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EDITORIAL

A European fiscal union: the case for a larger central budget

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1 Introduction

The future of European Union—and more specifically euro-area institutions—was at the center of a heated policy debate during 2011–2012, when the euro-area faced its deepest crisis since its birth. One key event during that period was the publication, on December 5, 2012, of the report "Towards a Genuine Economic and Monetary Union" authored by the so-called "four presidents" (Van Rompuy, Barroso, Juncker e Draghi) which identified four pillars on which a "stable and prosperous" monetary union could be built (see European Commission 2012).

One of these pillars—together with the banking union (or, more precisely an "integrated financial framework"), the integrated economic policy framework, and the strengthening of democratic legitimacy—was the "fiscal union"—at least this is the term used by many to refer to it, although more precisely the report referred to the achievement of an "integrated budgetary framework ensuring both sound national budgetary policies and greater resilience to economic shocks of the euro area as a whole". Since then, progress has been made in all these areas, although to different extents, with more progress being made in achieving an integrated financial framework. The update of the four presidents' report issued in June 2015 (actually now the five presidents' report, following the inclusion of the president of the EU Parliament; see European Commission 2015) makes new proposals on how to advance in integrating the institutions of the euro-area but is relatively less ambitious than the previous report, at least in terms of short-term objectives. The

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debate on the medium and long term future of European institutions is, however, still very much alive (see, for example, Sapir and Wolff 2015).

The need to base this debate on adequate information motivated the studies collected in a volume published at end-2014 (Cottarelli and Guerguil 2014), which was prepared primarily by economists of the Fiscal Affairs Department of the International Monetary Fund. The idea underlying this volume is that, in designing future European fiscal institutions, it is useful to look at the features of these institutions in other economic areas that share the same currency, the defining element of the euro area, and compare them with the current fiscal institutions in the euro area. In doing this, there is an obvious problem: other economic areas that share the same currency are—with the exception of the two African monetary unions and of the small Caribbean monetary union—also political unions while the euro area is not a full political union, at least not yet! In order to alleviate this problem, the book focused on fiscal institutions in policy unions in which the political power is less centralized, namely in federal states. In any case, even if imperfect, comparisons with federal states can still provide information on how some economic policy problems that characterize common currency areas have been addressed, thus providing a benchmark against which to assess current European institutions and perhaps suggesting the direction in which these institutions will evolve over the long term.

This article, based on the empirical evidence presented in the book, argues that the key differences between the fiscal institutions of the European Union and those of fiscal federations arise from the very limited role played in Europe by the Union budget, which is extremely undersized with respect to what is found even in the most decentralized fiscal federations. Furthermore, it is argued that the existence of a large federal budget plays a key role in ensuring the good working of a monetary union. Thus, while not being the only solution to the existing problems, the strengthening of the EU budget provides the logical evolution of—a logical ending point for—the process of integration of European institutions over the long term.

2 The most prominent feature of fiscal federations with respect to the EU: a larger central budget

The book focuses on the 13 largest federal states monitored by the Canadian Forum of Federations, a network of federal states based in Canada. Of these 13 federal states, eight are advanced economies: United States, Germany, Australia, Austria, Canada, Belgium, Switzerland, and Spain (the last one is not formally a federal state but, de facto, shares several institutional features with federal states). The other five are emerging economies: India, Mexico, Brazil, South Africa e Argentina.

The fiscal institutions of these federations are looked at from different perspectives, including:

- The degree of fiscal decentralization of taxation and spending decisions.
- The role of transfers among different levels of government.
- The fiscal rules constraining the various members of the federation.

– The support mechanisms in case of a crisis.

Along these dimensions, the book looks, in particular, at the fiscal relationship between the central government and the first sublevel of government (often called state or region, depending on the country), the one immediately under it and not, for example, to the relationship with lower levels of governments (say, municipalities). This is another reason why the study is particularly relevant as a benchmark for the fiscal institution of the euro area in which the key issue is the relationship between the EU level of government and the immediately lower level, the governments of the member states.

