europeG
Opinion and Discussion Group on Political Economy

Is the European Union really moving toward a Fiscal Union?

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1. Introduction

The euro crisis has put progress toward a fiscal union at the centre of the European debate. At first reluctantly, then ever more clearly, a fundamental consensus seems to have been reached on the need to move toward this fiscal union and on the idea that there will be no monetary union if it is not accompanied by fiscal union.

In fact, on 2nd March 2012, this apparent consensus resulted in the so-called Fiscal Compact, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), signed by twenty-five of the twenty-seven European Union member states, i.e. all except the United Kingdom and the Czech Republic. It is, therefore, a new intergovernmental treaty, that must be set alongside those which created the current structure of rules and institutions that rule the European Union, and it obviously cannot be understood or make sense without them, though in formal terms it stands outside the European Union itself.

This is the founding treaty of the new fiscal union, which has been preceded by many agreements and arrangements, starting with the Treaty of Maastricht and subsequently the Stability and Growth Pact, which established the deficit and public debt conditions with which member states should comply, and the procedures to be followed in situations of excessive deficits. At this time, the member states are in the process of validating the treaty and, together with the Commission, developing the various regulations that must be approved for its full implementation. In this context, in the next section of this Policy Brief, we propose to examine the current situation: the absence of fiscal union as one of the causes of the euro crisis, the basic contents of the TSCG, the proposals that are on the table and the lessons to be drawn from historical experience on the relationship between monetary union and fiscal union. In the third section, we make some proposals and recommendations on what, in the opinion of EuropeG, should be the contents of a fiscal union.

2. Euro crisis and progress toward fiscal union

The absence of fiscal integration: one of the fundamental causes of the euro crisis

2.1. Requirements of a monetary union

The sovereign debt and euro crises provide stark evidence of the consequences of an incomplete monetary union. Some already warned of this at the time and today everyone seems to agree. The fact is that reality tells us beyond any doubt that when the monetary union occurred, the conditions for an optimal currency area were not fulfilled. There are essentially two conditions.

In the first place, there must be sufficiently integrated markets and sufficient mobility of factors in order to facilitate a certain degree of convergence between the competitiveness of the member states of the monetary union (Box 1).

Secondly, monetary integration must be accompanied by an appreciable degree of fiscal integration, which is not possible without the corresponding political integration. This integration should be based on two institutional pillars which are extraordinarily weak in Europe at the present time: the budget and the Treasury. These are institutions that only acquire meaning if they exist together, because the role of the Treasury is to issue the debt required by the central ('federal') government budget, and the best guarantee

that the debt can offer its creditors is precisely the strength of the resources funding this budget.

A single currency is not possible without a budget and a 'federal' Treasury. In fact, it should be remembered that this was, at the time, the basic argument of those from the academic world (especially in the US) who were most critical (and pessimistic) about the design and implementation of the single currency. At that time no one wanted to listen to these voices, which were attributed to political animosity towards the emergence of a formidable competitor to the dollar as the leading global currency. This is a frequent error: the failure to give serious consideration to the arguments of those who criticize our approach, due to the conviction, perhaps correct, that these criticisms are politically motivated.

It should be noted that, according to other light versions, which we will discuss later, fiscal union does not necessarily need to include the budget pillar (and the consequent fiscal resources) characteristic of a 'federal' government and can be based solely on two components, combined with varying proportions: member states' budgetary discipline and mutualization of debt. The key question today, which is precisely the fundamental purpose of this *Policy Brief*, is what must be the characteristics of this fiscal union, which is essential to put an end to the crisis of the monetary union.

2.2. The role of the 'federal' budget in a monetary union

In the monetary unions which actually exist, fiscal integration means integration of the budget and the Treasury in the same area in which there is monetary integration, i.e. the eurozone in our case.

In such unions, the central government budget has three basic functions. The first is the stabilisation or anti-cyclical function. When a territory (whether it be rich or poor) experiences a particularly severe contraction in economic activity compared to the other member states, as a result of asymmetric shocks, and/or temporary divergences in the phases of the cycle, the central government budget tends to offset it automatically through the automatic stabilizers.

Box 1. Requirements of an optimal currency area

In the first place, there must be markets which are sufficiently integrated and sufficient mobility of economic factors in order to facilitate a certain degree of convergence between the competitiveness of the member states of the monetary union.

This is the 'classic' condition in the traditional theory of optimal currency areas, the first version of which (Mundell I) proclaimed that more efficient monetary union would be as (i) the greater the integration of the markets whose currencies were going to be joined (which in turn means that the foreign trade of the countries making up the monetary union would be heavily concentrated within the union) and (ii) the more effective would be the market-based adjustment mechanisms, to reduce differences in competitiveness or the impact of asymmetric shocks. These mechanisms basically include wage and price flexibility and mobility of labour and capital.

In the most recent version (developed in the seventies and known as Mundell II) [Bordo-Markiewicz-Jonung (2011)], the theory of optimal currency areas assigns an important role to the integration of financial markets, attributing to it a decisive function as an instrument for the mutualization of risks (risk-sharing), which allows them to serve as an adjustment mechanism in the case of asymmetric shocks.

Experience has shown that the first condition (either in the first version or the more sophisticated one) is manifestly not fulfilled in the eurozone, due to the rigidity of the labour market at European level and also in other markets, especially services, where positions of dominance occur at European level, and, needless to say, within member states. The same thing happens, in an even more aggravated form, in the labour market, where mobility problems are perfectly evident within certain member states.

The second function is the mutualization of risks, which is accompanied by the mutualization of the political, or decision-making, power at the central ('federal') level of government. That is to say, this is a *quid pro quo* between the transfer of political power (cession of sovereignty) to the federal government and its financial backing of the entire union (which is not the same as the backing of the governments of all the member states).

