

SHOULD EUROPE BECOME A FISCAL UNION?

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Introduction

The European unification process started with the creation of a common market area to allow member countries to benefit from the economic gains of free trade and factor movements in Europe (Keuschnigg and Kohler 1996). A key turning point was the adoption of a single currency to complete the economic unification process by eliminating exchange rate risks within the euro area, creating more liquid and integrated capital markets, and guaranteeing price stability at the European level (Sapir 2011). The current financial and fiscal crisis puts these achievements at risk, has revealed a political conflict over how to deal with the crisis and how to reform the institutions, and may even endanger the continued existence of the euro area. It is important to remember that the economic and monetary unification process was driven by the economic as well as political goals of establishing not only prosperity, but lasting peace in Europe. These fundamental political objectives, however, are not automatically guaranteed by deeper economic integration. Institutions must be reformed in a way that economic integration itself doesn't become a source of new and dangerous political conflict.

Should Europe opt for a fiscal union? The answer requires a consensus on whether Europe should move towards a closer political union and develop into a federal state with substantial fiscal capacity at the central government level. It also depends on whether one expects the creation of a fiscal union to be instrumental in solving the current economic crisis in Europe. The following section analyzes the emergence of the economic and fiscal imbalances that led to the current crisis (see also Keuschnigg 2012). The third section discusses the case for a fiscal union and argues that establishing a fiscal union will not address the key

problems that have led to the current crisis. The final section offers some conclusions.

Economic and fiscal imbalances

Prior to monetary unification, the guiding principle of European unification was the notion of subsidiarity. The subsidiarity principle implies that the power to levy taxes, to spend on public goods and services, and to regulate the behavior of the private sector should be decentralized whenever possible, and remain in the realm of autonomous sovereign countries (CEPR 1994). The introduction of the common currency was a decision to give up independent national monetary policy and to transfer responsibility for price stability to the European Central Bank (ECB). It also eliminated a country's independent exchange rate as a key relative price that could adjust to avoid large trade imbalances and unsustainable international borrowing as a result of divergent wage and productivity growth rates. The smooth operation of a common currency area requires that independent exchange rates are replaced by other adjustment mechanisms. Economic theory lists four such mechanisms (see e.g. De Grauwe 2009; Beetsma and Giuliodori 2010): (i) wage flexibility to realign unit labor costs with international competitiveness; (ii) labor mobility across regions; (iii) central fiscal institutions to provide insurance against asymmetric shocks; and (iv) strict fiscal rules to prevent negative spillovers of national fiscal policy to other member countries.

Divergent competitiveness

Up to very recently, none of the four conditions for an optimal currency area seems to have been fulfilled. Few member countries have reformed *labor market institutions* to allow sufficient wage flexibility that could compensate for the exchange rate as an adjustment mechanism. Due to cultural and language barriers, *labor mobility* across countries tends to be low in Europe and is certainly not happening to an extent that could significantly reduce major differences in unemployment and labor market conditions more generally. There is no central layer of government



