conseil d'analyse économique

Press Release

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Which Fiscal Union for the Euro Area?

The construction of the euro area left aside the question of a fiscal union, but the crisis re-opened the debate. "Every man for himself" weakens the Eurozone but coordination is difficult because it involves 19 national budgetary processes. Yet coordination is essential as fiscal policy in the euro area often tends to accentuate rather than attenuate the economic cycle. While the build-up of any meaningful federal budget is not plausible in the short term, **Agnès Bénassy-Quéré**, **Xavier Ragot** and **Guntram Wolff** lay out three possible paths for improvement: An extension of the European Stability Mechanism (ESM), a reform of the coordination framework of fiscal policies and a European unemployment (re)insurance scheme active in cases of severe recessions.

Why discuss fiscal union?

Countries typically have significant fiscal resources at the central level. If one were to consider the EU as a federation, it would be a complete outlier, with "local" (i.e. member state) budgets representing 98 percent of total expenditure. As for the euro area, it has no budget except the lending capacity of the ESM. The authors believe that a "fiscal union for the euro area" should focus on the stabilization function, the issue really specific to the monetary union. The Maastricht rules make sense during normal times but they are ill-adapted in times of crisis, particularly when the European Central Bank reaches its limitations. In the short term, progress in the coordination of national fiscal policies needs to be made. These shortcomings were notably apparent in 2012 and 2013, when the conjuncture of the Eurozone would have needed a coordinated pause from public finance consolidation. They were also apparent in 2000, when different member states failed to accumulate fiscal surpluses although the exceptionally good times would have made it possible.

More stabilizing national fiscal policies

In general national fiscal policy tends *de facto* to accentuate rather than attenuate the economic cycle, due to badly timed policy interventions resulting in particular from erroneous forecasts. Such feature does not come from the crisis alone, neither is it solely due to fiscal rules. In order to increase the stabilizing effect of national fiscal policies, the Note makes three proposals. The first consists of making public debt restructuring more feasible in the Eurozone, thanks to more diversified banks' sovereign exposures but also to reliance on the European Stability Mechanism to act as a firewall. The second suggestion is to identify in a transparent manner "exceptional" periods during which fiscal coordination is vital whereas during “normal” times the subsidiarity principle works fine. The third proposal is to replace the current flexibilities of the Stability and Growth Pact by national adjustment accounts which would incentivize the government to spend more in times of an economic slowdown and less during an upswing.

European unemployment insurance and labour market convergence

In the last part of the Note, the authors suggest to set up a European unemployment insurance scheme modelled along the lines of the US unemployment insurance in which the federal insurance only steps in during a severe crisis and operates beside the different states. Minimal labour market harmonization required for such an endeavour is itself desirable as it would facilitate monetary policy transmission and foster labour mobility. After having fulfilled a small number of key conditions, Member states would participate in the system with varying fees. In case of a sudden rise in unemployment rates, their economic activity would benefit from a stabilizing support mechanism, which would as well be symbolic for European solidarity.

The five recommendations of the *Note*

Recommendation 1. Complete the banking union with incentives to progressively diversify banks’ exposures to sovereign risks, and a deposit guarantee scheme backed by a common fiscal backstop.

Recommendation 2. Reinforce the European Stability Mechanism (ESM) so that it can act as a firewall in case of a sovereign debt restructuring.

Recommendation 3. Task the European Fiscal Board with identifying extraordinary good or bad times at euro-area level and providing independent guidance on the appropriate euro-area wide fiscal stance and its distribution between national budgets.

Recommendation 4. Replace the “flexibility” of the SGP with respect to the economic cycle by national adjustment accounts that would shift selective cyclical spending from “bad” to “good” times, as defined by the European Fiscal Board.

Recommendation 5. Launch an ambitious agenda for labour market convergence. A common unemployment (re)insurance scheme for large shocks would be one element of the agenda and would feature varying fees.

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