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## **FISCAL POLICY IN EUROPE: A HELICOPTER VIEW**

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Roberto Perotti

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# FISCAL POLICY IN EUROPE: A HELICOPTER VIEW

## Abstract

We discuss the main fiscal policy issues in the Eurozone, focusing on two that are at the core of the current debate. The first is that, right from the start, the government deficit and debt were the key objects of contention in the debate that led to the creation of the Eurozone, and they still are. The second issue is that a currency union implies the loss of a country-specific instrument, a national monetary policy. This puts a higher burden on fiscal policy as a tool to counteract shocks, a burden that might be even heavier now that the European Central Bank has arguably reached the Zero Lower Bound. Two obvious solutions are mutual insurance (or risk sharing, we use the two expressions interchangeably) between countries; and a centralized stabilization policy. Yet both have been remarkably difficult to come by.

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# Fiscal policy in Europe: a helicopter view\*

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## 1 INTRODUCTION

In this paper we discuss the main fiscal policy issues in the Eurozone. The Eurozone is a subset of the European Union<sup>1</sup>, and most fiscal policy issues at the European level are decided within the European Union. Because of the important interactions of fiscal policy with monetary policy and the banking system, in this paper we will focus on the Eurozone, although much of what we say applies also to the European Union.

As we have to be selective, we focus on two issues that we believe are at the core of the current debate, and on the proposals that have been put forth to address these problems. Our goal is pedagogical: we do not make any new proposal, but try to represent fairly the various sides of the debate. Since this debate plays out less on academic journals than on policy blogs and discussion papers of research centers and international organizations, the literature is particularly vast and we will not be able to cite all relevant work; but in emphasizing the distinction between different visions of “core” and “periphery” countries, we acknowledge our particular debt to Brunnermeier, James and Landau (2016).

The first issue we focus on is that, right from the start, the government deficit and debt were the key objects of contention in the debate that led to the creation of the Eurozone, and they still are. Strict limits to both were enshrined in the Maastricht Treaty of 1992 establishing the European Union, seven years before the Eurozone became operational. At the insistence of Germany, a no-bailout clause was also included in the Treaty: an insolvent government could not be bailed out by the other countries. Why this seeming fixation with the deficit and debt in a monetary union? The standard account is that Northern countries, with Germany in the lead, worried that high debt countries would eventually exert pressure on the common central bank to monetize the deficit - as they were used to do in the seventies and the eighties with their own central banks – thus imperiling the one feature of a currency union that Germany would never give up: a commitment to keep inflation low and stable (see James 2012). However, with the Quantitative Easing policy started in 2015, the European Central Bank has bought enormous quantities of government debt, tripling the monetary base by mid-2020 – much more than if it had monetized the deficits of all Eurozone countries – and inflation has not budged. Yet, if anything budget deficits and government debt are even more central to the debate on the reform of the Eurozone. The focus has shifted: from fears of inflationary pressure to fears of a variety of spillovers and contagion effects of a default of a monetary union member. This includes, but is not limited to, the fear

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<sup>1</sup> All 27 European Union members are part of the Economic and Monetary Union (EMU). Only 19 of these, however, have adopted the Euro and form the Eurozone. All countries that joined the EU after the creation of the Eurozone are waiting to qualify for the Eurozone; two older members of the EU, Denmark and Sweden, have chosen not to adopt the Euro for the time being.

that a default could force an exit from the Eurozone or the collapse of the financial system, or both, with unknown consequences for the working or even the viability of a currency union. Greece represents only 3 percent of the Eurozone GDP; yet, between 2010 and 2012 talks about a possible Greek default kept the entire Eurozone on edge, and fueled a raging debate about a Euro breakup.

The second issue we focus on is that a currency union implies the loss of a country-specific instrument, a national monetary policy. This puts a higher burden on fiscal policy as a tool to counteract shocks, a burden that might be even heavier now that the European Central Bank has arguably reached the Zero Lower Bound. Two obvious solutions are mutual insurance (or risk sharing, we will use the two expressions interchangeably) between countries and a centralized stabilization policy. Yet both have been remarkably difficult to come by.

Moral hazard is an obvious problem with any risk sharing arrangement, and it is certainly an important reason behind the core countries' deep suspicion of a European mutual insurance scheme. But another factor, which interacts with moral hazard, also plays an important role. The essence of risk sharing among countries is transfers between countries. In standard models of insurance across countries net transfers are zero *ex ante*, and shocks are temporary. In the real life Eurozone, countries have highly persistent differences, one of them being very different levels and riskiness of their government debts; shocks also tend to be highly persistent. Because of this, virtually all risk sharing arrangements and centralized stabilization policies that we can think of are likely to generate long periods of transfers in one direction from the core to the periphery, lasting perhaps a decade or a generation (we will call these "persistent, unidirectional transfers" for short).<sup>2</sup> Core country politicians would have difficulties justifying this in front of their electorate, especially in the current political atmosphere where nationalist feelings are resurgent everywhere. We emphasize that in politics a "long period" could be rather short: ten years can encompass two or three electoral cycles, an eternity in politics.

Of course, in theory one can design risk sharing arrangements where only the temporary component of asymmetric shocks is insured, and transfers even out over reasonably short periods with high probability; but in reality this is very difficult to do.

## 2 A NEGATIVE SHOCK IN A PERIPHERY COUNTRY

To understand these issues and the proposals on the table, it is best to start with a concrete question, and one that is at the center of the debate. Suppose a periphery country of the Eurozone, with high levels of public debt, is hit by a negative shock. Ignore initially the existence of treaties limiting (with varying degrees of effectiveness) the use of fiscal policy and ask the question: what will likely happen if the country uses fiscal policy to counteract this shock?

A plausible scenario is one in which markets will fret about the solvency of the government, and the cost of borrowing will increase. Still, for a long time the country will not lose access to the market, partly because the market will be unsure whether the no-bailout clause will be enforced in case of manifest insolvency: many participants will assume that the country will eventually be bailed out anyway, perhaps indirectly by the ECB via large purchases of its debt on the secondary market. Of course nobody knows in real time if a government is insolvent or simply illiquid: markets will also be uncertain if, at what conditions, and for what amount European governments and institutions will be called in to provide liquidity to an illiquid government. The result is a prolonged period of uncertainty, which will make the unavoidable fiscal adjustment even more costly in the end; or a disorderly, highly disruptive insolvency; or a market panic that transforms an illiquidity problem into a solvency problem. None of these three scenarios is appealing.