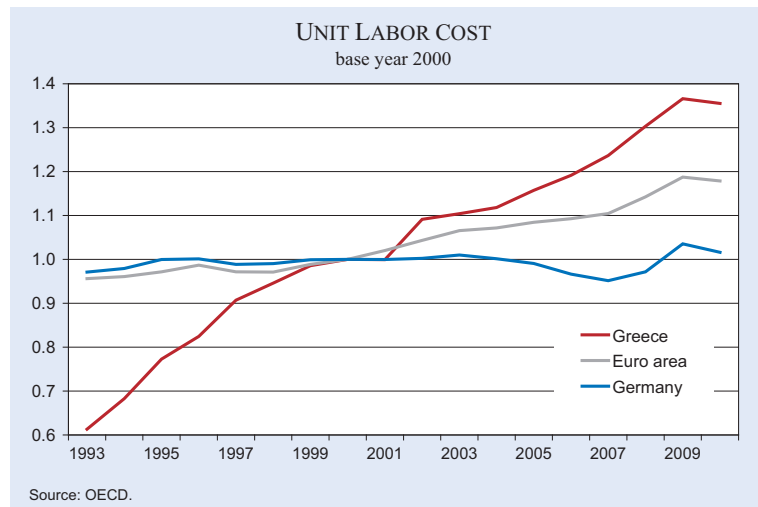
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with a budget that could provide fiscal insurance against asymmetric shocks and thereby dampen regional economic fluctuations. If a US state experiences an income loss of one dollar, about 40 cents are compensated by *fiscal insurance* as that region pays fewer taxes to the central government, but collects more transfers from unemployment insurance and other social programs. The European Union budget is far too small to achieve any similar automatic stabilization. Finally, the *fiscal rules* of the Maastricht treaty, which are meant to limit deficits to 3 percent and debt levels to 60 percent of GDP, have not been credible and have been plainly ineffective in preventing the current sovereign debt crisis in Europe. One must conclude that the consistent violation of those principles led to the current crisis (see, among others, Buiter and Rahbari 2001; Feldstein 2011; Roubini 2011; Sinn and Wollmershäuser 2011).

I believe that the single most important problem is the divergent trend of unit labor costs in Europe, as illustrated in Figure 1. Eventually, this persistent divergence must cause large trade imbalances, leading to accumulation of net foreign debt by weak countries in the southern periphery and net foreign claims by other, more competitive countries such as Germany. These divergent trends have not been corrected by an exchange rate nor a wage adjustment for a long time. For an uncompetitive economy, this implies the need for either an external or an internal devaluation, in both cases making a country's exports cheaper in world markets and imports more expensive, allowing the country to settle on a sustainable path of income growth consistent with national productivity. While Germany went through a prolonged period of wage moderation and painful labor market reform (Hartz reforms), Greece, Portugal, Spain and Italy (Ireland) have increasingly fallen behind. Rigid labor markets and nominal wage stickiness have prevented the requisite adjustment in these economies.

The wage costs per unit of output increase with higher wage rates and decline with productivity gains. When wages increase in line with productivity growth, unit wage costs stay constant. The rising unit wage costs in southern periphery countries are partly

Figure 1



induced by a capital market failure. Figure 2 shows that interest rate differentials in the euro area relative to Germany largely disappeared after the introduction of the euro, eliminating risk premia and inducing a real estate and investment boom in the South. The inflow of capital and low capital costs might have facilitated wage increases not backed by long-lasting productivity gains. When interest rate differentials appeared again in the last two years, a large part of these investments were probably no longer profitable with increased capital costs. The failure of capital markets to price in risk premia and the resulting allocation of capital towards uncompetitive economies is probably itself the consequence of a lack of credible fiscal rules and represents regulatory failure in Europe.

The Maastricht criteria were not effectively imposed and lacked credibility right from the beginning. Capital markets also seemed to conclude that the no-bailout rule would not hold up in a crisis since bankruptcy of a highly indebted member country would be perceived by the Union to be even more costly (this way, high debt creates a negative externality on other countries). Given this belief, banks and other investors must have expected to always get their money back, making government debt an apparently very safe investment. Under these circumstances, there was no need to include a risk premium, which would have increased interest costs in southern countries in the EU and could have helped to impose market discipline and to restrain the tendency towards excessive debt financing.

