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NO ESCAPE FROM POLITICS

FOUR TESTS FOR A SUCCESSFUL FISCAL INSTRUMENT IN THE EURO AREA

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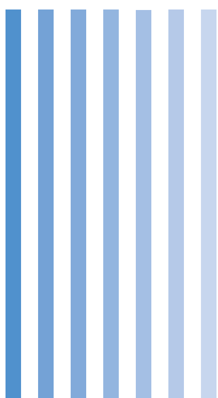
Executive summary

With his proposal for a euro area budget, Emmanuel Macron has put a common fiscal instrument back at the center of the euro area reform debate. The discussion about whether or not the euro area needs more fiscal integration may be older than the currency union itself, but there is good reason to believe that the coming months will be a critical juncture for European fiscal policy.

This policy paper makes two contributions to the debate. **We start out by arguing that a common fiscal instrument is desirable.** We suggest that proponents and opponents of fiscal integration alike should take heed of the unprecedented role the European Central Bank (ECB) played in safeguarding the stability of the euro area and facilitating its recovery. **In our view, the more ill-at-ease one feels with the scale of the ECB measures, the stronger the case for joint fiscal policy becomes.** From this perspective, alleviating the excessive dependence on monetary policy is a key rationale for developing a common fiscal instrument

We then sketch out **four tests** that we argue a new fiscal instrument needs to pass to be both economically and politically successful:

- **First, it needs to be macroeconomically significant:** Unless it reaches a certain size, such an instrument will not be a realistic solution to the inadequate policy mix of fiscal and monetary measures. In addition, the instrument will only make a difference in euro area-wide downturns if it can borrow in the markets or draw on previously accumulated reserves.
- **Second, it needs to be politically sustainable in the long run, not just feasible today:** In our view, this requires the avoidance of salient blanket transfers between Member States. This is because transfers would be easy to depict by populists as one-way handouts and strengthen divisive political dynamics even if they were distributionally neutral over time. As an alternative to transfers, we argue that a fiscal instrument with budget-like features including expenditure on European public goods and cyclical revenue sources could be more politically sustainable.
- **Third, it needs to feature effective governance:** We argue that a fiscal instrument requires a full political decision-making structure to have the democratic legitimacy necessary to make difficult judgment calls and trade-offs. Conversely, we are highly skeptical that technocratic bodies can be effective in a field that is as inherently political as fiscal policy.
- **Fourth, it needs to fit well with the rest of the EU's structures:** This means that it should be properly articulated with the EU budget and distinct in its functions from it. It should take into account the realities of the Single Market and the fact that most 'outs' will eventually

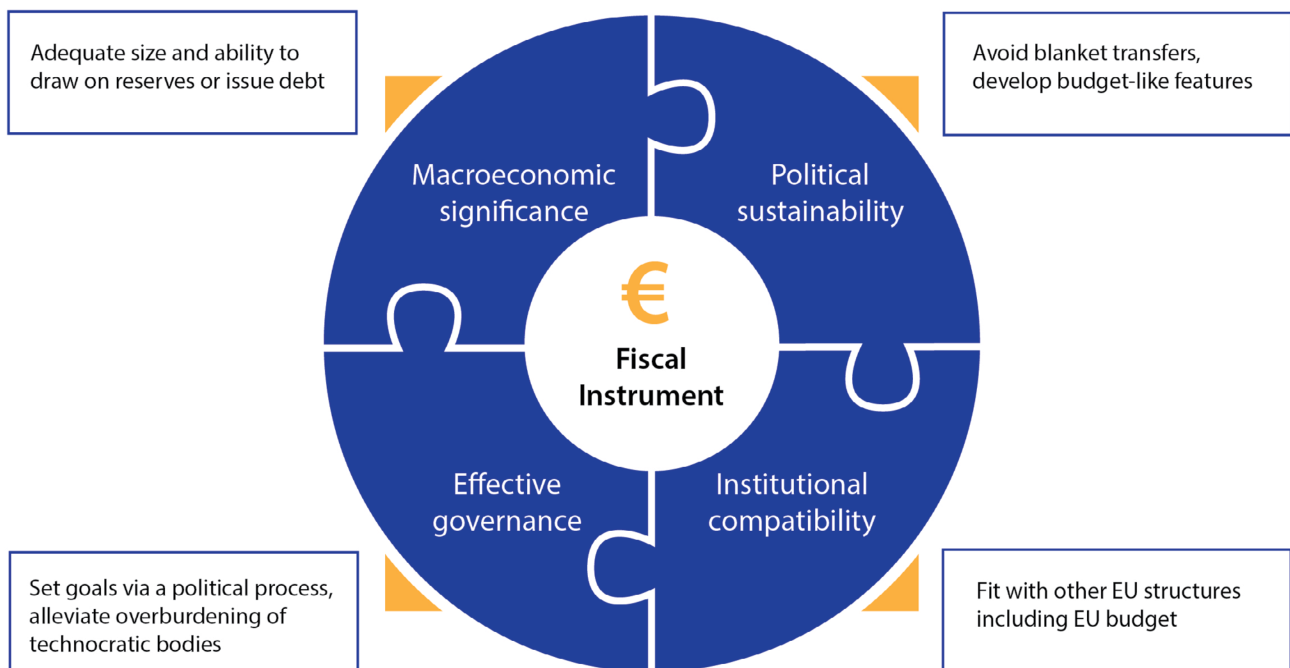


join the euro and hence it should be open to them. And it should not undermine incentives to comply with the economic governance framework.

In our view, **instruments conceived exclusively for the purpose of economic stabilization will have difficulty passing these tests**. Instead, **marrying the need for stabilization with the benefits of European public goods provision** in those areas where European provision is more effective (e.g. defense, network infrastructure, research & innovation), e.g. through an instrument with budget-like features that generate stabilization, could be a promising avenue.

