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Europe's Fiscal Crossroads

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This white paper is part of the Project on the Future of Europe, a project from the CSIS Europe, Russia, and Eurasia Program examining the European Union's growing geopolitical role and the implications for the United States and Europe. It seeks to raise awareness in the United States of the European Union's future trajectory, which will be critical to building a stronger transatlantic partnership.

Europe finds itself at both a geopolitical and fiscal crossroads. On the one hand, the European Union is no longer in danger of collapse after a decade of crises. The bloc is beginning to play a stronger global role, with European Commission president Ursula Von Der Leyen endeavoring–and largely succeeding–to lead a "geopolitical commission." But on the other hand, Europe is facing growing threats and acute challenges to both its security and its economic and governance model.

Russia's invasion of Ukraine and the threat posed by energy dependence and climate change have awakened Europeans to the need to invest in both defense and the energy transition. Europe also fears the possibility that the United States will be less engaged in ensuring European security, especially under a potential second Trump administration. Additionally, the need to support Ukraine and facilitate its European future has revived the potential of EU enlargement, which will require considerable resourcing. Lastly, the rise of China and its predatory business practices has prompted the European Union to take economic security seriously and advance efforts to "de-risk." As Mario Draghi aptly summed up in the ***Financial Times***, the era of relying on the United States for defense, China for exports, and Russia for energy is over. The former president of the European Central Bank and former Italian prime minister posited: "The geopolitical, economic model upon which Europe rested since the end of the second world war, is gone."

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Yet Europe is also finding that this new era of geopolitical competition is costly. Despite having created a monetary union with a common currency, the euro, and a powerful central bank, the European Union lacks a fiscal union and a common fiscal policy. The entire EU budget is less than $200 billion per year (about 1 percent of EU GDP), with 33 percent of that money going to agricultural subsidies. It also has tight fiscal rules (the so-called Stability and Growth Pact) that limit debt and deficit levels for EU member states. A **recently agreed reform** increases spending flexibility, but the new rules also put pressure on member states to reduce deficits.

This is the quandary facing Europe. It must meet the demands of this new geopolitical era, support Ukraine and strengthen its own defense, provide European public goods, and tackle the climate crisis, but it lacks the appropriate political and institutional mechanisms to fund these investments. The question is, "where will the money come from?"

This white paper outlines Europe's fiscal terrain and presents potential paths forward for the European Union. Whether Europe develops its collective fiscal capacities is of tremendous geopolitical importance and of relevance to the United States. NATO's defense spending goal of 2 percent of GDP is directly tied to Europe's fiscal landscape and EU fiscal rules. Moreover, Europe's capacity to accelerate the energy transition, reduce its energy insecurity, increase its competitiveness, and ensure its economic security crucially depends on the creation of a fiscal union to finance European public goods.

Europe is thus at a crossroads. It will not fall apart, as feared in the previous decade, but it could easily stagnate economically and geopolitically without major advances in its fiscal integration. For the European Union—and therefore Europe as a whole—to become a relevant geopolitical actor, Brussels will need to develop its own fiscal capacity.

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Europe's Fiscal Terrain

Unlike in the United States, where the federal budget is much larger than that of individual states, countries in the European Union have relatively high levels of public spending relative to GDP (the EU average is around **50 percent**, with some countries, such as France, well above that level). But the bloc, in contrast to the U.S. federal government, spends very little. Also, while U.S. states have credible rules for limiting spending and debt (precisely because federal spending is high), in the European Union such rules are not credible, which generates problems of excess debt and deficits in some member states. This prompted the creation of the Stability and Growth Pact in 1997, which stipulates that deficits should be below 3 percent of GDP and debt levels below 60 percent of GDP. However, these rules were suspended during the Covid-19 pandemic and have **recently been reformed** because there is **wide consensus** that applying them without substantial changes would force the European Union into austerity precisely when it needs fiscal flexibility to address its huge challenges.