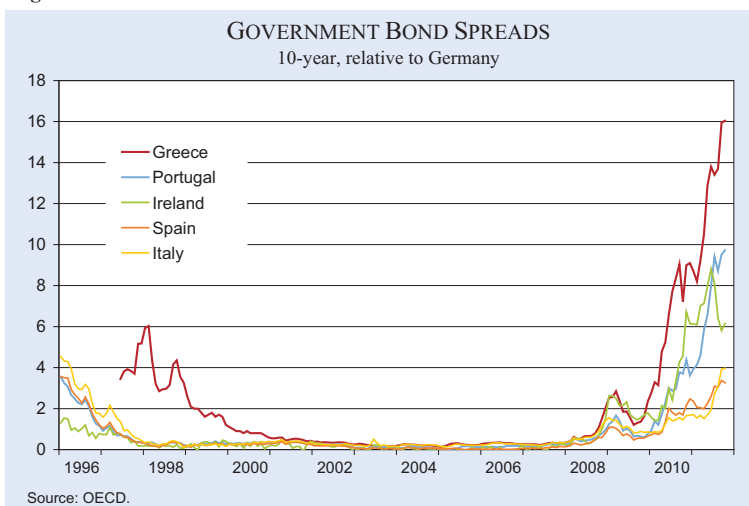
The second regulatory failure that probably contributed to the current debt crisis is that equity capital

standards for European banks were, and still are, too low which creates systemic risk. The weak capitalization of banks makes them vulnerable to economic shocks and raises the probability of bank failures. Given the inter-linkages and mutual lending in the banking sector, failure of one bank threatens the survival of others (a negative externality) and forces the latter to cut back lending to the private sector, which may trigger a sharp recession, or even a systemic crisis if other banks were to be pushed into bankruptcy too. Since a country conceivably cannot risk such a hugely costly course of events, it will always have to bail out distressed banks. If (systemically important) banks can expect an implicit state guarantee, they have easy access to cheap and apparently safe funds, which creates strong incentives to engage in risky lending and other risky investments. Such a strategy generates very high profits in good times, while large losses in bad times can be covered up by the tax payer (a negative externality). The implicit guarantee to the banking sector thus facilitates aggressive lending to risky countries and businesses and probably has made a significant to excessive lending to the private sector and governments in the southern European periphery. Higher minimum equity ratios of banks are essential to internalize the social costs of risky bank lending. They would make banks more hesitant to engage in risky lending, and more careful to evaluate credit risk and correctly assess the required risk premium. Higher equity standards thereby become a precondition for imposing market discipline on excessive deficit financing by financially weak governments and firms. They make banks more able to withstand negative shocks and reduce systemic risks. In making them safer, higher equity ratios should also reduce banks' costs of refinancing on the capital market and should

not contribute to higher credit costs to the private sector on average. They only eliminate those risky investments that are no longer profitable when the risk of failure is correctly reflected in the interest cost. Such investments, however, should not have been financed in the first place.

To sum up, the key problem to be addressed is the divergent competitiveness of European economies, resulting in balance of payment problems and large imbalances in international lending and borrowing. The euro is too strong for the less productive countries in the South and too weak for highly productive countries such as Germany. Even in the absence of fiscal debt, increasing net foreign debt of uncompetitive economies arises when the private sector overborrows compared to its capacity to generate wage income and profits. Clearly, if both the exchange rate and domestic wages do not adjust, the missing price mechanism leads to accumulating foreign debt, independent of public sector deficits. In part, the euro may actually create and exacerbate fiscal imbalances. Since the euro is too strong for low productivity economies, structural unemployment becomes very high and profits remain persistently low, making firms very vulnerable to adverse shocks. Unemployment inflates social spending and reduces wage tax revenue, low profits further reduce tax revenue and lead to high rates of business failure, which may cause further fiscal demands on the public sector to recapitalize banks or important private sector firms. The developments in Spain and Ireland, where fiscal debt was not excessively high prior to the crisis, seem to be in line with these arguments. Clearly, low growth and recessions are not conducive to healthy government finances.

Figure 2



Negative externalities

Negative spillovers affecting other member countries arise if a country accumulates unsustainable fiscal and private sector debt, and could occur in several ways, including (i) fiscal bailouts or sovereign default, (ii) contagion *via* financial markets, and (iii) inflation and/or high interest rates. The first and most obvious negative externality arises if other member countries are more or less forced to bail out an illiquid country to prevent the nega-

tive consequences of uncontrolled sovereign default. Large transfers and a redistribution of resources may be required to prevent default. If default occurs, wealth is lost in other countries since, in an integrated capital market, national debt is held by investors or banks in the entire union.

