

Flawed Fiscal Federalism and the Eurozone Crisis

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“The incompleteness of the euro design is Europe’s Achilles’ Heel.” -Mario Draghi



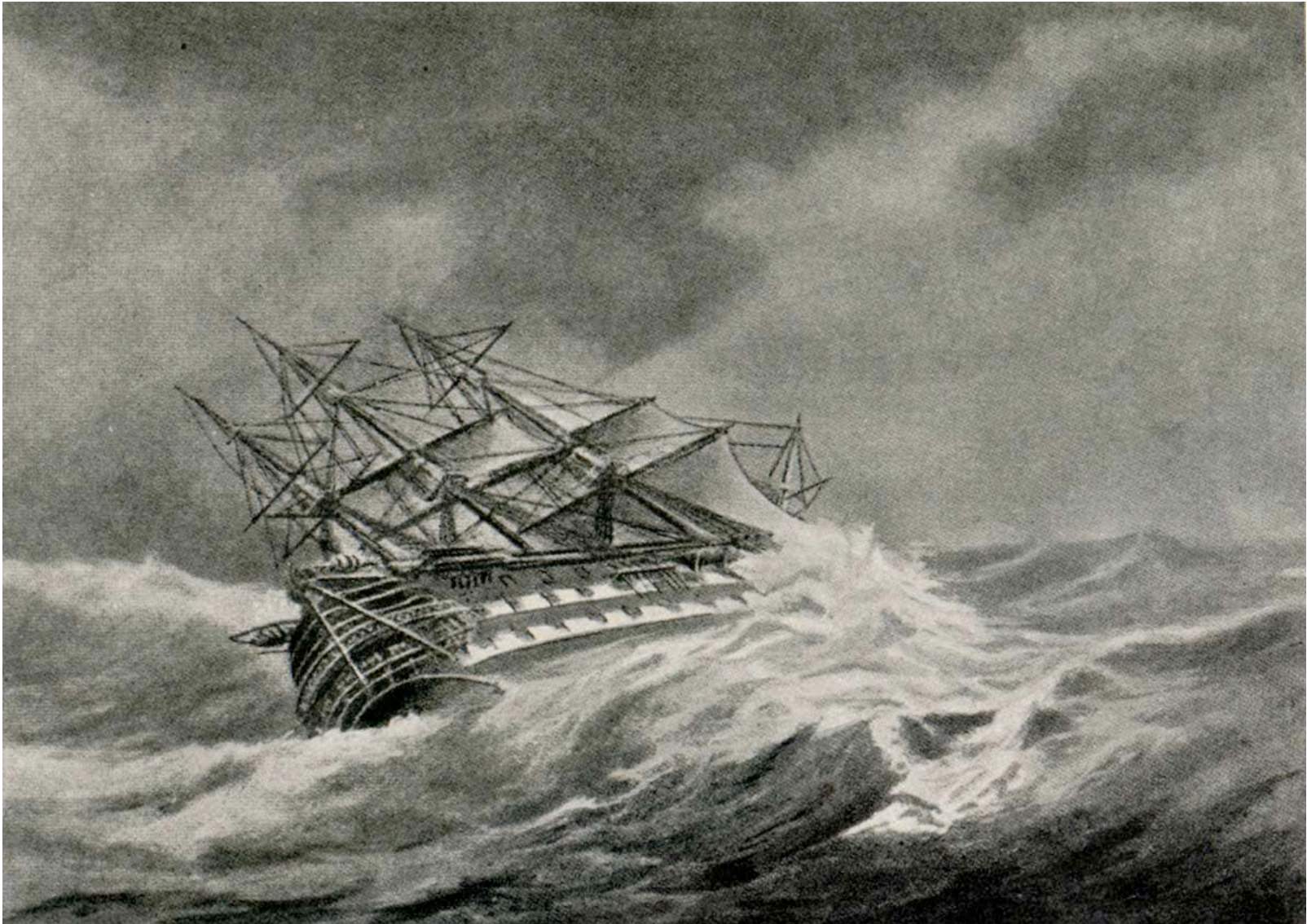
EMU as an Incomplete Construction

- Limited fiscal integration:
 - Small budget, no countercyclical redistribution
 - Flawed fiscal rules in Maastricht Treaty
- Weak and fragmented banking regulations
 - Pan-European banking, with national regulation
- Inadequate mechanisms to promote macroeconomic adjustment or convergence

Why didn't leaders worry more?

- I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a **crisis** and new instruments will be created. -Romano Prodi, 2001
- As on other occasions in European history, this **crisis** offers a chance to progress; we must be ready to act on it. Let us not waste this opportunity to advance European integration. – Peter Praet, ECB Executive Board, 2012
- Europe will be forged in crises, and will be the sum of the solutions adopted for those **crises**. – Jean Monnet, 1978

Then comes stormy weather



“All is lost ?”



Outline

- **An underlying cause of the crisis:** Flawed fiscal federalism
- **A misconceived response:** Why the Fiscal Compact Treaty won't work
- **Some Big Picture Conclusions:** Incomplete institutions and “Failing Forward” in the EU

Flawed Fiscal Federalism

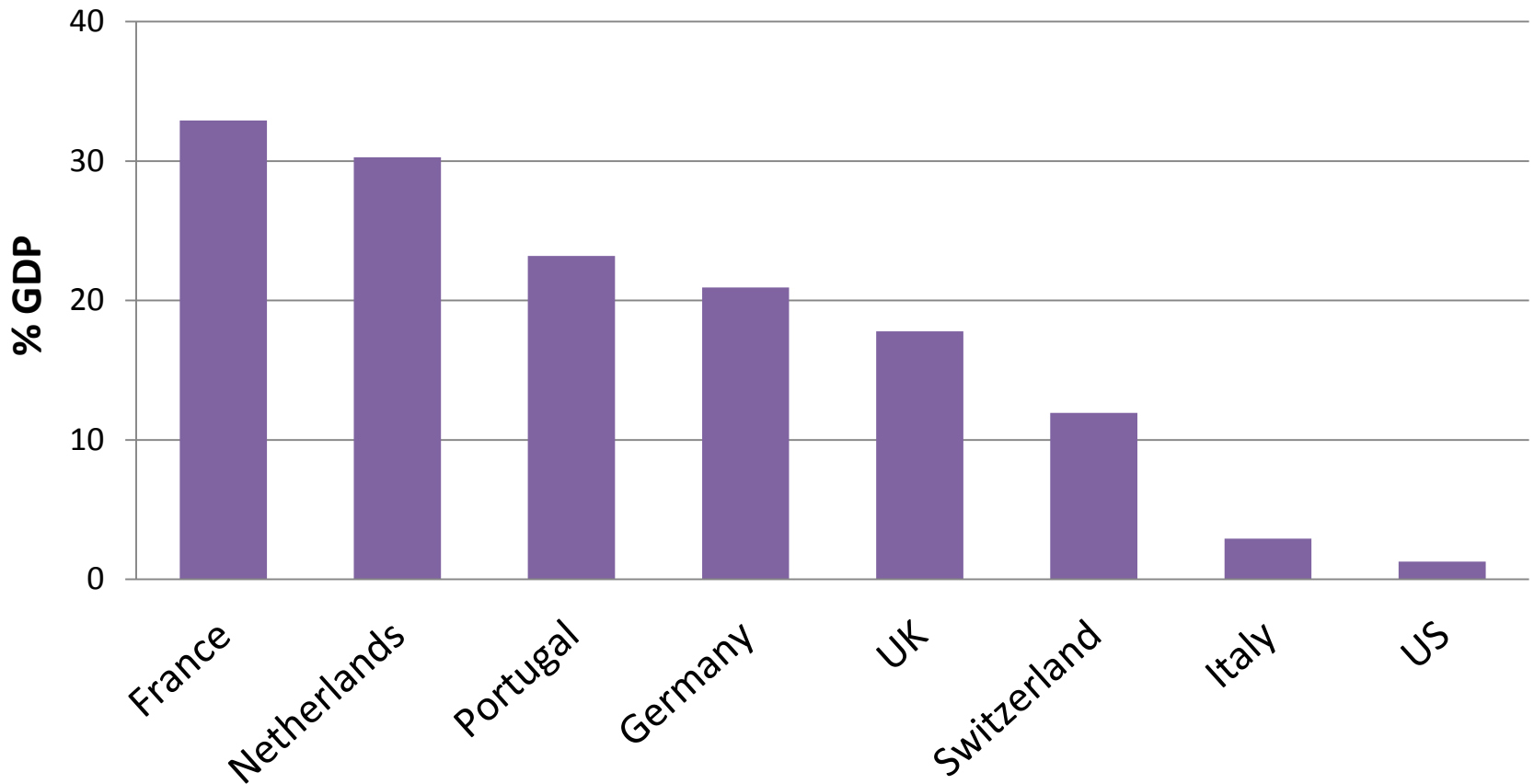
- Dilemma of Fiscal Federalism: In event of state fiscal crisis, pressure on feds to bail out struggling state. But if feds guarantee solvency, this creates moral hazard.
- Any quasi-federal system with free movement of capital, monetary union & state-level fiscal authority, must find a way to control state debts & limit moral hazard
- There are two ways to do this:
 - *Tough love*: let states default to establish credible commitment to no bail-outs (*e.g. USA in early 1840s*)
 - *Bailouts with conditions*: requires far-reaching interference with state gov't decisions

