



Conselho das Finanças Públicas
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the present and aspirations for the future*

The Reform of the EMU: from a Fiscal Union to a Fiscal Capacity

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The centralization of the fiscal policy – two stages

First stage - Seventies and the eighties – MacDougall (1977) and the Padoa-Schioppa (1987) Reports:

- Fiscal Union model based in the main ingredients of the classical 'Fiscal Federalism Theory' (Musgrave, Tiebout, Olson, Oates, Stigler, Buchanan):

In the MacDougall Report, a **fiscal union should precede the creation of a monetary union.**



The first years of the EMU were well-succeeded (in economic and monetary terms)

- The optimistic view prevailed (*One Money, One Market Report* – Emerson *et al.*, 1990): EMU would, by itself, foster the **synchronization of the business cycle** (shocks would become more symmetric);
- The **centralization of the fiscal rules** (coordination of fiscal policy) would be enough to ensure a smooth functioning of the monetary union: common fiscal rules would prevent the 'deficit bias' of the fiscal policy, thereby helping the monetary policy to control inflation and to avoid negative externalities coming from a Member State's expansionist fiscal policy both to the interest rate and to the exchange rate of the euro.
- In sum, **the monetary union could survive without relying in a true fiscal union.**



After the financial and sovereign debt crisis, things changed...

Second stage – The initial optimism was questioned by the crisis.

As an alternative to the fiscal union model, a **model of a 'nuanced' fiscal union** emerged, based in two main components:

- a) The development of the so-called **private risk-sharing mechanisms** (based in the 'Optimum Currency Areas' main assumptions, e.g. mobility of factors): the creation of a **Banking Union** and of a **Capital Market Union** seen as essential to ensure the well-functioning of the internal market and to improve the capacity of the currency union to absorb macroeconomic shocks.

- b) The limited acceptance of the so-called **governmental risk-sharing mechanisms** – more recently they have led to, and been requalified, as a '**fiscal capacity**' for the EMU. Note that this fiscal capacity can in turn assume different modalities (see below).
- The first question is whether this 'nuanced' model of a fiscal union still relies in the classical 'Fiscal Federalism Theory'.



“Finance follows function” (Shah, 1991).

So, the first step of the FF theory is 'functions assignment',
being 'revenues assignment' the second step.

- Considering the seminal Musgrave's (1959) framework for fiscal functions (allocation of resources, redistribution and stabilization),

"Allocation lies at the heart of FF"

So, the best candidate for fiscal decentralization (according to the **geographical scope of the public good's benefit**) is the resources allocation function – e.g. the provision of public and club goods by the sub-central governments.

In turn, whenever spill-over effects and economies of scale occur, there is an argument for the upgrading in decision level (that is, an argument pro centralization).

- In contrast, the other two fiscal functions, **(inter)individual economic redistribution and macroeconomic stabilization** are typically central government functions: they correspond to national goals;
- In turn, when it comes to fiscal policies, **stabilization goes hand-in-hand with redistribution**: stabilization is ensured through the normal interplay of (income) taxes and (social) expenditures that being used to address equity issues, can also work, and usually do, as macroeconomic stabilizers.

- Three orders of financing:

First order financing: Tax resources

Second order financing: Intergovernmental transfers

Third order financing: borrowing (debt)



First order financing: Tax resources

Includes two different aspects:

- a) Tax assignment (according to the **fiscal function** attached and **factors** involved as tax base)
- b) Tax autonomy (e.g. legal capacity to create new taxes; definition of the tax bases and/or tax rates; co-occupation of tax bases – “piggy-backing”; setting tax exemptions and tax credits; etc.)

Grants: coping with **vertical** and **horizontal fiscal gaps (equalization)**, according to principles of tax capacity and/or expenditure needs.

Grants can be **non-earmarked** (non-conditional) or **earmarked** (conditional), including, in this latter case, **matching grants**. In the former case, they ensure an income effect; in the latter, also a substitution effect.

Note that **anti-cyclical grants or grants with anti-cyclical effects are rare** (in fact, grants' main purpose is usually to attain long-run convergence between similar jurisdictions; to correct imbalances driven from different tax capacities and expenditure costs).

Two exceptions:

- Stabilization grants (Canada);
- The *Länderfinanzausgleich* (LFA) (Germany).



Third order financing: borrowing (debt)

- Here, the question is how to adequate member states (MS) or regions autonomy with the existence of budget constraints; ultimately the question is whether the central level can provide a bailout to the those MS or regions in case of fiscal distress or a debt crisis.

