FISCAL CAPACITY AND STABILIZATION FUNCTION WITHIN THE EUROZONE: A MATTER OF UNCERTAINTY

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I. INTRODUCTION

The Economic and Monetary Union (EMU) is based on an asymmetry: On one hand, there is the monetary dimension which falls within the exclusive competence of the European Central Bank (ECB), on the other hand, there are the economic and budgetary domains which fall within the competence of the Member States.[1]

There is, therefore, no centralization of the fiscal pillar within the euro area. Budgetary policies have remained national. This has resulted in a system of coexistence between a single monetary policy pursued by the ECB and budgetary policies conducted by the Member States. This institutional architecture had an economic impact: by limiting fiscal integration, it did not organize the existence of a stabilization function at a centralized level. There was no budget for the euro area. Indeed, macroeconomic stabilization is one of the tasks traditionally pursued by a federal budget.[2]However, it must be understood that this organization of things was not the result of chance.

This "organic dispersion"[3]which characterizes that the economic pillar of the EMU is the result of a deliberate choice made by the Member States, as soon as the euro was created, in order to reconcile on the one hand their wish to benefit from the advantages which one can draw from a single currency and, secondly, their desire to preserve their sovereignty.

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[1] Treaty on the functioning of European Union, 1957, art. 120 and 122, Acts of European Union, 1957 (Italy).
[2]RICHARD A. MUSGRAVE and PEGGY B. MUSGRAVE,PUBLIC FINANCE IN THEORY AND PRACTICE (McGraw Hill, 1989).
[3]FRANCESCO MARTUCCI, L'ORDRE ÉCONOMIQUE ET MONÉTAIRE DE LA COMMUNAUTÉ EUROPÉENNE 273 (Bruylant 2015).

At the time it was made, this choice was not, in the eyes of its promoters, meaningless. This architecture was supposed to be viable, despite the lack of centralization at the budget level. There was a rationality to the system, as it existed before the crisis.[4]On the one hand, there was the (ECB), which was supposed to absorb the shocks affecting the entire zone by acting on interest rates. On the other hand, there were national fiscal policies that managed specific shocks. Such a configuration could not pose any problems as long as public finances were healthy. But the arrangement from Maastricht has failed, and can be seen both before and after the crisis. Before the crisis, the Stability and Growth Pact could not eliminate sovereign debt risks. The advent of the sovereign debt crisis demonstrates this. During the crisis, the ECB's monetary easing instruments proved their limit, while the Member States had to tighten their fiscal policies.

Thus, the occurrence of the crisis has made some doubt the ability of the system, based on the maintenance of almost exclusive member states' competences in budgetary policies, even when those policies are coordinated to ensure the prevention of shocks that may affect the countries of the Eurozone. As a result, a debate is now taking place on how to make the euro area more resilient. This debate mainly focuses on the macroeconomic stabilization function within the euro area. For some, the euro area is facing an economic problem: namely, the absence of a centralized stabilization mechanism, which would be a gap in the euro area. To solve this problem, many are proposing the introduction of a Eurozone budget. However, we note that this debate is characterized by uncertainty about the reality of this economic problem, on the one hand, and uncertainty about the legal and institutional aspects of the solution proposed to this problem, on the other hand. This paper will be articulated around these two aspects.

II. UNCERTAINTY ON THE ISSUE

The first uncertainty is about the need put in place a budgetary capacity to ensure a stabilization function in the Eurozone. The question of necessity arises mainly from the economic point of

[4]Agnès Bénassy-Quéré ,Xavier Ragot and Guntram Wolff, *Quelle union budgétaire pour la zone euro,* 29 LES NOTES DU CONSEIL D'ANALYSE ÉCONOMIQUE 1, 1-12 (2016).

view. While it seems that a large part of the scientific community is leaning towards a positive response, arguments in the opposite direction are also invoked. As a result, two opposing points of view manifest the uncertainty in this matter.