In addition, the viability of the financial system would be called into question. Naturally, the negative shock hitting the country impacts the profitability of the banking system by increasing the stock of non-performing loans. But an additional channel is at work: for reasons that we discuss below, banks and insurance companies of periphery countries have large exposures to their own sovereigns; as a consequence, the decline

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<sup>2</sup> For simplicity, the expressions "long periods of transfers in one direction" or "persistent, unidirectional transfers" do not encompass only the case of a continuous flow of transfers year after year for a long period, but also of a large, one-off transfer which is unlikely to be offset by a transfer in the opposite direction over a politically realistic horizon. This is the case, for instance, of the Greek bailout.

in the market value of the sovereign through the mechanism illustrated above calls into doubt the viability of the financial system as well. This increases further the riskiness of the sovereign itself, as the market takes into account the possibility of a costly bailout of the financial system by the government. Thus, a two-way linkage arises, in which the riskiness of the sovereign and that of the financial system reinforce each other. While this type of “doom loop” between the financial system and the sovereign could arise in any economy, it is particularly dangerous in a currency union, where governments do not have access to their own “printer of last resort” and do not have the option to devalue to offset the negative shock, and where the spillover effects on other countries of a financial system breakdown could be particularly disruptive.<sup>3</sup>

In the rest of the paper we discuss the various proposals to address these issues. To impose some discipline on the discussion we highlight a few criteria that we will follow. First, we take political constraints seriously. The most important among these is perhaps the one we have highlighted above: persistent, unidirectional transfers are politically unfeasible – a theme that will resonate throughout this paper. Although the EU is formally largely run on the basis of “one country one vote”, and even requires unanimity in some cases, the political reality is that some countries matter much more than others: ingenious proposals that have practically no chance of being accepted in the foreseeable future by one or more of the major players with *de facto* veto power do not seem very useful to us. In this respect, we recognize that the difference between “core” and “periphery” countries is real: not only are their economies and cultures different in important ways, but the fact of the matter is that a “core Eurozone” could survive and maybe prosper, while a “periphery Eurozone” is unlikely to be viable. Hence, core countries have more bargaining power, and there is nothing to be gained by ignoring this simple fact. In addition, we believe that there is a fundamental asymmetry between a budget deficit and a budget surplus, and between a current account deficit and a current account surplus; proposals that rely on a symmetric adjustment of deficits and surpluses are not realistic. Finally, in virtually all countries nationalistic and Euro-skeptical parties are more and more important: even at the best of times appeals to the notion of “European solidarity” are unlikely to move many voters in the core countries, now they are simply unrealistic.<sup>4</sup> This was in clear view in July 2020 during the negotiations for a stimulus package at the European level of about 750bn euros, when the “frugal four” Northern countries – Austria, Finland, the Netherlands, and Sweden – openly defied an agreement by France and Germany to distribute large grants to Southern countries particularly hit by the pandemic, on the ground that these countries had a long history of mismanagement of their public finances. Three of the four “frugal” countries were led by social democratic government, facing high pressure at home from nationalistic parties.

The second criterion we impose is that the transition matters: we do not find very useful those proposals that would work in a steady state with low government debts but do not make concrete suggestions on how to get there, except perhaps recommending the implementation of some generic “good policies” or “better monitoring and supervision” of certain actors.

The third criterion is that, while we particularly highlight issues related to the Covid pandemic, our treatment is more general, and covers issues that precede the pandemic and will survive it.

### 3 MARKET DISCIPLINE VS. RULES

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<sup>3</sup> The doom loop first really became the object of a heated debate at the time of the sovereign debt crisis of 2011-2012, when Italian and Spanish banks surprised many by using the large injection of liquidity by the ECB to double down on their holdings of risky domestic sovereign.

<sup>4</sup> During the Greek crisis, one of the most popular arguments in support of a European bailout in the Italian media (and quite possibly in the media of other countries too) was that Greece was the cradle of the European civilization, it was the land of Plato and Aristoteles at a time when Germany was barely inhabited. Later, similar arguments (shifted forward by a few centuries to encompass the glories of the Roman empire, and perhaps with the additional supporting argument of the Renaissance a thousand years later) applied at the time of the Italian debt crisis in 2011-12. We doubt that many German taxpayers and voters found these arguments convincing.

### 3.1 RISK SHARING VS. RISK REDUCTION

At its core, the debate is a manifestation of two age-old debates: rules vs. discretion, and risk sharing vs. risk reduction and market discipline. An important recent contribution that has tried to reconcile the elements of this trade-off is the manifesto of the “7+7” (see Bénassy-Quéré et al. 2018), a group of seven French and seven German economists, that has sparked a large and fruitful policy debate on which we draw freely throughout this paper.

One extreme solution is to rely on the discipline imposed by markets. When a government is insolvent, markets pull the plug and force the government to restructure its debt. If this causes major disruptions to the economy, requiring a Euro-exit to repair, so be it. The problem with this approach is that markets are imperfect watchdogs of the sustainability of government finances: they typically ignore the problem for too long, while at other times they might panic and transform an illiquidity problem into an insolvency problem. It is fair to say that nobody, at least officially, advocates market discipline as the *only* approach.

At the other extreme, the solution is to rely on rules constraining national government deficits and debt. If the problem is excessive government debts, in principle it can be solved easily: membership in the monetary union requires compliance with specific limits on government deficits and debt. This is essentially the approach that was tried at the beginning.

### 3.2 THE EVOLUTION OF EUROPEAN FISCAL RULES

We can only summarize the evolution of the rules governing the Eurozone, as a full account would take more than one paper. The original Maastricht Treaty of 1992 envisioned two main rules: a 60 percent debt limit and a 3 percent budget deficit limit.<sup>5</sup> Countries violating these limits could be subject to an Excessive Deficit Procedure (the “corrective arm”), whereby the European Commission recommends measures to be taken and monitors the outcomes. At the time of writing (September 2020), all EU members except Luxembourg and Sweden have been subject to at least one Excessive Deficit Procedure; one (Romania) is still open. To reinforce the effectiveness of these rules, per the 1997 Stability and Growth Pact member countries should also have a budget position “close to balance or in surplus” over the medium term.

By 2005 it was widely agreed that this approach imparted a strong pro-cyclical bias to fiscal policies. When the economy is hit by a negative demand shock, the budget deficit and government debt as shares of GDP rise automatically, both because the numerator increases and the denominator decreases. Hence, the rules in place called for a restrictive fiscal policy exactly when the economy is hit by a negative shock. One answer is to express the rules in cyclically adjusted terms.<sup>6</sup> The 2005 reform introduced a role for the “structural” deficit (the cyclically adjusted deficit net of one-offs and of certain temporary components): each year, each country is assigned a Medium Term Objective (MTO) defined in terms of the structural balance (the “preventive arm”): up to 1 percent structural deficit if it had low debt and high potential growth, and a structural budget in balance or in surplus in the opposite case, or if the sustainability of its public finances were imperiled by aging of the population. The 2005 reform allowed for a country to deviate from its MTO, or from the adjustment path towards the MTO, in case it introduced a qualifying structural reform, on condition that it would get back to the path within four years.

One can see already how many elements of judgment were involved in these rules. Estimating the cyclically adjusted budget deficit involves first estimating potential output, and then estimating what government revenues and expenditures would be if actual output were at potential. Both steps are subject to

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<sup>5</sup> There are various accounts of where these numbers came from, none of which verifiable; we just note that in steady state the two numbers are compatible with each other if the rate of growth of nominal GDP is 5 percent, a figure that some countries have not seen for decades by now.

