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Do all roads lead to fiscal union?

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Options for deeper fiscal integration in the eurozone

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The financial and sovereign debt crises in the euro area has not only focused attention on the necessity of reforms in the member states, but also raised questions about institutional shortcomings and the necessity of a greater role for fiscal policy at the E(M)U level.

As a monetary union, the eurozone pursues a single monetary policy, but has only few instruments for shaping fiscal policy. This becomes a problem whenever a member country is hit by an asymmetric shock. In a heterogeneous monetary union the central bank cannot respond to purely country-specific shocks. Since shock absorption via market mechanisms does not function particularly well in the eurozone, unlike in the United States, effective stabilisation would only be possible by means of fiscal policy instruments.

Most countries with federal structures have equalisation and transfer systems to eliminate disparities between regions as well as substantial budgets with latitude to pursue stabilisation policy in the event of regional shocks. Existing elements of fiscal policy in the eurozone, such as budget or debt rules and the compromise on banking union, are geared more towards long-term stability. In this context, effective stabilisation of regional shocks is in the interest of all the members. Greater country-specific resistance to crises strengthens the stability of the eurozone as a whole and, thanks to a growing synchronisation of business cycles, it is becoming easier for the central bank to pursue monetary policy that is appropriate for every country.

This report examines some of the options for achieving deeper fiscal integration in the eurozone that are currently being discussed most: 1. a common budget, 2. an insurance mechanism against strong cyclical fluctuations, 3. a common unemployment insurance scheme and 4. an equalisation scheme for interest burdens.

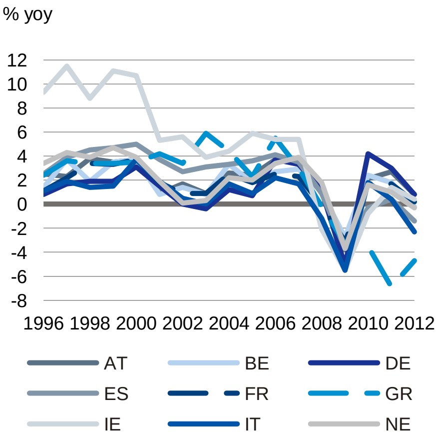
While all of these mechanisms are based on economic foundations, they open the door to moral hazard incentives for the member governments. As the Stability and Growth Pact has shown, this is why instruments are needed to discipline governments and to respond to negative developments. This insight is crucial for any reform of the fiscal architecture in the eurozone.

The current situation

As the current economic and financial crisis has shown, the European Economic and Monetary Union (EMU) remains a very heterogeneous economic area even more than ten years after the launch of the euro. Already at that time there was economic consensus that the EMU was not an “optimum currency area”. Nonetheless, there were hopes that the eurozone would develop in this direction over time. An influential article written by economists Jeffrey Frankel and Andrew Rose (1998) argued that the creation of a monetary union would boost intra-EU trade, resulting in greater synchronisation of business cycles there. The European Commission's EMU@10 report found that in the ten years since its establishment the euro area had achieved major success in terms of real economic and financial integration and was a guarantee of macroeconomic stability.

This positive evaluation was premature. For many years the member states have built up imbalances and they differ so much structurally that the eurozone is still a great distance away from being an “optimum currency area”. The dispersion index of the European Central Bank (ECB) shows that the launch of the euro in the 12 founding member states initially went hand in hand with a growing synchronisation of GDP expansion that reversed from 2008.[1] Since then the growth rates have been much more asynchronous again.

Real GDP growth convergerce 1



Source: Eurostat

In this environment, the ECB is faced with the challenge of pursuing a single monetary policy that is in the interest of all EMU members. However, if growth cycles diverge strongly, gearing policy to the average situation in the eurozone will lead to the ECB's interest rate policy becoming too restrictive for some countries and at the same time too expansionary for others, yet not optimal for anybody. In other words, “one size fits none”.

The members of a currency union refrain from pursuing their own monetary or foreign exchange rate policy. This means that an individual member is only left with fiscal policy as a direct instrument with which to react to idiosyncratic shocks. Unlike monetary policy, the responsibility for fiscal policy in the eurozone remains anchored with the national member governments. There is no supranational fiscal counterpart to the ECB. However, precisely the current financial crisis shows that a few countries very quickly find themselves at the end of their fiscal tether if they are left to their own devices.

It is interesting in this context to venture a comparison with the United States, also a federally structured and heterogeneous monetary union, albeit one that shows a significantly higher degree of fiscal integration. Strikingly, the eurozone is on a sounder footing in terms of its public finances in some respects. US public debt equals around 105% of GDP (compared with about 90% in the eurozone), and between 2009 and 2012 the US deficit, at roughly 10%, was approximately twice as high as the eurozone average. The US also has states that are deep in debt, with California at the top of the list. And yet it is the eurozone that has to battle with a sovereign debt crisis whose proportions pose a threat to the very existence of the single currency.

