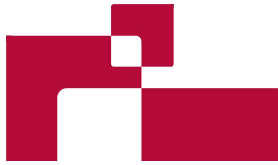

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WHAT KIND OF FISCAL UNION?

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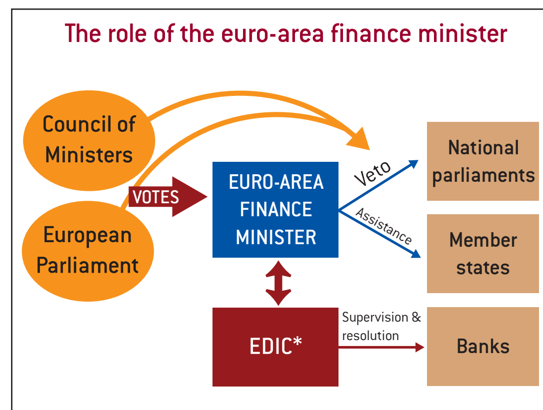
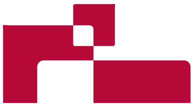
THE ISSUE The euro area's shortcomings have become abundantly clear. It was set up without powers of strict surveillance over macroeconomic imbalances, crisis management and resolution instruments, or adequate banking supervision and resolution tools. The core reason for these failures is the absence of a fiscal union with corresponding authority over fiscal, structural and banking policies. Attempts to right these wrongs have been ad hoc and have so far fallen short and moral hazard is prevalent. Financial markets are increasingly aware of these inadequacies, and have started to price in the possibility of the break up of the euro area.

POLICY CHALLENGE

We propose limited fiscal union, including the creation of a euro-area finance ministry, with a minister with veto rights over national budgets that could threaten euro-area sustainability. The ministry would also assess the liquidity and solvency of governments facing difficulties, and provide support to illiquid but solvent governments. It would be able to rely on federal tax resources, and would set up and back up a euro-area deposit insurance corporation with banking supervision and resolution authority. Our plan implies a significant transfer of sovereignty, requiring a new political contract between the euro area's nations and people. The finance minister would be held democratically accountable. Setting a clear transition to limited fiscal union should create space for the European Central Bank to act as lender of last resort.



Source: Bruegel. * Euro-area deposit insurance corporation.



THE EURO AREA faces severe challenges, with a break-up of the monetary union now being openly discussed. The recent crisis has clearly exposed the failure of the Maastricht architecture for Economic and Monetary Union (EMU). Central to this failure is the lack of any fiscal capacity at the euro-area level. This Policy Brief proposes that the EMU architecture must be strengthened by taking steps towards a fiscal union that involves both a political authority (a euro-area '**finance minister**'[1]) and fiscal resources to prevent, manage and resolve crises.

This would necessitate a new treaty. Since it would amount to a new contract between the member states and the citizens of the euro area, we propose that the new treaty be preceded by a Convention that would prepare the ground for an Intergovernmental Conference (IGC). The Convention would involve governments, national parliaments, European institutions and civil society, and would take perhaps one or two years. Another two years would probably be needed for the IGC to produce a new treaty and for its ratification.

Three or four years would not be excessive if the end result is an EMU architecture that includes sufficient fiscal-union elements that solidly reinforce the currently orphan monetary union. Nevertheless, this is much too long to be of help in resolving the current crisis. We propose therefore that euro area leaders adopt before the end of 2011 a declaration outlining the contours of such a process. By committing the heads of state and government of the euro area to create a fiscal union, this declaration should create the space needed for the European Central Bank (ECB) to act more forcefully to contain the crisis.

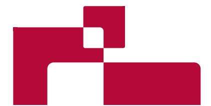
The starting point of the declaration would be recognition of the three omissions of Maastricht. First, failures in national structural policymaking that severely jeopardise EMU functioning were insufficiently addressed. Significant real economic divergences require very different structural institutions in a monetary union from those typically needed in an economy with independent monetary and exchange rate policies. While it is analytically challenging to precisely identify the most relevant aspects, it is clear that labour and product market institutions can have severe implications for the proper functioning of EMU.

'EMU architecture must be strengthened by taking steps towards a fiscal union.'

