

| BertelsmannStiftung

JACQUES DELORS INSTITUT
BERLIN

spotlight europe

2015 / 04 – October 2015

A Fiscal Union for Europe – Building Block and Not a Magic Bullet

Katharina Gnath

Bertelsmann Stiftung, katharina.gnath@bertelsmann-stiftung.de

Jörg Haas

Jacques Delors Institut – Berlin, haas@delorsinstitut.de

The negotiations with Greece have been a telling reminder of the weaknesses of the euro area. If the monetary union is going to be stable in the long term, some important elements will have to be changed. Yet there is little agreement on the details, particularly on further steps to integrate fiscal policies. A fiscal union can create stability only if it includes both credible budget rules and some kind of risk sharing. It is an important way of stabilizing the euro area, but not a universal remedy. A structured process is now needed to put together a reform package and to overcome mistrust between the euro members.

spotlight europe # 2015 / 04

A European Fiscal Union – What Is It About?

The idea of a European fiscal union is not new, and in fact was propounded as early as 1977 in the MacDougall Report. At the time the issue was a larger common EU budget, which was seen to be a precondition for more monetary integration. The current proposals for a fiscal union aimed at coordinating or communitarizing additional competences in the euro area cover a broader spectrum. Two basic strands can be discerned in the debate.

Sharing sovereignty. On the one hand there are those who advocate a fiscal union built on the idea of shared sovereignty. They demand better supervision of national budgetary policy, more intervention powers for the EU institutions, and greater incentives for more discipline in the area of public

finance. These objectives are mirrored for example in the proposals submitted by German finance minister Wolfgang Schäuble and by Jean-Claude Trichet, the former president of the European Central Bank (ECB), who have come out in favour of a European Commissioner or Minister with veto power over national budgets. The most important tasks of such a person would be to supervise the budgetary policy of each and every euro member, and to impose punitive sanctions even against outright resistance by national governments. Similarly, proposals by Germany's Bundesbank to establish a European Fiscal Council, which would pass budgetary assessments independent of political considerations, add up to a stricter supervision of national policy.

These proposals are all based on the assumption that the crisis was caused by the irresponsible expenditure policy of individual countries, and that the strategy of allowing the member states of Europe's monetary union to retain most of their fiscal policy sovereignty has been a failure. Confidence in the efficacy of the current European fiscal rules – and first and foremost in the Stability and Growth Pact – is low.

Shared Risk. On the other hand there are the proponents of a fiscal union who put the emphasis on risk sharing. They believe that the crisis has proven that country-specific shocks – no matter whether they are external or home-made – can lead to contagion and ultimately cast doubt on the stability of the monetary union as a whole. A fiscal union in this context means creating a system of mutual support, which makes it possible to share risks within the monetary union that the members can (no longer) shoulder on their own. With such a system in place, so the thinking goes, crises would occur less frequently in future and the members of the euro area would be less susceptible to systemic “spillover” effects. The specific proposals for greater risk sharing range from an anti-cyclical shock absorption mechanism based on “output gaps” via a common European unemployment insurance system to the issuance of common debt obligations.

More Stringent Budgetary Supervision Is Not Enough

Many measures designed to stabilize the euro area have been initiated since the outbreak of the crisis. However, the reforms of the fiscal framework that have been implemented so far have been largely concerned with sharing of sovereignty. The Fiscal Compact and the “six-pack” and “two-pack” legislation are designed to supervise the budgets of the euro member in a more comprehensive manner and to reduce deficits by threatening to impose more credible sanctions.