We acknowledge that **in the short run, it is unlikely that a solution can be agreed that will easily pass all four tests.** Still, they are useful as long-run yardsticks to enable muddling through with a goal in sight, as opposed to simply muddling through. Practically, this implies that solutions chosen now should at least be amenable for development towards passing all four tests, and should certainly not preclude this through means legal or otherwise. In particular, it implies that the design features of any instrument should encompass possibilities for scale-up and for improving political sustainability and institutional compatibility over time.

GRAPH 1 ■ Four tests for a fiscal instrument for the euro area



Source: Lucas Guttenberg & Johannes Hemker (2018): No escape from politics: four tests for a successful fiscal instrument in the euro area. Illustration: Cinthya Nataly Haas-Arana

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INTRODUCTION

The case for some **fiscal integration as a counterpart to a common currency** is far from novel. As early as 1977, the MacDougall Report had already pointed to the absence of a "substantial compensatory public finance mechanism" as an obstacle "of great importance to Community integration".[1] And, of course, similar arguments were often heard in the run-up to the Maastricht Treaty that laid the basis for economic and monetary union (EMU).[2] Already then, many scholars argued that a common currency without a fiscal equivalent would lead to imbalances and was ultimately bound to fail. With the onset of the euro crisis, these arguments re-entered the political debate. The **proposal of the new French president Emmanuel Macron to establish a fully-fledged euro area budget has broadened that debate and generated the political momentum previously missing**. What's more, in a move that is at the very least a symbolic nod to Macron, the German coalition government agreement explicitly refers to an investment budget for the euro area.

Yet, beyond such abstract talk, there is a lot of uncertainty about what such an instrument would look like. In this paper, we contribute two elements to the debate: First, **we provide a case for a euro area fiscal instrument** based substantially on the motivation to shift more of the burden of stabilization from monetary to fiscal policy. Second, **we formulate four tests that we argue such an instrument would need to pass to be both economically viable and politically sustainable**.

We acknowledge that fiscal policy in the euro area encompasses many more aspects than the debate on a fiscal instrument: The future of the fiscal rules, a possible sovereign debt restructuring mechanism, or the creation of a euro area treasury are all very important topics that are closely linked. Our paper focuses specifically on the component of a fiscal instrument which is bound to be just part of a much larger institutional transformation.

1 . THREE FUNCTIONS OF EURO AREA FISCAL POLICY

Let us first take a step back: What should be the objective of fiscal policy in the euro area? Put simply, euro area fiscal policy should have three key shared objectives: (1) **stabilization** of economic activity, (2) **fiscal sustainability** and (3) promoting long-run potential growth through **investment**.

Stabilization: In any economy, fiscal policy is a key tool for reacting to economic downturns. When growth plummets, unemployment rises, and households and companies spend less, public spending should, together with monetary policy, act to stabilize overall demand in the economy. Conversely, in good times, stabilization requires limiting expenditure growth and building up buffers in anticipation of future downturns.

Being part of a currency union affects countries' need and ability to use fiscal policy in three ways: First, monetary policy tools are unavailable to individual Member States as ECB mone-

1. See MacDougall et al. (1977), *Report of the Study Group on the Role of Public Finance in European Integration.*
2. See e.g. Italianer, A.and M. Vanheukelen (1993), *'Proposals for Community Stabilization Mechanisms. Some Historical Applications.'* European Economy – Reports and Studies, 5, pp. 493-510.

tary policy can only serve to stabilize output in the euro area as a whole. Second, being part of the euro means being at the mercy of sovereign bond markets as debt is issued in a "foreign" currency that cannot be printed at will. Third, because of the close integration of euro area economies, stabilization in one Member State can have strong spillover effects on others. This is true in particular when interest rates are at or close to their effective lower bound. Thus, national fiscal policies as a stabilization tool are heavily circumscribed for countries that share the common currency. This in turn suggests that a central stabilization instrument could be beneficial.

Fiscal Sustainability: In addition to their role in ensuring stabilization, fiscal policies in the euro area context also contribute significantly to preventing future crises by ensuring that Member States are able to service their debt at all times. Primarily, this means that these have to conduct prudent fiscal policies. However, stabilization and crisis prevention overlap when it comes to fiscal policy under very favorable economic conditions. As economies approach full employment and are at risk of overheating, governments may fail to constrain public spending growth, further contributing to the boom and then exacerbating the following bust. Euro area fiscal policy should not only counter negative shocks but also ensure that national fiscal policy does not add fuel to the fire in good times. It is beyond the scope of our paper to discuss how the rules of the Stability and Growth Pact (SGP) should be developed further to ensure the sustainability of national public finances. But it is clear that any euro area-wide fiscal policy also needs to take adequate account of sustainability concerns.

Investment: Long-run growth is determined by fundamentals such as the education and skills of the labor force, technology, and the state of infrastructure that facilitates economic activity. Investments in these are thus key to ensuring prosperity. Two rationales for common investment approaches are frequently invoked: given large spillovers from investments between Member States and/or economies of scale, joint institutions could achieve both higher total levels and better allocation of funds.[3]

2 . WHY THE STATUS QUO MIGHT BE SUFFICIENT

A number of observers argue that by and large today's euro area architecture is already sufficient to accomplish these goals. Specifically, they suggest that the policies of individual Member States, coupled with a full application of the instruments already available within the euro area's governance framework, are fully capable of delivering economic stabilization, sustainable public finances, and investments for long-run growth.

In this view, **economic stabilization occurs primarily by virtue of the "correct" operation of national fiscal policies**. In particular, the SGP anchors national fiscal policy to ensure long-run budgetary solidity and sustainability over the course of the business cycle, but also explicitly permits Member States to respond adequately to economic downturns. After all, the so-called "preventive arm" of the fiscal rules is based on an assessment of structural – i.e. cyclically adjusted – budget balances that take the state of the business cycle into account. Moreover, beginning in 2015, the European Commission allowed considerably more flexibility to Member States in the areas of investment and cost of structural reforms.[4]

3. Spillovers occur when any given Member States' decision has effects on other Member States. Economies of scale arise when large-scale provision of a good (e.g. at the European level) is more efficient than small-scale provision (e.g. at the regional or national level).

