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The only feasible fiscal union for the euro area

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Published online: 17 May 2017

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Abstract The need for a fiscal union in the EU is an issue which has been debated many times and about which much has been written. However, the economic and financial crisis we have experienced in recent years has cast doubt on whether we have taken this debate in the right direction. Sometimes we tend to focus the debate on marginal issues and unrealistic proposals. Rather than helping us to move forward, this paralyses the EU and distances us from feasible targets. This article aims to give a general overview of the debate on a fiscal union to find out where we are in the process of fiscal integration and what we can really expect from it.

Keywords European integration | Fiscal union | European Banking Union | Economic crisis | Structural reforms | European deposit guarantee fund

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Fiscal union: some introductory words

At this stage in the process of European integration, much has been said and written about the need to move towards a fiscal union as the only way to ensure the proper functioning not only of the eurozone, but of the whole EU. This article does not intend to provide technical arguments. Rather, it seeks to give a general overview of the debate on a fiscal union to find out what we could expect from such an arrangement. All of this is aimed at endorsing a conclusion: that keeping open debates on unattainable targets paralyses the EU and distances it from achievable targets likely to produce similar and more acceptable results for European citizens. This is particularly important now that European citizens seem to be tired of the existential debates going on in the EU and the limited results that the European project seems to have had in their daily lives, as can be seen from the increasing populist vote in recent years. This weariness has been reflected in both the outcomes of recent referendums and abstention in the European elections.

Theoretically, it would seem safe to say that the Economic and Monetary Union would work best if it rested on the foundations of a real fiscal union, even though historical evidence shows that monetary unions can work for many years without a fiscal union (Dabrowski 2015, 10–11). Examples of such arrangements are the West African Economic and Monetary Union, the Central African Economic and Monetary Community, and the nineteenth-century Scandinavian Monetary Union. Unfortunately, the EU is far from being a theoretical exercise.

The EU is possibly the greatest peaceful and voluntary integration exercise in human history. It is formed of a set of free nations and was born to build and secure peace and prosperity on the Old Continent. For many decades, the countries of the EU succeeded in this: there has been peace, Nazism and Communism were eradicated, and an area of economic stability capable of producing prosperity for hundreds of millions of Europeans has been established. However, as the EU has gradually expanded and the challenges of changing times have increased, the European project has started to lose momentum. Its effectiveness has suffered, and concerns about the EU's future viability are more present today than ever before.

At this point, one question that arises is whether we are giving the debate on fiscal union enough space. The 2008 economic crisis—probably the most devastating in modern history—has given us many clues. In fact, there is a widespread consensus that the design of the euro—with its poor institutional architecture that is yet to be completed—has much to do with the devastating effects of the crisis. To this it should be added that the economic good times that followed the creation of the euro did not provide sufficient incentives to correct this defect.

However, despite this widespread belief, we cannot know how the institutional architecture of the euro would have responded to the crisis if the member states had fulfilled the commitments made to the European institutions prior to the crisis, particularly those regarding budgetary stability. Nor will we know if the completion of the internal market

would have made it possible for the EU member states to better absorb the asymmetric impacts of the crisis. Perhaps the EU itself would have been able to limit the financial fragmentation following the crisis, but we cannot be sure about this either. This is a criticism not only of France and Germany's failures to meet their obligations at the beginning of the twenty-first century—as the spiritual drivers of the EU, both countries should have shown exemplary behaviour—but of all the member states that failed to meet the obligations set out in the Stability and Growth Pact (SGP).

What we do know with certainty is that when the crisis started the euro's potential was undermined by a lack of institutional development and the weak political will of the national governments.

Is Europe ready for a fiscal union?

These initial reflections are of great relevance to the discussion on a fiscal union. But a responsible and effective initial analysis such as this must be preceded by three questions, the answers to which should determine the structure and the scope of the fiscal union that the EU can and must have:

- What do we want from a fiscal union? What is the aim pursued?
- What degree of fiscal union would make it possible to optimise these preferences?
- What degree of fiscal union is achievable, taking into account that stability and sustainability must be the fundamental pillars of the final project?

