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EUROZONE BUDGET: 3 FUNCTIONS, 3 INSTRUMENTS

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The three possible functions of the Eurozone budget (macro-economic stabilization, a tool for structural reforms, fiscal support for the banking union) require different types of EMU budgetary instruments. This is the main argument of this tribune by Eulalia Rubio, based on an intervention at the workshop "The EU budget: a driving force for changing Europe?" organised by *Notre Europe – Jacques Delors Institute* in Rome on 30 October 2012, in partnership with the *Istituto Affari Internazionali*, the *Centro Studi sul Federalismo* and the *Institut für europäische Politik*.

The idea of creating a separate Eurozone budget is gaining momentum, after the latest European Council mentioned the creation of an "appropriate fiscal capacity" for the Eurozone as something to be "further explored"[1]. In this context, it seems particularly important to discuss the features of an eventual eurozone budget. As the Van Rompuy interim report notes, it could take different forms and various options would need to be explored in more detail in the run-up to the December European Council.

In particular, there are several open questions that need to be answered concerning the role, format and characteristics of an EMU budget:

- What type of functions would this budget perform?
- How big would it be, and how is going to be financed?
- Who would participate into it? Would it be strictly reserved to Eurozone countries, or open to other non-EMU countries willing to join the Eurozone in the long term (following the model of the TSCG)?
- Would it entail a borrowing capacity?
- Last but not least, who would be in charge of exercising the democratic control of this budget?

In the following, I will provide some thoughts on how to answer these questions. The key argument of my exposé is as follows: depending on how you answer the first question (functions), you will give different answers to the rest of the questions. In other words, different functions probably require totally distinct types of EMU budgetary instruments.

1. Three different functions for a Eurozone budget

To be precise, one should note that the crisis has already prompted the creation of specific EMU financial instruments: the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). The function of these two instruments is to provide financial assistance to eurozone countries confronted to liquidity crises. They are both relatively big and strictly reserved to EMU countries. They are not properly "budgets", composed by revenues and expenditures, but rather intergovernmental instruments that lend to EMU countries in difficulty by borrowing on the capital markets on the basis of guarantees issued by the 17 euro area countries (and partly on the basis on its own capital in the case of ESM).

The "financial capacity" for the Eurozone is not intended to be a replacement of these existing instruments (EFSF/ESM), neither a substitute for other future mechanisms to mutualise sovereign debts[2]. In current debates, three functions are usually cited as potential functions for a Eurozone budget:

1. To facilitate financial assistance to EMU countries in the event of an asymmetric shock (macroeconomic stabilisation);
2. To facilitate structural reforms in EMU countries through the provision of financial incentives;
3. To work as a fiscal backstop of a future EMU banking union.

The first two functions are explicitly mentioned in the Van Rompuy interim report as the main functions of a future EMU "fiscal capacity". The third function, fiscal backstop, is implicitly mentioned in the report when referring to the need to create a "common [banking] resolution authority with an *appropriate backstop*"[3] once supervision is effectively moved to the EU level. Theoretically, this "backstop" could consist into an ex-ante agreement for burden-sharing among national taxpayers, but the latter entails the risk of making resolution interventions cumbersome and lengthy. A common EMU fiscal capacity is thus the best option to provide this fiscal backstop.

Let's discuss in more detail the type of budgetary instrument required for each function.

2. The Eurozone budget as a macro-economic stabilisation tool

One of the functions which are frequently assigned to a potential EMU budget is to facilitate financial assistance to countries in the event of an asymmetric shock or suffering from EMU-induced cyclical downturns. In this case, the common budget would work as an insurance tool, shielding all EMU countries from the ups and downs of the economic cycle.

A budget functioning as a macro-economic stabilisation tool should be logically reserved to EMU countries. The need for a cyclical adjustment insurance scheme is linked to the fact that countries belonging to a common currency area have a particularly reduced capacity to stabilize their own economies, as they cannot resort to the use of the exchange rate instrument. In principle, hence, countries outside the EMU do have neither a need nor an interest to participate in such an insurance scheme.

If the eurozone budget has to perform as a cyclical adjustment insurance tool, then a key aspect is to ensure the latter works on a symmetric way, that is, it does not become a hidden instrument for permanent transfers (otherwise it would not be accepted by the richer countries). For this not to happen, two conditions seem important: First, it should be a scheme handling transfers between member states. The states would pay contributions into the fund when the economic situation is buoyant, and the states would receive money in the event of a recession. The alternative option, consisting of an "interpersonal" insurance scheme (for instance in the shape of a European unemployment insurance scheme[4]), would not function symmetrically on account of the absence of any major harmonization in the sphere of labour market regulations. Second condition, the scheme should work on a largely automatic fashion, allocating the money on the basis of strict objective criteria – such as changes in the growth rate relative to the euro area average – and avoiding all direct political influence. If these two conditions are met, and if limits are imposed to the amounts that any country can take for such a scheme (as proposed by the Tommaso Padoa-Schioppa Group's report[5]), then there is no need for a large borrowing capacity as the scheme is going to be in balance over the medium-term.

Finally, to be effective, an EMU budget playing a macro-economic stabilization function should be quite big. Taking this into account, and the other two requisites cited above (symmetry and automaticity), the most appropriate would be to finance this EMU insurance scheme through contributions from the national budgets. If financed in this way, the democratic control over this budget should be logically exercised by the national parliaments of the countries involved, rather than to the European parliament.

