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A Eurozone Budget – For Which Purposes Exactly?

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INTRODUCTION

The fact that monetary policy in the euro area has been centralized, while fiscal policy has essentially remained a national responsibility, is what Anglo-Saxon economists in particular have described as the original sin of the European Economic and Monetary Union (EMU). With reference to the theory of optimal currency areas, there is a plea for more fiscal integration in the EMU. The Glienicke Group (2013) as well as Dolls et al. (2014) can be mentioned here as examples from the field of science. However, enhanced fiscal integration in the EMU is not a panacea, and could result in considerable drawbacks under the current political circumstances. The following is a brief overview of some of the proposed fiscal policy instruments at EMU level, in addition to a general evaluation.

To begin with, there are proposals for far-reaching institutional changes to the fiscal architecture of the EMU, which include the creation of a European finance minister who could avail of a fiscal capacity, or the introduction of Eurobonds based on joint liability as a means for member states to raise funds based on a safe asset (Busch and Matthes 2012). Such proposals would help EMU countries finance their budgets, but also incur the risk of overspending at the expense of other member states.

To avoid moral hazard, EMU countries would have to surrender (part of their) fiscal sovereignty to the central level. For example, a European finance minister would have to be able to prevent national parliaments from implementing unsustainable public budgets. However, there is no political willingness in EMU member states to go this far. This limits the scope of any further fiscal integration in Europe, as liability and control have to go hand in hand. In the following, the focus is thus laid on less far-reaching proposals for a central fiscal capacity at euro area level. Nevertheless, the president of the Eurogroup has revived the discussion about a finance minister for the euro area in the context of the discussion about a eurozone budget that will be discussed in the following.

The meaning of a "central fiscal capacity" is not clearly defined. According to mainstream proposals, it is often intended to foster macroeconomic stability should individual EMU countries be hit by an asymmetric shock. This is regularly justified by the argument that the requirements of the Stability and Growth Pact (SGP) would impose fiscal constraints on individual member states so that they would not be able to react adequately in the event of an economic downturn. In addition, in the context of the optimum currency area (OCA) theory there is the argument that central fiscal stabilization is needed in a monetary union because individual member states can no longer devalue their currency in order to regain lost competitiveness. It is also no longer possible for them to manage their own monetary policy.

Macroeconomic stabilization could in principle be achieved in different ways through a common fiscal capacity in the euro area. Two such methods are deemed most suitable for fighting recessions (European Commission 2017a). First, the fiscal capacity could help stabilize public investment expenditure, which is particularly at risk of being cut in an economic downturn. Second, a fiscal capacity could potentially function as an unemployment reinsurance system and could reimburse part of the rising expenditure on unemployment benefits in the member states.

There are different options as to how to organize a potential fiscal capacity: it could be based on an independent budget of only EMU member states, or it could be broadly based on the budget of the EU-28 with special assignments for EMU member states, potentially in the form of a special budget line. Partly depending on this decision, there are also various options as to how the financial resources for a fiscal capacity can be raised: resources from the EU budget, special contributions by EMU member states (in relation to their GNI), and new sources of revenue stemming from new taxes. Financing through borrowing can also be considered, at least in principle. Obviously, any decisions regarding the organization and the financing mechanism would have consequences for the governance structure of a fiscal capacity, i.e., for whoever is entitled to decide on the allocation of funds.

STATE OF THE POLITICAL DEBATE ON A FISCAL CAPACITY AT EMU LEVEL

Proposals by the European Commission on an EISF

Apart from proposals from academia, the idea of a fiscal capacity has also been raised in the political arena. At EU level, important proposals for the creation of a fiscal capacity in recent years include the 2015 Five Presidents' report (Juncker 2015), the 2017 White Paper of the European Commission (2017b), and the related Reflection Paper on the deepening of the EMU (European Commission 2017a). More specific proposals were made in the Commission's Roadmap for deepening the EMU (the so-called 'Saint Nicholas' package of December 2017) and in the Commission's proposals for the Multiannual Financial Framework (MFF) for the years 2021 to 2027 (European Commission 2018). In the latter, the Commission proposes several instruments that could be part of a fiscal capacity for the euro area (for an evaluation, see Hüther and Matthes 2018; Demary et al. 2018).