Flawed Fiscal Federalism: The (defunct) Maastricht regime

- Relied on Tough love (backed by rules)
 - No Bailout Clause (Maastricht Art.104b, TFEU Art 125)
 - Stability & Growth Pact + Excessive Deficit Procedure
- But system was deeply flawed & not enforced
 - Germany & France killed SGP in 2003
 - No bailout clause abandoned in 2010
 - Feb. 2009, Steinbrück, “the treaties don’t foresee any help for insolvent countries, but in reality the other states would have to rescue those running into difficulty”

Why didn't EU stick with No Bailout clause?

Foreign banks combined consolidated claims on Greece, Ireland, Italy, Portugal, Spain (% GDP 2011)



Thanks to Mark Blyth for this slide!

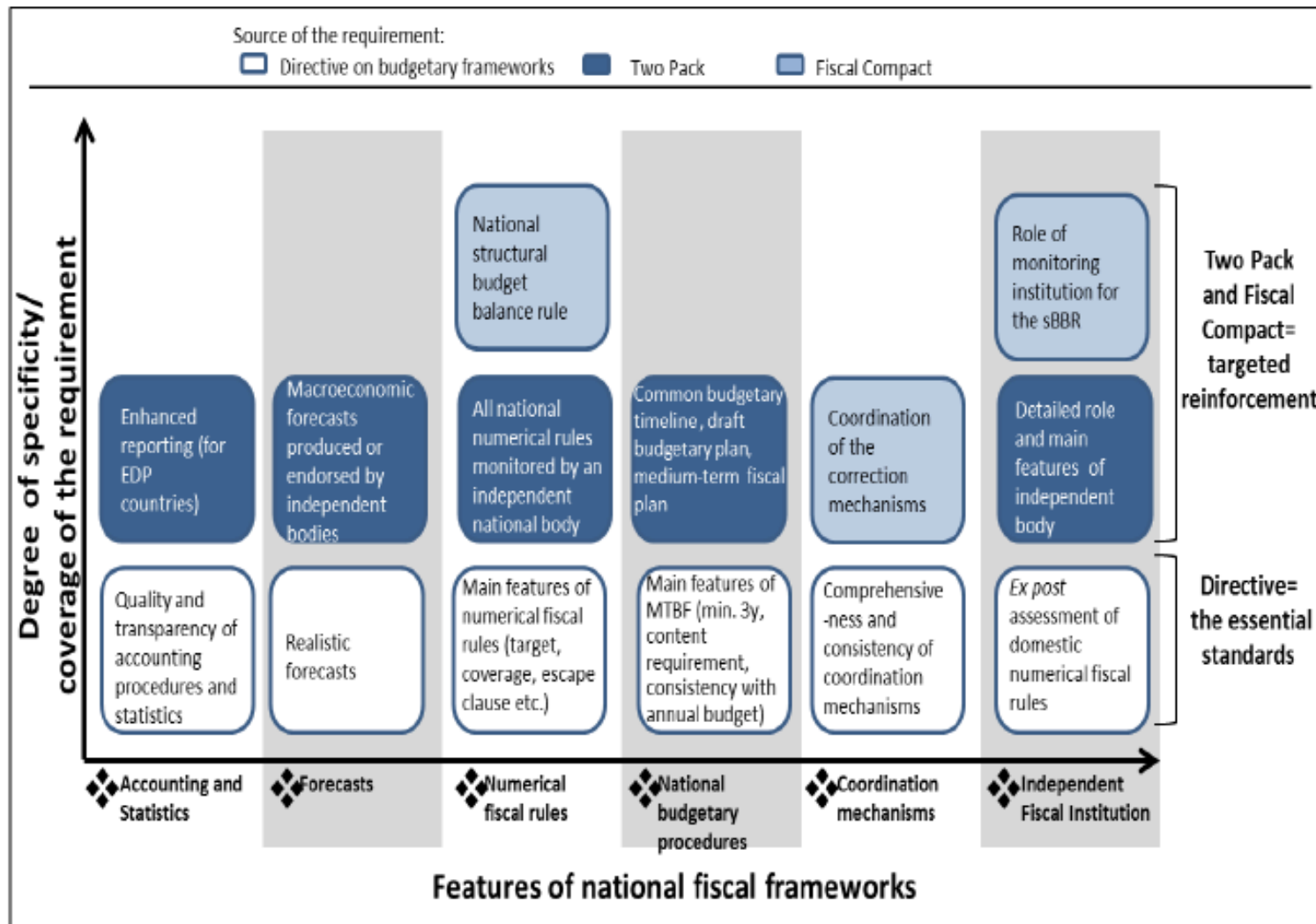
The new regime (Option 2): Bailouts, conditions, courts



The new eurozone governance regime

- **Money:** Hellenic Fund, EFSF, finally ESM
- **With Rules:** Stricter fiscal monitoring & sanctioning: Troika, European Semester (2010), “Six-Pack” (2011), Fiscal Compact Treaty (2012), “Two-Pack” (2013)
- **And Courts:** With **Fiscal Compact Treaty**, EU leaders hope to judicialize austerity (TSCG, Art. 3)
 - Balanced budget rule and debt brake
 - “The rules set out in paragraph 1 shall take effect in the national law of the Contracting Parties **through provisions of binding force** and permanent character, **preferably constitutional**, or **otherwise guaranteed to be fully respected** and adhered to...” (Art.3, para.2)
- **The Irony:** EU ends up with heavy controls over member state fiscal policy. US has no such controls.

Overview of European requirements



Can law save the euro?

- “Eurolegalism” in fiscal policy
- Can balanced budget rules (BBRs) work?
- Literature on US suggests:
 - BBRs encourage fiscal prudence and limit borrowing costs
 - BBRs work better the stricter their legal enforcement mechanisms
- But, BBRs are almost never enforced in court. In US only once in 170+ years.

