# The Fiscal Union of the EU – Opportunities and Challenges

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**Abstract:** *The European Union is the most developed integration community in the world. One of its most important features is the common currency and the shared monetary policy. The euro's first decades were successful, but not without serious challenges, most importantly the economic and debt crisis. The threat to the stability of the common currency has revived the debate about the creation of a fiscal union to complement the monetary union. There are already some important features of a common fiscal policy on the European level, including the EU budget, the Stability and Growth Pact and the European Stability Mechanism. However, this institutional framework is considered insufficient as a tool for macroeconomic stabilization and for the mitigation of country-specific economic problems. On the one hand, a genuine fiscal union would require centralized policies on taxes and public expenditure and most Member States are not willing to renounce their sovereignty in these important fields. On the other hand, there is an increasing understanding that in future the common European currency could again be placed under considerable pressure without stronger fiscal policy coordination. This understanding is reflected in the project for the next Multiannual Financial Framework 2021-2027 which envisages the establishment of new mechanisms and funds for macroeconomic stabilization. Against this background, the paper is devoted to the possibility for creation of a fiscal union in the EU. The objective is to outline the current institutional and legislative setting as well as to analyze the prospects for further integration. The present paper is devoted to the fiscal union of the EU. The objective is to outline the current institutional setting from the point of as well as to analyze the prospects for further integration. The paper is structured as follows: the first part outlines the existing elements of a fiscal union in the EU; the second part presents the new mechanisms envisaged in the Multiannual Financial Framework 2021-2027 governance; the third part analyzes the advantages and shortcomings of a possible complete fiscal union; and the fourth part concludes.*

**Key words:** *Economic and Monetary union, fiscal union, European integration, fiscal policy coordination*

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## Introduction

The Economic and Monetary union of the EU comprises 19 countries which share a common currency and monetary policy but have different budgetary policies. When the euro was introduced a fiscal union was not on the political agenda in Europe. However, the economic, debt and banking crises gave impetus for deeper integration. There is increasing awareness that stronger coordination in fiscal policy is necessary to complement and enhance the monetary union. Several projects were proposed in recent years, including the creation of a separate euro area budget, an EU finance minister and a European monetary fund. However, Member States are not willing to renounce their sovereignty in budgetary policy, therefore most of these ambitious ideas are not likely to be applied in the next Multi-annual financial framework 2021 – 2027. Against this background, the present paper is devoted to the fiscal integration in the EU. The objective is to present the current institutional setting as well as to analyze the advantages and risks of a complete fiscal union. The paper is structured as follows: the first part outlines the existing elements of a fiscal union in the EU; the second part presents the new mechanisms envisaged in the Multiannual Financial Framework 2021-2027; the third part analyzes the advantages and risks of a possible complete fiscal union; and the fourth part concludes.

## 1. Current institutional framework of the EMU

The economic literature does not provide a single definition of a fiscal union. According to Dabrowski a fiscal union is broadly defined as a transfer of part of resources and competences in the area of budgetary policy and management from the national to the supranational level (Dabrowski, 2015, p. 7).

Fuest and Peichl (2012) distinguish the following elements of a fiscal union:

- fiscal rules, policy coordination and supervision,
- a crisis resolution mechanism,
- joint guarantee of government debt,
- fiscal equalization and other mechanisms of fiscal transfers between countries and
- a larger EU budget and European taxes (Dabrowski, 2015, p. 7).

Thirion (2017) proposes a somewhat different architecture, which may include the following three tiers:

- fiscal rules and crisis management mechanisms,
- banking union, including common deposit insurance and/or a fiscal backstop,
- joint debt issuance and fiscal insurance (Thirion, 2017, p. 3).

An important feature in all the above definitions is the availability of a mechanism for fiscal risk-sharing among the participating countries. This in turn requires the existence of a common budget of significant size which allows for direct transfers to member countries experiencing asymmetric economic shocks. At present the EU budget lacks this property because its amount is insufficient for macroeconomic stabilization.

Many of these elements are already present in the European Union. It should be noted that a complete fiscal union was not on the political agenda when the EMU was created. In the first years of the euro the common fiscal framework was represented mainly by the EU budget and the Stability and Growth Pact. The consensus at that time involved a combination of fiscal rules and market discipline through commitment to no bail-out and no debt monetization (Thirion, 2017, p. 1). These mechanisms were considered sufficient to ensure the sustainability of the public finances of euro area countries.

At the beginning of the 2010s, after a series of crises, however, it became clear that the stability of the common currency required deeper integration. This decade has seen significant changes in the EU institutional setting with the introduction of more rigid rules on fiscal discipline and new indicators for monitoring of macroeconomic imbalances as well as new mechanisms for financial assistance (See Table 1). An important reform involved the establishment in 2012 of the European Stability Mechanism, whose main objective is to support euro area government and banks through low-interest rate loans. Since its inception the ESM provided financial assistance to several euro area countries and contributed significantly for the mitigation of the sovereign debt crisis and bank crisis.