Second, the euro area was not equipped with a crisis management and resolution framework. There was no institution that could deal with insolvent countries. No mechanism was available to deal with speculative attacks against solvent but illiquid countries. As has been pointed out[2], countries in a monetary union face the fundamental problem that they issue debt in a foreign currency. As a result, markets have the power to force default on an individual member state. A liquidity crisis will then turn into a solvency crisis.

The third omission concerns banking supervision and resolution. The current system remains centred on national supervision, but national supervisors do not fully take on board the impact of the fragility of national banking systems on other euro-area countries. National supervisors therefore have a tendency to conceal the true extent of problems in their banking system. The European Banking Authority does not have the power and capacity to conduct deep and far-reaching bank stress tests. In addition, doubt about the solvency of the sovereign quickly endangers the solvency of the national banking system, because national banking systems are heavily exposed to the country's sovereign debt. Conversely, fragility of the national banking system quickly raises doubts about the solvency of the sovereign. Banking systems in Europe are typically large relative to GDP, and thinly capitalised. The sovereign thus has only limited resources for protecting its domestic financial system[3]. The feed-back loop connecting the banking sector with fiscal fragility is the main reason why sovereign liquidity crises turn very quickly into fundamental financial-stability and solvency crises. Bold fiscal action alone cannot stabilise sovereign spreads because capital flight from the banking system happens very quickly and in turn aggravates the fiscal situation.

1. See Trichet (2011).
2. In particular by De Grauwe (2011).
3. See, for instance, Gerlach, Schulz and Wolff (2010) and Wolff (2011).



AN INADEQUATE RESPONSE

The reaction of euro-area policymakers to the crisis falls short on a number of grounds.

Adjustment mechanisms

The introduction of the euro typically was not accompanied by structural reform to provide countries with instruments to contain their internal and external imbalances. To address this, a new Euro Plus Pact commits members to competitiveness-enhancing structural reforms (eg further product-market liberalisation). The Euro Plus Pact has been complemented with the so-called Excessive Imbalance Procedure (EIP), a new surveillance instrument for non-fiscal imbalances. These two innovations are anchored into the European Semester, through which member states receive guidance on growth-enhancing structural reform early on in the process and before measures are discussed by national parliaments. These reforms move in the right direction but are not a true transfer of sovereignty to the euro-area level and lack appropriate legitimacy due to the modest involvement of the European Parliament and of national parliaments[4].

Fiscal assistance

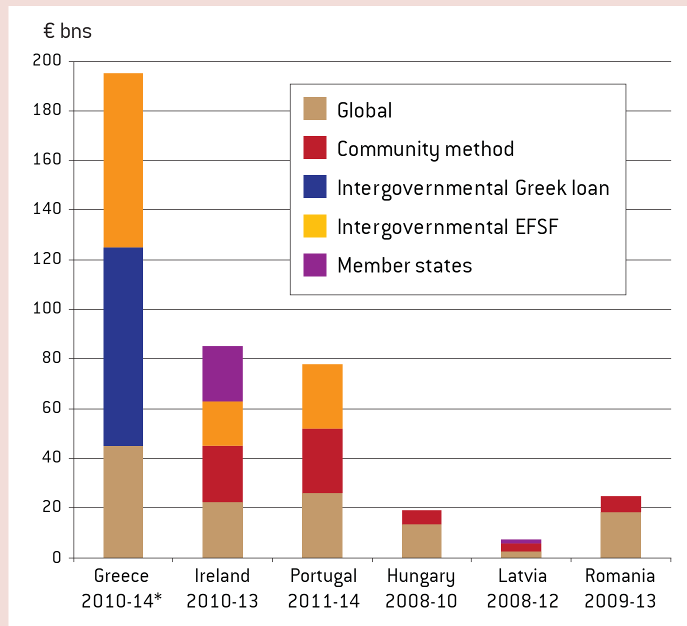
Euro-area policymakers have attempted to devise rescue instruments in the midst of the crisis. The result is a complex institutional set-up that is only partly coherent, certainly incomplete and possibly ineffective.

