The path forward – possible scenarios

(draft, as of May 3rd, 2021, to be developed further)

Learning from our model countries as well as from difficulties during the lifetime of EMU could inspire us to come up with scenarios for reforms. This would be a hypothetical academic exercise, based on past experience and cross disciplinary debate. Obviously, it inevitably includes taking choices. Scenarios of that kind are not purely analytical in nature, but normative in the sense that they present options allowing for informed political decision taking.

I. Scenario one – the status quo

Guiding idea: The monetary, fiscal and economic system of the EU will be maintained as it is today. Only minor changes will be considered (no Treaty change, no major changes to secondary legislation). Which improvements would we nevertheless highly recommend?

Key aspects:

EU budget and fiscal policy

- The enlarged EU budget and the joint borrowing as foreseen under the Own Resources Decision and MFF 2020 are considered temporary crisis measures and will not be adopted permanently
- The ESM continues to operate as is (it will not be transformed into a European Monetary Fund that includes a common backstop for the Single Resolution Fund; no central bank license)
- The Banking Union without a European Deposit Insurance Scheme or a common fiscal backstop for the SRF

Economic policy

- Enhanced economic cooperation and macroeconomic surveillance taking into account lessons learned from past experiences (*room for improvement*)

Monetary Policy

- The ECB's mandate remains narrow and focused on price stability; in accordance with ECJ case law (unconventional) monetary policies are possible under certain circumstances

Democratic Legitimacy, Accountability, and Implementation

- Parliamentarism (EP, NPs, interparliamentary co-operation) and blurred lines of accountability and responsibility remain substantially unchanged
- The EU continues relying on the political willingness and administrative capacity of the MS
- Improving the effectiveness and functionality of the European Semester

II. Scenario two – a more mature EU fiscal federal system

Guiding idea: Taking into account the experiences of the fiscal federal systems of our project countries a series of steps are proposed to create a more mature European fiscal federal system. Which elements are considered indispensable in order to achieve substantive progress that would reduce the identified weaknesses? Minimum standards for fiscal federations?
The scenario could include amendments of the current EU constitution (indicated below by 'TC' – treaty change). Taking this hurdle into account could lead to 2 subsets of scenario II.

Key aspects:

EU budget and fiscal policy

- Complementing the Banking Union with a European Deposit Insurance Scheme and a common backstop for the SRF in order to break the fatal state-bank-nexus (*moral hazard issues should be addressed; also important not to create a fatal EU-bank-nexus*)
- Enhancing the fiscal capacity of the EU by allowing for EU taxes whose revenue will be solely allocated to the EU (*preferably choosing a tax base that is not local but a product of cross border trade*) and by making the option of joint borrowing a permanent feature of the own resources decision (debt break rules for the EU necessary?)
- Making parts of the revenue of the joint borrowing (see above) available to the MS for the purpose of debt restructuring either through earmarked grants or loans with favorable terms (*moral hazard issue needs to be addressed; clear rules, conditions and centralized decision-making likely necessary; TC*)
- (Gradual) aligning of EU competences and EU taxation (TC)
- Fiscal Equalization through improved Fund system (likely by adding a new fund and cutting ineffective or redundant ones)
- Reducing the application of the conditionality principle (but *moral hazard issue*)

Economic policy

- Introducing a European unemployment scheme that can be complemented by national schemes (*"free riding" should be addressed and prevented*)
- A European Economic and Finance Minister (TC – as the president of the Council of Finance Ministers, or at least of the Eurogroup finance ministers, and with enhanced responsibility for the EU budget)
- Reducing the fiscal bias in legal rules (EU law focuses heavily on fiscal issues potentially at the detriment of other sources of economic imbalance that are just as systemically relevant)

- Enhanced economic cooperation and macroeconomic surveillance taking into account lessons learned from past experiences
- More effective or no sanctions against excessive deficits (monetary fines are counterproductive; overcoming collective action problems and political maneuvering), e.g. EU veto right against obviously ‘unsound’ national budgets; increased EU participation in passing the national budget once an ‘expert court’ established excessive deficits or loss of prerogatives for duration of the violation
- Foster further capital market integration as a means to reduce risk through diversification (requires adequate infrastructure, e.g. a capable lender of last resort)

Monetary Policy

- Stabilizing function for the euro system either for the ECB (see below IV a) or for the EU (fiscal stabilization instruments)
- Lifting the prohibition for the ECB and national central banks of purchasing debt instruments directly from Member States? (as well as from the EU?)
- Adjusting the convergence criteria with a view to capital market integration (TC)

Democratic Legitimacy, Accountability, and Implementation

- There is a clear division of competencies and responsibilities between the EP and NPs

III. Scenario three – common features of functioning fiscal federal systems

Guiding idea: Adopting the most important features of functioning fiscal federal systems that all or the majority of our project countries have in common; taking into account the lessons that can be drawn from their experience. Is there a common denominator of fiscal federalism?

