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## Article

# The Future of Fiscal Policy in the Euro Area

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## Massimo Bordignon and Angelo Baglioni The Future of Fiscal Policy in the Euro Area



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### INTRODUCTION

The European monetary union (EMU) is a largely incomplete currency union. The Euro founding fathers were very aware of this issue but, because of political constraints, they chose a “minimalistic” solution (Constancio 2018). The optimistic view of the time was that even an incomplete currency union would be enough to induce greater political and economic convergence among member countries, making it easier to adopt further reforms of the EMU architecture when, and only if, needed. Thus a common currency and a fiscal brake, in the form of the Stability and Growth Pact (SGP), represented the only two blocks of the original EMU. There was no perception that, in order to support the currency union, a common financial supervision for banks and a crisis management mechanism for member countries might also be needed.

As far as fiscal policy is concerned, the compromise reflected the leading macro-economic theories of the time. Discretionary “fine tuning” fiscal policy should be avoided to support the cycle, leaving that task to automatic stabilizers instead. Asymmetric shocks could be dealt at national level, using the fiscal buffer guaranteed by the respect of SGP in good times. Monetary policy could take care of symmetric shocks and, if needed, soft cooperation among national fiscal policies would go far enough. Indeed, the same notion of an aggregated fiscal policy for the Eurozone was absent from the debate.

The international crisis of 2008–09, and the Eurozone crisis of 2011–13 to an even greater extent, proved most of these ideas, and particularly the easy optimism of the founders, wrong. The financial crisis showed that recessions of such amplitude may exist that monetary policy could be stretched to a limit; and that fiscal policy may be called upon to play a more active role, beyond the role of automatic stabilizer. The spread of contagion between financially interconnected Euro area countries and the overlapping crises, hitting both the bank and the sovereign sectors, showed the

importance of a centralized supervision of banks (Draghi 2018). The risk of a break-up of the Eurozone led the ECB to resume a role of lender of last resort, at least under specific circumstances. On economic grounds, the crisis also stopped the process of economic convergence across Eurozone members, giving rise to increased divergence that only very recently seemed to start receding (see Figure 1).

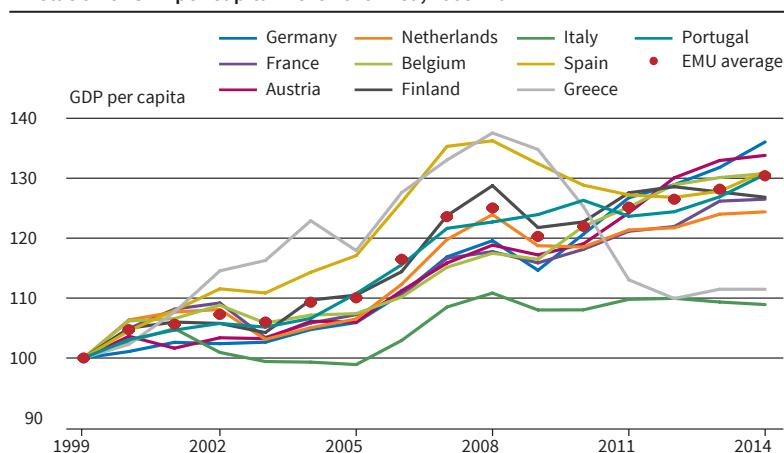
### THE LIMITS OF THE EUROPEAN FISCAL FRAMEWORK

The Eurozone took several steps to address these pitfalls. The most important progress has been made in the banking sector, where a single supervisory mechanism and a common resolution system have been introduced. However, it should be stressed that these steps are still largely incomplete. The lack of a common fiscal backstop for the banking sector and of a common deposit insurance system still creates a real risk of bank runs and capital flight if a new financial crisis were to occur, challenging the integrity of the Euro area. The proposal to establish a more comprehensive Capital Markets Union is still in its infancy.

