LUISS Guido Carli

LIBERA UNIVERSITÀ INTERNAZIONALE DEGLI STUDI SOCIALI

Dipartimento di Impresa e Management

Cattedra di Macroeconomia e Politica economica

INTRODUCING A FISCAL UNION IN THE EURO AREA: A POSSIBLE VISION FOR THE FUTURE?

RELATORE

Prof. Paolo Giordani

CANDIDATO

Giovanni Maria Cocilovo

Matr. 167031

ANNO ACCADEMICO

2013/2014

INTRODUCING A FISCAL UNION IN THE EURO AREA: A POSSIBLE VISION FOR THE FUTURE?

Summary

Introduction: Looking backward **5**

Chapter One: Which remedy to European recession? 8

1.1: Why the crisis has been so dangerously harmful in Europe.......................... 9

1.2: The reaction of European Union institutions 14

1.2.1: The European Semester 14

1.2.2: The *Sixpack*... 15

1.2.3: The EFSF and the ESM 17

1.2.4: The *Fiscal Compact*.. 18

1.3: Have the planned reforms been suitable to the situation? 19

1.4: Three possible future scenarios 22

1.4.1: The dissolution of the Euro area 23

1.4.2: The continuance of budget adjustment 26

1.4.3: A fiscal unification 27

Chapter Two: The necessary elements for a fiscal union **30**

2.1: Fostering fiscal discipline... 31

2.1.1: What is a fiscal union?.. 31

2.1.2: How to address fiscal policy to the central level? 32

2.1.3: A bailout institution to resolve crisis 36

2.1.4: The unification of the public debt.. 38

2.2: Risk sharing and insurance against asymmetric shocks 41

2.2.1: Private insurance.. 42

2.2.2: Macroeconomic insurance 42

2.2.3: The economic value and the implementation of the transfers 43

2.2.4: Empirical results 46

2.2.5: "*Currency unions and fiscal unions go hand in hand*" 48

2.3: Some examples from the history 49

2.3.1: The North America federations, United States and Canada.................50

2.3.2: The example of the 'European excellence': Germany 52

2.4: Would the fiscal union correctly operate?...53

Chapter Three: The desirability of a fiscal union 55

3.1: The question of moral hazard 56

3.1.1: Moral hazard and macroeconomic insurance 57

3.1.2: Moral hazard due to supranational borrowing.....................................59

3.1.3: Moral hazard with a bailout institution...61

3.1.4: Some conclusions about the question of moral hazard.........................62

3.2: The costs descending from the implementation of a fiscal union 63

3.3: Social, legal and political implications...65

3.3.1: A "*cultural clash*"...65

3.3.2: Some legal considerations 68

3.3.3: For a sustainable political development 70

Conclusions: A possible vision for the future 73

Bibliography 76

Sources of images and tables...78

"The economic and financial crisis has challenged the myopic belief that monetary union could remain just that, and not evolve into something closer, more binding, into an arrangement whereby national sovereignty on economic policy is replaced by the Community ruling"

- Mario Draghi, President of European Central Bank, 24th May 2012

Introduction:

Looking backward

The European Economic and Monetary Union (EMU) is a non-optimal common currency area, including nowadays eighteen of the twenty-eight States that compose the European Union, settled down with the Maastricht Treaty, signed in 1992.

The Treaty states that, in spite of a common monetary policy, the management of the fiscal policy is committed to the single member States (ensuring a common coordination in order to achieve the economic convergence), taking distances from the original Werner Plan and McDougall report (respectively submitted in 1970 and 1977) which provided a Monetary Union enforced by an Economic Union. The reasons why Maastricht Treaty abandoned the idea of a Fiscal Union are principally four: first of all in order to respect the preferences and the priorities of every member State, according to the right view that every State shall compose its own Public Budget; secondly, although the goal of the EMU is to reach economic convergence, the economic frameworks among various member States are still too different; thirdly the country-specific shocks are still too spread across member States, so a certain flexibility in fiscal policies is needed to face them; finally the decentralization of the fiscal policy contributes to maintain a certain rate of fiscal competition between member States, in order to purchase several incentives to industries and public policy.

Fiscal policy stated by Maastricht Treaty claims to achieve four principal objectives: to avoid deficit bias, that is to say the tendency of the national governments to obtain a high level of public spending in order to gain political success; secondly to avoid spillover effects, generated by non-careful fiscal policies implemented by one or more member States; thirdly to avoid moral hazard, due to the wrong conviction that the ECB would always save a member State in huge crisis in order to maintain the stability of the whole EMU; fourthly to ensure the credibility of the monetary union and the credibility of its acts in economic policy.

These objectives are accomplished with the aid of two fundamental corollaries: the 'no bailout' corollary, that is to say the deny for the ECB to finance directly the sovereign debt of any member State, with the purpose to prevent moral hazard and to emphasize the fiscal rules stated by the Union, and the independence of European Central Bank, a very important corollary in order to make the 'no bailout' clause respected. Thus the national fiscal rules assume the main role in the economic policy inside the EMU, leaving to the fiscal rules stated by Maastricht Treaty only a support role (it is valid the "subsidiarity principle": the competence of a selected matter can be entrusted to the EMU only if it is reasonable believing in a more efficient treatment). Nonetheless, coordination between national fiscal policies is necessary to achieve the stability of the Union and the credibility of the Euro.

In this context, the Stability and Growth Pact (SGP), introduced in 1999, assumes a great importance. The Pact is the main instrument, at the Union level, to monitor the efficiency of national fiscal policies, their compliance to the Maastricht rules and to achieve the economic convergence. The SGP is based on three pillars, whose subjects are the numerical objectives, the multilateral surveillance ant the Excessive Deficit Procedure (EDP). Member States of the European Union must keep their deficit-to-GDP ratio under the value of 3% and their debt-to-GDP ratio under the value of 60%.

Until 2005, deficit-to-GDP ratio was the main parameter to measure the behavour of public budget, if it had been major of 3%, the European Commission would have activate an EDP. After the cases of France and Germany, which exceeded the value of 3% in 2002 and 2003 with no penalty imposed, a reform has been regarded as necessary in order to maintain the SGP as credible as possible. Critics advocated that there was no flexibility in the application of the rule so other parameters had to be taken in consideration. The reformed SGP states that the behaviour of public budget must be considered cyclically adjusted (and not related to productivity-enhancing procedures), that the debt-to-GDP ratio and the duration of the slow growth period are now parameters to decide if activate or not an EDP, and that the medium-term objective for Member States of EMU is to be close to balance or in surplus.

With the recent crisis of the sovereign debt in 2010, this model showed its limits: it has not been able to prevent the recession and to ensure the economic convergence. In order to counteract the effects of the Great Contraction, many scenarios have been regarded, one of them is the creation of a stronger European Fiscal Union able to enforce the stability of the Euro system and the credibility of the common currency.

The purpose of this thesis is to analyse the effects (both negative and positive) descending by the possibly introduction of a fiscal union in the Euro area. After having summarized the current implementation of the fiscal policy in the EMU in this introduction, chapter one is going to analyse the malfunction occurred during the last three years in European political economy, giving also a picture of the different visions for the future of European Union, chapter two and chapter three are going to discuss about the creation of a European Fiscal Union, the one showing the effects on common economic policy, taking in consideration all of the possible implications, the other showing whether such a solution is really desirable, taking in consideration also some social and political implications. Then, at the end of the exposition there will be the conclusions about the economic scenario that we are going to examine.

Chapter One:

Which remedy to European recession?

"Back in the 1960s, a new concept emerged in international macroeconomics: optimum currency area theory. The question it sought to answer was, when should countries adopt a common currency? Everyone noted that by adopting a common currency, countries would give up much of their policy independence; the question was how costly that would be, and how large the benefits"

- Paul R. Krugman

According to the mathematical Theory of Chaos, which find its exemplification in the popular said "the beating of a butterfly's wings can cause a hurricane on the other side of the world", an event that is apparently insignificant and sufficiently far in time and space may have very important consequences over the affairs of the rest of the universe. The "Butterfly effect" is what happened in the world economy between 2008 and 2010, when the crash on the real estate market in United States has been able to bring Greece on the edge of default, even undermining the stability of the entire European Economic and Monetary Union. As we know, the crisis, started in 2008 in USA, spread in Europe through two channels. The first one is the financial channel: "toxic" titles, bought by European banks on international markets, created such a financial instability that banks had to force a credit squeeze on their customers, weakening the productive system. The second one is the international exchange system: there has been a loss of external demand by America, so exports of traded goods by Europe decreased in a little time. The effects of the crisis were largely visible on real economy: private consumption and investment decreased, the public deficit of European States increased, mining the stability of public finances. In only two years, States with a high level of public debt (such as Portugal, Italy, Ireland, Spain and Greece) found out many difficulties in order to react to Great Contraction: their public losses were increasing more and

more, so they have been penalized by market believing that they were "*no longer in the condition to meet their obligations*"[1]. The risk of default became very high, involving the declining of the stability of the Euro area and the credibility of the common currency.

1.1: Why the crisis has been so dangerously harmful in Europe

Reaction to the crisis has been stronger and more immediate in United States than in the European Union, thanks to Federal Reserve's quantitative easing and thanks to American fiscal framework, which is more developed and more integrated within monetary policy. Inside the EMU the European Central Bank is the only organ of federal nature able to take the necessary decisions to face the crisis, setting monetary policy in order to support banking system and to prevent default risk of PIIGS by buying their public debt titles on the secondary market (the no bailout clause prevents the ECB to finance directly the public debt of member states). In 2012, Mario Draghi declared: "*within our mandate, the ECB is ready to do whatever it takes to preserve the euro, and believe me, it will be enough*"[2], guaranteeing markets that the operating efforts of Euro area central bank had to be trusted. The effects of contraction have been stronger and more harmful in the EMU than elsewhere, as the result of the missing integration of economic policies among European Member States. Doubtless, efforts by ECB has been useful in order to ensure the credibility of the common currency across the world, but not enough to come out of the crisis and to obtain lasting economic stability for all the monetary union.

The reasons 'why things have gone so badly' stand principally in the architecture of European economic institutions and in the real and financial economic framework. The Optimum Currency Area literature commonly agrees in defining EMU as non-optimal one. According to this view, an OCA must respect four conditions in order to obtain a successful monetary policy, in spite of losing benefits of free exchange rates (enhanced by Friedman): factor mobility, openness, financial

[1] Majocchi, A. "*Towards a European Federal Fiscal Union*", 2011.
[2] Speech by Mario Draghi, President of the ECB, at the Global Investment Conference in London, 26th July 2012.

and fiscal integration. The presence of these features makes asymmetric shocks less possible to happen and the Union more able to face against them.

Robert Mundell (1961) emphasize the high mobility of labour as the main characteristic an OCA must have, actually the loss of exchange rate as a shock absorber by Member States of a monetary union needs a substitute instrument. Mundell's theory assumes a monetary union composed by two countries, conveniently called Spain and Germany, each producing a good. A demand shift caused by an asymmetric shock changes preferences from Spanish goods to German goods, lowering demand in Spain, raising unemployment and causing a trade imbalance, while inflation increases in Germany. In such a situation, a common monetary policy cannot solve the problems of both economies at the same time. A restrictive monetary policy might reduce inflation in Germany, but worsen the unemployment problem in Spain. An expansionary monetary policy would reduce unemployment in Spain, but worsen inflation in Germany. High labour mobility, instead, solves the problem: excessive supply of labour in Spain can be moved towards Germany restoring the full employment of resources in the first country and increasing production in the second one, this would cut down German inflation.

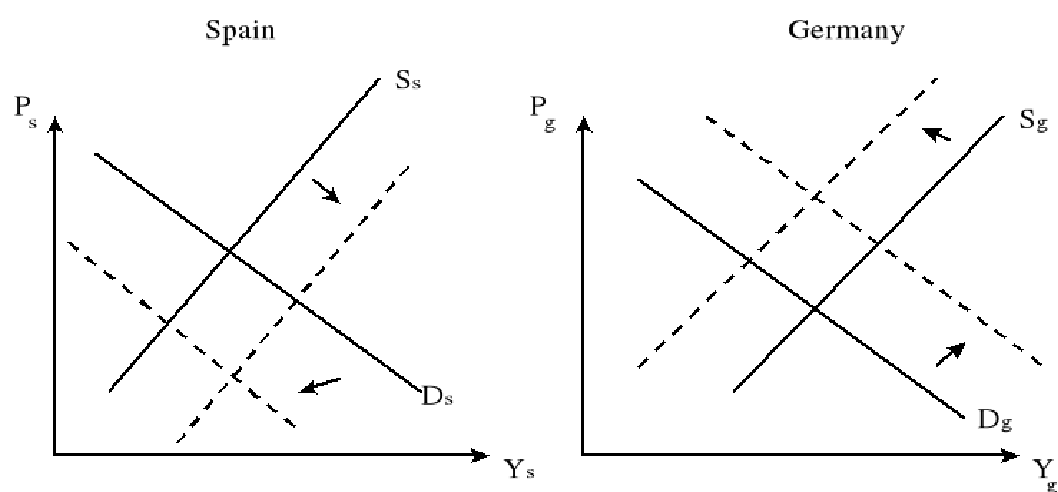

Figure 1.1: Shock absorption via the perfect mobility in labour market.

The figure above describes the adjustment of aggregate demand and aggregate supply, showing as labour mobility made exchange rate useless in absorbing asymmetric shocks.

Ronald McKinnon in 1963 resumed Mundell's work exposing his argument in favour of OCAs basing on economic openness. According to McKinnon more is the openness rate of a Member State's economy, more is that State desirable as a member of a currency area. Openness rate is calculated as:

$$EOR = \frac{(X + M)}{Y}$$

Where:

- EOR = economic openness rate
- X = exportable goods
- M = importable goods
- Y = national output

Major is the value of EOR minor would be the loss registered by a country which has renounced to the benefits of free exchange rate. Actually, we can consider the general price index (P_t) as a weighted average:

$$P_t = \alpha pi_t + (1 - \alpha) pev_t \varepsilon$$

Where:

- pi_t = internal price
- pev_t = price in external value
- ε = nominal exchange rate
- $(1\text{-}\alpha)$ = EOR, that is to say the economic openness rate

If the value $(1\text{-}\alpha)$ is very high, a depreciation of ε would have a greater impact on general price index. Thus, a country widely open to external commerce would have a major convenience of participating in a common currency area than a country with a closer economy.

Moreover, according to Peter Kenen (1969), a monetary union would never be optimum without a deep fiscal integration. In his work "*The theory of optimum currency areas: an eclectic view*" Kenen enlightens the importance of the binomial monetary union – fiscal union (argument taken afterward by McDougall report in

1977) asserting that a certain degree of fiscal federalism inside a currency union acts as a shock absorber. Let us consider two countries, Spain and Germany again, both composing an OCA. Incomes of common public budget are represented by taxes, outcomes by transfers and subsides, which are sensible to economic cycle. Supposing a demand shift caused by an asymmetric shock changes preferences from Spanish goods to German goods, increasing production in Germany and reducing production in Spain. Incomes from taxation would be major in Germany than in Spain due to changes in revenues, otherwise there would be a major necessity in Spain of subsides to unemployed people and industries. A federal budget would automatically transfer economic resources from the richest country to the poorest country, compensating and deleting the effects of asymmetric shock. This way, country-specific shocks would be less frequent and less sizeable than normal, creating the condition for further real economic convergence among Member States of a monetary union.