The current problems in the eurozone have sparked renewed debate about what fundamental design flaws mar EMU's architecture and whether reforms in the direction of a fiscal union are necessary. Two conceptually different approaches which pursue differing objectives are conceivable in this context:

[1] http://www.ecb.int/mopo/eaec/diversity/html/index.en.html

— A preventive mechanism: synchronisation of the growth cycles in the euro countries (reducing the asymmetry of shocks to boost the effectiveness of monetary policy)

— A reactive mechanism: fiscal stabilisation for countries in recession (reaction to a negative shock that has already taken place in a given country)

A fiscal union enables a federal state or a federation of several countries to conduct a coordinated fiscal policy and typically shows several (but not necessarily all) of the following components:

1. A common set of fiscal rules
2. Mechanisms for crisis intervention
3. Fiscal equalisation and transfer mechanisms between countries
4. A common budget

While most of these components may be both preventive and reactive in nature, depending on the specific design, 1) is clearly preventive and 2) clearly reactive.

Components 1 and 2 have already seen relatively widespread implementation in the eurozone. A common set of fiscal rules exists consisting of the Stability and Growth Pact (SGP) and the supplementary legislation in the EU's Economic Governance Package (called the “six-pack”). The banking union is aimed at securing the member countries against risks from financial institutions, and the EFSF and ESM were created as crisis intervention mechanisms. Combined, these components have the objective of making the eurozone less vulnerable to financial and liquidity crises.

By contrast, EMU has so far had neither jointly guaranteed debt instruments, nor fiscal equalisation and transfer mechanisms nor a common budget. Points 3) and 4) are found solely at the national level. The extent to which these components should be integrated into the architecture of the eurozone is a matter of dispute, however. The so-called Van Rompuy report[2] advocates the creation of a fiscal capacity for EMU in order to be able to better neutralise country-specific shocks. Also a topic of discussion is the creation of a European unemployment insurance scheme. At the upper end of the spectrum is the call by economist Kenneth Rogoff to transfer 30% of national tax revenue to a European central government. This would correspond to a budget of about EUR 1 trillion.

By contrast, others contend that seamless implementation of points 1) and 2) would be sufficient to make the eurozone more stable in the long run. It is thought that if there were closely monitored rules prohibiting the accumulation of excessive debt, countries would become less vulnerable. A country with little debt would be able to overcome a recession on its own via counter-cyclical fiscal policy. The banking union would significantly reduce the risk of contagion spreading from crisis-stricken banks to countries, with the ESM as a backstop in emergencies. This would obviate the need for deeper fiscal integration.

Even if the main focus of the current debate is on support in recession phases, effective stabilisation policy should be structured symmetrically. That is, it should also be able to rein in overheating economies, since during excessive boom phases in particular inflation pressures can develop which may lead to the formation of price bubbles and further amplify subsequent recessions.

Most of the discussed fiscal elements at the eurozone level inevitably bring with them a certain degree of redistribution. This political component will ultimately

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[2] Towards a Genuine Economic and Monetary Union, Interim Report. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/132809.pdf

prove to be at least as important as the questions motivated purely by economic aspects on the sense of EMU having a stronger fiscal component.

Following the Van Rompuy report, the European Commission has outlined a roadmap in its "Blueprint for a deep and genuine economic and monetary union"[3] which contains proposals for an EMU budget, the issuance of common debt and a full banking union. These far-reaching steps have not received full consent by the member states. Thus, in March 2013 the Commission proposed a Convergence and Competitiveness Instrument (CCI) which could provide financial assistance for structural reforms in member states currently facing economic difficulties. It also suggested arrangements for ex-ante coordination of economic policy reforms with potential spillovers to other members.[4]

This report examines several possible options for establishing a fiscal capacity for the eurozone and may be regarded as guidance for the current debate which is unlikely to die down for a while.

The fiscal policy framework of the eurozone

Fiscal policy coordination within the eurozone is mainly confined to a package of budgetary rules. Recently, the Stability and Growth Pact was supplemented with the Fiscal Compact, which prescribes automatic correction mechanisms for deficits and the introduction of national debt rules. For monitoring purposes, the EU authorities adopted the so-called "six-pack" (consisting of 5 EU regulations and 1 directive) in December 2011. Its aim is to eliminate design flaws in the SGP and strengthen both its preventive arm and its corrective arm. In addition to the Maastricht criteria (a maximum budget deficit of 3% of GDP and total general government debt of at most 60%) the European Commission now also monitors compliance with country-specific medium-term budget targets for member countries that are not saddled with an excessive deficit procedure (EDP). Countries that fail to observe the debt rules must reckon with the launch of an excessive deficit procedure, where penalty fines may gradually be increased to as much as 0.5% of GDP. The Treaty on Stability, Coordination, and Governance (TSCG) requires the member countries to confine their structural deficit to a maximum of 0.5% of GDP (or 1.0% for countries whose total debt falls far short of 60% of GDP). This is bolstered by what is known as the "two-pack", which provides for monitoring of draft budgets and greater surveillance of countries that have taken advantage of financial aid.

This reformed EU legislation represents a reaction to the obvious failure of the SGP to encourage the European countries to maintain fiscal discipline and sound budget conduct. The budget and debt situation of the EU countries is to be improved in such a way that they become less vulnerable to solvency crises in the long run and gain greater latitude to conduct counter-cyclical policy in times of recession. However, it remains to be seen whether this mechanism will prove to function any better than the original version of the SGP.