As a fiscal stabilization facility against macroeconomic shocks, a European Investment Stabilisation Facility (EISF) is put forward. In the event of an asymmetric shock, a member state could receive a (back-to-back) loan in order to stabilize public investment. The Commission defines an asymmetric shock as a situation in which the quarterly seasonally adjusted unemployment rate has risen by more than one percentage point compared with the previous quarter, and is above the average of the previous 60 quarters. Moreover, the proposal specifies particular access conditions in order to mitigate moral hazard concerns. The precondition for access to the EISF is that the economic policy of the applicant member state has complied with the rules of the EU's economic and fiscal surveillance framework in the period prior to the shock. This concept of ex ante conditionality appears reasonable and can be distinguished from the ex post conditionality applied in the context of a full ESM program, which requires a reform program as a precondition for financial support.

In terms of financing, the Commission aims to allocate EUR 30 billion to the EISF and establish the fund primarily within the EU budget, but outside the EU budget's expenditure ceilings proposed for each policy area. The proposal sees this EUR 30 billion used for loans which are guaranteed by the EU budget. The Commission would borrow the loans on the capital market and would lend them to the applicant state that has been hit by an asymmetric shock (back-to-back loan). Although the EU may not finance itself through loans, it may take out back-to-back loans within the margin between the budgetary framework and the own resources ceiling. The Commission's borrowing capacity is therefore limited. The Commission's proposal also contains a small transfer component in the form of interest subsidies to cover the costs of borrowing for the crisis state, but probably only after the loan has been repaid.

The Commission has also proposed other components of a potential fiscal capacity that focus more on structural policy aspects. This pertains to a EUR 25 billion Reform Support Programme for the new MFF, financed from the EU budget, to assist member states with institutional, administrative, and growth-enhancing structural reforms. The Reform Support Programme consists of three parts: a Reform Delivery Tool (EUR 22 billion) to foster and financially support reforms in the context of the European Semester; a technical support instrument (EUR 0.84 billion) to assist specifically with the administrative implementation of reforms; and a convergence facility (EUR 2.16 billion) to help "EMU outs" to prepare for the EMU.

French-German Initiatives and the Reaction of the Eurogroup

On a parallel track, the political process towards more fiscal integration in the EMU has been driven by France and Germany. Even though the Commission's proposals drew on important elements of the positions of both countries, several joint proposals of France and Germany exerted a more direct influence on the decision-making process of the Eurogroup and the Euro Summit.

It is striking that the French-German compromise on more fiscal integration in the EMU involved a major change in the German position on EMU reform. Previously, the need for a central fiscal stabilization function to sustain the EMU was broadly and constantly denied in conservative circles in Berlin. However, in the course of late 2017/early 2018, the position of the German Chancellor and of major parts of the CDU/CSU seemed to shift. This appears to be mainly due to the French president's strongly pro-European efforts and initiatives. In fact, Emmanuel Macron strongly favors an EMU-19 budget with a sizeable central fiscal stabilization function, particularly to support investment in economic downturns. With his impressive election campaign and particularly with his now famous Sorbonne speech in September 2017, Macron held out a hand that pro-European conservatives in Germany could not completely refuse to take. Thus, in the French-German duet, Macron clearly set the tone.

The change of course in the German position manifested itself in the coalition agreement of March 2018 (CDU/CSU/SPD 2018). On European issues, the agreement was interpreted to be a concession on the part of the CDU/CSU to the more integration-friendly SPD. The agreement advocates specific financial resources for "economic stabilization" and "social convergence," as well as "support for structural reforms in the euro area," which could be the "starting point for a future investment budget" of the euro area. A further milestone was an extensive newspaper interview with Angela Merkel (2018) on European challenges in early June 2018, in which she also briefly set out her views on EMU stabilization. By arguing for a short-term credit facility of the ESM, she also implicitly recognized the need for fiscal stabilization instruments. Moreover, she reiterated Macron's idea of an EMU budget for investment purposes. However, in her view, such a budget should focus not on macroeconomic stabilization but on mitigating structural weaknesses by fostering competitiveness and convergence.

This was followed by the formal French-German initiative of the Meseberg Declaration in mid-June 2018 (Bundesregierung 2018), together with a joint paper of both finance ministries (Nonpaper 2018). By that time, Paris had managed to get Berlin to agree to a stabilization function as a part of a "Eurozone budget within the framework of the European Union to promote competitiveness, convergence, and stabilization in the euro area, starting in 2021." The finance ministries' roadmap for the euro area put forward financing options such as, among others, new taxes on financial transactions or on the digital economy. It also included a vague proposal for a European Unemployment Stabilisation Fund. This suggestion was understood to be a pet pro-

ject of the German finance minister, in his attempt to also set the agenda in Germany (besides the Chancellor) and to position himself as sufficiently integration-friendly within the SPD.

