ARE WE MOVING TOWARDS A EU FISCAL UNION?

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Abstract:

The establishment of a European Recovery Instrument financed by joint EU borrowing (called „Next Generation EU", or NGEU) is an important step which will probably have long-term implications. This paper discusses what could be the legacy effects of NGEU. It starts with some general reflections about the lessons to be drawn from the US experience and about the meaning of EU fiscal union. It then sketches out four possible scenarios for the future, not necessarily mutually exclusive. These range from the maintenance of the EU covid debt to finance other joint investments to the introduction of reforms to the post 2027 EU budget without further centralisation.

Keywords: European union, fiscal union, Next Generation EU fund

Introduction

The agreement reached in December 2020 to set up a dedicated European Recovery Instrument financed by joint EU borrowing (called „Next Generation EU", or NGEU) has been unanimously described as an historical breakthrough. Yet will it be a game-changer?

Some say that it may constitute a 'Hamiltonian moment', in an allusion to the compromise engineered by the first US Treasury Secretary of the United States, Alexander Hamilton, to federalise the debts of the various US states after the Civil War. This is considered by US historians as one of the decisive steps towards the creation of the US federal government and thus a US fiscal union.

In truth, it is too early to know whether the Next Generation EU will lead to some permanent changes. There are reasons to be sceptical. The EU Recovery Fund is conceived as a one-off instrument. The crisis has not wiped out the almost allergic opposition in some northern EU member states to the idea of setting up a „EU fiscal capacity". At the same time, it is difficult to imagine that such a quantum leap in terms of EU economic integration will not have long lasting effects on the EU's economic governance.

To discuss the possible long-term implications of NGEU it is useful to start with some general reflections about the lessons to be drawn from the US experience and about the meaning of EU fiscal union. After that, I will sketch out various possible scenarios for the future.

1. Lessons to be drawn from the US experience

As said above, many have argued that NGEU may constitute a 'Hamiltonian moment'. It is not the first time that the US experience is taken as a benchmark in debates about Europe's economic integration. During the 2011-2013 crisis, for instance, references to the US monetary union were frequent to discuss the feasibility and appropriateness of different EMU reform paths. One can contend that a EU-US comparison has limitations, that the nature of the two entities is too different and the historical circumstances too diverse. Yet, as pointed out by many analysts[1], a look at the real 'Hamiltonian moment' may draw some lessons for the EU.

The first one is that the debates in Hamilton's time were as polarised as the debates taking place in Europe today. The opposition to the federalisation of the national debts was strong, particularly from 'virtuous' and richer states which had low debt levels and did not want to take on a part of the debt of poorer states. The process towards the establishment of a strong US federal government was long and difficult. In fact, the first time Hamilton proposed the assumption of national debts to the House of Representatives, the proposal was rejected.

A second lesson is that the proposal to federalise the national debts was not only driven by immediate concerns – to prevent the insolvency of highly indebted states after the Civil War – but was also inspired by a long-term political purpose, to build a strong federal government, endowed with full borrowing and tax powers.

Finally, the federalisation of national debts was not a standalone measure. It was accompanied with the creation of the U.S. Customs Service to collect import duties, the first step to the development of a true federal tax capacity. It also triggered changes at national level. Over time, the creation of a large federal budget responsible for the bulk of public debt was coupled with a de-facto 'no bailout regime' for national debts reinforced with budget balance rules in many States.

[1] See for instance Henning, R. and Kessler, M (2012), Fiscal federalism: US history for architects of Europe's fiscal union, Bruegel., or the symposium of views published in the summer 2020 issue of the International Economy magazine, „Did Europe Just Experience Its „Hamiltonian Moment"?

2. The meaning of 'EU fiscal union'

Turning now to the concept of 'EU fiscal union', what do we mean by that? If we advocate for the establishment of a permanent fiscal capacity built on NGEU, which type of EU fiscal capacity do we have in mind? It seems clear that nobody envisages the development of a US-like fiscal union, compounded with a sizeable EU budget representing 20 or 30% of the EU GDP playing strong allocative, redistributive and stabilisation functions and full tax powers. Yet there are different visions on which type of EU fiscal union do we need.