Before the crisis, the EU only had mechanisms to provide financial assistance to EU countries outside the euro area and to non-EU countries[5]. Since the start of the crisis, new mechanisms have been created to assist euro-area countries in difficulty. In turn, all the rescue instruments now available differ in terms of size, guarantee structure, target group and governance (Box 1). Some of the instruments build on the so-called Community method, in which the European Commission plays a key role and the Council of Ministers votes on financial assistance and the conditions attached to it by qualified majority voting (QMV). The European Financial Stabilisation Mechanism (EFSM), created in May 2010, is based on the Community method, as was the earlier balance-of-payments (BoP) assistance, which was the

BOX 1: FINANCIAL ASSISTANCE IN THE EU

Figure 1 shows the composition of financial packages for each currently or formerly assisted country. We distinguish between support from i) global institutions (IMF, EBRD, World Bank); ii) other member states through bilateral loans; iii) intergovernmental programmes (Greek loan facility, EFSF); and iv) Community tools (EFSM, BoP assistance). Most funds are disbursed under an intergovernmental logic. The second most important source of funding in Europe comes from the IMF, while mutual assistance under the Community method comes only third.

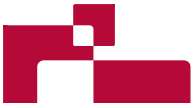
Figure 1: Financially-assisted countries by creditor and type of programme (2008-2014)



Source: Bruegel. * Figures for Greece include the €109 billion package agreed on 21 July 2011. The total sum is distributed across programmes on the assumption that €45 billion of deficit reduction is split by two-thirds and one-third between the EU and the IMF, as it was for previous programmes; €20 billion from the EFSF is used for debt buy-back programmes; and an additional €20 billion from the EFSF goes towards the recapitalisation of the Greek banking system, as in the draft agreement.

4. See Hallerberg, Marzinotto and Wolff (2011).

5. Marzinotto, Pisani-Ferry and Sapir (2010).



blueprint for the EFSM. By contrast, other crisis instruments, from the Greek loan facility to the European Financial Stabilisation Fund (EFSF) and the future European Stabilisation Mechanism (ESM), are based on intergovernmental arrangements or treaties between euro-area member states, where the European Commission only provides technical assistance and all important decisions are taken by governments acting unanimously.

In a nutshell, the euro-area financial assistance mechanisms set up since the start of the crisis have three distinct features:

- First, the traditional Community method has been sidelined. Most of the decisions are taken on the basis of intergovernmental deals between member states, with each exercising veto power. The future European Stabilisation Mechanism (ESM), due to start operating in 2013, will also be a stand-alone intergovernmental treaty, under which decisions to grant financial assistance will be taken by unanimity[6]. Yet, the unanimity principle reduces the efficacy of instruments that need to be promptly available on the market, and might end up defeating the purpose of financial assistance, as the recent difficulties of the EFSF attest.
- Second, the emerging governance framework is complex. The decision to grant financial assistance is taken sometimes by the Eurogroup, sometimes by the ECOFIN Council and sometimes by the European Council, with the consequence that the same country may be granted financial assistance through different procedures and disbursements made at different speeds[7]. Conditionality is exercised by different institutions than those responsible for loan disbursement, opening up an undesirable void between assistance and control.
- Third, the European and national parliaments are too little involved in the oversight of the financial assistance programmes (Goulard 2011). Except for the Bundestag, national parliaments have only been modestly involved *ex ante* in the discussion of size, definition, conditionality and disbursement of funds in accordance with national procedures. The European Parliament, in principle the institution best placed to represent the interests of the Union, has been sidelined.

The euro area needs a permanent and credible mechanism to counteract liquidity crises, but which is also able to cope with cases of insolvency. The ESM, due to start operating in June 2013, is a candidate for this. But it suffers from three major shortcomings. First, as major ESM decisions are taken by unanimity, delays are likely. Second, the ESM is not large enough to avert the risk of contagion to large countries. Third, its structure does not allow the identified weaknesses in banking supervision and resolution to be addressed, a topic that will be further discussed in the next section.

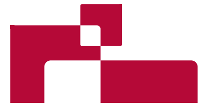
Strengthening surveillance of the financial system

The failures of financial sector supervision exposed by the 2007 crisis were addressed at EU level with the creation of new institutions responsible for macro- and micro-prudential supervision. These institutions are still in their infancy. One, the European Banking Authority (EBA), debuted with the round of stress tests in the summer of 2011, covering 90 European banks. Subsequent problems at one of the tested banks, Dexia, and the general decline in trust in the euro-area banking system, revealed, however, that the stress tests were insufficiently robust. The EBA still has to rely on information provided by national supervisors, who ultimately have the authority to intervene. The EBA is thus not yet a true European supervisor.