The third function of the federal budget is the implicit generation of fiscal transfers from the most competitive (and richer) countries to the least competitive (and less wealthy). In other words, it is a redistributive function. This is an implicit role, not formally set out in this way, an indirect consequence of the logic of the central government's activity, which can be viewed in the following terms: by providing a similar level of those services for which it is responsible in the member states and applying similar taxation to them, the central government generates fiscal flows from those with greater fiscal capacity towards those with less capacity.

It is important to distinguish between the redistributive nature of these transfers and the character of those arising from the stabilizing function. Flows arising from the redistributive function are structural in nature, more or less permanent, and are always from the richer regions to the poorer. On the other hand, transfers generated by the stabilizing function are related to the phase of the cycle, are temporary in character and in theory could perfectly well give rise to income flows from poorer regions to richer ones.

Fiscal integration, and in particular the central government budget, thus becomes an indispensable element for a successful monetary union. In the proposals for fiscal union that are now on the table in the EU, the emphasis is usually, at best, placed on the first two functions, while the importance of the third one is systematically forgotten.

However, this function is essential. In reality, it is this which allows the 'federal' budget to act as a kind of soft mechanism, permitting a certain process of convergence between the competitiveness of the various states making up the monetary union. This is because there is no country, however integrated in monetary terms, where there are no differences in competitiveness and productivity between its regions, or where the market alone is expected to correct these differences.

Certainly, the reforms necessary to allow markets to act in the most integrated, flexible and competitive way possible must be adopted. At the same time, however, the central government budget has a crucial role to play, in order to avoid the adjustments required to achieve this convergence (in terms of, for example, falling real incomes, migration of labour or falls in GDP and employment) having such high costs that they end up being socially unacceptable. For this reason, the action of the central government budget, exercising offsetting effects while the adjustment in real terms occurs, is essential.

It should be noted that at this point there is a dividing line or border, so narrow that it can very easily be unduly crossed. It is the dividing line that separates an action by the authorities aimed at stimulating adjustment for which the market's role is irreplaceable), while seeking to minimize its more traumatic effects, from an action which, on the contrary, tends to perpetuate, rather than reduce, differences in competitiveness between territories.

The so-called Fiscal Compact: the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG)

Before examining the content of the so-called Fiscal Compact or fiscal union (Box 2), it must be stressed that, at least in a slightly broader sense, the fiscal union currently being built in the eurozone has two complementary elements that cannot be ignored.

First, the proposal for banking union, approved in the EU Council of 28th and 29th June 2012, which consists of three basic components: the attribution of the supervisory function to the ECB, the creation of a Deposit Guarantee Fund at EU level and the establishment of a European resolution mechanism. The banking union is an important complement to the fiscal union, since one of the functions of the fiscal union, as a financial compensation mechanism of a stabilizing nature, could theoretically be performed effectively by the financial market, if this was truly integrated.

Box 2. Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, was adopted on 1st March 2012 by twenty-five of the twenty seven EU member states and is currently in the process of being adopted by the signatory states. The essence of the Treaty is summarized in the following points [ECB (2012)].

1. The basic aim of the Treaty is to strengthen the fiscal discipline of the member states, introducing the balanced budget rule, with the adoption of automatic correction mechanisms and the strengthening of the existing procedures (in the Stability and Growth Pact) applicable in case of excessive deficit. Fiscal union, as provided for in the Treaty, hence does not include the creation or strengthening of central government budgetary or taxation instruments.

2. The signatories of the Treaty undertake to establish in their domestic legislation a fiscal rule under which national budgets must be balanced or in surplus. It is understood that this objective is fulfilled if the annual structural deficit does not exceed 0.5% of GDP. To this end, structural is defined as "the annual cyclically-adjusted balance net of one-off and temporary measures" (art. 3, 3a) of the Treaty).

Only in very special circumstances will it be possible to exceed this deficit limit. On the one hand, when the country has a level of public debt well below 60%, its public deficit may reach 1% (art. 3.1D). On the other hand, in exceptional circumstances arising from unusual events, beyond the control of the member state, or periods of severe economic recession; and always supposing that the medium-term stability goal is not jeopardized.

3. The TSCG establishes the obligation to create an automatic correction mechanism, in the event of appreciable deviations from the deficit target. The Treaty itself does not specify what this mechanism should be. It limits itself to entrusting the Commission with the task of proposing common principles for such a mechanism, and to providing that member states should introduce these into national legislation, preferably at the constitutional level. The Treaty also approves an automatic corrective mechanism in the event of excessive public debt, providing that member states must reduce the percentage by which the deficit exceeds 60% of GDP at a rate of one-twentieth per year.

4. The Treaty establishes sanctioning mechanisms to ensure compliance with the balanced budget rule (art. 8). Both the Commission and any of the signatory states may bring another contracting state before the European Court of Justice (ECJ), if they understand that it has not properly transposed this obligation into its national legislation, or that it is not complying with it. The ECJ's decisions shall be binding and the Court is empowered to impose sanctions of up to 0.1% of GDP. Any funds so raised will go to the ESM, in the case of eurozone countries, or otherwise to the EU budget.

5. The TSCG reinforces the excessive deficit procedures existing in the Stability and Growth Pact, increasing the automaticity thereof in case of failure to comply with the deficit criterion. From now on, according to the Treaty's article 7, the Commission's proposals are automatically adopted by the Council, unless a qualified majority thereof (excluding the affected state) opposes them (unlike the current situation, in which proposals are adopted only if a qualified majority of the Council is in favour). In addition, the Treaty establishes the requirement for countries subject to an excessive deficit procedure to submit economic and budgetary collaboration programs, which should include a detailed description of the structural reforms planned, and these should ensure the effective and lasting correction of the excessive deficit (art. 5).

