The Cost of Fiscal Disunion in Europe and the New Model of Fiscal Federalism

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The sovereign debts crisis is a problem peculiar to the European Union caused by the fragility of the EMU, which was set up without a fiscal union nor a federal government. The aim of a monetary union is to remove the political risks – exchange rates and sovereign debt default – for internal financial transactions, as the US have done thanks to their federal constitution. In Europe, the financial crisis has caused a dangerous vicious debts-banks cycle, which can bring on the default of solvent but illiquid states of the EMU. The paper, after an analysis of the emergency measures approved or proposed, upholds that a new model of fiscal federalism is underway, based on the following principles: the relative autonomy of monetary policy from fiscal policy; hard budget constraints for every level of government; a limited transfer union; an autonomous federal budget. At present, the role of the EU budget is neglected. The author warns that a well-run monetary union cannot work smoothly without a federal budget.

"The peculiar federal problem is this. The federal principle requires that the general and regional governments of a country shall be independent each of the other within its sphere, shall be not subordinate one to another but co-ordinate with each other. Now if this principle is to operate not merely as a matter of strict law but also in practice, it follows that both general and regional governments must each have under its own independent control financial resources sufficient to perform its exclusive functions."

Kenneth C. Wheare (1967, p. 93)

MONETARY UNION AND FISCAL DISUNION

The Maastricht Treaty was a slippery step forward. The proposal for a “United Germany in a United Europe” produced an Economic and Monetary Union (EMU) without a fiscal union and without a federal

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government. The global financial crisis of 2007-08 showed how fragile the European institutional architecture was. When at the end of 2009 the Greek budgetary deception was discovered, a new stage of the financial crisis began: the crisis of the sovereign debts. Now, after a lot of shilly-shallying by national governments, the Monetary Union risks collapsing, and with the EMU so does the EU.

The crisis is made difficult by the EU asymmetry: while Germany and some other countries, for the time being, have not been hit, the other members of the Union are obliged to approve tough austerity policies. The European divide, between Northern and Southern Europe, is not new. It existed before the Maastricht Treaty, but today it is entangled with new problems, such as the challenge of global finance, the threat of climate change, the reform of the old welfare state and the development of a multipolar international system, with new big players, like China, India and Brazil.

The first aim of the paper is to show that the cost of the fiscal disunion of Europe is the serious recession underway and, for some countries, a depression causing high levels of unemployment, social discontent and rising nationalism. But the economic and political cost of fiscal disunion will become countless should the EMU break down. The second aim is to show that the European asymmetry can lead to two opposing directions: either the collapse of the European Union or a more perfect union, i.e. a Federal Union.

One of the difficulties of advancing towards this goal is the ignorance of the federalist principles. Frequently a Federal Union is imagined as a super state, a centralized bureaucracy or a kind of European Leviathan. Sometimes federal institutions are identified with one of the existing federations, such as the USA, Switzerland, Canada, Germany, Australia and so on. But the variety of federalisms in existence should suggest that federalism, as Wheare says in the excerpt, is founded on principles, which can be applied to different historical contexts. The European Union is the first experiment in history of supranational integration. After the Second World War a group of nation states decided to abandon some of their sovereign powers in order to build a peaceful community. Today, if they want to advance towards a more perfect union they must build a fiscal union and a federal government. The European fiscal union does not require a huge federal budget, as in the US, nevertheless some new fiscal powers should be entrusted to the federal government. In short, we try to show that a model of fiscal supranational federalism is possible and viable.

In order to explain the crisis of the sovereign debts in Europe, in section 2 we need to clarify the distinction between regional and
international payments. In section 3, we show how it was possible to build a monetary union in the United States, drawing some lessons for Europe. In section 4, we analyse the main features of the euro crisis. In section 5 we discuss the kind of fiscal union the EU is setting up. Finally, in section 6, we see why the federal budget is crucial to avoid a new crisis of the EU.

INTERREGIONAL PAYMENTS AND INTERNATIONAL PAYMENTS

Usually economists willing to discuss the benefits and costs of a monetary union take into consideration the theory of optimum currency area. The limit of this approach is that costs and benefits are considered only from an economic point of view. This is not the common sense notion of monetary union. Money has also a political aspect. In the last two centuries, ordinary people experienced that every nation state has its own money. A monetary union is similar to a national union. Within a national union no balance of payments is necessary among different provinces and regions; the balance of payments is a notion concerning foreign trade and foreign payments. To work smoothly, a monetary Union among different nation states should achieve the goal of removing the balance of payments constraints among the Union state members and establish a common balance of payments towards other countries. Therefore, we need to clarify the difference between interregional and international payments.

According to us, the main difference concerns the kind of risk related to monetary and financial transactions: a regional payment runs only economic risks; an international payment runs economic risks and political risks.

In order to discuss the difference between economic and political risks we adopt the analytical framework proposed by Tibor Scitovsky (1969: ch. 8). Let us imagine a world economy, with one currency and one central bank. The political system is federal, with two regional governments and one central government. Moreover let us imagine that our economy is in a state of simple reproduction, without growth. The national income is made up of the summation of household incomes and firm incomes. But the budget of each household and firm need not necessarily be in balance: somebody is indebted, because the expenditures are greater than the earnings; somebody else has credits, because the economic subject spends less than what it earns. Nevertheless, in the entire economy, the sum of credits and debts should be zero. Now, we will consider three kinds of financial assets: perfectly transferable, imperfectly transferable and foreign assets.
In our federal state, made up of two regions, C and D, we now imagine that all creditors live in C and all debtors live in D. Country C will have a surplus in its current account and D a deficit. Nevertheless, if financial assets – commercial papers, public bonds, company bonds, securities, mortgages – can circulate freely throughout the territory of the federation, the fact that C has a surplus and D a deficit in their current accounts does not create intractable problems in the financial and credit market. The confidence of the creditors in the solvency of their assets does not depend on the region in which their debtors live. If the legal system of the federation guarantees that the creditor can collect its money in both regions and works efficiently, there is no reason to fear insolvency caused by the debtor’s regional address.

Within all countries, when business activities are taken into consideration, it may occur that a debtor is insolvent or a firm goes bankrupt. But nobody considers this event as the cause or consequence of a balance of payment deficit. If financial assets are perfectly negotiable in both regions (for instance Federal Treasure Bonds), their value and their rate of return do not change according to the place in which they are held occasionally. In the long run, when creditors collect their money from debtors, the surplus in C and the deficit in D disappear. If financial assets are perfectly transferable in the entire economy, a balance of payments problem cannot arise.

