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Is it the time for European fiscal union?

Today is a historic day for Europe, the European Union and, more particularly the Eurozone. European citizens hope that the European Council today will go down in history as the beginning of the end of the 21st century euro crisis, and not as a day of missed opportunity. If this is the beginning of the end, it will be because today the European Council will have laid the groundwork for a new European Constitution redefining the fiscal policies of the member countries of the EU or the Eurozone.

Engaged in final preparations for the "historic" European Council, the heads of government will probably not have had time to hear or read yesterday's lesson by the Nobel laureate Thomas J. Sargent in Stockholm. A pity, because they could have learned from this lesson, titled "United States Then, Europe now".

It is not my intention to reproduce the lesson here (it is better to download it from the website), but to highlight some of the lessons that today's Europe should not forget. Sargent, with his characteristic modesty, says he is an "American provincial" and therefore refers almost exclusively to the history of the first 50 years of the Union. But he does this through the observational lenses of current economic and econometric theories.

In fact, Thomas J. Sargent and Christopher A. Sims have won the 2011 Nobel Prize in Economics for developing the lenses and the theory of macroeconomics. These allow us to better understand how different economic policies are interrelated, and the importance of the rules and institutions that shape this relationship.

The United States began to define a model of fiscal union and it took time to define their model of monetary union. Europe has started to define its model of monetary union, but there is still confusion about what its fiscal union model will be, and now this confusion is endangering the monetary union. As Sargent reminds us, the original model of the U.S. Constitution of 1781 was a union with a very low fiscal capacity and, therefore, it was unable to solve the problem of States' debts, a legacy of the war of independence. However, the triumph of the federalist ideas of Hamilton and Washington in the Constitution of 1788 was a key rectification of this model: fiscal capacity was given to the union, which took control of tariff policy, and in 1790 the union took advantage – not without controversy – of this source of revenue to absorb the debts of the States.

However, the lesson does not end there ("if you want to finance debt, better secure a source of revenue") but the story continues: the union had no capacity or mandate to make major infrastructure or other public expenditures, which were left to the states. These, confident that the investments would pay off, borrowed, and in the thirties of the nineteenth century there was a new United States debt problem. However, these were not debts from a common war of liberation, but debts of some States which had easy access to credit at low interest rates, protected by the reputation of the Union, which had proved that it paid its debts. And so, 50 years later and with the Constitution, the problem of the States' debts had a very different resolution: the Union in 1840 did not bail the States out and some of them defaulted.

This second episode, and an increasing fiscal capacity of the union – for example, the introduction of an income tax – defined the American model of fiscal union, based on three principles. First, as with Thomas Cooley we have already noted in these pages (El País 07/12/2011) "in most states, the payment of debt obligations has constitutional priority over other state expenditures." Second, there is a clear dividing line between the commitments of the union and those of the States. In particular, according to the U.S. Bankruptcy Code states cannot declare bankruptcy, i.e. the union does not bail out the States as "lender of last resort". Third, the federal budget has the capacity to provide protection to the States in situations of crisis or emergency.

The rule limiting States' deficits in the U.S. is similar, but more subtle, to a constitutionally fixed limit on the deficit/GDP ratio (possibly, structural deficit) as is now proposed in Europe and has already been approved in Spain. But there is a need to articulate the other pieces – not necessarily following the American model – and it is extremely urgent to solve the euro debt problem. Unfortunately, confusion still reigns here.

Using the historical example, confusion regarding the debt problem has two components. First, there is a failure to distinguish the extent to which the Eurozone today resembles the U.S. in 1790 or 1840. That is, whether this is a community problem for which the Eurozone must share responsibility or not. There are elements of both, but one has to draw the dividing line. Second, for the union to have sufficient fiscal capacity it must clearly define its sources of revenue. How are these two problems being addressed?

The proposal that Merkel and Sarkozy have put on the table, to guarantee "that what happened with Greece will never happen again," is to complement the constitutional deficit-limit commitment with a system of automatic penalties – possibly ruled by the European Court of Justice – for those who do not fulfil this commitment. Unfortunately, neither has the European Union credibility in imposing sanctions on its Member States (although it does on their companies) nor do we have good historical experiences that punishing sovereign countries is the way ... and the Germans should be the first to know this.

Nevertheless, there are two mechanisms that, as theory and experience tell us, work: inaction and "the carrot". If the union does not absorb a portion, or the total amount, of the debt of a State, it is a "sanction of inaction," while taking part of the debt – for example, by restructuring it over a longer term and with a lower interest rate, *if certain conditions are met* – can be a good "carrot." Both mechanisms are much more credible and immediate than the "stick" of imposing fines on countries in difficulties.

There is no doubt that if Europe knew how to and wanted to exploit its financial and monetary policy without creating further problems of credibility (moral hazard), the debt problem would be practically solved. How can it do it?

So far it has cautiously used the rescue fund and direct interventions by the ECB buying sovereign debt. Both mechanisms can be expanded. Proposals to advance and expand the Financial Stability Mechanism are on the table and the recent experience of the Federal Reserve shows that central banks may even benefit from refinancing debts harnessed with unsustainable high interest rates. For the health of the monetary system and to build confidence in general, it is better to make the Financial Stability Mechanism fully responsible for these policies. However, this mechanism requires clear rules. First, it must be a properly funded 'stability fund' and not a 'redistribution fund,' i.e. it cannot be a mechanism of permanent transfers, which is politically unsustainable. Second, it must establish which instability situations should "trigger the carrot". Without credibility in these rules, confusion and moral hazard problems can sink us in the future, and anticipating the future, markets will anticipate it by asking: Is it the time for European fiscal union?

Ramon Marimon
Director of the Max Weber Programme, Professor of Economics European University Institute and Universitat Pompeu Fabra, and Chair of the Barcelona Graduate School of Economics