<sup>6</sup> To obtain the cyclically adjusted budget balance, one subtracts from the actual budget balance the component that is due to the deviation of output from its potential level; in other words, the cyclically adjusted budget balance is the balance that would prevail, given the current legislation, if output were at its potential. Computing the cyclically adjusted balance therefore requires at least to estimations subject to high uncertainty: the potential level of output and the elasticity of government revenues and spending to output. In a recession, government revenues fall automatically as output declines, while government expenditures like unemployment benefits increase; hence, the government budget balance declines automatically. In a recession, the cyclically adjusted budget deficit is therefore smaller (in absolute terms) than the actual deficit, and the opposite in an upturn.

considerable uncertainty. In addition, because of the mechanics of the computation of potential output, in the early phases of a recession there is a tendency to attribute the recession to a decline in potential output, so that the initial estimates of the output gap are typically larger (in algebraic terms) than they should be. It follows that at the beginning of the recession countries are typically required to implement more conservative fiscal policies than they would be based on later estimates: this did play an important role in the austerity recommendations of 2011-2012. Fatás (2018) and Fatás and Summers (2018) argue that this mechanism made the recession deeper and, in a self-reinforcing loop, justified ex-post the estimates of a decline in potential output.

With the 2011 debt crisis the pendulum swung in the opposite direction: now there were calls by Northern countries to make the rules more binding. Hence the “*Six Pack*”, which introduced legally enforceable sanctions up to .2 percent of GDP, in the form of interest-bearing and then in case of further non-compliance, of no interest-bearing deposits. Predictably, these sanctions were never applied. To assuage the other countries, that regarded the high current account surpluses of Germany as a main source of disinflationary pressure in the whole Eurozone, the Six Pack also introduced the Main Macroeconomic Imbalance procedure, which would take into account a number of macroeconomic variables, including for instance an excessive current account surplus. Needless to say, the Main Macroeconomic Imbalance procedure has been largely toothless.

Still in response to the debt crisis, the Fiscal Compact, adopted by the Eurozone countries, introduced a debt-brake, by which a country with more than 60 percent of debt / GDP ratio would have to reduce it at an average speed of one twentieth of the excess per year, where the average is calculated over the last three years. It also called for all signatories to incorporate the balanced budget rule into their constitutions.

In 2015 the pendulum swung back again, reflecting a backlash against the period of fiscal austerity that has been perceived to have been imposed on the Eurozone countries by the Commission and the Northern countries. Within the existing rules, clarifications were issued about their implementation. Inevitably, the problem of procyclicality of rules was dealt with by introducing more and more exceptions, qualifications, and contingencies, in the end leading to a bewildering cobweb that even experts in the field have trouble navigating. Provisions were made to facilitate public investment and structural reform. Thus, members would be allowed to deviate temporarily from their MTO or adjustment path towards it to accommodate investment, provided that: “their GDP growth is negative or GDP remains well below its potential; the deviation does not lead to an excess over the 3 % deficit reference value and an appropriate safety margin is preserved; investment levels are effectively increased as a result; the deviation is compensated within the timeframe of the Member State’s Stability or Convergence Programme.” (European Commission 2015 p. 9). “Structural reforms” also give right to a deviation of .5 percentage points of GDP from its MTO “provided that such reforms (i) are major, (ii) have verifiable direct long-term positive budgetary effects, including by raising potential sustainable growth, and (iii) are fully implemented” (European Commission 2015 p. 12).

The budgetary and growth effects of reforms and public investment are pure guesswork, or rather the result of political give and take. For instance, in 2015 Italy was allowed to deviate from its MTO on the basis of three different clauses: the “unusual events” clause for .12 percentage points of GDP (half to cover the costs of refugee crisis and half for the security crisis after terrorist attacks in Europe); the “investment” clause for .25 pps; and the “structural reform” clause for .50 pps, based on a submission to the European Commission envisioning an effect of these reforms on the level of GDP of 1.8 percent in 2020 and 7.2 percent in the long run.<sup>7</sup>

Finally, to take into account cyclical conditions, the Commission devised the “matrix for specifying the annual fiscal adjustment towards the medium-term objective (MTO) under the preventive arm of the pact” (see Table 1). The degree of complexity of all these rules is self-evident. Even more important than the mind-boggling number of contingencies and escape clauses written in the Stability and Growth Pact, and its numerous modifications, are the exceptions granted on an ad-hoc basis. Almost by definition, rules cannot foresee all the relevant contingencies, and each time there will be pressure to correct the perceived negative side effects of a strict enforcement. The result is not just an unwieldy legislation, but endless litigation, backdoor bargaining, and ultimately loss of trust in the European institutions. Any government (and especially

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<sup>7</sup> See Italian Ministry of Economy 2015 p.48.



any nationalist party) in any country can point to an episode where they can argue that their own country was treated unfairly by their partners.

A further complication is that the rules concern not just fiscal variables, but a whole set of indicators of all sorts of macro variables. As a consequence, a country with a bad score on the fiscal policy side can always point out some problems in any other country, and decry the unfairness of the process. This seems particularly unnecessary because, while monitoring the fiscal accounts has a coherent rationale which was accepted by all, pursuing a country because, for instance, it has an “excessive” current account surplus is bound to be enormously controversial.

All these issues have not been made redundant by the pandemic. As it is well known, with the pandemic the Stability and Growth Pact has *de facto* been suspended: the “general escape clause” has become operational, allowing member states to depart from the adjustment path towards their MTO. Still, this is meant to be temporary, and if anything the pandemic has highlighted further the need for reform of the SGP.

**Table 1: The “matrix”**

		<b>Required annual fiscal adjustment (pp of GDP)</b>	
		Debt $\leq$ 60% and low/medium sustainability risks	Debt $>$ 60% or high sustainability risks
	<b>Condition</b>		
<b>Exceptionally bad times</b>	Real growth $<0$ or output gap $< -4$	No adjustment needed	
<b>Very bad times</b>	$-4 \leq$ output gap $< -3$	0	0.25
<b>Bad times</b>	$-3 \leq$ output gap $< -1.5$	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
<b>Normal times</b>	$-1.5 \leq$ output gap $< 1.5$	0.5	$> 0.5$
<b>Good times</b>	Output gap $\geq 1.5$	$>0.5$ if growth below potential, $\geq 0.75$ if growth above potential	$\geq 0.75$ if growth below potential, $\geq 1$ if growth above potential

Source: European Commission (2015) p. 20.

### 3.3 THE EXPENDITURE RULE

To correct the procyclical bias in the existing rules, several authors have proposed an expenditure rule (see e.g. Bénassy-Quéré et al. 2018, Claey's, Darvas and Leandro 2016, Darvas, Martin and Ragot 2018, Feld et al. (2018), European Fiscal Board 2019, Mohl and Mourrel 2020). There are several versions, all variants of the following approach: take government spending and subtract interest payments, unemployment benefits, one-off expenditures, a smoothed version of public investment, and the discretionary change in taxation. This

variable – call it “adjusted spending” - cannot grow more than a smoothed version of expected potential GDP in nominal terms over a window of ten years or so. Shortfalls of adjusted spending relative to this ceiling can be saved in an accumulation account, whose balance can be spent to finance excesses of adjusted spending in other years. Most proposals also envision a “debt-brake”, i.e. an adjustment of the ceiling based on the debt to GDP ratio: in countries with a higher ratio the ceiling would be revised downward. Escape clauses and further adjustments for the cyclical conditions are also typically envisioned. All the judgment calls (estimates of nominal potential growth, smoothing of public investment, the adjustments for the debt to GDP ratio and cyclical conditions, escape clauses etc.) would be made by a combination of the European Commission, a European Fiscal Council, and national fiscal councils.

