European Fiscal Union

European Fiscal Union: What Is It? Does It Work? And Are There Really 'No Alternatives'?

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Introduction

The eurozone is atypical as an economic union because monetary policy is decided at the central (European) level while fiscal policy is mostly carried out at the sub-central (member state) level (Bordo *et al.* 2011). Therefore the view is widespread that there are just two options for the future of the eurozone – either it is complemented by a fiscal union, or it will fall apart. This proposition raises a number of questions. Firstly, it is not always clear what is meant by the term 'fiscal union'. Secondly, it is unclear whether a fiscal union would really achieve what people expect from it. Thirdly, it is important to ask whether a fiscal union is really the only chance to save the euro, or whether the currency union might work under a different institutional arrangement.

This paper discusses these questions and provides the following answers. Firstly, we propose five possible elements of a fiscal union, of which three are at the centre of the current debate on fiscal union in the eurozone. Secondly, we argue that fiscal union will only work if political integration in Europe goes significantly beyond the currently planned reforms. Achieving the required level of political integration seems very difficult, if not impossible, at least in the short and medium term. Thirdly, there is an alternative, recently proposed by the Academic Advisory Board of the Federal Ministry of Finance (Wissenschaftlicher Beirat beim Bundesministerium der Finanzen 2010 and 2012), which places less emphasis on centralised fiscal policy coordination and instead focuses on financial sector reform and sovereign debt restructuring in the case of fiscal crises.

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What is a fiscal union?

In the debate on reforms of fiscal institutions in the eurozone, the term 'fiscal union' plays a central role. However, it is not always clear what exactly this term means and different people use it very differently. In this section, we discuss five possible elements of a fiscal union. It is important to note that a fiscal union may, but does not have to include all five elements.

Element 1: fiscal rules, policy coordination and supervision

The first and most widely discussed element of fiscal union is a set of rules for the fiscal policy pursued by the individual member states and, possibly, rules for other policy areas as well. Elements of this type of fiscal union were introduced when the euro was created, in the form of the so-called Stability and Growth Pact. These rules required member states to balance their budget and to keep the stock of public debt below 60 percent of GDP. Together with these rules a supervision mechanism was introduced, and countries violating these rules were to face excessive deficit procedures that could eventually lead to sanctions.[1]

More recently, new rules have been added to the old ones. The Stability and Growth Pact has been reformed, the Euro Plus Pact extends coordination to policy areas beyond fiscal policy, while policy coordination and supervision has been reformed in the so-called 'Sixpack'. Recently the so-called fiscal compact has been added, yet another set of fiscal rules, which obliges countries signing the pact to introduce balanced budget rules at the national level.

The logic behind this element of fiscal union is that, in the absence of constraints, there is a bias towards excessive debt financing in a monetary union. The cost of running excessive deficits is at least partly

[1] When Germany and France violated the rules but then prevented sanctions, the credibility of the Stability and Growth Pact was undermined and its enforcement was put into question.

borne by the currency union as a whole. This is because financial difficulties of one member country may threaten the stability of financial markets, create pressures to monetise public debt and interfere with monetary policy. Whether dealing with this requires balanced budget rules, other types of fiscal rules or discretionary policy coordination is a controversial issue. In particular, critics argue that balanced budget rules leave too little room for countercyclical fiscal policy.

A key issue with this institutional setup is the question of what happens if a country does run high budget deficits, accumulates more and more debt and faces bankruptcy, irrespective of whether or not sanctions are imposed. This can happen either because a government does not want to make the effort of cutting back the deficit, not even in the presence of sanctions, or because a country is hit by a severe recession or a banking crisis, so that tax revenues collapse and public spending automatically increases.

It was a severe shortcoming of the initial institutional setup of the eurozone that no preparations were made for this case. The 'no bailout clause', combined with the Stability and Growth Pact, seemed to suggest that a member state that runs excessive deficits would face sanctions. If the member state continued to accumulate debt and faced bankruptcy, the rest of the union would let this state go bankrupt. Although it was clear from the beginning that this scenario was not plausible (see e.g. Fuest 1993), this important issue was ignored until Greece did face bankruptcy and the question of how the eurozone would deal with insolvencies of individual member states could no longer be ignored.

