Building a Euro-area Budget Inside the EU Budget: Squaring the Circle?

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Abstract

This paper explores how a budget for the euro area might be established within the European Union budget as part of the 2021-2027 Multiannual Financial Framework. I first discuss what budgetary tool the euro area needs and what essential characteristics it should have. I then compare these with the characteristics of the 'Budgetary Instrument for Competitiveness and Convergence' agreed on by the Eurogroup in 2019. I conclude that in its current form this new instrument, which has been labelled a '*mini revolution*', will most probably be inadequate to deal with the most important challenges facing the euro area.

1. Introduction

In 2012, three major institutional developments marked a turning point in the unfolding of the euro-area crisis: the establishment of the European Stability Mechanism (ESM), the European Central Bank's announcement of its Outright Monetary Transactions (OMT) programme and the decision to create a European banking union. The combination of these institutional innovations finally brought to an end the crisis in the sovereign debt markets, which almost derailed the monetary union project.

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However, with the end of the most acute phase of the crisis, the deepening of Economic and Monetary Union (EMU) also came to halt, leaving the currency area incomplete. Several key pieces of the euro architecture to prevent crises and absorb shocks remain missing: the banking union is still incomplete, risk-sharing (both public and private) is still minimal and macroeconomic stabilisation policies remain too limited, especially with the ECB stuck at the lower bound (Claeys, 2017). Although the debate among academics and practitioners on what needs to be done has continued, nothing major has been enacted. In particular, the possibility of creating a euro-area specific budget was intensely debated but the discussion went unheeded.

At least, this was the case until 2018, when the European Commission tried to revive the euro-area budget debate by linking it to the discussion on the future of the EU budget and the negotiations on the Multiannual Financial Framework for 2021-2027 (European Commission, 2018). The Commission also made some detailed proposals on how to do this in practice, but these plans were quickly rejected by the EU countries. Nevertheless, since then the member states have taken up the issue and have tasked the Eurogroup with reaching an agreement in order to provide the euro area with a budgetary tool.

This paper investigates the reasons why it is essential to establish a budget for the euro area and how to do it in practice. I first discuss what kind of budgetary tool the euro area needs and what essential characteristics such a tool should have (Section 2). I then examine the benefits and drawbacks of establishing this euro-area specific instrument within the EU budget (Section 3). Next, I explore the main characteristics of the 'Budgetary Instrument for Competitiveness and Convergence' agreed on by the Eurogroup in 2019 and compare them to the needs of the euro area. I conclude that in its current form this new instrument, qualified by some policymakers as a '*mini revolution*', will most probably be inadequate to meet the most important challenges facing the euro area (Section 4).

2. Why does the euro area need a specific budget?

There are several important reasons why euro-area countries need a specific budget.

First, it is more difficult for countries inside a monetary union to deal with asymmetric shocks than for countries with their own central banks. In a monetary union, there is no exchange rate with the main trading partners that can depreciate quickly to regain competitiveness after a shock. There is no autonomous monetary policy if the business cycle diverges from the rest of the monetary union. And in the euro area in particular, unlike federations such as the United States, there are no alternative mechanisms available for shock absorption given that labour mobility, federal transfers and capital market integration are all very low.

This means that fiscal policy must play a more active role in the euro area to compensate for the other missing channels. However, national fiscal policy is constrained in the euro area. First, fiscal policies adopted by euro-area countries have to respect a series of complex fiscal rules that proved to be flawed during the last recession and which contributed to over-tight fiscal policy between 2011 and 2014. Second and more importantly, if a country experiences a large shock that leads to a significant increase in its debt-to-GDP ratio, doubt will be cast on the sustainability of its debt given that fiscal policy is under more scrutiny in the monetary union because of the prohibition on monetary financing by the ECB enshrined in Article 123 of the TFEU. The creation of the ESM and OMT in 2012 was clearly helpful but their setup is still imperfect (Claeys, 2019). As a result of these two elements, adequate stabilisation through national fiscal policy might be unavailable to some countries.

