THE FEDERAL TRUST
for education & research
enlightening the debate on good governance
European Policy Brief
August 2007 • The Federal Trust, 31 Jewry Street, London EC3N 2EY • www.fedtrust.co.uk

A Stabilisation Fund for the Eurozone

Mark Nevin

This paper sets out to explore the issues related to the establishment of a supranational fiscal stabilisation fund for the Eurozone . A brief outline of the current economic and fiscal working arrangements of the Eurozone is provided. A summary of likely benefits from creating such a stabilisation fund then follows. Issues of moral hazard and accountability in expenditure from the fund are identified with potential institutional solutions explored. An operable working arrangement for the fund is proposed, having considered these issues. This proposed model is built on economically defensible foundations, while respecting member state diversity and allowing national administrations significant flexibility to utilise the funding in what they consider the most appropriate manner. Oversight and sanctioning procedures are detailed which help to avoid many of the potential pitfalls which might hinder further European economic integration through the mechanism of the stabilisation fund.

Current EMU working arrangements

The Eurozone exhibits a uniquely structured division of responsibilities between national and supranational policy-makers in macroeconomic policy. This is the product of a tortuous series of negotiations between EU member states as has been outlined by the recent Federal Trust (2006) report titled 'The Governance of the Eurozone'.

Macro-economic fiscal and monetary policy functions in the Eurozone are sub-divided between national and supranational policy-makers. Fiscal policy is the responsibility of the national administrations, though it is subject to the constraints set by the Stability and Growth Pact (SGP). Monetary policy is conducted for the Eurozone by the independent European Central Bank (ECB), which sets the common interest rate for those participating member states. The ECB targets Eurozone aggregates when conducting monetary policy and has responsibility primarily for the control of inflation. General support for the economic policies of the member states as a whole is provided by the ECB though this is subordinate to the price stability objective being met. This subdivision of macro-economic policy functions implies a different policy response depending on whether an adverse economic shock is common to all or the majority (for example suddenly restricted supply of a raw material used by all to a similar degree), or asymmetric, affecting national economies in distinct ways (for example a large reduction in demand for exports that are unique to one member state).

This is the sixth in a series of *Policy Commentaries* produced by the Federal Trust. The aim of the series is to give the personal view of an experienced commentator on major controversies in the current British debate about the European Union.

The opinions expressed are those of the author and do not commit the Federal Trust. We welcome any comments or reactions.

The Federal Trust for Education and Research
31 Jewry Street, London, EC3N 2EY
0207 320 3045 www.fedtrust.co.uk

This Eurozone macro-economic policy structure might imply in some circumstances that the ECB will act to offset common shocks affecting euro area output and inflation, though the former is always subject to the inflation target's being met. Should the member states economies slow in aggregate, due to a demand shock, this will cause output growth to fall below potential and simultaneously lower the rate of inflation. The ECB would then have scope to cut interest rates to offset that common recessionary shock. However in other circumstances, it is quite possible that a trade off could arise in meeting both objectives, for example a supply shock which increases the price of oil, simultaneously slowing output growth and increasing inflation. Should such a trade off materialise, the ECB has made it clear that it will target inflation over output, as has always been its interpretation of the Maastricht Treaty.

The ECB does not seek to stabilise a region or regions suffering asymmetric shocks, since it targets only Eurozone aggregates when conducting monetary policy. A negative asymmetric shock affecting one or two member states may barely or not at all register at Eurozone level, or may be offset by a positive asymmetric shock elsewhere. Participating member governments must therefore strive by their own efforts to counter asymmetric shocks to their economy. The policy tools available to national administrations were presumably deemed sufficient to counter the effects of such asymmetric shocks when the Maastricht Treaty was drawn up.

National level fiscal policy (coupled with microeconomic management) is intended under the system developed at Maastricht to deal with an asymmetric shock affecting a specific member state or region, though is constrained by strict borrowing limits as set by the SGP. If the national exchequer has been in balance or surplus when the asymmetric shock hits, then there is considerable scope to use fiscal policy to counter the shock. On the other hand, a member state may have started to approach the SGP deficit limits and then suffer an asymmetric negative shock, as occurred in a number of bigger Eurozone member states after 2001. Strict application of the SGP rules in this instance requires a tax rise or spending cut to prevent a breach of the deficit limit of three per cent of GDP. This would have the effect of further depressing economic activity, with a likely additional reduction in government revenues. The scope for national fiscal authorities to counter asymmetric economic shocks under the current arrangement is therefore constrained to a degree often criticised by a significant number of European economists.

