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Pathways to achieve a Genuine Fiscal Union

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BACKGROUND

Since July 2012, financial-market pressure on the euro has eased, thanks to the European Central Bank's (ECB) commitment to do, in the words of President Mario Draghi, "whatever it takes" to save the single currency. But the euro area is still in a precarious condition which cannot be resolved, *in ultima ratio*, by the ECB's action: the aftermath of the Cypriot bailout shows that Europe is still facing a structural crisis.

While the financial crisis originated in the US through an excess of deregulation in financial markets, it acquired a truly European nature in 2010, when the survival of the single currency began to be questioned. Today, the euro area continues to face an *endogenous* crisis (generated by shortcomings in the design of the euro area) and fuelled by the macroeconomic imbalances that have emerged since the establishment of the single currency. These can only be addressed by structural reform of EU instruments and institutions.

Many now contend that some degree of fiscal integration is necessary to overcome the euro area's structural problems. To fulfill this role, any form of fiscal union must accomplish, regardless of its institutional shape, two basic *functions*: preventing the emergence of endogenous asymmetric crises[1], and correcting acute economic and fiscal crises.

To fulfill its 'preventative' function, a genuine fiscal union must have two kinds of mechanism: a credible system to coordinate economic policies (particularly in the field of employment) and fiscal rules to prevent governments from spending beyond sustainable limits.

To accomplish its 'corrective' function, there must be (i) a mechanism to support member states in the implementation of structural reforms by providing financial support, (ii) some form of fiscal rules to lend credibility to government claims of paying back debts, and (iii) instruments to promote economic growth where and whenever necessary.

STATE OF PLAY

So far, five building blocks have been created to reinforce the governance framework: the 'Six Pack', including five regulations and one directive (designed to strengthen the Stability and Growth Pact); the Fiscal Compact, a new treaty aiming to reinforce euro-area budgetary discipline; the 'Two Pack', two regulations designed to underpin the Six Pack; the European Stability Mechanism, providing a permanent financial rescue mechanism; and initial pieces of legislation regarding the creation of a banking union. There is widespread commitment among euro-area leaders to progress further, creating – in the medium term – a so-called 'Genuine Economic and Monetary Union' (GEMU).

But do these innovations deliver the two essential functions required for a fiscal union? And if not, what more needs to be done in the short and medium run?

Assessment of the preventative function: fiscal rules, policy coordination and imbalances

European fiscal rules are currently based on the **Stability and Growth Pact (SGP)** and the Fiscal Compact. With the Six Pack, the SGP has become stricter and more enforceable – and a new set of sanctions and new rules to deliver them have been introduced.

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However, such fiscal rules might not be credible if they deepen economic recession in crisis countries. Where they work effectively, for example in the US, pro-cyclical fiscal rules are complemented by counter-cyclical expenditure flows, aiming to offset some of the negative effects on individual states' economies. With the SGP, a similar function could be achieved with a counter-cyclical 'fiscal capacity' at European level. Even if the introduction of a fiscal capacity is now included in some official proposals aiming to further enhance EMU governance[2], its proposed functions, as well as its likely size, seem to be inadequate to deliver this counterbalancing function.

The second innovative instrument introduced with the Six Pack is the so-called **'European Semester'** (ES): a system of enhanced national economic policy coordination. The ES is built on the Annual Growth Survey (AGS), a strategic document on economic policy published by the European Commission at the beginning of each budgetary year, and on a process of coordination of national policies based on country-specific recommendations. The ES is complemented by a second package of legislation, the so-called **'Two Pack'**. The Two Pack gives the Commission the power to deliver recommendations on national budgetary laws, which must be submitted to the EU executive according to a common time schedule.

However, the implementation of reforms at national level still depends on the willingness of national governments and their parliaments to carry them out. This implies that member states, in most cases, pursue necessary (and often unpopular) reforms only in cases of extreme financial distress, when no other choice is possible. It would be more beneficial to have a mechanism to induce reforms in member states when imbalances are detected, before the critical phase of the crisis.

Ongoing discussions about the so-called 'fiscal capacity' (or 'solidarity mechanism') are mostly related to this shortcoming: following the political agreement of 29 June 2012, some kind of financial support might be provided to member states implementing recommendations agreed in the framework of the European Semester. The Commission announced on 20 March 2013 that it will propose such a financial instrument to support agreed reforms in member states. This development might be positive if the available resources are sufficient and if the conditionality attached to the agreed reforms is economically justified. In this regard, a better democratic legitimacy mechanism will be needed for the ES, provided that additional financial resources are made available.

