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Fiscal union for the euro area: an overdue and necessary scenario?

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Introductory note

In March 2011 we issued our report "Making the European Union work. Issues for Economic Governance Reform". The report was launched in Berlin and, soon afterwards, also presented and discussed with representatives from politics, business, academia and civil society in London, Budapest and Athens. Each debate had its particular focus.

Iain Begg, Professorial Research Fellow at the European Institute, London School of Economics and Political Science, was not only one of the authors of this report but also a member of the international experts group without whose expertise the report would not have come into being in times of rapid changes in the EU economic set-up. In one of his papers contributing to the work of this group he listed different options for fiscal union for the European Union, which, as we are all aware, have long since been a no go for Germany, in particular.

We requested Professor. Begg to expand on this idea and argue in favour of closer fiscal union as a welcome solution to the problems that have afflicted the euro over the last two years. In this essay, therefore, he seeks to construct a credible scenario for how such a fiscal union might look, taking account of the arguments for and against, and of the likely costs and benefits.

With the course of action becoming even more unpredictable over the past months, this has certainly not been an easy task.

We are grateful to Professor Begg for making a systematic approach to the much-debated issue of fiscal union and adding a much-needed positive voice to this often highly sensitive debate.

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Fiscal union for the euro area: an overdue and necessary scenario?

"No transfer union!" has long been the emphatic German position on the euro. Yet, increasingly, fiscal union is being spoken of not only as the most credible way out of the sovereign debt crisis afflicting the euro area, but also as an inevitable and logical consequence of monetary union. Fiscal union, in this reasoning, would make it far easier to achieve the promised benefits of the single currency and the gains would comfortably outweigh any costs.

Today, it is undeniable that fiscal (or political) union is a scenario for the development of the euro area that has to be taken seriously. The apparently insurmountable obstacles to moving in this direction may be sufficiently telling to render progress close to impossible[1]. However, given how many sacred cows have been slaughtered since the autumn of 2009, it may only need one or two more crises to shift the debate from 'whether' to "how" fiscal union is put in place. The aim of this essay is to set out the case for closer fiscal union as a welcome rather than sinister solution to the problems that have afflicted the single currency over the last two years. This essay seeks to construct a credible scenario for how such a fiscal union might look, taking account of the arguments for and against, and of the likely costs and benefits.

Plainly, though, there would be major obstacles – constitutional as well as political – to such a deepening of European integration. As the former leader of Germany's conservative party, the Christian Social Union, Edmund Stoiber put it in an acerbic comment addressed to Jean-Claude Juncker in 1998, transfer payments [across EU borders] are as absurd an idea as is famine in Bavaria: "Transferleistungen sind so absurd wie eine Hungersnot in Bayern". How public money is spent is a deeply political question and cannot be portrayed as just a technocratic matter to be decided behind closed doors.

1 Compromises and deficiencies

For many commentators, the euro is a 'project' that was incomplete and required a step change in political integration to be sustainable. Belgian economist Paul de Grauwe, one of the most prominent experts on monetary union, has long argued the case for a strengthening of political union as an essential complement to monetary union. In an article published in 2006 he argued that European Monetary Union (EMU) 'remains fragile because of a flaw in its governance' (de Grauwe, 2006: 728) which he explains as 'the absence of a sufficient degree of political union which includes a central European government with the power to tax and spend'.

The absence of systematic fiscal flows across EU borders has been repeatedly highlighted by sceptical economists as a flaw in the design of the euro. Drawing on optimal currency area (OCA) reasoning, the problem is that in the event of an asymmetric shock affecting a member state, the stabilising effect on demand arising from substantial inter-governmental net fiscal transfers will not occur in the euro area. Such transfers are of two types: vertical flows between higher and lower tiers of government; and horizontal, equalising flows at the same level of government. The German or Austrian system of *finanzausgleich* is a good example of the latter, but equalising transfers are by no means confined to federal countries. The key point about these transfers is that they provide

an automatic stabilisation function. American economists of different intellectual persuasions have been uncharacteristically united in arguing this case about the euro area, noting also the further absence of sufficient labour mobility.

A retort to these critics of the lack of centrally mediated fiscal mechanisms capable of stabilising

1 The German Constitutional Court recently ruled that while the proposals on the extension of the EFSF agreed on 21 July 2011 were not inconsistent with the Basic Law, any future steps towards fiscal union would require the approval of parliament. Arguably, this adds to the obstacles.

shocks is that EU countries have substantial public sectors and that these national budgets can achieve much of the needed stabilisation. Monetary union was also expected to intensify the integration of capital markets in a way that would allow private financial flows to mitigate shocks, a phenomenon that has been shown to be important in the United States. However, the magnitude of this effect is generally adjudged to be lower in the European Union.

