

Plan “E”: For the European Economic Union

The Federal Alternative to the European Super-State

by Guido Montani*

Jean-Claude Trichet has recently said that – since the Maastricht Treaty (1991) – only the monetary side of the Economic and Monetary Union (EMU) has been carried out; the “E” is still an empty box. The euro is doomed to be a wobbly project until this box is filled. The European governments reacted with *ad hoc* measures to the 2008 financial crisis. The aim was only to prevent major damage to their country, but a European project to fill the missing “E” was never proposed.

The aim of this article is to outline the main contents of a Plan “E” for a European Economic Union. In Maastricht the monetary skeleton of the EMU was laid on the solid pillar of the ECB. Indeed, the present EMU has the power to bring about an effective European monetary policy but not a European fiscal policy. The EU has a plethora of national fiscal policies, either badly coordinated or not at all coordinated. Now, the time has come to build the blood circulatory system of the EMU: the fiscal system is the nub of the missing “E”.

The European fiscal problem cannot be solved with the creation of a centralized institution, as was possible with the Monetary Union. The fiscal problem in the EU lies in finding the appropriate degree of revenues and expenses for all government levels: the national governments and the European government. In theory, the federal model shows how to coordinate a set of independent governments. However, before discussing the specific aspects of the European case, it is necessary to say that the main federal systems in existence do not provide a clear answer to our problem. For instance, neither the USA federal model, nor the German one can suit the EU. The USA model is so centralized, that we can hardly define it federal. The size of the federal budget is 55% of the total expenses, and the federal grants-in-aid (i.e. financial federal transfers to local governments) are about 3-4% of the US GDP: they add up to 29% of the GDP of the states. In the EU national expenses are 45-50% of GDP and the EU budget (1% of the European GDP) is only 2% of European expenses. The reason is that the burden of Welfare State systems and military expenses in Europe are borne by national budgets, while in the USA they are borne mainly by the federal budget. Moreover, even if the US Constitution is not clear on this point, the common belief is that the federal government is responsible, in the last resort, for the local states, which are not allowed to fail even if heavily indebted. The German federal model has a lighter system of grants-in-aid, but an effective system of horizontal financial equalization among the *Länder* (*Finanzausgleich*) so that the wealthy regions transfer funds to poor regions. Mrs Merkel probably alluded to this system when she said that Europe could not become a “Union of financial transfers.” Indeed, we should note that the degree of solidarity among territorial communities of the same nation is higher than the degree of solidarity among different national peoples. Therefore, it is reasonable that the Germans do not want to pay for the errors of the Greeks and the Irish.

The European federal model is different and new. Here, we try to sketch a federal model for interdependent national peoples, taking into consideration that the EU acts in a global market and in an unfriendly world. The federal model is based on the principle of subsidiarity, according to which the best distribution of powers among different levels of government requires that each government can act autonomously with its own financial resources. If the federal government has too much power, the member states become “dependent” on the central government (as happens in the USA). If the member states have too much power (as in the EU) the federal government cannot act for Union cohesion and the Union risks breaking up. If the principle of subsidiarity is correctly applied, the bureaucratic rules (e.g. the GSP) for the coordination of national policies are limited to a minimum. Of course, a federal model includes some degree of solidarity, but we think that the EU does not need a *Finanzausgleich*, provided that the “EU government” has adequate financial resources and powers to act. We propose three topics for the reform of the present EMU.

1. *Austerity Policy and Debt Management* – The cause of the 2008 financial crisis was not the exorbitant indebtedness of the EMU, but the malfunctioning of the banking system. In order to avoid a systemic crisis EU governments were obliged to bail out many banks “too big to fail.” The private

banks' debts are today the public debts of the EU. Fiscal austerity is necessary to avoid a new crisis, but fiscal austerity cures the consequences, not the causes of the EMU crisis. A better regulation of the banking system requires new institutions, such as the European Systemic Risk Board.

Nevertheless the financial crisis revealed a leak in the EMU. The crisis of the sovereign debts within the EMU clearly showed the existence of the "E" empty box. Let's compare the EU with the USA. Many of the 50 member states of the USA federation have today serious debt problems, but the EU has only a lender of last resort (the ECB), not a saviour of last resort, as the US federal government has with its federal budget. If each member state of the EU must face the global financial market alone in order to fund its budget, it is likely that it will be obliged to pay a high interest rate. A radical solution could be that the EU issues euro-bonds and, afterwards, it distributes the funds according to the needs of the states. But that centralized method can be rightly criticized because it creates moral hazards, i.e. it fosters national fiscal profligacy. The correct solution seems to be the proposals of issuing Blue-Bonds (Delpa-Von Weizsäcker, Bruegel Policy Brief, 2010): EU countries should pool up to 60% of their GDP of their national debt to a European Debt Agency which issues Blue-Bonds; the national debts beyond this share are considered Red-Debts, for which the national default can be declared. Thanks to the great quantity of Blue-Bonds – and the European guarantee based on a pact among national governments – their rates of interest will be significantly lower than the interest rates on any national bond (even the German ones), because of liquidity gains. According to this study the liquidity gain can reach 6% of GNP. Of course, national bonds, riskier, will pay higher interest rates. Therefore, the states which are excessively indebted have a real incentive to reduce their indebtedness (regardless of the rules of the GSP). Now this proposal has been partially relaunched by Mr Junker and Mr Tremonti who say: "Europe must formulate a strong and systemic response to the crisis ... launching E-bonds, or European sovereign bonds, issued by a European Debt Agency (EDA) as successor to the current European Financial Stability Facility ... with a mandate gradually to reach an amount of outstanding paper equivalent to 40% of the GDP of the EU and of each member state" (FT, Dec. 6).

