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Rationale behind a euro area "fiscal capacity"

Possible instruments including a dedicated budget

SUMMARY *The sovereign debt crisis exposed weaknesses in the economic and monetary union (EMU), the integration process that brought the creation of the euro. Member States and EU institutions have taken several measures to tackle these shortcomings, including stricter rules on economic governance and setting up the European Stability Mechanism. Ideas to further strengthen EMU include the creation of a specific "fiscal capacity" for the countries that have adopted the single currency. In the longer term, this could lead to the establishment of a euro area budget.*

In 2012, policy documents from EU institutions envisaged steps towards fiscal union, coupling budgetary discipline with solidarity tools. Two main functions are identified for an EMU fiscal capacity: 1) promoting structural reforms; 2) mitigating macro-economic shocks which affect only some euro-area countries.

The debate is now focusing on a "convergence and competitiveness instrument" (CCI) that would aim to address the first objective. A CCI would encompass both "contractual arrangements" through which Member States commit themselves to key structural reforms and financial incentives to facilitate the implementation of those reforms.

Proper democratic scrutiny of EMU economic governance, with new measures in this area possibly having implications for the European Parliament, is also central to the discussion.

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Glossary

Asymmetric shocks: Macro-economic shocks that affect only some of the states belonging to an area or hit them differently.

Economic cycle: The time period over which an economy undergoes different levels of activity, including one expansion and one contraction.

"Fiscal capacity": In EU policy documents[1], this is presented as some form of set of common budgetary instruments, which could include mechanisms to counter adverse shocks.

Background

In a single market, a common currency implies benefits such as lower transaction costs, better price transparency and absence of foreign-exchange risk[2]. If strong enough, it can reduce the exposure of the area to the monetary policies of other major economic powers[3]. On the other hand, a common currency reduces policy options for countering *asymmetric shocks*. A common central bank means countries have a single monetary policy. In addition, adjustment mechanisms such as exchange rate fluctuation within the area no longer exist.

The *Optimum currency area* theory[4] indicates a series of characteristics that a currency area (and its members) should have so as to function properly and be resilient to *asymmetric shocks*. They include: mobility of labour; openness to trade; fiscal, economic and political integration.

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After its creation in 1999, the euro ran smoothly for around ten years[5], soon becoming a major international currency (second only to the US dollar). Interest rates on sovereign debt and inflation were low, with growth in most countries. However, when the global financial and economic crisis triggered a sovereign debt crisis, the euro area (formed by the EU countries that had adopted the single currency[6], see table) exposed its vulnerability to *asymmetric shocks*. For example, in some Member States (MS), government borrowing costs rocketed.

According to many economists[7], the design of the currency area had shortcomings in respect of elements that the *Optimum currency area* theory considers as important for its functioning, including the level of economic, fiscal and political integration. Other weaknesses were identified, such as the lack of a lender of last resort[8].

MS and EU institutions have taken many measures in attempts to address these issues and to strengthen economic and monetary union (EMU), the integration process that brought the euro's creation. The main areas of action have included:

- *Increased coordination of MS' budgetary and economic policies, with stronger surveillance at EU level*. Building on the existing stability and growth pact (SGP), several changes in this area have been introduced with new legal obligations such as those contained in the so-called "six pack" (for all MS) and "two pack" (applying to euro area countries only). A working method for policy planning (known as the European Semester) ensures ex-ante coordination on a regular calendar. Additional measures were taken by groups of MS through an intergovernmental approach (e.g. Treaty on stability, coordination and governance signed by all but the Czech Republic and the United Kingdom).
- *Establishment of tools to provide support to MS confronted with liquidity crises*. For example, euro area countries created the European Stability Mechanism (ESM) by means of an intergovernmental Treaty. In 2012, the European Central Bank (ECB) presented its bond-buying programme (outright monetary transactions or OMT).
- *Revision of rules governing the financial sector*. Recent steps concern legislative proposals for a single supervisory mechanism for banks as part of a wider strategy aiming at a banking union. Discussions on common guidelines for bank resolution are under way.

