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A Fiscal Union for Europe: State of play of the debate and proposals

Abstract: A fiscal union can take a constellation of forms. One the one hand, some participants in the debate have advocated the need to move toward a type of fiscal integration that consists of reinforcing shared-sovereignty. They propose the creation of an EU finance minister with veto power over national budgets and other mechanisms to enhance policy coordination and reduce the risk of adverse shocks. On the other hand, others advocate the need to create fiscal insurance and enhanced risk sharing mechanisms. This paper consists of three sections. The first section identifies the gaps in the EMU architecture from a broad perspective. It then considers the specific economic rationale behind the different elements of fiscal integration proposed in the literature to remedy these gaps. In particular, the complementarity between different policies and elements of a fiscal union is emphasized. The third section starts by laying out the state of play of the debate among the main EU institutions and the member states. Finally, we assess the strengths and weaknesses of some of the most influential academic proposals for further fiscal integration in the EMU.

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1. Introduction

The idea that significant fiscal integration should accompany monetary integration dates back to the 1970s when the early talks about monetary integration were launched. The Werner report (Council and Commission, 1970) emphasized monetary unification would require a common budget managed at a central level. In the same line, the MacDougall Report (1977) concluded that a budget of at least 2-2.5 % of GDP during the transition period towards Federalism, and then 5-7 % of GDP during the Federal stage would be necessary in order to absorb macroeconomic shocks and provide transfers to foster some minimal convergence of income levels. However, these reports fell short of a political support at the time. At the time, the very proposition to create a common EU budget was the reason for France's rejection of the plan laid out by the Werner report.

However, monetary union only gained momentum in 1988, when Jacques Delors, new president of the European Commission, revived the project of monetary integration by turning it into a politically viable project. Hence, the Delors Report in 1989 that contained the blueprint for a monetary and economic union largely ignored considerations about fiscal union as it was considered as politically unrealistic. The underlying idea was that political and hence fiscal integration would follow deeper monetary and economic integration naturally. The common budget was thus set to remain small in a first time, in the order of 1% of GDP, and with responsibility for stabilization policy instruments assigned to national authorities.

The Stability and Growth pact enacted by the Maastricht Treaty was designed with the primary purpose of preventing persistent deficits and the accumulation of debt in member states, and to allow for a certain degree of flexibility that would enable to use fiscal policy to support the economy in the face of negative asymmetric shocks. In addition to the fiscal governance framework, member states were encouraged to pursue structural reforms to improve the resilience of the euro area to adverse shocks, while financial and trade integration were expected to foster convergence of the business cycle, eventually making the euro area move towards an optimal currency area (Frankel and Rose, 1998). Finally, the prevailing monetarist paradigm at the time implied that the ECB mandate on price stability was sufficient to avoid asset bubbles and provide financial stability. From 1999 through the eruption of the financial crisis in 2007-2008, the monetary integration proceeded smoothly, despite an EU budget barely reaching 1 percent of EU GDP and growing imbalances among member countries.

The experience of the euro area crisis has revealed critical 'design failures' (De Grauwe, 2013) in the functioning of the EMU. The institutional arrangements of the EMU and its Treaty proved unable to address a large crisis. Thus, member states and EU institutions implemented a range of reforms to strengthen the resilience of the EMU. Reforms sought to

enhance fiscal governance by: strengthening the rules, fostering economic policy coordination and the monitoring macroeconomic imbalances. Crisis resolution mechanisms have been or are being created, with a permanent European Stability Mechanism (ESM) to help recapitalize banks and to provide liquidity to distressed member states, the Outright Monetary Transaction (OMT) as introduced to suppress the so called "redenomination risk", and the establishment of the first pillars of a banking union. Despite the mutual insurance character of these novel instruments, the debate over the creation of a fiscal union has remained vivid as many authors believe that more should be done. In particular, remaining vulnerabilities are largely attributed to the lack of common fiscal resources or of a so-called 'Fiscal Union'.

Against this background, the next section identifies the gaps in the EMU architecture from a broad perspective. It then considers the specific economic rationale behind the different elements of fiscal integration proposed in the literature to remedy these gaps. In particular, the complementarity between different policies and elements of a fiscal union is emphasized. The third section starts by laying out the state of play of the debate among the main EU institutions and the member states. Finally, we assess the strengths and weaknesses of some of the most influential academic proposals for further fiscal integration in the EMU.

2. The rationale for fiscal Integration

2.1 What are the gaps in the EMU framework

The EMU institutional framework has showed important gaps in four fundamental aspects, of which the first three relate to the building blocks of OCA theory (Mundell, 1961, Mc Kinnon, 1966). First, asymmetric shocks have persisted. Expectations that the introduction of the euro area would provide an impetus for real convergence have not materialized: the euro area did not become an Optimal Currency Area as posited by Frankel and Rose (1998). The endogenous OCA hypothesis proved too optimistic. [2]Krugman's New economic geography, instead, turned out (at least partially) right. [3]Crucially, some of the asymmetric shocks were created by the system itself (eg fall in interest rates that fueled credit booms in Spain and Ireland) and by idiosyncratic domestic policies (eg lack of structural reforms, pro-cyclical fiscal policy). Overall, it showed that while synchronization of business cycles has increased with trade and financial integration, it does not necessarily mean that asymmetric shocks and their propensity to contagion effects are reduced as well. In addition, in line with the prevailing doctrine, the EMU construction largely overlooked the possibility of financial

[2] De Grauwe (2016) shows that while business cycles have been more synchronized, the variance between countries has increased (ie countries have different amplitudes for their cycles)

[3] He argues that the existence of increasing return to scale and integration mean that trade liberalization forces lead to increased regional specialization according to country's comparative advantage, which could result in divergence of business cycles in the EMU.

asset bubbles as put out by the work of Walters (1990)[4], which facilitated the creation of regional asset bubbles.

