No. 18
December 2013

EUROPEAN POLICY BRIEF

Contractual arrangements: the overlooked step towards a fiscal union

Xavier Vanden Bosch

'Contractual arrangements' were proposed as an initial step towards a fiscal union that would consolidate the EMU. At this stage, the debate should be centred on the cornerstone of these contracts: the solidarity mechanism. The form of the financial support should not be limited to loans, and include the possibility for grants. Only the countries with the greatest adjustment needs should benefit from the financial support of other countries. This solidarity could be justified in principle by the intensity of the 'shocks' they experienced. In this way, contractual arrangement would facilitate the completion of the necessary adjustment in the current crisis – thanks both to more structural reforms and more mutual support within the eurozone.

Towards the end of 2012, the concept of 'contractual arrangements' was presented in the four Presidents' report '*Towards a genuine Economic and Monetary Union*' and in the Commission's blueprint (under the name of 'Convergence and Competitiveness Instruments'). At this time, this kind of contract was presented as a first step towards a deeper and more integrated economic union (encompassing a 'fiscal union') that would reinforce the architecture of the Economic and Monetary Union (EMU) whose weaknesses the crisis revealed. Such a contract would bind a Member State in adopting structural reforms, while some EU financial support may be granted to the contracting Member State. They would be mutually agreed between the Commission and Member States and would involve all eurozone Member States, but be voluntary for the others. They would aim at strengthening the coordination of economic policies, notably by increasing the level of commitment, ownership and implementation of economic policies and reforms in the eurozone. This would in turn ensure the smooth functioning of the EMU, in particular by avoiding excessive divergences in competitiveness among its members.

More than a year after these early proposals were tabled, discussions on the elements of a fiscal union were largely sidelined, as the priority was given to setting up a Banking Union. Only the idea of 'contractual arrangements' remained on the agenda. One objective of the December 19-20 European Council will be to define their essential features.

Expanding on the recommendations formulated in the Egmont paper '*Money for structural reforms in the Eurozone: making sense of contractual arrangements*', this Policy Brief highlights several considerations for the current debate. First, it discusses the rationale behind the financial support which is both crucial for the effectiveness of contractual arrangements and the most politically delicate. Secondly, as recent discussions have indicated, financial support for these arrangements could come in the form of loans rather than grants. This brief discusses the possible implications of adopting a loan-based funding mechanism. Lastly, this brief emphasises the positive transformation that contractual arrangements could trigger within the EU economic governance.

THE INCENTIVE AND SOLIDARITY RATIONALES

The main justification for associating contractual arrangements with some form of financial support (a 'solidarity mechanism') is that it would act as an incentive for the contracting Member State. This argument is based on a political economy rationale. A government would incur a political cost for implementing structural reforms. Furthermore these reforms may not bring positive results until long after their implementation. Some external financial incentive would compensate (at least partially) for this cost. The politics behind this way of thinking may seem quite unethical. Many would consider such a financial incentive a 'bribe', which thus gives them the impression that sovereign governments are selling their sovereignty to the EU. If that were the case, contractual arrangements would be quite ineffective in promoting national ownership of the suggested reforms.

The incentive rationale could also be stated more simply. A contract necessarily has two sides. In the case of a contractual arrangement between a eurozone Member State and the EU, one side (the Member State) commits to structural reforms, while the other side (the eurozone as a whole) provides the first side with financial support. Without this symmetry, no country would voluntarily agree to enter into a binding agreement. For this reason, there cannot be talks of contractual arrangement without some sort of financial support.

However, there is a much more essential dimension to this concept of financial support. Intrinsically, the money tied to the contracts represents a form of 'solidarity' amongst Member States as the countries most heavily impacted by the financial crisis continue to adjust. Discussions on contractual arrangements should not lose sight of the fact that these contracts would constitute a step towards a fiscal union.

Insurance schemes in a fiscal union: a step too far?

