Making sense of the fiscal union: a budget for the Eurozone?

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Reconciling Governance and Model: A five-Fold Narrative for Europe,
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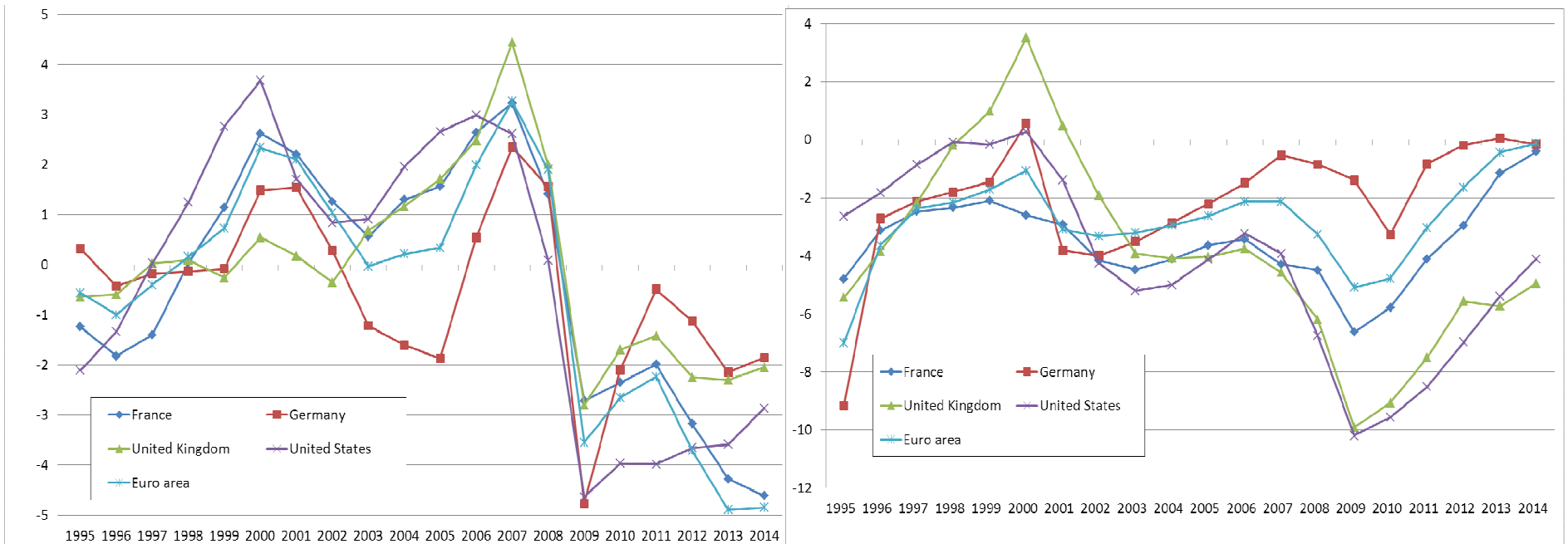# Three functions of public intervention
Musgrave and Musgrave (1986)

- **Allocation: raise social welfare**
  - Internalize externalities, produce public goods: which ones?
  - Financial stability: fiscal backstop to banking union
  - Infrastructure, R&S: a substitute for EU27? For national investment?
- **Redistribution: raise equity**
  - A political non-starter ("transfer union")
  - "It [the Union] shall promote economic, social and territorial cohesion, and solidarity among Member States", TEU, Art. 2
  - Euro may raise income inequality across Member states (through agglomeration effects)
- **Stabilization: reduce instability**
  - For the EZ as a whole (symmetric shocks, ZIRP)
  - For individual member states (asymmetric shock, unequal access to financial market)
  - For tail risks (banking union)
  - Probably the most legitimate purpose of a euro-area budget:
    - Common monetary policy
    - Constrained fiscal policies
    - Mundell (1961)

Pro-cyclical fiscal policies

Output gaps (in %)

Structural budget balances (in %)

Source : OECD EO92.

Stabilization: a problem of size

- **Budget**
  - MacDougall report (1970): 5-7% of GDP
  - Pisani-Ferry, Vihriälä and Wolff (2013): 1.8% of GDP over the cycle
  - Say 2% of GDP
- **Output gaps**
  - Say -/+6%
- **Multipliers/ automatic stabilizers**
  - Multiplier=1 (a 1% increase in public spend./fall in taxes raises output by 1%)
  - Automatic stabilizer at national level=0.5 (a 1% downturn reduces contributions by 0.5% of GDP)
  - EZ automatic stabilizer=0.5*2/40=0.025 (a 1% downturn reduces contributions by 0.025% of GDP)
- **Stabilization**
  - Assume the EZ is split in terms of output gaps: **-6%** in half of the zone, +6% in the other half
  - The +zone contributes 2+0.025*6=**2.15%** of GDP; the –zone contributes 2-0.025*6=**1.85%** of GDP; hence a **+/-7.5%** variation in contributions.
  - Output gaps are stabilized by (2/40)×7,5%=**0.375%**: from +/-6% to **+/-5.625%**
  - Assume the whole EZ is at -6% and can borrow 2% of GDP. National governments no longer contribute. Output gap stabilized by **2pp**, hence from -6 to **-4%**.

Implications: three ways

- **Balanced budget at EZ level, no borrowing from MS**
  - Limited stabilization properties, only anti-symmetric shocks
  - Significant only if counter-cyclical, targeted programme (youth unemployment, poor children,…)

- **Possibility of borrowing at EZ level, no borrowing from MS**
  - Significant stabilization properties at EZ level
  - But governance problem (discretionary policy)

- **No budget at EZ level, €bonds for MS**
  - Significant stabilization properties at national level
  - But governance problem (common pool)
  - Combine with surveillance?

The debate on legacy

- **Need for a "veil of ignorance"**
    - No room for insuring legacy assets
    - Moral hazard problem

- **Leaving it entirely to national governments unrealistic**
    - An impediment to swift bank cleaning-up
    - Shared mistake at the incept of the monetary union
    - Need for a fiscal backstop (ESM)

- **A temporary debt exchange**
    - Market-friendly bail in
    - Lengthen maturities
    - Temporary solidarity

No bail-out rule

- **Strict *de jure* (art. 125 TFEU)**
    - Art. 125 TFEU
    - Karlsruhe constitutional court

- **Lax *de facto***
    - No bailout + No restructuring + No exit
    - Risk of indirect bail out by the ECB

- **Need to close the gap**