The Puzzle

- How do BBRs work if they are never enforced in court?
- Existing literature said fear of courts: “legal deterrence”
- I argue instead (Kelemen & Teo APSR, 2014) :
 - Bond markets, not courts, punish fiscal irresponsibility
 - But markets often react too late and then so forcefully that they help drive states to default.
 - BBRs create a **focal point** around which investors can coordinate to punish excessive sovereign debt
 - To the extent that states obey balanced budget rules, they do so not to fear of judicial enforcement, but due to fear of the bond markets

Implications of BBR as focal point

- Clarity, not strict legal enforceability, is key to effectiveness
- The clearer a balanced budget rule, the greater its effectiveness
- If a balanced budget rule is unclear, increasing the strictness of legal enforcement will not increase its effectiveness
- Rules that enhance transparency and clarity are useful, those that focus on judicial enforcement are misguided

Are the Fiscal Compact Treaty's balanced budget rules clear? NO!!!

Treaty Article 3(1)(b) explains that a state's budget will be considered to be "balanced" if, "the annual **structural balance** of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact, with a lower limit of a structural deficit of 0.5% of the gross domestic product at market prices."

Article 3(1)(c) further allows that states "may temporarily deviate from their respective medium-term objective or the adjustment path towards it only in **exceptional circumstances**."

Will Fiscal Compact Work?

- “All this legal apparatus seems to have had little impact on actual fiscal policy-making.”
Gros and Alcidi, 2014
- “Fiscal Pact requires reliance on a statistic that cannot be observed,” -Prof. David Cameron, *Financial Times*, March 21, 2012, p. 8.
- “Portugal Court Rules Against Austerity.”
Financial Times, April 5, 2013.

“The incompleteness of the euro design is Europe’s Achille’s Heel.” -Mario Draghi



From Incompleteness to Crisis

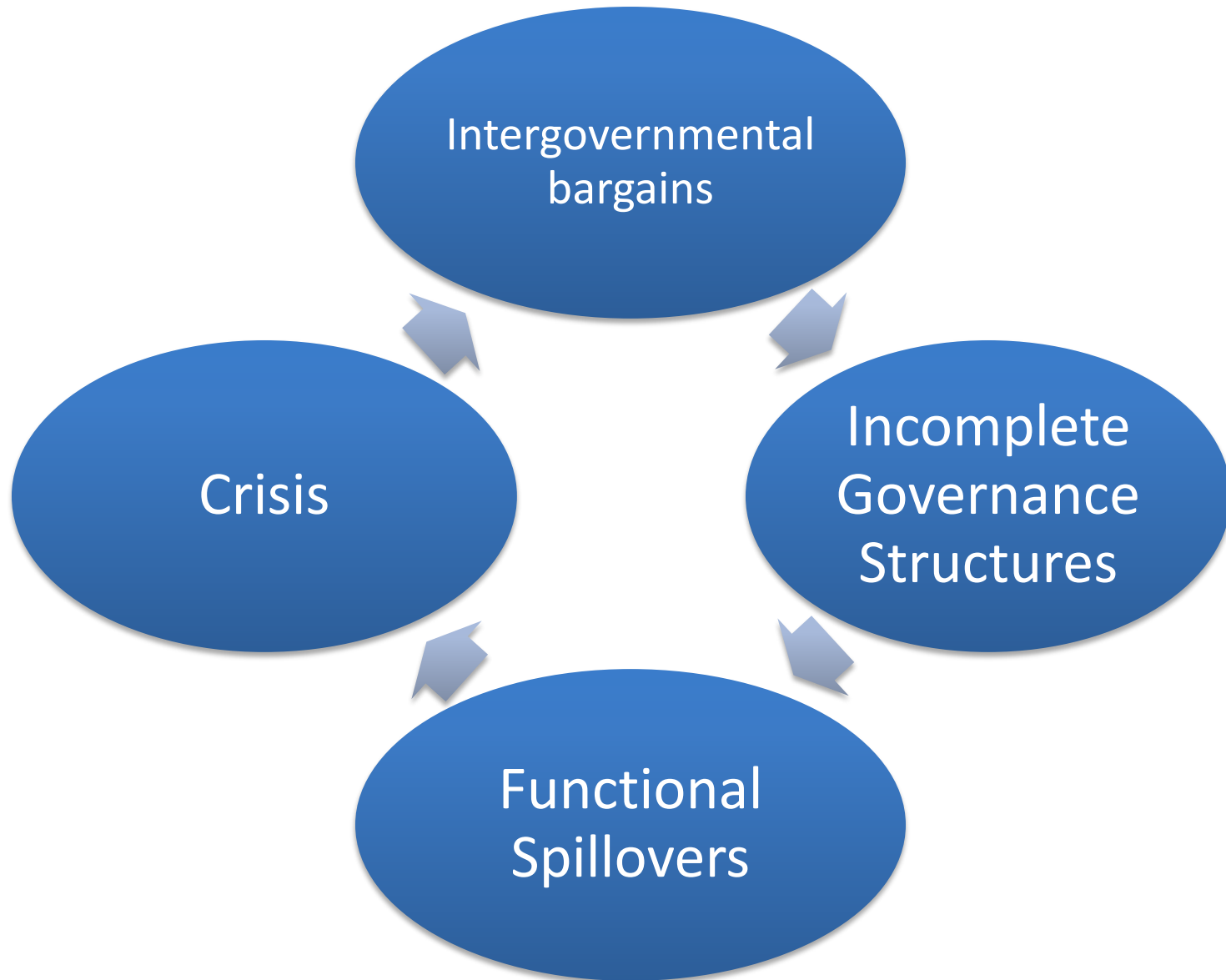
- Limited fiscal integration
 - Inadequate fiscal rules/ risk of default in Greece spurs panic, domino effect across periphery
- Fragmented banking regulation
 - Regulatory failure and contagion - Ireland
- Inefficient local factor markets
 - Absence of policies to promote macroeconomic convergence escalates crisis – surge in unemployment in periphery

Here we go again: Europe's Responses Remain Incomplete

- Implicit fiscal integration
 - EFSF/ESM too small to handle Italy. No surge in EU budget
 - Fiscal Compact Treaty = Flawed
- Macroeconomic imbalances and market structural reforms
 - Weak 'macroeconomic imbalances procedure' rather than real policy coordination
- Towards a banking union
 - ECB as SSM
 - Underfunded ERM
 - No pan-European Deposit Insurance yet

Integration through Crisis?

EU has been “Failing Forward” but this is unsustainable



Conclusions

- “Structural BBR” in fiscal compact too vague to be focal points for bond markets & won’t be enforced by courts
- US states could only adopt clear BBRs because federal gov’t could run deficits. Since EU can’t/won’t do major countercyclical policy, it cannot put in place BBRs with sufficient clarity to work.
- If politicians want to balance budgets & impose austerity, they shouldn’t try to get courts to do it for them.
- Bigger Picture: Integration via “failing forward” undermines public support for EU so is self-undermining & unsustainable.

What does this have to do with accounting?

- While focus on legal enforcement is wrongheaded, focus on transparent, accrual-based budget data is crucial
- 2011 Budgetary Frameworks Directive, “requires Member States to ‘have in place public accounting systems... containing the information needed to generate accrual data with a view to preparing data based on the ESA 95 (now 2010) standard.”
- 2013 Report from Commission to Council and EP, Towards implementing harmonised public sector accounting standards in Member States, “The majority of Member States have already implemented accruals accounting according to national standards across the government sector, or are in the process of doing so.”
- But is this a total fantasy in practice?