Secondly, the capacity of the euro area to absorb these asymmetric shocks has remained insufficient. Labour mobility has remained very weak as compared to other accomplished federations, and prevented migration from playing a significant shock absorber role (Barslund, 2015). Price and wage rigidities have remained large at the periphery, and prevented real exchange rate adjustments. Policy-makers wrongly believed these developments to be permanent, and delayed efforts to implement structural reforms. Structural weaknesses compounded with credit booms eroded the competitiveness of the periphery countries at times when Germany, the largest exporter, undertook important labor market reforms. This in turn resulted in the build-up of large macroeconomic imbalances.

Thirdly, the lack of market flexibility was compounded by the lack of incentives to pursue counter-cyclical fiscal policy and to reduce debt during good times. This phenomenon reinforced the dynamic of macroeconomic imbalance creation, and as the crisis illustrated it largely affected member states capacity to deal with asymmetric shocks (and to some extent to coordinate the overall fiscal stance in reaction to a symmetric shock). The pro-cyclical behavior of fiscal policy in the euro area is partly explained by the asymmetric nature of the rules, which do not comprise rules for prudence in upturns, and its weak enforcement. In addition to this, the role of market discipline has been largely ineffective following the establishment of the euro, and has been conducive to excess borrowing, both in the private and public sectors. Crucially, weak fiscal discipline has been related to the lack of credibility of the no bail out clause that certainly contributed to the elimination of market's sovereign risk for countries like Greece, Portugal, Spain or Ireland.

In conjunction with the three gaps discussed above (that broadly speaking relate to the OCA theory), the crisis revealed two crucial weaknesses of EMU. First, it demonstrated that financial market could price sovereign out of the market and force them to adopt a pro-cyclical fiscal stance when stabilization is most needed. This happened at the height of the crisis when some countries faced sudden stops and were forced to cut off stabilizers, and is one of the reason why many observers have called for a fiscal union. In addition, the resulting financial fragmentation undermined the transmission of monetary policy. Secondly, Allard et. Al (2015) stress that deeper financial integration exacerbated contagion risks, notably because certain banks became too large to be rescued domestically, but kept holding a large share of their sovereign debt. This combination made the euro area countries particularly vulnerable to negative feedback loop between domestic banks and sovereigns that was observed during the crisis. The lack of a firewall (eg a banking union or

[4] He demonstrated that a monetary union made up of largely heterogeneous economies and not fully synchronized/integrated is prone to pro-cyclical credit developments and dangerous asset bubbles.

common backstop) to cut the link between sovereign and banks can lead markets to price in default, which in financially integrated monetary union can also lead to large negative spillovers and contagion across the euro area.

2.2 How can a fiscal union fix EMU gaps?

What is a fiscal Union?

As noted by Dreze (2013), the term fiscal integration tends to be abused in the policy literature. The lack of a common definition of a fiscal union has implied the use of different definitions by authors that have proposed further changes in EMU governance. Interestingly (as will be discussed below) this also reflects the various assessments made as to what were the causes and potential solutions to the EMU crisis. The rest of this paper will use the broad definition proposed by Dabrowski (2015) who defines fiscal union as transfers of (parts of) fiscal resources and competences in the area of fiscal policy and fiscal management from the national to supranational level. Such definition implies that fiscal integration can be interpreted as attempts to further centralize fiscal policy in the EMU, hence further political union and a loss of some part of national sovereignty. Thus, any move toward further fiscal integration comes with serious legitimacy issues associated with the governance of a supranational mechanism. It can also be largely inconsistent with sovereignty principles, and is likely to require modifications of the Treaties to be sustainable[5].

From this definition it is clear that the existing supranational institutions and procedures of EU economic governance already contain several elements of a fiscal union, including a (small) common budget and some fiscal transfers, some degree of tax harmonization, common fiscal governance rules, coordination of budgetary policy, and mechanisms to deal with sovereign debt crisis. It is thus important to consider that according to a broad definition, some elements of fiscal union already exists.

The basic rationale for fiscal union starts with the observation that monetary integration transforms the role of national fiscal policy. As member states gave up monetary policy, counter-cyclical fiscal policy (or automatic stabilizers) becomes the prominent policy instrument to address country-specific output shocks in the short term. In the current decentralized context where member states pursue fiscal policy largely independently. One consequence is that they are only insured against negative shocks to the extent that financial markets allow them to borrow externally, which in the absence of a stand-alone

[5] Recent examples of these tensions were reflected in the debate that surrounded the European Stability Mechanism (ESM) loans and the introduction of the OMT procedure. These two key crisis management mechanisms introduced amidst the crisis have been accused of being inconsistent with the "no monetization" and "no Bail-out" clauses.

central bank has proven difficult in times of economic and financial stress[6]. In addition, Alcidi et al. (2014) points that the rationale for coordination of economic policies and sharing financial resources also stems from the presence of externalities inherent to a highly integrated monetary union.

Economic theory suggest that fiscal policy integration would complement the monetary union by: (1) providing mechanisms for fiscal stabilization of asymmetric shocks (via risk sharing or crisis resolution mechanisms) and (2) symmetric shocks (coordination or common budget)[7], and (3) enhancing the resilience of financial sector to systemic financial crisis (safe asset and banking union with a fiscal backstop). It should be seen as a complement rather than substitute to measures directed that seek to fill the gaps identified in the last section.

Policy coordination

Policy coordination is sometimes compared to the Loch Ness: an animal often discussed but rarely observed. What makes Europe different from other countries when it comes to coordination is that the high degree of trade and financial integration may warrant some coordination because of the risk of contagion and beggar-thy-neighbor policies. The need to create strong mechanisms for policy coordination rests on the well-known collective action. Without cooperation, the aggregate fiscal policy stance would end up being less expansionary than desirable. In practice, coordination is complicated to achieve, notably because the gains from coordination widely depend on the initial state of the economy and are difficult to internalize in the short term.