Scitovsky considers this first case as “the ideal situation”; the “general case” is more realistic. Let us imagine that the ideal situation is upset by a slight economic crisis centred in region D: some firms are not able to sell their products and they dismiss some workers; it may even happen that a certain number of firms goes bankrupt. In this new situation, the financial assets which come from D are considered insolvent or run the risk of insolvency. In C, creditors will accept financial assets from D only if debtors pay a higher interest rate (higher than the previous average interest rate) or the value of the assets is reduced. Therefore, the rates of interest become different in C and D where the debtors are obliged to pay a higher interest rate for the credit they require. This lack of confidence in region D’s assets will have an impact on the real economy. A greater quantity of region D’s income – where disposable income and employment decrease – should be paid to C citizens, where disposable income and employment increase. Region C’s current account surplus will increase. The existence of imperfectly transferable assets emphasizes short-term imbalances. However, in the long term some re-equilibrating forces will appear. Consumers and firms in D are obliged, by the higher interest rates
paid and by the lower disposable income, to reduce their expenses and consumption (of C products too; therefore C’s surplus will be reduced). In C, the greater disposable income will allow more consumption (of D’s products too; therefore D’s deficit will be reduced). Moreover, some displaced workers from D may migrate to C, thus levelling the wage rate in the two regions. Some C capitalists may decide to invest in D, where the rate of interest is higher, hence reducing the gap between the two rates. At the end of the process, C is a little richer and D a little poorer. But these real effects do not represent an obstacle for D’s debtors to pay their debts – capital and interests – to their C creditors, if the common legal system works effectively (if some firms fail, the loss hits their creditors, but private loss does not become a balance of payment problem). In the long run, the balance of payments will be in equilibrium again, even if a standing difference in per-capita income between the two regions may survive. On the other hand, something similar – if panicking is excluded – should happen in a nation state where debtors and creditors belong to a single administrative constituency and where, in the financial market, perfectly and imperfectly transferable assets are negotiated every day in the stock exchange and in other markets.

Now, let us consider the case in which C and D are not two regions of a federal state but two sovereign states, with a national currency and a national central bank. In this new political environment, financial assets of a foreign state can be traded in the other country only if they are evaluated in national currency. Unavoidably, the rate of exchange enters into the evaluation of the financial assets, which can no longer circulate freely between the two “regions” (or “states”). If two national currencies exist, the C businessman accepting an asset denominated in D’s currency runs an extra risk: a change of the exchange rate. Indeed, at the expiration of the credit, it may occur that D’s currency is devalued (i.e. with a unit of the C currency it is now possible to get more unities of D’s currency). This means that the C creditor, when changing his asset denominated in D currency into C currency, can get less local currency and can buy less commodities. Therefore, a foreign asset involves a supplementary cost compared not only to perfectly transferable assets, but also to imperfectly transferable assets. The integration of the financial market of the two “regions” (or states) becomes very difficult because a decision of one “sovereign” national government can change the value of the credit (or debt). In the last resort, when two countries have their own currency, the national governments can decide to make the national currency convertible.
or can declare default for its public debt, cutting the value of assets in the hand of foreign creditors down to zero.

To sum up, the feature of an interregional payment is the economic risk, for the creditor, when the debtor has problems reimbursing the money received; international payments run a supplementary political risk caused by the sovereign power of a national government to change the value of the financial assets in the hands of the creditor. The aim of a monetary union among different states is to reduce to the minimum the economic risks among assets issued in different regions and countries and to remove the political risks totally.

LESSONS FROM THE US MONETARY UNION

The years 1791 and 1792 can be considered the date of birth of the monetary union of the United States of America: 1791 because the bill instituting the First Bank of the United States, proposed by Alexander Hamilton, the Secretary of the Treasury, was signed by President Washington, and 1792, because the Congress approved the Coinage Act, always proposed by Hamilton. The silver dollar contained fifteen times as much metal as the gold dollar. Both dollars were considered legal tender. Therefore the United States was on a bimetallic standard.

Nevertheless the creation of a national bank and of a standard of value was only the beginning of the long and turbulent history of the monetary and financial integration of the US. Hugh Rokoff observes: “… it was not until the 1930s that all regions, including the South, could be said to be parts of a single optimal currency area. How long did it take the United States to become an Optimal Currency Area? A reasonable minimum might be one hundred and fifty years!” (Rokoff, 2003: 103).

Here, our task is much more limited. We simply try to show:
(a) how a certain imperfect transferable asset became a perfect transferable (nation-wide) asset; (b) the role played by perfectly transferable assets in solving the problem of the interregional (inter-state) balance of payments; (c) the relationship between monetary and fiscal integration.

At the beginning, commercial banks were allowed by a charter of its state to issue bank notes. Limitations to the issue required only that the total amount issued did not exceed a certain multiple (twice or three times) the bank’s capital. The outcome of this very loose regulation was that numberless bank notes could circulate in a very limited territory. Only bank notes issued by a reputable bank, with specie reserves, were taken at their face value. “Bills of other banks
were received at discount from 1 or 2 per cent up to 50 per cent or more. Distance from the city where the issuing bank was located affected the acceptability of notes.” (Robertson, 1964: 164).

During the gold standard age, the role of the central banks was not as crucial as it is today. When, in 1836, President Jackson refused to renew the charter of the Second Bank of the United States, the monetary and financial integration of the Union went on, even if in a wayward fashion. Very interesting is the history of commercial papers, especially the bills of exchange. Howard Bodenhorn studied the market of bills of exchange between the North (New York) and the South (Charleston and New Orleans) in antebellum America. The costs of the interregional transfers of capital were, at that time, defined as “domestic exchange rates,” likewise the “external exchange rate” between the dollar and the pound sterling. The study of the data at disposal confirms that: “Antebellum credit markets were apparently efficient in that they quickly dissipated regional interest rate differentials, making profitable arbitrage possibilities few and fleeting. The results also confirm the belief that antebellum markets were integrated” (Bodenhorn, 1992: 593). The role of the US Supreme Court was crucial in spurring market integration. During the 1820s and 1830s, litigants in different states frequently raised their case to the Supreme Court, which established uniform principles for law regulating bills of exchange. The federal court “by doing so eliminated the uncertainty and risk surrounding the movements of funds. By effectively eliminating the risk and lowering the costs of moving funds between regions, the Court indirectly facilitated long-distance trade in bills of exchange that, in turn, promoted the integration of regional capital market” (Bodenhorn, 1992: 597-8).

Checks are the second means of payments worth investigating. A check is a bill of exchange payable at par on demand and drawn on a bank rather than another trader. Before the Civil War the utilization of checks was limited to local markets, because the banking system was fragmented and the risks and costs for interregional trade were exorbitant. Only after the end of the Civil War, thanks to the National Banking Acts, which allowed charted federal banks to issue bank notes up to certain limits, a national banking system was set in motion. Nevertheless, the state banks were unwilling to abandon their privileges, by accepting the national charter. Only when the Congress passed a law, in 1865, taxing the circulation of the state bank note, the United States had a common currency (the Greenback) even though it did not have a central bank. Slowly, checks interstate payments
increased until the end of the century, when a national hierarchical correspondent banking system was formed, with New York working as the US clearing house. “Shipments to and from Boston, Philadelphia, Cincinnati, and San Francisco were largely confined to banks in their hinterland and New York. Outside these channels, they were negligible or zero. Consequently, any interregional currency shipments ... must have been relayed through New York banks rather than through correspondents in other centers” (James and Weiman, 2010: 244). To sum up, the National Banking Acts, approved during the Civil War, were the basis for the creation of the nationwide utilization of the check as an interstate means of payments and the development of an integrated banking system, with New York as the central clearing house.