The politics of lying about debt

- Paul Kazarian is right: Greece did get debt relief
- German gov't doesn't want to call it debt relief due to domestic politics, ideology and fear of moral hazard
 - If you highlight fact that Greece's debt servicing cost is lower than other states, others may want similar relief
- Debt relief: Is perception reality?
 - Do most potential investors consider cost of servicing debt, or do they just look at headline Debt-to-GDP ratio?

Extras below

The Cause of the Crisis: Whodunnit?



Responses to the Crisis

- When crisis hit, Maastricht governance regime was abandoned
- Over past 5 years EU has taken steps toward:
 - Fiscal Union
 - Banking Union
 - Debt Union
 - Political Union?
- ...but all incomplete, incremental steps

The underlying cause of the crisis: Flawed Fiscal Federalism (and links to banking regulation)

- Any political system with free movement of capital, monetary union & state-level fiscal authority, must:
 - Control state debts & limit moral hazard
 - And given link between sovereigns and banks, must also establish a banking union

Fiscal Union?

- New regime with greater fiscal oversight
 - 2010: European Semester/ Eurostat audits
 - 2011: “six-pack” legislation
 - 2012: Fiscal Compact Treaty
 - 2013: “two-pack” budget surveillance legislation
 - Troika inspectors
- Transfer Union?
 - Only on a small scale. No political support for more.
 - Modest budget (€140bn, 1% of GDP), but bigger than budgets of 19 member states
 - HFSF, EFSF and then ESM raises capacity by €500bn, but not real transfers

Banking Union?

Half way there:

- 2014: ECB runs 'Single Supervisory Mechanism'
- 2014/2016: Single Resolution Mechanism (with Single Resolution Board and Single Resolution Fund) (but inadequate)
- 2009/2014 revisions to Deposit Guarantee Schemes Directive, but no Common Eurozone Deposit Guarantee

Debt Union?

- Debt Union through front door or back door
 - Front door: EFSF or ESM loans
 - Front door: Eurobonds – Germany says Nein
 - Backdoor versions: “Quasi-Eurobonds”
 - ECB loans to banks (LTRO), which they used to buy gov’t bonds (Sarko Trade) (2008→)
 - ECB Securities Markets Program (2010→)
 - ECB Outright Monetary Transactions (OMT) (2012→)
 - ECB QE Public Sector Purchase Programme (2015→)
- Misinterpreting US experience: 1790s vs. 1840s

Political Union: Quo Vadis Europa?

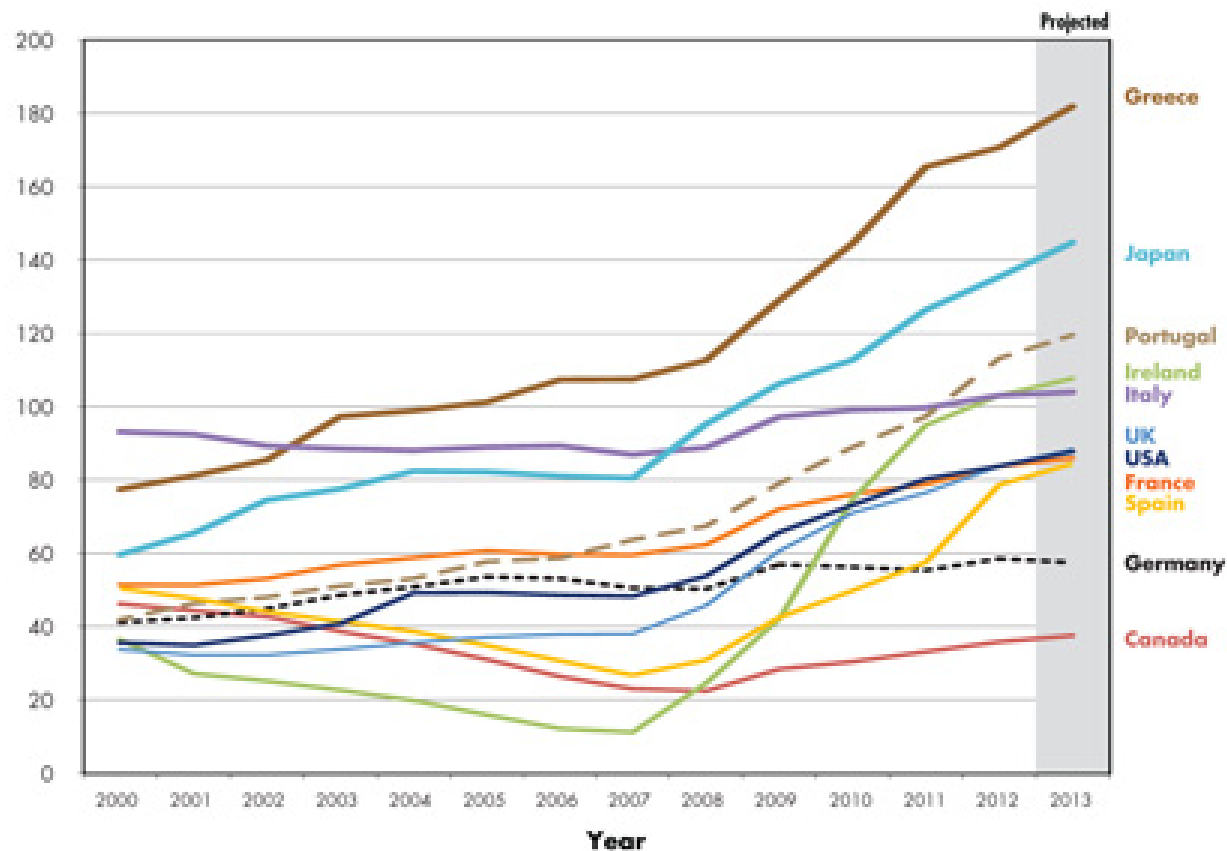
- Critics say ultimately EMU is only sustainable if embedded in a “political union”
- Lots of recent proposals for ‘political union’:
 - From Barroso, Van Rompuy, Future of Europe Group, Piketty and friends, French Minister Macron’s proposal for Eurozone economic government
- But what exactly is a political union?
 - Is the EU already a political union?
 - Is it becoming deeper in response to the crisis?