In 2012, policy documents outlined visions for the completion of EMU. One idea on the table is the creation of a "fiscal capacity" for the currency area, sometimes including references to a "euro area budget". Unlike the ESM, which was created to manage crises, such a tool should create adjustment mechanisms that increase the resilience of the area to *asymmetric shocks*.

A fiscal capacity for the currency area

What economists say

In the context of the *Optimum currency area* theory, Kenen[9] showed the role that fiscal integration can play in reducing the impact of *asymmetric shocks*. A central fiscal system that transfers funds to members adversely affected by *asymmetric shocks* allows for a smoother adaptation to such events. The 1977 MacDougall report[10] for the Commission argued that any plan for monetary integration needed a common fiscal stabilisation policy. But this function remained mainly at national level in EMU[11].

According to Krugman[12], the lack of fiscal integration - together with banking issues - was a key factor explaining the magnitude of the crisis in some euro area countries. He suggests that Florida was less severely hit by its housing bubble due to the much higher fiscal integration of the US; i.e. Florida received significant *de facto* transfers from the centre thanks to the tax system and a range of federal programmes. In addition, its banks benefit from federal financial backing. In his 2012 article, Krugman deemed full

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integration of the EU - involving at least fiscal transfers - to be one answer to the crisis. Considering it politically unlikely, he suggested focusing on banking issues first.

In 2012, Rogoff[13] argued that the euro needed a long-term vision aiming at a much deeper political and fiscal integration.

A different vision suggested[14] claims that proper implementation of new rules for economic governance plus banking union and ESM would be sufficient to ensure stability.

Euro area: countries that have joined

Year	Countries and events
1999	Belgium, Germany, Ireland, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland
2001	Greece
2002	Introduction of euro banknotes and coins
2007	Slovenia
2008	Cyprus, Malta
2009	Slovakia
2011	Estonia

Source: European Commission

EU policy documents

Reports of the four Presidents

Last year, European Council President Herman Van Rompuy worked on a roadmap for a genuine EMU, in cooperation with the Presidents of the European Commission (EC), the ECB and the Eurogroup. To consolidate EMU over the next decade, the June report identified four building blocks, including an integrated budgetary framework. Under this heading, possible steps towards a fiscal union are envisaged by coupling budgetary discipline with solidarity tools. In addition to the possible creation of a treasury office for the euro area, the document underlines the need to define the appropriate role and functions of a central budget.

The December report of the four Presidents further explores these ideas. While reaffirming that sound national budgetary policies are EMU's cornerstone, the text notes that all other currency unions have a central fiscal capacity. Imagining the gradual creation of a fiscal capacity for the euro area, the report identifies two complementary functions for this fiscal capacity: 1) promoting structural reforms (2013-2014); and 2) mitigating *asymmetric shocks* (post 2014). The fiscal capacity would be kept separate from the EU's multiannual financial framework (MFF) which does not cover these objectives. Financing could be ensured through "own resources", national contributions or a combination of both. The possibility to provide the scheme with the ability to borrow would be investigated in the longer term. As regards the shock absorption function, a series of principles are outlined, suggesting that the scheme could work as an insurance-type system between euro area MS. Each country would in turn contribute to and benefit from the scheme on the basis of its position over the economic cycle. Unidirectional or permanent transfers should be avoided. Appropriate mechanisms should be established so as to limit moral hazard.

European Commission

The report of the four Presidents is the basis for the debate on the future of the EMU. The EC's contribution, A blueprint for a deep and genuine EMU, envisages three phases:

- *Short term (2013-2014)*. A "convergence and competitiveness instrument" (CCI) would be created within the EU budget (but outside the MFF) to provide financial support to structural reforms in MS.
- *Medium term (2014-2017)*. Building on the CCI, a dedicated fiscal capacity for the euro area would be established, using own resources only.
- *Long term (post 2017)*. A euro area budget with stabilisation objectives could be put in place by developing the fiscal capacity.

The Commission indicates that medium- and long-term actions may require Treaty changes, such as provisions for a dedicated budgetary and own resources procedure. If the fiscal capacity were to be able to borrow or to raise taxes, amendments would also be needed as this is currently forbidden (Articles 310 and 311 TFEU).