On one side, there is the position of those who believe that the establishment of a fiscal capacity for the euro area is necessary, or at least, desirable. The 2008 financial crisis and the sovereign crisis of 2010 are presented as having shown that the EMU is likely to suffer and succumb to external shocks. Starting from this point, several factors have been put forward to explain this situation and thus justify the setting up of a stabilization mechanism. Most of these factors are based on a view of EMU as incomplete. This lacuna is deduced from Mundell's theory of optimal currency areas.[5]Through this theory, Mundell wanted to determine the conditions in which it would be relevant for regions to adopt a common currency. On the basis of this, the fact that EMU is not an optimal economic zone has been put forward. EMU was not an optimal currency area not only in view of the traditional criteria initially identified by Mundell but, furthermore, it was not so in the light of the other criteria developed as a result of Mundell's work. Indeed, among the works that succeeded those of Mundell, some put forward the need for a fiscal integration.[6]This fiscal integration itself implies a central budget for the monetary zone. From this perspective, a currency area cannot be optimal in the absence of a centralized stabilization mechanism. From this point of view, in the lack of a central budget, national fiscal policies, even when coordinated, are insufficient to ensure an adequate macroeconomic stabilization of the euro area. It thus follows from this argumentation the idea of an incompleteness of the euro area that should, therefore, be filled. Some writers have not hesitated to compare the Eurozone to a house without a roof.[7]The specificity of the euro area in relation to the federal countries[8]was also put forward: if these areas do not even fulfill the classic criteria of the optimal currency area, they

[5]Robert A. Mundell, *A Theory of Optimum Currency Areas*, 51AMERICAN ECONOMIC REVIEW 657, 657-665 (1961).
[6]JAMES INGRAM, REGIONAL PAYMENTS MECHANISMS: THE CASE OF PUERTO RICO, (University of North Carolina Press 1962); Peter Kennen, *The Theory of Optimum Currency Areas: An Eclectic View, in* MONETARY PROBLEMS OF THE INTERNATIONAL ECONOMY, (Richard A. Mundell and Alexander A. Swoboda 1969); James Ingram, *How: The Optimum Currency Problem, in* MONETARY PROBLEMS OF THE INTERNATIONAL ECONOMY, (Richard A. Mundell and Alexander A. Swoboda 1969) and Emmanuel Farhi and Ivan Werning, *Fiscal Unions*, 107(12) AMERICAN ECONOMIC REVIEW 3788, 3788-3834 (2017).
[7]Paul de Grauwe, *Design Failures in the Eurozone: Can they be fixed?,* LSE 'EUROPE IN QUESTION' DISCUSSION PAPER SERIES 1, 1-32 (2013).
[8]INTERNATIONAL MONETARY FUND, *Toward a fiscal union for a Euro Area*, pg. 15 (September 2013).

nevertheless have one thing in common that distinguishes them from the Eurozone is that they have a central budget responsible for managing asymmetric shocks.[9]In countries as different as the United States, Australia[10]or India[11], there are macroeconomic instruments that are supposed to cushion the effects of the business cycle.

On the other hand, there are those who argue that there is no need to put in place a fiscal capacity. In addition to criticisms and doubts about the relevance of using the theory of optimal currency areas to explain the inadequacies of EMU[12], this position is based on several arguments that can be grouped into three categories. Firstly, there is a questioning of the external nature of the shocks affecting the countries of the euro area. So there are experts stating that "an external shock is often a great deal less than ' external ' than the term implies, with shocks being caused by insufficient supervision by member states, delayed reforms, missed growth opportunities, and letting debt rise unsustainable levels."[13]The idea is that the shocks are in fact due to the inadequacies of the Member States in respect of their commitments. If states fail to cope with the crisis, it is because they do not have room to act. This situation results from non-compliance with the rules of the Stability and Growth Pact. If the rules and principles of the Stability and Growth Pact had been respected, then the states concerned could have better cushioned their shock. From this point of view, it is not the exclusively decentralized nature of stabilization that poses a problem. On the contrary, in order to make the EMU more resilient, the stabilization and internal damping mechanisms of the member states should be strengthened. It is not necessary to change the architecture EMU. Second, there is the same effect, those who believe that the difficulties facing the EMU are not the fact of its institutional architecture. These difficulties are in fact linked to the lack of mobility of the factors of production. It is then a question of taking targeted measures on