New studies from Mundell in 1973 stated that financial integration could act as a substitute of fiscal federalism in an OCA. Actually, if Spanish families hold in their financial portfolio a significant quantity of Bunds and German families hold the same percentage of Bonos, when a country-specific shock affects Spain, according to Mundell's view, the rising quotation of Bunds slows the fall of Spanish consumption by increasing incomes from investments. By contrast, the lowering quotation of Bonos would smooth German consumption, restrain inflation caused by an uprising demand. However, we will see that further studies of Emmanuel Farhi and Ivan Werning (2013) demonstrate as "*financial integration is only a partial substitute for fiscal integration*"[3], enlightening as fiscal unions are more efficient for absorbing asymmetric shocks, especially in presence of closer economies, thus, in open contrast with McKinnon's theory (see *infra* Chapter Two).

However, analysis of Jeffrey Sachs and Xavier Sala-i-Martin (1992)[4] advocate that the monetary union born with Maastricht Treaty is still too far from the concept of fiscal federalism proposed by Kenen (as it happens in the United States) and it

[3] Farhi, E. and Werning, I. "*Fiscal Unions*" 2013
[4] Mentioned in Verde, A. "*Unione monetaria e nuova governance europea*".

would never be an optimal currency if this lack of fiscal integration continuously persists. Moreover, Michael L. Katz and Olivier Blanchard (1992) reached the same conclusion with a regard to labour mobility: in their vision, there are many cultural, social, economic obstacles between Member States of EMU, which prevent an adequate labour mobility. Further empirical analysis brand the Euro area as a non-OCA, leading to two important conclusions: there is a high probability that asymmetric shocks happen inside the Union (as in 2010), and there is no functional mechanism for absorbing them.

Furthermore, the non-OCA characteristic of the EMU involves also the presence of inhomogeneous evolution in Member States' economies: on the one hand, some countries have structural deficit in their current accounts (*e.g.* Greece); on the other hand, the remaining countries are in a situation of surplus in their balance of payments (*e.g.* Germany). This situation of external imbalance is another important cause of the current sovereign debt crisis. Before 2010, States in surplus bought public debt titles of States in deficit, financing their economies: Germany purchased titles issued by PIIGS, ensuring a stable flux of capital towards weaker economies. With the supervening crisis, this capital flow stopped, forcing PIIGS to finance their public debt on TARGET2 system (that is to say via national central banks). In an integrated fiscal union transfers between Member States would solve the problem of external imbalances, aiding economies in a situation of structural deficit and correcting excessive surplus obtained by stronger economies. The absence of this feature caused a speculative attack against States in deficit, which took as objective their public debt titles. Speculation, betting on the death of the European Monetary Union, moved a great flux of capital, inciting to moral hazard with no regard to market regulation. In addition, Joseph Stiglitz (2014) advocates that the so called *austerity* imposed by Germany in order to re-asset public finances of Member States of the EMU is currently having some negative impacts on European economic policy. *Austerity* weakens future growth perspectives, mining European Union's survival; moreover, it promotes the deterioration of income distribution among Member States, this way consumption propensity reduces. Thus, the lack of cohesion and the missing adequate institutional framework are the main reason for Eurozone breakdown and for the slowness of its reaction.

1.2: The reply of the European Union institutions

The reaction of European Union to the crisis, although its inefficiency and its lack of timeliness, moved across three directions: firstly with the purpose of aligning macroeconomic surveillance to budgetary surveillance, secondly in order to provide to EMU a newly improved Stability and Growth Pact and finally in order to ameliorate the mechanisms that aim to resolve economic crisis.

Main reforms in these senses have been: the European Semester for the budgetary surveillance, the *Sixpack* for a new SGP and for the macroeconomic surveillance, the EFSF and the ESM in order to manage crisis reaction. In this framework, the introduction of the *Fiscal Compact*, in order to strengthen fiscal discipline, plays a very important role in European economic policy.

1.2.1: The European Semester

The European Semester is the "*mean to allow all countries to reap the full benefits of the single currency. And it prohibits individual countries from pursuing policies that harm themselves and the Euro area as a whole*"[5]. The Semester has entered into force in 2011 with the precise purpose of coordinating *ex ante* budgetary policies among Member States of the whole European Union. The process of coordination is six month long, in the while the European Commission submit public budgets and reform programs of every European country, monitoring if they are following the directives and the recommendations stated by EU. The novelty lies in the fact that this surveillance is executed during the process of composition of the budget, this way, European Commission is able to warn Member States on time, if possible infringements of European fiscal directives have noticed.

Critics about European Semester are largely positive as having a fundamental role in the firmness of the Euro. In fact, the Semester makes recommendations of the Commission stronger and more credible, giving it an effect, though still theoretical, power of imposing its own fiscal policy on Member States. It represents the first step towards a deeper centralization of national budgetary policies.

[5] Trichet, F. in Financial Times, 8 June 2011.

1.2.2: The *Sixpack*

The *Sixpack* is an ensemble of six regulations stating a set of economic rules, issued by the EU, in order to reform the SGP and to improve macroeconomic surveillance. This legislative set entered into force in 2011, after a year of debates and negotiations, due to the importance of the proposed reforms.

On the side of fiscal policy, the introduction of a third Pact has the purpose of avoid more strongly moral hazard by enforcing the parameters stated in 2005. It still recommends to member States, as medium-term objective, of being close to balance or in surplus, with the clause that, otherwise, countries in deficit must adjust their balance by reducing yearly their deficit by 0.5% of GDP.

According to the *Sixpack*, the deficit cannot be covered using extraordinary incomes; actually, filling the deficit with temporary and cyclically favourable incomes would have positive effects on the short run, but can lead to harmful consequences in the medium-long run: first of all, it encourages the abandonment of prudent fiscal policies and moral hazard. More precisely, in order to obtain a prudential economic policy, the growth rate of budgetary outcomes must not exceed the long period growth rate of GDP.

The deficit and debt criteria remain the same: as in 2005, Member States of the EMU must keep their deficit-to-GDP ratio under the value of 3%, always considered cyclically adjusted and not related to productivity-enhancing procedures, and their debt-to-GDP ratio under the value of 60%. However, there is a novelty: the two criteria must be applied together in the evaluation of the behaviour of public budget, to decide if it is or not the case of applying an Excessive Deficit Procedure. In addition, the new SGP includes the obligation, for countries whose debt exceeds 60% of GDP, to reduce it in the extent of at least 1/20 of the amount in excess by the target of 60%, calculated over the past three years.

Always on the side of fiscal policy, other novelties concern penalties imposed on countries whose budgetary policies are not careful. These penalties are more severe and applied immediately when an EDP is activated. Particularly, the main important reform in this sense is the application of the *inverse majority principle*, that is to

say that a penalty is imposed over a non-careful Member State in any case, but it can be removed only if this is the decision of the qualified majority of European Council. Moreover, the *Sixpack* provides also new frameworks for national budgets, the so-called Medium-Term Budgetary Frameworks (MTBFs), introducing new minimum requirements in order to ensure a major reliability, a major consistency with the SGP, and a major transparency for the public budget.

On the other side, legislation stated by *Sixpack* involves also macroeconomic surveillance, in order to prevent and rectify the effects of excessive macroeconomic imbalances. Actually, the external imbalances occurred at the outbreak of crisis created so many problems to fiscal policies in EMU to menace with the risk of default of some Member States (e.g. Greece and Ireland).

Macroeconomic surveillance is divided in a *preventive arm* and in a *corrective arm*. According to the *preventive arm*, the Commission is deputy to evaluate, with the aid of an apposite scoreboard based on specific indicators[6], the risk for every Member State of being in a macroeconomic imbalance situation. If the threshold of one or many indicators is violated, an early warning starts for the transgressing country, which may turn in an Excessive Imbalance Procedure (EIP) if the violation persists. The activation of the EIP represents the beginning of the *corrective arm*. At this time, the Commission urges the transgressing country to adopt necessary measures with the purpose to correct the imbalance, which are stated by an apposite plan written under the patronage of the Commission itself and the Council. European Council checks the fulfilment of the plan: if the corrective measures is effectively adopted, the EIP ends with deadlines, with the imposition, if necessary, of appropriate penalties on the transgressing country.

On 30 May 2013, European Parliament approved two more regulations that represent a further reform on the side of fiscal policy. This new reform, also known as *Twopack*, will be applied from 2014 with two important purposes: to strength the corrective arm of SGP, by the application of special rules in the Excessive Deficit

[6] Indicators concerning variables such as current account balance, productivity, real exchange rate, public and private debt and other minor, but still relevant, macroeconomic variables.

Procedure, and to enhance the surveillance over the drafting process of national public budgets.

A memo of European Commission explains the necessity of a reform. Actually, in order "*to strengthen the economic pillar of the Economic and Monetary Union, euro area Member States needed to go beyond the 'Six-Pack' legislation agreed in 2011. Economic and budgetary policies pursued in euro area Member States have evident spillover effects elsewhere in the common currency area.* […] *In harder times, it means risks are shared to a greater extent. This risk sharing should be accompanied by shared responsibility, implying a greater degree of information sharing and coordination as well as a seamless procedure covering all eventualities, including the use of financial backstops*"[7].

Starting with the forthcoming budgetary cycle, the *Twopack* introduces a common budgetary timeline and common budgetary rules for Member States of the Euro area. However, the major innovation is that the European Commission will examine and give an opinion on each draft budget. If the Commission detects "*severe non-compliance with the obligations under the Stability and Growth Pact*"[8], it will put a veto over the national fiscal policy of the non-careful Member State, asking it to submit a revised plan.

1.2.3: The EFSF and the ESM

In 2010, with the purpose to introduce new mechanisms for reacting to the crisis, the European Union create the European Financial Stability Facility (EFSF), a vehicle society whose function was to finance directly the public debt of Member State affected by the contraction. The very important novelties were that the EFSF could issue bonds guaranteed by all European countries and it could buy the public debt titles of Member States that were on secondary market. This way, the EFSF limited the risk of default of any Member State and reduced the effort of the ECB in aiding countries in difficulties.

[7] From European Commission, MEMO/13/457 27/05/2013.
[8] From European Commission *op. cit.*

However, in July of 2012, the EFSF has been closed and substituted by the European Stability Mechanism (ESM). The ESM is a corporate, with its registered office in Luxembourg, whose Board of Governors is composed by the secretaries of Treasure of the Member States of EMU plus the president of the ECB and the European commissioner for Monetary Affairs.

The ESM is deputy to finance the debt of countries of the EMU, which are in a serious condition of financial crisis. This kind of corporate has the power to provide liquidity to a country by purchasing its bonds on the primary and secondary market, bypassing the limits imposed on the ECB with the “no bail out clause”. The purpose of the ESM is to avoid the risk of financial default and to avoid the speculative attacks over public debt titles, which represented a very important factor for the current crisis. For this reason, the granting for a loan by the ESM depends on important and precise requirements: there must be the risk of default for the whole Euro area; the asking State must have already subscribed the *Fiscal Compact* (*infra*); the asking State must pursue a program of reforms with the purpose to adopt a more careful fiscal policy, under the patronage of European Commission, ECB and International Monetary Fund; there must be the approval of every Member State of the EMU.

There have been many critics, especially from German government, against the ESM, following the opinion that countries in surplus must mandatory aid countries in deep deficit, so taxpayers of careful Member States would carry the burden of the loans.

1.2.4: The *Fiscal Compact*

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, also referred to as *Fiscal Compact*, is an intergovernmental treaty composed by sixteen articles stating a set of rules strengthening the fiscal principles of SGP. The *Fiscal Compact* have been currently signed by twenty-five of the twenty-eight Member States of EU, including the eighteen countries of the EMU.

The *Fiscal Compact* is different from the Stability and Growth Pact; first of all, it has not be adopted with the communitarian method, but with an intergovernmental

procedure, that is to say an agreement between the joining Member States, in order to abbreviate the protocol. Thus, the *Fiscal Compact* is valid only for these agreeing States, after the approval of the national Parliaments (except for Member States of EMU, for which is always valid).

According to *Fiscal Compact*, the medium term objective, as in the SGP, is to be close to balance or surplus, and in order to make this principle respected, the cyclically adjusted deficit must not exceed the 0,5% of GDP or the 1% of GDP if the country has a debt-to-GDP ratio minor than 60%. The limit of 3% for the deficit-to-GDP ratio is always needed in order to activate an Excessive Deficit Procedure, as it is stated by the SGP, but this process would start immediately, that is to say at the moment the Commission would notice a too deep deficit. The criterion of *inverse majority* is valid in order to deactivate the Procedure. Whenever a Member State is in an EDP, the Commission and the Council improve a stronger and more precise activity of monitoring, forcing the non-careful country to draw up an apposite economic plan, including all the necessary reforms to reduce excessive deficit. This plan shall be presented to the Commission following specific deadlines.

Moreover, the *Fiscal Compact* claims that the joining Member States shall insert (if possible) the objective of being close to balance inside the fundamental national legislation (e.g. the Constitution), with the purpose to make the full accomplishment to this rule: in Italy this legislative process have been fulfilled with the "l. cost. 1/2012".

1.3: Have the planned reforms been suitable to the situation?

After having summarized the new regulatory post-crisis framework, it remains to be seen whether all the measures have been sufficient. Roel Beetsma[9] and Raymond Gradus[10] critically browse in their article "*A discussion of the changes to Europe's*

[9] Professor of Pension Economics at the University of Amsterdam.
[10] Director of CDA Research Institute and Professor of Public Administration and Economics at the University of Amsterdam.

macro-fiscal framework in response to the crisis"[11] the effects and the consequences brought by adjustments in the European economic framework.

According to Gradus and Beetsma's vision, the ESM, born with the aim of safeguarding financial stability of the EMU, has a very important weakness: the effective credibility of the strict conditionality clause. If it is not enough credible, there is a serious danger of recurring moral hazard in a worse way than before the crisis.

This weakness depends on the fact that the Board of ESM is composed by politicians, who can find difficulties in order to deny help to each other and may succumb to public pressure; this way moral hazard would spread through countries with a weak fiscal discipline. This is also where the SGP failed in 2002. Moreover, "*the first signs of this danger have already become visible. Despite agreements on raising tax collection and privatization of public enterprises in return for financial help, Greece has made hardly any progress in this direction*"[12].

For what concerns fiscal control, the new Pact introduced by the *Sixpack* is well addressed against moral hazard, making it harder to escape sanctions, but many doubts remain about the *Fiscal Compact*. Jens Weidmann[13], president of Deutsche Bundesbank, showed the *Compact* in a bad light by saying that "*the guidelines for the national fiscal rules leave considerable room of 'manoeuvre' and there is no control on a European level to check if they are really respected*"[14]. Actually, some lacunas occur in the *Compact*; firstly it does not specify nor what should happen to countries that do not achieve the medium term objective of 0,5% neither what should be the precise form of correction mechanism when a deviation occurs. Secondly, the structural cyclically adjusted deficit is not a directly observable measure, but it is the result of a series of hypothesis and assumptions, so non-careful Member States might not improve the necessary adjustments to comply with the target value.

[11] Published in CESifo Forum, volume 13, spring 2012.
[12] Beetsma, R. and Gradus, R. *op. cit*.
[13] Mentioned in Beetsma, R. and Gradus, R. *op. cit*.
[14] Weidmann, J. in Financial Times Deutschland, 2 February 2012.

Criticism involves also the MTBFs, introduced by the *Sixpack*. In Gradus and Beetsma's vision, these frameworks are self-imposed fiscal rules that cannot be suitable to European political situation. The two Professors go back to Bohn and Inman's idea that a self-imposed rule is strictly effective only if there is an independent supreme authority capable to monitor and imposing serious penalties over countries that do not adhere to the rules. In their opinion Europe should follow United States model where budgetary frameworks are contained in the Constitution rather than in secondary legislation. In addition, "*the national legal status of numerical rules and MTBFs may differ across countries*"[15].