The second feature of the US monetary union to consider is one important side effect of the creation of perfectly transferable assets: the mitigation of balance of payments problems among different regions and states of the federation. In a crucial paper, James Ingram examined the case of the financial integration of North Carolina in the US economy, where its rate of interest differs only marginally from the general level of the US rate. In such a case, an inflow or outflow of capitals does not create dramatic problems, as can happen in a sovereign state with its own currency. The result of Ingram’s analysis is that the main difference between the interregional balance of payments and the international balance concerns the banking system. “In an integrated economy, where a small number of banks have nationwide branch-banking facilities, payments from one region to another create no difficulties because total reserves and deposits are unaffected. In the US system, payments from North Carolina to the United States reduce North Carolina reserves and deposits and increase US reserves and deposits, but North Carolina banks can forestall any pressure toward multiple contraction by selling US securities or other secondary reserves in the United States” (Ingram, 1959: 629). This result is possible because of the development of large holdings of “generalized” (or perfectly transferable) financial assets. The difference with a regional and an international balance of payments is clear. “When payments are made from one nation (A) to another (B), the fall of A’s reserves and deposits is more likely to set in motion a multiple contraction because the assets of A-banks may not be readily saleable in B, or because of restrictions on such a sales by A-authorities, or because B-Banks and other financial institutions are not allowed to hold ‘foreign’ securities” (Ingram, 1959: 929).
Scitovsky reached the same results in his analysis of balance of payments problems. He observes that the very existence of transferable assets substitute the mobilization of reserves in the banking system. "Here then is a large part of the explanation of why the balance-of-payments equilibrium is so easily and automatically maintained between different regions in the United States. Any imbalance between one region’s exports and imports is automatically balanced by an offsetting imbalance between that region’s inflow and outflow of assets: ... These equilibrating autonomous asset flows explain balance-of-payments equilibrium between the regions of a country in the short run – and the short run in this context can last for years" (Scitovsky, 1969: 96).

Of course, the existence of a large and well-integrated market of perfectly transferable assets does not completely eradicate the regional problems in the long run, when structural differences in the regional level of per-capita income exist, as noticed by Pfister in a Comment to Ingram’s paper (Pfister, 1960). In effect, as we shall see a little further on, a monetary union cannot work smoothly without a fiscal union, but one crucial feature of a monetary union is to do away with any risks provoked by fluctuations of the rate of exchange and sovereign debts defaults. After WWII, in the US economy differences among rates of interest among the states existed, but they were mainly due to liquidity costs caused by transferring funds outside the regions. “Given the diversity of investment opportunities and the variety of costs that may be encountered in the interregional transfer of funds, it would seem that these interest rate differentials are to be expected and, perhaps, are even an integral part of a complex interregional money market” (Cebula and Zaharoff, 1974: 94).

The last feature of the US monetary Union we want to highlight is the relationship between the monetary union and the fiscal union. In a paper of 1949, just after the New Deal and when the transit clearings among the twelve districts of the Federal Reserve System consisted of gold, Penelope Hartland explains that the districts that lost funds in transit clearings – with a negative balance of payments – gained funds through the operation of the Treasury (tax proceeds, unemployment benefits and other aid), and the districts that gained funds in transit clearings – with a positive balance of payments – lost funds via Treasury transfers. The net result was that over a certain number of years the net accumulation or loss of gold by any region was zero. In this way, Treasury transfers enabled the deficit districts to maintain a certain level of consumption, which would have not been possible in the case
of a bank reserve leakage. “In brief, the activities of the Treasury increased the mobility of capital in the country; creditor regions were forced to lend; debtor districts were enabled to borrow – but with no provision for a return flow in the future. ... The direction of Treasury transfers reflected not only an anti-depression policy of borrowing, but also the movement toward greater equality of income” (Hartland, 1949: 402 and 406). The general conclusion is that the interregional gold standard in the US federal system was a success, while during the same decades the international gold standard collapsed.

Although Penelope Hartland does not talk about fiscal federalism it is obvious that she is describing an economy in which next to a federal monetary system a federal fiscal system was working. Rokoff is correct in saying that one hundred and fifty years were necessary to build an optimal monetary union in the US, but it is more correct to say that without a fiscal federal union an optimal monetary union is impossible. For this reason, instead of “optimal” we prefer to speak of a well-run monetary union and to run a monetary union well, a fiscal union and a federal government are necessary.

THE EUROPEAN CRISIS

The financial crisis burst in the USA in 2007, and in 2008, after the failure of Lehman Brothers, spread across Europe. The European Commission, between October 2008 and October 2011, approved €4.5 trillion – equivalent to 37% of EU GDP – of state aid and measures for financial institutions (EC, 2012b). The banks’ private debts automatically became public debts, worsened public finance benchmarks, and burdened European taxpayers. This was only the first act of the European drama. The second stage started when it became clear to the international financial markets that the European Union did not have a European fiscal parachute nor a European government (see ECB, 2012b: 51-64). The euro zone had a better ratio of debt/GDP and deficit/GDP compared to the USA, but the “US dollar zone” was better equipped to face the financial storm. In effect, shock off-the-cuff measures were taken by the Franco-German directoire, without a comprehensive policy goal. At a certain point, the very survival of the Economic and Monetary Union (EMU) was at stake. This second act of the crisis was typically European, thought the IMF was involved in sharing the cost of European measures, because the EMU was considered more similar to an international system than a federal one.

Here, our task is not to describe the several events and stages of the European crisis. Our aim is to show that: (a) from the beginning of
the EMU, in 1999, to the eruption of the financial crisis, in 2008, financial integration and rates of interest convergence were in fact taking place; the euro crisis sharply stopped integration; (b) the sovereign debts and the banking system crisis are two interdependent phenomena; (c) there is an unavoidable link between monetary union and public finance, with the consequence that the political division of Europe causes its financial and banking division.