Certainly, the EU budget does not provide an answer. Not only is it too small relative to GDP – barely 1 percent – to have more than a minimal stabilising effect, but it is also structured in a way that does not easily respond to macroeconomic shocks or cycles. Indeed, the rather desperate and ineffectual efforts to accelerate payments to the Greeks under EU cohesion policy highlight this shortcoming. The explanation is simple: public investment projects take time to prepare and launch, and trying to rush them is likely to result in poor choices. This absorption problem is well-known and, indeed, is why cohesion spending so often happens with a sizeable lag. It is true that reducing the co-financing rate demanded from recipient member states for cohesion projects can offer one means of easing budgetary pressures and is one of the ideas that has been canvassed. But while helpful, it is small compared to the scale of fiscal consolidation required of vulnerable member states. Arithmetic matters.

One crucial aspect of the euro governance framework that has now become only too visible was rarely mentioned as a threat. This is that so long as national governments remain responsible for the debt they sell, there will be a national credit risk. What the events triggered by the attack on Greece after the autumn of 2009 have demonstrated with a vengeance is that speculative capital flows can rapidly become so destabilising that they push the spread on a member state's debt to an unsustainable level. Markets, in other words, can pick on the weaker member states one after the other, and the scale of these attacks – especially when magnified by the derivatives markets, automated trading and short-selling – can soon swamp all defences. The obvious way to overcome the fragmentation that allows these attacks is to integrate. In the United States, after all, the markets do not target individual states as they do in Europe.

At the same time, as US economist Paul Krugman (2011) and Paul De Grauwe (2011) stress in different ways, the members of the euro area do not have the monetary or fiscal means to ease their problems. Countries with separate currencies retain some scope to monetise debt and to ease monetary conditions, whether by aggressive interest rate cuts or some form of quantitative easing. Fiscal transfers can attenuate budgetary stress by, essentially, shifting the burden either to other levels of government or to partners. As Krugman (2011) so vividly demonstrates, when the bubbles burst more or less simultaneously in Nevada and Ireland, Nevada was supported by transfers from the US federal budget, as well as by a rapid cut in interest rates and by provision by the federal authorities of financing for the rescues of banks that suddenly found their loans-books had turned toxic. Ireland initially had no direct help from Europe, and had to impose draconian budgetary measures, leading to a huge surge in its public debt. For Greece, the prospects of breaking out of the vicious circle of austerity and stagnation still look slender, even after the third rescue package agreed at the end of October 2011 and the subsequent appointment of Lucas Papademos as a technocrat to run the government. Anticipating these sorts of difficulties, De Grauwe (2006) issued a stark warning that has yet to be heeded:

"It is difficult to conceive how a union can be politically sustainable if each time a country of the union gets into trouble because of asymmetric developments, it is told by the other members that it is entirely its own fault and that it should not count on any help. Such a union will not last."

2 Towards fiscal union

After a first decade during which the euro seemed to have been an unqualified success, the turmoil of the last two years, coupled with the suddenness and intensity of market attacks, caught Europe's leaders unawares. In part, this is because the extent of the change wrought by monetary union is often, and too easily, forgotten. Decisions on monetary policy are now supranational and fiscal policy has to operate under the constraint of rules, which not only deprives governments inside the euro area of some of their powers to implement discretionary policies, but also means that they have fewer policy instruments with which to respond to crises. Governments, consequently, are now in the uncomfortable position of remaining accountable to their citizens for outcomes for which they have lost some responsibility.

The history of many existing federations shows that step changes towards fiscal union have occurred in response to "exceptional events, often downturns in economic activity during deep crises" (Bordo et al., 2011). Indeed, following the 1930s depression, five countries covered by Bordo et al. (United States, Canada, Switzerland, Argentina, Brazil) all adopted fiscal centralisation. The European Union is far from having the attributes of a country that might facilitate change. But step changes are occurring in response to the crisis, notably through the strengthening of fiscal rules in the governance reforms agreed in 2011. The "six-pack" of measures[2] designed to strengthen prevention of unsustainable macroeconomic policies and to enhance policy coordination will further constrain national governments, and (if they work as intended) should, in time, make crises less likely. In parallel, treaty change to establish a permanent crisis resolution mechanism – the European Stabilisation Mechanism (ESM) – will usher in a more comprehensive approach.

