Looking at US experience in view of deepening EMU

SUMMARY

Although the fiscal frameworks of the United States of America and the European Union were set up during different historic periods, had different economic drivers and are at different stages of development, the euro area can learn from the US experience. For instance, recent research suggests that one useful element might be to earmark revenue, i.e. to pre-identify sources of revenue to be directed to fund those policies that are better dealt with at EU level, so that there is a direct link between revenue collected and issues solved. 'Trust fund' structures of this type can be financed by means of explicit user fees (e.g. for visas), fees on related use items (e.g. air or sea fare tickets) or broad-based taxes (e.g. income, payroll or consumption tax).

Other research in this area focuses on the factors behind the contrasting experiences of the United States and the euro area during the financial crisis as regards consumption smoothing or resilience to shocks. Research shows that the role of automatic stabilisation in US fiscal policy, including that of unemployment insurance, has been overstated and that other factors should be taken into account to explain the United States' resilience during the crisis. When it comes to resilience to shocks, the contrasting experience of the euro area cannot meanwhile be attributed wholly to the fact that market-based risk-sharing is higher in the United States, but weight must also be given to measures, such as the interventions of the Federal Deposit Insurance Corporation to protect deposits, or ad hoc policy interventions by the Federal Reserve and Congress, such as the action plan to avoid the default of Fannie Mae and Freddie Mac.

Jacob Funk Kirkegaard and Cinzia Alcidi, with EPRS DIrector-General, Anthony Teasdale (left).

In this briefing:

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Glossary

Asymmetric shocks: macroeconomic shocks that affect only some of the states belonging to an area or hit them differently.

Automatic stabilisers: economic policies and programmes that are designed to offset fluctuations in a country's economic activity without intervention by the government or policymakers; examples include corporate and personal taxes, and transfer systems such as unemployment insurance and welfare; they are 'automatic' because they act to stabilise economic cycles and are automatically triggered without explicit government intervention.

Counter-cyclical fiscal policy: a fiscal policy that reduces fluctuations in a country's economic activity (i.e. a fiscal policy that is expansionary in a recession and contractionary in an economic upturn).

'Fiscal capacity': in EU policy documents, a set of common budgetary instruments that could include mechanisms to counter adverse economic shocks.

Pro-cyclical fiscal policy: a fiscal policy that accentuates fluctuations in a country's economic activity (i.e. a fiscal policy that is expansionary in an economic upturn and contractionary in a recession).

Introduction

The rekindling of the debate around the further development of economic and monetary union has been linked to the sovereign debt crisis. In the context of this debate – and more specifically, of the possibility of creating a central fiscal capacity – several options have been considered, and several angles have been analysed by both legislators and academics.

One of those angles examines the construction of the fiscal union in the United States and on the possible lessons the European Union can draw from it to deepen its own economic and monetary union: while it is true that the fiscal frameworks of the United States and the European Union were set up under different historic circumstances, had different economic drivers and are at different stages of development, elements from the former can be useful to the latter.

In that vein, on 28 September 2017, the European Parliamentary Research Service hosted a conference entitled 'Designing the future of the Eurozone: Next steps in deepening EMU'. The conference gave the opportunity to two researchers, Jacob Funk Kirkegaard – senior fellow at the Peterson Institute for International Economics – and Cinzia Alcidi – senior research fellow at the Centre for European Policy Studies – to present their recent research. Dr Kirkegaard has been researching the historical evolution of the United States' fiscal union and draws relevant conclusions for the euro area, while Dr Alcidi's research has focused on claims surrounding the factors behind the contrasting experience of the United States relative to the European Union during the financial crisis with regard to consumption-smoothing or resilience to shocks. This briefing summarises their main findings.

Lessons from the historical experience of the USA in establishing a fiscal union and key elements relevant to the euro area

Jacob Funk Kirkegaard's paper focuses on the historical aspects of the formation of the US fiscal union, noting that government expansion in the USA was incremental – the author points out that it took more than 120 years for the US federal government's non-war expenditures to permanently exceed the share of the economy of today's European

Union budget (approximately 1.17 % of GDP) – and came mainly in response to military or economic events of major importance (the American Civil War, the two world wars, the financial panic of 1907 and the Great Depression of the 1930s) which contributed to making the public willing to accept previously unacceptable centralisation and expansion of federal government power.[1] Aiming predominantly to promote peace and cooperation, the European Union finds itself, in that respect, at a disadvantage in relation to the United States, when trying to pursue the expansion of a central fiscal capacity.

