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Eurozone Stabilisation Fund: Revisited

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Unprecedented financial and political upheaval have reshaped the institutional and geo-political landscape of both the Eurozone and the EU over the past ten years. Europe has endured its worst recession in living memory, straining the Eurozone almost to breaking point. Despite this, and somewhat paradoxically, the Eurozone has grown in size, adding a further three members, and the financial integration of the Eurozone has deepened. Severe economic crises drove that round of reform, but the Eurozone continues to suffer an inherent instability that must be addressed – no other currency area functions without fiscal transfers between high growth and slow growth regions. The endeavour that is the euro now faces a major crossroads. Should it: integrate further to improve the economic performance of the Eurozone, and how; or persist with the status quo and endure the resultant political damage?

In the aftermath of the financial crisis, multiple publications from academia and think tanks highlighted continuing shortcomings in the Eurozone's configuration, particularly the absence of a functioning mechanism to stabilise inevitable positive or negative asymmetric regional shocks, which the common monetary policy cannot cater for.[1] Whereas a number of shortcomings have been addressed since 2008, the Eurozone remains a monetary block without corresponding budget transfers between regions that help stabilise economic output. Many observers view this as a critical weakness in the design of the Eurozone which serves to increase regional boom and bust or prolong recessions, with associated political malcontent.

[1] See Sources, in particular Baldwin, Giavazzi et al (2016)

More recently, debate over fiscal transfers between Eurozone nations has moved from the academic to the political realm, with leading voices in Brussels, France and Germany calling for the next wave of Eurozone integration.[2] Against this backdrop, there appears to be greater potential to deliver on further Eurozone integration, rather than expend political capital on changing the more diverse EU block.

Recent elections in founder nations of the EU and Eurozone, France, Germany, the Netherlands and Italy have seen voters turn in growing numbers to anti-EU, anti-establishment and nationalist parties in search of alternatives. Those political forces appear to have momentum, and no doubt will continue to have unless projects such as the euro deliver on their promise of wider and deeper prosperity for European citizens. Moreover, several countries have sustained political deadlock following inconclusive elections, and populist forces may yet force European integration into reverse. Another major consequence of the financial crisis was Brexit. Arguments about the UK being 'shackled to a European corpse' resonated and it is beyond doubt that the Eurozone took a long time to recover.

The growth spurt in recent years provides a window of opportunity to improve the functioning of the Eurozone through proactive, rather than reactive, measures. Political leaders may in fact embrace such reform. President Macron has made very clear his desire to establish a Eurozone budget and finance minister.[3] Eurozone reforms have also been a central feature of

[2] Refer to Five Presidents Report (2015), Juncker (2017) and Marcon (2017)
[3] Macron (2017)

recent coalition talks between the CDU, CSU and SPD in Germany. A renewed Franco-German axis would provide leadership and generate political momentum, which has been lacking for the EU over the past decade. Moreover, most if not all Eurozone countries have experienced positive and negative asymmetric shocks since its creation which would have been easier to manage if stabilisation funding were in place. Nevertheless, political leaders across the Eurozone will need to be persuaded, most especially those sceptical of their tax receipts being spent elsewhere.[4]

Numerous proposals have been made for a Eurozone budget. These are either scant on detail or have major economic or political shortcomings. Rightly or wrongly, unemployment transfers between countries would feed into a narrative of rewarding bad behaviour. This paper argues for and proposes a Eurozone Stabilisation Fund (EZSF) that addresses a key structural weakness by insuring against asymmetric economic shocks that the common monetary policy cannot cater for. More importantly, payments into and transfers from the EZSF are based on national economic performance relative to each country's potential growth rate; thus incentivising and supporting reforms to boost growth, rather than rewarding poor performers.

The Eurozone in 2018

The Eurozone exhibits a uniquely structured division of responsibilities between national and supranational macroeconomic policy-makers. Monetary policy is set by the European Central Bank for the Eurozone as a whole. Fiscal policy remains the preserve of national governments, subject to the Stability and Growth Pact (SGP), signed with a view to enforcing the debt and deficit limits written into the Maastricht Treaty. In recent years, several shortcomings in the original SGP have been addressed to allow flexibility in interpretation and to increase monitoring, transparency and foresight.[5]

National finance ministries meet through the Eurogroup, an informal body established in 1997, to discuss fiscal and policy cooperation between Eurozone member states.

Twelve countries participated at the outset of Economic and Monetary Union in 2002. The Eurozone has gradually expanded since to a total of nineteen countries by 2018 (see map), including several recent entrants to the EU, a testament to the enduring trade-related and macroeconomic advantages.[6]

Financial Crisis Driven Integration

The global economy witnessed a severe and prolonged financial crisis from 2008 onwards, felt across Europe, with some countries hit much harder than others. It is

no coincidence that those countries that had grown most strongly over the prior decade (particularly Spain, Greece, Portugal and Ireland), built up the greatest imbalances (measured by trade deficits and private debt) and suffered the greatest downturn. A large-scale credit crisis resulted, with several Eurozone countries frozen out of debt markets. This highlighted a major structural flaw in the Maastricht design: the common currency area lacked a buyer of last resort for bad private or government debt. Liquidity crises rapidly translated into sovereignty crises necessitating assistance from their EU partners. The fallout from the credit crisis strained the Eurozone almost to breaking point and illustrated very clearly the shortcomings in the original Maastricht design.