The most obvious difference arising in comparing the EU fiscal institutions with those of federal states is the very small size of the EU budget.

On the spending side, the EU budget includes only some spending programs aimed at reducing economic differences across members and regions (cohesion funds, structural funds), the common agricultural policy, as well as some spending projects involving synergies at the European level. On the opposite side of the budget, EU revenues consist of some customs duties on trade with countries outside the European Union, of a small percentage of VAT revenues transferred from Union members, and, especially, of contributions from member states (representing some 70 % of total revenues).

Altogether, the EU budget represents about 1 % of EU GDP, the same percentage for both revenues and spending as the EU budget must always balance and the EU does not issue bonds to finance its deficit (always equal to zero). EU revenues and spending are about little more than 2 % of the revenues and spending of the euro area.

This contrasts sharply with the size of the central budget in fiscal federations. Central government revenues represent on average more than 55 % of general government revenues (more than 60 % if social security contributions are included, as in almost all federations the pension system is managed centrally). Typically, personal income and corporate income taxes are centralized (although often additional taxes can also be levied at the sub national level), while consumption taxes are centralized in 70 % of the federal states considered in the book), while real estate taxes are usually decentralized (although often at the municipal level).

The degree of centralization is high also on the spending side: on average 60 % of spending (including pension spending) is centralized and even in the most decentralized federations (like Canada) central spending does not fall below 40 % of general government spending. Centralized spending typically include defense, foreign affairs, social protection (which also plays a redistributive role across regions) and, of course, large infrastructural projects. Sub national spending typically includes education, environmental spending, health care spending and, in part, public order.

In fiscal federations there is also a strong coordination of the spending policies that are not centralized. For example, even if education spending is usually decentralized, education policies are typically harmonized at the central level. The same holds for health care policies. There is instead less involvement of the central government in the design of local taxes, especially in the most decentralized

federations (like Canada and the United States) where the periphery has almost complete control of the definition of both tax bases and rates.

Centralizing 60 % of spending, on average, means a degree of centralization that is about 30 times larger than the degree of centralization prevailing in the EU (which we have seen centralizes little more than 2 % of spending). There is another anomaly in the EU: in fiscal federations the transfers are almost exclusively from the center to the periphery, reflecting the somewhat higher degree of centralization of revenues with respect to spending (as needed to allow a closer adjustment of spending policies to local needs). In the EU, instead, the transfers from the periphery to the center are sizable (compared to EU own revenues). In other words, you keep central spending under control also through discretional decisions on the transfers to the EU budget.

3 The role of the central budget in a monetary union

The underdevelopment of the EU budget is a significant shortcoming in the design of EU fiscal institutions because the existence of a large central budget plays a critical role in the working of a monetary area, particularly in a long run perspective. The ultimate reason for this is that the appropriate working of a single currency area requires the attainment of a certain degree of convergence of macroeconomic conditions, of economic policies and of the structure of economic markets and the centralization of key fiscal policy decisions through a central budget promotes this convergence and harmonization across the monetary area.

This occurs through four different channels.

First channel: centralizing—and therefore fully harmonizing—certain spending and revenue policies helps fostering the convergence of product and factor markets. Let's consider some examples (see also Cottarelli 2013):

- First example: centralizing the corporate income tax helps create a level-playing field for investment decision throughout the whole area.
- Second example: centralizing unemployment subsidies helps make more homogeneous the labor market and, in addition, could become the catalyst for the centralization of other labor market policies.
- Third example: centralizing pension systems would also make more homogeneous the European labor market.

One could go on with other examples. The key point is that the structure of tax and spending policies—their specific form and design—is a key factor in shaping the working and the evolution of factor and product markets and its full harmonization therefore helps in fostering the convergence in the working of those markets.

The second channel through which the centralization of fiscal policies helps convergence relates to fiscal discipline: centralizing fiscal policy decisions—that is assigning to the center responsibility for specific areas—reduces the risk that unsustainable fiscal policy decisions are undertaken by single member states. For

example, if unemployment benefits were centralized, the risk that unsustainable unemployment benefits are introduced by single members would be eliminated. In other words, the centralization of fiscal policy decisions is the final solution to avoid the risk of free riding in a monetary union. If, in principle, all fiscal policy decisions were centralized, it would not be possible for union members to run unsustainable deficits or to accumulate unsustainable debts.