4. See the Commission communication *Making the best use of the flexibility within the existing rules of the Stability and Growth Pact* (COM/2015/012 final)

Skeptical commentators also emphasize the role of public debt levels in sparking crises and will point to the debt reduction objectives already enshrined in the Stability and Growth Pact.[5] Enforcing these objectives more stringently, they might argue, would be a more important contribution to crisis prevention than fiscal policy integration. In addition, Finance Ministers in the Eurogroup are already free to coordinate their fiscal responses in response to economic downturns – as they did in 2008/09 – and ensure that the overall fiscal stance (i.e. the overall discretionary stimulus or contraction) is appropriate.

On investments for potential growth, skeptics might query the premise that euro area measures are necessary to further this goal. If investments boost growth opportunities in the future, it is at least unclear which element of the current architecture stops Member States from implementing them on their own. Even if one were to accept the premise that common measures in this area are desirable, several tools to boost investments have existed in the EU budget for some time. Moreover, the investment function has experienced a considerable upgrade with the development of the European Fund for Strategic Investment (EFSI) since 2014.

Finally, a number of observers have argued that if one wanted to improve stabilization in the euro area, the focus should be on private risk sharing. In this view, facilitating cross-border holding of debt and equity which would help spread the burden of a regional downturn more broadly in the euro area, thus supporting adjustment. This approach would call for completing banking union and getting closer to a real capital markets union.

Overall, in this view, the current fiscal policy framework, whilst imperfect, is sufficient to support economic stability and prosperity in the euro area.

3. THE FOUR TRILLION EURO ELEPHANT IN THE ROOM

Alas, **such a view remains incomplete on a number of fronts**. **Most importantly, it simply fails to take into account the enormous role that the ECB has played** – or had to play – both in stabilizing the euro area and in supporting the present recovery. In addition, we explain in Box 1 why this view also ignores certain features of national fiscal policies within a currency union and why financial market integration is unlikely to do the trick on its own. But we will focus our main argument on the mix between monetary and fiscal policy.

The ECB's interventions occurred through **two types of measures**:

- First, starting as early as 2010, the ECB took a number of **measures to ensure that its monetary policy would continue to be effective** even in the face of financial market turmoil.[6] This included the Securities Markets Programme (SMP), a series of Long-Term Refinancing Operations (LTROs) and the announcement of Outright Monetary Transactions (OMT). As a byproduct, these measures led to a considerable improvement in market access for Member States that had come under siege on sovereign bond markets and strongly boosted investor confidence in the integrity of the euro area. This dispelled the danger of a break-up of the currency union. But the measures also prevented Member States from having to further reassure markets by taking even swifter action to improve

5. According to the so-called "debt rule", Member States are required to reduce their debt to below 60% by 1/20 of the distance between their debt level and 60% every year.
6. Financial markets had become extremely fragmented, meaning that, for example, a rate cut by the ECB had vastly different effects from one Member State to the other.

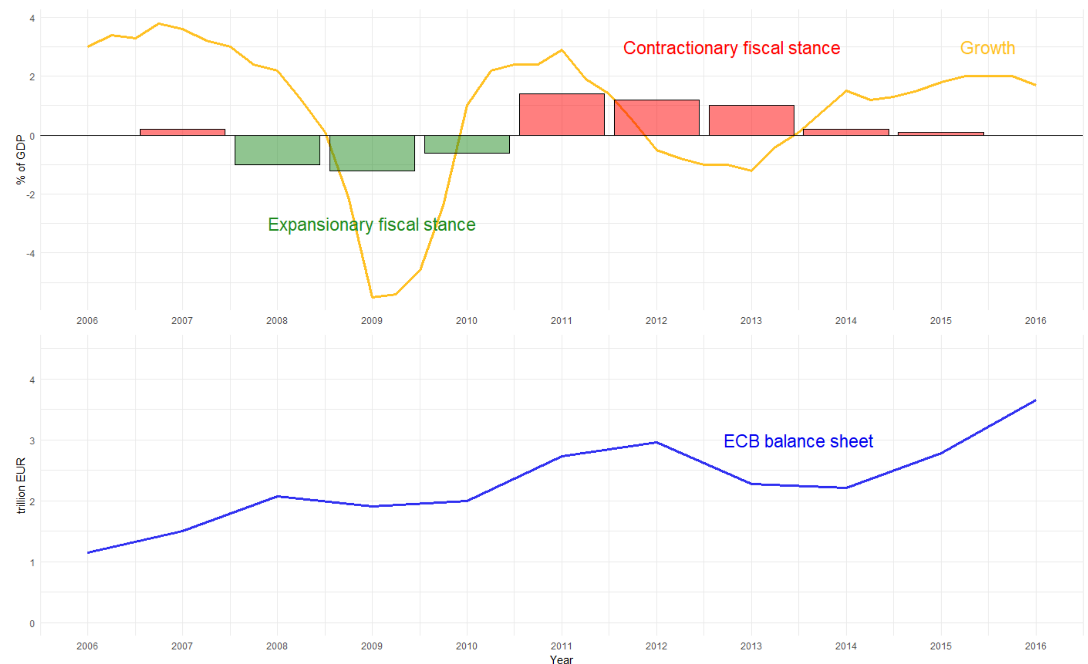
their budget balances, thereby plunging their economies even deeper into recession. The aggregate effects of such additional fiscal contractions would have been very substantial because of the large number of Member States concerned and the presence of strong spillovers between them.

