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## FIXING THE EUROZONE SETUP: ON VIABLE FORMS OF FISCAL UNION

### ABSTRACT

There is a growing consensus that the eurozone configuration requires substantial reforms, but member countries have vastly different views on the issues that should be addressed and the specific reforms to be implemented. A number of limited and sometimes unbalanced packages concerning fiscal coordination, the Banking Union and a European Monetary Fund have yet to be completed and a more ambitious effort concerning a Fiscal Union is still in the stage of a laborious political debate. In this paper, we focus on reform proposals that can deliver effective results by discussing different forms of Fiscal Union and looking for one that is more likely to survive the conflicting point of views of the different eurozone members. Finding that an unemployment insurance scheme is the more plausible short-term step to bolster the current reform efforts, we discuss different alternative implementation strategies for such a scheme. We conclude that a scheme with direct payments to the unemployed is the most effective approach to equip the eurozone with central shock absorption capacity while taking into account political feasibility, and that scientific literature provides appropriate backstops and conditionalities to prevent moral hazard.

**Keywords:** EMU, Fiscal Union, European Unemployment Insurance

**JEL Classification:** E62, F02, F45, H87

### RIASSUNTO

#### *Come riformare la configurazione dell'Eurozona: sulle forme praticabili di unione fiscale*

Esiste un crescente consenso sul fatto che la configurazione dell'Eurozona necessiti di sostanziali riforme, ma i paesi membri continuano ad avere posizioni divergenti sui problemi che dovrebbero essere affrontati e sulle specifiche riforme richieste. Una serie di interventi limitati e non sempre equilibrati in materia di coordinamento fiscale, di Unione Bancaria e di un Fondo Monetario Europeo deve ancora essere completata, e il progetto più ambizioso di una

Unione Fiscale si trova ancora allo stadio di una complicata discussione politica. Questo lavoro si focalizza sulla discussione di proposte di riforma che possano portare risultati effettivi, presentando una rassegna di diverse forme di Unione Fiscale e cercando quella destinata più probabilmente a sopravvivere ai punti di vista conflittuali dei paesi membri. Una volta stabilito che uno schema assicurativo contro la disoccupazione sia il modo più plausibile per rafforzare i pacchetti di riforme già in corso, discutiamo diverse strategie alternative di implementazione per uno schema di questo genere. Concludiamo il nostro articolo identificando uno schema con pagamenti diretti ai disoccupati come l'approccio più efficace per fornire all'Eurozona una capacità centralizzata di assorbimento degli shock macroeconomici che tenga però conto della praticabilità politica e identifichiamo in letteratura diversi strumenti di salvaguardia e condizionalità in grado di prevenire situazioni di azzardo morale.

## 1. INTRODUCTION

In the wake of the Brexit results and the looming possible access of eurosceptic parties to power in a number of crucial countries in the euro area, starting with Italy, there is an urgent need of a relaunch of the European project, due in the first instance to new initiatives put forth by a revamped Franco-German engine, led by President Macron and Chancellor Merkel.

In addition to fresh and more effective policies for coping with challenges posed by increased migration flows, terrorism and external threats, possibly within the Community framework, the Union has to definitively fix the very foundations of the most advanced stage of integration: the monetary union, whose flaws were at the roots of the sovereign debt crisis and the eurozone Great Recession, with its heavy legacy in terms of foregone growth, high unemployment and income inequality, perhaps the initial main drivers of euroscepticism.

From such a standpoint we have to take stock of the fact that remedies so far employed by member countries for fixing the euro area fault lines in the framework of intergovernmental decisions are not enough. All that has been devised and introduced in the EU public space: strengthening of *ex-ante* governance rules with a progressive shift of budgetary powers from the national to the European levels, setting up of financial backstops, accommodative BCE monetary policies, developments towards banking and financial unions and the like can at best be considered unfinished interventions. The EMU structure is still a frail one, governance

reforms so far carried out have not yet fully countered the euro redenomination risk and a possible new external shock might put in jeopardy the eurozone survival.

Against such a background, however, scholars and decision makers too are often aware of the need to definitively fix the eurozone configuration by advances towards more complete stages of economic union, among which recently their attention has been focused on forms of fiscal union, in order to complement monetary integration with a standard budgetary policy instrument. Indeed, a number of official EU documents and a growing literature have been devoted to such a perspective, as we shall see in the following lines, with the caveat that any of their proposals might be accepted within the reforms that will be part of the needed relaunch of integration.

To be more precise, the core topic of our paper aims at identifying possible forms of fiscal union, taking into account decisive factors for their viability, which make them acceptable both by creditor and debtor countries within the euro area.

In our search we will be guided by a number of evaluation criteria in order to identify in a clear way the best proposals so far advanced for introducing viable forms of fiscal union in the eurozone setup. According to our investigation such criteria could be summarised in terms of conditions for their acceptability as follows: i) the absence of permanent income transfers between countries; ii) the possibility for the creditor countries of the euro area too to receive such transfers in case of need; iii) the presence of transfers to the benefit of debtor countries; iv) the possible presence of direct transfer of the European funds from the Union to the households of the receiving countries. With the specification that the first two criteria can be considered together as necessary conditions for the proposals to be accepted by creditor countries of the eurozone, while the third could play the role of necessary condition for the debtor countries and the last one could enhance the acceptability of Union's policies at large by their citizens<sup>1</sup>.

The remainder of the paper is organised as follows. Section 2 offers a summary of the general debate on pros and cons of a possible European fiscal union, while Section 3 deals with different forms of fiscal union, underscoring also the link with a fully fledged political union. The

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<sup>1</sup> As to the acceptability of Union's policies by citizens that bore the brunt of the Great Recession, ours is only an item of a possible long list comprising criteria suggested by foremost personalities such as Mario Draghi (2016), who supports reforms delivering tangible and immediately recognisable results, for instance a European unemployment insurance fund, or Emmanuel Macron, who advocates "*une Europe qui protège*".

following Section 4 elaborates on unemployment insurance schemes, identified as possibly the best reforms at hand according to the chosen criteria. Section 5 brings to a close the paper with a few concluding considerations.