In this context it is important to note that the failure of the Stability and Growth Pact to secure solid public finances in the eurozone is not only due to the fact that the enforcement mechanisms did not work. Even if the member states had agreed to procedures and sanctions against individual member states, it is unlikely that this would have prevented the current government debt crisis. Firstly, financial sanctions would have made the financial situation of the highly indebted countries even worse. Secondly, at least countries like Spain and Ireland had very low public sector deficit and debt levels for a long time. However, they were then hit by sharp recessions caused by the bursting of the real estate bubbles and banking crises in these countries. Even a government with the best intentions to maintain sound fiscal policies could not, and arguably also should not, have prevented public sector budget deficits from increasing sharply in this situation.

What can be learned from this is that even the best fiscal rules and strong enforcement mechanisms cannot rule out that individual member states of the eurozone may face fiscal crises and, possibly, insolvency. Therefore these rules cannot replace arrangements for the case of debt crises in individual member states.

Element 2: a crisis resolution mechanism

Given that insolvencies of member states of a currency union cannot be ruled out, the question is how such crises should be dealt with? Clearly, the simplest way of resolving a debt crisis would be to let the governments of insolvent countries negotiate with their creditors and restructure their debt, as private insolvent debtors normally do. There are two objections to this solution. The first is based on the idea of multiple equilibria in capital markets. As long as investors think that a highly indebted country can repay its debt, interest rates will be low and the country remains solvent. However, if for some reason investor confidence declines, the situation may change, risk premia may shoot up and, at a higher level of interest rates, the country may indeed become insolvent. In such a situation, political intervention may be welfare enhancing if it succeeds in stabilizing the equilibrium with high investor confidence and low interest rates.

The second objection to letting countries always restructure their debt if it becomes unsustainable is that this may give rise to a banking crisis if highly leveraged banks have to write off government bonds.

One way of addressing both issues is to set up a crisis resolution mechanism along the lines of the currently planned European Stabilisation Mechanism (ESM),[2] which is supposed to operate as follows. If a country faces serious financial difficulties and loses access to private capital markets, it may apply for support from the ESM. This will set in motion a crisis resolution process consisting of the following steps. The first step is a detailed analysis of the economic and financial situation to determine whether a macroeconomic adjustment programme may restore the sustainability of the country's public finances. If the answer is yes, the second step is the drafting of a memorandum of

[2] The following refers to the draft treaty in the version made available by the European Commission, see http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf, downloaded 3 March 2012.

understanding specifying the financing needs of the country and the macroeconomic adjustment programme. Financial help provided by the ESM to countries in financial difficulties may be used not just for the financing of general government expenditure, but also for the recapitalisation of banks.

The ESM treaty is less clear about what happens if the analysis leads to the result that a macroeconomic adjustment programme will not restore debt sustainability. The ESM draft treaty includes two provisions, which suggest that in this case a debt restructuring with private sector involvement may be carried out. Firstly, government bonds issued by ESM member states will include collective action clauses, which ensure that a restructuring can take place for all creditors if a majority of creditors agrees. The second provision states that 'adequate' and 'proportionate' private sector involvement will be considered 'in exceptional cases'.

In this sense, the economic role of the ESM is thus twofold: firstly, to avoid sovereign debt restructurings in cases where crises can be overcome without them – cases where countries face liquidity crises, but are fundamentally solvent – and, secondly, to make restructurings possible in cases where they cannot be avoided because countries are insolvent. Making restructuring possible means that the ESM would ensure that funds are available to stabilise the financial sector and prevent the restructuring from triggering a banking crisis.

The economic implications of establishing a crisis resolution mechanism like the ESM are controversial. Critics have argued that the ESM weakens incentives for both policymakers and private investors to behave prudently. Whether this is true is a complex question. A key issue is whether the absence of a crisis resolution mechanism makes bailouts for countries and banks more or less likely. In the presence of a fragile financial sector, a sovereign insolvency is likely to trigger a banking crisis, and therefore governments cannot afford to let it happen. To the extent that a crisis resolution mechanism like the ESM can prevent a banking crisis, it increases the likelihood that sovereign restructurings with private sector participation will take place. In other words, it reduces the likelihood that an insolvent government will be bailed out. The extent to which banks are to be bailed out still remains unclear, but if banks are too big to fail, they will be bailed out anyway.

Things are different if the financial sector is sufficiently robust to absorb a sovereign restructuring without government intervention. In such a situation, the case for a crisis resolution mechanism is much weaker, and its existence is likely to increase moral hazard.

Another critical issue is the decision over whether or not to impose a haircut on private investors in cases where a country applies for help. It is clear that the analysis of the country's economic situation and the sustainability of its debt will be exposed to political pressure. This might give rise to a bias towards the result that a country can restore sustainability after a macroeconomic adjustment programme. The official analysis of the situation in Greece is a good example of this type of bias. One way of dealing with such bias would be to limit discretionary decision-making in this area.[3] For instance, a mandatory haircut for private creditors could be foreseen in cases where countries have received ESM support for a period of two or three years without regaining capital market access.

