Fiscal integration at the time of Brexit: the way forward for the eurozone

- The Economic and Monetary Union (EMU) faces important decisions. Long-term stability requires deeper fiscal integration – and some corresponding degree of shared decision-making. However, there is currently a lack of public support for further integration on economic policy. This puts the eurozone in a quandary.
- On 16 September, the EU 27's leaders meet in Bratislava to discuss the way forward after Brexit. Within the EMU, the "big fix" is highly unlikely to come at this stage.
- We explore public sentiment towards integration through the lens of the Eurobarometer survey and find that the appetite for common policies is not dead. We also analyze the federal fiscal arrangements of the US and Switzerland to draw key lessons for eurozone fiscal integration.
- We argue that the way forward for fiscal integration is a gradualist approach that allows the size of the common budget to be enlarged on key issues such as security and defense, foreign and energy policy. Crucially, these are policy areas that continue to enjoy strong public support for deeper integration.
- To ensure some degree of countercyclicality, countries' contributions to this augmented common budget should be based both on GDP per-capita and some measure of cyclical conditions such as deviation of GDP growth from a trend. Whereas the allocation of funds should follow criteria that reflect the costs incurred by countries to reach the common objectives.

The need for fiscal integration

There is a general consensus that the institutional arrangements of the eurozone make it a flawed monetary union. One of the main reasons is the lack of a common fiscal policy. Under a currency union, countries lose the control of both the exchange rate and the interest rate, so they miss two key re-equilibrating macro variables. If this is not compensated by the capacity to achieve some fiscal adjustment, countries end up having very limited instruments to respond to negative shocks and external imbalances. Therefore, in order to improve and guarantee the long-term stability of the Economic and Monetary Union (EMU), some degree of fiscal integration is needed.

The result of the UK referendum and the rise of anti-European political parties in core countries signal a serious challenge to public support for further integration. Nevertheless, after Brexit, political leaders are putting the future of Europe high on their agenda. The meeting of Angela Merkel, François Hollande and Matteo Renzi in Ventotene, the place where the seeds of European integration were planted, was mostly symbolic, but nonetheless politically significant. Similarly, the first summit on the EU's future after Brexit, to be held in Bratislava on Friday, 16 September, will provide a relevant discussion platform.

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Paradoxically, the Brexit shock could trigger political momentum for gradual reforms that may lead towards reinvigorated integration in the coming years. In this context, the focus on fiscal integration is likely to surge. However, it will take time for the eurozone to fix its deep-rooted problems.

In this paper we identify the policy areas that offer the best opportunities for enhancing European integration and we look at some of the features of fiscal policy in the US and Switzerland. The experience of these two federal states is a good starting point to assess the scope for increasing fiscal integration in the EMU, obviously considering the unique political and economic constraints that characterize the euro area. We focus on the US because it provides the strongest benchmark of economic and political integration; and on Switzerland because, with its four languages and the differences across cantons, it can be seen as more closely resembling some of the features of the eurozone.

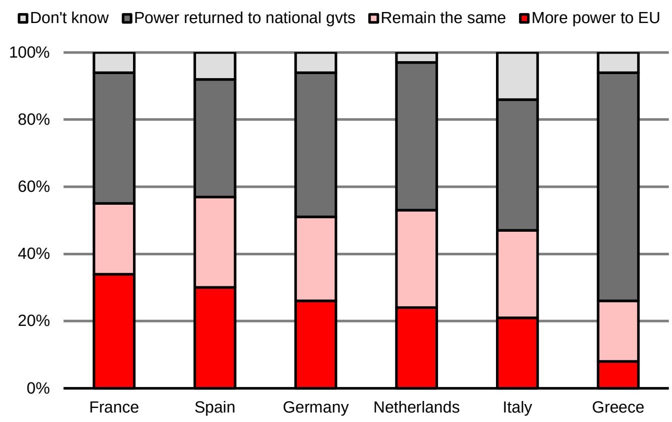
European integration from here: what is feasible, and what is not (yet)

The latest wave of integration among eurozone countries has mainly occurred on economic and financial grounds, reflecting a forced response to crises rather than deliberate decisions backed by political consensus. For example, this was the case of the EFSF/ESM, as well as the common bank supervision and recovery/resolution rules. Together with ECB action, this policy response has played an important role in calming financial markets and facilitating the return of economic growth in the weakest countries of the euro area.