[9]GEROGE ANDERSON, FISCAL FEDERALISM COMPARATIVE AN INTRODUCTION (Oxford University Press 2009); FRANCE GIUSEPPE FERRARI, FEDEALISIMO, E SISTEMA FISCAL E AUTONOMIE: MODELLI GIURIDICI COMPARATI (Donzelli 2010).
[10]Miranda Stewart, *Australia*, *in* TAX ASPECTS OF FISCAL FEDERALISM: A COMPARATIVE ANALYSIS 137, 137-180 (Gianluigi Bizioli & Claudio Sacchetto 1 ed. 2011).
[11]Ashutosh Varshney, *How has Indian Federalism Done?,* 1(1) STUDIES IN INDIAN POLITICS 43, 43-63 (2013).
[12]Ivo Maes, *Optimum Currency Area Theory and European Monetary Integration,* 37(2) TIJDSHRIFT VOOR ECONOMIE EN MANAGEMENT 137, 137-152 (1992) ; EUROPEAN PARLIAMENT,*Adjustment to asymmetric Shocks,* 1-75 (September 1998).
[13]Adrian Schout, *The EMU does not have any flaws. A Critique of the European Commission's Reflection Paper on the Deepening of the EMU,* CLINGENDAEL- NETHERLANDS INSTITUTE OF INTERNATIONAL RELATIONS (June 12, 2018, 9:02 P.M.), https://www.clingendael.org/publication/emu-does-not-have-any-flaws.

this dimension rather than reforming the architecture of the Monetary Union. Finally, another trend challenges the need for a fiscal union.[14]The crisis has led to a number of reforms. One of the most important is the establishment of the banking union, and the strengthening of budgetary surveillance, notably through the implementation of the European Semester. These mechanisms, whose purpose is to prevent systemic risks from the banking sector and, for the other, to prevent macroeconomic imbalances, have suggested that it would no longer be necessary to introduce stabilization tool at the level of the euro area. The idea being that risk reduction would somehow replace its sharing. In other words, a banking sector better monitored and more solid, and a level of public and private debt and stockings reduce the need for a fiscal stabilization tool. In the same vein, an increasingly popular opinion is to argue that, instead of trying to establish a fiscal capacity, Europe should pursue a more pragmatic solution, which is to "complete the banking union" and transform the existing European Stability Mechanism (ESM) into a European Monetary Fund (EMF).[15]

On the political scene, the desirability of setting up a stabilization tool is also debated. The uncertainty is manifested here too by the presence of two opposite positions. The principle of the organization of a centralized stabilization in the euro area enjoys political support in the European Union. If the question of fiscal integration is a long-standing concern in the European Union[16],the first time the budget capacity phrase is used in an official document of the EU is in the Van Rompuy report prepared by the Chairman of the Council and published in 2012. In this report, it is explicitly stated that the strengthening of fiscal discipline is not sufficient and that fiscal capacity should be developed. This idea of a fiscal capacity attached to the EMU was also mentioned and supported, both by the Commission[17]and the European Parliament[18]as well as some Head of

[14]ANSGAR BELKE AND DANIEL GROS, BANKING UNION AS A SHOCK ABSORBER: LESSONS FOR THE EUROZONE FROM THE US (Rowman and Littlefield International 2015).
[15]Andre Sapir and Dirk Schoenmaker, *We need a European Monetary Fund, but how should it work?*, BRUEGEL (June 17, 2018, 9:20 P.M.), http://bruegel.org/2017/05/we-need-a-european-monetary-fund-but-how-should-it-work.
[16]This concern can be found in the Werner report of 1970 or the MacDougall report of 1977, in which it was stated that a budget of 5-7% of Community GDP would have been sufficient to ensure the stabilization function of the federal state budgets. However, the idea of adding to the Economic and Monetary Union a fiscal capacity is fairly recent, even though the Delors Report of 1989 was already approaching that idea.
[17]PRESIDENT OF EUROPEAN COMMISSION, *Completing Europe's EMU* (June 2015).
[18]EUROPEAN PARLIAMENT, *Towards a genuine EMU,* pg. 7 (November 2012).