## 2. A SNAPSHOT ON A LONG OVERVIEW DEBATE

The notions of a European monetary and fiscal union have been strictly associated since the early stages of the Euro project. In the aftermath of the first, failed attempt at creating a common currency in the 1970s, economists were divided between sceptics (Eichengreen, 1993; Feldstein, 1997; Krugman, 1993) and supporters (Kenen, 1995; McKinnon, 1997; Mundell, 1961, 1973) of a monetary union in Europe. However, both fields broadly agreed that, in case a monetary union was finally established, the survival of the common currency required a fiscal union (Dabrowski, 2015). In fact, prominent among the arguments against the monetary union, was the idea that a common currency could not exist without the backing of a sovereign state, as such equipped with the role of fiscal policymaker.

A softer stance was connected with the developing theory on the Optimum Currency Area (OCA) but only insofar as the criteria defining optimum areas (for instance capital and labour mobility, price and wage flexibility and similar business cycles) required a comparatively small role for fiscal policy in absorbing idiosyncratic shocks affecting a member country. Around the time of the Maastricht treaty, the debate was focused on whether the conditions for an OCA were satisfied by European countries and if the benefits of joining exceeded the costs. Early formulations of the OCA theory, particularly the work by Mundell in the 1960s, seemed to imply that the response to asymmetric shocks in a currency area could be decentralized. If optimality conditions were met, member countries were mostly going to be subject to symmetric shocks and had enough buffer to absorb occasional idiosyncratic shocks, even in the absence of monetary accommodation, by the means of their domestic fiscal policy (Bordo *et al.*, 2011). As discussed by De Grauwe in his review of those developments (De Grauwe, 2006), the initial formulation of the theory correspondingly implied that countries not joining the monetary union could instead use their national monetary policy to stabilize their economies in case of need. Within that framework, which was prevalent among economists as late as in the 1980s, the main issue was that the costs of a monetary union outweighed the benefits because of the scarce symmetry of the European economies and the lack of labour mobility.

Notably, a 1973 work by Mundell opened up a significantly different perspective within the OCA theory, based on the hypothesis that monetary policies of countries outside a common currency could be a source of asymmetric shocks rather than a stabilising factor and that monetary unions could in fact prevent such effect. Based on those considerations, the costs of being part of a monetary union seemed considerably lower and, as a consequence, authors associated with the development of OCA theory (Kenen, 1995; McKinnon, 1997; and, from 1973 onwards, Mundell himself) were actually among the few who supported the prospects of a European monetary union. At the same time, lower costs of entering a monetary union implied less stringency on factor mobility, market flexibility and symmetry of the economies, less automatic stabilization and a greater need for fiscal integration.

Ultimately, the Euro project prevailed not because European countries were expected to experience mostly symmetric shocks but because the monetary union was identified as the “least bad choice” compared to full flexibility of exchange rates (De Grauwe, 2006). Nonetheless, the previous interpretation of the OCA theory remained influential to the point of being reflected in the decentralized, constrained and coordinated system of national fiscal policies set up by the Maastricht treaty and the Stability and Growth Pact (Dabrowski, 2015). The emphasis on fiscal coordination in the initial structure of the treaties was not intended to provide instruments for counter-cyclical policies but rather to control cross-border policy externalities (Thirion, 2017).

The consistency of a system based on decentralized fiscal stabilization but lax criteria on optimality soon came under scrutiny. With the European Central Bank (ECB) having assumed its full powers a few months earlier, Hughes Hallett *et al.* (1999) remarked that the Maastricht treaty and the Stability and Growth Pact were more concerned with constraints to national fiscal policies as a method to obtain convergence than with the operation of the common monetary policy. In their view, that framework left a number of open issues in terms coordination of national fiscal policies with the ECB monetary policy and the opportunity of forms of fiscal federalism and insurance at a European level.

Indeed, the rationale of the treaties was to look for a balance between decentralized fiscal stabilization and preservation of fiscal sustainability, with the latter component intended to create an ex-post convergence of member countries towards symmetry and to prevent

opportunistic behaviour under the shelter of a stable macroeconomic environment. Consistently with this view, in Schuknecht (2004), the currency area was interpreted as an environment of repeated cooperation games in which transaction costs and time inconsistencies in fiscal policy setting, which favour opportunistic national policies, should be counterbalanced with appropriate self-enforcing contracts determining automatic compliance or sanctions for non-compliance to fiscal rules. In that strictly regulated framework, fiscal centralization was merely considered as a threat for non-compliant members. Along those lines, Thygesen (1999) evaluated the room left for decentralized stabilization actions to be sufficient even under the constraints to budgetary deficits imposed by the treaties. In his view, the argument for a fiscal transfer to the central level as a stabilization instrument was not very compelling, at least in the initial stages of the common currency. Similarly, Gali and Perotti (2003) found no evidence in data from the previous 23 years, that stabilizing fiscal policies could have been seriously impaired by budgetary constraints such as those determined in the treaties, or that giving up the monetary instrument had produced a sufficient deviation from the correct monetary stance for each member country to suggest that more fiscal stabilization was necessary. However, they also warned that the time period covered in their data included few real recessions in which the recently introduced budget constraints would have been really binding for fiscal stabilization policies.

At the opposite, a number of economists were not persuaded about the effectiveness of decentralized fiscal stabilization in the face of asymmetric shocks and under tight budget constraints. Early examples of this can be found in Eichengreen (1992) where high costs were predicted for the elimination of the exchange rate as an instrument of adjustment and several rationales are proposed for running deficits larger than those allowed by the Maastricht treaty under given conditions and for limited amounts of time. It was also suggested that fiscal transfers within monetary unions are essential in order to respond to temporary income fluctuations and they should have led to a much larger common budget. Andersen and Dogonowski (1999) presented empirical evidence that the 3 percent limit to budget deficit would indeed be a binding constraint for EU countries during realistically severe recessions. They found that most countries over a presumably long transition period were likely to experience budget deficits and therefore be affected even in case of mild recessions, and that countries with high public debts would almost inevitably be restrained by budget norms in their ability to absorb shocks. Beetsma *et al.* (2001) investigated the circumstances in which coordination of

fiscal policies would provide benefits and found them to coincide with the case of asymmetric shocks. Von Hagen and Mundschenk (2002) pointed to similar conclusions, stressing that the existing mechanisms did not provide for a necessary joint fiscal policy stance, nor did they ensure its coordination with the common monetary policy. They also found the treaties lacking mechanisms to express and aggregate preferences of member countries on macroeconomic targets and take consistent choices at a central level.

