Presidency Issues note

Deepening the EMU – fiscal pillar

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On 22 June 2015, the Five Presidents' Report set out plans to deepen the Economic and Monetary Union in three stages. As part of progress towards a Fiscal Union that delivers both fiscal sustainability and fiscal stabilisation, the Report proposes the establishment in 'Stage 2' (mid-2017 – 2025 at the latest) of a common macroeconomic stabilisation function. To that end, the Commission plans to present a White paper outlining concrete steps needed to complete the EMU in spring 2017, relying on the advice of an expert consultation group.

Progressing towards a fiscal union can potentially reduce severity of possible future crises by providing an ex ante framework for enforced fiscal discipline and a central mechanism designed to cushion large macroeconomic shocks. However, the idea of a common fiscal capacity remains a highly sensitive issue, and the Slovak Presidency considers it essential for ECOFIN ministers to express their views on the substance and process ahead.

1) Incentives and Conditions for the common Fiscal Capacity

Fiscal capacity and macroeconomic policy. Economic theory and empirical observation identify several different roles of supranational fiscal policy in well-functioning monetary unions. The euro area currently lacks at least two of them: the insurance function, which temporarily transfers resources to the regions suffering from an asymmetric shock; and the global stabilisation function, which acts to absorb symmetric shocks to the monetary union as a whole. By definition, single monetary policy alone cannot address problems of countries in different stages of their economic cycles. Given that euro area Member States can no longer adjust to shocks through the nominal exchange rate channel, the absorption of asymmetric shocks should be ensured at the euro area level. For symmetric shocks, the single monetary policy is generally sufficient. However, it becomes less effective in a situation of close-to-zero interest rates. In such a situation, the existence of a fiscal capacity would also decrease the pressure on the central bank to engage in non-conventional monetary policy.

Fiscal Policy and Fiscal Rules. Member States have national fiscal policies at their disposal, subject to the rules of the Stability and Growth Pact. However, the lack of a binding coordination mechanism for the aggregate EU or euro area fiscal stance makes national fiscal policies alone much less effective in stabilising domestic economic activity, in particular in the case of more open economies with larger fiscal spill-overs. Fiscal capacity contributing to a more appropriate aggregate fiscal stance could therefore strengthen the resilience of euro area economy even if all Member States had structurally balanced budgets and could take full advantage of the fiscal space provided by the SGP.

Confidence and mutual trust. High level of structural economic divergence and a relative lack of trust among Member States and institutions persist in the EU. In this situation, it appears desirable to discuss the need for an improved implementation of the existing economic and fiscal rules with a twofold purpose: to reduce the differences in the Member States' vulnerabilities to shocks, and to embark on a confidence building exercise, which would enable Member States to move towards a future fiscal risk sharing. Such an approach is also outlined in the Five Presidents' Report (2015) which proposes a convergence process on the basis of a set of common standards.

Risk reduction and risk sharing. A possible method for bridging the gap between the Member States' divergent views would be to adopt a simultaneous, comprehensive approach to risk reduction and risk sharing. Some ex post risk reduction may be achieved by the common stabilisation mechanism itself, as increased business confidence in the face of shocks reduces their size. On the other hand, access to stabilisation mechanism could become available to participating Member States under certain, pre-agreed, specific, risk-reducing conditions. For example, an agreement could be found on a set of measures to improve the effective implementation of the rules and benchmarks (e.g. compliance with SGP, including debt rule and the Macroeconomic Imbalance Procedure). These considerations could be reflected in the discussions on simplifying the assessment of compliance with the SGP, launched at the previous informal ECOFIN in Amsterdam. For example, the existence of a stabilisation capacity could reduce the need for the current complexity in the SGP as a result of the flexibility granted for cyclical conditions, structural reforms and allowances for unusual events.

Incentives for structural reforms. Fiscal capacity itself could in fact be designed to stimulate structural reforms. For example, participation in the common fiscal scheme could also be linked to the implementation of country-specific-recommendations. Alternatively, fiscal capacity could also be used for incentivizing reforms directly, by providing financial compensation for difficult structural measures, as was envisaged in the Four Presidents' Report (2012). Depending on the form of fiscal capacity adopted, the design of the scheme itself might provide incentives for structural reforms aimed at harmonisation of social standards and greater resilience of the labour markets.

Preventing permanent transfers and avoiding moral hazard. The common fiscal capacity must not represent a disguised form of permanent transfers from one part of the union to another. Without effective safeguards in the design of the mechanism, which will ensure its fiscal neutrality amongst the Member States in the medium term, it could prove difficult to address the concerns of some Member States that they will become overall net contributors. Equally, moral hazard must be prevented – common European fiscal mechanisms must not compensate the lack of structural efforts by any Member State.