In most proposals (Feld et al. 2018 being an exception) the existing structural balance rule would be replaced by this expenditure rule. The alleged advantages are numerous. We list four that can be found in the literature; we find all of them debatable at the very least (see also Barnes and Casey 2019). First, the expenditure rule is more transparent than the construction of the structural balance. However, as we have seen, the construction of an expenditure rule involves *more* steps and many actors, some of which – like the national fiscal councils – in some countries have not proved to be authoritative. Second, it is less subject to the vagaries of cyclical adjustment, partly because revisions to the estimates of expected nominal potential output are less frequent and smaller than revisions of the estimates of output gap. However, this does not mean that estimates of the expected potential output are better in some statistical sense: in fact, calculating the expected nominal potential growth over a ten-year period is an extraordinarily uncertain exercise, and it is not clear that it should be less controversial than estimating an output gap. Third, adjusted spending is under the direct control of the government, and does not involve relying on estimates of controversial tax elasticities.<sup>8</sup> However, the expenditure rule requires subtracting the effects of discretionary tax changes, which conceptually involves the use of tax elasticities; the estimate of these effects in the national budget is often more a political than an economic exercise. Fourth, the expenditure rule is less procyclical.<sup>9</sup> However, because of the way it is constructed the expenditure rule essentially imposes a ceiling on the change of a version of the cyclically adjusted primary deficit. There is no clear logical or practical advantage relative to setting a MTO for a different version of the cyclically adjusted primary balance.

Perhaps most surprisingly, since the “Six Pack” reform of 2011 an “expenditure benchmark” is already in place among the EU rules: “public spending must not rise faster than medium-term potential GDP growth, unless it is matched by adequate revenue increases.” In implementing this rule, the construction of “public spending” is exactly as in the expenditure rule proposals we have described above (see Barnes and Casey 2019 or Mohl and Mourre 2020 on the performance of the expenditure benchmark).

### 3.4 RULES VS. STANDARDS

Thus, while there is a widespread agreement that existing fiscal rules are too complicated, unwieldy, even arbitrary, the quest for alternative rules does not seem to us to have made substantial progress; in fact, it might have led to a regress. Blanchard, Leandro and Zettelmeyer (2020) argue that in the presence of large Knightian uncertainty one should simply recognize that rules cannot foresee all possible contingencies *ex ante*, and advocate moving from rules to standards, i.e. principles that “leave room to accommodate the particulars of individual circumstances [...] Rules have the advantage of providing greater clarity *ex ante*. But a case-by-case approach may be preferable when ‘public authorities cannot design general rules, because they lack relevant information ... or rules [would] be poorly suited to new circumstances turned up by unanticipated developments.’” (Blanchard, Leandro and Zettelmeyer 2020 p. 20, citing Sunstein 1995). They argue in favor of simple, generic rules like the current article 126 of the EU Treaty; “Member states shall avoid excessive government deficits”, to be made operational for instance by resorting to stochastic debt sustainability analysis (essentially, a fan chart of debt developments). Whether this is a practical basis for a yearly political process involving 26 different countries is very much an open issue.

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<sup>8</sup> Tax elasticities are used in the construction of the cyclically adjusted budget balance to subtract from actual tax revenues the component due to the deviation of output from potential output.

<sup>9</sup> When GDP grows less than the ceiling, and adjusted expenditure grows at the ceiling, the actual expenditure to GDP ratio increases, and the opposite in periods of high GDP growth.

## 4 MUTUAL INSURANCE

The alternative, or complement, to rules is mutual insurance. Theoretically, mutual insurance is easy to justify (see e.g. Farhi and Werning 2017): in the presence of asymmetric shocks in a currency union, even with complete financial markets real relative prices (i.e. real exchange rates) do not adjust efficiently to provide full insurance because of the rigidity of the nominal exchange rate. Transfers between currency union members, contingent on the shocks, increase macroeconomic stability and have an aggregate demand externality effect. The private sector does not internalize this effect, hence even with perfect financial markets the amount of insurance, absent inter-government transfers, is suboptimal. In practice, however, it is another story. There are several instruments of mutual insurance, but for reasons of space and to keep with the subject of this paper – fiscal policy – we consider two obvious candidates: a European deposit insurance scheme (Edis) and a European unemployment insurance scheme (Euis). Both have figured prominently in the academic and policy debate; both have failed to make much inroad among policymakers. The main reason is that almost any conceivable implementation of such schemes would give rise to large, persistent unidirectional transfers.

### 4.1 A EUROPEAN DEPOSIT INSURANCE SCHEME (EDIS) AND SAFE ASSETS

Consider deposit insurance first. It is commonly considered the third step of a banking union, after a common resolution procedure and a common supervision system. At a very abstract level, one can think of a banking union as a risk-sharing tool because its ultimate goal is to ensure that risk-adjusted funding costs for banks are the same across member countries, and they are independent, in particular, of sovereign risk.<sup>10</sup> Europe has largely completed the first two steps of a banking union, but Edis has found the unsurmountable opposition of Germany and other core countries.<sup>11</sup>

The moral hazard problem of a Edis should not be underestimated: it is not difficult to imagine that in a crisis governments insured by a Edis will put pressure on their banking system to purchase government debt and to keep lending to firms in distress. To preserve the correct incentives, most proposals of Edis envision premia based on bank-specific and country-specific risk, and a first loss taken by the domestic government. Country-specific premia might be challenging to implement in practice, as they must be based on measures of the solidity of each country's banking system that are likely to be even more contentious than government debt ratings or country-specific output gaps.

But even abstracting from moral hazard and the practical difficulties of pricing bank insurance, the key problem of a Edis is that in the presence of the doom loop it can lead to very large and persistent transfers to periphery countries.<sup>12</sup> To make Edis possible, therefore, one has first to break up the doom loop. Simplifying, there are three key proposals.

First, concentration charges (see e.g. German Council of Economic Experts 2015, Veron 2017, and more recently the proposal by the German Finance Minister, see Sholz 2019): the higher the share of a sovereign in the total assets of a bank (or in the total sovereign holdings), the higher the capital charge coefficient applied to the holdings of that sovereign in that bank. Even though all agree that they would have to be introduced very gradually, it should not be surprising that the mere mention of concentration charges is anathema to periphery, high-public debt governments and their central bankers.

Second, risk weights. The EU has chosen to make use of the discretion allowed by the Basel rules, and has adopted a zero risk weight on the government debt held by any EU bank under the “standardized approach” and issued by any EU country (see European Parliament 2019 for a useful summary of the issues). Differentiating the capital charges according to risk would disincentivise banks from holding the riskier

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<sup>10</sup> Martinez, Philippon and Sihvonen (2019) study the comparative properties of risk sharing via a banking union or a capital market union.

<sup>11</sup> Recently, a non-paper by the German Finance Minister has made some overtures to Edis: see Sholz (2019).

