Economic Union: if fiscal union is possible(?), why not economic union

Comments regarding specific shocks absorption policy & sequence of events

Comments
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Problems with a standard definition of an economic union

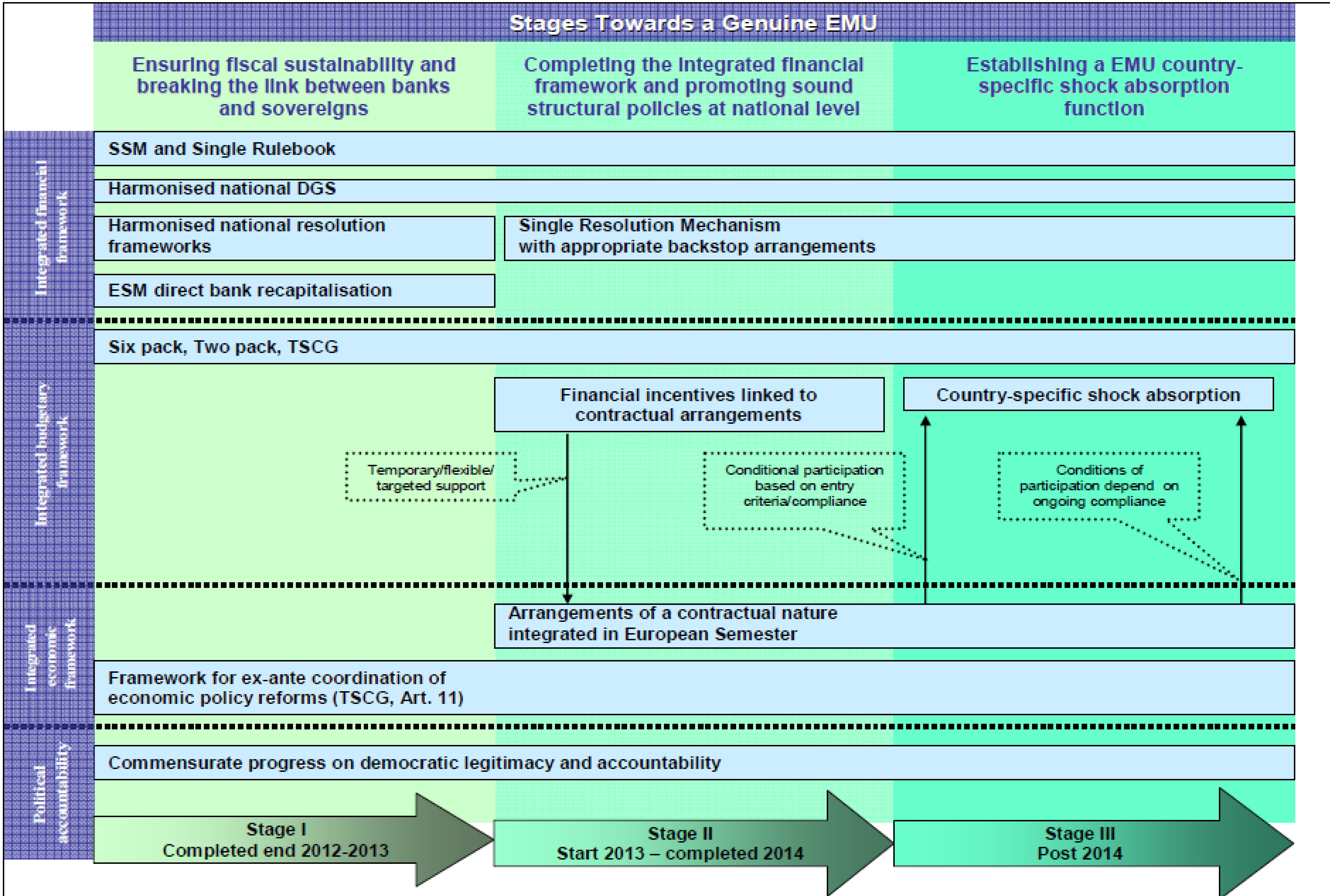
- **OECD:** An economic union is a common market with provisions for the harmonisation of certain economic policies, particularly macroeconomic and regulatory. The European Union is an example of an economic union.
- **Business dictionary**: A common market involving more than one nation based on a mutual agreement to permit the free movement of capital, labor, goods and services. An economic union can also require the coordination of various social, fiscal and monetary policies among participating nations.
- **Wikipedia**: An **economic union** is a type of trade bloc which is composed of a common market with a customs union. The participant countries have both common policies on product regulation, freedom of movement of goods, services and the factors of production (capital and labour) and a common external trade policy.
    - The countries often share a common currency.
    - Purposes for establishing an economic union normally include increasing economic efficiency and establishing closer political and cultural ties between the member countries.