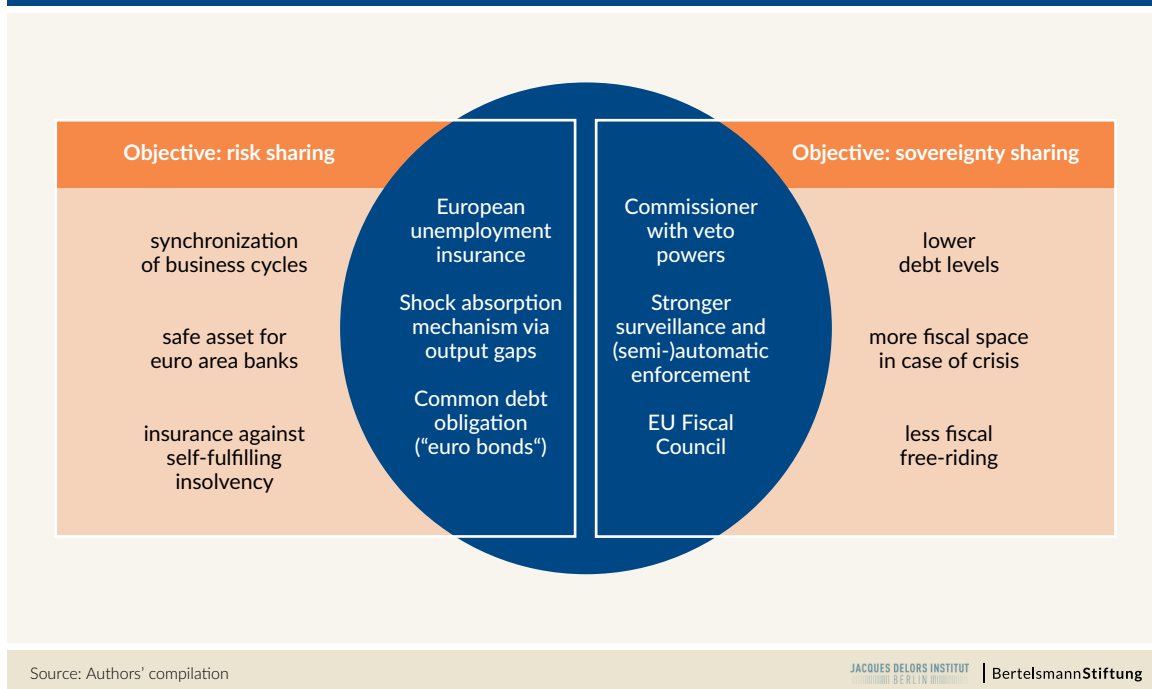
More stringent budgetary rules can help to stabilize a currency union. A country with low levels of debt has more room for manoeuvre with regard to anti-cyclical policies in the event of a crisis. It can increase expenditures and thus bolster internal demand. Furthermore, if it had to be rescued by fellow euro area members, it could expect more

understanding from them. However, more stringent budgetary supervision alone cannot create sufficient stability for the euro area.

Imperfect enforcement. First, there are well-founded doubts about whether the rules can ever be implemented to the extent envisaged by this approach. The Stability and Growth Pact has been broken on numerous occasions, and it is surely no accident that sanctions were not imposed, even though it would have been perfectly possible to do so. As long as ECOFIN or the Eurogroup are responsible for such decisions, there is always the danger of mutual forbearance among the member states. This would not change even if there were such a thing as a more stringent European supervisory and sanctions regime with veto power. However, if the Commission was granted powers which make mutual forbearance a thing of the past and effectively curtail budgetary sovereignty, there would be a need for greater democratic legitimacy on the European level. Both in Greece and Italy today, and in Germany and France in the 2000s, the current amount of supervision has provoked a great deal of opposition. Moreover, tightening up the budgetary rules would make it harder to coordinate a common fiscal stance of the euro area, since deficits would be limited, but surpluses would not.

Systemic risks. Second, an approach that limits further integration to more stringent budgetary supervision assumes – either tacitly or openly – that the euro area is no more than the sum of its parts. That is not the case. Eighteen euro countries with stable government debt ratios do not necessarily constitute a stable monetary union. A country without a monetary policy of its own is limited in its ability to react to crises, since the decisions of the ECB take into account only the overall situation in the euro area. Especially the smaller euro countries are solely dependent on their own fiscal policy in times of crisis. But at the same time they are subjected to far greater shocks than they would experience without monetary union. The highly integrated European financial system can lead to a great deal of turmoil, as Ireland and Spain found out to their cost. The fact that these countries had adhered to the European budgetary rules and were able to point to very low levels of debt turned out to be of little importance in the crisis. The ECB was unable to react to the

Proposals for a European Fiscal Union



specific problems by way of monetary easing, and it was unable to calm down the markets by acting as a lender of last resort. The harsh austerity measures that had to be adopted as a result of this had a pronounced pro-cyclical effect and contributed to the “self-fulfilling insolvency” phenomenon. Suspicions about whether or not a state was solvent weakened its actual solvency on account of higher interest rates on government debt. Thus the fiscal union can be an effective way of stabilizing the euro area only if it also includes some kind of risk sharing.

Risk Sharing to Complement Budgetary Rules

A fiscal union which not only punishes deviation from the rules but also includes mechanisms has three distinct advantages.