In the long term, Eurozone governments can attempt to deal with asymmetric shocks through microeconomic reforms and this capacity is not entirely dependent on fiscal policy. Nevertheless, reforms take time to deliver real improvements, and are generally rather costly to implement in the short run both politically and economically. National policy makers in Eurozone member states can therefore find themselves on occasion locked into in a downward growth spiral, with curtailed fiscal tools, restricted potential to deliver microeconomic reforms and an inappropriate monetary policy exclusively targeting Eurozone aggregates. Moreover, the prospect of a devaluation of the exchange rate through market mechanisms or otherwise to correct the economy's imbalance has been removed by joining the single currency.

Where national administrations are constrained in their tools of economic management and this constraint is coupled with a European central bank focused upon a set remit for price stability, a deflationary bias in the structure is arguably unavoidable. This deflationary bias has been noted by numerous scholars of European political economy, and regarded by some as one cause of the underperformance in growth of the Eurozone since the inception of EMU. It is worth repeating however that each member government is required by strict application of the SGP medium term objective to move to a structural surplus in times of growth. This obligation has not always been observed as seriously as had been wished or anticipated.

Current fiscal working arrangements

Fiscal policy is primarily the responsibility of the national administrations at present, as is the vast majority of European public expenditure. In so far as supranational budget policy does exist in the EU, it is set entirely separate from EMU with little or no overlapping or complementary objectives. The current EU level budget is directed towards a limited number of objectives such as cohesion policy, the common agricultural policy, the environment and foreign aid. It is small (in terms of GDP); quite inflexible and unsuited to short term economic stabilisation. This arrangement is in contrast to the federal system of the US (or pre-EMU Germany) whereby regional economic shocks are in part countered by federal level transfers from faster growth regions (much of which is mediated through social welfare systems), playing a not insignificant part in stabilising consumption across states or Lander. For the US (or pre-EMU Germany) this provides an inter-regional insurance mechanism whereby federal level transfers benefit those states or Lander suffering asymmetric shocks, thus lessening their impact and smoothing the transition back to the region's growth potential.

Stabilisation fund model for the Eurozone

To deal with at least some of the problems sketched out above, a detailed and robust stabilisation fund model for the Eurozone is the aim of this policy brief. This paper will argue that the remit for the fund should be set out as a counter cyclical tool to stabilise a member state economy in EMU struggling with economic growth below potential and facing an inappropriate monetary policy targeting Eurozone aggregates. This stabilisation funding would constitute a tool of cross-regional stabilisation to assist member states in dealing with asymmetric shocks inside the common currency area.

As a general outline the revenues for this fund would be collected from those Eurozone member states growing at or above their economic potential. Payments out would be concentrated to where most needed. An automated system is incorporated in the proposal whereby a payment would be triggered by a participant state's economic growth slowing significantly below a set potential rate. The determination of that set growth potential would be the responsibility of an independent institution, and subject to periodic review. This process of collecting revenues and making payments would occur annually so that the fund could adjust and react to new circumstances in the member states. Should revenues be left over after all payments out are made, these would be returned to the paymaster states of that year.

The model requires that a supplementary mini-budget for the expenditure of the stabilisation funding would be drawn up by the national administration in addition to the national budget, but impacting a few months later. This would allow fiscal policy to react more quickly to new problems. The national finance ministry would determine the best use of the funding in any given year, whether that would be to stabilise demand, facilitate economic reforms or make investments to boost national growth.

This working model would provide timely assistance to the slow growth member states, while respecting their diversity and capacities for national problem solving. Concerns which arise are detailed, with solutions proposed in the main body of this paper. Moral hazard risks would arise if the provision of the fund increases the probability of events which require a payment from the fund. Specific member states might adopt risky policies or postpone reforms which could create successive unidirectional flows through the stabilisation fund. Mechanisms to address such concerns are incorporated into the model. Capping of the overall size of the fund and any one member state's annual entitlement would limit the capacity for unidirectional flows. The mini-budget from the national ministries would also be scrutinised in every instance by means of oversight and accountability procedures built into the model. These safeguards are later shown to address the likely criticisms of the proposal and help to deliver an improved economic performance for the Eurozone as a whole.