Element 3: joint guarantee for government debt

A third, widely discussed element of a fiscal union would be a joint guarantee for government debt. This may come in many forms: with or without limitations regarding the duration of the joint guarantee and the amount of debt covered by it, and with different forms of governance regarding access to the funding. Examples of proposals that have been made include the Eurobond proposal or the idea to introduce a debt redemption fund (see German Council of Economic Experts 2011). How is this different to a crisis resolution mechanism? Clearly, this depends on the way in which a joint debt guarantee is introduced. There is a wide spectrum of possible approaches, which can be characterized by the answers provided by the latter to the following questions:

1. How much debt is covered by joint guarantee?
2. Is the joint guarantee introduced for a limited amount of time or indefinitely?
3. Under which circumstances do individual countries get access to funds covered by joint guarantee?
4. If a country fails to service debt under the joint guarantee, how is the cost of servicing the debt distributed among the remaining countries?

[3] See also Advisory Board of the German Federal Ministry of Finance (2011).

A very restricted approach, which would be close to a crisis resolution mechanism like the ESM, would answer these questions as follows. The debt covered by joint guarantee is limited to, say, 500 billion euros. The joint guarantee is provided indefinitely. The latter reflects that the ESM is set up as a permanent institution. Individual countries would be granted access to debt issued under the joint guarantee if they apply for assistance, as stipulated by the rules of the ESM. If a country fails to service the debt, the losses are distributed among the other member states according to their capital shares in the ESM. In this case, the only significant difference to the ESM arrangements in the draft treaty would be the point that the ESM could not go bankrupt as long as at least one member country services its debt. In contrast, under the current arrangements, each member country guarantees only a specified share of the capital. How relevant this distinction would be in the case of a crisis where some member countries default is an open question.

Of course, this is not what proponents of joint guarantee for government debt in the eurozone have in mind. The most extreme form of introducing joint guarantee would be to extend coverage to all existing government debt in the eurozone, and to do so indefinitely. In this case, access to funding covered by the guarantee would only be relevant for new debt, or, more precisely, debt that exceeds the rollover of existing debt. In addition a rule would be required regarding the distribution of costs in cases where individual member states decide not to service the debt covered by the joint guarantee.

The main objection to concepts involving a joint guarantee is that of moral hazard. Firstly, a joint guarantee for government debt may erode the incentives to maintain sound fiscal and economic policies. Secondly, a joint guarantee could erode the incentives to service the debt covered by the guarantee. While these issues are, obviously, related, they are not the same. We will come back to the moral hazard issue below, where we discuss how the various possible institutional elements of a fiscal union in the eurozone would fit together.

Element 4: fiscal equalisation and other mechanisms for transfers between countries

The elements of a fiscal union discussed so far include elements of transfers only in the scenario where individual member states fail to meet their obligations and do not repay their debt.[4] A further possible element of a fiscal union would involve explicit transfer mechanisms of significant magnitude between countries. Clearly, the current EU budget does include transfers in the framework of structural and regional funds, as well as agricultural policy. However, these transfer mechanisms are essentially unrelated to the functioning of the monetary union. Moreover, with approximately 1 percent of GDP, the size of the EU budget is quite small, so that the magnitude of the transfers is limited.

A standard argument in favour of a fiscal union states that a monetary union should be complemented by a fiscal equalisation scheme to help absorb asymmetric macroeconomic shocks. The underlying idea is as follows. In a monetary union, member countries do not have access to monetary policy to react to a downturn. They can only use fiscal policy, but their room for manoeuvre may be limited if capital markets are sceptical about the solvency of the country. The view is widespread that pressure from capital markets may force countries to adopt counterproductive, pro-cyclical fiscal policies.[5] In such a situation a fiscal equalisation scheme may provide insurance through financial transfers to countries affected by asymmetric negative macroeconomic shocks.

