communities*: in bridging market dynamics, and the role of collective decision-making of public authorities (Rajan 2019); and in their key role of community control and absorption of the negative effects of globalization. This suggests that a truer – and constitutionally recognized – multi-layered system of (independent and coordinated) governments[1] might be able to more efficiently cope with the multilayered nature of the problems we face (Robbins 1937).

As a consequence of the current State-centered approach to public choice, two layers of government remain underfinanced and underprovided for in terms of (collective) public goods: the *community* level, and the *supranational* level. For this reason, we suggest that an existing supra-national financial instrument like the ESM, suitably modified, might serve as a fund for supporting the lower, community-level, long-term public investments (as argued also by Sassoli 2020), solving the twofold problem related to the under-provision of both supranational and sub-national public goods.

This would allow both a joint, strategic view of the required investment policies, accompanied by collective financing, monitoring and control; and a bottom-up design of community-specific infrastructure, that would ensure full democratic involvement (Rossolillo 1983: 47).

In the first instance, this requires identifying the *smallest surviving units*, and the role of community-based infrastructure. The *smallest surviving units* can be defined (in the 2020 world) as local systems large enough to allow for the smooth functioning of the underlying (internal) community (Olivetti 1945) and small enough to be identifiable from the rest of the greater (external) community, proving an optimum balance between agglomeration economies and diseconomies. Each of them can be visualized as the spider's web system of public goods and services (utilities, transports, social and cultural centers, etc) needed for everyday life to be operational and resilient to shocks (World Urban Forum 2020). In many cases, these are metropolitan areas, or major coordinated local systems of highly interconnected territories. Of course, *surviving units* do not imply self-sufficiency: we are living in a complex and intertwined world that cannot survive in the long term without major connecting infrastructure. But they are able, in cases of shorter-term perspectives

[1] In the USA too, there is an increasing awareness on the need to return to a more decentralized, genuinely multilayered, federal structure of the State.

driven by emergencies, to react efficiently to exogenous shocks, absorbing their negative impact.

When we speak of community-based infrastructure, we do not just mean traditional infrastructure such as roads, bridges, airports; but broadband, energy production and distribution, waste recycling, innovative and flexible hospitalization and health management systems, research laboratories and networks, interconnected logistics, social mobility, new ways to design the relationship between major cities and their territories, re-engineering the welfare state to cope with an ageing population, etc. Most of this (material and immaterial) infrastructure requires enormous capital and a governing system involving the active participation of a number of private and public actors, on multiple levels.

This is where the financial support from a supranational institution like the ESM comes in.

3. Contextualizing the nature and scope of the ESM

The ESM was established in 2012 to tackle potentially destabilizing financial imbalances in any of the euro-area members, more promptly and effectively than the *European Financial Stability Facility* (hence EFSF), by furnishing them credit when market conditions turn unfavorable. The fund has an authorized capital of 704.8 billion euros, of which only 80 billion are actually paid-up, and has a lending capacity capped at 500 billion euros.

As a joint enterprise of the euro-area member-States, loans from the ESM represent a joint obligation in case of sovereign default. They are, therefore, a collective liability. Being a permanent financial institution under public international law that (after the IMF) can claim a preferred creditor status, the ESM can also (and usually does) issue bonds on the market that, being backed collectively, have a 'triple A' rating (Fitch).

According to its extra-ordinary mission, to tackle cases of severe financial distress, the ESM provides liquidity, conditional on a wide-ranging program of debt restructuring and reduction. In fact, such strict conditionality proved socially and politically destabilizing only in the Greek case (out of five applying countries, the others – Ireland, Portugal, Cyprus and Spain – having used the ESM's resources successfully, the last one to strengthen its banking system). In the Greek case, more than three hundred billion euros were provided (in three rounds of negotiations, that started under the EFSF) to stabilize the macroeconomic figures of a country that had experienced deficits of up to 15% of GDP for some years. Greece ended its ESM program after eight years (EFSF plus ESM), in August 2018.

Acknowledging the imminent need for the ESM to go beyond its original mission, in December 2017 the *European Commission* published a roadmap, setting the target for the transformation of the ESM into a proper *European Monetary Fund* (EMF). This proposal had a threefold aim: (a) to increase the accountability and legitimacy of its decision-making mechanism and procedures, bringing it within the scope of the EU legal system; (b) to facilitate the implementation of the Four/Five Presidents' Reports of 2012 and 2015 on the completion of the economic and monetary union and; (c) to anticipate the extension of the euro-area to the whole EU27. In the meantime, the *European Council* decided to use the ESM as a backstop for the *Single Resolution Fund* within the EU's banking union, a reform currently under scrutiny by the Member States.

