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A Fiscal Union in Europe: why is it possible/impossible?

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This talk

FROM non-controversial aspects

- General definition of a fiscal union
- Need to move forward
- A gradual approach

TO controversial aspects

- Why vs. why not a fiscal union
- Which fiscal union

A broad consensus

Consensus on a general definition of a fiscal union
What is a fiscal union?

A fiscal union is the integration of the fiscal policies of some nations.

In a fiscal union decisions about taxation and public expenditure are largely taken by common institutions; fiscal stabilization is usually allocated to the central government.

The EU is not yet there.

- **The EU budget is about 1% of GDP and is largely allocated to agricultural subsidies and regional policies.**
- **Decisions about expenditures and revenues are mostly taken at the national level.**
- **The risk sharing & fiscal stabilization role of the EU budget remains limited.**

Consensus on the need to move forward

"An integrated budgetary framework is part of an economic and monetary union. In that context, further mechanisms, including an appropriate fiscal capacity, will be explored for the euro area." - ***European Council conclusions on completing EMU, 18th Oct. 2012***

"In the longer term, the European Union should move towards a full banking union, a full fiscal union, a full economic union, which all require, as a fourth element, appropriate democratic legitimacy and accountability of decision-making. Major Treaty reform will be required on this path." – ***European Commission, "A blueprint for a deep and genuine economic and monetary union. Launching a European debate", 30th Nov. 2012***

"The crisis has revealed the high level of interdependence and spill-overs between euro area countries. It has demonstrated that national budgetary policies are a matter of vital common interest. This points to the need to move gradually towards an integrated budgetary framework ensuring both sound national budgetary policies and greater resilience to economic shocks of the euro area as a whole. This would contribute to sustainable growth and macroeconomic stability." – ***Van Rompuy et al., Towards a genuine economic and monetary union, 5th Dec. 2012*****.**

Consensus on a gradual approach

Stage 1: "The completion and thorough implementation of a stronger framework for fiscal governance ('Six-Pack'; Treaty on Stability, Coordination and Governance; 'Two-Pack'). … will provide for ample ex ante coordination of annual budgets of euro area Member States and enhance the surveillance of those experiencing financial difficulties."

Stage 2 (2013-14): "The setting up of a mechanism for stronger coordination, convergence and enforcement of structural policies based on arrangements of a contractual nature between Member States and EU institutions on the policies countries commit to undertake and on their implementation. On a case-by-case basis, they could be supported with temporary, targeted and flexible financial support."

Stage 3 (post 2014): "the establishment of a fiscal capacity to facilitate adjustment to economic shocks. This could take the form of an insurance-type mechanism between euro area countries to buffer large country-specific economic shocks. Such a function would ensure a form of fiscal solidarity exercised over economic cycles, improving the resilience of the euro area as a whole and reducing the financial and output costs associated with macroeconomic adjustments."– ***Van Rompuy et al., Towards a genuine economic and monetary union, 5th Dec. 2012*.**

Why a fiscal union?

Why a fiscal union? [1/3]

The sovereign debt crisis revealed the weakness of the European institutional framework, including neglect of macroeconomic imbalances

1. **The Stability and Growth Pact (SGP) did not guarantee the adoption of prudent fiscal policies in good times; some countries failed to build adequate buffers during economic expansions.**

2. **There were no procedures for managing sovereign debt crisis: this created uncertainty and lengthened the time needed to reach a solution.**

3. **Fiscal imbalances are not the only critical factors; macroeconomic imbalances can undermine fiscal sustainability and sharpen financial tensions (part of private debt often becomes public debt). They were not properly monitored. Lack of tools to manage systemic risks.**

Why a fiscal union? [2/3]

There is a broad consensus about the lessons learned from the crisis:

- **"The coordination of national economic policies beyond the budgetary area relied on soft instruments – peer pressure and recommendations – and had a limited impact on the action of individual euro area Member States. The instrument was therefore too weak to counter the progressive opening of competitiveness gaps and growth divergences between Member States. Little consideration was given to the euro area-wide spillover effects of national measures. National economic policy-making paid insufficient attention to the European context within which the economies operate." –** ***European Commission, "A blueprint for a deep and genuine economic and monetary union. Launching a European debate", 30th Nov. 2012***