In response, the Eurozone chose a path of further integration over fragmentation. Bailouts were negotiated for five countries (Ireland, Portugal, Greece, Spain and Cyprus) from early 2011 with far-reaching conditions for domestic reform attached to restore recipients' competitiveness. At the height of the financial crisis, the Outright Monetary Transactions (OMT) programme was announced by the ECB, an unlimited tool that allows it to purchase countries short term bonds in the secondary market and substantially reduce the interest rate paid by a Eurozone country in crisis.

Shortly after the creation of the OMT programme in October 2012, these bailouts were enveloped into the

[4] See Rutte (2018)
[5] See Commission (2018)
[6] Image reproduced from https://europa.eu/european-union/about-eu/money/euro_en#euro

European Stabilisation Mechanism (ESM), a safety net that can provides financial loans to struggling countries in crisis. ESM loans are similarly conditional on the implementation of structural reforms to tackle underlying economic weaknesses. Uneven and lax financial regulation across countries was also seen as a key contributor to the build-up of structural imbalances prior to 2008. In order to remedy this, there were broad transfers of sovereignty to the Eurozone level in the area of banking supervision and oversight during 2013, providing the ECB with a range of new powers to harmonise supervision (called the Single Supervision Mechanism) and resolve crises (the Single Resolution Mechanism).

The economic crisis from 2008 to 2013 forced unplanned further integration and a host of new institutional configurations for the Eurozone. Theories of European integration help explain what has been observed. Neo-functionalism predicts that a step towards integration necessitates another to consolidate or realise the full benefits of the prior step. One can argue that banking union was an inevitable consequence of a single market and monetary union, lest the project might have disintegrated. An inter-governmental or realist approach would observe that economic failure in peripheral economies threatened others to such an extent that it was in all parties' interests to integrate further. Whatever theoretical lens one views the past ten years with, substantive further integration has taken place.

Viewed today, the Eurozone constitutes monetary union, banking union and refined mechanisms for political and fiscal cooperation, yet it still looks incomplete.

When it Works and Doesn't

The Eurozone structure is well placed for harmonious, non-inflationary growth, where countries grow at their potential rates and inflation comes in at the target rate.

The ECB cannot stabilise a national economy suffering asymmetric positive or negative shocks, since these often do not register at all in the Eurozone aggregates[7]. The government in question must strive by its own policy efforts to counter asymmetric shocks to that national economy. The two broad options include fiscal stimuli or structural reforms, i.e. policy change or other legislative means which increase competitiveness or productivity. When the Maastricht Treaty was signed, these national-level policy options were presumably deemed sufficient to counter the effects of asymmetric economic shocks.

When faced with a common interest rate set for the Eurozone aggregate however, a country suffering a negative demand shock will likely experience slower inflation and higher real interest rates than the aggregate, thus slowing business investment and demand further. Prior to entering monetary union, that country's central bank would have cut interest rates to a level appropriate to its national circumstances that stimulated investment and demand. The country in question would probably also have benefited from a lower exchange rate for its currency, stimulating exports. Inside the Eurozone, policy choices for that country are constrained and adjustment is more difficult. Net government expenditure can increase to stimulate the economy (through higher spending or reduced taxation) but its magnitude is limited by the SGP. Where the national exchequer has been in balance or surplus, there is considerable scope to use fiscal stimuli (and potentially other policy or legislative means) to counter the shock, and a stable growth path resumes. On the other hand, a country that is already close to the SGP limits has little or no latitude to spend more. Structural reforms that increase competitiveness or productivity are the only real policy option but these take time before delivering higher output and attract a high political price.

Politically Driven Disintegration?

Although the European economy has recovered in recent years, growth is not guaranteed to continue when unprecedented monetary stimuli such as quantitative easing are withdrawn. Furthermore, the recovery has been insufficient to quell political discontent and instability. Spain suffered political deadlock after two inconclusive elections in 2015 and 2016. In 2017, France ended up with a pro-European government after a bumpy ride. Germany has seen six political parties win seats in the Bundestag, followed by protracted coalition negotiations into 2018. Taking traditionally pro-EU Italy as another example, in March 2018 voters turned to anti-establishment and populist parties in search of new solutions. A new Italian government will emerge and no doubt will adopt a harder line which complicates further discussions in Brussels.

Although the economy is not the sole cause of voter dissatisfaction, it is a core consideration in any national election. The Eurozone needs to deliver satisfactory living standards for citizens or risk them supporting populist alternatives such as scrapping the euro currency, promulgated by Alternative for Germany and the National Front in France. Marine le Pen has promised to 'protect voters from globalisation' by withdrawing from the euro. A member state leaving the Eurozone could be terminal for the entire project. There have been a number of near misses where a populist government almost took the helm in a founder member of the EU. In those countries, anti-euro sentiment is still lingering.

The Eurozone cannot muddle along indefinitely with structural weaknesses that can trap a member country in a

[7] Eurozone aggregates refers to the combined total of underlying national data, see ECB (2018)

low growth funk. Abandoning the project entirely would be unimaginably disruptive. There is no alternative but for this path of integration to continue with reforms that foster economic growth. This is essential to the long term economic and political health of the Eurozone and by extension, the European Union.