Political Union

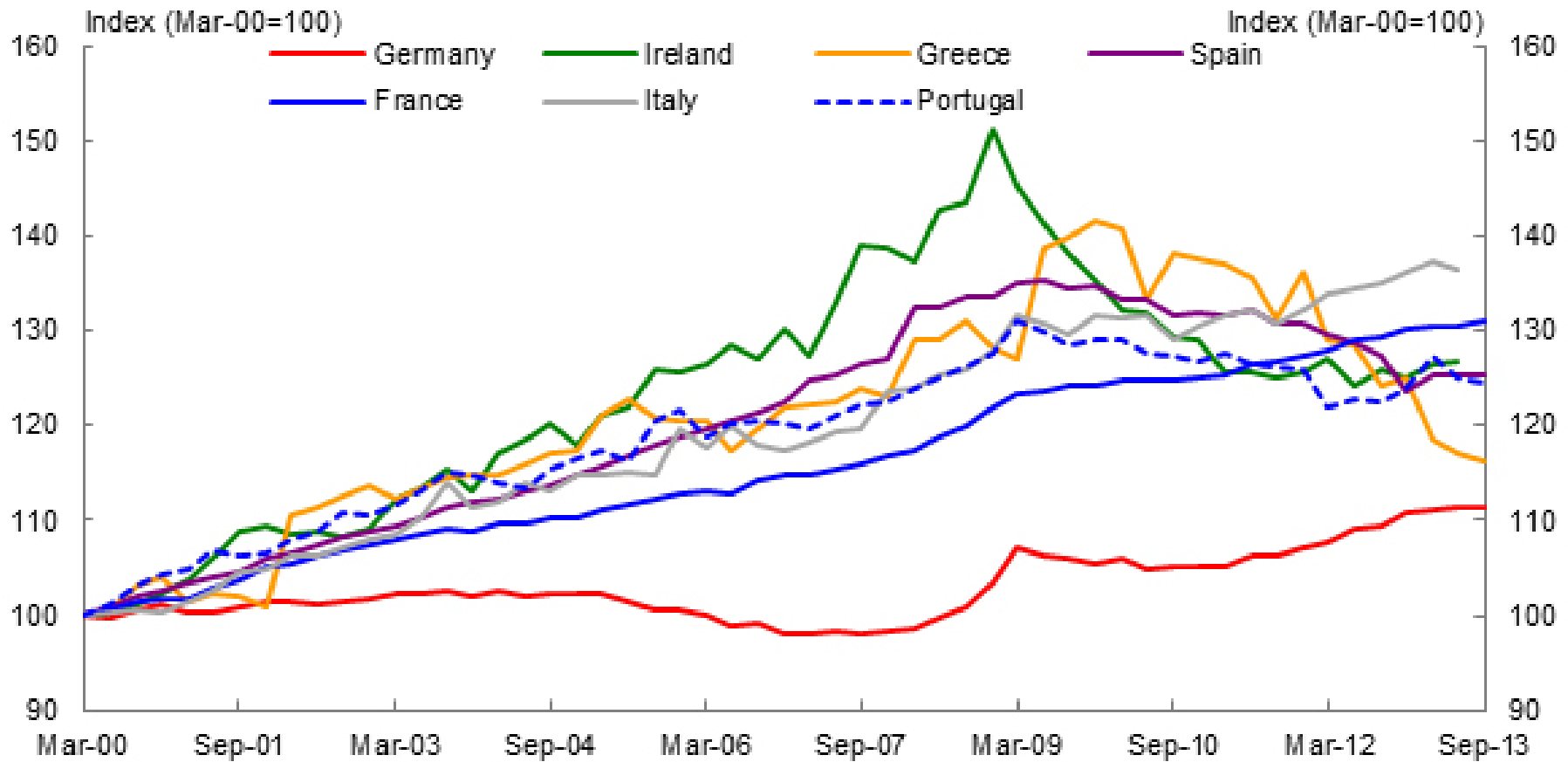
- EU has always been a political union, albeit a limited one
- Lisbon Treaty deepened political union:
 - More powers: traditional “core state powers”: foreign affairs, immigration, police & judicial
 - More democracy: Lisbon empowered EP and 2014 “Spitzenkandidat” process extended this
- But how much political union are EU leaders and citizens willing to accept?