Usually, significant fiscal equalisation schemes only exist in monetary unions with a high degree of political integration, typically federations with a strong central government. Of course, this does not necessarily mean that a fiscal equalisation scheme could not be introduced in the eurozone or the EU. However, one difficulty that does arise is that it is not straightforward to separate the insurance effect of fiscal equalisation, which is crucial for its macroeconomic stabilisation effect, from the income redistribution effect. While a pure insurance mechanism might find sufficient political support, introducing a significant redistribution mechanism would face more resistance. Another issue is that, depending on the type of shock, stabilisation through fiscal equalisation may also delay necessary adjustments in the country hit by the shock.[6]

[4] To be precise, loans from one country to another at interest rates that do not reflect risks of insolvency constitute transfers even if no insolvency occurs.
[5] One should note that this is not easily reconciled with the fact that, in principle, private creditors should be interested in the fiscal policy that has the highest chances of restoring the economic stability of the country. Of course, things may be complicated by heterogeneity of interests between old and new creditors.
[6] For a thorough debate of these issues – see e.g. von Hagen and Kletzer (2000).

Element 5: a larger EU budget and European taxes

Finally, a fifth possible element of a fiscal union would be an extended government budget at the EU level, combined with an EU tax.[7] Such an increase of the central government budget would require a significant shift of policy responsibilities to the European level, which raises many questions. From the perspective of macroeconomic stabilisation in the monetary union, the key issue is whether this would improve fiscal shock absorbers in the presence of asymmetric shocks. In order to achieve macroeconomic stabilisation, contributions to the central budget would have to decline automatically in the presence of negative shocks, while central government expenditure in the country would ideally increase.

Currently contributions of the member countries to the EU budget are approximately proportional to GDP. Since the size of the EU budget is only just over 1 percent of GDP, and given that its expenditure in individual member states is mostly unrelated to macroeconomic conditions, the amount of fiscal stabilisation it could offer is quite small.

There are, in principle, various ways of reinforcing the stabilising effects of the budget. Firstly, the EU could take on tasks involving more countercyclical revenue and expenditure like, for example, unemployment insurance. Secondly, the EU could rely on EU taxes or be more directly linked to the tax revenues of the individual member states (see Bargain *et al.* 2012). There is recent evidence that tax revenue collection is very sensitive to the business cycle, more sensitive even than tax bases (see Sancag *et al.* 2009).

How can these elements be combined?

In the current political debate on reforming fiscal institutions in Europe, attention focuses largely on fiscal rules and supervision, the ESM as a permanent crisis resolution mechanism, and the possibility of joint guarantees for government debt like, for example, Eurobonds (elements 1, 2 and 3 described above). Proposals to set up a fiscal equalisation scheme, to enlarge the EU budget or to introduce European taxes (elements 4 and 5) play a lesser role. In this section, we therefore focus on the former, but we will come back to the latter further below.

[7] For instance, Cnossen (2002, 466) argues in favour of "a federal government with real taxing powers and financial leverage over the Member States to mitigate adverse effects that might arise from Member State tax policies".

How are fiscal rules and supervision, the ESM, and joint guarantees related? As pointed out in a recent report by the Advisory Board of the German Federal Ministry of Finance (Wissenschaftlicher Beirat beim Bundesministerium der Finanzen 2012), in a rather fundamental sense, fiscal governance of the eurozone will only work if the institution that guarantees government debt also controls the policies determining government debt.

Joint guarantee for government debt requires centralised fiscal policy

In the extreme case of an unlimited joint guarantee for government debt in the eurozone as a whole, it is evident there would have to be strong centralised control over the level of debt each member country is allowed to take on. In this respect, fiscal rules (element 1) and a joint guarantee for government debt (element 3) seem to be complementary. Unfortunately, the degree of control required would go far beyond the fiscal rules and supervision mechanisms as currently considered for Europe. In the absence of this centralised control, however, a severe moral hazard problem would arise. Individual countries would have incentives to neglect sound economic policies when they are inconvenient, incur large deficits and, if this leads to financial difficulties, let other countries pay for their debt.

In its 'Green Paper on the Feasibility of Introducing Stability Bonds' published in 2011 the European Commission acknowledges that the moral hazard issue is of central importance and discusses various ways in which this could be addressed. One possible approach is to rely on tighter policy coordination and supervision. In addition, the Green Book suggests that, while interest rates on bonds covered by the guarantee would obviously be uniform, a rule could be introduced which would imply that countries with high deficits or debt levels pay an interest premium, while countries with solid fiscal policies are granted a discount. This is similar to the idea of introducing financial sanctions against countries that violate deficit rules.

Moreover, the Green Book includes proposals to ensure that bonds covered by joint guarantees will be of higher quality than 'normal' government bonds. Firstly, collateral could be required for bonds issued under the joint guarantee. The collateral could take the form of gold, cash or shares of public companies. Secondly, the bonds could be given seniority status relative to other forms of government debt. Thirdly, the revenue from specific taxes of the debtor countries

could be earmarked to service the debt, so that some tax revenue would automatically be absorbed by the debt service.