For those who believe that we need a fiscal union in order to prevent another crisis like the one we have suffered through, we could use two arguments in reply. First, a deep and profound crisis like the one we have experienced is highly unlikely to occur again in the next few decades. Second, before making any assessment of the optimum degree of fiscal union, we need to remember that many steps have already been taken to put an end to this crisis (as we will see in the next section). In fact, member states have given up a great part of their sovereignty in a short space of time and most of the steps taken are recent and still need to be tested.

As for the advocates of a more extreme version of fiscal union—we could call it the federalist path—we believe that this is a politically unfeasible option. Furthermore, opening a debate on this matter paralyses the EU's efforts and frustrates the possibilities of achieving more limited, but clearly attainable versions of fiscal union.

Furthermore, many dream of creating a European common treasury financed through tax revenues from all the member states. Managed by a central, independent authority, this common treasury would be capable of issuing debt backed by a joint and several guarantee, capable of harmonising the welfare state benefits (pension insurance, unemployment insurance, etc.) of the 28 member states and authorised by the European

Central Bank (ECB) to implement the monetary policy. Unfortunately, such a vision is still far from reality—the capacity for consensus in the EU is still very limited and, consequently, it is far from generating the stability, credibility and sustainability required, even if a multi-speed EU were to emerge.

Anticipating some of the conclusions of these initial reflections, we can say that Europe is still not ready for a fiscal union for a number of reasons. The most important of these is probably that Germany is not willing to pay for the over-expenditures of other member states. Given this, and knowing that the institutional architecture of the euro is lacking a fiscal back-stop, we need to take another viable and already known route. In particular, we need to complete the European Banking Union by adding a third pillar: a European deposit guarantee fund. In this way, the Banking Union would be able to provide the EU with a limited version of a fiscal union, which would function automatically, regardless of political decisions, and without *ex ante* winners or losers. There are differing views on which institution should manage such a fund. For instance, according to the European Commission (2015, 7), the European deposit guarantee fund could be managed by the Single Resolution Board (for more in-depth information see Juncker et al. 2015, 11; Schoenmaker and Wolff 2015; Schoenmaker and Gros 2012, 2). However, the debate should not focus on this particular question but on what really matters, which in this case is creating such a fund as soon as possible.

Fiscal union: Where are we?

One of the things that draws attention when tackling the debate about a fiscal union is the high degree of semantic confusion in terms of the dichotomous approach to the debate—the idea that it is either a ‘yes’ or a ‘no’ to a fiscal union. This creates a distorted picture of the debate, confuses citizens and frustrates the progress already made, which usually ends up looking insufficient and inefficient, even before it has been tested.

Any external and objective observer of the EU institutional framework would be unlikely to say that there is no fiscal union. The simple fact that ownership of the ECB is shared means there is a mutualisation of its balance risks—a balance that, by the way, will continue to grow for at least another year, as will the shared risks. But beyond the ECB, and knowing that the crisis has highlighted the institutional gaps and weaknesses in the euro’s economic integration, the truth is that the European Monetary Union has responded strongly to these weaknesses and today it has a much stronger institutional framework than it did in 2008.

Overall, when the crisis hit, the structural reforms needed to address it came swiftly. On the one hand, the introduction of the Macroeconomic Imbalance Procedure helped the EU prevent the emergence of new, potentially harmful macro imbalances that could endanger economic stability. In addition, the European Systemic Risk Board (responsible for macro-prudential oversight of the systemic risks to the EU’s financial system) and the Single Supervisory Mechanism (responsible for the micro- and macro-prudential

supervision of the financial institutions in the countries joining it) contributed to further securing the stability of the EU's financial system.

On the other hand, however, there were also problems of sovereign debt in many European countries, as public finances deteriorated significantly when the financial crisis started. The average government debt in the euro area is still extremely high, and at the end of the first quarter of 2016 it stood at 91.7% of GDP (Eurostat 2016, 1). These problems were tackled by the SGP and the 'Fiscal Compact', which both aimed to achieve sound public finances in the member states and strengthen fiscal policy coordination. Linked to this, it should be remembered that the Fiscal Compact actually aimed to strengthen the SGP after the failure of many member states to comply with their earlier commitments, an issue that was closely linked to the euro's weakness in the face of the crisis.

