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This report suggests a way to break the deadlock over the MFF. We recommend restructuring the EU budget into federal and confederal parts. Eurobonds could then be launched without changing the treaty or breaking the balanced budget rule, and at no extra cost to national treasuries. Only if the EU acts federally will it acquire the common fiscal policy it needs to invest in economic recovery.

A Federal Europe: the way out of the crisis

From public health to constitutional crisis

The European Union is once again in deadlock. The coronavirus pandemic has spawned a new financial crisis. While there was certain to be another financial shock after the crash of 2008, we were unsure of its timing, provenance and symmetry. Nor could we predict the mega scale of the crisis: the collapse of supply and demand, the closure of much of Europe's business for at least the first half of 2020, and rapidly rising unemployment which could lead to a deep depression.

The European Union is not sufficiently robust to face this crisis with equanimity. The unification project, now 70 years old, is still far from complete. The EU is an integration experiment conducted in real time. There is no precedent for a number of nation-states to engage voluntarily in building a federal union. The emergence of previous federations, notably the USA, postulate analogies but offer no clear roadmap for contemporary Europe.

So the Union today is a hybrid, part federal and part confederal. The federal ambition – “ever closer union” – is not dead, but it no longer commands the allegiance of all its member states or political parties.¹ By way of successive treaty changes and some path-finding jurisprudence of the European Court of Justice, the Union has built up its supranational authority. But most of the EU institutions are still run in an intergovernmental way, by traditional diplomatic methods. Decision making in a confederate Europe is bound to be slow and fractious, leaving the potential of the Union as a whole unfulfilled, and its governance weak.

The spread of the coronavirus pitches the EU into its next constitutional crisis. For the Union is unfinished business, a fragile polity under stress. Debate about “the future of Europe” is uncertain. No settled consensus has formed around the final size and shape of the Union. Indeed, the United Kingdom, one of its major member states, has just seceded. Eurosceptic leaders in Hungary and Poland challenge the premise of the rule of law on which the Union's claim to legitimacy rests.²

The creation of the internal market and single currency are great achievements, but they risk being undermined by the failure of EU leaders to pursue integration to its logical conclusion. The European Central Bank (ECB) has to manage its common monetary policy without the aid of a common fiscal policy run by the Commission. The Bank is expected to stabilise the banking system of the eurozone without having proper oversight of the financial services industry. The fact that the EU has no central fiscal policy to complement the national budgetary policies of euro members has led to much discussion about the creation of a fiscal capacity unique to the eurozone. Nothing has been decided, however, leaving the ECB solely responsible for risk-sharing in the eurozone.

A common fiscal policy, of course, would require the coming into being of a discernibly federal government of the Union. The Commission is designed to act as a proto-government, but it has to

¹ Article 1 TEU.

² Article 2 TEU.

share its executive authority in many areas with the Council. Although the Council itself, and its senior partner the European Council, can vote to take decisions, they usually prefer the longer and more difficult route of acting by consensus. In any case, the unanimity rule is still imposed for all critical decisions of a constitutional nature.

In other fields, too, the EU house is only half-built. The elaborate 'external action service' has no serious common foreign policy, still less a common defence policy or integrated military forces. The European Parliament does its best to bring democratic accountability to the Union but it is not elected on a transnational basis and does not enjoy federal political parties to connect it with the electorate. There are still too many restrictions on full legislative power for the European Parliament, not least with regard to budgetary matters. National parliaments, meanwhile, cannot act federally even if they wished to do so. Parliamentary influence on the shaping of the general interest of the Union remains weak.

The Union's latest Treaty of Lisbon (2007) includes provisions that would streamline decision-making in a democratic way, but these lie unused.³ Nowhere are the internal contradictions of the EU's structure more exposed than in the regular round of argument over spending money. Every seven years after debilitating negotiations on the Multi-Annual Financial Framework (MFF), which must be decided by unanimity, we sigh and say "never again".⁴ But reform of the system never takes place. Seven years later we are back where we started, with squabbling between the richer and poorer states, frayed tempers and, eventually, sub-optimal results.

What are we arguing about?