Moreover, an adequate aggregate fiscal stance and ensuring the right policy mix with the ECB's monetary policy have proven very difficult to attain in recent years. Coordination through the fiscal framework or the European semester has proved illusory. In particular, when some countries are constrained from implementing what would be the optimal fiscal policy, there is no way to force other countries that have fiscal space to use it if it does not seem to be directly in their own interests. As a result, the aggregate fiscal stance in the euro area has been too tight on many occasions during the last decade. Moreover, if you combine fiscal and monetary policy to determine what should be the optimal mix of macroeconomic stabilisation policies, the fact that monetary policy is currently stuck (and is expected by financial markets to be stuck for a long time) at the lower bound makes the situation even worse in terms of policy mix. In particular, a side-effect when monetary policy is constrained by the lower bound is that inaction on fiscal policy obstructs the efforts of the central bank to fulfil its mandate and to bring inflation back towards its target.

A fiscal stabilisation tool at the euro-area level would provide a welcome solution to these problems.

3. What should a euro-area budget ideally look like?

In order to play this role and to be both economically effective and politically acceptable, such a tool should have seven main characteristics.

First, it should be of a sufficient magnitude to be able to deliver the right level of stabilisation in combination with the ECB's monetary policy and with national fiscal policies. If it is not large enough at its inception, the instrument should at least be scalable if it is needed in the future.

Second, it should provide cross-country risk sharing in the case of large shocks that countries cannot deal with on their own without risking their debt sustainability being questioned by the markets. Loans (such as those that can be provided by the ESM) can be helpful but are not sufficient to deal with this issue as they only shift the debt problem to another level.

Third, to increase its stabilising effectiveness through intertemporal smoothing, such a tool should have a borrowing capacity. Given the uncertainty about the size of future shocks, being able to borrow is more efficient than having an *ex-ante* limited rainy day fund, which might either be too small when needed or might never be used. This also means centralising some resources to pay for the debt. One step in this direction would be to fund the euro-area budget with a volatile tax and allow for borrowing over the cycle to ensure stable spending.

Fourth, in order to have the maximum impact (i.e. to have the highest fiscal multiplier), a stabilisation tool should be targeted – as argued by Summers (2008) when the crisis started in the US – both geographically and in terms of the type of expenditure which is chosen.

Fifth, the deployment of such a tool should be timely. For this, its release should either be automatic or, if this is not the case, it should be activated as quickly as possible. This is also to maximise its impact because multipliers are higher in the trough of a recession.

To these crucial economic characteristics, two more features should be added to make a stabilisation tool politically acceptable for all European countries.

Sixth, the creation of a stabilisation tool should not give an incentive to countries to reduce fiscal discipline or neglect structural issues.

Seventh, a euro-area fiscal capacity should not lead to permanent or even persistent transfers between countries. Ideally, it should be designed behind a veil of ignorance. Economically, this means that the tool should be budget-neutral in the long run for each country.

4. Should this euro-area budget be within the EU budget?

There might be several advantages to establishing an EU budget line to create a stabilisation tool for EMU (Claeys and Wolff, 2018). An EU budget line would, in principle at least, avoid the need to create a new *ad-hoc* inter-governmental institution, and it would avoid driving an additional political and financial wedge between euro- and non-euro-area countries.

Another important justification for keeping the euro-area budget in the EU budget is a political economy one. One reason why setting up new budgetary resources for the euro area faces fierce resistance in some countries is the perception that existing EU resources are poorly used. Politically, an important precondition for mobilising additional resources for the euro area is therefore a better use of existing EU resources. This should put reform of the EU budget at the centre of the euro-area budgetary discussion.