As far as fiscal policy goes, the progress made so far is even more limited. The main innovation has been a further strengthening of fiscal rules, with the introduction of an international treaty, signed by all Euro area countries, the Fiscal Compact, and the revision of the SGP, strengthening the role of the European Commission in enforcing the rules. A second innovation has been the introduction of the European Stability Mechanism (ESM), as the result of another international treaty across the Eurozone countries. The ESM provides financial support to Euro countries in trouble, in exchange for strict conditionality. However, the ESM is not a tool for macro-fiscal management, but a fund of last resort. It can only intervene under very specific circumstances, namely when a member country has lost access to financial markets, after a technical judgement by the

Figure 1

Evolution of GDP per Capita in the Euro Area, 1999–2014



Note: Selected countries. Base year = 1999.  
Source: Penn World Table – version 9.0 (2015).

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Commission and the ECB on the sustainability of its debt, and with decision rules that require the unanimity of lenders<sup>1</sup>. Financial assistance takes the form of a loan (not a grant) at favourable interest rates and reimbursable over a long period<sup>2</sup>.

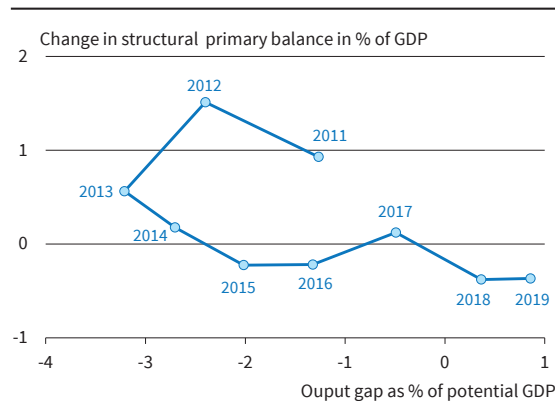
The strengthening of the SGP finds little justification in the crisis itself, in the sense that it would be difficult to argue that lack of discipline in controlling public finances were the main cause of the Euro crisis. With the exception of Greece, lack of control of the banking sector, the emergence of private debts and the accumulation of internal and external imbalances are much more obvious culprits (Baldwin and Giavazzi 2015). Indeed, some of the countries more damaged by the crisis posted the best results in terms of their public finances just before the Euro crisis hit. In 2007, for example, public debt to GDP was 65% in Portugal, 36% in Spain and 25% in Ireland respectively. In other words, these figures were well below the Euro average. Even Italy, another high debt country, had managed to bring debt over GDP down to 103% just before the crisis hit.

The revision and strengthening of the fiscal rules have been accompanied by some attempts to improve coordination of fiscal and economic policies. The European semester was introduced in order to increase coordination of fiscal policies, and a new Macro-Economic Procedure was set up to avoid the formation of imbalances and to increase the convergence of economic policies. But both tools have no real teeth. The macro-imbalance procedure is difficult to enforce because, unlike fiscal budget aggregates, it is harder to pinpoint the specific responsibility of a country on several macro indicators. The Commission's Country Specific Recommendations, when touching upon issues outside the fiscal area, are just suggestions and they are treated as such by member countries. Finally, the SGP is a fiscal brake, not a tool for aggregate fiscal management. It contains several provisions to shape the fiscal adjustment required for a country, taking into account its position in the economic cycle; however, it only looks at each country in isolation, discarding the potential fiscal spill-over effects across countries. Thus, no country, when deciding its own fiscal policy, takes into account the effects of its choices on the other countries, leading to potentially sub-optimal Nash equilibria, particularly in those situations in which fiscal spill-overs are important.

These problems were made painfully clear during the 2011–13 recession. A more coordinated fiscal response would probably have alleviated the hardship of the recession in the crisis-hit countries; but simultaneous fiscal consolidation in all countries, including those that did not need it, made things worse. Figure 2 illustrates this point. The Figure plots the aggregate fiscal stance of the Eurozone (defined as the sum of the

Figure 2

## Fiscal Stance in the Euro Area



Source: European Fiscal Board (2018).

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variations in structural primary fiscal balances of Euro countries) against the difference between potential and actual output for the area. The Figure illustrates how fiscal policy was strongly pro-cyclical in those years, aggravating the general recession in the area. Indeed, according to estimates by Veld (2013) and Rannenberg et al. (2015), fiscal consolidation in 2011–13 caused a loss in Euro area GDP of between 8% and 20% with respect to a baseline scenario, depending on the countries considered.