Third channel: a budget that centralized spending and revenues items that are sensitive to the economic cycle, like the corporate income tax or unemployment subsidies, would imply that it is the center and not the periphery that would run larger deficits in economic downturns. And if we assume that the center can borrow from markets more easily than at least some countries of the periphery particularly during crisis periods—as evidenced by the experience of the euro area during the recent crisis—centralizing the automatic stabilizers enhances their effectiveness because it is less likely to cause an increase in interest rates. Consequently member countries and ultimately the whole area become less vulnerable to shocks, including those of idiosyncratic nature. This is the best way to achieve risk sharing, without having to introduce ad hoc transfer across member countries (as discussed below).

Fourth, and related, channel: a larger central budget, again under the assumption that the center can borrow more easily than at least some member states, can also more easily run discretionary counter-cyclical policies.

To sum up, the centralization of key policy decision through a central budget plays a critical role in the good working of a common currency area: if fosters economic convergence because it makes more similar the structure of economic markets, reduces the risk of fiscal free riding, allows a better risk sharing in the presence of shocks through the work of automatic stabilizers, and allows the management of more effective countercyclical policies.

4 Shortcomings arising in the euro area from the absence of a larger central budget

The costs arising from the absence of a central budget that could play these roles emerged clearly before, during, and after the 2011–2012 euro-area crisis:

- First, a key factor behind the 2011–2012 crisis was the insufficient convergence of factor and product markets, which led, for example, to strong differentials in the growth of unit labor costs across the area and unsustainable current account imbalances in the countries featuring lower productivity growth. There is therefore a need to further foster the convergence in the working of factor and product markets.
- A second cause of the crisis was the development of unsustainable fiscal positions: there is therefore the need of fostering further fiscal convergence.
- Third, a key focus of euro area discussions during the crisis was the need for better risk sharing. There were talks about setting up a system of transfers to support countries hit by idiosyncratic shocks. Indeed, many economists (see, for example Von Hagen 1992; Bayoumi and Masson 1995, as well as the references

in section III of Poghosyan, Senhadji and Cottarelli 2014) have noted that the existence of intra-area cyclical transfers is a key feature of single currency areas, while these transfers are almost non-existent in the euro area. What escaped that debate, however, is that in monetary areas intra members transfers are primarily the result of the centralization of automatic stabilizers (in turn arising from centralized revenue and spending policies), not of ad hoc transfers from the center that, while possible (as in the United States in 2009)—are more the exception than the rule and are relatively small (see Cottarelli and Guerguil 2014, Chapter 2).

- Fourth, there continue to be difficulties in implementing fiscal policies that take into account the needs of the whole area, particularly in those countries that have a relatively strong fiscal position but do not believe—quite understandably—that they have a responsibility to use their fiscal policy to address demand shortfall for the euro area. And yet the fiscal position of the euro area as a whole is much stronger than the fiscal position of the United States where fiscal policy has been used more proactively. In 2014 the fiscal deficit in the euro area was 2.7 % of GDP, half of what it was in the United States. Public debt was 94 % of GDP, 15 percentage points below the debt ratio in the United States. And Europe is in a stronger position also when it comes to medium-term pressures arising from pension and health care spending: the net present value of future increases in pension and health care spending for the next 35 years is estimated at some 200 % of GDP in the United States (3–4 times more than in the euro area; see International Monetary Fund 2015, Table A23). Altogether, the euro area has more fiscal space than the United States, grows less, and yet is not using this fiscal space to support economic activity, something that could be done through a central budget with tax or spending initiatives, for example a centralized infrastructural investment program (although, the Junker Plan tries to move in that direction; see below).
- Finally, the weakness of the market for bonds issued by European institutions has prevented the euro from playing fully the role of reserve currency played by the dollar.