In this diverse landscape of positions, it was ultimately the financial crisis that forced a major rethinking about the opportunity of leaving the fiscal stabilization function as decentralized as it had been for the first decade of the Monetary Union. In front of the empirical evidence emerging from the 2008-2012 period, the original arguments questioning the ability of governments to smooth asymmetric shocks under budgetary constraints came back to the forefront.

Wolff (2012) straightforwardly concluded that in monetary unions national fiscal deficits cannot counterbalance deep recessions, and that a common Euro-area budget must provide for temporary but sizeable transfers towards countries hit by large regional shocks. Similarly, De Grauwe (2013) suggested that the stabilizing mechanisms at work at a national level prior to the introduction of the common currency had been stripped away from member states without being transferred to the central level, thus leaving member states vulnerable to the consequences of regional shocks. De Grauwe noted how the ability to issue debt in a currency under national control was lost, with the consequence that the liquidity crisis caused by the recession could not be controlled by forcing a national central bank to provide liquidity at the appropriate time. Thus, the liquidity crisis had evolved into a solvency crisis as governments lacking resources had started a deflationary cycle by imposing austerity programs on economies that were already experiencing decreasing outputs, while the automatic stabilizers in the budget never came to be activated.

The reforms implemented after the crisis, including the European Stability Mechanism (ESM) and the so called “six pack” and “two pack”, regardless of their effectiveness, seemed to reflect the idea that a central stability instrument was needed but conditionality and constraints remained the fundamental focus. The acknowledgement of some design failures in the monetary integration process is also, somewhat reflected in a growing number of recent documents produced by the European institutions, seeking for additional reform strategies to be

implemented beyond those produced as a reaction to the pressing needs of the crisis. The Four Presidents' Report (Van Rompuy, 2012) explicitly called for a European deposit insurance scheme and a “qualitative move towards a fiscal union” in the form of a medium term timeframe to develop a scheme of common debt issuance, through the financing of undefined short-term funding instruments or a redemption fund, along with some instrument of fiscal solidarity.

However, the report was noticeably anchored to the idea that all those instruments should be conditioned to a greater pooling of budgetary decision making as a mean to prevent deficit and debt. In that framework, the central level would act first as an enforcer of national budget constraints and later, conditionally on the first step, as a treasury office managing a central budget. The Five Presidents' Report (Juncker *et al.*, 2015) expanded the reform project, detailing four axes of advancements: the Economic Union, which refers to structural convergence parameters, the Financial Union, on the advancements in risk-sharing in the private sector through the integration of the banking system and the capital markets system, the Fiscal Union which is supposed to deliver both sustainability and stabilization and, finally, the Political Union. The document acknowledges that all mature monetary unions have developed some common macroeconomic stabilization function to counter shocks that overcome the cushion capacity of national fiscal policies.

However, risk sharing in the private sector is the only stabilization mechanism that is actually more developed compared to what appeared in the previous report. The elaboration of the forms of a fiscal union is left to further analysis and both convergence and fiscal reform are intended to strengthen the sustainability rather than the stabilization capacity of the union, in order to provide greater enforcement strength to the macroeconomic imbalance procedure and more control over reforms and budgetary policies. A more explicit recognition of the insufficient fiscal buffers available at a national level and the limitations to market access for financing public debt can be found in the Commission reflection paper on the future of Euro (European Commission, 2017a), including explicit remarks that economic and budgetary prescriptions should make sense for the specific country under consideration and for its economic cycle and “pro-cyclical” measures should be avoided. The paper also reframes the timeline of the reform process by stating that risk-reduction and risk sharing should proceed in parallel. Additionally, it provides a much more compelling and detailed structure to the previous proposals about a possible macroeconomic stabilization function for the central level of the Euro area. The Commission

concedes that such a function should avoid permanent transfers, minimize moral hazard and not overlap with the existing ESM mechanism. At the same time, it also considers such a function very beneficial to the Euro area and explicitly mentions the goal to introduce a fiscal capacity for the central level and two possible strategies to make use of it as a stabilization instrument: protection of public investment during economic downturns and unemployment insurance.

The Commission reflection paper on EU finances (European Commission, 2017b) furthers the notion of an expanded EU budget as a possible consequence of a number of future challenges, among which a potential and qualitative new role of the European Union as the managing institution of a stabilization function. Following several different scenarios on the evolution of the Union, the paper indicates possible reforms of the EU budget and possible sources of additional revenue to support EU policies if they were extended in terms of size or goals. These potential sources of revenue could have different links with fiscal integration depending on which group of countries (members of the EU or members of the Monetary Union) would potentially benefit from the macroeconomic stabilization function. The paper implies that the new function would probably be implemented in at least two of the five scenarios. Finally, the recent December 6<sup>th</sup>, 2017 policy package presented by the European Commission (European Commission, 2017c) proposes a roadmap for the future steps towards completing the European Economic and Monetary Union. Specific proposals include the establishment of a European Monetary Fund in substitution of the ESM; the integration into the Union legal framework of the Treaty on Stability, Coordination and Governance<sup>2</sup>; the development of new budgetary instruments to support structural reforms, introduce a new stabilization function to stabilize investment in the presence of large asymmetric shocks and to provide a backstop for the Banking Union.

While the reform process of the Union proceeds slowly, hampered by national positions, the increasing dynamics of official proposals nonetheless corresponds to an emerging consensus, in the scientific debate on fiscal integration in the Euro Area, over some form of macroeconomic stabilization function to be located at a central level. Bénassy-Quéré and Giavazzi (2017) support the view that the eurozone remains vulnerable to financial shocks and has little instruments to control aggregate demand when the monetary policy of the ECB, although being oriented to provide liquidity to the system as a lender of last resort, has to face null or negative interest rates.