However, we believe that “forced convergence” cannot represent a model for future integration. Appetite for a further sharing of national sovereignty is running low across the whole euro area, in both core counties and the periphery, although we note that in the largest member states about half of the population still wants the EU to retain or increase its current powers (Chart 1). In this context, pushing through integration measures that do not enjoy broad democratic legitimacy could backfire.

CHART 1: SUPPORT FOR FURTHER INTEGRATION LANGUISHES

How should the division of power between the EU and national governments change in the future?



Source: 2016 Spring Global Attitudes Survey, UniCredit Research

Importantly, the current state of affairs depicted in Chart 1 reflects only a general feeling, which masks a number of trends and determinants. The best way to identify these heterogeneous trends is to look at the Eurobarometer survey, which provides valuable information on how Europeans perceive EU objectives, policies and institutions.

The main caveat is that questions in the Eurobarometer series are often discontinued or rephrased in ways that do not allow full comparability over long time horizons.

Keeping these limitations in mind, we reach the key conclusion that appetite for deeper integration is not dead, although European citizens make a clear distinction between policy areas that should mainly be dealt with at the EU level and those that should be retained or returned to national authority. In the former camp, we find security/defense, foreign, environmental and energy policies – just to name a few. Data suggest that support for a common approach to these policies remains high and was generally unscathed by financial turmoil and economic hardship (see charts 2 and 3). Social security, taxation, labor market legislation and education are some of the policies belonging to the latter camp. This set of policies touches areas that Europeans traditionally consider as belonging to domestic sovereignty, either because they have substantial budgetary implications or because they tend to be identified with national culture and values.

CHART 2: SUPPORT FOR COMMON DEFENSE & SECURITY POLICY

Are you for or against a common defense and security policy?

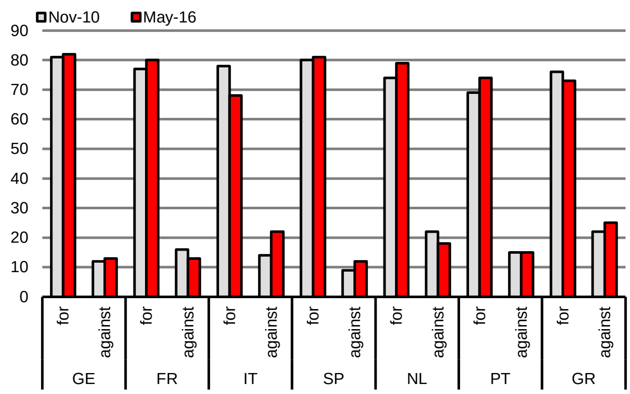
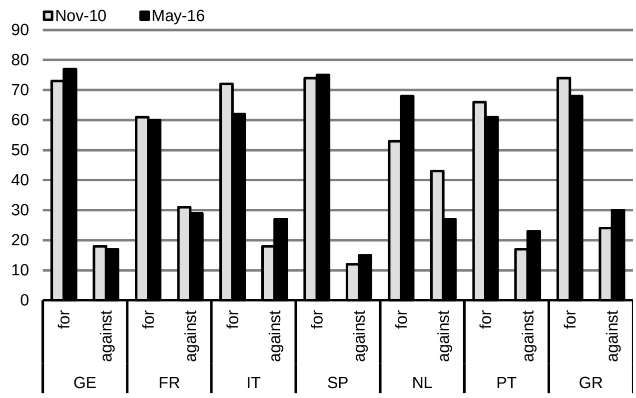


CHART 3: SUPPORT FOR COMMON FOREIGN POLICY

Are you for or against a common foreign policy?



Source: Eurobarometer, UniCredit Research

Data are not available to gauge the impact of the crisis on the assessment of policies that are generally perceived as more "domestic", given that Eurobarometer stopped asking such questions in 2010-11. However, we would expect a further erosion of the (already low) support for EU involvement, especially in the weaker countries, given how often "Eurocrats" have crossed the borders of national sovereignty on sensitive issues such as pensions, wages, taxation, workers' rights and public sector employment. It is likely that this increased dissatisfaction played a key role in explaining the broader attitude depicted in chart 1.

Overall, this highly heterogeneous pattern of popular support for EU involvement provides important indications as to the policy areas where some degree of fiscal integration is more likely to be achievable. In our view, any future roadmap towards deeper integration should reflect this, and take into account that any move towards increased fiscal sharing should be matched by a similar degree of shared decision-making.

It is not clear what minimum level of fiscal federalism would be required to make a currency union work. In the next section we look at the federal systems of the US and Switzerland and reach the conclusion that public opinion in the eurozone may be willing to accept a degree of federalism that resembles some of the features of the Swiss model.

