Center for Social and Economic Research

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Fiscal or Bailout Union: Where Is the EU/EMU's Fiscal Integration Heading?

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Key issues to be discussed

- Various meanings of fiscal union
- Interrelations between monetary union and fiscal union
- Arguments in favor and against fiscal integration
- The size of EU budget and its revenue sources
- Fiscal discipline vs. bail out
- Conclusions related to fiscal integration within the EU and EMU

Various meanings of fiscal union

- No single definition of fiscal union
- Various practical meanings in the context of EU debate:
  - Centralization of fiscal resources on a supranational level
  - Supranational income sources (taxes)
  - Harmonization of taxation/ entitlements
  - The single mechanism of fiscal discipline on national level
  - Fiscal solidarity in time of distress/ bailout/ debt mutualization
  - Building institutions with fiscal authority on a supranational level (some symbolic proposals like creating EU's MoF)

Interrelations between monetary and fiscal union

- Both advocates and opponents of the Euro project claim it must be accompanied by a fiscal and political union
- However, this is not obvious on both theoretical and empirical ground
- The OCA theory may be interpreted in two ways: (i) cross-country transfers are needed to cushion consequences of asymmetric shocks or (ii) substantial national fiscal capacity and buffers should be retained to respond to such shocks (in the absence of monetary accommodation)
- Historical and contemporary examples of monetary unions without fiscal and political union: gold standard, WAEMU, CAEMC, unilateral dollarization/ euroization, currency boards
- Frequent comparison of the EU/EMU with the US disregards historical evolution of the latter and all characteristics of US fiscal federalism

Examples of one-side statements on Eurozone

- "*The euro area is the first case in the history of monetary unions where monetary policy-making is centralized under one central bank while fiscal policy-making is decentralized in the hands of the national governments of the member states. This institutional framework is new for economists and policy-makers alike.*" (Bordo, M.D., Markiewicz, A., Jonung L. (2011): *A Fiscal Union for the Euro: Some Lessons from History*, NBER Working Paper, No. 17380)
- "*The EMU is unique among modern monetary unions in that it combines a centralised monetary policy with decentralised responsibility for most economic policies, albeit subject to constraints as regards national budgetary policies. Unlike other monetary unions, there is no centralised fiscal policy function and no centralised fiscal capacity (federal budget)*" (European Commission (2012): *A Blueprint for a Deep and Genuine EMU. Launching a European debate*, Communication from the EC

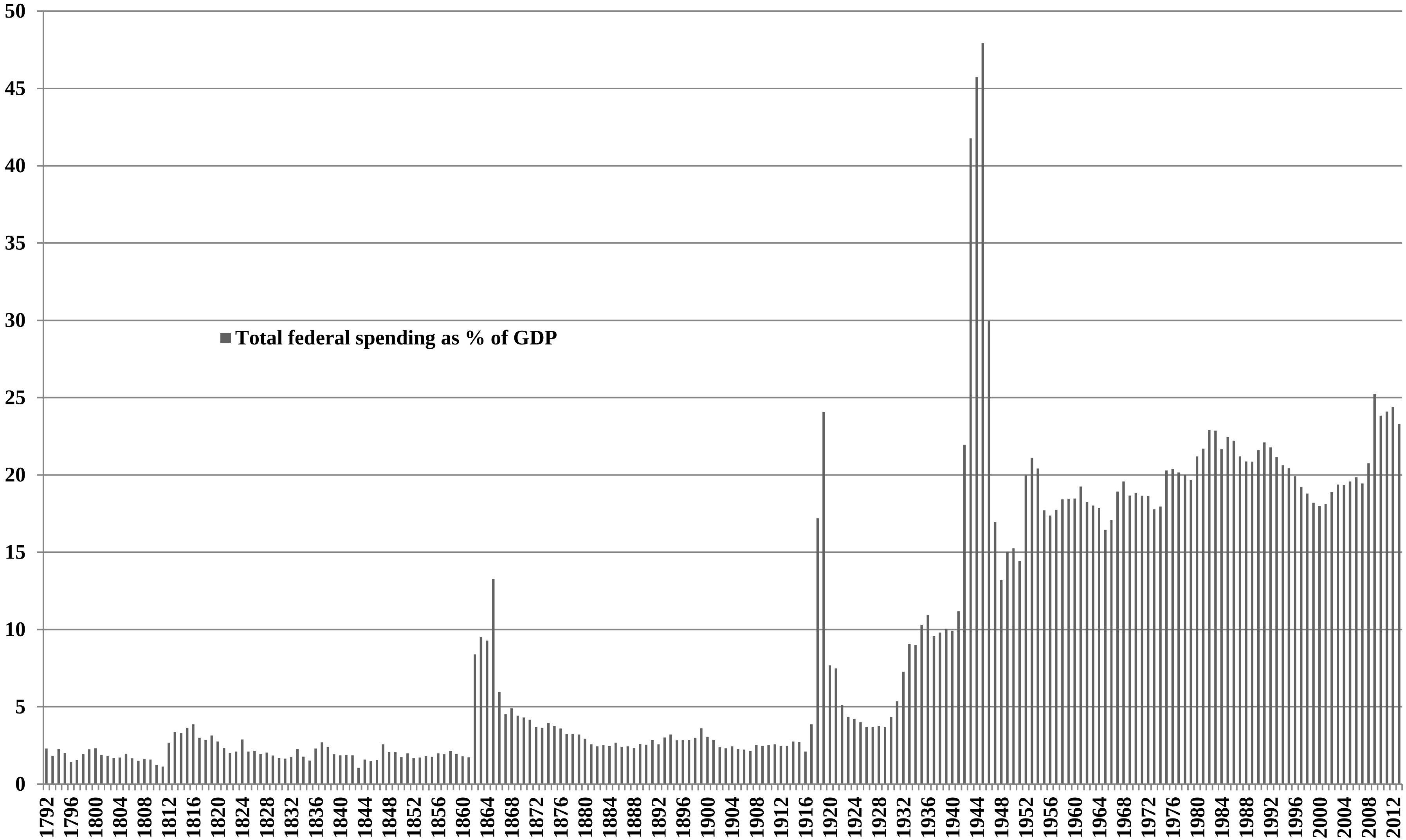
Arguments in favor and against fiscal union