However, while these changes can be expected to improve stability, a major concern today is that economic growth is so anaemic and that the harsh medicine of fiscal consolidation risks killing some of the patients. An austerity spiral is to be feared not just for economic reasons, but also for its political ramifications and, especially, how blame and responsibility are apportioned. Hence, the asymmetry between responsibility and accountability is relevant in considering fiscal union, and highlights the challenges confronting member states that are hit by asymmetric shocks. Specifically, it can be argued that the corollary of forgoing autonomy in certain aspects of macroeconomic policy is that it creates an obligation on the monetary union as a whole to offer support if a member is hit by problems. A rationale for fiscal union is, thus, partly about dealing with stabilisation challenges at the European Union, national, and even regional levels and partly about the pooling of risk in the common interest. But it is also about legitimating the loss of control over key policy areas.

2.1 The emerging way forward?

Following the extraordinary meetings of Eurogroup heads of state and government on 21 July and 26 October 2011, culminating in the agreement of a package of measures to support Greece, to shore-up banks and to counter the risks of contagion affecting other vulnerable member states, some form of fiscal union now seems inevitable. Yet it attracts considerable opposition, although the opposition is encouraged by vagueness about what it might entail. Three distinct forms of fiscal union, each reflecting different political compromises and strategic visions of the euro, can be envisaged (Bastian, Begg and Vannahme, 2011):

- A first, comparatively narrow, variant would be an intensification of the oversight of national fiscal policies. The six-pack effectively moves the European Union (and more so, the euro area) in this direction, namely to a rules-based union;
- The second interpretation is the provision of support for financing difficulties, especially when market pressures lead to unreasonably high interest rates. The mutual support offered in an *ad hoc* way to Greece and subsequently through the packages for Ireland and Portugal,

[2] See the explanation in Bastian et al. (2011) for more detail.

drawing on the two temporary support funds (EFSF and EFSM), exemplify this approach (a liquidity or financing union). Bond purchases by the ECB have also, effectively, provided this kind of support. The proposed new crisis resolution mechanism (the ESM) would enshrine this form of fiscal union in the governance framework;

- Third, it could mean a system of transfers from member states with relatively abundant public resources to fiscally strapped parts of the European Union to pay for public services (a genuine transfer union). Net fiscal transfers across jurisdictions are the norm inside member states, occasionally reaching as high as 30 percent of disposable income in regions with weak productive bases and substantial social protection demands.

At present, the first form of fiscal union is being put in place and will be consolidated by the adoption of the "six-pack". Although there will inevitably be objections to the application of the rules, there does now seem to be a consensus in favour of a more effective rules-based union. This will have repercussions for decision-making and may provoke a political backlash about the legitimacy of government by technocrats at the expense of political choice. It will therefore be incumbent upon decision-makers to explain better and to communicate the policy strategy to the public.

However, the third form of fiscal union continues to look like a step too far for a Europe in which the limits of solidarity are already being severely tested. West Germans may have cavilled at the cost of unification, which entailed very large net fiscal transfers to the five länder of the former GDR. But they ultimately accepted the burden. Extending the same generosity to the less competitive members of the euro area has, hitherto, seemed beyond the pale, although even then the watchword might be "never say never".

Much of the current debate is, consequently, about the conditions under which a financing or liquidity form of fiscal union should develop. Several elements are already in place, but there is increasing uncertainty and awkward political disputes around how the provision of liquidity should develop. One of the trickiest is that the boundary between illiquidity and insolvency is fuzzy. Rescuing Ireland makes sense if it enables the Irish to overcome a temporary liquidity problem, but for Greece a widespread view is that it has crossed the boundary to insolvency and that default is inevitable. If this latter view is correct, loans from partner countries not only risk being wasted, but simply prolong the agony needlessly. Liquidity provision also faces the arithmetic challenge that the more countries that have to seek rescues, the fewer will be left to supply the loans.

The growth of populist parties objecting to crossborder rescues also testifies to a diminishing solidarity. But a separate facet of the politics can be summed in the rhetorical question 'who is holding whom to ransom?'. Debtor countries know that if they default, especially in a disorderly manner, it becomes a problem for creditor countries, and that the risks are greater where the web of connections among financial intermediaries is extensive: both "too big" and "too connected" to fail are risks where this is the case.

2.2 Prodigal partners

One of the most intractable issues around fiscal union is moral hazard. Simply put, if the virtuous assist those who have only themselves to blame for their own difficulties, does that not encourage delinquent behaviour? The generic answer is yes, and in many instances, moral hazard arguments are compelling. Allowing a bank that has offered too many risky loans to fail if they turn bad is usually the best course of action because it punishes (and thus deters) rash behaviour, whereas even an implicit commitment to prevent the collapse of a bank too big to fail (on the grounds that the systemic impact will be huge) can encourage rash behaviour.