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<sup>2</sup> The document also refers to the flexibility rules built into the Stability and Growth Pact.

They support the prospects of reinforcing the ESM and completing the Banking Union as the initial steps before some form of more extensive efforts to create stabilization instruments for the entire Euro area. However, they concede, experts seem to agree on the need for counter-cyclical fiscal policies, but not on the exact instruments to achieve the results. Further complications are caused by the presence of high levels of debt in some member countries, which seem to block the implementation of insurance schemes as the probability of crisis is different between countries. As a consequence, fiscal integration is seen as an opportune but challenging way to fix the issues of the Monetary Union and one that should proceed in parallel with efforts to solve structural issues.

Thirion (2017) deems the ESM ill-suited both for *ex-ante* fiscal stabilization and systemic crises management. The banking and capital unions, while providing further buffer in case of shock, would fall short of ensuring the kind of long-term benefits that some form of fiscal insurance could yield. The issuance of some form of common debt would serve well in a complementary role, particularly with the aim of controlling self-fulfilling high-interest rates on the sovereign bonds of some member countries. Thirion acknowledges a number of challenging design problems to be solved regardless of the political opposition to such instruments. In any case, he supports the view that risk-sharing has to be complemented with tools that allow the stabilization of the business-cycle across the Monetary Union. In fact, the ECB might not be able to control fluctuations in the aggregate Euro-area business cycle because of the zero lower bound constraint or because the transmission mechanism is ineffective. In that case, the insurance schemes activated by the large common shocks would have de-stabilizing effects, forcing some countries to take pro-cyclical measures<sup>3</sup>.

Beck (2017) proposes a centralized authority to restructure and recover non performing loans or, with a more radical solution, a temporary restructuring agency owning liabilities, assets and equities in the process of restructuring and resolution, consequently sharing the risk between creditor and debtor countries. A further proposal is that of identifying a small eurozone budget (about 2% of the GDP of the Euro area) to be financed through some dedicated fiscal capacity. Such budget would serve the purpose of financing cross-border investment projects addressed at particularly sensitive issues (for instance, youth unemployment).

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<sup>3</sup> For instance, in the case of a generalized recession, some affected countries would have to pay transfers to countries suffering a deeper recession, with a consequent pro-cyclical decrease in government expenditure that might not be desirable.

De Grauwe (2017) maintains that consolidating national government bonds into a common bond would be the most effective strategy to tackle the issue of member countries dealing with national government bond markets without the backing of a central bank capable of giving support in times of crises. Since this first-best solution appears politically impracticable, De Grauwe supports the idea of a common unemployment insurance scheme along the lines of the Four Presidents' Report (Van Rompuy, 2012).

In anticipation of a fiscal union Tabellini (2017) essentially inverts the priority of functions that is generally found in all but the latest documents produced by the European Commission: the first goal of a fiscal union would be providing fiscal stabilisation, the second would be ensuring the instruments to withstand systemic financial crises and, last, strengthening the enforcement of fiscal discipline. In Tabellini's view, the ordinary task of cyclical stabilization is a responsibility of the European monetary policy, but in severe recessions monetary and fiscal policies should be coordinated to sustain aggregate demand, all the more if monetary authorities are constrained by the zero bound on interest rates. Additionally, the current role of ESM as an answer to financial and sovereign debt crises is insufficient both because of a lack of resources and as a consequence the unanimity rule required to activate the stability mechanism and the further, *ex-ante* scrutiny granted by national laws to some parliaments. While supporting the view that a much stronger risk-sharing mechanism in difficult times would be opportune, Tabellini does not envision stable risk sharing instruments like unemployment insurance to be a priority based on the idea that it would be difficult to design out of such schemes the risks of moral hazard and permanent transfers between countries. The main instruments to achieve the goal of a fiscal union would be a European Fiscal Institute to be established as an evolution of the ESM and equipped to issue and manage a common debt instrument (a "Stability Bond"). The proceeds of such instrument would be transferred to member states in proportion to GDP to reimburse their national debts and to smooth cyclical downturns of aggregate demand, in exchange for a commitment to transfer a share of national yearly tax revenue to the European Fiscal Institute.

Honohan (2017) describes a possible strengthening of the ESM by the means of a more sophisticated debt instrument consisting of GDP-linked repayment contracts structured as debt-to-equity swaps with built-in incentives to reduce additional public borrowing which could impact the country's access to the markets. This is seen as a long due increment in the effort of

fostering countermeasures for high levels of national debt and regional deficiencies in aggregate demand, in front of the disappointing lack of ambition from the Commission and the accommodating stance of the ECB which has temporarily masked but cannot solve the issues generated by excessive levels of debt.

Less favourable positions on fiscal integration are reflected in Gros (2017) that is exclusively focused on the Banking Union and on a common tool for deposit insurance as tools to shield the eurozone from the spreading of crises, whereas the ESM is considered the appropriate tool for dealing with systemic risk.

A more radical scepticism is expressed by Eichengreen and Wyplosz (2017) that consider a fiscal integration, in the absence of a political union, an illusion destined to fail against the overwhelming importance of fiscal policy as a national prerogative. This entails the futility of threats of sanctions and fines as well as that of some hypothetical function of supra-national surveillance over national fiscal policies. The authors support a full return of fiscal policies to the national levels and outside the influence of the arbitrary constraints defined over the years starting with the convergence process and the Maastricht treaty. In their view, member countries can be left managing their own fiscal policies without major negative spillovers to other countries in the currency area, as long as each country is equipped with constitutional legislation dedicated to fiscal discipline, requiring a balanced budget in the medium term, and provided that a mechanism is put in place to stop the negative feedback between sovereign risk and the banking system. With this last issue in mind, they propose that some central entity like the ESM could issue a safe asset to be exchanged with sovereign bonds held by banks, providing actual, rather than apparent, risk-free assets to be held by banks as capital.