Focus on root causes, not symptoms

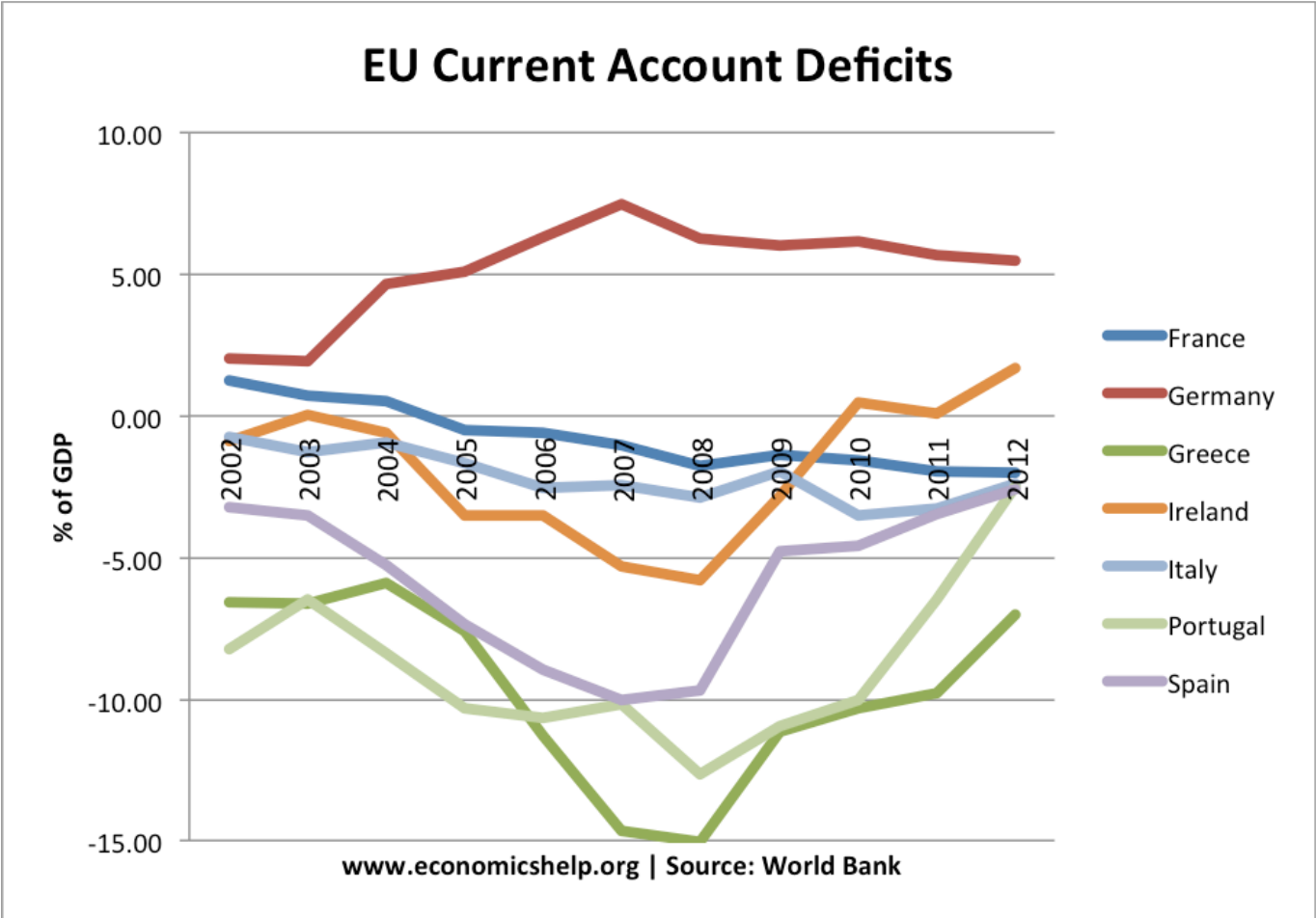
FIGURE 2
GENERAL GOVERNMENT NET DEBT AS A PERCENTAGE OF GDP



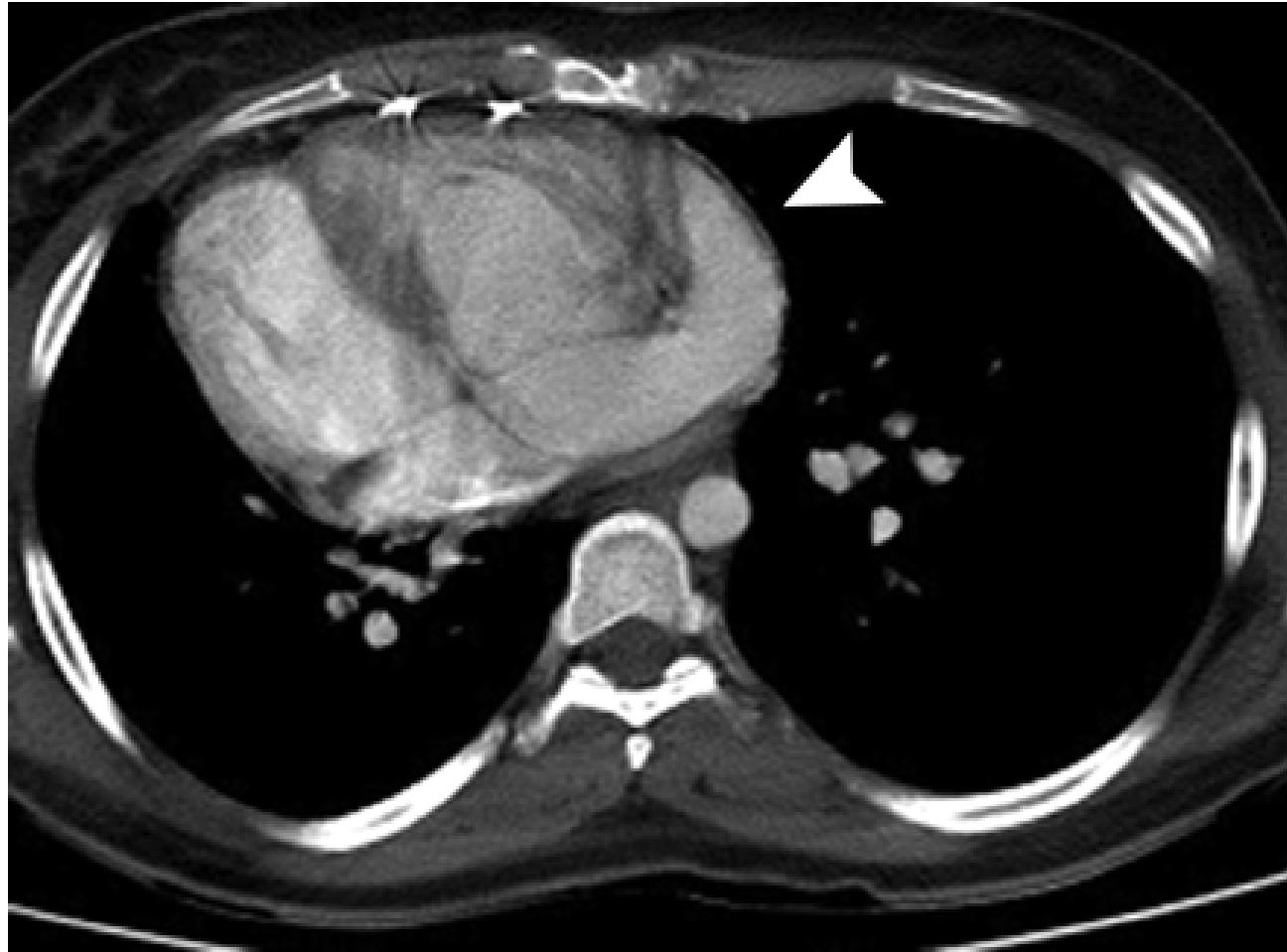
Competitiveness vis-à-vis Germany? Unit Labor Costs



Growing macroeconomic imbalances?



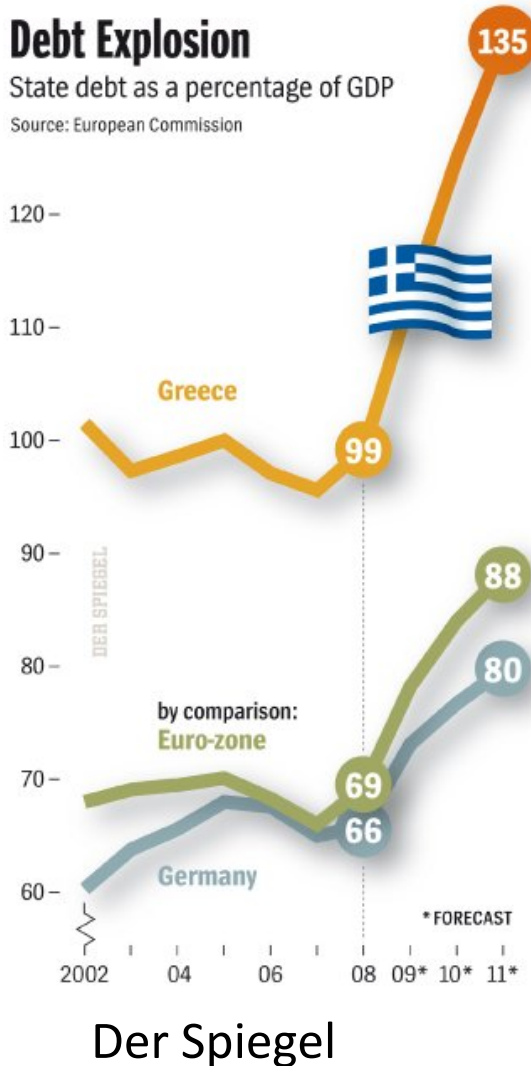
A congenital defect in eurozone
governance?



The Cause of the Crisis: Whodunnit?

