European Stability Mechanism

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Towards a Fiscal Union for the Euro Area

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To overcome the financial and sovereign debt crisis, euro area Member States have further enhanced the economic and monetary union (EMU). The measures taken were largely driven by the need to complete and strengthen the institutional setup of EMU, address the budgetary and macroeconomic imbalances underlying the crisis, and calm financial markets. In parallel, many euro area countries consolidated their budget and implemented significant structural reforms to put their economies back on a sustainable path and to regain competitiveness. All these measures have strong implications for the fiscal set-up in the euro area, its crisis resolution capacity, and the euro area banking system. In combination with actions taken by the ECB, these policy initiatives allowed the euro area to leave behind the immediate crisis phase of high asset market volatility and acute financial stability risks.

Further steps towards fiscal union, as proposed in the report "Towards a Genuine Economic and Monetary Union", jointly prepared and presented in 2012 by the Presidents of the European institutions[1] and by others, could support more growth in the euro area and increase its overall resilience.

I will look at the progress achieved and the more far-reaching proposals presented in the Presidents' report and discuss their benefits in the current economic situation. It is up to the euro area Member States to decide whether to pursue these proposals.

It is true that the environment of cheap and ample financing in financial markets currently sets little incentives to move towards more fiscal union. However, this calm may be elusive. But I think it is also important to note that any further steps towards a fiscal union require a sufficient strengthening of the central euro area level governance power.

Improved fiscal coordination and euro area crisis resolution capacity

The euro area's institutional setup was overhauled during the crisis to overcome existing weaknesses. Arrangements have been made to strengthen the governance framework, and Member States have pooled resources to establish a permanent euro area crisis resolution mechanism, the European Stability Mechanism (ESM) and have created a banking union, which includes a common supervisory structure, resolution authority and resolution fund.

[1] Towards a Genuine Economic and Monetary Union, Herman Van Rompuy (President of the European Council), in close collaboration with: Jose Manuel Barroso, President of the European Commission, Jean-Claude Juncker, President of the Eurogroup, Mario Draghi, President of the European Central Bank, 5 December 2012

The completion of the governance framework during the crisis strengthened fiscal and macro-economic policy coordination and bolstered the crisis prevention capacity. The Treaty on Stability, Coordination and Governance, more commonly known as the Fiscal Pact, the Six-Pack and the Two-Pack tighten existing coordination procedures and incentives for compliance, and tie in fiscal policies at an early stage of the decision-making process. The Macroeconomic Imbalance Procedure also extends this framework to policy areas other than fiscal. Member States are now gaining first experiences in the implementation of these policies, with mixed results so far. The follow-up on country-specific recommendations provided by the European Commission within this governance framework is far from complete, in particular in the area of structural reforms. More needs to be done in this respect. It is now key that the reforms, rules and procedures are implemented and lived up to in a credible manner.

The ESM was established in October 2012 and since then has been operating as the euro area's crisis resolution mechanism. Together with the temporary crisis resolution fund – the EFSF – the euro area countries have pooled resources to build up a common firewall of €700 billion, helping countries in financial trouble with an efficient set of support instruments. The ESM has a maximum lending capacity of €500 billion. So far, only €50 billion has been used. In other words: €450 billion is not tapped, which leaves plenty of room to address any possible future crisis needs. The ESM will also have a role as last line of defence in the banking union. The ESM's experience with financial assistance programmes, some of which have already been successfully completed, shows that its approach of providing support against the delivery of budgetary consolidation and structural reforms has been effective.

The banking union effectively breaks the link between banks and sovereigns through a new bail-in regime and by shifting supervisory and resolution authority to European level. The creation of the Single Supervisory Mechanism (SSM), a joint resolution authority, provides the basis for further financial integration in Europe and irons out remaining supervisory weaknesses. Moreover, Member States have shifted the responsibility for resolving problems in the banking sector from the public purse back to investors and the industry itself through far-reaching bail-in rules and an industry funded Single Resolution Fund (SRF). This should substantially help to prevent future crises and increase Europe's resilience. The resolution regime still has to be fully finalized as resources of the resolution fund are limited and backstopping arrangements still have to be sorted out in the long-run.

