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COHESION AS A GUIDING PRINCIPLE FOR EU FUNCTIONING THE ROLE OF THE EU BUDGET (some thoughts)

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The EU budget is more than a critical policy issue in the EU Member States, not least in view of the huge challenges they face domestically and internationally. Social strain and fragmentation due the financial/economic crisis against the backdrop of unrestrained (unmanaged) globalization and disruptive technological change, the Eurozone (EZ) pains, massive immigration and human capital exodus from eastern Member States, security threats, climate change, and, not least, rising protectionism (an inward-looking syndrome) and erosion of international multilateralism dominate public agenda.

The EU budget *problematique* is to be embedded in the overall debate on the future of Europe.

Below are a few thoughts on cohesion and the EU budget by considering national interests in conjunction with common interests, with the future of the EU .

1. The context in which Member States are discussing the new MFF

The geopolitical context is substantially different from the one in which the current (2014-2020) MFF was discussed/negotiated; it is highly complex and complicated. A brief outline is made below:

- Border security and internal security (counter-terrorism), common defense (new types of conflicts including "hybrid wars") challenges, climate change;
- Economic difficulties in the Member States and problems afflicting the EZ, which call for reforms and adequate mechanisms/instruments;
- Social fragmentation amid the economic crisis and disruptive technological change. One-sided public policies have underestimated distributional aspects and have favored the rise of populism and radical political movements, of Euroscepticism;

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- A contradiction between deeper integration and resurgence of national interests;
- Lack of trust among Member States, between EU institutions and Member States; a problem of "legitimacy" and "accountability" should also be highlighted in this respect;
- The "social contract" seems to break down in numerous Member States; more inclusive policies are needed;
- Divides in the Union: North-South (in the EZ), West-East – the latter highlighting a sort of "economic emancipation" of the East (an attempt to deal with the *middle income trap*);
- Some eastern Members States have undergone massive human capital depletion due to migration; this cripples their future economic prospects;
- Brexit is as big blow for both sides. A special arrangement between the EU and the UK is necessary in order to limit damage.
- The erosion of multilateralism and the emergence of a multi-polar world together with the economic rise of Asia –this raises a host of geopolitical and economic challenges.

2. Markets and democracy – where limits show up and where cohesion enters the picture

Markets are the driving force behind entrepreneurship and a vibrant economy. But market failures require government intervention. This has brought about, over time, the development of public sectors, the setting up of public and private institutions that insure against risks (pension systems, health-care systems, etc.), and mechanisms for the regulation and supervision of financial markets, including antitrust law (against collusion/oligopolistic agreements, rent-seeking).

<u>The very functioning of the democratic state has required public policies meant to ensure basic public goods. History shows that where social cohesion is badly damaged, negative consequences arise and 'social capital' and 'social cement' get diluted, whereby cracks emerge in the democratic process that may give rise to social and political conflict.</u> Whenever inequality crosses the frontier of what people/citizens perceive as tolerable, when the sense of 'social justice' and fairness is blatantly disregarded, it is democracy that bears the brunt.

Social fragmentation and growing perceptions of individual and collective insecurity can augment political demands for protection via government intervention. The backlash against globalization, a spreading propensity to turn inwards and the rise of protectionism are associated with the fallout from a simplistic vision of globalization, one which disregards (and underestimates) the number of losers. Globalization, as an embodiment of liberalization/economic openness, unless it is wisely and pragmatically managed, leads to fierce counter-reactions.

It is often said that people do not grasp the benefits of globalization. The problem with this assertion is that while benefits may frequently prevail over costs at the aggregate level, at local/community level costs may be massive, and social dislocations hard to bear. It is no wonder that international institutions, like the World Bank, the International Monetary Fund, the OECD, the EBRD, etc., pay increasing attention to the effects of globalization, and a thinning of the social fabric and social fragmentation that can end in full-blown political disarray. Major central banks (the Federal Reserve, the Bank of England, the ECB, etc.)

devote increasing attention to income distribution, a research topic one could hardly have imagined them focusing on not so long ago.

Things get more complicated in countries where political leaders justify public policies that entail high social costs by repeating constantly that 'there is no other way', or 'that this is what international markets demand'. This type of argument is likely, in the end, to damage the institutional and political legitimacy of policymakers; and it can fuel social and economic pressure (on the part of local business groups) in favor of protectionism. A reinterpretation of globalization is, therefore, needed; one that takes into account the relationship between the wide diversity of citizens' social and economic circumstances.

In other words, a narrowly-understood economic liberalism, i.e. market fundamentalism, can pave the way for the erosion of the social foundation of democracy, i.e. the erosion of the middle class. Market fundamentalism works against liberalism, against democracy, in its deepest meaning.

3. Legitimacy and democratic accountability

The European project aimed to reconstruct economies after World War II and put aside the great rivalries between European powers. It was a success story, despite the bumpy road towards building a new Europe – from six founding states in 1957 to 28 member states by 2013.