This leads to the second externality, i.e. contagion of other countries *via* financial markets. Anticipating the risk of default, investors demand a risk premium on newly issued debt, and the value of outstanding debt declines to reflect the higher yield due to increased risk. The devaluation of fiscal debt, triggered by unsustainable fiscal policies, destroys large amounts of wealth in other countries, be it with banks, insurance companies, pension funds and private investors. If banks are weakly capitalized, as is a main problem in Europe, other member countries may ultimately be forced to invest substantial public funds to recapitalize systemically important banks or to protect other investors, at the taxpayers' cost. In the worst case, when these countries themselves become increasingly exposed to fiscal risk, investors and rating agencies will have to reassess their sovereign risk as well, leading to higher costs of government financing.

Finally, depending on the nature of common monetary policy, the tendency for debt financing may affect other countries in terms of higher inflation or higher interest rates. The inflation tax devalues the real value of savings and financial wealth, as well as that of private and public debt in all member countries, and thereby redistributes in an uncontrolled way from savers towards debtors. To prevent inflation, the ECB is committed to price stability and is not allowed to engage in government debt financing. Alternatively, given a non-accommodating monetary policy, excessive debt may contribute to a higher interest rate in a common capital market, thereby restricting investment and growth in the entire union.

An externality distorts economic behavior. From the perspective of the entire union, the presence of negative externalities arising from high fiscal debt means that individual member countries do not fully internalize all economic costs and might rely excessively on deficit financing. Moral hazard implies that member countries will not be able to fully exploit the gains from European unification. To realize the full gains, moral hazard must be contained and external costs must be effectively internalized. This can be achieved by market forces, fiscal rules and banking regulation. In a well functioning capital market, interest rates

should include a risk premium that accounts for sovereign default risk. The prospect of rising interest costs imposes market discipline on individual member countries and helps to restrain deficit financing. The institutional solution, as enshrined in the Maastricht Treaty, implements fiscal rules that restrict the admissible deficit and debt levels, and punishes countries for exceeding these thresholds. Higher equity standards and tighter regulation of banks can significantly reduce the risk of contagion through a weakly capitalized banking sector.

Coordination failures

The sovereign risk premium serves a key purpose, namely to impose market discipline on government debt financing. It reflects investors' perception of a country's bankruptcy risk, the risk of not getting back a large part of one's money in case of a haircut, as in Greece. Banks and investors, possibly supported by the analysis of rating agencies, must judge a country's ability to service and pay back debt in full when it is due. The risk premium is a forward looking concept that reflects a country's future fiscal capacity. It depends on the strength of tax revenues, which itself is a function of a country's growth potential. It reflects unfunded pension obligations that entitle workers to pension benefits in exchange for contributions and are a promise no more or less than the promise given to investors to pay back government debt with interest. The risk premium also reflects other expenditure risk like the need to recapitalize banks under adverse economic conditions, or the need to fulfill the guarantees that are given to fend off the fiscal crises and sovereign bankruptcy in other countries. Finally, and very importantly, the risk premium reflects the perceived interest rate risk of a highly indebted country.