According to this logic, it is correct to blame (and punish) the Greeks for not acting sooner to rein in their public debt, or the Irish for failing to curb an asset bubble that yielded short-term gains for all. However, there are always at least two sides to any transaction or to the sorts of imbalances that arose in the euro area, raising the question of who is to blame. Is it the French and German banks who were so happy to buy Greek bonds yielding higher coupons than their domestic bonds, not to mention the British banks who saw rich pickings in lending to Irish property developers? In so doing, they generated higher profits, at least some of which generated tax revenues for their respective finance ministries. Or should the opprobrium be directed at the public bodies in Greece or Ireland that were so willing to let it happen and to take the credit for the short-term economic advantages? Plainly, there are no easy answers.

Moreover, moral hazard can more readily be dealt with in 'normal' circumstances than when there are evident systemic threats. With hindsight, the decision to let Lehman Brothers go in September 2008 (essentially on moral hazard grounds) was calamitous and it is now clear that the costs of doing so are orders of magnitude higher than a bail-out would have been. Certainly, there were legitimate concerns that bail-out after bail-out would undermine market discipline and stoke even bigger problems, but the lesson to draw is, surely, that it is the balance of costs and benefits that matters, not rigid adherence to the principle. As German political scientist Fritz Scharpf (2011: 23) puts it, 'the expensive guarantees and credits appeared as a lesser evil' than the uncertain and alarming consequences that could be envisaged from default and exit from the euro.

2.3 Plausible or not?

One of the main reasons why the fiscal union debate is so inconclusive is – at the risk of stating the obvious – that fiscal policy fulfils two quite distinct roles in economic governance. As one of the principal instruments for the attainment of macroeconomic stability, the budgetary balance is clearly of central importance. But fiscal policy is also about the distributive choices made between different forms of tax, how public money is spent and its division between different groups, the total tax take, and total public expenditure. The same budget balance can be arrived at by very different mixes of tax and spending, but when a budget balance has to be adjusted, some of the prior tax and spending choices are much easier to undo than others.

Typically, the benefits of lax fiscal policy are short-term, whereas the costs are longer-term and, often, cumulative. With an extensively interconnected financial system, as the sovereign debt crisis has shown, these longer-term effects can very rapidly become systemic and, in the absence of countervailing measures, generate just the sort of adverse contagion effects seen recently in the euro area. It is for these reasons that fiscal rules are advocated as a way of tying the hands of politicians whose horizons rarely extend beyond the next election.

The logic of policy independence and constraints has to be examined. The development of the euro crisis has shown that countries in trouble progressively lose any room for manoeuvre, yet there is no systematic help available from partners. On the contrary, the initial response of Greece's partners (and subsequently, Ireland's and Portugal's) and the EU authorities alike has been to condemn reckless fiscal behaviour and to call for redoubled reform efforts. The recent vulnerability of Italy has seen a similar trajectory. As a result, the country under pressure is left with no choice but to barter ever more severe austerity against rescue packages reluctantly offered by partners. In these circumstances, it is no surprise that populations rebel while markets salivate about default or euro exit. While editorial after editorial talks about the inevitability of one of these outcomes, they do not dwell on the ramifications of default or exit, and they often overlook the fact that there is the alternative scenario of moving to deeper union.

Indeed, the popular dissent-default-euro exit scenario is frequently portrayed as a minor technical matter and lauded as the least-cost solution. Latin America in the 1980s or 1990s, and Argentina a decade ago are held up as the exemplars and the cussedness of EU leaders in continuing to resist is met with bewilderment. In practice, however, a forced ejection from the euro is not a soft option and would have severe repercussions all around. They would comprise:

- Even before the event, the emptying of bank accounts in the exiting country, imperilling the solvency of the banking system and undermining financial stability;
- A significant surge in inflation in the exiting country;

- More worryingly, the prospect of bank solvency problems in partner countries, leading to a freezing-up of inter-bank lending and a lurch into recession;
- As a result, still greater pressures on the public finances of other member states;
- Threats to the ECB itself, given its purchases of assets from the exiting country that will plummet in value and imply a weaker balance sheet.

