

A reform agenda for the EU budgetary system: Bringing macro-economics into the debate

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Rationale of the paper: Bringing together three dispersed debates

1. The debate on automatic stabilizers
 - Divergence in EMU business cycles?
 - National fiscal policy as a possible destabilizer (France; Italy?)
2. The debate on national public finances
 - Reform of Stability and Growth Pact
 - Sustainability of debt
3. The debate on the EU budget
 - Efficiency of money spent given e.g. the Lisbon goals
 - „Rendez-vous-clause“ in the compromise for the 2007-2013 budget

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Outline

- Arguments for a more coherent and efficient budgetary system in the EMU
- Requirements of a coherent system
- Review of the European budget
- Reform proposals for the income and expenditure side
- Discussion of the political feasibility

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Closing the gap between the Lisbon process and macroeconomic stabilization I

Traditional (post-Maastricht) view on fiscal stabilization policies

- No long-term consequences of macroeconomic fluctuations
- No negative spillovers from failing to stabilize
- Fiscal policy has very little scope for stabilization policies (due to Ricardian equivalence)
- Small costs of macroeconomic fluctuations (Lucas 2003)
- EMU will lead to more flexible labour markets and thus a diminishing need for stabilization policies
- Action on stabilization policy is not overly pressing

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Closing the gap between the Lisbon process and macroeconomic stabilization II

New insights on fiscal stabilization policies:

- Fiscal stabilization policies can be very effective, as Ricardian equivalence does not hold empirically
- New Growth Theory: Link between short-run fluctuations and long-term growth
 - Aghion/Howitt (2006): Periods of low growth might lead to less R&D
 - Hysteresis in the labour market
- EMU prolongs business cycle; long boom and bust cycles (Lane 2006; Enderlein 2004; Dullien/Schwarzer 2005; 2006)
- Efficiency loss due to business cycle fluctuations might be higher than thought (Galí/López-Salido 2005)
- Business cycle fluctuations might undermine political support for structural reform (OECD 2005)

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Closing the gap between the Lisbon process and macroeconomic stabilization III

Conclusion from recent theoretical developments:

1. Lisbon process and stabilization policies are complements, not substitutes!
2. Europe might need more, not less stabilization than the US because of less flexible markets

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How to stabilize: Arguments for automatic stabilizers

- Lag in economic data makes discretionary fiscal policy hard to conduct
- Possible additional implementation lag in fiscal policy due to budgetary process
- Stabilization policy is most effective when limited to a short period (Andersen 2005), while political economy consideration suggest that discretionary fiscal policy might change government expenditure in the long run
- Politicians tend not to act anti-cyclically in an upswing (Tanzi 2003)

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How we stabilize: Experience of first years of EMU (I)

- In principle: Europe has strong automatic stabilizers (van den Noord 2000)
- We could expect high degree of stabilization
- But: Galí/Perotti (2003) show that fiscal policy has been slightly pro-cyclical both prior and after 1992; no analysis of post-1999 data

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How we stabilize: Experience of first years of EMU (II)

- Econometric study following Galí/Perotti up to 2006; analysis for pre- and post-1999 period
- Reaction of structural deficit to changes in the output gap (proxy for discretionary policy):
 - US: strong positive reaction (high stabilization)
 - Japan until 1999: strong positive reaction
 - EMU: negative reaction, but not significant (might be pro-cyclical), both before and after 1999
 - Germany and Portugal turn strongly pro-cyclical after 1999
- Reaction of overall deficit to changes in the output gap (proxy for overall fiscal policy):
 - Slightly pro-cyclical in EMU (albeit not significant)
 - Strongly counter-cyclical in the US and Japan

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What's wrong in EMU: Explaining the failure to stabilize

- Fiscal federalism in Europe today: National governments are responsible for stabilization
- Problem of externalities:
 - In small open economies, a lot of stabilization benefits end up with the neighbors
 - Costs have to be borne solely by country that undertakes stabilization
- Problem of incentives: pro-cyclical policies both in bust and boom times (currently F, I)
- Solution: In a federal system, stabilization should be undertaken at the highest level of government (Goodhart/Smith 1993) and governed by fiscal rules

