Fiscal Union

The Maastricht Treaty signed in 1991 established the creation of a monetary union in Europe without a common budgetary and fiscal policy.

The idea was that benefits would accrue to members of the euro, such as transactions cost reduction and, and that these benefits increase with openness and flexibility.

The costs of monetary union occur in the face of asymmetric shocks, as evidenced by the sovereign debt crisis, where heterogeneity and structural differences could not be reconciled by one-size—fits-all monetary policy.

In an OCA, the adjustment mechanisms for asymmetric shocks include flexible wages and prices, labor mobility and capital markets.

Obstfeld and Peri (1998) find there is little migration in response to asymmetric shocks within European countries, relative to the US, implying labour is not mobile enough in Europe to compensate for shocks.

Dessy (2004) finds evidence of a high degree of nominal wage rigidity for all Eurozone members, also implying a lack of flexibility to enable countries to adjust to asymmetric shocks.

Capital markets can provide a private insurance mechanism if agents hold an internationally diversified stock portfolio, however, financial markets aren't fully integrated and the average citizen does not hold foreign shares.

As the Eurozone is not an OCA, these adjustment mechanisms do not function effectively, however.
OCA theory thus recommends either that national policies should be used in a flexible way or that a system of fiscal transfers is used.

Recent experiences have shown that fiscal policies are not the flexible instrument which OCA theory presumes.

Countries that systematically use fiscal policies run into the problem of unsustainable debt dynamics, which imposes negative spillovers on other members.

Increasing recourse to the capital markets by one country increases debt and the likelihood of default, which raises the union interest rate due to the prospects of contagion, so other countries become more constrained in their fiscal policies.

The accumulation of deficits can lead to unsustainable debt dynamics, however, as future generations of French people will have to repay debt to future generation Germans.

In light of these spillovers, a need to constrain national fiscal policy inspired the Stability & Growth Pact and more recently the Fiscal Compact, which restricts budget deficits to less than 3% of GDP and a debt:GDP over 60%.

This in itself limits the ability of national governments to respond to asymmetric shocks.

De Grauwe (2008) believes these are unsustainable, however, as national governments are more politically accountable than the Commission, and so when conflicts arise, national governments will always triumph (e.g, France/ Germany in 2003 disregarded the SGP). The S&P has little traction.

These credibility issues suggest the EU is unsustainable in its current form.
OCA theory **(Mundell, 1961)** recommends a centralised European budget or common fiscal authority, if possible. The implication of this is a Fiscal Union on the basis of political unification.

Baldwin and Wyplosz (2014) also offer political criteria:

The Transfer criterion: Countries that agree to compensate each other for adverse shocks form an OCA.

The Solidarity criterion: When a common MP gives rise to conflicts of national interest, the countries that form a Currency area need to accept the costs in the name of a common destiny.

A centralised budget will allow countries that are hit by negative asymmetric shocks to receive automatic transfers from countries receiving a positive shock, reducing the social costs of a Monetary Union.

This exists at the national level in Germany (Länderfinanzausgleich), but is absent at the European level, as the budget is only 1% of EU-GDP, instead of the 5-7% which the MacDougall Report recommends.