The need for a fiscal union to complement and 'complete' a monetary union is founded on textbook discussions on 'Optimum Currency Areas'. When a particular region of the monetary union faces an 'asymmetric economic shock', part of this shock may be 'absorbed' by some fiscal transfers coming from other regions. Another related theoretical justification is that economic cycles may differ among regions of the monetary union. A common fiscal capacity could act as a mutual insurance mechanism to absorb shocks and smooth out business cycles – ensuring economic stability of the union as a whole. Such an insurance scheme was put forth as a key element of a fiscal union for the EMU. Some of the proposals are based on unemployment figures, other on output gaps.[1]

However, such insurance mechanisms remain extremely controversial, and particularly so when imbalances across countries are wide – as is currently the case in the eurozone. As in any insurance mechanism, some moral hazard issues are inevitable. Automatic transfers may discourage the recipient country from reforming. For example, a supranational unemployment insurance scheme across countries may deter Member States from reducing labour market rigidities which prevents the necessary adjustment to take place in the first place. It may also be noted that labour systems are too heterogeneous in Europe. As for insurance mechanism to smooth out business cycles, they rely on output gaps which are notoriously difficult to estimate in real time. More generally, many would fear these supposedly temporary automatic transfers – as net beneficiaries change over time – may actually become permanent.

Reluctance can also be explained by considering the varying perceptions of the risks these insurance schemes are designed to mitigate. An insurance mechanism is best put in place under a 'veil of ignorance', when risks are perceived as nearly equal, whose realization is a distant, uncertain prospect. In the current situation, risks have already materialized as shocks for several countries. In this context, unwinding the imbalances that accumulated seems a prerequisite for setting-up an insurance mechanism.

Contractual arrangements as an intermediate step facilitating the adjustment

Contractual arrangement may offer an intermediate solution. If setting-up an insurance mechanism is not yet feasible, why not try to emulate one and implement it on a smaller scale during a transition period? Such an instrument would not amount to an insurance mechanism and would not imply any automaticity in the transfers. There hence should be no concern for any moral hazard. Contractual arrangements would be designed to *speed up* not *slow down* the adjustment process – they would be contracts not insurance policies. Recipient countries would be contractually bound to implement the labour market and product market reforms that aim to facilitate the adjustment. Since they would be based on ad-hoc agreements, there would be more *control* over the direction and scope of the money flows (and possibly their use). Transfers would be more *limited, timely, targeted and temporary* than those implied in automatic insurance schemes. They could range between 0.2% and 0.5% of the recipient country's GDP.[2]

Many economists prefer to strictly distinguish the rationale for contractual arrangement (solidarity for structural reforms) from the rationale for economic stabilizer schemes (solidarity against a shock or cyclical downturn). However, that distinction is not so clear-cut. The structural reforms themselves should aim to facilitate the adjustment after a shock.

Moreover, the idea that contractual arrangement should be 'preventive' rather than 'corrective' in the sense that they should enact reforms that are necessary to prevent a *future* crisis rather than address the *present* one is odd. It seemingly ignores the imbalances that have yet to be fully addressed in the eurozone. It also implies that all eurozone countries should ideally enter into a contractual arrangement, which does not seem very effective. Some prioritization is indeed required in order to ensure that the money goes where it will be most effective – toward supporting reforms in countries where imbalances have proven the most unsustainable and where there is the greatest need for adjustment.

Finally, using contractual arrangements as discretionary and ad-hoc shock absorption instruments does not contradict but rather complements the purpose of the Banking Union. Restoring normal lending conditions and reversing financial fragmentation in the eurozone would allow for capital to flow 'downhill' again from creditor to debtor countries. By aiming to do so, an effective

Banking Union should ultimately prove more effective in absorbing shocks than any form of fiscal transfers within the eurozone. But the effective adjustment of countries is certainly another precondition for cross-border financial flows to resume, and ultimately for restoring growth and creating jobs. In prompting the necessary reforms, contractual arrangements would thus effectively complement the building of a Banking Union.

The nature of the support: loans rather than grants?

Financial support was originally thought of in the form of grants. But grants necessarily imply some pooling of common fiscal resources and transfers – two aspects are not met with much enthusiasm from Member States. Consequently, discussions surrounding the form the financial support could take was enlarged to the possibility of granting loans to the contracting Member States[3]. Countries engaging in a contractual arrangement would benefit from 'cheap loans' i.e. they would access loans on concessional terms, at lower lower interest rate than the prevailing market rate of their own national borrowings.