Inefficiency of *Sixpack* is not circumscribed to the fiscal framework, but affects also the macroeconomic surveillance, seen as an "*imperfect answer to emergence of excessive imbalances*"[11]. Indeed, indicators introduced in 2011, in order to measure the extent of a macroeconomic imbalance exists, are not able to perfectly determine whether an imbalance exists neither whether they are harmful for the economy. Moreover an excessive imbalance does not always mean a non-careful economic policy. For instance, a too large current account deficit may be justified if due to undertaken policies with the aim of an economic development, taking advantage of good growth perspectives. Otherwise largely visible current account surpluses could require correction because they are the result of harmful policies: e.g. the extraordinary incomes avoided by the *Sixpack*.

The current situation is that Northern Europe countries are getting current account, principally because they have improved clever structural policies, a good educational system and a wage and prices restraint, which gave them a strong competitive edge. Meanwhile, Southern Europe countries, with their very large negative imbalances, are getting a lack of competitiveness due to heavy malfunctions in their labour and product markets, more and more damaged by an inefficient financial market.

So, is it righteous punishing Member States of EMU for their imbalances? In Gradus and Beema's advice, a first best policy would be to help countries following

[15] Beetsma, R. and Gradus, R. *op. cit*.

the wrong guidelines with a series of structural reforms in order to ameliorate the condition of labour and product markets. Unfortunately, improvements in these economic features concern to national level, as far as regulation and surveillance of financial sector. However in the latter field a stronger breakthrough is currently carrying on with the creation of the Banking Union and its forthcoming implementation in the very next years.

This way, the current arrangements proved to be not completely suitable to the economic after-crisis situation. Firstly, it has to be seen whether public's and governments' willingness to adhere to these rules will be the same during the next crucial years: actually, any measures that lacks of sufficient ownership at the national level are doomed to fail, enhancing the risk of moral hazard, which still remains the "Achilles heel" of the European political and economic framework.

Particularly, the newly approved rules may become good recipes for moral hazard, if the real "sinners" in budgetary terms would not bear the responsibility for their wrong policies, undermining more and more the credibility of common currency.

So a deeper and stronger structural reform is still considered necessary with the aim of safeguarding the consistency of the whole European Union, a strict measure towards a true fiscal centralization, able to completely eliminate the moral hazard and the risk of default of any Member State.

1.4: Three possible future scenarios

Taking all these arguments in consideration, the current situation of Europe is still too weak and its destiny is uncertain. The credibility of the common currency is nowadays paying the bill of wrong past policies and of a too largely spread optimism. In 1997, before the introduction of the Euro, Milton Friedman said that "*the drive of the Euro has been motivated by politics not economics. The aim has been to link Germany and France so closely as to make a future European war impossible, and to set the stage for a federal United States of Europe. I believe that adoption of the Euro would have the opposite effect. It would exacerbate political tensions by converting divergent shocks that could have been readily accommodated by exchange rate changes into divisive political issues. Political*

unity can pave the way for monetary unity. Monetary unity imposed under unfavourable conditions will prove a barrier to the achievement of political unity”[16]. Friedman underlined the fact that constituting a European Monetary Union with the simply sharing of a common currency and a single supranational monetary authority would not ensure the survival of the union itself: monetary policy is necessarily linked to other economic characteristics such as fiscal policy and financial markets, as in the United States of America. What is more, there are also many social questions that make Europe disunited: different languages, different customs, and a too deep patriotism. Thus such a union would not have a *raison d'être*.

At the present moment, the debate about the future of the Euro area is very bright: there is an ensemble of different visions about the future of the Euro area, which agree on the fact that the Union cannot remain as it is nowadays, a change is needed.

The prevailing views are three. The first one is favourable to the dissolution of the Eurozone, according to the idea that belonging to the Union is a constraint rather than an occasion for economic development. The second one, that is the most widespread vision, is about keeping on with the public balance adjustment until the restoration of the economic equilibrium, this way there would be a semi-automatic correction of the errors in economic policy. Finally, the third one is the more radical, but also the most functional to the current situation, that is to say the creation of a European Fiscal Union with the aim to support the Monetary Union. Let us start analyse the first vision.

1.4.1: The dissolution of the Euro area

The complete destruction of the Eurozone is the most drastic hypothesis for the future of monetary policy and, as many economists advocate, it would be the worst scenario.

The Eurosceptic current of thought has become more and more widespread across the continent from the breakout of the crisis in 2010. The recession powered minds

[16] Friedman, M. “*The Euro: monetary unity to political disunity?*”, 1997.

of who saw the membership in a common currency area as a restriction for national authority. However roots of Euroscepticism do not lie in economic reasons as much as in political ones: the loss of national identity, the loss of national sovereignty over some economic affairs, too widespread migratory fluxes across Member States of EU. In addition, the presumed failure of the common currency keeps feeding the dissatisfaction among people, who is giving to these Eurosceptic movements increasingly importance in national Parliaments as well as in the European Parliament.

Although many economists, such as Friedman and Krugman, expressed their disagreement to the constitution of a monetary union without any form of economic and political convergence. According to Krugman (2013), weak countries as Italy have become as Third world countries, which must loan a stronger "foreign" currency in order to pay their debt. However in his vision, the economic program of the Union have to go forward, to the achievement of an economic policy that was able to ensure growth and stability to all the Member States. Actually Krugman argues that Europe is still an active and dynamic continent, whose only fault has been the choice of the wrong governance and institutions in order to manage economic policy, but it is still on time for searching a remedy. Nowadays there is pessimistic turning in the economic views about the Euro area: the common currency must disappear. French economist Jacques Sapir is one of the main supporters of this idea, tying the public debt crisis to the presence of the Euro. According to Sapir, the disintegration of the Eurozone would not imply a catastrophic destiny, but a life-saving solution for the whole Southern Europe in order to curtail public debt of the PIIGS.

In the work paper "*Les scenarios de dissolution de l'Euro*", Sapir asserts there are three hypothesis for the dissolution. The first one deals with a "controlled exit" from the Euro: the tensions in the Eurozone would reach such a level that countries decide by mutual agreement to abandon the single currency, by adopting drastic control measures capital in order to stem the depreciation or appreciation of their currencies. A residual coordination mechanism would remain so that former Member States can avoid economic unrest and re-equilibrate their trade balance.

The second one envisages a split in the EMU between northern countries", anchored to Germany, and "southern countries", whose pillar would be the France. In this case there would be two Euros circulating in two different monetary unions, though coordinated by a sort of mechanism aiming to economic convergence. Finally, the third one shows the possibility of an "uncontrolled exit": every Member State would exit by the EMU in such a dispersive and chaotic manner that would bring Europe in a deeper disorder. In Sapir's view, a controlled exit would bring back economic growth to all the former Member States, ensuring a strong reduction of unemployment.

The estimates about economic prosperity state that the rate of cumulative growth of GDP would settle between 8% and 20% in the following three years after the Eurozone dissolution: for example in Portugal and Greece this rate would be respectively 11% and 15% in the worst hypothesis. The perspectives on unemployment are also very positive: for example in France the number of unemployed people would reduce of 2,5 millions in the same three years, ensuring a fast return to equilibrium with higher consumption and higher investments and renewing the vitality and the competitiveness of Southern Europe products.

Following Sapir's advice, the coordinated dissolution would give a new life to a European monetary system, as in the past, with the introduction of a *monnaie commun* that would join the national currencies as an instrument for international transactions. The new system must have some important characteristics. Firstly, the exchange rates between the currencies of the former Member States of the EMU must be fixed, determined within of an international economic council, while remaining subjected to regular review, in order to avoid a repeat of the imbalances that prevail today. Moreover, Both the deficit that the surplus should be reported to a special account of the ECB (which then would play the role of clearing house) and should be taxed proportionally to their importance and duration. The ECB would also have the role to harmonize the banking legislation and to manage the *monnaie commun* in commercial and financial transactions to extra-area countries. The objective is to significantly reduce both credit and debit positions in the trade

balance and to re-nationalize the public debt of European countries, whose titles are principally held (quantitatively from 30% to 65% of total) by foreign investors.

The dissolution in this terms would not, in Sapir's view, sign the defeat of economic policy implemented until nowadays, but it will re-enhance European economy on the global scene.

1.4.2: The continuance of budget adjustment

At the moment, the most reasonable choice in fiscal policy is to keep on with the process of balance adjustment. Actually, policymakers of Europe have taken important steps to strengthen economic and fiscal governance; the *Sixpack*, the *Twopack* and the *Fiscal Compact* represent important goals, but not the end of the process needed to re-achieve economic and fiscal equilibrium. At the end of 2012, European Commission and the President of European Council both issued their proposals in order to obtain a deeper fiscal integration in the immediate future, providing a precise roadmap for what are the next important communitarian objectives.

Following their advice, it is necessary to arrange these achievements in a multi-periodical vision, by considering improvements that can act within the current Treaty framework on the short term and improvements that require Treaty modifications on the medium/long term. Firstly, there is the need of fully implementing the reforms currently in train (the *Sixpack*, the *Compact* and the newly approved *Twopack*) and of setting up the operational framework for bank recapitalization, directly through the ESM or on the secondary market through the ECB. Furthermore, on the medium term, it is underlined the importance of establishing a well-defined fiscal mechanism in order to improve shock absorption capacities, through an insurance system set up at the central level, with built-in incentives for Member States to pursue carful and rigorous fiscal and structural policies. European Commission proposes a Fund able to coordinate reduction in public debt and the introduction of the so called *Eurobills* to foster the integration of financial markets.

Yet this process of fiscal adjustment is still too long and too slow. Many economists and national authorities advocate that such a course is very onerous for Member States, which are already carrying on the heavy burden of the Austerity imposed by Germany, but it makes these countries still too vulnerable to further international and idiosyncratic shocks.

1.4.3: A fiscal unification

The third possible vision for the long run is the creation of a European fiscal union in order to support monetary policy managed by the common deputy authorities and in order to strengthen the Euro area against asymmetric shocks.

According to Alberto Majocchi, recovery process of the Eurozone is slowly go to an end, thus it is strictly necessary "*to promote the realization of a sustainable development model on the economic, social, and environmental plan*"[17]. In this perspective the convergence towards a common fiscal model is inevitable with the aim to bring back to the continent a good level of investments, consumption and GDP growth. The introduction of such a union it is not a simple process, but it must be articulated in a series of subsequent stages. The firs of them is the creation of a sort of European fiscal institute whose main task is "*to arrange the bail-out of the countries that risk to be swept away by the sovereign debt*"[18]. Such an institute would be the equivalent of the European Monetary Institute as the predecessor of ECB. A step in this way is represented by the ESM (*v. supra*), but it has still many limits: the necessity of a unanimous consensus, the granting of loans subjected to an interest rate and some social costs. For this reason the ESM is not suitable to act as a bailout institute.

Going forward, the following stage is to create a federal fiscal union with the setting up of a European Treasury. As the ECB monetary authority, the Treasury would be an independent institution, whose term concerns the governance over the fiscal federalism of the Euro area. Although, there would be some differences between the ECB and the fiscal authority. First of all, the Central Bank is "*a constitutional*

[17] Majocchi, A. *op. cit.*
[18] Majocchi, A. *op. cit.*

organ whose independence is ratified by the Maastricht Treaty and whose task is to guarantee price stability with interventions decided in full autonomy"[19]. A European Treasury would have a completely different ground. According to the old principle of democracy "no taxation without representation", such an institution could operate efficiently only with the consensus of the European Parliament, which would be also entrusted of its control; this way, the Treasury could act "*within the framework of a government representative of the people's will*"[20].

Such a plan requires also a financial provision in order to improve fiscal federalism and shock absorbing in the Euro area. Thus, it is evident the necessity of issuing Eurobonds, that is to say communitarian public debt titles. The Eurobonds would help to improve economic growth in the Eurozone by financing a communitarian public budget whose expenditure items would involve education, research and innovation, technological development and environmental conservation. Various proposals about the creation of a European debt have submitted several times, but most of these proposals have been rejected especially by Germany and United Kingdom. Criticism concerns the fact that careful Member States would carry the main burden by free helping non-careful-Member States: German surpluses would be used in order to cover the great deficits of the PIIGS. Moreover the presence of the Eurobonds would also enhance moral hazard by stimulating non-careful budgetary policies. Such policies would cause the increasing of interest rates and the start of inflationary spirals. However, all these effects would be avoided by the presence of a single fiscal authority: the previously defined European Treasure exactly.

This scenario is the object of our analysis in the following chapters, which goal is to give an answer to the question if such a monetary and fiscal union will be able to solve problems in economic policy of Europe. The use of macroeconomic models will help the analysis of the effects that the introduction of the fiscal union implies: would benefits be major of disadvantages or *vice versa*? In order to have a positive response, it is necessary to improve a discussion about the measures that allow to

[19] Majocchi, A. *op. cit.*
[20] Majocchi, A. *op. cit.*

have an efficient entrustment of economic policy at the Union level. In addition, the execution of such a plan is strictly relied to credibility and confidence of European citizens in supranational institutions, which are two important features that have been heavily weakened, as noticed, by the crisis. Thus, the next chapter is going to deal with the positive analysis, by explaining which are the necessary measures in order to have a well-functioning fiscal union and by examining the benefits in the economic policy; a particular emphasis would be given to the role of fiscal integration as shock absorber and insurance against sudden changes in the financial markets. Chapter Three, instead, will go to explain how credibility and confidence could be restored in the European economic context.

Chapter Two:

The fundamentals for a fiscal union

"*Fiscal unions mean different things to different people. One perspective is that a fiscal union is needed to set rules for the division of seignorage or, relatedly, that due to budgetary effects, monetary and fiscal policy are inseparable. Another perspective focuses on the role that the union's central bank may play as the lender of last resort to both sovereigns and banks; the latter is sometimes referred to as a banking union"*

- Emmanuel Farhi and Ivan Werning

According to the view of the IMF[21] staff led by Céline Allard[22] (2013), the Euro area "*cannot afford a repeat of the imprudent fiscal and financial policies undertaken by some countries in the first decades of EMU*"[23]. Indeed, Chapter One has pointed out that there are many meaningful gaps currently experienced by fiscal discipline of the Euro area, which can be summarized in four main topics: the presence of non-smart fiscal rules at the national level, the inefficiency of corrective mechanisms, the absence of a strong coordination between countries and, finally, the lack of a suitable degree of risk sharing as in the existing federations. In this chapter we are going to discuss how these lacunas can be fulfilled with the introduction of a fiscal union, which should provide a series of tools and measures able to correct inefficiencies and prevent asymmetric shocks.

In order to consider the possibility of introducing a fiscal union in the Euro Area, we must take on the balance all the features and all the implications that this kind of solution should purpose. Therefore, the analysis will focus on the features that a

[21] International Monetary Fund.
[22] Deputy Division Chief at the IMF.
[23] Allard, C. and others "*Towards a fiscal union for the Euro area*", IMF staff discussion note, 2013.

new deeply integrated fiscal policy should have and on its effects over economic situation of EMU Member States. It is clear that this proposed hypothesis would significantly change not only economics but also the political affairs of the European Union.

The current chapter is articulated in three paragraphs: the first one deals with a series of tools that could implement a more center-based fiscal discipline in the European currency area, the second one discusses about a macroeconomic system of insurance against asymmetric shocks for the Member States, finally the third one is going to show how, in past centuries, federations have become more fiscal integrated in order to response to economic and financial crisis.

2.1: Fostering fiscal discipline

In this first paragraph, we will see how, inside the Euro area, the fiscal and budgetary policy could be efficiently transferred from the national level to the central level.

2.1.1: What is a fiscal union?

