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ARTICLE



What are the prerequisites for a euro area fiscal capacity?

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ABSTRACT

This paper discusses a pathway towards achieving fiscal union in the euro area. It outlines three steps and their prerequisites. In the first step, Banking Union would be completed to increase the financial stability of the euro area. It would render the “no bailout” clause more credible and thereby allow to deal better with insolvent governments. In the second step, more centralised funds would be created in order to provide important public goods and in order to deal with large asymmetric shocks. The third step, which is currently unattainable, consists of a true federalisation of important government functions.

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Policy Highlights

This paper discusses a pathway towards achieving fiscal union in the euro area. It outlines three steps. In the first step, Banking Union would be completed to increase the financial stability of the euro area. It would render the “no bailout” clause more credible and thereby allow to deal better with insolvent governments. In the second step, more centralised funds would be created in order to provide important public goods and in order to deal with large asymmetric shocks. The third step, which is currently unattainable, consists of a true federalisation of important government functions. The following policy recommendations can be considered prerequisites for achieving the various steps.

- (1) Address the remaining non-performing loans and reduce the exposure of banks to sovereign debt while introducing and gradually increasing European deposit insurance. Increase the legitimacy and accountability of European decision-making in resolution cases when fiscal resources are needed.
- (2) Improve resilience of national economies to shocks with appropriate structural reforms. Improve European checks and balances for the additional European funds.
- (3) The last step is only sensible with a very different degree of political cohesion and a huge change in the existing real economic differences. It can therefore be shelved for now as a long-term analytical benchmark.

1. Introduction

The debate on what kind of fiscal union is needed for Europe’s monetary union dates back to before the start of Economic and Monetary Union (EMU) (Commission of the European

Communities 1977; Eichengreen and von Hagen 1996; Verdun 1998) and has re-emerged with the more recent crisis.¹ One view is that fiscal union for the euro area was rejected before monetary union started because it would have required political union, which member states did not want at that time (Verdun 2000). But the view held by others, perhaps most notably former German chancellor Helmut Kohl, was that the euro would ultimately lead to irreversible European unification (Dyson and Featherstone 1999; Mody 2014). In other words, monetary unification would eventually spillover to political integration.

Historical-comparative research typically finds that monetary and fiscal unions go hand in hand. Functioning monetary unions require at a minimum a credible no-bailout clause, i.e. the ability of the union to deny with credibility a financial rescue operation to one of its parts, and a central budget that provides for union-wide public goods and services. The central budget is decided on by way of appropriate mechanisms that ensure political legitimacy. In established political unions, this central budget is typically large enough to provide some fiscal stabilisation itself (Bordo, Markiewicz, and Jonung 2011) or at least provide for insurance-type mechanisms across the union.²

The history of fiscal integration in the United States (US) often serves as a yardstick of comparison for the EU. One important argument by Woźniakowski (2018) is that the emergence of federal power to tax is a result of the sovereign debt crisis of the states in the fiscal history of the US. But such comparison has limitations.³ The level of political integration that already existed in the US, the relatively small debt markets and the unsophisticated nature of the financial system in the 19th century, all mean that such comparisons are not entirely relevant to the euro area. Furthermore, since US states had an overall small government sector, it was a comparatively small step to add the federal layer in the course of the 19th and 20th centuries. But in the euro area, government spending is much larger, at between 34 per cent and 56 per cent of Gross Domestic Product (GDP).⁴ If fiscal union is to be understood as a centralisation of fiscal policy, one would have to discuss the shifting of significant spending from the national to the union-wide level or accept an increase in the size of the government sector due to the additional “federal” layer. Such a step would immediately raise questions of institutional design as there can be no taxation without representation.

In this paper, we discuss how the euro area could further develop its fiscal policy framework. The merits (or lack) of the issue have been discussed extensively in the literature starting with that on optimal currency areas. What we add to this discussion is an incremental approach to creating fiscal capacity, starting from the minimum required to preserve EMU resilience all the way to a federal system that acts more as a benchmark.

