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Prospects for a euro-area budget: an analytical outline

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Abstract In a reflection paper intended to generate debate among euro-area governments, the European Commission has put forward ideas on what could be done to deepen the Economic and Monetary Union by 2025. One of the ideas outlined by the Commission is the creation of a euro-area budget. This article reviews the key issues that are relevant in the discussion on establishing such a budget; outlines the possible functions of such a budget, such as incentivising structural reforms or ensuring macro-stabilisation; and discusses the issues of size, funding, moral hazard and governance, while touching upon the role of non-euro-area member states. The article concludes with the assertion that the answer to this question is essentially political in nature and could constitute an example of how member states are ready to integrate further, while giving non-euro-area member states the opportunity to participate.

Keywords Eurozone | Budget | Structural reforms | Moral hazard | EMU

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Introduction

If fiscal space was circumscribed to just the national level, states could use national monetary policy for stabilisation purposes. However, as monetary policy is conducted at the euro-area level, member states have abdicated the possibility to use it to counteract idiosyncratic asymmetric shocks (Hebous and Weichenrieder 2015). At the EU level, the treaties suggest that fiscal policy constitutes a decentralised instrument, while fiscal discipline is an absolute collective requirement (Wyplosz 2016). Given the current framework, new solutions are required in order to endow the euro area with enhanced fiscal discipline and thus to provide governments with more room for manoeuvre to counter economic shocks.

In a reflection paper intended to generate debate among euro-area governments (European Commission 2017), the Commission has put forward ideas on what could be done to deepen the Economic and Monetary Union (EMU) by 2025. One of the ideas suggested is the creation of a euro-area budget.

The idea of creating a budget for the euro area was initially presented in 2012, in the Four Presidents' Report (Van Rompuy et al. 2012). The report stated that a budget was required to improve the resilience of EMU as it would provide a shock-absorption function at the central level (Bénassy-Quéré et al. 2016). Furthermore, in June 2015, *The Five Presidents' Report* (Juncker et al. 2015) defined the role of the euro-area budget as an instrument that would 'improve the overall economic resilience of EMU and individual euro area countries. It would thus help to prevent crises'.

The goal of any new euro-area budget should be the improvement of the overall competitiveness of the EU. If our economies are strong and competitive, and our goods are in demand in the global market, we will be more resilient to economic crises in the future. The needed reforms have to be conducive to more investment, profitable projects and enhanced productivity.

An incentive for structural reforms

Structural reforms are highly important for the functioning of the euro area. They can incentivise long-term growth by increasing the adjustment capacity of the economy and by raising its potential growth rate, and can improve the functioning of the economy with the objective of producing better long-term GDP (Brinke and Enderlein 2017).

By increasing the adjustment capacity of the economy, relative prices would be able to adjust faster and thus output would be less affected by shocks. Moreover, the economy would be able to reallocate resources in a more efficient way, leading to faster output recovery. Other essential benefits of the ability to adjust capacity would be a reduction in the duration of unemployment periods for individuals and a lessening of the depth of any recession.

Additionally, by reinforcing supply capacity, the structural reforms would also contribute to ensuring long-term growth. This would help to address the challenges that production factors face.

A euro-area budget could support, for instance, pension, labour market or public administration reforms. Pension reforms could be supported through providing financial incentives for measures that promote lifelong learning or active ageing, which are both consequences of a higher retirement age. If people are expected to live longer, social measures that encourage older people to stay active and acquire new skills could be stimulated and financed by a euro-area budget.

Those temporarily unemployed as a consequence of labour market reforms could be financially supported by the EU with training, mobility and assistance in finding a job. Financial support for the externalities of labour market reforms is a key factor for less competitive economies (e.g. the training of personnel; the consequences of labour market reforms, such as redundancies in the public sector and the need for requalification; and support for reforming the public administration). If public administration reforms demand investments in digitalisation or e-governance, the costs involved could be carried by a euro-area budget, thereby incentivising member states to implement the needed reforms.

A tool for counteracting asymmetric shocks

Fiscal stabilisation is the use of fiscal policy to keep the economy afloat through higher spending or lower taxes in a downturn and the elimination of the budget deficit in an upturn (Bénassy-Quéré et al. 2016). At the national level, fiscal policy can be used as a tool to offset country-specific shocks. However, in a currency union such as the euro area, the issue is more complex. The initial configuration of the EMU did not include tools that would prevent asymmetric shocks.

In the euro area, monetary policy is constrained and cannot assist a single member state. If one country is hit by an asymmetric shock or if the structural differences across multiple members are significant, it is not possible to use an interest-rate policy alone to stabilise the economy of a specific member state (Rubio 2017).

The European Stability Mechanism (ESM), a permanent crisis management mechanism, currently provides safeguards against imbalances in individual countries. It can provide exceptional assistance to countries in trouble by temporarily taking the place of private lending and offering conditional funding. Nevertheless, as already underlined in the academic literature, the ESM cannot be regarded as a substitute for a euro-area budget as it represents a mutual assistance scheme. It therefore cannot be construed as a common budget, as this would entail the entrusting of some competences to the centre (Pisani-Ferry 2014). Stabilisation through the ESM should therefore be complemented by other shock-absorption mechanisms.