In normal times, monetary and fiscal policies interact with each other: a loose overall fiscal stance tends to put pressure to tighten monetary policy and vice and versa. During times of crisis, we have learnt that the role of fiscal policy gains prominence as monetary policy is constrained by the zero bound and ineffective to boost demand in countries where the monetary transmission channel is broken. The question of coordination of the overall Euro area fiscal stance becomes crucial under these circumstances given that the effect of positive fiscal policy spillovers through the demand (import) channels (Auerbach and Gorodnichenko, 2013). These externalities are however unlikely to be taken into account by national fiscal authorities given the incentives to free ride on others. The result is a suboptimal level of fiscal stimulus. For instance, many observers have pointed that the overall fiscal stance of the EMU could have been less contractionary should have Germany used its fiscal space in order to support aggregate demand in the EMU, hence compensating for the depressing and deflationary effects of consolidation in countries carrying out adjustment of their external balance. Coordination failure can explain part of the pro-

[6] The federal budget in accomplished federations plays an important macroeconomic stabilization role, even though the role of credit markets is larger. In the euro area, consumption smoothing is essentially obtained through the international lending and borrowing (Furceri, 2013).
[7] See Alcidi and Thirion (2015) for an extensive review of the policy spillovers within the EMU.

cyclical behavior of fiscal policy during the crisis. Similarly, the fiscal policy stance has appeared significantly expansionary in the EMU during the 'good times' (Alcidi et. al, 2016) pointing to a lack of commitment to create fiscal buffers during the upturns.

Cross-country fiscal risk sharing

Cross-country risk sharing [8]and consumption smoothing arrangements take an additional degree of relevance in monetary union because monetary policy is no longer able to respond to temporary country-specific shocks, since the euro area monetary policy is based on the fundamentals of the aggregate situation. Similarly, downward wage and price rigidities and limited labor mobility (Barslund, 2015) affect the way asymmetric shocks are absorbed. All this points to domestic fiscal policies as the central policy tool to handle asymmetric shocks in a monetary union. However, as showed above, a country capacity to be counter-cyclical tends to be particularly restricted during large crisis, when countries find it particularly difficult to borrow to smooth consumption.

To some extent, European Central Bank liquidity provisions, official cross-country flows (TARGET2 settlement mechanism), and the ESM have contributed to compensate the lack of credit provided by private credit markets at the height of the crisis (Cecchetti, et. Al. 2012). However empirical evidence shows that cross-country risk sharing is only roughly half the one of the US (Furceri and Zdzienicka, 2013) and has collapsed during the crisis. Hoffman and Sorensen (2012) have pointed out that that risk sharing in the US mostly occurs through private mechanisms, in particular via capital markets, and suggests that the completion of the banking union and capital market integration should be the priority rather than a fiscal union.[9] Farhi and Werning (2014) suggests that theoretically, there is no tradeoff between private and fiscal risk sharing. They argue that fiscal risk sharing in a monetary union is needed even with complete financial markets. The argument is that private agents do not purchase the efficient amount of private insurance because they do not internalize the positive externalities form macroeconomic stabilization effects of their portfolio choices. In addition, Allard et a. (2015) points out that contagion and spillover effects in the face of self-fulfilling crises are better addressed with a fiscal backstop. Overall, having a minimum degree of fiscal risk sharing should also help preserve the social fabric of the country hit by

[8] There seem to be confusion about the strict meaning of the term "risk sharing" in the policy debate. We chose to adopt a broad (or loose) definition of fiscal risk sharing, and refer to it for all the policy instruments that imply international pooling and/or transfer of resources among sovereigns and joint guarantees like commonly issued debt, even though for the latter risk sharing only occurs ex-post (after default). However, Asbrudali (2005) emphasizes that "a clear distinction must be drawn between risk sharing channels that provide ex ante insurance and channels that provide intertemporal smoothing ex post. Government smoothing, or fiscal stabilizers, may include both types: some activities are pre-arranged but others may take place ex post."

[9] Gros and Belke (2015) argue that risk sharing through a well-functioning banking union and capital market union may be sufficient to absorb losses from most financial crises, without the need of a fiscal union, provided that the a common system of deposit reinsurance is in place. Others (Gern et al., 2015), argue that making the system more resilient would reduce the need for risk sharing since it would reduce the risk of shocks.

an adverse shock, and should prevent country-specific shocks to spill over the other member states, thus reducing the risk of an ex-post bailout program and making the no-bail out clause potentially more credible.

Most of recent policy discussions have focused on the need for a *fiscal stabilization mechanism* that would be triggered by well-defined events agreed upon ex-ante. Leaving aside the general debate about the effectiveness of fiscal policy measures in stabilizing the economy [10]along the cycle, the purpose of a fiscal stabilization mechanism starts with the observation that the assumption that international financial markets could allow governments to pursue fiscal stabilization in all circumstances is erroneous, even for fiscal prudent countries. In a monetary union, the repayment of sovereign debt is similar to a payment abroad when regional governments do not have control over the currency in which their debt is issued. Without the possibility to monetize, member states are more prone to liquidity issues (ie sudden stops) when an asymmetric shock hits (De Grauwe, 2013). Thus in a monetary union lacking a budget backed by lender of last resort guarantee, markets can push member states into a bad equilibrium in which liquidity issues can become solvency issues because of financial markets fears of insolvency. If a country is pushed into a bad equilibrium, the problem becomes similar to a balance of payment crisis: the current account deficit can no longer be financed and it will need to adjust its external account through internal devaluation. Authors (eg Obstfeld, 2013) have argued that the risk of exit and of sudden stops remains a significant concern, which is not fully addressed by the European Stability Mechanism and OMT procedure (Tabellini, 2016). The argument is that to be sustainable in the long run, the monetary union needs stronger risk sharing mechanisms, in particularly in extreme circumstances, such as sudden stops and systemic financial crisis where risk sharing has been close to zero during the sovereign crisis (Furceri and Zdzienicka 2013, D'Imperio, 2016., and Alcidi and Thirion, 2016).