The reasons for the differences between the EU and U.S. fiscal structures are historical. In the United States, political union came before monetary and fiscal union. In 1790, Alexander Hamilton, then

secretary of the treasury, transferred the outstanding debts of the federated states to the federal government in exchange for a compromise where states promised to run balanced budgets. On the monetary side, it was only in 1913 that the Federal Reserve was created, inaugurating the contemporary structure of American monetary policy. Otherwise, federal spending in the United States grew as the need to finance public goods, such as defense and infrastructure, increased.

In the European Union, on the other hand, economic integration began in the 1950s, as most countries had already created or were creating their welfare states, which entailed taxes and spending at the national level. In that context, the EU budget, known as the Multiannual Financial Framework, was created. But it was envisioned—and still is—as a small complement to national budgets for common policies (including agriculture and cohesion funds). In fact, EU rules stipulate that the European budget, which is negotiated for periods of seven years, has to be balanced (i.e., contributions from member states and EU taxes, which are negligible, have to finance all EU spending, and debt issuance is not allowed).

As a result, efforts to invest in European public goods with strong positive externalities, such as decarbonization, digitalization, transport and energy infrastructure, or defense, are left to member states. This inevitably leads to shortfalls and discrepancies in investment due to the varying financial capacities of each country, conditioned by its debt and differing national priorities. It also makes pan-European, cross-border investments, whether in infrastructure or defense, more difficult. This creates a typical collective-action problem where joint European action that would benefit all is put on hold, leading to major gaps in European capacity. Not only can this tie the hands of the European Union, leaving it unable to take strong action, but it can also threaten the single market, creating significant disparities between European countries.

In short, the European Union (and in particular the eurozone) does not have a coherent and common fiscal policy, but a poorly coordinated one that prevents the adequate financing of many of the urgent European public goods that the new global economic and geopolitical reality makes increasingly necessary.

This is not news. It has long been recognized that the lack of a common fiscal capacity is a significant gap in the European project. However, in the last year, calls for Europe to take the next step in its integration and develop a fiscal union are coming from increasingly prominent voices and in unexpected places. Leading them is Mario Draghi, who recently wrote in the ***Economist*** that:

> Europe must now confront a host of supranational challenges that will require vast investments in a short time frame, including defense as well as the green transition and digitisation. As it stands, however, Europe neither has a federal strategy to finance them, nor can national policies take up the mantle, as European fiscal and state-aid rules limit the ability of countries to act independently.

He further developed his ideas and called for a fiscal union in the 15th Annual Feldstein Lecture in 2023 (“**The Next Flight of the Bumblebee: The Path to Common Fiscal Policy in the Eurozone**”). But Draghi is not alone. International institutions such as the **International Monetary Fund** and a variety of t**hink tanks** and academics have long argued that the European Monetary Union requires a fiscal (and also a political) union to be sustainable—an idea that is backed by significant historical evidence.

More recently, Paolo Gentiloni, the European comissioner for economy, has **suggested** that the bloc establish a central treasury to finance common goods through issuing eurobonds in order to address massive spending demands.

Momentum is moving toward fiscal union. Should the European Union decide to develop its fiscal capacities, it would be emulating the history of U.S. economic integration. As **Jacob Kirkegaard and Adam Posen** write, "US national economic institutions formed gradually during the 19th and 20th centuries not only within the confines of a changing federal constitution but also often in response to *the specific political events and natural disasters of the time*."

Why Europe Needs to Spend

The current geopolitical environment provides a clear rationale for collective European investment. There are three clear lines of effort for greater EU spending: defense and foreign policy (including military and economic support for Ukraine), the energy transition, and economic competitiveness. These goals have proved exceptionally difficult given the fiscal constraints explained above.