Lessons from federal states

The US and Switzerland are two federal states that could inspire some of the features of a future effort to deepen fiscal integration in Europe. The following are the main lessons we draw from these examples:

- **Lesson 1: Economic fundamentals in eurozone countries are sufficiently homogenous for deeper fiscal integration. The disparities across eurozone states are comparable to those across US states and Swiss cantons.**

It is often argued that eurozone countries are too diverse in terms of income, unemployment and debt levels to share a common fiscal policy. In Table 1 we compare the disparities across eurozone countries (we consider EZ-12) with those of US states and Swiss cantons.

TABLE 1: HOW HETEROGENEOUS ARE EUROZONE COUNTRIES COMPARED TO US STATES AND SWISS CANTONS?

	Eurozone		United States		Switzerland ‡
Coefficient of variation (weighted)	**2007**	**2015**	**2007**	**2015**	**2013**
GDP per-capita	0.16	0.19	0.18	0.19	0.28
Unemployment	0.18	0.55	0.17	0.16	0.33
Debt per-capita	0.32	0.17	0.29	0.32	0.60
GDP, cumulated growth (from 2002)	0.43	0.78	0.43	0.52	0.45
Cumulated inflation (from 2002)	0.03	0.03	0.03~	0.04~	n.a.
Minimum					
GDP per-capita (EUR)	16,650	16,575	24,978	24,724	36,833
Unemployment (%)	4.2	4.6	2.6	2.7	0.9
Debt per-capita (EUR)	5,973	19,616	2,543	2,651	1,873
GDP, cumulative growth from 2002 (%)	6	-10	0	-1	1.8
Cumulative inflation from 2002 (%)	5.2	19.1	11.5	25.8	n.a.
Maximum					
GDP per-capita (EUR)	*38,383	*38,355	^54,079	^51,810	119,140
Unemployment (%)	9.1	25	7.1	6.9	5.6
Debt per-capita (EUR)	28,231	43,341	11,486	14,809	28,252
GDP, cumulative growth from 2002 (%)	110*	21*	32	50	18
Cumulative inflation from 2002 (%)	17.3	36	24.4	47	n.a.

*Excludes Luxembourg. ~Inflation dispersion for the US refers to metropolitan areas. ^Excludes the District of Columbia. ‡Official data on GDP and GDP per-capita by canton are available for 2008-13 only. Data on Swiss unemployment refer to 2002-15.

Source: Eurostat, BLS; Swiss Statistics; UniCredit Research

Our favorite measure of dispersion is the coefficient of variation weighted by population share.[1] We compare countries in 2007, just before the global financial crisis and in 2015 (or the latest data available). The comparison focuses on GDP per-capita, unemployment rate, debt per-capita, cumulative GDP growth since 2002 and cumulative inflation, which captures the degree of internal real exchange rate dispersion.[2] When we look at debt, we consider total public debt for eurozone countries and state/canton plus local debt for the US and Switzerland. We also report the minimum and maximum values of the variables to provide an idea of the interval of variation.[3] We express the minimum and maximum values of GDP per-capita and debt per-capita in euros also for the US and Switzerland: for FX conversion, we use the average 2002-15 exchange rate in order to neutralize short-term FX volatility.

[1] The coefficient of variation is the standard deviation divided by the average. Simply comparing the standard deviations across groups of countries characterized by different means would be inappropriate.
[2] We have also looked at debt-to-GDP and the results are very similar.
[3] When reporting the maximum of GDP per-capita for the eurozone and the US, we exclude Luxembourg and the District of Columbia, which are clear outliers with little population weight.