Insurance effect. Euro countries face the problem that they borrow in a currency that they do not directly control. Risk sharing by way of issuing a limited number of common debt obligations would make it possible to absorb sudden changes in market risk perceptions, and would protect states against self-reinforcing effects. There are fears that this might encourage states to take on exces-

sive amounts of debt, and they are certainly justified. For this reason it is important to see common bonds as a complement to and not as an antithesis of more stringent budgetary supervision. Furthermore, the precise institutional design can be an effective way of dealing with misplaced incentives. A precondition is that a state guilty of misuse can be denied further support in some credible kind of way.

Resilient financial system. If euro members were to finance themselves partly (though not completely) via common bonds, banks would have a sufficient supply of safe assets which do not depend on the solvency of a single vulnerable state. This would not weaken the disciplining effect of the markets on government expenditure. In point of fact market discipline would only now start to be effective. State insolvency would become a credible option, since it would no longer lead to the collapse of the entire national financial system and thus to politically and socially unacceptable costs.

Smaller imbalances. The ECB’s single monetary policy, which is based on averages, can fit the needs of the euro countries only if their economic cycles are more or less in sync. If this is not the case, interest rates are too low for rapidly growing

countries with high inflation, and too high for countries with low growth and inflation (“one size fits none”). For this reason interest rates tend to exacerbate divergent trends which ultimately translate into different levels of competitiveness. In theory this could be resolved by a discretionary coordination of fiscal policies. However, in practice this is well-nigh impossible on the international level. In this context automatic stabilizers may perhaps be the solution. There are several options available, such as a common unemployment insurance system or a stabilization mechanism based on output gap measurements. They all have in common that they redistribute money from booming countries to those languishing in a cyclical recession. Thus they can help ensure that monetary policy fits the needs of euro area member states. Such mechanisms should not be confused with instruments designed to foster real convergence in living standards. They do not equalize structural differences and for this reason do not necessarily lead to long-term net transfer payments.

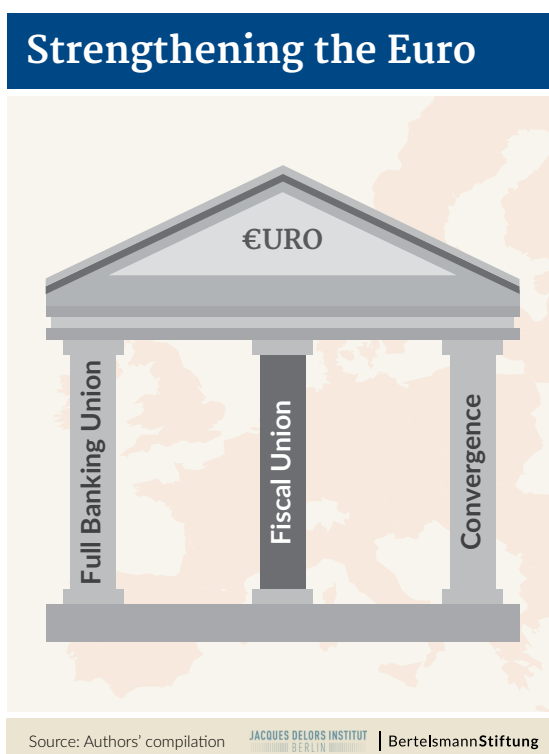
Beyond Fiscal Union

Additional private risk sharing. The proposed mechanisms for sharing fiscal risks are not a universal remedy. Risk sharing should also be a feature of the private sector. A glance at the United

States, which is often cited as the model of a functioning monetary union, reveals that risks are shared not only via fiscal policy, but also via the credit and financial markets. Capital invested across state borders ensures that financial shocks and the ensuing profits and losses are distributed over the whole of the monetary area, even if initially they impact only one part of it. In the euro area the brunt of a shock is often borne by a single country. For this reason a greater cross-ownership of assets in Europe is desirable.

Completing banking union. To prevent such financial integration from generating panic in the next economic downturn, it is also important to assume joint responsibility for the system. The creation of a (still incomplete) banking union with a single supervisor and resolution mechanism is an important step in the right direction. However, what is still missing is the certainty that a national crisis will not lead to exclusion from the monetary union. For example, the State of California has been on the brink of insolvency on several occasions. Nevertheless there was no reason to think that it would leave the dollar area. Consequently, there was no exchange rate risk. Investors and citizens assess the situation in the euro area differently, as the huge capital outflows from Spain or more recently Greece have shown. Only a credible commitment to the irreversibility of the common currency, for example, in the shape of a common deposit guarantee scheme, can prevent the kind of capital flight that is bound to reinforce the crisis.