These changes were all made in the pre-Covid19 era, and still aimed at better safeguarding the financial stability of euro-area Member States. The current, generalized and symmetric shock delivered by the coronavirus pandemic offers an opportunity to accelerate and widen the nature of this transformation. The recent decision to allow access to the ESM to finance improvements to health systems is a step in this direction.

Three directions of change seem to be imperative for the EU: enhancing its fiscal capacity, in order to increase its ability to finance collective (European-wide) public goods; the need to design a viable compromise between the two-tiered federal model of the USA (and of most traditional federal States) and the decentralized model of the current EU, with the aim of establishing a three-tier multilayered democracy, where *local*, *national* and *supranational* governments are recognized; and a long-term perspective with financial engineering to support massive public (European-wide) investments.

Our proposal tries to address all three challenges, providing a scheme for financial intervention to finance the third, crucial but missing, layer of government in Europe: *major local systems* or *smallest surviving units*.

This should be understood as a further, synergic instrument in the comprehensive framework of extraordinary financial effort provided to tackle the emergency and restart the economy in Europe: this will complement the ECB's monetary policy, the EIB's investment fund, the Commission's SURE instrument, and the forthcoming *Recovery Plan* to be established within the *Multiannual Financial Framework*.

4. An instrument for multi-layered public investments

We have already stressed that most services/infrastructure can be best organized, managed and monitored at the level of major local areas: health-care systems and the welfare state, public transport, cultural socialization, innovative solutions for an ageing population, energy production and distribution, etc. We suggest that such investments (by large municipalities or consortia of local authorities) should be implemented through the emission of *Sustainable Bonds* by the ESM. As we have seen, the ESM can be flexible and reactive; and it can be adjusted to serve the agenda set by the European Commission and its six priorities (in particular the *Green Deal*), therefore assuring strategic unity in providing funds for investments.

The ESM might therefore be transformed into a lending facility for the support of long-term investments, following the model of national financial institutions like Deposit and Loans Funds (*Cassa Depositi e Prestiti* in Italy, *Caisse des dépôts et consignations* in France, *Crédit Communale de Belgique*, etc), and thus act as the EU's arm for executing public policy mandates. *Sustainable Bonds* should have a long maturity and might be purchased by the ECB (as is presently the case for most of the ESM's debt).

For this purpose, the ESM can (currently) count on a paid-up capital of 80 billion euros, with a lending capacity of 500 billion euros. This means that a leverage of six can be seen as a reasonable proxy for its enhanced lending capacity. We know that the total authorized capital of the ESM is 704.8 billion euros. Once all this capital is paid (let's imagine a schedule of ten years to reach the target), the credit capacity of the ESM might hit 4.000 billion euros. This might be a sufficient amount, around 3% of the EU27 GDP (about 13.500 billion euros in 2018) for ten years.

The ESM should also operate as a re-insurer to the system of national public investment banks (the *Cassa Depositi e Prestiti*, etc.) to finance smaller local initiatives, such as the modernization of local transport or building schools, hospitals, waste recycling facilities and the like in small cities.

The only conditionality required in this initiative should concern the use of resources to finance investments that prove to be sustainable in terms of: financial soundness (ability to generate cash-flows that guarantee the payment of debt installments), social cohesion, intergenerational opportunities, environmental protection, and technological and energy innovation. The eligibility criteria, selection and monitoring of such initiatives should be set by the European Commission, acting according to the strategic plan for a *Green Deal*.

This specific role for the EMS, providing collective public goods at the subnational, community, level that is usually neglected, might also have a positive impact on European citizens' perception of the role of European institutions.

5. Concluding remarks

The pandemic-related emergency has highlighted the relevance of local authorities in responding to social challenges, and their role should be enhanced in shaping the future system for the provision of essential public goods. A new, bottom-up, process of local democracy should be built, constitutionally recognized/legitimized, and made enforceable; a process that allows for locally decentralized responses and strategic unity.

Such strategic unity, pending the implementation of a more democratic collective decision-making process in Europe, can be provided by the six priorities set by the new *European Commission* for its mandate. In particular, the *Green Deal*: meant to remind us of the *New Deal* launched by Roosevelt in the Thirties to restart the economy after the *Great Depression*, the *Green Deal* aims to foster innovation, the transformation of production and building infrastructure that can cope with future sustainability challenges, and competition.

Hence the need for a *Sustainable Fund*, helping finance long-term local investments in infrastructure with *Sustainable Bonds*. For its supreme flexibility and adaptability, we suggest that an instrument that can be promptly and effectively made available for this purpose is the ESM, redesigned as a long-term investment bank for major (and, indirectly via national financial public institutions, minor) local communities.

Disclosure statement

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