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Requirements for a coherent system of EU revenue and expenditure

Three principles:

- Money should be spent in a way that enhances the productivity of the European economy and thereby works toward the Lisbon goals
- In contrast to today, both EU revenue and expenditure should be raised and spend in a way that they do not contribute to boom and bust periods in the business cycle
- An explicit pillar to stabilize the business cycle, both at the regional level as well as at the union level should be introduced

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Today's EU budget: Evaluating its properties against our principles

■ Revenue side:

- „Own resources“ are acyclical; include some elements without economic basis (rebate for the British)
- Lengthy negotiations on finance make reaction to fluctuations all but impossible

■ Expenditure side in the 2007-2013 framework

- Main expenditure is agriculture (680 bn €), which is acyclical
- Second large element is structural and cohesion policy (308 bn €), which is sometimes even pro-cyclical
 - EU money has fueled Spanish boom when construction sector was already overheating

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Proposals for reform: The revenue side of the EU budget

- Ideally, tax revenue should fluctuate with the business cycle
 - VAT and tariffs are not ideal, as they are among the least cyclically sensitive of all taxes
 - Best solution would be a progressive personal income tax on the EU level
 - But: large differences between national systems
- Possible solution: EU wide corporate tax
 - Would introduce cyclically sensitive financing
 - Would introduce minimum tax rate for EU
 - Parallel to US set-up, each country could levy additional tax on top
 - Could easily finance the whole EU budget (corporate taxes in the EU amounted to 3.2 percent of GDP in 2004, while EU budget stands at 1.27 percent)

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Proposals for reform: The expenditure side of the EU budget

- Condition disbursements of funds for construction on the position in the business cycle
 - In an upswing, contractors would be allowed to work slower, construction would be delayed
 - In a downturn, contractors would be required to deliver earlier
- Vary the co-payments of national governments with the economic cycle
 - In a boom, national governments would have to pay a larger share of the spending from structural and cohesion funds, thus adding strain on their budgets to keep them from excessively spending in a boom

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Adding a third pillar to the EU budget: A European Unemployment Insurance (EUI)

- Unemployment insurance as a regional transfer mechanism
 - Net payments would flow from booming countries into the fund
 - Net payments would flow from the fund to countries in dire straits
- Unemployment insurance as overall stabilization mechanism for EMU business cycle
 - EUI would build up reserves in good times
 - EUI would run down reserves in a EMU-wide downturn
 - Would remove single country's discretion over use of unemployment insurance surplus/deficit

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Adding a third pillar to the EU budget: A European Unemployment Insurance (EUI)

- Why unemployment insurance (and not other transfer systems such as proposed in von Hagen/Hammond 1995 or Italianer and Vanheukelen 1993)?
 - EUI would force national governments to use the money for stabilization purpose
 - Experience in other federal systems (US; Germany)
 - Unemployment insurance is easy to understand
 - No elaborate econometric estimations are needed
 - Short-term unemployment is by definition a good indicator for the output gap
 - Very short-term fluctuations are neglected, only those lasting for several quarters have effects on transfers