European Parliament

The European Parliament (EP) adopted a resolution on the future of EMU, while considering it democratically unacceptable that its President had not been involved in the drafting of the report of the four Presidents. According to the EP, the acknowledgment that the smooth functioning of EMU requires a move towards a fiscal union is an important step forward. The resolution includes a series of recommendations to this end. As regards budgetary aspects, the EP is of the opinion that a well-functioning EMU needs an increased capacity within the framework of the EU budget. This should be achieved through genuine and specific own resources. In addition, the EP calls for the democratic legitimacy and accountability of EMU governance to be strengthened.

Possible forms for a fiscal capacity

The debate on a possible fiscal capacity for the euro area has seen a number of contributions, not necessarily limited to a budget proper. Some include references to fiscal support for the banking union, which should prevent contagion from crisis-stricken banks spreading to sovereign debts.

Appropriate tool depends on the function

A Notre Europe article[15] from November 2012 argues that different objectives for an EMU fiscal capacity require different budgetary instruments. A budget financed by own resources could support the promotion of structural reforms. However, it would risk overlapping with the Cohesion and Structural Funds. Financial support for a banking union would require borrowing or taxing capacity. According to the article, the goal of mitigating *asymmetric shocks* would be better served by an insurance scheme relying on national contributions. To this end, another Notre Europe paper[16] proposes an insurance fund aimed at increasing the convergence of the economic cycles of euro area MS. Based on differences in output gaps, this fund would be balanced every year. The authors present a simulation suggesting that net transfers for countries would be close to zero over the long run.

In favour of a fiscal capacity

According to an analysis by Bruegel[17], the euro area requires a central fiscal capacity to ensure stabilisation policies and financial stability together with the necessary fiscal consolidation. The resources needed to counter *asymmetric shocks* are estimated at 1% of the area's gross domestic product (i.e. €95 billion in 2012). The author concludes that, despite some shortcomings, payments based on gaps between output and potential are likely to be the best solution. The system would be neutral over the economic cycle, avoiding permanent transfers. It could include tools promoting the implementation of structural reforms. As regards shocks simultaneously hitting the entire area and a fiscal backstop for the banking union, a borrowing capacity is proposed. Another 1% of the area's GDP could be needed for these functions.

After presenting four options for a fiscal capacity (common budget, insurance-type tool against output gaps, unemployment insurance scheme, equalisation of interest burden on government bonds), a Deutsche Bank Research paper[18] notes that stabilisation tools may be in the interest of all euro area countries. It underlines the need for strong mechanisms against moral hazard.

Against a dedicated budget

An opinion paper from the CEPS think tank[19] argues that the stability of the euro area depends on completing the banking union rather than on the creation of a fiscal capacity in the form of a common budget. When comparing Nevada with Ireland, the author says that the former was hit less severely by its housing bubble because its banks' losses were mainly taken up by federal institutions. Such support brought a significant transfer from centre to local level.

State of play in the debate

European Council conclusions
Last December, leaders discussed the report of the four Presidents. As regards the fiscal capacity, their conclusions only refer to contracts for competitiveness and growth that could be coupled with solidarity mechanisms. These points, which appear to correspond to the objective of promoting structural reforms identified by the report, will be further explored in June 2013.

According to press sources, the push for more integration has lost political momentum. This would be due to the decreased tension on financial markets that has followed the presentation of the ECB's bond-buying programme (OMT).

Commission and Parliament
In March 2013, the Commission published a communication outlining possible features of a CCI, the instrument that was envisaged in its blueprint as a first step in the creation of a fiscal capacity for the euro area. On the one hand, the CCI would encompass "contractual arrangements" through which MS commit themselves to structural reforms deemed to address key weaknesses in their economies. On the other hand, it would imply conditional financial incentives that should help MS implement those reforms. Either national contributions or new specific financial resources could ensure financing. The EC suggests including the instrument in the EU budget outside the MFF ceilings (i.e. as external assigned revenues). Its financial resources would be limited in the beginning, but could be increased at a later stage if the CCI proves to be effective. A concrete proposal should be put forward by the end of the year following discussions with Parliament and Council.