The absence of a lender of last resort was another major problem that Europe faced when the crisis erupted. The European Financial Stability Facility and the European Stability Mechanism were created with the aim of providing financial assistance to the member states as necessary—as happened in Portugal, Greece and Ireland. However, this problem—the lack of a lender of last resort—was not resolved until the ECB launched the Outright Monetary Transactions programme in 2012. With this, the ECB became the lender of last resort for all euro area member states' governments and failing national banks.

With the crisis and the consequent deterioration of the economic situation throughout Europe, the banking sector was also in need of reform to clean it up so as to ensure its stability and proper functioning. The set of reform measures included in Basel III helped to achieve this goal: they aimed to strengthen the regulation, supervision and risk management of the banking sector (Bank for International Settlements 2011). These measures were complemented by the work of the European Banking Authority, whose main objective was to maintain financial stability in the EU.

Overall, these reforms have been steps in the right direction and have proved successful in tackling the roots of the crisis, as evidenced by the elimination of the 'redenomination risk'. This has enabled the economic and employment growth that we are now experiencing within the EU. It is nevertheless true that there is still much work to do, especially at the national level, and further reforms will need to be implemented—the steps already taken were necessary to solve the crisis, but are not sufficient to ensure the future stability of the eurozone.

Fiscal union: What can we expect?

Summing up all that we have seen and experienced since the economic crisis, we can say that the institutional architecture of the euro has indeed improved thanks to the strengthening of the Banking Union and the introduction of integration and economic control mechanisms. These mechanisms remain political in nature as regards

the decision-making progress, but they are still proportional, or not mutualised, when bearing a financial burden—as, for example, is the case with the European Stability Mechanism.

For its part, the ECB has assumed an increasing role not only in the eurozone’s economic growth, but across the whole EU, thereby offsetting the lack of political will from national governments to introduce the economic reforms to which they have committed in their national reform plans. Finally, the eternal debate continues on the need to move towards a fiscal union as the only way for the eurozone to survive. And interestingly, neither advocates nor opponents of this particular idea have changed their minds in years. That said, we must be precise and answer the questions we asked ourselves in the first section of this article, and try to reach a conclusion on what kind of fiscal union we can really seek. For this, we should bear in mind three conditioning issues, which are too often forgotten:

- First, the necessary condition for a fiscal union to function properly—that is, reaching a minimum degree of solidarity among European citizens—does not yet exist. The crisis has forced the EU to bail out countries close to collapse, something that was repeatedly justified by the argument of the ‘contagion’ effect—transfers were therefore seen as a lesser evil—rather than by the principle of solidarity, as should have been the case. The debate on a fiscal union is unsustainable without solidarity, and this is unfortunately something that it will not be easy to change. Schuman was the first to appeal for solidarity as a necessary condition for the EU to work (Fondation Robert Schuman 2011); 60 years later solidarity is still far from being consolidated.
- Second, we cannot act as if the euro is ideologically neutral in the eyes of Europeans. Moreover, we cannot act or open debates without taking into account that a significant part of the European population—a growing part as populism gains momentum—does not share the obligations deriving from more economic integration. The sustainability of a fiscal union—in its most advanced version—requires the constitutionalisation of strict budgetary discipline, structural reforms and market flexibility so as to remove them from the influence of political fluctuations. The stability required for a fiscal union cannot depend on political programmes, but we still seem to be far from consensus in this respect.
- Finally, if we seek a sustainable fiscal union, we need to bear in mind that the EU is still a union of sovereign and independent nations—and that they want to remain so. Therefore, any solution provided must be respectful of the parliamentary democracies on which the EU is founded, and it must include recognisable elements of national sovereignty. Any maximalist approach should be discouraged simply by thinking of the failure to enshrine the European Constitution.

In view of these restrictions, which are very much incontestable, it is easy to conclude that the only way open to us is that of creating a limited version of a fiscal union.

This being so, we should ask ourselves what the ultimate purpose of a limited version of a fiscal union would be. In this regard, taking into account the above-mentioned restrictions, trying to preserve financial stability through an effective surveillance of the effects of the banking crises would be a laudable aim. If we look at the economic history of bygone centuries, many social upheavals were preceded by banking crises, which, through their links to the state, often ended up harming citizens' daily lives.