On defense, Europe faces an urgent crisis that requires massive expenditures. The European Union needs to not only support Ukraine's war effort militarily, but it also needs to urgently rebuild its own militaries. As for Ukraine, wars are incredibly expensive and require massive fiscal outlays and expenditure. The European Union collectively has provided significant economic and military aid to Ukraine. But EU member states have now given away most of their stockpiles of ready military equipment, meaning additional military support for Ukraine requires buying from industry, which is more costly. Moreover, European militaries also require major investment to acquire immediate capabilities–to make up for present shortfalls and to ensure Europeans have the basic capabilities to defend themselves. European states need to spend not just to replace equipment given to Ukraine but also to drastically increase their own stockpiles. Yet, Europe also needs to invest in major capabilities over the medium and long term that both reduce and mitigate Europe's dependence on the United States. These include the capacity to procure major enabling capabilities, such as air-to-air refueling, as well as invest in the next generation of weaponry, from fighter jets to tanks to air defense systems. This both requires an immediate injection of funding as well as a sustained financial pipeline.

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On energy, the needs are great not just for climate but for the competitiveness of European firms, especially in a context in which most great powers, including the United States through the Inflation Reduction Act, are heavily subsidizing energy and green investments. Europe needs to dramatically accelerate the green transition not just for climate purposes but to lower its energy costs, which now largely come from expensive hydrocarbon imports.

Europe needs energy interconnections in order to increase the flexibility and resilience of its electricity system, as well as to be able to leverage the comparative advantages of the different member states in the production of different types of energy. For instance, Spain is becoming a major producer of solar energy, but this energy cannot currently be exported in large quantities to the rest of Europe due to inadequate transmission infrastructure.

Additionally, a subsidy race has begun in the world economy for which the European Union is woefully unprepared. China has increased its support for all types of domestic manufacturing and technology industries, while the United States has revived its own industrial policy with generous support for green and digital industries. The situation is potentially pernicious for European industry because many of the U.S. subsidies consist of tax credits (which are much simpler to implement than European ones). Moreover, the American economy is not permeated with as much bureaucracy as the European Union, and, in addition, its trade and industrial policies contain a series of protectionist clauses that are incompatible with World Trade Organization (WTO) rules ("Buy American"), whereby only products almost entirely manufactured within the United States will be able to benefit from federal subsidies.

The European response cannot come from each of its individual member states because this would lead those with more fiscal space to inject public funds into their companies, thus undermining fair competition within the internal European market. Therefore, Europe's response would need to come from industrial policies at the European level.

For all of these investments, the private sector has an important role to play. However, the fragmentation of European financial markets makes it difficult for private investment to adapt adequately to European needs and thus complement public investments. The European Union therefore will also need to promote the deepening of its banking and capital markets union and move toward the creation of a truly European, risk-free sovereign asset. But since financing public goods and risky investments requires that the public sector takes the lead, it is essential to increase the bloc's public financial capacities.

How Europe Could Spend

To address Europe's challenges and to take on a larger geopolitical role, the European Union will need a substantial increase to its budget. In 2022, which is the latest official available figure, the bloc's GDP was almost **€16 trillion** ($17 trillion) and the EU budget was **€168 billion** ($182 billion), equivalent to 1.1 percent of its GDP.

The European Union could increase its budget in three ways.

First, member states could increase contributions to the EU budget. Member countries pay the European Union every year based on their population and GDP, and those funds are then spent on common policies. To grow the EU budget, larger and richer countries would have to pay more. These

countries are typically the ones that benefit most from the existence of the single market. In addition, since the European Union cares about economic convergence and social cohesion between its regions, it is logical that richer countries contribute more.

However, the next EU budget negotiations will not take place until 2027. Member states could in the interim create off-budget vehicles to fund certain priorities. For instance, the European Peace Facility is an off-budget EU instrument, meaning it is not funded by the "EU budget" but by member states contributing at a national level to a separate pot of funds allocated toward a policy priority that benefits the whole bloc.

Second, the European Union could issue more joint debt. More debt issuance at the central level raises complex **legal and distributional questions**. However, it makes little economic sense that the bloc is unable to issue common debt on a regular basis to finance some specific investments. All other great powers do it. Moreover, the experience of the **Next Generation EU (NGEU)**—the program launched in 2020 to finance the economic recovery from Covid-19, by which the European Union is issuing up to €750 billion ($814 billion) worth of debt and transferring funds to member states as grants and loans—provides a useful blueprint. In fact, if the European Union were to issue large amounts of debt, it could take advantage of economies of scale which would structurally reduce long-term financing costs and therefore increase the sustainability of national public debts. It would also increase the international role of the euro. There are growing calls from countries such as Estonia for the European Union to issue eurobonds to invest in defense and to provide aid to Ukraine. The issuing of debt for the NGEU program is also leading to investments in the green transition and economic competitiveness.