It should be recognised that any proposal to establish this type of Eurozone stabilisation fund would require EU treaty revisions. It would be opportune to couple reform of governance procedures in the Eurozone (incorporating this stabilisation fund model) with a changed mandate for the ECB to target symmetrical inflation target and/or economic growth in the Eurozone. This modification would be complementary to the establishment of a stabilisation fund since it would clarify the role of the ECB in targeting common shocks to the Eurozone economy, but it is not a prerequisite.

Benefits of a stabilisation fund for the Eurozone

There are a series of benefits likely to accrue to participants from the operation of a stabilisation fund for the Eurozone, some being realised in the short term with others playing out over a longer period. A stabilisation fund for the euro area would operate as an inter-regional insurance mechanism, helping to stabilise output growth and consumption levels between high and slow growth regions.

Firstly, over the short term consumer expectations would be stabilised to a greater degree, through restored disposable income and the knowledge that an additional fiscal stimulus will be available when required. Under the current arrangements, when a member state experiences an asymmetric negative shock affecting output, the common monetary policy becomes overly restrictive for that member state, consumers' disposable income falls and they anticipate fiscal restraint to remain within the SGP limits. This has a negative impact on consumer expectations and it becomes rational to hold back expenditure, which further slows the economy. Stabilisation fund transfers would help to restore disposable income and support expectations.

Secondly, a stabilisation fund would serve to stimulate the depressed member state's economy, facilitating a quicker return to potential growth rates. This would boost capacity to engage in economic reforms (to whatever extent they are required) by providing timely additional resources at member state level. A greater capacity to pursue and implement reforms should in the medium to long term deliver a higher output growth potential for that member state.

Thirdly, an established stabilisation fund would serve to transfer fiscal resources away from high growth regions, thus limiting the prospect of gov-

ernment expenditure causing growth to overshoot potential. Should a region experience an economic upturn relative to the euro area average, the common monetary policy becomes overly accommodating, and national output growth may accelerate above potential, generating inflation. No clear restriction exists within the SGP for governments to reduce their deficits in an economic upturn, though they are required to move to a structural surplus or small deficit over the medium term, a requirement not always fulfilled. Finance ministries in high growth regions are free to engage in unimpeded expenditure which can push economic growth above potential, generating higher inflation.

A fourth short term benefit, which derives from the previous two, be to make the ECB's role in conducting monetary policy significantly easier. Persistent inflation disparities in the early years of EMU hampered the monetary authority's capacity to deal with slowing economic growth for the Eurozone. Inter-regional fiscal transfers would operate as an automatic supranational level counter-cyclical device to stabilise member states struggling in part due to the common monetary policy, whether too rigid or too loose for their individual situation.. The outcome at Eurozone level would be to even out at least partly member states' growth, inflation and real interest rate levels.

Macroeconomic policymaking in Germany and Italy in the early years of EMU gives plausible examples of likely benefits from the proposed system. Had a stabilisation fund for the Eurozone been established in tandem with the common monetary policy, then inter-regional fiscal transfers would have helped to stabilise consumer expectations, stimulate domestic demand and boost reform potential. To some extent member state inflation differentials would have been levelled out, which may have created scope for the ECB to lower interest rates. All of this would have facilitated a quicker return to growth potential for both Germany and Italy. From the point of view of the other member states, in this instance, there is little benefit in having persistent slow growth in a sizeable proportion of the Eurozone. Since the Eurozone economy is highly integrated, fellow member states would benefit from a more speedy recovery to overall demand in the short run and likely higher output growth potential facilitated by an increased capacity to reform.

There would also be political advantages deriving from a well-designed stabilisation fund. The longer term viability of the common currency project would be bolstered through a Eurozone stabilisation fund which delivers improved economic performance, providing tangible benefits to the European citizenry. The European public tend to attribute some blame for slow growth continental economies to the institutional configuration of the Eurozone. A reformed structure delivering improved economic performance could only improve the public's attitudes to Europe's single currency.

Inter-regional transfers would also facilitate the emergence of an enduring European identity over time. A new sense of European civic identity would be fostered through the shared endeavour that the stabilisation fund would constitute. A timely, visible and positive economic stimulus to different states at different times would encourage citizens to feel an increasingly positive sense of civic belonging to the European project.