Unfortunately, these safeguards are less convincing than they may seem at first glance. Firstly, if governments had sufficient collateral, there would be no need for joint guarantees. Secondly, and more fundamentally, the trouble is that it is practically impossible for ultimately sovereign member states to commit to the implementation of safeguards like, for instance, the earmarking of tax revenue sources. Clearly, in a situation of financial distress, countries would have strong incentives, and possibly also good arguments, to revise earlier decisions about earmarking or collateralisation.

Of course, joint guarantees could be made conditional to member states complying with contracts on safeguards like those proposed in the Green Book. However, in that case the joint guarantee would not achieve its objective, which is to convince investors that the debt will be paid back even if things go wrong in the country which issued the debt.

Effective fiscal governance is difficult to achieve and requires far-reaching political integration

Ultimately, effective control over national economic policies and an effective collateralisation of government debt require that member states give up political sovereignty. Even if they were willing to do so, institutions would be required that would have the legitimacy to replace decision-making at a national level. This can only mean fully developed democratic institutions at the European level. In other words, the eurozone or the EU would have to take an institutional leap towards a federal state, something like the 'United States of Europe'; and even this might not be enough. Many federal states struggle with the issue of fiscal stability of sub-central governments, and a joint guarantee for the debt of sub-central government is the exception, rather than the rule. For instance, in the United States, no such joint guarantee exists, and insolvencies of municipalities or even states occur, as the example of California shows.

An alternative strategy: focus on decentralised responsibility and financial sector stability

The alternative to the creation of a fiscal union would be to maintain a set-up whereby the individual member states are ultimately responsible for fiscal policy and public sector debt. This was the intended set-up for the currency union when it was created. Clearly, this set-up can only work if it is ruled out that one member state is bailed out by other member states. In the case of the current crisis, this 'no-bailout rule' was violated, mainly because the financial sector was not robust enough and too exposed to government debt to absorb a sovereign insolvency. In order to prevent this from happening again, regulation of the financial sector would have to be changed to make the sector much more robust. This would require, among other things, much stricter capital requirements and changes in the risk rating regulations. Clearly, the risk rating of government bonds could no longer be zero. Banks investing in government debt would have to provide sufficient equity, and they would be required to diversify their government bond holdings. If that can be achieved, an orderly debt restructuring can take place if a member state cannot repay its debt without (big) risks to the financial system.

This would have a number of advantages. Most importantly, financial markets would set better incentives to limit government debt. A key reason for the failure of international capital markets to differentiate sufficiently between member states according to the state of their public finances was that investors could expect that countries would receive help if they faced financial difficulties. The no-bailout rule was not credible, and a sufficiently robust financial sector would restore its credibility.[8]

There are basically two objections to this proposal. Firstly, one can argue that the financial sector will need time to adjust to the new rules. This would suggest that a transitional regime is needed. Such a regime would include a crisis resolution mechanism that could be phased out or reduced in size and scope after a number of years. Secondly, the proposal does not address the concern that a monetary union may need fiscal shock absorbers. However, elements 1–3 discussed in the second section do not include this feature either. It is true that a monetary union without union-wide, fiscal shock absorbers requires low levels of government debt and deficits, so that individual member states have room for expanding government debt if a severe crisis occurs. This suggests that bringing down government debt levels to create more room for national fiscal policy in the event of a downturn could be essential. Again,

[8] See Advisory Board of the German Federal Ministry of Finance (2010).

this will take time. In addition, a large degree of wage and price flexibility is required. Clearly, reforms in labour markets, social insurance systems and other areas are necessary for this.

Conclusion

Given the widespread view that the eurozone can only survive if it is complemented by a fiscal union, we have discussed five possible elements of such a fiscal union. We argue that the concept of fiscal union will only work if political integration goes significantly beyond the current state of affairs, and probably far beyond levels that would currently be supported by European citizens and voters. Clearly, there is a danger that the process of fiscal policy governance in the eurozone remains weak and ineffective, while at the same time joint guarantee for government debt spreads. This could lead to a situation whereby safeguards for responsible fiscal policy-making are undermined.

In this paper we have argued that the eurozone is not doomed without fiscal union. A different approach is possible, which preserves decentralised responsibility for government debt and focuses on the reform of the financial sector. There is no guarantee that this would be enough to make the currency union work smoothly, but the concept of preserving decentralised responsibility for public debt does have the advantage that it does not rely on achieving a degree of political integration in Europe that seems far removed from anything that can realistically be achieved and find democratic support in the near future.

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