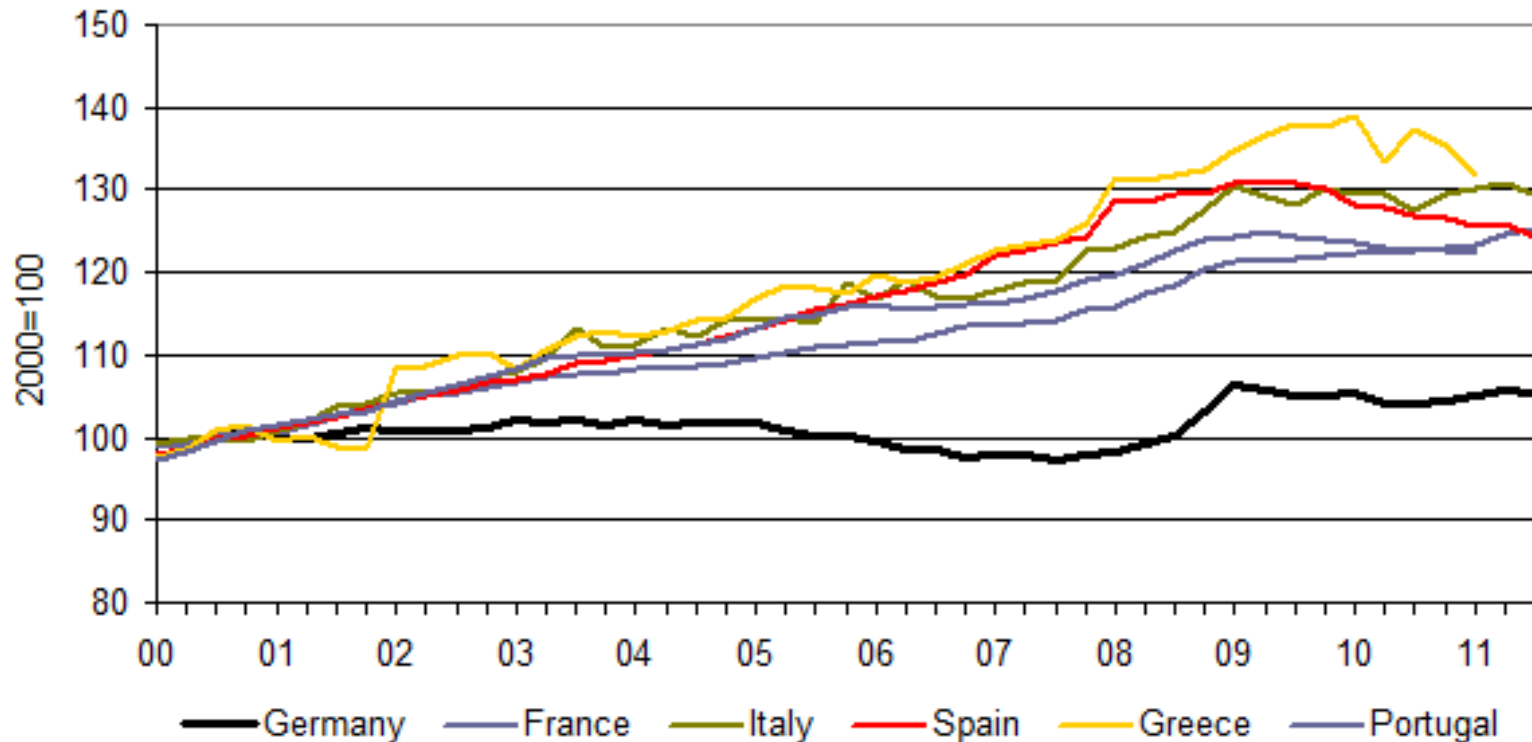


Excessive Debt as cause? Or symptom?

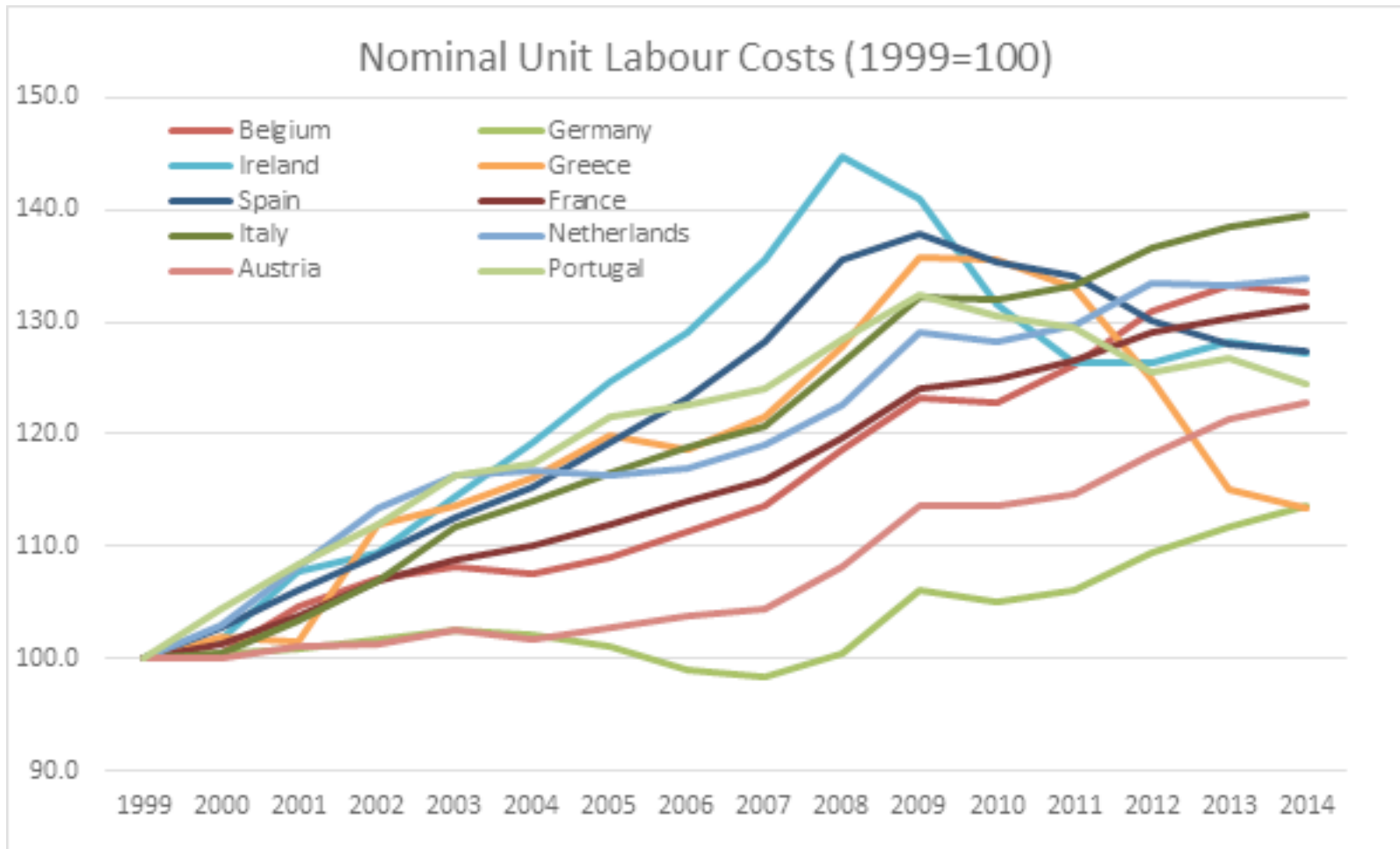


- Debt mostly exploded after crisis hit and had been very low in some crisis affected states such as Ireland and Spain