A further advantage of the Blue-Bonds proposal is that the internal financial market of the EU becomes as attractive as the USA market for international investors and sovereign funds. In this way, the euro can become even stronger than the dollar in the international market. Therefore, when Mr Sarkozy and Mrs Merkel say that they want a strong euro, they should also say that they support the Blue-Bonds proposal.

Nevertheless this proposal cannot be realized until the most indebted countries of the EU do not reach a tranquillity zone, i.e. until they reduce their indebtedness drastically. A European bail out to avoid a sovereign debt failure is tantamount to a hidden European *Finanzausgleich*. Therefore, countries such as Italy, with a debt of 120% of GDP and Greece with a debt of 160% of GDP should agree, with the EU, on an emergency plan to reduce their indebtedness to a reasonable level, for instance 80% for Italy and 100% for Greece in three or four years. The launch of the Blue-Bonds should go with the approval of national plans for sustainable indebtedness.

2. *The European Growth Strategy and the EU Budget* – The EU budget is the fundamental tool for implementing European policies. Without its own budget the EU is powerless.

The disgraceful situation of the present EU budget is well depicted by the President of the European Parliament's Budget Committee, Alain Lamassoure: "The funding of European policies is in stalemate. Because they have failed to provide the Union with its own adequate resources, as planned for in all the European treaties, the member states have condemned themselves to being its subscribers: national budgets fund the European budget to a total of over 80%. This system which is anti-community by its very nature obviously encourages every Finance Minister to ask for a 'fair return' on their contribution. The result is that, nearly twenty years after a political agreement that set the European budget at 1.24% of the Union GDP and in spite of four new treaties, which considerably extended the Union's competences, together with three waves of enlargement which doubled the number of its 'poor' members, this budget has remained set at 1% of the GDP." In spite of this admonition, five leaders of national governments (Cameron, Merkel, Kiviniemi, Rutte, Sarkozy) have recently (Dec. 18th) asked to freeze the EU budget to 1% of the GDP until 2020, because of the exceptional efforts the member states are making to put their finances in order. This stance is not only anti-communitarian, it is also a profession of economic parochialism.

Let's observe that the present unequal development of the EU member states – with strong economies and weak economies – should be considered a European defeat, not evidence of virtue and laziness. The Treaty says: “the Union shall work for sustainable development of Europe based on balanced economic growth, a social market economy, highly competitive and aiming at full employment and social progress, and with a high level of protection and improvement of the quality of the environment.” These goals should be considered European public goods, contributing to the well being of all European citizens. Indeed the European Commission has already proposed a strategy including these goals – the “Europe 2020” strategy – for smart growth (fostering knowledge, innovation, education and digital society), sustainable growth (making European production more resource efficient while boosting competitiveness) and inclusive growth (raising participation in the labour market, the acquisition of skills and the fight against poverty). But in order to reach these goals, the European Commission needs appropriate financial means. For this reason in its “EU Budget Review” the European Commission proposes, in agreement with the European Parliament, to issue “EU Project Bonds” to finance infrastructures in energy, transport and ICT, and the creation of new “own resources”, such as taxation of the financial sector, revenues from auctioning under the greenhouse gas Emission Trading System, charges related to air transport, EU VAT, energy tax and corporate income tax.