<sup>12</sup> Carmassi et al. (2020) argue that regardless of which of several different risk-weights is used, the cross-subsidization via an Edis would be zero or minimal even in the presence of bank failures well in excess of those seen in the Great Recession. However, their results are based on symmetric shocks (in each country, banks representing a given percentage of that banking system's assets fail, and the loss rate is the same across countries).

sovereigns. This proposal too is anathema to periphery countries. In addition, it would largely refute current ECB policy, which applies a rather crude differentiation to the haircut of government bonds in its repo operations, with *de facto* only two categories of sovereign risk.<sup>13</sup> The simulations of Alogoskoufis and Langfield (2019) show that even following the finer ratings of rating agencies would not achieve a substantial reduction in risk, because these ratings are noisy and unreliable.

Third, safe assets. A large literature maintains that the supply of safe assets has shrunk dramatically in recent years<sup>14</sup> while the demand has increased because investors seek protection for the tail risks. One result is the “safety trap” of Caballero and Farhi (2017) and Caballero, Farhi, and Gourinchas (2020), as summarized in the stylized model of Caballero, Farhi, and Gourinchas (2016). Suppose (for illustrative purposes, and taking various shortcuts) that the demand for safe assets depends positively on output and negatively on the safe interest rate, and that the central bank controls the safe interest rate via a Taylor rule. When the net supply of safe assets declines, output declines for any given level the safe interest rate; the central bank can avoid this, and achieve the natural level of output, by reducing the safe interest rate. But once the Zero Lower Bound is hit, further declines in the supply of the safe assets must be met by a decline in output. In other words, the real safe interest rate is above the natural safe real interest rate, which equates demand and supply of safe assets at the natural level of output; as a consequence, recession ensues. This is a modern version of the keynesian “paradox of thrift”: an excess demand for safe assets leads to a recession.

While this is a general phenomenon, it is of specific interest in the context of the present paper for two reasons. First, it is sometimes argued that the creation of the Eurozone caused by itself a decline the supply of safe assets (see e.g. De Grauwe and Ji 2018). As long as they had their own central banks, the governments of Italy and Spain could be immune from default since their central banks had always the option of buying their debt. With the creation of the Eurozone, these previously safe assets became risky, and spikes in their riskiness were associated with massive capital “flights to safety”, i.e. to Northern government debt. We disagree with the first part of this argument: bonds with the backing of their own central bank *could* be made safe (and even hundred per cent safe) in nominal terms, but not in real terms. What makes a sovereign safe in real terms is the government’s ability to raise sufficient *real* revenues to pay interests and principal. In fact, the interest rate on Italian and Spanish government debt started to decline dramatically after the Madrid Summit of 1995 set an irrevocable timetable for the introduction of the Euro in 1999, by which time the yield differential with the Bund was almost nil. We find it more plausible that the spread with the Bund started increasing again when Spain and Italy were perceived to pursue fiscal policies that made their debt unsustainable in the view of many market participants.

The second reason why the “safe asset shortage” phenomenon is of specific interest to the context of this paper is the idea that, if periphery banks had access to a large supply of well diversified safe assets, a loss of confidence in their own sovereign need not be reflected in a “flight to safety” and in a decline in their solidity. This idea rests on two premises: first, there is a dearth of safe assets; second, periphery banks would gladly invest in them. For the sake of the argument we will take the first premise as given (although defining and measuring the supply of safe assets is not uncontroversial). We argue however that the second premise is controversial.

To increase the supply of safe assets, Brunnermeier et al. (2011) and Brunnermeier et al. (2017) propose to pool Eurozone sovereigns according to, say, their GDP weights, and then tranche the resulting security. The senior tranche (called “Esbies”) can be made virtually as safe as one wishes, depending on its waterfall structure: simulations in Brunnermeier et al. (2017) show that when the junior tranche absorbs the first 30 percent of losses, and under the observed matrix of correlations, the senior tranche can effectively be made as safe as a Bund. Note that pooling and tranching could be done by the market, once the ECB announces that it will accept the senior tranche as collateral.<sup>15</sup>

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<sup>13</sup> The 7+7 rule out differentiating risk weights in their proposal.

<sup>14</sup> Caballero, Farhi and Gourinchas (2017) argue that between 2007 and 2011 alone the supply of safe assets declined from 36 to 18 percent of the world GDP due to the downgrade of AAA-rated assets in the US (both GSE-issued and privately-issued assets) and of the Spanish and Italian government bonds.

<sup>15</sup> Since 2011, there have been many variants on this proposal, which we do not have the space to review here. The adoption of Esbies has been recommended by the European parliament in April 2019. See Garicano (2019) for a proposed path to the implementation of Esbies.

However, this process comes at the cost of also increasing the supply of more risky bonds. While this may be beneficial in itself if there are agents with different preferences for risk, to highlight the key aspects for our purposes consider the case of risk neutral banks. Imagine a world in which the price of government debt can fall because investors expect the government to incur the cost of a bailout of the banking system when banks' capital becomes negative. In turn, banks' capital can become negative because banks have a home bias and the decline in the price of government bonds has a large impact on their balance sheets – “the doom loop”. Thus, there is always a “good” equilibrium in which the government is not expected to bailout banks and banks' capital remain positive. However, there can also be a “bad”, or “sunspot”, equilibrium, in which the government is expected to bail out banks with negative capital, and banks have negative capital because the government is expected to bail them out.<sup>16</sup>

The availability of Esbies to banks eliminates the sunspot equilibrium on a region of parameters, which can be large. Essentially, access to Esbies reduces one leg of the loop - the home bias of banks. Obviously Esbies work if banks are willing to buy them instead of domestic government debt. Answering this question calls for a deeper investigation of the causes of the home bias of periphery banks. Although there is no consensus, we list four possible explanations, not necessarily mutually exclusive. First, moral suasion by the government: anecdotal<sup>17</sup> and empirical<sup>18</sup> evidence shows that governments can influence the investment decision of financial institutions. Second, limited liability: banks at the periphery loaded up on domestic sovereigns (and doubled down on them when the opportunity arose, such as with the ECB's two large Long Term Refinancing operations of 2011-2012) because increasing their exposure to high-yield assets with zero capital weight was almost their only chance to avoid bankruptcy and to keep paying dividends, after a deep recession that had saddled them with a large share of non-performing loans. In short, it was a classic case of “gambling for resurrection”. Third, the marginal cost of borrowing for banks (the interest paid on the bonds they issue) is closely related to the interest paid by their sovereign – and this is largely independent of the amount of sovereign they hold: rating agencies typically do not rate financial institutions more than two notches above their sovereigns. In fact, Constancio (2018) shows that the increase in CDS premia of Italian banks during the debt crisis of 2011-2012 was unrelated to their exposure to their sovereign. Fourth, life insurance companies also hold large amounts of their sovereign. Typically, the guaranteed return on their life insurance contracts are linked to domestic interest rate: insurance companies of the periphery could not make a profit unless they invest their premia disproportionately in their sovereigns.

If these explanations for the home bias are correct, it is unlikely that there would have been a large demand for Esbies by the banking sector; periphery banks *could* have invested in a safe, Euro-denominated asset virtually identical to Esbies – the Bund – but they *chose* not to. In fact, increasing the supply of safe bonds at the expense of investable risky bonds could conceivably *hurt* the banking sector of periphery countries.