The latest exceptions notwithstanding, the prevalent position in the scientific debate seems to increasingly point towards fiscal integration as the appropriate step to mend the deficiencies of the current set-up of the eurozone (De Grauwe and Ji, 2018; Majocchi, 2018).

### 3. A TAXONOMY OF FISCAL RELATED UNIONS

In elaborating on feasible forms of fiscal union, one has to bear in mind that lessons from the eurozone long crisis show that the single currency lacked a sound economic and technical

configuration<sup>4</sup> and an efficient policy management<sup>5</sup>, whose combined effects gave rise to a heavy Great Recession<sup>6</sup>.

In front of such a state of affairs, the Eurogroup, initially within the framework of intergovernmental bargaining, and later on in the eurozone institutions decided several governance reforms and interventions, whose main outcomes have been a growing transfer of fiscal attributions to the European level and the shift of the ECB to the stage of lender of last resort, thanks to the strong leadership exerted by its President Draghi, who fully deserves his fame of a European Hamilton, with his credible commitment to do “whatever it takes” to save the single currency and the ensuing quantitative easing policy. However, in line with a widespread belief, the euro area predicament has not been definitively fixed but at best frozen, as shown by the subsequent search of further institutional remedies in the field of fiscal mechanisms, leading so far to the still incomplete banking union and in general to possible new forms of fiscal union.

Indeed, according to a number of official statements<sup>7</sup> and an increasing strand of literature, the safest method for making the eurozone foundations sounder and resilient consists in complementing the current monetary integration institutions with some forms of fiscal union, mimicking the structure of many federal countries all over the world. In fact, as demonstrated in

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<sup>4</sup> Recall that following the two main theoretical references produced in literature on monetary integration an *ex-ante* judgment clarified that the Maastricht treaty could at best deliver only an incomplete currency union. Indeed, according to the chartalist view of money it was a commonplace that a viable currency not backed by a sovereign state could not exist. The same holds for the modern theory of money too, which can be considered as an updated version of the chartalist approach. See Mosler (2013). However, according to a less demanding political approach, the OCA theory, separate countries could merge into a currency union, as long as the latter is endowed with buffers absorbing asymmetric shocks, such as labour mobility and a common budget, or in general terms common and flexible input and product markets, also concerning credit and capital transactions providing sufficient automatic stabilisation effects.

<sup>5</sup> The reference here is to the procyclical measures by which the Eurogroup unsuccessfully tried to counter the crisis, on the basis of the wrong belief that austerity could translate into a recovery with a fall in debt-GDP ratios. On the shaky scientific basis of the theory that austerity, improving the international financial markets willingness to invest in a debtor country in the aftermath of a fiscal consolidation, delivers as a rule an economic expansion, see Praussello (2016). Within the long-lasting debate on expansionary austerity theory, besides the literature quoted in the latter, which falsifies it in the most of cases, a very recent study is possibly to be found in Auerbach and Gorodnichenko (2017), where for a sample of developed countries experiencing low interest rates and public high debt levels it is shown that a fiscal stimulus can improve fiscal sustainability.

<sup>6</sup> With the caveat that the costs of austerity imposed by the Eurogroup in terms of output losses and increased unemployment might have been particularly high for programmes based on tax increases instead of spending cuts (Alesina *et al.*, 2015), and due to real fiscal multipliers larger than initially forecast (Blanchard and Leigh, 2013).

<sup>7</sup> See a number of recent documents such as the Four (Van Rompuy, 2012) and Five Presidents' Report (Juncker *et al.*, 2015) along with Commission reflection papers on the future of euro (European Commission, 2017a), and the European budget (European Commission, 2017b).

Section 2, in favour of such a conclusion stands the bulk of technical studies on this topic<sup>8</sup>, whereas a few papers cast into doubt that advancements in this area are necessary, employing however counter-arguments that often are not fully convincing<sup>9</sup>.

That said, we have to notice that in literature there is not a single definition of fiscal union and of its possible components. Without going into much detail, we can distinguish a number of different kinds of fiscal and fiscal-related unions in the following terms.

The starting point is the union providing fiscal transfers deriving from a super-local system in order to insure a region or a country at a local level against the occurrence of asymmetric shocks. It is the type of fiscal device working in a national economy to the benefit of its different regional areas or with reference to several national economies belonging to a currency union, following the OCA theory approach. Most of the literature on the relationships between the eurozone and a possible fiscal complement of it shares this characterisation, which could be dubbed the “standard definition of a fiscal union”, or a “transfer union”, as in Germany is often considered politically correct to call it. In addition, von Hagen (2014) considers three other options encompassing also fiscal-related unions: a fiscal union with strong centralised competences and resources with collective sovereign risk, that can be defined as a “centralised fiscal union”, a “debt union” with decentralised fiscal attributes and resources joined with collective sovereign risk, and a “monetary union with fiscal autonomy and individual sovereign risk”.

The centralised fiscal union may be considered as a fiscal straitjacket imposed on member countries by a federal-type centre, which is the sole public authority allowed to issue a European debt, whereas the former are not entitled to borrow in front of the benefits deriving from the sharing of the common debt among them, the lower interest rates due to the latter’s better

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<sup>8</sup> Amongst the most recent surveys on these studies see Thirion (2017), Kamps *et al.* (2017), and Bénassy-Quéré and Giavazzi (2017). Interestingly enough, fresh studies have singled out also salient merits of European risk-sharing devices in terms of enhanced capital markets and fiscal policies resilience to shocks due to the financial cycle (Alcidi, 2017).