Potential pitfalls do exist that this paper next seeks to identify. An ill-designed stabilisation fund could create perverse incentives for national policymakers that may create a wedge against further integration, especially if transfers became unidirectional from paymaster member states to specific under performers. The next section articulates this moral hazard risk which could be an unwelcome (but foreseeable) consequence of an established fund. The subsequent sections will detail institutional remedies to that same risk.

Moral Hazard issue outlined

The general concept of moral hazard is an omnipresent feature of risk-sharing and insurance schemes. In the context of this stabilisation fund model," moral hazard" would arise when the provision of the fund increases the probability of events that would require a payout from that fund. Arguably, the existence of an external rescue package could diminish the incentives for individual member states to invest or engage in reforms which would reduce the risk and intensity of economic downturns. Future financial support would come to be expected by the member states from the European level in the event of a national crisis, or asymmetric economic shock. It must be an issue of concern whether the provision of a stabilisation fund would create perverse incentives which would negatively influence member governments' behaviour.

The provision of any collective good such as stabilisation funding risks a free rider outcome whereby particular member states might succumb to the temptation to postpone challenging reforms or undertake risky policies. Should a crisis in those member states then manifest itself, they might subsequently expect to receive further payments through the system of fiscal transfers. The cost of those payments would be covered by transfers from fellow participants who in contrast are pursuing policies suited to ongoing stable economic growth.

The existence of a Eurozone level insurance scheme therefore could risk creating perverse incentives, especially if a sizeable stabilisation funds were

on hand. Annual budgets at member state level would presumably be drawn up year on year after the set formulae to allocate the Eurozone stabilisation fund payments had been enshrined in treaty. It would be very challenging to subsequently alter this payment structure. In the absence of a sensible oversight procedure, member governments could conceivable manipulate this set system of allocation by postponing reforms or adopting risky policies.

Specific member states may be more likely to engage in such free riding behaviour, which might create successive unidirectional transfers between member states. With hindsight the stabilisation fund could begin to look like a permanent redistribution to the slow growth, more profligate national administrations. This could emerge as a controversial political issue within the more prudent member states' national arena, souring public attitudes towards new European level projects.

This moral hazard problem is not insurmountable. There would be scope to reduce that risk through institutional design. Capping of the overall size of the fund and the annual payment out to any one member state, along with ex post monitoring of expenditure from the fund are potential mechanisms to tackle the issue. Both could be incorporated without significantly compromising the fund's stabilisation objectives. Limiting the size of payments, monitoring expenditure and applying sanctioning procedures could strive to minimise the incentives to under-invest or take policy risks. These mechanisms should feature as core elements of a sensible stabilisation fund, such as the institutional model detailed in the following section.

Proposals to cap entitlements and oversee expenditure would avoid moral hazard and impede free riding for the following two reasons. Firstly, capping creates a situation in which the level of inter-regional transfers would not be sufficient to rectify fully the consequences of national economic problems nor to guarantee an adequate standard of living for their citizens in the event of a major economic depression. This would diminish the incentive to engage in risky policy-making.

Secondly, oversight and accountability procedures would create doubt in the minds of the national administrations about the guarantee of future payments arriving from the fund. If the funds in one year are spent badly, then the administration could be sanctioned and a payment would probably not arrive the following year. On the other hand, sensible use of the funds would be rewarded with another payment in the following year, should output growth remain below potential, allowing that member state to continue with its recovery strategy.

A workable stabilisation fund model for the Eurozone

Some current propositions for a Eurozone stabilisation fund envisage a 'rainy day' fund which would accumulate resources over time at the European level to be released at some future date when economic growth slows. A rainy day fund would therefore constitute cross temporal stabilisation. A stabilisation fund, however, along the lines here envisaged should have no facility for cross-temporal stabilisation since this is already catered for through borrowing or running budget surpluses at member state level. It would seem odd to accumulate additional fiscal resources at Eurozone level, on top of the SGP medium term objective of budget surplus or close to balance. It would also be politically challenging to withhold and accumulate resources over time in this manner and few such examples have been established at national level outside prudent resource-rich nations. A 'rainy day' fund would also impact strongly on Eurozone aggregates when eventually released, and might well initiate an offsetting monetary policy reaction from the ECB.