The limited supervisory role of the EBA is, of course, related to the absence of financial means at EU level to support banks in difficulty. Taxpayers' resources remain firmly in the hands of national governments and parliaments, and logically therefore member states have the sole responsibility for banking supervision. The European Council of 21 July 2011 gave the power to the enhanced EFSF to provide loans for banking sector support, even to countries not formally under programme. While this agreement is a step towards some euro-area banking arrangements, it creates a number of problems. First, it does not completely break the

6. Non euro-area member states eligible for BoP assistance will paradoxically remain the only ones that receive financial assistance under Community rules.

7. By way of example, Greece received funding through the Greek loan facility decided at the May 2010 European Council, but was also promised assistance through the EFSF, disbursements from which are decided by the Eurogroup.



link between banking and sovereign risk at national level because support to banks would be channelled via their sovereign. Second, the governance of the new system does not provide the right incentives. It reduces the *ex-ante* incentive for governments to properly supervise national banks. Third, loans provided to countries that do not fall formally under conditionality raise the issue of *ex-post* control.

TOWARDS A FISCAL UNION

EMU set-up needs a significant overhaul because current structures are clearly inadequate. We propose the creation of a limited euro-area fiscal union. The core of any fiscal union is the availability of fiscal resources at the federal level. A corresponding structure is needed with a federal finance ministry headed by a minister with the power to raise revenues and take decisions on how to use them. We spell out the functions that would be exercised at euro-area level, how they could be exercised, and how they could be subject to democratic oversight.

Functions to be exercised at euro-area level

The euro area needs a lender of last resort that can help illiquid but solvent countries. As a first step, a decision needs to be made on whether a country is insolvent or illiquid. *De facto*, it is very difficult to make such a decision and in reality even in cases of insolvency there may be a desire to provide assistance to preserve financial stability. Conceptually it is clear, however, that the euro area should have a system that allows for orderly sovereign default for insolvent countries[8]. The euro-area finance ministry could do the initial insolvency assessment.

For clear cases of illiquidity, the natural lender of last resort should be the ECB since it is the only institution that can provide unlimited liquidity. With common euro-area fiscal resources available, the ECB could fulfil the lender-of-last-resort function that its current mandate does not permit. The euro-area finance ministry would need to stand behind any possible losses the ECB may incur resulting from exercice of this function.

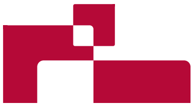
Some may object, however, to the ECB playing this role. The main reason is that there could be political pressure to monetise the debt of what appear at first sight to be illiquid countries, but which turn out to be insolvent. In fact, allowing the ECB to act as a lender of last resort will change the federal finance ministry's incentives in its assessment of insolvency versus liquidity. In case of realised losses, the euro-area finance minister may exert significant pressure on the central bank to recover the losses by monetising them. Giving the ECB this role could thus ultimately be inflationary. This is the central reason why Germany currently does not accept the ECB acting as the lender of last resort.

The creation of a euro-area finance ministry can, however, easily mitigate this. In fact, as currently foreseen with the ESM, the euro-area finance ministry could play the role of lender of last resort. In case of illiquidity in a euro-area country, the finance ministry should have the ability to credibly intervene in the bond market. The euro-area finance ministry needs, however, to have sufficient firepower to ensure that this can credibly be done. The euro-area finance ministry as we envisage it is certainly credible, as it would have direct recourse to euro-area taxpayers and consequently could borrow on the market at lower rates than the country facing liquidity problems. Different forms of intervention can be envisaged. One could think of taking a country from the market as is currently done in countries receiving financial assistance. After a period of adjustment, the country would regain market access as confidence is restored. Alternatively, the euro-area finance ministry could commit to payments that would offset the increased borrowing costs due to rising rates. This would change the debt solvency dynamics and prevent self-fulfilling crises. It would imply comparatively small payments equivalent to the difference in the market interest rate and the rate that is deemed sustainable, multiplied by the debt to be refinanced[9].