Key aspects:

EU budget and fiscal policy

- Enhancing the fiscal capacity of the EU by allowing for EU taxes whose revenue will be solely allocated to the EU (*preferably choosing a tax base that is not local but a product of cross border trade*) and by making the option of joint borrowing a permanent feature of the own resources decision (debt break rules for the EU necessary?)
- Dissolving the ESM, instead shifting its tasks to the Commission (financed by EU budget/debt instruments) which shall be accountable for its financial aid operations to the European Parliament (TC)

Economic policy

- Introducing a European unemployment scheme that can be complemented by national schemes (*free riding" should be addressed and prevented*)
- Foster further capital market integration as a means to reduce risk through diversification (requires adequate infrastructure, e.g. a capable lender of last resort)

Monetary Policy

- Abolishing the prohibition on monetary financing (TC)

Democratic Legitimacy, Accountability, and Implementation

- Enhancing the role and the powers of the EP and related issues (quality of representation, functioning of the party system at the EU level etc.)

IV. Scenario four – scaling back to the minimum necessary crisis intervention

Guiding idea: return to the pre-crisis consensus with a hard currency, low inflation, sustainable public finances, moderate economic coordination, a strong internal market with competition among Member States and national responsibility and accountability for national economic and fiscal choices. However, in light of recent experiences the need for a stabilizing force is acknowledged. This can be achieved either by allowing the ECB to fulfill a stabilizing role within the monetary union in order to make up for tradeoffs related to the loss of national monetary sovereignty (scenario IV a) or by introducing a limited fiscal stabilizing mechanism (scenario IV b).

Key aspects **scenario IV a**:

EU budget and fiscal policy

- Dissolving the ESM
- The enlarged EU budget and the joint borrowing as foreseen under the Own Resources Decision and MFF 2020 are considered temporary crisis measures and will not be adopted permanently
- The Banking Union remains, if necessary to be complemented by a common backstop for the SRF and/or supervisory powers to be shifted from the ECB either to the Commission or to existing agencies (eg. EBA, ESMA etc.)

Economic policy

- Strict adherence to the no-bail-out rule
- More effective sanctions (monetary fines are counterproductive; overcoming collective action problems and political maneuvering), e.g. EU veto right against obviously 'unsound' national budgets; increased EU participation in passing the national budget once an 'expert court' established excessive deficits or loss of prerogatives for duration of the violation
- Foster further capital and financial market integration as a means to reduce risk through diversification (requires adequate infrastructure, e.g. a capable lender of last resort)

Monetary Policy

- Transparency about the need for and stabilizing effect of monetary policy
- Broadening the mandate of the ECB accordingly (TC)

Democratic Legitimacy, Accountability, and Implementation

- Adequate channels of national parliamentary accountability, accompanied by the EP
- Enhanced national administrative capacity

Key aspects **scenario IV b**:

EU budget and fiscal policy

- Transparency about the need for a stabilizing mechanism
- Dissolving or repurposing the ESM into a new, limited fiscal stabilizing mechanism (financial aid in form of grants to stabilize during grave economic downturn, to be stopped once economy stabilizes regardless of level at which it finally stabilizes) (*moral hazard issues; automatic stabilization or discretionary, unconditional or conditional?)*
- The enlarged EU budget and the joint borrowing as foreseen under the Own Resources Decision and MFF 2020 are considered temporary crisis measures and will not be adopted permanently
- Banking Union? (*risk pooling but perhaps at the expense of national accountability and danger of uniform policies that may facilitate contagion during crisis*)

Economic policy

- More effective sanctions (*monetary fines are counterproductive; overcoming collective action problems and political maneuvering*), e.g. EU veto right against obviously 'unsound' national budgets; increased EU participation in passing the national budget once an 'expert court' established excessive deficits or loss of prerogatives for duration of the violation
- Foster further capital and financial market integration as a means to reduce risk through diversification (requires adequate infrastructure, e.g. a capable lender of last resort (in this sub-scenario this role would have to be taken on by the stabilizing mechanism))

Monetary Policy

- Restricting the mandate of the ECB (less leeway for unconventional policies, assessment of accepted collateral in line with actual status of Member States) (*risk of aggravating the situation in case the stabilizing and other preventive mechanisms fail; decision about assessment of collateral may become highly political)*

Democratic Legitimacy, Accountability, and Implementation

- Adequate channels of national parliamentary accountability, accompanied by the EP

V. Scenario five – Utopia, the perfect fiscal federal system

Guiding idea: let us rethink fiscal federalism and come up with a system as close to 'ideal' as possible without being beholden to existing structures. Feel free to add your favorite 'out-of-the-box solution'!

- ….
- Sovereign debt restructuring procedure under the jurisdiction of the ECJ (would likely require a central lender of last resort for the duration of the procedure in order to guarantee the continued provision of state services and functions)
- …