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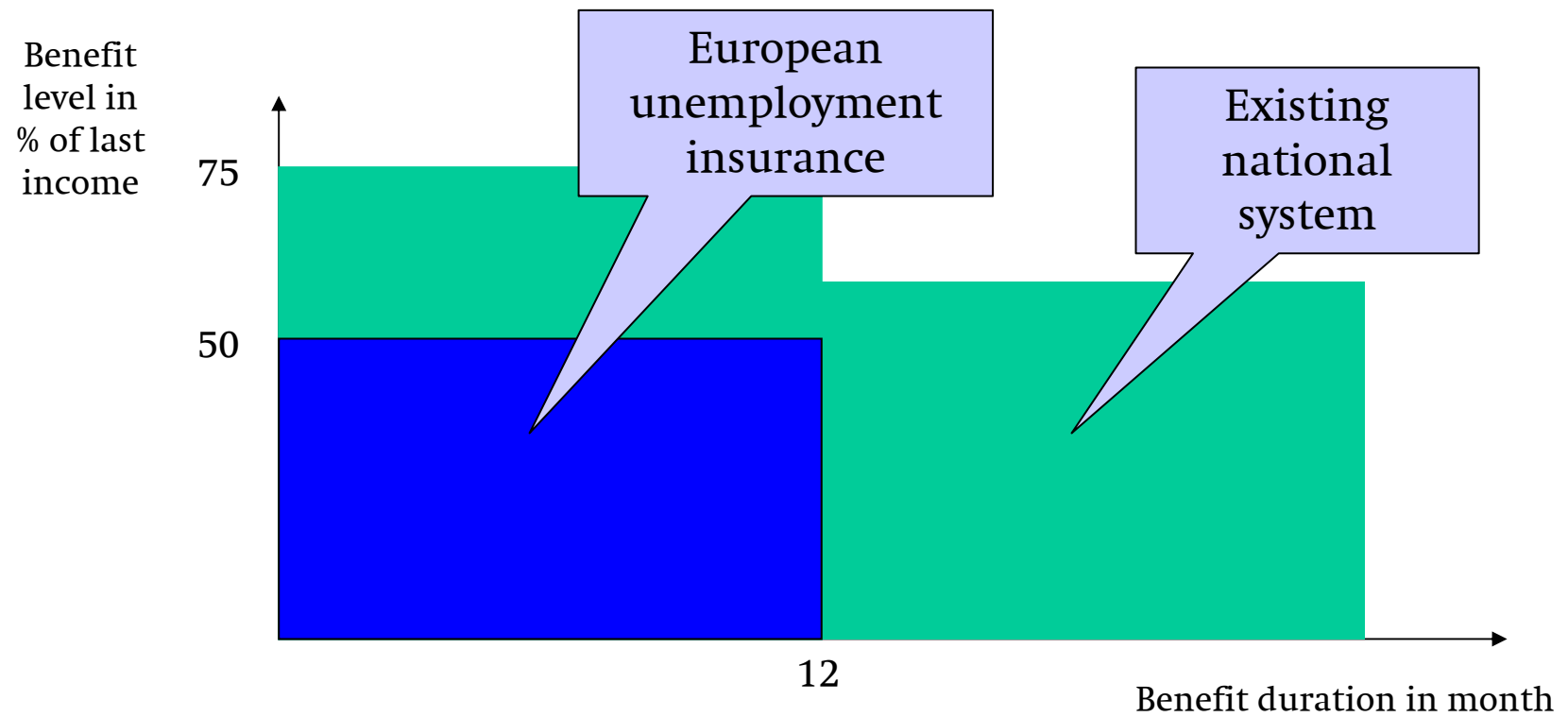
Basics of the European Unemployment Insurance (EUI)

- EUI would provide basic insurance against unemployment via a supra-national fund
- Individuals would be insured up to a certain limit
- Financing via a limited payroll tax
- Each country could add another layer of security
 - national sovereignty over social issues is preserved
 - Incentives for the unemployed are unchanged by the introduction of EUI
- Only short-term unemployment of formerly employed persons is insured so that mechanism does not finance structural unemployment and does not create moral hazard problems

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Interaction of EUI and national unemployment systems



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Specifics of a European Unemployment Insurance

- Benefit levels as a proportion of last insured earnings
- Payroll tax applicable up to a certain threshold
- Definition of maximum benefit and contribution levels as a percentage of average wage in individual country
- Proposal:
 - Benefits: 50 percent of past earning
 - Maximum contribution level: average wage in each country
 - Consequently: maximum benefit equals 50 percent of average wage level

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Implementation of European Unemployment Insurance

- Could be implemented either within EU structure or outside EU structure
- Preferably for all Eurozone countries, but could start with only a part of them
- Would fit nicely into existing systems:
 - All EMU countries with exception of Greece and Ireland have similar system in place in which benefits depend on past earnings
 - All countries but Luxembourg finance unemployment insurance with payroll tax, a part of which could be replaced by European payroll tax
 - No additional net tax burden

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Maximising the stabilization properties of EUI: Lessons from the US system