However, the incentive effect of such loans is questionable. Assuming the average funding cost of the vehicle used to provide these EU loans will be around 2%, only a country whose own sovereign borrowing rate is significantly higher may find this offer advantageous. Programme Countries already benefiting from EFSF/ESM loans would most likely be excluded, as long as they have not found their way back to the market (at this stage: Greece, Ireland, Portugal and Cyprus). At this time, the long-term borrowing cost of Italy (4.1%), Spain (4.1%) and Slovenia (5.9%) would suggest these countries as the most likely candidates for requesting such a support through a contract. But whether even this limited set of potential candidates would willingly engage into a contractual arrangement remains an open question.

Moreover, loans would not fit the rationale of contractual arrangements being used as an intermediary step towards a fiscal union (as exposed in the previous section). Such loans risk being reduced to little more than a symbolic gesture of solidarity. One can only hope this signal will be sufficient enough to encourage broader ownership of the suggested reforms in the eurozone. But this hope probably relies too much on the assumption that government are willing to undertake structural reforms, and are only prevented from doing so because they face some vested interests that could be overcome if only a contractual arrangement would ease their task.

How could the EMU governance evolve with contractual arrangements?

Beyond the question of the degree of fiscal union – and the underlying degree of solidarity – that is needed the smooth functioning of the EMU lies the question of how contractual arrangements would transform the current European economic governance.

Currently, Country Specific Recommendations (CSRs) issued during the European Semester either have a strict budgetary nature or a broader economic nature. Recommendations for labour market or product market reforms, which represent the main object of the contractual arrangement, fit in this second category. Such recommendations are based on two broad pillars: the Macroeconomic Imbalance Procedure (MIP) and the Europe 2020 Integrated guidelines for economic and employment policies. These Country Specific Recommendations are 'recommendations' in the strict sense. From a legal perspective, they are legislative acts that suggest a course of action to the member states *without* establishing legal obligations in that regard.

Only in cases where an excessive imbalance procedure (the corrective arm of the MIP) is opened for a country that presents 'excessive' imbalances can the Commission – as a last resort - propose to the Council to impose a sanction to this country for failing to sufficiently address the issue. But such a 'stick' may not be very efficient or credible. Can the Commission and the Council take such a hard stance against a Member State? Can financial sanctions be productive during times of economic difficulty? It is quite remarkable that the Commission chose not to request the opening of the excessive imbalance procedure when it finally decided to state that Spain and Slovenia presented 'excessive' macroeconomic imbalances in the 2013 cycle of the EU semester. This may indicate that the existing governance framework which largely relies on negative enforcement mechanisms has its limits.

Because Member States are sovereign on national economic policy matters, and because sanction mechanisms always raise questions of credibility, some recommendations that matter for the functioning of the eurozone are essentially ignored. Effectiveness and ownership remains low and the EU Semester is still a mostly bureaucratic exercise. Contractual arrangements precisely intend to increase both the effectiveness of EU policy recommendations and their ownership at the national level. They may do so for two reasons.

Firstly, contractual arrangement may allow for some prioritization across recommendations and across countries. Available financial resources for the contracts will very likely be limited. Financial support will thus have to be granted to support the reforms that are the most necessary and urgent in the eurozone. The Commission will therefore have to indicate for which country and for which recommendation a contractual arrangement would be desirable. In doing so it would suggest the type and scope of financing to the Council. The Commission would need to justify why addressing these recommendations particularly matters for the eurozone as a whole – notably by being as specific as possible on the potential 'negative spillovers' involved by not doing the reforms. Only then, can the Member State in question willingly propose a draft contract with a set of proposed reforms and a time-table, based on the suggestion by the Commission.

Secondly, contractual arrangements would add a positive incentive (a 'carrot') to the existing procedures rather than an extra negative incentive (a 'stick') to the existing ones, which largely dominate in the EU economic governance. Such an approach could induce a more 'bottom-up' and positive approach as the initiative for reform proposals would emanate from the Member States.

CONCLUSION

Basically put on hold for a year, the debate on the scope of a fiscal union has been resumed through the discussions on contractual arrangements. The December 19-20 European Council should specify their main features. As these instruments were initially considered to be a first step towards more ambitious schemes for a fiscal union, their design will reflect the remaining ambition to reach this goal. A central feature in this respect will be the scope of the solidarity mechanism i.e. the financial support that will be attached to the contractual arrangement.