6. Lastly, the Treaty establishes the need to provide the Council and Commission with ex-ante reports on debt issuance plans and includes certain provisions intended to improve the coordination of economic policies.

Secondly, the European Stability Mechanism (ESM), whose creation was decided at the June 2011 European summit and which, following approval by the German Constitutional Court, should enter its final implementation phase, beginning to operate in 2013. This fund constitutes a complement to fiscal union, as a result of two of its possible functions. One is to purchase the debt of member states in the primary market, which could make it the embryo of a European Debt Agency, or a European Treasury; the other is the possibility of it intervening directly in the rescue of financial institutions, which would make its contribution decisive in the effective implementation of the banking union, and consequently also in real progress toward an integrated financial market at European level.

Focusing on the essential pillar of fiscal union as it actually exists, it is useful to review the key points of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union [ECB (2012)].

The Treaty's fundamental objective is to assure fiscal discipline in member states' budgets, introducing the balanced budget rule, with the adoption of automatic corrective mechanisms and the strengthening of the existing procedures (in the Stability and Growth Pact) applicable in case of excessive deficit. For this purpose, it lays down a set of measures which toughen the correction mechanisms and sanction procedures in case of excessive deficits, at the same time reinforcing the automaticity thereof. Fiscal union, as provided for in the Treaty, hence does not include the creation or strengthening of central government budgetary or taxation instruments.

The essential point of the Treaty is to institutionalize the balanced budget rule. The signatory countries undertake to establish a fiscal rule in their domestic legislation, under which national budgets must be balanced or in surplus. It is understood that this objective means that the annual structural balance does not have a deficit of more than 0.5% of GDP. To this end, structural is defined as "the annual cyclically-adjusted balance net of one-off and temporary measures" (art. 3, 3a) of the Treaty). This definition is ambiguous enough to allow a margin in its exact determination. In particular, it is very important to clarify whether the deficit produced by the automatic stabilizers (the fall in fiscal resources and the increase in expenditure, notably on unemployment, both linked to the economic cycle) is regarded as temporary, or if this is reserved for those measures that are approved with a limited duration (e.g. discretionary fiscal stimulus packages). It should be pointed out that, if the latter interpretation were to prevail (i.e. the deficit created by the automatic stabilizers is not excluded), we would be faced with a highly restrictive deficit target, that would mean, in practice, that this 0.5% would be the absolute limit, even in strongly recessive circumstances, which would mean that in normal circumstances the budget should aim for a surplus of between three and five percentage points of GDP, in order to leave room enough to prevent the deficit exceeding 0.5% after taking account of the effect of the automatic stabilizers.

In any case, the approval of this measure, which is the formal culmination in a treaty of the series of measures already adopted over the past three years, implies a radically restrictive version of the 'golden rule' prevalent until now. Indeed, what the golden rule establishes is the need for borrowing to be used to finance investment, but never current spending. This means that budgetary current saving must always be positive, and that it is only acceptable to incur deficits to finance investment. The new rule excludes the possibility of resorting to borrowing to finance investment, with all the consequences this may have in terms of equity (intergenerational distribution of the tax burden used to finance infrastructure and facilities with intertemporal benefits) and efficiency (suboptimal level of socially desirable investment). However, these are considerations that far surpass the scope of this *Policy Brief*.

Elements of a fiscal union: main proposals and experience of existing fiscal unions

The Treaty on Stability, Coordination and Governance focuses exclusively on the fiscal discipline of the signatory states, without entering in any way into other areas, such as progress toward any form of federal fiscal government, or the mutualization of risks through joint borrowing mechanisms. With regard to fiscal discipline, two main elements stand out. First, the deficit target is more restrictively defined; and second, existing procedures to be applied in the case of excessive deficits are reinforced.

This observation leads to two questions: in the first place, is there a need for fiscal union, understood as a strict fiscal discipline on the member states, as the TSCG does?; And second, is this enough to solve the

underlying problems that have led to the crisis of the monetary union, or should we go further? In our view, the answers to these two questions are: yes, we need fiscal discipline; and no, this is not sufficient. To solve the problems of the eurozone and consolidate the monetary union, it is necessary to go further. Fiscal discipline on the part of member states is one of the requirements for a genuine fiscal union, but it cannot be the only component thereof.

The fact is that there are numerous proposals and analyses, both prior and subsequent to the adoption of the Fiscal Compact, on the appropriate characteristics of a fiscal union in the EU, as well as a number of studies on the history and comparative experience in this regard, i.e. with regard to the crucial question of the relationship between fiscal integration and monetary integration.

In this regard, it is an extremely useful exercise to attempt to identify elements common to those political realities where three factors are present: a single currency, some intermediate (sub-central) level of government with fiscal and budgetary responsibilities and fiscal union (also) at central government level (hence unitary countries are excluded due to the absence of the second factor).

The existing fiscal unions with a shared currency, as defined by the three factors above, present a series of common elements [especially, Bordo-Markiewicz-Jonung (2011) and Henning-Kessler (2012)]:

First, a central government which has: a) a significant budget; (b) its own tax resources; c) a Treasury responsible for the issuance of debt.

Second, there may be (in fact, there are in all cases, except the United States) equalization transfer mechanisms, which complement the shock absorber role of the federal budget to offset the financial effects (via imbalance on the internal current account balance) of differences in competitiveness between the territories of the monetary union.

Third, the sub-central governments enjoy different degrees of fiscal autonomy, to meet their financial obligations with their own fiscal resources.

Fourth, there is also, in all the fiscal unions, some sort of requirement to ensure the fiscal discipline of sub-central governments.