No fiscal union without convergence. Last but not least, the move to more risk sharing must be accompanied by a structural convergence of the European economies. This will contribute to the completion of the single market and thus provide support for the synchronization of business cycles through classical market mechanisms. There is an opportunity for interlinkage which has been recognized in the recently published “Five Presidents’ Report.” The prospect of a stabilization mechanism can be an incentive for those countries in the euro area which would otherwise be either unable or unwilling to work towards greater convergence. At the same time, it would also generate more political support in countries which are afraid to be disadvantaged by a stabilization mechanism.



Source: Authors' compilation

JACQUES DELORS INSTITUT BERLIN | BertelsmannStiftung

To summarize, a fiscal union is no more than a building block for the stabilization of the monetary union, albeit an important one. A combination of sovereignty sharing and risk sharing would provide a sound foundation on which other areas of the European Economic and Monetary Union – including the market-based ones – can function and withstand crises in the future. There may well be distributional effects from a fiscal union, but the cost is likely to be much lower than that of ongoing instability in the euro area.

The Five Presidents' Report – Starting Point for a Reform Package

It will not be easy to reach political agreement on greater fiscal policy integration. Currently only a handful of euro countries seem to be interested in concrete reforms, even if there is a fundamental – albeit vague – understanding that they are necessary. Giving up decision-making powers in the area of budgetary policy will come up against a great deal of opposition even in countries such as Germany which are officially in favour of the move. Furthermore, the proponents of a fiscal union, as we have seen, are split into two camps, which at times are very suspicious of each other. They have different perceptions of the central problem and different political preferences for the future of the euro area. And, last but not least, the transfer of additional budgetary competences to the European level, which would become necessary when building a fiscal union, will most likely make it necessary to amend the European treaties.

The status quo is not a viable option. Should Europe wait and insist on adherence to the existing rules until the member states have once again developed mutual trust and respect? This path sounds promising only at first sight. In fact, the alternative to a substantial reform of the euro area is not the continuation of a more or less stable status quo, but the regular recurrence of crises. Under the current framework conditions imbalances are part of the common currency. If the euro area proves unable to deal with crises through democratically sanctioned instruments, the course of action will be dictated by the requirements of monetary policy. The ECB has in the past – though in an implicit manner – implemented both sovereignty sharing and risk sharing in order to preserve its ability to manage monetary policy.

The OMT (“outright monetary transactions”) programme is an example of the former, and macro-economic conditionality in the case of ELA loans (“emergency liquidity assistance”) for states such as Ireland is an example of the latter. This situation is neither desirable for the ECB nor for the member states. However, it is the logical outcome of an incomplete monetary union.

Thus two areas of controversy can be discerned in the current reform debate. First, the fiscal union can be an effective way of strengthening the euro area, though it should not be the only one. Second, all attempts at reform will come up against robust political opposition, but doing nothing is not a viable option. It follows that a structured reform process is urgently needed in order to assemble a comprehensive package and overcome mistrust between the member states.

Reform as a package. Currently the preconditions for such a process are rather favourable. In the wake of the showdown over Greece policy-makers have started again to set their sights on the euro area's future. There is certainly no dearth of proposals. In June 2015 Jean-Claude Juncker, the President of the European Commission, presented the Five Presidents' Report, which he coordinated. It shows how steps leading to reform can interact and interlock. German, Italian and French ideas on a possible European minister of finance were made public during the summer recess. Emmanuel Macron, the French economy minister, has issued a call for “refounding Europe”. This would include a “full” fiscal union with permanent fiscal transfers and a European finance minister. One does not have to agree with all of Mr. Macron's proposals. However, the members of the euro area should now use the opportunities presented by the reform process that has been initiated by the Five Presidents' Report in order to come out of the defensive. The guiding question should no longer be “What do we want to prevent?” It ought to be “What do we want to achieve and what can we do to get it?” As far as France is concerned this will mean fleshing out the recent proposals. And for Germany, it will mean specifying how much sovereignty sharing and economic convergence would be needed in order to agree to a greater degree of risk sharing in the monetary union. ■

Further reading:

Allard, Céline et al., *Toward a fiscal union for the euro area*, IMF Staff Discussion Note SDN/13/09, International Monetary Fund, September 2013, <https://www.imf.org/external/pubs/ft/sdn/2013/sdn1309.pdf>