In addition to the fiscal mechanisms presented in the Table below, the foundations of a banking union were laid through the establishment of single bank supervision and single resolution fund. A banking union and fully integrated capital markets are also important building blocks of a genuine Economic and Monetary Union, along with a fiscal union.

*Table 1: Existing elements of a fiscal union in the EU*

| Initial mechanisms | |
|---|---|
| **EU budget** | Amounts to around 1% of EU gross national income. The largest shares of the expenditure are devoted to the Common agricultural policy and the Cohesion Policy. |
| **Stability and Growth Pact (SGP)** | Set of quantitative criteria regarding several economic indicators, including level of budget deficit, public debt, inflation rate, long-term interest rates and exchange rates. Its objective is to promote nominal convergence of national economies of the countries sharing the common currency. |
| **Mechanisms introduced after the crises** | |
| **Economic governance package** | A set of rules for economic and budgetary surveillance, which comprises five regulations and one directive intended to strengthen the SGP. An important part is the European Semester. The package also introduced an Excessive Imbalances Procedures aimed at reducing macroeconomic imbalances. |
| **European Stability Mechanism** | Provides financial assistance to euro area countries and financial experiencing severe financial difficulties. Its lending capacity is 500 billion Euro. |
| **Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (Fiscal Compact)** | A treaty concluded after the outbreak of the debt crisis in the euro area. It requires from the EU Member States to introduce a balanced budget rule in their national legislations. The treaty is binding for the euro area countries, Bulgaria, Denmark and Romania. |
| **European Fiscal Board** | Its main responsibilities include evaluation of the implementation of the Union fiscal framework and the appropriateness of the fiscal stance at euro area and national level; suggestions for the future evolution of the Union fiscal framework, etc. |

*Source: European Commission, Council of the EU*

## 2. Will MFF 2021 – 2027 lead to deeper fiscal integration in the EU?

The necessity to deepen the Economic and Monetary union through the creation of a fiscal stabilization function was recognized in recent years. In the so-called Five Presidents' Report from 2015 the former president of the European Commission Jean Claude Juncker stated that an automatic stabilization at the euro area level was necessary in order to improve the cushioning of large macroeconomic shocks and thereby make EMU overall more resilient (Juncker, 2015, p. 14).

Following this statement, in 2017 the European Commission presented a Roadmap with several ambitious steps for completion of the Economic and Monetary union by 2025, including:

- Establishment of a European Monetary Fund,
- Integration of the Fiscal Compact into the Union legal framework,
- Introduction of the position of a European minister of Economy and Finance and
- New budgetary instruments for support of euro area member countries (European Commission, 2017).

The proposed position of a European Minister of Finance and Economy would be a result of the merger of an EU commissioner and the president of the Eurogroup. Its institution would aim at improving the policy coordination and overseeing the EU and euro area budgetary instruments (European Commission, 2017, p. 10). As regards the European Monetary Fund, the intention expressed in the Roadmap was for it to replace the European Stability Mechanism. The creation of a common fiscal backstop to the Single Resolution Fund was also envisaged with in order to achieve convergence to prudent levels of public debt.

The basic principle laid down in the Roadmap was that any new financial mechanism for support of euro area countries should be a part of the EU budget. In particular, four specific functions were proposed for deepening of the Economic and Monetary Union:

- support to structural reforms in the Member States, □
- a dedicated convergence facility for Member States on their way to joining the euro, □
- a backstop for the Banking Union, through the European Stability Mechanism/European Monetary Fund and

- a stabilization function, bringing together different EU and euro area level funds and financial instruments, to be used to maintain investment levels in the event of large asymmetric shocks (European Commission, 2017, p. 8).

Despite the ambitions of the European Commission, and the support of Germany and France, only some of the described steps were included in the draft of the Multiannual Financial Framework 2021 – 2027, which was put forward in the spring of 2018. The MFF envisages the creation of the following new mechanisms to support the EMU:

- ***European Investment Stabilization Function (EISF)***

The EISF is intended to provide financial assistance in the form of loans and interest rate subsidies for public investment to a Member State which is experiencing a large asymmetric shock. It will be available for euro area Member States and other Member States that participate in the Exchange rate mechanism (European Commission, 2018, p. 19). The EISF is expected to mobilize up to EUR 30 billion in loans.

- ***Reform Support Programme***

With an overall budget of EUR 25 billion, it will assist Member States, through technical and financial support, in conducting reforms in product and labour markets, education, taxation, capital markets development, etc. As part of this mechanism, a Convergence Facility will also be established to support non-euro area Member States seeking to adopt the single currency (European Commission, 2018, p. 10).

- ***Budgetary Instrument for Convergence and Competitiveness (BICC)***

This instrument was not included in the initial draft of the MFF 2021 – 2027. It was initiated in late 2018 by Germany and France and the elaboration of the details was assigned to the Eurogroup. At the end of 2019 the Member States agreed on the establishment of the new BICC to be introduced in the next long-term budget. The BICC will be dedicated only to Euro area member states and the countries participating in ERM II. It will finance public investments and structural reforms with the aim to strengthen the potential growth of the economies and the resilience of the single currency against economic shocks (Council of the European Union, 2019). The new instrument will draw on the EU budget and it will be financed by the Member States.

