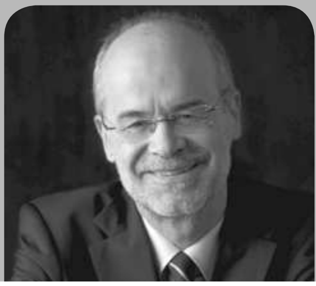

# The Uncertain Path towards European Fiscal Union

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The Great Recession has revealed serious shortcomings in the design of the monetary union, a set of shortcomings that have led to serious imbalances, above all with regards to external debt and current account balance, in the less competitive countries of the euro area (the so-called peripheral countries), as well as between these peripheral countries and the core countries of the eurozone.

These imbalances did not suddenly appear when the crisis broke out, neither are they a consequence of it, rather just the reverse. The crisis highlighted just how severe they were and just how unsustainable they had become, bringing about the closure of the financial markets. Indeed, the imbalances had been allowed to gradually build up during the boom years, in the face of the widespread indifference and unawareness of all the economic agents – the national central banks, the ECB, regulators, governments, markets, rating agencies, debtors (who got into deeper debt than they could afford) and creditors (who assumed more risks than was prudent).

The origin of these imbalances lies precisely in the design flaws of the monetary union. Today, it is widely accepted that the single currency was launched in the late nineties without the necessary conditions having been met to ensure its success. Two such conditions are generally recognised. First, in accordance with the traditional theory of optimum currency areas, the markets need to be sufficiently integrated and to enjoy high factor mobility. In its most recent version, this theory grants a particularly important role to the integration of the financial markets, identifying this as an essential instrument for risk-sharing.

Second, monetary integration needs to be accompanied by an appreciable degree of fiscal integration, which in turn is not possible without the corresponding political integration. This fiscal union needs to be based on two pillars: on the one hand, on a common government, with its basic responsibilities – a budget, tax revenues and a treasury authorised to issue debt; and, on the other, on mechanisms that ensure the budgetary discipline of the (sub-central) States making up the union.

The reality of the matter is that when the monetary union was created it barely met either of these two conditions. At the time, too much weight was attached to the wilfulness and political prestige of being among the founding countries of the eurozone, and too little to adopting the necessary realism and rigour to assess the risks of launching a project of this magnitude, in conditions that were far from favourable.

This was to have two particularly grave consequences, which we have probably not been able to appreciate fully until the onset of the crisis. The first one is that a monetary union without a fiscal union leads to a weakening of the instruments that provide macroeconomic stability (those of a monetary as well as of a budgetary nature) when having to face asymmetric or idiosyncratic shocks. A monetary policy determined on the basis of the needs of the entire eurozone and not on those of each individual country has a procyclical effect on all of them. It is too expansive for countries immersed in an expansive phase of the cycle and too contractive for those who find themselves in the opposite situation. And, moreover, the monetary union has accentuated the limitations of the fiscal policy as an instrument for providing national stability, as the restrictions on running up a public deficit and getting into debt are set much higher when the sovereign cannot exercise any control over its own currency. The first consequence is, therefore, that the creation of the euro has led, de facto, to the disappearance (in the case of monetary policy) or the more than notable loss of effectiveness (in the case of fiscal policy) of the national macroeconomic instruments that provide stability, without their having been replaced by similar instruments at the European level.

The second consequence has had a particularly marked impact on the less competitive countries of the eurozone. In all probability, the effects on these countries of renouncing two such important economic policy instruments as those of their interest rate and exchange rate were underestimated. These instruments act both as a warning sign and as a mechanism of correction to prevent and/or correct any imbalances that may arise in terms of the current account balance and external debt, precisely because these countries are not so competitive. As is well known, the loss of competitiveness suffered by these countries throughout history was corrected time and again by successive devaluations. It is clear that such measures did not solve the underlying problem, but it prevented the imbalances from becoming unsustainable and the correction from having very high social costs. This time, however, there was no warning sign (i.e., pressure on the exchange rate), so that the imbalances were allowed to accumulate and reach unprecedented levels, neither was there a mechanism of correction available, namely, that of devaluation.

This meant that the only solution available to fix the imbalances, without leaving the euro, was to force internal devaluation by implementing harsh austerity policies, which have had visible consequences in terms of a real collapse of economic activity and unemployment and the increase of inequality. The second consequence that the crisis has revealed is therefore that a monetary union without a fiscal union cannot allow marked differences of competitiveness between regions to steadily accumulate, and that if they do, the only way to correct them, in the absence of redistributive budgetary mechanisms, is by implementing policies of adjustment, policies that are unlike to remain socially acceptable for long.