The third innovation introduced by the Six Pack is the **Macroeconomic Imbalances Procedure**, which aims to prevent the emergence of serious imbalances within the euro area and individual member states. Even if the mechanism provides limited incentives to avoid excessive imbalances, some of them – for example excessive intra-euro area current account surpluses or deficits – are typically a matter of coordination, and often arise following unilateral reforms enhancing asymmetrically the competitiveness of one member state relative to others. Effective *ex-ante* coordination, more than *ex-post* sanctioning, is what matters when dealing with potential macroeconomic imbalances; the excessive imbalance procedure may therefore complement *effective* policy coordination across the EU, but by itself it is insufficient.

Assessment of the corrective function: the European Stability Mechanism and the new role of the ECB

While there has been some progress in terms of preventing future crises, the euro area still lacks a proper tool to pursue macroeconomic stabilisation in the event of asymmetric shocks. The only instrument introduced so far is the European Stability Mechanism (ESM), which provides finance to member states having difficulty funding their spending through the financial markets: provided that they accept the conditionality attached to ESM support and are ready to give up substantial sovereignty on fiscal issues and policy design.

This mechanism has three major shortcomings: first, the intergovernmental nature of the contributions to its funding implies that national parliaments could acquire veto rights on aid disbursements to partner countries, undermining the credibility of the mechanism, as a level of uncertainty remains. Second, the limitations imposed on a country's sovereignty have proven to be so severe that member states do not ask for help until in desperate need, wasting the opportunity to deal with problems when they first emerge. Thus there is a risk that the ESM, which can intervene only when there is no other alternative and via adjustment programmes painful for populations, will be perceived as lacking in democratic legitimacy in the affected countries. Third, the size of the fund is limited, raising concerns over its capability to bail out large countries like Spain or Italy.

Finally, there is the new role for the ECB. Under Mario Draghi's leadership, the ECB has already played an essential role, buying time by calming financial markets. Now the Bank is becoming the institutional cornerstone of a European Banking Union. But the contribution of the Banking Union to euro-area stability is limited by its current design. The goal of a banking union is to break the vicious circle between distressed banking systems and sovereign finances. To achieve this, banking unions usually have three elements: supervision powers, resolution powers and a deposit guarantee. In the European case, however, only the first two are being discussed. The final element, the joint deposit guarantee, which would have prevented a substantial proportion of capital outflows from peripheral countries (stabilising banks and reducing the need for support) is not on the table at the moment, depriving the European Banking Union of an essential facility. The weakness of the Banking Union measures being discussed at the moment was evident during the Cyprus crisis, when a full-fledged banking union could have prevented capital flight from the country: thus avoiding the re-introduction of capital controls, which have distanced the isle from the rest of the Monetary Union.

PROSPECTS

Addressing the euro area's structural shortcomings: the way forward

These reforms represent a concrete step towards creating a sustainable monetary union. In terms of *prevention*, significant steps have been taken, but the euro area still lacks a genuine and enforceable mechanism of policy coordination, as well as a fiscal capacity that provides positive incentives for reform before a crisis spreads and that is able to make counter-cyclical investments that lend credibility to national fiscal rules. In terms of *correction*, the main instrument, the ESM, is lacking in several respects: there is a lack of democratic legitimacy in programme countries, an excessive dependency on national parliaments' decisions, and a lack of credibility for troubled countries, as well as a lack of sufficient firepower to deal with bigger countries.

Some steps could be taken immediately to address these problems and boost stability and growth in the euro area:

Firstly, an agreement must be reached over the **role of the European Parliament** in legitimising the Commission's recommendations and shaping the AGS.

Secondly, euro countries should fully implement the third point of the euro-area agreement of 29 June 2012, creating a **mechanism to deliver positive financial incentives** from the ESM to countries respecting the Country-Specific Recommendations agreed under the ES process.

Thirdly, the **ESM should be reinforced with its own system of 'own resources'** (for example, building on the Financial Transaction Tax) to ensure that its size can be adapted over time to emerging challenges. In this framework, the European Parliament should acquire a role in providing a democratic backstop to EU decisions.

In the medium term, further action is needed to create a **Genuine Fiscal Union**, to address such fundamental problems as democratic legitimacy, coherence and accessibility for EU citizens, as well as adding further elements of strength to prevent a similar crisis from destabilising Europe again.

A genuine fiscal union should build on the foundations of fiscal and policy coordination facilities created during the crisis, reinforcing their democratic legitimacy and complementing them with additional instruments, rather than creating a completely different model.