Stabilisation Fund: Aim, Rationale and Outline

This paper proposes a robust Eurozone Stabilisation Fund (EZSF) to provide cross-country stabilisation for the Eurozone. The EZSF would help deliver longer term prosperity by enabling a smoother return to potential output for those countries facing unsuitable high interest rates set for the aggregate. The converse scenario is also beneficial for those countries growing above their potential and therefore risking over-heating due to inappropriately low interest rates. For them, payments into the EZSF would help prevent the increased tax take being spent domestically and stimulating that economy further. Payments from one country to another rightly raise concerns about appropriate use of those funds, which are addressed subsequently by this paper.

The aim of the EZSF is to establish a countercyclical pot of money to help stabilise a Eurozone member that is (or members that are) struggling with economic growth below potential. The rationale for the EZSF is sound: monetary policy is set for the Eurozone aggregate rather than national circumstances therefore a tool is required to support any country beset by an asymmetric shock that slows the economy significantly below its potential growth.

Revenues for the EZSF should come from Eurozone members growing at or above their economic potential. Payments out must be concentrated to where they can add most value. Payments from the EZSF should be automatically triggered by a member economy growing significantly below a set potential rate. To ensure objectivity and impartiality, potential growth rates would be calculated before the period in question by a credible independent institution, and subject to periodic review.

Fiscal stimuli are more effective when they are timely. Revenues into the EZSF and payments from it should occur at yearly, or even six-monthly intervals, so that the EZSF can adjust and react to changing economic circumstances in member states. If any money is left over in the EZSF after all necessary payments are made, it should be returned to the paymaster states of that year in proportion to their respective contributions.

Eurozone member states would be required to set aside a proportion of tax income in their national budget for the EZSF, which would then be pooled with other contributions. Each member's economic conditions would be analysed to determine their growth rates relative to potential. Those falling below potential would receive a pay out from the EZSF.

Upon receipt of that payment, the relevant national finance ministry would prepare a supplementary mini-budget, in addition to their routine national budget, but taking effect a few months later. This would allow fiscal policy to react more quickly to emergent problems. The national finance ministry would determine the best use of the additional expenditure, whether that is to stabilise demand, facilitate economic reforms or make investments that boost national growth.

The EZSF would provide timely resources for member states growing below potential, while respecting their diversity and capacities to solve problems at the national level. In a region as politically diverse as the Eurozone, there are a range of political ideologies and views on decisions taken by other national governments. Later sections of this paper investigate the potential for inappropriate use of these additional resources from the EZSF. A moral hazard risk arises if the provision of money through the EZSF increases the probability of events that would trigger a payment. For example, specific member states might adopt risky policies or postpone reforms in search of a free ride, i.e. successive unidirectional payments from the EZSF. Needless to say, this would upset contributors to the EZSF and generate political tension. Mechanisms to limit free-riding behaviour must be incorporated into the EZSF, for example a cap on the overall size of the fund and any one member's annual entitlement would limit the size of unidirectional flows. In addition, mini-budgets drawn up on receipt of EZSF money could also be scrutinised through oversight and accountability procedures built into the model. Later sections of this paper will illustrate possible safeguards and how they would help ensure that EZSF money is used appropriately to enhance capacity to reform and thereby deliver improved economic performance for the Eurozone as a whole.

Benefits of the Stabilisation Fund

Before outlining the mechanics of how the EZSF might operate, it is worth exploring potential benefits that stabilisation funding would bring to the Eurozone in the short term and over a longer period. Essentially the EZSF would operate as an inter-regional insurance mechanism, helping to stabilise output growth and consumption levels between high and slow growth regions.

Firstly, when faced with an asymmetric negative output shock, financial transfers to the affected region would help to stabilise consumer demand and expectations by restoring disposable income. Under the current

arrangements, a member state experiencing an economic shock which reduced growth below its potential will face overly restrictive monetary policy set for the Eurozone average rather than its circumstances. If inflation in that economy also falls, a higher real interest rate results, reducing the incentive to invest and further affecting consumers' disposable income. The government might also be forced to tighten national fiscal policy to remain within the limits set by the SGP. Collectively, these conditions have a negative impact on consumer demand and expectations. In this case, transfers from the EZSF would help stimulate demand, support consumer expectations and encourage new investment.

Secondly, stimulating the national economy through EZSF transfers would facilitate a quicker return to its potential growth rate. This would boost that country's capacity to engage in economic reforms (to whatever extent they are required) by providing timely additional resources when needed. A greater capacity to pursue and implement reforms should in the medium term deliver a higher potential for each member state and the Eurozone collectively.

Thirdly, the EZSF would serve to transfer fiscal resources away from countries which are growing more quickly than their potential rates, removing some of the temptation for those countries to overspend and thus limiting the prospect of growth overshooting. If a country experiences an economic upturn relative to the Eurozone average, the common interest rate becomes overly accommodating, stimulating the economy further and generating inflation. Although governments are required under the SGP to move to a structural surplus or small deficit over the medium term, there is no mechanism to enforce this and it has generally been disregarded. Finance ministries in high growth countries are unimpeded from overspending during economic good times, a temptation which can easily provoke overheating such as that witnessed in Ireland. In 2006, Taoiseach Bertie Ahern remarked that the 'boom is getting boomier' following a series of expansionary budgets.

A fourth short term benefit deriving from the two above, would be to make the ECB's role in conducting monetary policy significantly easier. Persistent inflation disparities in the early years of EMU hampered the ECB's capacity to deal with slowing Eurozone growth. Inter-regional fiscal transfers through the EZSF would operate as an automatic countercyclical tool to stabilise member states facing an unsuitable common interest rate (whether too high or too low). At Eurozone level, the EZSF would even out, at least partly, member states' growth, inflation and real interest rates.