The German-French proposal for a "Eurozone budget for competitiveness, convergence, and stabilization" was of major importance to the political debate. It was reiterated just a few days later in a letter from Eurogroup President Mário Centeno to the Euro Summit that took place at the end of June (Centeno 2018). However, Centeno had to report that differences remained on this issue among the finance ministers of the Eurogroup (in inclusive format, including EMU outs except the UK). Obviously, the initiative of the French-German tandem – which is usually considered to set the agenda – was met with considerable resistance.

In fact, a new grouping dubbed the Hanseatic League 2.0 had emerged in the political arena towards the end of 2017 (Financial Times 2017). Now led by the Netherlands, it includes, among others, Ireland, Austria, and the Baltic countries. The emergence of this group can (also) be understood as a reaction to the German government's change of course on EMU issues (and to Brexit). In the past, most smaller EMU members of the Hanseatic group supported Germany's opposition to more fiscal integration for stabilization purposes. From this comfortable position, hiding behind Germany's broad shoulders, they now had to step to the fore and stand up for their arguments. As a result of strong opposition from the Hanseatic League 2.0, particularly from the Netherlands, the Eurogroup report of early December 2018 to the Euro Summit in mid-December 2018 eliminated the stabilization function from the purposes of the Eurozone budget and deferred it to technical discussions alone (Eurogroup 2018).

Budgetary Instrument for Convergence and Competitiveness (BICC)

This left only convergence and competitiveness as objectives for the envisioned EMU budget. Accordingly, the Euro Summit in December 2018 tasked the Eurogroup to design the features of a Budgetary Instrument for Convergence and Competitiveness (BICC) within the context of the MFF.

Again, a (leaked) French-German proposal (Non-paper 2019) set the tone for the discussions.

However, no common position has yet emerged regarding financing aspects. The BICC will be part of the EU budget, but France in particular intends to enlarge the funding base through regular contributions from EMU members only. With this step, France also intends to open the door for autonomous decision making of EMU members. This would likely require an Intergovernmental Agreement (IGA). Even though Germany resents France's EMU-only approach and insists on keeping fiscal integration open to all EU members, Berlin has broadly supported the French proposal. However, other finance ministers in the Eurogroup do not seem convinced of the need for an IGA. Based on the endorsement of the progress achieved so far by the Euro Summit in June 2019, the Eurogroup will thus strive to achieve agreement in autumn 2019 so that the BICC can be included in the final phase of the MFF negotiations.

EVALUATION OF SPECIFIC PROPOSALS FOR MORE FISCAL INTEGRATION

Central Fiscal Stabilization Instrument

Concerning a possible central fiscal stabilization mechanism in the EMU, we share the scepticism of the Hanseatic League 2.0 for various reasons. The arguments brought forward to justify such an instrument do not appear to be sufficiently convincing (Matthes, Iara, and Busch 2016).

First, to justify a central fiscal stabilization instrument with the alleged limited flexibility of the SGP appears problematic. The SGP prescribes a balanced budget in normal times, in principle, so in a crisis there is ample fiscal space for national countercyclical fiscal policy up to the fiscal deficit ceiling of 3 percent of GDP. Moreover, in crisis situations, the 3 percent criterion is not sacrosanct. Thus, the SGP leaves plenty of room for fiscal maneuver to combat economic crises. Indeed, from the point of view of the subsidiarity principle, fiscal economic stabilization is primarily a national task (Diermeier et al. 2018). In the recent crisis, fiscal space was not available in the downturn to some countries, for the precise reason that they had not adhered to the SGP rules beforehand (it was also due to the impact of the global financial crisis). To justify a greater degree of common risk sharing without adherence to the SGP is highly questionable.

Second, from the economic perspective of the OCA theory, the EMU appears to be in better shape than its reputation suggests, at least on closer inspection (Matthes and Iara 2017).

Structural reforms in the southern EMU countries have reduced EMU countries' heterogeneity in terms of the key aspect of labor and product market regulation.

The one-size-does-not-fit-all problem of monetary policy, with its problematic real interest rate effect, can be tackled in a country-specific manner by means of macroprudential policies that have proved to be effective.