These macro-economic failures become even more worrying when one considers the mechanisms in place to cushion economic shocks in the Euro area. The Euro area lacks, or only has to a limited extent, a number of mechanisms that - in other currency unions - smooth the impact of region-specific shocks, reducing consumption less than the fall in GDP, such as: intergovernmental transfers, federal income taxes and private sector risk sharing<sup>3</sup>. Indeed, a number of studies (like Alcidi and Thirion, 2017), that compare the Euro area with the US document that, in the latter, risk sharing is both higher and is accomplished with different means than in the former. Surveying this literature, Milano and Reichlin (2017) conclude that country specific GDP shocks are smoothed by 57% in the USA, but only by 29% in the Eurozone<sup>4</sup>. Not only, but while capital income from cross border asset ownership provides most insurance in the US, in the Eurozone this channel is far more limited (62% versus 24% respectively, according to an old report by the European Commission (2007)). The bulk of insurance in the Euro area comes from the domestic public sector, so it follows that when this is fiscally constrained, insurance can only be limited. Completing the Banking Union and establishing a Capital Market Union will certainly increase the importance of the private sector channel

<sup>1</sup> Except in exceptional cases.

<sup>2</sup> So far, 5 countries have had access to ESM programs, Greece, Ireland, Spain, Portugal and more recently Cyprus.

<sup>3</sup> Even labour mobility across Euro countries, an admittedly long run insurance mechanism, it is much lower – although increasing – in the Eurozone than in other currency unions.

<sup>4</sup> Approximately, this is the ratio of the covariance between growth rates of country-specific consumptions and GDP to the sample variance of GDP growth rates.

in the Euro area. However, this process might take several years. Moreover, some evidence (Furceri and Zdzenicka 2015) suggests that this channel is less effective during severe downturns, when credit markets are constrained. Private sector risk sharing can also turn pro-cyclical in downturns and it is more effective in conjunction with public sector risk sharing (Kalemli-Ozcan et al. 2014).

### WHY WE NEED A COMMON FISCAL CAPACITY

Those are the main reasons why, starting with the Five Presidents' Report (2015), academic experts, some Eurozone member governments, the European Commission and many international organizations have all argued in favour of the introduction of a "common fiscal capacity", or a macroeconomic stabilization mechanism for the Euro area. The mechanism should be able to provide fiscal ammunition to support monetary policy in case of large symmetric shocks and provide insurance to member countries in case of asymmetric shocks. The fact that monetary policy is already constrained by the "zero lower bound" in the Eurozone, and it is likely to remain so for a long time, adds some urgency to the proposal.

A question, over which there is still debate between economists and member countries<sup>5</sup> related to the introduction of a "common fiscal capacity", is how important are business cycle shocks for the Euro area and what is the degree of synchronization of member countries' economies. The 2008–09 crisis was certainly exceptional and one could argue that if "normal" shocks in the Euro areas were limited, there was little point in introducing another fiscal instrument beyond what national governments and common monetary policy can already achieve. However, data analysis does not seem to confirm this rosy view (EFB 2018). Since early 2000s, the average magnitude of output gap fluctuations in the Euro area has been close to 2% of GDP; and in several cases it has exceeded 3% of GDP. Moreover, aggregate volatility is smaller than fluctuations at a national level. Disparities between member states' output gaps exceeded 2% of GDP in normal times and almost doubled during the crisis. Bilateral cross-country correlation of output gaps is on average close to 60%, but with a great deal of heterogeneity, ranging from zero to 90%, depending on the countries under consideration.