There is a lot of evidence of a process of financial integration in the euro area. The ECB (2012a) in its Financial Integration in Europe divides the member countries into “surplus countries” (Belgium, Germany, Luxembourg, the Netherlands, Austria and Finland), with a current account surplus before the crisis, and “deficit countries” (Ireland, Estonia, Greece, Spain, France, Italy, Cyprus, Malta, Portugal, Slovakia and Slovenia). The first evidence of financial integration is the trend of intra euro area cross-border financial transaction. The trend – including transactions with the rest of the world – of debt securities (from 200bn to about 1,300bn) and of other instruments (from 1000bn to about 6,000bn) unambiguously increases from 1999 to 2008, the year of the Lehman Brothers bankruptcy (ECB, 2012a: 105-6), but falls down sharply after 2008. Moreover, also the relative share of cross-border transactions of deposits, loans and equity increased steadily. During the rising trend, one can conjecture that surplus countries purchased debt securities issued by deficit countries. The second piece of evidence is the location of savings and investments in the two groups of countries. In the years preceding the crisis, most of the saving was located in surplus countries while investments took place in deficit countries. Integrated financial systems “allow funds to be channelled from those economic agents with a surplus of savings to those with a shortage and they allow risk to be traded, hedged, diversified and pooled” (ECB, 2012a: 39). In 1980 Feldstein and Horioka observed that international financial markets were not well integrated since savings and investments are highly correlated in the same country. On the contrary, in the EMU the evidence is that savings were mainly located in surplus countries and investments in deficit countries (ECB, 2012a: 104). The third evidence concerns the share of domestic banks and non-residents in total holdings of domestic sovereign debt. In nearly all countries of the euro area the share of national governments’ debt in domestic banks steadily decreased prior to the crisis – a process of portfolio diversification was taking place – but the trend was reversed after the crisis, with the exception of Germany. After the crisis, in deficit countries the share of non-residents in total holdings decreased while
increasing in Germany, showing that Germany played the role of a financial safe-haven (Merler and Pisany-Ferry, 2012b: 8). Finally, it is important to observe that a process of interest rates convergence had been taking place prior to the crisis, especially since 2000, when the international financial market was convinced that the EMU was an economically and politically viable project (ECBa, 2012: 20).

Now, let’s consider the relationship between the sovereign debt crisis and the bank industry crisis. As we said before, the euro zone crisis was caused by the end of two groundless tenets: the first was that the EMU could work well on the basis of the fiscal rules of the Stability and Growth Pact (SGP); the second tenet was that the Lisbon Treaty was able to provide an effective EU governance. It may be useful to remember that the Basel regulatory framework allowed for zero-risk weighting of sovereign bonds. Nevertheless, the international financial markets understood that the problem was not the macroeconomic health of the whole euro zone, but the specific national economic health of the member countries of the EMU, which were now unable to devalue their currency. In the USA, as we have seen, the integration of the national banking system – with the creation of perfectly and imperfectly transferable assets thanks to the existence of a federal political and legal system – occurred during the 19th Century and was completed with the creation of the Federal Reserve System in 1913 so that, when the 1929 crisis erupted, the federal government was able, during the 1930s, to exploit monetary and fiscal policies to fight the great depression. On the contrary, in Europe the financial market perceived the frailness of the integration process and that the political risk had to be taken into account: a euro invested in Greece had a different risk compared to a euro invested in Germany, as was the case before the crisis. At that point, the CDS on sovereign bonds, banks and some other industries increased (ECB, 2012a: 23), making refunding more expensive. Non-euro area residents withdrew their deposits from the euro area (ECB, 2012a: 52) and the rates of interest on new loans to household and to non-financial corporations sharply increased in deficit countries of the euro area (ECB, 2012a: 46-47). The European banking industry was re-nationalized because “the share of domestic sovereign debt held by domestic banks increased significantly between 2007 and 2011 in all countries” (Merler and Pisany-Ferry, 2012a: 5). The vicious-circle between sovereign debts and banks is very dangerous: at the beginning the national governments were obliged to rescue the ailing banks and to increase their public debt; the excessive public debt became risky, reducing the value of the assets held by banks;
with reduced reserves, banks shrank credit to households and firms; the rate of growth of indebted countries slowed down and the risk of default loomed dramatically above deficit countries in recession.

The debt-bank vicious cycle is only the technical aspect of a more general European crisis. The real origin of the European crisis was political. The Lisbon Treaty instituted ineffective and undemocratic governance. The main powers were located mainly in the European Council, led by the Franco-German directoire. In 2009, the disclosure of the manipulation of Greece’s public finance accounting opened the euro-area’s sovereign debt crisis. In effect, it was very soon clear that the Commission did not have the power – political and financial – to solve the Greek crisis and that the other governments were not disposed to pay for Greece’s debt. In January 2010, Prime Minister George Papandreou asked the EU aid for €10bn, but the German government refused this request. At last, after dithering and disputes, and the involvement of the IMF, an aid of 110bn was granted but with drastic conditionality clauses, which plunged the Greek economy into deep depression. The history of the Greek crisis is a good example of how the intergovernmental system of governance is structurally asymmetric and inefficient. There were two reforms, already underway or under discussion, which could have stopped the infection of other banks in the EU and removed the risk of national defaults. The first reform was the creation of a banking resolution authority, complementing in this way the reform of the financial supervision framework decided in 2010, on the basis of the European commission’s proposal (the European Systemic Risk Board, the European Banking Authority (EBA) and other supervision authorities). This first set of supervision authorities did not have the power to seize the ailing bank when it was still functioning, to remove its management and eventually to wind it down, liquidate or merger it. National governments did not agree to surrender this power to the EU institutions, because the decision of the European resolution authority could have had an impact on national budgets. The second reform under discussion was the creation of Eurobonds. This proposal was already included in the Monti Report on the completion of the single market. The Report observed that “the government bond market is still fragmented, as debt issuance remains at national level” and no European national bond could compete on the global financial market. “The recent fall of the euro during the Greek crisis reflects capital outflows from Europe towards US-Treasuries, which even the quality of the Bund was not able to contain. Europe clearly loses from its lack of a global asset.”
proposal of the Report was that “borrowing at large scale through a European body, and then on-lending to member states, may represent a balanced solution. On-lending to member states should not exceed a given level of a country’s GDP (the same for all member states) so that, for the financing needs not covered through this mechanism, governments would continue to issue their own, national debt for which they would remain individually responsible” (Monti, 2010: 63).

The European Council did not accept these reforms, because the German government refused any proposal leading to a “transfer union”: the German government accepted only to pool a limited quantity of money in the EU purse, but the deficit countries had to accept severe fiscal austerity conditions. And, since the money at the disposal of the EU to save the weak member states was granted slowly and parsimoniously, the crisis spread from Greece to Ireland, Portugal, Spain and Italy. An economist, who detected the frailty of the European banking system in advance, writes: “Even though it is impossible to know counterfactuals, had the western European banking sector been less fragile at that time, it is very possible that a different course would have been taken involving Greek debt restructuring as early as 2010, and everything afterwards would have developed very differently. Put bluntly, the moral hazard created by the Greek package is largely a consequence of the failure or unwillingness of European policymakers to resolve the European banking crisis in 2009” (Véron, 2011: 5).

Was a “different course” possible? Only future historians will answer this difficult question. Here we can only propose a conjecture. Since 1950, with the ECSC, the initiative for more European integration was always taken by the Franco-German couple, but France, one of the winners of WWII and one of the members of the UN Security council, was the leading country. In effect, de Gaulle could theorize “l’Europe des patries” led by France. During the present financial crisis, it became clear that the economic power of reunified Germany was crucial. So France had to accept willy-nilly the German austerity policy. At a certain point, a “gaullism allemand” seemed to inspire the German government for a new “Europe des patries” since a project for a Federal Union was not on the table. Jürgen Habermas says that the traditional European vocation of Germany was replaced by “an undisguised leadership claim of a ‘European Germany in a German Europe’” (Habermas, 2012: 133). But, the German government, by pushing the austerity policies too far, caused a further division between virtuous and profligacy countries and put at risk the very survival of the EMU. The reversal of this strategy came about only when the German
government realized that Germany itself could become the victim of the European catastrophe.