The adjustment capacities to asymmetric shocks also appear better than commonly suggested. Structural reforms have enhanced price and wage flexibility. Indeed, by drawing on micro-data, nominal and real wage flexibility has been shown to be as high in southern European countries as it is in the United Kingdom and the reaction of wage policy to unemployment broadly as high as in the United States (Verdugo 2016). Equally, short-term labor mobility has been proved to be as high as it is in the United States in the recent crisis (Beers et al. 2014).

However, even though the OCA properties of the EMU appear better than commonly suggested, there is no guarantee that they will suffice to ensure the EMU's future sustainability. Indeed, high public debt burdens render some EMU countries vulnerable to economic shocks. Therefore, it appears reasonable to introduce an ESM-light instrument based on sound and reliable ex ante conditionality, as has been suggested (Matthes 2017) and as the Eurogroup proposed in December 2018. On top of this ESM-based stabilization tool, it appears that further fiscal stabilization tools in connection with a eurozone budget are not indispensable.

Upon final analysis, the question of whether or not an additional stabilization instrument for a greater degree of risk sharing among EMU members should be recommended from an economic point of view depends on the degree of risk aversion. When deciding on this issue, political considerations also come into play. As already pointed out in the introduction, more fiscal integration (or risk insurance) always incurs the risk of moral hazard, i.e., national misconduct. For example, the existence of a common unemployment insurance system could reduce incentives for member states to make their national labor markets more resilient. Moreover, the possibility of unintended permanent transfers has to be considered. It is true, that most proposals do not intend a central fiscal stabilization instrument in the EMU to redistribute financial resources among EMU members in the long term. However, there is no way of saying whether this goal can be achieved.

Intelligent rules for new instruments might be imagined to mitigate both the risks of moral hazard and of permanent transfers. However, there is no guarantee that such rules would be followed in all circumstances due to time inconsistency problems. Experience to date with Europe's fiscal rules is not particularly encouraging in this respect, as they involve large degrees of flexibility and discretion.

Budgetary Instrument for Convergence and Competitiveness

It is true that the EMU lacks income convergence and that certain EMU countries lack competitiveness. Reforms to tackle these weaknesses would surely improve the functioning of the EMU. However, it is questionable whether a country should receive money for structural reforms from the EU if the measures are in the member state's own interest. A certain justification might lie in the fact that some structural reforms incur economic or political costs that reduce the incentive for policy makers to undertake such reforms. However, it is very difficult to quantify such costs. Moreover, the danger is that offering money for reforms reduces the ownership of structural reforms. In other words, a reform might be undertaken simply because money is being made available from Brussels, even though the respective national government is not convinced that the reform is justified. This could pose risks for the operational implementation and sustainability of reforms in the medium term. Moreover, the BICC runs the risk of subsidizing reforms that would have been carried out anyway.

The BICC focuses on the structural weaknesses of the EMU countries, as do the existing structural and regional policies of the EU. The focus of the BICC on investment also coincides with the InvestEU project and the EFSI. Thus, there is a risk of developing inefficient twin structures. For example, financial support is also foreseen for EMU outs to help them prepare for joining the EMU. Yet the Cohesion Fund is already designed to help prepare for the euro. In fact, in 2017 alone, the EMU outs received around EUR 5.6 billion from the Cohesion Fund, while the other member states that met the eligibility criteria received EUR 1.5 billion. In contrast, the Commission has proposed a budget of EUR 2.16 billion for the above-mentioned convergence facility for the entire seven-year funding period of the next MFF.

The redundancy of conflicting twin structures could be partially mitigated if the BICC focused especially on fostering innovation in lagging countries, or if the BICC provided more flexibility in the shorter term to change the allocation of resources in line with changing priorities. However, another tricky problem is that it is unclear how the BICC could avoid the kind of waste and lack of effectiveness from which the EU's structural funds suffer.

Various arguments come into play concerning financing aspects. If the BICC were based on grants, the financial needs would be larger than if it relied on loans. Basing the BICC within the MFF of the EU budget tends to limit its financial scope. This would be all the more true if, in the course of current MFF negotiations, funds for structural policy programs were reduced in substitution for the BICC. Nevertheless, introducing the BICC opens the door for potential future extensions of its financing.

Overall, there is a risk that in order to accept even the briefest shake of Macron's hand, a false compromise will be reached by creating a new instrument that is redundant, overly bureaucratic, and lacking in effectiveness. The BICC needs to be very cleverly designed if it is to avoid these potential drawbacks.

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