- Hardening budget constraints:
 - a) *Ex ante*: Market discipline vs Fiscal rules;
 - b) *Ex post*: limiting a bailout; bankruptcy vs debt restructuring.



The difficult transposition of FF premises to the EMU scenario

This difficult transposition has different types of explanation:

- EU atypical nature and the fact that EMU is not politically embedded (McNamara, 2015) - ("a single currency without a state;
- EU is a 'club of clubs' with different preferences (Majone, 2014, Bongardt and Torres, 2017);
- The way countries look differently to (fiscal) rules: opportunism from the South vs. lack of solidarity from the North (Majone, 2014)



The difficult transposition of FF premises to the EMU scenario

As for functions assignment:

- a) The E(M)U is a **disjointed territory**: as for the plausible stabilization function, the central fiscal policy is assigned to EU Budget that includes 28(?) Member States, whereas the central monetary policy (in the ECB) is restricted to 19 members;
- b) The EU is **not an all-purpose organization** (economic affairs still prevail today, even after Maastricht): therefore, certain areas (public goods) that should be allocated to the centre (e.g. Defence) are not;
- c) With respect to the **first fiscal function (allocation of resources)**, there is some concession to the FF theory (some functions are assigned to the EU level, due to spillovers and/or economies of scale, or the need to favour the functioning of the internal market, e.g. environmental policies, transports and communications, competition, regulation);



The difficult transposition of FF premises to the EMU scenario

- d) However, due to the **small dimension** of the EU Budget (around 1% of the EU GDP) and due to the design and scope of its main instruments – revenues and expenditures –, this Budget was **not conceived to play any individual redistributive and/or stabilizing role**;
- e) Moreover, the **Multiannual Fiscal Framework** (MFF), due to the strict definition of appropriations within its main Headlines is considered to be very **inflexible** and insensitive to the business cycle.



The difficult transposition of FF premises to the EMU scenario

As for revenues assignment:

- a) Some of the FF theory criteria for tax assignment can be found in one of the EU own resources: the case of **VAT-based resource. Harmonization of VAT** rules was made to prevent beggar-thy-neighbour policies that could put into jeopardy the internal market.
- b) On the other hand, **the VAT-based is not as cyclically sensitive as it is at the national level;**
- c) Moreover, the **Gross National Income-based resource** is mostly made to obtain additional revenue to meet expenditures and to ensure the EU budget balance, which impairs a full reaction to the economic cycle;
- d) As the **EU budget** must be in a **strictly balanced position** borrowing is admitted only in limited cases, regardless the business cycle;



The difficult transposition of FF premises to the EMU scenario

- e) EU grants (e.g. **Structural and Cohesion Funds**) – are mostly **matching grants**, to ensure long-run convergence between EU regions and countries; however, they are not typical equalization grants;
- f) MS tax autonomy is combined with the **centralization of fiscal rules** (*ex ante* hard budget constraints) that limits states borrowing capacity; still, decentralized/market-driven solutions for the case of a debt crisis (**the prohibition of bailout**):
 - This is an *atypical configuration* in face of other experiences (e.g. German vs US model), and it was critical during the crisis!
 - The 'Jean Monet Curse' (W. Schelkle, 2017): some mechanisms of solidarity (bailouts) occurred by hazard and were forced by the crisis.



After the crisis the 'nuanced' version of FF has emerged: a fiscal capacity for the EMU

Policy questions to be addressed:

- a) Will fiscal policy be more (German model) or less (US model) centralized?
 - b) Will centralization mean not only the common fiscal rules, but even more than that (e.g. the creation of a common 'Minister of Finance').
- Or eventually a more balanced solution, overcoming this Manichean vision, to combine reinforced common fiscal rules with strong national Independent Fiscal Institutions in the surveillance of national Governments compliance with fiscal rules: this would at the same time prevent the abovementioned 'deficit bias', and preserve at the same time national sovereignty regarding fiscal functions.

A 'fiscal capacity' for EMU: designing issues and nature

General qualifying issues:

- Is the 'fiscal capacity' a **direct and visible stabilizing instrument** or only **an indirect one** ? (In this latter case, stabilization would take place as a consequence of other fiscal functions, either the action of redistributive instruments, e.g. direct taxation, or of the allocation of resources, e.g. investment expenditure in communications, transports, renewable energies, etc.);
- Does this instrument exhibit features of an **insurance device** (or not quite)?