Nonetheless, recent history in Ireland and Spain teaches us that fiscal rules alone are not enough. Both of these countries had been model pupils in the eurozone, adhering to the SGP and regularly posting budget surpluses and low debt levels. Adverse shocks triggered by the bursting of the real estate bubble and the subsequent need for bank bail-outs rapidly resulted, however, in these countries only being able to refinance on unfavourable conditions and thus falling victim to the downward spiral of a self-fulfilling prophecy. The consequences would presumably have been less serious if the ESM, banking

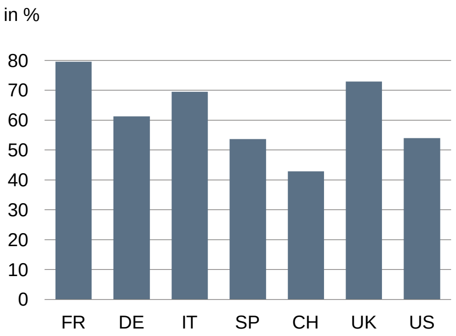
3 http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/11/20121128_2_en.htm
4 http://europa.eu/rapid/press-release_MEMO-13-259_en.htm

union and European banking supervisor had already been in place. These examples also show, though, that even countries that are fiscally sound on paper can be affected by very strong asymmetric shocks which they are unable to handle on their own.

Stabilisation policy in a federal union

In a federal system, the highest-level instruments of fiscal policy are deployed in pursuit of two major objectives: the redistribution of income between richer and poorer regions and the stabilisation of the system in the event of asymmetric shocks. The degree of redistribution varies considerably in federally structured countries and is an expression, not least, of political preferences and of the feeling of national unity, as conflicts of interest may arise between net contributors and net recipients. However, effective stabilisation is in the fundamental interest of all members of a federal union, since it is a type of insurance against idiosyncratic negative shocks regardless of economic strength.

Share of public spending at national level (2011) 2



Source: OECD Fiscal Decentralisation Database

The eurozone currently does not have such stabilisation instruments at its disposal. Stabilisation policy is pursued on a decentralised basis by the national governments. Coordination is done – if at all – on an informal basis, but not in an institutionalised framework. Above all, EMU does not have a fiscal capacity in the shape of its own budget. This arrangement seems all the more curious considering that even in relatively decentralised countries such as Switzerland nearly half the budget is administered at the national level (see chart 2). In countries with a highly centralised system, such as France, no less than 80% of the total budget is for the top level of government.[5]

The loss of an exchange rate mechanism as a stabilisation instrument can be compensated by means of a fiscal counterpart. Most of the federally structured countries have an inter-regional transfer mechanism such as the Länder fiscal equalisation system in Germany. In the United States, too, there is a sizeable degree of redistribution between the states via taxes and transfers. The Economist calculates that Delaware and Minnesota contributed net payments totalling 206% and 199% of their 2009 GDP, respectively, between 1990 and 2009.[6] The fiscal transfers benefited recipient states such as West Virginia, Mississippi, New Mexico and Puerto Rico, which accumulated more than double their 2009 GDP in payments from the system over these 20 years.

Absorption of regional shocks: US vs. eurozone

Instead of using federal transfers risks can also be spread between regions via market mechanisms. Idiosyncratic negative shocks can be neutralised in an integrated economic area by ensuring that governments, companies and households can secure loans from other countries in the currency area. However, if the economic agents have limited access to credit because of rampant debt or if redenomination risks emerge, this channel ceases to function. Capital markets can stabilise regional shocks if equities and fixed-income instruments are broadly diversified in geographical terms and profits or losses thus do not only have an impact at home. Investors in the euro area have a pronounced home bias, though, and except in Austria over 50% of total equity holdings are in the hands of resident investors. However, since there is a risk of redenomination (unlike in the US), this mechanism is not very effective

[5] According to the OECD Fiscal Decentralisation Database, Greece shows the highest degree of centralisation with 94% of the budget earmarked for the national level.
[6] http://www.economist.com/blogs/dailychart/2011/08/americas-fiscal-union

particularly in times of major crisis. Last but not least, shocks can be neutralised if in reaction to a regionally limited recession members of the labour force migrate to a different area within the monetary union. While this channel works well in the US, labour mobility in Europe is still relatively low, though, even though it is trending upwards.

Generally speaking, the system of shock absorption via capital and labour markets does not function particularly well in the eurozone. For a quantitative assessment it is especially interesting to compare the record with the US as a considerably more strongly integrated monetary union. Economists Asdrubali et al. (1996) estimate that on average 39% of a state-specific shock in the US between 1963 and 1990 was smoothed over via inter-regional (public and private) ownership of capital investments, with the trend steadily rising. In the 1990s the share had already reached 55%, compared to only 9% in what later became the eurozone.[7] Even after the monetary union was created only 14% of a regional shock was ironed out by cross-border capital investments.[8]

For the US, Asdrubali et al. (1996) estimated that an additional 23% of an idiosyncratic shock was absorbed via credit markets and a further 13% via fiscal channels such as taxes and transfers. Thus, even though the inter-regional distribution of risk in the US is not perfect, a very large part of a shock is offset. In EMU, by contrast, this held true for only about 30% in the 1990s, and 50% or so from 2001 to 2007.[9] Since market-based mechanisms in the eurozone have such a minor impact, fiscal policy could in principle play a very important role in shock absorption.