- Second, ECB **monetary policy delivered a massive boost to the euro area recovery** with a series of measures going back at least to the reversal of its interest rate hike in 2011. On the one hand, these included several interest rate cuts and the first-ever negative interest rates on the deposit facility, an instrument that banks use to store excess cash with the Eurosystem. In addition, of course, the ECB launched its large-scale asset purchase program – known as quantitative easing (QE) – beginning in 2015, which has so far resulted in the purchase of more than EUR 2 trillion in securities.

Two responses to the crisis: anemic fiscal policy, determined monetary impulse

How does this compare to the fiscal policy response to the crisis? In Graph 1, we look at how national fiscal policies and the ECB each responded to the crisis. The top portion of the graph displays euro area quarterly growth rates (line) and the fiscal policy impulse ("fiscal stance", colored bars). Bars above zero indicate fiscal contraction, bars below zero indicate fiscal stimulus. The bottom portion displays the growth in the ECB's balance sheet over the same period, as a very rough overall proxy indicator of the size of the monetary stimulus.[7]

GRAPH 2 ▪ Growth, fiscal stance and ECB balance sheet during the crisis



Source: ECB, European Commission. The fiscal stance is the change in the cyclically-adjusted budget balance according to Commission figures

7. The ECB balance sheet (more precisely the Eurosystem balance sheet) depicts the assets and liabilities held overwhelmingly for monetary policy purposes – mostly securities bought outright in markets and lending to euro area banks as part of monetary policy operations. Roughly speaking, the bigger the size of the balance sheet, the more liquidity has been injected into the financial system. See ECB web link for data.

Graph 1 shows that **while the ECB was engaging in massive monetary stimulus, pushing its balance sheet close to four trillion euros, euro area fiscal policy failed the test spectacularly**.[8] Not only was fiscal policy strongly contractionary between 2011 and 2013, deepening the crisis, but was even more contractionary than the European fiscal rules required. Of course, at the country level, there were a variety of rationales for this, including most importantly reassuring bond markets of debt sustainability. But from a euro area perspective, fiscal contraction at the height of the crisis was counterproductive with tremendous negative consequences for output and employment.

In effect, in its attempt to get inflation back to its medium-term objective, **the ECB picked up an important part, though by no means all, of the slack left by anemic fiscal policy**.

Of course, the ECB's measures have provoked substantial controversy. Many observers have criticized the extent to which the bank intervened in markets, with some claiming that its actions have stretched or even burst its mandate. Others argue that QE should have come even earlier and with more determination. The bank itself insisted that the actions were necessary and lawful, with their legality confirmed by the ECJ. But the ECB itself insisted that **a better mix between fiscal and monetary policy stimulus would have been the better solution**.[9]

Hence there is a fundamental inconsistency between the view that the ECB delivered excessive monetary stimulus, and the view that, given the recovery, the euro area does not need further reforms. Had the ECB been any less active during and after the crisis, the recovery would have been even slower and the fiscal quagmire in the euro area would only have visibly deepened. And it would have become even harder to argue that the euro area architecture as it stands is capable of securing stability and employment.

In our view, **the dependence of the euro area economy on the ECB during the last five years highlights the urgency of reform**; delaying it until after the next crisis would be calamitous. Moreover, those who feel uncomfortable with the ECB's disproportionate role in the current recovery have a particularly good reason to be in the vanguard of reforming euro area fiscal policy: a common fiscal counterpart to monetary policy would reduce the need for ECB intervention.

And indeed, we would argue that ECB critics and supporters already agree on a number of arguments why a more limited ECB role in the future would be desirable:

- **Monetary policy is a relatively blunt tool**. Downturns affecting only a subset of Member States are hard to cushion efficiently by means of a common monetary policy. And even when a downturn hits the euro area as a whole its effect will be very uneven across Member States. This strengthens the case for a targeted response.
- Monetary policy can have **unintended side effects** ranging from potential bubbles in asset and financial markets to substantial redistributive effects via its impact on asset prices.
- Monetary policy has a **finite arsenal of tools**. These have been deployed heavily during the most recent crisis. The more measures the ECB has to deploy at a given moment, the less margin remains to use monetary policy in a new crisis or in the event of an unforeseen shock to inflation.
- Monetary policy is – for good reasons – **decided in a technocratic fashion** with only price stability in mind. Fiscal policy is the outcome of a democratic process and has greater legitimacy when it comes to deciding on the kind of trade-offs that come with large-scale stabilization efforts.

8. See for a very useful discussion of the different causes for the depth of the recession Terzi, A. (2018), *Macroeconomic Adjustment in the Euro Area.*

9. See e.g. Draghi, M. (2014), *Unemployment in the euro area.*

BOX 1 ▪ Why overburdening monetary policy will not be solved through national policies or more private risk sharing alone

Better functioning of national fiscal policies is desirable but insufficient

Of course, one could argue that a larger role for fiscal policy could simply be achieved through a better functioning and coordination of national fiscal policies. As an example, one might point specifically to the first downturn in 2008/2009, when Member States coordinated their fiscal responses to achieve stabilization with some success. Certainly, better coordination is desirable. However, there are four reasons why it is likely to be insufficient.

First, **Member States had much bigger fiscal buffers** when the crisis hit in 2008, as debt levels were substantially lower. Today, many would find it difficult to react on their own to a new downturn in a determined fashion.

Second, the crisis showed that **even if countries conduct prudent fiscal policies in line with the rules, national fiscal buffers can become overburdened** – the shock just needs to be severe enough.

Third, the **perception of participants on financial markets has changed**. In 2008, they still assumed there would be a full bailout of euro area Member States, an assumption made obsolete by Greek debt restructuring. While the no-bailout clause still lacks credibility, investors remain uncertain today whether there will be any private sector involvement or not. Hence, if an individual Member State deploys a massive fiscal response, there is now always the danger of losing the confidence of markets, which can turn rapidly into a loss of market access especially once monetary policy will have normalized and spreads will naturally have widened already.