According to the definition of Michael D. Bordo, a fiscal union "*entails fiscal federalism among its members, which could be either sub-national political units or nation states*"[24], where fiscal federalism means a series of cooperative arrangements between all the members in tax distribution and public expenditures. Sorens (2008)[25] depicts an ideal type of fiscal federalism as a consisting of four important elements: first of all, sub-central political units have to be autonomous in deciding taxes and expenditures, secondly, there must be a severe budget constraint from the federal level, enforced by a strictly credible no-bailout rule, thirdly, the area must be characterized by a high level of mobility of traded goods and labour, fourthly, the system of fiscal federalism must be institutionalized in a set of rules (e.g. in the Constitution). In addition, this kind of market shall be based on common

[24] Bordo, M. D. "*A fiscal union for the euro: some lessons from history*" in CESifo Economic Studies, vol. 59, March 2013

[25] Mentioned in Bordo, M. D. *op. cit.*

currency. As it can be seen, this definition is strictly concordant with the OCA theory proposed by Mundell, McKinnon and Kenen.

As a matter of fact, in Kenen's view (1969), "*it is a chief function of fiscal policy, using both sides of the budget, to offset or compensate for regional differences, whether in earned income or in unemployment rates*". Indeed, countries such USA, share federal revenue and transfers in such a manner that provides automatic stabilizers across the States, thus USA can be thought as an exemplary model in this sense. Actually, in the OCA theory an appropriate level of fiscal federalism or financial integration could replace the loss of exchange rate as a shock absorber (especially if asymmetric). Particularly, Mundell identified the private insurance channel, provided by the market, as a source of risk sharing and consumption smoothing. However, as advocated by Farhi and Werning (2013), this proposal is quite inefficient so a system of interregional and intertemporal transfers among members is required, in order to provide a macroeconomic source of insurance. In their vision, transfers have two important roles: "*first, they help smooth consumption—the usual direct role of insurance; second, under a fixed exchange rate, in the presence of nominal price or wage rigidities, and with non-traded goods or home bias, transfers also have an indirect effect by affecting the pattern of spending, which in turn affects output and hence income or wealth and this helps mitigate recessions*"[26].

2.1.2: How to address fiscal policy to the central level?

History shows that periods of crisis, such as the one experienced during the last years, led federations to adopt a more central control in fiscal discipline (see *infra* paragraph 2.3). For example, in the late XVIII century, the US central government intervened in saving many States, which were in bankrupt because of high military expenses due to the Revolutionary War. Hence, the federal government assumed liabilities of these States, ensuring them dedicated revenues and laying the foundations for a federal budget. A similar situation happened in the '90s, when Brazilian federal government bailed out a number of states assuming at the central

[26] Farhi, E. and Werning, I. *op. cit.*

level spending and borrowing controls. These episodes are very like to the one currently experienced in the EMU: actually, the crisis required the applying of very strong solutions such as *Sixpack*, *Twopack* and *Fiscal Compact*, which allow the Union to 'meddle' deeper in the fiscal affairs of single Member States. Unfortunately, some economists advocate that these interventions are not sufficient to foster fiscal discipline.

Currently, economic policy of the Euro area still lays on self-imposed budgetary constraints (stated by the SGP), which purpose a high national autonomy in fiscal discipline accompanied with a strict no-bailout rule (see figure 2.1). However, according to Clemens Fuest and Andreas Peichl[27] (2012), it is not the optimal solution. In their vision, the benefits of a single market, which should strengthen international finance and economy, by increasing trade, prompting labour mobility and enhancing economic convergence, are not experienced by the EMU. Frictions and imperfections of cultural and economic nature make asymmetric shocks still too frequent. Government failures, weak national fiscal policies and non-smart international fiscal rules may threaten the stability of financial markets, in such a matter that common monetary policy, as it has been seen in the last years, is not sufficient in replying.

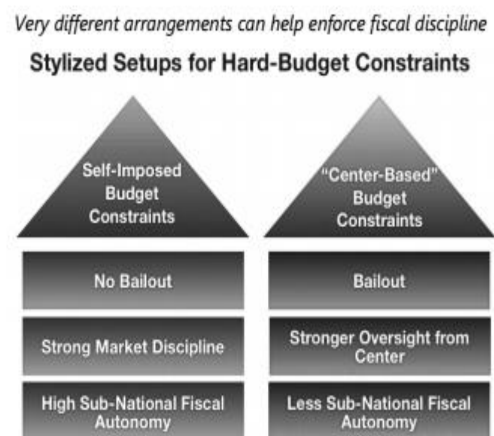

Figure 2.1: Center-based approach versus self-imposed approach

Let us consider a country participating to a currency union with the same features of the Euro area. If this country runs high budget deficits year after year, in open violation of the constraints, it accumulates increasingly a great stock of debt facing a serious risk of bankrupt. Financial difficulties threaten grievously financial markets generating negative spillover effects on other countries of the currency union. Moreover, this country may create pressures to monetize public debt and

[27] Professors respectively of the University of Boston and of the IZA of Bonn.

interfere with common monetary policy and enhancing moral hazard. Supposing that the rest of the union is composed by countries adopting a careful fiscal policy, a government that does not intend to cut back the deficit and continues to accumulate debt, even in the presence of sanctions, could be ousted by the rest of the Union and left to go bankrupt. This way, a self-imposed budget constraint is not efficient: it does not enhance coordination in national fiscal policies, it does not solve economic crisis and, in addition, financial sanctions can make the situation of indebted non-careful countries even worse.

A center-based approach would be different. Such a solution implies that the central authorities of the currency union assume also responsibilities for fiscal discipline, by improving a strong supervision over budgetary policy of member countries. Thus, fiscal policy of the currency union is decided at the central level, leaving to national autonomies only a marginal role. This way, there can be settled more binding fiscal targets, which can be more systematically improved, and increased fiscal transparency and accountability.

Richard Musgrave (1959) states that an efficient fiscal system is deputy to three fundamental functions: firstly an allocative function, which concerns the provision of public goods to citizens that cannot be supplied efficiently by the market, secondly a redistributive function, which concerns the distribution of wealth and revenues among citizens and regions, with the conviction that such a goal cannot be obtained privately on the market, and thirdly a stabilization function, which ensures the full employment of resources with no risk of high inflation. According to Musgrave, in a fiscal federation, the center-based approach should assign the stabilization function and the redistributive function to the union level while the allocative one remains at the national level, because of the righteous motivation that each country has its own needs and its own preferences.

In this vision the central budget of the union becomes the most important tool in order to maintain fiscal discipline stable among each member country. Addressing budgetary policy to the central level means give it both powers of raising taxes and decide public expenditures. This way, the previous country cannot allow to undertake the same non-careful fiscal discipline, because the expenditure topics are

established at the central level and deficit margins are limited by the central budget. Thus, such an approach does not need to apply financial sanctions and punish imprudent countries. Moreover, a central well-functioning budget is able to compensate deficits obtained during downturn periods with surpluses obtained in boom periods, by improving a good anti-cyclical economic policy.

However, at the present day, the European budget represents only 1% of the whole wealth produced by the Member States and, for the greater part, it is used to provide subsides, social aid and to improve economic growth. As it can be seen, the leeway in fiscal discipline is reduced to minimum. Thus, there is no doubt in the fact that such a European budget may not carry out an autonomous role in the economic policy working together with the national budgets, as in the case seen above, especially if it is compared to the American case, indeed we can think USA as an ensemble of currency union within a fiscal union. According to Guido Montani[28] (2005), in the United States "*the budget of the federal government was equal to 19.9% of the American GDP in 2003, so, taking the meagre size of the European budget into consideration, we can conclude that the European Union cannot carry out the function of promoting an economic growth similar to that of the government of Washington*"[29]. Actually, European budget does not perform an allocative function, because it does not provide communitarian public goods to the citizens, nor a redistributive function, because it does not allow an equal distribution of wealth and incomes among citizens, neither a stabilization function, because it does not ensure the full employment of resources, necessary to long run equilibrium.

In order to make European budget well-functioning as Musgrave advocated, it should have the same margins of flexibility of the national ones, by imposing a limit in public expenditures, in order to have a sustainable deficit that must not be covered with financial borrowing. Moreover, aiming to have a completely autonomous central budget, it is necessary assign to the EU the power to impose taxes on citizens, bypassing local authorities, obtaining in this way its own financial resources. At the present day, European budget is financed principally with national

[28] Professor of the University of Pavia.
[29] Montani, G. "*The role of the European budget in European economic policy*" 2005

contributes, earned by every Member State, which claims a *juste retour* in exchange. However, in order to have a functioning central budget, the taxation must be out of every sort of national influence. In order to obtain its own resources, the Commission proposed three options: "*the first is a tax on energy, […] a percentage on VAT, which should not cause a rise of the existing rates, but in a greater transfer at European level, […] the third resource proposed, more difficult to carry out, concerns company taxation. A fourth proposal should be added to these ones: a tax on personal income"*[30]. Especially this final solution should enforce, under a political point of view, citizens' sense of belonging to a greater community than the one included in national boundaries.

Doubtless, such a power implies a very significant shift of policy responsibilities from national to European level. Thus, it is necessary the creation of a single European Authority deputy to budgetary policy, which is able to take decisions basing on a democratic process. Professor Majocchi (see *supra* Chapter one) proposed the introduction of a European Treasury, under the direct control of the Parliament, but independent from the other institutions (first of all from the ECB and the national governments). However, this authority must not necessarily have a ministerial nature but it could also be an institution within the Council (Montani, 2005) even though it should be representative of citizens' will and thus subjected to the *veto* of the Parliament.

2.1.3: A bailout institution to resolve crisis

A central level budget and the institution of an apposite authority is not sufficient to avoid public debt crisis among members of the Euro area. Therefore, it is necessary to set up a suitable crisis resolution mechanism able to bring countries out of financial difficulties.

Following to Fuest and Peichl's advice (2012), a center-based approach should provide the Union with the introduction of a 'bailout institution' in order to give a strong support to fiscal discipline. This is a very important feature for two reasons:

[30] Montani, G. *op. cit.*

firstly, it allows to provide the supporting facilities to Member States in bankrupt or liquidity risk, secondly, it allows to reduce stress in financial markets due to periods of economic instability produced by asymmetric shocks. This opinion seems to be in open contrast with what Sorens stated (see *supra* paragraph 2.1.2) about the fact that no-bailout rule must be a fundamental feature for fiscal federalism. However, there are two important reasons why a 'bailout institution' has to be considered necessary in this context. First of all, if a country member of a currency union has a high stock of debt, after an asymmetric shock, can get into a high risk of insolvency and find itself in a huge crisis. Thus, if there is no 'bailout institute' this country shall re-negotiate with its creditors the conditions of its debt in order to resolve crisis, restructuring terms and interest rates. However, such a situation make the trust of investors fall down so higher risk premia are asked and risk of insolvency becomes more and more evident. Secondly, debt restructuring spread crisis also to banking sector, which can find unsustainable holding public debt titles of the mentioned country, thus its intention is to write off government bonds in order to not find itself in a deep counterparty risk. However, critics especially argued that this way there would be no incentives to adopt a careful fiscal policy, therefore, a strict regulation is necessary in order to avoid moral hazard and excessive sovereign borrowing in the presence of strict borrowing arrangements. For example, the ESM goes forward in this direction, tying the bailout process activation to precise requirements, such as the proven risk of default for the whole Euro area and the preventive subscription of the *Fiscal Compact*, which purpose the enshrining of careful fiscal rules in the national legislation (see *supra* Chapter One).

The ESM represents an optimal starting point to introduce such a 'bailout institution' in the Euro area, despite all its constraints do not allow it to carry out a true rescue function, so its suitableness should be enlarged. The renewed ESM should have both functions of analysis and bailout, the first one is to decide whether a country of the EMU lies or not in a situation of financial and macroeconomic instability, which cannot be solved with a simple adjustment in public expenditures and taxation. The second foresees that the ESM act as a lender of last resort by purchasing financial aid to the country following a strict programme of

'rehabilitation' of fiscal discipline set up *ex ante*. The bailout may act also with the aim of recapitalizing the banking sector. In this sense, the ESM plays a fundamental role, indeed, using the words of Fuest and Peichl, it would be able "*to avoid sovereign debt restructurings in cases where crises can be overcome without them (cases where countries face liquidity crises, but are fundamentally solvent) and, secondly, to make restructurings possible in cases where they cannot be avoided because countries are insolvent. Making restructuring possible means that the ESM would ensure that funds are available to stabilise the financial sector and prevent the restructuring from triggering a banking crisis*"[31].

However, as we will see afterwards in this chapter, a better method to ensure a strong insurance against recessions is by improving a system of interregional and intertemporal transfers, which are able to act as semi-automatic stabilizers in fiscal policy for Member States of EMU.

2.1.4: The unification of the public debt

The increasing of public expenditure during downturn period is strictly necessary aiming to undertake an anti-cyclical economic policy. At the present time, each country in the Euro area borrows its own resources on financial markets, but as we have seen during the last crisis this solution is not efficient when countries participate to a currency union, now it remains to see whether this is also an inefficient solution inside a fiscal union.

A national borrowing has several benefits; first of all, it allows to organize public expenditure according to the necessities of citizens in each Member State. Thus, a country would borrows as long as this needs persist. However, this question would be overcome by the presence of the common budget: actually, resources would be allocated on needs and requests directly by the central authority. By contrast, according to Steven B. Webb (2004)[32], national borrowing in debt markets is often involved in information asymmetries. Firstly in moral hazard, because lenders and

---

[31] Fuest, C. and Peichl, A. "*European Fiscal Union: what is it? Does it work? And are there really no alternatives?*" in CESifo Forum, Volume 13, spring 2012.
[32]Mentioned in Bordo, M. D. *op. cit.*

borrowers expect the bailout from the Union level government in case of default. Secondly in adverse selection, because borrowers have an incentive not to reveal certain important characteristics about their financial and economic situation, falsifying their creditworthiness. These agency problems can be solved with a central level borrowing: their high liquidity and their low insolvency risk require a lower risk premium, finding out also a more wide international market. "*The main argument for a common European government bond is that it would promote further market integration, especially on the supply side, and greater debt management coordination. The efficiency gains from a unified bond market could be substantial: liquidity could be enhanced by larger outstanding volumes, which would, in turn, reduce liquidity premia and, thus, the costs of borrowing for Member States, with greatest advantage for smaller and medium sized issuers*"[33].

According to Waltraud Schelkle[34] (2012), the so-called *Eurobonds* may be designed as risk-sharing arrangements, pursuing a joint and several liability for all the Member States for their issue, in addition to an individual liability for each Member State for their sharing. However, nowadays there are three further proposals from the Committee on Economic and Monetary Affairs of the European Parliament (summarized in figure 2.2) for the introduction of the *Eurobonds*. The first one pursues the issue of a single debt instrument by an independent agency "*with funds raised and obligations divided between participating issuers in specific fixed proportions*"[35]. Each participating Member State would guarantee only its share of the joint instrument, that is to say "*while the Eurobond would trade as a single debt instrument, each participant would be liable only for the interest payments and principal redemption corresponding to its share of the bond, and not for the debt of the other issuers*"[36]. The second proposal is more radical and it pursues that "*each participating issuer would guarantee the totality of the obligations of the common instrument, thereby making it an indivisible legal object*"[37]. The issue could be

[33] Favero, C. and Missale, A. "*EU public debt management and Eurobonds*" for the European Parliament's Committee on Economic and Monetary Affairs (2010).
[34] Professor at the London School of Economics.
[35] Favero, C. and Missale, A. *op. cit.*
[36] Favero, C. and Missale, A. *op. cit.*
[37] Favero, C. and Missale, A. *op. cit.*

entrusted to an independent agency as in the first case or to an institutional fund as the ESM or another one specifically created. In addition, the debt-service obligation would be divided between Member States in relation to the amount of funding obtained. The third proposal, finally, is about an instrument issued by a European institution (for example the European Commission or the European Investment Bank) that lends the funds raised on financial international markets to the Member States "*at an interest rate reflecting funding costs plus, eventually, a margin possibly different across States*"[38]. Such an instrument would have a joint guarantee from all the Member States of the European Union: "*if the common bond were issued by the European Commission (EC) the guarantees would derive from the legal obligations of the Member States under the EU Treaty; if the bonds were issued by the EIB, it would be backed by the capital subscribed by EU Member States*" [39]. In both cases the Eurobonds would be a high creditworthiness and thus their risk premia would be very low.

