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The Debate on Eurozone Fiscal Capacity

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On December 2012, the then President of the European Council Herman Van Rompuy proposed in "*Towards a Genuine Economic and Monetary Union*" the creation of a budget for the eurozone[1]. At this stage fiscal capacity was conceived of as a financial support to countries who had agreed to implement structural reforms as recommended by the European Commission.

Later, fiscal capacity assumed different understandings, either as a true stabilisation mechanism against large asymmetric shocks, or as a fiscal backstop to the banking union, as a resolution fund common to eurozone countries.

Some doubts can be raised about the fiscal capacity of the eurozone as a support for reform. Is it possible to restrict the commitment to making structural reforms to the eurozone countries only, given that the European Semester, which includes national reform programs, is a procedure for all Member States (MS) of the European Union? As regards the fiscal backstop, although completing the banking union is considered by some observers to be a priority that alone would be enough to stabilise the eurozone, for others a stabilisation component is still necessary, given the pro-cyclicality of financial markets in times of crisis.

Macroeconomic stabilisation is therefore the most consistent form of fiscal capacity for the eurozone, for various reasons: the impossibility for a MS to resort to exchange rate devaluation; the limited scope of monetary policy beyond a certain level, through the management of the interest rate and unconventional monetary policies; the rules of fiscal consolidation that weigh on national budgets.

Various proposals have been presented for a stabilisation function, at different levels (from institutions, national governments and among academics). They all focus on making the eurozone more resilient against shock, but they disagree, for instance, on the mechanism through which to collect and distribute resources, conditionality on access and use, use of resources and duration.

1. Proposals for a stabilisation function

The main proposals advanced so far can be divided into three categories, according to the mechanism through which resources are collected and distributed, which have elements of overlap:

a) borrowing - lending scheme: funds are raised on the market to then be transferred in the form of loans;

b) contribution - transfer scheme: this is an insurance mechanism (a rainy-day fund) which aims to stabilise cyclical divergences between countries;

c) own resources - public goods scheme: national contributions or European taxes are used to finance both stabilisation and a comprehensive program of common public goods.

a) borrowing - lending scheme

• The European Commission's proposal

In order to support public investment in countries hit by severe asymmetric shocks the European Commission has proposed creating a budget line within the EU budget, called the "economic and monetary union", which includes a European Investment Stabilisation Function (EISF)[2]. The proposed tool comprises a mixed scheme – a loan element and a grant element. In the first case, the Commission makes back-to-back loans, up to a total of €30 billion: on the one hand it borrows resources on the market, thanks to guarantees provided by the budget, and on the other it lends to the requesting country, on the same conditions, thus acting as an intermediary between the market and the final recipient.

The second element is a grant to support interest expenditure and it is created through a new Stabilisation Support Fund (SSF), which effectively exempts the country from the payment of interest on the loan received. The SSF will be funded by own resources such as seigniorage profits of the ECB amounting to €600 million a year, and, although outside the EU budget, it will be administered by the Commission. This component is different from the loan, being a non-repayable grant: over time it is expected that the SSF may evolve into a voluntary insurance mechanism, supplied by national contributions or other resources, in which the future European monetary fund could play a role.

Support requested by the MS would be provided subject to conditionality, both ex-ante, such as compliance with tax rules, and ex-post, i.e. the amount the MS will have to finance public investments, whose level should not fall with respect to the average value of the five previous years.

b) contribution - transfer scheme

- **The IMF's proposal**

Some IMF economists propose a fund fed by regular annual contributions from member countries to build assets in good times and make transfers to MS in period of crisis[3]. It would also have a borrowing capacity for use in the event of exceptionally large shocks, whenever reserves are depleted and new ones required. The level of annual contributions deemed necessary is estimated at around 0.35% of GDP.

In order to guarantee symmetry, and avoid the risk of permanent transfers (from "net contributor" to "net recipient" countries) rules are foreseen, such as making transfers on the basis of cyclical fluctuations – not the structural situation – of unemployment; calculate the contributions to be paid on the basis of the previous use of the fund (a sort of malus/bonus clause); limit the accumulation of transfers and / or contributions over time.

The transfer would be given on the basis of compliance with fiscal rules, However, non-compliance would not cause a suspension of the transfer, but just a reduction. As a rule, there are no ex-post conditions on the use of transfers, because each country has to examine its fiscal policy priorities, thus both public investment or unemployment benefits are possible.

- **The 14 French-German economists proposal**

One element of a comprehensive reform proposal set out by a group of Franco-German economists concerns the stabilisation

of the euro zone[4]. The idea is similar to that of the IMF, but less supportive, for two reasons: 1) it provides a reinsurance fund against asymmetric shocks in the labour market, whereby the main effort is supported by the national government, while the fund steps in only above a certain threshold and covers only a part of the surplus; 2) the fund gives transfers until exhausted, beyond which there is no borrowing capacity.