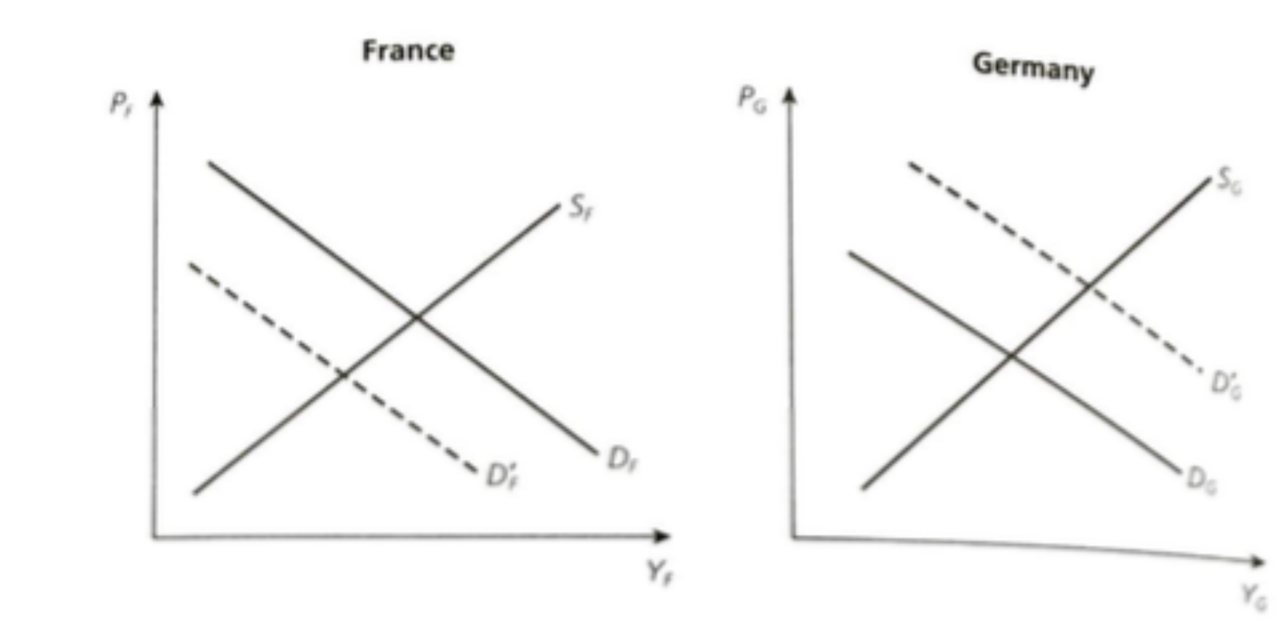

Figure 10.1 Asymmetric shock in France and Germany.

Consider Figure 1. An asymmetric shock occurs as European consumers shift demand in favour of German products at the expense of French products. France experiences a negative demand shock (Df->DF') and Germany experiences a positive demand shock (Dg->Dg').

In a MU the ECB is powerless, and so France will have to increase its borrowing, meaning unsustainable debt dynamics may arise.

With a centralised budget, France receives automatic transfers from Germany as an insurance mechanism to mitigate against the asymmetric shock. The centralised budget works as a shock absorber.

In France output declines and unemployment increases, which has a double effect on the EU budget - incomes taxes and social security contributions decline, whereas unemployment benefits increase. Exactly the opposite occurs in Germany, where output increases and unemployment declines.

Thus, the centralised European budget automatically redistributes income from Germany to France. This acts to smooth the shock, shifting (Df) and (Dg) back to their original positions and reducing the social costs of MU.

The motivation for Germany to do this is that they will experience an asymmetric shock at some stage in the future, and be compensated accordingly.

This depends on **von Hagen and Hammond's (1998)** assumption that shocks are serially uncorrelated and randomly distributed with zero conditional expectation, so you contribute as much as you receive in the long run.

In reality, shocks are not always exogenous and random, as periphery countries like the PIGS have lower competitiveness than Germany, for example.

This may lead to fiscal transfers not being temporary, as designed, but permanent.
Fuest & Peichl (2012) note the problem with this is that transfers maybe income redistributing rather than providing an insurance against the specific shocks faced by a country, which could raise political hostility from contributor countries

The insurance mechanism should therefore be temporary, as to not prevent adjustment taking place through wage changes and mobility.

However, if a preference shock is permanent, then transfers might need to be permanent, which risks reducing the pressure on France to adjust wages so as to eliminate the disequilibrium - the moral hazard problem.

The reason is that such transfers reduce the need for adjustment, keeping real wages excessively high and eliminating the incentives to labour mobility, as **Goodhart and Smith (1993)** note.

This is known as the 'Mezzogiorno problem', and is also attributed by **Hughes et al. (1993)** to German unification.
Thus, one way to reduce moral hazard is to guarantee that transfers are transitory despite the shock persistence.