The risk premium thus reflects the investors' forecast of future fiscal capacity and risk of sovereign default. Obviously, it depends on informed judgments and expectations. In case of highly indebted countries, these expectations often depend on volatile investor sentiment and can realistically turn into self-fulfilling prophecies. Suppose a highly indebted country has accumulated debt in the expectation of historically low interest rates on safe government debt of, say 3 percent, and suppose the budget is balanced to keep debt from growing further. At this rate, the share of interest spending in total expenditure is reasonably manageable. If a recession comes or another unforeseen expenditure shock arrives, the budget runs into deficit and the country may experi-

ence a liquidity problem. If investors become more pessimistic, they might start to anticipate problems with the country's solvency and upwardly revise the country's risk premium. As debt is rolled over and an increasingly larger share must be refinanced at high interest rates (say 6 percent), more and more of the budget must be reserved for interest payments, leading to a further deterioration in the country's fiscal position and an even larger risk of default. As interest rates rise even more (see Figure 2) and expenditure for debt service explodes, the country maybe effectively be pushed into default. The key point is that a highly indebted country with a liquidity problem would still be solvent and could pay back debt at normal interest rates of 3 percent, but is insolvent and must default when interest rates rise to levels of 10 percent and more. Expectations are self-fulfilling. When investors are optimistic and believe in solvency, they expect to get their money back and can do at a safe interest rate of 3 percent. At that kind of interest rate, the country is solvent. When investors are pessimistic, they expect to lose their money with a high probability and can lend only at a very high interest rate to compensate for the risk of default. At the higher rate, the country is insolvent and must default. Volatile expectations can cause large welfare losses as market expectations 'coordinate' on a bad equilibrium (see e.g. De Grauwe 2011).

Sovereign risk premia are important to impose market discipline on governments. It is equally important that they are not driven by volatile expectations on the part of nervous investors, which may end up in excessive interest costs for countries that face a liquidity problem, but are still solvent at normal interest rates. There are arguably three ways to prevent coordination on a bad equilibrium with sovereign default, which all involve some form of limited guarantee. The first and crudest way is to require the *ECB* to give an implicit guarantee by purchasing government debt to stabilize the market and prevent interest rates from rising above a maximum level. In keeping interest rates low, it helps highly indebted countries to stay solvent, but does nothing to improve incentives for responsible fiscal behavior, and may even lead countries to relax and further postpone consolidation efforts. It is criticized as being incompatible with the *ECB*'s task of price stability and not financing government debt. The second is the creation of *Eurobonds* that are jointly guaranteed by euro area member countries and would be rated as very safe. In their crudest form, they would be available to all euro area countries at the same interest rate, which would be higher for fiscally strong and

lower for weak countries, thereby redistributing from strong to weak countries. More refined versions such as Muellbauer (2011) would essentially combine this with administered risk premia, set by an independent Union agency, where revenues could also be used to compensate tax payers in strong countries to compensate for extending the guarantee to weak countries. This would reward fiscally responsible behavior and make excessive debt financing more expensive. The responsibility to push through structural reform to strengthen the fiscal capacity would remain with the commission or other institutions. The third way to address a bad equilibrium with distressed countries risking default are *public lending institutions* such as the European Financial Stability Facility (EFSF) and its follow up institution, the European Stabilization Mechanism (ESM), and the International Monetary Fund (IMF).

When a country is shut off the capital market, it may obtain 'conditional' lending *via* the ESM (in the following, ESM also refers to EFSF as well) in collaboration with IMF and the European Commission. A member country can get lending from the ESM only if it accepts strict surveillance and implements a tight restructuring program to restore competitiveness, growth and fiscal solvency (Gros and Mayer 2010, suggested a 'European Monetary Fund'). Since *conditional* ESM lending implies a considerable loss of national sovereignty, a country applies only if financing on the capital market is no longer possible at acceptable interest rates. The ability to impose a painful restructuring program makes ESM lending different from other sources of funds, and allows for the refinancing of distressed countries even when normal banks cannot lend any more. The conditionality is also the key difference to the *ECB* buying government bonds to stabilize markets. In this case, the responsibility to push through painful adjustments to restore growth and fiscal sustainability rests with other institutions. The key advantage of ESM lending is that refinancing cannot happen without an adjustment program, i.e. refinancing and structural reform are tightly connected and surveyed by the same institution. In this respect, the creation of a powerful ESM fund valuably complements existing institutions to support convergence, such as fiscal rules, coordination and surveillance of economic policy, and the limited investments by the commission's structural funds. If these institutions fail to prevent divergent competitiveness in Europe, a tight restructuring and adjustment program under ESM lending may force such adjustment *ex post*.

