PERSPECTIVE

# Breaking the shackles of austerity?

## Using the EU budget to achieve macroeconomic stabilisation

**IAIN BEGG**

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Since the euro sovereign debt crisis erupted, Europe's leaders have been struggling to find enduring solutions. Paradoxically, they have also pushed through extensive governance reforms and more are on the agenda, including the possibility of a fiscal union, albeit with no real consensus about what such a union would imply.

As the EU ponders its Multi-annual Financial Framework (MFF) for the period 2014–20, it is striking that there has been virtually no discussion of whether or how the EU budget could be used to help resolve the crisis. In particular, the scope for the EU's finances to play a role in macroeconomic stabilisation – a role routinely undertaken by the highest level of government in other systems – is barely mentioned.

The MacDougall report offered a menu of options, starting with a minimal stabilisation capacity but going as far as a sizeable budget of up to 7 % of GDP.[1] At that level, a stabilisation impact could have been substantial. Similarly, the Werner report offered a roadmap for monetary union which included proposals for a more limited stabilisation capacity at the EU level.[2] Moreover, when the financial crisis of 2008 led to a sharp recession, there was a sizeable coordinated response both globally and in the EU. As part of the EU package, it was agreed that a moderate amount of fiscal stimulus should come directly from the EU budget, at least establishing the principle that the latter could act in this way.

Can a future role in stabilisation be envisaged as part of a new budgetary deal? This *Perspective* explores how a stabilisation capacity at EU level could be created without a substantial quasi-federal budget. Four main options suggest themselves:

- A budget with more flexibility to vary spending in response to the economic cycle.
- Using the limited EU resources to underwrite borrowing by Member States such that their ability to use fiscal policy for stabilisation purposes is enhanced.
- Changes in the revenue raising capability of the EU.
- A separate budgetary mechanism for the euro area (and, possibly, other Member States which choose to opt-in).

## The economic logic

An argument for some form of central budget, whether it is used systematically for equalisation purposes or is confined to providing temporary relief, is that lower tiers of governments are less able to insure themselves against asymmetric shocks, whereas in a centralised tier of government, the risks are pooled across countries/regions of the whole economic territory.[3] There is, though, always going to be an enduring tension between the stabilising and redistributive effects of central spending.[4]

One of the recognised governance gaps in the EU, especially the euro area, is the inability of the current

1. MacDougall, D. (1977): Report of the Study Group on the Role of Public Finance in European Integration. Brussels: European Commission.

2. Werner, P. (1970): *Report to the Council and the Commission on the realisation by stages of Economic and Monetary Union in the Community, Bulletin of the European Communities, Supplement 11/1970.*

3. Boadway, R. (2004): The theory and practice of equalization, *CESifo Economic Studies* 50: 211–54.

4. Mélitz, J. and Vori, S. (1993): National insurance against unevenly distributed shocks in a European monetary union, *Recherches Economiques de Louvain* 59.1/2, 81–104; Majocchi, A. (2003): Fiscal policy rules and the European constitution, *The International Spectator* 38.2, 27–41.

budget to contribute to macroeconomic stabilisation in the way that is expected of the public finances of the highest level of government elsewhere, whether in unitary or federal states. In most other mature economies, the federal or central level of government performs this crucial role, partly through the action of »automatic stabilisers« which arise from the interaction of public expenditure and taxation – tending to offset any fall in demand – and partly through discretionary changes in public expenditure or tax rates.

There are three main reasons why the EU budget does not fulfil this function:

- First, because the EU budget is so small as a proportion of EU GDP, it is incapable of stabilising the EU economy as a whole. The EU budget is around 1 % of GDP, and only a fraction of a percentage point of EU GDP could realistically be used for discretionary fiscal policy. By contrast, as the experience of the last few years has shown, stabilisation policy in a severe recession has seen swings in budget deficits of several percentage points of GDP.

- Second, the pattern of expenditure is not sensitive to cyclical fluctuations and many of the multi-annual programmes (such as cohesion policy or research) tend to spend more heavily in the latter years of the MFF.

- Third, the treaty requirement (article 310.1, TFEU) to balance the annual budget means that the EU is not able to borrow (or run a surplus) as means of managing demand – although the recent experience of »unconventional« monetary policies suggests that the treaty can be less binding than is often assumed.

However, 1 % of aggregate EU GDP can be very large as a percentage of many individual Member State's GDP.[5] For the great majority of Member States, this means that a relatively moderate proportion of the EU budget could play a sizeable stabilising role. It would manifestly be less valuable to larger Member States, but since they tend to be more heterogeneous anyway, they will normally already benefit from a spread of risks.

