Speech: What are the prerequisites for a euro area fiscal capacity?

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Introduction

Let me start by thanking the presidency for the invitation to present my thoughts on what could be the conditions for a euro area fiscal capacity. The debate on what kind of fiscal union is needed for Europe's monetary union is an old one that has revived with the recent crisis.

Historical-comparative research typically finds that functioning monetary unions 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 and stabilisation policies. The central budget is decided with centralised political legitimacy.

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Currently, fiscal policy is essentially a national responsibility in the euro area.

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.

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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 essentially to the ESM. 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.

Towards an effective fiscal framework

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. The credibility of the no-bailout clause depends, somewhat paradoxically, on the level of fiscal and financial centralisation. 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. Addressing the fiscal dimension of banking union is therefore an important part of establishing a clear fiscal framework with national responsibilities and less intrusive involvement in national budgetary policies.

A small fiscal capacity

A small fiscal capacity could fund some European public goods, such as external and internal security, climate policies and migration policies. 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. Moreover, an insurance system (for example a European unemployment reinsurance) could be established to help those euro-area countries hit by large shocks. The risk sharing would help with national fiscal stabilisation policies, should national borrowing become constrained. However, the risk-sharing would not address the euro-area wide fiscal stance, for which one would need centralisation of spending or coordination.

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.

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

Most of the 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 and this could be even truer after Brexit. 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 and could come from national budgets or a new tax at the central level (environmental tax?).

Prerequisite 2: Establish a system of checks and balances

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 an 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

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, this 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.

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.

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 a matter of trust. It is also a question of the available instruments, which are mostly national, to achieve some convergence. Instruments like the Macroeconomic Imbalance Procedure have proven rather ineffective to coordinate necessary actions. Ultimately, it is up to national policy makers to act and to European partners to coordinate their actions and to create institutions that allow for legitimate and efficient risk sharing and a better management of the euro area's fiscal stance. In current circumstances, a good start may be to focus on European public goods that show a value-added to citizens. But the work on finishing banking union and introducing additional risk sharing cannot be avoided for the euro area to prosper in the long-term.