Fourth, **the fiscal rules at work today do not lead to anything resembling optimal fiscal outcomes from a euro area perspective.** Since spillovers can be large between the integrated euro area economies, and downturns can be much more pronounced in some countries than others, Member States would need to take account of the effects of their fiscal policy on the others – but the rules do not factor this in. This led to a situation in 2012-13 when practically only Germany had room to spend more to improve the euro area fiscal stance but did not do so – in full compliance with the rules. Conversely, the 2003 downturn was particularly pronounced in Germany that would have stood to benefit greatly then from a unified euro area fiscal response – which it in fact proceeded to engineer domestically by breaking the fiscal rules instead.

Private risk sharing alone will not do the trick

A number of observers have argued that the euro area does not need a fiscal instrument because stabilization could best be achieved through private markets. The relevant policy instruments for this would be banking union and capital markets union. Fully discussing this question would go beyond the scope of this paper and others have already done it well.[10]

While **increased private risk sharing would undoubtedly help, two considerations make us skeptical that it will reach levels that would be sufficient.**

First, politically **it seems less and less likely that banking union will be completed with a robust fiscal underpinning anytime soon.** Curiously, those who are skeptical of a new fiscal instrument for the euro area also cast most doubt on a backstop for the Single Resolution Fund and a viable common deposit insurance with firm fiscal backing. However, it seems very unlikely that, without these elements, the scale of private risk sharing will ever be enough to make a new fiscal instrument obsolete. Private risk-sharing seems contingent on some degree of public risk-sharing.

Second, and more fundamentally, one should not forget that **precisely at the moment when it was vital, private cross-border risk sharing was in full retreat** during the crisis as banks bought their home country's sovereign debt and the nexus between sovereigns and banks intensified.[11] One should at least be skeptical that even full banking union will be able to fully preclude such a development in the future.

10. See e.g. Farhi, E. and I. Werning (2017), *Fiscal Unions*, and Berger et al. (2018), *Revisiting the Economic Case for Fiscal Union in the Euro Area.*
11. ECB (2017), *Financial integration in Europe.*

4 . FOUR TESTS FOR A SUCCESSFUL FISCAL INSTRUMENT FOR THE EURO AREA

Suppose one accepts the conclusion that the euro area needs a stronger role for fiscal policy, and that better coordination and private risk sharing, while desirable, are no substitute for a central fiscal instrument. The next question then becomes "how?"

This debate will become heated in the months to come and there are already myriads of different technical proposals out there. We argue that **any fiscal instrument needs to pass four tests to be both economically effective and politically viable** in the long run:

- It needs to be **macroeconomically significant**: This is a question of size, expenditure composition, and whether or not the instrument can go into debt or tap a reserve fund.
- In order to be **politically sustainable**, it should avoid direct transfers between Member States and instead focus on real European expenditure and revenue.
- For an **effective governance**, it should not rely on technocratic bodies, but on political decision-making with strong democratic legitimacy.
- It has to be **institutionally compatible** with the rest of the EU's structures; in particular it needs to be well-articulated with the EU budget.

It will be politically very challenging – maybe impossible – to find a setup that passes all four tests right from the start. Therefore we discuss possibilities for transitioning towards such an instrument at the end of this paper.

4.1 The macroeconomic significance test

Alleviating the burden of the four-trillion-euro elephant requires more than a fiscal mouse. Any new fiscal instrument will need to be able to tackle the issues we have outlined above. Otherwise, it will lay a debate to rest without actually improving the resilience of the euro area.

This implies two conditions: a common fiscal instrument has to enable a better response at the European level to developments in Member States and at the same time improve the mix between monetary and fiscal policy in downturns affecting the entire euro area. This is, in turn, a function of two factors: First, obviously, **size**. Second, the **capacity to draw on reserves or issue debt**.

Size matters, but additionality does not

While it would be unwise to feign precision, **instruments that are an order of magnitude smaller than 1% of euro area GDP,** about the size of the current EU budget**, are very unlikely to make a dent in the long run**. This is particularly true if the instrument is supposed to have an impact not only in smaller Member States, but also in medium-sized and large economies. In turn, positive impacts on Member States large and small would also seem a necessary condition for political viability.

Yet, **separating the euro area fiscal instrument debate from age-old struggles about the public share of total expenditure and average tax burdens is imperative**. An ambitious instrument does not need to come "on top" of existing national budgets and need in no way imply

higher total public spending. Instead, re-allocating functions to the European level in those cases where it is better equipped to exercise them should generate savings and/or improved public service quality.[12] In our view, **the push for an ambitious common fiscal instrument can and should go hand in hand with reformist commitments to refocus European (and national) spending** on programs that work, and to let others expire.

Case in point: 38% of the current EU budget is dedicated to a Common Agricultural Policy which is not exactly a model of European public goods provision. Hence it would seem puzzling if an investment of roughly similar magnitude in the stability and prosperity of the currency union were to be dismissed as "too expensive".

Why outside funding via reserves or debt is important

If a fiscal instrument is to contribute to a better policy mix between fiscal and monetary policy in a euro area-wide downturn, it **needs to be able to alter the fiscal stance of the euro area as a whole**. Critically, this has to function at a moment when revenues are declining. In this situation, there are only two routes to go: Building up reserves in advance that can then be drawn down, or allowing the instrument to issue debt when necessary.

The **difference between debt and reserves should not be overstated**. If the budget is balanced over the medium run, financing arrangements are stable and Member States remain solvent, then whether good times are used to build up reserves in a low-return fund or pay down low-return debt makes a bigger difference politically than it does economically.[13] Of course, a reserves-based system would ensure that no additional liabilities are created. Nevertheless, building up reserves is costly and could lead to scenarios where fiscal impulses are necessary but reserves are drawn down. In any case, the important part from a stabilization perspective is that additional funding needs to be available in case of a downturn affecting all Member States.