The key question remains whether the ESM is endowed with enough financial capacity and guarantees from the member states to be able to handle a speculative attack on government bonds by large member countries such as Italy and Spain. If this happens, very fast policy action and large amounts of financial resources are required. Under normal conditions, the ESM should be able to refinance itself on the capital market at low rates, reflecting a triple A rating thanks to the paid in capital and additional guarantees of the euro area member states. The credibility of this arrangement seems to be doubtful as large member states have already been downgraded recently. In the event of a sudden systemic crisis, the ESM might not be able to raise enough funds in short order to support large countries. One option would be to endow the ESM with a banking license, allowing the required refinancing with the ECB. Such refinancing could be limited to well specified and exceptional conditions, and would not be possible under a more normal course of events. Even if such refinancing occurs, it would not be possible unconditionally, but could only happen when the country subjects itself to an ESM program for tight structural adjustment.

A fiscal union for Europe?

Should Europe become a federal fiscal union with a central government with own taxes and a substantial fiscal budget? One can approach this question from at least three perspectives. Firstly, independent of the current crisis, one may discuss the economic arguments in favor of centralization or decentralization of different functions of government in a federal state, and how many and which countries should be members of the union. Secondly, there are important arguments beyond narrow economic considerations in favor of or against a closer political union such as establishing peace in Europe or enhancing Europe's influence in world politics. And thirdly, one can ask whether moving towards a fiscal union is a way out of the current crisis and can provide the required conditions for the smooth operation of the economic and monetary union.

In a federal state, some important advantages speak in favor of centralization (see Oates 1999 or CEPR 1994 on vertical assignment of government functions; Bordo *et al.* 2011 and Henning and Kessler 2012, for an account of US history). When there are important spillovers from local government activity, centralization can improve policy outcomes by internalizing

spillovers. Most evidently, public goods with community wide benefits should be centralized to exploit economies of scale. If labor mobility is very high, redistribution and income protection might be more effective at the central level. The argument is that the tax benefit system attracts welfare recipients and alienates tax payers, which puts fiscal pressure on individual governments and might lead to a 'race to the bottom'.¹ Centralization also facilitates decision making and policy coordination, especially when a large number of national decision makers with diverse interests have to come to an agreement, or if the joint benefit of common policies yields different distributional results across regions. Policy coordination and spillovers call for centralization of macroeconomic stabilization. If macroeconomic fluctuations are statistically independent or at least imperfectly correlated across regions, the community can stand to gain significantly from insurance against asymmetric shocks.

There are important arguments in favor of decentralization. Local governments are closer to citizens and are thus democratically more accountable. They tend to be better informed about local affairs so that decentralized policies are much better aligned with local economic conditions and preferences. Decentralization also leads to more experimentation in policy making and favors political innovation, which may be imitated by other regions. The experience of more innovative governments provides valuable insights into the effectiveness of new policies and sets benchmarks for good policy-making. Decentralization leads to fiscal competition that might not be seen as a race to the bottom, but rather as a welcome discipline for the excessive growth of government that might arise from adverse incentives in the political process. The EU once adopted the principle of subsidiarity which, by default, argues in favor of decentralization. Member states should be fully sovereign over fiscal policy. Fiscal rules such as the Maastricht Treaty or the new fiscal compact will prevent negative spillovers to other countries. While fiscal policy remains under national sovereignty, member countries have ceded considerable regulatory power to establish common goods markets and protect the free movement of capital and labor in Europe.

