Governance of the Euro Area: Fiscal Union, Debt Union, Fiscal Freedom

Jürgen von Hagen

University of Bonn, Indiana University, CEPR, and Portuguese Public Finance Council[1]

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1. Introduction

Contrary to popular expectations, the euro has reduced the debt capacity of the member states. Governments in Southern European countries in particular had hoped that the euro would enable them to borrow more rather than less due to lower inflation expectations and interest rates. During the first few years of the euro, this wish seemed indeed to materialize. Nominal interest rates converged at low levels and governments used the opportunity to increase their borrowing.

Since then, large fiscal expansions have occurred in most member states as governments tried to counteract the recession triggered by the banking crisis and/or let themselves be persuaded to rescue failing banks. As a result, the average government debt/GDP ratio in the euro area increased from 66.4 percent in 2007 to 92.9 in 2012, with the largest increases in Ireland (92.6%), Greece (69.3%), Spain (49.8%), Portugal (48.8%), and Cyprus and Slovenia (30.9%). As debt ratios increased, so did real interest rates for these countries, indicating that markets (investors) were demanding increasing premiums for the risk of default. These premiums are the clearest indication that some euro-area countries have surpassed the limits of sustainable public debt. Although the ECB's guarantee of putting a floor under bond prices has abated risk premiums in the last few months, the underlying problem has not disappeared.

Outside a currency union, control of a country's rate of inflation is an important determinant of the government's debt capacity, because inflation is the government's key to solving a debt crisis. A government facing an unsustainable level of public debt denominated in its own currency can regain sustainability in one of two ways. It can default on (part of) its debt, shifting all losses on the bond holders, or reduce the real value of its debt through inflation, spreading the losses over all holders of bonds and national currency. History teaches that governments prefer inflation to default,

[1] The views expressed in this paper do not reflect the official position of the Portuguese Public Finance Council.

because the consequences of default are viewed as more painful than the consequences of inflation. Default leads to a decline in aggregate demand and tax revenues, while inflation comes with an expansion of both. Anticipating this, bond holders protect themselves against inflation by demanding adequate nominal interest rates.

By joining the euro, governments have given up control over the rate of inflation. This implies that, for any level of debt, the probability of a partial default has increased. Realizing this, bondholders demand an interest premium compensating them for the greater risk of default. The fact that this did not happen soon after the start of EMU has two interpretations. One is that markets perceived debt ratios then to be sufficiently low and the risk to be so small that the premium remained invisible. This is in line with research using data from before the crisis showing that interest rate spreads in the euro area were correlated with government debt and deficits but quite small. The other interpretation is that investors did not take default risk into account before the crisis and only became aware of it in the wake of the crisis of 2008-9. This is consistent with US experience in the 1970s, where yield spreads in the municipal bond market became much more differentiated across states after the near-default of New York City.

Be that as it may, the crisis has triggered a revision in the way markets price public debt and raised the awareness of the risk of sovereign default. Contrary to the claims of the ECB, this is not a sign of dysfunctional markets preventing monetary policy from operating properly. If it were, the conclusion would have to be that US monetary policy has been dysfunctional for the past 40 years. In the past, yield spreads among the now euro-area countries reflected different inflation expectations. Today, they reflect different degrees of sovereign risk. Interestingly, the countries in fiscal crisis today pay interest rates on their government debts close to those before the euro-induced convergence began. Most governments in the euro area will need to reduce their debt levels to come back to lower risk premiums and regain sustainability. If the experience of other large monetary unions like the US, Canada, or Australia teaches us anything, debt/GDP ratios of 60 percent are probably not compatible with sustainability, especially if one takes into account the rising pension liabilities these governments have.

For the euro area, the challenge today is how to manage the process of getting there. There are three options: A *fiscal union* with strong centralized fiscal competences, resources and collective sovereign risk, a *debt union* with decentralized fiscal competences and resources but collective sovereign risk, and a *monetary union with fiscal freedom* and individual sovereign risk.

Following the tradition of the optimum currency area theory and the MacDougall Report[2], the official and academic debate over fiscal union in Europe has generally focused on the potential benefits from sharing the risk of regionally asymmetric shocks that such a union could provide. In this view, a fiscal union is primarily a system of fiscal transfers responding to differences in the cyclical positions of the member economies and reducing the amplitudes of regional booms and busts. The fiscal union would thus compensate for the loss of the control over monetary policy at the national level.