[10] Blanchard and Leigh (2013) have pointed out that multiplier effects during crisis times have been systematically underestimated. Auerbach (2013) finds that fiscal stimuli are particularly effective when they consist of increased government expenditures and target consumers with a high propensity to consume (such the unemployed – see EUBS), and when the zero lower bond is constraining monetary policy.

3. The building blocks of a Fiscal Union (II): official positions and proposals

The European policy debate around a fiscal union has thus far focused on four main (broad) elements that could be seen as different building blocks of a fiscal union, and reflect the various theoretical underpinnings discussed previously:

- Crisis resolution mechanisms
- Rules, coordination and risk reduction
- Common debt issuance
- Fiscal insurance and Stabilization funds

Our discussion will address the three latter elements. We do not cover the crisis resolution mechanisms, the OMT and ESM, which are already in place. The different proposals for a fully-fledged banking union (including a fiscal backstop) will also be left out of the analysis since the banking union is currently being designed. These mechanisms are however crucial complements of a fiscal union, and can eventually have fiscal risk sharing consequences ex-post in the event that a sovereign doesn't meet its obligations (e.g. defaults).

Table 1 presents a summary of the key elements suggested by key proposals (in the same vein as Fuest et al. (2015)). The rest of this section first focuses on the official proposals, and discuss the position of relevant institutions and governments. The second part assess some of the most relevant proposals to the policy debate around fiscal integration.

Table 1: propositions for a fiscal Union in Europe (adapted by the authors from Dolls, 2014)

	Crisis Resolution Mechanism	Rules, Coordination, Monitoring	Joint Guarantee for Government Debt	Insurance and Stabilization
CEPS De Grauwe, Moesen (2009)			X	
CEPS – Gros, Mayer 2010	X			
Bruegel - Gianviti et al. 2010	X			
Bruegel - Delpha, Weizäcker 2010			X	
European Commission 2011, 2012		X	X	X
Bofinger (2011)			X	
Van Rompuy 2012		X		X
Enderlein et al. 2012			X	X
Belke 2013		X	X	X
Bordo et al. 2013			X	X
Cottarelli 2013		X		X

Enderlein et al. 2013				X
IMF – Furceri, Zdzienicka 2013				X
IMF - Allard et al. 2013		X	X	X
CEPR - Corsetti et al. 2014		X	X	
Gros – 2014				X
CEPS – Beblavi, Gros, Maselli 2015				X
Dolls et al. 2015	X			X
Fuest at al. 2015	X			
Juncker 2015		X		X
Bruegel – Benassi et al. 2016				X

3.1 Positions of main institutions in the fiscal union debate

The Van Rompuy report (2012) includes some important proposals for further risk sharing and shared sovereignty at the same time. It laid out a roadmap to a “deep and genuine economic and monetary union” with a common EU fiscal budget, common debt issuance, and fully-fledged banking union. The new fiscal capacity would include an insurance system set up at the central level, where each country would contribute or receive transfers on the basis of its position in the business cycle, on the condition of implementing reforms. This report was a first and important step into the debate on the fiscal integration, and was shortly followed by the Commission ‘Blueprint for a deep and genuine EMU’. The latter proposed a specific timeline for future governance reforms. Steps towards a deeper EMU were scheduled to be sequenced in three phases:

- Short term (within 18 months): implementation of the new economic and fiscal governance framework, and adoption of proposals for joint banking supervision and resolution, and the creation of an instrument to foster economic reform in the member states.
- The medium term (up to five years): Deeper economic and budgetary integration, with the creation of a common fiscal capacity, and common short term debt issuance (as well as a common redumption fund and direct budget surveillance).
- Long term (More than five years): Adds the building of a common deposit insurance scheme and the implementation of a fiscal stabilization mechanism to stabilize asymmetric shocks. The issuance of common bonds would gradually move forward longer-term maturities.

The 'Five Presidents Report' issued in June 2015, which built upon the 'Four Presidents Report' (2012) and the Commission's 'Blueprint' (2012)[11] welcomed the significant improvements made to strengthen the economic governance framework, and proposed the creation of an advisory 'European Fiscal Board' to coordinate and complement the national fiscal councils. Interestingly, the EC idea of European Redemption Fund and a move towards direct national budget controls was not followed, and no mention of debt mutualisation was made. The report reiterated the need for a euro area-wide *fiscal stabilization function* to deal with severe crisis, which *should* rest on the following guiding principles:

- It should not lead to permanent transfers between countries;
- It should not undermine the incentives for sound national fiscal policy-making;
- It should be developed within the framework of the European Union (ie within the EU budget);
- It should be an instrument for crisis management;

On October 2015, the European Commission communicated the decision to establish an independent European Fiscal Board, with the mandate of providing an evaluation of the implementation of the EU fiscal framework. In particular, the Board should check the cross-country consistency of the commission's decision and implementation of the budgetary surveillance, promoting fiscal coordination as a way to achieve an appropriate fiscal stance for the euro area.

As for the European Parliament's position, the Special Committee on the Financial, Economic and Social Crisis (CRIS) established by the European Parliament, concluded in 2011 that the EU needs a budget of sufficient size to accommodate the euro in a sustainable way, recalling that preceding reports suggested the creation of an EU budget between 2.5 and 10% of Union GNI. They proposed (among other measures) the possible mutual issuance of sovereign debt and Eurobonds, as a way to stimulate fiscal discipline and achieve a better balance between economic and social policies.
Recent European Parliament reports stressed that any new specific fiscal capacity or budget for the euro area must be financed over the EU budget and be developed within the Union framework, to allow proper democratic scrutiny and accountability. In particular, the EP proposed the creation of two separate instruments: a 'euro area fiscal capacity' based on specific own resources, able to assist member countries in the implementation of agreed structural reforms; and a 'shock absorbing mechanism' with temporary transfers among member countries, able to reduce the business cycle variability.