National contributions would be made each year, for a total annual amount of 0.1% of GDP. To avoid moral hazard behaviour, each country would contribute based on the probability of having to resort to the fund: the higher the probability, the greater the contribution. If a country found itself having to contribute a lot, due to the fact that it had often had to resort to the fund, then it could evaluate the expediency of participating in it. There would be both ex-ante conditionality, such as compliance with fiscal rules, and ex-post conditionality, i.e. the financing of active or passive policies relating to unemployment or of public investment.

- **The Italian proposal**

In 2015 the Italian government presented a European scheme of unemployment benefits to dampen the effect that major shocks can have on workers[5]. Their aim was to prevent an increase in cyclical unemployment from turning into structural unemployment, for which countries would have to respond through domestic reforms. The fund would be financed by contributions from member states, for a total amount of 0.5% of the eurozone GDP to be used in the event of asymmetric shocks, and would provide loans, not grants, to be repaid when macroeconomic conditions are improved.

The proposal also provided that in case of symmetrical shocks the fund could be financed by issuing debt securities, with low risk and low yield. Conditionality would concern the use of loans only: the funds would be used for policies to support the unemployed, in particular unemployment benefits, to provide limited coverage (duration of 6-8 months, for 40% of the salary previously received).

c) own resources - public goods scheme

• Macron's proposal

The European project of President Emmanuel Macron presented at the La Sorbonne University in Paris is broad and very ambitious: it aims at a "sovereign, united and democratic" Europe, able to face global challenges and protect the European values of democracy and equity[6]. The eurozone is considered to be the driving force behind the integration process and must therefore be made stronger and more attractive. With this in mind, Macron, in addition to talking about economic stabilisation, introduced a fourth sense of the fiscal capacity of the eurozone, i.e. support for investment, not only in research and innovation, but above all for common public goods such as security, management of migration, and environmental transition.

The planned tool would be a separate eurozone budget, financed by European taxes, for example in the digital, environmental and corporate sectors, and managed by a eurozone Finance minister, placed under parliamentary control at European level. Details on activation mechanisms, conditionality and duration were not provided. However, access to the eurozone budget was linked to compliance with common social and tax rules in order to combat social dumping.

2. The contrary positions

In addition to these proposals, other positions on fiscal capacity, more or less articulated and flexible, have appeared in the debate. Although less developed they are very clear in adopting a clear contrary stance to the progress of the euro area. Noteworthy among these are:

• Eight countries of Northern Europe

A group of eight countries (Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, the Netherlands and Sweden) has openly opposed further transfers of sovereignty to the European level[7]. Although within the group there are also countries outside the euro, their demand is that eurozone reform be discussed in an inclusive format, i.e. extended to the whole of the EU, because "the future of the eurozone is important for all and it must be discussed and shared by everyone." According to the eight "minimalist" governments, the eurozone needs a greater respect for the rules and the application of structural reforms and national responsibility for the stabilisation policy. Therefore, it is within the national budgets that fiscal space must be created for automatic stabilisers and discretionary policies. They mentioned the creation of buffering but not the possibility of having to deal with shock.

• Schäuble non-paper

A similar position was expressed by the then German finance minister, Wolfgang Schäuble: a stabilisation function is considered unnecessary from an economic point of view, thanks to the existence of stabilisers in national budgets[8]. Furthermore, the capacity to absorb shocks must be sought through a deepening of the Single market, with the mobility of capital and people, as well as greater integration in the banking sector.

- **154 German economists**

A further refusal came from the German academic world, not only to Macron's proposals but also to the expansive stance of the ECB's monetary policy in recent years[9]. In particular, the group of economists believes that a European finance minister, endowed with a fiscal capacity and with a role of counterpart of the ECB, would contribute to further politicisation of monetary policy.

3. The starting point: the agreement between Merkel and Macron

The starting point for future negotiations on the reform of the eurozone will be the Meseberg Declaration, the result of the meeting between Angela Merkel and Macron[10]. The document provides for the creation of a eurozone budget that would involve investment in innovation and human capital, but also a stabilisation fund for unemployment. From the revenue point of view, the agreement envisages the use of national contributions and European fiscal resources, hinting at the use of carbon pricing (of which the carbon tax is an expression) as an incentive for environmental transition. The Declaration did not specify the extent to which the budget of the eurozone would fall within the EU budget framework. However, three points are clear: the stabilisation mechanism should not involve transfers between countries; it should not be used to finance common goods such as security and defence; and no mention made on the creation of a European finance minister.