Problems with the definition of an economic union: the EU approach

- **European Commission**: The decision to form the Economic and Monetary Union (EMU) was taken by the European Council. EMU takes the EU one step further. Economic integration brings the benefits of greater size, internal efficiency and robustness to the EU economy as a whole and to the economies of the individual Member States. In practical terms, EMU means:
  - Coordination of economic policy-making between Member States
  - Coordination of fiscal policies, through limits on government debt and deficit
  - An independent monetary policy run by the European Central Bank (ECB)
  - The single currency and the euro area
- **Herman Van Rompuy** (Dec. 2012): Genuine economic & monetary union: a vision for a stable & prosperous EMU based on 4 essential building blocks:
  - An integrated financial framework
  - An integrated budgetary framework
  - An integrated economic policy
  - Ensuring the necessary democratic legitimacy and accountability

The political concept of <u>deep & genuine EMU:</u> the major buildings blocks presented by the President of the European Council (June 2012)

- An integrated <u>financial framework</u> to ensure financial stability in particular in the euro area and minimise the cost of bank failures to European citizens (banking union?).
  - responsibility for supervision on the European level, and provides for common mechanisms to resolve banks and guarantee customer deposits.
- An integrated <u>budgetary framework</u> to ensure sound fiscal policy making on the national and European levels (fiscal union?)
  - coordination, joint decision-making, greater enforcement and commensurate steps towards common debt issuance. This framework could include also different forms of fiscal solidarity.
- An integrated <u>economic policy</u> framework which has sufficient mechanisms to ensure that national and European policies are in place (economic union ?)
  - To promote sustainable growth, employment and competitiveness, and are compatible with the smooth functioning of EMU.
- Ensuring the <u>necessary democratic</u> legitimacy and accountability of decision-making process (political union ?)
  - within EMU, based on the joint exercise of sovereignty for common policies and solidarity.


Stages Towards a Genuine EMU
Ensuring fiscal sustainability and breaking the link between banks and sovereigns
Completing the integrated financial framework and promoting sound structural policies at national level
Establishing a EMU country-specific shock absorption function
Integrated financial framework
SSM and Single Rulebook
Harmonised national DGS
Harmonised national resolution frameworks
Single Resolution Mechanism with appropriate backstop arrangements
ESM direct bank recapitalisation
Integrated budgetary framework
Six pack, Two pack, TSCG
Financial incentives linked to contractual arrangements
Country-specific shock absorption
Temporary/flexible/ targeted support
Conditional participation based on entry criteria/compliance
Conditions of participation depend on ongoing compliance
Integrated economic framework
Arrangements of a contractual nature integrated in European Semester
Framework for ex-ante coordination of economic policy reforms (TSCG, Art. 11)
Political accountability
Commensurate progress on democratic legitimacy and accountability
Stage I
Completed end 2012-2013
Stage II
Start 2013 – completed 2014
Stage III
Post 2014

TOWARDS A GENUINE EMU

The stages proposed in the document presented on 5th December of 2012 by:

- Herman Van Rompuy, President of the European Council
    - In close collaboration with:
    - José Manuel Barroso, President of the European Commission
    - Jean-Claude Juncker, President of the Eurogroup
    - Mario Draghi, President of the European Central Bank

Stage I: of deep & genuine union: fiscal sustainability

- To ensure sound management of public finances and break the link between banks and sovereigns, which has been one of the root causes of the sovereign debt crisis.
  - thorough implementation of a stronger framework for fiscal governance ('Six-Pack'; Treaty on Stability, Coordination and Governance; 'Two-Pack').
  - framework for systematic *ex ante* coordination of major economic policy reforms, (Article 11 of the Treaty on Stability, Coordination & Governan)
  - establishment of Single Supervisory Mechanism (SSM) for the banking sector and the entry into force of the Capital Requirements Regulation
  - Agreement on the harmonisation of national resolution and deposit guarantee frameworks, for appropriate funding from the financial sector
  - Setting up of the operational framework for direct bank recapitalisation through the European Stability Mechanism (ESM).

Stage II Completing the integrated financial framework & promoting structural policies

- The integrated financial framework through the setting up of a common resolution authority to ensure that bank resolution decisions are taken swiftly, impartially and in the best interest of all.
- 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. As this financial support would be temporary in nature, it should be treated separately from the multiannual financial framework.

Stage III: creation of a shock-absorption function on the central level

- Establishing a well-defined and limited fiscal capacity to improve the absorption of country specific economic shocks<u>, through an insurance system set up on the central level</u>
- An increasing degree of common decision-making on national budgets & an enhanced coordination of economic policies,
  - in particular in the field of taxation and employment, building on the Member States' National Job Plans.

Arguments presented in favor of specific shocks absorption policy

- In the euro area, where labour mobility is low, services are not fully liberalized sudden swings in capital flows can undermine financial stability, and structural rigidities can delay or impede price adjustments and the reallocation of resources.
- ➔ In such cases, countries can easily find themselves pushed into „bad equilibria"
- ➔ argument for setting up risk-sharing tools, such as a common but limited shock absorption function,
- ➔ Goal: to cushion the impact of country-specific shocks and help prevent contagion across the euro area and beyond with negative implications for the euro area as a whole.

Possible approaches to the shock absorption function of the euro area fiscal capacity (presented in the document)

- A limited asymmetric shock absorption function could take the form of an insurance-type system between euro area countries.
- 2 possible approaches
- 1. The macroeconomic approach, where contributions and disbursements would be based on fluctuations in cyclical revenue and expenditure items, (or on measures of economic activity).
- 2. The microeconomic approach could be linked to a specific public function sensitive to the economic cycle, such as unemployment insurance.
  - In this case, the level of contributions/benefits from/to the fiscal capacity would depend directly on labour market developments.

Recommended principles for the shock absorption function of EMU fiscal capacity

- the absorption of country-specific shocks should be structured in such a way that they do not lead to unidirectional and permanent transfers between countries, nor should they be conceived as income equalisation tools.
- Over time, each country, as it moves along its economic cycle, would in turn be a net recipient and a net contributor of the scheme.
- Such a function should neither undermine the incentives for sound fiscal policy making at the national level, nor the incentives to address national structural weaknesses.
    - Appropriate mechanisms to limit moral hazard and foster structural reforms should be built in the shock absorption function.

Recommended principles for the shock absorption function of EMU fiscal capacity continued

- Linking to compliance with the broad EU governance framework, including possible arrangements of a contractual nature should be envisaged.
- The fiscal capacity should be developed within the framework of the EU institutions. ➔ guarantee for consistency with the existing rules-based EU fiscal framework and procedures for the coordination of economic policies.
  - The fiscal capacity should not be an instrument for crisis management, as the European Stability Mechanism (ESM) has already been established for that purpose. By contrast, the fiscal capacity's role should be to improve the overall economic resilience of the EMU and euro area countries. It would contribute to crisis prevention and make future ESM interventions less likely.
- The design of the fiscal capacity should be consistent with the principle of subsidiarity, and its operations transparent and subject to appropriate democratic control and accountability.
  - Equally, it should be cost-effect and not lead to the undue development of costly administrative procedures or unnecessary centralisation. It should not lead to an increase in expenditure or taxation levels.