Despite the fact that the technical challenges to establish a fiscal capacity in the EMU could be overcome support for the creation of a budgetary capacity for the euro area (as

[11] The document was prepared by the European Commission President Jean-Claude Junker in collaboration with presidents of the European Council, the European Parliament, the Eurogroup and the ECB.

proposed with different options by the European Institutions) is however much more limited among the national governments. Instead, the debate at the national level has so far been centered on the idea of a European Finance Minister, a strong political authority with the mandate of safeguarding the economic interests of the Eurozone as a whole, against national interests. In particular, the German position is closer to the principle of shared sovereignty because of moral hazard concerns due to the pooling national tax revenues. For instance, the Germany finance minister Wolfgang Schäuble and Jean-Claude Trichet, former president of the European Central Bank (ECB), have advocated the introduction of a European Finance Commissioner or Minister with veto power over national budgets. An EU treasury minister would supervise the budgetary policy of member states, and could impose sanctions. Consensus is much more limited on a risk-sharing approach, were the European Finance Minister would have a discretionary power over a Eurozone budgetary capacity, with the goal of buffering regional shocks. On the other hand, the French[12] and Italian[13] governments have officially supported a risk sharing approach.

Beyond Europe, the International monetary Fund, which was involved in bail-out programs as member of the Troika, has also suggested the creation of a fiscal capacity for Europe (eg Allard et al. (2015), Furceri and Zdzienicka (2013). Allard et al. (2015) identify key "minimal elements' for a fiscal union in the euro area. It suggests better oversight and incentives to prudent fiscal policy based on systematic carefull application the new Fiscal governance rules. They argue for an area-wide fiscal backstop for the banking sector, that should primarily be financed by the banking sector but should also be supported by a credit line from the ECB or alternatively by common fiscal resources in case of a systemic crisis. The report also advocates the creation of a fiscal risk-sharing device and public goods provision; although they remain vague on the form the latter should take (i.e. unemployment insurance, a rainy day fund, or a common budget). Finally, they also highlight the necessity, in the longer run, for common debt issuance, which would not only create a safe asset but could also be used to finance a fiscal stabilization mechanism and a fiscal backstop to the banking union.

3.2 Review of key proposals from academia and think tanks

At this point it is interesting to distinguish proposals for reforming the EMU between those related to 'shared-sovereignty' and those involving some type of resources pooling or sharing. While the two approaches are complementary and jointly acknowledged in most

[12] Macron declared in August 2015 that "The Eurozone needs new institutions to which national governments transfer sovereignty: a strong European economic government with its own budget" and that "it could ensure, for example, necessary financial transfers if a country is in crisis, or push through reforms to avoid discrepancies between our economies"

[13] Renzi made a recent proposition for a better functioning EMU: http://www.governo.it/sites/governo.it/files/ASharedPolicyStrategy_20160222.pdf

cases, proposals also tend to reflect a different assessment of the origin of the crisis, and some political preferences for one type of integration over the other. In this respect it is important to stress that however strong the economic rationale for further fiscal integration, it will always need to be weighted against concerns such as national sovereignty (Begg, 2009), and generally limited willingness to share resources and to relinquish sovereignty over domestic policy.

Shared sovereignty is mainly about building upon the current (complex) rules based system of fiscal policy coordination. It includes reinforcing the supervision of national budgets by lending more intervention power to EU institutions, notably by introducing an EU minister with veto power over national budgets and possibly coordinating the overall fiscal stance. Fiscal rules and policy coordination seek to play a strong ex ante role by reducing the risk negative shocks, but also help responding to large more symmetric shocks that require joint fiscal action. Another approach consists of pooling resources, not only policy decisions. These mechanisms, which can have an ex-ante or ex-post nature, are mostly concerned with the existence of shocks that tend to propagate through the whole Euro Area, and can eventually put at stake the stability of the monetary union as a whole (eg a sovereign debt crisis). It aims at creating common buffers and preventing shocks from spilling over Europe and threaten the stability of the system.

3.2.1 Shared sovereignty: Rules, coordination and risk reduction

By and large, proponents of shared sovereignty support the introduction of stronger EU institutions in charge of fiscal policy supervision of national budgetary policy coordination. The EMU was founded around elements of a fiscal union of such type (rules), with the Stability and Growth Pact that required to abide with deficit and debt level rules. This was accompanied by an excessive deficit procedure, that could lead to sanctions. Recent reforms of the SGP has extended this type of coordination and supervision with the Six-Pack, and the Fiscal Compact was introduced to introduce balanced budget rules at the national level. Nevertheless, while such constraints are necessary, and better market discipline should prevail in a monetary union, stronger fiscal rules would not have been sufficient to prevent to sovereign debt crisis (eg Ireland and Spain), notably because the large degree of integration in EMU means that shocks can be transmitted extremely easily and lead to contagion. In addition, enforcement is also likely to remain an issue, as seen in the past with the SGP, and now with the flexibility approach to the Fiscal compact rules.

The intention to pursue these objectives has been mirrored in recent debates by Schauble and Trichet (2011) who spoke out in favour of a European Commissioner or Finance Minister that has veto power on member states budgets. Such arrangement would allow the person in charge of EMU public finances to supervise the budgetary policy of member states, and possibly enforce sanctions in case of resistance by sovereigns to adopt the required fiscal policy stances.

In the same vein, the 'Five President' report formally proposed the creation of a European Fiscal Board, as initially proposed by the Bundesbank (2015) and the ECB (2015)[14]. The European Fiscal Board will act as a watchdog on national public finances to the extent that it would receive the task to pass budgetary assessments independent of political considerations. The board will comprise five members with the task to assess fiscal developments in the whole euro area, and to identify the exceptional circumstances under which policy coordination should prevail in order to ensure an appropriate euro area fiscal stance. It will also reinforce the role of the independent national fiscal councils that were established by the Fiscal Compact by providing an independent assessment of how national budgets perform with respect to the euro area-wide policy objectives. One important role of type of coordination is that *it could make fiscal policy 'rules' more symmetric*. In particular, during particularly good times, it could recommend member states to run fiscal surpluses and make fiscal space for the bad times. It would thus provide independent guidance as to what policy stance has to be adopted during exceptional economic circumstances, and on the distribution of the effort across member states. This closely relates to the idea of internalizing the spillovers of fiscal policy via coordination of fiscal policy.

