Which Fiscal Union?

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One of the main lessons of the financial crisis is that, to preserve full financial integration and financial stability, the Euro area needs to build elements of a common fiscal policy – see Obstfeld (2013) and Tabellini (2015) but also the Five President Report (European Commission 2015). This note discusses the principles and priorities of how this could be done.

Realizing such a deep transformation would require Treaty changes and Constitutional reforms in member states, something that does not appear politically feasible in the near term. Yet, at some point the Euro area will have to grapple with these issues, and the more thoroughly they are discussed, the sooner they will fill the political agenda. Moreover, the task of economists is also to discuss hypothetical reforms, so that they can be swiftly implemented once political conditions allow it. Of course a large literature already exists on this topic. In what follows, I draw in particular on Ubide (2015) and Sapir and Wolf (2015) – see also CEPR (2015) and Paris and Wyplosz (2014).

1. Priorities

Unlike for the US and other federations that achieved integration at an early stage of state development, all Euro area countries already have large (arguably too large) government spending and taxation. Under any foreseeable scenario, most of these government functions and capacities will have to remain national. The fiscal union should have a few main purposes and priorities, namely to complement the monetary union in three main ways. :

i) By providing an arrangement that allows fiscal stabilization at the level of the Euro area as a whole.
ii) By providing resources to withstand systemic financial crisis (banking crisis and sovereign debt crisis).
iii) By strengthening the enforcement of fiscal rules to insure fiscal discipline in member states.

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Point (i) was emphasized also in the Five President Report. The Euro area needs a policy tool with which to manage aggregate demand and stabilization policies during large Eurozone recession. European monetary policy should bear the primary responsibility for cyclical stabilization during normal times. But in exceptional circumstances, monetary policy alone becomes over-burdened and is constrained by the zero lower bound on nominal interest rates. A major lesson of the financial crisis is that, when this happens, monetary policy should be coordinated with fiscal policy to sustain aggregate demand. Given current deflationary trends, it is quite possible that the zero-bound on interest rates will be a recurrent threat during recessions for years to come. If so, the lack of an aggregate fiscal policy tool will be a major handicap for the Euro area. A primary goal of the fiscal union should be to remove this handicap. Of course, the common fiscal policy tool should aim at the Euro area average and be activated only in exceptional circumstances, leaving idiosyncratic national shocks to be dealt with by member states.

Corsetti et al. (2016) emphasize a second problem with the current arrangement, which is particularly relevant for highly indebted countries. Suppose that a country is hit by a large adverse macro shock, and that the appropriate response would be to expand the fiscal deficit. If the country has a large public debt, the fiscal expansion may increase default risk. The reason is lack of commitment: the deficit increases now, but the promise of having larger fiscal surpluses in the future may lack credibility. If the country had its own currency, the higher default risk would also lead to an exchange rate depreciation, with an additional expansionary effect on aggregate demand. But inside the Eurozone, the currency cannot depreciate, and a fiscal expansion may become self-defeating because the higher sovereign default risk would have contractionary effects on domestic demand. In other words, the loss of monetary sovereignty also makes fiscal policy less effective as a stabilization tool, for a highly indebted Eurozone member state. In principle, fiscal rules are supposed to prevent this problem. In practice, however, we have seen that the enforcement of these rules is highly problematic (more on this below).

Point (ii) (a backstop for financial and sovereign debt crises) is perhaps more controversial, because it can be argued that the ESM already performs this function. The ESM arrangement is certainly an important step forward, but it is doubtful whether its current structure is adequate to prevent the risk of sudden stops.

- First, its resources (a maximum lending capacity of 500 billion, about 5% of Eurozone GDP) may be insufficient to deal with large systemic crisis - in many European countries bank assets are several multiples of GDP.

- Second, the decision to provide stability support to an ESM member is taken by unanimity and requires prior approval by some national Parliaments. [2] This makes it highly uncertain and open ended whether and how the ESM resources would actually be available.

For these reasons, the risk of Euro exit and of sudden stops remains a significant concern. To be viable in the long run, the monetary union needs an effective system of risk sharing in exceptional circumstances, such as sudden stops and systemic financial crisis (see Obstfeld 2013). Conditioning such an arrangement on the approval of national political majorities vastly reduces its effectiveness, both ex- ante and in the case of need.