However, this view is conceptually flawed[3] and empirically irrelevant.[4] The conceptual flaw is that such a mechanism would stabilize the individual economies around the average cyclical position of the monetary union. Whether this leads to more or less stability of output and employment in the individual economies is an open question. The potential benefits from such a mechanism would depend crucially on the nature of the shocks that cause the differences in individual cyclical positions. In addition, a large body of empirical research has shown that the response of fiscal transfers to asymmetric cyclical movements in existing federations is weak at best. Empirical estimates for the US have converged to the result that such transfers offset about ten percent of asymmetric shocks among the states. For Germany, the number is even smaller. One would have to believe in very large multipliers to think that these mechanisms play a significant role in the functioning of existing federations.

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[2] European Commission, „Report of the Study Group on the Role of Public Finance in European Integration", Vols. I and II, Brussels 1977; see also Kenen, Peter B. 1969. The Theory of Optimum Currency Areas: An Eclectic View. In: *Monetary Problems of the World Economy*. eds. Robert Mundell and Alexander Swoboda. Chicago: University of Chicago Press.

[3] See: Kletzer, Kenneth, and Jürgen von Hagen. 2001. Monetary Union and Fiscal Federalism. In *The Impact of EMU on Europe and the Developing World*. ed. Charles Wyplosz. Oxford: Oxford University Press

[4] Ralph Hepp and Juergen von Hagen, "Fiscal Federalism in Germany: Stabilization and Redistribution Before and After Unification." Publius: Journal of Federalism 42:2, 2012, 243-259

The true nature of fiscal unions is not risk sharing. Instead, fiscal unions constitute a specific assignment of the responsibility for the sustainability of public finances. This is what Europe needs to decide now.

2. Fiscal Unions

A fiscal union is characterized by the strong centralization of fiscal resources and competences and the allocation of the responsibility for the sustainability of public finances at the center. For the euro area, a fiscal union would mean the merging of all existing public debt into a common debt issued and guaranteed by the center of the union, the Center for short. Individual countries are not allowed to borrow in their own right. The Center is the sole public authority in the euro area issuing debt. Therefore, a fiscal union has no need for emergency lending mechanisms such as the ESM. The Center apportions the funds it borrows to the governments of the member states in an arrangement that could be designed along the lines of the Australian Loan Council. The member states benefit from the better status of the Center as a borrower in the financial markets and the assurance that they can never fall into a debt crisis. Additional benefits would come from the creation of a large, unified bond market with greater liquidity than the current markets.

Like Australia, the fiscal union needs a mechanism through which the member states and the Center agree on the annual amount of borrowing and its partitioning among the members. The Australian experience teaches that such agreements are not easy to reach and maintain, when states have different growth perspectives and different financing needs. One way to do that is to allocate the annual borrowing among the member states according to a fixed rule and allow them to accumulate reserve funds in times when they do not need to run deficits, from which they could draw in times of need. Such an arrangement, however, could lead to macroeconomic disturbances if the states withdraw from or build up reserves in uncoordinated ways. Alternatively, member states can exchange rights to fiscal union debt among themselves, allowing states with larger financing needs to borrow from states with smaller financing needs under the common deficit ceiling.[5]

The Center of the fiscal union needs sufficient fiscal resources to assure the sustainability of the union's public debt. In terms of the intertemporal budget

[5] See Alessandra Casella, „Tradable Deficit Permits: An Efficient Implementation of the Stability Pact in the European Monetary Union." *Economic Policy* 14, 1999, 321-362

constraint, this requires that the Center can credibly commit to a future stream of primary surpluses sufficient to cover the union's debt outstanding. The larger the union's debt, the larger would have to be the Center's resources to generate such surpluses. In addition, the Center needs sufficient resources to remain liquid and able to refinance its debt even in times of economic and financial distress. The more volatile the union economy and its parts, the larger the Center's resources have to be to achieve that.

Germany's experience in the early 20th Century teaches that a fiscal union in which the Center depends entirely on transfers from the member states will be perennially fragile. States might withhold transfers in times of fiscal distress leaving the Center unable to meet its financial obligations. Therefore, the Center must have its own tax resources large enough to guarantee the union's debt, a fiscal administration collecting its own taxes throughout the union, and the ability to adjust these resources to a growing debt stock.

Finally, since the possibility of fiscal distress cannot be excluded at the level of the union, the Center needs some degree of authority over the union's central bank in order to be able to fend off a fiscal crisis without having to resort to partial default. For example, the rules of the union could allow the Center to temporarily suspend the central bank`s independence and oblige the central bank to buy union debt during a fiscal crisis.