Possible problems related to the implementation of fiscal shock absorption policy

- The cost-benefit analysis should be done first: perhaps the completion of the single market should come first
  - Especially important in the light of subsidiarity principle
- Risk of „one side" fiscal policy: intervention in terms of fiscal expenditures and not in terms of tax reductions
- precise criteria would be needed for a prompt fiscal reaction: can they be settled and agreed? what time horizon would be acceptable?
- Moral hazard problem: no country would be willing to receive fiscal stimulus in the second row
- Reference to the output gap as a main macro criterion for intervention?
- How to agree on common microeconomic criteria with huge differences in the levels of unemployment (will Spain agree for a temporary fiscal support for Germany)
- Political economy of the whole process: are fiscal transfers feasible without genuine fiscal union?
- Perhaps it is easier to complete the genuine single market first?

A step back: perhaps the genuine single market should be completed first

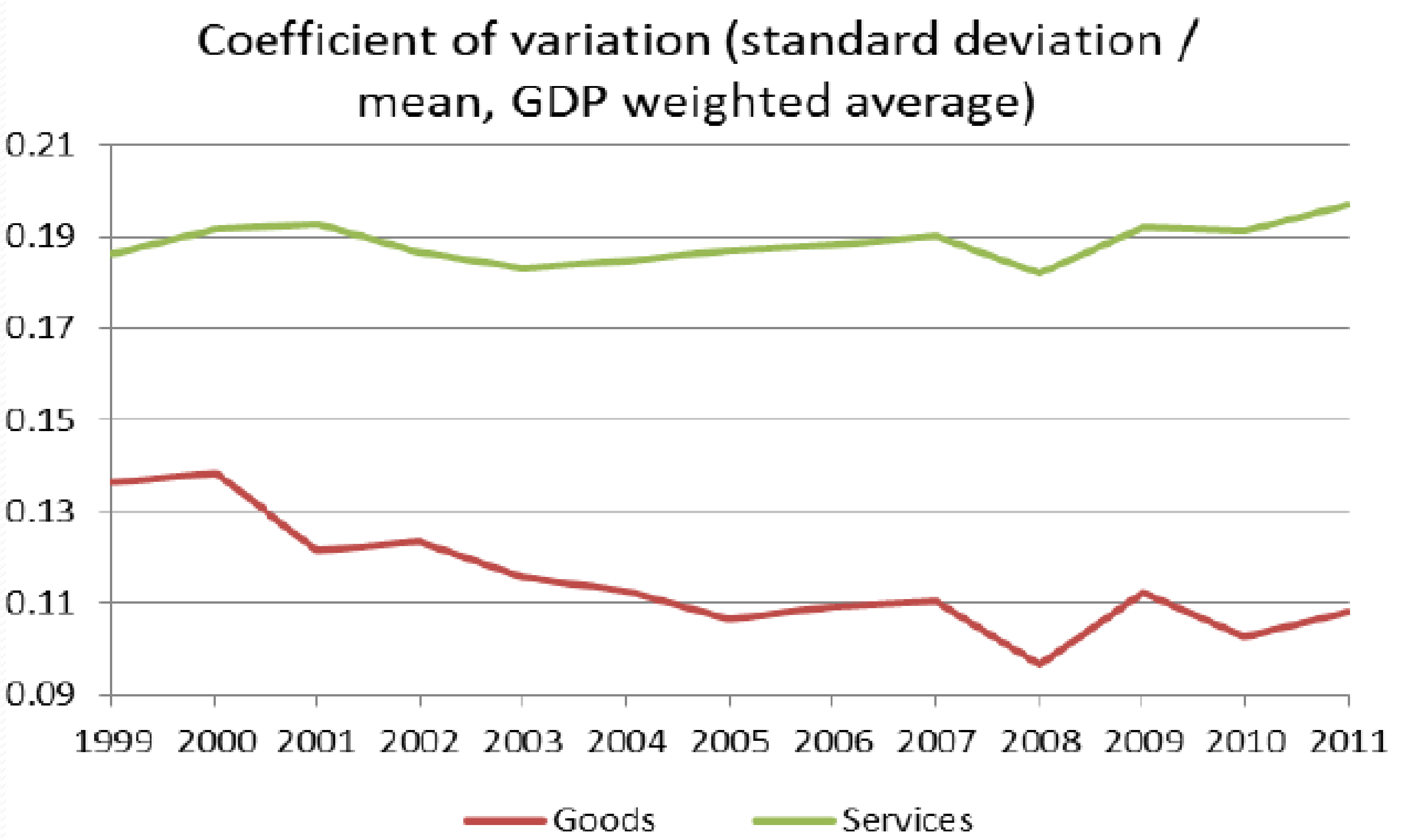
- Single Market: removing the barriers to the free circulation of people, goods, services and capital, allows firms to:
  - benefit from IRS, enhance their capacity to innovate, to invest, become more productive and generate jobs.
  - increased competition ➔ a wider variety of cheaper and higher quality products for consumers
  - & react rapidly to business cycle changes