Bertelsmann Stiftung (ed.), *A European Unemployment Benefit Scheme: How to Provide for More Stability in the Euro Zone*, 2014, <https://www.bertelsmann-stiftung.de/de/publikationen/publikation/did/a-european-unemployment-benefit-scheme/>

Commission of the European Communities, *Report of the Study Group on the Role of Public Finance in European Integration ("MacDougall Report")*, April 1977, http://ec.europa.eu/archives/emu_history/documentation/chapter8/197704_01en73macdougallrepvol1.pdf

Delors, Jacques et al., *After the Greek Deal: Three Dangers and Three Opportunities*, Notre Europe – Jacques Delors Institute, Tribune, 22 July 2015, <http://www.institutdelors.eu/media/afteragreementdelorsenderleinlamyvit torinojuly2015.pdf?pdf=ok>

Delpla, Jacques and Jakob von Weizsäcker, *The Blue Bond Proposal*, Bruegel Policy Contribution 2010/03, May 2010, <http://bruegel.org/2010/05/the-blue-bond-proposal/>

Deutsche Bundesbank, *Approaches to strengthening the regulatory framework of European monetary union*, Monthly Report, March 2015, https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report_Articles/2015/2015_03_approaches.pdf?__blob=publicationFile

Enderlein, Henrik, Joachim Fritz-Vannahme and Jörg Haas, *Repair and Prepare: Strengthening Europe's Economies after the Crisis*, Bertelsmann Stiftung and Jacques Delors Institut – Berlin, November 2014, https://www.bertelsmann-stiftung.de/fileadmin/files/user_upload/Pilot_Study_Repair_and_Prepare.pdf

Enderlein, Henrik, Lucas Guttenberg and Jann Spiess, *Blueprint for a cyclical shock insurance in the euro area*, Notre Europe – Jacques Delors Institute, Studies & Reports No. 100, September 2013, <http://www.institutdelors.eu/media/blueprintforacyclicalshockinsurancene-jdissept2013.pdf?pdf=ok>

Enderlein, Henrik et al., *Completing the euro: a road map towards fiscal union in Europe*, Notre Europe – Jacques Delors Institute, Studies & Reports No. 92, 2012, <http://www.institutdelors.eu/media/completingtheeuroreportpadoa-schioppagroupejune2012.pdf?pdf=ok>

Enderlein, Henrik and Jörg Haas, *A smart move: why the Five Presidents' Report is cautious on substance and ambitious on process*, Jacques Delors Institut – Berlin, Policy Paper No. 139, 2015, http://www.delorsinstitut.de/2015/wp-content/uploads/2015/07/20150703_5PresidentReport_Enderlein_Haas.pdf

Trichet, Jean-Claude, *Building Europe, building institutions*, Speech by the president of the ECB on receiving the Karlspreis, 2 June 2011, <https://www.ecb.europa.eu/press/key/date/2011/html/sp110602.en.html>

Tumpel-Gugerell, Gertrude et al., *Final Report of the Expert Group Debt Redemption Fund and Eurobills*, 31 March 2014, http://ec.europa.eu/economy_finance/articles/governance/pdf/20140331_report_en.pdf

This publication is part of “Repair and Prepare: Strengthen the euro”, a larger research project of the Bertelsmann Stiftung and the Jacques Delors Institut – Berlin, www.strengthentheeuro.eu.

Responsible:

Bertelsmann Stiftung
 Carl Bertelsmann Straße 256
 D-33311 Gütersloh
www.bertelsmann-stiftung.de

Isabell Hoffmann
isabell.hoffmann@bertelsmann-stiftung.de
 Telefon +49 5241 81 81313

Joachim Fritz-Vannahme
joachim.vannahme@bertelsmann-stiftung.de
 Telefon +49 5241 81 81421

ISSN 1865-7451

Latest editions:**spotlight europe # 2015/03**

Money or Democracy? Greece and the Euro Dilemma
Katharina Gnath, Isabell Hoffmann

spotlight europe # 2015/02

A Gulf CSC Could Bring Peace and
 Greater Security to the Middle East
Christian-P. Hanelt, Christian Koch

spotlight europe # 2015/01

Turbulent Times in the Disunited Kingdom
Joachim Fritz-Vannahme

**All "spotlight europe" editions
 can be downloaded at:**

www.bertelsmann-stiftung.de/spotlight