Finally, we note that a fiscal instrument that passes the macroeconomic significance test would also contribute to fiscal sustainability. Demonstrably stronger stabilization in the euro area would reduce the risk of countries becoming unable to service their debt, durably improving their financing conditions and the sustainability of their public finances.[14]

4.2 The political sustainability test

It is obvious that political feasibility constraints need to be taken seriously into account in designing a common fiscal instrument. **But once they are in place, policies create their own politics.** Therefore, a second and perhaps less obvious criterion is what kind of political dynamic a policy will give rise to once implemented, and whether this dynamic will allow it to be politically self-sustaining. Put differently, the results of putting a policy in place should not undermine public support for it. We argue that political sustainability should figure prominently among policymakers' concerns, and that it militates against fiscal instruments based on transfers between Member States.

12. Along these lines, see also Bertelsmann Foundation (2017), *How Europe Can Deliver: Optimising the division of competences among the EU and its member states.*

13. Issuing debt would also have the additional advantage of providing additional safe assets to the financial system. Discussing the implications of this aspect goes beyond the scope of this paper as it would heavily depend on other factors, in particular the regulatory treatment of sovereign bonds of Member States.

14. As a recent IMF paper has pointed out, increased fiscal risk-sharing could even help make the no-bailout clause more credible "by reducing the EMU-wide costs of idiosyncratic country shocks". See Berger et al. (2018), *Revisiting the Economic Case for Fiscal Union in the Euro Area*, p.14

"Technocratic" stabilization instruments as politically feasible options

The imperative of political feasibility has led many proposals for a fiscal instrument to be structured around four criteria:

- The volume would need to be very limited, at least at the start;
- There should be no permanent transfers between countries;
- Decision-making should be as depoliticized and based on "objective" criteria as possible;
- Moral hazard concerns about the wrong incentives generated through insurance would need to be prominently addressed.

In this vein, **the debate has focused on what could be called "technocratic" stabilization instruments**. Ideas in this direction were already floated before the start of the euro in the 1990s. More recent examples include a proposal for a cyclical shock insurance[15]; a paper by 14 Franco-German economists, the forthcoming proposal by the European Commission for an investment protection scheme and the proposal by the ESM Managing Director for a so-called rainy-day fund.[16]

What unites all these proposals is that they define rules and an underlying technocratic process according to which Member States receive fiscal support if certain conditions beyond their direct control are met. The proponents of this approach argue, perhaps correctly, that by avoiding deeper full-scale political choices about expenditures (and revenues), such a tool is more palatable to Member States and the public and thereby stands a higher chance of being implemented before the next crisis than deeper fiscal integration. And indeed, such concepts can make sense in the short run to avert the possibility that the euro area faces the next crisis without any additional safeguards.

Why transfer-based instruments risk being politically unsustainable

Still, we believe this approach falls short in one important way: it **will likely breed highly divisive politics**, rendering it politically unsustainable in the long run. While any forward-looking analysis of these aspects is inherently speculative, there are good reasons for concern based on what we know about voter's perception and behaviour.

Any system of straight-up transfers between Member States would allow populists to create the perception of one-way hand-outs since it would remain alien and unintelligible to voters. Whether or not the system is distributionally neutral over time – i.e. avoids permanent transfers from one country to another – is a key concern for many in the current policy debate. But this is unlikely to alter political perceptions at any given moment: Populist messaging and media reporting would focus on the immediate flow of transfers instead of on the long-run properties of the instrument. Thus, even if the outcome proves distributionally neutral in the long run, voters with little trust in the European Union will scarcely be reassured by obscure references to "experience rating" and "claw-back mechanisms". Once transfers are triggered, the political backlash would set in before the system could equilibrate.

Design features of a transfer system could inadvertently amplify this tendency. Setting the bar for triggering payouts very high (e.g. requiring a drastic increase in unemployment) in order to limit the frequency of transfers might even *underscore* voters' sense of a transfer union at work since it would more closely align actual cash flows with perceptions of economic turmoil.

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15 .Enderlein, H., L. Guttenberg and J. Spiess (2013), *Blueprint for a shock insurance in the euro area*

16. Bénassy-Quéré, A. et al. (2018), *Reconciling risk sharing with market discipline: A constructive approach to euro area reform*; European Commission (2017), *New budgetary instruments for a stable euro area within the Union framework*; Regling, K. (2017), *Unfinished business in the new EU political constellation*

Moreover, the type of support that would be most beneficial from a macroeconomic perspective – un-earmarked cash for the public purse – is precisely the one that would also be easiest to depict as a crude give-away to spendthrift governments.

There is also an **important connection between size, design and salience of a fiscal instrument**: the more it moves away from acting as a targeted and salient stabilizer and shifts towards a "normal" budget, the weaker its stabilization properties become, and the larger and more salient it has to be to achieve a given stabilization effect. This is amplified by the choice of revenue streams.

Finally, **the salience of short-run distributive transfers would not only be politically pernicious in itself**: it would also stand to be the *only* aspect of the policy that voters naturally experience and learn about in their daily lives. A stabilization scheme is as abstract as it gets and – beyond the political discourse – completely invisible to voters. It is difficult to avoid the conclusion that there is no natural constituency beyond macroeconomists that would sustain it politically. Politicians in "receiving" countries would have no obvious reason to share the credit for swifter recoveries with an impersonal pot of money. Politicians in "sending" countries would either seek to criticize the transfers or downplay them.