However, there would also be major drawbacks to building a euro-area tool within the MFF. The EU budget is based on a highly complex set of treaty rules, allowing for limited flexibility and essentially no borrowing capacity.[2] Moreover, the establishment of real own resources for the EU budget would need unanimity among the members. In addition, the use of a tax more substantial than regulatory taxes (e.g. environmental taxes) to finance the EU budget (such as a corporate tax) would also require a Treaty change. That is why there is currently no borrowing capacity and no own resources in the EU budget, apart from customs duties representing less than 10% of the revenue. This means that, unless there are major changes to the EU budget (which would probably involve Treaty changes), a euro-area stabilisation tool as a part of the EU budget would not function with taxation and borrowing.[3]

Overall, while it is important to acknowledge the constraints on the EU budget and existing EU structures, it is also important not to confuse cause and effect. The constraints on the EU budget are a result of a desire by some countries to prevent taxation and borrowing at the EU level. Therefore, the real question is not the legal constraints but the political willingness of EU countries to upgrade the EU's fiscal capacities. The EU budget could be substantially modified to provide more meaningful European public goods and also to allow for some stabilisation. To transform it into an insurance policy for large asymmetric shocks will essentially require much political will. Once the determination is there, meaningful instruments can be built either within or outside the EU budget.

5. What have euro-area countries agreed so far?

At the beginning of May 2018, the European Commission made a full proposal for the future of the EU budget after 2020. Part of this (European Commission, 2018) was two concrete tools to try to improve the functioning of the monetary union: the European Investment Stabilisation Facility (EISF) and the Reform Delivery Tool (RDT).[4]

Despite the modest scope of the EISF (Claeys, 2018), the Commission's proposal was quickly dismissed by member states, while most of the funds that were intended to be devoted to the RDT were re-routed to other initiatives.

Instead of the Commission's proposal, after months of difficult negotiations, the Eurogroup and the European Council agreed to set-up a so-called 'Budgetary Instrument for Competitiveness and Convergence' (BICC) for the euro area. What are the main characteristics of this future instrument dedicated to the euro area and how does it fulfil its needs?

At first glance, the stated objectives of this new instrument are both structural and cyclical, as it is intended to "*strengthen potential growth of euro-area economies and the resilience of the single currency against economic shocks*" (Council of the EU, 2019b). In order to do this, the idea is to use dedicated funds from the EU budget to co-finance structural reforms and public investment in euro-area countries.

However, despite highlighting "*the lack of a fiscal pillar*" and the importance of "*increas*[ing] *the effectiveness of monetary policy,*" it appears that the main objective of the BICC will not be to provide *ex-post* stabilisation but only to enhance the competitiveness of, and the convergence between, euro-area countries to avoid crises *ex ante*. This is not a bad idea *per se*, as countries participating in the monetary union should converge (or at least avoid building up large differences in competitiveness as happened in the years before the last crisis) and should share some essential characteristics (for instance in the way their labour markets function) for the currency area to work smoothly.

However, there are two main problems with the BICC proposal. First, it is naïve to believe that convergence and improved competitiveness are substitutes for macro stabilisation policies. Even if euro-area economies converge fully and are highly competitive, there will always be economic crises to deal with – whether they originate from exogeneous or endogenous shocks – and the euro-area countries will have difficulties in dealing with them for the reasons I have discussed. Structural and cyclical policies are complements not substitutes. Second, the BICC very much duplicates existing programmes financed by the EU budget as its objectives are similar to those of the EU Structural Funds. The main differences are its narrower focus (i.e. to finance structural reforms) and geographical scope (the euro area) and its governance (as the Eurogroup will provide "*strategic guidance*" on the use of funds). The only stabilisation element in the current 'term sheet' (Council of the EU, 2019a) is the possibility of reducing the rate of co-financing provided by member states from 25% to 12.5% in "*severe economic circumstances.*" However, this 'stabilisation' measure is not specific to the BICC. In 2011, the Commission significantly reduced (to 5%) the minimum financial contribution to projects financed by EU structural funds of the countries most affected by the crisis.[5]

How does the BICC compare with the other previously described desirable characteristics?

First, the BICC will be characterised by its small size. While the current BICC proposal (Council of the EU, 2019b) evokes an "*indicative*" amount of €17 billion over the whole seven-year multi-annual financial framework – i.e. the equivalent 0.14% of the euro-area yearly GDP but for seven years and for 19 countries – the most recent proposal for the 2021-2027 MFF from the Finnish Presidency reduced the funds devoted to the BICC to €13 billion (Council of the EU, 2019c). This means that the BICC will be irrelevant from a macroeconomic perspective. In addition, at the time of writing, the tool will not be scalable. Member states have not yet managed to conclude an intergovernmental agreement to increase its size outside the EU budget if it is needed, for instance if there is a crisis and countries want to use the BICC to avoid a harmful reduction in public investment similar to that observed during the last euro-area recession.