This suggests quite substantial economic reasons for supporting the introduction of a common fiscal capacity in the Euro area. However, there are also political reasons. We live in democracies. Shocks of the magnitude experienced by several Euro countries in the periphery during the recent crisis are bound to create anxiety and revolt in public opinion, in addition to leaving long term scares in these economies. The European Union and the Euro are easy scapegoats for politi-

cians relying on this discontent. Political backlash and reform reversal become a possibility, threatening the survival of the Euro project. Indeed, there is some evidence to show that while Euro countries kept converging, in spite of the crisis, on economic grounds (for example, in the liberalisation of markets and in the quality of their key services), they strongly diverged in citizens' perception of the quality of government and trust in national and European institutions (Bordignon et al. 2018). Some form of European fiscal insurance, reducing the extent of the economic pain of citizens during a heavy crisis, and thus showing that Europe "cares", could be very helpful in reversing these feelings.

### SEVERAL PROPOSALS ON THE TABLE

However, even assuming that a common fiscal capacity is desirable, there is still the question of how to introduce it, taking into account all legal, technical and political difficulties, including the need to avoid permanent transfers and potential moral hazard problems. In national countries, fiscal insurance to sub-national governments is provided somewhat automatically by the national budget, through progressive income taxation, national expenditure on public goods and explicit intergovernmental transfer mechanisms. The EU budget cannot play the same role. It is too small, it is not financed by its own fiscal resources, which also implies that it cannot borrow and raise debt to address large shocks, and it is also based on procedural rules that limit flexibility in the use of resources. Finally, it is the budget of the European Union, not of the Euro area. It is not obvious that an EU budget should be used to address a specific problem of the Euro countries, namely the impossibility of devaluating their currency to address asymmetric shocks.

None of these characteristics is likely to change in the near future. The bulk of public expenditure in national countries is accounted for by their social welfare systems, where national political preferences are still too diverse to imagine a larger devolution of competences. This, of course, does not mean that the EU budget should not and could not be revised. On the contrary, there are strong economic arguments for returning some competences to member countries, with the European budget focused more heavily on truly European "public goods"<sup>6</sup>. And relatively large expenditure programmes on some general topics of interest for EU countries (such as infrastructure or digital economy) could provide some form of insurance. But size still matters.

An example is the recent proposal by the EU Commission (May 2018) to use the EU budget to provide some insurance for Euro member countries. The Com-

<sup>5</sup> See Campos et al. (2018) for a recent meta-analysis that summarises the macroeconomic literature on the synchronisation of shocks in the Euro area.

<sup>6</sup> The proposal of the EU Commission for the Multiannual Financial Perspectives in 2020–27 makes some timid steps in this direction, marginally reducing the share of the EU budget going to agriculture and cohesion funds and increasing instead expenditures on security, border controls and defense.

mission advocates the introduction of a European Investment Stabilisation Fund, making loans to support public investments in Euro countries hit by a large crisis, coupled by a grant in the form of interest rate subsidies, which can cover the entire interest payment. But leaving aside other details, the size of the envisaged programme is too small to provide any meaningful support, 30 billion for all Euro countries<sup>7</sup> for the entire period. Loans to countries are also capped, so back of the envelope computations suggest that actual support would probably be less than 0.1% of GDP in the entire period. Clearly, this is not enough.

Several authors (Ubide 2015, Tabellini 2017, Corsetti et al. 2016) have discussed ways to tackle this problem, namely how to build up a relatively large Euro fiscal capacity without a large Euro Budget. In the present context, these ideas sound as political science fiction, but it is worth recalling that a solution could be found if there were enough political will. The general idea is to set up a system where countries commit to transfer part of their fiscal resources (like 1% of GDP<sup>8</sup>) for a long period of time (such as 50 years) to a Euro Fiscal Authority (the Euro Minister of Treasury? A reformed ESM?). Out of these committed future payments, the Fiscal Authority would issue bonds (generally called stability bonds). In normal times, these bonds would just be given back to member countries in proportion to their payments and could be used by countries to substitute national bonds. In exceptional times, the Fiscal Authority could use these stability bonds to support the economy of the Euro area through general expenditure programs; or to help countries hit by particularly strong negative shocks. Of course, the Fiscal Authority should be governed by Euro member countries, with rules less stringent than unanimity, and being made accountable to the Euro-Parliament to maintain democratic legitimacy.