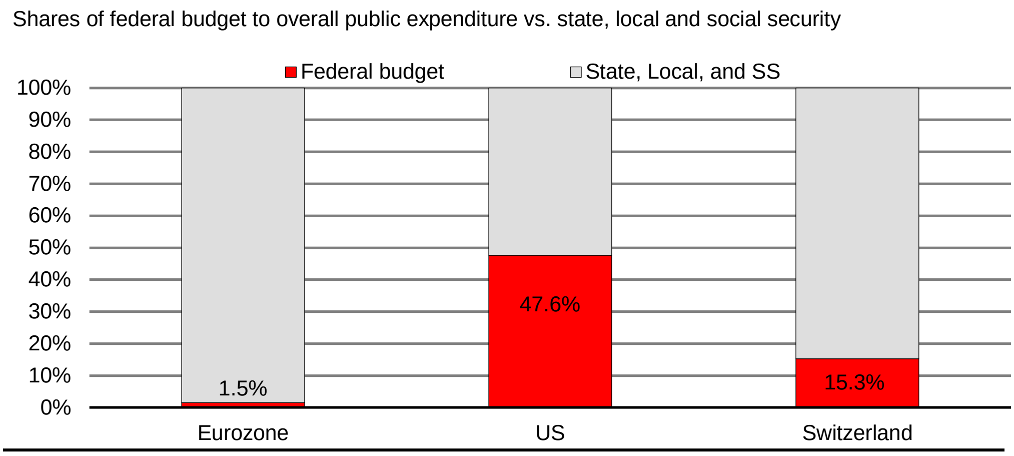
The table shows that, until the crisis, eurozone countries were as homogenous as the US states across all dimensions. After the global financial crisis, and the debt crisis in particular, the eurozone experienced an increasing dispersion of unemployment and cumulated GDP growth, which is now significantly higher than in the US and also Switzerland. Nevertheless, the overall degree of dispersion across eurozone countries in terms of GDP per-capita, debt, and inflation is still remarkably low compared with the US and Switzerland. However, in the case of Switzerland, it is important to bear in mind the range of values over which the coefficient of variation is computed. For instance, both the eurozone and Switzerland have high dispersion of unemployment, but in Switzerland this spans very low values between 0.9% and 5.6%.

In all these considerations, we have to take into account that the level of dispersion depends on the degree of fiscal integration itself. As a matter of fact, the increase of the dispersion of unemployment and GDP growth that we observe across eurozone countries after the crisis also stems from the lack of fiscal integration. For instance, the role the US federal budget plays in financing unemployment benefits represents a source of internal adjustment that the eurozone lacks.

- **Lesson 2**: **There is room for Europe to increase and reshape the common budget on key politically viable areas of spending.**

Chart 4 compares the proportion of the spending side of the EU budget in eurozone countries with that of the federal budget in the US and in Switzerland. The number for the EU28 would be about twice that of the eurozone, but still – unsurprisingly – extremely low in absolute terms.

CHART 4: LARGE DISPARITY IN THE SHARES OF FEDERAL BUDGETS



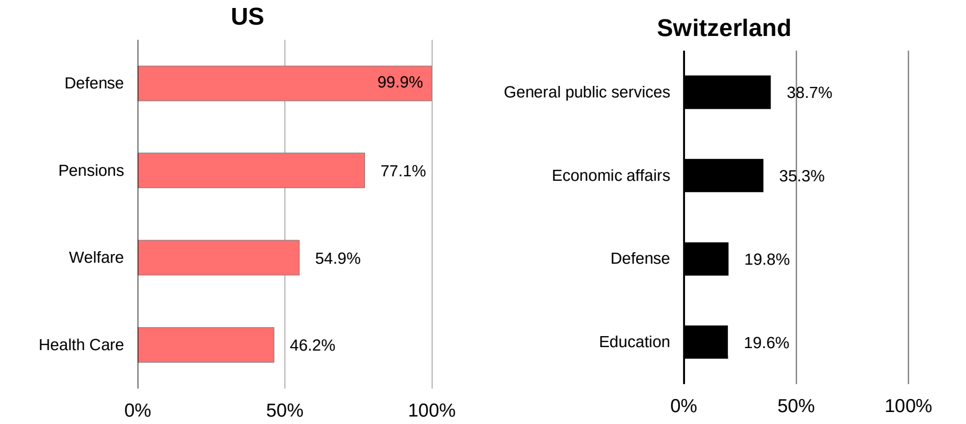
Source: Eurostat, BLS; Swiss Statistics; UniCredit Research

The US records the strongest federal features, with almost half of overall public spending covered by the federal budget. Switzerland is an interesting case, because its federal budget is comparatively small. Swiss federalism is even less pervasive considering that public spending as a share of GDP in Switzerland (34%) is lower than in the US (36%) and much lower than in the eurozone (50%). Overall, these data show that fiscal federalism is a broad concept, which in the real world may see varied implementation. This implies that, in order to increase fiscal integration to a level where fiscal policy can become a common tool of macro-stabilization, it is not necessary to raise a federal budget to the US level. A significantly lower threshold can be sufficient.