Characteristic	Type 1	Type 2	Type 3
Issuing Entity	Independent Agency	Independent Agency or EMU Fund	EU Institution EC or EIB
Participation	Open	Open	27 EU Member States
Fixed Shares for each Country	Yes	No but limits on debt of each participant	No but limits on debt of each EU Member
Guarantees	Several	Several and Joint explicit	Several and Joint from EU Treaty
Mutualisation of Default Risk	No	Yes	Yes
Credit Rating	Weighted Average of participants	Reflect Rating of larger participants. Highest (AAA) if all euro-area Members join	Highest (AAA)
Liquidity	Conditional on Market Size and Participation	Conditional on Market Size and Participation	Conditional on Market Size
Management	Inflexible	Flexible	Flexible
Legal Obstacles	None	Change in TFEU Art.125 No-Bailout	Change in TFEU

Figure 2.2: the three typologies of Eurobonds

[38] Favero, C. and Missale, A. *op. cit.*
[39] Favero, C. and Missale, A. *op. cit.*

2.2: Risk sharing and insurance against asymmetric shocks

An asymmetric shock (also known as country-specific shock) is a phenomenon that may give rise to an economic or a social change in a specific country, but it does not spread to other countries. Some examples could be: shocks to productivity of inputs, to preferences of agents, to the endowment of traded goods and so on. Asymmetric shocks pose dramatic challenges to macroeconomic stability, especially to those countries participating to a currency union because of their relevance over common monetary policy.

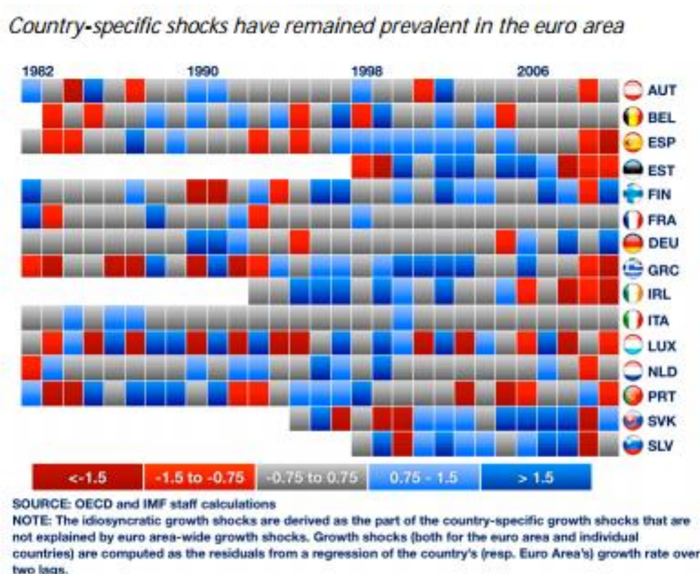

Figure 2.3: Country-specific growth shocks (percent) in the Euro area.

Actually, as it has been stated in Chapter One, Member States of a monetary union lose the benefits deriving by flexible exchange rates, first of all the possibility to use them as shock absorbers. Thus, there is the need of improving a substitute instrument: the OCA theory proposes (*supra*, Chapter One) financial or fiscal integration. In Mundell's analysis these two features are seen as perfect substitutes: a perfect financial integration does not need also a fiscal unification, or the contrary, the institution of a fiscal union would be as good as a suitable deep fiscal integration.

Farhi and Werning in their paper work "*Fiscal Unions*" (2013) argue that fiscal integration and financial integration are not perfect substitutes. Their study bases on cross-country insurance among members of a currency union against country-

specific shocks: can the agents improve the optimal insurance privately on financial markets or there is the need of the government's intervention.

2.2.1: Private insurance

Private insurance is almost impossible. If markets are perfect households and firms can improve the best level of insurance with no meddling from the government. Nevertheless, a laissez faire policy is not acceptable because markets are not perfect. Perfection is absent relatively to four reasons: no full information, the presence of constraints in borrowing, incomplete markets and the presence of nominal rigidities are not able to lead agents building a Pareto-efficient portfolio. This way, agents "*do not internalize the macroeconomic stability consequences of their portfolio decisions*"[40], so the intervention of the government is strictly necessary. In addition there is the risk that a private market with no public regulation would be able to amplify the effects of the shocks, generating very harmful spillover effects. "*Even if private asset markets are perfect, we find that private insurance is imperfect within a currency union. A role emerges for governments to arrange for macro insurance. We think of this as proving a rationale for a fiscal union within a currency union*"[41]

2.2.2: Macroeconomic insurance

Macro-insurance can be purchased to the system across financial markets or by interregional and inter-temporal transfers. On financial markets governments can improve a system of taxation and subsidies able to lead individuals to optimal portfolio choices in a Paretian sense. This way some obstacles posed to private insurance can be torn down, first of all the information problem and some questions about nominal rigidities: firstly, households are allowed to hold titles from different countries of the currency union (preventing idiosyncratic risk), secondly, taxes and subsidies can make prices of financial activities so much flexible to react to unexpected variations in risk and rates. However the problem about incompleteness of markets still remains, making this solution not suitable: "*macroeconomic*

---

[40] Farhi, E. and Werning, I. *op. cit.*
[41] Farhi, E. and Werning, I. *op. cit.*

insurance markets are imperfect or nonexistent"[42]. This is a very important reason for the creation of a well-functioning fiscal union.

Risk sharing can be improved in a better way through an international system of fiscal transfers between Member States of a currency union, such as the EMU. According to Farhi and Werning transfers make that "*the value of gaining access to insurance, for any given level of insurance, is greater*" and "*transfers go beyond emulating the outcome that private risk sharing would reach if only asset markets were complete*"[43].

2.2.3: The economic value and the implementation of the transfers

Let us take in consideration the case of a country in the Economic and Monetary Union hit by a negative shock. This country would bear a loss in terms of output and in terms of fiscal policy: there must be an increase in public expenditures in order to resettle the economy in an equilibrium situation. This is not a simple process especially with the presence of hard budget constraints and if the country has a high level of debt (such as the PIIGS). However, if the country receive a transfer proportional to the size of the shock it might have enough available resources to react to downturn.

The development of an efficient system of transfers might be seen as very similar to the 'bailout institution' aforementioned, but there are important differences. The bailout institution is a constituted governmental establishment appointed to solve crisis *ex post*, when there is no alternative strategy available. The system that we are going to see is like to what the Tommaso Padoa-Schioppa Group (2012)[44] defined a '*rainy day fund*', that is to say a mechanism of financial nature, which raises resources *ex ante* in order to purchase contingent transfers to Member States in difficulties. In this sense, the communitarian budget plays a principal role, by obtaining resources from 'boom countries' and earning them to 'bust countries', going to compensate deficits with surpluses.

[42] Farhi, E. and Werning, I. *op. cit.*
[43] Farhi, E. and Werning, I. *op. cit.*
[44] Mentioned in Allard, C. and others *op. cit.*

According to Hammond and Von Hagen (1995)[45] such a fund must respect two precise characteristics. Firstly, the system must be "*simple and automatic*", in order to be generally accepted by citizens of the union and to reduce timing and strategic implementations. Secondly, contributions from States in surplus and transfers to States in deficit should be non-regressive, that is to say that their size should not decrease as the income per capita gets smaller. Moreover, other important features can be added to these: transfers must be temporary and should be a function of serially uncorrelated shocks, this way the risk of moral hazard is strictly reduced by prevent that a too widespread aid could be manipulated by Member States; finally, the scheme should be able to offset a large part of the shock, that is to say benefits must overcome the implementation costs of the insurance measure.

Now, we are going to see how such a system of transfers could be efficiently implemented in a fiscal union within a currency union, using the empirical model of Davide Furceri[46] and Aleksandra Zdzienicka[47] (2013). This model purposes to explain how a semi-automatic and non-regressive transfer mechanism is able to completely smooth asymmetric shocks.

Let us consider a currency union composed by *n* countries that share a communitarian budgetary policy. Central authorities require that a τ part of annual GNP of each country is collected in a stabilization fund, which is allowed to be used only in the case that one or more countries are hit by an asymmetric shock. The stabilization fund collected at the central level at the year *t* would be equal to:

$$Fund = \sum_{i} \tau GNP_{i,t-1}$$

Where:

- $GNP_{i,t-1}$ is the gross national product of the country *i* at the time *t-1*;
- τ is a predetermined constant that represents the gross contribution rate.

[45] Mentioned in Furceri, D. and Zdzienicka, A. "*The Euro area crisis: need for a supranational fiscal risk sharing mechanism*", 2013.
[46] Professor at the University of Palermo and researcher at the International Monetary Fund.
[47] Researcher at the International Monetary Fund.

This expression means that the total amount of collected resources is equal to the sum of a proportioned quantity of GNP of the previous year for each country in the union. The partial or total amount of this fund would be used during year t if an asymmetric shock happens, but, at the contrary, if it is not the case, financial resources would be retained for the forthcoming years. Now, let us consider that, at the time *t*, a country *i* is hit by an idiosyncratic shock, whom value is $\epsilon_{i,t}$[48].

Therefore, the redistributive system of transfers act as follows. If the value of the shock is positive (or if the shock is nonexistent), $\epsilon_{i,t} \geq 0$, the amount of transfers to the shocked country is equal to 0:

$$T_{i,t} = 0$$

If the value of the shock is negative, $\epsilon_{i,t} < 0$, the amount of transfers to the country in recession is:

$$T_{i,t} = |\epsilon_{i,t}| \frac{DNI_{i,t-1}}{\sum_i DNI_{i,t-1}} \sum_i \tau GNP_{i,t-1}$$

Where:

- $|\epsilon_{i,t}|$ is the absolute value of the shock;
- $\frac{DNI_{i,t-1}}{\sum_i DNI_{i,t-1}}$ is the relative size of the economy measured in terms of DNP (disposable national income) because it is a value affected by net international transfers[49];
- $\sum_i \tau GNP_{i,t-1}$ is the size of the stabilization fund.

---

[48] In their analysis, Furceri and Zdzienicka used a log-log regression model to estimate, country by country, the approximate values of the shocks for Member States of the Euro area:

$$\Delta logGDP_{i,t} = \alpha_i + \sum_{j=1}^{2} \beta_j \Delta logGDP_{i,t-j} + \epsilon_{i,t}$$

Here two measures of the shock are considered: the output gap and the growth deviations from historical averages. The output is here expressed by the gross domestic product, whom relation with the gross national product is: $GDP = GNP - (international\ income\ transfers)$.

[49] The disposable national income is equal to:
$DNI = GNP - (capital\ depretiation) - (net\ international\ taxes\ and\ transfers)$

Thus, it is shown that optimal transfers during negative idiosyncratic shocks must be proportional to the size of the shock, aiming to cover the major part of the caused loss, and to the relative size of the economy of the country, especially in relation to the part of incomes that can be used to private and public expenditures and to improve saving.

2.2.4: Empirical results

Now it remains to see whether such a system of international transfers is able to ensure a correct level of insurance across the fiscal union. Furceri and Zdzienicka applied their model to the European Economic and Monetary Union, by considering eleven of the current eighteen member countries. Through the use of a logarithmic regression model they calculated the amount of country specific shocks happened in this area between 1979 and 2010, by sampling the output gaps and the growth deviations[50] and seeing if the shocks were correlated or uncorrelated. The purpose is to obtain the optimal level of τ in order to raise a fund able to ensure the full insurance to the whole union and the adequate level of transfers calculated as in the model above. Furthermore, they posed the target to have "*zero unsmoothed shocks*"[51], that is to say to void the effect of the shock and restore the previous equilibrium.

Results attained by Furceri and Zdzienicka demonstrate that reaching a successful full stabilization is possible. Table 2.1 shows the different levels of the gross contribution rate, calculated as percentage of GNP, in different situations. As it can be seen, before the introducing of the fund it was not possible to completely smooth the shock. By contrast, in a fiscal union within a currency union, the effect of idiosyncratic shocks can efficiently eliminated: the macroeconomic insurance is well-functioning whatever the economic condition may be. Moreover it can be also seen that the gross contribution rate is relatively small: in the worst case, during severe and persistent downturns, it is about 4,5% of GNP.

---

[50] The output gap is calculated as the difference between the effective output and the potential output; the growth deviation is the standard deviation of samples from the average of growth rates.
[51] Furceri, D. and Zdzienicka, A. *op. cit.*

Stabilization fund: normal times vs. severe downturns						
	(I)	**(II)**	**(III)**	**(IV)**	**(V)**	**(VI)**
	Normal	**Severe downturns**	**Very Severe**	**Severe & Persistent**	**Severe & Unanticipated**	**Severe & Symmetric**
τ	3.3	4.0	4.5	4.5	4.0	4.1
Unsmoothed *after* stabilization fund	0	0	0	0	0	0
Unsmoothed *before* stabilization fund	0.658*** (12.18)	0.780*** (7.91)	0.878*** (9.41)	0.863*** (9.63)	0.782*** (9.20)	0.784*** (9.11)
Net international taxes and transfers	0.696*** (3.16)	0.828*** (3.15)	0.927*** (3.15)	0.921*** (3.14)	0.829*** (3.14)	0.847*** (3.15)

***, **, * denotes significance at 1%, 5%, 10%, respectively. z-statistics in parenthesis. The number of observation in each estimated equation is 376.

Table 2.1

Table 2.2, instead, shows the average size of transfers that the considered eleven countries would have received between 1979 and 2010 if they would participate to a fiscal union within a currency union. Transfers are calculated as percentage of GNP of each country and it can be seen that, in every case, they are only a small part of the gross national products. Transfer values are different if the shocks are expressed with growth deviations or output gaps, and especially if they are serially uncorrelated or not. "*The transfers generated by the mechanism vary across countries, with largest transfers received by the more volatile economies, typically the smallest*"[52].

Average transfers in the case of full stabilization, 1979-2010 (%of country's GNP)

	Uncorrelated shocks	Output gaps	Growth deviations
Austria	1.7	0.4	1.1
Belgium	1.9	1.4	1.1
Finland	2.9	3.5	2.1
France	1.5	1.5	1.0
Germany	2.1	1.0	1.3
Greece	2.9	1.1	2.3
Ireland	2.3	3.8	2.3
Italy	1.7	1.7	1.2
Netherlands	1.6	1.3	1.4
Portugal	2.6	2.3	2.2
Spain	1.6	1.9	1.6
Average	2.1	1.8	1.6

Table 2.2

[52] Furceri, D. and Zdzienicka, A. *op. cit.*

However different results can be attained with different targets. Particularly, if the objective is to have only a partial stabilization (for example to cover the 20% of the shock) the amount of optimal transfers and of optimal gross contribution rate would be significantly reduced.

What is more, Farhi and Werning demonstrated that transfers are more beneficial to the economy the more it is close, in open contrast with McKinnon. In their view, the calculation of the economic openness rate (supra, Chapter one) does not consider the amount of transfers; consequently results obtained by McKinnon have been distorted. In conclusion we can say that "*stabilization is increasing in the persistence of the shock and decreasing in openness*"[53].

2.2.5: "*Currency unions and fiscal unions go hand in hand*"

Indeed, the problem of automatic stabilizers is crucially solved, the deeper fiscal integration, argued by Kenen, represents the best substitute to the loss of flexible exchange rates. Member States of a currency union, such as the EMU, should apply as in Farhi and Werning's analysis, by improving the right degree of macroeconomic insurance and develop a well-functioning system of fiscal transfers. To sum up, we can say, under a risk sharing point of view, that there is no currency union without a fiscal union. Therefore, it can be seen that "*a supranational fiscal risk sharing mechanism financed by relatively small gross contribution would be able to provide full insurance*"[54].