These consequences are of such gravity and relevance that the question arises as to whether a monetary union is viable without a fiscal union. Some of the contributions to this IEB Report, especially the articles written by Martine Guerguil and Remy Prud'homme, clearly show that in existing monetary unions, the central government budget (or, in its case, that of the federal government) plays an essential role in the prevention and correction of these imbalances. This budget basically performs three functions. First, it has a stabilisation or countercyclical function, which means that when a region (rich or poor) experiences a specific or asymmetric shock, the federal budget tends to offset this shock automatically by employing its instruments of stabilisation, which have an expansive impact on the region. Second, it serves a risk-sharing function, which has its clearest expression in the existence of a common treasury, which issues 'federal' debt (i.e., that which corresponds to the central level of government). A common currency requires the counterweight of common sovereign debt, in order to prevent any episode of sovereign debt crisis in any of the Member States of the monetary union from contaminating the single currency. Third, the federal budget generates fiscal transfers from the most competitive regions (and those with the highest incomes) to the least competitive regions (and those with the lowest incomes). This is an implicitly redistributive function – one that is not formally provided for in these terms, which occurs indirectly as a result of the budgetary activity of the central government, to the extent to which it provides a similar level of services and applies a similar taxation (based on fiscal capacity) to the citizens under its jurisdiction throughout its territories.

In exercising these functions, the budget of the central ('federal') government becomes an essential element for the success of the monetary union. On the one hand, it has an irreplaceable role in the area of macroeconomic stabilisation, to respond to income shocks that affect a specific region or which impact the whole of the union when the restrictions on its monetary policy are especially high, as happens when the country is at the zero lower bound. On the other hand, the federal budget acts as a cushion to facilitate a process of convergence of competitiveness between the countries that make up the monetary union. In reality, in all countries (in all existing monetary unions) there are differences in competitiveness between regions, and although the markets may tend to correct them, these differences do not lead to unsustainable imbalances for the less competitive regions for two reasons: first, because there is an integrated financial market and a set of financial institutions implanted uniformly across all the regions of the union; and, second, because of the compensatory action of the central government's budget.

The contrast with other monetary unions and the experience of the Great Recession tell us that the monetary union is unlikely to be consolidated and to become sustainable unless decisive steps are taken towards introducing a fiscal union, which in turn is unlikely to occur if it is not accompanied by genuine progress towards a political union, that is, towards the establishment of a European political power with full democratic legitimacy.

In fact, if we step back and examine what has happened in recent years, we can see just how far we have actually come since the crisis began in restructuring the eurozone and in adopting common decision-making mechanisms. The magnitude of the transfer of sovereignty that has taken place from the nation states to the institutions of the European Union since 2010 would have been quite unthinkable some years ago.

During this time there has been an undeniable strengthening of the institutionalisation of the eurozone. The articles by Martine Guerguil and Antonio de Lecea that appear in this IEB Report are particularly illustrative of this point. To mention only the main actions, in recent years we have seen the creation of the European Stability Mechanism (ESM) to provide common financial support to countries facing problems selling sovereign debt; the European Central Bank (ECB) has intervened decisively to uphold the eurozone, providing liquidity and creating instruments (such as its Outright Monetary Transactions) and adopting policies (its quantitative expansion programme) that clearly expand the boundaries of its traditional activities; a rigorous system for monitoring the macroeconomic situation of Member States has been established; decisive steps have been taken towards creating a Banking Union, with the ECB being given supervisory functions and with the deployment of unique mechanisms for the resolution and guarantee of deposits; and recently the European Investment Plan (or Juncker Plan) has been launched, an undoubtedly important initiative both in terms of boosting demand and improving productivity.

Similarly, in the fiscal domain many significant initiatives have been adopted: the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, the so-called 'Two-Pack' and 'Six-Pack' and the European Semester. Despite all the hesitations and contradictions, these years have witnessed an intense process by which sovereignty on relevant budgetary matters has been transferred from the nation states to the EU institutions. Many issues that were previously decided quite independently by national governments and parliaments are today decided in Brussels, or at least require EU approval, especially in those peripheral countries that have needed some kind of financial assistance.

However, this process of institutionalization and strengthening of EU institutions has two limitations that make it particularly vulnerable. The first is a general limitation, not solely applicable to the fiscal union, but to all areas affected by the integration process in the eurozone, and it is the growing importance of its intergovernmental institutions, at the expense of its 'federal' or community character. In other words, what we have seen is an intense process of sovereignty being transferred from national governments to the EU institutions, but this sovereignty has gone to rest in the intergovernmental institutions, not in the European government (or the embryo of a European government) with democratic legitimacy. Paradoxically, at the same time as Europe is taking a significant step towards political union, with an unequivocal federal stamp, with the creation of the ECB, there has been a clear shift in the centre of gravity of the eurozone away from the Commission (an institution with a clear federal vocation) to the Council (with its markedly intergovernmental character).