A well designed EZSF would also yield political benefits and improve public perception of the EU institutions. The long-term viability of the euro would be bolstered through an EZSF which delivers improved economic performance, providing tangible benefits for Europeans through better economic performance. A timely, visible and positive economic stimulus to different states at different times could encourage citizens to feel more positively towards the European project.

Pitfalls also exist. An ill-designed stabilisation fund could create perverse incentives for national policy-makers to pursue unidirectional transfers. That constitutes a moral hazard risk. Unidirectional flows from paymaster states to the under-performing nations (often called free riding) would be politically toxic and risk a fatal fracture in the Eurozone.

Moral Hazard

Moral hazard is an omnipresent feature of risk sharing and insurance schemes. This arises when the provision of a stabilisation fund increases the probability of events that would require a payment from that fund. There are strong arguments that the existence of an external rescue package could diminish incentives for member states to invest or engage in reforms to enhance growth, particularly those that are costly over the upcoming political horizon.

The existence of a Eurozone level insurance scheme, or budget of any kind, risks on this analysis creating perverse incentives, which arguably grow with the magnitude of transfers available. Without a functioning oversight mechanism, a stabilisation fund could be manipulated by postponing reforms or adopting risky but domestically popular policies. Should unidirectional flows result, the stabilisation fund would look like permanent redistribution to more profligate national administrations. This would doubtless generate political dissatisfaction and sour public attitudes to the euro and EU overall.

Fortunately, this moral hazard risk is not insurmountable. There is scope to reduce that risk through institutional design. Capping the overall size of the fund and annual payments to any one member state, along with ex post monitoring of expenditure from the fund (with sanctions applied if necessary) are potential methods to address the problem. Another way to reduce this risk is to align the triggering mechanism for pay outs with potential growth rates. If a member state postpones reforms, or pursues risky policies, their medium to longer term economic health would suffer, thus reducing their potential growth rates and chance of receiving transfers. All of these can successfully be incorporated without significantly compromising a stabilisation fund's core objectives. Moreover, they must feature as central elements and have been incorporated into the design of the EZSF, as presented in the following section.

Capping payments, oversight of expenditure, and

periodically reviewing potential growth rates can minimise moral hazard and the risk of free-riding. Firstly, an overall cap sets the amount of funding available at a level insufficient to rectify entirely the consequences of postponing reforms or pursuing risky policies. The transfers available would neither be enough to rescue the economy, nor guarantee an adequate standard of living for their citizens in the event of a downturn or persistent slow growth.

Secondly, oversight and sanctioning would mean that future transfers from the fund are not guaranteed. If the transfers provided in one year are squandered, that national government could be sanctioned by withholding subsequent payments. On the other hand, sensible use of transfers would be rewarded with further payments in subsequent years if output growth remains below potential.

Thirdly, by aligning payments in and the triggering mechanism for pay outs with projected potential growth rates, countries are incentivised to get those rates as high as possible. If a payment in is made when annual growth is at or above a pre-determined potential rate, it is self-evident that a country would strive to achieve the highest possible potential growth rate. Consider the difference between projected potential rates of 1% and 2%. A potential rate of 1% means that whenever actual growth comes in above 1%, a payment would need to be made into the stabilisation fund. At 2%, the economy needs to grow considerably faster before a payment would be made.

Conversely, where payments are received when growth falls below potential, the incentives work in the same direction, a higher potential rate again means there is a wider range of actual growth rates that result in a pay out. This would work against the moral hazard risk by incentivising the pursuit of reforms. Since its inception, many Eurozone countries have been justifiably criticised for postponing essential reforms, so a carrot that encourages growth enhancing reforms would be highly beneficial.

The Eurozone Stabilisation Fund (EZSF)

A number of proposals have been made for a Eurozone budget. Some envisage a common budget with targeted investment that boosts economic capacity. Others envisage a 'rainy day' fund which would accumulate over time to be released at some future date when economic growth slows. These are in fact types of cross-temporal stabilisation, already well established at national level by running surpluses (as intended by the SGP) or borrowing. For obvious reasons, it would be politically challenging to withhold and accumulate resources at Eurozone level. Few such examples exist in the world outside prudent resource rich nations. A 'rainy day' fund would also impact strongly on Eurozone aggregates when paid out, which could elicit offsetting monetary policy from the ECB.

Other proposals have suggested that unemployment benefits be centralised at Eurozone level. This would face considerable moral hazard problems since a country can outsource the cost of high unemployment to more successful Eurozone partners. Due to policy choices made at member state level, some have higher natural rates of unemployment (the rate at which the national labour market is in equilibrium) than others, and those with lower rates should not bear the cost of higher rates elsewhere. It is far more equitable across time for stabilisation to operate by transferring resources from those growing at or above potential economic growth to those where growth has fallen below its potential. Such a model also has the significant advantage of positively incentivising countries to raise their potential growth rates.

No other model aligns payments into and from a fund with growth relative to potential, core to this proposed EZSF. Before delving into the mechanical operation of the EZSF, the next section of this paper outlines the principles by which the EZSF would operate.

Principles for Sound Operation of the EZSF

The EZSF is designed to operate in accordance with a range of key principles: proportionality, automaticity, incentives, transparency and subsidiarity.