States.[19]However, a certain number of States, mainly in northern Europe, have expressed some skepticism at the idea of a stabilization mechanism. This is how the Dutch Prime Minister declared that "we've come a long way, and the EU has shown that it can take action when it has to. But we're not sufficiently prepared for another crisis. And yes, I know that a currency union needs stabilization mechanisms at times of crisis. But if the 19 Eurozone countries were to put their own budgets and national debts in order that would probably be stabilization enough. That, too, is simply an existing agreement under the Stability and Growth Pact". More recently, in June 2018, several European countries, including the Netherlands, reiterated their opposition to a euro area budget. In their view, the need for such a mechanism does not arise. What is needed is a stronger performance on national structural and fiscal policies in line with common rules. In other words, the lack of a centralized stabilization mechanism is not the fundamental problem of the euro area.

If an uncertainty weighs on the economic necessity justifying the setting up of a budget for the euro area, uncertainty also weighs on the legal and institutional conditions for carrying out such an approach.

III. UNCERTAINTY ON THE SOLUTION

This uncertainty can be seen across three aspects of the fiscal capacity: its establishment conditions, its revenues and its expenditures.

Amending the Treaties is not an easy task, especially for a subject as delicate as the establishment of a fiscal capacity for the Eurozone. And that is where the first source of uncertainty lies. Indeed, for certain forms of fiscal capacity, it will be necessary to amend the Treaties. It should be noted now that the discussions on a fiscal capacity are also about the form it will take. Various proposals have been made. This fiscal capacity could be a full-fledged budget, an insurance-type tool against output gaps or an unemployment insurance scheme, etc. These different forms do not have the

[19]Both Emmanuel Macron and Angela Merkel showed their support for a euro area budget during their meeting of June 19, 2018.

same legal implications. In the case of an unemployment insurance scheme, for instance, it will be necessary to amend the Treaties.

Other sources of uncertainties in establishing a fiscal capacity for the euro area can be illustrated through the European Commission's president proposal.[20]This proposal argues in favor of a fiscal capacity for the Eurozone financed by a line on the European Union's budget. The first problem arises from the need to find a legal basis in the treaties enabling the establishment of such a capacity for the Eurozone. It should be noted that the implementation of any expenditure appearing in the Union budget requires, according to Article 310 (3) TFEU, the prior adoption of a legal act corresponding to this expenditure. The legal basis will depend on the type of fiscal capacity that one wishes to put in place (a rainy day fund scheme, an unemployment reinsurance scheme, an investment Protection scheme, etc.). Two issues need to be addressed in setting up this capacity.[21]Firstly, because of the principle of conferral, the scope of action of the fiscal capacity will be limited by the scope of the corresponding legal basis. Secondly, the establishment of this capacity will require the involvement of representatives from all EU Member States. This requirement poses apparent difficulties. However, while there are ways to avoid the involvement of representatives of all Member States, including limiting participation in the decision-making process to the Eurozone Member States only, these means have a limited reach. Although it would be interesting to consider the establishment of a fiscal capacity through Article 136 TFEU, this article only concerns the coordination and the surveillance of national budgets. It is not clear that this article can then serve as a legal basis for establishing fiscal capacity for the euro area states. It might also be envisaged to go through the enhanced cooperation procedure. But here again, there is no certainty about the use of Article 20 as the legal basis for the establishment of the fiscal capacity.

[20]Jean-Claude Juncker, State of the Union Address to the European Parliament, Strasbourg, 13 September 2017.
[21]Richard Crowe, *Is a separate Eurozone Budget a good idea?,* ADEMU- A DYNAMIC MONETARY AND ECONOMIC UNION (June 11, 2018, 7:35 P.M.), http://ademu-project.eu/wp-content/uploads/2018/06/120-Is-a-separate-eurozone-budget-a-good-idea.pdf.