Nor is it obvious that the promised recovery would happen as quickly or as smoothly as protagonists believe. While it can be easier to restore competitiveness by devaluing a currency than by holding down labour costs (so-called internal devaluation) and this option avoids the debt-deflation spiral in which nominal debt is fixed but the nominal incomes used to service the debt are falling, there are medium term costs of higher inflation and a diminished impetus to address structural weaknesses. The devaluation route is, consequently, a soft option in two senses of the word soft: possibly easier, but also less robust.

Starting from this analysis, the alternative of fiscal union is more appealing, despite its evident shortcomings. To render it politically palatable, it is best to see it as the lesser – by some distance – of two evils, rather than the optimal solution. The other side of the equation has to be, however, that the members of the euro area accept closer integration of economic policy-making, something that was always in the EU treaties, but which was implemented in so limited a manner that it was ineffective. However, the flurry of governance reforms now being pushed through the EU legislative process must be expected to result in a tougher regime, though the real test will only come when they move to implementation.

3 *Back to the future: the Werner and MacDougall Reports revisited*

Economic and monetary union in Europe had long featured in the plans for advancing economic integration, and it is instructive to look back at some of the debates and analyses from decades ago. They are a reminder that fiscal union is far from a new concept for the European Union or the euro area. Thus, the 1970 Werner report (Council and Commission, 1970), which set out a blueprint for attaining economic and monetary union in Europe, suggested a degree of centralised fiscal capability. Similarly, the MacDougall report, published in 1977, put forward a series of options for an EU-level fiscal capacity for both stabilisation and distributive purposes. MacDougall also commented on the low EU budget and its inability to perform this stabilisation function, adding that 'this is an important reason why in present circumstances monetary union is impracticable' [paragraph 5].

The Werner report, which envisaged a ten-year transition to monetary union, explained the minimum action needed to achieve an effective economic and monetary union. It drew attention to the challenges for budgetary policies:

> "For influencing the general development of the economy 'budget policy' assumes great importance. The Community budget will undoubtedly be more important at the beginning of the final stage than it is today, but its economic significance will still be weak compared with that of the national budgets, the harmonised management of which will be an essential feature of cohesion in the union." [Section III]

While stressing the need to avoid excessive centralisation, the report calls for a:

> "centre of decision for economic policy [that] will exercise independently, in accordance with the Community interest, a decisive influence over the general economic policy of the Community. In view of the fact that the role of the Community budget as an economic instrument will be insufficient, the Community's centre of decision must be in a position to influence the national budgets, especially as regards the level and the direction of the balances and the methods for financing the deficits or utilising the surpluses." [Section III]

The MacDougall report looked into what would be needed to achieve satisfactory public finances for the then EEC of nine countries and came up with different figures depending on how much fiscal union was politically feasible, with one option as high as 7 percent of EU GDP. The report starts by recalling that public spending in 1977 was about 45 percent of GDP – much the same as now – and that the equalising effect of public expenditure within the countries studied in the report reduced regional disparities by around 40 percent on average. By comparison, the redistributive effect of the EU budget was then (as now) marginal. Moreover, between a half and two-thirds of any cyclical downturn at regional level was offset by lower payments to central government and higher induced receipts.[3]

Today, the numbers proposed in the MacDougall report look fanciful and it must be expected that the forthcoming debate on the EU budget for the period after 2014 will be on fixing to two decimal places in the range 0.9 to 1.10 percent of GDP what the future budget should be. Nevertheless, it is worth re-examining the reasoning. MacDougall estimated that a pre-federal European Union (then comprising only nine members, and thus a much more homogeneous entity than the EU27 of today) would need a budget of the order of 2 to 2.5 percent of GDP. The spending seen as most pressing in this regard would have been for 'structural, cyclical, employment and regional policies', whereas MacDougall excluded social protection. A closer union, but still with 'light' federal functions would need around 5-7 percent of GDP as direct expenditure that could extend to stabilisation and some equalisation functions.

3.1 Still longer ago…

Intriguingly, the United States had to resolve similar dilemmas over two centuries ago. Alexander Hamilton, the first US treasury secretary, proposed a common bond as long ago as 1790, in the *First Report on Public Credit*, communicated on 14 January 1790, arguing the case for the federal government to assume the debts of the states. In the paper, it is stated that:

> "The Secretary, after mature reflection on this point, entertains a full conviction, that an assumption of the debts of the particular states by the union, and a like provision for them, as for those of the union, will be a measure of sound policy and substantial justice."