Whatever the political explanation of the crisis is, it is necessary to find a way out. And since the main hurdle seems to be unfamiliarity with the principles of federalism, in the following sections we try to show that a European fiscal union is possible and viable.

THE EUROPEAN FISCAL UNION AND HAMILTON’S PROBLEM

Fiscal federalism is the field of public finance studying the appropriate allotment of fiscal revenues and expenditures among different levels of government. Nevertheless the bulk of the literature on fiscal federalism assumes, implicitly or explicitly, the US institutions as a model. Here we need to overcome this limit. At present, the United States of America are a centralized federation, with roughly two third of tax revenues collected by the federal government. This degree of centralization can be explained by the fact that US citizens accept to share with the other citizens some “national” duties (for instance military service and income tax) and some “national” services (for instance, Medicare and Medicaid). In short, the USA is a nation in which the federal institutions are considered a means for a decentralized form of government.

The EU is not a nation, but a supranational union of national peoples. Here, we should look for a supranational model of fiscal federalism in which, presumably, the degree of solidarity among citizens of different nations is lower than the degree of solidarity among citizens of the same nation state. Since the crucial principles of federalism can produce different effects according to the society wishing to adopt them, here we try to draft a new model fitting the European people’s needs. Alexander Hamilton, the Secretary of the Treasury of the Washington government, was the first to understand and theorize the problem of a fiscal system subdivided among different governments. Therefore we try to redefine what is known as Hamilton’s paradox (Rodden, 2006), or Hamilton’s problem (Fiorentini and Montani, 2012: ch. 6), if one wishes to stress that a solution is possible.

In order to have a well-run monetary union, we uphold that the main principles of the European model of fiscal federalism are: (a) the relative autonomy of monetary policy from fiscal policy; (b) hard budget constraints for every level of government; (c) a limited transfer union; (d) an autonomous federal budget (this fourth principle will be discussed in the last section).
Autonomy of Monetary Policy from Fiscal Policy

The no-bail out clause for the ECB is clearly stated in the Maastricht Treaty; the Lisbon Treaty inherited it. The ECB, according to this clause, cannot purchase directly member states’ debt. This clause is necessary in order to make the ECB independent from the will of national governments: its statutory goal is price stability. Notwithstanding, during the crisis many economists (for instance, De Grauwe, 2011a and b; Bradford DeLong, 2011) strongly supported the view that the ECB should intervene in the market buying national bonds under attack, fully playing its role as lender of last resort to save not only the banking industry but also the European system of public finance. The German government and the Bundesbank always refused this proposal. Let’s consider their point of view.

In a nation state if the Central Bank issues an excessive quantity of paper money causing an inflationary process, a vertical distribution of income among different groups of citizen is the result, because there will be some groups able to defend their purchasing power and some other weak groups whose real income will be eroded by price increase. In a monetary union an inflationary process can provoke not only a vertical redistribution of income but also a horizontal transfer of income among countries. For instance, country A has a zero debt; country B has a debt of 100% of GDP. An inflation of 10% will reduce the same amount of the purchasing power of all citizens, of A and B, but will also reduce 10% of the real value of B’s debt: in such a way citizens of country A will contribute to pay for B’s fiscal consolidation. A hidden horizontal transfer of income in the long run can destroy a monetary union. In a nation state this problem is seldom detected. In the USA during the 1970s and 1980s the inflation rate sometimes reached the two digits level, but none of the 50 states of the federation protested. In the EMU the degree of tolerance to inflation changes drastically from country to country. The same problem can arise even without inflation. Consider a case in which the Central Bank buys directly the bonds of state B, which after a while is obliged to default. The Central Bank will have a loss in its budget, which should be recapitalized with the contribution of all the other member states of the monetary union.

These arguments are usually accepted in “normal” times, but when the crisis bites and the EMU risks collapsing, the ECB should play the role of lender of last resort, because a liquidity crisis can easily becomes a solvency crisis, both for the banking industry and for some governments. Only the ECB can provide an unlimited amount of cash.
The significance of this thesis can be tested by the present condition of the US and UK economy, which have a higher debt/GDP and deficit/GDP than the euro zone but are not besieged by international finance. The objection is that, if the ECB buys an unlimited amount of some national debts, it opens the doors for a new debt issuance; there is a problem of moral hazard. De Grauwe correctly observes that one should distinguish the role of the institution providing liquidity from the institution charged with the regulation and supervision of bond issue. “The ECB assumes the responsibility of lender of last resort in the sovereign bond markets. A different and independent authority takes over the responsibility of regulating and supervising the creation of debt by national governments. To use a metaphor: when a house is burning the fire department is responsible for extinguishing the fire. Another department (police or justice) is responsible for investing wrongdoing and applying punishment if necessary. Both functions should be kept separate.” (De Grauwe, 2011a: 9).

This advice can be accepted, with two qualifications. The first is that the principle that the ECB cannot bail out national governments is to be maintained, but it should be admitted that “when the integrity of the euro zone is threatened” the ECB can act as lender of last resort. If the EMU crumbles, the ECB crumbles. At present, Europe is undergoing a dangerous situation because the EMU was set up without a fiscal union and a federal government. The monetary policy can be really autonomous only if public finance is independent of private finance. If the house burns, the ECB must play the role of the “fire brigade” supplying the liquidity necessary to stop the fire; but the “police department” has the duty to prevent a pyromaniac from setting the house on fire. Further on we shall discuss the function of the “European financial police.” The second qualification concerns the ECB, which must not only guarantee price stability to the euro area, but also financial stability. In fact, the request of a “banking union” is an attempt to fill the present gap. In short, the ECB should become responsible for a European resolution authority and a guarantee scheme for EMU bank customer deposits, as proposed in “Towards a Genuine Economic and Monetary Union” by the President of the European Council (Van Rompuy, 2012). The European Commission has already proposed a provisional scheme for a banking union (EC, 2012a).

**Hard Budget Constraints**

In a competitive market, a company fails when it is not able to meet its debts. This company has hard budget constraints. If this company has
a reasonable expectation that somebody – for instance a benevolent government – will bail it out, it has a soft budget constraint. Now we can transpose this concept into a political system, where the existence of hard (soft) budget constraints can be taken as a measure of the degree of centralization or decentralization. If the central government is financially strong, in the sense that the bulk of financial resources are centralized, usually local governments have soft budget constraints, because they can rely on the bail out of the central government in the case of an unsustainable deficit. On the other hand, in an anarchical international order, a sovereign state burdened with unsustainable debts has no alternative to default. In a federal state, which is a system of independent and coordinate governments, the principle of hard budget constraints should be applied to every level of government, from the local one to the central government. Autonomy involves responsibility. This in theory; in practice it is very difficult to find a federation in which this principle is fully applied (for a survey, Rodden, Eskeland, Litvack, 2003).