However, it is wrong to consider that such a fiscal integration could solve all the problems affecting a currency union, especially during crisis periods. It is crucial to take on the balance questions like moral hazard or liquidity and solvency problems in banks and governments. A simply system of interregional transfers is not able to ensure stability in every case, after all, the economies participating in the fiscal union are not perfect, neither perfectly integrated insofar every obstacle cannot be torn down. For this reasons there are still necessary all the features like crisis

[53] Farhi, E. and Werning, I. *op. cit.*
[54] Furceri, D. and Zdzienicka, A. *op. cit.*

resolution mechanisms and coordination systems in budgetary policies and raising financial resources.

2.3: Some examples from the history

We can find out a justification for the creation of a fiscal union in the Euro area even in the history. Indeed, there are many historical cases that show how nations created *ex novo* a federal union, by responding to a series of needs and gaps threatening economic and political stability. Is the Euro area arrived to a historical conjuncture which requires that Member States join together in a more integrated Union?

Even though federations all over the world have their own features, most of them created their unions for similar reasons: independence wars, huge crisis, economic convenience have been the main rationales to their foundation. For examples the USA have been founded in revolution against the British Empire, while the creation of German federation has been boosted by both political and economic reasons. According to Frank (1968) there are some very important factors that are able to foster the integration of independent countries, such as the common language, the degree of convergence of the economies, the similarity of the institutions; however, these are fundamental conditions but not sufficiently able to ensure the success of the federal institution. In Friedrich vision (1968), the most important feature in order to build a union is what he calls the ‘federal spirit’, that is to say the desirability of citizens to join together in a more large institution and accept necessary compromises for a communitarian benefit.

Nowadays, it cannot be said whether European Union in such a crucial situation, neither if European citizens are ready to bear the heavy burden of decide if it is necessary to get more integrated and to accept compromises or breaking every communitarian link and restart to act as single economic units. However, we can see some examples that can us help to understand how in serious economic and political situations single small countries decided to join together more than being one against each other.

2.3.1: The North America federations, United States and Canada

United States. USA gained independence at the end of XVIII century and became an economically strong federation of states. In 1790s Alexander Hamilton, Secretary of the Treasury, worked with the purpose to strengthen American economic policy in order to bear the heavy debt raised to finance independence wars. His drive in both monetary and fiscal discipline was to create a national debt, in order to facilitate States for borrowing resources on financial markets, to institute a 'sinking fund', in order to acquire more public securities and capability to pay off the debt, but not to bailout the single States, and finally the creation of a central bank, the First Bank of America, on the model of the Bank of England. Doubtless, Hamilton's boost to fiscal policy have been an important contribution to create the basis for the economic supremacy of the USA, but it has not been necessary to ensure macroeconomic stability to the whole union; this is demonstrated by the default of many American States between 1839 and 1840, as a result of the Congress' decision to strictly apply the no-bailout clause.

Until the firs decades of XX century the public federal budget and debt of USA did not play important roles in fiscal policy. Expenditures and taxation were mostly implemented at the local level with very little interference from the central level. Federal borrowing increased only in wartimes, leaving to State autonomous debt the role of finance public expenditures. Nevertheless, the situation radically changed with the supervening of the Great Depression in 1929. During the 30s the States were not able to carry on an effective response to the crisis on their own, unemployment rate was too high and output growth rate was too low that a local macroeconomic reaction was not only inefficient, but also there was the risk of creating harmful spillover effects on the whole union.

The New Deal represented a turning point in American fiscal discipline. First of all reforms implemented the role of federal budget: there has been an important shift of public expenditures from local to central level, actually, between 1932 and 1940, the federal share for the expenditures rose from 30% to more of 46%, while at the local level the share decreased from 50% to only 24%; moreover the 75% of total government expenditures have been covered by a joint program between States and

Washington. These costs generated a high deficit that have been covered partially with taxation raised both at the central and local level, but principally with a prolonged and extensive use of federal public borrowing. This was the first case in American history that a federal deficit have been used as tool for macroeconomic stabilization, in order to attenuate the economic cycle.

Nowadays, American fiscal policy is developed in accordance with a high degree of fiscal federalism: every State is free to choice its optimal level of taxation with few limitations imposed by the central government; moreover, there is a high autonomy in deciding expenditure items in local budgets, with important exceptions when expenditure concerns questions of great national relevance, such as defense, pensions and health insurance. Limitations, however, are imposed on borrowing: every State must respect some centrally imposed budgetary constraints, allowing to the federal government a major authority in raising debt (for questions tied to moral hazard and risk premia reduction). Currently, the debt-to-GDP ratio of USA is about 70%. The federal government pursues a strict no-bailout policy.

Canada. Canadian federation is born with the British North America Act (1867), with which former colonies of Great Britain joined together to face the economic and political supremacy of the next United States. Such a union is organized with high concentrated central powers especially in taxation and borrowing, in front of a certain degree of autonomy in public expenditure at the local level (about the 50% of the total).

Until the 30s Canadian economy has been characterized by a strictly *laissez faire* policy, with few intervention of the government. However, especially after the Great Depression, fiscal policy in Canada has greatly developed to face the crisis. Federal government started borrowing extensively on financial markets but the risk premium asked for Canadian titles did not increase during the whole period. The reason why the market had a considerable trust in Canadian creditworthiness lies in a series of intervention the government made to foster fiscal discipline. First of all, the central level acquired the jurisdiction over personal and corporate income tax, by reducing a lot the autonomy of States in raising fiscal funds. In addition, a new born Committee was appointed to develop a well-functioning system of inter-state

transfers, with a redistributive more than an insurance function. This way Canadian government guaranteed the service of debt for the whole period of recession.

Nowadays, the system of interregional transfers is still improving. Actually, central government is characterized by high revenues, but few expenditure items, which are addressed to questions with a high national interest. By contrast, States have many expenditures in order to improve and ensure public services to the citizens, but very few sources of income. Thus, federal budget still plays the fundamental role in order to transfer resources from areas in surplus to areas in need.

2.3.2: The example of the 'European excellence': Germany

The German Federation have been built at the end of World War Two, with the fall of the Third Reich, and completed in 1990 with the absorption of Deutsche Democratic Republic. The federation is divided in sixteen Länder, which are provided of an autonomous fiscal discipline, coordinated by the central level.

"*Although the German federal government and the Bundesbank are famous for its prudent monetary and fiscal policies, the fiscal performance of sub-national sector is far less admirable*"[55]. Actually, between 70s and 80s, imprudent fiscal policies at the local level made debts of both central and Länder government increase considerably. The high level of debt forced the federal government to intervene with a series of bailout measures, by improving a system of transfers from central to local level. Particularly, Länder of Bremen and Saarland required special extra transfers in order to not end in a default situation.

This irresponsible local fiscal policy brought Germany to macroeconomic instability culminated with the missing respect of Maastricht parameters for deficit and debt in 2002. No Excessive Deficit Procedure, neither punishment have been imposed to Germany, receiving a sort of bailout from the European Union, conditioned to the promise of a more prudent fiscal policy in the future.

The current situation in German federation shows that disequilibrium still remains vivid: there are Länder that have become permanent borrowers to the central level,

[55] Bordo, M. D. *op. cit.*

while others are permanent net lenders. As a result, creditworthiness of sub-national level is very low, making impossible to borrow at the local level on financial markets. The strong dependence of the Länder reached in the last years such a high value (70% of total share) that makes impossible for the central government to improve a strictly credible no-bailout rule.

However, despite the inefficiency of fiscal policy at the local level, it can be seen that the currently implemented system of transfers, coordinated by central authorities, still plays an important role in order to share risk and avoid asymmetric shocks and defaults.

2.4: Would the fiscal union correctly operate?

In conclusion, it can be seen that introducing a fiscal union in the Euro area is a possible choice to fill most of the gaps currently experienced by communitarian and local economic policy. Actually, a centralized budgetary policy together with a federal public debt constitute the core for the deeper fiscal integration argued by Kenen. Moral hazard mostly disappear, forcing Member States to be fair and prudent in implementing local fiscal policies. This way, market inefficiencies can be reduced to minimum, limiting spillover effects and enhancing major coordination and the achievement of the economic convergence aimed by European authorities. Moreover, an efficient system of transfers integrated with a bailout institution is a suitable way to improve a crisis resolution mechanism, aiming to avoid a repeat of the current crisis.

However, it remains to be seen whether this is the optimal solution to ameliorate economic conditions in the Euro area or there are other more suitable ones, by taking on the balance all the pros and cons that such an arrangement involves. Moreover, it remains also to be seen whether citizens of the European Union would accept such a radical and innovative change in economics and politics. Indeed, the attested efficiency of the fiscal union does not necessarily imply a full acceptance, especially if there are still too high social and cultural barriers between Member States. Do the growing Eurosceptic movement, the dissatisfaction tied to the *austerity* policies and the credit crunch foresee that there are no place for further

communitarian economic improvements? Or rather the contrary, that the promise of a new economic federal policy may generate a change in citizens' vision, predicting the end of every hardship?

Chapter Three is going to deal with those arguments, by analysing the question of the fiscal union desirability, explaining whether it is really implementable in the Euro area in the next future years.

Chapter Three:

The desirability of a fiscal union

"It is neither populism nor shortsightedness that has led citizens to reject the policies that have been imposed on them. It is an understanding that these policies are deeply misguided. […] *An alternative set of well-discussed policies could work. Europe needs greater fiscal federalism, not just centralized oversight of national budgets. To be sure, Europe may not need the two-to-one ratio of federal to state spending found in the United States; but it clearly needs far more European-level expenditure, unlike the current miniscule EU budget, whittled down further by austerity advocates"*

- Joseph E. Stiglitz

In Chapter Two it has been possible to see that introducing a fiscal union in the Euro area is a suitable way to fill all the lacunas affecting current European economic policy. The combined presence of a common more articulated budget at the union level and a system of interregional transfers enhance the reach of the economic convergence promoted by the Maastricht Treaty, making asymmetric shocks less likely to hit national economies and negative spillover effects less widespread across the Euro area. In addition centralized borrowing allows to put a restraint on raising deficit and debt, avoiding heavy sovereign debt crisis and external imbalances, such as those happened to the PIIGS, by reducing also the risk of a speculative attack against their bonds. Finally, an improved ESM can always save countries in difficulties with bailout interventions even in very severe downturns.

However, it remains to be seen whether this is the most efficient solution among the proposed alternatives in Chapter One, by considering that a fiscal union does not imply only benefits, but also some disadvantages that may reduce its efficiency

in purchasing economic and financial support to Member States. Moreover, the proposed solution represents a radical change in the structure and in the institutions of the EMU: arrangements such as a centralized budgetary authority, a bailout institute to save countries in financial crisis and a central-raised borrowing are too distant from the models of economic policy currently adopted by the countries of the Euro area, and, especially, by the Eurozone itself at the Union level. Thus, the extreme novelty of improvements and the stronger intervention of the central level in economic matters rise a question of social nature: citizens would accept that not only monetary policy, but also fiscal policy would be entrusted to the European Union? Only with analysing these particular problems it could be said if, under an economic point of view, a fiscal union for the Euro area should be an acceptable and implementable solution.

Chapter three is going to discuss about these topics concerning the desirability of the fiscal union. Firstly it is going to take on the balance the problem of moral hazard, which is the greatest thorn in the side for any economic unified policy, secondly, it will consider the costs that Member States of Europe might bear for the implementation of the fiscal union, and thirdly, it will deal with constitutional and legal questions that may condition the decision of introducing a fiscal union in the Euro area.

3.1: The question of moral hazard

Moral hazard is seen by many economists as the most important and dangerous problem that can affect the institution of a fiscal union. The question of moral hazard has been already mentioned in discussing about the Stability and Growth pact, concerning that the excessive deficits accumulated by non-careful Member States (such as Italy and Greece) contributed to rise the social cost for the whole Union. The problem remains a pathology for the economic system even in the presence of a deeper fiscal integration, especially because, in absence of a truly effective coordination in fiscal disciplines, careful countries would bear the cost of sustaining non careful countries. Let us see now how moral hazard may incur in a monetary union within a fiscal union in relation to the system of international risk

sharing, the supranational borrowing on financial markets and the bailout institution proposed by the discussion.

3.1.1: Moral hazard and macroeconomic insurance

The question of moral hazard can be noticed in the fact that, according to the system of transfers aforementioned in Chapter Two, countries in surplus are required to help countries hit by asymmetric shocks, by financing their losses. Such a problem was evident even before the foundation of the current Economic and Monetary Union and it was the main reason for the abandonment of every policy of fiscal integration in the past years. Back in 1998, Roel Beetsma and Arij Lans Bovenberg[56] explained in their work paper "*The optimality of a monetary union without fiscal union*" that a monetary union within a fiscal union could not correctly work because of the risk that Member States do not pursue prudent budgetary policies. They consider a fiscal union as a union based only on a system of international transfers (but with no common budgetary policy), similar to the model explained in Chapter Two, that ensures a full insurance against country-specific shocks. In their vision, this is not an efficient solution for two reasons: firstly because "*country specific shocks are not perfectly observable*" and secondly because such a system "*rewards governments for less fiscal discipline*"[57].

The first limit to the macroeconomic insurance is evident: the value of the shocks is determined by improving an econometric estimation based on a double logarithmic regression model, which is subjected to calculation errors. Such errors may occur in undervaluing or overvaluing the entity of the shock, and as far as the estimation is not precise there will be major errors also in calculation of transfers to provide (supposing that the estimated shock is negative). This way, hit countries may receive an amount of transfers major or minor than what they need: in the first case they are prompted to apply less fiscal discipline by increasing public expenditures, in the second case there is the risk that negative shock would be not fully absorbed.

---

[56] Professors respectively at the University of Amsterdam and at the Tilburg University.
[57] Beetsma, R. and Bovensberg, A. L. *op. cit.*

Moreover, benefits descending from macroeconomic insurance depend on the size of the shocks: major is their dimension, major would be the revenues obtained by international risk sharing system. Indeed, small country-specific shocks, which involve only a small quantity of economic aids from the central macroeconomic insurance, may not be economically convenient to be smoothed because implementation costs of the transfer could be major than the amount of received revenues. In this case, there would be a net loss at the Union level that supranational authority would decide to not improve any transfer. Thus, in order to avoid this inconvenience, the country at risk would have an incentive to distort the real entity of the shock in order to make it appear more harmful and significant with the purpose to even receive an amount of transfers from the Union's *rainy day fund*.

In addition, according to Beetsma and Bovenberg, the presence of an international system of transfers can prompt national governments to improve insufficiently prudent fiscal policy "*as some of the costs of lack of discipline can be shifted to the other members of the union*"[58]. As far as the macroeconomic insurance is supported by the joint financial effort of every Member State, a single country would bear a smaller loss in terms of decreasing output and increasing national deficit when hit by an asymmetric shock. Consequently, risk sharing produces a distortive effect over national budgetary policies in the way that the government is tempted to correct public expenditures upward, shifting the cost of this imprudent fiscal discipline to the other Member States. Thus, there is a loss in terms of social welfare that enlightens a trade-off between fiscal discipline and risk sharing: in order to protect prudent fiscal discipline it is necessary to improve a mechanism that is not able to ensure full insurance, this way, a part of the shock would always be borne by the single country, which has now interest to apply a more careful fiscal discipline, and not only by the Union as a whole.

This is the main reason why the German governments is unlike to improve such a system inside the EMU: a country like Germany, which attains continuously budgetary surpluses, would be forced to pay for PIIGS' deficits, giving them a motivation to not align their fiscal discipline to the one stated by the Stability and

[58] Beetsma, R. and Bovensberg, A. L. *op. cit.*

Growth Pact. In the same situation would find all the small northern countries, such as Netherlands and Belgium, which would see their surpluses reducing in the eventuality of cheats from countries in deficit. Consequently, such a moral hazard would break the EMU in two parts: countries in surpluses on the one side, countries in deficit to help continuously on the other side. Thus, according to Beetsma and Bovenberg, such a union would not survive over time.