One important illustrative example in this regard is the scheme for fiscal transfers between German states (called *Länderfinanzausgleich*, or inter-state financial equalization). For many decades, a distinct part of this complex redistribution process featured blanket straight transfers between states. Although the redistributive effect achieved through this part of the process was no larger than many other regionally redistributive effects in the German tax, health care, and social systems, it drew the ire of state politicians for decades. This is because the distributive effect was extremely salient, and the amount redistributed from or to a state, with no strings attached, made for an excellent talking point at political events. In 2017, the straight transfer element was finally rescinded on the initiative of net contributor states. A good portion of the scheme's redistributive effect is now generated by other, less salient mechanisms that do not draw comparisons with alms or handouts in the daily news.[17]

We think this example is important for two reasons. First, it illustrates that **the salience of transfer systems matters greatly politically** and is not nearly as directly a function of raw economic factors as one might think. Second, the now-defunct equalization payments system often serves as the lens through which the German public views regional transfers. Understanding why it was politically unsustainable even within one country is crucial to building a euro area fiscal instrument that would support stability and growth in the long run.

What could make proposals politically sustainable

Given the above, **equipping a common fiscal instrument with clear budget-like features could be a way out**. This could in particular include expenditure on European public goods and genuine European revenues.

European public goods: The irony behind much of the debate on joint expenditures is that proposals are often motivated not so much by specific spending priorities, but by the macroeconomic arguments for joint expenditure *per se*. For many macroeconomists worried about the euro area, the first-order priority is the stabilizing effect of fiscal stimulus, not the substantive spending priorities themselves. Of course, this is the inverse of the process normally observed in fiscal policy, where substantive expenditure priorities arise as a political response to substantive needs. In our view, reconciling the macroeconomic rationale for joint expenditure with

17. Ifo Schnelldienst (2016), *Reform der Finanzbeziehungen zwischen Bund und Ländern: Fairer Kompromiss oder Setzen neuer Fehlanreize?*

the inherently political logic of any given expenditure priority is one of the key challenges that advocates of fiscal reform need to convincingly address.

This is why we think **it might be most promising to link a common fiscal instrument to a clear economic case and a compelling political narrative** on why some important policy goals are best pursued at the European level – not only for the sake of stabilization but because European provision provides better value for citizens. **Such a narrative would need to explain clearly why and how European expenditure generates European public goods that nation states are increasingly unable to provide** – financial stability, the fight against climate change, a functioning Single Market, internal and external security, to name but a few.

Stabilization should clearly feature as a prime concern in the initial design. But it *cannot* be an end in itself.

Genuine European revenue: The revenue side of a common fiscal instrument tends to receive considerably less attention than the expenditure side. This is particularly unfortunate since the macroeconomic effects of the revenue side are *a priori* just as important. Moreover, stabilization might be easier to accomplish on the revenue side: using inherently cyclical revenue sources such as a common corporate tax would generate "automatic" stabilization as opposed to "planned" stabilization using targeted transfers.[18]

At the same time, how revenues are collected – via direct checks from Member State budgets or indirectly in a more diffuse way through taxation – makes a big difference politically. Making the revenue side politically sustainable would also suggest **avoiding blanket checks from governments** to a common pot or directly to other governments and instead **relying on real common revenue sources** such as a common corporate tax or a CO2 levy. Besides the benefits that common revenues could generate from a tax policy perspective, they could also help overcome the obsession over net balances which dominates discourse over EU finance, and which is exacerbated by ex-ante planning of national contributions.

In sum, this suggests that **a new fiscal instrument would need to avoid salient direct transfers between governments**. Adopting the logic of a genuine budget with dedicated revenue and expenditure would be one way to pass this test.

4.3 The effective governance test

Deciding on a new fiscal instrument such as a euro area budget will also entail deciding on its governance. In particular, this involves finding the **right balance between political decision-making and technocratic action** to ensure effectiveness and democratic legitimacy.

Why technocratic bodies should not decide on fiscal policies

One understandable tendency among proponents of a euro area fiscal instrument is the desire to depoliticize decision-making as much as possible. The hope is straightforward: If politicians cannot influence the outcome, funds will be most stringently spent on achieving the economic goals they were set out to accomplish.

Certainly, technocratic bodies can help find the best means to achieve given ends – for example, use data and monetary policy tools to stabilize inflation. But **fiscal policy is about ends just as much as means**. This makes it **fundamentally political**. As Schumpeter wrote in citing

18. Of course, "automatic" stabilization could also be generated by countercyclical expenditure, for example through an unemployment insurance scheme, or on both sides of a budget simultaneously. See also DG Trésor (2016), *A contribution to the work on the strengthening of the euro area.*

Goldscheid: “the budget is the skeleton of the state stripped of all misleading ideologies”.[19]

On the spending side, fiscal policy requires prioritization among an unlimited set of rival possibilities. In the logic of a euro area budget, every euro that is spent on a road in Northern Finland can no longer go towards cancer research in Lisbon. It is hard to see how a technocratic body could make this kind of judgment call without firm democratic control. On the revenue side, it is similarly difficult to envision technocrats de facto creating liabilities on households, businesses or sovereigns, which is traditionally the prerogative of parliaments for good reason.

Why political sustainability requires political institutions

Fundamentally, asking technocratic bodies to make these kinds of decisions means asking too much of them. When faced with inherently political issues and associated political pressures, **technocratic bodies lack the necessary legitimacy and political capital to act and become overburdened and political themselves**. This poses a threat to their political sustainability when Member States and voters lose faith in their ability to be impartial arbiters, eroding the basis for technical deliberation and consensus-building. In short, overburdened technocratic bodies undermine the political conditions that sustain them by blurring the distinction between setting political targets and examining technical means to an end.

Thus, **a new euro area fiscal instrument should rely on a political decision-making process**. It should be implemented by an executive that is politically accountable, democratically controlled, and has the legitimacy necessary to make judgment calls. The easiest way forward here would be to rely on existing EU institutions to the largest extent possible.

4.4 The institutional compatibility test

The design of a new fiscal instrument has to ensure it **fits with the overall architecture of the European Union** in three ways. First, it has to take account of the fact that while some Member States are not part of the euro area yet, they are part of the Single market and are expected to join the euro at some point. Second, the new instrument has to be properly articulated with the EU budget. And third, it has to complement the rules of the economic governance framework.