After the Maastricht Treaty, the European governments considered the SGP as a guarantee for the fiscal probity of the member states of the EMU. When the crisis came, the Greek case was considered by the German government more of a scandal than a political problem. Only after many off-the-cuff measures and mistakes did it become clear that the existence of the EMU was at stake and that a comprehensive reform – a fiscal union – was necessary. The principle of hard budget constraints is never mentioned in the official documents, but the declared goal is to achieve a full fiscal responsibility of national governments. The Treaty on Stability, Coordination and Governance, approved by the Council on January 31st, 2012, the so-called Fiscal Compact, is in effect a reinforced SGP: it includes the main decisions taken during the crisis, with some new important innovations. In 2010 the Commission proposed the European semester, in order to involve the national governments, the national parliaments and the European parliament in a process aimed at strengthening the coordination of macroeconomic policies and the formation of national budgets. During the first semester of every year, the EU member states debate and coordinate ex-ante their fiscal policies, growth policies and structural reforms, fixing medium term objectives. The intrusive power of the Commission in national economic policy is strongly increased. The aim is to steer the economies of the member states toward a level of debt and deficit below the default risk and to avoid pro-cyclicality in economic policies. The Fiscal Compact establishes a legal framework
and allows more power to the Commission to implement medium term objectives: the budget of the member states must be in balance or in surplus; only a structural deficit of 0.5% of the GDP is tolerated; if the debt exceeds 60% of GDP it should be reduced at an average rate of one twentieth per year as a benchmark. The member states of the EMU have to put in their constitution or in their national legal system the balanced budget rule, which is incorporated into the jurisdiction of the Court of Justice. If the Commission observes that a member state has failed to comply with the agreed medium term objectives (MTO), the matter will be brought to the Court of Justice by one or more governments and the judgement of the Court is binding. The Court may impose a lump sum or a penalty payment that shall not exceed 0.1% of the GDP of the non-compliant state. The recommendation of the Commission on the corrective measures can be opposed only by a reversed qualified majority of the Council.

The European Parliament is discussing a resolution, called “two pack”, which increases the control power of the European Commission over the euro zone countries’ fiscal policy, but these powers will be subject to more democratic control – by means of delegate acts – and the budget cuts suggested by the Commission should not be made at the expense of killing off investments with growth potential, not least those in education and healthcare. Moreover, the Parliament proposes an institutionalized mechanism to allow for a national default, according the US style Chapter 11, in order to provide legal protection for any member state that is at risk of default. The member state is required to submit a debt settlement plan for approval by the Commission and all creditors have to make themselves known to the Commission.

To sum up, the supranational powers of the Commission (the police department) are greatly increased allowing both an ex-ante power to implement national plans for growth and yearly budgets and an ex-post power, thanks to the new powers of European jurisdiction, to punish the countries of the EMU in breach with the agreed medium term objectives. Moreover, and this regulation is crucial to set in motion the hard budget constraints, an institutional mechanism for a national orderly default is established. With these measures the political risk of a sovereign debt default is turned into an economic risk (similar to the risk a creditor must bear for a private company default). Finally, the default of one member state should not be confused with its expulsion from the EMU. The expulsion of a member state is nothing but the admission of the failure of the European Union, which according to
Art. 3 of the Lisbon Treaty “shall promote economic, social and territorial cohesion, and solidarity among Member States”. The leaders of the EU should explain to their voters that the European citizens not only have rights, but also duties.

**A limited Transfer Union**

During the New Deal, the US government created some crucial welfare state institutions at federal level. In Europe, the welfare state institutions have firm national roots. Citizens in the member states of the EU feel a higher degree of solidarity towards their fellow citizens than towards other European citizens. In the 1990s the German federal government bailed out the Land of Saarland and the City of Bremen; the German reunification was a kind of bail out of the Eastern Länder, but in 2010 the German government refused to bail out Greece. The German government does not accept a hidden or unverifiable transfer of revenue from country to country, as in the case of a bail out of the ECB or the mutualisation of national debts. Of course similar behaviour can be verified in other EMU countries. This does not mean that the degree of solidarity among European peoples is zero. Some new institutions were set up to come to the rescue of distressed states, but not without intergovernmental control and conditions.

In 2010 the European Commission created the European Financial Stability Mechanism (EFSM) an instrument that allows the European Commission to borrow money on the capital market, thanks to the guarantee of the UE budget, in order to aid distressed countries. The EFSM has a borrowing capacity of €60ml. In the same year the national governments created the European Financial Stability Facility (EFSF) as a temporary intergovernmental instrument to borrow money on the capital market. It has a lending capacity of €440bn. It was utilized to provide financial assistance to Greece, Ireland, Portugal and Spain. Since 2012, the permanent intergovernmental instrument of solidarity is the European Stability Mechanism (ESM). It can borrow money on the basis of its own capital: €80bn granted by the EU member states and a callable capital of €620bn. It will have an effective lending capacity of €500bn.

The institutional structure and the goals of the ESM are similar to the IMF. The fund of €80bn is the founding capital of EU member states and will have an impact on their gross sovereign debt level but not on their budget deficit. Since it can issue its own bonds, its debt will not be consolidated with that of member states. The callable capital will not have an impact on the sovereign debt of member states as long as
there are no losses to record (caused by some EMU member state’s default). The goal of the ESM is to lend money to distressed countries, at a rate of interest lower than the usually unsustainable rate the financial market asks for a failing country, but a little higher than the normal market rate and not without conditions. The ESM can recapitalize banks directly and reduce the spread in interest rates on bond issuances among euro zone countries. It is interesting to see what happened with Greece. “The three-year bilateral loans granted [by the EFSF] to Greece in May 2010 have indeed increased the sovereign debt of each EMU member state. In fact, each country has been forced to issue new bonds in order to be able to grant Greece a loan. Yet, given that Greece pays them interest at a rate higher than that at which they themselves are borrowing on the money markets, these new issuances of debt have not increased their public deficit because the costs of issuing have been balanced out by the interests paid by Greece” (Fernandes and Rubio, 2012: 4). Therefore, the impact of the ESM on the national budgets of the EMU member states, if we exclude a dramatic default, will be limited to the cost of the founding capital. Since the ESM is able to guarantee that each member state under stress can raise money at a given (though at a penalty cost) rate of interest, its function will be similar to that of a “Eurobond.” The real difference with a traditional loan is that the ESM will impose restructuring financial plans, similar to those imposed by the IMF, as happened for Greece, Ireland and Portugal.

