Executive Summary

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is is the background paper for the presentation given at the informal ECOFIN in Bratislava on 9 September 2016. A shortened version of this paper was circulated to the Ministers and is also available for download on the Bruegel website.

[illegible] without scal union is generally considered to be incomplete. We consider three steps for increasing the centralisation of scal functions, and discuss the prerequisites for moving forward at each one. Above all, scal integration is a matter of trust, which is currently at a low level.

[illegible] would be to complete banking union and establish a more credible no-bail-out clause. e conditions for addressing the scal dimensions of banking union are a denationalisation of the banking policy framework – including as regards exposure to sovereign debt – addressing non-performing loans and legitimising the scal backstop.

[illegible] would move on from the rst by adding funds for public goods and investment in the EU. is step would create a re-insurance framework to help euro-area countries absorb large shocks. We consider a review of the EU budget and additional resources as conditions for this scenario. A system of check and balances is important. Last, we consider

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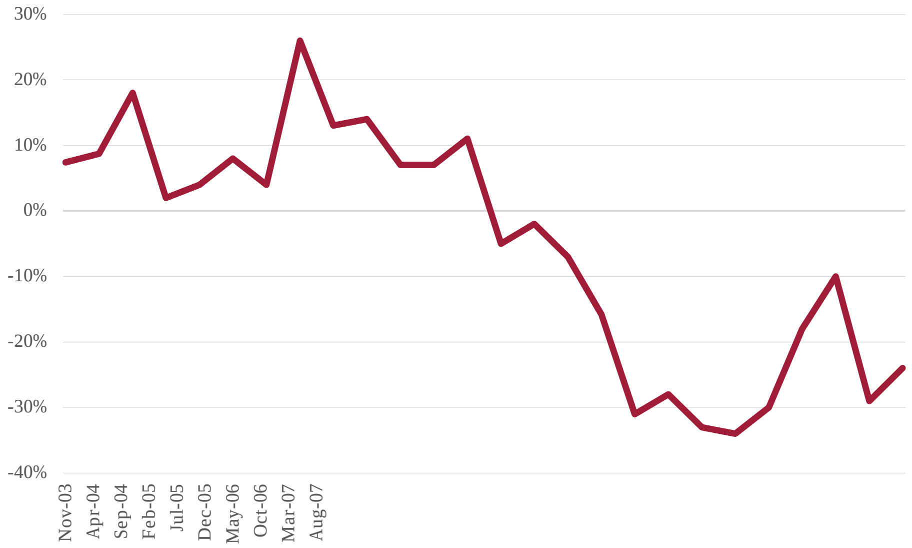
theless, there is a perception that the no-bailout clause is not credible and nancial assistance might even be given to countries with unsustainable debt.

Figure 1: Trust in the EU



of the EU: it allows the possibility of providing a loan on the condition that debt is sustainable, but it does not allow the assumption of unsustainable debt. We define credibility as the existence of a hard budget constraint, ie a financial assistance programme will only be approved if the country passes the debt sustainability analysis[11]. The no-bailout clause is more credible with greater financial stability. A fiscal backstop for the financial system and for essential government spending (for example through a European Stability Mechanism/Outright Monetary Transactions (ESM/OMT) programme) can achieve greater stability. More specifically, to enhance financial stability, it is important to reduce the exposure of banks to sovereign decisions and sovereign debt[12].

The credibility of the no-bailout clause depends, somewhat paradoxically, on the level of fiscal and financial centralisation. When important government functions are centralised, it becomes easier to maintain stability in extreme situations, compared to unions in which the sub-central level carries out almost all functions of government. The degree of fiscal and financial centralisation and the enforcement of responsibilities at the national level are therefore linked.

2.1 Step A: completing banking union

Our step A would complete first and foremost the banking union. This still requires a European Deposit Insurance System, an appropriate fiscal backstop and a further denationalisation of banking policies, including less exposure to sovereign debt and changed bank ownership structures. Banking union is indispensable in a monetary union that wishes to ensure stability, even in the face of possible sovereign debt crises. Financial stability crucially hinges on the stability of banks. Finally, and with all of the above achieved, we would subsequently envisage a gradual reduction in the intrusiveness of European fiscal rules and a reform of the EU's fiscal rules.

It is important that the ESM and OMT programme continue to exist in order to ensure that sovereign debt is not subject to self-fulfilling liquidity crises. Sovereign debt would remain a national responsibility and a safe asset comparable to sovereign debt outside of monetary unions. Only, in extreme cases, if the Eurogroup/ESM decides that debt is not sustainable, would its nature change.