Although effective ex-ante and ex-post coordination appears to be theoretically desirable, a closer scrutiny reveals some serious practical challenges to its feasibility. As argued by Alcidi et. Al (2015), the design of effective ex-ante policy coordination is a very difficult task, partly because spillover effects are likely to depend on the state of the economy and several transmission channels can be at work at the same time. On the other hand, while ex-post coordination may react to economic circumstances in a more flexible manner than ex-ante coordination it can be a complex and costly process, particularly from a political point of view. This suggests that ex-post coordination is likely to fail unless gains from coordination are very large. One example highlighting the difficulty is the reluctance of Germany to use its fiscal space in order to support the euro area fiscal stance. In addition, relying on such policies may run in contradiction with the essence of fiscal rules, since asking Germany to increase fiscal discretionary spending during the crisis is akin to ask them to pursue pro-cyclical policies.

In academic circles, Fuest and Peichl (2012) are highly skeptical of any further fiscal integration steps. They point out that the lack of possible political integration in the medium run implies that further fiscal integration would not be successful. Hence, they propose to get back to a decentralized fiscal system, with decentralized responsibility for sovereign debts, and advocate financial reforms in order to decrease the risk of shocks. This approach, is also to some echoed by proposals by the Academic Advisory Board of the Federal Ministry

[14] Majocchi (2013) proposed the introduction of a European Treasury, under the direct control of the Parliament, but independent from the other institutions (ECB and the national governments). 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

of Finance (2010, 2012) that argue for policy efforts to diminish risk as opposed to risk sharing institutions.

Finally, it is important to add that most proposals that propose some fiscal capacity for the EMU have also argued for stronger rules and mechanisms to coordinate policy in order to reduce the risk of moral hazard associated with pooling resources.

3.2.2 Instruments to 'share' fiscal risks

Two key types of possible (largely complementary) elements of a fiscal union with the objective of increasing fiscal risk sharing have been proposed:

- The issuance of common debt.
- Fiscal stabilization/insurance device

While both mechanisms are arguably rooted in strong economic theory foundations, they can also lead to moral hazard incentives for member states. This is why they need to be complemented by strong rules.

Common debt or centralized debt instrument

The idea of having some form of centralized debt instrument that allows taking advantage of risk pooling is not completely new in the EU. In practice, the ESM is a form of collectively guaranteed borrowing scheme to lend money to distressed member states, but with a conditionality component to it. In the same vein, the European investment Bank also borrows by using member state guarantees in order to fund investment projects throughout Europe. This suggests a certain market appetite from to provide funding for collective euro area wide borrowing needs. The motivation for the various proposals for the creation of safe common EU bond is to ensure the government's capacity to finance fiscal stabilization policies in the event of adverse swings in risk premia. In addition to this, creating a safe and liquid asset would also enhance financial market stability and reduce the risk of negative feedback loops between sovereigns and banks.

A number of proposals have called for the introduction of so-called 'Eurobonds'. Eurobonds are securities commonly issued and backed by all member state. Depending on the setup, the aim is to lower the average interest paid and/or to restore market access for those countries in financial distress. However, with the creation of the Eurobonds, countries lose the market signal on their fiscal behaviour, a crucial incentive for sound fiscal policies. Moreover, as stressed by the European Commission (2011), the creation of Eurobonds 'would have to be accompanied by a substantially reinforced fiscal surveillance and policy coordination as an essential counterpart, so as to avoid moral hazard and ensure sustainable public finances'.

Right after the beginning of the financial crisis, De Grauwe and Moesen (2009) proposed the introduction of a Eurobond for the euro area, issued by the European Investment Bank (EIB). Each government would participate on the basis of its equity shares in the Bank. Interest rates on the Eurobond would be calculated as the weighted average of the yields observed in each government bond market at the moment of issue and proceeds channelled using the same weight. With this setup, countries do not obtain a reduction on the interests paid, but market access is restored for those economies in financial distress shut out from the market.

Enderlein et al. (2012) suggested the implementation of a European Debt Agency (EDA); not a fully-fledged finance ministry or treasury, but a flexible instrument able to facilitate debt issuance in normal times and assist countries during short-term financial market pressure, against some conditionality. The Agency would be jointly and severally guaranteed by all euro area countries. In normal times, sovereigns would issue a fixed share of debt through the EDA, benefiting from a lower interest rate on average. Member countries would continue to issue the rest of the debt as national. Should a country be affected by a financial crisis, it would be allowed to increase the share of debt financed through the EDA until a certain amount and, under increasing conditionality, to higher amounts.

The ‘Blue-Red bond’ proposal was made in 2010 by Delpla and Von Weizsäcker. The main idea is to mutualise the first 60% of national debt to GDP through the issuance of a common ‘blue-bond’, which benefits from joint and several guarantees of the member states. The remaining amount of debt, so called ‘’red-debt’’, continue to be issued by national governments, with higher costs reflecting the creditworthiness of the issuing country. In this framework, countries face reduced debt costs and fiscal discipline is preserved, as governments have a strong incentive against the issuance of debt beyond 60% of GDP.

Bofinger et al. (2011), following the 2011 report of the German Council of Economic Experts, proposed the implementation of a European Debt Redemption Fund. The key idea is to divide the stock of debt accumulated by member countries in two parts. The part exceeding the 60% of GDP, should be refinanced through the Redemption Fund, which benefits from the joint guarantee of all the member states. While each country will have to service its own share of debt transferred to the Fund, the joint liability should allow a strong reduction of the costs linked to debt, facilitating the reduction of the stock of debt overtime. The fund has the scope of reducing the debt burden of over-indebted member countries (at least) to the 60% debt-to-GDP ratio, would have a limited duration and would require strong commitments from member states.