3. The Eurozone budget as an instrument to facilitate structural reforms

Another function assigned to a potential EMU budget is to facilitate structural reforms in the EMU countries through the use of "limited, temporary, flexible and targeted financial incentives"[6]. In this case, the logic would be that of "stick and carrot": EMU countries would commit to undertake structural reforms, eventually through the signature of a "contract" vis-a-vis the EU commission, but in exchange they would be allowed to have some financial help to put these reforms into place (ex ante) or rewarded ex post for having implemented this structural reforms.

An EMU budget designed to play this role must be necessary different than an EMU budget for macro-economic stabilisation purposes. To start with, it will not be symmetrical, as it will largely benefit those EMU countries having competitiveness problems. It cannot be automatic in its functioning: there should be someone who decides who deserves this financial help and who does not. Precisely because of these two requisites (non-symmetrical and the need for political discretion), in this case it is important to have an EMU budget financed through own resources and not through national contributions. A budget financed through own resources would avoid decisions on spending be misguided by the conflicts between net recipients and net contributors, as it is currently the case for the EU-27 budget. It would also guarantee that it is the European Commission, and not the main EMU contributors, who decide on the allocation of funds. If financed through own resources, the democratic control should logically be exercised by the European Parliament, or an "ad hoc" committee composed by MEPs from euro area countries. Finally, there is no reason why an EMU budget of this nature should require a borrowing capacity.

A key question is whether a eurozone budget of this type should be restricted to EMU countries. On the one hand, EMU richer countries will logically be against the entrance of other non-EMU countries if the latter are seen as potential recipients of this new budget. On the other hand, non-eurozone countries could legitimately argue that there is no strong justification for the construction of a sort of "EU cohesion policy II" to which they will be excluded. Indeed, one might even wonder whether we need a separate budget to undertake this task. A more feasible solution would consist into re-designing the use of Structural and Cohesion funds for EMU countries, by increasing the powers of the Commission in the planning and selection of projects and by applying a stricter conditionality, so as to make sure that at least part of these funds are used to facilitate structural reforms[7].

4. The Eurozone budget as a fiscal backstop of an EMU banking union

Another potential function for an EMU budget is to serve as "fiscal backstop" of an eventual EMU banking union. Among experts, there is overall consensus on that a fully-fledged banking union requires a single banking resolution authority and a common banking deposit insurance scheme. In principle, these two schemes should be as much as self-financed as possible (that is, through contributions coming from the banks). However, in the event of a major systemic financial crisis, these schemes might not be sufficient and there might be a need to call upon the taxpayers. Leaving national governments assume the costs in case of major systemic crisis is problematic, as it can seriously threaten the solvability of those countries most affected by the crisis and can ultimately lead to a fragmentation of the EMU financial market: thus the need for some sort of common EMU fiscal backstop.

A budget conceived to function as a fiscal backstop would require a high degree of discretion: someone has to decide which banks to be saved and which not. It should be also flexible enough to be able to deploy resources in emergencies. Both requisites call for an EMU budget financed by own resources and under the control of a central authority (probably an EMU banking resolution authority). However, as systemic financial crisis entail potentially significant costs, a budget to function as a fiscal backstop should be very big, of around 4-5 per cent of EMU GDP according to some experts[8].

It seems unrealistic to imagine EMU countries agreeing to set up a common budget of this size and to leave it untouched just for the event of a major banking crisis. Besides, even a budget of this size might reveal insufficient in the event of an extraordinary financial crisis. Maybe the right EMU budgetary instrument for this function is not a budget properly speaking, but to give to a single EMU authority (for instance, an EMU minister of finances) the capacity of borrowing /taxing in the event of a major systemic financial crisis.

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The three different functions usually cited as potential functions for a "Eurozone budget" require distinct EMU budgetary instruments. Only the support for structural reforms would require a real EMU budget financed through own resources, and still it is not clear that a separate EMU budget is essential to undertake this task. The other two functions (to work as a macroeconomic stabilisation tool for the eurozone and to serve as fiscal backstop of an EMU banking union) would be better exercised by an insurance scheme funded through national contributions and a contingent EMU borrowing/taxing capacity respectively.

1. European Council conclusions, 18-19 October 2012.
2. Even if, politically, one might suspect that the German government's support for a eurozone budget is a concession intended to avoid other stronger forms of solidarity such as Eurobonds (Zuleeg, F and Emmanouilidis, J 2012 , "A budget for the euro zone? ", *EPC commentary*, 15 October 2012).
3. "Towards a genuine economic and monetary union", Interim report by the President of the European Council Herman Van Rompuy, 12 October 2012.
4. As suggested by Pierre Moscovici, the French Ministry of Economy, in a speech at Bruegel Annual Meeting, 7 September 2012.
5. "Completing the Euro: A road map towards fiscal union in Europe", Tommaso Padoa-Schioppa Group, *Studies and Reports Nr. 92, Notre Europe – Jacques Delors Institute*, June 2012.
6. Herman Van Rompuy interim report, op. cit.
7. This was one of the proposals we put forward in the policy paper "Solidarity within the Eurozone: how much, what for, for how long?", Sofia Fernandes and Eulalia Rubio, *Policy Paper Nr. 51, Notre Europe*, February 2012.
8. Jean Pisani-Ferry, Guntram B. Wolff, "The fiscal implications of a banking union", *Bruegel Policy Brief*, September 2012.

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