This fact is perhaps understandable, albeit unavoidable, in the short term. The institutionalization of the European Union has always been the result of a balance between a 'federal' or community rule, on the one hand, and a intergovernmental rule, on the other – between the power of new institutions, which seek to represent the union, and the old states, each an expression of a national sovereignty. This tension is inevitable. And probably the monetary union has given rise to a certain fear, a politically understandable reaction, on the part of the nation states as they seek to preserve their prerogatives.

However, this 'intergovernmental' logic, understandable, as I have said, in the short term, is not sustainable as a more or less permanent engine of the institutionalization of the eurozone. And here the reasons are diverse and powerful: it tends to establish a hierarchy of political power between the states, which is hard to accept and which can hardly be considered viable; and it creates a dynamic in which individual interests prevail over the common interest, which is clearly prejudicial to the vision of Europe projected among European citizens. And above all, the intergovernmental logic has serious limitations because it inevitably leads to a dangerous rupture of democratic principles.

This rupture finds expression in the division between legitimacy and power. Democratic legitimacy is obtained basically in the national arena, while power is increasingly being exercised in the European arena. European citizens have the perfectly well-founded perception that those that take decisions and that exercise power have not been elected, while those that have been elected do not have sufficient power to decide the fate of their peoples. We should not be surprised, therefore, that in almost all European countries there is currently a marked distancing from the European project and a loss of confidence in the functioning of nationally elected institutions.

It has been noted that the intense process of institutionalization has given rise to two serious limitations. The first, which I have just described, is its growing intergovernmental nature. The second applies exclusively to the field of fiscal union and is closely related to the first. It concerns the fact that until now this process has been focused exclusively on one of the pillars that all fiscal unions should possess, namely, the fiscal discipline of the Member States, while the other pillar has remained virtually undeveloped, namely, the creation of common fiscal institutions. Logically, the fiscal discipline of the Member States is essential. Here, the eurozone has opted for a strong regulatory model, based on the supervision and control of the central government (the Eurogroup), though it is not at all clear that this is the most appropriate in terms of incentives. But it is probably justified, because as long as there is the risk of contamination of the solvency of the sovereign debt of any country towards the single currency, it seems difficult to apply schemes that are based more squarely on market discipline and strict compliance with the 'no bail-out' clause.

Any advances in relation to the other pillar, the creation of common fiscal institutions, have so far been virtually non-existent. Naturally, this has much to do with the shift in the centre of EU decision-making towards mechanisms of an intergovernmental nature. Since there can only be common fiscal institutions if there is first a common government endowed with the essential powers to operate in this area: a budget, tax revenue and a treasury. In fact, as pointed out by De Lecea and Guerguil in this IEB Report, many proposals have been made in recent years to construct this pillar, ranging from the strengthening of the EU budget and the eurozone, with the granting of significant responsibilities in the provision of certain services, to the allocation of certain taxes to this government, and the issuing of joint bonds.

Of these proposals, the one that seems to have advanced furthest, and concerning which there seems to be the broadest consensus, is the creation of a fiscal mechanism to provide stability within the eurozone. The fiscal capacity discussed in the 2012 Four Presidents' Report (Van Rompuy et al.) constituted a brave step in this direction, in terms of its ambition, the degree of detail of the proposal, and the timeframe drawn up for its implementation. But the stabilisation function that appears in the 2015 Five Presidents'

Proposal (Juncker et al.) is much more cautious and vague, and above all, represents a serious delay in the schedule proposed in the earlier report.

In short, in the same way that the crisis has highlighted the consequences of an incomplete monetary union (i.e., one without a fiscal union), we are now making the mistake of building an incomplete fiscal union, based exclusively on the fiscal discipline of the Member States while forgetting to build common fiscal institutions. It is true, as De Lecea points out, that in creating the ground rules and the institutions for a union of different states, a balance must always be struck between risk mitigation and risk sharing. But it is illusory to pretend that by solely adopting measures of budgetary discipline we can prevent the repetition of the serious problems that have affected the eurozone because of the lack of any common fiscal institutions, when a new crisis occurs.

The problem, therefore, is that it is not going to be possible to consolidate the monetary union if this is not accompanied by a fiscal union (which, in turn, will require a significant degree of political union); but, at the same time, it is necessary to acknowledge that the current political conditions are far from ideal for taking decisive steps in this direction. Prud'homme rightly points to the core of the problem when he highlights that the fiscal union is simultaneously necessary and impossible. This raises a serious problem that cannot be solved simply by denying it or ignoring its existence. It is just as naive to think that a United States of Europe of federal inspiration is just around the corner as it is to pretend that it is possible to consolidate everything that has been achieved to date, unless significant steps are taken towards closer political union. The path is uncertain, the road to be taken is difficult to predict, any progress is difficult and often seemingly contradictory, but the direction cannot be any other than to advance little by little towards the creation of common fiscal institutions and policies.