Belgian Financial Forum

Some Thoughts on a Fiscal Union for the Euro Area

Report of the speech given by Frank Smets, Advisor of the President of the ECB, for the Belgian Financial Forum, 7 November 2016[1]

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At the informal ECOFIN meeting in Bratislava in September 2016 the ministers discussed possible alternatives of a fiscal capacity for the euro area, based on presentations by Daniel Gros (CEPS), Vitor Gaspar (IMF) and Guntram Wolff (Bruegel). The idea of a fiscal stabilisation mechanism was also put forward in the Five Presidents Report and may be further elaborated in the forthcoming White Paper by the European Commission that lays out a roadmap for completing EMU. At the same time, one has to recognize that the appetite for a breakthrough in completing fiscal union is currently quite low. Other issues such as security, migration and defence that also demand a European approach are considered to be more urgent and address the current needs of European citizens. Before the end of 2017 and after the current electoral cycle with elections in the Netherlands, France, Germany and Italy no major steps forward should therefore be expected.

But this does not mean we should not continue to discuss what should be the main objectives and features of an enhanced fiscal union for the euro area. What is it that we really want in fiscal matters? In this lecture, no new proposals are formulated. The intention is rather to offer a framework within which existing proposals can be debated.

[1] Speech written by Frank Lierman, Chairman of the Editorial Board of Bank- en Financiewezen/Revue bancaire et financière.

Objectives of a fiscal union

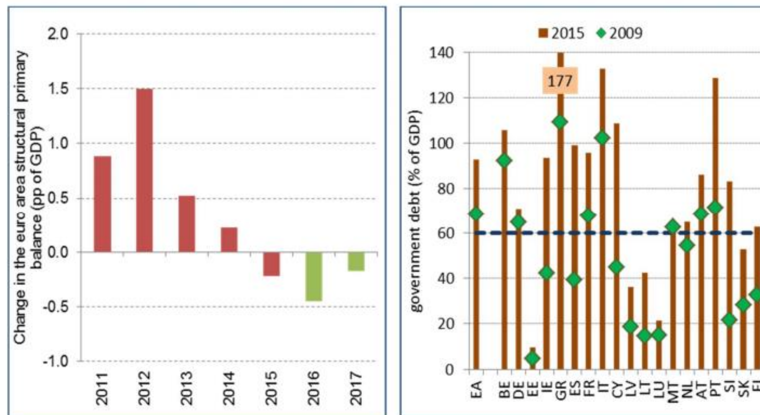
The basic objectives of a fiscal union are fiscal sustainability and economic stabilisation. These objectives are specifically important for a monetary union such as the euro area for several reasons. Firstly, being part of a monetary union, may lead to a debt bias as some of the negative externalities of excessive debt accumulation are born by the other members of the monetary union. Secondly, in view of the loss of the monetary policy instruments, there is a need for larger fiscal buffers in order to smooth the effects of asymmetric shocks. In addition, a central fiscal stabilisation mechanism may provide some public risk sharing as is the case in many well-established monetary unions. Finally, it may also be appropriate to build a central fiscal capacity or enhance the coordination of national fiscal policies in order to avoid a bias in the aggregate fiscal stance, in particular when monetary policy is constrained at the effective lower bound of interest rates.

Diagnosis

The experience since the start of the EMU has not been a great success. We observe very high government debt/ GDP ratios with a lot of heterogeneity across countries. Fiscal policies have often been pro-cyclical at the national level and to some extent also at the aggregate level. Market discipline has not worked very well. Sovereign risk premia were very low before 2007 when the financial imbalances built up, and became excessively high during the sovereign debt crisis of 2010-2013. And, finally, the amount of cross-country private and public risk sharing has been limited, in particular during the financial and sovereign debt crises, as it was shown by a recent IMF study.

Realities and constraints

Euro area fiscal stance and government debt



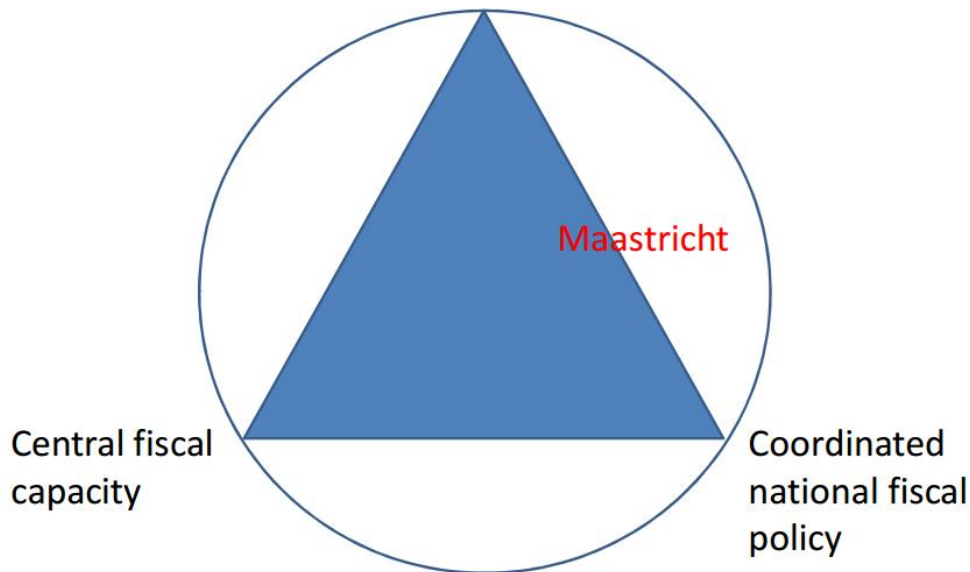
Source: EC's Spring 2016 European Economic Forecast