In a recent contribution, Gros and Belke (2015) have argued that risk sharing through a well-functioning banking union and capital market union may be sufficient to absorb losses from most financial crises, without the need of a fiscal union, provided that the a common system of deposit re-insurance is in place. A discussion of this issue goes beyond the goal of this article, but I note the following.

- First, current arrangements limit the resources needed from the newly constituted Single Resolution Fund in the event of a banking crisis, because they impose very demanding bail-in requirements on bank creditors. This increases the risk of contagion and domino effects, however, and may not be a viable solution in the event of systemic banking crises.
- Second, a truly trans-national banking union is unlikely to emerge in Europe even in the long run, if the risk of Euro exit and of sudden stops remains significant. In the presence of this risk, banks will retain a large home bias even if supervision is common (rather than national).

A comparison with the US, where state debt is negligible and a fiscal union already exists, is misleading. A fiscal union is a pre-requisite for a well- functioning capital market and banking union. Although it may be true that, once credible elements of a fiscal union are in place, the banking system could evolve so that most of the risk would be shared by financial markets and the losses born in the private sector, rather than by tax-payers.

Point (iii) (the need to better enforce fiscal discipline) is becoming more and more manifest. The Six-Pack procedure is very articulate and ambitious, but the evidence so far is that it has very little bite. Several member states have repeatedly found a reasons to claim exceptions to the fiscal rules, with

[2] When the European Commission and the ECB both conclude that a failure to urgently grant financial assistance would threaten the economic and financial sustainability of the euro area, unanimity is replaced by an 85% qualified majority. In this case an additional reserve fund needs to be set up as a buffer (Art 4 of the ESM Statute).

no relevant cost or disincentive. To enforce fiscal discipline on a reluctant member state, more interference with national sovereignty is needed than under existing rules.

Points (i) and (ii) deliberately do not include another controversial issue, namely whether a fiscal union should also perform some of the risk sharing functions towards individuals that are currently performed by national governments. I think this is not a priority at the current stage. Risk sharing between countries is required in a monetary union, but should mainly be limited to exceptional circumstances, such as sudden stops and systemic financial crisis, or very large shocks. A European system of unemployment insurance (or other welfare programs directly insuring individual risks) may be politically or symbolically attractive, but would entail great difficulties. To avoid moral hazard and permanent transfers between countries, a common system of unemployment insurance would require strict harmonization of national labor market institutions, which is difficult and perhaps undesirable. Such a system would also have small economic benefits, for two reasons. First, all members states already have the capacity to directly insure their own citizens. Second, if countries do not lose market access, they should be able to self-insure against small shocks and business cycle fluctuations. What is most important is to insure against large shocks or events that could entail the loss of market access or threats to financial stability. It is in such circumstances that individual member states are powerless, and that systemic externalities are most threatening.

An implication of the foregoing remarks is that the Euro area does not need to build a large tax capacity of its own. What it needs is the ability to enforce the collection of transfers from member states, not necessarily in very large amounts at once, but for possibly very long periods of time. This would enable the Euro area to issue its own debt at times of crisis, or for fiscal stabilization purposes. As in the proposals by Ubide (2015) and CEPR (2015), this debt would be backed by specific tax revenue collected by member states, but earmarked to service Euro area debt.

According to CEPR (2015), member states would pledge specific sources of future revenue (such as seignorage, or a fraction of the VAT, or the proceeds from a recurrent wealth tax) for say 50 years. The Euro area could then issue "Stability Bonds" backed by these future sources of revenue. In the CEPR proposal, the proceeds of the Stability Bonds would then be used to retire national debt from circulation, until all national public debts have reached 60% of GDP in all member states. The main goal of the proposal is to reduce the fragility of the Euro area by getting rid of the legacy of high public debts.[3] Since the current stock of national debt differs between countries, the Stability Bonds

[3] Paris and Wyplosz (2014) formulate an alternative proposal of debt reduction, based on pledging larger amounts of future seignorage revenues.

would be backed in greater proportion by pledges from the currently highly indebted countries, that need to retire larger amounts of their debt. This is a drawback of the arrangement, which could undermine the rating of the Stability bonds. Another drawback is that in the long run the Eurozone may exhaust all its borrowing capacity to redeem national debts, with no margin left to smooth cyclical fluctuations or other emergencies.

