Fixing Europe in the short and long run: The European Federal Institute

Luigi Guiso, Massimo Morelli 03 November 2014

Eurozone countries need to stop the stagnation and improve their management of future crises. In this column, the authors argue that both issues should be addressed simultaneously. To achieve this goal, they propose the creation of a European Federal Institute. This Institute would coordinate short-run anti-recession measures, and implement steps towards a federal budget that would fix the European institutional design in the long run.

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Making Europe grow now and work better later – two birds with one stone. Eurozone countries are facing two main questions:

- How can the the current stagnation be stopped?
- How can the ability of the Eurozone to manage future crises be improved?

We argue that it is necessary to face both simultaneously.

The first short-run problem is the immediate need to jumpstart growth. Now that the Crisis is touching central and northern European countries – after having crippled the Mediterranean ones – this need is clearer than ever. The second problem is how to fix the institutional structure of the monetary union along the lines suggested in a vast literature (see among others Bordo *et al.* 2011, Cooper and Kempf 2004, Dixit and Lambertini 2003, de Grauwe 2011, Guiso *et al.* 2014).

Reforms are needed so that small future crises – crises as small as the Greek crisis was when it first came up – do not balloon into daunting situations like the one we are now facing.

We argue that these two problems must be faced simultaneously and immediately.

The need for a new mechanism

There is no way that EZ countries can defeat the area-wide stagnation without a joint, coordinated, and substantial effort. This coordination, however, can succeed if and only if we construct a mechanism aimed at reducing the justified fear by the northern countries' leaders about moral hazard behaviour by the southern countries – which have been viewed up till now as the sole beneficiaries of any further expansionary monetary policy.

Such a mechanism would have to guarantee that the expansionary measures – which must be transitory in nature – will be followed by financial stabilisation. Short-term measures cannot be allowed to contribute to public debts of countries already burdened by excessive debts. This objective is not out of reach, but it requires the creation of a federal budget managed by a European fiscal authority. Such an authority would have to 'replace' the fiscal authorities of the member states on some, possibly limited, budget items or competences.

The new fiscal authority would endow the monetary union with an additional important countercyclical policy management institution. At the same time, it would resolve the problem of Germany's reluctance to concede to requests that member states deviate from fiscal compliance rules agreed upon in the EU Treaties.

In a recent Vox column, Giavazzi and Tabellini have proposed to resolve the short-run crisis with a generalised tax cut across all European countries simultaneously, to be followed only later on, at end of the Crisis, by expenditure cuts nation by nation (Giavazzi and Tabellini 2014). This fiscal countercyclical policy measure would have to be accompanied by ECB's quantitative easing in order to avoid a hike in interest rates. But who can reassure the German, Dutch, and Finnish leaders that countries like Italy and Greece wouldn't keep a greater debt for future European generations to repay instead of scaling down their public sectors after the recession? The answer is nobody, and this is why the Germans do not want to endorse any purchase of individual state treasury bonds by the ECB.

Our proposal

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This is where our proposal comes in. It may indeed complement the fiscal stimulus with a mechanism that should yield the necessary guarantee for the sceptical German leaders. We propose the creation of a European Federal Institute, with the twin mission of coordinating the anti-recession short-run measures as well as taking the first steps towards the creation of a EZ-wide federal budget. To make this happen, events could unfold as follows:

- As a first step, the European Federal Institute issues federal bonds that are purchased by the ECB for an amount equal to at least 3-4% of the total Eurozone GDP.
- As a second step, the Institute lends to each country an amount equal to 3-4% of their respective GDPs; recipients of such loans would simultaneously cut taxes for an equivalent amount of tax revenue.

The simultaneous cutting of taxes in all member countries sustains the jump in aggregate demand because, as argued by Giavazzi and Tabellini, for every investor on the international market the direct effect of their tax cut is amplified by the indirect effect of higher demand by the other countries as well.

Once the critical phase of the EZ Crisis is over and a new growth path is on the way, the EZ nations would be required, in a manner contracted at the time of the loan, to transfer to the European Federal Institute the accumulated debt with the Institute. That is, each Eurozone member should transfer to the European Federal Institute a piece of its budget equal to some agreed-upon share of the value of the European Federal Institute's accumulated debt, transferring authority over both taxation and expenditure sides.