Next steps

The current debate on fiscal union draws on the already mentioned "Four Presidents Report" and contributions from other policy makers. Recently, the designated Commission President Jean-Claude Juncker also added steps towards a more complete economic and monetary union to his political agenda for the next Commission's mandate from 2015 to 2020. These proposals partly comprise the measures outlined above, but further steps are envisaged to achieve fiscal union. Steps which would give more fiscal capacity to the euro area level.

Contractual arrangements

A first step is an incentive-based arrangement of contracts with the Commission to support structural reforms. The arrangements would work within the European Semester, which was created to coordinate macro-economic policy. They are thought to be mandatory for euro area countries, and voluntary for others. The Commission would make suggestions for reforms, agree with the Member State and monitor implementation within a multiannual plan. The fiscal component is that the scheme could be supported through financial incentives. Member States with excessive structural weaknesses engaging in significant reforms could get a temporary transfer.

Significant structural reforms are the key priority to enhance growth prospects for the euro area. Any incentive scheme which can be found to support reforms should be welcome. Adding positive incentives to the overall governance framework provides value added. From an economic perspective, some reforms may carry economic costs in the short run, such as foreclosure measures, and only longer-term benefits. Providing limited support in an area complementing structural reform such as funds for venture capital or project finance when business is deregulated may also multiply this positive effect.

Politically, receiving financial support can help to break a political stalemate and create ownership. On top of that, the formula that financial support is provided upon the delivery of structural reforms minimizes the moral hazard problem. I would like to point out that this formula has been included in the ESM framework and worked successfully during the crisis.

The financial incentives may include the creation of "fiscal space" or financial transfers. One could exploit the flexibility of the existing fiscal rules to set reform incentives. However, existing fiscal rules must be firmly applied and using the flexibility within this framework cannot create any ambiguity. Anything else would lead to a credibility loss of the reshaped fiscal framework. Where no fiscal space is left, transfers or EU financing for the private sector in that respective country may provide extra help. EU structural funds or EIB support come to mind here. It could be considered, for example, to lower the own contribution rate of Member States for structural funds.

Macroeconomic Insurance Schemes

A further step in the medium term focuses on risk sharing between Member States, in line with the subsidiarity principle. A central fiscal function designed to absorb asymmetric economic shocks across euro area countries would have to be based on a set of key principles. First, the financial mechanism needs to be designed to temporarily cushion economic fluctuations, and not to persistently transfer resources for re-distribution. This is not an easy task as even short-term economic disruptions can have longer lasting effects. For example, a short-term increase in unemployment may eventually lead to a more persistent ratcheting up of long-term unemployment. Second, it must be accompanied by a governance structure ensuring that Member States keep the incentives for structural reforms and fiscal prudence, in order to counteract any possible moral hazard problem.

Different institutional set-ups can be envisaged for such a macroeconomic shock absorption scheme. It can be arranged as a "rainy day fund" which is built up in good times to support the economy in bad times, as was suggested by the Padoa-Schioppa Group. Alternatively, it can be arranged as a common unemployment insurance. The French Treasury has recently published a more elaborate proposal. Here transfers are linked exclusively to short-term unemployment in order to avoid persistent payments. [2]

[2] Tresor, An unemployment insurance scheme for the euro area, Tresor Economics, June 2014, No. 132

Social funds buffering the effect of macroeconomic adjustments already exist in the EU. One is the European Globalisation Adjustment Fund. This fund receives €150 million per year to support workers having lost their jobs due to globalisation. More importantly, the European Social Fund provides financing of €10 billion per year to support the (re-)integration of workers into the labour market. These instruments would have to be harmonized and integrated in any new scheme. At the same time, they could provide a platform to temporarily increase resources for a shock absorption scheme and gain experience, if Member States want to go that route. At the moment, however, there is no consensus among Member States on such schemes.

Joint debt issuance

A third step for more fiscal union would be the joint issuance of public debt. The four Presidents' proposal mentions this in passing when talking about the financing of specific measures. It is assessed more broadly by the Tumpel-Gugerell expert group[3], which looked in depth at eurobill issuance and a potential debt redemption fund to address the current debt overhang. The report concludes that both options have merits in stabilising government debt markets, supporting monetary transmission, and financial stability and integration. At the same time, the group points out that these merits are coupled with economic, financial and moral hazard risks.

