The EU at the time of a new cold war: a Manifesto

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The key message in the Manifesto is that a gradual and pragmatic federalism is necessary to make Europe fit for the challenges ahead. A new world order is in the making against a difficult background of geo-political tensions, technological transitions, and high uncertainty. Massive expenditure pressures await member countries for supporting common strategic objectives (energy, climate, green, digital and AI transitions, technology, defence and security), for coping with large shocks and extreme events, and addressing unfavourable demographic and climate developments.

The question at stake is to provide fiscal space, both at the national and EU level, while ensuring the sustainability of large public debts. Striking a balance between fiscal space and fiscal discipline is by no way an easy task, especially in the presence of moral hazard and lack of trust. A solid fiscal governance in Europe requires good rules and strong institutions, including independent fiscal authorities, and some form of common fiscal capacity.

The new governance framework for Europe is a modified version of the original proposal of the European Commission. Is it fit for purpose? Overall, the balance between pros and cons is positive, and the more so if additional steps are taken toward what the Manifesto calls a pragmatic federalism. I will focus on three of these steps.

On the positive side, the new framework focuses on medium-term debt dynamics, which is what matters for the sustainability of public finances. Country-specific adjustment plans allow consolidation efforts tailored on the needs of each member country, while medium-term budgetary planning accounts for investments and reforms. A stronger sense of national ownership reinforces the commitment to sustainable public finances and the credibility of the adjustment. A simplified monitoring mechanism – based on a net primary spending indicator – makes it easier to trace the effective implementation of the plan, striking a reasonable balance between complexity (before the plan is defined) and simplification (thereafter).

On the downside, the introduction of common safeguards on debt and deficit might unnecessarily restrain the scope for fiscal stabilization in member countries and at the EU level. Looking at Italy, a forthcoming UPB study shows medium-term fiscal trajectories in case of 4-year or 7-year adjustment plans with and without the common safeguards.[1]

[1] Nota di Lavoro 1/2024, The reform of the EU governance framework: Illustrative scenarios for Italy.

The common safeguards are irrelevant for the first period of adjustment, while only the deficit resilience safeguard would bind thereafter. The deficit safeguard requires an additional annual adjustment - equal to 0.4 percentage points of GDP in case of an adjustment path of 4 years or 0.25 in case of an adjustment path of 7 years - until the overall structural balance is below 1.5 per cent of GDP.

In case of 4-year adjustment plans, an additional adjustment would be required in 2030 and imply a primary surplus of 2.7 per cent (2.9 per cent in structural terms). The debt-to-GDP ratio would fall slightly below 128 per cent in 2032. With 7-year adjustment plans, the deficit resilience safeguard would bind in 2032. The structural primary surplus would then reach 3.1 per cent of GDP against a value of 2.9 per cent in the absence of the safeguard clause.

As a consequence, by 2041 the debt-to-GDP ratio would decline by almost 4 percentage points more than in the absence of the safeguard clause with adjustments in 4 years, and slightly less than 3 percentage point in case of 7-year adjustment. A permanent higher primary balance would then be required - starting from the end of the first plan - compared to what needed for ensuring fiscal sustainability on a risk basis.

In principle, an extra "resilience margin" might be useful in good times, as a means for inducing the creation of fiscal buffers for the rainy days. However, it might turn counterproductive in bad times, especially in a context in which many member states are required to pursue fiscal consolidations (even more than what needed for ensuring sustainability), and the incentive for using available fiscal space in other countries remains weak. Efficient coordination mechanisms are a necessary complement to fiscal rules (first step).

The introduction of common safeguards reflects the worry that country-specific adjustment plans might not ensure a level playing field in the common area, failing to provide equal treatment across countries. Yet, the adoption of common standards and best practices for policy assessment favours equal treatment and effective monitoring. Independent fiscal institutions provide a standard of prudent assessment based on common methodologies, high technical expertise, and, most importantly, independence from all parties in the game. Achieving a common standard of solid, independent fiscal institutions across member states is of utmost importance in a framework, like the new one, in which adjustment efforts vary across countries. On this ground, there is still a long way to go in the EU (second step).

Finally, I agree with the Manifesto that some form of common fiscal capacity is essential for supporting EU strategic objectives (third step). One simple reason is that member states alone might not have enough resources, and collective action to financial markets is more efficient than individual access (though it can come at the expense of self-discipline).

The provision of common resources - via debt or taxes – has to be designed in a way that reduces the scope for moral hazard, especially concerning debt mutualisation, and avoids permanent transfers across member states. Once again, coordination mechanisms across countries and with the supra-national monetary policy are important, as well as a strategy for completing financial market integration. The NGEU programme - and its Recovery and Resilience Facility (RRF) – constitutes a useful benchmark, because of its own borrowing capacity, a prospective ability to finance itself with own resources, and a strategy for combining the needs of individual countries with the pursuit of common goals.