More generally, some critics of Esbies would argue that their key goal – reducing the home bias of the periphery's banking system – is misguided in the first place.<sup>19</sup> Conditional on periphery countries having high public debt, not only is the home bias inevitable for the political and economic reasons that we have seen, but it also acts as a stabilizing force in the market for the domestic public debt.

In terms of the model sketched above, suppose that the “sunspot” is a pure liquidity crisis on government debt, not associated with a bailout.<sup>20</sup> By investing in their own sovereigns the banking systems of periphery countries stabilize the markets of their sovereigns; and in a liquidity crisis, they use cheap ECB liquidity to buy domestic sovereigns, thus avoiding a debt run. Clearly in this view the original sin is the high government debt: until it is reduced, forcing a reduction of the home bias could be counterproductive. And to reduce the high government debt, rules constraining national fiscal policies should be strengthened, not weakened.

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<sup>16</sup> See Brunnermeier et al. (2017) and especially its online appendix for a model that formalizes these ideas.

<sup>17</sup> Including conversations with top managers of major Italian financial institutions.

<sup>18</sup> See Becker and Ivashina (2018), Acharya and Steffen (2015), De Marco and Macchiavelli (2010), and Horvath et al. (2019).

<sup>19</sup> See e.g. Tabellini (2017) and (2018).

<sup>20</sup> In the model of Esbies, the price of government bonds falls (driving the banks' capital below 0) because there is the expectation of a bailout.

Similarly, concentration charges and risk weights could backfire, reinforcing rather than weakening the doom loop. Given that government debt is high, concentration charges and risk weights could increase the probability of a debt run. At the same time, if the underlying cause of the doom loop is moral suasion and gambling for resurrection, and as a consequence banks' exposure to their sovereigns is inelastic to the latter's risk, concentration charges and risk weights would make domestic banks *more* risky when the sovereign becomes more risky.

#### 4.2 A EUROPEAN UNEMPLOYMENT INSURANCE SCHEME (EUIS)

Unemployment insurance is perhaps the most basic and natural case of risk-sharing arrangement. In fact, a European unemployment insurance scheme (Euis) is perhaps an even more frequent proposal than Edis, possibly because moral hazard considerations at the country level seem less plausible. Yet, Euis has not found much more success than Edis with core governments.<sup>21</sup> The reason, once again, is the potential for large and persistent unidirectional transfers.

The two panels of Table 2 display the difference between the unemployment rate of the “core” Eurozone countries and that of Italy and Spain, respectively, from the beginning of the Great Recession until now. Except for five country-years at the very beginning of the sample, in Italy the unemployment rate has always been higher than in each of the core countries; in Spain it has been higher in every single year, and by a large amount. Any Euis designed on the basis of the levels of the unemployment rates would have generated enormous and persistent transfers.

Of course one could design a Euis in terms of *differences* of the unemployment rate from a “neutral” or “long term” level, but this would entail all the problems that we know are associated with estimates of notions like “potential output”, “potential growth”, the “output gap” or the “NAIRU”: statistical fragility, large role for judgment, and, ultimately, controversy and litigation. Delegating everything to an independent council will not work, because politics can always take over, and it *will* take over when a large shocks makes the stakes high. Or, a Euis could be based on *changes* in unemployment instead of levels, but then one could have large transfers from countries with high but temporarily decreasing unemployment to countries with low but temporarily increasing unemployment, something that would quickly become unacceptable to the large public.

Other features largely defeat the purpose of Euis, or are also difficult to apply in practice. Like for Edis, these include adjusting contributions for country-level risk; in practice, this would require assessing the risk of a country's unemployment, which is different from the already controversial rating of a country's government debt. In many proposals, national unemployment schemes would take the first loss: this would further limit the ability of a Euis to act as an effective countercyclical tool. The same would apply to the proposal of limiting the Euis to a catastrophic insurance scheme, paying only in the case of extremely large increases in unemployment. Once again, delegating to an independent body the determination of the catastrophe clause trigger is unlikely to work when it matters most.

**Table 2: Difference between the unemployment rate of core countries and that of Italy, Spain**

Country	Difference with Italy										
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Belgium	-0.1	0.1	1.2	3.1	3.8	4.2	3.4	3.9	4.1	4.6	4.6
Germany	0	1.4	2.6	5.3	7	7.7	7.3	7.6	7.4	7.2	6.8
France	-1.3	-0.9	-0.8	0.9	1.9	2.4	1.5	1.7	1.8	1.6	1.5
Netherlands	3.4	3.4	3.4	4.9	4.9	5.3	5	5.7	6.3	6.8	6.6
Austria	2.5	3.6	3.8	5.8	6.8	7.1	6.2	5.7	5.7	5.7	5.5
Finland	-0.4	0	0.6	3	4	4	2.5	2.9	2.6	3.2	3.3

<sup>21</sup> The measures taken by the European Union in response to the Pandemic include the SURE program (“Support to mitigate Unemployment Risks in an Emergency”), providing loans up to 100bn euros to supplement national expenditure on short-term working schemes. Thus, this is a loan, not an unemployment insurance scheme proper.

Country	Difference with Spain										
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Belgium	10	11.6	14.2	17.2	17.7	16	13.6	11.8	10.1	9.3	8.7
Germany	10.1	12.9	15.6	19.4	20.9	19.5	17.5	15.5	13.4	11.9	10.9
France	8.8	10.6	12.2	15	15.8	14.2	11.7	9.6	7.8	6.3	5.6
Netherlands	13.5	14.9	16.4	19	18.8	17.1	15.2	13.6	12.3	11.5	10.7
Austria	12.6	15.1	16.8	19.9	20.7	18.9	16.4	13.6	11.7	10.4	9.6
Finland	9.7	11.5	13.6	17.1	17.9	15.8	12.7	10.8	8.6	7.9	7.4

Source: European Commission, AMECO Database

## 5 A EUROPEAN ORDERLY RESTRUCTURING SCHEME (EORS)

There is a more general reason why risk-sharing arrangements are hard to implement. High-debt countries are exposed to a high risk of default. Defaults are typically chaotic and accompanied by deep recessions: hence, core countries are likely to be on the losing side of a mutual insurance arrangement. This is perhaps the key message of the famous “non-paper” circulated by the then German minister of finance, Schäuble (2017), which with some oversimplification can be summarized as follows: “introduce a Eors, put your house in order by reducing your debt, and then we might talk about a mutual insurance scheme.”

An Eors is also a fundamental proposal of the 7+7 group, and the basic reasoning is slightly more articulated. Exactly because defaults are often chaotic, they are typically more costly than they could be. This increases the probability that they will be accompanied by a bailout: ex post it might be rational for core countries to limit the contagion and spillovers effects by bailing out the defaulting government. Knowing this, however, high debt countries procrastinate and delay the adjustment, reducing the recoverable value when the default becomes unavoidable; and the resulting disorderly default *cum* bailout further destroys recoverable value, because of the holdout and other problems.<sup>22</sup> In turn, core countries will be unwilling to enter a risk-sharing arrangement with a high debt country with a high default risk.