On this final and crucial point, however, it needs to be stressed that there are two completely different schools of policy. According to one of them, especially in the United States, what ensures the budgetary discipline is the need for credibility with creditors. In consequence, there are no mechanisms for the central government to bail out states of the union at risk of default. In return, this entails a broad fiscal capacity of the states to service their creditors (no imbalance gap between expenditure obligations and tax-raising potential).

According to another school, in contrast, discipline must be ensured by heavily restrictive regulations, approved and supervised by the central government (this is a procedure of a hierarchical nature). Normally, under this option sub-central governments have a low (or in any case heavily limited) fiscal capacity to ensure the sustainability of their resources. Also, in one form or another, there are bail-out clauses, which provide for the central government to rescue sub-central administrations at risk of default. This is consistent with the fact that sub-central governments must meet obligations not decided by themselves and that they lack the means to ensure their compliance with them (they do not have the key to their resources).

Ultimately, what the lessons of history and comparative experience tell us is that there are two basic archetypes. According to one of them, the market is the most appropriate mechanism for promoting budgetary discipline in sub-central governments, which is accompanied by the acceptance of default risk (there is no bail-out) and the fact that these governments' revenues are strongly linked to their tax base. According to the other, the mechanism to achieve budgetary discipline is hierarchical in nature, imposed by the central government; in exchange, it must, directly or indirectly, guarantee that sub-central governments in danger of default will be rescued, since the latter have only a limited scope to determine their own resources.

In the case of the EU, and more specifically the eurozone, numerous proposals, studies and approaches have been made as to which should be the characteristics of this fiscal union. According to these, the main elements that should be included are the following [Box 3]:

1) Fiscal discipline of the states of the monetary union
2) Mechanisms for crisis resolution
3) Mutualization, or joint guarantee, of public debt
4) Mechanisms for interterritorial transfers
5) Creation of a genuine central ('federal') European government with its corresponding budget and treasury

As can be seen when examining the proposals outlined in Box 3, the models of fiscal union on the table in the EU are far distant from what reality tells us that fiscal unions are like in actual monetary unions. Without going into a detailed analysis thereof (which would inevitably overlap with the recommendations made in the next section), it is useful to make a few brief comments about them, in order to reinforce these recommendations.

In the first place, most of these proposals do not really offer a significant advance toward a fiscal union 'at the federal level', with the creation of a federal government and its corresponding treasury and budget, or through a very decisive strengthening of the current Commission. At most, they propose modest progress in this direction (perhaps at the limits posed by political realism), such as endowing the Commission with fiscal resources raised directly from European taxpayers and the creation of a eurozone Minister of Finance, who could be responsible for deciding on these tax resources and for monitoring and approving, and even vetoing, national budgets. However, even these modest advances would increase the EU budget much beyond the most ambitious of the scenarios considered in the *Financial Perspectives (2010-2014)* currently under discussion.

Secondly, the recommendations to establish some kind of fund for stabilization or for absorption of asymmetric shocks also point in the direction of fostering a new fiscal power at European level. In this respect, the Van Rompuy proposal (2012) to create a specific budget for the countries of the eurozone ('new fiscal capacity') is especially important, as it would mean a limited form of solidarity exercised over the economic cycle, intended for the absorption of asymmetric shocks at the central level.

Thirdly, all the proposals relating to fiscal union in the EU include the budgetary discipline of member states as an essential point, if not the fundamental one. At this point, which as already indicated occurs in the comparative experience, there are two schools of policy, depending on whether it is considered that these governments must respond exclusively to their citizens and to the markets (which precludes the existence of bail-out formulas) or that this discipline should be imposed through hierarchical procedures established by the central government. What characterizes the proposals in the case of the EU is a much stronger bias in favour of this second option than exists in real fiscal unions with a common currency.

Finally, many of the proposals on EU fiscal union include banking union as one of their central points. This reaches such an extreme that some of them seem to confuse the boundaries and at times, under the heading or title of fiscal union, go deeper into aspects related to banking union rather than to fiscal union per se, which evidently does not help to clarify the proposals. Although banking union is closely linked to monetary union, its connections with fiscal union are more distant. It's however true that an efficient and truly integrated financial market would, in theory, be in a position to make the stabilizing function of the central government budget unnecessary (in the face of asymmetric shocks, for example), because it should not have difficulty on financing the cyclical deficits of sub-central governments with no problems of fiscal sustainability.

3. What should fiscal union include?

Two essential and complementary elements of European fiscal union: European central government and fiscal discipline of the member states

The core of the European fiscal union should contain two essential elements: decisive progress toward a European central government, and effective mechanisms to exercise fiscal discipline on the budgets of member states. The two pillars are vital. With this statement, we wish to point out the shortcomings of those approaches that put the accent only on the second of them, such as the fiscal union proposal currently on the table, but we also wish to underline the error of those who present these two pillars as

Box 3. Main proposals on fiscal union in the EU

The elements that a fiscal union can include, according to the various studies available, are the following:

a) Fiscal discipline of the states participating in the monetary union. This means the existence of strict requirements of sustainability with regard to public finances, which translate into mandates in terms of budgetary balance and limits on public debt. The proposals are divided into two radically different alternatives: strict adoption of the no bail-out clause or very severe central regulations [Bordo-Markiewicz-Jonung (2011), Buiter-Rahbari (2011), Darvas (2010), Fuest-Peichl (2012), Henning-Kessler (2012), Majocchi (2011), Marzinotto-Sapir-Wolff (2011) and Enderlein et al. (2012)].