3.1.2: Moral hazard due to supranational borrowing

Similar considerations may be carried on about the *Eurobonds*, by considering that fiscal and financial integrations are strictly correlate. The system of central level borrowing seen in Chapter Two (taking on the balance all of the three characterizations it can assume) may be bearer of moral hazard in an equal way than the system of supranational risk sharing. Daniel Gros[59] (2011) argues that issuing a joint-guaranteed debt instrument on financial markets would be not attractive neither for investors nor for debtors; the reasons are several: political distortions, lack of commitment in budgetary policy and still a too high interest rate required on markets.

For what concerns political distortions, investors noticed that, in the immediately past years, "*many arrangements to deal with the Eurozone debt crisis have been overturned by politicians*"[60]. Acting in this way, politicians have been able to find a more widespread political consensus by enhancing or devaluating measures improved to face the Great Contraction. Consequently, the proposal of *Eurobonds* may also become a political vehicle in order to conquer citizens' approval and, unfortunately, such a political speculation would represent a bet over European Union's future economic policy. Thus, financial markets "*may not fully trust the joint and several guarantee*"[61] of the Eurozone debt because of the fear that these distortions can persist over time generating doubts about the real existence of this guarantee.

[59] Director of the Centre for European Policy Studies (CEPS).
[60] Gros, D. "*Eurobonds: wrong solution for legal, political and economic reasons*" in www.voxeu.org, 2011.
[61] Gros, D. *op. cit.*

Furthermore, the presence of a joint-guaranteed debt instrument can prompt, as in the case of supranational risk sharing, a serious lack in national budgetary policy. Let us consider for a while the present situation in which every country issues its own public debt bonds. For example, "*if investors believe that Italy is fundamentally solvent they will buy Italian government bonds at an interest rate of below, say, 5%. In this case debt service will be bearable. […] But if many investors have doubts about the solvency of the country, interest rates will shoot up. […] The economy will then tank, reducing government revenues at exactly the time the government faces higher debt service costs*"[62]. Thus, in such a situation, a country would incur in many disadvantages if keeps borrowing, so it would be prompted to contain both deficit and debt stock, in order to restore its previous creditworthiness at investors' eyes. With a joint guaranteed bond a country would be, instead, enhanced to borrow more than the necessary, applying a non-careful discipline in budgetary policy, with the myopic conviction that the economic burden and the responsibility of the debt is mutually borne by all the Member States and, thus, less significant at the national level. Therefore, even in this case, there would be a shift of the costs of the excessive borrowing from non-careful countries to prudent countries, by increasing the nominal interest rate of the bonds.

Indeed, *Eurobonds* present also another important problem: the question of interest rates paid by Member States over the borrowed stock of debt. At the present time, spread between German rate and other European countries' rates underline the difference in creditworthiness among the different Member States: titles with a yield to maturity more similar to the German one have a superior quality. However, according to Gros, the presence of one single debt instrument on financial market, which represent the debt of the whole EMU, means that there would be a single rate paid by all the countries. The single rate of the *Eurobonds* would be equal to "*the weighted average of the yield on outstanding debt in the Eurozone*"[63]. This implies that countries like Italy would take advantage, by paying an inferior interest rate

[62] Gros, D. *op. cit.*
[63] Gros, D. *op. cit.*

than the actual one, but countries like Germany would be penalized to pay a higher interest rate than the normal.

However, according to Yanis Varoufakias[64] (2011), a strong reduction of moral hazard can be achieved by entrusting the issue of *Eurobonds* to an independent European institute (as it has been proposed in Chapter Two) and by the exclusion of Germany from the joint guarantee of the instruments. This point of view has nevertheless a fundamental weakness: the issuance of such an instrument cannot be entrusted to a European institution (such as the EIB or the Commission, as proposed in Chapter Two) and at the same time exclude a Member State from its participation, because it would create a conflict of interest situation. Actually, each institution of the Union is founded with the participation of every Member State, therefore, in this case there would be an entity with German participation able to determine part of the economic policy of the rest of European countries. Thus, such a solution would have a lack of acceptance.

3.1.3: Moral hazard with a bailout institution

Even the strengthening of the European Stability Mechanism, with the purpose to transform it into a true bailout institute, finds a strong opposition due to risk of moral hazard. The motivations still remain the same: the encouraging of undertaking imprudent fiscal policies and the shift of costs from Southern to Northern Europe.

As a matter of fact, the ESM found a large opposition among Northern Europe's countries, especially in Germany, already at the moment of its establishment, back in 2012. Indeed, German party *Mehr Demokratie* prosecuted a lawsuit to the Federal Constitutional Court against German ratification of the treaty establishing the ESM; it was strong of about 37 thousand citizens' consensus plus the support of other political representatives of the Reichstag and a part of German economists, first of all Hans Werner Sinn[65]. Sinn (2013) advocates that the no bailout clause was the strict "*Germany's condition for giving up the Deutschmark*", thus,

[64] Professor at the University of Athens.
[65] President of the IFO of Munich.

improving an institute able to save non prudent countries is a reasonable motivation for the *Bundesbank* to abandon all the OMT program[66] carried on by the ECB, to declare the ESM foundation treaty not compliant to German constitution and then to press European Court of Justice with the purpose to withdraw it.

However, in March 2014 Constitutional Court of Karlsruhe rejected the prosecution, declaring that ESM was perfectly compliant with German legislative system, although a power of veto is assigned to German Parliament over decisions implying the assignment of facilities from the ESM to Member States in difficulty.

3.1.4: Some conclusions about the question of moral hazard

To sum up, it is necessary to bring on the balance some considerations. The problems of moral hazard exposed in this paragraph came out because none of the aforementioned arguments considered the contextual presence of a European budget as it has been done in Chapter Two. Beetsma and Bovenberg expressly assumed a fiscal union only as a source of macroeconomic risk sharing with no other political implications. Moreover, Gros sees *Eurobonds* as instruments for which the joint guarantee covers the individual stocks of debt that each member state raised autonomously, but it is not aimed at a unified Euro area debt arose from a common budgetary policy.

The importance of the common budget in order to fight against moral hazard is very high. According to Montani (2012), a common budgetary policy, which is able to reduce the national expenditure level, by reinforcing the union expenditure level, and to raise a centralized debt and a common taxation, by entrusting these powers to a central authority, as it has been shown in Chapter Two, is even able to smooth moral hazard in a suitable way to make instruments of common fiscal policy perfectly functioning. A fiscal union with no common budgetary policy is what Montani says a "*phoney fiscal union*".

[66] Operations that allow ECB to buy, on the secondary market the government bonds of troubled Eurozone countries that subject themselves to the ESM's conditions. Also these operations are currently under process at the German Federal Constitutional Court to test their compliance to German law.

However, according to Beetsma and Bovenberg, a centralized budgetary policy is not a simple process of coordination and harmonization of different policies like one currently undertaken by the EMU; it represents, instead, a deep change very difficult to accept because it would be a too big step in political sense for Member States of EMU. Thus, in their vision, a common budgetary policy would be not a useful instrument to solve questions of moral hazard in a fiscal union.

3.2: The costs descending from the implementation of a fiscal union

In order to analyse the economic convenience of introducing a fiscal union in the Euro area, it is necessary to analyse also the question of costs. Actually, as well as the scheme of economic policy described in Chapter Two is able to bring several benefits to the whole Eurozone, it must be remembered that, by contrast, the implementation and the maintenance of such arrangements require a certain level of economical efforts, which may have very different nature. In this paragraph we are going to see where this costs do come from.

Implementation costs refer to all those expenses that Member States must jointly bear during the phases of development and activation of common economic policy to make the fiscal union effectively functioning. Maintenance costs, instead, refer to all those expenses that occur during the continuous operation of the institutions and mechanisms deputies to achieve the objectives of common fiscal policy, even during periods in which these mechanisms do not have any task to be performed: for example, during periods of general economic growth and social welfare, international transfers must not to be granted, but the *rainy day fund* and the bailout institute keep on working, because they are not occasional but permanent arrangements.

Moreover, implementation costs contain what Celine Allard and her team at the IMF call political costs. This part of total expenditure refers to the loss of national sovereignty over fiscal policy and to the transfer process, in a legislative point of view, of the fiscal policy authority from national to supranational level. The extreme relevance and novelty of a solution like a fiscal union require an extensive public debate at both national and international level, especially about questions

like feasibility and general acceptance. In order to have appropriate degree of debate it is necessary collect and develop a great number of information and analysis, which involve several transactional and research costs. Political costs concern not only necessary expenses in order to improve national and international debate, but also all these expenses tied to the legislative modifications to be produced in both European and national legislation (see *infra* paragraph 3.3.2). Indeed, the great relevance of the new proposed arrangements would require a long legislative proceeding, especially in transposition of the new institutions inside the national legal frameworks: it must be remembered that despite Maastricht Treaty has been signed in 1992, the monetary union became effective only in 1999.

Their sum gives the total financial effort necessary to improve a fiscal union. In order its creation may be convenient, the sum should be minor than the total economic benefits received by the Euro area as a whole from the presence of the fiscal union, enhanced previously in Chapter Two. The reason is clearly evident: if costs are major than the benefits none of Member States of EMU would accept to join together in a fiscal union because there is no economic and social gain in improving it. Furthermore, implementation and maintenance costs should also be lower than the economic and financial burdens eventually borne by countries if hit by a shock, in a situation where there is no shock-absorbing mechanism (as it currently happens inside the Euro area). Even in this case there is a clear rationale. The costs of a shock are represented not only by a loss in terms of output and increased unemployment, but also by the expenses sustained in order to activate *ex post* measures. If amount of ex post effort is lower than the costs for implementing *ex ante* shock-absorbers, the Union would have no economic benefit from introducing a fiscal union.

To conclude, let us consider U^{MU} and U^{FU} as the social utility of the whole Euro area in the case it is only a monetary union and in the case it is a fiscal union within

a monetary union. According to Guiso, Herrera and Morelli[67], it would be economically convenient for the EMU improve a fiscal union only if:

$$U^{FU} - U^{MU} > C$$

Where C represents the sum of all the costs considered in this paragraph. Thus if difference in social utility is major than the total expenditure necessary to improve a fiscal union, this latter solution is able to produce in the Member States of EMU the benefits described in Chapter Two.

3.3: Social, legal and political implications

As it has been stated at the beginning of this chapter, the introduction of a fiscal union in the Euro area has significant implications for social, political, and legal affairs both at national and international level. Actually, in order to be generally accepted by the citizens of each country, it is necessary that Member States of EMU compromise one to each other: they should relinquish their "national pride" over economic policy with the aim to have a well-functioning form of supranational economic administration, that is to say, able to be Pareto-efficient for the whole Union. The task of the exposition is now to go to deal with this specific issue, going to see if social and political questions, which may arise with a possible fiscal unification, could go to be honed.

3.3.1: A "*cultural clash*"

European fiscal and monetary union can be seen as a mild form of political and social integration in open comparison to the stronger bond existing between the United States of America. Indeed, USs share not only the same political and legislative *corpus*, but also the same culture descending from both the Anglo-Saxon and Hispanic traditions; therefore, it is less difficult for them to be joint in the same federal economic union. The proposed European monetary and fiscal union is different from the American model, because it is not going to undermine the cultural differences that exist among populations of each Member State, nor even to go to

[67] Luigi Guiso is Professor at the Einaudi Institute for Economics and Finance in Florence, Helios Herrera is Professor at the HEC of Montreal, Massimo Morelli is Professor at the Columbia University of New York.

cancel the historical and political heritage of each nation. However, the extreme novelty and complexity of proposed institutions deputy to ensure the financial stability at supranational level may bring a lack of acceptance, due to what Professors Guiso, Herrera and Morelli call a "*cultural clash*".

In their paper "*A culture based theory of fiscal union desirability*" (2013), Guiso, Herrera and Morelli remark that even small differences in cultures of two distinct countries (*e. g*. Germany and Greece) may prejudice their participation in a monetary union within a fiscal union, realizing, this way, the cultural clash. In their advice, such a problem manifested even at the moment of the birth of the monetary union back in 1992, but became more relevant at the breakout of the Euro crisis in 2010. When it has been discovered that Greece cheated on the real conditions of its budget, contrasts occurred between Greek government and other Member States' governments, especially with the German one.

As a result of Greek imbroglio in budgetary policy, the largest part of German people sided in favour of pursuing a punishing policy against the "sinner" country. Guiso, Herrera and Morelli advocate that in 2010, according to the polls, 67% of Germans were contrary to purchase any kind of economic help to Greece. This sentiment against Greece's cheating has persisted over time, particularly, in 2011, when the decision of giving a second aid to Greece was being discussed, the polls reported that about 60% of German people were unfavourable and 80% of German people were condescending to a possible exit of Greece from the EMU if the government did not accomplish to the program of economic recovery imposed by the Union. Afterwards, the percentage of Germans with an unfavourable opinion about Greek bailout increased up to 79% in 2012. Apparently it seems to be a profound anti-Greek sentiment in Germany, however further poll-based analysis refute this idea. Among German citizens, in 2012, the part of people who believe that Greece could come out from crisis, by following rigorously the imposed recovery plan, is larger than the part believing that Italy would equally be able to (11% for the Greece and 8% for Italy). This fact shows clearly that the will of punishing Greece at all costs does not come out from a general sentiment of dislike toward the small Mediterranean country. By contrast, 18% of Greek people fully

trust in Germany, in relation to the way with which the Teutonic country is currently managing the crisis at the European level, believing that the recovery plan imposed on them is really useful to restore economic order in the country and in the whole continent[68].

Now the question is: where does the German desire to punish Greece unconditionally come from? Guiso, Herrera and Morelli give the following interpretation: Germany is a country with a secular Protestant tradition, according to which if a person commits a sin he or she "*will never be forgiven for his sins, nor will people grant forgiveness to the sinners*"[69]; thus, if a country does not accomplish to EU legislation, it is natural to impose a sanction over it in order to make it repay the other Member States for its cheating, whatever the "sinner" country may be. By contrast, an Orthodoxy-based culture, as the Greek one, has a warmer regard toward sinners by allowing them the access to Heaven even for those who have not repent. This story goes further the current discussion about the convenience of introducing a fiscal union in the EMU, but it depicts a perfect example of cultural clash, as presented by Professors Guiso, Herrera and Morelli, "*as it provides a rationale for why the Germans feel obliged to punish the Greeks and why Greeks cheated on the budget*"[70] and an explication to how two countries with different cultures may find some difficulties to participate in the same fiscal union.

Nevertheless, according to Guiso, Herrera and Morelli, a fiscal union could be not considered as a further source of cultural clash, having, thus, a negative impact on relations between participating countries, but it can perform a positive role of cohesion form of cultures though different but with the same roots. A fiscal union, indeed would allow "*to replace multiple authorities subject to cultural clash with a unique new authority, hence facilitating convergence, commitment and*

[68] All the data exposed in the discussion are from: Guiso, L., Herrera, H. and Morelli, M. "*A culture based theory of fiscal union desirability*", Tables 2, 3 and 4.
[69] Guiso, L., Herrera, H. and Morelli, M. *op. cit.*
[70] Guiso, L., Herrera, H. and Morelli, M. *op. cit.*

enforcement"[71]. However, the fiscal unification step is as greater as higher is the degree of cultural heterogeneity of Member States.