The stabilisation fund should therefore not accumulate resources over time, nor have facility to borrow, and should not operate as a 'rainy day fund'. It would be more sensible to limit the stabilisation fund's remit to cross-regional stabilisation to minimise the impact on Eurozone aggregates and ECB policy-making. The increased fiscal stimulus available to the benefactor member state would be offset by a transfer payment from those other states with economic growth at or above potential; therefore no impact on Eurozone aggregates would result.

Principles for sound operation of stabilisation fund model

Under this model, the stabilisation fund would operate in accordance with a number of basic principles, here set out in order of proportionality, automaticity, incentives, transparency and subsidiarity.

Proportionality

Payments into the fund would need to increase in times of economic upswing in a particular member state (cooling regional inflationary pressures). Therefore the paymaster member states would be those enjoying reasonable to good economic growth. Payments into the fund should be reduced (or ceased) in times of economic downturn or recession.

Furthermore, it would be wise to stipulate that a member state's growth would need to fall more than 0.5% below potential before funding is released. This concentrates the available funding to member states which are struggling to the greatest degree, all the more necessary should the overall size of the fund be capped. Should a particular member state suffer slightly

below potential growth (though not enough to pass the 0.5% threshold), then payments into the fund for that state could that year be suspended.

Automaticity

There should be minimal time lag in delivering a fiscal stimulus to where it is required. Revenue collection for the fund, from national accounts, should therefore occur simultaneously with payments out. To further minimise any lag, it would be necessary to evaluate on the most current and accurate output growth statistics, and to administer speedy delivery at national level through a supplementary mini-budget drawn up by the finance ministry.

Payments from the fund ought to be automatically triggered from an economic slowdown or deviation below a set growth potential yardstick. The most appropriate triggering mechanism would be output growth falling below a predetermined potential rate for each member state. Setting this triggering mechanism for payments from the fund would require independent technocratic input to evaluate each state's growth potential. This system could impartially determine whether a particular member state automatically receives a payout in any given year.

Difficulties arise in determining the growth potential for any economy but such data is already widely available from numerous independent sources. Growth potential varies over time with changing demographics, terms of trade, capital investment, technical advancements, reform of fiscal policy or the social welfare model and institutional reform of product and labour markets. However it is possible to technically set an estimate for output growth potential over a three to five year horizon with an agreed set of criteria to determine this.

This growth potential estimate could become a set yardstick to measure whether a particular member state would qualify for stabilisation fund transfers in any given year. The estimate could be reset annually or after a three to five year period lapsed, always by that same independent institution. The European Commission would possess the necessary independence from national administrations and the technical competence to set this measure. This makes it well placed to determine the yardstick against which payouts would then automatically be triggered.

Incentives

It would be in the interest of every national administration to aim for as high a recognised potential growth rate for itself as possible (for calculations bearing on the stabilisation fund). Achieving a high set potential growth rate would increase the nominal growth level (potential rate minus 0.5%) that would trigger a stabilisation payment. This would offer some reward, in the event of an asymmetric economic slowdown, to those Eurozone economies that endeavour to achieve strong non-inflationary growth.

In the event of a stabilisation payment, its size could be weighted by deviation below the set potential growth level. Falling more significantly below potential would increase the member state's entitlement up to a capped maximum (say two per cent of GDP with no contribution paid in that year). This would have the advantage of channelling stabilisation funding for maximum impact. Over time this triggering mechanism and weighted payment structure would provide new motivation for national governments to undertake challenging reforms (whether fiscal, social or to labour or product markets) or to invest to boost economic capacity. Independently determined rates of growth potential for each member state would offer voters a distinct measure of their government's performance relative to other EMU participants, made public by the European Commission. This validation by the European Commission might make reform proposals from Eurozone governments increasingly legitimate.

Transparency

A separate mini-budget should be drawn up by each beneficiary country for its use of the fund's expenditure, being adopted a few months after the national budget, to increase the visibility of the stabilisation fund's impact and to facilitate oversight and accountability procedures. Coming a few months after the national budget would allow this additional expenditure to address new problems or realised shortcomings of the national budget and shorten the time horizon within which fiscal policy might react to new developments in the economy.