b) Mechanisms for crisis resolution and the rescue of member states. This mechanism would be the ESM, and it would extend to the banking sector, allowing progress towards a banking union, a complementary element of fiscal union. The proposals differ as to whether this mechanism should be limited to cases of liquidity problems, but not solvency, in which case it would be compatible with the maintenance of the no bail-out clause; or if it could also be applied to rescue countries whose public finances had become unsustainable (as has happened in the eurozone with Greece), in which case it would be incompatible with the application of this clause [Bordo-Markiewicz-Jonung (2011), Henning-Kessler (2012), Fuest-Piechl (2012) and Enderlein et al. (2012)].

c) Mutualization, or joint guarantee, of public debt. The emblematic proposal is the issue of 'eurobonds'. It would mean the creation of a European agency to issue debt, with the guarantee of all eurozone member states, which would be able to finance those which cannot fund themselves in the markets or can only do so at prohibitive prices. Some formulas propose that eurobonds cover sovereign debt up to 60% of GDP; others, that they cover it precisely from 60%, in order to deal with the pressing situations of the most heavily indebted states. Indeed, the mechanisms that until now have been put in place (the EFSF and, as of January 2013, the ESM) can be considered embryonic institutions of an eventual European Debt Agency. A radical development of this element would be the existence of a federal Treasury, as a result of the prior existence of a European federal government [Henning-Kessler (2012), Fuest-Piechl (2012), Marzinotto-Sapir-Wolff (2011) and Enderlein et al. (2012)].

d) Interterritorial transfer mechanisms . The explicit objective of such mechanisms is to help absorb asymmetric shocks between territories, i.e. the stabilizing goal of a federal budget. Some of the proposals call this mechanism exactly that, a cyclical stabilization insurance fund [Enderlein et al. (2012)], and emphasize that the resulting income flows between countries should not go in only one direction, since the relevant factor is not a country's absolute level of income, but the phase of the cycle in which it finds itself. Others, though labelling them equalization funds, define them strictly in terms of the stabilizing function. In reality, it would be a grants mechanism playing the same role as the automatic stabilizers of the central budget in the various territories [Bordo-Markiewicz-Jonung (2011) and Fuest-Piechl (2012)]. The Van Rompuy proposal (2012) to create a 'new fiscal capacity' implies a qualitatively more ambitious step, because it would mean the creation of a central budget for the eurozone countries, designed to deal with asymmetric shocks, and which over the cycle should be fiscally neutral for all countries.

e) Creation of an authentic central ('federal') government with its corresponding budget and Treasury. An essential element of this government is the existence of fiscal resources obtained directly from the European taxpayer [Bordo-Markiewicz-Jonung (2011) and Henning-Kessler (2012)]. Some proposals [Fuest-Piechl (2012)], though few, dare to comment on which taxes would appear most suitable (those which have tax bases with greater mobility and which play a more prominent role as automatic stabilizers) and others [Marzinotto-Sapir-Wolff (2011)] emphasize that without a significant increase, however prudent and gradual, in the EU budget (at least, up to 2% of GDP) it is mere pretence to speak of progress toward a fiscal union. Some proposals suggest the creation of a Minister of Finance for the eurozone as a intermediate step [Enderlein et al. (2012) and Marzinotto-Sapir-Wolff (2011)], with the functions of deciding the fiscal resources of the eurozone, directing the European Debt Agency, and supervising and approving, or even vetoing, national budgets. In any case, this Minister should be designated by means of a democratically 'reinforced' procedure, by the European Parliament, with the eventual involvement of national parliaments.

These are the elements that can potentially configure a fiscal union, which could adopt different configurations, given the countless possible combinations between them, and depending on its precise design.

contradictory or alternative tracks. Both are necessary. Therefore, if the current TSCG (the fiscal pact approved in March) is a first step in this direction, it is a step forward, but it will be a wrong step, and in the long run a step backwards, if it seeks to put the weight of fiscal union exclusively on the budgetary discipline pillar of the signatory states, avoiding the issue, without doubt politically complex but inescapable, of creating a central government, one possibility would be through a decisive empowerment of the current Commission, considering that this could be the embryo of such a government.

There will be no fiscal union without determined progress toward an unambiguously democratic European central government, i.e. with a legitimacy of origin that the current Commission lacks. This greatly weakens the relationship of institutional hierarchy between it and the Council in the adoption of big decisions, as is visible every day. The analysis, the arguments of economic policy and comparative experience allow us to affirm that there is no fiscal union without a budget and a Treasury at the central level. Any fiscal union which ignores this fact is doomed to failure and, of course, will not resolve the shortcomings showed by in the monetary union. Monetary institutions are not sufficient for a solid, stable currency: fiscal institutions are also necessary. There is no system that works with a monster composed of a single monetary head and by seventeen (or twenty seven, according to preference) small budgetary heads. Who rules over this monster?

The responsabilities of the central government in a fiscal union

Fiscal union requires the existence of a central ('federal') government with three fundamental responsabilities: fiscal resources obtained directly from the citizens, a budget financed basically from these resources, and the capacity to borrow through its own Treasury.

History tells us that fiscal union has generally preceded monetary union, and that political union is a prerequisite for fiscal union [Bordo-Markiewicz-Jonung (2011) and Sargent (2011)], i.e. the logical order is: first political union, and immediately afterwards fiscal union (in fact, they go hand-in-hand), and afterwards monetary union.

In the United States, the Constitution, setting up the federal government, was adopted in 1788 and George Washington began his first term as the first president in 1789. In 1790, the Congress decided to assign the import tariffs (by far the most important tax resource at the time) to the federal government, in exchange for the Federation assuming the debts of the states, heavily indebted after the War of Independence. Alexander Hamilton, Secretary of the Treasury and the strong man of the federal government, insisted on paying creditors in full at maturity, despite the fact that others, such as James Madison (together with Hamilton the father of the Constitution, by the way, but at this time on the opposing side), opposed this, arguing that these creditors had taken advantage of the deep uncertainty about the states' solvency to buy their debt at a heavy discount. However, Hamilton won the day, arguing that changing the rules of the game 'ex-post' would damage the future creditworthiness of the Federation (i.e. it would have 'ex-ante' consequences in the future). This was done, and it was the only occasion in the United States when the federal government bailed out state governments [Sargent (2011)].