The current EU budget runs at €150 billion per year (smaller than that of Belgium) and represents only 2% of the combined spending power of the national budgets of the 27 member states. **Like the Union itself, the budget is a hybrid creature, part federal and part confederal.** The EU's capacity to spend and borrow is rigidly constrained by the ceiling of 1.23% GNI imposed in the 'own resources' decision of 2014.⁵

Revenue for the budget is mostly supplied on a confederal basis. The larger part of the EU's income, about 70%, is provided by direct subscriptions from national treasuries based on the GNI of the member state. These fees are supplemented by transferring a tranche of national VAT receipts. The rest of the revenue, about 15%, comes from 'genuine own resources' – that is, customs duties, levies and penalty fines accruing directly to the Commission.

Discussions about budgetary reform are perennial. Many good proposals have been made to render the system more transparent, to focus on improving the added value of EU spending, and to skew the budget to meet contemporary political needs (such as scientific research, digitalisation and climate change mitigation) and away from traditional policies in need of reform (notably, agriculture). Worthy objectives of increased fairness, sufficiency and stability are agreed in principle - then ignored in practice. Democratic accountability is impaired because the European Parliament is denied the right of co-decision over revenue.

No serious structural reform of EU finances has been implemented. Member states are obsessed with the practice of *juste retour* – what Margaret Thatcher once described, rather rudely, as "getting our money back". In this situation, where the notion of common good is lost sight of, the debate

³ Notably, Article 48(7) TEU.

⁴ Article 312 TFEU.

⁵ Article 311 TFEU.

divides net benefactor creditors from net recipient debtors. Finance ministers of the ‘frugal’ northern states trumpet their refusal to increase transfers to the spendthrift south and east. The principle of solidarity among states and citizens, which imbues the EU treaties, disappears.⁶

Recent efforts to broker agreement in the Council have come to nothing. The European Council has again passed the buck to the Commission, which has been asked to come up with new proposals for the next MFF for 2021-27 in the next weeks. Can they succeed?

Never miss a crisis

Paradoxically, it is fortuitous that the MFF is up for renegotiation bang in the middle of the wider political crisis caused by the pandemic. If the Union cannot rise to the level of this uniquely critical occasion, it will justifiably be treated with scorn.

Recovery from Europe’s economic collapse will require a massive fiscal stimulus over the medium term. In April the EU agreed a package of short-term, small-scale measures to increase credit lines to those states most distressed by the effect of the pandemic. However useful these initiatives prove to be, they are not the stuff of macroeconomic recovery. Indeed, hard-pressed states which accept bail-outs from the European Stability Mechanism (ESM) or loans from the European Investment Bank (EIB) will be saddling themselves with the burden of yet more national debt. Regional imbalances within the eurozone will be accentuated. Spreads are already widening despite the active purchase of Italian and Spanish government bonds by the ECB. It is difficult to see how the Union can avert another banking crisis once the full scale of the economic crash becomes clear.

When it makes its proposals, the Commission should take the opportunity to remind the Council of the federalist principle of subsidiarity. This guides the Union to take action at the Union level “if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States ... but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level”.⁷ Eurosceptics have long used subsidiarity as an argument against increasing the competences of the EU. Today, federalists must reclaim the principle to argue exactly the opposite.

Self-evidently, an effective response to the pandemic crisis requires a sharing of risk and a pooling of resources at the level of the Union. **Where the EU institutions are made responsible for the management of shared risk, decision-making power should be federal and not confederal.** Intergovernmental arrangements permit each state, especially the richer and larger states, to wield a veto. That is why confederations are even more difficult to run than federations, where decisions are taken by a democratic majority. The European Union, for its part, has had long experience of working well through the supranational Community method – and somewhat less well intergovernmentally.

The European Council has yet to think federally. At their meeting on 23 April, the leaders descended into a long and inconclusive argument about whether the very limited financial incentives so painfully agreed should take the form of loans or grants. When Commission President von der Leyen argued for the centrality of the EU budget in the rescue package, she implied that the Commission should be empowered to leverage money secured against the joint and several liability of all the member states. That proposal, too, was shot down because it failed to relieve the ‘frugals’ from the risk that the weaker states would default on their commitments.

⁶ See particularly Article 2 TEU and Articles 122 and 222 TFEU.

⁷ Article 5(3) TEU.