We propose three steps that take account of political realities in today’s euro area but are geared towards stabilising the monetary union and improving its functioning. The paper then discusses prerequisites for each of these steps. The key thesis of this paper is that at least step 1 is needed so that the euro area remains stable. This judgement is confirmed by a number of empirical and theoretical studies that are referenced. But as such, many political factors play a role for the stability of the euro area so that this judgement necessarily can be debated. The second main argument is that further steps, especially towards a true (fiscal) federation for the euro area, would be extremely difficult to achieve at the current level of huge heterogeneity in terms of economic, political, administrative and institutional quality. Historical evidence suggests that stability of the monetary union may require steps well beyond banking union, but available indicators of lack of trust among member states and populations also suggest that the euro area falls well short of allowing for

such steps forward soon. The paper therefore proposes an intermediate second step, which would primarily focus on providing for true European public goods, which, if executed well, would help in driving convergence and creating trust.

Discussing fiscal union is not easy in the current circumstances. Trust in the European Union has fallen during the crisis years. And while it has recovered considerably more recently, the percentage of respondents that do not trust the EU still exceeds that of those that do (Figure 1). There are substantial differences across different member states also, with countries that have in particular suffered from the financial crisis losing more support in the crisis years. Some survey evidence suggests that support for the EU has risen in a number of countries after the Brexit vote.⁵ However, the United Kingdom's vote to leave the EU is often interpreted as a pushback against far-reaching integration steps,⁶ though there is a counter view that the only way to salvage the monetary union project is to undertake further integration steps to improve its performance.⁷ Nevertheless, there is substantial intellectual disagreement on what further integration steps would actually be helpful and necessary.⁸ And the issue of lack of trust remains an important obstacle to whatever steps may be required to ensure the viability of monetary union.

The currently ongoing euro area reform process is making little progress. The roadmap designed by the “5 Presidents report” or the “Meseberg declaration”⁹ has produced little to no tangible progress. We would argue that the lack of trust, the large heterogeneity among member states, and the volatile political situation in key member states are all reasons behind that lack of progress. Moreover, since the sovereign debt crisis is largely overcome, the political pressure to move further than the current architecture is limited. Indeed, the US federal taxation power was strengthened during the state fiscal crisis (Woźniakowski 2018). The question is therefore whether a more realistic roadmap can be designed in current circumstances and what would be the prerequisites for the various steps on the map. This is where this paper aims to make a contribution.



Figure 1. Trust in the EU.

Source: Based on Standard Eurobarometer (EB), 88, Autumn 2017. <http://ec.europa.eu/commfrontoffice/publicopinion/index.cfm/Chart/index.cfm> Trust is measured as the difference between “tend to trust” and “tend not to trust”.

In our assessment, the current euro area institutional set-up has a number of key problems and while it is difficult to blame it for the loss of trust, ineffective delivery can contribute to dissatisfaction with the EU. The euro area has given itself a set of fiscal rules that limit deficits in order to ensure that country fiscal policies are sound and oriented towards long-term fiscal sustainability and therefore to limit the probability of a fiscal bail-out programme. Yet, current fiscal rules, which very much focus on a structural deficit measure, are not well implemented,¹⁰ lack credibility, and do not achieve the optimal combination of fiscal policy's purpose, which is that of sustainability and stabilisation. The EU's fiscal framework has also been shown to suffer from significant measurement problems (Claeys and Darvas 2015). A further problem is the absence of the definition of a fiscal policy stance for the euro area as a whole in a situation in which the effectiveness of monetary policy is constrained by the zero-lower bound, i.e. the inability of monetary policy to lower interest rates significantly below zero (Benassy-Quéré, Ragot, and Wolff 2016). There is doubt that the necessary fiscal buffers to enable national automatic stabilisers in case of a shock are available. A first recommendation is therefore certainly that governments need to build sufficient fiscal buffers in good times – which is incidentally what the EU's fiscal compact rule tries to achieve by requiring countries to reduce their debt to GDP ratio to 60 per cent. Risk-sharing between countries to cater for large national shocks is limited. All the same, estimates of the welfare gains arising from fiscal policy coordination in the Euro area vary considerably (Belke and Osowski 2019; Weyerstrass et al. 2006). The case for a fiscal capacity remains controversial as other adjustment mechanisms such as labour mobility are seen as preferable (Belke 2013; Heijdra et al. 2018). At the same, there is a perception widely shared by European policymakers that the no-bailout clause is not credible and financial assistance might even be given to countries with unsustainable debt.