Let's now consider some reasons to refuse the economic parochialism of the governments willing to freeze the EU budget for a decade. *First*, these governments think that the growth of their national economy does not depend on a thriving European integration. In Germany, for instance some opinion polls reveal that a majority of Germans want to get rid of the euro and go back to the Deutsche Mark. It is a dangerous illusion. The German government should explain to its citizens that, in a global economy, an isolated national state has no possibility of competing successfully with global giants, such as China, India, Russia, USA, etc. The collapse of the EMU means the balkanization of Europe and the revival of nationalism. *Second*, the “Europe 2020” Plan must be implemented, by giving the European Commission the required financial power: i.e. own financial resources and EU Project bonds. A European Plan is necessary because no national government is able to provide European public goods, such as R&D in advanced technologies. Therefore, the European Plan adds some value to national economies, boosting cooperation among member states and market operators. Of course, the European Plan is a tool for solidarity policies, like the fight against poverty. But this is exactly what is necessary to give some content to European citizenship. People should recognize that being a European citizen adds something to national citizenship. *Third*, the governments willing to freeze the EU budget, because the priority is national austerity, forget in their calculation the savings that come from pooling some national expenses into the EU budget. Scale economies are not an economists' fantasy. Now, that a European External Action Service is coming up, why not pool all national aid for development into the EU budget? Moreover, since national governments decided to create a Rapid Reaction Force (RRF), why not pool a share of national military expenses into the EU budget? Today, 27 European national armies total 1.8 million men. The USA army has half a million men less, but its army is four times more efficient than the sum total of the 27 national armies. This kind of calculation shows that national governments willing to save financial resources should seriously take into consideration the possibility of eliminating national waste, pooling resources into the EU budget, at the same time lightening national budgets. This way, the citizens' tax burden can even be reduced. *Fourth*, even if the European Parliament and the European Commission are afraid of getting rid of the taboo concerning the size of the EU budget, this topic cannot be ignored. The last study on this issue is the MacDougall Report (1977), which evaluated the size of the EU budget at 2.5% of GDP, excluding an European army. Including the RRF, the size of EU budget should probably be 3.5-4.5% of the GDP; an amount very far from the USA model of federalism. The European Commission should sponsor a new study as soon as possible, because the size of the budget is a crucial issue for the whole European fiscal system. The EU budget is not only the main means for funding European policies, but it can also work as the centre of gravity for coordinating national policies. The Lisbon growth strategy, launched in 2000, failed for lack of coordination. Good European coordination can be easily achieved if European policies are financed in part (for instance 50%) by the EU budget and in part by national budgets. National governments must have a real interest in implementing EU programmes.

3. *The European Government* – A skeleton and a blood circulatory system are not enough for the smooth working of the EMU: it needs a head too. Mr Sarkozy and Mrs Merkel agree that a European economic government is necessary, but they are heading Europe in the wrong direction. A European economic government already exists: it is the European Commission. By proposing a new economic government, Mr Sarkozy and Mrs Merkel in fact want to create an alternative economic government: the Council. This muddled project confuses citizens, who do not understand who decides and who is democratically accountable for the decisions taken.

The claim that the Council can become the government of the EU comes from the fact that national governments maintain some power – especially concerning the budget and the foreign policy – that they do not want to share with the European Parliament. On all these issues the Council decides on the basis of the unanimity rule, so that a single country can affirm its sovereignty. On the contrary, the community method is based on the majority rule in the Council and in the European Parliament. In such a case the Commission becomes the only executive organ of the EU. Therefore the transformation of the Council into a “government” of the EU involves the exclusion of the European Parliament from the decision-making process and the transformation of the Commission into a kind of “secretariat” of the Council. Is this proposal reasonable?

If we consider the history of the financial crisis the answer is negative. Not only the Council reacted to the crisis, day by day, without a vision of the EU future, but gradually the Council became a “directoire”, at the beginning a Franco-German directoire and, more and more, a German directoire. It is understandable. Germany is the most powerful and virtuous economy of the EU. The other member states cannot do without Germany. But the German point of view not always coincides with the European point of view. The German government rightly fosters austerity policies. But this is only one side of the problem. The other side is growth. Without a growing European economy the other member states will never be in a position to support the austerity policies required to maintain the EMU alive. Riots of young people in many countries are a symptom of a serious social disease: they do not see a future for themselves in this kind of Europe. And if any member state fails, the collapse of the EMU becomes a real possibility. The two policies discussed above – austerity and growth – must be merged into a single European Plan.

Who should govern Europe? The Lisbon Treaty states: “The European Commission shall promote the general European interest and take appropriate initiatives to that end.” But this is not what is happening. The Council is building a complicated set of rules to sidestep the Commission. The new funds are put outside the control of the European Parliament. There will be a new Growth and Stability Pact providing more severe sanctions for undisciplined states. The Council decides – by means of a new practice, the so-called European semester – the expenses of each member state budget. But who is democratically accountable for the implementation of this fiscal policy? All this construction smells anti-democratic: it looks like a Super-European State. If the Commission cannot become the democratic government of the EU – according to national governments – an alternative should be envisaged. What is clear is that the EU should have one and only one democratically accountable government. This problem concerns not only European democracy, but also the EU’s role in the world. Who will represent the EU in the IMF, in the WTO, in the G20, in the Security Council?

In short, the problem of a European Economic Union cannot be discussed disregarding the wider problem of European democracy. One of the pillars of modern democracy is the saying: no taxation without representation. In order to follow this old democratic and wise indication, the first step could be to convene European Assizes, on the model of Rome’s Assizes in 1990, between the European Parliament and the national Parliaments for a European-wide consultation of representatives of the people and, if necessary, a new European convention.

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