Empirical evidence on the effectiveness of stabilisation policy

One crucial factor for the effectiveness of government stabilisation policy is the fiscal multiplier, i.e. the percentage change in GDP on a 1% increase or decrease in government spending. The size of the multiplier is difficult to determine empirically and varies not only from country to country and across time periods, but also depends on the type of fiscal stimuli and the general state of the economy. In the IMF's World Economic Outlook of October 2012, Olivier Blanchard argues that the multiplier effect may so far have been systematically underestimated.[10] His assertion is partly refuted by European Commission and ECB analyses.[11] There is at least a general consensus among researchers that fiscal stimuli are particularly effective if (i) they enter the economy directly in the form of government expenditures, (ii) they specifically target households with a high propensity to consume (e.g. via unemployment insurance), (iii) a large share of the population is heavily restricted in its access to liquidity and credit and (iv) if nominal interest rates are not able to react strongly enough because they are close to zero.

Referring to the current situation, Eggertsson (2011) shows that given a recession in a low-interest environment the bolstering of aggregate demand is most effective via, for example, a temporary increase in government expenditure or a decrease in value-added tax. Measures geared to the supply side such as a reduction of taxes on labour and capital gains would, by contrast, intensify the recession. However, this only holds for a temporary shock; permanent increases in government spending tend to have a contractionary effect. In this vein, Nickel and Tudyka (2013) show that the effectiveness of fiscal stimuli is sharply reduced if public debt is high. In line with Ricardian equivalence, firms and households expect that a combination of large debt and counter-cyclical fiscal

7 See Kalemni-Ozcan (2005).
8 See Balli et al. (2012).
9 See Balli et al. (2012).
10 See also Blanchard and Leigh (2013).
11 European Economy No. 7/2012 and ECB Monthly Bulletin December 2012.

policy will lead to long-lasting higher taxes. For this reason an expansionary fiscal policy in tandem with high government debt results in a crowding-out of private investment and a higher propensity to save, and thus a negative multiplier.

This systemically oriented perspective is set against the microeconomic logic of the efficient allocation of capital. Intergovernmental transfers boost efficiency if funds transferred to recipient regions generate a higher marginal return. Taking the example of the EU Structural Funds, Checherita et al. (2009) show that fiscal transfers did not lead to increased growth, since growth was hit harder in the net contributing regions than in other regions. Transfers can trigger undesired side-effects by, for example, reducing the mobility of labour in weaker economic regions and hampering price adjustment processes. Inter-regional transfers from structural funds are not designed for the long term, though, so these results should not be automatically applied to a stabilisation policy geared to the short term.

Requirements on a fiscal stabilisation mechanism

A realistic proposal for an economically sensible and politically viable fiscal mechanism in the eurozone would have to fulfil several general requirements.

Setting of direct fiscal stimuli

The effectiveness of a stabilisation instrument to fight recessions crucially hinges on how rapidly counter-cyclical stimuli feed through to the real economy. If the stimulation occurs following an excessive time lag and the given economy has already left the trough of recession the effect would in fact be procyclical. Moreover, the fiscal multiplier is larger at the beginning of a recession and that is when expansionary fiscal policy makes the most sense.

If deviations from previously established indicators (e.g. the deviation of GDP from potential output) function as a trigger for support, it has to be borne in mind that these are determined retroactively. However, support payments could also be embedded in a multi-phase mechanism. In the first phase, part of the funds could already be allocated when forecasts point to a strong downswing. In the next phase, transfers could be adjusted up or down accordingly to account for any forecast errors.

A common unemployment insurance scheme would automatically react to an increase in unemployment. However, a downswing phase does not feed through to the labour market immediately, since firms initially run down their order backlogs and there are institutional rigidities in the way, such as notice periods.

No excessive financial burdens on national budgets

Having a European fiscal mechanism only makes sense if it is powerful enough to provide effective assistance also to a fairly large country or to a small group of countries. On the other hand, those who pay into the system must not be unreasonably limited in their capacity to pursue independent economic policy. After all, in the face of an impending downswing a country should be able to respond with counter-cyclical stimuli on its own at an early stage.

A priori fiscal neutrality

Funding neutrality could be a politically decisive criterion. The primary objective of a fiscal capacity should not be a convergence of incomes within the eurozone, but merely the short-term absorption of country-specific shocks. Countries in dire financial straits ought to receive sufficient additional funds at short notice, but not become permanent recipients.

Deeper fiscal integration is scarcely likely to succeed without some type of redistribution component. However, the creation of a permanent transfer union would be difficult to sell to those who would presumably be the net payers. At the very least there should be no incentives created to remain a net recipient permanently.

Scope for sanctions and corrective measures in the event of negative developments

Experience with the Stability and Growth Pact shows how important credible sanctions are. It is utopian to believe that comprehensive fiscal changes in the eurozone would function flawlessly from the outset and that all governments would act in the interest of all the other member states. Therefore, feasible correction mechanisms must be an integral component of any option worth discussing. Note that there are two major sub-aspects: the disciplining of member states and the adaptation of the mechanism to changing circumstances.

Which options are up for discussion?

Various options for deeper fiscal integration are conceivable, each of which would represent a serious departure from the existing economic policy framework of the European Union and of the eurozone. The following overview briefly outlines the underlying logic of various proposals.

Option 1: A common budget for the eurozone

The Van Rompuy report (2012) demands that the central level of the euro area be equipped with powers for common decision-making on national budgets or else be given a fiscal capacity of its own. By analogy with the EU budget, a fiscal capacity could be funded from contributions of member states in relation to their economic output. Alternative potential sources of funding include a fixed share of national taxes (e.g. value-added tax), or a common European tax like the financial transaction tax. The latter would have to be collected in all the euro countries, though.