About expenditure, it is clear that the choice of spending is an essential issue in the implementation of the fiscal capacity. Indeed, the fiscal capacity must make expenditures. That's how it carries out its tasks. But the expenditure aspect of the capacity carries two major issues.

The first question is the function of this fiscal capacity: should it be limited to the stabilization function, which is its primary function, or should it be extended to the other functions traditionally assumed by a budget, such as the financing of public goods?[22]It is indeed possible to imagine that this capacity would finance certain public goods at the level of the Eurozone, whether in terms of environment, infrastructure or health. In this case, it is necessary to ask whether it is possible to imagine public goods that would only benefit the members of the Eurozone. In this aspect, the Eurozone would be exposed to a free rider problem: non-euro area countries will be the free riders. Such a situation will most likely reinforce the reluctance of some countries to finance goods from which all Member States will benefit. But this question of the financing of public goods by the budget of the euro area involves another aspect: the problem of a two-tier European Union. Indeed, financing public goods for the countries of the Eurozone is tantamount to erecting this zone into a real subsystem.[23]

This remark leads us to the second issue arising from the extension of the functions of the euro area budget. If the fiscal capacity must finance public goods, bodies able to make choices and to define priorities should be established. In other words, the Eurozone should be granted some form of institutional autonomy. It will be necessary to have an entity entrusted with the task to define how the funds should be spent. The institutionalization of the Eurogroup is one the way to

[22]Jean Pisani-Ferry, Erkki Vihriälä, and Guntram Wolff, *Options for a Euro-area Fiscal capacity,* 1 BRUEGEL POLICY CONTRIBUTION 1, 1-14 (2013); Eulalia Rubio, *Budget de la zone euro: trois fonctions, trois instruments*, 567 REVUE DE L'UNION EUROPÉENNE 214, 214-217 (2013) and STÉPHANIE HENNETTE, THOMAS PIKETTY, GUILLAUME SACRISTE, AND ANTOINE VAUCHEZ, POUR UN TRAITÉ DE DÉMOCRATISATION DE LA ZONE EURO (T-DEM), (Éditions du Seuil 2017).

[23]But perhaps the euro zone is already a subsystem. A hypothesis can be made that through the ESM, there is already a public good only financed for the members of the Eurozone, it is the financial stability. In addition, the Member States of this zone have already accepted a loss of sovereignty superior to that of the other Member States.

tackle this issue.[24]Aside from the uncertainties and obstacles related to expenditures, there are those related to the revenues of the fiscal capacity.

How will the euro area budget be financed? There are many possibilities. But these different possibilities are not without problems. These include what has been called the problem of asymmetry and the issue of unanimity.[25]

The first possibility is to make Member States finance the capacity. It is the idea of a Eurozone budget that would be funded by a line in the budget of the European Union. This solution nevertheless raises a problem of asymmetry. In accordance with the budgetary principle of universality, the funding devoted to the fiscal capacity will come from the common pot, to which all Member States contribute. As a result, the problem posed by asymmetry will manifest itself on two levels. Firstly, there are differences in size, wealth and economic performance between Member States. As it may have emerged from the statements of some European political figures, the establishment of a European budget should not devote a Union of transfer, with payments made by rich Member States in favor of poor Member States. The differences in size between Member States coupled with the particular nature of the European construction appear to be obstacles to the establishment of a fiscal capacity since it will be easy for some Member States to feel exploited by others. Secondly, the problem of asymmetry will also be manifested by the fact that States that are not members of the Euro Zone will be reluctant to finance a capacity that will only benefit the members of that zone. The logic of equalization, which is found in some federal states, is less well understood within the framework of the European Union.