In a May 2013 resolution on future EMU legislative proposals, the EP reaffirmed the need for proper democratic scrutiny of economic governance, while stressing that full implementation of the new governance framework already agreed should have priority over any further proposals. For a possible CCI, Parliament formulated a series of recommendations. The instrument should be based on conditionality, solidarity and convergence and avoid overlapping with cohesion policies. It should be adopted through the ordinary legislative procedure, providing conditional support for structural reforms enhancing competitiveness, growth and social cohesion. As such, it could represent a step towards a true fiscal capacity. It should apply to the euro area, but also be open to other MS.

France and Germany
In May 2013, French President François Hollande called for deeper integration, including an economic government for the euro area and a dedicated budget, with the possibility to borrow. Press sources reported prudent reactions in Germany.

Subsequently, France and Germany jointly published a proposal laying out their contribution to the June European Council. It sets out the steps to be taken within the next two years to further strengthen EMU. It mentions the need to define better the concept of "contractual arrangements for growth and competitiveness" engaging all euro area MS, and to create solidarity tools in this context. To this end, a specific fund for the euro area is envisaged. It would provide limited and conditional financial incentives. In addition, on economic governance and democratic control, the text suggests creating specific structures for the euro area within the European Parliament after the 2014 elections.

What role for the EP?

Scrutiny of economic governance
In the wake of the crisis, the architecture of EMU appears increasingly complex. Crisis-resolution measures were adopted through different methods, which can involve varying groups of countries. This poses a series of challenges, including from an institutional standpoint. Decisions taken outside the EU framework have generally

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seen only limited involvement of the European Parliament. In some cases, the response to the crisis raised questions about the democratic control and legitimacy of anti-crisis decision-making. In a series of resolutions, the EP has stressed the need for proper scrutiny and accountability. The level at which this should occur is debated.

Both the report of the four Presidents and the Commission's blueprint say that any further strengthening of EMU requires strong mechanisms for accountability and democratic legitimacy. These should occur at the level where decisions are made. The EP is indicated to be the best-placed institution to take into account the common interests of the EU and to carry out these functions for decisions made at EU level. The role of national parliaments in economic governance is also noted.

As regards the fiscal capacity, the report of the four Presidents says that its creation should include arrangements ensuring full democratic legitimacy and accountability. "The details of such arrangements would largely depend on [the fiscal capacity's] specific features, including its funding sources, its decision-making processes and the scope of its activities."

The Notre Europe analysis[20] says that the EP would be better placed to exercise control over a budget endowed with own resources to promote structural reforms. On the contrary, a fiscal capacity functioning as an insurance scheme funded by national contributions should be controlled by the parliaments of the countries participating. According to the Commission's blueprint, inter-parliamentary cooperation does not ensure democratic legitimacy for EU decisions. To this end, a representative assembly in which votes can be taken is needed, with the EP being that assembly for the EU and for the euro. Along the same lines, a report[21] by the EP Secretary-General on the future of the EP considers that, should a euro area budget be created, only the EP would have the necessary pan-European structure and perspective to legitimise it.

Possible developments for the EP

Last year, Parliament's President Martin Schulz proposed that a specific committee in charge of democratic scrutiny of EMU issues be set up within the EP. It should be composed of Members coming from participating MS. Opponents of the idea argue that, as representative of EU citizens, the EP is institutionally indivisible. The recent Franco-German paper on the future of the EMU envisages specific structures for the euro area within the EP. The Conference of Presidents is due to revert to this issue in July, after input from the ECON Committee.

Examining the legal options available for an additional EMU fiscal capacity, a Policy Department study[22] requested by the EP concludes that this can be created under the existing Treaties if it is designed as an enforcement mechanism with assigned revenue promoting structural reforms. In this case, the EP should play a supervisory role for the fiscal capacity on the basis of EU budgetary law. As regards "contractual arrangements", the EP would be involved in their implementation, but not in their negotiation and conclusion. On the other hand, only parts of an insurance-type tool to mitigate *asymmetric shocks* could be created under current EU law. Some issues, notably those of democratic accountability, would require Treaty changes.

A different approach

From a different perspective involving significant reforms, another Policy Department study[23] suggests the creation of a new European political space. EP elections would become a competition to form the government of Europe. An increased EU budget funded by real own resources would play the fiscal stabilisation role in this context. A paper[24] by the European Policy Centre think-tank also envisages a reformed EU budget with some degree of fiscal sovereignty to include a shock absorption function.