Even if the proposed new mechanisms are adopted, the EU budget will still have relatively limited capacity for macroeconomic stabilization. Its size of around 1% of Gross National Income is insufficient for fiscal transfers among Member States. Moreover, the budget is financed mainly with GNI-based contributions, whereas taxes have a small share. In this sense, the EU budget is secondary to national budgets. A complete fiscal union would

require significantly larger share of own resources. Moreover, the MFF does not include the most ambitious reforms proposed by the European Commission, such as the establishment of a European Monetary Fund and a European Minister of Economy and Finance.

## 3. Advantages and risks of a complete fiscal union

Despite the significant developments of the past decade, the fiscal union in Europe is not yet completed and its institutional setting needs further improvements, beyond the changes envisaged in the MFF 2021 – 2027. According to Claus Regling, managing director of the European Stability Mechanism, the main goal in the next years will be to strengthen crisis mechanisms and particularly risk-sharing (Regling, 2018). A full-fledged fiscal union, with a risk-sharing mechanism, would bring significant benefits. In the first place, it is justified from the point of view the theory of optimum currency area. One of the criteria of an optimum currency area is the existence of a mechanism for fiscal transfers to participating countries experiencing economic and financial shocks. A supranational fiscal transfer system would compensate the lack of nominal exchange rate adjustments. Contrary to the prescriptions of the theory, EU Member States are still exposed to specific economic shocks, especially where public debt levels are already high, and governments have little room to respond with fiscal policy. Furthermore, euro area banks own large amounts of domestic sovereign or government debt, opening the door to a vicious cycle in which sovereign and financial distress reinforce each other. Therefore, an automatic fiscal risk-sharing mechanism is considered the most efficient way to insure against business cycle risks (Berger, Dell'Ariccia, & Obstfeld, 2018).

Moreover, in large economic regions monetary policy can be pro-cyclical. Real interest rates tend to be too low in regions or countries with high growth, which leads to higher inflation, whereas regions with low growth rates tend to have high real interest rates (Regling, 2018).

The completion of the fiscal union would also reduce the pressure on the European central bank. Monetary policy has been the main tool on an EU level for macroeconomic stabilization since the outbreak of the crisis. But it has reached its limits, as evidenced by the persistently low and even negative interest rates. According to the former ECB governor Mario Draghi “the extraordinary monetary stimulus may have to last for a long time if there is no support from fiscal policy” (Financial Times, 2019).

The importance of closer coordination of fiscal policies has been confirmed by the increased confidence in the common currency. The strengthening of the institutional setting of the EMU has dispelled the fears for a possible breakdown of the euro area. Although, the consequences of the economic downturn are not fully overcome in some Member States, most of them have experienced stable growth in recent years. The ECB had the greatest role in restoring economic growth, whereas fiscal policy had complementary role. Nevertheless, the new elements of a fiscal union have become an integral part of the new, strengthened institutional framework of the EMU. In particular, the European Stability Mechanism was successful as a crisis management tool.

On the other hand, further fiscal integration implies some risks. First and foremost, budgetary policy is the only macroeconomic tool available for EMU countries and its centralization would lead to a loss of control of national authorities over their economies. Therefore, many Member States oppose to the initiatives for a stabilization function on an European level.

In the next place, the possible creation of a risk – sharing mechanism, with fiscal transfers among Member States, would lead to moral hazard. From this point of view, fiscal risk-sharing needs to be combined with mechanisms to ensure the implementation of structural reforms and to guard against incentives to adopt loose fiscal policies (Thirion, 2017, p. 2) It is also important to guarantee that a risk-sharing mechanism would not lead to permanent fiscal transfers.

Furthermore, a fiscal union alone would not be enough to guarantee the stability of the common currency without a banking union. Some major elements of the latter were already created, including the Single Supervisory Mechanism and the Single Resolution Mechanism. However, a common fiscal backstop continues to be needed to enhance the financial capacity of the Single Resolution Fund. Such a backstop would increase the confidence in the banking system (European Commission, 2017, p. 6).

## 4. Conclusion

The brief outline of the development of the institutional setting of the EMU shows that many of the elements of a fiscal union are already in place. The economic, debt and banking crises gave impetus for significant developments in the EMU "architecture" with the introduction of new mechanisms and rules. Despite these improvements, the fiscal union is far from completed and this will remain so after 2021. The project of MFF 2021 – 2027 envisages the establishment of several new financing mechanisms, including a

small euro area budget. These new tools are much more limited than the proposals made by the European Commission in its Roadmap for the completion of the EMU. However, the focus of this new tools is placed more on convergence rather than macroeconomic stabilization. Furthermore, the ideas of the European Commission for a European Monetary Fund and a European Minister of Finance were not included in the proposal for MFF. Thus, the important role of the public sector for macroeconomic stabilization will continue to be performed mainly by the Member States.

The main conclusion that can be drawn is that the creation of a full fiscal union in Europe is a long-term process. Many of its elements are already present in the institutional architecture of the EU while others, such risk-sharing mechanisms, remain to be developed.

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