Ubide (2015) proposes a similar scheme, except that pledges of future revenues would be the same proportion of GDP for all member states, and the Stability bonds would primarily be used for fiscal stabilization and risk sharing in exceptional circumstances, rather than for national debt reduction. He envisages capping the Stability bonds at 25% of Eurozone GDP. Below I discuss more in detail how this arrangement could work. Like in Ubide (2015), debt would be backed by the same GDP percentage of revenue from all member states, and it would be used mainly as an instrument of aggregate demand or crisis management.

In this perspective, the Euro area would exploit its key prerogative, of being a super-national institution. In pledging and earmarking specific future sources of revenues to the Euro area in predetermined amounts, member states would accept an irreversible transfer of sovereignty over those revenues. On their own, member states would not have the commitment capacity to credibly earmark future sources of revenue for, say, a sinking fund designed to retire outstanding public debt, or to back a senior debt instrument in times of emergency. An international agreement (with the associated autarky costs of unilaterally breaking the agreement) would provide this commitment capacity. Such an arrangement would give the Euro area the ability to access financial markets in favorable terms, without necessarily having developed its own tax capacity.

2. Governance

Achieving a common fiscal policy means first of all having a Euro area policymaker in charge, say a European Fiscal Institute (EFI) to adapt the name from the precursor of the ECB. Coordination of national fiscal policies will not do, because enforcement of coordination is inevitably imperfect, and policy needs to be guided by a Euro area perspective rather than by national interests.

The EFI could be the logical evolution of the ESM, as it acquires new functions and additional resources, and as it adapts its governance structure to the new greater responsibilities. Sapir and Wolf (2015) have suggested to model the EFI on principles similar to those used for the ECB, clearly a

well-functioning European institution.[4] The key governing body is the Eurogroup (i.e. a council of national Economic and Finance ministers that already acts as the Board of Governors of the ESM) plus a smaller Executive Committee with agenda setting powers and consisting of appointed individuals. The Chairman of the EFI is also the chairman of the Executive Committee, like the ECB President, and would resemble a Euro area Treasury Minister. Most decisions are by simple or qualified majority, depending on the subject matter, with Executive Committee members having considerable weights.

The key innovation here is the abandonment of unanimity in most decisions. This is inevitable, because if national vetoes can block the implementation of a common policy, then the EFI would not be very different from the Eurogroup, and we have already seen the difficulties of this body in reacting to the financial crisis. This poses the challenge of how to give democratic legitimacy to the Common fiscal policy – unlike monetary policy, fiscal policy also concerns redistribution and cannot be guided exclusively by efficiency criteria. The obvious answer is to involve the European Parliament: all major policy decisions of the EFI also have to be approved by an ad hoc committee of the European Parliament, or by the European Parliament itself, restricted to Euro area representatives.

3. Stability Bonds

The main responsibility of the EFI would be to manage a debt instrument of the Euro area (following Ubide (2015) and CEPR (2015), call it Stability Bonds), backed by a Euro area tax capacity. Here is how this could be done, following Ubide (2015).

- All Euro area member states agree to transfer to the EFI a given amount of their yearly tax revenue (expressed as a percentage of their GDP), upon request by the EFI, up to a pre-established ceiling and up to a pre-determined future date. The transfer is the same percentage of GDP for all member states, to avoid redistribution between countries. This would provide the back bones of a Euro area fiscal capacity with which to service the Stability Bonds over time.

- At the time of issue, the overall amount of Stability Bonds cannot exceed a predetermined percentage of aggregate GDP, say 25% of GDP as in Ubide (2015). Of course, the EFI debt ceiling

[4] Sapir and Wolf (2015) call it the Eurosystem of Fiscal Policy (EFP). In their proposal, the EFP could impose specific targets (for fiscal deficit or surplus) to all member states, with the aim of achieving an appropriate fiscal stance in the Euro area as a whole. This would be less effective than a fiscal stabilization achieved through Stability bonds, however, since the fiscal expansion (or contraction) would only occur in some countries and not necessarily in the countries that need it most. Guiso and Morelli (2014) suggest the creation of a European Federal Institute, but they are less specific about institutional details, and they don't discuss Euro area debt.

and the ceiling on the pre-committed national funds would have to be mutually consistent. These ceilings could only be changed under unanimity rule. Ubide (2015) and CEPR (2015) provide different numerical hypothesis and also include a discussion of which sources of government revenue (including seignorage from the ECB) could be most easily pledged.