When signs of recession emerge in one country or in a small group of countries, funds could be made available from the common budget to enable the implementation of growth-stimulating measures and to avoid cutbacks of a damaging nature for the long run (e.g. in investments in infrastructure, education, or research and development). The fiscal capacity would have to be able to effectively support one major euro country or a few closely integrated euro economies (Spain and Portugal, for instance). This would probably require a sum equal to about 2% of eurozone GDP.[12] A “smaller” solution would be little more than a token gesture.

[12] See Wolff (2012), for example.

Output gap 3

The output gap is defined as the deviation of an economy's GDP from its long-term growth potential. A positive gap is an indicator of high capacity utilisation and the development of inflationary pressure. The earliest-possible recognition of an output gap is important for the timing of counter-cyclical stimuli. Estimates of output gaps are published by, among others, the OECD, the IMF and the European Commission.

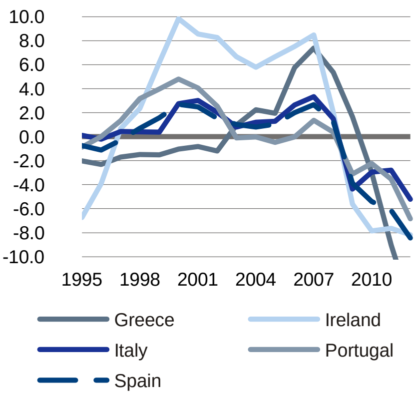
The first component, GDP, does not tend to be a problem. What is much more complex is the estimate of potential growth, i.e. the maximum growth rate that an economy can achieve in the long run without the development of inflationary pressure. One simple method is to adjust quarterly GDP series using the Hodrick-Prescott filter. This trend can be interpreted as the potential growth rate. The aforementioned international organisations estimate potential growth with macroeconomic production functions.

One serious problem is the precision of the estimate for the most recent periods. New and revised GDP figures often lead to a major reassessment of growth potential. So once an output gap has been established it can subsequently still be revised considerably either to the upside or to the downside.

Chart 6 compares the OECD's and the IMF's output gap estimates for a series of countries from 2000 to 2012. A coefficient of 1 means that the two institutions assess the development of the output gap identically, which for several countries is indeed almost the case (Italy: 0.99; Belgium and Spain: 0.96). However, the OECD and IMF estimates differ from one another significantly for say France, Ireland and Greece.

Output gap: GIIPS 4

% of GDP



Source: OECD

One crucial issue apart from budget funding is who should decide on the allocation of funding. This could be addressed at the level of the EMU finance ministers or by an as yet to be created EMU fiscal authority. Equally, it would have to be clarified whether budget appropriation targets are binding, or whether national governments would be allowed to allocate funds at their own discretion. The first case would give rise to the question of democratic legitimation. In the second case there is a risk that the very government that is on the wrong economic policy track would be provided with additional room for manoeuvre.

Option 2: A fiscal insurance mechanism against output fluctuations

In this model all member countries pay contributions into the system in normal years. The insurance event kicks in as soon as a country experiences a strong negative shock. One yardstick for a shock could be that the deviation from potential output crosses a certain threshold, e.g. a negative output gap of 2% (see box 3 for details on the output gap methodology). Then the country in question would receive transfers from the insurance fund to compensate for a given part of the shortfall (e.g. 25%). Since extreme negative shocks require disproportionately intense fiscal counteraction, it might make sense to consider a non-linear disbursement function.

The appeal of this model lies in the fact that theoretically it should indeed be nearly funding neutral. In 2004 and 2005, for example, Germany reported the lowest potential growth in the eurozone and could have received transfers from expanding economies such as Spain, Ireland and Greece (see charts 4 and 5). A problem arises if – as between 2009 and 2012 – almost all the countries show a negative output gap, since in this case the system can no longer be funded.

The choice of appropriate yardstick for determining contributions and disbursements is not unproblematic, however. The deviation of GDP growth from long-term potential growth is an attractive indicator in theory, but one fraught with huge measurement problems. Estimates of potential output are subject to very great uncertainties, especially for periods in the recent past, and depend on the method selected. As the basis for decisions on transfers of the envisaged order, potential growth therefore appears to be a rather inappropriate measure. A report submitted by the Padoa-Schioppa group[13] proposes a more simple disbursement rule, that is to look at the deviation from average GDP growth in the eurozone. However, this does not take due account of differences in country growth potential. While there is much less uncertainty in calculating GDP than potential output, decisions here, too, would be taken on the basis of provisional data that may subsequently be revised.

Regardless of the decision-making basis for disbursements a rigid mechanism would potentially be vulnerable to moral hazard in the participating countries. For example, they could possibly postpone their own growth stimuli in order to obtain earliest-possible access to the available funds. Therefore, instead of fixing a specific threshold there ought to be a rule for phased disbursements.