Debt-financing payments will come out of the EU budget, as they are intended for the NGEU. But increased debt-servicing payments will either require increases to the EU budget or difficult trade-offs.

Third, the European Union could introduce European taxes. These are called "own resources" in the EU jargon because they are collected directly by the European Union. These new European taxes could be "green" taxes, tariffs (such as the **Common Border Adjustment Mechanism**), levies on multinationals' profits (as agreed by the Organisation for Economic Cooperation and Development), and levies on financial transactions. Another option, capable of raising much more revenue, would be to transfer a percentage of what member states collect in value-added tax (VAT) to the EU budget. In any case, more EU taxes would be politically difficult, as they may or may not imply lower taxes at the national level (using VAT solves this problem). But they might increase the centrality of the European Union in European politics because citizens would see more clearly that their taxes directly finance European public goods. In this sense, the American saying "no taxation without representation" in the European Union works backwards. There is representation (directly at the European Parliament) and indirectly at the European Commission and European Council, but Brussels has virtually no taxation powers. Approving these new "own resources" requires unanimity by member states, which is not easy, but it does not require treaty change.

The Political Challenge

While there is momentum for more EU spending, there is also strong resistance inside the European Union to developing the bloc's fiscal capacities. The major problem is resistance to the redistributive nature of fiscal integration and common debt issuances, particularly in wealthier Northern European

countries. Opposition has become deeply entrenched politically, with claims that the NGEU was merely a "one-off."

The difficulties of increasing the EU budget were demonstrated in December, when, despite all the pressing challenges, the increases requested by the European Union were **cut**. The European Commission's initial proposal to add €99 billion ($107 billion) between 2024 and 2027 (€66 billion of grants and €33 billion of loans) was reduced to €66 billion (€33 billion of loans and €33 billion of grants), of which only €21 billion is new financing (the rest comes from existing EU funds).

During the euro crisis during the 2010s, a divide was created between creditor countries in the north and debtor countries in the south that still persists and impedes consensus. Germany, the Netherlands, and other northern countries are particularly reluctant to mutualize risks and to create financial instruments that increase their solidarity commitments with southern countries, which exhibit higher levels of debt and deficits. They argue that until the usefulness of the NGEU funds can be assessed in 2027, it is premature to consider new joint debt issues. They are also unwilling to increase their contributions to the Multiannual Financial Framework due to tight domestic fiscal environments related to low economic growth, as well as for fear that this will increase support for extreme right-wing parties. The discourse in northern countries is still anchored in the need for rules and spending restraint to avoid the rise of extreme right-wing political groups, which continue to accuse the southern countries of being profligate.

Moreover, the fact that the European Union currently has a majority of center-right (and even some far-right) governments, whose liberal economic visions preach fiscal prudence and a reduced role for the state, also makes it difficult to reach ambitious agreements. Additionally, the ascendency of some far-right parties to positions of power in Europe may make reaching agreement on EU financing efforts extremely challenging. There are tremendous political hurdles to moving forward on fiscal integration.

However, it has become cliché to say that Europe is forged through crises. A crisis prompts the need for tangible action, which prompts European states to act. This was evident in response to the Covid-19 pandemic when the European Union bought vaccines for the entire bloc and allocated €750 billion ($814 billion) for its economic recovery, funded extensively through issuing joint debt. The security and energy crises caused by the war in Ukraine may therefore spur further action. The European Union will likely create a fiscal union, perhaps not by setting out with that goal but instead by seeking to address tangible and urgent issues, such as the need to arm Ukraine or accelerate the energy transition.