5. Arithmetically, it is the reciprocal of the Member State's share of EU GDP. Thus for small states with barely 1 % of EU GDP, the EU budget is equivalent to 100 % of their GDP; if the share of EU GDP is 5 %, the EU budget equates to 20 % and so on.

There are, too, respects in which the EU budget does impinge on the macroeconomic conditions of Member States which receive sizeable payments for cohesion policy. Where the money is used for public capital projects it can (as occurred in Spain and Ireland) cause an imbalance by over-stimulating the construction sector. Today, the reverse has occurred as the property bubbles unwind.

## Spending over the budgetary cycle

Manifestly, in a world in which *juste retour* logic is paramount, the political core of the budget negotiations *is* about what is spent in each Member State, but the formal provisions do not appear to preclude a territorial rebalancing of expenditure over time within a budget heading.

In budgetary matters, the Lisbon Treaty includes a new provision (Article 312) on the Multi-annual Financial Framework, an element of which is the requirement (Art. 312.1) that the »annual budget of the Union shall comply with the multiannual financial framework«. As in previous rounds of the MFF, the new provision imposes annual ceilings for major policy areas. What it does not do, however, is to impose inflexible allocations on annual expenditure by Member State.

An answer may therefore be to alter the timing of expenditure over the cycle in policy areas such as cohesion, whether by re-scheduling projects or altering co-financing rates. In this way, some stabilisation effects could be achieved at the level of the Member State.

## Under-writing national borrowing

In a period in which several Member States are likely to face an acute squeeze on public finances, the scope for leveraging the EU budget could be critical to underpin public investment. It is worth drawing the parallel with the original motivation for the Cohesion Fund, which was to enable lower income countries to maintain public investment when faced with a need for fiscal discipline to achieve the criteria for monetary union.

Financial engineering is already undertaken using the EU budget, albeit on a relatively limited scale, through mechanisms such as the Risk Sharing Finance Facility (RSFF) through which investment in research capacity is supported by the budget of the 7th Framework Programme for Research. The way it works is that a financial package is put together comprising direct funding from the EU budget and loans from the European Investment Bank (EIB). In this way a relatively small direct disbursement can be multiplied into a much bigger investment. An evaluation of the RSFF found that up to fourteen times the initial outlay from the budget could be generated.[6]

There is, however, a risk with leveraged funds which is that, in macroeconomic terms, they still constitute an increase in debt and that debt will add to what is already on the books of the Member State. Nevertheless, by involving the EIB with its triple A borrowing status, Member States can indirectly borrow on more favourable terms than if they are at the mercy of markets.

## Changed revenue-raising mechanisms

To engage in discretionary fiscal policy, a government has to be able to generate revenue, but at present the EU has no »power to tax« and many Member States continue to be highly sceptical about conferring any such power on the EU. The present revenue arrangements do mean that relative shifts in prosperity are accommodated from year to year because of how national contributions are calculated. Fixed sum GNI rebates are an exception because the amount does not change even if the underlying economic position of the country evolves. To the extent that a severe downturn in a Member State's GNI reduces its gross payment into the EU budget while leaving its receipts unchanged, there is an automatic stabilising effect similar in nature though much more limited in magnitude than in national systems.

Indeed, the drift since the 1970s, when a substantial proportion of EU revenue was raised from genuine own resources in the form of customs duties, has been for a growing proportion of EU spending to be funded by national contributions. While this arrangement does not materially alter the revenue available to the EU, it does affect the political dynamics of the EU budget by emphasising the fact that it is Member State money rather than EU money.

6. Expert Group chaired by Erika Mann (2010): Mid-term evaluation of the Risk Sharing Financial Facility (RSFF), Report to the European Commission.

A recent proposal is that some Member States might use enhanced cooperation to introduce a financial transactions tax and then use the proceeds from such a tax as part of their contribution to the EU budget. This has strong political appeal in the wake of the problems caused by the financial sector and might contribute to financial stability, but is less likely to have an explicit stabilising effect on aggregate demand.

However, an EU level corporate tax could have bigger anti-cyclical effects than many other potential own resources, because of the well-known sensitivity of profits (the tax base) to the economic cycle. Even if the opposition of many Member States to any EU tax could be overcome, introducing an EU corporate tax will not be easy, not least because of the enormous differences in tax exemptions. Efforts to agree a common tax base are foundering, yet there is a single market logic to having a single corporate tax regime. Such a tax would, assuming that currently prevailing rates are maintained, yield more revenue than is needed for the present EU budget and the presumption would then be that the balance is distributed to Member States using a key such as nominal GNI. However a proportion of the excess could conceivably be held back for stabilisation purposes without compromising the EU's need to balance the budget.

