JUST ROUND THE CORNER? PROS, CONS, AND IMPLEMENTATION ISSUES OF A FISCAL UNION FOR THE EURO AREA

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“Anaemic Europe: How to Achieve Dynamism and Mass Flourishing"
1) Reasons for (and against) a Fiscal Union

2) A Fiscal Union for the Euro Area: the official debate

3) A Fiscal Union for the Euro Area: implementation issues
Reasons for a FU

• A common fiscal capacity acts as an **insurance device against country-specific shocks** which cannot be offset by the common monetary policy and by movements of the exchange rate (Kenen, 1969).

• **Spill-overs**, which reduce the capacity of national fiscal policy to stabilize the economy, are likely to be strong among countries which belong to a MU. A fiscal union is a way to internalize these spill-overs (Oates, 1972).

• We should also look at **real world**: established monetary unions are also fiscal unions (Asdrubali et al., 1996; Melitz and Zumer, 2002).
Counter-arguments

• **Insurance can be also pursued through financial markets, as it happens in other well-established monetary unions.**
  
  *True, but there is not much cross-border asset-holding among European households. Furthermore, this channel could not be available for poorer households. Finally, there might be a tendency to under-insure (Fahri and Werning, 2012).*

• The argument for FU rests on **asymmetric shocks**: but **how important they are** (old debate: Frankel and Rose, 1998)? **How to recognize them?**

• **Moral Hazard.** – Insurance provided by the FU reduces the incentive to pursue structural reforms at the national level (Persson and Tabellini, 1996)

• **Fiscal policy spill-overs are small** (for Europe, see e.g. Beetsma et al. 2006, Cwik and Wieland, 2011).
  
  *True, but they are probably larger in recessions (Auerbach and Gorodnichenko, 2013)*
In mid-2012, the European Council invites its President “to develop, in close collaboration with the President of the Commission, the President of the Eurogroup and the President of the ECB, a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union”

According to the December 2012 Report by the President of the European Council, “establishing a well-defined and limited fiscal capacity to improve the absorption of country specific economic shocks, through an insurance system set up at the central level” is a goal for the longer term.
• November 2012 European Commission Blueprint «EMU should also be underpinned by an autonomous and sufficient fiscal capacity that allows the policy choices resulting from the coordination process to be effectively supported”.

• As in the Presidents’ reports, the Blueprint proposes a phased approach:
  ✓ The first step would be “the establishment of a financial instrument within the EU budget to support re-balancing, adjustment and thereby growth of the economies of the EMU”.
  ✓ The second step, would be a proper fiscal capacity for the EMU to support the implementation of the policy choices resulting from deeper policy coordination.
  ✓ Finally, in the long term (beyond 5 years), “based on the progressive pooling of sovereignty and thus responsibility as well as solidarity competencies to the European level, the establishment of an autonomous euro area budget providing for a fiscal capacity for the EMU to support Member States in the absorption of shocks should become possible”.
The official debate (3)

The documents share several points:

• They acknowledge that a fiscal capacity is necessary for the EMU inter alia (also common infrastructure, reforms) to increase its ability to absorb asymmetric shocks;

• They are concerned with the risk of moral hazard;

• They consider the fiscal union a medium- to long-run project, not something to be implemented to help countries out of the current crisis;

• They deny any redistributive role to the common fiscal capacity
Current situation

Elements of a common fiscal buffer have been already introduced (or in the process of being introduced):

- **ESM** – but there are lengthy procedures which are triggered only by a severe crisis

- **Banking union** (fiscal backstop) – tackles, with a significant delay and up to a ceiling, only a specific risk

Therefore, further elements of risk sharing are probably needed
Implementation: Main issues

• Two broad approaches: intergovernmental transfers (Rainy funds) or «federal» social insurance schemes

• The implementation of rainy funds appears very problematic, as it rests on the possibility to identify in real time the cyclical position of each country

• Concerning the second approach, the crucial choice is about which scheme should be centralized. In what follows we will discuss unemployment benefits and pensions.
Problems:

- **Unemployment reacts with a (country-specific) lag** to cyclical conditions: this reduces the stabilizing effects of the scheme.

- It is **difficult** to choose the parameters of the common system (contribution rates, eligibility, duration, replacement ratio) in such a way to **avoid cross-country redistribution**. In some countries long-term unemployment would be subsidized.

- Furthermore, **labour market legislation** across the euro area **should be harmonized** as much as possible, not an easy task.
Implementing: A centralized pension scheme (1)

- The build-up of a new pension scheme is **lengthy**, but given that the **FU project is for the long term this is not necessarily bad**.

- The European contributory pension pillar could be made **redistribution-free** adopting a **Notional Defined Contribution (NDC)** system.
  
  *In each Country, the notional rate of return would be a function of the growth of the Country’s contribution base and of the Country’s longevity developments.***

- **Social pensions and other social-assistance provisions** (e.g. disability) **could be left at the national level**, reflecting national preferences for redistribution.
In addition to being a shock-absorber (through the contribution side of the scheme), a EU NDC would have several advantages:

- NDC systems are incentive-friendly, so they can be fairly large. A European pension budget of about 5% of GDP could be a realistic target. Size is crucial to increase the shock absorbing capacity of the Euro area budget.

- Financial sustainability could be built-in once-and-for-all in the initial rules of the system. No need to reach an intergovernmental agreement ex post on parametric adjustments.

- it would enhance cross-country mobility of workers (Holzmann, 2006). The contributions of an Italian working in Germany would be credited the German rate of return; his/her expected longevity could be determined on the basis of the Italian demographic projections

- it would reduce mistrust across European citizens concerning fiscal behaviour (and fiscal sustainability) in other countries Economist website 02-23-2011
Concluding remarks

- **Economic reasoning** and the **experience** of other established monetary unions suggest that the Euro Area would benefit from the establishment of a common fiscal capacity.

- This fiscal union could be **limited in size**, and should be **only concerned with the cyclical stabilization function**. Relative to other existing federations, States’ budgets in normal times should be able to pursue most of the shock-absorbing function.

- **A common NDC pension scheme** could be an appropriate building-block of the European fiscal union.

- 2 important issues: **political feasibility** and **democratic legitimacy** (enhanced central fiscal powers require changes in decision-making processes - Political Union?)
Thank you for your attention