Proportionality

Payments into the EZSF should be set proportionate to national GDP and need to increase during an economic upturn, thus cooling regional inflationary pressure. The paymaster states would therefore be those enjoying reasonable to strong economic growth. Payments into the fund should be reduced or ceased in economic downturns or recessions.

Furthermore, in order to concentrate funding to where it is needed most, a Eurozone member's growth should fall 0.5% below its potential before funding is released. Greater assistance would therefore be available to those struggling to the greatest degree, which is prudent when the overall size of the fund is capped. If a country records growth slightly below its potential (say of less than 0.5% below potential), then it would not need to make a payment into the fund for that year and can use that money to support its own economy.

Automaticity

There should be minimal time lag in delivering a fiscal stimulus to where it is needed. Revenue collection (from national governments) should occur simultaneously with

payments to where they are needed. This requires evaluation based on the most current and accurate output statistics available.

Payments from the EZSF should be automatically triggered by an economic slowdown that causes growth to fall below its predetermined potential level. The relevant yardstick for each country would be set independently and prior to the year in question. An independent technocratic institution would need to evaluate each state's growth potential. This would allow impartial determination of whether a Eurozone nation ought to receive a payment.

Difficulties arise when determining the growth potential for any country, but such data is already widely available for European economies from independent modelling and forecasting. Growth potential varies across time due to changing demographics, terms of trade, capital investment, technical advances, reform of fiscal policy or social welfare, and institutional reforms to labour and product markets. There are shortcomings in forecasting future economic performance however it is possible to estimate potential output growth over three to five-year horizons with commonly set criteria across Eurozone countries.

The estimated potential growth would become a set yardstick to ascertain whether a particular member state would pay in or qualify for EZSF transfers in the subsequent years. This estimate would need to be re-evaluated periodically but always by the same independent institution. A body like the European Commission possesses the necessary independence from national administrations and the technical competence to set these yardsticks. The ECB and national finance ministries perform similar analyses for other purposes and could publicise their economic projections to allow for scrutiny of potential rates set by the Commission.

In line with the principle of automaticity, transfers from the fund should be administered quickly through a supplementary mini-budget drawn up by that country's finance ministry.

Incentives

A common criticism of Eurozone nations has been their reluctance to pursue economic reforms that boost growth. The EZSF must be designed to incentivise national administrations to achieve the highest possible projected potential growth rates. If payments into and from the EZSF relate to actual growth relative to that country's potential, Eurozone nations are motivated to maximise potential growth by boosting investment, adjusting tax rates or reforming product or labour markets. As noted above, payments would be made into the EZSF when actual growth is at or above potential. A pay out would be received when actual growth registers 0.5% below potential. Neither a payment nor a pay out would apply when growth falls in between. Consider another example with two countries, one (A) with a potential growth of 1%, a second (B) with 3%. Country A would pay into the fund when actual growth is 1% or higher. If growth is between 0.5% and 1%, no payment is made. A pay out is received when growth is less than 0.5%. For country B, payments into the EZSF are made when actual growth is 3% or above, and pay outs are received when growth is below 2.5%.

Under these scenarios, countries are clearly incentivised to have the highest possible potential growth rate, by investing to boost capacity or undertaking necessary reforms whether fiscal, social, to labour or product markets. Furthermore, the independently determined rates of potential growth on which the EZSF operates would take on a new significance, offering voters a measure of their government's performance relative to other Eurozone nations.

Transparency

A separate mini-budget should be drawn up by those countries in receipt of EZSF money. This additional budget should take effect some time after the national budget, allowing the government to address emerging challenges and shortening the timeframe within which fiscal policy can react to new developments.

A separate budget also has the advantages of visibility and transparency (for citizens and other observers), enabling oversight of the use of Eurozone tax receipts and therefore holding the relevant national government to account.

Subsidiarity

This core principle from the Treaty of the European Union should apply. Payments into (and out of) the EZSF should come from (or go to) national administrations, albeit with EU level oversight, collection and transfer between countries. National finance ministries are best placed to determine the optimal use of stabilisation payments, which need to fit with existing national policies and expenditure programs.

In the event that no Eurozone country grows less than 0.5% of its potential rates, the EZSF's stabilisation function would not be required for that year. In order to respect the subsidiarity principle, the money collected for the EZSF should be returned to paymaster states in proportion to their contribution for that year. Similarly, whenever money is left over after pay outs are made, those funds would be returned to paymaster countries in the same manner. The revenue collection process would begin anew the following year.

EZSF Revenue Collection and Payments – Who Pays, Who Benefits?

Thorny issues arise when determining who funds EU projects, evidenced by the periodic reviews of the EU budget, and associated heated disputes. There is usually significant resistance to any increase in the level of the EU budget relative to GDP, while individual countries baulk at increasing their own contributions. Devising a new budget outlay such as the EZSF would likely face similar obstacles.

The set objective of the EZSF is to collect sufficient revenue to provide for targeted countercyclical stabilisation for those Eurozone countries growing significantly below potential. Putting the politics of relative contributions to one side, there are good reasons to set an overall cap for the EZSF in any given year.

Firstly, as previously discussed, moral hazard and free-riding risks arise from the EZSF. Capping any one member state's potential pay out is one mechanism to limit this risk.

Secondly, since the EZSF has a narrowly defined remit, it would not need to be large relative to Eurozone GDP. The EZSF would only assist those member states who are suffering a negative asymmetric economic shock that causes growth to fall below potential. The amount required to provide for this regional cross stabilisation would be sizeable but still significantly less than the proportions of GDP spent on typical public goods such as healthcare, education, defence, social welfare or infrastructure.