This proposal would kill several birds with one stone. Once a sufficient amount of stability bonds had been issued, they would become the “safe-bond” that is generally argued is needed to anchor the Eurozone financial systems and complete both the Banking and Capital Markets Unions. National banks and other financial institutions would hold them and the ECB could use them for its open market operations. This would ease the “doom loop” problem, the excess holdings of domestic public debt by national banks. Lacking the potential support of the ECB, national debt would also become riskier, imposing a higher marginal cost on high debt countries, thus strengthening market discipline.

The problem with this proposal is that in order to eliminate moral hazard effects, the Fiscal Authority would need more incisive powers over the budget choices of member countries. The Fiscal authority should not only be in charge of fiscal surveillance of

member countries, implementing the SGP, but it should also have the power to veto *ex ante* the budget law of a member country if the latter violates the EU rules. This would ensure the more financially sound countries that the risk sharing that they implicitly provide, would not be wasted by the irresponsible behaviour of other member countries. However, no Euro country seems to be willing to consider this passage: sovereignty in fiscal matters is still perceived as too central for the national authorities' role, to give it up to a federal body. More generally, this refusal reflects the fundamental problem of the EMU: the lack of a political union, or of a federal body with sufficient resources and democratic legitimacy to back the monetary union when needed.

Given this political deadlock, the other solutions on the table are just pale versions of the proposal discussed above and are very probably less effective. A widely discussed option is to enlarge the tasks of the ESM, allowing it to intervene even before a country has lost access to financial markets<sup>9</sup>. As is the case with the International Monetary Fund, the ESM could provide precautionary credit lines and short-term loans based on *ex ante* (but not *ex post*) conditionality to countries that have temporary difficulties in accessing financial markets. This may prevent a full-blown financial crisis from occurring; and improve financial integration across Euro member countries as a result. *Ex ante* conditionality (such as the respect of the SGP) would also provide better incentives for policy setting by governments. However, the effectiveness of this proposal depends heavily on its design. The experience of the IMF with similar programmes is not very encouraging. Countries typically do not apply to these programmes, because they are afraid that applying might send a negative signal to markets, precipitating rather than averting a crisis. Moreover, enlarging the role of the ESM would probably require a deep reform of its governance system, overcoming the unanimity rule. While several proposals are on the table, including one by the Commission itself<sup>10</sup>, the positions of member countries differ too substantially on this issue to predict a rapid solution.

A second set of proposals (not necessarily alternative to the first one) focus instead on the idea of setting up a “rainy day fund”. In normal times, Euro countries would transfer resources to a European body (the ESM? The EU budget? Another specific budget for the Euro area?); and in bad times, the fund would support countries in difficulty. The annual payment by each country to the fund would be very low (depending on the proposal, about 0.1-0.3% of GDP) and contributions from the fund (or at least, in some proposals, the part in excess of the cumulated contribution by each single

<sup>9</sup> This hypothesis is usually associated with the proposal of transforming the ESM into a European Monetary Fund, but it is not obvious why. In fact, the ESM already has two of these types of facilities, the precautionary conditioned credit line and the enhanced condition credit line, none of which has ever been used by member countries. The proposals typically suggest revising these two tools and making them more user-friendly in order to incentivize their use.

<sup>10</sup> See the December 2017 proposal of the Commission (2017).

<sup>7</sup> Plus Denmark, although it is not clear why.

<sup>8</sup> Some suggest these fiscal resources could come from the seignorage that is paid by the Eurosystem to national treasuries.



country) would be conditional to the respect of fiscal rules (that is, there would be *ex ante* conditionality). Total payments to the fund could also be capped at some level, that is: the fund might not receive further contributions, when they reach some predetermined level of Euro countries' GDP. To avoid moral hazard and the transformation of support from the fund into permanent contributions from other countries, one might also think of other mechanisms, such as a cap on the maximal level a country can receive from the fund, increased contributions by countries that more often receive resources from the fund. The general idea is that the fund should provide some insurance against large shocks and, at the same time, give the correct incentives to member countries. These would come from *ex ante* conditionality (the respect of fiscal rules), but also by the fact that financing the fund in good times means forcing fiscal policy to be less pro-cyclical than it usually is in these periods, as some money would be subtracted from a country treasury.