When thinking about the optimal design of a fiscal union for the EMU, one needs to take into account some realities that follow from the sui generis nature of the EMU. First, migration is unlikely to become a strong adjustment mechanism. Secondly, there is no political appetite for a transfer union, implying that permanent transfers are likely to remain relatively small. Thirdly, national fiscal and economic policies and also national politics and parliaments will continue to play a dominant role. The EMU will remain much more decentralised than other monetary unions.

Corner solutions do not work

Because of these realities, corner solutions will not work. Graph 2 illustrates the three relevant corner solutions:

- fully independent national fiscal policies, disciplined by the market and a credible no bail-out mechanism;
- fully coordinated national fiscal policies, controlled and enforced by the centre; full centralisation of fiscal policy at the euro area level.



The Maastricht Treaty tried to find a middle way between two of these three corner solutions by on the one hand emphasising the role of market discipline and the no-bail-out rule, and on the other hand designing a set of fiscal rules in the context of the Stability and Growth Pact to monitor and discipline national fiscal policy. The Maastricht design did not work very well for two reasons. First, the no bail-out provision was not credible due to the risks of contagion with banks and other governments in the monetary union. Secondly, the rules were difficult to enforce. In fact, no sanctions have ever been imposed. Moreover, the Maastricht design paid no attention to the aggregate fiscal stance.

Different proposals for enhancing the fiscal architecture of EMU often focus on strengthening one of the corner solutions.

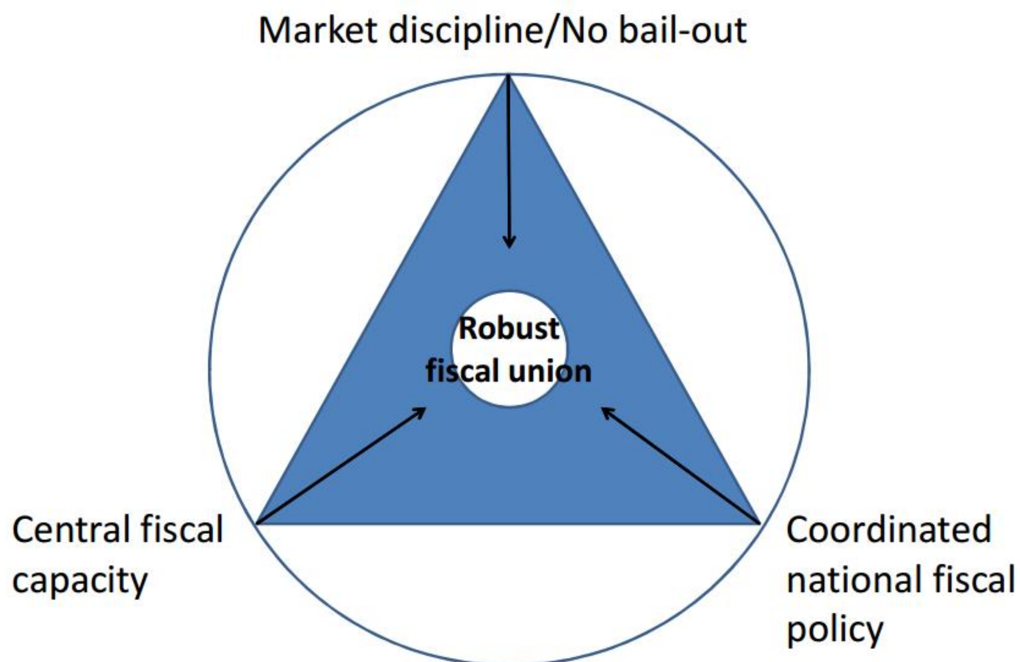
Some current proposals for completing fiscal union are pushing towards more market discipline and no bail-out. This is the case in the recent Bundesbank analysis (2015), which stresses a strengthening of the no bail-out provision by cutting the bank-sovereign doom loop (*e.g.* by reducing national sovereign exposures of banks) and facilitating sovereign debt restructuring. Eichengreen and Wyplosz (2015) also move in this direction but more because of their disillusion with the SGP framework and its procyclical features.