It was only in 1791, after sorting out the fiscal problems, that the establishment of the dollar and the central bank was agreed. Moreover, the Congress chartered the latter only on a provisional basis for twenty years (and again with the opposition of Madison). It is paradoxical that in 1811, after these twenty years had passed, the same Madison, then president himself, proposed to renew this charter and Congress rejected it.

In Canada too, the political (and fiscal) union, which occurred in 1867, preceded the creation of the central bank, which did not occur until the 1930s [Bordo-Markiewicz-Jonung (2011)]. The same thing has happened in the other monetary unions: political and fiscal union preceded monetary union.

The EU made a mistake, now widely accepted, in addressing monetary union without the fundamental prerequisites for it to work. There is no turning back in the process now: monetary union was first. However, it should be noted that to adopt fiscal union now, without openly considering political union, would be to repeat the same mistake. The same can be said of claiming that a project whose design lacks the three key elements referred to above is truly a fiscal union.

In the case of United States, the reasons for the sequence of actions taken are clear. The starting point was that the federal government was obliged to assume the debt of the states, because doing so responded to reasons of 'national interest' (they had borrowed for a higher cause, the war of independence, not strictly for state purposes, and in addition they were all practically in bankruptcy), but this must not become the norm in the future. To maintain its access to credit in the markets, it was needed to guarantee fiscal discipline (i.e. the sustainability of public finances): in the future there could be no more bail-outs [Sargent (2011)].

However, in that case it was essential that two conditions were met. In the first place, there had to be a federal budget that could act as a cushion in the event of serious upsets in the states, which implied the federation's capacity to borrow, with a flexibility which the states would necessarily lack. Secondly, if the states were to be left to their own fate in financial terms, then it was imperative that they had their own fiscal resources.

Similarly, if the federal government needed to be able to borrow, it was essential that it also enjoyed its own fiscal resources, as the repayment (financing) of the debt required either these tax resources or its monetization, which would lead inevitably to an increase in inflation, and the loss of value of the federal debt (with the consequent negative impact in terms of creditworthiness in the markets, which was precisely what the Federation sought to avoid).

In short, the credibility of federal debt in the markets is inextricably linked to the sustainability of federal public finances, and hence to the existence in the future of the appropriate flow of fiscal resources. The creditworthiness of the debt therefore depends on the ability of the issuing government to have the key to its tax resources. Thus, there cannot be a proper fiscal union without a central government with its own fiscal resources.

The speed at which this process can be carried out is another question. Of course, it is unthinkable that the EU (or the eurozone) could have a central government with a budget in terms of GDP close even slightly to that of the central governments of federal countries. With regard to the speed of the process and the size of the budget in terms of GDP, ranges of options are admissible, but the aim of achieving this goal should be clear and so should the determination with which it is carried out. On the other hand, history tells us that in all federations are the moments of crisis which have triggered a decisive leap in both the absolute weight of the central government budget in terms of GDP and its relative importance within the public sector as a whole [Bordo-Markiewicz-Jonung (2011)]. In the United States and Canada, it was the Great Depression which caused this step change in the importance of the central government budget.

The fiscal discipline of the states in the fiscal union

Together with the allocation of fiscal responsabilities at the central level of government, the fiscal discipline of the member states is the other essential pillar of a fiscal union. It is not the only one, but it is essential. For this reason, the fiscal pact adopted by the twenty-five signatory states of the Treaty on Stability, Coordination and Governance, is an insufficient, though necessary, step.

By fiscal discipline, we mean compliance with certain targets with regard to balancing the budget. This principle would lead clarifying some extremely important issues, which we have already discussed in part in the sub-section devoted to the Fiscal Pact. First: to establish a clear distinction between the definition of balanced budget (i.e. zero deficit) and the definition of sustainable public finances, a concept that is linked to three crucial factors: the interest rate, the GDP growth rate and the stock of public debt, in relation to GDP. Public finances can be sustainable without the requirement of zero deficits, and they may be unsustainable even if this requirement is fulfilled. Second: to define the structural deficit or, alternatively, to specify whether a balanced budget is a goal to be achieved each year (as in the TSCG) or over the cycle. Third: to determine if the drastic limitation on borrowing represented by the zero deficit target includes total or partial financing of investment, with all the consequences that this may have, with regard to both equity and efficiency.

In any case, the fiscal discipline of the states (or sub-central governments) participating in the union is essential. When they issue debt, or borrow in the markets, these governments must provide full

assurance that they are able to repay it. It should be emphasized that this is the key and fundamental reason for the budgetary discipline requirement: to maintain the markets' trust in the governments' solvency. It is crucial to stress this fact: sub-central governments must be solvent and trustworthy because otherwise they would not obtain credit in the market, not because they must protect their currency. In the United States, the states are to be disciplined (many have adopted state laws making a balanced budget obligatory), not to protect the dollar, but to protect their credit in the markets [Auerbach (2011)].

In a fiscal and monetary union, it is in any case the central government's debt which could endanger the stability of the currency, not that of the sub-central governments. This is a point both essential and peculiar to the European situation, where the role of 'federal' debt (which would correspond to the EU level) is irrelevant, and it is this point which has led to this confusion of roles (are fiscal discipline measures taken for reasons of fiscal policy or for monetary reasons?) and to restrictions on the autonomy of the member states which go far beyond what would be considered reasonable in any fiscal and monetary union.