Reduced need for EU financial safety nets. An increased resilience of the euro area to economic and financial shocks based on the full Banking Union, greater possibility for private risk-sharing through a Capital Markets Union and the creation of a common fiscal capacity should also limit the scope for cross-country contagion and market panic. The decreased effect of economic and financial shocks on individual Member States, coupled with more effective implementation of the SGP and the MIP and greater economic convergence through structural reforms, would also likely reduce the need for future euro area financial assistance programmes. In this environment a prospective framework for orderly restructuring of unsustainable public debts could also be considered without triggering unwarranted financial market turbulences.

Issues for the discussion

- What are the economic and political conditions necessary for creation of a common fiscal capacity?
- Do Ministers agree that a prospective fiscal capacity could incentivize a better implementation of the existing policy surveillance mechanisms and/or potential further systemic changes of the EMU framework?
- How to gain broader public support for a common fiscal capacity?

2) What kind of Fiscal Capacity for the Economic and Monetary Union?

Shock absorbing mechanisms open to all. The Slovak Presidency would like to highlight this principle of inclusivity by tabling this sensitive item on the agenda of the EU28 during the informal ECOFIN meeting in Bratislava. The Banking Union provides an example that ambitious and far-reaching reforms of the EMU can be effectively agreed in the EU28 format, as long as interests and concerns of the euro area ins, outs and pre-ins are all taken into account, in particular as the EU Member States with a derogation from euro adoption are foreseen to join the euro area at some later stage.

Possible forms of fiscal capacity. Given the political difficulties associated with establishing a proper euro-area budget, less demanding forms incorporating the economic essence of a fiscal capacity should be scrutinized. Regardless of the specific form of a common fiscal capacity, its ultimate objective should be a more resilient EMU.

Potential options:

European Unemployment Insurance Scheme (EUIS). An automatic stabiliser could be created by emulating national unemployment benefit systems at the European level. The social insurance systems normally register a surplus in economic 'good times', when payments by workers exceed the expenditure on the unemployed, and vice versa. In a situation of an asymmetric shock, surplus would be accumulating in the European unemployment insurance scheme from the countries experiencing good times, and it would be used to cover the corresponding deficit in the countries experiencing recession. If such a system were designed as a complement to the national schemes, only covering swings in cyclical unemployment, it would be subject to less moral hazard, as it would not reduce incentives for reducing structural unemployment. Fiscal neutrality in the medium term could be ensured by using a claw-back mechanism[1] or an experience rating[2].

[1] Clawback mechanism involves a periodical assessment of net contributions, with those Member States whose balance turns out to have been negative over the period obliged to clear their deficit, and those Member States whose balance is positive having their future contributions appropriately reduced.

[2] Experience rating means that the contributions to the mechanism are directly linked to the previous use, so that the Member States that receive higher benefits or get them more often are then obliged to pay in increased contributions.

'Rainy day fund'. A second option could be a simple stabilisation fund which would provide supporting payments to Member States experiencing 'rainy days'. Such a fund could be financed by annual contributions, or by contributions paid in during good times. Questions associated with this kind of fund concern its calibration – in particular, the definition of 'rainy days' when support is to be provided. Payments could be tied to estimated measures of the cyclical position, such as the output gap. Or they could be linked to observable magnitudes, such as unemployment. The latter option would mean that the fund would become in some ways equivalent to the European unemployment insurance, but with the option that the payments could be used by governments on other types of expenditure, such as investment.

Common investment fund. Investment could also be financed by another type of fiscal capacity – namely, a common investment fund. This kind of instrument would be especially helpful for the symmetric shocks, since it could raise investment volumes at a time when private investment was falling. It would be able to undertake large, pan-European infrastructure projects, especially in the crucial areas of Energy, Digital Agenda and Transport (e. g. the 'missing links' for a pan-European high-speed rail network).

Essential features of the common fiscal capacity. The automatic nature of the instrument would be an important factor for its effectiveness. In the absence of automatic distribution of benefits, a time gap between the occurrence of a shock and the fiscal capacity's reaction thereto could arise. This would undermine its effectiveness and reduce the credibility of the instrument. Political discussions and lengthy decision making procedures should therefore be avoided. A clear, ex-ante framework for activation, conditions, size of financial flows, the use of financial resources, repayment conditions, and others, would need to be agreed. An agreement on these specific features of the instrument would reduce the room for double standards and politicisation of its use afterwards.

Issues for the discussion

- What form of the common fiscal capacity would you, once the necessary economic and political preconditions are fulfilled, consider the most suitable: an unemployment insurance scheme, a fund for investments, rainy day fund or another type of scheme?
- Should the common fiscal capacity support individual Member States affected by country-specific shocks or should it be exclusively used to mitigate the effects of symmetric shocks on the EU / euro area economy as a whole?
- Should the fiscal capacity aim to stabilize all business fluctuations or should it respond only to large shocks exceeding some specific threshold? How should such shocks be measured?