To break this vicious circle one needs to make defaults less costly, so that core countries will be willing to participate in a risk sharing arrangement; in turn, this requires making the no-bailout clause more credible, so that high-debt countries will not choose to procrastinate the adjustment. A Eors has this function: it reduces the cost of default, making it a predictable, orderly process that increases the recoverable value and involves a creditors’ bail-in; as a consequence, a bailout is less likely to be optimal ex post. Essentially, a Eors increases the recoverable value conditional on a default, but also makes the default (with restructuring and bail-in) more frequent and a bailout less frequent. Both effects need to be appreciated in order to understand the arguments pro and against a Eors. If the first effect prevails, core countries will be more willing to enter a risk sharing arrangement with high debt countries.<sup>23</sup> In turn, a risk sharing arrangement makes a Eors more acceptable to periphery countries, because it absorbs parts of the costs associated with a restructuring process. The key point of the 7+7 proposal is precisely that there is complementarity between risk sharing and market incentives (a Eors).

Supporters of a Eors assume that the first effect does prevail. Although we have scant evidence on Eors’, we know what happened after the introduction of mandatory collective action clauses (CACs) on government bonds issued by Eurozone countries with maturities in excess, starting on January 1 2013: the yield on sovereigns with CACs fell relative to the same sovereigns not covered by CACs. If one takes CACs as close substitutes of a Eors,<sup>24</sup> one could interpret this as evidence that in a Eors the first effects prevails, and the cost of borrowing for the government falls. Tabellini (2018) offers the opposite interpretation of the same

<sup>22</sup> See Panizza (2013a) and (2013b) for a discussion of the costs of the absence of an Eors. The holdout problem arises because it is rational for a creditor not to accept a debt restructuring scheme, given that the others creditors do accept it: by holding out when the others do not, a creditor can appropriate the haircut taken by the bailed-in creditors.

<sup>23</sup> See Gourinchas, Martin and Messer (2020) for a model that can be used to rationalize this argument.

<sup>24</sup> CACs are designed to mitigate one of the problems that Eors are designed to solve, namely the holdout problem.

piece of evidence: CACs were meant to make default (with bail-in) more likely, hence they should have increased borrowing costs; instead, borrowing costs decreased because holders of government bonds issued under international law enjoy more protection than holders of government bonds issued under national law (one possible reason is that national courts are captive to the domestic government). Tabellini (2018) concludes that issuing debt under international law makes debt renegotiation more, not less, difficult. However, as we have argued above, while it is true that CACs are meant to make default with bail-in more likely, they were also meant to reduce the cost and disruption of such an occurrence. This is consistent with a Eors reducing the borrowing costs of a government and reaching its goals.<sup>25</sup>

Another problem with procrastination of the adjustment is that, in the absence of a well-defined seniority structure, additional borrowing by a government close to default hurts all existing creditors. This is different from the case of corporations, where a better defined seniority structure protects the more senior creditors. As part of a Eors, the 7+7 group advocate forcing countries to issue junior debt when their debt exceeds a certain threshold: this will increase market discipline as the country must pay a higher interest rate at the margin.

Critics of a Eors argue that once again it ignores the transition. First, merely talking about the possibility of a restructuring increases the cost of borrowing in periphery countries and, by increasing the costs of rolling over debt, it might transform a liquidity problem into a solvency problem (see e.g. De Grauwe and Ji 2018). However, as we have shown above whether the cost of borrowing will go up or down with a Eors depends on the alternative: if it is a bailout, it will increase; if it is a disorderly default, it might decrease. Of course, this second outcome assumes that the no-bailout clause is credible: this is precisely what a Eors with risk sharing is designed to do.

Second, a restructuring of a periphery country sovereign would take down with it the banking system of that country anyway. Most proposals recognize this second problem, although they usually rely on generic recommendations that Eors should be accompanied by a reduction of non-performing loans and of the banking system's exposure to domestic sovereigns.

Third, achieving an explicit seniority structure by forcing governments to issue junior debt would backfire, because a default on even junior debt would most likely trigger a run on the whole debt stock. A better way to introduce a seniority structure in government debt would be to introduce GDP-linked bonds (see Tabellini 2017). A GDP-linked bond is *de facto* junior, because it pays less in bad times.<sup>26</sup>

Thus, to its critics a Eors tips the scale too much in favor of market discipline. Reducing debt in high debt countries must be achieved before a Eors can be introduced. Once again, to ensure that debt falls, rules constraining national fiscal policies should be strengthened, not weakened.

## 6 CENTRALIZED FISCAL POLICY, DEBT MUTUALIZATION, AND FISCAL UNION

Edis, Euis and Eors are all but a small number of fiscal policy instruments. Most proposals on the table go well beyond these. Roughly speaking, most of these proposals go in the direction of “more fiscal policy at the European level”. What is meant exactly by this expression is however rarely spelled out exactly. In what

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<sup>25</sup> However, as we have argued above, while it is true that CACs are meant to make default with bail-in more likely, they were also meant to reduce the cost and disruption of such an occurrence. This is consistent with a Eors reducing the borrowing costs of a government and reaching its goals.

<sup>26</sup> The idea of GDP-linked bonds goes back to Shiller (1993); see Cecchetti and Schoenholtz (2017) and Shiller, Ostry, Benford, and Joy (2017) for an exposition of the key issues. To date, no country has issued GDP-linked bonds where the investors takes both the downside and the upside risk. The leading explanations are the risk premium demanded by investors to take on a more volatile returns, and the liquidity premium associated with a new instrument. Blanchard, Mauro and Acalin (2016) argue that for these reasons GDP-linked bonds are more appropriate for countries with high, but not “catastrophically” high, debt. Kim and Ostry (2020) argue that the advantages of GDP-linked bonds have to be set against possible moral hazard considerations. However, we find it implausible that governments might induce a recession in order to reduce the value of the principal or interest of their debt.



follows we try to highlight the main possible meanings of this expression, and the difficulties with implementing them.

## 6.1 A EUROPEAN MONETARY FUND

The advantage of automatic risk sharing mechanisms like Edis or Euis is that once in place they work in the background and do not need an explicit political agreement every time that they redistribute resources. The limitation is that they have limited redistributive capacity. In many circumstances more risk sharing might be needed.

Risk sharing could occur on an ad hoc basis, if institutions are in place to collect and redistribute resources among member countries, as the IMF does at the world level. The European Stability Mechanism is meant to be such an institution. It leverages a relatively small paid-in capital of 80bn euros (paid roughly in proportion to the GDP shares of each country) to borrow on the market. Because it does not borrow more than the total callable capital of a few core countries, about 500bn euros, effectively its debt is rated AAA; it then lends to illiquid countries at a rate below their borrowing rates. Core countries have insisted on three key features. First, to comply with the no-bailout rule the ESM can lend only to countries whose debt has been deemed “sustainable”; second, by implication, countries with unsustainable debt can borrow only if they restructure their debt; third, ESM lending is subject to various degrees of conditionality, depending on the program chosen. Periphery countries object to all three features: a periphery government that borrows from the ESM would immediately be accused by a large share of the electorate to yield to austerity plans imposed from outside, and the mere possibility of debt restructuring is unacceptable to any periphery government already struggling with the market’s perception of its solvency. In short, core countries want to make the ESM the instrument of risk prevention and the guardian of rules; periphery countries would like to make it an instrument of risk sharing, with more resources and less conditions attached. Be as it may, since the Great Recession it has not been used. As we write, the two countries most affected by the pandemic, Italy and Spain, appear to be inclined to reject Covid-related loans of the ESM at near zero rates because of the domestic political implications of conditionality.