The Road toward Fiscal Union: A Permanent Fiscal Capacity

Given that increasing the EU budget will be politically difficult in the short run, an alternative option could be to create a permanent fiscal capacity, which would function as an embryo of a European treasury. A permanent fiscal capacity would be an independent extension of the European budget. It would issue triple-A-rating debt backed by revenues from the European Union's own resources, thus guaranteeing that the debt would be repaid (if there is political agreement, the issued debt could be rolled over indefinitely, as is the case for most countries with sound fiscal policies).

The fiscal capacity would enable the European Union to respond to crises and urgent issues. It could also play a countercyclical role during crises for the eurozone as a whole, complement national

automatic stabilizers, support investment in highly indebted member states, and finance specific European public goods with positive externalities, such as those outlined above.

The easiest way to create this permanent fiscal capacity would be the institutionalization of the NGEU as a common financing tool. The logic behind the instrument is simple. The European Union borrows and gives grants or "cheap" loans to member states to finance specific investments and reforms previously negotiated with the European Commission and approved by the European Council. The investments have to focus primarily on the green and digital transitions, as well as defense, and the reforms have to address recommendations that the European Commission makes every year to improve member states' socioeconomic performance (the so-called "Country Specific Recommendations" of the **European Semester**).

The disbursement of the funds is conditional. It only takes place once member states have passed the reforms or started the investments. Therefore, it provides a positive incentive for reform: there is a carrot, but there is no stick. If a country does not pass the milestones and targets established in their Recovery and Resilience Facility agreed to with Brussels, it does not receive access to the funds, but it is also not fined.

Although the NGEU funds **can be improved** in terms of efficiency control or agility in their provision, it would be a mistake to give up the possibility of extending the use of an already implemented and relatively successful (although improvable) mechanism such as the NGEU debt. Some countries insist on canceling the instrument and confirming this experience as a one-off, but the truth is that the current geopolitical demands go far beyond the mere economic recovery needs of Covid-19, which were the original justification for the NGEU.

This paper's proposed permanent fiscal capacity would imply transfers to member states similar to the current NGEU, but they would be demand-based and without preassigned amounts by country. They should focus on the priorities established above: defense, the energy transition, and competitiveness. Access to the permanent fiscal capacity should be subject to a stricter conditionality, better in terms of milestones, reforms, and assessment than that of the current NGEU mechanism. Governance and ownership should be enhanced through a coordinated decisionmaking process between the European Commission and member states, later ratified by both the European Council and the European Parliament.

Finally, part of the spending coming from the fiscal capacity could go directly to European companies that develop investment projects instead of going through member states. This is particularly relevant for defense spending, trans-European infrastructure, and projects of strategic interest entailing substantial research and development investment. Direct procurement by the European Commission could speed up the projects, reduce the administrative burden, and help develop a culture of collaboration between companies from different member states.

Conclusion

The European Union will struggle to make progress in addressing the collective European challenges it is facing without massive investment. Yet it is trying to achieve vital goals—ensuring Ukraine's survival, decarbonizing, rebuilding EU militaries, and enhancing competitiveness—without an adequate budget that supports these objectives, finances basic European public goods, and contributes to the

macroeconomic stability of the eurozone. The current debate, however, is focused not on the financial tools needed to achieve preset objectives, but on reducing debt imbalances. While it is important for the European Union to ensure the long-term sustainability of national budgets, it is also important to gauge the financial capacity of the European Union as a whole to take on the current challenges.

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Finally, if the European Commission were to issue large quantities of debt on a permanent basis, the international role of the euro would be strengthened. The euro is already the second-most internationally traded currency after the dollar, but it still lags in terms of some of the key functions of an international currency, such as serving as a reference for private and official use. Beyond economic factors, the euro has also lacked the political support to become a more entrenched reserve currency. But things have changed. The erosion of the so-called liberal economic order and the increasingly hostile external environment have alerted the bloc's leaders to the urgent need to bolster their defense and strengthen economic security. The euro is one of the remaining reliable foundations upon which Brussels can strengthen its geo-economic might. The euro, an orphan currency at its inception, can thus find more backing now than could previously have been imagined. Thus, a permanent fiscal capacity or a fiscal union in the European Union would greatly contribute to the project of making the bloc a geopolitical actor. ■

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