It also depends on how the fiscal transfer system is organised: **Von Hagen & Hammond (1998)** argue that fiscal insurance against asymmetric shocks may actually increase the variability of output and employment over time even if it stabilises fluctuations around a common trend.

They also claim that any transfer system would throw up serious equity issues because Eurozone member countries differ greatly in size and per capita incomes, therefore the contribution as a percentage of GDP across countries will not be equal. This is illustrated by the example of Germany requiring a transfer to adjust to an asymmetric shock; because it is larger than other Eurozone countries, it will require a bigger transfer to be paid by smaller countries.

There are further benefits to fiscal union too over and above a simple transfer system: national fiscal policy is an important source of asymmetric shocks. Even if a common symmetric shock hits Eurozone coutnries, the differing magnitudes and speeds of response across nations will cause asymmetric effects.

The fact that fiscal policy has remained in national hands is a source of asymmetric shocks due to a 'beggar-thy-neighbour policy'. This has also resulted in different transmission mechanisms for real/ nominal shocks.

Carlino and Inman (2013) note that fiscal spending has externality on other members, which implies a return to coordinating fiscal policy. For example Germany has created asymmetric shocks by following a tight policy of wage moderation, which has led to divergent trends in competitiveness between members of the Eurozone. This policy stance is unlikely to have occurred under a more central EU fiscal oversight where the effects of German wage moderation on other nations would have been internalized.

Fiscal union is internalises these spillover externalities as it allows for increased coordination by a central body.
Increased need for political integration.

EU wide economic management also assures markets, which increases credibility reduces borrowing costs.

The McDougall Report (1977) notes that consolidating govt debt issues, reduces the fragility of a MU.
Rather than individual country bonds, there would be a common Eurobond for financing Euro debt.
Eurobonds would be seen as a safe investment to rival US Treasuries, bringing down borrowing costs further.
Euro as international reserve currency

An implication of fiscal union is tax harmonisation, as, if spending is centralised, taxes have to be centralised.

Competitiveness of some countries who depend on low tax rates may be adversely affected (Ireland).
Tax and spending system imposed by supranational body effectively impose a straight-jacket on political ideologies/ democracy, which is undemocratic. The suitability of voter ideologies varies (French prefer higher taxes). Furthermore it is welfare-reducing as the average preference distance between what country citizens desire and what they get in terms of government policy increases.

Maybe if a one-size taxation scheme was taken on, different countries will be taxed different amounts as a % of GDP.

The most obvious cost of fiscal union is the loss of autonomy by the central government, which may cause frictions in that local problems call for decisions at the federal level/ local solutions.

Bordo and James (2008) note that all past Fiscal Unions have been preceded by a Political Union, so it is considered a pre-requisite.

Centralisation of political power necessary for tax harmonisation
De Grauwe (2008) believes political union necessary - political accountability and stability

Fiscal union allows for better coordination: better organisation of fiscal transfers
It is necessary to take in account the political problems created by a situation in which high and permanent regional transfers go in only one direction.

Since such problems could jeopardise national unity at a national level, European nations will have to consider them when conjecturing about the centralization of its national budgets.

Citizens have to be 'willing to accept' deeper integration

The difficulties of implementation of that scheme remains the problem of lacking "European solidarity".
De Grauwe (2008) has identified an 'Omitted deep variable'.

The sense of common purpose which drove monetary and political union in Germany is seen as absent in Europe makes the progress towards political union so difficult in Europe.

The lack of a deep variable also explains why Europe started with monetary union. The latter can be considered to be the easy part on the road to political union. But at the same time it puts the whole process at risk.

Without a sense of common purpose it is very doubtful that further progress towards political union will be made. And as we have argued, without these steps towards political union the monetary union will remain a fragile construction.

Lindseth (2010): Despite functional demands of political union

there has been a degree of resistance/ unwillingness to accept a 'common destiny'
The Greeks do not appear to be ready to embrace this option yet.