3.3.2: Some legal considerations

In going into the explanation of how it is possible to introduce a fiscal union in the Euro area there must be considered also some issues of legal nature. Actually, the realization of a deeper fiscal integration involves a legislative proceeding nature, because the new institutions and mechanisms that it introduces require a very important modification in the set of rules at both international and national level. The discussion is now going to give a brief *excursus* about some of the possible changes that may occur in the European legislative corpus with the eventual introduction of a fiscal union in the EMU. Aspects concerning changes in national legislation will be left apart, the reason stands in the fact that every Member State has its own set of rules and its own transposition procedure, so it is impossible going to examine every legislative implication that incurs in all the eighteen countries that compose the Euro area.

According to Celine Allard and her team at IMF (2013), "*while the EU legal framework allows for key elements of a fiscal union, the TFEU*[72] *does not envisage common elements of fiscal policy specifically at the Euro area level*"[73]. Secondary legislation, actually, purposes a control in fiscal policy, though at national level, via the SGP and the small EU budget integrated with a system for the redistribution and allocation of resources (elements that has been already mentioned in the previous chapters). However, in order to have a truly functioning fiscal union a more radical change in the primary European legislation is needed.

A fundamental question is represented by the fact that the TFEU does not recognize the Euro area as a separate entity from the larger European Union. This lack of personality of the EMU would create not a few problems in the process of fiscal unification, especially with regard to the governance of the newly introduced institutions. A similar problem occurred at the moment of creation of the currency

---

[71] Guiso, L., Herrera, H. and Morelli, M. *op. cit.*
[72] Treaty on the Functioning of the European Union.
[73] Allard, C. and others *op. cit.*

union, actually, the ESCB[74], which is composed by the ECB and the national Central Banks of Member States of EU, has been created to be the deputy authority to control the monetary policy in the Euro, but the lack of participation of every European Union's country to the Euro does not allow it to well-perform this fundamental function. Indeed, back in 1992, there was the optimistic believing that every country that signed Maastricht Treaty would have participated to the Euro; nevertheless, this is not what really happened, thus, nowadays it is necessary to distinguish between the ESCB and the Eurosystem[75] (the true monetary policy maker inside the EMU), which is characterized by the lack of personality and, thus, which makes the legislative and governmental process at the Union level more difficult to carry on. Such a problem would appear in the process of strengthening of the European budget. Actually, the EU budget contains fund raised all over the Union, even among countries that are not part of the EMU, thus, these countries would not approve to use their funds for a budget that exercise a redistributive function only toward countries of the Eurozone. According to Allard, these problem could be solved as it has been done with the Eurosystem, that is to say, by distinguishing the EU budget from an autonomous EMU budget, establishing it as a part of the former one. This could be an efficient idea for avoiding the direct modification of primary legislation (that require a more complex proceeding) by enshrining the "creation" of the currency union budget in the secondary legislation. However, this would be a momentary solution waiting for a true and permanent change in the TFEU, probably in the eventuality that all the European Union's countries would join the currency, and then fiscal, union.

Another question refers to the *rainy day fund* that would bring the macroeconomic insurance to Member States of EMU. Allard suggests that, through secondary legislation, it could be possible to create an apposite authority with the power of manage the fund or, alternatively, the same fund can be instituted by an intergovernmental treaty, outside the EU framework, as it has been done with the *Fiscal Compact*. The latter solution is less onerous to improve for two reasons:

---

[74] European System of Central Banks.

[75] Contrary to the ESCB, the Eurosystem is composed by the European Central Bank and the national Central Banks only of those countries that have joined the Euro area.

firstly, Member States have not to bear financial costs for the institution and the functioning of any authority, and secondly, there is a lower need to separate the EMU budget from the EU budget in order to apply the redistributive function, that would be earned in the largest part by the fund. However, the envisaged solution involves also some disadvantages: the autonomy of EMU budgetary policy cannot be avoided because a Euro area budget does not only perform the redistributive function (*supra* Chapter Two) and, moreover, an intergovernmental act might be seen by extra-Euro countries as a political move reduce their decisional power in supranational affairs, purposing the complete emancipation of the Eurozone.

The last question to analyse is the possibility for the Union to pose a *veto* over national budgetary policy if not compliant to the EU legislation. In Chapter Two it has been explained that the supranational control of national budgets has a primary importance in order to have a truly integrated fiscal policy, thus, the Commission or even the Parliament must be able to exercise this kind of control. Such a power, though in a milder way, has been already envisaged for the Commission by the *Twopack* (*supra* Chapter One); however, according to a large part of the fiscal union literature, such a power might be entrusted to the Parliament in compliance to the ancient motto "no taxation without representation" (*supra* Chapter One). In Allard's view, such a proceeding would require also radical changes in constitutions and other forms of primary legislation of each Member State of EMU.

3.3.3: For a sustainable political development

In 2012, Herman Van Rompuy[76], in close collaboration with Jose Manuel Barroso[77], Jean-Claude Juncker[78] and Mario Draghi[79], submitted a paper named "*Towards a genuine economic and monetary union*" in which have been laid down "*the actions required to ensure the stability and integrity of the EMU*" with the purpose to call Member States and European institutions for "*a political commitment to implement the proposed roadmap*"[80]. The roadmap plotted by Van

[76] Current President of the European Council.
[77] Current President of the European Commission.
[78] Former President of the Eurogroup.
[79] Current President of the European Central Bank.
[80] Van Rompuy, H. *op. cit.*

Rompuy towards an efficient currency union is composed by three stages (which two of them are currently being implemented), whom the last one aims to create a shock-absorption mechanism of fiscal nature at the Union level. The proceeding envisaged by the President of the Council is very close to the one seen in our discussion in Chapter Two: economic stability should be achieved with integrated budgetary and fiscal frameworks at international level with the aid of a single crisis resolution mechanism that would be able to bail out countries in financial troubles. In Van Rompuy's vision, the works for the effective realization of the shock-absorption mechanism should start in 2014, possibly after the European elections, lasting until the effective achievement of a source of macroeconomic risk sharing.

Moreover, in the final part of the exposition President Van Rompuy calls on the institutions of the European Union and its Member States requiring their commitment to foster the democratic proceeding for "*ensuring the effectiveness of the integrated financial, budgetary and economic policy frameworks*". He suggests that the effort for a further fiscal integration must have place both at national and international level with the joint participation of the European Parliament and local governments. "*Decisions on national budgets are at the heart of Member States' parliamentary democracies. At the same time, the provisions for democratic legitimacy and accountability should ensure that the common interest of the union is duly taken into account; yet national parliaments are not in the best position to take it into account fully. This implies that further integration of policy making and a greater pooling of competences at the European level should first and foremost be accompanied with a commensurate involvement of the European Parliament in the integrated frameworks for a genuine EMU*"[81].

Following Van Rompuy's advice, the joint effort must focus on three fundamental principles: more responsibility, more commitment and more democratic legitimacy. An increased responsibility means that both national and international institutions have to foster the circulation of information across the union and increase the transparency in their political acting. A major commitment means that "*Member States should ensure the appropriate involvement of their national Parliaments in*

[81] Van Rompuy, H. *op. cit.*

the proposed reform arrangements", sharing an appropriate sense of purpose and a high degree of social cohesion. Finally, an increased democratic legitimacy purposes to avoid that the proposed reforms come to life with intergovernmental arrangements, such as the Fiscal Compact, but, instead, they are the result of a democratic process interior to the national and European institutions; actually, there is the need that reforms are fully integrated in the European legislative corpus in such a way that they shall be immediately well-functioning.

To conclude, it can be said that, in Van Rompuy's vision, the creation of an effective system of fiscal transfers is not only a possible target to achieve in the very next years, but it is also a crucial step in order to have a "*genuine Economic and Monetary Union*"[82]. This way, its effective realizing require a political involvement both at international and national level greater than that used in responding to the crisis in the immediately past years.

[82] Van Rompuy, H. *op. cit.*

Conclusions:

A possible vision for the future

As it has been possible to see in the discussion, the realization of a fiscal union for the Eurozone is a solution that may really be taken in consideration in order to restore and maintain a more persistent economic equilibrium. A fiscal union, indeed, allows to Member States of the European Economic and Monetary Union to take advantage of the benefits descending by their participation to a currency union, perfectly in accordance to what is stated by the OCA theory. Actually, in full compliance to what has been stated by Kenen, the role of fiscal policy of absorbing asymmetric shocks and compensating differences among countries would be perfectly fulfilled. Firstly, fiscal unification ensures the financial and economic stability for all the member countries, that is to say it ensures the capacity to get out of recessions, to maintain a certain degree of creditworthiness and to grow economically over time (in terms of aggregate output and lower unemployment). Moreover, it is necessary to consider that a fiscal union allows the Union to achieve more efficiently the economic convergence enhanced by the Maastricht Treaty. Thus, the imperfections of a self-imposed budgetary constraint (such as that stated by the SGP, signed by every Member State) are overcome by the common budgetary policy promoted by the fiscal unification. Actually, common taxation and common expenditures may bring all the countries of EMU towards a unique model of fiscal management even at the national level. In addition, there would be further benefits in increasing output and international trade.

Joseph Stiglitz (2014)[83] concluded his intervention "*Can the Euro be saved?*" at LUISS University[84] by arguing that the Eurozone needs a deep change in its structure, by the joint introduction of a common fiscal framework and a mutualization of debt. In Stiglitz's advice, such policies would be able to bring

[83] Professor at the Columbia University and Nobel Prize for the Economics in 2001.
[84] Speech held the 6th of May 2014 during the "*XIV lezione Angelo Costa*" at LUISS Guido Carli University of Rome.

Europe out from the Great Contraction, to prompt the harmonization of economic policies across the EMU and to enhance the industrial production and productivity, by removing also the tax competition among countries. Therefore, under these points of view, it is reasonable believing that introducing a fiscal union in the Euro area could be an efficient way to solve the problems and questions currently affecting economic policy in the Old Continent's monetary Union.

For what concerns the disadvantages, it must be noticed that only the question of moral hazard represents the very harmful problem in a fiscal union within a monetary union, especially with a regard to the macroeconomic insurance. Yet, as it has been possible to see in Chapter Three, the presence of a common strong budget and a supranational borrowing could be useful instrument to reduce moral hazard. However, Farhi and Werning (2013) recommend that studies about moral hazard are not adequately detailed at the present time, thus it is necessary to improve them before giving a fully reliable judgment about the extent of the problem. In their advice the analysis of feasibility of a fiscal union should also include problems descending from liquidity and solvency risks both in banks and sovereigns.

Apart from the economic issues, the root of the problem concerning to the feasibility of a fiscal union still lies in political debate. Actually, as a result of the European elections in 2014, the Eurosceptic movement seems to have gained a larger consensus in comparison to the past years, maybe reflecting a shift in citizens' view, from optimistic to pessimistic expectations. It must been noticed that the last recession, which seems to continue over time especially in Southern countries, keeps weakening the idea of having a more integrated Europe. Indeed, as a result of the failure of Euro and the common monetary policy (as Professor Stiglitz advocates) citizens could induce governments, at both national and international level, to stop further common economic policies, laying, thus, a more and more insurmountable obstacle to the effective realization of a European Fiscal Union.

However, it must be remembered that the seed for the current European Union has been placed in a very controversial historic conjuncture, in which it would have seemed impossible that France and Germany could participate to the same political and economic union. Yet in 1941, the "*Manifesto of Ventotene*", written by Altiero

Spinelli and Ernesto Rossi, envisaged the creation of a United Europe, whom aim was to create a supranational authority able to ensure economic and political stability across the Europe. "*The question which must be resolved first failing which progress is but mere appearance, is definitive abolition of division of Europe into national, sovereign States. [...]The general spirit today is already far more disposed than it was in the past towards a federal reorganisation of Europe*"[85] are the words of the *Manifesto*. Therefore, if during the last war it was thought to solve political problems with a deeper political integration, at the present time it is not impossible believing to solve economic troubles across Europe with a deeper and well-functioning economic integration. Thus in the end of our discussion, it can be said that introducing a fiscal union in the Euro area is a possible vision for the future.

[85] Spinelli, A., Rossi, E. "*Manifesto of Ventotene*", 1941, translation by Urgesi, E.

Bibliography

Allard, C. and others (2013) “*Towards a fiscal union for the Euro area*”, IMF staff discussion note.

Beetsma, R. and Bovenberg, A. L. (1998) “*The optimality of a monetary union without a fiscal union*” in “*Journal of money, credit and banking*”, Vol. 33, No. 2, pages 179-201.

Beetsma, R. and Gradus, R. (2012) “*A discussion of changes in Europe’s macro-fiscal framework in response to the crisis*” in “*CESifo forum*”, Vol. 13, No. 1, pages 17-23.

Bordo, M. D. (2013) “*A fiscal union for the Euro: some lessons from history*” in “*CESifo Economic studies*”, Vol. 59, pages 449-488.

Farhi, E. and Werning, I. (2013) “*Fiscal Unions*”.

Favero, C. and Missale, A. (2010) “*EU public debt management and Eurobonds*”, a working paper for the European Parliament's Committee on Economic and Monetary Affairs.

Friedman, M. (1997) “*The Euro: monetary unity to political disunity?*”, published in Project Syndicate.

Fuest, C. and Peichl, A. (2012) “*European Fiscal Union: what is it? Does it work? And are there really no alternatives?*” in “*CESifo forum*”, Vol. 13, No. 1, pages 3-9.

Furceri,D. and Zdzienicka, A. (2013) “*The euro area crisis:need for a supranational fiscal risk sharing mechanism?*”, IMF working paper.

Gros, D. (2011) “*Eurobonds: wrong solution for legal, political and economic reasons*”, published in www.voxeu.org.

Guiso, L., Herrera, H. and Morelli, M. (2013) “*A culture based theory of fiscal union desirability*” in the University of Warwick working paper series.

Majocchi, A. (2011) “*Towards a European Federal Fiscal Uion*” in “*Perspectives on federalism*”, Vol. 3, issue 1, pages 78-98.

Montani, G. (2005) “*The role of the European budget in European economic policy*” in “*The Federalist*”, Vol. 47, No. 3, pages 144-177.

Montani, G. (2012) “*No to a phoney fiscal union*” published in www.euractiv.fr.

Sapir, J. (2013) “*Dissoudre l’Euro: une idée qui s’imposera*”, published in www.russeurope.hypotheses.org.

Schelkle, W. (2012) “*European fiscal union: from monetary back door to parliamentary main entrance*” in “*CESifo forum*”, Vol. 13, No. 1, pages 29-34.

Sinn, H. W. (2013) “*Germany’s case against the ECB*” published in Project Syndicate.

Spinelli, A., Rossi, E. (1941) “*Manifesto of Ventotene*”, translation by Urgesi, E.

Stiglitz, (2014) “*Can the Euro be saved*”, speech held at the LUISS University during the “*XIV lezione Angelo Costa*”.

Van Rompuy, H. in close collaboration with Barroso, J. M., Juncker, J. C. and Draghi, M. (2012) “*Towards a genuine economic and monetary union*”, report of the European Council.

Varoufakis, Y. (2011) “*Why Eurobonds are essential and fiscal union a folly*”, published in www.yanisvaroufakis.eu.

Verde, A. (2012) “*Unione monetaria e nuova governance europea*”, Carocci Editore.

Sources of images and tables

Figure 1.1 is from www.rincondelvago.com.

Figure 2.1 is from Allard, C. and others (2013) "*Towards a fiscal union for the Euro area*" IMF staff discussion note.

Figure 2.2 is from Favero, C. and Missale, A. (2010) "*EU public debt management and Eurobonds*" for the European Parliament's Committee on Economic and Monetary Affairs.

Figure 2.3 is from Allard, C. and others (2013) "*Towards a fiscal union for the Euro area*" IMF staff discussion note.

Table 2.1 and Table 2.2 are from Furceri,D. and Zdzienicka, A. (2013) "*The euro area crisis:need for a supranational fiscal risk sharing mechanism?*", IMF working paper.