- The single market is still <u>incomplete</u> in terms of:
  - Labour mobility &
  - Free flow of services

Labour market: incomplete genuine single market

- EU level of labor mobility is low:
  - EU citizens active in another EU country represent only 3.1% of the labor force
  - Only 28% of working age EU citizens would consider working in another place
- The major barriers:
  - Language and family considerations plus social & cultural factors
  - Administrative barriers: red tape, recognition of qualifications, social security systems
  - Certain supplementary pension scheme rules, tax obstacles (obtaining allowances, tax reliefs, double taxation) & lack of awareness.
- Macroeconomic drivers of labour mobility:
- relative income differences ➔ largest net outflows from the poorer countries: reinforcing the gap between core and peripheral regions (relevance of New Economic Geography)
- ➔ do we need more structural polices to prevent long term „peripherization"?
- It seems that a prompt reaction of labor flows in response to business cycles remains rare (as described by the standard OCA theory)

Dispersion of prices across the EU states: insufficient level of services' market integration



Services integration: some of the existing barriers:

- Key element: **freedom to provide services** (Services Directive)
- Member States mostly: treat cross-border service providers in the same way as established ones ➔ **unjustified double regulation** as they need to comply with both home and host country rules (eg. in relation to professional insurance)
- Services sectors include many professions that are regulated **at national leve**l:
- ➔ **many entry barriers still exist:**
  - requirements **reserving the exercise of certain activities** to the holders of specific qualifications
  - **conduct** barriers (i.e**. restrictions to the exercise of professional activities** such as requirements on companies,)
  - significant differences in the scope of **reserved activities** and in the level of qualifications required

Limited scope of market integration in services

- **The Services Directive is the cornerstone of Single Market integration in the services area.**
- **But many barriers still exist**
- If all Member States approached the average level of the 5 best countries in terms of barriers per sector (close to the elimination of all restrictions covered by the Services Directive)
- **➔ the economic impact could reach a 2.6% increase in GDP.**

Genuine economic & monetary union: facing a feasibility problem

- It seems that recent initiatives of the EU (genuine & deep EMU) are imperfect substitutes of „real” banking, fiscal, economic and political unions
- In the past monetary unions were functioning within federal states & were endowed with a central fiscal capacity
- It seems that the smooth functioning of monetary union requires a high level of fiscal, economic coordination & political solidarity ➔
- Can the economic and monetary union function efficiently without high (federal) level of economic and political coordination?