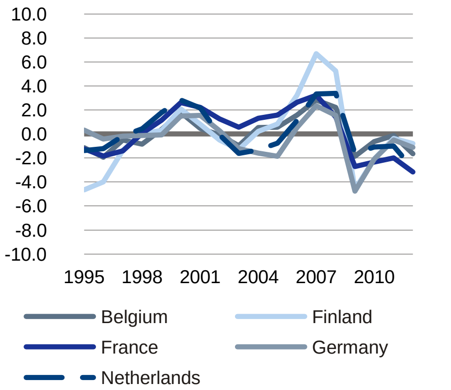
Option 3: A common unemployment insurance scheme

Unemployment insurance acts as an automatic stabiliser, i.e. it enables counter-cyclical fiscal policy even in the absence of active political intervention. If as a result of a growth slump there is an increase in the unemployment rate, a larger number of people will receive transfer payments from the national budget. Given an upturn in the economy the employment level picks up again and the government automatically reduces its disbursements via this channel.

[13] See Enderlein (2012).

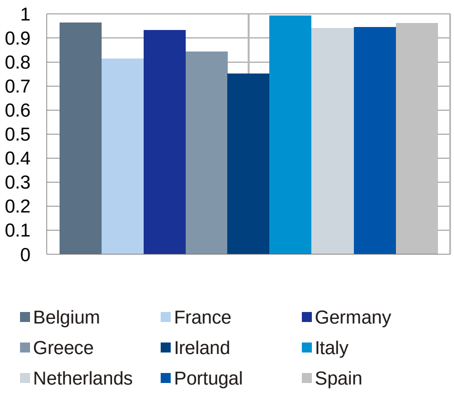
Output gap: Other euro members 5

% of GDP



Source: OECD

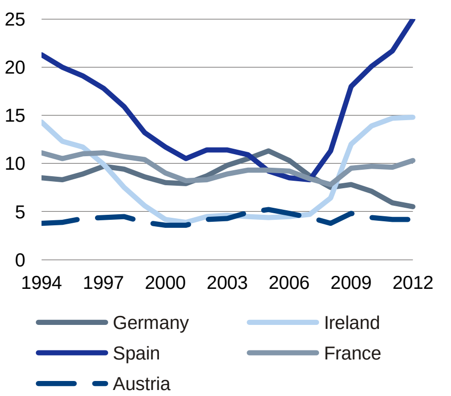
Correlation of OECD and IMF output gap estimates (2000-2012) 6



Source: OECD, IWF

Unemployment rates in Europe 7

in %



Soruce: Eurostat

A common unemployment insurance scheme in the eurozone would centralise parts of the national systems at the European level. Thus, given a strong increase in unemployment a country would be relieved of part of the burden since it would not have to provide additional funds for the unemployed all on its own. Disbursements from the pooled funds could be confined to short-term benefits, for example to an unemployment period lasting up to one year.[14] The national systems would continue to exist in parallel and limit themselves to supporting the long-term unemployed. This division of responsibilities should ensure that the countries continue to bear a share of the costs directly and have an incentive to fight unemployment effectively. A European unemployment insurance scheme would only fulfil the criterion of funding neutrality if the unemployment rate were not systematically higher or lower in several eurozone countries than the long-term mean. As chart 7 shows, this was more or less the case over the past 20 years for Germany, France and – with considerably greater fluctuations – also Ireland. By contrast, the long-term average unemployment rate in Austria, for example, was much lower than the average, and in Spain it is usually much higher than the average. Contributors from countries with structurally low unemployment such as Austria, Luxembourg and the Netherlands would thus effectively subsidise countries with high unemployment.

At present, the social security systems in the euro area display substantial differences. This applies not only to the ratio at which employers and employees pay into the system, but also to the conditions for drawing payments as well as their size and duration. A European insurance scheme would require a partial harmonisation of the key parameters. However, countries with particularly generous benefits would presumably not be prepared to heavily adjust the rules to the downside, since the governments would face stiff political resistance. In countries with comparatively low levels of unemployment aid an adjustment to the upside would result in negative labour market effects, though, and reduce migration incentives.

Option 4: Equalisation of interest burden via a European debt agency

The motivation for this proposal is to reduce fundamentally unjustified interest rate spreads between countries. Before the Outright Monetary Transactions programme (OMT) enabled the ECB to buy the sovereign debt of countries under EFSF/ESM surveillance the crisis-stricken countries of Europe had to struggle with continually increasing risk premia, whereas the countries regarded as “safe havens” were able to fund themselves at historically low interest rates. Paradoxically, not only economically relatively sound economies such as Finland, Luxembourg and the Netherlands gained an interest rate advantage this way, but also highly indebted Belgium. In this respect, these countries actually benefit from the difficult funding situation besetting the countries of southern Europe. ESM head Klaus Regling estimates that these circumstances provide Germany with a funding advantage of EUR 10-20 bn every year.[15]

The Padoa-Schioppa group[16] proposes that in future all countries issue a portion of their sovereign debt (e.g. equivalent to 10% of GDP) via a European Debt Agency. This would create a liquid market equal to roughly half the size of the German sovereign debt market. All countries would pay the same interest rate for these bonds. If a member country were to fall into a solvency crisis and its own bond yields were to skyrocket, it could issue a further tranche of

[14] See Dullien and Fichtner (2012).
[15] http://www.spiegel.de/wirtschaft/soziales/esm-chef-klaus-regling-glaubt-an-zukunft-der-euro-zone-a-879665.html
[16] See Enderlein (2012).