To achieve liquidity of the new debt instrument, the EFI would start by gradually issuing a minimum amount of Stability bonds (until it has reached up to say 10% of aggregate GDP). The proceeds from the Stability Bonds would be returned to member states (also in proportion to GDP, to avoid redistribution), who would have to retire their own national debt. In a similar proposal by Corsetti et al. (2016), the EFI would purchase national debts, rather than disbursing the proceeds to member states. But this would have the disadvantage of backing the new Eurozone debt with the existing national debts, leading to a mutualization of legacy national debts. Disbursements of cash (to redeem national debt in circulation) is preferable, because it clarifies that the new Stability Bonds are backed by the own tax capacity of the Eurozone, and not by national debt instruments of heterogeneous rating inherited from the past.

The main purpose of the Stability Bonds, however, would be to give the Eurozone a new instrument for intertemporal aggregate demand management without relying on fiscal policy coordination. Thus during deep Euro area recessions, the EFI would issue additional amounts of Stability bonds and give the proceeds to member states (also in proportion to national GDP), who would be free to use them as they deem appropriate. In particular, the debt proceeds from the Stability Bonds could be used to enact a counter-cyclical fiscal policy in the Euro area, if necessary in coordination with monetary policy (including so as to replicate the economic effects of "helicopter money", as suggested by Turner 2015).

Note that, because both tax collections and disbursements are in proportion to GDP, there is no redistribution between member states: this would not amount to a "Transfer Union". Nevertheless, if one wanted to achieve some risk sharing between member states against idiosyncratic cyclical fluctuations, debt proceeds could be distributed according to projected or trend GDPs, while transfers would be collected in proportion to actual GDP.

Similarly, in the event of major systemic financial crisis or sudden stops, the EFI could use the debt proceeds (or part of the yearly transfer from member states) to restore financial stability by lending to member states who have lost market access, under strict conditionality, or to supplement national deposit insurance or to directly recapitalize insolvent financial institutions. In this, the EFI would

undertake some of the roles currently attributed to the ESM, which would cease to exist and would merge its procedures and activities in the EFI.

Once the outstanding stock of Stability Bonds is sufficiently large to be liquid, the EFI would manage it so as to avoid excessive debt accumulation. Thus, in normal times the transfers from member states would be used to retire the Stability Bonds that were issued during previous large recessions (or no new transfers would be collected, if the stock of outstanding debt is deemed appropriate).

This arrangement would have several benefits. The Eurozone would acquire a fiscal policy tool with which to stabilize aggregate demand or to grant emergency lending. Over time the public debt composition in the Eurozone would also become more efficient. The Stability Bonds would be relatively safe, because they could be senior to national bonds, circulating in relatively small amounts, backed by a pool of revenues from several member states, and managed by a technical body less easily captured by domestic political uncertainties. They could be used by the ECB for QE and by domestic banks to diversify their portfolio, reducing the risk of the bank-sovereign “doom loop” that was at work during the crisis. At the same time, national debts would become smaller in size (although by only a small amount). Finally, the stronger enforcement capacity of the EFI compared to current arrangements would give more credibility to the goal of debt reduction in the highly indebted countries, and would more easily prevent new accumulation of national public debts (more on this below).

A natural question is how to insure that the Stability Bonds enjoy a high rating and are a safe nominal asset. For instance, suppose that a member state defaulted on its obligations because it left the EU. In such extreme circumstances, the predetermined transfers by the remaining member states could be insufficient to service the Stability bonds. Alternatively, major economic and financial shocks could have similar implications, or induce a funding crisis that prevents the Stability Bonds from being rolled over, even if no member states was in default.