The proposal was opposed by representatives of low-debt states, notably Thomas Jefferson of Virginia, on the grounds that it was invidious for the fiscally disciplined to pay for those who had been profligate. Yet it was eventually accepted. In time, Hamilton's proposals became the Treasury bond we know today, and it is fascinating to revisit the rationale he put forward:

> "It would, in the opinion of the Secretary, contribute, in an eminent degree, to an orderly, stable and satisfactory arrangement of the national finances. Admitting, as ought to be the case, that a provision must be made in some way or other, for the entire debt; it will follow, that no greater revenues will be required, whether that provision be made wholly by the United States, or partly by them, and partly by the states separately."

It is not hard to find echoes of today's debates in these of the United States of the 1790s. In a further revealing statement, Hamilton adds that 'he is so far from acceding to the position, in the latitude in which it is sometimes laid down, that "public debts are public benefits," a position inviting to prodigality, and liable to dangerous abuse,—that he ardently wishes to see it incorporated, as a fundamental maxim, in the system of public credit of the United States, that the creation of debt should always be accompanied with the means of extinguishment'.

[3] More recent data for the European Union confirm these orders of magnitude.

4 The case for €urobonds

The ad hoc rescue package for Greece in May 2010, followed by the creation of the European Financial Stability Facility (EFSF) and its subsequent application as part of the rescue packages for Ireland and Portugal, did just enough to prevent a sovereign default, but as the continuing travails of Greece in the autumn of 2011 showed, did not do enough to make the problem go away. Unsurprisingly, turmoil has continued in the sovereign debt markets, with first Spain, then Italy in the firing line, and even occasional speculation against France. It is, moreover, generally agreed that these temporary arrangements would be swamped if any of these larger countries had to be rescued, highlighting the need for a more enduring solution to the fragmentation of sovereign borrowing that makes it easy for the markets to pick off countries one at a time.

The way forward that many now regard as an inevitable development of a fiscal union is the issue of collectively guaranteed Eurobonds. In appraising the case for such bonds, it is instructive to consider some of the advantages that the United States gains from having the Treasury bonds. There is a manifestly large, liquid market and even after the contentious downgrading of US debt announced by Standard and Poor's on 5 August 2011, US rates fell and remain at very favourable levels, certainly compared with Italy or Spain around the same time. For the major creditor nations, such as China or the Gulf States, only the United States appears to offer a safe haven for their assets, despite the fact that the United States' public deficit and debt are higher than that of the euro area as a whole. To employ former French President Valéry Giscard d'Estaing's term, this is an 'exorbitant privilege'.

In practice, sizeable steps towards Eurobonds have already been taken. The EFSF is a form of collectively guaranteed borrowing to provide loans to member states in need, but with restrictions on circumstances in which loans can be granted, and the imposition of conditions on member states which borrow. The European Investment Bank, which funds major projects by borrowing on the basis of member state guarantees, can also be seen as a form of collective bond issue. Both demonstrate that the markets are willing to fund collective euro-area borrowing on favourable terms. The desirable features of a Eurobond include the fact that it would:

- Raise credibility of borrowing by all euro-area members by pooling risk;
- Provide enhanced liquidity that would facilitate lower interest coupons;
- Offer a rival to the US Treasury bond that could attract enhanced inflows of funding from creditor countries keen to diversify their reserve portfolios;
- Overcome the fragmentation of euro-area borrowing that has allowed markets to pick-off the weaker members.

4.1 Then why not?

The biggest impediments to Eurobonds are the justified fears that they will not only induce free-riding and diminish pressures to carry out needed reforms, but also be incompatible with the letter of the treaty's no bail-out provisions (see the debate between de Grauwe and Moesen, 2009, and Kösters, 2009). A simple solution can, however, be put forward. By creating a de facto European Treasury which acts as the borrower, but is then able to vary the terms on which individual member states borrow from it, the moral hazard risk can be attenuated. In today's environment, for

example, Greece might be asked to pay a somewhat higher interest rate, but would have strong conditions imposed on progress in economic reform.

To a degree, the Delpla and von Weizsäcker (2011) proposal for blue and red bonds is a variant on this idea. What they propose is to have debt issue up to 60 percent of a country's GDP (the blue bonds) that would be jointly and severally guaranteed by all euro-area members – that is, making each guarantor liable for the whole of the debt, not just up to the percentage it contributes to the pool –, with the understanding that these would have the highest credit rating. A country wishing to borrow more could still issue euro bonds, but would be solely responsible for the remaining tranche (red bonds), an arrangement that would make it highly likely that these red bonds would be difficult to sell in the market unless they offered very high coupons. This, the authors argue, would give strong incentives to curb borrowing, although it would plainly not be a short-term solution to the funding difficulties of countries like Greece, or even Italy.