commonly guaranteed bonds (provided it fulfilled the EU fiscal rules). If the crisis were to worsen and a country could only raise funding at unreasonably high levels, it would obtain access to a further tranche (e.g. amounting to 20% of GDP); however, this would be at higher interest rates and only on the condition that the debt agency obtained control and decision-making rights in respect of the national budget. An interest burden equalisation scheme proposed by the Kiel Institute for the World Economy is based on a similar principle.[17]

One alternative way of reducing the "safe-haven" effect has been proposed by the euro-nomics group, that is to create what they call European Safe Bonds (ESBies).[18] To this end, the debt agency would purchase much of each country's debt (about 60%) at going market prices and, as with Collateralised Debt Obligations (CDOs), repackage them in a senior and a junior tranche. The senior tranche (ESBies) should account for roughly 70% of the debt purchased, so the ESBies themselves would still be nearly risk-free in case of a sovereign default. The remaining 30% would be a much riskier asset class, that is of junk standard with a higher yield. Thanks to this construct, every country would gain access to an extremely safe asset class, stopping investors from taking flight to safe havens such as Germany and reducing the average interest burden on countries with a lower credit standing.

How effective would these instruments be?

Engler and Voigts (2012) use a DSGE model with two countries to simulate the transmission channels of a demand shock in one of the two countries. The reference scenario is two countries that conduct independent monetary and exchange rate policies, so a negative demand shock at home can be absorbed via the devaluation of the domestic currency. The second scenario is a monetary union without any equalisation system for the business cycle. In this case, a convergence of growth cycles can only be achieved if the real economies of both countries are very strongly integrated, since such a demand shock then spreads evenly between domestic and foreign goods. But if the countries of a monetary union have only loose real economic ties, this will not work. However, Engler and Voigts show that in this case a degree of stabilisation can be achieved via an equalisation system with transfers from the relatively faster growing economy to the relatively slower growing one.

Pisani-Ferry et al. (2013) compare what impact different mechanisms would have had on the debt burdens of Greece, Ireland, Portugal and Spain between 2008 and 2014.[19] The fiscal relief effect would have been very mixed. Ireland and Spain would have benefited above all from a European unemployment insurance scheme that could have reduced their debt level by about 11 percentage points up to and including 2014. For Greece, the strongest effect would have come from an output insurance scheme. With each of the two options, the average debt level of these countries would have been 6 percentage points lower in 2014. Jointly issued bonds would have been only half as effective.

While these calculations are helpful illustrations, naturally they are unable to take account of possible changes in the economic agents' behaviour. Thanks to a stronger fiscal safety net, politicians would have had an incentive to pare back their reform efforts. On the other hand, firms, investors and consumers might have gained more confidence in the strength of the growth recovery, investing

[17] See the IfW's Kiel Policy Brief: The Kiel Policy Package to Address the Crisis in the Euro Area, No. 58a, 2013.
[18] See Brunnermeier et al. (2012).
[19] Pisani-Ferry et al. (2013).

and consuming more accordingly. Moreover, the calculations imply that the required funds would have been available to a quasi-unlimited degree.

The current crisis is not a suitable reference period to assess these options since the status quo has changed in the meantime. After all, since then the fiscal rules have been reformed (Fiscal Compact, “six-pack”, “two-pack”), the ESM created and steps towards a banking union taken. Moreover, with its OMT programme the ECB has signalled its readiness to purchase sovereign debt if necessary, resulting in a noticeable downward correction of crisis-country risk premia. The current crisis would have been less severe if these measures had already been installed before 2008 and applied in a consistently rigorous manner since then. So given the changes in the framework conditions, the decisive question is how much of an additional contribution a fiscal capacity could make. The answer to this could prove to be more sobering.

Open issues on design and implementation

Integrating these options into existing EU and EMU law and implementing them on a viable basis would be a complex issue. Regardless of which option(s) become established in the political debate, a host of fundamental questions need to be answered.

Funding: National contributions vs. European taxes?

Contributions to a European unemployment insurance scheme would come from the payments of employees and employers, as in the national systems. A European budget, by contrast, would require a different type of funding. On the one hand, contributions could conceivably be tapped from national budgets in relation to a country's GDP, similar to the EU budget. However, it would be more sensible and simpler to arrange the funding by earmarking a certain share of cyclically sensitive taxes, such as income and corporation taxes, for instance. This way, the contribution burden would automatically adjust to the economic situation. A European tax such as the financial transaction tax would conceivably also be possible, but then it would have to be introduced in parallel across all the countries of the eurozone. The revenues anticipated from the financial transaction tax equalling 0.3-0.4% of eurozone GDP would not suffice to foot the bill, however, even after accumulating over several years.[20]

Democratic legitimation: How much of a say do citizens have?

The bundling of additional competences at the eurozone level raises the question of what democratic legitimation a eurozone fiscal authority would have. For effective surveillance and control it would be desirable for it to be largely independent of the national governments. This suggests that the European Parliament could assume a major role. Unlike the ECB, whose independence is essential for it to fulfil its mandate, a fiscal capacity would have to be integrated more strongly into the process of how the democratic will is shaped in Europe. Moreover, it would also be necessary to clarify how the authority would interact with the European Commission.

[20] The joint study conducted by PwC and HWWI (2013) proposes a funding solution that calls for a 10% European income tax.

Flexibility: Automatic mechanisms vs. discretionary scope?