It is against this background that we discuss three incremental steps for strengthening the fiscal framework at the euro-area level.¹¹ These steps would lead to less interference in national fiscal policymaking due to a more credible no-bailout clause, increased risk sharing and different degrees of provision of euro area-wide public goods and fiscal stabilisation.¹²

2. Strengthening the euro area's fiscal framework in three steps

We consider strengthening the euro area's fiscal framework in three consecutive steps.¹³ This first step can be seen as the minimum required to put the euro area onto a more stable footing, while the third can be seen as an analytical benchmark with a centralised fiscal budget and sufficient resources to fulfil a stabilisation role from the centre. The second step is an intermediate one that would help strengthen efficiency by centralising a small number of activities, establishing better provisioning of European public goods and introducing elements of risk sharing for large idiosyncratic shocks.

The first step would entail finishing the integration of the financial policy framework, in particular Banking Union with its pillars of supervision, resolution and deposit insurance. The second step would be the creation of some fiscal resources at the central level beyond those needed for financial and Banking Union. The third step is an analytical benchmark of substantial centralisation of fiscal resources.

One could envisage some other sequencing. For example, one option would have been to first centralise fiscal policies before then moving to a more integrated financial policy framework. In fact, at the height of the euro area crisis in 2010–2012, the various options

were heatedly discussed inside public administrations and among researchers close to policymakers. In particular, it had become clear that the combination of banking fragilities and public finance weaknesses made for a toxic mix that put the stability of the currency area at risk. The famous sovereign-banking doom loop was correctly identified by policymakers as being at the core of the euro area crisis. The two options that were discussed at the time were to either fully mutualise sovereign debt with the creation of a “Eurobond”, i.e. centrally issued debt, or to create a Banking Union, in which responsibility for banks only would be centralised.

At the European Council of June 2012, European Heads of State and Government declared that “We affirm that it is imperative to break the vicious circle between banks and sovereigns.” Subsequently and in a very short time span, the European institutions created a centralised banking supervisor.¹⁴ The decision, which was an important step to preserve the unity of Europe’s monetary union, was then given as a key political signal by ECB president Mario Draghi to stabilise sovereign bond markets with the announcement of a possibly unlimited bond purchase programme.

Yet, despite these two important policy steps, the current framework is incomplete. In particular, Banking Union remains unfinished and the fiscal framework creates substantial confusion. Our proposed sequencing therefore builds upon the current state of the euro area and recommends continuing the work on finishing Banking Union before moving to completing the fiscal framework.

Final responsibility for decision-making over fiscal policy has been and remains largely national. But the EU fiscal rules create an impression of centralised control; in some cases, they may even imply substantial control and loss of national authority. While there is an elaborate EU framework of fiscal rules, application of decisions taken at the EU level rests fully in the hands of national authorities. This has created a rather confusing picture on national fiscal policies. On the one hand, elaborate EU rules suggest that fiscal policy is decided at the European level. On the other hand, ultimate budget sovereignty rests with national parliaments.

An effective fiscal framework should assign responsibilities and legitimacy clearly between the European and the national levels. As long as the final decisions on national fiscal policies remain with national policymakers, the ultimate responsibility for debt if things go extremely wrong has to remain national. This means that in extreme situations, the no-bailout clause needs to bind. We understand the no-bailout clause in line with Article 125 of the Treaty on the Functioning of the EU: it allows for the possibility of providing a loan on the condition that debt is sustainable, but it does not allow the assumption of unsustainable debt. In other words, the European bail-out fund, the European Stability Mechanism (ESM), can provide loans to a country only if debt is sustainable, a requirement that is also set in the ESM treaty. We define credibility as the existence of a hard budget constraint; i.e. a financial assistance programme will only be approved if the country passes the debt sustainability analysis. The no-bailout clause is more credible with greater financial stability. In turn, financial stability is better ensured with two mechanisms: first, in the presence of a fiscal backstop and fiscal resources for essential government spending, for example, through a European Stability Mechanism/Outright Monetary Transactions (ESM/OMT) programme. Second, it is important to reduce the exposure of banks to sovereign decisions and sovereign debt while simultaneously increasing deposit insurance.

The credibility of the no-bailout clause depends, somewhat ironically, on the level of fiscal and financial centralisation. When important government functions are centralised, it becomes easier to maintain stability in extreme situations, compared to unions in which the sub-central level carries out almost all functions of government. The degree of fiscal and financial centralisation and the enforcement of responsibilities at the national level are therefore linked. We consider the first two steps described below as measures going in a centralising direction which would increase financial stability and ensure the providing of essential public goods so as to make it easier to deny granting a financial assistance programme.