Related to this, we propose the creation of euro-area institutions to regulate and supervise the euro-area financial system. Euro-area banking systems are large compared to their national sovereigns. No fiscal capacity is currently available to deal with

8. Gianviti *et al* (2010) have made proposals to this effect.

9. Italian financing needs until the end of 2012 do not exceed €500 billion. At a current rate of seven percent, a payment of €15 billion (€500 billion x three percent) would bring the actual budget impact down to a *de-facto* interest rate of four percent.



the insolvencies of banks that are too large to be saved by national taxpayers, even if this capacity were in the interest of the euro area as a whole. The very high level of financial integration in the euro area should be matched by an equally integrated banking supervision and resolution authority. The euro-area finance ministry should help establish such an authority. It should have sole supervisory authority over all systemic banks, with complete and direct access to all information for the relevant institutions. In addition all euro-area banks that accept deposits should contribute an insurance premium to this authority which would therefore act at a euro-area deposit insurance corporation (EDIC) similar to the US FDIC[10]. A euro-area deposit insurance scheme would go a long way to breaking the existing link between banks and their national sovereigns which tends to become a vicious circle in times of crisis. The EDIC would ultimately have to be backed by euro-area fiscal capacity.

The creation of euro-area institutions to regulate and supervise euro-area financial institutions does not mean that EU-wide institutions such as the European Systemic Risk Board (ESRB) and the European Banking Authority (EBA) should be discontinued. On the contrary, since all EU countries belong to the single financial market these institutions should be reinforced. However, there is a strong case for also creating specific euro-area institutions owing to the fact that the ECB, the euro-area central bank, plays a role of lender of last resort vis-à-vis the euro-area financial system. Having euro-area institutions to regulate and supervise euro-area financial institutions should therefore be viewed as the complement to the ECB in its lender-of-last-resort role.

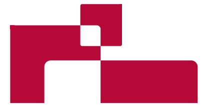
Increased fiscal integration would have to be accompanied by euro-area level competencies and powers over the supervision of national policymaking. In case of national economic policy decisions with potentially significant negative impact on the rest of the euro area, the euro-area finance minister should be given a veto right over such decisions. This veto right should be far reaching and extend to budget decisions. Such strong control is necessary in order to avoid massive free-riding by individual nation states. In exceptional circumstances, when a country is declared insolvent, the federal level could even be given the authority to approve the appointment of a number of key senior national policymakers[11]. In addition, the euro-area finance ministry could be given the right to directly access certain revenues should national policymaking fail to stick to commitments. In terms of structural policies, intervention should take place if a strong analytical basis exists demonstrating severe implic-ations for the functioning of EMU. For the financial system, a common fiscal back-stop will require a common supervisory authority to offset the moral hazard.

The effectiveness and impartiality of the euro-area finance minister would be increased by the creation of an independent fiscal council that issues opinions on budgetary situations, the need for assistance, solvency assessments, the implementation of reforms and national-level fiscal adjustments. Its mandatory opinions would be delivered not only to the finance minister but also to the European Parliament and national parliaments so as to ensure wide publicity. While its opinions could be overruled by the euro-area finance minister, the latter would have to explain its reason for doing so in front of the European Parliament.

Our proposal addresses most of the shortcomings we have identified in the responses to date to the euro-area crisis. First, decisions about financial assistance should be taken at a supranational level by majority so that they cannot be blocked by each and every member state. Second, the overall procedure for crisis prevention, management and resolution would ultimately be simplified because all stages are in the hands of the same actor. Third, the interlinkages between the fiscal situation and financial supervision and regulation could be addressed, not least because the future European banking union would be based on some concrete fiscal capacity. Finally, the legitimacy of the new euro-area set up would be strengthened, as pointed out below where we clarify the details of the financing, the legitimacy and the transition to the fiscal union.

10. The IMF endorsed early on the need for EU banking federalism. For an overview, also on the FDIC, see Fonteyne *et al* (2010).

11. Federal decision-making can only operate effectively if national political and administrative systems follow orders and play by the rules.