A fiscal capacity could be based on rules that are clearly defined ex ante, or at least be given partially flexible room for manoeuvre. Rules that kick in automatically have the advantage that national governments would have no formal way of exerting influence on related decisions. A central decision-making body with discretionary scope could respond more rapidly to impending economic slumps, but it would also be exposed to political pressures.

In this context, another important question is how to deal with member states that violate common principles or prove to be chronic net recipients in a system that is largely funding-neutral. This would require the creation of clearly defined sanctioning options that cannot be retroactively circumvented.

Legacy: How should the transition from the current situation be staged?

A fiscal capacity would come too late to fight the current crisis, so debate should focus primarily on the medium to long-term prospects. The question as to how the transition from the current situation could be staged has several facets. Can there be a multi-speed fiscal union? Will the countries have to fulfil access conditions, such as having complied with the EU fiscal rules for several years in a row and implemented structural reforms? Will convergence criteria have to be met, such as an unemployment rate of less than 15% to gain access to the unemployment insurance scheme? What degree of harmonisation regarding for example tax systems or employment policy arrangements would the different options require?

More fiscal elements in the framework of existing arrangements?

The ESM secures liquidity for countries that can no longer obtain funding in the capital market. In its current form that makes it strictly a crisis intervention instrument. A European debt agency could in principle be embedded in the current framework.

Fiscal stabilisation components could also be embedded in an EU framework instead of in EMU. With an insurance mechanism against output fluctuations, a larger circle of paying contributors would in fact make sense with a view to offering better risk diversification, as this would probably result in lower contributions per country. A common unemployment insurance scheme could be installed just as easily at the EU level. Moreover, a common budget already exists at the EU level; however, it has a volume of only about 1% of EU GDP. Of this volume, more than 35% is earmarked for the Structural Funds and for the Common Agricultural Policy, respectively. There is a lack of instruments to conduct stabilisation policy at present, because the Structural Funds are by design not geared to short-term stabilisation measures, but instead to long-term convergence. The EU initiative against youth unemployment, despite its moderate funding of EUR 6 billion for 2014-2020, could be an example for including stabilisation policy tools in the EU framework. A medium-term restructuring could aim at achieving better macroeconomic coordination and a tighter focus on stability. However, it is unrealistic to expect an EU-wide solution, since the consent of the non-EMU countries may be regarded as beyond reach.

How are negative incentives for the member states avoided?

At the political level deeper fiscal integration leads to national governments not having to bear the consequences of economic policy errors to such a great extent themselves. If a European equalisation mechanism results in countries being subsidised by other EMU members in spite of misguided growth, budget and labour policies as well as a lack of willingness to tackle reforms, this weakens the degree of direct responsibility at the national level. The aid guarantee allows the loss of a key corrective force which would need to be offset by means of a strong supervisory authority.

In the face of an impending recession a government could be tempted to refrain from the outset from seizing its own counter-cyclical measures in order to gain rapid access to funds from a common budget or output insurance. Conversely, in good economic phases it might be tempted to increase spending for popular measures and try to minimise the country's contributions to an output insurance system. The excessive debt in the eurozone results mainly from meagre surpluses in good times. For this reason, it is necessary to agree binding, enforceable rules on budget conduct in boom phases.

The harmonisation of the rules that goes hand in hand with a European unemployment insurance scheme would not be problem-free, either. If countries with less generous social security systems adjust their conditions to the upside, negative labour market effects may ensue. Even if only short-term unemployment is shouldered by the European unemployment insurance scheme, countries with high unemployment could use the related savings to increase other social benefits. This would create negative migration incentives which cannot possibly be desirable in view of the already low level of internal mobility in the eurozone.

The access to cheaper bonds via a European debt agency would reduce not only the financial costs of raising debt, but also the political costs. Therefore, this option can only function if it is closely linked with the rules of the Stability and Growth Pact.

Conclusion

Compared with the United States as a long-existing, successful monetary union, the eurozone has substantial shortcomings when it comes to absorbing regional shocks. This is the consequence of a smaller degree of financial and real economic integration and a federal architecture without reactive stabilisation components. For this reason, fiscal instruments to drive the synchronisation of business cycles and absorb asymmetric shocks may indeed be in the common interest of all the euro countries.

The options under discussion at present would mean a fundamental departure from the European framework. This mainly raises the question of how they could be put into practice without this leading to irreversible negative developments. After all, the eurozone is a much more heterogeneous economic area than the United States in many respects, and there is arguably less of a sense of solidarity between its members. Given the fundamental imbalances in Europe, however, fiscal integration will not be manageable without redistribution components.

Citing the current crisis as justification for a fiscal union would be misguided, though. The sovereign debt crisis had its roots in the combination of a largely symmetric shock, which only developed strongly asymmetric effects over time, and severe country-specific shocks. Since the GIIPS countries generate roughly 25% of eurozone GDP, the countries hit less hard would probably only have been able to fund a fiscal capacity with negative repercussions for their own growth. A fiscal capacity would not solve the structural problems of the member states anyway. In the worst case, it would tend to delay their elimination since it would reduce the immediate pressure to push through reforms.

Therefore, every step in the direction of a fiscal capacity of whatever nature would require a strong supervisory authority that is not only able to prevail over opportunistic governments, but also able to exert influence on negative structural developments in the individual countries.

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