<sup>9</sup> As a case in point we can quote Gros (2013), who maintains that a European fiscal union is not necessary, since the case of the US shows that a well functioning banking union could be a sufficient condition to insure against local financial shocks, however missing the fact that in the eurozone a lot of general features are different from those prevailing in the US, where markets are flexible and integrated since at least in the aftermath of the Great Depression in last century, namely requiring an appropriate starting period to be reformed in order to be fully compatible with OCA characters. A more extreme view is expressed by Von Hagen (2012), according to whom a European fiscal union can be a root for debt and deficits, since it cannot allegedly overcome the standard public finance common pool problem, implying competition for financial resources among different political constituencies, even though a standard remedy to externalities is in reality to shift their control from the local to the super-local level: from the national to the European institutions when it comes to the need for some form of common countercyclical policy, as shown in Wyplosz (2015), elaborating on the classical fiscal federalism theory as developed in Oates (1972).

creditworthiness and the common insurance mechanism against asymmetric shocks. It could become a eurozone choice in the future, as a possible unbalanced compromise between the needs of its debtor countries and the creditors led by an austerian Germany. And indeed, the German government, led in this case by its Finanzminister Wolfgang Schäuble, has long been putting forth the need to centralise the budgetary management within the eurozone, in what it calls a “stability union”, another nominal version of this type of union (Thirion, 2017).

A debt union, in turn, implies the freedom of member countries to issue their own liabilities, in the presence however of a weak central union providing a common guarantee. Lastly, a monetary union is void of a common risk insurance device and member countries are free to borrow in a regime of fiscal independence. With the consequence that the present state of affairs within the eurozone is a mix between the last two situations, taking into account the partial freedom enjoyed by member countries in the aftermath of the shift from the national to the European levels of fiscal powers, along the presence of some forms of common guarantees such as the European Stability Mechanism (ESM) and the ECB policies.

The key character of the standard fiscal union, the kind of fiscal structure generally deemed to be necessary in order to definitely fix the eurozone predicament, consists in being an international budgetary mechanism helping the monetary union to work as an asymmetric shock absorber, along the lines of the OCA model<sup>10</sup> and the theory of fiscal federalism. More in detail, beyond the optimality conditions linked to flexible input and product markets, it offers a European public consumption-smoothing stabiliser which complements other tools for alleviating the negative impact on income during a downturn, such as national countercyclical policies, together with private international credit and capital markets, allowing to borrow abroad or to resort to extra earnings deriving from portfolio diversification or a varied portfolio of international investments or insurance contracts (Bluedorn *et al.*, 2013). All that, in the framework of a stabilisation task centrally attributed to the European level over local national jurisdictions.

As to the content of the standard fiscal union, beyond the completion of the banking and capital market unions which are part of the financial union along with the economic union advocated by the Five presidents’ report, a possible non-exhaustive list of its components has recently been suggested by Thirion (2017), who identifies five main building blocks of a fiscal union, classified

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<sup>10</sup> For an up-to-date discussion on the state of play of different channels allowing to smooth the effects of country-specific shocks following the EU broad governance reforms see Alcidi and Thirion (2016).

in order of increasing fiscal integration. The first three describe the steps already at least partially achieved as a consequence of the sovereign debt crisis: i) the rule and coordination stage in terms of shared-sovereignty (from the SGP to the Fiscal compact); ii) the crisis management mechanisms (from the ESM and its possible transformation in a European Monetary Fund, EMF, with powers similar to the IMF's, to the Outright Monetary Transaction (OMT) facility, to which other ECB policies could be added too, with specific reference to the quantitative easing measures); and iii) the incomplete banking union, by which a further stage of the incoming capital market union (CMU)<sup>11</sup>, or the second pillar of the financial union (FU), could be followed. The last two stages are betting on the future since they are founded on risk-sharing schemes at the European level: iv) the fiscal insurance, and v) the joint debt issuance steps, to which that of the economic union in the well-known standard Balassa's sense (1961) could finally be added.

Common fiscal insurance within the euro area or the EU includes a number of different elements, which range from rainy-day funds to unemployment insurance instruments. The former imply the setting-up of a common credit instrument financed by countries experiencing an economic expansion and transferring resources to countries possibly hit by a severe downturn (Gros, 2014), while the latter could represent an innovative form of delivering a positive European message to the continental public opinion at large, after long years of suffering and hardship. However, the said elements specifically singled out by the author could be better comprised within a large enough centralised budget, a standard component of the set of conditions focused on by the OCA theory.

The next, final stage of Thirion's list (2017) has to do with what could be dubbed the mother of all fiscal EU struggles: the joint debt issuance, the issue popularly known as the Eurobonds controversy on which here it is probably in vain to elaborate due to the long public debate it has aroused, with the irreconcilable views between eurozone creditor and debtor countries<sup>12</sup>. With the caveat that perhaps, it would be more useful to level a criticism against the incompleteness of Thirion's enumeration (2017), which might be better concluded by evoking the ultimate step of the political union, beyond the economic stages, as we shall see later.

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<sup>11</sup> On this point see Hübner (2016), Hoffmann and Sørensen (2012), along with European Commission (2017c).

<sup>12</sup> On this point see Gandullia and Praussello (2012).

At this point in our research, before trying to identify the more suitable forms of fiscal union among those so far described, taking into account the whole configuration of conditions characterising the current state of affairs of integration and the criteria for assessing the feasibility of different reform proposals, we have to take stock of a number of stumbling blocks challenging the continuing drive towards an ever closer union, beyond the physiological reaction of nation states to give up the remainder of a vanishing national sovereignty. Suffice it here to emphasise one of the most difficult to overcome: the stubborn refusal of German decision makers of any type of what they call “transfer unions”.

At the root of the refusal lies the old alternative between the conflicting views concerning the need to improve the eurozone capacity to alleviate the consequences of country-specific shocks, even in the aftermath of recent governance reforms (Alcidi and Thirion, 2016). In front of those, such as the German decision makers, who maintain that the latter will heighten the working of private risk-sharing channels and countercyclical national policies, without requiring new tools, we find those who suggest additional developments at the EMU level in terms of European risk-sharing mechanisms. A dividing line which is mirroring a deeper contrast between debtor countries, who often advocate increasing risk sharing among euro area partners, and creditor countries which are nominally available to concede, but only when common risks will be controlled and reduced enough<sup>13</sup>.