Other proposals are geared at strengthening the coordination of and central influence over national fiscal policies. The fiscal compact is built on this philosophy. Other examples are Villeroy (2016) and Trichet (2011) who are putting forward an EMU finance minister and a strengthening of federal institutions to control national fiscal policies.

The third group of proposals are pushing towards a central fiscal capacity. Such a fiscal stabilisation mechanism is included in the Five Presidents Report. It is also the cornerstone of the Verhofstadt (2015) proposal and of the many proposals that focus on the issuance of so-called Eurobonds.

Fiscal union sui generis

Given that a dominant part of fiscal policy in the euro area will remain within the realm of national competency, the key question for a sui generis fiscal union is, however, how to combine market discipline, policy coordination and surveillance and a euro area fiscal capacity to build a robust fiscal union that achieves the objectives of sustainability and stabilisation.



And in particular, how can we structure a sui generis fiscal union so that the three elements reinforce each other? We know that the more credible market discipline is, the more room there is for an independent national fiscal policy margin. Similarly, a common fiscal capacity strengthens the credibility of market discipline and supports the acceptance of federal control over national fiscal policies. The name of the game is therefore to strengthen the three building blocks so that they reinforce each other.

The first building bloc is to enhance market discipline. As national fiscal policies remain dominant and enforcing/sanctioning ex-ante coordination is difficult, more market discipline

helps alleviating the free rider problem and ensuring sustainable policies. Full mutualisation of national debt is therefore out of question. But how can the credibility of no bail-out be enhanced? The first task is to reduce the contagion towards the national banking system, *i.e.* to eliminate the sovereign-bank doom loop. This requires that we complete the financial union and in particular set up a common fiscal backstop to the resolution fund and a common deposit insurance scheme, but also that we limit the national sovereign exposures of banks and promote truly European banks that operate across the euro area and are therefore less exposed to national risks. Secondly, also contagion towards other sovereigns must be reduced. This requires that we enhance the European Stabilisation Mechanism (ESM) as a crisis-management tool, e.g. by transforming the ESM into a proper European Monetary Fund (EFM) with the appropriate euro area governance and accountability. Finally, in order to find the right balance between liquidity and solvency considerations, an orderly sovereign debt restructuring mechanism may need to be set up.

The second building block is the establishment of an euro area fiscal capacity. Such a fiscal capacity could have three main objectives: i) maintaining an appropriate aggregate fiscal stance; ii) providing risk sharing through automatic stabilisers as is mentioned in the Five Presidents Report (e.g. through an unemployment insurance mechanism); and iii) maintaining minimum government services necessary to attract capital. The latter may be important due to the lack of labour mobility. Clearly, this raises a whole series of important questions. What choice should be made between on the one hand euro area public investment expenditures, e.g. in the digital, transport, education and, R&D fields and on the other hand temporary transfer payments (e.g. through unemployment insurance)? How should such a fiscal capacity be financed and, in particular, which tax instruments should be used at the European level: corporate taxes, VAT, financial transaction tax, ECB seigniorage...? And finally, how much leeway should the central fiscal capacity get to issue euro area debt?

Finally, the third building block is to strengthen the governance and coordination of national fiscal policies. This implies on the one hand a streamlining of the Stability and Growth Pact rules which now are overly complex (structural targets, debt rules, expenditure rules), but also the creation of an independent euro area fiscal board to create transparency and accountability. On the other hand, it requires a strengthening of enforcement. In this respect a particularly promising idea is to give the centre, e.g. the euro group or a new euro area finance ministry, the right to decide on the issuance of senior national debt, e.g. along the lines of the blue-red bond proposal. This would strengthen central control over the issuance of senior national debt, while giving more freedom to national governments to issue junior debt.

Interaction of fiscal union with financial union

When designing a sui generis fiscal union for the EMU, it is also important to consider the interaction with progress made in building a more complete financial union. There is certain degree of substitutability between the two unions because the more effective private risk sharing through financial markets is, the less necessary public risk sharing is likely to be. Building a robust, integrated financial system that provides private risk sharing in the face of asymmetric shocks requires progress in a number of areas. First, the completion of the banking union with a strong common fiscal backstop (e.g. by the ESM) to the single resolution mechanism and a single European deposit insurance system. Secondly, a delinking of banks from sovereign risks, a need to promote equity-based rather than debt-based financial integration and the development of a capital market union. And, finally, the provision of a sufficient supply of safe assets. Here the development of common debt issuance and senior tranches of national debt issues can play an important role (see also the so-called Esbies proposal).

Institutional design

Finally, a sui generis fiscal union should also be embedded in an enhanced political union, whereby decision, control and accountability are executed at the same level. On the one hand, this must lead to a strengthening of decision-making institutions at the euro area level, for example through the creation of a euro area finance ministry or treasury. Some economists (e.g. Tabellini) propose to structure such a decision making body like the ECB with a Governing Council and an Executive Board. Such an institution needs to be accountable to European Parliament. On the other hand, the mandate of such an institution should be clear and limited and allow for national fiscal authorities to play their important role.