It is likely that more than one member state will underperform in output growth relative to potential in any given year. A better option for the EZSF would be to weight payments in and pay outs from the fund by relative deviation above or below potential growth, essentially using a sliding scale in both directions. Although more complex to demonstrate, this would have the added advantage of reducing the step change between a payment in, no payment and a pay out. If this proposal is considered for implementation in the Eurozone, more detailed economic modelling regarding a range of growth rates and their relative weighting is strongly recommended

Payments into the fund should also be made contemporaneously with pay outs to maximise timeliness, which may also help prevent a struggling member state from breaching the limits in the SGP. Whenever resources remain after all payments are made, the EZSF would return those to the paymasters for that year in proportions that match their original contribution.

There are many methods by which contributions to the EZSF might be calculated, and they are likely to prove controversial, particularly where it impinges on national public policy options. Payments in ought to increase as GDP rises, therefore possibilities include taking a proportion of member states' revenues from specific taxes (e.g. consumption, income or corporate taxes), taxes collected or to take a portion of overall GDP. Tax rates vary considerably between Eurozone countries, and reflect legitimate national policy choices, which the EZSF should neither constrain nor meddle with. If contributions were made relative to overall taxes collected, those countries with a larger public service would be disadvantaged. It is more equitable for payments in to be made relative to national GDP, and to cap that figure at 1% of GDP.

Given a contributions cap of 1%, pay outs to any one country from the EZSF should subsequently be capped at 2% of GDP. A country in receipt of funds would not make a payment that year, therefore the stimulus received would be 2% of GDP. This amount would provide for significant countercyclical stabilisation, but not be so large that it would encourage free riding. More importantly, an annual cap of 2% for payments allows all member states in theory to receive a pay out from the fund similar to their proportionate contribution at some point in the future, including the largest Eurozone countries. This would be particularly important to persuade the largest countries to agree to its establishment and for the benefits to even out for all participating countries over one or two economic cycles. An illustration of the mechanics, relevant calculations and formulae for the EZSF model is provided in Appendix 1.

The size of the EZSF must be sufficient to provide a benefit for every country. Consider the case of Germany, the largest economy composing approximately 30% of Eurozone GDP. If only Germany experienced an asymmetric economic shock knocking growth more than 0.5% below potential, while other participating member states grew at or above potential, Germany would receive a maximum payment from the fund (2% of German GDP plus no contribution). That would encompass 90% of the EZSF funds available in that year, and the remainder would be returned to the paymaster states.

Whatever mechanism the EZSF chooses to determine contributions, a new balance of paymasters and contributors would emerge in the short term, which will be subject to close examination. Capping payments into the pay outs from the EZSF in terms of GDP offers some promise that each member state will eventually benefit to some degree relative to their annual contributions, which is how an equitable risk sharing endeavour ought to operate. Moreover, a fair system fosters solidarity between Eurozone nations.

As an aside, the establishment of the EZSF will require reconsideration of existing and future national budgets to account for this new contribution. It may be politically more appealing to phase in the EZSF by gradually increasing each member state's annual contribution, for example starting at 0.25% of GDP, then 0.5% and 0.75%, before reaching the capped maximum of 1%. A gradual introduction allows readjustment of established spending commitments by national governments.

EZSF Payments

The EU has experienced a range of difficulties with mismanaged expenditure from the EU budget. Having learned from this experience, the EZSF must incorporate workable oversight procedures that ensure prudent expenditure of this money by national administrations. Oversight is also essential to limit the potential for politically toxic unidirectional flows. In national budgeting, governments and finance ministers are accountable to parliament and therefore the electorate. There is no plausible electoral mechanism to punish national politicians for misuse of EZSF funds, simply because the taxpayers who contribute are based in different jurisdictions. The rules and administration of the EZSF therefore need clear oversight mechanisms to ensure accountable expenditure of funds, backed by the power of sanction.

Whereas national administrations should have autonomy to determine how they use additional fiscal stimulus from the EZSF, that autonomy cannot be without limit. As noted above, funds from the EZSF should be spent via an additional 'mini-budget' to increase visibility and allow ex post assessment of their use.

Oversight, Accountability and Sanctions

Resourcing for the EZSF ultimately comes from Eurozone taxpayers. The countries benefitting from EZSF payments should be accountable to those taxpayers through the most direct and democratic mechanism possible through existing EU institutions. The original version of this paper outlined the relative advantages of the EU's institutions in oversight and the application of sanctions under the EZSF.[8] This has been updated and is available in Appendix 2.

Due to their relative strengths in this regard, the institutional tasks of the EZSF should comprise:

- Setting of potential growth rates for each Eurozone member state by the Commission (potentially also debated and given political legitimacy by the Eurogroup)
- Determination of actual growth rates by the Commission
- Collection and disbursement of EZSF funds through the Commission
- Preparation of mini-budget by the recipient national finance ministry, which has the option of seeking advice at monthly Eurogroup meetings
- Ex post review of mini-budgets (prepared by the national finance minister when spending EZSF money) by the Commission
- Consideration of conclusions from the Commission's review by a European Parliament (EP) committee in advance of wider deliberation
- Debate and discussion by the EP, followed by a vote of MEPs from Eurozone states (since they would not have contributed that year).