- The main argument in favor of fiscal union: pooling resources to carry out common policies and provide supranational public goods
- Economic criterion of selecting policies/ public gods to be centralized: (i) increasing returns to scale; (ii) addressing externalities (functional analysis based on theory of fiscal federalism– Berglof et al (2003): *Built to Last: A Political Architecture for Europe*, Monitoring European Integration, vol. 12, CEPR)
- Political considerations: national sovereignty concerns, interests of incumbents on national level (e.g., building the EBA), limited appetite for cross-border fiscal redistribution (the case of redistributive programs/ mechanisms; the same phenomenon within some national states in respect to cross-regional transfers)

The size of EU budget and its character

- The size of EU budget: 1% of GDP + newly created bailed out facilities. It is largely concentrated on redistribution (CAP, cohesion and structural funds, bailout facilities)
- The US federal budget: 2-3% of GDP until the WWI (in peace time) concentrated on provision of federal public goods (almost no redistribution)
- Several areas where common EU policies based on pooled resources would be potentially beneficial (financial sector supervision and resolution mechanisms, defense, foreign policy, joint border management, etc.) but political obstacles

US total federal spending as % of GDP



Source: http://www.usgovernmentspending.com/spending_chart_1792_2013USp_13s1li011mcn_F0f_Spending_In_20th_Century