Subsidiarity

Payments into and out of the fund should be administered through the national finance ministries. They would be best placed to determine optimal use of the stabilisation payments, which would need to fit with pre-established national expenditure programs. Further institution building at supranational level which would impinge on national budget policy is not politically feasible as a proposition.

In any given year, should all member states happen to grow at or above potential then the stabilisation funding would have no purpose or objective. Funding would then be returned to the participants in proportions which match their contribution in that year. The revenue collection process would begin anew the following year. Similarly if resources were left over when the payments out had been made, then the remainder would be returned to the paymaster states in the same manner.

Revenue Collection and Payments: who pays, who benefits?

Thorny issues arise when determining who should fund payments into European level projects, as is evidenced by the periodic EU budget reviews which often erupt into heated disputes. There is usually significant resistance to any increase in the level of the EU budget relative to overall GDP, while individual member states baulk at increasing their own net contributions. Devising a new budget outlay (which the stabilisation fund would encompass) for national administrations would be likely to face similar objections.

While bearing this political difficulty in mind, given the set objective of the fund, the pot of collected revenue should be of sufficient size to provide for counter cyclical stabilisation in states growing significantly below potential, when required. However there are good reasons for setting an overall cap on the size of such a fund.

Firstly, this paper has set out the potential free riding risk which arises from a supranational fiscal fund. Capping on any one member state's annual entitled payout from the fund is one mechanism to limit this risk, as discussed.

Secondly, a narrowly defined remit means the fund would not need to be particularly sizeable as a proportion of Eurozone GDP. This paper has argued for a stabilisation fund objective set to assist those participants suffering a negative asymmetric economic shock causing growth to fall below potential. The amounts involved to provide for such cross-regional stabilisation would be significantly less than those GDP proportions usually spent on public goods such as healthcare, education, defence, social welfare provision and capital for infrastructure.

It is probable that more than one member state will be underperforming in terms of output growth in any given year. The fund's expenditure should therefore be divided among those Eurozone member states growing below potential, weighted by deviation from potential growth rates and national GDP. Payments into the fund should be made simultaneously with payments out to ensure a timely impact, also preventing those slow growth member states from breaching the SGP deficit limits. Should resources remain after payments are made to the laggard growth member states, then the excess would be returned to the paymaster member states of that year in proportions that match that year's contributions.

Devising an agreed upon method for revenue collection into any type of stabilisation fund will prove complicated. To ensure payment into the fund increases during a member state's economic upswing, possibilities would include taking as contribution a proportion of member states' revenues from specific taxes (consumption, income or corporation) or a percentage of overall taxation or GDP. Setting the paid contribution in terms of GDP (instead of overall tax take) would probably be more equitable since it would not prejudice those member states having a larger public sector. In any given year the maximum payment into the fund should be capped at one per cent of national GDP. The maximum payment out from the fund might be set at as figure such as 3% of national GDP (or 2% received with no contribution made in that given year). This would allow for a significant counter-cyclical stimulus but not be so large as to risk free riding problems. Setting this type of upper limit on annual payments from the fund allows all member states (in theory) to receive a gain from the endeavour, similar to their proportionate contribution, if not now then at some point in the future. This would be especially important in persuading the bigger member states to agree to its establishment. Germany for example makes up approximately 30% of the Eurozone GDP. Should only Germany suffer an asymmetric shock relative to the other participating member states, she could then receive a maximum payout from the fund (2% of GDP received with no contribution in that year) which would utilise 90% of the overall funding available in that year. The remaining funds would be returned to the pay master member states of that year.

This issue of revenue collection would be challenging since it cannot be devised in a simplistic manner without creating a new balance between net paymasters and benefactors inside the Eurozone. By setting the payments into and out of the fund in terms of GDP, this offers some promise that each member state will eventually benefit in some proportion which matches their annual contributions. It is also possible to envisage a phasing in period during which each member state's annual contributions would rise over time up to the capped maximum of one per cent of GDP. A gradual introduction would facilitate readjusting national budgets to incorporate another annual payout alongside established spending commitments.

Payments from the fund

Oversight procedures are desirable to ensure prudent use of expenditure from the fund by national administrations. Such oversight would be considered necessary to limit the potential for uni-directional flows to become a charged political issue within specific member states. In national budgeting, governments and finance ministers are accountable to parliament and therefore the electorate. For this proposed stabilisation fund, there exists no plausible simple electoral mechanism to punish national politicians if they misuse resources. The rules and institutions surrounding the administration of any stabilisation fund would therefore need to set out oversight mechanisms to en-

sure accountability in expenditure, backed by some power of sanction.