The many proposals on the table (like, for instance, EU Commission 2017, Beblavý and Karolien 2017, Bénassy-Quéré et al. 2018, Arnold et al. 2018, Carnot et al. 2017) differ greatly from each other along several dimensions. 1) In terms of the expected size of the fund. 2) In terms of the “trigger” mechanism allowing access to the fund, and specifically whether it would be automatically activated on the basis of economic indicators, or based on some technical assessment and discretionary decision. 3) In terms of whether the fund should aim to cover only asymmetric or also symmetric shocks. 4) In terms of whether the fund could borrow (out of expected future payments) in cases where it had not yet accumulated enough resources to play its role once a crisis hit. 5) In terms of whether the fund should aim to cover only large shocks or relatively smaller ones. 6) Finally, they differ in terms of whether the fund's resources could be freely used by a country; or only used to finance some particular type of expenditure (such as unemployment benefits or infrastructures). All of these issues would require a lengthy discussion; indeed an entire chapter of the June 2018 Report (EFB 2018) of the European Fiscal Board (to which one of the authors of this paper contributed) is devoted to these questions. Let us briefly summarise the report's main conclusions.

Firstly, size is important. The IMF (see Arnold et al. 2018) estimates that somewhere between 1 to 2% of the GDP of a country hit by a large recession (as witnessed during the recent financial crisis) would be needed to provide relief *ex post* and proper incentives *ex ante*. As yearly contributions to the fund are supposed to be very small (for both political and practical reasons, as they are not returned to countries in normal times), this implies that, if the fund is not allowed to borrow, it would take a very long time to accumulate enough resources for it to be of any use. Secondly, as the main important shocks in the Euro area are symmetric, and we already had evidence of sub-optimal

fiscal policy in the presence of a large symmetric shock, it would not make much sense to limit the fund to just addressing asymmetrical shocks. Thirdly, as there are already several lines of defence at the national level against a downturn, the fund should really only be activated in the presence of a relatively large shock. Fourthly, automaticity has its merits, both for a timely response and on political grounds. But the long list of criteria that have been proposed in the literature as potential trigger mechanisms for the activation of the fund (variations of GDP and/or unemployment with respect to a trend, output gap measures, current balances, etc.) all have their limits, given the well-known difficulty of assessing the condition of an economy in real time. It is difficult to avoid the conclusion that some kind of in-depth technical analysis is needed to establish if the conditions for triggering the fund are satisfied, leaving it to politics to take the final decision. Fifthly, *ex ante* conditionality, in terms of respecting the rules, it is hard to establish with the present overly complex system of fiscal surveillance. A simplification of the rules (as proposed by several bodies, including the Commission and the EFB itself) would make it much easier to enforce the mechanism and induce correct incentives on governments. Sixthly, there are strong arguments for conditioning resources from the fund to finance only some specific components of public expenditure. There is an over-whelming body of evidence showing that during a crisis, fiscal consolidation is typically obtained by sacrificing mostly investment and capital expenditure. Indeed, public investments in the Euro area have been slashed dramatically as a result of the crisis and are still way below their pre-crisis level. This was a bad move, both because fiscal multipliers are typically higher for capital expenditure than current expenditure, and because cutting capital expenditure means reducing future growth.

## CONCLUDING REMARKS

The European monetary union needs some urgent reforms to thrive. Completing the Banking Union and starting with a Capital Markets Union are surely priority projects. But fiscal policy also deserves consideration. Fiscal brakes are important, particularly in a currency union, but they are not a tool for macroeconomic management; and coordination of the fiscal policies of otherwise completely autonomous countries has proved to be a chimera. Some centrally-managed macro-economic mechanism is needed to increase risk resilience in an otherwise poorly-equipped monetary union. Large mechanisms that would make the EMU more similar to other monetary unions and national states are technically possible, but probably unrealistic at the current political juncture. But some intermediate mechanisms, such as a common fiscal capacity, could be introduced. If correctly managed, such a mechanism would also provide strong incentives for risk reduction, strengthening the monetary union.

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