Given the political difficulties associated with joint guarantees, the Euronomics group (Brunnermeier et. al. 2011) suggest the creation of a European Debt Agency (EDA) with the goal of issuing a European Stability Bond (ESBies) without public guarantee. The new EDA

would buy sovereign bonds of member states according to their size and use these bonds as collateral to issue two securities: the ESBies and a second security with junior claim. The ESBies would be a senior claim on the payments from the sovereign bonds held in the portfolio, while the junior security would absorb the first losses. The ESBies would be the new safe asset, while the second security would be used to hedge (or speculate) on the member countries ability to service their debt. This proposal do not involve any joint guarantee by member states and, according to the authors, should reduce the need for a fiscal union. The EDA would makes use of financial engineering to create a safe and a junior security asset, backed by national bonds. This should reduce the likelihood of future sovereign debt crisis, avoiding the ''flight to safety'' from a sovereign to another, in a setup where investors would move from a security to another, without affecting the countries' fiscal sustainability. Beck, et al. (2011) proposed the creation of a Synthetic Eurobond, similar to the ESBies but without the junior security tranche able to absorb the first losses.

Fiscal stabilization device

The elements of a fiscal union discussed so far can only lead to real transfers in the case where a country fails to meet its obligations (default). Recently, the debate has been extended to different types of macroeconomic stabilization mechanisms introducing a system of international fiscal transfers that could serve as an insurance mechanism against asymmetric shocks. The issue to be tackled is that in a monetary union, member states cannot use monetary policy to react to asymmetric shock: they can only react via fiscal policy, but in period of recession, governments may not be able to fund fiscal stabilization policies as their access to funding may become restrained by market pressure. As a result, the amount of shocks to GDP smoothed during crisis is lower than the one smoothed during normal times. As observed during the crisis, this can threatens the stability of the whole eurozone. In such context, strong rules and coordination efforts may not be sufficient to prevent shocks and ensure an appropriate response: a fiscal risk sharing mechanism may be needed to ensure against this risk.

The idea of such scheme, is that during 'normal times' countries would pay contribution into the system and be forced save the fiscal windfalls during good times, while insurance is provided to countries that experience bad times so that they can smooth the cycle. An additional objective of some of these schemes (eg Enderlein et al. 2012) is to foster the convergence of the business, hence, improving the effectiveness of monetary policy.

Following Hammond and Von Hagen (1995), Furceri and Zdzienicka (2013) put forward interesting 'optimal features' of a possible stabilization mechanism:

- The mechanism should be simple and automatic.
- Contributions to the stabilization fund and transfers should be non-regressive.

- Transfers should be temporary and shall be restricted to provide insurance against temporary shocks or, when permanent, should be used only temporarily.
- Transfers should be tied to serially uncorrelated shocks so to reduce the risk that transfers can be manipulated by member countries, therefore reducing moral hazard problems.
- The scheme should be able to offset a large part of the shock (see Gros 2013) to avoid implementation costs to outweigh the benefits.

However, as the authors point out, these features cannot be satisfied simultaneously which implies that sort of trade-off should be considered. In particular, the effectiveness of such mechanism crucially hinges on the choice of a robust trigger for disbursement and contributions. On the one hand, the trigger (which somehow needs to reflect countries position in the cycle) must ensure contribution neutrality in order to ensure the long term fund sustainability and its political acceptability. Alternatively, some types of clawback mechanisms can be designed. On the other hand, it is paramount that the measure is available in real time, and ideally cannot be easily manipulated in order to identify the position of a country in the business cycle, and to measure in real time who is net contributor or recipient. This raises the difficult question of the ex-ante identification of the shocks (symmetric or asymmetric, supply or demand), and whether their nature provide justification for international transfers.

The *macroecoeconomic approach* to the design of such scheme measures the cycle such as the output gap or GDP growth forecasts. For instance, member states are net contributors to the fund when the output gap is positive, and net recipient when the output gap is negative. The most discussed proposal for a macro fiscal capacity was presented by the Tommaso Padoa-Schioppa Group of thinkers (Enderlein, 2012) who have proposed a roadmap towards fiscal federalism in EMU. They propose a 'cyclical shock insurance fund' to provide automatic macroeconomic fiscal stabilization in the face of country specific shocks. The fiscal insurance mechanism would be based on the national output gaps relative to the euro area output gaps where the fund would be under control of the national parliaments. Hence, countries experiencing an output gap higher than the euro area average, would have to pay into the fund, even during periods of negative output gaps while countries with lower relative output gaps would be recipient.

The idea behind the authors' proposal is that single monetary policy can have a procyclical effects *if inflation differentials persist* due to weak price and wage adjustments and labour mobility. In such case, real interest rates are systematically too high or too low for certain economies. They argue that such mechanism would substantially alleviate the procyclicality of the ECB's "one size fits all" monetary policy because it will lead to a synchronization of the business cycle.

One feature of their proposal is its ‘inter-country’ risk sharing nature in the sense that using relative output gaps prevents the system to run surpluses or deficits, hence it presents the advantage that surpluses or deficits are not carried over. From the point of view of overall fiscal stabilization, such system based on relative output gaps may however pose problems if the ECB happens to be unsuccessful at stabilizing the overall business cycle [15]in the Euro Area. In particular, if the average output gap were significantly larger or smaller than zero since member states with positive (negative) output gaps would end up potentially receiving/contributing procyclical transfers during upturns (downturns), which is likely to add political tensions. In such case, it would likely fail to stabilize the fluctuations in national business cycle. An additional concern is that the degree of (relative) demand stabilization achieved would eventually depend on whether the governments do use the extra fiscal space available to carry public spending or fund tax cuts that would stabilize aggregate demand.[16]

In fact, if the average euro area output gap is zero and the shocks are randomly distributed, the system (1) never runs deficits or surpluses (neutrality) and (2) leads to more macroeconomic stabilization on aggregate, and (3) fosters convergence in the member states business cycles and facilitate the effectiveness of monetary policy. However the three objectives cannot be reconciled if shocks are not randomly distributed or the overall output gap is significantly different to zero.

