

Did you say federalism?

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It is an old debate, but tensions within the euro area have revived it: can a monetary union survive without some form of fiscal federalism?

Until recently it was merely a topic for academic research. It is now of persistent concern for investors worldwide. Holders of European government bonds believed they knew what they had bought. Sure, there was no such thing as a euro-area government security. But German, French, Spanish and even Greek bonds all carried roughly the same interest rate, so they were deemed equivalent. Investors have now realised that they did not really understand what these papers represented. And as the crisis has taught them, when you do not understand a financial product, you should not buy it. If they behave in this way, we are far from finished with European crises.

So the question arises, should Europe embrace fiscal federalism to strengthen the euro area and restore investor confidence?

It is not clear, however, what fiscal federalism really means. US citizens think they do know: a central government with a large budget (about 20% of GDP), whose macroeconomic role is to absorb shocks. In the US, where most states are constitutionally committed to some sort of balanced-budget rule, counter-cyclical spending and taxation belong to the federal government. This was very clearly the case for the stimulus programme launched in 2009, which included federal transfers to the states, whose aim was to avoid the discontinuation of social programmes at state level. Similarly, when a state such as Illinois is hit by recession in the sector it specialises in (the auto industry), Washington collects less federal tax, but does not reduce spending locally (in fact it tends to increase it), resulting in an automatic, stabilising transfer. Economically, therefore, the federal budget cushions national shocks automatically through discretionary action and regional shocks. Politically, it embodies solidarity and therefore helps cement the union.

If this is what is meant by federalism, it is better for the EU to forget it immediately. The EU budget amounts to about one percentage point of GDP, just a fortieth of total public expenditure. No one, not even die-hard European integrationists, imagines that it can reach five percentage points (it is more likely to decrease). However, even a five-percent-of-GDP budget would not be sufficient to play a meaningful macroeconomic role.

A second solution is what can be called distributive federalism. The goal here is not to absorb shocks but to reduce income gaps across regions. In Germany, a redistribution of tax revenues takes place horizontally between states. This is another form of solidarity, which in fact exists in the EU, where regional development funds are allocated to poorer regions to foster catching-up. These are significant for poor countries: they amounted to about €300 per person and per year for Greece and Portugal between 2000 and 2006. Europe, in this respect, is not qualitatively different from the US, as shown in a recent [paper](#) by my Bruegel colleague Zsolt Darvas

The problem is that these transfers have accelerated convergence where they have been put to good use (for example in several Spanish provinces) but have been ineffective when wasted (as in Greece). This feeds doubts about the usefulness of solidarity. The Germans, who since unification know what they speak about as regards transfers, do not want to hear about a Europe where rich regions would permanently finance pockets of under-development. They are not alone in raising such objections.

What then? Conceptually, the euro area must include solidarity with countries facing hardship, because this is what unites and gives strength to the whole – but without the heavy machinery of a federal budget, or a permanent increase in transfers. It needs some sort of mutual insurance – what could be termed insurance-based federalism.

This is what inspired the decision taken in May to create a financial facility (the EFSF), so that assistance could be provided, jointly with the IMF, to partner countries in times of crisis. This is also what inspired the simultaneous launch by the European Central Bank of a government bond asset-purchase programme, which has been used to buy Greek and Portuguese bonds.

The problem is that these decisions have caused so much uproar that they reinforce, rather than dispel, doubts. In Germany, the creation of the EFSF is seen by many as a violation of a fundamental principle according to which governments cannot be bailed-out. Even worse, the transformation of the central bank into a quasi-fiscal agent (because if the Greek debt is restructured, the ECB will have to record losses) is regarded with horror because it breaks with the principle of having a watertight separation between money and public finances. Instead, it is claimed, states should have been allowed to default. No matter that the public debt of the average US state is less than 0.5 percent of total US GDP, against five percent in the euro area, which implies that the financial impact of a euro-area state bankruptcy would be much higher; and no matter that the treaty does not prohibit the purchase of government bonds on the secondary market: the Rubicon has been crossed and this makes the Germans very nervous.



As a result there is no agreement yet to make the EFSF permanent, and it has been built to be as un-federal as possible. And when it comes to buying government bonds, the ECB has shaky hands and no one understands exactly for what purpose and within what limits the new weapon is supposed to be used. Meanwhile, suggestions that the EU should be able to assess national draft budgets before they are voted on by national parliaments have been met with recriminations from French MPs, serving as a reminder that in France (and elsewhere too) there is much cheap talk about coordination but less willingness to give it content. Part of the French political elite does not yet understand that there must be a quid-pro-quo for solidarity.

The Europeans have thus begun to assemble the bricks for a new building, but for now those bricks are laying in a disorderly pile. This may make sceptical the very people European policymakers wanted to convince. It is high time to accept that those who are lending you significant amounts of money are entitled to ask inconvenient questions, and to expect clear answers.

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