Another interesting insight comes from the fact that, as late as 1932, US state and local governments together had more outstanding debt than the federal level, despite the fact that already then they could legally issue mutualised federal government debt. This shows that the political will to rely mostly on central government debt can be lacking, despite an existing federal setup, the legality of issuing such debt and the financial advantages of doing so (in terms of low interest costs). This in turn, the author notes, has implications with regard to debt mutualisation proposals voiced during the recent crisis, since equivalent increases only happened in the USA during the Great Depression or to meet the costs of preparing to enter the Second World War.

Another important lesson drawn from the United States is that, in general, debt issued at state and local government level is not used in the financial sector as a safe asset. This means that these bonds can be subject to credit risk without creating market turmoil, thus muting market discipline on state and local government issuers. This in turn highlights the idea that restructuring mechanisms for sovereign bonds should be attempted only if another safe asset has been created, so that the ability to restructure government debt at lower levels of government does not create unmanageable financial market risks for the relevant government issuers.

Lastly, Dr Kirkegaard notes that the incremental increase in government powers came in areas – such as army veterans' pension expenditures, disaster relief, or the financing of public infrastructure – that concerned the whole of the United States, rather than focusing on one state only, and that could be achieved more effectively at federal level.

As to the lessons to be learned from the above for the EU's future fiscal capacity, the author starts by noting that a central budget should fulfil three main central government budgetary functions: promoting economic convergence, ensuring macroeconomic stabilisation and funding policies that are better dealt with at central level.

Dr Kirkegaard is of the view that the European Union should not currently focus on the first function, promoting **economic convergence** among (in the case of the European Union) Member States, for two reasons: this goal, at least in the medium term, is already one of the existing European Union budget goals – at least as far as the investment dimension (i.e. structural funds) is concerned. What is more, the experience of some Member States and their regions suggests that this strategy is probably not very effective.

With regard to the second function (countering geographically isolated **asymmetric shocks**), the sovereign debt crisis showed that there are significant deficiencies in the current European structure. In Dr Kirkegaard's view, macroeconomic stabilisation is linked to the banking union and, as such, the success of the former depends on the completion of the latter (that is, a fully mutualised European Deposit Insurance Scheme). At the same time, however, he notes that, in the case of the European Union, there seems to be no need for a large permanent euro area budget to perform stabilisation functions in order to counter cyclical downturns, as stabilisers such as social protection are already fully available at Member State level. Instead, what is needed is a capacity to borrow and fund – in a concessionary manner – for the purpose of financing traditional Keynesian policies in eligible Member States. However, in the current state of European Union reform, centralised debt issuance of this kind seems unfeasible, at least in the near future, without at the same time, an agreement being reached over additional pooling of political sovereignty over fiscal issues (and a more intrusive capacity for fiscal oversight). Nevertheless, while fully joint debt currently seems unfeasible, issuance of common debt instruments under strict conditionality seems more likely.

Regarding the last function, i.e. **funding those policies** that are **better dealt with at central level**, Dr Kirkegaard notes that this area is neither fixed nor predetermined, as historical analysis of the creation of the United States fiscal union demonstrates that political determination is subject to changes over time and depends on events. In the short term, however, and in the current context of the debate about the budget, its resources and the legitimacy of its use, the European Union could gain by adopting one practice that is already in use in the United States, namely that of earmarking revenue to flow directly to the European Union budget i.e. pre-identifying sources of revenue to be channelled towards solving a specific policy issue, so that there is a direct link between the revenue collected and the issue addressed. This would enable European Union budgets to establish 'trust fund' structures to address specific tasks that – by political agreement– are best solved at European Union level. The author provides three examples of how these trust funds could be financed directly:

- Explicit user fees: here, the author brings as an example the current issue of external border control. Using a back-of-the-envelope calculation, he notes that it would cost around €30 billion a year to protect Europe's borders effectively. This could be funded directly at least partly by user fees on European Union or Member State visas for visits, work, study or other activities. Another example of such fees is provided by arrangements based on the 'polluter pays' principle (such as the banking union's Single Resolution Fund, which will be funded exclusively by fees paid by participating EU banks).
- Fees from related use items: some issues, such as the financing of European Union infrastructure, or, in the previous example, external border control measures could, following an established US model, be financed by small fees on related products and services, such as gasoline, air or sea fare tickets, or natural resource or electricity distribution.
- Broad-based taxes: with more far-reaching budget invention the European Union could establish budget trust funds to be funded directly by broad-based income, payroll or consumption taxes for instance, mirroring the US federal government's social security trust funds, which are funded through federal payroll taxes.

The important element of the above structures is that they link funds to tasks resolved at European Union level. This shifts attention away from fiscal transfers to specific countries to the provision of funds to solve a particular issue at European Union level. In this way, the recurring debate on transfer-to-Member State compensatory rebates can be avoided.

Dr Kirkegaard stresses that this is a reform that relates to the whole of the European Union budget and not only to the euro area, because it would allow the gradual improvement and extension of resources available at European level. This does not imply that the current budget should be abandoned altogether, but rather that it should be reformed so that resources can be linked to actions, and so that transparency – and by extension – democratic accountability, can be better achieved in the long run.

Fiscal risk sharing and consumption smoothing or resilience to shocks: patterns in the United States and the euro area

When thinking – in economic terms – of the next steps for EMU, there are two critical areas: how to deal with the important debt legacy of the past; and how to make sure that the euro area is able to deal with shocks. Cinzia Alcidi has recently carried out research in the second area – namely, how to dampen the effect of asymmetric shocks.

She begins by noting that in the first 15 years of EMU, there was an expectation that asymmetric shocks would become rarer; this expectation in turn was based on the assumption that fiscal rules were in place (e.g. the stability and growth pact) and on the premise that those rules would be followed. The sovereign debt crisis proved this wrong, as the rules did not work as expected, resulting in (or, at least, not preventing) major asymmetric shocks. Furthermore, the original EMU design did not give the appropriate weight to the financial sector. The idea, at the time, was that only fiscal shocks were relevant. In this respect, the 2007 to 2008 financial crisis showed that financial crises can be very extensive (to the extent that the downturns were much greater than those traditionally associated with the business cycle) and lead to contagion.

The United States managed to face the crisis much better than the euro area – in that the recovery was stronger and the time it took for the United States to recover to pre-crisis levels was shorter than in the European Union. Looking for the causes behind this divergence, some researchers have pointed to two main factors: that the United States is a federal state and it has a common budget, while the European Union is not and has not; and that, in the United States, markets are able to absorb shocks by means of various mechanisms.

With regard to the second issue (capital market integration), a number of studies show that United States capital markets are indeed well-integrated. Therefore, when a shock hits only one US state, a number of mechanisms allow for almost half of that shock to be absorbed, and the impact is eventually dispersed. The role of the federal budget in absorbing shocks is however very small. In the United States, at federal level, only unemployment insurance performs a stabilisation function and this is quite small. Compared with unemployment insurance in individual European Union Member States, the US federal level is less powerful when it comes to asymmetric shocks.

Domestic fiscal policy in the European Union is the most important tool when it comes to dealing with shocks. When it performs well, it can absorb around 50 % of the shock. The problem is that the capacity of fiscal policy to absorb shocks is cyclical. In other words, in the event of a major crisis, the effectiveness of fiscal policy collapses, exactly when it needs to work best (in that, countries are already constrained and cannot borrow more, exactly when they need to be able to do so).

Since the introduction of EMU (in 1998), a financial cycle that coincides with the crisis can be observed: the expansion phase in the 1998 to 2007 period when financial markets, and fiscal policies looked sound; and then a financial cycle downturn, when everything collapsed. In the case of the euro area, the above, as well as additional constraints imposed by the common currency, compounded the shocks experienced by peripheral countries, especially Spain, Ireland and Greece.