The case against Eurobonds has been stated in characteristically robust terms by former ECB executive board member and chief economist Otmar Issing (2009) who argues that 'the "medicine" of a common eurozone bond would not cure the problems of its weakest members, but would instead prolong their reliance on budget deficits while encouraging them to hope for the de facto "bail-out" that is waiting just around the corner'. His reasoning is that not only would a common bond mean that fiscally sound countries had to pay more, thereby penalizing their taxpayers, but also that the incentives to deal with the underlying structural problems would be diminished and the burden would be shifted from the prodigals to their partners. As he puts it, 'the costs of this "support" would have to be borne by the citizens of other countries. It would be hard to find a clearer case of a free riding'. Add moral hazard, and the charge sheet becomes still heavier.

More fundamentally, Issing sees Eurobonds as a threat to the stability culture fundamental to the success of the euro. His clear message is that there is no alternative to swallowing the bitter medicine of austerity and reform, and he maintains 'that a common bond would also be harmful because it would foster the illusion that it is possible for a country to get out of difficulty without having undertaken fundamental reforms. And in fact the opposite holds true; times of crises give governments the best argument to take tough measures needed to get the country back on a sustainable path'.

In a further article in the *Financial Times* of 9 August 2011, Issing articulates fears that moves towards political union will 'only further alienate the people from Europe itself' and he expresses strong scepticism about political union, arguing that its 'collapse would be brought by resistance from the people. In the past, cries of "no taxation without representation" have brought war. This time the consequence would be to threaten the collapse of the most successful project of economic integration in the history of mankind'.

4.2 Conditions for successful Eurobonds

While all Issing's points are valid, two questions have to be posed: the first is whether the alternative would ultimately be more or less costly; and, second, could a Eurobond be designed in such a way as to mitigate the negative consequences while accentuating the benefits. In answer to the first question, the principal risk is that what ought to be a manageable liquidity problem mutates into a more severe re-run of the solvency and credit crunch problems that followed the collapse of Lehman Brothers just three years ago.

Turning to the second question, finding the right formula for Eurobonds will not be easy, but neither is it that hard to identify what it has to encompass. Four main principles would have to be satisfied:

- First, the aim should be to establish a single financial instrument which is jointly and severally guaranteed by all euro-area states, openly traded, and available to all potential investors, such that it is a very liquid financial asset akin to the US T-bond;
- The second is that all governments should be able to access funding from Eurobonds;
- Third, there will need to be some agency to emit the bonds and to control the terms on which they are used to finance sovereigns – in effect a euro-area treasury or debt agency;
- However, a fourth principle would have to be that access to the bonds should be subject to conditions and, potentially, price differences for sovereigns that represent bigger risks – conditionality of this sort is critical to contain moral hazard and to convince taxpayers in fiscally sound member states that their exposure is protected.

A tricky problem would still be the political one of overcoming the objections of public opinion (usually portrayed as the taxpayer) in fiscally responsible member states. This can be managed by careful procedures and effective communication. It is also useful to distinguish the immediate problem of crisis management from the longer term and to ensure that today's temporary transfers are not allowed to become quasi-permanent. If they do, they will inevitably engender resentment on the part of contributors, while also potentially creating adverse incentives for recipients, undermining their willingness to adjust. A new euro debt agency would probably have to be created and this would have to be set up in a way that gave confidence to lenders that their interests were being protected – echoing the advice of Alexander Hamilton.

5 Conclusions: I wouldn't start from here…

Current debate on fiscal union is, unavoidably, coloured by the immediacy of crisis resolution and, in this regard, echoes the old joke about the traveller in rural Ireland who asks the local priest for directions to Dublin, eliciting the reply 'I wouldn't start from here'. Crisis resolution is about finding a short-term way out of a pressing problem and should not be confused with what is put in place for more normal times. From the crisis standpoint, it is easy to understand why Finnish voters or German parliamentarians should oppose bailouts for what they perceive to be 'feckless' Greeks. However, the unfolding crisis of the euro area is sorely testing these hostile positions, to the extent that what was so recently unthinkable is now very much on the agenda.

