The idea that the euro area needs a common "fiscal capacity" has gained ground since the publication of the Van Rompuy report in 2012. Since then, a rich literature has emerged on the role and functions that this fiscal capacity should perform, and different modalities for fiscal risk-sharing mechanisms have been proposed and discussed. Too often, however, discussions on fiscal capacity pay little attention to politico-economic considerations shaping the prospects of European Monetary Union (EMU) reform. Some aspects should be taken into account when reflecting on a future fiscal capacity for the euro area.

Fiscal union is broader than fiscal capacity

Discussions on fiscal capacity came after the introduction of major reforms in the fiscal arrangements for the EMU. New financial assistance mechanisms have been created since 2010 to help those countries suffering tensions in the sovereign debt markets (culminating with the establishment of the permanent European Stability Mechanism), and the rules and procedures for fiscal discipline have been strengthened, both through a reform of the Stability and Growth Pact (SGP) and the establishment of a new Treaty on Stability, Coordination and Governance (TSCG, also known as Fiscal compact).

Even if the establishment of a fiscal capacity has been endorsed in various EU official documents, there is a need to better explain, argue and justify the need for it.

There is general consensus on the fact that these reforms do not suffice. However, not everybody believes that the right path is to further centralize fiscal powers (see for instance this recent article by Barry Eichengreen and Charles Wyplosz). Besides, the idea of pooling fiscal resources or transfer budgetary powers to the EU level is politically explosive in some countries. Thus, even if the establishment of a fiscal capacity has been endorsed in various EU official documents, there is a need to better explain, argue and justify the need for it. A fiscal capacity will only see the light if the majority of stakeholders and populations are convinced that a certain level of fiscal policy centralisation is necessary to guarantee the stability and resilience of the EMU.

The need for consistency and clarity

Looking at the big picture also means thinking about the consistency between the different decisions taken on various budgetary aspects at the euro area level. Is it logical to push for greater stabilization at EU level while maintaining important restrictions to the capacity to stabilize at national level (through the SGP and the TSCG)? Do we need the same degree of EU-level fiscal stabilization capacity if we expand the size and functions of the European Stability Mechanism or, on the contrary, if we opt for restricting the use of ESM to address temporary liquidity crisis and submit sovereigns to more intense market discipline (for instance by creating a sovereign debt insolvency regime)? These questions should be put on the table at the moment of discussing the appropriate roles and functions of a euro area fiscal capacity.

Circumstances might trigger the introduction of important changes in the EMU fiscal arrangements in the short or medium term, which might eventually determine the choices of tomorrow.

The first step when thinking about possible modalities of a Eurozone fiscal capacity is to clarify what its role and functions will be. There is widespread consensus on that the fiscal capacity should be mainly used to provide stabilization against shocks affecting the euro area, but there might be discrepancies as regards to the type of shocks to absorb. The Van Rompuy report essentially conceived the fiscal capacity as a mechanism to mitigate asymmetric shocks. The Five Presidents' Report takes a broader approach and refers to the need to set up a "common macro-economic stabilisation function to better deal with shocks that cannot be managed at the national level alone". A fiscal capacity strictly focused on absorbing temporary asymmetric shocks can consist of a fund based on pre-defined automatic rules for allocation, working under a balanced-budget rule. Such a fund does not need to be very big, and could be managed by the Commission as it would work on a quasi-automatic basis. If the fiscal capacity is also used to boost the economy in the event of large symmetric shocks, then we will need a significant euro area budget, or to endow the euro area with some borrowing capacity and/or capacity to coordinate national budgetary decisions. The latter will require discretionary powers, and thus a more 'political' body (some sort of euro area Treasury).

Connect short- and long-term actions

The establishment of a euro area fiscal capacity is usually seen as a long-term project. However, circumstances might trigger the introduction of important changes in the EMU fiscal arrangements in the short or medium term, which might eventually determine the choices of tomorrow. A worsening of the Greek debt crisis can force a "hard" restructuring of the Greek debt and increase the support to the creation of a euro area sovereign debt insolvency regime. If the economic situation does not improve, there might be more pressures to coordinate an aggregate fiscal stimulus. This can lead to the establishment of "proto-solution", which might eventually become the embryo of a future fiscal capacity.

Too much effort on rendering the system "neutral" might reduce the effectiveness of the mechanism.

Connecting short- and long-term actions also implies thinking carefully on how to ensure the right conditions for the establishment of a fiscal capacity. To be politically acceptable, a common fiscal stabilisation mechanism requires a minimum degree of convergence among euro area economies. It is realistic to expect that this convergence will be attained only through the establishment of common binding standards, as assumed in the Five Presidents' Report? Shouldn't we complement this with some targeted budgetary support to member states undertaking reforms (following the logic of the Cohesion Fund, created in 1994 to support member states' efforts to fulfil the Maastricht convergence criteria)?

Do not obsess with perfect neutrality, and aim for own resources

It is widely agreed that a fiscal capacity should not lead to permanent or unidirectional transfers. This is indeed very important, not only to render the instrument politically acceptable for strong economies but to ensure that the capacity does not undermine the incentives for sound fiscal policy in weaker economies. Having said so, too much effort on rendering the system "neutral" might reduce the effectiveness of the mechanism. A system for instance in which each member state maintains a balanced account with the common fund would significantly diminish its capacity to absorb shocks. Besides, the idea that one should render the system perfectly neutral is based on the assumption that all potential redistributive effects are unjustifiable because they reflect free riding or moral hazard at the national level. This is false, however: euro-area countries might differ with regards to their vulnerability to shocks for objective reasons that are beyond national governments' control (i.e. smaller countries have less-diversified economies and are thus more prone to idiosyncratic shocks than bigger countries).

A fiscal capacity can be financed through national contributions, taxes or through new borrowing capacities at the EU level. At first sight, national contributions might seem the easiest and more straightforward method to finance the new capacity. However, this system of financing is applied to the EU budget and has important negative side-effects. In particular, it reinforces national governments' tendency to calculate their "net returns" (that is, the direct short-term benefits and costs of the common mechanism for their public finances and territories). Applied to the fiscal capacity, this is likely to exacerbate tensions between stronger and weaker euro area economies and magnify the redistributive effects of the mechanism while neglecting the common good provided (i.e. the stability of the Eurozone). Another lesson from the EU budget is that, once established, a system based on national contributions becomes very difficult to modify. Hence, the use of national contributions might not be seen as a first, provisional step before the establishment of an own-resource system.

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