- **"Many observers have stressed the need for better risk-sharing tools that could help member countries hit by idiosyncratic shocks overcome their temporary difficulties." –** ***C. Cottarelli, IMF, Presentation at the November 1-2 Gerzensee Conference, 2012***

Why a fiscal union? [3/3]

In other words

- **There is a widespread belief that a monetary union cannot work without a fiscal union. Combining supranational monetary policies with national fiscal policies is not sustainable. The euro area is vulnerable to asymmetric shocks and fiscal indiscipline.**

- **Is the fiscal union only rescuing EMU?**

Why not: arguments against a fiscal union

- **A fiscal union may increase moral hazard. There might be pressures to turn the fiscal union into a transfer union. Countries running loose fiscal policies might have to be bailed out. The incentives to run balanced budgets and introduced structural reforms may be reduced.**

- **An unpopular fiscal union may increase political tensions. It may foster anti-European feelings. It may even threaten the foundations of the EU.**

- **The underlying issue here is that of having a fiscal union without a true political union.**

Which fiscal union?

Which fiscal union? [1/4]

- **Even if there is a consensus on a general definition of a fiscal union, the latter can in principle take several very different forms.**

- **The size, scope and shape of a fiscal union are a matter of social and political preferences. This is why it is generally stressed that fiscal integration will have to move hand in hand with increased political integration.**

Which fiscal union? [2/4]

- **Given (present) reasons for a fiscal union and social and political preferences, the fiscal union is possible but on a limited scale (minimum conditions approach).**

- **Indeed, features and size of the fiscal union have to strike a balance between the monetary union requirements and the still relevant heterogeneity in social and political preferences across Europe.**

  From the banking union perspective, think of the developments concerning the common backstops in the context of the asset quality review to assess the importance of national preferences.

Which fiscal union? [3/4]

- **The fiscal union can complement the monetary union if it effectively implies some form of risk sharing (given the size and potential for contagion of country-specific shocks).**

- **Risk sharing can take several forms (from temporary transfers across member states to a proper common budget).**

- **In any case risk sharing implies both costs and benefits from the national perspective.**
  - **Less national sovereignty on fiscal issues.**
  - **Benefits stemming from a properly functioning monetary union and from avoiding extreme circumstances (e.g. sovereign bond market disruption due to contagion).**

Which fiscal union? [4/4]

Some form of fiscal union could work only under certain conditions.

- **Risks are reduced (at the national level) via strengthened governance and enforcement of (not only fiscal) rules and commitments. A tighter framework should also deal with moral hazard issues.**

- **A solid political awareness emerge on the fact that "ex ante risk sharing only means that, at any point in time, countries experiencing better cyclical conditions support those at the other end of the spectrum; it does not mean the same country would *always* be on the giving or receiving end" (IMF Discussion Note, September 2013).**

- **Other non-fiscal risk sharing tools are developed (e.g. a proper banking union, capital market reintegration).**