2.1 Step A: completing banking union

Our first step, and minimum needed, is a completed Banking Union. A completed Banking Union can be defined as a union in which the link between banks and national sovereigns is largely broken. To achieve this goal, it is necessary on the one hand to reduce substantially the exposure of banks to sovereigns (for example, with limits on the holding of sovereign debt) and to the economy of the country (for example, by increased cross-border lending activity and merged bank groups), while on the other hand removing the implicit and explicit state guarantee for banks from the responsibility of the country. Institutionally, supervision of banks has already been centralised.¹⁵ Rules have been passed to reduce the implicit state guarantee for bank liabilities (BRRD), but they still lack some credibility, while the build-up of sufficient amounts of junior bonds and equity is ongoing. For resolution cases, a single resolution board and a resolution fund have been created.

The missing pieces from a complete Banking Union are a European Deposit Insurance System as well as an explicit arrangement to share the fiscal burden of large, systemic banking crises. Moreover, banking activities must become more European and move away from their strong national orientation, for example, through greater numbers of cross-border mergers.¹⁶

Banking Union is indispensable in a monetary union that wishes to ensure stability, even in the face of possible sovereign debt crises. Financial stability hinges critically on the stability of the banking sector. We therefore consider finishing the Banking Union along the lines described above as the crucial agenda for the next years. It is well understood that a completed banking union would also allow to absorb asymmetric shocks in EMU to a large extent (see Belke and Gros (2016) showing this for the US).

With Banking Union achieved, we would subsequently envisage a gradual reduction in the intrusiveness of European fiscal rules and a reform of the EU's fiscal rules.

It is important that the ESM and OMT programmes continue to exist in order to ensure that sovereign debt is not subject to self-fulfilling liquidity crises. Sovereign debt would remain a national responsibility and a safe asset comparable to sovereign debt outside of monetary unions. Only in extreme cases, if the Eurogroup/ESM decides that debt is not sustainable, would its nature change and sovereign debt would become non-safe, i.e. subject to possible haircuts.

Step A would not address the problem of the macroeconomic management of the euro area as a whole. In particular, when interest rates are at the zero-lower bound, the European Central Bank becomes less effective in achieving its inflation objective. In such situations, it would be up to fiscal and economic authorities at the

country level to support euro area macroeconomic management with appropriate fiscal and structural policies. But in this first step, there would be no central tool other than monetary policy to ensure price stability. Loose fiscal policy coordination should play a role but is unlikely to be fully up to the task. A second problem would be that for countries which mismanage their public finances and lose market access, there would be limited fiscal instruments other than the ESM to prevent large, pro-cyclical fiscal tightening. A third unaddressed problem is the absence of any financing mechanisms to provide for commonly shared public goods, such as climate policies or security and defence measures.

2.2. Step B: providing European public goods, financing investments and insuring against large idiosyncratic risks

In our second step, we envisage adding a modest fiscal capacity, which would fund some European public goods, such as external and internal security, climate policies and migration policies, beyond what is currently funded by the EU budget. The fiscal capacity would also provide resources for pan-European investment, such as pan-European infrastructure projects. This part of fiscal union need not be restricted to the euro area but can involve the EU as a whole, because public goods of the type we consider are not just for the euro area. Moreover, an insurance system (for example, European unemployment reinsurance) would be established to help euro-area countries that are hit by large shocks. Such insurance would be about providing temporary transfers to countries hit by large shocks and would presuppose some degree of ex-ante conditionality. In some estimates, resource of around €50bn could be necessary annually in case of a severe crisis.¹⁷ Such relatively large sums would require substantial real economic, policy and political convergence as we discuss below. This convergence should ideally be a convergence towards the top performing group of countries.

The important *value added* of this second step is that it would provide common solutions to problems shared by European citizens – in effect, truly European public goods. In addition, depending on the way these goods are funded, the fiscal capacity could contribute to cyclical stabilisation of the euro area as a whole. The more counter-cyclical the revenue sources, the greater their stabilisation properties could be.

The modest fiscal capacity could create a mechanism to mitigate the impact of major recessions on those that are the most affected. The implied risk sharing would also somewhat help with national fiscal stabilisation policies, should national borrowing become constrained. But overall it is clear that this second step does not create a fiscal capacity at the euro-area level to manage fiscal stabilisation policies. Maintaining sound national fiscal policies would remain crucial to retain the necessary fiscal space so that automatic stabilisers at the member state level can play their roles in full.