This scenario would not address the problem of the macroeconomic management of the euro area as a whole. In particular, when interest rates are at the zero lower bound, the European Central Bank becomes less effective in achieving its inflation target. In such situations, it would be up to fiscal and economic authorities to support macroeconomic management with appropriate fiscal and structural policies. But in this first step, there would be no central tool other than monetary policy to ensure price stability. Loose fiscal policy coordination should play a role but is unlikely to be fully up to the task.

A second problem would be that for countries that mismanage their public finances and lose market access, there would be limited fiscal instruments other than the ESM to prevent large, pro-cyclical fiscal tightening.

would also provide resources for pan-European investment. This part of fiscal union need not be restricted to the euro area, but can involve the EU as a whole, because the public goods are not just for the euro area. Moreover, an insurance system (for example European unemployment reinsurance) would be established to help euro-area countries that are hit by large shocks.

The important of this second step is that it would provide common solutions to problems shared by European citizens – so truly European public goods. In addition, depending on the way these goods are funded, the fiscal capacity could contribute to cyclical stabilisation of the euro area as a whole. The more cyclical the revenue sources, the greater their stabilisation properties could be. Such fiscal capacity could create a social mechanism to mitigate the impact of major recessions on those most affected. The implied risk sharing would also somewhat help with national fiscal stabilisation policies, should national borrowing become constrained[13].

But overall it is clear that this scenario does not create a fiscal capacity at the euro-area level to manage fiscal stabilisation policies. Maintaining sound national fiscal policies would remain crucial to allow the necessary fiscal space so that automatic stabilisers can play their roles in full.

2.3 Step C: A true fiscal federation with spending and taxing powers at the federal level

Our last step C, which we consider an analytical benchmark, would shift significant spending items to the federal level in order to centralise or federalise important functions of fiscal and public policy. This would be a much more ambitious plan that aims to apply European solutions in areas such as defence and social policy. The federal level would take care of significant parts of stabilisation policy, for example through centralised unemployment insurance, health insurance and pension system amounting to perhaps 20 percent of total government spending. It would make the euro area's fiscal union more comparable to the United States, where about 65 percent of total government spending is at the federal level. The ability to raise federal taxes and to issue federal debt would be part of this scenario. Reaching this last step would essentially mean the end for national fiscal policy coordination. There would be a euro-area fiscal capacity of sufficient size to deal with all aspects of the euro area's fiscal affairs, ie allocative, redistributive and for stabilisation purposes. National fiscal policy would correspondingly lose importance. In this scenario, the no-bailout clause for nationally-issued debt would be as credible as it can get through design, and would remain central.

3 Prerequisites for each step

Achieving different levels of fiscal integration in a currency union is above all a political question. It involves complex questions of political trust, shifting legitimacy and accountability from the national to the supra-national level, and also dealing with different citizens' preferences. In general terms, the provision of European public goods could be done more effectively at the European level because it could take into account the cross-border externalities. However, a more centralised provision of public goods may not be appropriate if citizens have very different preferences.

The achievement of a fiscal union as described in step A boils down to managing importhat is very different from today. The second step involves difficulties that are between those of the other two. The time horizon for the different scenarios is different. A time horizon of 2-5 years might be adequate to complete step A, while step C would serve as an analytical benchmark beyond the time horizon of policymakers.

3.1 Prerequisites for moving forward with step A

of baskets of debt or to introduce safe European debt, possibly in the form of synthetic ESBies (Brunnermaier et al., 2011).

Prerequisite 3: Address non-performing loans in the banking system

The ability of banks to withstand transition problems as banking union advances depends on the overall state of their balance sheets. Currently, the acute problem of NPLs in a number of countries implies that the financial system is still vulnerable to unforeseen shocks and to new architectural demands. Certainly in transition, addressing the issue of unproductive debt in a timely and effective way is a significant prerequisite for the completion of banking union.

Prerequisite 4: Ensure the legitimacy and accountability of the fiscal backstop

Creating such a complete banking union framework also raises issues of political accountability. Is the Eurogroup the right political counterpart to Europe's single supervisor? Does the definition of a proper European fiscal backstop not also require the creation of a political head in charge of that backstop? Who would have the legal and political authority to authorise funds? A possible step could be the creation of a permanent Eurogroup president, who would be appointed by the Eurogroup and the European Parliament in euro-area composition. But as long as the resources primarily come from national tax authorities, there will be significant constitutional and political problems. To fully move the framework to a truly centralised authority, a legal base would need to be established.