A key question is whether a fiscal union could make Europe more of a common currency area, provide

¹ Labor mobility is certainly much higher within homogeneous member states, but is traditionally low across culturally diverse European countries. Hence, the argument seems to favor centralization of redistribution at the national, but not at the union level.

effective automatic stabilization of the economy, and help to prevent a repetition of the current crisis.² To discuss this matter, it is useful to distinguish between the concepts of a fiscal union and a transfer union. A *transfer union* leads to systematic and long-lasting income transfers and redistribution across different regions such as in Germany after unification, which are both presumably intended to narrow down the differences in income and welfare levels. Such transfers currently occur in limited amounts in terms of EU spending on structural funds, which provide co-financing of national infrastructure and other investments to make economically backward regions more competitive. How much they contribute to effective economic convergence is subject to debate. Large and persistent transfers, especially for consumptive purposes, may create substantial political tensions and frictions among culturally heterogeneous regions. Donor countries resent the fiscal cost of net contributions, while net recipients resent the conditions and foreign influence that usually comes with such transfers. Even within more homogeneous nation states, interregional redistribution as part of fiscal equalization schemes is often hotly disputed and sometimes creates political forces for separation (the Italian North-South divide, Belgium, or the separation of Czechia and Slovakia). There are serious doubts as to whether a large scale transfer union could be politically sustained in Europe.

A *fiscal union*, in contrast, is set up to provide fiscal insurance to smooth income fluctuations over time and across regions. Insurance means that transfers are transitory and unsystematic. Suppose that unemployment insurance were to be centralized with uniform benefit rules and contribution rates in all member countries such that the central budget would be balanced as long as unemployment rates do not deviate from trend levels. When the economy moves into recession, the system runs into deficits that are reversed in subsequent boom periods. Such an insurance system would smooth income fluctuations *over time* and provide important automatic stabilization, provided that the insurance system is endowed with an effective debt brake. There must be an automatic increase in contribution rates or a tightening of benefit rules to repay debt incurred after a recession. Unemployment insurance at the

European level could also smooth income fluctuations *across regions*. When Germany is in a boom and France experiences a recession, the average unemployment rate may just be ‘normal’. The system then sends a net transfer from Germany to France without there being a deficit or surplus in the central budget. Contributions exceed benefits in Germany, but the surplus just offsets the deficit in France. If the economic situation is subsequently reversed, the net transfer flows into the other direction. This way, a fiscal union can dampen regional fluctuations and automatically stabilize the economy without there being a systematic and sustained transfer across countries.

The precondition for a fiscal union is that unemployment risk is independent and fluctuations are uncorrelated across regions and over time. If countries have structurally different unemployment rates, the system will again lead to systematic cross-subsidization and redistribution, as is the case in any system that provides uniform insurance of good and bad risks. Systematic cross-subsidization within an insurance system may be politically as unacceptable as open income transfers and redistribution across countries with very different cultures. Even worse, when the fiscal union degenerates into a transfer union, it contributes to moral hazard and may slow down the reform effort. Cross-subsidization implies that the cost of high unemployment is partly paid by others and diminishes a country’s incentive to actively fight structural unemployment by forcing greater wage flexibility and implementing other painful labor market reform. To avoid this, contribution rates and benefit rules would have to be adjusted to account for country specific unemployment risk. The system would need to specify a much less attractive tax benefit ratio for Spain, Greece, Italy and also France while the package could be more attractive for Austria, Netherlands and Germany.

The key problem in a currency union is that exchange rate adjustments must be replaced by wage adjustment to offset different productivity growth and divergent international competitiveness. While a fiscal union may be able to insure part of the unsystematic fluctuations across regions, it will not help to eliminate sustained income and employment differentials, and may, in fact, even aggravate the problem by reducing incentives for implementing painful labor market reform. It does nothing to offset the tendency towards balance of payment imbalances and the accumulation of foreign debt on the part of weak and uncompeti-

² Marzinotto *et al.* (2011) suggest the creation of an EU finance ministry to supervise fiscal policy and assess liquidity and insolvency of member countries. It would have veto rights over national budgets and a taxing capacity of maybe 2 percent of GDP to be activated in the event of crisis. They also recommend tighter regulation and supervision of financial institutions and the creation of a euro area deposit insurance system for banks.

tive countries. Expanding the scale of structural fund spending and concentrating it more on weak countries could, in principle, help the latter catch up and become more competitive. If not complemented by wage moderation, countries such as Greece tend to find it difficult to fully absorb structural funds and translate them into productivity-increasing investments. Experience to date with structural funding has been rather mixed and it takes far too long to have a significant impact.