With regard to the first point, the Declaration therefore shares some aspects of the Commission's proposal, i.e. a loan-based scheme. This is possible within the EU budget, as an exception to the general rule of balanced budget. The borrowing capacity for stabilisation will have to be subject to a limit, set at around €35 billion a year, within which two other financial instruments of the budget must also be included – one of these is the European Financial Stability Mechanism, which supported Ireland and Portugal at the beginning of the crisis[11]. The new stabilisation fund proposed by the Commission should therefore replace and not add to resources already budgeted in the previous Multiannual Financial Framework (MFF).

Questions of the scope of a stabilisation fund should also be noted: according to IMF ex-post simulations, if eurozone countries had contributed regularly to the fund in the pre-crisis period for a total amount of 1.6% of euro area GDP (around €190 billion), the fund would have financed transfers to countries until 2012 and, once exhausted, would have resorted to debt issuance for the period 2013-2017, with a peak of 1.1% (€130 billion) in 2014. In sum, the Commission's proposed EISF appears to be poorly resourced.

Assessed against this second point, Macron's idea of financing genuine European public goods with genuine own resources is a valid proposal, because it highlights the European dimension of fiscal capacity both on the expenditure side, financing fundamental services that benefit all citizens, and on that of the revenue, resorting to taxes applied homogeneously to all member countries. In this way the link between what is financed (common public goods) and how it is financed (European taxes) should become clearer.

However, it clashes with a problem of domain: can one properly speak of a common defence or migration management which only concerns the countries of the monetary union? For these challenges, in fact, there is the EU budget, which should be oriented more towards these policies. The Commission has put forward its proposal on the future MFF 2021-2027[12]: a strengthening of common spending on security and defence and border management is foreseen, to the detriment of traditional policies, such as the Common Agricultural Policy and cohesion policy.

There is a telling silence within the Declaration about the creation of a European Finance minister. As observed by a group of economists with a federalist vision[13], the approach to the reform process should not be focused on purely economic solutions, although important, but involve the institutional set-up of the euro zone, recognising that the mechanisms and instruments currently in use have not been able to solve the crisis. The crucial aspect of reforms should be the creation of a genuine European government, accountable to Parliament, able to exercise a discretionary and coordinated economic policy between member countries. In the current structure of economic governance, however, decisions are taken unanimously within intergovernmental institutions (the European Council and the Council of Ministers), excluding the European Parliament, while the Commission, which obtains Parliament's trust, plays a technical support role.

Conclusion

The starting point for future negotiations on the stabilisation function of the euro area seems to be a fund to support public investment, financed by a mix of national contributions, loans and

own resources. This is a good start, provided it is developed with a wider used of additional own resources, such as a carbon tax. A system based on national contributions alone could generate tension between the need for a sufficiently well-funded fund, on the one hand, and the fact of removing resources from national budgets, on the other; while a loan-based mechanism could likewise burden the public accounts of the member countries.

Among all the proposals, the Italian paper has the merit of focusing on supporting the income of the unemployed instead of supporting public investment. The theme of declining public investment has rightly become a priority of the European Commission and stable interventions have been created, such as the Investment Plan (public and private) for Europe, the so-called Juncker Plan – which is preparing to be renewed in the next QFP although with a fresh look (InvestEU program). A European unemployment benefit scheme should receive the same attention, even if it would require a certain level of harmonisation in the labour markets of member countries, as well as administrative efforts for the distribution of subsidies at the individual level. On the other hand, it could prove to be a tool to materialise, albeit temporarily, the presence of Europe alongside disaffected citizens.

After months of high expectations, The European Council of 28-29 June made progress on the eurozone's financial policy with the launch of the European Stability Mechanism (ESM) as a pathway toward backing the Fund for the resolution of banking crises, but did not reach an agreement on the stabilisation function, due to deep differences of opinion. However, the Eurogroup said it was open to discussions on this in the future, starting with the Commission proposal on the EISF and also assessing the idea of a European unemployment fund[14]. Therefore, for the eurozone budget, the political moment is not yet ripe, but the debate is full of proposals to move towards a monetary union more resistant to future shocks.

Note

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13 Andor L. et al. (2018), *Blueprint for a democratic renewal of the eurozone*, Politico, https://www.politico.eu/article/opinion-blueprint-for-a-democratic-renewal-of-the-eurozone/

14 *Letter by Eurogroup President Mário Centeno to European Council President Donald Tusk ahead of the Euro Summit of 29 June 2018*, 25 giugno 2018, http://www.consilium.europa.eu/media/35798/2018-06-25-letter-president-centeno-to-president-tusk.pdf

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