Chart 5 digs into the structure of federal outlays in the US and Switzerland. In the US, it is defense that enjoys the largest backing from the federal budget, which provides virtually all of the funding. The federal budget also accounts for a large share of pension outlays and about half of overall welfare and healthcare spending. Switzerland has a different structure for federal spending. Here, the federal budget mainly finances expenditure in general public services, especially for international relations and foreign policy, and in economic affairs, in particular agriculture, while other spending areas see a much more limited contribution. In the case of defense, and in contrast to the US, only 20% of Switzerland's overall expenditure comes from the federal budget.

CHART 5: WHAT IS THE FEDERAL BUDGET USED MORE INTENSIVELY FOR?

Ranking of the shares of federal budget in specific outlays



Source: Eurostat, BLS; Swiss Statistics; UniCredit Research

In the eurozone, the allocation of EU funds follows a completely different pattern from both the US and Switzerland. Chart 6 shows that biggest focus of the common budget that eurozone countries receive is targeted to agricultural policy (EUR 35bn); with such transfers accounting for about one quarter of the total EU budget and half of the budget that goes to EZ-12. Very little is spent on key common issues that could also benefit from economies of scale, such ICT and migration and asylum (less than EUR 300mn combined).

CHART 6: BIG EXPENDITURE ON AGRICULTURE….

EU outlays in EZ-12 (EUR mn, 2015)

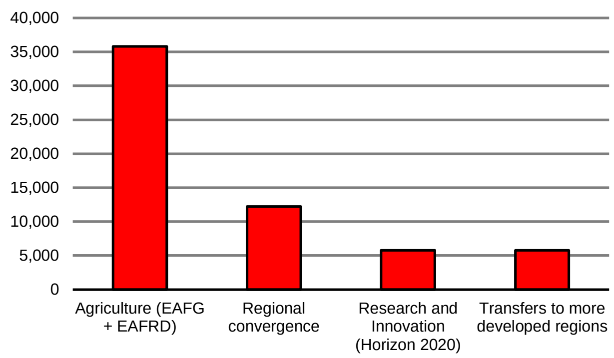
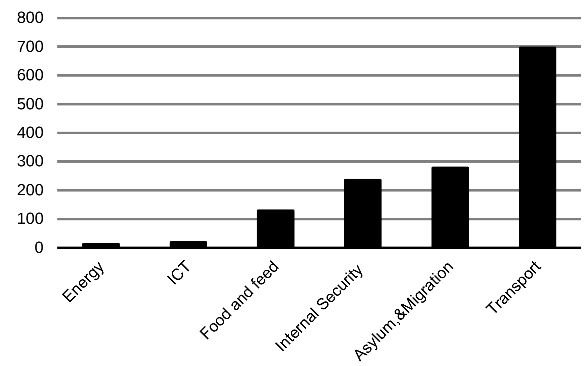


CHART 7: … BUT A FEW MILLIONS ON KEY COMMON ISSUES

EU outlays in EZ-12 (EUR mn, 2015)



Source: European Commission, UniCredit Research

All in all, there appears to be room for Europe to start increasing, or at least reshaping, its common budget in a way that better reflects new priorities. For example, we think that new geopolitical threats call for a step-up of the efforts towards a stronger common security and defense policy (CSDP), considering that currently only 0.3% of the EU budget is allocated to internal security issues. Energy and to some extent transports are other areas where common and coordinated expenditure is low at present, but where economies of scale can be obtained and, importantly, enjoy democratic legitimacy.

■ **Lesson 3**: **The stronger countercyclical component of federal fiscal integration comes from the payment rather than the expenditure side.**

In the US, the federal system of taxes and transfers provides both redistribution among states and business cycle stabilization. Redistribution implies that funds are transferred from richer to poorer states over the long run, while stabilization consists of support to states hit by temporary economic shocks. Redistribution does not automatically provide stabilization. This is an important distinction, because a permanent redistribution mechanism between eurozone member states (i.e. a transfer union) is not politically viable, while a stabilization mechanism has a better chance of being considered.

A paper from the San Francisco Fed[4] investigates how much stabilization in the US is achieved via taxes and how much via transfers. The main finding is that virtually all the (substantial) stabilization provided by the US system comes from the tax system, while federal government transfers to states – either to local governments or to the private sector – play a marginal role. This is also reflected in the strong correlation between federal tax payments and state income in chart 8, and by the weak correlation between federal transfers received and state income in chart 9. Other research tends to support these conclusions.