Further reading

Europe's unfinished currency. The political economics of the euro / Mayer T., 2012, IX-262 p.

Do all roads lead to fiscal union? / Vetter S., DB Research, 2013, 16 p.

Options for a euro area fiscal capacity / Pisani-Ferry J., Vihriälä E. and Wolff G. B., Bruegel Policy Contribution, 2013, 14 p.

The euro. The first decade / Buti M., Deroose S., Gaspar V. and Nogueira Martins J. (editors), 2010, XXXI 1015 p.

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Endnotes

1 Towards a genuine economic and monetary union / Van Rompuy H., European Council, 2012.

2 The euro. Its origins, development and prospects / Mulhearn C. and Vane H. R. 2008, XII, p. 62.

3 Why Europe needs the euro/ Mayer T., in: Europe's unfinished currency. The political economics of the euro, Chapter 10.

4 A 1961 article by Robert Mundell (A theory of Optimum Currency Areas in: The American Economic Review, 51 (4), pp. 657-665) initiated this theory. Several other economists such as McKinnon and Kenen later contributed to it.

5 The euro's happy childhood and its abrupt end/ Mayer T., in: Europe's unfinished currency. The political economics of the euro, Chapter 4.

6 Currently, the euro is the currency of 17 EU countries (see table). 'Opt-out' clauses in the Treaty allow Denmark and the United Kingdom not to adopt it. Latvia is expected to be the next MS to join the euro area. In June 2013, the European Commission assessed that this country had achieved a high degree of convergence, proposing that the Council decide on Latvia's adoption of the euro as from 1 January 2014. The remainder EU countries do not meet yet the criteria to adopt the single currency.

7 See for example: Revenge of the Optimum Currency Area / Krugman P., 2012.

8 Managing a fragile Eurozone / De Grauwe P., 2011.

9 The Optimum Currency Area: An Eclectic View / Kenen P. B., in: Monetary Problems of the International Economy/ Mundell R. A. and Swoboda A.K. (editors), 1969, 405 p.

10 Report of the Study Group on the Role of Public Finance in European Integration/ MacDougall, D. et al., Commission of the European Communities, 1977.

11 Generally, the EU budget, which applies to all MS, is not considered to be able to tackle *asymmetric shocks* due to its size and little flexibility in the context of Multiannual financial framework planning. See for example: European Union Budget Reform/ Benedetto G. and Milio S. (editors), 2012, XIX-213 p.

12 Kenen, Mundell, and Europe / Krugman P., 2011; Revenge of the Optimum Currency Area/ Krugman P., 2012.

13 A Centerless Euro Cannot Hold /Rogoff K., Project Syndicate, 2012.

14 Quoted in: Do all roads lead to fiscal union? / Vetter S., DB Research, 2013, p. 3.

15 Eurozone budget: 3 functions, 3 instruments / Rubio E., Tribune, Notre Europe – Jacques Delors Institute, 2012.

16 Making one size fit all. Designing a cyclical adjustment insurance fund for the eurozone / Enderlein H., Guttenberg L., Spiess J., Policy Paper Nr. 61, Notre Europe – Jacques Delors Institute, 2013.

17 A budget for Europe's monetary union / Wolff G.B., Bruegel Policy Contribution, 2012.

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19 The False Promise of a Eurozone Budget / Gros D., Centre for European Policy Studies (CEPS), 2012.

20 Rubio E./ op. cit.

21 Preparing for complexity. European Parliament in 2025 / Team EP 2025 Long Term Trends, Cabinet of the Secretary General, European Parliament, 2013.

22 Legal options for an additional EMU fiscal capacity / Repasi R., European Parliament, Directorate-General for Internal Policies, Policy Department C - Citizens' Rights and Constitutional Affairs, 2013.

23 A new governance for the European Union and the euro: Democracy and Justice / Poiares Maduro M., European Parliament, Directorate-General for Internal Policies, Policy Department C - Citizens' Rights and Constitutional Affairs, 2012.

24 Pathways to achieve a Genuine Fiscal Union / Nicoli F., European Policy Centre, 2013.

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