In the medium term, such a Genuine Fiscal Union could have three main pillars to deliver the preventative and corrective functions:

A reformed EU budget[3] with a degree of fiscal sovereignty for the EU institutions. This implies three elements: an own-resource system based on (limited) tax-raising powers; flexible spending power in areas of EU competence; and the power to make localised investments to offset, when required, negative pro-cyclical consequences of fiscal rules. Such a system of own resources would provide a backstop to issue Union Bonds[4], which could leverage the EU's investment capacity.

The functions of the EU budget would be threefold: firstly, it would continue to deal with existing supranational policies. Secondly, it would deal with emergency cases, providing financing to member states in financial difficulty under strict conditionality (with the funding and functions inherited from the ESM, now merged into the EU budget). Thirdly, it would provide an investment vehicle to sustain the real economy of countries adjusting their fiscal balance. Euro-area budgetary support should be subject to democratic scrutiny at EU level through the European Parliament, with the Commission accountable to Parliament for discretionary expenditure.

In terms of resources, these operations could be financed with Union bonds backed by the EU's new fiscal powers: this would substantially boost the link with own resources (and therefore legitimacy) while postponing the financing needs of the adjustment to the future, *after* the rebalancing process, reducing the actual financial burden on today's lending countries. This solution would be attractive both for lending countries, which would pay less for euro-area adjustment, and for crisis countries, which would enjoy financial support for reforms that they had already committed to implementing.

A Joint Budgetary Procedure: The second pillar would include the functions of budgetary and policy coordination managed today under the ES and the Two Pack. The Joint Budgetary Procedure would be negotiated through a reiterative process between national governments and parliaments and the EU institutions. Parliaments would retain power over their part of the spending and would be incentivised to follow the EU framework by having a guarantee underpinning at EU level the part of their spending agreed with their partners.

This procedure gives all member states a clear incentive to comply: firstly, effective coordination would free up resources for use in national budgets. Secondly, it would be politically difficult for non-cooperating countries to obtain resources from the EU budget. Finally, lack of cooperation would imply participating in guaranteeing other countries' debt without enjoying the same protection – which could meet with political opposition from national constituencies.

A 'super-commissioner' elected by the European Parliament would have the power to veto implementing budgets if they differ from the Joint Budget Agreement. A joint guarantee from member states might be available for debt emitted in order to achieve the agreed level of expenditure, while no guarantee would be available for debt emitted to finance budgets vetoed by the Commission but still pursued at member-state level.

National budgets: In this proposed model of fiscal union, member states would autonomously pursue their own aims and would finance their sovereign budgets independently for any kind of expenditure that is not a source of systemic risk. No joint guarantee on debt emission would apply for this national expenditure. The only constraint would be the SGP, applied to the national budget in its totality. Surpluses or balanced budgets under the second pillar would free up resources for non-systemic expenditure, creating a sustainable dynamic; deficits under the second pillar would not create systemic risks but would impose restrictions on national budgets.

In the event of heavy financial distress at national level, the EU budget and the ESM might provide, under strict conditionality, temporary financial support for sovereign budgets.

The threefold model of fiscal union has its advantages: it addresses the shortcomings of the euro area's design, prevents long-term mutualisation of historical debt stocks (a politically and economically tricky issue), and creates strong policy coordination in many sectors where EU added value could be the foundation of a European renaissance.

There are, of course, other models of how to complete fiscal union; most of them, however, fail to take into account both the needs and interests of surplus and deficit countries. They lack the element of 'great bargaining' that would ensure the compliance of all member states. Whatever route is chosen, the creation of a genuine fiscal union must be a political priority for euro-area countries. Any delay or eventual failure to proceed with fiscal integration would leave the shortcomings of EMU unaddressed, leading to the reemergence of the crisis once the effect of the ECB's monetary interventions inevitably wanes.

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1. An *asymmetric* crisis occurs when two countries are hit by the same phenomenon in opposite ways: for example, falling GDP in the first country and increasing GDP in the second country at the same time. Such crises are particularly dangerous for monetary unions, because neither monetary policy nor exchange rates can act as tools for adjustment.
2. The 'four presidents' report and the European Commission's 'Blueprint'.
3. In the long run, all member states except the UK and Denmark are committed to participating in the Monetary Union. However, it is unclear whether all of these countries will indeed join the euro area. If they do not, the creation of a single Union Budget might be problematic, and specific solutions for the euro area would be needed.
4. Union bonds, in contrast to Eurobonds, are not a form of mutualisation of historical national debt: they represent an instrument to pursue new forward-looking joint expenditure.

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