The centralization of fiscal policies in a budget significantly larger than the current one, and a budget that could move from a surplus to a deficit position depending on cyclical developments, would address the above shortcomings through the mechanism explained earlier.

5 Alternatives to a larger central budget

Is this the only solution to the existing problems? Certainly not. Indeed, in the last few years alternative ad hoc approaches have been introduced as an imperfect substitute for the absence of a central budget, but with mixed results.

For example, the introduction of the so-called "macroeconomic imbalance" process is consistent with the need to make the adjustment process symmetrical between deficit and surplus countries and, therefore, to provide a stronger support to

aggregate demand with the help of surplus countries like Germany. But it is a weak process in terms of consequences for noncompliant countries.

The Junker plan also aims at supporting aggregate demand in the euro area through a centralized financing mechanism. It is a good initiative but its real effectiveness remains to be seen with respect to what would be possible if a central budget managed an infrastructural investment program. In particular, the additionality of Junket Plan initiatives is highly uncertain.

Regarding risk sharing mechanisms, the ESM represents an important step forward but its intervention modalities are complex (with the need, for example, to have every disbursement approved by several euro-area parliaments). Note also, as discussed in Cottarelli and Guerguil (2014), chapter 6, that specific support mechanisms do not exist in fiscal federations precisely because that support can be flexibly provided by a central budget if needed following a subnational crisis.

In any case, mechanisms such as the ESM aim at alleviating the effect of crisis at the sub-national level, not at preventing the insurgence of crisis through countercyclical transfers. There has been no progress in the euro area in setting up such risk sharing mechanism, in spite of much discussion and studies.

These ad hoc interventions, while imperfect substitutes, should nevertheless be seen positively. They do imply an attempt at centralizing certain policies, even if in a less stringent way than what would be possible through a central budget. Indeed, they are probably the only form of centralization of policies that may be possible at present, taking into account the constraints coming from the current euro skepticism mood.

6 Concluding remarks

However, over the long run, there is a need to move in the direction towards which almost all single currency areas have moved, namely that of realizing a fiscal union centered on a central budget of size and importance much larger of the current one. This would be in line with the design of a European Union built on trust and solidarity (Padoan 2015).

It would also be in line with early views on how public finance institutions should shape in Europe. While a proper treatment of this issue goes well beyond the scope of this article, at least two points should be mentioned:

- Jean-Claude Juncker has recently advocated the creation of a European Army, which, presumably, would require increasing significantly the size of the current EU budget. In this respect, it is worth recalling that as early as in 1952 the European Defense Community Treaty (signed by the government of Italy, France, Germany and the three Benelux countries) envisaged the creation of "common institutions, common armed Forces and a common budget". Unfortunately, the Treaty was stopped by the French Parliament, which never ratified it.
- The 1977 report prepared by a group of independent experts headed by Sir Donald MacDougall on the future of public finance in the EU concluded that a EU budget amounting to 5–7 % of GDP (or 7½–10 % of GDP if defense were included) would "facilitate the creation of a monetary union" and that monetary

unions in existing federations were “powerfully assisted by the largely automatic equalizing and stabilizing inter-regional flows through the channels of federal finance (MacDougall Report 1977, p. 21).

One last issue needs to be discussed before concluding. The EU budget belongs to all EU countries, including those that are not part of the euro area. This opens the question of whether a stronger central budget should refer to all EU countries or only to euro area countries. One could simply dismiss the issue by noting that, over the long run, there is a chance that all EU countries will be members of the euro area. But, even if this were not the case, one can consider a policy centralization that only referred to euro area countries, with some special arrangement for EU countries that did not intend to centralize their policies.

Of course, the creation of a meaningful EU central budget will take time and, probably, will also require a larger degree of political integration than the current one and than what it appears now possible. However, many things have been implemented in the euro area in the last few years that appeared completely impossible just a few years ago—the setting up of a banking union being perhaps the most prominent example. If one really believes in the future of a united Europe one cannot get discouraged against these difficulties. It is a long-term project and yet a very grand one.

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