If both the Commission and EP agreed that the member state in question had inappropriately spent EZSF money, they could request: that the money be paid back; or that the recipient is cut off from EZSF entitlements in the following year; or apply a combination of both depending on the severity of the offence.

The EP's voting procedure is important to consider. All MEPs should participate in debate on expenditure from the EZSF as they may have relevant perspectives and there can be economic implications for non-Eurozone countries. However, since funding for the EZSF comes from Eurozone countries, only their MEPs should be entitled to vote.

Even if sanctions were not applied, debate in the EP would increase significantly the level of transparency on expenditure from the EZSF and make the national ministries in question more accountable. The process of debate might uncover information that is politically advantageous or damaging for the national finance ministry in question.

Political horizons can be short therefore it is right and proper to have the quickest possible retribution for bad behaviour. This may require pay outs from the EZSF to be split into two interval payments, so that the second payment could be withheld if the first were misused. Further options arise such as suspending future entitlements to EZSF funding while requiring that country to pay a full contribution even if growth again falls below potential. These are options to consider in the political determination of the final format, structure and functioning of the EZSF.

[8] See Nevin (2007)

Conclusion

This paper presents a sound working model for a Eurozone Stabilisation Fund that would achieve proactive reform, provide maximum economic benefit over time and builds on the existing institutional configurations of the Eurozone.

The EZSF would bolster the capacity of national administrations to deal with asymmetric economic shocks that can cause their growth to overheat or fall significantly below potential. Consumption and output levels across Eurozone countries would be better stabilised, at or close to their potential rates. When needed, timely additional resources could be provided through the EZSF to invest, stabilise consumption or facilitate reforms that ease the path back to stable economic growth.

This paper also details valid concerns regarding moral hazard, free riding and misuse of EZSF funds. These concerns can be addressed and the risks substantially reduced through two institutional mechanisms. Firstly, the overall size of the EZSF and maximum payment in any given year would be capped. Secondly, expenditure from the EZSF would be monitored and sanctions applied for misuse of the fund. Oversight would be convened through a partnership of the Commission, utilising its technical capabilities, and European Parliament, leveraging its representative and democratic role for the Eurozone taxpayers who would fund the EZSF. A menu of sanctions is also envisaged for profligate national governments.

Limiting the remit of the EZSF to cross-regional stabilisation minimises the impact on Eurozone economic aggregates and the ECB's policy decisions. Expenditure within the EZSF model is concentrated to where it would have greatest impact, with payments triggered when growth falls significantly below potential. Contributions to the fund and payments from it are proportionate to GDP. Crucially, this model means that all Eurozone countries would be treated equally and all could receive support in proportion to their annual contributions.

National finance ministries would draw up an additional mini-budget to deliver the additional fiscal stimulus from the EZSF with minimal time lag. This respects the principle of subsidiarity, allows member countries to retain significant autonomy and reflects their capacity to determine how the additional resources should align with their recovery strategy and national characteristics. Their use of EZSF funding would subsequently be examined to determine the appropriateness, allowing for oversight and accountability which is in the interests of Eurozone taxpayers who would ultimately pay.

The EZSF has been presented here as a stand-alone configuration, however the design principles might also be incorporated as a Eurozone component of the EU budget. Its size could also be scaled down or up depending on the political consensus reached by key decision-makers. Econometric analysis is needed to illustrate how the EZSF would have functioned, with the financial implications for member countries, had it been in place at the birth of the euro in 1999. Notwithstanding this, the rationale and need for cross country stabilisation are clear and it is not hard to imagine how the EZSF could have helped avoid some of the imbalances in the lead up to 2008.

The economic outlook and political climate are now more favourable than have existed since the euro came into being. Furthermore, there are substantial and growing political risks from inaction - maintaining the status quo is untenable. In short, the Eurozone must address its shortcomings to enhance prosperity and sustain the euro. Strong leadership will be required from France, Germany and others to persuade their partners to capitalise on this strong economy and drive Eurozone integration. The Eurozone Stabilisation Fund is needed to achieve meaningful reform and support growth for years to come.

Appendix 1

Calculations and Formulae for EZSF in any given year

The model for the Eurozone Stabilisation Fund (EZSF) operates in accordance with the following calculations.

$EZSF_t$ = Overall size of the EZSF in any given year t

GDP_n = Total GDP for county n in year t

MS_n = Contribution from relevant member states in year t – set at 1% of GPD_n

g_n = Actual economic growth of country n in year t

g^*_n = Potential economic growth of county n in year t

PO_n = Pay out received by a recipient country n in year t

RF_n = Returned funds to county n in year t (where there is money left in $EZSF_t$ after all pay outs are made)

Prior to the start of the first year, a potential growth rate is impartially set for each member state by the European Commission.

Potential rates = $g^*_1, g^*_2, g^*_3, \ldots g^*_{19}$.

At the end of the first year of its operation, a calculation is made by the European Commission to determine the actual growth rate of each member state.

Actual growth rates = $g_1, g_2, g_3, \ldots g_{19.}$

As outlined in the paper, payments are made into the EZSF from member states growing at or above potential. Consider the three scenarios below.

a) If $g_n \geq g^*_n$ then county n pays in 1% of its GDP in year t, denoted as MS_n

b) If $g_n < g^*_n - 0.5$ then country n receives a payment from the EZSF in year t, denoted as PO_n

c) If $g^*_n - 0.5 \leq g_n < g^*_n$ then that country neither makes a payment nor receives one that year

In year t, the overall size of the EZSF will be the summation of all member state contributions from scenario a).