The ESM as an instrument is not considered powerful enough to face all the European problems. In effect, some reasonable doubt exists on its capability to face a default of some big countries, such as Spain or Italy. Moreover, many debtor countries think that it is unfair that in a monetary union some countries can raise money at very low interest rates (like Germany) and other countries are obliged to face unsustainable rates. In the US the 50 states can find specific difficulties in borrowing on the market, but the spread in interest rates is not so high as in the EMU, because the federal government greatly reduces their financial needs thanks to federal grants. In the EU the “federal” budget is too small to provide significant aid to member states.

One way to solve the problem of a “common and fair rate of interest” for every country is the creation of Eurobonds. Two are the most interesting proposals. The first one, originally drawn up by Delpa and von Weizsäcker (2010) and adopted by the European Commission (EC, 2011), is that the EU countries pool up to 60% of GDP of their national debt assuming a joint liability for the common European debt.
The national debts beyond the Blue bond allocation are considered Red bonds, for which the issuing national government is fully liable. Of course, the Red bonds will pay a higher interest rate, thus pushing the issuing government to converge to the 60% level. The advantages of the Blue bonds proposal are several: “The euro area Blue bond market could amount to 60% of euro area GDP (about €5,600bn), which is about five times the current market for the German Bund and almost as large as the US Treasury debt market (about $8,300bn). Other things being equal, greater liquidity in bonds reduces the borrowing costs” (Delpa and von Weizsäcker, 2010: 4). Notre Europe (2012: 38-41) proposes a similar, but more gradual scheme. A European Debt Agency will issue 10% of GDP euro zone of member states debts. A discount window would allow euro area states to borrow up to 20% of GDP relatively easily, but for tranches above 20% the interest rate will be raised and the distressed country must agree to an adjustment program.

The second alternative is a redemption fund, based on the proposal made by the German Council of Economic Experts (2011). The EMU member states should pool their debts exceeding 60% of GDP into a European fund. EMU members are jointly and severally liable for redeeming their part of the debt in 20-25 years, but have the advantage of paying a low interest rate since the European Redemption Fund (ERF) can issue its own bonds. The conditions for EMU members to take part in the ERF are that they should devote part of their tax revenue to pay their lump yearly amount to the ERF and deposit collaterals. Some governments prefer this second alternative – and also the European Parliament supports it – but it has the drawback of leaving the EMU at the end of the transitory period of 20-25 years without European bonds. In fact, for a smooth functioning of the European financial and banking system a “perfectly transferable” asset – similar to the US Treasury Bonds – is necessary.

**FEDERALISM IS NEITHER CENTRALIZATION NOR DECENTRALIZATION**

The abovementioned three principles of the European model of fiscal federalism show that the EU is embarking on a different path from the one chosen by the US. In Europe the bulk of public revenues are allocated at national level and the EU budget is only about 2% of the total EU revenues. In fact, the small EU budget is basically ignored in the debate over the fiscal union. The proof is that the next Multiannual Financial Framework 2014-2020, at present under discussion, does not forecast any significant change from that amount (about 1% of EU
This is a grave error both of the national governments and of the European Parliament: if a fiscal union is to be set up in the next few years – and this step is necessary to save the EMU – it will not work properly and frequent reparations will be required in order to avoid a new dramatic crisis. Here we try to show the relationships between the three features listed previously and the EU budget. A fiscal union is a set of constitutional rules regarding the apportionment of fiscal resources among independent and coordinated governments. But, as Wheare says, if federalism “is to operate not merely as a matter of strict law but also in practice,” the European level of government should have autonomous financial resources. The solution to this problem is the creation of a federal budget, which entails a federal government (a reformed Commission, with a Ministry of Finance) responsible before a bicameral parliament – a chamber of representatives and a chamber of national governments. Let’s consider again the three features already discussed under this new perspective.

Autonomy of Monetary Policy from Fiscal Policy

As we have already seen, the autonomy of monetary policy from fiscal policy involves the full responsibility of the ECB for the functioning of the European banking industry. A banking union must be set up, with a resolution authority and a euro area deposit guarantee fund. At present, the supervision system is rooted at national level. The EBA needs information from national supervisors to intervene. “The limited supervisory role of the EBA is, of course, related to the absence of financial means at EU level to support banks in difficulty. Taxpayers’ resources remain firmly in the hands of national governments and parliaments.” (Marzinotto, Sapir, Wolff, 2011: 4). The same observation should be made for the deposit guarantee fund because the bank industry should contribute to the fund with an insurance premium, in order to avoid public finance authorities being obliged again to rescue the banking industry should a new crisis arise. “A euro area deposit insurance scheme would go a long way to breaking the existing link between banks and their national sovereigns which tends to become a vicious circle in times of crisis. The [fund] would ultimately have to be backed by euro area fiscal capacity” (Marzinotto, Sapir, Wolff, 2011: 6). Unfortunately, the proposal under discussion in the EU (Van Rompuy, 2012) is that “the ESM could act as the fiscal backstop to the resolution and deposit guarantee authority.” If the financial stability of the euro zone is considered a European public good – as it is – the fiscal backstop should be the EU budget and not the ESM, which is a
life belt for distressed countries. To these observations one must add that the intergovernmental decision-making system is too slow in the case of crises. The ECB must make very quick decisions consulting the European Finance Ministry, which is of course politically responsible before the European parliament for the utilization of the taxpayer’s money.

**Hard Budget Constraints**

The set of financial and accountability constraints included in the Fiscal Compact are a necessary guiding line for a sound fiscal policy in EMU member states. But these rules will be applied and work smoothly only if each government can rely on enough fiscal resources, given the expectations and needs of their citizens.

Unfortunately, in the EU member states a dysfunctional equilibrium exists between national political commitments and national fiscal resources. After WWII, during the first decades of European integration and the NATO military protectorate, European governments were able to build a satisfactory welfare system, granting high levels of employment and good public services. Today, European governments must face new challenges, such as new military commitments for peace keeping and peace enforcing, in the framework of the UN, and the ecological reconversion of their old system of production. Moreover, globalization is relentlessly eroding the financial basis of the European fiscal system. The liberalization of capital movements allows financial capitals to fly where profit perspectives are higher and risks lower. International direct investments go where tax rates are lower. Global competition among national fiscal systems increases the fiscal burden on the working and middle classes, as the increasing rates of indirect taxation (like VAT) compared with the decreasing rate of corporate taxation show. Income inequalities are increasing everywhere (see Fiorentini and Montani, 2012, ch. 3 and 6).

Therefore, national governments can recover their power to tax only at supranational level, in the EU with a federal government and, when it becomes possible, at world level.

National governments strongly resist devolving more fiscal powers (a fiscal capacity) to the EU, but are unable to supply the public goods citizens need. The national waste of European resources causes less growth, more unemployment and more poverty in the EU. This waste is clearly substantiated in a Report by three members of the European Parliament (Haug, Lamassoure, Verhofstadt, 2011) who show how miserable and anti-democratic the management of the EU budget is.
For instance, the EU decided to create an External Action Service in order to set up a European foreign policy. But, at present, the EU member states employ 94,000 staff members while the US has only 22,000 staff members. The European system of central banks employs 44,000 people while the US Federal reserve banks employ 18,000 people. In the defence sector, split into several national systems, the European system employs 2 million people, but the potential effectiveness on the battlefield is cruelly lower than that of the US, as the Afghan and Libyan deployments have exemplified.