It is important to highlight that this step would be distinct from the existing emergency mechanism, the European Stability Mechanism (ESM). The ESM is a mechanism to provide funding to countries that have lost market access but are judged to be solvent. As such, it is a last resort mechanism while our step B is primarily about providing public goods that the EU can deliver better than any nation state on its own. We would argue that a European provisioning of these public goods, together with a completed banking

union and the existing ESM/OMT, would make the “no-bail-out” clause substantially more credible, allowing to impose losses on sovereign creditors more easily.

2.3. Step C: a true fiscal federation with spending and taxing powers at the federal level

A **third step**, which we consider politically unrealistic in the current juncture, would shift significant spending items to the federal level in order to centralise or federalise important functions of fiscal and public policy. This would be a much more ambitious plan that aims to apply European solutions in areas such as defence and social policy. The federal level would take care of significant parts of stabilisation policy, for example, through centralised unemployment insurance, health insurance and pension system, amounting to perhaps 20 per cent of total government spending. It would make the euro area’s fiscal union more comparable to that of the United States or Canada. While from the point of view of the monetary union such a step is desirable, it is undesirable given the low degree of political cohesion of the union. We are therefore writing down this step more as an analytical benchmark that can be useful in public debate.

The ability to raise federal taxes and to issue federal debt would be part of this scenario. There would be a euro area fiscal capacity of sufficient size to deal with all aspects of the euro area’s fiscal affairs; i.e. allocative, redistributive and for stabilisation purposes. National fiscal policy would correspondingly decrease in importance. In fact, achieving this last step would essentially mean the end for the need for national fiscal policy coordination. In this scenario, the no-bailout clause for nationally issued debt would be as credible as it can get by design.

3. The long road towards the different steps

Achieving different levels of fiscal integration in a currency union is above all a political issue. It involves complex questions of political trust, shifting legitimacy and accountability from the national to the supra-national level, and also dealing with different citizens’ preferences. In general terms, the provision of European public goods can be done more effectively at the European level for public goods with strong cross-border externalities. However, a more centralised provision of those public goods may not be appropriate if citizens have very different preferences as regards the precise way these public goods are provided. Thus, on the one hand, there are externalities that can be best served centrally, but on the other hand, there is the important subsidiarity principle that allows for countries to want different things.

The achievement of a Banking Union as described in step A boils down to managing important transition questions but also major political questions in relation to banking policies. The full fiscal union of step C on the other hand involves a level of political integration that is very different from what exists today. The second step involves difficulties that are between those of the other two. A time horizon of five years might be adequate to complete step A, while step C would serve as an analytical benchmark beyond the time horizon of policymakers.

Obviously, there is no automaticity in the steps and prerequisites proposed. On the contrary, we are aware that the prerequisites outlined to achieve the steps involve a fair degree of judgement on our side – which is why we explicitly highlight this as a political process.

3.1. How to complete banking union

Step A aims to achieve less-intrusive fiscal governance on narrow budgetary matters while Europeanising financial and in particular banking policy. Managing the transition from a national-based banking system to a predominantly European banking policy system remains the central issue since the July 2012 decision of heads of states and government to “*break the vicious circle between banks and sovereigns*”. As of today, the vicious circle still exists.

Prerequisite 1: Address the fiscal dimension of a Banking Union

After the creation of the Single Supervisory Mechanism and the Single Resolution Mechanism, the debate has now shifted to the third pillar of Banking Union, the European Deposit Insurance System (EDIS). The policy debates on EDIS and on the backstop to the resolution fund are necessary but controversial because they concern the fiscal dimension of banking union (Pisani-Ferry and Wolff 2012).¹⁸ The primary role of deposit insurance is to create and maintain trust in the financial system. Depositors’ confidence in the safety of their deposits in banks is fundamental to financial stability and banking stability in a monetary system based on fiat money. There are three basic arguments that call for the creation of a pooled European insurance system (Wolff 2016). The first is about size: insurance works better, the greater number of banks that it covers. If insurance in a small country only covers a few banks, a claim could increase the costs of subsequent insurance permanently, thereby imposing a burden on that country’s banking system. Second, centralised supervision and decentralised deposit insurance are inconsistent. *In extremis*, national deposit insurance and national taxpayers would have to stand ready to address problems that have arisen because of potentially inadequate European supervision. Third, decoupling banks from sovereigns – the very aim of Banking Union – requires European deposit insurance as otherwise confidence will depend on the creditworthiness of the sovereign.