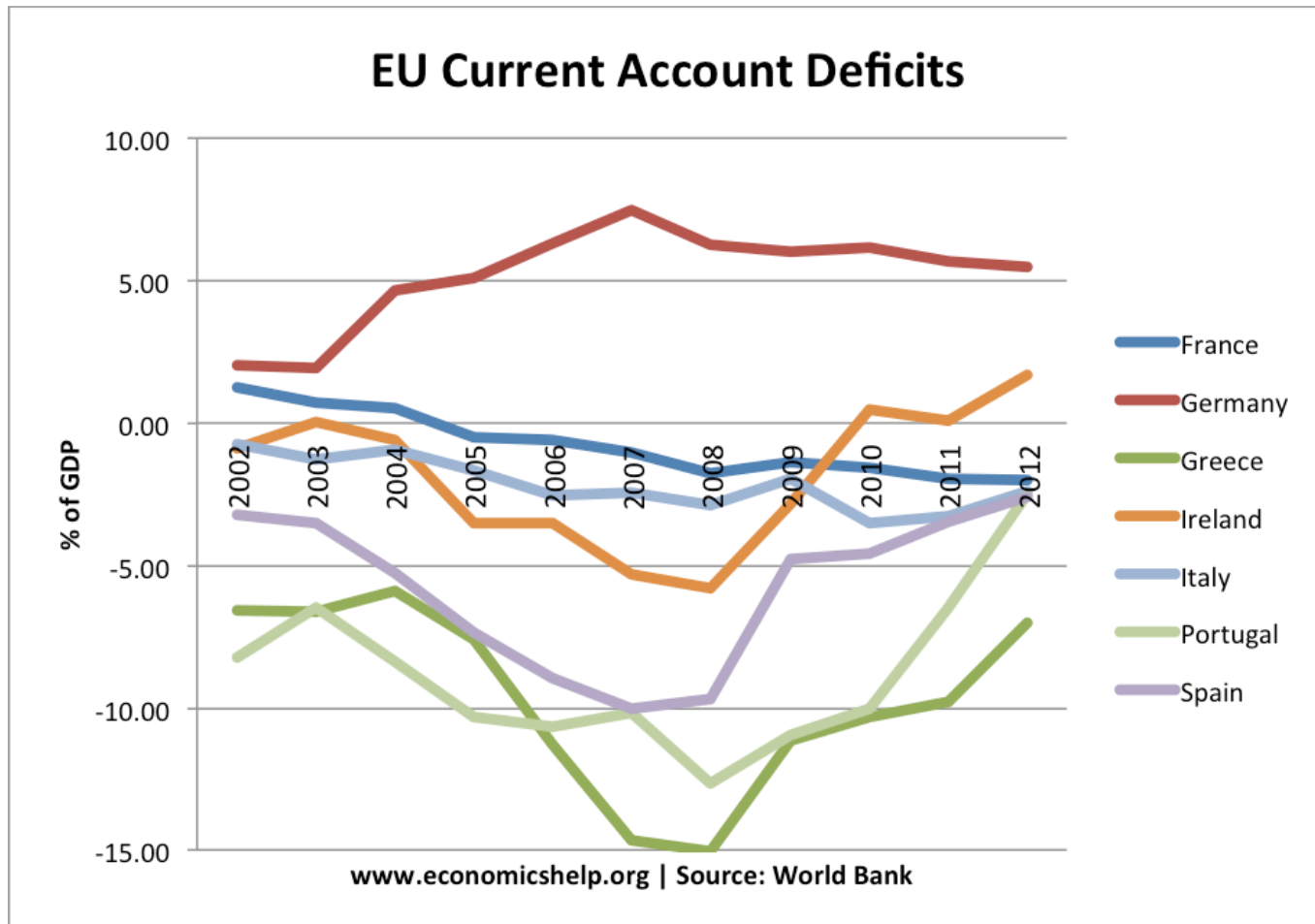
Lack of competitiveness vis-à-vis Germany as cause? Unit Labor Costs



Competitiveness of periphery has improved



Growing macroeconomic imbalances as cause?



Regulatory Failure as cause

- EU created a single market in finance, with inadequate regulatory regime
- Weak banking regulation
 - Lax lending standards and inadequate supervision of cross-border activities
 - Systemically important banks at risk
 - Excessive private sector borrowing
- No backstops to contain cross-border contagion in event of financial crisis

European Integration through Crisis? Or failing forward until you don't.

R. Daniel Kelemen

Professor of Political Science and Law, Rutgers University

Roundtable:

"What does the euro crisis say to our theories of economic and political integration?"

Council for European Studies

Philadelphia, April 2016

Is integration proceeding through crisis?

Europe will be forged in crises, and will be the sum of the solutions adopted for those **crises**. – Jean Monnet (1978)

I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a **crisis** and new instruments will be created. - Romano Prodi, Dec 2001

As on other occasions in European history, this **crisis** offers a chance to progress; we must be ready to act on it. Let us not waste this opportunity to advance European integration. – Peter Praet (Member of ECB Executive Board, 2012)

Crisis or slow motion train wreck?

- *6 and ½ good years*: January 2002- September 2008 (then Irish Banking Crisis and first spike in Greek borrowing costs)
- *7+ “crisis” years (on & off)*: October 2008 - present
- *Rule of thumb*: if half of life is a “crisis” that no longer qualifies as a crisis but as the “new normal”
- *Perhaps several crises?* Autumn 2008 Ireland, Spring 2010 Greece, Summer 2012 PIIGS, Summer 2015 Greece

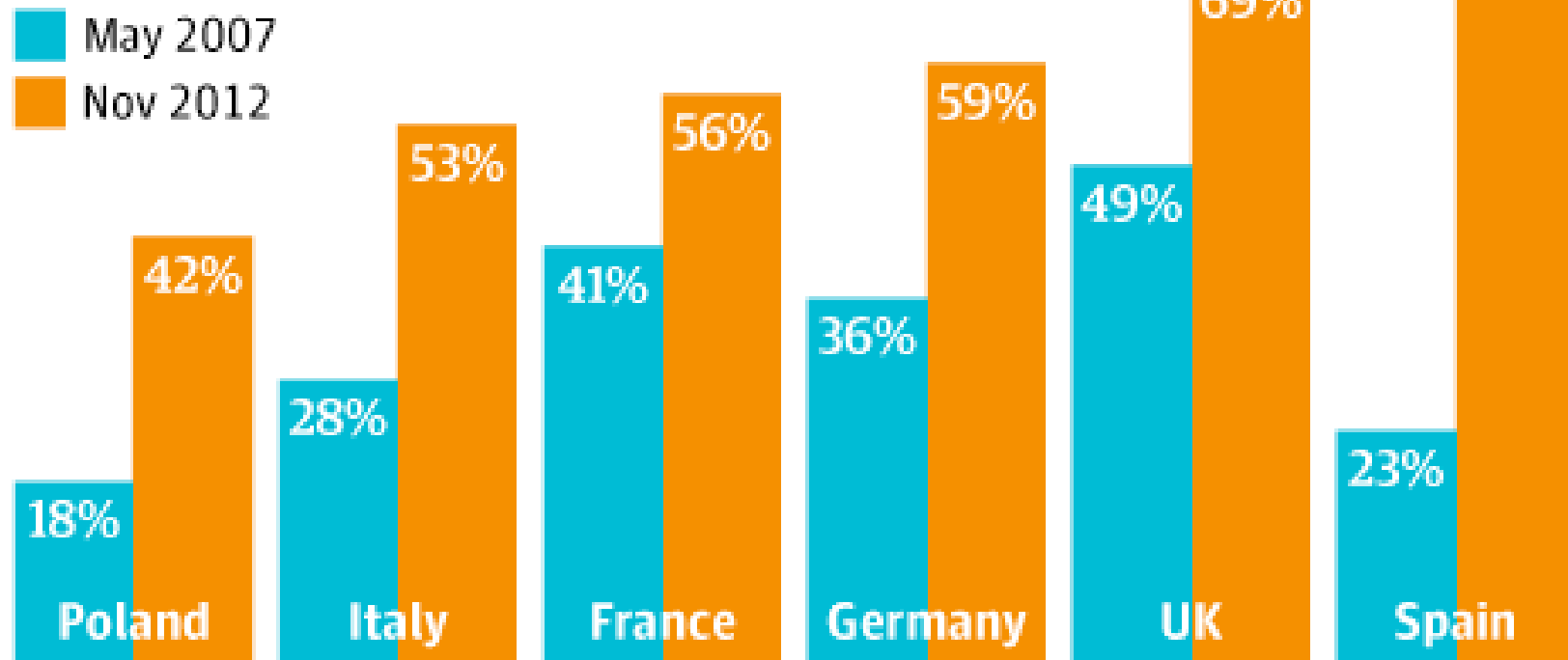
Is **integration proceeding** through crisis?

- Integration = Deepening = changes in rules or practices that increase the EU's authority over existing areas of competence or that extend EU authority to new areas.
- The crisis has prompted rapid deepening...
 - But is it still “deepening” if it prompts Grexit? Or if it drives rift between euro ins and outs, encouraging Brexit?
 - Will other crises lead to deepening or unraveling (ie of Schengen)?

Crisis damages public support

Lack of trust in the EU

Percentage of nationals who said they tended not to trust the EU, as an institution



SOURCE: EU, EUROBAROMETER

Far-Right Leads Eurosceptic Earthquake

Performance of eurosceptic parties in the 2014 European elections*