The Center needs strong authority over the member states to assure a debt path consistent with sustainability of the union. Since the member states will often be tempted to circumvent the ban on borrowing, the Center needs sufficiently strong coercive powers over the member states to that ban. It must be able to oversee the members' entire financial operations at all levels of government and have police powers to enforce union rules. Beyond that, however, the fiscal union has no need to control the fiscal policies of its member states in any detail. States are completely free to do as they wish within their budget constraints.

Obviously, such a powerful Center would need strong democratic controls to prevent it from turning into (a bureaucratic) dictatorship.

3. Debt Unions

In a debt union, member states borrow in their own right, but their debt is guaranteed by the union and the Center is weak in terms of financial, political, and legal resources. For the euro area, a debt union can consist of the mutual commitment of the member states to guarantee their public debts through a rescue fund like the ESM. Alternatively, it can mean the merging of all or large parts of existing public debt and the issuance of euro bonds guaranteed collectively by the member states, or a combination of the two. Like the fiscal union, the debt union pools the sovereign risks of its member states. It also creates the benefits of a larger bond market.

Member states issue Eurobonds on their own initiative, or they issue national bonds under the mutual guarantee of the rescue fund and convert parts of them into Eurobonds ex post. From the point of view of the markets the distinction between Eurobonds and national bonds will soon become irrelevant. A true distinction between the two implies the possibility that member states default on national bonds while Eurobonds are guaranteed by the debt union. But a default on national bonds will cause the very economic and financial turmoil for the euro area that the member states wished to avoid by setting up the debt union in the first place. Therefore, the threat of letting member states default on national bonds is not credible. In a fiscal crisis, the debt union would always stand ready to convert national bonds into Eurobonds. Anticipating this, both would be priced in the same way, creating the illusion that each member state's quality as a borrower is as good as the quality of the union as a whole. For the same reason, limiting the financial power of the rescue fund is not credible. If a crisis hits, all members will always want to increase the fund's resources to avoid any other member's default. The truth is that the ESM is an open ended fund.

The debt union creates a classical fiscal common pool problem, giving governments access to the tax revenues of other member states without facing the political costs of taxation. As a result, all governments have an incentive to borrow more than they would otherwise. This incentive is particularly strong for small member states, who feel the common pool externality less than large states and anticipate that large states will always want to protect the credibility of the common debt from being damaged by the default of a small state. The law of the debt union is, therefore, that small members are "too small to fail."

In view of this adverse incentive problem, the debt union has a vital interest in controlling the fiscal policies of its member states tightly to assure that each state maintains sustainable public finances. The debt union will create a system of budgetary rules much tighter than the fiscal union and a machinery of fiscal plans and programs, ambitious fiscal targets and detailed norms all monitored by the Center in order to identify situations where member states drift into unsustainability. In doing so, the debt union puts its members into fiscal straightjackets constraining their short-term flexibility much more than what is required for maintaining sustainable public finances. Meanwhile, the member states will seek ways to circumvent the rules, use creative accounting and find new debt instruments to get around the strictures of the debt union.

The tragedy of the debt union is that the Center lacks the information and coercive powers to keep its members from borrowing excessively. It must rely on the information provided by the members and on their administrations to enforce its rules. It is able to constrain fiscal plans, but not fiscal outcomes. In the end, the idea that the debt union controls the fiscal policies of the member states remains an illusion.

This illusion is the mark of the new framework for fiscal governance in the euro area, the “Six Pack” and the “Fiscal Compact”. Experience has shown that peer pressure and public exhortation are not enough to keep member state governments from embarking on unsustainable policies. There is little reason to believe that that will change. Furthermore, the European Commission is not the kind of neutral and competent judge over fiscal policies that a debt union would require. For lack of expertise or political stamina, the Commission has a tendency to focus on headline numbers such as the budget balance instead of looking at the structural issues that cause unsustainable policies. Identifying these issues requires substantial knowledge of a country’s economic, political and cultural institutions and addressing them requires interference with a member state’s internal affairs to an extent the Commission seeks to avoid. It is interesting in this regard to notice that the Commission’s 2012 *Sustainability Report* (p. 43) singles out Italy as the only euro-area state with sustainable public finances in the sense of having positive net public sector worth, a result based on the assumption that all reforms intended by the previous Italian government will be carried out fully and effectively.