Financing

We note that all successful currency areas have a sizeable federal budget; our proposal involves a smaller one. We argue that the euro-area finance ministry would need a taxing capacity of perhaps two percent of euro-area GDP in case loans provided to an illiquid country were to turn bad or bank recapitalisation needs were to exceed the funds available in the EDIC insurance. Euro-area GDP is around €9,000 billion. With a permanent income stream of €90 billion annually (ie one percent), one could borrow up to €2250 billion at a hypothetical interest rate of four percent. This borrowing capacity would be large enough to take Italy and Spain from the market for several years. Alternatively, a payment mechanism that would guarantee that liquidity crises do not become self-fulfilling by reducing the budgetary impact of spreads could be established with limited tax resources[12]. Until a proper insurance fund for bank deposits is built up, some further tax capacity may be needed to cover the most immediate recapitaliation needs of banks.

The tax-raising power would not necessarily be activated. In fact, as in the current EFSF/ESM, the euro-area finance ministry would borrow on the market at a low interest rate and lend to the country concerned at a preferential interest rate. The euro-area revenue would only have to be activated if the country was to default. The capital provided and injected into the banking system would have to be borrowed directly against the revenue flow. If one was to choose fiscal payments to countries under attack, one would obviously have to raise the revenue.

We leave open which tax instruments the euro-area finance ministry could use to raise federal revenue. To cover the cost of the EDIC insurance, an insurance fee would be raised from the insured industry, even though when it is introduced tax revenues may be needed until the insurance fund has built up capital. Tax-raising power would always be needed to backstop the insurance in case of a severe shock. From an optimal taxation point of view, it is important that tax rates are relatively stable, and that they are levied on relatively inelastic revenue items.

Legitimacy

The euro-area finance minister would head a powerful institution. It is thus of the utmost importance that its establishment and operations be democratically legitimised. For the establishment, the institutions preparing the necessary Treaty revisions, ie the IGC and the European Convention preparing the IGC, will need to involve governments, national parliaments, European institutions with more than just observer status, and civil society representatives. The President of the European Convention and the IGC should be democratically accountable. The (indirect) involvement of citizens will be paramount.

It is beyond the scope of this Policy Brief to elaborate the democratic framework underlying the euro-area finance ministry. Certainly, the euro-area finance minister will need to be elected by the European Parliament and the Council in euro-area composition by the normal majority rule. All major decisions would have to be put to a vote in the two chambers. This would concern in particular decisions to raise taxes and to veto national policies. The new federal structure would thus have to acquire federal democratic legitimacy. It is also crucial that decisions taken by the euro-area finance minister that would alter national government and parliament decisions, be explained and debated in front of national parliaments by the euro-area finance minister.

Transition

Euro-area leaders have asked the Euro-Summit President to make proposals for limited treaty changes. We have sketched out proposals for major treaty changes that we think will ultimately have to be put in place in order to put the euro on a sound footing. We are aware that this will not happen overnight. It is important, however, to reach a swift political agreement to move forward in such a direction in order to allow current institutions to prevent the worst from happening.

In the short term, the most urgent task is to end the fragility of the banking sector and the increasing sovereign market

12. In the worst case scenario, under which Italian sovereign rates would stay at 10 percent until all €1900 billion of debt is rolled over, around €110 billion in annual payments would be needed to offset the budget impact of the high rates.

pressures. Only part of the banking fragility is related to the feedback loop connecting sovereign and banking risk. Bank recapitalisation is therefore needed as such, even if the sovereign bond market could be completely stabilised. Bank recapitalisation could be achieved as follows. First, the EFSF/ESM should have the capacity to directly recapitalise the banks and to guarantee deposits. Second, if needed, the resources of the EFSF/ESM should be increased. Third, access to the appropriate personnel to restructure and control banks is necessary. For this, a Resolution Trust Cooperation under the control of a euro-area political representative could be formed. The EBA and ESRB would need to step up banking sector supervision and should be placed under the control of the same political representative. The same political representative would also head the EFSF and the emerging ESM. Existing functions of the Commission should be merged with the nucleus of the finance ministry, and the resulting structure should be outside the Commission principle of collegiality. The emerging euro-area finance minister would from the outset be appointed by the Council and European Parliament in euro-area composition.

In the transition phase, the ECB will have to play a significant role to back-stop the financial system and the sovereign bond market. The latter can be done once there is a commitment to move towards more fiscal federalism and as long as reforms are continuously enacted.

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13. Posen and Véron (2009).

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