What are the prerequisites for a euro area fiscal capacity?

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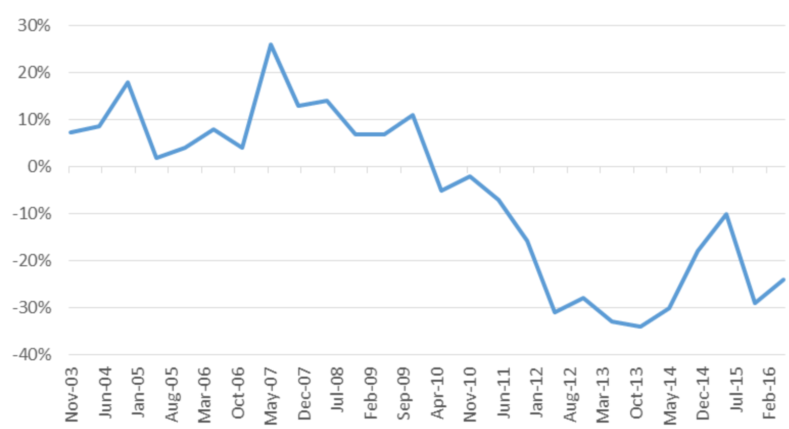
Introduction

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) and re-emerged with the more recent crisis. Historical-comparative research typically finds that monetary and fiscal unions go hand in hand. Functioning federations require, at a minimum, a credible no-bailout clause for sub-federal debt and a central budget that provides federation-wide public goods and services. The central budget is decided upon by way of appropriate mechanisms that ensure political legitimacy. In established political unions, this central budget is typically large enough to provide fiscal stabilisation. In the euro area, with government spending at between 40 percent and 58 percent of GDP, this could only be achieved by shifting substantial spending from the national to the central level.

Discussing fiscal union is not easy in current circumstances. Trust in the European Union has fallen in recent years and remains at low levels (Figure 1). Although some survey evidence suggests that support for the EU has risen in a number of countries after the Brexit vote, others have interpreted it as a signal against more integration[1].

Figure 1: Trust in the EU



Notes: Trust is measured as net trust in the euro-area countries. Net trust is computed as the difference between 'tend to trust' and 'tend not to trust'.
Source: Eurobarometer, Bruegel.

[1] 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.

In our assessment, the current euro-area institutional set-up has a number of key problems. The fiscal rules in place are not implemented, therefore undermining trust, and do not achieve the optimal combination of fiscal sustainability and stabilisation. A further problem is the absence of the definition of a fiscal policy stance for the euro area as a whole, when this is necessary. Confidence is lacking that necessary fiscal buffers are available to enable national automatic stabilisers to play their role when needed. Risk-sharing between countries to cater for large national shocks is limited. Nevertheless, there is a perception that the no-bailout clause is not credible and financial assistance might even be given to countries with unsustainable debt. Finally, there is not enough clarity on the financing for Europe-wide public goods.

Responsibility for decision-making over fiscal policy is and remains largely national, despite an elaborate EU framework of fiscal rules. An effective fiscal framework should divide responsibilities and assign legitimacy clearly between the European and the national levels. This means that in extreme situations, the no-bailout clause needs to have some credibility. We define the no-bailout clause in line with Article 125 of the Treaty on the Functioning of the EU: it allows the possibility of providing a loan on condition that debt is sustainable. 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, which in turn depends on a completed banking union with a fiscal backstop and European Deposit Insurance. The credibility of the no-bailout clause depends, somewhat paradoxically, on the level of fiscal and financial centralisation. Completing banking union is therefore an important part of establishing a clear fiscal framework with credible national responsibilities.

Prerequisites for increasing euro area fiscal capacity

A small fiscal capacity could 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. This part of fiscal union need not be restricted to the euro area, but can involve the EU as a whole, as public goods are not just for the euro area. Moreover, an insurance system (for example a European unemployment reinsurance) could be established to help those euro-area countries hit by large shocks.

The important *value added* of such a capacity is to provide common solutions to problems shared by European citizens – so truly European public goods. In addition, depending on the way these goods are funded, it could contribute to cyclical stabilisation of the euro area as a whole. The more cyclical the revenue sources, the greater their stabilisation properties could be. Moreover, it could create a social mechanism to mitigate the impact of major recessions on the unemployed. The risk sharing implied would therefore also help with national fiscal stabilisation policies, should national borrowing become constrained.

What are the prerequisites for adding a small fiscal capacity? Achieving different levels of fiscal integration in a currency union is above all a political question. It involves complex questions of political trust, legitimacy and accountability and also dealing with diverse citizens' preferences.

<u>Prerequisite 1</u>: Finance public goods that are truly European in nature

Providing European public goods is, above all, a question of political will. The sources of financing of such goods are important. 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. But additional resources also appear necessary to provide for the significant increase in tasks. The central question is then whether the fiscal resources should come from national budgets or a new tax at the central level. These options would have different implications in terms of governance, legal base and also their economic stabilisation properties.

Prerequisite 2: Establish a system of checks and balances

How can political checks and balances, accountability and good governance that are acceptable to all 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 authority's 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 needs 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. Monetary union lacks the exchange rate as an adjustment channel. Therefore, other adjustment mechanisms, such as flexible labour markets, are needed to cater for shocks. 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 fairly 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.

Prerequisite 4: Reduce real economic dispersion

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 EA employment rates are comparable to those in the US, potentially allowing for a form of partial unemployment insurance.

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

Coeff. of variation	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

Note: GDP per capita and employment rate in percent of the working age population. The coefficient of variation is a normalised measure of dispersion that allows comparisons. Higher values indicate more significant differences across states.
Source: Bruegel based on AMECO (ECFIN) and Bureau of Economic Analysis.

Reducing real economic differences could help increase the appetite for risk sharing. Structural reforms that, for example, improve the effectiveness of the justice system, improve educational outcomes, enable better management of the debt overhang and insolvencies, or improve the resilience of the financial system, are important for growth performance and for 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.

Conclusions

Increasing 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 raises serious questions about cohesiveness and how much economic convergence is needed. We have discussed possible conditions that in our view would make progress easier. The question then is what type of policies are available to policy makers and what European-level involvement is desirable. Instruments like the Macroeconomic Imbalance Procedure have proven rather ineffective. Ultimately, it is up to national policy makers to act and to European partners to coordinate their actions to make progress and create institutions that allow for legitimate and efficient risk sharing and a better management of the euro area's fiscal stance. It is also about generating trust by implementing decisions and deliver results visible to all.