National administrations should retain significant autonomy in determining how this additional fiscal stimulus would be utilised though this should be subject to strict supervision. To maximise the economic impact, it would be beneficial to draw up a separate 'mini-budget', as has been noted, which would increase the visibility of the new money's impact and facilitates oversight.

Oversight, Accountability and Sanctioning

The resources for the stabilisation fund have been sourced from Eurozone taxpayers. The ultimate benefactor from that payout should therefore be accountable to those taxpayers through the most direct and democratic mechanism that is possible through the existing EU institutions. This section of the paper will explore the four principal European institutions, assessing their capacity to oversee the use of the funding by national administrations.

Firstly, the European Court of Justice, though a well respected institution, would not be suitable to oversee the running of this stabilisation fund model. It is quite remote from the European public, being appointed by common accord of the member state governments. Judicial procedures would likely be slow to deliver a result. Furthermore, budget policy is rarely a judicial consideration at member state level unless it impinges on constitutional issues.

Secondly, the Council does currently operate as the holder of the power of sanction in the SGP. Substantial conflicts of interest could be foreseen if the Council were also to oversee expenditure from this stabilisation fund. The individual finance ministers would be drawing up those same budgets which would undergo scrutiny from a body which they are part of. There would create considerable scope for collusion and horse trading for political favours, especially given the lack of transparency in Council decision-making. The Council's track record in punishing those in breach of the SGP deficit criterion has been somewhat lacking, despite a number of high profile referrals from the Commission.

The European Commission possesses substantive technocratic ability to monitor the likely impact of expenditure plans drawn up by member governments from potential stabilisation funding. The Commission already draws up growth forecasts for the member states and would be well placed to assess whether an individual economy is growing at or below potential. The Commission could play an invaluable role in impartially determining which member states would be entitled to funding in any given year. It would also be well placed to monitor expenditure from the fund, and to assess whether those resources were being put to good use. Few would dispute that the Commission is technically adept to undertake this task. Where the Commission might be found lacking is in its political legitimacy, especially if it were given final say in this paper's proposed sanctioning procedure.

The fourth principal EU institution, the European Parliament (EP) offers a body with democratically founded legitimacy which could play a vital role in this model's oversight procedures. The EP consists of elected representatives which represent the taxpaying Eurozone public who would be ultimate paymasters into any supranational level fund. For this reason the EP would have a derived legitimacy to oversee the expenditure of citizens' tax contributions. Being external to the national administration being overseen, the EP would also be a credible enforcer. Where the EP would be lacking is in terms of its technical ability to assess the economic impact of budgeting procedures. However it is possible to conceive of the EP taking advice from the Commission prior to determining whether sanctions should be imposed on any profligate member governments. The most appropriate monitoring and sanctioning procedure should involve the Commission and the EP working in tandem to oversee the workings of this model.

As has been outlined, the Commission would be well placed to determine which member states would receive stabilisation funding in any given year. The Commission could also monitor use of this funding, and report its findings to the EP. A monitoring committee of MEPs could be established from across the political spectrum, which would analyse the Commission's report before deliberation in the EP. Should both the Commission and the EP committee agree that the member state in question had inappropriately spent the fund's resources, then a high threshold voting procedure (perhaps in the region of 66%) could determine whether to sanction by cutting off funding to the offending member state for that year. For particularly serious offences the following year's entitlement to funding could also be suspended.

It is important to consider how this voting procedure on an individual member state's use of the funds could work in parliament. All MEPs should perhaps participate in the debate on the committee's findings, but only those MEPs from Eurozone member states would be entitled to vote. Logically, voting rights would be suspended for those MEPs from the offending member state (being voted on) to eliminate potential conflicts of interest and to level the playing field for the big and small member states. One additional disincentive to economic profligacy under this oversight procedure would be the scrutiny which the national mini-budget would inevitably receive in the EP during the debating process. This process could turn out to be politically damaging for

the finance ministry in question, perhaps even regardless of the outcome of the vote.