Put differently, the ultimate reason of the German idiosyncrasy against a transfer union is the fear<sup>14</sup> that following a risk pooling at the European level the German tax payers will be obliged to share the debt burden of partner countries. Inter-country solidarity within the EU seems to have become a rare good, even though a basic tenet of our liberal democracies is that the power to tax belongs to the citizens through their political representation in elected parliaments, a precondition not yet fully realised in the case of EMU<sup>15</sup>.

However, it should be added that the transfers which are not acceptable in this context must be permanent, direct and horizontal among partner countries (Heinen *et al.*, 2011). Furthermore, it

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<sup>13</sup> On this point see Allard *et al.* (2013), along with Stuchlik (2017).

<sup>14</sup> For a case in point of such an obsession see Sinn (2011), according to whom financing the eurozone peripheral countries by the Target 2 account managed by the ECB represents a bailout, with the consequence that in the future the euro area could fall apart or a transfer union could be established, “*in which the current account deficits will be financed with inter-country donations*”. A response to Sinn’s arguments is given in Whelan (2011).

<sup>15</sup> Hence the manifold interventions of the Frankfurt Constitutional Court, which makes Germany’s European obligations conditional upon approval by its Parliament.

has to be underlined that EMU has been already functioning, at least partially, as a transfer union. In a number of key cases cash flows between partners have already taken place, e. g. in the framework of Greek bailouts, whereas potential transfers have been materialised, i.e. owing to interest changes linked to ECB measures, while others might follow, should current guarantees attached to EMU governance interventions be mobilised or in the event of a country failure<sup>16</sup>.

Having thus elucidated a number of relevant points, we can conclude that perhaps some forms of fiscal union elements are at hand, which could overcome Germany's opposition to advancements beyond the already accepted instruments for fixing the eurozone shaky structure. Would-be candidates are surely not a large centralised budget or worse a joint Eurobond issuance, which are currently not acceptable by creditor countries implying permanent income transfers to the benefit of debtor partners, in contrast with our criteria, but other piecemeal instruments could do the job. Between the remaining choices in Thirion's list (2017) we would exclude the rainy-day funds, which are too technical to be sold to policymakers and public opinion in general, and bet on unemployment insurance, our preferred option<sup>17</sup>.

#### 4. EUROPEAN UNEMPLOYMENT INSURANCE SCHEMES

The suggestion to resort to a European Unemployment Benefit Scheme (EUBS) in order to provide European institutions with a macroeconomic stabilisation capacity dates back to the Seventies of last century and was put forward, namely, in the Marjolin Report (1975), with missions in areas of stabilisation and income redistribution among regions. However, the bulk of literature on this issues was developed in recent times in the run-up to and above all in the wake of the Great Recession triggered by the global financial crisis and the eurozone predicament, as it was to be expected. Recent surveys of significant papers on EUBS with reference not only to European but to external experiences too, starting with that of the US's system, are to be found in Dullien (2017) and in general in the studies made available to EU institutions in the last couple of years by the Centre for European Policy Studies (CEPS): Beblavý *et al.* (2015), Laenerts *et al.* (2017), alongside Beblavý and Lenaerts (2017).

<sup>16</sup> Only in 2009, for instance, Germany transferred to Greece a cash flow of about 866 million, whereas potential transfers due to EMU rescue packages and ECB supporting measures for partners in trouble amounted, in that order, to 580 and 408 bn euros (Heinen *et al.*, 2011).

<sup>17</sup> Indeed, rainy-day funds, even though organised in a such a way as to fill the first three of our conditions, due to their cumbersome technical features might in particular result lacking in view of the fourth criterion of enhancing the acceptability of Union's policies at large. From this standpoint, possibly the choice of unemployment insurance could be a superior option.

In this context, particularly influential have been lessons deriving from the US model, where unemployment insurance is organised at two levels of Federation and local states, complementing each other and solving coordination issues among the latter, thus optimising social protection of the whole structure (Lenaerts *et al.*, 2017). The US insurance system mainly pertains to the “genuine” unemployment insurance type<sup>18</sup>, where payments are directly transferred to unemployed individuals and from such a standpoint it differs from an “equivalent” insurance scheme, in which benefits are intermediated by local jurisdiction agencies.

One of its striking characters relates to the link between the two levels on which it is based. Amongst the financial sources paid by employers which support it there is a federal unemployment tax too, besides the local ones, whose amount is however reimbursed up to 90 per cent if local jurisdictions are in line with a number of federal requirements.

At the same time public spending in unemployment benefits increased US GDP by multipliers in the 0.7-1.9 range (Beblavý *et al.*, 2015), whereas in the aftermath of an unemployment shock around 34 per cent of its impact was absorbed (Dolls *et al.*, 2009).

In the EMU case a similar system, where benefits are straightforwardly paid out to unemployed workers would imply an extra stabilisation capacity added to the national ones, which are constrained by eurozone governance rules, high public debt and other restraints within financial markets. Furthermore, applied to the eurozone setup it would be in line with our fourth criterion of acceptability of Union’s policies at large by citizens of receiving countries.

However, moral hazard issues, which begets every kind of insurance, have to be dealt with, introducing backstops that have long been identified in literature, preventing the chosen schemes from giving rise to permanent transfers between winners and losers (Lenaerts *et al.*, 2017).

As a case in point of moral hazard linked to European risk-sharing mechanisms, Beblavý *et al.* (2015) quote the unwillingness of the government of a partner country to introduce a costly policy in terms of popular support, such as a pension reform, in the knowledge that thus it will be entitled to request a European compensation.

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<sup>18</sup> In addition, it encompasses also discretionary federal programmes, were local state jurisdictions are centrally financed by the federal state.

In order to mitigate this type of market failure two major tools are at hand: to resort to a trigger for insurance benefits, on the one hand, and to a claw-back or an experience rating mechanism, on the other. From a technical point of view, the most suitable solutions would be to devise a system linked not to the level but to changes in unemployment rates to be sure that all partner countries in the future could take advantage of it, at the same time paying directly benefits to unemployed or the most damaged people by integration, thus satisfying the political feasibility requisites from the standpoint of debtor countries.