The question is, therefore, what can be done to avoid this kind of outcome? Dr Alcidi considers two aspects. First of all, those very large swings in financial markets must be prevented; and here, the role of the banking union (and therefore the importance of its completion) and of the various macroprudential policies adopted during the crisis is very important. However, while regulation can smooth the impact of a crisis, it can seldom help to avoid it. Therefore, this aspect must be completed by a second one, namely, action to guarantee the ability of Member States to play their stabilising role, through a central fiscal capacity (understood as a Euro area central automatic stabiliser).

In this context, the Dr Alcidi has demonstrated in a recent briefing, that the macroeconomic insurance role of United States federal fiscal stabilisers against asymmetric shocks has been largely overstated in the current debate, given that, despite the absence of a centralised euro area automatic stabiliser, euro area member states did more than previously expected to smooth the asymmetric shocks (as direct transfers to individuals are greater in the euro area[2] (about 20 %) than they are in the United States (about 10 %)). Instead, her research highlights **other features** that **should be taken into account** to explain the resilience of the United States during the crisis.

First of all, the discretionary nature of United States fiscal policy makes it better suited to deal with large US-wide recessions than state-specific shocks. This suggests that 'the main benefits from a euro area fiscal stabiliser could also arise in the face of large common output fluctuations'.

Furthermore, the coexistence of different private and public risk-sharing mechanisms implies that the low level of inter-state fiscal risk sharing could also be attributed to the effective action of other private or public insurance mechanisms that spread the consequences of shocks in the United States, and thereby reduced the need for inter-state fiscal stabilisation (see the conclusions of her second briefing, below). There is therefore a need to investigate further and do more to understand the potential interaction effects across private and public risk-sharing channels in the United States and the euro area.

Lastly, United States unemployment insurance shows that 'ex ante re-insurance of decentralised basic unemployment insurance schemes can be achieved such that it limits the degree of inter-state solidarity to a large extent, while allowing for outright transfers in the face of large shocks'.

In a second briefing, Dr Alcidi examines the more successful experience of the United States relative to the European Union in the face of the financial crisis by focusing on market-based risk-sharing,[3] which is more prevalent (particularly in terms of its private component) in the United States. The results show that while euro area capital markets performed better than previously expected in supplying risk-sharing until 2008, since the crisis they have not and, indeed, seem instead to amplify shocks rather than absorb them. Dr Alcidi notes that the better performance of the United States can be explained both by the higher persistence of shocks in the euro area compared with the United States and by the poor shock-absorption dynamics in the peripheral euro area countries, especially after 2010.

Dr Alcidi attributes the persistence of shocks in the euro area when compared with the United States to the fact that, in the euro area, total savings and borrowing[4] probably played a greater role than in the US, where the greater part was played by capital markets. Meanwhile, given that shock absorption through saving and borrowing does not usually work in response to persistent shocks, this might explain the increase in the unsmoothed share of the shock in the euro area. In addition to this, while in the EU fiscal policy was the only tool contributing to smoothing the effect of the shocks, in the United States other measures, such as the interventions of the Federal Deposit Insurance Corporation (FDIC) to protect deposits, or the action plan to avoid the default of Fannie Mae and Freddie Mac,[5] played in important role in strengthening the resilience of personal savings.

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Endnotes

[1] The author adds further that, in some cases – such as the Lender of Last Resort capacity for the ECB and the significant budgetary resource shifting between lower level government entities and the post-2004 EU budget – the European Union has been faster than the USA to introduce important innovations.

[2] Note: the authors use data for the 'EA11', that is, the Member States of the euro area minus the Baltic states, Slovakia and Slovenia for lack of data and Luxembourg, Malta and Cyprus 'which are very small and atypical'.

[3] The international risk-sharing framework is based on the assumption that 'country-specific shocks cannot be avoided, but their effects can be distributed over other countries (...) to reduce their impact on domestic consumption'.

[4] These include corporate, household and national budgetary savings.

[5] These government-sponsored enterprises went into administration in the autumn of 2008.

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