Geographic scope

At the outset, it seems clear that the main motivation behind a common fiscal policy would call for a clear focus on the euro area: Countries that have given up their own monetary policy are less well-equipped to deal with asymmetric downturns than those outside the euro area. And for all euro area members, the stability of their partners is much more vital for their own financial stability and growth prospects than that of the ‘outs’.

However, when it comes to potential spending priorities that go beyond pure stabilizing transfers, many are likely to be as relevant for the EU-27 as for the euro area – be it climate change, R&D, infrastructure investment or internal security. The current EU budget addresses some of these but does not contribute much to cross-border stabilization. Therefore, one could also imagine a common fiscal instrument that covers EU-wide priorities while delivering stabilization and investment. This seems all the more reasonable when considering that post-Brexit euro area countries will account for 85% of EU GDP and that, apart from Denmark, all Member States are legally required to join the euro at some point. In addition, the four freedoms in the Single Market call for a level playing field in a whole range of matters, which will make it even

19. Schumpeter, J. (1918), *Die Krise des Steuerstaats*, p.6

more compelling not to differentiate between 'ins' and 'outs' when it comes to the provision of public goods.

In summary, **a fiscal instrument for the euro area should at least be open to non-euro area Member States** that would be willing to participate.

Articulation with the EU budget

The new fiscal instrument would need to fit well with the current architecture of EU public finances, in particular with the EU budget, to avoid any duplication of functions. This is essential for making a compelling case as to why an additional instrument is necessary at all.

One possibility for making the new instrument complimentary with the EU budget could be for it to become a second, dynamic part of the EU budget where expenditure follows common priorities and responsibilities and where revenue sources exhibit stronger stabilization properties than is currently the case. The current budget, in turn, could be downsized to mainly provide catch-up support to poorer Member States.

Interaction with the economic governance framework

The economic governance framework of the EU with the European Semester at its core is supposed to ensure sound economic policies in Member States. Any new fiscal instrument would need to be designed in a way that contributes to this objective.

However, in our view, the further away an instrument moves from direct transfers between governments and the closer it gets to a real budget with own competences at the European level, the less pressing concerns about moral hazard, i.e. setting wrong incentives for national policies, become. It is plausible that straight transfers to Member States might reduce their appetite for sound policies. However, it is much less clear why more central funding for innovation or transnational infrastructure would lead to more lavish economic policies in Member States. Given the centrality of moral hazard concerns in the debate, we think that this is an important advantage of a fiscal instrument with budget-like features.

One tool that could contribute to building trust across Member States in the run-up to a common fiscal instrument would be a new convergence process akin to the one before the start of the euro. Joining the fiscal instrument could be predicated on successful completion. In such a convergence process, Member States would commit to following the rules of the governance framework and would strive towards similar levels of resilience against shocks that could make a joint fiscal policy more viable politically.

5 . TRANSITION: MUDDLING THROUGH WITH A GOAL IN SIGHT

It is highly **unlikely that any short-run solution will be deemed politically feasible** by all relevant players and will pass all four tests outlined above. However, this is **no excuse for inaction**: The problem we have outlined in the first part of this paper – the inadequate contribution of fiscal policy to the policy mix – remains too acute not to be dealt with before the next crisis hits.

But if muddling through with an imperfect instrument is the only available option politically, it should be with the goal of passing all four tests eventually clearly in sight. This implies several elements:

- Political commitment: Should policymakers agree on an instrument that does not pass all four tests, they should do so with a **clear understanding that such an instrument would be temporary in nature** and that it should not close the debate on the right contribution of fiscal policy in the euro area.
- Passing the macroeconomic significance test: If the fiscal instrument to be decided upon now fails to be macroeconomically significant, it can still function as the **nucleus of a meaningful instrument** further down the road. But to be such a nucleus, it needs to include clear scope for **scalability** and should **allow for further changes to its design**. This is particularly relevant if in a first stage, a possibility to build up reserves or to go into debt is not foreseen.
- Passing the political sustainability test: If one were to initially rely on direct transfers between governments, it would nevertheless be important to start work on **building the infrastructure for a viable long-run solution in parallel,** and to foresee clear transition dates for this. On the revenue side, this could involve relying on financing sources that mimic real European revenues rather than blanket checks. For example, an 'imputed corporate tax' based on estimated corporate tax bases in each Member State could be used as a holdover revenue source while work on the common corporate tax progresses. A similar tool is already used to calculate Member States' VAT-based contributions. On the expenditure side, earmarking transfers and centralizing the administration in areas where European provision is more efficient could make a contribution towards the institutionalization of European public goods provision.
- Passing the effective governance test: The governance of a new fiscal instrument ought to **foreshadow to the largest extent possible a political decision-making process** rather than establishing new technocratic bodies that would be very difficult to turn into political institutions further down the road. The easiest way would be to rely by and large on existing institutions.
- Passing the institutional compatibility test: The new fiscal instrument would need to be designed in a way that does **not duplicate functions already carried out at EU level** through the EU budget. It should **include the possibility for non-euro area members to join** if they wish. The upcoming discussion on the Multiannual Financial Framework post-2020 could be a useful forum to discuss how a new euro area fiscal instrument and the future EU budget could complement each other. Finally, it could **include a new convergence process** to ensure that Member States follow the rules of the economic governance framework prior to the start of the instrument.

Keeping these elements in mind in the coming months will help policy-makers focus on the important trade-offs to be made when making first steps towards a new fiscal instrument for the euro area.

At first glance, such long-run plans may seem overly ambitious. But there is, we think, a larger lesson to be learned from the development of the currency union over the past years. Sharing a common currency is a much deeper and much more political commitment than is frequently realized. To a limited but important extent, we already live in the "political union" that many think remains on the drawing board. That this shared reality should increasingly be reflected in joint economic governance may be less revolutionary than current thinking would have one believe.

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