The EU budget is not a piece of the transfer union, because its main function is to provide European public goods, which benefit all the Union’s citizens. But the EU national governments do not accept the obvious fact that a federal budget is the most effective way to collect European taxes, to reduce the risks of economic cycle and to exploit economies of scale for the provision of European public goods. The size of the federal budget is considered a taboo. The first and last study on this problem was the McDougall Report drawn up for the European Commission in 1977. According to this Report the EU budget should reach 5-7% of GDP. But it took the US as a model. Today, a suitable size for a European federal budget can probably be more modest. Here, it is necessary only to recall that the EU budget must be financed with 100% of own resources: with an ensemble of a financial transaction tax, a VAT, a carbon tax, a corporate tax and an income tax. Moreover, the growth plan “Europe 2020,” proposed by the European Commission, must be financed as soon as possible if the EU wishes to save the EMU and to avoid further years of distress for European citizens. The decision, taken by the European Council on June 27-28th 2012, to launch a “Compact for Growth and Jobs” of 1% of EU GDP is only a timid step forward: €55bn are reallocated structural funds, already in the EU budget; only the increased lending capacity of €60bn of the EIB is a real new measure, together with the first issue of project bonds (€5bn), already approved by the European Parliament. All in all, the effectiveness of the EU budget for the growth and stability of the European economy is greatly underrated. Thanks to the principle of co-financing, European expenses stimulate national investments too and, in fact, the EU budget coordinates all EU investments in a more effective way than administrative rules.

A Limited Transfer Union

The debate on the transfer union disregards the fact that the size of the EU budget is part of the problem. The EU budget finances the provision
of European public goods, such as Galileo, a number of industrial and scientific research projects and, hopefully, the growth plan “Europe 2020.” These expenses, together with other policies, such as the structural funds, favour convergence among rich and poor regions and increase the welfare of the European citizens. If the size of the EU budget is not enough to create an effective convergence, the hard budget constraints for national governments become a straitjacket: austerity policies provoke recession and fiscal unsustainability. When the EU budget fails to guarantee a convergence process, distressed countries seek the help of the ESM and, if the financial strength of the ESM is not enough, the integrity of the euro zone is threatened. Hard budget constraints are not the only criteria for assessing the efficiency of a fiscal union: an efficient fiscal union should also guarantee the real convergence of diverse and dissimilar national economies (as art. 3 of the Lisbon Treaty states).

Moreover, instead of the ESM, which is an intergovernmental instrument, the same function can be carried out better by the EFSM, which is financed by the EU budget and is under the control of the European Commission. The problem with the EFSM is that its financial capacity is small because the EU budget is small. But from a European point of view the best place to put the European taxpayers’ money is the EFSM, a fund managed by the Commission, not the ESM.

Finally, let’s consider the question of Eurobonds. Apropos, we should distinguish between the problem of national debt management and the structural needs of a “perfectly transferable financial European asset.” For national debt management the proposal of the creation of the ERF is likely the most appropriate. But the EMU needs a permanent transferable financial asset for two reasons: (a) to avoid a new double crisis, of the national debts and the banking industry; (b) to attract capitals from outside Europe and make the euro zone a competitive global financial market. From this second point of view the best solution is for the European Commission, if the EU budget is financed by own fiscal resources, to issue its own bonds, i.e. federal bonds, not only project bonds. The rules of the Fiscal Compact should be applied at European level too. The budget of the EU must become flexible, with some low deficits and surpluses according to the phase of the economic cycle, like the national budgets. The European citizens and financial investors should (and probably will) buy federal bonds in alternative to national bonds.

A fiscal union without a federal budget is like a sailing ship without the mainmast. The omission of the size of the EU budget in the plans
for the European fiscal union reveals that the compliance of hard budget
constraints at national level will rely more on administrative rules than
an effective and agreed process of economic convergence among
the national economies. This approach may cause political and social
protests against Brussels’ bureaucracy and the national governments
which support these policies. To avoid this danger, the creation of a
federal budget and a democratic European government are necessary.
The citizens will accept to give more fiscal powers to the EU if they
trust the new federal government and the political parties, which
support it in the European Parliament. This outlook will require time
to be fulfilled and real political leadership, but it is possible because a
proper federal budget can decrease the fiscal burden of European
citizens.

At present, the national political leaders, with their disagreements,
wavering and errors, have brought the EMU on the verge of collapse.
Their duty is to get out from this quagmire as soon as possible by
setting up the necessary institutional reforms to save the EMU; this
urgent decision must be coherent with the creation of a federal
government, fixing the stages and the date for its establishment. Human
institutions were never born perfect. The US states, in spite of their
federal constitution, caused a civil war before finding the way for a
more perfect union. In Europe, we have already had two bloody civil
wars; now we must work incessantly to save the European construction
and render it more perfect.

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Notes
1. Here we employ the term model – as usual in economics – to show that the
whole is made up of coherent elements or principles. For this reason we
uphold that the four principles here proposed must include a federal budget
with an appropriate fiscal capacity, otherwise the new model of fiscal
federalism is not sustainable.

2. Several economists consider the division between surplus countries and deficit
countries – or the North South productivity gap – one of the main causes of
the EMU crisis. Here, we do not deny that the gap exists – likewise a similar
gap exists among the US states – but we maintain that this gap is not the
main cause of the crisis. One should note that Ireland and Spain get into
trouble because of the excessive exposure of their banking system, not because of their current account deficit. The existence of deficit countries (with negative current account) and surplus countries preceded the creation of the EMU and continued to be there from 1999 to 2009, the first decade of the EMU. As we show in the next section, the existence of transferable assets within the EMU set in motion a transnational movement of capitals, just like Ingram and Scitovsky stated, from surplus to deficit countries, which smoothed balance of payments problems within the EMU. Of course, this does not mean that the structural problems of persistent per-capita income gap, unemployment and competitive differences will disappear only thanks to capital mobility. A recent research on the Appalachia region shows that regional and state cooperation is crucial for a successful development policy in the long run. The policy conclusion of this research is that “without higher-level government coordination regional cooperation is difficult to achieve, and states need to encourage or create a framework to enact this type of cooperation. The role of the state is particularly important because the results also indicate the presence of agglomeration economies which, combined with the economic weakness of countries with small and dispersed communities, suggests that concentrating public development investments in centers will yield a greater return than treating all locations equally” (Gebremariam, Gebremedhin, Schaeffer, 2011: 118). The conclusion of the present section, concerning a well-run monetary union, suggests that an effective regional policy is an unavoidable complement of a monetary union. In the EU the social and regional cohesion policy is entrusted to structural funds and, as is well known, their effectiveness is disputed (Marzinotto, 2012). In effect, the EMU crisis can be looked upon as a demonstration of their insufficiency. This is one of the reasons why we propose the creation of a true federal budget in our last section.

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