In the previous point, we noted that the solvency of the central government debt is closely linked to its access to tax resources. The same is true for sub-central governments. The first condition for ensuring responsible fiscal behaviour is that the government knows that it depends on itself, and for this the link between its tax revenues and its spending responsabilities must be as close as possible. The reason for this is twofold. In the first place because when it borrows, the government must know that it has a limit, or restriction, which is represented by the fiscal resources that it may reasonably generate in the future to fund its budget (including, of course, the servicing of this debt). The second, because, on the other side, the markets will provide credit if they calculate that these tax revenues will be sufficient to finance the budget. Incidentally, this brings us back to the definition of sustainability formulated above; where we noted that the GDP growth rate is one of the three variables (along with the interest rate and the outstanding debt) which determine the sustainability of public finances. This is so because we assume that there is a link, through the tax base, between economic prosperity and government revenue. Breaking this link is seriously negative from many points of view, and produces perverse incentives in the self-discipline of governments.

The second condition for budgetary discipline is that non-compliant governments must know that non-compliance will have negative consequences. That is to say, there must be positive incentives to meet obligations and negative ones to not do so. To what extent must this condition lead to the adoption, formal or de facto, of the no bail-out clause? In other words, should it be clearly proclaimed that governments at risk of default will not be rescued? This is a crucial issue. It must be remembered that in the eurozone, in fact, the creation of the euro was accompanied by the solemn adoption of this clause. However, this has not prevented the subsequent direct rescues of three countries and the indirect rescue of someone else.

Although, as noted above, there are in fact two extreme alternatives on this point, in reality it seems clear that bail-outs can only be accepted in exceptional situations and, in any case, with very tough conditions on rescued governments. However, it is true that as long as there is no federal government, with the corresponding federal debt, it seems likely that serious debt problems in any of the member states of the monetary union would end up affecting the strength of the currency, i.e. unlike what happens in a federation, the credibility of the states' debt is certainly important to ensure the stability of the currency. As a result, it seems unlikely that the no bail-out clause will be adopted in a strict form. On the other hand, however, it is important to restrict the clause very severely. Governments must have instruments to maintain budgetary discipline (i.e. they must have the key to their revenue) and, if they have it, they must know that the breach of this discipline has a very high cost, although ultimately there are mechanisms to prevent a default.

That is why the formulas adopted in the eurozone in relation to the existence of bail-out formulas must necessarily be a hybrid. It is not acceptable that the default of one member state could endanger the survival of the common currency, but neither could there be mechanisms that, in the long run, end up creating negative incentives in relation to budgetary discipline.

In any case, as pointed out in the last paragraph of point 2, it is useful to recall that there is a direct correlation between 'hierarchical-bureaucratic' mechanisms, lack of fiscal autonomy and bail-out clauses, on the one hand, and market mechanisms, fiscal autonomy and the no bail-out clause, on the other. The more a government depends on itself, the more the market will impose budgetary discipline and the more justified the absence of rescue mechanisms. On the contrary, the less ability a government has to determine its revenue, the more the central government (which will hold the key thereof) will be forced to establish clauses for rescue in the event of risk of imminent default, and the more hierarchical and administrative in nature will be the mechanisms adopted to ensure budgetary discipline. The case of the eurozone is peculiar, because in fact it applies the second alternative (hierarchical methods and rescue), without the central government having the key to the tax revenue, which continues to be fully 'national'. Hence the reason why the bankruptcy of the states cannot be allowed is not that they do not have room for revenue manoeuvre, but that their collapse could drag down the common currency, as has been pointed out.

Mutualization of public debt

The issue of mutualization of debt, and in particular the discussion on the eurobonds proposal, has become one of the central points of the current debate on fiscal union in the EU.

Throughout the sovereign debt crisis, several proposals have emerged, ranging from one extreme to the other, suggesting the creation of eurobonds. Some propose that the countries may call on this mechanism up to a debt limit of 60% of GDP, which would do little to alleviate their difficulties when they find themselves in truly critical situations beyond this level, and would rather make rescue inevitable, in this extreme situation. Other alternatives are proposing the exact opposite. It would be a mechanism activated from a level of debt of 60% of GDP, precisely to cope with emergency situations, which would make this instrument a form of covert bail-out.

In any event, these are proposals that are on the table and they have certainly become a regular feature of the debate. Moreover, the different rescue funds (EFSF and ESM) are forms of funding by national governments that could be considered part of the generic family of eurobonds. However, for the effective implementation of this proposal, there is still the basic difficulty of the asymmetry implied by advancing decisively in the mutualization of the public debt, without the corresponding mutualization of political power. This explains the reluctance of some countries (in this case, Germany's attitude seems perfectly reasonable).

This is because in federal systems (i.e. those in which there is a fiscal union with a monetary union), there is indeed a Treasury to issue bonds, but it is the federal Treasury, issuing federal bonds, and it is backed by the budget of the Federation. This is not a kind of federal Treasury which issues bonds, with the warranty and backing of the federal government, to meet the financing needs of the states. Here, on the contrary, the intention would be to create a form of European Bond Agency (substitute for a European Treasury), that would lack the support of the EU budget, having this one neither the size nor the fiscal resources of its own that permit so, but the resources contributions of the member states. The creation of a European Bond Agency before making decisive progress on political union would be to fall into the same type of mistake that was made by creating monetary union without a previous fiscal union. It would be putting the cart before the horse again. As has been pointed out above, the right order of doing things is: first, political union; afterwards (almost simultaneously) fiscal union, with the creation of the corresponding Treasury (eurobonds); and then monetary union. It was a mistake to adopt monetary union before fiscal union. Now it would be a still more serious error to create an intergovernmental Treasury without the corresponding government. There can simply be no Treasury without a government.

