Softly, softly a federal Europe draws nearer

The bold deal that saved the euro from collapse will shift key policies on tax and spending beyond national control

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While British and US politics have dominated the headlines this year, the truly historic events have occurred in Europe. Britain may have its first coalition government for 70 years and US voters may have shackled their politicians with legislative gridlock, but Europe has done something much more momentous. The EU has taken its most decisive step towards becoming a genuine unitary State, by shifting key policies on taxes and public spending from national to federal level.

That one of the most controversial decisions in modern European history has been taken with almost no public awareness or debate is a tribute to the top-down style of government perfected by the EU's political elites. The EU version of elitist representative democracy, despite its apparent drawbacks, may go down in history as a more successful mechanism for managing the complex compromises demanded in a world of huge geopolitical change than the more populist US and British models.

The story begins, like almost everything else these days, with the financial crisis. After the collapse of Lehman Brothers in September 2008, it became almost inevitable that financial panic would spread to Europe and threaten the survival of the euro. The crisis hit in the autumn last year and reached a climax over the weekend of May 8-9, when the Greek Government was unable to repay loans that matured the following Monday.

European leaders realised that a Greek default would trigger a run on every bank not only in that country, but also in Ireland, Portugal, Spain and Central Europe. This, in turn, would lead to the collapse of most businesses in the peripheral eurozone countries, bringing down many financial institutions in Italy, France and Germany. In days, if not hours, euros

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in the banks of Greece, Spain and Italy would be worth a fraction of those in German and Dutch banks. In effect, the euro would cease to exist.

Europe was on the edge of a precipice on the night of May 9 this year, just like the US on the night of September 14, 2008, before Lehman was declared bankrupt. The difference was that Europe's leaders decided to step back, while the Bush Administration marched boldly forward. EU leaders created a financial mechanism, worth up to €750 billion, to bail out nations unable to raise money from private investors.

Much more importantly, Angela Merkel, the German Chancellor, swallowed her principles and agreed to suspend the "no-bailout clause" painstakingly inserted into the Lisbon treaty to reassure the German public that adopting the euro would not make them financially responsible for the spendthrift governments of the "Club Med". Just as amazingly, the British Treasury agreed to joint EU borrowing programmes and powers to supervise national tax and spending plans from Brussels that effectively created a EU federal budget.

"It was truly a night of miracles," said Emma Bonino, Italy's former EU commissioner, a few months later at a seminar run by the European Council of Foreign Relations. Lord Kerr of Kinlochard, the British diplomat who was the principal author of the EU constitutional treaty, remarked at the same event dryly: "A treaty that took us ten years to negotiate took them ten hours to tear up."

The deal stitched together in May to save the euro was never more than a temporary solution. It was never going to survive without some kind of commitment to permanent collective guarantees for the debts of eurozone governments. Such guarantees could never work without mechanisms for fiscal transfers across the eurozone. And such transfers would never be agreed by Germany and other creditor nations without much greater central control over national budgets than anyone had previously suggested.

At the EU summit in Brussels last weekend, these mechanisms for control were in principle agreed. Most of the headlines were about peripheral bureaucratic issues such as David Cameron's defence of Britain's budget rebate and Ms Merkel's insistence on revising EU treaties. The real story, however, was that Germany had again backed down. The summit agreed that no country could be forced to leave the euro for failing to pay its debts, but that government defaults within the

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eurozone remained unacceptable.

The implication, which Germany appears to have accepted, although nobody including the leaders themselves can be precise about what was agreed, was that the EU would create permanent mechanisms for mutual financial support among all eurozone countries, enshrined in future EU treaties. Ms Merkel's insistence on treaty changes, far from protecting German taxpayers from the financial consequences, reinforces the commitment to future bailouts. By explicitly revising the no-bailout clause, Ms Merkel's treaty revisions will ensure that EU fiscal federalism will have irreversible legal force.

Why would German politicians agree to such costly new obligations? There are two reasons. First, German industry and finance are critically dependent on the stability and prosperity of the eurozone. Second, political unification has long been regarded as manifest destiny by Germany's political and business elite.

The Germans, however, are not stupid. They will not agree to become permanent guarantors for the more improvident EU countries without much closer supervision over their tax, spending and borrowing. The condition for fiscal federalism will be a degree of political centralisation that may be hard to imagine at present but is starting to look inevitable.

It is hardly conceivable, for example, that different countries can have widely differing retirement ages, welfare benefits and even healthcare arrangements if the costs of these policies are jointly guaranteed. Indeed, the gradual convergence towards retirement at 67 across Europe is one of the most encouraging consequences of the financial crisis from a strictly economic point of view. Similarly, tax policies will have to be co-ordinated once mutual responsibility for public debts and deficits becomes an acknowledged fact.

European integration has always advanced through crises — and a great leap forward towards fiscal and political federalism has become irreversible after this year's eurozone crisis. That was precisely what the euro's creators intended.

Anatole Kaletsky was named Financial Commentator of the Year at the Editorial Intelligence Comment Awards