It is true that, for the time being, the *ex ante* checks on the fiscal position of member states have actually been strengthened, and the Single Resolution Mechanism is an important step towards mutualisation on the path to financial stability. It is also true that all member states have accepted the 'almost-lender of last resort' role of the ECB—including Germany, even though it has been reluctant to do so. However, the fact remains that there is general agreement in the eyes of the international markets that a credible fiscal back-stop is still absent.

This fiscal back-stop could take different forms, but a European deposit guarantee fund that secures European citizens' savings would be the most appropriate. This kind of fund would allow the single currency to be of equal value to all the regions and countries in the EU, which is precisely the necessary condition for the proper functioning of any monetary union.

Of course, problems also result from the differing situations and conditions of the countries and their banking systems, that is, the famous legacy assets. But there are also different ways of financing the fund, in some cases through more public money and, in other cases, with less public money. And of course, it may not be possible for us to finance a fund that would enable a systemic crisis to be brought to an end. But the point of such a fund is for there to be a powerful enough deterrent, thus reflecting the euro-area countries' commitment to the single currency.

There are no successful precedents of a monetary union in which national guarantee funds compete with one another. Nevertheless, there have been positive experiences of banking unions. This is the case for the US and the Federal Deposit Insurance Corporation. Daniel Gros's (2012) article comparing the banking crises in Nevada and Ireland provides a good illustration—these two crises are perfectly comparable because of the size of the two economies and their real-estate bubbles. The US is a banking union and therefore the responsibility for banking problems is federal; in contrast, in the EU responsibility for banking losses remains national. As Gros says in his text, insolvent banks in Nevada were seized by the Federal Deposit Insurance Corporation, which covered the losses and transferred the operations to stronger banks, all without any disruption to Nevada's banking system. In short, the rescue mechanism in Nevada is automatic, removed from political decisions and has no *ex ante* winners or losers. Its automaticity speeds up the decision-making process and prevents countries from defending their own national positions. This automaticity is precisely what a European deposit guarantee fund would need.

We need to put an end to the idea of the Banking Union being a question of solidarity. It is not a north–south transfer mechanism, and history shows that no country is safe from banking crises that affect not only their financial stability but also their partners'. The success of the Banking Union is a question of efficiency, and until it is completed with a European deposit guarantee fund we will not be able to benefit from the single currency's full potential. Furthermore, we will not be able to ensure optimum functioning of the monetary policy transmission mechanisms, nor will we be able to prevent episodes of financial fragmentation such as those which followed the 2008 crisis.

This full version of the Banking Union should be the end, at least for the time being, of the debate on a fiscal union. A Banking Union that works through automatic mechanisms, independent of politics, with no *ex ante* winners or losers and with a single supervisory authority would probably produce similar results to more profound versions of fiscal integration which, we should remember, would be politically unviable.

Conclusion

Given that some versions of a fiscal union are not feasible in the short and medium term, keeping open the debate on creating a fiscal union results in two regrettable outcomes:

- First, it creates a distortion in the assignment of responsibilities, and this confuses citizens. The responsibility for the economic crisis was mainly national; therefore, solutions must also be national. Identifying a fiscal union as the solution to all the problems in Europe is indeed a mistake. The member states cannot continue to shift the responsibility for economic growth to the ECB or to a fiscal union that is politically unviable. The structural economic reforms needed to support economic growth and job creation in the long term must be taken at a national level.
- Second, it leads to unrealistic expectations which slow down and even paralyse the decision-making process on fundamental issues that, if resolved, would contribute to better economic integration. Considering the fiscal union as a necessary and natural consequence of the Banking Union is a big mistake. Such a move has been immediately rejected by some member states, especially Germany, and has thus prevented the putting forward of more limited and viable versions of risk mutualisation that would be acceptable to all member states.

The EU cannot continue to take steps forward without consolidating those it has already taken. Completing the Banking Union by adding a European deposit guarantee fund is the most important step, as this article notes. There are also other challenges, such as completing the single market and establishing free trade with other economic areas to create sufficient and sustainable growth. It must be tangible results that convince Europeans of the need for more Europe, and not flirtations with unworkable ideas.

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