$EZSF_t = \sum(MS_1 + MS_2 + MS_3 + \ldots + MS_n)$

Pay outs are made to any country whose actual growth turns out to fall over 0.5% below its potential growth (g^*_n), therefore facing scenario b).

$EZSF_t$ is allocated across those countries facing scenario b). If there is sufficient funding available, their relative pay outs PO_n are calculated according to their GDP, with a maximum pay out of 2% of GDP_n. Any funds left over are paid back to the contributor member states in year t in proportion of their original contribution.

Where funds are outstanding in $EZSF_t$ after all pay outs as made, remaining funds are returned to each country (RF_n) in proportion to the size of their original contribution MS_n relative to the total contribution (or $EZSF_t$).

Total remaining funds after all pay outs made = $EZSF_t - PO_1 - PO_2 - \ldots - PO_n$

The returned payment for each contributor in year t is calculated as follows

$RF_n = (EZSF_t - PO_1 - PO_2 - \ldots - PO_n)*(MS_n)/(EZSF_t)$

If there is insufficient funding available in $EZSF_t$ in year t to pay each recipient 2% of its GDP, the pay outs for each country for that year are set based on their GDP relative to the sum of GDP for all recipient countries.

In this case, $PO_n = (GDP_n)/(GDP_n + \text{GDP of other pay out recipients that year})*EZSF_t$

Consider the following example in which ten countries grow at or above potential under scenario a), three countries have economic growth substantially below potential, under scenario b) and six grow just below their potential under scenario c). Assume that the amount of money in the EZSF for that year is insufficient to pay all three countries a stabilisation pay out of 2% of their GDP. Expenditure from the EZSF would be allocated to the three countries in proportion to their GDP.

Countries 1 – 10 make a payment to the EZSF, therefore $EZSF_t = \sum(MS_1 + MS_2 + MS_3 + \ldots + MS_{10})$.

Countries 11 – 16 neither make a payment nor receive a contribution.

The $EZSF_t$ is divided between Countries 17 – 19 based on the following calculations

$EZSF_t = PO_{17} + PO_{18} + PO_{19}$

$PO_{17} = (GDP_{17})/(GDP_{17} + GDP_{18} + GDP_{19})*EZSF_t$

Similarly $PO_{18} = (GDP_{18})/(GDP_{17} + GDP_{18} + GDP_{19})*EZSF_t$

Also $PO_{19} = (GDP_{19})/(GDP_{17} + GDP_{18} + GDP_{19})*EZSF_t$

Application of Sanctions

As outlined in the paper, expenditure from the EZSF would be assessed to determine whether or not it is spent appropriately. If country 18 is considered to misspend its allocation PO_{18} in year t, it would not receive a pay out in year t+1 even if its growth continues to fall significantly below potential.

Appendix 2

Role of EU Institutions in Oversight and Sanctioning

Role of EU Institutions in Oversight and Sanctioning
This section considers the capacity of the four major existing EU institutions to oversee EZSF expenditure. Firstly, the European Court of Justice, although a well-respected and impartial institution, is unsuited to oversight of the EZSF. The ECJ is remote from the European public as judges are appointed by common accord of member state governments. Judicial procedures are generally slow to deliver an outcome. Furthermore, budget policy is rarely a judicial consideration at national level unless it impinges on constitutional matters. Secondly, the Council might be considered, particularly since it already holds the power of sanction under the SGP. However, substantial conflicts of interest can be foreseen if the Council, particularly the Eurogroup, also oversaw EZSF expenditure. The Eurogroup is made up of the same finance ministers who draw up national budgets would also hold responsibility for the mini-budgets that spend EZSF money. It would not be appropriate for the same group of finance ministers to scrutinise one another's budgeting, however they might play an advisory role. If finance ministers were to assess their own actions, there would be scope for collusion or horse trading for political favour, especially given the lack of transparency in Council decision making. The

Council's track record of punishing those in breach of the SGP has been patchy, despite a number of high profile referrals from the Commission. Notwithstanding this, due to the redistributive nature of stabilisation payments based on potential growth rates, the Council may well insist on political oversight of this triggering mechanism by the Eurogroup of finance ministers.

The European Commission possesses substantial technocratic ability to administer the collection and disbursement of EZSF funds and monitor their impact through national mini-budgets. The Commission already draws up growth forecasts for EU member states and is well placed to determine whether an individual economy is growing at its potential. The Commission could play a valuable role in impartially determining those member states who are entitled to EZSF funds in any given year. It would also be well placed to monitor expenditure from the fund and to assess whether those funds are being put to good use. Few would dispute that the Commission is technically adept to undertake this task. Where it might be found lacking is in terms of its political legitimacy, especially if it had final say over sanctions.

The fourth principal EU institution that could play a role is the European Parliament (EP). The EP has democratic legitimacy that could play a vital role in oversight of the EZSF. The EP consists of elected politicians who represent the same taxpaying Eurozone public ultimately funding stabilisation payments. For this reason, the EP has a derived legitimacy to oversee the expenditure of citizens' tax contributions, much like national parliaments do. Furthermore, MEPs are external to the national administrations being overseen, making the EP a credible enforcer. The EP already plays a central role in the budgetary processes of the European Union. It is possible to conceive of the EP taking advice from the Commission prior to determining whether sanctions should be imposed upon profligate member governments who waste EZSF money.

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