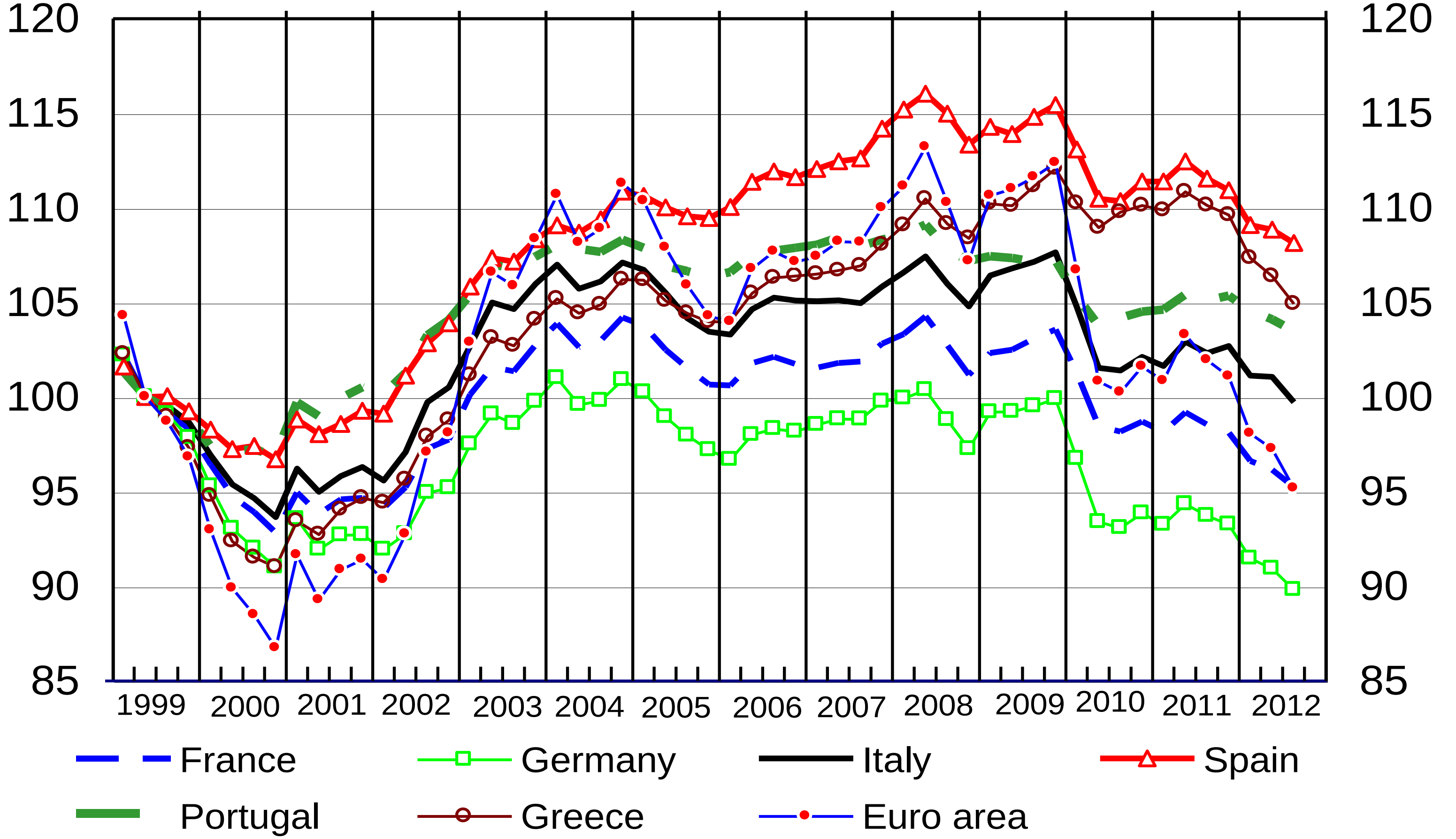
Open issues

Open issues [1/3]

Don't forget macroeconomic imbalances

Preventing and correcting macro imbalances is currently the most challenging task for the EU, as several technical and political difficulties need to be tackled. It implies interfering with economic policy at the national level in a very broad sense. In the end, it implies an extensive EU evaluation of national policy making.

There were large gaps in competitiveness



Open issues [2/3]

The burden of the past . Tackling debt legacy

- **We need a credible reduction in public debt ratio to below the 60% ceiling. It could lower overall financing costs of over-indebted Member States; it could enhance EU growth;**

- **"The reduction of public debt significantly exceeding the Treaty criterion could be addressed through the setting-up of a redemption fund".** ***European Commission, "A blueprint for a deep and genuine economic and monetary union. Launching a European debate", 30th Nov. 2012***

- **Conditional steps in debt mutualisation. Is the European Redemption Fund feasible? Is current budgetary coordination able to address the moral hazard issues? How are preferences across Europe?**

Open issues [3/3]

The governance of fiscal union

- **How to address the "democratic legitimacy"? Wide debate, both at the national and the EU level.**
- **At the national level, strengthened surveillance on MSs has the form of joint decisions on national budgets (including the possibility to require their revision in line with European commitments). Is this compatible with democratic accountability of national elected representatives?**
- **At the supranational level, the set up of a credible tax resource requires political accountability : proper executive and legislative powers. Do we have to change European institutions?**