The need for a financial support is supported by various rationales for solidarity in the EMU. This Policy Brief argued that the transfers implied should be considered in relation to the automatic absorption/stabilization function of more ambitious insurance schemes that were proposed for a 'fiscal union'. However, bound in contractual arrangements, these transfers could be more limited, targeted, timely and temporary. They would be strongly conditioned to the timely implementation of labour market reforms and product market reforms, and thus designed to facilitate the adjustment of countries most affected by imbalances. This rationale would underline that contractual arrangement would constitute an 'embryo' for bolder schemes that could be put in place once the eurozone imbalances have levelled out.

Effective contractual arrangements could increase the effectiveness of European economic governance. This financial instrument would introduce a 'positive' incentive ('carrot') in the EU semester which is so far dominated by negative incentives ('sticks'). Since financial resources backing the contracts will likely be limited, this should trigger prioritization across Country Specific Recommendations. The Commission would specify for which eurozone country and for which recommendation for structural reforms a contract would be desirable. Then the selected countries would voluntarily propose an agenda of reforms for which support would be granted. Accordingly, only the eurozone countries most seriously affected by the crisis will be concerned.

However, the discussion on contractual arrangement now incorporates the idea that grants (outright transfers) could be substituted by loans. In this case, the incentive to enter into a contractual arrangement may wear thin, even for eurozone countries now facing the highest borrowing costs (Spain, Italy, Slovenia). Moreover, the solidarity dimension of the financial support would also singularly diminish. For these reason, loans may only serve as a symbolic gesture of EU solidarity that would – one may hope – create ownership for the reforms at the national level.

This seems like wishful thinking. If contractual arrangements represent a step towards bolder fiscal union schemes, the European Council should be ambitious in setting the key features of the solidarity mechanism that will back them. Grants should not be excluded at this stage. The core principle behind the solidarity mechanism should be that it would support the correction phase of the current crisis. Failing to attach sufficient financing scope to them could bury any remaining ambition for a fiscal union for the foreseeable future.

Xavier Vanden Bosch is Research Fellow at Egmont – Royal Institute for International Relations.

The author thanks Frank Vandenbroucke, Renaud Thilaye and Shahin Vallée for their discussion on contractual arrangement during a debate organized by the Egmont Institute on the 3rd of December 2013. The exchange of views contributed in the development of this Policy Brief.

ENDNOTES

[1] The four Presidents' report refers to a 'Shock absorption function' (Van Rompuy, 2012) and the commission's Blueprint to a 'stabilisation function' (European Commission, 2012). For examples of Schemes based on out-put gap, see Pisani-Ferry et al (2012) where transfers represent 0.25% of the absolute output gap above a 2% threshold and Enderlein et al (2012) where transfers represents 0.5% of relative deviations of output gap relative to the euro-area output gap. See Dullien (2013) and Bontout & Lejeune (2013) for discussions on unemployment insurance schemes.

[2] See Vanden Bosch (2013) for some simulations for a limited set of countries.

[3] Notably, as in the annotated agenda for the Sherpa meeting on contractual arrangement which has since leaked in the press. See http://blogs.ft.com/brusselsblog/files/2013/11/Sherpa.pdf.

REFERENCES

Bontout, O., Lejeune, G., (2013), 'Paper on Automatic Stabilizers', paper prepared by a working group chaired by Robert Strauss (DG EMPL), October.

Dullien, S., (2013), 'A euro-area wide unemployement insurance as an automatic stabilizer: Who benefits and who pays?', Paper presented for the European Commission (DG EMPL), January.

Enderlein, H., Guttenberg, L., Spiess, J., (2013) 'Making one size fit all: Designing a cyclical adjustment insurance fund for the eurozone', Policy paper 61, Notre Europe, 23 January.

European Commission (2012), 'Communication from the Commission: A blueprint for a deep and genuine economic and monetary union Launching a European Debate', COM(2012) 777 final, 28 November.

Pisani-Ferry, J., Virhiälä V. and Wolff, G., (2013), 'Options for a Euro-Area fiscal capacity', Policy Contribution 2013/01, Bruegel, January.

Vanden Bosch, X., (2013), 'Money for structural reforms in the eurozone: making sense of contractual arrangements', Egmont Paper 57, May.

Van Rompuy, (2012), 'Towards a genuine Economic and Monetary Union', final report, 5 December.