Federal recovery bonds

Now is the time to oblige the European Council to discuss the merit of installing a level of competent government up above the level of the member states. **Seizing the chance for a radical reform of EU finances, the Commission should propose the creation of a special purpose vehicle of a federal eurobond secured not by the member states but by the Union.**⁸

The new funds created would not themselves be part of the EU budget, but interest to eurobond-holders would be paid exclusively from that part of the budget based on the genuine own resources. The new MFF would restructure and compartmentalise the budget into two ring-fenced parts. National GNI contributions would be unaffected by the development of the Union's autonomous fiscal capacity. **National treasuries would save money, and the EU's important balanced budget rule would be maintained.**⁹

For this scheme to work, two things have to happen. First, the portion of revenue raised from genuine own resources must be dramatically expanded. The Commission, supported by the European Parliament, has already proposed a number of new sources of revenue. These include a tax on non-recycled plastics, a digital tax, proceeds from the EU's carbon emission trading scheme and a slice of corporation tax following agreement on a consolidated base. Other ideas, including a tax on financial transactions, are also available. A thorough reform of the VAT system, moreover, would allow a tranche of that tax to be hypothecated directly for EU purposes. **Whatever new taxes are introduced, they should be linked to the strategic common policies of the Union.** EU citizens must have confidence that their taxes are being spent in a productive and efficient manner.

The second necessary reform entails the lifting of the ceiling of own resources to allow a large-scale eurobond issuance without jeopardising the AAA credit rating of the Union. Ursula von der Leyen spoke of a temporary raising of the headroom to 2% of GNI. However, a permanent ceiling of 2.5% would allow the Union to borrow up to €400 billion per year (€2.8 trillion over the seven year period of the new MFF).¹⁰ That is serious money at the disposal of the EU's treasury facility.

As to the type of eurobonds, there are two options, the choice of which can be determined by the prevailing market conditions and economic forecasts at the time of their launch:

- bonds issued in perpetuity, or 'consols', with no date for the redemption of the principal, paying fixed term coupons;
- maturing bonds in the form of long-term annuities (up to 30 years), paying variable rates of interest.

Recovery eurobonds promise to be an attractive, low-risk investment for governments, central banks, institutional and private investors. Purchasers would be signalling commercial and political confidence in the stability of the euro and the durability of the Union itself.

How to spend the money

A large-scale EU economic recovery fund would have several objectives. Its central task would be productive investment, especially in projects with a European dimension that could not be financed through normal channels, such as the EIB. Mass vaccination against COVID-19 is the obvious priority.

⁸ On the legal basis of Article 352 TFEU, the 'flexibility clause'.

⁹ Article 310(1) TFEU.

¹⁰ In 1929, the US federal budget was raised to 3% of GNP. By 1944 it had reached 40%.

Building Europe's capacity in 5G is another, before boosting the European R&D effort in 6G and artificial intelligence. Restructuring some business sectors where there will be excess supply, such as aviation, will require EU-wide coordination and support. **A new sustainable and future-oriented industrial policy, part funded by the EU, will be a necessary component of keeping the single market up and running.**

The Commission's proposals for the European Green Deal provide a number of avenues for mixed public and private investment, such as energy grids, carbon capture and storage, and modern public transport infrastructure. The EU has important powers to coordinate and supplement member state efforts in education, social care and public health, all of which sectors will require an injection of public investment during the recovery phase. Beyond grants, the Commission should also use its new treasury facility to take equity in private sector firms as stock markets struggle to return to normal levels of activity.

The fund should also be used progressively to replenish the (reformed) ESM with federal money as the new reality of a fiscally-empowered Union takes shape. **Macroeconomic stabilisation is a federal function.** The launch of a federal eurobond will put an end to the argument over creating a dedicated fiscal capacity for the eurozone. It will also settle the otherwise intractable MFF negotiations.

Future fiscal union

The initiatives we recommend here can be undertaken quickly and without EU treaty change. In the long run, however, fully mutualised debt security as a permanent fixture of an EU fiscal union will need the legal certainty that can only be provided by a formal shift of competence from the national to European level. Ultimately, a 'sovereign' Union means treaty change. The EU's constitutional courts, led by the European Court of Justice, will tolerate nothing less.

In the meantime, however, and for the foreseeable future, the special purpose vehicle of the eurobond recovery fund is the simplest and most straightforward solution to Europe's immediate and acute crisis. We urge the Union to act.

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