The eurozone needs its own budget with significant capacity to absorb major shocks and tackle the crisis.

by Blog Admin

Herman Van Rompuy, President of the European Council, has called for a euro-area budget, with the ability to absorb country-specific shocks in member states at a central level. **Guntram Wolff** *looks at these proposals, saying that there is a strong case for a eurozone federal budget, and a strongly defined banking union, to be used for stabilisation policy. He suggests that the existing European Stability Mechanism should be explored as a basis for developing the eurozone's fiscal capacity.*

In the run up to last week's important European Council, Herman Van Rompuy published a report that dedicates two of eight pages to a "fiscal capacity for the EMU", going beyond the EU budget. He sees this capacity as facilitating the absorption of country-specific shocks by providing for some absorption at the central level. Moreover, the fiscal capacity should promote structural reforms and improve competitiveness, while not leading to permanent transfers nor undermining incentives to address structural weaknesses and stick to fiscal discipline. Finally, it would be able to borrow. So how could such a euro-area budget be structured, how would it work and is it really the missing part of a "genuine" monetary union? Here are some key considerations.

Euro-area countries such as Spain and Ireland that followed the fiscal rules in the run up to the crisis responded to the downturn and the huge private sector deleveraging with a fiscal expansion. The rules of the Stability and Growth Pact foresaw that in such a situation the national automatic stabilisers would take care of the downturn. But the recession has been so deep and the associated banking sector problems so large that debt-to-GDP ratios have increased very rapidly. The mechanics of monetary union imply that markets are less and less willing to finance fiscal deficits. Country borrowing essentially leads to balance-of-payment crises with private sector financing drying up and bond yields rising for the government and the private sector. This further deepens the recession. The basic idea of Maastricht – that national stabilisation policy would suffice – has proved wrong for such large shocks.

Fiscal federations therefore typically assign stabilisation functions to the federal level. The federal stabilisation policy fulfils two basic functions. First, it is aimed at stabilising large regional shocks. Second, it aims to provide a response to a recession in the federation as a whole. National stabilisation policy alone will not provide an adequate aggregate fiscal response because of free riding behaviour. In the euro area, no clear fiscal response to the drop in GDP growth of -0.5 percentage points next year has been formulated, and the space for monetary policy to address this decline in GDP is limited. There is thus a strong case for a federal budget to be used for stabilisation policy, but this would have to be well defined.

Credit: Denis Skley (Creative Commons BY ND)

Federations also provide public goods such as defence and price and financial stability. Views on defence policy are certainly too different for this to become a public good provided in the euro area. For financial stability, steps towards a banking union have been agreed, but central parts of the banking union are still missing. One option would thus be to use a federal budget as a backstop to the banking union, thereby breaking the vicious circle between banks and sovereigns that currently undermines financial stability. The fiscal backstop behind common resolution will mean that financial conditions stabilise across the euro area.

A well-defined banking union with a common fiscal backstop would be an important stabilisation tool as it would absorb the impact of regional shocks on the financial system. But federations typically use additional stabilisation tools, such as unemployment insurance, to mitigate regional shocks. Should the euro area contemplate such measures? In the short run, this appears to be difficult. Introducing common unemployment insurance while keeping labour market laws national could create significant incentives to free-ride on the common insurance provision. Yet in the long-run, more labour-market harmonisation may be desirable. A more feasible approach now would consist of increasing and re-designing Structural and Cohesion Funds in the euro area to target growth in the most-affected countries. Overall, it is clear that in case of major shocks, support would be provided for several years.

How should the euro-area budget be financed? Ideally, the revenue source should be stable and have minimal distorting effects. Using taxes that have an already fairly harmonised base at EU level, such as VAT or corporate taxes or the financial transaction tax, may be one option, but agreed contributions from national budgets would also be possible. Clearly, separate euro-area resources to support the emerging banking union and growth in the most affected countries would be a key ingredient in making the euro area more stable and monetary union more effective. The European Stability Mechanism, as a euro-area institution, should be further explored as a basis for the euro-area budget. The next step may be to grant some tax-raising autonomy underpinned by greater democratic legitimacy. Certainly, the euro area needs a mechanism with significant resources to absorb major shocks.

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