Given the shortness of political horizons, it would be advantageous to have the quickest possible retribution for bad behaviour. This may require payouts from the fund to be spread over time or to split into two interval payouts, so that the second sum could be withheld if funding were misspent. A further level of sanction could be envisaged, whereby the following year's entitlement to payment would also be suspended. The member state in question could still be required to contribute up to their maximum of 1% of GDP, even if growth again falls below potential. The degree to which sanctions are applied would be best determined in the EP, though a recommendation could be provided by the Commission.

From this assessment of the principal European institutional bodies it would seem sensible to draw in tandem upon the technical ability of the Commission and the democratic legitimacy of the EP. This pairing would provide a robust oversight and sanctioning procedure for this stabilisation fund model. Both have the advantage of being independent of the national administrations which would receive a counter cyclical stimulus from the fund.

Conclusion

This paper has presented an operable working model for a stabilisation fund for the Eurozone, which would fit easily alongside pre-existing EMU institutions. The model has been set out in a manner which would bolster the capacity of national administrations to deal with asymmetric shocks that cause their economic growth to fall significantly below potential. Consumption and output growth levels across high and slow growth member states would then be better stabilised. Timely additional resources would be made available under this model which could boost national reform potential and facilitate a quicker return to higher stable growth.

This paper has detailed the concerns of moral hazard and the potential for successive unidirectional flows to undeserving recipient states. Both sets of concerns would probably be voiced prior to any stabilisation fund's establishment. These risks can be substantially reduced through two institutional mechanisms. The first is that the overall size of the fund and the annual payment out to any member state in a given year should be capped. Secondly, the monitoring of expenditure and the application of sanctions for misbehaving would minimise incentives to take policy risks and under invest. This oversight mechanism would rest on the technical ability of the Commission in tandem with the democratic legitimacy of the EP. A variety of levels of sanction have been devised, though all would be required to pass a high voting threshold in the EP.

The remit for the proposed model has been limited to cross regional stabilisation only, thereby minimising the impact on Eurozone aggregates and ECB policy-making. Funding would to be concentrated to where it would have the greatest impact, with a payment out triggered when growth falls significantly below potential. Contributions to the fund and payments out are proposed to be in proportion to overall GDP. This offers some promise that all could eventually gain in proportions that match annual contributions. Under this model, national finance ministries would be required to draw up a supplementary mini-budget to deliver the additional fiscal stimulus with minimum lag. Significant autonomy would therefore be retained in the hands of the member states' finance ministries, which remain best placed to fit this additional resource into national growth and recovery strategies. It should therefore be possible to maintain a balance between the welfare and needs of the Eurozone as a whole and the rights and competencies of governments to conduct national policy making.

It seems unlikely that negotiations are in immediate prospect to review the governance structure of the Eurozone. It may, however, be that after the question of a successor treaty to the European Constitutional Treaty has been resolved that the European Union's member states will turn their attention to these issues. A successor treaty might free up the Eurozone to pursue enhanced cooperation and a greater degree of economic integration. The question of a "stabilisation fund" or similar arrangement is already one that has provoked some discussion, and this discussion is likely to gather pace rather than diminish over the coming years. This brief is a contribution to that incipient debate.

Sources

Allsopp, C. and Artis, A. (2003): The Assessment: EMU, Four Years On, Oxford Review of Economic Policy 19 (1), pp..1-29

Fatás, A. (1998): Does EMU need a fiscal federation? Economic Policy 26 (2), pp..163-203

Federal Trust (2006) The Governance of the Eurozone October 2006. Available online at www.federaltrust.co.uk

Gramlich, E.M. and Wood, P.R. (2000): Fiscal Federalism and European Integration: Implications for Fiscal and Monetary Policies, International Finance Discussion Papers No.694, Washington DC: Board of Governors of the Federal Reserve System.

Lane, T. and Phillips, S. (2000): Does IMF financing result in moral hazard? IMF Working Paper 00/168 October 2000. Available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=880201

Oates, W. (1999): An Essay on Fiscal Federalism, Journal of Economic Literature 37 (3), pp.1120-1149

Perrson, T. and Tabellini, G. (1996): Federal fiscal constitutions: risk sharing and moral hazard, Econometrica 64 (3), pp..623-646

Scharpf, F.W. (1988): The joint-decision trap: Lessons from German federalism and European integration', Public Administration 66, pp..239-278