Given that crisis resolution is rarely a satisfactory basis for an enduring solution, it is essential to stand back from the current turmoil to ask what would constitute a better fiscal framework. The case for a deeper fiscal union for the euro area looks increasingly persuasive and the main imperative for decision-makers ought now to be to find a way of putting it in place, rather than finding reasons not to do so. The challenge is how to achieve governance reforms that are credible, effective, and legitimate. Some of the obstacles straddle the boundary between the constitutional and the political, especially when, as in Germany, the constitutional court is ready to rule on cases brought about by the legal basis for different forms of fiscal union. Other impediments are more overtly political, inevitably so when there are, on the one hand, needs for compromise on where power lies and, on the other, delicate bargains to be struck about how risks are apportioned in future and burdens shared. Similarly, it is easy to identify institutional hurdles

and to conclude that what might be a good idea in theory is incapable of being implemented or susceptible to being introduced only in a lowest common denominator form that undermines the very purpose of the change.

Clearly, difficult compromises and the resolution of awkward questions of burden-sharing will be needed, as well as finding ways around the constitutional objections. But the real search should be for a design that achieves the maximum benefits with the least costs. The case for the scenario of deeper integration explored in this paper is compelling. It can build on the considerable developments in euro governance since the spring of 2010 to construct a fiscal union comprising enhanced rules and collective financing. Substantial direct cross-border transfers to pay for current public services are neither necessary nor plausible, since they would be distributive in character and, thus, do not bear so directly on the issue this essay confronts, which is how to render the governance of the euro area more robust in achieving the macroeconomic objectives of growth and stability.

It is important to recognise how much has already shifted. The EFSF has established the principle of joint bond issuance for the euro area and of the pooling of national guarantees. Although the further step of making the guarantees joint and several is a qualitatively larger one, it no longer looks impossible. Indeed, the Eurobond solution has so many advantages that there are grounds for optimism that the (wholly understandable) objections of the fiscally sound member states can be overcome. Finding a middle-way between sovereign default that hits the financial sector and blanket state guarantees that puts all the burden on ordinary citizens will not be easy, but the agreements reached at the July and October 2011 meetings of the Eurogroup leaders extend the principle. So too does the decision that the EFSF can act directly to support national bonds. It is a demanding agenda, but not an impossible one.

From a macroeconomic policy perspective, there is a compelling case for a mutualisation of debt: Eurobonds, in other words, are overdue. All the policy effort should now go into finding the formulae that will ensure that the known drawbacks, such as moral hazard, are deterred, while ensuring that the benefits in terms of lower financing costs and fiscal discipline are maximised. But fiscal union also has to be attuned to boosting growth. The EU level of government today is not in debt and, consequently, starts with a cleaner slate than most member states. But it lacks its own taxpayer base and that is the nub of the problem, because it means that the guarantees have, ultimately, to come from national taxpayers who continue to see themselves as Germans, Austrians, Slovenians or (admittedly, too few of them) Greeks. Establishing a sufficient degree of fiscal union in the euro area is, therefore, an economic and institutional challenge wrapped inside the political one of persuading sceptical populations that the common interest is also their interest. It means moving from the temporary fix of the EFSF (which must nevertheless be regarded as a de facto Eurobond, albeit with more limited liabilities for the individual guarantors) to a system that does more than the ESM that is scheduled to take over in 2013.

There are also long-term concerns that will need careful management if the integrity of the single market and, conceivably, of the European Union itself are not to be undermined. The possibly unexpected statement[4] by George Osborne, the UK Chancellor of the Exchequer (finance minister), that the euro area needs closer integration, points to the risks. He said, "I think we have to accept that greater eurozone integration is necessary to make the single currency work and that is very much in our national interest". In what could be seen as a significant reorientation of UK policy on Europe, given past opposition to a two-speed Europe, he added that "we should be prepared to let that happen". At the same time, the UK stance remains that euro-area debt problems should be dealt with by the euro area and should not impose burdens on non-participating member states – reaffirming the line that the bilateral loan from the United Kingdom to Ireland was a special case.

Similarly, Marek Belka, governor of the Polish central bank, has observed[5] that the principles of monetary union that countries like Poland thought were fundamental – such as no bail-outs – have been shown to be fungible. For the Poles and others, this gives reason to re-think commitments to join the euro as soon as possible. The deeper issue here is whether such detachment – especially if it is emulated by other 'outs' – inserts a wedge between the euro-area 17 and the other ten that becomes highly divisive.

Many of the metaphors around the crises of the last three years have referred to politicians looking over the edge of the cliff into the abyss and persuading themselves of the merits of not jumping. But retreat is not always the best answer. The leap now required is one over, instead of into, the abyss: political courage is needed to jump to a more fiscally united euro area.

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4 In an interview with *Financial Times* journalist George Parker, just before the 21 July 2011 Eurogroup meeting.

5 Speech to the TEPSA pre-presidency conference, Natolin, 30 June 2011.

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