Another solution would be to ensure that the fiscal capacity has its own resources. This can be achieved by raising a new tax.[26]But is it possible for a tax to be created at the European level? For

[24]Furthermore, the gradual evolution of the role of the Eurogroup since the 2008 crisis can be seen as the first step toward a movement that will lead to the recognition of this entity as a formal body of the European Union. On this point See Louise Fromont, 'L'Eurogroupe, le coté obscur de la gouvernance économique', *Revue du droit de l'Union européenne*, no. 4 (2017), pp. 195-221.

[25]See Federico Fabbrini, *Economic Governance In Europe. Competitive Paradoxes and Constitutional Challenges* (Oxford: Oxford University Press, 2016), pp. 154-179.

some, the combination of Articles 311 and 113 TFEU allows such an approach. Beyond the legal controversy on this point[27]if we admit that this is possible, we soon find ourselves in front of another obstacle. These two articles operate on the basis of unanimity. And this unanimity constitutes in itself an impediment to the financing and, therefore, the establishment of fiscal capacity. It will be complicated to get the agreement of all the Member States. To overcome this difficulty, one could consider going through the method of enhanced cooperation, but the saga of the tax on financial transactions shows the limits of this scheme.

Even if the obstacle of unanimity is overcome, there will remain another problem: the democratic legitimacy of the capacity. The lack of democratic legitimacy manifests itself through the marginal place occupied by the European Parliament in all this architecture. If a tax is established under the Eurozone to finance the fiscal capacity, would this not be a breach of the principle of consent to tax, and its equivalent in other countries, when it's known that the European Parliament has only advisory powers in tax matters. Some may argue that it will be the sign of a lack of representation. One way to solve this issue would be to devote a parliament of the Eurozone. But in that case, it will then be necessary to amend the treaties.

A solution to this problem could be that only the euro area Member States would finance the euro area's fiscal capacity. In this case, the euro area Member States could contribute to the fiscal capacity through derogation from the principle of universality found in Article 21 of the Financial Regulation. It's the method of external assigned revenue. This method allows Member States to contribute additional amounts to specific actions of the Union. This circumvents article 314 TFEU.[28] Member States will directly allocate the funds to a particular expense on a voluntary basis. Thanks to this method, Member States will be able to finance the capacity by making an agreement between them in which they commit themselves to pay predetermined amounts to the fiscal

[26]Daniel Gross, *Eurobonds: Wrong solution for legal, political, and economic reasons*, VOX CEPR POLICY PORTAL (June 15, 2018, 9:45 P.M.), https://voxeu.org/article/eurobonds-are-wrong-solution.
[27]Edoardo Traversa & Alexandre Maitrot de la Motte, *Le fédéralisme économique et la fiscalité dans l'Union européenne*, *in* L'UNION EUROPÉENE ET LE FEDERALISM ÉCONOMIQUE 343, 343-380 (Stéphane de La Rosa, Francesco Martucci & Edouard Dubout 2015).
[28]The budgetary procedure of article 314 implies the participation of the representatives of all Member States.

capacity. However, this solution presents two difficulties. On the one hand, this mechanism leaves little power to the Commission, which cannot effectively compel Member States to respect their commitments. On the other hand, since this mechanism is based on direct payments by Member States, it brings out the link between financial transfers between Members States and fiscal capacity. Once again, the problem of asymmetry will arise: the wealthiest states of the EMU will be reluctant to finance the least wealthy ones.

IV. CONCLUSION

The uncertainties surrounding the establishment of a budgetary capacity for the Eurozone constitute one of the significant challenges of the reform of the EMU. We have seen that these uncertainties concerned both the need to develop a fiscal dimension for the euro area and the legal conditions for carrying out such a project. In any case, the establishment of this capacity will only come at the cost of many efforts, which makes the realization of such a scenario unlikely, without making it impossible, in the near future. Regarding these developments, alternative solutions are increasingly being discussed, such as strengthening the banking union. Are these solutions likely to resolve the difficulties facing the euro area? Only time will tell. But what is certain is that as long as there is uncertainty about the best way to make the euro area more resilient, its future will also remain uncertain.