This leads us to two final comments. The first is that as long as there is no 'federal' European debt, the risk of contagion from turbulence in the states' sovereign debts over the stability of the single currency is very high. On the one hand, this requires the ECB to weigh this variable in its decisions, something that does not occur in other fiscal unions. On the other hand, it makes the risk of default by member states much more dangerous, and makes the establishment of rescue mechanisms inevitable, for reasons not of fiscal or budgetary policy, but of monetary policy. In other words, these mechanisms are not introduced basically because it has been concluded that this is the best way

to ensure sustainable and sound public finances, but because the default of a member state's sovereign debt could have very serious consequences for the stability and strength, and even the survival, of the euro. This is the case with the default of any central government in a fiscal and monetary union, but in the eurozone there is not just one central government, but seventeen.

For this reason, here we cannot apply the recipe appropriate to fiscal (and federal) unions, and clearly that of the United States; this is that the governments of the member states concern themselves with their financial solvency in order to preserve the markets' confidence and not to protect the currency; it cannot be applied for the simple reason that in the eurozone there is no central government with its own debt.

This constant contamination between the Eurozone states' budgetary policy and the ECB's monetary policy produces extremely negative disturbance in both directions. On the one hand, because the ECB, as we have seen, cannot wash its hands of the financial fate of the member states, and has to perform a difficult play to justify the measures taken to preserve the stability of their finances in terms of monetary policy. On the other hand, because member states' financial difficulties (as a consequence of the severity of the fiscal adjustment processes that they must enact) are exacerbated by the risk of a break-up of the euro, i.e. by the implicit risk of devaluation of the currency of the country in question.

The second comment relates to the direct or indirect actions of the ECB, to address the liquidity and solvency problems of the member states of the monetary union. The distinction between the financial difficulties arising from solvency problems and those due to liquidity problems has been extensively used and is in some way an argument that has been discredited, as it has so often been used by states with liquidity problems. It is clear that the dividing line between the two types of problem is very narrow, and that liquidity problems, when they persist and worsen, end up becoming solvency problems.

Having said that, it is imperative that mechanisms (the ECB or, if it is unable to act for legal reasons, other institutions able to finance themselves from it) exist to tackle liquidity problems immediately, as soon as they appear. And in such cases, it is a mistake to make these liquidity facilities conditional to comply with requirements related to the fiscal sustainability of the recipient states and not with their liquidity position. A perfectly sound government, even one with no deficit, may have liquidity problems, and in such a situation it is wrong and harmful to mix measures designed to solve liquidity problems, with budgetary discipline conditions. However, this is exactly what is happening at the moment: any type of measure is called a rescue, whether the objective is liquidity or solvency. It is a mistake and it is counter-productive, because the imposition of this type of measure only serves to increase any doubts the markets may have about the solvency of countries which, as noted, perhaps have liquidity problems, but may have perfectly sound finances.

One thing is rescue measures to address situations of unsustainable public finances in a sub-central government, measures that involve some form of bail-out or, if you like, debt restructuring. Another thing is measures to mitigate the lack of liquidity in the markets to finance solvent governments, with sound and sustainable public finances. When it comes to the central government, and the regulatory framework allows, it is the central bank which must act as a lender of last resort, and when it comes to other governments, appropriate funding mechanisms must be established, with no justification for conditional measures.

4. Concluding remarks

The crisis of the euro clearly shows the consequences of an incomplete monetary union. There is no monetary union without fiscal union, and fiscal union, in turn, must consist of two basic elements: fiscal institutions appropriate to a political union (the budget and the treasury of the central government) and the budgetary discipline of the participating states of the union.

The two pillars are necessary. Today, however, the European Union (and the eurozone, more specifically) is moving to meet only one of the shortcomings, the budgetary discipline of the member states. This pillar is necessary, but it is not enough. There must also be decisive progress in the creation of a 'federal' European government with the appropriate fiscal powers.

It is clear that there are powerful political restrictions that make it very difficult to move in this direction. It is also true that in the last three years there has been a

major transfer of sovereignty in fiscal matters from the member states to European institutions. However, this transfer has been mainly toward intergovernmental ones, and not toward a new 'federal' European government of unequivocally democratic origin.

The current situation is acceptable, perfectly reasonable even, if it is conceived as an intermediate stage. Otherwise, it can hardly be a permanent and sustainable solution. Political restrictions undoubtedly influence the timetable and pace of progress, but they should not prevent the rigorous setting of the goals to be achieved to arrive at a genuine fiscal union.

That is why it is essential to define the content that such a union must have and the timetable in which it should be achieved. This content should include, in accordance with point 3 above, a gradual increase in the European 'federal' government budget, until it reaches a certain percentage of GDP; fiscal resources, obtained directly from European taxpayers, which should fund this budget; the creation of a European Treasury; and, as this European 'federal' government budget becomes more firmly established and provides a strong enough guarantee to support the euro, the strict application of the no bail-out clause to the member states.

Just as there is no monetary union without fiscal union, it is even clearer that there is no fiscal union without political union. Finally, fiscal institutions (the budget, with its corresponding taxes, and the treasury) are institutions inherently linked to the prior existence of a government (a political power). Hence the discussion on what kind of political union is required for fiscal union is a crucial issue and it will be the subject of a future EuropeG *Policy Brief*.

It should be noted that the argument to convince the citizens of the value of this great project of European political union cannot be that this union is necessary to save the euro. We do not want political union because it is the instrument needed for the euro to work. It is the other way around. It is because we wish to live together, because we share certain values and we feel ourselves citizens of the same political community, because we have a common project, that we create shared institutions and choose our leaders together. It is for all these reasons that we also want to share the currency. Only thus, from this historical and cultural reality, from this community of values which have become universal, which is Europe, may a true political subject raise.

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