The debt redemption fund would allow Member States to offload a certain portion of its public debt. The Fund would issue bonds above a maturity of 2 years so that national debt can be rolled over into medium- to long-term euro area debt. After the roll-in phase, the fund would redeem bonds over 20-25 years during which Member States jointly repay their European debt receiving earmarked revenues from Member States. On this score, the debt redemption scheme goes beyond the ESM arrangements, where the obligation to repay stays with the country receiving financial support. Repayment falls on all countries for the debt redemption fund and therefore mutualizes liabilities among Member States. Once the repayment has been accomplished, the Fund would expire.

The eurobill proposal envisages a permanent common issuance of short-term notes by a euro area DMO. The option could be introduced with a test phase, but it would unfold its full benefits over time, when the euro area DMO is fully established in the market. Confidence effects, financial market integration and the support for monetary policy transmission based on common short-term debt instruments are expected to increase over time and keep their benefits persistently.

The mutualisation of public liabilities requires a relationship of trust among Members, based on a fiscal framework much stronger than the one we currently have. The expert report recommends to first gain experience with the current framework to acquire sufficient confidence regarding its efficiency. Then it can be judged what additional elements may be needed. Further safeguards can be mentioned, such as prior conditions (similar to the eligibility criteria for new euro area Member States for joining EMU), enhanced envisaged competences for the euro area level in case of fiscal leniency or even default, and a system of automatic sanctions within the financing scheme (interest rate mark-up). It is important to point out that legally, the mutualisation of debt through taxes or joint and several guarantees requires an EU Treaty change. This precludes any short-term steps in this direction.

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[3] Expert Group on Debt Redemption Fund and Eurobills chaired by Gertrude Tumpell-Gugerell, Final Report, 31 March 2014

The short-term and medium-term economic benefits of the debt redemption fund and eurobill issuance are more limited in a calm market environment. Benefits are relatively small as long as market financing is cheap and secured for Member States. The benefits increase when a new crisis situation emerges with high market volatility in the refinancing costs of countries, or the threat of a sudden liquidity problem. The current easy access to market finance for all sovereigns may be elusive given the "risk-on" and search for yield investment mood. At the same, financial market volatility and contagion should be less severe in the future compared to the financial crisis episode in 2010-12 given the improvement in the institutional set-up of the euro area.

A long-term perspective

Over the very long-run, solutions that would lead to an even larger degree of fiscal centralisation – based on a European or euro area budget, may gain some traction. The precondition would be that confidence in national and local government fiscal responsibility becomes fully anchored. This central budget could be limited and complement national budgets in areas with strong cross-border effects (such as networks infrastructure or defence). Further measures towards the fiscal union require policy-makers to strengthen, under all circumstances, the democratic procedures legitimizing such a set-up. Policy-makers, most prominently Minister Schäuble in a recent contribution, as well as think-tanks have made proposals in this respect. Minister Schäuble supports the idea of a strong European budget commissioner having the authority to reject national budgets, and a stronger democratic legitimisation of European institutions. This could include the direct election of the Commission President and a common European electoral law creating a multi-level democracy.[4] The implementation of any measure of that sort would require a deeper revision of the EU Treaties and profound legal and institutional reforms.

Today the euro area's fiscal capacity is limited to crisis resolution events. Euro area fiscal policy currently follows a rules-based approach and relies on policy coordination among Member States. This is very limited compared to any existing federal system, including the USA. But one needs to remember that the prevailing central government role in fiscal federations has been achieved over long periods and is based on a political union. The lesson from existing fiscal federations is that a higher degree of fiscal union also requires a deeper political union. On this account, further steps towards fiscal union in the euro area have to be in tune with a more powerful euro area governance structure.

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This note reflects the intervention of Rolf Strauch at the Eurofi Panel on Fiscal Union, at the Eurofi Conference, Milan on 10 September 2014. It was prepared by Rolf Strauch in collaboration with ESM Senior Policy Strategist Kari Kohonen.

[4] Wolfgang Schäuble, Die Lage in Europa: Welche governance braucht die Europäische Union?, Speech at the international symposium; „Governance in Europe: Taking Stock for moving Forward, Hertie School of Governance Berlin, 27 May 2014.