- In the US, benefit duration increases automatically when unemployment increases over certain thresholds („extended benefits“)
- This feature can greatly increase stabilization properties
- EMU would benefit from such a rule

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Potential financial flows and stabilization properties of EMU unemployment insurance

- Scenario A: No extended benefits
 - Annual volume (1999-2005): € 54 bn
 - Payroll tax needed: 1.75 percent
 - Stabilization: 5 percent of fluctuation
- Scenario B: Extended benefits; triggers for individual countries
 - Annual volume (1999-2005): € 62 bn
 - Payroll tax needed: 2.02 percent
 - Stabilization: about 13 percent of fluctuation
- Scenario C: Extended benefits; triggers for EMU as a whole
 - Annual volume (1999-2005): € 63 bn
 - Payroll tax needed: 2.04 percent
 - Stabilization: about 16 percent of fluctuation

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Stabilization properties of EUI: Details

Country	(1)	(2)	(3)	(4)	(2) in % of (1)	(3) as % of (1)	(4) as % of (1)
	Output GAP in % of GDP (time period)	UI Balance in % of GDP (time period)			Change in transfers as share of change in output gap (proxy for degree of stabilisation)		
		No extended benefits	Individual country trigger for extended benefits	EMU wide trigger for extended benefits	No extended benefits	Individual country trigger for extended benefits	EMU wide trigger for extended benefits
Euro-Zone	-3,5 (2000-2005)	-0,17 (2001-2004)		-0,56 (2001-2004)	4,9%		16,0%
Belgium	-3,3 (2000-2005)	-0,23 (2001-2003)	-0,56 (2001-2003)	-0,56 (2001-2003)	7,0%	17,0%	17,0%
Germany	-4 (2000-2005)	-0,32 (2001-2005)	-0,8 (2001-2005)	-0,73 (2001-2004)	8,0%	20,0%	18,3%
Spain	-2 (2000-2005)	-0,21 (2001-2003)	-0,22 (2001-2003)	-0,83 (2001-2003)	10,5%	11,0%	41,5%
France	-3,2 (2000-2005)	-0,11 (2001-2004)	-0,53 (2001-2004)	-0,53 (2001-2004)	3,4%	16,6%	16,6%
Italy	-3,5 (2001-2005)	-0,04 (2001-2002)	-0,04 (2001-2002)	-0,25 (2001-2003)	1,1%	1,1%	7,1%
Netherlands	-5,6 (2000-2005)						
Austria	-3,5 (2000-2005)	-0,16 (2001-2002)	-0,47 (2001-2002)	-0,37 (2001-2003)	4,6%	13,4%	10,6%
Portugal	-5,7 (2000-2006)	-0,37 (2000-2003)	-0,66 (2000-2005)	-0,73 (2000-2003)	6,5%	11,6%	12,8%
Finland	-4,3 (2000-2004)	-0,1 (2000-2001)	-0,11 (2000-2001)	-0,56 (2000-2003)	2,3%	2,6%	13,0%

Source: Own simulations based on AMECO/Eurostat data

Table 9: Output Gaps and Hypothetical Transfers by EMU unemployment insurance in the most recent recession

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Political Feasibility of an EUI: Which country would accept such a system?

- In the past recession, Germany would have enormously profited from the system, especially if automatic triggers for individual countries had existed
 - Large transfers to Germany from 2002 to 2005 (shift in net payment balance from 2001 to 2005 equals € 17.5 bn or 0.8 percent of GDP)
 - Would have pushed German budget deficit below 3 percent in 2004 and 2005.
- For countries like Spain, this could be an insurance against a bust in the construction sector
 - Example Portugal: Would have been net payer when things went well (late 90s); would have received net payments in crisis

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Political Feasibility of an EUI (II): Which actors would accept the system?

- Is the EUI not a move against the independence of the ECB and towards an old-Keynesian fiscal policy approach?
- No!
 - The EUI system is a rule-based framework for economic stabilization by fiscal policies.
 - EUI weakens the argument of those that favor discretionary fiscal policy
- Those actors who have been proponents of debt sustainability and a rule-based framework for EMU should favor such a scheme (EU Commission, German government, ECB) to prevent harmful national policies

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