For example, if a country accumulates a debt of €80 billion with the European Federal Institute – say, €40 billion as the response to the 3% cut of the pre-intervention national tax revenue and another €40 billion if the tax cut is kept for a second year – the agreement could be that at the end of the Crisis, i.e. at the start of the third year, the country will pass to the European Federal Institute €80 billion while at the same time transferring authority over a percentage of the post-intervention budget, so that in principle the Federal authority could fully re-enter from the initial loan either by cutting the corresponding expenditure, or by raising taxes on the domain of newly transferred authority.

Table 1 clarifies the mechanism with an example assuming that there are two countries of equal size in the Eurozone, each with an initial balanced budget with revenues and expenditure of 100 and no accumulated debt. The first panel shows what happens during the implementation of the fiscal stimulus (here assumed to last two years). Tax revenue falls to 96 in each country, a deficit of 4 emerges and is funded by accumulating debt towards the Federal Institute, which will total 8 in each country at the end of the second period. Panel B shows the changes at the end of the two years. The debt of the two countries is passed to the European Federal Institute for a total of 16; each country also transfers to the Institute tax revenue competencies for 3 and expenditure competencies for 7, so that the national budget is balanced and the debt is back to zero. The Federal Institute's budget has now tax revenues for 6, expenditure for 14, and an initial debt of 16. It starts with a potential federal deficit of 8 but has the means to contract it, either by reducing expenditures, raising the federal tax or both, and timing the actions according to the evolution of the economy in the area. The example ignores the fact that if the economy has meanwhile recovered, tax revenues may have increased so that nations' budgets in the second year may look better.

Table 1A. Balances during the European Federal Institute (EFI)'s stimulus coordinated policies: two-year stimulus, zero interest on EFI debt

	Country 1	Country 2	EFI
Tax revenue	96	96	0
Expenditure	100	100	0
Debt	0	0	0
Surplus	-4	-4	0
Net Debt	-8	-8	0

Table 1B. Post-EFI intervention budgets

	Country 1	Country 2	EFI
Tax revenue	93	93	6
Expenditure	93	93	14
Debt	0	0	0
Surplus	0	0	-8
Net Debt			16

Of course, the Institute will have to determine, country by country, which components of revenue and expenditure it should have authority over. This should be done at the time of the initial public agreement on the loan.

The national budgets will be smaller; the national public debts will be the same as before the creation of the new Institute. The budget of the Institute will be equal to the competences transferred, and the federal debt will be equal to the accumulated one. As a side result, if the centralised budget items will concern issues and policies with significant externalities, such as environment and research, other types of inefficiencies in the coordination of independent fiscal policies will be resolved.

The creation of a Federal budget could also be achieved in other ways. For example, the new Institute could use the ECB's money to undertake public good investments (infrastructure, defence, immigration, research) rather than lending in exchange for simultaneous tax cuts, introducing centralised taxes later on. This alternative would produce an even larger overall role of public management in Europe. Our mechanism instead aims to simultaneously achieve stimulus, institutionalised countercyclical fiscal policy, and a potential reduction of expenditure, though the latter depends of course on which items are transferred to the European Federal Institute.

At this point, the Institute will have completed its function, and a newly created European Ministry of Finance will be made responsible for the management of the newly constructed federal budget. The new minister will have authority to act on both taxation and expenditure on the budget, and hence will be in charge of the decisions concerning the speed of elimination of the federal debt created at the time of the jumpstart that comes with the creation of the European Federal Institute.

Given that the management of the federal budget and the decisions about the elimination of the federal debt will be in the hands of a new federal authority, rather than remaining at the national level, this mechanism should resolve, or at least greatly reduce, the scepticism of northern European countries – especially if the chosen minister were to be German! At the same time, since a federal budget is now available and can be used to respond to the shocks that hit the Eurozone countries (either through the working of automatic stabilisers that respond to both common and country-specific shocks), fiscal discipline at the country level can become tougher.

Today, Europe is stuck. Neither steps forward nor steps back seem capable of generating agreement. Our proposal could create the necessary level of confidence for a big push out of the Crisis as well as for a desirable partial fiscal policy integration.

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