There are at least two (not mutually exclusive) alternatives to address these issues. One possibility, proposed by Corsetti et al. (2016), is to make the Stability Bonds a joint liability of the EFI and of the ECB. In this way they would be risk free, because they would be redeemable in Euros at maturity. The alternative is to give the EFI the authority to request exceptional transfers in excess of the predetermined amount, if this was motivated by exceptional debt service needs, and according to pre-specified procedures. This more open ended commitment of resources to back Eurozone debt should be accompanied with a greater ability of the EFI to interfere with national budgetary policy, as

described below. In choosing between these two alternatives, the tradeoff is between central bank credibility vs interference with national sovereignty.

Note however that the maximum amount of yearly national resources pledged by member states to back the Stability Bonds need not be large. Suppose that Stability Bonds amount to 20% of GDP, that they have a balanced maturity of 10 years, and that they earn a nominal interest rate of 4%. The debt service needs in each year (interest plus redemption) would be less than 3% of GDP. And the flow of interest payments, if debt was rolled over indefinitely, would be less than 1% of GDP.

4. Supervision of national debt policies

Besides managing the common fiscal policy, the EFI would also assume the role currently performed by the European Commission together with the European Council, of enforcer of fiscal discipline in member states. With the stronger risk sharing capabilities discussed above, moral hazard would be an even bigger concern than under current arrangements. Moreover, care must be taken to avoid the danger that Stability bonds would pile up on unsustainable national debts, rather than leading to an overall debt reduction. Thus, in exchange for the enhanced risk sharing capabilities, member states would have to accept a more intrusive external interference in national fiscal policy.

Specifically, the EFI should also have authority to veto national budgets, and impose specific targets for deficits or surpluses, as suggested by Sapir and Wolf (2015). This interference with national political decisions would have to be justified by exceptional circumstances, such as a country being in gross violation of the debt sustainability requirement. The main goal here is to insure adequate fiscal discipline in all member states, but it is also conceivable that the EFI could impose a more lax fiscal policy than approved at the national level, if a fiscal expansion is justified by a major Euro-wide recession.

5. Evolution

Over time, the EFI could evolve into a more accomplished fiscal union for the Euro area. On the one hand, the fiscal union could evolve so as to fund a small set of European public goods such as border patrols, European infrastructures, a European defense system, scientific research.

On the other hand, the revenue collection system could also evolve. Rather than relying on transfers from member states, the EFI could be given its own tax bases (or fractions of national tax bases, such as the VAT), on which to levy its own tax rates. This could have symbolic and political benefits, but it would require some centralized tax collection or monitoring capacity, to avoid moral hazard in the

enforcement of tax collections. A true Euro area tax would also entail the risk of excessive expansion of public spending at the Euro area level, something to be avoided given the size of national government spending.

6. Concluding remarks

The arrangement described above entails two obvious political obstacles. First, countries have to give up sovereignty over a fraction of their tax revenues. It is important to stress, however, that the sacrifice needs not be large in terms of size of yearly revenue. Stability bonds don't need to be a large fraction of aggregate GDP, in order to insure adequate fiscal stabilization or to provide risk sharing during emergencies. What is essential is the long time horizon: the pledge to transfer national revenue to the Euro area should extend for a long period of time. A pledge over several decades can provide adequate backing, even if the yearly transfer is relatively small, provided that the arrangement is credible and lasting. In other words, setting up a fiscal union along these lines entails an important element of irreversibility. Without the expectation of irreversibility, the pledge would lack credibility and the arrangement would fail. But the expectation of irreversibility is at the core of the Single Currency, and it is meant to distinguish it from a fixed exchange rate regime.

The second political obstacle is that the benefits of this arrangement may not be perceived as symmetric. The weaker and highly indebted countries are more likely to lose market access, or to be involved in a sudden stop. The benefits of Stability Bonds is likely to be greater for them than for the stronger member states. On the other hand, the arrangement also entails a greater expected loss of sovereignty for the weaker or highly indebted member states, who are more likely to incur in the veto of the EFI over their national budgets. In other words, there is an implicit exchange: in order to enjoy the potential benefits of this arrangements, the weaker member states have to accept a temporary loss of sovereignty if they don't meet the sustainability requirements established ex-ante. This of course is a greater loss of sovereignty than that envisaged by ESM conditionality (which member states are always free to refuse). This makes the distribution of net benefits more symmetric across countries, and strengthens long run sustainability. And of course, the benefit of a stronger and more viable monetary union accrues to all.

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