Prerequisite 2: Ensure that banking policy is denationalised

But EDIS and a fiscal backstop alone would not completely denationalise banking policies. Most importantly, bank exposures to domestic sovereign debt must be reduced. Other policies that materially influence the health of banks, issues such as insolvency legislation and the influence of governments over the ownership of banks need addressing. The already existing single supervisor is an essential step, but for many of the issues, new legislation will be required.

How can banks’ exposure to domestic sovereign debt be reduced? Reducing banks’ exposure to sovereign debt is one condition for creating EDIS, as otherwise, the insurance would potentially have to cover sovereign problems. But introducing a simple exposure rule or sovereign risk weights can create substantial problems at the point of introduction. The main risk is that holders of weak debt would sell it, thereby triggering a sovereign debt crisis. One option to deal with this transition problem would be to create a transitional buyer. Creation of a joint-and-several stability fund to manage this problem has been suggested, but it has been noted that the ECB currently is a large buyer of sovereign debt and the risk of introducing

exposure rules for banks is therefore muted.¹⁹ Depending on the way banks' debt holdings are reduced, there might be a need to either introduce preferential treatment of baskets of debt or to introduce safe European debt, possibly in the form of synthetic ESBies (Brunnermeier et al. 2011). A further option would be the introduction of sovereign concentration charges applying to newly issued debt only to reduce the risk of disruption.²⁰

Prerequisite 3: Address non-performing loans in the banking system

The ability of banks to withstand transition problems as Banking Union advances depends on the overall state of their balance sheets. NPLs render the financial system vulnerable to shocks. While certainly improving, addressing the issue of unproductive debt in a timely and effective way is a significant prerequisite for the completion of Banking Union.

Prerequisite 4: Ensure the legitimacy and accountability of the fiscal backstop

Creating such a complete Banking Union framework also raises issues of political accountability. Is the Eurogroup the right political counterpart to Europe's single supervisor? Does the definition of a proper European fiscal backstop not also require the creation of a political head in charge of that backstop? Who would have the legal and political authority to authorise funds? A possible step could be the creation of a permanent Eurogroup president, who would be appointed by the Eurogroup and the European Parliament in euro-area composition, as discussed in detail in Wolff (2017). In particular, such a position would strengthen the representation of euro-area wide interests while still acknowledging that national finance ministers are in charge of fiscal resources. As long as the resources primarily come from national tax authorities, there will be significant constitutional and political problems with fully moving the framework to a truly centralised authority.

Prerequisite 5: Reduce interference in national fiscal policies

Finally, Europe's current fiscal framework could also be reformed during this step. As the prerequisites we have mentioned are put in place, the no-bailout clause would become more credible, reducing the need for intrusive fiscal monitoring in normal times. We would envisage a reform that pushes the responsibility for achieving sound and stable public finances largely to the national level. Suitable rules could be defined at European level but implemented through national institutions.²¹ Overall, this would allow national fiscal policies to play their fiscal stabilisation role in full, depending only on the available fiscal space and taking account of political constraints arising out of national application of fiscal rules – and not the unpopular interference from Brussels.

3.2. Prerequisites for moving forward with step B

Building on what would have been achieved in step A, step B would then allocate some fiscal resources to the centre to provide for common public goods, to increase and finance European investment and to insure against large, country-specific shocks. We would envisage that these resources would be used for managing border protection, perhaps even defence, investment and European unemployment re-insurance in the event of major shocks. The key issues for discussion are financing and governance.

Prerequisite 1: Finance public goods that are truly European in nature

Providing European public goods is, above all, a question of political will. In current circumstances, there is an emphasis on demonstrating to citizens that EU policies provide concrete value added. Most of these public goods are not specific to the euro

area. Some are directly related to the Schengen area while others are related to the EU. The EU budget could be the main vehicle for such public goods. Arguably, part of the funding could come from a spending review of the current EU budget. The question is then where the additional fiscal resources should come from. In principle, they could either be a contribution from national budgets or a new tax resource at the central level. These options would have very different implications in terms of governance, legal base and also in terms of what stabilisation properties they have.

Prerequisite 2: Establish a system of checks and balances

How can political checks and balances, accountability and good governance be ensured? The more functions are centrally provided in the EU, the more this question becomes central. For example, external border control is a topic of great importance to citizens. While it can be provided through a technical authority like Frontex, there needs to be a political mandate and clear rules of political accountability for such actions. Equally important is execution, effectiveness, decision processes and involvement of national authorities. The more centralised the execution of tasks becomes, the more the legitimacy and checks and balances need to come from centralised bodies.