As an alternative, fiscal insurance mechanisms based on *micro indicators* are considered by other proposals as they allow directly stabilizing households incomes in the event of negative shock affecting a specific variable. Dullien (2007; 2014) has been one of the early advocate of the microeconomic approach to insurance. He proposes to establish a euro area wide benefit unemployment insurance scheme, where the common unemployment fund would distribute transfers automatically and directly to EU citizens (under pre-defined criterion) in order to stabilize consumption in the face of a downturn. Such scheme would thus be an automatic stabilizer that enables counter-cyclical policy action without political intervention.

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[15] This may happen for a number of reasons, including the zero bound constraint or issues in the transmission of monetary policy.

[16] In a policy paper refining the implementation of the initial proposal, Enderlein et al. (2013) propose a simulation exercise that suggests almost all EMU founding countries would have been close to a net zero financial position at the end of the simulation period. They stress that the average standard deviation of member states output gaps from the eurozone aggregate output gap would have been 39.4% lower than what has been observed over the past 14 years

Further to the creation of the fun, they advocate an expansion of the redistributive role of the EU wide budget by increasing the own resources of the EU budget, propose the creation of European Debt Agency that would issue jointly guaranteed debt in order to provide the EMU financial sector with a safe asset and liquid asset, and to ensure access to financing for sovereign that could be prone to self fulfilling solvency crisis. Finally, they also suggest to reinforce the common regulatory framework, improve supervision, and to create a deposit insurance in the banking sector.

Under such system, transfers would be limited to a maximum of one year, and recipients would require to be insured by the system for a period of certain amount of months before being unemployed. Benefits would be determined by contributions based on wages, and governments would be able to top up the benefits or to increase coverage. Dullien (2014) argues that such system would ensure that the scheme's generosity is automatically in line with country's GDP per capita, and would allow for a large degree of discretion over national social policy. At the same time, it should ensure that member states do not shift the cost of longer term unemployment to the EU fund.

One potential issue with such mechanism, is that mutual insurance runs into trouble if endogenous asymmetric shocks are not prevented. These are shocks that result from the policy itself as member-states pursue fiscal or structural policies leading to permanent divergence such as large imbalances. Similarly, the system runs into problem when all the countries experience a downturn since the system can no longer be funded. The schemes presented are therefore strictly restrained to asymmetric shocks. Recent research led CEPS (Beblavy et. al. forthcoming) is currently considering additional types of mechanisms, that could use a claw-back system as to avoid permanent transfer, and consider scenarios where some common debt can be issued.

In addition, it should be noted that if harmonization of social policy is a pre-requisite for a successful EUBS, it may well be a largely more challenging task to achieve due to political resistance to modify their social standards. Equally important is that the contribution to the mechanism have to be sufficiently large so that it can provide buffers to large economies (or a group of small interconnected countries), while not being a strain to the member states own ability to carry out their independent economic policy.

A central question that has remained open in the debate relates to what types of shocks should be insured by such mechanism. In this respect, Gros (2014) has made the proposition that such contingence insurance mechanism would be the most helpful if it protects against shocks which are rare, but potentially catastrophic, such as those that can make constrain national fiscal policy to provide fiscal stabilization (due to high debt levels and high risk premia on government bonds). Thus, since in normal times cyclical shocks are more minor and do not impair the functioning of financial markets, stabilization should be dealt with via borrowing at the national level. In case of large shock, the fund would then support the national system in countries where the unemployment rate has increased suddenly above a certain threshold. A proportion of the unemployment compensation cost would thus be refunded by a common Eurozone fund, which would be financed by yearly premiums of 0.1 pc each year until the level of 0.5 pc is reached. This argument seems to have gained prominence in the debate, has reflected by recent proposals (eg Benassy-Quere et. al. 2016)

Finally, Dolls et al. (2015) propose a fiscal union that would reconcile the necessity to create a fiscal insurance mechanism with market-based discipline. For this purpose, their proposal include a debt restructuring procedure in case of insolvency and stronger rules. They argue that fiscal insurance is complementary to the creation of an insolvency procedure for member states because fiscal insurance limits the stability risk associated with an insolvency procedure, while the insolvency procedure helps avoiding the risk that the fiscal insurance scheme for asymmetric shocks turns into a permanent transfer device.

4. Concluding remarks

This paper considered the different elements of fiscal integration advocated in the debate after the euro area crisis. From this analysis, we can conclude that:

1. The case for a fiscal union should not be examined regardless of the other key pillars of economic policy. In particular, we have highlighted the necessary and complementary roles of structural policies and labour mobility, mechanisms for risk prevention, and efficient rules to ensure prudent fiscal policy along the cycle. A great lesson from the crisis is that imbalances matter, and that better surveillance is crucial. However, the nature of national fiscal policy in EMU implies that additional mechanisms for fiscal sharing could have important stabilizing effects, even taking into account the recent establishment of the ESM and the first steps made towards a banking union. Its potential benefits crucially depend on strict enforcement of rules and mechanisms to reduce moral hazard.
2. A certain academic consensus seems to emerge around to the need to endow the EMU with a fiscal capacity able to ensure against asymmetric shocks. EU institutions and the IMF also support this view, and it appears that the option of linking it to short-term unemployment shocks is being favoured in the debate. Significant challenges remain, however, as to how to formally design such scheme (e.g. the size of the shocks to insure against, the possibility to issue debt, a claw back system…). Similarly, a majority of proposals recognizes the potential benefits of common debt issuance. In both cases, the central challenge is to reduce the risk of moral hazard, and prevent permanent transfers to prevail.
3. While EU institutions and the IMF are broadly in line with the leading academic views, national government are more reticent to move towards further fiscal integration, even though the Italian and French governments have officially advocated the need for a fiscal union. Other countries, led by Germany, seem to prioritize shared-sovereignty approach over instruments that involving pooling more resources. In any case, it should be remembered that legitimacy issues will be extremely difficult to manage should we move toward a fiscal union. The question remains whether citizens will accept to give up further national sovereignty.

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