Second, there will not be much cross-country risk-sharing in the BICC, as the usual *juste-retour* logic in the EU budget will apply in full. The agreement stipulates that at least 70% of the funds go back to the contributors. This ensures that there are no significant transfers between countries, but it also means that the tool will not be flexible and that the

5 For details, see https://ec.europa.eu/commission/presscorner/detail/en/IP_11_942.

money will not go to the countries that need it most. This also implies that the instrument will not be targeted geographically and therefore that its macro impact will not be maximised.

Third, there is no borrowing capacity envisaged in the BICC. The idea is not even discussed in the current documents and, as was highlighted in Section 4, it is practically impossible to build up a borrowing capacity in the current version of the EU budget.

Fourth, in terms of timeliness, it seems that the funds from the BICC will not be released quickly given the particular governance of the tool and its inclusion in the European Semester. The process will probably be quite lengthy as the Eurogroup will first provide its strategic priorities before countries can submit proposals (which should consist of packages of reforms and investments) for the next year's budget and the Commission approves them.

On the other hand, the BICC fully responds to the political constraints put forth by some countries – probably at the expense of other desirable characteristics. With the BICC there will be no significant transfers between countries and, given the insignificance of the tool, countries will have no incentive to reduce fiscal discipline or to neglect structural issues.

6. Conclusions

The agreement on the BICC has been sold to citizens as a '*mini-revolution*'[6] or, at least, as a first step towards a genuine euro-area budget, the scope and size of which can be increased later if needed. However, for this to be possible the BICC needs to be both flexible and scalable, which is not the case for the moment (Guttenberg, 2019).

As the proposal stands (at the beginning of 2020), the BICC is unlikely to fundamentally change the nature of fiscal stabilisation policy in the euro area. In addition, even from a convergence perspective, the BICC mainly duplicates something – EU structural funds – that already exists but with more complex governance and no noticeable improvement other than its focus on the euro area. It is therefore largely a reshuffling of funds inside the EU budget with no real value added. As a result,

6 See, for instance, the declarations of France's Finance Minister Bruno Le Maire after the agreement in June 2019: https://www.lefigaro.fr/flash-eco/union-europeenne-compromis-sur-un-futur-budget-de-la-zone-euro-20190614.

the BICC does not represent an enhancement of the still incomplete euro architecture.

There are two ways forward at this stage:

If it is still possible to amend the agreement, then it should be done. At the moment, discussions appear to be closed but this should not necessarily be the case because the BICC should be discussed again as part of the overall MFF negotiations between countries, and because it also needs to be approved by the European Parliament. In this case, the proposal should be changed in two main ways: 1) it should be made flexible by escaping the *juste-retour* logic; and 2) it should be made scalable with an intergovernmental agreement in order to be macroeconomically relevant and effective when it is needed. Both changes are equally necessary because they are complementary. Imagine that the size increases later thanks to an intergovernmental agreement but that the *juste-retour* rule continues to prevail. In that case, for every additional euro a country would put in it would always get back at least 70 cents, which would prevent risk-sharing and the efficient use of the tool.

If changes are not possible at this stage, it might be better to abandon the current BICC project altogether. In the worst case, the BICC could be damaging by giving a false sense of security to euro-area countries, leaving them with the false impression that they can rely on a euro-area budget. In addition, the BICC's mere existence might make it more difficult to re-open the discussion about a genuine euro-area budgetary tool. If countries that have been pushing for a euro-area budget suggest, for political (and purely domestic) reasons, that the BICC is the adequate tool to meet euro-area challenges, then they will have some difficulties in justifying that another tool might be necessary later when the BICC proves inadequate. It might therefore be preferable to abandon the BICC now and wait for the right time when it will be politically feasible to build a euro-area stabilisation tool (e.g. in the form of a European unemployment insurance scheme, as discussed in Claeys, 2017), either outside the EU budget or inside it as part of a comprehensive future reform of the EU budget.

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