Measures to increase macro- and micro-prudential supervision, with the aim of strengthening the banking sector, are not enough to prevent a severe financial crisis. A euro-area budget could constitute a tool for ensuring macro-stabilisation in the case of asymmetric shocks. However, the issue of moral hazard has to be analysed thoroughly before this can happen.

Moral hazard

A key issue of this new financial construction that needs careful consideration is the risk of moral hazard. Member states could start to disregard their obligations to reduce debt if they know that there is a high chance that they would be bailed out should they get into difficulties. Moreover, the macroeconomic insurance that a budget would create for member states could create a rise in durable transfers and provide incentives to act in less responsible ways.

To reduce moral hazard, the budget would need to be constructed in a manner that would ensure distributional neutrality over time. According to this principle, net transfers could go towards a negatively affected country over a number of years, with the condition that after several years those same transfers would be offset. Consequently, greater mutual surveillance and stronger governance would need to be implemented.

Size and financing means

Like any budgetary instrument, a euro-area budget would have to be clearly defined in terms of size and funding mechanisms. This will, however, have to take into consideration the political challenges at play. Given the limited funds currently available and the incumbent exit of the UK, it appears that the budget would probably be rather limited in size, which raises the question of the effectiveness of such an instrument.

As for the funding mechanisms, to avoid adverse effects on domestic demand, it would be advisable not to provide resources through regressive taxes, such as VAT. One option would be for the resources to originate from a European tax. However, this could entail political challenges. Hence, any new tax should be fiscally neutral to consumers and companies.

One other source of funding could be from a corporate income tax. The current practices of tax avoidance and tax optimisation have led to a situation where many multinationals take advantage of the differences that exist between national legislations. Therefore, a firmly regulated common corporate tax base, which would still allow each country to set its own tax rate but with an additional rate levied at the federal level, could

lead to the creation of an important source of funding for the euro-area budget (Piketty 2014).

Other options to ensure funding of the budget could be through member state contributions or the transfer of a proportion of taxes collected at the national level. However, the foreseeably limited size of the budget raises the issue of *effectiveness*.

Studies have shown that a federal budget of 20% of GDP provides a consumption smoothing effect of 15% in the US (Sørensen and Yosha 1998). Consequently, if the euro-area budget was the equivalent of 2% of GDP, it would presumably have a smoothing effect of 1.5% (Bénassy-Quéré et al. 2016). Furthermore, recent literature concludes that, again in the US, the degree of cyclical stabilisation via the federal budget is quite small, with only between 5% and 10% of state shocks being buffered through federal transfers (Poghosyan et al. 2015). A euro-area budget would not be large in size. Given these examples, it appears that such a budget would not be able to provide any noticeable smoothing. Any new euro-area budget must also be able to ensure the prevention of further crises; it must not only constitute a tool for managing such situations when they occur.

Governance

The creation of a euro-area budget would also create a new institutional gap which would have to be addressed. One solution could be to set up an entity with executive powers that would have competences in the area of establishing structural reform packages and, consequently, in the area of implementation. A euro-area treasury, led by the Eurogroup president and subject to full parliamentary control, could be one option. Another option could be a European minister, fully accountable to the Parliament, who promotes and supports structural reforms in member states. Ideally he would also be a vice-president of the Commission. The aforementioned control could be ensured by creating a Parliamentary Committee for the Euro Area, or by following the model of the economic dialogue held with Mario Draghi every year.

What about non-euro-area member states?

We must recall that *The Five Presidents' Report* underlined the principle that any budget should be open and transparent vis-à-vis all member states. Therefore, non-euro-area member states should be given full rights of participation and benefits. Moreover, they should be involved in the process of governance. This approach would allow for a euro-area budget that would improve the overall economic resilience of the EMU and of the individual countries that will eventually join the euro area. In turn, this would contribute to the prevention of future crises and secure sound and smooth integration into the EMU.

Any euro-area budget should be open to all EU member states. Countries that have a treaty obligation to join the euro area and that make efforts to do so, should be given full rights of participation: they should contribute and benefit financially and take part in the governance. The economies of many non-euro-area countries lack competitiveness, especially in the public sector. These are impediments that need to be overcome to become a member of the euro area.

Adopting the euro now would be too early for many non-euro-area member states and thus the consequences of such a move could be negative. For their economies to benefit from joining the euro, these countries must become competitive enough to be able to face the competition in the euro area. Participating in the euro-area budget would help them to converge with euro-area countries, make their economies more competitive and ensure their further integration into the governance structure of the euro area.

Previous experience has clearly shown that instruments which were not specifically designed for non-euro-area member states, such as the Fiscal Compact or the Euro + Pact, have been beneficial for them.

Conclusion

After providing a careful analysis of what a euro-area budget could entail, it appears that the question of whether such an instrument is necessary remains unanswered.

While this article suggests that there is a strong economic *raison d'être* for a euro-area budget, one should not disregard the strong link between this potential construction and the issue of a multi-speed Europe, which is of great political significance. The creation of a euro-area budget—which, in turn, may lead to the creation of a euro-area finance minister and even a euro-area parliamentary committee—could constitute an example of how member states might integrate further, while giving non-euro-area member states the opportunity to participate. It would thus provide a strong example of an inclusive project of further integration.

The past economic and financial crisis has led to divergence and mistrust among member states. In light of current challenges, including the refugee crisis, increasing Euroscepticism and international conflicts, the way forward for Europe is more unity. The answer is a stronger Europe, as the best tool to overcome any future challenge.

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