## 6.2 A FISCAL UNION

Many proposals go one step further and advocate a centralized European entity with an autonomous taxing and spending authority: in other words, a “European finance minister”. This European finance minister can spend (as opposed to re-lending) its resources, either as block grants to individual countries, or directly on specific projects, like a new high-speed train, or via automatic programs, like a European pension system. It can be funded both by its own dedicated taxes (like a European plastic or digital tax), by shares of tax revenues collected by the member states, or by the issuance of its own debt. Thus, there is a large number of combinations of funding and spending patterns, which are rarely specified. In any case, this seems to be what people have in mind who advocate a “fiscal union”.

Such a European finance minister could be an instrument for risk sharing if it redistributes resources to countries hit by asymmetric negative shocks, either automatically or on an ad hoc basis. It could also be an instrument for stabilization policies at the aggregate level: the obvious advantage relative to stabilization policies at the national level is that it can internalize the many spillover effects, and implement a policy to offset, say, a pandemic when individual countries would be reluctant to do so in isolation. Supporters of a European finance minister also often argue that it is a precondition for a closer political union, by which presumably one means that more and more decisions must be taken at the central level.

Despite sometimes paying lip service to more fiscal integration, core countries are unenthusiastic about it. Once again, the key problem is its distributional implications. We have already seen this in the case of risk sharing. In the case of centralized stabilization, in principle it could be implemented in a distributionally neutral way. In practice, however, it is easy to imagine that it would lead to large and persistent flows of resources from the core to the periphery.

If the centralized stabilization is funded by taxes, in theory one could imagine a spatial allocation of spending exactly equal to that of taxes: the European finance minister could hand each country an amount equal to the resources it collects from them. This would be a balanced budget fiscal expansion done at the

central level, without any ex-ante or ex-post redistribution between countries. However, if the European finance minister goes beyond purely disbursing grants to governments, it is almost bound to generate large persistent transfers. The bulk of government spending is on pensions, health, and government employment; the levels of these expenditures and the systems governing them are very different across European countries. Core countries fear that centralized spending on these items will inevitably flow disproportionately to the higher spending countries.

On the other hand, if more centralization requires first more homogenization of policies, this by definition means going against the collective preferences of some or all member countries on sensitive areas like pension, health and educations spending. Such an attempt would generate a strong political backlash, and could well endanger the monetary union rather than strengthening it, particularly in the present political circumstances with resurgent nationalism in virtually all countries.

This trade off remains unresolved, or even unacknowledged, in virtually all proposals for more centralized fiscal policy. Academic economists and policymakers outside a few core countries mostly take it as given that more centralized European fiscal policy is always good and must be the ultimate goal. We believe that in a real world full of political and economic frictions and imperfect information, at the normative level it is not easy to justify centralized spending on policies governed by very different collective preferences. At the positive level, it could simply backfire.<sup>27</sup>

### 6.3 EURO BONDS

So far we have assumed that centralized fiscal policy is financed by taxes. But it could be financed by debt issued at the central level. This adds another channel of potential redistribution. Currently, the debt issued by the ESM would be covered by a *proportionate* guarantee of the member states: in case of a default by the borrower, the other countries will cover the shortfall in proportion to their shares of capital, hence approximately in proportion to their GDP. Others go a step further, and propose a debt issuance at the European level covered by a *joint and several* guarantee of each member country,<sup>28</sup> a type of debt that is usually referred to as Eurobonds (although, somewhat confusingly, the same name is used sometimes to denote any debt issued at the European level, even without joint and several guarantees). In such a type of debt, if a guarantor defaults on its guarantee, in principle any country can be called upon to pay the whole amount. Obviously Germany risks more than Greece in this circumstance.

It should come as no surprise that Eurobonds, in all their shapes, have been proposed only by periphery countries. We regard this proposal as a political no-starter: no core country government will ever accept a joint and several liability with periphery countries, and innumerable statements by Northern politicians confirm this. Note that the Coronabonds that will finance part of the European Recovery Fund, although often characterized as Eurobonds, do not contain a joint and several guarantee.

In many cases, proposals for Eurobonds appear to be *intended* to be explicitly a mechanism for ex-ante redistribution, even though exactly how the proceeds of a Eurobond issue are distributed to and repaid by the individual countries are almost never specified.

Over time, there have been a number of proposals to mitigate the more crude aspects of Eurobonds. Predictably, they have not made any inroad in core countries. Consider for instance the “Blue and Red Bond” of Delpla and Weizsäcker (2011). In steady state, an amount of debt up to a maximum of 60% of the GDP of each country, called the “Blue bonds”, would be covered by a *joint and several* guarantee: thus, effectively it would be the Eurobond we have just described. Any part in excess of this, the “Red bonds”, is serviced by the issuing country, and it is junior to the Blue bonds. An independent council would decide each year how much Blue debt a country can issue, based on its performance in terms of some fiscal policy indicators (obviously if a country has already reached the 60% limit of Blue bonds, it can only issue Red bonds). Because it is covered by a joint and several guarantee, the Blue debt will pay a low interest rate, allowing high debt countries to save on interest payments. Because it cannot be guaranteed, bought or rolled over using funds from the rescue programs of Europe, the Red debt preserves the market signal at the margin.

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<sup>27</sup> See Alesina and Perotti (1998).

<sup>28</sup> In a joint and several guarantee, each guarantor can be called upon to pay for the *whole* guaranteed amount in case of default by one or more of the joint issuers. That guarantor can then ask the other guarantors to contribute their shares.

The working of this proposal largely depends on the discretion of the independent council. Suppose a country experiences a sharp downturn: to be effective, the proposal should allow for a larger emission of Blue bonds by this country. But this would amount to an implicit subsidy by the other countries, and would be subject to the usual problems: it could translate easily into a semi-permanent transfer. In addition, independent councils can be easily overruled by the main countries, exactly in the same way that treaties have been changed based on the conditions of the moment.

## 7 CONCLUSIONS

The goal of this paper was pedagogical: to present the various sides of the debate on the main issues of fiscal policy in Europe. Rather than repeating the main arguments, in these conclusions we emphasize two points. First, we have not dealt with the design of optimal policies in a formal setting: the literature on optimal fiscal policy in the presence of externalities is enormous, and many surveys exist. Rather, we have focused on the policy debate, on practical implementation issues, and on political constraints. Obviously *some* notion of optimal fiscal policy is often in the background of this discussion, but this was not the focus of our analysis.

Second, we have touched only tangentially on the recent developments following the Coronavirus pandemic. Among other things, Europe has set up a Recovery Fund that will distribute 750bn euros by 2025, of which 390bn in grants and the rest in loans. While we do not discuss the specifics of this Fund (and the programs and projects it will finance in the various countries have yet to be defined at the time of writing), the policy debate and political negotiations leading to the adoption of this important step have revolved around the key issues we have highlighted in this paper.

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