In principle, **direct and visible stabilizing instruments tend to act more as insurance devices as well.**



A 'fiscal capacity' for EMU: designing issues and nature

To be considered an insurance device, the instrument must present some of these **features**:

- 1) Be automatic (the trigger activates automatically the mechanism and the reaction is automatic);
- 2) Covering large and idiosyncratic shocks;
- 3) No permanent transfers (no redistribution) and the fund should be balanced in the long-run;
- 4) Addresses moral hazard:
 - *Ex ante*: Contributions; deductibles; commitment with certain behaviour (e.g. fiscal discipline or sustainability);
 - *Ex post*: penalties; clawback mechanisms; etc..



A 'fiscal capacity' for EMU: designing issues

Specific qualifying issues:

- 1) Is the mechanism ensured through de **EU budget** or **outside** of it?
- 2) Does the mechanism works **only for EMU countries** or will it cover **all EU member states**?
- 3) How is it **financed**: through the existing **own resources system**, redesigning it, or implying the creation of a **new resource (tax)**? Which? Will it be sensitive to the business cycle?
- 4) The fund will be **typically an anti-cyclical fund** or will it be a **convergence-type fund** (eventually based in a principle of tax capacity) but at the same time ensuring some kind of stabilizing effect?
- 5) Will the fund have a **borrowing capacity** or not?



A 'fiscal capacity' for EMU: modalities

- Four main options (discussed after the crisis):
 - a) **The European Unemployment Benefit Scheme (EUBS);**
 - b) **Anti-cyclical funds;**
 - c) **Convergence-based funds:**
 - Bottom-up approaches
 - Top-down approaches
 - d) Reshaping the **European Stability Mechanism (ESM)**

The European Unemployment Benefit Scheme (EUBS)

- Two models:
 - a) **Genuine EUBS**: based on contributions from employers and employees and paying direct benefit to unemployed persons – it is an automatic and visible transfer scheme, a **typical insurance instrument**; high sensitivity to the business cycle both from the revenue and expenditure side (**automatic stabilizers**);
 - b) **Equivalent EUBS**: financial transfers would occur between the states and an supra-state entity – it is a reinsurance scheme (it is closer to an anticyclical fund, *infra*).

Trigger: deviations of the short-term unemployment rate from a certain (national) average.

Measures to prevent moral hazard: 'claw-back' and 'experience rating' mechanisms.



Anti-cyclical funds

- In general, these are **automatic and visible transfer schemes** based on the business cycle and using **deviations from potential output** as an indicator or benchmark;
- They are **linked to the SGP framework**: countries would have to comply with fiscal rules in good times (therefore **preventing moral hazard**); **in bad times**, countries could be allowed to **run deficits** and would be **supported** by common resources;
- **Several types of taxes** can be used, including taxes sensitive to the economic cycle;
- The instrument would have **borrowing capacity** and would balance out over the business cycle (no permanent transfers).

- Two approaches:
 - a) **Bottom-up approaches:** one of the pillars of the *Juncker Plan* was the creation of a **European Fund for Strategic Investment** (combining the action of the EC and the EIB Group) – investment in strategic areas (e.g. digital, transport and energy, R&D), and indirectly it has the capacity to leverage private and public investment in Europe, by exhibiting its **multiplier effect** (so, an indirect effect on stabilization grounds);

- b) Top-down approaches:** although related to the allocation of resources and/or to the promotion of inter-regional distribution (convergence), and even to the implementation of structural reforms, these new funds aim at being, in the first place, stabilizing instruments:
- The **European Stabilization Fund** (ESF);
 - The **Budgetary Instrument for Convergence and Competitiveness** (BICC)

Doubts as to the final design, financing support, and functioning of the instrument: for the time being, not too much ambition.



Reshaping the European Stability Mechanism (ESM)

- It seems clear that the role of the ESM will increase in the near future.
- It is a **non-EU budget financial assistance instrument** for situations of economic, fiscal and financial distress (e.g. governments and banks);
- It can give rise to a 'true' **European Monetary Fund**: a financial assistance institution with a special creditor status;
- Moreover, it can assume fiscal-type functions, acting as a '**fiscal backstop**' (for example for the future European Deposit Insurance Scheme, EDIS);
- Eventually, it can assume the role of a **typical fiscal institution**, becoming the new **Debt Agency** or **Treasury** of the E(M)U.



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Thank you very much for your
attention!

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