As to the cost-benefit analysis of a possible European unemployment insurance system, estimates of recent literature simulations range from 0.3 to 0.85 per cent of EU/eurozone GDP for contributions incurred and from 10 to 30 per cent for marginal stabilization effects obtained in countries severely hit by a downturn (Beblavý *et al.*, 2015).

In addition, EUBS can also satisfy our i) and ii) criteria of the crucial requisite of political feasibility by creditor countries. Indeed, they have as a major advantage that of avoiding to make transfers among partner countries permanent, given that a number of studies show that the temporary tax-payments mechanisms on which these schemes are based might benefit creditor countries such as Germany too (Furceri and Zdzienicka, 2013; Bornhorst *et al.*, 2013; Dullien and del Prado, 2017), should the need arise.

A last point to be underscored has to do with the relationship between EUBS or other forms of fiscal union and the European political union. As we have already hinted in elaborating on the German idiosyncrasy against the so-called “transfer union”, in our European systems of liberal democracies fiscal matters have to be decided by people representatives within parliamentary institutions. In our case, all that needs to be referred not only to existing national democratic bodies but also to a fully fledged European democratic framework, currently only in a nascent stage.

Unemployment insurance mechanisms are probably the most easily political feasible variety of fiscal union, as we have tried to show, but anyway touch on the ultimate Gordian knot concerning sovereignty, intended as democratic accountability in the European public space. Indeed, as a matter of stringent logic, a long-term risk-sharing capacity among EMU countries could only be introduced under the political supervision of the European Parliament.

In such a way, contradictions between deep integration and democratic politics of the well known Rodrik trilemma (2000) could be overcome by adding the comprehensive European sphere to the national ones in the context of a global federalist compromise and the EU, or the eurozone countries which shall decide so, could be heading towards its own complete form of international democracy.

## 5. CONCLUSIONS

As the member countries of the European Monetary Union are gradually recovering acceptable growth rates under historically favourable macro-economic conditions (exceptionally low interest rates, a vast ECB bond-buying programme, reasonable exchange rates, sustained external demand and low oil prices) the emerging consensus among economists and officials in the European Institutions is that in the case of future asymmetric shocks, the reforms adopted during the crisis will not prove sufficient to shelter those members with more constrained public finances. Of all the reforms included in a meaningful strategy to strengthen the eurozone, the Banking Union and the crisis management mechanism, in the form of a European Monetary Fund, have yet to be completed; coordination has been implemented to a degree, although at the risk of making stabilization of asymmetric shocks more difficult. The Fiscal Union, which has long been considered a necessary complement to any monetary union, has yet to overcome the political opposition of creditor countries and the debate is open on the appropriate forms to design it.

In this work, we first tried to qualify a basic taxonomy of the different forms of Fiscal Union by the means of three broad models, based on the degree of centralization of fiscal competences and the degree of mutualisation of sovereign risk. We found the model of centralized fiscal unions, consisting of a strong supranational system of fiscal competences and mutualised sovereign risk as a plausible, if unbalanced, landing spot for a long term reform process, necessarily encompassing a challenging transfer of fiscal powers to a central parliamentary institution. In the short term, we found a more practicable solution to be, as in Thirion (2017), the finalization of the ongoing reforms on the European Monetary Fund and the Banking Union along with the introduction of some instrument of fiscal insurance, thus outlining a more centralised structure with a small budget ensuring some macroeconomic stabilisation capacity. Contrary to Thirion,

we found debt mutualisation as an unlikely building block of a fiscal union to ever reach general consensus among member countries in the foreseeable future.

In a second step we identified, among different fiscal insurance instruments, an unemployment insurance scheme with direct payments to the unemployed as the most effective approach to equip the central level with shock absorption capacity while taking into account political feasibility and, consequently, preventing permanent fiscal transfers between winners and losers. Such mechanism should be designed so to prevent moral hazard issues, but appropriate backstops are available and well-known in literature, including the possibility to make the insurance system conditional to changes in unemployment rates rather than to levels of unemployment.

As a final remark, it should be noted that, at the time of writing this paper, the complex negotiations to complete the eurozone reforms are possibly pursuing even broader and more articulated bargains in the attempt of overcoming national vetoes. A recent paper authored by 14 French and German economists of great stature (Bénassy-Quéré *et al.*, 2018) and widely regarded as the first publicly discussed platform for a possible Franco-German agreement, puts forward a number of intertwined conditions for advancing with the reforms. The document proposes a very ambitious reform of the eurozone financial sector in which, for instance, sovereign concentration<sup>19</sup> charges for banks is a pre-requisite for a common deposit insurance. In a similar fashion, the fiscal architecture proposed in the paper implies a bargain between deeply reformed rules on expenditure<sup>20</sup> and “incentive-friendly” fiscal stabilisation tools embedded with a number of guarantees to prevent a “transfer union”<sup>21</sup>. The proposed reform package is completed with a number of centralization rules and controls and the emission of a synthetic common bond, conditional to the reduction of sovereign concentration risk, which would offer investors an alternative safe asset to domestic sovereign bond and provide a smoothing of the transition from the current situation of excessive concentration on home country government debt.

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<sup>19</sup> By which the authors intend the unbalanced exposure of banks to sovereign risk due to a biased preference for domestic government bonds

<sup>20</sup> Most notably, countries with debt reduction targets would have to issue costly junior sovereign bonds to fund any expense in excess of the amount compatible with the agreed path

<sup>21</sup> For instance, the mechanism would work as a re-insurance with a “first loss” mechanism, meaning that the country itself would be responsible for covering the scheme until a certain level of shock is reached

Aside from its stern, controlling approach towards debtor countries, which might not win much support for it in South European countries, and aside from a lack of ambitious reforms of the political component of the European institutions, the paper provides compelling evidence of the intrinsic complexity of the negotiations. At the same time, it reaffirms the urgency of additional reforms and, specifically, the need for the introduction of a Fiscal Union built around a supplementary, centralised unemployment insurance scheme triggered by sharp changes in unemployment (a stabilisation-improving measure) and a set of counterbalancing, discipline-improving tools meant to overcome the reluctance of Germany and other North European countries.

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