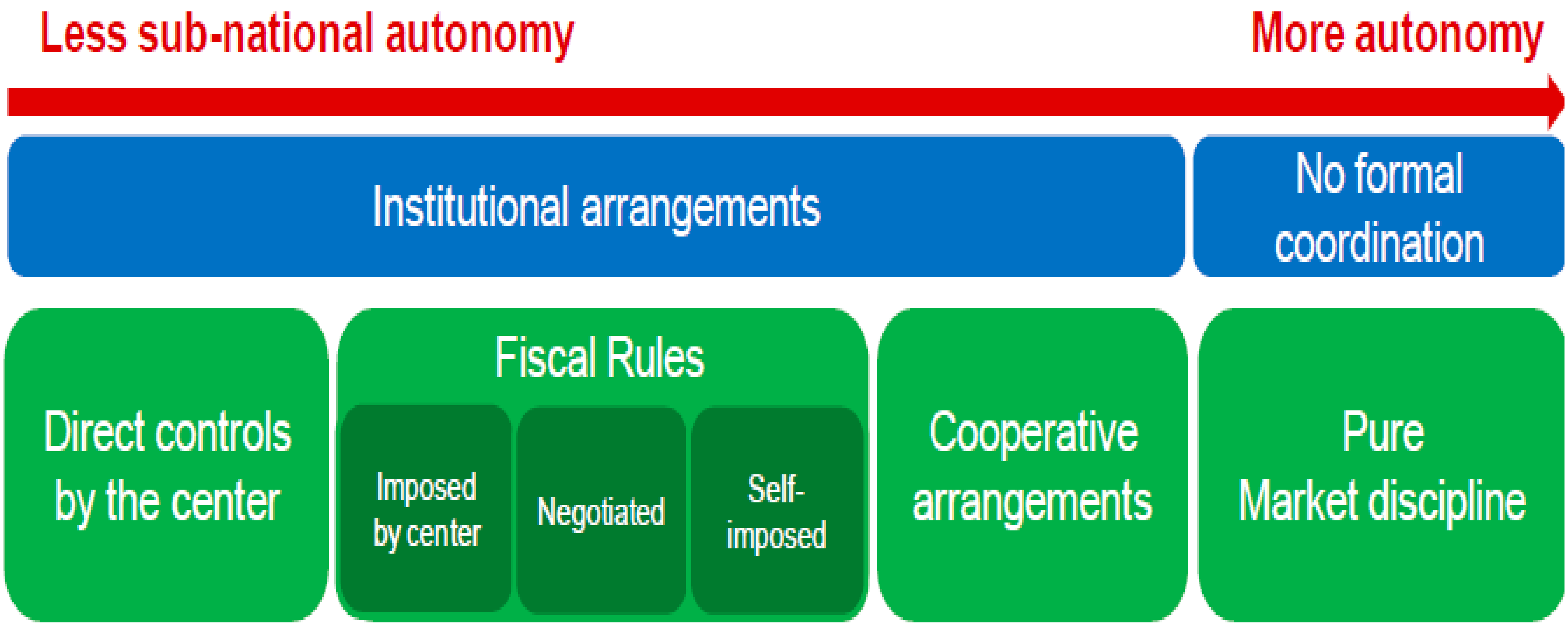
The EU budget: sources of revenues

- Largely countries' contributions negotiated within MTBF (for 7-year period); decision requires unanimity
- As result - bias towards redistribution rather than financing European public goods and low transparency
- Own sources (custom duties and part of VAT revenue) – marginal importance
- No Union-wide entitlement system
- Hypothetical increase in size of EU budget would require more Union-level revenue $\Rightarrow$ increasing role of the EP
- Until the 16th Constitutional Amendment (1913) very limited tax power of US federal government (import tariffs and excises)

Fiscal discipline

- Important for macroeconomic and financial stability (public good by itself)
- Particularly important within federations/ confederations/ integration blocks
  - cross-border spillovers and contagion
  - opportunities to free ride at the cost of neighbors,
  - moral hazard problem (expectation of bailout)

Arrangements to Constrain Subnational Fiscal Policy



Source: Eyraud, L. & Gomes Sirera, R. (2013): *A Comparative Perspective on the European Fiscal Governance Framework*, IMF FAD

Evolution of fiscal arrangements within the EU/EMU

2010 (1st Greek crisis)

Debate on Deep and Genuine EMU

Article 125 TFEU + Stability and Growth Pact

→

Article 125 TFEU suspended (EFSM, EFSF, ESM) + enhanced SGP + European Semester + imposed national fiscal rules

European Redemption Fund + Eurobonds + ECB as LOLR to sovereigns + intrusive control of national budgets

Market discipline + fiscal rules imposed by EU

→

Conditional bailout + more fiscal rules

→

Unconditional bailout + direct control by EU

Causes of evolution

- Giving up to financial market pressures (fear of contagion)
- Fear of banking crisis
- Fear of collapse of Euro as the common currency
- The role of MS in taking Union-level decisions, difficulty to reduce substantially MS sovereignty
- Intellectual confusions (sovereign default vs. exiting Eurozone, negating fiscal nature of the crisis, anti-austerity hysteria, monetary union vs. fiscal union)

Learning others' experience

- The US, Canada and Switzerland do not have a mechanism of bailing out sub-national governments which forces the latter to adopt self-imposed fiscal rules
- Misreading of US experience (especially of Hamiltonian debt mutualization)
- Numerous experiences of dysfunctional fiscal federalism (e.g. Argentina and Brazil) when federal government bailed out subnational entities

Conclusions (1)

- Not obvious that monetary union requires fiscal union
- Elements of fiscal union already exist in the EU/ EMU
- More fiscal centralization may be justified by increasing returns to scale and externalities on the EU level
- More fiscal centralization will require EU taxes and increasing political power of the EP
- Tax harmonization – the issue related to SEM rather than fiscal rules and policy

Conclusions (2)

- Importance of market discipline and stronger fiscal rules backed by automatic and painful sanctions (e.g. suspending voting rights in the Council)
- Rebalancing fiscal rescue mechanism to eliminate moral hazard and return to Art. 125
- Sharing fiscal responsibility (Eurobonds) should be avoided (danger of moral hazard)
- The above conclusions apply to all EU members not only the Eurozone