But the EU is a vast, very intricate institutional construction. The union's economic gains hid for quite a while the incompleteness of its design (to take just one example, the lack of a significant budget, as stipulated by the 1977 MacDougall Report, of 2-2.5 percent of GDP at the beginning and 5-7 percent of GDP upon the establishment of monetary union).

The financial crisis that broke out in 2008 underscored the shortcomings of its decision-making procedures and a stark fact: European institutions suffer from a 'democratic deficit'. Financial assistance programmes for beleaguered eurozone countries (grappling with liquidity and solvency crises) have been implemented via sui generis methods and mechanisms. The latter, albeit largely understandable due to the enormous pressure of events and the need to manage acute crises, have fueled popular discontent and increased the amount of distrust in the functioning of national and European institutions.

In light of the need to reform eurozone institutions and policies a key question arises: can financial integration overcome economic fragmentation without fiscal arrangements, i.e. risk-sharing schemes? I will get back to this issue in a later section. Fiscal integration implies more than institutional cooperation; it requires institutional integration and a eurozone budget, which leads implacably to the fundamental political question of the eurozone – integration. But political integration in the euro area is a fantasy under the present circumstances. Besides, there is a fundamental contradiction in European integration, which is epitomized by Dani Rodrik's trilemma: integration (globalization via the 'single market') can hardly cohabit with autonomous economic policy and with democratic accountability at the national level; something must give in in this triumvirate. This trilemma may simplify reality, and trade-offs and compromises may be worked out. However, it poses a formidable challenge to the eurozone unless integration is backed by policies and mechanisms that can iron out excessive heterogeneity and competitiveness gaps between member states – policies and tools which would prevent growing tensions that erode the social fabric and give rise to extremist reactions, populism, Euroscepticism, etc. Again, the incompleteness of the eurozone is to be singled out.

Why is the fiscal challenge critical to the eurozone? Deeper integration (a single budget, among others) would bring, as mentioned above, the political issue to the fore. Wealthier/creditor countries fear a 'transfer union' (fiscal transfers), however much sense the latter makes in a monetary union that would not be merely a single currency area. Yet, beyond narrowly-defined economic interests, there are constitutional impediments posed by fiscal arrangements that involve fiscal transfers. Here lies the greatest difficulty in reforming the eurozone. To believe that the Banking Union (when it is completed with the setting up of a single deposit insurance scheme and a more solid common resolution fund) can make up for fiscal arrangements is, arguably, an unrealistic approach.

4. Judging the EU budget and its track record

- Over the years, the share of national contributions has grown to about 70 percent of today's budget resources – compared to about 10 percent two decades ago. At the same time, the share of customs duties as own resource, has steadily decreased (presumably as a result of rounds of liberalization of world trade). And the share of VAT has fallen a lot – from, for example, about 57 percent in 1988 to about 15 percent in the last decade.
- The EU budget reflects the degree of political integration among Member States (including the EZ) and a "transactional" paradigm in its construction, which builds on a quid pro quo logic. This logic reduces the chances of reaching common goals, and, often, "we cannot see the forest for the trees";
- "Net balances" count for governments more than "European public goods" – close to the previous remark.
- The rebate system illustrates the transactional logic between Member States. The "British Rebate" is notorious, but the story is ample. Brexit would have to force a reform by eliminating rebates; this is what the Monti Report recommends.
- There are differing, and at times opposing, views among Member States on the structure of the EU budget (expenditure): countries that want more for new challenges (including research and development, climate change) and the "traditionalists" countries that emphasize the Common Agricultural Policy (CAP) and regional development (solidarity).
- It is necessary for the EU budget to respond better to the new challenges, but Andre Sapir's statement that the current structure of the EU budget is a "relic" is an extreme metaphor. This is because big economic disparities between countries can blow up the EU. In fact, the crisis of mainstream parties in Member States reflects this state of affairs;
- It would be a mistake if the funds for regional development and the CAP were drastically reduced, even if the latter is to be reformed;
- The Commission made proposals for the funding structure over the 2021-2027 period and "new resources" (from the consolidated corporate tax base, to emission certificates based on plastic / organic packaging waste, etc) should reach about 12 percent of the EU budget; it is an important change that corresponds to a decrease in traditional contributions (GNI and VAT) to 72 percent, from about 83 percent in 2018.

5. Relating national interests to common interests – an emerging economy perspective

Below are some guidelines for understanding the EU budget and how it relates to national interests, especially of European emerging economies, in the context of many uncertainties and risks:

- It is a must to combine specific/national interests with the general interests of the Union;
- It makes sense to support the increase in the EU budget (to around 1.1-1.2 percent of the overall GDP) to harmonize the CAP and regional development (cohesion) with the financing of new needs;
- Reducing funds for the CAP and regional development / cohesion considerably is premature given the economic discrepancies in the EU. The CAP does not ensure equity between Member States;
- The financing of European public goods in higher demand is to be supported. For instance, border protection, for which 4-5 billion EUR are proposed; development programs in the neighborhoods to mitigate immigration flows.
- It is necessary to increase the EU budget's own resources.
- Tax evasion and avoidance should be punished drastically; the EU budget could benefit on resources gained from the fight against tax evasion and fiscal optimization;
- <u>When it comes to EU's investment programs (e.g. the Juncker Plan), the post-2020 MFF would, arguably, require positive discrimination in favor of less developed countries, especially the countries facing labor exodus.</u>
- Linking the European objective with the national one through a common approach on migration, supporting Member States in combating youth unemployment would also bring added value more consistently at both European and national level. Additionally, business opportunities through co-operation in the region could be expanded, regardless of whether the regions are physically connected.
- <u>National development (promotional) banks are to be set up to the extent that it would facilitate synergies between financial instruments;</u>
- <u>Take better advantage of the transfer possibilities between the funds of the different EU programs, which gives the opportunity to improve the coordination between investments in infrastructure, human capital development, the environment, labor market flexibility and other reforms that are included in country specific reports (CSR);</u> in other words, a better linking of national CSR objectives to European objectives.
- The materialization of this opportunity (i.e. the financing of as many CSR as possible) hinges on the quality of institutions and the development of the administrative capacity necessary to improve the cooperation between the different management authorities.
- The more one moves away from CSR and from the European objectives, the less money would be available in the next post-2020 MFF.
- <u>Of great relevance to all actors involved in the negotiation of the current post-2020 MFF is sustainable development.</u> For Member States, sustainable development is all the more important as it provides the foundation for lasting and sustainable convergence.
- Collaboration and coordination between the national authorities and the European Parliament (its specialized commissions conducting the analyses and discussions in the EP plenary) is becoming more and more important, especially for a net beneficiary of EU funds.

6. EZ budget and EU budget

Economic recovery in the EZ has been driven by cyclical factors and the unconventional policies of the ECB. But an economic slowdown (even a recession in the foreseeable future) is underway. Trade conflicts and the erosion of multilateralism would play a role in this regard too.

- It is essential for the EZ to have tools that help absorb asymmetric shocks. That is why reform proposals are to be welcomed. A “fiscal capacity”, the emergence of a European Monetary Fund to help restructuring processes (but which should not be triggered automatically, thus inducing panic and market tensions), completing the Banking Union with a collective deposit guarantee scheme, are key steps for the viability of the EZ; they involve risk-reduction and risk-sharing arrangements;
- A budget of the EZ and other instruments that require funding should not hollow out the EU budget.

7. What sort of financial integration?

Financial integration in the EZ, the establishment of a banking union that includes a collective deposit insurance scheme, raise a fundamental issue: whether the BU can overcome market fragmentation and economic divergence in the absence of fiscal arrangements that would enable accommodation of asymmetric shocks and foster economic convergence. Some argue that a complete BU would dispense with the need of fiscal integration in the EZ . But is it sufficient for a robust economic and monetary union that risk-sharing applies to finance (banks) only? And would private risk-sharing be sufficient to cope with systemic risks in financial markets? Relatedly, it is not clear that a collective deposit insurance scheme (EDIS) could involve private money only, under any circumstances; some fiscal risk-sharing may be needed in worst case scenarios . What if economic divergence persists, or even deepens, since banks may discriminate among economies not least due to perceived risks that originate in bailing in schemes and other vulnerabilities? A disconnect between a Banking Union, in which “’risk-sharing” operates, and real economies is hard to imagine.

The progress of the EZ, of the BU, demands a reconciliation between rules and discipline on one hand, and risk sharing (private and public) on the other hand; with risk-sharing designed in such a way as to reduce moral hazard while, simultaneously, taking into account asymmetric shocks, different strengths of national budgets and of member states’ economies .

Only private risk-sharing schemes would not make the EZ more robust. Financial markets are too fickle and produce systemic risks recurrently; the Great Recession showed that public intervention was needed, ultimately, in order to avoid a catastrophe. Unless it will get adequate risk-sharing schemes, the EZ will continue to be very rigid and prone to experience tensions and crises recurrently.

8. Accession to the Eurozone

NMS are bound by EU accession treaties to join the EZ.

- Successful EZ accession hinges on achieving a critical mass of real convergence, and proper control of imbalances, internal and external.
- For the economies that practice managed floating of their currencies (Czech Republic, Hungary, Poland, Romania) entering the ERM2 is no less demanding that EZ accession proper.
- Competitiveness is essential and should not be achieved via low wages primarily.
- Reforms for bolstering the robustness of the EZ would make it “friendlier” to countries that aim at joining it.

9. New conditions for access to European resources

A conditionality regime should keep economic issues separate from political issues as much as possible. This is because:

- Development funds are not “grants” given by some states to others, but fit the logic of creating a level playing field – equitable conditions in a single market characterized by asymmetries;
- The single market implies competition among Member States. However, differences in endowment with the factors of production and the very different power of companies and economies shape large differentials among Member States in terms of productivity/competitiveness;
- There is a conditionality in the accession of EU funds as OLAF, for example, checks the correctness of the use of these resources.
- A regime of new conditions that would link access to the way a Member State fulfils the CSR can be considered;
- Member States must respect the rule of law, the basic rules and values that underpin the EU.