Prerequisite 3: Improve resilience to shocks

Improving structures that increase resilience to shocks is indispensable for sharing risks coming from large shocks.²² Monetary union lacks the exchange rate as an adjustment channel. Therefore, other adjustment mechanisms, such as flexible labour markets, are needed to absorb shocks.²³ However, adjustment mechanisms in the form of more flexible labour markets can also interfere with Europe's social model.

Additional fiscal risk-sharing will require institutional convergence so that country policy responses to similar shocks are not free-riding on insurance. For example, creating a system that can re-insure national unemployment insurance would require some minimal convergence on labour market institutions. But full European unemployment insurance would require converged – or even a single set of – labour market institutions.

The more one wanted to increase fiscal risk sharing, the more important it would be to reduce real economic dispersion and enhance political legitimacy.

3.3. Prerequisites for moving forward with step C

Step C requires that A and B are in place. This implies the establishment of European Banking Union with common supervision and that is backed by a European deposit guarantee system and a fiscal backstop. Also, domestic banking sectors will have a looser relationship to the sovereign than currently, reducing their mutual dependence. What constitutes a European public good will be identified and a centralised budget will provide for it. How responsibilities are divided between national authorities and the European ones and on how accountability is sought will have been established. Sufficient structural convergence will have been achieved to increase resilience to country-specific shocks.

Although short of a full fiscal union, such starting conditions would mean that some fiscal resources will have already been pooled. The countries themselves, however, remain in charge of fiscal budgets and are thus responsible for contributing to their own macroeconomic stabilisation. We identify two prerequisites to move forward.

Prerequisite 1: Reduce real economic dispersion

Table 1. Real economic dispersion across the euro-area countries by comparison to US states: GDP per capita and employment rate.

Dispersion ^a	Euro area (w/o Lux) 1999	Euro area (w/o Lux) 2015	United States (w/o DC) 2015
GDP per cap.	0.54	0.41	0.18
Employment rate	0.07	0.06	0.07

Source: Bruegel based on AMECO (ECFIN) and Bureau of Economic Analysis. Note: GDP per capita and employment rate in per cent of the working age population.

^aDispersion is measured by the coefficient of variation. Higher values indicate more significant differences across states. Numbers based on 18-member euro area. For employment rates, we have also considered the original 10-euro area members instead: 0.059 and 0.052 for 1999 and 2015 respectively.

Experience shows that structural differences can be persistent. And while there has been some convergence in the euro area, the differences in income levels are still larger than in the US (Table 1). Direct fiscal transfers from relatively rich to relatively poor regions exist in full federations to help sustain their cohesiveness. But if differences are too large, they may not be sustainable politically. However, differences in euro-area employment rates are comparable to those in the US, potentially allowing for a form of partial unemployment insurance.

Reducing real economic differences could help increase the appetite for risk sharing. Structural reforms that, for example, improve the effectiveness of the justice system and the government sector more broadly, improve educational outcomes, enable better management of the debt overhang and insolvencies, or improve the resilience of the financial system, are important for the growth performance of the economies of EU member states and for their resilience against global shocks. We consider progress in these areas an important political condition for more far-reaching fiscal risk-sharing, but we note that fiscal transfers aim at increasing cohesiveness of unions with different living standards. Overall, the goal of this step is to achieve an upward convergence on institutional quality.

Prerequisite 2: Taxation and representation

Shifting macroeconomic stabilisation from the national level to the European centre requires a major shift in sovereignty, spending and taxation to the European level. It would require the political will to grant direct authority to raise taxes and political authority to form a proper euro-area government in charge of the policy areas that are centralised. For this to happen, it would be fundamental to move to a different level of democratic accountability and institutions. The outcome would be essentially a political union with democratic decision-making and executive authority at a federal level. Achieving such a vision is, to our mind, currently unattainable. Perhaps the most important prerequisite would be a clear sense of European identity among citizens.

Table 2 summarises the various steps on the road to a more cohesive euro area.

4. Conclusions

Increasing euro area level fiscal capacity is desirable for the economic stability of the euro area and would improve economic performance. But advancing this agenda is difficult politically and may undermine euro area political stability unless serious political and economic convergence is achieved in advance. Conversely, while it is difficult to causally connect lack of trust in the EU with bad delivery on policies and high unemployment, it certainly makes sense to argue that better economic performance would contribute to increased happiness with the EU. For example, addressing the problem of youth unemployment should certainly be a political priority, and it is worthwhile to explore what EU-level action should be taken to

Table 2. Summary of conditions necessary to achieve greater fiscal centralisation.