The more closely the debt union monitors the budgetary policies of its members, the more it implicitly assumes responsibility for their outcomes. If a member state finds itself in fiscal distress, its government will turn to the debt union and ask for help, arguing that it did what it was told to do by the Center. The union will find it difficult to reject such requests, with the result that rescue operations will become more frequent. In the end, the illusion of tight control of the public finances of the member states results in the opposite of what was intended: More debt and more bailouts.

In sum, the debt union is itself an unsustainable arrangement. Historical experience shows that debt unions sooner or later end up drowned in debt or in high inflation.

4. Monetary Union with Fiscal Freedom

A monetary union with fiscal freedom is characterized by the rule that each member state is solely responsible for its own public finances. It leaves the member states complete freedom over their finances and has no need to subject them to any strictures and controls. Member states pay interest rates on their public debt reflecting the quality of their policies and they have to bear the consequences of their own policies, but they are free to adopt the policies they consider best for themselves. However, fiscal freedom needs some institutional features to be credible. The most important one of these is a framework for an orderly sovereign default. Four things need to be addressed.

First, it must be absolutely clear that a member state's debt crisis does not lead to its expulsion from the monetary union and that a debt crisis is not a crisis of the euro. Second, a set of rules must be in place by which a state in fiscal crisis and its creditors are brought together to negotiate a restructuring of the unsustainable debt. This could be achieved by the creation of a sovereign default court at the European Court of Justice. Third, the link between sovereign debt and the banking sector must be addressed. Openly acknowledging the possibility of sovereign default will already make banks more cautious in investing in public debt. In addition, banks should be required to hold capital against public debt similar to other risky assets. Central bankers might object that monetary policy operations rely on the existence of risk-free public debt, but this only says that the ECB would have to change its operating procedures appropriately. Finally, the liquidity shortage a state undergoing default will find itself in must be addressed. The ESM could be used to make bridge loans to

governments in default, but only on the condition that an agreement for restructuring has been reached with its creditors and approved by the court of default. Such loans do not have to come with painful adjustment programs as ESM loans currently do. They will, therefore, not create the same divisiveness among the member states we have witnessed in the past three years.

With fiscal freedom, the member states have a vital interest in good fiscal institutions. For some, this may mean fiscal rules and constitutional debt brakes, for others it may mean having a finance minister with strong control over public finances. Some countries may wish to emulate the Netherlands and have a CPB-like public finance council, others may prefer other arrangements. The monetary union may provide advice in this, but there is no need to have a one-size-fits-all approach to fiscal institutions.

The open flank of the monetary union with fiscal freedom is that it rules out the use of monetary financing to resolve a fiscal crisis. It leaves the common money stock untouched as a base for the inflation tax. This is significant especially because the inflation tax required to solve a given problem of excessive debt could be much smaller in a monetary union than in a national currency system as the inflation is spread over more countries and holders of nominal public debt. Realizing this, highly indebted governments will wish to find ways to tap into that fiscal resource. One way to read the current debt crisis is that some states in the euro area were smarter and faster than others to see the potential of this unused tax base, and moved themselves strategically into a position where they would benefit from a monetary policy aiming at bringing public debt back into sustainability. Preventing such strategic behavior remains a justification for monitoring the member states' fiscal policies even in a monetary union with fiscal freedom. But there are more natural ways to achieve that goal, such as holding the ECB accountable for overstepping its mandate.

5. Conclusions

In the past three years, the euro area has gone a long way towards a debt union. But a debt union is not a sustainable arrangement for the euro area. It does not create the incentives to reduce public debt, it will keep the fiscal crisis lingering, and, ultimately, result in high inflation or a collective debt crisis. Both can destroy the euro.

Sooner or later the members of the euro area must choose between a fiscal union and a monetary union with fiscal freedom. Either one will set them on a course of reducing the public debt ratios substantially to regain and maintain sustainable public finances. Choosing between these two is not the choice between a federal Europe and a union of sovereign states. Federations can be fiscal unions such as Australia, debt unions such as Argentina and Germany, or monetary unions with fiscal freedom such as the Unites States. Historically, some federations have drowned in debt, others in high inflation, others have maintained sustainable public finances at the central and the state level.

In the fiscal union, sustainability will be achieved by a powerful Center forcing the member states to pursue the policies it desires. In the monetary union with fiscal freedom, each member state will seek its own preferred way to achieve and maintain sustainability. As always, the price of freedom is individual risk and responsibility.