## A separate euro area budget?

The conclusions of the October 2012 European Council (EC) recall that »the history of other currency unions shows that there are various ways of progressing towards fiscal union«. Perhaps reflecting the divisions within the EC, the conclusions go on to note that »the EMU's unique features would justify a specific approach« followed by a very general discussion of the case for »developing gradually a fiscal capacity for the EMU«.

A separate euro area budget, as implied by the October 2012 European Council conclusions, would be a major development and would raise a number of tricky questions. Foremost is how it would be used. The conclusions explicitly refer to facilitating »adjustments to country-specific shocks by providing for some degree of absorption at the central level«. However, the text goes on to specify that any such fiscal risk sharing should »not lead to permanent transfers across countries«. It also refers to the need to examine whether a new facility would be able to borrow, yet appears immediately to reject the idea by stating that a balanced budget rule would apply to it.

There have been various proposals over the years for temporary schemes that potentially boost fiscal capacity, including through unemployment insurance funds. For example, Italianer and Vanheukelen suggest that stabilisation could be achieved with an EU budget line of as little as 0.2 % of GDP, although their analysis is based on relatively limited shocks.[7] In similar work, von Hagen and Hammond show that if a sufficiently intricate econometric methodology is used to determine eligibility, a stabilisation system can work.[8] They note, however, that the methodology they propose will not be easy to use routinely and that some form of simplified eligibility rule would be needed to make it practical to implement. They find, though, that such simplification would make the system less attractive and may, in particular, result in permanent transfers rather than temporary relief of a shock.

The essence of such schemes is that they are triggered when a Member State exceeds a threshold which can be a level or a rate of change in the relevant variable. One proposal, put forward by the European Commission in 1993, was that a deviation of the unemployment rate from a trend should be the criterion.[9] If, in buffer funds of this sort, unemployment rises temporarily, the Member State would automatically receive some help in dealing with the cost of unemployment benefit, mitigating the negative effect on its economy and its public finances. In good times it would pay in to the fund.

7. Italianer, A. and Vanheukelen, M. (1992): Proposals for community stabilization mechanisms: some historical applications, in *The Economics of Community Public Finance, European Economy,* Special issue number 5, 493–510.

8. von Hagen, J. and Hammond, G.W. (1998): Regional insurance against asymmetric shocks: an empirical study for the European Community, *The Manchester School* 66.3, 331–53.

9. European Commission (1993): Stable Money – Sound Finances: Community public finance in the perspective of EMU. *European Economy* 53.

## Conclusions

No recasting of the EU budget will ever be easy and the current period, characterised by the intensity of the economic and debt crises, has to be regarded as exceptional, and therefore provides a dubious basis for appraising new structures for the budget. Yet when so many Member States are plainly at the limits of what they can borrow, it is worth examining whether an entity such as the EU can offer an alternative.

Despite some quite formidable constraints, there are various ways in which the EU public finances could be adapted to facilitate macroeconomic stabilisation. The key is to recognise that what most affects the aggregate EU (or euro area) fiscal position is what happens in national budgets, not the net balance of the EU level in isolation. Even if some means could be found to circumvent the treaty requirement to balance the annual EU budget, the stabilising effect of a surplus or deficit of a fraction of a percentage point of GDP at EU level would be minimal.

However, where individual Member States have no option but to consolidate public finances, there is a danger of a collective deflationary bias, and *vice versa*. Using the EU budget to influence national budgets could therefore be a means of achieving collective stabilisation objectives, especially for the smaller Member States, compared with which EU spending is substantial.

Three distinct means of stabilising via the EU budget can be envisaged: redirecting spending to ensure a better balance of economic activity between national economies; guarantees for the borrowing of fiscally constrained Member States; or shifts in revenue raising that smooth economic shocks to a greater extent than the current EU own resources. In addition, the case for a separate euro area budget is becoming increasingly persuasive.

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**About the author**

**Iain Begg** is a Professorial Research Fellow at the European Institute of the London School of Economics and Political Sciences, London.

Friedrich-Ebert-Stiftung | International Dialogue | International Policy Analysis
Hiroshimastr. 28 | 10785 Berlin | Germany | Tel.: ++49-30-269-35-7745 | Fax: ++49-30-269-35-9248
E-Mail: info.ipa@fes.de | www.fes.de/ipa

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