	Fiscal centralisation element	Conditions
Step A	<ul style="list-style-type: none"> • Deposit insurance & fiscal backstop • Less intrusive intervention on national fiscal policies from centre 	<ul style="list-style-type: none"> • Greater credibility of no-bailout clause • Denationalise banking policy framework • Address non-performing loan problems • Address the issue of legitimacy and accountability of the fiscal backstop • Reduce interference in national fiscal policies from the centre
Step B	<ul style="list-style-type: none"> • Provision of European public goods • Resources for investment spending • Re-insurance system to address large country-specific shocks 	<ul style="list-style-type: none"> • Establish a system of checks and balances • Structural convergence for increased ability to react to shocks
Step C	<ul style="list-style-type: none"> • Significant centralisation of government spending and resources 	<ul style="list-style-type: none"> • Reduce real economic dispersion • Taxation through representation or political union

be credibly achieving this priority. The agenda on deepening fiscal integration raises serious questions about cohesiveness and how much economic convergence is needed. Advancing fiscal integration, economic and institutional convergence and political cohesiveness is a complex and mutually conditioning endeavour. The euro area agenda also as such has implications for EU countries outside the euro area that may find it more or less attractive to join a reformed euro area. Overall, it remains important to advance on this difficult agenda – trust will be an important determinant of success.

Notes

1. See for example Kenen (2010), Verdun (2010), Marzinotto, Sapir, and Wolff (2011); Pisani-Ferry, Vihriälä, and Wolff (2013), Von Hagen (2014), Benassy-Quéré, Ragot, and Wolff (2016), Macron and Gabriel (2015), Van Rompuy (2012), Eichengreen and Wyplosz (2016), Mody (2015), Allen, Carletti, and Gulati (2018) and for an overview Schlosser (2019).
2. Commission of the European Communities (1977), available: http://ec.europa.eu/archives/emu_history/documentation/chapter8/19770401en73macdougallrepvol1.pdf.
3. Frieden (2016) and Henning and Kessler (2012) provide overviews.
4. Figures retrieved from AMECO (last updated 9 November 2017) for 2016, excluding Ireland.
5. According to surveys from YouGov, support for remaining in the EU increased relative to leave in Germany, Finland, France and Sweden, while it decreased in Denmark, between end-May and end-July 2016.
6. See Tusk (2016); Schäuble (2016).
7. See Gabriel and Schulz (2016); Verhofstadt (2016).
8. Baldwin and Giavazzi (2015) formulate an economists' "consensus" narrative. This, however, is not uniformly shared, showing the disagreement in academic circles.
9. Juncker et al. (2015) and Press and Information Office of the Federal Government (2018), respectively.
10. Darvas and Leandro (2015) and Efstathiou and Wolff (2018) document how ineffective policy coordination through the European processes is.
11. The three steps are comparable but not identical to those outlined in the *Five Presidents' Report*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf.
12. The table in the annex summarises our three steps and lists the conditions that are needed in each case.
13. This is one of the parallels with the proposals in the *Five Presidents' Report*.
14. See Veron (2015) for an account.
15. Schoenmaker and Véron (2016) provide a first assessment of the effectiveness of the new supervision.

16. Goncalves Raposo and Wolff (2017, 2017) show that so far, the creation of Banking Union has not changed the merger behaviour of banks in the euro area. Mergers remain predominantly national.
17. Claeys, Darvas, and Wolff (2014).
18. Brandt and Wohlfahrt (2018) discuss design of the backstop.
19. Corsetti et al. (2016); Moghadam (2016). Andritzky et al (2016) propose the introduction of automatic debt restructuring clauses as debt is rolled over. They argue that this would allow for a smooth process, but this can be debated.
20. Veron (2017).
21. An example of a new rules framework would be along the lines of Claeys, Darvas, and Leandro (2016) with emphasis on government expenditure, debt and a special golden rule to allow for investment expenditure.
22. Bayoumi and Eichengreen (1994), Frankel and Rose (1998).
23. Demertzis and Hughes Hallett (1998), Demertzis, Hughes Hallett, and Rummel (2000a), Demertzis, Hughes Hallett, and Ma (2000b), Pissarides (1997).


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