Before Covid, discussions on the EU fiscal union were part of broader debates on EMU reform. They were very much framed by the narrative of making the euro resilient to shocks. There were many different proposals of EU fiscal capacity circulating[2] but the dominant view was that a common capacity was first and foremost needed to stabilise the euro area economies, not so much to jointly finance EU public goods. There was also consensus on the fact that, to be meaningful from a macro-economic perspective, a fiscal capacity should be sizeable enough – less than 1-2% of EU GDP was considered irrelevant. Since the dominant legal interpretation at that time was that the Commission could not massively issue debt within the framework of the EU budget, and given the difficulties to raise the ceilings of the EU budget, most experts called for the establishment of a fiscal capacity outside the EU budget financed through common debt or national fiscal transfers.

Should we return to the pre-Covid debates on fiscal capacity? I do not think so, for various reasons.

- In terms of governance and design, the NGEU has set a precedent. Now we know that it is possible to build up something sizeable within the framework of the EU budget. There is no need for complex intergovernmental structures, subjected to unanimity rule and weak accountability.
- In terms of coverage, the creation of NGEU and SURE covering the whole EU-27 makes it difficult to imagine the development of future eurozone-centred fiscal mechanisms.
- In terms of purpose, the case for a permanent EU insurance-based stabilisation instrument may be more difficult to sell politically after this crisis. The political narrative before Covid was that „we need to equip the euro with a fiscal stabilisation mechanism in order to protect the economies in the event of another crisis". But, in fact, the eurozone economies have weathered the storm relatively well without having such an instrument. In a context of low interest rates and with a very active ECB, sovereign debt markets have remained calm and national governments have been able to pursue very expansionary fiscal policies. Part

[2] An overview of the different proposals can be found in the 2020 annual report of the European Fiscal Board, section 5.2 („completing fiscal governance in the EU: a central fiscal capacity").

of the reason why the markets have remained calm is the announcement of NGEU and SURE. Yet, this is not noticeable for citizens. Against these circumstances, it will be difficult to convince them about the need to set up a fully-fledged EU unemployment scheme or a rainy-day fund to deal with modest asymmetric shocks. If something, citizens have understood the value of quickly reacting to crises by setting up exceptional, ad hoc and temporary instruments (NGEU, SURE) but not necessarily the need for permanent EU fiscal stabilisation in normal times.

- At the same time, there are new and powerful arguments in favour of a EU fiscal capacity for allocative purposes. There is growing recognition that Europe needs to massively invest in energy and transport in the coming two decades to succeed in the transition towards climate neutrality. Doing so while at the same time reining in national public debts will be a big challenge. At pointed out by Darvas and Wolff (2021)[3], a possible solution to this trade-off between fiscal consolidation and climate investment needs could be the creation of a centralised EU borrowing mechanism to fund climate investment.

3. Different possible scenarios for the future

Coming back to the initial question, will the NGEU pave the way towards more EU fiscal integration? We can imagine various scenarios, which are not necessarily mutually exclusive.

3.1. EU's Covid debt is rolled over

To start with, something that is conceived as temporary can unintentionally become permanent. In theory, the repayment of the EU´s Covid debt shall conclude by 2058 at the latest. In practice, absent an agreement to create new EU revenue sources, debt repayments will have to be ensured by increasing Member States´ national contributions to the next seven-year EU budget or major cuts on future EU spending programmes. EU budgetary negotiations, however, are terribly path dependent. Any proposal to significantly cut EU spending is likely to be blocked by beneficiary Member States. Faced with the perspective of seeing their national contributions increase, EU leaders may end up preferring to roll over the EU covid debt, postponing its repayment by seven additional years. This would not be illogical, if interest rates remain low. In this case, the debt rollover will not have any fiscal costs. It would also have other advantages. The additional EU debt-financing expenditure could be used to finance joint investments with strong EU-added value which are traditionally under-funded by the EU budget. Besides, keeping the EU Covid debt would help Europe to consolidate a common capital market and would strengthen the euro as an international currency.

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[3] Darvas, Z. and G. Wolff (2021) 'A green fiscal pact: climate investment in times of budget consolidation', Policy Contribution 18/2021, Bruegel

3.2. A new NGEU-type borrowing mechanism for climate investment

Another possibility is that Member States and the European Parliament[4] agree to set up a new NGEU-type borrowing mechanism to support climate investment. This could be seriously envisaged as a solution if Member States struggle to reconcile fiscal consolidation efforts with the imperative to address climate investment needs. Financing climate investments by EU debt could be advantageous not only for highly indebted Member states but also for those having very strict national deficit rules (e.g. Germany). It is worth noting, in this respect, that whereas RRF loans will weight on national deficits and debts, Eurostat treats the EU borrowing to finance RRF grants as EU debt which does not record on national debts[5].