Prerequisite 5: Reduce interference from the centre in national fiscal policies

Finally, Europe's current fiscal framework could also be reformed during this step. As the prerequisites we have mentioned are put in place, the no-bailout clause would become more credible, reducing the need for intrusive fiscal monitoring in normal times. We would envisage a reform that pushes the responsibility for achieving sound and stable public finances largely to the national level. Suitable rules could be defined at European level but implemented through national institutions[15]. Overall, this would allow national fiscal policies to play their fiscal stabilisation role in full, depending only on the available fiscal space and not on political constraints arising out of the application of Stability and Growth Pact recommendations.

3.2 Prerequisites for moving forward with step B

Building on what would have been achieved in step A, step B would allocate some fiscal resources to the centre to provide for common public goods, to increase and finance European investment and to insure against large, country-specific shocks. By allocating funds to the centre, this scenario would be a clear departure from the current system and therefore would require new agreements between members. We would envisage that thesehe a0bG1 ( )-16opeefor(ur)

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either be a contribution from national budgets or a new tax resource at the central level. ese options would have very di erent implications in terms of governance, legal base and also their economic stabilisation properties.

Prerequisite 2: Establish a system of checks and balances

How can political checks and balances, accountability and good governance be ensured? e more functions are centrally provided in the EU, the more this question is central. For example, external border control is a topic of great importance to citizens. While it can be provided through a technical authority like Frontex, there needs to be a political mandate and clear rules of political accountability for such authority's actions. Equally important is execution, e ectiveness, decision processes and involneses and involnh9D 460 alances to those in the US, potentially allowing for a form of partial unemployment insurance.

Table 1: Real economic dispersion across the euro-area countries by comparison to US states: GDP per capita and employment rate

Coeff. of variation	Euro area (w/o Lux) 1999	Euro area (w/o Lux) 2015	United States (w/o DC) 2015
GDP per cap.	0.54	0.41	0.18
Employment rate	0.07	0.06	0.07

Source: Bruegel based on AMECO (ECFIN) and Bureau of Economic Analysis. Note: GDP per capita and employment rate in percent of the working age population. The coefficient of variation is a normalised measure of dispersion that allows comparisons. Higher values indicate more significant differences across states. Numbers based on 18-member euro area. For employment rates we have also considered the original 11-euro area members (without Luxembourg) instead: 0.059 and 0.052 for 1999 and 2015 respectively.

Reducing real economic differences could help increase the appetite for risk sharing. Structural reforms that, for example, improve the effectiveness of the justice system and the government sector more broadly, improve educational outcomes, enable better management of the debt overhang and insolvencies, or improve the resilience of the financial system, are important for the growth performance of our economies and for their resilience against global shocks. We consider progress in these areas an important political condition for more far-reaching fiscal risk-sharing but we note that fiscal transfers aim at increasing cohesiveness of unions with different living standards.

Prerequisite 2: Taxation and representation

Shifting macroeconomic stabilisation from the national level to the European centre requires a major shift in sovereignty, spending and taxation to the European level. It would require the political will to grant direct authority to raise taxes and political authority to form a proper euro-area government in charge of the policy areas that are centralised. For this to happen, it would be fundamental to move to a different level of democratic accountability and institutions. The outcome would be essentially a political union with democratic decision-making at the federal level and executive authority at that level. Achieving such a vision is, to our mind, far away. Perhaps the most important prerequisite would be a clear sense of European identity among citizens.

4. Conclusions

Increasing fiscal capacity is desirable for the economic stability of the euro area and would improve economic performance. But advancing this agenda is difficult politically and raises serious questions about cohesiveness and how much economic convergence is needed. We have discussed possible conditions that in our view would make progress easier. The question then is what types of policies are available to policymakers and what European-level involvement is desirable. Instruments such as the Macroeconomic Imbalance Procedure have proven rather ineffective. Ultimately, it is up to national policymakers to act and to European partners to coordinate their actions to make progress and create institutions that allow for legitimate and efficient risk sharing and better management of the euro area's fiscal stance. It is also about generating trust by implementing decisions and delivering results that are visible to all.

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Annex

Table: Summary of conditions necessary to achieve greater fiscal centralisation

	Fiscal centralisation element	Conditions
Scenario A	• Deposit insurance & scal backstop • Less intrusive intervention on national scal policies from centre	• Greater credibility of no-bailout clause • Address scal dimension of banking union • Denationalise banking policy framework • Address non-performing loan problems • Address the issue of legitimacy and accountability of the scal backstop • Reduce interference in national scal policies from the centre
Scenario B	• Provision of European public goods • Resources for investment spending • Re-insurance system to address large country-speci c shocks	• Finance public goods that are of true European nature • Establish a system of checks and balances • Structural convergence for increased ability to react to shocks

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