In practice, when a state's economy enters a downturn, stabilization is achieved by the decrease in the state's net contribution to the federal budget – tax payments minus federal transfers. When the state's economy recovers, the opposite occurs. The authors estimate that a decrease in a state's per capita personal income of one dollar leads to a 38-cent decrease in the state's net contribution to the federal budget, of which 36 cents is due to reduced tax payments and 2 cents comes from increased federal transfers.

CHART 8: STABILIZATION COMES FROM TAX CONTRIBUTIONS…

State income and federal tax contributions

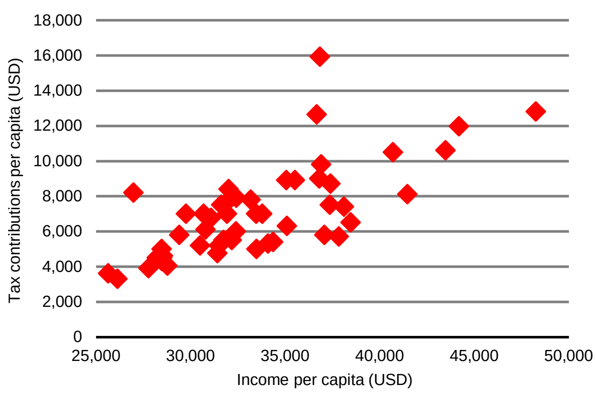
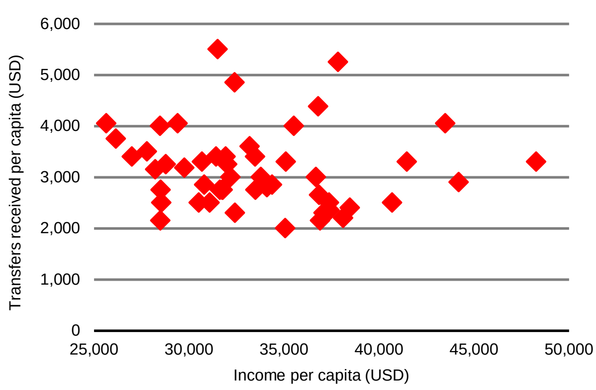


CHART 9: …NOT FROM TRANSFERS

State income and federal transfers received



Source: San Francisco Fed, UniCredit Research

[4] Malkin, I. and D.J.Wilson. 2013. "Taxes, Transfers, and State Economic Difference." *FRBSF Economic Letter*: 2013-36.

The implications of the US experience is that, if Europe were to move towards a common budget for a (presumably limited) set of policies, it would be worth exploring solutions to introduce countercyclical features in the national contributions to this budget that would allow some business cycle stabilization to be achieved among member states.

This could include a system based on a combination of **1.** GDP per-capita and **2.** some measure that captures the cyclical conditions of the economy, such as the deviation of GDP growth from trend, although we acknowledge that this may not be straightforward. For example, the European Commission's estimates of potential output and output gap have come under criticism by a number of countries complaining about the potentially misguided effects on their budgetary policy. That said, a well-designed system based on both criteria would ensure reasonable progressivity and some degree of countercyclicality.

- **Lesson 4**: **The allocation of funds should follow criteria that reflect the costs incurred by countries to reach the common objectives.**

In order to determine how the augmented outlays should be allocated across countries, the Swiss mechanism of "national fiscal equalization" provides interesting guidance. Switzerland has a redistribution scheme across cantons of CHF 4.9bn (about 1% of GDP). This scheme aims to reduce the financial inequalities across cantons that arise from **1.** the different financial resources available to cantons due to economic and population structure, such as the level of agriculture in a canton and its working-age population; and **2.** the different costs of implementing cantonal and federal obligations due to different geographical and socio-demographic factors, i.e. Alpine cantons face higher costs for maintaining basic infrastructure, whereas central cantons face higher welfare expenditure due to their larger share of elderly or migrant populations. The national fiscal equalization scheme identifies a series of key variables that generate unequal financial resources and expenditure and through a series of formulae determines the redistribution scheme across cantons.

What is interesting for the European experience is that a similar approach, especially the features outlined in point 2, could provide guidelines to determine the allocation of funds for common policy. This implies that, for each expenditure function, a set of variables that influences the costs incurred by countries to fulfill a common task should be determined. For instance, the length of external borders or the severity of the terrorist threat are some of the key variables that determine the cost faced by each country for internal security tasks. Identifying this set of variables and the algorithm that produces the allocation of funds would probably require a lengthy and difficult process of political bargaining among countries. The final result should ensure an allocation that fairly equilibrates the financial resources available across countries based on the costs that member states incur to reach the common objectives.

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