This new „EU climate fund" could be the result of an agreement to raise new EU debt. It could also be financed by rolling over the Covid debt, as a variant of scenario 1. The new fund could finance climate investment projects through calls prepared at the level of the Commission or provide support to national climate investment plans. In the latter case, it would have the additional advantage of allowing the EU Commission to closely control Member States´ climate investment, reducing the risks of ´greenwashing´ inherent to a 'golden green rule' applied at national level.

3.3. A permanent SURE-type fiscal stabilisation capacity for large crises

As argued before, the crisis may have weakened the case for a permanent EU financial stabilisation capacity to deal with ordinary asymmetric shocks. There will be attempts to revive old proposals to set up a fully-fledged EU unemployment reinsurance scheme, or an EU rainy-day fund, but these are not likely to succeed. A more realistic scenario is to transform SURE – which is available until December 2022 – into a permanent instrument. This would imply having a ´dormant´ instrument that can be quickly activated based on a well-defined clause in the event of another large crisis.

As proposed by Corti and Alcidi (2021)[6], we could envisage some changes in the design of this permanent SURE to allow a quick activation. At present, SURE is backed by a EU budget guarantee reinforced by national guarantees,

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4 The Parliament did not have a say in the creation of NGEU, which was based on a Treaty article that does not require Parliament´s consent (art 122 TFEU). However, as part of the NGEU-MFF agreement the European Parliament has obtained the right to scrutinise any future setting-up of crisis mechanisms based on Article 122 TFEU. A specific procedure for this purpose is detailed in a joint declaration of 16 December 2020.

5 Eurostat, Guidance note on the statistical recording of the recovery and resilience facility, Eurostat, Directorate D - Government Finance Statistics (Gfs) September 2021.

6 Corti, F. and Alcidi. C (2021) The time is ripe to make SURE a permanent instrument, CEPS policy insights, n. PI2021-10, June 2021.

and to activate it the Commission needs the consent of each and every Member State to provide the national guarantee. An option would be to build SURE 2.0 on a single EU budgetary guarantee, as it is the case for other EU lending programmes such as the Balance-of-Payments mechanism or the European Financial Stabilisation Mechanism (EFSM). Like these other programmes, the activation in this case would only require a qualified majority in the Council.

This permanent SURE would not be as ambitious as a fully-fledged EU unemployment scheme. It would be only activated in case of large crises, and would provide soft loans. At the same time, it would avoid the technical difficulties that entail the set up of a fully-fledged EU unemployment re-insurance scheme, which requires certain harmonisation of unemployment schemes. Politically, the extension of SURE is more realistic than the creation of a grant-based EU unemployment scheme.

3.4. Reforms in the EU budget without further centralisation

Finally, there is also the possibility that NGEU does not lead to further centralisation but triggers some changes in the EU budget. In particular, there may be lessons drawn from the governance of the EU Recovery and Resilience Facility.

In principle, the RRF looks similar to the 'classic' EU structural funds. In practice, however, it works very differently. It is the Council, not the Commission, who adopts the national RRF plans. Investment is combined with reforms and closely aligned to country-specific recommendations formulated in the European Semester. The EU Commission´s controls over the use of the RRF funds are lighter and the disbursement of EU funds is based on the attainment of objectives rather than the declaration of costs incurred.

The experience with the RRF will undoubtedly influence the governance of other EU funds, particularly the EU cohesion policy funds. Over the last years, there have been steady efforts to simplify EU cohesion policy rules and procedures, adopt a more performance-oriented approach and strengthen the alignment of cohesion policy funds with the European semester. If the RRF governance proves successful in all these aspects and, above all, ensures a quick implementation of the funds without endangering the quality of investment, there will be pressures to implement a similar performance-based approach for the EU cohesion funds.

4. Final remarks

The establishment of the EU Recovery Fund is an important step which will probably have long-term implications. It can also be seen as part of a deeper change in the EU's fiscal policy thinking. Everywhere in the world there is a growing recognition that fiscal policy is back and deemed to play a more relevant role in the coming decades. Europe in particular will need more fiscal activism, not only to support the post-Covid recovery but also to succeed in the transition towards climate neutrality and to sustain the EU´s new geopolitical ambitions. This should logically translate into a strengthening of EU's fiscal policy capacity, but also a different philosophy in the coordination of national fiscal policies, both through the EU fiscal rules imposed by the Stability and Growth Pact and the EU state aid rules.