If a fiscal union is excluded and automatic stabilization cannot happen *via* a central budget, there must be sufficient flexibility at the national level. To dampen short-run fluctuations, automatic stabilizers must be effective *somewhere*, at the central or de-central level. Effectively limiting deficits to 0.5 percent of GDP permanently as part of the new fiscal compact may be too strict. If deficits are not allowed to fluctuate enough, member countries might end up with sharper recessions. In my view, fiscal rules in Europe should achieve two conceptually different tasks. Firstly, they must ensure a reduction of fiscal debt over a prolonged period to a low target level of 60 percent or less, a level that is realistically safe to keep risk-premia and interest costs low. However, debt ratios should not be reduced to zero if deficits are strictly and permanently limited to 0.5 percent of GDP, as this would amount in many countries to a huge program of intergenerational redistribution. Secondly, they must guarantee an effective debt brake that allows debt to GDP ratios to fluctuate at around this target level so that fiscal systems can be effective automatic stabilizers. However, as a legacy of past fiscal irresponsibility, the stabilization function is probably impaired in the first adjustment period. To bring down debt ratios in the union, the bias towards deficits must be turned into a bias towards surpluses, allowing for deficits only in very exceptional circumstances and in limited amounts.

Conclusions

Moving towards a fiscal union does not address the fundamental problems of divergence in Europe. Given the large cultural heterogeneity and diverse preferences over the size and scope of government activities, fiscal policy should remain in the realm of national sovereignty, while important regulatory power is assigned to the European Commission. Although several different scenarios seem possible, I believe that current institutional developments and

further reform will result in a better functioning of the euro currency area. Key developments are: (i) more credible fiscal rules to prevent negative spillovers to other member countries, combined with tighter fiscal and economic surveillance; (ii) more market discipline by a better capitalized and more prudent banking sector with sovereign risk-premia differentiated according to fiscal stance and economic competitiveness; (iii) ESM lending to member countries with liquidity problems subject to strict conditionality. Lending under an ESM program is coupled with painful adjustment programs and will, *ex post*, impose those reforms to restore competitiveness and fiscal capacity that were neglected *ex ante*. Restructuring and tight surveillance under an ESM program should significantly reduce the risk of a speculative attack and the forced default of a distressed member country.

These developments should be complemented by further reform: (i) by strengthening the financial capacity and institutional independence of the ESM, maybe elevating it to a status similar to that of the ECB or the IMF. The mission of the ESM is to provide conditional lending to distressed member countries coupled with tight surveillance of adjustment programs; (ii) tighter regulation and more ambitious recapitalization of the European banking sector. Higher equity standards will make banks more robust and reduce cross country contagion in an integrated capital market. They are also a precondition for more prudent lending and for banks to better exercise the required market discipline; (iii) revising the fiscal compact. After a transition towards low target levels of public debt, the debt brakes must allow for sufficient flexibility, so that automatic stabilizers can dampen short-run fluctuations.

Recent developments and further reform could internalize a large part of negative spillovers of irresponsible fiscal and economic behavior to other member countries. In a union with very heterogeneous cultural values and preferences, large scale transfers and interregional redistribution are likely to be a constant source of political tensions, quite in conflict with the political goals of establishing peace and harmony in Europe as a result of economic unification. By contrast, economic and institutional reform as suggested above should prevent, or at least significantly reduce the negative consequences of national decisions on other member countries, and would be more in line with the political goals of European leaders.

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